Weekly commentary

January 2, 2024

BlackRock

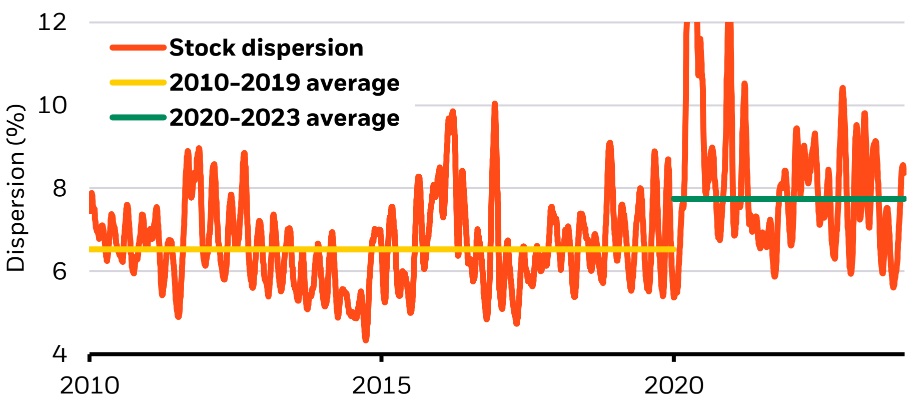
Three 2023 lessons we carry into 2024

- We think 2023 stressed the value of adapting to a new volatile macro regime, and leveraging investment insight and structural forces to find opportunities.
- U.S. stocks surged in 2023, a reversal from their 2022 underperformance. Flip-flopping market views about the policy path stoked volatility in long-term bonds.
- December U.S. jobs data out this week should signal how much more the labor market needs to normalize. Slower jobs growth is a long-term supply constraint.

We take three lessons from 2023 to shape our investment approach in the new year. First, markets flipflopping between macro narratives does not reveal new information about where we will end up. This is not a typical business cycle and context is everything. Second, greater dispersion is creating opportunities. That requires skill and granularity. Third, artificial intelligence buzz has underpinned U.S. stock performance – and shows mega forces matter now, not just in the future.

New regime = more dispersion

Dispersion of S&P 500 performance, 2010-2023



Past performance is not a reliable indicator of current or future results, and index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from LSEG Datastream, January 2024. Notes: The chart shows the 20-day average of dispersion in S&P 500 monthly stock returns (dark orange line) and the median level of dispersion from January 2010 after the global financial crisis through 2019 (yellow line), and from 2020 through to Dec. 13, 2023 (green line).

Looking back, 2023 largely saw a concentrated tech stock rally, with the Nasdaq up 55% from 2022. A market-wide rally since November also supported tech and led the equal-weighted S&P 500 to eke out a 12% return. Overall, we are seeing more dispersion in individual stock returns since 2020 (green bar in the chart). Macro uncertainty, geopolitics and structural shifts are driving volatility and dispersion. We think markets have stoked volatility, too, by viewing the new regime through the lens of a typical business cycle. Investors leaned into long-term bonds in early 2023 on hopes the Federal Reserve would cut policy rates by year end. It then became clear higher government spending and labor shortages are set to make inflation persistent and keep interest rates above pre-Covid norms. Ten-year Treasury yields surged to 16-year highs near 5% in October as markets priced in this outlook. They tumbled back below 4% by year end after the Fed blessed the pricing of rate cuts.

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These volatile moves underscore the first lesson that was reinforced in 2023: The macro backdrop is much more uncertain today than during the Great Moderation period of stable growth and inflation. This is tough to navigate for markets, with them flipflopping between macro narratives through 2023. In the final quarter alone, both stocks and bonds surged on news of lower inflation – with the November PCE report confirming a goods-led slowdown – and dovish Fed projections. Small caps rallied on hopes for a soft economic landing. And markets have repeatedly priced in aggressive rate cuts just to walk them back. All this shows markets may extrapolate a lot from one piece of data or central bank comment. That's taking a big bet on the macro outlook when the range of outcomes is wide, in our view. We don't believe the prevalent market narrative tells us new information about where the macro will end up. Yet we are cognizant markets can run with a narrative for some time. This is why we turned tactically neutral on long-term U.S. Treasuries last October. We think long-term yields will resume their rise over time as investors demand more compensation amid persistent inflation and budget deficits.

The greater macro risk means the dispersion of returns has increased. The result: a wide divergence in performance across equity sectors – and greater opportunities for investment expertise to shine, in our view. The correlation between bond and stock returns has flipped firmly into positive territory, meaning stocks and bonds fall or rise simultaneously. As a result, the old approach to portfolio construction that relied on bonds to offset equity sell-offs won't work, in our view. Instead, we advocate breaking up broad asset allocation blocks and digging deeper. All this is why our second lesson is that granularity is more essential now. We look beyond the macro to seek above-benchmark returns, or alpha, by being dynamic and selective.

