Weekly commentary

October 2, 2023

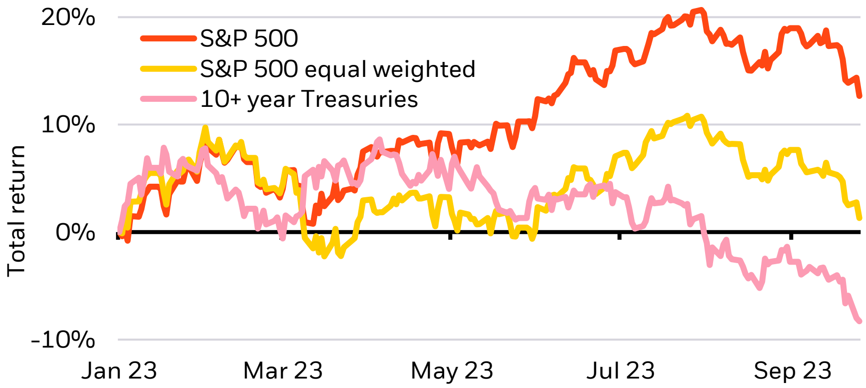
Finding new opportunities as Q4 starts

- Markets are adjusting to the new, more volatile regime. We see opportunities in the UK and euro area bond repricing, and still prefer Japanese equities.
- U.S. stocks dipped last week, and 10-year Treasury yields fell sharply from the week's highs. A further drop in goods prices helped cool August PCE inflation.
- A U.S. government shutdown has been averted for now. Yet the risk of one highlights ongoing U.S. fiscal challenges.

Markets are adjusting to the new regime of greater volatility and higher interest rates. This is starting to create some opportunities, in our view. Yields in long-term government bonds have surged, making European bonds look more attractive to us. Yet broad developed market (DM) equities still don't fully reflect the new rate environment or unfriendly macro backdrop, even with their retreat. We stay selective in stocks, still preferring Japan and mega forces like artificial intelligence.

Adjusting to new regime

Total return for U.S. stocks and long-term Treasuries, Jan.-Sept. 2023



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.. Source: BlackRock Investment Institute, with data from LSEG Datastream, September 2023. Notes: The chart shows total returns for the S&P 500, S&P 500 equal-weighted index and Bloomberg U.S. Government 10 year+ index.

Ten-year U.S. Treasury yields have jumped to 16-year highs and long-term Treasury returns have slid (pink line in chart). The sharp rise in yields since the summer sparked a pullback in equities – with the equal-weighted S&P 500 (yellow line) that adjusts for the outsized impact of mega-cap companies erasing almost all its year-to-date gains. The rise in yields so far has largely been about markets realizing that central banks are poised to keep rates higher for longer, in our view. This adjustment to higher yields is bad for fixed income returns. But not all yield rises are created equal. The repricing of expected policy rates has largely played out, yet the compensation investors demand for the risk of holding long-term bonds – or term premium – has only risen a fraction of the amount we expect. We expect an increase in term premium to drive the next leg of higher yields. That is bad for bonds but not necessarily bad news for equities.

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Concerns over U.S. debt levels and large Treasury issuance have prompted investors to demand more compensation for the risk of holding long-term bonds, driving long-term yields higher. We expect a further rise in such term premium and long-term yields due to those factors, plus persistent inflation and higher-for-longer rates. With long-term yields at multi-year-highs, bonds offer more income. Yet a march higher in yields can wipe that out: A roughly 0.5 percentage point rise in yields could drag on valuations enough to erase a full year of income for a 10-year duration bond. And such moves can happen quickly in this new macro regime. We stay underweight long-term bonds in our tactical and strategic views in Q4. The threat of a U.S. government shutdown – if pushed back for now – also highlights the long-term fiscal challenges the U.S. faces. If Congress eventually fails to provide funding for the new fiscal year, we expect a limited macro and market impact – similar to past shutdowns – because only a small part of the economy is directly impacted.

The difficult macro environment keeps us underweight the broad U.S. equity market on a tactical horizon of six to 12 months: Stocks don't fully reflect higher-for-longer rates and the ongoing activity stagnation we expect. With the Q3 earnings season starting soon, analysts now see a mild contraction in broader Q3 earnings after having eyed growth earlier in the year, LSEG data show. We are getting closer to turning more positive on stocks given the recent retreat – but we're not quite there yet.

As markets play catch up with the new regime and its implications, we take advantage of relative disconnects in market pricing and find new opportunities based on what's in the price. We recently went overweight long-term euro area government bonds and UK gilts on higher yields and our view policy rates will be cut more than the market is pricing. Higher yields also underpin our overweights to short-term Treasuries and EM hard currency debt – generally issued in U.S. dollars.

We center our outlook on mega forces, or structural forces that can drive returns now and in the future. We get granular within asset classes to find sectors and regions that can thrive even as growth broadly stagnates in coming quarters. We went overweight Japanese stocks last month on the potential for earnings to beat expectations and ongoing shareholder-friendly reforms. We're also neutral on UK and EM stocks. Our overweight to the digital disruption and artificial intelligence (AI) mega force in DM stocks taps into markets favoring companies generating ample profits over any hit from higher-for-longer rates.

