CIO View
Americas CIO View
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Marketing material

New S&P 500 target of 5300: A.I. lives and it needs food and shelter

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IN A NUTSHELL

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We raise our 12-month S&P 500 target to 5300 as it's parenting A.I.

At our recent CIO Day, we raised our S&P 500 target from 4700 for 2024 end to 5300 for March 2025. We boosted our fair S&P price-to-earnings (P/E) ratio estimate from about 20 to 21.5 times our forecasts for trailing earnings per share (EPS). This higher PE is assigned because a recession is unlikely, despite U.S. Federal Reserve (Fed) hikes, and the biggest S&P 500 companies are ramping up investment spending to raise their artificial intelligence (A.I) capabilities. Such investment helps the economy grow, directly benefits producers of A.I. equipment and infrastructure and could deliver accelerated EPS growth for the overall S&P 500 in the years to come. We maintain our 2024 & 2025 S&P EPS estimates of $243 & $260, an 8% growth trend; but we acknowledge the possibility of 10%. Analyst bottom-up consensus estimates for 2024 & 2025 S&P 500 are now $245 and $275. However, estimates continue to be trimmed outside of Tech, but rising at digital and especially semi-conductors.

A.I. lives: This child needs chips, servers, data centers, electric equip. and power

The promise of A.I. has gained traction with the biggest tech and digital service companies, sparking a capital expenditure (Capex) race. These companies are spending on microchips, adding computer servers, expanding their data centers for their use and their cloud customers. Our S&P EPS estimates include very strong growth forecasts for semi-conductors, cloud providers, electrical equipment and even electric utilities. We also expect continued healthy earnings growth at the software and internet service companies and the divisions of such at the tech titans. While we expect benefits of A.I. to come to other industries, especially healthcare and financials, it remains uncertain when it will be significant and how significant.

It's because of this A.I. investment boom that we forecast 7-10% S&P EPS or above normal, despite an expected slowing of US gross domestic product (GDP) through 2025 and continued slow global GDP growth. Our S&P EPS forecasts by sector are inside. We note slow growth forecasts at Energy, Financials, conventional Media/Telecom, conventional Retailing and most Consumer Goods across Discretionary & Staples. We see strong demand at parts of Industrial Capital Goods and stability and cost control at Transports.

Beyond the A.I. child? 2024 Fed cuts still expected and an uncertain U.S. election

Many macro considerations remain for equities, especially for businesses that are not A.I. centric. We still expect the Fed to cut rates in 2024, but 3 years of inflation significantly exceeding the Fed's 2.0% target, a still very tight labor market despite some signs of slower job creation, US GDP likely up 2.5% in 1Q24, federal deficits still 6%+ of GDP and a stock market and household wealth at all-time highs, requires that expectations for future Fed Funds rates be approached with due uncertainty. The cuts could still be later and less than the market's recently moderated expectations. We expect 3 cuts by March 2025 and see the 1995-96 episode as a reasonable analogue with cuts in July '95, Dec '95 and Jan '96 with no further cuts until more evident signs of a recession or inflation below target. Presidential elections are always uncertain and this one will likely be too close to call until Election Day. We think the deficit needs to be addressed after the elections. A Biden win and mostly Democratic Congress would likely lead to higher taxes, including for companies. A Trump win and mostly Republican or populist Congress would likely lead to more tariffs. A split government that manages to find a balanced and credible path toward fiscal repair would be the best outcome. We wonder about the patience of bond investors if inflation or deficits remain above norms, 10yr Treasury yields could climb despite Fed hikes. We forecast a 4.5-4.75% Fed Funds rate and 4.2% 10yr Treasury yield at March end 2025.

Most valuation metrics have failed badly; EPS yield vs. real yields best of bunch

Valuation doesn't matter until it does, but it's always important to use robust valuation frameworks. Many once popular S&P valuation metrics or really heuristics have fallen on the ash heap of history. The recently fallen include S&P market cap to US GDP, Shiller's PE, 20 PE minus inflation, etc. The S&P's price-to-book multiple is now 4.7x, which can only begin to be understood by considering the S&P's 22% RoE. The best high-level valuation metric and guide remains S&P EPS yield less long-term Treasury Inflation-Protected Securities (TIPS) yields. This valuation metric, aka the implied Equity Risk Premium, suggested attractive compensation for macro risk from 2010-2020. Since 2021, it implies below normal and still diminishing compensation. Yet this metric might also require looking deeper into its fair drivers. Owing to the S&P's compositional shift toward digital firms, we add a value-added growth premium on top of our fair steady-state S&P PE calculation. Our 21.5x fair trailing S&P PE target for March 2025 includes a 15% premium above our fair steady-state S&P PE estimate of 18.5x. This "digital growth premium" is the largest we have used yet and can be interpreted as expecting S&P EPS growth 2-4% above steady-state EPS growth of 6.5% (nominal cost of equity minus dividend yield) for the next several years. We would expect the S&P PE to fall back toward its steady-state level as superior EPS growth is delivered and likely exhausted at some point. This introduces an uncertain pricing dynamic into the market which could play out smoothly or abruptly. While we think a 10-20% growth premium is appropriate, it's risky.

We see low S&P reward/risk before elections, but favor Healthcare and Financials

Glossary

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

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

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

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 term federal funds rate refers to the target interest rate range set by the Federal Open Market Committee (FOMC). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

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.

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

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

The cyclically adjusted price-to-earnings ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure usually applied to the U.S. S&P 500 equity market. It is defined as price divided by the average of ten years of earnings (moving average), adjusted for inflation.

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.

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.

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

Important information – EMEA, APAC & LATAM

Important information – North America

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