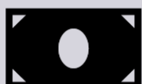
iSHARES 2023 MIDYEAR OUTLOOK

iShares by BlackRock

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 Pal 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

2018	2019	2020	2021	2022	2023 YTD
Cash, 2%	S&P 500, 31%	Gold, 21%	S&P 500, 29%	Cash, 2%	S&P 500, 15%
Bloomberg US 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 US Agg, -13%	EM Equities, 7%
S&P 500, -4%	Gold, 18%	World ex-US, 11%	Bloomberg US Agg, -2%	World ex-US, -16%	Gold, 6%
World ex-US, -14%	Bloomberg US Agg, 9%	Bloomberg US Agg, 8%	EM Equities, -2%	S&P 500, -18%	Bloomberg US 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.

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:

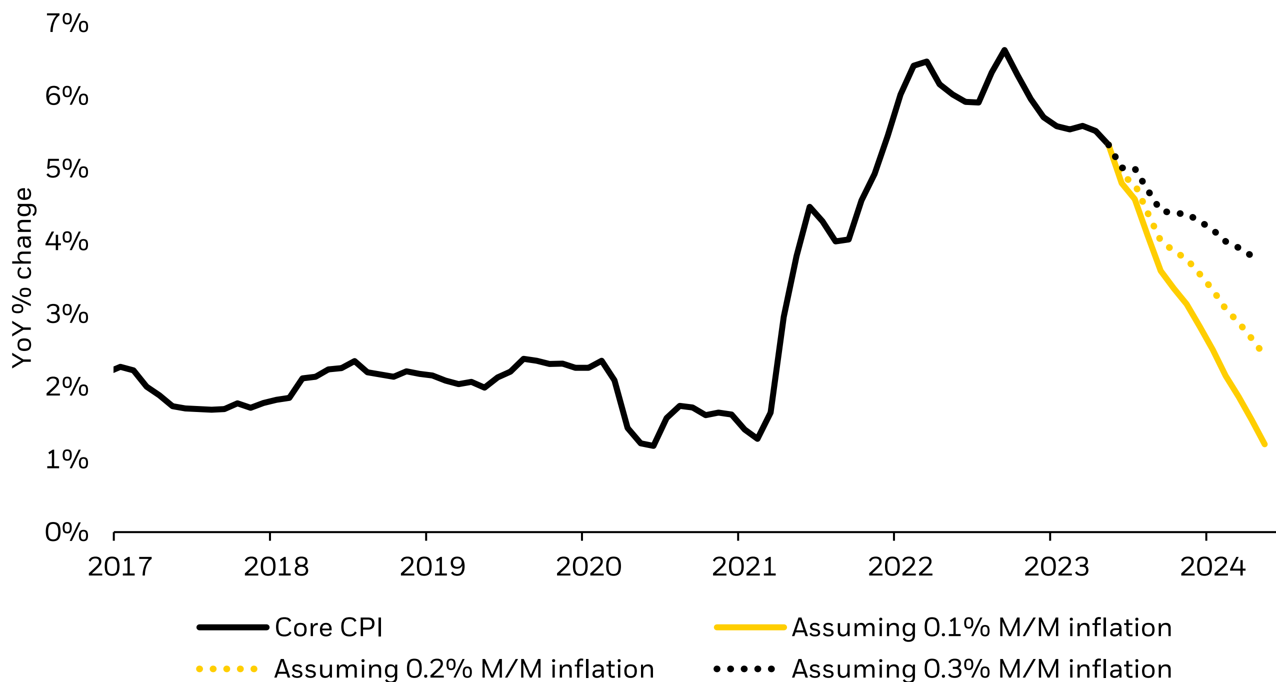
1. The Federal Reserve nearing the end of its hiking cycle and pausing on rate hikes, which could allow duration in the belly of the curve to return as a ballast in portfolios.
2. Inflation remaining sticky, much above the Fed's 2% mandate, allowing for interest rates to remain high for the near term. 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.

THEME ONE: 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.

