Weekly commentary

BlackRock

November 1, 2021

Corporate earnings beyond the restart

- We see above-trend corporate earnings growth moderating as we move beyond the economic restart. We remain overweight Europe and neutral U.S. equities.
- U.S. stocks rallied to all-time highs on better-than-expected corporate earnings. Euro area economic activity is now close to its pre-Covid level.
- The Federal Reserve is expected to announce the start of its taper of asset purchases this week and may push back against market pricing of rate hikes.

Strong earnings growth is due to the strong economic restart – and the realization of such strength was priced in by higher multiples last year as stocks surged back from the Covid-19 shock. We are likely to see earnings growth normalize as activity settles after the powerful restart. Historically high earnings beats are partly due to conservative guidance. We see near-term upside to that guidance and expect it to help support equities – and stay tactically pro-risk amid very low real rates.

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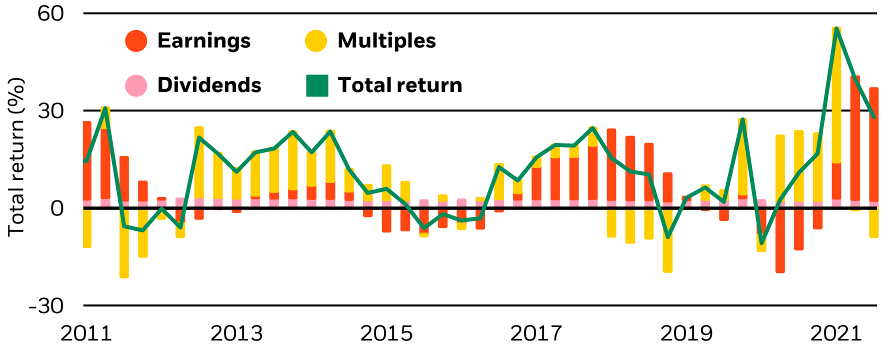
Equity return drivers

Sources of MSCI ACWI Index total return, 2011-2021



Past performance is no guarantee of 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, October 2021. Notes: The bars shows the 12-month total return of the MSCI ACWI Index into dividends, earnings and multiple expansion. Earnings growth is based on 12-month change in 12month forward I/B/E/S earnings estimates.

Companies representing more than half of the S&P 500 Index market value have reported third-quarter earnings. Over 80% of them have beaten expectations on profit and more than three quarters have exceeded revenue estimates. These beat rates are slightly below the elevated levels of the past few quarters but well above long-term averages. Multiples surged last year as investors eyed the strong rebound from the Covid-19 shutdowns – and earnings growth has delivered in the powerful economic restart. Multiples have since declined slightly, but that only reflects that markets had priced in this earnings strength and would be less responsive to the actual outcome compared with a typical business cycle recovery, in our view. See the chart above. The U.S.-led restart means activity will start settling back into more typical, if still-strong levels – supported by ample household savings. Markets may overreact to earnings normalizing as we get beyond the restart bump, and supply chain disruptions will likely remain a challenge. But we would caution against reading too much into such a negative reaction. The fact that U.S. equities have still been scaling all-time highs suggests markets may be prepared for the downshift in earnings momentum.

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We believe the bulk of the restart-fueled earnings surge is behind us, and a moderation of earnings growth into next year is to be expected. The restart can only take place once. Yet companies may well continue to exceed earnings expectations, in our view. The earnings revisions ratio – the number of companies with upward revisions versus those with downward revisions – remains in positive territory and is now higher in Europe than in the U.S. We are overweight European equities and neutral U.S. equities as the restart broadens beyond the U.S. – and this feeds into expected corporate earnings.

It's not a surprise that we've seen more mentions of supply constraints and cost pressure, but the overall picture is not as pessimistic as feared. S&P 500 profit margins have dipped but remain above historical averages. We see margins holding up: Companies have showed their ability to manage inflation and to pass higher costs on to consumers. The pent-up demand unleashed by the restart will support revenue and profitability. Markets have punished companies failing to meet earnings estimates or guiding down future results while giving little reward to those with earnings beats. This may encourage companies to be more conservative in their own profit guidance – and create more near-term upside.

We prefer to look at valuations through the lens of earnings risk premium (ERP) rather than multiples, adjusting for the structural decline in interest rates. This is especially true in our *new nominal* theme that the response of central bank policy and nominal bond yields to higher inflation will be muted compared with the past. That's underpinned by historically low real yields – a positive for risk assets. Even with the spike in short-term yields across major economies due to a surprisingly hawkish shift by some central banks, including the Bank of Canada last week, real yields remain at or near record lows in negative territory. We see nominal and real yields rising from here but remaining historically low. The European Central Bank pushed back against the market pricing of rate hikes last week, but not enough to change the trend. The risk is of further confusion about the current inflation environment, supply shock and what the monetary policy response will likely be. Eyes are on the Federal Reserve meeting next week – and we expect pushback against current pricing on the policy path.

