

Weekly commentary

July 22, 2024

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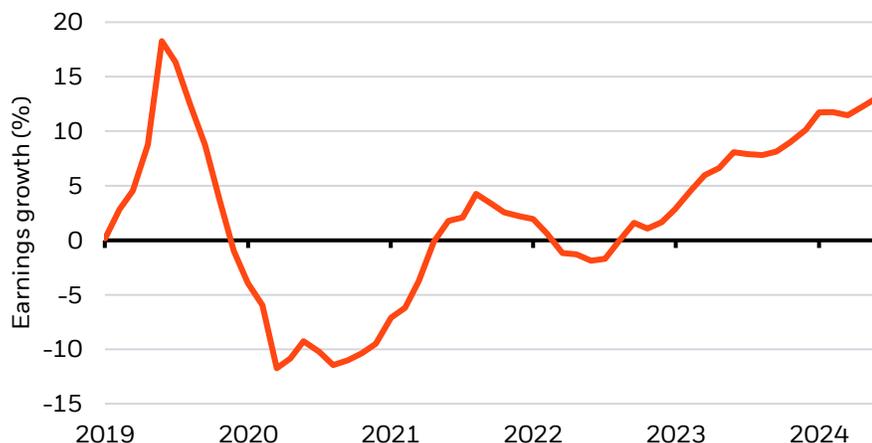
Tech still likely to deliver on earnings

- We think major tech firms can keep delivering on high corporate earnings expectations. We stay positive on stocks and the artificial intelligence theme.
- U.S. stocks retreated last week, led by technology. We see some bouts of volatility ahead over the short term. Stocks of smaller-sized firms rose further.
- We're eyeing how a surprisingly soft U.S. CPI report translates into PCE data. We think cooling inflation means the Fed can start cutting rates in coming months.

A tech-driven pullback has hit stocks this month as investors piled into segments like smaller companies on hopes for cooling inflation and Federal Reserve interest rate cuts. Looking through this near-term noise, we think tech will drive returns as consensus expects big tech companies to carry positive earnings results for the market. We see pullbacks as an opportunity to lean into stocks. We stay overweight the AI theme and U.S. stocks as we watch for the AI buildout to boost other sectors.

Tech vs. the rest

Earnings expectations for S&P 500 tech sector over other sectors, 2019-2024



Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, with data from LSEG Datastream, July 2024. Notes: The chart shows the gap between 12-month forward earnings expectations for the S&P 500 tech sector over other sectors, using monthly data.

Tech stocks have led the U.S. equity retreat from record highs, reached on hopes for big tech companies to keep beating high earnings expectations thanks to the AI theme. Stocks for debt-laden and interest rate-sensitive small companies surged 3.7% after the soft June CPI data reignited market hopes for quicker Fed rate cuts. We expect this rebound to be short lived as central banks likely hold rates higher for longer given persistent inflation pressures. Rather than the macro, we think the market is being driven by structural shifts like AI that are spurring a transformation. We're monitoring the impact on Q2 earnings. Why? Consensus forecasts for tech earnings have risen well above those for the rest of the S&P 500. See the chart. That's still playing out: Analysts see tech earnings growing 18% year over year in Q2 versus 2% for the rest of the index, LSEG Datastream data show.



Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute



Helen Jewell
Chief Investment Officer EMEA, Fundamental Equities – BlackRock



Natalie Gill
Portfolio Strategist – BlackRock Investment Institute



Carolina Martinez Arevalo
Portfolio Strategist – BlackRock Investment Institute

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Such forecasts set a high bar for tech companies to keep delivering on earnings. We think they can, but more volatility could be ahead with Nvidia's highly expected results due in late August. We especially see sudden pullbacks during the northern hemisphere summer, when reduced trading activity can exacerbate market volatility. The tech sector could also suffer if investors worry earnings growth won't justify big capital spending on AI. Those worries likely contributed to the share drop for major chipmakers – on top of news of potential U.S. efforts to further limit foreign access to chips. Any trade or regulatory policy changes after the U.S. election in November that restrict the AI buildout could hurt tech, too. U.S. President Joe Biden's announcement over the weekend that he will drop out of the presidential race may add to volatility, although pressure had been building in recent weeks. We monitor these risks while staying overweight the AI theme – and for now see sudden pullbacks as an opportunity to dial up risk-taking. This environment requires a new investment playbook.

The earnings lead for the tech sector could narrow later this year as analysts expect earnings to improve in other sectors. We see the buildout of AI boosting sectors such as industrials, materials, energy and healthcare as it helps drive a transformation potentially on par with past technological revolutions. We don't believe the rally in U.S. small capitalization stocks is part of this eventual earnings improvement. They are more sensitive to higher interest rates and not exposed to the drivers of the transformation we expect. Case in point: U.S. small caps have suffered five quarters of shrinking earnings due to higher rates.

