Weekly commentary

BlackRock

Oct. 7, 2019

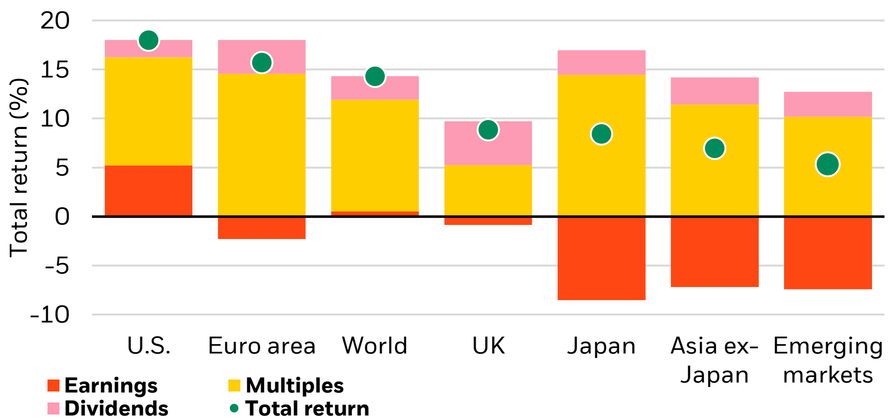
Why earnings season matters

- We see third-quarter earnings season offering some limited support to U.S. stocks in the near term, as a growth rebound is months away.
- Signs of weakening economic activity beyond the manufacturing sector have revived concerns about the growth backdrop.
- U.S.-China trade talks are scheduled to resume this week. A trade truce is possible, but a comprehensive deal remains unlikely.

Equities have stumbled this month, as weak economic data has revived recession fears. This comes after central banks' dovish pivot fueled significant multiple expansion. Where to now? We see limited additional monetary easing ahead. This means earnings will be key for further U.S. equity gains. Third-quarter earnings season may offer some limited support as the macro backdrop worsens. But we see easier financial conditions helping growth and earnings over 6-12 months.

Chart of the week

Equity sources of total return in 2019



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and MSCI, October 2019. Notes: The bars show the breakdown of each market's return year to date into dividends, earnings and multiples. The dots show each market's total return over the same period. Earnings refers to changes in 12-month forward I/B/E/S earnings estimates. Multiples refers to multiple expansion (or contraction) – the change in the 12 month forward price-to-earnings ratio. The indexes used are MSCI indexes representing each market. Returns are in local currency except World, Asia ex-Japan and EM returns, which are in U.S. dollars.

Multiple expansion – rising price-to-earnings ratios – has been the principal contributor to global equity performance in 2019. Earnings growth has only been a modest contributor in the U.S. – and detracted in other regions. See the chart above. Behind the multiple expansion, in our view: monetary easing. Lower rates are typically reflected in higher price-to-earnings ratios. The Federal Reserve has cut rates twice this year to cushion the economy. We do expect the Fed to cut further, yet we believe markets may be pricing in too much additional easing in the year ahead. This points to limited scope for further multiple expansion and increases the importance of earnings growth in driving further gains.

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BlackRock **Investment** Institute

U.S. stocks have outperformed in 2019 – even as analysts' earnings expectations have drastically fallen. A year ago, S&P 500 earnings were expected to grow roughly 10% this year; that number has dwindled to around 2%. Expectations point to a modest year-on-year contraction in third-quarter U.S. earnings. This partly reflects a high bar set in 2018, when corporations enjoyed a one-time boost to earnings from U.S. corporate tax cuts. Companies across most sectors have been guiding expectations lower as reporting nears. The lowered expectations mean the weak earnings season may offer some upside surprises; quarterly results have beaten the conservative guidance that prevailed prior to each quarter this year.

Yet renewed growth concerns and lingering trade uncertainty cloud the near-term profit and market outlook. Persistent uncertainty from the protectionist push is weighing on corporate confidence and slowing business spending, as we write in the Q4 update to our 2019 Global investment outlook. In the near term we see potential for further bouts of market volatility, as fallout from the unresolved trade war is reflected in weak economic data. We do not expect significantly looser U.S. monetary policy on the horizon in response. Complicating the case for further Fed easing: Supply chain disruptions could foster mildly higher inflation, even as growth slows. The trade war fallout could also weigh on a rosy corporate profit outlook for 2020 – adding to the pressures from declining profit margins typical of the late stage of a business cycle.

