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Stock market monitor

Q2 2023 equity market outlook from BlackRock Fundamental Equities

A quest for quality. Amid heightened volatility, we believe careful selection of companies with strong business fundamentals can offer a measure of resilience -- and potential for outperformance of the broad market. Our view heading into Q2:

We see further volatility as higher rates impact economies	Quality companies can support returns – but quality differs across sectors	Regional resilience may be found in Europe and emerging markets

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We expect further market turbulence in 2023 as the impact of higher interest rates filters through to economies, with recent pain seen in the banking sector. At the same time, inflation could stick above major central bank targets of around 2% as wages continue to rise. Central banks may, therefore, keep monetary policy tighter for longer than many market participants expect, even as the fallout from this tightening means they may reduce the rate of change.

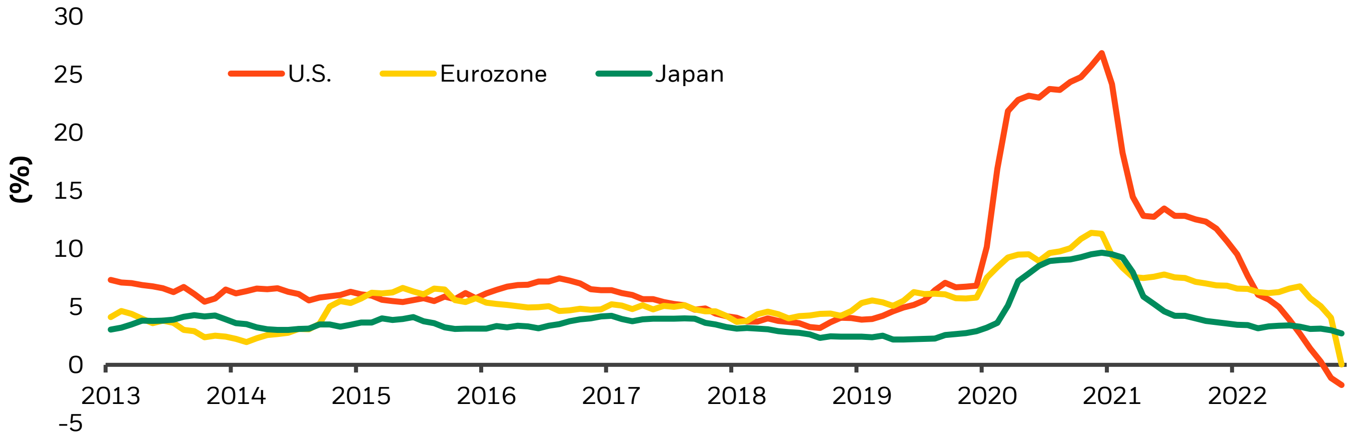
Uncertainty remains, but we do see a clear end of the cheap-money era that followed the Global Financial Crisis (GFC). The chart below shows how money supply (essentially public money in circulation) is shrinking in the U.S. – and tight policy could bring about developed-market recessions in the second half of this year, in our view.

For equity markets, we believe this means fewer returns from "beta" – or overall market gains – and a greater share of performance via "alpha" – or above-market returns. We believe market fluctuations offer potential opportunities for active, long-term investors to pick up quality companies at a discount.

In-depth, stock-by-stock research can unearth quality companies across sectors and regions, in our view. This active approach can add resilience to portfolios during economic tumult and offers the chance for long-term returns once economies reaccelerate.

Follow the money

Money supply growth, 2003-2023



Source: Refinitiv Datastream, BlackRock Investment Institute, March 14, 2023. The chart shows the money supply growth (M2) for each region.

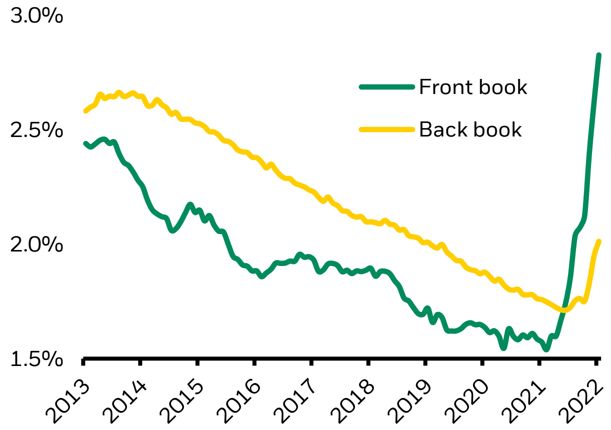
Where we find quality across sectors

How to define "quality"? Traditional definitions focus on high profit margins, stable earnings, low debt levels and return on capital. These are all important metrics. But quality can mean different things across different sectors, in our view, and it can be hard to find at the right price. Here are some examples from sectors chosen based on recent discussions across our global BlackRock Fundamental Equities platform:

Financials

Recent events have put the financial sector in focus. We still see potential opportunities in the sector and, in our view, those recent events reinforce the need for selectivity. The move away from negative interest rates has been transformational for European banks. We believe they are in a strong position to profit from higher rates – interest received on front-book (new) business is far higher than on back-book (old) business (see the chart below) – and high levels of liquid assets mean they are much more resilient than they were during the GFC.

