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Stock market monitor

Q3 2022 equity market outlook from BlackRock Fundamental Equities

Seeking opportunity amid volatility. Global central banks are battling with inflation, and one consequence of their policies is slowing economic growth. How should investors wrestle with the prospect of recession? We outline the areas of the stock market where we believe caution is warranted – and highlight where we see long-term opportunities. Our outlook:

We are cautious on technology and consumer stocks amid the shift to a new economic regime	**We see opportunities in financials as rates rise, and industrials as long-term capex spending booms**	**Supply chain security concerns are leading to long-term investment opportunities**

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The COVID-19 pandemic ground much of the global economy to a halt. Central banks lowered interest rates and bought greater amounts of government bonds – printing money – allowing governments to support households and businesses. This stoked demand at a time when supply chains were disrupted, creating inflation. Much of this money ended up in the equity markets, boosting valuations.

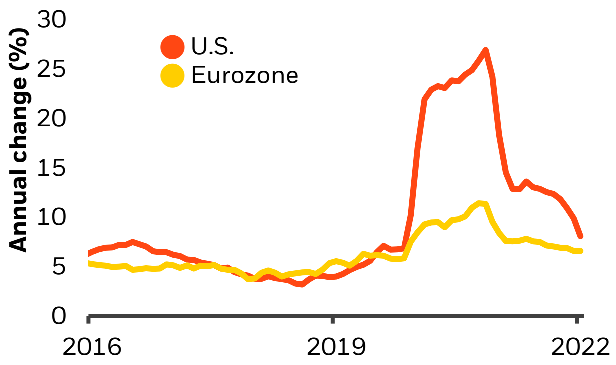
To tame inflation, central banks are draining this excess money supply by raising interest rates and reducing their purchases of government bonds. This "quantitative tightening" may have only just begun, so we see elevated asset price volatility for the rest of the year. European stock valuations have already fallen below historical averages. But in the U.S. – where money supply increased 43% between 2019 and 2021 – stocks still appear expensive on a historical basis. See the charts below.

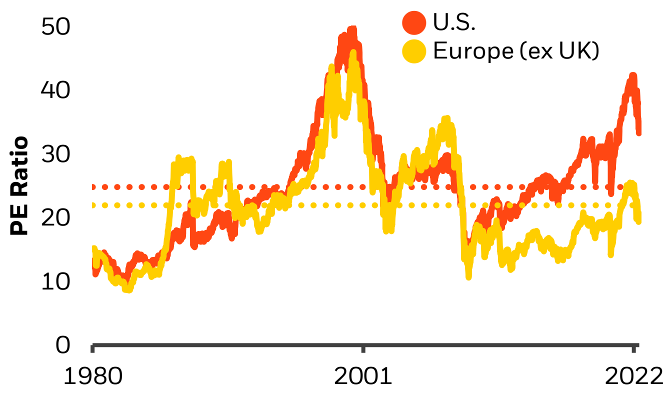
Rising rates dent consumer demand and corporate activity by increasing the cost of borrowing. Despite the prospect of recession, many analysts continue to forecast record earnings levels until 2024. This raises the risk of earnings downgrades. We seek companies with resilient business models, present-day cash flows and growing dividends. These companies can be found across the market, in our view. Yet there are some sectors that are more vulnerable in this changing economic environment, and others where we see a greater prospect of earnings strength.

> "Risk of recession means investors must seek companies with resilient business models, present-day cash flows and growing dividends."

As money supply growth slows, stock market valuations at risk

Money supply growth in the U.S. and eurozone, and U.S. and Europe stock market valuations





Sources: BlackRock, Refinitiv DataStream, June 2022. The left chart shows the annual change in the M2 money supply , a measure of money in the economy, for the U.S. and eurozone. The right chart shows the cyclically-adjusted price-to-earnings (PE) ratios for stocks in the MSCI USA Index and the MSCI Europe ex UK Index. PE ratios are a way of valuing companies by dividing the stock price by earnings per share. The dotted lines are averages. The higher the PE ratio,the higher the perceived value of the stock.

A sector assessment

A period of rising interest rates and higher inflation reverses the trend of the past four decades. The result could be that some of the big sector winners since the great financial crisis might not be market leaders in the new regime.

