With inflation at the highest level in decades and interest rates on the rise, equity investors are questioning their next moves. In fact, more than three in five Americans view inflation as the biggest risk facing the U.S. stock market over the next six months, according to a recent BlackRock Fundamental Equities survey of more than 1,000 individual investors. Equity CIO Tony DeSpirito offers timely perspective:

**What is the current state of inflation?**

The Consumer Price Index (CPI) reading of 7.9% as of February represents the highest headline inflation level since 1982. Core CPI, which excludes volatile components such as food and energy, registered at 6.4%. This comes after core inflation has lingered around 2% or below since the Global Financial Crisis (GFC) of 2008.

The COVID-19 pandemic and ongoing recovery have fueled the sharp uptick. An unprecedented and disruptive economic shutdown/reopen cycle has left the supply of goods low and consumer demand for them high as coincident fiscal and monetary stimulus helped to pad pocketbooks and set up a strong spending cycle. Intermittent factory closures around the world, which are continuing with the most recent outbreak of COVID in China, have upset global supply chains and exacerbated the imbalance. The war in Ukraine is only going to add to inflationary pressures.

**Shades of inflation**

- **CPI (or headline CPI):** The broadest measure; considers the cost of a fixed basket of goods/services
- **Core CPI:** Removes food and energy costs, which are seen as volatile and potentially influenced by non-economic forces
- **Sticky CPI:** A subset of the CPI that includes those components that change price less frequently

---

With inflation falling from lofty levels but settling into a range somewhat higher than recent history. Companies appear well-positioned to weather higher inflation, exhibiting strong earnings and pricing power. Value stocks hold an edge; sector outcomes may look different from the 1970s inflation episode.

**Tony DeSpirito**
Chief Investment Officer, U.S. Fundamental Equities

---

USRRMH0322U/S-2085721-1/5
A sticky situation
Atlanta Fed’s “Sticky CPI,” 1990-2022

![Graph showing year-over-year change in Sticky CPI from 1990 to 2022]

Source: Federal Reserve Bank of Atlanta, data from January 1990 through February 2022. The Atlanta Fed’s sticky-price CPI is a weighted basket of items that change price relatively slowly.

What is your outlook for inflation?
We do not see inflation sustaining at the current decades-high level over the long-term, but we do expect it will settle into a range higher than the sub-2% seen in the post-GFC period. This is because some inflation, such as shelter and services inflation, is “sticky” — meaning it will not work its way out as easily as other inflationary pressures where a rebalance of supply and demand will naturally create price stability.

We could see inflation move toward its new long-run trend starting in the second half of this year. If we use “Sticky CPI” (shown above) as the worst-case predictor, we estimate that could put inflation in the 3%-4% range. We see this higher level of inflation reinforced by a few key secular trends: 1) lingering supply chain issues; 2) deglobalization, including an onshoring of supply chains and an end of the era of cheap goods from China as its workforce shrinks; and 3) the spending required to decarbonize and finance the energy transition.

How have stocks historically fared amid rising inflation?
We believe stocks are one of the best places to be in a rising inflation world. Our review of data back to the 1920s finds that equities perform well as long as inflation isn’t out of control — over 10%, which is historically rare and not our expectation even in this unusual cycle. In above-average inflation environments (5%-10%), value stocks have performed particularly well.

So far, companies have been able to pass their higher input costs on to the end consumer. As mentioned earlier, the consumer is in a position of strength and has shown a willingness to pay up for goods and services, affording companies pricing power.

What else do companies do when their costs are rising?
They try to save money, particularly on labor. They invest in labor-saving and cost-saving devices, such as technology solutions and machinery. Recent data shows spending intentions on these items are high. We see this as an area of growth for companies and the economy — and a positive for stocks.

How does this affect your view of stock markets?
It is very likely that the economy and markets are going through a regime change that we believe will require investors to reset and adjust how they have viewed the opportunity set over the past 14 years. We characterize the regimes as follows:

- **2008-2020, Post-GFC Era:** “Underwater” consumers repairing balance sheets, low to moderate economic growth, low inflation and interest rates.
- **2020-2021, Pandemic Era:** Massive policy stimulus expands the monetary base; technology powers a low-contact, stay-at-home world.
- **2022-?, Post-Pandemic Era:** Full employment, strong consumer and corporate balance sheets, rising inflation and interest rates.

We see implications for growth versus value, setting up a more balanced backdrop than the one that favored growth for many years prior. We also see stock selection becoming more important as individual companies will navigate this transition with varying degrees of dynamism and success.

**2022-?, Post-Pandemic Era**

Full employment, strong consumer and corporate balance sheets, rising inflation and interest rates.

We see implications for growth versus value, setting up a more balanced backdrop than the one that favored growth for many years prior. We also see stock selection becoming more important as individual companies will navigate this transition with varying degrees of dynamism and success.
What allows value stocks to do better?

