In addition to a strategic allocation to the tech sector, CIO sees a particular opportunity in small-cap stocks supported by the beginning of the Fed's easing cycle. (UBS)

Fundamentals should support further stock gains

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Equity gains have been relatively tepid in recent days compared to the rally in US Treasuries, despite weaker economic data boosting expectations for the Federal Reserve's rate cuts this year.

Recent signs of economic softening have included the job openings and labor turnover survey (JOLTS), which showed US job openings falling to the lowest level since February 2021. Meanwhile, the ISM manufacturing index for May fell for a second consecutive month, and further into contraction territory.

But while fixed income remains our most preferred asset class, we also believe stocks can advance further. In our base case, we see the S&P 500 reaching 5,500 by year-end amid Fed rate cuts, robust profit growth, and the secular growth trend brought by artificial intelligence (AI).

The macro environment is favorable. Recent data suggest the US economy is gradually slowing down, but not too abruptly. While some may interpret weaker numbers as a deterioration in the growth picture, we believe it is more indicative of a healthy deceleration that should allow for further disinflation, enabling policymakers to cut rates. We continue to expect cumulative cuts of 50 basis points by year-end, with the first easing move likely at the September meeting. This potential for looser financial conditions provides a healthy backdrop for stocks.

Corporate profit growth is healthy. The upward revisions in guidance and the broadening of profit growth beyond mega-cap tech stocks during the first-quarter earnings season were two standouts to us. Excluding some one-offs in the healthcare sector, the first three months of this year marked the first quarter of positive year-over-year earnings growth for S&P 500 companies excluding the Magnificent 7 (i.e., the S&P 493) since the fourth quarter of 2022. We expect the growth rate differential to narrow further throughout the year, and forecast an 11% earnings growth for the S&P 500 this year.

The AI revolution is set to drive further growth. As evidenced by stronger-than-expected capital spending and monetization trends, the AI growth story remains solid. We believe the technology will be a key driver of growth in the years ahead as it continues to disrupt and transform businesses and industries. We see sustained earnings growth for AI related companies, and forecast 20% growth this year and 16% in 2025 for the broader global tech sector.

So, we believe US stocks are likely to remain supported as the year progresses. In addition to a strategic allocation to the tech sector, we see a particular opportunity in small-cap stocks supported by the beginning of the Fed's easing cycle.

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