BlackRock

September 2022

Global outlook – Midyear 2022

Back to a volatile future

BlackRock
Investment
Institute

Midyear 2022 investment themes

Bracing for volatility – The Great Moderation, the four-decade period of steady growth and inflation, is over, in our view. Central banks are rushing to raise rates to contain inflation that's rooted in production constraints. They are not acknowledging the stark trade-off: crush economic growth or live with inflation. We see this driving a new regime of higher macro and market volatility, with short economic cycles.

Implication: We see higher risk premia across the board and think portfolio allocations will need to become more granular and nimble.

Living with inflation – We are in a world shaped by supply unlike any we have seen in recent decades. For all the noise about containing inflation, we see policymakers ultimately living with some of it once the cost on growth and jobs becomes clearer – and is acknowledged.

Implication: We cut risk further tactically and cut DM equities to underweight – but are looking for a dovish pivot by central banks to turn more positive. We remain strategically overweight equities. We tactically upgrade global credit to overweight on what we see as contained default risks.

Positioning for net zero – We see the bumpy transition to net-zero carbon emissions shaping the new regime. We see a key role for fossil fuels in the transition – and we don't think markets have fully priced in the transition yet.

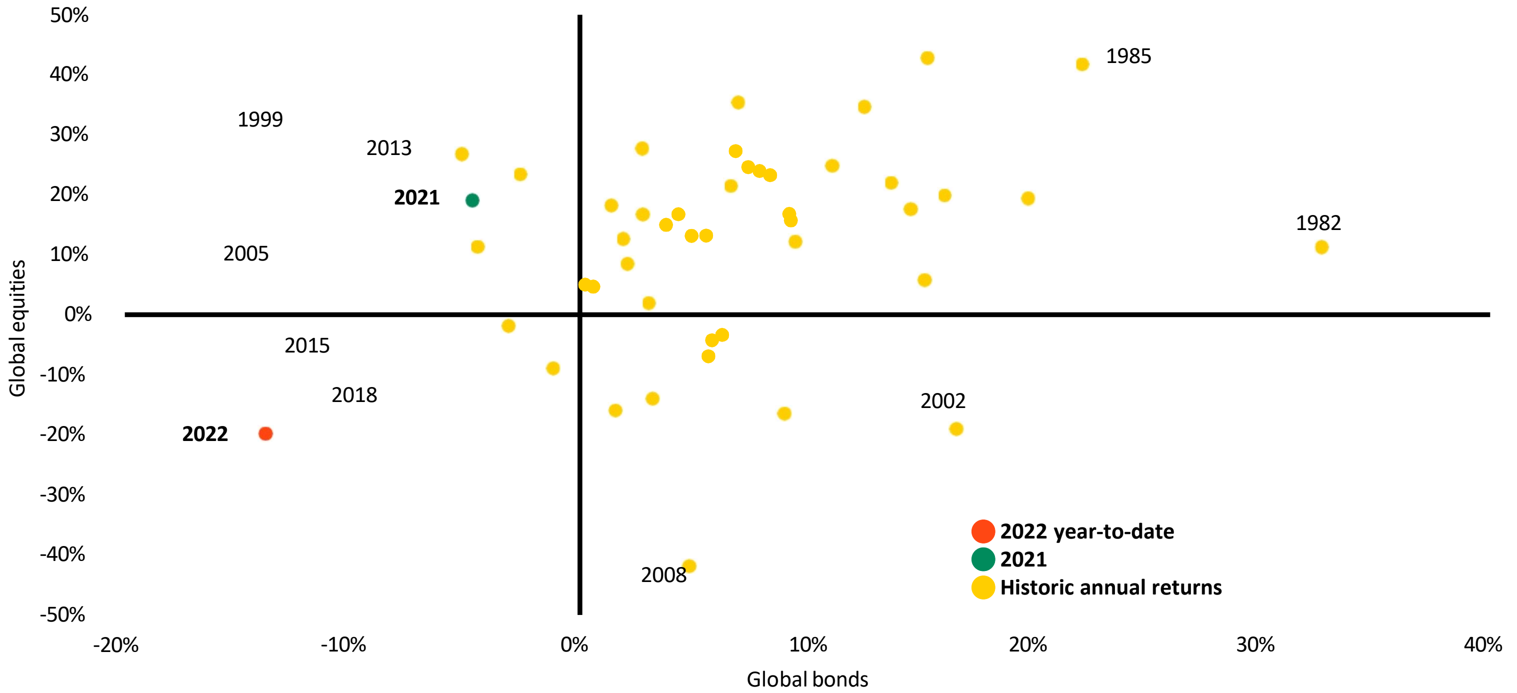
Implication: Investors can be both bullish on commodities and sustainable assets. Changing investor preferences are likely to give sustainable assets a return advantage for years to come, in our view.

The opinions expressed are as of July 2022 and are subject to change at any time due to changes in market or economic conditions. Strategic implications refer to long-term views, tactical implications refer to asset views on a 6-12 month horizon.

A critical juncture for markets

The historically unprecedented year-to-date selloff in stocks and bonds was the backdrop for BlackRock Investment Institute Midyear Outlook Forum – the first in-person forum in 2-1/2 years.

Global equities vs. global bonds annual returns, 1977-2022



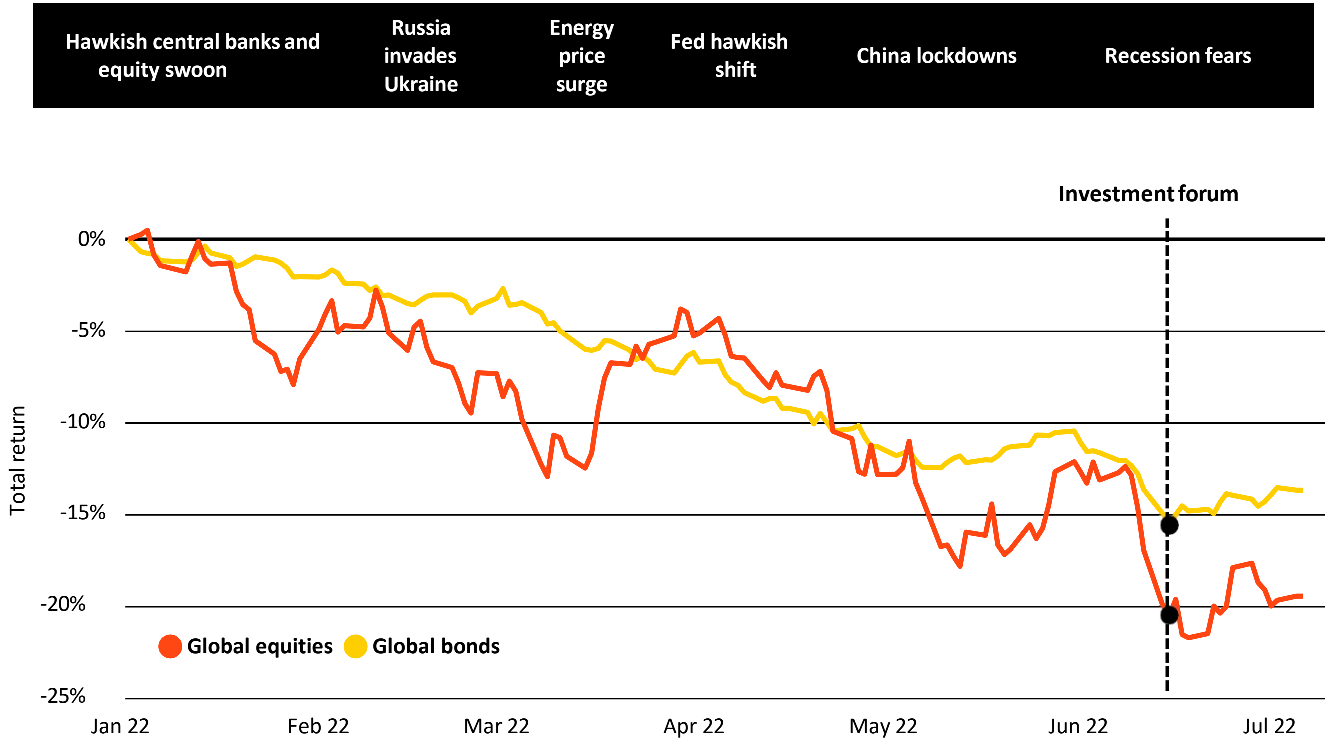
Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index.

