Weekly commentary

November 27, 2023

BlackRock.

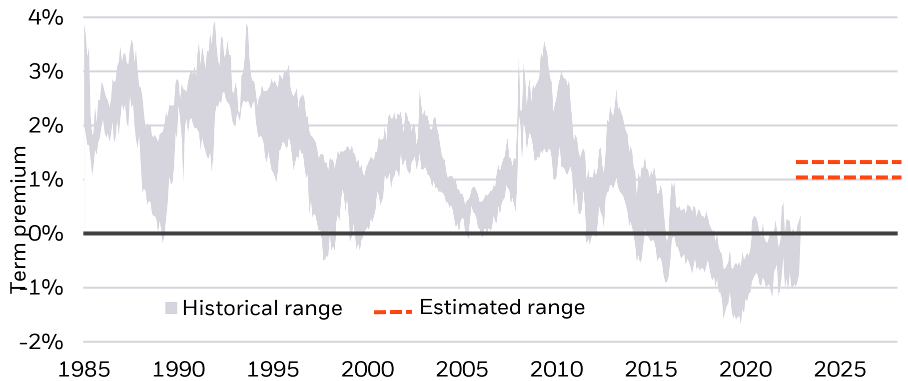
Getting granular in our strategic views

- We turn more positive on short- to medium-term developed market (DM) sovereign bonds in our latest strategic update. We trim DM stocks to neutral.
- Ten-year U.S. Treasury yields steadied after their drop from 16-year highs. We think yields will stay volatile but ultimately resume their climb in the long term.
- U.S. PCE inflation data out this week should gauge if price pressures are cooling further. We don't see inflation coming down to the Fed's 2% target long term.

We think granularity is key as government bond yields hit multi-year highs. We turn more positive on short- and medium-term DM bonds as we factor in high interest rates for longer in our strategic views of five years and over. We stay underweight long-term bonds, leaving us neutral DM bonds overall in our latest quarterly update. We like inflation-linked bonds and cut DM stocks to neutral on valuations. We remain underweight credit, preferring income in private markets.

Riskier long-term bonds

DM government bond term premium, 1985-2023



Forward-looking estimates may not come to pass. Source: BlackRock Investment Institute, November 2023. Notes: The chart shows the historical and estimated term premium ranges. The range captures three regions: U.S., Germany and UK. Term premium is defined as the compensation investors demand for the risk of holding long-term bonds. Our historical estimates of term premium are based on the Adrian, Crump and Moench (2013) "ACM" model, described in detail here: Our estimated range represents a five-year view, from 2023 through 2028.

We had been underweight DM government bonds since March 2020 as we expected yields to rise. We gradually trimmed the underweight as our view played out, increasingly preferring shorter-dated bonds. Now with yields even higher, we explicitly carve out an overweight on DM short- and medium-term government bonds. We stay underweight long-term bonds as we see room for long-term yields to climb again. Why? Investors will demand more term premium, or compensation for the risk of holding these bonds across DMs, in our view. See the chart. This is due to more uncertain and volatile inflation spurring heightened bond market volatility. We also see weaker demand for bonds amid rising debt levels. Central banks are no longer reinvesting the proceeds of maturing bonds as part of quantitative tightening, and investors are struggling to digest a flood of new bonds.

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BlackRock **Investment** Institute

The path to higher long-term yields is unlikely to be straight in the next five years. Indeed, we recently went neutral long-term Treasuries from a tactical, six-to-12-month view because we see more even odds of yields swinging in either direction. Inflation-linked bonds remain our highest-conviction overweight on the strategic horizon. Sure, inflation is falling in the near term as pandemic-era mismatches unwind, with consumer spending shifting back to services from goods. But in the long run, we see inflation well above 2% central bank policy targets. The reasons are big structural shifts constraining supply: slowing labor force growth, geopolitical fragmentation and the low-carbon transition. That's why we see central banks keeping interest rates high for longer. Our updated strategic views bake in the impact of this.