The overall outlook looks better on a 6-12 month horizon. We see a trough in U.S. economic growth, as the global monetary stimulus delivered to date feeds into the economy. This should boost companies' top-line growth – at the late stage in the economic cycle when U.S. equities have historically delivered above-average returns. Against this backdrop, we maintain our moderately pro-risk stance over the longer horizon, even as additional volatility could be with us over the shorter term. We prefer U.S. stocks for their quality bias, higher return on equity and lower exposure than other equity markets to manufacturing and industrial production weakness. We also see expectations of low-teens earnings growth in 2020 for regions such as emerging markets (EMs) as much less realistic. Through a factor lens, we prefer min vol and quality for their defensive properties. Bottom line: We remain overweight U.S. stocks as third-quarter earnings season kicks off.

Market backdrop

Signs that the drag on economic activity from the global protectionist push is spreading beyond the manufacturing sector have revived concerns about the growth backdrop, weighing on risk assets. Major central banks have taken a dovish stance — the Fed has cut rates in line with market expectations, following the European Central Bank's broad stimulus package. Yet we see limits to how much monetary easing can be delivered in the near term. Monetary policy is no cure for the weaker growth and firmer inflation pressures that may result from sustained trade tensions.

Assets in review

Selected asset performance, 2019 year-to-date and range

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.

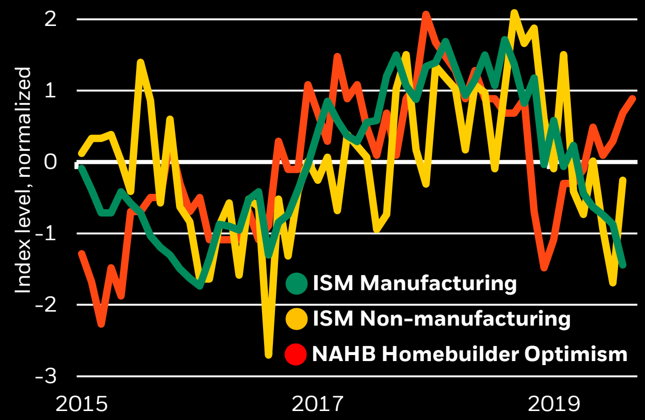
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2019. Notes: The dots show total returns of asset classes in local currencies. Exceptions are emerging market (EM), high yield and global corporate investment grade (IG), which are denominated in U.S. dollars. Indexes or prices used: spot Brent crude, MSCI USA Index, DXY, MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S. and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

Macro insights

Global financial conditions have eased this year, after a dovish shift by global central banks. Overall growth has not yet picked up as a result – but some pockets of the economy that are more sensitive to interest rates appear to be responding to the easier financial conditions. U.S. housing had been a drag on growth in eight of the past nine quarters as interest rates rose. But the housing sector is now showing signs of a rebound, with key metrics (starts and permits, new and existing home sales) all picking up in the past few months as real mortgage rates have followed U.S. Treasury yields down. The chart shows how the optimism in the U.S. homebuilding sector has rebounded while other sectors – especially manufacturing – have weakened further. Without central bank stimulus measures and the easing of financial conditions, the overall growth outlook would likely look even more subdued than it does now.

Building back up

ISM indexes, NAHB housing market index, 2015-2019



Sources: BlackRock Investment Institute, with data from the National Association of Home Builders and the Institute for Supply Management, October 2019. The chart shows the Institute for Supply Management (ISM) Manufacturing Index, the ISM Non-manufacturing Index, and the National Association of Home Builders sentiment index. The data have been normalized so they can be plotted on the same chart.

Investment themes

1 Protectionist push

- U.S.-China tensions ostensibly eased ahead of a new round of trade talks in October. We don't see any short-term deal solving long-term strategic issues such as technological dominance and implications for national security.
- Persistent uncertainty from protectionist policies is denting corporate confidence and slowing business spending, hurting the global industrial cycle — a key reason for our global growth downgrade.
- The longer-term risk from protectionism: The unravelling of global supply chains delivers a supply shock that saps productivity growth, reinforces a slowdown in potential output and leads to higher inflation.
- The attack on Saudi Arabia's oil facilities shows how geopolitical risks can materialize in multiple ways. A prolonged oil price shock, along with tariffs, could deepen concerns around the risk of lower growth and firmer inflation pressures.
- **Market implication**: We favor reducing risk amid rising protectionism, including raising some cash.

