Weekly commentary

BlackRock.

August 7, 2023

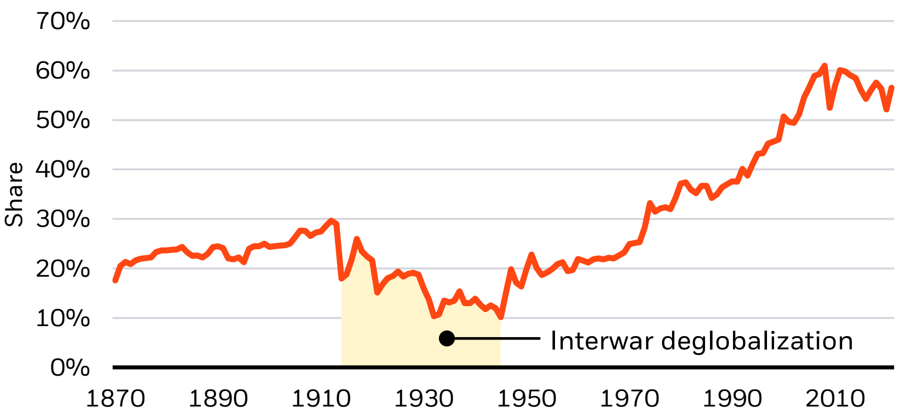
Opportunities in globalization rewiring

- We see emerging markets better withstanding volatility and benefiting as supply chains rewire. We switch our EM debt preference to hard currency from local.
- Developed market stocks slid last week and long-term bond yields jumped as markets focused on U.S. fiscal challenges. We see long-term yields rising more.
- All eyes are on U.S. inflation this week after softer-than-expected data in the last CPI print. We see persistent wage pressure keeping core inflation sticky.

Last week's bond yield jump and stock tumble underscore we're in a new regime of greater volatility. A renewed focus on U.S. fiscal challenges and surprise policy tightening in Japan have stirred up volatility in developed markets (DM). We think emerging market (EM) assets have an edge as their central banks cut rates and some benefit from rewiring supply chains. What's in the price is key. We rotate our EM bond preference to favor hard currency and stay granular in EM stocks.

Globalization rewired

World trade as a share of GDP, 1870-2021



Source: BlackRock Investment Institute, Klasing and Milionis (2014), Penn World tables, World Bank, August 2023. Notes: The chart shows the sum of world exports plus imports, divided by world GDP. The yellow shaded area highlights the period between the first and second world wars when trade integration fell materially.

Trade activity between nations dipped between World War One and World War Two (yellow shaded area in chart) before surging in the decades after World War Two as globalization took shape. Yet trade as a share of global GDP has plateaued (orange line) since the 2008 global financial crisis – one sign that globalization is under pressure. We see a world of fragmentation ahead: Competing defense and economic blocs are emerging. Multi-aligned nations are set to grow in power and influence, and we expect many major EMs to fall into this camp. As global fragmentation plays out, countries and companies are increasingly prioritizing security and resiliency – through industrial subsidies, export controls and other tools – over maximum efficiency. We see this shift in priorities accelerating the rewiring of supply chains as nations aim to bring production closer to home. All this favors selected EMs, in our view.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Against that structural backdrop, we also favor broad EM exposures over DMs in the short term. DMs are experiencing bouts of volatility and we see risk of more. The Fitch Ratings downgrade of the U.S. credit rating last week and the U.S. Treasury's sizable borrowing needs put a spotlight on the challenging U.S. fiscal outlook. We think EMs are relatively better positioned to withstand some of this volatility. That's partly due to EM central banks nearing the end of their rate hiking cycles. Some have started to cut policy rates, like in Chile and Brazil. Yet they're not immune from a sharp hit to risks assets, in our view.

We put our new playbook in action again by gauging what's in the price. We flip our overweight to EM local currency debt to neutral and turn overweight EM hard currency debt on a six- to 12-month tactical horizon. We had been overweight EM local currency debt since March on attractive yields from EM central banks nearing the end of their hiking cycles and a broadly weaker U.S. dollar. We began to reassess our view on local currency in July: Yields have fallen closer to U.S. Treasury yields. Rate cuts seem largely priced in and could put downward pressure on EM currencies, dragging on local currency returns.

