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Weekly commentary

BlackRock

November 13, 2023

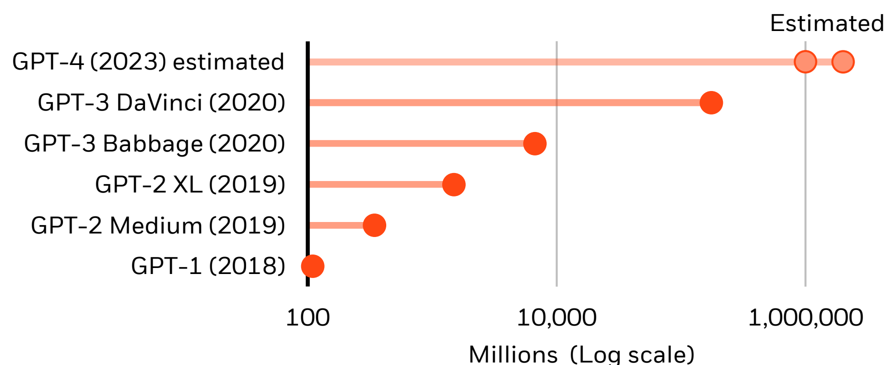
AI: a mega force driving returns

- We see artificial intelligence (AI) as a mega force shaping the new regime. We are overweight the AI theme in developed market stocks.
- U.S. stocks and 10-year Treasury yields both rose last week. We see investors demanding more compensation for the risk of holding long-term bonds.
- U.S. CPI data is in focus this week. The presidents of the U.S. and China will meet for a summit at a time of heightened strategic competition and tensions.

The buzz about AI is getting louder, with tech shares maintaining their outperformance and major players getting ready to roll out new AI tools. We see AI as one of five mega forces, or structural shifts that can drive returns now and in the future. We are overweight the AI theme in developed market (DM) stocks. We see the implications of AI going beyond pure technology companies, transcending sectors and geographies. See our new publication, AI – beyond the buzz, for details.

Exponential advances

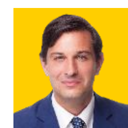
Number of parameters in selected Open AI GPT models, 2018-2023



Source: BlackRock Investment Institute with data from Open AI and Cornell University, November 2023. Notes: The chart shows the increase in parameters in selected iterations of Open AI's GPT models between 2018-2023. Data available on page 8 of this paper. Open AI has not disclosed details on the training data and architecture for GPT 4. The estimate is based on independent analysis, industry watchers and media reports, as well as cited in sell-side research including JPMorgan.

Advances in computing hardware and deep learning innovations led to an inflection point for AI in late 2022. We think we are at the dawn of an intelligence revolution – with exponential advances. For example, the number of "parameters" between OpenAI's ChatGPT-1 and GPT-4 models has likely surged exponentially in five years. See the chart. Parameters are elements of a model learned from historical data that allow it to generate text or multimedia content based on a prompt. The higher the number of parameters, the more sophisticated a model's understanding of patterns and the more nuanced its output. We expect exponential growth to persist. The tech sector is largely benefiting so far: Mega cap tech names account for most S&P 500 returns this year, yet when stripping out their impact broader stocks are down, LSEG data show. Mega cap tech stocks have outperformed by delivering on earnings, even with the yield jump that can hurt long-term valuations.

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute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We observe a fundamental shift in the tech industry towards AI-centric business models, igniting a competitive race among a handful of mega cap companies. We view this evolution in terms of a technology "stack," with increasingly foundational technologies appearing closer to the bottom. The first layer covers cloud infrastructure and chipmakers – the building blocks of computing power that have already begun to reap the benefits of AI advancements. The second layer covers models, data and data infrastructure. This layer may be underappreciated as demand for digital infrastructure like hardware, data and server farm locations is likely to outstrip supply. At the pinnacle of the stack are the applications that leverage these innovations. We think we are currently somewhere between the first and second layers, with the top layer likely coming next.

