Weekly commentary

BlackRock

April 24, 2023

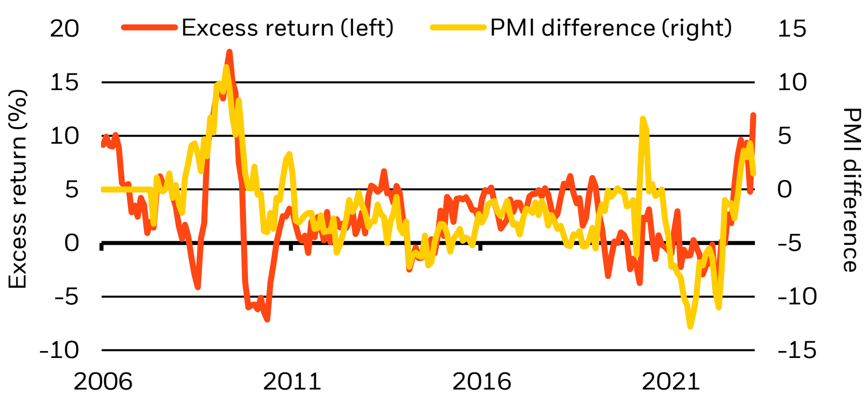
EM assets have the edge – for now

- We are leaning into our preference for emerging market (EM) assets due to China's restart, ending EM interest rate hiking cycles and a weaker U.S. dollar.
- Global stocks were flat on the week. PMI data showed economic activity holding up in the U.S. and Europe. Sticky UK inflation pointed to more rate hikes.
- This week's GDP data in the U.S. and euro area will help gauge the economic damage from rate rises. We see hikes hitting growth later this year.

Our new playbook calls for quickly shifting portfolios based on how much damage is priced in. We went overweight EM stocks and our long-held preference for EM debt in March on a six- to 12-month tactical horizon as they price in more rate hike damage than developed markets (DM). We took advantage of near-term events favoring EM assets: China's economic restart, pausing EM interest rate hikes and a weaker U.S. dollar as the Federal Reserve nears the end of its rate hike campaign.

Relative strength

EM excess total bond returns and activity vs. DM, 2006-2023



Source: BlackRock Investment Institute, Bloomberg, S&P Global and JPMorgan, with data from Refinitiv Datastream, April 2023. Notes: The chart shows 12-month rolling total return of JPMorgan's GBI-EM index minus the 12-month rolling total return of the Bloomberg U.S. Credit USD. This is referred to as the excess return. It also shows the difference between the S&P emerging market manufacturing PMI and U.S. PMI.

It may seem an unusual time to favor EM after major central banks' rapid interest rate hikes. Yet we've seen a clear resilience in EM economic activity (yellow line in chart) even as rising rates have slowed DM activity. Total returns for EM debt have jumped above returns for DM credit since mid-2022 (dark orange line) as a result. A key difference: EM central banks kicked off rate hikes as much as a year before DM peers. Some already stopped hiking, while DM central banks have more to do and likely won't cut rates soon given stubborn inflation. Brazil's central bank has held its policy rate at 13.75% since September. Central banks for India, South Korea and other nations have paused policy rates more recently. Rate cuts would help ramp up EM economic growth sooner than in developed economies. The International Monetary Fund still sees EM GDP growth about three times higher than for advanced economies this year and next, its April forecasts show.

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We don't think EM central banks will need to keep up with DM central banks' rate hikes to avoid currency depreciation. EM currencies have, in fact, gained against the U.S. dollar as the Fed nears the end of its hiking cycle. Plus, EM debt is now more concentrated in local currencies than the dollar, JP Morgan index data show. We think that makes any future weakening in EM currencies easier to handle. This means EM central banks have paused and can begin cutting rates sooner than DM counterparts. We see DM central banks keeping rates higher for longer to fight sticky inflation, making rate cuts this year unlikely. This will all help EM economies keep outpacing developed economies this year, in our view. We turned overweight EM local-currency debt again in March, after having a relative preference for most of last year. While fund flows show investors have favored EM stocks since 2022, flows into EM local debt remain more muted and have the potential to increase.

Even with investors leaning into EM shares, they've underperformed DM stocks for over a decade. We don't think EM shares are reflecting the likely growth outperformance of emerging economies this year. We went overweight EM stocks in February to get short-term exposure to China's restart. The restart helped China's Q1 GDP beat market expectations last week, in line with our view of growth around 6% for the year. It's also helped EM economic activity outpace DM economies since the year started. We expect policy in China to stay supportive given very low inflation, and that benefits EM stocks: Chinese companies make up a large share of major EM equity indexes. The pickup in Chinese demand and tourism should especially boost Asian firms' earnings and shares. Renewed demand for commodities is another positive helping emerging economies such as in Latin America. Longer term, China's powerful restart doesn't change structural trends like aging populations and tensions with the U.S that will drag on long-term growth. We think the geopolitical risk of holding Chinese assets has risen. We see investors demanding more compensation to reflect that and risks from regulatory and government intervention.

