Weekly commentary

BlackRock.

August 15, 2022

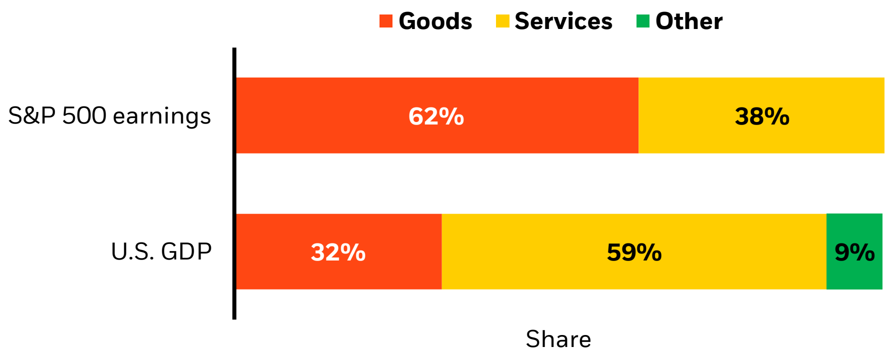
Caution: earnings under pressure

- We see company earnings deteriorating amid a rotation in consumer spending and a sputtering restart. This is partly why we remain cautious on stocks.
- Stocks jumped on hopes of the Fed pausing hikes soon as inflation edges lower. We think that's premature and see inflation settling above pre-Covid levels.
- U.S. activity data could show how much the economic restart is slowing. UK CPI is likely to continue its march up amid high energy costs.

Stocks are rallying as markets believe inflation is waning and the Fed will slow hikes soon. We don't think the rally is sustainable. Why? We see the Fed hiking rates to levels that will stall the economic restart. Corporate earnings may weaken more as consumer spending shifts and profit margins contract. This is not a typical business cycle, so we expect differentiated regional and sectoral effects. The risk of disappointing earnings is one reason we're tactically underweight stocks.

Good for whom?

Goods and services split for U.S. economy and S&P 500 earnings



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and U.S. Bureau of Economic Analysis, August 2022. Notes: The chart shows the breakdown of S&P 500 earnings and U.S. GDP into goods and services. S&P data uses analyst earnings estimates for full-year 2022, and groups S&P 500 sectors into goods and services, excluding financials and energy. GDP data is based on 2022 Q1 and Q2. The "other" category includes new physical structures.

The pandemic and unique restart of economic activity brought about a massive re-allocation of resources. During the pandemic, consumer spending shifted to goods and away from services. That propped up goods producers' earnings. That's changing, in our view. Goods demand is weakening. Overstocked inventories, from retailers to semiconductor firms, are evidence of that. Meanwhile, spending is returning to services. This shift could hit stocks. Why? Earnings tied to goods are expected to make up 62% of S&P 500 profits this year, versus 38% tied to services. See the top bar of the chart. In addition, the stock market isn't the economy. Goods accounted for less than a third of the U.S. economy in the first half of this year. See the bottom bar. This means a boom in services doesn't power S&P 500 earnings as much as it does the economy.

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Beata Harasim
Senior Investment Strategist – BlackRock Investment Institute

Tara Sharma
Investment Strategist – BlackRock Investment Institute

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BlackRock **Investment** Institute

Today's labor market also shows we're not in a typical business cycle. The labor shortage has been a key production constraint after many people left the workforce during the pandemic. We think higher wages would help normalize the labor market by encouraging workers to return and incentivizing employees to stop hopping jobs for more pay. On the flip side, higher wages also ratchet up companies' costs and pressure margins. These spending and labor dynamics are unfolding as the restart itself sputters. In Europe, the energy shock amid Russia's invasion of Ukraine will likely trigger a recession later this year, as we said in Taking stock of the energy shock. The restart is stalling in the U.S. as it bumps into production and labor supply constraints, and we believe U.S. activity is now set to contract.

What does all this mean for earnings? S&P 500 earnings growth has essentially ground to a halt, we calculate, if you exclude the energy and financial sectors. That's down from 4% annualized growth last quarter, Bloomberg data show. What's more, we believe analyst earnings expectations are still too optimistic. There are huge differences between sectors. High oil and gas prices have led to record profits for energy companies. We see these trends persisting for now. The reason: The West is aiming to wean itself off Russian energy and needs other suppliers. In the long run, high prices and profits could be eroded by the march toward decarbonization. The U.S. Senate passed a bill, called the Inflation Reduction Act, that is likely to shake up the sector. It calls for green energy infrastructure investments and tax benefits to incentivize the transition to net zero emissions.

