Capital Markets Mid-Year Outlook 2024

Fixed income yields stand at near two-decade highs
The last time US and European bonds offered yields this high was in 2007. As central banks are expected to keep rates higher for longer, DM fixed income is offering strong returns for low risk

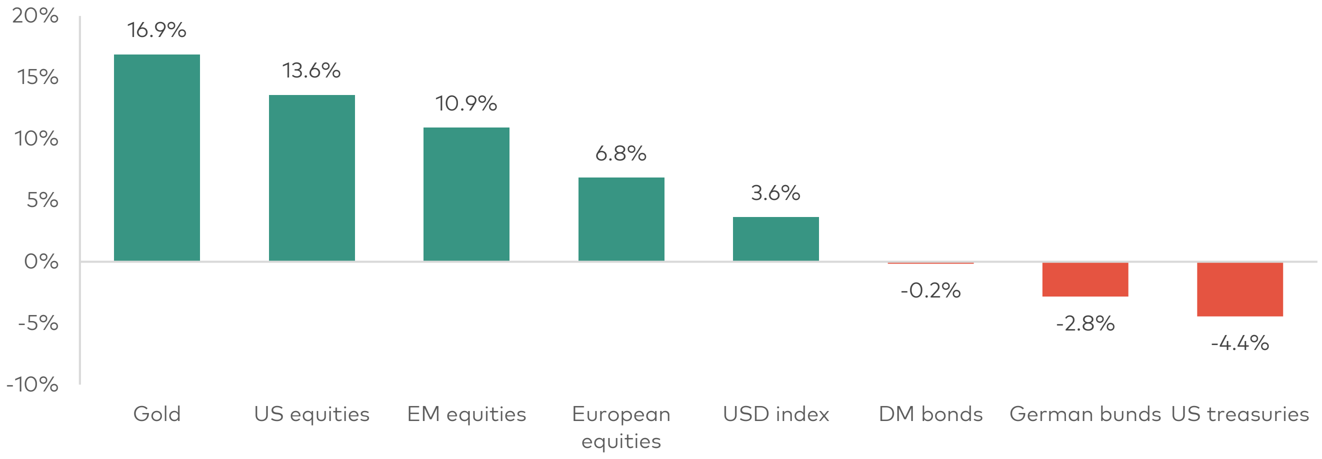
AI theme has a broad range of potential beneficiaries
After semiconductors and Magnificent 7 stocks, analysts expect biotechnology, cybersecurity, and robotics related stocks to rally next in the face of further progress in AI development

Investors should hedge against the prevailing geopolitical risks
High quality fixed income, defensive equities, gold, and defense industry stocks can be good hedges against current geopolitical risks

Summary

- Both economic growth and inflation have been resilient in the US. This has reduced the hopes for rapid Fed rate cuts – a major factor underlying the currently elevated yields in fixed income markets
- As spreads have narrowed significantly on US investment grade bonds, the high yield category seems more attractive in terms of income
- The first phase of AI excitement has primarily benefitted semiconductors and mega-cap US tech stocks. Analysts expect biotechnology, cybersecurity, and robotics & automation companies to rally next
- In the next twelve months, analysts have a positive view on the US and Japanese equities. In S&P 500, analysts expect materials, financials, and energy stocks to outperform the index

Price performance of select assets in 1H 2024 (negative sign of bonds & treasuries means that yields increased)



Source: Bloomberg
Note: figure illustrated performance of follwing indices: Gold – Gold August 2024 futures, US equities – Dow Jones US Total Stock Market Index, EM equities – MSCI Emergin Markets Index, European equities – STOXX All Europe Total market Index, USD index – DXY, DM bonds – S&P Global Developed Markets Corporate Bond Index, German bunds – iShares Germany Government Bond UCITS ETF EUR, US treasuries – iShares US Treasury Bond ETF

Fixed Income

Growth was resilient in the US, but so was inflation

At the start of this year, markets were anticipating strong growth in the US and a rapid return of inflation towards the 2% target. In return, this should have prompted a strong cutting cycle from the Fed (markets were pricing in five or six 25bps rate cuts in 2024).

Although economic activity did remain robust, the progress on inflation front was weaker than initially expected. While core CPI declined from 3.9% in January to 3.4% in May, headline figure ticked upwards from 3.1% to 3.3%. As a result, markets are now pricing in only two 25bps cuts from Fed by the end of 2024.

