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Weekly commentary

BlackRock

May 20, 2024

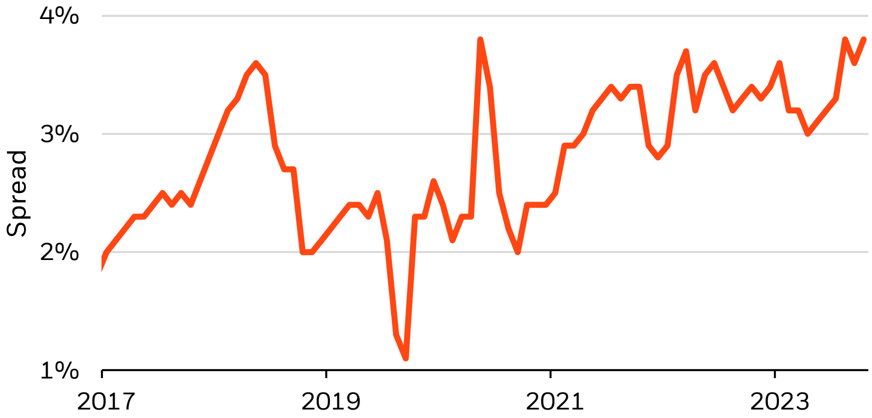
Staying dynamic in our strategic views

- We stay dynamic on a strategic horizon to take advantage of sharp valuation shifts. We go overweight emerging market stocks for the first time since 2020.
- U.S. stocks hit all-time highs while 10-year yields fell after the CPI data met expectations. We think the Fed needs to see inflation cooling more to cut rates.
- We eye Japan inflation data this week and the implications for the Bank of Japan. We see the BOJ supporting the return of mild inflation and wage growth.

We see the new macro regime of greater volatility causing more frequent valuation shifts between asset classes. Valuations may not always drive short-term results but matter long term. Staying dynamic – even on a strategic horizon of five years and longer – creates opportunities to capitalize on these shifts. Getting granular allows us to target areas where we see the most repricing potential, like emerging market (EM) stocks. We go overweight developed market (DM) government bonds.

Relatively cheap

Spread between EM and DM equity risk premia, 2017-2024



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Index performance does not account for fees. Source: BlackRock Investment Institute with data from LSEG Datastream, May 2024. The chart shows the difference between our estimates of equity risk premium – the excess yield investors receive for the risk of holding stocks over cash – by using a dividend discount model for DM and EM equities.

We're in a new, more volatile regime where macro risks are elevated and valuations are shifting more quickly. Assessing valuations on a strategic horizon of five years and longer is key for long-term investors, even if short-term performance can be driven by other factors. We get granular to uncover opportunities. In EM equity, we don't feel prices reflect fair value over a strategic horizon. The difference in equity risk premia – a gauge of the excess yield investors receive for the risk of holding stocks over cash – between EM and DM equities has grown to its widest level in nearly four years, reflecting cheaper relative EM valuations. See the chart. DM government bonds are another area we find opportunities – notably in short-dated DM and long-dated DM bonds excluding the U.S. We go overweight EM stocks and DM government bonds for the first time in four and five years, respectively.

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Under the hood of our strategic overweight to EM stocks, we stay selective. We see broad EM stock valuations as attractive. While China's structural challenges remain, we consider them largely understood by markets and reflected in valuations. We find opportunities in EMs like Mexico, India and Saudi Arabia that we see at the crosscurrent of many mega forces – structural shifts driving returns now and far in the future. EMs rich in natural resources and supply chain inputs stand to benefit from geopolitical fragmentation, turning them into multi-aligned trading partners. Demographic divergence favors most EMs – where domestic working-age populations are still growing – over DMs with flat or shrinking worker pools.

We remain neutral DM stocks and stay selective – yet see reasons to like Japanese equities. The long-awaited comeback of inflation in Japan brightens the outlook for corporate profits as companies can raise prices on products and services while rising wages are set to support consumer spending. Ongoing corporate reforms aimed at boosting shareholder value also underscore our view. We favor an above-benchmark allocation to Japan over a strategic horizon (for professional investors).

