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IDEA

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US Equity Strategy | North America

Weekly Warm-up: Is the Correction Over?

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With the S&P trading at the low end of our 1H range, a tradable rally is likely. Sentiment/positioning are lighter, seasonality is improving, and the DXY/10Y yield are down 6%/50bps over the last 2 months. This doesn't mean growth risks are extinguished. Volatility is likely to persist in '25.

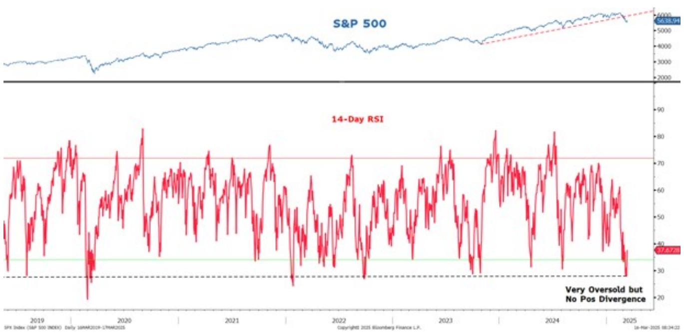
- **5500 Holds, For Now…**As expected and discussed in last Monday's note, negative earnings revisions breadth, fiscal headwinds, immigration enforcement, and tariffs took the index to the low end of our 1H range (5500-6100) last Thursday. However, indices also got as oversold as they've been on a daily RSI basis since 2022, sentiment/positioning gauges have lightened up considerably, and seasonals improve in the second half of March. Recent dollar weakness could provide a tailwind to earnings revisions, and the decline in rates should benefit economic surprise indices. We stand by our call from last week that 5500 should provide support for a tradable rally led by cyclicals, lower quality, and expensive growth stocks that have been hit the hardest and where the short base is the greatest. Friday's price action seems to support that call.
- **…But Growth Concerns and Volatility Are Likely to Persist…**Policy uncertainty has only ramped up further recently, which means growth risks are likely to persist over the coming months. Perhaps even more importantly, this administration doesn't appear to be preoccupied with stock prices. In other words, we don't think investors should view a relief rally from oversold levels as a sign that volatility is subsiding in a durable manner. Not only is policy being sequenced in a more growth-negative way to start the year (in line with our views from last November), the speed and uncertainty around new policy introduction is denting investor, consumer and corporate confidence. As discussed in our Year-Ahead Outlook, we ultimately think the market will focus on the positive aspects of the Trump policy agenda (No Pain, No Gain), but the path is going to take time and is unlikely to be smooth (YE '25 base case S&P 500 target is 6500). The flip side is that the Fed does have fire power and will use it if growth (labor data, specifically) deteriorates materially, or we see stress in credit/funding markets, both of which are stable, for now.
- **What Are We Watching?** So far this month, growth data has been ok—ISM Manufacturing and Services were above 50, payrolls were largely in line with expectations, and higher frequency initial jobless claims are not showing signs of labor market stress. To confirm that a more significant deterioration in the growth backdrop isn't taking hold, we would like to see payroll gains of at least 100k, a stable unemployment rate, ISM Manufacturing above the mid 40s, ISM Services above 50, and reaccelerating earnings revisions

breadth (in line with seasonals). We also think it's important for the S&P 500 to respond to the ~5500 level given the fundamental and technical support there. If it doesn't, that's a potential sign that growth could be deteriorating faster than expected, and recession risk could be increasing along with the odds of our bear case outcome.

Is the Correction Over?

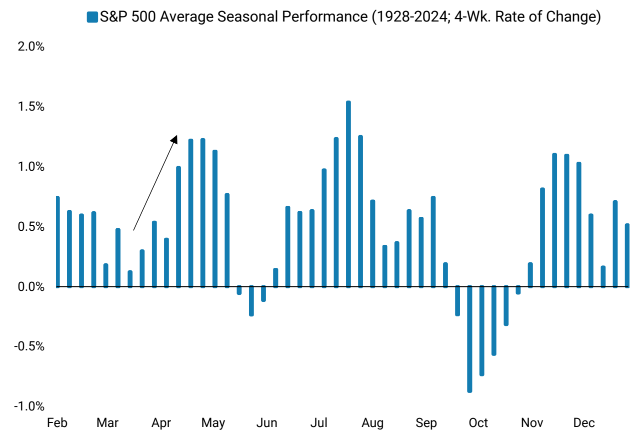
Major US equity indices are as oversold as they've been since 2022, sentiment/positioning gauges have lightened up considerably, and seasonals are set to improve in the second half of March for earnings revisions and price. Furthermore, recent dollar weakness should provide a tailwind to 1Q earnings season/2Q guidance relative to 4Q24, and, if historical patterns hold, the decline in rates should lead to upside in economic surprises. In short, we stand by our view that 5500 on the S&P 500 should provide support for a tradable rally led by the lower-quality, higher-beta stocks that have sold off the most, and it looks as if it may have started on Friday after the S&P traded at 5505 on Thursday.

