iShares
by BlackRock

Precision insights: Sectors

Updated January 2024

Taking stock of Q3 earnings

The Q3 reporting season saw a slight recovery in US earnings, with earnings per share (EPS) moving back into positive territory at the headline level (3% YoY). In the eurozone, however, EPS contracted at the headline level (-3% YoY), weighed down by results from the materials and energy sectors.[1] See page 2 for more.

1 Source: Source: JP Morgan, as of 17 November 2023.

Sector selectivity: blending bright spots and havens

We outline our latest views on sectors, updated regularly to reflect the latest macro and microeconomic developments.

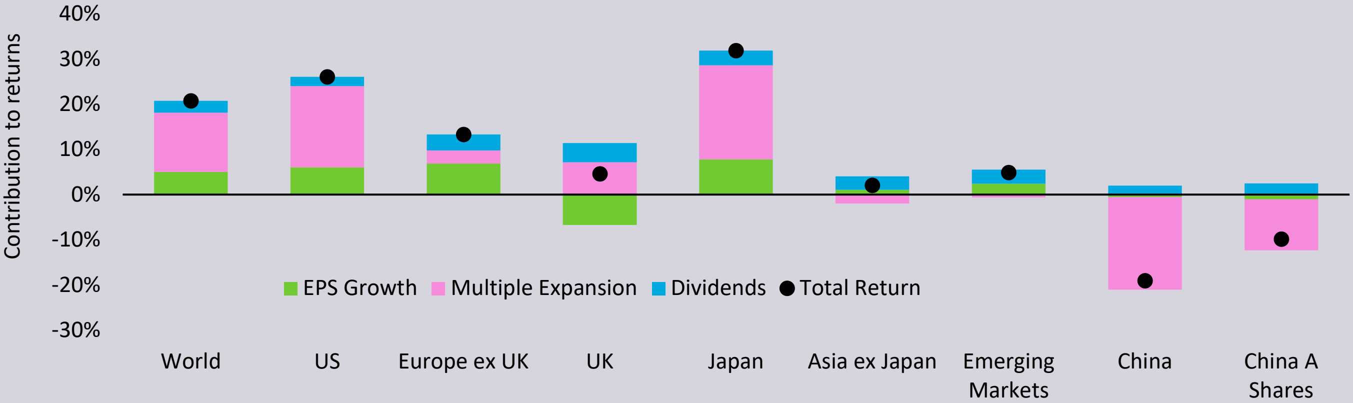
Click through to explore our precision sector views in detail.

Sector	View	Outlook
Communication services	↓	We remain underweight communications services, with unremarkable fundamentals and a strong 2023 meaning that valuations are slightly more elevated.
Consumer discretionary	—	We stay mixed on the consumer discretionary sector: despite tailwinds for European luxury, the automobiles subsector remains a risk.
Consumer staples	—	We bring staples up to a mixed view: profitability has improved and valuations have come down.
Energy	↑	Energy remains one of our highest conviction sector calls, especially in the US. The sector remains cheap versus its own history.
Financials	—	We maintain a mixed view on global financials, but retain our preference for European banks, where we see potential value.
Healthcare	↑	Healthcare remains a defensive position in our view – valuations look justified and profitability is high.
Industrials	↑	We remain positive on global industrials, but tilt towards Europe, where the sector has been able to capture the reshoring and nearshoring trade.
Information technology	↑	We keep our preference for tech as a quality allocation, despite a strong 2023 for the sector.
Materials	—	We stay mixed on the materials sector, after yet another underwhelming earnings season. We prefer to stay selective, tilting towards the mining subsector.
Real estate	—	We close out our underweight on the real estate sector as valuations have become more attractive. While the macro backdrop is still uncertain, real estate was excessively punished in 2023, in our view.
Utilities	—	We have no strong view on utilities. The sector comes at a premium for its defensive qualities, although valuations have started to come down.

