iSHARES FALL 2023 INVESTMENT DIRECTIONS

iShares by BlackRock

KEY TAKEAWAYS

1 Interest rates are likely to remain higher for longer on the heels of better-than-expected growth.

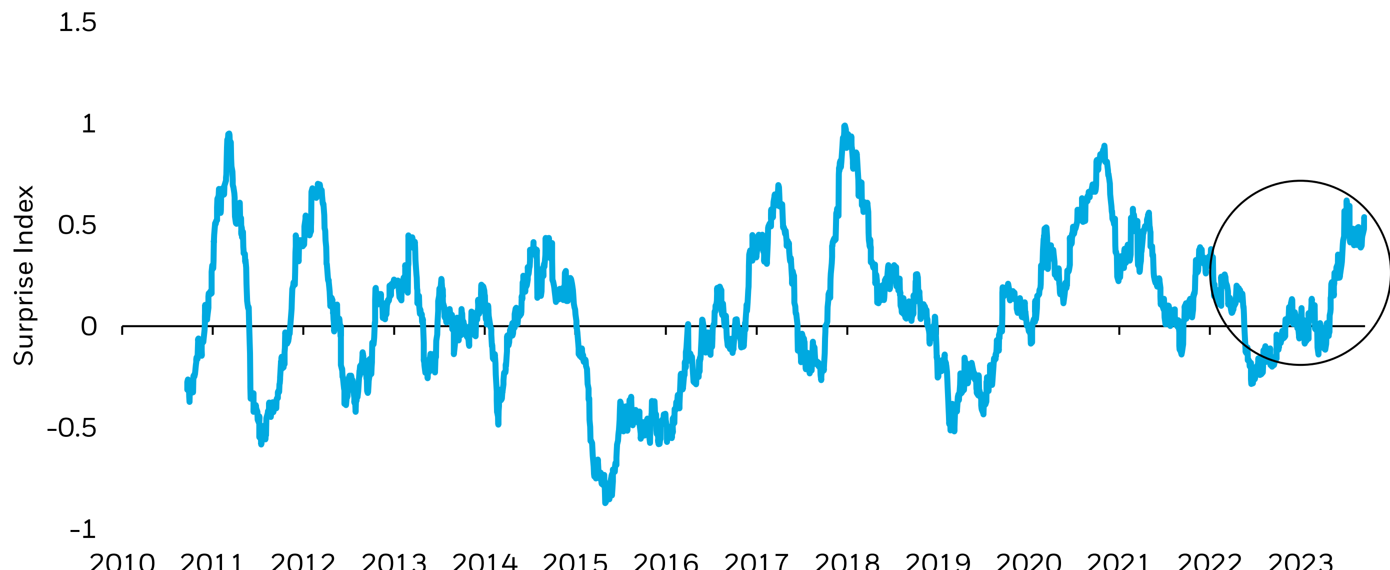
2 Fixed income remains our highest-conviction trade, although we see select opportunities in high-quality equities such as energy and industrials.

3 We see potential upside abroad in countries like Japan, Mexico, and India, which benefit from structural trends like deglobalization and nearshoring.

INTRODUCTION: MACRO OVERVIEW

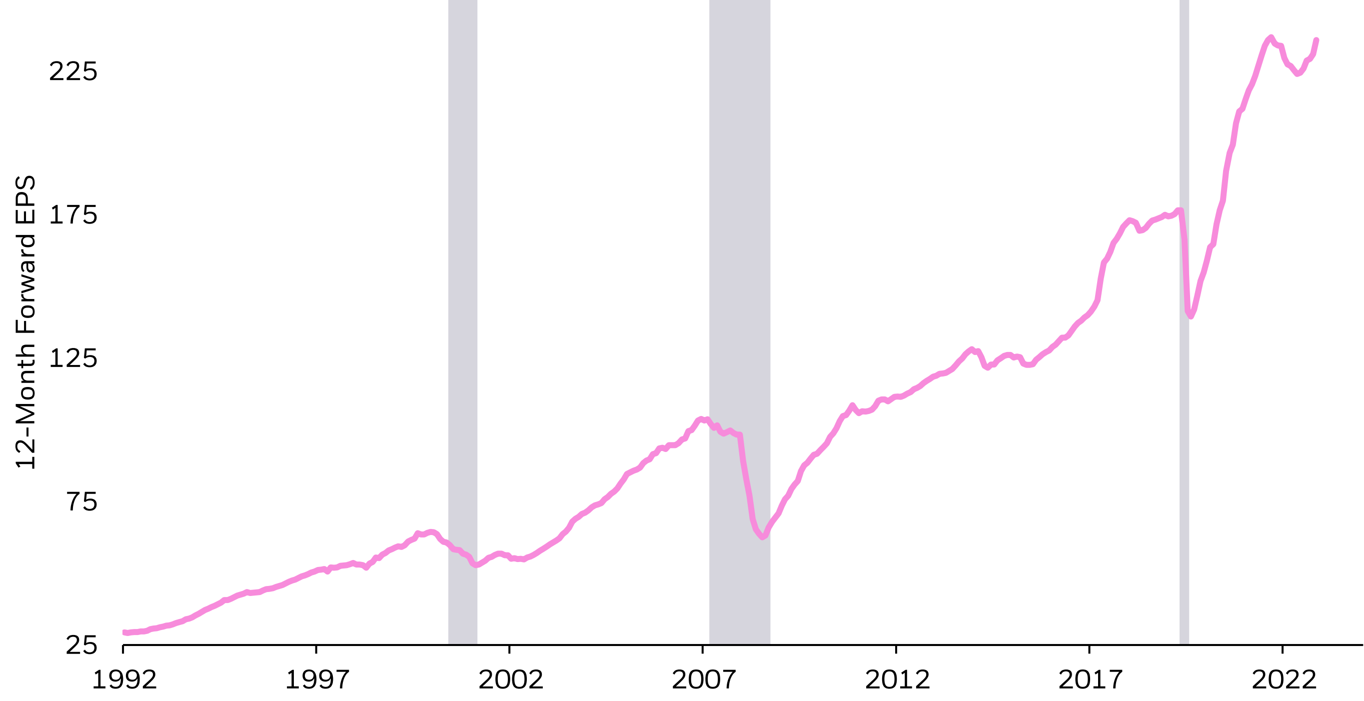
Diminishing probabilities of a recession have supported asset performance. Equity valuations and interest rates have been buttressed by the surprising strength of economic activity. Growth data of every variety have all surprised to the upside. The Atlanta Fed's GDP 'nowcast' is running at 4.9% for Q3 and 12-month forward S&P 500 earnings expectations have rebounded to $235/share, about the level they were when the Fed began its rate hike campaign in 2022.[1]

Figure 1: U.S. economic surprises trend up



Source: BlackRock, Bloomberg. Index as represented by Bloomberg ECO US Surprise Index. As of September 15, 2023.

