

Weekly commentary

March 27, 2023

BlackRock

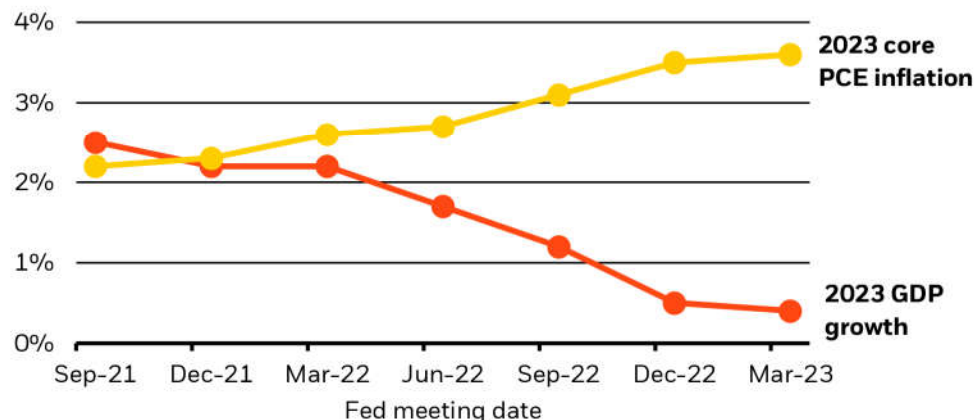
Recession – but no central bank rescue

- Central banks confront the growth-inflation trade-off, with the Federal Reserve seeing recession but no rate cuts. We agree – and prefer inflation-linked bonds.
- Bank stocks remained under pressure last week. The two-year U.S. Treasury yield slid further as the market priced in a series of Fed rate cuts.
- We're watching inflation data on both sides of the Atlantic this week for further signs of it staying elevated, while monitoring the ongoing banking sector woes.

The central bank trade-off between crushing activity or living with inflation is now impossible to ignore as economic damage and financial cracks emerge. That was evident in the Federal Reserve's forecast of recession this year and sticky inflation in years to come. Central banks have clearly separated responses to the banking tumult and kept hiking rates. We see a new, more nuanced phase of curbing inflation ahead: less fighting but still no rate cuts. We favor inflation-linked bonds.

The trade-off

Federal Reserve projections for Q4 2023 GDP growth and inflation



Source: BlackRock Investment Institute and Federal Reserve, March 2023. The chart shows the progression of the median Federal Open Market Committee projection for Q4 2023 U.S. real GDP growth and core PCE inflation year-over-year, from September 2021 through March 2023.

The progression of the Fed's forecasts shows it has been repeatedly too optimistic on both growth and inflation – that's the trade-off in action. See the chart. Its latest projections imply a recession in the months ahead, with growth stalling later in 2023 after a strong start to the year (red line). The Fed still doesn't plan to cut rates because inflation is persistently above its 2% target. So it is expecting to live with lingering inflation even with recession – it sees PCE inflation remaining above 3% at the end of 2023 (yellow line). It doesn't see inflation falling back near its target until 2025. Even so, we think the Fed is underestimating how stubborn inflation is proving due to a tight labor market: Inflation could remain above its target for even longer than that if the recession is as mild as the Fed projects.



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The Fed and other central banks made clear banking troubles would not stop them from further tightening. U.S. authorities acted swiftly to help stem contagion by protecting depositors from bank failures. By clearly separating financial and price stability goals and tools, major central banks carried on with rate hikes through the tumult. The Fed, European Central Bank and the Bank of England all did so. Even the Swiss National Bank lifted rates by 0.5% just days after facilitating a takeover of long-troubled Credit Suisse. The bank troubles imply higher borrowing costs and tighter credit availability – and are part of the economic and financial damage we’ve long argued would come. That damage is now front and center – central banks are finally forced to confront it. We think this means they are set to enter the new phase of curbing inflation that we’ve been flagging. We see major central banks moving away from a “whatever it takes” approach, stopping their hikes and entering a more nuanced phase that’s less about a relentless fight against inflation but still one where they can’t cut rates.

Markets have been quick to price in rate cuts as a result of the banking sector turmoil and the Fed signaling a coming pause. We don’t see rate cuts this year – that’s the old playbook when central banks would rush to rescue the economy as recession hit. Now they’re causing the recession to fight sticky inflation – and that makes rate cuts unlikely, in our view. Stocks have held up due to hopes for rates cuts that we don’t see coming. We think the Fed could only deliver the rate cuts priced in by markets if a more serious credit crunch took hold and caused an even deeper recession than we expect. We stay underweight developed market (DM) stocks because we don’t think they reflect the damage we see ahead.

Inflation is likely to prove even stickier than the Fed expects without a deep recession, in our view. The February U.S. CPI data confirmed our view that inflation is still not on track to settle at the Fed’s target. Current market pricing of U.S. and euro area inflation just above 2% on a 10-year horizon has edged lower recently – we think levels are likely to stay much higher than that. This is why we see value in inflation-linked bonds and prefer them to nominal peers. We also find very short-term government paper attractive for income given the potential for the market to price out rate cuts quickly. Strong money market demand provides additional support, in our view. We’re underweight long-term government bonds as we see yields rising with investors demanding more compensation for holding them, or term premium, given persistent and volatile inflation.

