Equity Insight
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Monthly Equity Market Topics

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In brief

- **AI and macro continue to drive equity markets**
- **Multiples and Magnificent 7 doing all the heavy lifting**
- **Margin of safety has shrunk for US relative to European equities**

AI and macro continue to drive equity markets, though on the macro front, the narrative in the United States has changed. The old narrative was driven by the US Department of the Treasury shifting the composition of its debt issuance last autumn and was driven further by a dovish Fed pivot. The new narrative is that we're in a perfect environment for equity markets: strong growth, a belief that inflation is easing toward the US Fed's 2% target (despite a slight uptick in January) and stable labor markets, which support consumers. This is a trifecta that has driven markets to all-time highs. A 50-basis-point rise in 10-year yields and expectations for only three rate cuts in 2024 (down from six in January) hasn't deterred equity investors. Suddenly we've flipped from rates cuts being the driver for stocks to growth and a rebound in productivity driving equities higher. And speaking of productivity, Goldman Sachs has come out with a report that says, "The current wave of healthcare innovation such as AI-powered drug discovery coupled with GLP-1s (obesity and diabetes drugs) could raise the level of US GDP by 1.3%."

Supporting the risk-on posture were headline-grabbing earnings from Nvidia, Meta and Amazon, with much of the market following in their slipstream. Surprisingly, Meta has cut its workforce by a third while doubling its earnings per share, a trend Scott Galloway eloquently calls corporate Ozempic. Is this the start of AI productivity improvements? While much capital is being put to work in building AI infrastructure and solutions, only a few companies have yet seen improving revenues or margins. The megacaps seem to the best placed to benefit, and the market has recognized this, but as capital chases "AI stocks," some are going to disappoint.

Despite strong earnings for a few megacaps, it's P/E multiple expansion that continues to drive the overall market. The S&P 500 P/E ratio is up 6% to 24.4x in the first two months of 2024 while the S&P 500 total return index rose 7.1% over the period. Alongside this, the Bloomberg Magnificent 7 index has gone from 35x to 40x. Digging below the surface, it's the Mag 7 that are driving earnings. The S&P 500 grew earnings 8% last quarter, but ex Mag 7 that dropped to -2%. However, we believe broader earnings growth over 2024 is likely as economic growth recovers.

Strong economic data has triggered debates over stickier inflation and whether the Fed cuts rates at all this year. Given that this is an election year, the Fed is walking a tightrope as its actions will likely be used by the two major political parties to support competing political narratives. While we're seeing many signs of a positive outlook for the economy, there are three areas you should be watching closely:

- **Consumer spending –** There are signs of accelerating weakness.
- **Unemployment –** Since this is a lagging indicator, look to indicators such as hours worked and job openings.
- **Small business –** It's feeling the brunt of higher rates and input costs.

European stocks have also rallied, carried along by the AI wave, but also perhaps picking up on improving regional economic data while luxury goods benefit from resilient Chinese consumer demand. It's been a good start to the year for many of the global equity markets, with Japan also reaching new highs. Japanese stocks are being driven by improving corporate governance, capital allocation and an increased willingness to engage shareholders. In addition, a drive by the Tokyo Stock Exchange is pushing companies to improve their return on equity and unwind cross shareholdings.

The MSCI Europe Index is trading at 14x, as of 29 February 2024, a significant discount to the S&P 500, and even when you adjust for the sector differential between the indices, Europe trades at a large discount. While the US should trade at a premium, it has advantages, such as being the world's technology leader, lower energy costs (and self-sufficiency), healthier demographics, greater labor flexibility and better productivity driving its superior earnings growth and premium multiple. European equity markets, however, aren't nearly as concentrated as those in the United States, though their largest stocks also carry high multiples. As ASR reports, the top five stocks in Europe trade at a forward P/E of 28x, as of 29 February 2024. The US and European equity markets are in different places, and the margin of safety has shrunk for US relative to European equities.