2024 Global Outlook

Grabbing the wheel: putting money to work

BlackRock

BlackRock **Investment** Institute

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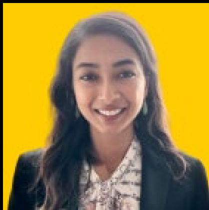

Tara Iyer

Chief North America Macro Strategist

BlackRock Investment Institute

The new regime of greater macro and market volatility is playing out in Canada. The economy stagnated for several quarters, inflationary pressures persist and policy has become incrementally tighter. The greater uncertainty and dispersion of returns in the new regime calls for a more active approach to managing investment portfolios. We like short-term Canadian bonds for income, remain cautious on credit, and focus on quality within Canadian equities such as the energy sector and equities that benefit from the artificial intelligence (AI) mega force.

Persistently high rates and greater volatility define the new regime. This is a structural shift and different from the decade following the global financial crisis, where expanding production capacity allowed central banks to stabilize the economy while promoting growth through low rates. Production constraints abound in the new regime. What does this mean for Canada?

The Canadian economy is normalizing from the pandemic, with inflation falling fast towards the Bank of Canada's (BoC) 2% target. Bringing inflation closer to target has required economic activity to stagnate over the past few quarters. This is a world with sharper trade-offs for central banks, including in Canada, due to greater production constraints in the goods, labor and energy markets.

Canada is currently a global supplier of energy. But like other countries, it will face cost pressures during the transition to a low-carbon economy due to investment in renewable sources of energy. Supply constraints in the goods market are rising due to increasing geopolitical fragmentation. Some production constraints have been alleviated thanks to strong immigration – and that could also ease pressures from an aging workforce.

We see Canada on a weaker long-term growth path as it climbs out the deep pandemic hole and as growth has been muted due to tight monetary policy. Canada's weakness is also due the greater sensitivity of the economy to higher rates due to higher levels of private sector debt. Mortgages in Canada are shorter term and variable rate, making the housing sector more rate sensitive than the U.S. Household and corporate balance sheets are getting stretched, in our view. Corporate debt is much higher than the U.S. and has been rising faster over the past few decades.

High and rising debt servicing costs and weakening economic activity have led the BoC to pause rate hikes earlier than the Federal Reserve. Quicker disinflation and the economy's greater rate sensitivity will prompt the BoC to trim policy rates in 2024 a bit more than we expect from the Fed. But what matters most: The new regime implies persistently higher interest rates.

Along with higher global rates and to mitigate terms of trade and market volatility amid such production constraints, we think Canadian policy rates will settle higher than they had in the pre-pandemic period.

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Markets are still adjusting to this new regime, and that's why context is key for *managing macro risk*, our first theme. We think differentiated macro insights will be rewarded. Greater volatility and dispersion of returns create space for investment expertise to shine, as detailed in our second theme – *steering portfolio outcomes*. One way to drive portfolio outcomes is by *harnessing mega forces* – our third theme. One mega force – geopolitical fragmentation – is highlighted by the rising political tensions between Canada and India. Other mega forces, such as the AI revolution, we see driving returns across Canadian sectors.

Investors need to take a more active approach to their portfolios. This is not a time to switch on the investing auto pilot; it's a time to take the controls. It's important to be deliberate in taking portfolio risk, in our view, and we expect to deploy more risk over the next year.

Our macro view in the new regime keeps us underweight developed market (DM) equities tactically. We expect growth to stay stagnant with persistent inflation, prompting central banks to keep policy rates higher for longer. But the AI theme and the potential for greater alpha in the new market regime lift our DM equity view closer to neutral.

We see greater dispersion of returns unfolding across global markets, creating opportunities for investors who get selective within and across regions. We believe high quality Canadian companies, with sustainable business models and low leverage ratios could keep outperforming next year. Energy companies – a sizable share of Canadian equity markets – score high on quality metrics.

Slowing growth in Canada and higher rates create a better backdrop for fixed income assets. We think investors will be rewarded for taking a granular approach within bond allocations. On our six- to 12-month tactical horizon, we like short-term Canadian bonds for income. Over the strategic horizon we see a rise in term premium, or the compensation investors demand for the risk of holding long-term bonds. That makes us cautious on the long end.

We are underweight investment-grade credit, as tight spreads don't compensate for the expected hit to corporate balance sheets from rate hikes, in our view – both in Canada and globally. In Canada, corporate spreads have been held down by technical dynamics even as growth has slowed. Over a strategic horizon, we think private credit offers potentially attractive opportunities as banks pare back lending.

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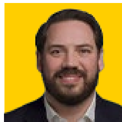

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The new regime of greater macro and market volatility has resulted in greater uncertainty and dispersion of returns. We believe an active approach to managing investment portfolios will carry greater rewards as a result. This is a sea change from relying on the one-and-done asset allocations that worked so well during the Great Moderation, the long period of stable growth and inflation. That period is over. We believe this is a time to grab the investing wheel – and seize the opportunities the new regime has on offer.

Higher rates and greater volatility define the new regime. It's a big change from the decade following the global financial crisis. Ever-expanding production capacity allowed central banks to stabilize economies and shore up growth through loose monetary policy. That helped suppress macro and market volatility, and stoked bull markets in both stocks and bonds. Investors could rely on static, broad asset class allocations for returns – and gained little advantage from differentiated insights on the macro outlook.

Today, we think the flipside is true. Production constraints abound. Central banks face tougher trade-offs in fighting inflation – and can't respond to faltering growth like they used to. This leads to a wider set of outcomes, creating greater uncertainty for central banks and investors.

There's a temptation to interpret the new regime by taking a classic business cycle view of the current environment, we believe. Markets are swinging between hopes for a soft landing and recession fears as a result. This misses the point: the economy is normalizing from the pandemic and being shaped by structural drivers: shrinking workforces, geopolitical fragmentation and the low-carbon transition. The resulting disconnect between the cyclical narrative and structural reality is further stoking volatility, we believe.

Seemingly strong U.S. growth actually reflects an economy that's still climbing out of a deep hole created by the pandemic shock – and tracking a weak growth path. What matters most, in our view, is that the environment implies persistently higher interest rates and tighter financial conditions. Financial markets are still adjusting to this new regime, and that's why context is key for *managing macro risk*, our first theme.