EM hard currency debt – issued in U.S. dollars and thus cushioning returns from any local currency weakness – looks more attractive. Hard currency debt is more diversified than local currency, based on J.P. Morgan indexes, and it could benefit from the rewiring of globalization. We also think lower credit ratings in EM hard currency debt are priced in given that yields are at a near 14-year high versus local currency bond yields, Refinitiv data show.

We prefer EM bonds and stocks as we see a rewiring of supply chains benefiting select countries that offer valuable commodities and supply chain inputs. That includes oil from the Gulf states; India's chemicals and industrial manufacturing; South Korea's battery and memory supply chain businesses; Indonesia's nickel and cobalt; and Chile's lithium. Some, like Mexico, could benefit from U.S. and other DM efforts to reshore production closer to home. That push includes the making of semiconductors – the technology powering artificial intelligence (AI) and a key part of major EM tech sectors. Yet as an investment opportunity, the AI mega force may be bigger within DM, supporting revenues and margins across sectors.

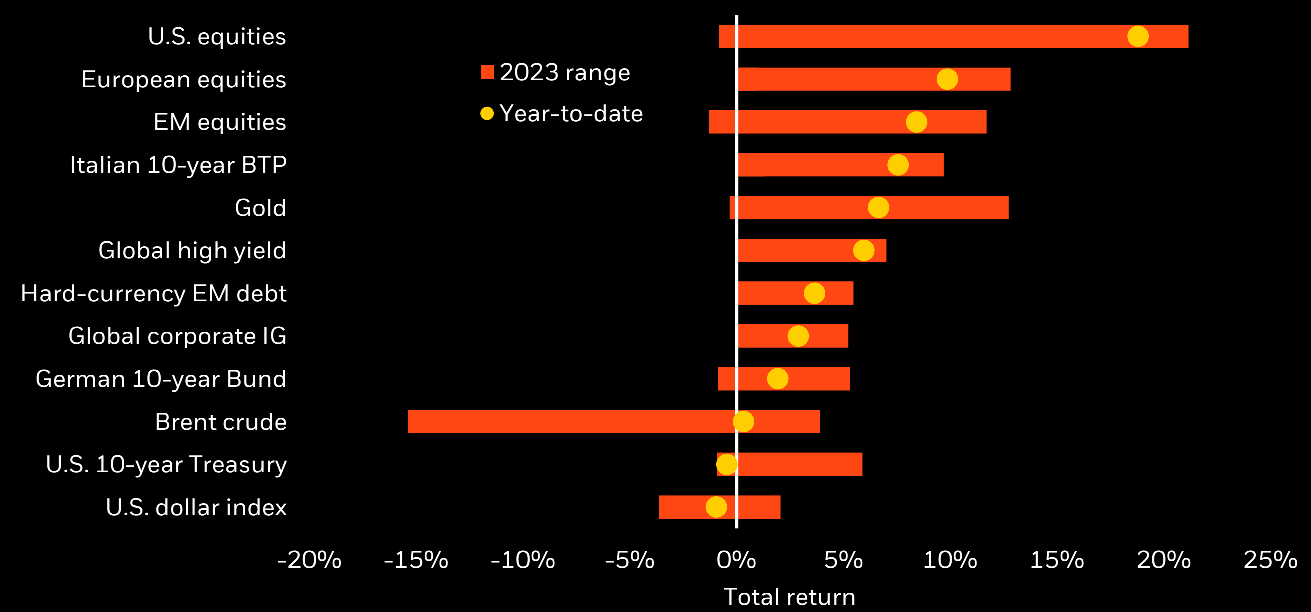
Bottom line: We are in a new regime of greater volatility – and we see EMs better positioned to withstand it, for now. We harness mega forces to find opportunities based on what's in the price. We stay overweight EM debt overall but switch our preference to hard currency on its high yields. We like EMs that may benefit from rewiring globalization.

Market backdrop

Developed market stocks retreated and long-term government bond yields rose, with the U.S. 10-year Treasury yield jumping above 4% to near 15-year highs reached last year. We think the U.S. rating downgrade helped put a spotlight on the fiscal challenges it faces. Along with greater U.S. Treasury bond issuance, that could prompt investors to demand more term premium, or compensation for the risk of holding long-term government bonds – and push long-term yields even higher.