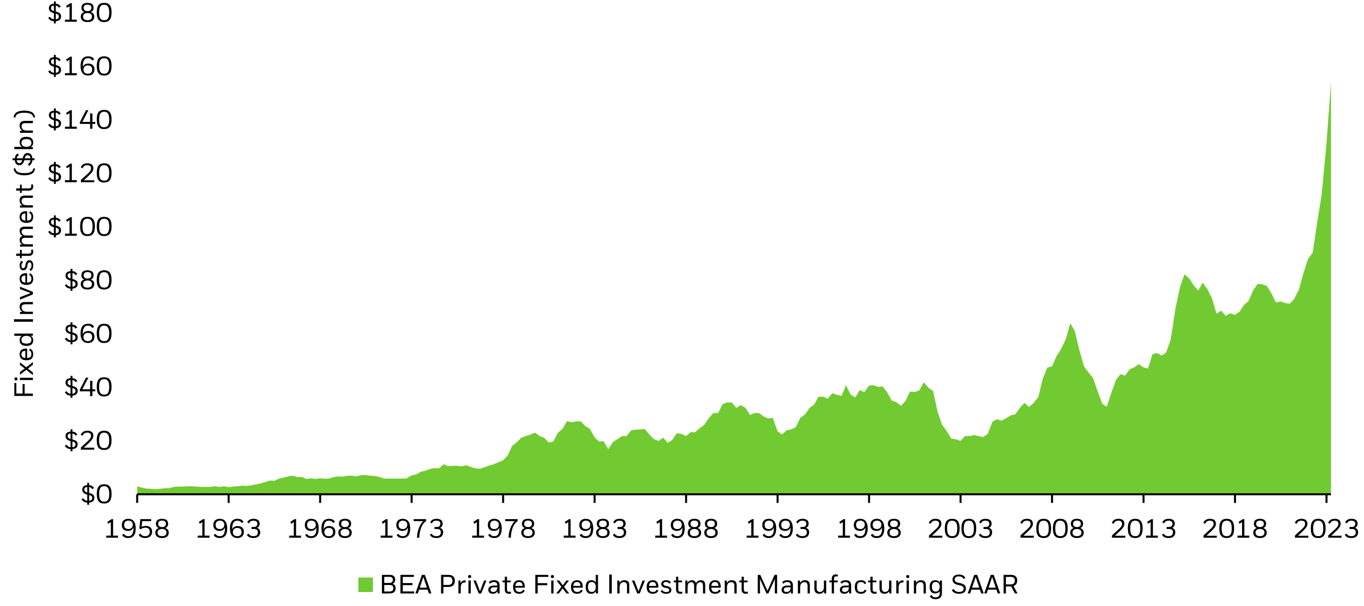
Figure 2: S&P 500 12-month forward EPS



Source: BlackRock, Bloomberg. S&P 500 represented by SPX Index. Grey areas indicate historical periods of U.S. recession, as determined by the National Bureau of Economic Research monthly recession binomial index (USRINDEX Index). As of September 10, 2023. **Past performance does not guarantee future results.**

The reasons for the stronger-than-expected growth remain unclear, though we believe the impact of fiscal spending is likely a factor. Private fixed investment in manufacturing surged to $154 billion in Q2, driven by various government spending packages (CHIPS Act, Infrastructure and Jobs Act, Inflation Reduction Act). When all is said and done, estimates of the fiscal multiplier will likely need to be reassessed.

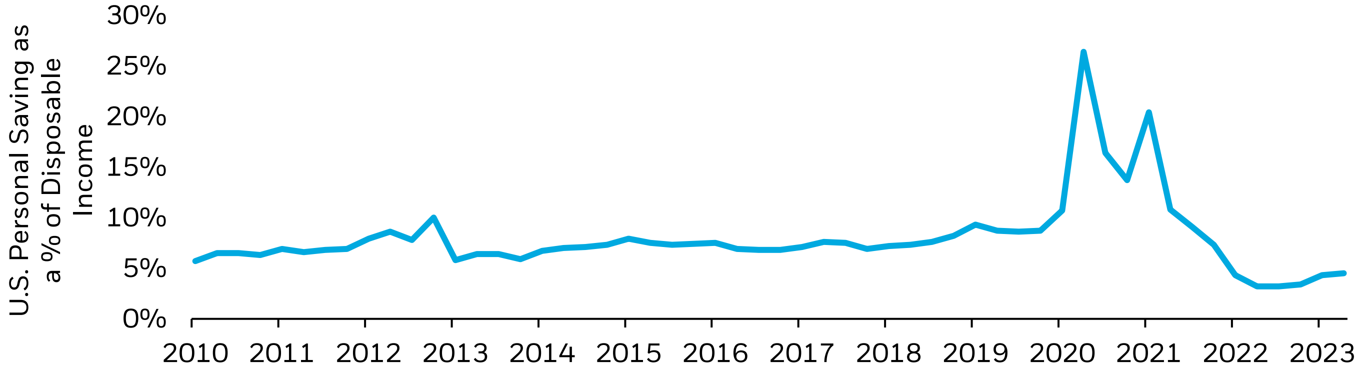
Figure 3: Private manufacturing fixed investment growth



Source: BlackRock, Bloomberg. BEA Private Fixed Investment Manufacturing as represented by BEA Private Fixed Investment Manufacturing SAAR Index. Fixed assets by type as defined by the BEA as buildings, trucks, software, and more used in production for at least a year. As of September 10, 2023.

Whatever the proximate cause of the above-average growth, a virtuous cycle of strong consumption has been created. Consumption has been boosted by healthy wage growth (average hourly earnings +4.3% year-over-year) and spending down savings (Personal Savings Rate plunging to 3.5%, well below its long-run average).[2] Such cycles can last only as long as the conditions that fuel them, and we expect domestic growth and earnings to slowly deteriorate as the cumulative impact of Fed hikes continues to be felt on credit creation and investment.

