STRATEGAS insight

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Earnings, Interest Rates & Four Thematic Investment Ideas

It is difficult not to be bullish. While showing some modest signs of softening domestically (e.g., consumption), the economy is generally strong globally. Market performance remains robust, operating rates are expanding, and corporate profit expectations are revising higher and broadening. At the same time, it is difficult not to harbor skepticism. The perception (among some) that there remains a continued need for government "tools" to bolster economic activity would seem to stretch the definition of a strong, self-reinforcing economy. Moreover, equity valuations have shifted higher, into the upper strata of their historical range, where the forward return profile is not particularly robust for new money. Still, there appears little to put the domestic bull market into abeyance – we remain *bullish 'til the bill comes due.*

We have long held that earnings and interest rates are the principal building blocks of equity prices. Trends in both appear supportive over the intermediate term.

Valuations, while stretched, are benefitting from continued optimism for corporate profits in 2H'24 and into CY'25. Under the surface, the earnings recovery for the broader S&P – outside the Magnificent 7 and some adjacent growth darlings – had been slower to materialize this cycle. Trailing S&P EPS finished CY'21 at ~$209 and then spent the next eight quarters between $215 (2Q'22) and $223 (4Q'23) before "breaking out" to a new cycle high of ~$226 in 1Q'24. The culprit has largely been the mismatch between softer-than-expected post-pandemic revenue growth and higher-than-expected cost pressures. The uptick in labor expenses has been notable. Still, several tenants of our broader "deglobalization" theme, notably trade relations, natural resource procurement, and supply chain strain, have also caused margin compression. However, these pressures appear to be decreasing.

With aggregate profits breaking out of a two-year range, we were cheered to see three important signposts of earnings health improve in recent months:

1. The divergence between the percentage of S&P sub-industries expecting (NTM) and delivering (TTM) positive earnings growth has narrowed – with estimates in an upward trend
2. Earnings growth, excluding the strongest sector (i.e., the "weakest" 10 sectors), has turned higher after a period of contraction
3. The S&P 500 "PEG" ratio (the P/E ratio divided by the earnings growth rate) has continued to move lower. Strategas is estimating S&P 500 EPS to grow +8% this year, 2024 vs. 2023, and +10% next year, a touch below the consensus.

Though history suggests rate cuts are better feared than hoped for, the market appears to have disregarded this analog and continues to lean into markets providing (relative) policy accommodation. As Don Rissmiller, Strategas' chief economist, has put it, "a central bank pivot has started to develop globally." The ECB has cut and appears poised to be somewhat aggressive, with an estimated 3-4 cuts by year-end. The Fed is likely to join them in September, but signaling from the Committee suggests members are undecided on timing and scale. What if data in the U.S. remains mixed? There's been a package of improving U.S. inflation data in the past several weeks. Inflation and the volatility of inflation expectations appear anchored — for now. In our opinion, September is still live for a Fed rate cut.

In May, we increased the exposure of developed markets from "neutral" to "overweight" as the cyclical tailwinds appear a touch stronger across developed economies. Domestically, policymakers seem intent on leveraging every tool at their disposal to prime the pump ahead of domestic elections. In this *bullish 'til the bill comes due* environment, the thematic setup becomes quite compelling. In our work, four themes continue to gather the momentum we find compelling:

Artificial Intelligence – While still early days for business use, i.e., the benefits must accrue beyond the technology's purveyors, AI is likely to be an important driver of organic growth that will continue to gain attention and capital from tech and non-tech corporate operators looking to expand their franchise.

Cash Flow Aristocrats – At its base level, companies essentially have seven decision points for capital: three return OF capital options (buybacks, debt retirement, and dividends); three return ON capital options (acquisitions, labor, and CapEx); or retained earnings. With the economy digesting tighter financial conditions, economic opportunities for capital have become increasingly competitive, while strong free cash flow begets optionality. Companies with optionality have an advantage when the competition for capital intensifies.

Deglobalization – The gnawing uncertainty (and opportunity) of a multipolar world is likely to result in the continued breakdown of long-held, post-World War II operating conventions. The industrial implications will, in our view, be numerous, impacting everything from trade relations and supply chains, natural resource procurement and energy security, defense alliances, technology alignment and IP sharing, and labor.

Industrial Power Renaissance – Global population growth, artificial intelligence, electric vehicles, reshoring, and the continued regulatory debate over traditional and alternative energy sources all contribute to a re-examination of the developed world's needs and sources of power.

For more information, visit our website: [Strategas Asset Management]

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About Strategas

Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. Fed Funds Rate, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The Gross Domestic Product (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. Real Gross Domestic Product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. Nominal Gross Domestic Product is gross domestic product (GDP) evaluated at current market prices. The S&P 500 Index is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The Russell 1000 Index is a market capitalization weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index. The Russell 2000 Index is an unmanaged index considered representative of small-cap stocks. The PCE (Personal Consumption Expenditure) Index of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. FAANG is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The North American Free Trade Agreement (NAFTA) is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The Seasonally Adjusted Annual Rate (SAAR) is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The Atlanta Fed GDPNow forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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