BlackRock

Stock market monitor

Q3 2024 equity market outlook from BlackRock Fundamental Equities

A broader set of stock-picking opportunities. We believe market leadership may extend to more cyclical, or economically sensitive, areas – especially those with long-term earnings support from artificial intelligence, decarbonization and reshoring. As we enter Q3 we see:

Leadership widening as earnings improve across sectors

Both cyclical and structural support for several industries

Reasons to be positive on European and UK equities

At the start of 2024, many equity markets were close to record highs as investors anticipated that major central banks would cut rates several times over the following 12 months. However, at the midpoint of the year, the European Central Bank (ECB) is the only major central bank to have cut rates. Yet markets have continued to climb.

Why is this? We believe equities have been supported by a benign macroeconomic environment, as inflation has come down from peaks and recessions have mostly been avoided. And earnings have been resilient, forecast to rise globally by 8% in 2024.[1] What next? We expect markets to retain the same focus on rates in the second half of the year, and for artificial intelligence (AI) to keep capturing attention.

What might change? Market leadership may broaden out as earnings come through across sectors. The earnings revision ratio for global stocks is back above zero – which means a greater number of companies are seeing upgrades to earnings forecasts than downgrades. See the chart below.

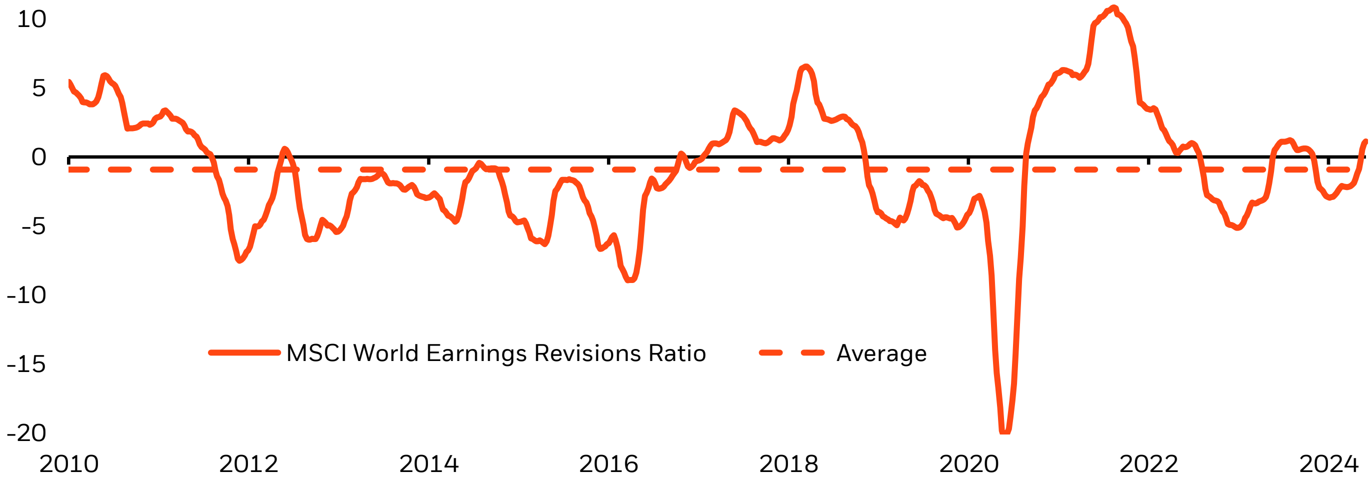
And rate cuts may support more cyclical areas of the market, a theme we explore on page 2. So even as AI remains in focus, we expect to see a broader set of winners for active managers to unearth – a ripe environment for stock selection.

Helen Jewell

Chief Investment Officer, BlackRock Fundamental Equities, EMEA

"We believe interest rate cuts could lead to a wider set of opportunities for skilled stock pickers to find a new set of market winners."

Earnings on the up for broader set of companies
MSCI World Earnings Revisions Ratio, 2010-2024



Source: LSEG DataStream, BlackRock Investment Institute, June 11, 2024. The chart shows the number of upward EPS estimates minus downward estimates as a share of total estimates, for companies in the MSCI World Index.

[1] MSCI, Datastream, June 2024

Structural support plus a cyclical boost

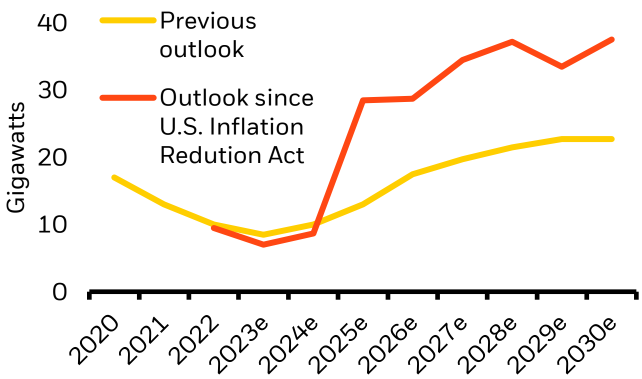
We expect cyclical sectors – especially in Europe – to benefit from falling rates and healthier economic activity. Below we explore areas that may receive a cyclical shove in the right direction – and yet are also supported in the long term by structural changes, including the move toward decarbonization, reshoring and the rise of AI.

