iShares 2023 Midyear Outlook

Gargi Pal Chaudhuri Jun 28, 2023

Fixed Income

KEY TAKEAWAYS

- **Holding tight.** Higher for longer interest rates support allocations to high quality fixed income.
- **Pivoting to new opportunities.** Equity markets are priced for an optimistic outcome; investors may want to consider steering towards a defensive stance.
- **Mega-forces, mega soon.** Trends such as demographics and artificial intelligence are impacting present day returns, not just in the future.

> **In my view, investment returns in the second half of the year will be driven by the 3 Ps: the duration of the Fed Pause, focusing on corporate Profitability, and growing role of fixed income in Portfolio construction.**

– Gargi Chaudhuri
Head of iShares Investment Strategy Americas at BlackRock

INTRODUCTION

The first half of 2023 has been characterized by opposing narratives. In the recessionary data camp, we've seen a slowdown in the manufacturing sector coupled with tighter credit conditions following March's banking turmoil. Excess savings rates have fallen, especially in lower income households.[1] On the soft-landing end of the spectrum, however, the labor market remains incredibly robust, with unemployment rates hovering near all-time lows.[2] Inflation has moderated only slightly, despite the Federal Reserve hiking interest rates 500bps to levels not seen since 2007, pointing to a resilient consumer buoyed by stable earnings potential as wage growth remains firmly above the pre-pandemic decade.[3]

Still, despite divergent signals in the macro data, financial markets kicked off the year with a stellar start — seven of the eleven S&P GICS sectors are in the green, and most financial assets have outperformed cash allocations so far in 2023 (Figure 1). While many point to the artificial intelligence (AI) boom as a driver of the market rally, a closer look tells a broader story: the trimmed mean performance of the S&P 500 (removing the top and bottom 10 performers) has returned 8.8%, suggesting that the equity market is pricing in an optimistic outcome on both growth and earnings, in our view.[4]

Figure 1: Total return across asset classes

Cash 2%	S&P 500 31%	Gold 21%	S&P 500 29%	Cash 2%	S&P 500 15%
Bloomberg U.S. Agg 0%	World ex-US 22%	EM Equities 19%	World ex-US 8%	Gold -1%	World ex-US 11%
Gold -3%	EM Equities 19%	S&P 500 18%	Cash 0%	Bloomberg U.S. Agg -13%	EM Equities 7%
S&P 500 -4%	Gold 18%	World ex-US 11%	Bloomberg U.S. Agg -2%	World ex-US -16%	Gold 6%
World ex-US -14%	Bloomberg U.S. Agg 9%	Bloomberg U.S. Agg 8%	EM Equities -2%	S&P 500 -18%	Bloomberg U.S. Agg 2%
EM Equities -14%	Cash 2%	Cash 1%	Gold -4%	EM Equities -20%	Cash 2%

Source: BlackRock, Bloomberg, chart by iShares Investment Strategy. As of June 20, 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.** *Index performance is measured by the following indexes: EM Equity: MSCI Emerging Markets IMI Index; Gold: ICE LBMA Gold Price Index; S&P 500: SPX Index; Bloomberg US Agg: Bloomberg US Aggregate Bond Index; World ex-US: MSCI World Ex USA Index; Cash: ICE BofA 0-3 Month US Treasury Bill Index.*

Chart description: Quilt chart showing the performance across various asset classes (broad stock market, bond market, gold, world equities excluding US, emerging market equities, and cash). The quilt is dated from 2018 to 2023 YTD and ranks each asset by total return. In 2023, the S&P 500 is the top returning exposure.

We think that outcome is far from certain given the disparities outlined above, but expect the second half of 2023 to be driven by three main narratives:

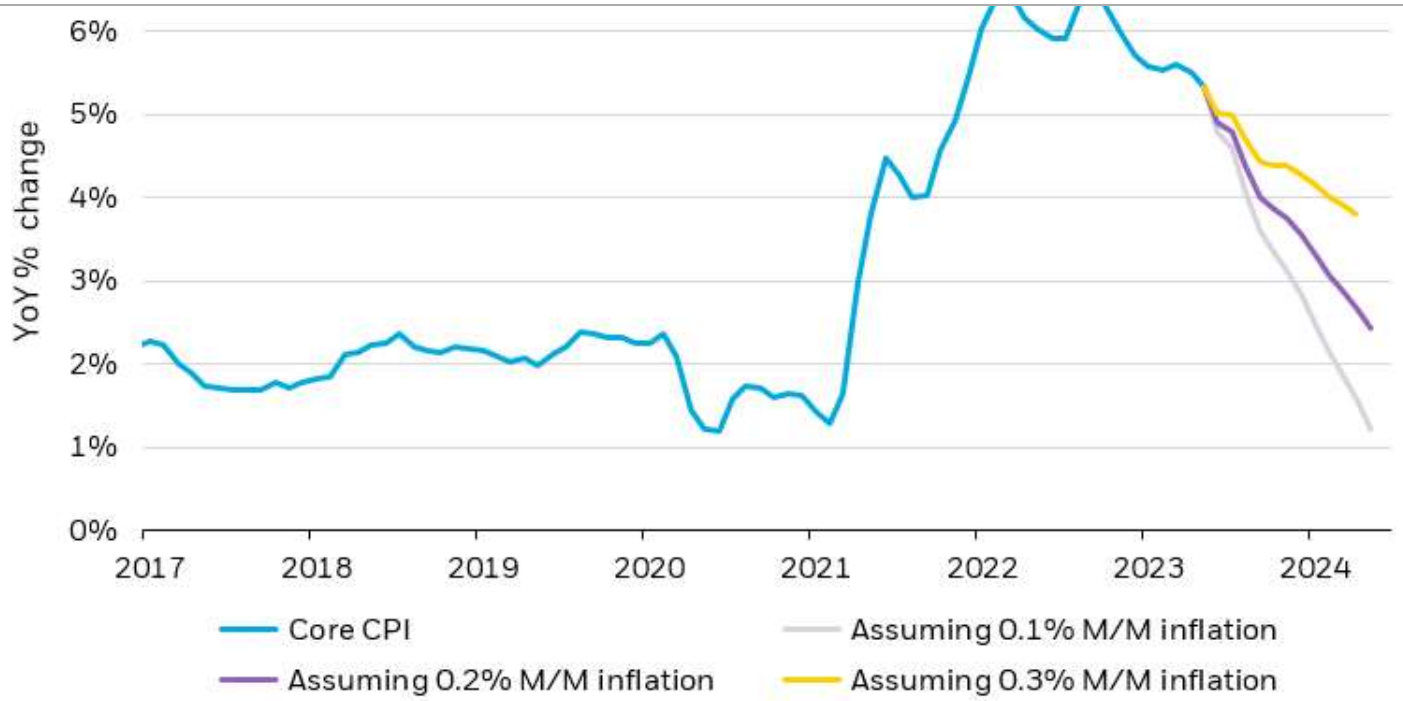
1. The Federal Reserve nearing the end of its hiking cycle and pausing on rate hikes, which could allow duration in the belly of the curve to return as a ballast in portfolios.
2. Inflation remaining sticky, much above the Fed's 2% mandate, allowing for interest rates to remain high for the near term. Investors may want to focus on the growing role of bonds as an income generator in portfolios.
3. Corporate profitability coming into question as firms grapple with higher input costs, which means focusing on companies with strong balance sheets and margin resilience remains paramount.

We believe that this is an investment regime where nimble asset allocation and a willingness to tweak portfolio positioning to adjust to the macro data is prudent. ETFs can be an important tool to do so efficiently.

HOLDING TIGHT

During the Global Financial Crisis and pandemic era lockdowns, central banks slashed policy rates and introduced quantitative easing to stimulate slowing economies. Central banks were able to respond to these crises forcefully because inflation pressures were well-contained amid surging unemployment. Today, however, unemployment is near record lows while headline CPI is running at twice the Fed's 2% inflation target. The pace of inflation is declining but still needs to fall further. Although inflation has averaged a monthly rate of 0.3% over the past six months, it needs to average just below 0.08% to reach the Fed's target by the end of the year and open the door for policy easing.[5]

Figure 2: Potential inflation paths



Source: BlackRock, Bloomberg, Bureau of Labor Statistics, chart by iShares Investment Strategy. As of June 1, 2023.
Forward looking estimates may not come to pass.

