Fundamental Equities

Solutions for 2023

BlackRock.

Fundamental Equities

Expert insight

Quick read

Five key macroeconomic considerations

A more volatile inflation environment, heightened geopolitical risk, mixed picture for corporate earnings, valuations to be critical and an accelerating low carbon transition

Combination of strategies

We see strong arguments for a combination of fundamental equity strategies, providing exposure to advantaged sectors, themes, factors and investment styles

Six favoured investment areas

These are: healthcare, natural resources, sustainable themes, quality, income, absolute return.

Developing strategies for 2023

Introduction:

In this paper, we consider fundamental equity strategies for the new investment environment. We expect fundamentals to be the key driver of returns through 2023 which, in our view, creates an excellent opportunity for our division of active equity investors.

This paper covers: what we believe to be the most important macroeconomic considerations this year, investment areas we believe are well placed for this environment, our outlook for each of those favoured areas as well as Fundamental Equities product options.

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Macroeconomic considerations

Our five most 'front-of-mind' considerations for 2023

1. A more volatile inflation environment

After a decade of low and relatively stable inflation, we believe that 2021 marked a breakout year into a more volatile inflation regime (see chart below). Deteriorating global economic growth combined with higher interest rates will have a disinflationary impact in 2023 but we see this being offset by further supply chain disruptions, onshoring from companies and underinvestment in the unpredictable supply of traditional energy commodities. These inflationary forces are all in nature, which we see driving continued volatility in inflation expectations.

2. Heightened geopolitical risk

We expect global economic growth challenges to be exacerbated by heightened geopolitical risk this year. The Russia-Ukraine crisis remains unpredictable but it's difficult to see a near-term positive resolution. Meanwhile, mounting tensions between China and Taiwan add further uncertainty. Lastly, the cost of living crisis is impacting the poorest in society the hardest, which could contribute to a surge in populism.

3. Mixed picture for corporate earnings

Corporate earnings were relatively resilient in developed markets in 2022. However, we expect to see more divergence in the coming months as reduced consumer demand and cost inflation begin to bite. We have a preference for higher quality companies with more resilient margins that were indiscriminately caught up in market weakness through 2022.

4. Valuations to be critical

From 2011 until the end of 2020, unprecedented, loose monetary policy meant that biasing portfolios towards high-growth technology stocks yielded the best investment returns. We believe the opportunity set in this new market regime (characterised by higher interest rates and higher inflation) will be far broader and more differentiated. A rigorous focus on valuations and being dynamic will be critical, in our view, in what should be a supportive environment for active stock pickers to generate alpha.

5. Accelerating low carbon transition

Global regulatory buy-in, extreme weather, the Russia-Ukraine crisis and higher fossil fuel prices are likely to accelerate the low carbon transition theme, in our view. We believe investors may do well to explore non-traditional ways to get exposure to the transition, such as investing in the producers of materials required to make lower-carbon technologies.

> **2022 equity returns were macro driven by a massive shift in rates. We see a different environment in 2023 with company fundamentals being the key driver of returns. This provides excellent opportunities for disciplined fundamental stock pickers to take advantage of valuation anomalies that emerge.**
>
> **Nigel Bolton,** Co-Chief Investment Officer for BlackRock Fundamental Equities

Exhibit 1: US inflation expectations

Source: DataStream, 31 December 2022.

Favoured investment areas

Factors and styles

Quality

Higher-quality companies with pricing power – cushioning the adjustment to higher input prices and wages – can provide resilience in earnings streams. Investing in those businesses can help insulate portfolios amidst volatile inflation.

Income

Companies with sustainable cash flows and growing dividends can provide a positive real return. Dividend-paying stocks have historically outperformed in high inflation environments*.

Absolute return

In a more volatile, lower return environment with high cross-sectional volatility, absolute return may provide an effective source of alpha.

Thematics and sectors

Healthcare

Healthcare is typically a more defensive sector and has tended to outperform during global recessionary environments. Meanwhile, the inelastic nature of demand for healthcare products typically leaves the sector well-positioned for higher inflation environments.

