Weekly commentary

BlackRock

February 7, 2022

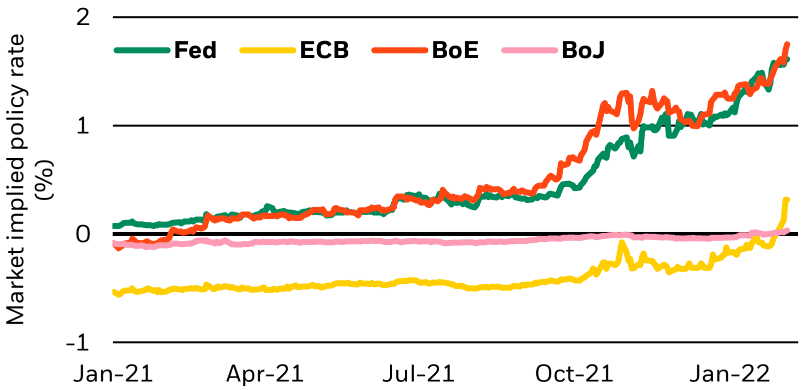
Market view of rate hikes too hawkish

- Markets are pricing in ever more rate hikes amid hawkish policy signals. We see the eventual outcome as more benign–but brace for volatility along the way.
- Bond yields rose across the globe after hawkish policy moves, record euro area inflation, and much stronger-than-expected U.S. employment trends.
- U.S. CPI will be in focus as the Fed is set to start raising rates amid 40-year high inflation. We still see a historically low sum total of rate hikes supporting stocks.

Central banks are giving ever more hawkish signals to appear to be responsive to surging inflation. Normalizing policy rates to pre-pandemic levels makes sense to us, as the powerful economic restart does not need stimulus. Markets are betting they will raise rates well beyond that. We disagree, as such policies wouldn't contain inflation without a heavy toll on growth. This is why we believe central banks will live with inflation for years to come as the world shifts to decarbonize.

Sharp rate shift

Market pricing of future policy rates, 2021-2022



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, 4 Feb. 2022. Notes: The chart shows the pricing of expected central bank policy rates via forward overnight index swaps. The rate shown is the one-year OIS rate expected starting one year from now.

Inflation keeps surprising to the upside, and central banks are quickly pulling back emergency stimulus. The European Central Bank (ECB) last week suggested an early end to asset purchases that have underpinned European bond markets. The Bank of England (BoE) again raised rates, and nearly half of its policymakers wanted a bigger rise. Clearly, this is a big deal. Yet markets are ratcheting up expectations of future rate hikes ever higher, as the chart shows. Even the easing stalwart ECB is now expected to raise rates above zero this year (the yellow line). Market expectations may go higher yet, but we think they are already overdone: Fewer rate hikes will actually be delivered. We believe central banks are talking tough but ultimately will acknowledge that fighting inflation by aggressively hiking will come at too high a cost to growth. Why? Today's inflation is driven by supply bottlenecks, energy mismatches and resources reallocation. This is why we see the eventual policy response as muted–but brace for bouts of volatility.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BlackRock **Investment** Institute

We trimmed risk heading into 2022 because we thought confusion over the macro backdrop could stress markets. The confusion now is stemming from central banks, in our view. Many are opportunistically framing policy normalization to pre-pandemic levels as "fighting inflation." Normalization is prudent, in our view, but justifying it as fighting supply-driven inflation is not. This is not a typical recovery, with a surge in demand overheating the economy, but a *world shaped by supply* where growth is still below potential. Central banks already have accepted more inflation, and we see this continuing given the costs of pushing it down. The problem: The tough talk may open a Pandora's box of risks. Central banks may undermine their credibility. Markets could keep pricing in ever more rate rises, increasing the risk of market stresses. Yield spreads between peripheral European bonds and German bunds already widened significantly last week. All this translates into more volatility for now – even as we believe the eventual policy response to inflation will be historically muted.

Tough policy choices and bouts of market volatility are here to stay, we believe. Why? We expect the transition to reach net-zero carbon emissions by 2050 to transform the macro environment. Will it hurt growth or be inflationary? Compared with the past, yes. But we believe the rear-view mirror is irrelevant for what's ahead. Climate change is here. An orderly transition should boost growth and mitigate inflation versus no climate action or an eventual rush to decarbonize, in our view. Energy prices are a key part of the supply-driven inflation story. Overall production costs will likely rise as the world shifts away from carbon-intensive energy sources. We see this happening whether the shift is prompted by carbon taxes, regulations or consumers simply choosing to pay more to avoid climate damages. The transition's resource re-allocation will add to inflation, in our view, as demand and supply shift across companies and sectors. Understanding how the net-zero journey will unfold has never been more important. See *Managing the net-zero transition*.

