

Weekly commentary

May 6, 2024

BlackRock

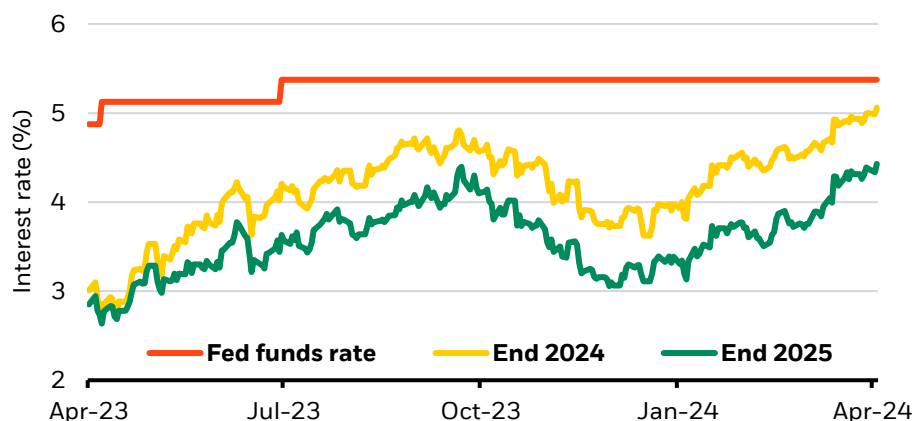
Looking through the Fed's signals

- We look to incoming data to determine where the Federal Reserve will go, rather than its policy signals. Solid corporate earnings keep us overweight U.S. stocks.
- U.S. stocks clawed higher thanks to earnings beating expectations, even as the Fed meeting confirmed we're in a structurally higher interest rate environment.
- We expect the Bank of England to hold rates steady this week. Markets have pared back their expectations of rate cuts this year due to slowly falling inflation.

Q1 inflation surprises have pushed the Fed to flip on its December view and accept that interest rates will have to stay high for longer at last week's meeting. We're in a world shaped by structural forces and supply – creating greater uncertainty for the Fed and markets. That's why we eye new data, not Fed signals, to gauge the policy path. We see high-for-longer rates, a view markets now reflect. We stay overweight U.S. stocks as solid corporate earnings help offset pressure from high rates.

Moving on up

Market pricing of the fed funds rate, 2023-2024



Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, with data from LSEG Datastream, May 2024. Notes: The chart shows the current fed funds policy rate and market expectations of the fed funds rate via SOFR futures pricing. The fed funds rate shown is the midpoint of the Federal Reserve's target range.

At its December meeting, the Fed's communications and its economic forecasts all signaled that inflation would fall toward 2% by the end of this year, meaning the central bank would be able to cut rates in 2024. Markets took that as a blessing to price in roughly seven quarter-point rate cuts, predicting the fed funds rate would fall as low as roughly 3.6% by the end of this year and 3% by 2025. See the yellow and green lines in the chart. Any forecast for inflation falling steadily toward 2% assumes that goods prices will keep sliding and that services inflation will ease materially from elevated levels. Those outcomes are highly uncertain, we believe. Instead, both goods and services inflation have been hotter than expected – a reality check for the Fed and markets alike. Market pricing of where rates will be by the end of this year and next has jumped in response to such sticky inflation.



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On our part, we had expected goods deflation to pull inflation briefly toward 2%, before stubborn services inflation moved it back further above target in 2025. Our view on inflation’s destination likely holds. But the ramp-up in goods prices suggests it will be difficult to achieve even a near-term dip. The Fed is now accepting rates need to stay high for longer given sticky inflation. It also pushed back against hikes. Yet greater macro volatility makes it harder for both markets and policymakers to predict what’s ahead. That’s why we rely on new data, instead of Fed policy signals, to shape our view of the likely policy path.

Higher interest rates usually hurt U.S. stock valuations. Instead, strong Q1 earnings have supported stocks even as high rates and lofty expectations raise the bar for what can keep markets sanguine. Some 77% of S&P 500 firms reporting have beat the consensus, LSEG data show. Tech stocks and artificial intelligence beneficiaries have kept up their robust growth, while other sectors also see recoveries. Given volatile data and policy uncertainty, we think long-term U.S. Treasury yields can swing in either direction for now and stay neutral on a six- to 12-month tactical horizon. In the longer run, we think long-term yields will climb as investors demand more term premium, or compensation for the risk of holding bonds. With the U.S. Treasury boosting borrowing, we see rising debt leading to term premium’s return.

High-for-longer U.S. interest rates have implications globally, like in Japan, where the yen has slid to 34-year lows against the dollar. Suspected efforts by Japanese authorities to buy dollars may slow the slide, but the divergence between Bank of Japan and Fed policy is the source of yen weakness. Yet the European Central Bank may be able to cut rates even if the Fed keeps policy tight for longer. Europe’s inflation is cooling further toward 2% and economic activity has been weak since 2022, even with a surprise bump in Q1 GDP. The muted growth and weak earnings backdrop keeps us underweight European stocks.

