July 2, 2024

Morning Briefing

Earnings In ’25 & AI Exuberance

Check out the accompanying chart collection.

Executive Summary: With this year half over, it’s time to look at which S&P 500 sectors and industries embody Wall Street analysts’ highest expectations for earnings rebounds next year. Jackie has the data and discusses what’s been going on within these industries to light fuses under their earnings growth. … And in our Disruptive Technologies segment: We’re the first to agree that widespread adoption of AI will be a game-changer for many an industry. But tech CEOs are making some pretty wild claims. Is the potential of AI really all they’re cracking it up to be?

Weekly Webcast. If you missed Monday’s live webcast, you can view a replay *here*.

Strategy I: Earnings Fireworks. The Fourth of July is a great time to grab a hot dog and hang out with friends and family. As the second half of the year starts, it’s also a good time to see what’s expected for S&P 500 earnings growth after the calendar flips to next year. Wall Street’s analysts believe that the S&P 500 companies they follow are headed for strong earnings-per-share growth of 14.5% in aggregate during 2025. That would be impressive following this year’s expected growth of 10.6%. We’re forecasting S&P 500 earnings-per-share growth of 12.1% this year and 8.0% in 2025.

The breadth of earnings growth forecasted by analysts for next year is also striking. All 11 sectors of the S&P 500 are expected to grow earnings next year, as are all but 7 of the 135 S&P 500 industries we follow. That breadth has been a powerful tailwind lifting the S&P 500’s forward earnings—i.e., the time-weighted average of consensus operating earnings-per-share estimates for the current year and following one. And that earnings strength validates the S&P 500 price index’s 14.5% ytd gain through Friday’s close (*Fig. 1* and *Fig. 2*).

Here’s the expected earnings growth derby for the S&P 500 and its 11 sectors: Information

Technology (20.2% in 2025, 19.3% in 2024), Health Care (18.4, 8.4), Materials (17.4, -2.2), Industrials (15.2, 5.7), S&P 500 (14.5, 10.6), Communication Services (12.7, 22.3), Energy (10.3, -4.5), Financials (10.2, 8.7), Utilities (8.3, 12.8), Consumer Staples (7.8, 4.5), and Real Estate (7.7, 0.7).

A table that Melissa constructed lays out the earnings growth rates expected this year and next for the S&P 500 industries as well (*Table 1*). Notably, several industries with some of the strongest expected growth in 2025 may be flying under investors' radar because they're expected to have minimal earnings growth this year. Interactive Home Entertainment, topping the 2025 earnings growth list (46.5% projected in 2025, 5.5% in 2024), falls into that camp.

Other industries expected to see sharply improving earnings growth in 2025 from low levels this year include: Copper (39.6% in 2025, 7.1% in 2024), Casinos & Gaming (28.1, -10.7), Paper & Plastic Packaging Products (24.7, -5.2), Personal Care Products (23.0, -17.2), Passenger Airlines (20.3, -3.9), Specialty Chemicals (18.4, -7.0), Biotechnology (17.7, -1.2), Home Furnishings (17.3, 4.2), Regional Banks (16.6, -10.4), and Fertilizers & Agricultural Chemicals (15.7, -14.7).

Here are some of the industry trends we'll be keeping an eye on as the second half of the year takes off:

(1) *Gaming wins big.* The video gaming industry is expected to produce faster earnings growth in 2025 than any other industry in the S&P 500. Investors can thank the scheduled rollouts of Grand Theft Auto VI in the fall of 2025 and College Football 25 later this month. The games are published by Take-Two Interactive Software and Electronic Arts, respectively, the sole constituents of the S&P 500 Interactive Home Entertainment industry.

The industry is expected to produce 46.5% earnings growth next year, following 5.5% growth this year and a decline of 2.4% in 2023 (*Fig. 3*). The Interactive Home Entertainment industry's stock price index has risen 13.2% over the past year in anticipation of the releases (*Fig. 4*).

