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Portfolio perspectives
June 2022

Strategic implications of the yield spike

We reduce our long-running underweight to government bonds in strategic portfolios as short-dated debt is more attractive after this year's surge in yields – and keep our overweight to equities.

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Summary

- This year's surge in bond yields has spurred changes in our strategic – or long-term – asset views. Most notably, we have reduced our long-running underweight to government bonds, in large part due to less unattractive valuations and better income on offer at the short-end of the curve. We stay firmly underweight long-dated bonds as we see yields rising further as investors demand greater compensation for holding them in an inflationary backdrop. Developed market (DM) equities remain one of our largest overweights - underpinned by still appealing expected returns on a long-term view.
- Both equities and bonds have seen sharp selloffs this year. The drawdown in equities reflects, in our view, investors grappling with the difficult trade-off confronting central banks on growth and inflation. Central banks have turned increasingly hawkish to counter elevated inflationary pressures, sparking a sharp repricing higher of expected policy rate paths. The near-term risk of a renewed hawkish repricing in markets amid persistent inflation pressures spurred us to cut risk in our tactical views last month.
- Yet we expect this the excessive hawkishness to subside over a strategic horizon as central banks ultimately choose to live with inflation that we see persisting over the medium term rather than slamming the policy brakes and choking off growth. That scenario favors equities over bonds, in our view, underscoring our broad asset preference. Our expected returns for equities have risen modestly as the lift from cheaper valuations after the selloff is offset by the drag from a higher projected path for short term rates in the near term.
- In fixed income, the rise in long-term yields is consistent with the underweight to DM nominal government bonds we have held in our strategic positioning since April 2020. We still see higher long-term yields over the next five years, driven by investors demanding a higher term premium for the risk of holding long-term bonds. We also cut Chinese government bonds to neutral as their previous yield advantage over DM yields has disappeared.
- We still favor inflation-linked bonds in this environment due to higher real rates and our expectation that inflation will settle at levels above pre-pandemic levels. Breakeven inflation rates – a market proxy for market inflation expectations – remain well below our estimates of where inflation is likely to be in five years' time.
- In private markets – as in public – the higher path of short-term rates brings down our expected returns on the asset class. In our last *Portfolio perspectives* we highlighted the increased attractiveness of public equities over private markets to get exposure to growth. That relative appeal persists. We prefer private credit over public credit on a strategic horizon due to our higher expected returns on a risk-adjusted basis.
- The current environment reinforces the importance of distinguishing investment views on tactical (6-12 months) and strategic (five years and beyond) horizons. Over a strategic horizon, our core stance of favoring equities over nominal government bonds holds, in our view, even as markets remain volatile in the near-term. In our strategic asset allocation we assume an investor is typically targeting a specific long-term outcome, does not shift risk levels and stays fully invested. Given these constraints - typical among institutional asset owners - the reduced underweight to a large asset class like nominal government bonds warrants an adjustment elsewhere – in this instance, via a small cut to the DM equities allocation. Yet the bigger picture remains that we maintain a significant preference for DM equities over nominal government bonds.

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Our latest strategic views

This year's spike higher in bond yields and equity selloff has spurred a change in our strategic asset preferences. See chart on the left below. Most notably, we have reduced our long-running underweight to government bonds, in large part due to less unattractive valuations and better income on offer at the short-end of the curve. The outlook for long-date bonds remains challenged, in our view. We keep our overweight to equities and inflation-linked bonds. Over a strategic time horizon, we see central banks keeping rates lower than they would've normally done at similar levels of inflation. We think the front-end of DM yield curves are pricing in too much tightening that central banks will not be able to deliver once the costs of higher rates become clear - a scenario that favors equities over bonds over the long-term, in our view.

In the near-term, tough talk from central banks on inflation has sparked concerns of interest rates moving past neutral into restrictive territory – one reason equities have been roiled. These moves reflect, in our view, a market grappling to come to grips with the difficult trade-off that central banks face between between choking off growth via sharply higher rates or living with supply-driven inflation. Beyond tighter monetary policy, a commodity price shock and China's restrictive Covid lockdowns are also weighing on the near-term economic outlook. This is why we have cut risk in our tactical investment views by downgrading DM equities to neutral. The current volatility underscores the importance of having investment views on both a tactical horizon – over which the consequences of the these risks will be felt – and a strategic horizon over which some of these market factors wash out. That's why we keep our strategic overweight to DM equities.

