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Weekly commentary

BlackRock

March 25, 2024

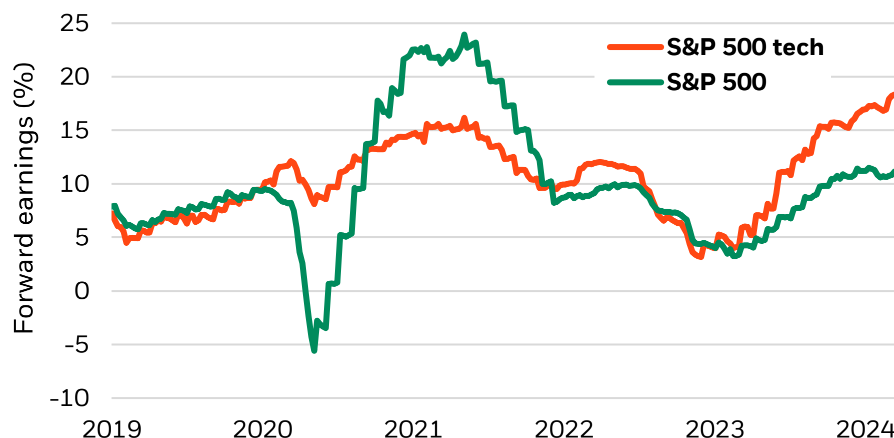
Why we stay risk-on in the short term

- We see falling inflation, nearing interest rate cuts and solid corporate earnings supporting cheery risk sentiment. We tweak our tactical views and stay pro-risk.
- U.S. stocks hit record highs last week and 10-year yields fell as the Fed stuck with planned rate cuts. Japanese stocks gained on a cautious BOJ policy pivot.
- U.S. PCE takes center stage this week. We see goods deflation pulling down overall U.S. inflation for now before inflation resurges in 2025.

Central bank activity last week gave markets the thumbs up to stay upbeat. That keeps us pro-risk in our six- to 12-month tactical views as Q2 starts. We see stock markets looking through recent sticky U.S. inflation and dwindling expectations of Fed rate cuts. Why? Inflation is volatile but falling, Fed rate cuts are on the way and corporate earnings are strong. We stay overweight U.S. stocks but prepare to pivot if resurgent inflation spoils sentiment. We up our overweight on Japanese stocks.

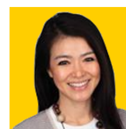
Broadening optimism

S&P 500 forward earnings expectations, 2019-2024



Forward looking estimates may not come to pass. Index returns do not account for fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from LSEG Datastream, March 2024. Notes: The chart shows 12-month forward earnings expectations for the overall S&P 500 index and S&P 500 information technology stocks.

As Q2 kicks off, we still see a more supportive near-term backdrop for risk-taking. U.S. inflation has eased from its pandemic highs and growth has held up. And expectations for S&P 500 earnings growth for 2024 have been revised up to about 11%, LSEG data show. Earnings expectations are even higher for tech companies that markets see leveraging artificial intelligence (AI). See the orange line in the chart. Earnings expectations for the broader market are also on the mend (green line), with sectors except commodities and healthcare seeing earnings recover. Plus, the Federal Reserve reaffirmed its intention to make three quarter-point rate cuts this year, while lifting its growth and inflation forecasts. After the recent Fed signals, we believe the bar is high for market pricing of immaculate disinflation – inflation falling near the Fed's 2% target while growth holds up – to be challenged.



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Against that backdrop, we remain tactically overweight U.S. stocks. We think upbeat risk appetite can broaden out beyond tech as more sectors adopt AI, and as market confidence is buoyed by recent Fed messaging and broadly falling inflation. We still prefer the AI theme even as valuations soar for some tech names. Stock valuations are supported by improving earnings, with the tech sector expected to account for half of this year's S&P 500 earnings, Bloomberg data show. That has led to a fall in price-to-earnings ratios – share price divided by earnings per share – for some companies, unlike in the dot-com bubble when they soared. To compare the periods, BlackRock's systematic equities team analyzed 400 metrics related to valuations and other features and found that the number flashing red now is 50% lower than when the dot-com bubble burst in 2000.

What would change our risk-on stance? First, risk appetite being challenged as markets shift focus from cooling inflation to inflation on a rollercoaster back up in 2025. We think it will settle closer to 3% as high wage growth keeps services inflation sticky. Persistent inflation pressures from mega forces, or big structural shifts we see driving returns, also call for a higher neutral rate – the interest rate that neither stokes nor limits economic activity – than in the past. We think the Fed's nudged-up long-run policy forecasts are starting to reflect our view of rates staying higher for longer than pre-pandemic. Markets are not eyeing that outlook for now. Second, stocks could grow more sensitive to macro news as profit margin pressures mount.

As Q2 kicks off, Japanese equities become our highest-conviction tactical view as solid corporate earnings and shareholder-friendly reforms keep playing out. We add to our overweight because we think the Bank of Japan policy stance is supportive of local markets. The BOJ made clear that ending negative rates is about normalizing policy, not anxiety over inflation, and it pledged to limit spikes in long-term yields. We think the BOJ will act cautiously and not sabotage the return of mild inflation. We also up euro area inflation-liked bonds to neutral as market expectations for persistent inflation have eased.

