MARKET SIGHT LINES

Firming Consumer Inflation Renews Focus on the Federal Reserve and Earnings

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To start the year, many market participants have been overly optimistic about monetary policy easing, contributing to positive views on equity earnings. This week, the January Consumer Price Index (CPI) report disappointed. In this week's Sight|Lines, we discuss how firming inflation has renewed the focus on Federal Reserve (Fed) policy, company earnings, market valuations, and a breakdown of the "magnificent seven" (M7: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla), versus the rest of the market.

THE TAKEAWAY: FIRMER INFLATION HAS SPOOKED INVESTORS

By compiling all individual stock analysts' reports, we can see that, on a "bottom-up" basis, investors are optimistic about earnings, partly based upon forecasts for cooler inflation and Fed rate cuts. But a firmer than expected CPI may call those views into question. In summary:

- Market participants had been signaling a quarter-point rate cut in March and many more throughout the year, but a disappointing January CPI report calls that into question.
- After a solid start to the year, markets reacted negatively to the CPI report.
- Investors are processing the implications of firmer-than-expected inflation, implying fewer cuts later in the year, but they are still too optimistic in our view.
- Earnings season continues as companies report fourth quarter and 2023 results.
- While results are positive overall, the M7 had a great year, and when excluding those stocks, earnings declined in 2023.
- As we carry the analysis forward to understand future forecasts, we see the M7 are expected to grow much more in 2024 and 2025.
- Notably, when considering growth, the M7 may be less overvalued than traditional metrics imply.

IN-DEPTH: A DISAPPOINTING CPI REPORT HAS SHIFTED EXPECTATIONS FOR FED POLICY SHIFTS IN 2024, CALLING INTO QUESTION EARNINGS AND MARKET FORECASTS

Investors have been optimistic about future earnings, an optimism built on forecasts for cooler inflation and Fed rate cuts. But a firmer than expected CPI has market participants shifting their Fed forecasts, which may negatively impact earnings growth. Going deeper:

- Market participants have been optimistic about Fed rate cuts:
    - As recently as mid-January, Fed futures implied a quarter-point rate cut in March and six more through the rest of the year.
    - These were more optimistic than our outlook for two-to-three cuts during the fourth quarter.
- The S&P 500 was up 5.4% through February 12 but reacted negatively to the CPI report:
    - On February 13, January CPI was reported at 0.3% versus a consensus forecast of 0.2%, with the shelter and food components rising firmly.
    - That day, the S&P 500 fell 1.4%, and the 10-year Treasury yield rose 13 basis points to 4.31%, signaling possible higher-for-longer rates.
    - Note that markets have moved higher since, recovering almost all of the losses.
- Fed futures now signal a Fed rate cut in June and three more in 2024, still too optimistic in our view.
- This earnings season shows the importance of the M7 as it applies to past and future earnings. Here are S&P 500 earnings growth forecasts, according to FactSet:
    - 2023: 1.3%, with the M7 growing 32.5%, and the rest of the market declining 3.7%.
    - 2024: 10.8%, with the M7 growing 22.3%, and the rest of the market growing 8.3%.
    - 2025: 13.3%, with the M7 growing 16.5%, and the rest of the market growing 12.6%.
- While the M7 may look more overvalued than the market overall based on the price-earnings (P/E) ratio, we can adjust the analysis to account for earnings growth by using the PEG (P/E over growth) ratio:
    - The S&P 500 has a P/E (based on 2024 earnings) of 20.4, and a PEG of 1.9.
    - The M7 combine to have a P/E of 29.9, and a PEG of 1.3.
    - The non-M7 members of the S&P 500 combine to have a P/E of 18.0, and a PEG of 2.2.
    - So, when adjusting for growth, the M7 may not be overvalued compared to the market overall.

CONCLUSION

During 2024, market participants have been optimistic about cooling inflation and a dovish shift in Fed policy, fueling a positive view on equity earnings looking forward. We've considered these forecasts overly optimistic, and our outlook has been for fewer Fed cuts later, with more limited but still positive earnings growth. The January CPI report disappointed, and market participants have adjusted their views. This will be important as we analyze earnings going forward, both for the strong performing "magnificent seven" and the rest of the market.

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