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Portfolio perspectives
August 2022

Positioning for a new regime of higher volatility

We lay out how our strategic asset views are positioned for a new regime of greater macro and market volatility.

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Summary

- **The Great Moderation, a period of steady growth and inflation, is over**, in our view. Instead, we are in a new regime of heightened macro volatility driven by production constraints - due to post-Covid supply disruptions and labor shortages in the near-term and structural forces such as a bumpy net-zero transition and a rewiring of global supply chains amid geopolitical tensions over a longer horizon. This warrants higher risk premia – the compensation investors want for holding assets - for bonds and equities. We ultimately expect central banks to live with inflation, but only after stalling growth. The result? Persistent inflation amid sharp and short swings in economic activity.
- What does it mean for investments? Typically stable strategic views and asset allocations need more frequent adjustments in the new regime. **A higher risk premium and worsening macro backdrop lowers our expected equity returns**, spurring a reduction in our overweight to the asset class to only a modest preference.
- In fixed income, the rising rate environment, higher inflation and elevated debt loads means **we go maximum underweight nominal developed market (DM) government bonds. We prefer inflation-linked bonds (now maximum overweight) and credit, particularly investment grade**, where we turn overweight for the first time in two years. Overall in duration, our preference for IG credit and inflation-linked bonds offsets our underweight nominal government bonds.
- **We like publicly-traded credit – including high yield - as our expected returns for the asset class are up significantly due to attractive valuations and income potential.** The brighter appeal of public credit means the relative attractiveness of private credit diminishes in our strategic allocations.
- We have edged up our medium-term estimates of the risk premia for equity and credit to reflect the wide range of macro outcomes ahead**. A more volatile world should mean investors demand more compensation to take on risk.** Our prior estimates were calibrated to movements of macro and market variables over the Great Moderation – and so are no longer applicable, in our view. We don't see current levels of macro volatility falling back to pre-pandemic levels – even as things calm down a bit from here.
- Our capital market assumptions (CMAs) latest estimates of how the transition to net zero carbon emissions will unfold. **A key takeaway of our ongoing work is that we see a bumpier transition than before as economies and sectors such as energy and transportation are reshaped. The upshot: more macro volatility, regional divergence and supply shocks**. We will detail how our updated views on the transition play into our strategic views in coming months. Access all our portfolio construction work on our hub.

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Our latest strategic views

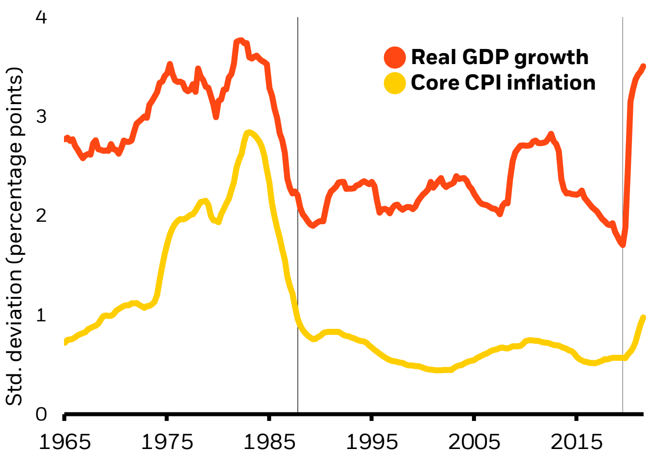
The post-pandemic period marks a departure from an unusual period of mild volatility in output and inflation. See the chart on the left below. The Great Moderation – the four decades from the early 1980s to 2019 that sustained a multi-decade stocks and bonds bull market – is over, in our view. We don't expect the current, elevated level of macro volatility to persist, yet we believe that we're in an era of persistent inflation amid sharp and short swings in economic activity. The new regime is a riskier one than the Great Moderation, in our view. That means investors should demand more compensation for taking the same levels of risk – higher risk premia.

