Weekly commentary

BlackRock

February 12, 2024

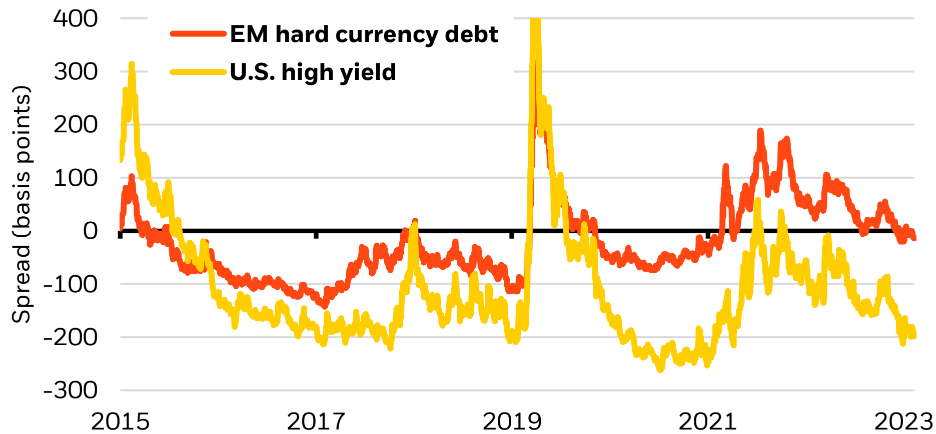
Staying selective in emerging markets

- We like emerging markets as upbeat risk appetite carries on. We also see big structural shifts creating granular opportunities within countries.
- U.S. stocks hit another all-time high last week thanks to earnings beats, even as U.S.10-year yields ticked up. We think positive sentiment can persist for now.
- This week's U.S. inflation data should show if falling goods prices are still pushing inflation down. We think wage growth will reignite inflation after 2024.

We see broader support for emerging markets (EMs) given the market's upbeat sentiment on risk assets as U.S. growth holds up, inflation cools and the Federal Reserve prepares to cut policy rates. EMs have been resilient to the latest Fed rate hikes. We get granular through mega forces – big structural shifts we see driving returns. We're overweight EM hard currency debt on its relative attraction and quality, plus stocks in Mexico and India that are set to benefit from mega forces.

Better priced

EM hard currency debt and U.S. high yield spreads vs. average, 2015-2024



Source: BlackRock Investment Institute, with data from LSEG Datastream, JP Morgan, Bloomberg, February 2024. Notes: The orange line shows the spread for EM hard currency debt, using the JPM EMBI Global Diversified Index and based off U.S. Treasuries of similar maturity and adjusted for any credit enhancements. The yellow line shows the Bloomberg US Corporate High Yield Index, an option-adjusted spread. We look at the spreads relative to their 2000-2024 average.

We think the outlook for broad EM assets is supportive as market sentiment stays positive. Robust U.S. economic activity, nearing Fed rate cuts and falling inflation have lessened the market's recession worries – a boon for EM. As markets priced in sharp Fed rate cuts, 10-year Treasury yields slid from 16-year highs near 5%. That helped tighten the gap between Treasury yields and higher hard currency EM debt yields. But spreads remain near the long-term average (orange line in the chart). U.S. high yield credit spreads are well below the long-term average (yellow line) – a sign of expensive valuations. We prefer EM hard currency debt and stay overweight. Along with attractive relative value, it includes more countries with higher-quality credit ratings than riskier high yield. Often issued in U.S. dollars, hard currency EM debt is also cushioned from EM currency weakness as EM central banks cut rates.

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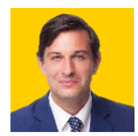

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While we see broad support for EM assets ahead, selectivity is key because of the divergent performance across EMs. Overall EM stocks underperformed DM peers last year and that trend has persisted into the new year. China's elevated equity volatility and policy uncertainty prompt us to take above-benchmark risk elsewhere. China's share of the MSCI Emerging Markets index has edged down while the weight of countries like India has climbed, according to LSEG data. As we stay nimble with our views, we identify country-specific opportunities through the mega forces we track.

Geopolitical fragmentation is one of five mega forces we see playing out now as competing geopolitical and economic blocs harden. Multi-aligned or "connector" countries like Mexico are increasingly acting as intermediate trading partners between blocs. The U.S. imported more goods from Mexico than China last year for the first time since the early 2000s, U.S. data show.

Demographic divergence is another mega force we track. Many EMs benefit from young, growing populations compared with aging populations in the U.S. and Europe. That's one reason India – the world's fastest-growing economy – stands out. India's talent pool, start-up ecosystem and software firms with a global footprint also make it an up-and-coming hub for artificial intelligence (AI) software, in our view. Digital disruption and AI is a mega force we see being a key driver of corporate earnings. We think these drivers support the momentum of Indian stocks even as 12-month ahead valuations – while below their post-Covid peaks – are near their highest levels of the past 20 years. By contrast, those in Mexico are closer to the 20-year average.

