Weekly commentary

BlackRock

June 20, 2023

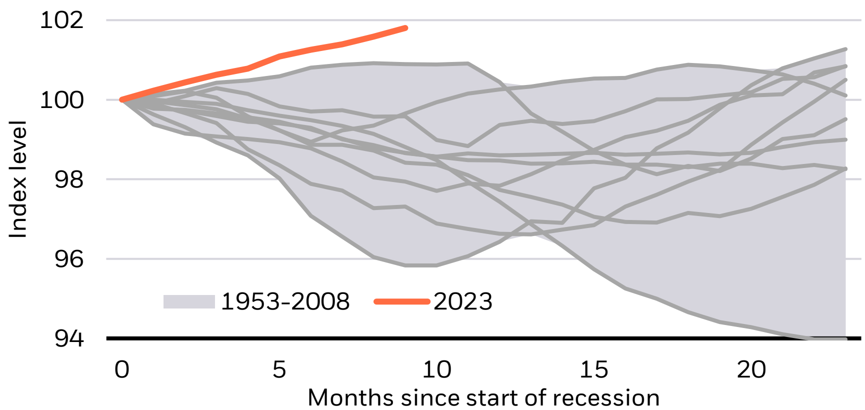
Central banks compelled to hold tight

- Sticky inflation is leading major central banks to keep policy tight. We prefer emerging market debt as policy loosens and like short-dated bonds for income.
- Developed market short-term bond yields jumped after central banks signaled more rate hikes to come. We see rates staying higher for longer.
- This week's PMIs will help gauge how much rate hikes have cooled activity. We already see signs that a mild recession has unfolded in the U.S. and euro area.

Sticky inflation looks to compel developed market (DM) central banks to crank policy rates higher – and keep policy tight for longer. The Federal Reserve paused last week but pointed to more hikes on the way. The European Central Bank (ECB) raised rates and made clear it wasn't done. Others hiked after earlier pauses. We prefer emerging market (EM) debt due to looser policy potential, like recent rate cuts in China. We also like income opportunities such as short-dated bonds.

Jobs-growth disconnect

U.S. non-farm payrolls in recessions, 1953-2023



Source: BlackRock Investment Institute, Bureau of Labor Statistics. with data from Haver Analytics, June 2023. Notes: The chart shows U.S. non-farm payrolls indexed around recession peaks as defined by the National Bureau of Economic Research. 2020 is excluded from the sample. The red line is indexed to Q3 2022 prior to the start of the contraction in the average of GDP and growth domestic income (GDI).

Labor shortages are fueling wage growth, keeping core inflation elevated. That has led the Fed to double down on a "whatever it takes" approach to fighting inflation: Last week it signaled more hikes in the same meeting where it paused. This is happening as central banks in Australia and Canada resumed hikes after attempted pauses – and as the ECB hiked again. We think the Fed and ECB appear to be underappreciating the existing damage from hikes. The Fed revised its growth forecast up based on historically low unemployment. The Fed may be relying on a job and growth relationship that has broken, in our view. Labor shortages have made firms reluctant to let workers go, even as demand slows and growth stagnates. That has made job growth look resilient (orange line in the chart) in recent months compared with weaker jobs data in past recessions (gray lines), even as some data suggest recession may have already arrived.

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BlackRock **Investment** Institute

A broad measure of activity that in the past has been a good indicator suggests as much. The average of U.S. gross domestic income and GDP has contracted for two consecutive quarters. We think the Fed's improved growth forecast ignores the sharp trade-off it faces: crush growth or live with inflation. We think it also exposes an important inconsistency: even higher rates to combat still-high inflation – but with a better growth outlook than previously expected. We don't think the Fed can expect to bring inflation back down so quickly and maintain such an optimistic view on growth. CPI data last week confirmed core inflation is not cooling enough yet for inflation to return to 2%. We prefer short-term government bonds for income as interest rates stay higher for longer.

