Weekly commentary

BlackRock

November 22, 2021

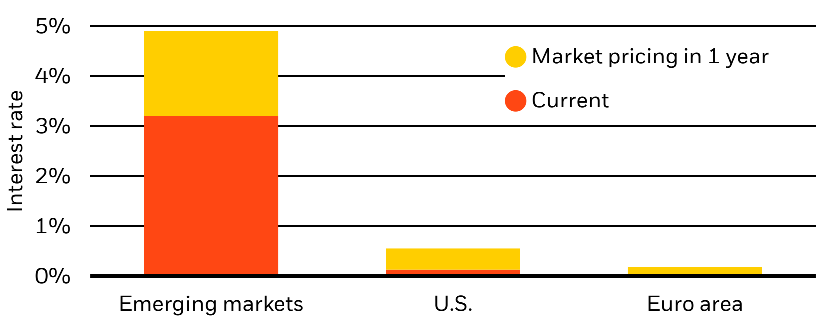
Liftoff? EM has already taken off

- Emerging markets have raised rates as they struggle with inflation, whereas the Fed has yet to lift off. We see their approach creating opportunities in EM debt.
- A meeting between the U.S and China sought to prevent strategic competition from turning into outright conflict but produced few tangible results.
- U.S. core inflation data will provide a read on the intensity and nature of price pressures. We expect inflation to moderate next year but see it as persistent.

As U.S. inflation is hitting three-decade highs, market talk has been all about "liftoff:" When will the Federal Reserve and others start raising their policy rates? This is old news in emerging markets (EMs), where many countries have already raised rates to try to tamp down inflation. Their approach has pressured growth already hurting from a delayed vaccine rollout. This makes us cautious on EM equities, but has made selected EM debt more attractive in a world starved for yield.

EM head start in raising rates

Central banks' current and implied policy rates



Sources: BlackRock Investment Institute and Bloomberg, November 2021. Notes: The chart shows the current and 1-year forward central bank policy rates. 1-year forward rates based on futures market pricing. Emerging markets policy rates are weighted based on the JP Morgan GBI-EM global Diversified Index.

Central banks across the emerging world have been raising interest rates to try to contain inflation and prevent their currencies from depreciating sharply. The rate increases have accelerated as inflation has picked up and the U.S. dollar strengthened. A wide variety of countries is now tightening policy, ranging from Brazil to Russia and South Korea. The result? The emerging world has a head start in normalizing policy. A weighted average of EM policy rates now stands at 3.2%, as the red part of the left bar in the chart shows, versus near zero or negative rates in the U.S. and euro area. Market pricing (the yellow parts of the bars) shows much of the work is done in EM, whereas developed markets (DMs) have yet to lift off. This ties in with the much more muted response to rising inflation seen in the developed world, thanks to unprecedented fiscal–monetary coordination in helping the economy bridge the virus shock and new central bank policies of letting inflation run a bit hot. EM central banks historically have had less credibility, while inflation and currency pressures have been much greater. But many are acting earlier and faster this time to prevent things from spinning out of control.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What does the EM head start in raising rates mean for investments? We believe it supports EM debt. The hiking cycle has started well ahead of the Fed's tightening – which has often spelled trouble for EMs as investors start to demand more compensation for holding riskier assets. The Fed has just started to taper asset purchases, and we don't see it raising rates until the middle of 2022. The EM approach has created a large interest rate buffer versus DM, lowered valuations and raised coupon income. This makes EM debt attractive versus DM credit in a world starved for yield, in our view.

Improved valuations and coupon income should help cushion any yield rises and prevent disorderly moves in EM bonds when the Fed lifts off, we believe. Indeed, we don't see a repeat of 2013's taper tantrum when the Fed's decision to cut back asset purchases caused havoc for EM assets. Why? First, the trajectory of rates matters more than the timing of liftoff, in our view. We see a very shallow rates path in DM this time, given the historically muted response to inflation. Second, many EM countries are now better positioned to weather Fed tightening and a stronger U.S. dollar. Currencies have adjusted, foreign ownership has declined, and inflation-adjusted yields have risen. There are exceptions, including EMs with weakening balances sheets or loosening policy, as country-specific risks always loom large in the diverse EM investing universe.

