(UBS)

Three reasons stocks can rally from here

03 June 2024, 5:28 pm CEST, written by UBS Editorial Team

May was a tale of two halves. The first few weeks brought a ferocious rally in stocks, with the S&P 500 bouncing back 7% from its April low, as Fed officials clarified that a rate hike was unlikely and as April inflation data surprised to the downside. Yet in recent weeks the market was mostly range-bound, with rising concerns on the potential deceleration of the economy and volatility driven by a few select tech stocks.

Looking past the recent choppiness, we continue to believe that the outlook for stocks in the balance of the year is constructive for three key reasons:

1) Macro environment is supportive
Data in recent weeks shows the economy is cooling, which increases the likelihood of a Fed pivot before year-end. Real GDP figures for 1Q24 were recently revised down to an annualized rate of 1.3%, below the initial reading of 1.6%.

And on the inflation front, better news is finally trickling through. April's Headline CPI print, which came in below market expectations for the first time since October, was followed by last week's April core PCE data, which stood at 0.25% m/m, a four-month low.

What we are seeing is an economy that is gradually slowing down, but growing nonetheless. While bears may interpret the latest data as a deterioration in the growth picture, we believe it is more indicative of a healthy deceleration that should allow for further disinflation, enabling policymakers to cut rates. In this context, we are standing by our base-case of cumulative Fed cuts of 50bps by year-end, with the first easing move in the September meeting.

Most important, though, is the fact of the matter that the current balance of risks is heavily biased toward a Fed cut, not a hike, in our view. As such, any pronounced weakness in the economy can likely be countered by the "Fed put." This potential for looser financial conditions provides a healthy backdrop for stocks.

2) Profit growth remains robust

First quarter earnings season is now mostly in the books, and not only were results better than expected, we were especially encouraged by the upward revisions in guidance and by the broadening of earnings beyond the Magnificent 7. Trends in artificial intelligence (AI) were particularly robust, driven by a surge in capex spending by mega-cap tech companies. Not only is this investment spending benefiting semiconductors, but it is also starting to show up in stronger results outside of tech, including within the utilities, industrials, and materials sectors.

We acknowledge that there were some high-profile misses in the first quarter, though. The recent results from Salesforce and Dell are a good reminder that even amid AI tailwinds, we can't expect every tech giant to beat in perpetuity. Companies will now face the challenge of exceeding loftier and loftier expectations, while growth decelerates and poses challenges to more cyclical areas of the market, like IT spending.

Taking all the profit results together, we increased our S&P 500 earnings per share (EPS) estimates by USD 5 for this year and next. We now expect 11% y/y growth in 2024 (USD 250) and 6% y/y growth in 2025 (USD 265).

3) AI spending continues to unlock value

The best proxy to review is Nvidia, for which 1Q24 earnings exceeded expectations across the board, with upside surprises in both revenues and guidance. Notably, Nvidia's data center business, which accounts for more than 85% of total revenue, grew more than 400% in 1Q24, with the data center GPU business up by nearly 5x.

In particular, there was one key message in the Nvidia's earnings call that caught our attention. Management commented that every dollar spent on GPUs is expected to generate USD 5 in downstream revenue over four years. While all company estimates should be taken with a grain of salt, we believe this point highlights the investment opportunities that will arise across the AI value chain, in areas like software, services, and beyond. We believe these downstream stages should eventually bring a meaningfully larger amount of value creation than the infrastructure build-out, consistent with past tech cycles.

The bottom line

We believe US stocks are likely to remain supported by favorable macro conditions, healthy earnings growth, AI tailwinds, and the potential for a Fed pivot before year-end. Hence, we recently increased our year-end S&P 500 target to 5,500, up from 5,300, previously. Within our sector strategy, we still favor information technology and industrials, while we've downgraded healthcare from most preferred to neutral.

Main contributor: Solita Marcelli, GWM Chief Investment Officer Americas

See the full report - **May is in the books: Three reasons stocks can rally from here**, 3 June, 2024.

Important information

As a firm providing wealth management services to clients, UBS Financial Services, Inc is registered with the U.S. Securities and Exchange Commission (SEC) as an investment adviser and a broker-dealer, offering both investment advisory and brokerage services. Advisory services and brokerage services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that you carefully read the agreements and disclosures UBS provides to you about the products or services offered. For more information, please visit our website at www.ubs.com/workingwithus.

© UBS 2024. All rights reserved. UBS Financial Services Inc. is a subsidiary of UBS AG. Member FINRA/SIPC.

There are two sources of UBS research. Reports from the first source, UBS CIO Global Wealth Management, are designed for individual investors and are produced by UBS Global Wealth Management (which includes UBS Financial Services Inc. and UBS International Inc.). The second research source is UBS Group Research, whose primary business focus is institutional investors. The two sources operate independently and may therefore have different recommendations. The various research content provided does not take into account the unique investment objectives, financial situation or particular needs of any specific individual investor. If you have any questions, please consult your Financial Advisor. UBS Financial Services Inc. is a subsidiary of UBS AG and an affiliate of UBS International Inc.