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Stock market monitor

Q2 2022 equity market outlook from BlackRock Fundamental Equities

Where to find resilience in uncertain times. The war in Ukraine is a human tragedy. And it has brought with it great market uncertainty. A steep rise in energy prices has triggered lower growth expectations and rising stagflation concerns. We don't know when or how the war will end. But we can provide insight into the future consequences for companies and what this means for our investment decisions.

We add to quality growth and value stocks with more attractive valuations after the selloff

Present-day cash flows and earnings growth are key to performance in a new market regime

A renewed push for renewables and European energy independence is a key investment theme

Nigel Bolton

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The geopolitical implications of the war will take a toll on global growth as higher fuel and food costs – pushed up by Russian sanctions and supply disruption in Ukraine – hit companies and consumers. Europe's energy bill has risen to nearly 9% of GDP, up from 3% in 2019. See the chart below. Spiralling energy costs add to shaky supply chains. Ukraine may no longer be able to supply key product inputs, such as the neon gas needed to make semiconductors or wire harnessing for cars.

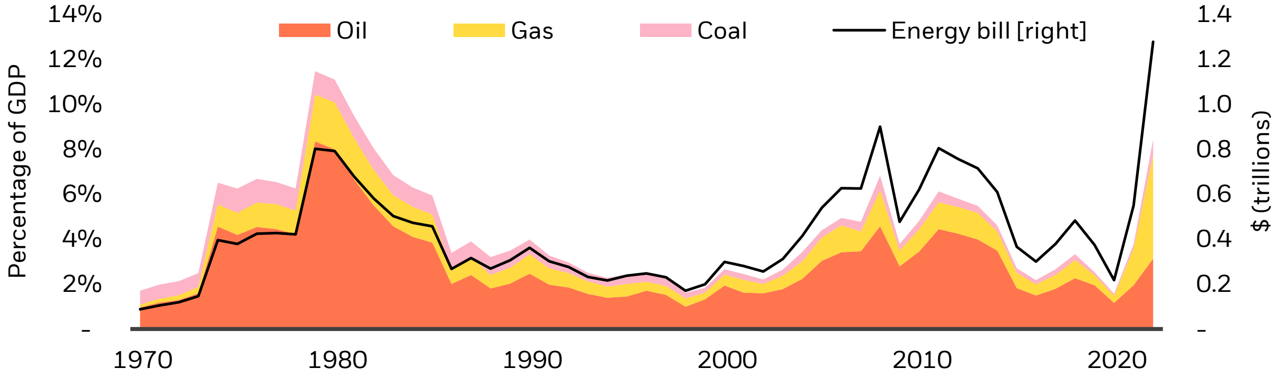
This raises the spectre of stagflation – last witnessed globally in the 1970s, when central banks cranked up rates to combat inflation. We don't see a repeat of that era because – as we said in the first quarter – inflation-adjusted interest rates in our view should remain negative in the long term due to high global debt levels. Yet we see an era of tighter monetary policy, persistent inflation and slower growth.

Portfolio resilience and diversification are vital in this new regime. We seek quality companies across the market – growth stocks that can deliver cash flow and are resilient in an economic slowdown, low-volatility companies that provide attractive dividends that can grow over time, and companies that may benefit from the positive outlook for commodity prices. We also invest in companies set to contribute to long-term policy aims accelerated by war – the transition to a low-carbon economy and European energy and security independence.

> "The reset of the past few months has thrown up some opportunities in high quality companies, but selectivity is vital."

Feeling the heat

The European Union's energy bill as a percentage of GDP



Sources: Bloomberg, BP Statistical Review of World Energy, IEA, World Bank, UN Population Division and BlackRock estimates. Note: The energy prices used are the regional spot commodity prices on March 10, 2022.

Where to focus when resilience is required

Markets sold off quickly in response to the war in Ukraine. Valuations outside the U.S. are below 10-year averages. See the chart below. Indiscriminate selling means that many companies with strong underlying fundamentals are available at attractive prices and across sectors. The common characteristics of these companies will be their ability to deliver and beat expectations on margins, earnings and cash flow in a more volatile macro environment.

A quest for quality

Quality companies are highly profitable, have strong market share and consistently grow their earnings and cash flow. We buy these companies and hold them for the long term – and seek to add to our positions in times of market volatility. These companies have the ability to absorb higher costs – or the brand and market strength to pass those costs on; they can use their clout to purchase key components during times of supply chain stress; they serve growing markets, and they remain resilient throughout economic downturns. Dominant software companies, online advertising giants and powerful payment companies make it onto this list. We also like semiconductor companies that can command a high price for their product amid a global shortage.

