OPTIMISM AMID SOLID U.S. FUNDAMENTALS

OPTIMISM AMONG CHIEF EXECUTIVES SPIKES

Even though the U.S. is grappling with Russia, Syria, ISIS, North Korea, China, health care reform, tax reform, and the eventual revitalization of its physical infrastructure, corporate leaders appear to be pretty sanguine about business prospects within the U.S.

During the first quarter of 2017, the Business Roundtable CEO Economic Outlook Index, an index based on a survey of 141 CEOs from some of the largest U.S. companies, logged its biggest increase in CEO optimism since the fourth quarter of 2009. In fact, the index recently surpassed its historical average of 79.8 for the first time in seven quarters. Since index levels in excess of 50 suggest economic expansion over the ensuing six months, an index level of 93.3 portends a fairly high degree of optimism among folks who are particularly well positioned to act on that optimism. Here's how the index looks:

Various *sub-components* of the CEO Economic Outlook Index also surged:

⇒ *Sales* advanced 21 points to its highest in the last five years (123.8),

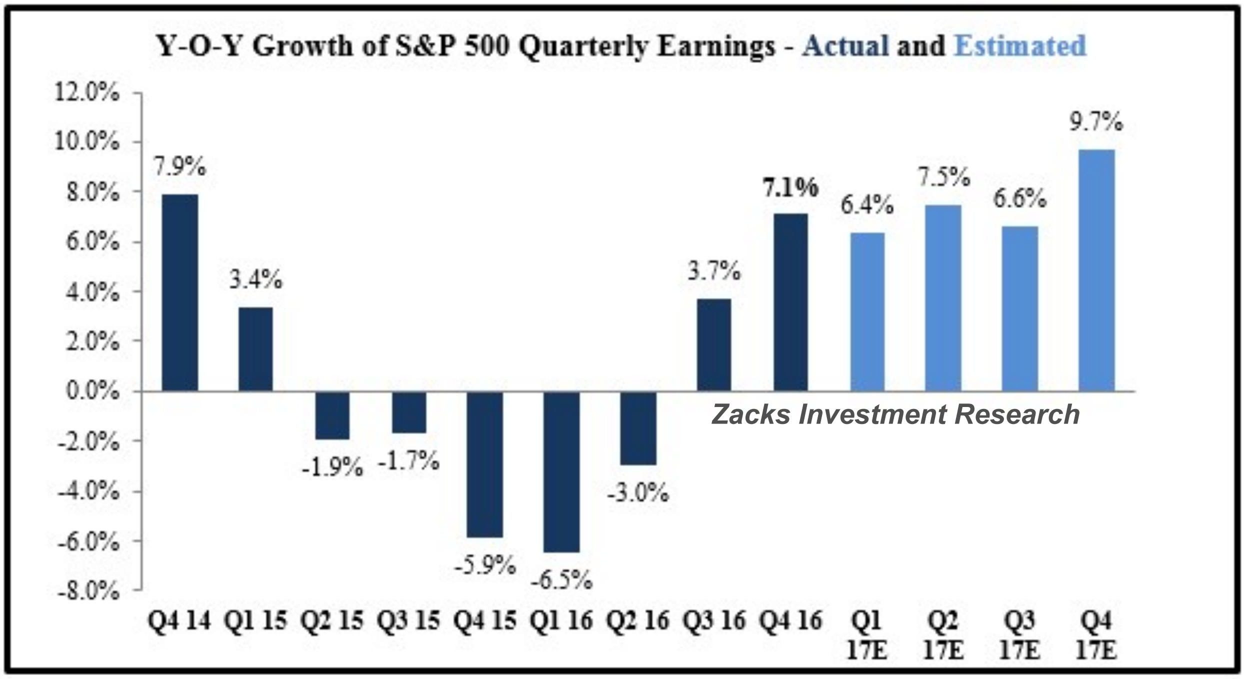
⇒ *Employment* logged its largest advanced in the past 7 years (+18 points to 73.6),

