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BlackRock

Stock market monitor

Q3 2023 equity market outlook from BlackRock Fundamental Equities

An exciting time for stock pickers. Company earnings have been remarkably resilient in the first half of 2023, but macroeconomic turbulence is widening the gap between the winners and the losers – and creating attractive valuation opportunities for investors. Highlights of our Q3 outlook include:

Investors can capitalize on stock dispersion as economies slow	**We seek a mix of quality, defensive stocks and underpriced cyclicals**	**The healthcare sector offers both resilience and growth opportunities**

Helen Jewell

Deputy Chief Investment Officer, BlackRock Fundamental Equities, EMEA

"We believe an uncertain economic environment requires even greater focus on company fundamentals – and provides an opportunity for stock picking to make a difference in investor outcomes."

The first half of the year has been positive for European equities. This has come against a backdrop of persistent inflation, rising interest rates and recession fears, demonstrating the importance – in our view – of staying invested in equities, rather than trying to time the market.

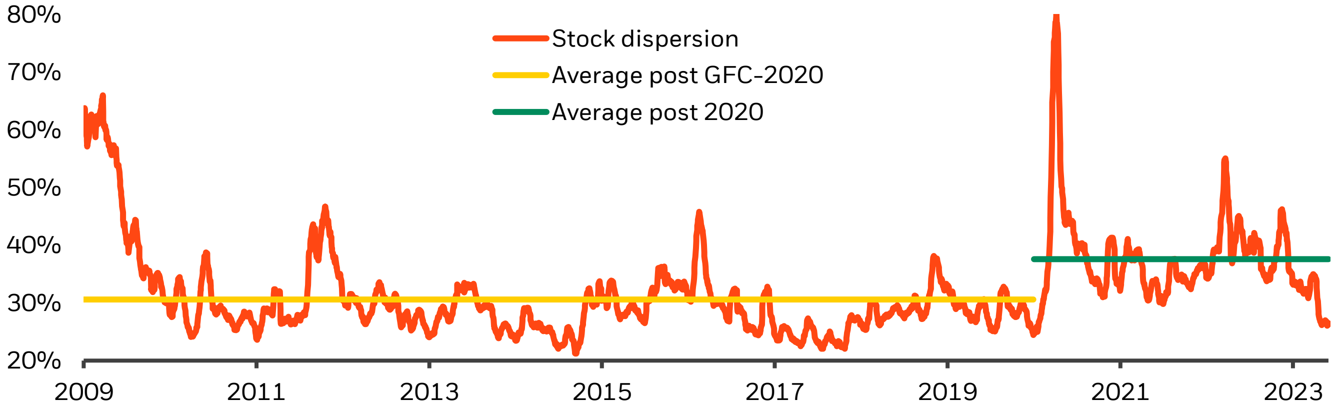
Our view for the second half of 2023 is for flatter returns as the impact of higher interest rates filters through to economies. Recessions may result from these rapid rate rises, and official data shows that Germany indeed entered a mild recession in the first quarter.

However, we see two reasons why stock market investors should remain positive. First, even if economies shrink, we believe recessions may be shallower than we saw after the Great Financial Crisis, with nominal growth – which does not adjust for inflation – above zero. We believe this can be a supportive environment for equities.

Second, we expect slowing growth and sticky inflation to bring about greater dispersion between companies. The chart below shows how the gap between winners and losers has been wider among global stocks since the post Global Financial Crisis (GFC) era of rock-bottom rates ended, and we recently wrote about how this played out in Europe's Q1 earnings season. This presents opportunities for active managers to generate attractive investment returns, in our view – even if the market overall remains flat.

Gap between winners and losers has grown

Stock return dispersion, 2009-2023



Source: BlackRock Fundamental Equities, with data from Refinitiv, March 2023. Chart shows the dispersion among stocks in the MSCI ACWI Index displayed as a 21-day moving average from January 2009 to May 2023. **Past performance is not indicative of future results. It is not possible to invest directly in an index.**

An active playbook for an uncertain economy

The investor's recession dilemma

These are challenging markets for investors to navigate. Core inflation (excluding food and energy) in Europe and the UK remains well above central bank targets. Interest rates may, therefore, have to remain at current levels – or higher – to bring inflation down, and as credit conditions tighten, economies could dip into recession. Across European and U.S. bond markets, short-term yields are higher than long-term yields, and this has historically been a signal that recessions are on the way.

On the positive side, we are not seeing much weakness among consumers or companies. In Europe, unemployment is low, wage growth is accelerating, and excess savings remain higher than pre-pandemic levels. Many luxury companies continue to report stellar growth, some of Europe's industrial "bellwethers" are expanding revenues and future orders at rates well above their past average, and many European banks are strong enough to return large amounts of cash to shareholders. Earnings forecasts are recovering globally and improving in Europe. See the chart below.

