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Weekly commentary

BlackRock

October 16, 2023

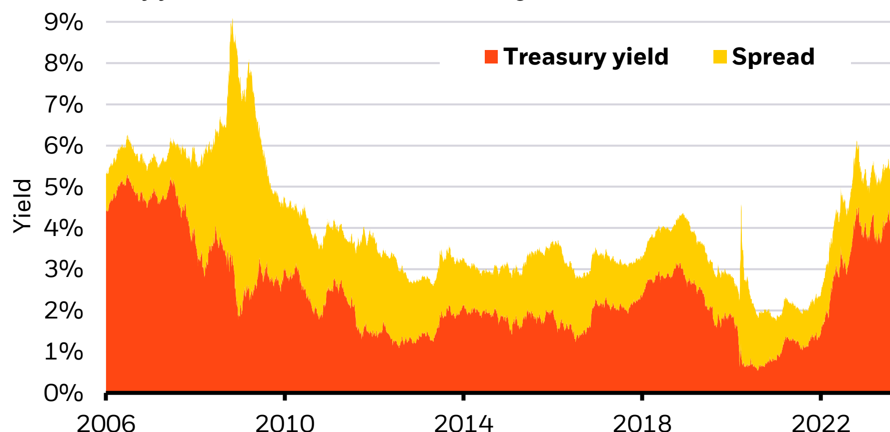
U.S. yields: two-way volatility ahead

- We turn tactically neutral long-term Treasuries as markets price high-for-longer policy rates but stay underweight strategically. We cut high quality credit again.
- U.S. stocks steadied last week as Q3 earnings season started. Ten-year Treasury yields dipped. U.S. core CPI reinforced why we see the Fed holding policy tight.
- China GDP and Japan inflation are in focus this week. We see China on a lower growth path and higher inflation in Japan paving the way for a policy change.

We have been underweight long-term U.S. Treasuries since late 2020 as we saw the new macro regime heralding higher rates. U.S. 10-year yields at 16-year highs show they have adjusted a lot – but we don't think the process is over. We now turn tactically neutral as policy rates near their peak. The next step is not overweight: we see investors demanding more compensation for bond risk and stay underweight on a long-run, strategic horizon. We downgrade high grade credit further.

Yield surge

U.S. Treasury yield and corporate investment grade credit spread, 2006-2023



Sources: BlackRock Investment Institute, with data from LSEG Datastream, October 2023. Notes: The chart shows the yield of the Bloomberg U.S. Corporate Investment Grade Index broken into option-adjusted spread (yellow) over U.S. Treasuries (orange).

We've long said higher interest rates are a key part of the new regime. Why? Supply constraints make inflation persistent; bond supply is swelling due to high deficits; and macro and geopolitical volatility abound. That's why we went underweight long-term Treasuries on a six- to 12-month tactical horizon when yields were below 1%. We expected investors to demand more compensation, or term premium, for the risk of holding bonds. That has started to occur in recent months, but the repricing of Federal Reserve policy rates has been a big part of the yield move (orange area in chart) since the Fed's first hike in 2022. We see the yield surge driven by expected policy rates nearing a peak. Rising term premium will likely be the next driver of higher yields. We think 10-year yields could reach 5% or higher on a longer-term horizon. Yet the gap between investment grade credit and 10-year bond yields hasn't widened as we expected, so we further downgrade credit.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Michel Dilmanian
Investment Strategist – BlackRock Investment Institute

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We now see about equal odds that Treasury yields swing in either direction. In other words, we see two-way volatility ahead. One reason: The Fed is likely nearing the end of its fastest hiking cycle since the 1980s after raising rates into restrictive territory. We see policymakers shifting to assessing financial conditions. Fed officials said last week that tightening financial conditions due to surging long-term yields are likely doing some of the Fed's work for it. The U.S. economy has already stagnated for the past 18 months after averaging GDP and gross domestic income – which adds up incomes and profits of households and firms. Further damage from rate hikes will likely become clearer over time. We think these conditions bring us closer to when the "politics of inflation," or pressure on the Fed to curb inflation, will turn into pressure to stop hurting economic activity with tight monetary policy. We still see the Fed holding policy tight to lean against inflationary pressures.

We think long-term yields have not fully adjusted yet. They will eventually resume their march higher as term premium gradually rises, in our view, to account for greater macro volatility, persistent inflation plus large fiscal deficits and debt issuance. In the near term, inflation is easing as pandemic mismatches unwind from consumers shifting spending back to services from goods. We see inflationary pressures on a rollercoaster ride beyond the near term as an aging population shrinks the workforce, fueling wage and overall inflation. That backdrop begs the question: What will be the neutral policy rate that neither stimulates nor slows activity? Drivers of further yield jumps and tightening financial conditions are up for debate, too. These uncertainties are set to create more volatility in the near term, without yields moving in a clear direction.

We fund our tactical upgrade by further downgrading IG credit tactically after recently going underweight last month. Why cut IG and not the lower quality high yield credit? We have expected U.S. credit spreads to widen due to rate hikes. Yet the IG spread has tightened since the Fed's first hike, while high yield has widened. We also opt to further downgrade IG rather than high yield to avoid reducing our portfolio risk levels and exposure to risk assets.