Interest rate revival
Front vs. back book rates at European banks



Source: BNPExane, 11 January 2023. The chart shows the average interest rates European banks charge on front book and back book loans.

Energy

Energy was last year's standout sector, yet we are cautious on near-term returns as a warm winter has reduced physical demand for oil and gas. Over the medium term, we see supply remaining tight and expect some of the European oil majors to generate impressive amounts of cash – while currently trading at a discount to U.S. peers. Quality companies should be able to use their free cash flow to offer attractive dividends and buybacks, pay off debt, buy smaller companies to bolster market position, and allocate substantial investment toward renewable forms of energy.

Healthcare

Healthcare earnings have historically been resilient during recessions as spending on health can be seen as an essential expense. This in itself is a quality characteristic. But not all healthcare is the same, and there can be widespread dispersion of performance within the sector, as the chart on the right shows. In addition to resilient earnings, we look for opportunities for growth tied to expanding healthcare needs such as Alzheimer's, diabetes and obesity. Given the technical nature of the industry, having a deep understanding of the science behind each company is key when looking to invest in this area, in our view.

Consumer

Consumer staples companies have also offered resilience during previous recessions but, again, it's important to be selective. Wage pressures and continued supply chain dislocation are challenges. Quality companies here combine operational execution and supply chain excellence. This means having the right products in the right place when consumers want to buy. On the flip side, companies must be conscious to avoid inventory build-ups as demand wanes.

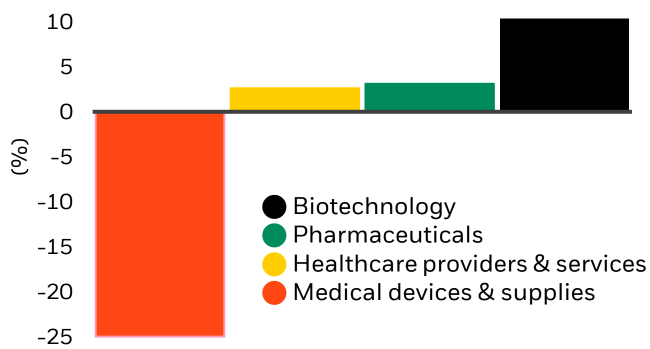
Discretionary companies – such as luxury names – may not offer obvious recession resilience, so it's particularly important to be choosy. We believe companies with a strong brand, constrained supply, a stable footing in the U.S. and Europe as well as exposure to Chinese consumers, are best positioned to pass on higher costs and maintain healthy profit margins.

Technology

Tech companies were the winners of the past decade, and their valuations surged as the COVID-19 crisis accelerated several digital trends. Last year was different and a sharp valuation reset has now opened some attractive entry points across the sector. Quality companies in this area have management teams capable of leading in a new era of artificial intelligence (AI) while also controlling costs now that cheap money isn't readily available to finance growth.

An enormous amount of computing power is needed for the advancement of AI, a realization that has boosted the share prices of semiconductor companies this year. In the more immediate term, semis are essential for cloud infrastructure, electrification of the automobile industry, renewable power, factory automation, the internet of things and 5G penetration. Within this growing industry, we believe the quality companies have unique products, supply chain dominance and a crucial part to play in the need for smaller, more powerful chips.

The ups and downs within healthcare
Global healthcare subsector returns, 2022



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index returns are for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Source: Factset, MSCI, 31 Dec. 2022. The chart shows 2022 returns for subsectors within the MSCI World Healthcare Index.

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Searching for regional resilience

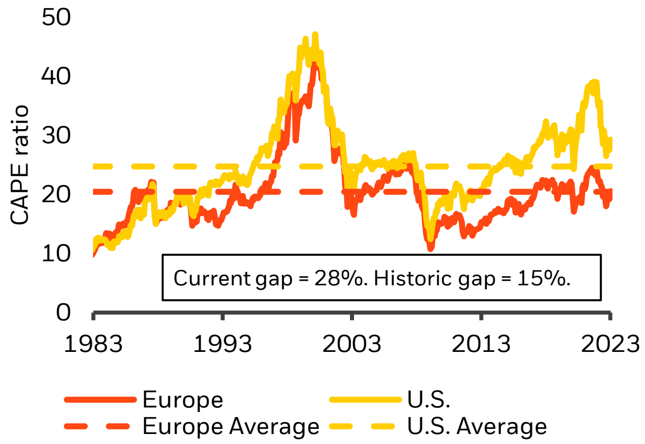
We are not the only investors who seek quality and resilience at times of market and economic uncertainty, and the danger is that companies with the characteristics mentioned above reach valuations that might look historically expensive. One way to look for "discounts" among quality stocks is to search regionally. Are certain stocks cheaper than their fundamentals suggest simply because the region broadly is underpriced for its prospects? We believe this might currently be the case with Europe and emerging markets.