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 Aug. 3, 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

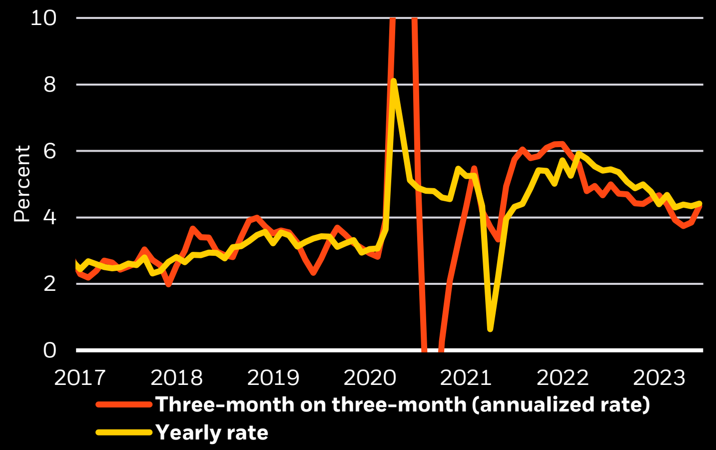
Last week's U.S. jobs report for July clearly shows wage pressures aren't abating just yet despite recent data raising hopes of U.S. inflation falling durably back to the Federal Reserve's 2% target.

Growth in average hourly earnings – a key gauge of wage trends – is still elevated at a 4.7% annualized pace over the three months through July. See the chart. Even though employment growth is slowing, the labor market is set to tighten at this level of job growth. The labor force participation rate remains stuck for the fifth month in a row and the unemployment rate ticked down near five-decade lows to 3.5%. That's the labor supply shock at work.

As the U.S. population ages, workers retire and labor supply gets squeezed, we don't think this level of employment growth is slow enough to help ease pressures on wage growth to a level consistent with 2% inflation. That's even with the seemingly positive news from the second quarter labor cost data. We see the Fed keeping rates high as a result. See our Macro take blog posts here.

Still stubbornly high

U.S. average hourly earnings growth rates, 2017-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, Haver Analytics, August 2023. Notes: The chart shows U.S. private sector average hourly earnings growth. The yellow line shows the annual inflation rate, and the orange line shows the three-month growth over the preceding three months, expressed as an annualized 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

Aug. 8	China trade data	**Aug. 10 – 17**	China total social financing; U.S. July CPI (Aug. 10)
Aug. 9	China CPI, PPI	**Aug. 11**	UK GDP; U.S. PPI, Michigan consumer sentiment survey

We're watching July U.S. CPI inflation this week after softer-than-expected data in June. We expected the normalization in consumer spending to lead to a decline in goods prices. The key for us: persistent service price pressures from wage growth in a tight labor market. Payrolls data last Friday confirmed that tightness, with unemployment still near historical lows.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, August 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.
Equities	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.
Developed market government bonds	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.
Public credit and emerging market debt	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.
Public credit and emerging market debt	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.
Private markets	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, August 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	Neutral	We are neutral. Bank of Japan policy is still easy, shareholder-friendly reforms are taking root and negative real rates support 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.
	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	+1	We are overweight. We see brighter relative growth trends in EM over DM, valuations remain appealing and EM rates cycles are nearing peaks.
	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.
	Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand greater term premium.
	U.S. inflation-linked bonds	+1	We are overweight and prefer the U.S. over the euro area. We see market pricing underestimating sticky inflation.
	Euro area inflation-linked bonds	-1	We prefer the U.S. over the euro area. Markets are pricing higher inflation than in the U.S., even as the European Central Bank is set to hold policy tight, in our view.
	Euro area govt bonds	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.
	UK gilts	Neutral	We are neutral. We find gilt yields better reflect our expectations for the macro outlook and Bank of England policy.
	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	Neutral	We are neutral on tighter credit and financial conditions. We prefer Europe's more attractive valuations over the U.S.
	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 (● previous view: Neutral)	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 (● previous view: +1)	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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