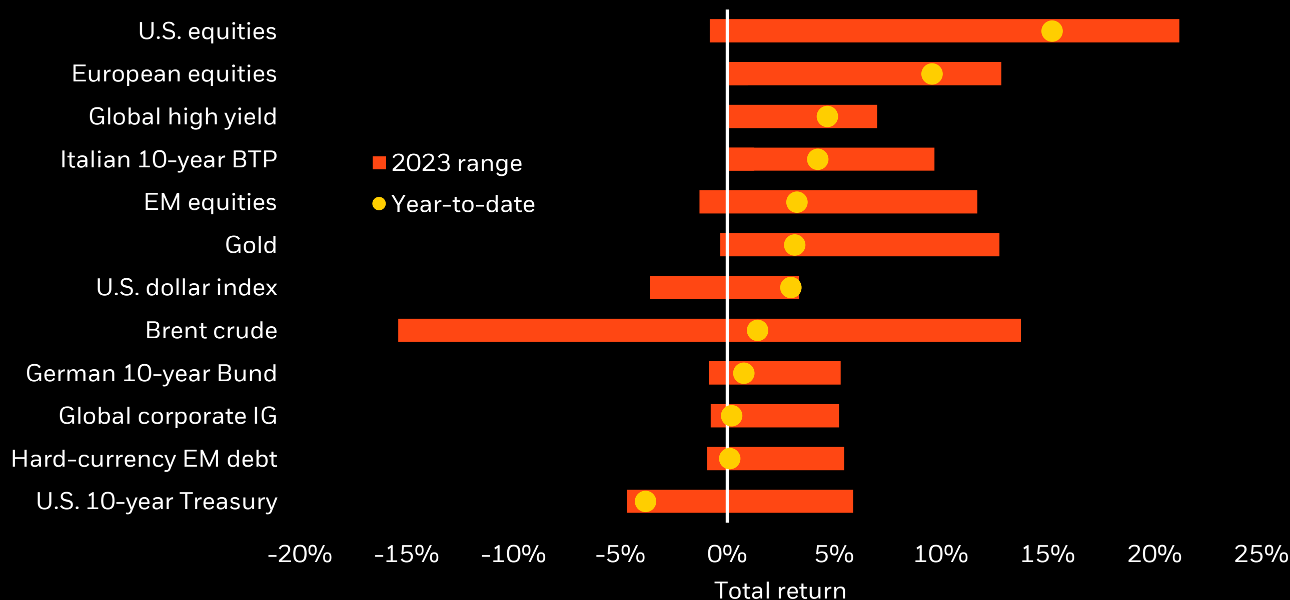
Bottom line: We turn tactically neutral long-term Treasuries but stay underweight strategically. Instead of IG credit, we tap into quality in short- and long-term Treasuries and U.S. agency mortgage-backed securities (MBS). Agency MBS carry minimal default risk given the implicit protection offered by the U.S. government.

Market backdrop

U.S. stocks steadied for a second week, while 10-year Treasury yields retreated from 16-year highs hit earlier in the month. We think the volatility in long-term yields is likely to persist, even as central banks have likely reached peak policy rates. Fed comments this week that higher longer-term yields were doing the policy tightening work for them helped confirm this. But a renewed surge in U.S. core services CPI excluding housing reinforced why we think the Fed will hold tight on policy.

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. 12, 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

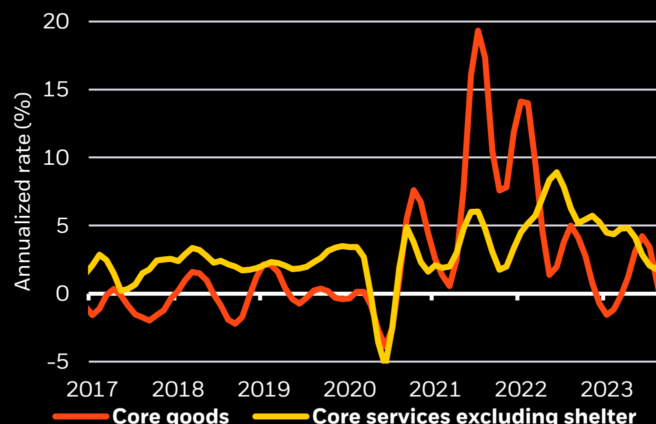
U.S. core consumer prices – excluding energy and food – rose 0.3% in September, bringing the annual inflation rate down to a two-year low of 4.1%. While still much higher than the Fed's 2% policy target, we expect inflation to fall further.

Goods prices are falling as spending further normalizes toward services and away from goods. See the orange line in the chart. Yet core services inflation excluding housing ticked higher. See the yellow line. It's not running at a pace consistent with inflation falling to the Fed's 2% target, but we think it's heading lower. Companies are more easily hiring workers now versus when the economy was restarting. That should cool wage growth, a key driver of services inflation.

The Fed will welcome that U.S. core inflation is cooling. But we still think it will keep policy tight. Why? An aging population is constraining the workforce. That means job gains must slow or else inflation could bounce back above 2% going into 2025. That's why we don't see big rate cuts coming even as economic growth stagnates. Read our latest Macro take post here.

Services inflation stays sticky

Core CPI inflation, 2017-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, October 2023. Notes: The chart shows core goods and services inflation measured by the change in the most recent three-month average over the preceding three months, at an annualized rate. Core goods inflation covers all goods excluding energy and food costs; core services inflation covers all services excluding energy and shelter costs.

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.

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Week ahead

Oct. 17	UK unemployment, U.S. retail sales	**Oct. 19**	Japan trade data
Oct. 18	UK CPI; China Q3 GDP	**Oct. 20**	Japan CPI

Asia is in focus this week: China faces weak consumer and export demand and the economic restart from Covid lockdowns is sputtering. We see the economy resetting lower than the pre-pandemic trend growth rate. Inflation has returned in Japan. We see risks of spillovers to global bond markets as the central bank faces pressure to change its ultra-loose policy.

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 (● previous view: -1)	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 (● previous view: -1)	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 (previous view: -1)	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 (previous view: -1)	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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