Sources: BlackRock Investment Institute with data from Refinitiv Datastream and Bloomberg, July 2022. Notes: The chart shows annual returns for global equities and bonds in U.S. dollar terms from 1977-2021. Index proxies are the MSCI All-Country World index for equities (MSCI World before 1988) and Bloomberg Global Aggregate index for bonds (U.S. Aggregate before 1991). Data as of 6 July 2022.

Historic selloff in stocks and bonds

Policy confusion, the war in Ukraine and recession fears have roiled markets this year. We see persistent inflation amid sharp and short swings in economic activity ahead, keeping markets volatile.

Global equities and bond total returns, 2022



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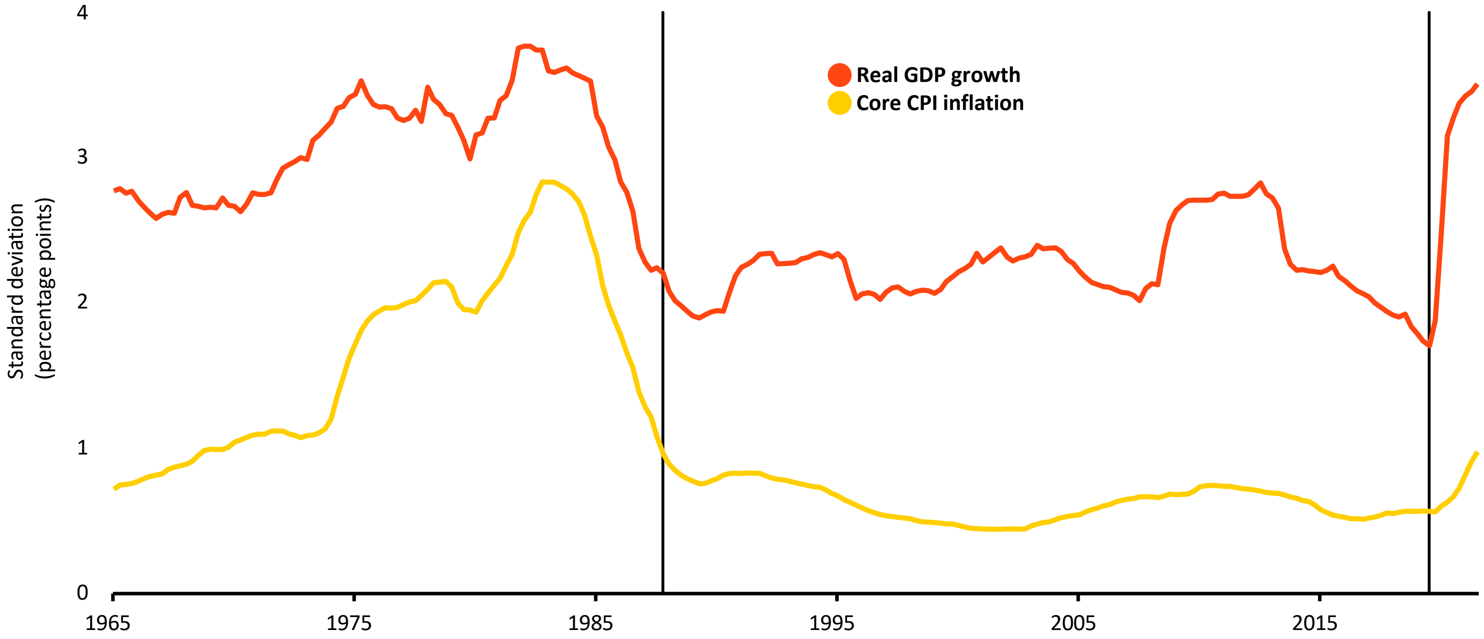
Sources: BlackRock Investment Institute with data from Refinitiv Datastream and Bloomberg, July 2022. Notes: The chart shows year-to-date to returns for the MSCI ACWI index and Bloomberg Global Aggregate index for bonds since the start of the year. Data as of 5 July 2022.

End of the Great Moderation

The pandemic upended an unusual period of mild volatility in output and inflation. That period – that supported a sustained stocks-and-bonds bull market for decades - is over, we think.

Volatility of U.S. GDP and CPI, 1965-2022

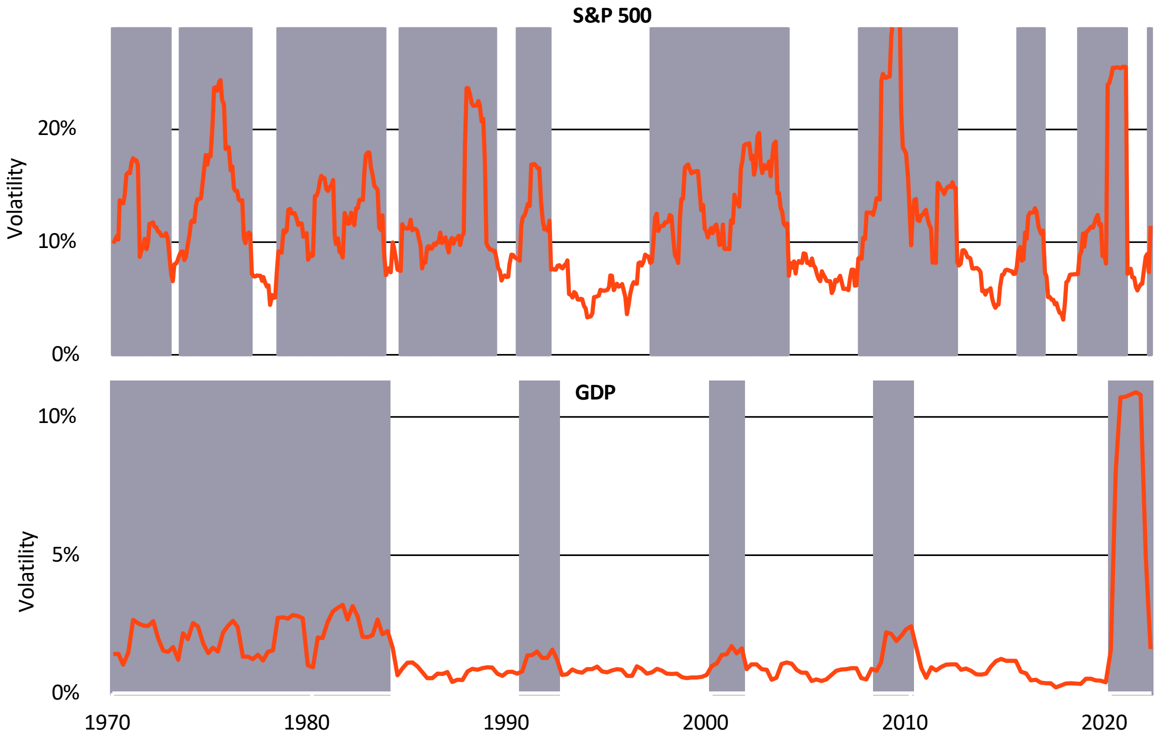


Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis and Labor Department, with data from Haver Analytics, July 2022, Notes: The chart shows the standard deviation of the annualized quarterly change of U.S. GDP and the Consumer Price Index.

