Investment Directions

BlackRock

2025: Exposures for today's markets

At a moment of economic transformation, investing itself is changing, the BlackRock Investment Institute (BII) explains in its Global Outlook – and this may require investors to rethink their approach to portfolios. In *Investment Directions*, we highlight potential opportunities across asset classes and strategies, all connected by an overarching view on positioning portfolios for today's markets. We retain tactical conviction in US stocks and see a need for increasing selectivity elsewhere. Duration isn't delivering the reliable diversification it used to, particularly in the US, so we focus on spread income in fixed income. This results in greater exposure to economic growth, doubling up on the main risk driver behind equity allocations. Investors may therefore need to rethink diversification, through liquid alternatives. Meanwhile, inflation and fiscal risks mean we lean towards a broader set of diversifiers, including scarce assets. Higher-for-longer interest rates also mean a higher performance bar, calling for greater focus on return enhancers, which may include private markets and exposures geared towards mega forces such as AI.

Equity

Focus on the US & selective elsewhere

The US stood out in 2024 vs. other regions: within our high-conviction view on US stocks, we favour a building block approach, sizing exposure to mega caps and the equal-weight S&P 500 (p. 2). We take a selective approach to equities beyond the US, focusing on company-level rather than broad market risk (p. 3).

Fixed income

Carry with quality

We focus globally on spread income in fixed income, rather than duration, given US fiscal policy and sticky inflation (p. 4). Yet we still see opportunities in EUR rates and high yield (HY) as European Central Bank (ECB) rate cuts continue, and selectively in emerging market debt (EMD), amid US dollar strength and prospective tariffs (p. 5).

Diversifiers & enhancers

Managing beta

Less-reliable duration and higher volatility make the case for careful diversification. Investors can take down broad market beta and replace with uncorrelated alpha risk with diversifying liquid alternatives (p. 6). Gold and digital assets offer ways to hedge inflation and geopolitical risks (p. 6).

Enhancing potential returns

We see upside from many of the mega forces transforming economies but get more selective as they start to be more appreciated by markets (p. 7). The opportunity set is increasingly in private markets: reconfiguring portfolios to include private assets may enhance risk-adjusted returns (p. 8).

All figures are in US dollars, unless stated otherwise.
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Equity

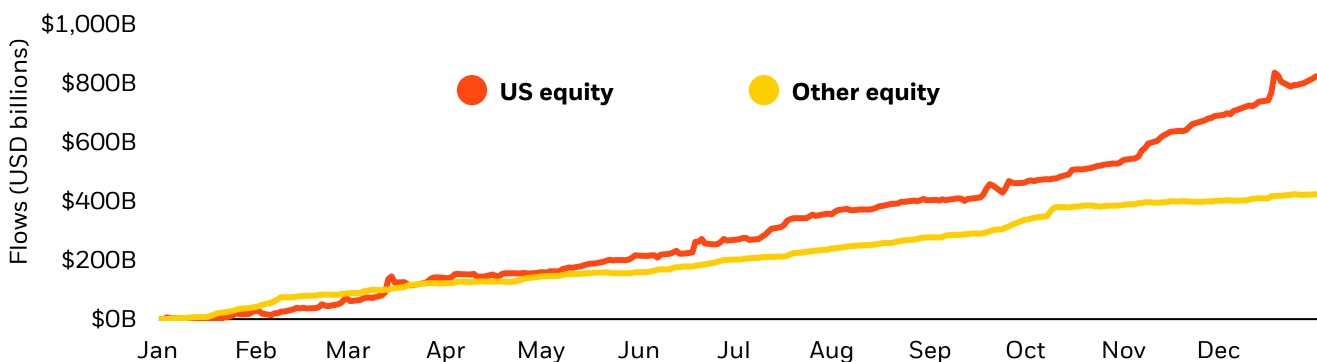
Focus on the US – and selectivity elsewhere

The US stood out across global equities last year – and we think the trend looks set to continue. BlackRock's investment teams are broadly risk-on and lean into US equities as the area of greatest opportunity.

- Strong sentiment in 2024 – investors added $822.5B to US equity ETPs globally, setting a new record (see chart) – helped push valuations to 25x P/E vs. a 10Y average of 21.4x. Yet we think the prospect of continued strong earnings growth justifies this: 12m forward EPS is at 14.1%.[1]
- The equity market's changing sector makeup – shifting towards growth and tech companies – limits the utility of historic comparisons. The S&P 500 equal-weight index being near historic valuations (19.1x current vs. 18.7x 10Y average P/E) is evidence of this.[2] Moreover, we find that valuations typically matter less for returns in the near term.

