Weekly commentary

BlackRock.

December 11, 2023

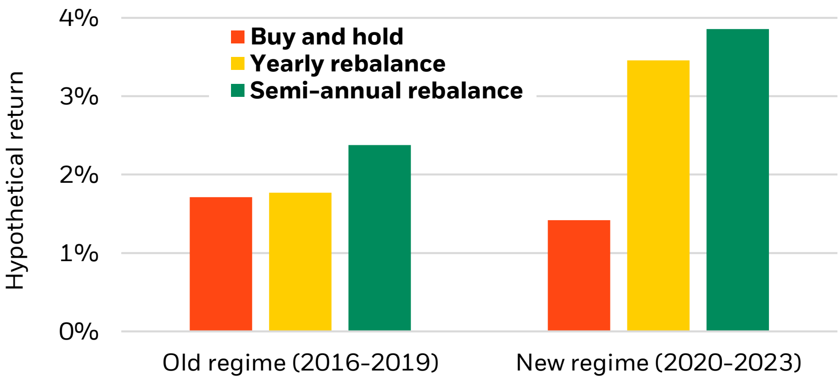
Putting money to work in 2024

- The new regime has led to greater dispersion of returns. We think this backdrop calls for managing macro risk, being selective and seeking out mispricings.
- U.S. stocks hit a new 2023 high and U.S. Treasury yields inched up on Friday after U.S. payrolls data. Market pricing of rate cuts in 2024 still looks overdone.
- We see central banks pushing back against market hopes for rate cuts at this week's meetings. We expect structurally higher interest rates in the new regime.

We think the new regime of greater macro and market volatility makes this the time to grab the wheel and take an active portfolio approach. Our 2024 Global Outlook outlines how we do that. First, we are deliberate in managing macro risks. Second, we aim to capitalize on greater dispersion of returns by getting selective within asset classes, geographies and sectors. Third, we tap mega forces, the structural shifts we see driving returns and transcending the macro backdrop.

More rewards for dynamism

Hypothetical impact of rebalancing on U.S. equity returns, 2016-2023



Past performance is not a reliable indicator of future performance. Index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, MSCI with data from Bloomberg, December 2023. Notes: The chart shows monthly U.S. equity returns based on the MSCI USA in the old and new regime in three scenarios: keeping the holdings unchanged (buy-and-hold), yearly rebalances and semi-annual rebalances. Rebalances optimize portfolios for returns, diversification and risk with perfect foresight of equity sector returns in the MSCI USA index.

The new regime's higher interest rates and greater volatility are a sea change from the Great Moderation, the four-decade period of stable growth and inflation that was capped by ultra-low rates in the wake of the financial crisis. That helped suppress macro and market volatility, stoking bull markets in both stocks and bonds – but also limiting the reward of having investment insight. We find that reward is back. The test: Imagine you could perfectly predict future U.S. equity sector returns and adjust your portfolio to capture them. That would have had little upside in the four years before the pandemic. "Buy-and-hold" strategies (the orange bar on the left chart) would have generated similar returns to portfolios allocating to outperforming sectors more frequently (the left yellow and green bars). The reward has been much greater since the pandemic, with rebalancing delivering more than double the hypothetical returns of a buy-and-hold strategy. See the gap between the orange bar and the others on the right chart.

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How do we try to capitalize on this new regime? First, we focus on *managing macro risk* – the first of three investment themes that help us identify opportunities to generate alpha, or above-benchmark returns. Markets have been swinging between hopes for inflation to fall as growth holds up and recession fears. Yet we think the context is that the economy has just climbed out of a pandemic-shaped hole. Plus, structural drivers such as shrinking workforces are poised to push up inflation. One macro risk we're watching is the uneven market adjustment to structurally higher rates. The income cushion bonds provide has increased, leading us to upgrade long-term Treasuries recently to neutral on a tactical horizon. We went overweight European and UK government bonds at the same time, but have since trimmed again given the fall in yields. This more dynamic approach contrasts sharply with our previously long-held underweight in developed market long-term bonds.

Greater dispersion of returns creates space for investment expertise to shine and means security selection is likely to be more impactful – as detailed in our second theme, *steering portfolio outcomes*. This involves being dynamic with both indexing and alpha-seeking strategies, while staying selective and seeking out mispricings. For example, we upgraded Japanese equities twice without hedging against currency swings this year due to high compensation for the risk of holding them, strong earnings growth and shareholder-friendly corporate reforms. On sectors, we like European banks for their low valuations and positive outlook for net interest margins, as well as developed market technology.