We think macro insights will be rewarded in the new regime. Greater volatility and dispersion of returns create space for investment expertise to shine, as detailed in our second theme – *steering portfolio outcomes*. This involves being dynamic with indexing and alpha-seeking strategies, while staying selective and seeking out mispricings.

One way to drive portfolio outcomes is by *harnessing mega forces* – our third theme. These are five structural forces we see driving returns now and into the future. They have become important portfolio building blocks, in our view.

Our bottom line for 2024: Investors need to take a more active approach to their portfolios. This is not a time to switch on the investing auto pilot; it's a time to take the controls. It's important to be deliberate in taking portfolio risk, in our view, and we expect to deploy more risk over the next year.

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Context is everything

Multiple times in 2023, market hopes have been revived that the U.S. economy can achieve a soft landing – or inflation getting back to the Fed's 2% target without a recession. What's fueling those hopes?

In contrast to other major economies, the U.S. grew at a robust clip in the third quarter of 2023. Core inflation has fallen sharply. And nearly 7 million new jobs have been created since January 2022 – a phenomenal pace of jobs growth compared with a typical economic expansion. See the chart top right.

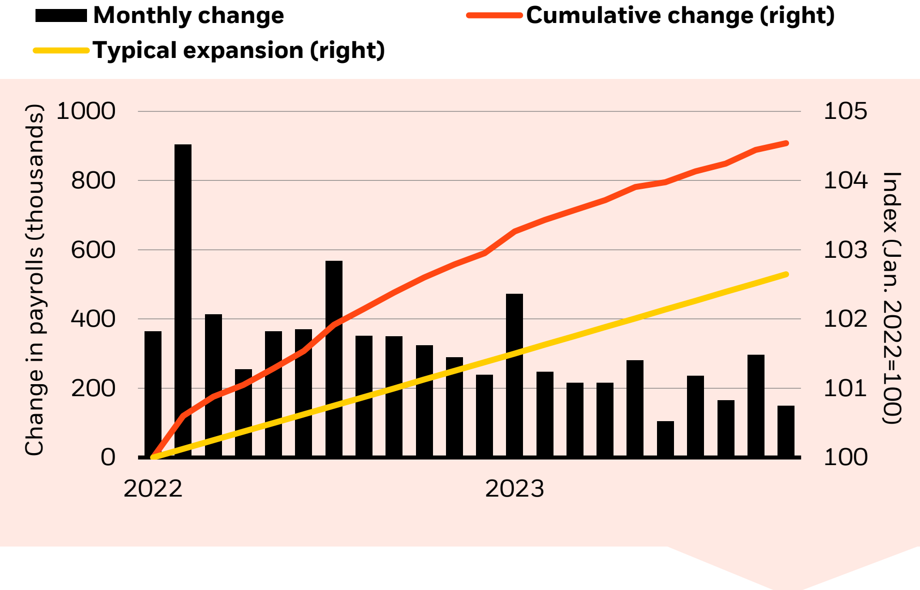
But zoom out and look at the bigger picture (chart below right): The economy has just been climbing out of the pandemic hole:

- Some 22 million jobs were lost when the pandemic struck. Strong job gains since then largely reflect the recouping of those lost. The level of employment is well below the track we would have expected to be on before the pandemic.
- Looking at broader economic activity, the U.S. economy has grown by less than 1.8% a year, on average, since the pandemic. That's well below the trend we would have expected pre-pandemic – and well below where the consensus and Federal Reserve had expected. That's nothing to be excited about.
- This resulted in even with more muted growth, historically low unemployment and higher inflation.

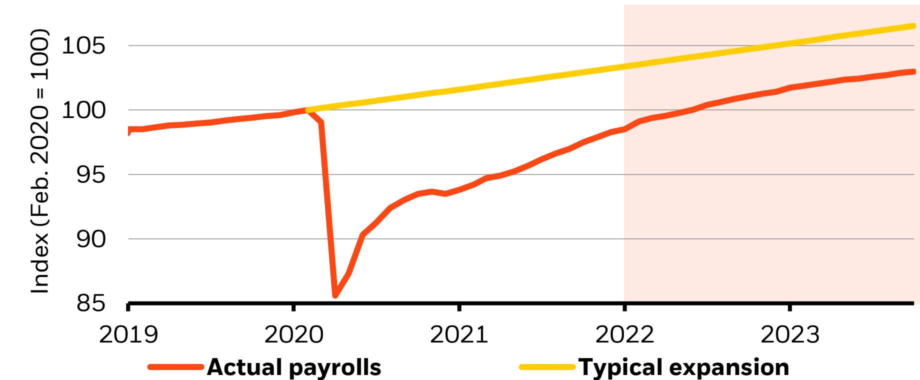
Our bottom line: Something has changed – and it's structural in nature. We are on a weaker growth path and got here with more inflation, higher interest rates and much higher debt levels. The upshot for investors? We think the key is to focus on how the economy and markets are adjusting to the new regime. Adopting the typical cyclical playbook may be misguided.

Strong employment gains...

U.S. payroll changes vs. typical expansion, 2022-2023 and 2019-2023



...but still climbing out of a deep pandemic hole



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, December 2023. Notes: The charts show U.S. nonfarm payrolls. The orange lines show the actual level of total nonfarm payroll employment indexed to two different start dates: in the upper chart, January 2022=100 and in the lower chart February 2020=100. The yellow lines in both charts show hypothetical payroll employment as if the economy had continued to grow at the average rate observed during U.S. post-1945 expansions. The black bars in the upper chart show actual monthly payroll gains (in thousands) since January 2022.

Structural shift

Markets have been flip-flopping between hopes for a soft economic landing and fears of yet higher rates that ultimately result in recession. This has created volatility, as the chart shows.

The U.S. economy has been navigating two large shocks, in our view. The first was the pandemic. Over the past two years, most new jobs created have been due to the restart of activity after shutdowns.

A shift in consumer spending drove up inflation by creating a mismatch between what people wanted to buy and what the economy was set up to produce. That mismatch is now resolving, and inflation has been falling as a result.

As the effects of the pandemic shock recede, the effects of the second, more structural one are becoming clearer: A worker shortage has emerged, as a growing share of the U.S. population ages into retirement.

That's why unemployment is at historic lows – even though U.S. growth has averaged well below its pre-Covid rate. See page 5.

The workforce is growing more slowly in Europe and China, too, and it's one of several long-term production constraints we think will prevent many economies from growing at their pre-pandemic pace without sparking renewed inflation.

