Weekly commentary

July 31, 2023

BlackRock.

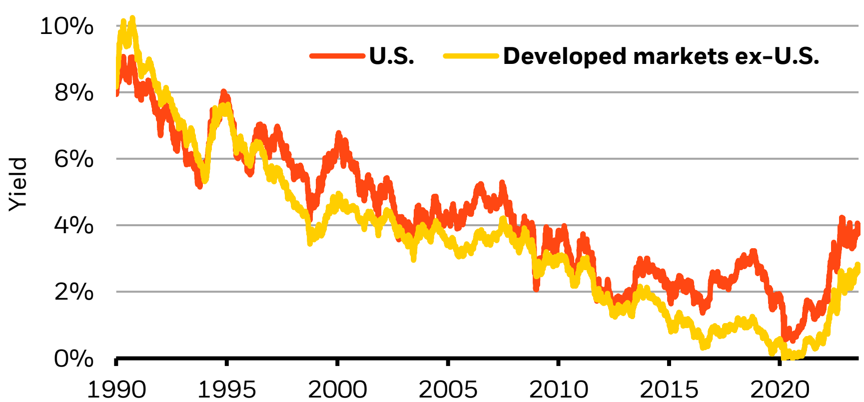
Tighter policy all around

- Major central banks tightened policy last week, including unexpectedly in Japan. We see the potential for rising Japanese bond yields to pull global yields higher.
- The Bank of Japan tweaked its yield cap, sending local yields to a nine-year high. Developed market stocks hit 15-month highs.
- U.S. jobs data this week is likely to show still-low unemployment, confirming a tight labor market. We see weak euro area activity as rate hikes bite.

The Bank of Japan surprised markets last week after it tweaked its yield curve control policy again, joining a tightening wave across developed markets (DM). The Federal Reserve hiked rates and said more could come: It may be overestimating the economy's strength, we think. By contrast, the European Central Bank signaled an end to its tightening bias and a new phase of data-dependency. We see global yields rising with tighter policy all around and favor European bonds in DM.

Upwards together

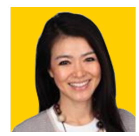
Ten-year U.S. yields vs. average of developed market yields, 1990-2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2023. Notes: The chart shows U.S. Treasury 10-year yields and an average of 10-year German, Japanese, UK and Canadian yields.

The Bank of Japan (BOJ) took another step last week to wind down stimulus by loosening its policy of capping 10-year bond yields. The shift saw Japanese 10-year yields rise to a nine-year high. Most global yields rose as well, highlighting why the BOJ move matters for markets – the gravitational pull between DM bond yields is strong. Take the 10-year bond yield of U.S. Treasuries and the average DM peer: They have largely moved in lockstep for decades – apart from 2015-2020 when the euro area and Japan were fighting deflationary risks with negative interest rates and hefty bond purchases. See the chart. We think the BOJ's move to relax its yield curve control is an important development: It is gradually joining the global policy tightening campaign, and in this case policy is about letting long-term government bond yields rise. We see potential further tweaks to BOJ policy pulling up developed market bond yields alongside Japanese ones.

Jean Boivin
Head – BlackRock Investment Institute



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The BOJ unexpectedly shifted its hard yield cap up to 1% from 0.5% but kept the half a percentage point range either side of zero as a "reference point," allowing flexibility on bond purchases. Inflation has returned but not as much as in other economies – and the BOJ is unsure if higher wages will be sustained and keep inflation around its target. The BOJ is still projecting inflation below target a few years ahead but sees a risk of higher-than-forecast inflation in the interim. We expect the BOJ to let yields rise as inflation gets more entrenched, but only gradually. This is a form of tightening, in our view. It has gone smoothly for now, but we think the muted market response may embolden the BOJ to do more, though it could become trickier. It may be some time before the BOJ lifts short-term policy rates from the current -0.1%.

The Fed and ECB have a different problem: Inflation is still too high. Last week's U.S. PCE inflation and wage data showed a move in the right direction. But we fear an inflation rollercoaster as service price pressures persist – and jobs data this week will be key to assessing the outlook. The Fed, like us, is not yet convinced that inflation is on track to reach its target. It thinks economic weakness is the only way to get there – and sees resilient GDP and consumer spending as signs the demand in the economy is still too strong. We think the Fed may be misreading the economy's strength based on low unemployment: That shouldn't be taken as the usual sign of a buoyant economy, but rather a result of structural worker shortages holding back growth potential. We think this perceived strength raises the risk that the Fed hikes more than markets expect and then cuts as it generates *too much* weakness – rather than just holding tight.

The ECB also believes economic weakness is needed to get inflation down to target. It hiked again last week but signaled an end to its tightening bias and a new phase of data-dependency. The ECB recognizes that it's already causing damage, as seen in PMIs. Yet we still see it holding policy tight to get inflation right down even as more weakness emerges.

