Yardeni Research

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# Morning Briefing

## Lowering Our S&P 500 Targets

*Check out the accompanying chart collection.*

**Executive Summary:** It has dawned on Wall Street (and us!) that President Trump's tariffs aren't negotiating chips to help the US lower tariffs around the world, promoting free trade. They're trade barriers, triggering other countries to respond in kind, and they jeopardize US inflation and economic growth. We expect Mr. Trump to relent lest he cause a recession that reverses the GOP majority in Congress during the 2026 mid-term elections. But in response to the now heightened risk of stagflation, we are lowering our S&P 500 valuation expectations and year-end price targets. … Also: Eric discusses the potential for Fed rate cuts this year based on the latest inflation data.

**Strategy I: Where Do We Go from Here?** John Maynard Keynes is credited with saying, "When the facts change, I change my mind. What do you do, sir?" However, there is no definitive evidence that he actually said or wrote it.

Wall Street's forecasting community (including us) is scrambling both to assess February's weaker-than-expected batch of economic indicators for January and to reassess the likely near-term negative impact of Trump 2.0. The Citigroup Economic Surprise Index surprised most forecasters during the second half of last year with positive readings (*Fig. 1*). It has surprised them with slightly negative readings since February 20. We continue to bet on the resilience of the economy. However, we acknowledge that it is being severely stress-tested now by Trump 2.0's tariff turmoil and shotgun approach to paring the federal workforce.

Perhaps the biggest surprise is that President Donald Trump wasn't bluffing or even just exaggerating when he often said during his presidential campaign rallies that he loves tariffs. The widespread assumption was that his constant threat to raise tariffs was mostly a negotiating tool to force America's major trading partners to lower their tariffs. However, he also often said that he viewed tariffs as a great way to raise revenues and to force US-based companies to move operations back to the United States.

President Trump talked about tariffs at the Inauguration Day parade held in the Capital One Arena in Washington, D.C. He said, "I always say tariffs are the most beautiful words to me in the dictionary." He added that "God, religion, and love are actually the first three in that order, and then it's tariffs." That sounded like Trump's typical bluster, positioning him to make deals to reduce other countries' tariffs. But, apparently, he meant it: The man loves tariffs. He has even called himself "tariff man."

On March 7, Commerce Secretary Howard Lutnick said, "We're going to make the External Revenue Service replace the Internal Revenue Service." In other words, revenues from tariffs will replace revenues from taxes on individuals and corporations. That's simply dangerous and delusional nonsense. It certainly isn't passing the sanity test in the US stock market. Consider the following:

(1) Over the past 12 months through January, federal tax receipts totaled $4.9 trillion (*Fig. 2*). That included a piddling $87 billion in customs duties (*Fig. 3*).

(2) A 20% tariff on all imports including goods and services would raise less than $1 trillion over a 12-month period (*Fig. 4*). It would take a 100% tariff to raise the $5 trillion necessary to shut down the IRS and replace it with the ERS. The tariff would have to be even higher if it is imposed on only on imports of goods, which totaled $3.3 trillion over the past 12 months through January—and that includes January's huge jump inflated by importers' front-running tariffs, especially of gold bars (*Fig. 5*).

(3) And that would still not balance the federal budget. To do that, customs duties would have to be much higher to match federal outlays, which were $7.1 trillion over the past 12 months.

(4) Of course, the above assumes that funding the External Revenue Service of America doesn't instigate a global trade war, which might cause a depression and a collapse of global trade, including US imports! That is probably a bad—and very dangerous—assumption, since some countries are already retaliating against Trump's tariffs. So far, that group consists of just Canada, China, and the European Union. But lots of others may join the fray on April 2, when the US is scheduled to impose reciprocal tariffs.

(5) Tariffs are taxes that are paid by consumers of those goods, importers of them, and/or exporters of the goods. Of the three, consumers are the ones most likely to pay the tax in the form of higher prices. The tax base of tariffs (i.e., imports) is much smaller than is the tax base that includes personal income and corporate profits. A consumption tax would make more sense as a revenue raiser, since consumption represents the largest tax base.

