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BLACKROCK INVESTMENT INSTITUTE

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WEEKLY COMMENTARY • MAY 14, 2018

Key points

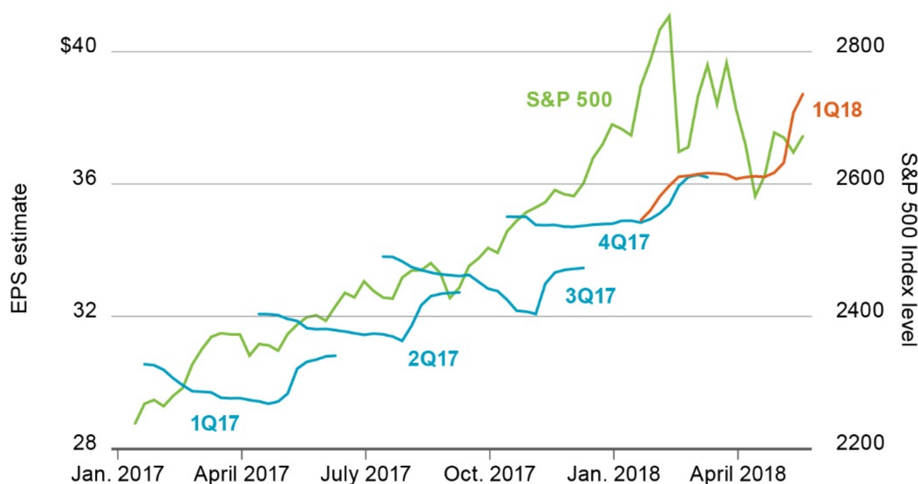
1. Market reaction to strong first-quarter earnings has been surprisingly lackluster. Our take: Fears of peaking earnings are overdone.
2. Oil prices rose after the U.S. withdrew from the Iran nuclear deal. The momentum factor led stocks higher, and EM currencies struggled.
3. U.S. economic data this week are likely to provide more evidence of U.S. economic strength, a trend seen in recent jobs data.

1 Our take on an unusual earnings season

With many developed market firms having reported first-quarter results, we can say without doubt it's been an unusual earnings season. Strong beats were met with little investor cheer. The worry: Earnings are close to a peak. Yet we see more room for earnings to climb this year and next, and reaffirm our overweight to U.S. equities.

Chart of the week

S&P 500 performance and earnings estimates, 2017-2018



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 FactSet and Bloomberg, May 2018. Notes: The green line represents the performance of the S&P 500 Index. The other lines represent analysts' consensus estimates of quarterly earnings per share (EPS) from the first quarter of 2017 to the first quarter of 2018. Estimates are tracked from 60 trading days prior to each earnings season until actual EPS results are released. Estimates for the first quarter of 2018 are as of May 8, 2018.

The muted market reaction to strong earnings has been most evident in the U.S., as shown in the chart above. Tax cuts have helped many U.S. companies post their best earnings growth in years. This is reflected in the sharp spike in analysts' earnings per share (EPS) estimates for S&P 500 companies since the first quarter earnings season began in mid-April (see the orange line). Yet S&P 500 Index performance (the green line) has not followed suit, a break from the recent past when market moves mirrored earnings upgrades. European and Japanese earnings results have been somewhat weaker, but average price reactions in all three regions have been disappointing. Market moves for stocks in the day following earnings reports are at the lowest levels since 2011 in Europe and have been negative in Japan the last two quarters.

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As good as it gets?

Sentiment has improved as earnings beats keep rolling in, and equity markets have risen over the past month. A sluggish market reaction to stellar results reflects investor worries that earnings may be nearing a peak, in our view. More reserved guidance from company management teams has stoked these concerns. U.S. tax cuts helped propel year-over-year EPS growth for S&P 500 companies to nearly 24% in the first quarter, the highest since the third quarter of 2010. Outside the U.S., the pace of earnings growth moderated, and stronger local currencies have pressured sales growth in Europe and Japan.

We do expect the rapid pace of earnings growth to slow. Recent strength, partly driven by one-off tax cuts, sets a high bar. Macro uncertainty has also increased amid trade tensions and U.S. fiscal stimulus at a late stage in the economic cycle. Growth and policy fears, it seems, have overshadowed current strong company fundamentals. Yet we believe companies will maintain a tight grip on expenses to shield margins from rising costs. With solid corporate health across regions, our base case is that the cycle has room to run. U.S. companies in particular are flush with cash from strong profits and lower taxes. This should boost corporate spending on buybacks, mergers & acquisitions and capital investment. Equity prices do not appear to fully reflect these prospects, though they have already baked in the lower tax rates that led stocks to record highs in January and have adjusted to modestly rising interest rates.

Against this backdrop, we see stronger earnings from companies that can generate sales growth and control expenses, as input costs inch higher and the economic cycle matures. We see better prospects for sales growth in the U.S. than in other developed markets. The U.S. has the healthiest ratio of earnings upgrades to downgrades globally, and economic data look solid and consistent with an expansion. Within the U.S., we prefer high-margin sectors with strong cash flows, such as technology, over low-growth defensives.

