Weekly commentary

BlackRock

February 5, 2024

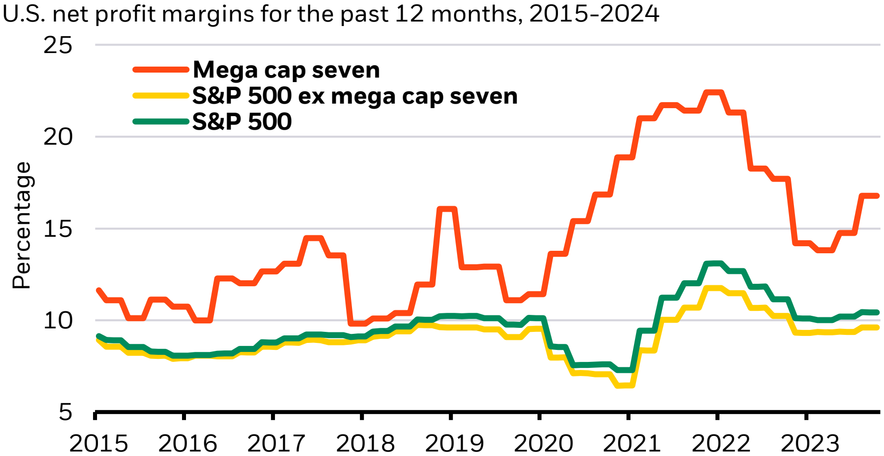
Earnings unlikely to spoil stock rally

- We don't see Q4 earnings challenging upbeat risk appetite even as we see 2024 earnings growth below the consensus. We're overweight U.S. stocks overall.
- U.S. stocks hit an all-time high last week as mostly solid tech earnings offset some disappointments. U.S. 10-year yields jumped on robust January jobs data.
- We follow this week's global PMIs to gauge how firms are adapting to still-high rates. China credit growth is in focus to gauge the impact of policy stimulus.

U.S. Q4 corporate earnings season is in full swing. We don't see it spoiling upbeat risk appetite for now. The S&P 500 hit an all-time high last week as most top tech firms beat high earnings expectations. Yet we think earnings will recover less than markets expect this year after stagnating in 2023. Tech gains and cost cutting have buoyed margins, but we see pressures mounting over time. We're overall overweight U.S. stocks as we think rosy market sentiment can persist for now.

Big tech buoys margins

U.S. net profit margins for the past 12 months, 2015-2024



Source: BlackRock Investment Institute, with data from Bloomberg, January 2024. Notes: The chart shows net corporate profit margins for the seven largest companies listed on the S&P 500 by market capitalization (mega cap seven), the S&P 500 excluding the mega cap seven, and the overall S&P 500 for the past 12 months.

We're in a new regime of greater macro and market volatility, and that's reflected in corporate profit margins. S&P 500 net profit margins expanded to all-time highs during the pandemic as firms passed on higher costs to consumers. The reversal of pandemic spending patterns and solid wage growth have pushed margins down from a peak of roughly 13% (green line in the chart). Still, margins have held up better than we expected against these pressures and higher interest rates. We think a handful of mega cap tech firms – those with ultra-large market capitalizations – have buoyed margins. Stripping out mega cap tech, S&P 500 profit margins have normalized closer to pre-Covid levels (yellow line). Cost-cutting measures such as layoffs have helped companies preserve profit margins for now. We think margins have room to fall further once cost cutting ends and inflation resurges.


Jean Boivin
Head – BlackRock Investment Institute


Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute


Natalie Gill
Portfolio Strategist – BlackRock Investment Institute


Carolina Martinez Arevalo
Portfolio Strategist – BlackRock Investment Institute

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Mega cap tech stocks have rallied since last year over excitement about artificial intelligence (AI). Digital disruption and AI is one mega force, or structural shift, we seeing playing out over years and being a key earnings driver. Our work finds a positive correlation between a rise in AI patents and earnings growth in the one-to-two years after the patent registration. Analysts expect mega cap tech earnings to grow 21% this year – a third of S&P 500 earnings growth, LSEG data show. That's a high bar, in our view. So far, most mega caps tech names have beat lofty Q4 expectations.

