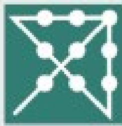
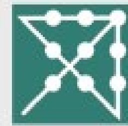


Yardeni Research



July 30, 2024

Morning Briefing

YRI's Earnings Tweaks & Dudley's About-Face

Check out the accompanying chart collection.

Executive Summary: We're updating our S&P 500 price targets for this year and the rest of the decade. Near term, we see the index continuing to churn below its July 16 record high through election time; it seems to have support around 5450, its 50-day moving average, which we don't think will be breached given companies' earnings strength. A strong rally at year-end might sweep the index to a new record high around our (newly raised) 5800 target. Dr. Ed shows the math that yields this and our subsequent years' price targets. … Also: Eric counters NY Fed President Dudley's recent op-ed argument for easing sooner than September.

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

Strategy I: Earnings Review. On July 10, Eric, Joe, and I raised our year-end target for the S&P 500 from 5400 to 5800. That might have been a contrary indicator, at least in the short run. The S&P 500 peaked at a record high of 5667.20 on July 16 (*Fig. 1*). The next day, the Biden administration threatened to impose draconian measures on semiconductor equipment manufacturers to stop them from selling their chip-making machines to China. Both the S&P 500 Semiconductor Equipment and Semiconductor stock price indexes peaked at their record highs on July 10 and June 18, respectively (*Fig. 2*).

The S&P 500 fell after its July 16 peak despite investors' expectations for two Fed rate cuts over the remainder of this year (*Fig. 3*). The index seems to be finding some support around its 50-day moving average (dma) of 5450. If that fails, the next area of support might be around 5250. If that doesn't hold, then the S&P 500 should find solid support at its 200-dma, which is currently around 5000. On July 16, the S&P 500 exceeded its 200-dma by 15%, which is a relatively high reading (*Fig. 4*). On Friday, this technical indicator was back down to 10%.

We're betting that the S&P 500 will hold its support at its 50-dma. That's because we

believe that the Q2 earnings reporting season is going relatively well. Our hunch is that the S&P 500 will continue to churn around current levels, rotating and remaining below its July 16 record high through the presidential election. We expect a strong year-end rally to deliver a new record high. We are still aiming for our new target of 5800. In the next section, we'll update our targets for the S&P 500 for the rest of the decade.

But first, let's review the latest analysts' consensus expected earnings data:

(1) *Quarterly S&P 500 EPS.* So far, Q2's earnings reporting season is going well. The blended reported/estimated earnings-per-share (EPS) growth rate for the S&P 500 companies has stopped its recent fall and edged up to 8.7% y/y during the July 25 week (*Fig. 5* and *Fig. 6*). We are expecting 10%-12% y/y. On the other hand, company managements may be offering cautious guidance, perhaps ahead of the November elections, as Q3 earnings growth has fallen to 6.8% y/y. Yet they are currently predicting a 13.7% y/y increase for Q4.

(2) *Annual S&P 500 EPS*. The industry analysts' consensus expectations for S&P 500 companies' earnings per share for 2024, 2025, and 2026 rose during the July 25 week to $243.56, $279.65, and $317.11 (*Fig. 7*). That's up 10.0% this year, 14.8% next year, and 13.4% in 2026.

(3) *S&P 500 forward earnings.* S&P 500 forward earnings per share (i.e., analysts' consensus EPS expectations calculated for the coming 12 months) tends to do a good job of forecasting actual earnings when the economy is growing. S&P 500 forward EPS hit a new record high of $264.38 during the July 25 week, suggesting a solid gain in S&P 500 EPS during Q2 and boding well for Q3 (*Fig. 8*).

By the way, S&P 500 forward revenues per share continues to rise in record-high territory (*Fig. 9*). During the July 18 week, it was up 5.7% y/y. That's a solid increase considering that inflation has moderated significantly over the past year. The S&P 500 forward profit margin at 13.4% currently is almost back to its record high of early 2022 (*Fig. 10*).

Strategy II: YRI Earnings Update. Now let's detail why we raised our year-end outlook for the S&P 500 price index to 5800 from 5400.

In brief, we think that the very highly valued Magnificent-7 stocks will remain magnificent and continue to sport a high collective forward P/E, providing support to the S&P 500. The forward P/E of the S&P 493—i.e., the S&P 500 minus these seven—is relatively high as

well, but it could go higher as corporate profit margins rise to record highs thanks to technological innovations including automation, robotics, AI, the cloud, and super-computing. These developments are all consistent with our Roaring 2020s scenario in which the economy is boosted by faster technology-led productivity growth.

Productivity rose 2.9% y/y through Q1-2024, exceeding its 2.1% average since the late 1940s (*Fig. 11*). A good proxy for productivity is real GDP divided by aggregate hours worked in private industry (*Fig. 12*). It rose 1.7% y/y during Q2-2024. We think productivity can grow twice as much over the rest of the decade.

