All I Want for Christmas ... Is An Earnings Reacceleration (in 2024)

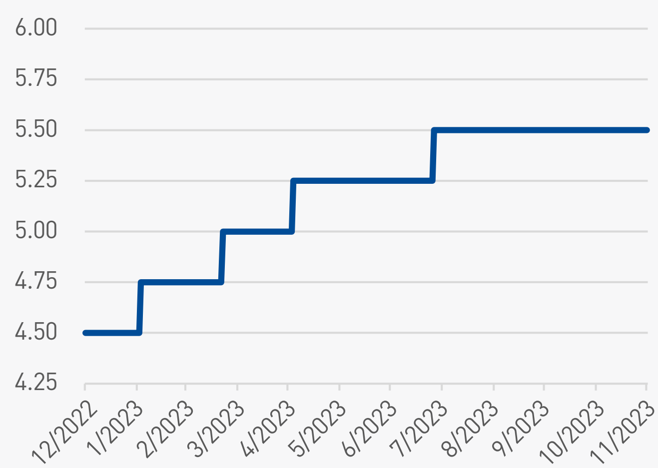
'Tis the season for our annual holiday tradition! Again, we challenged ourselves to determine what could be the single-most important catalyst to drive markets higher in the new year, and put it atop our wish list for Santa Claus.

At the top of our Christmas wish last year was to see an end to further interest rate hikes from the Federal Reserve (Fed). We must have been on Santa's naughty list again this year because while the Fed has not raised rates since July, it has increased the fed funds rate a cumulative 100 basis points (bps) in 2023 while also leaving the chimney open to further hikes, if needed (**Figure 1**).

With 2023 effectively "wrapped" up, consensus does not expect any additional rate hikes from the Fed's current tightening campaign. Instead, the focus has shifted to predicting the path of the business cycle in 2024. Will it be a "soft landing" with a continuation of slowing global growth, or a "hard landing" in the form of an economic recession? Regardless, we believe landing the economic sleigh will be challenging, especially in the face of still-elevated inflation, a tight labor market and contracting leading economic indicators, all in a presidential election year.

The good news ringing in the new year is that for the first time since the pandemic, we expect monetary policy to play a smaller role in shaping markets in the months ahead — a welcome change. Instead, we have another market catalyst in mind for Santa in 2024. Topping our Christmas wish list this year is...
an earnings reacceleration!

Figure 1. Fed Funds Rate (%)
We got a lump of coal in 2023 with four rate hikes



As of 11/30/2023. Source: Bloomberg L.P.

Do They Know It's Christmas?

A key tenet of our investment process is that earnings drive prices in the long run. As such, correctly assessing the future path of earnings growth is imperative for our long-term market views and asset allocation positioning.

Most stocks did not have strong performance in 2023, even though the S&P 500® was up more than 20% through November 30. Driving the bulk of positive returns were just seven stocks, coined the "Magnificent 7": Apple Inc.; Microsoft Corp.; Amazon.com, Inc.; Alphabet Inc.; Nvidia Corp.; Tesla Inc. and Meta Platforms, Inc. In fact, the S&P 500 Equal Weight Index was up a mere 6.7%, the median stock return was only 5.1%, and more than two hundred large-cap stocks had negative returns over the first 11 months of the year! It's as if one batch of Christmas cookies turned out fine and the rest came out of the oven slightly burnt.

As we would expect, these return divergences have largely tracked earnings estimates. As of November 30, the consensus estimate for 2023 earnings growth was less than 1%. However, ex-Magnificent 7, the estimate falls to -3.9%.

While headline estimates indicate the S&P 500's earnings recession ended in the third quarter, in our view, the dependence on just seven companies suggests there is likely material fundamental weakness lurking beneath the surface. The outlook for the fourth quarter is quite similar and points to further negative growth rates, excluding those seven companies.

Smaller-cap stocks are facing even greater relative pressure from higher borrowing costs and the tight labor market. Current 2023 earnings growth estimates for the S&P MidCap 400® and Russell 2000® are -10.9% and -16.9%, respectively. Outside the United States, it's a similar story, with -2.6% estimated earnings growth for the MSCI World ex USA Index and -0.7% for the MSCI Emerging Markets Index.

We believe without the support of fundamental revenue and earnings improvement, the market rally could fizzle out and follow the path of earnings growth — downward. 'Tis indeed the season to ask Santa for an earnings reacceleration!

Spreading Christmas Cheer

In the spirit of "be careful what you wish for," high inflation over the past few years was positive for corporate profits, as companies were able to increase prices and pass through increased costs to their customers. For example, the U.S. Consumer Price Index peaked in June 2022, and margins followed suit, highlighting how companies were net-beneficiaries of higher inflation, at least at first. However, as inflation decreased, it has become increasingly difficult for companies to raise prices. The ISM Manufacturing Prices Paid Index has been in contraction since May 2023, reflecting this trend. Likewise, operating margins for a number of sectors have fallen to pre-pandemic levels as earnings growth weakened and global economic growth has slowed (**Figure 2**). This is a textbook earnings recession, and it's helping fuel the performance disparities between the Magnificent 7 and the rest of the market.