Rising production costs in a fragmenting world will also push up inflation across major economies over the longer term, in our view. And the transition to a low-carbon economy is creating price pressures as the energy system is being rewired.

This means central banks face a tough trade-off. If they want to stop inflation resurging, they will need to keep policy tight. We think policy rates are poised to settle well above pre-pandemic norms. Ultimately, we see central banks living with higher inflation amid hefty government spending and debt loads.

Our bottom line: This is a regime of slower growth, higher inflation, higher interest rates – and greater volatility.

Yield swings on short-term surprises

Sensitivity of U.S. 10-year yield to economic surprises, 2003-2023

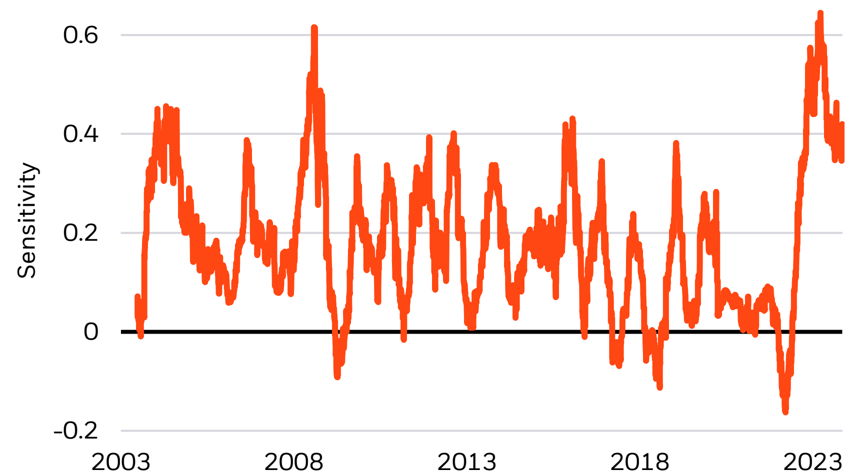


Chart takeaway: *Data surprises are driving the sharpest, sustained swings in U.S. 10-year Treasury yields of the past two decades. We believe this reflects greater uncertainty from investors still trying to view the economy through the lens of a typical business cycle.*

Source: BlackRock Investment Institute, with data from LSEG Datastream, December 2023. Notes: The chart shows how sensitive the U.S. 10-year Treasury yield is to economic surprises. This is calculated by using regression analysis to estimate the relationship between U.S. 10-year Treasury yields and the Citi Economics Surprise Index over a rolling six-month window. The sensitivity is how closely movements of the U.S. 10-year Treasury yield align with fluctuations in the Citi Economics Surprise Index, relative to how much the Surprise index itself varies. This analysis is only an estimate of the relationship between the 10-year Treasury yield and economic surprises. Past performance is no guarantee of future results.

If central banks want to stop inflation from resurging, we think they will need to keep holding back economic activity with higher policy rates.

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Managing macro risk

This is a regime shift, not about whether a recession happens. So it doesn't make sense for investors to wait for the macro environment to improve, in our view. We think investors should seek to neutralize macro exposures or – if they have high conviction – be deliberate about which exposures they take.

We see more scope to outperform the market now than in the less volatile Great Moderation. Production constraints abound. Central banks face tougher trade-offs in fighting inflation and can't respond to faltering growth like before. We think this leads to a wider dispersion of views.

For example, analyst estimates of future S&P 500 equity earnings are more dispersed now than before the pandemic, according to LSEG data. See the chart. They are having a harder time reading the earnings outlook. So macro insight is likely to be more rewarded.

Still, we think investors need to be alert to risks around macro exposures in the new regime.

First, markets are slowly adjusting to structurally higher inflation and policy rates, but it is uneven. U.S. 10-year yields surged to 16-year highs around 5%, for example. But most DM equity earnings yields haven't risen much. This adjustment matters more than if a technical recession occurs, in our view, and keeps us cautious on broad exposures.

Second, structurally lower growth and higher rates pose a problem for ballooning U.S. government debt. If borrowing costs from higher yields stay near 5%, the government could spend more on interest payments than Medicare in a few years. This increases the long-run risk of higher inflation as central banks become less aggressive on inflation.

We also see a rise in term premium, or the compensation investors demand for the risk of holding long-term bonds. This, plus our expectation of more yield volatility, keeps us tactically neutral and strategically underweight long-term U.S. Treasuries. Our largest strategic overweight is instead to inflation-linked bonds.

Adjusting to new regime

Dispersion of U.S. equity analyst earnings estimates, 1995-2023

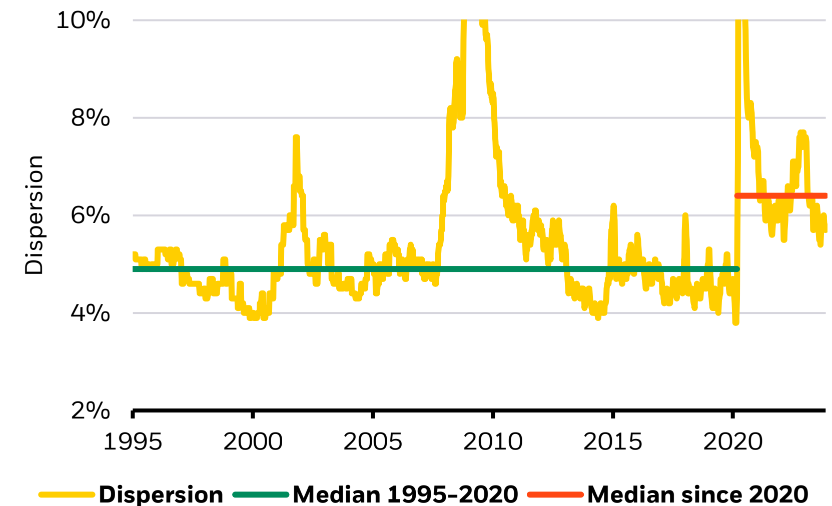

Chart takeaway: *During the Great Moderation, analyst views of expected company earnings were much more grouped together outside of major shocks. Now they are more dispersed, showing that an environment of higher inflation and interest rates makes the outlook harder to read.*

Source: BlackRock Investment Institute, LSEG Datastream, December 2023. Notes: The chart shows the aggregate standard deviation of analyst earnings estimates for S&P companies. The green line shows the median from 1995 to end January 2020, the orange line shows the median since February 2020

The macro outlook is more uncertain. Exposures to macro risk can be punished as well as rewarded, so we think investors should be deliberate about which exposures they take.

