

Weekly commentary

December 16, 2024

BlackRock

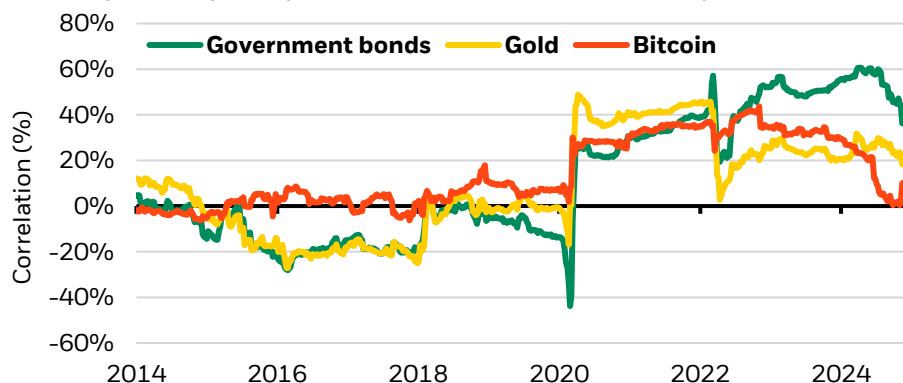
Diversifying our portfolio diversifiers

- We see a transformation underway making a wide range of outcomes possible. That alters how we assess portfolio diversification and drivers of risk and return.
- U.S. stocks hovered near all-time highs last week. U.S. 10-year yields jumped sharply to near 4.40% before the Federal Reserve's expected rate cut.
- Even if the Fed cuts further in 2025, markets have come around to our view that sticky inflation means policy rates will settle well above pre-pandemic levels.

We believe economies are undergoing a transformation that could keep shifting the long-term economic trend. That creates a wide range of potential outcomes and a need to use scenarios to guide portfolio construction, we think. Government bonds have become a less reliable cushion against risk asset selloffs in this new regime. So investors should consider new diversifiers like gold and bitcoin – not to replace bonds, but to get exposure to distinct drivers of risk and return.

Not so correlated

Bitcoin, gold and global government bond correlation to equity returns, 2014–2024



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Indexes are unmanaged and index performance does not account for fees. Source: BlackRock Investment Institute, with data from Bloomberg, December 2024. Notes: The chart shows the correlation of bitcoin, gold and global government bonds to developed market equity returns on a two-year historical window and calculated using weekly total returns. Indexes used: Bloomberg Global Agg Treasuries Total Return Index Value Unhedged USD for bonds and Bloomberg Developed Markets Large & Mid Cap Total Return Index for equities. Spot prices are used for gold and bitcoin.

To help track the wide range of possible outcomes, we and BlackRock portfolio managers created five scenarios to map different market and economic outlooks over the next six to 12 months. Of the two scenarios where stocks sell off, we expect government bonds to provide protection in only one. Why? The long-negative correlation between stock and bond returns varies with the macro backdrop. It has turned positive amid sticky inflation – see the chart – so bonds less reliably cushion portfolios against equity selloffs. We eye other diversifiers since historical options don't work as well. Take gold and bitcoin. Their correlation to global stocks remains limited, even with the occasional spike, making them better diversifiers than bonds in the last two years. This isn't about replacing bonds: Today, gold and bitcoin don't have the negative correlation bonds did but instead offer distinct sources of return.



Wei Li

Global Chief Investment Strategist – BlackRock Investment Institute



Samara Cohen

Chief Investment Officer of ETFs and Index Investments – BlackRock



Vivek Paul

Global Head of Portfolio Research – BlackRock Investment Institute



Paul Henderson

Senior Portfolio Strategist – BlackRock Investment Institute



Laszlo Tisler

Portfolio Strategist – BlackRock Investment Institute

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We think gold has diversification properties because its risk and return drivers are different than those for equity and bond returns. Investors have long turned to gold to protect their portfolios from inflation and geopolitical risks, and to act as a store of value because its limited supply preserves value over time. Gold prices have surged this year alongside the U.S. dollar – a break from their traditional inverse relationship. What’s behind that? Investors seeking to protect portfolios against higher inflation, and some central banks seeking alternatives to major reserve currencies against the backdrop of heightened geopolitical tensions. Such demand can drive returns for alternative diversifiers like gold, no matter past correlations.

