Weekly commentary

April 21, 2025

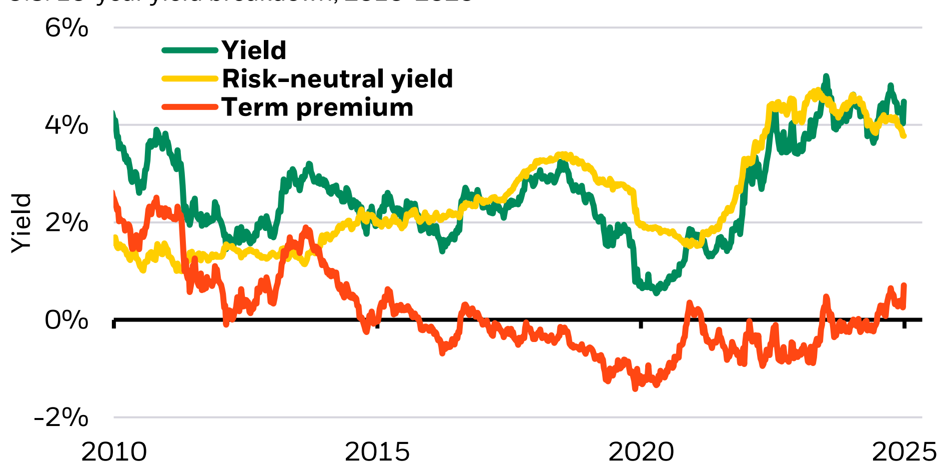
When economic rules start to bind

- U.S. policy shifts are adding to the global transformation already underway. We track rules that will shape policy and focus on themes – like AI – driving returns.
- U.S. stocks steadied last week but are still down 6% since the April 2 tariff announcement. U.S. 10-year yields are up since then to near 4.35%.
- Global flash PMIs will be the main focus this week to see how U.S. tariffs and policy uncertainty are impacting incoming orders and the outlook for activity.

We have argued for a few years that mega forces, like geopolitical fragmentation, are transforming the world. U.S. trade policy is adding to this transformation. This isn't a business cycle, but a long-term structural shift. It raises big questions about the trajectory for global markets, making long-term expectations more sensitive to short-term news. We focus on themes that can drive returns over broad asset classes. We see the AI mega force driving returns over time, mostly in the U.S.

Term premium returns

U.S. 10-year yield breakdown, 2010-2025



Source: BlackRock Investment Institute and New York Federal Reserve, with data from LSEG Datastream, April 2025. Note: The chart shows the New York Fed's estimate of the 10-year term premium – the extra compensation investors demand for the risk of holding long-term bonds – along with the risk-neutral yield. Both make up the total yield.

How will the role of U.S. Treasuries in portfolios evolve? It's one of the big questions raised by the recent collision of two mega forces: geopolitical fragmentation and the future of finance. We argued in 2021 that higher inflation and interest rates at a time of elevated debt create a "fragile equilibrium" for U.S. bonds, one vulnerable to shifts in investor confidence. We have long expected structurally higher interest rates. The recent unusual surge in Treasury yields as U.S. stocks and the dollar slid suggests a desire for more compensation for risk and brought that fragile equilibrium into sharp focus. See the chart. Predicting the end state of a transformation is near impossible, compounded now by unpredictable trade talks. Yet the policy-setting process will bump up against economic rules that put bounds on the realms of what's possible. We track those rules, not each policy twist.

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The U.S. runs large fiscal deficits and high debt, about 30% of which is held by foreign investors, Fed data show. An economic rule in play here? The current account deficit cannot be reduced without a corresponding fall in foreign financing. By pushing to reduce the trade deficit quickly, the U.S. will find it harder to finance its debt, especially if unpredictable tariff negotiations dent the confidence of foreign investors. That points to higher bond yields and debt servicing costs, upending budgetary arithmetic. Another rule? Global supply chains can evolve over time but cannot be rewired at speed without major disruption. Tariffs not only raise costs but can cut access to key inputs and potentially halt production. That risks a growth slowdown or recession with high inflation, just like in the pandemic. That limits any central bank response. In seeking to slash trade deficits fast, the U.S. will bump up against these economic rules. That seems to have already happened with the recent rapid Treasury selloff and tariff exemptions for electronics to avoid the most obvious supply chain disruptions.

