

Weekly commentary

April 18, 2022



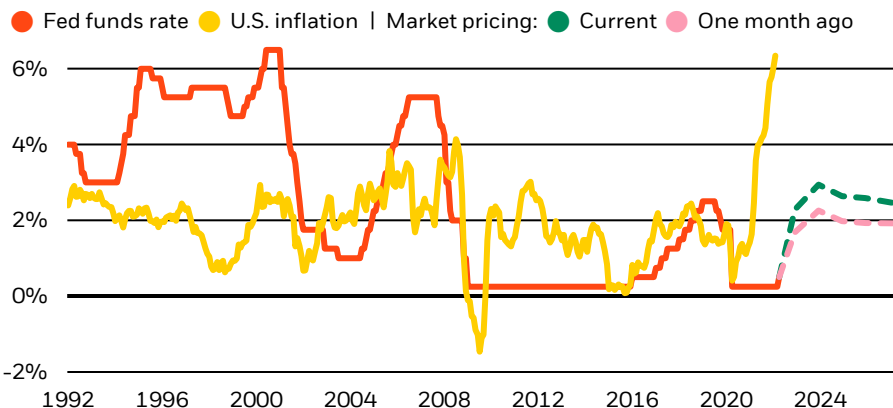
Why we still like stocks as yields spike

- We prefer equities even as bond yields have sprinted higher. Global growth is still solid, and we see central banks ultimately living with inflation.
- U.S. 10-year yields hit new three-year highs last week, and stocks fell. The European Central Bank affirmed our view it will normalize policy very slowly.
- Sentiment data this week could show the economic impact of the tragic war in Ukraine. Chinese GDP data may indicate how lockdowns are affecting growth.

Bond yields have sprinted higher on ballooning inflation and hawkish comments by central banks. Yield spikes have often spelled trouble for stocks, but we believe the past is an imperfect guide in a world shaped by supply shocks. We see central banks normalizing quickly - but not slamming the brakes on the economy. This should keep real yields low and underpin equity valuations. The inflationary backdrop and growth momentum led by the U.S. also favors stocks, we believe.

Historically low rates ahead

Fed funds rate and U.S. inflation, 1992-2027



Sources: BlackRock Investment Institute, with data from Refinitiv, April 2022. Notes: The chart shows the path of U.S. interest rates (Federal Funds Target rate) and annual U.S. personal consumption expenditure price inflation since 1992. The dashed line shows forward market pricing of U.S. policy rates based on interest rate swaps.

Yields on benchmark 10-year U.S. Treasuries hit three-year highs last week after data showed inflation was still running at levels not seen since the early 1980s. This understandably created angst about equities, especially about stocks of fast-growing tech companies. Higher discount rates make future cash flows less attractive. We believe fears about a further downdraft in equities are overblown. The rate hikes we expected are happening faster, but we don't see central banks raising policy rates beyond neutral levels that neither stimulate or restrain the economy. Markets have priced in a rapid rise of the fed fund rate to 3% in the next year, followed by a leveling out to 2.5% in five years' time (the green dotted line in the chart). That's markedly higher than a month ago (dotted pink line), just before the Fed raised rates and started to talk tough on inflation. We don't see the Fed going this high. Even if it did, the level would still be historically low compared with previous hiking cycles (red line) and the level of inflation (yellow line).



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The big picture: Markets have swiftly brought forward a rise in policy rates in the past year and now are pricing in a steep lift-off. Yet it's the sum total of rate hikes that matters for equities, in our view, not the timing and speed. Why? We use the cumulative rate for determining future corporate cash flows, not the current rate or bond yields. And the higher the peak rate in this cycle, the bigger the impact because of the compounding effect over time. As a result, we believe equities can thrive when the end destination of policy rates is historically low. Central banks will be forced to live with inflation, in our view, to avoid destroying growth and employment. We see inflation settling higher than pre-Covid levels because of the supply shocks triggered by the restart of economic activity and the horrific Ukraine war. This means real yields, or inflation-adjusted yields, should remain low and underpin equity valuations. We could see long-term yields rising further as investors demand higher compensation for holding them in the inflationary backdrop. This is not necessarily bad news for equities as it could trigger a re-allocation away from bonds into equities.