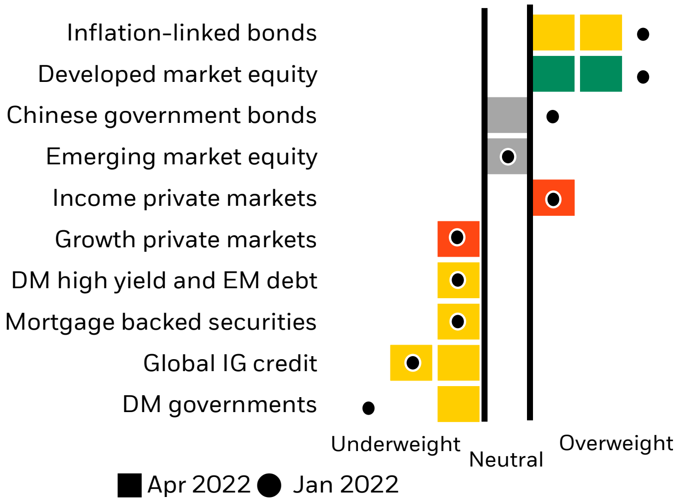
Over a strategic horizon of five years and beyond, we believe the core framing underpinning our 2022 Global Outlook will reassert itself. To recap: we see inflation as driven largely by production constraints due to the pandemic and the war in Ukraine rather than due to exuberant demand in the restart. We see inflation easing from current elevated levels as supply disruptions work themselves out while staying higher than pre-Covid levels. Central banks will choose to live with some inflation rather than destroy growth and employment in a bid to fight supply-driven inflation, in our view. In other words, they will likely pause after an accelerated return to neutral policy rates rather than slamming the brakes by going beyond and tipping economies into a recession.

Our strategic asset positioning has been positioned for higher long-term yields since April 2020 by being maximum underweight developed market (DM) nominal government bonds. Since then the Bloomberg U.S. Treasury bond index is down 18%, according to Refinitiv data. We are now trimming this underweight. This is driven in large part by the increased appeal of short-term paper over longer maturities. The outlook for longer-dated bonds remains challenged, in our view, as we see the term premium – the extra compensation investors demand for holding longer-term bonds – rising further and pushing bond yields even higher. See more on the following page.

The relative attractiveness of equities over bonds has diminished marginally. We trim our overweight to +2 from +3. The asset remains a large overweight. The slide in equities has offset the drag on expected returns from the higher policy rate paths, especially given our growth outlook. Our risk-adjusted expected returns for DM equities are higher than last quarter but less so than shorter-maturity DM government bonds (see chart on the right). We reduce our overweight to inflation-linked bonds as breakeven inflation rates have moved higher in line with our views. But we still see more room for higher pricing. We cut Chinese government bonds to neutral as their yield differential over DM bonds has disappeared.

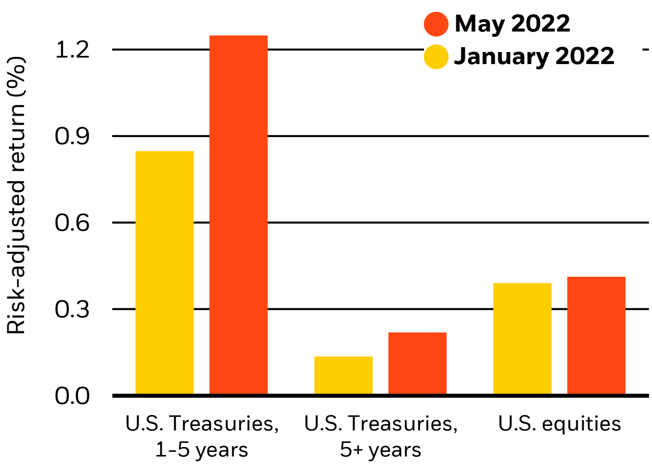
Still prefer equities over bonds

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



An improvement at the short end

Change in risk-adjusted 10-year expected returns



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, June 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. The chart on the right shows our expected returns for long-term U.S. Treasuries (5+ years), short-term U.S. Treasuries (1-5 years) and U.S. equities.

Short-end appeal

We expect bond yields to keep climbing higher over a strategic horizon even after this year's surge. The key driver: investors demanding a higher term premium over the medium term due to ballooning sovereign debt burdens and the shift to a higher inflation regime – two fallouts of the pandemic. See chart on the left below. Our expected returns for nominal government bonds have risen over the previous quarter – largely due to the upward pressure on yields from the excessive hawkishness priced into short-term interest rates and more attractive carry on offer. This brightens the appeal for short-dated government bonds even as the outlook for long-term bonds remains challenged, in our view.

We expect inflation over the strategic horizon to be higher and more uncertain than over the decades preceding the pandemic. This should spur investors to demand greater premium for holding longer-dated bonds. The expectation of higher yields over the medium term keeps us broadly underweight nominal government bonds. But within this underweight we see shorter-dated bonds playing a greater portfolio role thanks to higher income. This appeal has spurred a reduction in our overall underweight to -1 from the maximum of -3 we have had in place since April 2020.

Yields have spiked higher since our last update. Yet the spot yield curve (red line in the right chart below) is still below our estimate of what the yield curve will look like in five years' time (purple line). The other key observation: the gap between the two gets greater as you go further out the yield curve. That means our CMAs expect a larger valuation drag from higher long-term yields - both on account of duration and our yield estimates – than at the short end.