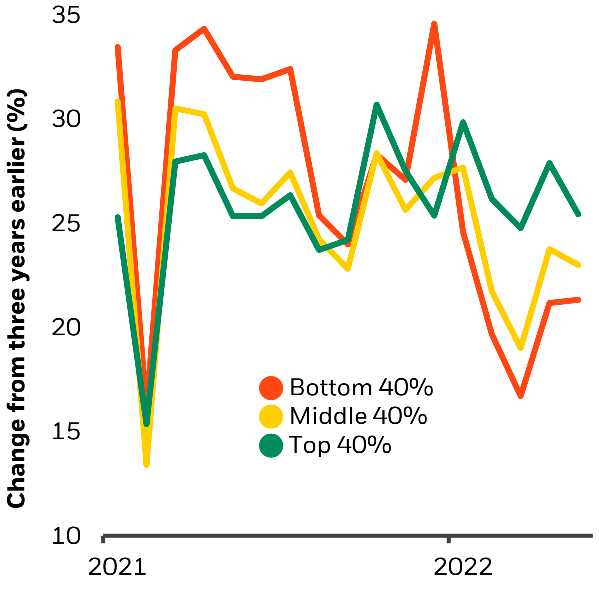
Areas of caution

Technology: The valuations of many tech companies that don't make a profit have plummeted this year. Higher rates make it harder to borrow or raise money to support loss-making operations, and there is now a sharper focus on cash generation. This could drag down the broader sector. Companies such as Uber, Robinhood and Coinbase have all announced cost-cutting measures over the past few weeks, and this might in turn reduce the amount being spent on other areas of tech such as digital marketing[1]. Streaming businesses have started to show weakness as consumers worry about their cost of living, and e-commerce growth is now slower than it was before the pandemic[2]. Even some of the more resilient areas in tech this year – such as enterprise software companies – are showing signs of vulnerability as some of their smaller customers limit their spending.

Consumer: The war in Ukraine and sanctions on Russia have disrupted the supply of oil and gas, as well as the trade in key crops. Rising interest rates – and central bank guidance that they may increase further – have pushed up mortgage payments. Consumer spending is slowing across income levels as the costs of food, energy and housing soar. See the chart below. McDonald's said in April that customers are "trading down" as they feel the pain of higher prices. Consumer goods companies may struggle as spending wanes or is redirected to services like travel. Companies in the U.S. such as Walmart, Costco and Target have all reported an excess of stock because of the shift in consumer spending as well as over-ordering during the supply chain crunch.

Spending subsiding

Change in U.S. consumer credit card spending



Sources: BlackRock, June 2022. The chart shows the growth in U.S. consumer credit card spending, versus three years earlier, divided into the bottom 40% of earners, the middle 40% and the top 20%.

[1] Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and should not be construed as investment advice or investment recommendation of those companies.

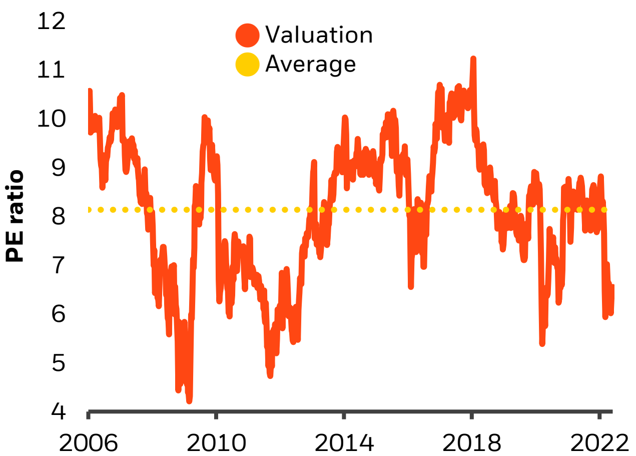
[2] Adobe Digital Price Index, April 2022

Areas of opportunity

Financials: Higher interest rates benefit banks because they can increase their net interest income (NII) – the difference between revenue from loans and the interest they pay on deposits. This means profit margins at "rate-sensitive" banks – where NII grows more as rates rise – may expand even if growth slows, and they could be able to buy back shares. COVID accelerated the shift to digital banking, allowing some banks to close branches and cut costs. And even as central banks forecast higher rates, banking sector valuations remain low on a historical basis. The chart below shows how European banks are now trading at valuations near those during the 2008 financial crisis. One reason is that a recession would be bad for banks – they would have to set aside more money to cover loan losses. But we believe the higher net interest income would more than make up for this, depending on the severity of any recession.

Bank valuations down in the vault

European bank valuations, 2005-2022



Sources: BlackRock, Refinitiv DataStream, June 2022. The chart shows the price-to-earnings ratio of the STOXX Europe 600 Banks Index. It is not possible to directly invest in an index.

Energy: There is a renewed emphasis on energy security and energy prices, especially in Europe, which relies on Russia for roughly 40% of its natural gas. We seek to invest in companies that provide innovative solutions to the energy crisis, such as the production of hydrogen that can replace fossil fuels in industrial manufacturing; in the makers of semiconductor manufacturing equipment essential to the shift to electric vehicles; in the insulation and heat-pump manufacturers than can improve the energy efficiency of buildings, and in those companies that are innovating to recycle carbon-intensive materials such as cement.