The update to Take-Two's Grand Theft Auto is the first in more than a decade for the third bestselling video game ever, but there are rumblings that the launch could slip into 2026. Meanwhile, Epic received earlier this year a $1.5 billion investment from Disney. The companies intend to create new games and an "entertainment universe" surrounding Epic's Fortnight franchise.

(2) *Relying on semiconductors.* The Information Technology sector's strong expected earnings growth next year is highly dependent on the success of two related industries: Semiconductors and Semiconductor Materials & Equipment.

The Semiconductors industry, which had only 0.2% earnings growth in 2023, is projected to grow earnings by 47.5% this year and 38.8% in 2025 (*Fig. 5*). The estimates are supported by expected strong gains in revenue growth and widening margins (*Fig. 6* and *Fig. 7*).

That said, Joe calculates that chip stalwart Nvidia's earnings account for between 50%-52% of the industry's expected total earnings during 2024, 2025, and 2026. That's up from a 37% earnings share in 2023 and just 10% in 2022. Nvidia accounts for 47% of the earnings growth analysts forecast for the industry in 2025. Excluding Nvidia, growth would be projected at 43.5% next year instead of 38.8%, as Nvidia's 34.5% growth forecast trails that of rest of the industry.

Semiconductors' success is far from a secret. Its stock price index has climbed 252.4% over the past two years, and its forward P/E has jumped to 32.8 from a recent low of 13.1 in July 2022 (*Fig. 8* and *Fig. 9*).

Conversely, the Semiconductor Materials & Equipment industry is expected to rebound next year to 21.2% growth from a tough 2024, when earnings are forecast to decline 5.0%. Unlike Semiconductors' successive new highs, its forward earnings just recently crested the prior peak hit in May 2022 (*Fig. 10*). The industry's stock price index has front-run the expected earnings rebound and hit new highs, now towering 27.5% above its previous high in December 2021 (*Fig. 11*).

(3) *A material bounce.* Those worried about an economic slowdown may take solace in the rebound analysts are targeting for the earnings of many of the S&P 500 Materials sector's businesses. The Materials sector is expected to have the second largest earnings decline of the S&P 500 sectors this year, -2.2%, making its expected rebound to double-digit earnings growth, 17.4%, in 2025 notable.

The S&P 500 Copper industry's anticipated earnings growth of 39.6% in 2025 is the second highest among the S&P 500 industries. The price of copper has roller-coastered over the past two years, climbing from $321.05 during July 2022 to a peak of $551.90 during May 2024 before retracing half of that ascent, tumbling to a recent $439.05 (*Fig. 12*).

Copper prices were initially driven up by concerns that production couldn't meet the projected demand, boosted by broader adoption of electric vehicles and green energy sources and the buildout of AI data centers. Prices rose too far too fast as hedge funds and others jumped on the bandwagon, then just as abruptly sold off. With prices down roughly 20% from their highs, the commodity may be ready to stabilize and continue its climb.

With Freeport-McMoRan as its sole constituent, the S&P 500 Copper stock price index has risen 93.7% from its July 2022 low and fallen 11.4% from its May 20, 2024 record high (*Fig. 13*). While the industry's forward revenues has inched past its 2022 highs, margins and earnings remain depressed, leaving plenty of room for the improvement analysts expect (*Fig. 14*, *Fig. 15*, and *Fig. 16*).

Strategy II: High Sights for MegaCap-8 Industries' Growth. The industries holding the MegaCap-8 stocks—Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla—are expected to offer up strong earnings growth next year, anywhere from 8.9% to 46.5%. Here's a quick look what analysts are forecasting:

(1) The S&P 500 Semiconductors industry, with Nvidia leading the way, has the strongest expected earnings growth in 2025 of the MegaCap-8's assorted industries (38.8%, as mentioned above).

(2) Alphabet and Meta are in the Interactive Media & Services industry, which is expected to post solid but moderating earnings growth from 40.1% in 2023, to 32.1% this year and 13.9% in 2025. But even those decelerating growth forecasts have been enough to send the industry's price index to new record highs (*Fig. 17* and *Fig. 18*).

