

## BLACKROCK SYSTEMATIC

# Easing into elections

Fixed income market views from BlackRock Systematic

Elections have been anything but easy for investors—from the repricing of fiscal policy expectations following French, Mexican, and Indian elections to the bear steepening in US treasuries. These dynamics could impact the pricing of government debt and contribute to rising term premia, potentially undermining the attractiveness of longer maturity bonds.

What *has* been easy is financial conditions in the US relative to the level of policy rates, fostering the debate over the degree of policy restrictiveness as global monetary easing begins. The transmission of the US Federal Reserve (“Fed’s”) asymmetric policy stance to the real economy and markets has contributed to strong returns to risk assets so far this year. This has played out with significant divergence under the surface, creating a rich environment for alpha generation in long/short equity strategies.



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## Key points

### Elections prompt fiscal consternation

The reordering of US election outcomes led to a bear steepening in US treasuries. Globally, French, Mexican and Indian elections all led to repricing fiscal policy expectations. This common thread in elections across the globe may have meaningful implications for the pricing of global government debt and term premia moving higher and steeper, putting pressure on long-end exposures.

### Global central bank policy easing underway

The global easing cycle kicked off with the European Central Bank, Bank of Canada, Riksbank, and Swiss National Bank all beginning interest rate cuts. However, expectations for a smooth cycle of rate cuts may be under review following upside inflation surprises in Canada and Australia. The Fed “dots” pushed out the expected cutting cycle into 2025 and 2026, but a soft June CPI print and the long-awaited slowing in housing related inflation alongside ongoing labor market slowing validated our expectations for a Fed willing and now able to start its cutting cycle in September.

### Bifurcation beneath the surface

Financial markets this year are like ducks on the water—all the action is beneath the surface. Overall rate, spread, and equity volatility is dampened and down this year. Policy choices fueling greater divergence across both the corporate and consumer spheres and the (so far) “winner take all” dynamics powering secular technology leaders underlie the substantial performance differences creating an ideal environment for alpha investing.

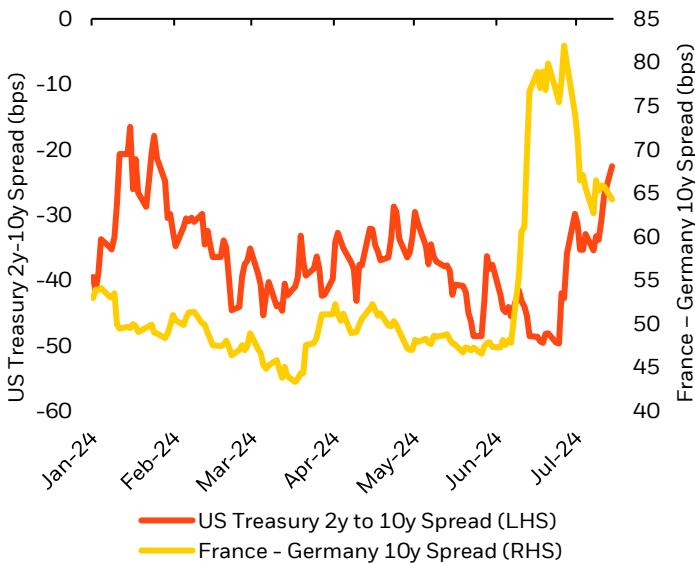
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# Elections prompt fiscal consternation

The reordering of US election outcomes led to a bear steepening in US treasuries. Globally, French, Mexican, and Indian elections all led to repricing expectations for fiscal policy. This common thread across global election impacts has the potential to hold meaningful implications for the pricing of global government debt and term premia becoming higher and steeper, undermining the attractiveness of long end exposures.

**Figure 1: Fiscal policy concerns prompt spread widening (France and US)**

US Treasury 2y-10y and France-Germany 10y spreads



Source: BlackRock, with data from Bloomberg, as of July 15, 2024.

Fiscal policy concerns underscore the widening of spreads (US curve spreads and French vs. Germany spreads) in the above chart. This reflects the growing recognition by bond markets that increasing debt and deficits in an era of central bank policy less geared towards Quantitative Easing (“QE”) requires more private financing of government debt. While the debt will clear, it’s the price that is resetting to reflect the anticipation of a greater supply burden.