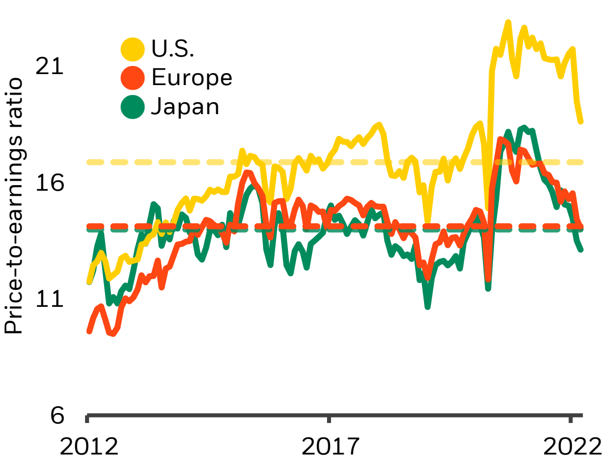
Quality companies have strong future growth prospects but also generate profits and cash flow now. With an economic slowdown looming and interest rates rising, we would avoid those long duration companies whose value rests solely on future growth.

Investing for income

Stocks that provide growing dividend income are appealing during a period in which we expect inflation-adjusted interest rates to remain negative. These companies have historically been less volatile than the overall market, which makes them attractive during times of turbulence. Stable income generators can be found across sectors. Within healthcare, we like those companies with strong balance sheets, smart capital allocation and a healthy pipeline of future treatments. We prefer insurance companies among financial stocks, and established consumer finance companies that have embraced digitalisation to reduce costs. Consumer staples companies should also fare well in a downturn – as spending on basic necessities should remain – but we have to closely watch their resilience to rising food costs. Ukraine and Russia export 30% of the world's wheat, according to Gro Intelligence.

A rapid de-rating

Regional equity valuations, 2012-March 2022



Source: Refinitiv Datastream. Note: Data as of March 1, 2022. The dotted lines show the 10-year average P/E ratio for each region. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.**

Profit heavy, asset light

Some of the quality companies we like are considered "asset light" – they own few plants or factories and little equipment. Asset-heavy commodity companies have historically done well amid inflation. In the shorter term, we expect this to remain true – they can charge more for their materials. But in the longer term, they may have to reinvest in new plants and their costs will be greater due to inflation. So we look for companies that have high margins but also low input costs.

This applies to the software and online advertising companies already mentioned. But asset-light companies can be found in less obvious areas. One example might be online real-estate listing companies that charge physical estate-agent branches for use. Inflation might even benefit these companies – if house prices go up, so do their fees.

Hotel franchise companies may also benefit from inflation. They charge a set percentage of sales for hotel owners to use their name. If the hotel owner charges 10% more for rooms to offset the higher cost of building hotels, this means the hotel-franchise company also earns 10% more. Wages are the main costs for asset-light companies, so we watch wage inflation closely.

Financing the transition

The European Union (EU) now plans to be independent from Russian fossil fuels well before 2030. This might be achieved in three main ways:

On the gas. It will be hard for Europe to find gas from outside Russia due to global shortages, but there are some U.S. companies that can help. We like companies with gas distribution networks and long-term contracts that generate a lot of cash and can grow as part of the energy transition. We also like companies that can help supply gas while providing carbon capture and blue hydrogen services.

Energy efficiency. The EU aims for greenhouse gas emissions to be 55% lower than1990 levels by 2030, and to reach net-zero emissions by 2050. The war in Ukraine has injected greater urgency into this policy. Buildings account for 40% of Europe's energy consumption, so we look for companies that can reduce the energy bill – insulation and window companies, heat pump manufacturers and waste management companies, to name a few.

Renewed push for renewables. The EU hopes to triple solar and wind energy by 2030, saving 170 billion cubic meters of gas use. Direct providers of wind and solar energy are clear beneficiaries. But the supply of raw materials and mining of industrial metals is also essential to this process – and to electrification in general. See the following page where we show how resource intensive renewable energy can be, with a spotlight on the need for copper.

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Spotlight topic: Copper and decarbonization

Renewable energy and electrification rely on a mass of raw materials. The image below shows the commodities needed to replace the output of a gas turbine with wind power. One of the industrial metals integral to the process is copper – and we see long-term demand remaining robust.

Electric demand

Copper is essential for renewable energy and decarbonization. It is conductive, malleable and cheap when compared with other conductive metals such as silver. Two-thirds of global copper demand is related to electrification, according to our analysis. Copper is used in wind turbines, solar panels, heat pumps, building automation systems, electric vehicles and car-charging infrastructure. The average electric car has around 80 kilograms of copper, compared to 20 kilograms in the average internal combustion engine vehicle.

The shift to renewable energy may now accelerate as Europe seeks to diversify its energy supply. Copper is a key enabler of this transition. We see higher prices as the growth in "green" copper demand offsets potential declines in the Chinese property sector over time. Copper is also key as global government infrastructure spending ramps up after the COVID-19 crisis.

