BlackRock's 2024 Global Outlook: a fixed income perspective

BlackRock

Quick read

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High levels of dispersion create further opportunities for alpha, as sectors and issuers adjust at differing rates to the new regime. We expect more opportunity for managers with a focus on deep bottom-up research to differentiate themselves in 2024.

The green bond market provides an avenue for investors to directly participate in financing the low-carbon transition. There are opportunities for active managers to add both traditional alpha and 'impact alpha' through security selection.

BlackRock's 2024 Global Outlook: a fixed income perspective

As detailed in the 2024 Global Outlook from the BlackRock Investment Institute, 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. Bond markets benefitted from central bank asset purchase programmes. 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 – with top-down asset allocations driving a large portion of returns in relation to the contribution from alpha.

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 and a greater proportion of total portfolio return potential from alpha.

We explore the 2024 Global Outlook from a fixed income lens, focusing on 3 key investment themes:

- Managing macro risk
- Steering portfolio outcomes
- Harnessing mega forces: investing in the net zero transition

Theme 1: Managing macro risk

The end of ultra-loose monetary policy, onshoring and nearshoring of supply chains, shifting workforce demographics, and the transition to a low-carbon economy are contributing to a regime shift. This makes the macro-outlook more uncertain. Exposures to macro risk can be punished as well as rewarded, which is why the 2024 Global Outlook calls for investors to be deliberate about where they take risk and neutralise macro risks where they don't have high conviction.

Unconstrained funds can help investors navigate this new environment. Deliberate exposures can be taken where we have high conviction, while other macro risks can be neutralised, or expressed in less directional relative value trades, leaving investors less exposed to a volatile macro environment. Sector allocation can be managed free of constraints, focusing only on the issuers and sectors we believe best suited to navigate the new regime.

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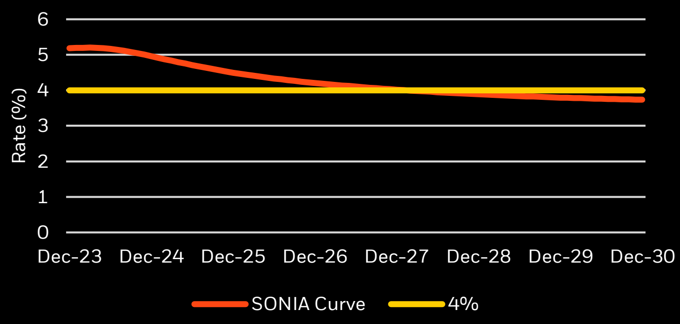
Investor insights

A high conviction view we have held in Q4 is in owning front-end UK rates, where the market priced the Bank of England to maintain rates above 4% until 2028. This is despite a weak growth picture, which after stagnation in 2023 is likely to take off in 2024. Both UK Manufacturing and Services PMIs remain in contractionary territory (below 50), and wage data is decelerating, indicating that the impact of past rate hikes is working their way into the real economy.

We prefer relative value expressions in European government bonds, however, where the case for an outright long position is less clear given the unwind of the ECB's PEPP programme and higher net supply in 2024. Below we look at a France 10s30s steepener versus Germany. Long-end France has outperformed, driven by particularly high demand from long-term investors. However, into 2024, we anticipate high supply potentially driving spreads vs Germany wider and a steeper curve.

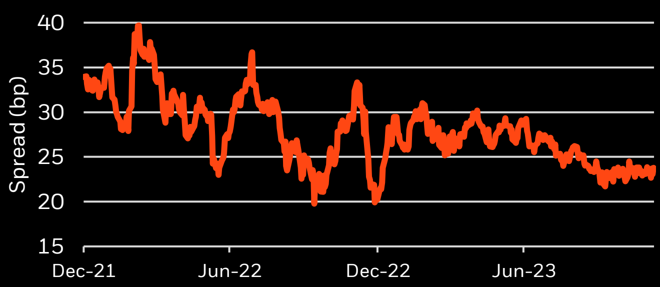
Flexibility to manage duration and curve exposure free of benchmark constraints also enables unconstrained funds to respond quickly to equally fast-moving markets.

