Weekly commentary

January 3, 2023

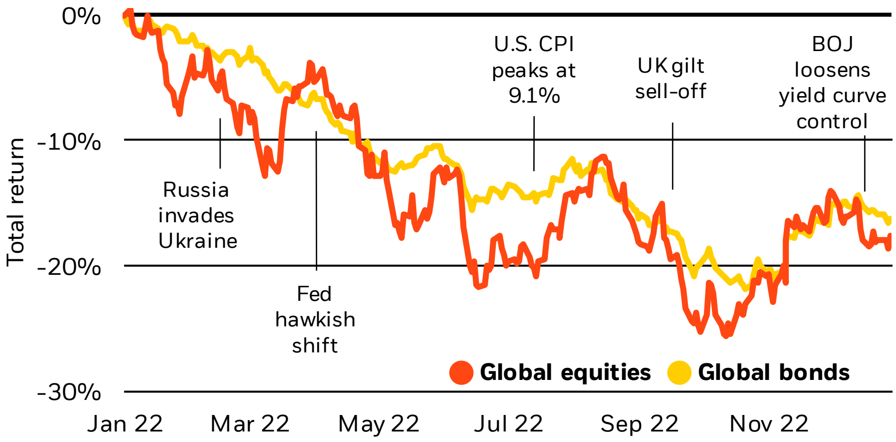
Three investment lessons for 2023

- A historic 2022 taught us to widen the lens of possible scenarios, factor in geopolitical risk and use a new playbook for more frequent portfolio changes.
- Global stocks ended the year down 18%, while bonds fell 16%. This marked the biggest market storm in decades amid inflation and hawkish central banks.
- U.S. jobs data this week are set to jolt market expectations of the Fed's rate path. PMI data is likely to show further slowing in manufacturing activity.

The historic shocks of 2022 – war, soaring inflation and a perfect market storm – shape our three investment lessons for the new year. First, widen the lens of possible scenarios and beware of inertia and other behavioral biases. Second, factor in compensation for geopolitical risk. Third: We need a new investment playbook – the key theme of our 2023 Global Outlook. That means more frequent portfolio changes in the new regime of greater macro and market volatility.

A historic year

Global equity and bond total returns, 2022



Sources: BlackRock Investment Institute with data from Refinitiv Datastream and Bloomberg, December 2022. Notes: The chart shows year-to-date to returns for the MSCI ACWI index (orange) and Bloomberg Global Aggregate index for bonds (yellow) since the start of the year. Data as of Dec. 29, 2022.

Last year's shocks were extreme, causing sharp stock and bond sell-offs. See the chart. Russia amassing troops on Ukraine's border quickly erupted in the full-blown war that is still raging. That sent energy prices soaring, stoking already hot inflation from pandemic-induced production constraints. Headline inflation surged to 40-year highs, spurring the Federal Reserve to embark on the steepest rate hike path since the early 1980s. A year ago, markets expected policy rates to rise to 1% by year-end. They are four times as much now, and we see more to come. Other shocks like the UK gilt crisis showed a return of the so-called bond vigilantes: market forces punishing fiscal splurges with higher yields and diving currencies. The Bank of Japan also surprised markets by loosening its yield control policy just days before year-end.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Vivek Paul
Head of Portfolio Research – BlackRock Investment Institute

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

The lesson: We must widen the lens of possible scenarios because the new regime of higher macro and market volatility entails a wider range of outcomes. And it requires quick reactions. We must fight behavioral biases like inertia that make it hard to embrace change or carry out too little to make a difference. Sometimes you know something is happening but just don't want to believe it – either because recency bias or out of sheer disbelief.

Our second lesson: Geopolitical risk now warrants persistent risk premia across asset classes, rather than being something markets only react to when it materializes. We see a fragmented world of competing blocs replacing an era of globalization and geopolitical cooperation. Geopolitics are driving economics now, instead of economics driving geopolitics, in our view. We think the war in Ukraine and strategic competition between the U.S. and China are long-term geopolitical risks, not just market drivers of short-lived sell-offs. Fragmentation could also create more supply and demand mismatches as resources are reallocated. We see this keeping inflation pressure higher than before the pandemic and contributing to market volatility.