Exhibit 1: Markets Got Very Oversold Last Week as the S&P 500 Tested 5500...



Source: Bloomberg, Morgan Stanley Research.

Exhibit 2: ...Seasonals Improve from Here



Source: Bloomberg, Morgan Stanley Research.

The more important question is whether such a rally is likely to extend into something more durable and mark the end of the volatility witnessed year to date. The short answer is, probably not. First, from a technical standpoint, the major indices have suffered significant damage—more than we witnessed in recent 10% corrections like last summer's. More specifically, the S&P 500, Nasdaq 100, and Russell 1000 Growth and Value Indices have all traded straight through their respective 200-day moving averages, now making these levels resistance rather than support. Breadth has also deteriorated significantly which can mark a short term low, but it must improve materially to justify higher highs for the index. Meanwhile, many stocks are closer to a 20% correction, with the lower-quality Russell 2000 clearly falling below its 200-week moving average for the first time since the 2022-23 bear market. At a minimum, this kind of technical damage will take time to repair, even if it doesn't lead to more price degradation at the index level.

Exhibit 3: But Key Support Levels Did Not Hold During This 10% Correction Like Past Few Years

Source: Bloomberg, Morgan Stanley Research.

Exhibit 4: Breadth Is Rarely This Weak and Should Recover, but Suggests Index Could Fall Further If It Doesn't Improve

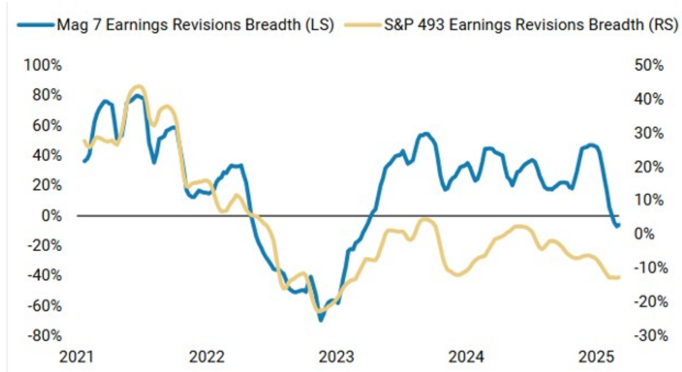
Source: Bloomberg, Morgan Stanley Research.

To forecast a larger recovery, it's important to acknowledge what's really been driving this correction. From our conversations with institutional investors, many appear to be focused primarily on the tariff announcements and rapid-fire changes from the new administration. While these issues *are* weighing on sentiment and confidence, other factors started this correction back in December, in our view. In our 2025 outlook, we had forecast a tougher first half of the year for several reasons. First, stocks were extended both on a valuation basis and relative to the key macro/fundamental drivers, including earnings revisions which peaked in early December, before the new administration took office. As noted going into 4Q reporting season, we thought these revisions were at risk of rolling over mainly due to the strong dollar and higher rates and the impact these variables would have on 2025 guidance when companies provided it in January/February. It's also important to note that earnings revisions breadth for the Mag 7 has been leading to the downside. The spread between earnings revisions breadth and y/y change in the S&P 500 was historically wide *before* the revisions rolled over, but this was largely ignored until revisions breadth began to decline. Without a positive reversal in this metric, it will be hard for the index to recover in a sustainable manner and make new highs. This is particularly true because multiple expansion due to accommodative liquidity, in particular, is now likely coming to an end as the reverse repo is now close to zero and this Treasury is unlikely to issue *incremental* T-Bills as a percentage of the total debt issuance. Assuming no recession (our economists' base case), earnings growth will likely plateau, but won't collapse. We believe the positive policy changes (de-regulation, potential further tax cuts for consumer, lower rates and dollar, less crowding out of the private economy) could start to impact 2026 forecasts by the second half of this year—i.e., bend, don't break. Obviously, if a recession arrives that scenario would change, and our bear case would apply (S&P 4600).

Exhibit 5: Earnings Revisions Breadth Began to Roll Over in Early December...

Source: FactSet, Morgan Stanley Research.