Natural resources

Unlike equities and bonds, commodity prices tend to be positively correlated with inflation expectations. The natural resources sector has a strong track record during historic periods of rising inflation expectations*.

Sustainable thematics

Whilst sustainable thematics tend to have more of a growth tilt, we see idiosyncratic factors today which support an allocation e.g. regulatory support and improving economics.

> **“BlackRock Fundamental Equities offers a broad and diverse platform of active equity funds. Based on the macroeconomic views from our Chief Investment Officers, we see strong arguments for a combination of the above strategies in 2023.”**
>
> **Becci McKinley-Rowe,** Co-head of Blackrock Fundamental Equities

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Source: BlackRock, January 2023. For illustrative purposes only. This should not be construed as an investment recommendation. *In the 10 highest inflation calendar years since 1973, the World DataStream Mining TR Index returned +15.1% on average, the World DataStream Energy TR Index returned +15.4%, the Lipper Equity Income TR Index returned +9.0% and the World DataStream Total Market TR Index returned +8.6%.

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Fundamental Equity product options in areas favoured by our Chief Investment Officers for 2023

Healthcare

- BGF World Healthscience
- BGF Next Generation Health Care

Sustainable thematics

- BGF Climate Action
- BGF Sustainable Energy
- BGF Circular Economy

Natural resources

- BGF Natural Resources Growth & Income
- BGF World Energy
- BGF World Mining

Quality

- BlackRock Global Unconstrained Equity Fund
- BGF Global Long-Horizon Equity
- BGF European Value

Income

- BGF Global Equity Income
- BlackRock UK Income
- BGF US Mid-Cap Value

Absolute return

- BlackRock UK Absolute Alpha
- BSF Asia Pacific Absolute Return
- BlackRock European Absolute Alpha

Source: BlackRock, January 2023. For illustrative purposes only.

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Healthcare in 2023

A scientific approach to healthcare

1. Resilience in volatile times

We believe healthcare stocks can help equity investors partially mitigate some of the investment challenges present today. According to BlackRock's Fundamental Risk for Equities model, healthcare equities are less sensitive than stocks in other sectors to both equity market volatility and foreign exchange volatility. Furthermore, healthcare equities have historically outperformed global equities in both recessionary and inflationary periods.[1] Meanwhile, long-term secular trends, such as an aging global population, continue. Healthcare equities offer defensive characteristics and access to growth opportunities driven by long-term secular tailwinds.

2. Inflation and recession resistance

The inelastic nature of demand for healthcare products and services have helped the healthcare sector historically outperform broader equity markets during periods with high inflation. Healthcare equities have also shown resilience during economic contractions. Over the last 7 recessionary periods, the healthcare sector has outperformed broad equity markets by an average of 10%[2] driven by the ability to improve fundamentals in the face of market weakness. Since 1980, healthcare equities have led the pack in earnings growth during periods identified as economic recessions.[3]

3. An attractive entry point

Valuations for the healthcare sector are below the historical average, despite the many benefits healthcare equities offer in volatile markets.[4] Investors can use healthcare equities to access defensive active equity characteristics, without having to pay a significant premium. With attractive valuations and comparatively stable high cashflow generating companies, we see this as a potentially attractive entry point for those seeking to add resilience to portfolios.

