Weekly commentary

BlackRock

October 21, 2024

U.S. earnings strength stands out

- We think U.S. corporate earnings strength will keep broadening beyond tech in the Q3 season. We also see bright spots in Japan and European sectors.
- U.S. stocks ticked up last week to new record highs, powered by the ongoing rotation into small caps. U.S. 10-year Treasury yields hover near recent peaks.
- This week, we eye euro area flash PMIs after the European Central Bank (ECB) cut interest rates for a third time. We think it will step up the pace of rate cuts.

U.S. stocks are hitting new highs – after a summer slump – as Q3 corporate earnings season kicks off. We prefer broad U.S. equities as we expect corporate earnings strength to keep broadening beyond tech. Federal Reserve rate cuts and solid economic activity underpin our U.S. view. We're overweight Japanese stocks as earnings prove resilient to a stronger yen. Weak growth keeps us underweight European stocks overall, but we have favored sectors like financials.

Wei Li

Global Chief Investment Strategist – BlackRock Investment Institute

Carrie King

Chief Investment Officer of U.S. and Developed Markets, Fundamental Equities – BlackRock

Carolina Martinez Arevalo

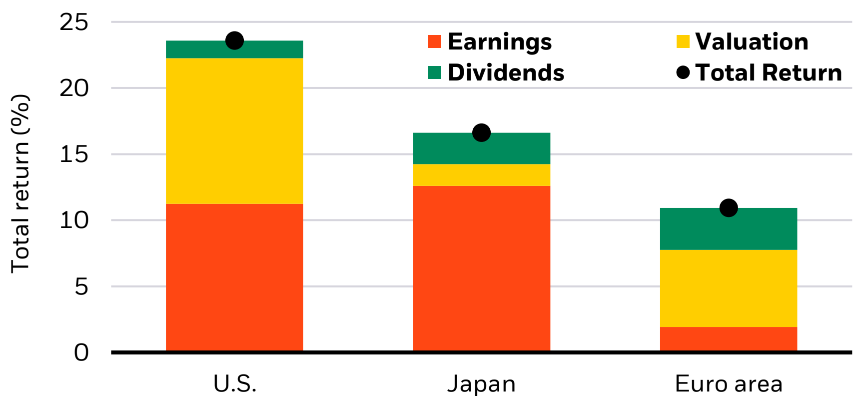
Portfolio Strategist – BlackRock Investment Institute

Michel Dilmanian

Portfolio Strategist – BlackRock Investment Institute

The earnings divide

Equity sources of total return, year to date



Past performance is not a reliable indicator of future results. It is not possible to invest in an index. Index performance does not account for fees. Source: BlackRock Investment Institute, MSCI, with data from LSEG Datastream, October 2024. Notes: The chart shows the breakdown of each market's local currency year-to-date return into dividends, earnings growth and valuation. The dots show total year-to-date returns. Earnings growth is based on the year-to-date change in 12-month forward I/B/E/S earnings estimates. Returns are based on MSCI indexes.

Favoring stocks over bonds has been rewarded this year as equities have climbed to new highs. Even as doubts over tech investment in artificial intelligence (AI) and recession fears stoked volatility, U.S. stocks have outperformed other regions this year on earnings growth and soaring tech valuations. See the chart. Jitters about lofty valuations and U.S. election uncertainty can drive market volatility. Yet on a six- to 12-month horizon, we stay overweight U.S. stocks as markets expect double-digit earnings growth over the next year and falling interest rates. We're overweight Japanese stocks. Strong earnings growth that has boosted stock performance is slowing but remains resilient to a stronger yen. Europe's story is slightly different: Earnings have been weak given poor economic growth. We're underweight euro area stocks overall but see bright spots in sectors like financials and healthcare.

We prefer U.S. over European stocks. The reason: The near-term macro backdrop supports risk-taking in the U.S., even as markets have priced out some rate cuts. The Fed is cutting even as growth and the labor market hold up. We think earnings strength will keep expanding beyond tech, narrowing the gap between tech and other sectors. Earnings for a handful of top companies, mostly tech-related, are expected to grow 19% next year, down from about 30% in 2023 and 2024. Analysts see earnings for the rest of the S&P 500 growing 4% this year and 14% in 2025 after contracting last year, FactSet data show.