Our CMAs and strategic views had already been positioned for a high inflation risk premium – most directly via an overweight to inflation-linked bonds and a long-standing underweight to nominal developed market government bonds. In our latest update, we incorporate the impact of a higher – currently unpriced equity risk premium – that lowers our expected risk-adjusted equity returns at a 10-year horizon. A higher equity risk premium and deteriorating macro backdrop trims our overweight to DM equities to a modest one at +1. We still have a strategic preference for equities for the long term as we see central banks ultimately pivoting to living with some inflation. Another notable change this quarter is that we turn overweight public credit for the first time in more than a year. The colored boxes on the chart on the right below shows our latest strategic preferences compared to our prior views shown by the dots. We think strategic allocations - that typically would have remained relatively stable in a world of low macro and market volatility – will likely need more frequent adjustments.

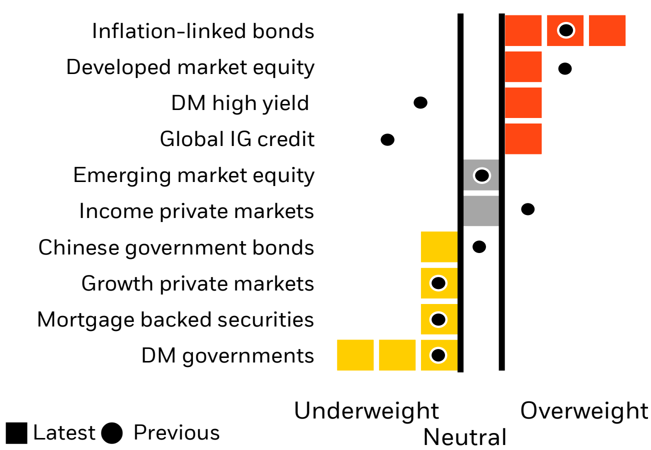
Three factors are driving the regime change, in our view. First, production constraints – stemming from a massive shift in spending and labor shortages - are hampering the economy and driving inflation. Over a strategic horizon, we expect structural forces such as a bumpier transition to net zero and a rewiring of global supply chains to contribute to supply shocks. Second, record debt levels mean small changes in interest rates have an outsized impact on governments, households and companies – limiting how far central banks can go in raising rates and forcing them to live with some inflation. Third, the politicization of everything – from inflation to climate change to geopolitics – feeds growing populism and greater polarisation and raises the risk of oversimplified policy solutions in a more complex world.

Policymakers face a tougher trade-off between growth and inflation today than when demand shocks dominated. Monetary policy was more effective in influencing demand – and helped to supress volatility. It is less suited to supply shocks, in our view, meaning policymakers may face a worse mix of higher output or inflation volatility. Reining inflation comes at a much greater cost to growth. Preserving growth comes with much higher inflation. That is at the crux of the problem central banks are grappling with currently. We see most developed market central banks taking policy into restrictive territory, but ultimately pivoting and choosing to live with some inflation as the cost to growth becomes clear. That's why we think the volatility of each will be higher in the new regime. We expect inflation to remain above target in the U.S. over the next 5 years. The choppy restart following Covid offered a glimpse of the long-term impact structural supply shocks may have on the economy. A notable example is the net-zero transition, as we now believe it will be bumpier and a bigger drag in coming years than we previously anticipated.

End of the Great Moderation...
Volatility of U.S. GDP and CPI, 1965-2022



... calls for more dynamic strategic allocations
Hypothetical U.S. dollar 10-year strategic tilts, August 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, U.S. Bureau of Economic Analysis and Labor Department, with data from Haver Analytics, August 2022. Notes: The chart of the left shows the standard deviation of the annualized quarterly change of U.S. GDP and the Consumer Price Index. The chart on the right 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 U.S. core real estate. Growth private markets comprise global private equity buyouts and infrastructure equity. Index proxies are listed in the Appendix. **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.**

Upgrading credit to overweight

There is great uncertainty around how the conundrum facing policymakers gets resolved. Central banks have turned increasingly hawkish to counter elevated inflationary pressures, sparking a sharp repricing higher of expected policy rate paths. That rhetoric has intensified since our last update as policymakers continue to respond to the politics of inflation. We no longer expect central banks to pause at neutral – the level of rates that is neither restrictive or stimulative – even though tighter policy does little to address supply-driven inflation. It does mean growth over the near term suffers as interest rate-sensitive sectors of the economy bear the brunt. In our CMAs, we further raise our estimates for the policy path across major central banks that feed directly into our expected returns across asset classes, most notably fixed income.

