# Weekly commentary

BlackRock

November 6, 2023

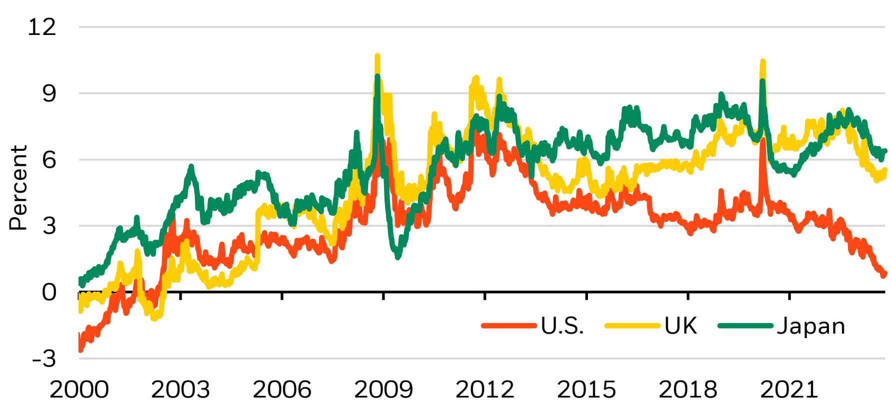
## Going granular in DM stocks

- Developed market (DM) central banks have signaled high-for-longer policy rates. We stay selective in DM equities and prefer international stocks.
- U.S. stocks bounced 6% last week as 10-year Treasury yields plummeted on the Fed's pause and slowing wage growth, underscoring the new regime's volatility.
- This week's slew of macro data will likely show muted economic activity in China on weak consumer spending and exports. We're neutral emerging stocks.

Markets rallied last week from multi-month lows after central banks kept rates steady and signs emerged of slowing U.S. wage growth, highlighting the volatility of the new macro regime. What got lost in the shuffle: Central banks have signaled policy rates are staying high for longer. As markets adjust, we find that granular opportunities abound. We stay selective in DM stocks and bonds, tapping markets like Japanese stocks on the back of corporate earnings and reforms.

### Regional divergence

Earnings yield minus bond yield, 2000-2023




Source: BlackRock Investment Institute, with data from LSEG Datastream, November 2023. Notes: Each line in the chart shows the earnings yield – or the inverse of the price-to-earnings ratio – minus the yield for 10-year government bonds for the U.S., UK and Japan.

We see regional stock markets facing diverse policy, inflation and growth prospects – affecting corporate earnings. That variety is reflected in the wide dispersion in excess compensation investors receive for the risk of holding stocks over bonds – or earnings yield minus bond yield – in different DMs. That divergence creates opportunities to be selective, in our view. The excess yield is compressed in the U.S. (dark orange line). We remain underweight U.S. stocks – still our largest portfolio allocation – on a six-to-12-month, tactical horizon. We get exposure to the tech sector, which has outperformed the broader U.S. stock market, through an overweight to the artificial intelligence (AI) theme in DM stocks. The compensation is higher for the UK (green line) but we see diminished growth prospects there. We're neutral UK stocks. The excess yield is slightly higher for Japan (yellow line) where we are overweight.


**Jean Boivin**
Head – BlackRock Investment Institute

**Wei Li**
Global Chief Investment Strategist – BlackRock Investment Institute

**Alex Brazier**
Deputy Head – BlackRock Investment Institute

**Ben Powell**
Chief Investment Strategist for APAC — BlackRock Investment Institute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Ten-year Treasury yields saw their largest weekly drop in a year last week. We went neutral long-term Treasuries last month because we saw equal odds of Treasury yields swinging in either direction after their surge to 16-year highs. That two-way volatility is playing out now in large daily moves – and yields are still sharply higher since the start of the year. U.S equities have bounced up after a stretch of losses – even when stripping out the impact of the largest public companies. Higher valuations have pinched the earnings yield gap over higher bond yields. Yet U.S. corporate earnings growth has sputtered in the past year as economic activity has broadly slowed. We stay cautious on DM stocks. U.S. Q3 corporate earnings have slightly beat muted expectations on modest revenue growth, pointing to an expansion of profit margins. But we think higher interest rates and financing costs will crunch earnings and profit margins.

We assess what's in the price for both stocks and bonds in other DM markets. We recently went overweight euro area government bonds and UK gilts to lock in higher yields as markets price in rates staying higher than even we expect. We stay underweight euro area stocks: Even with attractive valuations versus U.S. stocks, expectations for high single digit earnings growth over the next year look too rosy to us. Euro area corporate margins face pressure from higher rates and slower global growth. We upgraded UK stocks to neutral in July and stay there as attractive valuations better reflect the weak growth outlook and hit from rate hikes. Yet we don't see a catalyst for turning more positive.

We're underweight Japanese government bonds. We see their yields rising further: The Bank of Japan took a step away from its ultra-loose monetary policy last week when it loosened the cap on 10-year yields even while reserving the option to intervene if yields rise too fast by making 1.0% the "reference rate." We still see a supportive backdrop for Japanese corporate earnings and stocks thanks to stronger growth and reduced policy uncertainty. We stay overweight after upgrading them from neutral in July. Corporate reforms such as bigger share buybacks and dividends are also shareholder friendly.

