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CIO believes the recent rise in yields largely reflects better economic performance, which is supportive for earnings growth. (UBS)

Attention shifting from macroeconomic data to micro trends in the coming weeks

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With this week's start to the fourth quarter earnings season, investors are likely to shift some attention from macroeconomic data to micro trends in the coming weeks.

The S&P 500 index is just 2.3% below its all-time high in December, after making gains of close to 25% for two consecutive years.

We anticipate solid results overall for October to December 2024, with S&P 500 earnings likely up 7-9% year over year, supported by resilient economic growth. Big tech companies are likely to post another quarter of strong earnings growth of over 25% y/y amid the continued build-out of AI infrastructure and growing signs of AI adoption.

But as market sentiment remains fragile ahead of Donald Trump’s inauguration, we offer several perspectives for investors as they navigate this results reason.

US dollar and tariff risks are potential headwinds. Despite the generally favorable backdrop, the stronger US dollar could crimp first quarter guidance for US multinational companies. We estimate this could cut first-quarter earnings growth by about 1.5 percentage points. Potential tariffs from the incoming Trump administration could also be a source of uncertainty. Strong results in certain industries could reflect pre-buying ahead of potential tariffs, while others many delay business plans until there is further clarity. However, we believe that part of the strong dollar risks have already been priced in and that the tariff impact is unlikely to be strong enough to derail healthy earnings growth.

Recent rise in Treasury yields has more to do with a solid economy. Historically, when rates rise rapidly, it can weigh on equity markets. But we believe the recent rise in yields largely reflects better economic performance, which is supportive for earnings growth. In our view, stocks should digest the higher yields and ultimately move higher. We would be more concerned if higher yields reflected an acceleration in inflation, a possible pivot to Fed rate hikes, or significant concerns about government debt. So far, that does not seem to be the case.

High valuations should not stand in the way of further stock gains. US equity market valuations are important, and on an absolute basis, the S&P 500's forward price-to-earnings ratio of 21.5 times is high by historical standards. This may dampen the outlook for longer-term returns. But when thinking about returns over this year, investors should keep a few things in mind. First, valuations are generally a function of the macro environment. When inflation expectations and unemployment are low, as they are now, valuations tend to be higher than average. Second, profit growth is more important for stocks over the next 12 months, and profits should be a key tailwind in 2025.

We continue to view US equities as Attractive, forecasting that 9% earnings growth this year will drive the S&P 500 to 6,600 by the end of the year. Large-caps should outperform mid- and small-caps given their greater AI exposure, better earnings trends, and less dependence on Fed rate cuts. Sector-wise, we like information technology, financials, utilities, communication services, and consumer discretionary.

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Original report: US fourth-quarter earnings should stay solid despite noise, 17 January 2025.

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