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Steering portfolio outcomes

Heightened volatility and dispersion call for an active approach to managing portfolios, in our view.

Structurally higher policy rates should eventually mean higher returns on all assets. But not all asset valuations have adjusted, we think. And static exposures to broad asset classes are unlikely to deliver the risk-adjusted returns they did during the Great Moderation's bull markets in both stocks and bonds.

We see alpha, or above-benchmark returns, playing a bigger role in the new regime – and believe a more dynamic portfolio approach is warranted when cash offers attractive returns.

What if you were able to accurately predict U.S. equity sector returns with perfect foresight? Acting on this hypothetical ability more frequently would have paid off much more since 2020 (see the right bars in the chart) than in the four years prior left bars). The upshot? Good insight, acted upon in a timely manner, has yielded greater rewards than buy-and-hold strategies since 2020.

Investors can also thrive in the new regime by getting granular with portfolio allocations. For example, returns on short-term Treasuries have outpaced those on long-term bonds since mid-July 2023, according to LSEG data, as investors started to demand compensation for taking long-term interest rate risk. Lastly, dispersion of returns has risen in the new regime. This means security selection is likely to be more impactful, in our view. We see a wide arsenal of tools and strategies to help outperform static portfolios. Investors can blend indexes to build core allocations, implement alpha ideas and hedge risk.

Our bottom line: Investment expertise is likely to give portfolios an edge in the new regime.

> **"Mega forces and the macro: these are inspirations, not constraints, in finding alpha."**

Raffaele Savi
Global Head of BlackRock Systematic

More dynamic

Hypothetical impact of rebalancing on U.S. equity returns

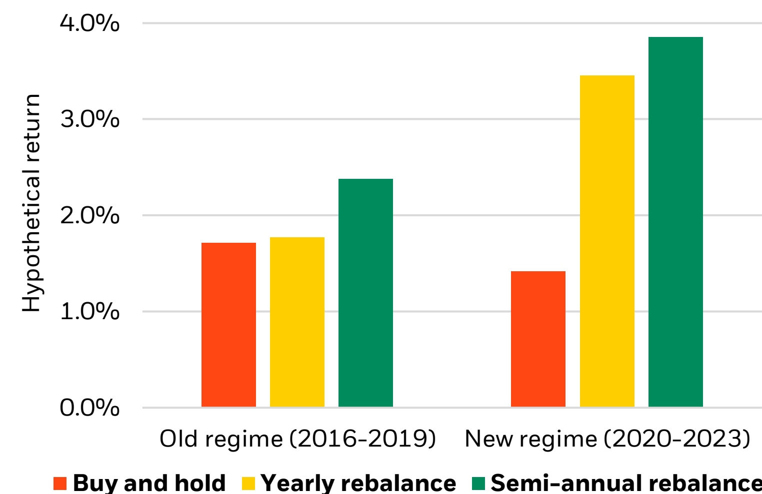

Chart takeaway: *Taking a more dynamic investing approach in in the new regime would have likely outperformed a buy-and-hold strategy to a much greater extent than before the pandemic.*

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 under three scenarios: keeping the holdings unchanged (buy-and-hold), yearly rebalances and semi-annual rebalances. The rebalances optimize the portfolio for returns, diversification and risk with perfect foresight of equity sector returns in the MSCI USA index. This analysis uses historical returns and has been conducted with the benefit of hindsight. Future returns may vary and these results may not be the same other asset classes. It does not consider potential transaction costs that may detract from returns. It also does not represent an actual portfolio and is shown for illustrative purposes only.

We believe the new regime rewards an active approach to portfolios. We don't see one-and-done strategies working as in the past.

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Harnessing mega forces

We think mega forces are another way to steer portfolios – and think about portfolio building blocks that transcend traditional asset classes. They stand out as drivers of corporate profits on their own, in our view, and so could offer potential opportunities that may be uncorrelated to macro cycles.

These forces are already reshaping markets. Take **digital disruption and artificial intelligence** (AI). The chart to the right illustrates the outperformance of U.S. tech relative to the broader market this year. We think this reflects how quickly markets embrace such fundamental shifts in the market outlook.

We think the winners and losers can broaden the AI tech stack. When incorporating this mega force into our tactical views, it can push up our stance on DM equities closer to neutral even if the macro backdrop isn't rosy. See pages 10 and 16.

That's just one example of why we think harnessing mega forces will enable investors to outperform simple, static allocations.

The far-reaching consequences of mega forces create new investment opportunities – and markets can be slow to price them in.

Capital pressures on banks are opening a path for private credit and non-banks to fill the lending void – part of the **future of finance**. Private credit can be an illiquid asset class not suitable for all investors.

Aging populations in major economies are poised to limit how much countries can produce and grow – depending on how they adapt in **demographic divergence**.

Climate resilience is emerging as a new investment theme within the **low-carbon transition**, in our view. As climate damages mount, we are seeing increased demand for solutions that help economies prepare for, adapt to and withstand climate hazards, and rebuild after damages. See page 11.

We see **geopolitical fragmentation and economic competition** driving a surge of investment in strategic sectors like tech, energy and defense. See page 12.

Mega force at work

S&P tech sector vs. S&P 500 performance, 2023 year-to-date

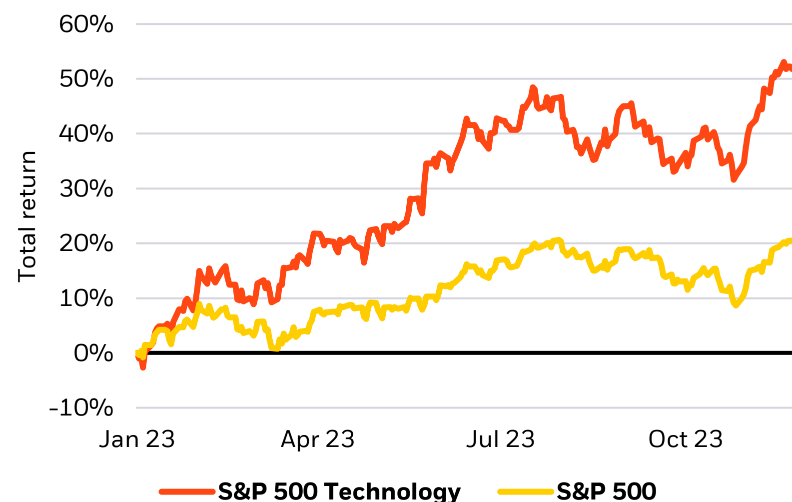

Chart takeaway: *Investor enthusiasm for AI and digital tech has offset the drag of rising yields. That has pushed U.S. tech stocks to easily outshine the broader market in 2023.*

Past performance is not a reliable indicator of future results. Index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from LSEG Datastream, December 2023. Notes: The chart shows the total year-to-date returns in U.S. dollar terms for the S&P 500 Technology sector (orange line) and the S&P 500 index (yellow line).