Sustained macro volatility implies higher risk premia

A higher macro volatility regime will sustain a higher market volatility regime, we believe. We expect higher risk premia for both bonds and equity – and don't see this as a buy-the-dip environment.

U.S. equity and GDP volatility and regimes shaded, 1970-2022

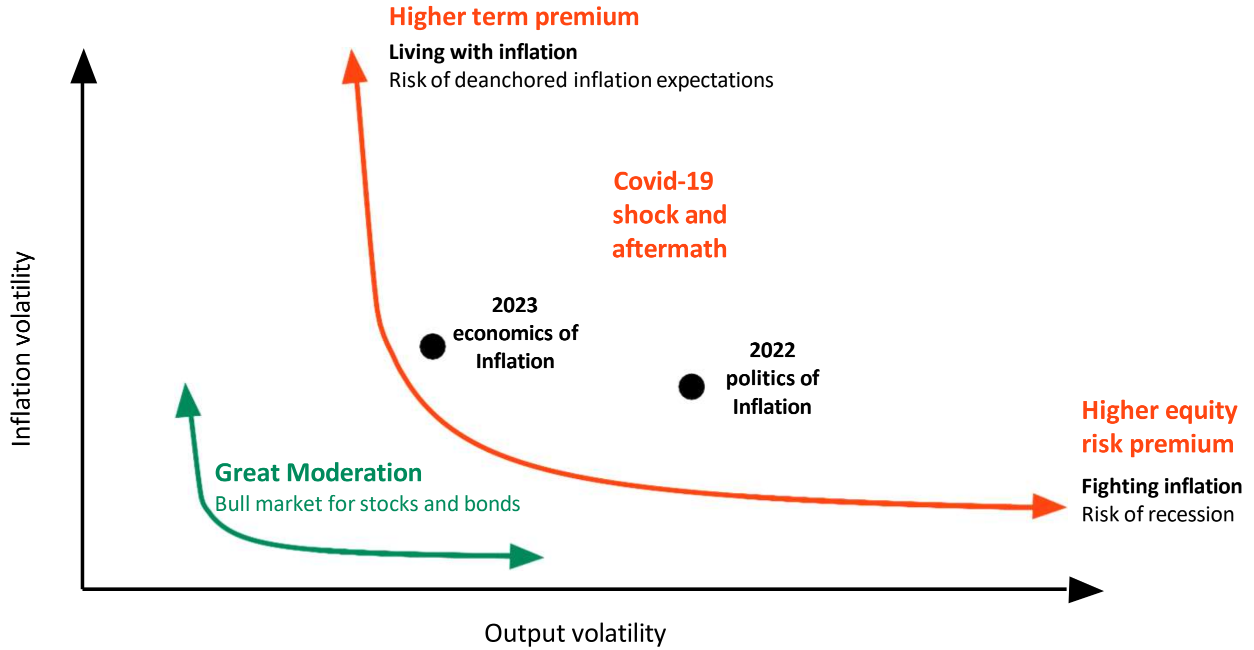


Sources: BlackRock Investment Institute, with data from Haver Analytics, July 2022. Notes: Volatility is calculated as the annualized standard deviation of monthly changes in the S&P 500 over a rolling 12-month period, using a Markov-Switching regression model in the same manner we did in our 2017 work. Given the severity of macro volatility during the Covid-19 shock, we calculate four vol regimes. We show only the intermediate, high and extreme volatility regimes in the gray bands, the rest of the periods are regimes of low volatility. These lines plot the average volatility level during each regime based on a broader sample from 1960 to 2022. We use the same regime methodology for U.S. GDP based on annualized quarterly data as of Q1 2022.

The upshot: higher risk premia ahead

Policymakers face tougher trade-offs in the new regime. Reining inflation comes at much greater cost to growth. Preserving growth comes with much higher inflation. Result: higher risk premia.

