Weekly commentary

BlackRock

November 20, 2023

Volatility a key feature of new regime

- We see volatility as a constant in the new regime. We're neutral long-term U.S. Treasuries because risks are more balanced after three years of rising yields.
- Stocks and bonds rallied last week on milder-than-expected U.S. inflation data. We see the U.S. economy on a weak growth path, with policy rates staying high.
- Global PMI data this week will likely confirm that higher interest rates are causing business activity to stagnate. We don't expect rate cuts this year.

The plunge in long-term U.S. Treasury yields last week on news of slowing U.S. inflation shows volatility is persistent in the new regime of greater macro uncertainty. Compounding this is a disconnect between the latest cyclical market narrative of a strong expansion – and the reality we have just climbed out of a deep economic hole caused by the pandemic. This disconnect risks obscuring the new regime's opportunities – a key conclusion of our 2024 Outlook Forum last week.

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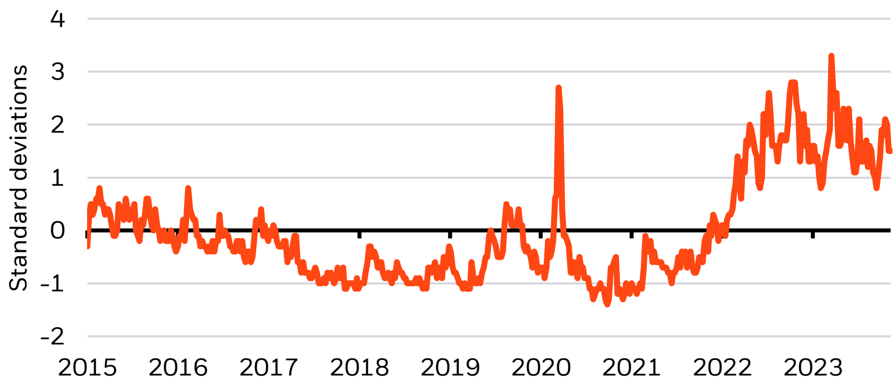
Yield swings

U.S. government bond volatility, 2015-2023



Source: BlackRock Investment Institute, with data from LSEG Datastream, November 2023. Notes: The chart shows volatility in U.S. Treasuries based on the MOVE index. The series is shown in standard deviations from average during the period shown.

Stocks rallied, and yields on 10-year U.S. Treasuries tumbled 19 basis points last week – the biggest one-day move since the March U.S. banking turmoil. The drop came after news of a slower-than-expected pace of inflation. This is keeping bond volatility at much higher levels than before the pandemic, as the chart shows. The current market narrative: Inflation is falling while growth is holding up. We agree with the first part – for now. We see core inflation hitting the Fed's 2% target in the second half of 2024. The problem: Inflation is falling because rapid rate rises to combat it have pushed U.S. growth trend below pre-Covid levels. We think more of the same is needed to keep inflation down as price pressures resume amid slowing labor force growth and geopolitical shocks. Markets appear to miss this bigger picture, and we see more volatility ahead as they swing between hopes for a "soft landing" and fears about higher rates and recession.

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BlackRock **Investment** Institute

We upgraded long-term Treasuries to neutral on a tactical, six-to-12-month horizon last month because we now see even odds of yields swinging in either direction in this volatile environment. That's in part because the Fed seems to be at the end of its rate hike cycle. Yet looser fiscal policy and slowing labor force growth will likely force the Fed to keep rates high for longer. Long-term yields should eventually resume their march higher. Why? We expect the term premium, or the compensation investors demand for the risk of holding long-term bonds, to keep rising amid greater macro volatility, large fiscal deficits and high debt issuance.

Indeed, U.S. fiscal challenges have already contributed to volatility, and we see that playing out further. The U.S. government ramped up spending to restart the economy from pandemic lockdowns and launched other stimulus such as the Inflation Reduction Act. Bond issuance ballooned as a result. Higher interest rates are feeding into this cycle by raising government borrowing costs and adding to the debt burden. If borrowing costs stay near 5% as we expect, the U.S. government is poised to spend more on interest payments than on Medicare in a few years time. Investors are struggling to absorb the bond supply. Their indigestion spurred another surge in bond yields earlier this month after an auction for 30-year Treasuries saw historically weak demand.

