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Weekly commentary

BlackRock

June 12, 2023

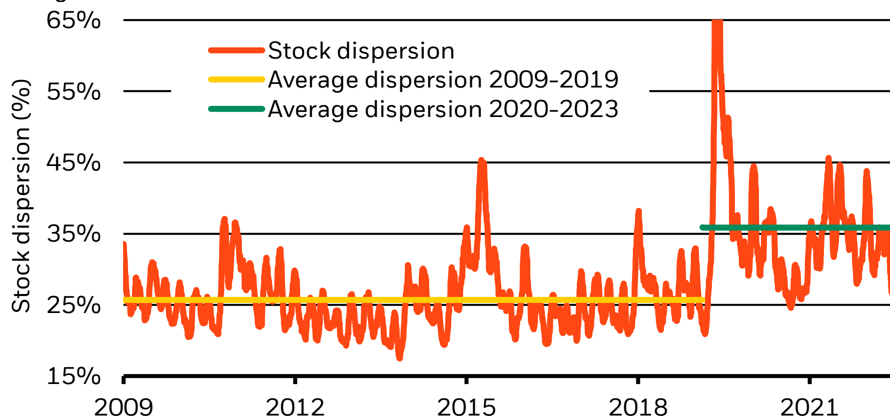
Notes from our Outlook Forum

- BlackRock investment leaders at our Outlook Forum agreed the new regime is playing out. They eye assets that price that in and benefit from structural trends.
- Developed market (DM) stocks ticked up last week, led by U.S. tech. Bond yields rose as markets priced out Federal Reserve rate cuts ahead of its June meeting.
- We see the Fed and the European Central Bank (ECB) keeping rates higher for longer to fight inflation. We think that overshadows rate decisions this week.

BlackRock investment leaders at our June 6-7 Outlook Forum agreed the new regime of macro and market volatility is playing out. The consensus: Granular investment opportunities abound even against that backdrop. Counting on broad market moves won't do now, in our view. That shift comes as U.S. and European economies have entered recession. But we don't see central banks coming to the rescue with rate cuts. We see opportunities in relative pricing and structural trends.

Stock divergence

Range of individual stock returns vs. Russell 1000 index, 2009-2023



Source: BlackRock Investment Institute, with data from Refinitiv, June 2023. Notes: The chart shows the dispersion in Russell 1000 stock returns based on a 21-day moving average (dark orange line), average dispersion from July 2009 after the global financial crisis through 2019 (yellow line), and average dispersion from 2020 through June 8, 2023 (green line).

The average range of individual stock returns versus broad index returns, or dispersion, since 2020 (green line in chart) has jumped about 10 percentage points above the average from 2009 to 2019 (yellow line). We think that reflects the new macro regime and structural changes shaping returns. Forum attendees agreed the new regime of heightened volatility is playing out. We see supply constraints driving higher inflation in the new regime. Persistent inflation makes it unlikely developed market (DM) central banks will cut interest rates this year. The new regime presents central banks with a sharp trade-off between living with some inflation and crushing activity, as we've argued. That shift is in sharp contrast with the four-decade period of steady activity before 2020 known as the Great Moderation. Today's environment offers new opportunities, in our view, thanks to market divergences and structural changes playing a bigger role.

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BlackRock **Investment** Institute

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Roughly 100 of BlackRock's portfolio managers, executives and experts gathered in London for our semiannual forum to debate the macro and market outlook. They agreed the new regime calls for getting more selective and dynamic in making investment decisions. That approach starts by first assessing to what extent assets are pricing in the economic damage from rate hikes. They're also eyeing relative pricing divergences across sectors and regions. A case in point: We think emerging market (EM) stocks better price in the damage we expect than developed market (DM) peers. EM stocks and local currency debt also benefit from China's economic restart, EM hiking cycles nearing an end and a broadly weaker U.S. dollar.

Megaforces, or structural changes shaping returns now and longer term, were also top of mind. Investment decisions need to reflect them, in our view – even within a cautious macro outlook. We see some megaforces already playing out: There is a widening disconnect between bond and stock pricing of the macro environment. The market's hopes artificial intelligence (AI) will gain widespread adoption may help explain that gap. Just a few technology firms valued over $200 billion are carrying the U.S. equities rally so far this year, and upbeat tech earnings expectations are reinforcing the gains. Other megaforces include aging populations, geopolitical fragmentation causing a rewiring of supply chains and the transition to a lower carbon economy. These forces are likely to be largely inflationary over time, though AI could eventually help lessen inflationary pressure as it delivers productivity gains.

We focus on other methods of generating additional returns as the macro outlook itself calls for keeping risk low. Core inflation has fallen from its highs but remains above the Fed and ECB's 2% policy targets. We think tight labor markets are driving wage gains and making core inflation sticky – even as the U.S. and European economies have arguably slipped into recession. In particular, the U.S. lacks enough workers to fill job openings, while in Europe, workers have left the private sector for the public sector. Tight labor markets could squeeze corporate profit margins or force companies to trim workforces to maintain profits. These dynamics mean broad asset class exposure may not generate the same level of returns as in the past.

