Weekly commentary

BlackRock

April 11, 2022

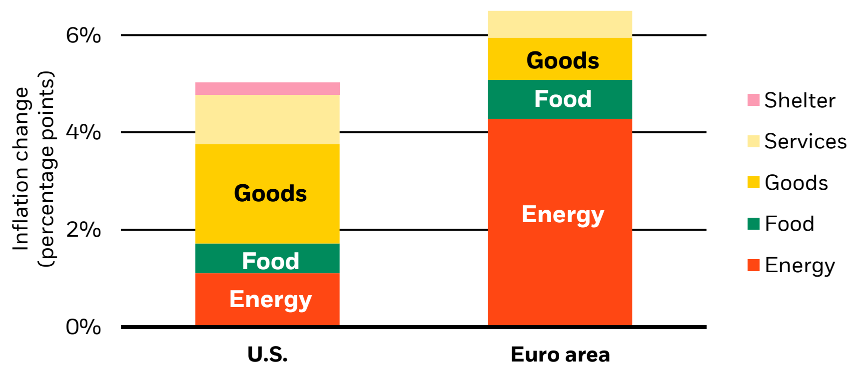
Scarcity inflation raises growth risks

- Supply shocks have created scarcity inflation, making higher inflation more persistent and increasing the risk of a growth slowdown.
- Ten-year U.S. Treasury yields hit three-year highs after it became clear the Fed will start to reduce its balance sheet quickly. We see further yield rises ahead.
- We could see European Central Bank officials trying to guide down market expectations for multiple rate hikes this year and next.

Scarcity inflation is here. Supply shocks have created shortages of goods, energy and food that are driving up prices. We see this making inflation more persistent. It's also spurring central banks to normalize policies faster. This is needed, in our view, as the economy no longer requires stimulus. The problem: Scarcity inflation has raised the risk of a global growth slowdown, either via the direct impact of the supply shocks or through central banks slamming the brakes on the economy.

Scarcity shock and inflation

Change in U.S. PCE and euro area inflation, 2022 vs. 2015-19 average



Sources: BlackRock Investment Institute, with data from Haver Analytics, April 2022. Notes: The chart shows how different categories of U.S. PCE and Euro area HICP contribute to the 2022 increase in inflation compared with the 2015-2019 (pre-Covid) average. U.S. numbers are based on February 2022 data, euro area data are based on the flash inflation release for March 2022 and are subject to revision.

Higher inflation is still driven by the sudden restart of economic activity from the pandemic's lockdowns. Supply has struggled to keep up with shifting bursts in demand across sectors. Russia's horrific invasion of Ukraine added a classic supply shock that is driving inflation higher and hurting economic activity. First, the West's drive to wean itself off Russian energy added to an existing energy crunch. The result: Rising energy prices today are contributing 4 percentage points more to euro area inflation than in the five years before COVID, as the chart shows. Second, reduced food and fertilizer exports from Russia and Ukraine have created food insecurity around the word. These new supply disruptions add to existing pressures: Farmers already faced sharply higher fertilizer and diesel costs. Food inflation (green bars in the chart) could become a larger driver of inflation in developed markets as a result. World food prices jumped 13% in March to a new high, Food and Agriculture Organization data show.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Nicholas Fawcett
Macro research – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on global economy, markets and geopolitics.

BlackRock **Investment** Institute

What is the impact of the two supply shocks and resulting scarcity inflation? It differs greatly by region. For Europe, the second shock could result in outright stagflation as the region's energy costs have surged to near-record levels, as we detail in A new supply shock. In the U.S., a net exporter of energy these days, the momentum of the economic restart is strong. The risks to growth there stem from the Federal Reserve's response to headline inflation running at 40-year highs, in our view.

