Weekly commentary

BlackRock

July 17, 2023

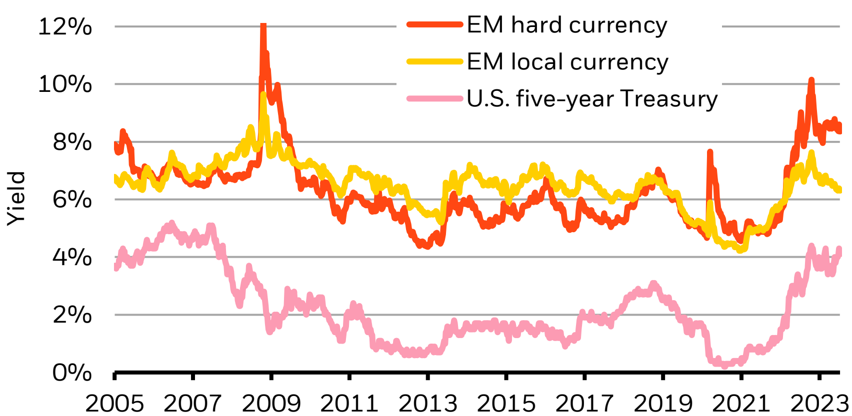
Applying our playbook to EM

- We favor emerging market (EM) to developed market (DM) assets on a brighter macro backdrop. We get granular and harness mega forces, per our playbook.
- U.S. bond yields slumped last week on softer CPI inflation data. We think still-tight labor markets will compel the Federal Reserve to hold policy tight.
- We look to this week's U.S. data for more signs higher policy rates are cooling production and spending. We see policy staying tight even as activity weakens.

We tapped into what's proved a stealth rally in EM stocks and bonds, along with the DM stock gains this year. We still think EM assets have an edge over developed market (DM) peers in the first layer of our new playbook, the macro assessment. Inflation is cooling enough in key EMs to allow policy rate cuts. We get granular in our playbook's second layer to find countries and sectors we like. Our third layer harnesses mega forces to capture structural shifts within EMs.

Emerging market edge

Emerging market bond vs. U.S. Treasury yields, 2005-2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2023. Notes: The chart shows yield levels for the JP Morgan Emerging Market Bond Index Global Diversified (EM hard currency), JP Morgan GBI-Emerging Market Bond Index Global Diversified and the benchmark U.S. five-year Treasury.

We've preferred EM debt to DM long-term peers for some time. We went tactically overweight EM local currency debt in March, picking up higher yields for carry and benefiting from a broadly weaker U.S. dollar plus tightening spreads this year (yellow line in chart). Higher EM yields remain attractive, but tightening spreads with Treasuries (pink line) lead us to consider switching to hard currency peers typically issued in U.S. dollars (orange line). But peaking DM policy rates should support EM currencies, bolstering EM local debt for now. DM rate hikes have hit EM hard in the past, but we think they're in a different spot now thanks to improved external balance sheets. We think that's why we're not seeing the EM asset volatility as in the 2013 taper tantrum. The Fed's plan to taper bond purchases then sparked sharp EM capital outflows and currency depreciation. It's the opposite now: capital inflows and stronger currencies are boosting returns in EM local currency bonds.

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A brighter EM macro and policy picture may also be underappreciated, in our view. DM central banks inching toward the end of rapid hikes is good for EMs – but a key difference is we think EM peers are closer to rate cuts as inflation falls. EM central banks were well ahead of DM peers in hiking – and some have hiked much more to bring inflation down quickly. Take Brazil: Policy rates have risen to just under 14% from 2% in 2021. When it comes to EM investing this year, much focus has been on China's economy losing steam. But outside China, EM equities have staged a stealth rally with double-digit gains across Latin America and other parts of Asia. We see more upside there and more attractive valuations relative to DM economies as the policy picture and EM economic growth prospects improve, even as China's restart sputters. That's the first layer of our new playbook in action: our macro take in the context of what's in the price.

The second layer of our new playbook is about getting granular. We go beyond broad EM exposures to find the brightest macro backdrops across countries and most attractive valuations under the surface. Within EM local currency bonds, we like Mexico for its quality tilt and Brazil for its exceptional carry from still-high bond yields. Our playbook also calls for being nimble. EM is not disconnected from global growth, so we are constantly watching for how that may affect the EM backdrop.

We also get granular in sectors and regions and use the third layer of our playbook – harnessing mega forces – to capture returns now and in the future. We see five big structural forces transcending the macro backdrop: digital disruption and artificial intelligence (AI), geopolitical fragmentation, the low-carbon transition, aging populations and the future of finance. We see abundant EM equity opportunities through these mega forces – what matters is what markets have priced. The semiconductor industry is powering AI and is a key part of the EM technology sector. A rapidly growing population in India sets the country apart from DMs. India's system of digital payments also bodes well for the future of finance there, we believe: It could pave the way for a credit boom as banks adapt lending. We think the low-carbon transition presents an important opportunity for Latin America, especially for countries that hold large reserves of key resources like copper and lithium. The rewiring of supply chains due to global fragmentation could also have significant implications for countries like Mexico that could benefit if U.S. companies bring operations and production closer to home.

