Weekly commentary

BlackRock

November 25, 2024

Getting active to identify AI winners

- We believe AI could radically reshape economies and markets. Identifying the full slate of potential beneficiaries calls for an active investment approach.
- U.S. stocks edged up near record highs last week, with Nvidia's results highlighting the AI buildout. U.S. bond yields held near six-month highs.
- We eye October U.S. core PCE. Recent wage data shows gains remain high and suggests core inflation is unlikely to cool near the Federal Reserve's 2% target.

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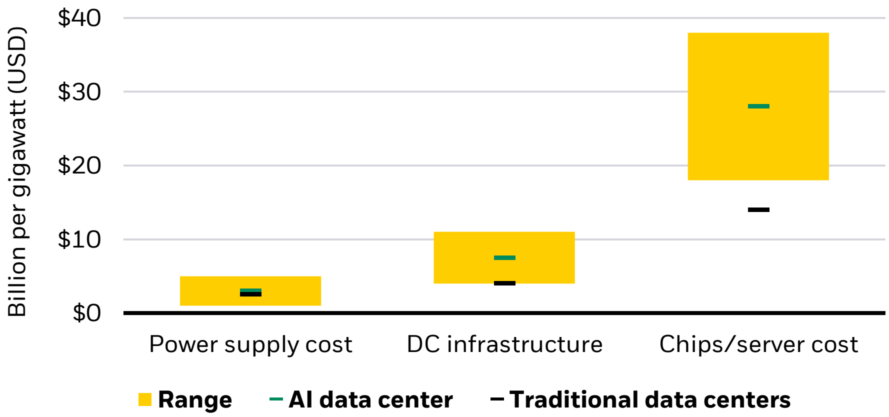
Nvidia's Q3 corporate earnings results show the buildout of artificial intelligence (AI) data centers is powering ahead as tech firms race to build the infrastructure AI needs. We think AI could eventually radically reshape economies and markets. Yet uncertainty over how AI evolves from here raises big questions. We use our three-phase framework – buildout, adoption, transformation – to track the AI revolution. Taking an active approach helps us identify and capture investment opportunities.

Traditional vs. AI data centers

Range of estimates of data center buildout costs



Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, Thunder Said Energy, November 2024. Note: The chart shows the estimated costs across three key components for data centers. Data center infrastructure relates to the full infrastructure build, excluding the cost of chips and servers. Power supply costs relate to the building of facilities needed to power data centers.

In the buildout phase underway, tech giants are pouring record amounts of capital into AI. Chips are the single largest cost and Nvidia is one of the big winners of that demand. Some of the most powerful chips can cost $40 billion per gigawatt versus $10-20 billion for traditional chips, according to Thunder Said Energy. Advanced chips are one reason AI data centers – the backbone of the buildout – are costlier than traditional ones. See the chart. Spending on traditional and AI data centers combined could top U.S. $700 billion annually by 2030, industry estimates show. All this spending could add to inflation, including via higher near-term energy costs given AI's huge power needs. Eventually, AI could boost energy efficiency, offsetting some of the initial spike in energy demand. Yet those savings can come only after mass AI adoption, a process that will take time.

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We think investment in AI could rival the amount seen in the industrial revolution – especially once including the spending on energy infrastructure as part of both the data center buildout and the low-carbon transition. Investment of this magnitude demands significant financing, creating a key funding role for capital markets and private markets. Yet private markets are complex and not suitable for all investors. We see big cloud providers and chip producers as the buildout's main beneficiaries – particularly mega cap tech companies, whose unmatched resources and tech expertise give them a competitive advantage.

Questions around AI overinvestment are valid. Yet we think this should be assessed in aggregate, given AI's potential to unlock new revenue streams across the whole economy. Mega cap tech does not look overextended for now. Comparisons to the dot-com era fall short, according to BlackRock's Systematic Active Equity team: Analysis of hundreds of metrics on valuations, earnings and other features reveals few similarities between now and then. Beyond tech, other likely beneficiaries of the buildout include companies in the utilities, energy, industrials, materials and real estate sectors providing key inputs.

What comes after the buildout raises more big questions. Part of AI's promise hinges on its ability to drive a productivity boom. Near term, we expect moderate productivity gains as AI reshapes specific tasks. Longer term, AI could accelerate the process of generating new ideas and discoveries, with far-reaching implications for innovation and growth. Much depends on how rapidly AI is adopted across industries. Broad adoption could alter the makeup of the economy by shifting labor and resources, creating new jobs and industries. Sectors like finance and IT could benefit as early adopters. If adoption happens too quickly, it could drive inflation as demand grows faster than resources can be reallocated and workers reskilled. Yet it is difficult now to imagine all of the future AI use cases. Navigating this uncertainty calls for an active investment approach, in our view. Private markets can provide an opportunity to invest in potential winners before they are publicly listed.

