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Decoding upside and downside risks

Equity market views from BlackRock Systematic

The first half of 2024 in equity markets was characterized by strong headline returns, low volatility, and persistent mega cap tech leadership that underpinned steady momentum factor outperformance.

Now, recent macroeconomic and geopolitical developments along with shifting AI sentiment have raised concerns over whether these dynamics can continue as we look ahead. This quarter, we explore the potential for emerging risks to upend year-to-date trends, and where investors can seek opportunities amid greater uncertainty.

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Key highlights

The left tail: geopolitics and trade protectionism

Election uncertainty has turned market focus to the potential for protectionist trade policies and new regulations at a time of heightened geopolitical risks. We emphasize the use of data-driven insights to decipher which firms are engaging in activities such as reshoring that may be more resilient to geopolitical tensions.

The right tail: more room for markets to price a soft-landing

Soft inflationary data in the US spurred the recent market rotation as investors adjusted expectations for interest rate cuts. Our alternative inflation measures suggest that price pressures are increasingly easing, and our estimated probability of recession remains below market consensus. Analysis of market pricing dynamics implies that there's more room for markets to price in positive macro developments ahead.

AI sentiment slipping, but not "DotCom 2.0"

While skepticism has grown around potential returns to AI-related capital expenditure investments, the tech sector continues to look different today versus the early-2000s tech bubble—particularly across quality and volatility characteristics. However, the slight detachment in sentiment underscores the need to take a more nuanced view of the AI opportunity beyond first-order effects.

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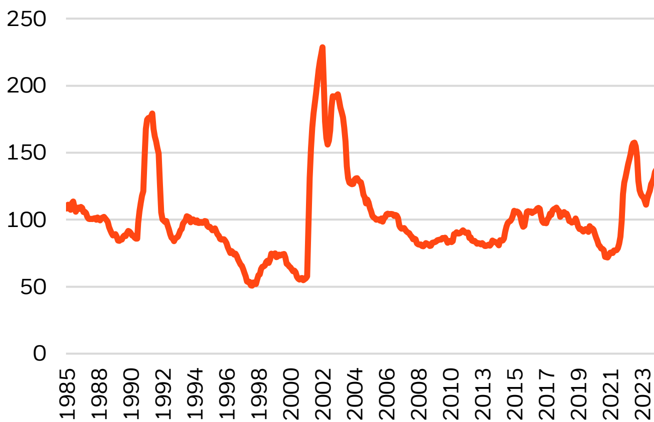
The left tail: geopolitics and trade protectionism

Geopolitical tensions have been steadily rising over recent years on the heels of more frequent global conflicts, trade disputes, and heightened strategic competition. Figure 1 illustrates how global geopolitical risks have reached highs not seen in more than a decade based on an index which measures the volume of monthly news articles related to adverse geopolitical events.

Figure 1: Geopolitical risks have reached levels not observed in several years

12-month average Geopolitical Risk Index (Global)



Source: Caldara and Iacoviello Geopolitical Risk Index, data downloaded from https://www.matteoiacoviello.com/gpr.htm on 7/30/2024.

With the US election cycle underway, market focus has shifted to the potential for protectionist trade policies and new regulations to disproportionately impact globally exposed firms. Against this backdrop, we've increasingly turned to data-driven analysis that helps decipher which companies are building domestic self-sufficiency and managing geopolitical risks.

The act of reshoring, or bringing production, supply chains, and other business operations back to domestic locations, is one way that companies are adapting to a more fragmented world. Figure 2 shows the steady long-term rise in company announcements related to reshoring jobs which reached around 350,000 for 2023, along with Google search traffic revealing growing attention to the topic.