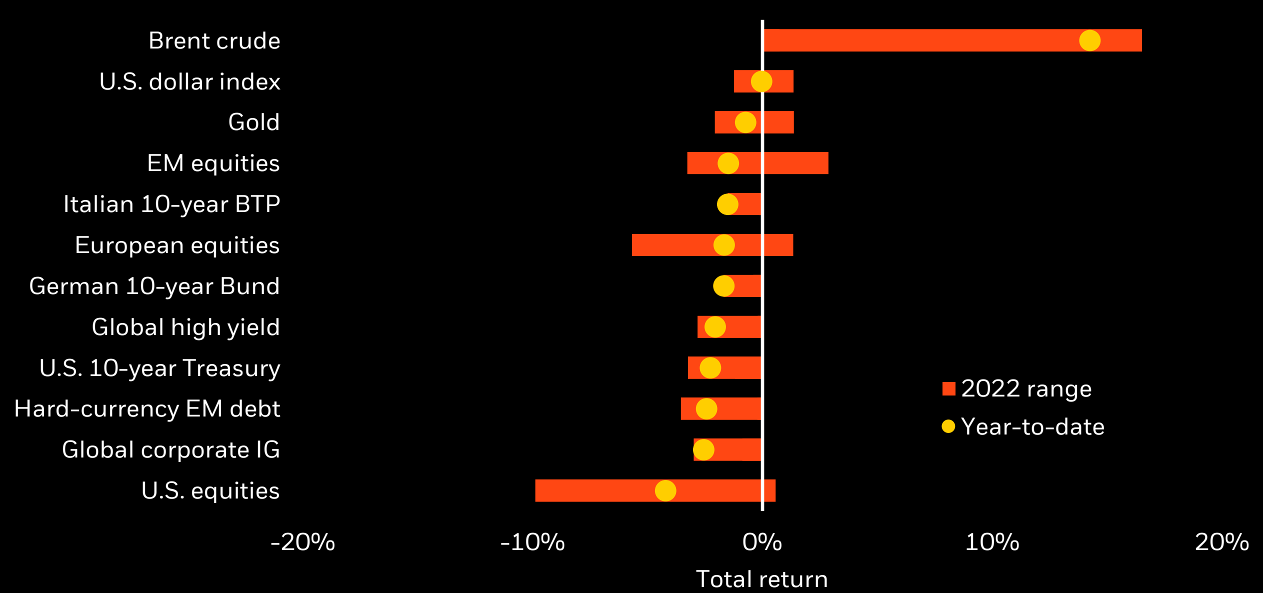
Our bottom line: Many central bankers want to be seen as doing something about inflation, if only for fear of being seen out of touch. Markets are egging them on by pricing in ever more hawkish policy moves. Our compass: It's not about what central banks say; it's about what they will have to do. Central banks eventually will be forced to live with inflation, we believe, given the macro backdrop. We are underweight developed market government bonds as we see investors increasingly demanding higher compensation for the risk of holding government bonds. We keep our modest overweight on equities because of the still-low sum total of expected policy rate hikes, but are bracing for bouts of volatility along the way. We see this creating opportunities for those with long investment horizons after a tough start for risk assets this year.

Market backdrop

Bond yields jumped around the globe amid hawkish policy signals and strong economic data. The ECB suggested it would wrap up its asset purchases earlier than expected and declined to rule out a rate increase this year after euro area inflation rose to a record 5.1%. The BoE raised rates again, and the latest U.S. jobs trends were much stronger than expected. What's key: The cumulative pricing for rate hikes hasn't changed and is a historically muted response to higher inflation.

