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Weekly commentary

BlackRock

April 3, 2023

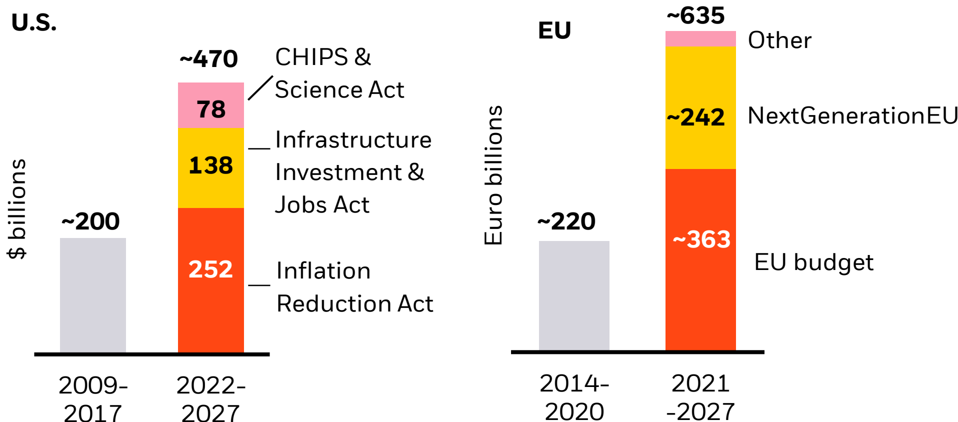
Implications of clean energy race

- We see the U.S. policy push for leadership in clean tech and Europe's fast-developing response creating near-term and strategic investment opportunities.
- Risk assets rallied amid stabilizing sentiment toward banks. Yet the disconnect between sticky inflation and market expectations of rate cuts persists.
- This week, we're watching U.S. employment data to gauge how tight the labor market remains. We see wage pressures contributing to persistent inflation.

U.S. industrial policy has sparked a global clean energy race, we believe, opening up investment opportunities that so far have gone largely under the radar. It's key not to lose sight of such profound policy developments amid market volatility. The U.S. already has strong incentives for domestic clean-tech production. The European Union (EU) now aims to speed up deployment of funds and to build out clean tech at home, driven by a search for energy security and competitiveness.

Clean energy rush

U.S. and EU pledged transition funding



Source: BlackRock Investment Institute, Rocky Mountain Institute and European Commission, December 2022. Notes: The chart shows pledged funding (colored bars) versus previous funding (gray bars) by region taken from "Congress's Climate Triple Whammy: Innovation, Investment, and Industrial Policy;" "Long-term EU budget 2021-2027 and recovery package;" "Fit for 55: Council and Parliament reach provisional deal …;" "Factsheet on Financing REPowerEU."

The U.S. Inflation Reduction Act of August 2022 unleashed a slew of production incentives in areas tied to the transition to lower carbon emissions. The EU already had robust transition policy. An expanded carbon pricing program encourages EU firms to expedite transition plans, with the price of carbon recently passing €100 per tonne. The EU also had put even more public investment in aggregate on the table (see the chart). But an estimated $400 billion of that is still unspent, and the EU had less focus on encouraging domestic production of low-carbon technology. The EU responded to the U.S. this year with its Green Deal Industrial Plan (GDIP). This aims to boost European manufacturing of key transition technologies via domestic production targets, provide easier access to funding and fast-track permitting. The resulting growth in these areas is not always fully reflected in markets, in our view, creating global investment opportunities.

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The U.S. and European policy initiatives are about getting a slice of the growing clean-tech pie and reducing reliance on China for minerals and metals needed for the transition, in our view. We see this as the start of a clean energy race as countries rush to adopt similar policies – a strategic priority against a backdrop of growing geopolitical fragmentation. The UK, Canada and Australia are all set to jump in, and this race fits with our view that the transition is likely to accelerate.

