ETF implementation guide

Insights from BlackRock

iShares by BlackRock

Summary

- We believe a seismic structural transformation is underway, with potential to reshape the investment landscape. This environment of structurally higher uncertainty calls for a more nimble, granular approach to identifying investment opportunities.
- In Fixed Income, our macroeconomic outlook for slowly normalizing interest rates and decelerating growth in Canada and the U.S. implies a favourable environment for carry and modest duration extension.
- In Equity, while market volatility has risen in August, we believe that fundamentals remain broadly constructive. We remain bullish on AI and see opportunity in the massive infrastructure investment – and energy – needed to fuel its expansion.
- At the same time, we think investors may want to look beyond traditional equity and bond allocations to build diversified portfolios that have the potential to outperform as the transformation unfolds.
- This report is intended help our clients navigate opportunities in fixed income, domestic equity, U.S. equity, and thematics for the rest of 2024 with ETF implementation ideas.

Fixed income

Our macroeconomic outlook for slowly normalizing interest rates and decelerating but still positive growth in both Canada and the U.S. implies a favourable environment for carry and modest duration extension. While we don't believe that policy rates are likely to return to pre-pandemic levels, given structurally higher inflation and the AI-fueled investment boom, we anticipate that stable growth and slowing inflation can provide an opportunity for clipping coupons in fixed income markets. However, the uncertainty around inflation – and therefore central bank policies – creates volatility that calls for careful and precise navigation.

We believe the 'belly' of the curve presents the best trade-off between current yield and the potential for returns from falling rates and duration. In our view, the iShares Core Canadian Short Term Bond Index ETF (XSB) and iShares Core Canadian Universe Bond Index ETF (XBB) are able to take advantage of potential outperformance in the belly of the curve.

We expect the yield curve to steepen, led by slow declines in rates on the short end of the curve. We remain cautious about taking exposure at the very long end of the yield curve, as we expect additional issuance in the U.S. and the normalization of term premium will keep longer rates elevated. As a result, we would expect spillover from the U.S. yield curve to the Canadian curve.

On the short end of the yield curve, there are opportunities beyond cash for income. Given the persistent inversion of the yield curve and our expectations for only a gradual reduction in policy rates, it could make sense to have some allocation to short-term high quality spread assets. Canadian and U.S. high quality short-term investment grade corporates currently offer a yield of 4.4-5.1% with a duration of only ~2.7 years[1]. **Short term investment credit fundamentals look satisfactory, and we believe that stable, non-inflationary growth could support corporate earnings and keep default rates low.** Although spreads have tightened, the all-in yields in short-term corporate credit still look attractive.

[1] Refers to yield-to-maturity. Short-term I.G. Corp represented by iShares Core Canadian Short Term Corporate Bond Index ETF (XSH) and iShares 1-5 Year U.S. IG Corporate Bond Index ETF (CAD-Hedged) (XIGS); Source: BlackRock; Data as of July 31, 2024. Yield to Maturity (YTM) is the discount rate that equates the present value of a bond's cash flows with its market price (including accrued interest). YTM is gross of ETF fees and expenses.

We also see opportunities in Emerging Market 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.

This period of structurally elevated inflation, slowing growth, low term premium and concerns around rising deficits can be one where remaining in high-quality parts of fixed income can help investors navigate the road ahead.

Related Funds

Theme	Ticker	Fund Name
Balancing between current yield and duration benefits	**XBB**	iShares Core Canadian Universe Bond Index ETF
	XSB	iShares Core Canadian Short Term Bond Index ETF
Put cash to work	**XSH**	iShares Core Canadian Short Term Corporate Bond Index ETF
	XIGS	iShares 1-5 Year U.S. IG Corporate Bond Index ETF (CAD-Hedged)
Improving emerging market rate environment	**XEB**	iShares J.P. Morgan USD Emerging Markets Bond Index ETF (CAD-Hedged)

Canadian equities

We remain neutral on Canadian equities. While the economy had experienced a rebound in activities in the first half of 2024, weakening economic conditions and labour market data have led the Bank of Canada to cut rates earlier than the U.S. Federal Reserve.