We see nominal yields in five years' time significantly higher than current levels. That repricing is a valuation drag on expected returns for nominal government bonds. We go back to a maximum underweight stance on the asset class and prefer to take duration risk in credit, particularly higher quality investment grade. We turn overweight both IG and high yield (HY) credit in developed markets for the first time in more than two years.

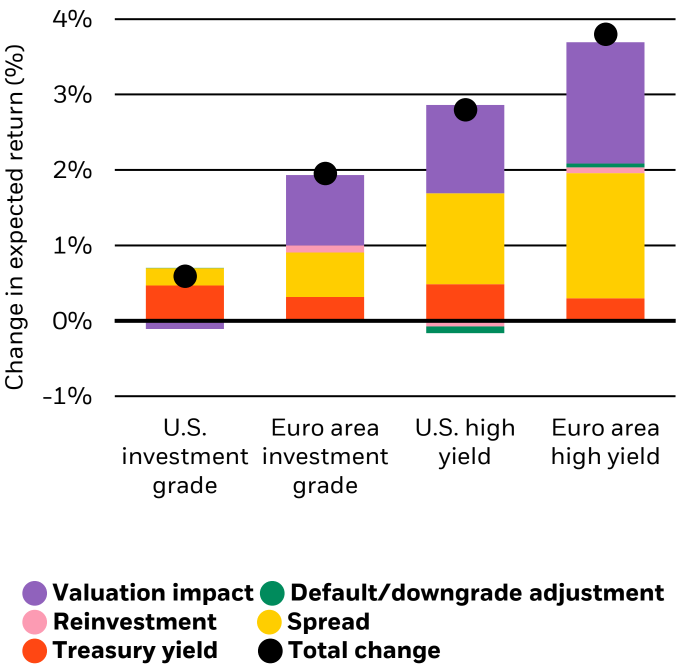
Widening spreads – partly a reflection of growth fears – have pushed up our expected returns and brightened the risk-reward for credit. Slowing economic growth is a valid risk – yet we don't expect the kind of deep recession that would cause defaults and downgrades to explode higher and damage the case for credit. In that backdrop, we think higher spreads and higher government bond yields – both drivers of our expected credit returns – make credit an asset class with attractive income potential. An anticipation of wider spreads and higher yields had kept us underweight public credit. Both are now at more attractive levels – and spreads are no longer a drag to returns. The chart on the left below shows how valuation, the impact of higher spot yields and higher expected income have pushed up our expected returns across DM credit markets. We see spreads compressing over a strategic horizon as the economy stabilizes following central bank pivots. We see spreads compressing over time, yet not immediately.

The repricing of public credit reduces the relative attractiveness of private credit over public. For instance, wider HY spreads have made the asset class competitive against private income markets such as direct lending. We turn neutral private income in our latest update, yet maintain a significant allocation. Within private income, we prefer floating rate exposures as we believe they are better positioned for a rising rate environment, in our view.

Finally in fixed income, we return to a maximum overweight on inflation-protected government bonds. Why? We believe markets are once again underappreciating the persistence of higher inflation. The U.S. inflation breakeven rate fell sharply over the second quarter from its March 2022 peaks – see chart on the right below – due to broader risk-off sentiment and as recession fears took hold. The drop has taken market-implied pricing well below our estimates for forward inflation expectations over the next five years – the yellow dot in the chart.

