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Weekly commentary

BlackRock

April 22, 2024

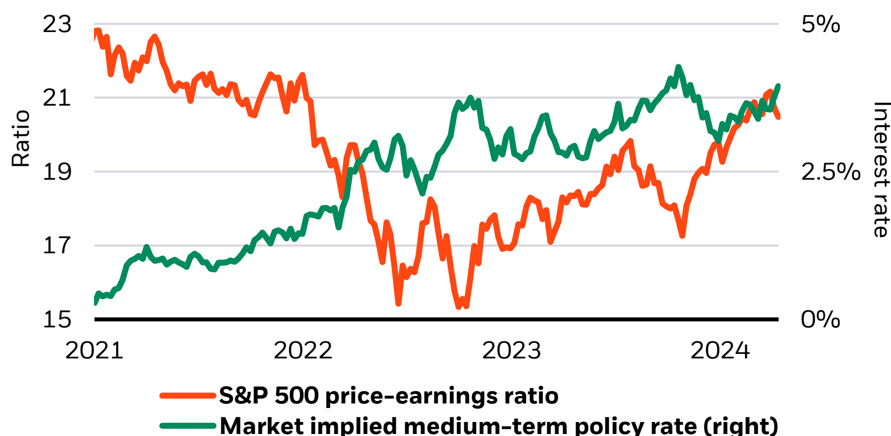
Higher bar for U.S. earnings to deliver

- U.S. stocks have slid from their highs as inflation proves sticky and geopolitical tensions rise. We eye whether corporate earnings can keep buoying sentiment.
- The S&P 500 slid 3% last week on jitters before key tech earnings results and rising bond yields. Geopolitical flare-ups are keeping oil prices elevated.
- We look to this week's U.S. PCE release for any signs of acceleration or stubborn services inflation. We see inflation and interest rates staying higher for longer.

We saw 2024 as a year of two stories. First, cooling inflation and solid corporate earnings would support upbeat risk appetite. And later, resurgent inflation would come into view and disrupt sentiment. We stay overweight U.S. stocks yet are ready to pivot. The second leg may be playing out now, reinforcing our expectations for persistently high inflation. That raises the stakes for Q1 corporate earnings to buoy sentiment, in our view, just as higher bond yields add pressure to equity valuations.

Baking in higher-for-longer rates

S&P 500 valuations and interest rate expectations, 2021-2024



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 and Bloomberg, April 2024. Notes: The chart shows the forward price-to-earnings ratio for the S&P 500 and the market pricing of the fed funds rate in three years, based on SOFR futures.

We've expected inflation would be on a rollercoaster as the drag from falling goods prices faded and firm wage growth made services inflation stubborn. Yet the March pick-up in core services inflation shows that inflation is proving sticky. Further escalation of Middle East tensions could see oil prices staying elevated, reinforcing higher inflation and higher-for-longer interest rates. Sticky inflation has prompted markets to slash their expectations for Federal Reserve rate cuts to less than two this year (green line in chart) in line with our view. The Fed has gone from blessing market hopes for inflation to fall to 2% without a growth hit to implying policy may have to stay tight. The S&P 500 price-to-earnings ratio – a popular valuation metric – shows stocks feeling the heat from higher rates (orange line). We think that's why it's more crucial that companies keep meeting or beating high earnings forecasts.

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We question whether the slide in stocks is a blip or a bigger shift toward pricing in inflation – and interest rates – settling higher than pre-pandemic. We stay overweight U.S. stocks on a six- to 12-month tactical horizon but are ready to pivot given that uncertainty. We have broadened out our stock view to include segments of the market with an improving earnings growth outlook. And we have leaned against small cap stocks whose earnings are at greater risk from higher rates. Earnings face a critical test this week, with some mega cap tech companies reporting. With stocks under pressure and rate cut hopes fading, we think the bar is higher for tech firms to deliver on earnings expectations – and for other sectors to show an earnings recovery. Confirmation of inflation settling higher and earnings misses could trigger a change to our view.

We still prefer artificial intelligence (AI) beneficiaries to tap into the AI and digital disruption mega force – a structural shift driving returns now and in the future. We went overweight early AI winners and enablers like chip and hardware makers in 2023. That view paid off as some valuations soared above historical averages. We are eyeing potential winners further up the technology stack – the layers of technology needed to develop AI applications – and beyond as AI adoption spreads. That's the case in healthcare, financials and communication services, sectors we like because they have more scope for productivity gains. Outside of tech, those sectors have had some of the most mentions of AI-related keywords in earnings calls and company filings, BlackRock's Systematic Equity team finds. AI mentions in non-tech sectors have soared 250% since 2022.

