Weekly commentary

BlackRock

April 1, 2024

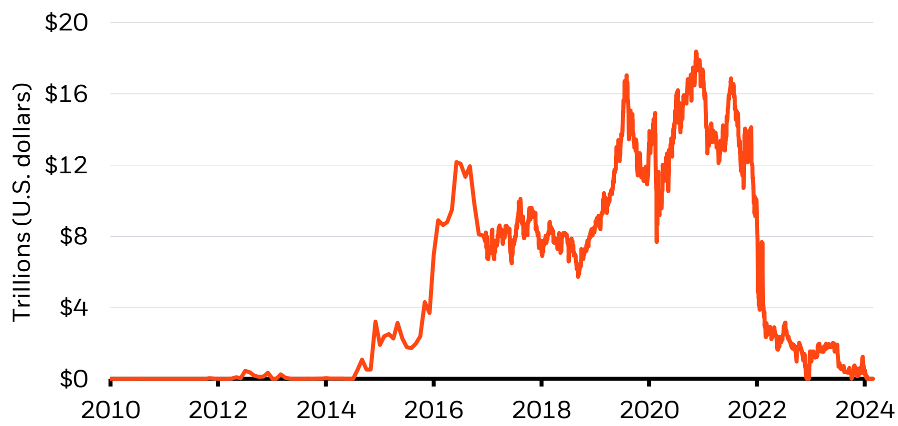
Staying nimble while seeking income

- Yields have surged across fixed income in the new regime. In Q2, we stay nimble and selective, preferring short-term sovereign bonds and high yield credit.
- The S&P 500 jumped 10% in Q1 even as bond yields rose on markets pricing out rate cuts. In Japan, the yen slid to a 34-year low against the U.S. dollar.
- We eye this week's U.S. payrolls data to see if rising immigration will keep boosting job gains, offsetting for now an aging population and workforce.

Yields jumped as central banks hiked rates to historic highs – ushering in a new era for fixed income. We see higher yields persisting even if rate cuts are coming. We think central banks will keep rates higher for longer than pre-pandemic due to persistent supply constraints. While income is back, tight U.S. credit spreads and long-term yield volatility pose risks. To kick off Q2, we stay selective in fixed income and credit. We favor hard currency emerging market debt and high yield credit.

No more negativity

Market value of global bonds with negative yields, 2010-2024



Source: BlackRock Investment Institute, with data from Bloomberg, March 2024. Notes: The chart shows the total market value in U.S. dollars of all negative yielding bonds in the Bloomberg Global Aggregate Index. The index consists mainly of government bonds, mortgage-backed securities and investment grade credit.

For a decade, negative yielding bonds flooded global markets as central banks slashed rates and bought bonds to loosen policy, surging to above $18 trillion at its peak in a key global bond index. See the chart. Negative yields are now history – a massive shift for fixed income markets. Yields hit multi-decade highs after central banks hiked rates to rein in inflation after the pandemic, with U.S. 10-year yields hitting 16-year highs last year. We had expected long-term yields to surge – staying underweight for a few years on both tactical and long-term horizons until turning neutral tactically last year. We think interest rates will stay higher for longer as inflation proves sticky, limiting how far central banks cut rates. Higher rates mean bonds provide more income cushion. Yet greater macro volatility has hampered their ability to offset risk asset selloffs. That's why we stay selective in fixed income.

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We get selective on a six- to 12-month tactical horizon given ongoing volatility in long-term bond yields and tightening U.S. credit spreads. We're neutral high yield credit and find that overall yields for the riskier asset class are more attractive than for investment grade (IG) credit, where spreads have tightened more on a relative basis. Returns for high yield credit are also less sensitive to elevated interest rate volatility. While default rates have risen since 2022, they seem to be stabilizing, Moody's data show. We prefer euro area high yield where spreads have not tightened as much relative to the U.S. Our risk-on stance in this environment underpins our preference for high yield credit over IG, and is more supportive of stocks over bonds. Yet IG credit may be attractive for investors solely focused on fixed income, as we don't expect spreads to widen notably this year.

We stay nimble and granular on a regional level in our other views, too. For example, we favor emerging market (EM) hard currency debt – largely issued in U.S. dollars – over developed market government bonds. EM hard currency debt spreads have also not tightened as much as overall euro area and U.S. credit spreads. And we see a near-term macro backdrop that is more supportive of risk-taking, with some EM central banks cutting rates as inflation cools. On inflation-linked bonds, we had preferred the U.S. Now, we up euro area inflation-linked bonds to neutral as market inflation expectations fall as we expected.

How do our views differ on a strategic horizon of five years and longer? We are overweight developed market inflation-linked bonds due to persistent inflation pressures – and prefer them over long-term government bonds. We stick with our tactical and strategic preference for short-term bonds. We see long-term yields rising as investors demand more compensation for the risk of holding long-term bonds given record debt loads and ballooning bond supply. On credit, we prefer private over public. We see greater demand for private credit as banks pull back on lending and yields better compensate for risk than public credit. Private markets are complex, with high risk and volatility, and aren't suitable for all investors.