We see U.S. policy shifts adding to the structural transformation already underway. That transformation could have any number of outcomes in coming years. We can no longer extrapolate from past trends or rely on long-term assumptions to anchor portfolios. The distinction between tactical and strategic asset allocation is blurred. Instead, we need to constantly reassess the long-term trajectory and be dynamic with asset allocation as we learn more about the future state of the global system. Uncertainty about that future landscape can also incentivize non-U.S. investors to keep more money in local markets.

The binding effect of these economic rules on trade negotiations mean it will take time to uproot the current system. In the near term, today's financial order remains the starting point. We focus on themes powering the global transformation. We still see the AI mega force driving returns, especially in the U.S. We find selective opportunities in Europe, for example in banks and defense. We prefer European credit and government bonds to the U.S. How the bloc responds to shifting global dynamics and tackles its structural challenges will be key.

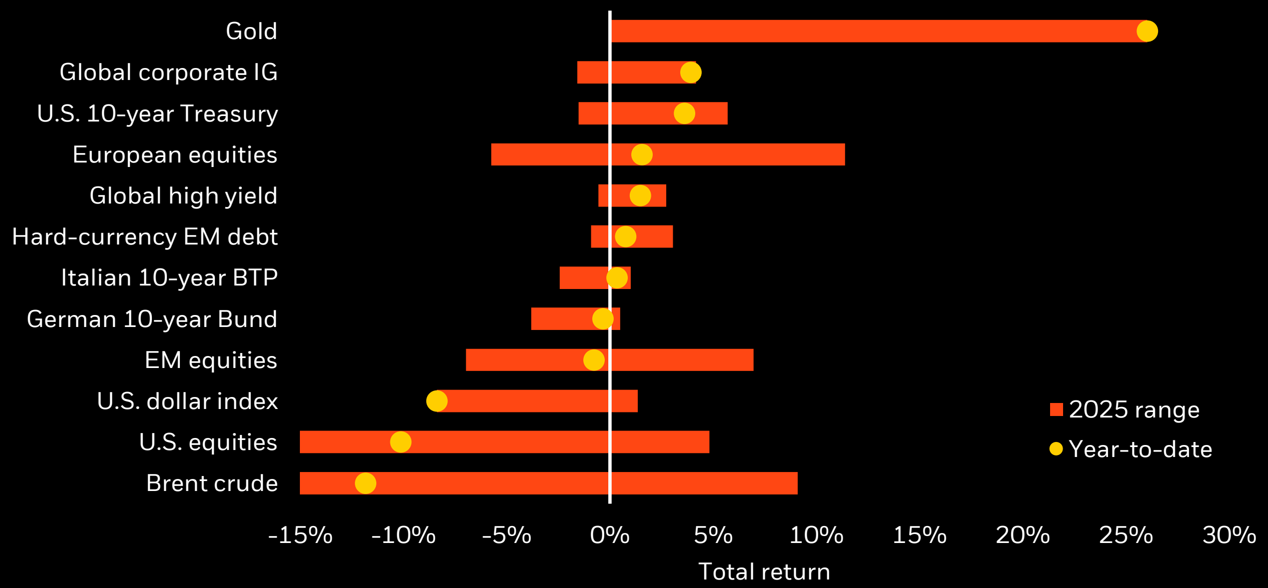
Bottom line: Many different outcomes are feasible, so we navigate near-term uncertainty by tracking economic rules that will shape trade policy. We like U.S. stocks as a route to invest in AI and stay selective in Europe. We underweight U.S. Treasuries.

Market backdrop

U.S. stocks steadied after the historically big volatility since the April 2 announcement on U.S. tariffs. The S&P 500 was flat for the week and still down about 6% since then. Nvidia came under pressure after the U.S. announced export controls on one of the main chips it sells to China. U.S. Treasury yields fell on the week but are still up 14 basis points to 4.34% since April 2, highlighting their reduced ballast role in portfolios. The U.S. dollar held near a three-year low against major currencies.

