BLACKROCK INVESTMENT INSTITUTE

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WEEKLY COMMENTARY • JAN. 21, 2019

Key points

1 We see the potential for more earnings downgrades due to slower growth and rising pressure on profit margins as the economy enters late cycle.

2 Global stocks extended gains into a fourth straight week. U.S. earnings season kicked off with better-than-expected results for many financials.

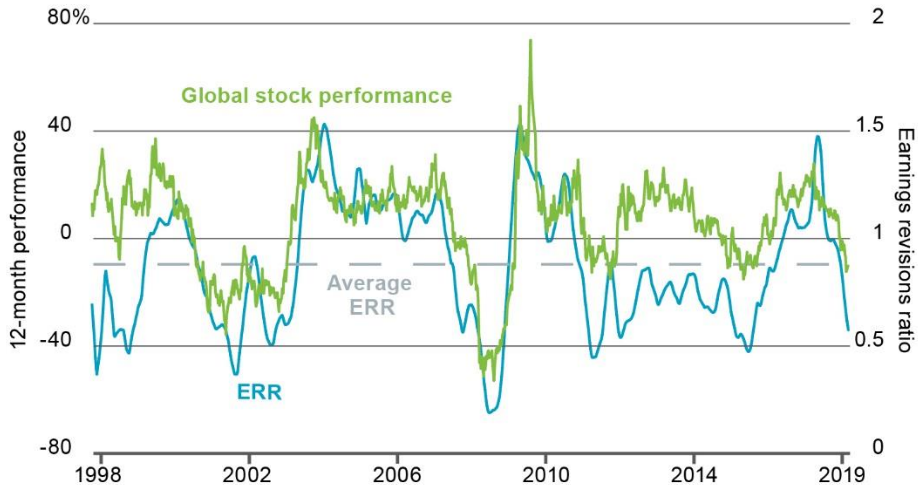
3 This week's China data, especially on industrial production, will show if the policy easing so far has fed through to the real economy.

1 What to expect from this earnings season

Global stocks have rallied since the start of 2019 after posting the steepest decline since 2008 last year. This hasn't lifted the gloom over the current earnings season. Analysts have aggressively cut their forecasts, yet we see some potential for more earnings downgrades. This argues for more carefully balancing risk and reward in portfolios.

Chart of the week

Global stock performance and earnings revisions ratio, 1998-2019



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 and IBES, January 2019. Notes: The earnings revisions ratio (ERR) is the number of companies in the MSCI ACWI Index with earnings-per-share (EPS) estimates revised up divided by those revised down. Stock performance is based on 12-month rolling returns; the ERR is a rolling three-month average.

The pessimism on corporate earnings is palpable. Sentiment is the weakest since mid-2016, as suggested by the earnings revisions ratio (or ERR, the number of analysts upgrades versus downgrades). The ratio for global companies at the start of January is about a quarter lower than the historical average ahead of fourth-quarter earnings seasons. The ERR and equity performance have tended to move in lockstep historically, with negative earnings sentiment associated with falling stock prices, and vice versa. See the chart above. We see some potential for more downgrades, although the ERR is nearing past trough levels outside of recessions. U.S. earnings are coming off a "sugar high," with 2018's fiscal stimulus and tax cuts setting a high bar to clear. Earnings per share (EPS) of global stocks are expected to grow 6.6% in 2019, versus 14.9% in 2018, according to consensus estimates.

Challenges in 2019

Corporate earnings are becoming harder to forecast as the economic cycle moves into its late stage. Rising worries about slower global growth amid tightening financial conditions point to further risks to earnings estimates, particularly in the first half of 2019. Other concerns include emerging late-cycle pressure on corporate profit margins, elevated risks around U.S.-China trade conflicts, and other geopolitical issues. We may see large swings in prices in reaction to earnings surprises.

One key to watch in earnings releases: sales guidance. It peaked in early 2018 with rising corporate confidence in global growth, and has trended lower ever since. Some early indicators of corporate sentiment, such as the Duke CFO Global Business Outlook, suggest companies have become more concerned about their firms' financial prospects – and global growth. Yet it's not all doom and gloom. We still see solid, albeit slowing, global growth in 2019. And we view the near-term risk of a U.S. recession as low, even as the U.S. economic cycle enters late-stage. The Federal Reserve is likely to put its rate increases on hold until the second half of the year, boding well for stocks and other risk assets, we believe. More stimulus in China and Europe could potentially provide further support for risk appetite. Another plus: more attractive equity valuations after last year's selloff. Global stock valuations have dropped to about 13 times forward earnings from 16 a year earlier, as markets have priced in greater uncertainty and a sharp slowdown in earnings growth.

Bottom line: We believe equities can post positive returns this year, but heightened uncertainty may cap valuations. We prefer quality companies with strong free cash flows and balance sheets, and the U.S. over other developed markets. We see the companies that can protect their margins at this stage of the cycle as likely to outperform. Health care is among our favored sectors. We like emerging market equities after a big derating in 2018, against a backdrop of improving earnings growth, economic reform and policy stimulus. We also see a growing role for bonds as portfolio diversifiers as the maturing cycle brings the potential for more frequent risk-off episodes.

