January 27, 2025

Morning Briefing

Anatomy Of The Bull Market (Will DeepSeek Sink It?)

Check out the accompanying chart collection.

Executive Summary: The current bull market has been driven mostly by valuation expansion; now valuation is historically high. We expect earnings growth to perpetuate the bull market this year; any more valuation expansion could leave the market vulnerable to a meltdown. Our year-end target for the S&P 500 is 7000, based on a solid rise in earnings with no further valuation expansion. … Much of our optimism rests on the Magnificent-7 remaining magnificent. If they don't disappoint investors, the S&P 500 likely won't either given their hefty collective share of the index's market capitalization. … However, a competitive threat to their magnificence has emerged from China: DeepSeek, with reportedly cheaper AI. Could DeepSeek deep-six the Mag-7? ... Also: Dr Ed reviews "American Primeval" (++).

YRI Weekly Webcast. Join our live webcast with Q&A on Mondays at 11 a.m., EST, with Ed and Eric. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

Strategy I: Earnings-Led Bull Market in 2025. The current bull market in stocks started on October 12, 2022. Since then, the S&P 500 soared 71.1% from a low of 3577.03 to a record high of 6118.71 on Thursday of last week. Over this period, the forward P/E of the S&P 500 stocks as a group rose 46.7% from 15.2 to 22.3, while S&P 500 forward earnings rose 17.1%. So the bull market has been significantly driven by the rising valuation multiple. (FYI: Forward earnings is the time-weighted average of analysts' consensus operating earnings-per-share estimates for the current year and the following one; the forward P/E is the multiple based on forward earnings.)

Last year was a more balanced one for the stock market; the forward P/E rose 9.8%, while forward earnings rose 12.3% (*Fig. 1* and *Fig. 2*). This year, Eric, Joe, and I expect that most of the bull market's heavy lifting will be attributable to earnings growth. That's because the valuation multiple is historically high. It will be in meltup territory if it goes much higher, making the market vulnerable to a meltdown.

To be more specific, we project that the S&P 500 will increase 19.0% this year to 7000. We estimate that S&P 500 earnings will rise 15.6% this year to $285 per share (*Fig. 3*). Of course, at the end of this year, the stock market will be discounting 2026 earnings per share, which we project will be $320 (*Fig. 4*). Our 7000 target implies that the forward P/E will be 21.9 at the end of this year, unchanged from its current value.

The latest Bloomberg poll of 22 of the Street's investment strategists shows an average S&P 500 target of 6600 by year-end with average earnings per share at $266 for the year. The highest estimate for the S&P 500 is 7100 and the lowest is 5500. The highest and lowest earnings estimates are $282 and $227.

Here are some related matters:

(1) *Revenues growing solidly.* Our earnings-per-share projection is based on S&P 500 revenue gains of 4.0% this year. That's consistent with the historical average since 1995 of 4.3% (*Fig. 5*). The pushback we get is that even if the US economy continues to grow solidly, the rest of the world's economies are likely to be weak, as recently projected by the International Monetary Fund (see our January 22 *Morning Briefing*). Then again, the historical average growth rate of revenues includes three US recessions. Almost no one is expecting a recession in 2025.

Meanwhile, forward revenues per share rose to a record high during the January 16 week, with a solid growth trend despite the current weakness in the world economy outside the US (*Fig. 6*). This series is a great weekly coincident indicator of actual S&P 500 revenues per share.

(2) *Profit margin in record-high territory.* We are estimating that the S&P 500 profit margin rose to 12.5% in 2024, up from 11.9% in 2023 and below the record high of 13.3% during 2021. We are projecting that the profit margin will rise to a record high of 13.9% this year and 14.9% in 2026 (*Fig. 7*). That's consistent with our productivity-led Roaring 2020s scenario. We are encouraged to see that the S&P 500 forward profit margin rose to a record high of 13.7% during the January 23 week (*Fig. 8*).

We are also expecting that Trump 2.0 will include a cut in the corporate tax rate from 21% to 15% later this year. What about the rise in interest rates? Corporations refinanced much of their long-term debt at record lows during the pandemic. Indeed, the net interest paid by nonfinancial corporations as a percentage of their after-tax profits fell to 7.6% during Q3-2024, the lowest since Q4-1955 (*Fig. 9*). This series might start rising in 2025, but not enough to offset the positive impact on the profit margin of higher productivity growth and a lower tax rate, in our opinion.

