December 19, 2024

Morning Briefing

AI, Earnings
& More AI

Check out the accompanying chart collection.

Executive Summary: Twenty-twenty-four no doubt will be remembered by equities investors as the year that everything AI-related trounced everything not. Jackie has the striking performance data to prove it. … Also: For some of the fastest-growing S&P 500 sectors this year, earnings could decelerate sharply in 2025 if analysts' estimates pan out. … And: Websites breathed life into the Internet and apps into the iPhone. Now AI has opened the floodgates to the development of AI-infused apps that can expedite everything from creative endeavors to routine tasks.

Strategy I: AI's Influence on 2024. The 2024 gains in the S&P 500 were truly amazing, especially since they defied the expectations of many folks at the start of the year that a recession would cast a pall over the financial markets in 2024. Instead, artificial intelligence (AI) took off, the elections went off without a hitch, and the economy was much more resilient than widely expected (except by us). Even the Federal Reserve decided the economy is strong enough to reduce its interest-rate-cut forecast to only two cuts next year instead of the four cuts that was expected previously.

Here's the performance derby for the S&P 500 and its 11 sectors ytd through Tuesday's close: Communication Services (44.1%), Information Technology (39.3), Consumer Discretionary (38.2), Financials (30.1), S&P 500 (26.9), Utilities (20.2), Industrials (19.1), Consumer Staples (15.9), Real Estate (5.1), Energy (2.6), Materials (2.2), and Health Care (1.7) (*Fig. 1*).

Look back over the past two years, and the results are even more impressive, with the S&P 500 gaining 57.6%. Here's the performance derby for the S&P 500 and its 11 sectors from January 2, 2023 through Tuesday's close: Communication Services (122.4%), Information Technology (117.8), Consumer Discretionary (94.9), S&P 500 (57.6), Financials (43.0), Industrials (38.2), Real Estate (13.8), Consumer Staples (13.4), Materials (12.7), Utilities (8.0), Health Care (2.0), and Energy (-2.3) (*Fig. 2*).

Investors can credit AI for the voracious demand for Nvidia's semiconductor chips; the need for server space offered by Amazon, Google, and Microsoft; and the software being developed by newcomer OpenAI as well as Meta Platforms and the thousands of other small developers that collectively have created a whole new business that didn't exist three years ago. Even the normally sleepy utilities sector benefited from the surge in demand for electricity to run the servers handling the AI programs.

Let's take a deeper dive into what drove this year's gains:

(1) *AI benefits chips.* Nvidia remains the rockstar of tech, with a share price that has risen 163.3% ytd, driving the S&P 500 Information Technology sector's Semiconductor industry price index up 84.4% ytd (*Fig. 3* and *Fig. 4*). The company's earnings growth rate continues to shock and awe. Even after its remarkable recent growth, analysts are calling for Nvidia's forward earnings to grow 56.3%, which makes its forward P/E of 31.2 seem reasonable (*Fig. 5* and *Fig. 6*).

Demand for chips involved with AI also helped to lift the shares of Broadcom, up 115.2% ytd, and Marvell Technology, up 86.1%. Those chipmakers who missed the AI boat didn't fare nearly as well: AMD's shares fell 15.2% ytd, and Intel's lost -59.3%.

(2) *AI benefits servers.* The voracious need for computation power to run AI has benefited the bottom lines of server providers scattered across three different sectors. Amazon's share price has risen 52.1% ytd, helping to lift the S&P 500 Consumer Discretionary sector's Broadline Retail industry index 51.6% ytd. Microsoft shares have gained 20.9% ytd, helping to propel the Information Technology sector's Systems Software industry index 25.4% higher this year.

Finally, the shares of Google's parent Alphabet have appreciated 39.9% ytd. Google and Meta, which has its own generative AI program and rose 75.0% this year, both reside in the S&P 500 Communication Services sector's Interactive Media & Services industry, with a price index up 51.5% ytd.