Taking stock of Q3 2023 earnings

At the headline level, US earnings shifted back into positive territory in the Q3 season, with 3% YoY EPS growth, while eurozone earnings continued to be weighed down by poor results from materials and energy firms, leading to -3% YoY EPS growth for the region.[2] The significance of earnings increased throughout 2023: they were the largest contributor to returns in the eurozone, albeit playing second fiddle to multiple expansion in the US. Heading into 2024, we believe there is room for earnings to play an even larger role in global equity returns. In this new investing regime of higher macro and market volatility, we see increased dispersion among sectors, and fundamentals should play more of a role in helping drive this dispersion.

Figure 1: Equity sources of total return, trailing 12 months

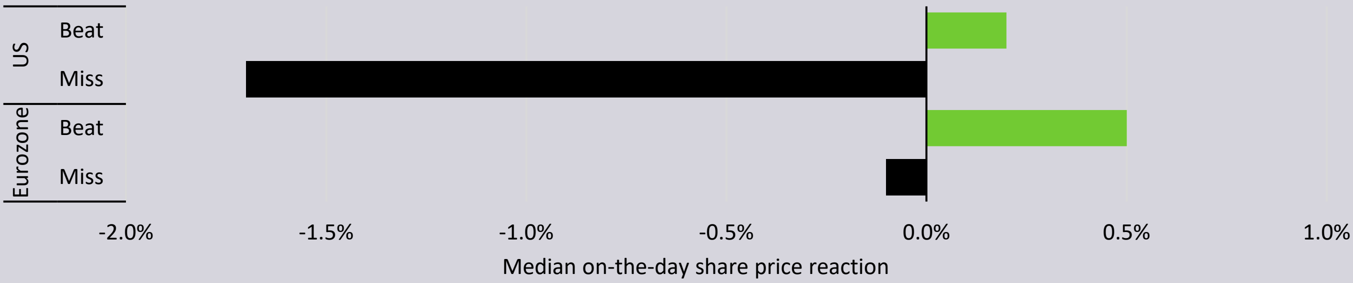


The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Source: LSEG Datastream, MSCI and BlackRock Investment Institute, as of 5 January 2024. The bars show the breakdown of each market's 12-month return into dividends, earnings growth and valuation. The dots show each markets total 12m local currency returns. Earnings growth is based on the 12m change in 12m forward IBES earnings estimates. World is defined as MSCI ACWI. Returns based on MSCI Indices. See Figure 5 overleaf for five-year performance history.

Key trends from the Q3 season

- **Divergence in reaction:** expectations for US earnings remained high heading into the Q3 earnings season, and have been sequentially increased post-reporting as well. This meant that, relative to the eurozone, the bar was high: US stocks were not generally rewarded for beating expectations, and were broadly punished when missing the high bar. In the US, the median 0.2% on-the-day share price rise in response to a beat was in line with the Q2 reporting season, while the 1.7% drop in response to a miss was marginally better than the 1.8% fall in the previous reporting season. In general, the reaction in the US was in line with what we saw earlier in 2023: beating on earnings didn't generally lead to positive price action. In the eurozone, however, not only were expectations not as high, but the beat rate was also lower at 55%. This resulted in beats being rewarded at the highest rate since Q3 2022, with a median move of 0.5% on the day, while misses were punished with a median 0.1% fall, in line with the previous quarter.[3]
- **Communication services (40% EPS growth YoY) and consumer discretionary (56% YoY) led the way in the US,** with all sectors apart from energy, materials and healthcare contributing positive EPS growth. The same three sectors, as well as consumer staples, also contributed negative EPS growth in the eurozone, dragging the overall EPS figure into negative territory. Once again, for both regions, the ex-energy EPS growth reading (6% for the eurozone and 9% for the US) was much higher than the headline figures. **In the eurozone, financials (22%) and consumer discretionary led earnings.**[4]
- **Expectations for 2024 earnings in the US rose after the Q3 season, while in contrast, upwards revisions in the eurozone have been more muted.** Delving into the season in the eurozone in particular, guidance has remained weaker, with clear dispersion among sectors: materials and industrials companies were by far the most cautious on their 2024 outlooks, while utilities and tech firms remain relatively optimistic. Banks and energy – two sectors we like in the eurozone – are two of the main drivers of the upgrades, after a relatively solid Q3 season.[5]

Figure 2: Median share price reaction on day of earnings release, Q3 2023



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Source: JP Morgan, as of 27 November 2023.

