Weekly commentary

BlackRock

March 20, 2023

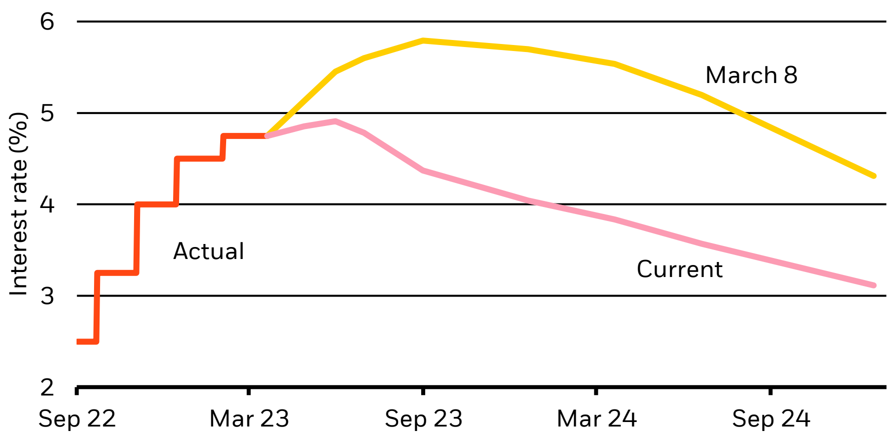
Financial cracks show: What to do now

- More financial cracks from rapid rate hikes are emerging. We stay underweight equities, downgrade credit and prefer short-term government bonds for income.
- Bank troubles on both sides of the Atlantic hit the sector's shares last week. Short-term bond yields plunged on hopes for sharp central bank rate cuts.
- We don't see central banks coming to the rescue with rate cuts but using other tools to ensure financial stability. The Federal Reserve is set to hike this week.

The U.S and European bank tumult is the latest sign rapid rate hikes are causing financial cracks, reinforcing our recession view. We expect central banks to keep hiking to fight higher inflation – not come to the rescue. We stay risk-off: underweight developed market (DM) stocks and trim credit to neutral. But we are ready to seize opportunities as macro damage gets priced in. We overweight very short-term government paper for income and prefer emerging markets.

Rethinking rates

Market pricing of fed funds rate, March 2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2023. Notes: The chart shows the forward fed funds rate through December 2024 as implied by SOFR futures prices as of March 8 and March 17.

Banking troubles on both sides of the Atlantic were roiling markets last week. That's the latest fallout from the most rapid rate hikes since the early 1980s. We have argued that bringing inflation down would be costly, creating economic damage and cracks in the financial system. This week's events will crimp bank lending, reinforcing our recession view. As the cracks emerged, market expectations for peak rates plummeted, as the pink line in the chart shows. The reason: hopes that central banks will come to the rescue and cut rates, as they did in the past. That's the old playbook – and it no longer works. Central banks are set to keep fighting stubbornly higher inflation, and use other tools to safeguard financial stability. Case in point: The European Central Bank raised rates by 0.5% last week. And we see the Fed raising rates this week. Our conclusion: Investors need a new investment playbook and to stay nimble in this new market regime.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The banking stresses that are roiling markets are very different – but what they have in common is that markets are now scrutinizing bank vulnerabilities through a lens of high interest rates. We don't see a repeat of the 2008 global financial crisis. Some of the troubles that emerged recently were longstanding and well-known, and banking regulations are much stricter now. Instead, this is about a recession foretold. Why? The only way central banks could bring inflation down was to hike rates high enough to cause economic damage. The latest financial cracks are likely to tighten credit, dent confidence – and eventually hurt growth. What does this mean for investing? We see three clear takeaways:

First, we stay underweight equities and downgrade credit to neutral. We believe risk assets are not pricing the coming recession. This is why we stay underweight DM equities on a tactical horizon of six- to 12-months. We expect reduced bank lending in the wake of the sector's troubles. The recession is likely to see more credit tightening now. We downgrade our overall credit view to neutral as a result, trimming investment grade (IG) credit to neutral and high yield to underweight. We have a relative preference for European IG because of more attractive valuations versus U.S. peers.

Second, we overweight short-term government bonds. We think this recession will be different. Central banks will not try to resuscitate growth by cutting rates. The reason: persistent inflation. We think major central banks will distinguish their inflation fights from any actions taken to shore up the banking system. The ECB did so last week by hiking rates as it originally telegraphed – even as markets had started to doubt its resolve. We expect the Fed to take a similar approach when it hikes rates this week. The U.S. CPI last week confirmed core inflation is not on track to fall to the Fed's target. That's why we could see a reversal of the recent sharp drop in two-year and other short-term government bond yields. As a result, we now prefer even shorter maturities for income in this asset class. We stay underweight long-term government bonds and upgrade inflation-linked bonds given our view inflation is likely to stay well above current market pricing.

