BlackRock

Q1 2022

European Equity Barometer

Insights from the Fundamental Equities Team

European markets rose to record highs in 2021, supported by a cyclical rebound, positive earnings revisions and accommodative policy. All sectors of the MSCI Europe Index generated positive returns, highlighting the impact of the recovery backdrop. As we head into 2022, we see growing need for selectivity as some tailwinds begin to fade.

Tailwinds are fading, 2022 should bring greater market dispersion

Inflation remains, but underlying drivers in Europe remain transitory in nature

Real rates are influencing markets short term; pricing power is more important over the long-term

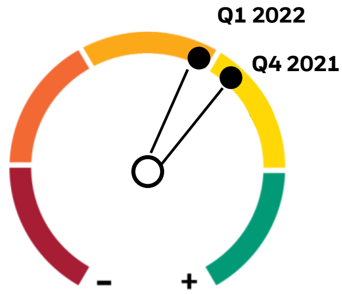
BlackRock's Fundamental European Equity team
20 Investors
1 Data scientist
> 230 years of experience

Market overview and outlook

In a year where both financials and technology led markets, there was, overall, less dispersion between sectors than perhaps we've seen historically. As macro tailwinds fade, we see greater need for selectivity in 2022.

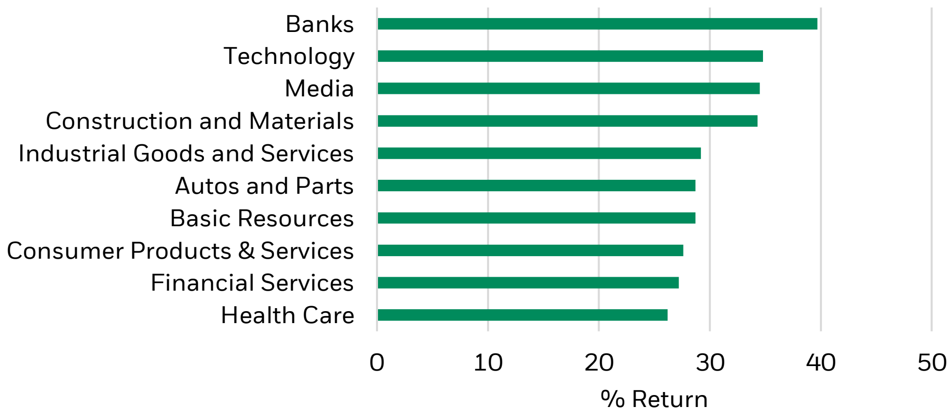
Market volatility remains elevated, with expectations on rates and inflation driving near-term moves. European stocks are impacted by US rates, and the market has priced in a rate hike cycle for 2022. Equally, we note with interest a flattening of the US yield curve, which suggests that any US hiking cycle is likely modest in nature. We see the market dislocations created by these episodes as opportunity. Companies with pricing power, more resilient supply chains and strong management teams stand in good stead in this environment.

Conviction gauge



We have devised a schematic to illustrate the current strength of our conviction on the market 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.

All boats rising: 2021 offered broad market opportunity
Stoxx 600 Top 10 sector performance in 2021



Source: BlackRock, Bloomberg January 2022. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** You cannot invest directly in an Index.

1 Inflation: weighing up wages

Inflation, despite original beliefs it was transitory, remains with us. As, however, do many of the Covid-19 induced reasons for it, including continued disruption and the impacts of government stimulus programmes. We are therefore still of the belief that inflation will likely peak and normalise in Europe over the year. We argued in a previous edition of the Barometer that wage inflation, and the expectation of continued wage increases, were a key component required to drive more persistent inflation. Wage inflation certainly exists in some corners, but in Europe it is not widespread, or seemingly baked into expectations. In Germany for example, we are already seeing deceleration of wage growth from close to 3% to 1.5%. Interesting to note are the negotiations of the Verdi trade union, who struck a 2-year deal with German state governments, offering a one off bonus and 2.8% second year wage increase, at the same time as inflation surged to 5.2%. By the time other sectors come to negotiate new wage contracts in late 2022, headline inflation will likely have dropped. We therefore see wage pressures but expect it to remain modest.

This less flexible labour market, alongside different government stimulus packages through the pandemic, and less evidence of a "great resignation" mean Europe's wage bill is more under control than that of the US. For our portfolios, we have little exposure to labour-intensive businesses with significant wage pressure.

2 Sticking with Semis

Strong performance in the European Technology sector in 2021 was led by the Semiconductor industry. Supply shortages abound and rampant demand from broad end markets amplified pricing power and saw volumes surge. For a historically cyclical sector, market commentators have been keen to call the peak many times over the last six months. While there is potential that volume growth in certain end markets may be slower year-on-year, and inventories may have built up in some supply chains, we still believe in the long-term earnings power of companies within this sector.

With rapidly evolving technology, we must consider not only volume growth in end markets, but uplift in content. Electric Vehicles for example require between 5-7x more content than a traditional combustion engine.

This led to semiconductor growth within the auto market of 25-30% in 2021, despite production only growing by 1%. Whilst some of this is down to mix-shift, more higher value cars were produced, a good portion is from content uplift.

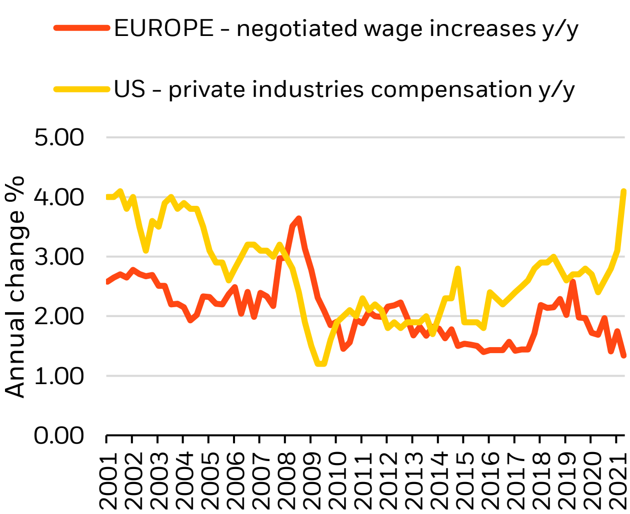
In our portfolios, we have a preference for equipment makers, rather than chip manufacturers. These businesses, to our mind, are going to benefit from less cyclical, and more structural growth as demand for both memory and logic grows across a broadening end market. These companies have enjoyed not only volume growth, but significant pricing power. Notably, ASML's next generation lithography machine, HNA, will start taking orders this year at a price tag around US$300m per unit, this is a >US$150m uplift from the previous generation of technology.

3 Careful on consumer

We believe that the consumer remains broadly resilient as we enter 2022. Excess savings accumulated during the pandemic remain at least partially intact, and as noted, certain jobs are enjoying healthy wage increases. Our portfolios remain exposed to high-quality luxury goods companies where we still see potential for long-term growth under highly impressive management teams. We are, however, growing more cautious of areas of mass market consumption, and companies with thinner margins, particularly within the UK. A confluence of factors, from inflation, to interest rate hikes, to soaring energy costs and a pending tax rise may cause a year of squeeze in this market. The energy cost problem for consumers, despite generous subsidies in some markets, extends to Europe also. The average consumer in Europe may face a >EUR600 increase in utility bills in 2022. This makes us more cautious on certain areas of discretionary consumption.

All $ figures are in USD.

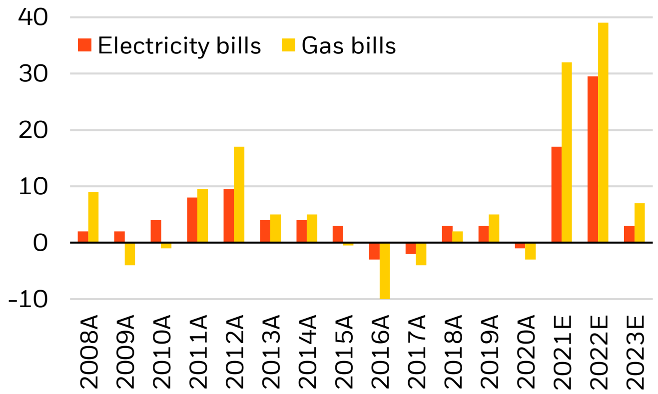
European wage pressures are benign



Source: ASL ltd./Eurostat/US BLS/Refinitiv Datastream, December 2021

Bills on the rise: domestic energy costs for Europe

YoY underlying change in domestic energy bills, average for main European countries - Consumer electricity and gas bills likely to rise significantly in 2021-22E



Source: Eurostat (up to 2020), BofA Global Research estimates (2021+). Calculation excludes government surplus. Forecasts made may not come to pass.

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Growth, Value and a rising rate environment

European stocks are clearly impacted by US rates and the market is pricing in a rate hiking cycle in 2022. Equally, we note with interest a flattening of the US yield curve, which suggests that any US hiking cycle is likely modest in nature. With this in mind, our portfolios are typically positioned towards higher quality businesses, with lower levels of debt, structural drivers to demand, and with clients that themselves are not overly levered.

