Is it too late to invest in healthcare and tech?

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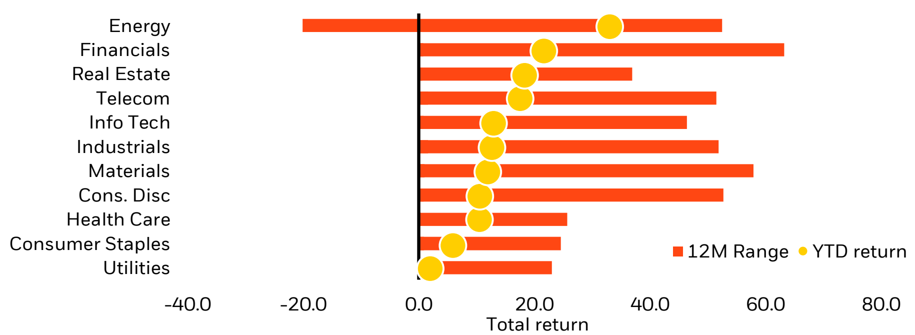
Despite a challenging economic backdrop the last few quarters, equities have performed strongly and companies have been putting up solid numbers. As the activity restart continues, however, we're seeing a new set of obstacles including percolating inflation and supply chain disruptions. Likewise, "COVID-winner" sectors like tech and healthcare have been more challenged in recent months, and investment flows into them have tapered off. Have we reached the end of the road for the strong performance of these sectors?

Our BlackRock experts believe there is still room to grow, and our outlook on equities remains constructive relative to other asset classes – but less so than in previous quarters.

Assets in review – still room to run for tech and healthcare?



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of June 10, 2021. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are, in descending order: spot Brent crude, MSCI Europe Index, MSCI USA Index, MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), spot gold, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

Healthcare

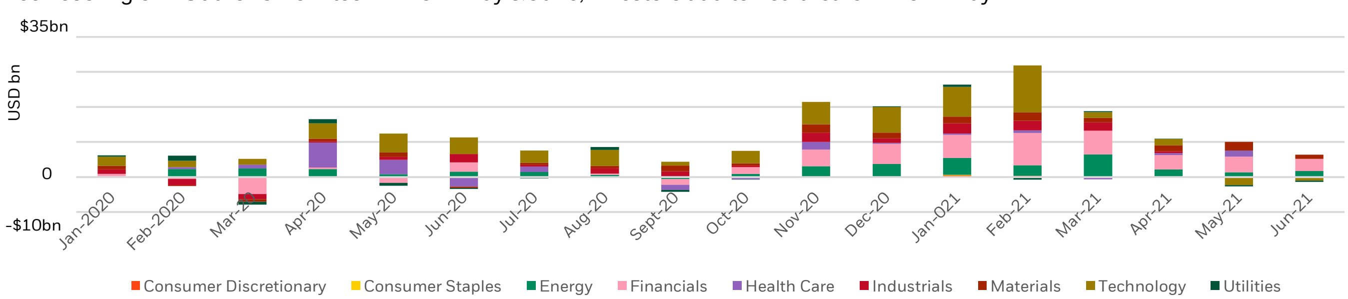
We remain constructive on healthcare as a structural growth sector and from a near-term valuation perspective, supported by long-term drivers of aging populations fueling an increasing demand for healthcare, as well as increased innovation and efficiency in the bio-tech industry. Last year was an unprecedented one for healthcare, and while many companies experienced short-term setbacks we don't forecast any slow-down in demand going forward.

Technology

Technology was the best performing sector last year and has demonstrated sustained outperformance. External factors like rising interest rates may be putting a temporary pause on the sector momentum, but technology is at the structural core of every industry – and something the global economy can't function without. As in healthcare, we don't see a scenario in which demand for technology decreases over the medium- to long-term.

ETP sector flows Jan 2020 – June 2021

Tech cooling off? Outflows from tech ETPs in May & June; Investors add to healthcare ETPs in May



Source: BlackRock and Markit data, 11 June 2021

Contributors

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In conversation with

Isabelle Mateos y Lago, *Global Head, Official Institutions Group*

Is it too late to invest in healthcare and tech?

Isabelle Mateos y Lago (IML): Kate, what have you learned from Q1 earnings season? And what's your outlook through the end of the year?