(3) *Coincident economic index bullish for earnings*. As noted above, given the economic weakness overseas, we are encouraged to see that S&P 500 forward earnings is on a solid uptrend and at a record high. It continues to track the US Index of Coincident Economic Indicators (*Fig. 10*).

It is interesting to see the recent divergence between the forward earnings of the S&P 500 and that of the S&P 500 Air Freight & Logistics industry (*Fig. 11*). The latter series reflects global economic activity, and it has been falling since early 2022 when the Fed started to tighten monetary policy, Russia launched its invasion of Ukraine (which depressed Europe's economy), and China's property market imploded. Yet by early September 2023, the S&P 500 forward earnings was rising to new record highs!

Strategy II: Concentration Update. We are assuming that the forward P/E of the S&P 500 will remain between 21.0 and 22.0 this year, and probably next year too. That's because we believe that the Magnificent-7 stocks will remain magnificent, maintaining a collective forward P/E around 30.0, while the rest of the stocks in the index, the "S&P 493," continue to trade collectively around a 20.0 multiple—in other words, the levels they trade at now (*Fig. 12*).

The S&P 500 is likely to remain concentrated. The S&P 500 Information Technology and Communication Services sectors currently account for a record 41.4% of the market capitalization of the S&P 500 (*Fig. 13*). They also account for a record 35.1% of the forward earnings of the S&P 500.

The current market cap of both these sectors together is $21.2 trillion. They include five of the Magnificent-7 stocks, all but Amazon and Tesla, which are included in the S&P 500 Consumer Discretionary sector. However, the collective market capitalization of the Magnificent-7 is currently $18.0 trillion (*Fig. 14*).

Strategy III: What Could Possibly Go Wrong? Might DeepSeek deep-six the Magnificent-7? In last Thursday's *Morning Briefing*, Jackie wrote about China's AI ambitions and observed the following: "The latest startup capturing headlines is DeepSeek. The company shocked the tech industry when it reportedly spent only $5.6 million over two months to develop its latest LLM, which outperformed rival US LLMs from Meta and ChatGPT, a January 21 *SCMP* *article* reported. The company kept costs down by using less powerful

Nvidia H800 chips. DeepSeek was spun out of High-Flyer Quant, a Chinese quantitative hedge fund. High-Flyer was developing AI to help it research stocks, and both firms are headed by Liang Wenfeng."

Jackie scooped CNBC, which posted an *article* on Friday morning titled "How China's new AI model DeepSeek is threatening U.S. dominance." The key conclusion for stock investors was the first paragraph: "A little-known AI lab out of China has ignited panic throughout Silicon Valley after releasing AI models that can outperform America's best despite being built more cheaply and with less-powerful chips."

Not much is known about DeepSeek. It's a Chinese company with a *website* that claims: "DeepSeek-V3 achieves a significant breakthrough in inference speed over previous models. It tops the leaderboard among open-source models and rivals the most advanced closed-source models globally." The company's *technical report* about this LLM is also available online.

One *skeptic on LinkedIn* views this development as a plot by the Chinese Communist Party to undermine American AI innovation. He observes that the reported costs to train the LLM are suspiciously low. The fact that it is available on an open-source basis suggests that the Chinese aim to be the low-cost producers of AI, reducing the competitiveness of US developed private AI systems.

Jackie also scooped *The Wall Street Journal,* which posted an excellent *article* on this subject at 12:00 a.m. Sunday morning titled "Silicon Valley Is Raving About a Made-in-China AI Model DeepSeek." Marc Andreessen, the Silicon Valley venture capitalist who has been advising President Trump, in an *X post* on Friday raved: "Deepseek R1 is one of the most amazing and impressive breakthroughs I've ever seen—and as open source, a profound gift to the world."

In our Sunday morning QuickTakes, we concluded the following about the impact of DeepSeek on the Mag-7:

(1) "This might be bad news for the Mag-7 that have plans to dominate the AI market with their (expensive) AI services. On the other hand, it might mean that AI systems will be more accessible and cheaper. If so, the best way to play AI might be the S&P 493 companies that will be cutting their costs and boosting their productivity using this new technology."

(2) "It might be good news for the Mag-7 that can learn from DeepSeek to design AI

systems with cheaper GPUs. That would reduce their capital spending and boost their profits. It might not be a happy development for Nvidia."

We are even more confident in our technology-driven, productivity-led Roaring 2020s scenario and are sticking with our S&P 500 targets of 7000 for 2025, 8000, for 2026 and 10,000 for 2029.

