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Weekly commentary

BlackRock

July 18, 2022

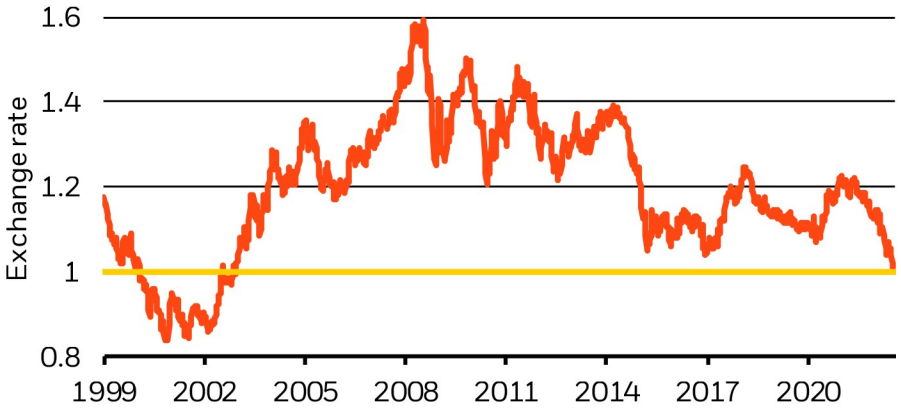
ECB may limit hikes as recession nears

- Europe is facing the risk of an energy shock-driven recession and periphery stress. That's why we think the ECB will stop hiking earlier than the Fed.
- Relentless U.S. inflation last week signaled a big rate hike by the Fed later this month. Long-term yields fell amid fears rate hikes may trigger a slowdown.
- We see the ECB raising rates by 0.25% this week amid high inflation and despite recession fears. We also expect details on its anti-fragmentation tool.

The European Central Bank (ECB) is set to lift rates for the first time in over a decade this week. Both the ECB and Fed are for now pandering to "the politics of inflation," or pressure to tame inflation. We think the ECB will pause its hiking first. Why? The energy crisis means Europe's growth is likely to stall soon. Higher rates and political turmoil may also send peripheral borrowing costs spiraling. All this leaves us favoring credit over stocks and neutral on euro area government bonds.

Parity pain

Euro to U.S. dollar



Sources: Refinitiv Datastream and BlackRock Investment Institute, July 2022. Notes: The chart shows the exchange rate of the euro against the dollar since the euro's creation in 1999. The red line shows the USD to euro exchange rate. The yellow line marks the point of parity, or a 1:1 exchange rate.

In a new regime of increased volatility, the ECB faces an even starker trade-off between crushing growth and living with inflation amid the energy shock. The central bank has yet to acknowledge this, in our view, as its forecast assumes inflation can come down in a growing economy. We think that's unlikely – and see the euro area growth falling into recession even if rates rise only very little. Why? We've argued since right after Russia's invasion of Ukraine that the energy shock will drag down economic activity. We see the ECB pausing when faced with rapidly slowing growth. Yet markets are still expecting significant hikes in the next year, Refinitiv data on futures pricing show. The dollar's strength against the euro reflects the more pessimistic growth outlook for Europe, in our view. It's near parity with the U.S. dollar, its weakest level in 19 years. See the chart.

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BlackRock **Investment** Institute

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Why is Europe's growth slowing? Surging energy prices have heralded a recession in Europe since the invasion, as we said in A new supply shock. The impact on Europe is similar to the oil price shock in the 1970s, in our view. Europe's reliance on imports means it's more sensitive to higher energy costs than the U.S. Persistently high energy prices will likely squeeze real incomes, dampen business and consumer confidence as well as elevate financial stress. The drag on growth could be much bigger if Russia restricts supply, spurring rationing and production interruptions. Rationing is of particular concern for Germany, where some worry Russia may use pipeline maintenance as an excuse to cut off the flow of gas.

There's another challenge weighing on the ECB: the risk of the euro zone fragmenting. High debt loads in peripheral nations such as Italy mean slowing growth and higher rates have contributed to widening yield differentials between peripheral bonds and their German counterparts. That prompted the ECB to plan to launch an anti-fragmentation tool: a program to purchase bonds from countries where borrowing costs deviate materially from the rest of the euro area. The ECB is set to give details this week. It hasn't been easy historically to unite Europe around what is effectively sharing debt. The plan is likely to come with strings attached that could prove politically unpalatable for countries like Italy, where a brewing political crisis is adding to the stress. It's also not clear when the ECB would use the tool.