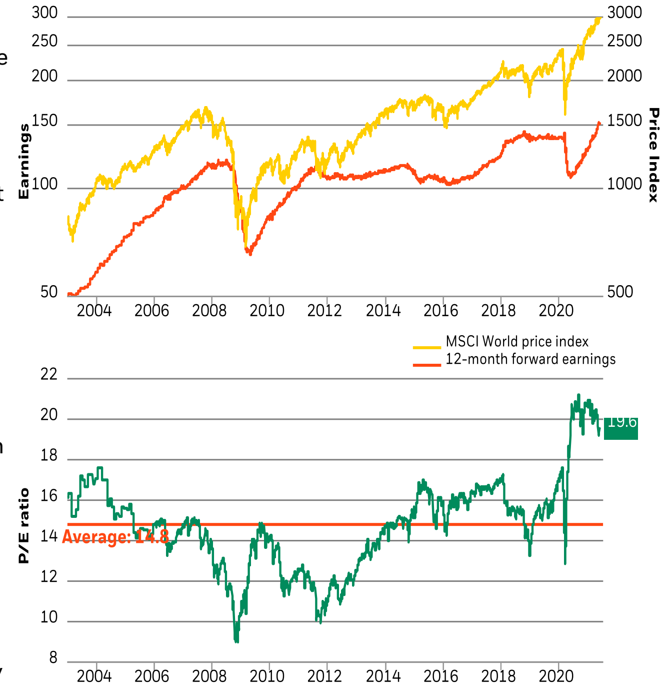
Kate Moore (KM): It was an exceptional quarter and very unique because of the comparisons to Q1 2020 from when most of the world was locking down or locked down. With close to 50% year-over-year growth, earnings were outstanding globally and particularly in the U.S.

Three observations round out the story for Q1 earnings reporting:

- Ex ante positioning matters: while we saw some incredible numbers, not everyone was a winner – in fact, most winners were not rewarded by the market with higher stock prices. There was a bit of a gap between some published forecasts and what buy-side investors were expecting, and equity markets had moved in advance of earnings releases. For the most part, investors are already long equities, so there wasn't much room to add even for some of these companies that are posting great numbers.
- Looming inflation: we've seen aggressive cost control that resulted in impressive improvements and pre-tax margins for many companies, not just in Q1 but in H2 2020 as well. Now we're discussing percolating inflation, the sustainability of inflation, labor shortages, supply chain disruptions, and the challenges of the activity restart, whether in services or in the manufacturing sector. This leaves huge uncertainty for margins over coming quarters. We'll be watching very closely in H2 this year what margins look like, given these broad-based issues around supply chain and labor.
- Policy matters: whether its fiscal or monetary policy, policy has a significant impact on perceptions of earnings as well as the outlook for equities. Our research has indicated most companies weren't talking about policy changes coming down the pike or factoring them into their own estimates, however – so there is a bit of uncertainty around what the impact of policy will ultimately be.

With these considerations in mind, I expect we'll see even more upward revisions to earnings, even in a period where the market is range-bound. Across the whole spectrum of assets, from rates and currencies to credit and commodities, we still think equities have the most powerful and durable upside.

Price index and forward earnings continue upward trend, P/E ratios remain well above average



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Source: Refinitiv Datastream, MSCI and BlackRock Investment Institute, June 15m 2021.
Notes: The lines on the top graph are the components of the P/E rations on the lower graph since 2003. The P/E ratios are calculated using I/B E/S earnings statements for the next 12 months.

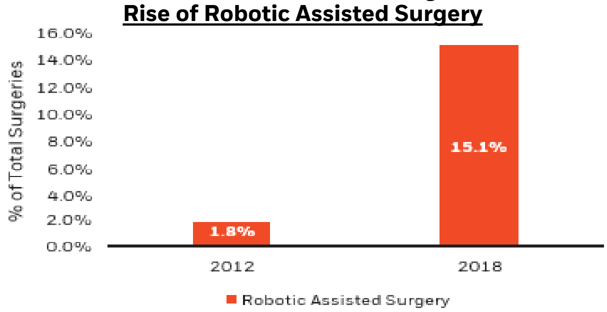
IML: Erin, if we look at Q1 earnings and performance over the last 12 months, healthcare has been somewhat lagging the broader market which seems counterintuitive in the middle of a global pandemic. Looking at things with a longer-term perspective, where are we right now in terms of the attractiveness of the healthcare sector?