2-4 Source: JP Morgan, as of 17 November 2023. **5** Source: Barclays, as of 10 November 2023.

A framework for analysing sectors

We pay close attention to how profitability and valuations appear in the current environment and use this framework in conjunction with our qualitative assessment of macro and microeconomic trends to gauge each sector's outlook. The table below highlights Z-scores for MSCI World sectors across a range of metrics, with high profitability and reasonable valuations increasing the attractiveness of a sector.

Figure 4: Framework for analysing profitability and valuations of MSCI World sector index range, November 2023

	Profitability			Valuations		
	EPS	EBITDA	CPS	P/E	P/B	Earnings yield prem./disc. to 10Y avg
MSCI World Communication Services	1.27	-0.51	-0.71	0.23	0.73	0.23%
MSCI World Consumer Discretionary	2.13	2.51	2.28	0.24	0.81	0.27%
MSCI World Consumer Staples	2.15	2.25	1.71	-0.43	0.49	-0.14%
MSCI World Energy	1.32	1.04	1.53	-0.98	1.07	-4.07%
MSCI World Financials	1.49	-0.07	0.49	-0.67	2.02	-0.50%
MSCI World Healthcare	1.49	1.53	1.61	1.07	0.65	0.35%
MSCI World Industrials	1.93	2.20	2.68	0.38	1.15	0.30%
MSCI World Information Technology	1.80	1.78	1.61	1.30	1.26	1.10%
MSCI World Materials	0.76	0.54	1.16	-0.02	0.21	-0.02%
MSCI World Real Estate	7.21	7.23	6.90	2.00	3.17	0.61%
MSCI World Utilities	2.96	2.87	0.98	-1.54	0.03	-0.75%

Source: BlackRock and LSEG Datastream, as of 20 November 2023.

Figure 5: Five-year performance of MSCI regional and sector indices

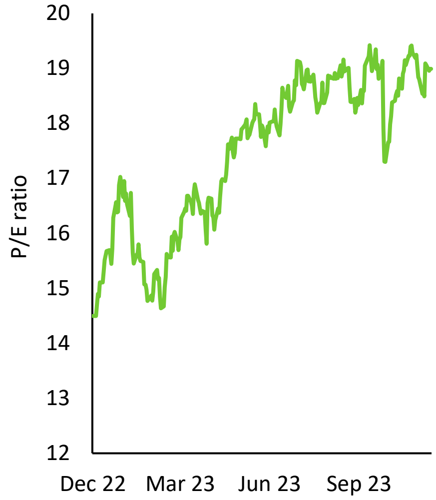
Performance (%)	2018	2019	2020	2021	2022	2023
MSCI All-Country World (ACWI)	-9.41	26.60	16.25	18.54	-18.36	22.20
MSCI USA	-5.04	30.88	20.73	26.45	-19.85	26.49
MSCI Europe ex UK	-15.14	24.81	10.91	15.66	-17.96	21.69
MSCI UK	-14.15	21.05	-10.47	18.50	-4.84	14.09
MSCI Japan	-12.88	19.61	14.48	1.71	-16.65	20.32
MSCI Asia ex Japan	-14.37	18.17	25.02	-4.72	-19.67	5.98
MSCI Emerging Markets	-14.57	18.42	18.31	-2.54	-20.09	9.83
MSCI China	-18.88	23.46	29.49	-21.72	-21.93	-11.20
MSCI China A	-28.26	36.17	43.20	3.20	-25.90	-13.47
MSCI World	-8.71	27.67	15.90	21.82	-18.14	23.79
MSCI World Communication Services	-10.02	27.39	22.98	14.35	-36.93	45.55
MSCI World Consumer Discretionary	-5.51	26.57	36.62	17.93	-33.36	35.05
MSCI World Consumer Staples	-10.10	22.80	7.78	13.06	-6.13	2.31
MSCI World Energy	-15.84	11.45	-31.46	40.09	46.01	2.54
MSCI World Financials	-16.97	25.51	-2.84	27.87	-10.19	16.16
MSCI World Healthcare	2.51	23.24	13.52	19.80	-5.41	3.76
MSCI World Industrials	-14.54	27.77	11.68	16.60	-13.20	23.16
MSCI World Information Technology	-2.60	47.55	43.78	29.85	-30.79	53.27
MSCI World Materials	-16.93	23.35	19.94	16.32	-10.75	14.77
MSCI World Real Estate	-5.04	26.07	-5.27	36.02	-25.91	10.10
MSCI World Utilities	1.97	22.53	4.76	9.84	-4.66	0.28

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. Source: BlackRock and Bloomberg, as of 31 December 2023.

