Weekly commentary

June 6, 2022

BlackRock

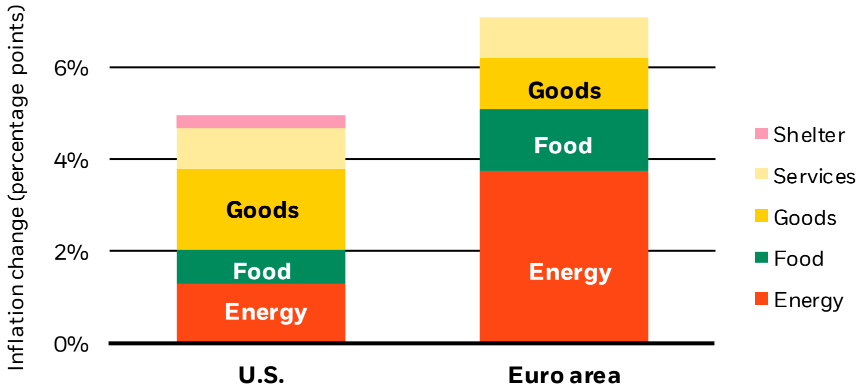
Markets primed to be hawkish on rates

- Central banks have primed markets to expect too many rate hikes in the face of persistent inflation, in our view. This keeps us neutral on stocks in the short run.
- The U.S. added 390, 000 jobs in May – a number that was matched by new entrants to the labor force. This shows the labor market is not as tight as feared.
- The European Central Bank (ECB) this week is set to give more clues about its rate path. U.S. inflation data could provide crucial inputs for the Fed's rate hikes.

The ECB is set to confirm this week that rate increases are imminent, and markets expect it to hike well into 2023. The Fed is seen to reach peak rates at this year's end. The sum total of rate hikes will ultimately prove to be historically low, we believe, as central banks choose to live with inflation rather than squash growth. The problem: Markets have been primed to assume hawkish intent and are quick to perceive risks of overtightening. This keeps us neutral on equities in the short run.

Same high inflation, different drivers

Change in U.S. PCE and euro area inflation, 2022 vs. 2015-19 average



Sources: BlackRock Investment Institute, with data from Haver Analytics, June 2022. Notes: The chart shows how different categories of U.S. PCE and euro area HICP contribute to the 2022 increase in inflation compared with the 2015-2019 (pre-Covid) average. U.S. numbers are based on April 2022 data, euro area data are based on the flash inflation release for May 2022 and are subject to revision.

The ECB and the Fed both need to quickly normalize policy from the emergency settings adopted when the pandemic first hit. And they both face inflation that's running at multi-decade highs – and are feeling pressure to rein it in. The difference: the drivers of inflation. Inflation in the euro area is driven primarily by higher energy and food bills that were exacerbated by the tragic war in Ukraine. See the red and green shaded areas in the bar chart on the right. This should dissipate in the medium term, in our view, as Europe finds new energy and food sources. In the U.S., inflation is more broad-based, with increases driven by goods and energy in almost equal parts (the left bar). We see U.S. inflation as persistent and expect it to settle at higher levels than pre-Covid.

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BlackRock **Investment** Institute

We have entered an era where production constraints have become the dominant drivers of inflation. Think about bottlenecks and difficulties in producing, sourcing, transporting and staffing. Both central banks have yet to acknowledge the sharp trade-off when trying to rein in this type of inflation with rate hikes: Squash growth and jobs or live with higher inflation than before the pandemic. We don't see a goldilocks outcome where inflation stays near 2% while unemployment remains low and growth resumes an upward trend. This leaves the door open for markets to expect overtightening at any signs of persistent inflation, a tight labor market or economic strength – and keeps us neutral on equities in the short run.

The situation is most acute in Europe. Markets expect the ECB to hike rates well into 2023 to rein in inflation that was running at an annual clip of 8.1% in May. Instead, we see it quickly raising rates out of negative territory but then pausing in the face of a recession triggered by Europe's 1970s-style energy crisis. Last week's decision by the European Union to ban most Russian crude oil imports is the latest example of how the West is determined to wean itself off Russian energy. This is pushing up oil prices and dragging down growth. We see a material slowdown in euro area economic activity as a result. This should do much of the ECB's work for it. Conclusion: We believe market expectations for ECB rate hikes are overly hawkish.

