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Strategies For Equity Market Myopia

EPS estimate reductions reduce risk of disappointment

Key Takeaways

- We believe earnings per share (EPS) for the S&P 500 may have risen nearly 10% in the year through 1Q 2024 rather than the reduced gain of 1.3% predicted by analysts who cut estimates sharply just ahead of results. While large cap tech and telecom services firms are expected to post large EPS gains in excess of 20% in 1Q, we expect a broadening of profit gains for other industry sectors in the next few quarters.
- *Only the future* counts for determining the value of equities. A good quarter past will not matter for a firm that is closing its doors. Therefore, guidance on future quarters matters most, and some firms that have experienced a huge lift to estimates in the year past will struggle to keep exceeding expectations.
- Full year estimates of US corporate profits have fallen below our own forecast near an 8% gain for 2024. Yet for many firms, beating in 1Q will merely allow them to *maintain* rather than boost full year estimates. While large cap US tech shares weakened ahead of EPS results, "FOMO" (fear of missing out) strategies that simply chase the best performers are unlikely to succeed in the way they have during the past half year.

Portfolio Implications

Our expectations are consistent with high single-digit gains for the S&P 500 index overall in 2024, but likely stronger gains for the equal-weight S&P 500 (please see Wealth Outlook 2024). The drop in EPS estimates and share prices in April has moderately improved the return outlook from here.

We've long identified Tech and Healthcare as sectors with strong long-term growth prospects. While tech recovered last year after its 2022 swoon, this year healthcare looks poised for recovery. Swerving away from a "FOMO market," investors can seek to align portfolios with the longest standing, most consistent drivers of returns. This may include investing in dividend growth and "quality" – a measure of corporate risk. We also believe investors can seek to reduce idiosyncratic portfolio risk with "broadening" strategies as fundamentals improve for more firms.

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Zoom Out from the Earnings Report Cacophony

Last week, about 30% of publicly listed US firms reported earnings results. In the coming week, 35% more will report. Firms in other regions will report quarterly or bi-annual results around the same time. This amounts to a blast of information that many will cherry pick for value at ever-faster speeds.

As usual, firms in the same industry can suffer diverging performance. On a given day, some observers will extrapolate a tiny nugget of news on a firm's fortune to the economy as a whole. The next day, a different result will change the narrative.

As we discussed in our CIO bulletin of April 7, 2024, analysts are the proverbial "easy graders" when it comes to setting quarterly expectations. Individual firms beat research analyst estimates about 70% of the time. If analysts were truly unbiased, beats would only occur half of the time. Amazingly, since 2009, the overall S&P 500 has seen earnings fall short of consensus in only two quarters (3% of cases).

With corporate confidence rising in 1Q and purchasing managers reporting a stronger "breadth" of industries with activity growing, our S&P 500 EPS estimate for the quarter is far above the reduced EPS levels analysts predict for the quarter past (see **FIGURE 1**).

If correct, will the near 10% year/year gain in 1Q EPS we expect help equities regain their footing following a 5% drop in the first three weeks of April? We think it is likely, particularly if bond market pressures and inflation fears calm (see **FIGURE 2**). With this said, investors should see the bigger picture. US corporate profits (representing more than 65% of global market cap) have durably risen as a share of national income already. For those looking for big profit gains from here at a macro level, corporate profits are far from depressed (see **FIGURE 3**).

FIGURE 1: S&P 500 EPS Year over Year (Y/Y%) Including 1Q Analyst's Estimates vs CEO Confidence Index Y/Y Difference

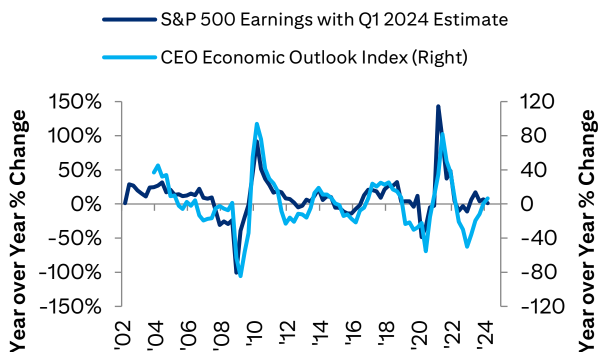
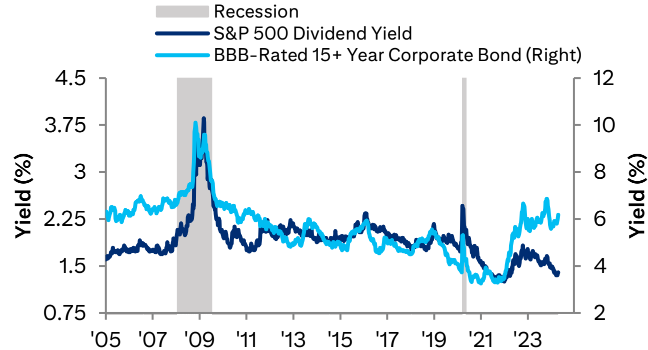