Markets priced the Bank of England to maintain rates above 4% in the UK into 2028



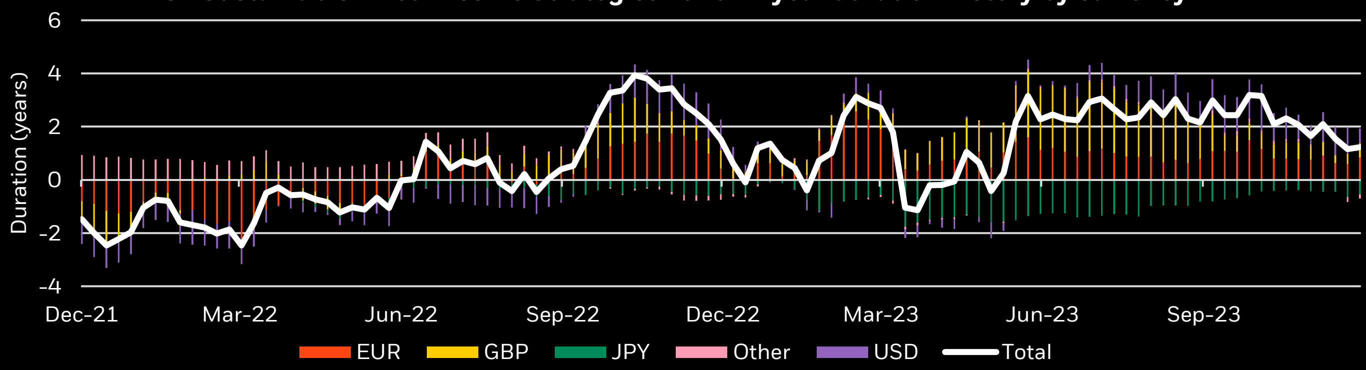
Source: BlackRock, Bloomberg as of 6th December 2023

Relative value: France vs Germany: 10s30s box



Source: BlackRock, Bloomberg as of 6th December 2023

BSF Sustainable Fixed Income Strategies Fund: 2-year duration history by currency



Source: BlackRock, Bloomberg as of 30th November 2023

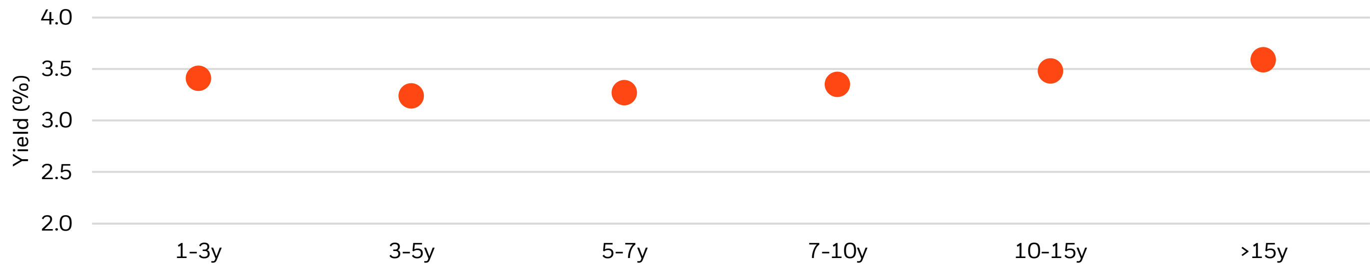
Implementation ideas

	Category	Asset class	Duration range	Spread duration range	Nominal Yield
BSF Sustainable Fixed Income Strategies Fund	Flexible	Aggregate	-3 to +4 years	+1 to +7 years	6.7%
BSF Sustainable Fixed Income Credit Strategies Fund	Flexible	Investment Grade Credit	-3 to +3 years	+1 to +7 years	5.2%

Source: BlackRock, as of 30th November 2023. BSF = BlackRock Strategic Funds

Recent months have also seen a rise in term premium, with investors demanding greater compensation for holding long-term bonds in this regime of higher uncertainty. For investors still cautious on holding long-term bonds, inverted yield curves mean that attractive yields can still be found in short- and medium-term exposures.