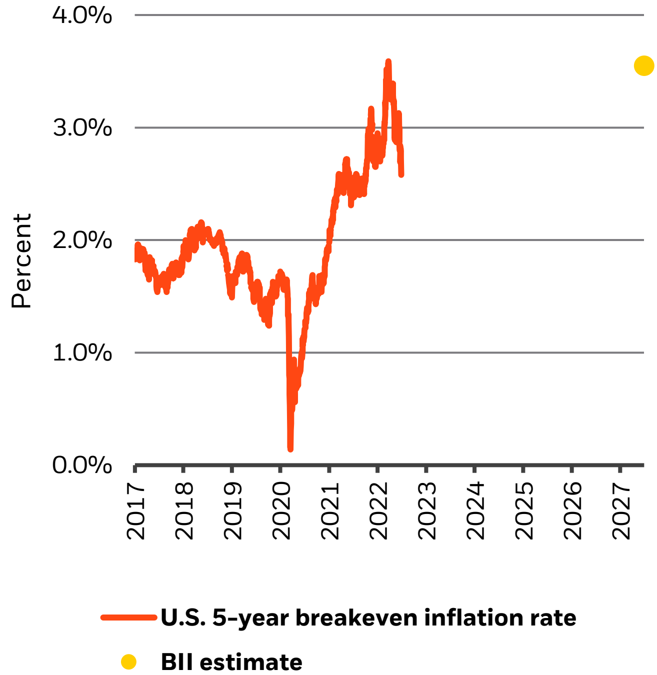
Bump up in our expected returns for credit

Quarter-on-quarter change in credit expected returns



Higher inflation over the medium term

U.S. inflation breakevens vs our estimate



Sources: BlackRock Investment Institute, New York Federal Reserve, with data from Eikon, August 2022. BlackRock Investment Institute, estimate as of 29 June 2022 Notes: The chart on above shows the breakdown of our expected five-year, U.S.-dollar returns for respective credit markets. See https://www.blackrock.com/institutions/en-zz/insights/charts/capital-market-assumptions#methodology for more details. Index proxies: Bloomberg Barclays U.S. Credit Index, Bloomberg Barclays Euro Aggregate Corporate Index, Bloomberg U.S. Corporate High Yield and JPM EMBI Global Diversified. BBG Euro High Yield Index. The chart on the right market pricing of the five-year U.S. inflation breakeven rate and our estimate of average five-year forward inflation expectations.

Trimming the equity overweight

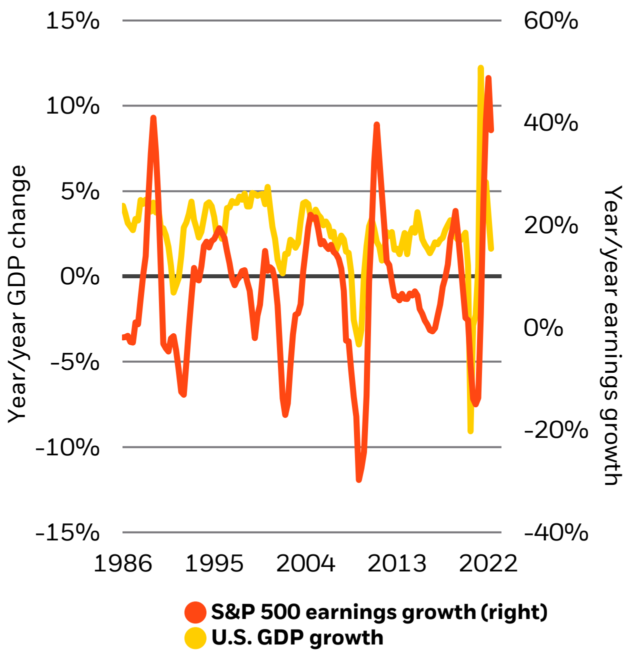
Global equities struggled over the second quarter. Markets have recovered some losses in recent weeks, yet the broad MSCI World index of DM equities is still down 15% year-to-date, according to Refinitiv data as of Aug. 8, 2022. Typically, falling prices would mean we would expect to see higher expected returns as, all else equal, valuations become more attractive. Yet, all else has not remained equal. Markets have grappled with the difficult trade-off that central banks face between choking off growth via sharply higher rates or living with supply-driven inflation. Tough rhetoric from central banks on inflation suggests interest rates – across most of DM – are likely to move past neutral into restrictive territory. Beyond tighter monetary policy, the implications of the energy price shock – particularly painful for Europe – and China's strict Covid lockdowns are weighing on the near-term economic outlook.