Though global monetary policy may be easing, that is mostly a function of interest rate policy and mostly at the short-end of the yield curve. Furthermore, market expectations for a continual smooth cycle of “maintenance cuts” as global inflation falls are already in question as upside inflation surprises in Canada and Australia undercut hopes for consecutive cuts and re-introduced the possible need for rate hikes. The Fed “dots,” representing the policy expectations of committee members, pushed out the cutting cycle into 2025 and 2026, but a soft June CPI and the long-awaited slowing in housing related inflation alongside ongoing labor market slowing validated our expectations for a Fed willing and now able to start its cutting cycle in September.

With bond market pricing now reasonably aligned to this more modest expectations of cuts, the path of inflation appears less of a risk to inducing bond market volatility in the US than earlier in the year. The front-end of the yield curve (2–5-year maturities) as a result offers a better tradeoff between carry and potential yield volatility, keeping it a potentially favorable area for fixed income investments.

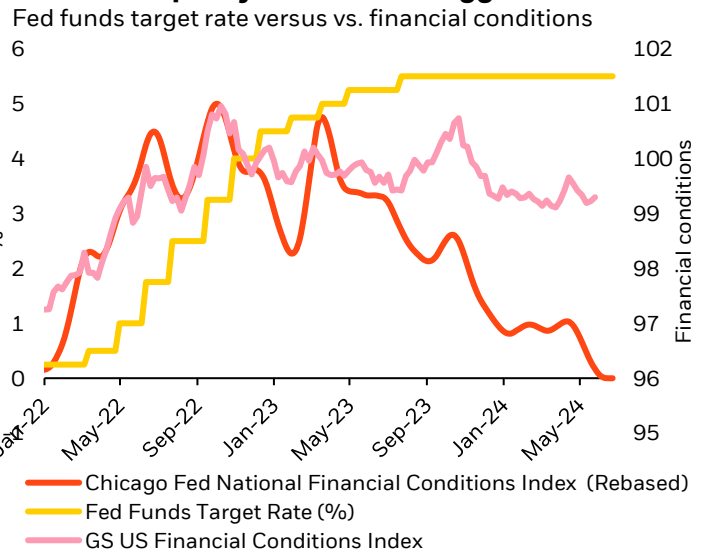
# The Fed’s asymmetry leads to (unintentional?) policy easing

The Fed has held short-term interest rates high, leading to a strongly inverted yield curve. This level of curve inversion typically precedes a recession, which contributed to the strong consensus expectations for recession last year. However, while holding rates high, the Fed has signaled a strong asymmetric response function to inflation outcomes. This implies that given substantial progress on inflation to date, further progress can be achieved by keeping rates steady as policy is “sufficiently restrictive.” On signs of inflation returning to 2% or any evidence that policy has become overly restrictive (i.e. labor market weakness, growth weakness, or a financial shock), the Fed has indicated a desire to rapidly cut interest rates.

This asymmetric response function is highly favorable to financial market assets and increases investors’ willingness to add risk in portfolios. Overall, stock market valuations have surged (albeit unevenly with secular growth and quality leading the way), volatility has collapsed, and credit spreads are at or through mid-cycle tight levels. These are all indicators of very benign investor risk concerns.

These dynamics make financial conditions much easier than current policy rates would imply. Figure 2 highlights the short-term evolution of financial conditions versus policy rates. Policy is much easier than rates would suggest when looked at through the lens of financial conditions.

**Figure 2: Financial conditions in the US are easier than policy rates would suggest**



Source: BlackRock, Bloomberg, Chicago Fed, and Goldman Sachs, as of June 2024.

The “sufficiently restrictive” characterization from Fed Chair Powell rests on two observations: (1) that real policy rates stand historically high, and (2) that labor market normalization supports the notion that monetary policy is slowing the economy.

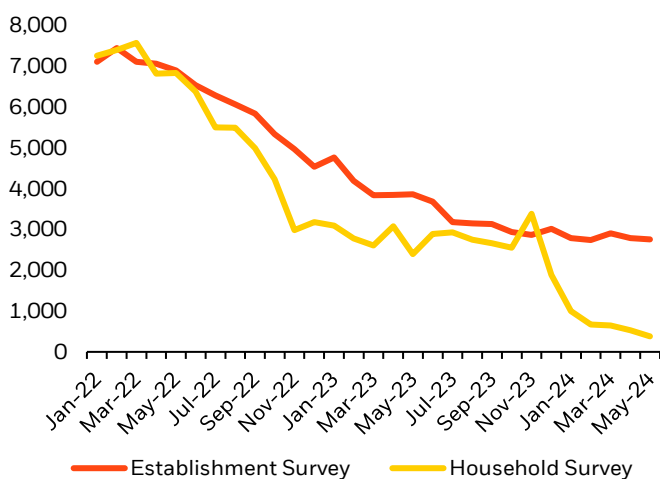
On real policy rate restrictiveness, this doesn’t depend on the absolute level of real policy rates, but rather on their level in relation to the concept of what is the *neutral rate*, or the rate that neither stimulates or restricts economic growth. However, post-COVID economic changes in the demand and supply of credit may be contributing to a higher neutral rate of interest, implying that policy is less restrictive than otherwise thought.

