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While our base case is for a soft landing, all signs also point to a "Goldilocks" scenario of resilient growth, low inflation, and easier policy being on the table. (UBS)

S&P 5,000: Where do we go from here?

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Last week the S&P 500 broke the 5,000 level, marking a roughly 5% increase year-to-date on top of the robust 25% rise in 2023. The question now on everyone's minds is, where do we go from here?

Goldilocks scenario incoming?

First and foremost, it's important to emphasize that the market's performance is more a reflection of a thriving economy rather than unwarranted "animal spirits" from investors. Some recent highlights include the stronger-than-expected numbers from both the 4Q23 GDP report and the labor market report for January.

And while Jerome Powell did squash hopes for a March rate cut, he also made it clear that the Federal Reserve would have no issue easing policy with inflation still on the right track, even if the economy and labor markets remain strong. So while our base case is for a soft landing, all signs also point to a "Goldilocks" scenario of resilient growth, low inflation, and easier policy being on the table.

It's also quite apparent that the economic dynamism is trickling down to the consumer and companies' bottom lines, as evidenced by the 4Q23 earnings season. With results from 80% of the S&P 500 market cap in the books, earnings growth is pacing to be greater than 7%, above our initial forecast of 4–5%. Moreover, guidance from companies has been encouraging. At this point, we think there is upside risk to our 2024 S&P 500 EPS estimate of USD 240, which could send us closer to our upside target of 5,300 by year-end.

The powerful force of innovation also continues to be on display. Artificial intelligence remains a key source of value creation, as reflected in part by Nvidia's stock price surging almost 50% already this year. But we've seen the impact of

disruption extend beyond AI into other sectors as well. For example, Eli Lilly has surged over 30% in response to the adoption of its obesity drugs.

What to watch from here?

While the commentary above paints a rosy picture, it's important to remember that a lot of the good news is already priced into markets. To continue on a path towards our upside scenario, there are a few signposts we would be watching:

First, more good news on the economy would be needed. Here, we believe a strong labor market will be particularly important, with jobless rates staying benign and supporting spending in consumer-focused sectors.

We continue to watch the weekly initial claims for unemployment insurance to gauge the health of the labor market, but the February and March jobs reports will also be important. We are also closely watching the ISM Manufacturing index as a sign of things to come. The new-orders component of the index has ticked up to 52.5—the first time in almost a year-and-a-half that it has crossed the 50 level that demarcates expansion and contraction.

Bear in mind that the long-term average for this reading is above 55, and that S&P 500 profits are more leveraged to goods than the US GDP is, at over 50% versus below 35%.

Second, we are looking for signs that Fed cuts are delayed, but not by too much. Market expectations have pushed out a vast amount of interest rate cuts beyond 2024, now pricing in less than 120 basis points (bps) of cuts this year compared with about 175bps just a few months ago. We believe the corresponding rise in the 10-year US Treasury yield has been a small price to pay for the more realistic assumption that the easing cycle would begin in May or June. But waiting until September or beyond may be a different story.

The longer the Fed waits, the greater the chance of a mismatch between the Fed's and the market's expectations. However, if the market's rate cut assumptions continue to get pushed out because the economy is stronger than expected, that should not be too problematic. More worrisome, in our view, would be a pickup in inflation that delays the easing cycle. As has been the case in the last few years, we will closely watch the monthly inflation data.

Finally, we are watching to see if AI monetization trends pick up. Here, we want to see more beneficiaries beyond just the household names that have already seen a material runup in their stock prices. Investors will likely want to see some more evidence that businesses and consumers are in fact adopting AI applications. From this perspective, it will be important to watch the uptake of AI tools from the software companies.

How to invest?

Taking all this together, we believe there is scope for further upside if the conditions outlined above are met, but we also would not be surprised to see a digestion phase in the near term. With the S&P 500 forward P/E approaching 20.5x, we would wait for better entry points before adding to positions.

Given our base case is still for a soft landing, our preference remains for quality stocks with strong returns on invested capital, resilient operating margins, and low debt, which are better positioned to generate profits in an environment where economic growth somewhat weakens relative to 2023.

In line with our view that the rally will broaden out from here, we continue to prefer small-caps to large-caps. We think small-caps should disproportionality benefit from falling interest rates given that half of their debt is floating-rate. They have also been unusually strongly correlated with the 10-year Treasury yield in recent months, which has proven a headwind with the recent rise in the 10-year yield toward 4.2%. But history shows that this correlation tends to be short-lived, and regardless, we believe the 10-year will trend lower toward 3.5% by year-end.

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Read the full report **S&P 5,000: Where do we go from here?** 13 February 2024.

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