Figure 4: U.S. personal savings retreat from pandemic highs

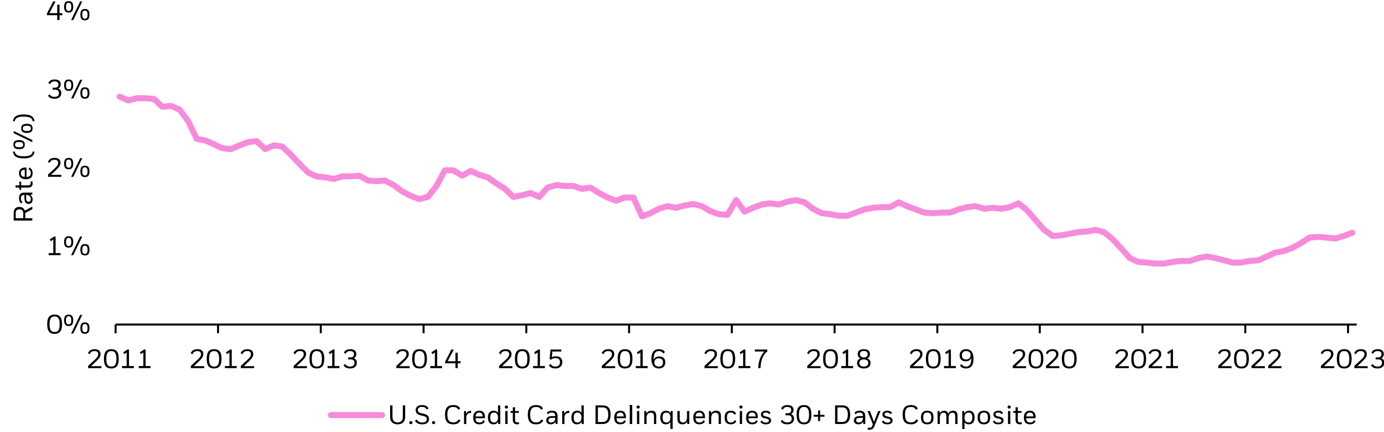


Source: BlackRock, Bloomberg. Savings rate as represented by US Personal Saving as a % of Disposable Personal Income American Savings Rate Index. As of September 18, 2023.

As labor supply and demand come back into balance, we believe wages and consumption should slow. Strong labor demand has finally increased participation rate to 62.8%, near pre-COVID levels, while increased immigration has expanded the labor pool in key industries like construction.[3] Prime age participation rate (25-54) has moved meaningfully higher, especially for women, where participation rates are at all-time highs.[4] Real wage growth has slowed from 1.2% year-over-year to just 0.5%.[5] Rising credit card delinquency rates suggest that further increases in consumption may be more difficult to fund as wages rise more slowly and private savings bottom.

Higher energy prices may further erode consumption. Saudi Arabia extended their voluntary production cuts of 1 million barrels per day into September. The 'swing producer' of OPEC is committed to higher oil prices to balance its fiscal budget and fund its diversification efforts via their Vision 2030 fund. Russia also pledged to continue cutting 300,000 barrels a day into the next month, pushing OPEC+'s larger reductions above 3.5 million barrels a day, signaling further unity among major non-U.S. producers to keep the market tight.[6] Meanwhile, the Strategic Petroleum Reserve (SPR) currently holds roughly 350 million barrels for the first time since 1983 (just a few years after the SPR was formed). The Department of Energy's total inventory has about 45 days' worth of supply, which is basically half of what it was early last year.

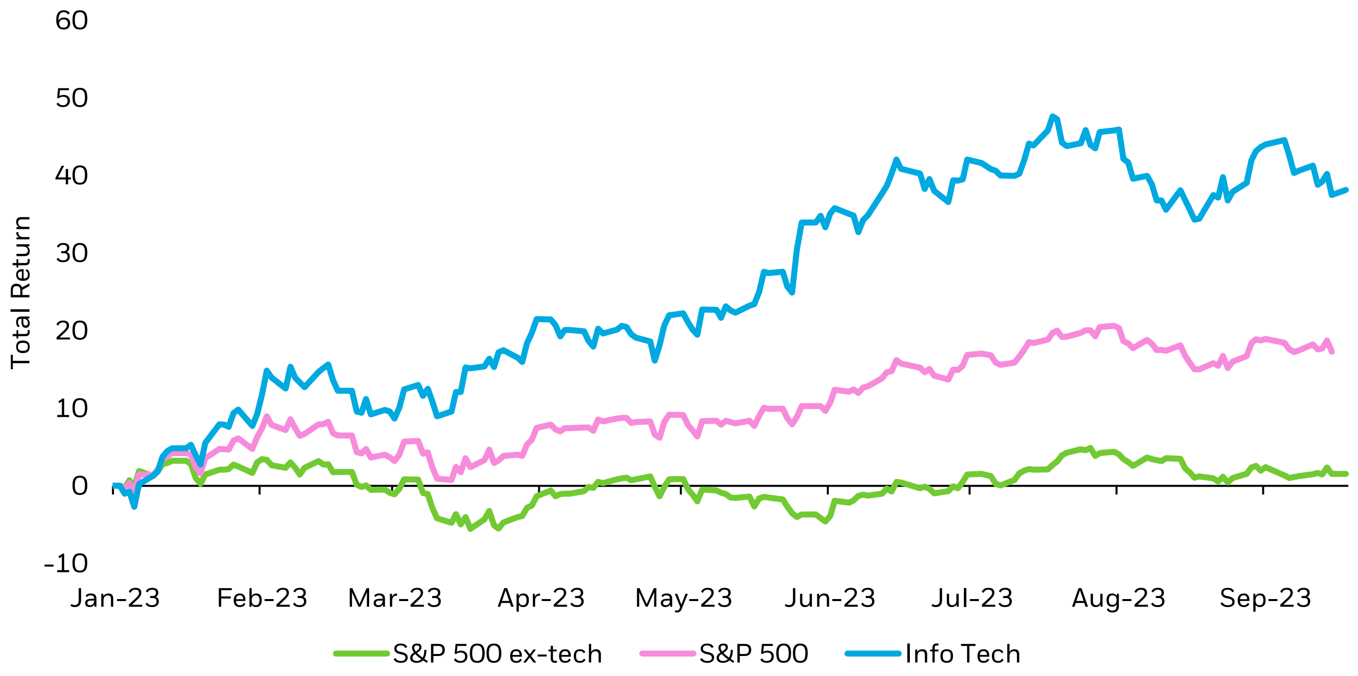
Figure 5: Credit card delinquencies begin to increase



Source: BlackRock, Bloomberg. Credit card delinquencies as represented by US Credit Card Delinquencies 30+ Days Composite U.S. Credit Card Delinquencies 30+ Days Composite Index. As of September 15, 2023.

