

# BLACKROCK INVESTMENT INSTITUTE



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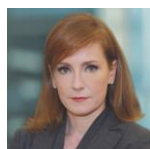
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## WEEKLY COMMENTARY • OCT. 8, 2018

### Key points

- 1 We see equities underpinned by strong fundamentals and earnings momentum, and believe concerns over narrow breadth are overdone.
- 2 U.S. government bond yields jumped to multi-year highs. Robust jobs data and a steady rise in wages underscored a strong U.S. labor market.
- 3 We see U.S. September inflation data rebounding from August's surprise decline, keeping the Federal Reserve on its policy normalization path.

## 1 Fear not a "narrow" stock market

Global equities' nearly decade-long bull run is stoking anxiety about its ability to power on. One concern: narrow breadth — a fragile state when a small group of stocks is contributing the lion's share of market returns, buoying the broader index. We see today's strong equity performance, especially in the U.S., as broad-based and driven by healthy fundamentals and solid earnings momentum.

### Chart of the week

Annual price return of S&P 500 Index and median stock, 1997-2018



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 Thomson Reuters, October 2018. Notes: The green dots show the annual price return of the S&P 500 Index of large-cap U.S. stocks, and the blue bars represent the price return of the median-performing stock in the index. Data for 2018 is year-to-date as of Oct. 4

The strongest-performing stocks in the S&P 500 this year have lifted the index, masking more muted returns from the median stock. See the chart above. Yet this year's narrower market leadership is far from extreme. The median stock has delivered positive returns year-to-date, supported by strong earnings — suggesting a resilient market. Contrast this with the extreme disparity between the haves and have-nots in the U.S. market in 1999, before the collapse of the dot-com bubble: The price return of the median stock lagged the index by 21% and earnings-per-share (EPS) growth trailed by 19 percentage points.

## Steady as it goes

Today's U.S. stock market appears to have little breadth — on the surface. The top-10 companies have accounted for 53% of the total return of the S&P 500 Index so far this year, versus 30% in 2017. Yet this says little about the remainder of the index constituents. The median stock's EPS growth stands at 21%, versus a 20-year average of 0.2%. We are not seeing signs of extremes in the market. Absolute stock valuations globally are within their historic ranges. In the U.S., valuations are above their long-term average, but not excessive beyond a small group of stocks. The 10 stocks with the best price performance in the S&P 500 have a median price-to-earnings ratio of 48 this year on a forward 12-month basis, while the median stock in the index has a multiple of just 17.2. Cross-sectional volatility — a measure of dispersion in returns across stocks — is near its lowest level in at least 20 years across most major regions, according to BlackRock's Risk & Quantitative Analysis team. This suggests most stocks are marching in the same direction, while outperformance of market leaders has been persistent — driven by strong fundamentals.

We see little evidence of a link between a narrow market and forward equity market performance. The relationship between the share of stocks outperforming the index at any point and market returns one year out is negligible, our analysis of historical data shows. A lack of breadth in declining markets also has little predictive power, in our view. The recent selloff in emerging market (EM) equities was led by a relatively narrow group of stocks, with the 10 bottom performers in the MSCI EM Index accounting for nearly 40% of the hit. A single stock was responsible for 14% of the decline. Yet we see EM stocks supported by attractive valuations and robust earnings.

Bottom line: We do not see narrowing equity market leadership as a warning sign of the market's health. More important than the number of stocks leading the market is the quality of the fundamentals driving the market. The [steady global expansion](#) underpins our preference for equities over bonds, and robust 2018 earnings estimates make the U.S. our favored region.

## 2 Week in review

- U.S. government bond yields hit multi-year highs on solid economic data, the Fed chairman's somewhat hawkish rhetoric and a reduced tax incentive that had spurred heavier demand for long-term Treasuries from pensions. An upward revision in the August payrolls number and a steady rise in wages underlined a strong labor market.
- Rising bond yields pressured stock prices and helped widen dispersion across equity market sectors. Bond proxies, such as real estate and consumer staples, underperformed. Financial and energy stocks outperformed. Canada joined the U.S.-Mexico trade pact, lifting a cloud of uncertainty that had weighed on Mexican and Canadian assets.
- Far-right candidate Jair Bolsonaro won the first round of Brazil's presidential election, but fell short of the majority needed to avoid a runoff contest. Italy showed some willingness to revise down its fiscal deficit targets.

## Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
<b>U.S. Large Caps</b>	-0.9%	7.9%	13.1%	1.9%
<b>U.S. Small Caps</b>	-3.8%	7.3%	9.3%	1.2%
<b>Non-U.S. World</b>	-2.8%	-5.8%	-1.6%	3.3%
<b>Non-U.S. Developed</b>	-2.3%	-3.7%	0.3%	3.4%
<b>Japan</b>	-1.4%	0.2%	8.2%	2.2%
<b>Emerging</b>	-4.5%	-11.8%	-7.1%	3.0%
<b>Asia ex-Japan</b>	-5.2%	-11.2%	-5.6%	2.9%

Commodities	Week	YTD	12 Months	Level
<b>Brent Crude Oil</b>	1.7%	25.9%	47.6%	\$84.16
<b>Gold</b>	1.1%	-7.6%	-5.1%	\$1,204
<b>Copper</b>	-1.4%	-14.8%	-7.9%	\$6,173

