

# Weekly commentary

March 13, 2023

**BlackRock**

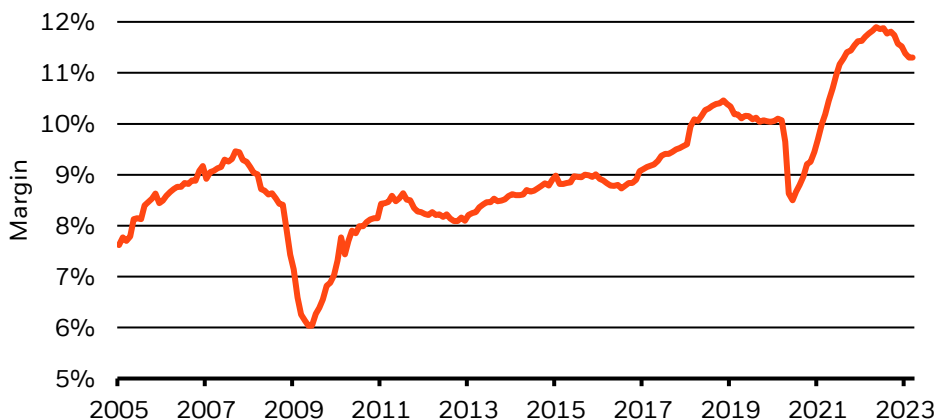
## Earnings expectations look too high

- Stocks are starting to reflect the economic damage from higher rates – and we see more hikes due to sticky inflation. But expected earnings still look rosy to us.
- U.S. stocks fell over 4% last week and erased most of their gains for the year, partly after Fed officials made clear they could step up the pace of rate hikes.
- This week’s U.S. inflation report will be a critical gauge before the Fed’s next policy meeting. The European Central Bank is likely to raise rates by 0.5%.

Stocks are starting to reflect the economic damage of rate hikes. We think earnings offer little support – expectations for this year are still too rosy. We think corporate margins could get hit by higher costs and reduced pricing power as goods shortages ease. We see an earnings hit on top of that from recession as central banks fight sticky inflation – and are poised to hold rates higher for longer. We prefer short-term bonds for income and emerging market (EM) equities.

## Profit margins at risk

Global equity forward profit margins, 2005-2023



Source: BlackRock Investment Institute, with data from MSCI and Refinitiv Datastream, March 2023. Notes: Chart shows MSCI World 12-month forward earnings divided by 12 month forward sales.

We are not in a typical economic cycle. Tight labor markets are driving persistently higher inflation. That’s why we see major central banks creating economic damage and recession as they try to bring inflation down to their 2% targets. We think this is a tough backdrop for earnings – and could get worse as profit margins are squeezed. Companies’ pricing power had increased as the pandemic-driven demand for goods created shortages. But now spending patterns are normalizing back to services and away from goods, so that pricing power is waning. This comes just as cost pressures are mounting from higher wages and funding costs. We expect a recession to hit sales and higher costs to pinch margins still near historically high levels. See the chart. That should crunch corporate earnings and is why we think the consensus for flat earnings in the S&P 500 for 2023 as a whole is still too optimistic.



**Wei Li**

Global Chief Investment Strategist – BlackRock Investment Institute



**Alex Brazier**

Deputy Head – BlackRock Investment Institute



**Kurt Reiman**

Senior Strategist for North America – BlackRock Investment Institute



**Carolina Martinez Arevalo**

Portfolio Strategist – BlackRock Investment Institute

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**BlackRock Investment Institute**

Good economic news – as seen in the February U.S. payroll gains, confirming a tight labor market – only adds to the risk that central banks will push policy rates even higher and keep them there, we think. This is an important lens through which we see the new regime of greater macro and market volatility playing out – and why good growth news could actually be bad news for markets.

