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Weekly commentary

BlackRock

July 8, 2024

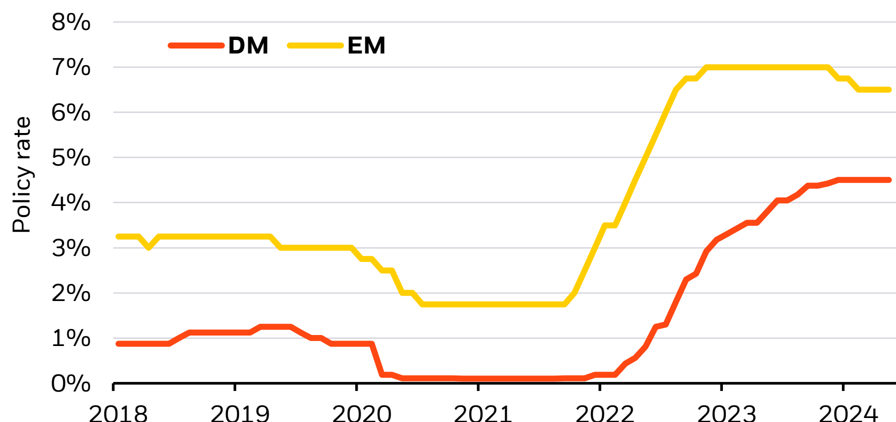
Taking a page out of the EM playbook

- Developed market central banks are starting to cut policy rates. We think they will have to keep them higher for longer, as some emerging markets already are.
- U.S. stocks hit a fresh record high and 10-year U.S. Treasury yields slid last week after U.S. jobs data showed moderating wage growth.
- We watch the U.S. CPI data for June this week to see where services inflation will settle. We think it will bounce back from its recent unusually low levels.

The Federal Reserve looks set to cut interest rates later this year, buoyed by inflation easing further after Q1 surprises, as this week's CPI data should reaffirm. Yet looking ahead, the Fed and its developed market (DM) peers will have to keep rates higher for longer as inflation settles above their 2% targets, we think. Some emerging market (EM) central banks are facing this fact, pausing their rate cuts with rates well above pre-pandemic norms. We lean into quality in fixed income.

EM central banks lead the way

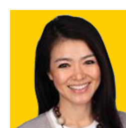
Median policy rate for developed versus emerging markets, 2018-2024



Source: BlackRock Investment Institute, with data from Bank for International Settlements, July 2024. Notes: The chart shows median central bank policy rates for developed markets (DMs) and emerging markets (EMs), on a monthly basis from 2018 to 2024.

Falling inflation has allowed DM central banks, like the European Central Bank, to start cutting rates recently. The Fed and Bank of England are likely to cut later this year. We think the odds of a Fed rate cut in September are marginally higher after the June U.S. job data. An average of about 180,000 monthly jobs have been added in the past three months – a level we think the economy can sustain for now without risking wage pressures given the surge in immigration. Yet we don't think that pace of immigration can persist. Plus, the pace of wage growth is still consistent with inflation above 2% in the medium term. The Fed has upped its long-term policy rate projections as it and its DM peers accept they'll have to keep rates higher for longer due to supply constraints. EM central banks have been ahead in both hiking and confronting that reality after the pandemic. See the chart.

Jean Boivin
Head – BlackRock Investment Institute



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Many EM central banks started cutting rates earlier this year – some as early as 2023 – as growth has moderated and with support from cooling inflation. Now those EM central banks are nearing the end of their easing cycles as they confront varied constraints on how much they can cut rates. EM central banks can only go so far in cutting rates, especially when DM central banks – notably the Fed – are holding interest rates steady or slow to cut. Such a policy divergence can hurt the local currency against the U.S. dollar, and some economies are more sensitive to the resulting inflation from a weaker currency.

Some EM central banks have highlighted other concerns as the driving force behind plans to pause rate cuts. Brazil's central bank held rates at 13.75% for a year after launching hikes in 2021 from a low of 2%. It has since cut rates to 10.5% as inflation has fallen to target. But it halted rate cuts in June, citing questions over the impact of loose government fiscal policy on inflation. Poland's central bank has frozen rates at 5.75% since October after two rate cuts. Why? Uncertainty over how the government ending measures to shield households from high energy costs will affect inflation, prompting the Polish central bank to boost its inflation forecast for next year. We see both EMs and DMs facing structural sources of higher inflation after the pandemic, including elevated public debt and geopolitical tensions leading to a rewiring of supply chains.

