Weekly commentary

BlackRock

January 22, 2024

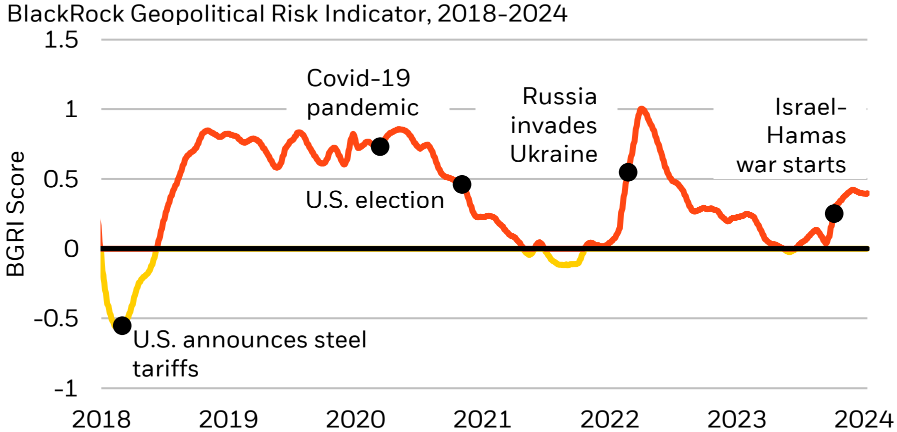
Geopolitical fragmentation plays out

- Geopolitical fragmentation is accelerating, as seen with recent events in Asia and the Middle East. We see it keeping inflation pressures elevated longer term.
- U.S. stocks climbed to record highs last week. The 10-year U.S. Treasury yield rose as markets priced in fewer rate cuts – but still more than we expect.
- We think the European Central Bank will hold rates steady at its policy meeting this week, and the Bank of Japan faces pressure to tighten its ultra-loose policy.

Geopolitical fragmentation, one of five mega forces or structural shifts we track, is playing out in recent events in Asia and the Middle East. Yemen's Houthi militants attacking Red Sea shipping highlights how hot spots can hit supply chains and up production costs. Fragmentation is a key reason we see persistent inflation pressures – keeping policy rates above pre-Covid levels. Countries like Mexico and Vietnam, and strategic sectors like tech could benefit from globalization rewiring.

Paying greater attention

BlackRock Geopolitical Risk Indicator, 2018-2024



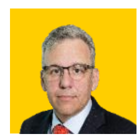
Forward-looking estimates may not come to pass. Source: BlackRock Investment Institute, with data from LSEG and Dow Jones, January 2024. Notes: The BlackRock Geopolitical Risk Indicator tracks the relative frequency of brokerage reports and financial news stories related to specific geopolitical risks. We adjust for whether sentiment in the text is positive or negative, and then assign a score that reflects the level of market attention to each risk versus a five-year history. More on our methodology.

Geopolitics has become a persistent and structural market risk over the last half-decade, in our view. The world has faced cascading crises – from the U.S. trade wars to the Covid-19 pandemic, Russia's invasion of Ukraine and now war in the Middle East. These developments have accelerated global fragmentation and the emergence of competing geopolitical and economic blocs. And the openness of countries to trade with each other has stalled, based on world trade as a share of global GDP. This is a marked departure from the globalization and geopolitical moderation of the post-Cold War period. We see the rewiring of globalization along geopolitical lines ramping up as countries and companies favor national security and resilience over pure cost efficiency. So it's no surprise markets are paying more attention to geopolitics, as measured by our Geopolitical Risk Indicator (see chart).

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Catherine Kress
Head of Geopolitical Research – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute



Axel Christensen
Chief Investment Strategist for Latin America — BlackRock Investment Institute

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Geopolitical fragmentation is one of the reasons we see persistent inflation pressures – and policy rates staying above pre-pandemic levels. Supply chains are becoming longer and more complex as "connector" countries like Mexico and Vietnam increasingly act as intermediate trading partners between different geopolitical blocs. Such countries may stand to benefit from competition between blocs, yet significant investment will be needed in areas like critical infrastructure for benefits to fully materialize. Companies that prove resilient to shifting supply chains may have a competitive edge – and some will also benefit from robust industrial policies like the U.S. Inflation Reduction Act and CHIPS and Science Act.

Fragmentation's economic and market impact will depend, in part, on if changes to the global order are managed or disorderly. Greater geopolitical volatility – and the rising number of violent conflicts worldwide – increase the risk of a more disorderly and less predictable path. Yet as broad stocks and other assets move on quickly from geopolitical events, we worry they may not be appreciating that we have entered a new geopolitical regime. The old playbook no longer applies, in our view.