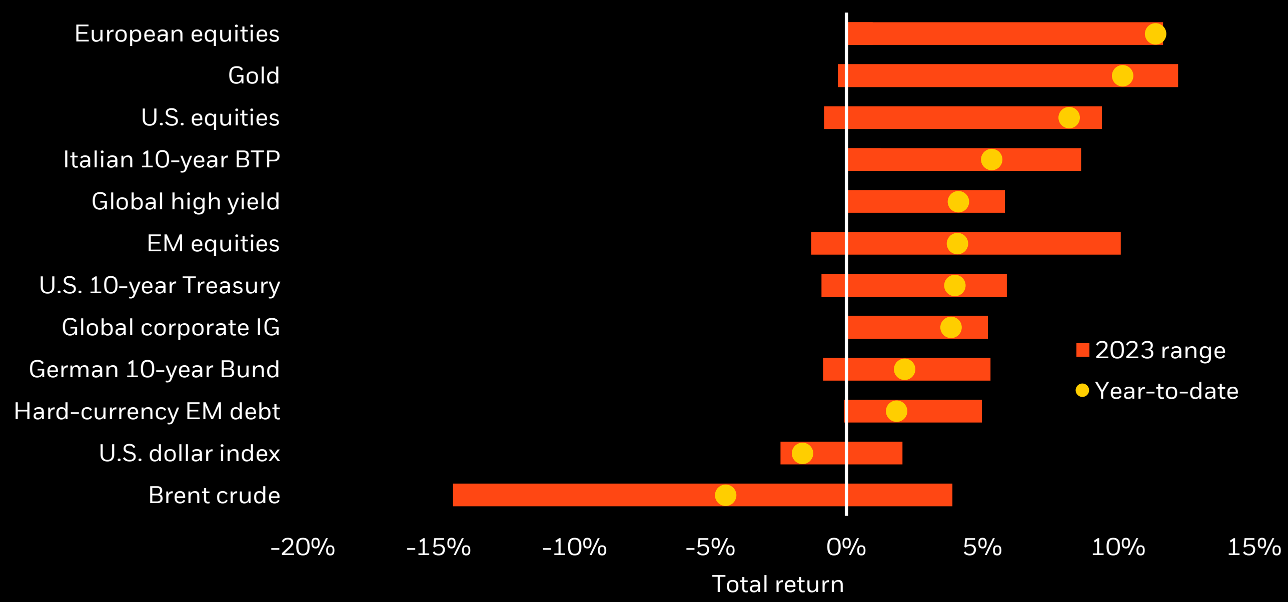
Bottom line: We like EM stocks and bonds over DM in the short run. We also prefer higher-rated countries within EM debt such as Mexico, similar to our overall quality preference – especially within DM equities and credit. Higher-rated countries have falling inflation, more balanced external accounts, adequate currency reserves and lower debt-to-GDP levels. Yet EM assets wouldn't be immune to a risk asset selloff and U.S. dollar surge from more Fed hikes. Our relative views flip on a horizon of five years and over. We see geopolitical risks weighing on EM risk-adjusted returns, so we prefer DM equities in the long run. We also think DM economies will benefit more from the transition to a lower-carbon world than EM on that horizon.

Market backdrop

U.S. stocks paused as European stocks hit a 14-month high last week. U.S Treasury yields largely steadied after a recent rise on expectations for the Fed to hike rates in May. The March UK inflation data showed how sticky inflation is proving across major economies. Sticky inflation and the April PMI data showing economic activity holding up in the U.S and Europe suggest major central banks have more work to do to fight inflation. We don't see them coming to the rescue with 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 April 20, 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

UK inflation remains in double-digit territory: The March data showed the overall CPI still rising at a 10.1% annual rate, above consensus forecasts.

That's largely driven by energy and food prices. Energy prices have started to fall, but food prices are still rising. And crucially for the Bank of England, core inflation – which excludes energy and food prices – is stubbornly high at 6.2%. See the yellow line. Services inflation is the main driver here: Wages are still rising quickly (pink line), even with some improvement in labor supply as more people return to the workforce. We think worker shortages – due to long-term sickness, Brexit and early retirement in the pandemic – will remain a key constraint for the UK economy.

The Bank of England expected those pressures to cool slightly, allowing it to stop rate hikes. But such stubborn inflation highlights the sharp growth-inflation trade-off it faces. The UK economy hasn't recovered to its pre-pandemic level and more rate hikes could mean even more economic damage. Explore our recent Macro take blog posts here.

Running hot

UK inflation and wages, 2019-2023

Source: BlackRock Investment Institute, UK Office for National Statistics, with data from Haver Analytics, April 2023. Notes: The orange line shows annual headline inflation, and the yellow line shows the inflation rate for all items, excluding food and energy. The pink line shows the three-month moving average for annual wage growth.

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. We think the Federal Reserve will halt rate hikes once the economic damage becomes clear. 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 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 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

April 25	U.S. consumer confidence
April 27	U.S. Q1 GDP
April 28	U.S. PCE and Employee Cost Index; euro area GDP; Bank of Japan policy decision

GDP data in the U.S. and euro area this week will help gauge the economic damage from rate rises. We see hikes hitting growth later this year and no rate cuts in 2023 from major central banks. We expect the Fed to stop hikes when the damage is clear but think the European Central Bank will keep going to get inflation to target regardless of the damage that entails.

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.

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.
Equities	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.
Equities	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.
Equities	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
Equities	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.
Equities	**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.
Equities	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.
Equities	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.
Fixed Income	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.
Fixed Income	Global inflation-linked bonds	+2	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
Fixed Income	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
Fixed Income	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.
Fixed Income	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
Fixed Income	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.
Fixed Income	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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