Weekly commentary

BlackRock

May 5, 2025

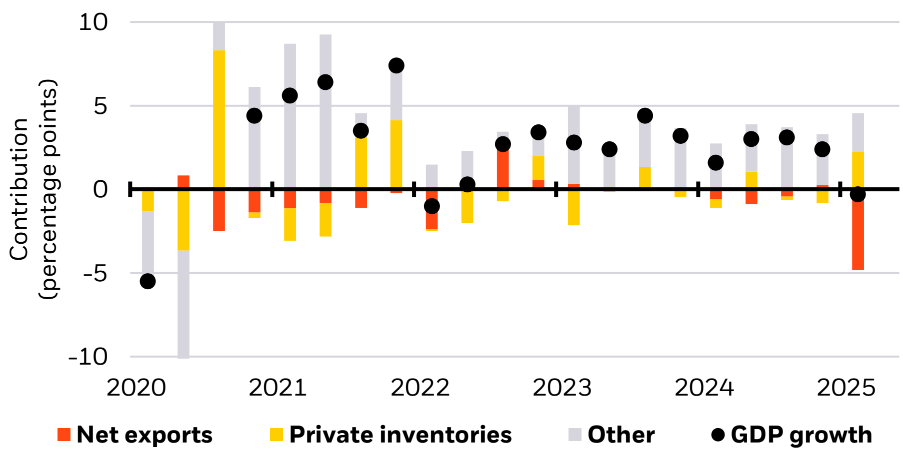
Tracking the trade conflict disruption

- We expect a U.S. contraction this year given supply disruptions from tariffs. We stay overweight U.S. stocks as the artificial intelligence theme rolls on.
- Above-consensus U.S. payrolls data helped boost risk assets last week, with U.S. stocks climbing 3%. U.S. 10-year Treasury yields ended the week steady.
- The Federal Reserve confronts sharpening policy tradeoff it between weaker activity and sticky inflation at its meeting this week as seen in the Q1 GDP data.

The trade conflict between the U.S. and China is causing major economic disruptions. If tariffs stay at current levels, we expect a supply-driven contraction in U.S. activity this year. Yet this is very different from a typical business cycle recession given Covid-like supply constraints. Hard economic rules binding on policy may limit the damage. The AI mega force keeps us overweight U.S. stocks and positive on developed market stocks, even with more volatility likely.

Getting ahead of tariffs

Contribution to annualized U.S. GDP growth, 2020-2025



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, April 2025. Note: The chart shows the contribution to of various economic activities to quarterly U.S. GDP growth, shown on an annualized basis. The grey bars include consumer & government spending, and non-residential & residential investment.

U.S. tariffs and uncertainty initially sparked concerns about waning confidence and declining demand. That's now evolving into supply-driven disruptions, akin to the difficulties U.S. companies faced getting inputs for goods during the Covid-19 shock. Case in point: Companies rushed to import goods during Q1 to get ahead of tariffs, leading to a record surge in imports. See the orange bar in the chart. Along with a surge in inventories, we expect more volatility in activity data that don't yet reflect the ensuing disruptions since the April 2 tariff announcement, especially the maximal U.S. stance on China. If current steep tariffs stay in place between the U.S. and China, we see a supply-driven economic contraction tied to trade-related disruptions like the Covid-19 shock. This contraction is not a typical business cycle recession – and one we can look through on a tactical horizon.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We expect a contraction marked by production shutdowns, bottlenecks and shortages like during the pandemic – though spending on services won't be as directly affected. Activity may also restart quickly as it did during the pandemic. These supply-driven elements could bolster the inflationary pressure from tariffs, building on already high inflation. That presents the Fed with a sharper trade-off between protecting growth by coming to the rescue with rate cuts and reining in inflation. We track a range of indicators – like port traffic, capital spending plans and high-frequency financial and consumer spending data – to monitor how the supply-driven shock ripples out. This reinforces the hard economic rule that supply chain dependencies can't be rewired quickly without disruption. If these rules constrain negotiations, damage could be limited.

Some sectors are more exposed to tariffs than others – with sectoral differences already at play in Q1 earnings reports. The companies at the forefront of the AI mega force have largely kept driving U.S. equity strength, while policy uncertainty weighs more heavily on the rest of the market. Some big tech companies have beat Q1 earnings expectations, noted surging AI-driven demand and announced plans to increase AI-related investment. That underscores how the AI mega force persists, even with major supply-driven disruptions – keeping us positive on developed market (DM) stocks, especially the U.S. On the flip side, automakers are among the most exposed to key supply inputs from China, with some flagging the impact of tariffs in their full-year earnings guidance. The longer policy uncertainty lasts, the deeper the damage could be.

