

Weekly commentary

September 11, 2023

BlackRock

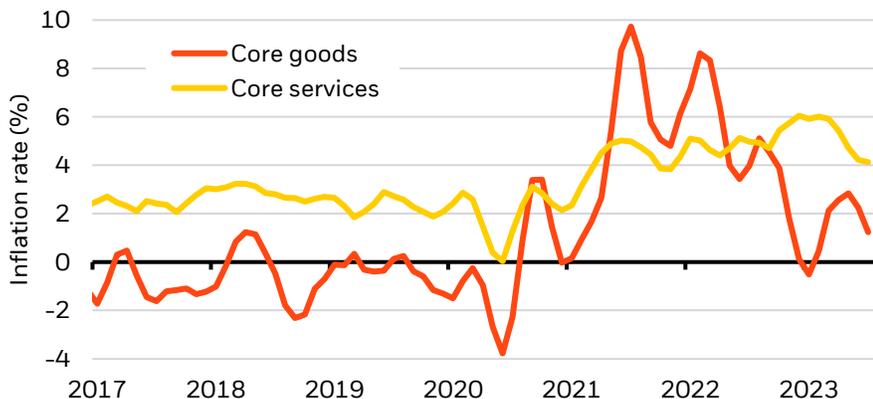
New regime fuels narrative flip flops

- Market narratives have flip-flopped through the year as the new macro regime plays out. We stay selective amid stagnating activity and volatile inflation.
- U.S. stocks dipped and bond yields climbed after solid U.S. services data. Markets are coming around to our view of key central banks holding policy tight.
- U.S. CPI data this week should show more post-pandemic normalization. We see inflation on a rollercoaster ride ahead as an aging population starts to bite.

We're in an unprecedented macro environment that is driving constant shifts in the market narrative: from hopes of avoiding recession to fears good macro news could be bad for markets in just a few months. We see the market moving with data as if we're in a normal business cycle. But we're in a new regime, with pandemic disruptions giving way to structural shifts that are playing out now, like an aging workforce. We see opportunities from timing market swings and staying selective.

Cooling down

Core goods and core services inflation, 2017-2023



Source: BlackRock Investment Institute, with data from LSEG Datastream, September 2023. Notes: The chart shows the three-month on three-month annualized rate of U.S. core goods and core services inflation using the Personal Consumption Expenditures (PCE) price index. The data has been rebased.

Inflation is likely to keep falling as pandemic mismatches resolve. See the chart. Core goods prices have seen the sharpest drop (dark orange line) as consumers shifted spending back toward services after splurging on goods during the pandemic. We estimate that about two-thirds of the spending shift has now unwound. At the same time, the spike in job openings is normalizing without a rise in unemployment. That has helped ease wage growth – leading to lower price pressure in core services as well (yellow line). Employers in leisure and retail, for example, now face less pressure to pay up for the workers they needed that were in short supply. Shifting narratives show how the market is trying to translate an assessment of the inflation and broader macro picture into investment views based on a typical business cycle. But we think mapping the macro outlook to markets is less straightforward in the new regime.



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Euphoria over artificial intelligence (AI) has buoyed U.S. equities this year even with the tough macro backdrop. The bank turmoil in March revived recession fears, but equities soon resumed a climb and gained steam on falling inflation. By August, stocks stalled. Data suggesting solid growth spurred fears of higher-for-longer rates – “good news” became “bad news” – and bond yields surged as investors started demanding more term premium for the risk of holding long-term bonds.

We think the narrative could flip again. A key part of the story has gone under the radar: stagnation. The economy has already stagnated for 18 months when taking the average of GDP and gross domestic income, according to U.S. Bureau of Economic Analysis data. Outright recession has so far been avoided and Q3 growth looks set to pick up, thanks to consumers spending their pandemic savings. But as savings are exhausted, next year could bring lower growth. Recession is still in the cards. But whether we go through recession and recovery, or flatlining activity, we think we end up in the same place. However we get there, it would mean the weakest two-and-a-half years for the U.S. economy outside the global financial crisis. So how has weak growth gone under the radar? One reason: Seemingly strong job growth largely reflects a catch-up from the pandemic shock. Adjusting for that, it’s been quite weak – and still worker shortages persist due to an aging population. With the job catch-up nearly complete, employment growth is slowing, we find. This sets up another potential narrative flip as stagnation sinks in. Take Europe. Activity has weakened and may be in recession. As a result, the early outperformance of European stocks this year has fizzled. And the European Central Bank may pause its rate hikes this week.

