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BlackRock

Stock market monitor

Q4 2023 equity market outlook from BlackRock Fundamental Equities

Opportunities in an unusual cycle. We believe the current business cycle is playing out in a manner that differs from the past, creating dispersion within markets and opportunities for stock pickers to achieve above-market returns. As we enter Q4 we see:

Sub-cycles within the cycle providing investment opportunities	**COVID-19 related supply disruptions still impacting earnings**	**Decarbonization and deglobalization driving the earnings of industrials**

We said in our Q3 Stock Market Monitor that equity markets may remain flat in the short term. That has been the case over the previous quarter and may continue for the rest of the year. Investors are tussling with the outlook for inflation and growth, keeping equity markets in something of a holding pattern. We believe the rates set by major central banks may be nearing a peak – a positive for equity markets – but the lagged effects of this potent rate-hiking cycle still present the risk of recessions, as we have seen in Germany this year.

However, this is no typical business cycle. We believe company earnings are still being impacted by overhangs from the COVID-19 pandemic, as well as by several long-term trends such as decarbonization and deglobalization. This may mean that an economic recession may not translate into an earnings recession and could explain stock market resilience amid slowing growth. See the chart below. We believe these forces have created sub-cycles within the business cycle, adding to dispersion within markets and creating opportunities for stock pickers. Cyclical companies – those whose earnings are most closely correlated with economic growth – have historically fallen out of favour as economies slow. This is an area that warrants investor caution, but we believe there could be opportunities among certain cyclical stocks that, for reasons mentioned above, do not behave cyclically.

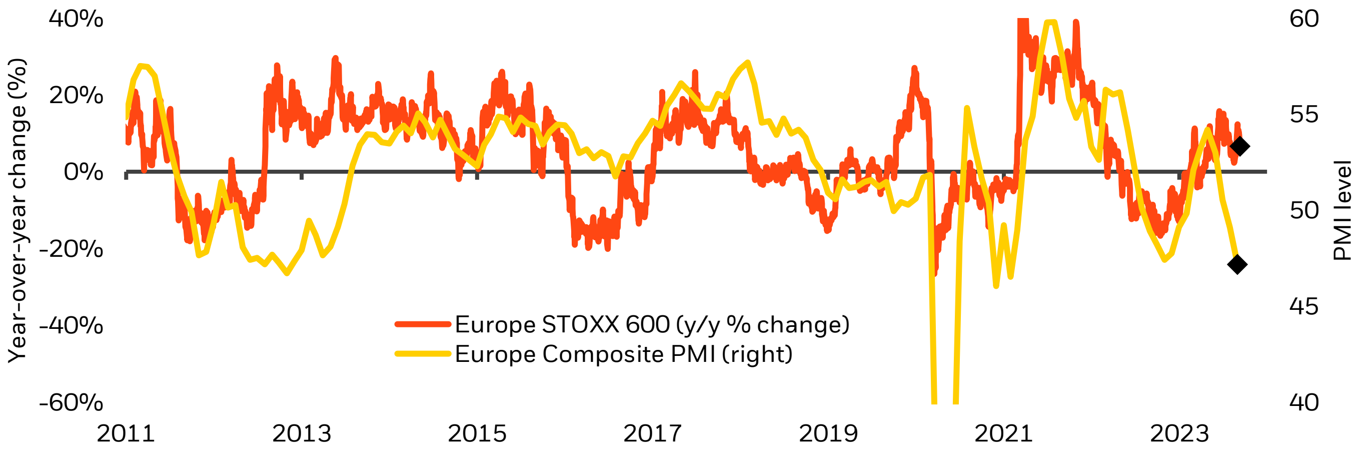
Helen Jewell

Chief Investment Officer, BlackRock Fundamental Equities, EMEA

> “We see several reasons for positivity around equity markets – a potential rate pause, consumer resilience and long-term earnings drivers such as decarbonization.

