Weekly commentary

BlackRock

August 14, 2023

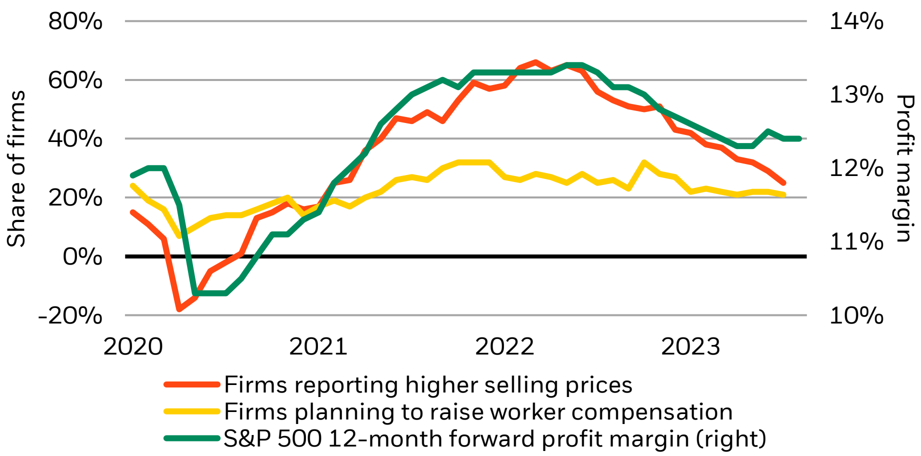
Three takeaways from U.S. earnings

- U.S. corporate earnings have stagnated for a year, but Q2 beat a low bar. Expectations of improving margins look rosy. We stay selective in equities.
- U.S. stocks moved sideways and 10-year Treasury yields surged in volatile trading last week after CPI data. We see inflation on a rollercoaster ahead.
- We're watching inflation in Japan this week after the central bank loosened its yield cap last month. We see that pulling local and global bond yields higher.

U.S. corporate earnings have stagnated over the past year even as Q2 earnings improved a bit on better profit margins. We still see a margin squeeze ahead as worker shortages push wages back up, even if that takes longer to play out – our first takeaway. So the consensus for margins to expand into next year looks rosy, to us. Second, we see clear sector winners and stay selective with and within sectors that delivered earnings growth. Third, we see key regional divergences.

Profit pressure ahead

U.S. NFIB survey selling prices and wages vs. S&P 500 margins, 2020-2023



Source: BlackRock Investment Institute and NFIB, Refinitiv Datastream, August 2023. Notes: The dark orange line shows the net percentage of respondents reporting higher average selling prices based on the NFIB Small Business Economic Trends survey. The yellow line shows the share planning to increase worker compensation in the next three months.

U.S. earnings have stagnated over the past year as pandemic-driven spending shifts normalized, squeezing profit margins. Margins ticked up in Q2, so earnings topped low expectations, partly from companies benefitting from lower input costs. We don't think this will last. The consensus for profit margins looks too rosy – our first takeaway from Q2 earnings (green line in chart). Firms may struggle to pass on persistent labor costs to consumers: The share of businesses reporting higher prices for their products is the lowest since January 2021 (dark orange line), NFIB data show. We see companies facing higher labor costs from lifting wages to attract fewer available workers: The workforce is 4 million smaller than it would have been if it had kept growing at its pre-Covid pace, we find. The recovery of jobs lost in the pandemic has masked what has proved tepid job growth. Competition for workers should boost employee wages – at the expense of profit margins and shareholders.

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BlackRock **Investment** Institute

We believe this structural labor shock is poised to take over as the driver of inflation as the pandemic-driven spending mismatch unwinds. That historic shift in consumer spending during the pandemic to goods from services created mismatches in production and consumption, and within the labor market as a result. It drove up prices and led to fatter profit margins, especially in the goods sector. Recent data showing a further sharp drop in goods prices in the July U.S. CPI and cooling Q2 wage data confirmed spending is normalizing. And that means profit margins are starting to normalize as well, even with the slight improvement in Q2. As worker shortages due to an aging population become more binding, we see firms needing to devote revenue to hiring or retaining workers – to the detriment of margins. We see inflation on a rollercoaster as the labor shock takes over from the spending mismatch. If companies try to protect margins from these wage pressures in a stagnant economy, that could add to inflation pressures and result in even higher central bank policy rates. We have evolved our macro framework to account for these forces. Read more in our blogs here and here.