Heightened market sensitivity to economic data releases has driven market volatility so far this year, especially in government bonds. Last week's U.S. CPI showed inflation slowing as expected – yet we still see inflation settling closer to 3% over the long term. This is not priced into fixed income markets in our view – underpinning our strategic preference for inflation-linked bonds. How inflation and central bank policy evolve from here will vary by region. We expect policy rates to fall more in the UK than the U.S. This dynamic makes UK government bond yields more attractive than other DM debt. That's why we like long-dated DM government bonds outside of the U.S., such as UK gilts. Yet we keep our preference of short-dated over long-dated maturities across DMs. We're now overweight DM government bonds overall on a strategic horizon for the first time in five years. In a whole portfolio context, we go underweight investment grade credit given tight spreads.

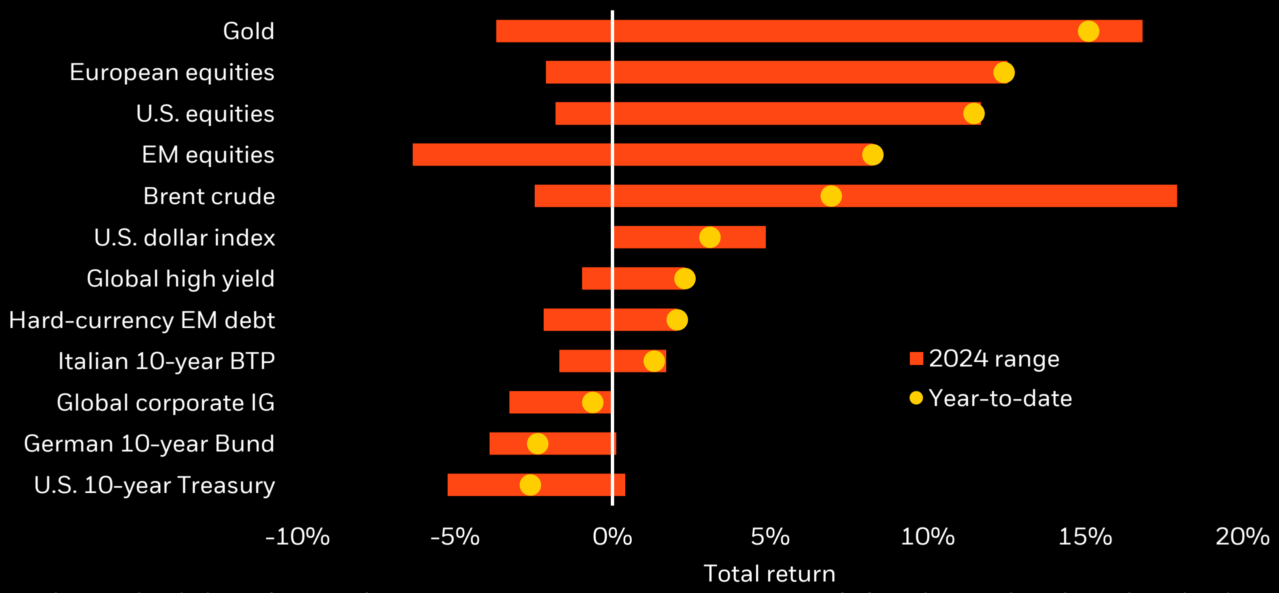
Bottom line: We prefer EM over DM equity given relative valuations but stay selective in both. We like inflation-linked bonds in a high-for-longer rate regime. We now favor DM government bonds over IG credit – driven by our preference for UK gilts.

Market backdrop

U.S. stocks notched fresh 2024 highs last week, while U.S. 10-year Treasury yields fell to around 4.40% – about 35 basis points below this year's peak. The U.S. CPI met consensus expectations and broke a three-month streak of hotter-than-expected readings. While the data may give the Federal Reserve some comfort that the previous upside surprises were anomalies, we think the Fed needs more evidence of inflation coming down to start cutting policy rates.

Assets in review

Selected asset performance, year-to-date return and range



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Sources: BlackRock Investment Institute, with data from LSEG Datastream as of May 16, 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

May 22	Japan trade data; UK CPI	**May 24**	Japan CPI; U.S. durable goods
May 23	Global flash PMIs		

We watch Japan inflation data for the Bank of Japan policy implications. We think the BOJ will be slow to tighten policy to support the return of mild inflation and healthy wage growth. Global flash PMIs will provide an update on whether growth momentum is picking up, if slowly, in the euro area and cooling in the U.S. The U.S. durable goods report will be in focus for another snapshot of how the industrial part of the economy is holding up.

Big calls

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

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 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.
		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 and shareholder-friendly reforms are 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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