

Weekly commentary

October 9, 2023

BlackRock

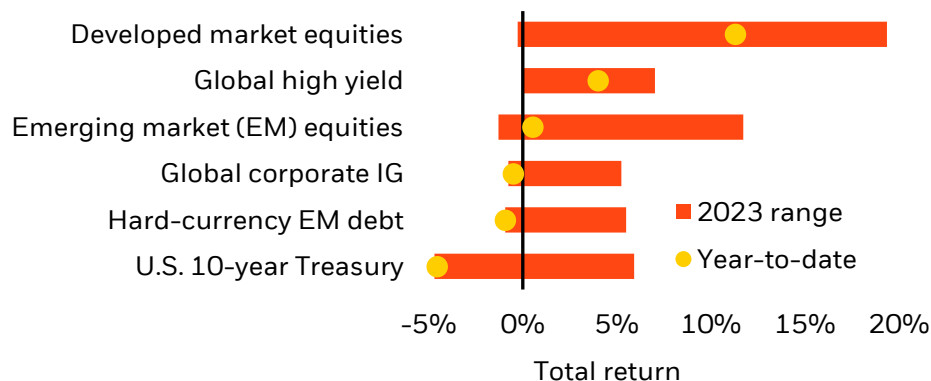
Why the structural matters now

- We see markets adjusting to the new regime. This is not a typical business cycle – structural mega forces are shaping the outlook now, in our view.
- The 10-year U.S. Treasury yield jumped to 16-year highs on markets pricing in higher-for-longer interest rates. Stocks ended a volatile week little changed.
- The Middle East conflict is in focus. U.S. CPI data this week will help gauge how quickly supply mismatches are unwinding.

Markets are adjusting to the new regime of greater macro and market volatility, in our view. This is not a typical business cycle. What matters are the mega forces – or structural shifts – playing out now. Most point to higher interest rates and lower long-term growth: Aging constrains the workforce, and geopolitical fragmentation rewires supply chains. But digital disruption has potential for productivity gains. We see mega forces creating opportunities and risks across sectors and regions.

Market reset

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. 6, 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 in U.S. dollars. Developed market equities based on the MSCI World Index. Other indexes used are listed in the chart on page 2.

Developed market (DM) stocks have erased about half of this year’s gains – though tech has held up partly due to momentum behind the artificial intelligence (AI) mega force. See the chart. The 10-year U.S. Treasury total return is nearing a loss of about 4% this year with capital losses wiping out the income it provides. And the risk it bears has been thrown into the spotlight this year: a full percentage point climb in 2023 and double-digit basis point swings each day becoming routine. Surging long-term Treasury yields show markets are adjusting to a higher level tied to mega forces: looser U.S. fiscal policy, the big reallocation of resources in the low-carbon transition and geopolitical fragmentation rewiring supply chains. We see many DM economies on a structurally weaker growth trend due to mega forces such as aging populations. Long-term yields are more in line with our views, but we think equities still don’t fully reflect higher-for-longer policy rates.



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BlackRock Investment Institute

Activity in the U.S. has stagnated for 18 months as the economy moves onto a lower growth path. Seemingly strong payroll gains last week might seem like good news. But companies were slow to rehire in the restart of activity following the pandemic – and they’re still catching up. We estimate that, without this catchup effect, job gains would be slowing. We think focusing on monthly job creation also masks a broader trend since 2020: Overall employment growth has been modest, yet unemployment is lower. That shows labor supply has slowed as the population aged. We think the tight labor market reflects this supply constraint, not a strong economy.

That’s why it’s key to harness the sector and company impacts of these mega forces in this tricky macro environment. The key for us: Identify the catalysts that can supercharge them, see how they interact with each other and uncover the likely beneficiaries not yet priced in by markets. We saw such a catalyst in AI earlier this year when we went overweight on our tactical six- to 12-month horizon. Our work finds the value of AI patents from public companies has surged, and it could suggest they’re submitting higher quality patents. This is not just about public markets: we find private markets make up a growing portion of firms filing for AI patents and may have more companies focused exclusively on AI.

We see other mega forces intersecting and creating big shifts in profitability across economies and sectors. We see potential across the energy system in the shift to a low-carbon economy, depending on the interplay of policy, tech, and consumer and investor preferences. Healthcare, real estate, leisure and companies with products and services for seniors may stand to benefit in DMs as people age, while emerging markets (EM) like India and Mexico benefit from younger populations. EM is also leading the way in digital payments in the future of finance. Some EMs could strike deals across divides in a fragmenting world and benefit from companies bringing production closer to home, while broader economic competition could spur global investment across tech, clean energy, infrastructure and defense. We also think a fast-changing U.S. financial landscape is poised to create opportunities in private credit as banks curb lending. U.S. regional banks have come under renewed pressure from surging yields just as Q3 earnings reporting season kicks off this week.