Regionally, we see selective opportunities in Europe as lower interest rates support growth and already improving earnings. At the sector level, we were more positive on banks earlier in the year given their resilient balance sheets. Relative valuations now look pricier. We prefer construction, utility and semiconductor companies that benefit from rate cuts and mega forces. We also went overweight UK stocks because post-election political stability and recovering growth could boost valuations.

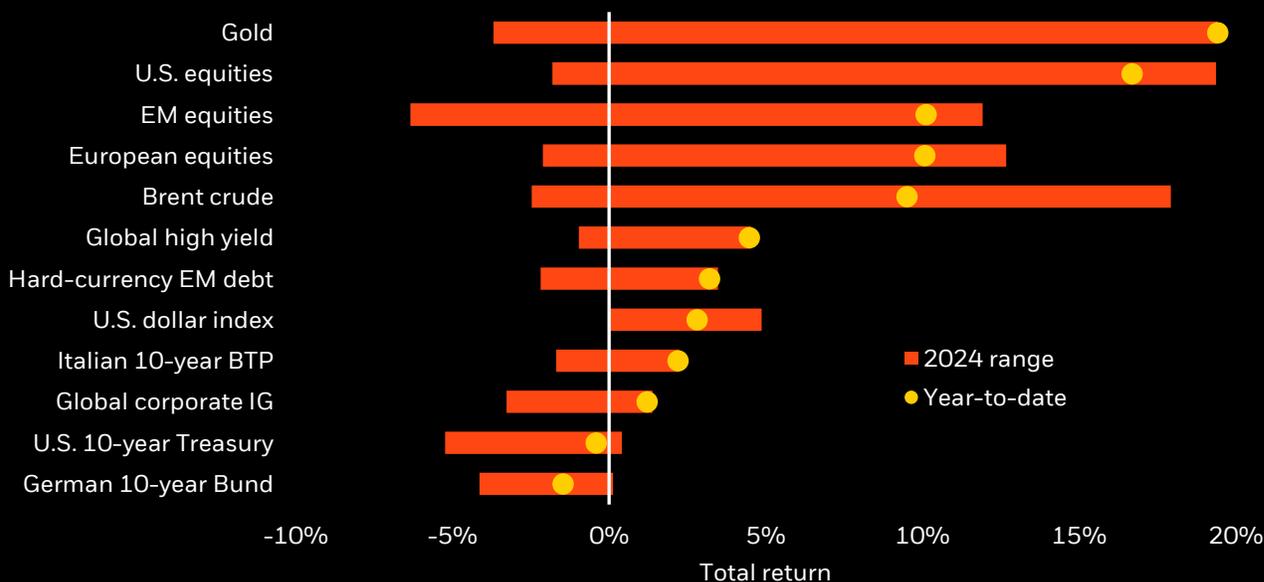
Bottom line: We lean against the market extrapolating too much from a single data release like the CPI. We expect big tech firms to keep driving equity returns. We stay overweight U.S. stocks and the AI theme.

Market backdrop

U.S. stocks pulled back from record highs last week. Technology names led the retreat, driven by concerns over potentially stronger restrictions on semiconductor exports to China. A global IT outage stoked further unease. We expect some bouts of volatility ahead, as reflected in the surge in small cap shares. U.S. 10-year Treasury yields edged up on the week – showing that investors were not viewing this equity rotation and volatility as a pure risk-off episode, in our view.

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 18, 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

| | | | |
|----------------|-------------------------------|----------------|--|
| July 23 | Euro area consumer confidence | July 25 | U.S. GDP and durable goods data; Japan service PPI |
| July 24 | Global flash PMIs | July 26 | U.S. core PCE; Tokyo CPI |

We're watching July U.S. PCE data – the Fed's preferred inflation measure – to see if the decline in CPI services inflation is repeated. June saw core services inflation, excluding housing, fall for a second month straight. We think the recent slowdown in services inflation is not consistent with current wage gains. We still expect the Fed to cut rates in 2024, but to levels higher than pre-pandemic.

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"> 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. |
| Japanese equities | <ul style="list-style-type: none"> 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. |
| Income in fixed income | <ul style="list-style-type: none"> 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. |
| Strategic | Reasons |
| Private credit | <ul style="list-style-type: none"> 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 | <ul style="list-style-type: none"> 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 | <ul style="list-style-type: none"> 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. |

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 |
| Equities | | | | | |
| Developed markets | | | | | |
| 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. |
| Emerging markets | | | | | |
| 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. |
| Fixed Income | | | | | |
| 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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