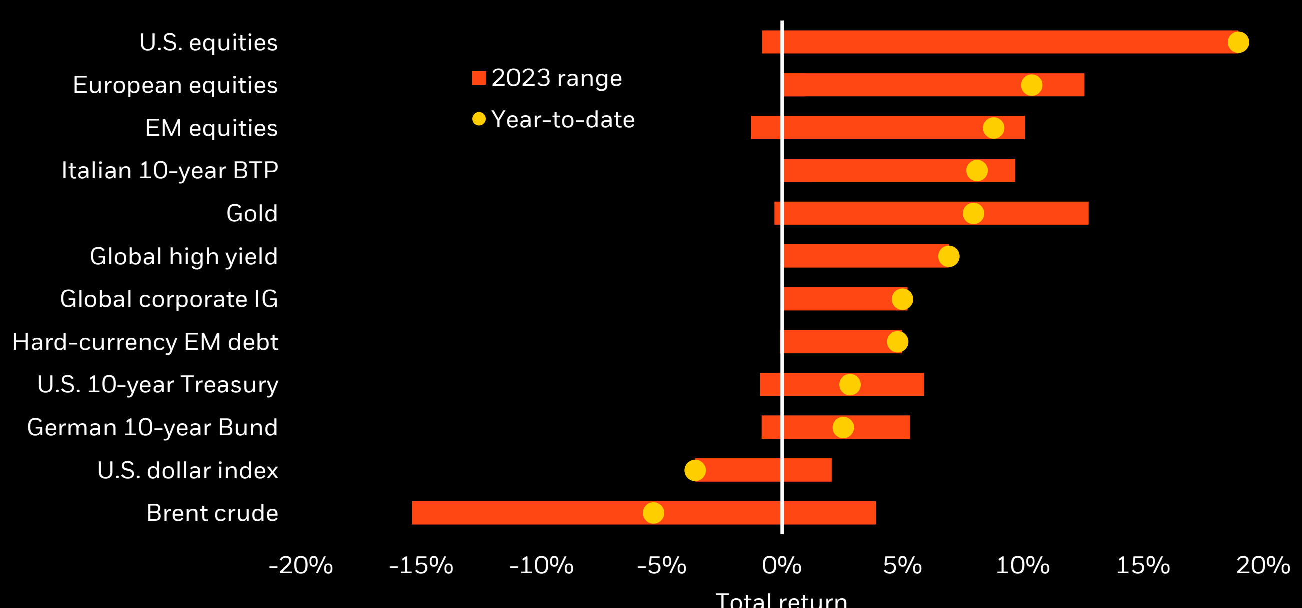
Bottom line: Our new playbook leads us to favor EM over DM assets. We see a brighter policy outlook as some EMs stand ready to cut policy rates. We get granular in EM debt across countries and in EM equities by harnessing mega forces.

Market backdrop

U.S. bond yields dropped and stocks climbed to 15-month highs last week as markets eyed an end in sight to the Fed's rapid hiking cycle after the softer-than-expected June CPI data. Both two- and 10-year Treasury yields posted their sharpest weekly declines since the March banking turmoil. The labor market is key for what lies ahead for inflation. We see still-strong wage growth keeping core inflation elevated, compelling the Federal Reserve to hold policy tight.

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 Refinitiv Datastream as of July 13, 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, Refinitiv 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

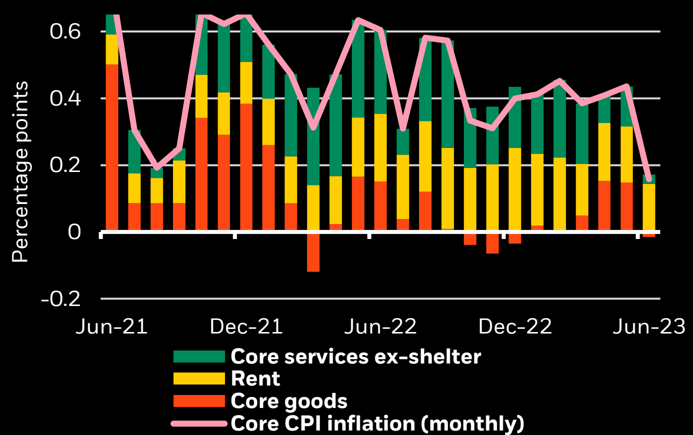
The U.S. core CPI inflation for June came in at 0.2% month-on-month, down from 0.4% in May and below expectations.

One element of that was unsurprising: the drag from goods prices. See the chart. We expected goods prices to fall as consumer spending normalized following a surge in goods consumption during the pandemic. Some of that started in the second half of last year (see the orange bars in the chart) and it reoccurred in June, driven by a decline in used car prices. We see more goods deflation ahead, reinforcing our view that overall inflation will be on something of a rollercoaster in coming months.