In short supply

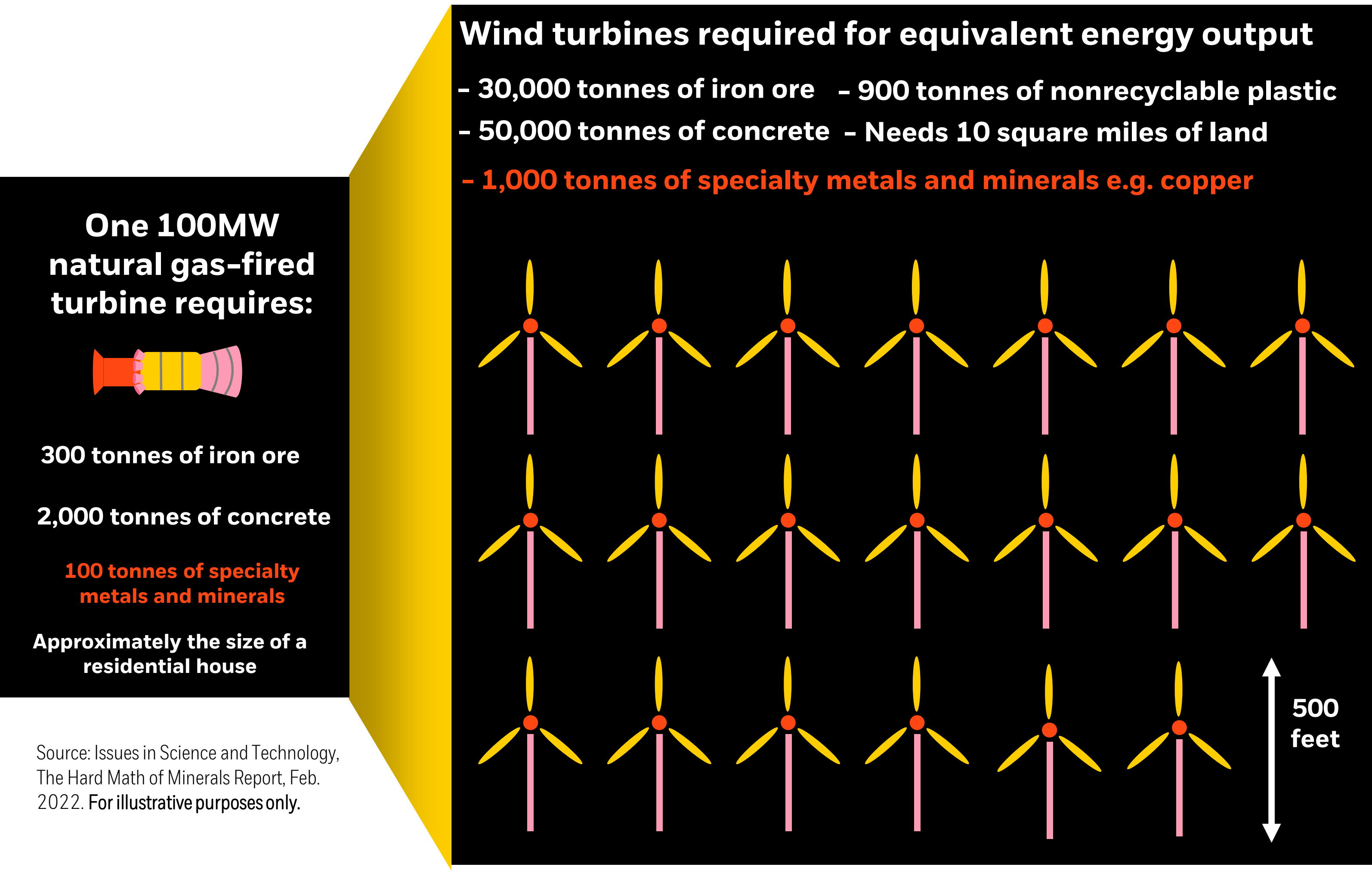
Another reason we see higher prices: tight supply. Russia provides just 3.5% of global copper. Yet the disruption to this source adds to an already constrained environment. Many existing copper mining assets are old, copper grades are declining, costs are increasing and miners are having to seek new assets in more challenging locations such as the Democratic Republic of Congo.

This shift to riskier locales comes as the world's major copper source, Chile, has made it more challenging for companies to set up new mines. Environmental, social and governance (ESG) requirements typically require a new mine to have a sustainable water and power sources. Water is a key component in copper production, and Chile has a water shortage. Last year was one of the strongest on record for the copper industry – but globally no new copper projects were approved.

Investment takeaways

Copper mining companies are key to the net-zero transition and often available at cheaper prices than the "pure play" renewable energy companies that depend on raw materials for growth. We closely monitor ESG issues at mining companies and engage with management teams to help them build sustainable businesses. We aim to invest in green copper assets – copper produced using renewable power sources.

Copper is completely recyclable – approximately 8.5 million tonnes of copper supply per year comes from the recycling of "scrap" copper – so we look for opportunities in metals recycling companies. This method of producing copper is less carbon intensive and involves no new digging, and it's an area we expect to grow as the economic basis for production improves.



Source: Issues in Science and Technology, The Hard Math of Minerals Report, Feb. 2022. For illustrative purposes only.

Olivia Markham, portfolio manager, contributed to this report

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