Equity markets keep on trucking

Annual change in European equity markets vs. European economic activity, 2001-2023



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: Refinitiv Datastream, Bloomberg, STOXX, Goldman Sachs Global Investment Research. The chart shows the year-over-year change in the Europe STOXX 600 index level (red) and the Europe Composite Purchasing Managers Index (yellow).

When cyclicals don't behave cyclically

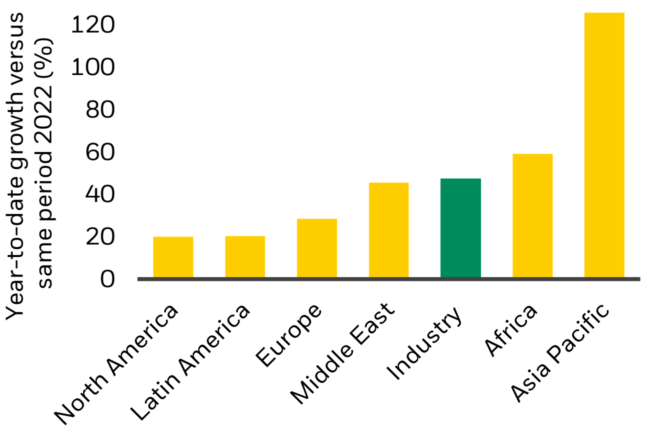
Still playing COVID catchup

The stop-start of the global economy in response to the COVID pandemic is still influencing company earnings today – and may continue to do so for many years. When economies slow, the product inventories of cyclical companies typically build up, and the process of clearing that inventory – for example by offering discounts – dents earnings. In this business cycle, there are some industries where this isn't happening. Supply is still unable to keep up with demand because supply never recovered from pandemic shutdowns. This is evident in some areas of the semiconductor industry – which we will explore further on page 3 – as well across the aerospace supply chain.

Aerospace: where have all the planes gone?

Aircraft makers reduced production during COVID as demand collapsed. Planes were either stored or retired to alleviate cost pressures. Travel demand has soared since the pandemic ended. In the first half of 2023, global air traffic jumped 47% versus a year earlier, as the chart below shows. And aircraft makers predict that production needs to double over the next 20 years as emerging markets grow richer – every person in India takes on average 0.1 flights a year; in the U.S., that number is 2.1.[1] Demand is also driven by the desire for more fuel-efficient aircraft, as carriers seek cost savings and aim to meet emission-reduction targets.

Air traffic is soaring
Year-to-date air traffic growth vs. 2022



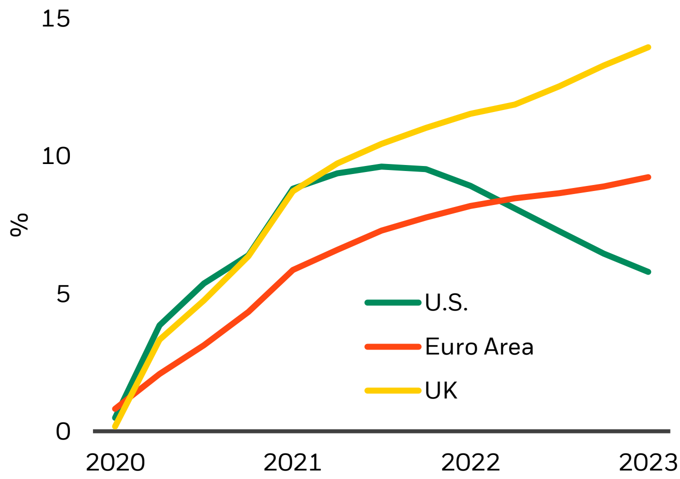
Source: International Air Transport Association, June 2023. The chart shows the growth in revenue passenger-kilometers for all regions. The RPK is the number of kilometers travelled per paying passengers.