Higher rates and volatility took center stage at our semi-annual Investment Outlook Forum held last week in New York. Some 100 BlackRock portfolio managers, executives and experts spent two days pinpointing investment opportunities and risks. Adapting portfolios to higher interest rates and mega forces – structural shifts such as geopolitical fragmentation and demographic divergence – were top of mind. Participants debated how to go beyond the obvious beneficiaries of mega forces, and highlighted granular opportunities within sectors and countries such as Japan. There was consensus that the new regime calls for selective and dynamic investment strategies, rather than static and broad exposures. And many saw wider dispersion of security returns – a feature of the new regime – and greater volatility opening opportunities to generate above-benchmark returns. Look for the details in our 2024 Global Outlook slated to come out in early December.

Our bottom line: Volatility is a constant in the new regime, with markets quick to extrapolate single data releases. We believe the Fed is ending its hiking cycle – and is set to keep rates high for longer. This underpins why we have turned neutral long-term Treasuries and are overweight short-term Treasuries and European government bonds for income.

Market backdrop

U.S. stocks jumped about 2% last week, and 10-year U.S. Treasury yields slid sharply after the U.S. CPI data showed inflation slowing more than expected. Long-term U.S. yields have swung sharply – a reflection of the volatile new regime – after reaching 16-year highs last month as markets hope for sharp Fed rate cuts next year. We don't think that is likely and see the Fed only starting to trim rates in the second half of 2024. See more in the *Macro take* on the next page.

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. 16, 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

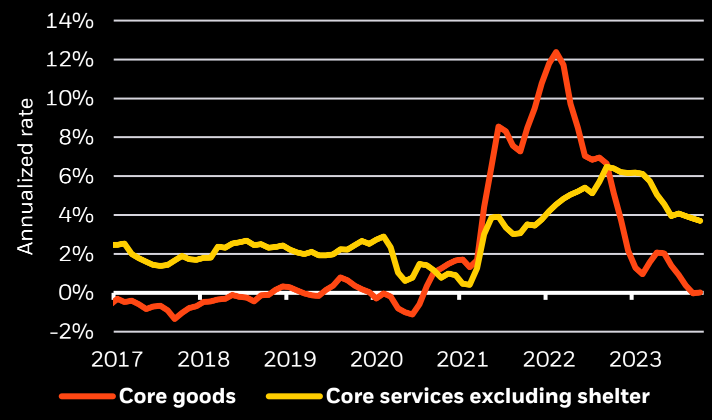
U.S. inflation has cooled further. The October CPI data showed core inflation – excluding food and energy – falling to 4%, well down from the peak of 6.6% reached in 2022.

The U.S. economy has made major progress recovering from massive pandemic shocks that caused such a historic shift in spending, and that's why inflation is falling. Consumers are spending more on services again after mostly buying goods during the pandemic. Mismatches in the labor market are also easing. The ongoing unwind of both shocks should help drag down goods and services inflation further, in our view. See the chart.

Falling inflation is good news. But it's still running at a pace too high for the Federal Reserve's comfort, so we don't see it cutting rates any time soon. Fed officials have stressed rates need to stay high, pushing back against suggestions of rate cuts early next year. We think rate cuts will come later - not before mid-2024 - as the Fed will want to see more progress of core inflation falling towards its 2% policy target. Read our latest Macro take post here.

Inflation in retreat

U.S. core goods and services CPI inflation, 2017-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, November 2023. Notes: The chart shows core goods and services inflation measured by the change in the most recent three-month average over the preceding three-months, at an annualized rate. Core goods inflation covers all goods excluding energy and food costs. Core services inflation covers all services excluding energy and shelter costs.

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. 23	Euro area, UK flash PMI
Nov. 24	U.S. flash PMI; Japan flash PMI, CPI

Global manufacturing and services PMI data out this week will likely confirm that higher interest rates are causing global production and business activity to stagnate. We think most developed market central banks will keep policy rates high for longer to lean against inflationary pressures – even as activity slows.

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	+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	Neutral	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. We stay strategically underweight U.S. nominal long-dated government bonds as we expect investors to demand more compensation for the risk of holding them. 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	+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	-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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