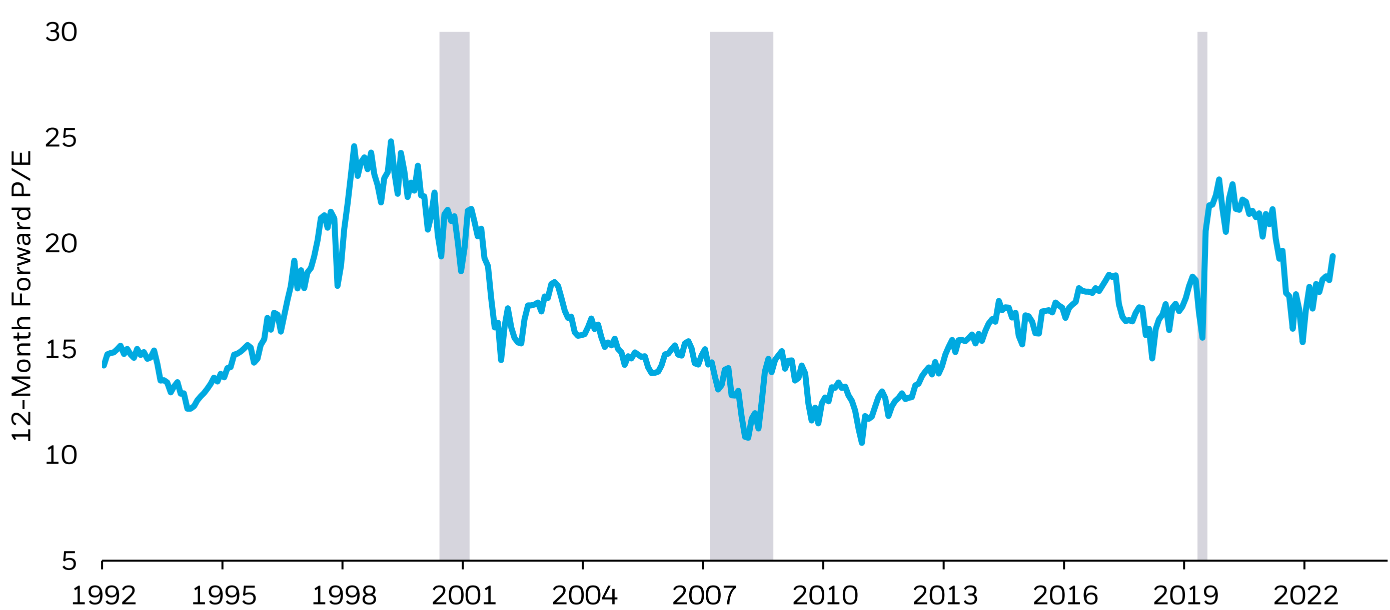
AI enthusiasm has also contributed to asset performances which we wouldn't typically expect in this macro environment. Year-to-date, 10-year bond yields have risen 0.45 percentage points and yet the S&P 500 technology sector – the sector many regard as having the 'longest duration' and most sensitivity to rising discount rates – has returned over 40% vs only 2.5% for the rest of the index.[7] Driven by lofty tech valuations, the consensus 12-month forward P/E on the S&P 500 has risen to over 19x, almost a full standard deviation above its 30-year average of 16.6x.[8]

Figure 6: Tech sector outperformance year-to-date



Source: BlackRock, Bloomberg. S&P 500 as represented by SPX Index; info tech as represented by S&P 500 Information Technology Sector GICS Level 1 Index. As of September 15, 2023.

Figure 7: S&P 500 12-month forward P/E



Source: BlackRock, Bloomberg. S&P 500 as represented by SPX Index. Grey areas indicate historical periods of U.S. recession, as determined by the National Bureau of Economic Research monthly recession binomial index (USRINDEX Index). As of September 10, 2023. **Past performance does not guarantee future results.**

iShares Investment Strategy Views: U.S. Equities

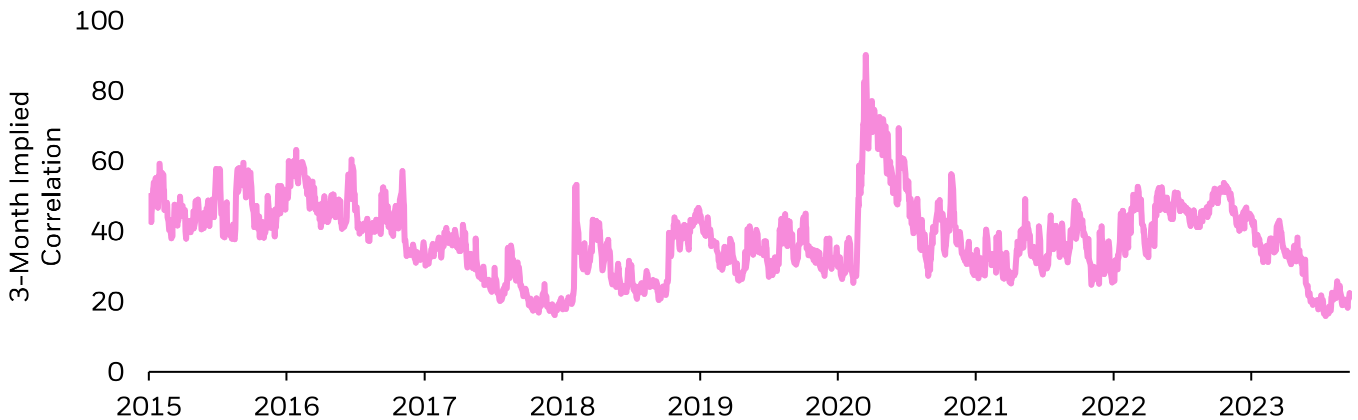
	Short Term	Medium Term	Outlook
Technology	–	↑	Multiple expansion, resilience priced in
Industrials	↑	↑	Benefit from cyclical upswing, low leverage
Energy	↑	↑	Global supply constraint, improving margins
Utilities	↓	↓	Poor quality characteristics (low profitability, high leverage)

As of September 15, 2023. Views are subject to change.

