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# 2024 Global outlook

## Grabbing the wheel: putting money to work

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**The new regime of greater macro and market volatility is unfolding in Europe – marked by a stagnating economy, inflation on a rollercoaster and tighter monetary policy. Mega forces driving the new regime – such as shrinking workforces, geopolitical fragmentation and the low-carbon transition – are also at play. This, coupled with macro uncertainty, is set to keep dispersion of market returns high. We take profit on our long-standing preference for Swiss government bonds, remain cautious on European equities for now and see value in European credit.**

Persistently high rates and greater volatility define the new regime. The European economy is normalizing from the pandemic, with headline inflation falling fast towards the European Central Bank's (ECB) 2% target as last year's energy shock unwinds.

But this remains a world without easy trade-offs for central banks, as clamping down on growth has been somewhat essential to drive inflation down. The ECB's historically sharp rate hikes - 450 basis points in just over a year – are already causing economic damage. Ultimately, higher rates raise the cost of borrowing for households, firms and governments. Yet the ECB will likely hold policy tight for longer to lean against sticky underlying cost pressures as unemployment close to multi-decade low and prospects of tight labor markets means workers are able to negotiate higher wages.

We expect headline inflation falling to – or even temporarily undershooting – the ECB's 2% target in 2024 due to weak activity and the impact of lower energy prices. That could pave the way for slightly easier interest rate policy and a modest growth pick-up. That means we are likely to see growth shaped by recovering real incomes on the one hand, against restrictive ECB policy – albeit less so than this year – and scaled back fiscal policy.

Still, we think putting too much weight on traditional business cycle developments is missing the broader context. We are in an environment that implies persistently higher interest rates and tighter financial conditions to keep inflation in line with ECB target than was the case in the last decade. Financial markets are still adjusting to this new regime where ECB actions are likely to be significantly more constraint, and that's why context is key for *managing macro risk*, our first theme.

We think greater macro volatility will lead to persistent dispersion of returns at securities, sector and country level going forward. In Europe, this global tendency might be amplified by the still-incomplete institutional architecture of the euro area. These developments create space for investment expertise to shine, as detailed in our second theme – *steering portfolio outcomes*.

One way to drive portfolio outcomes is by *harnessing mega forces*, our third theme. For Europe, we expect two of these forces – the low-carbon transition and the rewiring of global supply chains – to reinforce each other. The two shocks of the pandemic and tragic Ukraine war have been a wake-up call for Europe to address energy security.



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Encouraging progress has been made to address energy security, for example by seeking more diversified energy sources and broadening trading partnerships. In the longer run, Europe's low-carbon transition and build-out of new energy infrastructure is poised to accelerate noticeably, we think, and could prove a long-run competitive advantage for the region. The EU's Green Deal Industrial Plan complements ongoing transition initiatives while preserving the region's competitiveness in the sector.

Overall, we expect slower nominal euro area GDP growth in 2024 vs. 2023. Against that, we think the bar to meet consensus expectations of corporate earnings growth accelerating to 6.4% in 2024 (vs. 1.7% in 2023) is high. We also see margins under pressure as higher financing costs bite and real wage growth - negative in 2022-2023 - is expected to turn positive in 2024. We stay underweight broad European equities despite appealing valuations but have a relative preference for quality stocks. We see room for significant dispersion both in terms of security selection and sector performance – a hallmark of the new regime that warrants greater granularity. For example, we find European financials strongly capitalized and attractively priced in a scenario of structurally high interest rates.

Our expectation of slowing nominal GDP growth alongside a peak in policy rates in Europe creates a better backdrop for fixed income assets than the past two years. Yet we recently turned neutral (from overweight) euro area government bonds tactically as we think markets are overestimating the amount of easing ECB is willing to deliver over the next 12 months. We are also closing our long-held preference for Swiss government bonds after robust performance in 2023.

In credit, we are generally more inclined to take risk in Europe than in US. In global investment grade, where we hold an underweight to the asset class globally, we keep a relative preference for Europe. Why? We see spreads more attractively priced versus history. Additionally, the significant weight of financials in European indices is supportive. We are encouraged by European banks tightening lending standards at a considerably slower pace over the last two quarters. We also like European High Yield where we see higher quality and lower duration than the U.S. In our view, spreads compensate for risks of a potential pick-up in defaults.

In a tough macro backdrop, opportunities abound in Europe and globally. We hope you find our Global Outlook helpful in achieving investment objectives and wish you the very best for 2024.

**Philipp Hildebrand**
Vice Chairman — BlackRock

**Jean Boivin**
Head — BlackRock Investment Institute

**Wei Li**
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**The new regime of greater macro and market volatility has resulted in greater uncertainty and dispersion of returns. We believe an active approach to managing investment portfolios will carry greater rewards as a result. This is a sea change from relying on the one-and-done asset allocations that worked so well during the Great Moderation, the long period of stable growth and inflation. That period is over. We believe this is a time to grab the investing wheel – and seize the opportunities the new regime has on offer.**

Higher rates and greater volatility define the new regime. It's a big change from the decade following the global financial crisis. Ever-expanding production capacity allowed central banks to stabilize economies and shore up growth through loose monetary policy. That helped suppress macro and market volatility, and stoked bull markets in both stocks and bonds. Investors could rely on static, broad asset class allocations for returns – and gained little advantage from differentiated insights on the macro outlook.

Today, we think the flipside is true. Production constraints abound. Central banks face tougher trade-offs in fighting inflation – and can't respond to faltering growth like they used to. This leads to a wider set of outcomes, creating greater uncertainty for central banks and investors.

There's a temptation to interpret the new regime by taking a classic business cycle view of the current environment, we believe. Markets are swinging between hopes for a soft landing and recession fears as a result. This misses the point: the economy is normalizing from the pandemic and being shaped by structural drivers: shrinking workforces, geopolitical fragmentation and the low-carbon transition. The resulting disconnect between the cyclical narrative and structural reality is further stoking volatility, we believe.

Seemingly strong U.S. growth actually reflects an economy that's still climbing out of a deep hole created by the pandemic shock – and tracking a weak growth path. What matters most, in our view, is that the environment implies persistently higher interest rates and tighter financial conditions. Financial markets are still adjusting to this new regime, and that's why context is key for *managing macro risk*, our first theme.

We think macro insights will be rewarded in the new regime. Greater volatility and dispersion of returns create space for investment expertise to shine, as detailed in our second theme – *steering portfolio outcomes*. This involves being dynamic with indexing and alpha-seeking strategies, while staying selective and seeking out mispricings.