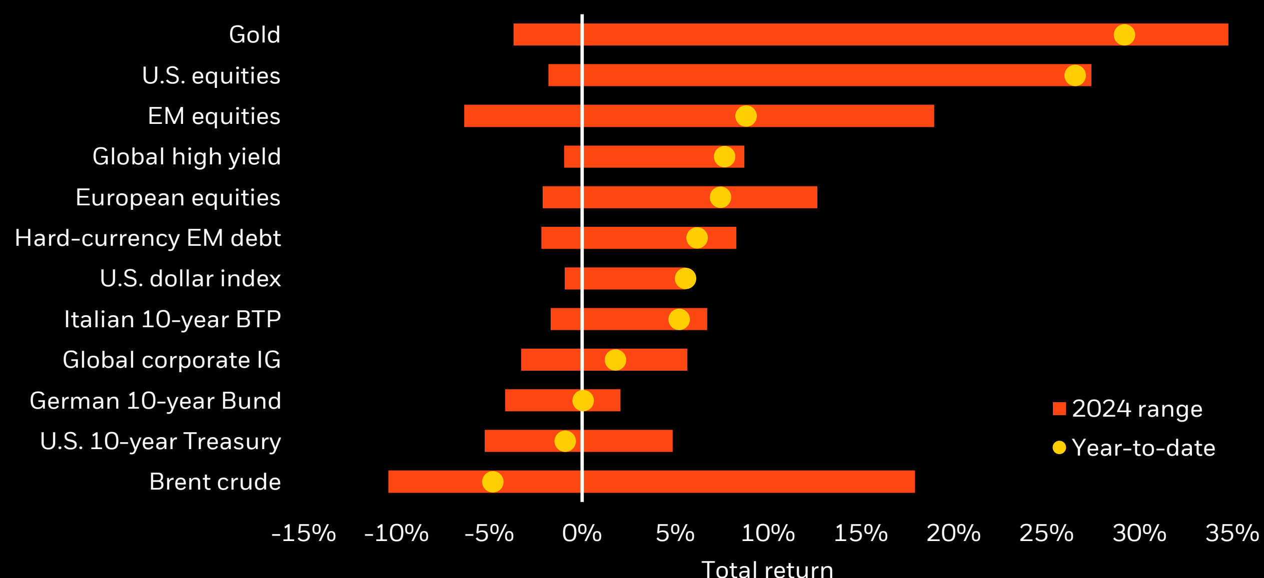
Bottom line: Investment opportunities in the AI buildout expand beyond tech into sectors providing key energy, infrastructure and data center inputs. Uncertainty beyond the buildout calls for an active approach to identify future beneficiaries.

Market backdrop

U.S. stocks edged up last week, hovering just off record highs. Nvidia's strong Q3 corporate earnings results show robust demand for its chips, a sign the AI buildout is powering ahead. Flash PMIs for November offered a glimpse into uneven global growth: The U.S. composite PMI showed growth accelerating further, while the euro area PMI showed activity shrinking and hit 10-month lows. U.S. 10-year Treasury yields were flat at 4.41%, sticking near their six-month peak.

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 Nov. 21, 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

Nov. 26	U.S. consumer confidence survey	**Nov. 29**	Euro area inflation data; Japan unemployment data
Nov. 27	U.S. core PCE; U.S. durable goods		

This week, we get October U.S. core PCE, the Federal Reserve's preferred inflation measure. We eye core services inflation for clues on where core inflation ultimately settles. Recent wage data shows gains remain elevated and suggests core inflation is unlikely to cool near the Fed's 2% target. Markets have been pricing out Fed rate cuts — and moving closer to our view — as it becomes clearer that inflation pressures could prove persistent.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, November 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 interest rate environment. We like quality income in short-term credit. We're neutral long-term U.S. Treasuries.
Strategic	**Reasons**
Private markets	We see opportunities in infrastructure equity due to attractive relative valuations and mega forces. For income, we prefer direct lending given more attractive yields than in public credit.
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, November 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, November 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**		
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	**Emerging markets**	Neutral	We are neutral. The growth and earnings outlook is mixed. We see valuations for India and Taiwan looking high.
Equities	China	+1	We are modestly overweight. China's fiscal stimulus is not yet enough to address the drags on economic growth, but we think stocks are at attractive valuations to DM shares. We stand 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.
Fixed Income	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.
Fixed Income	Global inflation-linked bonds	Neutral	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
Fixed Income	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.
Fixed Income	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.
Fixed Income	Japanese govt bonds	-2	We are underweight. Stock returns look more attractive to us. We see some of the least attractive returns in JGBs.
Fixed Income	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
Fixed Income	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.
Fixed Income	Short-term IG credit	+1	We are overweight. Short-term bonds better compensate for interest rate risk. We prefer Europe over the U.S.
Fixed Income	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.
Fixed Income	Global high yield	Neutral	We are neutral. Spreads are tight, but the total income makes it more attractive than IG. We prefer Europe.
Fixed Income	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
Fixed Income	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.
Fixed Income	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.

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