In fixed income, we stay neutral long-term U.S. bonds even as 10-year yields have risen this year. We think yields can swing in either direction as policy rate expectations shift in the near term. Long-term yields are moving toward our view that investors will demand more term premium, or compensation for the risk of holding long-term bonds in the long run. Term premium is muted for now. We prefer short-term bonds, euro area high yield credit and emerging market hard currency debt for income.

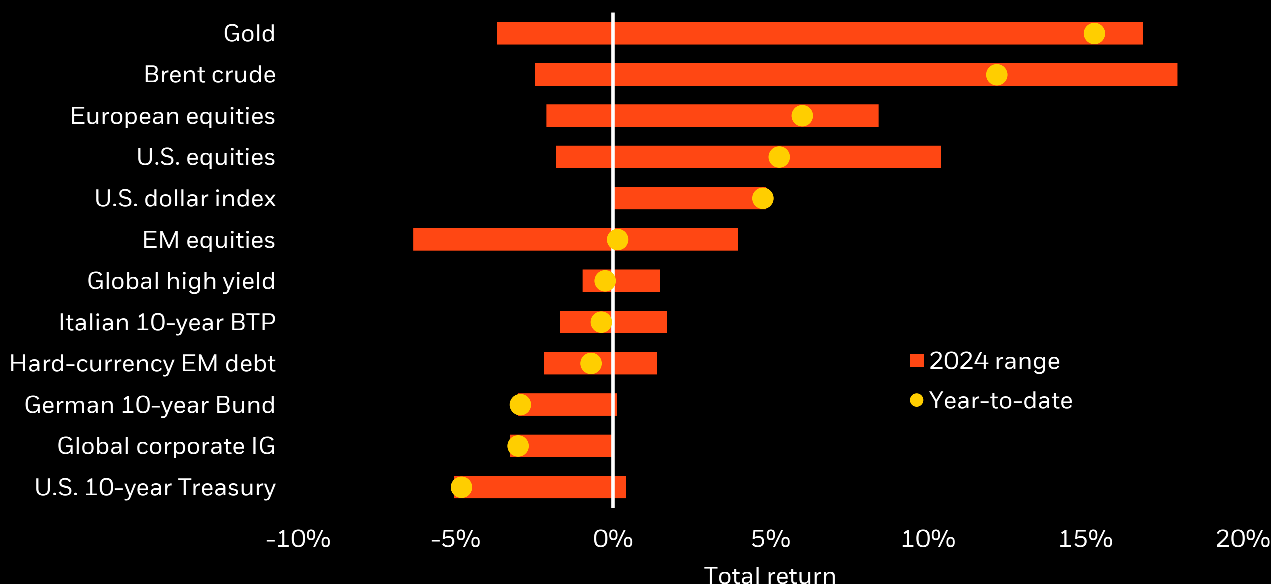
Bottom line: U.S. earnings updates this week will be key to see if they can keep topping expectations and buoying risk appetite in a higher-for-longer interest rate environment. We're overweight U.S. stocks and see the AI theme broadening.

Market backdrop

The S&P 500 slid 3%, led by tech, on jitters before key earnings results this week and rising bond yields. The first direct strikes between Iran and Israel also helped stoke market unease. U.S. 10-year Treasury yields hit a new 2024 high of 4.70% before settling back slightly. Oil prices eased 4% last week after having been pushed higher due to geopolitical unrest in recent months. We think we're in a world of structurally higher geopolitical risk – and a lower threshold for conflict escalation.

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 April 18, 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

April 23	Global flash PMIs	**April 25**	U.S. GDP data
April 24	U.S. durable goods; Japan services PPI	**April 26**	U.S. PCE; Bank of Japan policy meeting; Japan CPI

We're watching this week's release of March U.S. PCE data, the Federal Reserve's preferred measure of inflation, for any signs of acceleration or stubborn services inflation. U.S. CPI data showed that core services inflation, excluding housing, ramped up in March – signaling that inflation may not fall as much as markets expected. Elsewhere, we don't expect the Bank of Japan to hike rates. Markets will likely focus on its updated economic projections and CPI data.

Big calls

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