

Weekly commentary

June 17, 2024

BlackRock

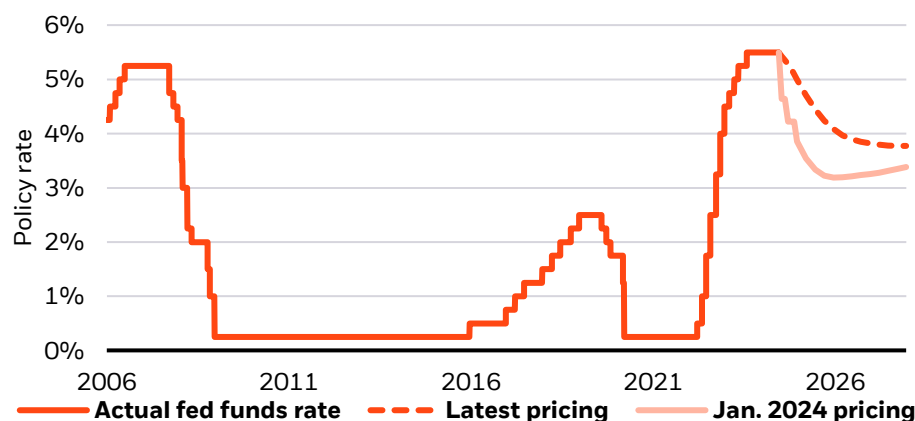
Consensus forms at Outlook Forum

- There's broad agreement among portfolio managers that a concentrated group of AI winners will drive returns over a short-term tactical horizon.
- U.S. stocks hit record highs and bond yields fell after the May CPI came in below expectations. The Federal Reserve now only expects to cut rates once this year.
- We're watching the UK CPI data to see if falling goods prices are bringing inflation down enough for the Bank of England to start cutting policy rates.

BlackRock investment leaders met June 6-7 for our semiannual Outlook Forum. There's a growing consensus among portfolio managers and central bankers that interest rates will stay higher for longer due to persistent inflation. We now think the artificial intelligence (AI) buildout could be inflationary in the near term – a shift in our view at the previous Forum that AI could cool inflation. We see a group of AI winners driving returns over a short-term tactical horizon of six to 12 months.

Higher rate reality hits

Historic and market pricing of fed funds rate, 2006-2027



Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, with data from LSEG Datastream, June 2024. Notes: The chart shows the historic future fed funds rate and the expected future path priced into SOFR futures.

Since our last Forum seven months ago, the growing consensus among our portfolio managers is that we're in a higher-for-longer interest rate environment. Back then, markets were pricing in repeated Fed rate cuts in 2024. Instead, the Fed has held its finger on the pause button, including last week. The Fed has gradually been adjusting to the reality that rates will need to stay high for longer – not only in the short term but also further out. That's illustrated by the gradual upward revision of its own estimate of long-run interest rates. Market pricing has adjusted accordingly. See the chart. The European Central Bank's move to cut rates earlier this month with growth improving, inflation still above target and unemployment at a record low did not mark the start of a deep rate-cutting cycle, in our view. The same will be true of the Fed if it starts to ease later this year, we think.



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We see central banks forced to keep interest rates higher than pre-pandemic to tackle persistent inflationary pressures. The new macro regime is marked by higher inflation, higher rates and lower growth due to supply constraints. We see this unprecedented macro cocktail persisting. Population aging, the rewiring of global supply chains and the low-carbon transition are constraining production and driving capital investment as economies try to adapt.

At our last Forum, AI garnered attention as a technology that could boost productivity in the long term, easing inflationary pressures. Those gains could still come – though they will likely take time to realize. And our portfolio managers increasingly think the initial AI capex buildout required to unlock the benefits could be inflationary. Capital spending on AI data centers has boomed since last year’s ChatGPT moment. A lot more is coming in the years ahead. This capex boom and draw on resources could create bottlenecks, meaning AI will likely be inflationary in the near term before unlocking any of the long-run benefits that could ease inflationary pressures. This nuance is not appreciated by markets or central banks, in our view.

