Weekly commentary

July 25, 2022

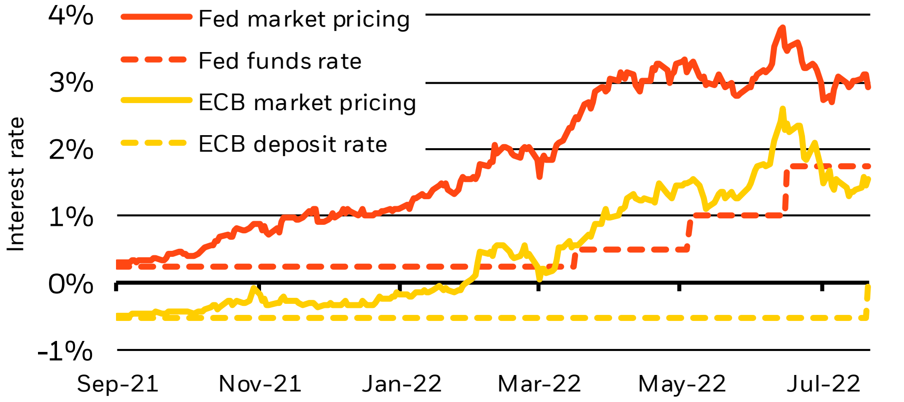
Expect more volatility after Fed hike

- Market views of Fed rate hikes have swung sharply. We see more volatility ahead as long as central banks think they can curb inflation without crushing growth.
- Yields spiked before easing after the ECB raised rates by 0.5% last week. We expect it to pause hikes before the Fed as the energy crisis hits growth hard.
- Markets are pricing another 0.75% rate rise by the Fed this week. We think the Fed will overtighten rates and cause acute damage to growth before pivoting.

The Fed is set to raise rates by an additional 0.75% or more this week as it scrambles to raise the fed funds rate into restrictive territory to rein in inflation. Market views on what to expect next for rates have been volatile. Why? Central banks think they can curb inflation and cause only a mild slowdown, whereas this is unlikely in reality, in our view. We see more volatility ahead until central banks take sides in the stark trade-off between growth and inflation they are facing.

Bumpy ride

Central bank policy rate pricing in rate forwards, Sept. 2021–July 2022



Sources: BlackRock Investment Institute with data from Refinitiv Datastream, July 2022. Notes: The chart shows expectations for three-month interest rates as implied by futures pricing for the U.S. and euro area. Solid lines show market expectations for 1-year rates in one year's time based on interest rate swaps. Dotted lines show central bank rates.

Market expectations for Fed and European Central Bank (ECB) policy rates have swung up and down in the past year, futures pricing of Refinitiv data show. First, market pricing for the fed funds rate jumped from near zero to almost 4% in June. See the red line in the chart. That epic move was followed by a one percentage point drop in just a month's time. The biggest monthly changes in rate projections have been more than double the average in the two decades before the pandemic, we find. The reason: Central banks have been ignoring the sharp trade-off they are facing: crush growth or live with some inflation. This has caused rate projections to surge higher on expectations central banks will fight inflation at all cost and then retreat on recession fears. The Fed's forecasts in particular suggest it believes it can bring inflation back to its 2% target without damaging growth.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist – BlackRock Investment Institute

Nicholas Fawcett
Macro research – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on the global economy, markets and geopolitics.

BlackRock **Investment** Institute

The Fed and ECB are hostage to the "politics of inflation," in our view, responding to a chorus of voices demanding they bring down inflation. The problem? Today's inflation is caused by production constraints, from labor shortages to supply chain kinks, not because of excessively high demand. Rate hikes can cool the latter but don't really fix the former, we think. Reducing inflation to 2% would mean slamming spending down so hard it would stall the economic restart. Yet the Fed and ECB still suggest they can engineer a "soft landing," where higher rates decrease inflation and cause only a mild slowdown. Case in point: The ECB explicitly said it doesn't foresee a recession when it raised rates by 0.5% last week.

