

# Weekly commentary

September 16, 2024

BlackRock

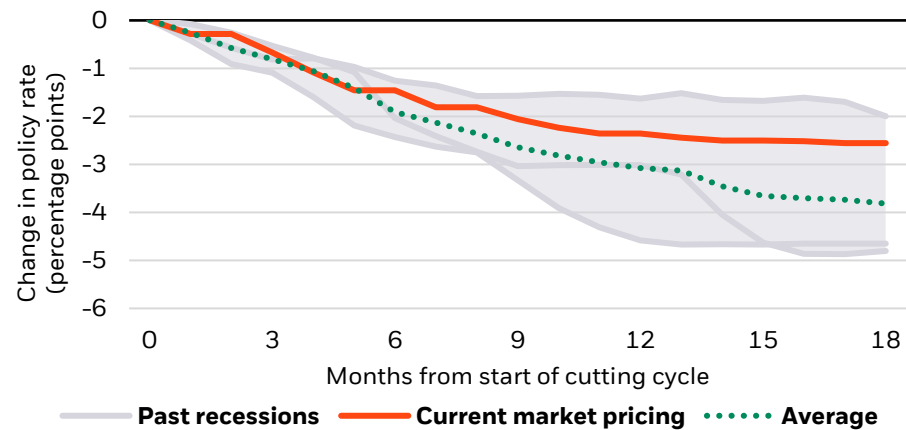
## Starting the tight policy unwind

- The Fed is set to cut interest rates for the first time since the pandemic. Yet central banks are not heading for an easy policy stance given sticky inflation.
- U.S. stocks rose about 4% last week, led by tech. U.S. 10-year Treasury yields touched 15-month lows, with markets pricing steep Fed cuts that look overdone.
- The Fed policy meeting takes center stage this week. The recent drop in U.S. core CPI stalled in August, likely taking a 50-basis-point cut off the table, in our view.

The Federal Reserve is set to start rate cuts this week after its rapid hikes to rein in inflation. Markets expect the Fed to cut rates sharply – and we think this pricing is overdone. U.S. inflation has slowed as pandemic disruptions have faded and due to a temporary immigration boost to the workforce. We see inflation staying sticky due to loose fiscal policy and the impact of mega forces, limiting how far the Fed can cut. Yet we think recession fears are overdone and stay overweight U.S. stocks.

## No recession response required

Fed rate cuts in response to previous recessions and current pricing



Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, U.S. Federal Reserve Board with data from Bloomberg and Haver Analytics, September 2024. Notes: The chart shows how much the Federal Reserve cut rates in response to recessions in 1989, 2000 and 2007 compared with current market pricing of Fed rate cuts using SOFR futures.

Markets have been quick to price in rate cuts after the Fed finished its fastest hikes since the 1980s – and price them out when inflation spooked to the upside. As the Fed readies to start cutting, markets are pricing in cuts as deep as those in past recessions. See the chart. We think such expectations are overdone. An uptick in the unemployment rate has stoked recession fears, yet employment is still growing. The unemployment rate is not rising due to layoffs, but because elevated immigration has expanded the workforce. Consumer spending shifting back to services from goods after the pandemic has helped inflation fall from its recent highs, allowing the Fed to cut rates. A larger workforce is helping cool services inflation. Yet in this new regime, central banks face a sharper trade-off between curbing inflation and protecting growth than in the decades-long period of steady growth and inflation.



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Cooling inflation is likely temporary. The post-pandemic normalization of spending and supply mismatches is largely over, while immigration is likely to fall back to historic trends. Once it does, the economy won't be able to add jobs as fast as it has been without stoking inflation. Wage growth has slowed but not enough to suggest that core inflation could fall to the 2% target. Supply constraints from mega forces, or structural shifts, are set to add to global inflation pressures. That's why the Fed and other central banks will keep rates higher for longer. Yet short-term U.S. Treasury yields have slid on expectations for deep rate cuts, so we went underweight. We stay overweight U.S. stocks but broaden our artificial intelligence view beyond tech. Our Midyear Outlook scenarios acknowledge the low odds of the Fed cutting rates as much as markets expect. That could occur if the Fed sees cooling job growth as a sign it's been too slow to react to worsening growth, echoing its rapid rate hikes. Risk sentiment may sour once it's clear the Fed won't cut rates as low as markets expect.

The European Central Bank (ECB) cut rates again last week even as inflation is above its target for now. We see euro area inflation falling to 2% and staying near there, unlike in the U.S. That's still far from the low inflation of the past decade. But the ECB tightened policy more than the Fed – even as it faced weaker economic activity – so it has more room to cut rates, in our view. We're neutral euro area government bonds and UK gilts as market pricing of rate cuts could go further, in our view.

The People's Bank of China has been cutting rates but it's not in the same boat as the Fed. It's facing weak consumer demand, excess production capacity and deflation – based on broad measures of inflation – that could become entrenched. The lack of fiscal and other policy support casts doubt on if the economy will hit this year's growth target. Export activity has been supporting growth, so it will be key to watch for any signs of weakness. Chinese equity valuations are low relative to other regions but given the tough macro outlook, we prefer developed market equities over emerging markets and China.

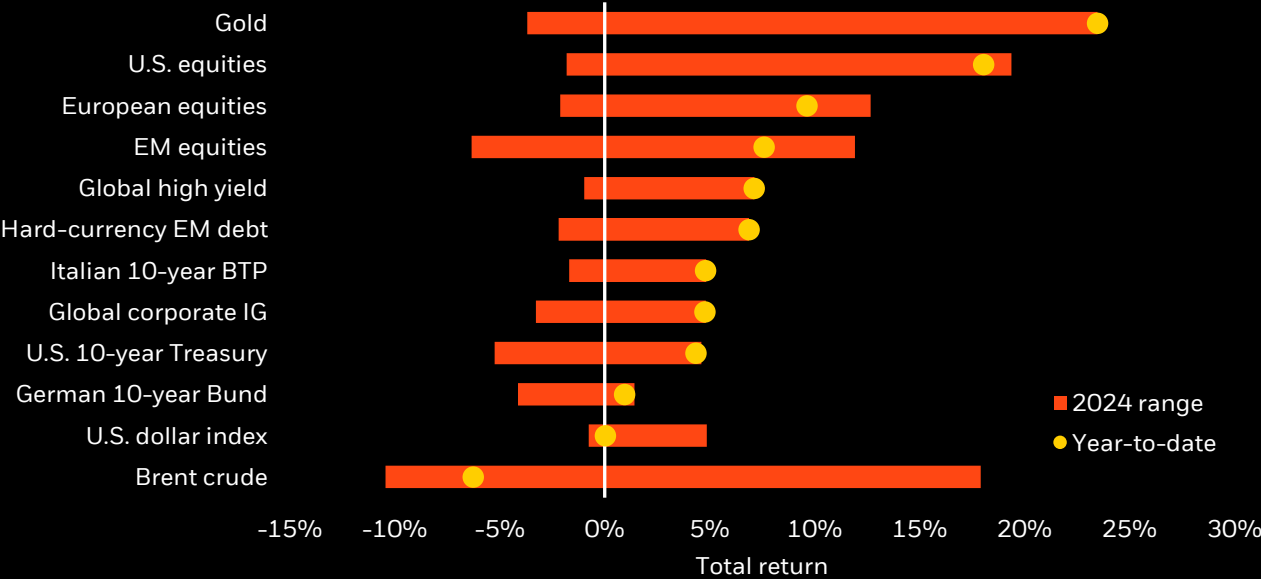
Bottom line: The Fed is following in the footsteps of other central banks to cut rates this week. We see sticky inflation limiting how far central banks can cut. We stay overweight U.S. equities and prefer European over U.S. bonds.

## Market backdrop

U.S. stocks rose about 4% last week, rebounding from their largest weekly drop in 18 months, with tech helping lead the way as recession fears faded and on coming Fed rate cuts. U.S. 10-year Treasury yields touched 15-month lows, settling near 3.66% with markets pricing in 200 basis points of Fed cuts by next June. We think this is overdone and could set up more sharp pricing shifts as markets see-saw between starkly different potential outcomes.

## 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. 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

Sept. 18	Fed policy decision; UK CPI; Japan trade data	Sept. 20	Bank of Japan policy decision; Japan CPI; euro area consumer confidence
Sept. 19	Bank of England policy decision; Philly Fed business index		

Central bank policy meetings take center stage this week, headlined by the Fed. We expect the Fed to cut rates for the first time since its rapid hikes launched in 2022. Yet the recent drop in U.S. core CPI stalled in August, likely taking a 50-basis-point cut off the table, in our view. The BOJ will also be in focus after being a source of market volatility after its last meeting in late July.

# 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	<ul style="list-style-type: none"><li>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.</li></ul>
Japanese equities	<ul style="list-style-type: none"><li>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.</li></ul>
Income in fixed income	<ul style="list-style-type: none"><li>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.</li></ul>
Strategic	Reasons
Private credit	<ul style="list-style-type: none"><li>We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to public credit risk.</li></ul>
Fixed income granularity	<ul style="list-style-type: none"><li>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.</li></ul>
Equity granularity	<ul style="list-style-type: none"><li>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.</li></ul>

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.





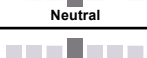










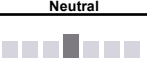
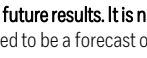

- 1. Demographic divergence:** The world is split between aging advanced economies and younger emerging markets – with different implications.
- 2. Digital disruption and artificial intelligence (AI):** Technologies are transforming how we live and work.
- 3. Geopolitical fragmentation and economic competition:** 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
<b>Developed markets</b>		
United States		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		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		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		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.
<b>Emerging markets</b>		
China		We are neutral. The growth and earnings outlook is mixed. We see valuations for India and Taiwan looking high.
Short U.S. Treasuries		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		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		We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
Euro area govt bonds		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		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		We are underweight. Stock returns look more attractive to us. We see some of the least attractive returns in JGBs.
China govt bonds		We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
U.S. agency MBS		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		We are overweight. Short-term bonds better compensate for interest rate risk. We prefer Europe over the U.S.
Long-term IG credit		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		We are neutral. Spreads are tight, but the total income makes it more attractive than IG. We prefer Europe.
Asia credit		We are neutral. We don't find valuations compelling enough to turn more positive.
Emerging hard currency		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		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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