Investment Directions

iShares by BlackRock

Fall 2024: Implementing ideas for today's market

Key takeaways

Macro

Our base case is for U.S. growth to gradually slow but remain positive

However, a cooling economy is more vulnerable to exogenous shocks, and we look ahead to potential volatility-inducing events, including the U.S. election.

Fixed Income

Timing and curve positioning are key in cutting cycles

We believe modestly extending duration to the belly of the curve early in the U.S. cutting cycle will be most rewarded.

Equity

We maintain our preference for quality and dynamic allocations, with an eye to valuations

Near term pullbacks can create opportunities to allocate to high quality companies, though we remain cautious on mid- and small-cap names.

Our macroeconomic outlook

The U.S. economic data has remained resilient but shows signs of slowing growth. While wage growth was strong in August, the three-month average employment gain was the weakest since the pandemic, averaging +116,000 jobs per month.[1] To us, that shows clear evidence of a cooling labour market, but not one hurtling toward a recession. Our base case calls for U.S. growth to gradually slow but remain positive.

The U.S. Federal Reserve (Fed) cut rates by 0.50% at its September meeting, initiating a cutting cycle 14 months after the last hike. We expect further rate cuts at the November and December meetings this year, but ultimately believe the market may be pricing in more rate cuts than will be delivered. The divergence of policy rates from expectations could have important near-term implications in fixed income and equity market performance.

Our main takeaway from the FOMC meeting was that the Fed will be proactive in their risk management approach and has room for further cuts if the data requires. With inflation moving towards the Fed's 2% target, the Committee's focus going forward will be more evenly distributed between labour markets and inflation.

We believe the cutting cycle is the time to move out of cash and take advantage of higher rates before they drop meaningfully. Our analysis shows that fixed income markets have historically outperformed cash during rate cutting cycles (Figure 1). The Fed's new focus on both sides of their dual mandate increases our conviction that intermediate duration fixed income can act as a diversifier to equities, if growth deteriorates from here.

Our highest-conviction ideas:

Ticker	Fund
XFLX	iShares Flexible Monthly Income ETF (CAD-Hedged)
XIGS	iShares 1-5 Year U.S. IG Corporate Bond Index ETF (CAD-Hedged)
XAGH	iShares U.S. Aggregate Bond Index ETF (CAD-Hedged)
XQLT	iShares MSCI USA Quality Factor Index ETF
XVLU	iShares MSCI USA Value Factor Index ETF
XMU	iShares MSCI Min Vol USA Index ETF
XEMC	iShares MSCI Emerging Markets ex China Index ETF
XEF	iShares Core MSCI EAFE IMI Index ETF
CGL.C	iShares Gold Bullion ETF

See pp. 2-9 for full implementation by asset class.

There is no guarantee that any forecasts made will come to pass.

All figures are in U.S. dollars, unless stated otherwise.

References to specific investments are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such investments.

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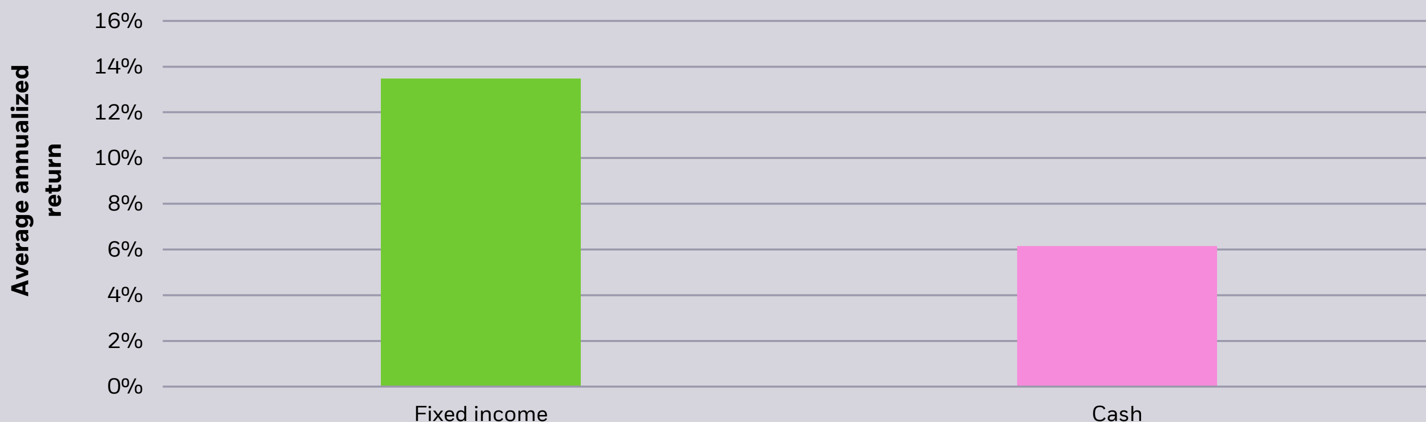
Figure 1: Fixed income has averaged higher returns than cash during interest rate cutting cycles

