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Weekly commentary

BlackRock.

August 1, 2022

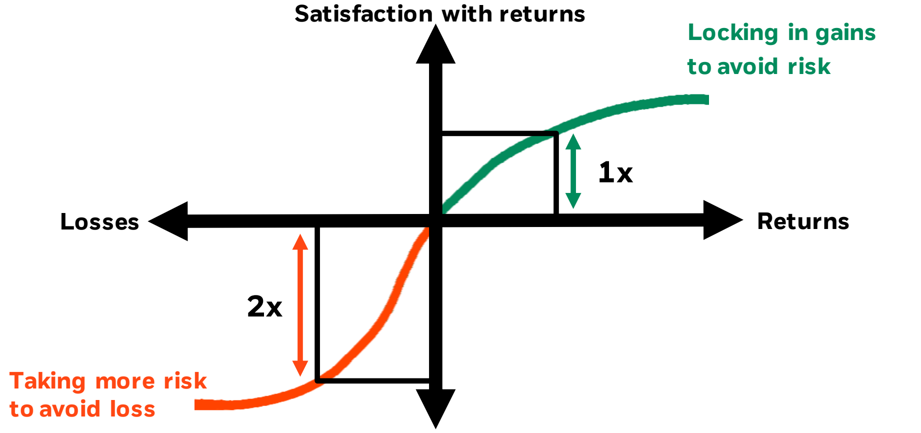
Beware behavioral bias in new regime

- We highlight the top three behavioral biases to avoid in the new, volatile market regime – and give tips on how investors can try to overcome them.
- Stocks rallied and yields fell last week after markets concluded the Fed's pace of rate hikes will slow. We are less sanguine and see a dovish pivot only later.
- We are watching this week's U.S. jobs report for any signs production capacity is on the mend. The labor shortage is a key production constraint.

Investors are strapped in for a market rollercoaster in a new regime of increased volatility. Views on central bank rates are shuffling fast, as last week's market reaction to the Fed's rate hike showed. We think this warrants careful thought about portfolio changes. But change is hard. Behavioral biases subconsciously influence investment decisions. We look at three biases likely to trouble investors, especially in this volatile market – and share tips on how to overcome these pitfalls.

Pain vs. gain

Satisfaction with gains and losses in behavioral finance prospect theory



Sources: BlackRock Investment Institute, adapted from Daniel Kahneman and Amos Tversky, Econometrica 12 (1980). Notes: The chart shows satisfaction levels from gains and losses relative to a neutral reference point. Black boxes show satisfaction magnitude along the S curve of risk tolerance – from risk seeking (red line) to risk averse (green line).

The first bias is the disposition effect, or the tendency to hold losing positions too long and sell winning ones too soon. We expect the disposition bias to be most prevalent when investors are feeling stinging losses – like so far this year. Both stocks and bonds have racked up declines not seen since the 1970s this year. Behavioral finance finds that people feel the pain of loss twice as strongly as they experience an equivalent gain as pleasurable (the red versus green arrow in the chart). As a result, people may hold on to losing positions to avoid the pain of a loss (bottom left in chart). Meanwhile, it's tempting to lock in gains too soon on winning positions because of a reluctance to take more risk for only marginal benefits (top right).

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There's a second bias that should really be public enemy No. 1 today for professional investors: inertia. This is a reluctance to make changes or making ones too small to affect performance. Why is this especially a problem now? The era of steady growth and inflation known as the Great Moderation is over, we believe. A new regime of increased macro volatility is in its place. Yet central banks appear to believe they can magically curb inflation and cause only a mild economic slowdown, as we wrote last week. We see more volatility ahead as markets have rallied on hopes the Fed is about to change course and relax policy. That optimism is misplaced, in our view. All of this calls for professional investors to change their portfolios more quickly. It will be costly, in our view, to just follow playbooks such as "buying the dip" or make slow and minimal changes.

