CIO sees the potential for further gains in the event of a "Goldilocks" economic outcome, in which US growth is stronger than expected and tame inflation allows the Federal Reserve to cut rates aggressively. (UBS)

The S&P 500 nears a milestone

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The S&P 500 came close to rising above 5,000 for the first time on Wednesday, with the index closing at a new record high.

The benchmark index came within 0.11 points shy of the milestone in intraday trading, and finished trading around 5 points below at 4,995. That left US stocks up 4.7%so far in 2024, after a 24.2% rally in 2023. The index has doubled since the March 2020 pandemic-low and has risen from 4,000 to nearly 5,000 in less than three years.

But while US stocks are now pricing in plenty of good news, we believe the rally has been well-supported. We also see the potential for further gains in the event of a "Goldilocks" economic outcome, in which US growth is stronger than expected and tame inflation allows the Federal Reserve to cut rates aggressively.

US economic data have remained stronger than expected. Last week's employment release for January was the latest in a string of data that surpassed forecasts, with job creation of 353,000 topping even the most upbeat projection from economists surveyed by Bloomberg. That followed the release of GDP data the prior week that showed annualized growth of 3.3%, well above the consensus forecast for 2%. Growth has now been above the Fed's estimate for the sustainable trend rate of 1.8% since the third quarter of 2022. Meanwhile, research from the Treasury has indicated that the real spending power of the median US consumer is now around USD 1,400 greater than prior to the COVID-19 pandemic, despite the burst of elevated inflation in the following years. Such releases have added to the potential that growth could remain close to, or even above, the sustainable trend rate—a key ingredient of a "Goldilocks" outcome.

Inflation releases have been reassuring. The Fed indicated at its January meeting that officials would need "greater confidence that inflation is moving sustainably toward 2%" before it would be appropriate to cut rates. Investors will be hoping that the release next week of consumer price data for January will contribute to this confidence. However, recent data have been consistent with the view that inflation is headed back to the Fed's target. The core personal consumption expenditures index—the Fed's favorite price gauge—came in at 2% annualized in the fourth quarter.

A rebound in earnings should also help maintain positive equity market sentiment. A positive fourth-quarter earnings season so far has reinforced our view that US profit growth is rebounding after a near-flat outcome for 2023 overall. We expect the earning per share of S&P 500 companies to grow 8% this year and 6% next. We see particular upside for tech earnings, propelled by the commercialization of AI. We also expect small-cap earnings to outpace the broader market, especially if the US economy is headed for a "Goldilocks" outcome.

So, our base case remains for a soft landing for the US economy, with the S&P 500 ending the year around current levels. However, recent economic data have highlighted the potential for a period of continued stronger growth, tame inflation, and swifter monetary easing. In this event, we believe the S&P 500 has the potential to rise to around 5,300 this year. We believe this would be a particularly positive outcome for small-cap stocks, which benefit more from Fed easing given their greater reliance on floating-rate debt.

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