A worsening trade-off for central banks

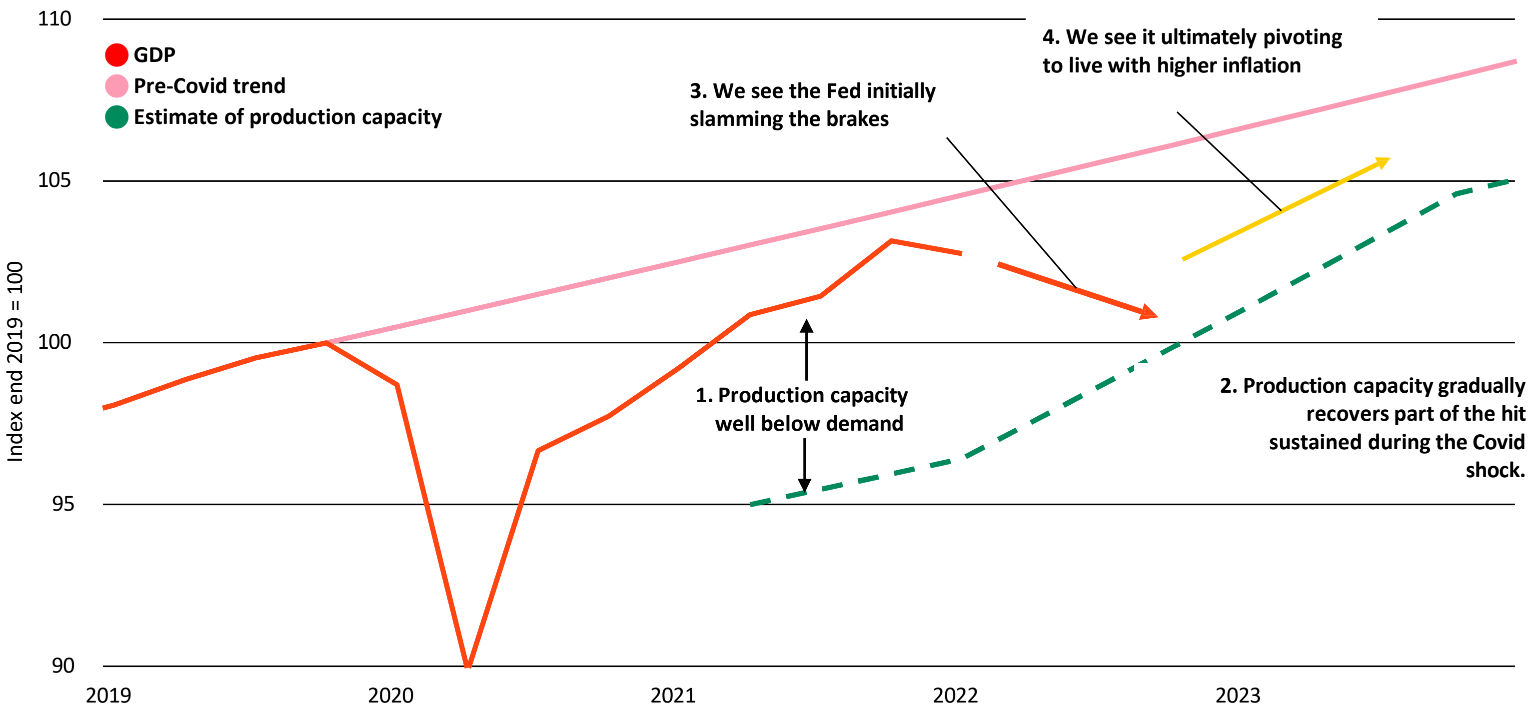


Sources: Blackrock Investment Institute, July 2022. Notes: The chart shows a stylized depiction of the volatility of U.S. inflation and output during the Great Moderation (1985-2019; green line) and since the Covid-19 shock (2020 to now; orange line). The curves show potential combinations of output (x axis) and inflation (y axis) volatility that can be achieved when central banks react to demand and supply shocks hitting the economy. Since the Covid-19 shock, the underlying volatility of demand and supply shocks has risen, as the orange line shows. This means central banks now face starker trade-offs. They can try to rein in inflation, but this comes at a cost of higher output volatility- the *Fighting inflation* outcome bottom right. Or they can try to dampen fluctuations in output at a cost of more inflation volatility – the *Living with inflation* outcome upper left. For illustrative purposes only.

Pivoting to live with higher inflation

Central banks face an imbalance between demand and production capacity. Overtightening will weigh sharply on growth in the near-term – but we believe central banks will ultimately live with inflation.

U.S. GDP and possible scenario

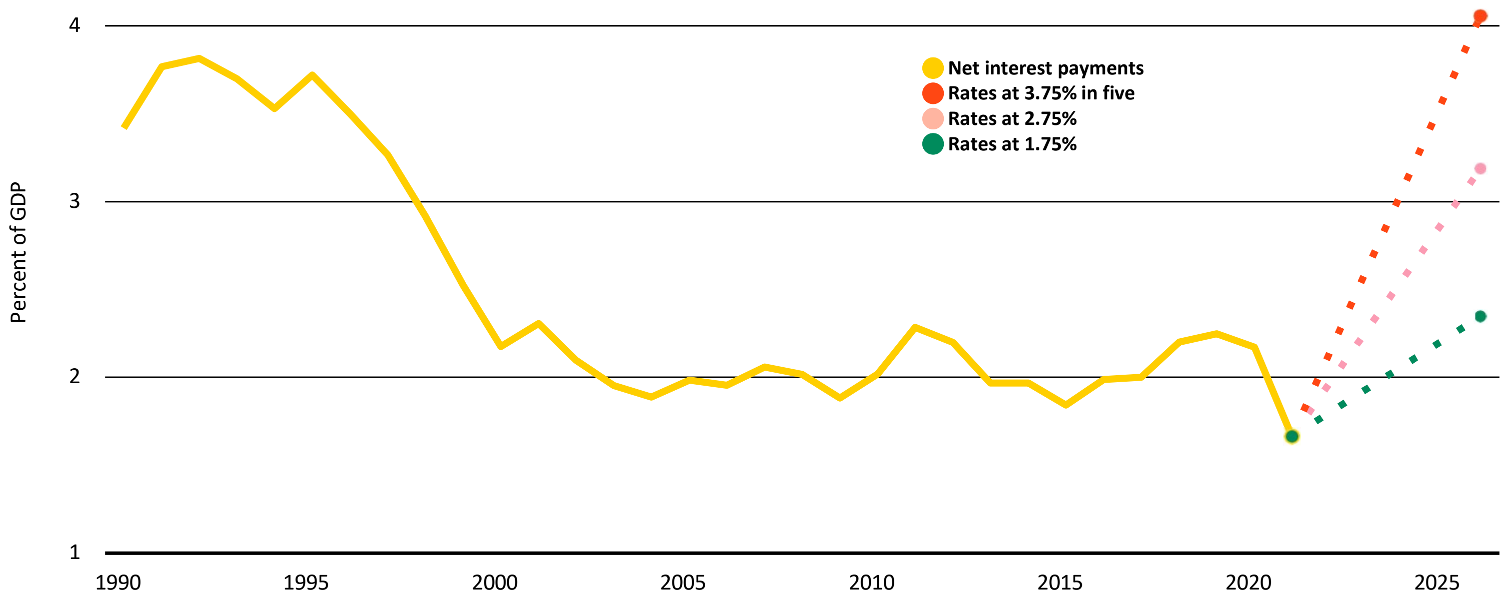


Source: BII, U.S. Bureau of Economic Analysis, with data from Haver Analytics. Note: chart shows the path of U.S. GDP (in orange) together with a stylized indication of how we expect it to evolve in coming quarters. The orange and yellow arrows indicate that we expect the Federal Reserve to tighten financial conditions to the extent that U.S. activity falls (orange arrow), before it changes course by easing policy to allow activity to recover somewhat (yellow arrow). The chart also shows estimates of U.S. productive capacity - how much it could normally produce while keeping inflation at 2% - based on a projection of pre-Covid trend (pink line) and our estimate of where it currently lies based on current core PCE inflation (green line). The future values of the green line indicate

Unprecedented debt caps central banks' ability to raise rates

Debt levels surged to fund the pandemic fiscal response. Sensitivity of high debt levels to higher rates makes it harder for central banks to raise rates – and more tempting to live with inflation.

U.S. net debt interest payments and scenarios, 1990-20

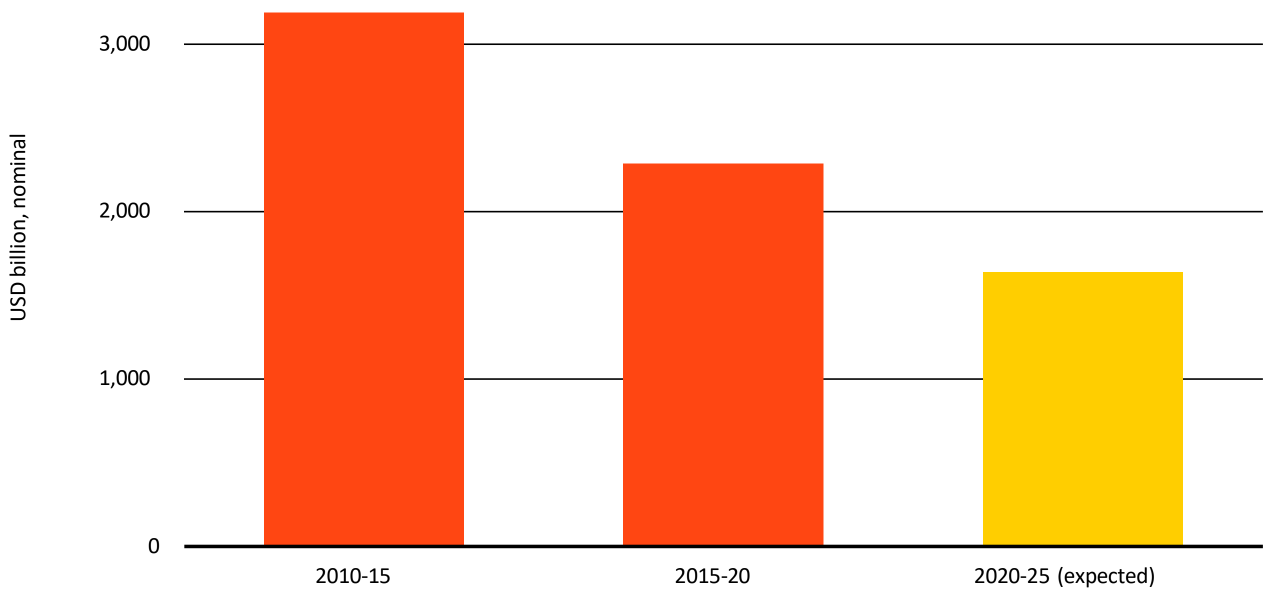


Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, OECD and International Monetary Fund, with data from Haver Analytics, July 2022. Notes: The chart shows projections for U.S. net interest payments based on different interest rate scenarios on a five-year horizon. The scenarios are calculated based on IMF projections of U.S. debt and hypothetical calculations of debt interest costs based on different assumptions for the path of interest rates as indicated in the legend..