Strategy IV: Will 2024 Laggards Be the Leaders in 2025? If it turns out that AI systems can be developed at a much lower cost than suggested by the enormous AI-related capital spending by American AI companies, and especially the Magnificent-7, then these stocks would be vulnerable to a selloff, which would depress the stock market given their weight in the S&P 500. However, such a selloff would be a good opportunity to jump into both the S&P 007 and the S&P 493, which would benefit from the availability of more affordable AI technologies. The S&P 493 have lagged the performance of the Magnificent-7.

We are assuming that US AI companies will achieve what DeepSeek has done as soon as possible; they'll likely be scrambling to do so. Right now, Elon Musk is busy undercutting Stargate. It is an AI infrastructure joint venture among SoftBank, OpenAI, and Oracle that Trump announced last week on January 21. Their respective companies will invest $100 billion in total for the project to start, with plans to pour up to $500 billion into it in the coming years. Musk questioned whether the venture has the money to back up their ambitions. On Thursday, Trump shrugged off the controversy, saying that Musk "hates one of the people in the deal," namely Sam Altman of OpenAI.

Perhaps DeepSeek's accomplishment means that AI systems can be designed much more cheaply than envisioned by Stargate. That would be a positive for everyone.

Movie. "American Primeval" (2025, ++) is a Netflix series that has been condemned by the LDS Church because it depicts Brigham Young, the founder of the Utah-based Mormon faith, as an unscrupulous and violent fanatic. The series certainly isn't a docudrama. Instead, it is a reminder of the violence of the Wild West with massacres aplenty, especially by the pioneers against Native American Indians. No one is disputing that aspect of the series. The series is beautifully filmed, constantly reminding us of the harmony and peacefulness of nature that was so often disturbed by all the violence of the Wild West. (See our movie reviews *archive*.)

Calendars

US: Mon: New Home Sales 670k; Dallas Fed Manufacturing Index; Chicago Fed National Activity Index. **Tues:** Consumer Confidence Index 106.0; Richmond Fed Manufacturing Index -8; Durable Goods Orders Total, Ex Defense 0.8%/0.4%; S&P Shiller Home Price Index 0.2%m/m/4.1%y/y. (FXStreet estimates)

Global: Mon: Germany Ifo Business Climate Index Headline, Current Assessment, and Expectations 84.6/85.4/84.0; Japan Leading Indicators 107.0; China NBS M-PMI 50.1; Lagarde. **Tues:** France Consumer Confidence 90; Spain Unemployment Rate 11.1%; Australia CPI 0.3%m/m/2.5%y/y; Cipollone Speech; Lagarde. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index rose 1.8% w/w, but underperformed the 2.7% gain for the AC World ex-US index. The US MSCI closed 0.3% below Thursday's new record high, its first since December 6. The AC World ex-US improved to 6.4% below its June 15, 2021 record high, but it was only 0.7% below at the end of September. EM Latin America was the best performing region last week, with a gain of 3.6%, followed by EMU (3.4%), Europe (3.3), EAFE (3.2), and the AC World ex-US. EM Asia was the worst regional performer, albeit with a gain of 1.7%, followed by EMEA (1.7) and EM (1.9). The Mexico MSCI index performed the best last week, with a gain of 5.1%, followed by France (4.9), Sweden (4.4), Germany (4.3), and Switzerland (3.4). India was the worst performer, falling 0.9%, followed by Hong Kong (0.6), South Africa (1.5), Taiwan (2.1), and Canada (2.1). The US MSCI index is up 3.9% ytd but lost most of its lead last week against the AC World ex-US (3.4). EMU and EM Latin America are ahead of the pack as the leading regions ytd, with gains of 7.4%, followed by Europe (6.2), EAFE (4.4), EMEA (4.1), and the AC World ex-US. The worst performing regions so far in 2024: EM Asia (0.4) and EM (1.4). Looking at the major selected country markets that we follow, Sweden is the best ytd performer with a gain of 9.7%, followed by Korea (8.9), France (8.9), Germany (8.8), and Brazil (8.0). The worst performing countries ytd: India (-4.5), Hong Kong (-2.3), China (-0.5), and Japan (-0.1).