Assets in review

Selected asset performance, 2022 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 February 3, 2022. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, 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 insights

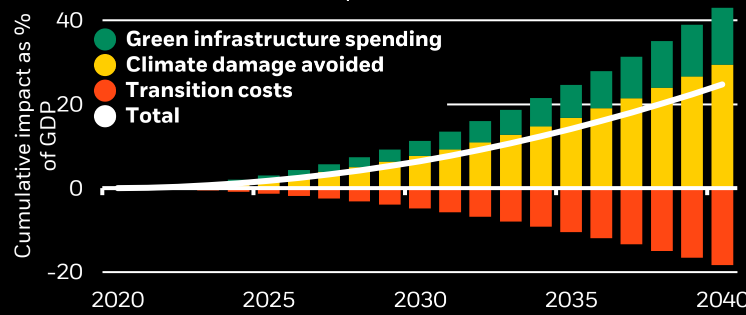
The popular notion that tackling climate change comes at a net economic cost is wrong, in our view. Sure, economic outcomes would be even better if there were no climate change. But that's the wrong starting point for comparisons because climate change is real.

A gradual and orderly transition to net-zero emissions by 2050 will help mitigate pressure points that could disrupt economic activity and drive up inflation, in our view. This will allow time to make the necessary investments, phase out carbon-intensive activities, redeploy workers, and develop new technologies to power the net-zero economy.

No climate action or a disruptive transition would be worse for inflation and growth, in our view. All in all, we estimate an orderly transition results in a 25% cumulative gain in global growth over the next 20 years. The chart shows how we believe the positive effects of avoiding climate damages (yellow bars) and green infrastructure spending (green bars) would far offset the cost of the transition itself (red bars). See our macro insights hub.

Net-zero transition = net economic gain

Estimated cumulative GDP impact of transition, 2020-2040



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, Banque de France, IEA, OECD, Feb 2022. Notes: The bars show the overall estimated impact of three factors: climate damages avoided (positive), green infrastructure spending (positive) and transition-associated costs (negative). The black line shows the estimated net impact. Our estimates of the impact under a climate-aware scenario are based on expected energy consumption changes including composition, relative carbon and renewables pricing and on potential losses due to global warming. Energy consumption is estimated as a function of GDP and the relative price of energy per Banque de France working paper no. 759. GDP losses from global warming are calibrated on analysis of Impact Assessment Models (W. Nordhaus and A.Moffat, 2017). We assume green infrastructure spending programs of 1% of GDP gradually phased out over the next 10 years.

Investment themes

1 Living with inflation

- We expect inflation to be persistent and settle above pre-Covid levels. We expect central banks to kick off rate hikes but remain more tolerant of price pressures, keeping real interest rates historically low and supportive of risk assets.
- Inflation is being driven by the unusual restart dynamics of extraordinary demand bumping up against supply bottlenecks. We expect many supply-demand imbalances to resolve over the year.
- The policy response to rising inflation isn't uniform. Developed market (DM) central banks have already demonstrated they are more tolerant of inflation, even as several are gearing up to kick off rate hikes with steeper initial increases. The Bank of England and many emerging market (EM) counterparts have already lifted off.
- The Fed has achieved its new inflation goal to make up for past misses and sees it has met its full employment mandate. This is the justification for kicking off rate hikes soon, likely in March. Still, we believe the total sum of hikes is unchanged and historically muted – and that's more important to markets.
- The Fed has sped up its tapering of bond purchases and has indicated it may start to trim its balance sheet earlier than expected by letting bonds run off when they mature. The European Central Bank has also indicated it may wrap up its asset purchases earlier than expected.
- **Investment implication**: We prefer equities over fixed income and remain overweight inflation-linked bonds.

2 Cutting through confusion

- A unique mix of events - the restart of economic activity, virus strains, supply-driven inflation and new central bank frameworks - could cause markets and policymakers to misread the current surge in inflation.
- We keep the big picture in mind: We see the restart rolling on, inflation meeting a muted central bank response, and real rates remaining historically low.
- We do see increasing risks around this base case: Central banks could revert to their old policy response, and growth could surprise on the upside or disappoint.
- There's also a risk markets misread China's policy. The country has emphasized social objectives and quality growth over quantity in regulatory crackdowns that have spooked some investors. Yet policymakers can no longer ignore the growth slowdown, and we expect incremental loosening across three pillars - monetary, fiscal and regulatory.
- **Investment implication:** We have trimmed risk-taking amid increasing risk central banks may slam the brakes.

