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Weekly commentary

BlackRock.

January 8, 2024

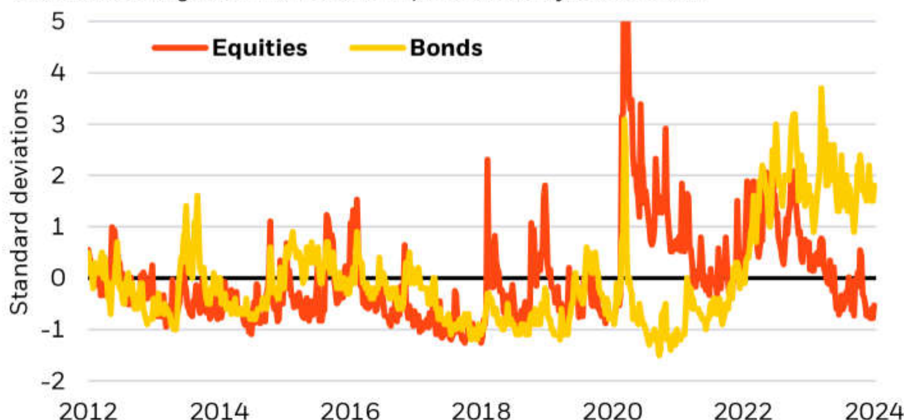
Navigating macro currents in 2024

- Risk assets surged to end 2023 as the Federal Reserve blessed market hopes for rate cuts. That momentum could persist for some time as inflation cools.
- Stocks slid and bond yields rose last week. Data pointing to sticky U.S. wages showed why we think market optimism on inflation may eventually be let down.
- The U.S. CPI this week will likely show falling goods prices leading inflation lower in 2024. We see supply constraints putting inflation on a rollercoaster.

Risk assets ended 2023 on an upbeat note as the Fed appeared to make a big bet on inflation coming down and growth only gradually slowing. Markets interpreted the Fed's messaging as a green light for aggressive policy easing. The end-2023 rally could keep going well into 2024 as inflation cools further. Yet the jittery start to 2024 for stocks and bonds suggests investors may be nervous about the macro outlook. We stay nimble and think macro risks need to be deliberately managed.

Volatility divergence

U.S. stock and government bond implied volatility, 2012-2024



BlackRock Investment Institute, with data from LSEG Datastream, January 2024. Notes: The chart shows the normalized level of equity and bond market volatility in standard deviations. The indexes used are the Chicago Board Options Exchange's Volatility Index (VIX) and the Merrill Lynch Option Volatility Estimated Index (MOVE), which respectively measure the market pricing of one-month implied volatility in S&P 500 and U.S. Treasuries based on options.

The U.S. 10-year Treasury yield closed the year roughly where it started – at about 3.8% – masking a major round trip between 3.3% and 5%. U.S. stocks ended 2023 just below their all-time high largely thanks to the Fed unexpectedly making a big bet for the market by seeming to endorse expectations for aggressive rate cuts at its last policy meeting of the year. That once again highlighted how hopes and disappointments about the Fed drove market flip-flops throughout 2023. The final rally was no different, in our view. It has left equity markets priced for a near-perfect outcome: a soft landing, where inflation falls and central banks sharply cut rates. Market pricing implies they would come to the rescue with even bigger rate cuts if growth risks emerge. That's why we think expected bond volatility remains high (yellow line in chart) relative to subdued expected volatility in stocks (orange line).

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Markets interpreted the Fed's communications around a potential peak in U.S. interest rates as opening the door to sharp rate cuts as inflation falls. We expect inflation to ease close to 2% in 2024 as consumer spending normalizes from the pandemic and goods prices fall. So beyond the early January jitters, the risk rally could extend – until the risk of inflation resurging comes into view later this year, as we expect. Markets pricing in a perfect outcome is a big macro bet, in our view. A soft economic landing is possible, but the range of potential outcomes is wide in the new regime of greater macro and market volatility. That's why we're ready to be nimble and selective on our six-to-12-month tactical horizon.

Case in point: Falling U.S. goods prices are dragging down inflation as pandemic-driven swings in spending unwind. Yet a tight labor market is driving stubbornly high wage growth, as seen in the December jobs data. We think that means inflation is set to rollercoaster back up near 3% in 2025 as the goods price drag fades. We see geopolitical fragmentation bolstering inflationary pressures in coming years, too. That's why we think the Fed may not be able to deliver the rate cuts markets expect, even with growth moderating as consumers exhaust their pandemic savings and government spending on defense and student loan forgiveness tapers off. The big question for risk assets: when they might start to reflect this outlook in 2024.

In fixed income markets, we see more volatility ahead partly as inflation's persistence becomes clearer. Plus, we see markets grappling with where neutral rates – the interest rate that neither stimulates nor restricts economic activity – are settling after the pandemic. We think neutral rates are higher in both the U.S. and Europe, partly due to looser fiscal policy and the investment demands tied to the low-carbon transition. We also think investors could demand more compensation for the risk of owning long-term bonds given rising public debt and a more uncertain inflation outlook.