Exhibit 6: ...Mag 7 Revisions Have Also Rolled Over, Which Has Less to Do with Policy Changes



Source: FactSet, Morgan Stanley Research. Series are smoothed.

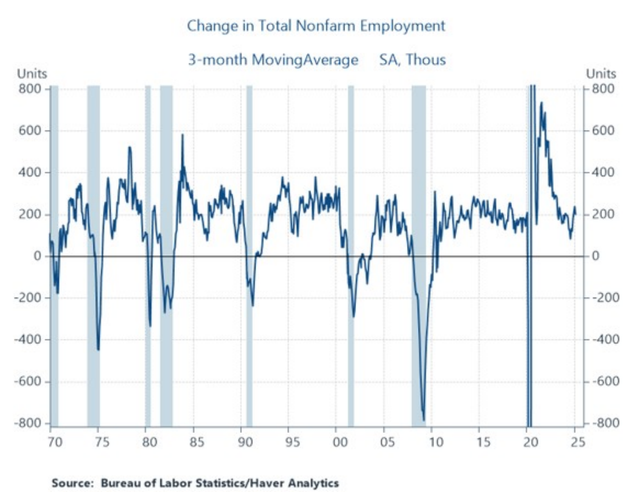
Second, this correction picked up momentum into year end as the Fed went on hold in mid-December after cutting rates aggressively by 100bp over the prior three months. Third, back-end interest rates and the US dollar were both near 52-week highs as we exited the year – a headwind for company guidance during 4Q earnings season, something we previewed ahead of reporting season. Fourth, we expect AI capex growth to decelerate this year (see GenAI Monetization – Assessing The ROI Equation), and that has weighed on several of the biggest stocks. Fifth, the fiscal deficit grew by 40%Y in the fourth quarter, so it was likely to be a headwind in 2025 with or without DOGE's efforts. Add in immigration enforcement, DOGE exceeding expectations, and tariffs, and it's no surprise that slowing growth forecasts are hitting equities in the form of lower multiples/higher risk premia. We noted these growth headwinds in our 2025 outlook back in November and have been citing a first-half range for the S&P 500 of 5500-6100. Finally, President Trump has recently indicated that he is not focused on the stock market in the near term as a barometer of his policies and agenda. Perhaps more than anything else, this is what led to the most recent technical breakdown in the S&P 500.

In many ways, the start of this year feels a bit like 2022 when investors were skeptical the Fed would raise rates so much to fight inflation. As a reminder, coming into 2022, there were only 3 Fed hikes priced into the curve, a seemingly conservative view given inflation was the highest in 40+ years. Once the Fed began to hike and signal a more hawkish tone, the markets had to adjust their views. However, it took a long time for this shift to sink in, and so rallies continued to fail throughout the year as the Fed stayed the course. This year may be similar in some respects except the surprise to investors thus far has been how committed the administration has been in pursuing its goals of lower immigration, smaller government and a rebalancing of the economy to help the average citizen and small businesses in the longer term. This "austerity" program is designed to rein in inflation, lower rates and generate better capital allocation and growth via the private economy. This will take time to sink in just like a very hawkish Fed in 2022; and therefore, several failed rally attempts are likely. The good news is that this time, the Fed has a lot of fire power to combat slowing growth if conditions get materially worse or if credit/funding markets get too volatile. However, those conditions will likely mean lower equity prices first, even if it's not as bad as 2022.

It will take more than just an oversold market to get more than a tradable rally, in our view. We firmly believe that earnings revisions breadth is the most important variable, and while we could see some seasonal strength/stabilization in revisions, we believe it will take a few quarters for this factor to resume a positive uptrend. As noted in our outlook, the growth-positive policy changes (tax cuts, deregulation, less crowding out, and lower yields/dollar) could arrive later in the second half of the year, but we think that's too far off and uncertain for the market to contemplate today. Finally, while the Trump put apparently doesn't exist, the Fed put is alive and well, in our view. However, as discussed, that will likely require conditions to worsen either for growth (specifically, the labor market) or in the credit/funding markets, neither of which would be equity-positive, initially. Bottom line, a short-term rally from the bottom of our 5500-6100 range is looking more likely after Friday's price action. It's also being led by lower-quality stocks. This factor supports our secondary view that the current rally is unlikely to lead to new highs until the numerous growth headwinds are reversed or monetary policy loosens once again.

