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Weekly commentary

BlackRock

December 4, 2023

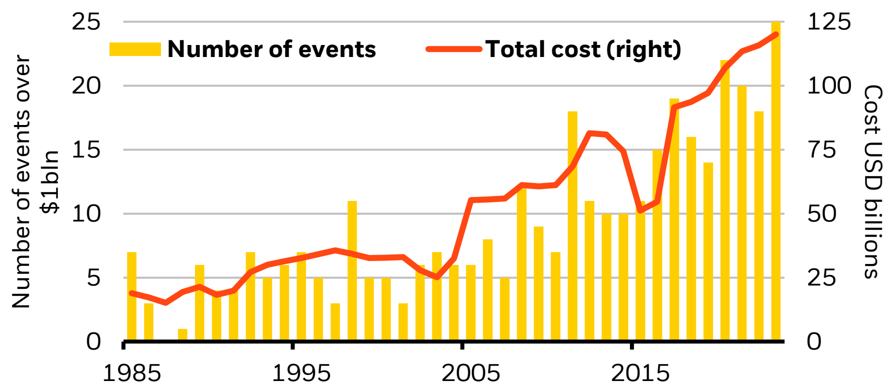
Three investment themes at COP28

- We track the low-carbon transition to identify investment opportunities and risks. We're eyeing three related themes at the annual UN climate conference.
- U.S. stocks last week hit their highest level of the year, and U.S. 10-year Treasury yields fell lower. We expect near-term volatility and rising yields in the long term.
- U.S. payrolls data this week will show if jobs growth is still slowing. We think the U.S. can only sustain a fraction of recent job growth without inflation resurging.

The low-carbon transition is one of five mega forces, or structural shifts, we track for investment risks and opportunities. We're following three investment themes at the UN climate conference (COP28) in Dubai. First, climate resilience – society's ability to prepare for and withstand climate risks – is an underappreciated theme, we think. Second, we eye progress on unlocking climate finance in emerging markets. Third, we watch for new policy plans that could shape the transition path.

Physical damages mount

U.S. events with inflation-adjusted losses over $1 billion, 1985-2023



Source: BlackRock Investment Institute, NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2023), data as of November 2023. Notes: The yellow bars show the number of climate events with losses greater than US$1 billion. The data include droughts, flooding, severe storms, hurricanes, wildfires, winter storms and freezes. The orange line shows the total cost as a 10-year moving average. The data are adjusted for inflation using 2022 dollars. All currency figures are in USD.

We highlight climate resilience first because it is an emerging theme not yet fully appreciated by investors. We think companies that create and adopt products and services that boost climate resilience will become a more widely recognized opportunity. Why? The number of U.S. climate events with damages above $1 billion has steadily climbed over the past roughly four decades. See the yellow bars in the chart. As such risks increase, we are seeing early signs of growing demand for climate resilience solutions. Case in point: Demand for home air-filtration appliances in the northeastern U.S. spiked during the Canadian wildfires in early 2023. Emerging markets (EMs) are set to bear some of these risks more acutely given greater exposure to physical climate damage. Yet they face difficulties in raising financing needed for the transition. We think this also offers an investment opportunity and is key to tracking the transition's overall speed and shape.

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The IPCC has reported persistent increases in average annual temperatures, precipitation and sea levels. The frequency and intensity of acute weather events, such as extreme heat and widespread floods, has also increased. We see policy and regulation driving the growth of the market for resilience products. Any COP28 agreement on a global plan for climate adaption could spur new policy. Some incentives to invest in resilience are already in place, including $50 billion from the Infrastructure Investment and Jobs Act and over $20 billion from the Inflation Reduction Act. Other support comes from building code updates in the U.S. and Europe explicitly focusing on improving climate resilience. Read more in our new paper.

