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BlackRock

# Stock market monitor

Q1 2024 equity market outlook from BlackRock Fundamental Equities

**Four themes for 2024.** We expect equity market momentum to continue in 2024, but a new backdrop of higher rates and volatility than much of the past 15 years could mean more differentiation in company results — and greater opportunity for stock selection to impact portfolio returns. As we enter 2024 we see**:**

| **Lower inflation boosting consumers and benefitting equities** | **Public spending and technological innovation driving company earnings** | **A focus on quality and valuations providing portfolio resilience amid higher rates** |
|---|---|---|

**Helen Jewell**

Chief Investment Officer, BlackRock Fundamental Equities, EMEA

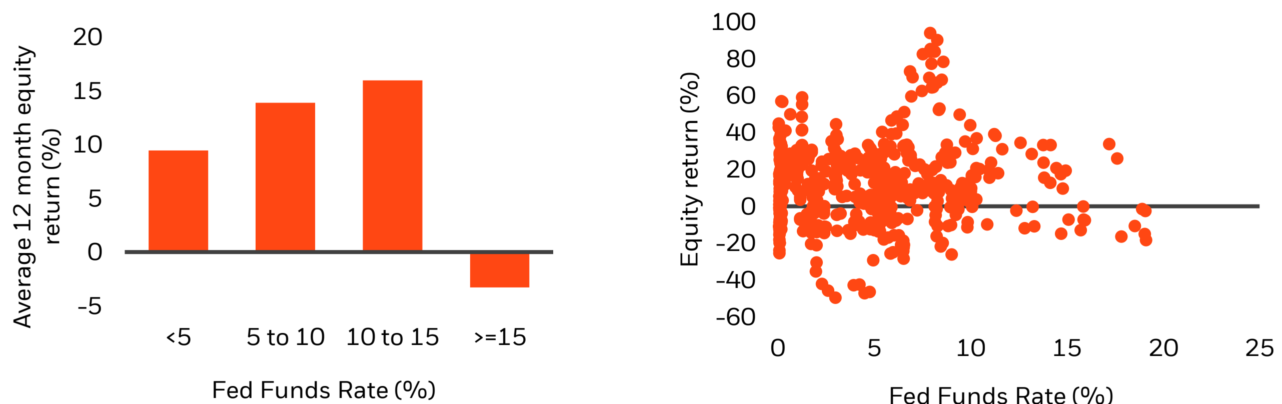
> “The medium-term for markets is bright, in our view, although selectivity will remain key as companies adjust to a new regime of higher rates.

Equities delivered strong returns in 2023, ultimately overriding concerns of stubborn inflation, higher interest rates and slowing economic growth. Global stocks were up nearly 20% at the time of writing.[1]

Can this momentum continue into 2024 – and can equities outperform the returns now available in lower-risk assets? We believe the answer to both of these questions is “yes.” Analysts forecast that corporate earnings globally will grow around 9% in 2024 and, historically, valuations have been closely correlated with stock returns. In Europe, the estimate is lower, at around 6%, but European stocks also offer a dividend yield of 4%.[2] And the macroeconomic picture has improved. Inflation has fallen globally, meaning many consumers are now seeing their inflation-adjusted wages grow.

For equities, the pace of interest-rate change is more important than the absolute level. The chart below shows how equities have historically performed better when rates are similar to current levels than when they were lower. Yet we do believe that these higher rates will pose a challenge to some companies, adding to earnings dispersion and a greater gap between equity market leaders and laggards. This is an environment ripe for stock picking, in our view, and in this report we explore **four areas of focus** as we target above-market returns.