Communication services

We maintain our low conviction on the communication services sector. At a fundamental level, as was the case in the Q2 reporting season, a strong Q3 earnings season has led to a relatively favourable EPS metric for the sector, but this is offset by a drop in EBITDA and cash flow per share. After a strong 2023, we see valuations as unjustifiably high, especially in the US (see Figure 6). Globally, valuations for the sector remain slightly above the long-term average based on the earnings yield premium.[6] Given that profitability remains a challenge, especially with the long-dated nature of some cash flows, we look to add risk in other sectors. Tight financial conditions remain a tail risk – while developed market (DM) central banks are at or near the end of their hiking cycles, market pricing for rate cuts looks overly optimistic, in our view. This could pose headwinds for growth-tilted sectors such as communication services.

Figure 6:
Forward price-to-earnings ratio for US communication services

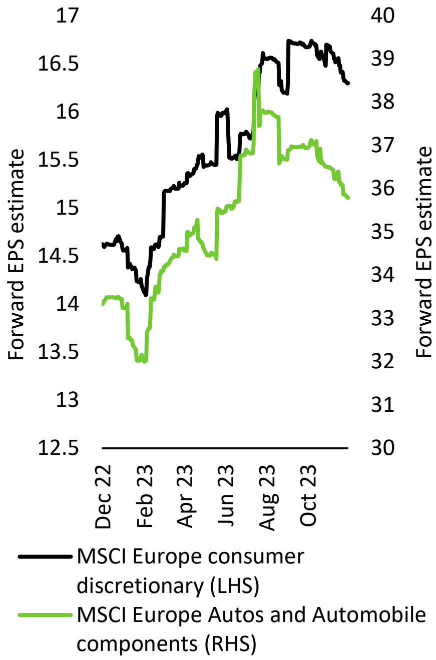


Source: Bloomberg, as of 13 December 2023.

Consumer discretionary

We remain mixed on the consumer discretionary sector, after moderating our view at the start of Q4 2023. A relatively strong consumer supported the sector in 2023, but with hard and soft data pointing to potential weakness in the consumer ahead, we see little room for sustained demand through Q1 2024. We continue to favour the European consumer discretionary sector, where forward guidance has been a little more positive, although exposure to automobiles remains a concern. We see structural headwinds for European autos, especially in relation to innovation, where they lag global competitors. Earnings expectations reflect this: growth for the European autos subsector is forecast to lag overall consumer discretionary in 2024 (see Figure 7).[7] Our preference for the European sector comes partly from its higher tilt towards high-end consumers, who may be more likely to continue spending through a downturn. We also look to exposure to emerging market (EM) consumers, amid broader tailwinds for the bloc, including a weaker dollar and central banks starting to cut rates, as well as growing disposable incomes in many EM regions.

Figure 7:
Forward earnings per share estimates for Europe consumer discretionary and European autos and automobile components



Source: Bloomberg, as of 13 December 2023.

Consumer staples

We close out our negative view on consumer staples after a tough year for the sector. As we highlighted last quarter, profitability has been improving for the sector, while valuations have also come down according to our framework. Our overarching lack of conviction comes from the macro backdrop: growth has proven more resilient than expected, especially in the US, and we struggle to see broad-based upside tailwinds. This is a marked change from H1 2023, when investors were largely focused on a challenging macro backdrop, which has historically been supportive for the sector. We continue to prefer to build defensive exposure through allocations to higher quality sectors. In Europe, we see potential for optimism in the staples sector: in the Q2 reporting season companies communicated confidence in their ability to pass on higher costs, and this came through in Q3, with staples reporting one of the highest beats on margins across sectors, despite negative YoY earnings growth.[8] In the US, staples have continued to fare better, with 6% EPS growth in Q3.[9]

