BlackRock

Q2 2021

Taking stock

Market views from BlackRock Fundamental Equities

Embracing the bright side. So far 2021 isn't looking too different from where we ended 2020. But we see the second quarter bringing greater economic re-awakening, underpinning our constructive outlook for U.S. stocks. What do we see for Q2?

Economically sensitive stocks continue to lead	An opportunity to boost value positions	Bouts of volatility sparked by rate movement

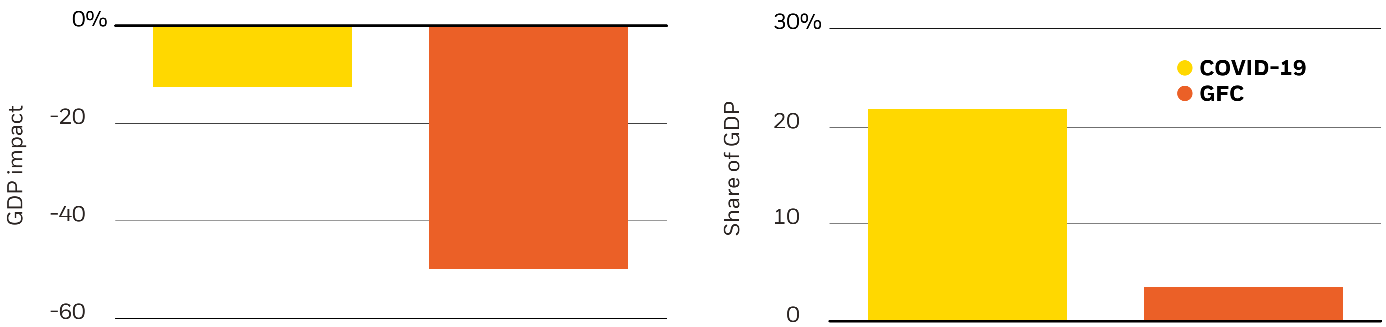
Stocks encountered volatility but powered ahead in the first quarter. Cyclical stocks — those sensitive to economic momentum — continued to lead, building on outperformance that began with positive vaccine news in November of last year. We see their strength continuing in the second quarter as economic signals point positive. For one, the new $1.9 trillion stimulus package adds to the unprecedented fiscal response, as shown in the chart below. Other growth propellants: Continued monetary policy support, an uptick in vaccine supply and distribution, and ample corporate and consumer cash waiting to be deployed. We think it makes sense to position for the start of a new and powerful economic cycle — while watching for signs of a downshift once the post-COVID bounce begins a transition to trend growth.

Tony DeSpirito
Chief Investment Officer,
U.S. Fundamental Equities

“The U.S. economy is being fueled on multiple fronts, making it very hard not to like cyclical stocks right now.”

A potent fiscal response

U.S. cumulative GDP loss and fiscal support, COVID-19 vs. Global Financial Crisis (GFC)



Source: BlackRock Investment Institute (BII), with data from Haver Analytics, March 2021. The chart shows BII estimates of the cumulative GDP loss from the GFC (2008-2009) and expectations for the COVID-19 crisis (2020-2021), and the discretionary fiscal support during each period.

What to watch in Q2

1. Interest rates

Recent spikes in bond yields incited mini taper tantrums in stocks, moderate versions of the 2013 market retreat when yields soared after the Fed hinted at a pullback in easy policy. Stocks may continue to react to rate moves, as low yields on bonds are a key contributing factor to the relative attractiveness of equities. Rising rates can undermine support for equity valuations.

Importantly, however, today's Fed is not contemplating near-term tightening, and interest rates are still very low on a historical basis. While future rate-related panics are likely, we expect rates to remain low for some time as central banks globally look to maintain support and see economies to full recovery. Ultimately, rates may only return to the average seen following the 2008 GFC, as we see no real structural changes in the economy that would suggest a growth trajectory far different from where we began. This is still a level that we would view as supportive of stocks.

2. Vaccine progress

Markets are priced for positive vaccine news, and while positivity is our base case, any disappointments in vaccine supply, distribution or adoption — or increased risk from virus variants — could stoke volatility.

