Weekly commentary

July 3, 2023

BlackRock

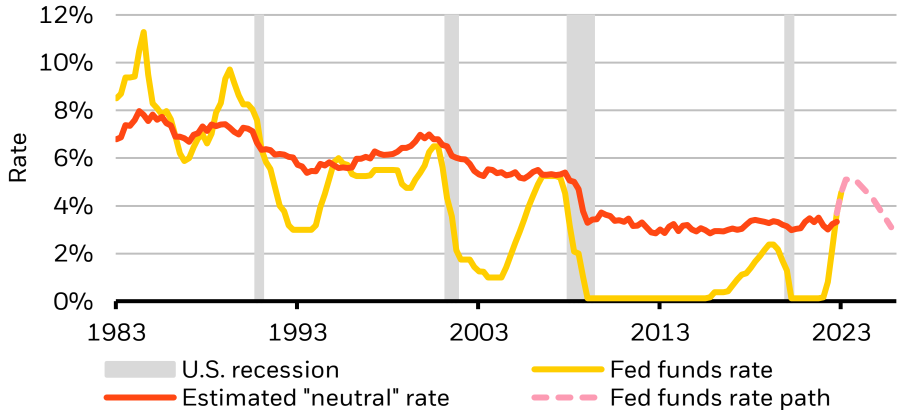
New regime, new opportunities

- We see different and abundant opportunities in the new macro regime. We go granular within asset classes, regions and sectors – and harness mega forces.
- Short-term bond yields rose last week as markets priced policy rates staying tight after U.S. data confirmed persistent inflation and activity holding up.
- U.S. jobs data is in focus this week. We think labor shortages have made firms reluctant to let workers go, keeping unemployment low even as growth sputters.

We see major central banks holding policy tight in the new macro regime. That bolsters income's appeal. We're also pivoting to new opportunities, evolving our playbook to go granular across asset classes, regions and sectors: The outlook is brightening for Japanese stocks, and we like emerging market (EM) debt as policy looks poised to loosen. We harness mega forces as well, leaning into the digital disruption of AI and private credit as it plays a bigger role in the future of finance.

Holding tight

U.S. Fed policy rate and projections vs. neutral rate estimate, 1983-2025



Source: BlackRock Investment Institute, New York Fed, U.S. Bureau of Labor Statistics, with data from Haver Analytics, May 2023. Notes: The chart shows the fed funds rate, an estimated fed funds rate path and estimated nominal "neutral" rate – or a hypothetical estimate of policy that will neither stimulate nor depress growth. The neutral rate is from the Holston Laubach Williams (2017) estimate of (real) neutral rate plus expected inflation from a D'Amico, Kim and Wei model (2018).

Markets have come around to the view that major central banks will not quickly ease policy in a world shaped by supply constraints – notably worker shortages in the U.S. Developed markets (DM) can no longer produce as much without sparking higher inflation. So, central banks are *holding tight*, the first new investment theme in our 2023 midyear outlook. That's a big change from the low-rate environment norm prior to the pandemic. Take the Federal Reserve. It has kept monetary policy loose since the early 1990s – and was quick to cut rates when recessions hit. See the yellow line and gray shaded areas in the chart. We don't see the Fed coming to the rescue. We see more supply constraints in the future compelling central banks to keep policy rates above neutral rates (red line), the estimated policy rate that neither stimulates nor depresses economic growth. That means policy is going to stay in restrictive territory.

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Policy rates staying tight bolsters the appeal of income – and the case for short-dated government paper. Three-month U.S. Treasury bill yields hit 22-year highs near 5.60% in June. We stay underweight long-term U.S. government bonds as we expect investors to demand more compensation for holding them given sticky inflation. Yet long-term bonds in the euro area and the UK are better pricing higher rates, so we're tactically neutral. We stay strategically overweight inflation-linked bonds on persistent inflation. But tactically, we prefer the U.S. over the euro area given current market pricing of each.

