Weekly commentary

BlackRock

September 9, 2024

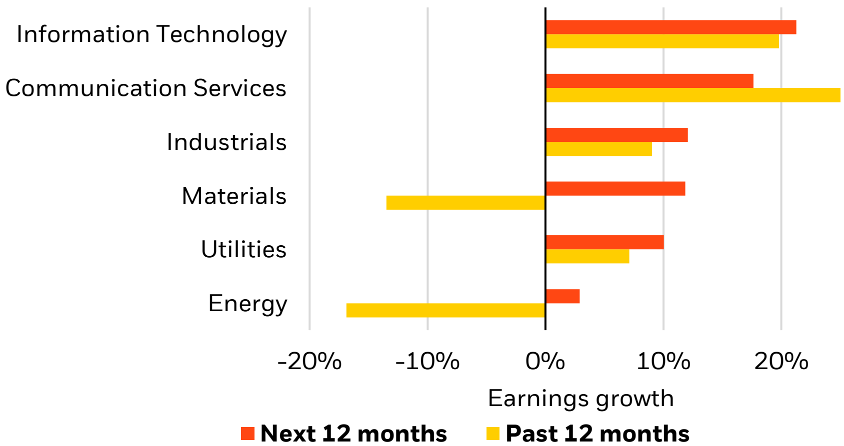
Why U.S. equity gains can broaden

- We get selective in artificial intelligence names, moving toward beneficiaries outside the tech sector. We look for quality in bonds after a sharp yield drop.
- U.S. stocks fell last week as recession fears and other factors shook markets. U.S. Treasury yields slid as markets priced in sharp Federal Reserve rate cuts.
- The U.S. CPI data this week will show whether services inflation is still cooling. We think the jobs data show market expectations for Fed rate cuts are overdone.

U.S. recession fears and other factors have jolted markets. We could see more volatility flare-ups ahead of the U.S. presidential election. We move from a U.S. tech focus within our equity overweight, leaning further into a wider set of winners from the artificial intelligence (AI) buildout. We don't see the Federal Reserve cutting policy rates as sharply as markets expect and go underweight U.S. short-dated Treasuries. We prefer medium-term Treasuries and quality credit.

Earnings broadening out

U.S. sector earnings, past vs. next 12 months, September 2024



Past performance is not a reliable indicator of current or future results. Source: BlackRock Investment Institute, with data from MSCI and LSEG Datastream, September 2024. Notes: The chart shows the change in aggregate analyst earnings forecasts for U.S. sectors.

We see multiple factors driving market volatility: resurgent recession fears due to some softer economic data, pre-U.S. election jitters and profit-taking as investors make room for new stock issues. Yet U.S. corporate earnings have proved resilient. All sectors beat expectations for Q2 earnings, driving broad improvement in profit margins. Overall S&P 500 earnings growth was 13% in Q2, beating the 10% consensus expectation, LSEG data shows. Analysts are forecasting broad-based earnings growth over the next 12 months – especially for sectors tied to the AI theme. See the chart. We see a narrowing gap in earnings growth between U.S. tech companies and the rest of the market – even if tech still leads the way – suggesting U.S. equity returns can broaden. We favor high-quality companies delivering consistent earnings growth and free cash flow in case volatility persists.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Natalie Gill
Portfolio Strategist – BlackRock Investment Institute

Beata Gamharter
Senior Investment Strategist — BlackRock Investment Institute

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We still favor the AI theme yet fine-tune our exposure. In the first phase of AI now underway, investors are questioning the magnitude of AI capital spending by major tech companies and whether AI adoption can pick up. While we eye signposts to change our view, we think patience is needed as the AI buildout still has far to go. Yet we believe the sentiment shift against these companies could weigh on valuations. So we turn to first-phase beneficiaries in energy and utilities providing key AI inputs – and real estate and resource companies tied to the buildout. Outside the U.S., we trim our overweight to Japanese equities. The drag on corporate earnings from a stronger yen and some mixed policy signals from the Bank of Japan following hotter-than-expected inflation make us less positive. But we expect corporate reforms to keep improving shareholder returns.

U.S. earnings growth broadening beyond early AI winners is a sign the economy is more resilient than markets are pricing. Growth is moderating as expected. Yet we view extreme market reactions to softening economic data as overdone. Activity is holding up versus what some sentiment data would imply. The unemployment rate has ticked up due to higher labor supply stemming from an unexpected rise in immigration, not lower demand. In the medium term, we see a shrinking labor force, large U.S. fiscal deficits and mega forces, or structural shifts, like geopolitical fragmentation all underpinning sticky inflation.

Even as inflation is falling toward the Fed's target in the near term, higher inflation over the medium term will limit how far the Fed can cut rates, we think. Growth jitters and cooling inflation have driven 10-year yields to 15-month lows as investors have priced in more than 100 basis points of cuts by year-end and about 240 basis points of cuts over the next 12 months – implying a Fed response to a recession. That would take policy rates below our view of the neutral interest rate – the rate at which policy neither stimulates nor holds back growth. We go underweight short-dated U.S. Treasuries, looking for income elsewhere in developed markets such as short-dated euro area bonds and credit.