We think a soft landing is unlikely. Central banks today face sharp trade-offs between growth and inflation, as detailed in our midyear outlook, and many have yet to acknowledge this. The ECB limited its maneuvering room by stressing it's only focused on inflation. This will make it harder to change course. We see a pivot later this year when a recession we flagged in early March comes knocking. We expect the Fed to change course only next year, when the economic effects of rate rises become clear. The market agrees. Rate projections now show the Fed *cutting* rates in 2023. That's consistent with our view.

The ECB and Fed will eventually choose growth over inflation, we believe. That means they won't have slammed demand all the way down to meet the low level of productive capacity. Production constraints are likely to keep fueling inflation as a result. That's why we think inflation will persistently run above central bank targets, even as it declines from current 40-year highs. Market expectations are not consistent with this. Breakeven inflation rates, a measure of expected inflation derived from bond yields, have fallen sharply in the past month. Markets appear to expect a typical slowdown, where both growth and inflation weaken. This means inflation data could surprise to the upside – and cause markets to rapidly price a higher rate path once again. Result: another equities sell-off. That's why we further reduced equities to a tactical underweight.

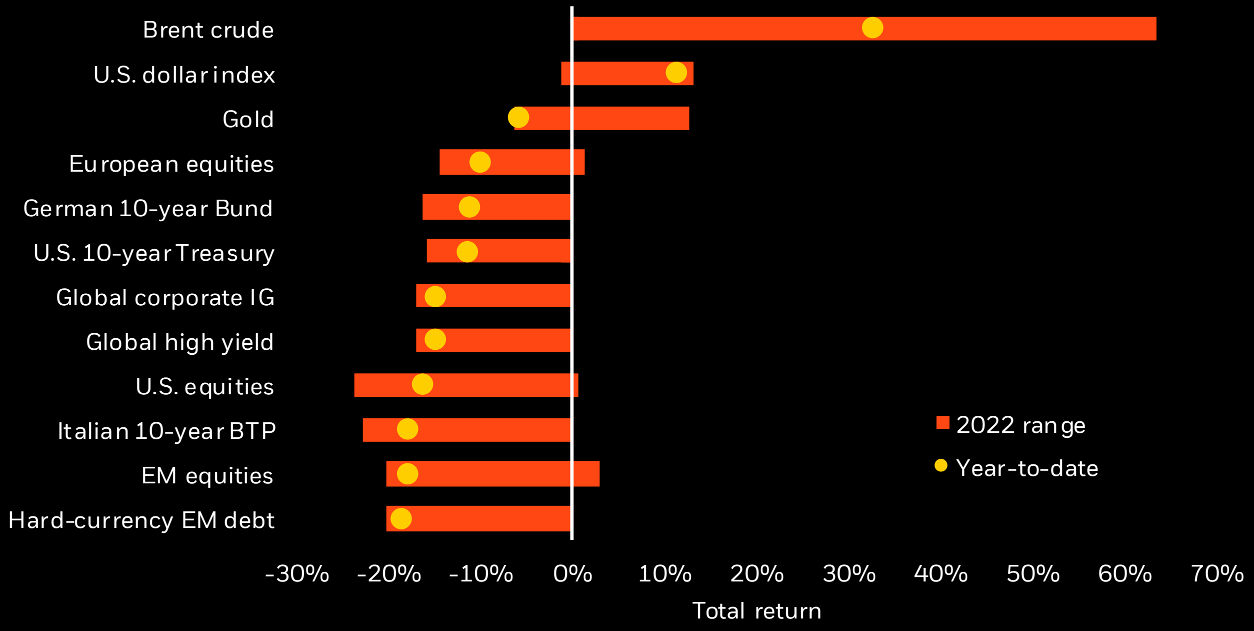
What's our bottom line? We expect more volatility, so we focus on nimble, tactical positioning. We are underweight developed market equities on a tactical horizon because central banks appear set to overtighten policy. We are ready to switch back to overweight once central banks pivot to a more moderate rate path. We're overweight credit amid higher yields and low default risks. We steer away from U.S. Treasuries as we expect further rate rises and a higher term premium, or the compensation investors demand for holding long-term bonds. We like inflation-linked bonds amid persistent inflation.

