CIO expects the S&P 500 to end the year around 5,200. But if inflation improves more quickly or earnings are better than expectations, their upside scenario of 5,500 appears reasonable. (UBS)

Encouraging profit trends are clearly good news for stocks

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First quarter earnings season is about to kick off and CIO expects another quarter of solid results. For the S&P 500 they look for year-over-year earnings per share (EPS) growth of 7-9%, which reflects higher than average earnings beats of 4-6%.

CIO convictions in this view stems from a few factors. First, the results from the early reporters—generally those companies whose quarters ended in February—have been very good with the median company beating by more than 7%. Still, this reflects results from only 22 companies, so we don't want to fully extrapolate these numbers for the full S&P 500. Nonetheless, the early reporters are usually a good indication of how the balance of earnings season will pan out.

Second, economic data has been strong. Monthly job gains have picked up to an average pace of 275k in the first quarter, compared to 211k in the fourth quarter. Perhaps more importantly, measures of manufacturing sentiment such as the ISM Manufacturing index have been rising. In March, this gauge moved into expansion territory for the first time since October 2022. In addition, banks have moved away from their tightening bias. Both the ISM and bank lending standards have a good correlation with S&P 500 profit trends.

Furthermore, the surge in AI investment continues to have very strong momentum, with the semiconductors needed to deploy AI likely to remain supply constrained through the balance of this year. But this is not just a semiconductor story. It affects everything from networking equipment, to electrical infrastructure, to HVAC systems. At the same time, tech end markets such as smartphones, PCs, and servers also appear to be improving. Away from tech, capital markets activity has been improving (good for the banks), industrial end markets such as aerospace remain robust, freight volumes are picking up, and even housing has been perking up.

Admittedly, there have been some more mixed data points related to consumer spending which likely reflects some pressure on the lower end consumer. But spending on travel and other services remains solid. From a broader perspective, as long as the job market remains healthy, we think consumer spending will be well-supported.

Given the generally solid backdrop, we think earnings growth will start to broaden out. Over the last four quarters, the Magnificent 7 (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) accounted for all of the profit growth in the S&P 500. Once the final results are tallied, we think the S&P 500 excluding the Magnificent 7 will post its first quarter of positive, albeit very modest, profit growth since the fourth quarter of 2022. Profit growth for the non-Magnificent 7 should accelerate over the balance of the year, consistent with the improving manufacturing sentiment and bank lending standards.

Over the last few quarters, the rise in the bottom-up consensus next 12-month EPS estimate for the S&P 500 had been largely driven by the Magnificent 7. But just in the last several weeks, this is starting to change and next 12-month estimates are rising for every sector in the S&P 500. We expect this trend to continue.

Ultimately, these improving profit trends should trickle down to small-cap companies. Sluggish profit growth has been one of the key reasons that small-caps have lagged large-caps over the last several quarters. In the absence of stronger profit trends, the rise in long term interest rates this year has had a disproportionately negative impact on small-caps. But with rates likely to fall from here as inflation ultimately cools and the Fed starts to cut rates—earlier this week we revised our outlook for rate cuts from three to two this year—long term interest rates should fall, which would be favorable for small-caps. The profit and rates dynamics, in conjunction with very attractive valuations, are key reasons why we maintain our most preferred view on small-caps.

The encouraging profit trends are clearly good news for stocks. But the challenge is that a lot of these positive dynamics appear to be reflected in large-cap shares. The S&P 500 is trading at a forward P/E of just over 20x consensus estimates. Even excluding the Magnificent 7, the forward P/E is over 18x. And after the 20% rally in the index over the last six months—among the strongest six-month returns in the last 80 years—sentiment and positioning measures have become elevated. Still, we think the risk of a significant sell-off is not very high. Probably the biggest risk right now is a continued rapid rise in long term interest rates. While this is not our base case, stocks would likely face more material headwinds if the 10-year Treasury yield rapidly rose towards 5%.

Overall, this leaves us at a neutral stance on US equities, which means that investors should have a full allocation, in line with their long term "normal" allocation to US stocks. Our S&P 500 price targets for June and December are 5,100 and 5,200, respectively. In our upside scenario, we think the S&P 500 could reach 5,500 by the end of the year. That outcome would likely be achieved if inflation pressures ease more quickly or corporate profit growth is stronger than expectations.

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