On labor markets, most measures have shown progress towards labor market normalization from the pandemic shock but remain elevated and consistent with pre-COVID tight labor market dynamics. So how much of this progress is due to the supply side normalization versus slowing demand driven by policy restrictiveness? Arguments on the data cut both ways.

For example, both household and establishment surveys of payroll growth show slowing (Figure 3), but households show a greater amount of slowing (and hence provide more evidence of policy restrictiveness). One side of the debate emphasizes undercounting of recent immigrants in the household survey. The other side highlights further evidence from alternative estimates of establishment payrolls, suggesting that the establishment survey may be overstating payroll growth. Ultimately, a larger move lower in payrolls appears necessary to settle the debate more fully, something both recent prints and critically downward revisions to prior data suggests.

**Figure 3: Labor markets normalizing, but to what degree opens a debate on data measurements**

Thousands, over-year-ago changes



Source: BlackRock, with data from St. Louis Fed, as of May 2024.

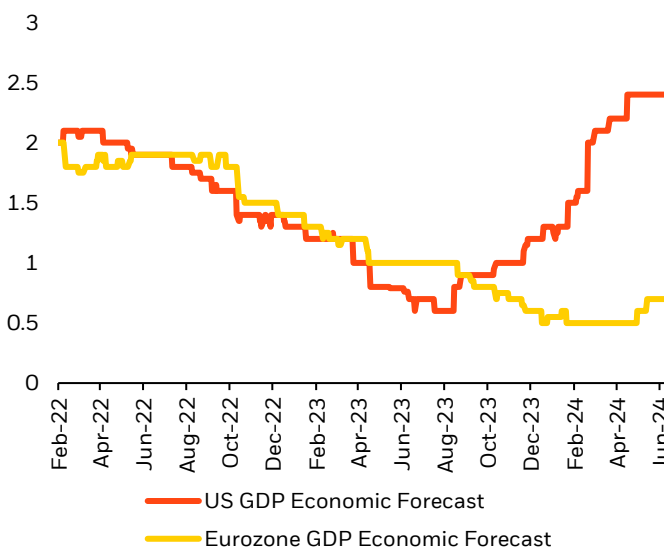
## The policy transmission of easy financial conditions

Though monetary policy affects interest rate sensitive sectors and especially housing, it is the impact on broad financial conditions through which policy most directly transmits to the real economy. Alongside the sensitivity to the risks of over-tightening, the Fed’s signaling of an asymmetric response function to inflation (inadvertently) encourages greater risk taking in financial markets. This in turn eases financial conditions in the form of higher asset values, tighter spreads, and easier access to financing. The result is higher wealth and greater spending fueling consumption and economic growth, but in an unequal distribution that reflects the concentration of wealth in higher-end consumers.

Overall, policy is easier than interest rate levels would suggest through its impact on financial conditions, supporting upward revisions to growth expectations since the peak in recession fears last year (Figure 4).

**Figure 4: US growth expectations diverge from other regions**

US vs Eurozone GDP Forecast



Source: BlackRock, with data from Bloomberg, as of June 2024.

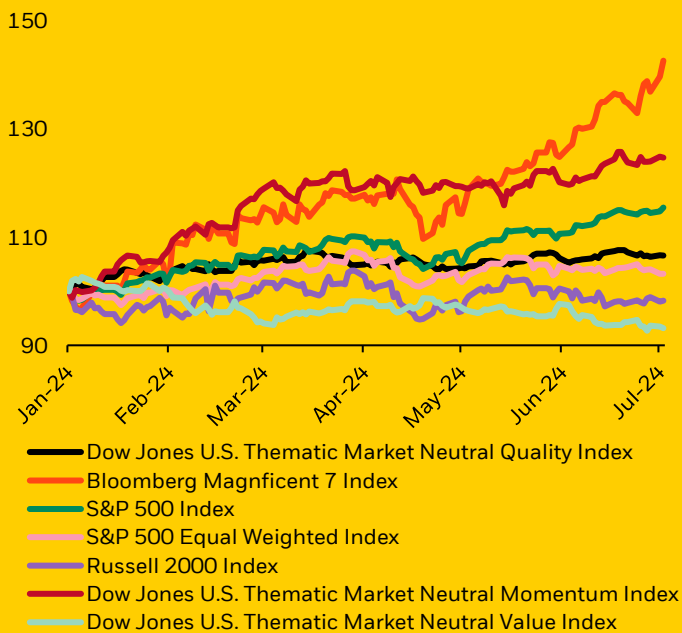
## Ducks on the water... all the action is beneath the surface

We can see an implication of this policy support in the cross-section of market performance—that is in how different sectors, factors, and individual specific return components to companies have diverged this year.