Mega forces are key drivers of the new regime, affecting the long-term growth and inflation outlook and creating shifts in profitability. We see them as a source of return now and far into the future.

AI: intelligence revolution

Advances in computing hardware and deep learning innovations led to an inflection point for AI in late 2022. We think advances from here are likely to be exponential as innovation snowballs.

Yet tracking investment opportunities across geographies and sectors comes with high uncertainty. The technology "stack" – layers of technology built on top of each other that enable further innovation — may offer a roadmap to help assess the investment opportunities. See the chart.

The bottom layer (in orange in the schematic) covers cloud infrastructure and chips – the building blocks. The second layer (in yellow) covers models, data and data infrastructure. The last layer – in white – comprises the apps that harness the innovation. We think we are somewhere between the first and second layers, with the last one likely coming next. We see the entire tech industry – led by a handful of large tech firms – pivoting their business focus to AI.

That suggests we may be just at the cusp of this intelligence revolution, in our view. Implications likely go beyond the near-term focus on productivity gains. Our early research shows a potential positive correlation between a pickup in AI patents and broad earnings growth.. We also find that investors are ascribing a rising economic value to these patents. Yet not all patents lead to profitable enterprises, and their future value is highly uncertain.

We're overweight the AI theme in DM stocks on a six-to-12-month horizon. We see the tech sector's earnings resilience persisting and expect it to be major driver of overall U.S. corporate profit growth in 2024.

> **AI is a major positive – both for earnings growth and productivity."**

Simona Paravani-Mellinghoff
Global CIO, BlackRock Multi-Asset Strategies & Solutions

The AI technology stack

BlackRock view of tech need to develop AI applications, December 2023

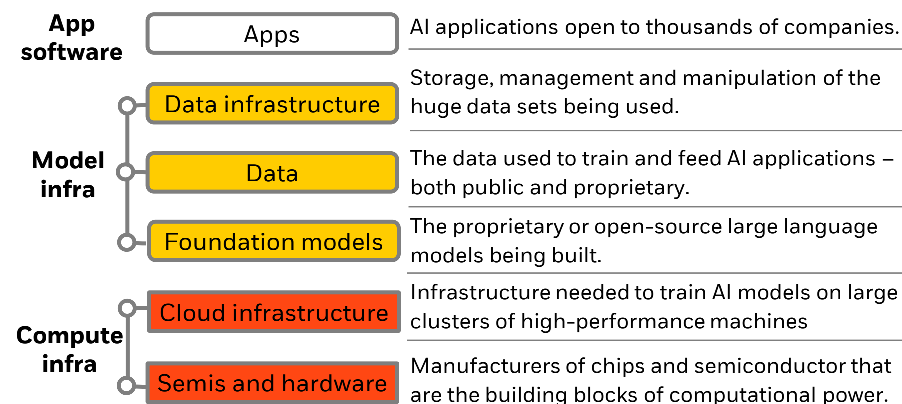

Chart takeaway: *We see investment opportunities moving up the stack as technology evolves – from hardware manufacturers to digital and data infrastructure and ultimately to applications.*

Source: BlackRock Investment Institute, December 2023. Notes: The schematic shows the technologies we think will be needed to develop AI applications. Each layer builds on the one preceding as technologies get "stacked" on top of one another, enabling further innovation. The schematic is for illustrative purposes only and intended as a guide based on what we know today. As the AI ecosystem evolves, some categories may be replaced by newer ones. References to securities are shown for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell.

We think the overarching race to build the smartest machines is akin to a revolution – like the industrial and information revolutions of the past.

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Investing in climate resilience

The low-carbon transition is one of the five mega forces playing out in markets today. We launched the BlackRock Investment Institute Transition Scenario to help investors navigate its risks and opportunities, with a focus on the energy transition. This is not just about identifying opportunities in renewables; traditional energy companies can also outperform, especially when there are supply-demand mismatches.

The energy transition tends to get the headlines, but we see a related theme becoming an important investment story: climate resilience. This is the ability to prepare for, adapt to and withstand climate hazards, and to rebuild after climate damage. Think early monitoring systems to predict floods, air conditioning to cope with heatwaves, or retrofitting buildings to better withstand extreme weather. With climate damages set to keep mounting in coming years, it will take extensive investment to build society's resilience to them.

Just how big will those damages be? It's hard to put a number on the impact on human health and well-being. The quantifiable economic damage is growing fast, as the chart shows. We already see demand growing for products and services that build climate resilience. Markets may be underappreciating how this can become a mainstream investment theme over time.

In our recent paper, we divide this theme into three sub-themes: assessing and quantifying risks, managing risk and rebuilding physical infrastructure. That helps us build a framework to identify opportunities that cut across sectors, such as industrials and technology, and asset classes.

We see opportunities in climate resilience solutions offering flood, fire and drought resistance."