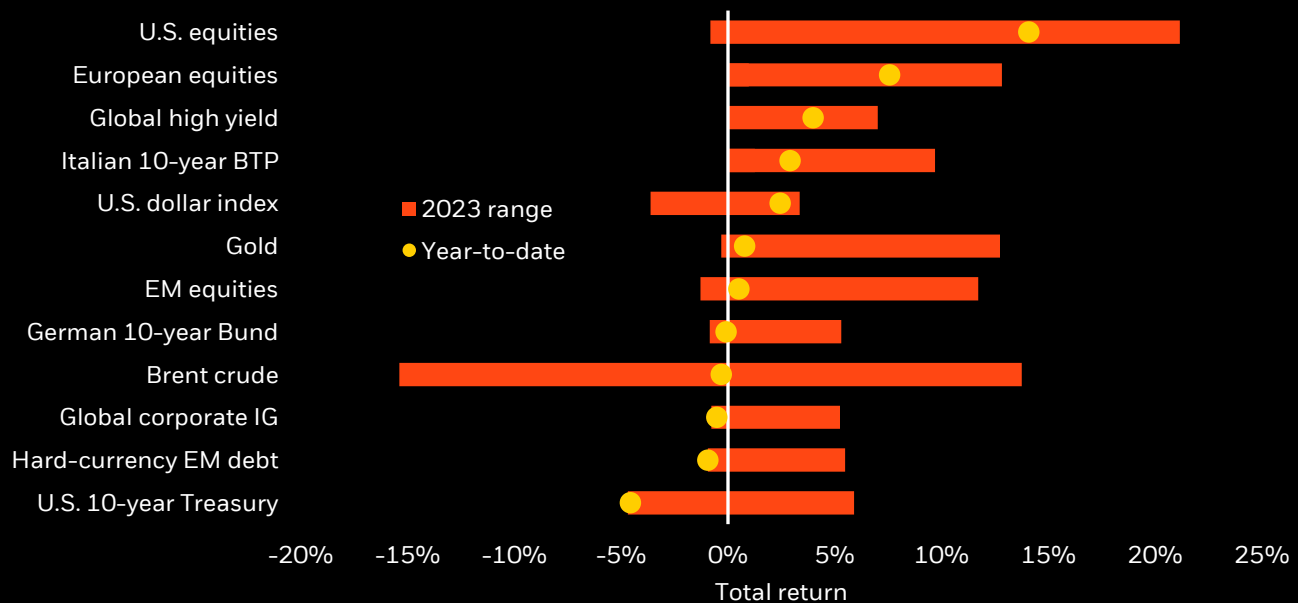
Bottom line: Mega forces are shaping the new regime – with geopolitical fragmentation now in focus. Our long-held tactical underweight to long-term U.S. Treasuries has served us well as yields rise. We stay underweight DM equities but lean into AI to harness mega forces while the macro backdrop remains unfriendly for broad asset class exposures.

Market backdrop

The 10-year U.S. Treasury yield jumped to new 16-year highs last week, while U.S. stocks ended a volatile week little changed. We are seeing the new, volatile regime in action, with sharp intraday and weekly market moves. U.S. payrolls data showed a surprisingly strong number of jobs created in September. We think the economy can only sustain a fraction of recent job growth as the population ages – or it risks stoking further inflationary pressures.

Assets in review

Selected asset performance, 2023 year-to-date return and range



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 Sources: BlackRock Investment Institute, with data from LSEG Datastream as of Oct. 6, 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

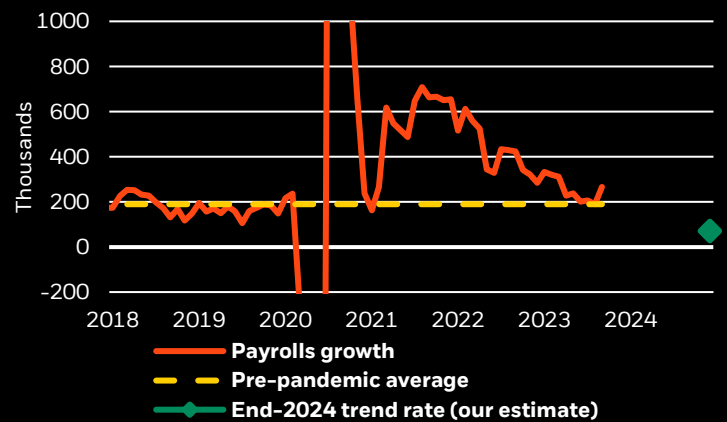
U.S. payrolls data last week showed a surprisingly strong number of jobs created in September – 336,000, nearly double the consensus expectation. The three-month average payroll gain rose to 266,000. See the orange line in the chart.