Erin Xie (EX): We remain very constructive on healthcare, given our belief it's a structural growth sector supported by long-term drivers and developments. This makes the underlying companies very attractive from an active investment perspective.

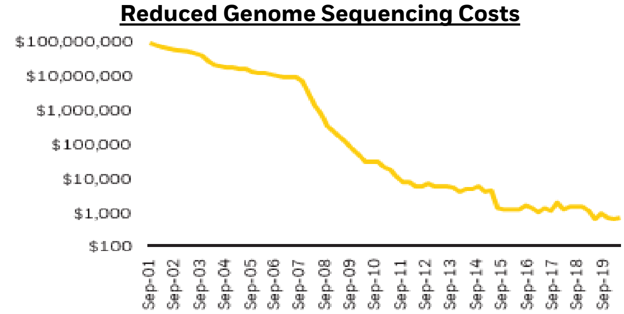
Innovations: We see a new wave of medicines being developed, from a decade of genomics research contributing to a better understanding of diseases to bio-pharma advancements in the drug development space. In bio-tech, we also see strong innovations in invasive surgeries and the incorporation of digital technology in medical equipment and diagnostic tools, enabling patients to have better communication with providers and allowing them to monitor their health in a more efficient way. We also see new business models being developed to address healthcare delivery and efficiency, incorporating technology.

Long-term structural tailwinds: Innovation

Rise of Robotic Assisted Surgery



Reduced Genome Sequencing Costs



Left hand chart: Jama Network, January 2020. Right hand chart: Source: NIH National Human Genome Research Institute, May 2020.

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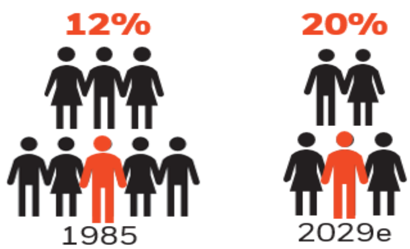
Demographic shifts: We see demographic shifts across the globe in all major countries and populations. If we think about the U.S., 1 in 5 people will be over the age of 65 – and Europe and Asia are aging too. This population shift will provide strong demand growth for healthcare, as an elderly population consumes more healthcare than a younger one. In Emerging Markets (EM), there's a significant gap in healthcare spending compared to Developed Markets (DM). There's significant demand growth from EM economies, however, and we think healthcare spending will outpace economic growth in these countries over the coming years and decades.

Long-term structural tailwinds: Demand growth

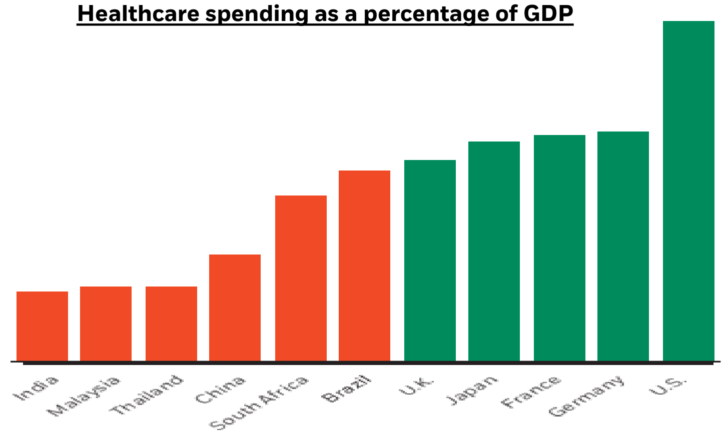
Proportion of population 65+



3x
Spent on healthcare when 65+ years vs <65 years[2]

20%
Of the U.S. population will be 65+ by 2029[1]

Healthcare spending as a percentage of GDP



Source: (1) World Bank data and estimates, current as at February 28, 2021. (2) Deloitte 2019 Outlook for Healthcare (3) The World Bank, Current as at February 28,2021, basedon 2018 expenditures. For illustrative purposes only. There is no guarantee that forecasts made will come to pass.

