CIO View

Americas CIO View

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Marketing material

Last days to price best of all possibilities: Tough decisions after the elections

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IN A NUTSHELL

- 100% hopeful now, 50% disappointed later: Markets appear to price best of each scenario
- It remains a tight presidential election, likely a small Republican Senate majority
- Next Fed meeting 2 days after the election: What if no fiscal tightening is likely?
- Few care about non GAAP EPS quality: At least a 5% deduction for S&P EPS
- S&P 500 targets: 5300-5500 for 2024 end, Sept. 2025 is 5800 & 6000 year-end
- Cautious on stocks around elections and into year-end: Preferred outcome plays

100% hopeful now, 50% disappointed later: Markets appear to price best of each scenario

Remove presidential candidates' names and the parties controlling Congress from election scenarios and markets appear priced for outcomes that produce: 1) no tariff hikes, 2) no tax hikes, and 3) the U.S. Federal Reserve (Fed) quickly cutting rates to neutral in 2025. Such expected political and policy outcomes for 2025 also include a macro backdrop of: 1) healthy U.S. gross domestic product (GDP) growth and inflation, 2) geopolitical stability, and 3) a deficit normalizing and trending to below nominal GDP growth, or the bond market just not caring about it, so 4) 10-year Treasury yields under 4%, and 5) a few years of 10% S&P earnings per share (EPS) annual growth. We imply such expectations by observing the S&P at 21.5 times our 2025 estimated EPS of $270, up 10% from 2024 estimate of $245, which assumes no corporate tax hikes. Our intrinsic valuation models support a 21.5 forward S&P price-to-earnings (P/E) ratio if S&P EPS increases 10% annually into 2027 and 10-year Treasury Inflation-Protected Securities (TIPS) yields fall to 1.5% with a 3.5% equity risk premium (requires a confident EPS and rates outlook) for a real cost of equity of 5.0%. Thus, a fair steady-state 20 forward PE for 6% long-term S&P EPS growth.

It remains a tight presidential election, likely a small Republican Senate majority

We think tax hikes are likely in 2025 unless a Presidential veto blocks them. While we expect Republicans to take Senate by a couple of seats, we think a Harris administration can push through higher top household income and corporate tax rates by offering industrial policy benefits to red state Senators. Tax legislation is likely a first 100 days priority and needed by 2025 end given sunsets. Raising the corporate tax rate to 28% is expected to hit S&P EPS by about 7%. The amount varies by sectors/companies on geographic mix.

Next Fed meeting 2 days after the election: What if no fiscal tightening is likely?

We remain surprised by the Fed's unwillingness to acknowledge the structurally unsustainable deficit and the differing implications for fiscal policy per election outcomes. If Trump wins and Treasury markets sell off, then the Fed might need to pause rest of year.

Few care about non GAAP EPS quality: At least a 5% deduction for S&P EPS

Both our and consensus S&P EPS estimates and the comparable histories of actual results are based on non Generally Accepted Accounting Principles (GAAP) figures. Non GAAP EPS is based on analysts excluding charges considered non-operating or unusual, such that exclusion better represents profitability during the short-term period being analyzed. Typical exclusions include loss on asset sales or impairments, restructuring costs, litigation costs, etc. We find non GAAP EPS measures analytically useful, but for decades we've cautioned that non GAAP EPS tends to overstate truly normalized earnings, historically by 5-10%. We make deductions to non GAAP EPS estimates when used in valuation models. We think GAAP EPS tends to understate normal.

Some investors argue for a sustained S&P PE well over 20 owing to higher Free Cash Flow (FCF) relative to earnings than history. It's true that FCF is higher relative to non GAAP earnings now than history, but this requires careful consideration to correctly factor into valuation. First, the calculation of FCF vs. non GAAP earnings must be consistent and conceptually sound. Non-GAAP EPS usually adds back all amortization of intangibles, which can have an economic cost. And sometimes stock option expense is also added back, yet stock option issuance will reduce future FCF per share. So be careful when calculating FCF using non-GAAP net income as the stem. Second, the difference between earnings and FCF is investment. Earnings reinvestment ratios vary historically, but what matters is the return on incremental investment. The incremental return is indeed higher over the past decade than history and higher than cost of equity estimates. We think this continues for several more years, but we capture this in our forecasted EPS growth rates and the valuation premiums we assign to each sector above steady-state PEs for overall value-added S&P EPS growth.

S&P 500 targets: 5300-5500 for 2024 end, Sept. 2025 is 5800 & 6000 year-end

We're assessing third quarter reporting, but we'll likely maintain our S&P EPS forecasts assuming no corporate tax changes: $245 in 2024, $270 in 2025, $300 in 2026. However, our S&P targets do not ignore the potential for tax hikes hitting our EPS estimates or affecting our 10-year Treasury yield outlook for being at 4% in a year. We will reassess after the election.

Cautious on stocks around elections and into yea-rend: Preferred outcome plays

Our preference remains for large cap and balanced style exposures. We're not overweight small caps and question whether a rally there is sustained or runs higher on Trump. We see best risk/reward on a Trump win at large Financials, Health Care and Communications and Tech stocks. We view best reward/risk on a Harris win at Utilities, REITS, Staples.

Glossary

Amortization is an accounting term which refers to the periodical reduction of the book value of intangible assets (such as patents) or bank loans.

A budget deficit is created whenever the spending in a public budget exceeds the income within a given time period

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Equity risk premium is an excess return earned by an investor when they invest in the stock markt over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The forward P/E ratio (or forward price-to-earnings ratio) divides the current share price of a company by the estimated future (“forward”) earnings per share (EPS) of that company.

Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Large cap firms generally have a market capitalization of more than 10 billion dollars.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A tariff is a tax imposed by one country on the goods and services imported from another country.

Tightening monetary policy refers to all actions undertaken by a central bank to slow down overheated economic growth. These include regulation of key interest rates, constraining monetary supply or increasing capital requirements for credit risks.

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

U.S. Treasury yield is the annual return investors can expect from holding a U.S. government security with a given maturity.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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