

Weekly commentary

May 1, 2023

BlackRock

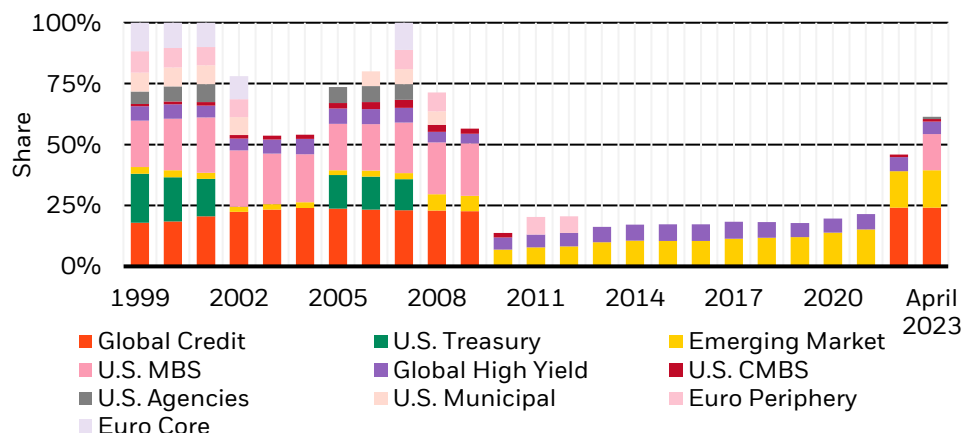
Income in the new macro regime

- We see bond yields staying high in the new macro regime – that means income is back as a portfolio driver. We stay nimble and granular across fixed income.
- U.S. stocks rallied from a four-week low last week after tech earnings beat. Yields fell even as data confirmed slowing growth and persistent wages and inflation.
- This week we see major central banks hiking rates again. We don't see cuts this year. We also expect U.S. jobs data to show a tight market still fueling wages.

Income is back as a portfolio driver as we see interest rates staying high in the new regime of macro and market volatility. We like bonds for income even if we don't expect them to offset risk-asset slides as much as they did in the past – or gain in price from falling yields. We favor very short-term, high-quality government paper and emerging market (EM) local currency debt. We also see value in high-quality credit as we keep risk low on a six- to 12-month tactical horizon.

Yield is back

Fixed income indexes yielding over 4%, 1999–2023



Source: BlackRock Investment Institute, April 2023. Notes: The bars show market capitalization weights of indexes with an average annual yield over 4% in a select universe representing about 70% of the Bloomberg Multiverse Bond Index. Euro Core is based on French and German indexes. Euro periphery is based on Italy, Spain and Ireland. Emerging markets combine external and local currency debt. Current calendar year data is not averaged and reflects month-end yield.

Yield is back: The share of fixed income indexes yielding over 4% is at its highest level since 2008 (see the chart). Global investment grade (IG) credit has come roaring back after a long drought (dark orange bars). We like income in bonds as a result. We also like that we can earn decent income from high-quality bonds without reaching into riskier parts of fixed income or even equities for dividends. We favor income in these bonds but don't think they'll play the ballast role of the past in portfolios. Policy rates used to fall quickly as an economic downturn struck, pushing yields lower – but we think sticky inflation makes that unlikely. That's why we think long-term government bonds' ability to offset selloffs in risk assets will be less now: We don't see major central banks coming to the rescue of the economy with rate cuts this year. We see the Federal Reserve and European Central Bank hiking rates again this week even as growth takes a hit.



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In the new macro regime of heightened growth and inflation volatility, we like bonds for income rather than earning returns from falling yields or using them as a portfolio ballast.

We're tactically overweight very short-term, high-quality government paper. Income is attractive, with limited credit and duration risk – or sensitivity to interest rate swings. Yet risks over raising the U.S. borrowing cap loom, with a deadline that could come sooner than initially expected as tax revenue comes in. We think a resolution will ultimately be reached. We see only a temporary rise in selected Treasury bill yields as the date nears when the U.S. Treasury might run into trouble making payments or need to prioritize debt payments over other obligations. Still, we could see market volatility and risk assets come under pressure as in past episodes. We remain modestly underweight U.S. stocks.

We think investment grade credit offers good income, with yields around 5% globally. We're tactically overweight European investment grade and prefer it to U.S. peers given more attractive valuations and its shorter duration. We put our new nimble playbook to work in March, cutting U.S. investment grade to neutral from overweight. We see less room for higher returns from tightening credit spreads but also see a decent amount of income with relatively limited risk compared with high yield. Still, we're monitoring the impact of tighter credit and financial conditions as higher interest rates hit economic growth and reverberate through the banking sector. We're also tactically overweight EM local currency debt on China's powerful economic restart, peaking interest rate hikes and a broadly weaker U.S. dollar.

Tactically, we prefer income from inflation-linked bonds over the dividend income provided by developed market (DM) equities. Equities can offer a sort of inflation protection if companies can pass on higher prices. But that depends on stocks reflecting the likely outlook for interest rates and growth – and we don't think DM stocks are pricing the damage from higher rates that we see ahead. That's a risk to dividends in the next 12 months – and the dividend yield of the S&P 500 is less than half of the 3.43% yield on the U.S. 10-year Treasury.

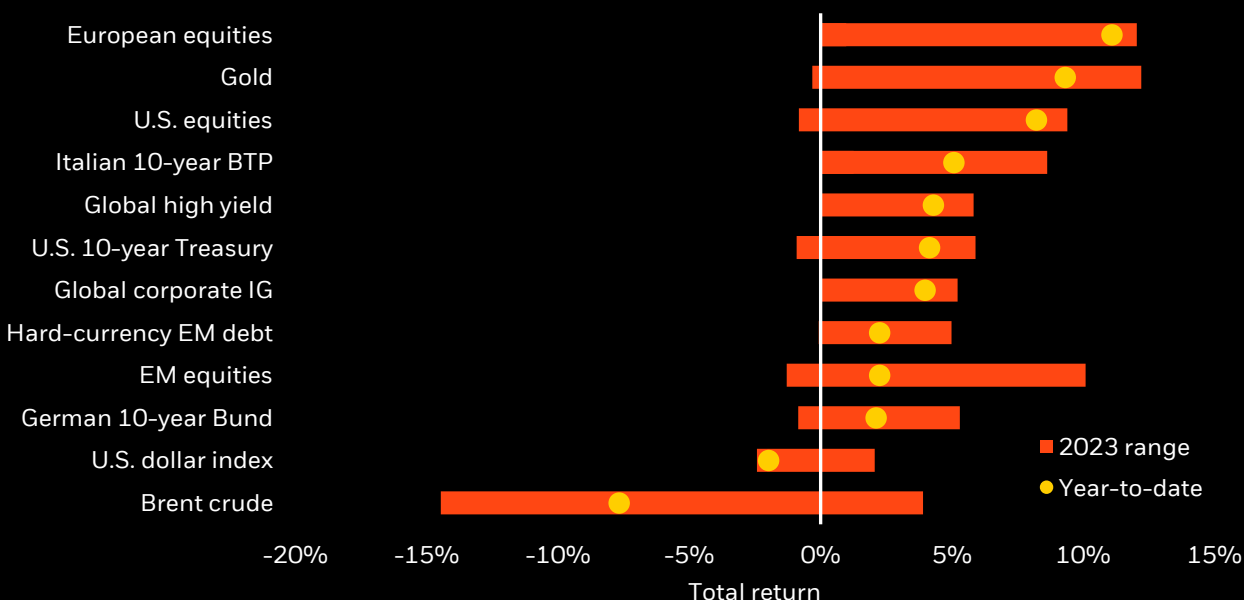
Bottom line: We see rates staying higher for longer in the new regime. That's why we favor bonds for income. We like very short-term, high-quality government paper, EM local currency debt and high-quality credit.

Market backdrop

U.S. stocks rallied from a four-week low last week after tech earnings beat expectations, helping offset renewed regional bank woes. The U.S. two-year Treasury yield fell back near 4.0% even as the market eyes a Fed rate hike this week. U.S. PCE data showed consumer spending losing momentum over the course of the first quarter. Strong U.S. wage growth pointed to inflation settling well above 2% policy targets – why we believe hopes for rate cuts this year are misplaced.

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 27, 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

Momentum in consumer spending slowed through the first quarter after a strong January, according to last week's U.S. spending data. We expect spending to drop in coming months as households run out of pandemic savings. Annual headline inflation cooled to 4.2% but annual core inflation remains high at 4.6%, as core services inflation eased but core goods inflation returned. See the chart. The Employment Cost Index release showed annual wage growth running at nearly 5%. If that pace continues, services inflation will stay sticky and overall inflation will stay well above the Fed's 2% target.

This highlights the difficult trade-off the Federal Reserve continues to face: With inflation this persistent, the only way to get it back near 2% is by generating a recession. And it's why the Fed is willing to tolerate economic damage and financial cracks like we've seen recently in the U.S. banking sector. We still believe market hopes for rate cuts this year are misplaced, given the persistence of inflation.

Explore our recent Macro take blog posts [here](#).

Inflation persists above policy targets

U.S. PCE inflation, 2001–2023



Source: BlackRock Investment Institute, Bureau of Economic Analysis, with data from Haver Analytics, April 2023. Notes: The orange line shows annual headline PCE inflation and the yellow line shows annual PCE inflation for all items excluding food and energy.

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

May 2

Euro area inflation and bank lending; U.S. job openings

May 4

European Central Bank (ECB) policy decision

May 3

Fed policy decision; U.S. ISM services PMI


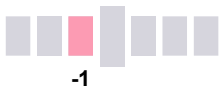






May 5

U.S. payrolls; China Caixin services PMI

This week's focus will be on the Fed and ECB policy rate decisions. We think they'll hike interest rates again – and we don't see major central banks coming to the rescue with rate cuts this year as inflation remains sticky. We're also watching U.S. jobs data where we expect to see ongoing labor market tightness. That is keeping wage growth and core inflation elevated.

Directional views

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

			● Previous view
			Underweight Neutral Overweight
Asset	Strategic view	Tactical view	
Equities		 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		 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		 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		 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, May 2023

Underweight
Neutral
Overweight
● Previous view

Asset	View	Commentary
Equities	Developed markets	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy and healthcare.
	United States	We are underweight. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
	Europe	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
	UK	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
	Japan	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	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	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	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
	Long U.S. Treasuries	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
Fixed Income	Short U.S. Treasuries	We are overweight. We prefer very short-term government paper for income given the potential for a sharp jump in Fed rate expectations.
	Global inflation-linked bonds	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
	Euro area govt bonds	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
	UK gilts	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.
	China govt bonds	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
	Global IG credit	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	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	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	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
	Emerging local currency	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	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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