Market backdrop

The ECB raised rates by 0.5% last week. European bond yields spiked briefly on the news before settling lower on recession fears. We see a euro area recession even if rates rise very little. Why? We think the energy shock from Russia's invasion of Ukraine will drag down economic activity. We're already seeing weakness in PMI data, especially in Europe. The ECB's new bond buying instrument to limit market stress may make it more inclined to overtighten policy into a recession, in our view.

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 July 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.

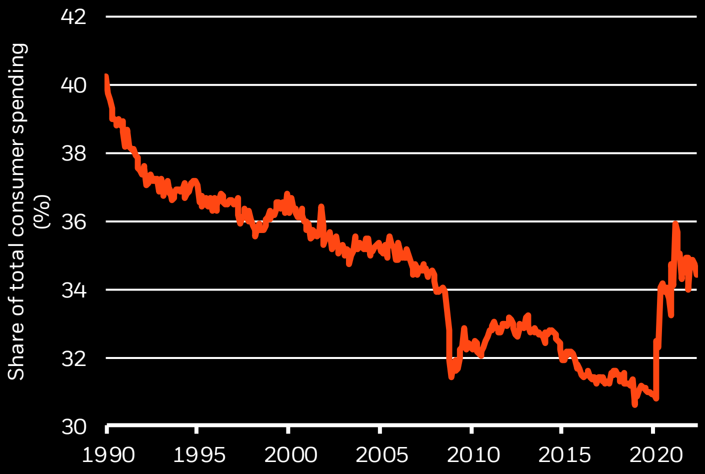
Macro take

Introducing our brand new Macro Take! This new blog-style series aims to break down – in simple terms – what's going on in economies around the world, how we see things developing from here and what policymakers might do faced with tough, new challenges. We'll be publishing a new post every two weeks or so.

In our inaugural post, Alex Brazier gives two reasons why – since Covid – economies are not able to produce as much now without creating price pressures. The first is the huge change in consumer spending in the pandemic: more on goods, less on services. For the 18 years prior, the percentage of total consumer spending on goods had been falling. Incredibly, that decline was completely reversed in just 18 months. See the chart. The economy wasn't set up to meet such a big change in the composition of spending: you can't just convert a restaurant into a factory overnight. That led to widespread bottlenecks and goods shortages. The second reason why economies can't produce as much? Employers are finding it more difficult to hire workers. Alex explains both reasons in more detail here.

More on goods, less on services

Goods share in total U.S. consumer spending, 1990-2022



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, July 2022. Note: The chart shows U.S. goods spending as a share of total consumer spending.

Investment themes

1 Bracing for volatility

- The Great Moderation, a long period of steady growth and low inflation, has ended in our view. We see macro and market volatility reverberating through the new regime. What changed? Production constraints triggered by the pandemic and exacerbated by the war in Ukraine are pressuring the economy and inflation. We see this persisting amid powerful structural trends like global fragmentation and sectoral shakeouts tied to the net-zero transition.
- Unprecedented leverage also gives policymakers less manoeuvring room, in our view. And the politicization of everything makes simple solutions elusive when they're needed the most, we think. This leads to bad outcomes.
- We expect higher risk premia for both equities and bonds – so investment decisions and horizons must adapt more quickly. Traditional portfolios, hedges and risk models won't work anymore, we think.
- In the U.S. we expect volatile growth and persistent inflation. The upside risk is that production capacity normalizes faster. The downside is that the Fed fails to change course next year and slams demand down to meet low capacity.
- In Europe, we see recession as likely even absent big rate hikes as broad economic stress from an energy crisis bites.
- **Investment implication:** Be nimble. We're tactically overweight investment grade credit on attractive valuations.