Endowment is the third kind of bias to guard against in the current market backdrop. Think of it as excessively deliberating over whether you may one day need something that sat collecting dust for years – whereas you clearly should be decluttering. People with this bias overvalue their assets. The longer they own them, the higher the price they demand to give them up. The endowment effect can lead investors to hold on to positions even after an investment strategy has played out. This can hurt performance. Positions often produce more returns earlier in their life spans, we find.

How can investors mitigate behavioral biases? First, do a blank-slate exercise – imagine you have realized all your gains and losses. Then construct the ideal portfolio for the most likely market and macro environment over your time horizon. That doesn't mean abandoning long-standing investment processes. Instead, consider portfolio changes without basing it on your historical portfolio holdings and performance. Second, think of future market events or performance thresholds that would signal when to take profit or cut losses. Making a plan can help determine how to react amid volatile markets and high emotions. This is the reason we give signposts for changing our views in our 2022 midyear outlook. Third, encourage open conversations about biases and the changes required to overcome them. Discuss your emotions after losses, examine mistakes even when performance is good, and weigh input from colleagues with an alternative point of view.

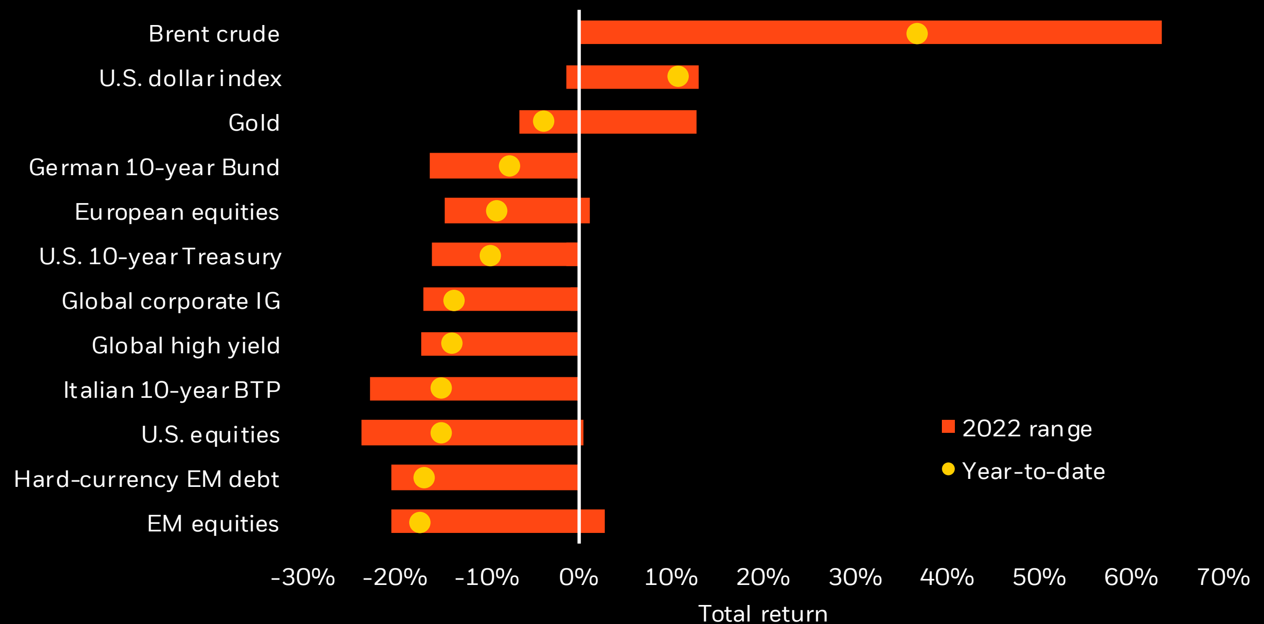
Our bottom line: Beware of behavioral biases in investing. We are guarding against their pitfalls because we believe the new regime requires an overhaul of portfolios. We've reduced portfolio risk throughout this year. Our latest tactical move: an up-in-quality portfolio shift by downgrading developed market stocks and upgrading investment grade credit. We underweight U.S. Treasuries and overweight inflation-linked bonds, believing markets underestimate the new regime's inflationary nature.

