BlackRock

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Taking stock

Market views from BlackRock Fundamental Equities

A delicate dance continues. Stocks look set to continue their stutter-step motion into 2023 after a downbeat and extremely volatile 2022. As we look toward the first quarter, we see:

Need for balance and resilience in equity portfolios	**Some light at the end of the tunnel for stocks**	**Earnings joining inflation and the Fed as wildcards**

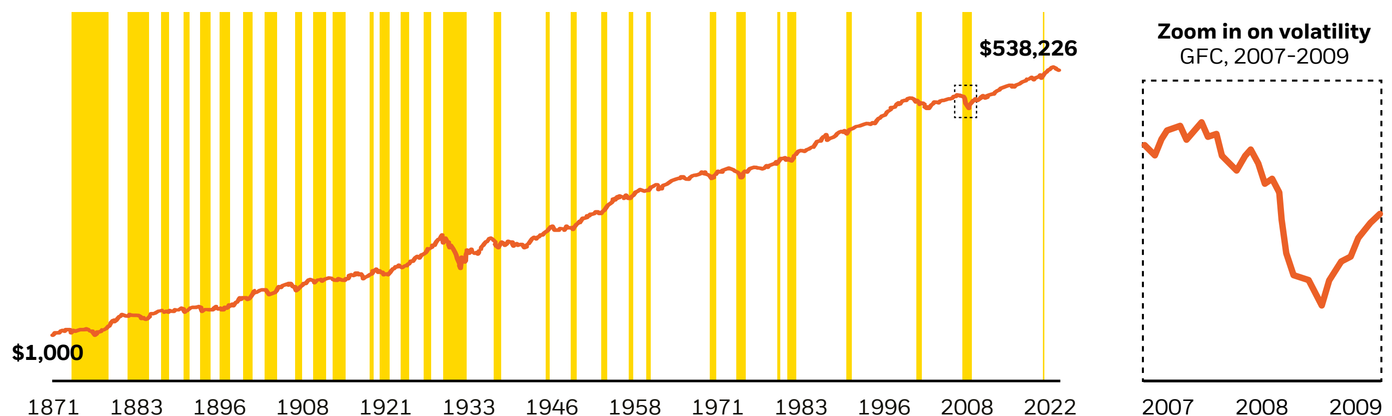
Market ups and downs in the final months of the year reflected investors' battle between ongoing fear and flashes of hope that the tough-talking Fed might be ready to ease its rate-hiking campaign. With inflation remaining elevated and the Fed intent on batting it down with higher interest rates, we see the equity bounces as bear market rallies rather than the start of a new bull trend — for now. Such "speedbumps" are not uncommon on the path to solid longer-term returns, as illustrated by the long-run zoom out and short-term zoom in to the Global Financial Crisis (GFC) below. Against this backdrop, we believe a focus on resilience remains paramount in equity portfolios. This includes stocks with quality characteristics and positions that seek to balance offsetting risks (e.g., value coupled with growth; defensives alongside cyclicals).

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

> "Being successful through difficult markets is as much about being opportunistic as it is about being defensive."

Zoom out: Equities have delivered across time

Hypothetical growth of $1,000 in U.S. stocks, 1871-2022



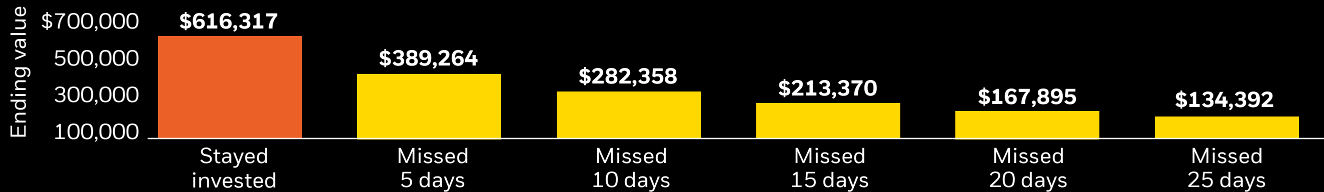
Source: BlackRock Fundamental Equities, with data from Robert J. Shiller, November 2022. U.S. stock data from 1957 to present represented by the S&P 500 Index. Earlier data from the Robert Shiller database, http://www.econ.yale.edu/~shiller/data.htm. Highlighted areas indicate recessions, as defined by the National Bureau of Economic Research (NBER). Returns assume reinvestment of dividends and capital gains and that assets remained fully invested. **Past performance is not indicative of current or future results. Indexes are unmanaged. It is not possible to invest directly in an index.**

Good news, bad news: The importance of staying invested

Bear market rallies can feel like cruel teasers of a turnaround. Yet history shows that some of the market's best days come within these episodes — a key reason long-term investors should stay invested even when it may not feel good. Missing those top-performing days can have a meaningful impact across time, as shown below. And because it's only possible to distinguish bear market rallies from a new bull market for certain in hindsight, trying to time such transitions increases the risk of decreasing long-term returns.