(3) *AI keeps the Magnificent-7 rising.* Five of the Magnificent-7 names—Amazon, Alphabet, Meta, Microsoft, and Nvidia—directly benefit from AI, and that has helped the Magnificent-7 rise a collective 52.4% ytd through Tuesday's close (*Fig. 7*). Those seven stocks represent 31.2% of the S&P 500's market capitalization, essentially matching the all-time high hit on July 9 (*Fig. 8*).

The index has also gained from Tesla shares, with a 93.1% ytd gain, helped by the cozy relationship between CEO Elon Musk and President-elect Donald Trump. Tesla is working on a new generative AI program, while Apple is hoping AI makes Siri much smarter (more on that below). Apple shares have risen 30.4% ytd, helping to knock the price index of its industry up by nearly that much: Technology Hardware, Storage & Peripherals has gained 29.1% ytd (*Fig. 9*).

The Magnificent-7 stocks collectively enjoy a forward profit margin that's far wider than the S&P 500, 25.4 vs 13.5 (*Fig. 10*). And analysts' consensus earnings forecasts make for forward earnings growth of 19.1%, which also is loftier than the S&P 500's 14.3% forward earnings growth (*Fig. 11*). Even after this year's strong stock price appreciation, the Magnificent-7 stocks' forward P/E is 30.9, around the midpoint between its 2020 high and 2023 low (*Fig. 12*). (As a reminder, the forward profit margin we derive from forward earnings and forward revenues. Forward earnings and revenues are the time-weighted average of analysts' consensus estimates for the current and following year. The forward P/E is the multiple using forward earnings.)

Strategy II: A Look Ahead at Earnings. Peering into 2025, analysts again expect earnings for the S&P 500 companies collectively to grow by a solid 14.3%, up a touch from this year's estimated 10.0%. But a look under the hood shows that there are some pretty large swings in the index's sectors and industries that are expected to enjoy the most earnings growth next year (*Table 1*).

Here's a quick look at some of the big movers:

(1) *Tech reigns supreme.* The S&P 500 Information Technology sector remains among the fastest growing sectors in the index, with analysts forecasting above-average earnings growth of 20.4% this year and 21.7% growth in 2025. The big change occurs in the Communication Services sector, where earnings growth slows from 24.4% this year to 14.9% next year. The fastest earnings grower in 2024, Communication Services' earnings will grow more slowly than four other S&P 500 sectors in 2025 if estimates come to fruition.

The sector's Interactive Media & Services' earnings are forecast to decelerate from 42.5% growth this year to 12.0% growth in 2025. The change can be attributed to the slowdown expected in Meta's earnings growth rate, from 52.4% in 2024 to 12.0% next year, while Alphabet's earnings growth is expected to be much steadier at 15.8% in 2025, down only a bit from this year's 16.6%.

(2) *Health Care for those who dare.* After Technology, the S&P 500 sectors growing their earnings the fastest are Health Care, Materials, and Industrials. The beaten-up Health Care sector is expected to see a rebound in earnings growth, from 5.0% this year to 20.1% in 2025, propelled by both the Pharmaceuticals (21.6% in 2024 and 33.1% in 2025) and Biotechnology (-12.1%, 30.9%) industries.

After Health Care, analysts are expecting big earnings growth improvement in both the Materials (-8.2% in 2024, 18.3% in 2025) and Industrials (0.5%, 18.2%) sectors. Industrials should benefit from Boeing's swing from losses to profits, as the airplane manufacturer has restarted its assembly lines after its workers' strike. And analysts seem to be optimistic about a rebound in many of the Materials industries, including Copper (-0.7%, 37.6%), Commodity Chemicals (-16.8%, 33.1%), and Construction Materials (-5.3%, 24.8%).

(3) *A tougher road ahead.* Analysts are calling for earnings growth to decelerate in the S&P 500 Financials sector from 13.5% this year to 7.4% in 2025. Earnings for the Diversified Banks industry are forecast to grow a mere 2.3% in 2025, and the earnings growth rate in the Consumer Finance industry is expected to slow sharply from 21.9% this year to 4.9% in 2025.