AI-powered automation has the potential to boost worker productivity, and may offer a competitive advantage to companies, sectors and economies that more adeptly adopt this technology. The implications may impact economies and markets faster than generally expected. AI's impact is set to span multiple domains, in our view, intersecting with mega forces like aging populations and geopolitical competition. Companies will likely succeed by attracting top talent and being able to invest in scaling up computational power to harness their data. The flood of AI patents may help identify some pioneers and laggards. Our research suggests there is a positive correlation between an uptick in AI patents and earnings growth in the one-to-two years after the patent registration. Our work also finds that private companies primarily produce AI patents, making private markets another way to tap into the AI theme. While not every patent leads to commercial success, the rising market value of AI patents indicates investor enthusiasm for the potential outsized returns for companies who are working to incorporate AI.

Like any technology, AI has adoption limits. Cybersecurity risks abound yet may spawn opportunities for consultancies or start-ups that specialize in setting up secure AI environments for other firms. Generative AI, which learns from massive data sets to create new content, still faces reliability issues. The tech can be prone to "hallucinations," generating outputs that aren't grounded in the input data. We think future versions will likely gradually improve. Global governments are trying to address the risks – potentially slowing adoption in some sectors – and shape AI business conduct, spurring opportunities.

Bottom line: AI's interaction with other technologies and mega forces is likely to yield the biggest investment opportunities, in our view. We see a multi-country and multi-sector AI-centered investment cycle unfolding that we think will support revenues and margins. We're overweight the AI theme in DM stocks on a six-to-12-month horizon as we see it set to keep unfolding.

Market backdrop

U.S. stocks gained and are up 7% from their October lows. U.S. 10-year yields edged up but are still below their 16-year highs hit last month. We think the yield volatility is one reason why investors are starting to demand more compensation for the risk of holding long-term bonds. U.S. Q3 corporate earnings results have showed a handful of mega cap stocks are still propping up earnings – and analysts are downgrading expected earnings due to the cautious tone from companies.

Assets in review

Selected asset performance, 2023 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 Nov. 9, 2023. 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 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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Macro take

Last week's Federal Reserve senior loan officer survey highlighted how tighter financial conditions are starting to crimp the U.S. economy.

Overall, the number of banks reporting tighter loan standards fell slightly but remained elevated. See the yellow line in the chart. We think the survey results are consistent with a sharp decline in actual bank lending.

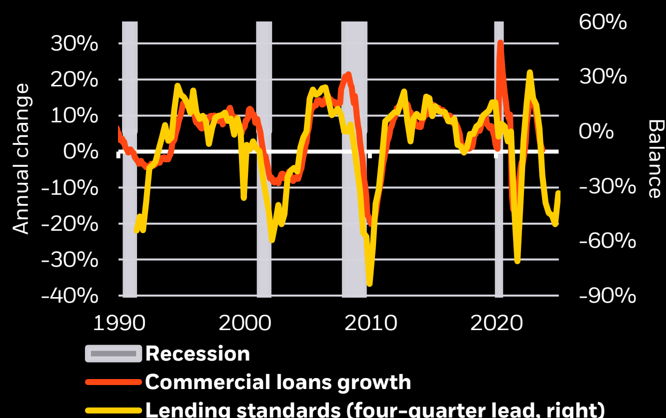
We're already seeing signs of that happening. Demand for loans fell in Q3 fell across a number of key categories: commercial real estate, household mortgages, and corporate and consumer loans. That fits with a picture of broader economic activity being subdued.

This shows the Fed's rapid rate hikes are indeed crunching demand. Along with a normalization of pandemic-induced supply shocks, we think it's another reason inflation should keep falling next year.

Read our latest Macro take post here.

Lending standards tighten

U.S. lending standards and commercial loans, 1990-2023



Source: BlackRock Investment Institute and Federal Reserve, with data from Haver Analytics, November 2023. Notes: The chart shows growth in commercial and industrial loans (orange, left-hand side), and results from FRB Senior Loan Officers Survey – net percentage balance tightening in standards for commercial and industrial loans to large and middle-market firms (yellow).