Earnings on the up

Equity earnings revisions, 2021-June 2023

Source: Refinitiv DataStream, MSCI. The chart shows weighted 3-month percent change in the 12-month forward earnings-per-share forecasts. Based on the MSCI index for each country/region.

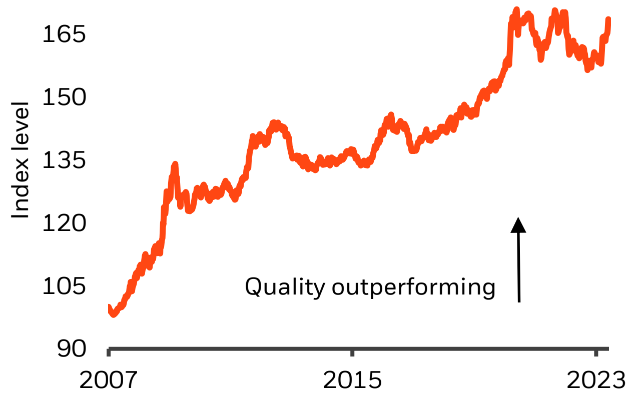
We believe it's sensible to position cautiously in portfolios, with a mix of quality, defensive stocks that can provide consistent earnings during economic turbulence, and cyclical stocks where valuations may be reflecting a deep, disinflationary recession of the type we saw after the GFC – rather than the shallow recessions we believe are more likely – where nominal growth may be positive.

Deciding among defensives

Defensive stocks have cash flows that we do not expect to fall much in an economic downturn – and have demonstrated this during past recessions. They have many "quality" characteristics such as stable year-over-year earnings growth, and the chart above right shows how quality stocks have outperformed during past recessions – such as the one in 2008-2009 – and again recently as recession fears rise. These stocks can become expensive, in our view, as investors crowd into the area. High valuations may be warranted, but companies must meet lofty earnings expectations. During the most recent earnings season in Europe, companies that missed expectations fell nearly 3% on average on the day.

Quality's history of resilience

Quality factor vs. global stocks, 2007-2023



Source: Refinitiv DataStream, MSCI. The chart shows the MSCI Quality Index relative to MSCI World Index. An increase in the index means quality is outperforming the broader market. Index rebased to 100. **Past performance is not indicative of future results. It is not possible to invest directly in an index.**

Pricing power is a key defensive characteristic, especially during inflationary periods when companies aim to pass on rising costs. Yet many goods and materials prices are now experiencing deflation, providing opportunities to find quality, defensive companies in less crowded areas of the market, in our view. We seek to identify companies that can maintain strong earnings at a time when core inflation remains high and the costs of materials is coming down. One example might be a drinks maker with a strong brand that can hold on to higher prices while key input costs, such as aluminium, begin to fall.

Seizing on cyclical opportunities

We believe the lingering effects of the COVID-19 pandemic are creating a business cycle that differs from historical examples, as, in areas, labor and goods supply remains tighter and demand more robust than expected. The overall result could be a longer, flatter cycle, and we see opportunities among cyclical stocks where the valuations have been beaten down by fears of a GFC-style deep recession.

Consumer spending has been bolstered by tight labor markets (partly a result of people leaving the workforce during COVID) and excess savings (the result of COVID stimulus measures). We believe the impact of higher rates, such as higher mortgage payments, will eventually curtail the consumer's enthusiasm, and so it's important to be selective among consumer cyclicals. In the luxury sector, for example, we believe those companies that sell premium, handmade products to high-income consumers – who believe those products will hold their value – can maintain healthy profit margins, and any pullback in valuations on economic growth fears may present an attractive buying opportunity.

Among industrial cyclical companies, destocking – running down inventory as a result of lower demand – has historically signaled recession. Yet COVID-related supply chain disruptions meant that in many cases, inventories never built up to excess levels. For example, electric vehicle demand and the explosion of Artificial Intelligence means that some semiconductor companies are not building up excess stock. We look for industrial cyclical companies with a dominant market position that are priced for a recession – and which we believe will trade strongly on positive economic news.

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Healthcare: A sector for all scenarios

The healthcare sector offers investors the chance to diversify across the kinds of companies we believe are suitable in this uncertain market – defensive companies that are well positioned to generate cash even as economies slow, and companies that are more innovative and cyclical in nature where we see attractive valuation opportunities.

Renowned for resilience

The healthcare sector has a history of stability and outperformance during periods of both recession and inflation, as the charts below show. Spending on health can be seen as an essential expense. Consumers may be unwilling to cut back even during times of economic uncertainty, and the ultimate purchaser of these products and services is often a government or an insurer. About half of the global sector is made up of pharmaceutical companies, and their main business is selling prescription drugs. These very often have to be purchased in good economic times and bad.

We see opportunity among drugs companies with products that tackle some of the world's fastest-growing health problems, such as diabetes and Alzheimer's disease. New therapies for obesity could add hundreds of billions of dollars of revenue to the US$1.5 trillion prescription drug market, according to our analysis. The mRNA technology that produced vaccines capable of combating COVID-19's evolving variants is now being repurposed to create potential treatments for cancer as well as diseases associated with ageing.

