Weekly commentary

January 29, 2024

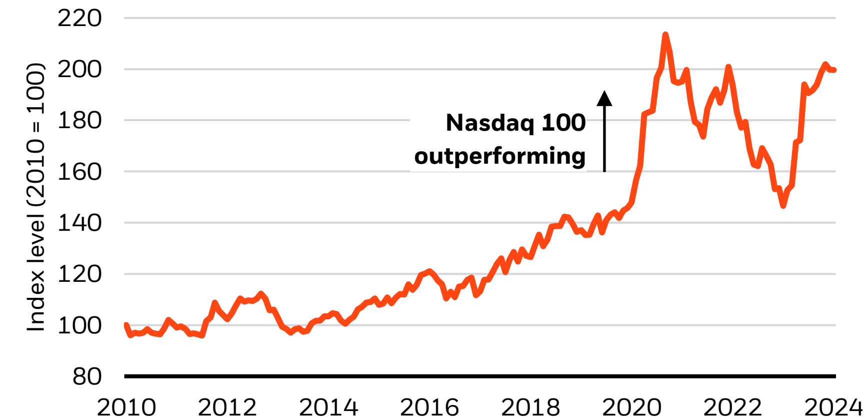
Upgrading our broad U.S. stocks view

- We think stock momentum can run for now as inflation cools and the Federal Reserve readies to cut rates. So we up our overall U.S. stocks view to overweight.
- Tech stocks led the S&P 500 to consecutive record highs last week. Robust U.S. Q4 GDP growth and falling inflation bolstered the market's rosy macro outlook.
- The Fed's policy meeting is in focus this week after it signaled in December that rates have peaked. We don't see it cutting rates as much as in the past.

Excitement over artificial intelligence (AI) spurred a rally in U.S. tech stocks that buoyed the market in 2023. We've said the rally can run for now – and broaden out. Why? Inflation will likely near the Fed's 2% target this year, and the Fed is set to start cutting interest rates. So we upgrade broad U.S. stocks – our index level view plus AI theme preference – to overweight on a tactical horizon of six to 12 months. We stay nimble as we expect resurgent inflation to become clear later this year.

Eyeing a broadening rally

Nasdaq 100 vs. equal-weighted S&P 500, 2010-2024



It is not possible to invest directly in an index. Indexes are unmanaged and performance does not account for fees.
Source: BlackRock Investment Institute, with data from LSEG Datastream, January 2024. Notes: The chart shows the performance of the Nasdaq 100 index relative to the equal-weighted S&P 500 on a total return basis, rebased to 2010.

In mid-2023, we shifted how we present our tactical views to capture opportunities from mega forces, or big structural forces. Our overall U.S. equity view was neutral – consisting of an underweight at the benchmark level and an overweight to the AI theme. That selectivity has been rewarded in the past 12 months, with tech pushing U.S stocks to all-time highs. The Nasdaq 100 surged 50% in that time, while the equal-weighted S&P 500 rose 4% in what's been a narrow rally. See the chart. We expect the rally to broaden out as inflation falls further, the Fed starts to cut rates, and the market sticks to its rosy macro outlook. Markets are pricing a soft economic landing where inflation falls to 2% without a recession. With markets tending to focus on one theme at a time, this narrative can support the rally over our tactical horizon and allow it to expand beyond tech. So we go overweight overall U.S. stocks.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Yet we stay nimble and ready to pivot as the new regime of greater macro, market and inflation volatility creates a wide range of possible outcomes. The consensus view of a soft landing could be challenged, but that may happen later in the year. We agree with markets that inflation will fall near 2% this year, helping the upward momentum extend into the year. Yet inflation is unlikely to stay there in the long run. December PCE data out last week showed declining goods prices are still pushing inflation down as consumer spending shifts back to services. Yet that drag is temporary and goods prices should rise anew when pandemic mismatches have finished unwinding. We think U.S. wage growth is still running too hot for services inflation to slow enough to keep core inflation near 2%. That means inflation will likely rollercoaster up toward 3% in 2025.

So far, corporate earnings and profit margins have held up against higher interest rates and costs. We think margins will face pressure in the medium term from high rates, wage pressures and lower but above-target inflation. Wage growth has stayed high as an aging U.S. population keeps the labor market tight. Other mega forces – or big structural shifts – like geopolitical fragmentation also add to inflation pressures, in our view. That's part of why we think the Fed won't be able to cut rates as much as in the past. The Fed may push back against market pricing of rate cuts, but we think any resulting equity pullback would likely be temporary – until the risk of resurgent inflation comes into view.

In the euro area, we're not expecting resurgent inflation. It has fallen as the energy crunch has abated. We see wage growth sliding as the European Central Bank holds policy tight, as it did last week. The Bank of Japan left its loose policy the same last week as it looks for wage gains and accelerating services inflation to anchor overall inflation sustainably at 2%.