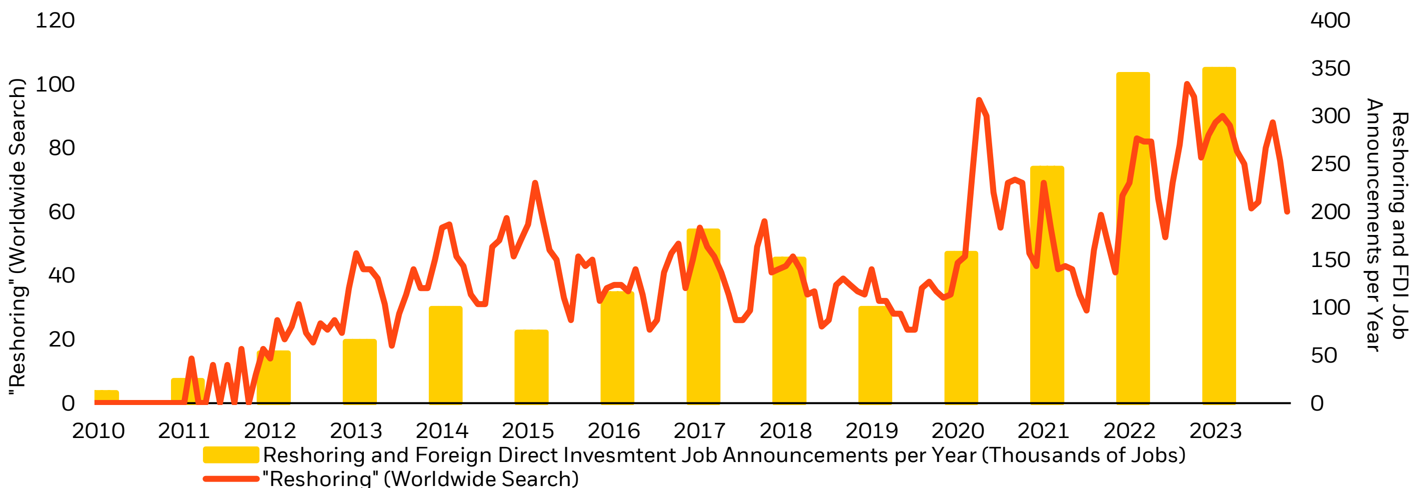
In identifying companies engaging in or benefitting from reshoring activities across industries, we employ a large language model (LLM) supplemented with granular text analysis and alternative data to help build a comprehensive basket of exposures. At a high level, this analysis reflects a positive view towards domestic industrials, raw materials suppliers, and real estate companies, and a relatively more negative view towards internationally exposed manufacturers and logistics firms.

Where innovation meets geopolitics

The technology sector has been a key area of focus around this topic given its highly global presence, with US tech companies generating nearly 60% of revenues overseas.[1] This puts the tech sector at the intersection of two prominent mega forces—AI and geopolitical fragmentation—with the potential to drive a wide range of stock-specific outcomes. Recent US executive actions, such as doubling semiconductor tariffs to 50% underscores potential headwinds to firms with global exposure.[2] Meanwhile, supportive legislation such as the CHIPS and Science Act of 2022 represents a nearly $53 billion investment in US semiconductor manufacturing, research, and development.[3] This reflects the US government's commitment to tech leadership which is likely to remain an area of political consensus, potentially creating a supportive backdrop for companies who are fostering US-centric technological innovation and production.

Figure 2: Company hiring announcements and Google search trends underscore the long-term trend towards reshoring business operations

"Reshoring" US company job announcements and Google search trends (2010 – 2023)



Source: BlackRock Systematic, as of December 2023. Reshoring Institute, 2023 Annual Report. Google Trends as of December 2023. Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term. 1 Source: BlackRock as of 4/30/2024. 2 Tariff Announcements 2024. 3 White House CHIPS and Science Act Press Release One Year After 2023.

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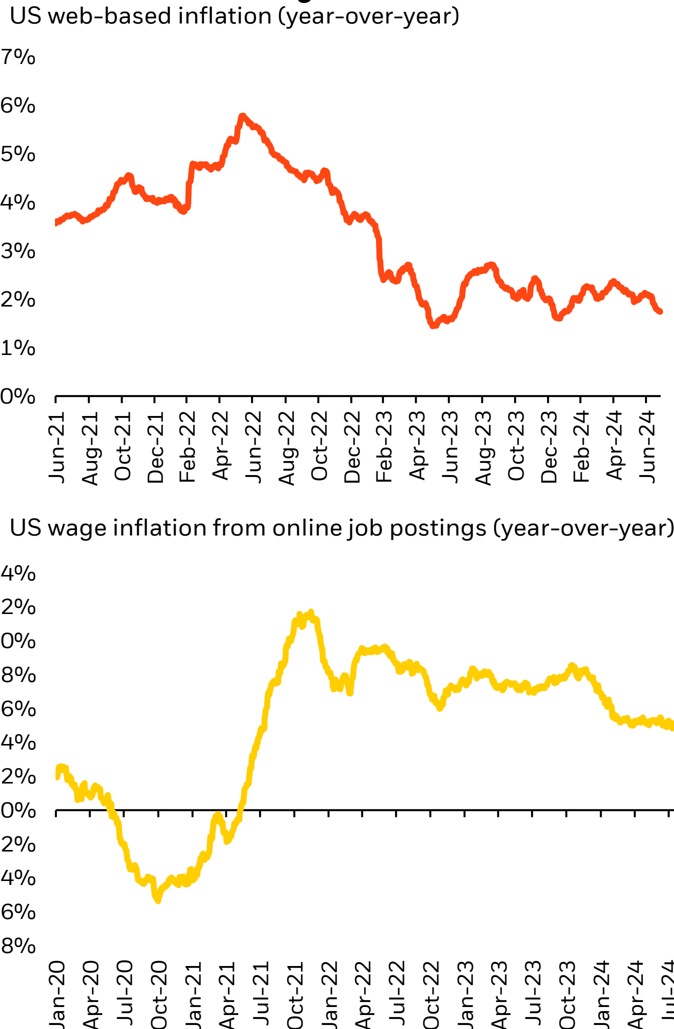
The right tail: more room for markets to price a soft landing

