

# Stay Focused on Earnings

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## CIO Weekly Perspectives

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Should a sticky inflation release cause investors to revise their outlook for equities?

A growing chorus of voices has been fretting about “sticky” inflation over recent weeks. Last week’s U.S. inflation data raised it to a clamor.

Investors, who had been pricing for six rate cuts in 2024 at the start of the year, are now skeptical that the U.S. Federal Reserve will deliver even two. The market’s odds of a first cut in July plummeted from near-certainty to fifty-fifty. Thereafter, favorable base effects on the year-over-year inflation rate begin to fade and the U.S. election starts to loom, potentially making it tricky for the Fed to act.

We have been arguing that a normalization of the economic outlook is encouraging investors to focus on economic growth more than inflation, leading to a reversal of the positive correlation between stocks and bonds and a broadening of equity market performance.

Did last week mark a premature end to that new trend? We think not, for two reasons: The inflation and rates concern may be overheated, and the earnings growth story underappreciated.

## **Inflation**

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On inflation, attention focused on month-over-month core CPI coming in at 0.4%, marking the third consecutive month at this kind of level.

Except it didn't really come in at 0.4%—it was 0.359%, rounded up. Never mind that it is only one data point; had the number been one basis point lower, it would have been rounded down to 0.3%, in line with expectations. While there is no doubt inflation is proving stickier than many anticipated, the stickiness is appearing in the expected places; services ex-shelter and owner-equivalent rents surprised on the upside while core goods surprised on the downside. Moreover, last week also revealed that inflation is running cooler for U.S. producer prices than for consumer prices, suggesting that the Fed's preferred measure, Personal Consumption Expenditures, could prove more benign when new data comes out in two weeks.

It can be easy to miss the forest for the trees when a data release like this comes out. The economy is expanding nicely and producing strong jobs growth. We believe that the risk of a return to truly problematic inflation is low, and we still think the Fed will cut rates this year. And even if it does not, sticky inflation is contributing to relatively high nominal growth, which has helped sustain earnings and build many companies' resilience against the current level of rates.

The S&P 500 Index total return has been 25% in just the past five months and is due a breather, but we think long-dated yields would have to be well above 5% before they cause a substantial equity-market correction.

## Earnings Outlook

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With first-quarter earnings season just getting underway, analysts currently expect something similar to the previous quarter. Earnings growth for the “big six” of Nvidia, Meta, Amazon, Microsoft, Alphabet and Google combined is expected to be more than 40%, and growth for the Technology, Internet Retail and Media & Internet sectors combined is expected to be almost 30%, while earnings for the rest of the S&P 500 Index are projected to have *shrunk* by 4%. Adding all that together would leave S&P 500 earnings up 4% or so for the upcoming quarter.

That said, there are early signs of broadening performance; for instance, in the fourth quarter of 2023, those “big six” names outgrew the broader Technology, Internet Retail and Media & Internet sectors by 25 percentage points, whereas in the first quarter the difference is expected to be half that.

As we move through the rest of 2024, analysts anticipate slower earnings growth from the “Tech-plus” stocks and improving growth from the rest of the S&P 500 Index. By the fourth quarter, the current consensus is that the growth rate for the “big six” will be almost the

same as the growth rate for the other 494 companies, potentially delivering close to 10% earnings growth for the broad Index this year.

This would be an important development in the equity market, in our view, as one of the key vulnerabilities causing concern for investors coming into 2024 was the unsustainability of mega-cap technology growth rates, given the high base set during 2023. Other sectors now look set to take up the slack.

## Risks

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Even with this, risks remain.

It is too early to dismiss the possibility of another inflation spike entirely, particularly against the current background of geopolitical tensions and conflict. And even as some of the extreme bifurcation between certain sections of the equity market begins to recede, the split between the “haves” and the “have-nots,” the cash-rich and the overleveraged, appears to be growing. Credit-card delinquencies are on the rise, and the NFIB’s small business optimism index, representing the sentiment of the thousands of companies that form the backbone of the U.S. economy, hit an 11-year low last week.

Nonetheless, the risk that these dynamics will be the cause of the next substantial drawdown in equity markets is, in our view, increasingly a tail risk—and a one-basis-point miss in the core CPI data doesn’t change the fundamental growth outlook.

## In Case You Missed It

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- **U.S. Consumer Price Index:** +3.5% year-over-year, +0.4% month-over-month (Core Consumer Price Index +3.8% year-over-year, +0.4% month-over-month) in March
- **China Consumer Price Index:** +0.1% year-over-year in March
- **China Producer Price Index:** -2.8% year-over-year in March
- **European Central Bank Policy Meeting:** The ECB made no changes to its policy stance
- **U.S. Producer Price Index:** +2.1% year-over-year, +0.2% month-over-month in March
- **University of Michigan Consumer Sentiment:** -1.5 to 77.9; one-year inflation expectations +0.2% to 3.1% in April

## What to Watch For

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- **Monday, April 15:**
  - U.S. Retail Sales
  - China 1Q 2024 GDP
  - NAHB Housing Market Index
- **Tuesday, April 16:**

- U.S. Building Permits
- U.S. Housing Starts
- **Thursday, April 18:**
  - U.S. Existing Home Sales
  - Japan Consumer Price Index

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For Available Investments and Market Insights

#### Select Your Location

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