



CIO Strategy Bulletin

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US Equities: Corporate Profits Already Making New Record Highs

Key Takeaways

- US equities have struggled a bit to reach new records as large cap tech remains below the recent July peak. Election uncertainties are just ahead. However, EPS gains are broadening with 9 of 11 sectors growing in the year through 2Q. This is a sharp improvement from 2023 when roughly half of S&P 500 constituents posted EPS declines.
- With most of 2Q in hand, we raise our S&P 500 EPS estimates slightly with gains of +9% and +8% expected for 2024/2025 (our previous estimates were for gains of 8% and 6% respectively). We believe these estimates are somewhat conservative, but still require continued economic expansion.
- There are two-sided risks for EPS in 2025 in particular. 1H EPS results for the S&P 500 were sub-10% despite a few large firms growing rapidly. The impact of AI spending on EPS is uncertain. A wide range of US policies from the new administration and Congress are possible. However, interest rates are falling while the economy is most likely to produce new record highs in corporate profits in coming years.

Potential Portfolio Implications

- US equity markets have snapped back quickly after leveraged investors cut risks in early August (see August 10th [CIO Bulletin](#) for more). We believe the underlying risk profile of US equities has moderated even as the S&P 500 equal weight index has reached a new record high.
- Broadening EPS growth and a sharp drop in debt capital costs is cushioning a market with a somewhat high overall valuation (for the S&P 500, 23X this year's EPS and 20X excluding tech). "Concentration risk" in mega caps has come down as the Magnificent 7 has underperformed since early July.
- Like politics, we see "checks and balances" slowing the broad US equity market ascent. We also see the strongest long-term opportunities outside the S&P 500 or even Nasdaq 100. Small and mid-cap growth shares are relatively inexpensive. What investors may not realize is that EPS growth for profitable, growing small and mid-cap firms has been faster than that of most large caps over the past five years.

Will Checks and Balances Remain?

As the clock counts down to another historic US election on November 5, investors will increasingly wonder if the present gridlock will give way to something bold and new. The US president holds great power to shape US foreign policy and domestic regulation. At the level of campaign proposals, the contest literally comes down to advocating tax cuts versus net tax increases. And of course, there's so much more (please see this [CIO Bulletin](#) for more).

We believe the potential for a *radical* shift in US fiscal policy is significantly diminished compared to the election of 2016. Then, a surprise win for Donald Trump and congressional Republicans allowed the top US corporate tax rate to fall from 35% to 21%. Increased US tariffs were another surprise in 2018.

Heading into the election of 2024, the large personal income tax cuts of the Trump administration will automatically reverse at the end of 2025. This is unless a closely divided US Congress takes action. We believe compromises to prevent most of the tax increases will be made, regardless of the choice of president. In our view, however, the probability of extending the tax cuts *and making them much larger* (to the chagrin of the bond market) seems fairly low.

Polling data in late summer are generally considered unreliable. In the US Senate, roughly three times the number of Democrats face reelection in 2024 than Republicans. This tilts the probability of a Republican "red sweep" well above that of a Democrat "blue sweep." Nevertheless, there are several ways that the election could still yield a divided government. Among them, the electoral math in the House of Representatives differs from the Senate. Checks and balances on the coming new government might still bind in a closely divided election.

Checks and balances in markets

As equity markets rebound from a summer swoon, it looks as if checks and balances are beginning to bind markets too. US equities (65% of world market cap) are struggling to recover their July 16 high even as they have rebounded about 8% from their August 5 low¹. This is with the help of a nearly 50 basis point drop in two-year US Treasury yields as the bond market priced in bolder easing steps from the Fed.

Even more importantly, the long-term cost of debt capital for US firms has fallen sharply from this year's high (BBB-rated long-term corporate debt has fallen from a peak of 6.8% to 5.6%²). The rally has also come as second quarter 2024 corporate profit levels reached a new record high, with solid visibility towards expanding EPS significantly further.

At the July high, the S&P 500's year-to-date total return exceeded 20%. This is no small feat after a 26% return in 2023. But this of course was made possible by the 18% loss in 2022.

This is where EPS comes into play. Following the bulk of 2Q EPS reports, we are making slight upward revisions to our S&P 500 EPS estimates for both 2024 and 2025 (see **FIGURE 1**). We now see S&P 500 EPS rising about 9% in 2024 and 8% in 2025 vs 8% and 6% previously.

The good news? We believe today's record high EPS levels will be exceeded through coming quarters. The bad news, our estimate increases are modest. The overall pace of EPS gains in 1H (just below 10%) is unusually strong for a period off Fed easing, but not historically rapid.