We are closely watching policy developments that could unlock investment opportunities in EMs. They play a pivotal role in the global reduction in carbon emissions, in our view. Why? We estimate EM will account for over half of energy demand and carbon emissions by 2050. Yet transition-related investment in EMs will likely be lower than in DMs due to a higher cost of capital from greater perceived investment risk, and greater exposure to physical climate damage. We think closing the financing gap would require significant public sector reforms and private sector innovation, resulting in greater "blending" of public and private capital. We think successful reforms could see low-carbon investment in EMs rise on average by a further $200 billion a year – or $4 trillion overall – above our base view of a major increase in investment between 2030-2050.

We think COP28 will also provide further details about policies that are likely to influence how the mix of energy use evolves – and the investment opportunities. We see policy, technology and consumer preferences driving an accelerating shift to renewable energy in DMs. 2023 has seen record growth of about 50-70% for renewable energy, according to the International Energy Agency. Countries at COP28 look poised to agree to a goal to triple capacity by 2030. We think further policy support may make the goal achievable – and yet the S&P global clean energy index is down about 28% year to date, LSEG data show. Even with this growth in renewables, meeting global energy demand will rely on traditional energy for some time – and we think it can outperform at times, especially when there are supply-demand mismatches.

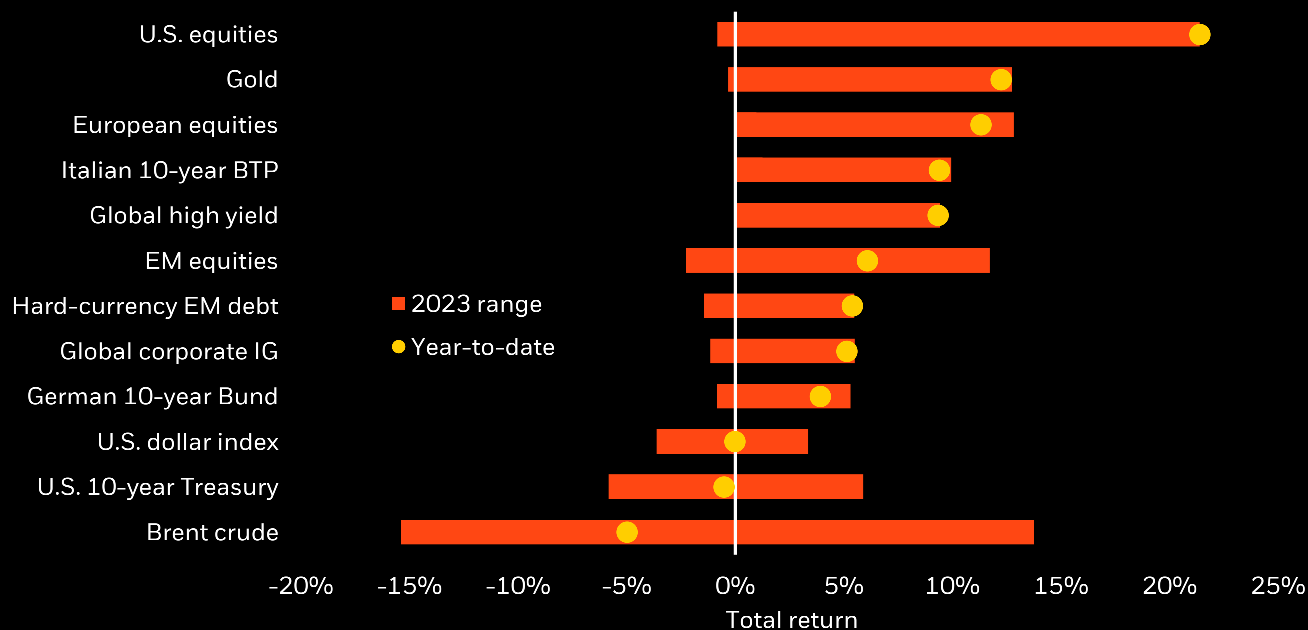
Bottom line: We monitor COP28 for signs of growth in transition-related investment themes. We see granular opportunities in public companies that produce climate resilience solutions across sectors. Solutions like early monitoring systems to predict floods or retrofitting buildings to better withstand extreme weather make the technology and industrial sectors stand out to us. And we think reforms could make it easier for private market players to fill the EM financing gap.