Figure 2. Trailing 12-month Operating Margins
Falling inflation leads to falling margins

	Operating Margin	2014-2019 Average	*Change*
Communication Services	16.8%	18.2%	*-1.4%*
Consumer Discretionary	9.1%	10.2%	*-1.1%*
Consumer Staples	7.6%	9.1%	*-1.5%*
Energy	16.9%	3.0%	*14.0%*
Financials	18.5%	21.0%	*-2.5%*
Health Care	8.3%	10.1%	*-1.9%*
Industrials	11.6%	12.4%	*-0.7%*
Information Technology	23.2%	21.8%	*1.4%*
Materials	12.4%	10.3%	*2.1%*
Real Estate	23.1%	24.0%	*-0.9%*
Utilities	16.8%	16.1%	*0.7%*
S&P 500	**13.5%**	**13.0%**	***0.5%***

As of 11/30/2023. Source: Bloomberg L.P.

Indices are unmanaged, not available for direct investment, and not subject to management fees, transaction costs or other types of expenses that an account may incur.

For us to find a 2024 earnings reacceleration under the tree, it's critical for companies to reverse recent margin contraction. Unfortunately, the fate of margins will largely depend on macroeconomic variables — inflation, in particular. If a mild recession surfaces in 2024, as is our base case, we would expect to see disinflation back toward the Fed's 2% target, which would help support margins.

At the sector level, 2023 earnings growth was driven by Communication Services, Consumer Discretionary and Information Technology, all sectors that include the Magnificent 7. In 2024, an earnings reacceleration needs to include not only these sectors, but also traditional value sectors or "early cyclical" areas of the market, including Financials, Health Care and Industrials (**Figure 3**).

Figure 3. S&P 500 Blended Earnings Estimates
The reacceleration has to happen in early cyclicals: Financials, Health Care and Industrials

	2023 Earnings Estimate*	Change since 11/30/2022	2024 Estimate*
Communication Services	23.5%	*8.7%*	16.9%
Consumer Discretionary	44.5%	*8.5%*	12.4%
Consumer Staples	2.6%	*-1.5%*	5.9%
Energy	-28.6%	*-16.1%*	4.1%
Financials	8.6%	*-4.6%*	6.8%
Health Care	-20.7%	*-15.5%*	19.1%
Industrials	11.2%	*-1.5%*	11.6%
Information Technology	4.3%	*1.7%*	17.1%
Materials	-23.9%	*-11.8%*	2.5%
Real Estate	3.0%	*-2.3%*	3.1%
Utilities	7.3%	*-1.7%*	8.5%
S&P 500	**0.7%**	***-4.3%***	**11.8%**

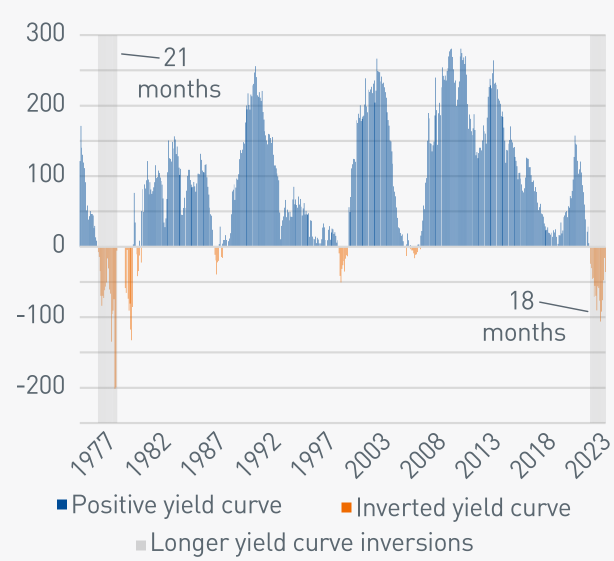
**Blended estimates include actual and consensus estimates*
As of 11/30/2023. Source: Bloomberg L.P.

If there is any promising news for 2024, it is that Health Care faces less challenging comparisons versus prior years. The sector has seen significant growth swings since the pandemic, and in 2023, earnings growth declined by more than 20%. Health Care is expected to experience an earnings rebound in 2024, but there is still significant risk that earnings are driven by more volatile industries, such as pharmaceuticals and biotechnology, rather than more defensive areas of the sector, such as providers or equipment suppliers.

The Financials sector certainly had its challenges in 2023 given the banking industry turmoil that emerged in March. Like 2023, the interest rate backdrop will be a key factor to make or break an earnings reacceleration in Financials next year. We believe a normalization of the yield curve is imperative for the sector's profitability in 2024 (**Figure 4**).

The yield curve has been inverted since July 2022 (as measured by the spread between 10-year and 2-year U.S. Treasury yields), the second-longest yield curve inversion in U.S. history, creating significant headwinds for Financials, generally.