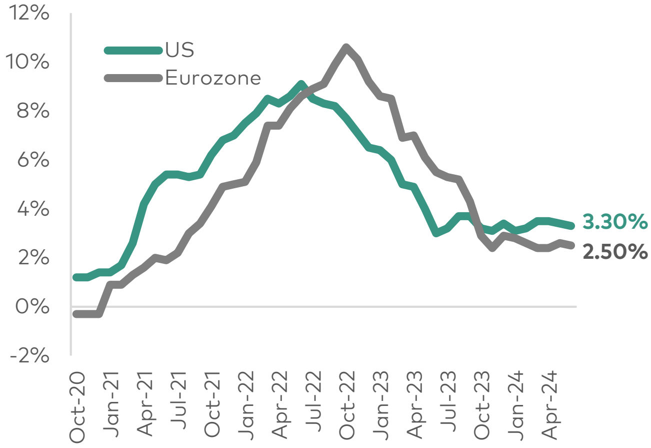
Overall, the consensus view is that both the Fed and the ECB will keep the rates higher for longer. This is a contrasting picture to that of near-zero interest rates seen before the inflation took off in developed economies.

What are the investment implications of higher rates?

The central bank interest rate is the single most important determinant of yields in fixed income markets. Higher interest rates imply greater yield on all debt securities (both government and corporate). Consequently, investors are currently offered good return on their investment for very low risk (something that was not on the table in the low interest rate environment).

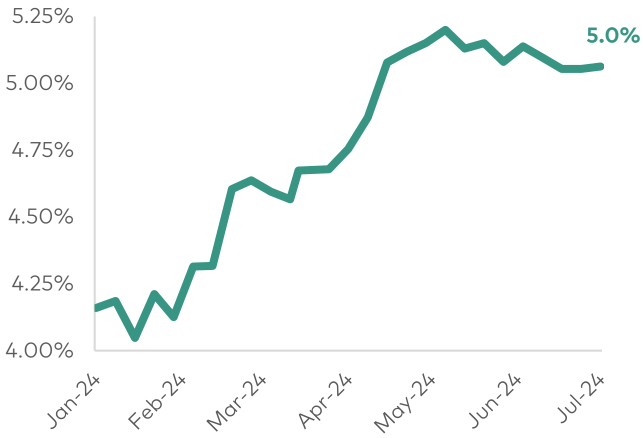
As of now, short term US treasuries are yielding in the range of 4.5%-5.0%, while German bunds (a European benchmark) have yields from 2.7% to 3.3%. Meanwhile, higher income is found in the corporate fixed income category. While investment grade (i.e. high quality) bonds offer low spreads, the high yield category has yields of up to 8.0%.

US and Eurozone inflation (headline CPI)



Source: US Bureau of Labor Statistics, Eurostat

End-2024 expected Fed rate (upper bound)



Source: Bloomberg

US investment grade bond spreads

Source: Bloomberg, Ice Data Indices
Note: figure displays ICE BofA US Corporate Option-Adjusted Spread Index, which is computed as differential of OAS index of all US investment grade bonds and a spot Treasury curve

Equities

Where does AI go next?

In past years, the Artificial Intelligence theme has gained ground both in terms of investor interest and product innovation. As of now, however, we are still witnessing an early stage of development for this new branch of technology.

In the early adoption phase, there were two primary beneficiaries in terms of equity returns: semiconductors and mega-cap US tech companies. While semiconductors are an essential hardware powering the AI, large tech firms provide the necessary data infrastructure and computational force to develop and implement the new technologies.

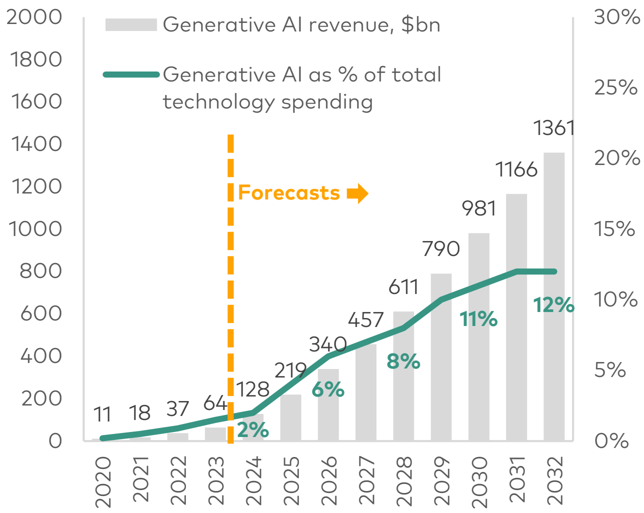
For the following decade, analysts forecast an exponential rise in both AI-generated revenues and spending on research and development of new AI-based products.