Our second takeaway from Q2 earnings season: Tech met a high bar and selectivity is coming through in earnings. Other sectors that perform well as economic activity picks up fared better than expected, like industrials, communication services and consumer discretionary. As U.S. growth stagnates, it would be logical to question consumer sector resilience – especially as pandemic savings dwindle. But that's the old playbook: The sector impact may be different. We think workers gaining income share from firms and unemployment staying low could reinforce consumer spending power for some time. We use our new playbook instead to get granular with and within equity sectors. Tech aligns with our preference for sectors delivering earnings growth. But we stay selective in tech with our overweight to the developed market (DM) artificial intelligence mega force theme, tapping into this structural shift within DM stocks, even when the macro is unfriendly to broad equity exposures.

Our last takeaway is regional differences. Q2 earnings of European firms contracted twice as much as U.S. peers, contributing to European stocks underperforming DM peers in recent months. Within DM, we prefer equities in Japan, where policy is still relatively easy, real rates are negative and shareholder-friendly reforms are taking root.

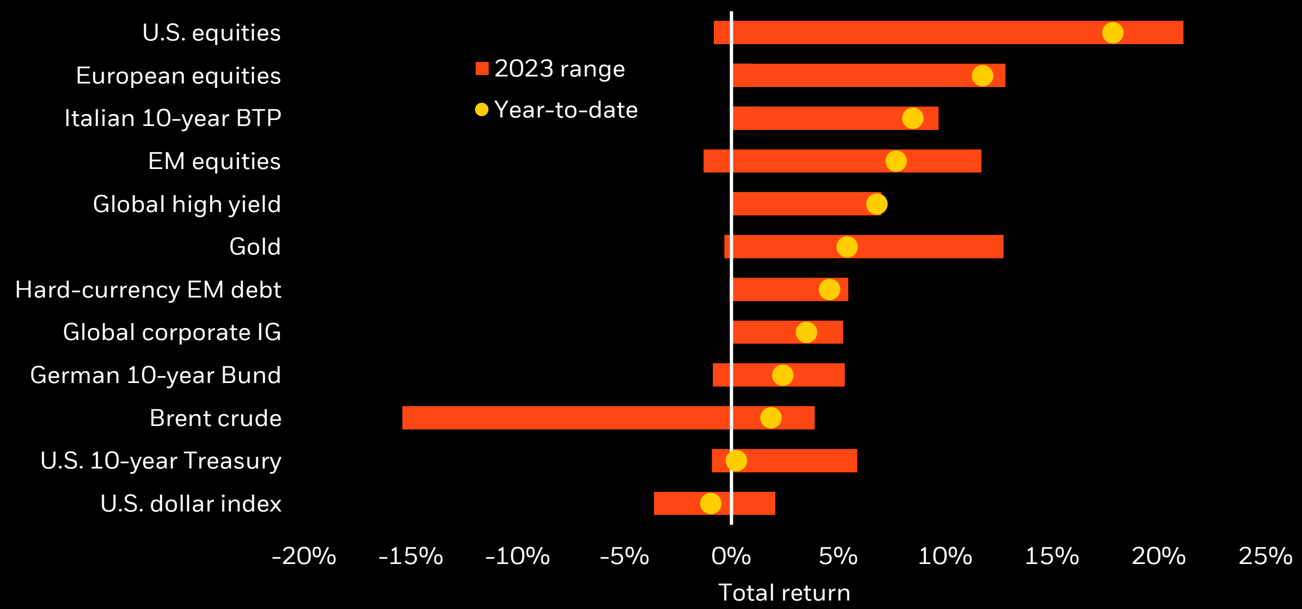
Bottom line: U.S. earnings are stagnating. Market expectations for a pickup in margins over the next year look rosy as worker shortages keep pressure on wages. We're keeping a close eye on the labor market as a result and stay granular in DM stocks.

