Weekly commentary

September 5, 2023

BlackRock

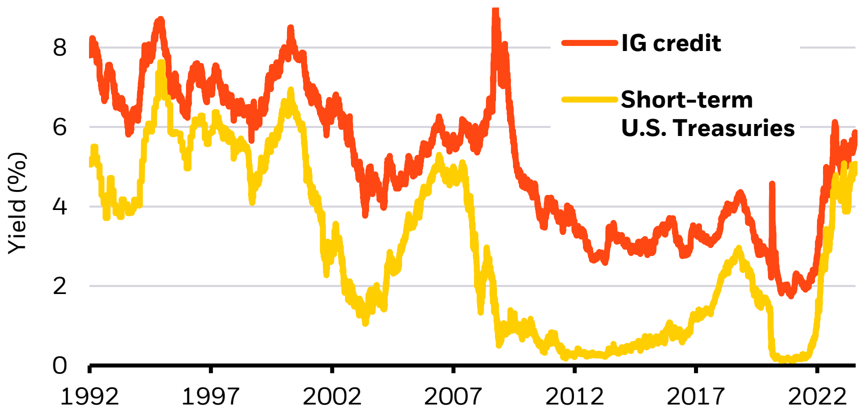
Favoring short-term bonds long term

- We up short-term sovereign bonds on attractive yields and downgrade credit in the long run. We stay cautious on long-term bonds even with the surge in yields.
- U.S. stocks recovered last week as 10-year yields slid from 16-year highs. Jobs data showed a normalizing labor market. We see demographics starting to bite.
- China data this week will help gauge fading economic momentum. We see weak consumer and export demand leading to growth below the pre-Covid trend.

Sovereign bond yields have surged this year, with U.S. long-term yields hitting 16-year highs last month. We prefer short-term government bonds over credit. We go underweight high quality credit on a strategic view of five years and longer and trim our overall underweight to sovereign bonds. We still see investors demanding more compensation for holding long-term bonds given higher inflation, greater macro volatility and rising debt levels. We also like inflation-linked bonds.

Closing the gap

Yields on U.S. investment grade (IG) credit and short-term Treasuries, 1992-2023



Source: BlackRock Investment Institute, with data from LSEG Datastream, September 2023. Notes: The chart shows the yields for U.S. investment grade credit (using the Bloomberg U.S. Credit USD index) and short-term U.S. Treasuries (Bloomberg U.S. Treasury 1-3 Year USD index).

We believe the new regime of greater macro volatility calls for more nimble and dynamic strategic views. Short-term government bond yields have risen alongside long-term yields due to rapid central bank rate hikes. That move has pushed short-term U.S. Treasury yields (yellow line in the chart) near high quality credit yields (orange line), making short-term bond income comparable. We trim our overall underweight to developed market (DM) nominal government bonds to lean into short-term paper and reduce investment grade (IG) credit to underweight from neutral. We think high quality credit offers limited compensation for any potential hit to returns from wider spreads and sensitivity to interest rate swings. We prefer higher yields in private credit and see alternative lenders filling a corporate financing gap as banks curb lending.

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Mega forces – structural shifts that can drive returns now and in the future – reinforce why we're in a new regime of greater macro and market volatility, in our view. Aging DM populations could add to inflation as workforces shrink, keeping labor markets tight and wage growth high. And the rate of growth the economy will be able to sustain without stoking inflation will likely be lower than in the past. Aging also tends to come with elevated levels of government debt. We see the low carbon transition, another mega force we track, driving up energy costs over the next decade. A related capital spending surge and additional government spending will likely boost economic activity and bolster inflationary pressures. These and other mega forces underpin why we see central banks having a tightening bias to try to keep inflation near their policy targets.

We went very underweight nominal government bonds in 2020 – but have trimmed that underweight at times when markets moved in line with our view. We trim it again but are not ready to turn positive on long-term bonds, even with the yield rise. That's because term premium, or the compensation investors demand for the risk of holding long-term bonds, has risen from its lows but remains negative – especially for U.S. Treasuries, according to LSEG data. That is historically unusual.

We see three reasons long-term bond yields and term premium can climb higher: First, we believe markets will price in inflation settling above DM central bank 2% policy targets longer term. Second, we also see investors demanding more term premium to reflect greater risk in nominal bonds due to higher inflation volatility and rising debt levels. The U.S. credit rating downgrade last month underscored the fiscal challenges ahead. Third, foreign demand for long-term Treasuries may wane: For example, Japanese investors may switch to domestic bonds as yields climb from the Bank of Japan further lifting its cap on long-term yields. To turn positive on long-term bonds, we would need to see term premium rise much more or think market expectations of future policy rates are too high. We are not there yet.