At the macro level, higher inflation and the benefits from rising wealth have hit consumers disproportionately with lower-end consumers more negatively impacted relative to higher-end consumers. While certainly not the only factor impacting cross-sectional performance, these dynamics may be showing up in historic levels of differentiation in the relative performance of market leaders and laggards. Figure 5 shows this in year-to-date factor portfolio performance which groups similar stocks based on characteristics and neutralizes portfolios for market and sector exposure.

**Figure 5: Divergence in equity factor basket performance**

Year-to-date performance



Source: BlackRock, with data from Bloomberg, as of July 2024.

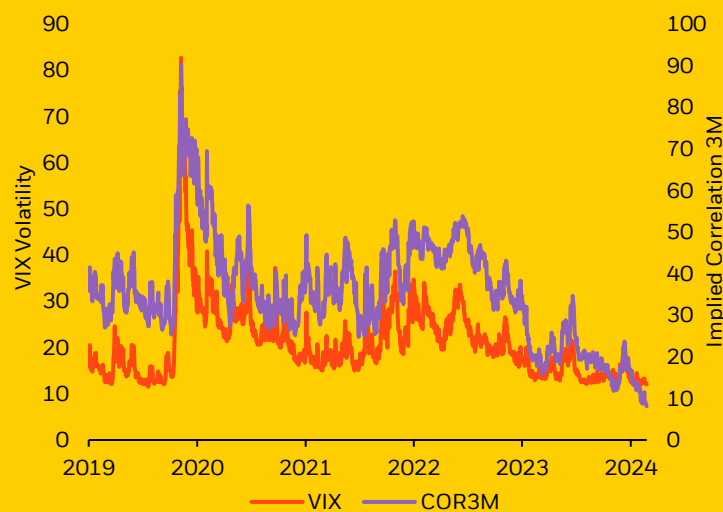
By far, the dominant equity theme remains large secular growth tech companies—captured in both the “Magnificent 7” portfolio and in the momentum factor exposure.

That concentration of tech winners continues to power forward the weighted S&P 500 exposure as technology captures a larger share of the market cap weighted indices, far outpacing the equal-weighted version. Quality stocks round out the category of top performers in contrast with the underperformance we continue to see in small caps and value styles. The sharp reversals in these trends as the market digested the soft June CPI print and priced in greater confidence in the Fed commencing its easing cycle highlighted the potential for the change in the macro growth and interest rate narrative to upend these trends. This, alongside whether earnings and cash flows can hold up to expectations and continue to support the outperformance of these sectors and factors, bears careful watching for whether a shift in equity market leadership is underway.

Figure 6 highlights that at the individual stock level, the degree of divergence between leaders and laggards creates an ideal environment for long/short market neutral equity investing. This investment style tends to thrive in environments of high dispersion in stock specific returns. The chart captures this by looking at the flip side of high dispersion which is low correlation among stocks, measured by the implied correlation index on the S&P 500.

**Figure 6: Implied US equity correlations reflect an alpha-rich environment for long/short equity market neutral investing**

US equity volatility (VIX) and implied 3M correlation (COR3M)



Source: BlackRock, with data from Bloomberg, as of July 2024.

## Conclusion

Global elections and resulting fiscal policy uncertainty has the potential to influence government debt pricing and push term premia higher, reducing the attractiveness of longer maturity exposures. The front-end of the yield curve (2–5-year maturities) remains more attractive given the closer alignment of bond market and Fed expectations for rate cuts improving the trade-off between carry and potential rate volatility.

The Fed’s asymmetric policy stance reflecting the view that policy is sufficiently restrictive has created a favorable backdrop for risk assets so far this year. Beneath the surface of muted market volatility, equity returns have shown significant divergence through a factor lens and across individual stocks. This high level of stock dispersion makes an ideal environment for long/short equity strategies designed to generate alpha in the cross-section of markets.



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