Indeed, scarcity inflation is compounding the dilemma for central banks around the world: Inflation is high, but economies are not overheating. The usual playbook of jacking up rates to cool the economy doesn't really apply in a world shaped by supply. Central banks are normalizing policy rates back to neutral levels that neither stimulate nor restrain the economy. Minutes of the Fed's March meeting released last week reinforced our view that the central bank is determined to normalize very quickly, with a large projected rate increase this year and a quick reduction of its balance sheet.

The key issue: Will central banks go beyond neutral and slam the brakes on the economy with higher rates that crush activity – and risk assets? We believe central banks will ultimately choose to live with higher inflation, rather than destroy growth and employment. As a result, we expect the sum total of rate hikes to be historically low given the level of inflation. Once the Fed gets closer to neutral levels of rates later this year, inflation will likely have peaked. Growth and spending on goods should be normalizing. We see two risks. First, central banks could slam the brakes anyway because they think they can lift rates higher without causing damage. Second, the sticker shock from higher day-to-day prices causes inflation expectations to become de-anchored from central bank targets.

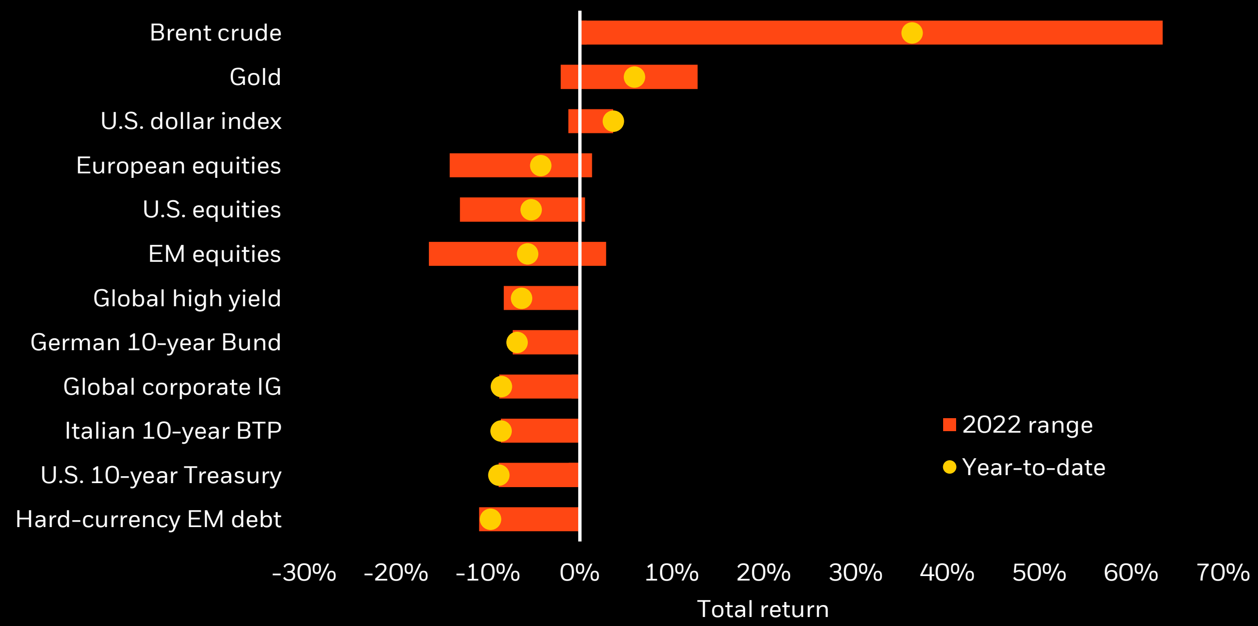
What are the investment implications? We prefer equities over credit because the inflationary environment favors stocks, in our view. Many developed market companies so far have been able to pass on rising costs and kept margins high. First-quarter results starting this week will provide a reality check. We are underweight government bonds. We see long-term bond yield rising further and yield curves steepening as investors demand extra compensation for the risk of holding long-term government bonds amid high inflation and debt loads. Short-term bonds could outperform as we believe market expectations for rate increases have become overly hawkish. Such a backdrop could still be positive for equities because it represents a relative investor preference for stocks over bonds. We favor U.S. and Japanese equities over European peers within developed markets because we see the impact of the energy and food shocks as greatest there.