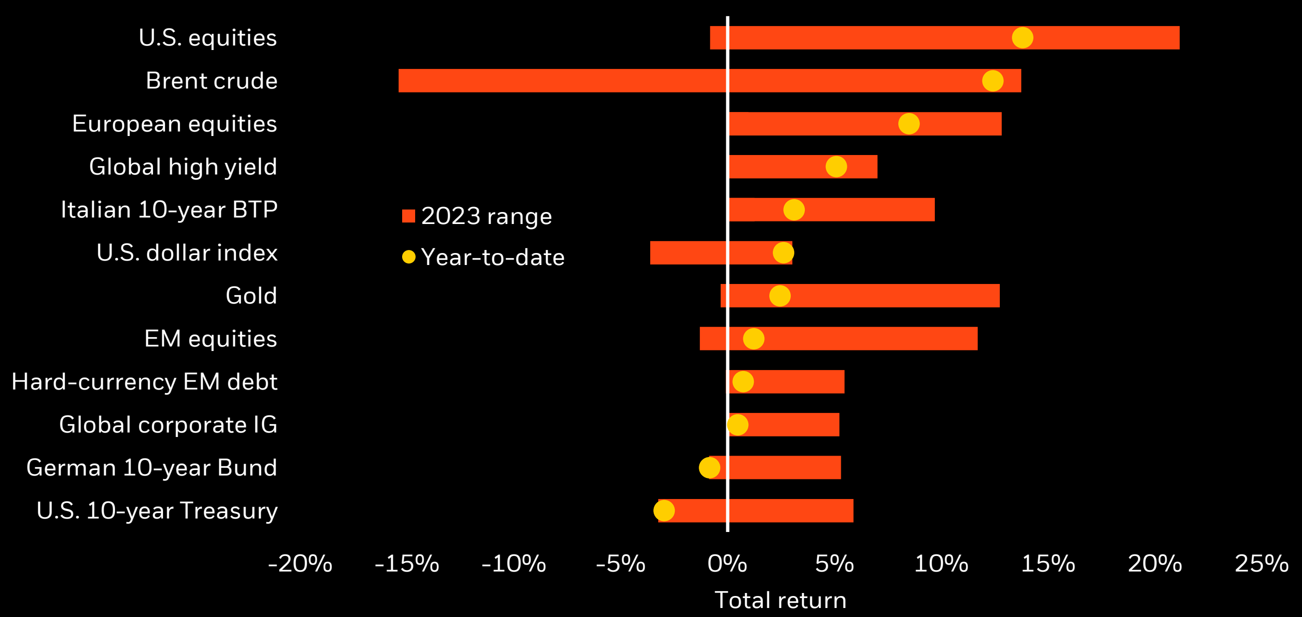
Bottom line: We find new opportunities in Q4 via pricing disconnects and mega forces. Read our updated global outlook.

Market backdrop

U.S. stocks dipped last week, while the 10-year U.S. Treasury hit a 16-year high of 4.69% before retreating sharply on Friday. Euro area bond yields hit multi-year highs last week as markets priced in policy rates staying higher for longer, with fewer rate cuts. And Italian government bond spreads widened on a wider-than-expected government budget deficit forecast. Meanwhile, U.S. core PCE inflation rose less than expected in August as goods prices extended their drop.

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 Sept. 28, 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

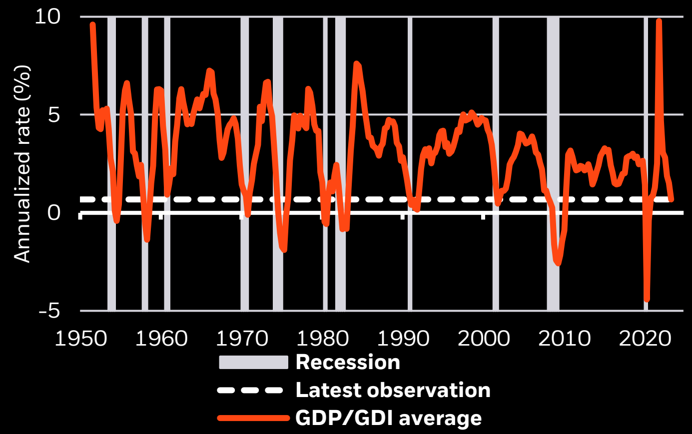
U.S. gross domestic income (GDI) – which adds up incomes and profits of households and firms – for Q2 was revised up last week, as expected. But it hardly changes the big picture: On such broad measures of activity, the economy has basically flatlined since the end of 2021. In fact, activity hasn't been this weak over six quarters outside a recession. See the chart.

Revisions to GDP show consumption – the main pillar of recent growth – looks much weaker. The contribution of services spending to Q2 GDP growth was cut in half. Consumer spending is coming under pressure as pandemic savings dry up and lending conditions tighten. Instead, it seems growth is being propped up by non-residential investment – which is historically sensitive to interest rates. We think the full impact of the Federal Reserve's rate hikes could eventually slow investment.

The bottom line: Inflation is falling but that's come with stealth stagnation in the economy. Read more in our latest Macro take blog post here.

Weak without recession

Six-quarter growth in U.S. activity, 1950-2023



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, September 2023. Notes: The chart shows total annualized growth in U.S. activity over a rolling six-quarter window. The measure of activity is the average of gross domestic product and gross domestic income. Gray shaded bands denote U.S. recessions as defined by the National Bureau of Economic Research (NBER).

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 well 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, 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

Oct. 2	U.S. ISM manufacturing PMI; euro area unemployment	**Oct. 6**	U.S. payrolls report
Oct. 4	U.S. ISM services PMI		

With a U.S. government shutdown avoided for now, U.S. payrolls data for September is in focus this week. Pandemic-era mismatches in supply are unwinding – helping to cool inflation. Yet we think a shrinking workforce as the population ages means the economy will only be able to sustain a fraction of recent job growth to avoid resurgent inflationary pressures.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, October 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 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	-1	-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 U.S. 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 overweight on euro area and UK bonds as we think more rate cuts are coming than the market expects.
	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	-1	-1	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, October 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	-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	+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	-1	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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