Weekly commentary

BlackRock.

April 25, 2022

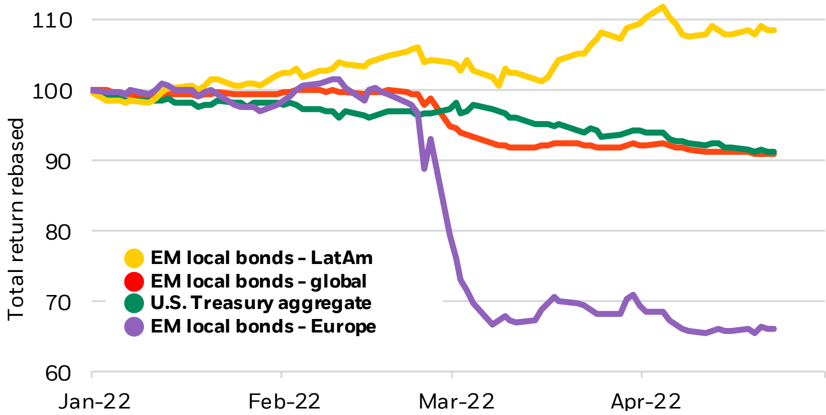
The differentiated appeal of EM debt

- We like emerging market (EM) local debt within an overall bond underweight. Much monetary tightening has been done, and valuations are compelling.
- U.S. Treasury yields hit new three-year highs last week, and equities fell. We still think stocks can weather the yield rise in the inflationary backdrop.
- U.S. and euro area data this week may show how the supply shock of the Ukraine war is affecting growth. We expect Europe to be hit harder than the U.S.

Inflation and hawkish central bank talk have spooked investors and led to bond losses not seen since the 1980s in developed markets (DMs). EM debt has also suffered, even ahead of the stress test of higher DM policy rates. The good news: Many EM central banks were early in raising rates to try to rein in inflation. This approach has created compelling yield and currency valuations, in our view. Broad indexes hide a lot of differentiation, so it's key to analyze the underlying exposures.

A tale of different EMs

Emerging market local debt vs. U.S. Treasuries total returns, 2022



Sources: BlackRock Investment Institute, with data from Refinitiv, April 2022. Notes: The chart shows the total returns for emerging market local-currency bonds compared with U.S. Treasury bonds based on the JP Morgan GBI-EM Global Diversified and regional (LatAm and Europe) indexes and Bloomberg U.S. Treasury USD index.

It's been an *annus horribilis* for bonds everywhere this year – except in some corners of the emerging world. Why? Scarcity inflation has arrived. Supply shocks have created shortages of goods, energy and food that are driving up prices. This has spurred DM central banks to signal faster policy normalization than markets expected and resulted in bond yields rocketing upward. Local-currency EM debt (the red line in the chart) has suffered alongside U.S. Treasuries (green line) so far this year. It's key to realize broad EM indexes hide a lot of differentiation. Local-currency debt of commodities producers such as Latin America (yellow line) and the Middle East & Africa have actually posted gains this year, outperforming debt of commodities-consuming Asia and Europe (purple line). The latter was directly hit by the fall-out of Russia's invasion of Ukraine.

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How about the risk of the Fed's upcoming rate hikes? This has often spelled trouble for EM assets. Investors have tended to demand a higher risk premium for holding them. Fed tightening also has frequently come with a stronger U.S. dollar, pressuring EM entities with hard-currency borrowings. We see the Fed's impact as more limited this time. First, the Fed is rightly racing to normalize policy, but we believe it won't fully deliver on its hawkish rate hike plans in the end. Second, we expect the sum total of rate hikes to be historically low given the level of inflation.

We also see a strong starting position for EM debt, given cheapened EM currencies, improved external balances, decreased foreign ownership and attractive coupon income. The main reason: Many EM central banks have been ahead of the curve in raising interest rates to fight inflation, as we noted in Liftoff? EM has already taken off of November 2021. This means they are much further along on the path to policy normalization than DM central banks. Real yields, or inflation-adjusted yields, have been edging into positive territory in some countries.