FIGURE 2: S&P 500 Dividend Yield vs Long-Term BBB-Rated US Corporate Bond Yield



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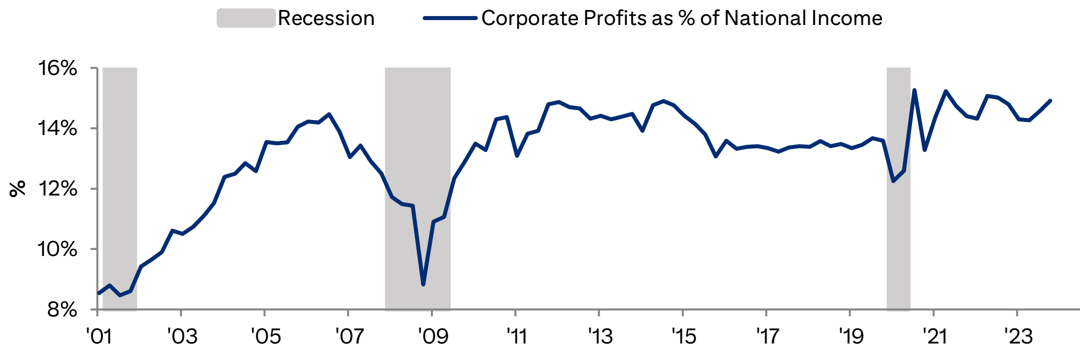
There are many factors helping profits stay high. Large US budget deficits are supporting demand in the economy. This is helping pricing power and therefore corporate profits. At the same time, innovation is helping firms cope with wage pressures. Wage gains, while moderating, are being "recycled" into demand for consumer goods and capital investments. This represents a self-reinforcing expansion cycle. Large Fed rate hikes in 2022-2023 "applied the brakes" to an overheating economy, but a salutary drop in inflation was of equal benefit to consumers.

FIGURE 3: US Corporate Operating Profits as % of National Income



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More Solid Gainers, Fewer Superstars

If certain firms can "shoot the lights out" with unexpected profit growth, history shows their share price performance can match. This was certainly the case for the "Magnificent 7" during their multi-year ascent and their stunning comeback from a poor 2022 (see **FIGURE 4**). But now, strong profit growth for the world's most highly valued companies will not come as such a strong surprise. Instead, a *broadening* of profit gains is likely to boost performance of other shares that "suffered their own earnings recession" in 2023. The healthcare sector in particular looks poised to recover from EPS declines last year (see **FIGURE 5**).

FIGURE 4: Magnificent-7 and Remaining S&P 493 Y/Y%

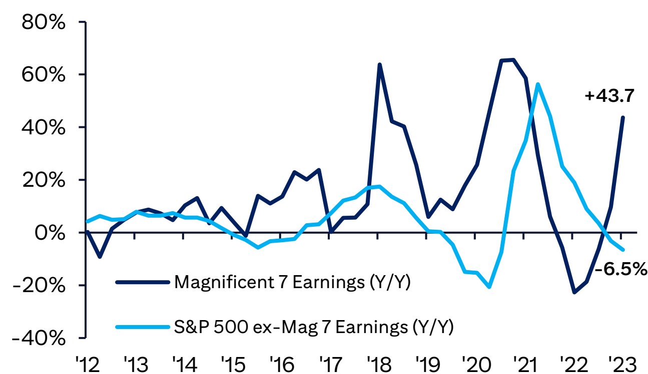
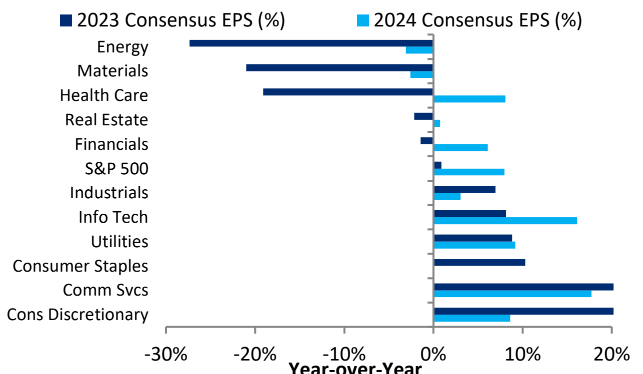