This new regime of heightened macro and market volatility requires us to constantly assess what is being priced by markets. That helps uncover regional nuance in how markets are interpreting the macro story across DM. The ECB's determination to keep hiking has pushed up euro area government bond yields. The market pricing of hikes by the ECB and the Bank of England have become more extreme than our view: Pricing shows rates for both staying higher for much longer than the Fed while inflation stays elevated. Recent wage data in the UK confirmed the worker shortage and supply constraints plaguing other DMs, but we don't see the inflation problems there or in the euro area as fundamentally much worse than in the U.S. The market pricing in more rate hikes than we think likely is what led us to close our previous underweight on UK gilts in May. We find gilt yields more attractive after having risen near levels reached during 2022's budget turmoil and prefer short-term maturities. We also like global inflation-linked bonds due to persistently higher inflation.

The EM policy picture stands in sharp contrast with DM. EM central banks started hiking sooner and we think their hiking cycles are closer to an end. That's why we like EM local currency debt, especially in Brazil and Mexico. Falling inflation makes room for central banks in the emerging world to loosen monetary policy, we think. Case in point: China cut some policy rates just last week as its economic restart from pandemic lockdowns loses steam. Brazil's central bank governor also hinted last week that the central bank could start cutting rates soon. The market has priced in cuts starting in August through year-end.

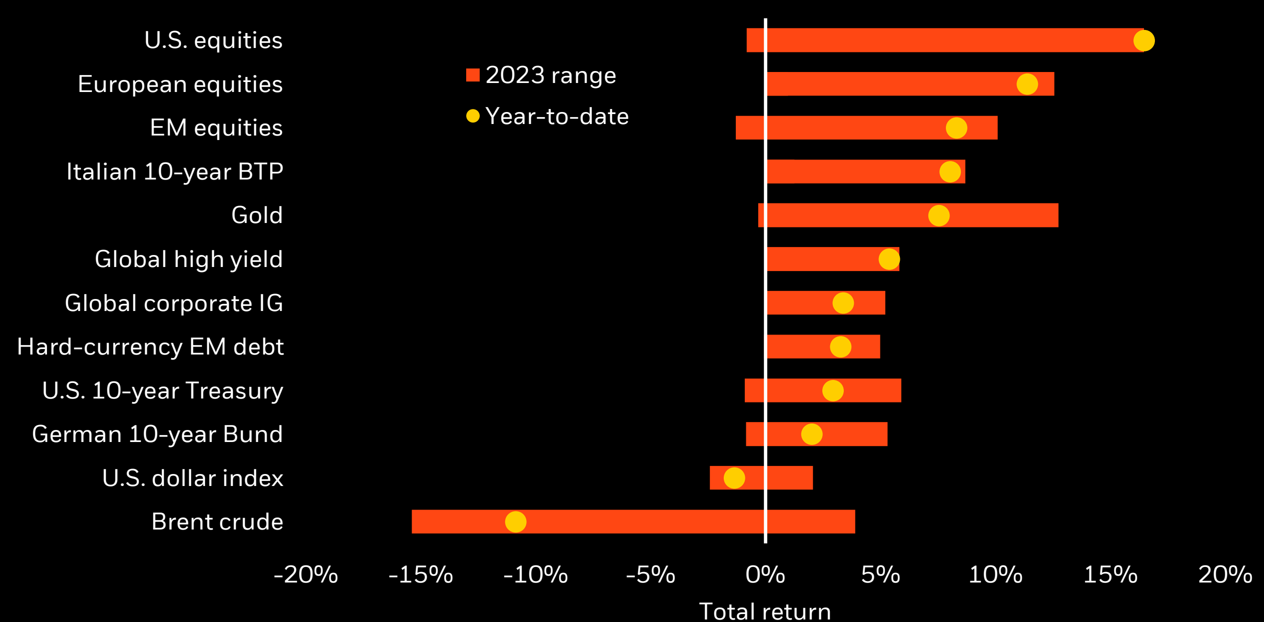
Bottom line: We think tight policy is likely here to stay as sticky inflation compels major central banks to keep policy tight – and likely tighten even further. We see more scope for policy easing in EM – that's why we prefer EM local currency debt. We also like short-dated bonds for income against this backdrop. Read more in our 2023 midyear outlook on June 28.