US exposures have dominated equity buying

Global flows into US equity and all other equity ETPs, 2024



Source: BlackRock and Markit, as of 31 December 2024.

We favour a **building block approach** in US equities, enabling investors to maintain exposure to the very largest companies while also positioning for broadening out of the rest of the index.

- The S&P 500's 7.9% EPS growth over the past 12 months has been concentrated in the Magnificent 7 (60.4%), with the rest of the large cap universe broadly flat.[3]
- Yet earnings growth has started to spread to other sectors and we see this accelerating as Federal Reserve (Fed) rate cuts work through the economy and growth stays resilient. We note that equal-weight and market-cap S&P 500 earnings expectations are at similar levels for 2025 (12.3% vs. 13.2%).[4]
- We look to capture this through **equal-weight S&P 500** index exposure.

We also note that many investors wish to maintain exposure to the very largest companies in the market-cap-weighted index.

- These firms have driven earnings growth and sentiment in recent years, particularly off the back of the growth of AI, and offer quality characteristics.
- We therefore look to the **S&P top 20** index and note that investors can also use this to size mega-cap exposure depending on views on concentration.

We also like systematic strategies that leverage big data and machine learning with the aim of identifying high-quality stocks and generating alpha, especially in the highly-efficient US stock market.

Going granular

Beyond broad allocations to US equities through equal-weight and top 20 S&P indices, we highlight two particular areas of potential opportunity:

- **US financials and banks** have reduced their interest rate sensitivity, mitigating the negative impact of rate cuts on net interest income, while strong loan books and resilient – or even rising – M&A activity could provide support in 2025. US financials ETPs ($13.8B) were the second-most popular US sector allocation globally in 2024 after tech.[5]
- Secular trends such as reshoring and increased defence spending globally support the case for **US industrials** – the third-most popular US sector allocation in 2024 in ETP flows globally, with $6.7B added.[6]

We see tailwinds for the momentum style factor, with the MSCI index increasing its weight to financials and industrials in the latest rebalance. We also note broad-based alpha opportunities amid high dispersion – US stock dispersion has averaged 8% over the past five years vs. 6.7% in the preceding five.[7] We think the transformative potential of AI is one such opportunity (p. 8).

- Our Fundamental Equity team notes that AI has yet to find its 'killer application' – one that significantly transforms industries or creates brand new markets. They suggest this may be an example of Amara's Law: we typically overestimate the impact of tech in the short term but underestimate it in the long term.
- Unconstrained equity strategies offer one way to tap into alpha opportunity. These strategies aim to look through short-term market noise to identify the rare businesses that will be able to deliver compelling revenue growth and profitability over many years, and in doing so compound earnings in a way which the market fails to appreciate today.

Selectivity outside the US

Euro area macro, political and tariff uncertainty have increased dispersion in equity performance to the greatest level seen since 2009,[8] highlighting the case for stock picking in **European equities** for investors with portfolios benchmarked to European equities. An active approach can help to identify European stocks that have been punished despite a strong fundamental outlook.

- Our Fundamental Equity colleagues see room for earnings surprise. The European market is not the European economy; it captures a diversity of earnings streams by geography and end market. Recent results show signs of optimism across numerous end markets, such as construction and life science, while others, such as autos, require caution.
- The team likes high-quality compounders and finds select value within banks and industrials. Despite the longer chip destocking cycle, Europe remains a key AI player, particularly via semiconductor equipment firms, which could see upside through the year from recovering end markets.

