

# Weekly commentary

August 12, 2024

**BlackRock**

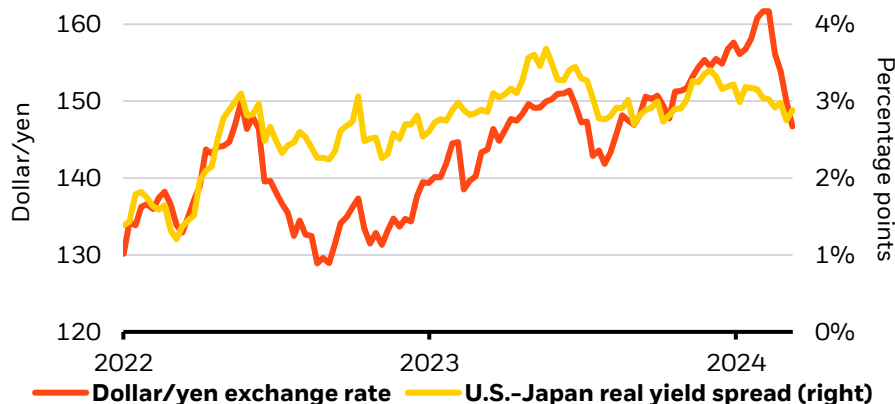
## Sticking with risk through turbulence

- Recent extreme market volatility show the impact of sudden sentiment shifts and sharp position unwinds. We lean into risk and our high-conviction ideas.
- U.S. and Japanese stocks clawed back after a record three-day slide in Japan. The yen slipped back after surging to seven-month highs against the dollar.
- The July U.S. CPI is in focus. Recent inflation and jobs data stoked expectations of sharp rate cuts. We see cuts ahead but rates settling higher for longer.

We had warned risk sentiment shifts and stretched positioning could lead to market air pockets of volatility. That played out as the yen surged and Japanese stocks suffered their worst three-day stretch ever, forcing the Bank of Japan to walk back a hawkish policy shift. We stay overweight Japanese equities as a result. In the U.S., macro data shows a slowdown, not a recession, in our view. We keep our overweight to U.S. stocks and are encouraged by upbeat tech earnings.

## A resurgent yen

U.S. dollar/yen exchange rate & U.S.-Japan real yield spread, 2022-2024



Past performance is not a reliable indicator of current or future results. Source: BlackRock Investment Institute, with data from LSEG Datastream, August 2024. Notes: The chart shows the exchange rate of U.S. dollars to Japanese yen and the difference between the real U.S. five-year Treasury yield and the real Japanese five-year government bond yield.

Unwinds of stretched positions, U.S. recession fears and policy uncertainty have sparked big market swings – exacerbated by thin trading activity. The BOJ’s sudden willingness to incorporate the yen as a factor in setting policy accelerated an unwind of carry trades that use the low-yielding yen to buy other assets. Speculators scrambling to close their short-yen positions drove one of the largest unwinds in yen futures on record in the past few weeks, according to CFTC data. Just how much of the carry trade has unwound is hard to quantify given the over-the-counter nature of many yen-funded positions. Yet the sharp closing of the gap between currency and rate spreads – see the chart – and rapid cutting of futures positions suggest a major unwind. Another position unwind – equity dispersion trades tied to index and single-stock volatility – magnified the stock slide.



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Up until recently the BOJ had been deliberate in trying to normalize policy without jeopardizing Japan’s return of inflation. Then came its sudden rate hike in July and blurring of its policy framework, including the yen as a factor. The rise of a BOJ policy misstep prompted us to reconsider our positive view on Japan. Yet we felt the BOJ would be forced to walk back – and did. We think the BOJ will now proceed cautiously on policy, so we stay overweight Japanese stocks on a currency-unhedged basis. Further carry trade unwinding and yen strengthening is a risk. Yet we like the virtuous circle of inflation driving wage growth – and thus corporate pricing power and earnings. Corporate reforms aimed at adding shareholder value are also key.

While Japan bore the brunt of last week’s turbulence, U.S. recession fears sparked the latest slide after U.S. payrolls data for July showed an uptick in the unemployment rate. Yet the unemployment rate is still remarkably low by historical standards – and it’s rising because of a growing labor force tied to immigration, not because of job losses. Total U.S. payrolls have grown more than 1 million over the past six months, well above usual pre-recession levels. The latest jobless claims, ISM services data and Fed bank lending survey all paint the picture of an economy that is slowing, not approaching recession, in our view.

Stronger-than-expected U.S. corporate earnings, especially in tech, reaffirm our positive U.S. view. To date, Q2 earnings growth for tech versus non-tech sectors sits at 20% and 5%, respectively – up from expectations of 18% and 2% at the start of earnings season, according to LSEG Datastream data. While tech is leading the charge, non-tech sectors are poised to log their first earnings growth since late 2022, a sign strong earnings may be broadening out. Easing cost pressures and moderating inflation have benefited U.S. corporates. We stay overweight U.S. stocks and the artificial intelligence (AI) theme.

Bottom line: We could still see air pockets of volatility in thin summer trading conditions. Rather than dialing back risk, we lean into our highest-conviction ideas. We stay overweight Japanese and U.S. stocks, and favor the AI theme in the U.S.

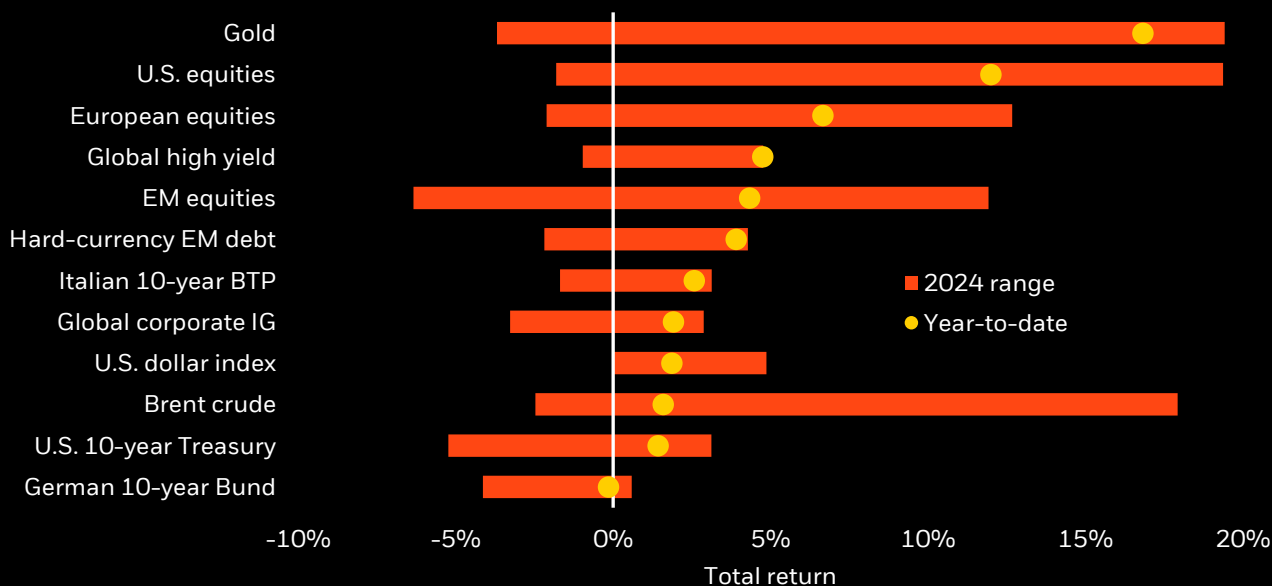
Note: The *Global weekly commentary* will resume on Tuesday, Sept. 3. But we will be responding to market volatility if it resumes, such as with [our recent BlackRock Bulletin](#).

## Market backdrop

U.S. stocks were flat last week, clawing back losses from Monday’s slide when Japan’s Topix plunged 12% for a record three-day drop. U.S. 10-year Treasury yields rose roughly 30 basis points from 14-month lows hit Monday during the worst of the tumult. Lower-than-expected U.S. weekly jobless claims helped alleviate recession fears, which we had flagged as overdone anyway. The yen eased from seven-month highs against the U.S. dollar, easing pressure on the unwind of carry trades.

## 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 Aug. 8, 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

**Aug. 13**

UK labor market release

**Aug. 15**

Philadelphia Fed business index; UK GDP; Japan GDP

**Aug. 14**

U.S. CPI; UK CPI

**Aug. 12-19**

China Total Social Financing

July U.S. CPI is in focus this week. Inflation below expectations and soft July U.S. payrolls data have radically shifted the Fed and market narrative. Both services and shelter inflation have come down materially in recent data, and wage inflation has eased to its softest pace since 2020. Yet we are not convinced inflation will ultimately come down in line with the Fed's 2% target.

## Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, August 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>A brighter outlook for Japan's economy and corporate reform are driving improved earnings and shareholder returns. We think the Bank of Japan will now be cautious in normalizing policy after its misstep in July.</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 intermediate credit, which offers similar yields with less interest rate risk than long-dated credit. We also like short-term government bonds, and UK 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, August 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, August 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. A brighter outlook for Japan’s economy and corporate reform are driving improved earnings and shareholder returns. We think the Bank of Japan will now be cautious in normalizing policy after its misstep in July.
<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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