One should bear in mind that not every firm can grow EPS 628% (that is the EPS gain for the world's most valuable chipmaker in 2Q). Even with it, we believe S&P 500 EPS rose 13% overall. EPS for indices are not market cap weighted.

As **FIGURE 2-4** show, the broader gains in profits across sectors justify a rise in *most* share prices in our view. It is somewhat trickier to make the case for some of the firms already valued in the trillions of US dollars.

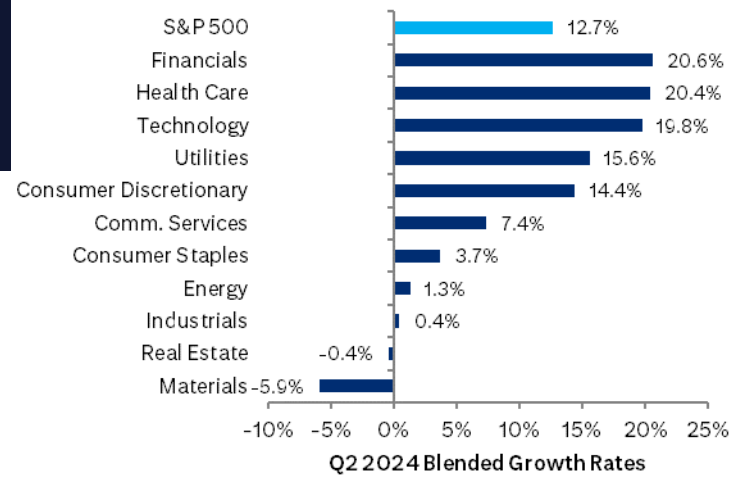
¹ Bloomberg as of August 30, 2024. S&P 500 is proxy for US equities.

² Bloomberg as of August 30, 2024. ICE BofA US Corporate Index: BBB 15+ Yrs used as proxy.

FIGURE 1: S&P 500 EPS estimates

CGWI EPS Forecasts (%)						
	2020	2021	2022	2023	2024E	2025E
S&P 500	-13.5	46.9	6.0	0.6	9.2↑	7.6↑
EPS Level	122	209	222	223	244↑	262↑
P/E	27.6	24.4	17.8	22.8	22.9	21.3

FIGURE 2: Sector EPS gains this year through Q2

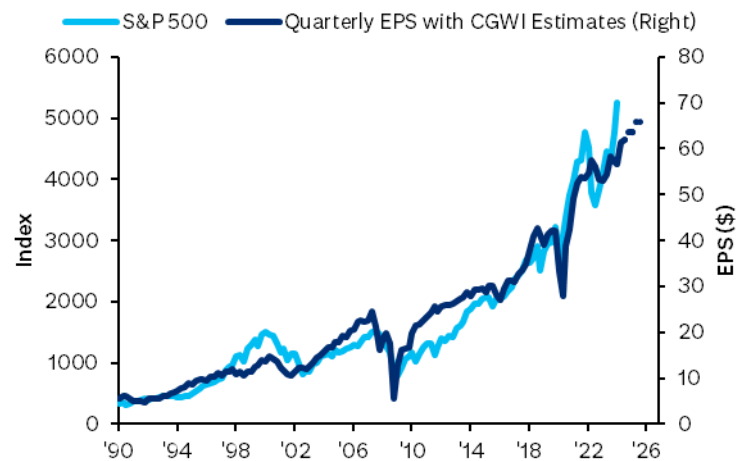


Source: Factset and Bloomberg as of August 29, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

FIGURE 3: S&P 500 EPS with CGWI estimates vs equal weight index Y/Y%



FIGURE 4: S&P 500 EPS with CGWI estimates vs market cap weight index Y/Y%



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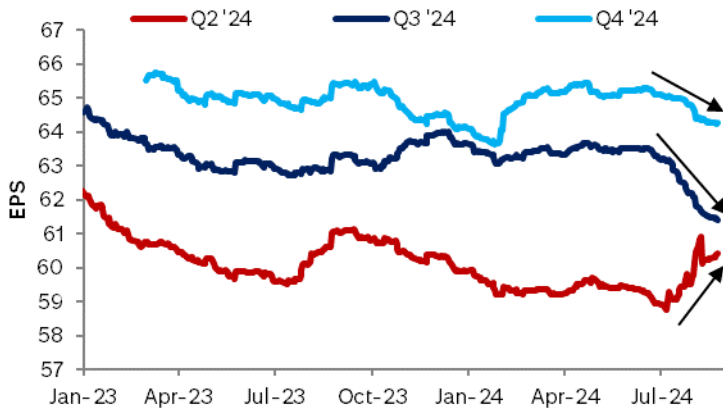
Q2 earnings round up: beat and lower the bar for another

