Weekly commentary

January 16, 2024

BlackRock

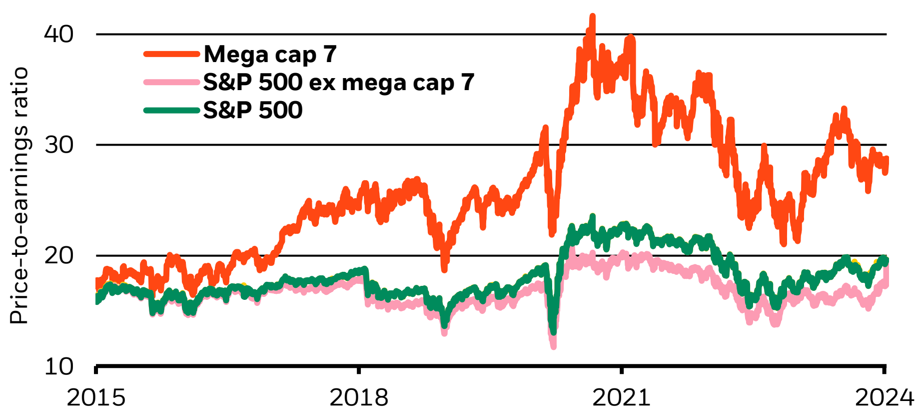
Why stocks can stay upbeat, for now

- U.S. stocks could run with hopes for inflation to fall to target and sharp rate cuts into 2024. We stay selective as we expect resurgent inflation to come into view.
- U.S. stocks climbed and the 10-year U.S. Treasury yield fell last week. The December U.S. CPI confirmed inflation is falling but set to rollercoaster back up.
- We look to U.S. data this week for more signs policy rates are cooling business activity and consumer spending. We expect growth to slow further this year.

Equity markets – and even the Federal Reserve – have largely embraced the soft landing narrative that inflation will fall to the Fed's 2% target without a recession. We agree that inflation will near 2% this year, likely supporting that narrative for now. The problem: Inflation won't remain at that target, in our view, and this risk becoming clearer could challenge upbeat sentiment. So we monitor earnings season for any signs of cracks given pricey valuations.

The best and the rest

U.S. equity 12-month forward valuations, 2015-2024



Source: BlackRock Investment Institute, with data from LSEG Datastream, January 2024. Notes: The chart shows the 12-month forward price-to-earning ratios for the top seven largest companies by market capitalization (or the mega cap seven, the S&P 500 and the S&P 500 excluding the mega cap seven.

Even after the market-wide rally in December, market concentration in a handful of mega caps – firms with ultra-large market capitalizations – remains high. Favored by markets for their ability to leverage artificial intelligence (AI), these technology companies drove U.S. stock market gains last year. Price-to-earnings ratios divide a company's share price by its earnings per share. Their expected price-to-earning valuations for the next 12 months (orange line in the chart) are about a third higher than for the S&P 500 and when excluding them (green and pink lines). Stronger earnings expectations have supported the mega cap rally, with valuations falling in the second half of 2023. Will pricey valuations halt the rally? We find valuations tend to matter more for long-term rather than near-term stock returns, and that's why they usually aren't enough to spoil market sentiment without a catalyst.

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Earnings could be a catalyst. We expect greater focus on earnings this year after consensus expectations rose through last year, with up to 11% growth now expected in the next 12 months, LSEG data show. The 2023 Q4 earnings season should shed more light on how such expectations will evolve. Profit margins in the U.S. and euro area have held up as companies have passed on higher costs to consumers and cut costs. We think they will normalize over time due to pressure from higher interest rates, ongoing wage gains and lower if still above-target inflation.

Inflation is another catalyst that could challenge the positive market sentiment, in our view. Stocks are currently priced for a near-perfect outcome: a soft economic landing, where inflation falls, central banks sharply cut rates and more cuts come if growth risks emerge. Appetite for investing in risk assets seems much stronger now as markets have confidence inflation is normalizing back to 2% and that rates cuts are on the way. Inflation falling closer to target will likely dominate market news in the near term and buoy stocks for some time. Yet market jitters in early January suggest there is some anxiety about macro risks further out. Our portfolio managers generally see 2024 as another year of flip-flopping market narratives – and volatility.