**Equities markets haven’t felt the heat of higher rates**
Global equity returns during different interest rate environments (1975-2022)




**The figures shown relate to past performance. Past performance is not a reliable indicator of current or future result. 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: Data from Ken French and Federal Reserve Economic Data, November 2023. Note: the left chart shows the average next-12-month global equity returns during different interest rate environments, 1975-2022. The right chart shows the return for each year and the corresponding interest rate for that year. Global equities are represented by MSCI World and returns are shown in value weighted dollar terms. [1] MSCI World, +19.5% year-to-date as of Dec. 11, 2023. Source: MSCI. [2] IBES, MSCI, Datastream, Dec. 04

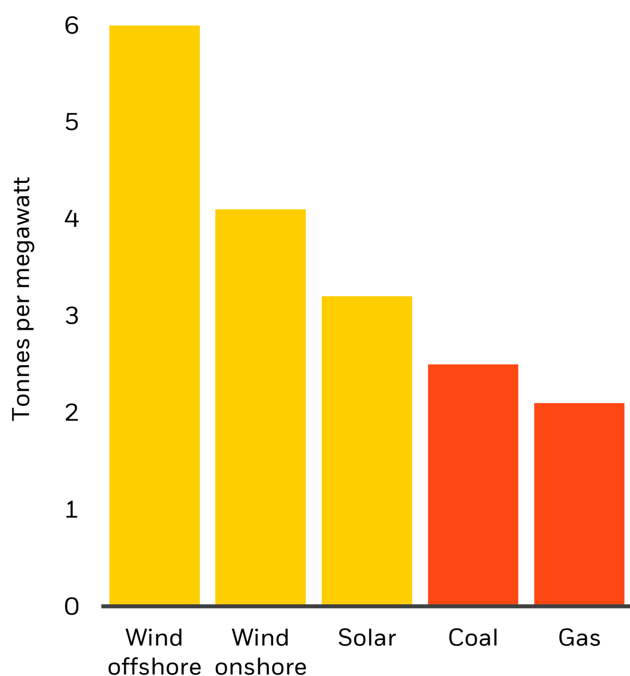
# A time for selectivity: four areas of focus for 2024

## Mind the government money

Government spending has helped offset the affects of tighter monetary policy in terms of net economic impact. Global public debt is nearly 10% higher than before the pandemic.[3] This money is being channeled into multi-decade projects such as decarbonization and supply-chain security. We believe this spending can help provide earnings resilience to a range of companies across sectors, even during economic slumps. There are already signs of dispersion within industrials, between those companies that provide energy transition solutions such as power grid and data center infrastructure, and those more closely tied to current economic output – as we mentioned in our Q3 earnings review. Certain semiconductor companies – essential to electrification – are available at attractive valuations due to cyclical demand concerns, as we discuss below. We also see opportunities among those materials companies that are providing metals essential to electrification and decarbonization, such as copper, steel and lithium. The chart below shows how much more copper is required for renewable energy than for fossil fuel power.

This spending comes with risks attached: If governments keep the money flowing, then inflationary pressures could resurface – resulting in a potentially bumpy ride for equities.

**Counting on copper**
Copper required per unit of power capacity




Source: BHP analysis, August 2023.

## Rapid change and innovation

Strong equity market returns in 2023 were in part powered by the rise of artificial intelligence (AI). We believe a new era in computing can power corporate earnings for years to come – but there may also be companies whose business models will be disrupted.

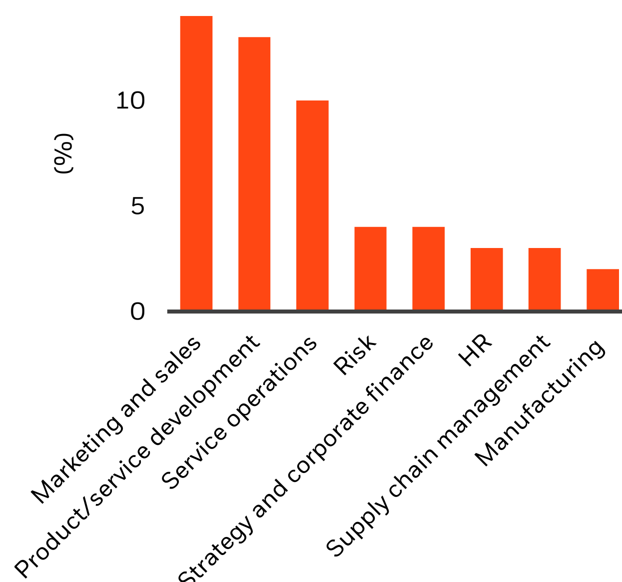
Many of the large U.S. tech companies have invested heavily in AI and remain well placed to benefit. We also seek to unearth some of the more underappreciated winners that come with lower valuations. These may be semiconductor companies that provide the much-needed memory that AI requires, or companies that can use AI to unlock the value of proprietary data. Companies across sectors with competent management teams should be able to boost margins with investment in AI – and the chart below shows how far AI adoption has to go.

