Weekly commentary

BlackRock

November 4, 2024

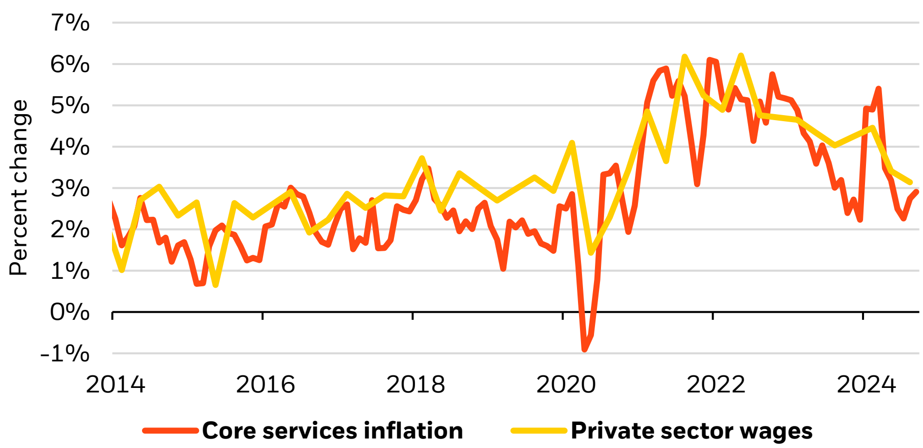
Structural forces playing out now

- Recent macro data reinforces our view that the Fed will not cut rates as much as markets expect. Weaker euro area activity gives the ECB more room to loosen.
- Mixed corporate earnings results and guidance from mega cap tech companies hurt U.S. stocks last week. U.S. 10-year Treasury yields hit four-month highs.
- The Fed and Bank of England are both poised for another 25-basis point cut this week. We still think U.S. rates will settle slightly higher than markets expect.

With the Federal Reserve poised to cut policy rates again this week, recent solid jobs and wage data – including last week's updates – reinforce why we do not see the central bank delivering the lower rates markets expect. We think investors are viewing structural changes through the lens of a typical business cycle – and that is driving market volatility. The European Central Bank is seen cutting rates closer to our view, one reason we prefer euro area fixed income over the U.S.

Inflation staying sticky

U.S. services inflation and private sector wages, 2013 to 2024



Source: BlackRock Investment Institute, with data from Haver Analytics, October 2024. Notes: The chart shows monthly annualized U.S. core services inflation, excluding shelter, using the BEA's Personal Consumption Expenditures (PCE) price index, relative to three-month annualized hourly earnings based on the BLS' Employment Cost Index (ECI).

We have seen huge swings in Fed rate cut pricing this year as markets struggle to put incoming – and often conflicting – macro data in context. The U.S. economy's unexpected recent resilience led markets to price out some rate cuts. But we do not think this is a typical business cycle. The unwind of pandemic-era supply shocks and a temporary immigration boost explain much of inflation's cooling, in our view. That is why U.S. wage growth cooled from near 6% annually in early 2022 to around 3% now. See the chart. Yet last week's labor data show wage growth is still strong, and current levels suggest core inflation could stay nearer to 3% versus the Fed's 2% target. We see mega forces, structural shifts driving returns now and in the future, at play that could keep inflation sticky longer term – notably an aging population that would limit labor supply and future growth.

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A still-thriving economy – even as the Fed has only just started cutting rates – has spurred markets to price out some cuts. Futures markets now show policy rates settling around 3.7% by the end of 2025, up from 2.8% in September, LSEG Datastream data shows. Yet markets are pricing in more Fed cuts than the central bank is likely to deliver, in our view.

Why? We see inflation staying higher than pre-pandemic levels. U.S. Q3 GDP data last week showed consumer spending is still driving overall economic growth. Average monthly job creation over the past three months now stands at 104,000 after last week's jobs report – still a healthy pace and one likely to pick up given hiring stalled due to hurricane-related disruptions. As the U.S. election occurs, neither presidential candidate is focused on budget deficits that are likely to stay large no matter who wins. The prospect of higher tariffs or reduced legal immigration would also have inflation implications. Population aging and other mega forces are inflationary, too. Massive capital spending and reallocation from the artificial intelligence buildout may spur inflation, as could increasingly complex global supply chains due to geopolitical fragmentation.

Market pricing of ECB rate cuts is more in line with our view than in the U.S. The ECB tightened by more than the Fed on the way up – 450 basis points from January 2020 to the peak versus 375 for the Fed. ECB policy looks even tighter given Europe's weaker consumer spending and limited fiscal support compared with the U.S. Tight policy gives the ECB more room than the Fed to cut rates to jump-start growth. That is why the ECB sped up the pace of easing in cutting rates a third time last month, making each policy meeting a live one. We see the ECB cutting to around 2%, consistent with market pricing. This drives our preference for European fixed income over the U.S., especially in credit. UK bond markets are eyeing the potential inflation impact of the tax and spending mix in the UK's new budget. We see a tepid UK growth outlook driving the Bank of England to cut more than markets have priced in. That is why we recently went overweight UK gilts.