Yields of the Bloomberg Barclays Euro Aggregate Index constituents by time to maturity



Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.
Source : BlackRock, Bloomberg as of 6th December 2023

Implementation ideas

	Asset class	Duration	% bonds <10y to maturity	Nominal Yield
BGF Euro Short Duration Bond Fund	Aggregate	~2 years	99%	3.6%
BGF Euro Corporate Bond Fund	Investment Grade Credit	~4.5 years	90%	4.1%

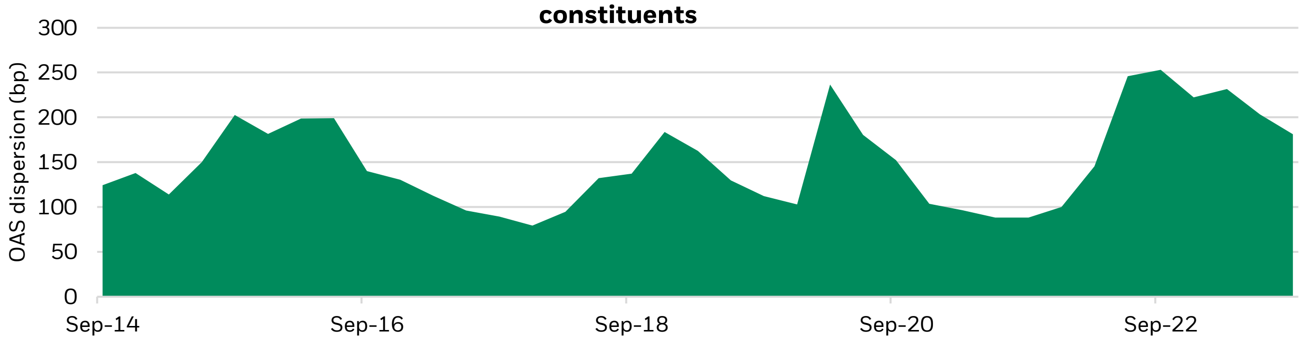
Source: BlackRock, as of 30th November 2023. BGF = BlackRock Global Funds

Theme 2: Steering portfolio outcomes

BlackRock's 2024 Global Outlook argues that heightened volatility and dispersion call for an active approach to managing portfolios. Higher policy rates are making their way into the economy unevenly, and while some asset values have adjusted to the new regime, not all have. We believe investment expertise and a focus on bottom-up research and security selection is likely to give portfolios an edge in the new regime.

We can already see much higher levels of dispersion in fixed income. The number of idiosyncratic issuer events over 2023, even within the investment grade universe, is notable (e.g. SVB, Credit Suisse, Thames Water, Orsted). In fact, the level of dispersion in the EUR investment grade credit universe is more than double the level seen throughout much of the QE-era.

EUR IG Credit Index: dispersion in spread between 10th and 90th percentile of constituents



The new regime also leads to a wider dispersion of views, creating more scope for active managers to outperform. Relative value strategies are particularly well suited to this environment, in our view, seeking to identify areas of the market which are typically highly correlated but where relative pricing has become stretched.

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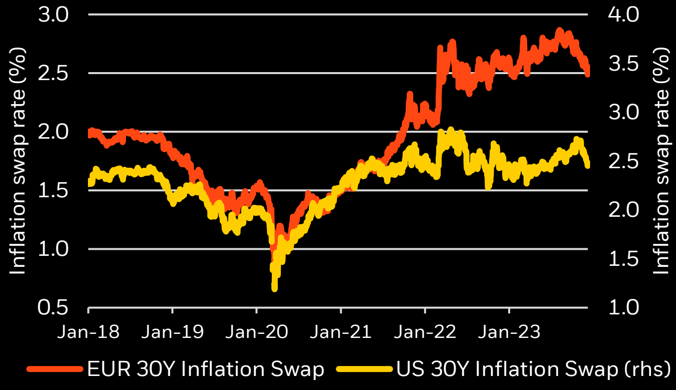
Source : BlackRock, Bloomberg as of 6th December 2023

Investor insights

One such example is the notable divergence in the performance of European and US inflation markets. In the former, markets are pricing in a shift to a higher inflation regime. While 30-year inflation swaps in Europe averaged 1.7% between 2018 and 2019, this has shifted to 2.7% in 2023. The US market has returned to pre-Covid averages, however. We view it as unlikely that inflation shifts structurally higher in Europe while settling back to historical levels in the US and have therefore been trading the relative relationship between the two markets. Such strategies can add alpha to portfolios without adding to beta.