Average annualized returns of fixed income and cash during interest rate cutting cycles



Source: BlackRock, Bloomberg. As of September 12, 2024. Fixed income represented by the Bloomberg Aggregate Bond Index (LBUSTRUU Index). Cash represented by the ICE BofA US 3-month Treasury Bill Index (G0O1 Index). Cutting cycles defined by the change of Federal Reserve Fed funds rate during the following periods: 3/10/1970 to 2/9/1971; 8/20/1974 to 5/20/1975; 8/7/1981 to 12/20/1982; 9/19/1984 to 8/16/1986; 6/5/1989 to 9/4/1992; 7/6/1995 to 1/31/1996; 1/31/2001 to 6/25/2003; 9/18/2007 to 12/15/2008; 8/1/2019 to 3/15/2020. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results..

Equity markets have also historically done well during cutting cycles, but performance has significantly lagged in rate cut cycles that end in recession.[2] While a recession is not our base case, some of the metrics that the National Bureau of Economic Research uses to determine the health of the economy are already beginning to moderate. This risks volatility ahead as markets become more sensitive to economic data, as was seen over the summer. Furthermore, we anticipate higher volatility tied to the U.S. election.

Figure 2: Asset class performance following previous Fed cuts

Historical 12m forward returns for the S&P 500, the Bloomberg Aggregate Bond Index, quality equities, and small cap companies after the first Fed cut of a cycle.

				12m forward return (%)			
First Fed cut	**Real GDP growth**	**Inflation (core CPI YoY%)**	**Unemployment rate (%)**	**S&P 500**	**BBG Agg**	**Quality equities**	**Russell 2000**
Jul '74	-3.7%	8.8%	5.4%	15.7			
Apr '80	-8.0%	13.0%	6.9%	40.6	13.0		65.5
Jun '81	-2.9%	9.4%	7.5%	-10.8	14.9		-21.0
Oct '84	3.9%	4.9%	7.4%	17.5	22.0	17.6	8.9
Jun '89	3.1%	4.5%	5.3%	17.8	8.8	21.2	-1.2
Jul '95	3.5%	3.0%	5.7%	21.4	2.6	22.4	20.2
Jan '01	-1.3%	2.6%	4.2%	-12.4	7.9	-11.6	3.8
Sep '07	2.3%	2.1%	4.7%	-18.8	5.4	-15.5	-9.1
Jul '19	3.5%	2.2%	3.7%	11.9	10.1	18.0	-4.6
Mar '20	-5.3%	2.1%	4.4%	29.4	0.5	27.8	50.5
Sept '24	3.0%	3.2%	4.2%				

Source: Bloomberg. S&P 500 as represented by S&P 500 Index, BBG Agg as represented by Bloomberg Aggregate Bond Index, Quality equities as represented by MSCI World Quality Index, Russell 2000 as represented by Russell 2000 Index. 12m forward return as rebased to 0 on the date of the Fed cut. Red lines indicate periods of recession as shown by negative GDP growth. As of September 1, 2024. *Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.*

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Timing and curve positioning are key

Timing and curve positioning are key in cutting cycles. We believe modestly extending duration to the belly of the curve early in the cutting cycle may be most rewarded. And yet, positioning data shows that investors continue to allocate to money market funds, with YTD inflows reaching new records.[3] While history tells us MMF outflows typically do not occur until later in the Fed's easing campaign, that same lookback shows that unwinding cash positions in favour of longer-dated fixed income allocations have tended to outperform when done earlier in the cycle.[4] Any back up in yields could represent an opportunity for investors to move out on the curve and reduce an overweight allocation to cash.

Figure 3: Investors have poured into cash since the pandemic

Money market fund AUM since 2007

Source: BlackRock, EPFR. As of September 15, 2024.

We believe fiscal policy can continue to weigh on the long end of the yield curve, regardless of the election outcome. While the front end of the curve trades on monetary policy, the back end is more closely tethered to Treasury issuance, fiscal spending, and normalizing term premium – a slew of catalysts likely to keep longer rates more elevated as the curve continues to steepen. With government spending unlikely to slow regardless of the election's outcome and U.S. debt already breaching new highs each month, there's precedent for rapid rate fluctuations in the long end of the curve – an unfavourable risk-reward profile.

Our preferred duration is the 3-7 year 'belly' of the curve. While the current level of yields has fallen over the past few weeks, the exposure remains attractive. Consider that the belly is currently yielding more than the long bond averaged in the last ten years.[5] We like locking up yields at the start of the Fed's easing cycle and look for any backup in rates as a buying opportunity. Additionally, the Agg's performance over the current Fed pause period has lagged the exposure's historical average for previous pauses, and we think that underperformance likely hails from the factors impacting the long end of the curve – our preferred duration is the belly as those headwinds remain (Figure 4).