Renewables and Utilities

Cyclical: Renewable projects require a large amount of up-front investment and higher rates have hindered the financing of these projects. Renewables are also raw-material intensive – wind power needs up to five times as much steel as gas, for example – and rising inflation put pressure on costs.[2] Wind turbine manufacturers are now past the worst point of material cost inflation, according to our analysis, and one of the world's largest turbine manufacturers said in its most recent earnings report that a greater number of projects delivered at higher prices should boost 2024 revenue.

Structural: Demand should remain robust in the long term. A focus on energy security in Europe has underpinned policy action such as REPowerEU, the Net Zero Industrial Act and recent attempts to reduce permitting time for new renewables projects. Spending on renewables in the U.S. Inflation Reduction Act should also benefit companies with global reach (see chart).

Wind in the sails of renewables
U.S. wind installations 2020-2030



Source: Bloomberg NEF, July 2023. For illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Cyclical: Utility companies are sometimes considered "bond proxies" because they offer a steady stream of income. These returns have appeared less attractive while the risk-free rate has been about 5%. If rates come down, then the appeal of their secure income streams increases. Performance has lagged year-to-date and we see room for this to rebound.

Structural: We believe "green utilities" are crucial to the energy transition – which means long-term earnings resilience. Yet it's important to be selective. Our investors look for those utilities companies that are consistently able to generate returns on renewable energy projects that exceed their weighted cost of capital – or expected rate of return.

Semiconductors

Cyclical: Different parts of the semiconductor industry have been in different cycles. Chips needed for smartphones and PCs lagged after a surge in demand during COVID, and this year has seen the beginning of a recovery. Auto-related semi demand has been strong, although there are some concerns here as electric vehicle sales growth slows. Overall, we expect the industry to benefit from a cyclical rebound this year and into 2025.

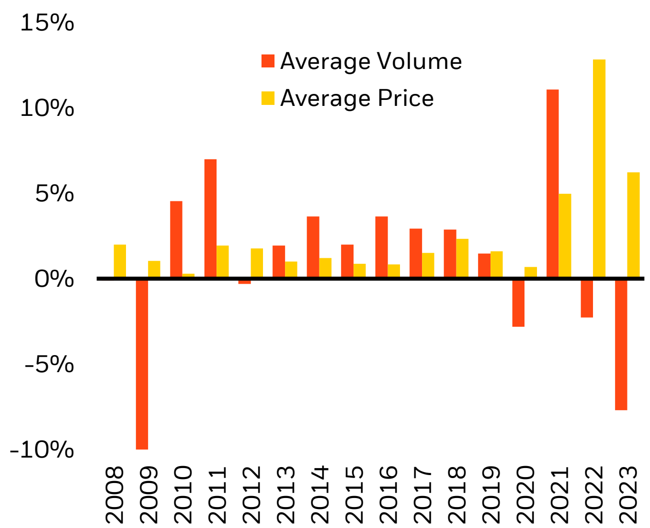
Structural: We expect data center demand – related to the rise of AI – to provide a long-term boost to several companies within the semiconductor industry. Many of the world's biggest tech companies are investing heavily in this area – our analysis of earnings reports show capital expenditures in 2024 up to 50% higher than in 2023. We expect much of this spending to benefit semiconductor companies – especially those companies in Europe that have dominant positions in the semiconductor equipment market – as well as smartphone and PC chip makers as AI drives demand for more memory.

Construction and renovation

Cyclical: Construction volumes in Europe hit a 14-year low, as the chart below shows. As rates in Europe come down, and if economic activity continues to recover, we would expect a rebound from these levels. At the same time, supply of some materials – such as cement – remains constrained, which should result in a strong pricing environment for construction and construction material companies.

Structural: Buildings account for 40% of global carbon emissions, with three-quarters of this driven by heating, cooling and lighting.[3] Companies that provide energy efficiency solutions in these areas are well placed to deliver strong earnings over the long term as governments and businesses race to hit net-zero targets. Data centre demand and a reshoring trend also provide long-term opportunities. Many of the world-leading companies that we expect to benefit from these trends are based in Europe – and we explore the European opportunity further on page 3.

Construction ready for a rebuild?
European construction price and volume growth



Source: BlackRock, company data covering businesses involved in construction in Europe with a breakdown of volume and price in annual earnings. March 2024.

[2] BHP analysis, August 2023

[3] World Green Building Council, September 2021

A spotlight on Europe and the UK

Many companies that are set to benefit from the short- and long-term trends outlined above can be found in Europe and the UK, so we believe skilled stock pickers can find rich rewards in these markets. In addition to these alpha opportunities, we believe there are compelling reasons these regions could flourish at the market level over a medium-term horizon.