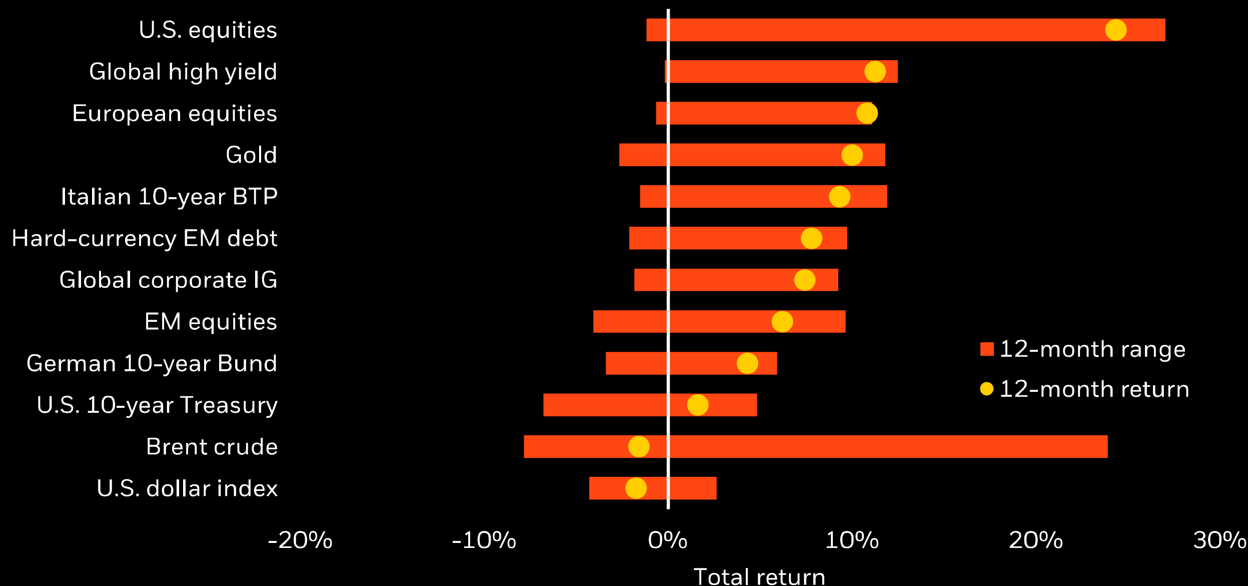
Bottom line: We get granular to navigate macro uncertainty, favoring Japan, tech and industrials in stocks. We also went tactically neutral long-term Treasuries in October and we keep our overweight to short-term Treasuries. Yields may swing in either direction as markets keep reassessing the outlook for policy rates.

Market backdrop

The S&P 500 fell about 2% last week after the 24% surge last year, while U.S. 10-year yields climbed back to around 4% and rose more than 25 basis points from the December low. The Fed's December meeting minutes highlighted the easing of financial conditions, adding to the risk asset jitters to start the year. The end-2023 market momentum could persist. But the December U.S. payrolls report confirmed ongoing wage pressures may ultimately disappoint the optimism on inflation.

Assets in review

Selected asset performance, 12-month 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 Jan. 4, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12 months, and the dots represent current 12-month 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.

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Week ahead

Jan. 9	Japan CPI	**Jan. 12**	China CPI and trade data; UK GDP
Jan. 11	U.S. CPI	**Jan. 10-17**	China total social financing

We're watching U.S. inflation data out this week to see if falling goods inflation will pull inflation further down in 2024 as pandemic mismatches unwind. Yet we think tight labor markets and slowing job growth will keep inflation on a rollercoaster beyond 2024. China macro data out this week will also help gauge how subdued activity remains. China's economy faces two key challenges: sluggish consumer spending and weak demand for its exports.

Big calls

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

Tactical	Reasons
DM equities	• Our macro view keeps us underweight, but we think the AI theme and alpha potential has taken us closer to a neutral view. See below.
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 credit risk.
Inflation-linked bonds	• We see inflation staying closer to 3% in the new regime than policy targets, making this one of our strongest views 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, January 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.

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, January 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	-1	We are underweight the broad market – still our largest portfolio allocation. Hopes for rate cuts and a soft landing have driven a rally. We see the risk of these hopes being disappointed.
	Europe	-1	We are underweight. The ECB is holding policy tight in a slowdown. Valuations are attractive, but we don't see a catalyst for improving sentiment.
	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	+1	We are overweight. We see stronger growth helping earnings top expectations. Stock buybacks and other shareholder-friendly actions are positives. Potential policy tightening is a near-term risk.
	DM AI mega force	+1	We are overweight. We see a multi-country and multi-sector AI-centered investment cycle unfolding set to support revenues and margins.
	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	-1	We are underweight. We prefer the U.S. over the euro area. We see markets overestimating how persistent inflation in the euro area will be relative to the U.S.
	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	-1	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
	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.
	U.S. agency MBS	+1	We are overweight. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG
	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 higher yields. 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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