What are the investment implications of a weaker earnings outlook? Stocks have rallied as markets price in hopes the Fed will pivot soon. But we're not chasing the rally. Why? First, market expectations for a dovish pivot are premature, in our view. We think a pivot will come later as the Fed is for now responding to pressure to tame inflation. Second, we see the market's views on earnings as overly optimistic. Spending returning to services, slowing growth and looming margin pressures pose risks.

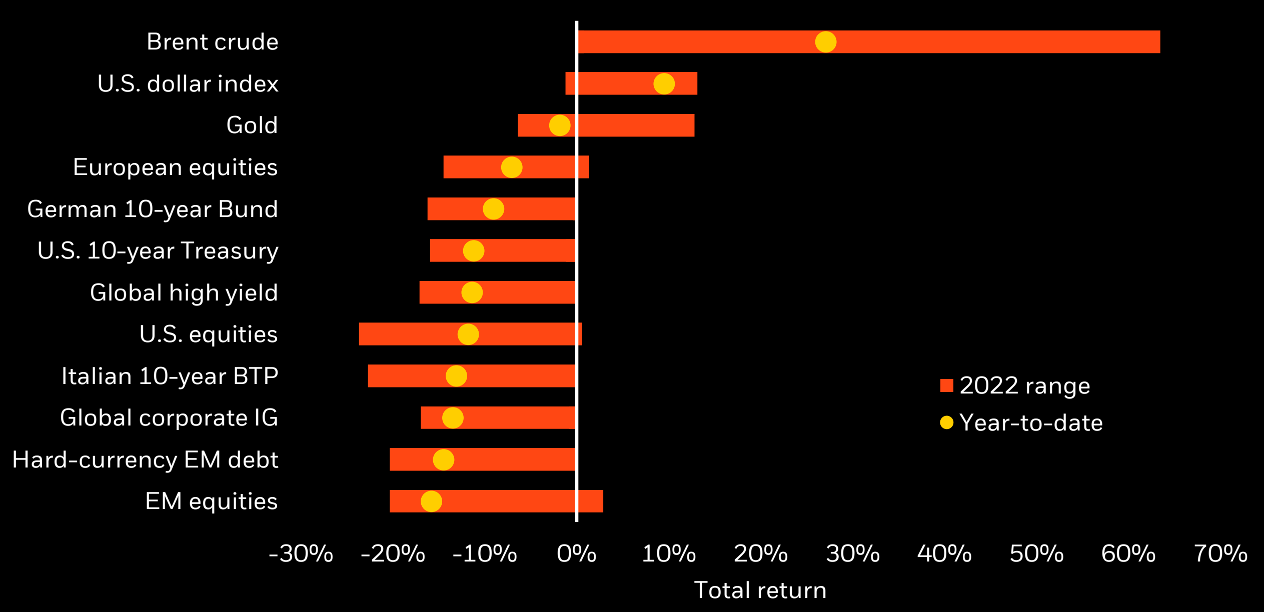
Our bottom line: We are cautious in the short run but are staying invested. We tactically prefer investment grade credit over equities because we think it can weather a slowdown that equities haven't priced in yet. We remain underweight most DM equities on a tactical basis until we see clear signs of a dovish central bank pivot. We like selected healthcare and energy stocks. We are cautious on tech stocks for now due to their sensitivity to higher rates. We do see strategic opportunities in tech and in healthcare as they're set to outpace carbon-intensive sectors in the energy transition. Within sectors, we prefer quality firms with the ability to pass on higher costs, stable cash flows and strong balance sheets.

Market backdrop

Stocks marched higher after markets priced in a slowing Fed hiking cycle on softer-than-expected U.S. CPI inflation. We don't think the equity bounce is worth chasing. We see inflation persisting and settling above pre-Covid levels. We believe the Fed will remain susceptible to "the politics of inflation," a chorus of voices demanding it tame inflation. Our bottom line: The latest inflation reading isn't enough to spur the Fed pivot we've been waiting for to lean back into stocks.

Assets in review

Selected asset performance, 2022 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. 11, 2022. 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: 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

The Federal Reserve still isn't acknowledging that quickly getting inflation all the way down to target would smash growth and jobs. Its most recent estimates see inflation coming down *and* the economy getting back to (almost) the growth path it was on before the pandemic – see the chart.