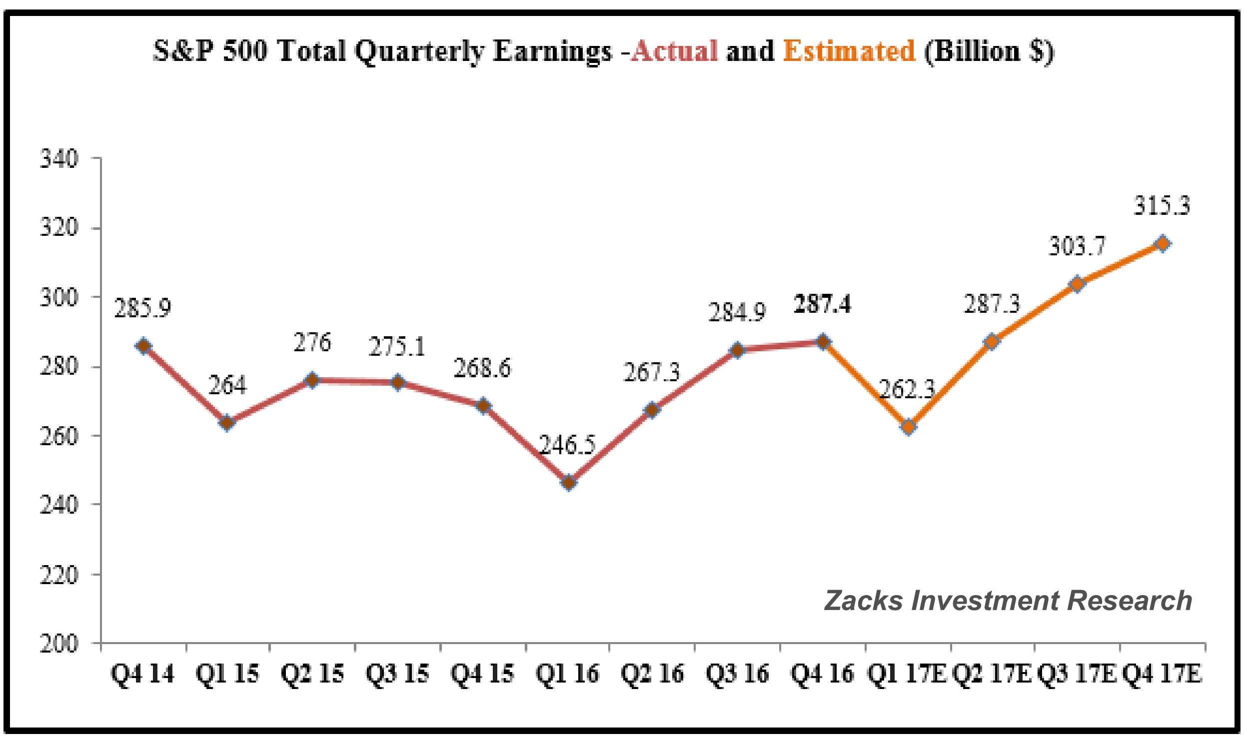
⇒ *Capital Spending* rose 18.4 points (to 82.6), and

⇒ *2017 GDP Growth Forecast* rose to 2.2% from 2.0% in December.

CORPORATE EARNINGS RECESSION BEHIND US …

The following graphs don't mean a thing with respect to whether stocks or other capital assets offer good investment value, but they do suggest that corporate earnings growth has, once again, become a reality. For all the uncertainty surrounding the new administration's policy proposals and the noisy political headlines, the fundamentals of corporate America seem intact.



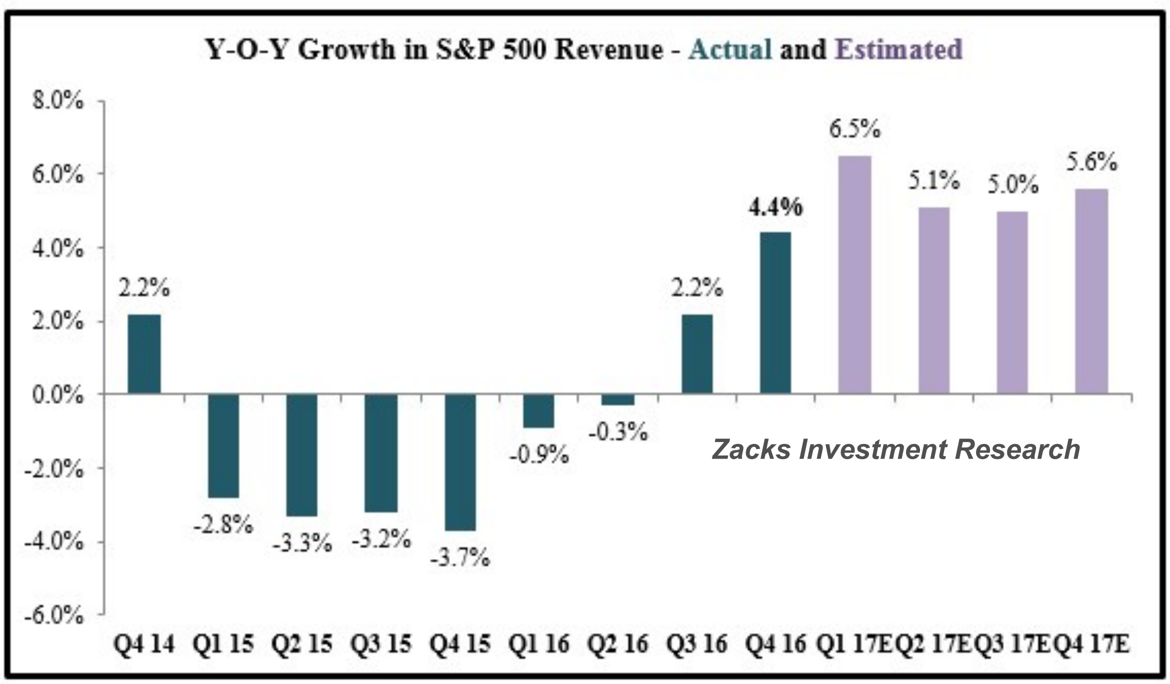


… TO BE DRIVEN BY HIGHER REVENUES

While corporations are likely to continue to pursue incremental earnings through a variety of cost-cutting measures, my sense is that most corporate management teams plucked most of the low-hanging earnings fruit that existed after the 2008/9 debacle long ago. Even if more of that fruit exists than I think, capturing sequential earnings gains through ongoing cost-cutting measures is generally a diminishing-returns proposition.

Of course, investors will accept whatever earnings gains they can get, but investors prefer those gains to be supported by organic revenue growth more so than by cost cutting, financial engineering, or accounting shenanigans.

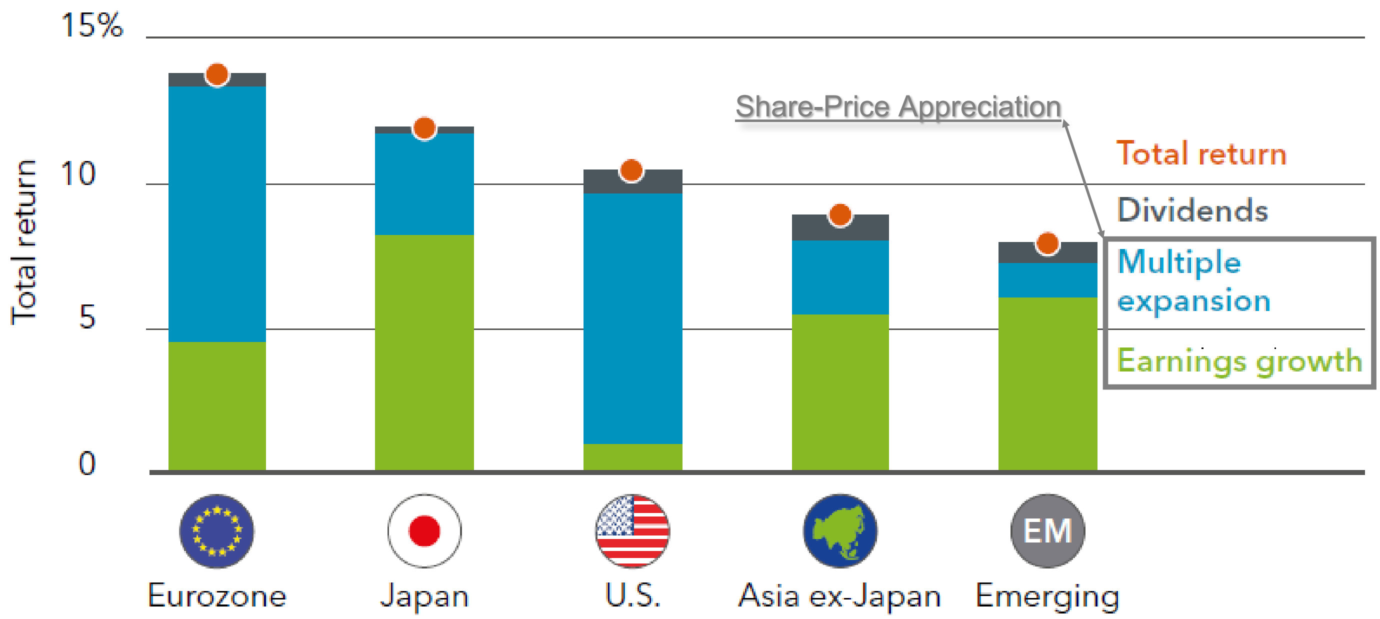
Securities analysts are an admittedly optimistic bunch, but here's what they, as a group, expect in terms of year-over-year revenue growth for 2017.



Through the power of operating leverage, revenue growth in the realm of 5—6%, as shown above, could easily translate into earnings growth of 6—9%, as shown on the previous page. This could provide a tailwind to equities, or it could help justify the share-price appreciation that we've already enjoyed. Either way, revenue growth is unambiguously positive.

COMPONENTS OF EQUITY RETURNS

Investors who hold equities (stocks) benefit from any dividends they might receive and, of course, from any increases in the market value of their shares. The chart below isolates the various components of total equity returns ("total return") across various regions since the U.S. elections, last fall. Although dividends have historically been a major component of equity returns, they can seem relatively inconsequential when equities advance smartly, as shown here.



Dividends aside, the major component of "total return" in the graph shown here is share-price appreciation which, itself, has two sub-components, "earnings growth," and "multiple expansion."

Say a company earns 5% more than it did during some previous period, but that its shares rise in value by 9%. Whereas the appreciation of 5% is said to be supported by earnings growth, the remaining appreciation of 4% is said to have occurred as a result of multiple expansion.

Note that I used the term "supported" when I referenced earnings growth, but not when I referenced multiple expansion. Because investors are forward-looking, they'll happily push the market value of equities higher on an *expectation* of eventual earnings growth or on an *expectation* that the investing climate will improve in some manner, but to the extent those expectations are not met, any share-price appreciation that came to fruition as a result of multiple expansion can easily be lost to subsequent multiple *contraction*. In fact, multiple expansion and contraction can, and often do, overwhelm earnings when it comes to stock values.

MULTIPLE CONTRACTION … THE OTHER SIDE OF THE SAME COIN

Notice how most of the share-price appreciation within the U.S. equities markets since the election last fall has been driven by multiple expansion rather than basic earnings growth. As long as U.S. equities were undervalued to begin with, or as long as U.S. companies eventually produce earnings to support the multiple expansion we've already enjoyed, or as long as investors remain optimistic that the overall investing climate is likely to improve, things could turn out fine for equity investors. Otherwise, we could be in store for some multiple *contraction*.

In fact, it's possible that even if U.S. corporations do deliver the earnings investors expect, investors might still be inclined to reduce the valuations they have already awarded to stocks and to other capital assets if they are fearful of or disappointed by tax reform, regulatory changes, the level of infrastructure spending, armed conflict, changes in the level of interest rates, trade deals, etc.

BLACKROCK ALSO SEES U.S. IMPROVING

Although we subscribe to research from Standard & Poor's, Credit Suisse, Value Line, Morningstar, and Zacks, I consider research opinions from other firms as well. BlackRock is the world's largest asset manager, so let's see what it thinks.

The graph at the top of the following page compares estimates for the Gross Domestic Product (a measure of total economic output) within the U.S. in the following way:

- Blue line: The current Consensus Economics estimate covering the next 12 months,
- Green line: BlackRock's estimate of what the above estimate will be 3 months hence.

In short, investors ought to be rooting for the green line to remain above the blue line, and for BlackRock to be correct, but I've embedded a few more notes in that graph to aid interpretation.

With respect to the U.S., not only is the green line above the blue line, it is substantially above it and the gap has been widening. If BlackRock's prescience is up to snuff, it could very well mean that the potential multiple contraction about which I just fretted, may not, in fact, visit us. However, even if BlackRock's forecasting is solid, unanticipated developments could alter the entire calculus. For instance, if the U.S. ends up tangling with North Korea in a meaningful way, I would expect both the green and blue lines to fall materially.