Our final lesson: We need a new investment playbook in the new regime. This means not being lulled into thinking what worked in the past will work now, like automatically buying the dip. We see stock rallies built on hopes for rapid rate cuts fizzling. Why? Central banks are unlikely to come to the rescue in recessions they themselves caused to bring inflation down to policy targets. Earnings expectations are also still not fully reflecting recession, in our view. But markets are now pricing in more of the damage we see – and as this continues, it would pave the way for us to turn more positive on risk assets. We don't count on long-term government bonds as diversifiers. We expect central banks to pause hikes when the economic damage becomes clearer – but keep rates at high levels. We also see long-term yields rising as investors demand more compensation for the risk of holding them amid persistently high inflation and record debt levels. We see services inflation as sticky due to worker shortages fueling wage growth. And we see long-term drivers keeping inflation pressures higher than before the pandemic: aging populations, geopolitical fragmentation and the net-zero transition. All these expectations feed into our new investing playbook of granular views and frequent portfolio changes.

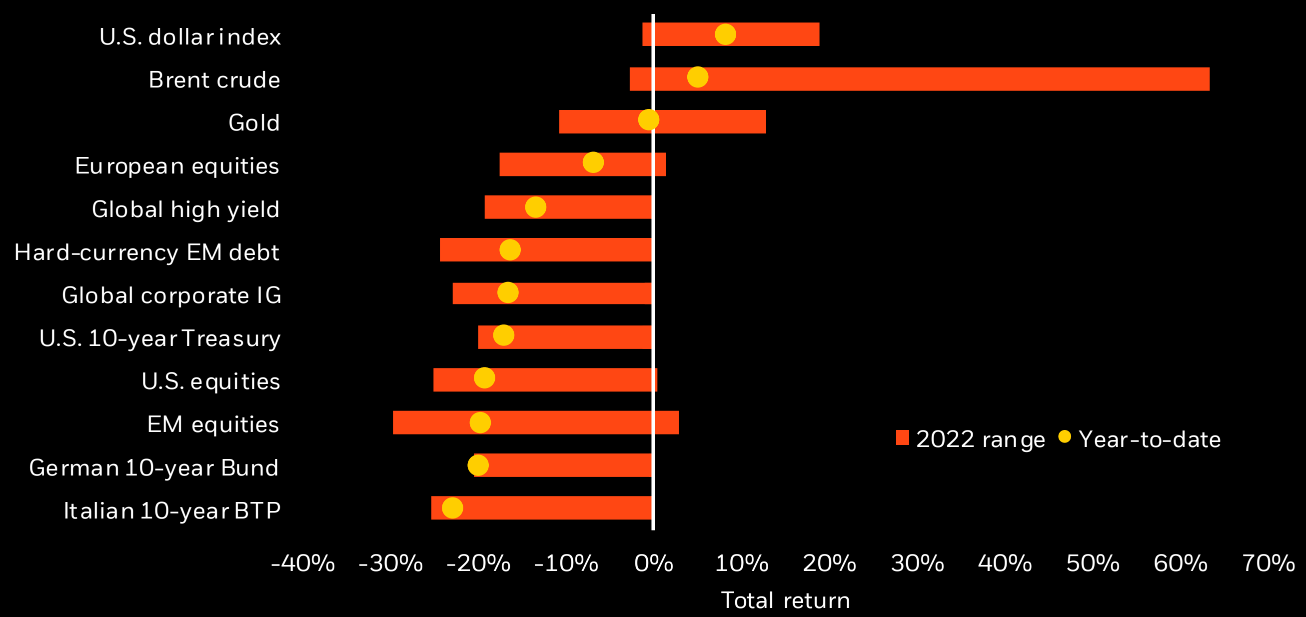
Our bottom line: We're widening our lens of scenarios, factoring in geopolitical risk and using a new playbook for 2023. We're tactically underweight developed market equities and long-term government bonds. Investment grade credit, U.S. mortgage backed securities and short-term Treasuries offer attractive income. And we prefer inflation-linked bonds over nominal peers.