The BII notes that while political stability could improve sentiment towards **UK equities**, a higher corporate tax burden could hurt profit margins near term. We see a role for UK equities in building defence against risks of a tariff-driven global trade slowdown: the beta of UK equity market returns to changes in world trade is the lowest among DM equity indices. Services-heavy UK exports may also be more shielded from a potential increase in global goods tariffs. UK equities still look attractively valued: UK large caps currently trade below their 10Y average multiple (12.3x 12-month forward P/E vs. 15.6x, respectively).[9]

> **We see European equities as a diversifier against too much concentration in US assets, as well as an important alpha opportunity given depressed valuations – even in companies with strong fundamentals and significant global revenue exposure.**

Helen Jewell
Chief Investment Officer, Fundamental Equities, EMEA

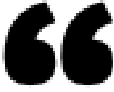
Fixed income

Carry with quality

The US economy entered 2025 on relatively solid footing: while rates stayed higher for longer than expected at the start of the year, growth didn't drop, as the AI investment boom and loose fiscal policy took effect. Although this helped keep inflation relatively elevated, it still fell as a labour supply boom kept a lid on wage pressures. We see proposed US tariff and immigration policy keeping inflation sticky, even as growth moderates, and the USD higher for longer this year, while potentially growing US budget deficits add to ongoing fiscal pressures. Europe, in contrast, faces downside risks to growth, evidenced in weakness in PMIs and rising trade uncertainty.[10]

This macro divergence has prompted some BlackRock portfolio managers to hold long duration exposure across European government bond markets against short duration positions in US Treasuries. The Global Tactical Asset Allocation team is positioned for a relative steepening of the US yield curve against those of more austere European economies.

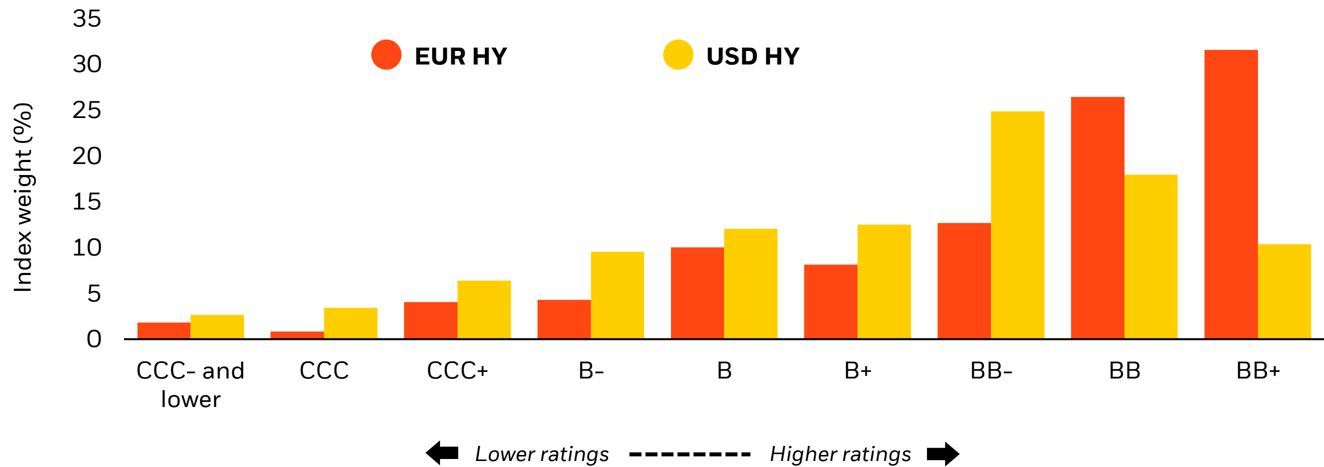
- The US Fixed Income team is focused on clipping solid yields at the **front and belly of the UST curve** and on achieving even more attractive income at shorter durations through selective exposure to quality spread assets.
- In **EUR rates**, our Fundamental Fixed Income colleagues argue that a supportive ECB keeps **EUR duration** attractive through a relative value lens, despite fiscal concerns and policy uncertainty in some eurozone economies. The team also notes that hedging costs in EUR may be set to widen again in 2025, with the Fed and ECB on different trajectories.
- The recent rise in front-end **UK gilt** yields has opened an attractive entry point, in our view. While UK headline inflation has remained stubborn and core inflation has risen, this has primarily been due to base effects, and services core has been coming under control. This suggests room for the Bank of England (BoE) to cut more regularly in 2025 and underpins our view that market pricing of BoE cuts is too hawkish. Growing demand is evidenced by investor appetite, with 2024 the second-highest inflow year on record for gilt ETPs globally, with $4.3B added.[11]



Carry was a bigger driver of bond prices than duration in 2024. With DM rate cutting underway, we think now is the time for income-focused solutions.