On the risks we're monitoring, we reaffirmed our highest-level *Gulf tensions* rating in December given the ongoing Israel-Hamas war. The risk of escalation is high, we believe, with attacks by Iranian-backed groups on the rise. The disruption of Red Sea shipping aiming to pass through the Suez Canal shows how the conflict can expand to hamper supply chains and drive up production costs, in this case via rising shipping costs. We keep our *U.S.-China strategic competition* risk rating at a high level. The November meeting between the U.S. and Chinese presidents has helped set a more positive tone for relations and expanded communications in the near term. But Taiwan remains a significant flashpoint, as the recent election shows. We think intense, structural competition between the U.S. and China is the new normal, especially in defense and technology.

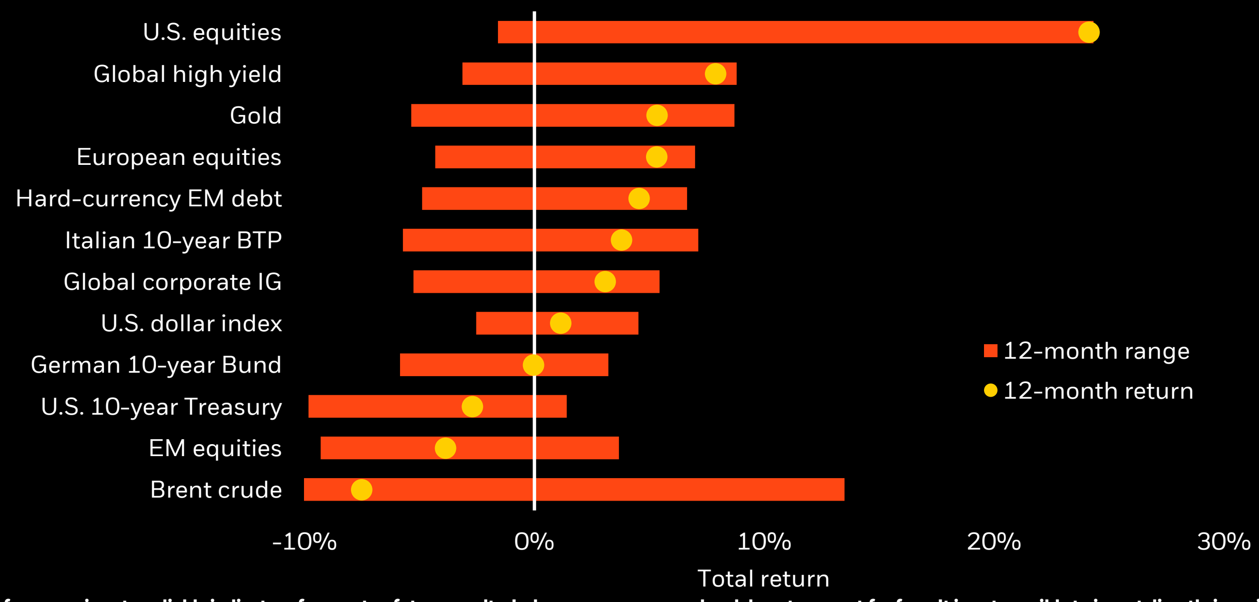
Bottom line: We expect deeper fragmentation, heightened competition and less cooperation between major nations in 2024. We see the rewiring of globalization benefiting countries like Mexico and Vietnam. It will also likely spur a surge of investment in advanced tech, clean energy, defense and other sectors seen as critical to a country's economic and geopolitical goals.

Market backdrop

The S&P 500 closed at its highest ever last week, and gains in tech shares pushed the Nasdaq 100 to an all-time high. The U.S. 10-year yield climbed above 4.10% as markets trimmed expectations for Federal Reserve interest rate cuts this year but still eye about six quarter-point cuts. Better-than-expected retail sales and Fed comments warning against rapid rate cuts spurred the repricing. We still see market pricing of rate cuts as overdone given the inflation rollercoaster we expect, but the quick shift in expectations underscores the importance of managing macro risk as market narratives can suddenly flip flop.

Assets in review

Selected asset performance, 12-month 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 Jan. 18, 2024. 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 12-month 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. 23	Bank of Japan (BOJ) policy decision	**Jan. 25**	U.S. GDP; European Central Bank (ECB) policy decision
Jan. 24	Global flash PMIs	**Jan. 26**	U.S. PCE

Policy rate decisions by central banks are in focus this week as both the ECB and BOJ meet. We expect the ECB to hold rates steady ahead while communicating future cuts. We're also following the BOJ as it faces pressure to tighten its ultra-loose policy. In the U.S, a slew of activity data is due for release, including PCE inflation data. We expect inflation to fall to 2% by year end as goods prices slide, but we see the risk of resurgent inflation coming into view later this year.

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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