Equity market volatility – at its lowest levels since December 2019 – stands in the face of the fading economic backdrop.[9] Twelve-month forward earnings growth expectations for the S&P 500 have risen two percentage points to 9.8% in the past three months and year-to-date total returns remain buoyed by valuation expansion.[10] The sanguine outlook discounts what could be a bumpy road to year-end.

Much like we've seen since the S&P 500 hit a recent peak at the beginning of August, we believe markets will remain beholden to parsing through every economic print, trying to determine whether the Federal Reserve has achieved what it set out to do. This type of environment – where event risk premia remain high and implied correlations are at 5-year lows – underscores our continued preference for identifying quality characteristics within equities.

Figure 8: S&P 500 3-month implied correlation declines

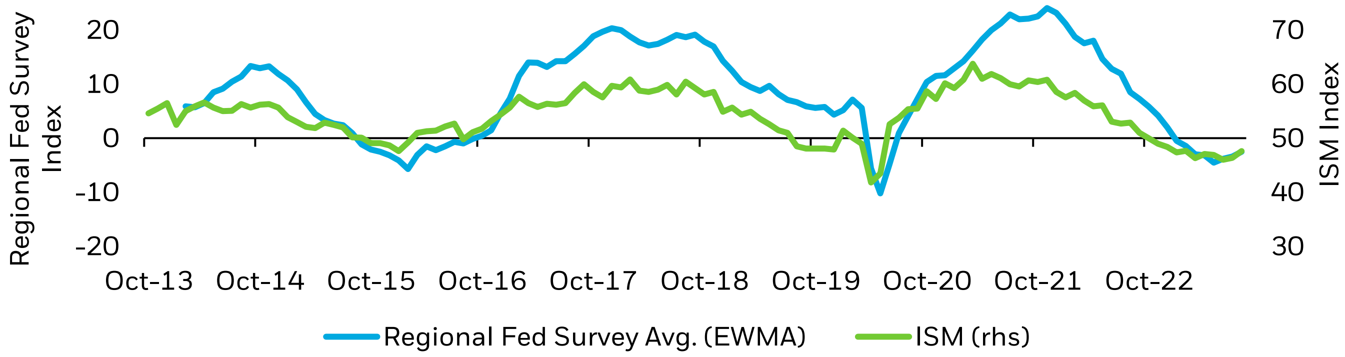


Source: BlackRock, Bloomberg. Implied correlation as represented by Cboe 3-Month Implied Correlation Index. As of September 15, 2023.

The result is a renewed focus on metrics such as low leverage, earnings stability, and profitability. Three sectors stand out: energy, industrials, and information technology.

- **We unpacked our optimistic energy outlook at the end of June in our Midyear Outlook, and since, crude has climbed over 30% with energy equities increasing in tandem.**[11] While the sector remains elevated on our quality screen on the back of strong earnings and high profitability metrics, year-to-date price action remains a corollary of crude prices. We see limited price downside as supply-dynamics remain tight, with a global daily deficit on the heels of domestic crude inventory draws paired with sustained OPEC+ cuts. We believe near-term contracts may continue to rise, towing energy equities up in the process.
- **We turn constructive on industrials.** The sector ranks high in its quality characteristics, particularly low leverage. We see fiscal spending continuing to support earnings and easing supply chains strengthening profit margins. With its P/E ratio right in line with its 10-year average at 17.6x, we like the 12-month forward earnings growth for the sector of 13%.[12] Our view is that a bottoming in U.S. manufacturing – maybe even picking up the growth baton from U.S. consumers – provides further upside risk headed into 2024.

Figure 9: Beginning of U.S. manufacturing bottom?

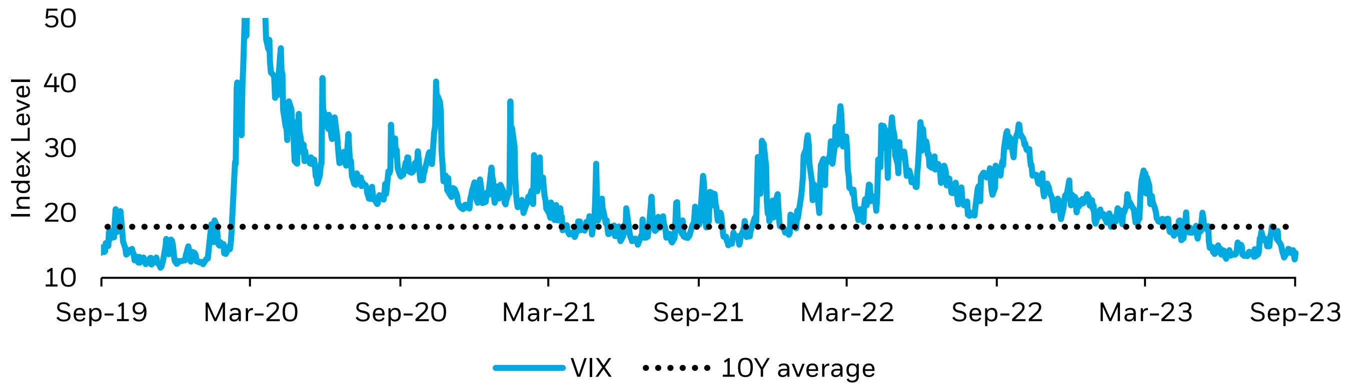


Source: BlackRock, Bloomberg. ISM as represented by ISM Manufacturing PMI SA Index; Regional Fed Survey average represented by EWMA of regional M-PMIs (Texas, Kansas City, Philadelphia, Richmond Fed, Empire State). As of September 10, 2023.

- Many large-cap **information technology** firms remain attractive according to our quality metrics. However, we suspect that such **resilience within high-quality tech companies has largely been priced in by investors (with a boost from AI optimism).** Hefty multiple expansion sees the sector trading at 25x 12-month forward earnings growth of 15%.[13] We believe there are other areas of the market – like industrials – that score comparably high on quality metrics and currently offer more reasonable valuations.
- We also utilize our quality preference to screen for sectors with subpar fundamentals. **Utilities unfold as our least-favored sector** on low profit margins and high leverage, coupled with a subdued dividend yield clocking in at a 3.3%, below its 10-year average.[14] This bearish outlook is reflected more broadly in investor positioning, too – utilities emerged as the largest underweight allocation in BofA's September Global Fund Manager Survey.[15]

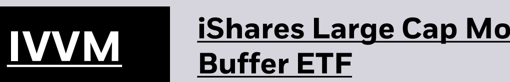
As we quickly approach year-end, we think investors may want to consider positioning against downside risk and volatility while remaining invested. Market volatility sits at 5-year lows, and buffered ETFs can take advantage of relatively low hedging costs in a depressed volatility environment. In capping downside losses while maintaining benchmark exposure, buffered ETFs can be used to help protect year-to-date gains or reduce active risk as we wait for more economic clarity in the months to come.