We have evolved our views as markets have adjusted to uncertainty. Just two days after April 2, we reduced risk by cutting our tactical horizon to three months. Yet the 90-day tariff pause showed economic rules can spur changes in policy. That led us to return our tactical horizon to six to 12 months to dial up exposure to developed market stocks. On a longer-term horizon, key questions remain about the best way to tap into an economic transformation, if investor bias for domestic assets will prevail, the outlook for the U.S. dollar's haven status, and investing in private markets amid structurally higher interest rates.

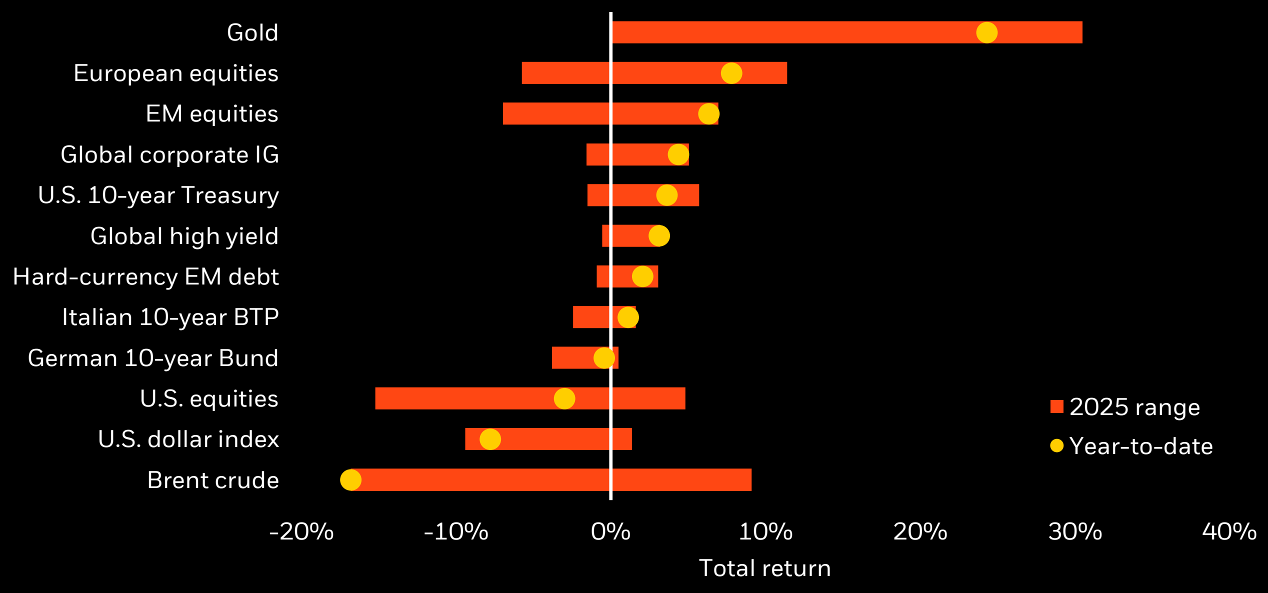
Bottom line: We expect tariffs at current levels to spur a supply-driven contraction this year, while supply disruptions boost inflation. The AI theme keeps us positive on DM stocks, especially the U.S., though more volatility is likely ahead.

Market backdrop

The above-consensus U.S. payrolls data helped boost risk assets and offset a drop in some tech shares on concerns about the tariff impact. The S&P 500 climbed 3% last week, closing the gap with where it was before April but still down 8% from the February all-time highs. U.S. 10-year Treasury yields ended the week at 4.31%, up about 40 basis points from their April lows. Markets have priced out some Federal Reserve rate cuts and now see a first quarter-point cut coming as soon as July.

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 May 2, 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

May 6	U.S. trade data	**May 8**	Bank of England policy decision
May 7	Federal Reserve policy decision	**May 9**	China trade data

The Federal Reserve takes center stage this week. Last week's U.S. Q1 GDP report showed major disruptions to activity even before the April 2 tariff announcement, sharpening the tradeoff the Fed faces between lower growth and higher inflation. Even with the contraction of activity we expect, we don't see the Fed cutting rates as much as the market is pricing in. U.S. and China trade data for March will reflect some of the frontloading of U.S. imports before the tariffs.

Big calls

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

Tactical	Reasons
U.S. equities	Policy uncertainty and supply disruptions are weighing on near-term growth, raising the risk of a contraction. Yet we think U.S. equities will regain global leadership as the AI theme keeps providing near-term earnings support and could drive productivity in the long term.
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 across 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, May 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, May 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-driven volatility and supply-side constraints are pressuring growth, but we see AI supporting corporate earnings in the near term and driving productivity over the long run.
	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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