The Energy sector's earnings are expected to return to growth in 2025, rising 4.6%, after a sharp downturn this year, -18.9%. Growth expectations for its component industries remain low, with analysts calling for 2025 earnings growth of 1.5% for the Integrated Oil & Gas industry and 4.0% for the Oil & Gas Exploration & Production industry.

Disruptive Technologies: AI Invades Apps. Most AI-related press focuses on the amazing things that generative AI programs like ChatGPT and Claude can do. But AI programmers are also focused on churning out AI-infused applications that do everything from draw to handle personal finances. It's a fast-growing area that's attracting dollars and developers, and it reminds us of the surge in app development following the introduction of the iPhone.

Here's a quick look at the growing area of business apps that can make operating a business more efficient than ever before. These tools, highlighted in two LinkedIn posts (*here* and *here*), help to even the playing field between large corporations and small startups, as their cost is often minimal.

(1) *An AI app can do that.* Developers have infused AI into all manner of business applications. Managers looking for insights about their business can use *Julius*, an AI app

that analyzes a business's data and presents it in charts and graphs. When it's time to put that data into a presentation, managers can turn to *Gamma* or *Decktopus AI*.

Want to increase your business's presence on Twitter? Try *Tweet Hunter*. It uses AI to offer content ideas, help write tweets faster, analyze Twitter traffic and identify sales leads. Prefer using LinkedIn? Turn to *Taplio*, which uses AI to create content, schedule posts, and track performance to engage and grow your audience.

Looking to improve your headshot on the company website? Upload everyday pictures to *HeadshotPro* or *BetterPic*, and they will take the best elements of each of the pictures and create a professional looking headshot. The AI programs let users pick the clothing, pose, and background used in the headshot.

Website need an upgrade? Use *Chatsimple* to create a chatbot that can answer customers' questions and generate sales. Prefer communicating with customers via newsletter? *Beehiiv.com* helps develop newsletters and turn web visitors into subscribers, while also attracting advertisers. And to keep your schedule in order, turn to *BeforeSunset*.

(2) *Dust off the ping pong tables.* The numerous new AI app startups have caught the attention of San Francisco real estate agents. "Remote work fatigue" has more of the younger crowd itching to return to the office and leave their cramped apartments, a December 6 CNBC *article* reported.

The San Francisco vacancy rate remains elevated, at 34.9% in Q3, but "artificial intelligence companies will continue as a driving force in the San Francisco market, fueling significant VC funding and leasing activity," according to a Cushman & Wakefield report quoted in the article.

(3) *Big guys building AI apps too.* Large companies are racing to infuse AI into existing and new apps. Salesforce is introducing Agentforce 2.0, which empowers companies to build autonomous AI agents that can answer complex questions using their company's information in Slack, CRM, and in the Salesforce data cloud. The new software will be available to customers in February.

Salesforce is using Agentforce 2.0 on its website's help page and has found that Agentforce solves 83% of customers' questions without a human, halving the number of issues that require human intervention, a December 17 company *press release* stated. Adecco used it to build a Recruitment Agent to screen candidates and schedule interviews. Salesforce plans to hire 2,000 people to sell its AI software to clients, CEO Marc Benioff said in a December 17 CNBC *article*.

Apple is hoping that the 3.4 million third-party app developers who have created apps for the iPhone will alter their apps to include Apple Intelligence, Apple's recently released AI offering. By doing so, Apple's Siri would potentially be able to execute an action in a developers' app, an October 4 CNBC *article* explained.

For example, Superhuman is an email app that plans to incorporate Apple's AI system. Users of the new program would be able to say, "Hey Siri, when does my flight depart?," and the app will search the user's email to find the information. Now that sounds like something we could use!