One way to drive portfolio outcomes is by *harnessing mega forces* – our third theme. These are five structural forces we see driving returns now and into the future. They have become important portfolio building blocks, in our view.

Our bottom line for 2024: Investors need to take a more active approach to their portfolios. This is not a time to switch on the investing auto pilot; it's a time to take the controls. It's important to be deliberate in taking portfolio risk, in our view, and we expect to deploy more risk over the next year.

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# Context is everything

Multiple times in 2023, market hopes have been revived that the U.S. economy can achieve a soft landing – or inflation getting back to the Fed's 2% target without a recession. What's fueling those hopes?

In contrast to other major economies, the U.S. grew at a robust 4.9% annual clip in the third quarter of 2023. Core inflation has fallen sharply. And nearly 7 million new jobs have been created since January 2022 – a phenomenal pace of jobs growth compared with a typical economic expansion. See the chart top right.

But zoom out and look at the bigger picture (chart below right): The economy has just been climbing out of the pandemic hole:

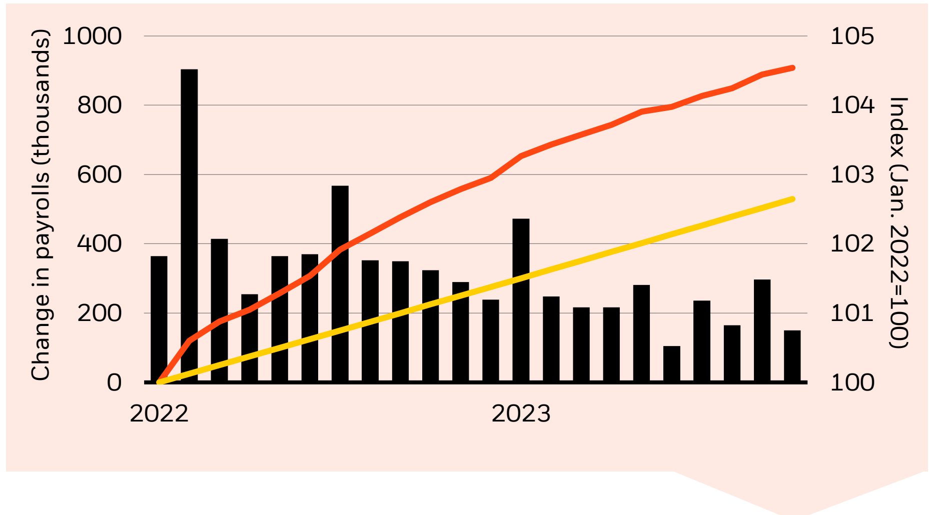
- Some 22 million jobs were lost when the pandemic struck. Strong job gains since then largely reflect the recouping of those lost. The level of employment is well below the track we would have expected to be on before the pandemic.
- Looking at broader economic activity, the U.S. economy has grown by less than 1.8% a year, on average, since the pandemic. That's well below the trend we would have expected pre-pandemic – and well below where the consensus and Federal Reserve had expected. That's nothing to be excited about.
- This resulted in even with more muted growth, historically low unemployment and higher inflation.

Our bottom line: Something has changed – and it's structural in nature. We are on a weaker growth path and got here with more inflation, higher interest rates and much higher debt levels. The upshot for investors? We think the key is to focus on how the economy and markets are adjusting to the new regime. Adopting the typical cyclical playbook may be misguided.

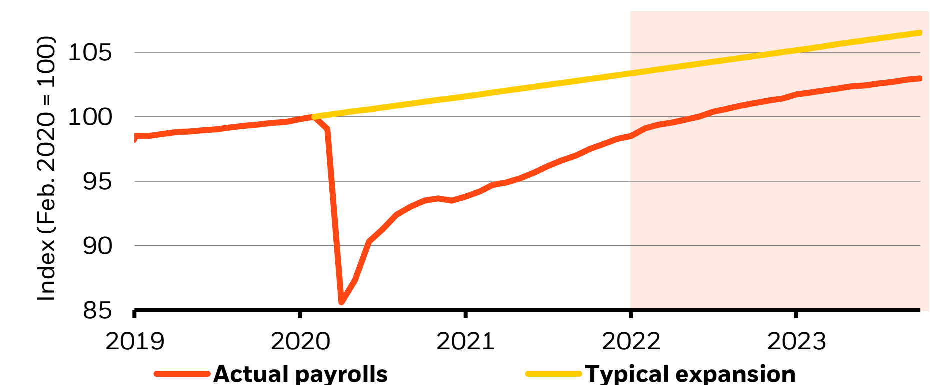
## Strong employment gains...

U.S. payroll changes vs. typical expansion, 2022-2023 and 2019-2023

**Monthly change** **Cumulative change (right)**
**Typical expansion (right)**




## ...but still climbing out of a deep pandemic hole




Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, December 2023. Notes: The charts show U.S. nonfarm payrolls. The orange lines show the actual level of total nonfarm payroll employment indexed to two different start dates: in the upper chart, January 2022=100 and in the lower chart February 2020=100. The yellow lines in both charts show hypothetical payroll employment as if the economy had continued to grow at the average rate observed during U.S. post-1945 expansions. The black bars in the upper chart show actual monthly payroll gains (in thousands) since January 2022.

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# Structural shift

Markets have been flip-flopping between hopes for a soft economic landing and fears of yet higher rates that ultimately result in recession. This has created volatility, as the chart shows.

The U.S. economy has been navigating two large shocks, in our view. The first was the pandemic. Over the past two years, most new jobs created have been due to the restart of activity after shutdowns.

A shift in consumer spending drove up inflation by creating a mismatch between what people wanted to buy and what the economy was set up to produce. That mismatch is now resolving, and inflation has been falling as a result.

As the effects of the pandemic shock recede, the effects of the second, more structural one are becoming clearer: A worker shortage has emerged, as a growing share of the U.S. population ages into retirement.

That's why unemployment is at historic lows – even though U.S. growth has averaged well below its pre-Covid rate. See page 3.

The workforce is growing more slowly in Europe and China, too, and it's one of several long-term production constraints we think will prevent many economies from growing at their pre-pandemic pace without sparking renewed inflation.

Rising production costs in a fragmenting world will also push up inflation across major economies over the longer term, in our view. And the transition to a low-carbon economy is creating price pressures as the energy system is being rewired.

This means central banks face a tough trade-off. If they want to stop inflation resurging, they will need to keep policy tight. We think policy rates are poised to settle well above pre-pandemic norms. Ultimately, we see central banks living with higher inflation amid hefty government spending and debt loads.

Our bottom line: This is a regime of slower growth, higher inflation, higher interest rates – and greater volatility.