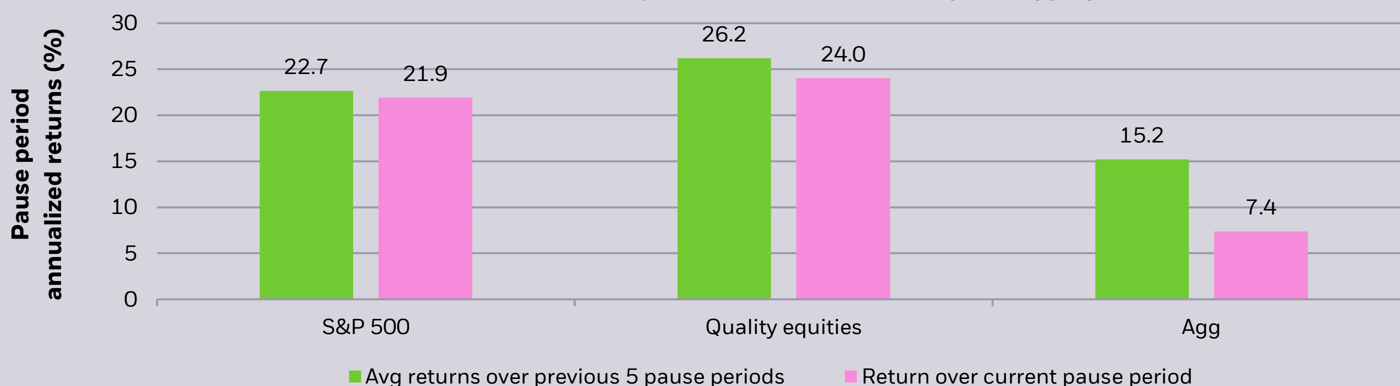
Duration extension

XIGS — **iShares 1-5 Year U.S. IG Corporate Bond Index ETF (CAD-Hedged)**

XAGH — **iShares U.S. Aggregate Bond Index ETF (CAD-Hedged)**

Fixed income

Figure 4: Fixed income markets have underperformed historical pause period returns
Pause period annualized returns of the S&P 500, quality stocks, and the Bloomberg U.S. Aggregate Bond Index



Source: Bloomberg, BlackRock. S&P as represented by S&P 500 Index, Quality equities as represented by MSCI World Quality Index, Agg as represented by Bloomberg Aggregate Bond Index. Pause periods as represented by the Fed's final hike on 2/1/1995, 3/25/1997, 5/16/2000, 6/29/2006, and 12/19/2018. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Past performance does not guarantee future results.

Stock-bond correlations are back in negative territory, adding to fixed income's appeal. This was most clear in performance during the first week of September: as the S&P 500 sank 4% on labour market fears, the Agg posted positive returns and broke the months-long positive relationship.[6] Look to the fixed income as both a potential source of diversification and income, but the fluctuating nature of that relationship also has us considering other diversifiers (*see Whole Portfolio*). We also see opportunities in EM debt, with continued deceleration in inflation and potential improvements in the global rate environment in the second half of 2024. Currently, we favour hard currency debt over local currency debt given our view that the USD will likely remain rangebound from here.

Given strong corporate fundamentals, we look to high yield bonds and structured credit to potentially add income to portfolios. Default rates remain below long-term averages but have ticked higher. High yield markets have been in negative net issuance and net leverage has come down across all ratings.[7] Even as the Fed kicks off their easing campaign, we expect rates to remain in restrictive territory. Consequently, the importance of selectivity in high yield markets to screen for companies able to balance still-high rates amid slowing growth increases.

EM Debt

XEB — **iShares J.P. Morgan USD Emerging Markets Bond Index ETF (CAD-Hedged)**

Seeking income

XFLX — **iShares Flexible Monthly Income ETF (CAD-Hedged)**

XHY — **iShares U.S. High Yield Bond Index ETF (CAD-Hedged)**

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Opportunity in volatility

Our equity outlook acknowledges the likelihood of volatility in the coming months. More than anything, markets dislike uncertainty, and election years often provide plenty. Our analysis underscores that relationship – equity volatility historically tracks higher in the 90 days preceding elections than the 90 days following them.[8] September and October have historically been the most negative months for U.S. equity performance, a seasonal trend that is only exaggerated in election years. And U.S. equities sit near all-time highs, accompanied by relatively rich valuations – a demanding setup for a challenging period.[9]

We also see opportunity in volatility. We like using any near-term pullbacks to allocate to high quality companies across a range of styles and sectors trading at reasonable valuations. We expect that risk taking to be rewarded later in the year with greater clarity over the cutting cycle and resolution of election uncertainty providing additional tailwinds.

We maintain our preference for quality-style strategies, which have outperformed the market this year, but that spread has been accompanied by increasing concern over valuations.[10] The richening in quality has been driven to a significant degree by the rising valuations of its technology-sector constituents. To date, technology's higher multiple has been justified by its rapid earnings growth, but consensus estimates forecast earnings growth rate to decelerate from here.