Market pricing of Fed rate hikes has cooled recently on market expectations that inflation is bound to come down. This spurred a rebound in equities from 2022 lows and stopped the U.S. dollar rally in its tracks. In other words, markets have moved as if inflation is yesterday's story. We disagree. Sure, core inflation is bound to come down from 40-year highs. But we see it as persistent and running above the Fed's 2% target for years to come. We see short-term risk of a snap back in the market's rate expectations as data show the persistence of inflation – and as the Fed keeps talking tough on inflation.

What does this mean for investments? The volatile macro and market landscape is here to stay, in our view. We believe central banks will ultimately deliver a historically muted response to inflation. That underpins our core strategic view of preferring equities over government bonds. We have less conviction on a tactical horizon of six to 12 months. This is why we have gradually trimmed risk all year and downgraded DM equities to neutral last month. We are looking for signs that central banks acknowledge the trade-off of living with some inflation for the sake of preserving growth. We could see another sharp policy pivot in the coming months, this time a dovish one. This would be a catalyst to go back to overweight equities.

Bottom line: The sum total of rate hikes will prove to be historically low, we believe, as central banks choose to live with inflation. But markets are primed to perceive a risk of overtightening. This is why we are neutral on stocks in the short run.

Market backdrop

The U.S. added 390,000 jobs in May – a number that was matched by new entrants to the labor force. This shows the labor market is not as tight as is commonly thought. The data triggered a fall in stocks and rise in yields, illustrating the market is conditioned for an overly hawkish Fed. A macro landscape shaped by production constraints is volatile, we think - and more so with central banks that appear oblivious to the sharp trade-off they are facing: live with higher inflation or squash growth.

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 May 31, 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.

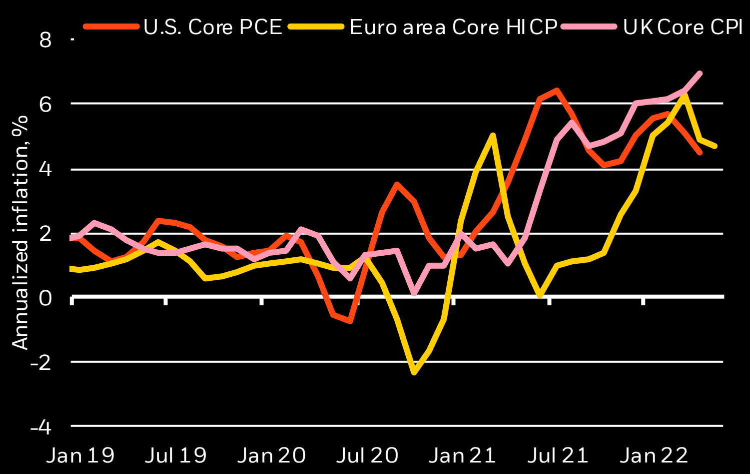
Macro insights

Core inflation (excluding volatile food and energy prices) has shot up across the developed world, as the chart shows. We believe that's largely down to the huge shift in consumer spending – from services to goods – triggered by pandemic lockdowns and restrictions. That, in turn, created production bottlenecks and shortages that pushed up prices, as we outlined in A world shaped by supply.

Where does inflation go from here? In the U.S., we see inflation coming off the boil over coming months as consumer spending normalizes. We expect it to ultimately settle above its pre-Covid rate – and the Fed's 2% target. In Europe, the war in Ukraine has led to production disruptions that feed into core inflation as well as headline inflation, including food and energy. More persistent inflation aggravates the headache for central banks. The only way to get production-driven inflation down quickly would be to raise rates to levels that hurt growth, at a time when slowing growth in China and the war in Ukraine already look set to drag down growth. See our macro insights hub.

Inflation: a core issue

Core inflation in the U.S., euro area and UK, 2019-2022



Sources: BlackRock Investment Institute with data from Haver Analytics, June 2022. Notes: The chart lines show core inflation in the U.S., euro area and UK measured by the three-month on three-month change in core price levels at an annualized rate.