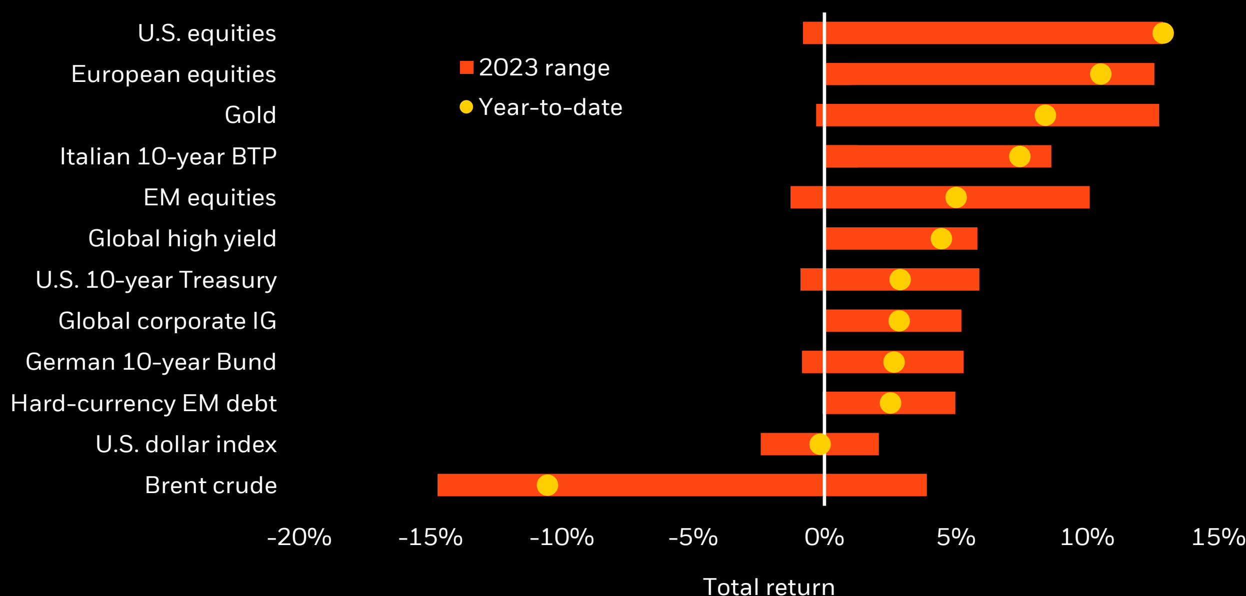
Bottom line: Forum participants agreed that the new regime keeps playing out as central banks' rate hikes start to kick in, but they debated the extent of the economic damage. We think the new macro regime still offers abundant, if different, investment opportunities relative to the past with the right approach. Read more in our 2023 midyear outlook on June 28.

Market backdrop

DM equities posted slight gains last week, with U.S. tech stocks pushing to 14-month highs. Short-term yields led an overall rise in government bond yields as markets further priced out Fed rate cuts later in the year heading into next week's meeting. The U.S. economy is in recession based on some income-based measures, while euro area Q1 GDP data confirmed it slipped into a mild recession. Last week's U.S. services activity data also showed the sector barely grew in May.

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 8, 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.

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Macro take

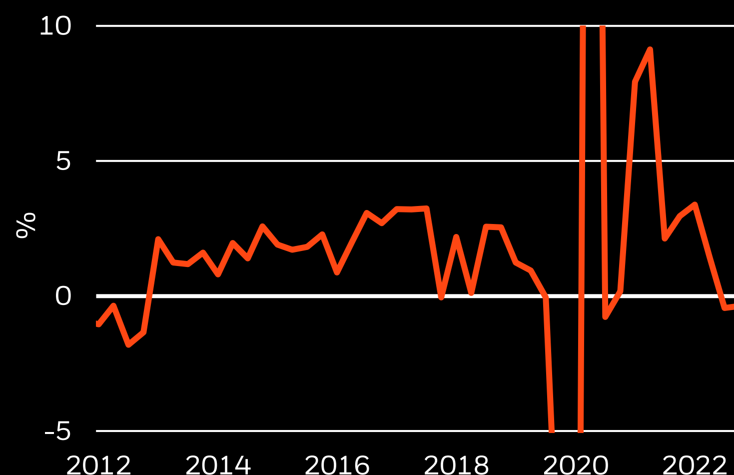
The euro area is in a technical recession. Activity shrank slightly over the Q4 2022 and Q1 2023 period on an annualized basis, meeting the technical definition of two straight quarters of contraction. See the chart. Consumption and investment declined over that period, with exports being the main positive contribution to economic activity.

This is why we think we are in a new regime of greater economic and market volatility. Activity across developed economies has been weak for some time – but core inflation remains stubbornly high. Supply constraints have significantly reduced how much economies can produce without sparking inflation.

That means central banks are set to keep interest rates at restrictive levels, in our view, crushing demand back to levels more consistent with that of constrained supply. We see tighter monetary policy bringing inflation down over the next year – but not back to 2% policy targets. We think that makes policy rate cuts before mid-2024 unlikely. Explore our recent Macro take blog posts here.

Euro area activity contracts

Quarterly real GDP growth, 2012-2023



Source: BlackRock Investment Institute, Eurostat, with data from Haver Analytics, June 2023. Notes: The chart shows quarter-on-quarter growth in euro area real GDP, expressed at an annualized rate.

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 signaled a pause after hiking rates in May. But it also reiterated that persistent inflation means no rate cuts this year. We see the European Central Bank 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.
- 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 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.

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Week ahead

June 13	U.S. CPI	**June 15**	ECB policy decision; U.S. industrial production
June 14	Fed policy decision	**June 16**	Bank of Japan policy decision; University of Michigan sentiment survey

Major central banks take center stage this week. We see rates staying higher for longer because of stubbornly high inflation, driven by wage pressures in tight labor markets. Central banks face a sharp trade-off: crush growth or tolerate some above-target inflation. We see the Fed eventually living with some inflation but see the ECB resolved to bring it down to target.

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.

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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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