Olivia Markham
Portfolio Manager,
Thematic and Sectors,
BlackRock
Fundamental Equity

Real physical damages mount

U.S. events with inflation-adjusted losses of $1 billion, 1985-2023

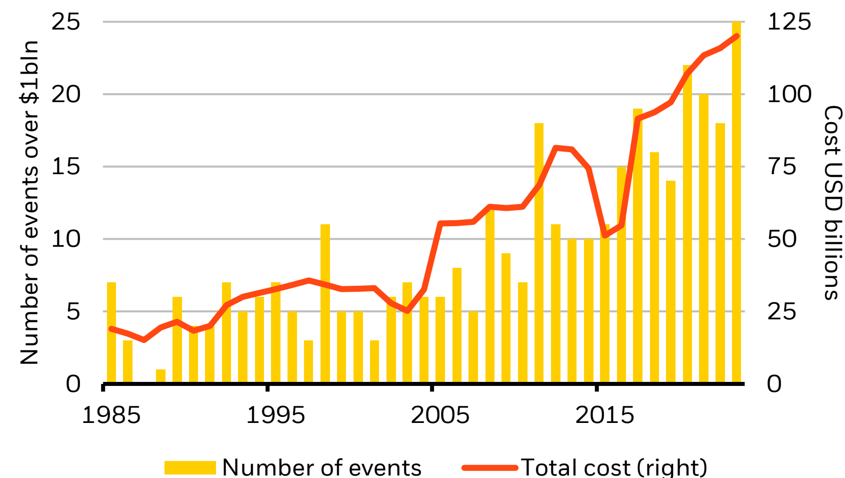

Chart takeaway: *The number of climate-related events with damages totaling more than $1 billion has steadily increased over the past roughly three decades. The U.S. hit a record number of such events just nine months into 2023.*

Sources: NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2023), December2023. Notes: The bars (yellow) show the number of climate events with losses greater than US$1 billion. The data include droughts, flooding, severe storms, hurricanes, wildfires, winter storms and freezes. The orange line shows the total cost as a 10-year rolling average. The data are adjusted for inflation using 2022 dollars. All currency figures are in U.S. dollars.

Markets may be underappreciating the prospects for climate resilience to become a mainstream investment theme over time, we think.

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Deepening fragmentation

Cascading crises have accelerated global fragmentation and the rise of competing geopolitical and economic blocs, in our view. Our BlackRock Geopolitical Risk Indicator is elevated – see chart – suggesting markets are paying more attention than before.

Should investors hunker down as a result – and keep their investments close to home? We don't think so. The new mantra of resilience over economic efficiency may raise costs – but also presents opportunities. Countries like Vietnam and Mexico could benefit from the diversification of supply chains, in our view. And we see opportunities in the Gulf states, India and Brazil. They are pursuing ties with multiple blocs and have valuable resources and supply chain inputs.

In this more competitive world, we expect a surge of investment in strategic sectors like tech, energy, defense and infrastructure. We also see opportunities in firms with expertise in managing and reducing cybersecurity risks.

War in the Middle East, ongoing conflict between Russia and Ukraine, and structural competition between the U.S. and China mean increased geopolitical risks. The number of volatile situations worldwide is the highest in decades, according to the UN. And 2024 is set be the biggest election year in history, with more than half the world population voting. We see the U.S. and Taiwan elections as particularly significant.

Navigating this new world order isn't necessarily about avoiding risks or positioning for specific events, in our view, but about whole portfolio strategies that aim to both seize its opportunities and mitigate risks.

> **"Repeated shocks are driving long-term, structural changes in the world order."**

Tom Donilon
Chairman, BlackRock Investment Institute

Paying more attention

BlackRock Geopolitical Risk Dashboard, 2018-2023

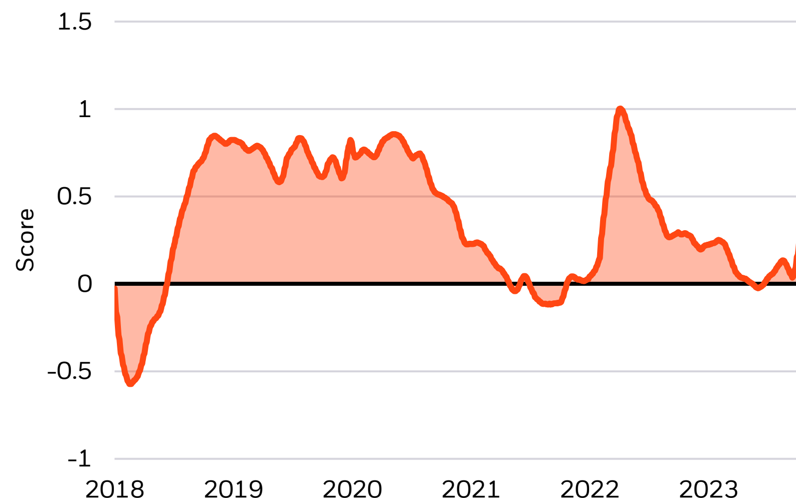

Chart takeaway: *Market attention to geopolitics has hit its highest this year, according to our BlackRock Geopolitical Risk Indicator.*

Source: BlackRock Investment Institute. December 2023. The BlackRock Geopolitical Risk Indicator (BGRI) tracks the relative frequency of brokerage reports (via LSEG) and financial news stories (Dow Jones News) associated with specific geopolitical risks. We adjust for whether the sentiment in the text of articles is positive or negative, and then assign a score. This score reflects the level of market attention to each risk versus a 5-year history. We assign a heavier weight to brokerage reports than other media sources since we want to measure the market's attention to any particular risk, not the public's.

The rewiring of economic ties along geopolitical lines is set to accelerate. We are focused on the investment opportunities this creates.

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Moving away from home

We see greater dispersion of returns unfolding across global markets, creating opportunities for investors who look beyond their home markets. We get selective across regions and countries, assessing valuations, earnings prospects and what's in the price.

Take Japan. We think 2023 was a pivotal year for the country. We upgraded Japan twice this year on appealing valuations, earnings growth, and as corporate reforms aimed at boosting shareholder take root. It remains our strongest DM equity view. Investors are latching on, partly explaining the broad market's surge this year.

Under the hood, a more nuanced move is unfolding. The chart shows the outperformance this year of companies that sit at the low end of price-to-book ratios – a reflection of investors getting in front of more value-enhancing measures coming at such firms. We still see overall valuations as attractive. One risk is potentially tighter monetary policy – and why we prefer to take equity risk without hedging for currency.

We have maintained a broad preference for emerging market (EM) assets over DMs. EMs are not disconnected from global growth, so selectivity is important, in our view.

Mega forces may offer abundant EM equity opportunities. India's system of digital payments bodes well for the future of finance there. We believe it could pave the way for a credit boom as banks adapt lending. We think the low-carbon transition presents an important opportunity for Latin America, especially for countries that hold large reserves of key resources like copper and lithium. And U.S. companies bringing operations and production closer to home could benefit countries like Mexico.

Japan and India are among the beneficiaries from global fragmentation."