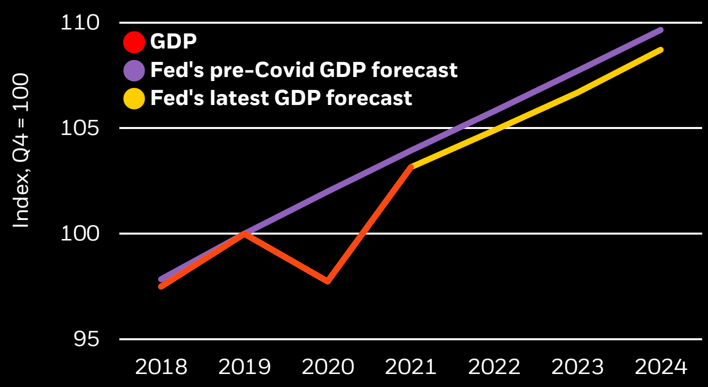
That's only possible if production capacity recovers fully by the end of this year. This is an unrealistic assumption, as we discuss in our blog. We expect the Fed to realize later this year that it has done more damage than its current projections suggest. This should prompt a course change by early next year.

Why? The Fed may realize that production capacity will be limited for some time - and that only a serious recession can get inflation all the way down. We then expect it to opt to live with more persistent inflation to avoid that cost.

The result, in our view: The Fed won't trigger the kind of recession needed to get inflation down. That means we'll be living with inflation above 2% for some time.

Fed feeling optimistic

U.S. GDP and Fed GDP estimates, 2018-2024



Forward-looking estimates may not come to pass. Sources: BlackRock Investment Institute, Federal Reserve and U.S. Bureau of Economic Analysis, with data from Haver Analytics, July 2022. Notes: The chart shows economic activity, measured by real GDP (orange line), as well as the Federal Open Market Committee's GDP forecasts from December 2019 (purple line) and most recently in June 2022 (yellow line).

Investment themes

1 Bracing for volatility

- The Great Moderation, a long period of steady growth and low inflation, has ended in our view. We see macro and market volatility reverberating through the new regime. What changed? Production constraints triggered by the pandemic and the war in Ukraine are pressuring the economy and inflation. We see this persisting amid powerful structural trends like global fragmentation and sectoral shakeouts tied to the net-zero transition.
- Unprecedented leverage gives policymakers less maneuvering room, in our view. And the politicization of everything makes simple solutions elusive when they're needed the most, we think. This leads to bad outcomes.
- We expect higher risk premia for both equities and bonds – so investment decisions and horizons must adapt more quickly. Traditional portfolios, hedges and risk models won't work anymore, we think.
- In the U.S., we expect volatile growth and persistent inflation. The upside risk is that production capacity normalizes faster. The downside is that the Fed fails to change course next year and slams demand down to meet low capacity.
- In Europe, we see recession as likely even absent big rate hikes as broad economic stress from an energy crisis bites.
- **Investment implication:** Be nimble. We're tactically overweight investment grade credit on attractive valuations.

2 Living with inflation

- We are in a new world shaped by supply. Major spending shifts and production constraints are driving inflation.
- Constraints are rooted in the pandemic and have been exacerbated by the war in Ukraine and China's lockdowns.
- The Fed increased rates by another 0.75% in July and reaffirmed projections of more rate rises with the aim to rein in inflation. The Fed is still looking through the lens of a typical late-cycle overheating as opposed to a restart, in our view. Reality will come knocking eventually, we think, and a stalled restart will prompt the Fed to change course.
- The Bank of England raised rates to 1.75% in August. It also acknowledged the growth-inflation trade-off – unlike other major central banks. It now sees a protracted recession through 2023, partly due to the energy shock.
- The ECB surprised with a larger-than-expected 0.5% rate rise in July. It also announced a new bond-buying facility to limit risks of higher rates causing the euro area to fragment. The ECB and markets underappreciate the risk of the energy crunch causing a recession, we think. The ECB will eventually accept this and rethink its rate path.
- **Investment implication**: We are tactically underweight most DM equities after having further trimmed risk.

3 Positioning for 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 net-zero journey is not just a 2050 story; it's a now story.
- We see a global drive for more energy security accelerating the transition in the medium term, especially in Europe.
- We also don't think the markets have fully priced in the transition yet. Over time, markets are likely to value assets of companies better prepared for the transition more highly relative to others, in our view.
- We think investors can get exposure to the transition by investing not only in "already green" companies but also in carbon intensive companies with credible transition plans or that supply materials critical to the transition.
- We like sectors with clear transition plans. Over a strategic horizon, we like sectors that stand to benefit more from the transition, such as tech and healthcare, because of their relatively low carbon emissions.
- **Investment implication**: Time horizon is key. We see tactical opportunities in selected energy stocks.

