Weekly commentary

BlackRock

August 5, 2024 (updated Aug. 6)

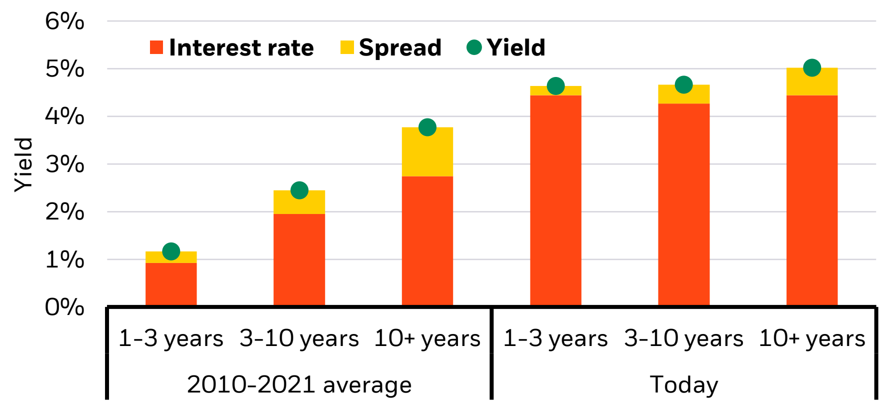
Rate cuts don't dull allure of income

- More central banks are starting to cut policy rates, but we think they'll remain above pre-pandemic norms. We prefer short-term government bonds and credit.
- U.S. stocks slid last week in a volatile week. U.S. bond yields dropped sharply after soft jobs data spurred expectations for a bigger Fed rate cut next month.
- We track China inflation and activity this week. China's trade data are likely to show exports are still underpinning an otherwise weak economy.

Central banks are starting to cut policy rates after the quickest hikes in decades. Cooling inflation should allow the Federal Reserve to cut next month. Yet we see persistent inflation pressures, partly due to ongoing fiscal deficits, keeping interest rates higher on average than pre-pandemic levels. We favor short-term government bonds and credit even as markets eye more rate cuts. In Japan, we stay overweight stocks and see the Bank of Japan adjusting its hawkish shift.

Income on offer

Bloomberg U.S. Aggregate bond index components, 2010-2021 vs. 2024



Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. Index performance does not account for fees. Source: BlackRock Investment Institute and BlackRock Fundamental Fixed Income, with data from Bloomberg, July 2024. Notes: The chart shows the total yield, spread and interest rate of the Bloomberg U.S. Aggregate bond index for: 1-3-year notes, 3-10-year notes and bonds with a maturity of 10 years and longer.

Investor appetite for bonds has grown. That comes as markets have priced in more Fed rate cuts on data showing cooling inflation and a softer U.S. jobs market. The Fed opened the door to a September cut last week, as we expected. Then the payrolls data stoked recession fears and market hopes for a large 50-basis point cut next month. We see this as another flip-flop in the market narrative with little evidence backing it: Unlike in recessions, a growing workforce is driving the rise in the higher unemployment rate, not falling employment. We stay cautious on long-term bonds, especially after the sharp yield drop over the past month. We still favor short-term paper including credit: It can offer similar income to long-term bonds with less sensitivity to interest rate swings. See the chart. That view has played out as short-term yields have dropped – and we think long-term yields can climb anew.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We think long-term yields will eventually climb in the long term as investors demand more term premium, or compensation for the risk of owning long-term bonds. The return of term premium will take time, so we stay tactically neutral long-term Treasuries as yields swing sharply on shifting policy expectations. We believe last week's yield drop on higher rate cut hopes and growth fears are overblown. The labor market remains resilient: jobs gains are slowing but strong, employment is still rising and layoffs are not increasing. And even if near-term U.S. inflation is proving volatile, ongoing pay pressures and a shrinking workforce support services inflation longer term. That, and large U.S. fiscal deficits in the future, could keep the neutral interest rate – one that neither stokes nor restricts growth – higher than pre-pandemic.