FIGURE 5: S&P 500 Sector EPS Y/Y% 2023 vs 2024 Estimate



Source: Bloomberg as of April 22, 2024. The Magnificent 7 stocks: Amazon.com (AMZN), Apple (AAPL), Google parent Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA), and Tesla (TSLA). All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance**. Past performance is no guarantee of future results. Real results may vary.**

Last year, the S&P 500 equal weight index fell behind the performance of the market cap weighted S&P 500 by the largest margin since 1998. This was because of the powerful gains among mega-cap tech firms. Indeed, a historically few number of firms were able to beat the S&P 500 last year (see **FIGURE 6**). In short, there were unusually few ways

for active stock pickers to outperform in 2023. This is changing now as profits improve across more sectors even as large cap tech-related profits slow from a pace above 40% in 2023.

To be clear, we see potential opportunities for both tech and healthcare as the two "super sectors" that outgrow broad economy profits over the longer term. Much like the industrialization of the economy in the 18th/19th century, these are the sectors that the economy is "becoming." While flush with competition, cyber-security software is a critical element of "Economic Security" we discussed in last week's bulletin. Semi-conductor equipment is a critical element of building secure technology supply chains. For long-term investors, we see a correction in related share prices as a mere "ripple in the tide."

However, we also see greater idiosyncrasy among large US tech platforms. The performance of electric vehicle makers, AI chips and smart phones was never likely to stay a "single trade." Generalizing, however, we would hold large cap US tech shares near an equal weight in diversified portfolios. We are not counting on a *repeat* of their outperformance in the year ahead (see **FIGURE 7**). To express this view, our Global Investment Committee holds an overweight position in the S&P 500 Equal weight index to potentially benefit from sectors that are rebounding from a depressed performance in 2023.

FIGURE 6: Share of S&P Constituents beating the S&P 500. Lowest since 1998 in 2023, Rebounding Now