"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

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

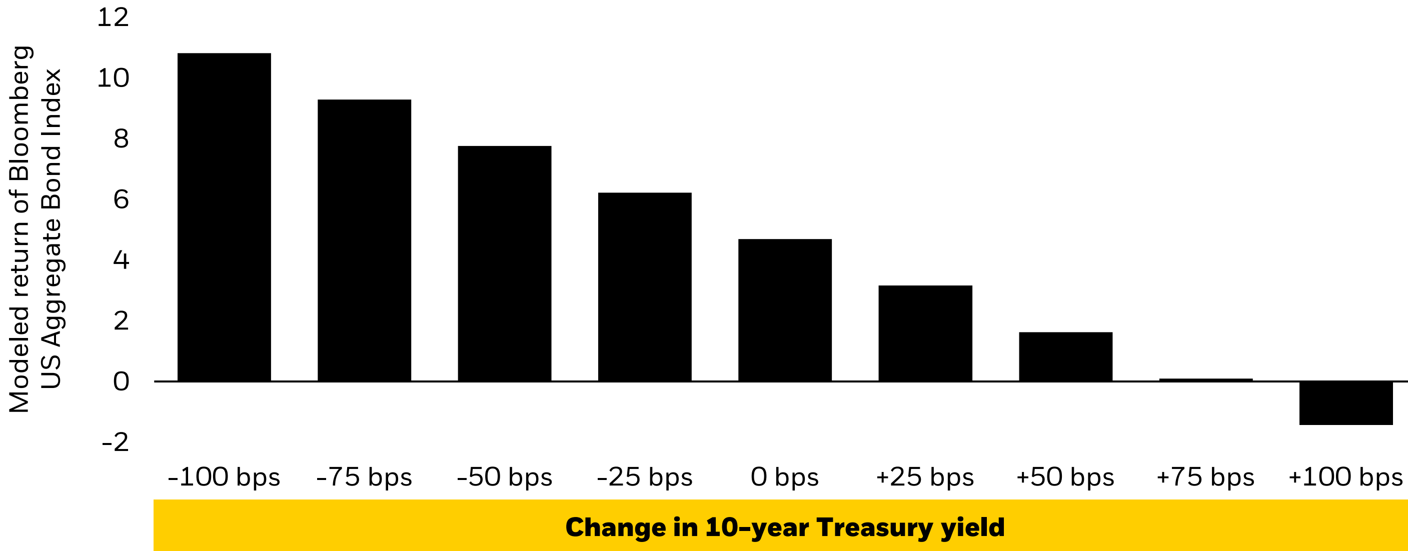
Many investors are overweight cash relative to historical allocations due to the deeply inverted yield curve, elevated fixed income implied volatility, and cash currently yielding about 4.9%.[7] Cash held by money market funds hit a record $5.5tn[8], while advisor model data suggests that average cash 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]

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, given many EM central banks target ~3% inflation. EM central banks may be able to start easing soon after a two-year hiking cycle that will benefit allocations to local currency EM bonds. We also believe that the U.S. dollar likely hit a cycle peak in Q4 2022, and outside of a 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).

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.

Related funds

AGG	**iShares Core U.S. Aggregate Bond ETF**	**TIP**	**iShares TIPS Bond ETF**
LEMB	**iShares J.P. Morgan EM Local Currency Bond ETF**	**BSIIX**	**BlackRock Strategic Income Opportunities Fund**