Belinda Boa
CIO of Emerging Markets, BlackRock Fundamental Equity

Reforms take root

Japan: equity relative performance by price-to-book ratio, 2023

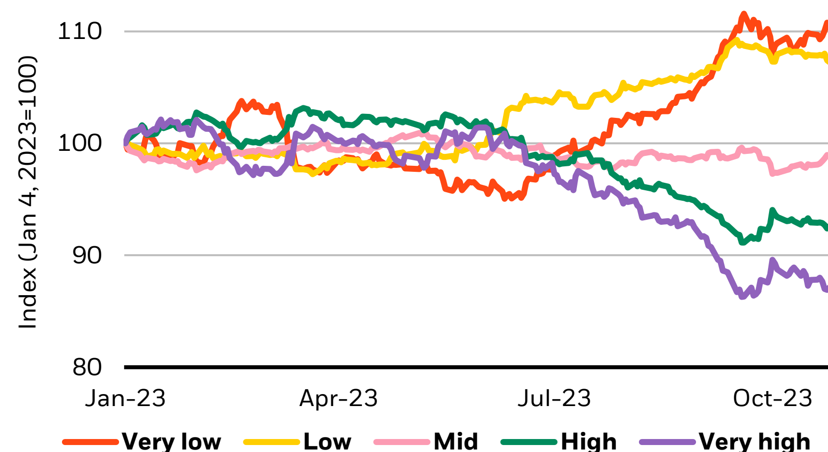

Chart takeaway: *Shares of Japanese firms with low price-to-book ratios have outperformed as investors anticipate such companies will double down on steps to boost shareholder value.*

Past performance is no guarantee of future results. Source: BlackRock Investment Institute, with data from QUICK and Daiwa. December 2023. Notes: The chart illustrates the year-to-date rebased performance of the TOPIX index constituents, grouped into five buckets based on their price-to-book (P/B) ratios. The process of grouping involves arranging the constituents in ascending order by their P/B ratios and then dividing them into five market-cap-weighted buckets, ensuring each bucket represents an equal segment of the market's total capitalization. For example, the "Very low" bucket comprises constituents with lowest P/B ratio. The buckets are rebalanced monthly.

Selectivity across geographies is an important layer of our playbook that aims to achieve above-benchmark returns in the new regime.

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Real estate opportunities

We think inflation will be structurally higher and see real estate and infrastructure playing a key role in strategic portfolios as a result. Why? Some real asset values or cash flows are linked to measures that correlate with inflation – think property prices or rental income.

But the macro matters here too. Low interest rates – previously a benefit to returns – have given way to structurally higher financing costs. The question now: how much is in the price today? We had expected valuations for core real estate to adjust to rising interest rates and financing costs – leading us to turn cautious on the asset class in June 2022.

Valuations have adjusted – but we think there's more to go. Capitalization (cap) rates – the ratio of a property's income to its price – are the commonly referenced valuation metric for real estate. As rates and yields surged, we expected cap rates for both private and public real estate to rise, too.

The reality? Cap rates for U.S. core real estate funds have moved less than publicly traded real estate investment trusts (REITs). See the chart. We think this shows public markets better reflect the new backdrop.

Cap rates at the aggregate level aren't the full story given large dispersion across geographies, sectors and strategy types. Plus, the nature of the underlying assets is why they differ in their relative attraction. U.S. REITs invest in a wider array of properties than core real estate funds, such as data centers and healthcare. That means some REITs could be more resilient to a weaker economy – and is why it's key to go beyond a simple mantra of buying real estate in inflationary times.

Our bottom line: Some public real asset prices have adjusted more than some private counterparts. Capturing the opportunities requires selectivity, understanding what's in the price and having the agility to shift between real assets at a granular level, in our view.

Private lags public

Real estate capitalization rates, 2017-2023

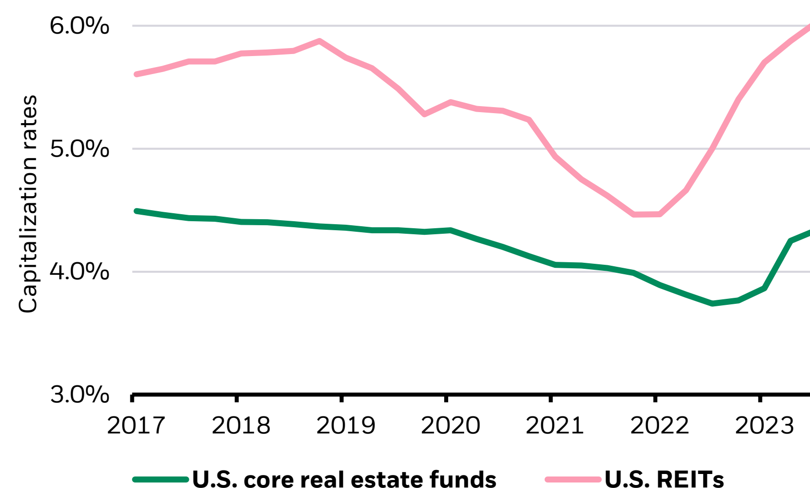

Chart takeaway: *Real estate investment trusts (REITs) valuations have reacted to rising interest rates faster and further than private real estate. We think that makes publicly listed REITs more attractive relative to private real estate.*

Sources: BlackRock Investment Institute, NCREIF and Greenstreet, December 2023. Notes: The chart shows historical capitalization rates (green line) and REITs (pink line). Past performance is no guarantee of future results.

Real estate valuations have adjusted differently to the new regime. We think structurally higher inflation should benefit real assets in strategic portfolios longer term.