One example of going beyond broad asset class exposures is to harness mega forces. The artificial intelligence (AI) mega force drove 2023 stock performance to an even larger extent than we had imagined. The importance of AI and other mega forces hammers home our third lesson: Structural forces matter now. Aging populations mean an ever-rising share of the population is past retirement age, resulting in worker shortages. That's a key constraint fueling U.S. inflation now as a tight labor market keeps wage growth elevated. Others include the low-carbon transition and geopolitical fragmentation. The latter is evidenced by wars in Ukraine and Gaza and the intensifying structural competition between the U.S. and China.

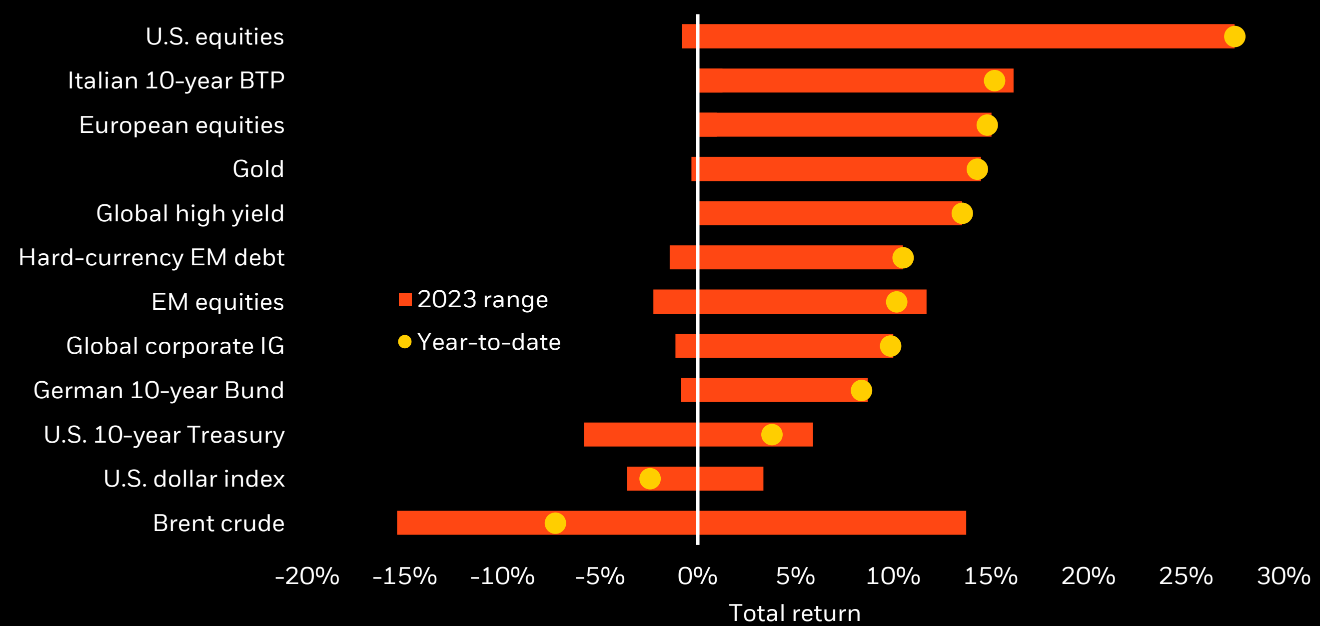
Bottom line: 2023 emphasized the macro risks but also the opportunities on offer from structural shifts and getting granular in the new regime. Our 2024 Global Outlook outlines how we capture them.

Market backdrop

U.S. stocks surged roughly 25% last year, a near mirror image of their downtrodden 2022 performance. That was partly driven by excitement over AI lifting tech stocks and carrying the broader market. Meanwhile, the 10-year Treasury yield ended the year where it started: It climbed from lows of roughly 3.3% in April, to 16-year highs near 5% in October before falling below 3.9% at year end. We think some of the sharp swings in narratives – and markets – reflect the new regime of greater volatility.

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 Dec. 28, 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.

Week ahead

Jan. 3	U.S. ISM manufacturing PMI	**Jan. 5**	U.S. payroll data; euro area inflation
Jan. 4	China Caixin services PMI		

We will be looking to the U.S. payrolls data for December out this week to gauge how much further the labor market has left to normalize in the new year after the pandemic. Structurally slower labor force growth is one of several long-term production constraints we think will prevent the U.S. and many other major economies from growing at their pre-pandemic pace without sparking renewed inflation.

Big calls

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

Tactical	Reasons
DM equities	• Our macro view keeps us underweight, but we think the AI theme and alpha potential has taken us closer to a neutral view. See below.
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 than policy targets, making this one of our strongest views 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, January 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, January 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**		
	United States	-1	We are underweight the broad market – still our largest portfolio allocation. Hopes for rate cuts and a soft landing have driven a rally. We see the risk of these hopes being disappointed.
	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.
	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.
	Japan	+1	We are overweight. We see stronger growth helping earnings top expectations. Stock buybacks and other shareholder-friendly actions are positives. Potential policy tightening is a near-term risk.
	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. 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
	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.
	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.
	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	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.
	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.
	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	-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.
	U.S. agency MBS	+1	We are overweight. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG
	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.
	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 EM hard currency debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
	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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