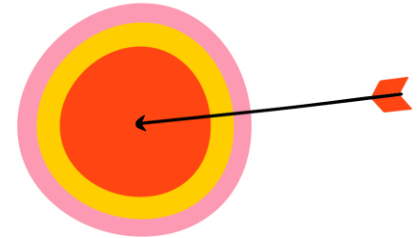
THIS DOCUMENT IS MARKETING MATERIAL

Macro update: Q2 2023

BlackRock.

Nimble in the new regime

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.



At the start of the year, we wrote that a new investment playbook was needed to stay nimble in a new economic regime, where growth and inflation are likely to fluctuate more than in the past – leading to higher market volatility, or larger and more frequent changes in the value of stocks and bonds. We've seen this play out in 2023 so far, following recent tumult in the banking sector.

Developed market (DM) central banks have been rapidly raising interest rates since last year, as they try to bring inflation back down to target. However, inflation remains persistently high, and economic growth appears to be slowing – reinforcing our view that a recession is likely in store later this year.

We don't think central banks will come to the rescue, as they have in the past; the old playbook – where central banks would have stepped in to support growth by cutting interest rates – no longer applies. We think major central banks will stick to a 'separation principle' – using interest rate levels to rein in inflation while turning to other tools to ensure the stability of financial markets.

Ultimately, the scale of the economic damage depends on how far central banks are prepared to go to bring down inflation. When they take stock of the damage caused, we expect they will eventually stop raising interest rates and learn to live with higher inflation. In the short term, we take a cautious view on riskier assets like equities, but we're ready turn more positive as the situation evolves: being nimble in portfolio decisions is a core tenet of our new playbook.

We focus on three key themes for Q2: 1) *pricing the damage* to see if the value of assets appears to be factoring in the damage we see ahead; 2) *rethinking bonds* and their role in portfolios, as we turn to bonds for income with yields back to more attractive levels; and 3) *living with inflation* by managing the effects of sustained price pressures on investments. Over the following pages, we explore how investors can implement these views in portfolios.

> **"Being nimble in portfolio decisions is a core tenet of our new investment playbook.**

Our investment themes for Q2

Pricing the damage

Economic damage is emerging from the fastest central bank rate hiking cycle since the 1980s. What matters: whether this is being reflected in asset prices.

Rethinking bonds

We look to bonds for income: after years of rock-bottom interest rates, bonds are again offering attractive yields, in our view. We prefer short duration bonds, which provide higher yields and are less sensitive to changing interest rates.

Living with inflation

We think central banks are likely to stop raising rates when the economic damage becomes clearer. We expect inflation to eventually settle above DM central banks' 2% targets, and look to prepare portfolios for higher inflation.

EIIiH0423E/S-2854841-1/4

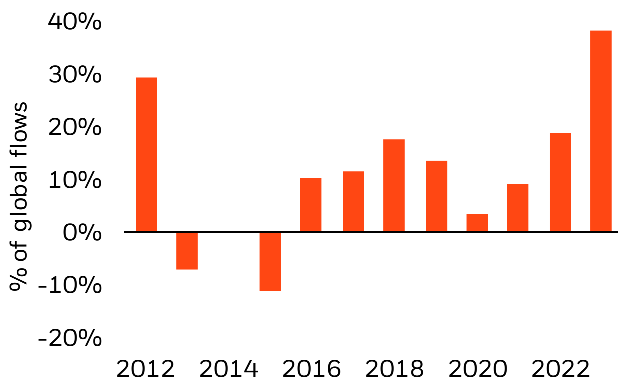
Pricing the damage

EM equities

We prefer emerging market (EM) equities over their developed market counterparts, for several reasons. Firstly, EM central banks are further along in their rate hiking cycles: many have already stopped hiking interest rates, and may soon start lowering them, in our view. Emerging markets may also benefit from a relatively weaker US dollar and China's economic reopening. We like **broad EM** exposure, as well as more selective investment in regions well-positioned to benefit from these tailwinds, such as **China**.