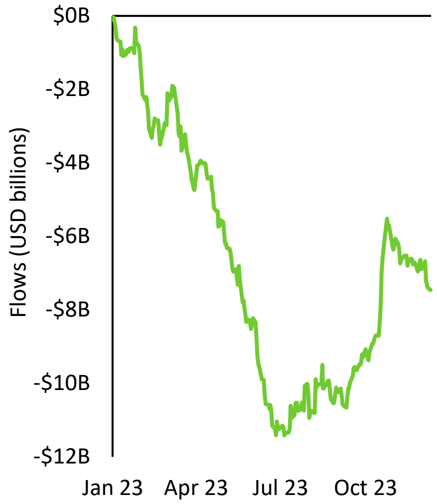
6 Source: BlackRock and LSEG Datastream, as of 20 November 2023. **7** Source: Bloomberg, as of 13 December 2023. **8** Source: Barclays, as of 10 November 2023. **9** Source: JP Morgan, as of 17 November 2023.

All figures are in US Dollars unless stated otherwise.

Energy

Energy – particularly US energy – is one of our highest conviction sector calls. Positioning remains light, with $9.4B of outflows from global energy sector ETPs in 2023, despite a Q4 bounce.[10] Our preference for the sector is underpinned by the continuation of the solid fundamental backdrop. While Q3 earnings figures once again pointed to a YoY decline,[11] this was largely priced in ahead of time. In fact, we look to energy as one of the sectors where we believe the economic damage from tighter monetary policy is priced in: full-year earnings growth expectations have come down significantly, and in the US, rising expectations are starting to look more realistic in our view. The energy sector continues to score highly according to our framework on both profitability and valuations, the latter of which remains 4.1% below long-term averages at the global level.[12] We tilt towards US energy, where the macro backdrop is slightly stronger, in our view, and profitability has been relatively robust. While the drop in crude oil prices in late 2023 impacted the sector, we see room for tactical allocation to energy, as efforts by energy-producing countries to curb supply could affect short-term dynamics. This is also one reason we prefer risk in energy equities over direct commodities. Capital discipline has been key for energy companies in recent years. Meanwhile, supply crunches have accelerated policy support for clean energy, providing further tailwinds and investment.

Figure 8:
Cumulative global flows into energy sector ETPs, 2023

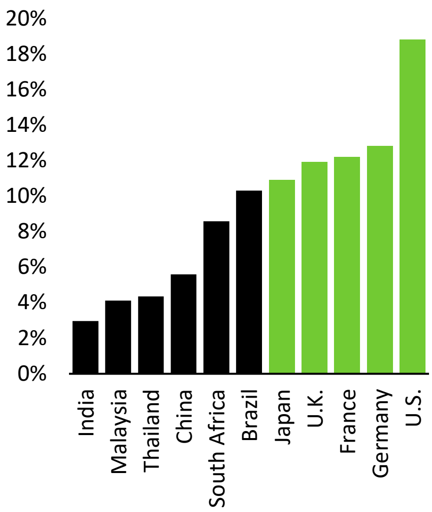


Source: BlackRock and Bloomberg, as of 11 December 2023.

Financials

Our mixed view on global financials still comes with a clear preference for European banks. Delving into earnings, solid growth across 2023 and profit realisation – particularly in the peripheral banks, where a higher proportion of mortgages are on variable rates – offers a key tailwind. The lack of pass-through of the higher rate environment to deposit rates remains a key element for profitability, and with our view of rates staying tighter for longer, this will likely remain a tailwind for Q1, we think. While valuations of European banks remain attractive relative to the US, as tends to be the case, our framework also shows that global financials are trading at a slight discount to their long-term average. In the US, the potential for more stringent regulation still looms; the stricter regulatory backdrop in Europe supports our regional preference. Sentiment towards financials was mixed in 2023, with $3.8B added to financials sector ETPs globally, most of which went into US financials in October.[13]

Figure 9:
Healthcare spending as a percentage of GDP, 2020



Source: The World Bank, current as of 30 April 2023, based on 2020 expenditures. For illustrative purposes only. There is no guarantee that forecasts made will come to pass.