3 Navigating net zero

- Climate risk is investment risk, and the narrowing window for governments to reach net-zero goals means that investors need to start adapting their portfolios today. The net-zero journey is not just a 2050 story, it's a now story.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. The green transition comes with costs and higher inflation, yet the economic outlook is unambiguously brighter than a scenario of no climate action or a disorderly transition. Both would generate lower growth and higher inflation, in our view.
- Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions.
- We favor sectors with clear transition plans. Over a strategic horizon, we like sectors that stand to benefit more from the transition, such as tech and healthcare, because of their relatively low carbon emissions.
- **Investment implication**: We favor DM equities over EM as we see them as better positioned in the green transition.

Week ahead

Feb. 7	China Caixin Services PMI	**Feb. 10**	China total social financing
Feb. 10	U.S CPI inflation	**Feb. 11**	U.S. University of Michigan sentiment: UK preliminary GDP

U.S. CPI data are in focus this week as markets are increasingly pricing in faster and more aggressive Fed rate hikes amid 40-year high inflation. The problem: This is a unique restart that will quickly slow down on its own. Inflation is driven by supply constraints following a huge shift to goods demand, not an overheating economy. So the old policy playbook of aggressively raising rates won't work, in our view. We still see a historically low sum total of rate hikes supporting stocks.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, February 2022

Underweight | Neutral | Overweight

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our overweight on equities on a strategic horizon. We see the combination of low real rates, strong growth and reasonable valuations as favourable for the asset class. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we are overweight equities amid solid economic fundamentals and historically low real rates.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich, and we prefer to take risk in equities instead. On a tactical horizon, we are neutral credit given low spreads across sectors and prefer EM local markets to high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. Within the underweight on nominal DM government bonds, we prefer shorter-dated over long-dated maturities. Rising debt levels may eventually pose risks to the low rate regime. We prefer inflation-linked bonds. Tactically, we trim our significant U.S. Treasuries underweight – we see the direction of travel for yields as higher but think the move is overdone for now. We prefer inflation-linked bonds for interest rate exposure and as a portfolio diversifier.
Private markets	Neutral	—	We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class and 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.

Tactical granular views

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, February 2022

Underweight **Neutral** **Overweight**

Change in view

Previous New

	Asset	Underweight	Overweight	
Equities	**Developed markets**			We are overweight developed market equities. We see still solid growth and low real yields supporting valuations. We prefer to diversify our exposure.
	United States			We are overweight U.S. equities on still strong earnings momentum. We do not see gradual policy normalization posing significant headwinds.
	Europe			We stay modestly overweight European equities given attractive valuations. We believe the rise in Covid infections may stall but not derail the restart.
	UK			We are neutral UK equities. We see the market as fairly valued and prefer European equities.
	Japan			We have a small overweight in Japanese equities. We see a global cyclical rebound boosting earnings growth following underperformance in 2021.
	China			We stay moderately positive on Chinese equities as we see a shift to a slightly easier policy. We expect the regulatory clampdown to last but not intensify.
	Emerging markets			We are neutral EM equities and prefer DM equities, given more challenged restart dynamics and tighter policies in EM.
	Asia ex-Japan			We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China relative to the broad region.
aFixed Income	U.S. Treasuries			We have reduced our underweight to U.S. Treasuries given the yield surge so far this year. Over a longer horizon, we see higher yields as investors demand a higher premium for holding governments bonds.
	Treasury Inflation-Protected Securities			We stay overweight U.S. TIPS as we expect inflation to be persistent and settle at a higher level than pre-Covid. We prefer TIPS for interest rate exposure and diversifiers.
	European government bonds			We keep our underweight on European government bonds. We see yields heading higher. Current market pricing points to no substantive change in monetary policy for several years.
	UK gilts			We are neutral UK Gilts. We see UK policy rates rising before DM peers, yet believe market expectations of the subsequent pace are overdone amid constrained supply.
	China government bonds			We are overweight Chinese government bonds. Potentially easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
	Global investment grade			We stay underweight investment grade credit. We see little room for further yield spread compression and remain concerned about interest rate risk.
	Global high yield			We are neutral high yield. We do not see compression in high yield spreads yet still find the carry attractive. We prefer to take risk in equities.
	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency			We are modestly overweight local-currency EM debt on attractive valuations and potential income. Higher yields already reflect EM monetary policy tightening, in our view.
	Asia fixed income			We stay overweight Asia fixed income. We find valuations in China compelling relative to risks. Outside China, we like Asian sovereigns and credit for income and carry.

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