Market backdrop

U.S. 10-year Treasury yields jumped to three-year highs of around 2.7% even as short-term yields steadied, causing the yield curve to steepen sharply. The Fed's plans to shrink its balance sheet – so-called quantitative tightening – was close to expectations but helped spark the back up in yields. We expect a further steepening of the yield curve as investors demand more term premium, or extra compensation for the risk of holding long-term bonds.

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 April 5, 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.

Macro insights

Traditional energy stocks have delivered strong returns amid a difficult start to the year for the broader stock market. See the yellow and orange lines on the chart. As the West seeks to wean off Russian energy, greater demand for non-Russian fossil fuels has pushed up prices, leading investors to expect higher profits from energy producers. Clean energy stocks have also outperformed the broad market since Russia invaded Ukraine (green line) as markets see the drive for energy security, particularly in Europe, as a positive for renewables.

Sustained high fossil fuel prices act like a carbon tax on consumers. Europe now spends over 9% of its GDP on energy, the highest share since 1981. Even before fuel prices surged, wind and solar power were competitive with fossil fuels. Renewables have become even more competitive now that fuel prices are even higher. This should spur Europe toward renewables and electrification. Bottom line: The effective stranding of Russian fossil fuel supply has created investment needs in both traditional energy and renewables. See our macro insights.

Energy outpaces global benchmarks

Global and clean energy equities total return, 2022

Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, April 2022. Notes: The chart shows the total return index for the MSCI World Energy Index, MSCI World Equity Index and S&P Global Clean Energy Index, rebased to 100 at the start of January 2022.

Investment themes

1 Living with inflation

- We expect central banks to quickly normalize policy. We see a higher risk of the Federal Reserve slamming the brakes on the economy to deal with supply-driven inflation after raising rates for the first time since the pandemic.
- The Fed has projected a large and rapid increase in rates over the next two years. We see the Fed delivering on its projected rate path this year but then pausing to evaluate the effects on growth.
- Normalization means that central banks are unlikely to come to the rescue to halt a growth slowdown by cutting rates. The risk of inflation expectations becoming unanchored has increased as inflation becomes more persistent.
- We believe the eventual sum total of rate hikes will be historically low, given the level of inflation. DM central banks have already demonstrated they are more tolerant of inflation.
- The Bank of England hiked rates for a third time but signaled that it may pause policy normalization on concerns about the growth outlook from spiraling energy costs. This is the bind other central banks will likely face this year.
- The European Central Bank has also struck a hawkish tone, planning to wind down asset purchases and leaving the door open for a rate increase later this year. We expect it to adopt a flexible stance in practice given the material hit to growth we see from higher energy prices.
- **Investment implication**: We prefer equities over fixed income and overweight inflation-linked bonds.

2 Cutting through confusion

- We had thought the unique mix of events – the restart of economic activity, virus strains, supply-driven inflation and new central bank frameworks – could cause markets and policymakers to misread the current surge in inflation.
- We saw the confusion play out with the aggressively hawkish repricing in markets this year – and central banks have sometimes been inconsistent in their messages and economic projections, in our view.
- The Russia-Ukraine conflict has aggravated inflation pressures and has put central banks in a bind. Trying to contain inflation will be more costly to growth and employment, and they can't cushion the growth shock.
- The sum total of expected rate hikes hasn't changed much even with the Fed's hawkish shift.
- **Investment implication:** We have tweaked our risk exposure to favor equities at the expense of credit.

3 Navigating 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 fossil fuels 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.
- The green transition comes with costs and higher inflation, yet the economic outlook is unambiguously brighter than a scenario of no climate action or a disorderly transition. Both would generate lower growth and higher inflation, in our view. Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions.
- We favor 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**: We favor DM equities over EM as we see them as better positioned in the green transition.

