

2024 Year Ahead: Inflation down plus higher demand = P/E expansion.

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HEAD OF RESEARCH

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In 2023, the S&P 500 gained 20% yet most investors sat on the sidelines as many expected the US economy to slip into a recession. And many remained skeptical throughout 2023 because they saw a Fed that was perceived to be hostile to markets. As we move into 2024, investor skepticism has diminished but investors are generally wary. We are overall positive on equities, but we believe much of the gains will come in the second half of 2024. Here are some high level takeaways:

- Fed shifting from "inflation war" to "business cycle management" = cuts more likely
- Pent-up demand suggests we are more early cycle, not late cycle
- P/E multiples expand given falling interest rates and pent-up demand
- Investors allocate into equities, particularly retail who withdrew \$240 billion in 2023 (vs 20% stock rise)

Bottom line: S&P 500 5,200 by YE, with gains in 2H

We expect equities to surprise consensus to the upside in 2024, delivering +12% to +15% returns.

- **BASE CASE:** Inflation tracks below consensus (and Fed) leading to faster than expected easing of financial conditions. No recession but probably weak jobs in first half 2024. This is a far better macro backdrop than 2023.
- **KEY DRIVER:** Financial conditions ease, leading to lower interest rates:
 - easing inflation is rise in "real" consumer income
 - 30-yr mortgage drops as spread normalizes vs 10-yr (160bp vs 293bp)
 - pent-up demand from corporates

- **EPS:** We see 2024/2025 EPS growth of 11.3%/8.3% to \$240/\$260 driven by cyclical EPS recovery.
 - corporate capex fell past few years, but easing FCIs mean capex recovers.
 - potential GDP recoveries in Europe/Asia and
 - weaker USD suggests upside to EPS.
 - Productivity is also improving.
- **P/E:** We see P/E expanding in 2024 towards 20X. While many argue for valuation compression, since 1937, the highest P/E realized when yields 3.5% to 5.5%. When between 4% to 5%, P/E is >18X 65% of the instances.
- **BEST IDEAS:** Our top sector pick is **Small-cap (\$IWM)** leading a breadth recovery. We also like **Financials, Industrials, and Technology**.
- **YE 2024 TARGET:** Our 2024 YE Target is 5,200 which is 20X 2025 EPS of \$260.

UNKNOWNNS: What will market resolve in 2024?

Impact on equities

	1H	2H
■ INFLATION: Inflation tracks sub-3% on housing and used cars	↑	↑↑
■ FINANCIAL CONDITIONS: FCI ease as Fed ends "inflation war"	↑	↑↑
■ MORTGAGE RATES: 30-yr drops to 6% as spread to 10Y normalizes		↑
■ PRODUCTIVITY: Lifts as immigrants and labor supply improve	↓	↑
■ GLOBAL GROWTH: Lift as Europe/or China emerge from stagnation	↓	↑
■ PENT-UP DEMAND: US companies expand due to pent-up demand	↓	↑
■ PROFITS: S&P 500 profits gain >10%	↑	↑↑
■ MULTIPLES: P/E reaches 20X equilibrium around 10-yr at 4.5%		↑
■ INVESTOR FLOWS: Investors allocate out of cash into equities	↑	↑↑

SECTOR: Top Sectors + Upgrades/Downgrades

S&P 500 Sector Views and #1 Sector Pick Performance

OW = Overweight. UW = Underweight. N = Neutral

	2021	2022	2023	2024
S&P 500	+27%	-19%	+20%	
Small-cap				OW 1
Cyclicals				
Consumer Discretionary	OW 1 +24%	OW	OW	OW
Industrials	OW 3	N	OW 3	OW 2
Information Technology	OW	OW 2	OW 1 +51%	OW 3
Communication Services	OW	OW	OW	N OW → N
Materials	OW	N	N	N
Near-Cyclicals				
Energy	OW 2	OW 1 +59%	OW 2	OW
Financials	OW	OW	OW	OW 1
Real Estate	UW	UW	UW	OW UW → OW
Defensives				
Consumer Staples	UW	N	UW	UW
Healthcare	N	OW 3	OW	OW
Utilities	UW	UW	UW	UW

Source: Fundstrat

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