BlackRock.

Portfolio perspectives
February 2022

Confusion yields opportunity

Updated capital market assumptions and re-iterating the big picture themes underpinning our strategic asset views

BlackRock **Investment** Institute

Summary

- Our strategic asset preferences – a broad preference for equities over nominal government bonds and credit – have been positioned for the new market regime we flagged in our 2022 Global Outlook. We see this regime driven by investors demanding greater compensation, or term premium, for the risk of holding government bonds and our expectation for higher inflation in the medium term. It reinforces a significant asset reallocation in favor of equities and away from developed market (DM) nominal government bonds that has only just begun, in our view.
- In the near-term, an unusual economic backdrop – of a restart, not a recovery – coupled with geopolitical concerns due to Russia's invasion of Ukraine have heightened the risk of confusion and policy mistakes that has weighed on equity markets this year. We think these dynamics are more likely to affect asset prices in coming months rather than over a multi-year horizon. As such, we see an opportunity to add to our overweight to developed market equities in a strategic asset views.
- It is important to stay focused on the big picture: we believe we entered a fundamentally different market regime in 2021 of supply-driven inflation and central banks' higher tolerance of such inflation. Central banks will be forced to live with more inflation, in our view, given the cost to growth of pushing down supply-driven inflation. This backdrop remains favorable for equities and challenging for government bonds, in our view.
- We take advantage of the year-to-date the selloff in developed market equities to add to our overweight. The cumulative path of rate hikes matters more for valuations than the speed of repricing over the next two years. Valuations – once low interest rates are taken into account – are not as stretched as traditional metrics suggest. Within equities, we see the net-zero transition driving a relative return advantage for "greener" sectors such as tech and healthcare over "browner" sectors such as energy and utilities, over the long term.
- We believe the outlook for developed market nominal government bonds remains challenged. We see the sharp rise in government bond yields this year as consistent with a fundamental asset reallocation driven by investors wanting greater compensation – or term premium - for the risk of holding government bonds. Rising term premium amid a shift to a higher inflation regime and bonds yields' proximity to effective lower bounds even after their recent rise still limits their ability to provide portfolio ballast in risk asset selloffs. Our view of higher medium-term inflation than the market currently is pricing supports our overweight to inflation-linked bonds.
- The confusion gripping markets is yet another reminder of why we believe investors should explicitly build uncertainty-aware, resilient portfolios as standard. The latest update to our capital-market assumptions (CMAs) is as of 24 January 2022, rather than end-December 2021, to capture some of the significant market moves we've seen since year-end.

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Our latest strategic views

We are now in a fundamentally different market regime from the one we've seen over the past decade – one driven by higher supply-driven inflation and a more muted cumulative central bank response to such inflation. This macro backdrop – already baked into our capital market assumptions (CMAs) since mid-2020 - reinforces a significant asset reallocation in favor of equities and away from DM nominal government bonds that our strategic asset preferences have already been positioned for. The dislocations in markets so far in 2022 - driven by an adjustment to this regime shift, geopolitical concerns and by near-term confusion stemming from the unusual economic restart, a surge in inflation and new central bank frameworks – presents long-term investors with a potential opportunity to bump up equity allocations. We add to our DM equity overweight while maintaining a strong underweight to DM government bonds. See the chart on the left below.