Soft inflationary data spurred the start of the recent rotation as investors adjusted expectations for monetary easing. As we look ahead, the potential for a right tail “FOMO” scenario could drive a more persistent rebound across segments of the market that lagged amid steady thematic and factor trends earlier in the year.

The two charts in Figure 3 show our alternative inflation indicators including web-scraped product prices and wage growth from online job postings which increasingly suggest that inflation is easing in real-time. Taken together with our estimated recession probability which remains below consensus estimates, hopes for a soft-landing have the potential to gain further traction in markets as these timely measures translate to official data releases.

Figure 3: Web-scraped product prices and wage growth from online job postings support the case for inflation continuing to moderate

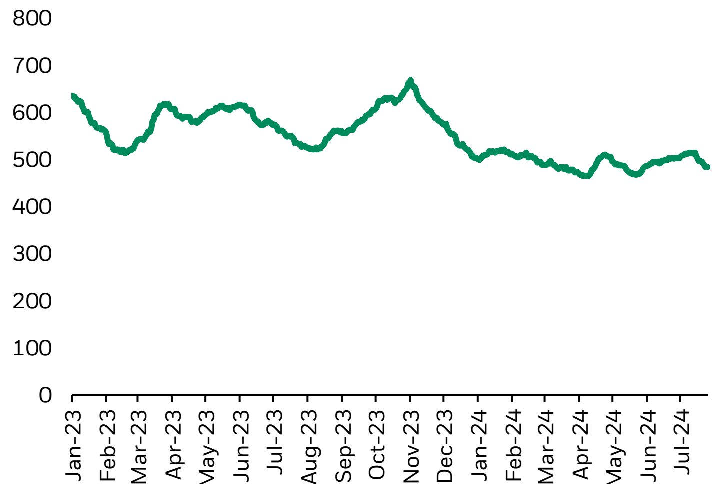


Source: BlackRock Systematic, with data from PriceStats and Burning Glass Technologies, as of July 2024.

Assuming this “right tail” macro narrative continues, the question becomes how much economic optimism is already priced? We explore this in Figure 4 by measuring how many companies across the US high cap universe are trading at a forward price-to-earnings (P/E) ratio that is below their average forward P/E ratio during previous recessionary periods. The chart shows that even after the strong market run of the past few months, there are still ~480 stocks trading below levels consistent with a recession, comprising more than one-third of the total universe. Recession-consistent pricing is concentrated within the most cyclical segments of the market, including airlines, construction, and housing, creating opportunities to exploit mispricings if data continues to point towards the economy avoiding a recession.

Figure 4: Opportunities remain for a soft-landing scenario to be priced

Number of companies in the US High Cap universe trading at forward P/E ratios below their average forward P/E ratio during previous recessions



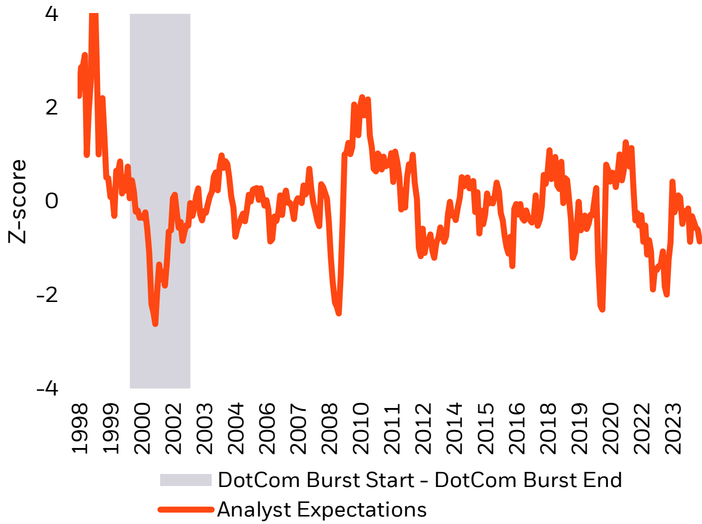
Source: BlackRock Systematic, as of July 2024.