What do we like within EM debt? The big picture is that we expect fixed income to be generally challenged amid persistent inflation, and underweight government bonds as a result. We see EM local-currency debt offering the most relative opportunities in this context. Current yields and currency valuations compensate for the risks, in our view. And we like local-currency EM debt for its relatively low duration, or sensitivity to rising rates, and diversification benefits. It gives exposure to regions that make up a small share of EM equity indexes, such as LatAm. We prefer local-currency bonds of higher-yielding countries with solid current account balances. We also overweight Chinese government bonds for their relative high yields and diversification properties. We remain neutral on hard-currency EM debt.

Bottomline: We generally prefer equities over bonds in an environment of solid growth, persistent inflation and low real yields. Many EM central banks have started raising rates well before DM counterparts in an effort to contain inflation. This has dampened EM growth and tightened financial conditions – and has turned us cautious on broad EM equities and favor DM stocks. Yet it also has opened up opportunities in EM debt, against a backdrop of higher yields in a world starved for income. We are modestly overweight EM local-currency debt as we see valuations compensating for the risks.

Market backdrop

A virtual meeting between U.S. President Joe Biden and Chinese leader Xi Jinping sought to prevent strategic competition from turning into outright conflict and created the atmosphere necessary for follow-up meetings. Equities have notched records while bond yields have edged up amid rising inflation. We see inflation dropping from current levels and settle at a higher pre-COVID level in 2022, while we expect a historically muted policy response to inflation.

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 Nov. 18, 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), MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, spot gold, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

Macro insights

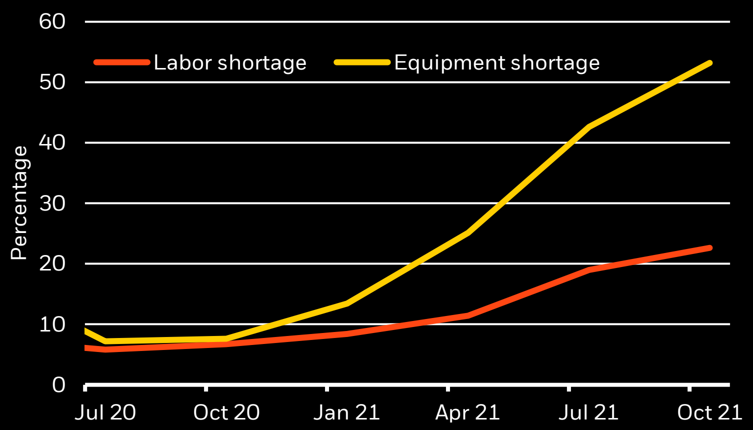
Supply chain disruptions have worsened around the world, pushing up inflation sharply and likely weighing on growth ahead. More than half of euro area manufacturing firms say equipment shortages are a material constraint on production, as the yellow line in the chart shows. In contrast to the U.S., labor shortages are less of an issue, though still affecting over a fifth. This is partly driven by different labor approaches during the pandemic, with the U.S. opting for lay-offs and the euro area for furlough schemes.

Within the euro area, shortages are more acute in Germany and less so in Italy and Spain. Why? Likely because the auto industry – a sector that's very exposed to semiconductor shortages – makes up a larger share of Germany's manufacturing output.

We see these supply bottlenecks easing next year and reducing the pressure on prices. We expect euro area inflation to fall back below 2% in the medium term, making a rate increase next year by the European Central Bank unlikely. See our macro insights hub.

Short on equipment, short on people

Euro area firms with equipment or labor shortages, 2020-2021



Sources: BlackRock Investment Institute, European Commission (EC), with data from Haver Analytics, November 2021. Note: The chart shows the share of companies reporting that equipment or labor shortages are constraining production in the EC quarterly manufacturing survey.