Week ahead

Aug. 15	Japan Q2 GDP	**Aug. 17**	U.S. retail sales, UK CPI
Aug. 16	U.S. industrial production	**Aug. 18**	U.S. Philadelphia Fed business survey

We're watching U.S. industrial production and retail sales to see how quickly activity might be slowing. Consensus forecasts see U.S. industrial production improving in July but retail sales cooling for the same month. UK CPI inflation is likely to show a continued increase after the Bank of England revised up its expected peak to above a 13% annual rate earlier this month. Persistently high natural gas prices are likely to keep fuel and power costs elevated.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, August 2022

Underweight **Neutral** **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+2	-1	We are overweight equities in our strategic views of five years or longer. We expect central banks to ultimately live with some inflation and look through the near-term risks. Tactically, we are underweight DM equities as central banks appear set to overtighten policy and we see activity stalling. Rising input costs also pose a risk to elevated corporate profit margins.
Credit	-1	+1	We are underweight publicly traded credit on a strategic basis and prefer to take risk in equities. Tactically, we are overweight credit given the jump in yields and credit spreads – and our view of contained default risk. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds, with a preference for short-dated maturities. We stay firmly underweight long-dated bonds as we see investors demanding higher compensation amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we are also underweight as we see long-term yields going higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers amid higher inflation.
Private markets	Neutral	—	We believe non-traditional return streams 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. We underweight private equity, favoring income assets such as private credit instead. Many institutional investors are 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.

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 2022

Underweight **Neutral** **Overweight** ● Previous view

Asset	View	Commentary
Developed markets	-1	We are underweight DM stocks on a worsening macro picture and risks to corporate profit margins from higher costs. Central banks appear set on reining in inflation by crushing growth – increasing the risk of the post-Covid restart being derailed.
United States	-1	We are underweight U.S. equities. The Fed intends to raise rates into restrictive territory. The year-to-date selloff partly reflects this. Yet valuations have not come down enough to reflect weaker earnings.
Europe	-1	We are underweight European equities as the fresh energy price shock in the aftermath of the tragic war in Ukraine puts the region at risk of stagflation.
UK	-1	We are underweight UK equities following their strong performance versus other DM markets thanks to energy sector exposure.
Japan	Neutral	We are neutral Japan stocks. We like stilleasy monetary policy and increasing dividend payouts. Slowing global growth is a risk.
China	Neutral	We are neutral Chinese equities. Activity is restarting, but we see 2022 growth below official targets. Geopolitical concerns around China's ties to Russia warrant higher risk premia, we think.
Emerging markets	Neutral	We are neutral EM equities on the back of slowing global growth. Within the asset classes, we lean toward commodity exporters over importers.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
U.S. Treasuries	-1	We are underweight U.S. Treasuries even with the yield surge. We see long-term yields moving up further as investors demand a greater term premium. We prefer short-maturity bonds instead and expect a steepening of the yield curve.
Global inflation-linked bonds	+1	We are overweight global inflation-linked bonds and prefer Europe. Markets are underappreciating the inflationary pressures from the energy shock, we think.
European government bonds	Neutral	We are neutral European government bonds. We think market pricing of euro area rate hikes is too hawkish.
UK gilts	+1	We are overweight UK gilts. Gilts are our preferred nominal government bonds. We believe market pricing of the Bank of England's rate hikes is unrealistically hawkish in light of deteriorating growth.
China government bonds	Neutral	We are neutral Chinese government bonds as policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
Global investment grade	+1	We are overweight investment grade credit. High quality corporates' strong balance sheets imply IG credit could weather weaker growth better than stocks.
Global high yield	Neutral	We are neutral high yield. We prefer up-in-quality credit exposures amid a worsening macro backdrop. We think parts of high yield offer attractive income.
Emerging market – hard currency	Neutral	We are neutral hard-currency EM debt. We expect it to gain support from higher commodities prices but remain vulnerable to rising U.S. yields.
Emerging market – local currency	+1	We are modestly overweight local-currency EM debt on attractive valuations and potential income. Higher yields already reflect EM monetary policy tightening, in our view, and offer compensation for inflation risk.
Asia fixed income	Neutral	We are neutral Asia fixed income amid a worsening macro outlook. We don't find valuations compelling enough yet to turn more positive on the asset class.

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