Figure 10: Volatility hovers below average



Source: BlackRock, Bloomberg. VIX as represented by Chicago Board Options Exchange Volatility Index. As of September 15, 2023. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Related funds



THEME TWO: FIXED INCOME

iShares Investment Strategy Views: Fixed Income

	Short Term	Medium Term	Outlook
Medium duration	∧	∧	Utilize 'belly' of the curve to lock in higher rates
Agency mortgages	∧	—	Mortgage spreads near recent wides
Municipal bonds	—	—	Relatively rich valuations
High yield	∨	—	We prefer investment grade exposures
TIPS	∧	—	Potential portfolio diversifier, hedge against oil prices

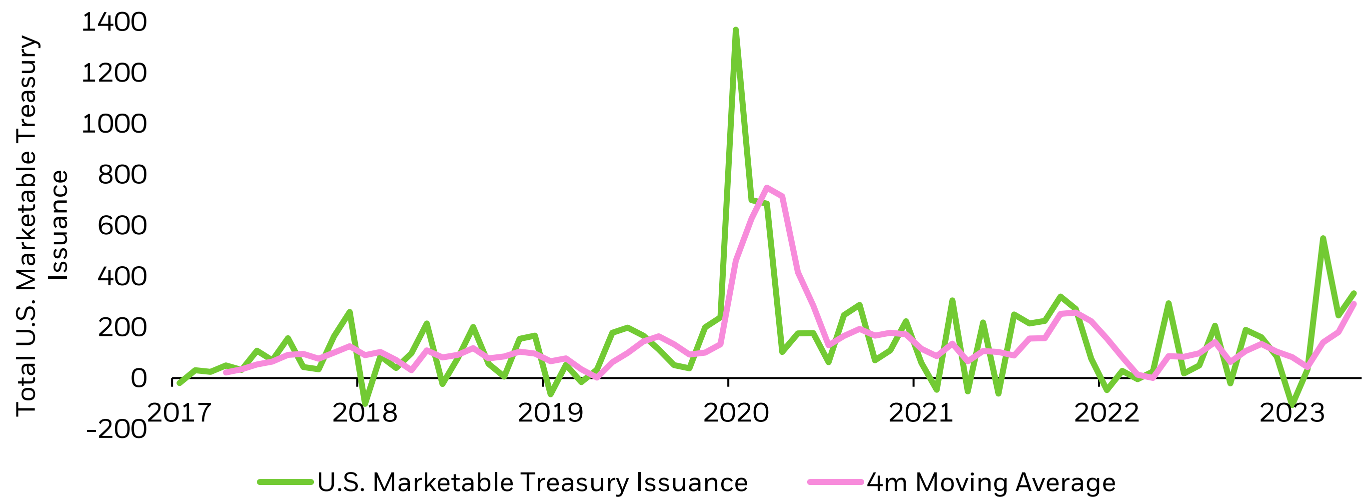
As of September 15, 2023. Views are subject to change.

Fixed income remains our firmest conviction. Consistent with our expectation for gradually slowing economic growth and corporate earnings, we prefer investment grade exposures to high-yield strategies. We believe the yield curve will likely flatten modestly as longer-maturity bonds sell off, but the curve may remain inverted through the end of the year. Yet given our belief that the Fed hiking cycle is at an end, we think the time has come to move out in duration and into the 'belly' of the curve (3- to 7-year duration) to lock in higher rates.

An improving economic outlook has been key to this year's rise in rates. As discussed in the introduction, economic data has been better-than-expected, especially given the Fed hiked policy rates by 5.25% since March 2022. Just two months ago, Fed funds futures priced that the Fed would cut rates this year to combat an expected sharp slowdown in economic activity. The improved growth outlook has now pushed the first expected Fed rate cut back to the second half of 2024. As Fed Chair Powell noted in the September FOMC press conference, "if the economy comes in stronger than expected, that just means we will have to do more in terms of monetary policy to get back to 2%" inflation. While growth should slow, the market believes there is enough momentum to rule out near-term rate cuts.[16]

Technical factors and supply may also lead to steeper curves. Treasury issuance are expected to top $1 trillion in the third quarter.[17] We believe supply over the next few quarters in the coupon sector should be digestible, but the CBO's longer-term forecasts show the budget deficit deteriorating from an already unsustainable level. With the Fed allowing $60 billion in Treasuries to roll off its balance sheet each month, higher rates may be required to attract marginal demand for duration. Weakening foreign demand for longer-dated Treasuries may also contribute to steeper U.S. yield curves. U.S. TIC data shows that Chinese holdings of U.S. Treasuries have reached their lowest level since June 2009.

Figure 11: Total U.S. marketable Treasury issuance



Source: BlackRock, Bloomberg. U.S. marketable Treasury issuance as represented by TISSTOTN Index. As of September 10, 2023.

In contrast to the problems facing long-dated Treasuries, we think the belly of the curve is attractive given its carry and cushion. Even as inflation is moderating and the rate hike cycle approaches its end, the 5-year yield is at its 99th percentile over past 10 years and 90th percentile over last 20 years.[18] These higher yields translate into higher carry, which can act as a 'buffer' against negative price returns.

We especially like agency mortgages at these rate levels because mortgage spreads are near recent wides. Mortgage spreads are correlated with implied fixed income volatility (because of the pre-pay option imbedded in fixed rate mortgages), so a decline in fixed income volatility should be consistent with a narrowing in MBS spreads. We believe that implied volatility will likely come down as it becomes clearer the Fed is done hiking and it becomes more evident that the Fed intends to leave rates higher for longer. Mortgages already compare favorably to investment grade bond spreads, but seasonal issuance and the need to secure funding before rates rise could add further investment grade credit supply and weigh on performance.