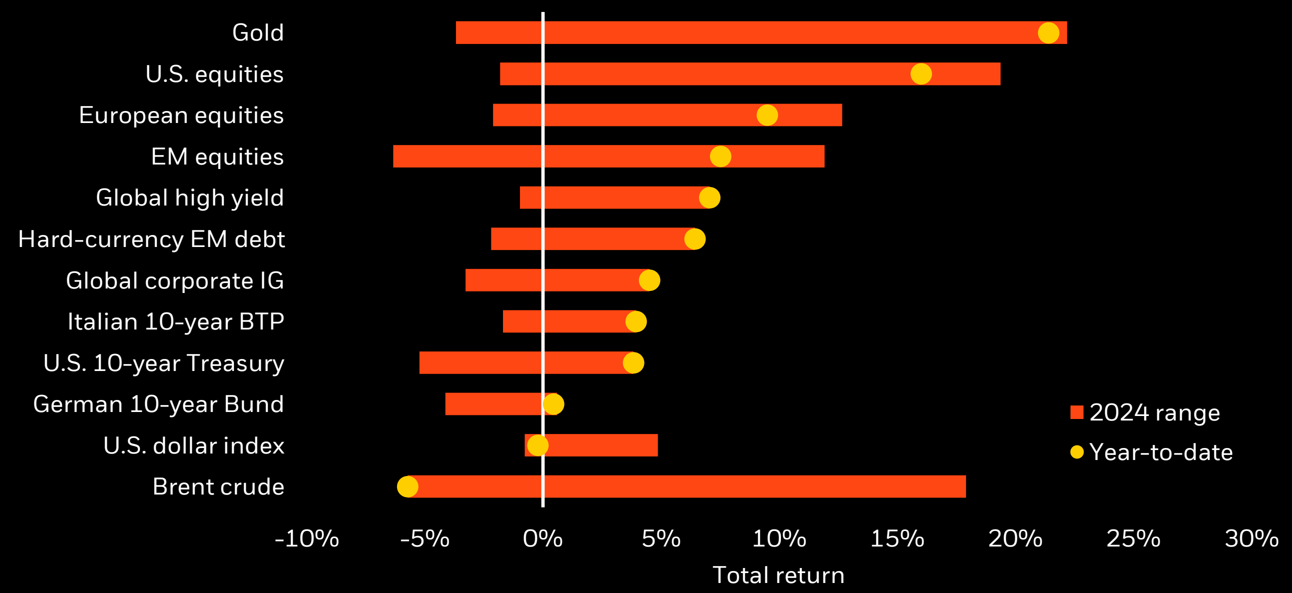
Bottom line: We expand from a U.S. tech focus, leaning into a wider set of winners from the AI buildout. We trim our Japanese equity overweight. We go underweight U.S. short-dated Treasuries, preferring medium-term maturities and quality credit.

Market backdrop

U.S. stocks tumbled as recession fears and other factors shook markets. The S&P 500 suffered its largest weekly drop in 18 months. Two- and 10-year U.S. Treasury yields slid to around 3.70% as markets priced in sharp Fed rate cuts in the next 12 months. We think these recession fears are overblown, as last week's U.S. jobs data confirmed. Job growth is slowing but is far from the layoffs that typically signal recession. Wage gains don't suggest inflation will cool to the Fed's 2% target, in our view.

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 Sept. 5, 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. 9	China CPI and PPI	**Sept. 12**	U.S. PPI; European Central Bank (ECB) policy decision
Sept. 11	U.S. CPI	**Sept. 10-17**	China total social financing

In the U.S., August CPI data is the main release this week. Services inflation has fallen in recent months as wage inflation has eased some thanks to a surge in immigration. Whether that labor supply shock persists will influence how much the Fed can cut interest rates, but we think market pricing of cuts is overdone, with wage inflation still too high to be consistent with overall inflation returning to 2%. We, like markets, expect the ECB to cut rates this week.

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 see the AI buildout and adoption creating opportunities across sectors. We get selective, moving toward beneficiaries outside the tech sector. Broad-based earnings growth and a quality tilt make us overweight U.S. stocks overall.
Japanese equities	• A brighter outlook for Japan's economy and corporate reforms are driving improved earnings and shareholder returns. Yet the drag on earnings from a stronger yen and some mixed policy signals from the Bank of Japan are risks.
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 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	+1 ●	We are overweight. A brighter outlook for Japan's economy and corporate reforms are driving improved earnings and shareholder returns. Yet the drag on earnings from a stronger yen and some mixed policy signals from the Bank of Japan are risks.
	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 underweight. We don't think the Fed will cut rates as sharply as markets expect. An aging workforce, persistent budget deficits and the impact of structural shifts like geopolitical fragmentation should keep inflation and policy rates higher over the medium term.
	Long U.S. Treasuries	Neutral	We are neutral. Markets have priced back in sharp 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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