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Weekly commentary

October 18, 2021

BlackRock

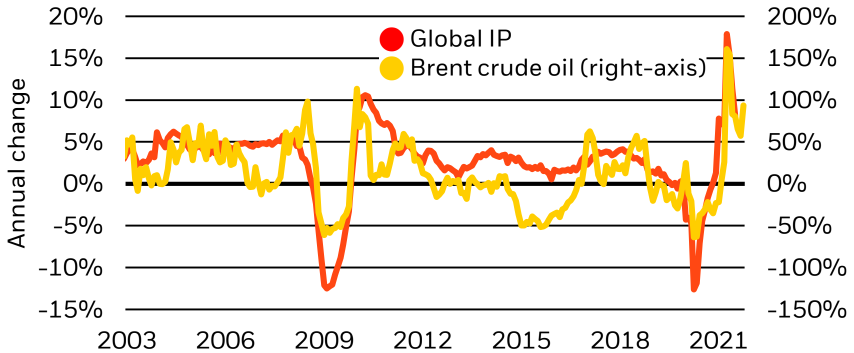
1970s stagflation? It's the opposite

- The inflation pressures we expected are here – and are persistent. This is not stagflation, and we remain pro-risk. But confusion over price surges is a risk.
- Global equities rallied as the third-quarter corporate earnings season kicked off with strong results in the U.S. We are focused on signs of cost pressures.
- We're watching the global Purchasing Managers' Indexes this week for read-outs on manufacturing bottlenecks and the strength of the economic restart.

Prices have climbed around the world, with commodities prices surging and U.S. inflation hitting a 13-year high. It's the first time since the 1970s that a supply shock is the main culprit. This is where the comparison ends. There's no risk of 1970s-style stagflation, in our view. Economic activity is increasing briskly and has room to run. We remain tactically pro-risk, but see a narrower path for risk assets to move higher as markets and policymakers could misread the price surge.

A growth-driven oil price increase

Global industrial production (IP) and Brent crude oil prices



Source: BlackRock Investment Institute, with data from BEA, Netherlands Bureau for Economic Policy Analysis, Energy Information Administration. Chart year-over-year growth in global industrial production (IP) on the left and Brent crude oil prices on the right.

We have long held that inflation was one of the market's most underappreciated risks. Now it's here. This year's surge is primarily driven by a major supply shock: the vaccine-driven restart of economic activity from the pandemic's shutdowns. Producers have struggled to meet resurgent demand, clogged ports have increased shipping costs, and surging commodities have added to price pressures. These dynamics mark a sea change from the environment many of today's investors know best: decades of low inflation on the back of deepening globalization and technological advances. The last time a major supply shock drove up inflation was in the 1970s, when an oil embargo by producers triggered a spike in oil prices. Today's oil price surge naturally raises the question of whether the economy is headed for 1970s-style stagflation, a period of high inflation coupled with weak growth. We think not. In fact, the growth situation today is in many ways the 1970s turned on its head. Growth is increasing at a rapid clip, rather than stagnating, as the restart rolls on. The oil price surge is to be expected in this environment, in our view. As the chart shows, oil prices (the yellow line) have moved in line with the resurgence in economic activity (red).

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Why is today's picture different? First, the current pickup in inflation is driven by the restart, not rising energy prices. Supply capacity has been slow to come back online, resulting in bottlenecks and price pressures. Second, growth has room to run, we believe, with global activity well below its long-run potential. Supply will eventually rise to meet demand, instead of the 1970s experience of demand going down to meet supply. Third, resurgent activity is increasing demand for oil and driving prices higher. Again, this is the exact opposite of the 1970s, when higher oil prices harmed economic activity.

We expect the restart pressures to persist well into 2022 before eventually subsiding as near-term supply-demand imbalances ease. There are factors beyond the restart that could add to this persistence: the consolidation in the resources industry, capital discipline by producers, years of underinvestment in production capacity, and perhaps the shift to more sustainable energy sources. The series of shocks provide a glimpse of what a disorderly transition to a more sustainable world could look like, with a risk of commodities volatility jumping to other asset classes – and a resulting increase of risk premia across the board. This underscores our 2021 Outlook theme the *Journey to net zero*.

The risk is that markets and central banks misread the current shocks, leading to fast-rising inflation expectations or premature monetary tightening. We believe central banks with credible inflation frameworks will largely look through the restart price pressures – and avoid a premature tightening that hurts growth but does nothing to address the bottlenecks. We expect this to play out differently around the world, and could see central banks that worry about their handle on inflation expectations take a more hawkish approach than others.