AI sentiment slipping, but not “DotCom 2.0”

As the risks of both left and right tail outcomes increase, investors may choose to reallocate capital concentrated in established positions that have significantly outperformed year to date, most notably the AI trade.

Investor sentiment towards the AI theme has waned recently in response to high growth in capital expenditure spending, particularly among the hyperscalers in this space, amid concerns that the returns on this investment may not be as high as initially expected. Analysts are increasingly questioning whether sales and earnings will be able to keep pace with these large investments over the coming years. This weakening sentiment is reflected in measures of analyst expectations shown in Figure 5 on the following page.

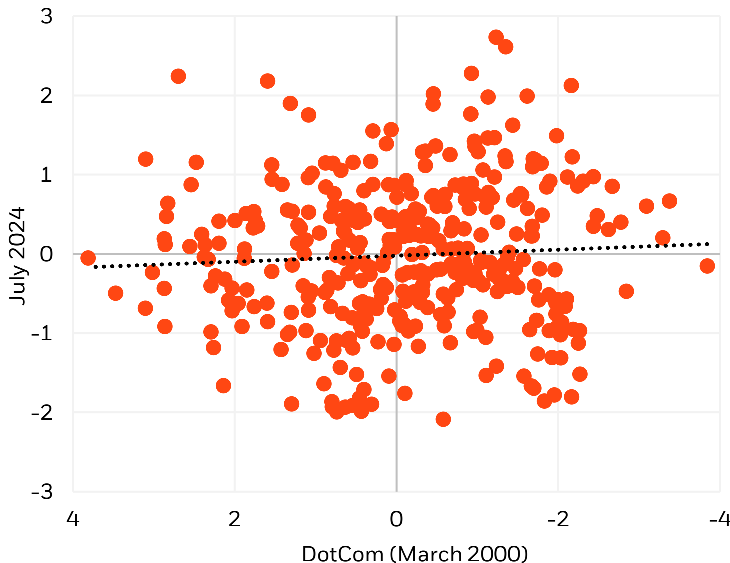
Figure 5: Analyst sentiment has shown some signs of slipping amid AI over-investment concerns
Average score for features related to **analyst expectations** over the Nasdaq 100 Index, full-sample z-scored



Source: BlackRock Systematic, as of July 2024.

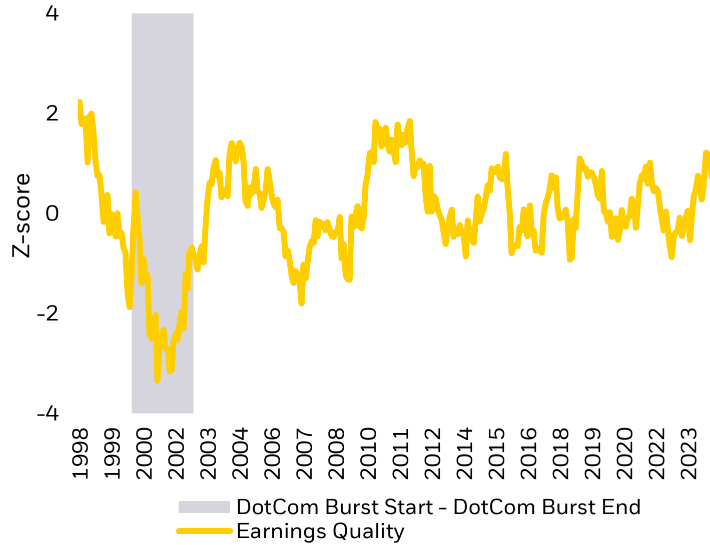
But more broadly, the current environment continues to look significantly different from the early-2000s tech bubble as illustrated in the series of charts in Figure 6. The first chart shows the z-scores of ~500 features for the Nasdaq 100 Index today versus at the start of the DotCom bubble burst—revealing very little similarity between the two periods, particularly along the dimensions of quality and volatility. The subsequent charts illustrate these differences with the time series of average aggregated feature scores across earnings quality, capital efficiency, and volatility buckets.