Bonds	Week	YTD	12 Months	Yield
<b>U.S. Treasuries</b>	-0.9%	-2.5%	-2.4%	3.2%
<b>U.S. TIPS</b>	-1.0%	-1.9%	-0.6%	3.3%
<b>U.S. Investment Grade</b>	-1.1%	-3.4%	-2.3%	4.2%
<b>U.S. High Yield</b>	-0.4%	2.1%	2.4%	6.4%
<b>U.S. Municipals</b>	-0.6%	-1.0%	-0.3%	3.0%
<b>Non-U.S. Developed</b>	-1.2%	-4.1%	-1.9%	1.1%
<b>EM \$ Bonds</b>	-1.3%	-4.3%	-3.4%	6.6%

Currencies	Week	YTD	12 Months	Level
<b>Euro/USD</b>	-0.7%	-4.0%	-1.6%	1.15
<b>USD/Yen</b>	0.0%	0.9%	0.8%	113.72
<b>Pound/USD</b>	0.7%	-2.9%	0.0%	1.31

Source: Bloomberg. As of Oct. 5, 2018. 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. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

# 3 Week ahead

**Oct. 9**

Germany trade balance; European Union and China hold trade talks

**Oct. 12**

China trade balance; Univ. of Michigan Surveys of Consumers; eurozone industrial production; International Energy Agency monthly report

**Oct. 11**

U.S. consumer price index (CPI); Organization of the Petroleum Exporting Countries (OPEC) monthly market report

**Oct. 14**

Germany's Bavarian state election

Inflation data will be in the spotlight this week. We expect the September U.S. core CPI data, which excludes volatile goods such as food and energy, to edge up after a surprise drop in August. A core CPI reading near or above the Fed's 2% inflation target would allow the central bank to proceed on its path of policy normalization. Our [BlackRock Inflation GPS](#) sees the U.S. core inflation hovering just above 2%, and some potential upside in Japan and eurozone inflation, albeit from much lower levels.

## Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Strong earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like the momentum factor and see a role for quality exposures amid steady global growth but rising uncertainty around the outlook. Technology tops our list of favored sectors.
	Europe	▼	Relatively muted earnings growth, weak economic momentum and political risks are challenges. A value bias makes Europe less attractive without a clear catalyst for value outperformance. We prefer higher-quality, globally-oriented names.
	Japan	—	We see a weaker yen, solid earnings and cheap valuations as supportive, but await a clear catalyst to propel sustained outperformance. Other positives include shareholder-friendly corporate behavior, central bank stock buying and political stability.
	EM	▲	Attractive valuations, along with a backdrop of economic reforms and robust earnings growth, support the case for EM stocks. We view financial contagion risks as low. Uncertainty around trade is likely to persist, though a lot of it has been priced in. We see the greatest opportunities in EM Asia on the back of strong fundamentals.
	Asia ex-Japan	▲	The economic and earnings backdrop is encouraging, with near-term resilience in China despite slower credit growth. 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 see rates rising moderately amid economic expansion and Fed normalization. Longer maturities are vulnerable to yield curve steepening but should offer portfolio ballast amid any growth scares. We favor shorter-duration and inflation-linked debt as buffers against rising rates and inflation. We prefer 15-year mortgages over their 30-year counterparts and versus short-term corporates.
	U.S. municipals	—	Solid retail investor demand and muted supply are supportive, but rising rates could weigh on absolute performance. We prefer a neutral duration stance and up-in-quality bias in the near term. We favor a barbell approach focused on two- and 20-year maturities.
	U.S. credit	—	Sustained growth supports credit, but high valuations limit upside. We favor investment grade (IG) credit as ballast to equity risk. We believe higher-quality floating rate debt and shorter maturities look well positioned for rising rates.
	European sovereigns	▼	The ECB's negative interest rate policy has made yields unattractive and vulnerable to the improving growth outlook. We expect core eurozone yields to rise. Valuations in the periphery appear tight. The exception is Italy, where spreads are reflecting simmering political risks. The upcoming end to the ECB's net asset purchases could dampen appetite for the asset class.
	European credit	▼	Wider spreads have created value, yet a defensive stance is warranted amid heightened political risks. We favor subordinated financial debt, where yields are more attractive. We also prefer European over UK credit as the market is not pricing in a significant Brexit premium. Industrials and financials are favored sectors.
	EM debt	—	We prefer hard-currency over local-currency debt and developed market corporate bonds. Slowing supply and broadly strong EM fundamentals add to the relative appeal of hard-currency EM debt. Trade conflicts and a tightening of global financial conditions call for a selective approach.
	Asia fixed income	—	Stable fundamentals, cheapening valuations and slowing issuance are supportive. China's representation in the region's bond universe is rising. Higher-quality growth and a focus on financial sector reform are long-term positives, but a sharp China growth slowdown would be a challenge.
Other	Commodities and currencies	*	Global supply constraints are likely to underpin oil prices. Trade tensions add downside risk to industrial metal prices. We are neutral on the U.S. dollar. Rising global uncertainty and a widening U.S. yield differential with other economies provide support, but an elevated valuation may constrain further gains.

▲ Overweight — Neutral ▼ Underweight

\*Given the breadth of this category, we do not offer a consolidated view.BII1018U/E-622545-1931391

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