

Q4 2024

Taking stock

US market views from BlackRock Fundamental Equities

The economy is not the stock market. And that’s good news. Summer market volatility tested investor conviction, but fundamentals prevailed and stocks quickly rebounded. As Q4 begins, we see:

Fed and election uncertainty fueling volatility

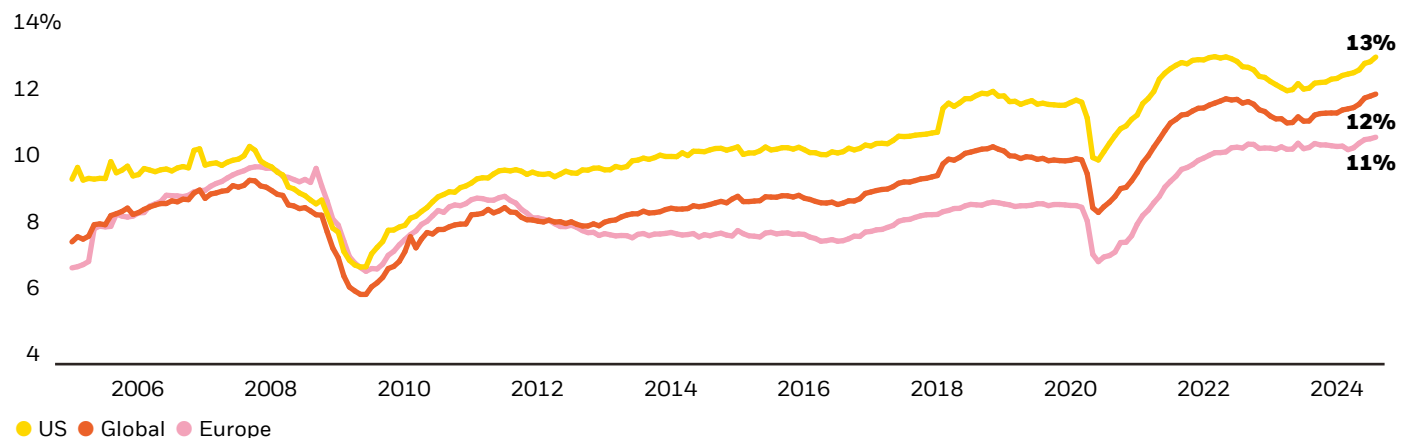
Generally positive stock reaction to rate cuts

Greater opportunity in large vs. both mega and small caps

Q3 volatility was at least partly rooted in concerns over a slowing economy and whether the Federal Reserve (Fed) was behind the curve in addressing it. We believe it had little to do with the fundamentals underlying the stock market, and this is an important distinction. Markets are an anticipatory mechanism and attempt to predict recessions, with historically mixed results. When the economy is in a slowdown, markets can struggle to discern a midcycle slowdown from a recession — stoking volatility. While the economy has struggled to recalibrate post-COVID, spiraling into a series of “mini rolling recessions” — first in technology, then in housing — we find that the stock market, and the companies that comprise it, have managed to adapt to what we see as a return to more “normal” conditions. Profit margins, as shown below, are on the rise. This resumption of normalcy also means more volatility, which we believe can be a boon for skilled stock pickers.

Stocks underpinned by strong fundamentals

Company profit margins, 2005-2024



Source: BlackRock Investment Institute, with data from LSEG Datastream as of Aug. 30, 2024. Chart shows 12-month forward profit margins, which are calculated as 12-month forward total earnings divided by sales. Global is represented by the MSCI World Index. Indexes are unmanaged. It is not possible to invest directly in an index.



Tony DeSpirito
Global Chief Investment Officer, Fundamental Equities

“Market volatility, while always unsettling, is not at all uncommon. It often presents the opportunity to add to fundamentally sound stocks at ‘sale’ prices.”

The two sides of volatility

Recent bouts of market volatility have served as reminders that sentiment can move markets, yet stock fundamentals prevail in the end. Sometimes that realization comes faster than others. This illustrates the importance of active selection and knowing (deeply) what you own, which can provide conviction when markets are on edge.