In this new phase of AI adoption, the major beneficiaries are expected to be companies from the fields of Biotechnology, Cybersecurity, and Robotics & Automation. As shown on the graph to the right, equity returns in these fields, although quite strong, are yet to catch up with those early beneficiaries, like semiconductors and Magnificent 7 stocks.

How to invest in AI-related industries?

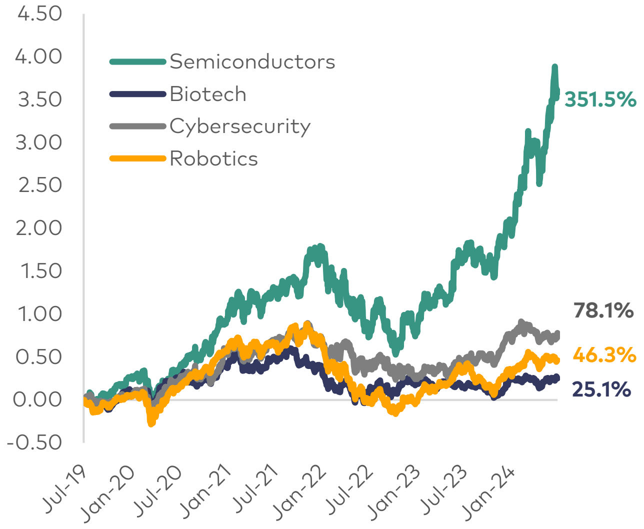
While investing in single stocks is one option, the exchange-traded fund (i.e., ETFs) may be a more practical alternative for many investors. Thematic ETFs, like IBB, IHAK, and BOTZ (all displayed in the figure to the right) allow investors to invest in diversified portfolios of AI-related industries in exchange for small fees.

Global generative AI revenue and spending forecasts



Source: Bloomberg, Citigroup

5-year performance of AI-related thematic ETFs



Source: Bloomberg
Note: figure illustrates performance of following ETFs: Semiconductors – VanEck Semiconductors (SMH), Biotech – iShares Biotechnology (IBB), Cybersecurity – iShares Cybersecurity and Tech (IHAK), Robotics – Global X Robotics and Artificial Intelligence (BOTZ)

Equities

Major geopolitical risks

After Russia's invasion of Ukraine, the geopolitical risks have increased considerably. As the world is becoming increasingly bipolar, there is higher chance of more military conflicts. BlackRock Investment Institute has outlined the following risks with the highest probability of occurrence in the near to mid-term period:

- Intensifying US-China strategic competition
- Global technology decoupling and tariff wars
- Potential Russia-NATO conflict
- Intensifying Gulf tensions
- Major terror attacks
- Major cyber attacks

Hedging against geopolitical risks

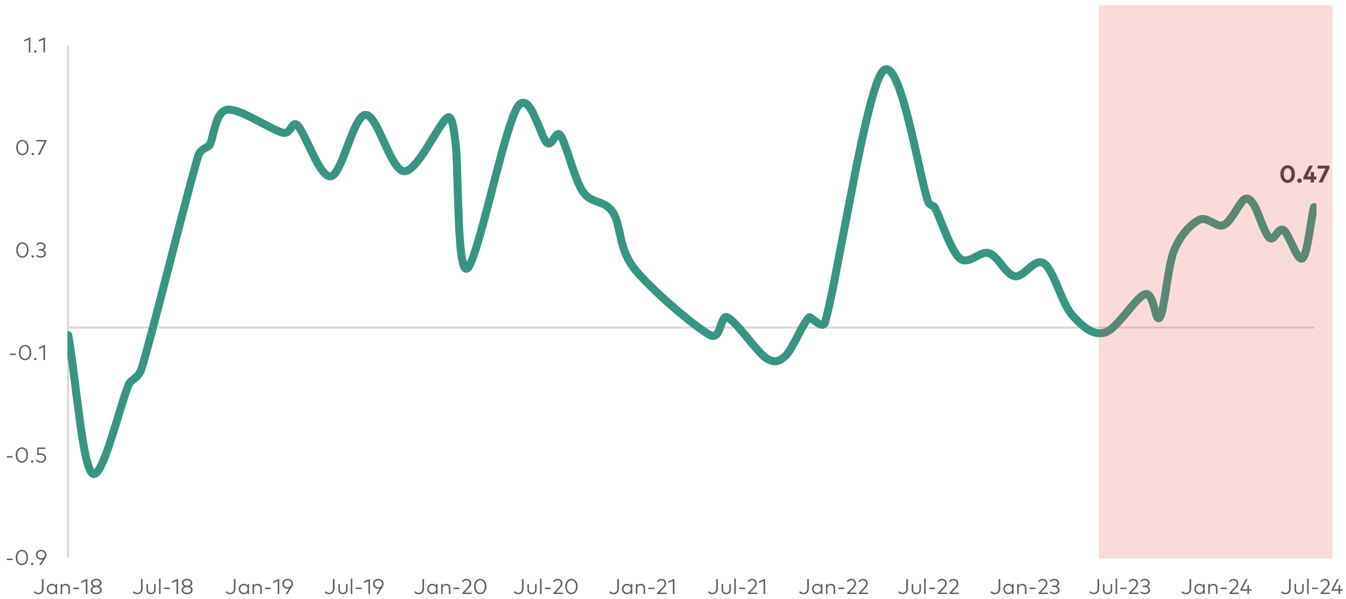
There are two primary ways hedge against geopolitical risks. The first is to invest in assets that inherently carry lower risk, such as short-term treasuries, high-quality corporate bonds, defensive equities, and gold.