Where do markets go from here? We believe the most likely scenario is a concentrated group of AI winners driving returns over a tactical horizon of six to 12 months. We stay overweight tech and the AI theme. The AI rally is supported by earnings and has more room to run, in our view. We don’t see an AI bubble, and the profitability of mega-cap tech companies stands in contrast to the unprofitable companies driving the dot-com bubble. Healthy corporate balance sheets and earnings momentum support our pro-risk view. We think the maturing debt of investment grade companies is manageable in coming years even with higher rates. And earnings keep improving: Eight out of 11 S&P 500 sectors expanded net profit margins in Q1, LSEG Datastream data show. Our risk-on stance means we broadly prefer equities over fixed income. Yet higher-for-longer rates mean we like short-term bonds for income. Look for more details in our 2024 Midyear Outlook in coming weeks.

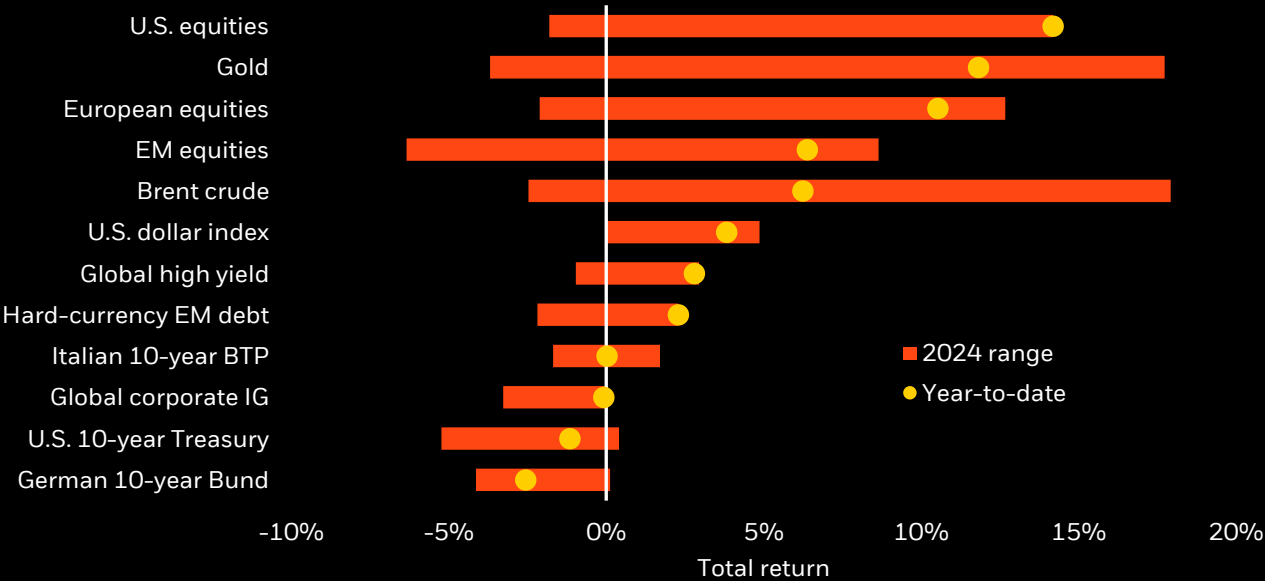
Bottom line: We see a concentrated group of AI winners driving returns over a short-term tactical horizon. We stay overweight tech and the AI theme. Our risk-on stance leads us to prefer equities over fixed income, but we like the short end for income.

Market backdrop

U.S. stocks hit record highs and are up about 14% this year. U.S. 10-year Treasury yields fell roughly 20 basis points to near 4.20%. The U.S. CPI for May came in below expectations thanks to a broad moderation in core services inflation. The Fed held rates steady as expected and now sees only one rate cut this year. Yet the Fed’s data-dependence means we don’t put much weight on its policy signals. French government bond yields jumped on worries about the snap election outcome.

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 June 13, 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 19	UK CPI data; Japan trade data	June 21	Japan CPI; Global flash PMIs
June 20	Bank of England (BOE) policy decision; Philly Fed business index		

We await UK CPI data this week and expect the BOE to look toward August to cut rates. Despite upside surprises in core services, falling goods prices are offsetting sticky services inflation – dragging overall inflation lower. Still, the BOE has acknowledged the risk of heightened inflation, especially due to the impact of geopolitical tensions.

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 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 the 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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