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WEEKLY COMMENTARY • MAY 6, 2019

Key points

1 U.S. earnings growth has slowed markedly from 2018, but a surprisingly resilient first quarter supports our still-positive view on U.S. equities.

2 The Federal Reserve maintained its patient policy stance last week, and U.S. jobs gains and eurozone growth both surprised to the upside.

3 U.S.-China trade talks resume in Washington this week. Markets may be too optimistic about prospects for a resolution to trade tensions.

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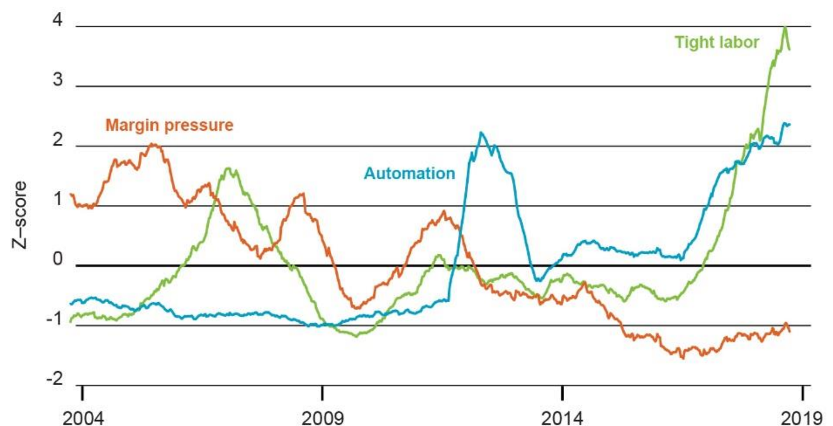
1 Takeaways from first-quarter earnings

U.S. stock indexes have rallied to new highs in recent weeks. The S&P 500 is up roughly 25% since its December low, fueled partly by encouraging first-quarter earnings results. What does this mean for our view of U.S. equities? We still favor them, as cost-cutting and efficiency gains help moderate the earnings slowdown.

Chart of the week

Analyst research reports including key phrases, 2004-2019



Sources: BlackRock Investment Institute, with data from Thomson Reuters, May 2019. Notes: The lines show the share of analyst research reports that mention a specific phrase within the Thomson Reuters global research database, expressed as a z-score, or the number of standard deviations from the 2004-2019 average.

U.S. corporate profit margins are holding up, despite rising concerns that today's low unemployment rate could spur labor shortages — and wage inflation. Attention to these trends is reflected in our text-mining analysis of broker reports from 2004 to 2019. We found the share of reports that carry the phrase "margin pressure" is now below the historical average, even as the share of documents with the phrase "tight labor" is at all-time highs. See the chart above. How to explain this apparent disconnect? Companies have been using technology to drive efficiencies that keep costs down, reduce the need for labor and help keep profit margins stable. See the "automation" line in the chart, which reflects this trend. To be sure, the pressure on earnings is likely to intensify in this late-cycle period as wage inflation picks up and productivity growth slows. Yet for now, companies are taking actions to cushion the downside, with many also returning capital to shareholders through share buybacks.

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A better (but not great) picture

U.S. earnings growth has slowed sharply from the double-digit pace of 2018. First-quarter earnings are up just 2.3% from a year earlier based on the companies that have reported to date, representing 80% of the S&P 500 market capitalization. Ahead of this earnings season, consensus estimates were pointing to a modest year-on-year contraction, the worst quarter for S&P 500 earnings growth since the second quarter of 2016. Companies have been beating forecasts at a higher rate than previous quarters, as subdued analyst expectations had lowered the bar for U.S. earnings beats. Earnings also appear solid when viewed in the context of slowing global economic growth and the fading impacts of U.S. fiscal stimulus. Yet we are still seeing more downgrades to analyst earnings expectations than upgrades this quarter, even as the pace of downgrades has eased over the last four weeks. Any bottoming out of earnings expectations could support a market that has rallied aggressively this year.

