Weekly commentary

January 9, 2023

BlackRock

Why 2023 will be different

- Recession foretold in developed markets (DM), a pause in central bank rate hikes and China's reopening help shape 2023 and reinforce our tactical views.
- European equities led DM stocks higher. Surprisingly weak U.S. services data spurred bets for Federal Reserve rate cuts this year, which we think are unlikely.
- We see the U.S. CPI slowing as spending shifts back to services from goods, but wage growth will keep core inflation higher than before the pandemic.

We see three shifts shaping 2023 as the new regime keeps playing out. First, we see DM economies facing recession. Second, DM central banks will halt rate hikes when economic damage is clearer. Goods inflation should fall sharply as spending shifts. But we don't expect rate cuts as inflation stays above policy targets. Third, China's reopening and domestic spending will drive global growth as DM recessions hit. We like emerging market stocks over DM and like high grade credit.

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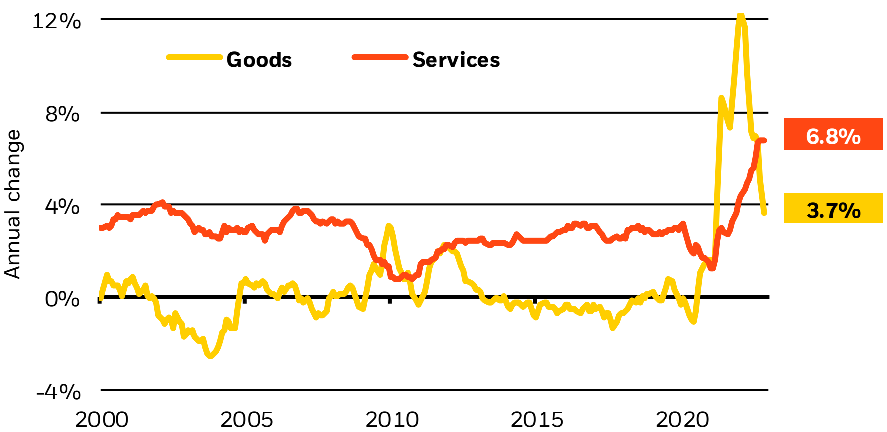
The inflation divide

U.S. core goods and services consumer price inflation, 2000-2022



Sources: BlackRock Investment Institute with data from U.S. Bureau of Labor Statistics, January 2023. Notes: The chart shows the annual change in U.S. core goods and services consumer price indexes.

In 2022, DM economies grew, China growth slowed, and inflation and interest rates surged. In 2023, sharp rate hikes aimed at pushing inflation down to policy targets will cause recessions in DMs – the first shift from last year. We're already seeing evidence that rate hikes are hurting the most interest-rate-sensitive parts of the economy, like housing. Hikes have an overall lagged effect that will reinforce economic pain from the energy shock in Europe and weigh on U.S. consumers as they exhaust savings. We think recessions will push central banks to pause hikes – the second shift. Inflation is set to fall as U.S. consumer spending rotates to services from goods, dragging down goods inflation (yellow line in the chart). But labor shortages will likely make services inflation stickier (orange line). So we don't see central banks cutting rates to rescue DMs from recession.

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Reduced U.S. labor supply means that companies are having trouble hiring. The December jobs data showed little sign of the situation changing fundamentally, in our view. Wage growth did cool, but labor shortages are still pushing it up to a level that makes achieving central banks' 2% inflation target unlikely. Getting inflation to settle back at targets would entail reducing labor demand – and would need an even deeper recession than we see ahead. That's why we see central banks keeping rates higher for longer than markets expect instead of cutting rates. And over the long term, we see three structural trends keeping inflation pressures higher on average than pre-pandemic: aging demographics, geopolitical fragmentation and the transition to net-zero carbon emissions.

The third shift: China is rapidly lifting Covid-19 restrictions. We estimate its economic growth will clock in above 6% in 2023, cushioning the global slowdown as recession hits major DM economies. But China's growth surge will be tempered by falling demand for its exports as U.S. spending shifts away from goods. We don't expect the level of economic activity in China to return to its pre-Covid trend, even as domestic activity restarts. We see growth falling back once the restart runs its course.

These three shifts we see ahead in 2023 reinforce our tactical views and are why we maintain our most defensive stance. Earnings expectations for 2023 are still not fully reflecting the DM recessions we expect, in our view. That's why we're underweight DM stocks. We stand ready to turn more positive on DM stocks when more of the economic damage we see ahead is in the price or our assessment of market risk sentiment improves. China replacing the U.S. as the driver of global growth underpins our preference for emerging market equities, including Chinese equities, over DM peers. Within fixed income, we see more attractive opportunities to earn income in investment grade credit, U.S. mortgage-backed securities and short-term Treasuries. We stay underweight long-term nominal government bonds because they don't reflect our view that yields will rise further as investors demand more term premium, or compensation for the risk of holding them amid persistent inflation and higher rates.