2 Living with inflation

- We are in a world shaped by supply unlike any we have seen in recent decades. Major spending shifts and production constraints are the driving force of inflation.
- Constraints are rooted in the pandemic and have been exacerbated by the war in Ukraine and China's lockdowns
- The Fed has made clear it is ready to dampen growth. It has projected a large and rapid increase in rates, raising rates by 0.75% in June in the largest increase since 1994. We ultimately think reality will come knocking and a stall in the restart will make the Fed change course.
- The Bank of England warned of the poisonous combination of recession and high inflation as it has raised interest rates further to 1.25% in June. This may indicate the start of a dovish pivot, in our view.
- The ECB surprised with a larger-than-expected 0.5% rate rise last week. It also announced a new bond-buying facility to limit risks of higher rates causing the euro area to fragment. The ECB and markets underappreciate the risk of the energy crunch causing a recession, we think. The ECB will eventually accept this and rethink its rate path.
- We think the eventual sum total of rate hikes will be historically low given the level of inflation but brace for volatility.
- **Investment implication**: We are tactically underweight most DM equities after having further trimmed risk.

3 Positioning for 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
- We also don't think the markets have fully priced in the transition yet. Over time, markets are likely to value assets of companies better prepared for the transition more highly relative to others, in our view.
- We think investors can get exposure to the transition by investing not only in "already green" companies but also in carbon intensive companies with credible transition plans or that supply materials critical to the transition.
- We like 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**: Time horizon is key. We see tactical opportunities in selected energy stocks.

Week ahead

July 26	U.S. consumer confidence	**July 28**	U.S. GDP
July 27	U.S. Fed interest rate decision	**July 29**	Euro area inflation, GDP; U.S. PCE, consumer spending

This week's Fed meeting is front and center. The market is pricing a hike of at least 0.75%. We think the Fed has boxed itself in by responding to political pressures to tame inflation. We see the Fed ultimately living with higher inflation, but only once the cost to growth from rising rates becomes clear. Second quarter U.S. and euro area GDP data will help gauge momentum.

Directional views

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

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

Asset	Strategic view	Tactical view	
Equities	+2	-1	We are overweight equities in our strategic views of five years or longer. We expect central banks to ultimately live with some inflation and look through the near-term risks. Tactically, we are underweight DM equities as central banks appear set to overtighten policy and we see activity stalling. Rising input costs also pose a risk to elevated corporate profit margins.
Credit	-1	+1	We are underweight publicly traded credit on a strategic basis and prefer to take risk in equities. Tactically, we are overweight credit given the jump in yields and credit spreads – and our view of contained default risk. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds, with a preference for short-dated maturities. We stay firmly underweight long-dated bonds as we see investors demanding higher compensation amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we are also underweight as we see long-term yields going higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers amid higher inflation.
Private markets	Neutral	—	We believe non-traditional return streams 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. We underweight private equity, favoring income assets such as private credit instead. Many institutional investors are 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, July 2022