Market backdrop

Global stocks fell 18% and bonds dropped 16% in 2022 – a rare joint selloff that only happened in two other years (2015, 2018) since the Bloomberg global aggregate bond index series started in 1990. And those losses were only single digits. Soaring inflation and aggressive rate hikes in response roiled markets as the pressure from production constraints tied to the pandemic converged with an energy crisis brought by the war in Ukraine.

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 Dec. 29, 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.

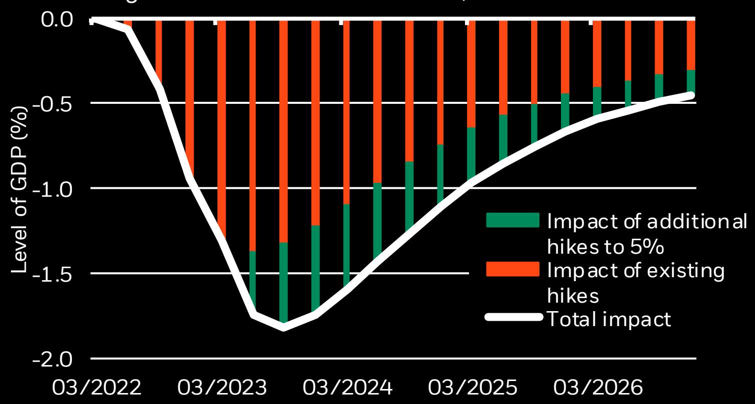
Macro take

How much economic damage will the Federal Reserve's rate hikes cause in the U.S.? Time will tell. We are already seeing more and more indicators of economic activity starting to flash red. But the impact of interest rates comes with a time lag, so most of the damage from the rate hikes that have already happened is yet to come in 2023.

We assess the size of the ultimate hit to growth by looking at 20 published models of how economic activity reacts to changes in interest rates. We take the average of the modeled responses and assume the Fed will raise rates to 5% early next year – though they could well go even further than that. The result: We estimate that only a fifth of the ultimate effect has manifested so far, based on those models. Peak pain won't come until late 2023. By then, we expect the damage to have spread more broadly and deeply through the economy. We estimate GDP will be nearly 2% lower in the second quarter of 2023 than would have been the case if the Fed had left rates unchanged since March 2022. See the chart. Read more in our latest blog post here.

Damage from rate hikes is growing

Estimated growth hit from Fed rate hikes, 2022-2026



Sources: BlackRock Investment Institute, Institute for Monetary and Financial Stability, Goethe University Frankfurt, December 2022. Notes: The orange bars show the estimated fall in growth due to rate hikes already done by the Fed. The green shows the estimated impact of additional hikes up to 5%. The white line shows the total impact. We calculate this by taking the average impulse response of output to policy rates from 20 different U.S.-calibrated structural models. To be on the conservative side, we select these 20 model impulse responses by trimming outliers in IMFS' Macroeconomic Model Database (otherwise the estimated impact would be even higher).

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks race to try to tame inflation. It's the opposite of past recessions: Loose policy is not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- That damage is building. In the U.S., it's most evident in rate-sensitive sectors. Surging mortgage rates have cratered sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- In Europe, the hit to incomes from the energy shock is amplified by tightening financial conditions.
- The ultimate economic damage depends on how far central banks go to get inflation down.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- The case for investment-grade credit has brightened, in our view. We think it can hold up in a recession, with companies having fortified their balance sheets by refinancing debt at lower yields. Agency mortgage-backed securities can also play a diversified income role. Short-term government debt also looks attractive at current yields.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication**: We prefer investment-grade credit over long-term government bonds.

3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The cycle of outsized rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. As the damage becomes clear, the "politics of recession" will take over.
- Even with a recession coming, we think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication**: We're overweight inflation-linked bonds on a tactical and strategic horizon.

