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BlackRock

Stock market monitor

Q2 2024 equity market outlook from BlackRock Fundamental Equities

A supportive environment for stock selection. Several global stock markets have soared to record highs to start the year, buoyed by resilient economic data and strong corporate earnings. So where next for equities? As we enter Q2 we see:

Equity market momentum broadening to more areas of the market

The outlook for Europe and Japan rewarding active stock selection

Opportunities in smaller-cap stocks as economic conditions improve

Helen Jewell

Chief Investment Officer, BlackRock Fundamental Equities, EMEA

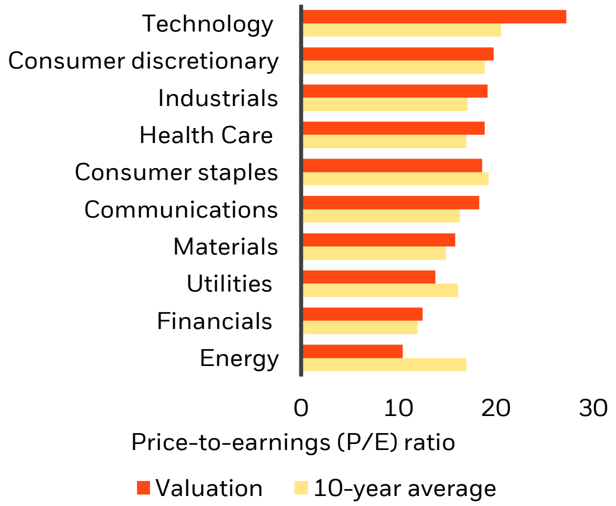
We believe equity market momentum can continue into the second quarter of the year – although returns may be more muted and across a broader section of the market. Inflation across developed markets such as the U.S., Europe and the UK has been on a downward trend, and this should give central banks the ability to cut interest rates. This would be positive for equities, in our view. However, we don't see a return to the "cheap money" era that followed the Global Financial Crisis (GFC), and we believe this will lead to a greater gap between the stock market winners and losers in a more alpha-centric investment regime.

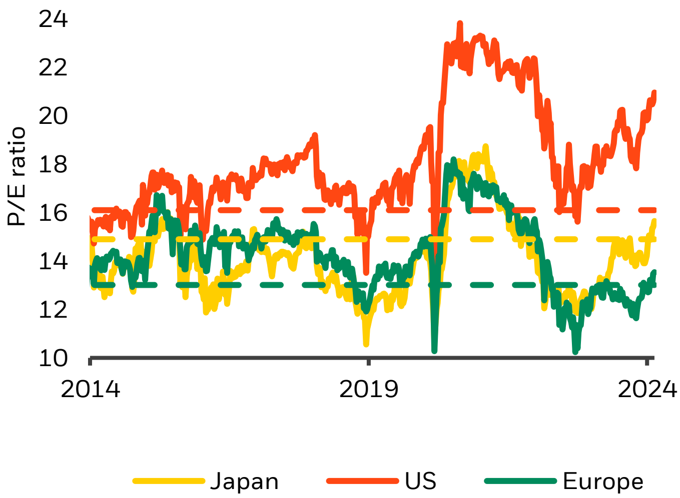
Technology-related stocks globally have led the way in 2024 – and for good reason. Some of these companies have delivered extremely strong earnings, powered by the mega force of digital disruption and artificial intelligence (AI). Yet valuations for these companies are lofty – as the charts below show. We believe potential rate cuts could lead momentum to broaden out to areas of the market that are cheaper, and also home to quality companies with attractive long-term earnings growth potential.

> “We expect the environment to remain supportive for stocks in coming months, but the leaders may come from a broader section of the market.

Lofty valuations for market leaders

Global sector valuations (left) and regional equity market valuations (right)





The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. An index is unmanaged and one cannot invest directly in an index. Source: BlackRock Investment Institute, March 07, 2024. The left chart shows the current 12-month forward price-to-earnings (P/E) ratios of MSCI sector indices (red bars). The P/E ratio measures a company's share price relative to its per-share earnings. The yellow bars show the 10-year average for each sector. The P/E ratios are calculated using I/B/E/S earnings estimates for the next 12 months. The right chart shows each market's current 12-month forward P/E ratio, based on MSCI indices. The dotted lines show the average for each region.

Mapping opportunities

Three reasons to consider Europe…

European equity markets have reached record highs this year – yet remain at a historically wide discount to U.S. stocks (see chart above). We don't see this gap closing, due to the earnings power of some of the biggest companies in the U.S. Yet we see three reasons why it may narrow in the medium term:

1) A supportive backdrop. Recession fears have been clouding the outlook for European equities in recent years. Yet the macroeconomic environment in Europe has improved. Economic activity has shown signs of picking up and energy prices have settled in a stable range. Consumer savings remain elevated and wages are growing even after taking inflation into account, which should support consumer spending.

2) Potential rate cuts. Inflation in Europe has fallen back to levels that are close to the European Central Bank (ECB) target, increasing the likelihood of rate cuts in the second quarter. This should provide further support for economies and European stocks. Small- and medium-sized (SMID) companies – where valuations are even more depressed than the broader European market – may see a recovery, as their overall higher levels of debt mean they could feel greater benefit from interest rate moves. See the spotlight topic on page 3.