Emerging interest in EM equities

EM equity exchange-traded product (ETP) flows as a share of total equity ETP flows globally, 2012 to 2023 YTD



Source: BlackRock and Markit, as of 23 March 2023. **Past flows into global ETPs are not a guide to current or future flows and should not be the sole factor of consideration when selecting a product.**

Selectivity in DM equities

We remain cautious towards DM equities, but think pockets of opportunity persist across listed and private equities – companies whose shares are traded on public stock exchanges, and those where ownership is more limited. We take a selective approach, looking to sectors, style factors (groups of companies that tend to have similar characteristics and performance) and regions that could benefit in the current environment. The **consumer discretionary sector** looks attractive, in our view, particularly in Europe: a strong labour market and record household savings levels, combined with a slowdown in energy prices, drive our positive outlook. The sector may also benefit from increased demand as the Chinese economy reopens and potentially imports more goods from abroad. In contrast, we have a mixed view on the global financials sector: while we see low risk of recent banking tumult turning into a systemic issue, recent events have weakened investor confidence in the sector. We prefer to take a selective approach through high quality exposures – companies with strong balance sheets, cash flows and profitability – within **European banks,** which are subject to tighter regulations than their US peers.

Investors looking to manage volatility in portfolios may consider DM companies with better fundamentals (such as relatively low debt and high earnings compared to their peers), and whose share prices have little correlation to the broader market. The **minimum volatility** style factor is one such example.

In an environment of greater macroeconomic uncertainty, we favour exposure to quality sectors, which may help boost portfolio resilience, or the potential to achieve stable returns through varied economic conditions. The **healthcare sector** continues to display strong profitability, and benefits from consistent demand that tends to make it less sensitive to fluctuations in economic growth – meaning it should be well-positioned to weather an economic downturn, in our view. We also think the **tech sector** looks attractive for its quality characteristics. While volatility may weigh on tech stocks in the short term, over a longer horizon, we believe the sector is supported by structural factors including the expansion of the digital economy, rising demand for cybersecurity, and the shift towards a lower-carbon economy.

Rethinking bonds

Cash & short-term bonds

We see a role for cash and short-term bonds in the current environment. **Cash**, or money market funds (MMFs), invest in a diversified portfolio of short-term, high-quality fixed income securities. MMFs offer low duration risk – that is, the risk that an asset's value will decline due to changes in interest rates over time. MMFs may help to minimise volatility and can quickly reflect the benefits of higher interest rates. We expect interest to persist over Q2, given increasing demand for liquidity – investments that can be bought and sold more easily than some others. Investors seeking higher yields and willing to tolerate slightly higher risk may also look to **ultra-short duration bonds**.

Government bonds

We like very short duration government bonds for their income potential, particularly **short duration US Treasuries**. While yields for short duration bonds declined in late Q1, they remain at multi-decade highs and could be an attractive source of income amid volatile markets. Furthermore, despite this rates volatility, short-term yields remain in line with their longer-term counterparts, with lower duration risk.[1] We remain cautious on longer duration bonds: investors may demand greater compensation for investments with higher duration risk in an environment of sticky inflation, given the possibility that interest rates could move higher.

1 Source: BlackRock, as of 19 April 2023.

EM debt

We've turned positive on EM debt, which may benefit from many of the same drivers as EM equities: the US dollar is likely remain weak over Q2, in our view, and EM central banks are further along in their interest rate hiking cycles, with many having already stopped raising rates. Why? Many started hiking before their DM counterparts, but inflation is more benign in some emerging markets, too. We prefer **local currency denominated EM debt**, which tends to be shorter duration than hard currency exposures.

Credit

Against a backdrop of tighter financial conditions – with markets becoming more conservative in their lending and investment practices – we have moderated our view on corporate bonds, or credit. However, we still see opportunities, particularly in **high-quality, short duration credit**. We think investment grade (IG) credit – which includes bonds issued by companies with higher credit ratings – could hold up better in a downturn in 2023, as many high-quality companies have already strengthened their balance sheets ahead of a potential recession. Short duration IG yields look attractive, in our view, and offer relatively low duration risk.

Living with inflation

Inflation-linked bonds

We continue to like **inflation-linked bonds** – bonds whose value is adjusted in line with changes in inflation – as a key tool to manage the impact of higher inflation on portfolios. While markets still expect inflation to fall significantly this year, we think it will persist at elevated levels over the medium term – creating a potential opportunity for investors in inflation-linked bonds, in our view.

Value

We think the current environment of higher inflation and interest rates should also benefit the **value style factor**. 'Value' stocks are those which look undervalued by the market, trading at a low price relative to their fundamentals, such as earnings and cash flows. While value has come under pressure in the run-up to past economic downturns, we think it could fare better this time around, as companies appear better-prepared for a potential recession, in our view.

