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Q1 2021

European Equity Barometer

Insights from the Fundamental Equities Team

At the very core of investing, active investors buy securities for one of two reasons – either they believe that the market is wrong on the future earnings expectations of a company, or wrong on the valuation ascribed to those earnings. We believe for many European sectors the market may be wrong on both, and see 2021 as having all the ingredients required for a strong year of earnings upside surprise.

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Head of European Equity Team

Europe has the ingredients required for a strong year of earnings upside surprise

Inflation is likely, but not all parts of the market can command pricing power

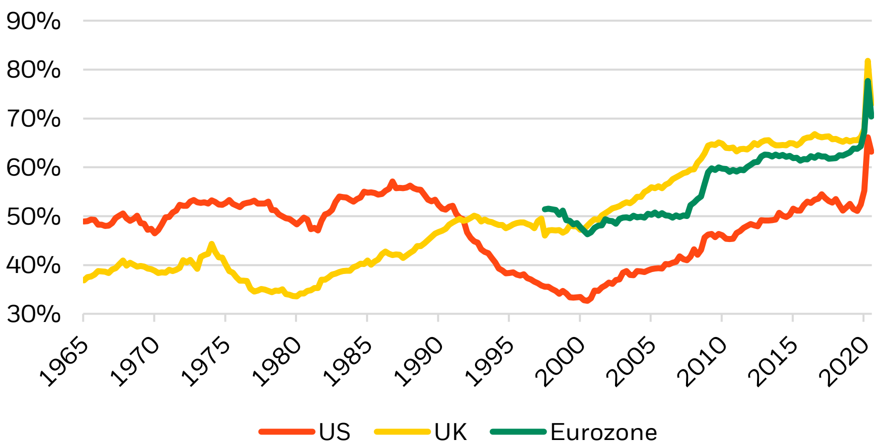
Rates are likely to remain low while European dividends may recover meaningfully

Market overview and outlook

In a tumultuous year, European equity markets ended 2020 with relative strength. We see this strength persisting into 2021 aided by better virus testing capabilities, a successful vaccine rollout and a resilient global consumer, alongside continued accommodative policy. Recovery will not be equal across all sectors: some still lack pricing power and are unable to reinstate dividends; others, however, such as travel exposed stocks, could see a meaningfully brighter 2021. Inflation may be on the horizon, but rates will likely remain low. A period of prolonged negative real rates and higher nominal growth is needed to allow governments globally to work their way out of the post pandemic debt overhang. We see this as being a supportive backdrop for equities.

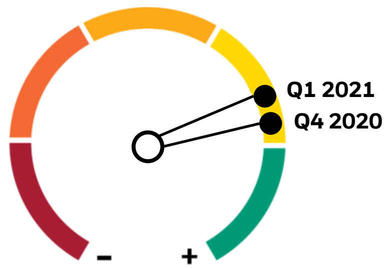
Aggregate consumer resilience

Household bank deposits (% of annualized GDP)



Sources: Federal Reserve Board, Bank of England, ECB, December 2020.

Conviction gauge



We have devised a schematic to illustrate the current strength of our conviction and how that has changed since last quarter. Far right is the strongest, or most positive, reading and far left the weakest, or most negative, reading. The middle position equals neutral.

1 Ready for take off

The positive phase III trial news delivered by vaccine manufacturers thus far has lifted sectors of the market which have suffered a torrid 2020 as a result of Covid-19 and associated lockdowns. While parts of the market may already have priced in the much awaited light at the end of the tunnel, there remain, in our view, numerous segments which have further to run.

Take travel as a good example, where the industry body IATA estimates that passenger traffic in 2021 will still be less than half of 2019, and won't recover to previous levels until 2024. Better virus testing capabilities, a successful vaccine rollout and a resilient global consumer are just three reasons we think this assumption set is eminently beatable.