Chart description: Line chart depicting the possible paths of inflation, dating from 2017, including 0.1%M/M, 0.2% M/M, and 0.3% M/M inflation. The chart shows inflation moderating most severely with 0.1% forecasts.

Central banks are now counting on a marked slowdown in growth to help them reduce inflation. Indeed, **the Fed** has **repeatedly cited** a "sustained period of below-trend growth" as a necessary precondition for reducing inflation to 2%.[6] This time around, central banks may not respond to a slowdown by riding to the rescue. Rather, they may need to maintain rates at a restrictive level for an extended period.

Stepping out of cash into high quality fixed income

Many investors are overweight cash relative to historical allocations due to the deeply inverted yield curve, elevated fixed income implied volatility, and cash currently yielding about 4.9%.[7] Cash held by money market funds hit a record $5.5tn[8], while advisor model data suggests that average cash allocation has risen to 5.5%, the highest on record.[9] Global money market funds have received nearly $800bn in inflows year to date.[10]

However, holding too much cash can leave investors at risk of missing out on bond or stock market rallies. As rates appear set to peak with the approaching end of the Fed's hiking cycle, investors may want to consider stepping into high-quality, medium-term fixed income (bonds with maturities between 3-7 years). On average, between 1990 and February 2023, core bond exposures performed 4% better than cash equivalents when the Fed held or dropped rates. Similarly, high quality short-term bonds performed 1.9% better than cash in the same environment.[11]

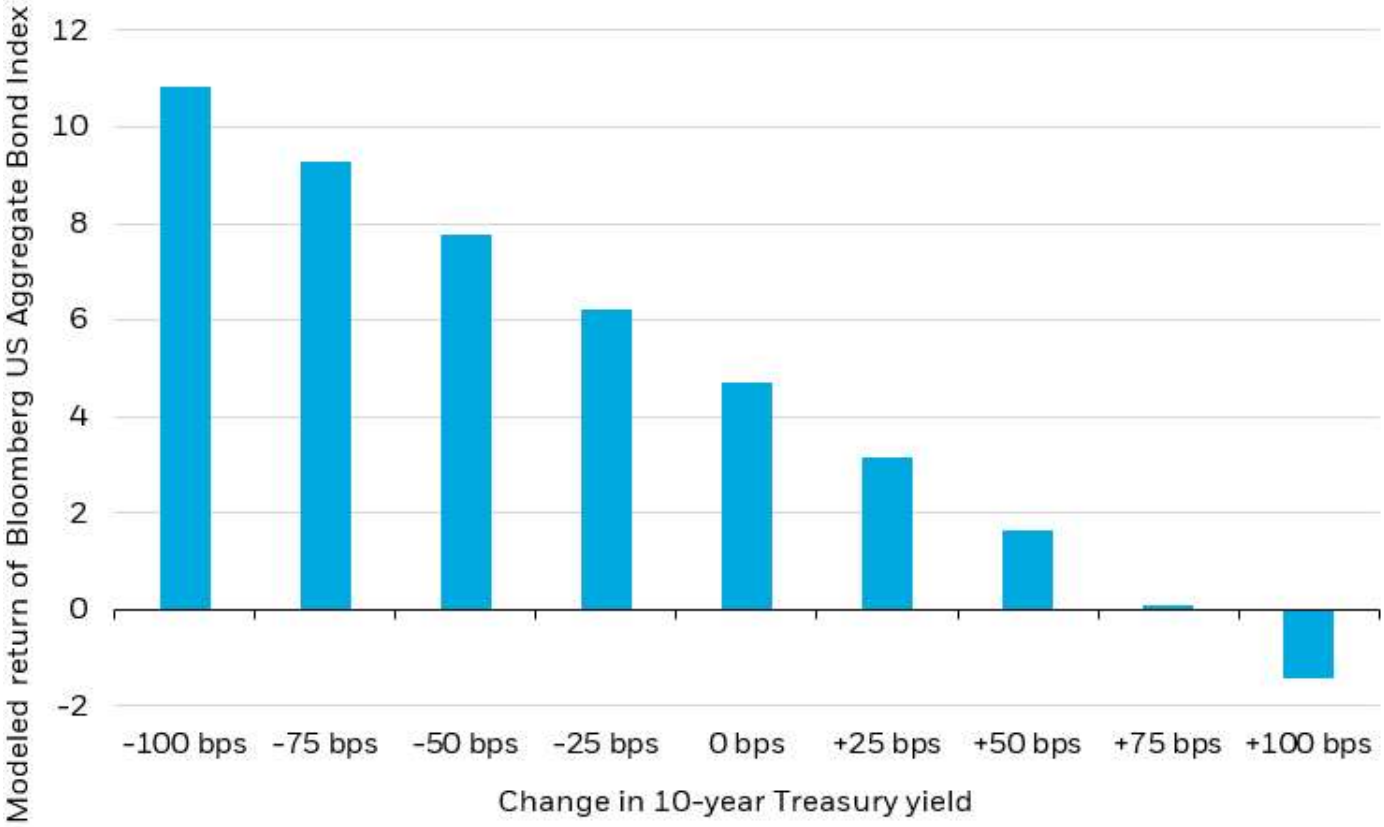
> **We are entering the late stage of the tightening cycle, and the Fed is draining liquidity from the system. We will likely see continued volatility in markets — but also opportunity. We like the yield and safety of developed market high quality bonds and the carry in select emerging markets.**
>
> – **Rick Rieder**
> Chief Investment Officer of Global Fixed Income and Head of Global Allocation