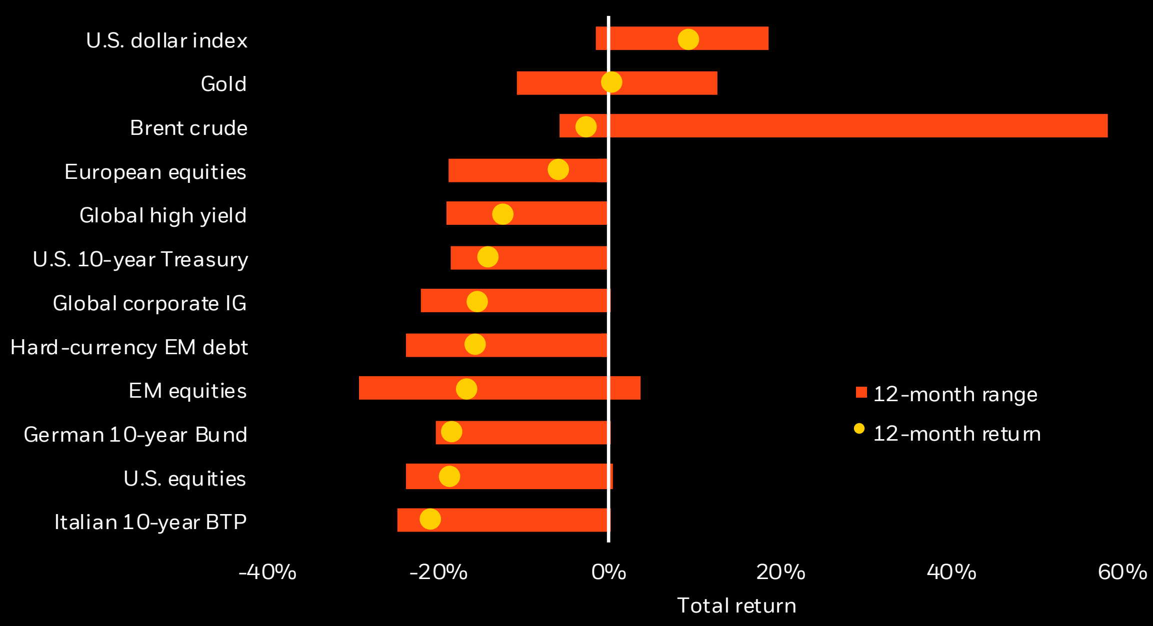
Our bottom line: 2022 was a year of soaring inflation, rapid rate hikes and pandemic-induced lockdowns in China. We see volatility ahead in 2023 but expect the year to be shaped by big shifts from last year: recessions in developed markets, inflation falling and central banks pausing their rate hikes, and China reopening. We'll likely turn more positive on risk assets after gauging what's in the price and market risk sentiment – a central theme of our new investment playbook.

Market backdrop

European equities led gains in DM stocks this week. Ten-year German bund yields led a drop in major government bond yields. Falling energy prices are helping pull down headline inflation and fanning hopes for less hawkish DM central banks. A sharp drop in the U.S. services PMI spurred expectations for Fed rate cuts next year. But we see sticky core inflation keeping central banks on track to overtighten policy – and keep policy rates higher than markets are expecting.

Assets in review

Selected asset performance, 12-month 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 Jan. 5, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, and the dots represent current 12-month 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.

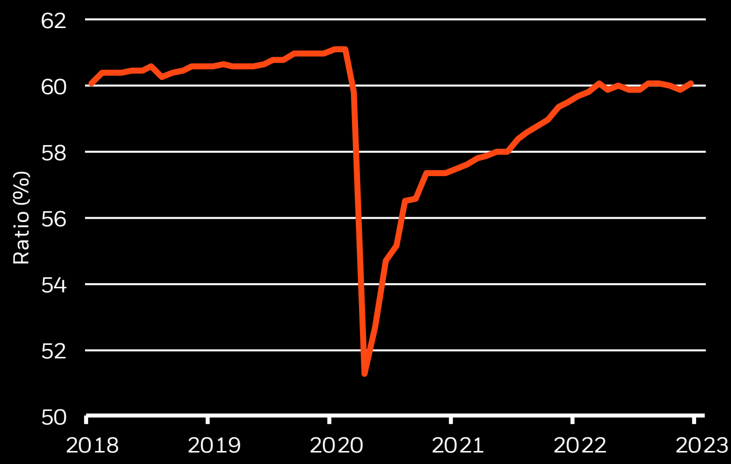
Macro take

U.S. wages are still rising quickly and the unemployment rate fell to 3.5%, according to last week's U.S. jobs report for December. We don't think these figures reflect excessive demand for labor: The overall number of people in work is only a touch higher than it was before the pandemic despite the adult population having grown by more than 5 million people. The share of the population in employment is still well below its pre-Covid level, as the chart shows.

We believe the labor shortage is driving up wages, as we said in a recent blog – many left the labor force during Covid and aren't coming back. Plus, a skills mismatch means it's harder for employers to recruit from those that are available. We don't see that worker shortage resolving any time soon. Labor demand will have to fall for wage pressures to ease. But that could take time: Slowing economic activity typically takes a year to feed through to labor demand and wages. So we think wages will keep pushing up inflation this year, preventing the Fed from cutting rates in 2023 despite rapidly falling goods inflation. See all our blog posts here.

A worker shortage

U.S. employment to population ratio, 2018-2022



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and U.S. Bureau of Labor Statistics, January 2023. Notes: The chart shows the proportion of the U.S. population that is employed.

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are 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. We think they will halt rate hikes once the economic damage becomes clear.
- **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. 10-17	China total social financing
Jan. 12	U.S. CPI
Jan. 13	UK GDP; U.S. University of Michigan consumer sentiment

We expect the annual change in the U.S. CPI to slow again in December, falling from the 40-year highs reached in 2022 as spending normalizes back to services from goods – putting pressure on goods prices – and thanks to lower energy prices. But sticky wage growth due to labor shortages is likely to keep core inflation sticky and the Fed on track to keep hiking rates.

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.

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