These shifts from mega forces favor investment areas like infrastructure, in our view. For example, investment in EMs related to the low-carbon transition – a mega force – will likely be lower than in developed markets due to a higher cost of capital. We think closing the financing gap offers opportunities but will require public sector reforms and private sector innovation.

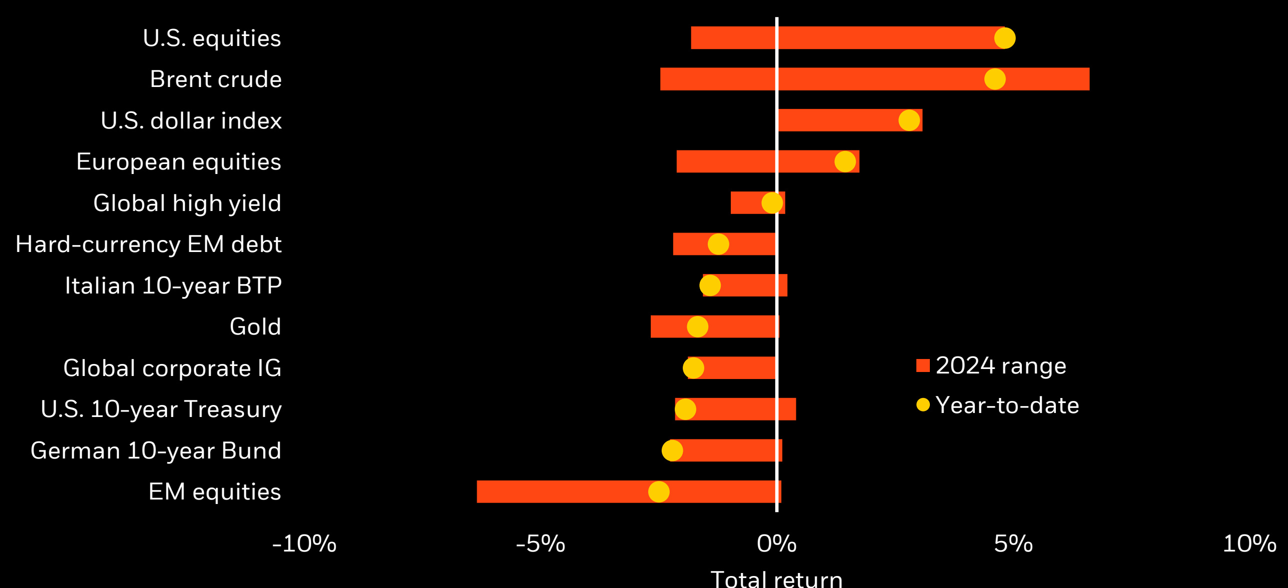
Bottom line: We see upbeat market sentiment boosting EM assets and stay overweight EM hard currency debt on still-attractive yields. We're neutral EM stocks overall. Within that stance, we are selective and overweight Mexico and India stocks. But we are monitoring a slew of elections in key EM countries this year, including in India, Indonesia and Mexico.

Market backdrop

U.S. stocks booked another week of gains, with the S&P 500 hitting a new all-time high as earnings beats have boosted sentiment and offset higher yields. U.S. 10-year yields climbed near 4.20%, up about 25 basis points from the start of the year. We think positive risk sentiment can run for a while as markets price in robust U.S. growth, cooling inflation and Fed rate cuts. Yet we think still-elevated wage growth will push inflation back up beyond this year, preventing the Fed from cutting rates as much as markets expect. We think resurgent inflation will eventually become clearer and challenge sentiment.

Assets in review

Selected asset performance, year-to-date return 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 LSEG Datastream as of Feb. 8, 2024. Notes: The two ends of the bars show the lowest and highest returns at any point 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: spot Brent crude, ICE U.S. Dollar Index (DXY), spot gold, MSCI Emerging Markets Index, MSCI Europe Index, LSEG Datastream 10-year benchmark government bond index (U.S., Germany and Italy), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI USA Index.

Week ahead

Feb. 13	U.S., India CPI data	**Feb. 15**	U.S. Philly Fed index; Japan, UK GDP data
Feb. 14	Euro area GDP data; UK CPI		

We're monitoring U.S. inflation data this week to gauge if falling goods prices will keep pushing inflation lower in 2024 as pandemic mismatches unwind. We think ongoing wage pressures in a tight U.S. labor market will put inflation on a rollercoaster beyond 2024. That's why the Fed won't be able to cut rates as much as the market still expects, in our view. In Europe, we look to GDP data for further signs of a divergence in growth among countries.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, February 2024

