

## Monthly Equity Market Topics

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### In Brief:

- Mega-cap tech ex-Mag 7 earnings are projected to catch up.
- While there are reasons to remain cautious, our outlook for equities remains relatively solid, with breadth expected to improve.
- The improving macro landscape, coupled with rate cuts, is increasingly positive for European equities both through earnings improvement and an uplift in multiples.

### Mega-cap tech earnings are projected to reach parity with the Mag 7

Outsized earnings have driven mega-cap tech outperformance, but the earnings landscape is leveling out. Since the rally began in October, improved market breadth has been key, yet the equal-weighted S&P 500 Index still lags its cap-weighted counterpart.

In May, mega caps (Apple, Microsoft, Nvidia, Alphabet) added \$1.2 trillion in market value, half from Nvidia alone, increasing market concentration as this accounted for more than half of the S&P 500's gain over the month.<sup>1</sup>

Phenomenal earnings growth from mega caps drove this performance. However, a recent note from Strategas highlights that Mag 7 net income growth for the latter half of 2024, and into 2025, will likely mirror the rest of the index, due to a slowdown in Mag 7 earnings and improvement among the other 493 stocks in the S&P 500.

Due to their weight in the index, **we expect that mega caps will continue to dominate index performance, though a leveling of earnings growth should broaden the opportunity set.**

### Reasons to remain cautious, yet optimistic

Sell-side analysts' forecasts for cyclical margin expansion are fueling expectations of a broader earnings recovery. Stabilizing input costs and recession-level troughs in inventories should bring an end to destocking, providing a stable inventory environment, supporting a recovery. Expanding capex in decarbonization, aerospace and defense, supply chains and AI adoption should also contribute.

Mega-cap tech names are expected to spend around \$200 billion on capex this year, much of it for AI-supporting data centers, per multiple sources. Industrial providers of high-end cooling, connectors, cabling and electrical equipment will likely benefit, improving their earnings outlooks. Additionally, a significant build out of power generation and transmission infrastructure will be required to support these power-hungry applications.



Softer US macro data and modestly higher unemployment should see inflation ease, supporting equities as soft-landing odds increase. The slowing economy is evident in increasingly bifurcated data. Lower-income and younger consumers show increasing stress, and slowing consumption may limit goods demand. However, upper-income and older consumers have fared better. Lingering commercial real estate and regional banking issues remain concerns, though we believe that pressures may ease a little if the US Federal Reserve cuts rates.

A prolonged high-rate environment affects small business confidence and profitability. Small-cap profitability has been pressured by higher wages and financing costs. Weaker earnings and fundamentals have dragged on small-cap performance, but companies with strong profitability, free cash flow and high interest rate coverage continue to outperform.

**The environment suggests a mid-cycle expansion rather than early-cycle or risk-on conditions. Investors should consider focusing on profitable businesses with strong cash flows and wide moats.**

### Positive Outlook for European Equities

Outside the US, improving macro data and stable employment are behind an improving earnings outlook. Positive real wages support a consumer spending recovery while recent manufacturing PMIs beat consensus and new business orders also rose, pointing to expanding activity. Peripheral Europe is showing strength and German business sentiment is rising.

The recent ECB rate cut, aimed at normalizing policy rather than reviving a deteriorating economy, is positive for European equities. With economic activity improving, steady unemployment and lower inflation, **the brighter backdrop supports improved earnings revisions and a potential valuation rerating, helping drive European equity markets higher.** ▲

### Endnote:

<sup>1</sup> Bloomberg.



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