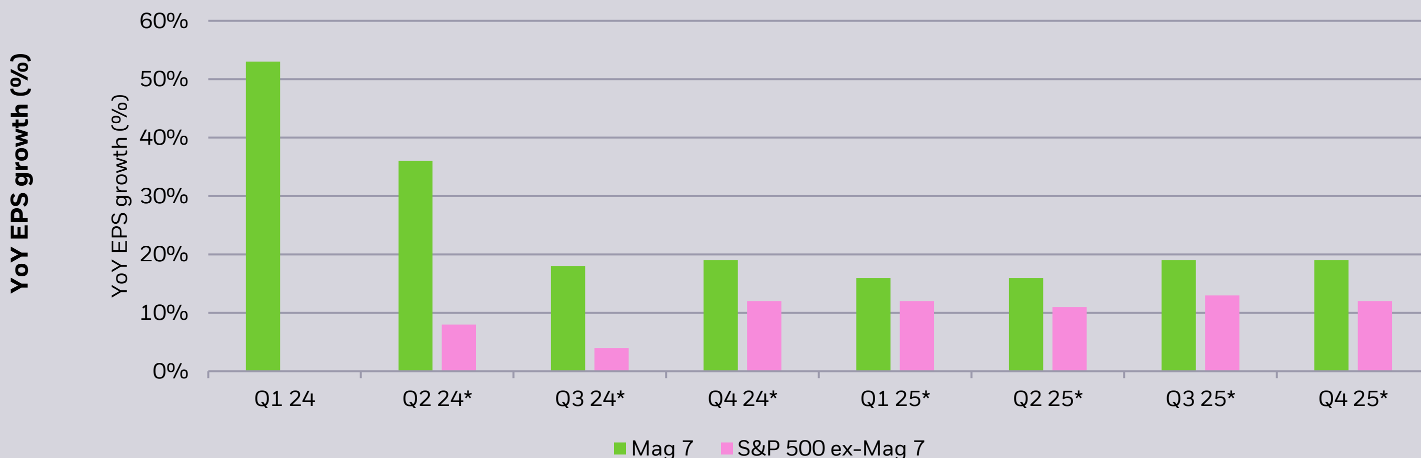
The yawning gap in earnings growth between technology and 'the rest' is set to narrow, an important catalyst to the broadening out trade that we expect to continue in 2025 (Figure 5). For this reason, we favour a sector-neutral approach to quality, seeking companies with quality attributes across sectors and industries rather than simply tilting more deeply towards technology. We would also supplement this core exposure to quality with selective allocations to industries and sectors that have not participated to the same degree in the market's rally and have further room to run.

Quality

XQLT | **iShares MSCI USA Quality Factor Index ETF**

Figure 5: Earnings growth expected to improve for 'the rest'

YoY earnings growth expectations for the Magnificent 7 and the S&P 500 ex-Mag 7



Source: BofA US Equity & Quant Strategy, Factset. As of September 10, 2024. There is no guarantee that such projections will come to pass.

Equity

A steepening yield curve with falling short rates should benefit exposures with value-tilts like financials, and lower rates and earnings growth can continue to benefit utilities.

- In addition to improving fundamentals, utilities have come into focus as a second order beneficiary of the AI build out. So far this year, investment into data centre construction has swelled - the dollar amount behind the buildout between January and July alone is nearly double the annual average amount over the last decade.[11] We think we are still in the early stages of this build and expect the historic capex cycle to continue to grow from here. Utilities have netted standout inflows so far this year on optimism for data centre buildouts (and the corresponding upped electricity demand)[12] We remain constructive on the sector and think the rally can extend from here – higher demand, reasonable valuations, and lower rates are all likely to provide further tailwinds.