Week ahead

April 11-18 China total social financing

April 12 Germany ZEW economic sentiment

April 14 ECB policy meeting; University of Michigan sentiment

The European Central Bank's rate decision is our focus this week, against a backdrop of hawkish market pricing that points to a lift-off in policy rates later this year. We think the ECB will be more cautious about lifting policy rates back near zero than markets currently expect. Our reasoning: The energy shock's hit to growth will do some of the work for the ECB.

Directional views

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

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

Asset	Strategic view	Tactical view	
Equities	+2	+1	We increased our strategic equities overweight in the early 2022 selloff. We saw an opportunity for long-term investors in equities because of the combination of low real rates, strong growth and a change in valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we favor developed market equities over emerging market stocks, with a preference for the U.S. and Japan over Europe.
Credit	-1	-1	We are underweight credit on a strategic and tactical basis against a backdrop of rising interest rates and high valuations. We prefer to take risk in equities instead. Tactically, we overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk, in our view.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio diversifiers with yields near lower bounds. We see investors demanding higher compensation for holding government bonds amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we also underweight government bonds 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 in the higher inflation regime.
Private markets	Neutral	—	We believe non-traditional return streams, including private credit, 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. Many institutional investors remain 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.

Granular views

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

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

Asset	View	Commentary
Developed markets	+2	We overweight DM stocks amid supportive fundamentals, robust earnings and low real yields. We see many DM companies well positioned in the inflationary backdrop thanks to pricing power. We prefer the U.S. and Japan over Europe.
United States	+2	We overweight U.S. equities due to still strong earnings momentum. We see the Fed not fully delivering on its hawkish rate projections. We like the market's quality factor for its resiliency to a broad range of economic scenarios.
Europe	+1	We are moderately overweight European equities as we expect the energy shock to hit European growth hard. We like the market's cyclical bend in the inflationary backdrop and expect the ECB to only slowly normalize policy.
UK	Neutral	We are neutral UK equities. We see the market as fairly valued and prefer other DM equities such as U.S. and Japanese stocks.
Japan	+2	We are overweight Japan equities on supportive monetary and fiscal policies - and the prospect of higher dividends and share buybacks.
China	+1	We now see Chinese stocks as more risky, but improved valuations leave us moderately overweight. China's ties to Russia have created a new geopolitical concern that requires more compensation for holding Chinese assets, we think.
Emerging markets	Neutral	We are neutral EM equities and prefer DM equities, given more challenged restart dynamics, higher inflation pressures and tighter policies in EM.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China because of easing monetary and regulatory policy.
U.S. Treasuries	-1	We underweight U.S. Treasuries even as yields have surged this year. We see long-term yields move up further as investors demand a higher premium for holding governments bonds. We prefer short-maturity bonds instead.
Treasury Inflation-Protected Securities	+1	We overweight U.S. TIPS as we see inflation as persistent and settling above pre-Covid levels. We prefer TIPS as diversifiers in the inflationary backdrop.
European government bonds	-1	We underweight European government bonds. We see yields heading higher even as markets have adjusted to price in an end to negative rates and beyond.
UK gilts	Neutral	We are neutral UK Gilts. We see market expectations of rate hikes as overdone amid constrained supply and weakening growth.
China government bonds	+1	We overweight Chinese government bonds. Easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
Global investment grade	-1	We underweight investment grade credit amid tight spreads and interest rate risk. We see more value in equities instead.
Global high yield	Neutral	We are neutral high yield. We do not expect credit spreads to tighten but find the income potential attractive. We prefer to take risk in equities.
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 interest rate risk.
Asia fixed income	+1	We stay overweight Asia fixed income. We find valuations in China compelling relative to risks. Outside China, we like Asian sovereigns and credit for income.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. 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 or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee