Weekly commentary

BlackRock

February 20, 2024

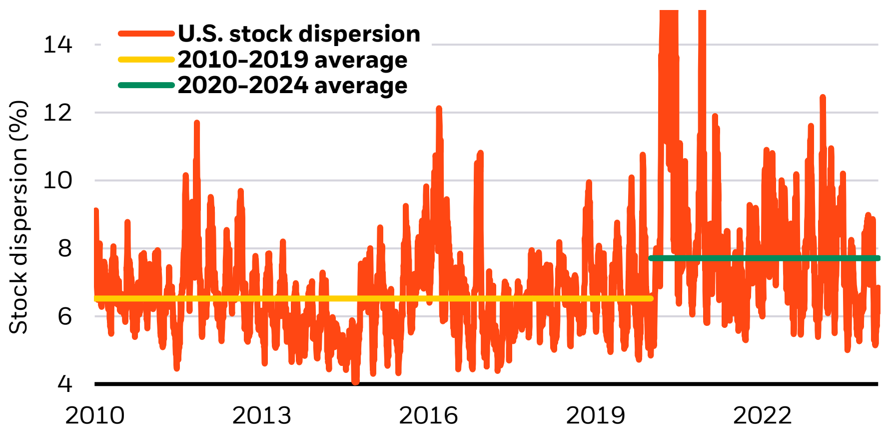
Strategic reasons to get active

- We think market optimism can persist for now but stay nimble. We get more active in our long-term portfolios given a greater dispersion of returns.
- U.S. stocks steadied after a brief dip on stronger-than-expected inflation data last week. We think that shows one data release won't spoil upbeat risk appetite.
- Global manufacturing and services activity is in focus this week. The data may offer an early gauge of Q1 GDP growth as central banks hold policy rates steady.

U.S. stocks recovered after a hit from strong inflation data last week, highlighting one data point won't disrupt buoyant risk appetite. We're tactically overweight U.S. stocks as we think market optimism can persist for now. Yet we are strategically active – or ready to pivot our views as we expect resurgent inflation coming into view to spoil sentiment. In the long term, we see a greater role for active strategies that can produce above-benchmark returns due to richer asset valuations broadly.

Uncertainty spurs dispersion

Dispersion of S&P 500 performance, 2010-2024



Past performance is not a reliable indicator of current or future results, and 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, February 2024. Notes: The chart shows the dispersion in S&P 500 monthly stock returns on a daily basis and the median level of dispersion from July 2010 after the global financial crisis through 2019, and from 2020 through Jan. 31, 2024.

We believe there is less consensus and more uncertainty about key macro variables, like inflation, than in the past. Elevated uncertainty is reflected in the heightened dispersion of returns in the new regime, we find. Monthly returns of individual S&P 500 stocks (orange line in the chart) have deviated more from their average since 2020 (green line) than in the prior decade (yellow line). We opted to be selective in U.S. stocks as a result last year, leaning into the artificial intelligence (AI) theme and away from the broad market. Last month, we turned overall overweight U.S. stocks on a six- to 12-month tactical horizon, while still preferring tech. That's because we think positive market sentiment can persist and broaden out for now as the Federal Reserve readies to cut interest rates and inflation falls nears its 2% target this year.

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Yet we are nimble in reassessing our views given our expectation inflation will resurge in 2025. We think mega forces – big structural shifts like geopolitical fragmentation, demographic divergence and the low-carbon transition – are set to make inflation more volatile and settle higher than before the pandemic. On a strategic horizon of five years and more, our stance on developed market (DM) stocks is less positive than our tactical view and we stay neutral. Persistent inflation means real returns, or those exceeding inflation, will be lower over a strategic horizon. Long-term valuations for some asset classes look too high when baking in this outlook and our expectation for interest rates to settle higher than before the pandemic.

That return outlook means that the traditional portfolio approach of static asset allocations won't work as well as in recent decades, in our view. We stay dynamic in our strategic views as one part of the solution. We trim our overweight to inflation-linked DM bonds as real yields have slid. We up investment grade credit to neutral on a preference for Europe, where credit risk seems better rewarded. In addition to being more dynamic, we think active strategies will play a greater role in strategic portfolios. Our work finds that the difference in our estimate of active returns between the top and bottom 25% of managers is near its widest since 2011. Skill and acting more frequently on good insights can be better rewarded now, in our view.