Market backdrop

Short-term bond yields jumped in the euro area and UK on market expectations for further rate hikes after the ECB's signal and UK data showed surprisingly strong wages. Two-year Treasury yields also rose as the Fed signaled more rate hikes even after a pause. These events confirm the ongoing tightening bias of central banks facing sticky inflation. DM stocks hit new 14-month highs, with gains broadening beyond the mega cap tech shares that have been the big winners 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 June 15, 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

Last week, data showed U.S. core inflation running hot at 5.3% year-on-year in May, as most expected. The surprise? A deeper look shows core goods prices – excluding food and energy prices – have accelerated. See the chart.

We expected goods inflation to keep falling this year, as the surge in U.S. consumer spending towards goods during the pandemic unwound. But it hasn't been smooth. Core goods prices fell sharply at the end of last year but have rebounded – driven by things like used car prices.

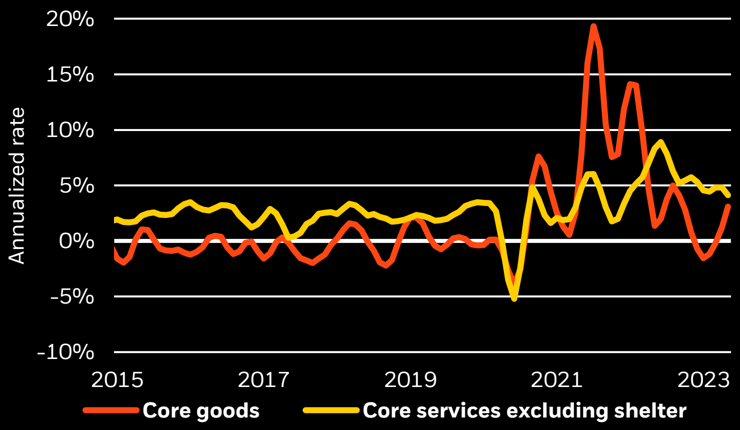
Core services inflation excluding shelter costs is stubbornly high. It reflects wage pressures, especially in contact-intensive service sectors, as firms deal with labor shortages.

Sticky inflation reinforces why the Fed will keep rates higher for longer. We expect inflation to stay high into next year – leaving central banks with no room to cut rates. That's even if activity weakens as the impact of the past year's rate hikes kicks in.

Explore our recent Macro take blog posts here.

Sticky inflation

Three-month on three-month U.S. core inflation, 2015-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, June 2023. Notes: The chart shows the three-month on three-month inflation rate in core goods Consumer Price Index (CPI) and core services CPI excluding rent of primary residence and owners' equivalent rent. Inflation rates are calculated by taking the three-month average of the price level and taking the percent change over the preceding three months.

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.
- The ultimate economic damage depends on how far central banks go to get inflation down. The Federal Reserve paused rates in June but signaled further hikes ahead. The European Central Bank hiked again in June. We see the ECB going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails.
- **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 bonds 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 short-term government bonds 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 Fed's 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

June 20	U.S. housing starts	**June 22**	U.S. existing home sales; Bank of England policy decision
June 21	UK CPI	**June 23**	Japan CPI; global flash PMIs

Global manufacturing and services data will be in focus this week to gauge how much rate hikes have cooled activity. The U.S. has entered a mild recession based on an income measure. So has the euro area, after two consecutive quarters of contracting growth. We think central banks will keep rates higher for longer to fight stubborn inflation even as activity slows.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, June 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	Neutral	Neutral	Strategically, we are neutral global investment grade. We don't think yields compensate investors for tightening credit conditions. 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 stay underweight nominal long-term bonds: Markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium, in our view. Tactically, we're 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	Neutral	—	We're underweight private growth assets and overweight on private credit from a starting allocation that is much larger than what most qualified investors hold. We find private credit yields more attractive than in public credit, and we like its floating-rate nature given our view that policy rates will remain higher for longer than markets expect. We think private credit can help fill a lending gap left by banks after sector turmoil. Overall, 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, June 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 short-term government bonds for income as interest rates stay higher for longer.
	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	Neutral	We are neutral. We find gilt yields attractive as they have risen back near levels reached during 2022's budget turmoil. 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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