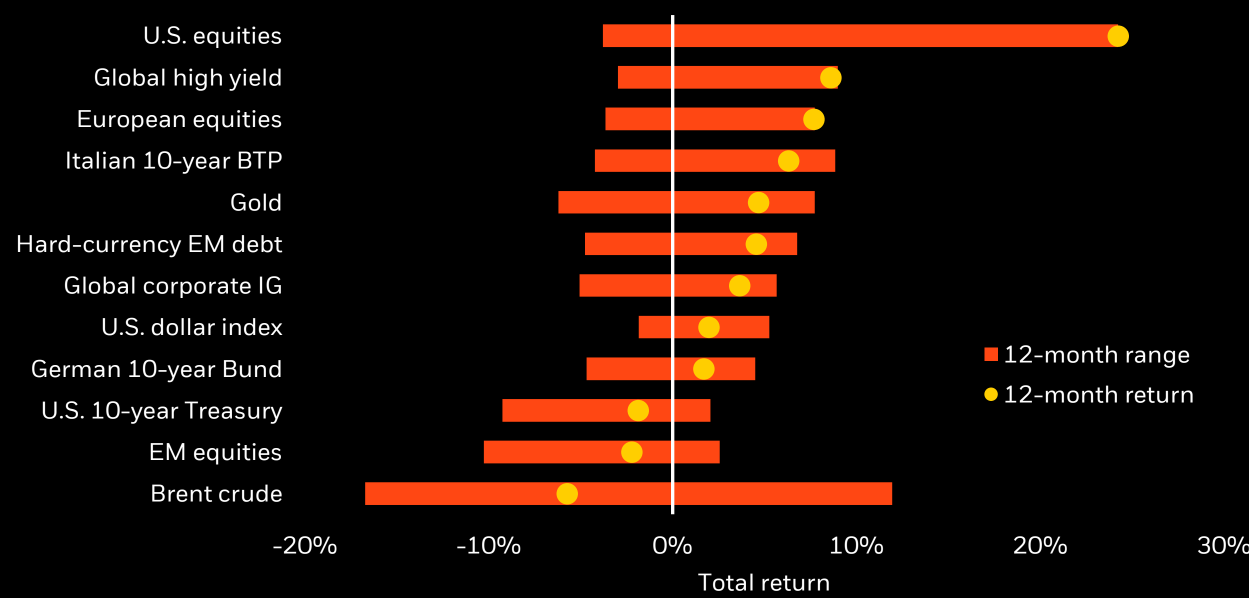
Bottom line: Upward momentum in U.S. stocks could carry on into this year, so we are overweight in our overall view. We stay nimble given the inflation rollercoaster we see ahead. We like AI-related and Japanese stocks on strong earnings potential. In fixed income, we still favor short- and medium-term bonds as we don't expect central banks to deliver as many rate cuts as markets expect. And we see the role of long-term bonds as a portfolio diversifier challenged – and stay neutral.

Market backdrop

The S&P 500 saw modest gains last week after hitting consecutive record highs as tech stocks rallied. The 10-year Treasury yield was steady, floating near its 2024 highs of roughly 4.16%. Data showing robust U.S. growth in the last quarter of 2023 while core inflation fell back to 2% annualized bolstered the market's soft landing hopes. We think that should sustain the stock rally for now, but December PCE data confirmed that an inflation rollercoaster could challenge the momentum. Meanwhile, Chinese stocks rebounded as officials rolled out policy stimulus – but they remain down for the year.

Assets in review

Selected asset performance, 12-month 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 Jan. 25, 2024. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12 months, and the dots represent current 12-month 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

Jan. 30	U.S. consumer confidence; euro area GDP	**Feb. 1**	Bank of England policy decision; euro area inflation
Jan. 31	Fed policy decision	**Feb. 2**	U.S. payrolls

We expect the Fed to hold interest rates steady at its policy meeting this week after signaling that rates have peaked at its last meeting. We don't think the Fed will be able to cut rates as quickly or as much as markets are pricing. Growth will need to be much weaker than in the past to keep inflation down given ongoing wage pressures and structural shifts like geopolitical fragmentation. Yet the level at which rates start to dampen growth is higher than before the pandemic.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, January 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 than policy targets, making this one of our strongest views 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, January 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, January 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. The ECB is holding policy tight in a slowdown. Valuations are attractive, but we don't see a catalyst for improving sentiment.
	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		+1	We are overweight. We see stronger growth helping earnings top expectations. Stock buybacks and other shareholder-friendly actions are positives. Policy tightening is a near-term risk.
	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		-1	We are underweight. We prefer the U.S. over the euro area. We see markets overestimating how persistent inflation in the euro area will be relative to the U.S.
	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		-1	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
	China govt bonds		Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	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.
	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 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 higher yields. 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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