Weekly commentary

BlackRock

September 18, 2023

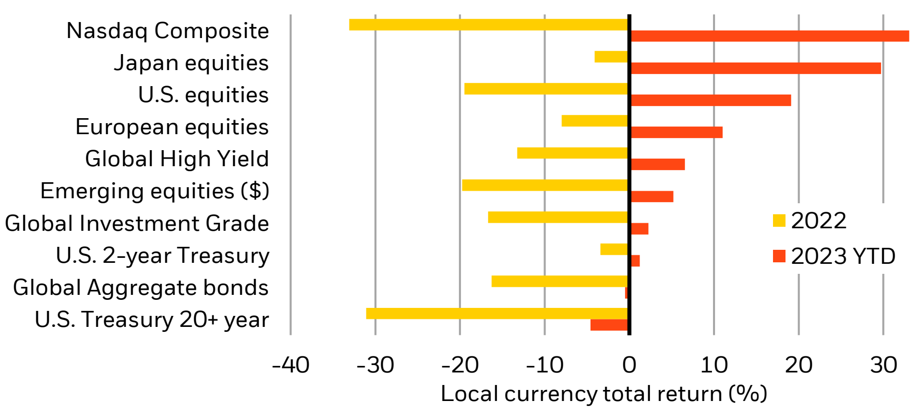
Seizing new regime opportunities

- We see the new regime playing out and a high interest rate world, with stagnant activity and persistent inflation. We shift our tactical views to reflect this outlook.
- European stocks rose last week after the likely last European Central Bank rate hike. U.S. stocks were flat after in-line CPI and strong retail sales data releases.
- Markets expect the Federal Reserve to keep policy rates unchanged this week. We see the Fed holding tight as inflationary pressures persist.

We see the new regime of greater volatility playing out: higher interest rates, stagnating activity and structural forces set to push inflation back up. Flip-flops in the market narrative make that clear. We stick with our core underweight to long-term U.S. Treasuries but adjust other key tactical views. We see reasons to favor European bonds and further upgrade Japanese stocks to an overweight. We downgrade high quality credit on tighter spreads and emerging market stocks.

Volatile markets

Selected asset performance 2022 vs. 2023 year-to-date



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. Source: BlackRock Investment Institute, with data from LSEG Datastream, September 2023. Notes: Indexes shown: Nasdaq Composite, MSCI Japan, MSCI USA, MSCI Europe, MSCI Emerging Markets, Bank of America Merrill Lynch Global High Yield Index, Bank of America Merrill Lynch Global Corporate Index, Datastream 2-year U.S. Government Benchmark, Bloomberg Global Aggregate, Bloomberg U.S. Treasury 20+ Year Index.

2022's equity selloff mostly reversed this year. But fixed income – especially long-term bonds – has largely not recovered. See the chart. We have conviction on factors that will drive bond yields higher: central banks holding policy rates tight as inflation pressures persist; growing bond supply as government debt balloons; and macro and geopolitical volatility. We expect that will spur investors to demand higher term premium, or compensation for the risk of holding long-term bonds, further pushing up yields. That's why we don't expect a sustained, joint rally of bonds and stocks as in the Great Moderation of stable activity and inflation. Higher yields challenge the relative attraction of broad equity allocations. Yet markets can run with alternative narratives as we have seen this year, creating opportunities on horizons shorter than our six- to 12-month tactical one. We think this environment offers different opportunities from those in the past.

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BlackRock **Investment** Institute

We take stock of our tactical views given recent market moves. Our underweight to long-term Treasuries – our view for roughly three years since yields were below 1% – has served us well as 10-year yields surged to 16-year highs above 4% last month. We stay underweight and expect yields to march even higher as term premium returns. We stick with short-term bonds for income. We also now see opportunity to upgrade euro area sovereign bonds and UK gilts to overweight from neutral. That change locks in higher yields as markets price in policy rates staying high for even longer than we expect.

On risk assets, we offset our government bond upgrades by downgrading high quality credit to underweight given tighter spreads. We also cut emerging market (EM) stocks, including Chinese equities, to neutral from overweight as China's property sector remains a drag even with growth showing signs of stabilizing. Our moderately risk averse stance keeps us underweight DM and broad U.S. stocks. The S&P 500 is up more than 16% this year. But a handful of firms are carrying market performance, with the equal-weighted S&P 500 up just about 4% this year. Rising valuations account for more than 80% of year-to-date global equity returns, LSEG Datastream data show. Earnings growth accounts for only about 4%, with U.S. earnings stagnating this year.

It may seem that the new regime offers few return opportunities due to greater volatility. Yet we see plenty that don't require a rosy view of the macro outlook. First, we harness mega forces – structural shifts we think can drive returns now and in the future – such as digital disruption and artificial intelligence (AI). We are overweight the AI theme that has excited markets as we see an AI-centered investment cycle that is set to support revenues and margins. Second, we get granular with regions and sectors to go beyond broad indexes. For example, we turn even more positive on Japanese equities, going overweight due to strong earnings, share buy backs and other shareholder-friendly corporate reforms. Third, we believe timing swings in market narratives creates opportunities on shorter horizons. It's not easy to seize these opportunities, in our view, and that makes the case for investment strategies focused on above-benchmark returns.

