Weekly commentary

BlackRock

July 1, 2024

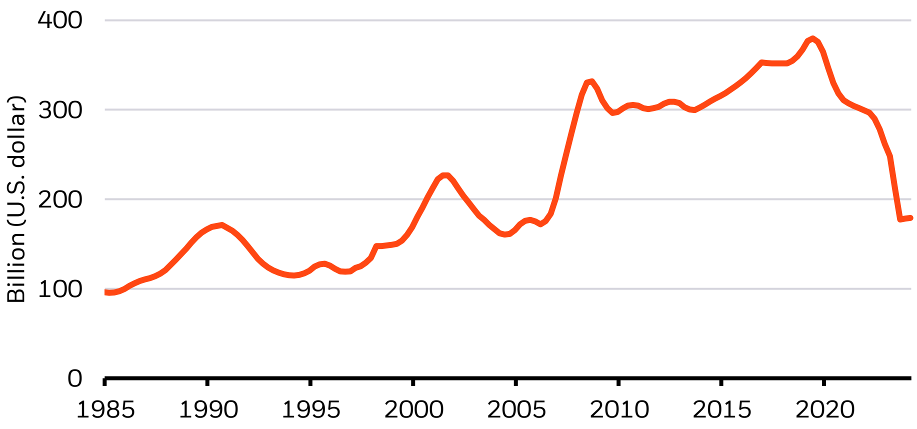
Leaning into income in fixed income

- Total income has returned to credit thanks to higher-for-longer interest rates. We prefer pockets of credit where investors are better compensated for risk.
- U.S. stocks ticked up to fresh all-time highs last week. U.S. PCE for May was flat month over month, the latest measure showing decelerating price growth.
- We're monitoring this week's U.S. payrolls data to see if rapid job gains will continue and if wage pressures will remain elevated.

The higher-for-longer rate environment has restored income in a range of different bonds. Total yields on offer in credit – in investment grade, mortgage-backed securities and high yield – provides long-term investors relatively attractive yield returns to risk, especially in shorter-term bonds. We favor areas where investors are more compensated for risk, preferring Europe over the U.S. and private credit over public. From a whole portfolio perspective, we prefer taking risk in equities.

Paying less interest

Non-financial corporate net interest payments, 1985-2024



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis (BEA), U.S. Department of Commerce with data from LSEG Datastream, July 2024. Notes: The chart shows the net interest paid by non-financial companies and the rest of the world for the U.S.' financial resources. Read more in the BEA's handbook.

Today is a different world for fixed income investing compared with pre-pandemic. After a historic string of central bank rate hikes, 86% of global fixed income assets are now yielding 4% or more, versus less than 20% in the decade leading up to the pandemic, LSEG Datastream data show. This means long-term investors no longer need to take on extra risk to generate solid income. And U.S. companies are proving resilient to higher rates. U.S. investment grade companies have less than 10% of outstanding debt coming due annually through 2030, Bloomberg data show. We don't see a maturity wall ahead that could raise questions about companies refinancing at higher rates. Many companies took advantage of low rates early in the pandemic, converting short-term debt to long-term. As a result, U.S. corporate net interest payments have plunged even after sharp rate hikes. See the chart.

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While the total income on offer is attractive for fixed income investors, we stay selective in credit. Spreads have tightened, largely a function of strong demand relative to supply and resilient corporate balance sheets. Spreads for U.S. investment grade companies are near their tightest levels in two decades – keeping us underweight. Within credit, we prefer the income from short- and intermediate-term bonds and pockets that compensate investors for risk-taking. We are neutral high yield credit globally on both a tactical and strategic horizon. The income cushion makes high yield more attractive on a total return basis relative to investment grade, in our view. We get granular by region, preferring European longer-term credit over the U.S. – spreads in Europe are not as tight relative to the U.S. or to their own history. We are keeping an eye on the French parliamentary election heading into the second-round vote on July 7. France makes up almost 20% of the European corporate bond universe, Bloomberg data show.

In a whole portfolio context, we prefer taking risk in equities – where expected returns are more attractive – over credit on a tactical horizon of six to 12 months. We stay overweight stocks and the AI theme.

On strategic horizons of five years and longer, we like private credit over public – even as U.S. direct lending default rates have risen, according to Lincoln International data. Defaults could be even higher if not for lender flexibility on companies breaching credit agreements. This factors into our conservative default assumptions for private credit – twice those of public high yield. Yet even after accounting for those potential losses, we remain positive. Defaults are still relatively limited. Private credit should also play a key role in the future of finance: We see rising appetite for non-bank lending driving steady demand for private credit. Private markets are complex, with high risk and volatility, and aren't suitable for all investors.