Vasiliki Pachatouridi
Head of iShares Fixed Income Product Strategy

Quality tilt: the EUR HY index has a higher average composite rating vs. USD HY
Sector weights for the ICE-BAML EUR HY and USD HY Corporate indices



Source: ICE-BAML, Bloomberg, BlackRock, as of 18 November 2024.

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With yields still close to generational highs and adequate growth, we see opportunities in **HY credit** – particularly at the higher-quality end of the sector. Our colleagues in Fundamental Fixed Income note that while USD and EUR HY spreads are nearly one standard deviation below 20Y averages (at 274bps and 312bps, respectively)[12] – offering limited capital appreciation – the yields on offer create a solid income cushion to help manage downside risk. On a regional basis, we prefer EUR HY over USD:

- Despite weaker growth, default rates are forecast to be equal for EUR and USD HY in 2025 (3.0%).[13] More aggressive rate cutting, attractive valuations and higher credit ratings vs. US peers underscore our regional preference.
- The EUR HY index's composite rating has improved from B to BB in recent years, yet at 1.12, the ratio of EUR to USD HY spreads is significantly wider than its historical average (0.79 over 10 years).[14]

With more diversification now available in the EUR HY universe, broad indexing strategies may offer some stability as each issuer or security contributes less to total return. Yet we see value in selectivity and active strategies in the HY space:

- Continued policy uncertainty following elections in 2024 will impact individual sectors and issuers differently. Moreover, issuer selection also allows for relative value opportunities to be captured, alongside upside convexity from any improvements in quality.

Our EMD team believes the asset class enters 2025 with the strongest **fundamentals** of the past five years. EMD has seen a turnaround in credit ratings, with more sovereign upgrades than downgrades for two years in a row (the first time this has happened since 2011-2012).[15] Fundamentals are supported by resilient growth and falling inflation, allowing central banks to lower rates in healthy economies, thus boosting growth.

- The team notes that **valuations** may seem tight from a spread perspective, but this is justified by historically strong credit quality and high all-in yield.
- Supporting **technical** factors include an expected negative supply of hard currency bonds, where coupons and principal paid to investors will exceed the amount of new issuance.[16] The team also views the asset class as broadly under-owned.

The team favours **hard currency** assets, given attractive carry, high all-in yield (even at shorter durations), low FX risk and low correlation to DM fixed income.

- We expect **sovereign HY** to remain in favour, particularly 'back-from-the-cold' countries that have experienced improvement in fundamentals and investor appetite after putting forward new growth policies.
- **Short duration** debt yields over 7% with low exposure to global rates volatility,[17] resulting in high but steady income with downside mitigation.

Diversification and asset allocation may not fully protect you from market risk. There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

Seeking income in equities

Active equity income strategies could help investors diversify sources of income, harnessing market volatility to enhance income generation through call writing. These strategies can also participate in market upside due to delta hedging that can offset beta drag, and reduce the style bias inherent in traditional dividend-paying stocks.

Managing beta

Duration may no longer offer reliable portfolio ballast in a regime of fiscal uncertainty and sticky inflation.

- With a less-reliably-negative stock-bond correlation, the classic 60/40 portfolio has become more volatile since 2019.
- Against this backdrop, clients have been telling us they're seeking to lower broad market exposure – and adding to idiosyncratic exposures that are not linked to the broader equity and fixed income markets.
- Such exposures have been more valuable in a regime of geopolitical uncertainty and structural mega forces creating dispersion through shifts in profitability across economies, sectors and companies.

Liquid alternative strategies are designed to capture this uncorrelated alpha across asset classes and market cycles, and may reduce broad market beta exposure by balancing long and short positions.

With traditional correlations under pressure, we also look to **gold** and **bitcoin** for potential resilience and returns.

- Gold retains its value as a portfolio hedge, we think, given persistent, robust central bank demand, global inflation dynamics and elevated geopolitical risk. Our Fundamental Equity colleagues highlight that gold producers appear relatively undervalued, offering attractive upside in tandem with rising prices.
- Bitcoin's potential as a new diversifier stems from its differentiated value drivers: predetermined supply, and demand based on investors' belief in its potential to be more widely-adopted as a payment technology. Those distinct drivers should make it less correlated with risk assets in the long term.

Investors may prefer to outsource portfolio diversification with **multi-asset active strategies**, blending high-conviction equity positions and diverse bond exposure to manage near-term volatility while investing for the long term.