Regarding relative performance over the past year, the health crisis was an unprecedented time with many healthcare companies experiencing near-term setbacks, such as cancellations of elective surgeries. There's also the inflation concern – but when we think about healthcare, we tend to focus on long-term demand, which we don't think would be impacted by an inflationary environment. Valuations are very attractive relative to the market, as healthcare multiples are below the long-term average: this underscores why we think healthcare is attractive from a near-term valuation perspective as well as a long-term structural growth perspective.

IML: Tony, the tech sector has been the darling of investors for some time now and even more so since the pandemic started and has done incredibly well. Is it too late or is it still a great time for loading up on the tech sector?

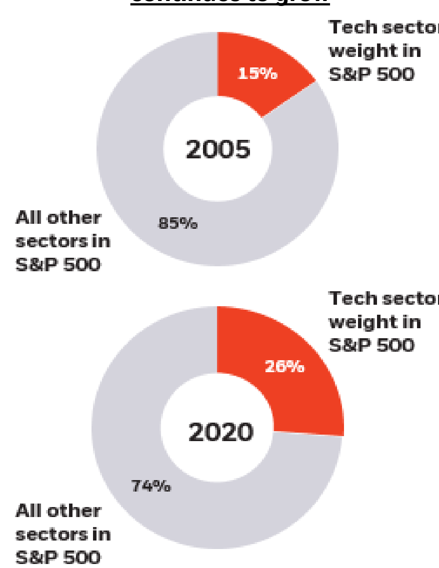
Tony Kim (TK): I've been asked the question about whether it's too late for tech for the past ten years; seemingly the answer every year has been no, it's not too late. After a stellar 2020, however, we seem to be taking a pause – though we're not expecting this pause to be long-lasting.

The technology industry has been the best performing not just last year, but over the last 5, 10, 15 years; it has been a systematic structural industry that's gone from 20% of the S&P to nearly 40% over the last 20 years. The centerpiece of all of this is that structurally and fundamentally, this is an industry that is a horizontal enabling tool made up of two components: code running on the chip, and software running on silicon. With a given business model you build a product, app, or service, and through applying this horizontal technology you promote and create new businesses attached to every industry. As a result, the tech industry's horizontal enablement has become like a predatory animal, attacking industries one by one and allowing it to double in market cap. It now affects and influences every sector on the planet – no company can function without software, and what we saw with COVID-19 was the proliferation of these tools into every single facet of the economy.

To me, the best measure of whether it's too late to invest in technology is the pace of change. If the pace at which the world and industries are changing is slowing down we will see less innovation. Then we don't invest in tech. But if you think the world is continually going to change at a rapid pace, you need these horizontal enabling tools. The rate of change, particularly over the past 10 years, has accelerated to a pace we've never seen before. In this kind of environment, regardless of GDP or macro outlook or inflationary environment, the technology sector will do well over a long-term time horizon.

Growing importance of tech is reflected in equity markets

Tech's market share in broad equity indices continues to grow



Source: Morningstar, FactSet September 30, 2020. For illustrative purposes only.

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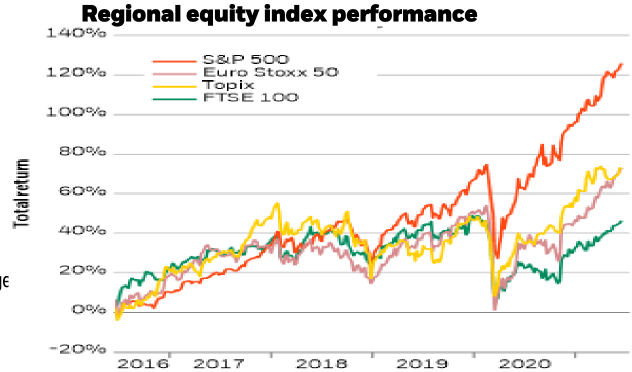
IML: The sector is very diverse, and it is challenging to think about valuation holistically. Having said that, we're almost certainly heading into a phase of rising interest rates. We don't know exactly when it will be, but we are confident this is the direction of travel. Does this impact the way you're thinking about the sector?

TK: On a tactical basis, yes. We've adjusted to this new reality in terms of portfolio composition for the higher-rate environment. The market is not paying attention to interest rates for long-term cash flows of cyclical companies, but eventually all companies have long-term free cash flow valuations. We consider this through a lens in which value is captured in the longer duration and we adjust to higher discount rates, which is the current tactical reality. A rising rate and inflation environment will hurt growth companies, but ultimately it will hurt everyone because everyone is going to be based on a long-term cash flow. Ultimately, you're starting to see these valuation gaps: if the gap between value and growth tech was huge last year, now they've reversed year-to-date. At some point, I don't know when, we're going to determine this 150% growth in the cyclical rebound is not 'real' growth. That's a once-in-a-cycle kind of growth.