2 Stretching the cycle

- The record-long U.S. economic expansion is supported by healthy household spending and looks unlikely to morph into a deeper downturn any time soon.
- The Fed cut rates by a quarter-point for a second time since the financial crisis, yet stopped short of bolder actions. This supports our view that the market's easing expectations are excessive. The trade war is bad for growth, but we still see potential for U.S. inflation to rise in the near term due to the direct one-off impact of tariffs. In the longer term the resulting hit to production capacity could also be inflationary, complicating the case for policy easing.
- We believe policymakers should lay the groundwork for a credible plan to navigate the next economic shock that includes unprecedented coordination between monetary and fiscal measures. We lay out the contours of such a framework in our latest Macro and market perspectives. Absence of a credible plan is contributing to market anxiety, and adding to the rush into the perceived safety of government bonds.
- Chinese authorities have cut bank reserve requirements, lowered private sector borrowing costs and boosted infrastructure spending. Yet the stimulus remains limited, with a focus still on shoring up the financial system.
- **Market implication:** We like U.S. equities and EM debt. We are overweight euro area government bonds: a relatively steeper yield curve brightens their appeal even at low yields. We are neutral European equities and credit.

3 Raising resilience

- A sharp spike higher in U.S. money market rates — a cornerstone of the financial system — jolted market participants and highlighted the importance of portfolio resilience.
- The underperformance of momentum and outperformance of value show the importance of minimizing portfolio exposure to pockets of the market where pricing appears stretched.
- **Market implication**: Government bonds play an important role in building portfolio resilience – even at low yield levels – both on a tactical basis and in long-term portfolios.

Week ahead

Oct. 7 through Oct. 11 – U.S. and China trade talks are slated to resume, as the China delegation returns to the U.S. We see some possibility of a truce, but a comprehensive trade deal remains unlikely.

Oct. 10 and Oct. 11 – We see the core inflation component of the September U.S. Consumer Price Index (Oct. 10) holding close to or above the Fed's target. The University of Michigan Consumer Sentiment Index (Oct. 11) will provide a signpost of whether a strong consumer can continue to offset manufacturing weakness. We expect to see ongoing consumer resilience.

Asset views

Views from a U.S. dollar perspective over a 6-12 month horizon

Asset class		View	Comments
Equities	U.S.	▲	A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective we like min-vol and quality, which have historically tended to perform well during economic slowdowns.
	Europe	—	We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼	We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	—	We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We see the greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support across the board, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼	We have downgraded Asia ex-Japan equities to underweight due to the region's China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region's debt instruments instead.
Fixed income	U.S. government bonds	▼	We remain underweight U.S. Treasuries. We do expect the Fed to cut rates by a further quarter percentage point this year. Yet market expectations of Fed easing look excessive to us. This, coupled with the flatness of the yield curve, leaves us cautious on Treasury valuations. We still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	—	Favorable supply-demand dynamics and improved fundamentals are supportive. The tax overhaul has made munis' tax-exempt status more attractive. Yet muni valuations are on the high side, and the asset class may be due for a breather after a 10-month stretch of positive performance.
	U.S. credit	—	We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. High-yield and investment-grade credit remain key part of our income thesis.
	European sovereigns	▲	The resumption of asset purchases by the ECB supports our overweight, particularly in non-core markets. A relatively steep yield curve – particularly in these countries – is a plus for euro area investors. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential.
	European credit	—	Renewed ECB purchases of corporate debt and a "lower for even longer" rate shift are supportive. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	EM debt	▲	We like EM bonds for their income potential. The Fed's dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We see local-currency markets having room to run and prefer them over hard-currency markets. We see opportunities in Latin America (with little contagion from Argentina's woes) and in countries not directly exposed to U.S.-China tensions.
	Asia fixed income	—	The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing . We have reduced overall risk and moved up in quality across credit as a result.

▲ Overweight — Neutral ▼ Underweight

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