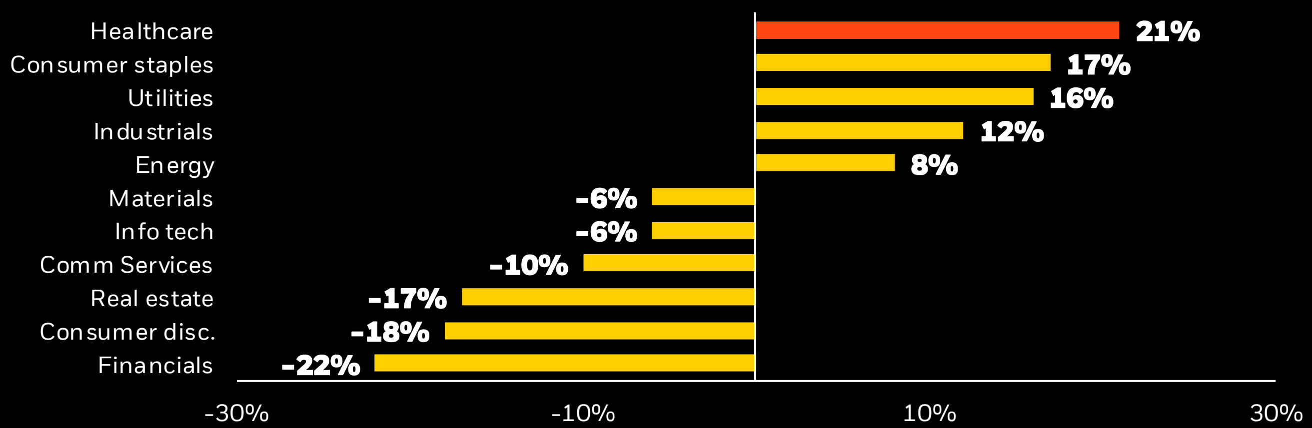
4. A scientific approach to healthcare

Scientific knowledge and a disciplined investment process are critical components of effective active healthcare portfolio management. Given the technical nature of the sector, we believe that it is imperative to understand the science behind the products and services offered by the healthcare sector. Our investment team boasts 5 Ph.Ds, 3 MBAs and 1 MD with an average of 17 years' experience in science and investing. Our team will often analyze clinical trial data, conduct regular field checks with physicians, attend industry conferences and take this information into consideration when evaluating investment decisions.

> **"As we anticipate continued equity market volatility driven by persistent inflation, geopolitical uncertainty and a looming global recession, we believe the healthcare sector offers attractive investment opportunity coupling defensive, resilient characteristics with innovation-driven growth."**
>
> **Dr. Erin Xie,** Lead portfolio manager of our healthcare strategies

1 BlackRock Fundamental Equities, with data from Refinitiv and Bloomberg as of Aug 2021.
2 FactSet, NBER as of October 2022.
3 FactSet as of September 2022; sectors represent GICS classification of Russell 1000 constituents.
4 FactSet, BlackRock - Risk & Quantitative Analysis (RQA). Data through 31 October 2022.

Exhibit 2: Healthcare earnings in recessions
Relative change in earnings during recessionary periods (1980-2020)



There is no guarantee that a positive investment outcome will be achieved.
Source: FactSet as of 30 September 2022; sectors represent GICS classification of Russell 1000 constituents.

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Natural resources in 2023

1. Demand

We don't expect commodities and natural resources equities to be immune to weaker global economic growth caused by central banks tightening monetary policy. However, whilst recession looms for developed markets, one of the world's largest commodity consumers*, China, is moving in the opposite direction, re-opening following a year of lock-downs and a strict zero-covid policy. Meanwhile, longer-term, demand for a range of commodities, such as copper, lithium and steel, is set to be boosted by accelerated adoption of lower carbon technologies, like wind and solar.

2. Supply

Commodity supply is being heavily constrained by producers' continued focus on capital discipline following years of underinvestment. This has in part been driven by investor pressure on companies to prioritise shareholder returns over production growth and, in part, by global decarbonisation efforts disincentivising investment in new supply. At the same time, geopolitical risk, record low inventory levels and a more challenging permitting process for new mines adds further uncertainty to the supply side of the equation.