The impact of these feed into our equity CMAs and inform our asset preferences by offsetting the boost from lower equity prices. Our estimate of where interest rates may get to has moved higher and the short-term path has steepened as discussed on previous pages. Higher short-term rates mean a higher discount rate for equities – a drag on valuations that diminishes our expected returns. Also, the near-term outlook for corporate earnings growth has worsened. The chart on the bottom left shows that current earnings are not fully reflecting the deterioration in the underlying growth picture, in our view. We see current consensus earnings expectations as too optimistic and expect downgrades ahead.

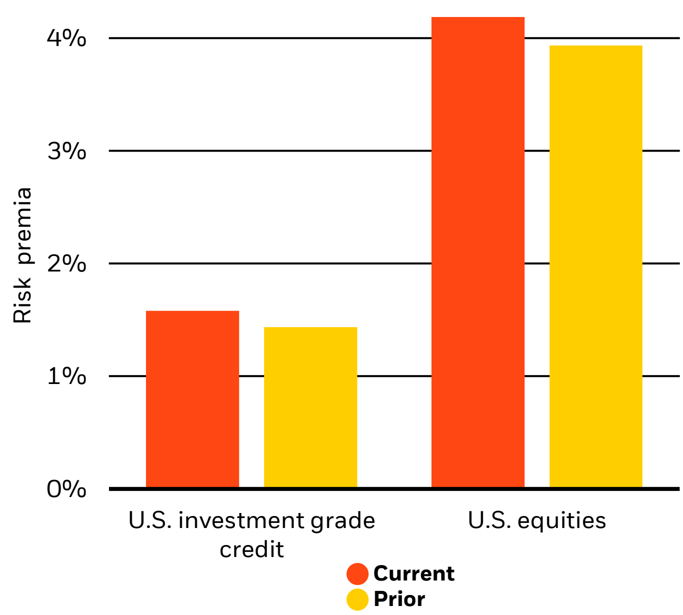
We have also modestly increased our estimate of the five-year ahead equity risk premium (ERP). We prefer the ERP as a valuation gauge over PE ratios, as the ERP takes into account both the price earnings in the year ahead and interest rate outlook. PE ratios only consider price and year-ahead earnings. Our prior expectations of the level of ERP in 5 years time were partly informed by historical data from 1995 onwards – the period of the Great Moderation. This is no longer an accurate benchmark for the future, in our view as it does not consider the new regime. Our revised estimates for the U.S. are shown on the chart on the right below. We now assume an ERP of about 4.2% for the U.S. vs. 3.9% earlier. We think this increase in risk premia is justified, with moderately higher volatility over the coming years.

We still prefer equities to bonds in our strategic views, yet trim our stance on equities to a modest overweight of +1. Over a 10-year horizon, we expect some of the market factors roiling equities to wash out. We expect central banks to live with some inflation after the damage to growth and employment from fighting supply-driven inflation starts becoming apparent. We believe that pivot will ultimately be supportive of equities. Yet we also do not expect that central banks will cut rates back down to stimulative levels as inflation is likely to stay stubbornly above their targets. Our lower expected returns for equities – and trimmed overweight – reflects these dynamics. A similar dynamic is at play in growth private markets such as private equity. Valuations here are slow moving, yet are not immune to higher interest rates. We stay modestly underweight.

Growth disconnect
U.S. GDP vs. S&P 500 earnings, 1986-2022



More compensation needed for taking risk
Estimated risk premia in five years' time, current vs. prior



Sources: BlackRock Investment Institute, New York Federal Reserve, with data from Refinitiv Datastream, August 2022. Notes: The chart on the left shows annual U.S. GDP growth and realized year-on-year earnings growth for the S&P 500. The chart on the right shows our current and prior estimate of the risk premia for U.S. equities and U.S. investment grade credit. Index proxies: Bloomberg Barclays U.S. Credit Index, MSCI USA Index It is not possible to directly invest in an index.

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 U.S. 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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