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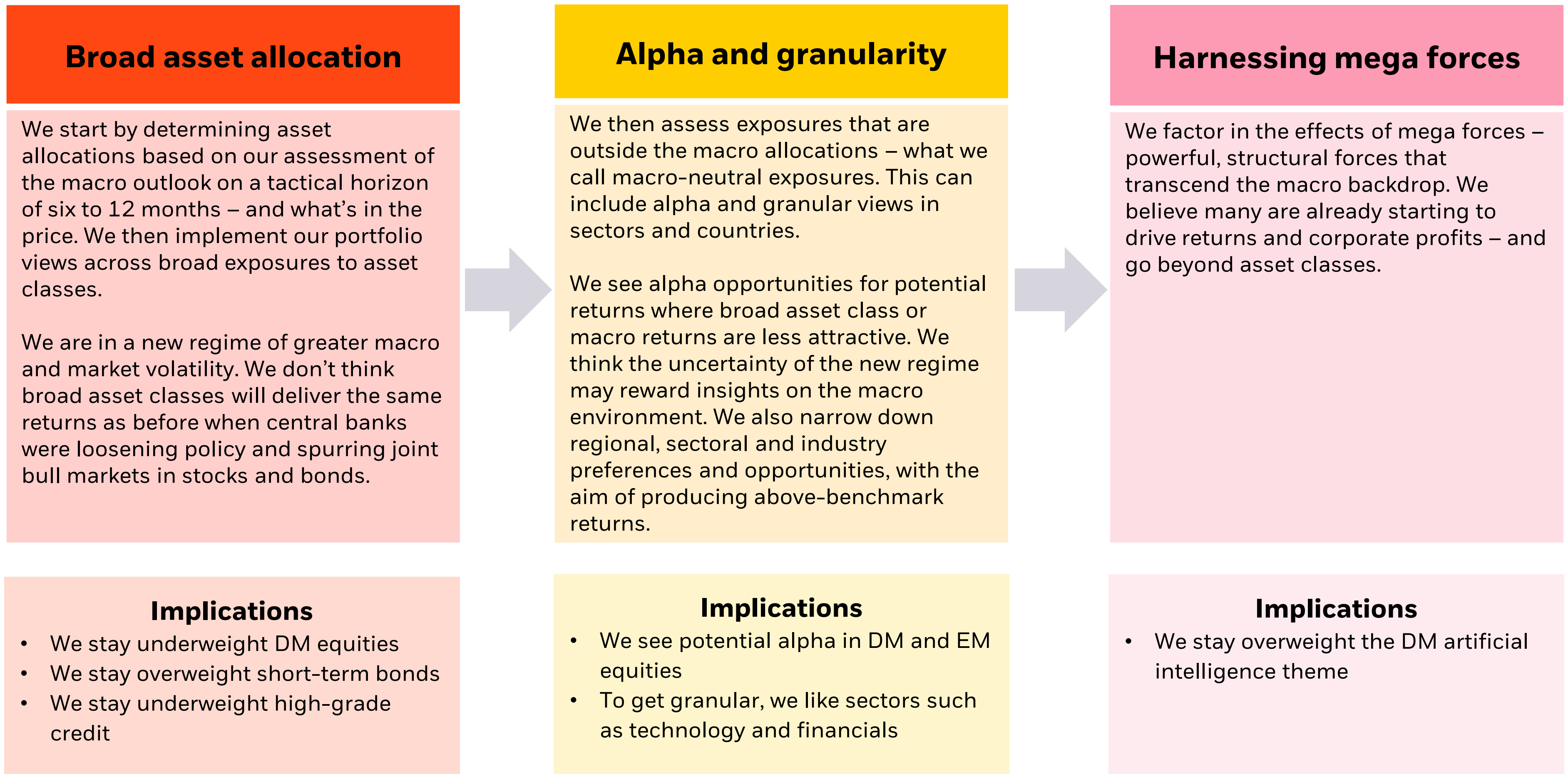
Behind the views

Explaining our approach to tactical asset allocation

Broad and static investment solutions won't take you as far in this new regime as in the past, in our view. We think it calls for selectivity and granularity instead. We further extend our investment playbook to include alpha.



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Dynamic and nimble

Our core conviction is that investors need to be more dynamic with portfolios in the new regime. The one-and-done approach to asset allocation simply won't work as it did before.

We have updated how we present both our tactical and strategic views to focus on where we have the strongest conviction on both time horizons – but with an emphasis on staying nimble and getting granular. We also break down how we now build on our macro view at the asset class level to incorporate a view of where we see potential return opportunities outside of such broad exposures.

On a tactical horizon, our overall macro view would keep us underweight DM equities as a standalone because we expect growth to stay stagnant with persistent inflation, prompting central banks to keep policy rates higher for longer. But we find greater alpha opportunities in DM stocks. When incorporating the AI theme and alpha, our overall view is more neutral on U.S. equities. See the example on the right. We stay positive on Japan as laid out on page 13. And we keep favoring the AI theme in DM stocks.

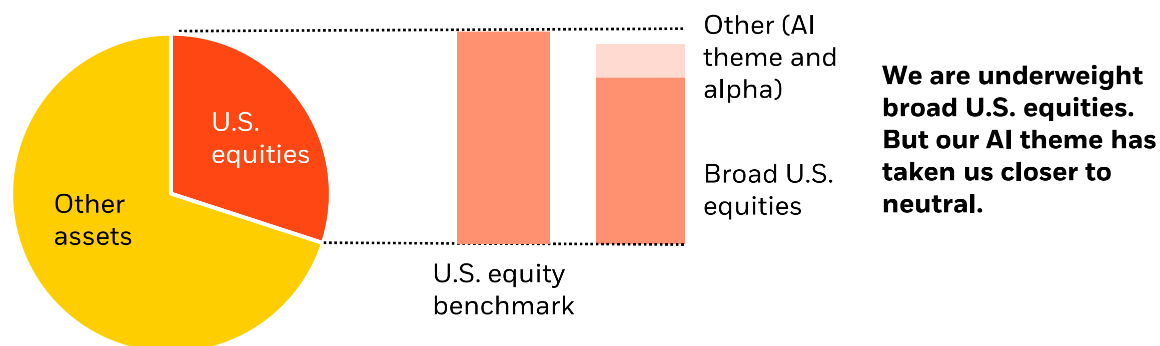
Strategically, it is more of an income story. Our inflation view keeps us maximum overweight inflation-linked bonds. We still like income within private markets. And within DM government bonds, we still prefer short- and medium-term maturities.

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 see 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 (see page 13) 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.

Deep dive of including the mega force overweight on overall U.S. equity view



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.

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Tactical 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. It 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 it is creating more space for alpha. For example, the alpha opportunity in highly efficient DM equities markets historically has been low. That's no longer the case, we think, thanks to greater volatility, macro uncertainty and dispersion of returns. The new regime puts a premium on insights and skill, in our view.

Equities	View	Commentary
U.S.	-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, multi-sector AI-centered investment cycle unfolding, likely supporting 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.

Underweight | Neutral | Overweight | ● Previous view

Fixed income	View	Commentary
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 (previous view: +1)	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 (previous view: +1)	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 (previous view: +1)	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 (previous view: -2)	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 (previous view: -1)	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.
EM 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.
EM 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.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. The statements on alpha do not consider fees. 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 or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

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