We also turn neutral DM equities, with U.S. stocks remaining our largest portfolio allocation. We had been overweight since the end of Western pandemic lockdowns due to attractive valuations. Bond and stock markets have been moving toward our view of high-for-longer rates in fits and starts, and long-term valuations for stocks now look about fair to us. This is why we have turned neutral on the broad asset class – and look for opportunities within. The new regime has created uncertainty, resulting in greater dispersion of sector and individual security returns. How to capture these potential opportunities to generate above-benchmark returns? Nimble portfolios, getting granular and investment skill are part of the answer, we think.

These changes demonstrate why we think it's important to be agile with strategic views. This new, more volatile regime means the relative attraction of different assets is shifting faster than we have been used to for a generation. Credit is a case in point. Just a year ago, we were overweight investment grade credit because spreads looked attractive versus our long-run expectations. Then spreads tightened materially, and we turned underweight as we expect them to widen in the long run. High-for-longer rates will likely eat into corporate margins and earnings, in our view, especially as companies refinance debt. We see private credit lenders benefitting from refinancing activity as banks curb lending due to high rates reshaping the financial industry. That said, private markets are complex and not suitable for all investors. And private credit is not immune to the tough economic backdrop, but we think current yields compensate investors for the risks.

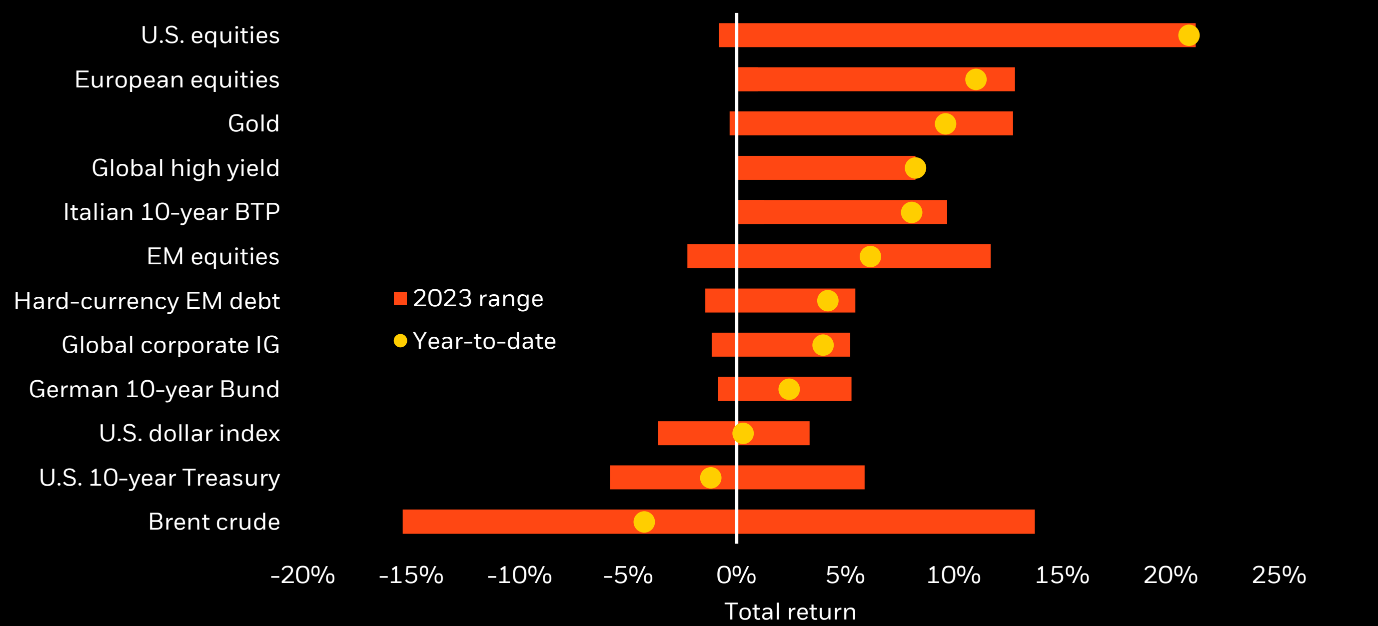
Our bottom line: High rates are a core tenet of the new regime. We carve out a strategic overweight on shorter-term DM bonds and stick to our preference for inflation-linked bonds. We go neutral DM stocks but see granular opportunities.