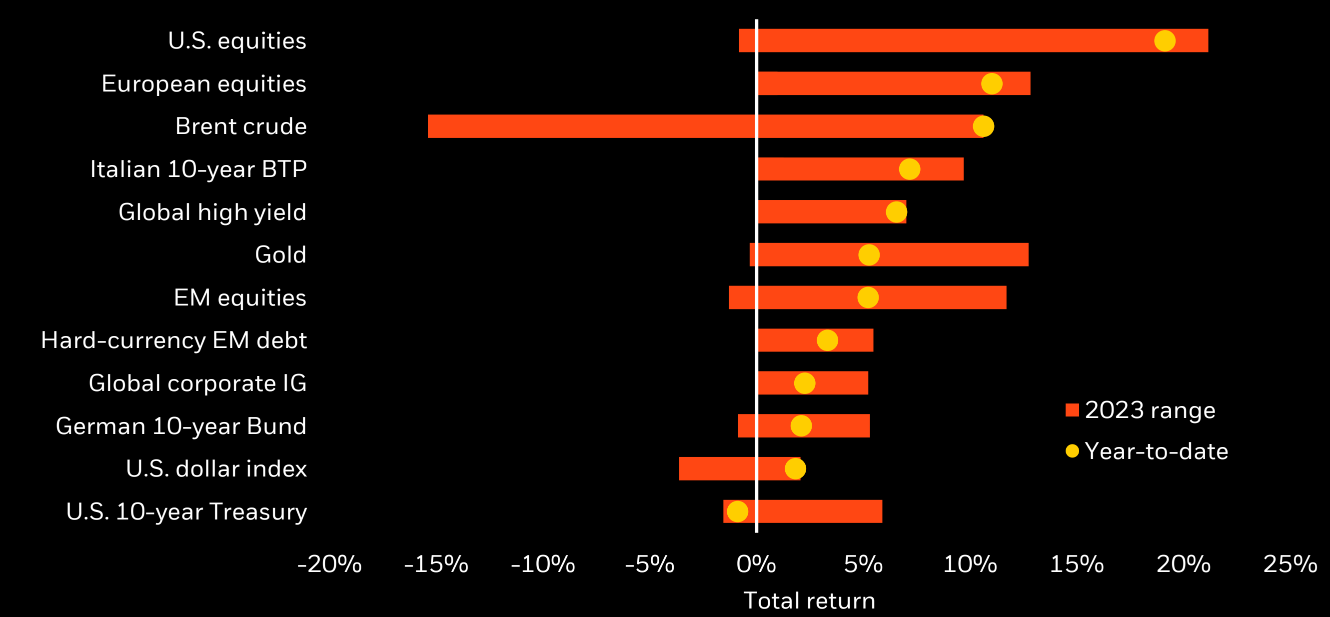
Bottom line: The new regime of greater volatility is why we remain cautious on risk-taking but lean into tactical opportunities as market pricing presents opportunities. We get selective and like long-term European government bonds, EM debt, the AI theme and turn more positive on Japanese stocks relative to DM equities.

Market backdrop

European stocks rose about 2% on the week after the European Central Bank raised policy rates 0.25% – seen as likely its last rate hike. The S&P 500 was flat and has largely stalled over the past few months. U.S. Treasury yields climbed back near 16-year highs – highlighting that we're in a new regime of higher rates. U.S. CPI data confirmed goods prices are still falling. We see inflation easing further before a sustained climb higher next year as an aging population bites.

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. 14, 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.

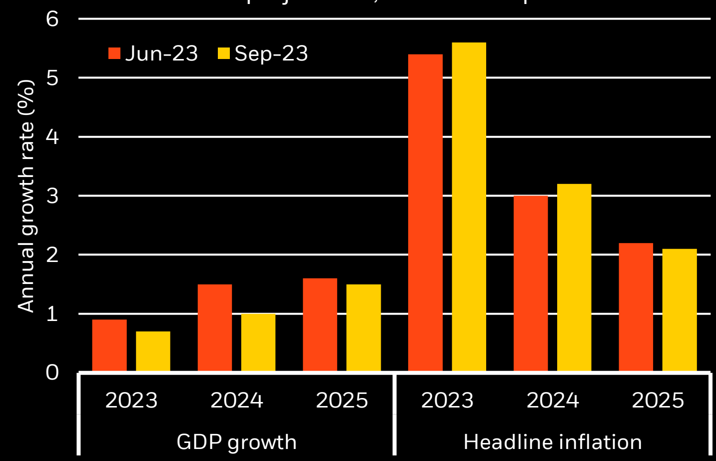
Macro take

In a split decision, the European Central Bank hiked rates again last week, taking its key interest rate to 4.0% – the highest in the central bank's history. The decision was driven by the expectation that inflation will remain "too high for too long," even as growth slows. Indeed, the ECB's new forecasts anticipate "significantly" lower growth over the next two years compared with what it had expected in June. But its inflation forecasts are little changed, with inflation still marginally above its 2% target in 2025. See the chart.

We think that was probably the last hike in this inflation-fighting campaign. The ECB believes rates are now at a level that "will make a substantial contribution to the timely return of inflation to the target." The focus now shifts to when it will start to cut. President Lagarde said rate cuts were not being discussed right now, but also didn't explicitly state that they would be kept where they are for an extended period. We don't expect any cuts before mid-2024, but also think that markets may be underestimating how many come thereafter. Have a look at our library of Macro take blog posts here.

Perhaps the last hike

ECB macroeconomic projections, June and September 2023



Source: BlackRock Investment Institute and European Central Bank, with data from Haver Analytics, September 2023. Notes: The chart shows the ECB's calendar year forecasts of euro area real GDP and headline inflation. The yellow bars show the latest forecasts as of September 2023, and the orange bars show the preceding June 2023 forecast.

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. 20	Fed policy decision; UK inflation; Japan trade data	**Sept. 22**	BOJ policy decision; Japan inflation; Global flash PMIs
Sept. 21	Bank of England monetary policy decision		

Markets expect the Fed to keep policy rates unchanged this week. We see the Fed holding policy tight as inflationary pressures persist. Inflation data out of Japan is also in focus as the Bank of Japan may pave the way for more policy changes. We expect ongoing weakness in global PMIs as the rapid rise in rates takes a toll.

Directional views

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