Our preference for tech is supported by our third theme, *harnessing mega forces,* which offer opportunities uncorrelated to economic cycles. Case in point: Investor enthusiasm for digital disruption and artificial intelligence (AI) – one of five mega forces we track – has buoyed U.S. tech stocks and offset the drag of higher bond yields. Our expectation for high-for-longer rates would keep us underweight broad U.S. equities on a tactical, six-to-12-month horizon. Yet adding the AI theme has taken us closer to neutral. Other mega forces present opportunities, too. Within the low-carbon transition, climate resilience – society's ability to adapt to and withstand climate hazards – is emerging as an investment theme. And we see geopolitical fragmentation dialing up investment in strategic sectors like tech, energy and defense.

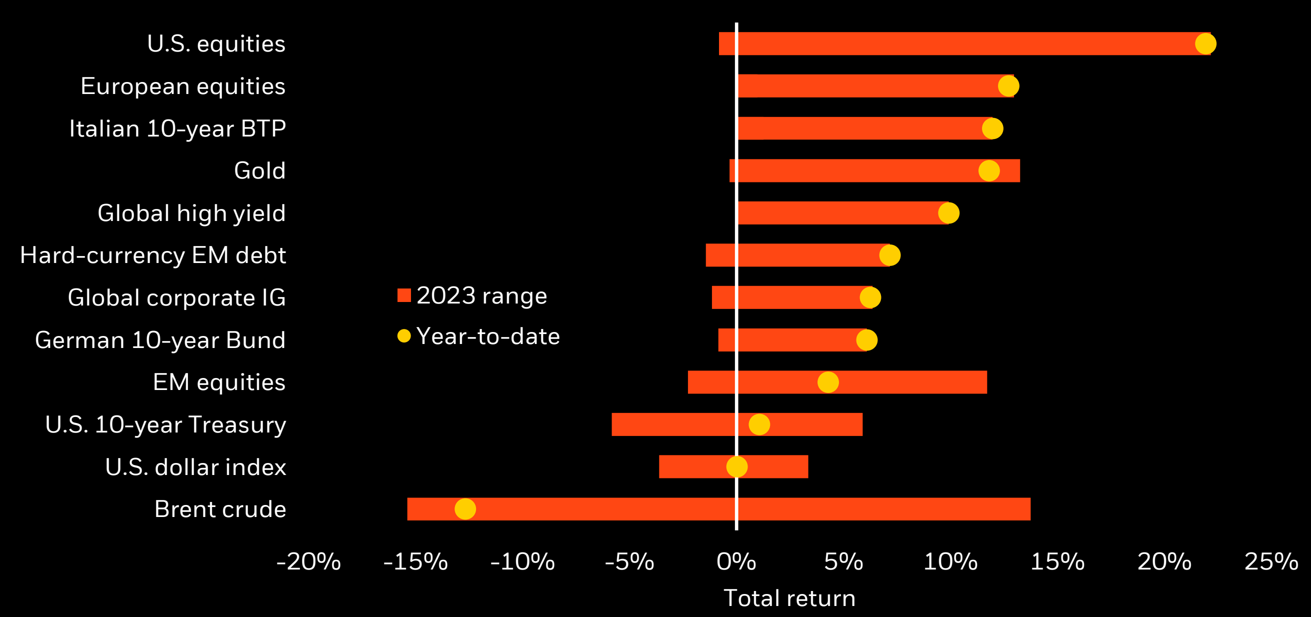
Bottom line: The three investment themes of our outlook guide us on how to take a more active approach to investing. Mega forces help us get granular in DM stocks. And higher rates have increased the income in fixed income, boosting its appeal. This is our last weekly commentary until the new year. We'll return on Tuesday, Jan. 2. Happy holidays!

Market backdrop

The S&P 500 hit a new 2023 high, beating the record it set on Dec. 1. The U.S. jobs report for November stemmed the fall in 10-year U.S. Treasury yields – down about 75 basis points from 16-year highs – from markets pricing in multiple Fed rate cuts next year. The data showed a gradually cooling labor market, but falling unemployment and still-high wage growth aren't consistent with inflation returning to the Fed's 2% target. So we don't think the Fed will cut rates as swiftly as markets expect.

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. 7, 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

Dec. 12	U.S. CPI	**Dec. 14**	European Central Bank (ECB), Bank of England policy decisions
Dec. 13	Federal Reserve policy decision	**Dec. 15**	U.S., UK flash PMIs

The Fed and ECB policy decisions will be the center of market attention this week. We think both central banks will push back against market expectations on how many rate cuts they'll deliver in 2024 and how soon they will come. For the Fed, in particular, persistent inflationary pressures and loose fiscal policy will prevent it from cutting rates as swiftly as markets expect, in our view.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, December 2023

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, December 2023. 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, December 2023

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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