BLACKROCK INVESTMENT INSTITUTE

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Key points

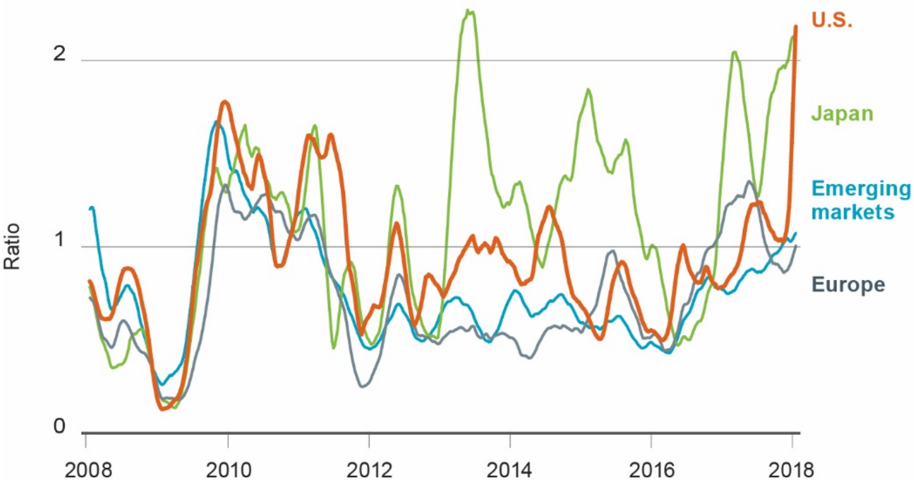
1. We have upgraded U.S. equities because of very strong earnings momentum, and consequently are now neutral on European stocks.
2. Global equity markets recovered some ground after their early February swoon and the VIX declined. U.S. inflation came in higher than expected.
3. Minutes from the Federal Reserve's late January meeting could show how the central bank may react to higher-than-consensus U.S. inflation.

1 An upgrade to U.S. equities

We have upgraded our tactical view of U.S. equities to overweight from neutral. The reason: Impending fiscal stimulus is supercharging U.S. earnings growth expectations. We have shifted our view on European equities to neutral as a result. Earnings momentum is solid in Europe — but lags that of other regions.

Chart of the week

Corporate earnings revision ratios, 2008-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, February 2018. Notes: The lines show the number of companies in the MSCI USA, Europe, Japan and Emerging Markets indexes with 12-month forward earnings-per-share (EPS) estimates revised up in the previous month divided by the number of companies with downward revisions to EPS estimates. A ratio above one means there are more upgrades than downgrades; a ratio below one means more downgrades than upgrades.

Our U.S. upgrade boils down to a fundamental story underpinned by earnings growth. An added bonus: U.S. valuations look slightly more attractive after the February stock market swoon. Economic strength was already changing the tone of earnings momentum, but U.S. tax cuts and government spending plans lit a fire under the trend. The chart above illustrates the sharp acceleration in U.S. earnings upgrades as analysts factored in the stimulus. The ratio of upgrades to downgrades for U.S. large caps (the orange line) stands at the highest level since the data series started in 1988. Upward revisions are solid globally, but the U.S. strength is unmatched. Japan is unique, as earnings revisions there tend to be noisy. We see the strong U.S. earnings momentum persisting in the short term and leading to higher returns.

Earnings growth eclipses valuations

U.S. earnings growth momentum was already strong before the announced tax cuts and fiscal stimulus, thanks to an improving economy. Earnings growth for S&P 500 firms was 15% year-over-year in the last quarter of 2017, and sales growth was the highest since the third quarter of 2011. Some 60% of the S&P 500 companies providing guidance during fourth quarter earnings season exceeded what analysts had penciled in for 2018. Companies have had an incentive to give conservative forecasts as stocks that disappointed on earnings and sales have been disproportionately punished in recent quarters. U.S. earnings estimates have jumped by more than seven percentage points to 19% growth for 2018, as analysts factored in corporate guidance and the stimulus benefits.

U.S. stocks have already retraced a large part of their early February losses, but we believe the coming positive effects of new U.S. tax and spending plans are still underappreciated by markets. Valuations are certainly still at the top end of their historical range and we see little scope for equity multiples in the U.S., or most other regions, to expand further. But we find earnings growth matters more than valuations over shorter time horizons at this stage of the bull market. We are in the ninth year of an unusually long economic expansion, and while we believe the cycle has room to run, we see gradually rising rates and modestly higher inflation ahead.

We see earnings-per-share (EPS) growth and dividends fueling returns. Some companies will choose to spend their tax windfalls on buybacks or dividends; others will boost capital spending. The scope for additional M&A activity is also large. The risks? Accelerating inflationary pressures could threaten margins and rising real rates may lead to lower multiples. We see the tax windfall providing an earnings buffer against these forces. We maintain high conviction in equities overall. We see solid European equity returns ahead, but lower earnings growth relative to other regions limits European stocks' potential to outperform in the short term. Emerging markets remain a favored region. In the U.S., we like the momentum and value factors, financials and technology firms.

2 Week in review

- Global equities rallied and the VIX measure of market volatility calmed. The S&P 500 regained nearly 8% from its February intraday low. Japanese stocks lagged the broader rally, as the yen rose to a 15-month high versus the U.S. dollar (USD).
- U.S. Consumer Price Index (CPI) inflation surprised to the upside on both headline and core measures, pushing U.S. 10-year Treasury yields to a four-year high and above 2.9% for the first time since 2014. U.S. retail sales slowed.
- Commodity prices rebounded, led by industrial metals and precious metals aided by a weaker U.S. dollar. The International Energy Agency and OPEC again forecasted increased 2018 U.S. oil production. The South African rand rose to a three-year high versus the USD after President Jacob Zuma resigned.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	4.4%	2.2%	16.4%	2.0%
U.S. Small Caps	4.5%	0.6%	11.8%	1.2%
Non-U.S. World	4.4%	1.5%	21.9%	3.1%
Non-U.S. Developed	4.3%	1.4%	21.1%	3.3%
Japan	2.8%	2.2%	20.9%	2.1%
Emerging	5.0%	3.7%	29.7%	2.7%
Asia ex-Japan	4.3%	1.8%	31.6%	2.5%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.3%	-2.2%	-0.1%	2.9%
U.S. TIPS	0.0%	-2.0%	0.2%	2.9%
U.S. Investment Grade	-0.2%	-2.5%	3.2%	3.7%
U.S. High Yield	0.8%	-0.5%	4.7%	6.2%
U.S. Municipals	-0.1%	-1.5%	3.2%	2.6%
Non-U.S. Developed	2.0%	3.5%	12.9%	0.9%
EM $ Bonds	0.4%	-2.1%	5.2%	5.7%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	3.3%	-3.0%	16.5%	$64.84
Gold	2.3%	3.4%	8.7%	$1,347
Copper	7.1%	-0.2%	20.6%	$7,233

Currencies	Week	YTD	12 Months	Level
Euro/USD	1.3%	3.3%	16.2%	1.24
USD/Yen	-2.4%	-5.8%	-6.2%	106.21
Pound/USD	1.4%	3.8%	12.3%	1.40

Source: Bloomberg. As of Feb. 16, 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

Feb. 20 Germany ZEW Economic Sentiment Index; eurozone consumer confidence flash

Feb. 21 Fed minutes; eurozone, Germany, U.S. Markit flash PMIs; Japan Nikkei flash Manufacturing PMI

Feb. 22 European Central Bank (ECB) minutes

Feb. 23 Japan CPI

Minutes from the Fed and ECB's late January monetary policy meetings may provide market surprises. The focus will be on how the Fed characterizes U.S. inflation as it nears the central bank's target. Markets raised their expectations for Fed rate increases last week after U.S. headline and core CPI came in above consensus. Markets now expect just under three Fed hikes this year, more in line with the Fed's dots, and these expectations could rise further depending on what the minutes show. Surprises in the ECB minutes could come regarding how the central bank characterizes the pace of European growth and foreign exchange developments.

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 due to corporate tax cuts and fiscal stimulus underpins 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 amid a stable yen outlook. We see BoJ policy and domestic investor buying as supportive. 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, and like Brazil and India. We are cautious on Mexico.
	Asia ex-Japan	▲	The economic backdrop is encouraging. China's growth and corporate earnings appear 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 expect rates to move moderately higher amid a sustained economic expansion and a tightening Fed. Rising inflation and lower valuations give TIPS an edge over nominal Treasuries. We are neutral on agency mortgages, given full valuations and the uncertain effect of the Fed's unwinding its balance sheet.
	U.S. municipals	—	Increased issuance driven by tax reform expectations should reverse in 2018, creating a more supportive supply/demand balance. This, plus solid appetite for tax-exempt income, underpins the asset class. We favor maturities of 0-2 and 20+ years.
	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 appear increasingly well positioned for rising rates.
	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, and spreads of semi-core and selected peripheral government bonds to narrow.
	European credit	▼	Ongoing ECB purchases have compressed spreads across sectors and credit-quality buckets. Negative rates have crimped absolute yields – and rising rate differentials make currency hedged positions increasingly attractive for U.S. dollar investors. Subordinated financial debt is less alluring versus equities after a strong 2017.
	EM debt	—	Gradual Fed rate increases favor local-currency exposures – especially their higher yields relative to major bond markets. A shift by EM central banks towards tighter policy reduces our return expectations. Solid fundamentals and inflows should limit EM currency volatility.
	Asia fixed income	—	Regional growth and inflation dynamics are supportive of credit. China's rising representation in the region's bond landscape 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	*	Oil prices are underpinned by supply-and-demand rebalancing. We are neutral on the U.S. dollar. The factors driving its recent slide are likely temporary, but it's unclear when the U.S. yield differential with other economies will reassert itself as the main driver.

▲ Overweight — Neutral ▼ Underweight

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

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