## Yield swings on short-term surprises

Sensitivity of U.S. 10-year yield to economic surprises, 2003-2023

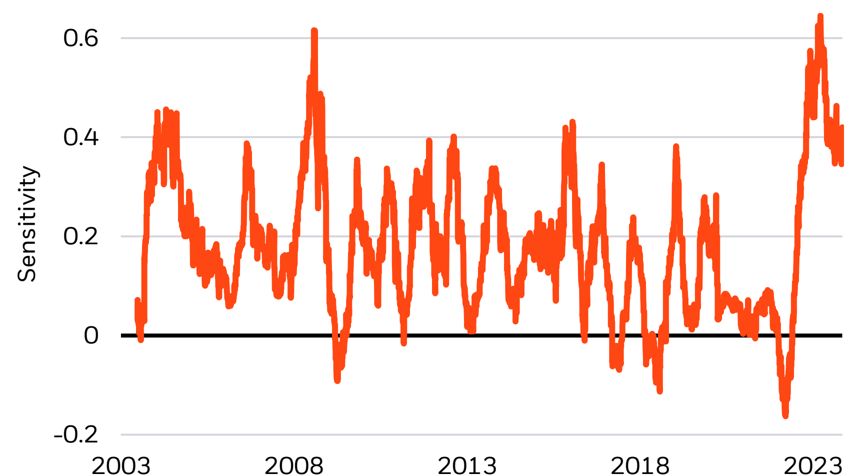


**Chart takeaway:** *Data surprises are driving the sharpest, sustained swings in U.S. 10-year Treasury yields of the past two decades. We believe this reflects greater uncertainty from investors still trying to view the economy through the lens of a typical business cycle.*

Source: BlackRock Investment Institute, with data from LSEG Datastream, December 2023. Notes: The chart shows how sensitive the U.S. 10-year Treasury yield is to economic surprises. This is calculated by using regression analysis to estimate the relationship between U.S. 10-year Treasury yields and the Citi Economics Surprise Index over a rolling six-month window. The sensitivity is how closely movements of the U.S. 10-year Treasury yield align with fluctuations in the Citi Economics Surprise Index, relative to how much the Surprise index itself varies. This analysis is only an estimate of the relationship between the 10-year Treasury yield and economic surprises. Past performance is no guarantee of future results.

**If central banks want to stop inflation from resurging, we think they will need to keep holding back economic activity with higher policy rates.**

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# Managing macro risk

This is a regime shift, not about whether a recession happens. So it doesn't make sense for investors to wait for the macro environment to improve, in our view. We think investors should seek to neutralize macro exposures or – if they have high conviction – be deliberate about which exposures they take.

We see more scope to outperform the market now than in the less volatile Great Moderation. Production constraints abound. Central banks face tougher trade-offs in fighting inflation and can't respond to faltering growth like before. We think this leads to a wider dispersion of views.

For example, analyst estimates of future S&P 500 equity earnings are more dispersed now than before the pandemic, according to LSEG data. See the chart. They are having a harder time reading the earnings outlook. So macro insight is likely to be more rewarded.

Still, we think investors need to be alert to risks around macro exposures in the new regime.

First, markets are slowly adjusting to structurally higher inflation and policy rates, but it is uneven. U.S. 10-year yields surged to 16-year highs around 5%, for example. But most DM equity earnings yields haven't risen much. This adjustment matters more than if a technical recession occurs, in our view, and keeps us cautious on broad exposures.

Second, structurally lower growth and higher rates pose a problem for ballooning U.S. government debt. If borrowing costs from higher yields stay near 5%, the government could spend more on interest payments than Medicare in a few years. This increases the long-run risk of higher inflation as central banks become less aggressive on inflation.

We also see a rise in term premium, or the compensation investors demand for the risk of holding long-term bonds. This, plus our expectation of more yield volatility, keeps us tactically neutral and strategically underweight long-term U.S. Treasuries. Our largest strategic overweight is instead to inflation-linked bonds.

### Adjusting to new regime

Dispersion of U.S. equity analyst earnings estimates, 1995-2023

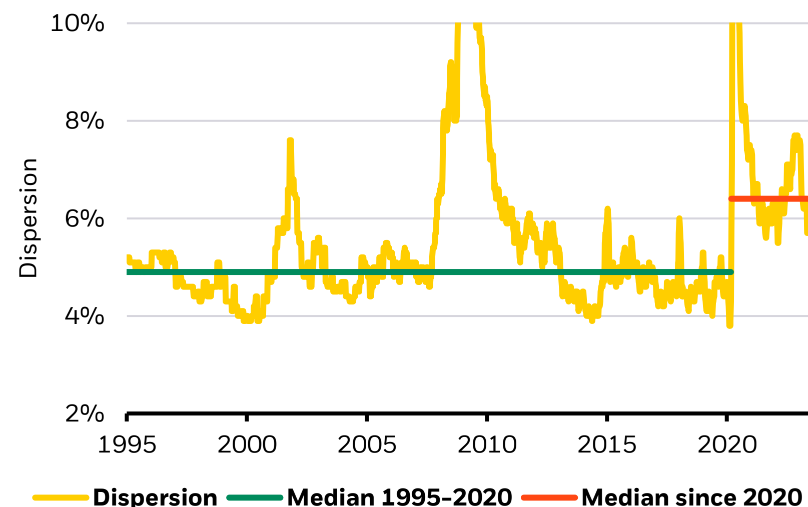


**Chart takeaway:** *During the Great Moderation, analyst views of expected company earnings were much more grouped together outside of major shocks. Now they are more dispersed, showing that an environment of higher inflation and interest rates makes the outlook harder to read.*

Source: BlackRock Investment Institute, LSEG Datastream, December 2023. Notes: The chart shows the aggregate standard deviation of analyst earnings estimates for S&P companies. The green line shows the median from 1995 to end January 2020, the orange line shows the median since February 2020

**The macro outlook is more uncertain. Exposures to macro risk can be punished as well as rewarded, so we think investors should be deliberate about which exposures they take.**

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# Steering portfolio outcomes

Heightened volatility and dispersion call for an active approach to managing portfolios, in our view.

Structurally higher policy rates should eventually mean higher returns on all assets. But not all asset valuations have adjusted, we think. And static exposures to broad asset classes are unlikely to deliver the risk-adjusted returns they did during the Great Moderation's bull markets in both stocks and bonds.

We see alpha, or above-benchmark returns, playing a bigger role in the new regime – and believe a more dynamic portfolio approach is warranted when cash offers attractive returns.

