BlackRock

Q4 2021

European Equity Barometer

Insights from the Fundamental Equities Team

Following a period of market updraft, floating all ships higher, we see increasing need for selectivity. Near-term disruptions to supply chains, changing political narratives and tougher comps are all providing pause for thought. A focus on the longer-term outlook and astute attention on fundamentals rather than narratives can help investors navigate these market dynamics.

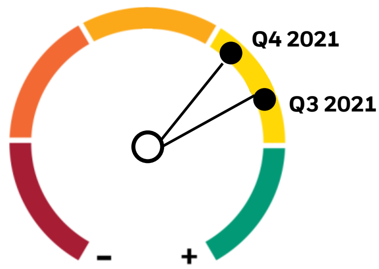
As the year-on-year comparison effect becomes more challenging, the importance of selectivity is rising

Luxury goods are down but not out. Policy change could create opportunity for growth

Rising power prices could cause further disruption, but also spur innovation

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

Conviction gauge



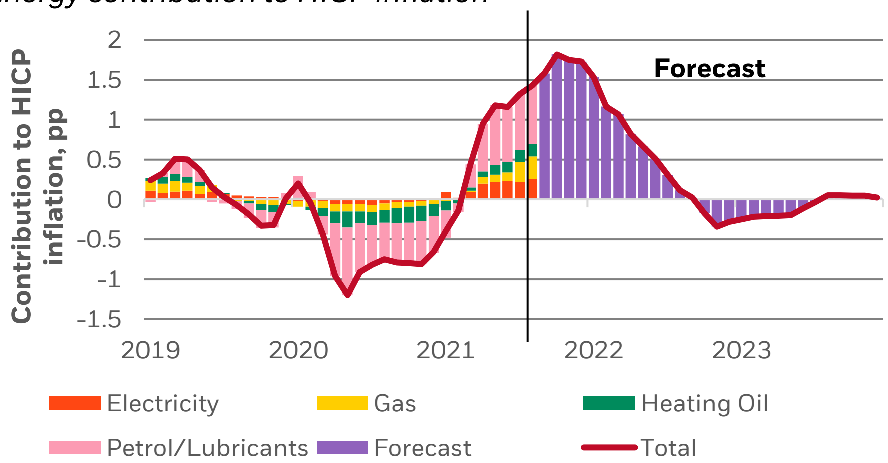
We have devised a schematic to illustrate the current strength of our conviction on the market and how that has changed since last quarter. Far right is the strongest, or most positive, reading and far left the weakest, or most negative, reading. The middle position equals neutral.

Market overview and outlook

The European market has moved higher year-to-date as earnings have recovered strongly on the back of improving activity, vaccine roll outs and easy fiscal and monetary policy. We believe that economic growth and aggregate market earnings still remain underpinned as we head into 2022, particularly with continued spending through the EU recovery fund, but raise caution on the most cyclical end of the market and the potential impacts of the rising power price. After a rampant recovery, we believe expectations, particularly for profitability, in some areas of the market to be overly optimistic. Here we look at the threats of continued disruption to supply chains and the inflationary consequences, what higher gas prices may mean for the market and society, and assess whether China's changing political rhetoric will weigh on Europe's darling: the luxury goods sector.

Power prices driving headline inflation likely have some duration, markets must consider second order effects

Energy contribution to HICP inflation



Source: BlackRock Investment Institute, Eurostat, Goldman Sachs. Note: forecasts are from Goldman Sachs

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1 Raw material inflation

Once again in our quarterly update we need to revisit inflation. The forces of disruption remain in place, which has caused greater friction in supply chains than we perhaps would have estimated at the onset of the year. This affect has been treated somewhat fairly by the market, with estimates for long-term inflation remaining muted, but has clear impacts for the market in the near-term. For many companies the effect of raw material inflation is typically lagged, which leads us to see growing threats to profitability in some areas of the market as we move into the close of the year. This is true of certain companies within consumer sector, such as HPC companies, as well as cyclical and industrials parts of the market, and becomes particularly acute when companies lack pricing power. In an environment where we may see a tougher comparison effect, combined with headwinds from raw material inflation, we believe selectivity becomes more important. Identifying pricing power, and robust supply chains which provide manufacturers of goods a competitive advantage in production, can offer opportunities for strong absolute and relative returns.