We prefer short-term government bonds offering attractive income over developed market (DM) equities given the risks we see to earnings. Equities are starting to better price in the economic damage we see ahead. Yet we think being selective is key. We prefer the energy sector as tight supply buoys energy prices. We also like healthcare for its defensive characteristics in a downturn and financials due to higher rates and profit margins – even with potential risks. The U.S. stock market’s concentration of tech and consumer discretionary companies make it more exposed to the wage pressures from a tight labor market, in our view. Earnings results from the fourth quarter of 2022 showed revenue growth slowing, and earnings contracted for the first time since late 2020. Both managed to top already lowered consensus expectations – but the earnings beat was the smallest in a decade, we find. We think this shows how inflation can hit earnings – especially with pressure from higher costs related to wages.

European companies face similar constraints in the labor market. Yet we see some support for European stocks because of a large concentration of financial and energy companies we like. We also think the consumer discretionary sector in Europe is set up to benefit from higher demand for luxury goods from China’s economic restart.

China’s restart is also an important reason why we prefer EM stocks over DM. We think it helps brighten the overall economic backdrop in EM compared with DM economies. We also think risks are better priced: EM central bank rate hiking cycles are closer to their peak, and the U.S. dollar is still broadly weaker from its 2022 peak – even with its strength this year.

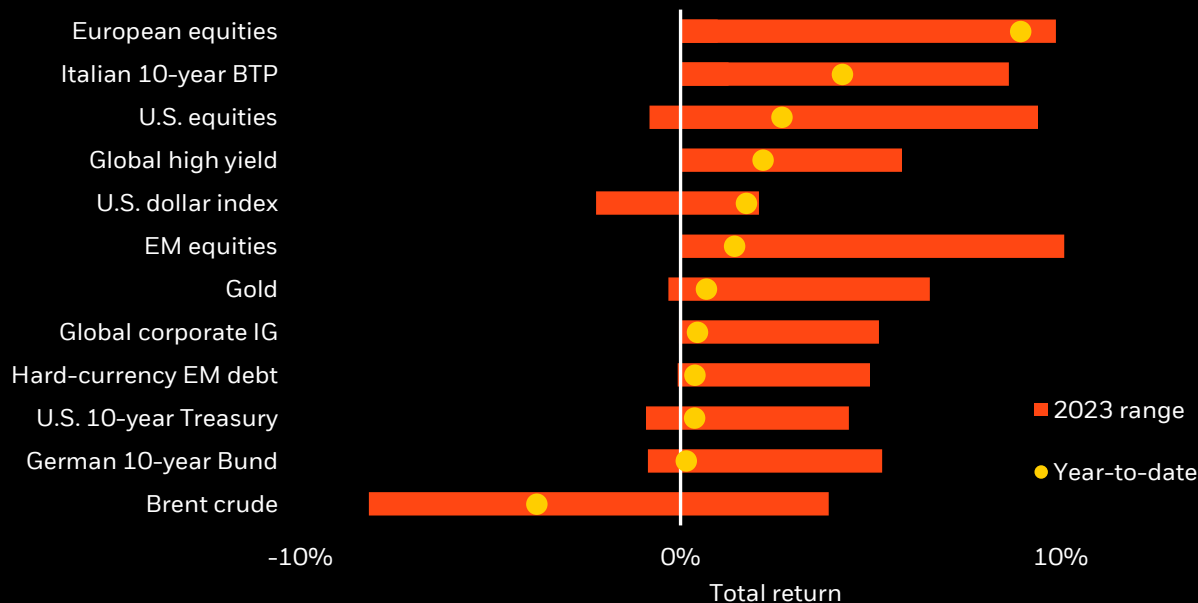
Bottom line: We think markets are waking up to the risks from the fastest rate hiking cycle since the 1980s. For now, we like short-term government bonds for income. We’re overweight EM stocks and prefer them to DM peers: We think risks are better priced in EM. We’re modestly underweight DM stocks. We think earnings expectations are still too high, so we look for granular opportunities in sectors instead.

## Market backdrop

U.S. stocks fell more than 4% last week and erased most gains for the year after Fed Chair Jerome Powell suggested it could pick up the pace of rate hikes and financial cracks emerged. We think the market is also starting to reflect the economic damage stemming from the rapid rate hikes of the past year. U.S. two-year yields fell sharply after hitting 16-year highs to price out rate hikes. We think rates are headed higher and the inflation problem for central banks remains the same.