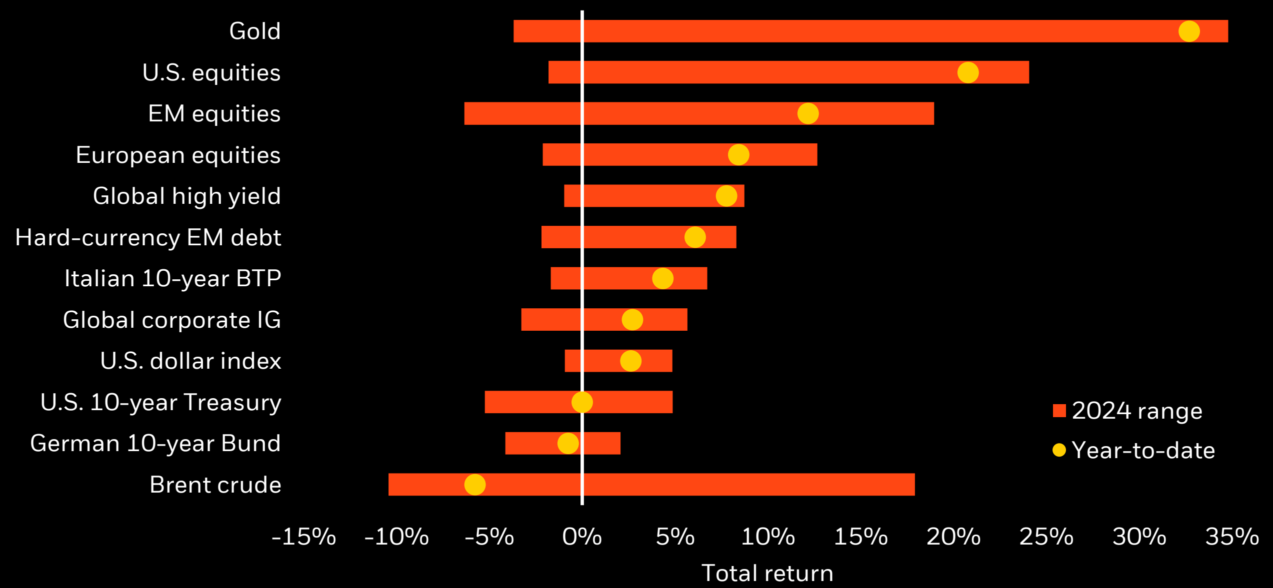
Bottom line: This is not a typical business cycle. We see structural forces holding inflation higher long term, keeping the Fed from cutting as much as markets expect. ECB rate cut pricing is closer to our view, one reason we prefer euro area bonds.

Market backdrop

U.S. stocks slipped last week, with tech leading the way down after some mega cap tech companies failed to deliver on high expectations for earnings guidance. Tech's troubles and weak U.S. payrolls for October overshadowed strong U.S. Q3 GDP growth fueled by resilient consumer spending. U.S. 10-year Treasury yields reached four-month highs near 4.40%. UK 10-year gilt yields hit 11-month highs after the new UK government budget boosted planned borrowing for investment.

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 Oct. 31, 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

Nov. 5	U.S. trade data	**Nov. 9**	China CPI and PPI
Nov. 7	Fed policy decision; Bank of England (BOE) policy decision; China trade data	**Nov. 8-15**	China total social financing

Central bank policy decisions are in focus this week. Markets widely expect both the Fed and BOE to cut rates another 25 basis points Thursday and will be watching for clues on the pace of future easing. The UK growth outlook is weaker than in other developed markets, meaning the BOE may cut further than the Fed in coming years, we think. Markets have come closer to our ultimate U.S. rate pricing, yet we still see rates settling higher than markets expect.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, November 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, November 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, November 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	+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.
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	+1	We are modestly overweight. Major fiscal stimulus may be coming and prompt investors to step in given Chinese stocks are at a deep discount to DM shares. Yet we stay ready to pivot. We are cautious long term given China's 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.
Fixed Income	Long U.S. Treasuries	Neutral	We are neutral. Markets are pricing in sharp Fed rate cuts and term premium is close to zero. We think yields will keep swinging in both directions on incoming data. We prefer intermediate maturities less vulnerable to investors demanding greater term premium.
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	+1	We are overweight. Gilt yields offer attractive income, and we think the Bank of England will cut rates more than the market is pricing given a soft economy.
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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