The EU has most at stake to ensure energy security as the West shuns Russian oil and gas, we think, and U.S. policy has shifted focus to domestic production. The EU has extended until the end of 2025 the temporary state aid rules introduced in response to the pandemic, renaming them the Temporary Crisis *and Transition* Framework. If implemented, this will make it easier for member states to offer similarly generous subsidies to prevent an exodus of clean-tech firms and capital to the U.S. The EU's plan could unleash more extensive public funding for European clean-tech production. But questions remain: Will member states agree to step up spending within the new rules? Can they afford to given the estimated $350 billion already spent on energy bill support for consumers last year? Can they cut more red tape? And will the EU's energy windfall taxes deter businesses and investors anyway?

The investment implications of these new policies depend on earnings impact and what's already reflected in market prices. We think the potential growth implications for selected transition-linked assets are not fully reflected – creating opportunities to add to returns. U.S. stocks seen as benefitting from recent transition policy jumped ahead of EU peers after the Inflation Reduction Act passed – the latter still show little impact from the GDIP, our analysis shows. Sustained growth of global energy demand and the West's shunning of Russian supplies mean we see ongoing demand for traditional energy – even with rapid growth of clean-energy production. Both traditional energy and renewable energy stocks outperformed their benchmarks last year, we find. Portfolios that exclude traditional energy are unlikely to be as resilient to the expected bumps in the transition to a lower-carbon economy, in our view. We think the new regime of more persistent and volatile inflation is likely to manifest in the transition as mismatches of supply struggling to meet rapidly increasing demand and investment.

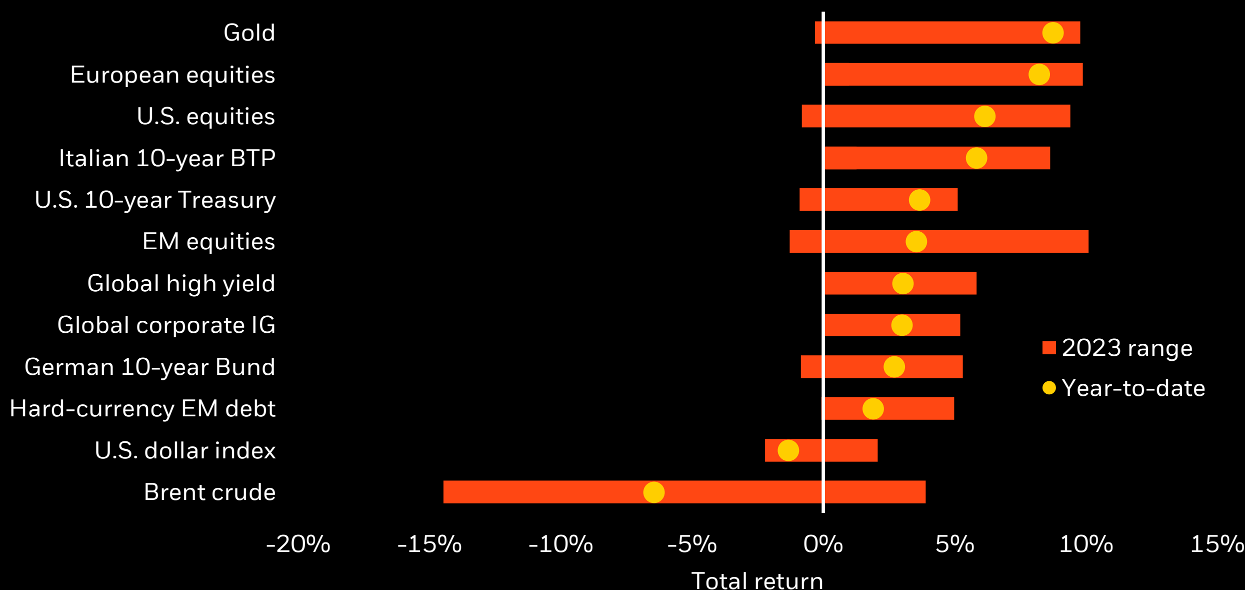
Bottom line: We see opportunities within transition-linked assets and stay nimble and selective for global diversification as a clean energy race heats up. We favor inflation-linked bonds on the potential for supply and demand imbalances in the transition and see real assets like infrastructure providing long-term hedging against inflation.

Market backdrop

Risk assets rallied this week amid stabilizing sentiment on banks to close a tumultuous quarter. Yet the disconnect between sticky inflation and market expectations of rate cuts persists. The Nasdaq – up nearly 20% in the first quarter of 2023 – had its best quarter in nearly three years. The two-year U.S. Treasury yield has steadied around 4.0% – about 1 percentage point below the 16-year high from early March with markets still eyeing two quarter-point Federal Reserve rate cuts this year.

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 30, 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

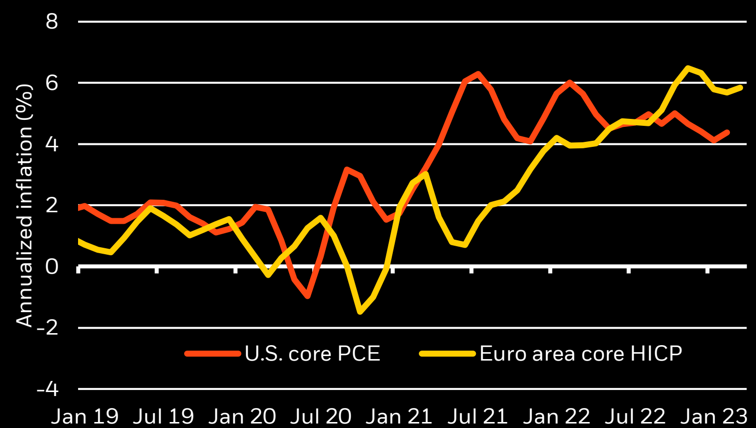
Core inflation is proving stubborn in both the U.S. and euro area, data showed last week. We don't see it stabilizing back at central banks' 2% targets any time soon. See the chart.

Why not? Goods prices have started falling as consumer spending normalizes back towards pre-Covid patterns – fewer goods, more services. That's bringing overall inflation down from its highs. Yet a persistent shortage of workers in both economies, even if for slightly different reasons, is causing wages to rise rapidly – and that's feeding into higher services prices, keeping services inflation elevated.

We don't expect those shortages to resolve any time soon – that is why we expect services prices to keep overall inflation high and sticky this year. As a result, we think the Federal Reserve and European Central Bank will keep interest rates high: The only way to ease those price pressures amid a worker shortage is to crush demand and spending so fewer workers are needed. That would ease pay pressures and, in turn, services inflation. Explore all of our recent Macro take blog posts here.

U.S. and Europe face sticky inflation

Three month on three month annualized core inflation, 2019-2023



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis and Eurostat, with data from Haver Analytics, April 2023. Note: The chart shows core inflation rates for the U.S. and euro area. U.S. core PCE excludes energy and food. Euro area core HICP excludes energy, food, alcohol and tobacco. We use seasonally adjusted data and express as the change in the average price level of the past three months over the three months before that, annualized.

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.
- Very short-term government paper looks more attractive for income at current yields, and we like their ability to preserve capital. Tighter credit and financial conditions reduce the appeal of credit.
- 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.

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Week ahead

April 3	U.S. ISM manufacturing PMI	**April 6**	China Caixin services PMI
April 5	U.S. ISM services PMI	**April 7**	U.S. payrolls and unemployment

This week U.S. payrolls will help indicate how tight the labor market remains and how resilient companies have been to the rapid rate hiking cycle. We see wage pressures contributing to persistent inflation. We're also watching PMI data in the U.S. to gauge if tightening policy is causing manufacturing activity to contract further and if service strength is waning.

Directional views

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

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, April 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. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
	Europe	-1	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
	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 market pricing underestimating the risk of persistently higher inflation.
	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
	UK gilts	-1	We are underweight. Gilts won't be immune to the factors we see driving DM bond yields higher. We prefer short-dated gilts for income.
	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM 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 due to China's restart, and we see EM debt as more resilient to tightening financial conditions than DM as EM hiking cycles near peaks.
	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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