Weekly commentary

BlackRock

April 29, 2024

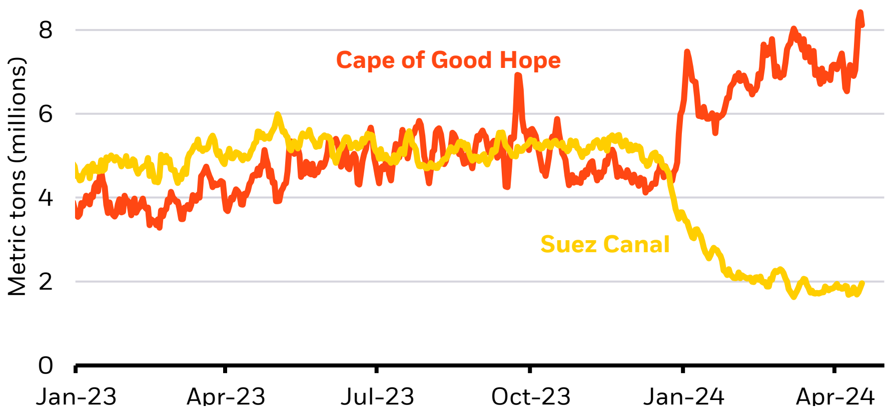
Mega forces: why they matter now

- Geopolitical risk has escalated in the Middle East. The flare-up of tensions in the region and brief market fallout underscore that mega forces affect returns now.
- U.S. stocks rose last week on mostly strong Q1 earnings for mega cap tech. The Federal Reserve's preferred inflation metric rose more than expected in March.
- This week, we watch U.S. payroll data for signs that immigration is still offsetting adverse demographics. The Federal Reserve is expected to hold rates steady.

We have long viewed the world through the lens of mega forces, or big structural shifts. They help explain macro and market outcomes not only long term, but right now. Geopolitical fragmentation is one of five mega forces we track. The strikes between Israel and Iran – and the market response – are one example of how mega forces impact returns now. Most of these mega forces create supply constraints. Yet a productivity boom from artificial intelligence could ease these constraints.

Taking the long way round

Daily transit trade volumes, 2023-2024



Source: United Nations Global Platform; PortWatch, April 2024. Notes: The chart shows the seven-day moving average of daily transit trade through the Suez Canal and the Cape of Good Hope, since January 2023.

We see escalating tensions in the Middle East as a sign we're in a new geopolitical regime. The first direct strikes between Israel and Iran structurally raise risk in the region, in our view. The strikes come as Iran has used proxy attacks by the Houthi rebels on ships in the Red Sea as a response to the war in Gaza. These attacks upended supply chains, diverting swathes of goods from the Suez Canal to the Cape of Good Hope. See the chart. Since the attacks began, shipping costs from China are still up about 75% from the end of last year, LSEG Datastream data show. Persistent supply constraints that keep inflation and interest rates above pre-pandemic levels are an upshot of our mega force view. The International Monetary Fund's recent discussions on the growth impact of structural challenges – like geopolitical risk and other mega forces – reflect similar thinking to ours.

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Since we rolled out our mega forces framework last year, we have seen more evidence that these forces are a useful investment lens. We think the geopolitical turmoil in the Middle East has lowered the bar for escalation in the region - upping the chances of persistently higher oil prices. Commodity shocks reinforce why governments are prioritizing energy security and affordability alongside decarbonization. The recent events show traditional energy still has its place, even in the low-carbon transition – and can be a buffer against geopolitical risk.

Population aging is another example of supply constraints playing out in real time. Shrinking working-age populations in developed markets are limiting productivity and output. An unexpected jump in immigration in the U.S. and other major economies offsets the impact of a dwindling domestic workforce for now. Yet we find this effect must persist for some time to outrun adverse demographics. We look to this week's U.S. payroll data for signs immigration is still supporting labor markets.

A resilient U.S. jobs market marked by persistent wage gains is keeping services inflation elevated. Markets now expect fewer than two Federal Reserve rate cuts in 2024, down from seven earlier this year. Higher-for-longer rates could keep squeezing bank deposits, where interest rates have lagged the Fed policy rate – unlike yields on money market funds. Plus, banks face stricter regulations. We like private credit – where default rates have fallen three quarters in a row – over public on a strategic horizon of five years and longer. Private markets are complex, with high risk and volatility, and aren't suitable for all investors.

One mega force that could ease supply constraints? AI. We think AI could deliver strong efficiency gains across sectors. We watch for AI adoption to broaden beyond tech – into sectors like healthcare, communication services and financials, and into applications like data centers and infrastructure. We see a high bar for Q1 mega cap tech earnings to beat lofty expectations. Early results have skewed positive – yet any signs of weakness could trigger a change in our U.S. stock view.

Bottom line: Mega forces provide a useful investment lens now, not just in the future, we think. We like energy stocks as a buffer against geopolitical risk. We prefer private credit over public on a strategic horizon. We stay overweight the AI theme.

Market backdrop

The S&P 500 broke a three-week losing streak last week and rose 3%, while U.S. 10-year Treasury yields hit new 2024 highs. The Federal Reserve's preferred inflation metric rose more than expected in March, supporting our higher-for-longer interest rate view. U.S. mega cap tech led a strong start to Q1 earnings – we think sticky inflation raises the bar for earnings to keep delivering and supporting sentiment. The Bank of Japan kept rates steady as expected, driving the yen to a new 34-year low.

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 April 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

April 30	U.S. ECI wage data; euro area flash inflation and Q1 GDP	**May 2**	U.S. trade data
May 1	Fed policy decision	**May 3**	U.S. payrolls data

The Fed policy decision, U.S. wage and payrolls data are in focus this week. The Fed is widely expected to hold interest rates steady at this week's meeting, and we look for signs of how the Fed has dialed back its own projections for three rate cuts this year. One important input for the Fed: the Q1 ECI, its preferred wage gauge. We eye signs of wage pressures easing and the potential knock-on effect on inflation. The payrolls data rounds out a busy week.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, April 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 equities 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.
Inflation-linked bonds	• We see inflation staying closer to 3% in the new regime on a strategic horizon.
Short- and medium-term bonds	• We overall prefer short-term bonds over long term. That's due to more uncertain and volatile inflation, heightened bond market volatility and weaker investor demand.

Note: Views are from a U.S. dollar perspective, April 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 that 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, April 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.
	United States	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, strong earnings growth and shareholder-friendly reforms are all 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 its 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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