Weekly commentary

July 10, 2023

BlackRock

Earnings outlook: Show us the growth

- Higher expected corporate earnings mask broad pressure under the surface. We see more earnings pain ahead and look for opportunities at the sector level.
- U.S. Treasury yields surged and stocks dipped last week. Data confirmed the U.S. labor market is still tight. We see signs markets are adjusting to the new regime.
- All eyes are on U.S. CPI inflation data out this week. Continued evidence of stubbornly high inflation could add momentum to the recent rise in bond yields.

Bond yields have jumped, and we think markets are at a key juncture as central banks are poised to hold tight on policy. As Q2 results begin, corporate earnings need to deliver on market expectations to support stocks, in our view. We see a key divergence in earnings forecasts: They have risen for a few tech firms, while the rest stagnate. Profit margins are shrinking, and we see more pressure ahead. So we get granular and favor sectors like healthcare within developed market stocks.

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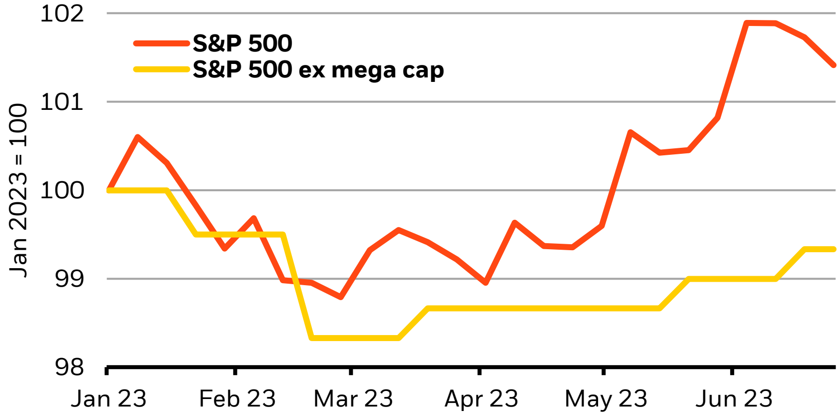
Split earnings outlook

S&P 500 earnings 12 months ahead, Jan.-June 2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2023. Notes: The chart shows 12-month forward aggregate earnings estimates for the S&P 500 and S&P 500 excluding mega cap names (the largest seven mega cap stocks). The data has been rebased with January 2023 = 100.

Q1 earnings growth was flat to slightly negative, Refinitiv and Factset data show. That masks significant divergence: We see a common denominator between what's driving market performance this year and earnings – the artificial intelligence (AI) buzz. S&P 500 earnings forecasts for the next 12 months have risen in recent months (dark orange line in the chart) along with the market rally driven by tech firms with the largest market capitalization. Stripping out those mega-cap tech stocks, forecasts are flat this year (yellow line). 2023 consensus estimates have been cut but remain well above our expectation. We expect Q2 data will be similar to Q1 as the reporting season kicks off this week, with a contraction hitting in the second half of 2023. We assess profit margins, shaped by earnings and revenues, for cracks, too. Margins jumped during the pandemic when consumer demand for goods was strong and companies could push up prices as input costs soared.

Margins have slid since last year as spending shifted back to services, but they remain above their pre-Covid highs. At the same time, data like Friday's U.S. jobs report reinforce how tight labor markets are in the U.S. and Europe. The key question right now, in our view: If rate hikes are not squeezing the labor market, where will the squeeze come from? Corporate profit margins, we believe, as wage gains and still-solid employment take a bigger toll on margins than in the past. Tight labor markets have caused employers to up wages to attract new hires. Broad worker shortages could incentivize companies to hold onto workers – even if sales decline – out of fear they won't be able to hire them back. This outlook poses the unusual possibility of "full employment recessions" in the U.S. and Europe.

Last week's surge in government bond yields put some pressure on equities – and highlights that companies will need to deliver on the market's earnings expectations as the Q2 reporting season gets under way to avoid more pressure. Resilient consumers have helped support earnings, but we see them exhausting the savings built up during the pandemic this year.

Yet not all corporate sectors will suffer margin pressures in the same way, as is reflected in market pricing. We tilt toward certain sectors within a modest underweight to developed market equities on a six- to 12-month tactical horizon: divergences create opportunities depending on what's priced in. For example, technology and healthcare margins saw a boost during the pandemic. They could avoid the broad decline we expect as quality sectors that stand to benefit from mega forces, like AI and aging populations. These forces are driving profits now and in the future – and markets are reacting, as with this year's tech rally. Plus, we like healthcare's more attractive valuations and generally steady cash flow during economic downturns.