Investment processes are becoming more and more efficient at absorbing and leveraging information, through systems that can scale and multiply the value of insights. With 30 years of machine learning experience, our Systematic team leverages AI to maintain a competitive edge.[18]

Raffaele Savi
Global Head of BlackRock Systematic and Co-CIO & Co-Head of Systematic Active Equity

Portfolio enhancers

Enhancing potential returns

With mega forces...

BlackRock's portfolio managers see the current market environment as characterised by a transformation and see long-term opportunities to enhance returns by aligning portfolios to mega forces like AI and the low-carbon transition.

In our 2024 survey of 50+ EMEA wealth and asset managers, over 95% of respondents reported having incorporated at least one mega force in their investment process – with c.60% of respondents planning to increase their exposure in the next 12 months and none planning to decrease it.[19]

Recent developments in AI have the potential to unlock new long-term revenue streams, we think, and it's important to look beyond the early beneficiaries.

The current **buildout phase** centres on data centres, AI models, and the power systems that support them.

- Significant capital is already going into the buildout, with investment in data centres and the chips that power them potentially topping $700B annually by 2030.[20]
- Private markets and infrastructure will play a crucial role in financing this buildout, we think (see overleaf). Private markets could also offer access to future winners before they go public.

As we move into an **adoption phase**, selectivity will be needed to spot adoption winners, which may emerge in unexpected areas.

- The Fundamental Equity team notes that we're at an unparalleled time in human history as we enter a new "intelligence revolution" era. Innovations in AI research have enabled the building of machine intelligence that could rival or surpass that of humans. AGI (Artificial General Intelligence) – the north star for leading AI technology firms – could have profound implications for the economy, society and tech equities and potentially be the most transformational technological wave in history.

Our 2024 survey showed the second-most prevalent mega force reflected in EMEA portfolios to be the transition to a low-carbon economy (c.60%).[21]

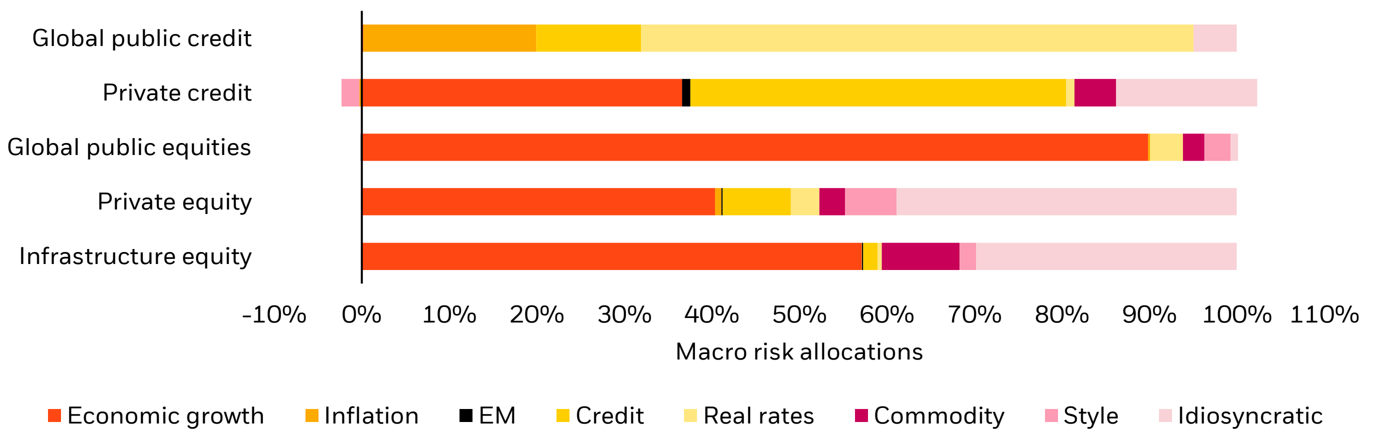
- Multiple drivers – such as technological innovation (including AI), government policies and consumer and investor preferences – are accelerating the **transition to a low-carbon economy**.
- Europe, with its history of regulation and innovation in this area, offers strong cross-sectoral stock picking opportunities.
- We also look beyond the 'obvious' exposures: our Fundamental Equity team believes that high-emitting companies becoming greener is essential for the transition – and could represent an investment opportunity from a re-rating perspective.