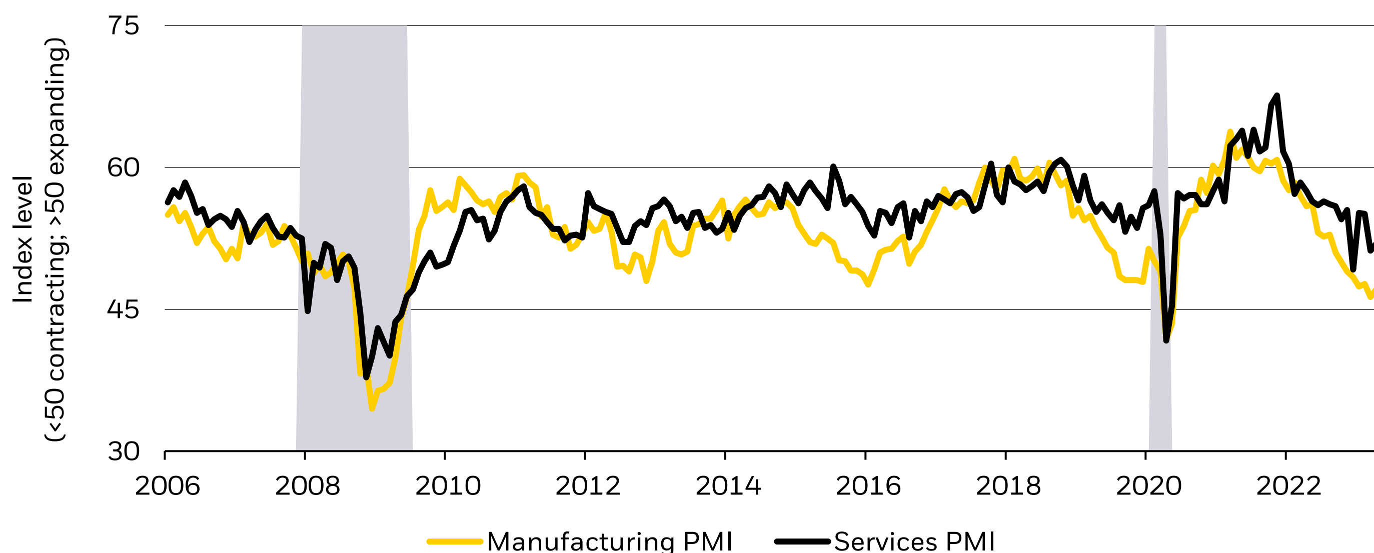
THEME TWO: PIVOTING TO NEW OPPORTUNITIES

Investors face a dilemma in the second half of the year: do they believe the pervasive market narrative that we're headed for a soft landing, which can extend the bull market, or do they brace for a slowdown in the economy and perhaps underpriced downside to equities?

Despite exogenous shocks of a regional bank crisis and the U.S. debt limit, the S&P 500 has rallied to highs not seen since before the Federal Reserve started hiking rates in 2022.[15] With equities seemingly pricing out diminishing risk to cyclicals, equity volatility has collapsed to levels more consistent with the post-GFC environment of zero-interest rate policy.[16] In part, the market optimism reflects the underlying data: real average hourly earnings has ticked positive in recent months, buoying strong retail sales data and underscoring the strength of the U.S. consumer.[17]

But if we shift our focus back to the underlying growth reality, the picture is more muddled: U.S. manufacturing PMIs remain in contractionary territory, services PMIs are in a downtrend, the labor market is showing signs of cooling, and credit conditions remain tight.[18] So while the hard data continues to hold up, leading economic indicators paint a more pessimistic portrait of growth in the back half of the year.

Figure 4: Leading economic indicators continue to contract



Source: BlackRock, Bloomberg, chart by iShares Investment Strategy. Manufacturing as represented by ISM U.S. Manufacturing PMI, Services as represented by ISM U.S. Services PMI. Grey area denotes recessionary period as determined by the National Bureau of Economic Research. As of June 20, 2023.

"Implied recession probabilities between equity and fixed income markets are at one of the biggest gaps in 50 years. If history is a guide, investors may want to side with bond markets. However, it is not clear cut. Our positioning has reduced directional exposures and targets opportunities in high quality large-cap companies."

Raffaele Savi, Global Head of BlackRock Systematic

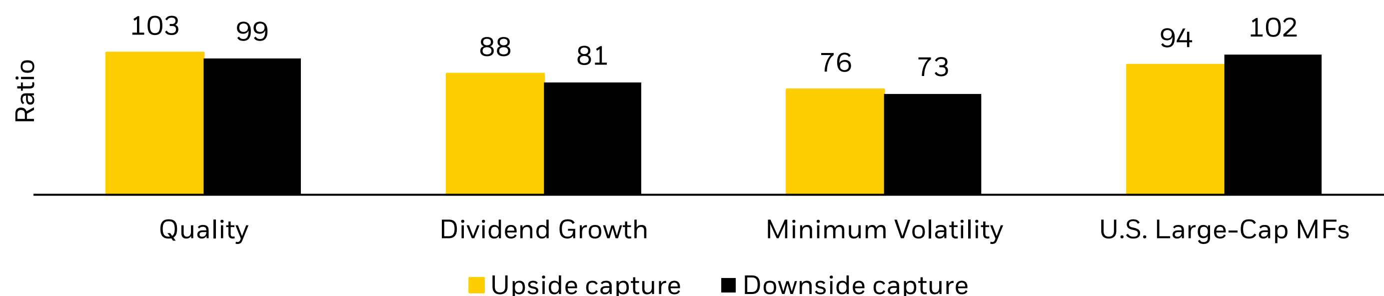
This is all to say that economic risks to the downside have not evaporated — yet we see scant evidence of them in current valuations. Changes in earnings expectations reflect newfound optimism, with 12-month forward EPS growth at nearly 7%, up from just 3% at the end of Q1.[19] Although investors may be keen to move beyond the recession narrative, we believe there is still widespread uncertainty around the lagged impacts of monetary policy, quantitative tightening, and credit conditions — that is a lot for a market to look past, particularly one plagued by narrow market breadth and significant earnings divergences.