Meanwhile, analysts expect broader earnings to grow about 11% this year, in line with expectations for S&P 500 margins to rebound toward 13% in the next 12 months, LSEG data show. That earnings growth would be an improvement from stagnation, with earnings on track to have grown just 1% in 2023. We expect earnings to land just below consensus this year. And while we think margins could tick up, analyst estimates look too optimistic. We see cost pressures on margins mounting as the year progresses. Yet tech delivering on earnings and further cost-cutting measures could alleviate pressures for now.

Ultimately, we think market sentiment on stocks is anchored on the outlook for policy rates and inflation. Stocks rebounded quickly from mixed tech earnings earlier last week and after Fed Chair Jerome Powell ruled out a rate cut as soon as March. The Fed is watching for inflation to fall sustainability to 2%. We've said before that we think goods inflation will push inflation near 2% this year. What matters is we think the Fed will start to cut rates as that scenario plays out. Yet we believe the rally will be upset by resurgent inflation coming into view later this year and margins facing pressure. Still-high wage growth is one key factor that will put inflation on a rollercoaster toward 3% in 2025, in our view. That will likely renew cost pressures on companies. We watch for wages growing faster than the prices received by good producers to gauge margin pressures.

Bottom line: We're overweight overall U.S. equities, including the AI theme, on a tactical horizon of six to 12 months. That's because we think the rosy market sentiment has room to run for now. Earnings and margins won't spoil the mood yet, in our view. We're neutral U.S. stocks on a strategic horizon as we expect high-for-longer interest rates to weigh on valuations.

Market backdrop

U.S. stocks pushed to new record highs, recovering from some mixed earnings results and the Fed pushing back against market pricing of a rate cut as soon as March. Some mega cap tech companies only met lofty earnings expectations, but enough handily beat the expectations to lift the broader market. U.S. 10-year yields jumped after the January payrolls report showed robust job gains and a pop in wage growth. We think ongoing wage pressures and other structural forces will put inflation on a rollercoaster. That's why the Fed won't be able to cut rates as much as the market still expects, in our view.

Assets in review

Selected asset performance, 12-month 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 LSEG Datastream as of Feb. 1, 2024. 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 12-month 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, LSEG 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.

Week ahead

Feb. 5	Global PMIs	**Feb. 7**	U.S. trade data
Feb. 8	China CPI and PPI	**Feb. 8-15**	China total social financing

Global PMI data takes center stage this week as we take stock of how corporate margins are holding up against high interest rates. China credit data is also in focus after authorities launched policy stimulus and vowed to support growth at the end of January. We don't think the structural challenges China is facing this year – and in some cases, further out – have changed: a high savings rate, low domestic investment, a shrinking labor force and waning foreign investment.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, February 2024

Tactical	**Reasons**
U.S. equities	• Our macro view has us neutral at the benchmark level. But the AI theme and its potential to generate alpha – or above-benchmark returns – push us to be overweight overall.
Income in fixed income	• The income cushion bonds provide has increased across the board in a higher rate environment. We like short-term bonds and are now neutral long-term U.S. Treasuries as we see two-way risks ahead.
Geographic granularity	• We favor getting granular by geography and like Japan equities in DM. Within EM, we like India and Mexico as beneficiaries of mega forces even as relative valuations appear rich.
Strategic	**Reasons**
Private credit	• We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to credit risk.
Inflation-linked bonds	• We see inflation staying closer to 3% in the new regime than policy targets, making this one of our strongest views on a strategic horizon.
Short- and medium-term bonds	• We overall prefer short-term bonds over long term. That's due to more uncertain and volatile inflation, heightened bond market volatility and weaker investor demand.

Note: Views are from a U.S. dollar perspective, February 2024. 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.

Tracking five mega forces

Mega forces are big, structural changes that affect investing now – and far in the future. As key drivers of the new regime of greater macroeconomic and market volatility, they change the long-term growth and inflation outlook and are poised to create big shifts in profitability across economies and sectors. This creates major opportunities – and risks – for investors. See our web hub for our research and related content on each mega force.