The onset of 2022 has already seen powerful market moves, in thin January market liquidity. However, we see these moves as a top-down market issue as strategists perpetuate a trade of low value stocks. The point at which we've historically looked to add deeper value and cyclicals to our portfolios is when the companies within this segment are reporting trough margins and a pathway for recovery. We've already seen margins for many cyclical, value businesses recover strongly over the course of the last 12 or so months and this is reflected in consensus not just for this year, but also into the future. For example, Mercedes is forecast to have a >11% margin for each of the next 3 years, despite the fact in the last 20 years the company have only achieved over 10% twice, and we now have clear structural pressures on the sector with markedly shifting competitive dynamics, particularly within the Electric Vehicle market. We believe in a number of areas of the market that these companies have been over-earning versus historical margin profiles on the basis of supply disruption and favourable cyclical tailwinds (see chart below).

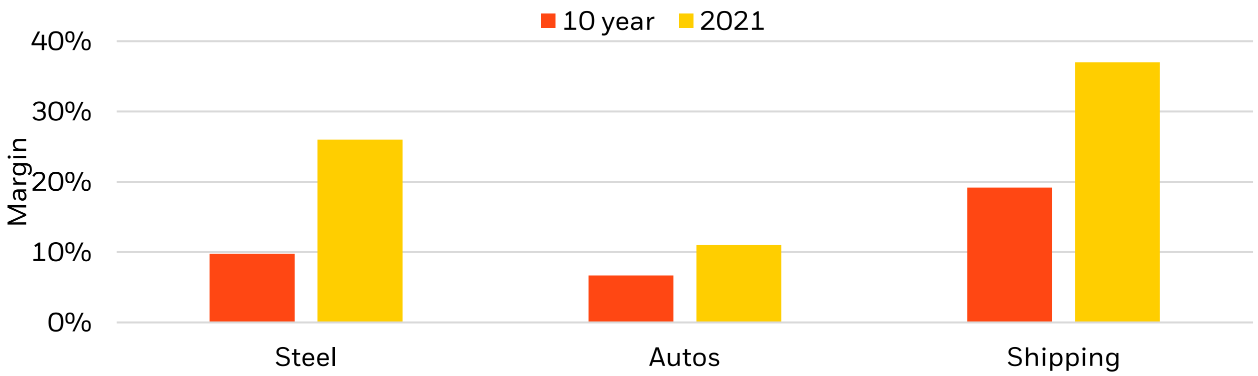
Equally, we do not see this as a time to buy European banks. Following a re-rating over H2 2020 and 2021, with the sector the top performer last year, we see very little value left. Whilst US rates may be rising at present, EURIBOR, the key rate for European banks, remains unchanged with no visible market expectations for a rate hike in the coming 12 months. Continued pressures of this interest rate environment on bank earnings is also compounded by lackluster loan growth, acute competition including pressure from FinTech firms, and cost inflation.

We do not believe we are entering a wholesale market regime shift with runaway inflation. The forces of disruption remain in place, which has caused greater friction in supply chains than we perhaps would have estimated. But ultimately, these factors remain transitory. Secular factors such as the high level of indebtedness in the developed world, ageing demographics as well as the deflationary impact of automaton and digitalisation on our economies, will have far greater bearing over any reasonable investment horizon.

At the same time, even despite near term inflation prints, we note with interest the US 10 year bond yielding just 1.7% (Source: Bloomberg, January 2022). We believe liquidity to be a key culprit here; US loan growth was close to 0% in 2021, against deposit inflow of +14%. Loan-to-deposit ratios continue to fall - we have now reached a point where for every $100 of deposits, only $60 is loaned to consumers and business (Source: Federal Reserve Economic Data). The essentially infinite Return on Equity that US banks can make by investing these excess deposits in the US 10-year, given the 0% risk-weighting applied, is too attractive to pass up. Thus, there remains a strong marginal buyer putting pressure on the long-end of the curve.

Rather than following narratives and perceived correlations, we believe at this point it is even more crucial to focus on company pricing power. We look to identify and invest in competitively advantaged businesses which have traits such as strong brands, attractive industry structures, or produce mission critical components for their customers. These traits enable these businesses to maintain pricing when demand is weak, or pass through higher raw material or input costs, or raise prices when demand is strong. In an environment where inflation presently remains high and cost pressures are growing, pricing power will be a differentiator.

Over earners: average margins in 2021 versus 10 year average



Source: BlackRock, Bloomberg, December 2021. Average margin based on 10 year history and current margin of key company within each respective sector.

Expert insights from the European Equity Team

Read Sarah Thomas' thoughts on European Health Care post an industry road show

Read Simon Hunter's thoughts on the impact of EV transition on Europe's OEMs

Fundamental Equities

Expert insight

People	Profound curiosity, deep conviction
Purpose	Active edge, sustainable outcomes
Perspective	Astute, diverse, panoramic
Performance	Long-term lens, risk-aware results

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