Higher-for-longer rates does not have to be bad news for risk assets, as we've seen this year. Top tech firms beating earnings expectations due to the artificial intelligence theme helped push stocks to record highs even as bond yields have risen on reduced Fed rate cut expectations. We stay overweight U.S. stocks and prefer quality income in short-term government bonds and credit. We went overweight EM hard currency debt, typically issued in dollars, in August 2023 just as EM central bank rate cuts were gearing up. We expected local currencies to fall against the dollar, hurting EM local currency debt. As that played out, EM hard currency debt has performed well. But we're reassessing our view as EM central banks pause rate cuts.

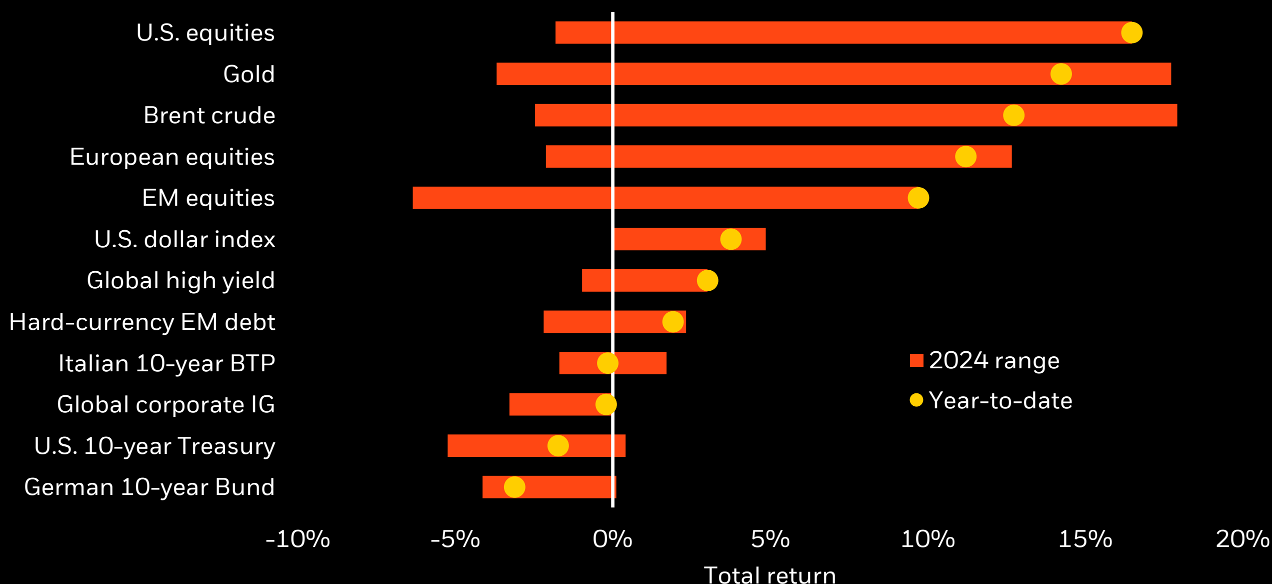
Bottom line: We think DM central banks will keep policy rates higher for longer than before the pandemic – just like EM central banks are doing now. We stay overweight EM hard currency debt yet stand ready to pivot as central banks shift policy.

Market backdrop

U.S. stocks hit a fresh record high and gained nearly 2%. Ten-year U.S. bond yields slid to 4.27% after the June U.S. jobs report and are in a rough 4.20-4.50% range over the past month. The data showed moderating wage growth but still at levels consistent with inflation staying above 2%. UK stocks were little changed after the Labour Party's landslide election victory. France's main stock index rose nearly 3% on the week before the final round of the parliamentary election.

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 July 4, 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

July 10	China CPI and PPI; Japan corporate goods prices	**July 12**	U.S. University of Michigan consumer sentiment survey; China trade data
July 11	U.S. CPI	**July 10-17**	China total social financing

June U.S. CPI is in focus this week as Fed officials have reaffirmed that the central bank's next move depends on data. Core services inflation, excluding housing, is proving volatile. It was unusually low in May but is likely to bounce back, so we're watching to see if it settles at a level consistent with 2% inflation.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, July 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 stocks 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.
Fixed income granularity	• We prefer inflation-linked bonds as we see inflation closer to 3% on a strategic horizon. We also like short-term government bonds, and the UK stands out for long-term bonds.
Equity granularity	• We favor emerging over developed markets yet get selective in both. EMs at the cross current of mega forces – like Mexico, India and Saudi Arabia – offer opportunities. In DM, we like Japan as the return of inflation and corporate reforms brighten our outlook.

Note: Views are from a U.S. dollar perspective, July 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 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, July 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 the 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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