The bottom line: There are persistent inflationary forces at play today. We see the restart price pressures eventually resolving themselves, and believe central banks with credible policy frameworks will look through most of them. Our *New nominal* investment theme keeps us moderately pro-risk on a tactical basis, even as we see a narrower path for risk assets to move higher. The inflation spike could result in inflation expectations spiraling upward, central banks tightening policy prematurely - or markets pricing in either of these outcomes before they actually happen. We are underweight government bonds as we expect yields to gradually catch up to the reality of the strong restart. On a strategic horizon, we still see a shift to a moderately higher inflation regime amid structural cost pressures and the ongoing policy revolution – the unprecedented coordination between monetary and fiscal policy. This keeps us preferring inflation-protected securities over nominal bonds.

Market backdrop

The third-quarter corporate earnings season kicked off with strong results that were boosted by the powerful restart. Overall, S&P 500 profits are set to jump 26% on revenue growth of 14%, according to consensus estimates. The top item to watch: signs of cost pressures. We view the recent yield backup as correcting a disconnect between the restart and low yield levels, rather than foreshadowing a more drastic yield rise.

Assets in review

Selected asset performance, 2021 year-to-date 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 Oct. 15, 2021. 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, in descending order: spot Brent crude, MSCI USA Index , MSCI Europe Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI Emerging Markets Index, Refinitiv Datastream Italy 10-year benchmark government bond index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

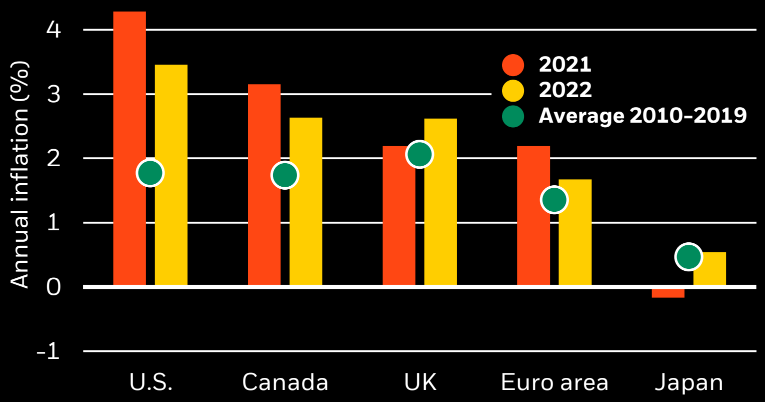
The International Monetary Fund (IMF) shares our view that the key driver of current high inflation is supply-demand mismatches due to the economic restart, according to its World Economic Outlook published last week. It has revised up its inflation forecasts – especially for 2021. They now stand well above 2% in a many developed economies, led by the U.S, before dropping off in 2022. See the chart.

What does this mean for central bank action? Here's where we differ with the IMF. The IMF urges vigilance on the part of central banks, calling on them to move quickly if there are signs of inflation expectations becoming unanchored - and it advises the Fed to raise rates before the end of 2022.

We agree there's a risk of inflation expectations becoming unanchored, but this is not our base case. We think central banks should avoid leaning against higher inflation at this time and expect they will respond in a more muted way to inflation than in the past – the key premise of our *new nominal* investment theme. This is why we remain pro-risk. See our macro insights hub.

IMF cautions on inflation risks

IMF October 2021 inflation forecasts and average realized inflation 2010-2019



Sources: BlackRock Investment Institute, IMF World Economic Outlook, U.S. Bureau of Labor Statistics, Statistics Canada, UK ONS, Eurostat, Japan Ministry of Internal Affairs and Communications, with data from Haver Analytics, October 2021. Note: Forecasts relate to headline consumer price inflation. The green dots show the average of calendar-year annual inflation rates between 2010-2019.

Investment themes

1 The new nominal

- The powerful restart of economic activity has broadened, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term. We see the Fed normalizing policy rates only in 2023 and the European Central Bank standing pat for much longer.
- *The new nominal* has largely unfolded in 2021: the rise in long-term yields has been mainly driven by higher market pricing of inflation, with real yields remaining pinned well in negative territory.
- The Fed has signaled that it is gearing up to start tapering around the end of the year. It appears reluctant to confirm its inflation mandate has been met, and this reinforces our *new nominal* theme.
- The ECB has made a significant change to its monetary policy framework by adopting a symmetric inflation target of 2%. We believe this is part of a global trend to relax the constraints in earlier frameworks preventing looser policy.
- **Tactical implication**: We are overweight European equities and inflation-linked bonds. We are neutral on U.S. equities. We upgrade EM local-currency debt to modest overweight.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is on the path toward greater role of state where social objectives will have primacy over quantity of growth. Yet the growth slowdown has hit levels policymakers can no longer ignore and we expect to see incremental loosening across three pillars - monetary, fiscal and regulatory.
- We believe investors should be mindful of ongoing geopolitical tensions, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We turn modestly positive on Chinese equities, and maintain an overweight on its debt.
- **Strategic implication:** Given the small benchmark weights and typical client allocation to Chinese assets, allocation would have to increase by multiples before they represent a bullish bet on China, and even more for government bonds.