How about equity fundamentals? Three things jump out at us as first-quarter results get underway this week. First, the powerful restart is providing a growth cushion for developed markets (DM economies), especially in the U.S. Second, record-high profit margins bear close watching. DM companies have been able to pass on increased input costs to consumers and kept labor costs in check – so far. Third, we see the economic fallout of the Ukraine war cutting into earnings even as analysts have been revising up estimates across the board. We expect estimates for European companies to come down in particular as analysts start factoring in the war's effects. Companies in the MSCI Europe index are export-oriented and derive just half of their revenues domestically, we calculate, softening the impact a bit. A weaker euro helps, too. All in all, this led us to reduce our overweight in European equities earlier this month. We prefer U.S. and Japanese equities instead.

What are the risks? First, central banks could trigger a recession by raising rates too high in an effort to contain inflation. Second, inflation expectations could become de-anchored from central bank targets and cause them to slam the brakes. Third, companies could see margins shrink amid escalating input costs and upward wage pressures.

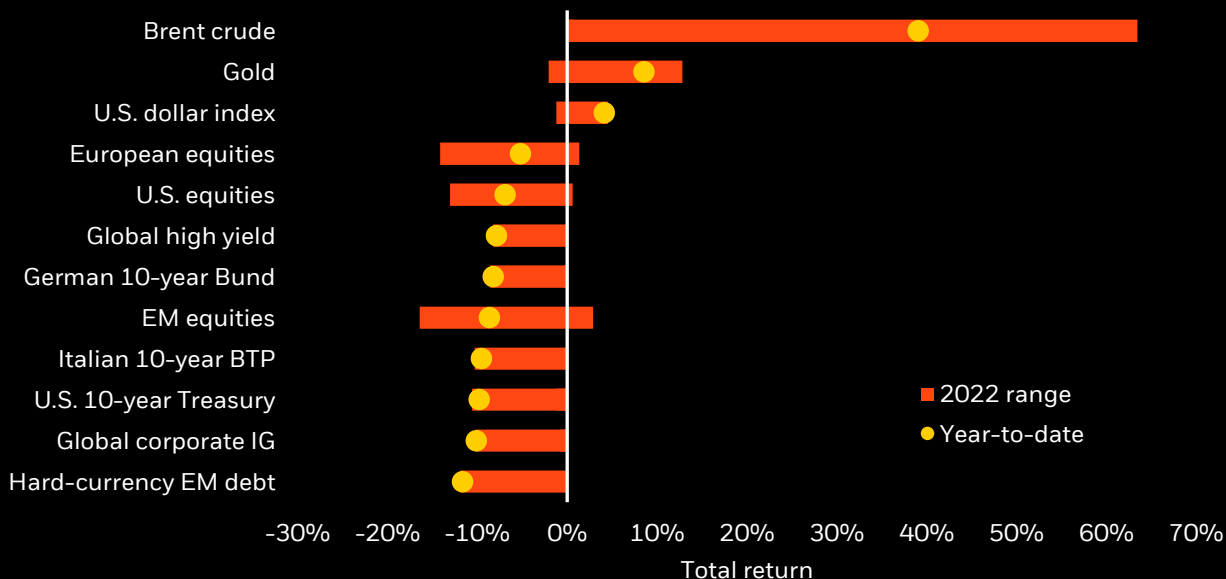
The bottom line: We prefer DM equities in the inflationary backdrop of the restart's momentum and a historically low sum total of rate hikes. We could see long-term yields rising further as investors demand a higher term premium, or extra compensation for holding them amid high inflation and debt levels.

Market backdrop

Yields of 10-year U.S. Treasuries hit new three-year highs last week, and stocks fell. We believe long-term yields can rise further and could see short-term bonds outperforming because market expectations for rate increases have become overly hawkish. The European Central Bank confirmed our view it will normalize slowly and gradually. It's set to end asset purchases in the third quarter and raise its policy rate "some time" thereafter.

Assets in review

Selected asset performance, 2022 year-to-date return and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.

Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of April 14, 2022. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, ICE U.S. Dollar Index (DXY), spot gold, MSCI Emerging Markets Index, MSCI Europe Index, Refinitiv Datastream 10-year benchmark government bond index (U.S., Germany and Italy), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI USA Index.