The macro backdrop is not friendly for broad asset class returns, but opportunities abound depending on how much of the macro is in asset prices. So we're *pivoting to new opportunities*, our second theme, and getting granular. We're modestly underweight DM equities in our six- to 12-month tactical view as they still don't price the damage from rate hikes. But Japan stands out. We upgrade Japan stocks to neutral. Why? Fewer supply constraints, supportive policy and corporate reforms. We tactically prefer EM equities to DM peers as EM policy looks closer to easing. But on a strategic horizon of five years and beyond, we're overweight DM stocks as we see returns above bonds' with growth returning and inflation lingering in the U.S.

Our third theme, *harnessing mega forces*, aims to leverage structural shifts that transcend the macro: digital disruption and AI, geopolitical fragmentation, the low-carbon transition, aging populations and the future of finance. The key is gauging what markets have priced in. We see these mega forces driving returns today and in the future. Case in point: The dip in semiconductor shares last week on potential U.S. export restrictions to China after this year's surge shows how mega forces like AI and geopolitical fragmentation can interact and impact markets now. We're overweight AI as a multi-country, multi-sector investment cycle unfolds, bolstering revenues and margins. We see geopolitical fragmentation rewiring supply chains and putting national security and resilience above efficiency. The upshot: We expect a surge in investment in areas like tech, clean energy, infrastructure and defense. We see other opportunities in the low-carbon transition's large capital reallocation – and across the energy system to get in front of shifts before markets. We also see regulatory and competition challenges for incumbent banks in the fast-evolving financial system, but also opportunities for non-bank lenders. We think private credit could help fill a void left by banks pulling back on lending after the tumult this year.

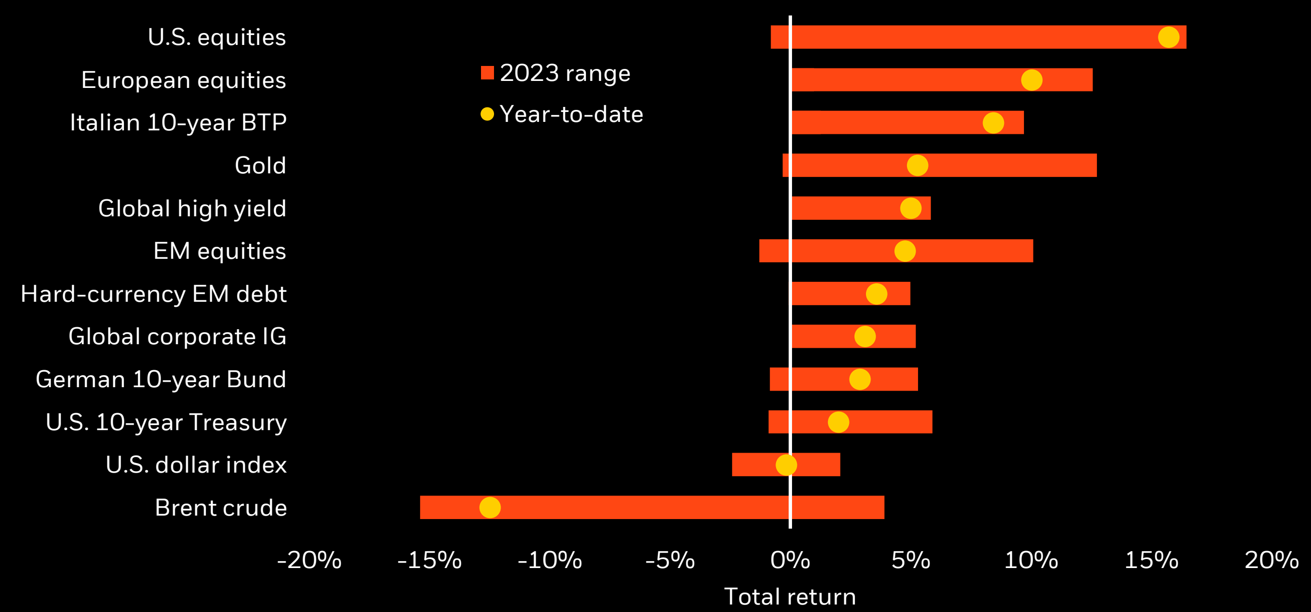
Bottom line: We're pivoting to new opportunities by getting granular as a tight policy environment makes it tough for broad asset class returns. We also harness mega forces to tap into structural shifts and upside beyond the macro backdrop.