Investment themes

1 The new nominal

- Inflation is being driven by the unusual restart dynamics of extraordinary demand bumping up against supply bottlenecks. We expect many supply-demand imbalances to resolve next year. We see inflation as persistent into 2022, moderating from today's elevated levels to settle at higher levels than before COVID.
- The policy response to rising inflation isn't uniform. The Fed and the ECB are more tolerant of inflation. Other developed market central banks have signaled policy rate paths with steeper initial increases.
- We have moved forward our expectation for the Fed to start raising interest rates to next year – if not as soon as the market pricing. But what really matters is the policy rate trajectory, not just the first hike. We expect the most muted policy response to inflation in decades.
- The Fed said it will start tapering bond purchases in November, trimming them by $15 billion a month. The central bank may have achieved its new inflation goal to make up for past misses, but will likely still keep rates low to achieve its more ambitious full employment mandate.
- **Tactical implication**: We prefer equities and inflation-linked bonds, and are underweight U.S. Treasury bonds.
- **Strategic implication**: We are underweight DM government bonds and prefer equities over credit.

2 China stands out

- China has emphasized social objectives and quality growth over the quantity of growth in a series of regulatory crackdowns that have spooked some investors. Yet a 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 the ongoing U.S.-China strategic competition, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We are modestly positive on Chinese equities and are overweight government bonds.
- **Strategic implication:** We believe global investors and should raise their allocations to Chinese assets for potential returns and diversification, given the small benchmark weights and typical client allocation to Chinese assets. Allocations would need to increase significantly before they reflect a bullish view, in our opinion.

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 net-zero journey is not just a 2050 story, it's a now story.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. The green transition comes with costs, yet the economic outlook is unambiguously brighter than a scenario of no climate action.
- Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions. Policy remains the main tool. Some carbon-heavy companies already are changing their business models, independent of regulatory and political outcomes, creating potential investment opportunities.
- We see sustainability-driven repricing as having just begun – with accelerating flows into ESG products a big drive
- Commodities such as copper and lithium will likely see increased demand from the drive to net zero. It's important to distinguish between near-term drivers of commodities prices – the economic restart – and the long-term transition.
- **Tactical implication**: We see opportunities in companies rapidly adapting their business models for net zero.
- **Strategic implication**: We like DM equities and the tech sector as beneficiaries of the climate transition.

Week ahead

Nov. 23	Purchasing Managers' Indexes (PMIs) for the U.S., euro area and UK
Nov. 24	U.S. PCE inflation, personal income and durable good data; Japan PMI

Investors will get a good read on U.S. inflation this week. Personal consumption expenditure (PCE) inflation, the Fed's preferred gauge for price rises, will show the intensity of price pressures. U.S. personal income and spending data will shed light on the mix of spending between goods and services. Global PMI releases will show the momentum of the restart of economic activity, in particular ongoing disruptions to supply chains.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We are overweight equities on a strategic horizon amid fair valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we are overweight equities amid solid economic growth and historically low real rates.
Credit	-1	Neutral	We are underweight credit on a strategic basis. 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. We prefer inflation-linked bonds – particularly in the U.S. relative to the euro area on valuations. Tactically, we are also underweight government bonds on expectations of gradually rising yields.
Cash		Neutral	We keep some cash to potentially 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, November2021. 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.

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, November 2021

	Asset	Underweight	Overweight	
Equities	United States			We are neutral U.S. equities. We see U.S. growth momentum peaking and see other regions as more attractive to capitalize on the next leg of the restart of economic activity.
Equities	U.S. small caps			We are 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.
Equities	Europe			We are overweight European equities amid a sizeable pickup in economic activity. Valuations look attractive, and investor inflows into the region are 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.
Equities	China			We are modestly positive on Chinese equities as we see a gradual dovish policy shift to fend off a slowdown. We expect the regulatory clampdown to last but lessen in intensity.
Equities	Emerging markets			We are neutral EM equities. Many EM central banks have raised rates in the face of inflation, dampening growth and tightening financial conditions.
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. Risks are tilted toward gradually higher yields as markets price in the economic restart.
Fixed Income	Treasury Inflation-Protected Securities			We are overweight U.S. TIPS amid high inflation in the near term. TIPS look attractive versus European inflation breakevens as the outlook for euro area inflation remains sluggish.
Fixed Income	German bunds			We are neutral on bunds. We see little room for a substantive change in monetary policy in the near term.
Fixed Income	Euro area peripherals			We are neutral euro area peripheral government bonds 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.
Fixed Income	Global high yield			We are neutral high yield. High yield spreads no longer provide attractive value. 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 coupon income in a world starved for yield.
Fixed Income	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield given the region's fundamental outlook.

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