2 Production and pricing

Auto OEM's have thus far been beneficiaries of supply chain issues. A well highlighted shortage in semi-conductor chips has caused downgrades to production and upgrades to margins as the limited chip supply is directed to completion and delivery of the most premium cars. The IHS shocked the market in September however, downgrading car manufacturing volumes for 2022 to 83 million units from 91 million previously, pushing out the sector's recovery to 2023 (source: IHS, September 2021). This was substantial given the IHS' usual pattern of guidance, small and incremental, and because it may tip the balance from tailwind to headwind for OEMs, particularly as the market's expectations for their margins over coming years is already generous.

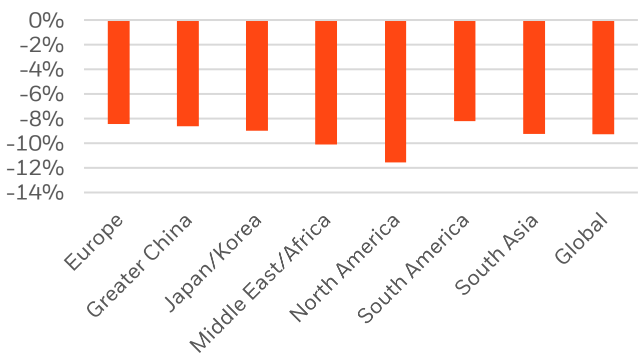
On the other side, auto semis companies continue to grow at a rate of 25-30% and foundries are providing more fabrication capacity for this industry. To our mind, the significant shortage experienced, not only for auto companies but computing, mobile, gaming device manufacturers and so on, creates an impetus to run higher inventory levels going forward.

This underlines the strength of demand we've so far been experiencing in semi-conductors, whilst comments from management teams of semi-conductor companies give us confidence on the discipline of capacity and pricing. Despite the great deal of strength these companies have seen in both demand and share prices over the last year, we continue to see further upside.

3 Limits on luxury?

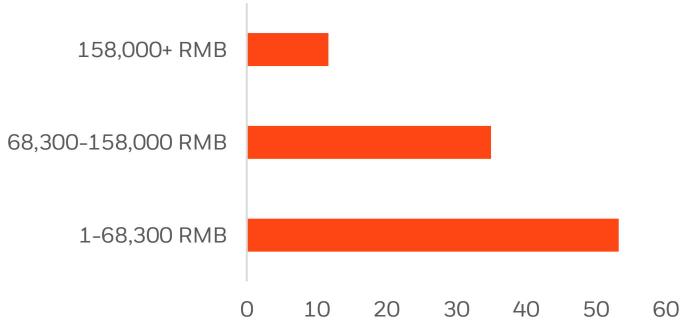
Chinese government rhetoric hit the European luxury goods sector through August as the aim for "common prosperity" raised fears of changing consumption patterns. This policy represents a change in motivation: from eliminating extreme poverty to promoting social equality. This shift hit the sentiment towards luxury goods, which have enjoyed around 70% of their demand growth over the last 10 years from China (Morgan Stanley, September 2021). While social equality under this regime may sound threatening to the future revenue prospects of these companies, we believe the actual underlying ambition of this policy, which is to double the size of the middle class over the next decade, could provide opportunity for growth. Most of the Chinese population are still from lower-income backgrounds (see chart below) and expansion of the middle class, not just uber rich, can provide meaningful market growth for luxury goods. Data shows that 69% of the middle-income consumers in China have purchased luxury jewellery in the last 24 months whilst 46% have purchased a luxury handbag (Source: Morgan Stanley Research, September 2021). This has been reflected in the results of companies such as LVMH, which recently reported over 40% organic growth in their fashion and leather goods business versus 2019 comparatives (Source: LVMH, August 2021). We believe that the structural drivers which have powered luxury demand growth in China remain intact, despite government policy change, and continue to see lower threat of disruption to consumption within luxury goods particularly because of the strong heritage the best-in-class brands exhibit. This spurs not only consumer desire, but superior pricing power too. In following the long-term trajectory of earnings and cash flows, and looking through short-term noise, we've retained our conviction in select European luxury goods companies.

IHS production downgrades for 2022



Source: IHS, Barclays, September 2021

Chinese population distribution by income (%)



Source: Bloomberg, Morgan Stanley Research. Annual household income

Power plays

Over the course of the past three months, European natural gas, carbon, and power prices have rapidly risen, with spot power prices in most European countries increasing more than 100% over the quarter and forward curves up over 60% during the same period (source: BlackRock, Bloomberg). While it is tempting to think that these moves will mean-revert over the medium term, there is credence to the view these elevated levels will persist for some time, with the tightness in the Natural Gas markets and limited supply of carbon (both inputs into the calculation of electricity prices) leading to a more sustained period of elevated prices, well into 2022. The market has witnessed some reaction to this dynamic, with the energy sector rallying into the end of the quarter, however we see more substantial and longer-dated impacts that could come to pass in the market.

