Weekly commentary

March 4, 2024

BlackRock

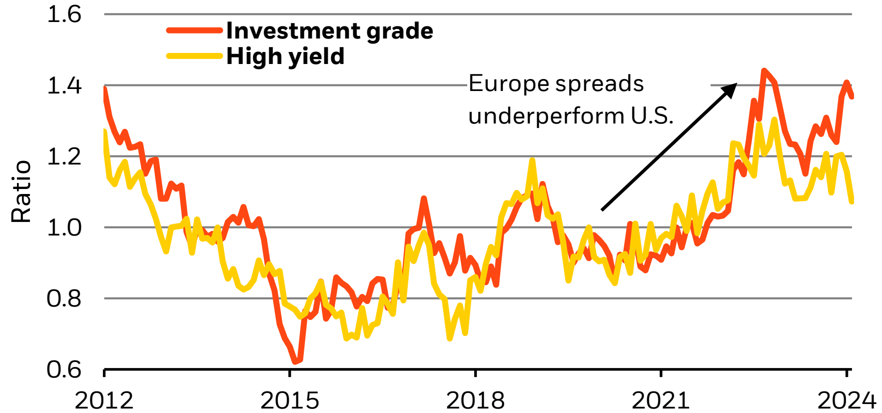
Taking selective risk in credit

- We get granular as the environment for risk-taking is supportive for now. That's why we like euro area high yield credit, emerging market debt and U.S. stocks.
- U.S. stocks soared to record highs again last week. Ten-year U.S. Treasury yields were largely unchanged but slightly below their 2024 highs.
- We're watching January U.S. payroll data out this week. A strong reading could confirm that still-high wage growth will stoke inflation, as we expect.

Getting granular and being nimble to seize opportunities in the new regime are key lessons guiding us. We heed that lesson as inflation falls and the Federal Reserve readies interest rate cuts. This more supportive backdrop for risk-taking anchors why we're overweight euro area high yield credit, dollar-denominated emerging market debt and U.S. stocks. We had preferred investment grade credit but now eye fixed income where spreads haven't tightened as much. We still like private credit.

Relatively attractive

Spreads of European credit relative to U.S. counterparts, 2012-2024



Source: BlackRock Investment Institute, with data from LSEG Refinitiv, March 2024. Notes: The chart shows the spreads for European credit relative to U.S. credit as a ratio. The orange line shows European investment grade (IG) relative to U.S. IG. The yellow line shows European high yield (HY) relative to U.S. HY. The black arrow represents a rising ratio, which means that European credit spreads are underperforming relative to U.S. spreads.

Even as sovereign bond yields were volatile over the past year, the spread between them and credit yields has tightened steadily. We cut global investment grade (IG) credit to underweight on a tactical, six- to 12-month horizon last September after preferring it over stocks and high yield since mid-2022. That change funds risk-taking in pockets of credit where the risks seem better compensated for. We favor high yield and stay neutral: Its yield is attractive and returns are less sensitive to interest-rate swings. Regional differences underpin why we prefer European credit overall. U.S. IG and high yield credit spreads are further below their 10-year average than European peers. See the chart. European spreads have underperformed since 2020 partly due to a different sector composition and weaker growth in Europe, in our view. Yet we think the excess yield in European credit compensates for the risks.

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We see markets embracing a more supportive near-term macro outlook. In the U.S., we expect inflation to fall near the Fed's 2% target this year before resurging beyond 2024. We went overweight U.S. stocks this year because we think the upbeat risk appetite can persist and broaden out beyond artificial intelligence, until resurgent inflation comes into view later this year. Robust U.S. growth, nearing Fed rate cuts and falling inflation have lessened the market's recession worries. That's good news for emerging market (EM) assets, in our view. We're overweight EM hard currency debt – mostly denominated in U.S. dollars – as spreads look more fairly valued than U.S. high yield. We see broader credit spreads staying tight for now given the supportive risk-taking backdrop, and strong demand for new issuance of U.S. IG and U.S. high yield credit bonds.