Investment themes

1 Holding tight

- The U.S. is navigating two large and unprecedented shocks. The first: A massive, pandemic-induced shift in consumer spending — most visible from services to goods – created a mismatch in what the economy was set up to produce and what people wanted to buy. The second: a worker shortage as baby boomers age into retirement.
- Our assessment is that we are set for "full-employment stagnation." Most of the inflation and wage growth we've seen to date reflects the mismatch associated with the pandemic. That is now reversing, and inflation is set to fall further. But as the process of resolving the mismatch ends and labor shortages start to bind, we expect inflation to go on a rollercoaster ride, rising again in 2024. A smaller workforce means the rate of growth the economy will be able to sustain without resurgent inflation will be lower than in the past.
- We see central banks being forced to keep policy tight to lean against inflationary pressures. This is not a friendly backdrop for broad asset class returns, marking a break from the four decades of steady growth and inflation known as the Great Moderation.
- **Investment implication:** Income is back. That motivates our overweight to short-dated U.S. Treasuries.

2 Pivoting to new opportunities

- Greater volatility has brought more divergent security performance relative to the broader market. Benefiting from this requires getting more granular and eyeing opportunities on horizons shorter than our tactical one. We go granular by tilting portfolios to areas where we think our macro view is priced in.
- We think dispersion within and across asset classes – or the extent to which prices deviate from an index – will be higher in the new regime amid the various crosscurrents at play, allowing for granularity. That offers more ways to build portfolio "breadth" via uncorrelated exposures, in our view.
- We think it also means security selection, expertise and skill are even more important to achieving above benchmark returns. Relative value opportunities from potential market mispricings are also likely to be more abundant.
- **Investment implication**: We like quality in both equities and fixed income.

3 Harnessing mega forces

- Mega forces are structural changes we think are poised to create big shifts in profitability across economies and sectors. These mega forces are digital disruption like artificial intelligence (AI), the rewiring of globalization driven by geopolitics, the transition to a low-carbon economy, demographic divergence and a fast-evolving financial system.
- The mega forces are not in the far future – but are playing out today. The key is to identify the catalysts that can supercharge them and the likely beneficiaries – and whether all of this is priced in today. We think granularity is key to find the sectors and companies set to benefit from mega forces.
- We think markets are still assessing the potential effects as AI applications could disrupt entire industries.
- Geopolitical fragmentation, like the strategic competition between the U.S. and China, is set to rewire global supply chains, we think.
- The low-carbon transition causing economies to decarbonize at varying speeds due to policy, tech innovation and shifting consumer and investor preferences. Markets have historically been slow to fully price in such shifts.
- We see profound changes in the financial system. Higher rates are accelerating changes in the role of banks and credit providers, shaping the future of finance.
- **Investment implication**: We are overweight AI as a multi-country, multi-sector investment cycle unfolds.

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Week ahead

Nov. 14	U.S. CPI; euro area and Japan GDP	**Nov. 17**	Euro area inflation
Nov. 15	Presidents Biden, Xi meet; UK CPI; Japan trade;		

We're watching U.S. inflation data this week to see how much inflation falls as pandemic-driven economic mismatches keep unwinding. Yet we think tight labor markets and a shrinking workforce will keep inflation on a rollercoaster. U.S.-China tensions will be in focus with Presidents Joe Biden and Xi Jinping set to meet at a summit in San Francisco.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 2023