The cost of missing the market's top days

$100,000 invested in U.S. stocks, staying invested vs. missing top days, 2002-2021



Sources: BlackRock, Bloomberg, as of year-end 2021. U.S. stocks are represented by the S&P 500, an unmanaged index that is generally considered representative of the U.S. stock market. **Past performance is not indicative of current or future results. It is not possible to invest directly in an index.**

Many risks remain as the calendar turns to 2023, keeping the market's volatile pattern intact. But we also see some potential light at the end of the tunnel for stocks:

Inflation past peak. We believe headline inflation has peaked for this cycle, even as it is retreating slowly. While the Consumer Price Index (CPI) hasn't declined at the hoped-for pace since its high reading of 9.1% for June, anecdotal data on the economy is moving more quickly: Housing demand and prices are easing, consumer confidence is waning and retail sales growth is showing some signs of stalling. This suggests CPI will eventually catch up, then giving the Fed room to pause its rate-hiking campaign. The chart below compares the year-over-year change in growth for select components of inflation currently and at the cycle's peak levels.

Election fog lifted. History generally has been kind to markets in the year after a midterm election. Our analysis shows you'd have to go back to 1938 to find a 12-month period where stocks were negative after an election. The consistency of the pattern suggests it's not just chance. It's often because markets have generally been weak leading into midterms, as elections inject an element of uncertainty. In our review of 23 midterm election cycles since 1930, we found the 12-month change in U.S. stocks leading up to the election was 2%. This year was -17%. The average change in the 12 months after was 13%.*

An attractive starting point. Valuations on the S&P 500 Index, as measured by trailing 12-month price-to-earnings (PE) ratio, have dropped from 24.7x at year-end 2021 to 19.7x as of Nov. 30. Could stock prices cheapen further from here? Yes. But is current pricing a compelling opportunity? We believe it is. We looked at S&P 500 returns starting from different PE ranges across time. Since 1957, average five-year returns have come in at 65% when stock valuations were at a starting point of 15x-25x.

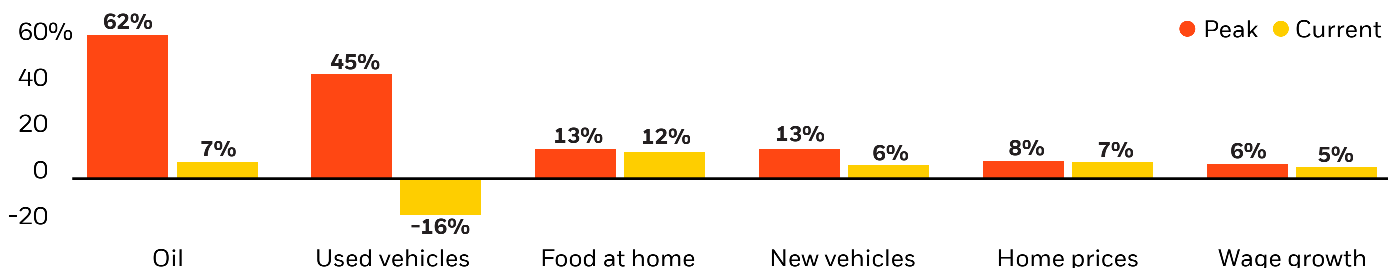
Starting valuations and returns across time

S&P 500 PE ratio	Average return		
	One year	Three years	Five years
Above 25x	5%	-2%	31%
15x to 25x	11%	37%	65%
Below 15x	17%	50%	93%

Source: BlackRock Fundamental Equities, with data from Bloomberg, 1957 to November 2022. PE ratios are for the trailing 12-month period. **Past performance is not indicative of current or future results. It is not possible to invest directly in an index.**

Inflation deceleration

Peak and current year-over-year price changes, 2022



Source: BlackRock Fundamental Equities, with data from Bloomberg, Bureau of Labor Statistics, Manheim Consulting, S&P Dow Jones Indices and Zillow, Nov. 30, 2022. Figures shown are rolling one-year changes in each index value, calculated monthly (using month-end data) and compared for the year-to-date 2022 time period.

