

Q1 2024

# Taking stock

Market views from BlackRock Fundamental Equities

**Safety is not without risk.** Cash is more attractive than it has been in years, yet 2023 was a reminder that there is an opportunity cost in not owning equities. As we look ahead to 2024, we see:

**Quality stocks in a strong relative position as rate hikes end**

**Greater market breadth creating stock-picking opportunities**

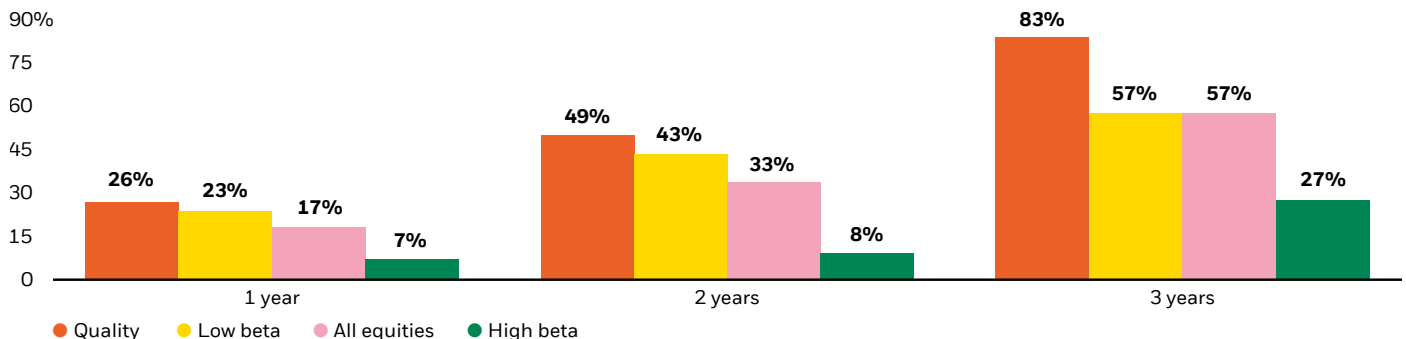
**Innovation, reshoring and geopolitics as investable themes**

Investing is an ongoing negotiation between risk and reward. With “risk-free” rates in the area of 5% (yields on cash and government bonds), many are all-in on safety. Yet there’s an opportunity cost to a secure 5%: U.S. stocks, as measured by the S&P 500 Index, have returned a far superior 20.8% year-to-date through Nov. 30. And a look at index data back to 1975 shows that equities on average have performed better when the fed funds rate is in the range of 5%-10% than when it is below it.\*

Despite their “risk asset” label, all stocks are not created equal. With inflation and economic uncertainty still high, we retain our focus on quality and lower-beta equities. Both have outperformed higher-risk counterparts in the years following the end of rate hikes, as shown below. While higher valuations, inflation and rates may mute overall stock market returns relative to the prior decade, we see attractive stock selection opportunities in 2024 amid a Fed pause and outlook for broadening market breadth.

### Rate hike halt historically good for quality and low beta

Equity performance in years after peak rates, 1984-2021



Source: BlackRock Fundamental Equities, with data from the Board of Governors of the Federal Reserve System and Bloomberg, calculated from Aug. 31, 1984-Dec. 31, 2021. Returns are calculated from the month when the Fed stops raising rates for peak rates periods in 1984, 1989, 1995, 2000, 2006 and 2018. All equities represented by the Russell 1000 Index. Quality is the top quintile of stocks as ranked in the Russell 1000 Index using a proprietary research screen that assesses companies on 13 “quality” metrics. High and low beta (a measure of volatility relative to the broader market) are derived from the BlackRock Fundamental Equity Risk Model (BFRE). **Past performance is not indicative of current or future results.** Indexes are unmanaged. It is not possible to invest directly in an index.

\*BlackRock Fundamental Equities, with data from Bloomberg. Analysis reviewed the average next-12-month % price change for the S&P 500 across different rate regimes from 1975 to present.



**Tony DeSpirito**

Global Chief Investment Officer, Fundamental Equities

“Looking out, we have more modest expectations for the overall market but are very bullish on the potential for skilled stock picking to generate greater alpha.”

# Getting back to market breadth

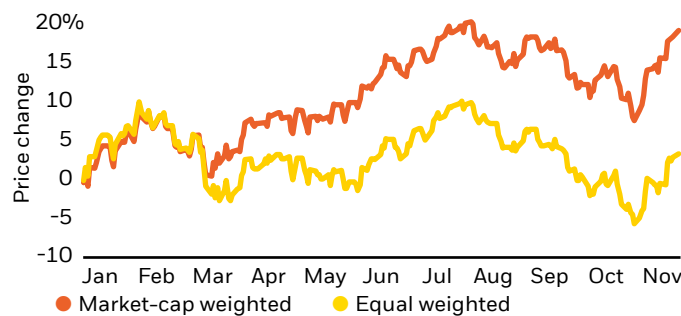
We expect the market dynamics that prevailed in 2023 to continue as the calendar turns. The economy is still late-cycle, prompting us to retain our focus on resilience in equity allocations, with a preference for quality exposures. Quality's historic tendency to outperform after Fed hiking ends only reinforces our conviction. Yet one unique aspect of 2023 that we believe could normalize in 2024 is market breadth.