A bumpy transition will contribute to the new regime

Commodities prices have spiked as demand from the restart clashed with tightening supply. We see the war and the transition keeping prices high and see a key role for fossil fuels in the transition.

Global capex expenditure in oil and gas, 2010-2025

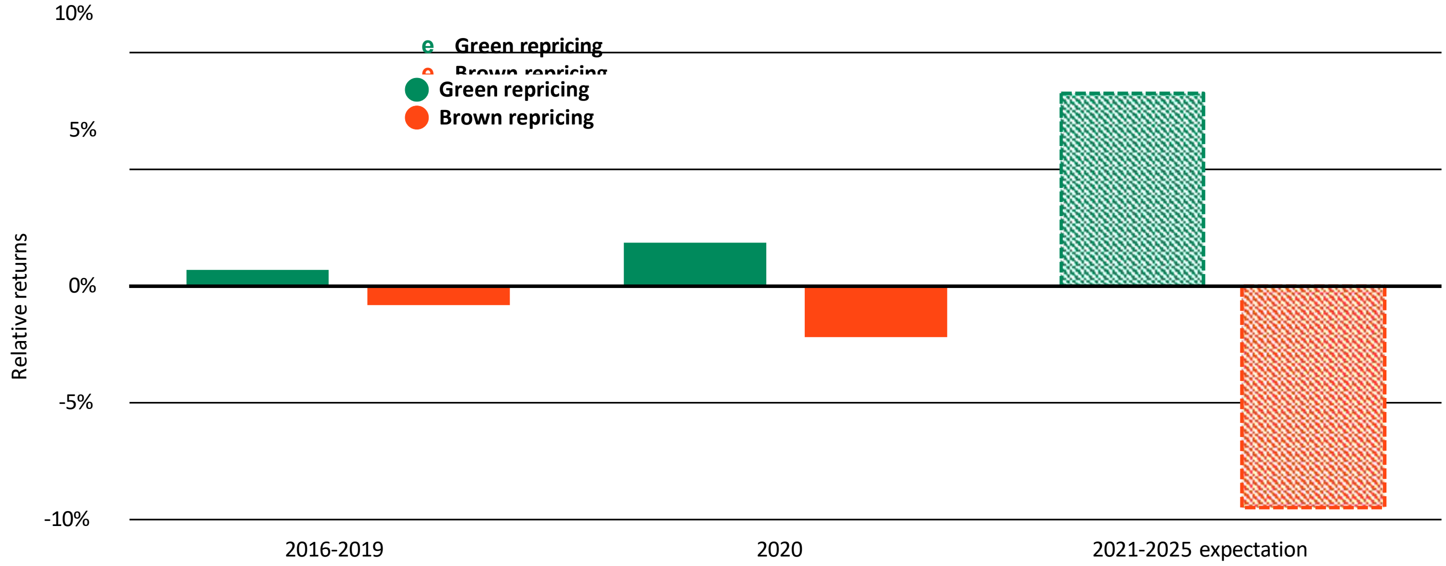


Forward-looking estimates may not come to pass. Source: BlackRock Investment Institute, Wood Mackenzie, June 2022. Note: The chart shows global capex expenditure in the oil and gas sector from 2010-2015 and from 2015-2020, as well as projected capex expenditure for the period 2020-2025.

Transition pricing in progress

We are seeing green sectors post better relative returns to brown sectors – and think it has room to run.

Relative returns of green vs. brown sectors, 2016-2025

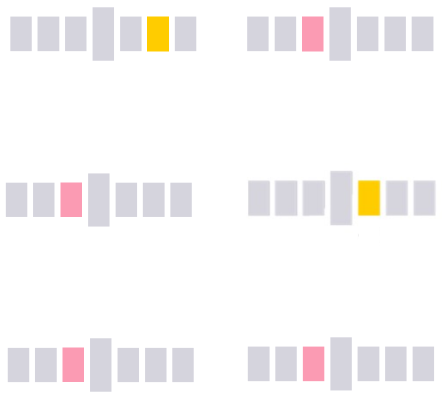


Past performance is no guarantee of current or future results. Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, with data from the Center for Research on Security Prices, Feb. 1, 2022. Notes: To estimate climate-driven repricing, we attribute historic returns to two drivers: cashflow news and discount rate (DR) news. We then identify the DR news associated with climate change using carbon emission intensity (CEI) as a proxy. To isolate the DR component of returns, we apply the standard decomposition formula of Campbell (1991) using a standard factor model of expected returns (which embed well-known predictors such as value, momentum, and quality). Attribution to climate scores is then given by forecasting regressions of DR news on a measure of CEI. Sector returns are MSCI US Sector index- weighted averages of stock-level returns. Green represents the technology sector, the most "green" in our work, whereas the utilities sector is the most "brown" in the repricing. The 2016-2019 bars represent the total repricing over this period; and the 2021- 2025 expectation is the cumulative repricing we expect over that period.The estimate is highly uncertain and is based on factors including risk premia effects in other long-run transitions such as demographic trends, market pricing of green bonds, and investor survey data on how much return they would be willing to give up to for more sustainable assets. See Sustainability: the tectonic shift transforming investing of February 2020 for details.

Snapshot of our views – July 2022

Latest directional views

Strategic view Tactical view



Equities

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 cut DM equities to underweight as we see activity stalling as central banks appear set to overtighten policy. Historically elevated corporate profit margins are at risk from rising input costs.

Credit

We are underweight public credit on a strategic basis on a view of a further rise in long-term rates, and prefer credit exposure in private markets. Tactically, we upgrade credit to overweight. Relatively healthy corporate balance sheets mean credit could weather stalling activity better than equities - with wider spreads providing a valuation cushion. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates for inflation risk.

Govt bonds

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 the direction of travel for long-term yields as higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers amid higher inflation.

