

Weekly commentary

September 25, 2023

BlackRock

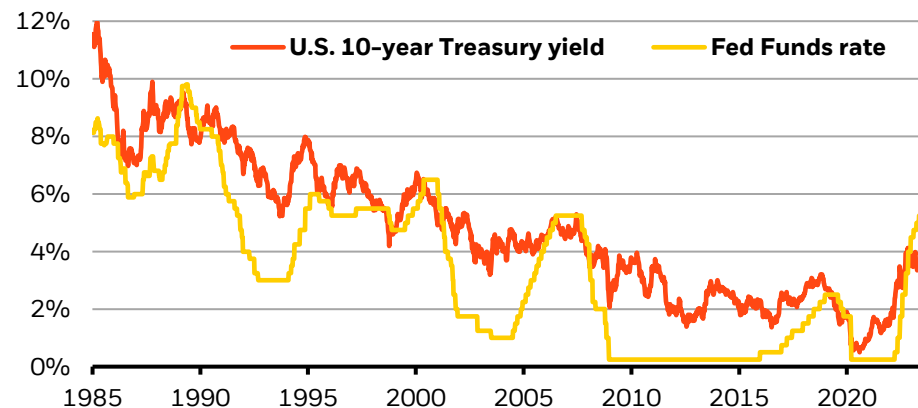
Yields surge as new regime plays out

- Bond yields are surging as the volatile macro regime brings uncertainty over central bank policy and risks ahead. We get granular in bonds and equities.
- The 10-year U.S. Treasury yield jumped to 16-year highs and stocks slumped over 2% last week. We think yields can go higher but see regional opportunities.
- U.S. and euro area inflation is in focus this week. Inflation has cooled as pandemic mismatches resolve, but we see demographics starting to bite.

Yields on benchmark 10-year U.S. Treasuries last week briefly rose to 16-year highs above 4.50% as major central banks paused rate hikes but left the door open for more. Markets are coming around to our view that rates will stay high – and now even exceed our expectations in Europe. Rising long-term bond yields show markets are adjusting to risks in the new regime of greater macro and market volatility. We get granular in bonds and equities.

Going up

U.S. Treasury yields and policy rate, 1985-2023



Source: BlackRock Investment Institute, with data from LSEG Datastream, September 2023. Notes: The chart shows the yield on the Datastream 10-year Benchmark Treasury and the U.S. Federal Funds rate.

All eyes initially were on monetary policy last week amid a blitz of central bank decisions. Then the main story quickly became surging 10-year bond yields to 16-year highs (dark orange line in chart) – even as the Fed and other central banks left policy rates unchanged (yellow line). We think the market is adjusting to the new regime and its implications – especially higher macro volatility. This is bringing to light just how uncertain the outlook is as well as the risks to longer-term bonds. As markets adjust to the new regime, we see opportunities. We've turned positive on long-term UK gilts and European government bonds, where that adjustment is more advanced. But we're not yet ready to jump back into long-term U.S. Treasuries. We think term premium – the compensation investors seek to hold long-term bonds – can return and push yields higher still, as can quantitative tightening and the step-up in Treasury issuance.



Jean Boivin

Head – BlackRock Investment Institute



Wei Li

Global Chief Investment Strategist – BlackRock Investment Institute



Alex Brazier

Deputy Head – BlackRock Investment Institute



Nicholas Fawcett

Macro Research – BlackRock Investment Institute

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BlackRock Investment Institute

Rate hikes are weighing on economies. Major central banks are administering the medicine of tighter monetary policy and economies have slowed. The medicine is still working its way through the system – and effects have varied across regions. PMI data across Europe has shown stagnation. GDP data suggest activity has held up in the U.S. But we think activity has actually stagnated there as well. That seems to have gone under the radar: a stealth stagnation. The average of GDP and another official measure of activity, gross domestic income, shows the U.S. economy has flatlined since the end of 2021.

The market narrative hasn't been one of U.S. stagnation though. One reason: We've avoided the short and sharp drop of recession for now. Instead, it's felt like a rolling effect of hikes rippling through the economy – that may be why the market feels different, too. The weakness we're seeing isn't a normal business cycle slowdown, in our view. Unemployment is still low. That suggests something structural is at play, so we don't think a purely cyclical lens applies. We've long said we're in a world shaped by supply – and this is playing out. We see constraints on supply building over time – especially from a shrinking workforce in the U.S. as the population ages. Central banks need to keep a lid on growth to avoid resurgent inflation once pandemic-era mismatches unwind. That's why we see them holding tight, not cutting rates like they did in past slowdowns.