3) Buybacks are back. Global investors may remain unconvinced about European equities. But company management teams see the appeal of their shares at these prices. Buybacks (when a company buys its own shares) in Europe have surged to historic highs and provide an attractive source of returns in addition to potential share-price growth. See the chart below. Some of Europe's banks, in particular, plan to return billions of euros to shareholders. Yet selectivity is important as the earnings boost from higher rates begins to fade.

… and three reasons to explore Japan

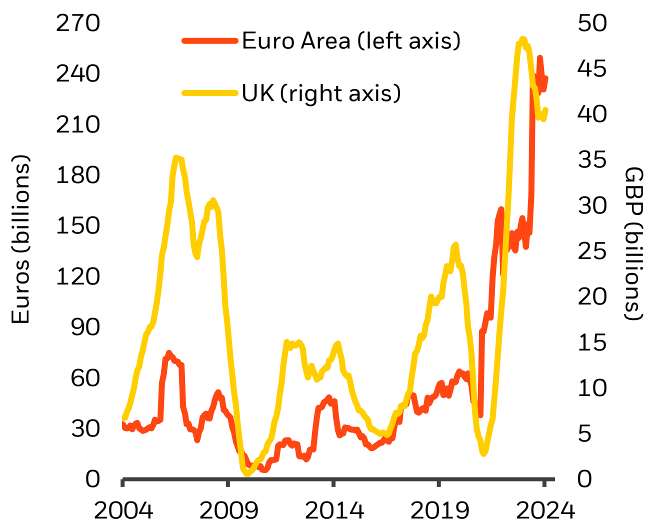
Japanese stocks have made a strong start to the year, with the Nikkei Index surpassing its 1989 high as sustained inflation has returned to the country. We see three reasons why this run may continue:

1) Company change. Japanese equity valuations are close to average levels from the past decade (see chart above). Yet overall return on equity – which indicates company profitability and efficiency – has gone up after many years of corporate reforms. See the chart below. The measure remains well below the global average, so we see further room for improvement – driven by the following two factors:

2) Pulling in the same direction. The actions of several major institutions should combine to add further support to Japanese equities, in our view. The **Japan Exchange Group** is pushing companies to improve shareholder returns and says it will publish lists of those companies doing the best job. The **government** is expanding tax-free investing for consumers, who still have only 13% of their savings in equities, versus 40% in the U.S., according to the Bank of Japan (BOJ). The **BOJ** ended the era of negative interest rates, with inflation now above 2%. Many Japanese companies became well practiced at cost control during long periods of deflation, and now sustained inflation may allow them to continue increasing prices.

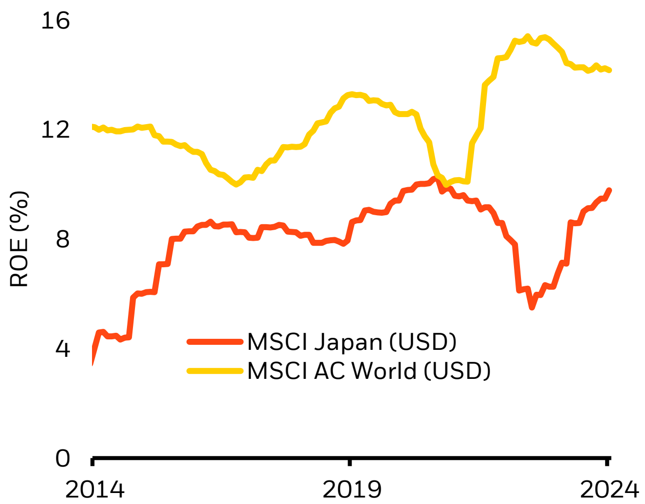
3) Companies capturing the capex. The trend of "friend-shoring" is boosting corporate Japan, as international companies direct their capital expenditures towards the country – by building new factories, for example – to diversify supply chains geographically. Geopolitical fragmentation is just one of the mega forces that we see benefiting Japan's best companies, and we will explore more on the next page.

Buybacks on the rise
European and UK company buybacks, 2004-2024



Source: Bank of England, European Central Bank, Haver Analytics, Goldman Sachs Global Investment Research, 31 Jan, 2024. The chart shows the rolling annual summation of buybacks in local currency for companies in the Euro Area and UK.

A rise in return on equity
ROE for MSCI Japan and MSCI World, 2014-2024



Source: BlackRock Investment Institute with data from LSEG Datastream, as of February 2024.

Marshalling the mega forces

We have outlined why we believe European and Japanese equity markets are well placed in coming months. Yet we anticipate growing earnings divergence within the regions as companies continue to adapt to a new regime of higher rates and inflation. Selectivity is key, and we favour those companies we believe can deliver strong earnings regardless of what happens with inflation and rates. Many of these fall within powerful secular growth trends that we refer to as mega forces.