Bonds and equities are usually purchased directly. When it comes to gold, however, many investors prefer to invest through an ETF rather than a traditional futures contract.

A gold ETF is an exchange-traded fund that invests in physical gold and, therefore, closely tracks the movements in gold price. Consequently, it gives investor the same exposure as would a direct purchase of gold. Holding gold is especially beneficial during the times of macroeconomic or geopolitical hardships, as investor demand for this safe haven asset strengthens, which naturally increases the price.

Another way to hedge against geopolitical risks is to invest in defense industry ETFs. VanEck Defense UCITS ETF (DFNS) and HANetf Future of Defense UCITS ETF (NATO) are common ways to achieve this.

BlackRock Geopolitical Risk Indicator



Source: BlackRock Investment Institute

Forecasts for 2024 and beyond

Fixed Income:

Analysts forecast a decline in yields throughout 2024, both in the US and in Europe. By the end-2024, a 2-year US Treasury yield is expected to reach 4.24% (down from current 4.46%), while a 2-year German bund yield is expected to fall to 2.35% (down from current 2.82%).

Equities:

According to BlackRock Investment Institute, the US and Japan equity markets should outperform other regional markets during the next 6 to 12 months. Meanwhile, the outlook is neutral for UK and Emerging Markets equities (including China) and negative for European stocks.

In terms of S&P 500 sectors, Charles Schwab analysts expect Energy, Financials, and Materials to outperform the rest of the market. Meanwhile, Consumer Discretionary and Real Estate are forecasted to deliver weaker performance as compared to the overall index.

FIXED INCOME

Yield forecasts (%)

	Last	3Q24F	4Q24F	1Q25F	2Q25F
US treasuries					
30-year	4.47	4.44	4.33	4.25	4.22
10-year	4.24	4.25	4.13	4.06	4.01
5-year	4.14	4.26	4.10	4.00	3.91
2-year	4.46	4.53	4.24	4.03	3.85
SOFR*	5.29	5.10	4.83	4.52	4.19
German bunds					
10-year	2.50	2.33	2.21	2.25	2.25
2-year	2.82	2.58	2.35	2.24	2.15
EURIBOR*	3.66	3.43	3.17	2.91	2.67

Source: Bloomberg

EQUITIES

12-month outlook

S&P 500 Sectors	ETF	Outlook
Energy	XLE	Positive
Financials	XLF	Positive
Materials	XLB	Positive
Technology	XLE	Neutral
Consumer Staples	XLB	Neutral
Communications	XLK	Neutral
Utilities	XLV	Neutral
Industrials	XLP	Neutral
Health Care	XLRE	Neutral
Consumer Discretionary	XLI	Negative
Real Estate	XLU	Negative

Source: Charles Schwab

6-12 month outlook

Regional Markets	ETF	Outlook
US	SPY	Positive
Japan	EWJ	Positive
UK	EWU	Neutral
Emerging Markets	EEM	Neutral
China	MCHI	Neutral
Europe	IEUR	Negative

Positive Neutral Negative

Source: BlackRock Investment Institute

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