Market backdrop

Short-term DM bond yields climbed last week as the market priced policy rates staying tight. The two-year U.S. Treasury yield pushed above 4.90%, pulling the U.S. yield curve near its most inverted level since the early 1980s. U.S. stocks hit 14-month highs after Q1 U.S. data on output and income was revised up. We think activity is holding up thanks to households spending pandemic savings – and persistent inflation as seen in PCE data may mean policy rates need to go even higher.

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 June 29, 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

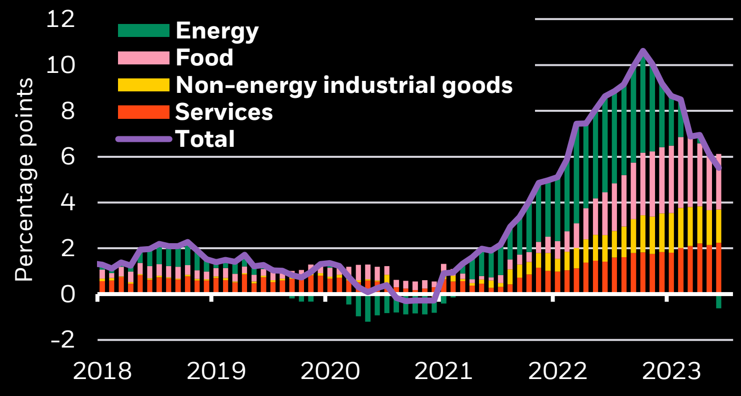
Euro area headline inflation fell in June, according to flash estimates last week. That was driven by energy prices declining below last year's levels. See the chart. Core inflation was also lower than expected, rising a touch to 5.4% year-on-year. Inflation has softened in recent months, and we expect further cooling in the second half of the year.

But policymakers are still worried: The pace of core inflation is still well above the European Central Bank's 2% target, due to ongoing supply constraints. The ECB fears that last year's high inflation could feed into bigger wage demands — creating stubborn inflationary pressure.

The result: The ECB – like other major central banks – is compelled to keep policy tight, even if it crushes activity. This is *holding tight*, the first theme of our midyear outlook in action. In a more volatile world dominated by supply constraints, central banks face persistent inflationary pressures. Their response? Tighter monetary policy than we saw in the four decades before the pandemic. See our Macro take blog posts here.

Falling – but not fast enough

Contribution to euro area annual inflation, 2018-2023



Source: BlackRock Investment Institute and Eurostat, with data from Haver Analytics, June 2023. Notes: The chart shows the contribution of energy, food, core goods (goods prices excluding energy and food) and services to overall euro area headline inflation.

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 3	U.S. ISM manufacturing PMI	**July 5**	China Caixin services PMI; S&P global services PMIs;
July 4	Reserve Bank of Australia policy decision	**July 7**	U.S. jobs report

The focus in next week's U.S. job report will be prevailing signs of a resilient labor market even with tight monetary policy. We see labor shortages fueling wage growth and keeping inflation stubbornly high as companies hold on to workers even as demand drops. That poses the unusual risk of "full employment recessions," where the unemployment rate stays low.

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.
Equities	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.
Developed market government bonds	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.
Public credit and emerging market debt	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.
Public credit and emerging market debt	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.
Private markets	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**		
	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. The European Central Bank keeps tightening in a slowdown and the support to growth from lower energy prices is fading.
	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.
	Japan	Neutral	We are neutral. Bank of Japan policy is still easy, shareholder-friendly reforms are taking root and negative real rates support 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.
	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	+1	We are overweight. We see brighter relative growth trends in EM over DM, valuations remain appealing and EM rates cycles are nearing peaks.
	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.
	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 has signaled more interest rate hikes ahead.
	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.
	UK gilts	Neutral	We are neutral. We find gilt yields better reflect our expectations for the macro outlook and Bank of England policy.
	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	Neutral	We are neutral on tighter credit and financial conditions. We prefer Europe's more attractive valuations over the U.S.
	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	Neutral	We are neutral. Better fundamentals and undemanding valuations are offset by the risk from rising U.S. yields.
	Emerging local currency	+1	We are overweight. EM central banks are closer to cutting rates than DM counterparts.

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