IML: Lets pivot now to geography – this is not strictly a U.S. conversation. Kate, you tend to like U.S. markets better than others – is this the case now as well despite richer valuations, or do you see better opportunities in other parts of the market?

KM: When I think about positioning from a global equity perspective, it's more about choosing the best and most exciting industries. I favor a barbell approach, with a significant portion of equity allocations in the U.S., and then a fair amount from China and other parts of emerging Asia where we see durable and dynamic growth. In Europe, I believe we need to be selective in choosing high-quality companies that have flexibility, are competitive relative to their peer group, and are forward-thinking, as opposed to an index approach.

Regional equity index performance



Past performance is not a reliable indicator of current or future results. Indices are unmanage and do not account for fees. It is not possible to invest directly in an index. Source: Refinitiv Datastrea, chart by BlackRock Investment Institute, June 15 2021. Notes: The lines show the performance of each index over a 5-year period. The index performance is in local currency.

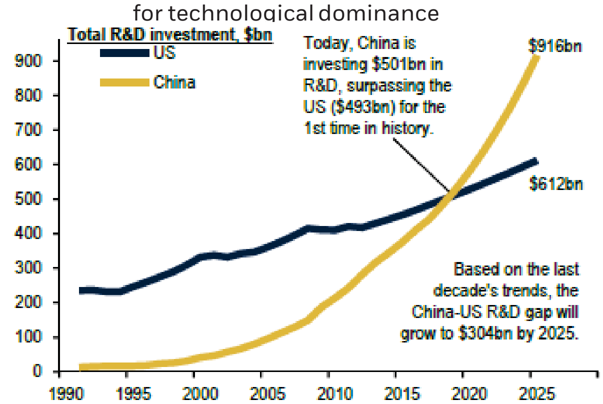
IML: Erin, Tony, where do you see the highest-growth markets in healthcare and tech?

EX: The highest-growth part of the market will be companies that are the most innovative. For the time being, we've seen the U.S. as the leader in healthcare innovation in medical technology and bio-pharma – but China is catching up. From a demand growth perspective, the U.S. and Europe are already mature markets, so we'll likely see stronger growth in EM. I'd expect a large market like China will continue to see strong growth.

TK: In technology some new things have come to light, which I believe ultimately favor the U.S.:

- U.S.-China tensions are centered on technology. China has realized their vulnerabilities where they were not owning or controlling certain technologies necessary to be an economic superpower. This creates a new 'cold war' of trying to control foundational technologies around semiconductors and software.
- Chinese tech companies are being subjected to tremendous anti-trust scrutiny, which are having a significant impact compared to the what US tech giants face in this respect.
- The GDP growth rate differential between the U.S. and China has significantly declined, diminishing the allure of China. In fact this is the case with a lot of EM, which begs the question of what exactly is the appeal?
- A lot of the cutting-edge foundation for new technology is still centered in the U.S. While China is catching up in certain areas, it still lags in others – and the rest of the world is far behind them.

The decoupling of globalized supply chains continues to intensify, as the US and China compete for technological dominance



There is no guarantee that any forecasts made will come to pass. Source: BofA Research Investment Committee, OECD.

IML: What are the key risks on the horizon that would change your outlooks?

KM: I think the hot debate right now is on the durability of inflation. We've acknowledged we're going to get higher inflation and rising prices across a variety of industries, but I think a big risk would be if this doesn't turn out to be transitory, and we need to resort to recalculating risk and opportunity sets for U.S. and global companies.

EX: Regulation is always a risk for healthcare, though given the government makeup we're not realty expecting drastic legislative changes right now. Another risk would be a new COVID variant that's unresponsive to current vaccines, forcing R&D to start from square one.

TK: The risks are out of our control, like inflation duration – which has the capacity to change the regime of investors' mentality and what they're interested in. My other concern is geopolitical risk around Taiwan, the epicenter of the global technology supply chain. I think regulation is a risk in China, but less so in the U.S.

Risks

Risk Warnings

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