CIO View

Americas CIO View

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Marketing material

Summer portfolio: Strong sun with fading liquidity, apply sunscreen

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IN A NUTSHELL

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The dangers of summer to autumn markets, a seasonal history worth respecting

Markets are following seasonal norms in 2024, so far. The year started with strong gains that continued through spring, as the April showers brought May flowers. We think this is a year to respect seasonal norms, which was historically flat or down equities in summer and repeat dips or deeper corrections in autumn. This seasonal pattern was more common and pronounced in election years, but also when expectations or hopes were high for U.S. Federal Reserve (Fed) cuts, without a recession looming, yet cuts didn't come or not until after an equity correction like in 1962, 1966, 1984. Other sunburn summers featured conflicts in 1973, 1990, 2006, 2022. Sovereign credit problems in 1998, 2010-2011. gross domestic product (GDP) soft patches or industrial/ profit recessions in 1985, 1994, 2015 and recessions in 2008, 2001-02, 1991, 1982, 1974, 1970, 1960. Since 1960, 35% of summers to autumn were down, 35% flattish, 30% steadily up.

Summer 2024 outlook: Growth slows, Fed waits, conventions, conflicts, rich valuations

We expected an economic soft patch to hit the US following the Fed's last hike in July 2023 to 5.5% with the usual one-year lag. While never expecting a recession, we thought real growth would be 0-1% for a couple of quarters as higher interest rates hit durable goods consumption, capital expenditure (capex) and construction. We predicted healthy service consumption growth, which we expect to continue, causing strong job gains over the past year. A tightened labor market combined with higher household living costs kept core inflation well above target in a price --> wage causality. 1H24 GDP is moderately exceeding our expectations owing mostly to a surge in capex and construction activity on data centers as discussed in our recent notes as well as bolstered household spending likely because of rising household wealth. Although initial 2Q indicators suggested a broad-based acceleration in US GDP, we think it's become clear that growth slowed broadly, but artificial intelligence (AI) related investment surged. From here, we think broad growth will continue to slow as the Fed waits longer to cut and the uncertainty from elections at home and conflicts abroad weigh on incremental activity. We think US GDP will trend at 1.5-2.5% growth well into 2026. No recession, but also no golden expansion as core inflation likely stays above real growth rather than well below it.

Summer macro risks and also valuations high at S&P 492, what about liquidity?

As detailed elsewhere, 1Q S&P Earnings per share (EPS) growth was 10% year-over-year (y/y), but up 55% at the Great Eight and up only 3% at the rest. Our and consensus estimates are for improved 6-8% growth y/y at the S&P 492 as the Great Eight stays over 20% to sustain 10% S&P EPS growth quarterly the rest of the year. But estimate revision trends suggest it might take longer for such healthy growth to come at the 492 and 8 or just 6 firms still do the heavy lifting. S&P 492 is at 18.5x 2024 estimated EPS. Given short and long-term real interest rates, this is a high price-to-earnings (P/E) for subpar real EPS growth. However, some argue that liquidity supports these P/E ratios, such as elevated money market balances. The summation of money market and bank deposits, essentially M2, has been declining since 2022. Moreover, M2 relative to S&P market cap is at a 25-year low. Thus, while liquidity remains ample it's on the wane since its 2020-2021 surge and not a great support without better EPS growth. Furthermore, household equity allocation of total financial assets is near its 2000 record.

AI is so bright, got to wear shades: Sun can burn even with shades & sunscreen

The earnings growth and revision trends remain encouraging at the Great Eight stocks, albeit downward at Tesla and merely stable at Apple. We are constructive on most of these stocks, but concerned about very demanding valuations and intensifying competition for electric vehicles and semiconductors worldwide. These are not industries with histories of sustaining high margins and returns on capital or many years of economic profit growth that the observed valuations imply. Whereas, the others are in industries with superior profit histories and have led such growth and profitability of industries and end markets that they essentially created. This group is at 30x 2024 estimated EPS on 20% EPS growth through 2026. These stocks are 35% of S&P 500 market cap and 55%+ of the Russell 1000 Growth index.

Summer portfolio sunscreen: Reduce risk and diversify from Magnificent Seven

In preparation for the summer, we favor short duration fixed income over equities and within equities a small under-weight of US stocks in favor of Japan & Europe (EAFE). Within US equity allocation, we favor large over small caps (large, not mega caps) and efforts to diversify away from the Magnificent 7 or Great 8-12 leadership. Our sector strategy is most overweight Health Care, Capital Goods, big Banks, Insurance, Oil Services and Utilities. We are most underweight Semiconductors, Auto, Retailers (goods), Capital Markets, Transports (OW Airlines), Materials.

Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

A correction is a decline in stock market prices.

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.

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.

M2 is a money-supply measure that includes physical money, bank deposits as well as other less liquid funds like savings that can quickly be converted to money.

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

Profit Margin is an accounting figure which describes profit in relation to revenue in percent.

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Real growth is nominal growth less inflation.

The Russell 1000 Growth Index states the performance of the companies included in the index that have higher price-to-book ratios and are forecasted with higher growth.

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

Small cap firms generally have a market capitalization of less than $2 billion.

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

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