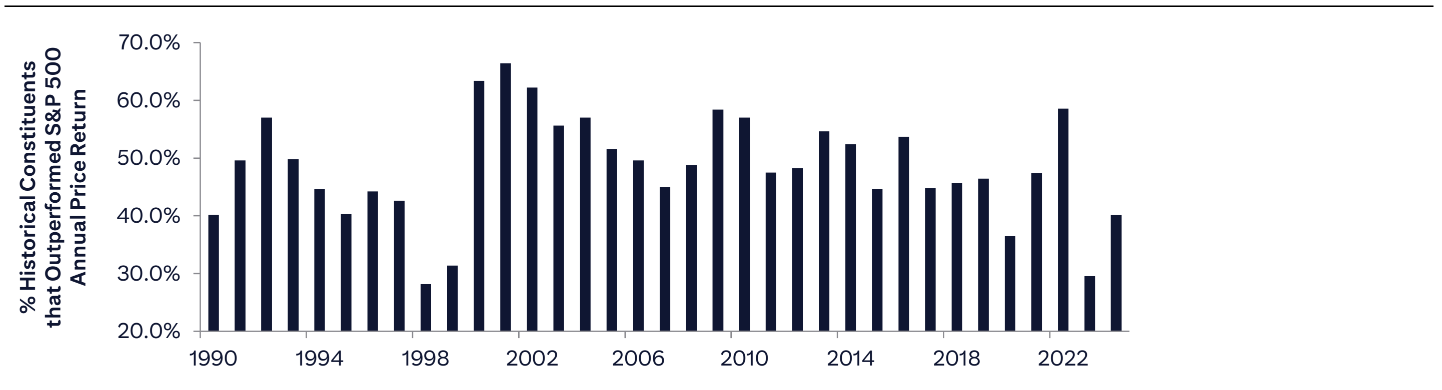


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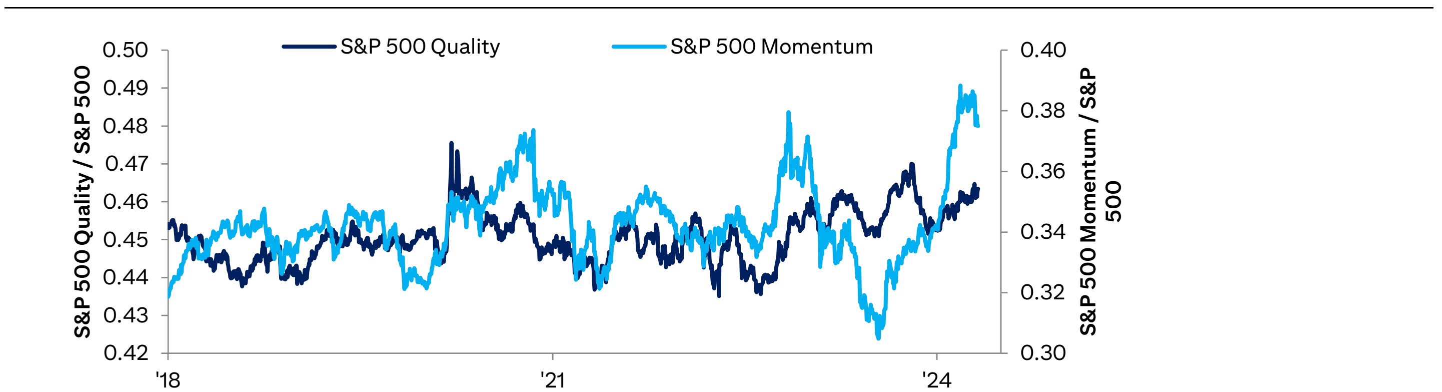
FIGURE 7: S&P Equity Style Indices: Momentum vs "Quality"



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Reasonable Expectations Are Still Positive

For long-term investors, we see potential opportunity in the economy's "Unstoppable Trends" as described in our Wealth Outlook 2024. The "digitization" of the economy – with the latest chapter driven by AI development – is at the forefront. Healthcare technology – with the demands of an aging global population – is another. Some of the trends and their consequences are unfortunate, such as geopolitical polarization and climate change. Investors still need to adapt when needed and seek to take advantage of growth opportunities when presented.

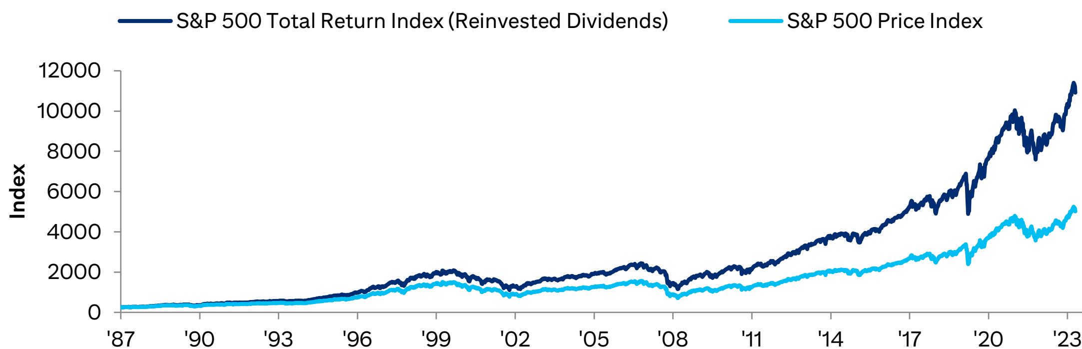
The ups and downs of the economy and short-term market performance is another matter. We believe the immediate backdrop for the economy has "no landing" in sight. Without eventual reductions in Fed policy rates, however, we would expect the US labor market to slow more than the Fed desires. As we discussed last week, we see views of the Fed and inflation as far more mutable than many believe.

After last year's equity market gains, the picture of the economy we described is not likely to result in boom-style equity returns, but rather gains consistent with a "mid-cycle expansion." After a 5% pullback through mid-April[1], the S&P 500 has still returned 23% and the S&P 500 equal weight index 22%[2]. We saw US and global equity markets as mildly depressed a year ago as recession and inflation fears still dominated investor psychology. Today, that depression rut is over.

With this in mind, it is important that investors understand the long-term drivers of equity returns. Even in the past three decades of tech and growth stock dominance, dividend growth, when reinvested, has accounted for roughly half of the S&P 500 total return (see **FIGURE 8**). Firms that invest, innovate to create new products and dominate their industry outperform. But from a total return perspective, less innovative firms that are consistent growers of dividends catch up in time.

In conclusion, we see more "solid players" on the field and fewer "superstars" for now. One can broaden a portfolio to cut down on the idiosyncratic risk of concentrated stock positions. In the market we foresee in the year ahead, we believe doing so will not weaken performance.

FIGURE 8: S&P Total Return Index with Reinvested Dividends vs Price Alone



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[1] Source: Bloomberg as of March 28, 2024, through April 19, 2024
[2] Source: Bloomberg as of October 30, 2023, through April 26, 2024

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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