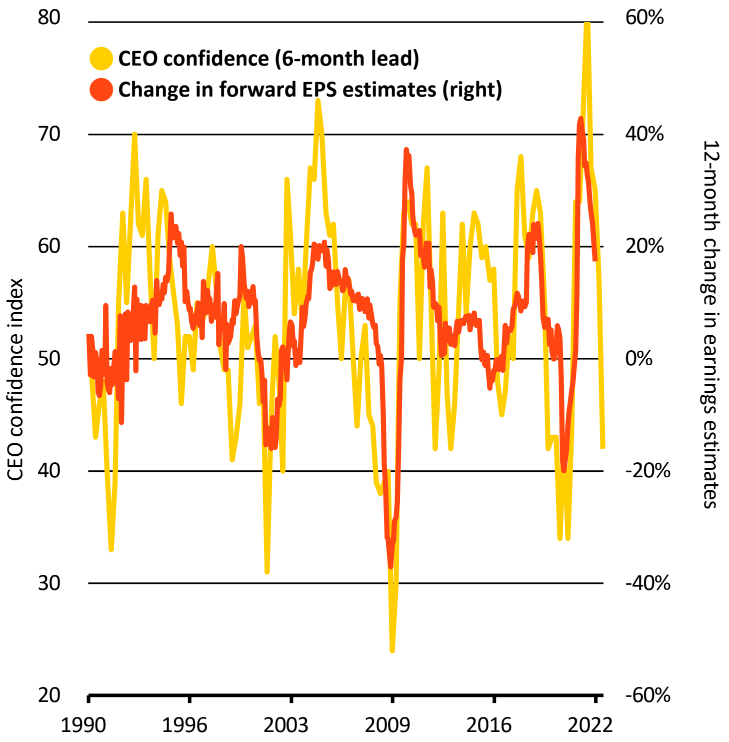
Tactical granular views - highlights

Developed market equities	**Underweight**	• We cut DM equities to underweight on a worsening macro picture and risks to corporate profit margins from higher costs.
Global credit	**Overweight**	• We upgrade global credit to overweight. The asset class is our preferred way to add duration to portfolio. Valuations are very appealing after the rise in yields and widening in spreads. Relatively healthy corporate balance sheets suggest credit can weather stalling activity better than equities.
UK gilts	**Overweight**	• We upgrade UK gilts to overweight as we see market pricing of policy rates as unrealistically hawkish in the near-term with activity poised to slow sharply.

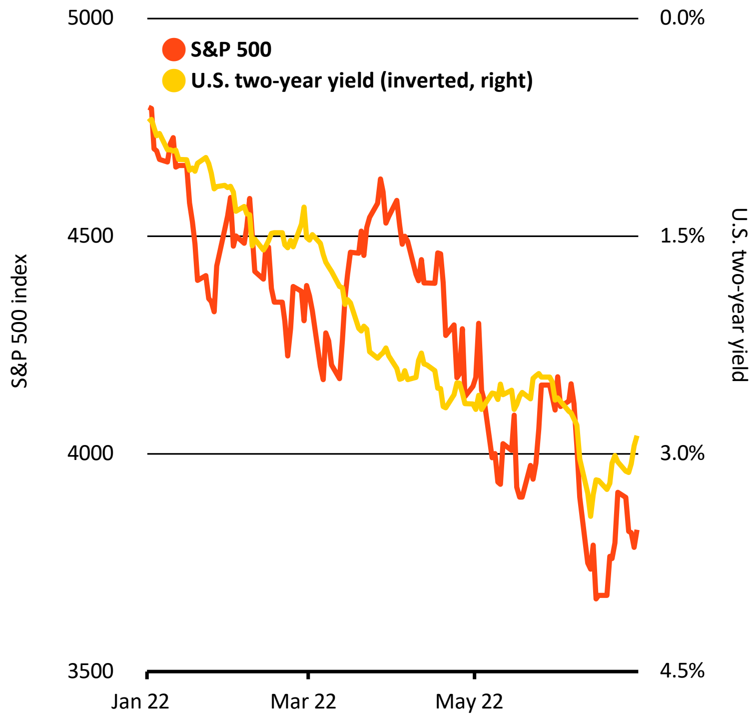
Downgrading DM equities to underweight

We see risks to corporate earnings as the backdrop worsens and to profit margins from higher costs. The year-to-date equity decline reflects rate pricing rather than poor earnings prospects, in our view.

U.S. CEO confidence and earnings, 1990-2022



S&P 500 vs. U.S. two-year yields, 2022

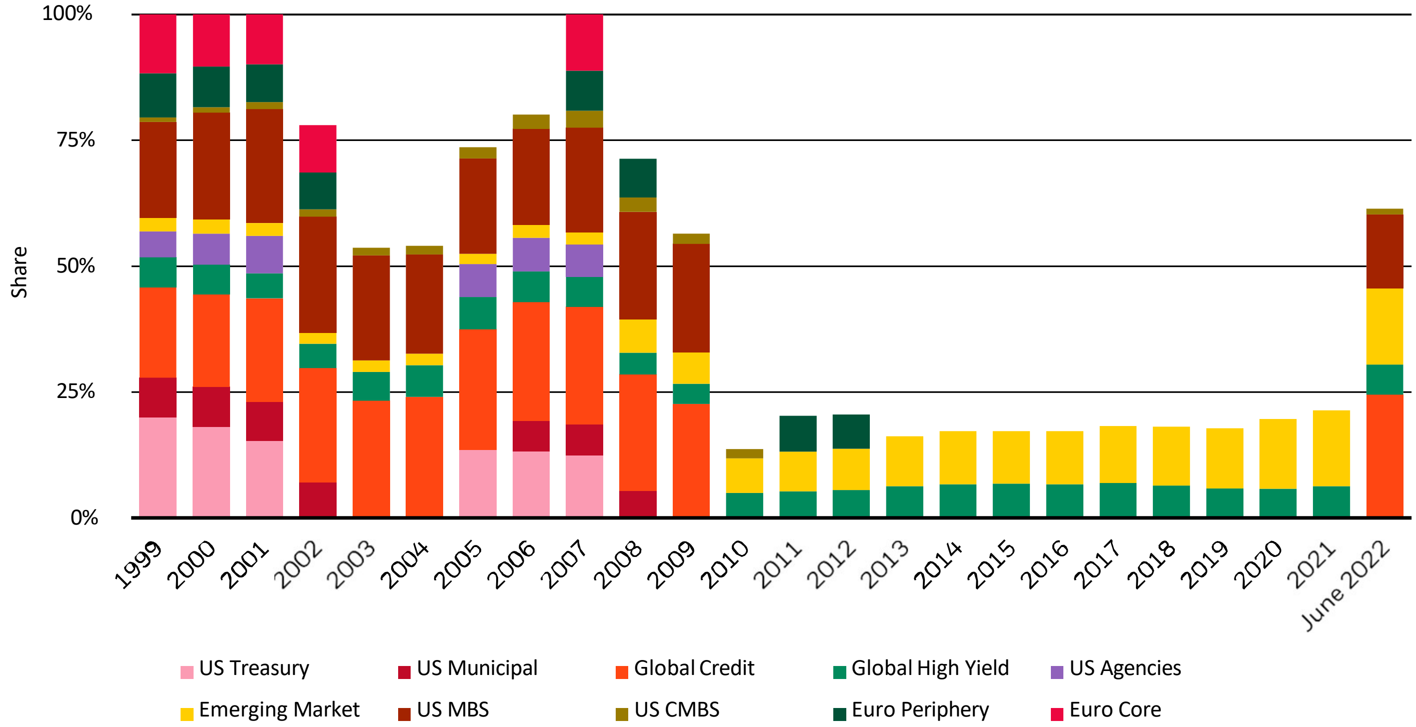


Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, May 2022. Notes: The chart shows the Conference Board CO Confidence Index and the year-on-year change in 12-month forward aggregate earnings estimates for the MSCI USA Equity Index. The right chart shows the year-to-date price move for the S&P 500 equity index and the yield of the U.S. two-year Treasury.

Upgrading global credit to overweight

Corporate cash buffers remain abundant and widening spreads have made valuations attractive, in our view. Credit is our preferred way of taking risk and adding duration given the yield surge.