Without further ado, let's do the math behind our S&P 500 targets:

(1) *Revenues.* We are expecting S&P 500 companies' collective revenues per share to increase 1.3%, 3.9%, and 4.1% this year, next year, and in 2026 (*Fig. 13*). There's no recession in our forecasts, which are relatively conventional ones since we're thinking that global real economic growth might remain lackluster for some time, with inflation remaining in the low double digits.

(2) *Earnings*. We are projecting S&P 500 EPS of $250, $275, and $300 for 2024, 2025, and 2026 (*Fig. 14*). The only change from our previous forecasts is that we raised our 2025 estimate by $5 per share.

(3) *Profit margin*. Our outlook implies that the S&P 500 profit margin will rise from 11.9% in 2023 to 13.2% in 2024, 14.0% in 2025, and 14.6% in 2026 (*Fig. 15*). The latter two would be record highs.

(4) *Forward earnings & forward P/E*. We are projecting forward earnings at the end of 2024, 2025, and 2026 of $275, $300, and $325 (*Fig. 16*). To derive our S&P 500 target ranges, we multiply these estimates by forward P/Es ranging between 16.0 and 21.0 (*Fig. 17*). Previously, the top of our forward P/E range was 20.0.

(5) *S&P 500 targets*. Here are the S&P 500 price target ranges for year-end 2024 (4400-5775), 2025 (4800-6300), and 2026 (5200-6825) (*Fig. 18*). In our Roaring 2020s scenario (with a 60% subjective probability), we think the top ends of these ranges can be achieved: 5775, 6300, and 6825 by the ends of the current year and next two years.

We expect that forward earnings could be $400 per share by the end of 2029, resulting in an S&P 500 stock price index of 8400.

The Fed: Dudley's About-Face. On July 24, Bloomberg posted an *opinion piece* by Bill Dudley, who served as president of the Federal Reserve Bank of New York from 2009 to 2018. It was titled "I Changed My Mind. The Fed Needs to Cut Rates Now." Prior to his change of mind, Dudley's views were in sync with ours, until his political leanings got the better of him, we reckon.

On *May 30*, Dudley eschewed the idea of cutting the federal funds rate (FFR) in pursuit of the unobservable "r*," as we did in our *Morning Briefing* of June 4. He suggested that the current FFR is barely restrictive considering the US economy's reduced sensitivity to rates and persistent strength; we made the same argument in our *Morning Briefing* of May 29.

We were happy to see Dudley in our no-cutting-yet camp. That changed on July 24, when he wrote his op-ed calling for the Fed to cut the FFR in July to mitigate the risk of recession. While we expect the Federal Open Market Committee (FOMC) to cut interest rates at its September meeting, we do not think it needs to because we don't see a recession looming. Let's revisit why we disagree with Dudley's latest assessment:

(1) *Long-and-variable-lags.* The crux of Dudley's recession worries is that a slow rise in unemployment will precipitate a much larger one, as waning job openings force consumers to retrench and businesses to cut back on investment, and then lay off more workers.

The long-and-variable-lag thesis misreads the typical cause of previous recessions. In the past, monetary policy tightening caused recessions as higher rates triggered financial crises, rather than steady economic slowdowns. As a crisis quickly morphed into a full-blown credit crunch, business production and investment dropped and companies laid off workers en masse (*Fig. 19*). Layoffs weren't instigated by workers, but their spending also dropped as they grew less confident about their job and wage prospects.

(2) C*risis averted.* The financial crisis in this cycle was quickly headed off by the Treasury and Fed in March 2023, when SVB and a few other regional banks failed. Uninsured deposits were backed, and the Fed unleashed a new facility that bought underwater debt at par; both reduced the banking sector's worries (*Fig. 20*). This time, the evidence suggests that US consumers are not retrenching; the personal savings rate fell in June to 3.4%, its lowest since late 2022 (*Fig. 21*). Meanwhile, the need to borrow has been depressed, as corporate and household balance sheets are much healthier today than they were preceding the Great Financial Crisis—the US government is the main borrower who is levering up these days (*Fig. 22*).

(3) *Labor loosening.* The labor market looks healthy to us, unwinding from its peak pandemic tightening to more normal, albeit historically strong, conditions. Much of the rise in unemployment thus far has been due to workers entering the labor market rather than employed workers losing their jobs.

The Sahm Rule is the simple arithmetic formula for a gradual rise in unemployment turning into a spike. But when applying it to the numbers of workers on insured unemployment benefits (meaning they had a job that they lost), the; unemployment picture looks benign (*Fig. 23*).

(4) *One-and-done.* We expect the Fed will cut the FFR by 25 basis points to a range of 5.00% to 5.25% in September, then leave it unchanged for the rest of the year, all else remaining equal. A rate cut in July is unlikely considering the strong Q2 GDP print—officials will also want to see Friday's employment report and August's CPI in a couple weeks.

The Jackson Hole symposium from August 22-24 is where Fed Chair Jerome Powell would likely announce any policy shift, especially as the financial markets may get ahead of themselves and begin pricing in a series of 25bps reductions when the first FFR cut is solidified. The futures market already anticipates five to six 25bps cuts over the next 12 months (*Fig. 24*).