More broadly, all these market narratives apply a typical business cycle lens. We think the core issue is structural and playing out now. The labor force is growing more slowly as the population ages. Weak growth doesn’t translate into higher unemployment like it used to: We see full-employment stagnation. Demographic shifts causing worker shortages mean inflation can only be kept low with weaker growth, in our view. As labor shortages start to bind, we think inflation pressures could build again, putting inflation on a rollercoaster ride and compelling major central banks to hold policy tight.

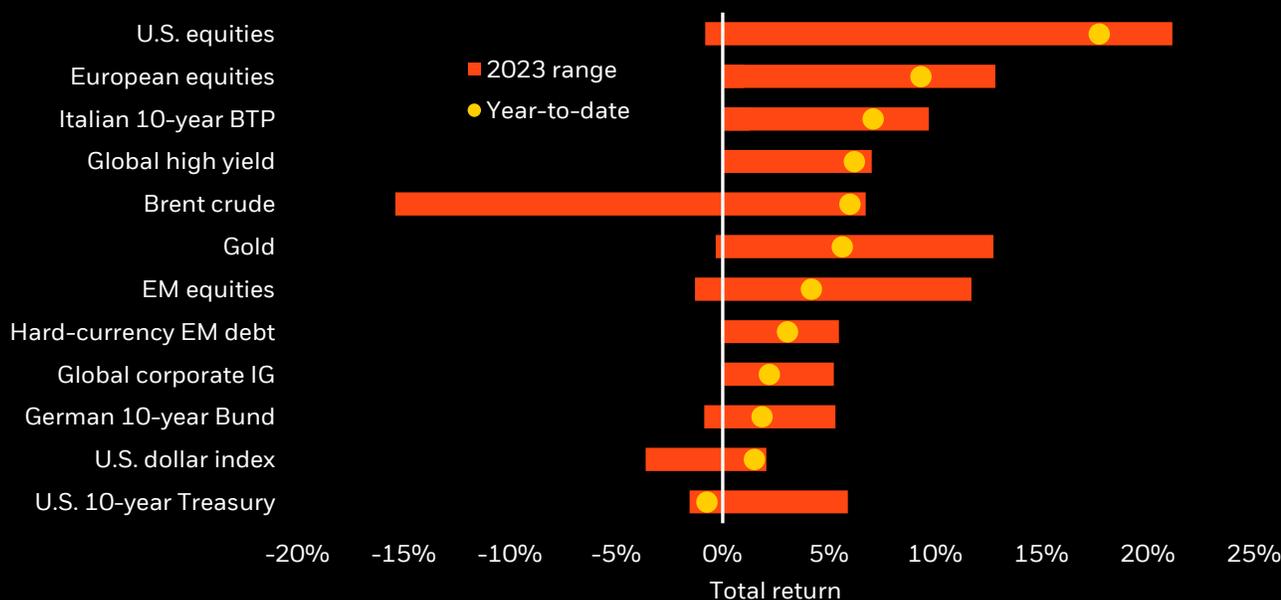
Bottom line: Markets can run with narratives a while before flipping, creating potential for market-timing opportunities with the swings. We stay nimble and selective in stocks and credit. We underweight the broad market of developed market equities on a six- to 12-month horizon. And over that horizon, we look to harness mega forces like AI to tap structural drivers shaping returns now and in the future.

Market backdrop

U.S. stocks fell more than 1%, coming under pressure as 10-year Treasury yields pushed back near 16-year highs and markets priced out some of the Federal Reserve rate cuts seen next year. This week’s narrative was again “good news is bad news” – U.S. services activity topped expectations in August, reinforcing the higher-for-longer view on policy rates. European stocks hit six-month lows as grim German industrial production data highlighted the euro area’s potential recession.

Assets in review

Selected asset performance, 2023 year-to-date return and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.

Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of Sept. 7, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, ICE U.S. Dollar Index (DXY), spot gold, MSCI Emerging Markets Index, MSCI Europe Index, Refinitiv Datastream 10-year benchmark government bond index (U.S., Germany and Italy), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI USA Index.

Macro take

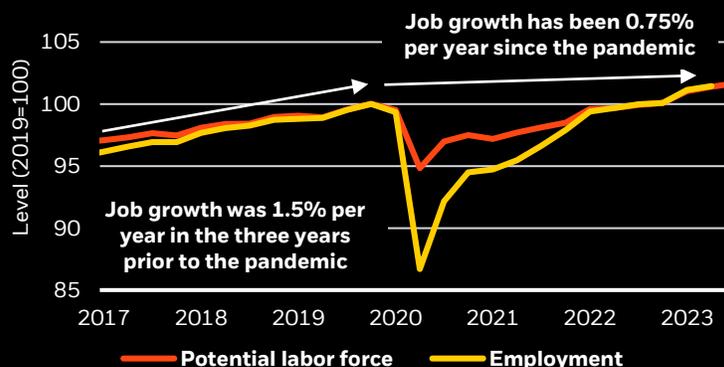
A growing share of the U.S. population is past retirement age, and that's creating a worker shortage. The U.S. workforce is four million smaller than it would have been if it kept growing evenly across age groups and at its pre-Covid pace. See the orange line in the chart.