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 April 16, 2025. 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

April 22	Euro area consumer confidence
April 23	Global flash PMIs
April 25	UK retail sales; University of Michigan consumer sentiment

Global flash PMIs for both manufacturing and services activity will be in focus this week as investors look for any signs of the U.S. tariffs, policy uncertainty and risk asset selloff having an impact. The University of Michigan's consumer sentiment survey will also be closely watched, especially given the surge in expected inflation among households as tariffs kick in. So far, higher household inflation expectations have not fed into market pricing of future inflation.

Big calls

Our highest conviction views on six- to 12-month (tactical) and over five-year (strategic) horizons, April 2025

Tactical	Reasons
U.S. equities	Policy uncertainty may weigh on growth and stocks in the near term. Yet we think U.S. equities can regain their global leadership. We think the underlying economy and corporate earnings are still solid and supported by mega forces such as AI.
Japanese equities	We are overweight. Ongoing shareholder-friendly corporate reforms remain a positive. We prefer unhedged exposures given the yen's potential strength during bouts of market stress.
Selective in fixed income	Persistent deficits and sticky inflation in the U.S. make us underweight long-term U.S. Treasuries. We also prefer European credit – both investment grade and high yield – over the U.S. on more attractive spreads.
Strategic	**Reasons**
Infrastructure equity and private credit	We see opportunities in infrastructure equity due to attractive relative valuations and mega forces. We think private credit will earn lending share as banks retreat – and at attractive returns.
Fixed income granularity	We prefer DM government bonds over investment grade credit given tight spreads. Within DM government bonds, we favor short- and medium-term maturities in the U.S., and UK gilts acrossan maturities.
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 the outlook.

Note: Views are from a U.S. dollar perspective, April 2025. 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, April 2025

We have lengthened our tactical investment horizon back to six to 12 months. The table below reflects this and, importantly, leaves aside the opportunity for alpha, or the potential to generate above-benchmark returns – especially at a time of heightened volatility.

Underweight | Neutral | Overweight | ● Previous view

	Asset	View	Commentary
Equities	**Developed markets**		
	United States	+1	We are overweight. Policy uncertainty may weigh on growth and stocks in the near term. Yet we think the underlying economy and corporate earnings are still solid and supported by mega forces such as AI.
	Europe	Neutral	We are neutral. We see room for more European Central Bank rate cuts, supporting an earnings recovery. Rising defense spending, as well as potential fiscal loosening and de-escalation in the Ukraine war are other positives.
	UK	Neutral	We are neutral. Political stability could improve investor sentiment. Yet an increase in the corporate tax burden could hurt profit margins near term.
	Japan	+1	We are overweight given the return of inflation and shareholder-friendly corporate reforms. We prefer unhedged exposure as the yen has tended to strengthen during bouts of market stress.
	Emerging markets	Neutral	We are neutral. U.S. tariffs and trade tensions are likely to drag on growth in China and emerging markets more broadly, even with potential policy support.
	China	Neutral	We are neutral. The uncertainty of trade barriers makes us more cautious, with potential policy stimulus only partly offsetting the drag. We still see structural challenges to China's growth.
Fixed Income	Short U.S. Treasuries	+1	We are overweight. We view short-term Treasuries as akin to cash in our tactical views – but we would still lean against the market pricing of multiple Fed rate cuts this year.
	Long U.S. Treasuries	-2	We are underweight. Persistent budget deficits and geopolitical fragmentation could drive term premium up over the near term. We prefer intermediate maturities less vulnerable to investors demanding more term premium.
	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	-1	We are underweight. We see room for yields to climb more as Europe moves to ramp up defense and infrastructure spending. The European Central Bank is also nearing the end of rate cuts.
	UK gilts	Neutral	We are neutral. Gilt yields are off their highs, but the risk of higher U.S. yields having a knock-on impact and reducing the UK's fiscal space has risen. We are monitoring the UK fiscal situation.
	Japanese govt bonds	-1	We are underweight. Yields have surged, yet stock returns still look more attractive to us.
	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.
	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	-1	We are underweight. We see emerging market currencies as especially sensitive to trade uncertainty and global risk sentiment.

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