Our long-held underweight to long-term U.S. Treasuries has served us well as yields climb. Markets have come around to our view on policy rates. Yet there is still little term premium. We prefer short-term Treasuries given comparable income to high-quality credit without the same credit or interest-rate risk. We also like long-term bonds in Europe and the UK. Ten-year yields there are around three percentage points higher than the pre-pandemic average, versus about two in the U.S.

Japan stands apart. First, the Bank of Japan is seeking to ensure it has got inflation up sustainably to 2%. Keeping policy unchanged last week suggests it would rather hike too late than risk being too early. Japanese bond yields have been relatively stable, but we expect a jump as suggested in market pricing with the BOJ loosening its yield cap over time. Second, Japan is not suffering the same structural downshift in growth – and corporate reforms are taking shape. We think strong growth can boost earnings and shareholder-friendly actions may keep attracting foreign investors to Japanese equities.

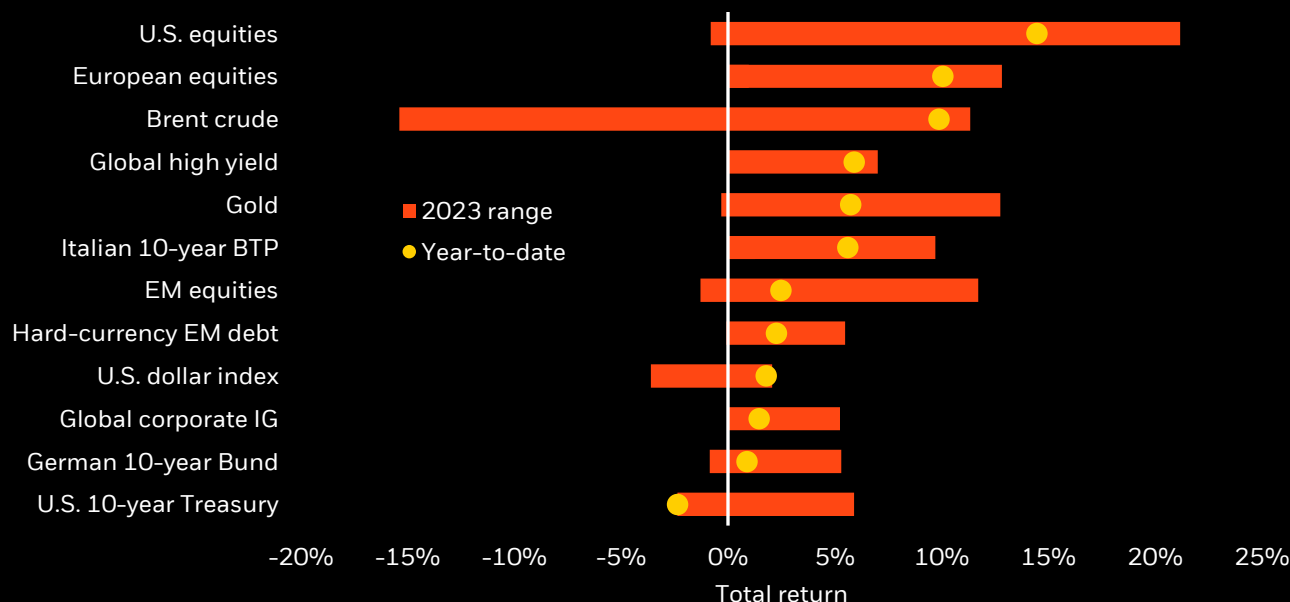
Bottom line: Bond yields are surging as the market adjusts to the implications of the new macro regime. We tactically prefer short-term bonds in the U.S. for income, long-term bonds in Europe and the UK – and Japanese stocks.

Market backdrop

The 10-year U.S. Treasury yield jumped to 16-year highs and U.S. stocks slumped over 2% last week – with the S&P 500 steadying some on Friday after its worst day since the March banking tumult. The Fed, the Bank of England and BOJ all kept rates unchanged. We think surging bond yields show markets reassessing the greater uncertainty and volatility in the new macro regime. We expect persistent inflationary pressures to play into this as demographic changes start to bite.

Assets in review

Selected asset performance, 2023 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 Sept. 21, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, 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.

Macro take

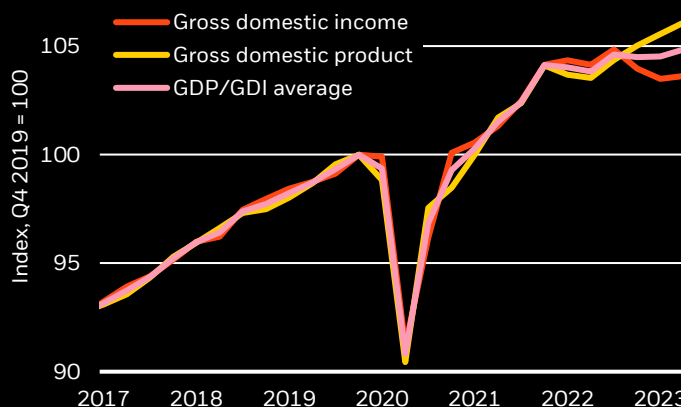
Is the U.S. economy really as resilient to rate hikes as many seem to think? We think it's important how you measure the strength of activity. Two key measures of an economy's total activity are gross domestic product (GDP) – which adds up total spending by households, firms, government and on exports – and gross domestic income (GDI) – calculated by adding the incomes received by households and firms.