Healthcare

We remain constructive on global healthcare. Our framework shows that valuations remain slightly above their 10-year average, but we think this is justified.[14] Earnings were challenged in 2023, which has led to lower overall expectations for 2024, although these could be revised up in the Q4 reporting season. The beat rate in US healthcare remained above 80% in the Q3 reporting season, and earnings remained negative at -20% YoY, while being marginally better in the eurozone at -15% YoY (albeit with a lower beat rate).[15] Healthcare profitability remains solid, and we see room for this to continue over the long term. Its combination of inelastic demand and high pricing power – at a time when margins are being squeezed – continues to look favourable. The over-65 segment of the global population is growing faster than any other age group, providing a structural source of demand. Biotech and innovative healthcare themes look well-positioned for this driver, as well as developments in artificial intelligence, miniaturisation and genomics. Significant government spending on healthcare offers another tailwind (see Figure 9), although the sector could come into focus and experience some volatility in the run up to the 2024 US election.

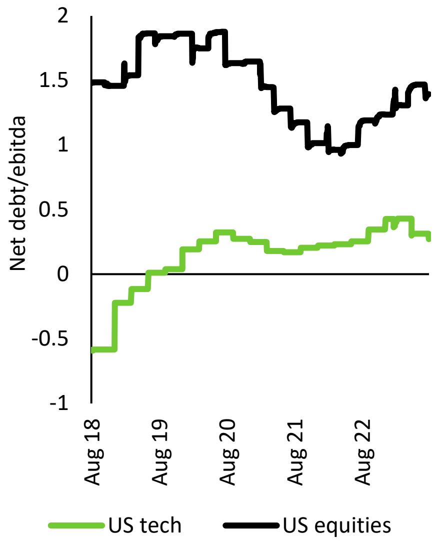
10,13 Source: BlackRock and Markit, as of 31 December 2023. **11,15** Source: JP Morgan, as of 17 November 2023. **12,14** Source: BlackRock and LSEG Datastream, as of 20 November 2023.

Industrials

We remain positive on industrials, with a preference for the European sector. An improving growth backdrop in 2024 coupled with structural nearshoring and reshoring trends could be supportive. Industrials delivered above-trend earnings growth in the US and eurozone in Q3, but expectations for 2024 growth remain depressed, especially in the eurozone.[16] While this is partly due to lower guidance from companies themselves in the Q3 reporting season,[17] we think a calibration to a more neutral growth outlook is understandable. Nevertheless, our fundamental framework highlights solid profitability metrics for the sector, especially on cash flow per share. Valuations are in line with their long-term average, but we don't see this as a significant detractor.

Within industrials, we like exposure to the automation and robotics themes. Robots can deliver cost savings and efficiency gains, helping to drive corporate profits for the coming decades. They can also help to address structural issues around precision, hazardous tasks, an ageing workforce and rising labour costs across the industrials sector.

Figure 10:
Net debt/EBITDA of US tech vs. broader market



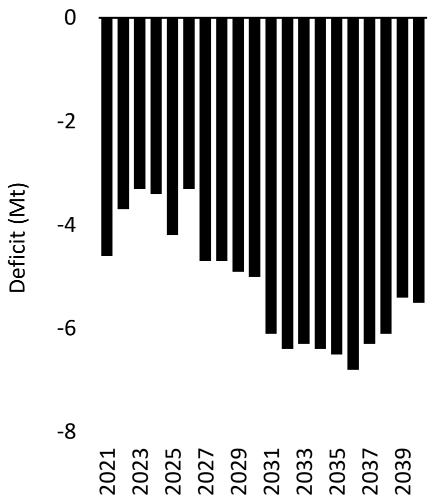
Source: Bloomberg as of 25 August 2023. Shows net debt/EBITDA of S&P 500 and S&P 500 Information Technology indices.