...especially in private markets

Private markets can offer early access to these structural mega forces reshaping global economies.

- The opportunity to add returns to public market exposures is vast, thanks to companies staying private for longer. **Private equity** valuations look attractive vs. public markets, with global private equity EV/EBITDA at just 12.7x vs. 16.5x for the S&P 500.[22] Private equity also offers a more differentiated risk profile than public equities (see chart).
- **Infrastructure** is set to become one of the fastest-growing private market segments. Societies are grappling with energy security pressures and the low-carbon transition, demographic change and urbanisation, realigning supply chains and the computing and energy infrastructure needed to power AI. Infrastructure equity also offers a differentiated risk profile.
- Market forces, technology, and regulation are moving financial activity to where it can be done most efficiently, making **private credit** a structural growth segment. We expect the private debt market will more than double to $4.5T by 2030.[23] As the chart below shows, private credit can provide complementary sources of risk (idiosyncratic and economic growth, rather than real rates) to a public credit sleeve.

An 'alternative' makeup of macro risks in public vs. private markets



Source: BlackRock Aladdin, as of 30 May 2024. Currency: EUR. Private markets exposures show BlackRock representative generic globally diversified investment baskets to proxy the asset class. Global EQ shows MSCI All Country World Index. Global Bonds shows Bloomberg Global Aggregate Index Hedged. FX risk for all exposures has been hedged.

Appendix

Notes

1 Source: LSEG Datastream, MSCI, as of 29 November 2024.
2 Source: Bloomberg, as of 24 December 2024.
3 Source: Bloomberg, as of 25 November 2024. Based on the Bloomberg Magnificent 7 Index.
4 Source: LSEG Datastream, as of 26 November 2024.
5, 6, 11 Source: BlackRock and Markit, as of 31 December 2024.
7 Source: BlackRock Investment Institute, with data from LSEG Datastream, December 2024. Notes: based on the dispersion in S&P 500 monthly stock returns on a daily basis and the median level of dispersion from December 2014 through November 2019 and December 2019 through November 2024.
8 Source: Morgan Stanley, as of 29 November 2024.
9 Source: Bloomberg, as of 29 November 2024. Based on the MSCI UK Index.
10 Source: BlackRock, Bloomberg, as of 31 December 2024.
12 Source: Bloomberg, as of 6 January 2025.
13 Source: Goldman Sachs, as of 19 December 2024.
14 Source: Bloomberg, as of 23 December 2024. Based on the option-adjusted spread (OAS) for the ICE BofA Euro High Yield Index and the ICE BofA US High Yield Index.
15 Source: Morgan Stanley Research, November 2024. Based on emerging market sovereign upgrades and downgrades by Fitch, S&P and Moody's.
16 Source: J.P. Morgan Research, as of November 2024. There is no guarantee that any forecasts made will come to pass.
17 Source: BlackRock, November 2024. Refers to the BSF Emerging Markets Short Duration Bond Fund, which has YTM over 7% and duration under 3Y.
18 Note: includes time at competitor firms.
19, 21 Source: BlackRock Portfolio Consulting, June 2024. Based on survey of 54 Wealth and Asset Management investors. Wealth includes independent financial advisors / wealth managers, private and retail banks and unit-linked insurance.
20 Source: BlackRock Investment Institute, Reuters, November 2024. Forward looking estimates may not come to pass.
22 Source: S&P Capital IQ, Pitchbook. Private Equity Multiple is for the 12 months ending 9/30/2024, S&P 500 Multiple is as of 31 October 2024.
23 Source: BlackRock, December 2024.

Annual flows into global ETPs by exposure type, 2020 – 2024

	2020	2021	2022	2023	2024
US financials sector	-$0.4B	$32.9B	-$16.0B	$0.5B	$13.8B
US industrials sector	$6.3B	$0.7B	-$2.5B	$0.6B	$6.7B
UK gilts	$0.2B	$0.1B	$1.7B	$4.3B	$4.3B
US equity	$199.9B	$578.4B	$342.6B	$362.2B	$822.5B
All equity ex-US	$236.5B	$435.6B	$256.6B	$282.9B	$423.4B

Source: BlackRock and Markit, as of 31 December 2024. Past flows into global ETPs are not a guide to current or future flows and should not be the sole factor of consideration when selecting a product.

MKTGM0125E/S-4174328-9/17

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