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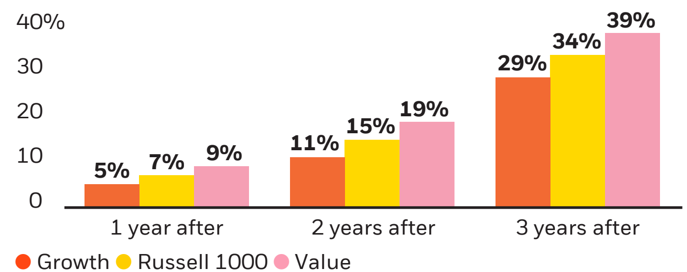
The bottom debate. Our work last quarter found that inflation peaks have historically coincided with market bottoms. Other evidence suggests equity bottoms most often take place during a recession. Yet it's important to note that recession onsets are called in hindsight — once the National Bureau of Economic Research (NBER) analyzes past data and makes a formal declaration. Similarly, the market bottom may only be clear in hindsight, with much of it hinging on the Fed and its read of inflation and the economy. Bottom or not, investors with a long-term mindset have a decent entry point today. We see an opportunity to capture value in stocks unduly punished in the downturn or those with quality characteristics that can offer greater resilience through a recession.

About that recession. We believe a recession is likely, for a few reasons. History suggests that inflation above 5% is a recipe for recession. And this time around, the Fed has made dramatic rate moves in a short time to catch up from a late start in addressing inflation. Fed actions historically affect the economy with long and variable lags, so the economic consequences are yet to be fully felt.

That said, we think any recession could be relatively shallow in depth and duration. The key reason: The consumer (which accounts for nearly 70% of U.S. GDP) remains in good shape without a heavy debt burden or balance sheet to repair, unlike the more protracted recession during the GFC. Using data from NBER, we calculate that the average recession in the post-WWII era has lasted just 10 months. Expansions, meanwhile, have averaged five years. Equity returns in the years following recessions historically have been positive, as shown below.

Returns around recessions

Average U.S. stock returns following recessions since 1978



Source: BlackRock Fundamental Equities, with data from Bloomberg and Russell indexes, November 2022. Data covers five NBER-defined recessions since 1978 (excluding the two-month 2020 recession). Growth and Value are based on their respective Russell 1000 indexes. **Past performance is not indicative of current or future results. Indexes are unmanaged. It is not possible to invest directly in an index.**

Earnings a wildcard

While inflation and Fed policy remain chief uncertainties headed in 2023, there is also a new wildcard weighing on stocks: company earnings. Companies have, for the most part, exhibited pricing power and an ability to pass rising costs on to consumers. But consumer lethargy amid higher prices is beginning to show. While consumer balance sheets are still healthy, saving rates are getting precariously low — at 2.3% in October compared to pandemic heights of 26.4% in Q2 2020, according to data from the Bureau of Economic Analysis. The University of Michigan's Consumer Sentiment Index hit a 70-year low over the summer and remains near this historical level.

For U.S. companies, the third-quarter earnings season started to expose signs of weakness. Earnings per share (EPS) growth of 2.4% on the S&P 500 Index was driven almost exclusively by energy companies. Goldman Sachs recently put EPS growth estimates for 2023 at 0%. As of mid-November, analysts' outlook for Q4 earnings was deteriorating and coming in below the historical sequential trend. Our analysis of earnings declines in prior recessions found an average drop of 13% in the 10 recessions since 1957. If we exclude the outsized 40% earnings deterioration during the GFC, the average recession-period earnings decline was 10%. We could see this episode falling in the average range (10%-15%).

A growing active opportunity?

As in prior recessions, dispersion in analyst earnings estimates is rising. One upshot is that this presents an opportunity for active stock pickers to apply their own research and analysis to identify fundamentally strong companies that may be positioned to deliver earnings growth above consensus expectations.

We also note that the influence of the top-five mega-cap stocks that have been dominating index performance for the past several years may be waning: Despite their largely disappointing earnings results in October, the overall market was strong. This "decoupling" between the top five and the broader market comes as index concentration is declining. The top-five S&P 500 constituents represented a record high of 22% of the index's total weight in August 2020, according to data from Refinitiv, and has been inching down since, sitting at just under 19% currently.

A continued decline in concentration could give an edge to active selection over index tracking. Because the major averages are market-cap weighted, index trackers benefitted from the strong returns in the dominant stocks in recent years. Looking ahead, stock pickers have an opportunity to diversify away from these former drivers and into those stocks with potential to generate more impressive earnings growth as the business cycle moves from recession to recovery to eventual growth.

Overall, we believe an active and nimble approach rooted in fundamentals could add value in 2023. Any market recovery is likely to be uneven, in our view, with individual company fundamentals increasing in importance and driving the speed and magnitude of any share price rebound.

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α Expert insight

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* U.S. stock data from Standard & Poor's via Bloomberg, as of Nov. 30, 2022.

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