Investment themes

1 Living with inflation

- Central banks are facing a growth-inflation trade-off. Hiking interest rates too much risks triggering a recession, while not tightening enough risks causing unanchored inflation expectations. It's tough to see a perfect outcome.
- The Fed has made clear it is ready to dampen growth. It has projected a large and rapid increase in rates over the next two years, and raised rates by 0.5% in May - the largest increase since 2000. But market expectations have recently cooled. 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 unanchored inflation expectations has increased as inflation becomes more persistent.
- The Bank of England warned of the poisonous combination of recession and high inflation as it has raised interest rates to their highest level since 2009.
- The European Central Bank has also struck a hawkish tone and looks poised to raise rates in July, but we expect it to adopt a flexible stance in practice given the material hit to growth we see from higher energy prices.
- We believe the eventual sum total of rate hikes will be historically low given the level of inflation.
- **Investment implication**: We are neutral DM equities after having further trimmed risk.

2 Cutting through confusion

- We had thought the unique mix of events – the restart of economic activity, virus strains, production-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 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 jobs. Central banks can't cushion the growth shock.
- We see a worsening macro outlook because of persistently high inflation, the commodities price shock and the spillovers from a growth slowdown in China.
- **Investment implication:** We remain underweight U.S. Treasuries and overweight inflation-linked bonds.

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 energy 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 equity sectors better positioned for the green transition.

Week ahead

June 6 – 8	China services PMI; India, Poland policy meetings
June 9	China trade data; ECB policy meeting
June 10	U.S. and China inflation data
June 11	China credit and money data

The ECB's media briefing is this week's key event after ECB President Christine Lagarde indicated rate hikes will kick off in July. We think the market's pricing of the ECB rate path is too aggressive and see the ECB pausing its hiking cycle amid materially weaker growth. U.S. consumer price inflation could inform the Fed's rate path in coming months.

Directional views

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

Underweight **Neutral** **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+2	Neutral	We are overweight equities in our strategic views, yet trimmed our overall tilt as the relative appeal versus bonds diminished. 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 are neutral DM equities due to a higher risk of central banks overtightening policy and a deteriorating growth backdrop in China and Europe.
Credit	-1	Neutral	We are underweight credit on a strategic basis against a backdrop of rising interest rates. We prefer to take risk in equities instead. Tactically, we had upgraded credit to neutral as the dramatic selloff this year restored value in areas such as investment grade. 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, with a preference for shorter-dated maturities over long-dated bonds. We see yields broadly climbing higher. We stay firmly underweight the long-end as 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, June 2022

Underweight **Neutral** **Overweight** ● Previous view

Asset	View	Commentary
Developed markets	Neutral	We are neutral DM stocks due to uncertainty over policy amid a worsening macro picture. Their appeal relative to bonds has also diminished. The risk has risen that central banks slam the policy brakes as they focus solely on inflation without fully acknowledging the high costs to growth and jobs.
United States	Neutral	We are neutral U.S. equities. The Fed's hawkish pivot has raised the risk that markets see rates staying in restrictive territory. The year-to-date selloff partly reflects this, yet we see no clear catalyst for a rebound.
Europe	Neutral	We are neutral European equities as the fresh energy price shock in the aftermath of the tragic war in Ukraine puts the region at risk of stagflation.
UK	Neutral	We are neutral UK equities. We see the market as fairly valued.
Japan	Neutral	We are neutral Japan stocks as part of a broader push to take more caution across DM equities.
China	Neutral	We are neutral Chinese equities on a worsening macro outlook. China's ties to Russia also have created a new geopolitical concern that requires more compensation for holding Chinese assets, we think.
Emerging markets	Neutral	We are neutral EM equities given challenged restart dynamics, high inflation pressures and tight policies.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's deteriorating macro outlook is a worry, and policymakers have yet to fully deliver on promises of easing.
U.S. Treasuries	-1	We underweight U.S. Treasuries even with the yield surge. We see long-term yields moving up further as investors demand a greater term premium. We prefer short-maturity bonds instead and expect a steepening of the yield curve.
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	Neutral	We are neutral European government bonds. Market pricing of euro area rate hikes is too hawkish, we think, given the energy shock's hit to growth.
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	Neutral	We are neutral Chinese government bonds. Policymakers have been slow to loosen policy to offset the slowdown, and yields fell below U.S. Treasuries.
Global investment grade	Neutral	We are neutral investment grade credit as this year's selloff has made valuations more attractive. Coupon income is the highest in about a decade.
Global high yield	Neutral	We are neutral high yield. We do not expect credit spreads to tighten but find the income potential attractive.
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	Neutral	We are neutral Asia fixed income. A worsening macro outlook and geopolitical concern about China's Russia ties make Chinese assets riskier, in our view. Outside China, we like Asian sovereigns and credit for income.

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