In reality, the two should match. But no measure is perfect and gaps sometimes open up between them. Right now, GDP data show the U.S. economy has grown by 1.9% in the past 18 months. See the yellow line on the chart. GDI says it has contracted by 0.5%. See the orange line. Statisticians can't find the income to match their estimates of spending.

Given this large discrepancy, we think a more reliable measure is an average of the two (pink line) – a view shared by the NBER committee, among others. That shows the U.S. economy is not proving all that resilient to rate hikes after all: it's been more or less flatlining for the last 18 months. Read more in our latest Macro take blog post [here](#).

Flatlining activity

U.S. GDP and GDI, 2017-2023



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, September 2023. Note: The chart shows two different measures of total U.S. activity: Gross Domestic Product adds up spending on goods and services by different parts of the economy (households, businesses, government and net exports with foreign countries) and Gross Domestic Income, which adds up total incomes of households and firms.

Investment themes

1 Holding tight

- The U.S. is navigating two large and unprecedented shocks. The first: A massive, pandemic-induced shift in consumer spending – most visible from services to goods – created a mismatch in what the economy was set up to produce and what people wanted to buy. The second: a worker shortage as baby boomers age into retirement.
- Our assessment is that we are set for “full-employment stagnation.” Most of the inflation and wage growth we’ve seen to date reflects the mismatch associated with the pandemic. That is now reversing well and inflation is set to fall further. But as the process of resolving the mismatch ends and labor shortages start to bind, we expect inflation to go on a rollercoaster ride, rising again in 2024. A smaller workforce means the rate of growth the economy will be able to sustain without resurgent inflation will be lower than in the past.
- We see central banks being forced to keep policy tight to lean against inflationary pressures. This is not a friendly backdrop for broad asset class returns, marking a break from the four decades of steady growth and inflation known as the Great Moderation.
- **Investment implication:** Income is back. That motivates our overweight to short-dated U.S. Treasuries.

2 Pivoting to new opportunities

- Greater volatility has brought more divergent security performance relative to the broader market. Benefiting from this requires getting more granular and eyeing opportunities on horizons shorter than our tactical one. We go granular by tilting portfolios to areas where we think our macro view is priced in.
- We think dispersion within and across asset classes – or the extent to which prices deviate from an index – will be higher in the new regime amid the various crosscurrents at play, allowing for granularity. That offers more ways to build portfolio “breadth” via uncorrelated exposures, in our view.
- We think it also means security selection, expertise and skill are even more important to achieving above benchmark returns. Relative value opportunities from potential market mispricings are also likely to be more abundant.
- **Investment implication:** We like quality in both equities and fixed income.

3 Harnessing mega forces

- Mega forces are structural changes we think are poised to create big shifts in profitability across economies and sectors. These mega forces are digital disruption like artificial intelligence (AI), the rewiring of globalization driven by geopolitics, the transition to a low-carbon economy, aging populations and a fast-evolving financial system.
- The mega forces are not in the far future – but are playing out today. The key is to identify the catalysts that can supercharge them and the likely beneficiaries – and whether all of this is priced in today. We think granularity is key to find the sectors and companies set to benefit from mega forces.
- We think markets are still assessing the potential effects as AI applications could disrupt entire industries.
- Geopolitical fragmentation, like the strategic competition between the U.S. and China, is set to rewire global supply chains, we think.
- The low-carbon transition causing economies to decarbonize at varying speeds due to policy, tech innovation and shifting consumer and investor preferences. Markets have historically been slow to fully price in such shifts.
- We see profound changes in the financial system. Higher rates are accelerating changes in the role of banks and credit providers, shaping the future of finance.
- **Investment implication:** We are overweight AI as a multi-country, multi-sector investment cycle unfolds.