Patent expiration is a risk to the recurrent revenues of drug companies. This is when competitors are legally allowed to copy a drug and introduce cheaper versions to the market. So we focus on those companies that have the financial muscle to invest in research and development, as well as a strong track record of successful innovation – both internally and by purchasing smaller companies that have developed proven new treatments.

A healthcare cycle and the COVID catch-up

Healthcare's resilience to the business cycle is what makes it attractive as economic growth slows. But there are cyclical aspects to some of the subsectors within healthcare, and we believe COVID's continuing impact on revenues is creating investment opportunities.

Biotechnology companies develop drugs based on living cells. Many are small, innovative, fast-growing companies, and valuations in this area have pulled back as higher rates make funding harder to secure. This may present attractive entry points for investors, and our teams continue to monitor clinical developments.

We also see opportunities among more stable areas within biotech, such as companies that provide outsourced manufacturing of biological drugs for smaller companies lacking necessary but expensive equipment. We see a mini-cycle playing out within healthcare as patients catch up on procedures delayed during COVID. This process benefits the medical devices subsector, including manufacturers of medical robots and joint replacements. We expect the catch-up momentum to continue for the duration of 2023 – especially in regions where private healthcare is predominant.

Conversely, the tools and services companies that enabled the surge in vaccine production during the pandemic now face a sharp dip in demand. Vaccine production has dropped more than 60% from the 2021-2022 peak, according to our analysis. Yet we now see attractive valuations among the stronger, more diversified companies in this area, which can offset pockets of weakness due to their broad offerings that remain highly valuable to the large drug companies.

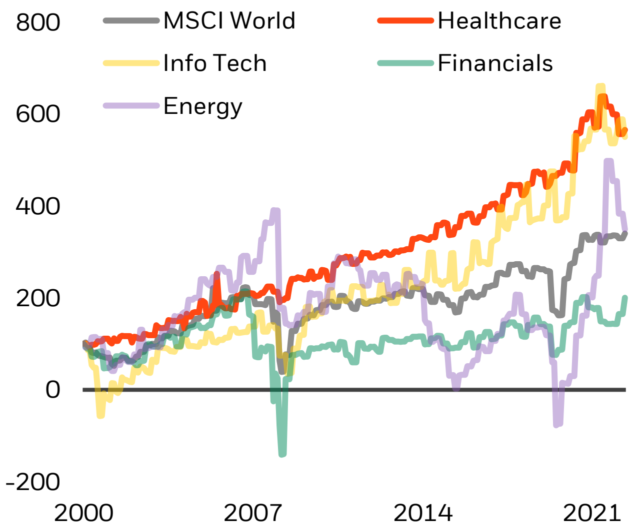
Diversification and duration

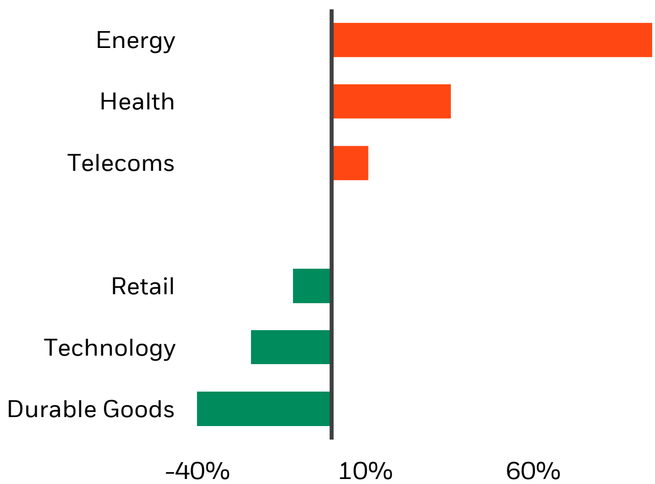
We believe diversification across healthcare subsectors can provide both resilience and growth opportunities. And the best healthcare companies, in our view, are dotted around the globe, providing sensible regional diversification. We are confident that structural forces such as ageing societies will drive returns in the sector for years to come. The number of persons aged 80 years or over is projected to triple, from 143 million in 2019 to 426 million in 2050. We seek a deep understanding of the science behind each company, in order to identify the future beneficiaries of these long-term trends.

-- Andy Kocen, healthcare analyst, contributed to this report.

Stable earnings and inflation protection

Global sector earnings growth, and top and bottom Industry returns during inflationary periods: 1939 –2012





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. Sources: BlackRock, data from Bloomberg. Left chart shows 12-month trailing earnings-per-share growth re-based to 100 for select sectors of the MSCI World Index, Dec. 2020 to April 2023. Right chart shows top and bottom industry returns curing inflationary periods: August 1939 – August 2012.

Fundamental Equities

Expert insight

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