Some of the biggest drags to results appear to be diminishing for cyclical and resource sectors. Consider the improving Chinese economy and incremental progress in U.S.-China trade talks. The latter, along with dovish Fed expectations, contributed to markets recently reaching record highs. Yet sentiment does not appear ebullient, and the ability of companies to generate decent earnings growth despite a slowing economy speaks to their ability to drive efficiencies. Meanwhile, China could be a further boon to earnings growth. We expect a turnaround in Chinese growth from the second quarter.

There are risks to our outlook. Trade tensions could intensify again. And market expectations for Fed rate cuts are too dovish, in our view, meaning the Fed is less likely to provide additional support to equities. Not all sectors are created equal. Analysts expect expanding margins this year in the technology, health care and consumer discretionary sectors, while they see margins of defensive sectors more challenged. Finally, market punishments for misses have been more severe than in previous quarters, with low tolerance for poor results at this late-cycle stage. Yet here's our bottom line: First-quarter earnings have confirmed a better earnings picture than expected, supporting our near-term preference for U.S. equities.

2 Week in review

- The Fed maintained its patient policy stance and made few changes to its statement. Fed Chair Jerome Powell said the central bank was comfortable with its current policy stance and does not see a strong case for moving in either direction on interest rates. He appeared to brush off concerns around recent declines in core inflation. U.S. non-farm payrolls climbed by 263,000, surprising to the upside. The dollar briefly appreciated after the stronger-than-expected job gains.
- Oil prices fell as increased U.S. crude oil inventories outweighed concerns around the expiration of waivers on U.S. Iranian oil sanctions and political turmoil in Venezuela. Oil prices had hit a six-month high the week before last.
- Euro area growth picked up more than expected in the first quarter, in line with our view that the worst of the deceleration in Europe should be behind us (see our recent Macro and market perspectives). Consumer prices in Europe rose 1.7% in April, the largest increase since November. Core inflation, which strips out volatile food and fuel prices, jumped to 1.2%.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.2%	18.3%	14.3%	2.0%
U.S. Small Caps	1.4%	20.2%	5.8%	1.6%
Non-U.S. World	0.3%	13.5%	-1.6%	3.2%
Non-U.S. Developed	0.3%	13.3%	-2.0%	3.4%
Japan	0.3%	8.5%	-6.8%	2.4%
Emerging	0.5%	12.7%	-2.1%	2.7%
Asia ex-Japan	1.0%	14.3%	-1.8%	2.4%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.1%	1.7%	4.7%	2.5%
U.S. TIPS	-0.5%	3.1%	2.9%	2.7%
U.S. Investment Grade	-0.2%	5.5%	6.6%	3.6%
U.S. High Yield	0.1%	8.8%	6.9%	6.1%
U.S. Municipals	0.2%	3.4%	5.9%	2.3%
Non-U.S. Developed	0.2%	0.9%	-2.0%	0.8%
EM $ Bonds	0.4%	7.5%	7.4%	6.0%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-1.8%	31.7%	-3.8%	$ 70.85
Gold	-0.5%	-0.3%	-2.5%	$ 1,279
Copper	-2.6%	4.5%	-8.7%	$ 6,236

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.5%	-2.3%	-6.6%	1.12
USD/Yen	-0.4%	1.4%	1.7%	111.11
Pound/USD	2.0%	3.2%	-3.0%	1.32

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Thomson Reuters. As of May 3, 2019. Notes: Weekly data through Friday. Equity and bond performance are measured in total index returns in U.S. dollars. U.S. large caps are represented by the S&P 500 Index; U.S. small caps are represented by the Russell 2000 Index; Non-U.S. world equity by the MSCI ACWI ex U.S.; non-U.S. developed equity by the MSCI EAFE Index; Japan, Emerging and Asia ex-Japan by their respective MSCI Indexes; U.S. Treasuries by the Bloomberg Barclays U.S. Treasury Index; U.S. TIPS by the U.S. Treasury Inflation Notes Total Return Index; U.S. investment grade by the Bloomberg Barclays U.S. Corporate Index; U.S. high yield by the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index; U.S. municipals by the Bloomberg Barclays Municipal Bond Index; non-U.S. developed bonds by the Bloomberg Barclays Global Aggregate ex USD; and emerging market $ bonds by the JP Morgan EMBI Global Diversified Index. Brent crude oil prices are in U.S. dollars per barrel, gold prices are in U.S. dollar per troy ounce and copper prices are in U.S. dollar per metric ton. The Euro/USD level is represented by U.S. dollar per euro, USD/JPY by yen per U.S. dollar and Pound/USD by U.S. dollar per pound.