Market backdrop

Last week, the S&P 500 closed at its highest level this year after rising roughly 9% in November – the largest monthly gain in 16 months. The U.S. 10-year Treasury yield slid lower to near 4.30%, with its November drop of more than 50 basis points marking the largest monthly fall in 12 years. We expect further volatility for bonds in the near term as policy rates peak. We think long-term yields will rise again as investors demand more compensation for the risk of holding long-term bonds.

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. 30, 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. activity data released last week revealed weaker economic growth in Q3 than earlier data suggested. The average of income- and spending-based measures of activity shows Q3 growth was 3.3% lower than the 5.1% reported by spending-based data alone. That's still above the recent trend, but we think it's an outlier. Zooming out shows growth over the past seven quarters hasn't been this weak outside a recession since 1945. See the chart.

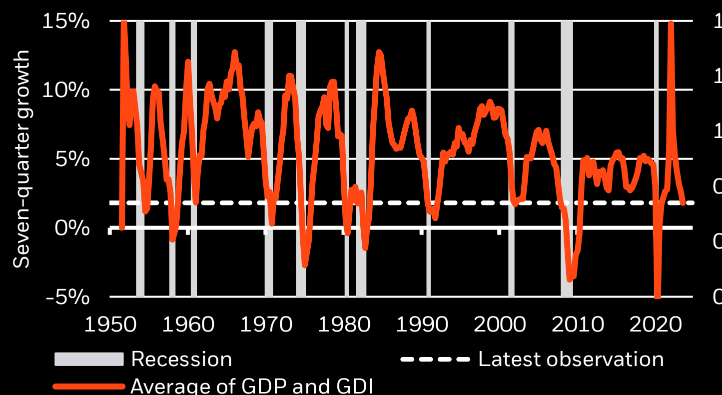
Strong spending fueled Q3 growth as consumers drew from pandemic savings. We don't think that's sustainable: Spending data for October shows consumers are saving much less today than they were pre-pandemic. So we don't expect strong growth next year as spending slows.

Even with weaker growth ahead, we don't see the Federal Reserve cutting rates as quickly as markets expect. We think rates cuts will come in the second half of 2024 but see inflationary pressures keeping rates higher than before.

Read our latest Macro take post here.

Stealth stagnation

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



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, December 2023. Notes: The chart shows U.S. activity growth over a rolling seven-quarter period (orange line). The white dotted line shows the most recent observation (for 2023Q3), and gray shaded bands show U.S. recessions as defined in the National Bureau of Economic Research classification of business cycles.

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.

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Week ahead

Dec. 5	Japan CPI; China PMI	**Dec. 8**	U.S. payrolls; University of Michigan consumer sentiment survey
Dec. 7	China trade data	**Dec. 9**	China CPI and PPI

The U.S. payrolls report for November is in focus this week. We are looking for signs that job growth is slowing further as the post-pandemic normalization runs its course. Structural labor shortages as the U.S. population ages means the economy will only be able to sustain a fraction of recent job growth without stoking inflation again, in our view.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, December 2023

Underweight | Neutral | Overweight | ● Previous view

	Asset	Strategic	Tactical	Commentary
Equities	Developed	Neutral	-1	We are neutral equities in our strategic views as high-for-longer interest rates lead us to re-evaluate our estimate for stock valuations from here. 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	Neutral	Neutral	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. Strategically, we carve out an overweight for short- and medium-term bonds as yields have surged. We stay underweight U.S. and euro area long-dated bonds as we expect investors to demand more compensation for the risk of holding them. We are strategically neutral on government bonds overall. 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	+2	Neutral	We are strategically 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, December 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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