European Utilities:

For those companies involved in power generation, the current higher power prices as we head into the winter heating season is causing concern for the affordability of consumers. While higher power prices in principle should drive upgrades for the generators, these extra profits may be viewed by some as a tax on the end customer, which given the regulated nature of most of the utilities companies, places them in the firing lines for potential government intervention. Spain has been the only EU country so far to introduce such measures, introducing a gas cap, carbon auctions and temporary electricity tax-breaks in order to smooth the impact of higher energy prices; essentially clawing back from the domestic generators the extra profits over a six-month period that result from the higher gas price. Not only does this result in a meaningful negative revenue and earnings impact for those generators affected, this action highlights the ever-present risk and subsequently the higher risk premium that needs to be applied to regulated utilities. The second derivative impact of this government intervention is a pause or even withdrawal of renewables investment from Spain, caused by increased uncertainty and lack of visibility in the current environment, as there is no guarantee that this emergency intervention won't extend beyond the proposed timeframe. We still expect the European utilities to experience secular growth given the vital importance of renewables investment to emissions targets; however this phenomenon is a set-back for the industry and dampens sentiment for Spanish exposed utilities in particular.

The social effect:

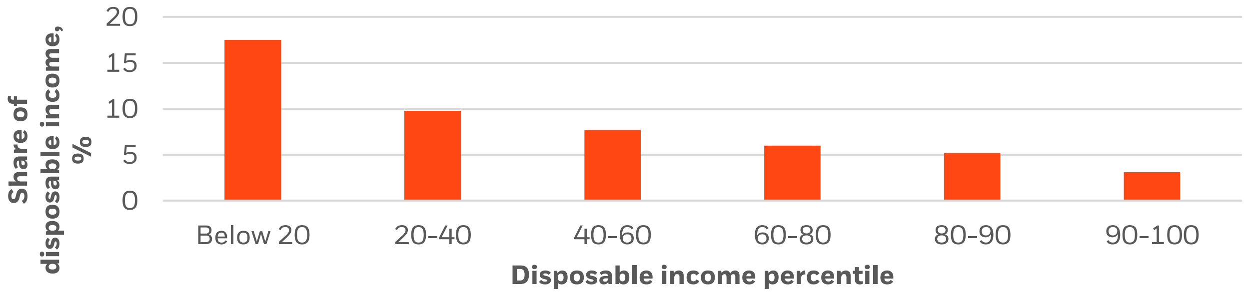
Rising gas prices and shortage of supply is also likely to force up coal demand in various parts of the world (China for example still generates 60% of its electricity using coal), as through the winter countries will opt to burn coal to generate power. This is not very efficient, and taking two steps back from the goal to decarbonize the world. This dynamic is one of many worrying factors, particularly when combined with concerns around social inequality (see chart on spending below), which have already been exacerbated in economies globally by the Covid-19 crisis.

This is a challenging proposition – how can we incentivise investment without penalising the industry that will enable the transition to net-zero, while at the same time protecting the wallets of consumers?

The underinvestment in these more highly pollutive industries (i.e. big oil, coal-closures, driven by sustainability motivations) mean we are less likely to see a supply response to the price increases (companies won't invest if the terminal value is zero), and so the cycle continues. Rather it is demand that must change, and consumers have to wake up to the real issues facing the climate and the individual responsibility to consume in more sustainable way.

This will not happen overnight, it is a multi-decade transition and Governments may be led to incentivize, or in some instances force, alterations in our patterns of demand to truly effect change. However, the magnitude of the price moves and the potential for a longer period of elevated levels may also stimulate further investment in, and development of, new technologies and methods to improve energy efficiency and support decarbonization, as long as the capital for these investments isn't all clawed back.

Share of household disposable income spent on utility bills, by income percentile



Source: BlackRock Investment Institute, ECB, Morgan Stanley, September 2021.

Expert insights from the European Equity Team

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Fundamental Equities

α Expert insight

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Purpose	Active edge, sustainable outcomes
Perspective	Astute, diverse, panoramic
Performance	Long-term lens, risk-aware results

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