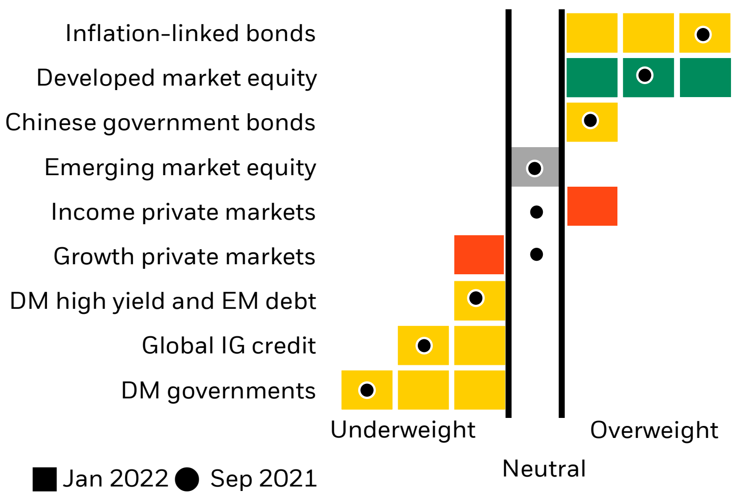
The speed of the market's repricing upwards of the path of interest rate hikes over the next two years – most notably at the Fed but also to varying degrees across other major DM central banks such as the European Central Bank (ECB) – has been striking. The swiftness of the move has sparked confusion – exacerbated by mixed messages from central banks themselves – about what is guiding their policy. The Fed appears to have effectively abandoned its prior guidance that it would wait until it reaches its "broad and inclusive" full employment objective before starting to raise rates. In doing so, it has lost an anchor for policy expectations and contributed, in our view, to the speed of the market's repricing of the rate path over the next two years. The pace of the repricing has weighed on equity markets, adding to some investors' concerns around slowing growth and potential erosion of profit margins as inflationary pressures build.

The confusion gripping markets may persist over the near-term – the repricing of the ECB's rate path occurred after our 24 January cut-off date for this CMA update. On a strategic horizon of five years and beyond, we believe fundamentals will matter more, spurring us to take advantage of the recent selloff add to our DM equity overweight. It is not strange that the central banks should want to get policy back to neutral and away from emergency measures – and do so quickly – as the restart does not require stimulus. Yet we believe what we are seeing for the Fed in particular is a re-timing of rate rises and not a re-assessment of how far rate rises are going to go this cycle. The chart on the bottom right contrasts market pricing of short-term (orange line) and long-run rate expectations (yellow line). Market expectations and the Fed's own projections of cumulative rate hikes – key for asset valuations - have remained stable at historically low levels through the repricing at the front-end. We believe central banks will ultimately choose to live with inflation. Why? The unusual supply-driven nature of inflation means fighting such inflation aggressively with monetary policy will dent growth while doing little to address the underlying cause. This suggests a muted policy response that keeps real rates relatively low and supportive of risk assets. We expect supply triggered inflation to last far beyond the restart. Why? We see the transition to reach net zero carbon emissions by 2050 completely rewiring the global economy and altering supply-demand patterns across sectors.

We believe bond markets are not fully pricing in higher medium-term inflation. We expect higher term premium to become a driver of higher nominal yields. This is also why we prefer and remain strongly overweight inflation-linked bonds. Our central case is for nominal yields to continue to rise. Yet they remain close enough to lower bounds to limit the effectiveness of DM government bonds as portfolio ballast. Meanwhile, China continues to stand out. In contrast to DM economies, the policy stance in China has become markedly dovish as policymakers look to counter the economic hit from new virus strains amid the Winter Olympics. We remain modestly overweight Chinese assets in strategic allocations, and like Chinese government bonds in particular for both returns and diversification.

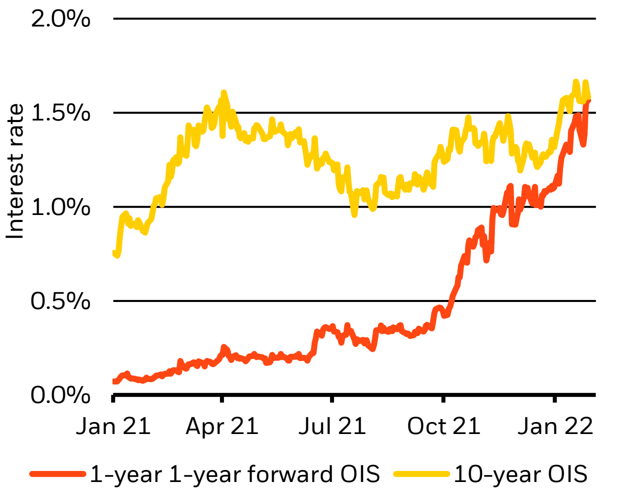
Prefer equities over credit and government bonds

