Weekly commentary

BlackRock

October 30, 2023

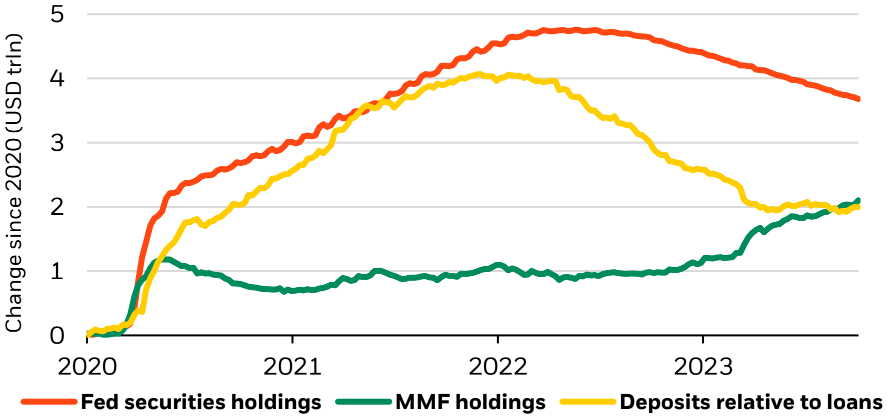
An evolving U.S. financial landscape

- Tectonic shifts in the U.S. financial sector are changing the markets for deposits and credit. This is a mega force we see affecting returns now and in the future.
- U.S. stocks hit five-month lows and 10-year Treasury yields rose above 5% last week. Q3 GDP was stronger than expected, but we don't see that continuing.
- The Federal Reserve takes center stage this week. We see the Fed holding policy tight as an aging population constrains the workforce and fuels wage pressure.

The future of finance is one global mega force we see affecting returns. It includes a changing U.S. corporate funding landscape, with less reliance on bank lending. That long-term trend has been bolstered by higher interest rates: Interest paid on bank deposits has lagged rate hikes, igniting competition for deposits. These shifts are good for savers, we believe. A more diversified funding pool makes the financial system safer and benefits borrowers overall, even if it means higher funding costs.

Follow the money

Deposit and money market fund assets, 2020-2023



Source: BlackRock Investment Institute, ISI, Federal Reserve, with data from Haver Analytics, October 2023. Notes: The chart shows the change since 2020 in U.S. Federal Reserve securities holdings, "excess deposits" (the difference between deposits and loans outstanding in the overall banking system, and money market fund assets.

Higher interest rates are a key tenet of the new regime of greater macro and market volatility, in our view. The end of zero interest rates has brought back competition for bank deposits. The interest rate U.S. banks pay on deposits has lagged Fed rate hikes since 2022. By contrast, other parts of the financial system, such as U.S. money market funds, have quickly offered higher rates. Savers have moved cash from banks to money market funds as a result: The Fed has injected $4 trillion into the economy since 2020 (orange line in chart), yet the banking system only has an additional $2 trillion of deposits over and above the loans it has made (yellow line) – still a comfortable buffer for now, but likely to run down as the Fed's quantitative tightening progresses. The rest is in rising U.S. money market fund holdings (green line). We think higher rates are here to stay as the Fed keeps policy tight to fight inflation – likely to be confirmed at the Fed's policy meeting on Wednesday.


Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute


Alex Brazier
Deputy Head – BlackRock Investment Institute


Vivek Paul
Head of Portfolio Research – BlackRock Investment Institute


Nicholas Fawcett
Macro Research – BlackRock Investment Institute

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BlackRock Investment Institute

The flight of deposits from banks sped up after the collapse of three U.S. regional banks in March, but this shift was already in motion. With more competition, banks can no longer cheaply fund loans by paying depositors rates well below the Fed policy rate as that would mean losing more depositors. We expect to see U.S. banks paying higher interest rates to savers as a result. Smaller banks have already started doing that this year. That, in turn, likely means higher interest rates on bank loans, which could crimp demand. Banks could choose not to pass on the extra cost of their deposits to borrowers. That would hurt their profit margins and reduce the profitability of lending, potentially discouraging them from lending as much. We see banks consolidating to reduce the need to support loans on their balance sheets. Overall, we expect a reduction in lending activity on bank balance sheets. U.S. regulatory proposals – partly in response to the U.S. bank turmoil – could reinforce the process.