## Magnificently narrow

The widely referenced S&P 500 is a market-capitalization-weighted index, meaning a company's size determines its share of the index. In 2023, the index's top stocks, dubbed the "Magnificent 7," drove the lion's share of return. In part, this may reflect the market extrapolating the future earnings growth potential of these companies as artificial intelligence (AI) advances.

### Cap weighted has dominated in 2023

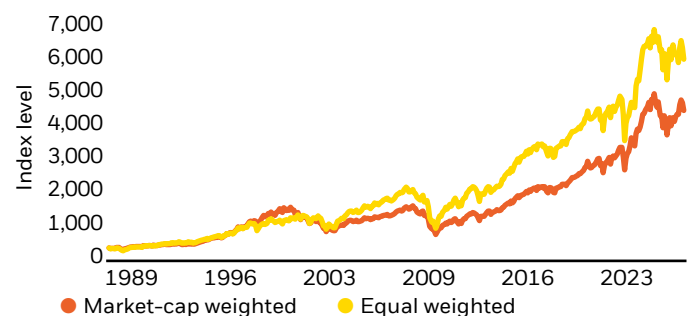
S&P 500 Index performance, 2023



Meanwhile, the equal-weighted S&P 500, which allocates share of the index to all 500 constituents equally, saw more modest positive returns. Assessing the two side-by-side reveals that the past year is the anomaly. Over the long run, the equal-weighted index has outperformed, as shown below:

### Equal weighted has won across time

S&P 500 Index performance, 1989-2023



Sources: Left chart: BlackRock Investment Institute, with data from LSEG DataStream, Nov. 20, 2023. Right chart: BlackRock Fundamental Equities, with data from Bloomberg, Sept. 30, 2023. **Past performance is not indicative of current or future results.** Indexes are unmanaged. It is not possible to invest directly in an index.

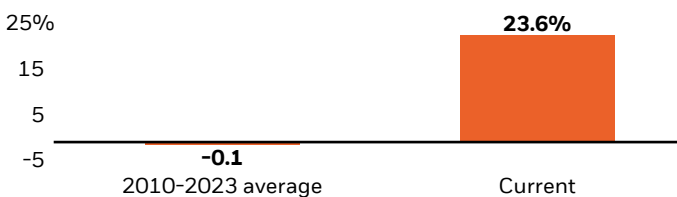
## Two reasons to bet on breadth

2023 marked one of the worst periods for the equal-weighted approach (and best for market-cap weighted) in 20 years, based on our analysis of rolling 12-month periods since 1926. Historically, however, this reverts to the long-run "norm," suggesting to us that the equal-weighted S&P 500 can resume its lead. But more important, we believe it implies widening market breadth and greater potential for stock-level dispersion in the process. We would expect such a reversion to the mean for two key reasons:

**1. Wide valuation gap:** Valuations on the market-cap-weighted index were 23.6% higher than the equal-weighted index, at 19.4x vs. 15.7x forward price-to-earnings as of Nov. 30. See chart below. This is the high watermark since 2010.

### A historic valuation premium

Valuation differential, market-cap vs. equal-weighted index



Source: BlackRock Fundamental Equities, with data from Bloomberg, May 31, 2010–Nov. 30, 2023. Chart shows the valuation premium (based on forward price-to-earnings) of the market-cap-weighted S&P 500 relative to the equal-weighted index. Current is as of Nov. 30, 2023.

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**2. Recessionary reversions:** Our analysis finds that past reversions to equal-weighted dominance have come in and around recessions. The table below captures the five most recent episodes where the equal-weighted index outperformed by the largest margin and the relationship to recession.

Episode	Relation to recession	% above market-cap weighted
End of dot-com bubble (3/2000)	13 months before	33.2%
End of GFC (2/2009)	14th month of recession	18.0%
Economic recovery (3/2003)	16 months after	13.6%
COVID-19 (3/2020)	1st month of recession	9.5%
1990s recession (10/1990)	3rd month of recession	8.8%

Source: BlackRock Fundamental Equities, with data from Bloomberg, Oct. 24, 2023. Performance shown is 12-month price return and calculated from the month-end of the date noted. **Past performance is not indicative of current or future results.** Indexes are unmanaged. It is not possible to invest directly in the index.