The Biden administration has indicated the U.S. will have enough vaccines for all adults by the end of May. Our analysis of data from the three major vaccine makers suggests this is entirely feasible. Efficacy data shows the current vaccines are effective in preventing severe disease and hospitalizations, which is what is needed for economic re-opening. The variants are perhaps the biggest risk to the restart, yet clinical data has shown current vaccines demonstrate sufficient efficacy against the known mutations — enough to provide immunity and alleviate hospitalizations.

In addition, the technology used to make the vaccines means formulas can be quickly adapted. The major vaccine makers are ready with boosters once initial doses are administered. All of this gives us confidence that vaccination programs will continue to do the hard work of combatting the virus and facilitating economic and market recoveries.

We give cyclical stocks and reopening plays in general the advantage for the moment.

3. Company earnings

Fourth-quarter earnings strongly beat consensus analyst estimates as well as what was mostly conservative company guidance. We generally see the pattern continuing this year. Though that should be good for the stock market broadly, we don't expect real clarity on the earnings picture until the third- or fourth-quarter earnings seasons.

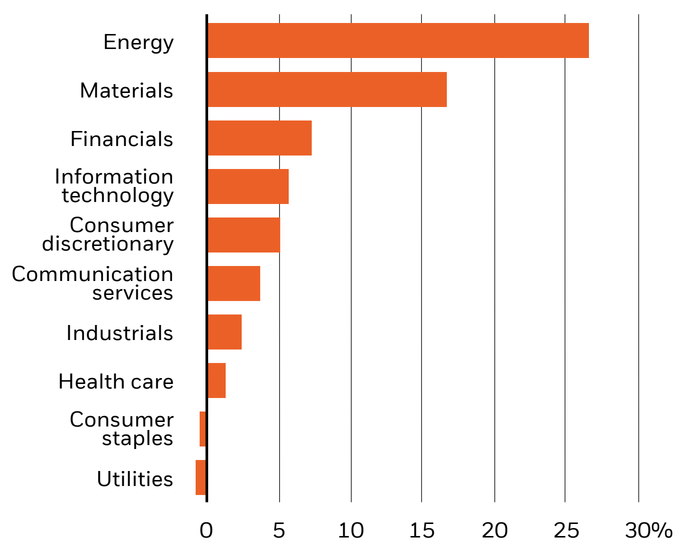
Economically sensitive sectors and stocks have the most potential to surprise to the upside, easily beating dismal prior year earnings. This is reflected in the earnings momentum chart below, which gives energy, materials and financials an edge. Growth companies that excelled in 2020 will find it much harder to exceed prior-year levels.

Many of the so-called stable sectors that did well in 2020 have poorer earnings momentum. Mega-cap technology stocks, long bastions of stability, also bore the brunt of the recent rates-related pain. Because these large tech stocks are long duration in their cash flow and growth prospects, they reap the greatest benefits from low rates and, in turn, have gotten hurt most as rates normalize upward.

We give cyclical stocks and reopening plays in general the advantage for the moment, while remaining watchful for signs of a cycle transition as the recovery moves forward — potentially returning the upper hand to growers.

An earnings edge for cyclicals

Three-month change in analyst earnings estimates, March 2021



Source: Refinitiv Datastream, MSCI and BlackRock Investment Institute, as of March 2, 2021. Chart shows the percent change in analyst earnings estimates over the last three months for the representative MSCI World sector indexes. **It is not possible to invest directly in an index.**

SPOTLIGHT TOPIC

Still time to stock up on value

Some call the recent rotation from growth to value outperformance transitory. We believe it may have staying power, making value stocks a formidable complement to growth in a balanced equity portfolio.

The benefits of a growth/value blend

We believe it's important to own both growth and value stocks in a portfolio, as a blend of the two investment styles has offered the most compelling risk/reward over time. Our research also reveals that growth and value are essentially anti-correlated: One generally thrives in an environment where the other lags, and vice versa. This means investors can build a more resilient, all-weather portfolio by incorporating the relative strengths of both growth and value.