(6) Our message to the White House: Mr. Trump, don't build your tariff wall! Tear down tariff walls around the world by negotiating free-trade deals!

**Strategy II: Time To Blink?** Given all the above, it isn't surprising that many forecasters are turning more cautious on the economic outlook. Some are lowering their outlook for GDP and their year-end forecasts for the S&P 500.

We respect the economists and strategists at Goldman Sachs. That's because they have often agreed with our outlook for the economy and financial markets. They are data dependent, as we are. However, it seems to us that they tend to tweak their forecasts faster and more often in response to new data than we do because we tend to stick to our base-case scenarios longer. So their forecasts occasionally reflect the latest data points sooner than we do. We, on the other hand, tend to question data that don't support our outlook. More often than not, this approach has worked for us, as subsequent data and/or revisions in the previous data often proved to support our narrative after all. In other words, Goldman's view tends to determine the consensus outlook. We tend to stray occasionally.

Both approaches have their advantages and disadvantages. The latest batch of economic indicators released on Monday, Tuesday, and Wednesday supported our resilient economy scenario with subdued inflation. Nevertheless, we can't ignore the potential stagflationary impact of the policies that Trump 2.0 is currently implementing haphazardly. Consider the following:

(1) The labor market indicators in Tuesday's NFIB survey of small business owners during February and January's JOLTS report provided solid readings on the labor market. Job openings remained relatively ample (*Fig. 6*). There were even 662,000 job openings in retail trade during January, which should offset some of the concern about the spike of 39,000 announced layoffs in the industry during February (*Fig. 7* and *Fig. 8*).

(2) Monday's report on consumers' inflationary expectations over the next 12 months released by the Federal Reserve Bank of New York showed a much more subdued response to tariffs during February than did the Consumer Sentiment Index survey (*Fig. 9*). The former reported the one-year ahead expected inflation rate at 3.1%, while the latter jumped to 4.3% (*Fig. 10*). February's CPI inflation rate reported on Wednesday was a bit cooler than expected.

The above are certainly not stagflationary readings.

Yet Goldman's economists cut their real GDP growth projection for 2025 from 2.4% to 1.7% in response to Trump's tariffs. That was on Tuesday. On Wednesday, Goldman's strategists lowered their year-end S&P 500 target from 6500 to 6200.

Today, we are blinking on the valuation multiple of the S&P 500. But for now, we are sticking with our strong estimates for S&P 500 companies' aggregate earnings per share of $285 this year and $320 next year. We are still targeting forward earnings per share—i.e., the average of analysts' consensus estimates for this year and next, time-weighted to represent the coming 12 months—of $320 at the end of this year and $360 at year-end 2026 (*Fig. 11*).

On the other hand, under the circumstances discussed above, we are lowering our forward P/E forecasts for the end of 2025 and 2026 to a range of 18-20, down from 18-22 (*Fig. 12*). That lowers our best-case S&P 500 targets for the end of this year from 7000 to 6400 and for the end of next year from 8000 to 7200 (*Fig. 13*). The worst-case scenarios using the same forward earnings and the same 18 forward P/E assumptions would be 5800 and 6500 for this year and next year.

That's if President Trump relents, as we expect he will to avoid a recession that would cost the Republicans their majorities in both houses of Congress in the mid-term elections in late 2026.

**Strategy III: Cover for Rate Cut?** The latest inflation data may provide some cover for the doves at the Federal Reserve who want to cut the federal funds rate (FFR) later this year. We remain in the none-and-done camp. We have been concerned that services inflation was getting stuck at an elevated level, so probable increases in goods inflation would boost the overall inflation rate of the Consumer Price Index (CPI). The FFR futures market, meanwhile, expects slightly more than three 25bps rate cuts over the next 12 months, ostensibly due to disinflation and/or a cooling labor market (*Fig. 14*).

The Federal Open Market Committee (FOMC) is unlikely to cut rates when it meets next week. Last Friday, Powell said, "The economy is fine. It doesn't need us to do anything, really. And so we can wait. ... We do not need to be in a hurry and are well positioned to wait for greater clarity." Still, the FOMC likely has an overall dovish bias to ease conditions at any signs of cracks in the labor market. The prior day, Fed Governor Christopher Waller said that he sees two rate cuts later in the year as his base case.

February's CPI gives Waller's view more credence. On a monthly basis, headline CPI rose

0.22%, its slowest pace since August (*Fig. 15*). The core CPI increased by 0.23%, its second slowest pace since July. That brought the y/y rates to 2.8% and 3.1%, respectively, reversing a possible reacceleration in consumer prices (*Fig. 16*). That said, if tariffs stick, the one-time price increase and uncertainty regarding its impact on inflation expectations are likely to be enough to keep the FOMC on pause.

Consider the details of the latest CPI data, and what they tell us about how inflation may unfold in the coming months:

(1) *Services*. Services inflation remains far too high above the roughly 3.0% y/y increase that is historically consistent with overall 2.0% y/y inflation. However, it is steadily dropping and may reach 3.5% by the second half of the year. In February, CPI services was 4.1%, and 3.8% excluding shelter costs (*Fig. 17*).

Airline fares fell 4.0% m/m after increasing 1.2% the prior month. That caused transportation services to rise 6.0% y/y, actually its weakest pace since early 2022 (*Fig. 18*). Weakening demand for travel may keep transportation services inflation subdued, which is important as it's been a major source of price pressure.

Removing shelter inflation, headline and core CPI rose just 2.0% and 2.2% y/y, in line with the Fed's inflation target (*Fig. 19*). Shelter's 0.3% m/m increase in February accounted for nearly half of the overall rise in headline CPI and is the primary sticking point in services inflation. Encouragingly, it rose just 3.6% on a three-month annualized basis, its slowest pace since 2021 (*Fig. 20*).

On the flip side, we expected auto insurance inflation to fall after jumping in January. Indeed, it rose just 0.3% m/m after increasing 2.0% the month before. However, it was still up 11.1% y/y (*Fig. 21*). We expect it to moderate in March.

(2) *Goods*. Tariffs are likely to make an immediate impact on goods prices, especially since they've been rising very slowly (or falling). CPI goods rose 0.6% y/y, down from 0.7% in January (*Fig. 22*). Durables continued to deflate by more than a percentage point in February, falling 1.2% y/y. Tariffs on Canada and Mexico may hit used cars the hardest—the CPI on used autos rose 0.9% m/m in February after rising 2.2% the prior month (*Fig. 23*).

The ISM manufacturing and services PMIs also suggest prices will be rising (*Fig. 24*). Potentially counterbalancing any stagflationary outcome is that we expect energy prices to remain contained. That should prevent an inflationary spiral as occurred in the 1970s (*Fig. 25*). Furthermore, Chinese producer prices fell 2.2% y/y in February, suggesting that US import price inflation will remain relatively contained once the price increases from tariffs are baked in (*Fig. 26*).

(3) *Economic policy*. A legitimate economic concern is that Trump 2.0 is enacting contractionary fiscal policy without accompanying easier monetary policy. Throw on tariffs—which in the end are a tax—and the compendium of US economic policy is a drag on growth. However, this latest CPI print may end the FOMC's pause and cause it to cut the FFR if the economic fundamentals start to deteriorate. Further progress on inflation is likely needed to assure investors that the "Fed put" is back.

The Bank of Canada cut its benchmark interest rate by 25bps today to 2.75% to counter US tariffs. Last week, the ECB cut rates to 2.5%. With the FFR still between 4.25%-4.50%, the Fed has room to cut as the gap between US policy rates and global rates widens (*Fig. 27*). In the meantime, a stronger dollar (and weaker foreign currencies) would shift some of the impact of tariffs onto exporters and away from US importers. Uncertainty with respect to all of these market dynamics remains high, especially as we await clarity on the ultimate landing point for trade policy.

## Calendars

**US: Thurs:** Headline & Core PPI 0.3%m/m, 3.3%y/y & 0.3%m/m, 3.6%y/y; Initial Claims 225k; Fed Balance Sheet. **Fri:** Baker-Hughes Rig Count. (FXStreet estimates)

**Global: Thurs:** Eurozone Industrial Production 0.6%m/m, -1.0%y/y; De Guindos; Nagel. **Fri:** Eurozone CPI 0.4%m/m, 2.3%y/y; France CPI 0.0%m/m, 0.9%y/y; Spain CPI 0.4%m/m, 3.0%y/y; Italy Industrial Output 1.2%; UK Headline & Manufacturing Industrial Production -0.1%m/m, -0.7%%y/y & 0.0%m/m, -0.4%y/y. (FXStreet estimates)

## Strategy Indicators

**S&P 500 Earnings, Revenues, Valuation & Margins** (*link*): The S&P 500's forward revenues jumped 0.5% w/w during the March 6 week to its first record high in four weeks. Forward earnings jumped 1.2% w/w, to its first record high in four weeks as well. The forward profit margin improved 0.1ppt w/w to a record high of 13.6%, its first since the January 23 week. It is now 3.3ppts above its seven-year low of 10.3% during April 2020. The consensus expectations for forward revenues growth rose 0.1ppt w/w to 5.6%, down just 0.2ppt from 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 rose 0.3ppt w/w to 12.4% from a 43-week low of 12.1%, and is now 1.9ppts below its 38-month high of 14.3% during the December 12 week and 8.8ppts 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 5.2% in 2025 (unchanged w/w) and 6.3% in 2026 (unchanged w/w), an acceleration from 2024's nearly finalized 4.9% (unchanged w/w). They expect an earnings gain of 11.6% in 2025 (unchanged w/w) and a 14.3% rise in 2025 (unchanged w/w) compared to 2024's forecasted earnings gain of 11.3% (up 0.1ppt w/w). Analysts expect the profit margin to rise 0.8ppt y/y to 13.3% in 2025 (unchanged w/w) and 1.0ppt y/y in 2026 to 14.3% (unchanged w/w), compared to 2024's forecasted 12.5% (unchanged w/w). The S&P 500's weekly reading of its forward P/E fell 0.6pt w/w to a 26-week low of 21.1, down 1.3pts from a four-year high of 22.4 during the February 20 week. It's up 1.4pts from a 14-week low of 19.7 during the August 8 week and 5.8pts 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 fell 0.07pt w/w to 2.87, down 0.16pt from a record-high 3.03 during the February 20 week. 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 March 6 week, forward revenues rose for ten of the 11 S&P 500 sectors and forward earnings rose for all 11. This led to rising forward profit margins for all 11 sectors too. These seven sectors posted record-high forward revenues this week: Communication Services, Consumer Discretionary, Financials, Health Care, Information Technology, Real Estate, and Utilities. Consumer Staples' forward revenues is just 0.1% below its February 6 record while Industrials' has improved to 2.9% below its early September record. Materials and Energy are struggling to improve, and remain the biggest laggards at 5.9% and 15.1% below, respectively. These four sectors have record-high forward earnings this week: Communication Services, Consumer Discretionary, Financials, and Information Technology.

These four sectors are less than 1.3% from their recent record highs: Consumer Staples, Health Care, Industrials, and Utilities. Real Estate is stalled 2.3% below its record high in August 2022, but Health Care has improved to just 0.1% below its February 2022 record. Among the remaining two sectors, forward earnings remains depressed for Energy and Materials, which are 33.9% and 26.4% below their respective highs during 2022. Looking at the record-high forward profit margin club, Financials' was steady w/w after entering the club during the January 16 week for the first time since August 2021. Also at a record high this week is Communication Services and Consumer Discretionary. In recent months, the Industrials, and Information Technology sectors were in that club. Among the laggards, Energy's forward margin of 9.4% is up 0.1pt from its three-year low of 9.3%; Consumer Staples' 6.8% is just 0.1pt above its seven-year low in March 2023; Health Care's 8.6% is only 0.1ppt above its record low in April; and Real Estate's 16.7% is up from a low of 12.4% in December 2020. 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 (27.2%, up 0.1ppt w/w and down from its 27.6% record high in September prior to low-margin Dell's index addition, which lowered the margin 1.3ppts then to 26.3%), Financials (20.2, up 0.2ppt w/w to a record high for an eighth week, the first since August 2021), Communication Services (18.7, up 0.1pt w/w to a record high), Real Estate (16.7, down from its 19.2 record high in 2016), Utilities (14.4, down from its 14.8 record high in April 2021), S&P 500 (13.6, up 0.1ppt w/w to a record high), Materials (10.6, up 0.1ppt w/w from a four-year low and down from a 20-month high of 11.6 in July 2023 and a 13.6 record high in June 2022), Energy (9.4, up 0.1ppt w/w from a 36-month low and down from its 12.8 record high in November 2022), Industrials (11.2, up 0.1ppt w/w and down from its 11.3 record high in early January), Consumer Discretionary (9.4, up 0.1ppt w/w to a record high), Health Care (8.6, only 0.1ppt 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 (6.8, up 0.1ppt w/w from a 19-month low and down from its 7.7 record high in June 2020).

## US Economic Indicators

**Consumer Price Index** (*link*): Both the headline and core CPI measures cooled in February. The *Headline CPI* rose 0.2% (vs 0.3% consensus estimate), slowing noticeably from January's 0.5% gain, while the *core CPI* ticked up 0.2%, half of January's 0.4% increase. The yearly inflation rates for both eased in February, with the *headline CPI* slowing from 3.0% in January to 2.8% in February, while the *core CPI* rate slowed to 3.1%—the lowest yearly rate since April 2021. The *goods inflation* (0.6% y/y) rate continues to hover around zero, with the yearly rate for durable goods at -1.2%, while the yearly rate for for nondurable goods was at 1.3%. *Services excluding energy services* continues to ease, slowing from its recent peak of 7.3% in February 2023 to 4.1% this February, though remains relatively high compared to rates a few years ago. Looking at *durable goods prices*, prices are falling for appliances (-3.1%), furniture & bedding (-2.1), new vehicles (-0.3%), while the yearly rate for used cars & trucks (0.8%) moved slightly above zero—after being in the red from September 2023 through August 2024. Here's a snapshot of yearly rates for some key *nondurable goods prices* from highest to lowest: recreational commodities (6.0%), medical care commodities (2.3), food (2.6), apparel (0.6), and housekeeping supplies (0.4). The rate for recreational commodities is down from its recent high of 11.2% last April, while energy prices fell below zero last August (-4.0), falling deeper into negative territory by September (-6.8), though moved up to 1.0% this January, before dipping back into negative territory in February (-0.2%). It posted a recent peak of 3.7% last May. The rate for medical care commodities has bounced up to 2.3% in February from its recent low of 0.4% in November. Turning to *services inflation*, *rent of shelter* remains high, though the yearly rates are easing from their recent highs in April 2023: rent of primary residence (to 4.1% from 8.8%) and owners' equivalent rent (4.4 from 8.1). Turning to *non-housing-related services*, the yearly rate for transportation service (6.0) remains high, though is down from recent highs, while the rate for recreation services (4.3) is up from September's 2.2%—which was the lowest since mid-2021. Meanwhile, the yearly rate for education & communication services has slipped below 2.0%, while the medical services (3.0) rate had been on an accelerating trend, up from its recent bottom of -2.6% in September 2023, though has stalled around 3.0%. The rate for other personal services (3.8) moved higher in February after easing to 2.3% in January—its lowest percentage since February 2021.

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