What are the risks? DM central banks could push rates to levels that destroy growth in an effort to rein in inflation. This would deal a blow to EM countries already struggling with high import prices of commodities and rising debt piles as a result of COVID relief programs. Alternatively, some EM countries could see runaway inflation, forcing their central banks to slam the brakes. And some could face social unrest in the face of fast-rising prices of food and other basic goods.

It's important to realize broad EM indexes hide a lot of differentiation. EM equity indexes, for example, are heavily weighted toward Asia. The benchmark GBI EM Diversified local-currency index has a 10% cap on any one sovereign issuer, giving more diversification and exposure to commodities exporters. It also means investors may need to go beyond indexes to get the exposures they are bullish on – and avoid the ones they have little confidence in. EM assets tend to offer fertile ground for security selection, we find, compared with heavily researched asset classes such as DM large-cap equities.

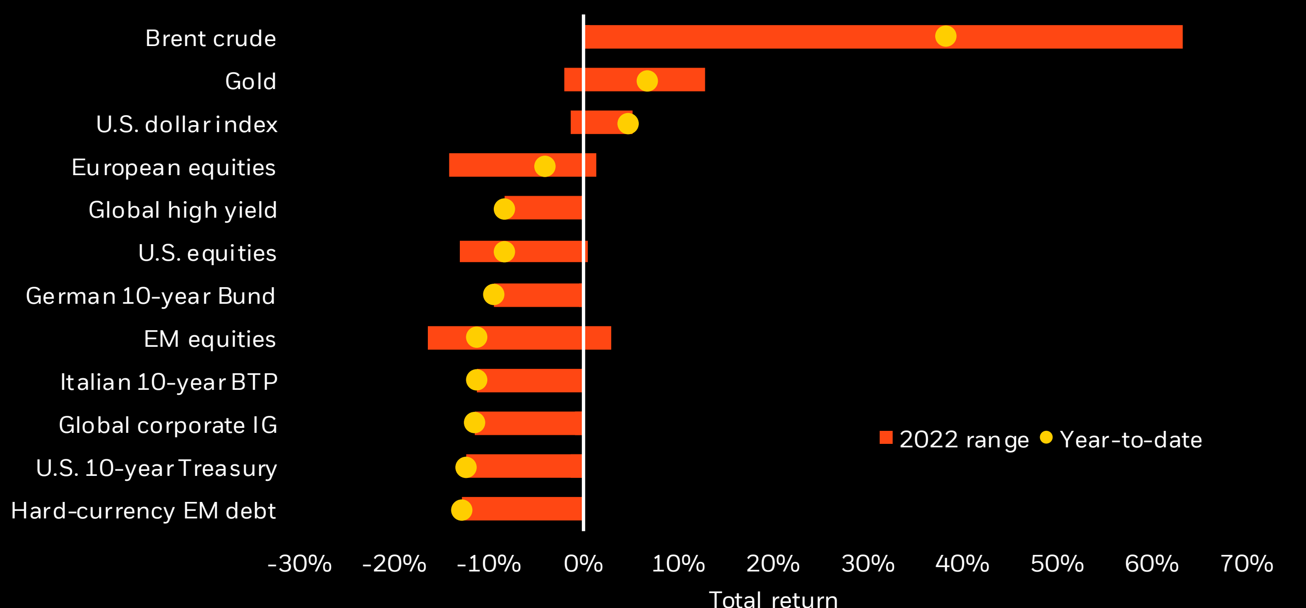
Our bottom line: We maintain a modest overweight to EM local-currency debt amid an overall underweight to bonds. Much monetary tightening is already done, and valuations are compelling. We are neutral hard-currency EM debt. It is sensitive to rising U.S. rates, and valuations are now less attractive vis-à-vis U.S. credit. We prefer to take EM risk in debt, rather than equities. We prefer DM stocks because of EM's challenged restart dynamics, inflation pressures and tighter policies.