Figure 6: Data centre construction investment continues to climb

Total USD investment into data centre construction

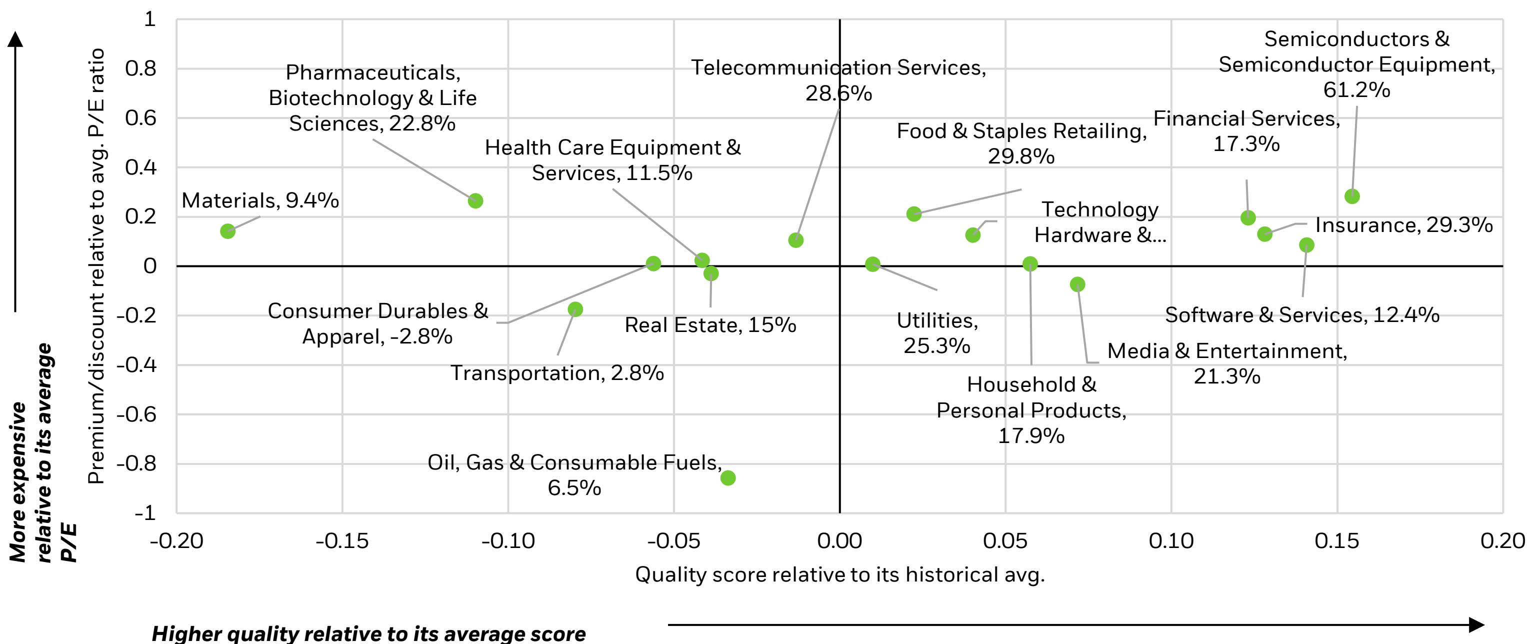
Source: United States Census Bureau. July -24p represents projected July 2024 spend. As of September 18, 2024.

- **Financials can benefit from a steeper curve and lower short rates through improved net interest margins**. We see opportunities to get more granular in the sector. We believe investment banks are particularly well-positioned, as lower financing rates should unlock the bottleneck in corporate actions like leverage buyouts and mergers. Broker-dealers may also be beneficiaries, as lower rates will support the already record pace of bond issuance, driving underwriting fees and volumes on trading desks.[13] Finally, insurance companies screen especially well on quality and valuation (Figure 7).

Sector opportunities

XUSF	**iShares S&P U.S. Financials Index ETF**

Figure 7: We remain constructive on high quality equities, but weigh rich valuations



Source: BlackRock, Bloomberg. Industries as represented by Global Industry Classification Standard (GICS). Premium/discount relative to average P/E ratio as determined by current 12m forward P/E ratio relative to its 5Y average P/E ratio (as determined by Bloomberg). Quality score relative to its historical average as determined by current quality score (quality defined by GPS Investment Strategy) relative to its 5Y average quality score. As of September 16, 2024.

Equity

From a portfolio perspective, the large outperformance of growth over value, and tech over the rest, may leave investors more heavily overweight growth and tech than they intended. Value currently represents its smallest weight in the S&P 500 in the last 25 years, and as such, rebalancing flows into the end of the year may provide a tailwind to value exposures.[14] Investors who have been disappointed with value index returns over the last decade may be turning to proven value managers to get back to a more even value and growth split - the Morningstar Large Value ETF category (U.S.-listed ETFs) has seen most H1 flows into active funds (59% vs. 41% index), a dramatic divergence from the growth ETF trend (93% of flows into index).[15]

Though July and early August saw elevated U.S.-listed ETFs flows into small caps, we think this is a moment to consider reallocating from mega-cap to large-cap, rather than from large- to mid or small.[16] Based on Fed forecasts for rates in their September Summary of Economic Projections (SEP), rates will remain close to 3% for the next two years, while economic growth will slow from current levels. While high beta small caps can post sharp rallies on rapid shifting narratives, we do not believe that the earnings backdrop or rates at current levels can support sustained small cap performance.

Active management may provide a way to nimbly adjust exposures in an environment of greater uncertainty, lower liquidity and more frequent episodes of volatility. Aside from election-related uncertainty, the Fed's balance sheet has shrunk by over $1.8tn since beginning their runoff in 2022, reducing market liquidity and raising the prospect of more frequent severe spikes in volatility.[17]