(3) Amazon is the 8,000-pound gorilla in the S&P 500 Broadline Retail industry. Analysts forecast that the industry's companies collectively will grow earnings 52.6% this year and 25.8% in 2025.

(4) Netflix is part of the S&P 500 Movies and Entertainment industry along with Disney. Its earnings are forecast to increase 27.3% in 2025, following a 65.9% jump this year and a 294.9% surge in 2023.

(5) Apple calls the S&P 500 Technology Hardware, Storage & Peripherals industry home. Analysts see that industry growing earnings 8.8% this year and 14.2% in 2025, bouncing back from a 5.1% decline in 2023.

(6) Systems Software includes industry giant Microsoft along with Oracle. The industry's

earnings are forecast to moderate from 19.5% growth this year to 12.9% growth in 2025.

(7) Tesla is in the slow lane compared to other MegaCap-8 constituents. It's a member of the S&P 500 Automobile Manufacturers industry, which has earnings forecast to climb 8.9% next year following a meager 2.8% increase this year and a 7.4% decline in 2023.

Disruptive Technologies: Signs of AI Inflation. Determining when an investment trend has run its course is more of an art than a science. While we love the productivity-enhancing possibilities that artificial intelligence (AI) offers, the AI phenomenon has many of the hallmarks of an inflating bubble. There are big bucks chasing the AI dream. New kings of industry have been crowned. And the hyperbole is flowing.

Let's take a look at some of the warning signs we're watching:

(1) *Funds are flowing.* We've been big fans of AI and what it can accomplish. This year alone, we've highlighted AI that *trains autonomous cars*; *develops drugs, plans weddings, and tickets drivers*; *helps teachers* develop lesson plans and grade papers; and *aids Madison Avenue's advertising pros* write copy and create videos.

But at some point, too much capital can end even the best of parties. There are hundreds of small companies that have raised billions of dollars from venture capitalists hoping to discover the next ChatGPT. Investors have poured $330 billion into 26,000 AI startups over the past three years, which is two-thirds more than was spent funding 20,350 startups from 2018-20, according to an April 29 *NYT* *article* citing PitchBook data. Likewise, generative AI deals attracted $21.8 billion last year, up fivefold from 2022, according to CB Insights data in an April 29 *WSJ* *article*.

Many AI newcomers have yet to turn a profit. The *NYT* highlighted a number of companies that were running out of funds, including Stability AI, which has laid off employees and watched its CEO depart. Inflection AI raised more than $1.5 billion to develop a chatbot that gave emotional support to its users, but its CEO and much of his staff left for Microsoft.

Fortunately, most of these companies haven't borrowed debt in the capital markets, so a repeat of the telecom bust is unlikely. But if AI startups run out of cash, their suppliers could find AI-related revenues dry up quickly.

(2) *The AI kings talk big.* Like every hip new tech industry, the AI world has its rockstars, including Nvidia's Jensen Huang, ChatGPT's Sam Altman, and Tesla's Elon Musk. Some

sound like they've drunk too much AI Kool-Aid.

At Nvidia's annual meeting last week, Huang noted that the Blackwell architecture platform may be the most successful product in the history of the computer, a June 26 Investopedia *article* reported. We have no doubt that Blackwell will be extremely successful, but we don't believe the semiconductor cycle is dead.

When semiconductor industry demand is strong, customers scramble to get their hands on chips, often over-ordering in anticipation of their entire order not being fulfilled. Once customers receive the chips they need, orders drop abruptly and manufacturers and wholesalers find themselves with excess inventory. AI may help manufacturers operate more efficiently, but it won't change human nature.

Huang also noted that the company's business was about to expand into the robotics and the sovereign AI businesses. "The next wave of AI is set to automate the $50 trillion in heavy industries" with robotics factories that "will orchestrate robots that build robots that build products that are robotic," the Investopedia article stated. The robotics industry already has many large, established companies, like Fanuc and Boston Dynamics, that are automated and using AI to improve their robots' capabilities.