This is not to say we expect a deep recession, but a mild slowdown also makes the case for a mild recovery. This leads us to believe that the near-term upside for markets is capped and downside risks are underappreciated: expectations may now (finally) exceed reality. In short, recent resiliency is not proof that these headwinds cannot spell pain ahead. An uncertain future calls for more balanced pricing of risk – one which we believe is poorly reflected in U.S. equity pricing.

Against this backdrop, we think there are three ways for investors to stay invested while bracing for a wider variety of outcomes than markets currently appreciate:

1. **Find income through dividends.** We emphasized earlier our preference for fixed income, but we also favor equity income for investors with current income needs. We like dividend growth strategies, which seek companies with a history of consistently growing their dividends. Financial strength and discipline underscore these exposures, which is coupled with quality characteristics: dividend paying stocks boast a higher free cash flow yield and lower leverage compared to the broader market.
2. **Focus on quality.** For those looking to moderately reduce risk, we see room to reallocate into high quality companies trading at reasonable prices. With our view that the Fed is unlikely to cut rates this year, we continue to avoid highly speculative growth, but do see opportunity in quality-tilted growth stocks.
3. **Seek to reduce portfolio risk with minimum volatility.** Bears bracing for a sharper downturn can add defensiveness with allocations to the minimum volatility factor to help hedge downside risk. Last year is emblematic of the role minimum volatility can play: MSCI USA Min Vol Index outperformed MSCI USA Index by 12.6% amid the volatility spurred by inflation and tightening monetary policy.[20]

Figure 5: Risk and reward: upside and downside capture in defensive exposures



Source: Morningstar Direct. Analysis shows cumulative 10-year upside and downside capture for each strategy in relation to the S&P 500 Index. "Quality" is represented by the MSCI USA Quality Index, "Dividend Growth" by the Russell 1000 Dividend Growth Index and "Minimum volatility" by the MSCI USA Minimum Volatility Index. "U.S. large cap MFs" is represented by a hypothetical portfolio meant to represent the U.S. large cap mutual fund universe as defined by Morningstar. Past performance is no guarantee of future results. You cannot invest directly in an index. As of May 31, 2023.

And, while we believe the soft-landing scenario is overly reflected in current market pricing relative to the odds of a recession, we still see pockets of opportunity in more cyclically oriented stocks where valuations haven't run up in the recent rally. U.S. energy equities should capture the upside of a growth environment if manufacturing and services PMIs reverse into expansionary territory, but still trade at a deep discount relative to history. Gravitating to higher quality companies and reasonable valuations makes more sense to us than positioning for a specific outcome, given the uncertainty of the path forward and our belief that it is simply too soon to tell whether a recession is on the horizon.