On the flip side, we do a lot of research on those areas where AI may disrupt business models, from call centers to graphic design to media and education companies.

Another innovation that impacted market leadership in 2023 is the adaptation of diabetes drugs to treat obesity. There are also plenty of subtleties when assessing the impact of the GLP-1 drugs used for weight loss. The market opportunity for these drugs in the treatment of both obesity and diabetes could potentially reach U.S.$90 billion.[4] The companies with proven products on the market have seen share prices surge. Yet competition is set to intensify, so the leaders have to keep investing in new treatments to stay ahead. We see these drugs benefitting those companies that can provide a full lineup of treatments for cardiovascular disease, while those without this ability may struggle to differentiate their offering.

There has been some spillover to consumer staples companies as investors speculate that weight-loss treatments could lead to lower demand for snack foods. But we believe it's too early to make this link – the difference in calories consumed among global populations over the medium term is likely to be minimal, especially as pharmaceutical companies say GLP-1 production levels may initially increase slowly.

**The early stages of AI**
Share of survey respondents who say their organization is regularly using generative AI




Source: McKinsey, April 2023.

[3] IMF, Sept. 2023
[4] IQVIA New Demand in an Old Market; September 2023



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## Quality and capital return

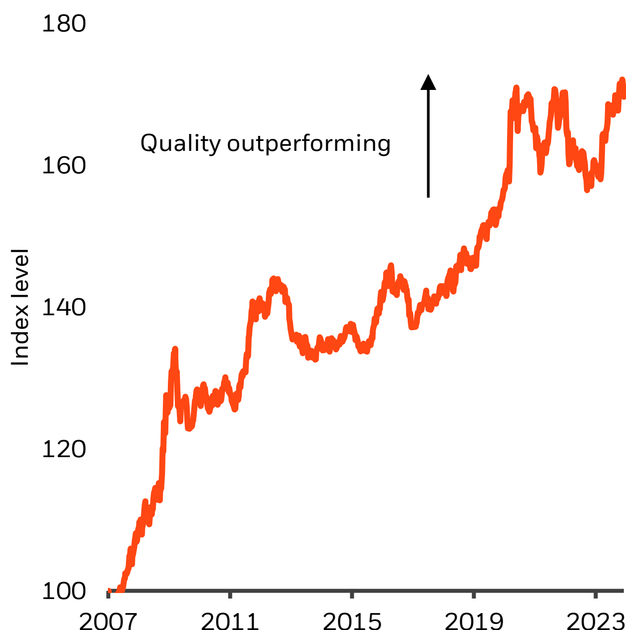
Many of the companies set to benefit from the trends above have "quality" in common – a characteristic we believe is important in the new era of higher interest rates. Quality companies, by our definition, have the resilience to ride out periods of economic turbulence and the ability to grow in an environment of lower economic growth. We find that companies that invested during the pandemic – in digital offerings and differentiated products, for example – are now able to manufacture their own growth. Quality companies may also have low leverage, generate strong free cash flow and be in a position to return cash to shareholders through dividends and buybacks – another form of resilience for portfolios. On the other hand, companies without differentiated product offerings that also have lots of debt may be doubly impacted by falling demand and higher interest rates.