Not to be outdone, ChatGPT CEO Sam Altman at the Aspen Institute Ideas Festival compared the rise of AI to the discovery of agriculture and the invention of industrial-era machines. He *claimed* that AI will dramatically increase productivity and help global GDP grow 7% annually to double within 10 years. While we concur with Altman that AI will enhance productivity and boost economic growth, doubling the size of the world economy in a decade is quite a claim.

Calendars

US: **Tues:** JOLTS Job Openings 7.860m; Auto Sales 15.9mu; Weekly Crude Oil Inventories; Powell. **Wed:** ADP Employment Change 156k; Initial Claims 235k; ISM N-PMI 52.5; Factory Orders; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Meeting Minutes; Williams. **Thurs:** None. **Fri:** Payroll Employment Total & Private 189k/160k; Averaging Hourly Earnings 0.3%; Average Weekly Hours 34.3; Unemployment Rate 4.0%; Baker Hughes Rig Count; Fed Monetary Policy Report; Williams. (FXStreet estimates)

Global: **Tues:** Headline & Core CPI 2.5%/2.8% y/y; Eurozone Unemployment Rate 6.4%; Italy Unemployment Rate 6.9%; Japan Tankan Large Manufacturers Index 12; China Caixin NM-PM 53.4; De Guindos; Elderson; Schnabel. **Wed:** Eurozone, Germany, and France C-PMIs 50.8/50.6/48.2; Eurozone, Germany, France, Italy, and Spain NM-PMIs 52.6/53.5/48.8/53.9/56.5; Eurozone PPI -0.1%; Lagarde; Lane. **Thurs:** Germany Factory Orders 0.5%; UK General Election; ECB Publishes Account of Monetary Policy Meeting; Lane; McCaul. **Fri:** Eurozone Retail Sales 0.2%; Germany Industrial Production 0.2%; France Industrial Production -1.2%; Italy Retail Sales 0.2%; Japan Leading Index 111.1; Lagarde; Elderson; Nagel. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): There were many constituent changes last week within the S&P 500/400/600 indexes. The three changes for the S&P 500 LargeCap caused its forward earnings to rise last week at the slowest pace in 10 weeks. It was a different story for the SMidCaps' forward earnings, which dropped at their fastest rate in many weeks. The S&P MidCap 400 had seven constituent changes and there were 13 for the S&P SmallCap 600. We think all these indexes will resume their simultaneous forward earnings uptrend, as they have risen together in 9 of the past 11 weeks. LargeCap's forward earnings rose less than 0.1% w/w to a new record high. It has achieved new record highs for 27 straight weeks and in 38 of the 42 weeks since mid-September; last week now matches the lengthiest string of record-high forward earnings for LargeCap in six years (since the March 16 week of 2018, when it hit record highs for 34 straight weeks). MidCap's fell 0.7% w/w from a 21-month high and is just 2.7% below its record high in early June 2022. SmallCap's fell 0.5% w/w from a seven-month high, and is still 10.5% below its mid-June 2022 record. Through the week ending June 20, LargeCap's forward earnings has soared 15.7% from its 54-week low during the week of February 1, 2023; MidCap's is 5.9% above its 55-week low during the week of March 10, 2023; and SmallCap's is 3.6% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows ago a year, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.3%, 14.2%), MidCap (2.0, 17.3), and SmallCap (-5.0, 19.3).

S&P 500/400/600 Valuation (*link*): Valuations were mostly higher during the June 28 week for these three indexes and remain slightly below their recent two-year highs. LargeCap's forward P/E remained steady w/w at 20.9, matching its 27-month high at the end of March and up from a seven-month low of 17.0 during the October 27 week. It's now up 5.8pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.1pt w/w to 15.1. That's down 0.9pts from a 27-month high of 16.0 at the end of March and up 2.8pts from a 12-month low of 12.3 at the end of October. It's now up 4.0pts from its 30-month low of 11.1 at the end of September 2022; these compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.2pts w/w to 14.1, and is now 0.6pt below its 28-month high of 14.7 during the May 17 week. It's up 3.5pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 28% discount to LargeCap's P/E is now testing its 29% discount a week earlier, which matched its 24-year-low 29% discount during the June 1, 2023 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 33% discount is also now testing its 34% discount a week earlier, which also matched its 23-year-low 34% discount during the October 19, 2023 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