What if you were able to accurately predict U.S. equity sector returns with perfect foresight? Acting on this hypothetical ability more frequently would have paid off much more since 2020 (see the right bars in the chart) than in the four years prior left bars). The upshot? Good insight, acted upon in a timely manner, has yielded greater rewards than buy-and-hold strategies since 2020.

Investors can also thrive in the new regime by getting granular with portfolio allocations. For example, returns on short-term Treasuries have outpaced those on long-term bonds since mid-July 2023, according to LSEG data, as investors started to demand compensation for taking long-term interest rate risk. Lastly, dispersion of returns has risen in the new regime. This means security selection is likely to be more impactful, in our view. We see a wide arsenal of tools and strategies to help outperform static portfolios. Investors can blend indexes to build core allocations, implement alpha ideas and hedge risk.

Our bottom line: Investment expertise is likely to give portfolios an edge in the new regime.

**"Mega forces and the macro: these are inspirations, not constraints, in finding alpha."**

**Raffaele Savi**
Global Head of BlackRock Systematic

## More dynamic

Hypothetical impact of rebalancing on U.S. equity returns

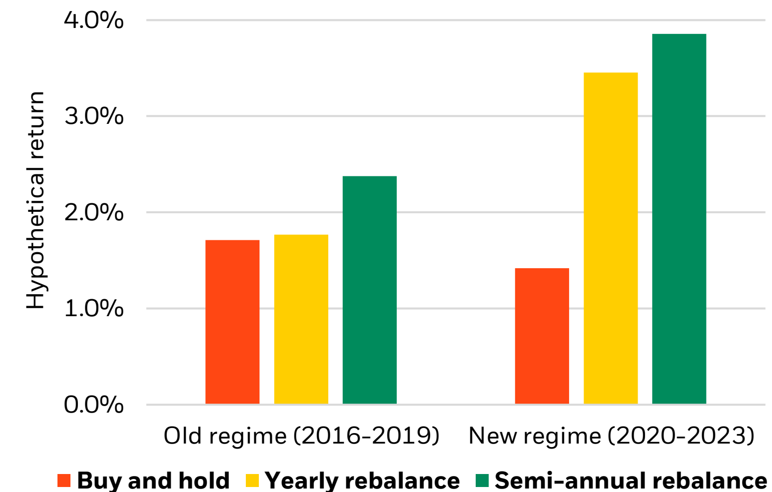


**Chart takeaway:** *Taking a more dynamic investing approach in in the new regime would have likely outperformed a buy-and-hold strategy to a much greater extent than before the pandemic.*

**Past performance is not a reliable indicator of future performance. Index returns do not account for fees. It is not possible to invest directly in an index.** Source: BlackRock Investment Institute, MSCI with data from Bloomberg, December 2023. Notes: The chart shows monthly U.S. equity returns – based on the MSCI USA – in the old and new regime under three scenarios: keeping the holdings unchanged (buy-and-hold), yearly rebalances and semi-annual rebalances. The rebalances optimize the portfolio for returns, diversification and risk with perfect foresight of equity sector returns in the MSCI USA index. This analysis uses historical returns and has been conducted with the benefit of hindsight. Future returns may vary and these results may not be the same other asset classes. It does not consider potential transaction costs that may detract from returns. It also does not represent an actual portfolio and is shown for illustrative purposes only.

**We believe the new regime rewards an active approach to portfolios. We don't see one-and-done strategies working as in the past.**

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# Harnessing mega forces

We think mega forces are another way to steer portfolios – and think about portfolio building blocks that transcend traditional asset classes. They stand out as drivers of corporate profits on their own, in our view, and so could offer potential opportunities that may be uncorrelated to macro cycles.

These forces are already reshaping markets. Take digital disruption and artificial intelligence (AI). The chart to the right illustrates the outperformance of U.S. tech relative to the broader market this year. We think this reflects how quickly markets embrace such fundamental shifts in the market outlook.

We think the winners and losers can broaden the AI tech stack. When incorporating this mega force into our tactical views, it can push up our stance on DM equities closer to neutral even if the macro backdrop isn't rosy. See pages 8 and 14.

That's just one example of why we think harnessing mega forces will enable investors to outperform simple, static allocations.

The far-reaching consequences of mega forces are giving rise to new investment opportunities – and markets can be slow at pricing in the impact of these long-term forces.

Capital pressures on banks are opening a path for private credit and non-banks to fill the lending void. Private credit can be an illiquid asset class not suitable for all investors. We take a selective approach, given structurally higher rates.

Aging populations in major economies are poised to limit how much countries can produce and grow – depending on how they adapt.

Climate resilience is emerging as a new investment theme, in our view. As climate damages mount, we are seeing increased demand for solutions that help economies prepare for, adapt to and withstand climate hazards, and rebuild after damages. See page 9.

We see geopolitical fragmentation driving a surge of investment in strategic sectors like tech, energy, and defense. See page 10.

## Mega force at work

S&P tech sector vs. S&P 500 performance, 2023 year-to-date

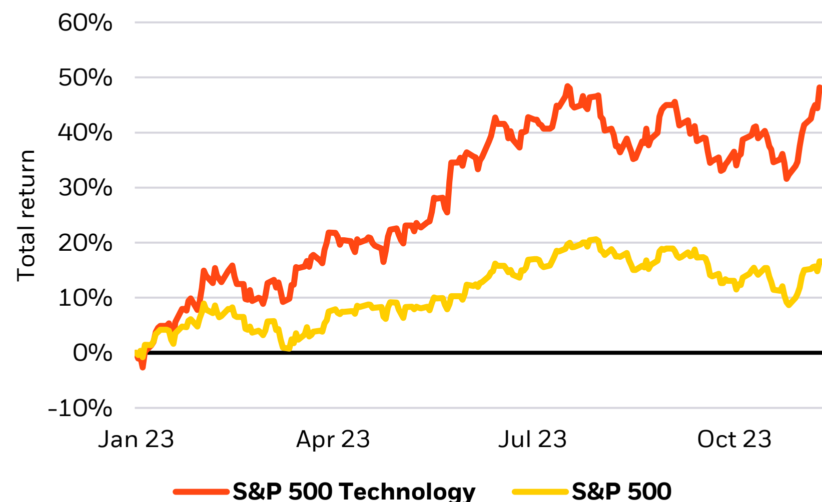


**Chart takeaway:** *Investor enthusiasm for AI and digital tech has offset the drag of rising yields. That has pushed U.S. tech stocks to easily outshine the broader market in 2023.*

Past performance is not a reliable indicator of future results. Index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from LSEG Datastream, December 2023. Notes: The chart shows the total year-to-date returns in U.S. dollar terms for the S&P 500 Technology sector (orange line) and the S&P 500 index (yellow line).

