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INSIGHT

MID-YEAR EQUITIES OUTLOOK

AI Surge and Economic Headwinds: Navigating the 2024 Market Divide

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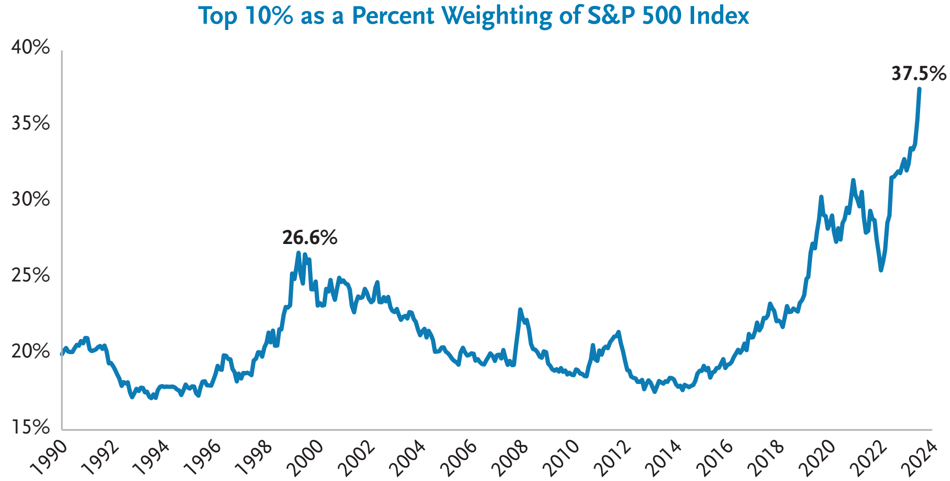
The U.S. equity market stands at a crossroads in mid-2024, with AI-driven giants having soared to unprecedented heights even as incoming macro data point to a more challenging economic backdrop down the road. This stark contrast sets the stage for a complex and potentially volatile period ahead where innovation's promises alone may struggle to power the overall stock market to repeated new highs.

The split narrative shows no signs of abating. Recently, the Standard & Poor's 500 Index notched its 33rd all-time high, extending the first half's 15% advance that added $3.3 trillion in market value. The "Magnificent 7" – market leaders driving the AI revolution – account for the lion's share. These tech giants' stellar performance underscores the market's concentration, with their underlying growth prospects validating both their remarkable stock gains and the bullish outlook on their future potential.

Yet, it's precisely this same market concentration factor that begs the question about the outlook for the broader market. The top ten stocks account for more than a third of the S&P 500's market cap – a new all-time high. Concurrently, a record low of just 25% of the constituents beat the S&P 500's overall return in the first half of the year. Also remember that while these mega-caps lead on the way up, they can also exacerbate spikes in market volatility as we've witnessed over the past week given the market rotation towards smaller capitalization names.

Top 10% as a Percent Weighting of S&P 500 Index



Source: Strategas, Bloomberg; Data as of June 13, 2024

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Mr. Reilly is the Chief Investment Officer of the Equities Group and Director of Equity Research. He joined TCW in 1992 as an Equity Analyst after working four years in corporate finance at Security Pacific Bank. In 1995, he assumed co-portfolio management responsibility for TCW's Latin America, Emerging Markets and International Equities investment strategies. Subsequently, from 2002-2005, he was Co-Portfolio Manager of the Société Générale Asset Management (SGAM) global equities team prior to assuming leadership of the Equity Research department in 2006. Mr. Reilly serves as a member of USC's Endowment Investment Advisory Board, Marshall Center for Investment Studies Board of Advisors, and the Dornsife Board of Councilors. Mr. Reilly graduated valedictorian of the University of Southern California with a BS in Finance and a BA in Spanish and also received his MBA from the University of Southern California. He was recipient of the Rotary Foundation Ambassadorial Fellowship for a year of postgraduate studies at Universidad Complutense in Madrid, Spain. He is a CFA charterholder.

Despite these disparities, there is some good news. Corporate earnings have shown impressive resilience. The S&P 500 posted nearly 10% earnings per share growth in the first quarter, with projections for over 7% in the second quarter, according to a July analysis from UBS. This means that the S&P 500 is on track for approximately 11% EPS growth for 2024, with FactSet estimating that even stripping out the Magnificent 7, the figure is still a respectable 6%.

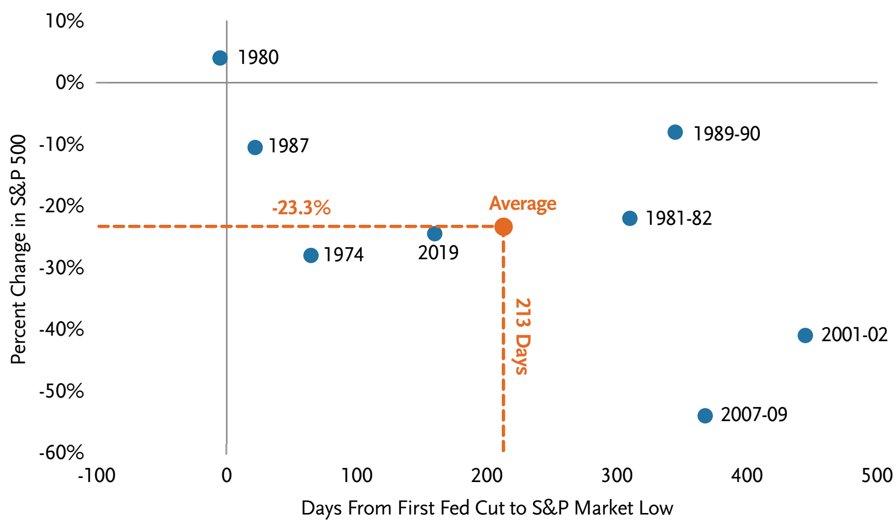
By most accounts, equity market valuations appear rich relative to their historical range, with the S&P 500 forward 12-month price-to-earnings ratio at 21.5x as of July 16, 2024, which is above both its 5-year average of 19.3x and its 10-year average of 17.9x. However, stocks look more moderately valued on an equal-weighted P/E basis, where the figure is about 17x.

Our biggest concern, though, is that consensus expectations for double-digit EPS growth in 2024 and 2025 may prove optimistic given the potential for economic deceleration. The S&P 500 Operating EPS is projected to grow by 10% year-over-year in Q3 2024 and 13% in Q4 2024, accelerating to a 15-17% growth rate in the first three quarters of 2025.

These projections seem ambitious given mounting economic headwinds. While the Bloomberg consensus real GDP growth forecasts remain solid at 2.3% and 1.8%, respectively, for this year and next, several leading economic indicators advise caution. Both the ISM manufacturing and services indices were in contraction territory in June. And, although wages continue to grow at nearly double the rate of the Fed's inflation target (average hourly earnings were up 3.9% year-over-year in June), consumer sentiment weakened to 66.0 in July, and the personal savings rate remains at the sub-4% level. Small businesses, often considered the "canary in the coal mine," are facing the steepest financing costs of the past 25 years, with interest rates on short-term loans reaching 9.5% in June.

Yes, with the moderation in CPI inflation witnessed in June, the Fed is more likely to cut interest rates at its September meeting, providing some relief to those businesses facing financing cost challenges. But equity investors should approach the prospect of Fed rate cuts with some caution. Historically, stocks have declined 23% on average over the ten months following the Fed's first rate cut, particularly in those cases where an economic recession has hurt earnings growth.

Trading Days from First Fed Rate Cut to S&P Market Low vs. S&P 500 Percent Change From First Fed Cut to Market Low



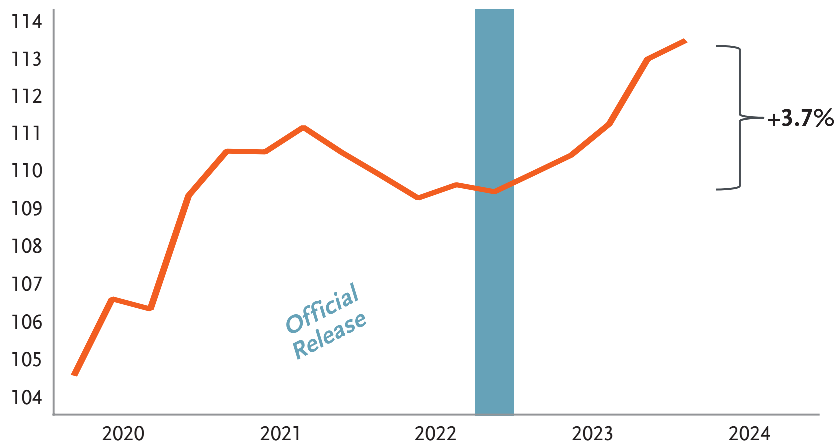
Source: Strategas; Data as of May 9, 2024

While past patterns suggest caution, we shouldn't assume history will repeat exactly. We may be headed for a milder slowdown where earnings growth proves more resilient. This economic cycle, shaped by unprecedented AI advancements and post-pandemic adjustments, may well defy easy comparisons to past downturns.

On a positive note, the prospect of risk-free returns has attracted a massive pool of capital to money market funds, with institutional money market fund assets reaching $3.6 trillion and retail assets at $2.5 trillion, according to a data from ICI. This represents significant dry powder that could potentially flow back into the equity markets.

These myriad economic challenges are likely to persist, potentially coming into sharper focus as the initial excitement of the AI boom settles. Investors will need to closely monitor how AI integration impacts productivity and profitability across various sectors. The initial data are encouraging, with at least some of the recent productivity gains in the economy traceable to AI.

U.S. Productivity
Nonfinancial Corporations
2024 Q1 113.6



Source: Piper Sandler; Data as of July 17, 2024

Despite these macroeconomic challenges, we believe that the equity market continues to offer numerous compelling secular growth opportunities. Generative AI is serving as a tremendous catalyst for new business opportunities. This trend has contributed to a surge in domestic investment spending, particularly in the areas of hyperscale capex and the race to meet the insatiable demand for power. The unswerving onshoring megatrend continues unabated in the U.S., and we see growing infrastructure-related investment opportunities as well.

In terms of international markets, the cheaper valuations for non-U.S. stocks are largely offset by a combination of their mixed economic growth prospects as well as geopolitical considerations. While the MSCI Europe and China indices traditionally trade at significant discounts to the S&P 500 on a forward P/E basis, we believe that current growth and earnings prospects validate that discount. And, while Japan's corporate profits outlook is encouraging, the Bank of Japan continues to struggle on its path towards interest rate normalization.

In this divided market of AI-driven excitement and looming economic headwinds, we believe that actively managed, diversified portfolios offer the best path forward. This approach allows investors to capitalize on key growth trends while navigating potential economic challenges, positioning them to seize opportunities amidst today's complex market crosscurrents. ■

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