Long-term inflation swap rates (30y, Europe and US)



Source: BlackRock, Bloomberg as of 6th December 2023

Theme 3: Harnessing mega forces: investing in the net zero transition

The low carbon transition is one of the five mega forces outlined in BlackRock's 2024 Global Outlook. Mega forces are key drivers of the new regime, affecting the long-term growth and inflation outlook and creating shifts in profitability. The transition to a low-carbon economy is set to spur a massive reallocation of capital as energy systems are rewired. We also 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.

Within fixed income, the green bond market provides an avenue for investors to directly participate in financing the transition to net zero. Unlike traditional bonds, green bonds are 'use of proceeds' instruments that fund projects with positive environmental outcomes. The green bond market therefore represents issuers, sectors and geographies directly investing in the energy transition and climate resilience, alongside other environmental themes such as biodiversity, water and waste management. Adding green bonds to a core fixed income allocation is one route for investors to directly invest in the net zero transition without adding beta tilts to their overall asset allocation.

Investor insights

The green bond market has grown to over US $1.1tr*, and is now well diversified across regions, currencies, and sectors. The market still exhibits great dispersion in the projects financed and therefore in expected environmental impact, however. We are committed to certain steps in our process which aim to ensure that green bond investments can deliver the intended impact, and to maximise the impact delivered through careful security selection.

BlackRock's green bond taxonomy assigns a tier to green bonds based the intended use of proceeds, associated environmental benefits and its issuers' commitment to allocation and impact reporting. Tiers range from very light green to dark green. Interestingly, we see no correlation between investor demand and pricing of bonds based on the tier. This creates an opportunity for active managers to maximise the impact potential of client investments without sacrificing yield.

*Source: Bloomberg MSCI Global Green Bond Index as of 30th November 2023.

Implementation ideas

	Asset class	Duration	% bonds financing projects seeking to advance UN SDG 13 (Climate Action)	Nominal Yield	Average credit rating
BGF Impact Bond Fund	Aggregate	~6 years	76%	4.9%	A+

Source: BlackRock, as of 30th November 2023.

Conclusion

For much of 2023 investors – scarred by the memories of 2022 – used inverted yield curves and high cash rates as a reason to stay conservative and wait for clarity on what is an unusually complex economic outlook. However, the case for fixed income has changed dramatically; the income bonds provide has increased across the board, and the potential for interest rate cuts in 2024 as inflation falls creates additional return potential through capital gains.

In an environment which remains volatile relative to 2010-2020, we see plentiful opportunities for active managers. 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. Unconstrained solutions can help investors navigate this environment, with the flexibility to pair high conviction macro exposures with less directional relative value trades with the ability to deliver alpha uncorrelated to the broad market.

High levels of dispersion create further opportunities for alpha, as sectors and issuers adjust at differing rates to the new regime. We have already seen this in credit markets in 2023 and expect more opportunity for managers with differentiated insights and a focus on deep bottom-up research to differentiate themselves in 2024.

Finally, we anticipate a massive reallocation of capital as part of the low-carbon transition, one of the mega forces which we expect to shape markets in the years to come. The green bond market provides an avenue for investors to directly participate in financing the transition, however not all green bonds are created equal, and with additional scrutiny on security selection there are opportunities for active managers to add both traditional alpha and 'impact alpha' – using the BlackRock Green Bond Taxonomy to direct capital to bonds where we see the greatest potential environmental impact.

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Credit Risk: The issuer of a financial asset held within the Fund may not pay income or repay capital to the Fund when due.

Liquidity Risk: Lower liquidity means there are insufficient buyers or sellers to allow the Fund to sell or buy investments readily.

Fund Specific Risks for the BGF Euro Short Duration Bond Fund

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