**Mega forces are key drivers of the new regime, affecting the long-term growth and inflation outlook and creating shifts in profitability. We see them as a source of return now and far into the future.**

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# AI: intelligence revolution

Advances in computing hardware and deep learning innovations led to an inflection point for AI in late 2022. We think advances from here are likely to be exponential as innovation snowballs.

Yet tracking investment opportunities across geographies and sectors comes with high uncertainty. The technology "stack" – layers of technology built on top of each other that enable further innovation — may offer a roadmap to help assess the investment opportunities. See the chart.

The bottom layer (in orange in the schematic) covers cloud infrastructure and chips – the building blocks. The second layer (in yellow) covers models, data and data infrastructure. The last layer – in white – comprises the apps that harness the innovation. We think we are somewhere between the first and second layers, with the last one likely coming next. We see the entire tech industry – led by a handful of large tech firms – pivoting their business focus to AI.

That suggests we may be just at the cusp of this intelligence revolution, in our view. Implications likely go beyond the near-term focus on productivity gains. Our early research shows a potential positive correlation between a pickup in AI patents and broad earnings growth.. We also find that investors are ascribing a rising economic value to these patents. Yet not all patents lead to profitable enterprises, and their future value is highly uncertain.

We're overweight the AI theme in DM stocks on a six-to-12-month horizon. We see the tech sector's earnings resilience persisting and expect it to be major driver of overall U.S. corporate profit growth in 2024.

> **AI is a major positive – both for earnings growth and productivity."**

**Simona Paravani-Mellinghoff**
Global CIO, BlackRock Multi-Asset Strategies & Solutions

## The AI technology stack

BlackRock view of tech need to develop AI applications, December 2023

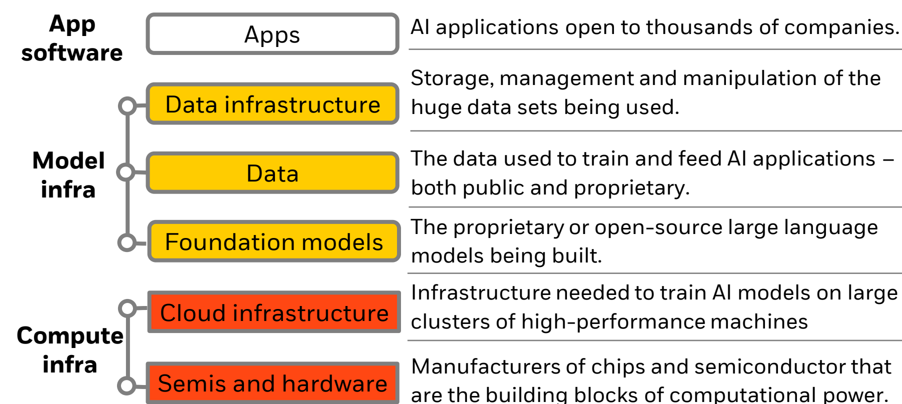


**Chart takeaway:** *We see investment opportunities moving up the stack as technology evolves – from hardware manufacturers to digital and data infrastructure and ultimately to applications.*

Source: BlackRock Investment Institute, December 2023. Notes: The schematic shows the technologies we think will be needed to develop AI applications. Each layer builds on the one preceding as technologies get "stacked" on top of one another, enabling further innovation. The schematic is for illustrative purposes only and intended as a guide based on what we know today. As the AI ecosystem evolves, some categories may be replaced by newer ones. References to securities are shown for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell.

**We think the overarching race to build the smartest machines is akin to a revolution – like the industrial and information revolutions of the past.**

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# Investing in climate resilience

The low-carbon transition is one of the five mega forces playing out in markets today. We launched the BlackRock Investment Institute Transition Scenario to help investors navigate its risks and opportunities, with a focus on the energy transition. This is not just about identifying opportunities in renewables; traditional energy companies can also outperform, especially when there are supply-demand mismatches.

The energy transition tends to get the headlines, but we see a related theme becoming an important investment story: climate resilience. This is the ability to prepare for, adapt to and withstand climate hazards, and to rebuild after climate damage. Think early monitoring systems to predict floods, air conditioning to cope with heatwaves, or retrofitting buildings to better withstand extreme weather. With climate damages set to keep mounting in coming years, it will take extensive investment to build society's resilience to them.

Just how big will those damages be? It's hard to put a number on the impact on human health and well-being. The quantifiable economic damage is growing fast, as the chart shows. We already see demand growing for products and services that build climate resilience. Markets may be underappreciating how this can become a mainstream investment theme over time.

In a recent paper, we divide this theme into three sub-themes: assessing and quantifying risks, managing risk and rebuilding physical infrastructure. That helps us build a framework to identify opportunities that cut across sectors, such as industrials and technology, and asset classes.

> **We see opportunities in solutions offering flood, fire and drought resistance."**

**Olivia Markham**
Portfolio Manager, Thematic and Sectors, BlackRock Fundamental Equity

## Real physical damages mount

U.S. events with inflation-adjusted losses of $1 billion, 1985-2023

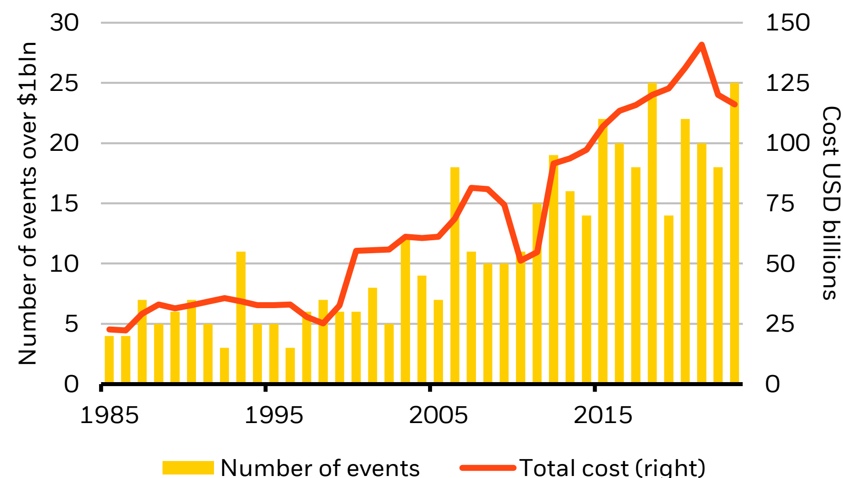


**Chart takeaway:** *The number of climate-related events with damages totaling more than $1 billion has steadily increased over the past roughly three decades. The U.S. hit a record number of such events just nine months into 2023.*

Sources: NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2023), December2023. Notes: The bars (yellow) show the number of climate events with losses greater than US$1 billion. The data include droughts, flooding, severe storms, hurricanes, wildfires, winter storms and freezes. The orange line shows the total cost as a ten-year moving average. The data are adjusted for inflation using 2022 dollars. All currency figures are in U.S. dollars.