Eyes on valuations

XVLU — **iShares MSCI USA Value Factor Index ETF**

Related funds

XUS — **iShares Core S&P 500 Index ETF**

XUSC — **iShares S&P 500 3% Capped Index ETF**

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Election spotlight

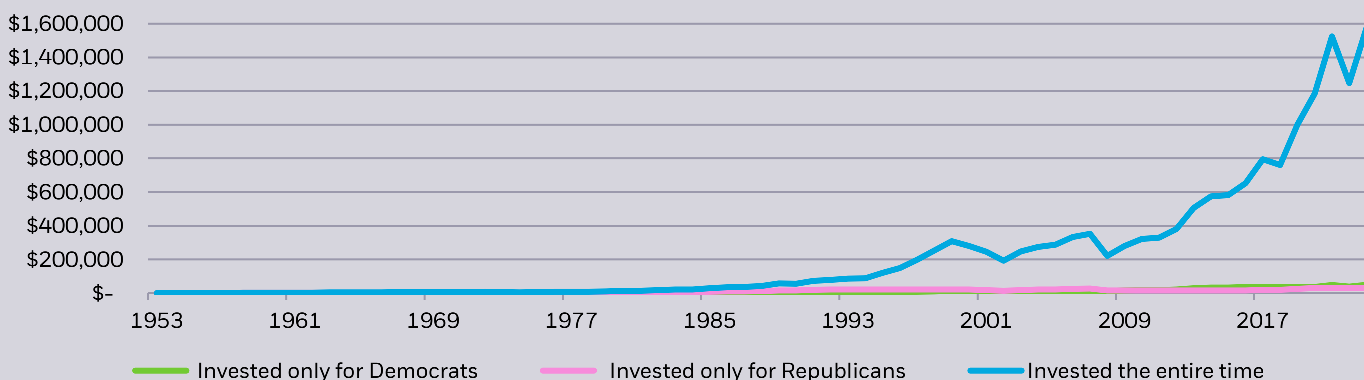
History tells us that while tight elections are usually associated with increased volatility, broad market performance is unaffected by which party wins the White House. At the index level, staying invested has been more important than which party wins the presidency. Investors who held the course as political winds changed earned nearly double those who shifted their strategy based on the election in the last decade – a trend only magnified over the very long term (Figure 8).

Manage volatility

XMU **iShares MSCI Min Vol USA Index ETF**

Figure 8: Last 70 years, $1,000 invested in 1953 depending on which party held presidency

Cumulative cash growth if invested in 1953



Source: BlackRock, Morningstar, as of December 31, 2023. Party presidency period determined by party presidency inauguration to next opposing party presidency inauguration. Stock market represented by the S&P 500 Index from 1/1/54 to 12/31/23. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. You cannot invest directly in an index.

President Biden's exit from the election cycle resulted in a tightening of polls, and key battleground states remain hotly contested.[18] While the two candidates have different policy ambitions spanning regulation, taxes, and trade, trading the election theme has become more difficult as the odds have narrowed.

Rather than tailoring a basket of favoured exposures dependent on the election outcome, we prefer looking to common ground – beneficiaries of infrastructure and nearshoring investments stand out as two key opportunities:

- We think infrastructure spending in the U.S. is likely to continue in 2025 and prefer investing in the theme rather than specific companies.
- We also look to manufacturing and prefer tilting towards companies focused on U.S. and 'friend-shored' tech production and distribution, especially as markets grapple with potential trade and tariffs.

An additional bipartisan theme: neither candidate has exhibited an appetite for curbing the current U.S. budget deficit. Both tickets are either reluctant to cut fiscal spending or have proposed tax cuts leading to a decline in government revenues. From an investment lens, the long end of the yield curve is tantamount with U.S. debt and deficit spending. While governments often prefer to issue more long duration bonds when running a deficit, the U.S. has chosen instead to issue primarily short-term Treasuries, making navigating the fixed income markets more complex - and active management potentially more beneficial.

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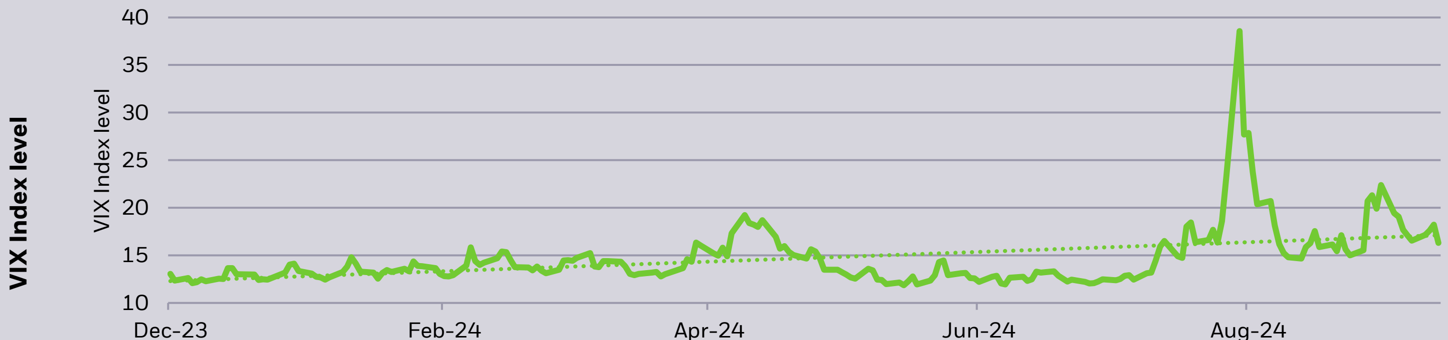
A transforming landscape requires new diversifiers

The next few months tee up a series of volatility (or at least, uncertainty) inducing events: questions about the magnitude and pace of U.S. monetary policy adjustments, diverging policy internationally, expectations for a weaker Q3 reporting season, all capped with November's election. We expect these catalysts to be drivers of sharp market reactions, and like looking beyond U.S. equities and bonds as investors construct their portfolios.