2 Week in review

- Global stocks rose, posting a fourth straight week of gains. U.S. large caps kicked off the earnings season with financials leading the performance on better-than-expected earnings. High yield bonds rose alongside stocks, with credit spreads tightening.
- The UK Parliament rejected Prime Minister Theresa May's Brexit deal with the European Union (EU), though her government survived a vote of no confidence. Markets fretted about the heightened political uncertainty.
- U.S.-China trade negotiations inched forward. Talks between mid-level trade officials appeared to yield modest results, but make little progress on structural issues ahead of senior-level talks at the end of the month. The U.S. government's longest-ever partial shutdown stretched into a fourth week, and was starting to raise uncertainty and dent consumer spending, the New York Federal Reserve's president said.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.6%	3.6%	-4.3%	2.2%
U.S. Small Caps	4.8%	7.4%	-7.6%	1.5%
Non-U.S. World	3.2%	4.1%	-13.3%	3.7%
Non-U.S. Developed	2.9%	3.9%	-13.1%	3.9%
Japan	4.1%	4.0%	-14.0%	2.6%
Emerging	3.8%	3.7%	-14.3%	3.3%
Asia ex-Japan	4.1%	2.6%	-14.9%	3.0%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.3%	0.0%	1.5%	2.7%
U.S. TIPS	0.2%	0.7%	0.0%	2.8%
U.S. Investment Grade	0.3%	0.5%	-1.6%	4.2%
U.S. High Yield	1.9%	3.1%	0.3%	7.2%
U.S. Municipals	0.0%	0.3%	2.0%	2.6%
Non-U.S. Developed	0.3%	0.9%	-1.4%	0.9%
EM $ Bonds	0.7%	1.7%	-2.6%	6.6%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	6.0%	12.4%	-12.7%	$60.48
Gold	0.3%	0.6%	-2.4%	$1,290
Copper	0.4%	-0.4%	-16.8%	$5,942

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.6%	0.0%	-4.7%	1.15
USD/Yen	0.0%	-1.1%	-2.5%	108.48
Pound/USD	1.0%	0.7%	-5.1%	1.28

Source: Thomson Reuters. As of Jan. 18, 2019. 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

Jan. 21	Deadline for UK's May to submit a Brexit "Plan B"; China data	**Jan. 24**	European Central Bank rate decision; flash Purchasing Managers' Index (PMI) data for Germany, eurozone, U.S. and Japan
Jan. 23	Bank of Japan rate decision; EU business and consumer surveys	**Jan. 22-25**	Davos World Economic Forum

Chinese economic data this week will be under close scrutiny for any signs of a lift from recent policy easing. The main focus: industrial production, after its growth deteriorated through last year. We believe the Chinese economy should regain its footing in the first half of 2019 as material policy easing gets underway. The latest round of easing came last week with a record injection of liquidity by the People's Bank of China into the country's banking system. Read our latest *Macro and market perspectives* for details. China is also set to release gross domestic product (GDP) and retail sales data this week.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Solid corporate earnings and ongoing economic expansion underpin our positive view. We have a growing preference for quality companies with strong balance sheets as the 2019 macro and earnings outlooks become more uncertain. Health care is among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance. We prefer higher-quality, globally-oriented names.
	Japan	—	We see solid corporate fundamentals and cheap valuations as supportive, but the market lacks a clear catalyst for sustained outperformance. Other positives include shareholder-friendly corporate behavior, central bank stock buying and political stability.
	EM	▲	Attractive valuations, coupled with a backdrop of economic reforms and policy stimulus, support the case for EM stocks. We view financial contagion risks as low. Uncertainty around trade is likely to persist, though much has been priced in. We see the greatest opportunities in EM Asia.
	Asia ex-Japan	▲	The economic backdrop is encouraging, with near-term resilience in China and solid corporate earnings. 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	—	U.S. Treasuries are an attractive offset to equity risk, particularly as U.S. interest rates near neutral and upward rate pressure eases. Weakening economic fundamentals and a slowdown in Fed normalization would support Treasuries. We see reasonable value in mortgages. Inflation-linked debt has cheapened, but we see no obvious catalyst for outperformance.
	U.S. municipals	—	Solid demand for munis as a tax shelter and expectations for muted issuance should support the asset class. We prefer a long duration stance, expressed via a barbell strategy focused on two- and 20-year maturities.
	U.S. credit	—	Solid fundamentals support credit markets, but late-cycle economic concerns pose a risk to valuations. We favor an up-in-quality stance with a preference for investment grade credit. We hold a balanced view between high yield bonds and loans.
	European sovereigns	▼	Yields are relatively unattractive and vulnerable to any growth uptick. Rising rate differentials have made European sovereigns more appealing for global investors with currency hedges. Italian spreads reflect quite a bit of risk.
	European credit	—	Valuations are attractive, particularly on a hedged basis for U.S. dollar investors. We see opportunities in industrials but are cautious on other cyclical sectors. We favor senior financial debt that would stand to benefit from any new ECB support, over subordinated financials. We prefer European over UK credit on Brexit risks. Political uncertainty is a concern.
	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	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could signal upside to industrial metal prices. We are neutral on the U.S. dollar. It maintains "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

▲ Overweight — Neutral ▼ Underweight *Given the breadth of this category, we do not offer a consolidated view.

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