3 Week ahead

May 7 Japan Nikkei Manufacturing PMI; Germany factory orders

May 8 Chinese officials arrive in Washington to continue U.S.-China trade negotiations; China trade balance; Huawei CFO's extradition hearing in Canada; Bank of Japan policy meeting minutes

May 9 China consumer price index (CPI)

May 10 U.S. CPI; UK GDP, industrial production, manufacturing production

U.S.-China trade negotiations resume this week, as the two sides edge closer to an agreement. We could see a deal that includes a Chinese commitment to purchase more U.S. goods, among other items. Yet markets may be too optimistic about a potential deal. And any deal may leave bigger questions unresolved, while enforcement will be challenging. Market attention to our global trade tensions risk has fallen sharply amid positive signals from recent talks, pointing to potential for greater market impact should the risk be realized.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	A slowing but still growing economy underlies our positive view. We prefer quality companies with strong balance sheets in a late-cycle environment. Health care and technology are among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are still challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance, such as a global growth rebound. We prefer higher-quality, globally oriented firms.
	Japan	—	Cheap valuations are supportive, along with shareholder-friendly corporate behavior, central bank stock buying and political stability. Earnings uncertainty is a key risk.
	EM	▲	Economic reforms and policy stimulus support EM stocks. Improved consumption and economic activity from Chinese stimulus could help offset any trade-related weakness. We see the greatest opportunities in EM Asia.
	Asia ex-Japan	▲	The economic backdrop is encouraging, with near-term resilience in China and solid corporate earnings. We like selected Southeast Asian markets but recognize a worse-than-expected Chinese slowdown or disruptions in global trade would pose risks to the entire region.
Fixed income	U.S. government bonds	—	We are cautious on U.S. Treasury valuations after the recent rally, but still see them as portfolio diversifiers given their negative correlation with equities. We expect a gradual steepening of the yield curve, driven by still-solid U.S. growth, a Fed willing to tolerate inflation overshoots — and a potential shift in the Fed's balance sheet toward shorter-term maturities. This supports two- to five-year maturities and inflation-protected securities.
	U.S. municipals	▲	We see coupon-like returns amid a benign interest rate backdrop and favorable supply-demand dynamics. New issuance is lagging the total amount of debt that is called, refunded or matures. The tax overhaul has made munis' tax-exempt status more attractive in many U.S. states, driving inflows.
	U.S. credit	—	A still-growing economy, reduced macro volatility and a decline in issuance support credit markets. Conservative corporate behavior – including lower mergers and acquisitions volume and a focus on balance sheet strength – also help. We favor BBBs and prefer bonds over loans in high yield.
	European sovereigns	▼	Low yields, European political risks, and the potential for a market reassessment of easy ECB policy or pessimistic euro area growth expectations all make us wary on European sovereigns, particularly peripherals. Yet any further deterioration in U.S.-European trade tensions could push yields lower.
	European credit	▼	"Low for longer" ECB policy should reduce market volatility and support credit as a source of income. European bank balance sheets have improved after years of repair, underpinning fundamentals. Yet valuations are rich after a dramatic rally. We prefer high yield credits, supported by muted issuance and strong inflows.
	EM debt	—	Prospects for a Chinese growth turnaround and a pause in U.S. dollar strength support both local- and hard-currency markets. Valuations are attractive despite the recent rally, with limited issuance adding to positives. Risks include worsening U.S.-China relations and slower global growth.
	Asia fixed income	—	A focus on quality is prudent in credit. We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia.
Other	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could boost industrial metal prices. We are neutral on the U.S. dollar. It has perceived "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

▲ Overweight — Neutral ▼ Underweight *Given the breadth of this category, we do not offer a consolidated view.

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