Hypothetical U.S. dollar 10-year strategic tilts, February 2022



Rate hikes re-timed, not re-assessed

Market expectations of U.S. interest rates, February 2022



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Source: BlackRock Investment Institute, February 2022. The chart on the left shows our asset views on a 10-year view from an unconstrained U.S. dollar perspective against a long-term equilibrium allocation. Global government bonds and EM equity allocations include respective China assets. Income private markets comprise infrastructure debt, direct lending, real estate mezzanine debt and US core real estate. Growth private markets comprise global private equity buyouts and infrastructure equity. The allocation shown is hypothetical and does not represent a real portfolio. It is intended for information purposes only and does not constitute investment advice

Adding to our DM equity overweight

Confusion over the restart, supply-driven inflation and new central bank frameworks has been evident in markets this year. This confusion, alongside mounting jitters over Russia's invasion of Ukraine, has weighed on equity markets. The swift repricing in the path of short rates has sparked a surge in bond yields and triggered a rotation away from long-duration sectors such as tech that have dominated equity markets over the past decade. For long-term investors, we see this selloff as a mispricing to exploit by adding to equity positions. We believe equity markets are not making the distinction between the repricing in the near-term path of policy rates – which has been sharp yet has a limited impact on long-term expected returns – and the muted change in long-run policy rate expectations – far more important for equity valuations and returns.

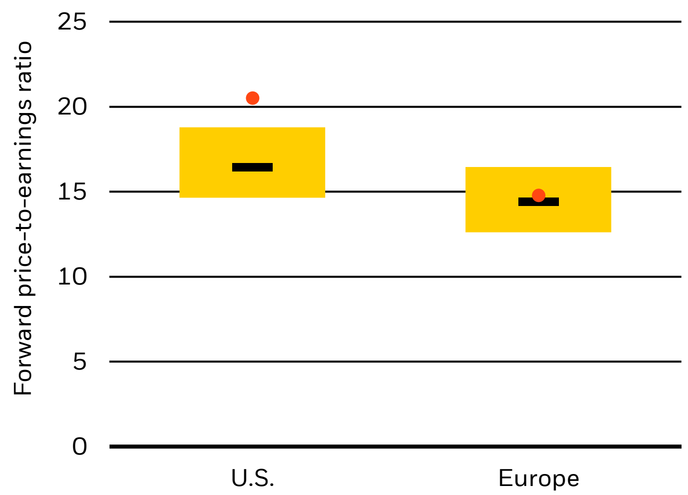
The value of a stock is based on the future value of cash flows – the vast majority of that value lies beyond 2022 or 2023, in our view. This means a higher discount rate in those years but not further out should, all else equal, have only a limited impact on long-term equity valuations. In our CMAs, certain key sectors – such as tech and communications - have become more attractive now than they were prior to the equity market sell-off, and our higher allocation to equities overall reflects a larger share of these sectors in our portfolios.

In a whole-portfolio context, the valuation argument has implications beyond public equities. In our paper the core role of private markets in modern portfolios, we emphasized that prevailing market conditions should dictate the split between public and private assets rather than a pre-determined split. We determine the attractiveness of private versus public markets independently every quarter. The relative attractiveness of public equity, and, as we'll discuss in the next page the relative unattractiveness of public fixed income influences our private market allocations. Today, we prefer to access credit exposures via private markets, and on a relative basis, prefer to access equity exposures publicly. Importantly, however, our relative underweight to private equity should not be seen as a recommendation to sell private equity allocations or abandon long-standing funding programs. We believe private growth assets should play a sizeable role in any institutional asset allocation eligible to hold such assets. Yet in a hypothetical scenario of designing a portfolio from scratch today, we believe such assets would play a lesser role than they did due to the increased attractiveness of public equity.

The bottom-line: The bigger picture is little changed amid the volatility of the past month. The sum total of expected rate hikes - key for asset valuations - has not moved much. That means publicly traded equities have become even more attractively valued than they were after their recent drop, leading to our upgrade. We find public equities particularly appealing relative to growth private markets where the repricing we describe above has not occurred, in our view. The evolving situation at the Ukraine border warrants near-term caution. Yet we are also mindful that geopolitical tensions tend to cause short term gyrations like the ones we're seeing rather than become ongoing market drivers.