Figure 4. Treasury Yield Curve (10-yr / 2-yr Spread) (bps)
A normalized yield curve is key for Financials sector earnings growth in 2024



As of 11/30/2023. Source: Bloomberg L.P.

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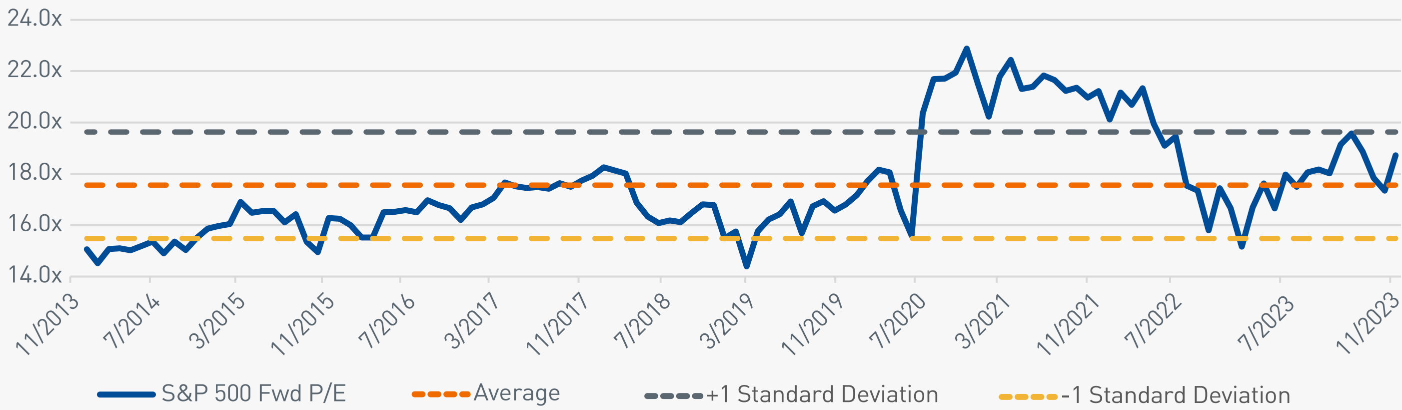
Figure 5. S&P 500 Forward Price-to-Earnings (P/E)
What is going to drive multiple expansion from here? An earnings reacceleration!



As of 11/30/2023. Source: Bloomberg L.P.

The Industrials sector typically benefits from the early recovery of a business cycle. Therefore, we will be watching earnings guidance and revisions in key industries such as machinery, passenger airlines and aerospace in 2024.

The Gift That Keeps On Giving

When it comes to navigating the earnings outlook, our investment process is like Rudolph's nose, lighting the path forward. Here is our quick take on where each of the three pillars of our process stand right now:

Business Cycle

Leading economic indicators have never been in contraction for this long without the economy succumbing to a recession. We expect a mild recession to occur mid-year as lagging indicators, such as the labor market and wage growth, continue to weaken. When leading economic indicators start to reach a trough and gradually improve, we also would expect to see an earnings reacceleration. It would be highly unusual for earnings to reaccelerate before an anticipated recession.

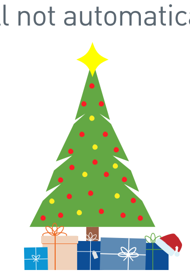
Valuations

Given most asset classes have single-digit returns amid negative earnings growth for much of 2023, forward-looking valuation metrics are generally at or below their 10-year averages. Even for the S&P 500, its forward earnings multiple is within one standard deviation of its 10-year average (**Figure 5**). Unless forward earnings estimates align (lower) with trailing earnings, we do not expect material valuation expansion in 2024. Thus, if an asset class already has "low" valuations, it should not necessarily be considered "cheap" given our expectation for a coming contraction.

Technicals

In the span of two years, global equities have been in a bear market, a new bull market and (through November 30) only a few percentage points from breaking all-time highs. Given the relatively high levels of volatility throughout much of 2023, long-term momentum is neutral, signaling markets are neither overbought, nor oversold. It is also important to remember that even if markets break all-time highs in the coming weeks, that will not automatically trigger a shift in momentum.

For us to see an earnings reacceleration under the tree in 2024, it's critical for companies to reverse recent margin contraction.



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Will The Fed Be The Grinch Who Stole Christmas?

Because the Fed is committed to lowering inflation back to its 2% target, there remains a low probability the Fed resumes its interest rate hikes and keeps monetary policy tighter for much longer than we expect. That scenario could lead to an extension of what happened in 2023 — slowing earnings, weakening margins and concentrated market performance. Regardless of what ultimately happens, we believe the fate of the market will be determined by not only the future path of earnings, but also by the companies driving it. For now, we are true believers that Santa will deliver the goods in 2024.

For more details on asset allocation guidance and recommended portfolio positioning, check out our forthcoming 1Q 2024 *Strategy Insights* publication, "Coming into Focus," which provides our investment and economic outlook for the new year.

For us, an earnings reacceleration equates to three or four gifts rolled into one, let's hope the Big Guy doesn't notice!

- Dan Brady
Managing Director,
Investment Strategy

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