Underweight | Neutral | Overweight | ● Previous view

	Asset	Strategic	Tactical	Commentary
Equities	Developed	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched. Tactically, we stay underweight DM stocks but upgrade Japan. We are underweight the U.S. and Europe. Corporate earnings expectations don't fully reflect the economic stagnation we see. We see other opportunities in equities.
	Emerging	Neutral	Neutral	Strategically, we are neutral as we don't see significant earnings growth or higher compensation for risk. We go neutral tactically given a weaker growth trajectory. We prefer EM debt over equity.
Developed market government bonds	Nominal	-1	Neutral	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. We stay strategically underweight U.S. nominal long-dated government bonds as we expect investors to demand more compensation for the risk of holding them. Tactically, we're neutral long-term Treasuries as the yield surge driven by expected policy rates approaches a peak. We're overweight euro area and UK bonds as we see more rate cuts than the market does.
	Inflation-linked	+3	Neutral	Our strategic views are maximum overweight DM inflation-linked bonds where we see higher inflation persisting – but we have trimmed our tactical view to neutral on current market pricing in the euro area.
Public credit and emerging market debt	Investment grade	-1	-2	Strategically, we're underweight due to limited compensation above short-dated government bonds. We're underweight tactically to fund risk-taking elsewhere as spreads remain tight.
	High yield	Neutral	-1	Strategically, we are neutral high yield as we see the asset class as more vulnerable to recession risks. We're tactically underweight. Spreads don't fully compensate for slower growth and tighter credit conditions we expect.
	EM debt	Neutral	+1	Strategically, we're neutral and see more attractive income opportunities elsewhere. Tactically, we're overweight hard currency EM debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
Private markets	Income	+1	–	We are strategically overweight private markets income. For investors with a long-term view, we see opportunities in private credit as private lenders help fill a void left by a bank pullback.
	Growth	-1	–	Even in our underweight to growth private markets, we see areas like infrastructure equity as a relative bright spot.

Note: Views are from a U.S. dollar perspective. 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.

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, November 2023

Underweight | Neutral | Overweight | ● Previous view

	Asset	View	Commentary
Equities	**Developed markets**		
	United States	-1	We are underweight the broad market – still our largest portfolio allocation. We don't think earnings expectations reflect the macro damage we expect. We recognize momentum is strong near term.
	Europe	-1	We are underweight. We see the European Central Bank holding policy tight in a slowdown, and the support to growth from lower energy prices is fading.
	UK	Neutral	We are neutral. We find that attractive valuations better reflect the weak growth outlook and the Bank of England's sharp rate hikes to deal with sticky inflation.
	Japan	+1	We are overweight. We think stronger growth can help earnings top expectations. Stock buybacks and other shareholder-friendly actions may keep attracting foreign investors.
	Pacific ex-Japan	Neutral	We are neutral. China's restart is losing steam and we don't see valuations compelling enough to turn overweight.
	DM AI mega force	+1	We are overweight. We see a multi-country and multi-sector AI-centered investment cycle unfolding set to support revenues and margins.
	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. Growth has slowed. Policy stimulus is not as large as in the past. Yet it should stabilize activity, and valuations have come down. Structural challenges imply deteriorating long-term growth. 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 is approaching a peak. We now see about equal odds that long-term yields swing in either direction.
	U.S. inflation-linked bonds	+1	We are overweight and prefer the U.S. over the euro area. We see market pricing underestimating sticky inflation.
	Euro area inflation-linked bonds	-1	We prefer the U.S. over the euro area. Markets are pricing higher inflation than in the U.S., even as the European Central Bank is set to hold policy tight, in our view.
	Euro area govt bonds	+1	We are overweight. Market pricing reflects policy rates staying higher for longer even as growth deteriorates. Widening peripheral bond spreads remain a risk.
	UK gilts	+1	We are overweight. Gilt yields are holding near their highest in 15 years. Markets are pricing in restrictive Bank of England policy rates for longer than we expect.
	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	-2	We are underweight. We take advantage of tight credit spreads to fund increased risk-taking elsewhere in the portfolio. We look to up the allocation if growth deteriorates.
	U.S. agency MBS	+1	We're overweight. We see agency MBS as a high-quality exposure within diversified bond allocations.
	Global high yield	-1	We are underweight. Spreads do not fully compensate for slower growth and tighter credit conditions we anticipate.
	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 emerging hard currency debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks start to cut policy rates.
	Emerging local currency	Neutral	We are neutral. Yields have fallen closer to U.S. Treasury yields. Plus, central bank rate cuts could put downward pressure on EM currencies, dragging on potential returns.

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