US Economic Indicators

Construction Spending (*link*): Construction spending fell short of expectations in May as higher interest rates depressed single-family homebuilding, though overall spending remains at record highs. *Total construction spending* slipped 0.1% in May (vs an expected 0.2% gain) following an upwardly revised 0.3% increase in April to a new record high (first reported as a 0.1% decline). Construction spending was 6.4% above a year ago. *Total private* construction spending slipped 0.3% in May, led by a 0.7% drop in *new single-family* homes, while *multi-family* units were flat during the month—though on a year-over-year basis, single-family construction expanded at a double-digit pace of 13.8%, while multi-family units contracted 4.6%. *Private nonresidential* construction fell 0.3% in May, led by declines in educational (-3.4%), religious (-2.9), health care (-2.2), and office (-1.7) buildings, though private nonresidential building was up 4.1% y/y, led by double-digit gains in manufacturing (20.2) and religious (16.9) structures. It remains stalled at record highs. *Total public construction* climbed 0.5% in May to a new record high, expanding 8.7% y/y.

Global Economic Indicators

Global Manufacturing PMIs (*link*): The growth rate of global manufacturing activity eased a bit in June, after reaching a 22-month high in May, remaining above the breakeven point of 50.0 for the fifth successive month; it was at 50.0 at the start of this year after a 16-month string of readings below the breakeven point. The *JP Morgan Global M-PMI* climbed for the fifth time in six months, from 49.0 in December to 50.9 in June. Four out of the five *PMI sub-indices* were at levels consistent with expansion—with output, new orders, and employment all rising and the suppliers' delivery times lengthening. *By country*, 18 of the 30 countries for which data are available expanded in June, led by *Asia*, with 10 nations experiencing growth—with India, Vietnam, and Thailand the leaders, followed by China and Japan. The *Eurozone* remained a weak spot, with output falling (on average) for the 15th straight month, as growth rates in Spain, the Netherlands, and Greece were more than offset by contractions in the other countries; the Big Three economies—Germany, France, and Italy—were all in the red. Meanwhile, expansions continued in the US, UK, and Brazil. *Turning to prices*, price pressures accelerated, with June's *input costs* (55.3 from 54.8) at a 16-month high and *output charges* (52.3 from 51.7) the fastest in 15 months. For both price measures, rates of increase were steeper, on average, in developed nations than in emerging markets.

US Manufacturing PMI (*link*): Manufacturing activity in June contracted again, while price pressures eased. The *M-PMI* fell for the third month, to 48.5 in June, after climbing from 47.8 in February to 50.3 in March. It was below the breakeven point between contraction and expansion for the 19th time in the past 20 months. According to ISM, the *overall economy* continued its expansion for the 50th month after a one-month contraction in April 2020. (A Manufacturing PMI above 42.5% over a period of time generally indicates an expansion of the overall economy.) The *production* (to 48.5 from 50.2) measure dropped below the breakeven point of 50.0 after three months above, while the new orders (49.3 from 45.4) gauge continued to contract, though moved up to within a couple of ticks of 50.0 in June. Meanwhile, the backlog of orders (41.7 from 42.4) measure contracted at a faster pace. The *supplier deliveries* (49.8 from 48.9) measure remained in "faster" territory—hovering just below 50.0. (The supplier deliveries component is the only measure that is inversed—a reading above 50.0 indicates slower deliveries, which is typical as the economy improves and customer demand strengthens.) Meanwhile, the employment (49.3 from 51.1) gauge dropped back below 50.0, after moving above in May for the first time since last September. Price pressures eased in June, as the prices-paid measure declined for the second month to a six-month low of 52.1 from April's 60.9, which was the highest since mid-

2022.

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