Week ahead

Sept. 26

U.S. consumer confidence

Sept. 30

China manufacturing PMI

Sept. 29

Flash euro area inflation; U.S. PCE

U.S. and euro area inflation is in focus this week, including the Fed's preferred PCE gauge. Inflation has cooled as the spending shift back to services helps resolve some the pandemic-era mismatches in supply. But we expect core inflation to stay on a rollercoaster as aging populations keep the labor market tight and keep up inflationary pressures.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, September 2023

		Underweight	Neutral	Overweight	● Previous view	
Asset						Commentary
Equities	Developed	 +1			 -1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched. Tactically, we stay underweight DM stocks but upgrade Japan. We are underweight the U.S. and Europe. Corporate earnings expectations don't fully reflect the economic stagnation we see. We see other opportunities in equities.
	Emerging	 Neutral			 Neutral	Strategically, we are neutral as we don't see significant earnings growth or higher compensation for risk. We go neutral tactically given a weaker growth trajectory. We prefer EM debt over equity.
Developed market government bonds	Nominal	 -1			 -1	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. We stay underweight U.S. nominal long-dated government bonds on both horizons as we expect investors to demand more compensation for the risk of holding them. Tactically, we are overweight on euro area and UK bonds as we think more rate cuts are coming than the market expects.
	Inflation-linked	 +3			 Neutral	Our strategic views are maximum overweight DM inflation-linked bonds where we see higher inflation persisting – but we have trimmed our tactical view to neutral on current market pricing in the euro area.
Public credit and emerging market debt	Investment grade	 -1			 -1	Strategically, we're underweight due to limited compensation above short-dated government bonds. We're underweight tactically to fund risk-taking elsewhere as spreads remain tight.
	High yield	 Neutral			 -1	Strategically, we are neutral high yield as we see the asset class as more vulnerable to recession risks. We're tactically underweight. Spreads don't fully compensate for slower growth and tighter credit conditions we expect.
	EM debt	 Neutral			 +1	Strategically, we're neutral and see more attractive income opportunities elsewhere. Tactically, we're overweight hard currency EM debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
Private markets	Income	 +1			—	We are strategically overweight private markets income. For investors with a long-term view, we see opportunities in private credit as private lenders help fill a void left by a bank pullback.
	Growth	 -1			—	Even in our underweight to growth private markets, we see areas like infrastructure equity as a relative bright spot.

Note: Views are from a U.S. dollar perspective. 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

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, September 2023

Underweight		Neutral		Overweight		● Previous view	
Asset		View		Commentary			
Equities	Developed markets						
	United States	-1		We are underweight the broad market – still our largest portfolio allocation. We don't think earnings expectations reflect the macro damage we expect. We recognize momentum is strong near term.			
	Europe	-1		We are underweight. We see the European Central Bank holding policy tight in a slowdown, and the support to growth from lower energy prices is fading.			
	UK	Neutral		We are neutral. We find that attractive valuations better reflect the weak growth outlook and the Bank of England's sharp rate hikes to deal with sticky inflation.			
	Japan	+1		We are overweight. We think stronger growth can help earnings top expectations. Stock buybacks and other shareholder-friendly actions may keep attracting foreign investors.			
	Pacific ex-Japan	Neutral		We are neutral. China's restart is losing steam and we don't see valuations compelling enough to turn overweight.			
	DM AI mega force	+1		We are overweight. We see a multi-country and multi-sector AI-centered investment cycle unfolding set to support revenues and margins.			
	Emerging markets						
	China	Neutral		We are neutral. Growth has slowed. Policy stimulus is not as large as in the past. Yet it should stabilize activity, and valuations have come down. Structural challenges imply deteriorating long-term growth. 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		-1		We are underweight. We see long-term yields moving up further as investors demand greater term premium.			
U.S. inflation-linked bonds		+1		We are overweight and prefer the U.S. over the euro area. We see market pricing underestimating sticky inflation.			
Euro area inflation-linked bonds		-1		We prefer the U.S. over the euro area. Markets are pricing higher inflation than in the U.S., even as the European Central Bank is set to hold policy tight, in our view.			
Euro area govt bonds		+1		We are overweight. Market pricing reflects policy rates staying higher for longer even as growth deteriorates. Widening peripheral bond spreads remain a risk.			
UK gilts		+1		We are overweight. Gilt yields are holding near their highest in 15 years. Markets are pricing in restrictive Bank of England policy rates for longer than we expect.			
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. We take advantage of tight credit spreads to fund increased risk-taking elsewhere in the portfolio. We look to up the allocation if growth deteriorates.			
U.S. agency MBS		+1		We're overweight. We see agency MBS as a high-quality exposure within diversified bond allocations.			
Global high yield		-1		We are underweight. Spreads do not fully compensate for slower growth and tighter credit conditions we anticipate.			
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 emerging hard currency debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks start to cut policy rates.			
Emerging local currency		Neutral		We are neutral. Yields have fallen closer to U.S. Treasury yields. Plus, central bank rate cuts could put downward pressure on EM currencies, dragging on potential returns.			

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