We see catalysts for term premium's return, but timing is uncertain. One catalyst: the U.S. election likely shifting focus to the fiscal outlook. The Treasury's bond issuance calendar suggests it doesn't need to make major changes for now. We think net issuance will eventually need to climb to match the pace of government spending. Markets struggling to absorb this supply could boost term premium. The Fed altering the size of its balance sheet or the maturity of its bond holdings is another catalyst. It's still a big buyer, purchasing 10% of 10-year and 30-year bonds in 2023 and holding about 30% of bonds with maturities longer than 10 years in circulation, based on analysis of New York Fed data by our portfolio managers. The mix of buyers also matters: While foreign buyers have retreated, U.S. households are increasingly stepping in to buy.

The BOJ policy shift also matters for global term premium. Its move to more actively manage inflation risks could boost bond yields and prompt domestic investors to favor local bonds over foreign bonds, especially in the U.S. and euro area. We see the BOJ adjusting its hawkish shift given the market fallout, especially the surging yen, and stay overweight Japanese stocks. A stronger yen had limited the return hit to our currency-unhedged preference.

Bottom line: The start of rate cuts doesn't mean this will be the typical easing cycle, and markets can overreact to volatile data given lighter trading activity. We prefer income in short-term bonds and credit. We stay overweight Japanese stocks.

Market backdrop

U.S. stocks slid last week, with small cap shares and tech leading the way. Growth fears exacerbated by soft U.S. jobs data drove a broad global risk-off move. U.S. two-year Treasury yields fell to 15-month lows near 3.90% as markets priced in the potential for a 50-basis point rate cut in September and multiple cuts through 2025. Japan's Topix stock index tumbled more than 6% last Friday – its worst day in eight years – on concerns about the BOJ policy shift and a resurgent yen.

Assets in review

Selected asset performance, year-to-date return and range

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Sources: BlackRock Investment Institute, with data from LSEG Datastream as of Aug. 1, 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

Aug. 5	Caixin services PMI	**Aug. 7**	China trade data
Aug. 6	U.S. trade data	**Aug. 9**	China PPI and CPI inflation

China's economic data is in focus this week. Chinese exports have proven resilient, helping prop up growth – and the latest trade data will give clues if that is still the case. Yet manufacturing activity has weakened, and subdued retail sales reflect cautious households struggling with the property sector's woes. We eye the services PMI for more clues on consumer spending. Weak activity has led to low inflation and even deflation. Without meaningful policy support for growth, we don't see that picture changing much.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, August 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	• A brighter outlook for Japan's economy and corporate reform are driving improved earnings and shareholder returns. We think the Bank of Japan will adjust its surprise hawkish shift on policy that spooked markets and stay cautious in normalizing policy.
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, August 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, August 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**		
Equities	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.
Equities	Europe	-1	We are underweight relative to the U.S., Japan and the UK – our preferred markets. Valuations are fair. A growth pickup and European Central Bank rate cuts support a modest earnings recovery. Yet political uncertainty could keep investors cautious.
Equities	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.
Equities	Japan	+2	We are overweight. A brighter outlook for Japan's economy and ongoing corporate reforms are driving improved earnings and shareholder returns. We think the Bank of Japan will adjust its surprise hawkish shift on policy that spooked markets and stay cautious in normalizing policy.
Equities	**Emerging markets**	Neutral	We are neutral. The growth and earnings outlook is mixed. We see valuations for India and Taiwan looking high.
Equities	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.
Fixed Income	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.
Fixed Income	Global inflation-linked bonds	Neutral	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
Fixed Income	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 uncertainty remains a risk to fiscal sustainability.
Fixed Income	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.
Fixed Income	Japanese govt bonds	-2	We are underweight. Stock returns look more attractive to us. We see some of the least attractive returns in JGBs.
Fixed Income	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
Fixed Income	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.
Fixed Income	Short-term IG credit	+1	We are overweight. Short-term bonds better compensate for interest rate risk. We prefer Europe over the U.S.
Fixed Income	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.
Fixed Income	Global high yield	Neutral	We are neutral. Spreads are tight, but the total income makes it more attractive than IG. We prefer Europe.
Fixed Income	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
Fixed Income	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.
Fixed Income	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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