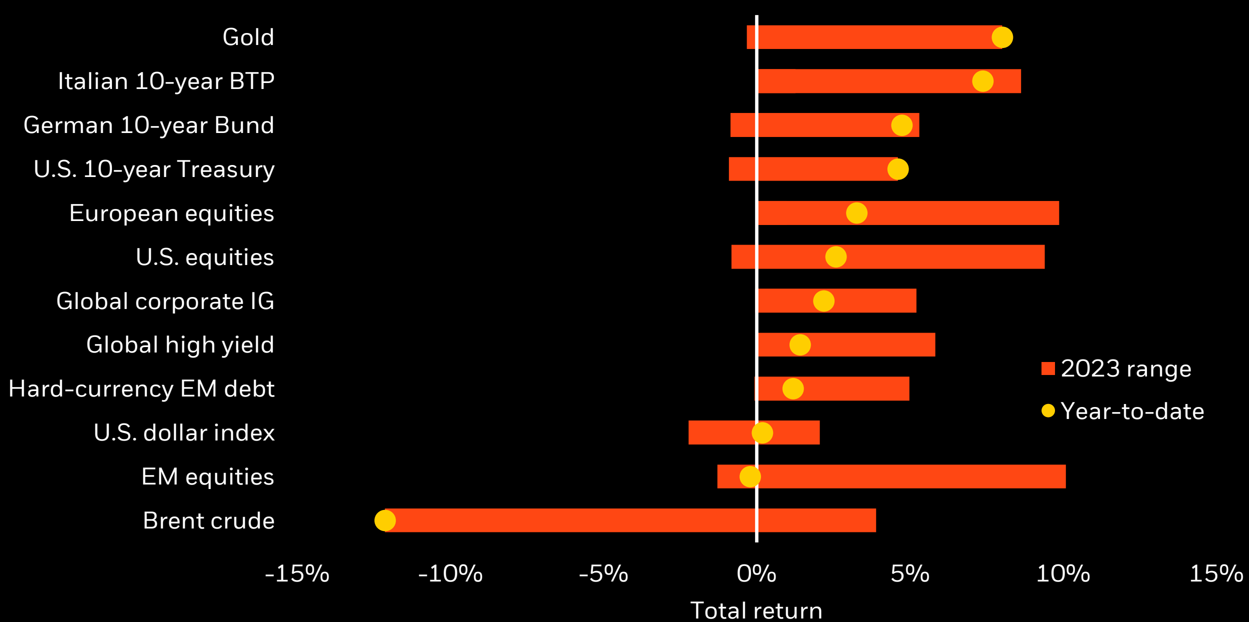
Third, we prefer emerging market (EM) assets. Markets have focused on the mayhem in the developed world. Under the radar has been confirmation that the economic restart in Asia from Covid restrictions is powerful. In addition, China's monetary policy is supportive as the country has low inflation compared with DM. This should benefit EM assets, in our view. As a result, we keep our relative preference for EM stocks. We also go overweight on EM local-currency debt as EM central banks near the end of their hiking cycles and possibly cut rates.

Market backdrop

Short-term government bond yields plunged as the emergence of financial cracks spurred the market's hopes for sharp rate cuts. Bank shares led losses in Europe and were a drag in the U.S. after the troubles at U.S. medium-sized banks and concerns over a large Swiss financial institution. We think central banks will keep hiking as they both seek to bolster banking systems but distinguish those efforts from the need to keep fighting inflation.

Assets in review

Selected asset performance, 2023 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 March 17, 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 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.

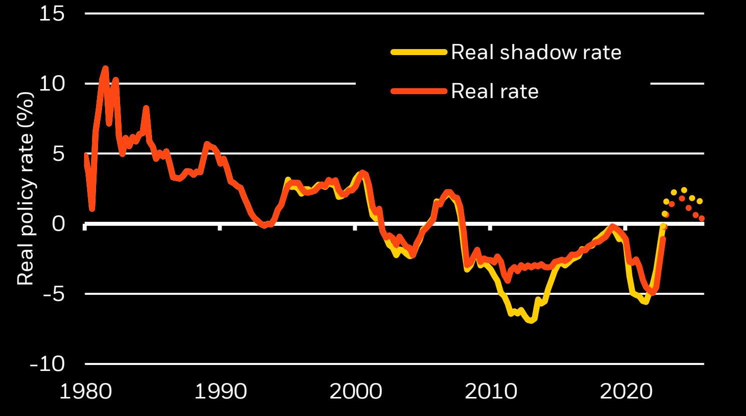
Macro take

The Fed has been hiking fast – that was bound to cause economic and financial damage of some kind, in our view. A comparison with the past reveals just how restrictive U.S. monetary policy is becoming. To do that, we look at borrowing costs in real terms, that is after accounting for the value erosion from inflation. See the orange line on the chart. We also account for the winding down of the Fed's asset purchases – or quantitative tightening – as it increases the cost of borrowing. If you translate that impact into an equivalent rate hike and add it to the real policy rate, you get the "real shadow rate." See the yellow line.