**Markets may be underappreciating the prospects for climate resilience to become a mainstream investment theme over time, we think.**

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# Deepening fragmentation

Cascading crises have accelerated global fragmentation and the rise of competing geopolitical and economic blocs, in our view. Our BlackRock Geopolitical Risk Indicator is elevated – see chart – suggesting markets are paying more attention than before.

Should investors hunker down as a result – and keep their investments close to home? We don't think so. The new mantra of resilience over economic efficiency may raise costs – but also presents opportunities. Countries like Vietnam and Mexico could benefit from the diversification of supply chains, in our view. And we see opportunities in the Gulf states, India and Brazil. They are pursuing ties with multiple blocs and have valuable resources and supply chain inputs.

In this more competitive world, we expect a surge of investment in strategic sectors like tech, energy, defense and infrastructure. We also see opportunities in firms with expertise in managing and reducing cybersecurity risks.

War in the Middle East, ongoing conflict between Russia and Ukraine, and structural competition between the U.S. and China mean increased geopolitical risks. The number of volatile situations worldwide is the highest in decades, according to the UN. And 2024 is set be the biggest election year in history, with more than half the world population voting. We see the U.S. and Taiwan elections as particularly significant.

Navigating this new world order isn't necessarily about avoiding risks or positioning for specific events, in our view, but about whole portfolio strategies that aim to both seize its opportunities and mitigate risks.

> **Repeated shocks are driving long-term, structural changes in the world order."**

**Tom Donilon**
Chairman, BlackRock Investment Institute

## Paying more attention

BlackRock Geopolitical Risk Dashboard, 2018-2023

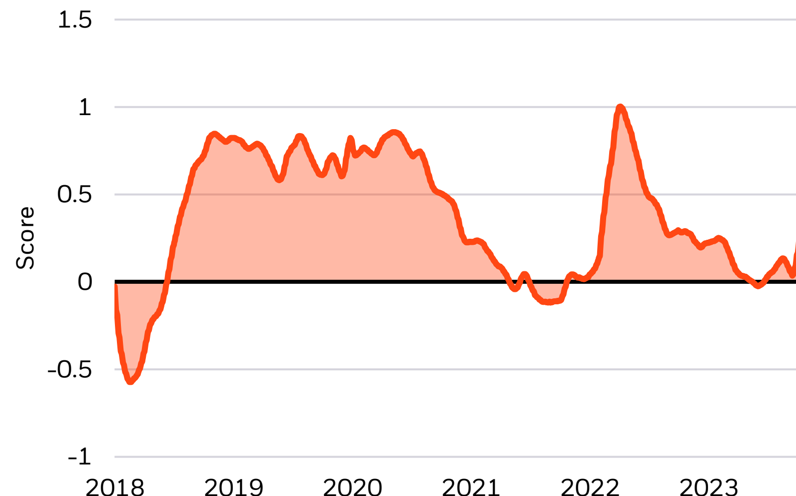


**Chart takeaway:** *Market attention to geopolitics has hit its highest this year, according to our BlackRock Geopolitical Risk Indicator.*

Source: BlackRock Investment Institute. December 2023. The BlackRock Geopolitical Risk Indicator (BGRI) tracks the relative frequency of brokerage reports (via LSEG) and financial news stories (Dow Jones News) associated with specific geopolitical risks. We adjust for whether the sentiment in the text of articles is positive or negative, and then assign a score. This score reflects the level of market attention to each risk versus a 5-year history. We assign a heavier weight to brokerage reports than other media sources since we want to measure the market's attention to any particular risk, not the public's.

**The rewiring of economic ties along geopolitical lines is set to accelerate. We are focused on the investment opportunities this creates.**

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# Moving away from home

We see greater dispersion of returns unfolding across global markets, creating opportunities for investors who look beyond their home markets. We get selective across regions and countries, assessing valuations, earnings prospects and what's in the price.

Take Japan. We think 2023 was a pivotal year for the country. We upgraded Japan twice this year on appealing valuations, earnings growth, and as corporate reforms aimed at boosting shareholder take root. It remains our strongest DM equity view. Investors are latching on, partly explaining the broad market's surge this year.

Under the hood, a more nuanced move is unfolding. The chart shows the outperformance this year of companies that sit at the low end of price-to-book ratios – a reflection of investors getting in front of more value-enhancing measures coming at such firms. We still see overall valuations as attractive. One risk is potentially tighter monetary policy – and why we prefer to take equity risk without hedging for currency.

We have maintained a broad preference for emerging market (EM) assets over DMs. EMs are not disconnected from global growth, so selectivity is important, in our view.

Mega forces may offer abundant EM equity opportunities. India's system of digital payments 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. And U.S. companies bringing operations and production closer to home could benefit countries like Mexico.

> **"Japan and India are among the beneficiaries from global fragmentation."**

**Belinda Boa**
CIO of Emerging Markets, BlackRock Fundamental Equity

### Reforms take root

Japan: equity relative performance by price-to-book ratio, 2023

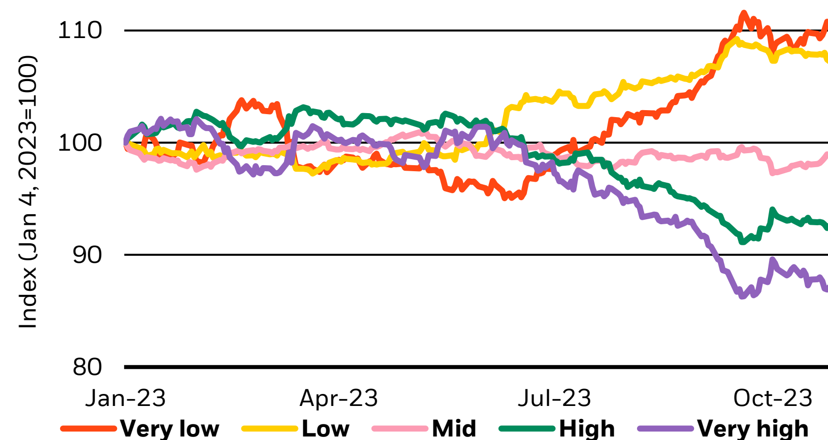


**Chart takeaway:** *Shares of Japanese firms with low price-to-book ratios have outperformed as investors anticipate such companies will double down on steps to boost shareholder value.*

**Past performance is no guarantee of future results.** Source: BlackRock Investment Institute, with data from QUICK and Daiwa. December 2023. Notes: The chart illustrates the year-to-date rebased performance of the TOPIX index constituents, grouped into five buckets based on their price-to-book (P/B) ratios. The process of grouping involves arranging the constituents in ascending order by their P/B ratios and then dividing them into five market-cap-weighted buckets, ensuring each bucket represents an equal segment of the market's total capitalization. For example, the "Very low" bucket comprises constituents with lowest P/B ratio. The buckets are rebalanced monthly.