We don't consider job growth a good guide to economic activity. Why? We estimate the U.S. economy needed to add over 7 million jobs 18 months ago just to adjust to activity levels. Job growth has only just caught up, so employment isn't signaling strong output growth. An average of GDP and gross domestic income – which adds up incomes and profits of households and firms – shows that economic activity has only grown 1% over the last 18 months. That's the weakest such period without a recession since World War Two.

An aging population is creating a worker shortage, which will keep the labor market tight. The result: full-employment stagnation. We find it means the economy will only be able to add about 70,000 jobs each month without inflation resurging vs. 200,000 pre-pandemic. See the yellow line and green dot on the chart. Read our latest Macro take post [here](#).

A structural slowdown

Average monthly payroll gains, 2018-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, October 2023. Notes: The chart shows the three-month rolling average of monthly nonfarm payroll gains, along with the 2015-19 average and the level of payroll gains by end-2024 that we estimate is consistent with stable inflation – see more [here](#).

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 well 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.

Week ahead

Oct. 12

U.S. CPI; UK GDP

Oct. 10-17

China total social financing









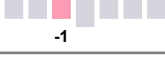
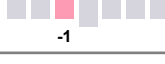

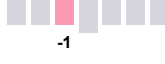



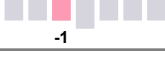
Oct. 13

China CPI, PPI, trade data;
U.S. trade data; University of
Michigan consumer survey

We're eyeing U.S. inflation and spending data this week to gauge if the drop in goods prices will keep leading inflation lower as consumer spending shifts back to services. We estimate about two thirds of the spending shift has now unwound. Yet population aging will likely keep the labor market tight, driving inflationary pressures and a rollercoaster ride in the data.

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 |  -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 underweight U.S. nominal long-dated government bonds on both horizons as we expect investors to demand more compensation for the risk of holding them. Tactically, we are overweight on euro area and UK bonds as we think more rate cuts are coming than the market expects. |
| | 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 |  -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 | |
|--------------------------|--|--|---|
| Developed markets | | | |
| Equities | United States | <p style="text-align: center;">-1</p> | 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 | <p style="text-align: center;">-1</p> | 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 | <p style="text-align: center;">Neutral</p> | 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 | <p style="text-align: center;">+1</p> | 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 | <p style="text-align: center;">Neutral</p> | We are neutral. China's restart is losing steam and we don't see valuations compelling enough to turn overweight. |
| | DM AI mega force | <p style="text-align: center;">+1</p> | We are overweight. We see a multi-country and multi-sector AI-centered investment cycle unfolding set to support revenues and margins. |
| Emerging markets | | | |
| Fixed Income | China | <p style="text-align: center;">Neutral</p> | We are neutral. We see growth on a weaker trajectory and see only limited policy stimulus from China. We prefer EM debt over equity. |
| | Short U.S. Treasuries | <p style="text-align: center;">+1</p> | We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer. |
| | Long U.S. Treasuries | <p style="text-align: center;">-1</p> | We are underweight. We see long-term yields moving up further as investors demand greater term premium. |
| | U.S. inflation-linked bonds | <p style="text-align: center;">+1</p> | We are overweight and prefer the U.S. over the euro area. We see market pricing underestimating sticky inflation. |
| | Euro area inflation-linked bonds | <p style="text-align: center;">-1</p> | 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 | <p style="text-align: center;">+1</p> | 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 | <p style="text-align: center;">+1</p> | 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 | <p style="text-align: center;">-1</p> | We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy. |
| | China govt bonds | <p style="text-align: center;">Neutral</p> | We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper. |
| | Global IG credit | <p style="text-align: center;">-1</p> | 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 | <p style="text-align: center;">+1</p> | We're overweight. We see agency MBS as a high-quality exposure within diversified bond allocations. |
| | Global high yield | <p style="text-align: center;">-1</p> | We are underweight. Spreads do not fully compensate for slower growth and tighter credit conditions we anticipate. |
| | Asia credit | <p style="text-align: center;">Neutral</p> | We are neutral. We don't find valuations compelling enough to turn more positive. |
| | Emerging hard currency | <p style="text-align: center;">+1</p> | 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 | <p style="text-align: center;">Neutral</p> | 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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