United States

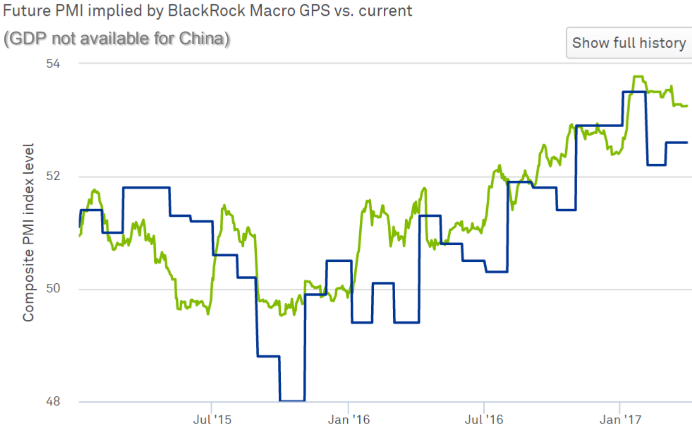
Future GDP growth implied by BlackRock GPS vs. consensus estimates

BlackRock is optimistic about the prospects for the U.S. economy, and for these other important economies, too:

China

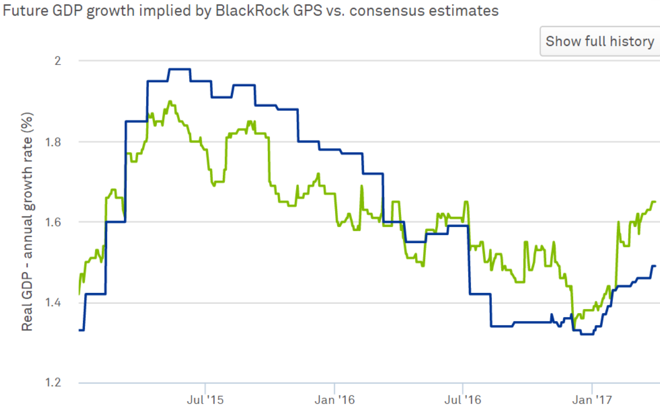
Future PMI implied by BlackRock Macro GPS vs. current

(GDP not available for China)