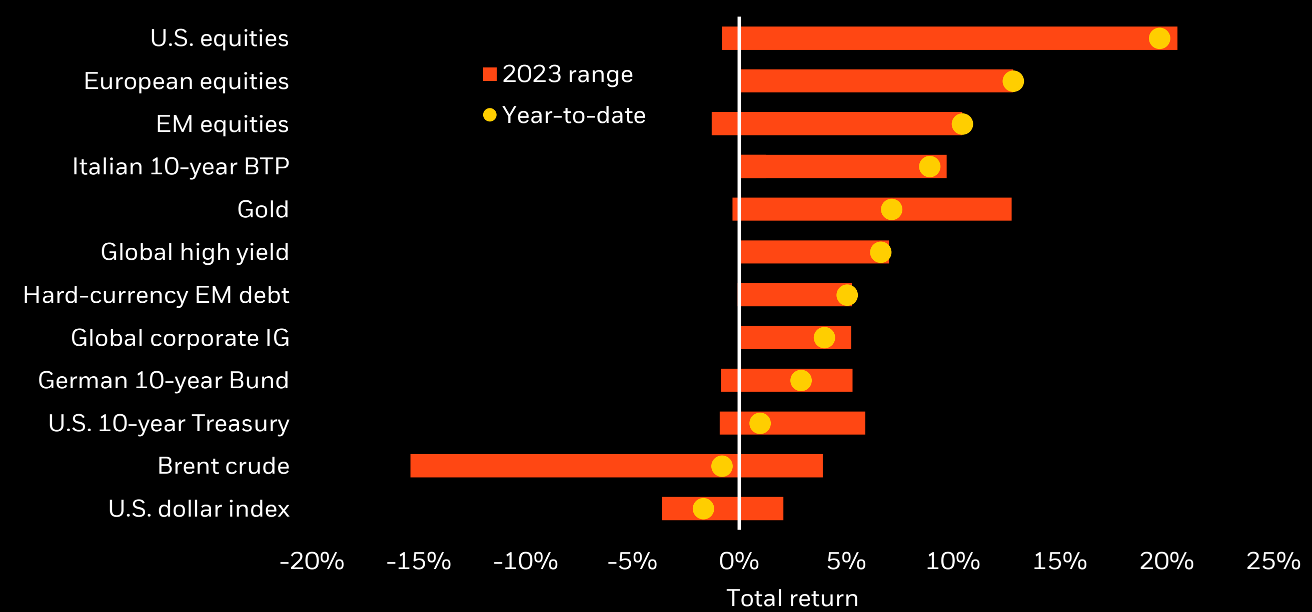
Bottom line: We see the BOJ's shift confirming why DM yields are likely heading higher as investors demand more term premium for the risk of holding long-term government bonds. We stay tactically underweight long-term bonds but see key regional differences. We tactically prefer euro area bonds to U.S. peers as market pricing better reflects ECB policy staying tight. That view played out this week with euro area yields flat while U.S. and Japanese yields climbed. We stay underweight Japanese bonds given the scope for a further yield rise. We also have a relative preference for high quality credit for income.

Market backdrop

The BOJ's tweak to its yield cap drove Japanese bond yields to nine-year highs and pulled along some other DM yields, with the U.S. 10-year Treasury yield up 10 basis points on the week to near 4%. The MSCI World index of DM shares edged higher on the week to hit a 15-month high. Mega cap tech firms met a high bar in delivering on expected second quarter earnings. Analysts are eyeing an earnings recovery beyond this quarter, but we expect them to stay under pressure over the next year.

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 27, 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

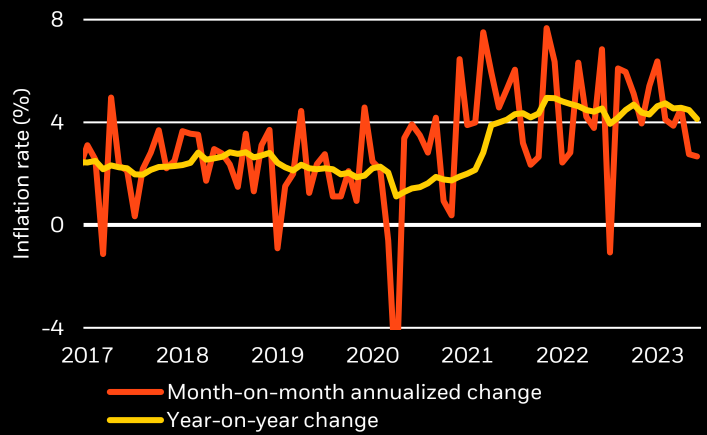
Last week's data releases showed important developments on the inflation front. First, the U.S. Employment Cost Index – the Fed's preferred gauge of wages – showed pay growth slowing further in the second quarter. We have been watching wage trends closely because of the link between a tight labor market, wages and core inflation. The current trajectory suggests that core inflation could settle below 3% – a notable drop from earlier in the year.

Second, PCE inflation for June confirmed the cooling we saw in the CPI earlier in the month. Some of that was driven by a sharp drop in goods inflation – and goods prices are set to keep inflation on a rollercoaster path in coming months. On top of this, annualized core services inflation excluding housing (shelter) was up just 2.7% on the month. See the chart. We think this points to broader signs of disinflation.

We have already seen core services inflation softening this much in this higher inflation regime, only to jump back again. If that pattern breaks in coming updates, it will be notable, in our view. See our Macro take blog posts here.

Cooling inflation

U.S. core services inflation excluding shelter, 2017-2023



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, Haver Analytics, July 2023. Notes: The chart shows the inflation rate of core Personal Consumer Expenditure (PCE) services excluding shelter. The yellow line shows the month-on-month inflation rate (expressed at annualized pace) and the orange line shows the year-on-year rate.

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 31	Euro area GDP and flash inflation data	**Aug. 3**	Bank of England policy decision; China services PMI
Aug. 1	U.S. job openings; euro area unemployment	**Aug. 4**	U.S. payrolls report

We're focused on U.S. jobs data this week. We think companies being reluctant to let go of workers in a tight labor market will likely keep unemployment low even as economic activity stagnates. Euro area activity data will likely show further weakness as rate hikes bite. Markets are also leaning toward another hike from the Bank of England this week.

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	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.
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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