The Bloomberg US Aggregate Bond Index (the Agg) now yields close to 4.7% and has a duration (or sensitivity to interest rates) of 6.3 years.[12] Even if the Fed were to raise rates higher than current market expectations, the carry earned from higher coupons can be sufficient to counter losses realized by rising rates (Figure 3). So far in 2023, investors have flocked towards longer-maturity exposures, a reversal from 2022's trend: intermediate and long-term fixed income ETFs have gathered $27.6bn of inflows year to date, 15% more than their short-term counterparts.[13]

For investors looking for more yield and willing to bear more risk, emerging market (EM) local currency bonds offer a yield of 7.7% on a weighted average coupon of 5.9%.[14] At these levels, we believe investors are adequately compensated for long-term inflationary risk,

global hard landing scenario that could trigger demand for safe havens, EM currencies seem primed to maintain their value versus the U.S. dollar in the second half of 2023.

Figure 3: Higher carry means more buffer against adverse price moves



Source: BlackRock, Bloomberg, chart by iShares Investment Strategy. As of June 20, 2023. U.S. Bond Aggregate yield and duration represented by the Bloomberg US Agg Total Return Value Unhedged USD Index (LBUSTRUU Index).

Chart description: Bar chart showing the different returns from the Bloomberg US Aggregate Bond Index as the 10-year Treasury yield adjusts. The chart shows a buffer – even as the yield moves down, the Bloomberg US Aggregate Bond Index can still provide positive returns.

Regardless of the duration profile investors choose, with elevated interest rates, investors may want to be flexible around incoming data. In practice, this means being more tactical in their strategies and adjusting allocations as incoming data clarifies the economic outlook. It also suggests being opportunistic in finding securities whose higher yields justify taking additional risk. Investors may wish to consider active strategies with experienced managers who have performed well in a variety of rate environments.

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[1] Source: BlackRock, Bloomberg, The Bureau of Labor Statistics. As of June 20, 2023.
[2] Source: BlackRock, Bloomberg, The Bureau of Labor Statistics. As of June 15, 2023.
[3] A basis point (bps) is one hundredth of one percent (e.g., one basis point = 0.01%).
[4] Source: BlackRock, Bloomberg. As of June 20, 2023. **Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.**
[5] Source: BlackRock, Bloomberg, The Bureau of Labor Statistics. As of June 15, 2023.
[6] Source: The Federal Reserve. As of February 01, 2023.
[7] Source: BlackRock, Bloomberg. The spread between the 2-year and 10-year Treasury was -96bps and the ICE Bank of America MOVE Index was at 104pts, both as of June 16, 2023. 'Cash yield' based on Crane 100 Money Fund Index, as of Jun 16, 2023
[8] Source: BlackRock, Investment Company Institute (ICI). As of June 14, 2023.
[9] These figures reflect the advisor model data collected by BlackRock over the prior 12 months from 18,384 models. The models are grouped into risk profile cohorts determined by equity weighting. Figures describe the average across all portfolios in the cohort for the metric in question. BlackRock's proprietary risk model data is supplemented by asset allocation and fund characteristic data from Morningstar. The portfolios analyzed represent a subset of the industry, and not its entirety. As such, there may be certain biases present in the data that reflect the advisors who choose to work with BlackRock to analyze their portfolios. All data is as of 2023-03-31 and the series begins 2023-09-30.
[10] Source: BlackRock, EPFR. As of June 15, 2023.
[11] Source: BlackRock, Bloomberg. Chart by iShares Investment Strategy. 'Core bond exposures' return as represented by Bloomberg US Aggregate Index, 'cash equivalents' as represented Bloomberg US Treasury Bill 1–3M, "high quality short-term bonds' as represented by ICE BofA 1-5 Year U.S. Corporate Index. Returns rebased to 0 on the day of the last hike for each cycle. Cycles referenced include the final Federal Reserve hike in the past five hiking cycles: February 1, 1995, March 25, 1997, May 16, 2000, June 29, 2006, and December 19, 2018. **Index performance is for illustrative purposes only. Index**