Tactical	Reasons
U.S. equities	• Our macro view has us neutral at the benchmark level. But the AI theme and its potential to generate alpha – or above-benchmark returns – push us to be overweight overall.
Income in fixed income	• The income cushion bonds provide has increased across the board in a higher rate environment. We like short-term bonds and are now neutral long-term U.S. Treasuries as we see two-way risks ahead.
Geographic granularity	• We favor getting granular by geography and like Japan equities in DM. Within EM, we like India and Mexico as beneficiaries of mega forces even as relative valuations appear rich.
Strategic	**Reasons**
Private credit	• We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to credit risk.
Inflation-linked bonds	• We see inflation staying closer to 3% in the new regime than policy targets, making this one of our strongest views on a strategic horizon.
Short- and medium-term bonds	• We overall prefer short-term bonds over long term. That's due to more uncertain and volatile inflation, heightened bond market volatility and weaker investor demand.

Note: Views are from a U.S. dollar perspective, February 2024. 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.

Tracking five mega forces

Mega forces are big, structural changes that affect investing now – and far in the future. As key drivers of the new regime of greater macroeconomic and market volatility, they change the long-term growth and inflation outlook and are poised to create big shifts in profitability across economies and sectors. This creates major opportunities – and risks – for investors. See our web hub for our research and related content on each mega force.

1. **Demographic divergence:** The world is split between aging advanced economies and younger emerging markets – with different implications.
2. **Digital disruption and artificial intelligence (AI):** Technologies that are transforming how we live and work.
3. **Geopolitical fragmentation and economic competition:** Globalization is being rewired as the world splits into competing blocs.
4. **Future of finance:** A fast-evolving financial architecture is changing how households and companies use cash, borrow, transact and seek returns.
5. **Transition to a low-carbon economy:** The transition is set to spur a massive capital reallocation as energy systems are rewired.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, February 2024

Our approach is to first determine asset allocations based on our macro outlook – and what's in the price. **The table below reflects this and, importantly, leaves aside the opportunity for alpha, or the potential to generate above-benchmark returns.** The new regime is not conducive to static exposures to broad asset classes, in our view, but is creating more space for alpha**.**

Underweight | Neutral | Overweight | ● Previous view

	Asset		View	Commentary
Equities	**Developed markets**			
	United States	Benchmark	Neutral	We are neutral in our largest portfolio allocation. Falling inflation and coming Fed rate cuts can underpin the rally's momentum. We are ready to pivot once the market narrative shifts.
		Overall	+1	We are overweight overall when incorporating our U.S.-centric positive view on artificial intelligence (AI). We think AI beneficiaries can still gain while earnings growth looks robust.
	Europe		-1	We are underweight. The ECB is holding policy tight in a slowdown. Valuations are attractive, but we don't see a catalyst for improving sentiment.
	UK		Neutral	We are neutral. We find attractive valuations better reflect the weak growth outlook and the Bank of England's sharp rate hikes to fight sticky inflation.
	Japan		+1	We are overweight. We see stronger growth helping earnings top expectations. Stock buybacks and other shareholder-friendly actions are positives. Policy tightening is a near-term risk.
	Emerging markets		Neutral	We are neutral. We see growth on a weaker trajectory and see only limited policy stimulus from China. We prefer EM debt over equity.
	China		Neutral	We are neutral. Modest policy stimulus may help stabilize activity, and valuations have come down. Structural challenges such as an aging population and geopolitical risks persist.
Fixed Income	Short U.S. Treasuries		+1	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer
	Long U.S. Treasuries		Neutral	We are neutral. The yield surge driven by expected policy rates has likely peaked. We now see about equal odds that long-term yields swing in either direction.
	U.S. inflation-linked bonds		Neutral	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
	Euro area inflation-linked bonds		-1	We are underweight. We prefer the U.S. over the euro area. We see markets overestimating how persistent inflation in the euro area will be relative to the U.S.
	Euro area govt bonds		Neutral	We are neutral. Market pricing reflects policy rates in line with our expectations and 10-year yields are off their highs. Widening peripheral bond spreads remain a risk.
	UK gilts		Neutral	We are neutral. Gilt yields have compressed relative to U.S. Treasuries. Markets are pricing in Bank of England policy rates closer to our expectations.
	Japanese govt bonds		-1	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
	China govt bonds		Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	Global IG credit		-1	We are underweight. Tight spreads don't compensate for the expected hit to corporate balance sheets from rate hikes, in our view. We prefer Europe over the U.S.
	U.S. agency MBS		Neutral	We are neutral. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG.
	Global high yield		Neutral	We are neutral. Spreads are tight, but we like its high total yield and potential near-term rallies. We prefer Europe.
	Asia credit		Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
	Emerging hard currency		+1	We are overweight. We prefer EM hard currency debt due to its relative value and quality. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
	Emerging local currency		Neutral	We are neutral. Yields have fallen closer to U.S. Treasury yields. Central bank rate cuts could hurt EM currencies, dragging on potential returns.

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