The real surprise was that core services inflation excluding housing was flat on the month. We think this could be a one-off and unlikely to happen again this year: It's difficult to see how core services inflation can be so low with wage growth remaining strong. We still think core inflation is proving persistent at levels well above the Fed's 2% target. And that's why we think the Fed will still hike rates later this month. See our Macro take blog posts here.

Inflation rollercoaster

Contribution to monthly core CPI inflation, 2021-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics with data from Haver Analytics, July 2023. Notes: The chart shows the contribution of individual components to overall monthly core Consumer Price Index (CPI) inflation. Rent refers to owners' equivalent rent. The core services ex shelter contribution is the contribution of "Services less energy services" inflation after excluding owners' equivalent rent.

Investment themes

1 Holding tight

- Markets have come around to the view that central banks will not quickly ease policy in a world shaped by supply constraints – notably worker shortages in the U.S.
- 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.
- Economic relationships investors have relied upon could break down in the new regime. The shrinking supply of workers in several major economies due to aging means a low unemployment rate is no longer a sign of the cyclical health of the economy. Broad worker shortages could create incentives for companies to hold onto workers, even if sales decline, for fear of not being able to hire them back. This poses the unusual possibility of "full employment recessions" in the U.S. and Europe. That could take a bigger toll on corporate profit margins than in the past as companies maintain employment, creating a tough outlook for DM equities.
- **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

July 17	China GDP, industrial production	**July 19**	UK CPI
July 18	U.S. industrial production, retail sales; Canada CPI	**July 20**	U.S. Philly Fed business index

We look to U.S. data out this week for more signs that higher policy rates are cooling production and spending. CPI data across developed markets will likely show persistently high inflation – making central banks hold tight on policy. We're also focusing on GDP and industrial data for China to gauge to what extent its economic restart is losing steam.

Directional views

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

Underweight **Neutral** **Overweight** ● Previous view

	Asset	Strategic	Tactical	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're underweight DM stocks as central banks' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession.
	Emerging	Neutral	+1	Strategically, we are neutral as we don't see significant earnings growth or higher compensation for risk. We are overweight tactically on brighter growth trends in EM over DM, still appealing valuations and EM rate cycles nearing their peaks.
Developed market government bonds	Nominal	-2	-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 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 neutral on euro area and UK long-term bonds because higher yields better reflect our view.
	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	Neutral	Neutral	We are neutral investment grade credit due to tightening credit and financial conditions but see it playing an important income role in portfolios on both horizons.
	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 local-currency EM debt. We see it as more resilient with EM central banks closer to cutting rates than DM counterparts.
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, July 2023

Underweight | **Neutral** | **Overweight** | ● Previous view

	Asset	View	Commentary
Equities	**Developed markets**		
Equities	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.
Equities	Europe	-1	We are underweight. The European Central Bank keeps tightening in a slowdown and the support to growth from lower energy prices is fading.
Equities	UK	-1	We are underweight. The Bank of England is hiking sharply to deal with sticky inflation. While equities price in more downside risk, we await policy clarity.
Equities	Japan	Neutral	We are neutral. Bank of Japan policy is still easy, shareholder-friendly reforms are taking root and negative real rates support equities.
Equities	Pacific ex-Japan	Neutral	We are neutral. China's restart is losing steam and we don't see valuations compelling enough to turn overweight.
Equities	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.
Equities	**Emerging markets**	+1	We are overweight. We see brighter relative growth trends in EM over DM, valuations remain appealing and EM rates cycles are nearing peaks.
Equities	China	+1	China's economic restart is fading, yet low inflation creates space for more policy easing. The bar for upside surprises is low given current valuations. Structural challenges like 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.
Fixed Income	Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand greater term premium.
Fixed Income	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.
Fixed Income	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 has signaled more interest rate hikes ahead.
Fixed Income	Euro area govt bonds	Neutral	We are neutral. Market pricing better reflects rates staying higher for longer. We see risk of wider peripheral bond spreads due to tighter financial conditions.
Fixed Income	UK gilts	Neutral	We are neutral. We find gilt yields better reflect our expectations for the macro outlook and Bank of England policy.
Fixed Income	Japanese govt bonds	-1	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
Fixed Income	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
Fixed Income	Global IG credit	Neutral	We are neutral on tighter credit and financial conditions. We prefer Europe's more attractive valuations over the U.S.
Fixed Income	U.S. agency MBS	+1	We're overweight. We see agency MBS as a high-quality exposure within diversified bond allocations.
Fixed Income	Global high yield	-1	We are underweight. Spreads do not fully compensate for slower growth and tighter credit conditions we anticipate.
Fixed Income	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
Fixed Income	Emerging hard currency	Neutral	We are neutral. Better fundamentals and undemanding valuations are offset by the risk from rising U.S. yields.
Fixed Income	Emerging local currency	+1	We are overweight. EM central banks are closer to cutting rates than DM counterparts.

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