Quality companies can be found across sectors, including sectors not historically associated with quality. Europe has several leading industrial companies that have aligned themselves with the global energy transition, lending them a quality edge. And some of the European banks – which benefit from higher rates – say they plan to buy back billions of euros worth of shares over the next few years.

A quality bias is popular among equity investors during periods of economic uncertainty. The chart below shows how quality companies have been outperforming the overall market in recent quarters, leading to lofty valuations. So we focus on areas where quality companies may also be available without the premium price tag.

**Quality popularity**

Global quality vs. global equities, 2007-2023




**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.** Source: LSEF Datastream, MSCI and BlackRock Investment Institute, Dec. 08, 2023. The line shows the MSCI World Quality Index relative to the MSCI World Index. An increase to the index level means quality is outperforming the broader market. The index is rebased to 100.

[5] Peel Hunt, October 2023

## Valuations – not necessarily "value"

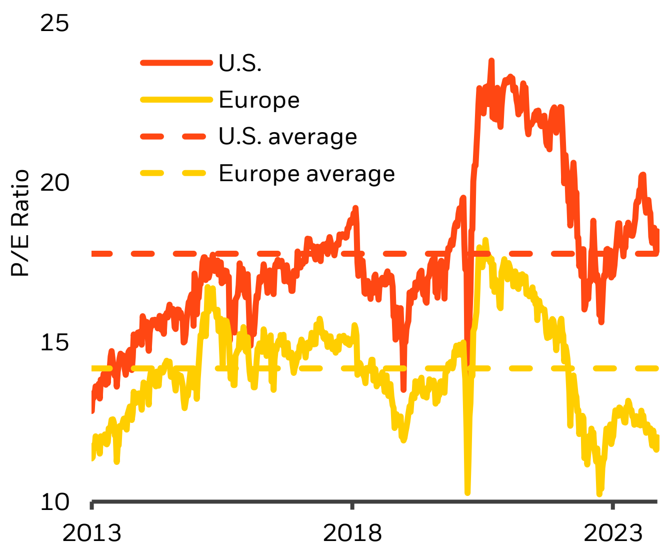
We believe it's possible to find companies that fit into the three buckets above at attractive valuations. This doesn't necessarily lead us to "value" companies – companies that are cheaper than their fundamentals suggest they should be, often associated with sectors such as energy and financials – although we see opportunities here too, as mentioned above.

Why might some quality companies be "cheap"? One reason could be that their valuations reflect fears of a cyclical economic downturn. We believe this is true for certain semiconductor companies which, as we have said, play a vital role in both the rise of AI and the energy transition. We also now see appealing valuations across renewable energy supply chains. Decarbonization and energy security remain powerful earnings drivers here, in our view, and many of the well-publicized problems in the area have been confined to offshore wind, a relatively small part of the renewable energy market.

Quality companies may also be cheap because they sit in categories or regions that are currently out of favour with investors. For example, mid-sized companies in the UK are nearly as cheap now as they were during the global financial crisis, and if money begins to flow back into the area then quality companies should again be rewarded for their earnings.[5] The valuation gap between Europe and the U.S. remains wider than the historical average. See the chart below. The result of this is that we see companies in Europe – for example within the healthcare or energy sectors – that have similar or better fundamentals than more expensive U.S. peers.

**Mind the valuations gap**

U.S. and Europe equity market valuations, 2013-2023




Source: LSEF Datastream, MSCI and BlackRock Investment Institute, Nov. 16, 2023. The chart shows each market's current 12-month forward price-to-earnings (PE) ratio. The PE ratios are calculated using I/B/E/S earnings estimates for the next 12 months. MSCI indices are used for each region.

As we mentioned at the start of this report, earnings expectations for 2024 are in positive territory. Our view is that these expectations may come down as higher rates continue to impact economies. But they won't fall uniformly across equity markets, in our view, presenting stock pickers with ample opportunity to separate the best from the rest, with a focus on long-term earnings drivers, earnings resilience and valuation protection.

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