Top managers may have more potential for active returns in private markets. Dispersion across them has risen in the new regime and tops public markets, based on the limited data available from NCREIF. We prefer income private markets over growth as a shifting U.S. corporate funding landscape likely boosts demand for private credit – part of the future of finance mega force. We see infrastructure equity as a bright spot within growth private markets as it cuts across all mega forces. Private markets are complex, with high risk and volatility, and aren't suitable for all investors.

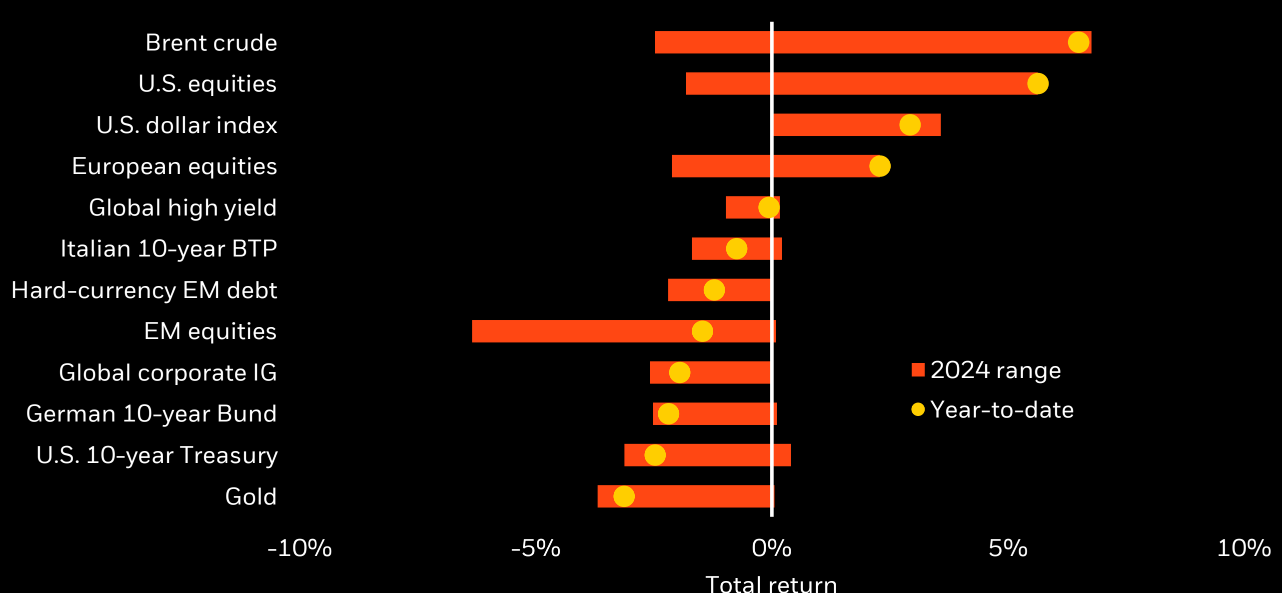
Bottom line: We're being strategically active in our portfolios. We're overweight U.S. stocks tactically as we think positive risk appetite can persist for now, yet we stay nimble. We take a more active approach in the long run as structural shifts play out. Professional investors can visit our Capital market assumptions website for more details on our strategic return expectations.

Market backdrop

U.S. stocks steadied last week, recovering from a brief dip after U.S. CPI inflation data for January was stronger than expected. U.S. 10-year Treasury yields jumped as markets priced out Fed rate cuts – bringing markets closer to our expectations for rate cuts. We think the quick recovery in stocks highlights that one data release is not enough to spoil positive market sentiment for now. The Fed starting to cut rates and inflation nearing 2% should support stocks in the near term, but we stay nimble.

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 Feb. 15, 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

Feb. 21	Euro area consumer confidence survey; Japan trade data
Feb. 22	Global flash PMIs
Feb. 23	Germany Ifo Business Climate Index

Global manufacturing and services activity is in focus this week, with global PMIs due for release, including for the U.S. and Europe. We look to the data as an early indication of Q1 GDP growth. We see interest rates in most developed markets remaining higher for longer than before the pandemic due to persistent inflationary pressures in the long term.

Big calls

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