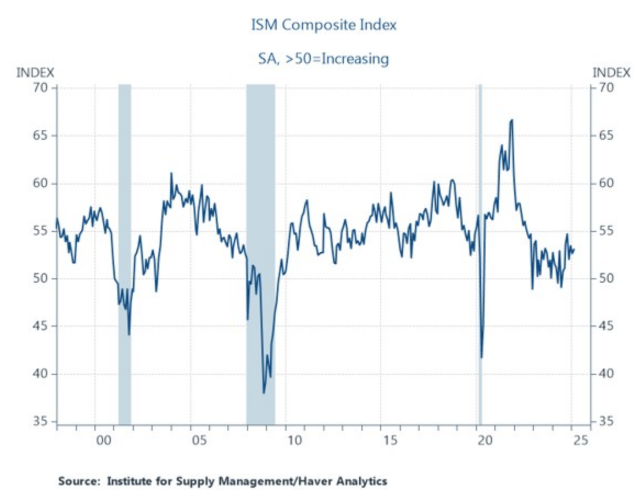
Another key question is what data points are we watching to inform our view on the path of the economy and earnings over the next several months. So far this month, growth data has been ok—ISM Manufacturing and Services above 50, payrolls were largely in line, and higher frequency initial jobless claims are not showing signs of labor market stress. To confirm that a more significant deterioration in the growth backdrop isn't taking hold, we would like to see payroll gains of at least 100k, a stable unemployment rate, ISM Manufacturing above the mid 40s, ISM Services above 50, and reaccelerating earnings revisions breadth (in line with seasonals). We also think it's important for the S&P 500 to respond to the ~5500 level given the fundamental and technical support there. If it doesn't, that's a potential sign that growth could be deteriorating faster than expected, and recession risk could be increasing along with the odds of our bear case outcome.

Exhibit 7: Payroll Gains Have Been Solid...



Source: Haver Analytics, Morgan Stanley Research.

Exhibit 8: ...And the ISM Composite Index Remains in Expansion Territory for Now

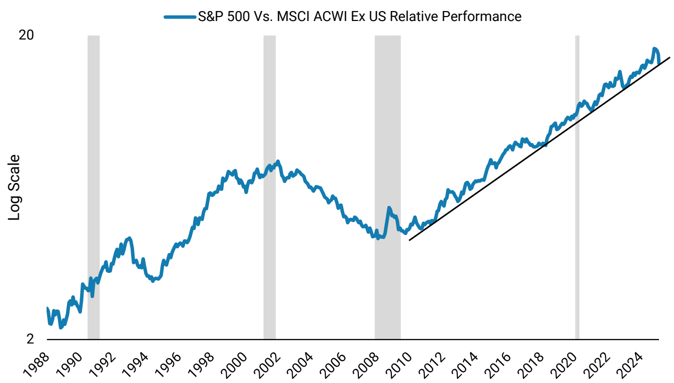


Source: Haver Analytics, Morgan Stanley Research.

Finally, we continue to receive questions on the relative underperformance of the US versus rest of world. While the recent rotation away from the US may have felt acute, it's interesting to note that S&P 500 versus MSCI ACWI Ex US relative performance (in US

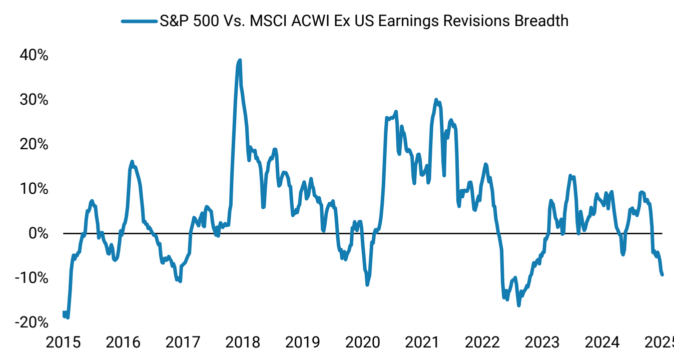
Dollars) is still holding the long-term uptrend despite the recent consolidation (Exhibit 9). The deceleration in earnings revisions breadth for the S&P vs. MSCI ACWI Ex US (Exhibit 10) helps to explain recent underperformance, though this relative earnings revisions trend is nearing the lower end of the historical range from which it tends to mean revert. Relative underperformance of the US also been a function of the weaker US Dollar which looks oversold in the short-term. From our standpoint, international equity markets tend to be more value-oriented and economically-sensitive than the US. Major US indices tend to be higher quality and growth-equity oriented, which typically makes them more durable later in the cycle (i.e., where we are today). In the event the growth backdrop deteriorates quickly (our bear case), we wouldn't be excited about adding international equity exposure because of the outsized cyclical weights in many of these markets.