Week ahead

Jan. 4	U.S. ISM manufacturing PMI; job openings
Jan. 5	China services PMI
Jan. 6	U.S. payrolls; U.S. ISM services PMI; euro area flash inflation

PMI data around the world will help confirm if recessions are starting to take root. A strong U.S. payrolls gain would embolden the Fed to stay hawkish. We don't expect much improvement in labor participation – worker shortages have been a key production constraint driving up wages and keeping inflation persistently higher.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, January 2023

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

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched to us. Tactically, we're underweight DM stocks as central banks look set to overtighten policy – we see recessions looming. Corporate earnings expectations have yet to fully reflect even a modest recession.
Credit	+2	+1	Strategically, we are significantly overweight global investment grade on attractive valuations and income potential given higher yields. We turn neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're also overweight investment grade and neutral high yield. We prefer to be up in quality. We are neutral EM debt after its strong run. We see better opportunities for income in DMs.
Govt bonds	-1	-1	The underweight in our strategic view on government bonds reflects a big spread: max underweight nominal, max overweight inflation-linked and an underweight on Chinese bonds. We think markets are underappreciating the persistence of high inflation and the implications for investors demanding a higher term premium. Tactically, we are underweight long-dated DM government bonds as we see term premium driving yields higher, yet we are neutral short-dated government bonds as we see a likely peak in pricing of policy rates. The high yields offer relatively attractive income opportunities.
Private markets	-1	—	We're underweight private growth assets and neutral on private credit, from a starting allocation that is much larger than what most qualified investors hold. Private assets are not immune to higher macro and market volatility or higher rates, and public market selloffs have reduced their relative appeal. Private allocations are long-term commitments, however, and we see opportunities as assets reprice over time. Private markets are a complex asset class 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, January 2023

Underweight | Neutral | Overweight | ● Previous view

Asset	View	Commentary
Developed markets	-1	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy, financials and healthcare.
United States	-1	We are underweight. The Fed is set to raise rates into restrictive territory. Earnings downgrades are starting but don't yet reflect the coming recession.
Europe	-1	We are underweight. The energy price shock and policy tightening raise stagflation risks.
UK	-1	We are underweight. We find valuations expensive after their strong relative performance versus other DM markets thanks to energy sector exposure.
Japan	Neutral	We are neutral. We like still-easy monetary policy and increasing dividend payouts. Slowing global growth is a risk.
China	Neutral	We are neutral. Activity is restarting, but we see China on a path to lower growth. Tighter state control of the economy makes Chinese assets riskier, in our view.
Emerging markets	Neutral	We are neutral. Slowing global growth will weigh on EMs. Within the asset classes, we lean toward commodity exporters over importers.
Asia ex-Japan	Neutral	We are neutral. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
Short U.S. Treasuries	Neutral	We are neutral. We remain invested in the front end due to attractive income potential.
Global inflation-linked bonds	+1	We are overweight. We see breakeven inflation rates underpricing the persistent inflation we expect.
European government bonds	-1	We are underweight the long end. We expect term premium to raise long-term yields and high inflation to persist. Rate hikes are a risk to peripheral spreads.
UK gilts	-1	We are underweight. Perceptions of fiscal credibility have not fully recovered. We prefer short-dated gilts for income.
China government bonds	Neutral	We are neutral. Policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
Global IG credit	+2	We are significantly overweight. High quality corporates' strong balance sheets imply IG credit could weather a recession better than stocks.
U.S. agency MBS	+1	We are overweight. We see the asset class as a high-quality exposure within a diversified bond allocation. Soaring U.S. mortgage rates boost potential income.
Global high yield	Neutral	We are neutral. We prefer up-in-quality credit exposures amid a worsening macro backdrop.
Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices yet it is vulnerable to rising U.S. yields.
Emerging local currency	Neutral	We are neutral EM debt after its strong run. We see better opportunities for income in DMs.
Asia fixed income	Neutral	We are neutral 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.

BIIM1222U/M-2658417-5/6

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.