Figure 12: Spreads between MBS and investment-grade credit continue to widen

Yield Spread Percentage (%)

7
6
5
4
3
2
1
0

2000 2002 2004 2006 2008 2010 2012 2014 2016 2018 2020 2022

Investment Grade Corporate Bond Spread
Agency Mortgage-Backed Security Basis

Source: BlackRock, Bloomberg. Investment grade corporate bond spread as represented by LUACOAS Index; Agency mortgage-backed security basis as represented by .MBSBASIS F Index. As of September 15, 2023. **Past performance does not guarantee future results.**

We also like TIPS as real rates have reached levels not seen since the GFC and can act as a portfolio diversifier. Despite the surge in oil prices, market expectations for inflation essentially remain within the range they have traded since May.[19] With 10-year real rates reaching 2%, inflation-protected Treasuries present the opportunity to hedge inflation risks at an attractive yield.

Selective exposure to municipal bonds also offers some opportunities. While flows to municipal bond ETFs have reached their highest levels in three quarters, relatively rich valuations and waning seasonal trends warrant some near-term caution for municipal bonds as an asset class.[20] For this reason, we prefer higher quality issues such as essential-service revenue bonds, high-quality state and local issuers with the broadest tax support, and flagship universities.

Related funds

IEI **iShares 3-7 Year Treasury Bond ETF**

iShares TIPS Bond ETF

iShares MBS ETF

iShares Investment Strategy Views: International

	Short Term	Medium Term	Outlook
Brazil	^	—	Central bank cutting rates, cheap valuation
EM ex-China	^	—	Slow growth in China, EM central banks cutting rates
Japan	^	^	Stronger than expected economic data, strong corporate governance
Mexico	^	^	Feedthrough from stronger U.S. growth, long-term near -shoring trend
India	—	^	Expensive valuations near-term, longer-term supportive demographics
Hard Currency EM Debt	^	—	Attractive yields, EM central banks cutting rates

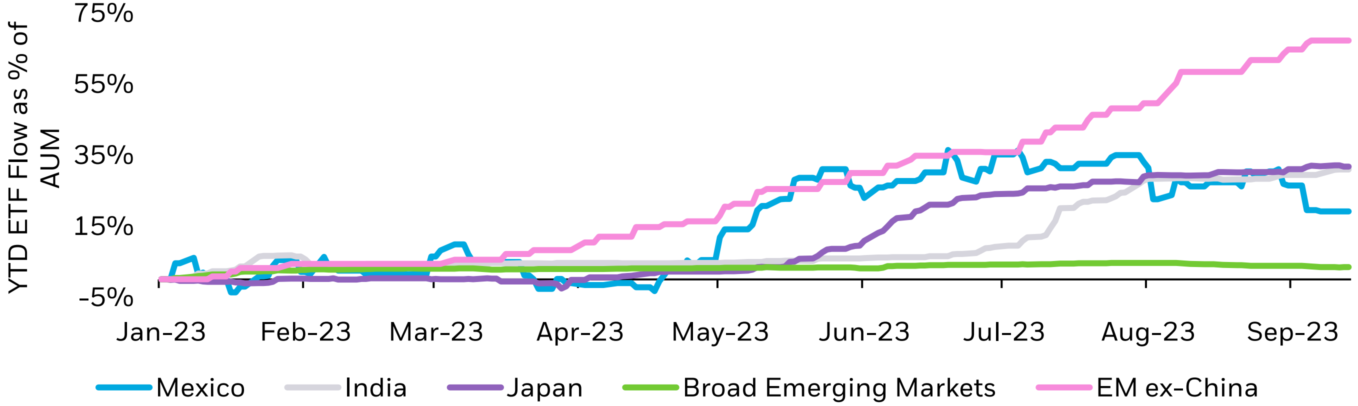
As of September 15, 2023. Views are subject to change.

Three main narratives, in our view, will drive international investing themes until year end. First, central banks will begin to diverge on policy as developed markets (DMs) are poised to keep interest rates restrictive for longer while emerging market (EM) central banks have begun or are preparing to cut rates. Second, slower global growth expectations may influence how investors approach EM allocations. Finally, structural trends from deglobalization and demographic changes may bolster certain regions outside of the U.S.

DM central banks in Europe and North America appear poised to keep interest rates higher for longer to bring down inflation. Meanwhile, we believe many EM economies, such as Brazil, face a better inflation and growth picture relative to developed markets, allowing their local central banks to consider cutting rates in the near-term. Brazil's central bank committed to cutting the Selic policy rate by 50 basis points in August with more expected by the end of 2023.[21] Overall, this reinforces our positive view for the Brazilian local equity market, and we believe more emerging market economies are expected to follow.

While China was expected to be a leader in global growth this year, other countries emerged as unexpected engines while strong data from the U.S. delivered a summer rally in the dollar. Investor sentiment for China worsened over the summer as the market struggled with high rates of youth unemployment, a declining property market, and weak consumer activity. Considering the disappointing growth picture, more investors have started to pick apart their EM and Asia-Pacific exposures with EM excluding China indexes. Japan's growth surprised to the upside, benefitting from a weaker currency, AI and robotic exposures, and potential end to its deflationary era. The U.S.'s stronger growth picture also led to resilience in the U.S. Dollar, which we think reached its cycle peak in Q4 2022.[22] The choppy USD and where global growth stands now are reasons why we think investors should be selective in their international allocations with EM ex-China and single country solutions.

