CIO believes earnings growth will remain the key driver of stock returns, and the 3Q24 results further reinforce our strongly positive view on the AI theme. (UBS)

Beyond earnings, macroeconomic fundamentals are supportive

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US equities fell on Thursday, led by a sharp decline in tech stocks as investors absorbed the latest earnings results from megacap companies.

Despite reporting better than consensus results, shares of Microsoft, Meta, and Alphabet all declined on Thursday. Investors appeared concerned by losses at OpenAI in Microsoft's results, while Meta disappointed elevated market expectations on user growth and projected higher capex spending in 2025.

After the market closed, Apple's December quarter revenue guidance was weaker than expected, while Amazon's cloud unit revenue jumped 19% y/y.

What do we think?

Against a backdrop of strong year-to-date gains, election uncertainty, and crowded positioning in some widely held stocks, a setback for tech stocks is understandable. The tech sector has rallied by around 10% since the end of the 2Q24 reporting season, which has pushed valuations close to 25x 2025 consensus price-to-earnings.

But we see support for equities both from tech fundamentals and a positive macro outlook.

Third-quarter tech results have showcased improving AI monetization, evidenced by accelerating growth for cloud platforms. Microsoft highlighted increased adoption of copilots "from customers in every industry."

With the Big Four (Microsoft, Alphabet, Amazon, and Meta) accounting for almost half of all AI spending, we believe their stronger balance sheets and willingness to invest will continue to support strong growth in AI spending. We now forecast their capex to be about USD 222bn in 2024 and USD 267bn in 2025.

In summary, we believe earnings growth will remain the key driver of stock returns, and the 3Q24 results further reinforce our strongly positive view on the AI theme. However, a growing divide between structural AI trends and a sluggish cyclical smartphone and PC recovery means that investors need to rightsize their tech exposure.

Beyond earnings, macroeconomic fundamentals are supportive.

The latest US data support a benign GDP growth (or "no landing") scenario. Thursday's unemployment claims data pointed to a resilient labor market. The ADP employment survey for October released on Wednesday showed a strong rise in private job creation (+233,000 versus 111,000 expected) ahead of Friday's nonfarm payrolls release, which may be distorted by strikes and storms. The US economy grew at an annualized rate of 2.8% in the third quarter, primarily driven by consumer spending, which comes after Bureau of Economic Analysis (BEA) revisions showing that GDP growth averaged 2.5% since 2019.

Benign PCE inflation data should allow the Fed to cut rates next week, in our view. Recent comments from Fed officials suggest that a 25-basis-point rate reduction remains probable, as the US central bank continues to move toward a neutral policy stance. We expect 50 basis points of rate cuts for the rest of this year and a further 100 basis points of easing in 2025. Historically, Fed rate cuts in non-recessionary periods have been favorable for equities.

How do we invest?

The combination of solid growth and Fed rate cuts provides a supportive backdrop for risk assets, in our view, while the AI trend should lend further fundamental support to equities. We view US equities as Attractive, and we target 6,600 for the S&P 500 by end-2025.

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