Like gold, bitcoin could appreciate over time when its predetermined supply is met with growing demand. But demand for bitcoin is based on investor belief in its potential to be more widely adopted – and is thus central to its investment case. Some potential drivers of adoption: Bitcoin is decentralized, with no direct government ability to change supply. It’s also perceived to be immune from the effects of persistent government budget deficits, rising debt and higher inflation eroding the value of sovereign currencies. We see these factors making bitcoin more attractive in today’s world, and it could be a more diversified source of return because its value drivers are different than for traditional assets. Yet it remains highly volatile and vulnerable to sharp selloffs. And its value could tumble if it’s not widely adopted. Read more in our [new paper](#) (for professional investors).

We stay pro-risk headed into 2025 and think the most likely near-term scenario is one where U.S. growth moderates, but corporate profits remain strong. Risks to our view include surging long-term bond yields and greater trade protectionism. Our scenarios outline other risks, such as sticky inflation spurring central banks to stop cutting rates or slowing growth. If such an outlook spurs markets to flip-flop in their pricing of interest rates, bonds may not effectively hedge against any stock selloffs. We think investors should broaden their diversification toolkits, with gold and bitcoin potentially promising additions.

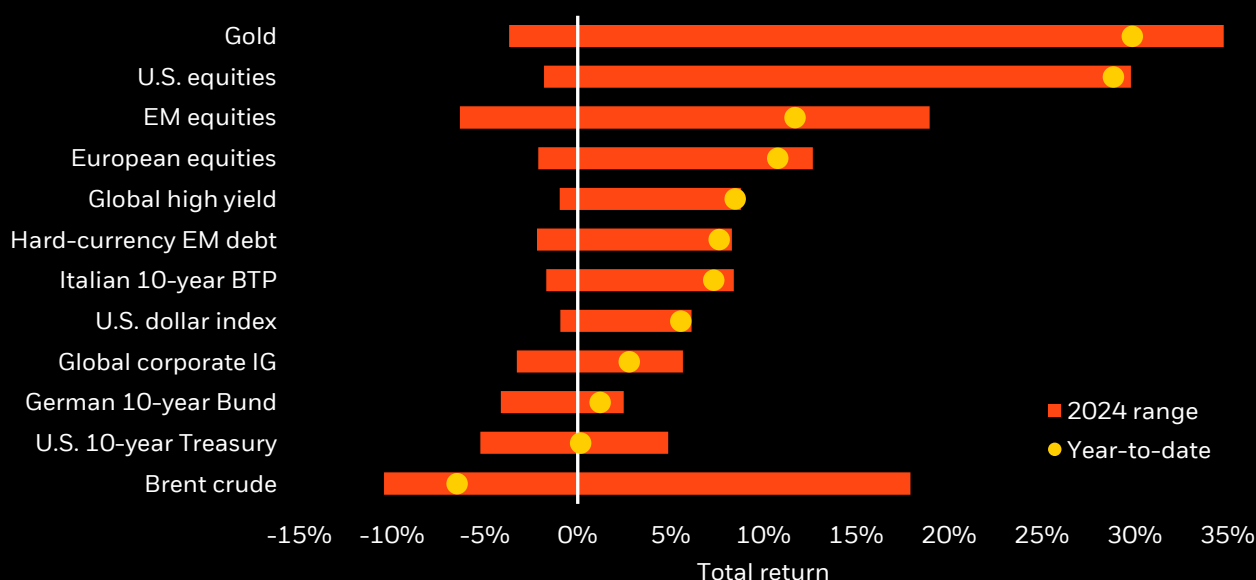
Bottom line: Bonds no longer reliably diversify portfolios across a wide range of possible outcomes and scenarios. That calls for a rethink of diversifiers. This is our last weekly commentary of 2024, and we will return on Monday, Jan. 6. Happy holidays.