2 Week in review

- President Trump announced the U.S. withdrawal from the Iran nuclear deal, reimposing sanctions on Iran and complicating U.S.-European trade relations. Brent crude prices spiked to their highest since 2014. Energy stocks rallied.
- Equities rose strongly despite heightened geopolitical risks. Momentum stocks performed well. The VIX dropped below 13 for the first time since its early February spike. The U.S. dollar (USD) rose to its highest level since last December. Emerging market currencies broadly weakened against the USD. Italy moved closer to having a coalition government likely comprising the Five Star Movement and Lega Nord – the two populist parties that won the election.
- March U.S. job openings hit an all-time high, rising above the number of unemployed in April. Headline and core U.S. Consumer Price Index (CPI) data rose slightly less than expected in April but confirmed gradually rising prices.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.5%	2.0%	13.9%	2.0%
U.S. Small Caps	2.7%	5.1%	17.1%	1.1%
Non-U.S. World	1.9%	1.3%	15.1%	3.1%
Non-U.S. Developed	1.6%	1.8%	13.9%	3.3%
Japan	1.1%	2.5%	18.6%	2.2%
Emerging	2.5%	1.0%	19.0%	2.7%
Asia ex-Japan	2.6%	1.9%	21.7%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.1%	-2.1%	-0.7%	3.0%
U.S. TIPS	-0.1%	-1.1%	1.1%	3.0%
U.S. Investment Grade	0.2%	-3.3%	0.8%	4.0%
U.S. High Yield	0.3%	0.0%	3.3%	6.3%
U.S. Municipals	0.2%	-0.8%	2.0%	2.7%
Non-U.S. Developed	0.0%	0.5%	8.1%	0.9%
EM $ Bonds	0.3%	-4.0%	0.4%	6.2%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	3.0%	15.3%	51.9%	$77.12
Gold	0.4%	1.3%	7.7%	$1,319
Copper	1.7%	-4.2%	25.2%	$6,942

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.1%	-0.5%	10.0%	1.19
USD/Yen	0.2%	-2.9%	-3.9%	109.39
Pound/USD	0.1%	0.2%	5.1%	1.35

Source: Bloomberg. As of May 11, 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

May 14 OPEC Monthly Oil Market Report

May 15 China industrial production; U.S. retail sales; eurozone industrial production; Germany GDP, ZEW Economic Sentiment Index

May 16 International Energy Agency Oil Market Report; Japan GDP; U.S. industrial production

U.S. economic data are likely to provide more evidence of economic strength, a trend seen in recent employment and inflation readings. This week's figures also could provide further evidence on the economic impact of the U.S. fiscal stimulus package. The consensus expectation among economists is that April U.S. retail sales growth eased from March's 0.6% month-on-month jump, while still eyeing a 0.3% gain. The March figure was likely boosted by consumers spending their tax refunds. April may bring a return to trend growth.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Extraordinarily strong earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like the momentum and value style factors, as well as financials and technology.
	Europe	—	We see economic expansion and a steady earnings outlook supporting cyclicals. Our neutral stance acknowledges that earnings momentum lags other regions. Euro strength also is a source of pain.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behavior and solid earnings. We see Bank of Japan policy and domestic investor buying as supportive. Further yen strengthening would be a risk.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks. Above-trend expansion in the developed world is another positive. Risks include a sharp rise in the U.S. dollar, trade tensions and elections. We see the greatest opportunities in EM Asia. We like Brazil and India, and are cautious on Mexico.
	Asia ex-Japan	▲	The economic backdrop is encouraging. China's growth and corporate earnings appear likely to remain solid in the near term. We like selected Southeast Asian markets but recognize a faster-than-expected Chinese slowdown would pose risks to the entire region.
Fixed income	U.S. government bonds	▼	We see rates rising moderately amid economic expansion and Fed normalization. Shorter maturities offer a more compelling risk/reward tradeoff. They and inflation-linked securities can be buffers against rising rates and inflation. We like 15-year mortgages relative to their 30-year counterparts and to short-term corporates.
	U.S. municipals	—	Solid retail investor demand and muted supply are supportive of munis, but rising rates weigh on absolute performance. A more defensive stance is warranted near term, we believe, though any material weakness due to supply may represent a buying opportunity. 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 prefer up-in-quality exposures as ballast to equity risk. Higher-quality floating rate instruments and shorter maturities are well positioned for rising rates, in our view.
	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. We are cautious on peripherals given tight valuations and the prospect of the ECB reducing its asset purchases.
	European credit	▼	Recent spread widening driven by increased issuance has created some value, while ongoing ECB purchases should support the asset class. Negative rates have crimped absolute yields — but rising rate differentials make currency-hedged positions increasingly attractive for U.S.-dollar investors. Subordinated financial debt looks less compelling versus equities.
	EM debt	—	Recent price moves have improved the valuations of hard-currency debt, increasing the relative attractiveness both to local currency bonds and to developed market corporates. Further support for valuations comes from slowing supply and strong EM fundamentals. Trade fears or geopolitical risks prompting a rapid tightening of global financial conditions represent downside risks.
	Asia fixed income	—	Regional growth and inflation dynamics are supportive of credit. China's rising representation in the region's bond universe reflects its growing credit market. Higher-quality growth and a focus on financial sector reform are long-term positives, but any China growth slowdown would be a near-term challenge.
Other	Commodities and currencies	*	Declining global crude inventories underpin oil prices, with geopolitical tensions providing further support. We are neutral on the U.S. dollar. Factors driving its recent strengthening are likely temporary, but higher global uncertainty and a widening U.S. yield differential with other economies may provide support.

▲ Overweight — Neutral ▼ Underweight

*Given the breadth of this category, we do not offer a consolidated view.

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