Q4 brings some key issues for investors to contemplate, which could further stoke market turbulence. While volatility gets a bad rap, it's important to remember that it entails ups as well as downs — and that context and circumstances are critical variables. When it comes to inevitable market angst, consider that:

1. Volatility can be healthy

Market resets can provide opportunities for investors to establish or increase exposure to stocks in which they have high conviction — and at a discounted price. This is particularly true in cases where volatility is driven by sentiment or technical factors (such as extended/crowded positioning or light trading as is common in summer months) rather than fundamentals (like company earnings growth and financial fortitude).

2. Volatility is normal

The period of moderation following the Global Financial Crisis (GFC) was unusual for many reasons — muted volatility among them. The VIX historically has experienced more dramatic gyrations than was the case post-GFC, particularly the very subdued 2012-2019. We see a return to a more normal environment where the VIX may experience more pronounced spikes, driven by such factors as the Fed, geopolitical tensions and a general proliferation of information and social media dissemination that can arguably make investors more anxious and markets less efficient.

3. Market corrections are not uncommon

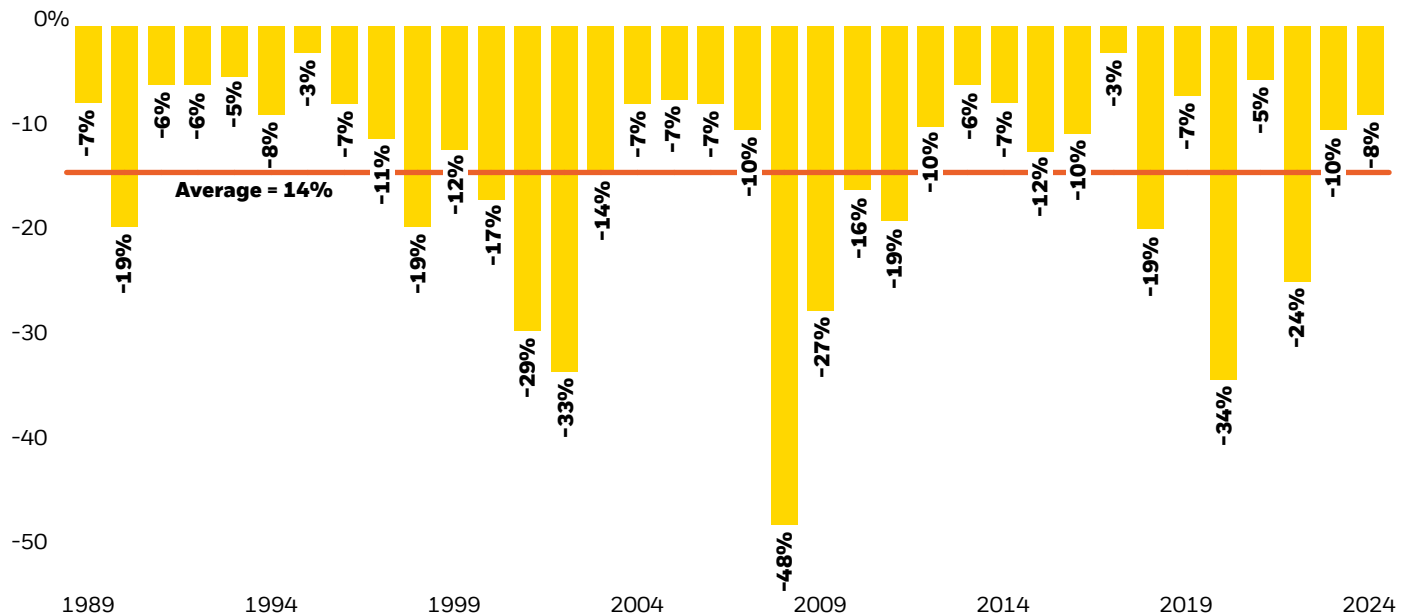
Corrections of 10% or more have happened in 20 of the last 35 years, with the average drawdown in that timeframe at 14%. See chart below. And yet the S&P 500 returned an average 11% per year (more than 4,000% on a cumulative basis) in that time. Investors who stay the course through bouts of volatility can be rewarded — sometimes quickly as was the case this August.