We think that rate will reach around 2.5% by the middle of the year. By comparison: From 2008 to 2019 the real shadow rate averaged around -3%. That makes monetary policy now the most restrictive it's been since the 1980s when you also consider the downward trend in interest rates over the last 20 years. It's clear that would cause damage, even if in unexpected places. It was always the cost of getting inflation down quickly. See our Macro take blog.

Tightest Fed policy since 1980s

Actual and expected U.S. real and shadow policy rate, 1980-2025



BlackRock Investment Institute, Federal Reserve, University of Michigan, LJK Limited, with data from Haver analytics, March 2023. Note: The orange line shows the effective Fed funds rate minus one-year-ahead inflation expectations. For past observations we use the University of Michigan survey of one-year-ahead inflation expectations. The yellow line adjusts the effective Fed funds rate to allow for the impact of asset purchases. This "shadow rate" is a metric for the true stance of monetary policy in a zero lower bound environment.

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.
- In the U.S., it's now evident in the financial cracks emerging from higher interest rates on top of rate-sensitive sectors. Higher mortgage rates have hurt 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, tighter financial conditions are biting even as the energy shock eases.
- 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.
- Short-term government debt looks more attractive for income at current yields, and we like their ability to preserve capital. We like investment-grade credit and think it can hold up in a recession, with companies having fortified their balance sheets by refinancing debt at lower 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 very short-term government paper 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 rapid rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. 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

March 21	U.S. existing home sales	**March 23**	U.S. jobless claims; Bank of England policy decision
March 22	Fed policy decision; UK CPI	**March 24**	Global flash PMIs; Japan CPI

We expect the Fed to press ahead with another rate hike, as the ECB did last week. The Fed's updated forecasts may prompt markets to price back in rate hikes after the February CPI data showed sticky core inflation. But the Bank of England could pause hikes next week. Global PMIs will help gauge how much rate hikes are denting economic activity.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, March 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' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight EM stocks and have a relative preference due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Credit	+1	Neutral	Strategically, we are overweight global investment grade but have reduced it given the tightening of spreads in recent months. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're neutral investment grade due to tightening credit and financial conditions. We're underweight high yield as we see a recession coming and prefer to be up in quality. We're overweight local-currency EM debt – we see it as more resilient with monetary policy tightening further along than in DMs.
Govt bonds	Neutral	-1	We are neutral in our strategic view on government bonds. This reflects an overweight to short-term government bonds and max overweight to inflation-linked bonds. We remain underweight nominal long-term bonds: We think markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium. Tactically, we are underweight long-dated DM government bonds for the same reason. We favor short-dated government bonds – higher yields now offer attractive income with limited risk from interest rate swings.
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, March 2023

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

	Asset	View	Commentary
Equities	**Developed markets**	-1	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy 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 developed markets thanks to energy sector exposure.
	Japan	-1	We are underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
	Emerging markets	+1	We are overweight and have a relative preference over DM stocks due to China's powerful restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
	China	+1	We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.
	Asia ex-Japan	Neutral	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
Fixed Income	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	+2	We are overweight. We prefer very short-term government paper for income given the potential for a sharp jump in Fed rate expectations.
	Global inflation-linked bonds	+2	We are overweight. We see breakeven inflation rates underpricing the persistent inflation we expect.
	Euro area govt 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. Investors could demand more compensation for long-term bonds amid high inflation and fiscal challenges. We like short-dated gilts.
	China govt bonds	Neutral	We are neutral. We find their yield levels less attractive than those on DM short-term government bonds.
	Global IG credit	Neutral	We are neutral. We see tighter credit and financial conditions. We prefer European investment grade over the U.S. given more attractive valuations.
	U.S. agency MBS	Neutral	We're neutral. We see agency MBS as a high-quality exposure within diversified bond allocations. But spreads near long-term averages look less compelling.
	Global high yield	-1	We are underweight. We think spreads are still too tight, given our expectation for tighter credit and financial conditions – and an eventual recession.
	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	+1	We are overweight. We prefer income in EM debt with central banks closer to turning to cuts than developed markets – even with potential currency risks.
	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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