Related funds

QUAL — iShares MSCI USA Quality Factor ETF

DGRO — iShares Core Dividend Growth ETF

USMV — iShares MSCI USA Min Vol Factor ETF

IYE — iShares U.S. Energy ETF

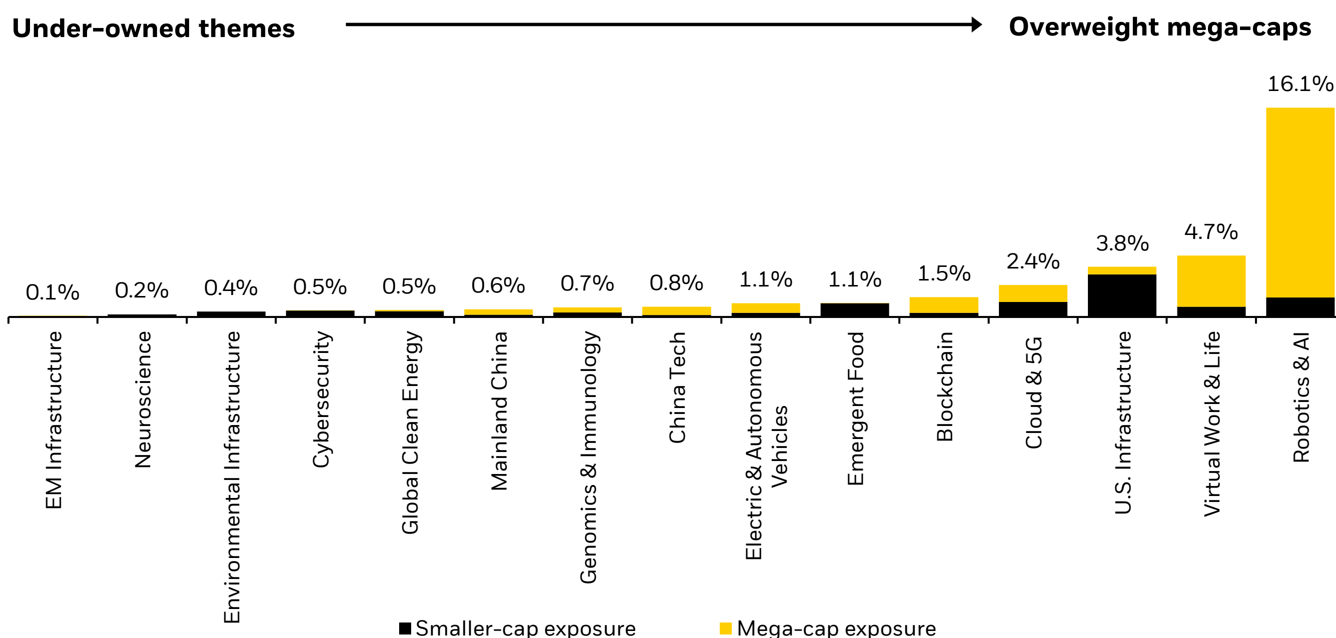
MADVX — BlackRock Equity Dividend Fund

THEME THREE: MEGA-FORCES, MEGA SOON

While global investors have been laser-focused on monthly inflation figures over the past two years, we see important mega-forces beyond the current economic cycle that could shape our societies and the longer-term inflationary environment in a more meaningful way. And the impact of those forces may be felt sooner than many investors appreciate.

Generative AI has been one secular force with surprisingly strong near-term tailwinds. Since **OpenAI's ChatGPT** release at the end of 2022, investors have expressed the market opportunities of the theme through a narrow list of mega-cap tech names. Ironically, many investors have already implicitly owned the theme of AI through market cap weighted equity indexes. A study of 21k portfolios shows that while an average moderate equity portfolio has 16% exposure to the theme of robotics and AI, over 90% of this exposure comes from mega-cap companies (companies that have a market capitalization of $100bn or more).

Figure 6: How much thematic exposures do you think you own?



Source: BlackRock, Morningstar, BlackRock Portfolio Solutions as of September 30, 2022. Starting Portfolio Allocation is representative of advisors' broad asset allocations for equities, based on analysis of 21,276 portfolios over the 12-month trailing period. For more information as how exposures have been determined, please see footnote 21.

"A faster than thought re-globalization trend is shining a new light on emerging markets. Despite historical headwinds we see EM as a unique source of uncorrelated alpha opportunities."