3. Financial health

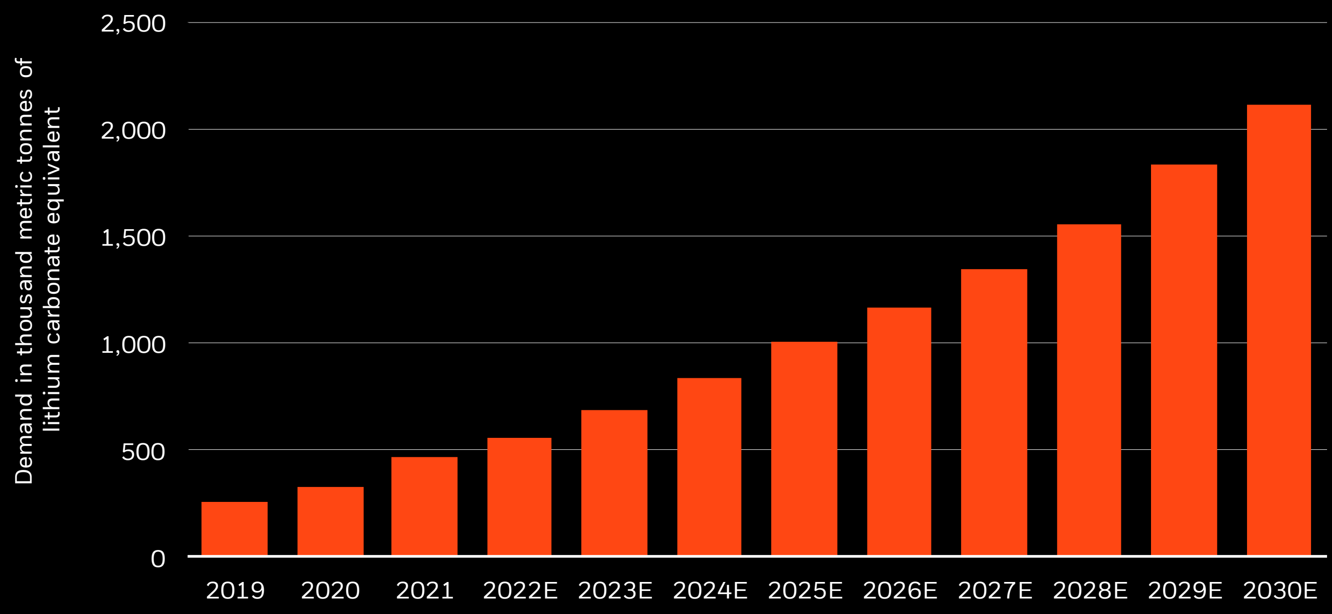
Natural resources companies have dramatically reduced their debt levels in recent years and today, mining and energy have amongst the strongest balance sheets out of all sectors globally**. Meanwhile, the companies continue to trade on attractive valuations, in our view, both relative to their history and relative to broader equity markets.

4. Brown to Green

We expect Brown to Green to emerge as a key theme in 2023. Early efforts to incorporate sustainability in investment focused on broad-based exclusions e.g. no fossil fuels exposure. However, we expect greater debate on whether it's in fact equally impactful to invest in companies that are improving their sustainability – rather than in those which are already at the destination. Indeed, for investors looking to back companies reducing their carbon footprints, natural resources companies are a clear place to start with amongst the greatest scope for improvements. We expect to see a re-rating for the natural resources companies able to best navigate this and are playing that in the portfolios.

> **"We expect to see wider appreciation that we need the mining sector to supply the materials required for lower carbon technologies. This could see investors reassessing their perspectives on ESG for the sector."**
>
> **Olivia Markham,** CFA, Co-manager of our mining and circular economy portfolios

Exhibit 3: Projection of worldwide lithium demand from 2019 to 2030



Source: Statista, 31 March 2022. *Source: CME Group, February 2022. **Source: DataStream, 01/03/23.
There is no guarantee that forecasts made will come to pass.