US Stock Indexes (*link*): All 48 of the major US stock indexes that we follow rose for a second straight week. The Russell MidCap Growth index was the best performer, with a gain of 2.5%, ahead of S&P 500 LargeCap Growth (2.4%), S&P 500 Transportation (2.3), and the 2.2% gains for the Russell 1000 Growth, Russell 3000 Growth, and Dow Jones 30 Industrials indexes. The Dow Jones 15 Utilities index, with a hair of a gain, was the worst performer, followed by Russell MidCap Value (0.7), Russell 2000 Value (0.8), S&P 400 MidCap Value (0.8), and S&P 400 MidCap Pure Value (0.8). All 48 of the indexes are still positive so far in 2025, up from just four indexes positive three weeks earlier and 46 rising in 2024. The S&P 500 LargeCap Pure Growth index is in the top spot as the best performer so far in 2025, with a gain of 7.4%, ahead of S&P 500 Transportation (6.8), Russell MidCap Growth (6.4), S&P 400 MidCap Pure Growth (5.7), and S&P 400 MidCap Growth (5.5). The worst performing major US stock indexes ytd: S&P 600 SmallCap Pure Value (2.5), Russell 1000 Growth (2.6), Russell 3000 Growth (2.7), S&P 500 LargeCap Value (2.7), and Russell 2000 Value (2.7).

S&P 500 Sectors Performance (*link*): Ten of the 11 S&P 500 sectors rose last week, and four were ahead of the S&P 500's 1.7% gain. That compares to all 11 S&P 500 sectors rising a week earlier, when seven were ahead of the S&P 500's 2.9% gain. The outperformers last week: Communication Services (4.0%), Health Care (2.9), Industrials (2.4), and Information Technology (1.9). The underperformers last week: Energy (-2.9), Materials (0.7), Consumer Discretionary (0.8), Utilities (0.9), Consumer Staples (1.0), Real Estate (1.2), and Financials (1.2). The S&P 500 is up 3.7% ytd, with 10 sectors in positive territory and seven sectors ahead of the index. Industrials wears the crown as the best ytd performer, with a gain of 7.0%, ahead of Communication Services (6.1), Energy (6.0), Materials (5.8), Financials (5.1), Utilities (5.0), and Health Care (4.8). These sectors are lagging the S&P 500 so far in 2025: Consumer Staples (less than -0.1%), Information Technology (1.7), Real Estate (2.1), and Consumer Discretionary (3.5).

US Economic Indicators

Consumer Sentiment Index (*link*): Consumer sentiment weakened for the first time in six months in January, on concerns about the labor market and higher prices for goods. The *consumer sentiment index* dropped to 71.1 in January after climbing from 66.4 in July to an eight-month high of 74.0 in December. It was below the mid-January reading of 73.2. The *current conditions* gauge declined to 74.0 this month after increasing from 61.3 in August to an eight-month high of 75.1 in December, while the *expectations* component fell to a six-month low of 69.3. Despite reporting stronger incomes this month, the report notes that unemployment concerns rose—with about 47% of consumers expecting unemployment to rise in the year ahead, the highest percentage since the pandemic. *Turning to inflation*, *year-ahead* inflation expectations soared from 2.8% in December to 3.3% in January—the highest since May 2024 and above the 2.3%-3.0% range recorded during two years prior to the pandemic. *Long-run* inflation expectations climbed from 3.0% in December to 3.2% in January, matching November's percentage. The report notes that for both the short and long run, inflation expectations rose across income and educational groups—with consumers expressing buy-in-advance attitudes to avoid future price increases.

Existing Home Sales (*link*): "Home sales in the final months of the year showed a solid recovery despite elevated mortgage rates," according to Lawrence Yun, chief economist of NAR. *Existing home sales* advanced 2.2% during December to 4.24mu (saar), the strongest pace since February 2024's 4.38mu. Sales were up 9.3% y/y, the strongest performance since June 2021's 23.0%. Despite 2024's strong finish, existing home sales averaged 4.06mu (saar) during Q4—the lowest level in nearly 30 years. Single-family sales advanced 1.9% to 3.83mu (saar) in December and were 10.1% higher than a year ago, while existing condominium and co-op sales rose 5.1% to 410,000 units—2.5% above year-ago levels. *Regionally*, existing home sales, both on a monthly and yearly basis, rose in three of the four regions, with the Northeast posting the largest monthly gain and West the largest yearly gain: Northeast (3.9% m/m & 10.4y/y), South (3.2 & 9.0), West (2.6 & 12.9), and Midwest (-1.0 & 6.5). Total housing inventory at the end of the year was 1.15mu, down 13.5% from November but 16.2% above year-ago levels. At the current sales pace, unsold inventory sits at a 3.3-month supply, down from 3.8 months in November but up from 3.1 months during the final month of 2023. *Looking at prices*, the median home price for all housing types was $404,000—6.0% above a year ago—with all four regions posting price gains. Lawrence Yun notes, "The median home price was elevated partly due to the upper-end market's relative better performance. Sales rose by 35% from a year ago for homes prices above $1 million, while sales fell for homes priced under $250,000."

