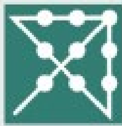

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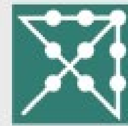

February 5, 2025

Morning Briefing

Investing Outside The Mag-7

Check out the accompanying chart collection.

Executive Summary: We continue to recommend overweighting the US stock market in global portfolios. While valuations might be lower in foreign markets, Eric explains, we don't see enough economic justification to abandon our Stay Home stance for a Go Global one. Within the US stock market, we like large caps, particularly S&P 493 companies, which should expand profit margins as they adopt productivity-boosting technologies. If volatile macro news provides opportunities to buy underappreciated Value stocks on dips, be sure those dips aren't traps. … Also: Joe reports that among Q4 reporters to date, Financials sector firms have outperformed on several metrics. He also updates us on analysts' estimate revisions trends.

Strategy I: Digging for Value in US Stocks. Our equity market preferences have been heavily biased toward US large-capitalization stocks for the past few years and remain so. We've preferred the Stay Home investment style—i.e., overweighting US stocks in global portfolios—over Go Global, which we've recommended underweighting since at least 2010. While ex-US developed market indexes look cheap on a relative valuation basis and may even have spurts of outperformance relative to US stocks, that's been the case since roughly 2009. At the moment, we see don't see enough fundamental economic reasons to inspire us to go neutral on the US and upgrade foreign markets.

Within the US, we still like the LargeCaps, but have grown increasingly interested in the S&P 493. We think there's room for the ex-Mag-7's collective profit margin to expand as productivity increases and the high-tech solutions (i.e., artificial intelligence, automation, etc.) utilized and churned out by the Mag-7 firms are implemented (*Fig. 1*). To be clear, we do not believe the Mag-7 are grossly overvalued—in fact, we think their current collective forward P/E of 29.4 is supported by strong profit margins and earnings growth expectations. However, we see room for the S&P 493 to outperform as its collective multiple expands above 20 times forward earnings (*Fig. 2*).

That's not to say that we have S&P 500 blinders on. In fact, we believe that the US MidCaps (represented by the S&P 400) present an interesting opportunity, especially for

investors who share our optimistic outlook for the US economy and markets. We'll also touch on the possible opportunity in Value stocks.

Here's more on how we're thinking about US equities:

(1) *A smidge of SMids.* For much of the Federal Reserve's latest tightening cycle, it's been an S&P 500 story with seven main characters. Indeed, it's been tough sledding for SMidCaps as far back as Trump 1.0. The S&P 400 and 600 have both been trounced by the S&P 500 (*Fig. 3*). Part of that story is that SMidCaps tend to have more leverage and less resilient cash flows, so two Fed hiking cycles and a pandemic took their toll.

It's also a Growth versus Value story, as SMidCaps tend to trade at cheaper valuations given their sector composition (lighter on the new economy tech-y industries, heavier on the old economy sectors like Industrials), greater earnings uncertainty, and survivorship bias. Both the SmallCaps and MidCaps are trading around 16 times forward earnings versus the S&P 500's 21.8 (*Fig. 4*). The best performing smaller stocks have often been Growth names that either grew into the S&P 500 or were picked off in a buyout by an S&P 500 company. So perhaps SMidCaps are just a big Value trap that should be avoided at all costs? We think that applies broadly to SmallCaps, but not so much for MidCaps.

(2) *Not-so-mid Mids*. The S&P 400's forward earnings per share (EPS) is just a touch away from notching a new record high for the first time in 33 months (*Fig. 5*). The S&P 600's forward EPS has plateaued at 11% below its 2022 record high and shows few signs of acceleration.

Analysts expect MidCaps' earnings growth to be strong this year (13.7%) and next (16.5%) after a 1.5% dip last year (*Fig. 6*). We believe last year's poor earnings have rendered MidCaps unappreciated by the broader investor community.

(3) *Buy the dip?* We're still in buy-the-dip mode for the US LargeCaps on the basis of volatile macro news but solid fundamentals. (The same goes for Super Bowl hors d'oeuvres, especially since the tariffs on Mexican goods won't be taking effect.) But beware of apparent dips that are actually traps. US Value stocks might be a case in point.

Part of the S&P 493 is indeed Value stocks. Within this cohort, we broadly favor cyclical sectors such as Financials, Industrials, Consumer Discretionary, Information Technology, and Communication Services (in no particular order). We would also avoid overly cheap plays (*Fig. 7*).

It can be tempting to dip into names trading cheaply relative to fundamentals when Growth has done so well for so long and the spread in valuations is so wide (*Fig. 8* and *Fig. 9*). Active portfolio managers can certainly find good buys in this pile, and we would suggest identifying companies that have the highest opportunity to replace labor costs with automation and/or higher productivity and thus to expand profit margins. But from a factor perspective, we'd hesitate to rotate into broad-based Value.

To those managing global portfolios, we understand that the MSCI World ex-US is trading below 14 times forward earnings (*Fig. 10*). And plenty of Value stocks in the Eurozone trade below 10 times forward earnings. Combing through underappreciated stocks may produce strong returns; cigarette butts are often still smokable. But we do not see the caliber of fundamentals to suggest longer-term outperformance.

Strategy II: Financials Shine Among Q4 Reporters to Date. Through midday Tuesday, just over 41% of the S&P 500's companies have reported fiscal Q4 earnings. Among the 211 companies that have reported so far, the aggregate revenue and earnings beats relative to analysts' consensus estimates are 1.3% and 6.6%, respectively (*Fig. 11* and *Fig. 12*).

We have more Q4 data in hand for some of the S&P 500 sectors than others at this point. Two-thirds of the companies in the S&P 500 Financials sector have already closed their books on Q4, for example, but less than 10% of firms in the Utilities sector have done the same. However, enough data has been reported to begin seeing takeaways about the quarter for the S&P 500, a few sectors, and the Magnificent-7.

The results to date combined with the Trump 2.0 policy agenda particulars suggest a higher growth path ahead for the Financials sector. Below, Joe compares the sector's Q4 results with those of the S&P 500 companies and the four Magnificent-7 companies that have reported so far.

(1) *A breakout quarter for Financials?* The firms in the S&P Financials sector collectively overshot analysts' consensus earnings estimate by 12.1%--the sector's biggest earnings beat since Q3-2021—outperforming the S&P 500's Q4 earnings beat reported to date (*Fig. 13* and *Fig. 14*). Financials, primarily viewed as a Value sector, bested its consensus revenue estimate by 2.0%, also ahead of the S&P 500.

In another solid performance for the sector, a record-high 89.8% of the firms recorded higher Q4 revenues than in the year-earlier quarter (*Fig. 15*). Looking at the bottom line, Q4

earnings rose y/y for 85.7% of the sector (*Fig. 16*). That's the highest percentage of companies with earnings growth since Q2-2021 and ranks among the best readings in the 60-plus quarters since the Great Financial Crisis.

(2) *Financials' strength casts shadow over early Mag-7 results*. Four of the Magnificent-7 companies have reported Q4 already. Tesla undershot estimates on both the top and bottom lines, but it did manage to eke out single-digit y/y percent gains in those measures (notwithstanding all the Tesla Cybertrucks on the road). Tesla's weakness dragged down the Mag-7's aggregate surprise and y/y growth numbers, causing the group to be a negative contributor to the overall S&P 500's revenue and earnings surprise metrics among reporters so far. However, the Mag-7 remains a net positive contributor to the S&P 500's y/y growth rates in revenues and earnings.

The S&P 500's revenue surprise of 1.3% improves to 1.4% when the Magnificent-7's revenue surprise of just 0.3% is excluded. Likewise, the S&P 500's earnings surprise improves to 6.9% from 6.6% when the Mag-7's 5.7% surprise is excluded. Looking at their y/y growth rates, S&P 500 revenues growth drops to 3.0% from 3.6% when the Magnificent-7 (8.6%) is excluded. Earnings growth drops to 11.1% from 1.5% with the Magnificent-7 (16.9%).

(3) *New era ahead for Financials and US?* We think the Financials sector's strong performance in Q4 is a sign of better times ahead. Trump 2.0 promises to be a growth catalyst for the sector as regulatory restraints are released. President Trump's *announcement* on Monday of the creation of a Sovereign Wealth Fund could be a positive for the industry too. How it will be funded remains to be seen, though initial indications suggest a plan to monetize the asset side of the US balance sheet. As government agencies and offices are closed for good, there will be physical assets left over to deal with.

This reminds us of the Resolution Trust Corporation (RTC). The RTC liquidated assets from failed financial institutions; it was a temporary government-owned agency created in 1989 by the Financial Institutions Reform, Recovery, and Enforcement Act (a.k.a. FIRREA) and operated until 1995.

Strategy III: S&P 500 January Revisions Activity Stable, But Few Leaders. Early this week, LSEG released its January snapshot of the monthly consensus earnings estimate revision activity over the past month. While the company provides raw data for all its polled measures, we focus primarily on the revenues and earnings forecasts, captured in our *S&P 500 NRRI & NERI* report. There, the analysts' estimate revisions activity is indexed by the

number of upward revisions in forward earnings less the number of downward ones, expressed as a percentage of total forward earnings estimates. We look at this activity over the past three months because that timespan encompasses an entire quarterly reporting cycle. Since analysts' tendency to revise their estimates differs at different points in the cycle, three-month data are less volatile—and misleading—than a weekly or monthly series would be.

Joe highlights what's most notable about the January crop of earnings revisions data below:

(1) *S&P 500 NERI negative for a fifth month.* The S&P 500's NERI index, which measures the revisions activity for earnings forecasts, was negative for a fifth straight month, but ticked up to -1.8% from an 11-month low of -1.9% in December (*Fig. 17*). A zero reading indicates that an equal number of estimates were raised as were lowered over the past three months. January's -1.8% is an improvement from its year-earlier reading of -3.8% and is nearly spot on with the average reading of -1.9% seen since March 1985 when the data were first calculated.

(2) *More sectors have positive NERI than a year earlier.* Three S&P 500 sectors had positive NERI in January, down from four sectors in December. But that's up from just one sector with positive NERI a year earlier in January 2024, when Energy made a brief appearance above ground level.

Financials' latest readings were best in class among the S&P 500's 11 sectors (*Fig. 18*). This sector's NERI was positive for a 12th straight month and at a 35-month high of 7.9%. Among the poorer performing sectors, Industrials' NERI dropped to a 24-month low, followed by the NERIs of Materials (at a 22-month low) and Health Care and Information Technology (both 12-month lows). Tech's NERI turned slightly negative for the first time in 13 months.

Here's how the NERIs ranked for the 11 sectors in January: Financials (8.0%, 35-month high), Communication Services (6.3), Utilities (0.6), Information Technology (-0.2), Real Estate (-1.5), S&P 500 (-1.8), Consumer Discretionary (-2.6), Industrials (-4.2, 12-month low), Health Care (-4.6), Consumer Staples (-8.8), Energy (-9.5), and Materials (-11.1).

Calendars

US: Wed: ADP Employment Change 150k; MBA Mortgage Applications; Goods Trade

Balance -$96.5b; Jefferson. **Thurs:** Nonfarm Productivity & Unit Labor Costs 1.7%, 3.4%; Initial Claims 215k. (FXStreet estimates)

Global: **Wed:** Eurozone Industrial Production 0.1%; Eurozone PPI 0.4%m/m, -09.1%y/y; Eurozone, Germany & France C-PMIs 50.2, 50.1, 48.3; Eurozone, Germany & France NM-PMIs 51.4, 52.5, 48.9; UK C-PMI & NM-PMI 50.9, 51.2; Japan NM-PMI 52.7; China NM-PMI 52.3. **Thurs:** Eurozone Retail Sales 0.0%m/m, 2.0%y/y; Germany Factory Orders 1.6%; UK Interest Rate Decision 4.50%. (FXStreet estimates)

US Economic Indicators

JOLTS (*link*): Job openings in December fell to lowest level since September. December *job openings* sank 556,000 to 7.6 million (below the consensus estimate of 8.0 million), following November's downwardly revised 8.09 million—first reported at 8.15 million. *Prior to the pandemic* in early 2020, the highest level of job openings recorded was 7.6 million, which matches the current level of job openings. Openings reached 10.0 million in June 2021 for the first time in the history of the series going back to 2000. Job openings have been on a steady downtrend since March 2022's 12.2 million peak. There were 6.9 million people unemployed in December, so there were 1.1 available jobs for each unemployed person for the sixth successive month. This ratio was at a recent high of 2.0 during March 2022. *By industry*, the biggest losses in job openings in December were led by professional & business services (-225,000), health care & social assistance (-180,000), finance & insurance (-136,000), and construction (-55,000), while the biggest gains occurred in leisure & hospitality (67,000), and trade, transportation, and utilities (58,000). *Separations* include quits, which are generally voluntary separations initiated by employees—serving as a measure of workers' willingness or ability to leave jobs. *Total quits* have been on a downtrend since peaking at 4.5 million during April 2022, though have been hovering around 3.0 million the past few months.

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