Market backdrop

The Federal Reserve increased the fed funds rate by another 0.75% last week. U.S. stocks rallied as markets concluded the Fed's pace of rate hikes will slow, while yields fell on news of stalling growth. The Fed still thinks hiking rates will only cause a mild slowdown. It has yet to acknowledge the stark growth-inflation tradeoff: crush growth or live with some inflation. We don't see a policy pivot until 2023, as data show persistent inflation. Expect more volatility until the Fed changes course.

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 28, 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.

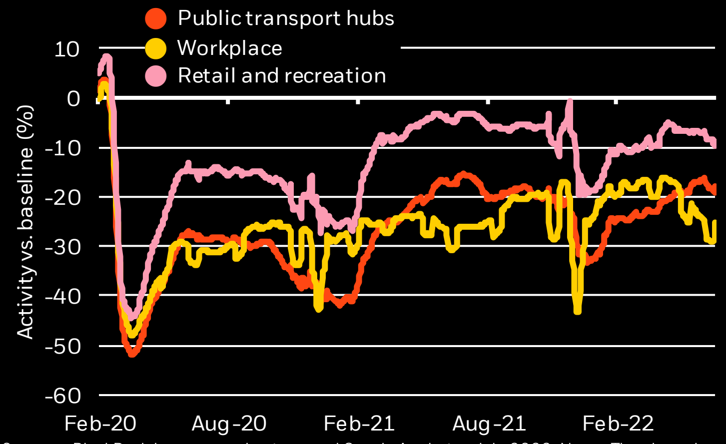
Macro take

Since Covid, production capacity in the U.S. has fallen by a huge 7% – this explains why inflation is so high right now. That's what we concluded in our inaugural *Macro Take* post. This time, Alex Brazier and Nicholas Fawcett consider how much of that 7% can be recovered. Short answer: probably only around half of it, and that's going to take a lot of time.

One reason for the 7% fall: The pandemic changed what consumers were spending on – more on goods, less on services. The economy wasn't set up to meet that new composition of demand. People haven't reverted to their old habits. The chart shows they're still visiting fewer museums, restaurants and cinemas, using public transport less and working from home more. The way we live and work has changed – it could take many years for the production side of the economy to adapt. Production capacity has also fallen because it's been harder for employers to find workers. Many people left the workforce in the pandemic. We haven't seen convincing signs of them returning yet. Read more on this and what it means for central banks and inflation here.

Not back to normal

Daily visits to various locations vs. pre-pandemic, 2020-2022



Sources: BlackRock Investment Institute and Google Analytics, July 2022. Notes: The chart shows daily visitor counts for types of locations relative to the baseline days before the pandemic. The baseline is based on the period from Jan. 3 to Feb. 6, 2020. Lines show a 14-day moving average. Retail and recreation examples are restaurants, shopping centers, theme parks and museums.

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 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 gives policymakers less maneuvring 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 new world shaped by supply. Major spending shifts and production constraints are driving inflation.
- Constraints are rooted in the pandemic and have been exacerbated by the war in Ukraine and China's lockdowns
- The Fed increased rates by another 0.75% in July and reaffirmed projections of more rate rises with the aim to rein in inflation. The Fed is still looking through the lens of a typical late-cycle overheating as opposed to a restart, in our view. Reality will come knocking eventually, we think, and a stalled restart will prompt the Fed to change course.
- The Bank of England warned of the poisonous combination of recession and high inflation as it 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 in July. 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.
- **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.
- We see a global drive for more 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

August 3	Caixin Services PMI	**August 5**	U.S. jobs report
August 4	Bank of England policy meeting	**August 7**	China trade data

This week's U.S. jobs report is front and center. The report will be key as the Fed looks to the labor market for further signs of healing in production capacity. The Bank of England (BoE) is set to increase interest rates again. But we think it is nearing the point where it changes course. To us, the growth cost of further rises will lead the BoE to live with inflation above target.

Directional views

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

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Granular views

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

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