Weekly commentary

September 3, 2024

BlackRock

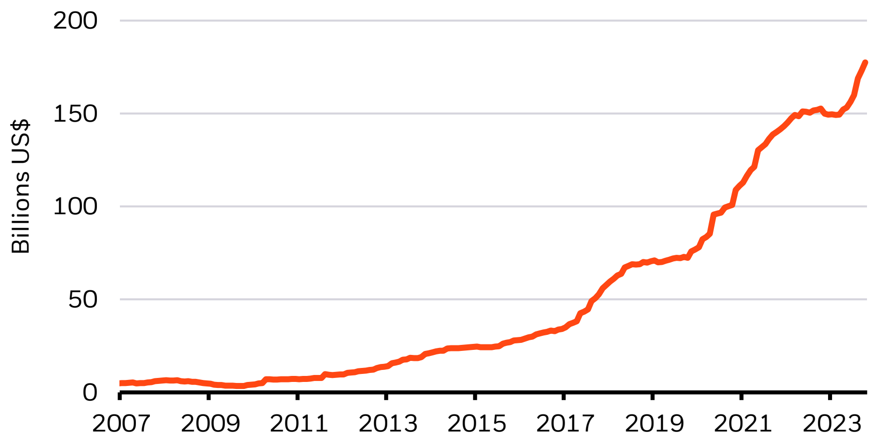
Patience needed in the AI buildout

- Investors have started to worry about tech companies spending big on artificial intelligence. We focus on the broader story and stay overweight the AI theme.
- U.S. stocks have climbed back near all-time highs. Resilient U.S. growth calls into question the scale of Federal Reserve rate cuts markets have priced.
- This week's U.S. payrolls report should show ongoing job gains even with the rise in unemployment. We don't think such job gains support recession worries.

Investors are debating whether future revenues for top tech and cloud computing firms could justify billions of dollars of capital spending being poured into artificial intelligence (AI). We think it's key to distinguish between the individual companies and broader economy when gauging the impact. We're overweight the AI theme and see winners along the AI supply chain. Yet we eye signposts for changing our view, including stalling revenue growth or sluggish AI adoption.

Big spending

Major tech and cloud company capital spending, 2007-2024



Past performance is not a reliable indicator of current or future results. Source: BlackRock Investment Institute, with data from LSEG Datastream, August 2024. Notes: The chart shows the combined 12-month trailing capital spending for Microsoft, Amazon, Meta and Alphabet.

In recent months, market buzz over the benefits of AI has flipped to worries that the companies investing big in it may not see the benefits so quickly. We assessed this sudden shift in sentiment with our portfolio managers. Overall capital spending by top tech and cloud players has surged in recent years, especially in energy-hungry data centers, as they race to build out AI. See the chart. Past investment ultimately led to a boost in revenue, helping deliver a return on investment, data from LSEG show. Yet some recent research has questioned if the revenues from AI alone will eventually justify this wave of capital spending on it. When assessing AI capex by individual companies, investors must consider if they are making the best use of their balance sheets and capital. But for the economy overall, we judge AI investment by the major revenue that AI could generate across sectors.

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Investment in AI could compare to capital spending on past tech innovations, like cloud computing. Yet it's possible that shareholders may not see further AI investment as the best use of corporate balance sheets. We see a disconnect between the short-term lens of some investors and the long-term visions of tech and cloud service providers. That divergence has spurred jitters among investors – but we think patience is needed. Some big spenders on AI have earmarked capex for building new data centers and exponentially multiplying processing power for AI. Such plans take years – not quarters – to complete. So it may take some time for revenues to fully realize AI capital spending. Some tech companies are already reporting increasing revenues from the roll out of AI-related products.

We see room for overall AI capex to spur some of the waves of transformation driven by mega forces, or structural forces shaping returns. Nvidia's Q2 revenues doubled from a year ago, showing that AI capex is sizable and ongoing. Nvidia's results highlight how the AI buildout is broadening: more than half its AI revenues came from non-tech sectors. We track a few signposts to assess our upbeat view on the AI theme. First, we look for signs of stalling revenue growth at top AI companies, adding to the importance of each earnings season. Second, we gauge changes in still-low AI adoption beyond the tech sector. Third, we eye any U.S. growth downturn that could spur big tech companies to curb spending.