guarantee future results.

[13] Source: BlackRock, Markit. ETF groupings determined by Markit. As of June 21, 2023.

[14] Source: BlackRock, Bloomberg. EM Local Currency Bonds as represented by the J.P. Morgan Government Bond Index Emerging Markets Global 15% Cap 4.5% Floor yield to maturity and average coupon. As of June 16, 2023.

[15] BlackRock, Bloomberg. Reference index is the S&P 500 Index. Rate hikes in reference to the Fed's hiking cycle starting on March 17, 2022. As of June 20, 2023. **Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.**

[16] BlackRock, Bloomberg. Equity volatility as measured by the CBOE Volatility Index, time frame in reference is Q2 2023. As June 20, 2023.

[17] BlackRock, Bloomberg, Bureau of Labor Statistics, U.S. Census Bureau. U.S. Real Average Hourly Earnings, Retail & Food Services Sales index. As of June 20, 2023.

[18] Source: BlackRock, Bloomberg, Department of Labor, U.S. Federal Reserve. ISM U.S. Manufacturing PMI, ISM U.S. Services PMI, U.S. Initial Jobless Claims, Senior Loan Officer Opinion Survey. As of June 20, 2023.

[19] Source: Reuters. Reference index is the S&P 500 Index. As of June 20, 2023.

[20] BlackRock, Bloomberg. Time period in reference is January 01, 2022, to December 31, 2022. **Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.**

[21] Source: BlackRock, Morningstar, BlackRock Portfolio Solutions. Starting Portfolio Theme Exposure breaks out the percentage overlap of the Starting Portfolio Allocation and respective megatrend product representative of its broader theme. EM Infrastructure is represented by the S&P Emerging Markets Infrastructure Index. Neuroscience is represented by the NYSE FactSet Global Biopharm & MedTech Index. Environmental Infrastructure is represented by the FTSE Green Revenues Select Infrastructure and Industrials Index. Cybersecurity is represented by the NYSE FactSet Global Cybersecurity Index. Global Clean Energy is represented by the S&P Global Clean Energy Index. Mainland China is represented by the MSCI China A Inclusion Index. Genomics & Immunology is represented by the NYSE FactSet Global Genomics and Immuno Biopharma Index. China Tech is represented by the MSCI China Technology Sub-Industries Select Capped Index. Electric & Autonomous Vehicles is represented by the NYSE FactSet Global Autonomous Driving and Electric Vehicle Index. Emergent Food is represented by the Morningstar Global Food Innovation Index. Blockchain is represented by the NYSE FactSet Global Blockchain Technologies Index. Cloud & 5G is represented by the Morningstar Global Digital Infrastructure & Connectivity Index. U.S. Infrastructure is represented by the NYSE FactSet U.S. Infrastructure Index. Virtual Work and Life is represented by the NYSE FactSet Global Virtual Work and Life Index. Robotics & AI is represented by the NYSE FactSet Global Robotics and Artificial Intelligence Index. "Mega-cap" exposure is defined as companies (all Reg NMS domestic public companies) with market cap greater than $100B. "Smaller-cap" exposure defined as market cap below $100B.

[22] Source: BlackRock, Markit. ETF groupings determined by Markit. As of June 16, 2023.

[23] Source: BlackRock, Markit. ETF groupings determined by Markit. As of June 20, 2023.

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