Typically, that would mean employers face more competition for workers, resulting in pressure to raise wages. Yet the recent easing in wage growth reveals this aging population is not yet biting. That's because overall job growth has been weak since the pandemic. We think the plentiful new jobs created in recent months reflects employment catching up to economic activity restarting after lockdowns. Since the restart, it has only created about half the number of new jobs in the last three years that it created the three years before.

This is partly why we're still cautious even as growth seems to hold up. We find that an aging population will limit the number of jobs the U.S. economy can add each month without spurring inflation to 70,000 vs. 200,000 before the pandemic. See more in our Macro take blog posts [here](#).

Meager job growth post-Covid

U.S. employment and potential labor force, 2017-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, September 2023. Notes: The yellow line shows U.S. employment level measured by the survey of households. The orange line shows the level of employment that would have been obtained had the unemployment rate held steady at 3.6%, the level in Q4 2019, given the actual labor force.

Investment themes

1 Holding tight

- The U.S. is navigating two large and unprecedented shocks. The first: A massive, pandemic-induced shift in consumer spending – most visible from services to goods – created a mismatch in what the economy was set up to produce and what people wanted to buy. The second: a worker shortage as baby boomers age into retirement.
- Our assessment is that we are set for “full-employment stagnation.” Most of the inflation and wage growth we’ve seen to date reflects the mismatch associated with the pandemic. That is now reversing well and inflation is set to fall further. But as the process of resolving the mismatch ends and labor shortages start to bind, we expect inflation to go on a rollercoaster ride, rising again in 2024. A smaller workforce means the rate of growth the economy will be able to sustain without resurgent inflation will be lower than in the past.
- We see central banks being forced to keep policy tight to lean against inflationary pressures. This is not a friendly backdrop for broad asset class returns, marking a break from the four decades of steady growth and inflation known as the Great Moderation.
- **Investment implication:** Income is back. That motivates our overweight to short-dated U.S. Treasuries.

2 Pivoting to new opportunities

- Greater volatility has brought more divergent security performance relative to the broader market. Benefiting from this requires getting more granular and eyeing opportunities on horizons shorter than our tactical one. We go granular by tilting portfolios to areas where we think our macro view is priced in.
- We think dispersion within and across asset classes – or the extent to which prices deviate from an index – will be higher in the new regime amid the various crosscurrents at play, allowing for granularity. That offers more ways to build portfolio “breadth” via uncorrelated exposures, in our view.
- We think it also means security selection, expertise and skill are even more important to achieving above benchmark returns. Relative value opportunities from potential market mispricings are also likely to be more abundant.
- **Investment implication:** We like quality in both equities and fixed income.

3 Harnessing mega forces

- Mega forces are structural changes we think are poised to create big shifts in profitability across economies and sectors. These mega forces are digital disruption like artificial intelligence (AI), the rewiring of globalization driven by geopolitics, the transition to a low-carbon economy, aging populations and a fast-evolving financial system.
- The mega forces are not in the far future – but are playing out today. The key is to identify the catalysts that can supercharge them and the likely beneficiaries – and whether all of this is priced in today. We think granularity is key to find the sectors and companies set to benefit from mega forces.
- We think markets are still assessing the potential effects as AI applications could disrupt entire industries.
- Geopolitical fragmentation, like the strategic competition between the U.S. and China, is set to rewire global supply chains, we think.
- The low-carbon transition causing economies to decarbonize at varying speeds due to policy, tech innovation and shifting consumer and investor preferences. Markets have historically been slow to fully price in such shifts.
- We see profound changes in the financial system. Higher rates are accelerating changes in the role of banks and credit providers, shaping the future of finance.
- **Investment implication:** We are overweight AI as a multi-country, multi-sector investment cycle unfolds.