Europe

European shares have lagged those in the U.S. over the past decade. We now believe that, at least in the short to medium term, this dynamic could reverse. Here are four reasons we believe in a regional resurgence:

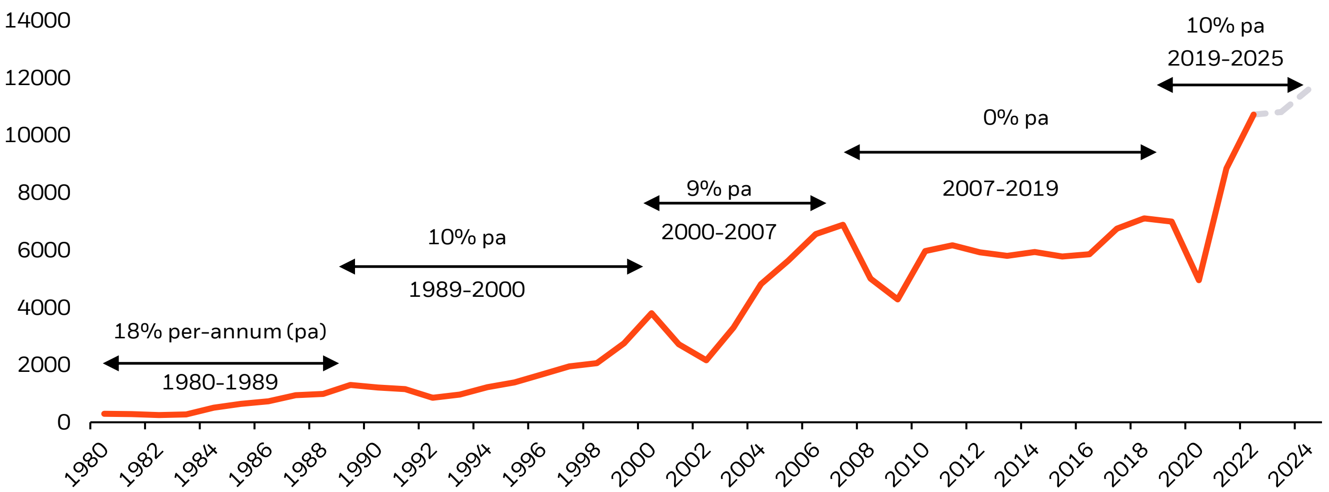
1.Earnings. Earnings growth in Europe has accelerated after a period of stagnation following the Global Financial Crisis (GFC). See the chart below. We see several reasons why this earnings momentum can continue: companies have significantly reduced debt levels; profitably remains robust despite the higher energy, material and labour costs of recent years; and companies have continued to invest in future growth.

2.Economics. Euro area inflation has fallen to 2.4%, close to the ECB's target. This allowed the ECB to be the first major developed-market central bank to cut rates this year. We expect this to provide a boost to the region's consumers and companies. And the economy is already showing signs of life – the composite purchasing managers' index has been rising for the past six months.

3.Valuations. European shares currently traded at a roughly 40% discount to U.S. peers, versus a historical average of about 20%.[4] They are also cheaper than their historical average. We believe these valuations can tempt investors back to the region. Indeed, there have been four consecutive months of inflows into European equities from global mutual funds.[5] And another important cohort who think European shares are cheap: European companies. The number of companies buying back their own shares is close to record levels, and this provides an attractive source of return for investors.[6]

4.Quality. Europe is home to a host of quality companies, across a broad range of sectors, that have been able to grow earnings regardless of macroeconomic or central bank policy fluctuations. Some of the areas we see opportunities include semiconductors and construction, as mentioned above; luxury, where pricing power for the best managed brands remains strong; banks, where we see support from buyback programs even as rates come down; and healthcare – some of the world's most innovative and profitable healthcare companies.

European earnings have rebounded
European earnings growth, 1980-2024



Source: Goldman Sachs, Factset, 15 June 2023. Base year indexed to 100: 1973. Consensus forecasts expect 10% earnings growth per annum between 2019 and 2025. There is no guarantee any forecasts made will come to pass.

The UK

The FTSE 100 Index has hit several record highs this year, and we believe the market will remain supported for many of the same reasons as Europe: cheap valuations, lots of buyback activity, a resilient economy and earnings momentum. Consumer confidence is at the highest level in nearly three years and consumer savings remain above the historical average. The UK also has a stable political outlook, which should be a boost to investment in the region, in our view. Inflation is coming down and markets expect the Bank of England to cut rates soon.

We believe this environment should benefit UK construction companies, housebuilders and property developers. We also think small- and medium-sized companies are well set for a rebound. These have historically outperformed large-cap peers over the past seven decades, but have lagged since the pandemic.[7] We see opportunities to invest in high-quality growth companies with the ability to generate cash and win market share regardless of interest rate moves. In these cases, we find the current depressed valuations are undeserved and the re-rating potential significant.

[4] BlackRock Fundamental Equities, with data from Bloomberg, May 2024 [5] Goldman Sachs, May 2024

[6] Goldman Sachs, April 2024 [7] Deutsche Numis, data for 1955-2023

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