

Altitude Sickness: Breathe, go slowly, stick to the big markers



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IN A NUTSHELL

- Valuations remain sky high, despite the gravity of new normal real interest rates
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Valuations remain sky high, despite the gravity of new normal real interest rates

At slightly more than one month into Trump 3.0 and nearly two months into 2025, the US equity market continues to trade at sky high valuations, despite real interest rates seemingly settling into a new norm of about 2% essentially across the curve. The chances of Fed Funds rate cuts this year have dimmed owing to inflation chronically above the U.S. Federal Reserve's (Fed's) target this cycle, but equity investors are focused on 10-year Treasury yields and fortunately Trump team 3.0 understands the importance of making efforts to keep 10-year yields under 5% while they keep fiscal policy loose.

The S&P 500 was a bit volatile last week, setting an all-time closing high of 6144 on Wednesday, but then dropping 2.1% by Friday to 6013, essentially back to levels the days after the election before drifting down about 2.2% in late December to finish 2024 at 5882 because 10-year Treasury yields climbed from about 4.25% near the election to 4.75% near 2024 yearend and now 4.5%. The nearly complete results and guidance of fourth-quarter (4Q) earnings season did not make the S&P 500 any cheaper; as the S&P set new highs on Feb 13th and then higher Feb 20th, S&P earnings per share (EPS) results only met 4Q expectations of \$65 and \$245 for 2024 and bottom-up 2025 consensus EPS was cut 1.5% year-to-date (YTD).

EPS Tracker (week 6): 4Q24 growth is an indicator for 2025 ex. tax cuts / tariffs

After a strong and truly better than expected start to 4Q24 earnings season from big banks, EPS results have been in-line with expectations before the routine window-dressing estimate cuts made within two months prior to actual reporting to deliver the usual or farcical average S&P beat of 3-5% that occurs every quarter absent the onset of recessions. Nevertheless, non-sense of the beat aside, 4Q S&P EPS growth year-over-year (y/y) was very strong as expected at 15%. With just Nvidia left to report, Great Eight blended EPS growth y/y is 31%. Notably, the S&P 492 at near 90% of earnings reported, has blended EPS growth y/y of 10% and while Financials boosted S&P 492 with near 30% EPS growth y/y, S&P 492 ex. Financials & Energy also had 10% y/y EPS growth.

Strong growth at Great Eight, Financials, Utilities, Health Care and mega-caps

Beyond the Great Eight and Financials, strongest sector EPS growth was at Utilities and Health Care. We also see an ongoing trend of the largest firms by sector and key industries posting stronger EPS growth than their smaller peers, despite usually having more dollar strength foreign exchange (FX) headwind. Larger companies are driving better sales growth and especially margin expansion.

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At least a few things seem to be driving this superior profit growth at the titans of their respective industries even beyond the Great Eight, including: 1) pricing power on high capacity utilization (most things electric power related) or just still hiking prices both in the U.S and also abroad, 2) less sensitivity to still upward wage/benefits pressure on lower pay employees, 3) better use of technology to drive cost savings. The biggest companies are also usually less commoditized, better branded and/or define their business segment. Furthermore, the goods retailing industry continues to consolidate to the titans. There are exceptions to this big has better profit growth trends to note right now, such as weakness at big Energy vs. small, better profit growth at smaller quick serve restaurants and self-inflicted problems such as that at the commercial aircraft leader.

Near-term risks and the long-term potential of AI favor bigger firms: Favor the 92

When assessing near-term uncertainties, in general, we think smaller companies are at greater risk to tariffs and the possibility of higher Treasury bond yields. Smaller companies still seem to be priced with hope for Fed Funds rate cuts this year, especially smaller banks (cuts without a faltering economy), and also seem to be priced more for the possibility of a lower US corporate tax rate than large companies. When assessing long-term trends such as the use of advanced technology and AI, in general, we think bigger companies are better positioned to benefit. Just as globalization helped big outperform small for a long time, digitalization might extend the large firm advantage. Thus, while we think it important to diversify from the Great Eight, we think the S&P 492 or just the next 92 of the S&P 100 is more attractive than the S&P 600 (small) or S&P 400 (mid-caps).

Trump 3.0: Bark & Bite with Tariffs, DOGE and Peace Now or Pay-the-Price

It's been hard to keep up with the many executive actions and announcements from the new administration. We believe more tariffs are likely on China and the European Union (EU), unless these two fall in line to oppose Iran and Russia and more fully cooperate with the US geopolitically, economically and on (less) regulation. We expect about \$150bn in annual tariffs by yearend, an about 5% aggregate tariff rate, or 0.5% of gross domestic product (GDP). This could raise inflation by 0.25% and slow growth by 0.25% all else the same. Because nominal US GDP is \$30trn, neither tariffs at this scale nor likely Department of Government Efficiency (DOGE) savings are likely to stall the economy or shrink the deficit. Trump is demanding immediate peace in the Middle East and in Eastern Europe on US terms. We are intrigued by such assertions and speculate that if Russia and supporters of Palestinians don't accept US terms then the US will turn its back on both while demanding that the EU and other allies commit forces and pay up to both finish the fight and rebuild afterward. This direct and bold strategy might work, but risks remain very high and how China reacts to it all is a wildcard.

S&P likely 5700-6300 rangebound until late 2025, favor Health Care & Financials

Go slowly at this altitude to evaluate monetization of AI services, AI chips competition/pricing, tariffs, interest rates, dollar FX rates, oil prices, war and peace, etc. We see it proper to seek stock specific alpha.

Glossary

Alpha refers to returns in excess of a benchmark's return.

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

Capacity utilization refers to the share of an economy's productive capacity that is in use.

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 **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

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.

FX or **foreign exchange** is the currency — literally foreign money — used in the settlement of international trade between countries.

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.

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.

The **S&P 100**, a sub-set of the S&P 500, is designed to measure the performance of large-cap companies in the United States and comprises 100 major blue chip companies across multiple industry groups.

The **S&P 400** provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

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

The **S&P 600** seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

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

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.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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