Figure 9: Volatility has tracked higher since the start of the year

2024 volatility as measured by the VIX



Source: Bloomberg. Volatility as represented by VIX Index, dotted line depicting trendline since December 31, 2023. As of September 15, 2024.

Think globally:

- **For investors aiming to dial down U.S. beta, we like adding to international allocations.** Equities abroad offer added diversification, especially given the relatively low tech sector concentration and inherent value tilt in developed ex-U.S. markets. International quality opportunities also trade at a discount – relative to both its own historical averages, and U.S. quality equities, while maintaining less exposure to global trade.[19]
- **In emerging markets, we are constructive on single country exposures rather than broad allocations as regions contend with distinct inflation, growth, and policy backdrops**. We've seen a divergence in EM policy decisions, with Brazil hiking rates while Indonesia's central bank eased on the same day. Chile, for example, is likely to continue benefitting from its exposure to the copper industry (as evident in August's strong mining exports) and its dovish central bank guidance – we maintain our overweight. For investors who do want broad allocations, we lean into emerging market ex-China exposures, as the country teeters towards deflation and manufacturing continues to contract. [20]

Think beyond stocks and bonds:

- **Investors can also look to innovative, non-traditional diversifiers that may potentially improve a portfolio's risk-return profile by diversifying risks, amplifying returns, or both.**
  - Market neutral strategies target consistent returns, regardless of market direction – a complementary source of potential diversification with its low correlation and beta to stocks and bonds.
  - Tactical opportunities strategies leverage both discretionary and systematic techniques to aim to achieve stable returns.
- Investors can blend both liquid alternatives for potential additional diversification benefits by combining uncorrelated alpha, allowing investors to fine-tune their desired balance between potential risk reduction and return enhancement.

Going international

XEMC	**iShares MSCI Emerging Markets ex China Index ETF**
XEF	**iShares Core MSCI EAFE IMI Index ETF**

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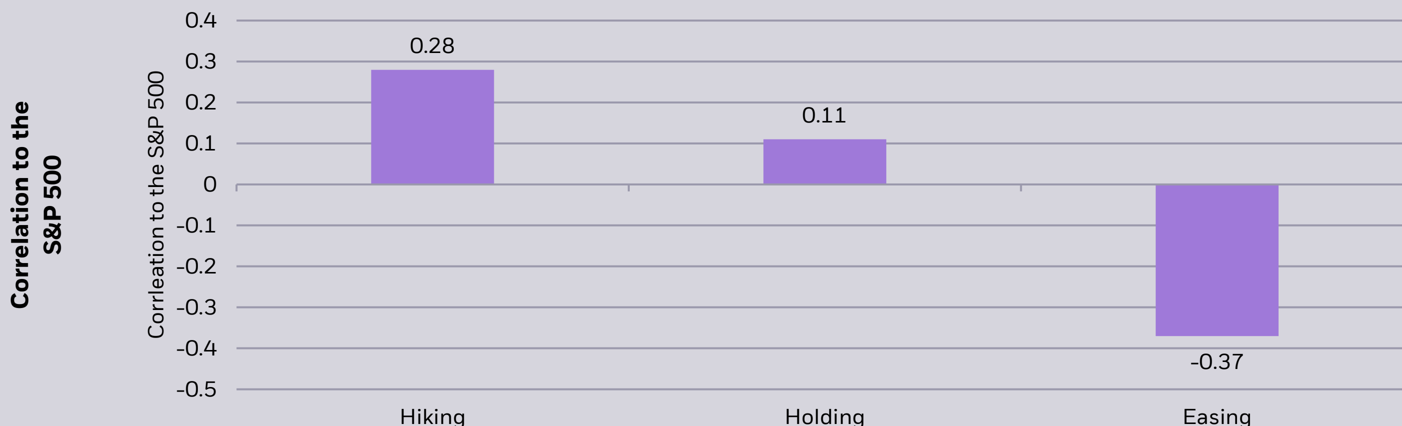
Figure 9: Alternative strategies correlation to the S&P 500 across rate environments

Alternative strategies boast low correlations with the S&P 500 during easing cycles



Source: Bloomberg, BlackRock. Chart by Market and Portfolio Insights team. A correlation coefficient greater than zero indicates a positive relationship, while a value less than zero indicates a negative relationship, measured on a scale that varies from +1 to -1. Data starts from the 1990 Fed hiking cycle. Alts represented by the Credit Suisse Global Macro Index; stocks represented by the S&P 500 Index. As of 3/31/2024..