## 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 Refinitiv Datastream as of March 9, 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, 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

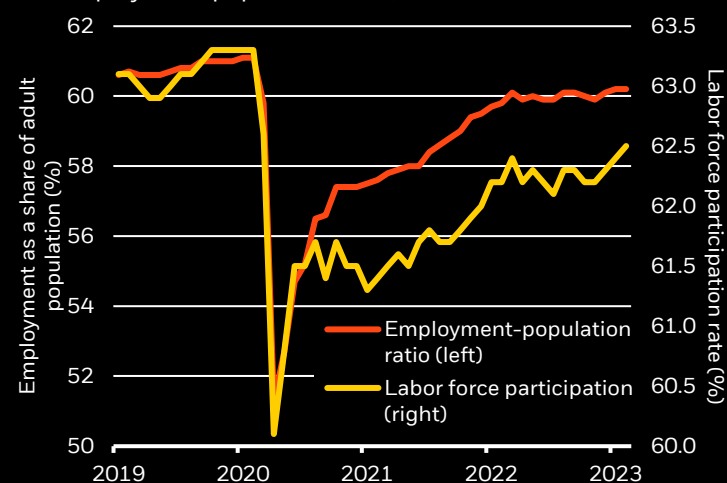
The number of people employed in the pandemic-hit leisure and hospitality sector grew faster than expected in February, last week's U.S. jobs report showed. That kept the share of the – growing – population with a job about the same. See the orange line on the chart. The number of people looking for work also rose unexpectedly, sending the unemployment rate back up to where it was early last year and causing a tick up in the participation rate – or the share of the population either in work or looking for work (yellow line).

Meanwhile, average hourly pay grew at a 4.3% annualized pace over the last three months. That's slower than before but still too fast for overall inflation to fall back towards the Federal Reserve's 2% target, we think.

Where does that leave the Fed? If it wants to get inflation back closer to target it will need to raise rates enough to tip the U.S. economy into recession. That would drive down demand for workers, causing wage growth to slow further. That's why we don't think the Fed has finished hiking rates yet. See our recent [Macro take](#) blog posts.

## U.S. labor market still tight

U.S. employment-population ratio, 2019-2023



Sources: BlackRock Investment Institute, Bureau of Labor Statistics, with data from Haver Analytics, March 2023. Note: The chart shows the share of the working age (16+) population in employment (orange line) and in the labor force - either in work or looking for a job (yellow line).

## Investment themes

### 1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- In the U.S., it's most evident in rate-sensitive sectors. Higher mortgage rates have hurt sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- In Europe, tighter financial conditions are biting even as the energy shock eases.
- The ultimate economic damage depends on how far central banks go to get inflation down. We think they will halt rate hikes once the economic damage becomes clear.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

### 2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- Short-term government debt looks more attractive for income at current yields, and we like their ability to preserve capital. We like investment-grade credit and think it can hold up in a recession, with companies having fortified their balance sheets by refinancing debt at lower yields.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication:** We prefer short-term government bonds and investment-grade credit over long-term government bonds.

### 3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The cycle of outsized rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. We think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication:** We're overweight inflation-linked bonds on a tactical and strategic horizon.

# Week ahead

**March 14**

U.S. CPI inflation

**March 17**

University of Michigan consumer sentiment survey

**March 16**

ECB policy decision

The U.S. CPI inflation data for February will be a critical gauge ahead of the Fed’s policy decision later this month. Markets are waking up to the risk that rates could stay higher for longer as labor market tightness persists and core inflation proves sticky. In Europe, the ECB is likely to raise rates by 0.5% to 2.5%, and we’re watching for updated economic projections.

## Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, March 2023

Asset	Strategic view	Tactical view
<b>Equities</b>	<p>+1</p>	<p>-1</p> <p>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 to us. Tactically, we’re underweight DM stocks as central banks look set to cause economic damage with their rate hikes. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight and have a relative preference for EM stocks due to China’s restart, peaking EM rate cycles and a broadly weaker U.S. dollar.</p>
<b>Credit</b>	<p>+1</p>	<p>+1</p> <p>Strategically, we are overweight global investment grade but have reduced it given the tightening of spreads in recent months. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we are overweight investment grade but have also reduced it. We are neutral high yield and prefer to be up in quality. We are neutral EM debt after its strong run. We see better opportunities for income in DMs.</p>
<b>Govt bonds</b>	<p>Neutral</p>	<p>-1</p> <p>We are neutral in our strategic view on government bonds. This reflects an overweight to short-term government bonds and max overweight to inflation-linked bonds. We remain underweight nominal long-term bonds: We think markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium. Tactically, we are underweight long-dated DM government bonds for the same reason. We favor short-dated government bonds – higher yields now offer attractive income with limited risk from interest rate swings.</p>
<b>Private markets</b>	<p>-1</p>	<p>—</p> <p>We’re underweight private growth assets and neutral on private credit from a starting allocation that is much larger than what most qualified investors hold. Private assets are not immune to higher macro and market volatility or higher rates, and public market selloffs have reduced their relative appeal. Private allocations are long-term commitments, however, and we see opportunities as assets reprice over time. Private markets are a complex asset class not suitable for all investors.</p>

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, March 2023

Underweight
Neutral
Overweight
● Previous view

Asset	View	Commentary	
<b>Equities</b>	<b>Developed markets</b>	<p style="text-align: center;">-1</p>	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy, financials and healthcare.
	United States	<p style="text-align: center;">-1</p>	We are underweight. The Fed is set to raise rates into restrictive territory. Earnings downgrades are starting but don't yet reflect the coming recession.
	Europe	<p style="text-align: center;">-1</p>	We are underweight. The energy price shock and policy tightening raise stagflation risks.
	UK	<p style="text-align: center;">-1</p>	We are underweight. We find valuations expensive after their strong relative performance versus other developed markets thanks to energy sector exposure.
	Japan	<p style="text-align: center;">-1</p>	We are underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
	<b>Emerging markets</b>	<p style="text-align: center;">+1</p>	We are overweight and have a relative preference over DM stocks due to China's powerful restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
	China	<p style="text-align: center;">+1</p>	We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.
	Asia ex-Japan	<p style="text-align: center;">Neutral</p>	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
	Long U.S. Treasuries	<p style="text-align: center;">-1</p>	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
	Short U.S. Treasuries	<p style="text-align: center;">+2</p>	We are overweight. We prefer short-term government bonds for income in this environment given the rise in yields and limited exposure to interest rate swings.
<b>Fixed Income</b>	Global inflation-linked bonds	<p style="text-align: center;">+1</p>	We are overweight. We see breakeven inflation rates underpricing the persistent inflation we expect.
	Euro area govt bonds	<p style="text-align: center;">-1</p>	We are underweight the long end. We expect term premium to raise long-term yields and high inflation to persist. Rate hikes are a risk to peripheral spreads.
	UK gilts	<p style="text-align: center;">-1</p>	We are underweight. Perceptions of fiscal credibility have not fully recovered. We prefer short-dated gilts for income.
	China govt bonds	<p style="text-align: center;">Neutral</p>	We are neutral. We find their yield levels less attractive than those on DM short-term government bonds.
	Global IG credit	<p style="text-align: center;">+1</p>	We are overweight. Spreads have tightened this year. But we think strong balance sheets imply IG credit could weather a recession better than stocks.
	U.S. agency MBS	<p style="text-align: center;">Neutral</p>	We are neutral. We see the asset class as a high-quality exposure within a diversified bond allocation. But tighter spreads make valuations less compelling.
	Global high yield	<p style="text-align: center;">Neutral</p>	We are neutral. We prefer up-in-quality credit exposures.
	Emerging hard currency	<p style="text-align: center;">Neutral</p>	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
	Emerging local currency	<p style="text-align: center;">Neutral</p>	We are neutral EM debt after its strong run. We see better opportunities for income in DMs.
	Asia fixed income	<p style="text-align: center;">Neutral</p>	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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