Quality, income and absolute return in 2023

The quest for quality

We believe it is important to invest in quality companies that are highly profitable, have strong market share and consistently grow their earnings and cash flow – regardless of economic conditions. We look for the following characteristics when seeking to identify these companies:

1. Pricing power

Companies that can pass rising costs on to their customers are poised to withstand periods of inflation. Pricing power often comes with a strong brand. Luxury goods companies with loyal customers might even be able to raise prices beyond inflation. Strong brands can also expand market share during periods of economic volatility, capturing demand from weaker rivals and growing through acquisitions.

2. Cash is king

We look for companies with cash flows that are not expected to fall significantly during an economic downturn – and have proven this during previous episodes. These companies should also deliver resilient, long-term growth.

3. Attractive income

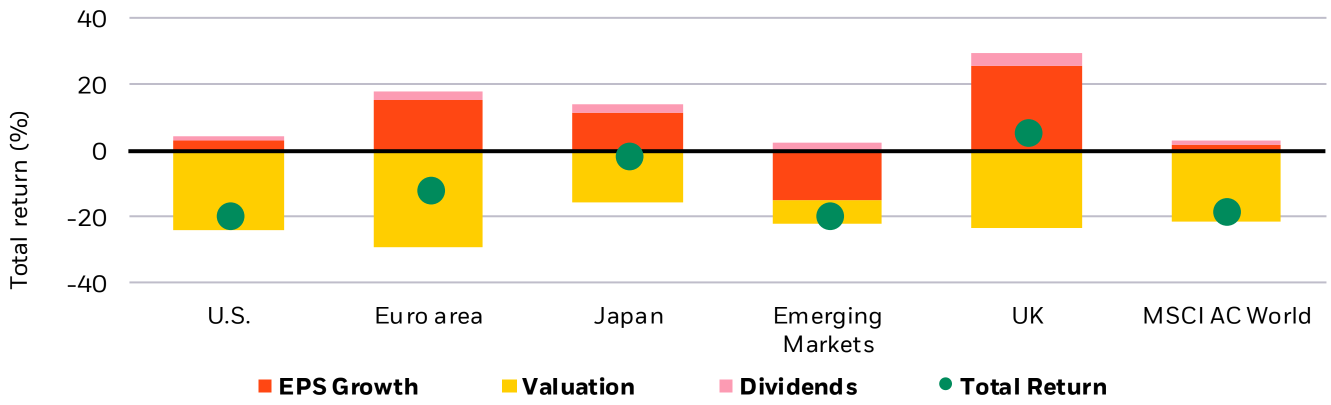
High-quality companies with sustainable cash flows and growing dividends can provide strong risk-adjusted returns over the long term. These stocks can deliver a smoother ride over the business cycle, in our view. Companies with these characteristics may also be in a strong position to buy back their own shares. Taking the FTSE 100 Index as an example can illustrate the potential power of dividends plus buybacks. The £51 billion in share buybacks by FTSE 100 companies recorded so far in 2022 equates to a nearly 3% buyback yield on the index, according to our calculations. When this is added to a dividend yield of 4.5%, the combined income totals more than 7%. This compares to the current yield on UK 10-year gilts of around 4%.

4. Absolute return

We believe a volatile market with lots of dispersion between company share price performance is well suited to absolute return strategies. This means there are potential opportunities to generate alpha for clients via companies that might struggle in this macro regime, as well as via the long investments in the kind of quality company mentioned above.

> **Rising inflation, higher interest rates and economic growth fears weighed on valuations in 2022. This is a negative market environment. But long-term investors can take advantage of market volatility and what we see as attractive valuations.**
>
> **Olivia Trehame,** Co-manager of our global long-horizon portfolios

Exhibit 4: Equity sources of total return in 2022



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.** Indices are unmanaged and one cannot invest directly in an index. Source: DataStream, MSCI and BlackRock Investment Institute, 30th of December 2022. The bars show the breakdown of each market's local currency 2022 return into dividends, earnings growth and valuation (multiple). The dots show each market's total 2022 returns. Earnings growth is based on the 2022 change in 12-month forward I/B/E/S earnings estimates.

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Sustainable themes in 2023

We define sustainable themes as those for which greater adoption will help to tackle climate change e.g. the transition to electric vehicles.