How consumers keep consuming

Consumer spending has so far withstood the impact of higher inflation and interest rates, defying what might have been expected during a cyclical slowdown. There are several reasons why this may be the case. First, excess savings remain above pre-pandemic levels, especially in Europe and the UK. See the chart above right. Second, energy prices have come down from the highs seen in the summer of 2022. And third, consumers may be more insulated from the direct effects of higher rates than they have been in the past. In the UK, for example, only 26% of homes are owned with a mortgage, down from 33% in 2012.[2]

We believe this resilience provides opportunities for stock pickers to find high-quality consumer companies at attractive valuations. And that word "quality" is important, as we seek companies that can withstand a potential consumer slowdown once excess savings run dry. We see opportunities across e-commerce, travel and luxury companies, but we focus on quality characteristics such as a strong brand and healthy cash levels.

Consumers supported by savings
Excess consumer savings as a share of GDP, 2020-2023



Source: Haver Analytics, Goldman Sachs Global Investment Research, September 2023. The chart shows excess consumer savings as a percentage of 2022 gross domestic product (GDP) for each region.

Slower growth, higher rates, watch the banks

When growth has slowed in the past, central banks have cut rates as a form of economic stimulus. Now – to bring down inflation – central banks are raising rates into a slowdown. Banks are normally thought of as cyclical stocks because in recessions there may be lower demand for credit and higher chance of loan defaults. Yet higher rates are positive for bank earnings as they can earn greater interest on loans. European bank earnings have reflected this in recent quarters – in Q2, they grew 24% from a year earlier – and we believe this momentum may continue even if the European Central Bank has finished raising rates.[3] However, there are risks around regulation and politics, which could result in windfall taxes and lending mandates that dent margins. Again, we lean towards the quality end of the spectrum, including banks that have the most attractive dividend and buyback plans.

[1] IHS Markit, Sabre GDD, Airbus, data for 2019
[2] UK Office for National Statistics, Feb. 2023
[3] Bloomberg, August 2023

Spotlight topic: the forces driving industrials

Industrial companies are inherently cyclical in nature. When economic growth is accelerating, more factories are built, more machinery is bought, more infrastructure is planned and so on. When growth slows, we see the reverse. Yet we believe that some recent, powerful forces mean the cyclical ups and downs for some industrial companies may be shallower, while the earnings trend rises. Many of these forces can be grouped together into two themes: ***decarbonization*** and ***deglobalization***.

Decarbonization and the electrification of everything

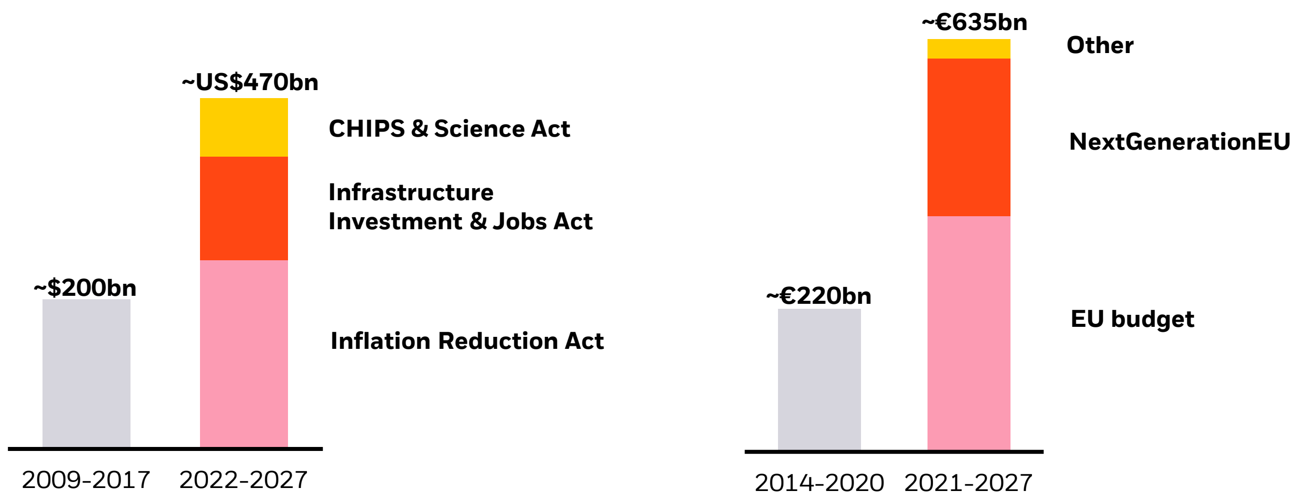
Governments are spending a huge amount of money on the transition to a lower-carbon economy, as the charts below show. Industrial companies are well placed to benefit from this spending. The electrification of cars, trucks, factories, buildings and heating systems, in order to reduce fossil fuel demand, requires the expertise of industrial companies. As electric vehicles (EVs) gain in popularity, industrial companies will be required to build the infrastructure to support this shift. Some may be involved in the planning and construction of new battery plants, as well as providing the latest industrial software to enable “digital twins,” or the virtual representation of production processes used in testing. Industrial companies also provide the renovation and insulation capabilities necessary to reduce building emissions – which are responsible for 40% of Europe’s energy consumption.[4]