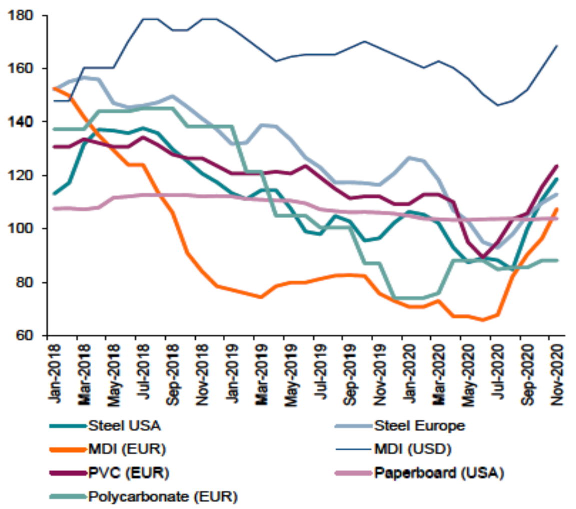
We have exposure to travel through aerospace engine manufacturers, such as Safran and MTU. These are companies with strong, and improving, market positions through large installed bases of engines that can generate significant cashflow as travel re-accelerates. Beyond that however, their new engine programmes are also key to helping the airline industry meet their carbon reduction goals. With potential to meaningfully improve fuel efficiency and carbon emissions, we can see strong demand for new engines whilst older, competitor engines are retired. Adding in the effects of cost cutting and freight exposure, we see these businesses poised for a brighter 2021 and beyond.

2 Inflation?

Following the Covid-19 crisis we see certain sectors experience supply and demand imbalances, which are leading to pricing pressure, as illustrated in the figure below. As we recover over the next two years, significant pent up demand, combined with supportive monetary and fiscal regimes could support higher prices. What does this mean for equity markets? We think the answer is more nuanced than what traditional economic theory would teach us.

For one, central banks intend to keep rates relatively low remain, as government debt has grown. This is a positive support for equities.

Rising input costs



Source: Exane BNP estimates, December 2020.

A period of prolonged negative real rates and higher nominal growth is needed to allow governments to work their way out of the post pandemic debt overhang.

Secondly, pricing power is not a universally enjoyed concept in the European market. As before the crisis, we can still identify many industries without pricing power, and in some cases Covid-19 has only acted to accelerate pre-existing deflationary trends.

Telecoms remains a clear example of this. Despite the huge cost and time investment in 5G roll out, our conversations with CEOs have told us the opportunity to monetise this investment remains elusive. Sweden, which is arguably the best telecoms market in Europe, is the only one to try buck this trend.

We therefore believe the low rate environment continues to support equities, whilst the nuances in pricing power for each industry and company call for selectivity.

3 Outlook for dividends

The outlook for dividends is also positive, albeit that investors will need to be selective to avoid value traps.

Top down forecasts suggest dividend payments should increase by c. 20% y/y in 2021, and by another 10% in each of 2022 and 2023 (Barclays, Markit, Dec 2020). However, this bullish outlook masks significant divergences: for instance, the energy sector, which historically represented a significant dividend pool, is facing structural challenges and will be unlikely to recover to previous levels in the foreseeable future.

We see attractive opportunities in the insurance industry, where selected names are benefitting from lower Covid related underwriting losses and higher pricing alongside a positive environment for investment books as credit spreads tighten and equity markets move higher. Balance sheets look over-capitalised, paving the way for distributions to shareholders in 2021.

Despite long-term headwinds for banks, solid capital ratios and low loan losses suggest further upside to share prices as well as the potential for a resumption of dividends following a relaxation of restrictions from regulators.

We're also optimistic about the prospects for companies in the utilities sector which are powering Europe's green transition. Investment in renewables capacity has led to durable earnings growth and high cashflow predictability which should result in resilient and growing income streams.

Investment learnings for 2020: integrating alternative data

Whilst BlackRock's journey with alternative data goes back decades with our quantitative focused colleagues, the process to truly embed it into our fundamental teams' investment process began only a few years ago. The advent of the Covid-19 crisis, and the lack of visibility management teams face throughout 2020, has brought home the importance of supplementing our fundamental insights with data.

Alternative data refer to any non financial or traditional sources of information that can be used to obtain insight into a company or an industry. This may include credit card transactions, social media posts, geolocation data (foot traffic), online web-browsing, price trackers, and since the Covid-19 crisis, ICU capacity. These data are not intended to be the key driver of an investment decision, but help us assess near-term risk and opportunities prior to company earnings updates. They also deliver unique insights on consumer behaviour, company strategy and a means to challenge or validate company management statements.

Important indicators in 2020 have included data tracking credit card spending, particularly in Asia via Union Pay credit card processing data to assess the consumer's propensity to spend as lockdowns were lifted. These data indicated strong acceleration of in store spending, particularly for key luxury goods brands, as illustrated by the figure below for China, helping underwrite our conviction on this area of the market.