Macro insights

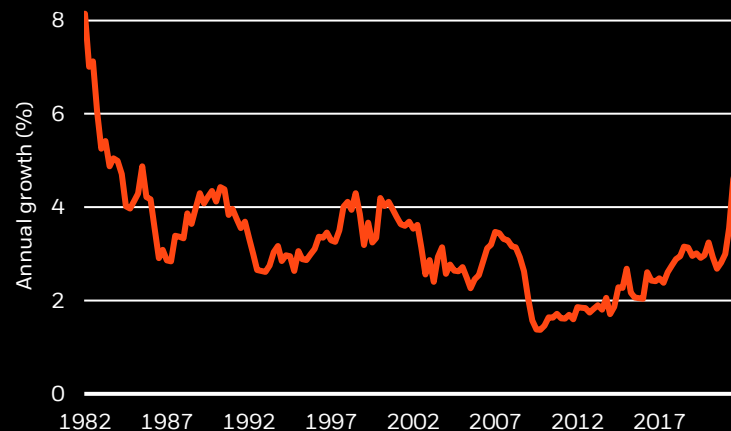
Private sector wages grew by 5% in the U.S. in 2021. This marked the fastest pace of gains since the 1980s, as the chart shows. Employers could fund higher wages by increasing prices, in turn causing workers to demand further pay rises – and so the loop goes on. In other words, is this the start of a wage-price spiral? We don't think so.

It has proven difficult to entice workers back to work as pandemic restrictions lifted, especially to services jobs that require a lot of contact with people. Wages have gone up to persuade them. This is unusual, given that many people have not yet returned to the workforce. These are not wage pressures typical of a normal business cycle: they're helping the economy adjust to a labor shortage.

Moreover, research shows that workers are 4.5% more productive now than before the pandemic. Greater productivity negates the need for price increases. And when you consider currently high inflation, there is still more room for individual wages to rise before they catch up with existing price increases. See our [macro insights](#) hub.

U.S. wages: room to grow

U.S. wages and salaries growth, 1982-2021



Sources: BlackRock Investment Institute, with data from Haver Analytics, April 2022. Notes: The chart shows year-on-year growth in private sector nominal wages and salaries from the Employment Cost Index (ECI) quarterly release. Latest data are for Q4 2021.

Investment themes

1 Living with inflation

- We expect central banks to quickly normalize policy. We see a higher risk of the Federal Reserve slamming the brakes on the economy to deal with supply-driven inflation after raising rates for the first time since the pandemic.
- The Fed has projected a large and rapid increase in rates over the next two years. We see the Fed delivering on its projected rate path this year but then pausing to evaluate the effects on growth.
- Normalization means that central banks are unlikely to come to the rescue to halt a growth slowdown by cutting rates. The risk of inflation expectations becoming unanchored has increased as inflation becomes more persistent.
- We believe the eventual sum total of rate hikes will be historically low, given the level of inflation. DM central banks have already demonstrated they are more tolerant of inflation.
- The Bank of England hiked rates for a third time but signaled that it may pause policy normalization on concerns about the growth outlook from spiraling energy costs. This is the bind other central banks will likely face this year.
- The European Central Bank confirmed plans to wind down asset purchases in the third quarter and raise rates some time afterward. We expect it to go slowly given the material hit to growth we see from higher energy prices.
- **Investment implication:** We prefer equities over fixed income and overweight inflation-linked bonds.

2 Cutting through confusion

- We had thought the unique mix of events – the restart of economic activity, virus strains, supply-driven inflation and new central bank frameworks – could cause markets and policymakers to misread the current surge in inflation.
- We saw the confusion play out with the aggressively hawkish repricing in markets this year – and central banks have sometimes been inconsistent in their messages and economic projections, in our view.
- The Russia-Ukraine conflict has aggravated inflation pressures and has put central banks in a bind. Trying to contain inflation will be more costly to growth and employment, and they can't cushion the growth shock.
- The sum total of expected rate hikes hasn't changed much even with the Fed's hawkish shift.
- **Investment implication:** We have tweaked our risk exposure to favor equities at the expense of credit.

3 Navigating net zero

- Climate risk is investment risk, and the narrowing window for governments to reach net-zero goals means that investors need to start adapting their portfolios today. The net-zero journey is not just a 2050 story; it's a now story.
- The West's decision to reduce reliance on Russian fossil fuels will encourage fossil fuel producers elsewhere to increase output, but we don't expect an overall increase in global supply and demand. We see the drive for greater energy security accelerating the transition in the medium term, especially in Europe.
- The green transition comes with costs and higher inflation, yet the economic outlook is unambiguously brighter than a scenario of no climate action or a disorderly transition. Both would generate lower growth and higher inflation, in our view. Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions.
- We favor sectors with clear transition plans. Over a strategic horizon, we like sectors that stand to benefit more from the transition, such as tech and healthcare, because of their relatively low carbon emissions.
- **Investment implication:** We favor DM equities over EM as we see them as better positioned in the green transition.

