

# Weekly commentary

July 29, 2024

**BlackRock**

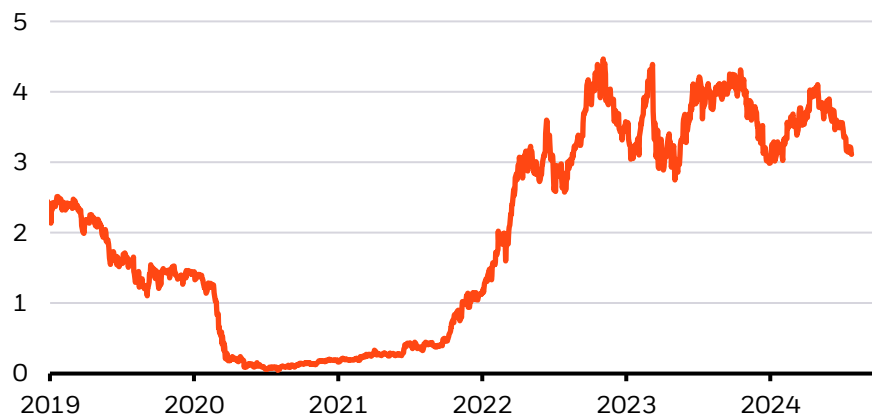
## Steering through market air pockets

- We see recent market volatility tied to near-term sentiment shifts rather than corporate earnings and macro data. We prefer to look through these air pockets.
- U.S. stocks fell for a second straight week, with the S&P 500 suffering its largest one-day drop since late 2022. Risk assets made up some ground by week's end.
- The Federal Reserve, Bank of Japan and Bank of England all meet this week. The Fed may signal a first cut in September, while the BOJ could hike again.

We've argued that markets are vulnerable to sudden risk sentiment shifts over short periods as has played out recently. Hopes for more Federal Reserve rate cuts, combined with another potential Bank of Japan hike, led to a yen surge and knock-on effects. Yet these Fed rate cut hopes have not driven a broad risk rally. Instead, we've seen markets grapple with tech's return potential on artificial intelligence (AI) – and this is driven more by sentiment than earnings prospects, in our view.

## Shrinking rate advantage

Spread between Fed and BOJ expected policy rates, 2019-2024



Source: BlackRock Investment Institute, with data from LSEG Datastream, July 2024. Notes: The chart shows the difference in the pricing of expected policy rates in the U.S. and Japan based on forward overnight index swaps. The rate is the one-year OIS rate expected starting one year from now.

The market volatility comes as the Fed could this week signal a first policy rate cut in September and markets are pricing in multiple cuts through next year. Pricing of Fed rate cuts should have been positive for U.S. risk assets – and yet last week the S&P 500 suffered its worst daily session since 2022. Stocks pulling back even as markets price in more Fed rate cuts is a sign momentum trades had run too far and were poised for a short-term reversal – and markets are still extrapolating too much from near-term macro news, as we have argued. The BOJ could hike for a second time this year Wednesday. That means the gap in Fed and BOJ expected policy rates, a big driver in the yen's drop to a 35-year low, is narrowing. See the chart. The yen's resulting surge caused investors to unwind positions using the low-yielding yen to buy higher-yielding currencies – what's known as the carry trade.



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One sign of yen-funded carry trades coming under strain: As the yen surged this month, leveraged funds closed their short-yen positions – used to fund a carry trade – at the quickest pace since 2011, CFTC data show. Such a sharp unwind may have been a technical factor driving some of the market volatility and air pockets. The yen’s popularity as a funding currency can cause knock-on effects in other markets, helping tighten global financial conditions. Technical factors like thinner trading activity in the northern hemisphere summer, the two-week buyback blackout period ahead of Q2 earnings and stretched positioning in U.S. equities have likely amplified these effects. We avoid getting caught in short-term crosscurrents by sticking to our framework. We don’t see the BOJ driving further sharp yen gains and expect it to go slow in normalizing policy.

The carry trade unwind is just one part of a broader global risk reassessment, in our view. Market sentiment has shifted on AI companies in the spotlight. Tech shares have retreated in recent weeks on concerns over further U.S. restrictions on chip exports to China and questions about the future returns major tech companies will achieve on their heavy AI investment. We had warned the outsized performance of AI winners made them susceptible to near-term pullbacks. Yet we still see AI supported by strong earnings. More broadly, Q2 corporate earnings have topped expectations so far, with S&P 500 earnings growth projected at about 13%, above the 9% expected at the start of the season, LSEG Datastream data show.

Bouts of volatility like we’ve seen are a defining feature of the new macro and market regime, we think. We eye opportunities that hinge on the real economy. The recent upside surprise in U.S. Q2 GDP growth, supported by capital spending on AI – on top of the investment in buildings and infrastructure tied to earlier policy incentives such as the CHIPS Act – is a sign of the transformation underway, in our view. We’re focusing on potential policy changes in the upcoming U.S. election, with Vice President Kamala Harris now set to be the Democratic candidate taking on former President Donald Trump in November.

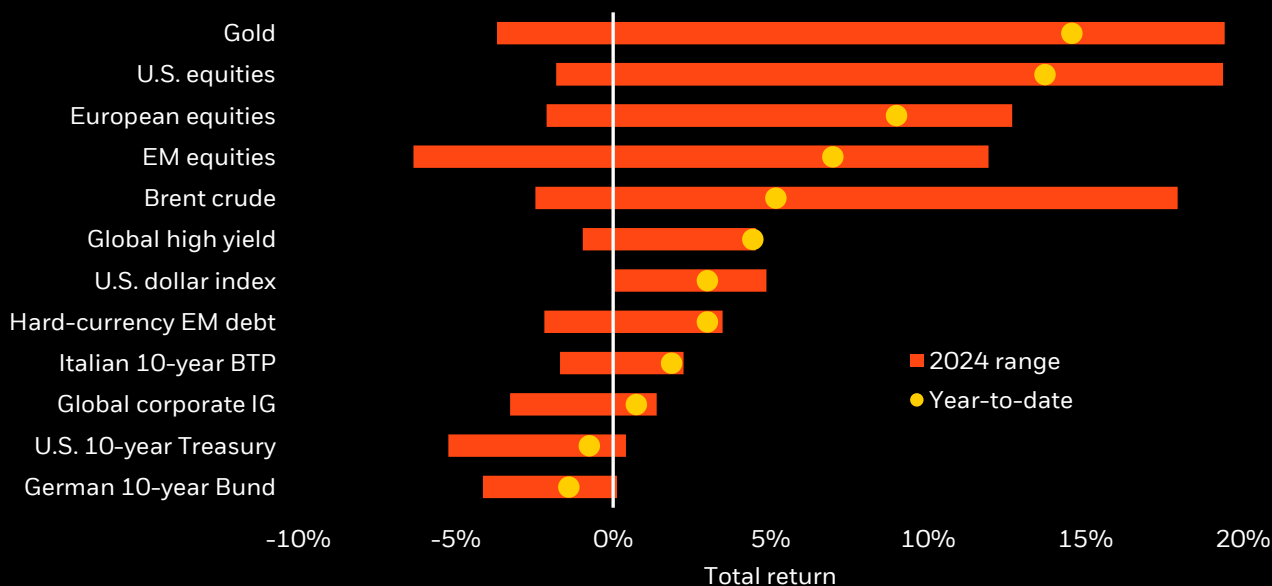
Bottom line: We see central bank policy expectations, equity factor rotations and currency moves driving the recent market volatility. We caution against extrapolating from these moves. We key on earnings and the real economy for opportunities.

## Market backdrop

U.S. stocks fell for a second straight week, led by technology names. The rotation into smaller companies carried on due to jitters about whether big tech firms can deliver on their heavy AI investment. We think the disconnect between stocks and U.S. 10-year Treasury yields – holding around 4.21% – reveal momentum and technical factors at work. We have expected spurts of near-term volatility as markets grapple with uncertainty on many fronts. The Japanese yen surged versus major currencies.

## 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 25, 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

<b>July 30</b>	U.S. consumer confidence; euro area GDP	<b>Aug. 1</b>	Bank of England (BOE) policy meeting
<b>July 31</b>	Fed policy meeting; BOJ policy meeting; euro area inflation	<b>Aug. 2</b>	U.S. payrolls data

Central banks take center stage this week as the Fed, BOE and BOJ meet. Markets will be parsing signals for future Fed rate cuts this year, as Chair Jerome Powell has hinted cuts could come before inflation hits the 2% target. We think falling inflation has made a September cut more likely. Markets are torn on whether the BOE will cut this week. Even if central banks start to ease policy, we expect higher-for-longer rates due to persistent inflation pressures.

## Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, July 2024

Tactical	Reasons
AI and U.S. equities	<ul style="list-style-type: none"> <li>We have high conviction that AI can keep driving returns in most scenarios. We see its buildout and adoption creating opportunities across sectors. The AI theme has driven U.S. stock gains and solid corporate earnings, making us overweight U.S. stocks overall.</li> </ul>
Japanese equities	<ul style="list-style-type: none"> <li>This is our highest conviction equity view thanks to support from the return of mild inflation, shareholder-friendly corporate reforms and a Bank of Japan that is cautiously normalizing policy – rather than tightening.</li> </ul>
Income in fixed income	<ul style="list-style-type: none"> <li>The income cushion bonds provide has increased across the board in a higher rate environment. We like quality income in short-term bonds and credit. We're neutral long-term U.S. Treasuries.</li> </ul>
Strategic	Reasons
Private credit	<ul style="list-style-type: none"> <li>We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to public credit risk.</li> </ul>
Fixed income granularity	<ul style="list-style-type: none"> <li>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.</li> </ul>
Equity granularity	<ul style="list-style-type: none"> <li>We favor emerging over developed markets yet get selective in both. EMs at the cross current of mega forces – like India and Saudi Arabia – offer opportunities. In DM, we like Japan as the return of inflation and corporate reforms brighten our outlook.</li> </ul>

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.

# 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
<b>Equities</b>					
<b>Developed markets</b>					
United States					We are overweight given our positive view on the AI theme. Valuations for AI beneficiaries are supported as tech companies keep beating high earnings expectations. We think upbeat sentiment can broaden out. Falling inflation is easing pressure on corporate profit margins.
Europe					We are underweight relative to the U.S., Japan and the UK – our preferred markets. Valuations are fair. A growth pickup and European Central Bank rate cuts support a modest earnings recovery. Yet political uncertainty could keep investors cautious.
UK					We are overweight. Political stability and a growth pickup could improve investor sentiment, lifting the UK’s low valuation relative to other DM stock markets.
Japan					We are overweight. Mild inflation and shareholder-friendly reforms are positives. We see the BOJ normalizing policy – not tightening aggressively. A weak yen is a drag on returns for international investors.
<b>Emerging markets</b>					
China					We are neutral. We see risks from weak consumer spending, even with measured policy support. An aging population and geopolitical risks are structural challenges.
<b>Fixed Income</b>					
Short U.S. Treasuries					We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer.
Long U.S. Treasuries					We are neutral. Markets have cut expectations of Fed rate cuts and term premium is close to zero. We think yields will keep swinging in both directions on new economic data.
Global inflation-linked bonds					We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
Euro area govt bonds					We are neutral. Market pricing reflects policy rates in line with our expectations and 10-year yields are off their highs. Political uncertainty remains a risk to fiscal sustainability.
UK gilts					We are neutral. Gilt yields have tightened to U.S. Treasuries and market pricing of future yields is in line with our view.
Japanese govt bonds					We are underweight. Stock returns look more attractive to us. We see some of the least attractive returns in JGBs.
China govt bonds					We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
U.S. agency MBS					We are neutral. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG.
Short-term IG credit					We are overweight. Short-term bonds better compensate for interest rate risk. We prefer Europe over the U.S.
Long-term IG credit					We are underweight. Spreads are tight, so we prefer taking risk in equities from a whole portfolio perspective. We prefer Europe over the U.S.
Global high yield					We are neutral. Spreads are tight, but the total income makes it more attractive than IG. We prefer Europe.
Asia credit					We are neutral. We don’t find valuations compelling enough to turn more positive.
Emerging hard currency					We are neutral. The asset class has performed well due to its quality, attractive yields and EM central bank rate cuts. We think those rate cuts may soon be paused.
Emerging local currency					We are neutral. Yields have fallen closer to U.S. Treasury yields, and EM central banks look to be turning more cautious after cutting policy rates sharply.

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