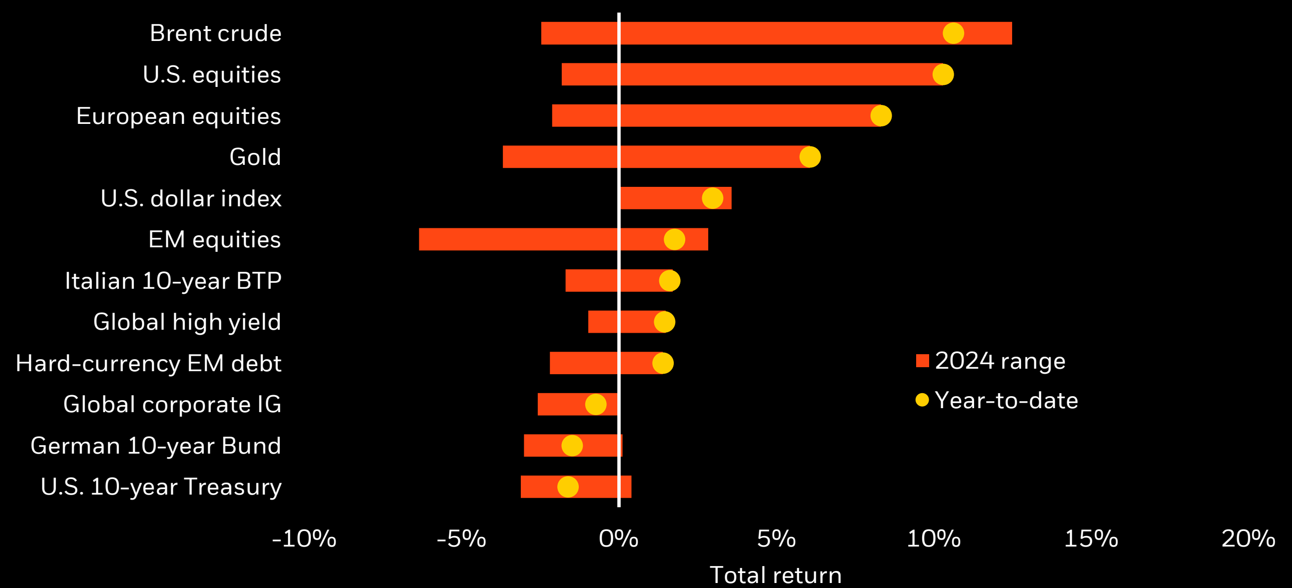
Bottom line: Higher interest rates in the have spurred a new era in the fixed income landscape. We stay selective in the Q2 update of our tactical views. We prefer short-term government bonds, euro area high yield credit and EM hard currency debt.

Market backdrop

The S&P 500 closed out Q1 at a new record high last week. The index jumped 10% in Q1 even as bond yields rose on markets pricing out rate cuts. The U.S. 10-year Treasury yield was mostly flat to finish near 4.20%. Japanese equities receded from record highs as the yen slid to a 34-year low against the U.S. dollar. Yields on Japanese 10-year government bonds dipped further after the Bank of Japan's end to negative rates last month was about normalizing policy, not anxiety over inflation.

Assets in review

Selected asset performance, 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 March 27, 2024. Notes: The two ends of the bars show the lowest and highest returns at any point year to date, 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

April 2	U.S. job openings and labor turnover data	**April 4**	U.S. trade data
April 3	Euro area flash inflation data and unemployment; China Caixin services PMI	**April 5**	U.S. payrolls

We keep a close eye on the U.S. payroll report out this week to gauge if job gains can keep growing sharply due to elevated migration. Longer term, we think the U.S. could face the risk of structurally slower labor force growth – a key production constraint – as its population ages and without a further boost from migration.

Big calls

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

Tactical	Reasons
U.S. equities	• Our macro view has us neutral at the benchmark level. But the AI theme and its potential to generate alpha – or above-benchmark returns – push us to be overweight overall.
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 public credit risk.
Inflation-linked bonds	• We see inflation staying closer to 3% in the new regime 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, April 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, April 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	Benchmark	Neutral	We are neutral in our largest portfolio allocation. Falling inflation and coming Fed rate cuts can underpin the rally's momentum. We are ready to pivot once the market narrative shifts.
		Overall	+1	We are overweight overall when incorporating our U.S.-centric positive view on artificial intelligence (AI). We think AI beneficiaries can still gain while earnings growth looks robust.
	Europe		-1	We are underweight. While valuations look fair to us, we think the near-term growth and earnings outlook remain less attractive than in the U.S. and Japan – our preferred markets.
	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		+2	We are overweight. Mild inflation, strong earnings growth and shareholder-friendly reforms are all positives. We see the BOJ policy shift as a normalization, not a shift to tightening.
	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		Neutral	We are neutral. Market expectations for persistent inflation in the euro area have come down.
	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		-2	We are underweight. We find more attractive returns in equities. We see some of the least attractive returns in Japanese government bonds, so we use them as a funding source.
	China govt bonds		Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	U.S. agency MBS		Neutral	We are neutral. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG.
	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.
	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 its relative value and quality. 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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