The September FOMC meeting will allow Fed officials to update their Summary of Economic Projections forecasts, so it will be a good time for the Fed to try to anchor market expectations.

The Fed's November meeting is the day after the November presidential election, with only the December meeting before year-end. Fed officials have repeatedly mentioned their shock at the rebound of inflation early this year when companies posted their annual price resets. With geopolitical developments skewing inflation risks to the upside, we think the Fed will leave the FFR above 5.00% heading into 2025.

Calendars

US: Tues: Consumer Confidence 99.8; JOLTs Job Openings 8.030m. **Wed:** Fed Interest Rate Decision 5.50%; ADP Employment Change 166k; Employment Cost Index 1.0%; Pending Home Sales 1.6%; Chicago PMI 44.1; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: **Tues:** Eurozone Business & Consumer Survey; Eurozone GDP 0.2%; Germany GDP 0.1%; France GDP 0.2%; Italy GDP 0.2%; Japan Industrial Production -4.2%; Japan Retail Sales 3.3%y/y; Australia CPI 3.8%y/y; Australia 0.3%; China M-PMI & NM-PMI 49.3/50.2; BoJ Interest Rate Decision 0.10%. **Wed:** Eurozone Headline & Core CPI 2.4%/2.8%y/y; Eurozone PPI; Germany Retail Sales; Germany Unemployment Change & Unemployment Rate 16k/6.0%; Germany Import Price 0.1; France CPI 0.3%; Japan Household Confidence 36.5; Japan Housing Starts -2.3%; Japan M-PMI 49.2; BoJ Outlook Report; China Caixin M-PMI 51.6. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week simultaneously for all three of these indexes, and has done so in 13 of the past 15 weeks. LargeCap's forward earnings rose 0.5% w/w to a new record high. It has achieved new record highs for 30 straight weeks and in 41 of the 46 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 rose 0.1% w/w and is just 2.0% below its record high in early June 2022. SmallCap's rose 0.3% w/w, but is still 9.6% below its mid-June 2022 record. Through the week ending July 26, LargeCap's forward earnings has soared 17.0% from its 54-week low during the week of February 1, 2023; MidCap's is 6.7% above its 55-week low during the week of March 10, 2023; and SmallCap's is 4.6% 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 just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.0%, 14.8%), MidCap (1.3, 17.7), and SmallCap (-5.3, 19.1).

S&P 500/400/600 Valuation (*link*): Valuations were mixed during the July 26 week for these three indexes, but remain at near recent multi-year highs. LargeCap's forward P/E fell 0.3pt w/w to a seven-week low of 20.6. That's down 0.8pts from a 30-month high of 21.4 during the July 12 week, but is up 3.6pts from a seven-month low of 17.0 during the October 27 week. It's now up 5.5pts 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 0.3pts w/w to a 17-week high of 15.7. That's down 0.3pts from a 27-month high of 16.0 at the end

of March and up 3.4pts from a 12-month low of 12.3 at the end of October. It's now up 4.6pts 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 0.5pts w/w to a 32-month high of 14.9. It's up 4.3pts 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 24% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 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 26% discount is up from a 24-year low 34% discount during the July 5 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

Regional M-PMIs (*link*): The *Dallas Fed district* has now released manufacturing data for July showing that manufacturing activity "remains flat amid weakening demand." This report follows the *New York Fed's survey* of manufacturing activity for the month, which showed activity contracted for the eighth straight month, while *Richmond's* saw manufacturing activity deteriorate, with firms less optimistic about local business conditions. Meanwhile, the *Philadelphia survey* saw the general activity measure expand and the future general activity reach its highest reading since July 2021. Looking at the *Dallas Fed Survey*, the *production index*, a key measure of manufacturing, held relatively steady, at -1.3, down slightly from June's 0.7. Perceptions of broader business conditions show both the *general business activity* (to -17.5 from -15.1) and *company outlook* (-18.4 from -6.9) measures continued to deteriorate, with the latter showing the steepest decline. Meanwhile, the *outlook uncertainty index* shot up to 30.7—the highest since fall 2022. The *new orders* (-12.8 from -1.3) and *shipments* (-16.3 from 2.8) gauges showed a significant pullback in demand, with the latter swinging from positive to negative. The labor market measures show *employment* (7.1 from -2.9) posted an increase in jobs, while *hours worked* (-13.8 from -5.0) showed a shorter workweek. The *wages & benefits* (21.2 from 24.3) index held relatively steady in July, around its historical average. *Turning to pricing*, the *raw materials* price (23.1 from 21.5) measure was little changed, while the *finished goods price* (3.4 from 14.4) measure showed an easing in pricing. Looking ahead, both the *future production* (32.0 from 27.1) and *future general business activity* (21.6 from 12.9) measures are expected to

improve over the next six months, with the latter posting its best reading since the fall of 2021. There was widespread improvement in the future manufacturing components for July.

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