4. Volatility good for return?

Data back to 1990 also suggests that higher volatility has produced higher short-term returns. Our analysis finds that muted VIX levels of 12 and below have resulted in S&P 500 returns of roughly 5% six months later. This compares to six-month returns of 16% when the VIX touches 29 or higher. The summer VIX spike, where levels hit a high of 65, quickly normalized. If historical precedent holds, moments like these could present attractive buying opportunities with potential for outsized short-term returns.

Corrections are common

S&P 500 largest intra-year drawdowns, 1989-2024



Source: BlackRock Fundamental Equities with data from Bloomberg as of August 2024. Chart shows the maximum drawdown of the S&P 500 Index each year since 1989 and the average across that time. **Past performance is not indicative of current or future results.** Indexes are unmanaged. It is not possible to invest directly in an index.

Equities and elections

Among the potential volatility-inducing moments in Q4 is one that has been anticipated all year: The Presidential election.

While history shows that the winning candidate or party has little long-term bearing on market returns, it is also interesting to note that markets do tend to have a visceral reaction (either positive or negative) on election outcomes. We looked at market performance in the first month after prior Presidential elections and then the 11 months following to see if the initial reaction to the result was the one that held in the following year. In five of seven elections since 1996, it was not.

The key takeaway: More evidence that elections may have short-term market impact but that policy regime changes and political machinations have little sway over longer-run stock performance.

For long-term investors, patience is a virtue

Since 1974, the stock market has endured a presidential resignation, the collapse of the “Nifty Fifty” blue-chip stocks, raging stagflation, the 1987 stock market crash, the rise and bursting of the dot-com bubble, three wars in the Middle East, the GFC and COVID-19 pandemic. And over those 50 years, \$5,000 (USD) invested in the S&P 500 Index would have grown to be worth \$1.3 million (USD) today.*

* Analysis is based on total returns with dividends reinvested from Jan. 1, 1974, to Aug. 5, 2024, with data from Bloomberg.

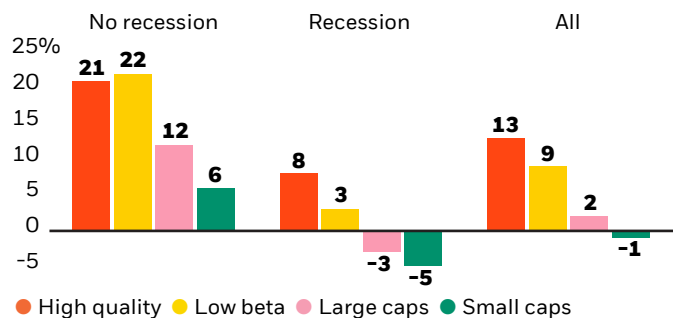
Equities and an easing Fed

Also likely to influence market sentiment in Q4 are Federal Reserve rhetoric and rate cuts. Equity markets generally perform well on Fed easing, particularly when rate cuts are not accompanied by a recession.

While the outcome for stocks can look different in an environment of recessionary rate cuts, history does reveal some patterns: Large caps generally lead small caps and high quality and low beta tend to outperform in the year after the onset of cutting, with or without a recession, as shown below. The pattern holds two and three years after the first cut, though value stocks also join the leaders in these time periods.

Easing and outperformers: Size and style

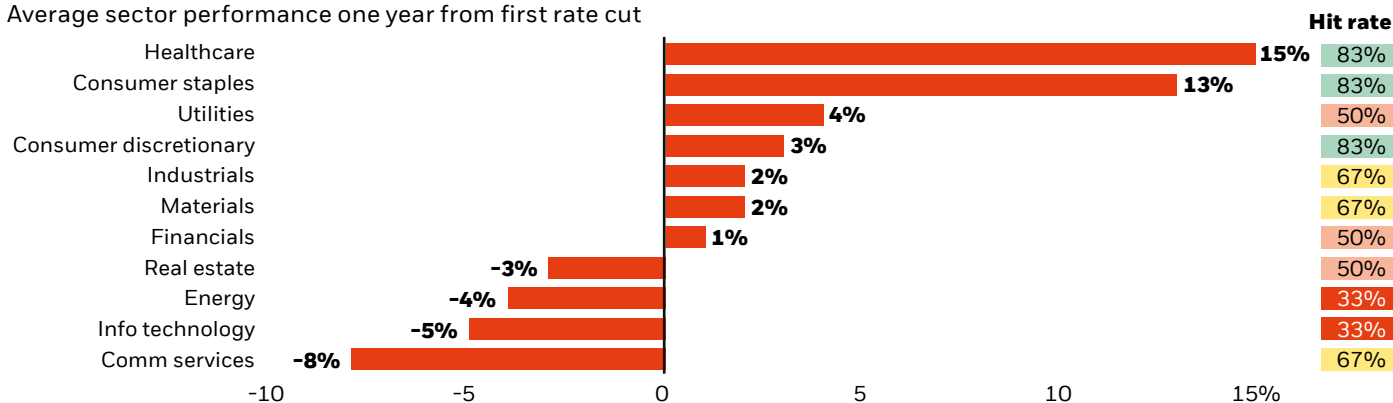
Average performance one year from first rate cut