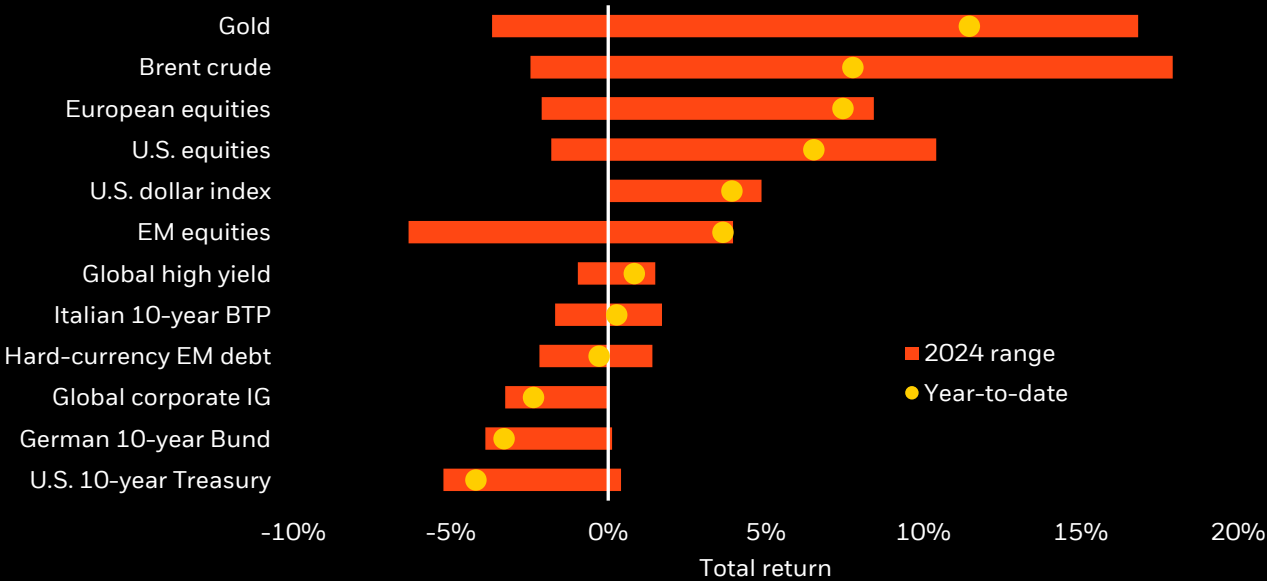
Bottom line: We see interest rates staying high for longer and keep eyeing incoming data. We remain tactically overweight U.S. stocks due to support from earnings and neutral long-term bonds given ongoing yield volatility. Professional investors can visit our Capital market assumptions [page](#) to learn more about our long-run view on developed market long-term bonds.

Market backdrop

The S&P 500 rose slightly last week and is up about 8% this year thanks to corporate earnings topping high expectations. U.S. 10-year Treasury yields dropped to around 4.50%, about 25 basis points below their 2024 high hit in late April, after U.S. payrolls undershot expectations and the Fed said its next move was unlikely to be a hike. Yet last week’s Fed meeting also confirmed we’re in a structurally higher interest rate environment.

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 May 2, 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

May 6	China Caixin services PMI	May 10	University of Michigan consumer sentiment survey; UK GDP data
May 9	Bank of England (BOE) policy decision; China trade data	May 10-17	China total social financing

We expect the BOE to hold rates steady this week. Markets have pared back their expectations of rate cuts this year due to slowly falling inflation. We watch UK GDP data out this week for signs growth momentum is starting to pick up from a period of stagnation. U.S. consumer sentiment data and data on China’s services sector, trade activity and domestic credit lending are also due for release.

Big calls

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

Tactical	Reasons
U.S. equities	<ul style="list-style-type: none">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	<ul style="list-style-type: none">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	<ul style="list-style-type: none">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	<ul style="list-style-type: none">We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to public credit risk.
Inflation-linked bonds	<ul style="list-style-type: none">We see inflation staying closer to 3% in the new regime on a strategic horizon.
Short- and medium-term bonds	<ul style="list-style-type: none">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, May 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, May 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	Benchmark	<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 in our largest portfolio allocation. Falling inflation and coming Fed rate cuts can underpin the rally’s momentum. We are ready to pivot once the market narrative shifts.
		Overall	<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 overall when incorporating our U.S.-centric positive view on artificial intelligence (AI). We think AI beneficiaries can still gain while earnings growth looks robust.
	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. While valuations look fair to us, we think the near-term growth and earnings outlook remain less attractive than in the U.S. and Japan – our preferred markets.	
	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. We find attractive valuations better reflect the weak growth outlook and the Bank of England’s sharp rate hikes to fight sticky inflation.	
	Japan	<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. Mild inflation, strong earnings growth and shareholder-friendly reforms are all positives. We see the BOJ policy shift as a normalization, not a shift to tightening.	
	Emerging markets			
	China	<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 growth on a weaker trajectory and see only limited policy stimulus from China. We prefer EM debt over equity.	
	Fixed Income	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>+1</div>	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer
		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>Neutral</div>	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		<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 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. Market expectations for persistent inflation in the euro area have come down.	
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. Widening peripheral bond spreads remain a risk.	
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>Neutral</div>	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		<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. We find more attractive returns in equities. We see some of the least attractive returns in Japanese government bonds, so we use them as a funding source.	
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.	
Global 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. 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.	
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 we like its high total yield and potential near-term rallies. 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>+1</div>	We are overweight. We prefer EM hard currency debt due to its relative value and quality. It is also cushioned from weakening local currencies as EM central banks cut policy rates.	
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. Central bank rate cuts could hurt EM currencies, dragging on potential returns.	

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