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Weekly commentary

BlackRock

October 23, 2023

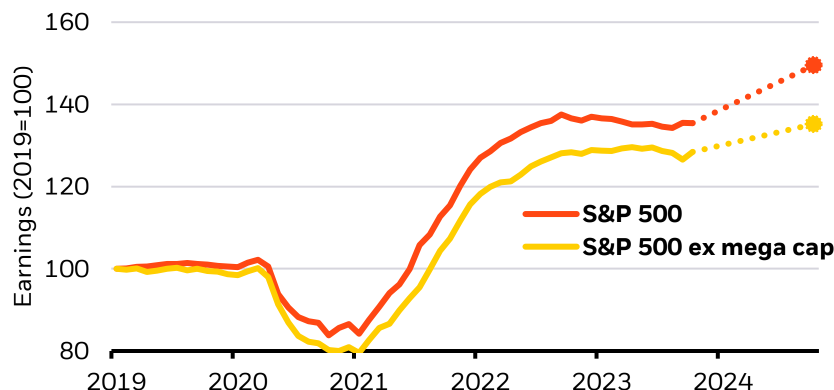
U.S. stocks: selective as earnings stall

- U.S. corporate earnings have stagnated with the economy. We stay selective in stocks and harness mega forces like artificial intelligence as key profit centers.
- The 10-year U.S. Treasury yield hit 16-year highs near 5.0% last week, while U.S. stocks fell more than 2% as markets eyed high-for-longer policy rates.
- The Federal Reserve's preferred inflation metric, PCE, is due for release this week. We expect consumer spending to keep shifting back to services.

Markets expect a pickup in corporate earnings to start in the Q3 reporting season that gets underway in earnest this week. We are cautious. U.S. corporate profits have plateaued along with the economy. We think this has gone under the radar. The macro backdrop is bad news for broad equities, we think, but opportunities in stocks abound. We tap mega forces like artificial intelligence (we are closely watching the results of top players) and find value in sectors such as healthcare.

Earnings plateau

S&P 500 trailing earnings and 12-month forward forecasts, 2019-2024



Sources: BlackRock Investment Institute, with data from LSEG Datastream, October 2023. Notes: The chart shows 12-month trailing earnings (solid line) rebased to 100 at the start of 2019. The dotted lines are based on 12-month forward aggregate analyst earnings growth estimates. S&P ex-mega cap excludes Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA and Tesla.

U.S. earnings growth has sputtered in the past year. See the solid lines in the chart. Markets expect year-over-year earnings growth to turn slightly positive in Q3. We think hopes of a long-awaited pickup are masking a still relatively stagnant growth trend. Modest earnings growth doesn't reflect the market narrative of a resilient economy either, in our view. Focusing on earnings beating expectations may miss the point, too: that would be confirmation that low expectations are being met. The consensus eyes renewed S&P 500 earnings growth of about 10% over the next year. We're more cautious – and selective. About half of expected earnings growth is tied to mega caps (orange dotted line), according to LSEG data, where the artificial intelligence (AI) mega force is well represented. Backing those out (yellow dotted line), expectations for broad equities are muted and overly optimistic, in our view.

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BlackRock **Investment** Institute

We think the current macro backdrop isn't friendly for broad equity exposures. Higher rates and stagnant growth have weighed on markets, but the move lower in stocks shows they are adjusting to the new macro regime. Stealth stagnation over the past 18 months – taking the average of GDP and gross domestic income, which adds up incomes and profits of households and firms – has been the weakest stretch ever seen outside a recession. We think this has gone under the radar because consumer spending, job growth and GDP have held up. We see stagnation persisting as the Federal Reserve keeps policy rates high in its battle with inflation.

We think the inflation rollercoaster we see ahead creates risks to corporate profit margins. Inflation is cooling now as the pandemic-driven mismatches in spending between goods and services normalize. That could also drag on corporate revenues as pricing power for some firms fades. A shrinking workforce means the rate of growth the economy will be able to sustain without stoking inflation is likely to be lower than we were used to in the past. We see the labor market remaining tight. If job growth keeps up at its current pace, we think wage pressure could come back to bite margins, too. The risk of resurgent inflationary pressures is why we see the Fed holding policy tight. We expect higher rates to increase the interest expense for companies. We think markets are underappreciating profit margin pressure – even if that takes some time. Tech has supported broader margins this year – and cash held by firms has dulled the blow from higher interest expenses.

U.S. stock valuations – the driver of performance this year as earnings stagnated – remain elevated, in our view. Taking into account higher yields, the income in bonds is also more attractive than stocks on a relative risk basis. We stay underweight on broad equities on a six- to 12-month tactical horizon. We favor sectors like tech and harness the AI mega force where we see more potential for earnings growth and expanding profit margins. Tech earnings have come through and are driving the upward revisions in overall profit expectations. We're closely monitoring the slew of big tech firm earnings reports in coming days. We also focus on granular sector or geographical opportunities, such as healthcare and Japanese equities.