Week ahead

April 18

China Q1 2022 GDP, retail sales, industrial output and urban investment data

April 21

Euro area consumer confidence flash; U.S. Philly Fed Business Index

April 19

IMF World Economic Outlook and updated forecasts

April 22

Japan CPI; Japan, Germany, Euro area and U.S. flash PMIs

We are focusing on sentiment data this week as investors gauge the economic impact of the war in Ukraine. Supply shocks caused by the conflict and pandemic will hit European activity, in our view, while U.S. activity should stay robust. China GDP data will give an early read on growth amid concerns around the impact of renewed lockdowns amid a spike in COVID cases.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, April 2022

	Underweight	Neutral	Overweight	● Previous view
Asset	Strategic view		Tactical view	
Equities	<p>+2</p>		<p>+1</p> <p>We increased our strategic equities overweight in the early 2022 selloff. We saw an opportunity for long-term investors in equities because of the combination of low real rates, strong growth and a change in valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we favor developed market equities over emerging market stocks, with a preference for the U.S. and Japan over Europe.</p>	
Credit	<p>-1</p>		<p>-1</p> <p>We are underweight credit on a strategic and tactical basis against a backdrop of rising interest rates and high valuations. We prefer to take risk in equities instead. Tactically, we overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk, in our view.</p>	
Govt bonds	<p>-1</p>		<p>-1</p> <p>We are strategically underweight nominal government bonds given their diminished ability to act as portfolio diversifiers with yields near lower bounds. We see investors demanding higher compensation for holding government bonds amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we also underweight government bonds as we see the direction of travel for long-term yields as higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers in the higher inflation regime.</p>	
Private markets	<p>Neutral</p>		<p>—</p> <p>We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class and not suitable for all investors.</p>	

Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular funds, strategy or security.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, April 2022

Underweight
Neutral
Overweight
● Previous view

Asset	View	Commentary
Developed markets	+2	We overweight DM stocks amid supportive fundamentals, robust earnings and low real yields. We see many DM companies well positioned in the inflationary backdrop thanks to pricing power. We prefer the U.S. and Japan over Europe.
United States	+2	We overweight U.S. equities due to still strong earnings momentum. We see the Fed not fully delivering on its hawkish rate projections. We like the market's quality factor for its resiliency to a broad range of economic scenarios.
Europe	+1	We are moderately overweight European equities as we expect the energy shock to hit European growth hard. We like the market's cyclical bend in the inflationary backdrop and expect the ECB to only slowly normalize policy.
UK	Neutral	We are neutral UK equities. We see the market as fairly valued and prefer other DM equities such as U.S. and Japanese stocks.
Japan	+2	We are overweight Japan equities on supportive monetary and fiscal policies - and the prospect of higher dividends and share buybacks.
China	+1	We now see Chinese stocks as more risky, but improved valuations leave us moderately overweight. China's ties to Russia have created a new geopolitical concern that requires more compensation for holding Chinese assets, we think.
Emerging markets	Neutral	We are neutral EM equities and prefer DM equities, given more challenged restart dynamics, higher inflation pressures and tighter policies in EM.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China because of easing monetary and regulatory policy.
U.S. Treasuries	-1	We underweight U.S. Treasuries even as yields have surged this year. We see long-term yields move up further as investors demand a higher premium for holding governments bonds. We prefer short-maturity bonds instead.
Treasury Inflation-Protected Securities	+1	We overweight U.S. TIPS as we see inflation as persistent and settling above pre-Covid levels. We prefer TIPS as diversifiers in the inflationary backdrop.
European government bonds	-1	We underweight European government bonds. We see yields heading higher even as markets have adjusted to price in an end to negative rates and beyond.
UK gilts	Neutral	We are neutral UK Gilts. We see market expectations of rate hikes as overdone amid constrained supply and weakening growth.
China government bonds	+1	We overweight Chinese government bonds. Easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
Global investment grade	-1	We underweight investment grade credit amid tight spreads and interest rate risk. We see more value in equities instead.
Global high yield	Neutral	We are neutral high yield. We do not expect credit spreads to tighten but find the income potential attractive. We prefer to take risk in equities.
Emerging market - hard currency	Neutral	We are neutral hard-currency EM debt. We expect it to gain support from higher commodities prices but remain vulnerable to rising U.S. yields.
Emerging market - local currency	+1	We are modestly overweight local-currency EM debt on attractive valuations and potential income. Higher yields already reflect EM monetary policy tightening, in our view, and offer compensation for interest rate risk.
Asia fixed income	+1	We stay overweight Asia fixed income. We find valuations in China compelling relative to risks. Outside China, we like Asian sovereigns and credit for income.

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