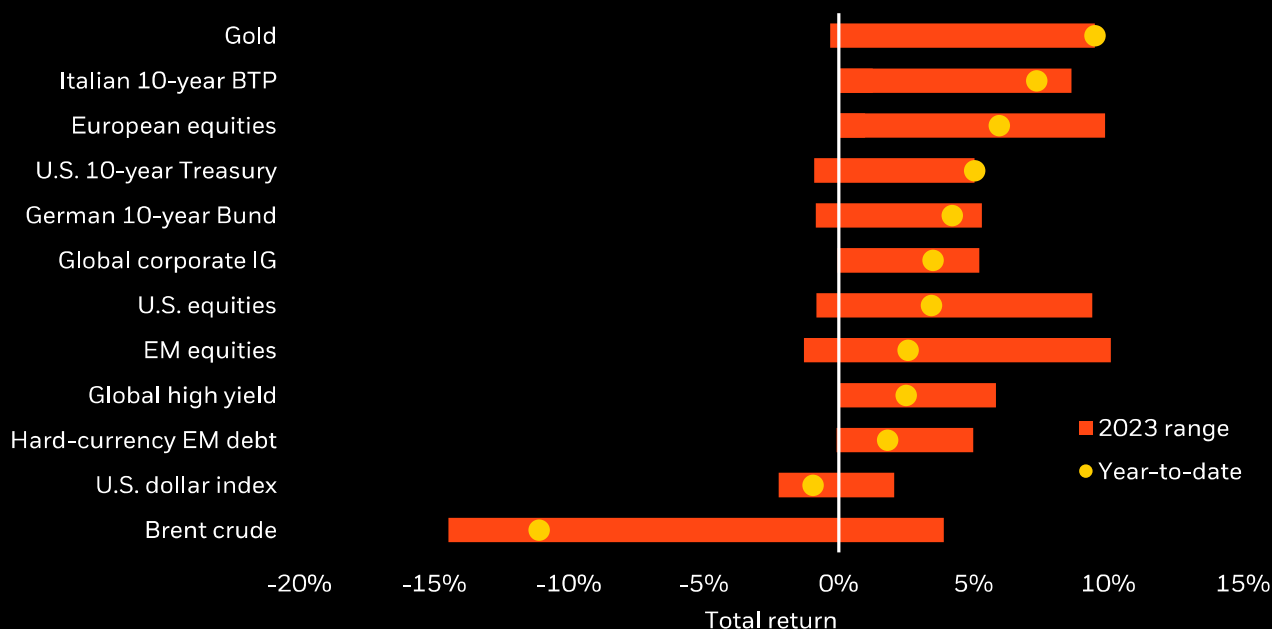
Bottom line: We overweight inflation-linked bonds and like very short-term government paper for income. We stay nimble in the new regime of greater macro and market volatility – and are ready for opportunities as rate-hike damage gets priced in.

Market backdrop

U.S. and Europe stocks steadied, even as bank and financial shares remained under pressure. Some European bank default protection costs jumped on the week. The U.S. two-year Treasury yield extended its historic drop and is down about 1.4 percentage points from a 16-year high hit earlier this month, causing a further steepening of the yield curve. The market is now pricing in about 1 percentage point of Fed rate cuts by the end of the year. We don’t think such cuts are coming.

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 March 23, 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

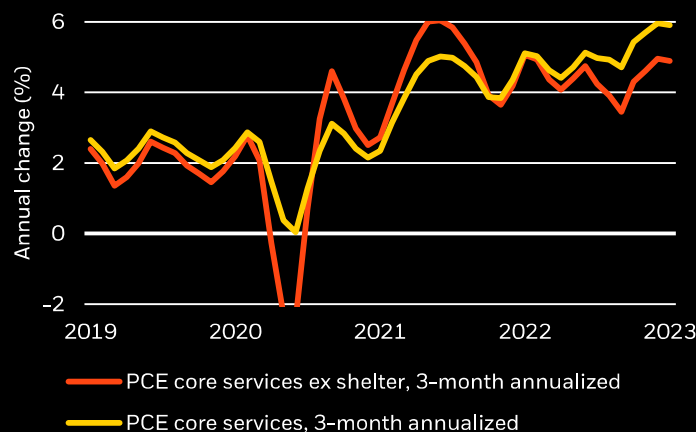
We have seen clear evidence over the past two weeks that central banks are separating financial stability and price stability goals. This separation contrasts with the central bank response to the 2008 bank failures and to the pandemic when they used all their tools – including rate cuts – to stimulate the economy.

We think stubbornly high inflation means a similar response this time is unlikely. Measures of core services inflation excluding housing remain well above levels that the Fed can likely tolerate. See the chart. We expect the February personal consumption expenditures data – the Fed’s preferred inflation gauge – to confirm inflation’s stickiness due to strong wage growth and tight labor markets.

Against this backdrop, we think market expectations of rate cuts are optimistic – and underappreciate the severity of the longstanding trade-off facing central banks. Their inflation fight means they are actively generating recessions this time, not trying to avoid one. See our [Macro take](#) blog.

Sticky inflation

U.S. personal consumption expenditures, 2019-2023



Source: BlackRock Investment Institute, with data from Refinitiv. Notes: The chart shows the annual change in measures of U.S. personal consumption expenditures on services – an inflation gauge closely watched by the Fed.

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.
- In Europe, tighter financial conditions are biting even as the energy shock eases.
- The ultimate economic damage depends on how far central banks go to get inflation down. We think they will halt rate hikes once the economic damage becomes clear.
- **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 cycle of 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

March 28

U.S. consumer confidence









March 31

U.S. PCE inflation and spending; euro area inflation and unemployment

We're watching inflation on both sides of the Atlantic – including the Fed's preferred PCE inflation gauge and flash inflation in the euro area. We expect services inflation to keep core inflation elevated. We're watching U.S. consumer confidence as well for more signs of damage from still-rising rates, sticky inflation and banking sector troubles.

Directional views

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

		Underweight	Neutral	Overweight	● Previous view
Asset	Strategic view	Tactical view			
Equities		 <p>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.</p>			
Credit		 <p>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.</p>			
Govt bonds		 <p>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.</p>			
Private markets		 <p>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.</p>			

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, March 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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