Week ahead

Sept. 12 UK labor market data

Sept. 14 European Central Bank (ECB) policy decision

Sept. 13 U.S. CPI

Sept. 15 University of Michigan consumer sentiment survey

U.S. CPI inflation data takes center stage this week. Inflation has fallen as pandemic-driven mismatches have reversed. We see inflation on a rollercoaster ride ahead as that process ends and an aging population constrains the workforce. In Europe, falling inflation and slowing economic activity will likely lead the ECB to hold policy rates steady this week.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, September 2023

Underweight
Neutral
Overweight
● Previous view

	Asset	Strategic	Tactical	Commentary
Equities	Developed	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched. Tactically, we're underweight DM stocks as central banks' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession.
	Emerging	Neutral	+1	Strategically, we are neutral as we don't see significant earnings growth or higher compensation for risk. We are overweight tactically on brighter growth trends in EM over DM, still appealing valuations and EM rate cycles nearing their peaks.
Developed market government bonds	Nominal	-1	-1	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. We stay underweight nominal long-dated government bonds on both horizons as we expect investors to demand more compensation for the risk of holding them. Tactically, we are neutral on euro area and UK long-term bonds because higher yields better reflect our view.
	Inflation-linked	+3	Neutral	Our strategic views are maximum overweight DM inflation-linked bonds where we see higher inflation persisting – but we have trimmed our tactical view to neutral on current market pricing in the euro area.
Public credit and emerging market debt	Investment grade	-1	Neutral	Strategically, we're underweight investment grade due to limited compensation above short-dated government bonds. Tactically, we're neutral on tightening credit and financial conditions.
	High yield	Neutral	-1	Strategically, we are neutral high yield as we see the asset class as more vulnerable to recession risks. We're tactically underweight. Spreads don't fully compensate for slower growth and tighter credit conditions we expect.
	EM debt	Neutral	+1	Strategically, we're neutral and see more attractive income opportunities elsewhere. Tactically, we're overweight hard currency EM debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
Private markets	Income	+1	–	We are strategically overweight private markets income. For investors with a long-term view, we see opportunities in private credit as private lenders help fill a void left by a bank pullback.
	Growth	-1	–	Even in our underweight to growth private markets, we see areas like infrastructure equity as a relative bright spot.

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 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.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, September 2023

Underweight
Neutral
Overweight
● Previous view

Asset	View	Commentary
Developed markets		
Equities	United States	We are underweight the broad market – still our largest portfolio allocation. We don't think earnings expectations reflect the macro damage we expect. We recognize momentum is strong near term.
	Europe	We are underweight. We see the European Central Bank holding policy tight in a slowdown, and the support to growth from lower energy prices is fading.
	UK	We are neutral. We find that attractive valuations better reflect the weak growth outlook and the Bank of England's sharp rate hikes to deal with sticky inflation.
	Japan	We are neutral. Bank of Japan policy is still easy, shareholder-friendly reforms are taking root and negative real rates support equities.
	Pacific ex-Japan	We are neutral. China's restart is losing steam and we don't see valuations compelling enough to turn overweight.
	DM AI mega force	We are overweight. We see a multi-country and multi-sector AI-centered investment cycle unfolding set to support revenues and margins.
Emerging markets		
Fixed Income	China	We are overweight. We see brighter relative growth trends in EM over DM, valuations remain appealing and EM rates cycles are nearing peaks.
	Short U.S. Treasuries	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer.
	Long U.S. Treasuries	We are underweight. We see long-term yields moving up further as investors demand greater term premium.
	U.S. inflation-linked bonds	We are overweight and prefer the U.S. over the euro area. We see market pricing underestimating sticky inflation.
	Euro area inflation-linked bonds	We prefer the U.S. over the euro area. Markets are pricing higher inflation than in the U.S., even as the European Central Bank is set to hold policy tight, in our view.
	Euro area govt bonds	We are neutral. Market pricing better reflects rates staying higher for longer. We see risk of wider peripheral bond spreads due to tighter financial conditions.
	UK gilts	We are neutral. We find gilt yields better reflect our expectations for the macro outlook and Bank of England policy.
	Japanese govt bonds	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
	China govt bonds	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	Global IG credit	We are neutral on tighter credit and financial conditions. We prefer Europe's more attractive valuations over the U.S.
	U.S. agency MBS	We're overweight. We see agency MBS as a high-quality exposure within diversified bond allocations.
	Global high yield	We are underweight. Spreads do not fully compensate for slower growth and tighter credit conditions we anticipate.
	Asia credit	We are neutral. We don't find valuations compelling enough to turn more positive.
	Emerging hard currency	We are overweight. We prefer emerging hard currency debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks start to cut policy rates.
Emerging local currency	We are neutral. Yields have fallen closer to U.S. Treasury yields. Plus, central bank rate cuts could put downward pressure on EM currencies, dragging on potential returns.	

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