1. **Demographic divergence:** The world is split between aging advanced economies and younger emerging markets – with different implications.
2. **Digital disruption and artificial intelligence (AI):** Technologies that are transforming how we live and work.
3. **Geopolitical fragmentation and economic competition:** Globalization is being rewired as the world splits into competing blocs.
4. **Future of finance:** A fast-evolving financial architecture is changing how households and companies use cash, borrow, transact and seek returns.
5. **Transition to a low-carbon economy:** The transition is set to spur a massive capital reallocation as energy systems are rewired.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, February 2024

Our approach is to first determine asset allocations based on our macro outlook – and what's in the price. **The table below reflects this and, importantly, leaves aside the opportunity for alpha, or the potential to generate above-benchmark returns.** The new regime is not conducive to static exposures to broad asset classes, in our view, but is creating more space for alpha**.**

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

	Asset		View	Commentary
Equities	**Developed markets**			
Equities	United States	Benchmark	Neutral	We are neutral in our largest portfolio allocation. Falling inflation and coming Fed rate cuts can underpin the rally's momentum. We are ready to pivot once the market narrative shifts.
Equities	United States	Overall	+1	We are overweight overall when incorporating our U.S.-centric positive view on artificial intelligence (AI). We think AI beneficiaries can still gain while earnings growth looks robust.
Equities	Europe		-1	We are underweight. The ECB is holding policy tight in a slowdown. Valuations are attractive, but we don't see a catalyst for improving sentiment.
Equities	UK		Neutral	We are neutral. We find attractive valuations better reflect the weak growth outlook and the Bank of England's sharp rate hikes to fight sticky inflation.
Equities	Japan		+1	We are overweight. We see stronger growth helping earnings top expectations. Stock buybacks and other shareholder-friendly actions are positives. Policy tightening is a near-term risk.
Equities	**Emerging markets**		Neutral	We are neutral. We see growth on a weaker trajectory and see only limited policy stimulus from China. We prefer EM debt over equity.
Equities	China		Neutral	We are neutral. Modest policy stimulus may help stabilize activity, and valuations have come down. Structural challenges such as an aging population and geopolitical risks persist.
Fixed Income	Short U.S. Treasuries		+1	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer
Fixed Income	Long U.S. Treasuries		Neutral	We are neutral. The yield surge driven by expected policy rates has likely peaked. We now see about equal odds that long-term yields swing in either direction.
Fixed Income	U.S. inflation-linked bonds		Neutral	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.
Fixed Income	Euro area inflation-linked bonds		-1	We are underweight. We prefer the U.S. over the euro area. We see markets overestimating how persistent inflation in the euro area will be relative to the U.S.
Fixed Income	Euro area govt bonds		Neutral	We are neutral. Market pricing reflects policy rates in line with our expectations and 10-year yields are off their highs. Widening peripheral bond spreads remain a risk.
Fixed Income	UK gilts		Neutral	We are neutral. Gilt yields have compressed relative to U.S. Treasuries. Markets are pricing in Bank of England policy rates closer to our expectations.
Fixed Income	Japanese govt bonds		-1	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
Fixed Income	China govt bonds		Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
Fixed Income	Global IG credit		-1	We are underweight. Tight spreads don't compensate for the expected hit to corporate balance sheets from rate hikes, in our view. We prefer Europe over the U.S.
Fixed Income	U.S. agency MBS		Neutral	We are neutral. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG.
Fixed Income	Global high yield		Neutral	We are neutral. Spreads are tight, but we like its high total yield and potential near-term rallies. We prefer Europe.
Fixed Income	Asia credit		Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
Fixed Income	Emerging hard currency		+1	We are overweight. We prefer EM hard currency debt due to higher yields. It is also cushioned from weakening local currencies as EM central banks cut policy rates.
Fixed Income	Emerging local currency		Neutral	We are neutral. Yields have fallen closer to U.S. Treasury yields. Central bank rate cuts could hurt EM currencies, dragging on potential returns.

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