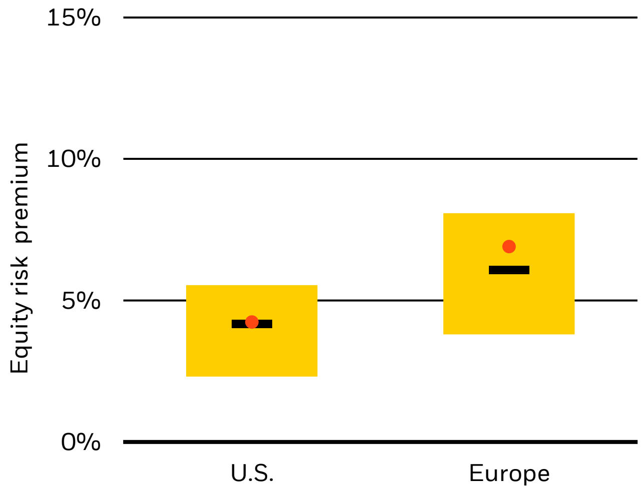
P/E ratios may look expensive but...

Forward price-to-earnings ratios vs history, 1995-2022



...the ERP suggests equities are fairly valued

Equity risk premium vs history, 1995-2022



● 24 January 2022 ■ Mean ■ Interquartile range

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Lower bounds still matter for bonds

Nominal government bonds have become less expensive since our last update, as yields have backed up. Yet we remain convinced in our underweight to nominal DM government bonds even after the backup in yields we have witnessed in recent months. Why? Two key reasons: first, we see yields as being close enough to effective lower bounds that bonds' role as portfolio ballast remains challenged and second, we believe we are seeing a re-assessment of fixed income risk in markets as term premium – or the extra compensation investors demand to hold long-term bonds – is restored. We believe there is further to go on the term premium, keeping our central estimate for expected returns low.

Given the move in yields, a valid question is whether they are sufficiently far away from effective lower bounds for them not to matter. Perhaps yes, for investors focused on short time horizons. But for investors building strategic horizon portfolios, history and our estimates of uncertainty around the path of returns going forward suggest not. Take the outlook for the U.S. Treasuries all-maturities index. When building a 10-year portfolio, the question 'do lower bounds matter?' effectively means asking what is the probability of falling around 150 basis points - the current average yield to maturity of the Bloomberg U.S. Treasuries index, as of 24 January 2022 - over the next 10 years. Data from Federal Reserve of St. Louis shows that since 1969 yields were 150 basis points below their starting levels five years later on 36% of the days over the whole period even after accounting for any structural decline in rates over time. See table below. Even when we adjust this data to allow for the structural decline in yields in recent decades, the number is 26%. That means based on history alone, we would expect more than a quarter of our return pathways to be impacted by the lower bound over a 10-year horizon.

But historical performance can be thought of as just one of multiple unknown pathways that asset prices might take going forward. The market environment of the past few months has underscored the importance of considering alternative scenarios – and incorporating uncertainty into return estimates. Such an approach has been central to our portfolio construction methodology that is based on achieving resilience in worst-case outcomes. We simulate thousands of potential return pathways around our central estimate and provide a "term structure" of returns over different time horizons – from five years out to the long-term. In our simulations, these worst-case outcomes are ones where risk assets such as equities do poorly. This could be, hypothetically, a recession - a plausible scenario over a 10-year year period. This is precisely when portfolio ballast will be needed. Yet it is in these same simulations where lower bounds on bond yields may be breached as yields fall again in response to accommodative monetary policy that has been employed to counter downturns and market shocks. See our April 2019 paper *Understanding uncertainty* for more on our approach to incorporating uncertainty.