Monetary policy can't save the day, in our view. The ECB faces some brutal trade-offs to get inflation back down to target. We expect the ECB to raise rates out of negative territory to levels not seen since 2013. Yet the fallout of the energy shock and stress in peripheral bonds will force the ECB to pause its rate hikes sooner than the Fed, in our view. That ultimately means the euro area lives with more persistent inflation.

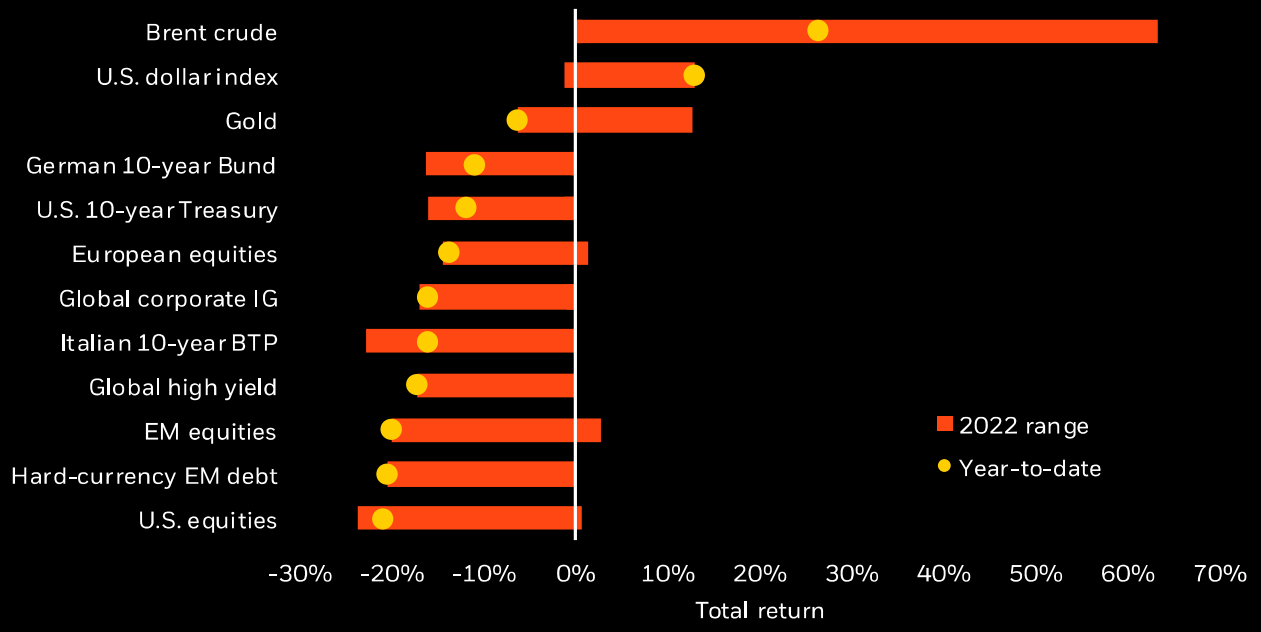
What does this mean for investments? Tactically, we're underweight European equities because we see the energy shock stalling growth. We do see opportunities within sectors like healthcare that derive a large portion of revenues from U.S. sales. We favor credit instead amid higher yields and limited default risk. Overall, we dislike U.S. Treasuries and most other government bonds in this inflationary environment. We see the ECB pausing its hiking cycle sooner than the market expects, so we're neutral on European government bonds. This includes peripheral bonds, even with the vulnerabilities. A key question there is whether markets are over- or underwhelmed by the scope and flexibility of the anti-fragmentation tool. Among global inflation-linked bonds, we prefer Europe. We believe the market underappreciates pressure from the energy crunch.

Market backdrop

Last week's U.S. CPI data showed inflation reached fresh 40-year highs in June. This likely cements the case for a significant Fed rate hike at its policy meeting later this month, in our view. We also see elevated inflation persisting in Europe, bolstering the ECB's decision to raise rates this week for the first time in over a decade. Markets showed high intraday volatility with stocks recovering most losses and long-term bond yields ticking lower as the euro leveled with the U.S. dollar.

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 July 14 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.

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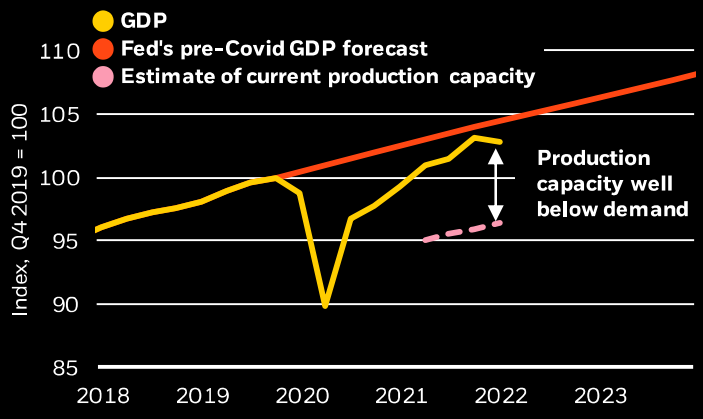
Macro take

Introducing our brand new Macro Take! This new blog-style series aims to break down – in simple terms – what's going on in economies around the world, how we see things developing from here and what policymakers might do faced with tough, new challenges. We'll be publishing a new post every two weeks or so.

In our inaugural post, Alex Brazier gives his take on why economies are not able to produce as much now – without creating price pressures – as they did before Covid. In fact, the production capacity of the U.S. economy as a whole could be as much as 7% less now than it would have been without the pandemic (pink dotted line in the chart). That's a massive economic shock and explains why inflation is so high – despite overall demand still being below where, before the pandemic, it was expected to be now (yellow line vs. orange line). That's a pretty scary situation for central banks. Why? Because they don't have tools to increase the economy's production capacity – all they can do is reduce demand. That leaves them with a brutal trade-off between inflation and growth. Read Alex's full explanation here.

Demand and supply out of whack

U.S. GDP and production capacity, 2017-2023



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, July 2022. Notes: The chart shows demand in the economy, measured by real GDP (in yellow), and the Federal Open Market Committee's GDP forecast made in December 2019 (in orange). The pink dotted line shows our estimate of current production capacity, which we infer from how far core PCE inflation has exceeded the Federal Reserve's 2% inflation target. The gap between production capacity and demand (white arrow) is approx. 7%.

Investment themes

1 Bracing for volatility

- The Great Moderation, a long period of steady growth and low inflation, has ended in our view. We see macro and market volatility reverberating through the new regime. What changed? Production constraints triggered by the pandemic and exacerbated by the war in Ukraine are pressuring the economy and inflation. We see this persisting amid powerful structural trends like global fragmentation and sectoral shakeouts tied to the net-zero transition.
- Unprecedented leverage also gives policymakers less manoeuvring room, in our view. And the politicization of everything makes simple solutions elusive when they're needed the most, we think. This leads to bad outcomes.
- We expect higher risk premia for both equities and bonds – so investment decisions and horizons must adapt more quickly. Traditional portfolios, hedges and risk models won't work anymore, we think.
- In the U.S. we expect volatile growth and persistent inflation. The upside risk is that production capacity normalizes faster. The downside is that the Fed fails to change course next year and slams demand down to meet low capacity.
- In Europe, we see recession as likely even absent big rate hikes as broad economic stress from an energy crisis bites.
- **Investment implication:** Be nimble. We're tactically overweight investment grade credit on attractive valuations.

2 Living with inflation

- We are in a world shaped by supply unlike any we have seen in recent decades. Major spending shifts and production constraints are the driving force of inflation.
- Constraints are rooted in the pandemic and have been exacerbated by the war in Ukraine and China's lockdowns
- The Fed has made clear it is ready to dampen growth. It has projected a large and rapid increase in rates, raising rates by 0.75% in June in the largest increase since 1994. We ultimately think reality will come knocking and a stall in the restart will make the Fed change course.
- The Bank of England warned of the poisonous combination of recession and high inflation as it has raised interest rates further to 1.25% in June. This may indicate the start of a dovish pivot, in our view.
- The European Central Bank (ECB) announced plans to end asset purchases and implement a rapid series of rate hikes in an effort to tame inflation. We think the ECB and markets underappreciate the risk of the energy crunch causing a recession. We expect the ECB to accept this at some point and rethink its rate path.
- We think the eventual sum total of rate hikes will be historically low given the level of inflation but brace for volatility.
- **Investment implication**: We are tactically underweight most DM equities after having further trimmed risk.

3 Positioning for 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.
- The West's decision to reduce reliance on Russian energy will encourage fossil fuel producers elsewhere to increase output, but we don't expect an overall increase in global supply and demand. We see the drive for greater energy security accelerating the transition in the medium term, especially in Europe
- We also don't think the markets have fully priced in the transition yet. Over time, markets are likely to value assets of companies better prepared for the transition more highly relative to others, in our view.
- We think investors can get exposure to the transition by investing not only in "already green" companies but also in carbon intensive companies with credible transition plans or that supply materials critical to the transition.
- We like 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**: Time horizon is key. We see tactical opportunities in selected energy stocks.

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Week ahead

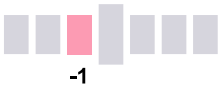
July 19	UK labor market data	**July 21**	ECB, Bank of Japan rate meets; U.S. Philly Fed business index
July 20	UK CPI; euro area consumer confidence	**July 22**	U.S., euro area, UK, Germany PMIs

This week's focus is on the ECB monetary policy decision. We see the ECB raising interest rates by 0.25% amid persistently high inflation and despite growing recession fears. We also expect more details on the anti-fragmentation tool that's intended to limit borrowing cost divergences. A series of PMIs will be a key gauge of economic activity around the world.

Directional views

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

Underweight | **Neutral** | **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+2	-1	We are overweight equities in our strategic views of five years or longer. We expect central banks to ultimately live with some inflation and look through the near-term risks. Tactically, we are underweight DM equities as central banks appear set to overtighten policy and we see activity stalling. Rising input costs also pose a risk to elevated corporate profit margins.
Credit	 -1	+1	We are underweight publicly traded credit on a strategic basis and prefer to take risk in equities. Tactically, we are overweight credit given the jump in yields and credit spreads – and our view of contained default risk. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds, with a preference for short-dated maturities. We stay firmly underweight long-dated bonds as we see investors demanding higher compensation amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we are also underweight as we see long-term yields going higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers amid higher inflation.
Private markets	Neutral	—	We believe non-traditional return streams 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. We underweight private equity, favoring income assets such as private credit instead. Many institutional investors are 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.

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Granular views

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

Underweight | **Neutral** | **Overweight** | ● Previous view

Asset	View	Commentary
Developed markets	-1	We are underweight DM stocks on a worsening macro picture and risks to corporate profit margins from higher costs. Central banks appear set on reining in inflation by crushing growth – increasing the risk of the post-Covid restart being derailed.
United States	-1	We are underweight U.S. equities. The Fed intends to raise rates into restrictive territory. The year-to-date selloff partly reflects this. Yet valuations have not come down enough to reflect weaker earnings.
Europe	-1	We are underweight European equities as the fresh energy price shock in the aftermath of the tragic war in Ukraine puts the region at risk of stagflation.
UK	-1	We are underweight UK equities following their strong performance versus other DM markets thanks to energy sector exposure.
Japan	Neutral	We are neutral Japan stocks. We like still-easy monetary policy and increasing dividend payouts. Slowing global growth is a risk.
China	Neutral	We are neutral Chinese equities. Activity is restarting, but we see 2022 growth below official targets. Geopolitical concerns around China's ties to Russia warrant higher risk premia, we think.
Emerging markets	Neutral	We are neutral EM equities on the back of slowing global growth. Within the asset classes, we lean toward commodity exporters over importers.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
U.S. Treasuries	-1	We are underweight U.S. Treasuries even with the yield surge. We see long-term yields moving up further as investors demand a greater term premium. We prefer short-maturity bonds instead and expect a steepening of the yield curve.
Global inflation-linked bonds	+1	We are overweight global inflation-linked bonds and prefer Europe. Markets are underappreciating the inflationary pressures from the energy shock, we think.
European government bonds	Neutral	We are neutral European government bonds. We think market pricing of euro area rate hikes is too hawkish.
UK gilts	+1	We are overweight UK gilts. Gilts are our preferred nominal government bonds. We believe market pricing of the Bank of England's rate hikes is unrealistically hawkish in light of deteriorating growth.
China government bonds	Neutral	We are neutral Chinese government bonds as policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
Global investment grade	+1	We are overweight investment grade credit. High quality corporates' strong balance sheets imply IG credit could weather weaker growth better than stocks.
Global high yield	Neutral	We are neutral high yield. We prefer up-in-quality credit exposures amid a worsening macro backdrop. We think parts of high yield offer attractive income.
Emerging market – hard currency	Neutral	We are neutral hard-currency EM debt. We expect it to gain support from higher commodities prices but remain vulnerable to rising U.S. yields.
Emerging market – local currency	+1	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, and offer compensation for inflation risk.
Asia fixed income	Neutral	We are neutral Asia fixed income amid a worsening macro outlook. We don't find valuations compelling enough yet to turn more positive on the asset class.

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