**Selectivity across geographies is an important layer of our playbook that aims to achieve above-benchmark returns in the new regime.**

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# Real asset opportunities

We think inflation will be structurally higher and see real assets such as real estate and infrastructure playing a key role in strategic portfolios as a result. Why? Some real asset values or cash flows are linked to measures that correlate with inflation – think property prices or rental income.

But the macro matters. Low interest rates – previously a benefit to returns – have given way to higher financing costs, structurally. The question now: how much is in the price today? We had expected valuations for core real assets in private markets to adjust to rising interest rates and higher yields – leading us to turn cautious on private real assets in June 2022.

Valuations have adjusted – but we think there's more to go. Capitalization (cap) rates – the ratio of a property's income to its price – are the commonly referenced valuation metric for real estate. As rates and yields surged, we expected cap rates for both private and public real estate to rise.

The reality is that cap rates for private real assets have moved less than publicly traded real estate investment trusts (REITS). See chart. This shows how, in this instance, public markets better reflect the new environment.

Cap rates at the aggregate level aren't the full story. The nature of underlying assets are one reason for the difference in private and public cap rates. REITS invest in a wide variety of properties, including sectors like data centers and healthcare. That means selected REITS could be more resilient to slowing economic activity than private real estate. It underscores why it's important to go beyond a simple mantra of buying real assets in inflationary times.

Our bottom line: Prices in some public real assets have adjusted to higher rates more than some private counterparts. Critical to capturing the opportunities that arise, in our view, are selectivity, understanding what is in the price and having the agility to shift between real assets.

## Private lags public

Real estate capitalization rates, 2017-2023

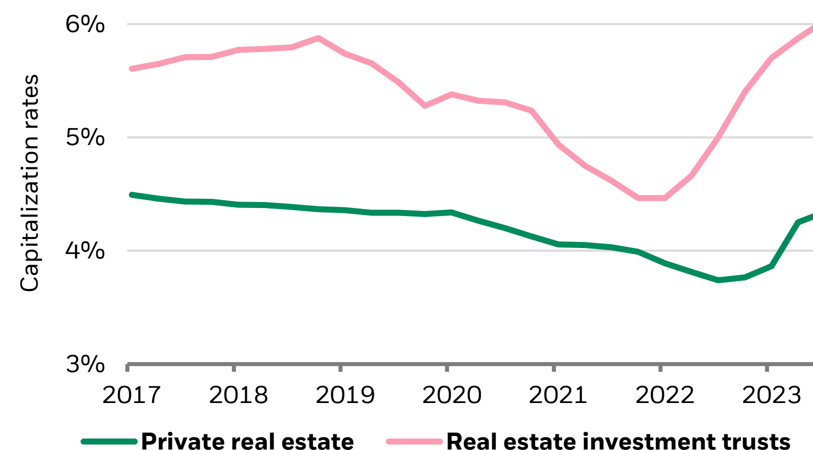


**Chart takeaway:** *Real estate investment trusts (REITs) valuations have reacted to rising interest rates faster and further than private real estate. We think that makes publicly-listed REITs more attractive relative to private real estate.*

Source: BlackRock Investment Institute, with data from NCREIF, December 2023. Notes: The chart shows historical capitalization rates (solid green line). Past performance is no guarantee of future results.

**Publicly traded real estate has adjusted to rising interest rates. We think that makes it more attractive than private real assets at this point.**

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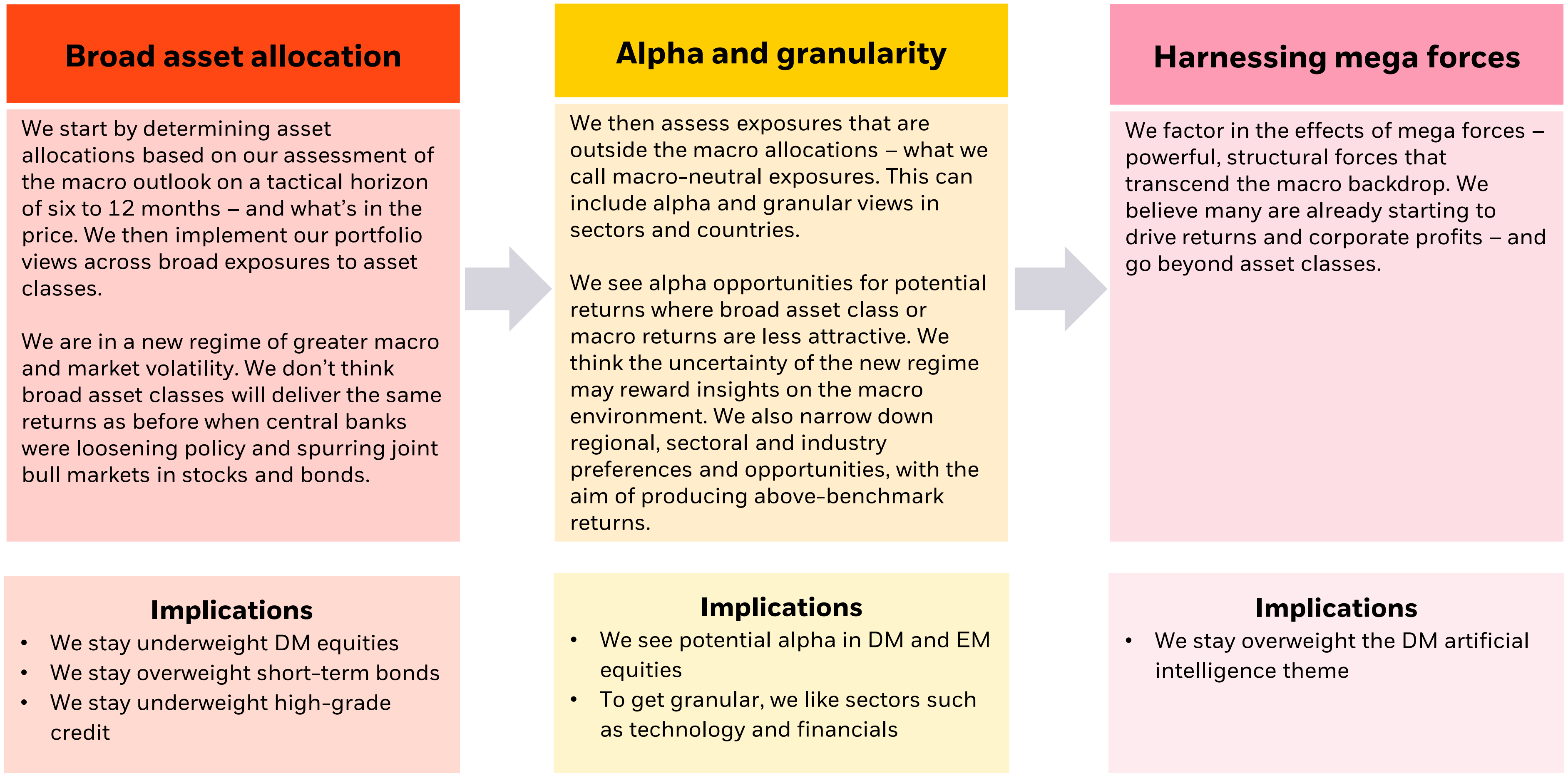
# Behind the views