Share of global fixed income assets yielding over 4%, 1999-2022

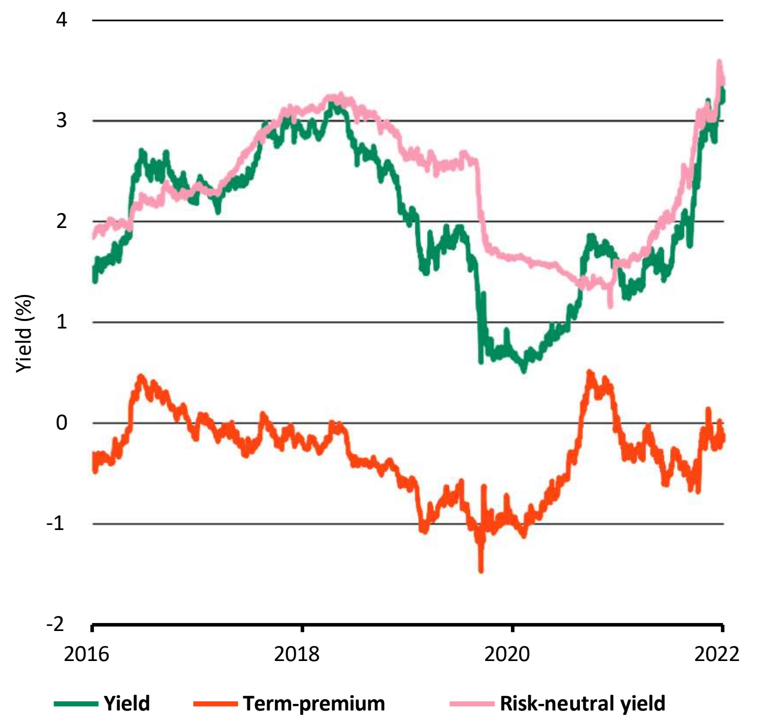


Sources: BlackRock Investment Institute, with data from Bloomberg, July 2022. Notes: Note: The bars show market capitalization weights of assets with an average annual yield over 4% in a select universe that represents about 70% of the Bloomberg Mulitiverse Bond Index. Euro Core is based on French and German government bonds indexes. Euro periphery is based on an average of government debt indexes for Italy, Spain and Ireland. Emerging markets combine external and local currency debt.

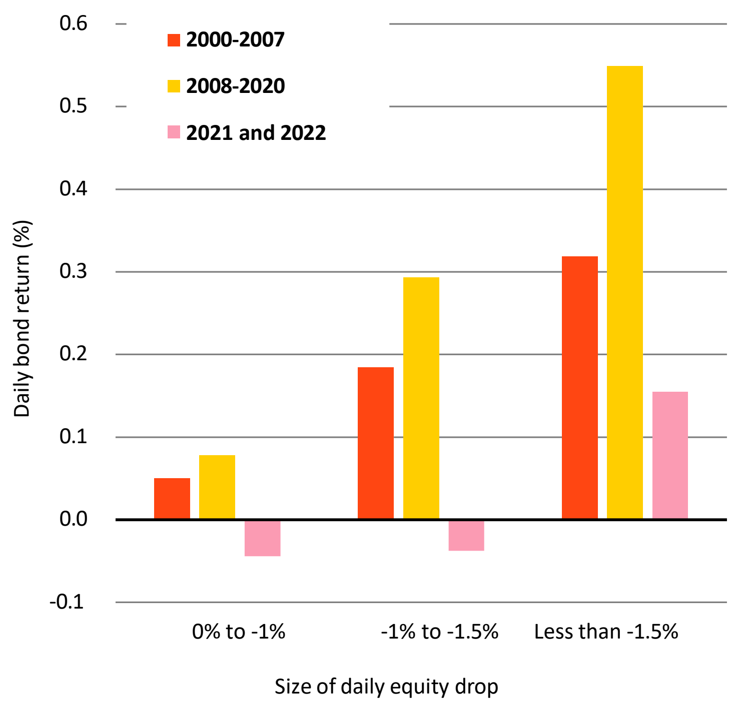
Sticking with our underweight to U.S. Treasuries

We see yields on long-term U.S. Treasuries rising further as term premium is restored. U.S. Treasuries' have also provided less portfolio diversification since 2021 – denting a major reason to own them.

U.S. 10-year yield breakdown, 2016-2022



U.S. Treasury returns on equity down days

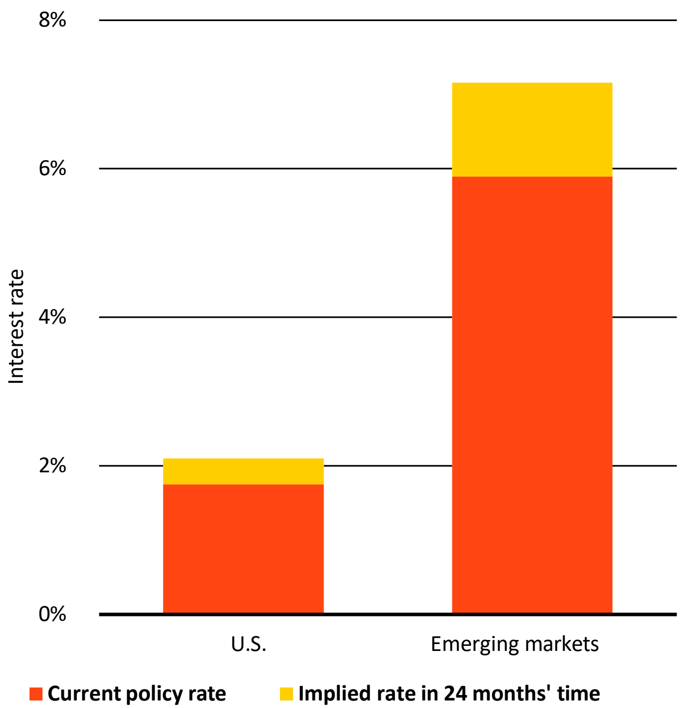


Sources: BlackRock Investment Institute, New York Federal Reserve, with data from Refinitiv Datastream. July 2022. Notes: The left chart shows the New York Federal Reserve's breakdown of the U.S. 10-year Treasury yield into the risk-neutral yield that measures the change in interest expectations and the term premium - the compensation demanded for bearing the risk of holding a government bond to maturity. The chart shows that most of the move higher in yields between mid-2020 to June 2022 has been due to rising rate expectations while the term premium has remained relatively suppressed. More information on the NY Fed model available here. The right chart shows the average daily move of the Bloomberg U.S. Treasury index on days the S&P 500 fell between 0-1%, 1% to 1.5% and more than 1.5%.

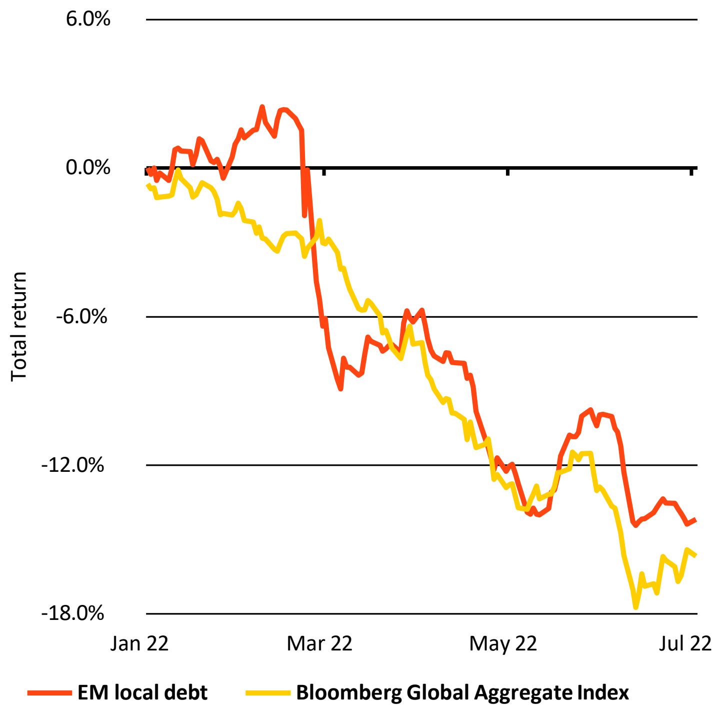
Still overweight EM local currency debt

An attractive combination of yields and carry supports EM local debt, in our view. EM local debt performance this year has been largely driven by the move lower in DM government bonds.