The bottom line: we keep our strong strategic underweight to government bonds even after the recent back-up in yields. Our central case assumes yields keep rising – driven in part by the return of term premium. See the chart below on the right for our estimates of where U.S. Treasury yields will be in five years' time relative to market estimates. That means our expected returns remain low relative to other asset classes, and the ability of government bonds to act as risk-off diversifiers remains challenged due to proximity of yields to effective lower bounds over a strategic horizon.

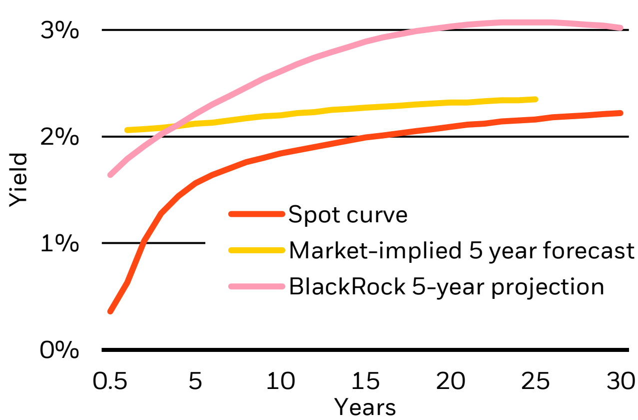
Lower bounds still in range

No. of days yields fell 150 basis point from starting level

Period	Percentage of days over 5-year horizon	Percentage of days over 10-year horizon
1969-2022 (adjusted for structural decline in interest rates)	16%	26%
1985-2022 (adjusted for structural decline in interest rate)	8%	8%
1969-2022 (unadjusted)	20%	36%
1985-2022 (unadjusted)	21%	42%

Steeper curves ahead

U.S. yield curve vs. estimates, Feb 2022



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Appendix

Index proxies

Asset	Index
Equities	MSCI Developed - US Gross TR Index
	MSCI Developed - United Kingdom
	MSCI EMU Index
	MSCI Developed Europe ex UK Gross TR Ind
	MSCI Developed - Japan Gross TR Index -
	MSCI Daily TR Gross Developed Pacific Ex
	MSCI China A Inclusion NET Index
	MSCI Emerging - China in CNY
	MSCI Emerging Markets ex China (Net)
Fixed Income (Sovereign bonds and investment grade)	Bloomberg Barclays U.S. Treasury 1-10 Yr Index
	Bloomberg Barclays U.S. Treasury 10+ Yr Index
	Bloomberg Barclays Euro Treasury 1-15 Year Index
	Bloomberg Barclays Euro Treasury 1-15 Year Index
	Bloomberg Barclays Sterling Aggregate Gilts (1-10)
	Bloomberg Barclays Asian Pacific Japan Treasury
	Bloomberg Barclays China Treasury + Policy Bank Total Return Index
	Bloomberg Barclays US Government Inflation-Linked Bond 1-10yr Index
	Bloomberg Barclays U.S. Tips Index 10Yr Plus - USD GROSS TR
	Bloomberg Barclays Euro Government Inflation-Linked 1-10 Years Index
	Bloomberg Barclays Inflation Linked Eurozone Inflation 10+Y
	Bloomberg Barclays MBS Index
	Bloomberg Barclays U.S. Credit Index
	FTSE Actuaries UK Index-Linked Gilts up to 5 Years Index
	FTSE Actuaries UK Index-Linked Gilts over 5 Years Index
	Bloomberg Barclays Euro Aggregate Corporate Index
	Bloomberg Barclays Sterling Aggregate Corporate Bond Index
Fixed income (High yield)	Bloomberg Barclays U.S. Credit Index
	Bloomberg Barclays Euro Aggregate Corporate Index
	JP Morgan EMBI Global Diversified Index
	JP Morgan GBI-EM Global Diversified Index
Income and growth private markets*	U.S. private equity
	Global direct lending
	Global Infrastructure equity
	U.S. core real estate
	Real estate mezzanine debt
	Hedge funds (global)
	U.S. infrastructure debt
	Developed markets infrastructure debt

* We use BlackRock proxies for selected private markets because of lack of sufficient data. These proxies represent the mix of risk factor exposures that we believe represents the economic sensitivity of the given asset class.

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