Industrials: Long-term infrastructure spending linked to the European Union's €1 trillion "green deal" and the $1 trillion infrastructure package in the U.S. means that many industrial companies have full order books. We believe that a period of weakness may provide an opportunity to pick up these long-term investments at an attractive price. Another driver of capital expenditure is the desire to protect future supply chains after the disruption caused by the pandemic and geopolitical friction. See the spotlight topic on the next page.

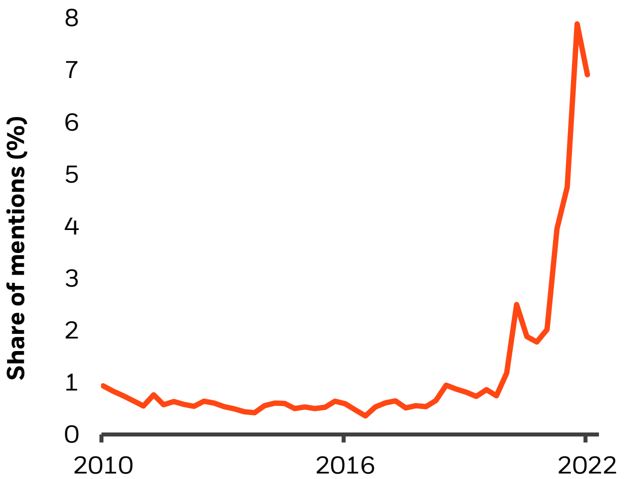
Spotlight topic: Onshoring and automation

The world has now had three clear reminders of supply chain fragility: first the U.S.-China trade wars of 2018, then the pandemic and most recently the war in Ukraine. As a result, there is increased interest among companies in "onshoring," where production is brought back to the country where goods are primarily sold, or "nearshoring," where production is brought closer to the prime market – perhaps Mexico for the U.S., or Eastern Europe for the European west. See the chart below.

This trend is in early stages, and there is a realisation that it will require significant investment in new factories and local workforces. As labour costs rise - and are a stickier element of inflation - automation becomes a larger draw across businesses.

Onshoring surge

Onshoring related mentions in earnings calls



Source: Goldman Sachs, May 2022. The chart shows the share of sentences mentioning the words onshoring, reshoring, nearshoring and backshoring in Russell 3000 Index earnings calls.

Semi sovereignty

The U.S. and China each buy about 25% of the semiconductors – essential for electronics – made globally each year. Yet only 13% of those chips are made in the U.S. and 16% in China[3]. Nearly half of all chips are made in Taiwan and South Korea. Countries in the West are now subsidising Asian semiconductor makers to build enormous factories on their turf, in the hope of securing future supply and achieving "semiconductor sovereignty." And in the U.S., the CHIPS for America Act passed last year aims to funnel billions of dollars to domestic chip production. We expect semiconductor equipment makers – providing the machines for the factories – to be beneficiaries of this long-run trend.

Rise of the robots

Labour costs are often higher in the West – and there is also a shortage of workers. In the U.S. in April, there were 11.4 million job vacancies, with the largest and growing share in manufacturing[4]. This has led to greater investment in robotics and automation. In 2021, 486,700 industrial robots were installed globally, 27% more than the year before[5]. Robotics companies say they are seeing rising interest, especially among consumer industrial companies such as appliance makers and auto manufacturers.

[3] Semiconductor Industry Association, April 2021
[4] U.S. Bureau of Labor Statistics, June 2022
[5] International Federation of Robotics, June 2022

Building the brains

Automation software is needed to tell most robots what to do. Production processes often contain inefficiencies. If a few seconds can be shaved off a task a robot performs millions of times, such as fetching a box from a shelf, then the gains can be impressive. Software and big data are also used to improve supply chain efficiency and visibility, joining all parts of the chain together so that a change in one area is reflected across all others. Investment here aims to address the problems highlighted by COVID when many companies realised they didn't have total control over their supply chains.

Counting the cost

Robots might lead to cost savings in the long run – but they are expensive to buy and install. This lends an advantage to large, cash-generative companies who can invest heavily and realise the benefits in the future. This skew is also a risk to some of the robotics companies that may rely on just a handful of customers for most of their revenue. Yet the playing field is slowly levelling. Cheaper "collaborative" robots, easily programmable by manually moving them once – removing the need for coding expertise – are being designed to work alongside humans on the factory floor. Some robotics companies are selling older, proven technology at a lower cost. And robot leasing programs are becoming popular.

Side by side

These trends may open up jobs requiring new skills as robots take on dangerous or less desirable tasks – such as mine drilling and sewer inspection (see the picture below) – and in new locations. We see the implications of onshoring and automation as far-reaching and see long-term investment opportunities across sectors and sub-sectors, from software to semiconductor equipment.

Source: Minicam Ltd, 2022. Image shows robots designed to inspect and maintain sewers.

Peter Hopkins, portfolio manager, and Achal Sultania and David Vos, sector analysts, contributed to this report.

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