The December CPI confirmed our view that U.S. inflation is on track to fall back near 2% this year due to falling goods prices. Yet data also reinforced that inflation will likely jump back near 3% in 2025 due to structural forces such as ongoing wage pressures in a tight labor market and geopolitical fragmentation. The risk of resurgent inflation coming into view – which we think will happen later this year – is one development that could spoil upbeat market sentiment. In Europe, banks have driven fatter profit margins for the broader market. But the European Central Bank cutting rates this year could dent their income.

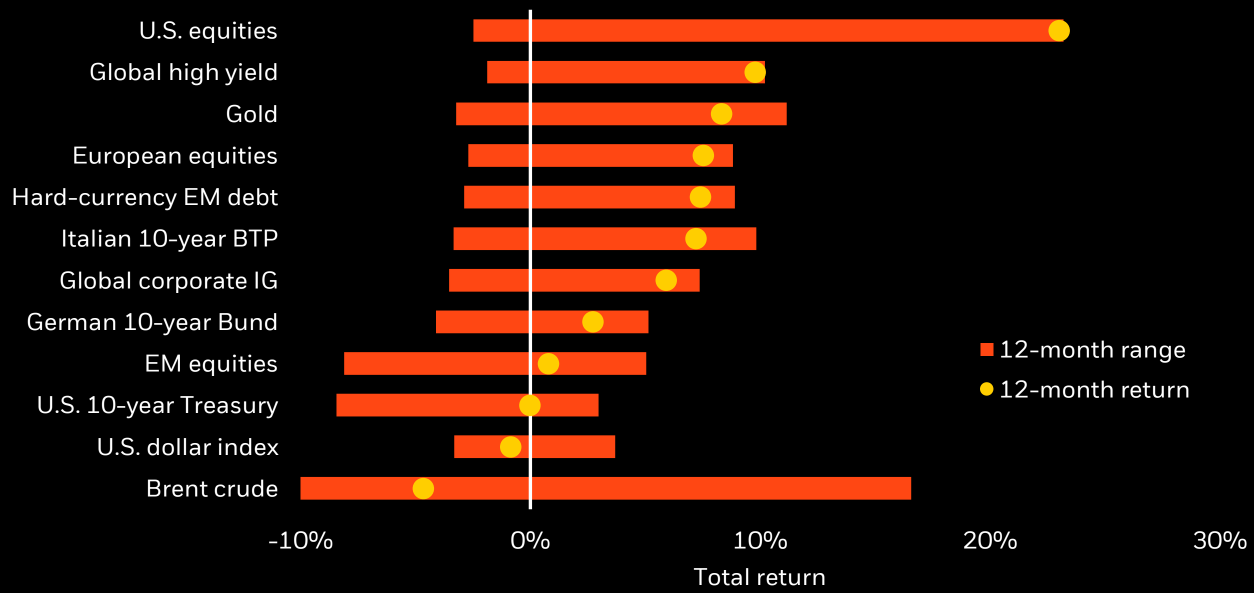
Bottom line: We think stocks can run with the soft-landing narrative into 2024, until other possible outcomes – like an inflation rollercoaster – come into view. We stay selective in developed market stocks. We still favor Japan, tech, AI and quality overall as they have outperformed – and will likely be more resilient to any shift in market narrative. Bond yields have fallen on market pricing of sharp rate cuts. We expect ongoing yield volatility as we don't see central banks delivering such cuts.

Market backdrop

U.S. stocks rose nearly 2% last week, now flat for the year, while the 10-year Treasury yield ticked down to 3.95%. We think long-term yields are likely to drift higher. That's because the Fed will not be able cut rates as deep or as quickly as markets are pricing due to the resurgent inflation we expect – a risk the December CPI confirmed. We also see investors demanding more compensation for the risk of holding long-term bonds given interest rate volatility and massive Treasury bond issuance.