Underweight | Neutral | Overweight | ● Previous view

Asset	View	Commentary
Developed markets	-1	We are underweight DM stocks on a worsening macro picture and risks to corporate profit margins from higher costs. Central banks appear set on reining in inflation by crushing growth – increasing the risk of the post-Covid restart being derailed.
United States	-1	We are underweight U.S. equities. The Fed intends to raise rates into restrictive territory. The year-to-date selloff partly reflects this. Yet valuations have not come down enough to reflect weaker earnings.
Europe	-1	We are underweight 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	-1	We are underweight UK equities following their strong performance versus other DM markets thanks to energy sector exposure.
Japan	Neutral	We are neutral Japan stocks. We like still-easy monetary policy and increasing dividend payouts. Slowing global growth is a risk.
China	Neutral	We are neutral Chinese equities. Activity is restarting, but we see 2022 growth below official targets. Geopolitical concerns around China's ties to Russia warrant higher risk premia, we think.
Emerging markets	Neutral	We are neutral EM equities on the back of slowing global growth. Within the asset classes, we lean toward commodity exporters over importers.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
U.S. Treasuries	-1	We are 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.
Global inflation-linked bonds	+1	We are overweight global inflation-linked bonds and prefer Europe. Markets are underappreciating the inflationary pressures from the energy shock, we think.
European government bonds	Neutral	We are neutral European government bonds. We think market pricing of euro area rate hikes is too hawkish.
UK gilts	+1	We are overweight UK gilts. Gilts are our preferred nominal government bonds. We believe market pricing of the Bank of England's rate hikes is unrealistically hawkish in light of deteriorating growth.
China government bonds	Neutral	We are neutral Chinese government bonds as policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
Global investment grade	+1	We are overweight investment grade credit. High quality corporates' strong balance sheets imply IG credit could weather weaker growth better than stocks.
Global high yield	Neutral	We are neutral high yield. We prefer up-in-quality credit exposures amid a worsening macro backdrop. We think parts of high yield offer attractive income.
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 inflation risk.
Asia fixed income	Neutral	We are neutral Asia fixed income amid a worsening macro outlook. We don't find valuations compelling enough yet to turn more positive on the asset class.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. 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 or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

General disclosure: This material is intended for information purposes only, and does not constitute investment advice, a recommendation or an offer or solicitation to purchase or sell any securities to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. This material may contain estimates and forward-looking statements, which may include forecasts and do not represent a guarantee of future performance. This information is not intended to be complete or exhaustive and no representations or warranties, either express or implied, are made regarding the accuracy or completeness of the information contained herein. The opinions expressed are as of July 25, 2022 and are subject to change without notice. Reliance upon information in this material is at the sole discretion of the reader. Investing involves risks.