Figure 6: Nasdaq 100 Index features continue to look dissimilar to those leading up to the early-2000s DotCom burst, particularly across quality and volatility measures
Nasdaq 100 Index feature z-scores at time of DotCom burst (March 2000) vs. July 2024

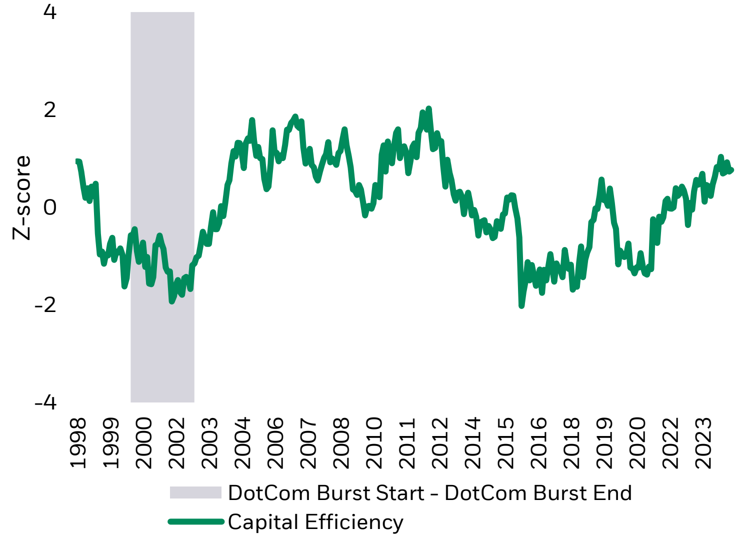


Source: BlackRock Systematic, as of July 2024.

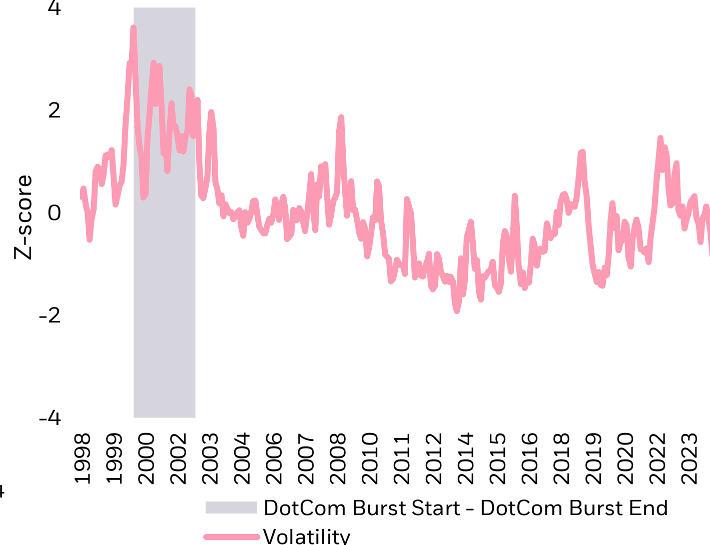
Average score for features related to **earnings quality** over the Nasdaq 100 Index, full-sample z-scored



Average score for features related to **capital efficiency** over the Nasdaq 100 Index, full-sample z-scored



Average score for features related to **volatility** over the Nasdaq 100 Index, full-sample z-scored



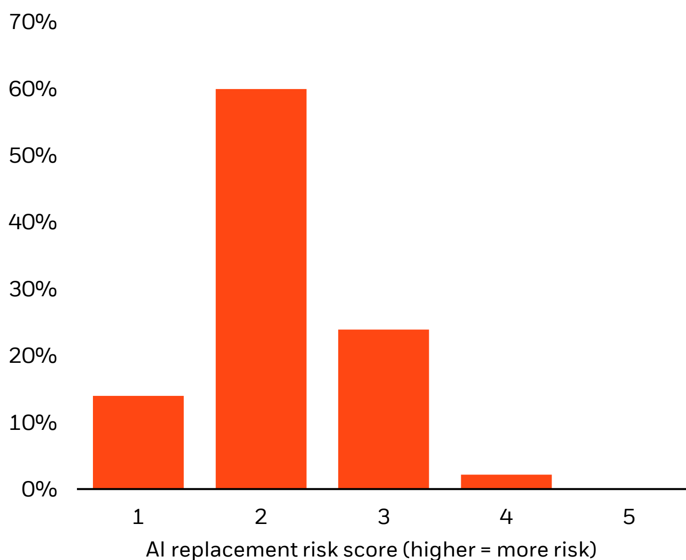
Source: BlackRock Systematic, as of July 2024.