Global Economic Indicators

US PMI Flash Estimates (*link*): "Output growth slows in January and price pressures rise, but employment jumps higher on sustained optimism," was the headline of the January report. *Business activity* in the US slowed from December's 32-month high, with the *C-PMI* (to 52.4 from 55.4) for January easing to a nine-month low, led by the service sector. *January's NM-PMI* (52.8 from 56.8) relaxed to a nine-month low, while the manufacturing sector showed a return to growth for the first time in six months. Both January's M-PMI (50.1 from 49.4) and *M-PMI Output* (50.2 from 47.7) measures moved out of contractionary territory, with the former at a seven-month high and the latter at a six-month high. The report notes that firms' expectations of output in the coming year is running at a level not surpassed since spring 2022, boosted by optimism about the new government policies, which has encouraged companies to hire staff at the steepest rate in 2½ years. *Turning to prices*, inflationary pressures heightened to a four-month high, with both input costs and selling prices accelerating in both the manufacturing and service sectors. *Looking ahead*, optimism for the coming years continued to run at an elevated level, with manufacturing confidence the highest since March 2022 and service confidence posting its second-highest reading over the past year.

Eurozone PMI Flash Estimates (*link*): “The opening month of 2025 saw a renewed rise in private sector business activity in the Eurozone,” according to the report. The *Eurozone’s C-PMI* (to 50.2 from 49.6) climbed to a five-month high, with the *NM-PMI* (51.4 from 51.6) holding steady just above 50.0 during the month, while the manufacturing sector's *M-PMI* (46.1 from 45.1) and *M-PMI Output* (46.8 from 44.3) continued to contract, though at a slower pace. The two largest Eurozone economies show business activity in Germany was broadly stable in January, while activity in France contracted at the softest pace in four months. *Germany's C-PMI* (to 50.1 from 48.0) climbed to a seven-month high, with the *NM-PMI* (52.5 from 51.2) expanding at its fastest pace in six months, while both the *M-PMI* (44.1 from 42.5) and *M-PMI* Output (45.2 from 41.7) measures contracted at the slowest pace in eight months. Meanwhile, the flash estimate shows business activity in France contracting by the softest pace in four months. *France's C-PMI* (to 48.3 from 47.5) contracted, with both the M-PMI (45.0 from 39.2) and M-PMI Output (45.3 from 41.9) measures contracting at the slowest pace in seven months. *Growth in the rest of the region* continued to outperform the largest two economies, seeing a further modest expansion in output for the thirteenth month in a row, though it did slow in January. *Turning to pricing*, *input* prices in the overall Eurozone accelerated for the fourth successive month in January, posting the steepest increase since April 2023 and above the series average. *Manufacturing input* costs rose for the first time in five months, though rate was more pronounced in the service sector—which reached a nine-month high. Output prices accelerated at the fastest pace in five months, with Germany posting the largest gain, while selling prices in France fell for the first time in nearly four years.

Japan PMI Flash Estimates (*link*): This year began with continued expansion of Japan's private sector for a third consecutive month and with the rate of growth strengthening to a four-month high. The *C-PMI* (to 51.1 from 50.5) flash estimate rose further above the breakeven point of 50.0, though the headline number masks the diverging trends between the service and manufacturing sectors. January's *NM-PMI* (52.7 from 50.9) saw the service sector record its best performance in four months, while the *M-PMI* (48.0 from 49.4) revealed the manufacturing sector recorded its weakest performance in 10 months.

Meanwhile, the report shows sentiment levels remained elevated, though the overall rate of degree of confidence eased to its lowest level since October. Still, private-sector firms recorded the strongest rate of job creation for six months—with both the service and manufacturing sectors recording upticks in workforce numbers. *Turning to prices*, the report notes composite *input prices* accelerated in January, led by the service sector, while the manufacturing sector recorded weaker pricing. Meanwhile, *output prices* in the manufacturing sector showed no change, while the service sector showed stronger inflation.

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