(UBS)

What will it take for the market rally to broaden?

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Gauging whether the market rally will broaden from here is no easy task, as investors must evaluate several factors—both micro and macro—weighing the path of the economy alongside the mega-trend of artificial intelligence.

Nonetheless, we see four conditions that need to be met for performance to start to spread out.

1. Inflation must remain contained: Last week brought good news on this front, as headline CPI surprised to the downside for third consecutive month. But most important, data under the hood suggests that further disinflation is likely in the months ahead. The long-awaited deceleration in Owners' Equivalents Rent (OER) finally showed up in June, which makes up roughly 25% in the CPI index. We believe disinflation will continue from here, albeit not necessarily in a straight line.

2. Fed needs to begin cutting rates: Market performance has been highly correlated to interest rates in recent months. A loosening of financial conditions and lower rates is necessary for areas like real estate, which has been harmed by higher rates, and outside the S&P, small caps, which are more dependent on floating rate debt. We do believe relief is coming on this front, and see the Fed cutting rates in September, and twice this year. If this view materializes, we see the 10-year US treasury yield heading toward 3.85% by year-end.

3. Economic growth must remain resilient: While a cooling economy was always expected and necessary to bring inflation down, recent months have brought perhaps an even sharper deceleration than welcomed. First quarter GDP growth was revised down to 1.3%, retail sales disappointed, and unemployment ticked up to 4.1% in June. Investors will want to see signs that the economy remains on solid footing before we see a more sustained rotation into cyclicals.

Our base case is for a soft landing, with growth averaging around 2% per year. But any growth disappointment will send investors gravitating back to high-quality secular growth companies.

4. Earnings growth needs to converge to the extent expected: The S&P 500 493 (excluding the Magnificent 7) are expected to post positive YoY earnings per share growth in 2Q24 for the first time since 2022. By 4Q24, consensus estimates have Mag 7 earnings growth at 17% versus a not too far off 11% for the rest of the S&P companies. While we believe with a high level of certainty that earnings growth will converge from here, the extent of the convergence is less certain. Although it is still early in 2Q earnings season, result so far indicate that the slowing economy and cooling consumer spending may be affecting the bottom line, with earnings momentum ticking down a notch. At the same time, we believe AI-related investment spending will remain strong. If tech companies continue to beat and raise the bar as a result, this could hinder a further broadening in performance. Furthermore, high-quality companies, which are predominantly in the large-cap growth segment, tend to outperform in late cycle environments like now.

So what should investors conclude? While all of these four factors seem very much possible and, on the table, it might take a disappointment in only one area to send any signs of broadening into reverse. We believe the first two factors—slowing inflation and fed cuts—are at less risk than the last two. However, the scope of the Fed rate cuts will also be important. If the Fed can cut rates significantly in the context of a soft landing, there will be better prospects for a re-acceleration in earnings growth for lower quality and cyclical segments of the market.

For more, see **Weekly - Regional View US: What will it take for the market rally to broaden? Our four-point checklist**, 15 July, 2024.