Natural resources & commodities

We also favour exposure to some of the underlying drivers of inflation, including **commodities**, **natural resources**, and **agribusiness**. While energy prices have normalised significantly since last year, they remain elevated; the sector looks attractive, in our view – particularly in the clean energy space – for its increasing tilt towards the quality factor, as energy companies focus on strengthening their balance sheets. Amid recent volatility, we've seen investors turning to **gold** – which tends to have low correlation to equities and bonds, and is therefore considered by some investors as a way to build resilience into portfolios.

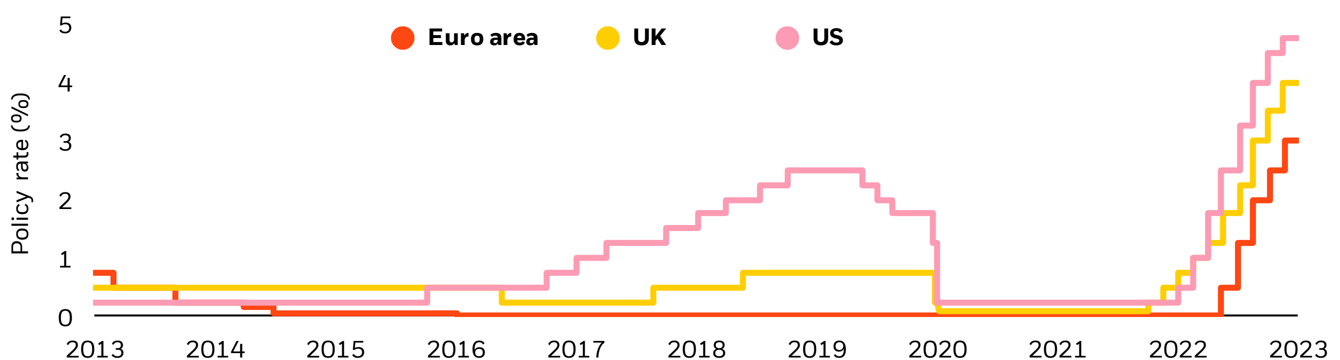
Alternatives

We also look to **alternative** assets. These are non-traditional investments with risk-return profiles that differ from traditional asset classes like equities, fixed income and cash – and may therefore offer potential diversification benefits. When it comes to building exposure to asset classes that tend to move in line with inflation or could benefit in a higher inflation environment, **infrastructure** remains one of our highest conviction calls, as its diversified sources of revenue may provide a buffer against higher prices. Infrastructure should also benefit from significant new investments, in our view, as countries around the world look to rewire supply chains.

Diversification may not fully protect you from market risk.

DM central banks have embarked on the fastest rate hiking cycle in decades

Policy rates (%), European Central Bank, Bank of England, US Federal Reserve, and the Bank of Japan



Source: Refinitiv Datastream, as of 17 March 2023.

This document is marketing material: Before investing please read the Prospectus and the PRIIPs KID available on www.ishares.com/it, which contain a summary of investors' rights.

Risk Warnings

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time.

Important Information

In the UK and Non-European Economic Area (EEA) countries: this is issued by BlackRock Advisors (UK) Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL, Tel: +44 (0)20 7743 3000. Registered in England and Wales No. 00796793. For your protection, calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock.

In the European Economic Area (EEA): this is issued by BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 – 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311 For your protection telephone calls are usually recorded.

In Italy: For information on investor rights and how to raise complaints please go to https://www.blackrock.com/corporate/compliance/investor-right available in Italian.

For investors in South Africa

Please be advised that BlackRock Investment Management (UK) Limited is an authorised Financial Services provider with the South African Financial Services Conduct Authority, FSP No. 43288.

Any research in this document has been procured and may have been acted on by BlackRock for its own purpose. The results of such research are being made available only incidentally. The views expressed do not constitute investment or any other advice and are subject to change. They do not necessarily reflect the views of any company in the BlackRock Group or any part thereof and no assurances are made as to their accuracy.

This document is for information purposes only and does not constitute an offer or invitation to anyone to invest in any BlackRock funds and has not been prepared in connection with any such offer.

© 2023 BlackRock, Inc. All Rights reserved. BLACKROCK, BLACKROCK SOLUTIONS, and iSHARES are trademarks of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.