In the **U.S. and Canada**, this material is intended for public distribution. **In the European Economic Area (EEA)**: this is Issued by BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 – 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311 For your protection telephone calls are usually recorded. **In the UK and Non-European Economic Area (EEA) countries**: this is Issued by BlackRock Advisors (UK) Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL, Tel: +44 (0)20 7743 3000. Registered in England and Wales No. 00796793. For your protection, calls are usually recorded. Please refer to the Financial Conduct Authority websitefor a list of authorised activities conducted by BlackRock. **In Italy,** For information on investor rights and how to raise complaints please go to https://www.blackrock.com/corporate/compliance/investor-right available in Italian. **In Switzerland,** This document is marketing material. Until 31 December 2021, this document shall be exclusively made available to, and directed at, qualified investors as defined in the Swiss Collective Investment Schemes Act of 23 June 2006 ("CISA"), as amended. From 1 January 2022, this document shall be exclusively made available to, and directed at, qualified investors as defined in Article 10 (3) of the CISA of 23 June 2006, as amended, at the exclusion of qualified investors with an opting-out pursuant to Art. 5 (1) of the Swiss Federal Act on Financial Services ("FinSA"). For information on art. 8 / 9 Financial Services Act (FinSA) and on your client segmentation under art. 4 FinSA, please see the following website: www.blackrock.com/finsa **For investors in Israel:** BlackRock Investment Management (UK) Limited is not licensed under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law"), nor does it carry insurance thereunder. **In South Africa**, please be advised that BlackRock Investment Management (UK) Limited is an authorized financial services provider with the South African Financial Services Board, FSP No. 43288. **In the DIFC** this material can be distributed in and from the Dubai International Financial Centre (DIFC) by BlackRock Advisors (UK) Limited — Dubai Branch which is regulated by the Dubai Financial Services Authority (DFSA). This material is only directed at 'Professional Clients' and no other person should rely upon the information contained within it. Blackrock Advisors (UK) Limited - Dubai Branch is a DIFC Foreign Recognised Company registered with the DIFC Registrar of Companies (DIFC Registered Number 546), with its office at Unit 06/07, Level 1, Al Fattan Currency House, DIFC, PO Box 506661, Dubai, UAE, and is regulated by the DFSA to engage in the regulated activities of 'Advising on Financial Products' and 'Arranging Deals in Investments' in or from the DIFC, both of which are limited to units in a collective investment fund (DFSA Reference Number F000738) **In the Kingdom of Saudi Arabia,** issued in the Kingdom of Saudi Arabia (KSA) by BlackRock Saudi Arabia (BSA), authorised and regulated by the Capital Market Authority (CMA), License No. 18-192-30. Registered under the laws of KSA. Registered office: 29th floor, Olaya Towers – Tower B, 3074 Prince Mohammed bin Abdulaziz St., Olaya District, Riyadh 12213 – 8022, KSA, Tel: +966 11 838 3600. The information contained within is intended strictly for Sophisticated Investors as defined in the CMA Implementing Regulations. Neither the CMA or any other authority or regulator located in KSA has approved this information. The information contained within, does not constitute and should not be construed as an offer of, invitation or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. Any distribution, by whatever means, of the information within and related material to persons other than those referred to above is strictly prohibited. **In the United Arab Emirates** is only intended for -natural Qualified Investor as defined by the Securities and Commodities Authority (SCA) Chairman Decision No. 3/R.M. of 2017 concerning Promoting and Introducing Regulations. Neither the DFSA or any other authority or regulator located in the GCC or MENA region has approved this information. **In the State of Kuwait**, those who meet the description of a Professional Client as defined under the Kuwait Capital Markets Law and its Executive Bylaws. **In the Sultanate of Oman,** to sophisticated institutions who have experience in investing in local and international securities, are financially solvent and have knowledge of the risks associated with investing in securities. In **Qatar**, for distribution with pre-selected institutional investors or high net worth investors. **In the Kingdom of Bahrain**, to Central Bank of Bahrain (CBB) Category 1 or Category 2 licensed investment firms, CBB licensed banks or those who would meet the description of an Expert Investor or Accredited Investors as defined in the CBB Rulebook. The information contained in this document, does not constitute and should not be construed as an offer of, invitation, inducement or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. **In Singapore**, this is issued by BlackRock (Singapore) Limited (Co. registration no. 200010143N). This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. **In Hong Kong**, this material is issued by BlackRock Asset Management North Asia Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong. **In South Korea**, this material is for distribution to the Qualified Professional Investors (as defined in the Financial Investment Services and Capital Market Act and its sub-regulations). **In Taiwan**, independently operated by BlackRock Investment Management (Taiwan) Limited. Address: 28F., No. 100, Songren Rd., Xinyi Dist., Taipei City 110, Taiwan. Tel: (02)23261600. **In Japan**, this is issued by BlackRock Japan. Co., Ltd. (Financial Instruments Business Operator: The Kanto Regional Financial Bureau. License No375, Association Memberships: Japan Investment Advisers Association, the Investment Trusts Association, Japan, Japan Securities Dealers Association, Type II Financial Instruments Firms Association.) For Professional Investors only (Professional Investor is defined in Financial Instruments and Exchange Act). **In Australia**, issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975 AFSL 230 523 (BIMAL). The material providesgeneral information only and does not take into account your individual objectives, financial situation, needs or circumstances. **In China**, this material may not be distributed to individuals resident in the People's Republic of China ("PRC", for such purposes, excluding Hong Kong, Macau and Taiwan) or entities registered in the PRC unless such parties have received all the required PRC government approvals to participate in any investment or receive any investment advisory or investment management services. **For Other APAC Countries**, this material is issued for Institutional Investors only (or professional/sophisticated /qualified investors, as such term may apply in local jurisdictions). **In Latin America**, no securities regulator within Latin America has confirmed the accuracy of any information contained herein. The provision of investment management and investment advisory services is a regulated activity in Mexico thus is subject to strict rules. For more information on the Investment Advisory Services offered by BlackRock Mexico please refer to the Investment Services Guide available at www.blackrock.com/mx

©2022 BlackRock, Inc. All Rights Reserved. **BLACKROCK** is a trademark of BlackRock, Inc., or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee