

# Weekly commentary

February 6, 2023

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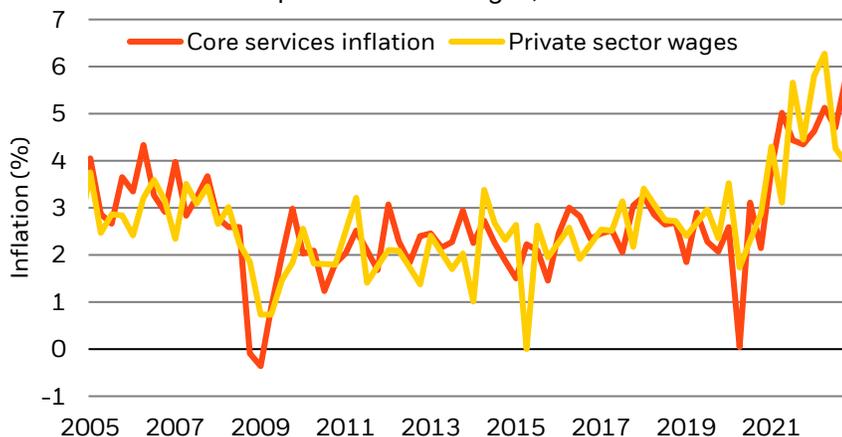
## Stumbling to new inflation fight phase

- We see central banks stumbling into a more nuanced phase of the inflation fight and nearing a pause on hikes. We like short-term bonds and credit for income.
- U.S. stocks rose but trimmed gains and Treasury yields jumped after U.S. jobs data showed a tight labor market, reviving expectations for Fed rate hikes.
- China inflation data out this week may show early signs of how the rapid restart from Covid lockdowns is affecting China’s economy.

Central banks are stumbling into a nuanced phase of policy tightening after major macro events last week. Lower energy and goods prices are pulling down overall inflation. Yet tight job markets should keep wage growth above levels needed for core inflation to fall to 2% targets, reflected in a 54-year low for unemployment in the U.S. We see central banks close to pausing hikes: Major economies will see mild recessions but lingering inflation. We like short-term bonds and credit.

## Wages key for core inflation

Services inflation and private sector wages, 2005-2022



Source: BlackRock Investment Institute, U.S. Bureau of Economic Activity, U.S. Bureau of Labor Statistics, with data from Haver Analytics, February 2023. Notes: The chart shows annualized quarter-over-quarter inflation of U.S. personal consumer expenditure (PCE) services inflation excluding energy services and the U.S. Employment Cost Index measure of annual private sector compensation.

Last year, major central banks took a “whatever it takes” stance on inflation. We saw this as phase one of their policy response in a new regime. We thought they’d one day pause their hikes and shift to more nuanced messaging when economic damage became clearer, then live with some inflation – phase two. Last week’s mixed messages imply they’re stumbling into phase two sooner than we thought and before the damage is fully clear – but we’re not there yet. Inflation is cooling, but it’s not on track to return to target. Some supply disruptions that fed inflation are resolving, and falling goods and energy prices are lowering headline inflation. The outlook for labor markets and wages is key now. We see a shortage of labor in the U.S. and Europe keeping wage growth (yellow line), inflation in the wages-sensitive services sector (orange line) and overall inflation persistently higher.



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Headline inflation, including food and energy, has been falling as consumer spending returns to services from goods. Core services inflation will drive overall inflation as spending normalizes, with the labor market central to how phase two plays out, in our view. Central banks seem to think wage growth can fall with headline inflation as workers dial down demands for pay raises to keep up with prices. The Bank of England (BOE) did so explicitly in forecasts last week, implying a deep recession isn't needed to get inflation to target. Recent job data has been sending inconsistent signals. Notably, Friday's data showed a still-tight labor market that could keep wage pressures high, notwithstanding recent softer data from ECI and payroll firm ADP. We think wage growth could be more persistent: It reflects a tight job market, difficulty hiring and low unemployment.

Signs the Fed is stumbling into phase two: Chair Jerome Powell made inconsistent statements after the Fed hiked 0.25% last week. Powell made clear in his scripted remarks that rates will rise, the Fed isn't eyeing rate cuts and its job to fight inflation isn't done. He also stressed that services inflation – the Fed's main focus – has not shown signs of falling. Yet his unscripted responses sent mixed messages. Powell failed to push back against easing financial conditions that work against the Fed's efforts to bring down inflation. He also seemed to imply the Fed's December economic forecasts were stale. While perhaps unintentional, this disconnect suggests the Fed may be nearing a pause, making communication challenges even trickier.

Other major central banks are facing the same communication challenges. European Central Bank President Christine Lagarde seemed to back down from previous whatever-it-takes language by not repeating that a shallow recession is "not enough" to hit the ECB's inflation goals. She said the risk of ultra-high inflation had receded and lower headline inflation may lessen wage pressures in nearing annual pay negotiations. The BOE upped its 2023 GDP forecast and lowered its inflation forecast. The ECB and BOE raised rates by 0.5% last week, with the ECB set to do so again in March. The Fed, ECB and BOE pausing slightly sooner would reinforce our view they will face milder recessions this year and live with inflation that's fallen a lot but is likely to settle above their targets. That means central banks are unlikely to cut rates as markets increasingly expect.

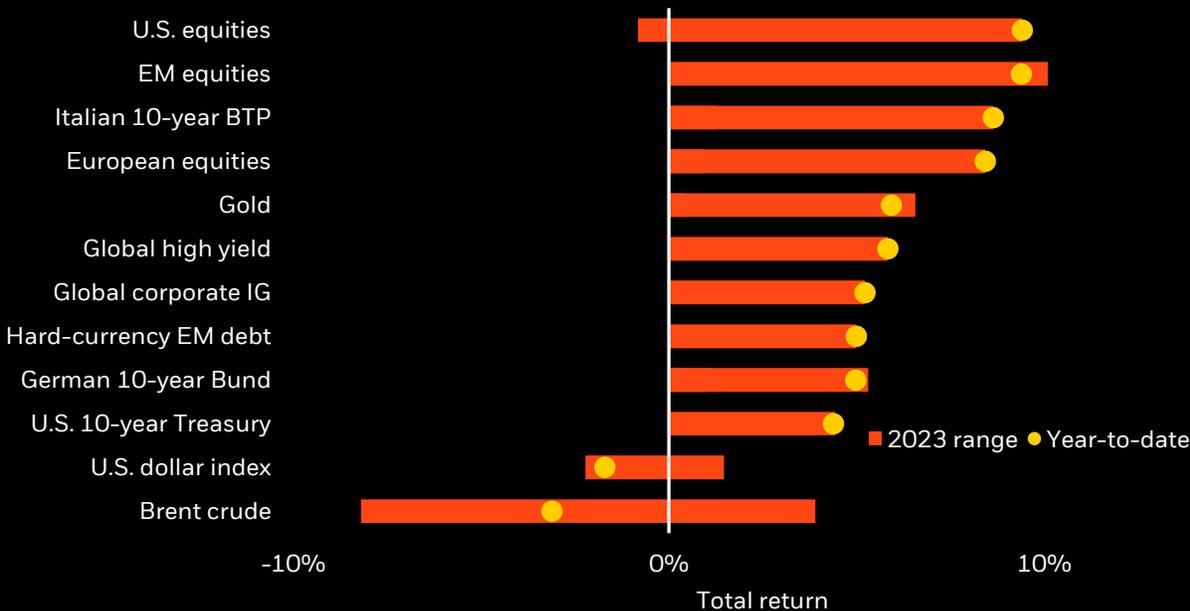
Our bottom line: We like high-quality credit, short-end government bonds and agency mortgage-backed securities for income as interest rates stay higher for longer. We have a relative preference for emerging market stocks. They've largely outperformed developed market (DM) stocks so far this year even as DM peers have rallied on hopes of a growth rebound, prompting some investors to jump in for fear of missing out. DM stocks aren't fully pricing the recession hit we see ahead.

## Market backdrop

U.S. stocks rose on the week, shaking off disappointing earnings, while Treasury yields reversed their drop after the Fed meeting. The U.S. jobs data this week brought back expectations the Fed was set to raise rates further in coming months. We think the key for the market outlook is whether inflation is on track to fall back to 2% targets and whether there will be a recession. Jobs data suggest the Fed has more work to do, even as the market still prices in rate cuts starting later in 2023.

### 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 Feb. 2, 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

U.S. job openings hit a five-month high in December, highlighting the tightness in the labor market – a key driver of ongoing wage pressures. See the chart.

We think tight labor markets in the U.S. and Europe reflect a problem of constrained supply – rather than a sign of economic strength. In the U.S., an aging population and the pandemic prompting earlier retirements has reduced labor participation. In Europe, an expanded public sector has shrunk the pool of workers that private-sector companies can hire from. More broadly, employers also seem to be having greater difficulty filling job vacancies from among those that are unemployed and looking for work due to a skills and experience mismatch.

How tight labor markets get resolved is key to the market outlook, in our view. A shortage of workers means the problem of tight labor markets won't get resolved easily, keeping wage growth high – and inflation more persistent. Read more in our latest [macro perspectives](#).

## A tight labor market

U.S. job openings vs. private sector wages, 2001–2022



Sources: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, with data from Refinitiv Datastream, February 2023. Notes: The chart shows monthly U.S. job openings vs. the year-on-year change in the U.S. employment cost index – a measure of labor costs and wage inflation.

## 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. 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, 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. 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

**Feb. 6**

UK PMI

**Feb. 10-17**

China total social financing

**Feb. 10**

China CPI; UK GDP; University of Michigan consumer sentiment survey

We're watching China inflation data for the first signs of effects from the economy's restart after Covid lockdowns. Low inflation has allowed policymakers in China to keep policy supportive – but the rapid restart may prompt a change. China's total social financing will be closely watched to see how current policy is translating into credit flowing into the economy.

## Directional views

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

		Underweight	Neutral	Overweight	● Previous view
Asset	Strategic view	Tactical view			
<b>Equities</b>	<p style="text-align: center;">+1</p>	<p style="text-align: center;">-1</p> <p>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.</p>			
<b>Credit</b>	<p style="text-align: center;">+2</p>	<p style="text-align: center;">+1</p> <p>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.</p>			
<b>Govt bonds</b>	<p style="text-align: center;">-1</p>	<p style="text-align: center;">-1</p> <p>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.</p>			
<b>Private markets</b>	<p style="text-align: center;">-1</p>	<p style="text-align: center;">—</p> <p>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.</p>			

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, February 2023

Asset	View	Commentary
<b>Developed markets</b>	-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.
<b>China</b>	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.
<b>Emerging markets</b>	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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