The combined pressure on bank profitability from lending less and paying higher deposit rates is already visible in the net interest margins of small banks. They have fallen by more than those of large banks this year, according to September 2023 data from the Federal Deposit Insurance Corp. Small to mid-sized banks are also feeling more earnings pressure, with Q3 results reported so far showing declines versus both last quarter and last year. Bigger banks are holding up better so far.

The higher rate regime is catalyzing longer-run changes in the U.S. financial landscape – like the expanding role of non-bank credit providers. Bank loans now account for around one-fifth of non-financial corporate borrowing, according to Fed data. That is about half their share in the early 1970s. We think companies will keep diversifying their funding towards non-bank sources. Take private credit: It could appeal to small to mid-sized firms who face high barriers of entry to accessing public markets. Private credit lending spreads have widened over the past 12-18 months, and we find them attractive. Plus, private credit loans tend to have floating interest rates, insulating their returns from being eroded by higher policy rates. We are overweight on a strategic horizon of five years and beyond. But private markets are complex and not suitable for all investors. We think private credit requires selectivity and a focus on how much of the opportunity and risks are already in the price.

Bottom line: Greater diversification is good for borrowers, higher rates benefit savers, and such shifts create a more stable system – even as financing costs rise, in our view. Savers are benefiting from the higher returns in U.S. money market funds and regulatory reforms that made them more resilient. The higher interest rate environment has also broadened the potential ways of making income in the new regime. We see investment opportunities in alternative funding sources like private credit.

Market backdrop

U.S. stocks hit five-month lows and 10-year Treasury yields reached 16-year highs above 5%. Tech stocks underperformed on some disappointing earnings, while regional bank shares broadly hit new lows for the year. U.S. core PCE data, the Fed's preferred inflation gauge, slowed further in September on falling goods prices. Strong consumer spending drove a stronger-than-expected rise in Q3 GDP. Yet we don't see that as sustainable as consumers exhaust their savings.

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 Oct. 26, 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

The U.S. economy grew a faster-than-expected 4.9% annualized in Q3, driven by strong consumer spending. This trend is not sustainable, in our view.

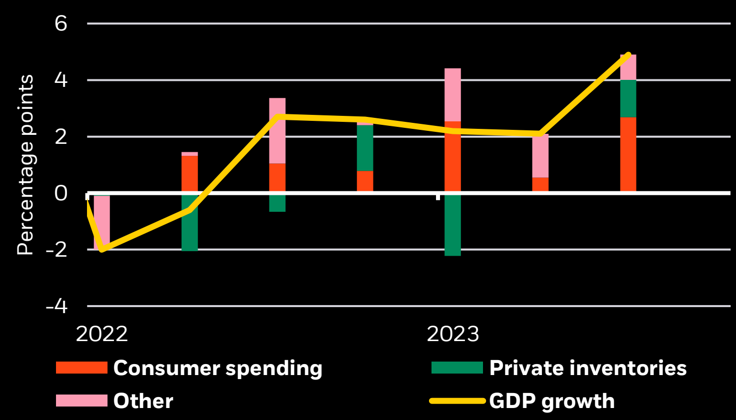
Why? Consumers are eating through savings built up during pandemic lockdowns. Spending accelerated during the quarter, even though consumers had less disposable income. See the orange bars in the chart.

We don't think consumers can keep spending at this pace. Other data – especially on consumer confidence – point to a slowdown in spending ahead. Growing inventories, or unsold stock (green bars), boost GDP now but suggest consumer demand for goods is waning. Companies may have in effect frontloaded production and can run down stocks to meet future consumer demand, potentially resulting in less economic activity.

We see GDP growth slowing from here and settling at a lower pace than we've seen recently. Read our latest Macro take post here.

An unsustainable surprise

Contribution to U.S. GDP growth, 2022-2023



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, October 2023. Notes: The chart shows the contribution of consumption, private inventories and other categories to overall quarterly GDP growth. The growth rate is shown at an annualized rate.

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, 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. 31	U.S. consumer confidence; Euro area inflation, Q3 GDP; Bank of Japan policy decision	**Nov. 2**	Bank of England policy decision
Nov. 1	Fed policy decision	**Nov. 3**	U.S. payrolls report; Euro area unemployment

The Fed takes center stage this week. We see the Fed holding policy tight as inflationary pressures persist, with an aging workforces keeping the labor market tight. U.S. payrolls are also in focus. We think the demographic shift in the labor force means the economy will soon only be able to sustain a fraction of recent job growth without stoking further wage pressure.

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	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, 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	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 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	-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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