# Implications for equity investors

A wide valuation gap between the market leaders and all the rest means many attractively priced stocks to choose from. The key is to determine where the fundamentals are priced right for the stock's future prospects — i.e., whether there is a thesis for valuation improvement as market breadth returns. Where are we looking?

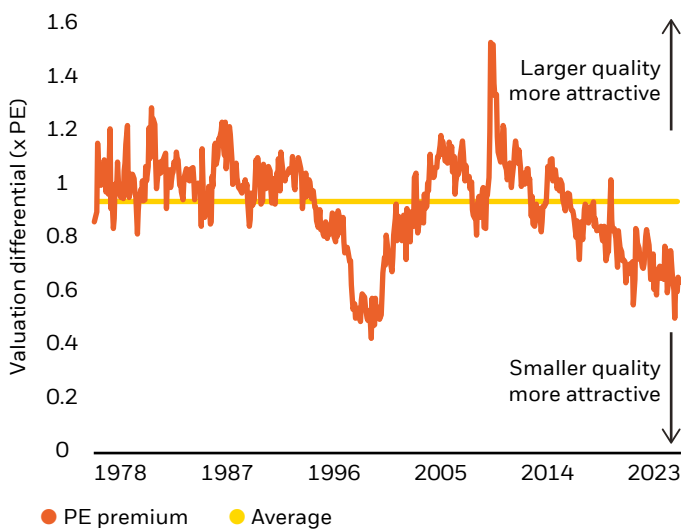
## The continued appeal of quality

We believe investors will continue to place greater value on quality characteristics in a still uncertain economic environment.

Quality generally did well in 2023. This was evident in the high-flying mega-cap stocks, many of which exhibit quality characteristics such as strong balance sheets and ample free cash flow. As these market leaders have grown expensive, we find quality in the smaller-capitalization range is priced well below its long-run average. See chart. This presents opportunities for stock pickers to source quality at a compelling price.

## A deep discount

Smaller and larger “quality” valuation differential, 1978-2023



Source: BlackRock Fundamental Equities, with data from Refinitiv, Sept. 30, 2023. Chart shows the price-to-earnings (PE) differential between the smallest- and largest-capitalization stocks within the first quintile of quality in the Russell 1000 Index. **Past performance is not indicative of current or future results.** Indexes are unmanaged. It is not possible to invest directly in the index.

**Bottom line:** Headed into 2024, we see greater opportunity for stock pickers to source potential winners as the market grows less concentrated and looks beyond the Magnificent 7 to price stocks based on their fundamentals and future prospects. With the Fed nearer to an interest rate pivot, our focus leans toward stocks with quality characteristics and capacity for sustained earnings growth amid a likely economic slowdown.

## The new growth/value dilemma

After a decade of growth outperformance, many indexes (and investor portfolios) are out of balance as growth has risen to dominate while value representation has shrunk. A style breakdown of the S&P 500 and Russell 1000 indexes reveals each has only a 22% exposure to value stocks. Even the Russell 1000 Value Index is light on value, at 42%, with a larger portion in the “core” and growth buckets (58%).

For investors, adding value could be helpful as inflation and rates remain elevated, given a history of value outperformance in these regimes. Because this is not easily achieved in an index today, it may be best sourced through an actively managed portfolio with a proven value-oriented investment strategy and process.

Source: BlackRock Fundamental Equities, with data from Morningstar as of Sept. 30, 2023.

## Alpha insights

Quality is a refrain that echoes across sectors and capitalization size. Digging deeper, our Fundamental Equities teams are finding opportunities in other key themes:

**Innovation.** Innovation is creating opportunities, sometimes unexpected ones, particularly in technology and healthcare. As we discussed in depth last quarter, AI is an evolving theme poised to create winners and losers across the economy, a prime hunting ground for stock selection.

In healthcare, the so-called GLP-1s (diabetes drugs with positive weight-loss side effects) are having a similar bifurcating influence. The drug makers have benefited as other areas of healthcare brace for a drop in demand as chronic diseases and obesity-related maladies are addressed (fewer insulin pumps and sleep apnea machines). Makers of snacks and beverages may struggle as consumption wanes. Much of this is already priced in the market, but we are watching for overreactions and underappreciated risks.

**Reshoring.** The onshoring and near shoring of global supply chains will hurt some businesses and help others. The U.S. Inflation Reduction Act, CHIPS Act and infrastructure bill are beneficial to reshoring themes, creating more opportunity for U.S. manufacturers given incentives to decarbonize and build operations at home. We see potential divergence in the auto industry, as an example, where some manufacturers may qualify for greater EV subsidies than others.

**Geopolitical risk.** We see underappreciated opportunities in defense and traditional energy companies as the world becomes more dangerous. Many companies in these categories are not priced for the potential increased demand for munitions and supply risks amid war and conflict-related disruptions.

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