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Do US equities still have some gas left in the tank?

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After a two-year journey, the S&P 500 officially hit an all-time high on 19 January, closing at 4,839. Despite a bit of a rocky start to 2024, with markets pricing in and pricing out the pace of Fed rate cuts this year, US stocks forged ahead with their move upwards.

While all-time highs are often met with flashing headlines to hit the sell button, our analysis shows that panic is not typically warranted. Over the past 60 years, in the one-, two-, and three-year periods following a new all-time high, S&P 500 returns have averaged 12%, 23%, and 39%, respectively. This is hardly different from the 12%, 25%, and 38% average returns for all other periods over the same time frames.

Still, while history provides some level of comfort, we also can't ignore the fact that the S&P 500 is now up over 17% from its October low, largely driven by higher valuations. So, do US equities still have some gas left in the tank?

What is the outlook going forward?
It's clear that after the rally in recent months, much of the optimism around a soft landing and Federal Reserve policy is already priced into equity markets. But while we don't expect a repeat of 2023, and it's possible stocks enter a digestion phase in the near term, we do believe the rally can extend a bit further throughout the course of 2024, for a few reasons:

First, we expect healthy earnings growth to support US equity markets, and see an 8% year-over-year increase in profits this year. And while it's true that valuations look rich, they cannot be assessed in a vacuum. In fact, US stocks do not look all that unreasonable when taking the macro backdrop into account. Since 1960, a "Misery Index" reading—the sum of the unemployment and inflation rates—of less than 6.1% has been consistent with a trailing price-to-earnings (P/E) ratio of up to 25x. Currently, we estimate a modified Misery Index of 5.9% and a trailing P/E for the S&P 500 of about 21.5x.

Now, all of this is not to say there aren't downside risks. For one, while much of the year-end rally was fueled by Fed optimism, we believe there's room for some disappointment around the timing and pace of the easing cycle. While the market is pricing in about 130bps of rate cuts, possibly starting in March, we believe 100bps starting in May is more likely.

At the same time, we are keeping a watchful eye on the recent escalation in the Middle East, although in our base case, we don't expect the violence in the Red Sea to meaningfully impact inflation or financial markets. At this stage, shipping may face delays, but outright shortages have been avoided, and shipping alone represents only a small portion of the cost of goods. In addition, we have yet to see a significant disruption to oil supply and don't believe one is imminent.

Overall, we can't ignore the risks, yet there is also reason to believe a meaningful sell-off is unlikely. This is especially true given that monetary policy is shifting from a headwind to a tailwind, with the Fed able to cut rates alongside any weakness in economic data. This should help curb any downside move in equity markets.
Putting this all together, we expect low- to mid-single-digit gains in the S&P 500 given our base case of a 5,000 level by year-end, with scope for more upside if economic growth proves even stronger than expected.

What should you do?
Overall, we believe investors should maintain a full allocation to US equities in line with long-term strategic targets. But for investors looking to add new positions, it is very possible there will be better entry points ahead, and given the more limited gains at the index level, being selective will be a key theme of 2024 as well. We continue to favor quality as a core theme in portfolios, since these companies tend to outperform as growth slows like we expect.

At the same time, we also think investors should position to capture further potential equity gains if a "Goldilocks" scenario plays out for the economy. We therefore recommend tactically adding positions to US small caps relative to large caps. Relative valuations of small caps are still very appealing at around a 30% discount to large caps. And given that around half of small-cap debt is floating-rate, these companies should be some of the biggest beneficiaries of a decline in Fed rates.

From a sector standpoint, we remain most preferred on consumer staples, energy, and information technology. We favor consumer staples, as the sector trades at a discount to the market and is attractive given its defensive profile. For energy, we think oil prices will rise as global production growth slows and the sector offers a cheap hedge to geopolitical tail risks. And within information technology, we think AI will continue to be a key driver; important end-markets—PCs, smartphones, and servers—are bottoming; and investors are likely to continue to be attracted to high-quality stocks with strong secular growth.

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For more, see **S&P hits all time high – but should investors be afraid of heights?** 21 January, 2024.