Canada's higher levels of private sector debt, weaker labour market growth and short-term mortgage rates could continue to contribute to further softness in data. A slowdown in housing sales trend in the near-term is likely to weigh on broader economic activities as well.

The lower share of technology firms in the domestic equity market will likely continue to exert downward pressure on relative performance, especially compared to the U.S. But we also like the energy, industrials, and materials sectors, all of which we think are set to benefit from the AI build-out in the near term and are overrepresented in Canada's equity market.

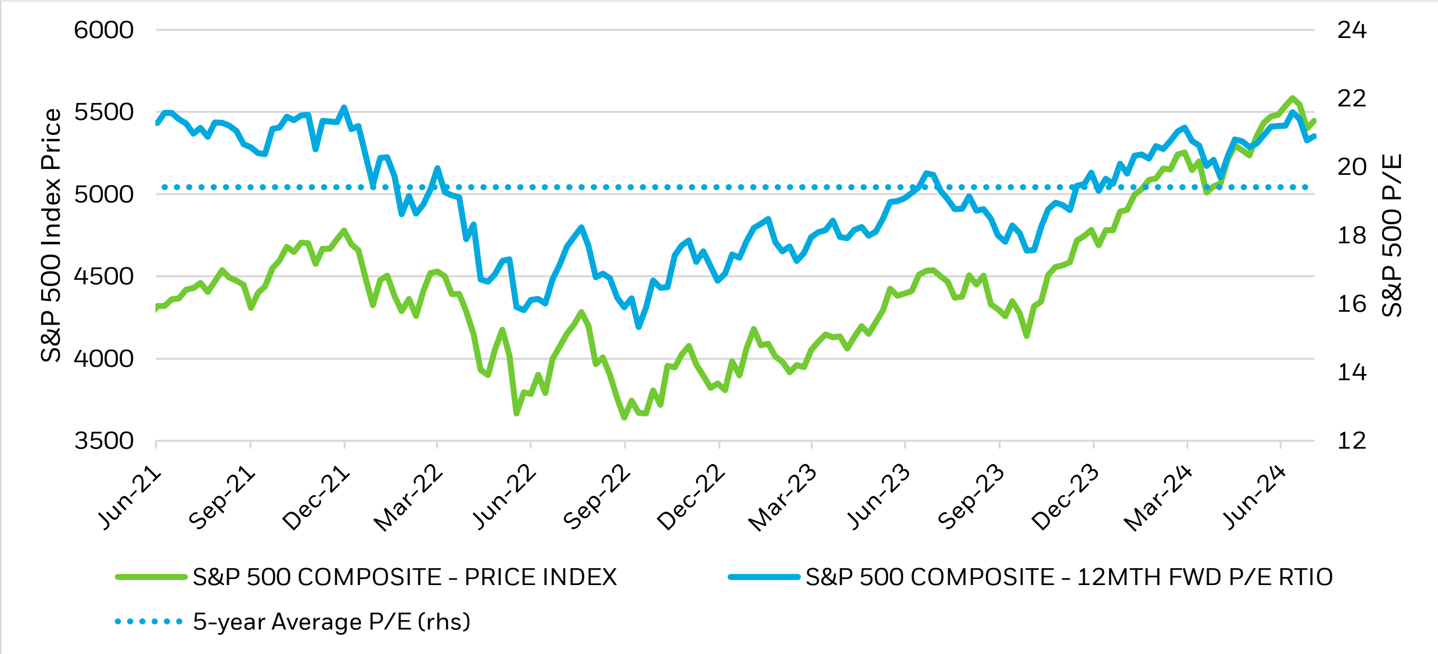
Related Funds

Ticker	Fund Name
XDIV	iShares Core MSCI Canadian Quality Dividend Index ETF
XEG	iShares S&P/TSX Capped Energy Index ETF
XBM	iShares S&P/TSX Global Base Metals Index ETF

U.S. equities

After posting double digit returns this year, the U.S. equity market's 12-month forward P/E has expanded moderately above its 5-year average. Despite the multiple expansion, earnings have driven ~35% of the S&P 500's performance, speaking to the durability of the move higher.[2] Narrow leadership has begun to broaden out, with 10 of the 11 S&P sectors in positive territory. At this time last year, only three sectors contributed to the market's gains, each tech or tech adjacent. But the back half of the year holds much uncertainty, specifically around the timing of Fed cuts and the results of the U.S. election, and recent bouts of volatility underscore the potential for dramatic price action ahead.