We also like the industrial sector, particularly automakers as they better price in future earnings risk while adding diversification and quality to our defensive portfolios. Automakers would also benefit if the downturns we expect do not occur and consumers stay strong. With a regional lens, we see the earnings improvement at European financials carrying on: Higher interest rates should boost their profit margins, and some are returning capital to investors via buybacks.

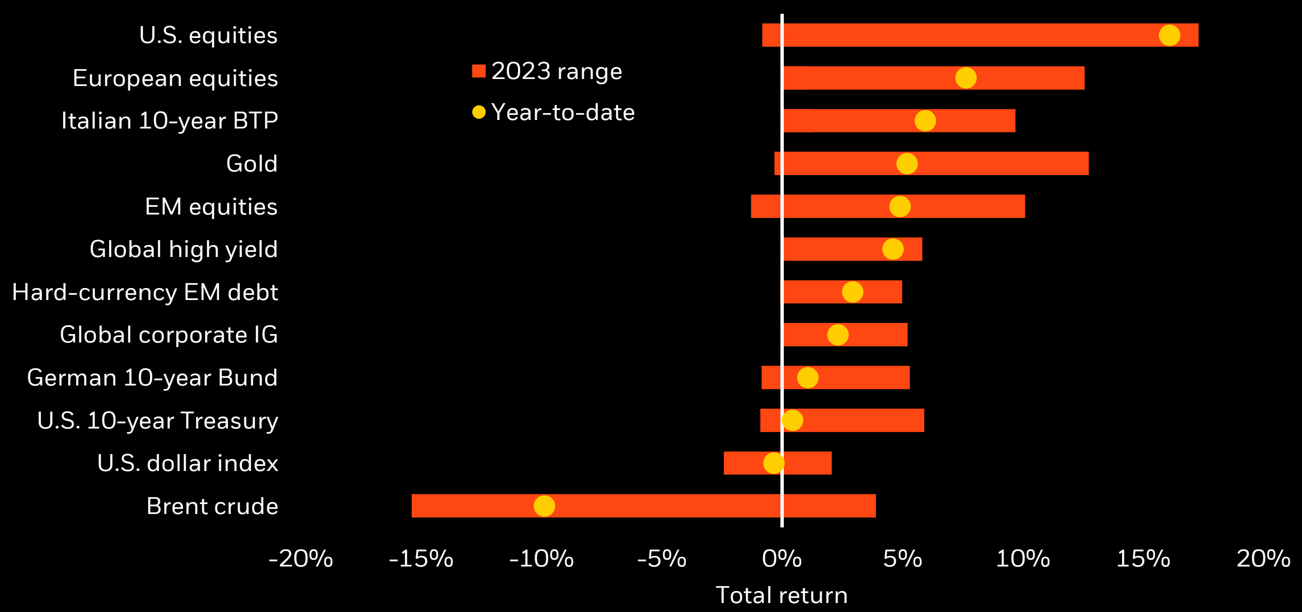
Bottom line: We see tight labor markets squeezing profit margins, and we think earnings will come under more pressure in the second half of the year. We think this macro environment is not a friendly one for broad asset class exposures. That's why we get granular within developed market stocks and identify our selective preferences across regions and sectors.

Market backdrop

U.S. 10-year Treasury yields approached 15-year highs above 4% and stocks dipped last week after U.S. jobs data showed a still tight labor market. The unemployment rate fell lower, labor participation hasn't risen further and wages are still growing even after the Fed's rapid rate hikes. We think the yield move and equity retreat signal we are at an important juncture: Markets are coming around to our view that central banks will be forced to keep policy tight to curb inflationary pressures.

Assets in review

Selected asset performance, 2023 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 Refinitiv Datastream as of July 6, 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 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, Refinitiv 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.

Macro take

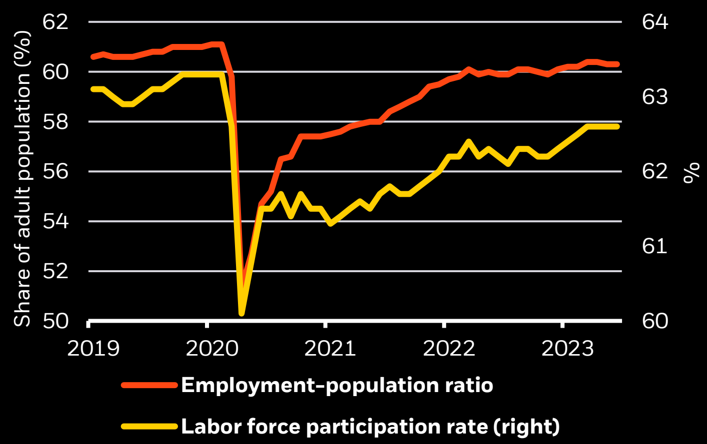
Last week's U.S. jobs data reinforced that labor supply remains constrained. Looking beyond the increase in overall payroll employment shows the extent of the labor shortages. The labor participation rate – the share of the population in work or looking for jobs – hasn't increased in the last four months. See the chart. And the unemployment rate remains near a five-decade low. That means the share of the population in employment hasn't grown much this year.

Data on job vacancies corroborate this picture. The number of job vacancies only fell slightly. The key message? Companies are not as effectively finding available workers since the pandemic struck three years ago.

That's helping sustain wage pressures. Average hourly earnings growth stayed high in June and is running at a pace well above what the Fed thinks is required to hit its 2% inflation target. We think these inflationary pressures compel the Fed and other central banks to keep policy restrictive: and so they're *holding tight* – the first theme of our midyear outlook. See our Macro take blog posts here.

Beset by shortages

U.S. employment-population ratio & participation rate, 2019-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics with data from Haver Analytics, July 2023. Notes: The chart shows the employment-population ratio – the share of the total adult population in employment – and the labor force participation rate – the share of the adult population in or looking for work – for the U.S. from 2019 onwards.

Investment themes

1 Holding tight

- Markets have come around to the view that central banks will not quickly ease policy in a world shaped by supply constraints – notably worker shortages in the U.S.
- We see central banks being forced to keep policy tight to lean against inflationary pressures. This is not a friendly
- backdrop for broad asset class returns, marking a break from the four decades of steady growth and inflation known as the Great Moderation.
- Economic relationships investors have relied upon could break down in the new regime. The shrinking supply of workers in several major economies due to aging means a low unemployment rate is no longer a sign of the cyclical health of the economy. Broad worker shortages could create incentives for companies to hold onto workers, even if sales decline, for fear of not being able to hire them back. This poses the unusual possibility of "full employment recessions" in the U.S. and Europe. That could take a bigger toll on corporate profit margins than in the past as companies maintain employment, creating a tough outlook for DM equities.
- **Investment implication:** Income is back. That motivates our overweight to short-dated U.S. Treasuries.

2 Pivoting to new opportunities

- Greater volatility has brought more divergent security performance relative to the broader market. Benefiting from this requires getting more granular and eyeing opportunities on horizons shorter than our tactical one. We go granular by tilting portfolios to areas where we think our macro view is priced in.
- We think dispersion within and across asset classes – or the extent to which prices deviate from an index – will be higher in the new regime amid the various crosscurrents at play, allowing for granularity. That offers more ways to build portfolio "breadth" via uncorrelated exposures, in our view.
- We think it also means security selection, expertise and skill are even more important to achieving above benchmark returns. Relative value opportunities from potential market mispricings are also likely to be more abundant.
- **Investment implication**: We like quality in both equities and fixed income.

3 Harnessing mega forces

- Mega forces are structural changes we think are poised to create big shifts in profitability across economies and sectors. These mega forces are digital disruption like artificial intelligence (AI), the rewiring of globalization driven by geopolitics, the transition to a low-carbon economy, aging populations and a fast-evolving financial system.
- The mega forces are not in the far future – but are playing out today. The key is to identify the catalysts that can supercharge them and the likely beneficiaries – and whether all of this is priced in today. We think granularity is key to find the sectors and companies set to benefit from mega forces.
- We think markets are still assessing the potential effects as AI applications could disrupt entire industries.
- Geopolitical fragmentation, like the strategic competition between the U.S. and China, is set to rewire global supply chains, we think.
- The low-carbon transition causing economies to decarbonize at varying speeds due to policy, tech innovation and shifting consumer and investor preferences. Markets have historically been slow to fully price in such shifts.
- We see profound changes in the financial system. Higher rates are accelerating changes in the role of banks and credit providers, shaping the future of finance.
- **Investment implication**: We are overweight AI as a multi-country, multi-sector investment cycle unfolds.