The bottom line: We still see above-trend U.S. earnings growth even as its pace is moderating as the restart runs its course. The broadening restart and low real rates support our tactical pro-risk view. We prefer European equities where the earnings restart bump is catching up to the U.S. Within the U.S. we prefer quality shares.

Market backdrop

U.S. stocks rallied to all-time highs on robust earnings while European shares climbed near record peaks. Short-term yields spiked after a surprisingly hawkish shift by the Bank of Canada last week prompted investors to sharply pull forward when it might lift policy rates next year. We think the broader market pricing of higher policy rates is overdone – both in how soon key developed market central banks may lift rates and how quickly they will do so. Euro area GDP data showed economic activity is now close to its pre-Covid level.

Assets in review

Selected asset performance, 2021 year-to-date 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 Oct. 28, 2021. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, 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, in descending order: spot Brent crude, MSCI USA Index, MSCI Europe Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI Emerging Markets Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

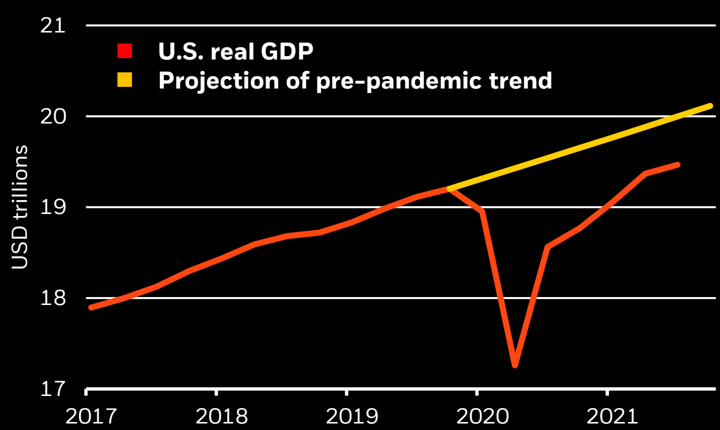
The U.S. economy grew by an annualized 2% in the third quarter – slower than the 6.7% expansion in Q2 and somewhat below expectations. We still see some room to run even as the pace of the restart is slowing. The softening in growth was mainly due to a fall in consumer spending on goods. This was expected given the end of stimulus checks, which had previously boosted goods consumption. Concerns about the Delta variant also contributed to the slowdown.

In contrast, spending on services continued to grow. Goods spending is above its pre-Covid trend, but services spending still remains far short. Non-residential fixed investment – i.e. company spending on physical assets like buildings, machinery and technology – is also far below pre-Covid levels and could provide a further boost to growth if it picks up again as uncertainty eases.

Overall, U.S. GDP has already surpassed its pre-Covid level but is yet to catch up with pre-Covid trend growth. See the chart. The restart is real – but not yet over. See our macro insights hub.

U.S. restart slowing but not over

U.S. GDP and projection of pre-pandemic trend, 2017-2021



Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Refinitiv Datastream, October 2021. Note: The orange line shows the level of U.S. real GDP in U.S. dollars at a seasonally adjusted annualized rate. The yellow line shows a projection of what U.S. GDP would have been had it grown steadily from Q4 2019 at the average growth rate over the period 2013-2019.

Investment themes

1 The new nominal

- The powerful restart of economic activity has broadened, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term. We see the Fed normalizing policy rates only in 2023 and the European Central Bank standing pat for much longer.
- *The new nominal* has largely unfolded in 2021: the rise in long-term yields has been mainly driven by higher market pricing of inflation, with real yields remaining pinned well in negative territory.
- The Fed has signaled that it is gearing up to start tapering around the end of the year. It appears reluctant to confirm its inflation mandate has been met, and this reinforces our *new nominal* theme.
- The ECB has made a significant change to its monetary policy framework by adopting a symmetric inflation target of 2%. We believe this is part of a global trend to relax the constraints in earlier frameworks preventing looser policy.
- **Tactical implication**: We are overweight European equities and inflation-linked bonds. We are neutral on U.S. equities. We upgrade EM local-currency debt to modest overweight.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is on the path toward greater role of state where social objectives will have primacy over quantity of growth. Yet the growth slowdown has hit levels policymakers can no longer ignore and we expect to see incremental loosening across three pillars - monetary, fiscal and regulatory.
- We believe investors should be mindful of ongoing geopolitical tensions, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We turn modestly positive on Chinese equities, and maintain an overweight on its debt.
- **Strategic implication:** Given the small benchmark weights and typical client allocation to Chinese assets, allocation would have to increase by multiples before they represent a bullish bet on China, and even more for government bonds.