As is custom in all but the deepest earnings downturns, with the help of analysts³, US firms had no problem exceeding estimates when they reported second quarter results this summer. But despite an average beat of over 5%, markets sold off during the busiest two weeks of the earnings season as many firms moderated guidance for the second half of 2024 (see **FIGURE 5**). After significant downward revisions to 3Q, we see the bar as sufficiently lowered to continue the

³ For the overall S&P 500, quarterly EPS results have been higher than the consensus of “bottom up” analysts in all but 2 quarters since 2010.

tradition of broad earnings beats next quarter. Consensus estimates for 2025 at 14.4% remain higher than our new estimates, but this is typical when looking at analyst estimates beyond a quarter ahead.

FIGURE 5: Q2 beats have been offset by Q3 cuts



Source: Bloomberg as of August 29, 2024. The arrows represent how S&P 500 companies have moderated guidance for the second half of 2024 after beats in the first half of 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Broadening earnings mean broadening markets

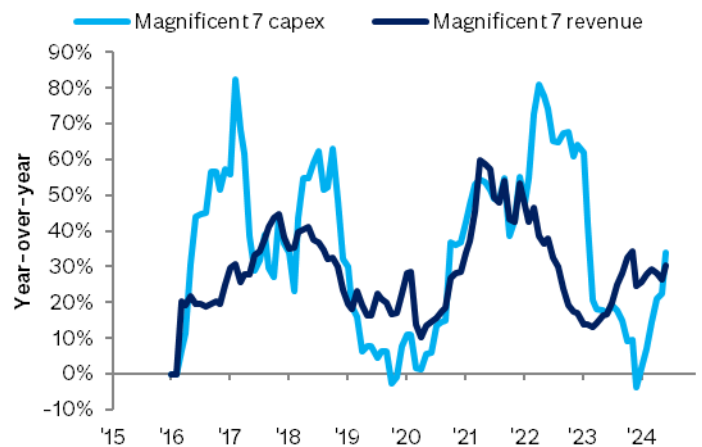
We have been on the “broadening train” all year for two reasons. First, we viewed excessive index concentration as a risk for investors who seek truly diversified exposure to public markets. Indeed, the Magnificent 7 concentration peaked at 31.5% of S&P 500 market cap in mid-July after strong outperformance throughout Q2 (see **FIGURE 6**). We’ve discussed in previous bulletins the perils of portfolio concentration (please see our June 22nd [CIO Bulletin](#)).

Second quarter earnings season reminded investors that mega cap tech is not invincible. Ongoing AI-related capex has far outpaced big tech revenues, and after six quarters of significant AI spending ramp-up, some investors are growing impatient about the eventual fruits of this investment (see **FIGURE 7**). Four of the Magnificent 7 sold off following their 2Q earnings results.

FIGURE 6: Magnificent 7 as % of S&P 500 market cap



FIGURE 7: Big tech capex is growing faster than revenues



Source: Bloomberg as of August 29, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Another driving force for our broadening call was our expectation for a wider range of companies to deliver positive earnings growth in 2024 and 2025, a dynamic which we see playing out in recent results. This has enabled the equal-weight S&P 500 to reach a new all-time high this week even while tech remains off its own peak (see **FIGURE 8**). While a 10% return in the average S&P 500 stock has not kept pace with tech year-to-date, our overweight has outpaced performance of broad bond indices where we remain underweight (the Bloomberg Barclays Multiverse is up 2.4% YTD).

FIGURE 8: Equal-weight S&P 500 made new highs this week

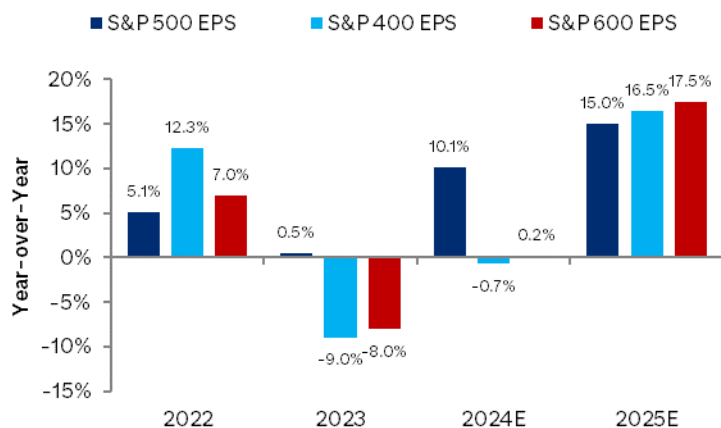


Source: Bloomberg as of August 29, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Earnings also come in small packages

As we continue to make new highs for profits into 2025, a nascent earnings recovery will also likely be playing out among smaller firms (see **FIGURE 9**). While small and mid cap companies have seen their profits lag in 2023 and 2024, falling financing costs and a less tech-dependent earnings backdrop should be supportive for SMID profitability next year. Within the profitable SMID universe, firms tend to operate with more debt and higher usage of floating rate bank financing. As the Fed cuts rates through 2025, earnings-after-interest costs for small firms should improve.

