Weekly commentary

January 13, 2025

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Triggers to change our pro-risk view

- We are pro-risk to start 2025. Yet we're ready to evolve our view if policy shifts, corporate earnings and financial market cracks spell a deteriorating outlook.
- U.S. stocks slid and 10-year U.S. Treasury yields climbed near 4.80% last week after a strong U.S. jobs report. UK gilt yields jumped on fiscal outlook concerns.
- We get U.S. CPI this week. Robust wage growth and sticky core services inflation should keep broad inflation from falling to the Federal Reserve's target, we think.

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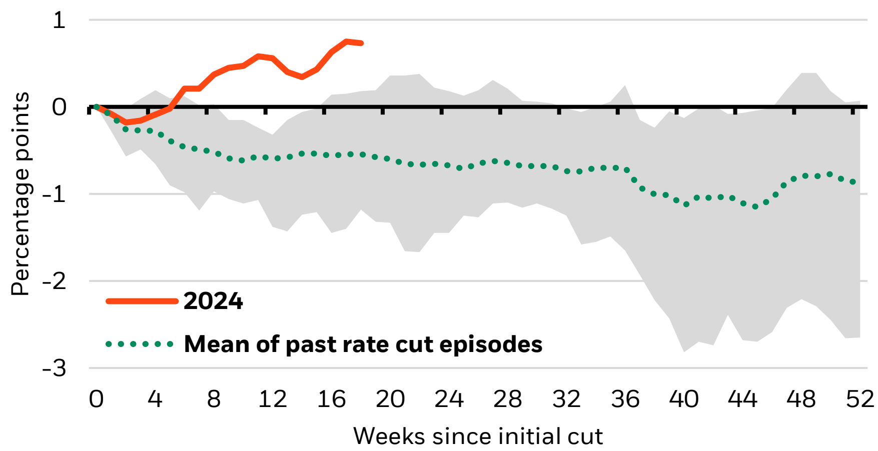
We are pro-risk, with the biggest overweight in U.S. stocks, yet eye three areas that could spur a view change. First, we're watching policy, notably how U.S. tariffs and fiscal policy shape up. Second, we watch whether investor risk appetite will sour due to corporate earnings and lofty tech valuations amid the artificial intelligence (AI) buildout. Third, we look for elevated vulnerabilities, like surging bond yields as markets price out rate cuts and corporate debt refinancing at higher interest rates.

Going up

Change in U.S. 10-year Treasury yields through rate cutting episodes, 1984-2024



Past performance is not a reliable indicator of current or future results. Source: BlackRock Investment Institute, with data from Haver Analytics, January 2025. Note: The chart shows the change in 10-year Treasury yields through periods when the Federal Reserve cut interest rates. The shaded area shows the range of those changes since 1984 and the dotted green line shows the average. The orange line shows the change in yields since the Fed's cut in September 2024.

We upped our U.S. equities overweight in December as we expected AI beneficiaries to broaden beyond tech given resilient growth and Fed rate cuts. We think U.S. equity gains could roll on. Yet an economic transformation and global policy shifts could push markets and economies into a new scenario from our 2025 Outlook. We look through near-term noise but outline triggers for adjusting our views, by either dialing down risk or shifting our preferences. First, we're tracking the impacts of global policy – especially U.S. trade, fiscal and regulatory policy. Second, we gauge whether risk appetite will stay upbeat as earnings results for AI beneficiaries come in and given high tech valuations. Third, vulnerabilities like a sudden jump in bond yields could also shift our view. The unusual yield jump since the Fed started cutting rates underscores this is a very different environment. See the chart.

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The first trigger to change our view is whether or not President-elect Donald Trump takes a market-friendly approach to achieve goals like improving growth and reducing budget deficits. In a market-friendly approach, rolling back financial regulation and cutting government spending could boost economic growth and risk assets. That, plus efforts to rebalance global trade and expand fiscal stimulus in countries where investment and consumer spending have lagged the U.S., may help address trade deficit worries. In a less market-friendly approach, plans to extend tax cuts alongside large-scale tariffs could deepen deficits and stoke inflation. More broad-based tariffs could strengthen the U.S. dollar, fuel inflation and call for high-for-longer interest rates. This plan would clash with Trump's calls for a weaker dollar to boost U.S. manufacturing and his push for rate cuts. We look through noisy headlines around policy and focus on how policy changes take shape this year.

The second trigger: deteriorating investor sentiment due to earnings misses or lofty tech valuations. The "magnificent seven" of mostly tech companies are still expected to drive earnings this year as they lead the AI buildout. Their lead should narrow as resilient consumer spending and potential deregulation support earnings beyond tech. While earnings might surprise to the upside, any misses could renew investor concern over whether big AI capital spending will pay off and if high valuations are justified – even if we think valuations can't be viewed through a historical lens as an economic transformation unfolds.

In our third trigger, we're watching for elevated vulnerabilities in financial markets – including an already jittery bond market. We expect bond yields to climb further as investors demand more term premium for the risk of holding bonds. Term premium is rising from negative levels and is at its highest in a decade, LSEG Datastream data show. The surge in UK gilt yields shows how concerns about fiscal policy can drive term premium – and bond yields – higher. The refinancing of corporate debt at higher interest rates is another risk. It could challenge the business models of companies that assumed interest rates would remain low. But many companies have refinanced debt without defaulting since the pandemic given strong balance sheets.

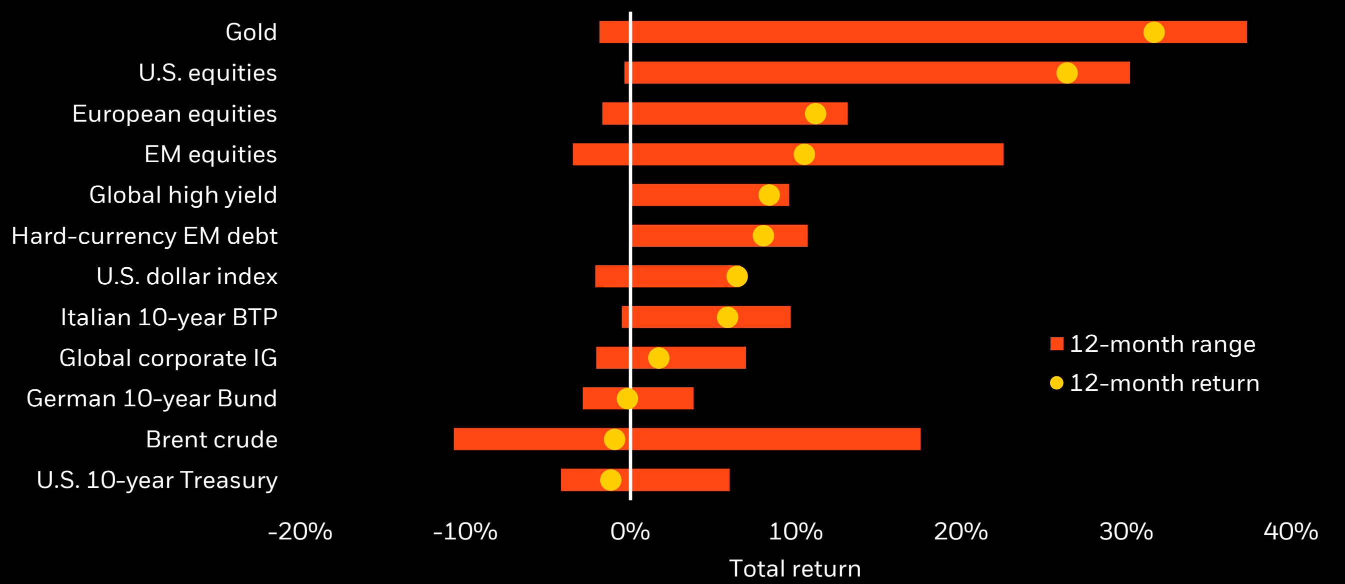
Bottom line: We see U.S. equity gains cooling from their highs this year but staying strong, while U.S. Treasury yields climb. We stay overweight U.S. stocks and underweight long-term Treasuries, yet we're watching triggers to change our views.

Market backdrop

U.S. stocks fell more than 1% last week. Ten-year U.S. Treasury yields climbed near 4.80%, to a 14-month high and near their 2023 peak partly due to a surprisingly strong U.S. jobs report. The data suggest immigration is still making it possible to sustain larger job gains without adding to wage pressures. Yet wage gains are still strong enough for the Fed to keep policy rates higher for longer. UK 30-year gilts yields hit their highest in almost three decades on concerns about the UK fiscal path.

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. 9, 2025. Notes: The two ends of the bars show the lowest and highest returns at any point in the past 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.

Week ahead

Jan. 13	China trade data	**Jan. 16**	UK GDP
Jan. 15	U.S. CPI; UK CPI	**Jan. 10-17**	China total social financing

U.S. CPI is in store this week. We watch for whether inflation stays sticky in line with the recent trend. Wage growth and core services inflation remain at a level inconsistent with overall inflation falling back to the Federal Reserve's 2% target, in our view. Longer term, we think labor supply constraints like population aging should keep inflation sticky, preventing the Fed from cutting policy rates much below 4% – much higher than pre-pandemic levels.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, January 2025

Tactical	Reasons
U.S. equities	We see the AI buildout and adoption creating opportunities across sectors. We tap into beneficiaries outside the tech sector. Robust economic growth, broad earnings growth and a quality tilt underpin our conviction and overweight in U.S. stocks versus other regions. We see valuations for big tech backed by strong earnings, and less lofty valuations for other sectors.
Japanese equities	A brighter outlook for Japan's economy and corporate reforms are driving improved earnings and shareholder returns. Yet the potential drag on earnings from a stronger yen is a risk.
Selective in fixed income	Persistent deficits and sticky inflation in the U.S. make us more positive on fixed income elsewhere, notably Europe. We are underweight long-term U.S. Treasuries and like UK gilts instead. We also prefer European credit – both investment grade and high yield – over the U.S. on cheaper valuations.
Strategic	**Reasons**
Infrastructure equity and private credit	We see opportunities in infrastructure equity due to attractive relative valuations and mega forces. We think private credit will earn lending share as banks retreat – and at attractive returns.
Fixed income granularity	We prefer short- and medium-term investment grade credit, which offers similar yields with less interest rate risk than long-dated credit. We also like short-term government bonds in the U.S. and euro area and UK gilts overall.
Equity granularity	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 the outlook.

Note: Views are from a U.S. dollar perspective, January 2025. 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, January 2025

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**		
Equities	United States	+2	We are overweight as the AI theme and earnings growth broaden. Valuations for AI beneficiaries are supported by tech companies delivering on earnings. Resilient growth and Fed rate cuts support sentiment. Risks include any long-term yield surges or escalating trade protectionism.
Equities	Europe	-1	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.
Equities	UK	Neutral	We are neutral. Political stability could improve investor sentiment. Yet an increase in the corporate tax burden could hurt profit margins near term.
Equities	Japan	+1	We are overweight. A brighter outlook for Japan's economy and corporate reforms are driving improved earnings and shareholder returns. Yet a stronger yen dragging on earnings is a risk.
Equities	**Emerging markets**	Neutral	We are neutral. The growth and earnings outlook is mixed. We see valuations for India and Taiwan looking high.
Equities	China	+1	We are modestly overweight. China's fiscal stimulus is not yet enough to address the drags on economic growth, but we think stocks are at attractive valuations to DM shares. We stand ready to pivot. We are cautious long term given China's structural challenges.
Fixed Income	Short U.S. Treasuries	Neutral	We are neutral. Markets are pricing in fewer Federal Reserve rate cuts and their policy rate expectations are now roughly in line with our views.
Fixed Income	Long U.S. Treasuries	-1	We are underweight. Persistent budget deficits and geopolitical fragmentation could drive term premium up over the near term. We prefer intermediate maturities less vulnerable to investors demanding more term premium.
Fixed Income	Global inflation-linked bonds	Neutral	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
Fixed Income	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. Political uncertainty remains a risk to fiscal sustainability.
Fixed Income	UK gilts	+1	We are overweight. Gilt yields offer attractive income, and we think the Bank of England will cut rates more than the market is pricing given a soft economy. But we are monitoring any government response to the recent fiscal concerns.
Fixed Income	Japanese govt bonds	-2	We are underweight. Stock returns look more attractive to us. We see some of the least attractive returns in JGBs.
Fixed Income	China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
Fixed Income	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.
Fixed Income	Short-term IG credit	+1	We are overweight. Short-term bonds better compensate for interest rate risk.
Fixed Income	Long-term IG credit	-1	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.
Fixed Income	Global high yield	Neutral	We are neutral. Spreads are tight, but the total income makes it more attractive than IG. We prefer Europe.
Fixed Income	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
Fixed Income	Emerging hard currency	Neutral	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.
Fixed Income	Emerging local currency	Neutral	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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