Scope to increase value

While both growth and value extend benefits, portfolios may have room for greater value exposure. A BlackRock Portfolio Solutions (BPS) review of more than 18,000 advisor model portfolios at year-end 2020 showed 62% were underweight value.*

We believe now is a particularly good time to consider increasing value positions, as recent strength could have staying power not seen in years.

Shorter- and longer-term tailwinds

The key near-term booster is value's history of outperformance in the period rising out of a recession. Cyclically oriented value stocks were the most depressed in the COVID-driven downturn and, we believe, have more room to run in the recovery period.

In the longer term, we see a higher inflation regime as supportive of value stocks. While we don't see rising inflation as an imminent issue, it is a real risk in the medium term. The coronavirus crisis compelled the biggest global fiscal and monetary stimulus seen in the post-WWII era. Combined with pent-up demand accrued during lockdowns and consumer savings waiting to be unleashed, the risk for rising inflation is higher than it has been in decades.

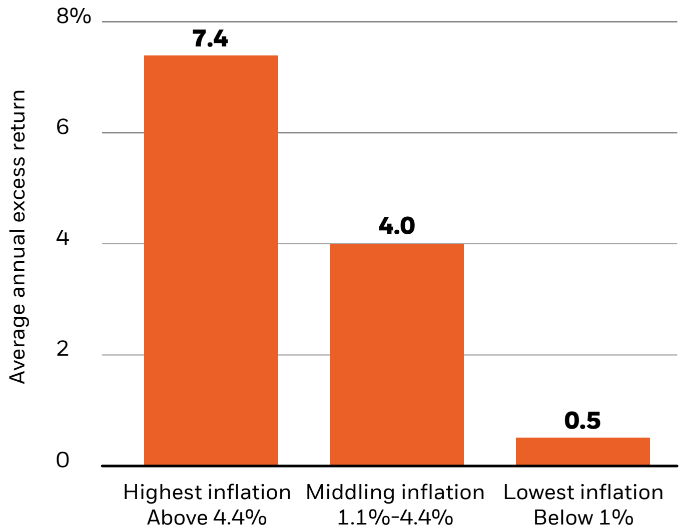
Value's edge amid rising inflation

Value equities have historically demonstrated greatest outperformance during inflationary episodes.

We looked at data back to 1927 and found value has outperformed growth by the largest margin in periods of moderate to high inflation, as shown in the chart above. It is only when inflation is very low that value performance pales — as evidenced in the past 10 years. Notably, it does not take runaway inflation for value to gain an edge. Value outpaced growth in the period of middling inflation, which ranges from 1.1% to 4.4%. This is more in keeping with our outlook this cycle versus the highest inflation periods that averaged 8.4%.

History of inflation fighting

Value outperformance by inflation regime, 1927-2020



Source: BlackRock, with data from the Kenneth R. French Data Library and Robert J. Shiller. Fama/French data uses the CRSP universe, which includes all companies incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ exchanges. The level of annual inflation is defined as the year-over-year change in the Consumer Price Index (CPI). "Lowest inflation" represents the bottom 20 years of inflation readings; "highest inflation" represents the top 20 years; and "middling inflation" represents the remainder. Value outperformance is annualized and calculated across various inflation regimes using annual data from 1927 to 2020. Value outperformance represents the performance of value stocks minus growth stocks, as defined by the Fama/French HML research factor (i.e., "high valuation minus low valuation" using book to price).

Actively managing risks

Whether focused on growth or value, we see an active approach as critical in the current environment where each presents distinct risks.

In the value universe, the key is avoiding "value traps" — companies that are cheap for good reason and unlikely to appreciate. In growth, the question is whether companies can continue meeting investors' lofty expectations. This means distinguishing between those companies that can continue to deliver earnings growth in a post-COVID world and those where demand was simply pulled forward during the pandemic, pinching future earnings potential. We believe navigating these risks well requires the expertise of a skilled active manager.

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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***** Based on a BPS analysis of the equity sleeves of 18,123 advisor models as of Dec. 31, 2020. Over/underweights are relative to the BPS Equity Benchmark (75% S&P 1500 Index and 25% MSCI ACWI ex-US Index).

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