Yet we see a risk that could cause high yield spreads to widen as markets price in more credit risk. About 10% of the market value of euro area high yield debt is maturing in 2025, 6% of U.S. high yield debt – and even more the next year, BlackRock Aladdin data show. We find that's not an exorbitant amount, and even the lowest-rated high yield issuers have been able to refinance debt this year. Still, refinancing at higher interest rates may challenge operating models that assumed rates would stay low, in our view. IG companies also have debt maturing, but we think their stronger balance sheets are more flexible.

A year after a few U.S. regional banks collapsed, we have seen the funding challenges higher interest rates create. We're monitoring the impact of higher rates and maturing debt on commercial real estate. The sector will likely face more pain, but we think it will be manageable as the reset to lower valuations occurs over multiple years. We see a more supportive near-term macro backdrop. Firms that need to refinance may turn to private credit as banks cut back on lending. We prefer private market credit over public on a strategic horizon of five years and longer because we think demand will rise and higher yields better compensate for risk. Yet private markets are complex, with high risk and volatility, and aren't suitable for all investors.

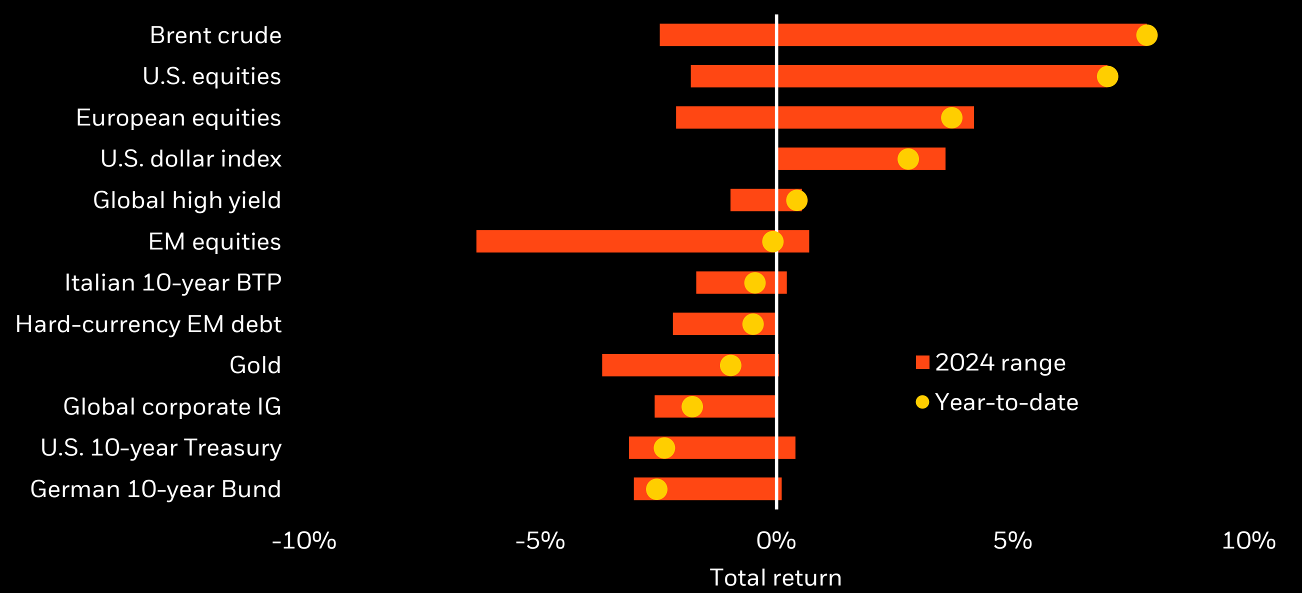
Bottom line: We get granular as the near-term macro outlook improves the environment for risk-taking. We're overweight U.S. stocks, euro area high yield and EM hard currency debt. We also see opportunities in private credit as public debt matures.

