Weekly commentary

BlackRock

July 15, 2024

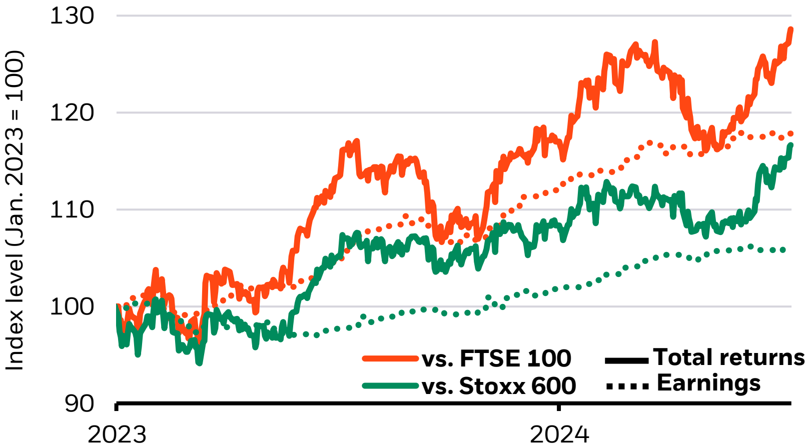
Why we keep leaning into risk

- We think a transformation akin to past technological revolutions is gearing up. We keep leaning into risk and the AI theme while upgrading UK stocks.
- U.S. stocks hit a new record high last week while 10-year Treasury yields fell. Volatility in small cap and tech shares shows markets can quickly get choppy.
- We expect the European Central Bank to hold policy rates steady this week. The ECB may cut rates in September, but we don't see a typical easing cycle ahead.

We see unprecedented waves of transformation creating an unusually wide range of outcomes. Our 2024 Midyear Global Outlook shows how, rather than waiting for clarity, we're leaning into risk. We stay overweight U.S. equities and the artificial intelligence (AI) theme yet monitor valuations. We like private markets as a way to access early winners. Elsewhere, we go overweight UK equities and stay overweight Japan. We favor short-term bonds for income and prefer quality in credit.

All about earnings

S&P 500 relative performance, 2023-2024



Forward looking estimates may not come to pass. It is not possible to invest directly in an index. Index performance does not account for fees. Source: BlackRock Investment Institute, with data from LSEG Datastream, July 2024. Notes: The chart shows the S&P 500 relative performance of total returns and 12-month forward earnings vs. the UK's FTSE 100 and Europe's Stoxx 600 indexes.

A transformation of a historic scale could be unfolding. Investment opportunities transcend the unusual macro backdrop of sticky inflation, higher interest rates, slower growth and elevated debt. U.S. equities had a banner first half of 2024 versus other developed markets (DMs) even as markets priced out Federal Reserve rate cuts. The strength of U.S. stock gains has been matched by corporate earnings beating expectations, led by a handful of AI names. See the chart. As a result, we see concentration as a feature, not a flaw, of today's market environment. We expect some volatility ahead as markets grapple with a wide range of outcomes – as shown by last week's brief retreat in tech shares. Recent low market volatility doesn't reflect all risks ahead, in our view. We still think the next six to 12 months is a time to lean into risk but we prepare to reassess as new opportunities arise.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist — BlackRock Investment Institute

Vivek Paul
Global Head of Portfolio Research – BlackRock Investment Institute

Natalie Gill
Portfolio Strategist – BlackRock Investment Institute

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BlackRock **Investment** Institute

In the near term, we see a concentrated group of AI winners driving returns. We stay overweight U.S. stocks and the AI theme. AI-related data center investment could rise by 60-100% annually in coming years, according to a mix of forecasters including the International Energy Agency. We see the AI theme playing out in three phases. This first AI buildout phase is already producing early winners – including big tech firms, chip producers and companies supplying key inputs like energy, utilities, materials and real estate. Yet this phase faces challenges, such as whether the power grid can keep pace. We think markets and central banks underappreciate the inflationary impact of this early phase. The next phase could see investment broadening to companies looking to harness AI's power. The final phase – potential economy-wide AI productivity gains – is highly uncertain. These gains can only come after AI capabilities are fully deployed, a process that could take many years.

We also lean into risk by going overweight UK equities. We see the Labour Party's landslide UK election victory increasing the likelihood of a two-term government. The potential for long-term policy implementation should bring relative political stability, in our view. We think perceived stability can help improve sentiment – especially among foreign investors who own more than half of UK shares. We added to our overweight to Japan equities in March due to corporate reforms. Wage gains are filtering into mild inflation and corporate pricing power, reinforcing our optimism on a long-term strategic horizon.

We balance our risk-on view by staying selective in fixed income, focusing on quality. We prefer short-term government bonds and credit that are delivering much higher income than pre-pandemic. We are overweight short-term investment grade credit given signs that lower-quality pockets are starting to show cracks from higher-for-longer rates. Strategically, we like private credit over public. Private credit defaults remain relatively limited. Private markets are complex, with high risk and volatility, and not suitable for all investors. By region, we like long-dated UK gilts over long-dated U.S. Treasuries strategically.

Bottom line: We see unprecedented transformation unfolding in the real economy. We lean into risk as a result. In stocks, we like the U.S., UK and Japan. We prefer quality income in fixed income – especially in short-term credit – and like private credit.

Market backdrop

U.S. stocks hit a new record high last week while 10-year Treasury yields fell to around 4.21%, down nearly 50 basis points from their April highs. The U.S. CPI for June came in surprisingly soft, but we think this level of inflation is unsustainably low given ongoing wage pressures. The drop in yields sparked a surge in small cap shares and a brief retreat in tech shares. We think this reflects how markets can become choppy again, even if leaning into risk will be rewarded.