We use our three-phase roadmap to track the economic and market impact of AI. The first phase – the buildout – is unfolding now as large tech companies race to invest in data centers. Early winners in this phase include those big spenders and chip producers. We also see opportunities in firms supplying key inputs like energy, utilities and real estate. In the second phase, we think AI adoption will expand to sectors beyond tech such as healthcare and financials. This could result in a third phase of broad productivity gains, but the size and impact is uncertain. Our coming research will explore this in more detail.

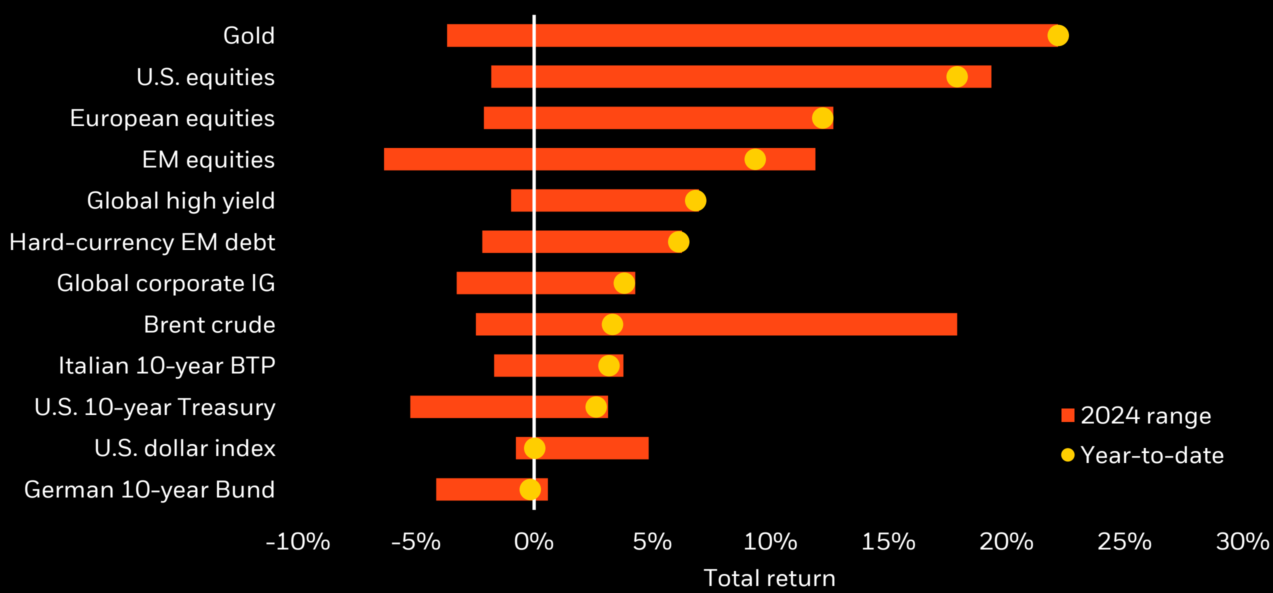
Bottom line: Investors are debating the implications of the AI capex boom. Some investors have cut positions in tech in recent months, implying room to rebuild holdings. We stay overweight the AI theme but eye signposts to change our view.

Market backdrop

U.S. stocks have climbed back near all-time highs. The AI trade regained its footing after the volatility in July and early August, even as Nvidia's shares stumbled on profit taking after its Q2 earnings beat expectations. Broadening Q2 corporate earnings growth, coupled with last week's upbeat jobless claims and GDP data, show U.S. economic growth is holding up – a positive for risk assets. We think the Federal Reserve is unlikely to cut rates as sharply as markets are pricing in.

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 Aug. 29, 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

Sept. 4	China Caixin services PMI; U.S. job openings; U.S. trade data	**Sept. 6**	U.S. payrolls; euro area employment
Sept. 5	U.S. ISM services PMI		

U.S. payrolls for August are in focus this week. At the Jackson Hole symposium, Federal Reserve Chair Jerome Powell noted the central bank is now focused more on any softening in the labor market. A further rise in the unemployment rate helped stoke recession fears last month. Yet this was caused by an immigration surge increasing labor supply, not layoffs. We expect this week's data to show signs of job growth holding up, alleviating lingering growth concerns.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, September 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 now be cautious in normalizing policy after its misstep in July.
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 intermediate credit, which offers similar yields with less interest rate risk than long-dated credit. We also like short-term government bonds, and UK 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, September 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, September 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 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.
	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. A brighter outlook for Japan's economy and corporate reform are driving improved earnings and shareholder returns. We think the Bank of Japan will now be cautious in normalizing policy after its misstep in July.
	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 uncertainty remains 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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