These dynamics have helped keep our confidence in the AI opportunity intact. However, the slight detachment in sentiment underscores the need for investment insights capable of looking beyond first-order effects.

For example, we've taken a deeper look at the long-run risks of business models being replaced by AI technologies. There is some nuance to this as companies facing redundancy risks could also be reaping the benefits of these technologies near-term. In this way, initial market excitement in response to AI-driven efficiencies and cost savings could eventually turn to skepticism over time. This is becoming more relevant as the eagerness to reward companies based on broad associations with the theme appears to be fading.

To explore potential redundancies, we analyzed ~2,000 unique revenue sources across the economy, using a large language model (LLM) to score their exposure to replacement risks (1: lowest risk of being replaced by AI – 5: highest risk). The histogram in Figure 7 shows the economy-wide distribution of scores, revealing that replacement risks are relatively low overall.

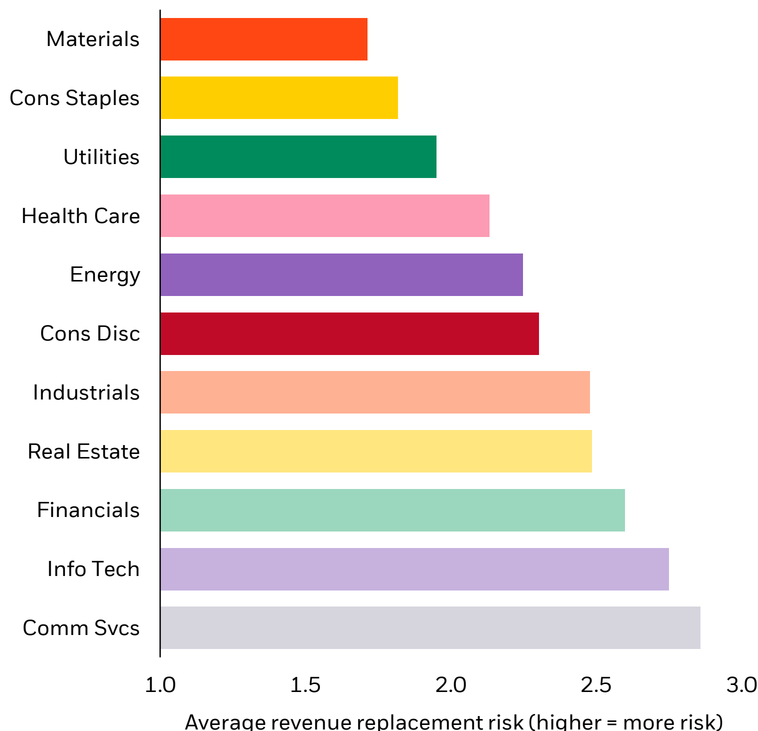
Figure 7: AI replacement risk is low on average based on our analysis of ~2,000 revenue streams
% of revenue sources within each AI replacement risk category (1: lowest risk - 5: highest risk)



Source: BlackRock Systematic, as of June 2024.

Figure 8 applies this analysis at the sector level. Materials and consumer staples appear the least vulnerable despite often being perceived as relative losers of the AI era given limited potential to benefit from these technologies. They are viewed positively in this context because demand for products is unlikely to be impacted by the progression of AI. In contrast, segments of information technology including software reflect a higher level of risk given AI's potential to replicate certain tasks. While this is just one of several lenses we apply to the AI theme, it offers a unique perspective as investors focus on companies positioned to deliver tangible long-term results.

Figure 8: Replacement risk analysis provides a differentiated lens into AI's impact over time
Average AI revenue replacement risk by sector



Source: BlackRock Systematic, as of June 2024.

Conclusion

The first half of 2024 was characterized by strong equity market returns, muted volatility, and persistent market themes. Now, equity investors are faced with a range of new risks across geopolitics, macroeconomic developments, and weakening AI sentiment.

While we remain net long the AI theme, we have reallocated somewhat in favor of higher duration, more cyclical macro expressions, supported by our dovish duration and inflation outlooks and compelling signs that the equity market has yet to fully price these encouraging developments.

In navigating these evolving dynamics, our diversity of research competencies and breadth of alternative data sources helps us remain nimble and harness new opportunities amid greater uncertainty.

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