Calendars

US: Thurs: Real GDP 2.8%; GDP Price Index & PCE Prices 1.9%/1.5%; Corporate Profits 0.0%; Leading Indicators -0.1%; Philadelphia Fed Manufacturing Index 2.5; Kansan City Fed Manufacturing Index; Initial Claims 245k; Existing Home Sales 4.1mu; Fed's Balance Sheet. **Fri:** Personal Income & Consumption 0.4%/0.5%; Headline & Core PCE Price Index 0.2%m/m/2.5%y/y & 0.2%m/m/2.9%y/y; University of Michigan Consumer Sentiment Total, Current Conditions, and Expectations 74.0/77.7/71.6; University of Michigan Inflation Expectations 2.9%; Baker Hughes Rig Count. (FXStreet estimates)

Global: Thurs: Germany Gfk Consumer Climate -23.1; BoE Interest Rate Decision 4.75%; Japan National CPI 2.6%y/y; EU Leaders Summit. **Fri:** Germany PPI 0.3%; Italy Business Confidence 86; UK Retail Sales 0.4%m/m/0.1%y/y; UK CBI Distributive Trades -10. FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* dipped this week for the second week, to 3.60, after rising the prior four weeks from 2.61 to 3.91—which matched its highest reading since late July. *Bullish sentiment* moved lower for the second week to 59.0%, after climbing the prior two weeks from 60.0% to 62.9%—which was the most bulls since late July, when the report noted seven consecutive weeks with bulls over 60%, ending at 64.2%. This week's reading remains in the high-risk danger zone above 55.0% for the tenth straight week. Meanwhile, *bearish sentiment* was unchanged at 16.4% this week, following a five-week drop of 5.9ppts (to 16.1% from 22.0%), which was the fewest bears since late July, when it dropped to 14.9%. The *correction count* rose for the second week, from 21.0% to 24.6%; it had been hovering around 20% the prior nine weeks. In the *AAII Sentiment Survey* (as of December 12), bullish sentiment about the short-term outlook for stocks fell, while pessimism and neutral sentiment rose. *Bullish sentiment* sank 5ppts to 43.3%, above its historical average of 37.5% for the 56th time in 58 weeks. Meanwhile, *bearish sentiment* edged up a percentage point to 31.7%, below its historical average of 31.5% for the third time in four weeks. *Neutral sentiment* climbed 4.0ppts to 25.0%, below its historical average of 31.5% for the 22nd time in 23 weeks.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin rose 0.1ppt w/w to a new record high of 13.5% during the December 12 week. It is now 3.2ppts above its seven-year low of 10.3% during April 2020. Forward revenues and earnings both ticked down 0.1% w/w from record highs. The consensus expectations for forward revenues growth rose 0.1ppt w/w to 5.6%, and is just 0.2ppt below its 23-month high of 5.8% during the August 1 week. It has gained 3.3ppts from its 33-month low of 2.3% during the February 23, 2023 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. The forward earnings growth forecast was unchanged w/w at a 38-month high of 14.3%. It's now 11.0ppts above its 31-month low of 3.3% during the February 16, 2023 week. That's down from its 23.9% reading at the end of April 2021, which was boosted by the recovery from the pandemic to its highest reading since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 4.8% in 2024 (unchanged w/w) and 5.5% in 2025 (unchanged w/w) compared to a revenues gain of 2.1% in 2023. They expect an earnings gain of 10.0% in 2024 (up 0.1ppt w/w) and a 14.3% rise in 2025 (down 0.1ppt w/w) compared to an earnings gain of 2.4% in 2023. Analysts expect the profit margin to rise 0.5ppt y/y to 12.4% in 2024 (unchanged w/w), compared to 11.9% in 2023, and to rise 1.1ppts y/y to 13.5% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E was steady w/w at a 43-month high of 22.4. It's up 2.7pts from a 14-week low of 19.7 during the August 8 week and 7.1pts from a 30-month low of 15.3 in October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio was also unchanged, but at a record high of 3.02. That's up from a six-month low of 2.22 during the October 26, 2023 week and compares to a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): During the December 12 week, forward revenues rose for three of the S&P 500 sectors, and forward earnings rose for two. This led to rising forward profit margins w/w for four of the 11 sectors. Four of the 11 sectors posted record-high forward revenues this week: Financials, Health Care, Real Estate, and Utilities. Industrials' forward revenues remains 2.5% below its early September record. Materials and Energy are the biggest laggards at 6.1% and 15.2% below, respectively. These two sectors had record-high forward earnings this week: Consumer Discretionary and Financials. Among the remaining nine sectors, seven are less than 1.4% below their recent records. Forward earnings remains depressed for Energy and Materials, which are stabilizing in recent weeks at 32.9% and 21.8% below their respective post-pandemic highs. Looking at the forward profit margin, these three sectors had record- or post-pandemic highs this week: Communication Services, Consumer Discretionary, and Financials. In recent weeks, the Industrials and Information Technology sectors were in that club. Among the laggards, Energy's forward margin was steady w/w at 9.5%, up 0.1ppt from a 33-month low of 9.4% in mid-November, but that's down 1.4ppts since its six-month high of 10.9% in mid-June; Consumer Staples' 6.9% is just 0.2ppt above its seven-year low in March 2023; and Health Care's 8.7% is only 0.2ppt above its record low in April. Here's how the S&P 500 and its 11 sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (26.9%, down from its 27.6% record high in September), Financials (19.6, down from its 19.8 record high in August 2021), Communication Services (18.6, a record high this week), Real Estate (17.1, down 0.1ppt w/w and from its 19.2 record high in 2016), Utilities (14.3, down from its 14.8 record high in April 2021), S&P 500 (13.5, a record high this week and in 14 of the past 15 weeks), Materials (11.2, down 0.1ppt w/w and from a 20-month high of 11.6 in July and a 13.6 record high in June 2022), Energy (9.5, up 0.1ppt from a 33-month low in November and down from its 12.8 record high in November 2022), Industrials (11.1, down from its 11.2 record high in early October), Consumer Discretionary (9.4, a record high this week), Health Care (8.7, 0.2ppt above its 8.5 record low at the end of April and down from its 11.5 record high in February 2022), and Consumer Staples (6.9, down from its 7.7 record high in June 2020).