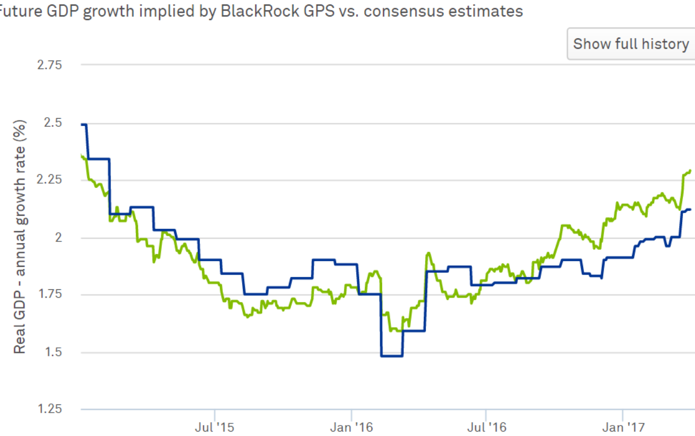
Germany

Future GDP growth implied by BlackRock GPS vs. consensus estimates



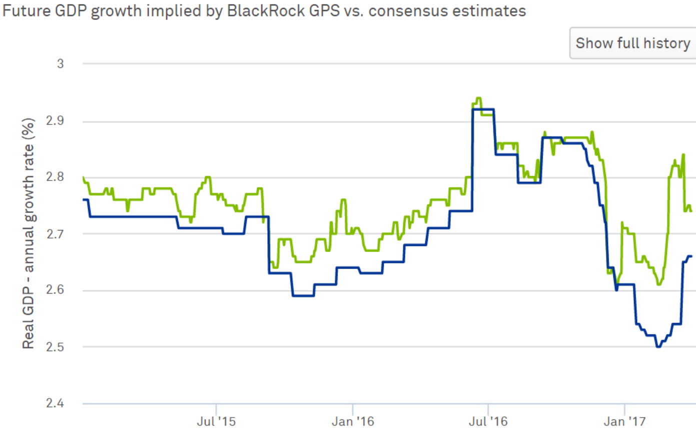
Canada

Future GDP growth implied by BlackRock GPS vs. consensus estimates

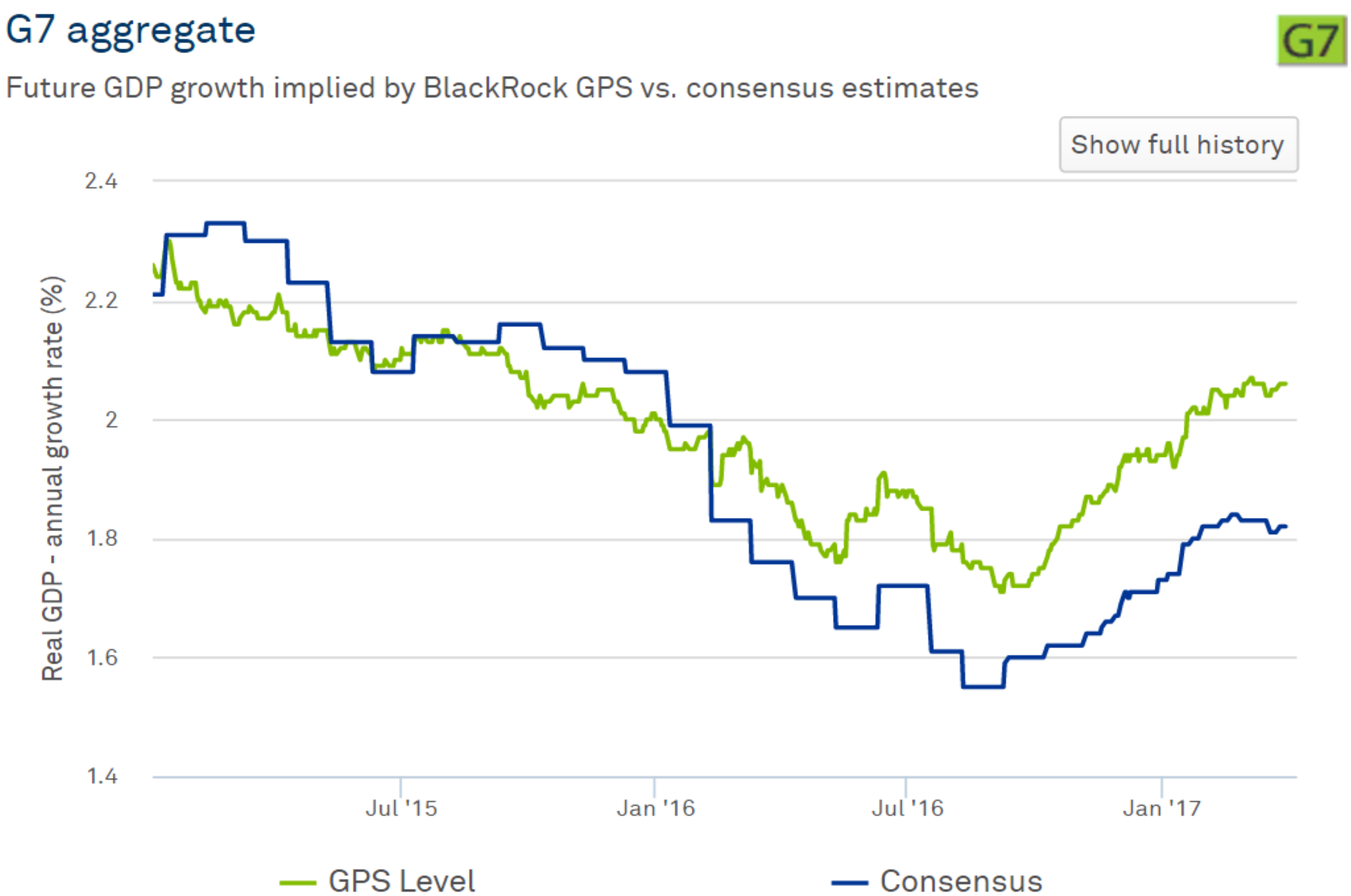


Australia

Future GDP growth implied by BlackRock GPS vs. consensus estimates



In addition to the U.S, Germany and Canada, the cluster of countries known as the Group of 7 (G7) also includes Japan, Great Britain, France, and Italy. BlackRock sees economic activity for this entire cluster of countries intensifying, as follows:

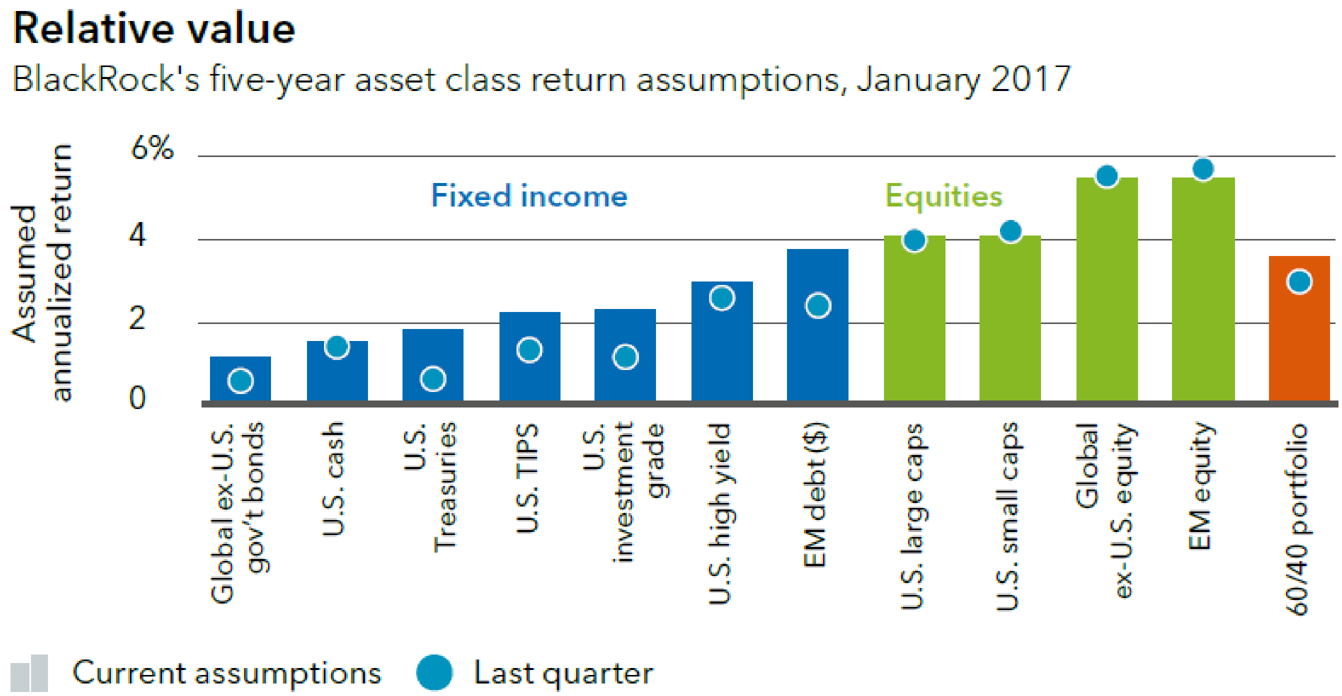


GDP GROWTH DOES NOT NECESSARILY EQUATE TO HIGH RETURNS

Some years ago when investors were particularly addicted to stimulus from the Federal Reserve, equity valuations within the U.S. would tend to surge on bad economic data because they knew it would spur the Fed into action. Similarly, stocks within the U.S. have performed pretty well of late, despite a dearth of earnings growth. The takeaway here is that whatever linkage may exist between GDP growth and stock valuations is indirect and highly variable.

BLACKROCK EXPECTS "MUTED" RETURNS NEXT 5 YEARS

BlackRock's asset-class return assumptions are as shown on the back page. Since we're just starting to come out of a low interest-rate environment, an expectation of low returns from cash



and fixed-income instruments should not be surprising. Since interest rates have already risen a bit, the market value of some fixed-income instruments has already faced a bit of pressure. This is why the returns BlackRock expects for fixed-income instruments are now somewhat higher than they were last quarter. With respect to the fixed-income portion of our portfolios, they are heavily tilted toward instruments I expect to better withstand the pressure from rising interest rates and/or toward instruments that offer pre-defined values and maturity dates that are known in advance.

Although BlackRock doesn't address this issue, the projections shown above are necessarily subject to a significant degree of estimation error, especially with respect to equities. Therefore, not only could the returns investors actually capture over the next 5 years turn out to differ wildly from the projections presented here, I would go so far as to say that actual returns are, at the very least, likely to differ materially, if not wildly.

Unless some type of systemic shock results in all asset classes getting marked down as a group, as was the case during 2008/9, the more usual circumstance is for certain asset classes to get marked down comparatively more than others. If history is any sort of guide, those times will equate to buying opportunities within whichever asset class might happen to go on sale.

— Glenn Wessel