Week ahead

July 10-17	China total social financing	**July 13**	China trade data; U.S. initial jobless claims
July 12	U.S. CPI inflation; Bank of Canada policy rate decision	**July 14**	University of Michigan consumer sentiment survey

Stubbornly high U.S. CPI inflation data this week could bolster the recent bond yield surge as markets expect the Fed to hike rates this month after a June pause. The Bank of Canada hiked after a pause – and markets are leaning toward odds of another hike this week. We think central banks will be forced to keep policy tight to lean against inflationary pressures.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, July 2023

Underweight **Neutral** **Overweight** ● Previous view

	Asset	Strategic	Tactical	Commentary
Equities	Developed	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched. Tactically, we're underweight DM stocks as central banks' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession.
	Emerging	Neutral	+1	Strategically, we are neutral as we don't see significant earnings growth or higher compensation for risk. We are overweight tactically on brighter growth trends in EM over DM, still appealing valuations and EM rate cycles nearing their peaks.
Developed market government bonds	Nominal	-2	-1	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. We stay underweight nominal long-dated government bonds on both horizons as we expect investors to demand more compensation for the risk of holding them. Tactically, we are neutral on euro area and UK long-term bonds because higher yields better reflect our view.
	Inflation-linked	+3	Neutral	Our strategic views are maximum overweight DM inflation-linked bonds where we see higher inflation persisting – but we have trimmed our tactical view to neutral on current market pricing in the euro area.
Public credit and emerging market debt	Investment grade	Neutral	Neutral	We are neutral investment grade credit due to tightening credit and financial conditions but see it playing an important income role in portfolios on both horizons.
	High yield	Neutral	-1	Strategically, we are neutral high yield as we see the asset class as more vulnerable to recession risks. We're tactically underweight. Spreads don't fully compensate for slower growth and tighter credit conditions we expect.
	EM debt	Neutral	+1	Strategically, we're neutral and see more attractive income opportunities elsewhere. Tactically, we're overweight local-currency EM debt. We see it as more resilient with EM central banks closer to cutting rates than DM counterparts.
Private markets	Income	+1	–	We are strategically overweight private markets income. For investors with a long-term view, we see opportunities in private credit as private lenders help fill a void left by a bank pullback.
	Growth	-1	–	Even in our underweight to growth private markets, we see areas like infrastructure equity as a relative bright spot.

Note: Views are from a U.S. dollar perspective. 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.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, July 2023

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. We don't think earnings expectations reflect the macro damage we expect. We recognize momentum is strong near term.
	Europe	-1	We are underweight. The European Central Bank keeps tightening in a slowdown and the support to growth from lower energy prices is fading.
	UK	-1	We are underweight. The Bank of England is hiking sharply to deal with sticky inflation. While equities price in more downside risk, we await policy clarity.
	Japan	Neutral	We are neutral. Bank of Japan policy is still easy, shareholder-friendly reforms are taking root and negative real rates support equities.
	Pacific ex-Japan	Neutral	We are neutral. China's restart is losing steam and we don't see valuations compelling enough to turn overweight.
	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	+1	We are overweight. We see brighter relative growth trends in EM over DM, valuations remain appealing and EM rates cycles are nearing peaks.
	China	+1	China's economic restart is fading, yet low inflation creates space for more policy easing. The bar for upside surprises is low given current valuations. Structural challenges like 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	-1	We are underweight. We see long-term yields moving up further as investors demand greater term premium.
	U.S. inflation-linked bonds	+1	We are overweight and prefer the U.S. over the euro area. We see market pricing underestimating sticky inflation.
	Euro area inflation-linked bonds	-1	We prefer the U.S. over the euro area. Markets are pricing higher inflation than in the U.S., even as the European Central Bank has signaled more interest rate hikes ahead.
	Euro area govt bonds	Neutral	We are neutral. Market pricing better reflects rates staying higher for longer. We see risk of wider peripheral bond spreads due to tighter financial conditions.
	UK gilts	Neutral	We are neutral. We find gilt yields better reflect our expectations for the macro outlook and Bank of England policy.
	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	Neutral	We are neutral on tighter credit and financial conditions. We prefer Europe's more attractive valuations over the U.S.
	U.S. agency MBS	+1	We're overweight. We see agency MBS as a high-quality exposure within diversified bond allocations.
	Global high yield	-1	We are underweight. Spreads do not fully compensate for slower growth and tighter credit conditions we anticipate.
	Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
	Emerging hard currency	Neutral	We are neutral. Better fundamentals and undemanding valuations are offset by the risk from rising U.S. yields.
	Emerging local currency	+1	We are overweight. EM central banks are closer to cutting rates than DM counterparts.

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