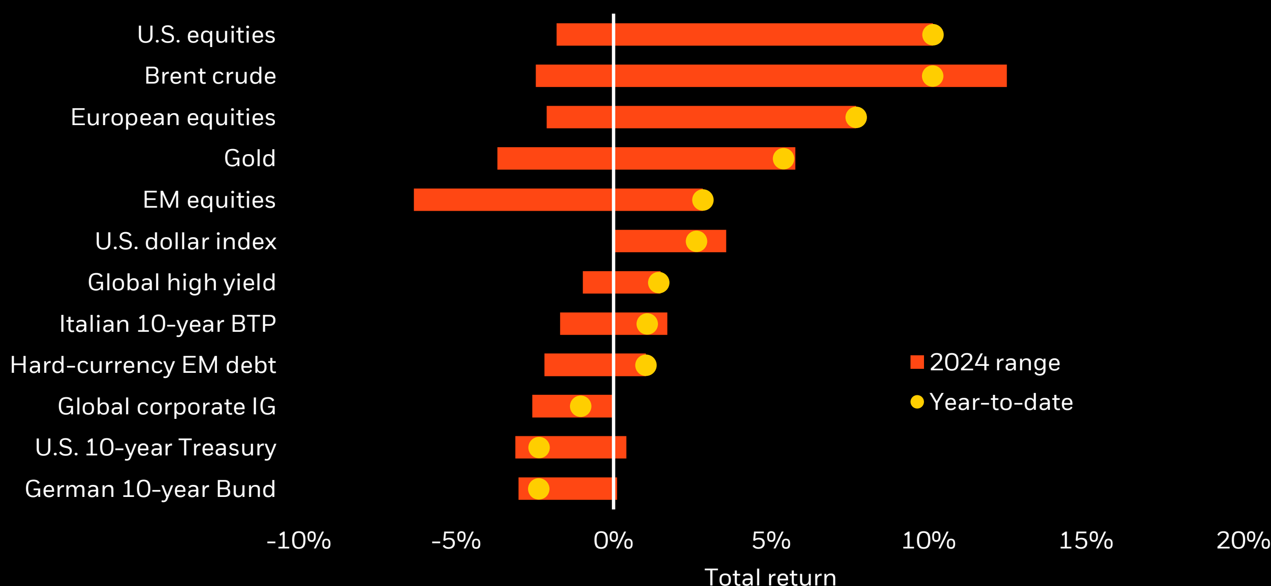
Bottom line: We see a supportive risk-taking environment for now, as inflation keeps falling and after the Fed reinforced upbeat sentiment. We stay overweight U.S. stocks and the AI theme. We go further overweight Japanese stocks.

Market backdrop

U.S. stocks climbed to all-time highs last week and U.S. 10-year Treasury yields slipped after the Fed stuck to its plans to cut policy rates three times this year even after lifting both its growth and inflation forecasts for this year. We think markets are underappreciating another change: the Fed nudging up its long-run policy rate. Japan's Nikkei stock index hit all-time highs after the BOJ ended negative rates and lifted its yield cap. Yields on Japanese 10-year government bonds dipped slightly.

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 March 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.

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Week ahead

March 26	U.S. consumer confidence and durable goods; UK GDP; Japan services PPI
March 29	U.S. PCE
March 31	China manufacturing PMI

This week, we focus on U.S. PCE data, the Fed's preferred measure of inflation. We think U.S. inflation can fall further toward 2% this year due to falling goods prices. Yet we see inflation on a rollercoaster back up in 2025, with inflation eventually settling closer to 3%. The Fed appears to be slowly adjusting to this view given its higher projections for policy rates two years out.

Big calls

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

Tactical	Reasons
U.S. equities	• 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	• 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	• 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	• We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to credit risk.
Inflation-linked bonds	• We see inflation staying closer to 3% in the new regime on a strategic horizon.
Short- and medium-term bonds	• 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, March 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.

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, March 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	Neutral	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.
	United States	Overall	+1	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		-1	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		Neutral	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		+2 (previous view: +1)	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		Neutral	We are neutral. We see growth on a weaker trajectory and see only limited policy stimulus from China. We prefer EM debt over equity.
	China		Neutral	We are neutral. Modest policy stimulus may help stabilize activity, and valuations have come down. Structural challenges such as an aging population and geopolitical risks persist.
Fixed Income	Short U.S. Treasuries		+1	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer
	Long U.S. Treasuries		Neutral	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		Neutral	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
	Euro area inflation-linked bonds		Neutral (previous view: -1)	We are neutral. Market expectations for persistent inflation in the euro area have come down.
	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. Widening peripheral bond spreads remain a risk.
	UK gilts		Neutral	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		-2 (previous view: -1)	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		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.
	Global IG credit		-1	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		Neutral	We are neutral. Spreads are tight, but we like its high total yield and potential near-term rallies. We prefer Europe.
	Asia credit		Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
	Emerging hard currency		+1	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		Neutral	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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