Market backdrop

U.S. stocks moved sideways below the 16-month high hit in July, with tech stocks underperforming after their sharp gains this year. Ten-year Treasury yields surged back near 15-year highs after volatile trading, partly due to a weak bond auction. The July CPI showed inflation cooling more. We see inflation on a rollercoaster ride ahead (see above). Market pricing of long-term inflation has diverged from shorter-term pricing, suggesting that markets see inflation pressures persisting longer term.

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 Aug. 10, 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.

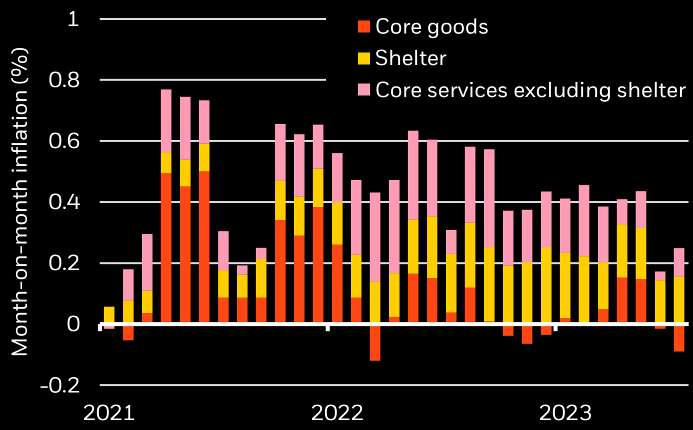
Macro take

Last week's U.S. CPI report showed core inflation at 0.2% in July, taking annual inflation down to 4.7%. We find that recent core inflation data has broken out of the pattern of higher readings over the past two years – and represents real progress on inflation. The mismatch between demand and supply is resolving as one shock, the pandemic-era shift in spending toward goods and away from services, unwinds. Goods prices are now dragging inflation down as demand normalizes. See the orange bars in the chart.

But as one shock fades, a second – the aging population – is poised to take over. And that could put inflation on a rollercoaster ride. An aging workforce means the U.S. economy soon won't be able to create as many new jobs without stoking inflation as it could before the pandemic. Without much weaker job growth or a surprise increase in productivity or immigration, we think labor shortages could lead to wage pressures resurging late this year or early next year. See our Macro take blog posts here.

Progress on inflation

Contribution to monthly core CPI inflation, 2021-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, August 2023. Notes: The chart shows the contribution of individual components to overall monthly core Consumer Price Index (CPI) inflation. Shelter refers to rental prices and the estimated equivalent from those owning homes.

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

Aug. 15	Japan GDP; China retail sales	**Aug. 18**	Japan inflation
Aug. 16	Euro area flash GDP; UK inflation		

We're watching GDP and inflation data across DMs this week. Inflation has returned in Japan but not as much as other major economies. The Bank of Japan (BOJ) is still unsure if higher wages are sustainable and can keep inflation around its target. Yet the BOJ loosened its yield cap again in July. We see that pulling local and global bond yields higher.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, August 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, August 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. We see the European Central Bank holding policy tight in a slowdown, and the support to growth from lower energy prices is fading.
	UK	Neutral	We are neutral. We find that attractive valuations better reflect the weak growth outlook and the Bank of England's sharp rate hikes to deal with sticky inflation.
	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 is set to hold policy tight, in our view.
	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	+1	We are overweight. We prefer emerging hard currency debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks start to cut policy rates.
	Emerging local currency	Neutral	We are neutral. Yields have fallen closer to U.S. Treasury yields. Plus, central bank rate cuts could put downward pressure on EM currencies, dragging on potential returns.

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