Market backdrop

Yields on 10-year U.S. Treasuries rose to near 3% last week, levels not seen since late 2018. Equities ended down as the first-quarter earnings season gathered steam. We still think stocks can perform even as yields rise in the inflationary backdrop. The IMF forecasts much higher inflation and weaker growth, especially in Europe, due to the supply shock emanating from the Ukraine war. We believe downside risks to growth in China have increased amid Covid lockdowns.

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 22, 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

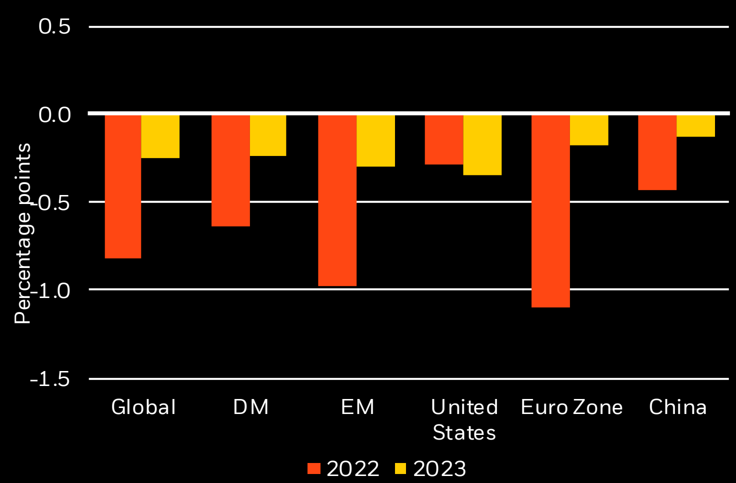
The International Monetary Fund (IMF) is expecting weaker global growth and higher inflation - especially in Europe – due to the shock emanating from the war in Ukraine. We agree. This is a new supply shock on top of the existing one driven by the post-pandemic restart of economic activity.

The IMF now expects global growth to be 3.6% this year and next, a downgrade of 0.8 and 0.2 percentage points respectively. See the chart. The impact of the war is greatest on Russia and the euro area, which together account for two-thirds of the downgrade. The IMF also expects elevated commodity prices to drive headline inflation rates even higher. It now sees U.S. inflation peaking near 9% later this year. The IMF echoes our view that the supply-driven inflation puts central banks in a bind. They want to lift policy rates quickly but try to avoid slamming the brakes on the economy.

Where do we differ? The IMF projects inflation to fall back to target even without overly aggressive policy tightening. We see inflation settling for a time above target, at around 3%. See our macro insights hub.

IMF cuts growth forecasts

IMF GDP growth forecast revisions, April 2022 vs. January 2022



Sources: BlackRock Investment Institute, IMF World Economic Outlook. Notes: The chart shows revisions to IMF growth forecasts made in April 2022 versus those made in January 2022.

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 has also struck a hawkish tone, planning to wind down asset purchases and leaving the door open for a rate increase later this year. We expect it to adopt a flexible stance in practice 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 26	U.S. durable goods and consumer confidence data
April 28	Germany CPI and HICP; U.S. GDP Q1 Advance; Bank of Japan meets
April 29	Euro area GDP and HICP Flash; U.S. consumption; Russia central bank meeting
April 30	China manufacturing PMI

This week's highlights will be U.S. and euro area inflation and GDP data releases that further reveal the growth impact of the stagflationary supply shock from the war in Ukraine. We expect Europe to feel the hit more than the U.S. China manufacturing data will likely reflect how a spike in COVID cases is restricting activity.

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	+2	+1	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.
Credit	-1	-1	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.
Govt bonds	-1	-1	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.
Private markets	Neutral	—	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.

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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