

Weekly commentary

June 3, 2024

BlackRock

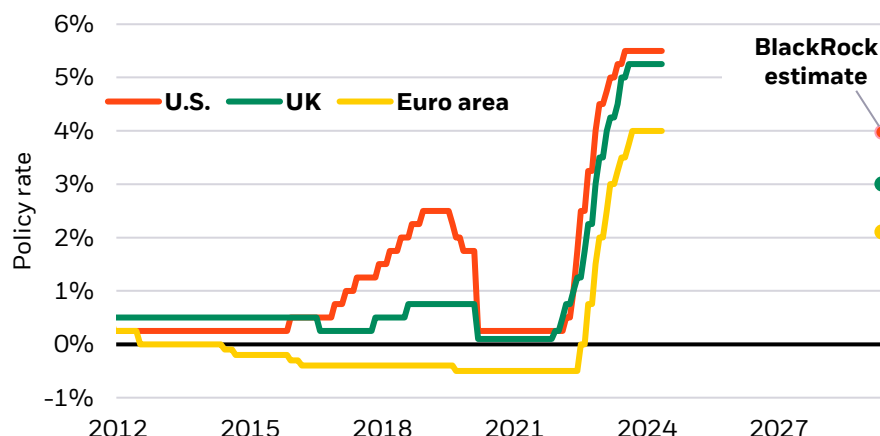
Not your typical rate cutting cycle

- We see inflation limiting how much central banks can cut interest rates. We like U.S. stocks over Europe's as they benefit from the artificial intelligence theme.
- Markets remain sensitive to Federal Reserve policy signals and its rate path, helping lift the VIX index of implied S&P volatility from four-year lows last week.
- Markets will be parsing signals for future rate cuts by the European Central Bank (ECB) and updated macro forecasts at the policy meeting this week.

Major central banks are gearing up to cut interest rates. But like their hiking cycles, this cutting cycle will be far from typical, we think. Why? The ECB is set to start easing before the Fed, but a wider policy gap between them will be temporary, in our view, even if a Fed hike is not impossible. Central banks are eyeing rate cuts with inflation still above 2% and growth strong or improving. We see them keeping rates high for longer. We prefer U.S. stocks over Europe because of the AI theme.

Coming down, slowly

Central bank policy rates, historic and our estimates, 2012-2029



Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, with data from LSEG Datastream, May 2024. Notes: The chart shows the central bank policy rates until 2024 and our estimate of policy rates in five years. The dots shown reflect our view of the neutral policy rate – that neither stokes nor dampens growth – and our assessment of the factors that will influence it. These estimates are subject to uncertainty and based on assumptions that may not come to pass.

European government bond yields have swung as markets question how far the ECB will ease policy beyond a first cut expected this week. Falling inflation and 18 months of weak economic activity make the case for the ECB to start cutting rates. But we don't think it will cut far and fast. Likewise in the U.S., we see just one or two Fed cuts this year. This is not your typical rate cutting cycle. Central banks are set to keep rates above pre-pandemic levels (see the dots in the chart) due to persistent inflationary pressures – and last week's euro area inflation data again showed stalling inflation progress. Unusually, the ECB is readying to cut when growth is improving, inflation is above its 2% target and the unemployment rate is at a record low. That's a far cry from the economic crisis and low inflation in the past decade that spurred the ECB to introduce negative interest rates and buy bonds at scale.



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In another unconventional step, the ECB is on the verge of easing policy before the Fed – and before it’s certain what’s next for monetary policy in the U.S., in our view. U.S. inflation is proving volatile and services inflation especially elevated, so another rate hike is not entirely off the table. This means that in the short term, the gap between Fed and ECB policy rates could widen and weigh on the euro against the U.S. dollar until the Fed starts cutting rates. Investors may see opportunities in further policy divergence, but we think it will be temporary as both central banks ultimately keep rates high for longer.

Even with anticipated rate cuts, we see policy rates in the U.S. and Europe settling at a far higher level than they were pre-pandemic. The reason: inflation. We don’t see euro area inflation falling below 2% as it did when central banks cut rates before 2020. That’s because we are in a world shaped by supply constraints – a reality ECB officials have acknowledged recently. Among those constraints are mega forces – structural shifts driving returns now and in the future – like geopolitical fragmentation, demographic divergence and the low-carbon transition. Those forces are also playing out in the U.S. As a result, we expect ongoing inflationary pressures and structurally lower growth than in the past across major economies.

The ECB trimming rates and recovering euro area growth should favor European stocks. Yet we are underweight, preferring U.S. stocks on a tactical, six- to 12-month horizon as they are set to get a bigger boost from mega forces like AI. Within fixed income, our preference flips. We scoop up the higher total yields on offer in euro area credit. Improving growth in the euro area could also limit any spread widening relative to the U.S. We are neutral euro area government bonds and UK gilts as market pricing of near-term rate cuts aligns with our view. We see support for European bonds due to smaller fiscal deficits than in the U.S. Rules on limiting deficits now apply again after being suspended during the pandemic. We await the results of the European parliamentary election in June and UK general election in July – but expect a muted impact on bonds.

Bottom line: An ECB cut is unlikely to be the start of a meaningful global easing cycle. We favor U.S. stocks over Europe’s on stronger corporate earnings and the AI theme. We’re neutral European government bonds but get income in European credit.

Market backdrop

U.S. stocks receded last week from record highs. Markets remain sensitive to Fed policy signals and the path of interest rates, helping lift the VIX index of implied S&P volatility from four-year lows. U.S. 10-year Treasury yields ticked up – partly due to weak Treasury auctions. German 10-year bund yields set fresh 2024 highs last week and sit near 2.64%. Ultimately, we see supply constraints creating persistent inflation pressure, keeping policy rates above pre-pandemic levels and growth below.

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 30, 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

June 4	U.S. job openings	June 6	ECB policy decision; U.S. international trade data
June 5	U.S. ISM non-manufacturing PMI; China Caixin services PMI	June 7	U.S. employment report; China trade data

Markets will be parsing signals for future ECB rate cuts from its updated macro forecasts and President Lagarde's press conference this week. We see the expected June 6 cut as the start of an atypical easing cycle as central banks keep interest rates high for longer. In the U.S., we rely on data – like this week's employment report and service-sector PMI reading – rather than [Fed signals](#) to determine the policy path.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, June 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 stocks 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.
Fixed income granularity	<ul style="list-style-type: none">We prefer inflation-linked bonds as we see inflation closer to 3% on a strategic horizon. We also like short-term government bonds, and the UK stands out for long-term bonds.
Equity granularity	<ul style="list-style-type: none">We favor emerging over developed markets yet get selective in both. EMs at the cross current of mega forces – like Mexico, India and Saudi Arabia – offer opportunities. In DM, we like Japan as the return of inflation and corporate reforms brighten our outlook.

Note: Views are from a U.S. dollar perspective, June 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, June 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 and shareholder-friendly reforms are 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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