3 Journey to 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 full consequences of the tectonic shift to sustainability are not yet in market prices, in our view. The path is unlikely to be a smooth one – and we see this creating opportunities across investment horizons.
- Certain commodities, such as copper and lithium, will likely see increased demand from the drive to net zero. Yet we think it's important to distinguish between near-term price drivers of some commodities – notably the economic restart – and the long-term transition that will matter to prices.
- Climate risk is investment risk, and we also see it as a historic investment opportunity. Our long-run return assumptions now reflect the impact of climate change and use sectors as the relevant unit of investment analysis.
- **Tactical implication**: We are overweight the tech sector as we believe it is better positioned for the green transition.
- **Strategic implication**: We like DM equities and the tech sector as a way to play the climate transition.

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Week ahead

Oct. 18	U.S. Industrial Production; China retail sales	**Oct. 21**	U.S. Philly Fed Business Index; Euro area Consumer Confidence Flash
Oct. 19	U.S. housing starts	**Oct. 22**	U.S., UK, euro area and Japan Markit Flash PMIs

This week, we're watching a slew of Purchasing Managers' Indexes (PMIs) for a read-out on manufacturing bottlenecks and to gauge the strength of the restart of economic activity. A continued restart could pave the way for further labor market normalization, while we expect supply chain frictions to ease as global manufacturing production and trade ramp up.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, October 2021

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our overweight equities on a strategic horizon. We see a better outlook for earnings amid moderate 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 stay overweight equities as we expect the restart to re-accelerate and interest rates to stay low. We tilt toward cyclicality and maintain a quality bias.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. Rising debt levels may eventually pose risks to the low rate regime. This is part of why we underweight government debt strategically. We prefer inflation-linked bonds – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		Neutral	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
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.

Notes: Views are from a U.S. dollar perspective, September 2021. 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.

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Granular views

Change in view
Previous → New

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, October 2021

	Asset	Underweight	Overweight	
Equities	United States			We are neutral U.S. equities. We see U.S. growth momentum peaking and expect other regions to be attractive ways to play the next leg of the restart as it broadens to other regions, notably Europe and Japan.
Equities	U.S. small caps			We stay overweight U.S. small-caps. We see potential in this segment of the U.S. equity market to benefit from the cyclical rebound in domestic activity brought about an accelerated vaccination rollout.
Equities	Europe			We stay overweight European equities on the back of a strong growth backdrop. We see a sizeable pickup in activity helped by accelerating vaccinations. Valuations remain attractive relative to history and investor inflows into the region are only just starting to pick up.
Equities	UK			We are neutral UK equities following their strong performance. We see the market as fairly valued and prefer European equities.
Equities	Japan			We are neutral Japanese equities. We see a global cyclical rebound helping boost earnings growth in the second-half of the year. The country's virus dynamics are also improving.
Equities	China			We are modestly positive to upgrade Chinese equities to overweight as we see a gradual dovish shift in monetary and fiscal policy in response to the cyclical slowdown and anticipate that the regulatory clampdown will become less intense.
Equities	Emerging markets			We are neutral EM equities. We see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring.
Equities	Asia ex-Japan			We are neutral Asia ex-Japan equities. Potential knock-on effects from slower growth in China and broader geopolitical risks dampen the outlook, in our view.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries primarily on valuations. We see the balance of risks is for gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
Fixed Income	Treasury Inflation-Protected Securities			We are overweight U.S. TIPS. We believe the recent pullback in the asset class presents an attractive opportunity, particularly on a relative basis against European inflation breakevens as the outlook for euro area inflation remains sluggish.
Fixed Income	German bunds			We are neutral on bunds. Although the ECB may begin tapering this year given inflation dynamics, we see little room for a substantive change in policy in the near term.
Fixed Income	Euro area peripherals			We are neutral euro area peripheral government bonds despite recent outperformance given stability in ECB policy, low volatility in peripherals and better value elsewhere.
Fixed Income	China government bonds			We are overweight Chinese government bonds. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
Fixed Income	Global investment grade			We are underweight investment grade credit We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
Fixed Income	Global high yield			We are neutral high yield after the asset class' strong performance. Spreads are now below where we see high yield as attractive valued. We prefer to take risk in equities.
Fixed Income	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
Fixed Income	Emerging market – local currency			We are modestly overweight local-currency EM debt. We believe the asset class offers attractive valuations and carry in a world starved for income.
Fixed Income	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield and income given the region's fundamental outlook.

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