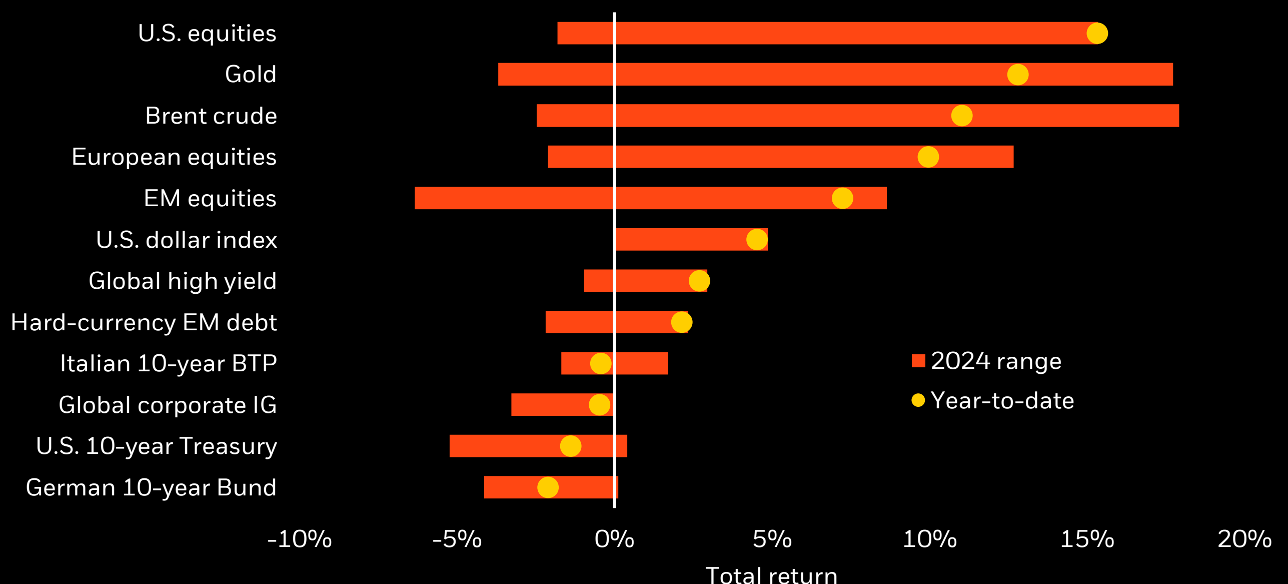
Bottom line: The fastest rate hikes in decades have put total income back into fixed income. We like pockets of credit where investors are more compensated for risk – like Europe over U.S., high yield over investment grade and private over public. Yet in a whole portfolio context, we prefer taking risk in equities.

Market backdrop

U.S. stocks rose to fresh all-time highs last week. U.S. PCE for May was flat monthly as expected, the latest inflation measure showing decelerating price growth. We watch for whether inflation ultimately cools enough to settle near the Fed's 2% goal. French assets came under pressure heading into the first round of the snap election. Spreads on French 10-year government bonds over German bunds pushed back to their widest level since the euro area crisis. French stocks hit five-month lows.

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 June 27, 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

July 2	Euro area flash inflation and unemployment data	**July 5**	U.S. payrolls data
July 3	U.S. trade data; Caixin services PMI		

We're keeping an eye on the U.S. payroll report out this week to gauge if recent rapid job gains will continue, boosted by bumper immigration flows. We're also watching whether pay growth remains elevated: It's currently running too hot for inflation to settle near the Fed's 2% target, in our view.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, July 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 stocks 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 public credit risk.
Fixed income granularity	• We prefer inflation-linked bonds as we see inflation closer to 3% on a strategic horizon. We also like short-term government bonds, and the UK stands out for long-term bonds.
Equity granularity	• We favor emerging over developed markets yet get selective in both. EMs at the cross current of mega forces – like Mexico, India and Saudi Arabia – offer opportunities. In DM, we like Japan as the return of inflation and corporate reforms brighten our outlook.

Note: Views are from a U.S. dollar perspective, July 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 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, July 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.
	United States	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. While valuations look fair to us, we think the near-term growth and earnings outlook remain less attractive than in the U.S. and Japan – our preferred markets.
	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		+2	We are overweight. Mild inflation and shareholder-friendly reforms are positives. We see the BOJ policy shift as a normalization, not a shift to tightening.
	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		Neutral	We are neutral. Market expectations for persistent inflation in the euro area have come down.
	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		-2	We are underweight. We find more attractive returns in equities. We see some of the least attractive returns in Japanese government bonds, so we use them as a funding source.
	China govt bonds		Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	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 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.
	Global high yield		Neutral	We are neutral. Spreads are tight, but we like the 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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