Market backdrop

U.S. stocks paused near all-time highs last week, with the S&P 500 up nearly 30% this year. U.S. core CPI for November cleared the way for a Federal Reserve rate cut this week but showed sticky services inflation, we think. U.S. 10-year Treasury yields rose more than 20 basis points to near 4.40% as the Fed could signal a pause in its cuts. Chinese 10-year bond yields fell the most since the 2020 Covid-19 outbreak on concerns expected stimulus may not be enough to revive growth.

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 Dec. 12, 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

Dec. 16

Global flash PMIs

Dec. 19

Bank of England policy decision

Dec. 18

Federal Reserve policy decision; UK CPI

Dec. 20

U.S. PCE; Bank of Japan policy decision; Japan CPI

Several central banks meet this week, with an expected Fed policy rate cut looming largest. U.S. core PCE, the Fed's preferred inflation measure, out later in the week will show whether services inflation remains sticky. Wage growth is holding at levels that don't suggest inflation is set to cool back near the Fed's 2% target. These are key reasons why, even if the Fed is likely to cut rates further in 2025, we see rates ultimately settling higher than pre-pandemic levels.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, December 2024

Tactical	Reasons
U.S. equities	We see the AI buildout and adoption creating opportunities across sectors. We tap into beneficiaries outside the tech sector. Robust economic growth, broad earnings growth and a quality tilt underpin our conviction and overweight in U.S. stocks versus other regions. We see valuations for big tech backed by strong earnings, and less lofty valuations for other sectors.
Japanese equities	A brighter outlook for Japan's economy and corporate reforms are driving improved earnings and shareholder returns. Yet the potential drag on earnings from a stronger yen is a risk.
Selective in fixed income	Persistent deficits and sticky inflation in the U.S. make us more positive on fixed income elsewhere, notably Europe. We are underweight long-term U.S. Treasuries and like UK gilts instead. We also prefer European credit – both investment grade and high yield – over the U.S. on cheaper valuations.
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 short- and medium-term investment grade credit, which offers similar yields with less interest rate risk than long-dated credit. We also like short-term government bonds in the U.S. and euro area and UK gilts overall.
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, December 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, December 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		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+2</div>		We are overweight as the AI theme and earnings growth broaden. Valuations for AI beneficiaries are supported by tech companies delivering on earnings. Resilient growth and Fed rate cuts support sentiment. Risks include any long-term yield surges or escalating trade protectionism.			
	Europe		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>-1</div>		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		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		We are neutral. Political stability could improve investor sentiment. Yet an increase in the corporate tax burden could hurt profit margins near term			
	Japan		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+1</div>		We are overweight. A brighter outlook for Japan’s economy and corporate reforms are driving improved earnings and shareholder returns. Yet a stronger yen dragging on earnings is a risk.			
Fixed Income	Emerging markets		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		We are neutral. The growth and earnings outlook is mixed. We see valuations for India and Taiwan looking high.			
	China		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+1</div>		We are modestly overweight. China’s fiscal stimulus is not yet enough to address the drags on economic growth, but we think stocks are at attractive valuations to DM shares. We stand ready to pivot. We are cautious long term given China’s structural challenges.			
	Short U.S. Treasuries		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		We are neutral. Markets are pricing in fewer Federal Reserve rate cuts and their policy rate expectations are now roughly in line with our views.			
	Long U.S. Treasuries		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>-1</div>		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		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.			
	Euro area govt bonds		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		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		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+1</div>		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.			
	Japanese govt bonds		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>-2</div>		We are underweight. Stock returns look more attractive to us. We see some of the least attractive returns in JGBs.			
	China govt bonds		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.			
	U.S. agency MBS		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		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		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+1</div>		We are overweight. Short-term bonds better compensate for interest rate risk.			
	Long-term IG credit		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>-1</div>		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		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		We are neutral. Spreads are tight, but the total income makes it more attractive than IG. We prefer Europe.			
	Asia credit		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		We are neutral. We don’t find valuations compelling enough to turn more positive.			
	Emerging hard currency		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		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		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>		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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