U.S. vs. EM policy rates, July 2022



Global vs. EM debt, year-to-date performance



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream. July 2022. Notes: The chart shows the current policy rate (green dot), market-implied pricing of central bank rates in 12 months' time (red bar) and 24 months' time (pink dot) and the change in the implied policy rate 24 months from now vs. 12 months from now (yellow) bar for the U.S. and across emerging markets using interest rate forwards. We use the J.P. Morgan GBI-EM Global Diversified index for EM and use a weighted avearge based on constituent weights as of 4 July, 2022. For the U.S., we use the the Bloomberg U.S. Treasury (all-maturity index).

Signposts to change views

Our conviction is that portfolios will need to change more quickly in a regime of higher volatility. We lay out the factors that could make us tactically change our views

Signposts

Positive

Asset	Signpost
Equities and credit	Decisive dovish pivot from central banks acknowledging the trade-off. Supply bottlenecks ease more quickly, relieving some inflation pressures and taking pressure off central banks. Valuations will likely determine the preference between equities and credit.
Govt. bonds	Dovish pivot as inflation expectations remain well anchored or yields reach levels that make them attractive in a whole-portfolio context.
Inflation-linked bonds	Supply-driven inflation not receding, and goods inflation stays elevated while services inflation picks up.
China equities	Greater elderly vaccination and a more forceful policy response to support the economy.

Negative

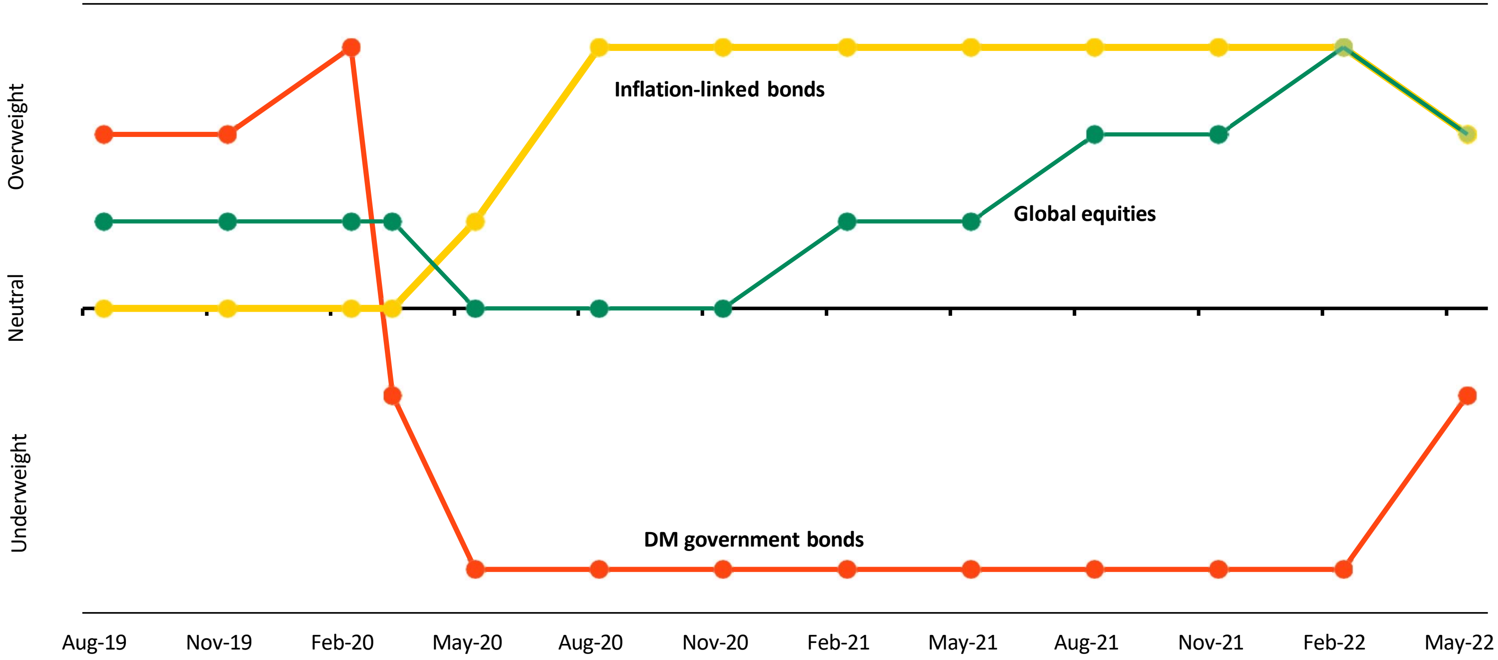
Asset	Signpost
Equities and credit	Higher inflation, hawkish policy and poor corporate earnings lasting beyond our tactical horizon.
Govt. bonds	Knee-jerk rallies in bonds and a low term premium despite volatile growth and inflation.
Inflation-linked bonds	Outright recession drives inflation lower.

Source: BlackRock Investment Institute, July 2022. Notes: 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 funds, strategy or security in particular.

Positioning for a volatile future

Our strategic views have been positioned for the new regime. A higher volatility regime means even strategic allocations will likely have to be more dynamic than before.

Evolution of our strategic views, 2019-2022



Forward looking estimates may not come to pass. Past performance is no guarantee of future results. Source: BlackRock Investment Institute, July 2022. Notes: The chart shows strategic investment views for U.S. Treasury Inflation-Protected Securities, global equities and DM nominal government bonds for a U.S. dollar investors on a 10-year view.

Tactical granular views: equities

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

Region	View	Commentary
Developed markets	-1	We cut DM stocks to underweight 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. But valuations have not come down enough to reflect weaker earnings prospects.
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 vs. 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 and not compelling enough valuations. 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.

Underweight | Neutral | Overweight | ● Previous view

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Tactical granular views: fixed income

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

Asset	View	Commentary
U.S. Treasuries	-1	We 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 now prefer Europe. The pullback in euro area breakeven rates since May suggests markets are underappreciating the inflationary pressures from the energy shock.
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 upgrade UK gilts to overweight. 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. Policymakers have been slow to loosen policy to offset the slowdown, and yields are no longer attractive relative to DM bonds.
Global investment grade	+1	We upgrade investment grade credit to overweight on attractive valuations. Strong balance sheets among higher quality corporates suggest IG credit could weather a weaker growth outlook better than equities.
Global high yield	Neutral	We are neutral high yield. We prefer up-in-quality credit exposures amid a worsening macro backdrop. We find parts of high yield offering 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 global macro outlook. Valuations are not compelling enough yet to turn more positive on the asset class, in our view.

Underweight | Neutral | Overweight | ● Previous view

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