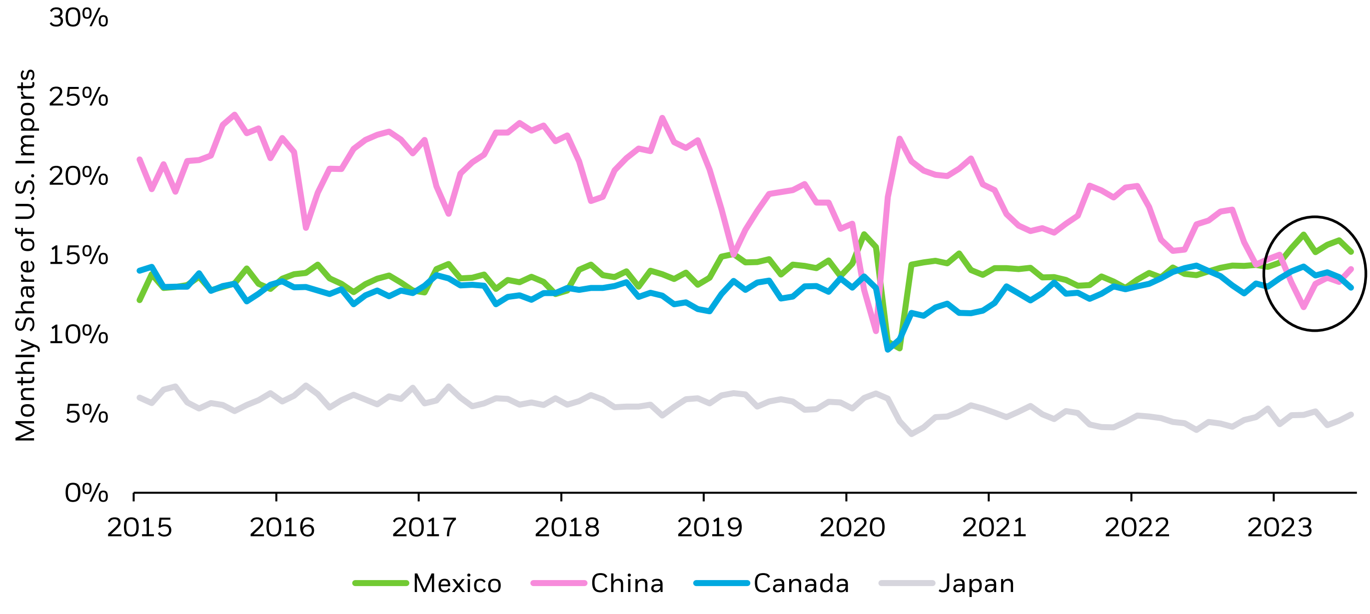
Figure 13: YTD flow % of AUM



Source: Bloomberg, as of September 13, 2023. ETF groupings determined by Markit. ETFs are U.S.-listed.

Lastly, structural global events like deglobalization and nearshoring may benefit select regional economies for the longer term. For example, we believe that India's growing workforce due to its expanding population – which is now the world's largest – may bolster the economy into a more sizable growth engine for Emerging Markets Asia. Another powerful long-term trend in play is nearshoring, where countries such as Mexico – which is strategically located close to the U.S. and offers competitive labor costs and favorable tax treatments – are poised to benefit from post-pandemic deglobalization forces.

Figure 14: Mexico surpasses China as the USA's main trade partner



Source: BlackRock, U.S. Census Bureau. As of September 13, 2023.

Regarding emerging market debt, we hold a preference for hard currency EM debt over local currency EM debt considering the strength of the USD. Yields for hard currency EM debt are currently attractive and could be cushioned from weakening local currencies as EM central banks start to cut policy rates.

Related funds

iShares MSCI Emerging Markets ex China ETF

iShares MSCI Brazil ETF

iShares MSCI India ETF

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[1] Source: Bloomberg, Atlanta Fed. S&P 500 represented by SPX Index. As of September 15, 2023.
[2] Source: Bloomberg. 'Long-run average' as represented by 10-year average. As of September 15, 2023.
[3] Source: Bloomberg, Bureau of Labor Statistics. As of September 18, 2023.
[4] Source: Bureau of Labor Statistics. As of September 18, 2023.
[5] Source: Bloomberg. As of September 18, 2023.
[6] Source: Bloomberg. As of September 09, 2023.
[7] Source: BlackRock, Bloomberg. S&P 500 represented by SPX Index; S&P 500 technology sector represented by S5INFT Index. As of September 15, 2023. *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.*
[8] Source: Bloomberg. S&P 500 Index represented by SPX Index. As of September 10, 2023.
[9] Source: Bloomberg. Equity market volatility as represented by VIX Index. As of September 15, 2023.
[10] Source: BlackRock, Bloomberg. S&P 500 represented by SPX Index. As of September 18, 2023.
[11] Source: Bloomberg. Crude represented by Generic 1st Crude Oil, WTI Index, energy equities represented by S5ENRS Index. As of September 10, 2023. *Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.*
[12] Source: Refinitiv Eikon. Industrials represented by S5INDU Index. As of September 15, 2023. The price-to-earnings ratio is used to assess a company's valuation.
[13] Source: Refinitiv Eikon. Information technology represented by S5INFT Index. As of September 18, 2023.
[14] Source: Bloomberg. Utilities represented by S5UTILS Index. As of September 18, 2023. *Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.*
[15] Source: Bank of America. As of September 09, 2023.
[16] Source: BlackRock, Bloomberg. Rate cut futures represented by USOAFR MAY2024 Index. As of August 04, 2023.
[17] Source: BlackRock, Bloomberg. As of September 10, 2023.
[18] Source: Bloomberg, Bureau of Labor Statistics. As of September 15, 2023.
[19] Source: BlackRock, Bloomberg. As of September 15, 2023.
[20] Source: BlackRock, Markit. ETF groupings determined by Markit. As of September 10, 2023.
[21] A basis point (bps) is one hundredth of one percent (e.g. one basis point = 0.01%).
[22] Source: Bloomberg. As of September 14, 2023.

Carefully consider the Funds' investment objectives, risk factors, and charges and expenses before investing. This and other information can be found in the Funds' prospectuses or, if available, the summary prospectuses which may be obtained by visiting www.iShares.com or www.blackrock.com. Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal.

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There can be no assurance that performance will be enhanced or risk will be reduced for funds that seek to provide exposure to certain quantitative investment characteristics ("factors"). Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods. In such circumstances, a fund may seek to maintain exposure to the targeted investment factors and not adjust to target different factors, which could result in losses.

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An investment in fixed income funds is not equivalent to and involves risks not associated with an investment in cash.

Funds that concentrate investments in specific industries, sectors, markets or asset classes may underperform or be more volatile than other industries, sectors, markets or asset classes and than the general securities market.

Actively managed funds do not seek to replicate the performance of a specified index. Actively managed funds may have higher portfolio turnover than index funds.

Commodities' prices may be highly volatile. Prices may be affected by various economic, financial, social and political factors, which may be unpredictable and may have a significant impact on the prices of commodities.

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The Fund invests in FLEX Options that derive their value from the Underlying ETF. FLEX Options are subject to counterparty risk, which is the risk that the other party in the transaction will not fulfill its contractual obligation, and may be less liquid than other securities. The value of FLEX Options may be affected by interest rate changes, dividends, actual and implied volatility levels of the Underlying ETF's share price, and the remaining time until the FLEX Options expire. Because of these factors, the Fund's NAV may not increase or decrease at the same rate as the underlying ETF's share price.

There is no guarantee that dividends will be paid.

Technologies perceived to displace older technologies or create new markets may not in fact do so. Companies that initially develop a novel technology may not be able to capitalize on the technology.

There can be no assurance that an active trading market for shares of an ETF will develop or be maintained.

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