Information technology

We still like tech for its defensive and quality characteristics. While US tech benefited from significant investor focus in 2023, we continue to like the sector. US tech displays quality characteristics and is not as indebted as some fear (see Figure 10). US tech earnings resilience was a staple in 2023, especially among chipmakers, where we have high conviction at the global level. We continue to favour US tech and global chipmakers, as we see the European tech market as too concentrated. Our framework points to valuations for the global sector being high – 1.1% above long-term averages – but profitability is also high, meaning that in our view, fundamentals back up the valuations for the time being.[18]

We still like semiconductors as a more granular exposure within global tech: chips are key to electrification and digitalisation, with wide applications. Semiconductor demand still outpaces supply and remains resilient, as we saw in earnings across the year. Our analysis shows that semiconductor companies broadly benefit from strong pricing power, which could help to cushion the adjustment to higher input prices and wages seen in 2023.

Figure 11:
Forecast supply deficit for refined copper, millions of tonnes



Source: Bloomberg NEF, as of 30 September 2023.

Materials

We remain mixed on the materials sector: continued disappointing earnings were a detractor in 2023, even if valuations are starting to look compelling. We continue to prefer a selective approach within the sector, tilting towards the mining subsector. From a regional perspective, we hold a tactical preference for European materials, given the sectoral differences between US and European materials – the former is tilted more towards chemicals, while the latter has more of a mining tilt. Structural supply-demand mismatches in commodities persist, especially for industrial metals such as copper (see Figure 11). Underinvestment among miners – as highlighted by still-depressed capex levels – is likely to keep a cap on supply. Meanwhile, demand for copper – a vital component in electrification across renewable energy, electric vehicles and infrastructure buildout – is expected to double by 2030, potentially outstripping current supply by over six million tonnes per year.[19] We see structurally higher demand for materials like copper that are critical for renewable energy infrastructure. Our fundamental framework shows that profitability metrics for the materials sector remain solid, particularly cash flow per share, yet valuations are marginally below their long-term average.

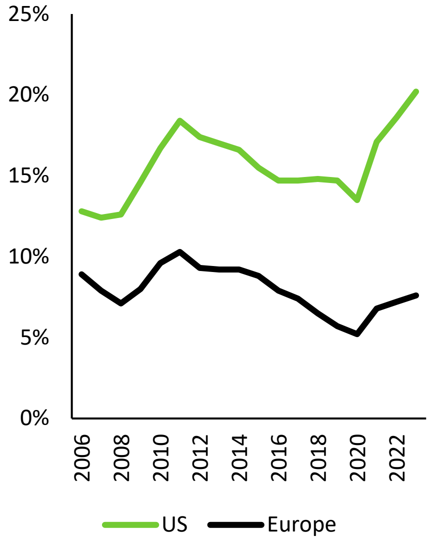
16 Source: JP Morgan, as of 17 November 2023. **17** Source: Barclays, as of 10 November 2023. **18** Source: BlackRock and LSEG Datastream, as of 20 November 2023. **19** Source: JP Morgan, as of 30 March 2023.

All figures are in US Dollars unless stated otherwise.

Real estate

We close out our less constructive view on global real estate. The macro backdrop remains a challenge for the sector, but valuations have come down, especially in the US, and earnings have returned to positive territory in the US and eurozone. At a global level, our framework points to relatively solid profitability metrics for the sector as a whole. The commercial real estate sector remains a risk and has been facing relatively low occupancy and tightening credit lines as a result of events in the banking sector, but risks are increasingly being priced in. Contrarian market views, especially in Europe, highlight that the sector tends to benefit when bund yields decline. However, we think that macro headwinds, such as higher rates and lower property prices, will outweigh this tailwind. We favour a selective approach, particularly through industrial real estate, which may not be best represented by a broad sector allocation.

Figure 12:
US and European office vacancy rates, 2006-2023



Source: JLL, August 2023.

Utilities

Utilities is a traditionally defensive sector and it has been popular during past economic downturns. However, investors tend to pay a premium for this exposure, which is why we broadly steer away from utilities and hold no strong view. The ability of utilities companies to pass on increased input costs has been supportive for profitability, but this hasn't necessarily been reflected in investor sentiment. Our framework points to valuations being marginally below their historical averages – having come down since our last update – and profitability remains high.[20] Yet we struggle to see further upside for the sector, especially given the better-than-expected growth backdrop in 2023 and expectations for resilient growth in 2024.

20 Source: BlackRock and LSEG Datastream, as of 20 November 2023.

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