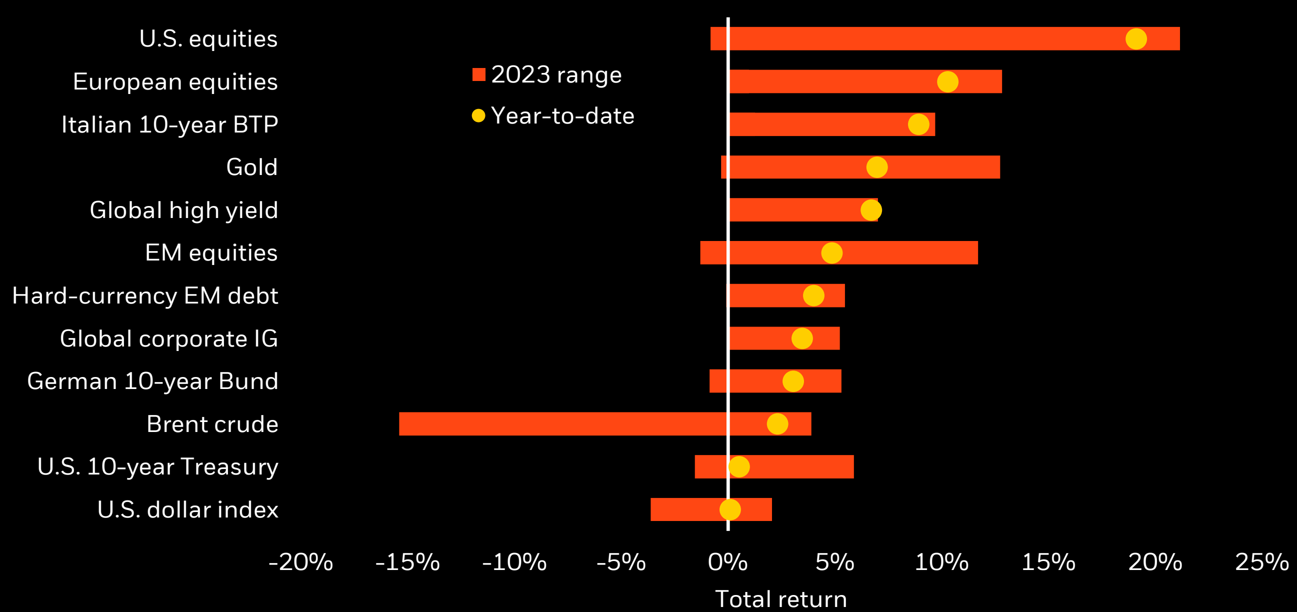
Bottom line: We evolve our views with the August update of capital market assumptions and strategic portfolios. We up our allocation to short-term sovereign bonds, trim our overall underweight to nominal government bonds and cut IG credit to underweight. We stay underweight nominal government bonds overall due to the risks we see in long-term bonds. We favor inflation-linked bonds. And we like equities in the long term. Their returns should surpass fixed income returns when growth rebounds from the near-term stagnation we expect – even if it muddles along due to the demographic hit ahead.

Market backdrop

U.S. stocks bounced back last week from a 2% drop in August as 10-year Treasury yields eased off a 16-year near 4.30%. The stock gains show just how sensitive market sentiment remains to yield moves and expectations for policy rates. The drop in July job openings and the August payrolls report indicated the U.S. labor market is now normalizing from pandemic mismatches. We see inflation on a rollercoaster ride ahead as normalization unfolds and an aging population starts to bite.

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. 31, 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

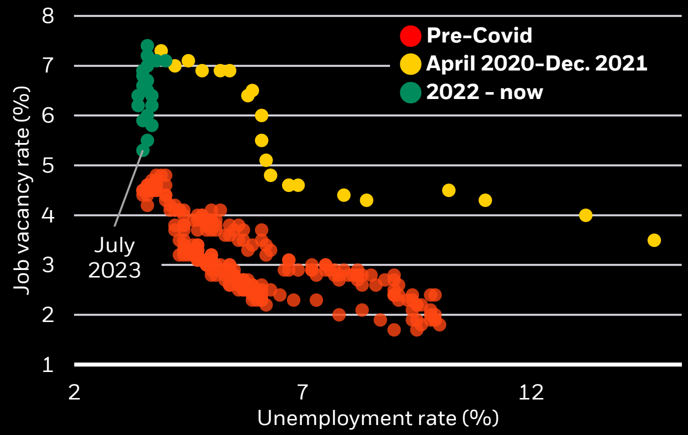
The U.S. has grappled with a huge mismatch after a pandemic-era shift in spending to goods and away from services made it hard for goods-producing companies to fill their vacancies. The latest labor data help confirm this mismatch has kept unwinding.

The level of unfilled job vacancies surged to be far higher since the pandemic for any given level of unemployment. See the yellow and orange dots on the chart. This relationship is slowly returning to pre-Covid levels. Data for July show vacancies falling sharply, even as unemployment was steady that month. That's good news. Consumer spending is normalizing as spending has shifted back to services from goods. That spending swing is reflected in prices: Core goods prices fell 5% at annualized rate in July.

Ultimately, this means inflation is set to decline further as the mismatch resolves. But don't count on this lasting. We think inflation will be on a rollercoaster as a worker shortage constrains how much the economy can grow without stoking higher inflation. See more in our Macro take blog posts here.

Harder to match workers

U.S. job vacancy and unemployment rate, 2001-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, September 2023. Notes: The chart shows the U.S. job vacancy rate vs. the unemployment rate in the same month.

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

Sept. 5	China Caixin services PMI	**Sept. 7**	China trade data
Sept. 6	U.S. ISM services PMI	**Sept. 8-15**	China total social financing; China CPI and PPI (Sept. 9)

A slew of China data this week will help gauge fading economic momentum after a rapid post-Covid restart. China is facing two key challenges: weak consumer and export demand. We cut our growth expectation for this year to around 5% as a result. Two-year average growth over 2022-23 is set to be about 4%, much lower than the pre-Covid rate of roughly 5%.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, September 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.
	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	-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 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.
	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	Neutral	Strategically, we're underweight investment grade due to limited compensation above short-dated government bonds. Tactically, we're neutral on tightening credit and financial conditions.
	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 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.
	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, September 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	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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