Assets in review

Selected asset performance, 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 LSEG Datastream as of July 11, 2024. Notes: The two ends of the bars show the lowest and highest returns at any point year to date, 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, LSEG 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.

Week ahead

July 17	UK CPI data	**July 19**	Japan CPI
July 18	ECB policy decision; Philadelphia Fed business index		

We expect the ECB to hold rates steady this week after their policy meeting. We think the ECB will act on forthcoming data in September but see rates staying higher due to inflationary pressures in the longer term. Overall, this remains an atypical rate-cutting cycle.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, July 2024

Tactical	**Reasons**
AI and U.S. equities	• We have high conviction that AI can keep driving returns in most scenarios. We see its buildout and adoption creating opportunities across sectors. The AI theme has driven U.S. stock gains and solid corporate earnings, making us overweight U.S. stocks overall.
Japanese equities	• This is our highest conviction equity view thanks to support from the return of mild inflation, shareholder-friendly corporate reforms and a Bank of Japan that is cautiously normalizing policy – rather than tightening.
Income in fixed income	• The income cushion bonds provide has increased across the board in a higher rate environment. We like quality income in short-term bonds and credit. We're neutral long-term U.S. Treasuries.
Strategic	**Reasons**
Private credit	• We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to public credit risk.
Fixed income granularity	• We prefer inflation-linked bonds as we see inflation closer to 3% on a strategic horizon. We also like short-term government bonds, and the UK stands out for long-term bonds.
Equity granularity	• We favor emerging over developed markets yet get selective in both. EMs at the cross current of mega forces – like India and Saudi Arabia – offer opportunities. In DM, we like Japan as the return of inflation and corporate reforms brighten our outlook.

Note: Views are from a U.S. dollar perspective, July 2024. 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.

Tracking five mega forces

Mega forces are big, structural changes that affect investing now – and far in the future. As key drivers of the new regime of greater macroeconomic and market volatility, they change the long-term growth and inflation outlook and are poised to create big shifts in profitability across economies and sectors. This creates major opportunities – and risks – for investors. See our web hub for our research and related content on each mega force.

1. **Demographic divergence:** The world is split between aging advanced economies and younger emerging markets – with different implications.
2. **Digital disruption and artificial intelligence (AI):** Technologies are transforming how we live and work.
3. **Geopolitical fragmentation and economic competition:** Globalization is being rewired as the world splits into competing blocs.
4. **Future of finance:** A fast-evolving financial architecture is changing how households and companies use cash, borrow, transact and seek returns.
5. **Transition to a low-carbon economy:** The transition is set to spur a massive capital reallocation as energy systems are rewired.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, July 2024

Our approach is to first determine asset allocations based on our macro outlook – and what's in the price. **The table below reflects this and, importantly, leaves aside the opportunity for alpha, or the potential to generate above-benchmark returns.** The new regime is not conducive to static exposures to broad asset classes, in our view, but is creating more space for alpha**.**

Underweight | **Neutral** | **Overweight** | ● Previous view

	Asset	View	Commentary
Equities	**Developed markets**		
	United States	+1	We are overweight given our positive view on the AI theme. Valuations for AI beneficiaries are supported as tech companies keep beating high earnings expectations. We think upbeat sentiment can broaden out. Falling inflation is easing pressure on corporate profit margins.
	Europe	-1	We are underweight. Valuations are looking more attractive. A pickup in growth and European Central Bank rate cuts support an ongoing earnings recovery.
	UK	+1	We are overweight. Political stability and a growth pickup could improve investor sentiment, lifting the UK's low valuation relative to other DM stock markets.
	Japan	+2	We are overweight. Mild inflation and shareholder-friendly reforms are positives. We see the BOJ normalizing policy – not tightening aggressively. A weak yen is a drag on returns for international investors.
	Emerging markets	Neutral	We are neutral. The growth and earnings outlook is mixed. We see valuations for India and Taiwan looking high.
	China	Neutral	We are neutral. We see risks from weak consumer spending, even with measured policy support. An aging population and geopolitical risks are structural challenges.
Fixed Income	Short U.S. Treasuries	+1	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer.
	Long U.S. Treasuries	Neutral	We are neutral. Markets have cut expectations of Fed rate cuts and term premium is close to zero. We think yields will keep swinging in both directions on new economic data.
	Global inflation-linked bonds	Neutral	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
	Euro area govt bonds	Neutral	We are neutral. Market pricing reflects policy rates in line with our expectations and 10-year yields are off their highs. Political developments remain a risk to fiscal sustainability.
	UK gilts	Neutral	We are neutral. Gilt yields have tightened to U.S. Treasuries and market pricing of future yields is in line with our view.
	Japanese govt bonds	-2	We are underweight. Stock returns look more attractive to us. We see some of the least attractive returns in JGBs.
	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	U.S. agency MBS	Neutral	We are neutral. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG.
	Short-term IG credit	+1	We are overweight. Short-term bonds better compensate for interest rate risk. We prefer Europe over the U.S.
	Long-term IG credit	-1	We are underweight. Spreads are tight, so we prefer taking risk in equities from a whole portfolio perspective. We prefer Europe over the U.S.
	Global high yield	Neutral	We are neutral. Spreads are tight, but the total income makes it more attractive than IG. We prefer Europe.
	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
	Emerging hard currency	Neutral	We are neutral. The asset class has performed well due to its quality, attractive yields and EM central bank rate cuts. We think those rate cuts may soon be paused.
	Emerging local currency	Neutral	We are neutral. Yields have fallen closer to U.S. Treasury yields, and EM central banks look to be turning more cautious after cutting policy rates sharply.

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