US Economic Indicators

Housing Starts & Building Permits (*link*): Housing starts fell unexpectedly in November, to a four-month low, on a drop in multi-family projects, while single-family starts rebounded from October's hurricane-related decline. *Housing starts* moved lower for the third successive month, by 1.8% in November and 6.5% over the period to 1.289mu (saar), with *multi-family starts*—buildings with five units or more—plunging 24.1% during the month. Meanwhile, *single-family* starts rebounded 6.4% in November to 1.011mu, led by an 18.3% surge in the South (the largest homebuilding region), as parts of the area rebounded from hurricane-related delays in late September and October. All other regions recorded declines in single-family projects during the month. *Total starts* fell 14.6% y/y, with multi-family down 28.8% y/y and single-family 10.2% lower. Meanwhile, *building permits*, a proxy for future construction, jumped 6.1% in November to 1.505mu (saar), led by a 22.1% surge in multi-family units, while single-family permits barely budged, recording a 0.1% uptick to 972,000 units. On a year-over-year basis, permits slipped 0.2%, with single-family permits dropping 2.7%, while multi-family permits climbed 4.8%.

Global Economic Indicators

Eurozone CPI (*link*): The *Eurozone CPI* rose 2.2% y/y in November, a tick below the flash estimate of 2.3%, following gains of 2.0% in October and 1.7% in September—which was the lowest rate since April 2021. Meanwhile, the *core CPI* was at 2.7% for the third successive month. The headline and core CPIs are down sharply from their recent peaks of 10.6% in October 2022 and 5.7% in March 2023. Looking at the components, the *services rate* ticked down to 3.9% from 4.0% and 3.9% the prior two months—hovering around 4.0% for several months. The rate for *food, alcohol & tobacco* eased to 2.7% y/y in November, after moving up from 2.3% in July and August to 2.9% in October. The rate for *non-energy industrial goods* accelerated to 0.6% y/y, up from 0.5% in October and 0.4% in both August and September; it was at 1.1% in March. Among the four *largest Eurozone countries*, the yearly CPI rate in Spain (2.4% from 1.8%) showed the biggest spread from month to month followed by Italy (1.5 from 1.0), with France (1.7 from 1.6) showing a slight uptick, while Germany's rate was unchanged at 2.4%.

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