Equally, the tracking of virus dynamics and mobility data, alongside trucking miles driven has given us a strong indication of potential for cyclical recovery which our portfolios leant into throughout 2020.

Where next for alternative data?

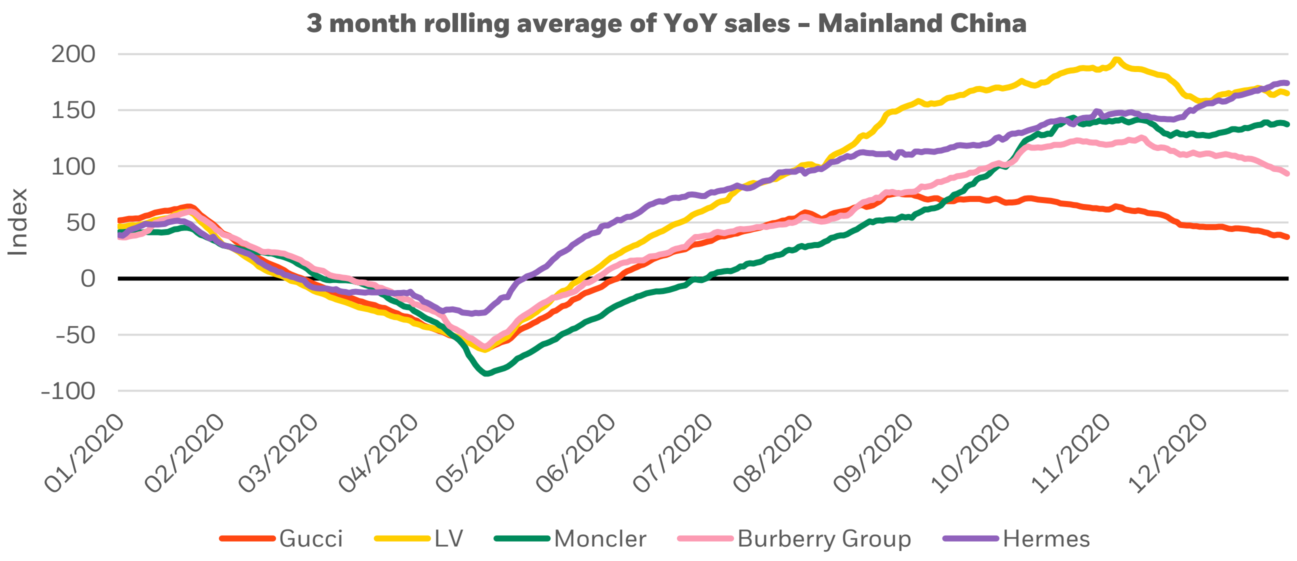
The pandemic still hangs over us and management visibility in many cases remains lower than usual. We intend to use alternative data to understand what trends that have arisen because of, or have been perpetuated due to Covid-19, are here to stay.

Thus far, data continue to show strong spending for electronics sales, online media, gaming and home renovation. However, in those periods restrictions have been lifted, we've seen a strong propensity to spend on the likes of bars and restaurants. This may indicate spending patterns quickly shifting back from goods, and towards experiences and services as economies normalise in 2021.

To further understand the potential for recovery in travel, for example, data on holiday searches and ticket prices are firmly on our radar. Since the release of Pfizer's Phase III vaccine trial data, the trend for searches has been positive, but not yet meaningfully accelerating. For ticket prices, it may still be too early to tell, but thus far advance prices printed now for next year look more robust than expected.

Understanding the outlook for the UK economy post Brexit and the investment opportunities it may hold is also paramount. Even into December 2020, data on consumer interest in UK homebuilders have been robust with visits and online searches accelerating. Following this trend post the removal of the stamp duty tax break could provide an indication of consumer sentiment as well as the resilience of foreign interest in UK investments.

We strongly believe using this data to supplement our fundamental understanding of companies can help challenge our thinking, underwrite our convictions and sharpen our investment edge in a rapidly changing investment environment.



Source: BlackRock FAE Alt Data, December 2020. Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy, and should not be construed as investment advice or investment recommendation of those companies.

Fundamental Equities

Expert insight

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Purpose	Active edge, sustainable outcomes
Perspective	Astute, diverse, panoramic
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