If you think about investing time horizon, the expectation is that a value stock will return capital to shareholders faster than a growth stock. This is because, by definition, much of the expected cash flows from lower-multiple (value) stocks is front-end loaded. Conversely, growth stocks are considered longer-duration assets with expectations of greater cash flows further into the future. In essence, a higher proportion of the stock’s price comes from far-off cash flows, and that gets discounted by higher rates. This gives value stocks, with more stable near-term cash flows, an upper hand in an inflating environment.

In an analysis of growth versus value using data since 1927, we found value has achieved greatest outperformance in periods of moderate to high inflation. It is only when inflation was very low that value performance paled, and that is what we saw in the “Post-GFC Era.” Analysis from BlackRock Risk and Quantitative Analysis has yielded similar results. Value stocks have also tended to perform well amid rising interest rates. Over the past 40 years, a sizable portion of value returns has come during periods of rising rates. (See charts below.)

What do higher rates and inflation mean for growth stocks?

Low interest rates and tame inflation in the “Post-GFC Era” were a boon for longer-duration assets, including growth stocks. We’ve seen the drag on growth stock performance early this year as the market priced in the impact of higher rates to fight inflation.

The flip side is that this dynamic does nothing to dilute the innovation that is powering many of these companies, particularly the proven business models with durable growth characteristics. In many cases, the sell-off was indiscriminate. This suggests many growth stocks, especially those unduly punished beyond what the fundamentals suggest, could present a good value for long-term investors.

In this unfolding transition period, we do not advocate taking big bets in one style over another. We do see an opportunity to re-evaluate intended value and growth exposures in portfolios, as many investors are underallocated to value after a decade in which its performance paled relative to growth. The current moment presents an opportunity to restore balance.

A historically strong showing as rates and inflation rise

Value outperformance by inflation regime, 1927-2020

<table>
<thead>
<tr>
<th>Inflation Regime</th>
<th>Average Excess Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest inflation &gt; 4.4%</td>
<td>7.4%</td>
</tr>
<tr>
<td>Middling inflation 1.1% - 4.4%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Lowest inflation &lt; 1.1%</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

Value returns amid rising vs. falling rates, 1978–2020

<table>
<thead>
<tr>
<th>Interest Rates</th>
<th>Value Factor Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rising</td>
<td>10.9%</td>
</tr>
<tr>
<td>Falling</td>
<td>3.4%</td>
</tr>
</tbody>
</table>

Left chart: Source: BlackRock, with data from the Kenneth R. French Data Library and from Robert J. Shiller. Fama/French data uses the CRSP universe, which includes all companies incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ exchanges. The level of annual inflation is defined as the year-over-year change in the Consumer Price Index (CPI). “Lowest inflation” represents the bottom 20 years of inflation readings; “highest inflation” represents the top 20 years; and “middling inflation” represents the remainder. The numbers below represent the range in inflation readings for each regime. Value outperformance is annualized and calculated across various inflation regimes using annual data from 1927 to 2020. Value outperformance represents the performance of value stocks minus growth stocks, as defined by the Fama-French HML research factor (i.e., “high valuation minus low valuation” using book to price).

Right chart: Source: BlackRock, with data from Compustat/IBES, Dec. 31, 1978-Dec. 31, 2020. Chart shows the annualized return of the cheapest stocks (Quintile 1) minus the most expensive (Quintile 5) as ranked by our proprietary value factor. Returns are aggregated for rising and falling interest rate periods. Monthly changes in the 10-year U.S. Treasury yield are used to define rising and falling interest rate periods.
Which sectors have done well in inflationary times, and could history repeat?

We’ve done a lot of work around how different sectors and industries have performed in prior inflationary environments, particularly the last critical period centered around the 1970s. Some anecdotal findings are that dynamics at the company and industry level have equal or greater bearing on outcomes than broad sector undercurrents. We also observed that, historically, some strange policies (such as price controls) came out of inflationary environments, a consequence we hope to avoid in 2022.

Top performers of the 1970s

**Energy:** Global supply disruptions, including the OPEC oil embargo and the Iranian Revolution, drove oil prices sharply higher and led to significant earnings and cash flow inflections for U.S. producers. This eventually ended with demand destruction in the early 1980s recession.

**Healthcare:** The 1970s were a highly innovative period in which the pharmaceuticals industry delivered double-digit revenue growth. Because raw materials are a small part of the cost structure, margins were much more stable for the healthcare industry during this inflationary period.

**Financials:** Banks were largely insulated from inflation. Insurance saw reduced capacity and higher pricing in response to inflation, which drove better returns in the latter part of the period.

Bottom performers of the 1970s

**Consumer discretionary/staples:** Company profit margins were depressed by higher input costs and reduced consumer demand amid high prices. Profitability was further pressured by price controls in the earlier part of the period.