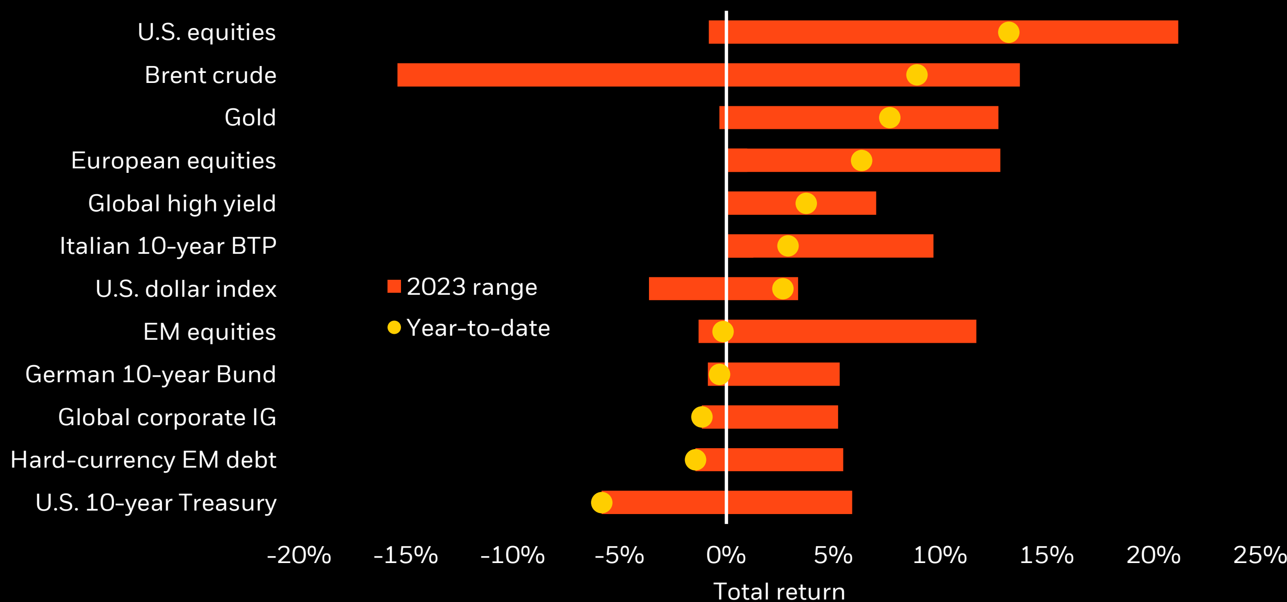
Bottom line: U.S. corporate earnings have stagnated along with the economy. Markets expect a pickup starting with Q3 reporting underway. We are cautious. Broad equities have started to adjust to the new regime of greater volatility, but don't fully reflect the macro damage we expect. We stay selective and harness mega forces. Read more in our new mega forces hub.

Market backdrop

The 10-year U.S. Treasury yield hit 16-year highs near 5.0%, while U.S. stocks fell more than 2%. Markets are coming around to our view of interest rates staying higher for longer in the new regime. Fed Chair Jerome Powell reinforced this in a speech last week – and suggested further hikes could be needed if sustained economic growth drives more persistent inflation. We think the tight labor market constrained by an aging population will eventually feed into inflation 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 LSEG Datastream as of Oct. 19, 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, 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.

Macro take

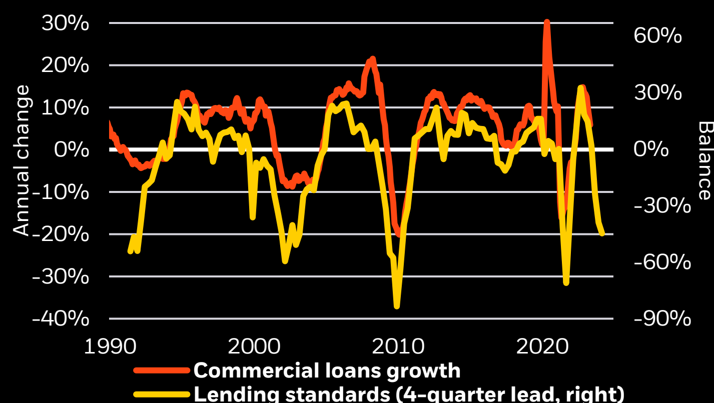
The Fed's previous rate hikes are starting to bite, as Fed Chair Jerome Powell noted last week. The rapid rate hikes since early 2022 to 5.25-5.5% are meant to dampen spending and investment, helping close the gap between demand and supply that's driving inflation.