Source: BlackRock Fundamental Equities with data from Refinitiv as of August 2024. Chart shows average return of the S&P 500 (large caps), Russell 2000 (small caps) and select styles in the Russell 1000 Index in the 12 months following prior rate cuts, covering six cycles since 1984. **Past performance is not indicative of current or future results.** Indexes are unmanaged. It is not possible to invest directly in an index.

Easing and outperformers: Sectors

Average sector performance one year from first rate cut



Source: BlackRock Fundamental Equities with data from Refinitiv as of August 2024. Chart shows average return of Russell 1000 sectors in the 12 months following prior rate cuts, covering six cycles since 1984. Hit rate represents the percent of times returns were positive. **Past performance is not indicative of current or future results.** Indexes are unmanaged. It is not possible to invest directly in an index.

This time... similarities and differences

Our analysis of data back to 1979 shows that healthcare is also a relative outperformer over the long term. While every cycle is different, we maintain our conviction in the healthcare sector given strong secular tailwinds, such as aging populations and rising health needs, alongside growth potential powered by innovation.

A review of stock dispersion within sectors over the past 20 years shows that healthcare was among three sectors (discretionary and tech being the others) that exhibited above-average difference between the best- and worst-performing stocks. This suggests potential for attractive stock picking in a sector that typically performs well in the environment we are entering.

The outlook for staples in this cycle is more nuanced. We find the sector to be well priced after being left behind in the 2023-2024 market upturn and attractive on a one-year horizon. Yet its future may not be as robust as in past cutting regimes.

On balance, the growth rate of staples has been in decline since the 1980s when dual-income families were coming into vogue and embracing the convenience of packaged foods. With that story mostly penetrated, the catalysts for significant staples growth are not what they once were. Another variable at play: The potential impact that GLP-1 diabetes and weight loss drugs may have on the demand for some packaged food items.

Meanwhile, the technology sector, a laggard in past rate-cutting regimes, looks far better positioned in this cycle. We find many areas of tech have become more staples-like, while AI also serves as a powerful secular propellant for growth in the sector.

Sizing up the market cap opportunity

We're often asked whether it may be time to pivot toward US small-cap stocks, and the episodes of Russell 2000 outperformance in July and August raised the volume around this question.

We're cautious on small caps, particularly into an economic slowdown given the data on the impact of rate cuts. We see a more interesting debate around the issue of large- versus mega-cap, as the valuations on the S&P 500 Index are distorted by the AI-leveraged mega-cap stocks.

The numbers are telling: The S&P 500's weighted average market cap stood at roughly \$950 billion (USD) as of mid-September. Removing the largest three companies brings it to \$422 billion (USD). Strike the six largest and it's \$231 billion (USD). This illustrates the heavy skew imposed by the mega-caps, in both market cap and valuation, that obscures the opportunity in a sizeable group of more "run of the mill" large-cap stocks.

Even after the top stocks' summer stumble, the cap-weighted index was 25% more expensive (based on price-to-earnings ratio) than the equal-weighted index. Meanwhile, small-cap stocks, as measured by the Russell 2000 Index, command the highest valuations with a PE of 33x as of Sept. 13 vs. 23x for the capitalization-weighted S&P 500. Bottom line: We see opportunity to invest in a subset of large caps at better valuations (and higher quality) than small.



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