

Weekly commentary

March 18, 2024

BlackRock

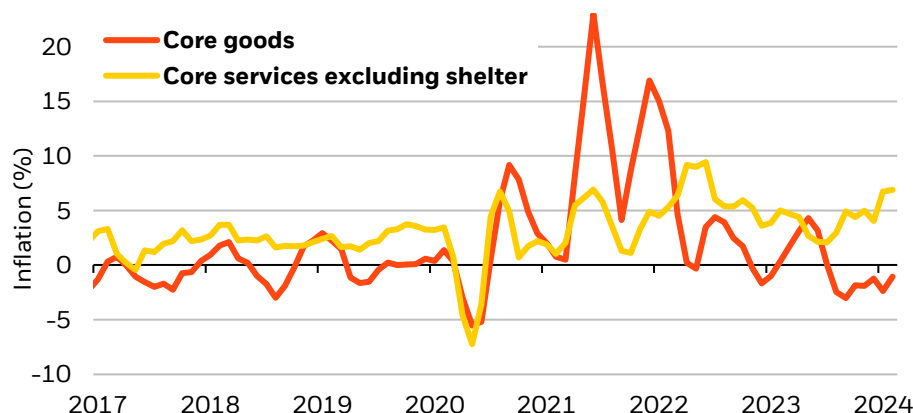
U.S. & Japan: a tale of two overweights

- Markets see a positive near-term macro and corporate backdrop for the U.S. and Japan. We eye risks ahead but remain overweight stocks in both countries.
- U.S. stocks were largely flat last week after hotter-than-expected inflation data. Both 10-year U.S. Treasury and Japanese government bond yields rose.
- The Fed policy decision is in focus this week. We see Fed rates staying higher for longer than pre-pandemic. We watch how the Bank of Japan interprets inflation.

Federal Reserve and Bank of Japan (BOJ) meetings this week and recent data put a spotlight on the U.S. and Japanese macro environments. U.S. markets are pricing in a positive macro backdrop as inflation cools. We don't see upbeat risk appetite being seriously challenged in coming months. By contrast, Japan's macro and corporate outlook is positive longer term. We see the BOJ simply ending negative interest rates, not starting to tighten. We stay overweight U.S. and Japan stocks.

An inflation rollercoaster

U.S. core CPI inflation breakdown three-month annualized, 2017-2024



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, March 2024. Notes: The chart shows core U.S. CPI goods and services inflation measured by the change in the most recent three-month average, at an annualized rate. Core goods inflation covers all goods, excluding energy and food costs. Core services inflation covers all services, excluding energy and shelter costs.

We've said before that this new macro and market regime is marked by persistent, structural inflation pressures. We think U.S. inflation can fall further toward 2% this year due to falling goods prices. See the orange line in the chart. Yet we see it on a rollercoaster back up in 2025 as the drag from goods deflation fades and elevated wage growth in a tight labor market keeps services inflation higher than pre-pandemic. Inflation is likely to settle above the Fed's 2% target in 2025. The spike in services inflation for January (yellow line) now looks like a one-off, but we think it keeps inflation on an elevated track that is inconsistent with overall inflation at 2%. And after months of falling good prices driving inflation lower, they suddenly rose in February. We see more goods deflation to come in the near term. Yet these one-offs may be offering a glimpse of the trickier inflation environment ahead later this year.



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Markets are, for now, comfortable that inflation will cool enough to allow the Fed to make three quarter-point rate cuts this year and keep cutting. We think upbeat sentiment can persist as inflation keeps falling. That’s why we stay overweight U.S. stocks and lean into the artificial intelligence theme as tech drives corporate earnings growth. The earnings recovery in other sectors is supporting risk appetite. Yet inflation could come in stronger than markets expect again and challenge risk-taking. That outcome would limit how far and how fast the Fed can cut rates from restrictive levels. We see Fed policy rates staying higher than before the pandemic as inflation likely settles closer to 3%. We believe that calls for staying nimble in portfolios.

Meanwhile, the BOJ is focused on keeping inflation sustainably at 2% after decades of ultra-low inflation. Its challenge: gauging how to normalize monetary policy without undermining its hard-won revival of expectations for sustained inflation, in our view. Rising import prices have helped Japan’s inflation rise above 2%. Yet keeping inflation there will require such expectations to feed through domestic prices and wages. The good news: Annual union wage negotiations resulted in pay gains topping 5%, the largest since the early 1990s. That should boost the BOJ’s conviction of overcoming a decades-long undershoot of its inflation target. Markets are pricing that the BOJ could end negative interest rates as soon as this week. If markets see the policy shift as normalizing policy, we think that would support risk appetite. Yet if this policy change is viewed as the BOJ getting nervous about inflation, that could spell bad news for sentiment.

Without buffering for swings in the yen, we’re overweight Japanese stocks. Their outlook seems positive given mild inflation, strong earnings growth and ongoing corporate reforms. Our overweight there will likely remain for longer than our U.S. stock overweight over a six- to 12-month tactical horizon. We’ve been underweight Japanese government bonds since July 2022. We expect yields to rise as the BOJ winds down loose policy, including yield curve control, even if likely in a measured manner.

Bottom line: U.S. inflation has been volatile recently, but we expect it to fall further this year before resurging in 2025. We see the BOJ ending negative interest rates – but eye risks to market sentiment. We’re overweight U.S. and Japan stocks.

Market backdrop

U.S. stocks retreated from near all-time highs to end the week largely unchanged, surrendering gains after the U.S. CPI and other inflation gauges surprised to the upside. U.S. 10-year yields jumped more than 20 basis points to near 4.30% after February CPI was hotter than expected, prompting markets to price out Fed rate cuts. Japanese 10-year yields reached this year’s high near 0.8% as markets eye an end to negative rates this week. U.S. crude oil prices gained 4% on supply concerns.

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 March 14, 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

March 19	BOJ policy decision	March 21	BOE policy decision; global flash PMIs; Japan trade data
March 20	Fed policy decision; UK CPI; euro area consumer confidence	March 22	Japan CPI

The Fed policy decision is the main event this week. Although markets don't expect the first rate cut until midyear, we think they'll focus on how the Fed is responding to recent higher-than-expected inflation data. Markets may also assess whether Fed projections indicate a more persistent inflation outlook. Meanwhile, the BOJ could end its negative interest rate policy as soon as this week, with markets pricing a small hike. We also await the Bank of England policy decision.

Big calls

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

Tactical	Reasons
U.S. equities	Our macro view has us neutral at the benchmark level. But the AI theme and its potential to generate alpha – or above-benchmark returns – push us to be overweight overall.
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 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, March 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.

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	Benchmark	

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