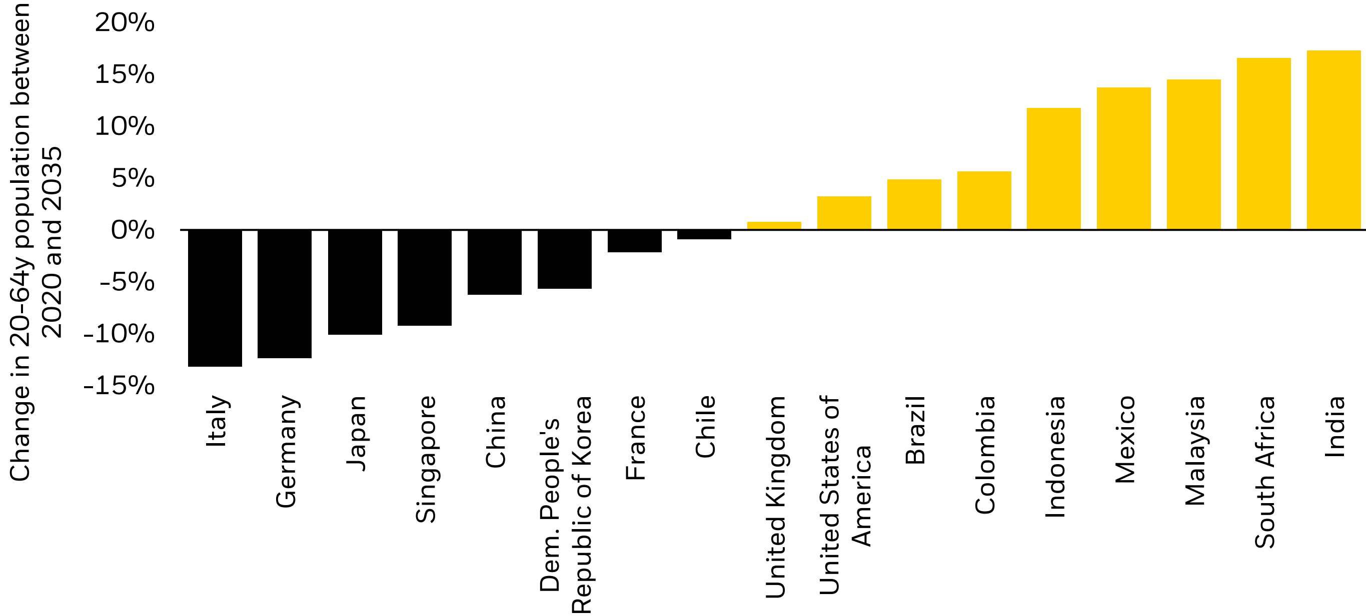
Belinda Boa, Chief Investment Officer of Emerging Markets Fundamental Equities

While those mega-cap tech companies are capturing the early adoption of generative AI, the power of this general-purpose technology lies in its potential to revolutionize industries beyond technology — from creating new art forms to improving health care outcomes.

We see it translating to real economic impact in the long run, from greater productivity across the economy to reduced costs in various sectors. Instead of focusing on just a few technology companies, investors who seek long-term growth could benefit from a thematic investment approach that accesses all parts of the AI value chain, including tool developers, data services, and robotic manufactures. Year to date, U.S. investors have added nearly $1bn in net inflows into AI and robotics focused ETFs.[22] Meanwhile, risk appetite for the broader technology sector also recently returned: U.S. listed tech focused ETFs saw the first largest week of inflows in May since December 2021, following months of outflows.[23]

With wider adoption in automation and advancement in AI-enabled medical research, the world is seeing more hopes for the demographic challenge of aging populations. However, there are more hurdles ahead. Over the next few decades, the working population is expected to continue to shrink as a share of total population on the back of low birth rates and increased life expectancy globally. This can be extremely costly for societies, reducing productivity and burdening public finance with higher total cost of healthcare and retirement programs. More importantly, the near-term demographic divergence between emerging market/developed market (DM) regions could further expand in the next 15 years, as DM economies see broad declines in working age cohorts while many EM economies could feel positive demographic impacts. Therefore, we see EM equities as an asset class that could benefit from the secular demographic force in the long run — the impacts of which could begin to be felt more near term.

Figure 7: Shrinking working age cohorts across various economies



Source: BlackRock, Bloomberg, UN Population Prospects, chart by iShares Investment Strategy. Change in population from UN Population Prospects, as of December 31, 2022. Forward looking estimates may not come to pass.

Related funds

IRBO — iShares Robotics and Artificial Intelligence Multisector ETF

IEMG — iShares Core MSCI Emerging Markets ETF

BTEK — BlackRock Future Tech ETF

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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 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.**
[12] 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.**
[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.

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.

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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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