Figure 1: Market gains while valuations stay in line with historic averages



Source: BlackRock, Bloomberg. As of August 8, 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. Chart description: Line chart showing the price of the S&P 500 along with 12-month forward P/E, since January 2024.

The quality factor is our preferred way to help avoid the riskiest pockets of the equity market, combining profitability and balance sheet strength with the aim of delivering positive returns even in a higher rate regime, or against a more volatile macroeconomic backdrop. That contrasts sharply with small and unprofitable names where restrictive monetary policy carries more bite: nearly half of the Russell 2000 constituents hold floating-rate debt, triple the total held by their large-cap counterparts.[3] Small caps are also tightly tethered to the growth outlook – any deceleration from here is likely to apply continued pressure on the exposure.

With election uncertainty ahead, the intersection of economics and geopolitics is more in focus than ever. Domestic and foreign policy is being reshaped with lasting impacts on supply chains, with technology and manufacturing at the centre of the 21st century economic arms race. We see opportunity in the companies that are reshoring jobs and bolstering U.S. technological independence.

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[2] Source: Bloomberg. U.S. equity market as represented by SPX Index. As of June 18, 2024. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

[3] Source: Bloomberg. Large-cap counterparts as represented by SPX Index. As of June 18, 2024.

Related Funds

Ticker	Fund Name
XQLT	iShares MSCI USA Quality Factor Index ETF
XUS	iShares Core S&P 500 Index ETF
XUSC	iShares S&P 500 3% Capped Index ETF
XQQU	iShares NASDAQ 100 Index ETF

Thematics

The arrival of artificial intelligence rapidly altered the investment landscape – triple-digit returns, and record earnings growth of AI-associated companies were largely undeterred by rates, growth, or inflation expectations. The breakthrough technology has already translated to substantial revenues and demand for clear beneficiaries – semiconductors are at the core of this transformation, and the industry has returned 85% so far this year, on the heels of triple digit 2023 gains.[4] We see opportunities as the trade broadens out to include energy providers; utilities are dialing up demand forecasts ahead on expectations for upped usage.

Recent elections in Mexico and India demonstrate how market reactions to election outcomes can lead to rapid spikes in near-term market volatility. Both India and Mexico experienced meaningful selloffs immediately following their unexpected election results – a sweep in the Mexican presidential and legislative elections by the incumbent party, and a lack of a similar sweep in India.

Investors could look beyond short-term volatility to focus on longer-term strategic trends. We see investable opportunities in demographic transformations and supply chain reshoring. Despite investor caution in Mexico and India due to post-election policy uncertainty, we see long-term investment opportunities in those countries due to the benefits from higher working age population and reshoring-related infrastructure and business investments.

U.S. investors continue to separate China from broader EM allocations. While Chinese equities experienced a recent rebound on the back of discounted valuations and better-than-expected policy support and macro data, a bevy of structural worries such as declining demand in the property sectors and slowing demographic growth continue to weigh on risk sentiment. U.S.-listed ETFs with a geographic focus on EM ex-China regions attracted nearly $5.8bn from the investor community YTD.[5]