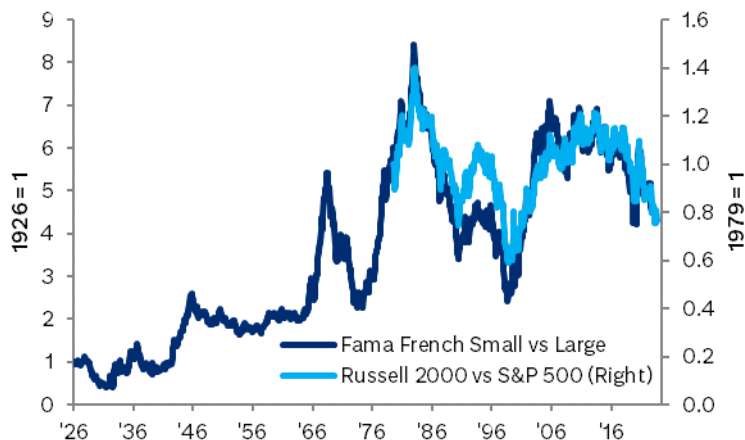
FIGURE 9: SMID earnings should start to catch up into 2025



Source: Bloomberg as of August 29, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

While smaller firms outperformed larger ones over the past century, their track record in recent decades is much more mixed (see **FIGURE 10**). Over the past decade in particular, mega caps have grown in size and market share, benefitting from “winner take all” tech developments and regulations that often entrench industry leadership. Platform technology firms benefit from scale, while investing in AI has so far been an extremely expensive endeavor that only the largest firms in the world (and largest governments) can afford to invest in.

FIGURE 10: Long financial history shows that smaller firms outperform



Source: Bloomberg as of August 29, 2024. Fama and French ‘3 Factor SMB’ Series: The series subtracts returns of large firms (with above median market capitalization) from the returns of small firms (with below median market capitalization). The series covers US firms listed on the NYSE, AMEX, and NASDAQ exchanges. Small firms are determined as companies having size below the median market capitalization for the group. Large firms are determined as companies having size above the median market capitalization for the group. Small-cap firms are then divided into three groups based on their book-to-market ratio, with the bottom 30% defined as “Small Growth”, the middle 40% defined as “Small Neutral” and the top 30% defined as “Small Value”. Large-cap firms are also divided into three valuation groups based on their book-to-market ratio, with the bottom 30% defined as “Large Growth”, the middle 40% defined as “Large Neutral” and the top 30% defined as “Large Value”. The SMB series is calculated by the authors as the difference in average returns across the three valuation groups for each size category of firm: $1/3 * (\text{Small Value} + \text{Small Neutral} + \text{Small Growth})$ minus $1/3 * (\text{Big Value} + \text{Big Neutral} + \text{Big Growth})$. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Despite these seemingly structural headwinds for smaller firms, earnings growth has not been materially stronger for large caps than SMID over the past half decade (see **FIGURE 11**). Only returns have lagged, driving a significant valuation gap in favor of SMID. With large firms trading near historical highs on a forward P/E basis, small and mid cap valuations are closer to their 20-year average. Much like the economy as a whole, SMID is priced for neither boom nor bust. More broadly, these “mid cycle” conditions speak to a full – if not outright overweight – allocation to equities with an eye towards quality earnings growth across the size spectrum.

FIGURE 11: Over the past 5 years, profitable SMID has grown earnings at pace with large caps

	5 Year EPS (CAGR)		
	Value	Core	Growth
Large	5%	7%	8%
Mid	6%	8%	11%
Small	-7%	6%	17%

Source: Bloomberg as of August 29, 2024. S&P 500 and its Value and Growth indices are proxy for large cap, S&P 400 and its Value and Growth indices are proxy for mid cap, and S&P 600 and its Value and Growth indices are proxy for small cap. CAGR stands for compound annual growth rate. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

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Medium grade	Baa	BBB	BBB
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Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
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- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
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- manager risk.

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