We're starting to see its impact – and more is set to come. Surveys show that lending standards have tightened sharply and that's impacting lending. See the chart. Total lending to businesses could shrink in the coming quarters.

Yet we don't see a 2008 style credit crunch in the cards. Corporate balance sheets are in much stronger shape, so we don't think they will come under forced pressure to deleverage. And easing supply disruptions tied to the pandemic suggest it may not take a deep recession to cool inflation. But beyond next year, we see higher borrowing costs, regulatory reforms and other factors shifting businesses towards non-bank sources of credit — part of a tectonic shift in the U.S. financial architecture. Read more about the future of finance here.

Tighter lending

Year-on-year commercial loan growth, 1990-2023



Source: BlackRock Investment Institute, Fed, with data from Haver Analytics, October 2023. Notes: The chart shows growth in commercial and industrial loans (orange, left-hand side), and results from FRB Senior Loan Officers Survey – net percentage balance tightening in standards for commercial and industrial loans to large and middle-market firms (yellow).

Investment themes

1 Holding tight

- The U.S. is navigating two large and unprecedented shocks. The first: A massive, pandemic-induced shift in consumer spending — most visible from services to goods – created a mismatch in what the economy was set up to produce and what people wanted to buy. The second: a worker shortage as baby boomers age into retirement.
- Our assessment is that we are set for "full-employment stagnation." Most of the inflation and wage growth we've seen to date reflects the mismatch associated with the pandemic. That is now reversing, and inflation is set to fall further. But as the process of resolving the mismatch ends and labor shortages start to bind, we expect inflation to go on a rollercoaster ride, rising again in 2024. A smaller workforce means the rate of growth the economy will be able to sustain without resurgent inflation will be lower than in the past.
- 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.
- **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.

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Week ahead

Oct. 23	Euro area consumer confidence	**Oct. 26**	U.S. durable goods, Q3 GDP; Japan services PPI
Oct. 24	Global flash PMIs	**Oct. 27**	U.S. PCE

U.S. inflation takes center stage this week with the Fed's preferred inflation measure, the PCE. We keep track of how consumer spending is shifting back to services from goods, driving down goods prices and inflation in the near term. Yet we expect an aging population to keep the labor market tight, putting inflation pressures on a rollercoaster ride.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, October 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 stay underweight DM stocks but upgrade Japan. We are underweight the U.S. and Europe. Corporate earnings expectations don't fully reflect the economic stagnation we see. We see other opportunities in equities.
Equities	Emerging	Neutral	Neutral	Strategically, we are neutral as we don't see significant earnings growth or higher compensation for risk. We go neutral tactically given a weaker growth trajectory. We prefer EM debt over equity.
Developed market government bonds	Nominal	-1	Neutral	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. We stay strategically underweight U.S. nominal long-dated government bonds as we expect investors to demand more compensation for the risk of holding them. Tactically, we're neutral long-term Treasuries as the yield surge driven by expected policy rates approaches a peak. We're overweight euro area and UK bonds as we see more rate cuts than the market does.
Developed market government bonds	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	-1	-2	Strategically, we're underweight due to limited compensation above short-dated government bonds. We're underweight tactically to fund risk-taking elsewhere as spreads remain tight.
Public credit and emerging market debt	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.
Public credit and emerging market debt	EM debt	Neutral	+1	Strategically, we're neutral and see more attractive income opportunities elsewhere. Tactically, we're overweight hard currency EM debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
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.
Private markets	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.

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, October 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	+1	We are overweight. We think stronger growth can help earnings top expectations. Stock buybacks and other shareholder-friendly actions may keep attracting foreign investors.
	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	Neutral	We are neutral. We see growth on a weaker trajectory and see only limited policy stimulus from China. We prefer EM debt over equity.
	China	Neutral	We are neutral. Growth has slowed. Policy stimulus is not as large as in the past. Yet it should stabilize activity, and valuations have come down. Structural challenges imply deteriorating long-term growth. 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	Neutral	We are neutral. The yield surge driven by expected policy rates is approaching a peak. We now see about equal odds that long-term yields swing in either direction.
	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	+1	We are overweight. Market pricing reflects policy rates staying higher for longer even as growth deteriorates. Widening peripheral bond spreads remain a risk.
	UK gilts	+1	We are overweight. Gilt yields are holding near their highest in 15 years. Markets are pricing in restrictive Bank of England policy rates for longer than we expect.
	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	-2	We are underweight. We take advantage of tight credit spreads to fund increased risk-taking elsewhere in the portfolio. We look to up the allocation if growth deteriorates.
	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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