Market backdrop

The S&P 500 hit a four-month high, taking its gains to about 11% from the October lows on a holiday-shortened trading week. The tech-heavy Nasdaq 100 hit its highest level since January 2022. Ten-year U.S. Treasury yields inched up back toward 4.5% but are still down about 50 basis points from their October peak. We think yields will stay volatile but resume their march as investors start to demand more term premium – a key part of our view on both tactical and strategic horizons.

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 Nov. 23, 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

Inflation is falling in the euro area as the impact of last year's energy price shock fades. It goes beyond food and energy prices: Core inflation has started to fall too. Headline inflation is now less than a third of its 2022 peak annual rate. See the chart.

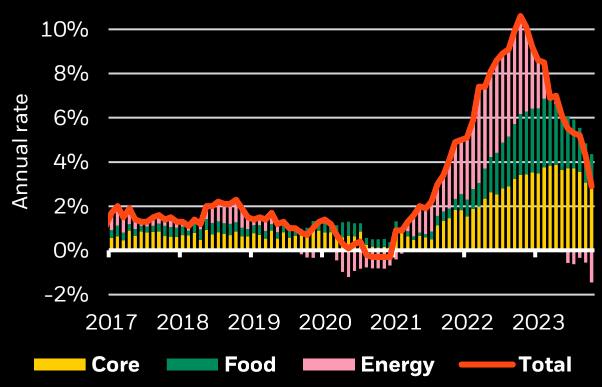
We see core inflation returning to 2% next year as economic shocks from the pandemic and the impact of last year's spike in energy prices wane further. That's lower than the European Central Bank's estimate of core inflation lingering above its 2% target even by the end of 2025. But it's taken weak growth for inflation to fall, in our view. Activity has only grown 0.1% year-on-year as the ECB's rapid rate hikes hit activity and higher energy prices squeeze incomes.

We don't think the ECB will ride to the rescue with rate cuts. Policymakers stress the need to crush demand to bring inflation down – especially as strong wage growth persists. Like other central banks, we see the ECB holding policy tight.

Read our latest Macro take post here.

Energy shock subsides

Euro area inflation, 2019-2023



Source: BlackRock Investment Institute, Eurostat, with data from Haver Analytics, November 2023. Notes: The chart shows the annual rate of total inflation and the contribution to total inflation from core, food and energy prices.

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, 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, demographic divergence 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

Nov. 29	Germany CPI	**Dec. 1**	U.S. ISM manufacturing PMI
Nov. 30	U.S. PCE; euro area flash CPI and unemployment		

We are monitoring U.S. PCE inflation data – the Fed's preferred measure of inflation – due this week to gauge if inflation is on track to fall to 2%. We think U.S. inflation will near the Fed's 2% policy target in the second half of 2024 but will not stay there long term. We think euro area inflation will also head back to target next year as economic activity stagnates.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 2023

Underweight **Neutral** **Overweight** ● Previous view

	Asset	Strategic	Tactical	Commentary
Equities	Developed	Neutral	-1	We are neutral equities in our strategic views as high-for-longer interest rates lead us to re-evaluate our estimate for stock valuations from here. 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	Neutral	Neutral	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. Strategically, we carve out an overweight for short- and medium-term bonds as yields have surged. We stay underweight U.S. and euro area long-dated bonds as we expect investors to demand more compensation for the risk of holding them. We are strategically neutral on government bonds overall. Tactically, we're neutral long-term Treasuries as the yield surge driven by expected policy rates approaches a peak. We're overweight euro area and UK bonds as we see more rate cuts than the market does.
	Inflation-linked	+2	Neutral	We are strategically 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	-2	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, November 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	Neutral	We are neutral. The yield surge driven by expected policy rates is approaching a peak. We now see about equal odds that long-term yields swing in either direction.
	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 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	+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	-2	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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