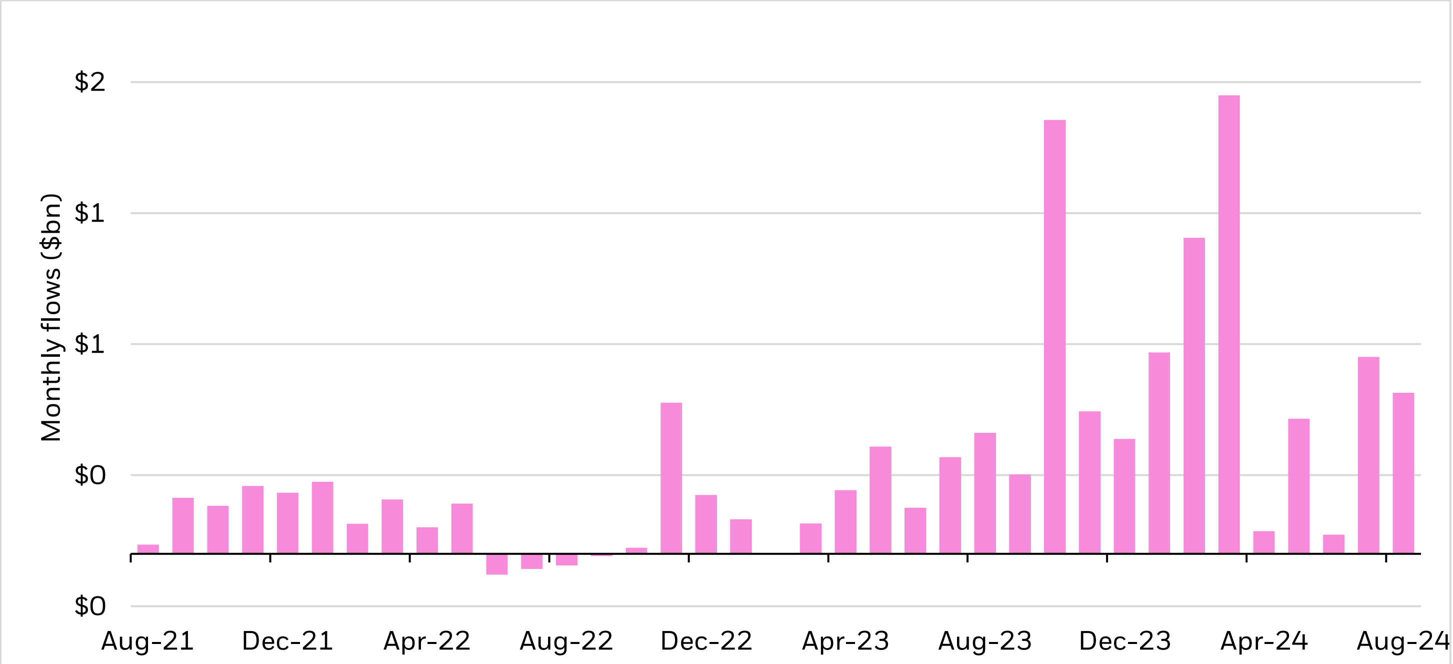
Commodities like gold can also serve as strong diversifiers within a portfolio and provide an alternative choice to investors who want further diversification from equity and fixed income markets. Gold is historically lauded as a haven during economic turmoil, viewed as a hedge against both inflation and geopolitical volatility shocks alike. While the non-yielding asset met muted interest in the last decade's bull market, investors turned to gold during the pandemic-induced economic plunge in 2020, looking for a store of value and resiliency outside of fiat currencies. Recent price appreciation hails from a few catalysts: central bank demand to diversify reserve holdings, adding over 2,000 tons in the past two years, heightened global geopolitical tensions, recent bouts of volatility, and concerns over budget deficits domestically.[6]

[4] Source: Bloomberg. Semiconductors as represented by S&P 500 Semiconductors & Semiconductor Equipment Industry Group GICS 2 Index. As of June 18, 2024. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

[5] Source: Bloomberg, Markit. ETF groupings determined by Markit. As of June 26, 2024.

[6] Source: Bloomberg. As of August 18, 2024. Price appreciation as determined by ICE Gold Index, starting in January 2024. Central bank reserve holding data from World Gold Council.

Figure 2: EM ex-China strategies continue to grow
Investors continue to separate China from their EM allocations amid a combination of structural worries



Source: BlackRock, Bloomberg, chart by iShares Investment Strategy. ETP groupings determined by Markit. As of August 18, 2024.

Related Funds

Ticker	Fund Name
XCHP	iShares Semiconductor Index ETF
XEMC	iShares MSCI Emerging Markets ex China Index ETF
XID	iShares India Index ETF
CGL	iShares Gold Bullion ETF

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