Europe: attractive earnings and valuations

Company earnings in Europe have been better than feared as lower energy prices and renewed demand from China boosted the economy. Even without the energy sector, fourth-quarter earnings for the Euro Stoxx 600 Index increased 13% year-over-year, according to Refinitiv data, whereas S&P 500 earnings fell 7.4%. Yet European equities remain at a discount to U.S. equities, as the chart below shows, so many quality companies in the region – with similar fundamentals to U.S. peers – can be found at attractive valuations for long-term investors, in our view.

Valuation gap

Europe vs. U.S. equity valuations, 1983-2023



Source: Barclays, MSCI, Feb.21, 2023. The chart shows the Cyclically Adjusted Price Earnings (CAPE) ratio for the MSCI U.S. and MSCI Europe Indices, 1983-Jan 31, 2023.

The impact of rising rates

Growth stocks – whose value is tied to the company's future prospect – have struggled as higher rates reduce the value of their future cash flows. Value stocks – which may appear cheap based on fundamentals – have generally held up better as their near-term cash flows were more greatly prized. This market rotation from growth towards value has benefitted Europe versus the U.S. – home to some of the world's largest growth stocks. This trend may continue if inflation stays higher for longer.

Geopolitical fortune

The reopening of China's economy after pandemic-related lockdowns has been a boost to Europe. Chinese consumers – along with their western counterparts – saved money during the pandemic and they may now be ready to spend again on items such as cars and luxury items. Overall, 8% of European company revenues come from China, according to data from BlackRock Systematic Active Equity. Meanwhile, energy prices in Europe have plunged from their highs last summer, benefitting both European companies and consumers. A combination of good luck (a mild winter) and prudent behaviour (industrial companies reducing gas use) mean that gas storage levels in Europe remained above 80% at the end of January.

Risks to the region

Recession fears remain. The BlackRock Investment Institute sees an economic contraction in the second half of 2023 – and if this doesn't happen, the European Central Bank may have to tighten monetary policy further to bring down inflation. On the other hand, if inflation eases faster than expected, the U.S. Federal Reserve may decide to cut interest rates, which could benefit U.S. growth stocks at the expense of European equities. Another reason that capital may head back towards the U.S. is the difference in government green spending. The $369 billion U.S. Inflation Reduction Act is a gamechanger for U.S. climate policy, in our view, and the funds are already flowing. The €600 billion Green Deal in Europe – while impressive in scale – may be hampered by permitting and state aid rules, delaying deployment of capital. The EU is taking action to address these potential delays, but risks falling further behind the U.S

Emerging markets: positive on rates

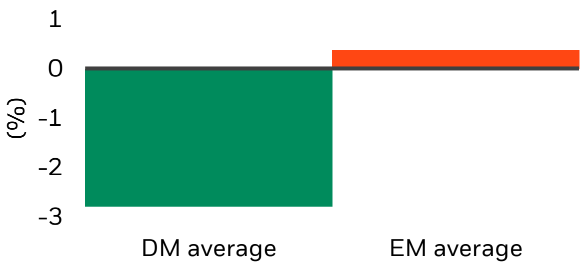
Emerging market (EM) stock valuations remain at a discount versus their 10-year history on a price-to-earnings basis, and EM equities should also continue to benefit from China's reopening, in our view.

Inflation is elevated across EM – but this is nothing new for many of these countries. And in general, EM central banks were earlier than developed market peers to raise interest rates, so inflation-adjusted interest rates are positive for EM on average. See the chart below. This means EM central banks are better positioned to cut interest rates to boost economies. We are favourable on certain Latin American and Eastern European countries for this reason.

Our investment teams use these macroeconomic views to support their company-level conviction when building portfolios. We believe this approach can unearth quality companies at an attractive price in this environment.

A real difference

DM vs. EM real interest rates, January 2023



Source: BlackRock Fundamental Equities and Bloomberg, January 2023. The chart shows the average real (inflation-adjusted) interest rate for DM (developed market) and EM (emerging market) economies.

This is a risky and uncertain market environment – which is why we believe it's important to search stock by stock, and region by region, for quality companies that can offer both resilience and long-term return potential.

Fundamental Equities

Expert insight

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Purpose	Active edge, sustainable outcomes
Perspective	Astute, diverse, panoramic
Performance	Long-term lens, risk-aware results

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