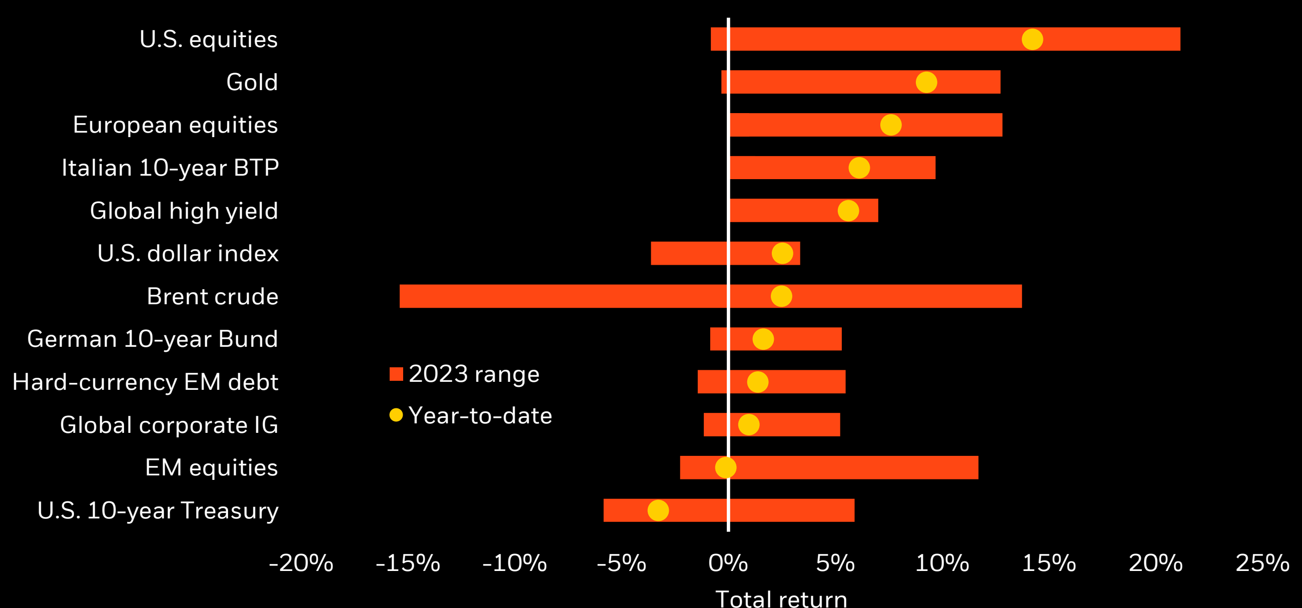
Bottom line: Markets are starting to price in the volatile new regime of higher rates and lower long-term growth. We see greater dispersion – and opportunities – as a result. DM stocks are the major building block of portfolios. We get selective across regions based on valuations, earnings prospects and what's in the price. We're overweight short-term Treasuries and recently upgraded long-term bonds to neutral. We are also overweight euro area government bonds and UK gilts.

# Market backdrop

U.S. stocks jumped 6% this week on the drop in long-term yields. Ten-year U.S. Treasury yields fell around 0.3 percentage points this week – the largest weekly drop in a year – and are nearly 0.5 percentage points below the 16-year high hit last month. We think these sharp yield swings reflect the more two-way risk for bonds as the Fed nears the peak in policy rates. While data revealing slowing wage growth is a step in the right direction, we don't see in rate cuts until later next year.

## 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 Nov. 2, 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

Last week, the Bank of England and the Federal Reserve joined the European Central Bank and left its policy rate unchanged. UK policy rates are now at 15-year highs, and euro area rates have never been higher since its formation. See the chart.

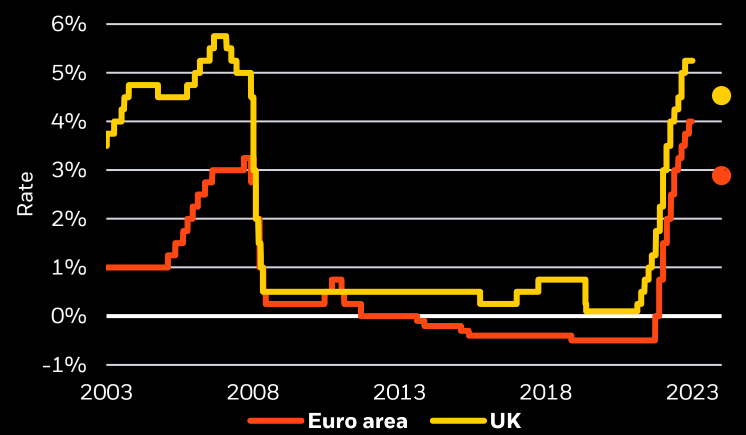
Markets expect central banks to hold tight and keep policy rates at restrictive levels well into next year, too – see the dots in the chart. And that's even with inflation falling across developed markets as pandemic-induced mismatches between supply and demand unwind. Case in point: Euro area inflation fell more than expected in September. We see inflation falling further.

But inflation is still too high for central banks to take comfort. Even as recent activity data points to stagnation in the euro area, we don't see major central banks coming to the rescue with rate cuts soon. Inflationary pressures persist, especially in the UK.

Read our latest Macro take post here.

## Holding tight

Central bank policy rates and market expectations, 2003-2024




Source: BlackRock Investment Institute, with data from LSEG Datastream, November 2023. Notes: , The lines show central bank policy rates. The dot shows one-year rate expectations in one years' time (November 2024) based on interest rate swaps.

# 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.

# Week ahead

| | | | |
|---|---|---|---|
| **Nov. 7** | U.S. trade data; China trade data | **Nov. 10** | University of Michigan consumer survey; UK GDP |
| **Nov. 9** | China CPI, PPI; U.S. initial jobless claims | **Nov. 10-17** | China total social financing |

China takes center stage this week. A slew of macro data will help gauge how subdued activity remains. Two key challenges weigh on China's economy: sluggish consumer spending and weak demand for its exports. Crucially, spending lags its pre-pandemic pace. We revised our 2023 growth expectations down to around 5% as a result.

# Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 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 | 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 | 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, November 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 | 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 | 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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