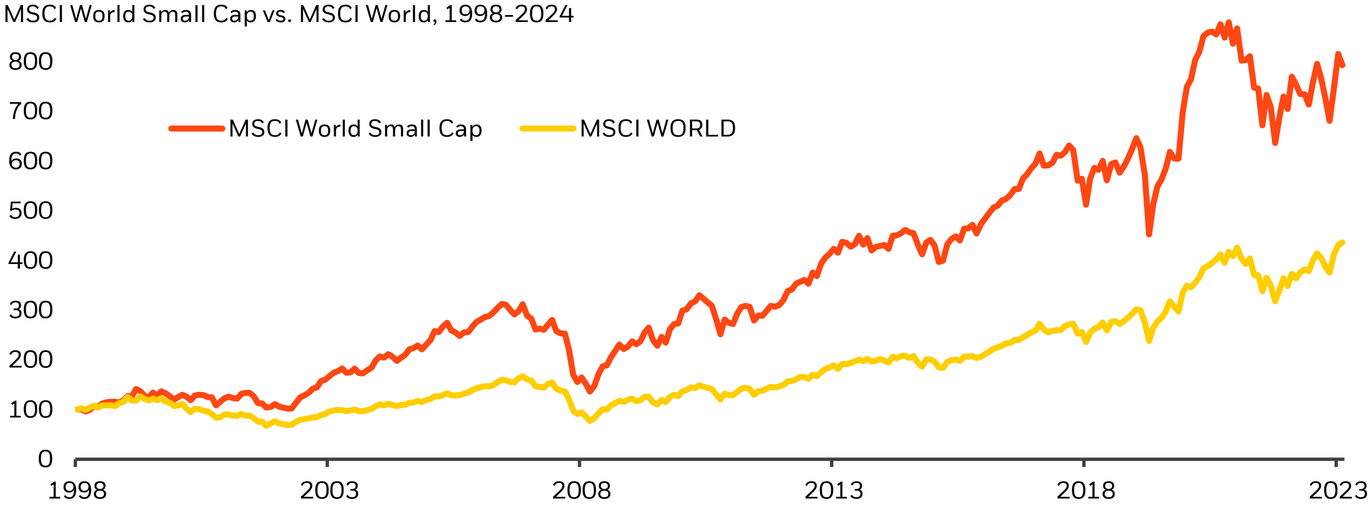
In Europe, this might be healthcare companies with blockbuster drugs that tackle diseases associated with **ageing populations**; industrials providing global solutions for the **low-carbon transition**; or semiconductor equipment companies essential for the manufacture of smaller and smaller chips that are central to **electrification and AI**.

Japan is a net energy importer and, as a result, has several companies with expertise in **energy efficiency** and electrification – including cutting-edge semiconductor and battery companies. And because Japan's labour force has been shrinking for decades, one result is a set of companies that has world-leading solutions for **ageing societies** – such as robotics, automation and med-tech companies.

Rie Shigekawa, portfolio manager, contributed to this report.

Spotlight topic: A smart time to consider the SMIDs?

Small caps have a history of outperformance
MSCI World Small Cap vs. MSCI World, 1998-2024



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. An index is unmanaged and one cannot invest directly in an index. Source: BlackRock and MSCI, 31 Jan., 2024. The average annual outperformance of small caps vs. the broader market equates to 2.7% per year. Returns rebased to 100.

The opportunity

We believe small- and medium-sized companies are undervalued. Global small caps are trading at around a 26% discount to large-cap companies, versus a historical premium of around 10%.[1] And over the past 25 years, global small caps have outperformed the broader market by an average of 2.7% per year, as the chart above shows. In our view, the drawdown in performance reflects outflows on macroeconomic fears we think are misplaced, rather than company fundamentals which in many cases remain solid.

The catalyst

What could spur a rebound in the performance of the SMIDs? Inflation has been falling towards central bank target levels in many developed markets, notably the UK, and this could lead to interest rate cuts during 2024. During previous market cycles, the outperformance of SMID caps has been greatest over the first 12 months after a recession-linked equity market low.[2] We believe falling inflation, lower rates, and economic recovery could persuade investors to reappraise the opportunity among SMID caps at current valuations. If market leadership extends to a broader range of areas, small- and mid-sized companies stand to benefit, in our view.

The importance of active management

It's important to remain selective when looking at small and mid caps, in our view. Not all companies in this universe are created equal. Rewards for success can be high, but punishment for disappointment may be severe. Indeed, our analysis of UK stocks shows that dispersion in returns for companies of this size has historically been far greater than it has been for the largest companies.[3] SMID cap companies are also covered by fewer equity analysts, so we believe there is greater opportunity for our in-depth research to unearth hidden company gems.

We expect to see a gradual economic recovery in 2024, and this isn't reflected in SMID cap valuations. We see opportunities to invest in high-quality growth companies with the ability to generate cash and win market share regardless of interest rate moves. In these cases, we find the current depressed valuations are undeserved and the re-rating potential significant.

Dan Whitestone, portfolio manager, contributed to this report.

[1] Blackrock and Jefferies, 29 Feb., 2024. [2] MSCI, July 2023.

[3] BlackRock, 31 Dec., 2023

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