- **While equity markets continue to flirt with new all-time highs the risk-on rally comes at the same time as the price of gold - typically seen as a haven in periods of economic downturns - also cleared new levels.[21]** Gold's advance likely hails from a handful of catalysts such as strong central bank buying and increased demand for hedges against escalating tensions in the Middle East. Both pull the price of gold higher all while further Fed cuts on the docket up the non-yielding asset's attractiveness, especially as the 50bps cut in September is likely to steer significant capital from developed nations into the gold market. Notably, the price rally has been met with a dearth of flows into gold ETPs, and we think that trajectory can reverse as record central bank buying is unlikely to slow, and further price upside is paired with portfolio diversification benefits.[22]

Keep taxes top of mind:

- **Near-term pullbacks also represent an opportunity for investors to harvest losses and redeploy into high conviction pockets of the market.** August delivered a dose of volatility, and while the downturn proved to be short-lived, investors can sell exposures at a loss in future retreats and invest the proceeds in a correlated instrument – thereby locking in losses to offset a future capital gain, all while maintaining market exposure.

Diversification

CGL	**iShares Gold Bullion ETF (CAD-hedged)**
CGL.C	**iShares Gold Bullion ETF**

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[1] Source: Bloomberg, Bureau of Labor Statistics. As of September 16, 2024.

[2] Source: Figure 2. A basis point (bps) is one hundredth of one percent (e.g. one basis point = 0.01%).

[3] Based on U.S. money market funds data. Source: BlackRock, Markit, Bloomberg. Groupings determined by Markit, EPFR. As of September 16, 2024.

[4] Source: BlackRock, Bloomberg. As of September 10, 2024. Cutting cycles in lookback period include the following periods: 3/10/1970 to 2/9/1971; 8/20/1974 to 5/20/1975; 8/7/1981 to 12/20/1982; 9/19/1984 to 8/16/1986; 6/5/1989 to 9/4/1992; 7/6/1995 to 1/31/1996; 1/31/2001 to 6/25/2003; 9/18/2007 to 12/15/2008; 8/1/2019 to 3/15/2020. Earlier in the cycle as represented by annualized returns on the day of the first cut relative to annualized returns 3 months following the first cut.

[5] Source: Bloomberg. Belly as represented by ICE US Treasury 3-7 Year Bond Index; long bond as represented by ICE US Treasury 20+ Year Bond Index. As of September 10, 2024.

[6] Source: Bloomberg. Agg as represented by Bloomberg Aggregate Bond Index. As of September 16, 2024.

[7] Source: Bloomberg. Leverage lookback period in reference from January 1, 2023, to September 16, 2024. As of September 16, 2024.

[8] Source: Bloomberg. Volatility as represented by VIX Index, lookback period in reference to January 1, 1992, to December 31, 2020. As of September 1, 2024.

[9] Source: Bloomberg. U.S. equities as represented by S&P 500 Index. As of September 15, 2024.

[10] Source: LSEG Refinitiv. Quality as represented by MSCI World Quality Net Total Return USD Index, market as represented by S&P 500 Index. Valuations as represented by current 12-month forward Price-to-Earnings ratio to 24.9x versus historical average of 19.7x. As of September 12, 2024.\[11] Source: BlackRock Systematic, Nvidia, OpenAI. As of June 20, 2024.

[11] Source: United States Census Bureau. As of September 18, 2024.

[12] Source: BlackRock, Markit. ETF groupings determined by Markit. As of September 15, 2024.

[13] Source: Bloomberg. Issuance as determined by Bloomberg League Table field. As of September 15, 2024.

[14] Source: Bloomberg. As of September 15, 2024.

[15] Source: BlackRock, Markit, Morningstar. ETF groupings determined by Morningstar. As of July 1, 2024.

[16] Source: Bloomberg, Markit. ETF groupings determined by Markit. As of September 15, 2024.

[17] Source: Bloomberg. As of September 15, 2024.

[18] Source: Bloomberg. Polls as represented by Bloomberg's 2024 US Presidential Election monitor. As of September 15, 2024.

[19] Source: Bloomberg. International quality opportunities as represented by MSCI World ex USA Sector Neutral Quality Index; U.S. quality equities as represented by MSCI USA Sector Neutral Quality Index. Valuations as represented by 12-month forward P/E ratio. As of September 17, 2024.

[20] Source: Bloomberg, as of September 13, 2023. China inflation represented by China CPI YoY index. China manufacturing activity represented by China Manufacturing PMI SA index. .

[21] Source: Bloomberg. Gold as represented by GOLDLNPM Index. As of September 15, 2024.

[22] Source: BlackRock, Bloomberg, Markit. Gold ETFs as classified by Markit. As of September 15, 2024.

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