## Explaining our approach to tactical asset allocation

Broad and static investment solutions won't take you as far in this new regime as in the past, in our view. We think it calls for selectivity and granularity instead. We further extend our investment playbook to include alpha.

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# Dynamic and nimble

Our core conviction is that investors need to be more dynamic with portfolios in the new regime. The one-and-done approach to asset allocation simply won't work as it did before.

We have updated how we present both our tactical and strategic views to focus on where we have the strongest conviction on both time horizons – but with an emphasis on staying nimble and getting granular. We also break down how we now build on our macro view at the asset class level to incorporate a view of where we see potential return opportunities outside of such broad exposures.

On a tactical horizon, our overall macro view would keep us underweight DM equities as a standalone because we expect growth to stay stagnant with persistent inflation, prompting central banks to keep policy rates higher for longer. But we find greater alpha opportunities in DM stocks. When incorporating the AI theme and alpha, our overall view is more neutral on U.S. equities. See the example on the right. We stay positive on Japan as laid out on page 11. And we keep favoring AI theme in DM stocks.

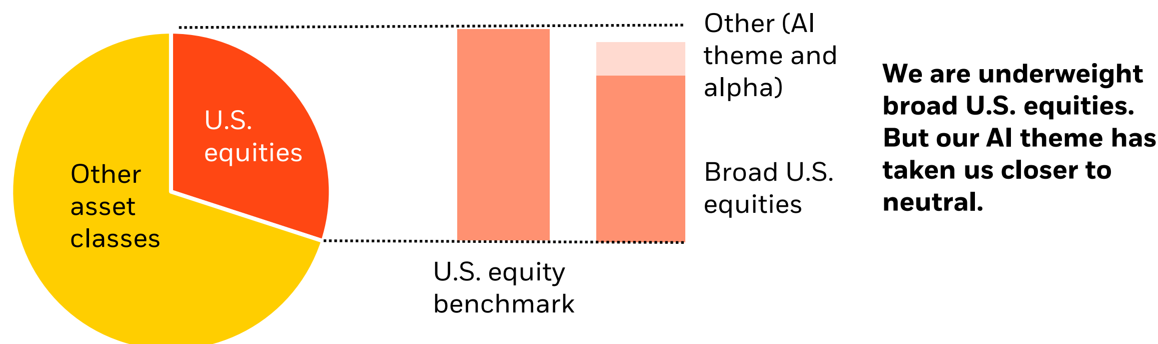
Strategically, it is more of an income story. Our inflation view keeps up maximum overweight inflation-linked bonds. We still like income within private markets. And within DM government bonds, we still prefer short- and medium-term maturities.

## Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, December 2023

| Tactical | Reasons |
|---|---|
| DM equities | • Our macro view keeps us underweight, but we see the AI theme and alpha potential has taken us closer to a neutral view. See below. |
| *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 (see page 11) and like Japan equities 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 credit risk. |
| Inflation-linked bonds | • We see inflation staying closer to 3% in the new regime than policy targets, making this one of our strongest views on a strategic horizon. |
| Short- and medium-term bonds | • We overall prefer short-term bonds over the long term. That's due to more uncertain and volatile inflation, heightened bond market volatility and weaker investor demand. |

### Deep dive of including the mega force overweight on overall U.S. equity view




Note: Views are from a U.S. dollar perspective, December 2023. 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.

## Tactical granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, December 2023

*Our approach is to first determine asset allocations based on our macro outlook – and what's in the price. The table below reflects this. It 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 it is creating more space for alpha. For example, the alpha opportunity in highly efficient DM equities markets historically has been low. That's no longer the case, we think, thanks to greater volatility, macro uncertainty and dispersion of returns. The new regime puts a premium on insights and skill, in our view.*

| Equities | View | Commentary |
|---|---|---|
| U.S. | -1 | We are underweight the broad market – still our largest portfolio allocation. Hopes for rate cuts and a soft landing have driven a rally. We see the risk of these hopes being disappointed. |
| Europe | -1 | We are underweight. The ECB is holding policy tight in a slowdown. Valuations are attractive, but we don't see a catalyst for improving sentiment. |
| 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 | +1 | We are overweight. We see stronger growth helping earnings top expectations. Stock buybacks and other shareholder-friendly actions are positives. Potential policy tightening is a near-term risk. |
| DM AI mega force | +1 | We are overweight. We see a multi-country, multi-sector AI-centered investment cycle unfolding, likely supporting 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. Modest policy stimulus may help stabilize activity, and valuations have come down. Structural challenges such as an aging population and geopolitical risks persist. |

Underweight | Neutral | Overweight | ● Previous view

| Fixed income | View | Commentary |
|---|---|---|
| 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 (● previous view +1) | We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term. |
| Euro area inflation-linked bonds | -1 | We are underweight. We prefer the U.S. over the euro area. We see markets overestimating how persistent inflation in the euro area will be relative to the U.S. |
| Euro area govt bonds | Neutral (● previous view +1) | 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 (● previous view +1) | 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 | -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 (● previous view -2) | 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. |
| U.S. agency MBS | +1 | We are overweight. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG. |
| Global high yield | Neutral (● previous view -1) | We are neutral. Spreads are tight, but we like its 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. |
| EM hard currency | +1 | We are overweight. We prefer EM hard currency debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks cut policy rates. |
| EM 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. |

**Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.** The statements on alpha do not consider fees. 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 or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

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