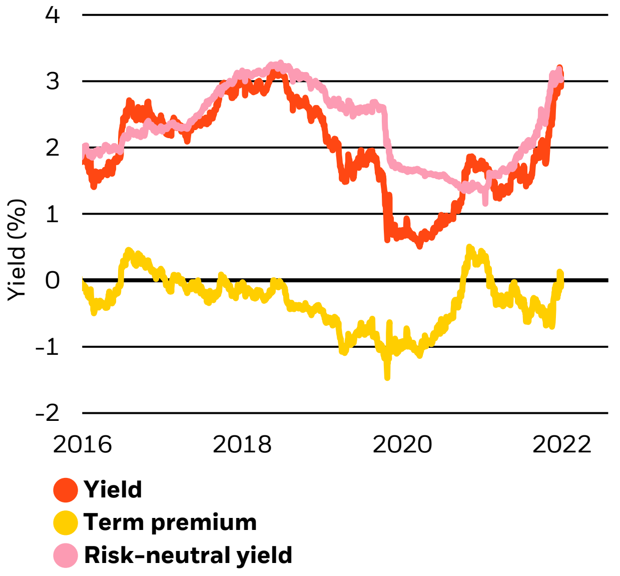
There is a high level of uncertainty on the outlook for interest rates. We believe it prudent in such a volatile environment to test the our views. We do this by studying two hypothetical scenarios and test how our views – and the changes we made this quarter – would change. First, if the term premium itself were to rise even more than we expect. Second, if the entire yield curve shifts higher – perhaps because short-term interest rates rise above our current expectations.

The chart on the right below illustrates the first hypothetical scenario where the term premium rises more than our current estimates. Here our view on nominal DM government bonds would remain at -1. Why? An increase in term premium is negative only for long-term bonds – an asset class on which we are already have a high conviction underweight. It suggests a relative preference for equities over bonds. A worse outlook doesn't change that view. Short-duration bonds don't suffer from increased term premium. The second scenario – a parallel shift higher in the yield curve – has more meaningful asset allocation implications. Here our underweight to nominal DM government bonds would be at -2. Why? Short-duration bonds suffer from the rate jump at the front-end of the curve. Importantly, our view on DM equities would be reduced to +1 from +2 in this scenario. Higher short-term rates mean a higher discount rate for equities, diminishing our expected return. A higher term premium will be particularly bad for long-term bonds and not necessarily so for equities, while a higher curve is bad for both equities and bonds, in our view.

At the short end of the curve, we believe the balance of risks to yields is now less skewed to the upside - one reason the relative attractiveness of equities over bonds has narrowed. Our sensitivity analysis shows that an expected overshoot of term premium versus our forecast would not make us more underweight bonds today. Only an overshoot of the whole curve would make us more underweight government bonds and this would be detrimental to equities too.

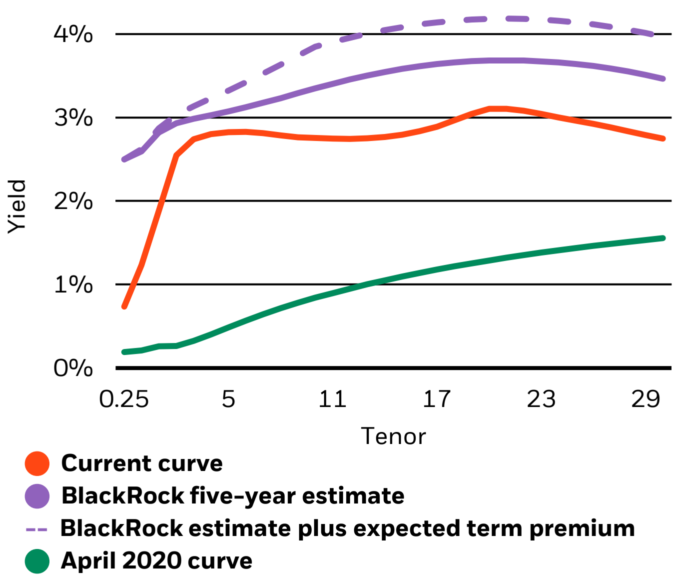
Term premium on the rise

U.S. 10-year term premium breakdown, 2016-2022



Leaning into the short end

U.S. yield curves, historical and estimated, May 2022



Sources: BlackRock Investment Institute, New York Federal Reserve, with data from Eikon, May 2022. The chart on the left breaks down the U.S. 10-year Treasury yield into changes in rate expectations and term premia using a popular model from the New York Federal Reserve. See here for more: https://www.newyorkfed.org/research/data_indicators/term-premia-tabs#/overview. The chart on the right compares the U.S. Treasury spot curve on 11th April to our expectation of the yield curve in 5 years' time, the market implied curve in 5 years' time and a hypothetical scenario where we increase the term premium in our 5 year yield curve forecast by 50 basis points.

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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