1. Powerful regulation

Regulatory support for sustainable themes is stronger than ever, with true global 'buy in'. We see the approval of the Inflation Reduction Act (IRA) in the US, for example, as a landmark victory. Despite its name, the bill's major provisions target climate change, with some USD 370bn in tax incentives, rebates, grants, and loans that could cut US emissions by about 40% from 2005 levels by 2030 – doubling the pace of decarbonisation in the US economy. Additionally, the IRA aims to boost US independence in clean energy technology – a key driver of the energy transition – across the ecosystem, from wind and solar farms to energy storage and battery technology.

2. Russia-Ukraine crisis impact

Energy security is now in focus globally. We see the crisis structurally accelerating the build out of renewable energy capacity and investment into energy efficiency as Europe seeks to reduce dependence on Russian gas. In May 2022, the European Commission launched its REPowerEU Plan which included a "massive scaling-up and speeding-up of renewable energy in power generation, industry, buildings and transport". The Commission also increased its headline 2030 target for renewables from 40% to 45%.

3. Extreme weather

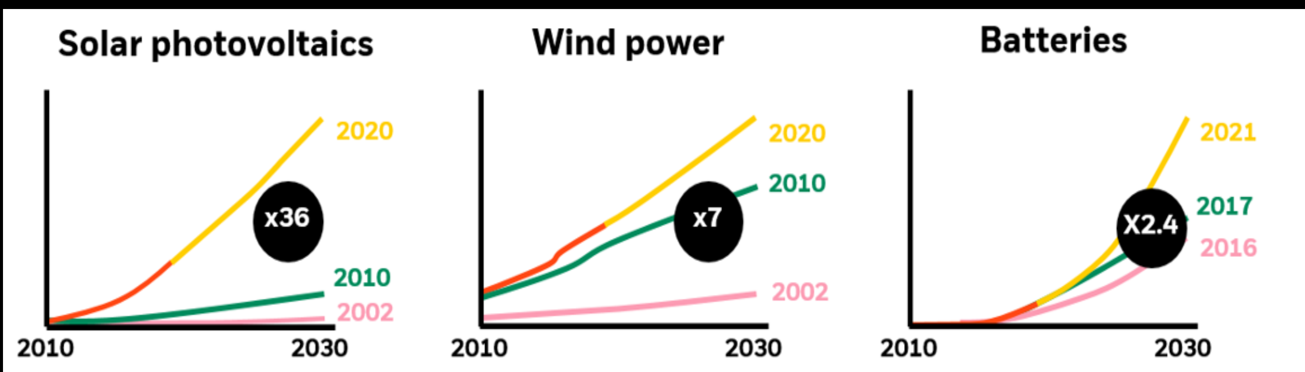
The extreme weather witnessed in 2022 was a stark reminder of the existential threat the world faces from climate change. Highest temperature records have been shattered across the world. August was the hottest month on record for North America and Europe, for example, with around half of Europe under drought warnings at the time*. Increasingly visible effects of global warming will likely accelerate investment into adaptation solutions that will help societies become more resilient to climatic changes.

4. Improving economics

Technology improvements have already resulted in huge reductions in the cost of lower carbon solutions. However, this is now being compounded by high fossil fuel prices that we expect to persist. When the greener option is cheaper, we see this facilitating large scale switching.

> **The Russia-Ukraine crisis structurally accelerates renewable energy adoption, in our view, as Europe seeks to reduce dependence on Russia's natural gas.**
>
> **Alastair Bishop,** Co-manager of our sustainable energy, future of transport, traditional energy and natural resources portfolios

Exhibit 5: Capacity projections:



Source: BlackRock, IEA, BNEF, IRENA, BCG, 25/01/22. **The projections are illustrative in nature and do not express a forecast.** Red line = actual capacity Pink, green and orange and yellow lines = consensus capacity projections out to 2030 at different points in time. *Source: Washington Post, September 2022.

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