3 Journey to net zero

- Climate risk is investment risk, and the narrowing window for governments to reach net-zero goals means that investors need to start adapting their portfolios today.
- The full consequences of the tectonic shift to sustainability are not yet in market prices, in our view. The path is unlikely to be a smooth one – and we see this creating opportunities across investment horizons.
- Certain commodities, such as copper and lithium, will likely see increased demand from the drive to net zero. Yet we think it's important to distinguish between near-term price drivers of some commodities – notably the economic restart – and the long-term transition that will matter to prices.
- Climate risk is investment risk, and we also see it as a historic investment opportunity. Our long-run return assumptions now reflect the impact of climate change and use sectors as the relevant unit of investment analysis.
- **Tactical implication**: We are overweight the tech sector as we believe it is better positioned for the green transition.
- **Strategic implication**: We like DM equities and the tech sector as a way to play the climate transition.

Week ahead

Nov. 1	U.S.. China manufacturing purchasing managers' index (PMI)	**Nov. 4**	Bank of England (BoE) policy decision
Nov. 3	Fed policy meeting; China, U.S. services PMI	**Nov. 5**	U.S. nonfarm payrolls

Market attention this week will be on the Fed and BoE's policy decisions. The Fed is likely to announce to start tapering its asset purchases and to push back on market pricing of multiple rate hikes as soon as next year. We do not expect a lift-off in its policy rate until early 2023. The BoE could become the first major developed market central bank to raise its policy rate since the pandemic hit.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, October 2021

Asset	Strategic view	Tactical view	Change in view: Previous → New
Equities	+1	+1	We keep our overweight equities on a strategic horizon. We see a better outlook for earnings amid moderate valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we stay overweight equities as we expect the restart to re-accelerate and interest rates to stay low. We tilt toward cyclicality and maintain a quality bias.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. Rising debt levels may eventually pose risks to the low rate regime. This is part of why we underweight government debt strategically. We prefer inflation-linked bonds – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		Neutral	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
Private markets	Neutral		We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class and not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, October 2021. 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

Change in view

Previous New

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, October 2021

	Asset	Underweight	Overweight	
Equities	United States			We are neutral U.S. equities. We see U.S. growth momentum peaking and expect other regions to be attractive ways to play the next leg of the restart as it broadens to other regions, notably Europe and Japan.
	U.S. small caps			We stay overweight U.S. small-caps. We see potential in this segment of the U.S. equity market to benefit from the cyclical rebound in domestic activity brought about an accelerated vaccination rollout.
	Europe			We stay overweight European equities on the back of a strong growth backdrop. We see a sizeable pickup in activity helped by accelerating vaccinations. Valuations remain attractive relative to history and investor inflows into the region are only just starting to pick up.
	UK			We are neutral UK equities following their strong performance. We see the market as fairly valued and prefer European equities.
	Japan			We are neutral Japanese equities. We see a global cyclical rebound helping boost earnings growth in the second-half of the year. The country's virus dynamics are also improving.
	China			We are modestly positive to upgrade Chinese equities to overweight as we see a gradual dovish shift in monetary and fiscal policy in response to the cyclical slowdown and anticipate that the regulatory clampdown will become less intense.
	Emerging markets			We are neutral EM equities. We see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring.
	Asia ex-Japan			We are neutral Asia ex-Japan equities. Potential knock-on effects from slower growth in China and broader geopolitical risks dampen the outlook, in our view.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries primarily on valuations. We see the balance of risks is for gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
	Treasury Inflation-Protected Securities			We are overweight U.S. TIPS. We believe the recent pullback in the asset class presents an attractive opportunity, particularly on a relative basis against European inflation breakevens as the outlook for euro area inflation remains sluggish.
	German bunds			We are neutral on bunds. Although the ECB may begin tapering this year given inflation dynamics, we see little room for a substantive change in policy in the near term.
	Euro area peripherals			We are neutral euro area peripheral government bonds despite recent outperformance given stability in ECB policy, low volatility in peripherals and better value elsewhere.
	China government bonds			We are overweight Chinese government bonds. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
	Global investment grade			We are underweight investment grade credit We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
	Global high yield			We are neutral high yield after the asset class' strong performance. Spreads are now below where we see high yield as attractive valued. We prefer to take risk in equities.
	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency			We are modestly overweight local-currency EM debt. We believe the asset class offers attractive valuations and carry in a world starved for income.
	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield and income given the region's fundamental outlook.

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