Market backdrop

The S&P 500 and Nasdaq keep marching higher, with both indexes hitting new all-time highs last week. U.S. Treasury yields retreated even as markets priced out more Fed rate cuts given resilient growth and sticky inflation – and now see just three quarter-point cuts this year. We still see inflation on a rollercoaster that the market could wake up to later in the year. The U.S. PCE inflation data confirmed that inflation will likely settle closer to 3% after falling toward the Fed's 2% target this year.

Assets in review

Selected asset performance, 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 Feb. 29, 2024. Notes: The two ends of the bars show the lowest and highest returns at any point year to date, 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.

Week ahead

March 5	Japan CPI; China Caixin services PMI	**March 8**	U.S. payroll data
March 7	ECB policy decision; U.S., China trade data	**March 9**	China CPI, PPI

U.S. payroll data for January is in focus this week. A strong reading could confirm that elevated wage growth will push up on services inflation – and overall inflation once the drop in goods prices has run its course. Structurally slower labor force growth due to an aging population is a key long-term production constraint we think the U.S. will face. Elsewhere, we expect the European Central Bank (ECB) to hold rates tight at its policy meeting.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, March 2024

Tactical	Reasons
U.S. equities	• Our macro view has us neutral at the benchmark level. But the AI theme and its potential to generate alpha – or above-benchmark returns – push us to be overweight overall.
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 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 on a strategic horizon.
Short- and medium-term bonds	• We overall prefer short-term bonds over long term. That's due to more uncertain and volatile inflation, heightened bond market volatility and weaker investor demand.

Note: Views are from a U.S. dollar perspective, March 2024. 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.

Tracking five mega forces

Mega forces are big, structural changes that affect investing now – and far in the future. As key drivers of the new regime of greater macroeconomic and market volatility, they change the long-term growth and inflation outlook and are poised to create big shifts in profitability across economies and sectors. This creates major opportunities – and risks – for investors. See our web hub for our research and related content on each mega force.

1. **Demographic divergence:** The world is split between aging advanced economies and younger emerging markets – with different implications.
2. **Digital disruption and artificial intelligence (AI):** Technologies that are transforming how we live and work.
3. **Geopolitical fragmentation and economic competition:** Globalization is being rewired as the world splits into competing blocs.
4. **Future of finance:** A fast-evolving financial architecture is changing how households and companies use cash, borrow, transact and seek returns.
5. **Transition to a low-carbon economy:** The transition is set to spur a massive capital reallocation as energy systems are rewired.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, March 2024

Our approach is to first determine asset allocations based on our macro outlook – and what's in the price. **The table below reflects this and, importantly, 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 is creating more space for alpha**.**

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

	Asset	View	Commentary
Equities	**Developed markets**		
Equities	United States – Benchmark	Neutral	We are neutral in our largest portfolio allocation. Falling inflation and coming Fed rate cuts can underpin the rally's momentum. We are ready to pivot once the market narrative shifts.
Equities	United States – Overall	+1	We are overweight overall when incorporating our U.S.-centric positive view on artificial intelligence (AI). We think AI beneficiaries can still gain while earnings growth looks robust.
Equities	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.
Equities	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.
Equities	Japan	+1	We are overweight. We see stronger growth helping earnings top expectations. Stock buybacks and other shareholder-friendly actions are positives. Policy tightening is a near-term risk.
Equities	**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.
Equities	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.
Fixed Income	Short U.S. Treasuries	+1	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer
Fixed Income	Long U.S. Treasuries	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.
Fixed Income	U.S. inflation-linked bonds	Neutral	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
Fixed Income	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.
Fixed Income	Euro area govt bonds	Neutral	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.
Fixed Income	UK gilts	Neutral	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.
Fixed Income	Japanese govt bonds	-1	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
Fixed Income	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
Fixed Income	U.S. agency MBS	Neutral	We are neutral. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG.
Fixed Income	Global IG credit	-1	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.
Fixed Income	Global high yield	Neutral	We are neutral. Spreads are tight, but we like its high total yield and potential near-term rallies. We prefer Europe.
Fixed Income	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
Fixed Income	Emerging hard currency	+1	We are overweight. We prefer EM hard currency debt due to its relative value and quality. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
Fixed Income	Emerging 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.

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