We see ample room for the AI theme to run: Its buildout is only in the early stages. Yet investor doubts about tech spending on AI linger. We've expanded our AI preference beyond tech to sectors like utilities, energy, real estate and industrials. U.S. utility earnings have grown 8.2% over the past year, the fastest since 2020, based on LSEG data, partly due to AI's big energy need. Utilities are neck-and-neck with tech as the best-performing sector this year. Our portfolio managers note that industrial companies tied to the AI buildout are seeing more demand than their peers.

Outside the U.S, we stay positive on Japanese stocks after trimming our overweight as a stronger yen drags on earnings. Solid wage growth, stronger corporate pricing power and shareholder-friendly reforms support earnings growth. Elsewhere in Asia, hopes for major fiscal stimulus have halted earnings downgrades for Chinese stocks. We've turned overweight Chinese stocks given this policy signal but that doesn't change the long-term, structural challenges we are concerned about.

We stay underweight euro area stocks given weak growth and a limited recovery. Q3 earnings are expected to grow just 3.7% from a year earlier, with revenues still contracting. Yet we have favored outperforming sectors like financials. We also get granular in healthcare as some businesses will benefit more from AI and other mega forces, or structural shifts. We prefer European healthcare companies over their U.S. peers as they face less risk of losing revenue due to drug patents expiring.

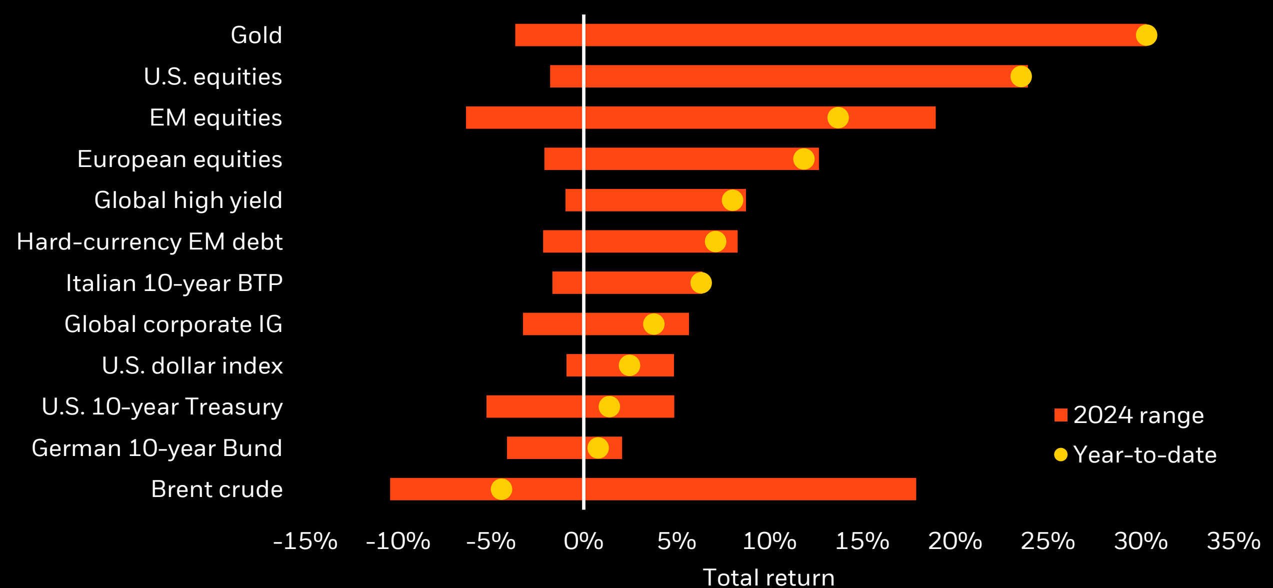
Bottom line: As Q3 earnings season gets underway, we stay overweight U.S. stocks and expect earnings to strengthen in sectors beyond tech. We're also overweight Japan's stocks. We're underweight European equities but get selective in sectors.

Market backdrop

U.S. stocks ticked up last week to new record highs as Q3 earnings season kicked off. Small-cap stocks led the climb, cruising to their highest level since 2021. Tech stocks rallied to end the week after chipmaker TSMC's sunny outlook hinted at robust demand for AI chips. U.S. 10-year Treasury yields ebbed to around 4.08%, just off recent highs but still up around 50 basis points in the past month. The ECB cut rates by 25 basis points for the third time this year and signaled a faster pace of cuts.