Assets in review

Selected asset performance, 12-month 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 Jan. 11, 2024. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12 months, and the dots represent current 12-month 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

Jan. 17	U.S. retail sales; UK CPI; China Q4 GDP	**Jan. 19**	University of Michigan consumer sentiment survey
Jan. 18	U.S. Philly Fed business index		

We look to U.S. data out this week for more signs that higher policy rates are cooling business activity and consumer spending. CPI data in the UK will likely follow other developed markets and show inflation falling as the mismatch between goods and services unwinds. Yet we see inflation rising again in early 2025 as an aging population keeps the labor market tight, driving wage pressures. That means central banks will likely keep interest rates high for longer.

Big calls

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

Tactical	**Reasons**
DM equities	• Our macro view keeps us underweight, but we think the AI theme and alpha potential has taken us closer to a neutral view. See below.
Income in fixed income	• The income cushion bonds provide has increased across the board in a higher rate environment. We like short-term bonds and are now neutral long-term U.S. Treasuries as we see two-way risks ahead.
Geographic granularity	• We favor getting granular by geography and like Japan equities in DM. Within EM, we like India and Mexico as beneficiaries of mega forces even as relative valuations appear rich.
Strategic	**Reasons**
Private credit	• We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to credit risk.
Inflation-linked bonds	• We see inflation staying closer to 3% in the new regime than policy targets, making this one of our strongest views on a strategic horizon.
Short- and medium-term bonds	• We overall prefer short-term bonds over long term. That's due to more uncertain and volatile inflation, heightened bond market volatility and weaker investor demand.

Note: Views are from a U.S. dollar perspective, January 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 that 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, January 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 underweight the broad market – still our largest portfolio allocation. Hopes for rate cuts and a soft landing have driven a rally. We see the risk of these hopes being disappointed.
	Europe	-1	We are underweight. The ECB is holding policy tight in a slowdown. Valuations are attractive, but we don't see a catalyst for improving sentiment.
	UK	Neutral	We are neutral. We find attractive valuations better reflect the weak growth outlook and the Bank of England's sharp rate hikes to fight sticky inflation.
	Japan	+1	We are overweight. We see stronger growth helping earnings top expectations. Stock buybacks and other shareholder-friendly actions are positives. Potential policy tightening is a near-term risk.
	DM AI mega force	+1	We are overweight. We see a multi-country and multi-sector AI-centered investment cycle unfolding set to support revenues and margins.
	Emerging markets	Neutral	We are neutral. We see growth on a weaker trajectory and see only limited policy stimulus from China. We prefer EM debt over equity.
	China	Neutral	We are neutral. Modest policy stimulus may help stabilize activity, and valuations have come down. Structural challenges such as an aging population and geopolitical risks persist.
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. The yield surge driven by expected policy rates has likely peaked. We now see about equal odds that long-term yields swing in either direction.
	U.S. 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 inflation-linked bonds	-1	We are underweight. We prefer the U.S. over the euro area. We see markets overestimating how persistent inflation in the euro area will be relative to the U.S.
	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. Widening peripheral bond spreads remain a risk.
	UK gilts	Neutral	We are neutral. Gilt yields have compressed relative to U.S. Treasuries. Markets are pricing in Bank of England policy rates closer to our expectations.
	Japanese govt bonds	-1	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	Global IG credit	-1	We are underweight. Tight spreads don't compensate for the expected hit to corporate balance sheets from rate hikes, in our view. We prefer Europe over the U.S.
	U.S. agency MBS	+1	We are overweight. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG
	Global high yield	Neutral	We are neutral. Spreads are tight, but we like its high total yield and potential near-term rallies. We prefer Europe.
	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
	Emerging hard currency	+1	We are overweight. We prefer EM hard currency debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
	Emerging local currency	Neutral	We are neutral. Yields have fallen closer to U.S. Treasury yields. Central bank rate cuts could hurt EM currencies, dragging on potential returns.

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