**Utilities:** Costs for fuel, labor and capital rose rapidly. With regulators reluctant to fully pass inflation through to consumers, utilities saw slower adjustments in return on equity (ROE).

**Materials:** The sector broadly lagged the market, although pricing power (and performance) diverged at the industry level. Many producers were energy-intensive (e.g., packaging, chemicals, steel) and could not fully pass on higher input and labor costs.

While we don’t see high inflation persisting for the extended length of time that it did five decades ago, we see some sector-level patterns that could repeat (or rhyme), and others where it is less likely. Our findings are summarized in the table below.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Annualized return, 1968-1981</th>
<th>Outlook for this time</th>
<th>Why (what’s different)?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>14%</td>
<td></td>
<td>Supply is more disciplined, but energy transition lowers multiples/terminal value</td>
</tr>
<tr>
<td>Utilities</td>
<td>5%</td>
<td>+</td>
<td>More automatic fuel inflation adjustment today</td>
</tr>
<tr>
<td>Materials</td>
<td>6%</td>
<td>+</td>
<td>Greater demand for energy transition metals; more disciplined producers</td>
</tr>
<tr>
<td>Technology</td>
<td>5%</td>
<td>+/-</td>
<td>Software nascent in 1970s, bigger today; hardware mature, less pricing power</td>
</tr>
<tr>
<td>Communications services</td>
<td>7%</td>
<td>+/-</td>
<td>More competitive U.S. telecom market today; new business models and less regulation</td>
</tr>
<tr>
<td>Consumer discretionary</td>
<td>3%</td>
<td></td>
<td>Greater pricing transparency today with eCommerce. But sector is fairly heterogeneous;</td>
</tr>
<tr>
<td>Consumer staples</td>
<td>6%</td>
<td></td>
<td>stock selection matters</td>
</tr>
<tr>
<td>Financials</td>
<td>8%</td>
<td>+</td>
<td>Price controls less likely, but pricing power weaker with more consolidated retailers</td>
</tr>
<tr>
<td>Industrials</td>
<td>6%</td>
<td>+</td>
<td>Lower labor cost pressures today given automation, lower unionization rate</td>
</tr>
<tr>
<td>Healthcare</td>
<td>8%</td>
<td>+/-</td>
<td>Pricing power more critical to pharma given slower growth; med-tech less cyclical and has</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>COVID recovery potential</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>7%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BlackRock Fundamental Equities, with data from S&P and Russell indices, March 2022. Performance figures shown are annualized returns from 1968 to 1981 for large-cap U.S. stocks in each sector and the S&P 500 Index. Past performance is not indicative of current or future results. It is not possible to invest directly in an index.
**Bottom line**
Companies generally have been able to manage higher costs, exhibiting pricing power and a willingness to invest in cost-saving measures to propel their businesses forward. That said, rising inflation and rates is also stoking higher volatility in stocks. All of this makes investing trickier and fundamental research more important to choosing those stocks with the potential to deliver above-market returns as the new post-pandemic regime takes hold.

**Fundamental Equities**

<table>
<thead>
<tr>
<th>People</th>
<th>Profound curiosity, deep conviction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purpose</td>
<td>Active edge, sustainable outcomes</td>
</tr>
<tr>
<td>Perspective</td>
<td>Astute, diverse, panoramic</td>
</tr>
<tr>
<td>Performance</td>
<td>Long-term lens, risk-aware results</td>
</tr>
</tbody>
</table>

**Learn more at blackrock.com**

The survey referenced on page 1 covered 1,083 Americans aged 25+ with a minimum of $250,000 in investible assets. The survey was conducted online from Jan. 21-28, 2022.

This material is provided for educational purposes only and is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of March 2022 and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and nonproprietary sources deemed by BlackRock to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. Past performance is no guarantee of future results. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader. The material was prepared without regard to specific objectives, financial situation or needs of any investor. Indices are shown for illustrative purposes only. It is not possible to invest directly in an index.

This material may contain “forward-looking” information that is not purely historical in nature. Such information may include, among other things, projections, forecasts, estimates of yields or returns, and proposed or expected portfolio composition. Moreover, where certain historical performance information of other investment vehicles or composite accounts managed by BlackRock, Inc. and/or its subsidiaries (together, “BlackRock”) has been included in this material, such performance information is presented by way of example only. No representation is made that the performance presented will be achieved, or that every assumption made in achieving, calculating or presenting either the forward-looking information or the historical performance information herein has been considered or stated in preparing this material. Any changes to assumptions that may have been made in preparing this material could have a material impact on the investment returns that are presented herein by way of example.

Investing involves risk. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Diversification does not ensure profits or protect against loss.

© 2022 BlackRock, Inc. All Rights Reserved. BLACKROCK is a trademark of BlackRock, Inc. All other trademarks are those of their respective owners.

Prepared by BlackRock Investments, LLC, member FINRA.