Deglobalization and the rise of automation

Supply chain disruption during the pandemic placed an emphasis on the need for supply chain security. Many companies are choosing to build factories closer to home – either “onshoring” or “near-shoring” production. Government spending amid geopolitical tension is also a boost to industries – such as semiconductors – deemed essential to national security, and domestic production is again being prioritized to secure supply. Cheaper labour was one reason production was “offshored” in the first place, so bringing production home can be expensive. And the problem of labour costs is exacerbated in an era of short labour supply and ageing societies. This provides opportunities for industrial companies that specialise in robotics and automation. This is smoothing out the ups and downs of an earnings driver that has historically been highly cyclical – the need for automation rises when factories are being built.

Follow the government money

U.S. pledged climate funding (left) and EU pledged climate funding (right)



Source: BlackRock Investment Institute, Rocky Mountain Institute and European Commission, December 2022. Notes: The charts show pledged funding (coloured bars) versus previous funding (grey bars) by region taken from “Congress’s Climate Triple Whammy: Innovation, Investment, and Industrial Policy”; “Long-term EU budget 2021-2027 and recovery package”; “Fit for 55: Council and Parliament reach provisional deal ...”; “Factsheet on Financing REPowerEU”.

Assessing the semi situation

Semiconductor companies are well placed to benefit from both decarbonization – via the electrification of everything – and deglobalization, as governments seek to boost domestic production. Yet there are many sub-cycles playing out within the industry, so it’s important to select carefully. Demand for semis in PCs and smartphones is still depressed because so many people bought these items during COVID. But autos-related chip makers are still seeing strong demand as the post-COVID catch-up continues and EV demand surges.

To make more advanced chips, the semi makers need the latest tools, and these are provided by only a small number of highly specialized companies. Even if the volume of semi demand flattens out, many of these companies stand to benefit as the desire for smaller, faster chips keeps growing.

The alpha opportunity

To gain alpha – or above-market returns – we seek to invest in companies that we believe can over-benefit from some of the powerful themes mentioned above. These are companies that have invested heavily in research and development, have a leading market share and can learn from their dominance in other areas. Sometimes these quality companies can seem expensive, but we find value among industrial companies in Europe. These may be cheaper than similar companies in the U.S., and yet they are also able to benefit from U.S. government spending on the energy transition and supply chain security. Many European industrial companies built global leadership positions over the past 20 years because there wasn’t much economic growth in their home market, and that puts them in a strong position now.

– Tom Joy, portfolio manager, and Achal Sultania, technology analyst, contributed to this report

[4] European Commission, Oct. 2022

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