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 Oct. 17, 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

Oct. 23	Euro area consumer confidence	**Oct. 25**	U.S. durable goods; Tokyo CPI
Oct. 24	Global flash PMIs		

Global flash PMIs are on tap this week. In the euro area, recent weak PMIs point to contracting business activity. Slowing growth, weaker employment and inflation undershooting projections prompted the ECB to cut policy rates by 25 basis points again last week. Incoming data will be key for an ECB that has vowed to take a meeting-by-meeting approach on future policy decisions. Yet we don't see the ECB returning to the old regime of very easy monetary policy.

Big calls

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

Tactical	**Reasons**
AI and U.S. equities	• We see the AI buildout and adoption creating opportunities across sectors. We get selective, moving toward beneficiaries outside the tech sector. Broad-based earnings growth and a quality tilt make us overweight U.S. stocks overall.
Japanese equities	• A brighter outlook for Japan's economy and corporate reforms are driving improved earnings and shareholder returns. Yet the drag on earnings from a stronger yen and some mixed policy signals from the Bank of Japan are risks.
Income in fixed income	• The income cushion bonds provide has increased across the board in a higher rate environment. We like quality income in short-term credit. We're neutral long-term U.S. Treasuries.
Strategic	**Reasons**
Private credit	• 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	• We prefer intermediate credit, which offers similar yields with less interest rate risk than long-dated credit. We also like short-term government bonds, and UK long-term bonds.
Equity granularity	• We favor emerging over developed markets yet get selective in both. EMs at the cross current of mega forces – like 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, October 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, October 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 overweight given our positive view on the AI theme. Valuations for AI beneficiaries are supported as tech companies keep beating high earnings expectations. We think upbeat sentiment can broaden out. Falling inflation is easing pressure on corporate profit margins.
	Europe	-1	We are underweight relative to the U.S., Japan and the UK – our preferred markets. Valuations are fair. A growth pickup and European Central Bank rate cuts support a modest earnings recovery. Yet political uncertainty could keep investors cautious.
	UK	+1	We are overweight. Political stability and a growth pickup could improve investor sentiment, lifting the UK's low valuation relative to other DM stock markets.
	Japan	+1	We are overweight. A brighter outlook for Japan's economy and corporate reforms are driving improved earnings and shareholder returns. Yet the drag on earnings from a stronger yen and some mixed policy signals from the Bank of Japan are risks.
	Emerging markets	Neutral	We are neutral. The growth and earnings outlook is mixed. We see valuations for India and Taiwan looking high.
	China	+1	We are modestly overweight. Major fiscal stimulus may be coming and prompt investors to step in given Chinese stocks are at a deep discount to DM shares. Yet we stay ready to pivot. We are cautious long term given China's structural challenges.
Fixed Income	Short U.S. Treasuries	-1	We are underweight. We don't think the Fed will cut rates as sharply as markets expect. An aging workforce, persistent budget deficits and the impact of structural shifts like geopolitical fragmentation should keep inflation and policy rates higher over the medium term.
	Long U.S. Treasuries	Neutral	We are neutral. Markets are pricing in sharp Fed rate cuts and term premium is close to zero. We think yields will keep swinging in both directions on incoming data. We prefer intermediate maturities less vulnerable to investors demanding greater term premium.
	Global 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 govt bonds	Neutral	We are neutral. Market pricing reflects policy rates in line with our expectations and 10-year yields are off their highs. Political uncertainty remains a risk to fiscal sustainability.
	UK gilts	+1	We are overweight. Gilt yields offer attractive income, and we think the Bank of England will cut rates more than the market is pricing given a soft economy.
	Japanese govt bonds	-2	We are underweight. Stock returns look more attractive to us. We see some of the least attractive returns in JGBs.
	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	U.S. agency MBS	Neutral	We are neutral. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG.
	Short-term IG credit	+1	We are overweight. Short-term bonds better compensate for interest rate risk. We prefer Europe over the U.S.
	Long-term IG credit	-1	We are underweight. Spreads are tight, so we prefer taking risk in equities from a whole portfolio perspective. We prefer Europe over the U.S.
	Global high yield	Neutral	We are neutral. Spreads are tight, but the total income makes it more attractive than IG. We prefer Europe.
	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
	Emerging hard currency	Neutral	We are neutral. The asset class has performed well due to its quality, attractive yields and EM central bank rate cuts. We think those rate cuts may soon be paused.
	Emerging local currency	Neutral	We are neutral. Yields have fallen closer to U.S. Treasury yields, and EM central banks look to be turning more cautious after cutting policy rates sharply.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on macroeconomics, sustainable investing, geopolitics and portfolio construction to help BlackRock's portfolio managers and clients navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee