Weekly View

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# Q4 Earnings Recap: US Large-Cap Earnings Justify Their Current Valuation

## US Small-Cap and Japanese Earnings also Strong; Europe Less Certain

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SUMMARY

- US large-cap earnings have continued to grow and surprise to the upside.
- Europe, Japan, and US small-cap earnings, while weaker, are improving, in our view.
- If this improvement proves sustainable, we see a potential rotation from Growth to Value and International themes.

While both valuations and macroeconomic data help clarify our long-term view at RiverFront, we view quarterly earnings season as a critical checkup on how markets are handling current challenges. In order to complete this checkup for the 4$^{th}$ quarter of 2024, we use our three 'earnings principles':

1. **Earnings/Revenue Surprises:** Were corporate results out of alignment with market expectations?
2. **Analyst Adjustments:** What was the direction and magnitude of analysts' estimate revisions after forward guidance was issued?
3. **Earnings/Revenue Trends:** What is the long-term earnings trend after the announcement?

Starting with the first principle, the S&P 500 posted another strong quarter relative to expectations; earnings were +6.5% higher than anticipated (source: Bloomberg), with every sector but Industrials beating. These results seem to corroborate our view that the combination of lower interest rates and sustained inflation between 2 and 3% has created an environment where business models with high fixed costs but low variable ones - a condition we refer to as 'high operating leverage' - can thrive. While we are encouraged by this trend, we must continue to monitor it given US policy volatilty.

**Chart 1: Earnings Continue Uptrend**

IBES S&P 500 12-mo fwd EPS estimate, Weighted Average, log scale, in USD


*Source: LSEG Datastream, RiverFront. Data weekly as of February 25, 2024. Chart right shown for illustrative purposes only. Past performance is no indication of future results.*

From a revenue perspective, sales were +1.1% higher than analysts expected, with only Materials and Utilities coming in below expectations. We continue to favor Energy and Industrials over Materials. Utilities is less of a surprise, as we have yet to see enthusiasm surrounding nuclear energy's resurgence translate to improved fundamentals for the sector.

For the S&P 500 overall, future expectations remained largely stable in response to positive earnings surprises. We would say this is positive overall, with Chart 1 (page 1, above) pointing to how strong earnings have been since early in 2023.

Finally, the annualized trend of US large-cap earnings continues to be a positive +7.7% overall, supported by revenue growth of +4.7%. Important to our thesis, earnings for 'growth' sectors (Technology, Communication Services and Discretionary) are maintaining strong top line and bottom-line results, and some 'value'-oriented and defensive sectors (Financials, REITs, Utilities) have benefitted from the interest rate relief the Fed has provided since June. The cylical sectors (Energy, Materials and Industrials) have not participated in this growth, which is something we will be watching in the quarters ahead.

**On balance, a positive trend growth rate, coupled with the updated analysts' views of growth into 2024 and 2025, provides an overall 'healthy' diagnosis for US large-cap stocks, in our view**. Given the positive backdrop, we are vigilant in searching for signs of weakness that the analyst community is seeing, that might challenge our view that earnings growth will be long lived. So far, there is little indication of any real challenges.

## Lots of Good News this Quarter

| | US large-cap | US small-cap | Europe | Japan |
|---|---|---|---|---|
| Revenue Surprise | Positive | Positive | Positive | Positive |
| Earnings Surprise | Positive | Positive | Positive | Positive |
| Estimates for 2024 / 2025 | Positive (+) | Positive (+) | Positive (+) | Positive (+) |
| Revenue Trend Growth | Positive | Positive (+) | Flat / Decelerating (-) | Positive |
| Earnings Trend Growth | Positive | Positive (+) | Flat / Decelerating (-) | Positive |
| Source: Bloomberg Estimates: -/+ indicates change from prior quarter | | | | |

*Source: Bloomberg, RiverFront. Data quarterly as of February 15, 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results. You cannot invest directly in an index. Not indicative of RiverFront portfolio performance. In the table above, US Large Cap is represented by the S&P 500, US Small Cap is represented by the S&P 600, Europe is represented by Euro Stoxx 50, and Japan is represented by Tokyo Price Index. See Disclosures section for definitions.*

The table above summarizes the earnings picture for four different market segments. Relative to the US large-cap - which has a clear growth/technology bias – US small-caps, Europe and Japan all have a greater weighting in the more value-oriented sectors. In the table, the "+" and "-"signs indicate how things have changed since the previous quarter. We are struck by the improvement of small-caps and, to a lesser extent Japan...whereas Europe is a mixed bag.

While this general improvement could be halted by an assortment of market risk factors including recession, inflation, and political uncertainty, the table generally aligns with our base case of a 'reflationary' environment – i.e., that inflation stays contained and the momentum of economic activity is able to persist. This suggests that keeping an eye on inflation and Fed policy is particularly important for us. We think the Fed is on hold, watching for clear evidence that the deceleration in inflation has not stalled. We think inflation will remain closer to current levels than the Fed's 2% target and thus see rate cuts as unlikely anytime soon.

## Beyond Large Cap: Other "Value-Led" Market Segments Improving

- **US small-cap:** Since rates rose in 2022, the combination of small-cap's shorter debt maturity and higher debt levels relative to large-cap has resulted in more margin compression. However, we view potential for improvement in earnings going forward. The Fed cut rates last year and we think this contributed to the positive earnings data we are beginning to see in small caps. The Fed has said interest rates are above their 'neutral' rate and thus the potential for further rate cuts could materialize eventually, which can unlock more earnings potential in our view. However, since the rate picture remains murky in the near-term, and small cap investments are more volatile, we have not added them in our more risk-averse portfolios.

- **Europe:** Europe faces two opposing forces: on one hand, the concentration of value-oriented companies in Europe means they should do well in a reflationary environment. To this point, European markets, led by financials, have been strong so far this year. On the other, the political tone from the Trump administration and other geopolitical factors create uncertainty for European businesses and investors. If we can get some positive resolutions from the political side, we would hope to see positive estimates and surprises to begin to create a positive trend in Euro earnings and revenue. We view this trend change as pivotal for us to make a larger allocation to Europe.

- **Japan:** From an earnings perspective, Japanese companies continue to produce strong results. However, Japan faces a challenge that is distinctly macro in nature. Japan's poor demographics and import dependence makes stimulating their economy difficult without spurring on inflation. So, while earnings at a corporate level do matter for Japan, they are partially fueled by a weaker yen. This creates a relatively narrow set of macro environment outcomes that are favorable for the country and prevents it from enjoying the valuation multiple expansion that might be otherwise warranted.

## Conclusion: Still Favoring US Large-Cap Stocks; Too Early to Gauge Trump and Fed Policy Impact

In our portfolios, we continue to favor stocks over bonds… and there is little in our earnings analysis above to challenge that position. We believe our focus from here shifts to two key areas: emerging policy impact and security selection. From a policy standpoint, the proposals currently on the table regarding US trade and defense policy have the potential to upset the current balance if enacted. However, there is also a strong possibility that most of more radical policies are negotiating tactics and may prove less tenable in execution (see recent *Weekly View* on this topic). We think the biggest risk to our view is that fiscal policy volatility causes spillovers to inflation, or elevated uncertainty causes corporate spending to slow down. We don't see the evidence of this as of yet, but we are still in the early days of the new Administration's policies.

*Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.*

*corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.*

*In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.*

*Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.*

*Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.*

*Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.*
*Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.*

*Index Definitions:*

*Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.*

*S&P 600 is a benchmark index for small-cap stocks. To be listed on the S&P 600, stocks must have a market cap of $850 million to $3.6 billion, preventing overlap with S&P's larger cap indices.*

*EURO STOXX 50 is a stock index of Eurozone stocks designed by STOXX, an index provider owned by Deutsche Börse Group. The index is composed of 50 stocks from 11 countries in the Eurozone. EURO STOXX 50 represents Eurozone blue-chip companies considered as leaders in their respective sectors.*

*The Tokyo Price Index, known as TOPIX, is a Japanese stock market index calculated and published by the Tokyo Stock Exchange (TSE). TOPIX tracks domestic companies in the exchange's first section, which represents Japan's largest firms by market capitalization.*

*Definitions:*

*A recession is a significant, widespread, and prolonged downturn in economic activity. A common rule of thumb is that two consecutive quarters of negative gross domestic product (GDP) growth indicate a recession. However, more complex formulas are also used to determine recessions.*

*Reflation is a fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession. The term may also be used to describe the first phase of economic recovery after a period of contraction.*

*Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.*

*The energy sector is a category of stocks that relate to producing or supplying energy. The energy sector or industry includes companies involved in the exploration and development of oil or gas reserves, oil and gas drilling, and refining. The energy industry also includes integrated power utility companies such as renewable energy and coal.*

*US Equities include stocks listed in the United States. Stocks represent partial ownership of a corporation. If the corporation does well, its value can increase, and investors can share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Small/mid-cap equities, MLPs, REITS and alternatives equities are types of US Equities and assume further risks described below.*

*Small-, mid- and micro-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.*

*When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios.*

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