Exhibit 9: S&P Vs. Rest of World Performance Is Still Holding the Long-Term Uptrend...



Source: FactSet, Morgan Stanley Research. Performance in USD.

Exhibit 10: ...And S&P Vs. Rest of World Earnings Revisions Have Decelerated, but Are Approaching the Lower End of the Historical Range



Source: FactSet, Morgan Stanley Research.

Fresh Money Buy List

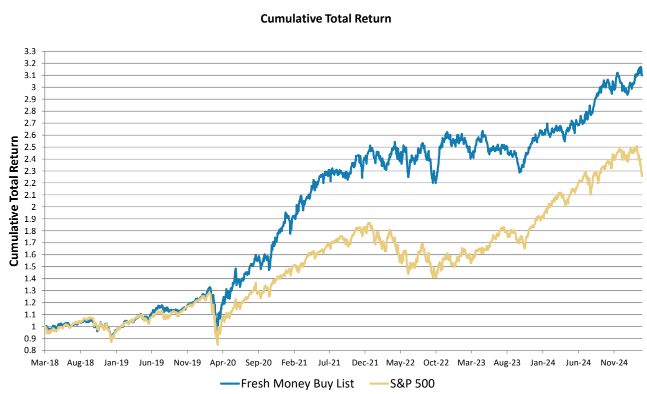
Exhibit 11: Fresh Money Buy List - Stats & Performance

Company Name	Ticker	MS Rating	Sector	Market Cap ($Bn)	Price	MS PT	% to MS PT	MS Analyst	Date Added	Total Return Since Inclusion	
										Absolute	Rel. to S&P
Abbvie Inc.	ABBV	Overweight	Health Care	$374.4	$212.06	239.00	12.7%	Flynn, Terence	8/12/2024	13.5%	7.1%
CenterPoint Energy Inc	CNP	Equal-Weight	Utilities	$22.6	$34.55	32.00	(7.4%)	Arcaro, David	3/21/2022	32.2%	(0.1%)
Coca-Cola Co.	KO	Overweight	Consumer Staples	$300.8	$69.94	78.00	11.5%	Mohsenian, Dara	3/28/2022	23.0%	(6.9%)
Colgate-Palmolive Co	CL	Overweight	Consumer Staples	$73.7	$90.82	104.00	14.5%	Mohsenian, Dara	3/27/2023	28.1%	(18.0%)
Eaton Corporation PLC	ETN	Overweight	Industrials	$114.5	$292.04	385.00	31.8%	Snyder, Christopher	10/7/2024	(11.3%)	(9.9%)
McDonald's Corporation	MCD	Overweight	Consumer Discretionary	$213.9	$299.40	335.00	11.9%	Harbour, Brian	10/18/2021	34.1%	1.3%
Northrop Grumman Corp.	NOC	Overweight	Industrials	$68.8	$475.10	580.00	22.1%	Liwag, Kristine	8/12/2024	(0.7%)	(7.1%)
The Progressive Corp.	PGR	Overweight	Financials	$162.7	$277.55	317.00	14.2%	Huang, Bob Jian	12/16/2024	14.9%	21.4%
Public Service Enterprise Group Inc	PEG	Overweight	Utilities	$39.7	$79.57	96.00	20.6%	Arcaro, David	8/12/2024	4.4%	(2.0%)
Walmart Inc	WMT	Overweight	Consumer Staples	$684.4	$85.20	115.00	35.0%	Gutman, Simeon	3/27/2023	84.8%	38.6%
Current List Performance											
Average (Eq. Weight)				$205.5			16.7%			22.29%	2.45%
Median				$138.6			14.4%			18.9%	(1.0%)
% Positive Returns (Abs. / Rel.)										80%	40%
% Negative Returns (Abs. / Rel.)										20%	60%
Avg. Hold Period (Months)											19.1
All Time List Performance											
Average (Eq. Weight)										28.2%	7.8%
Median										17.2%	(0.4%)
% Positive Returns (Abs. / Rel.)										78%	48%
% Negative Returns (Abs. / Rel.)										22%	52%
Avg. Hold Period (Months)											17.5

Performance returns shown above and below represent local currency total returns, including dividends and excluding brokerage commission. Returns are calculated using the closing price on the last trading day before the date shown in the "Date Added" column through close on the last trading day prior to publication of this report for stocks currently on the list and through close on the day of removal for stocks formerly on the list. These figures are not audited. Past performance is no guarantee of future results.

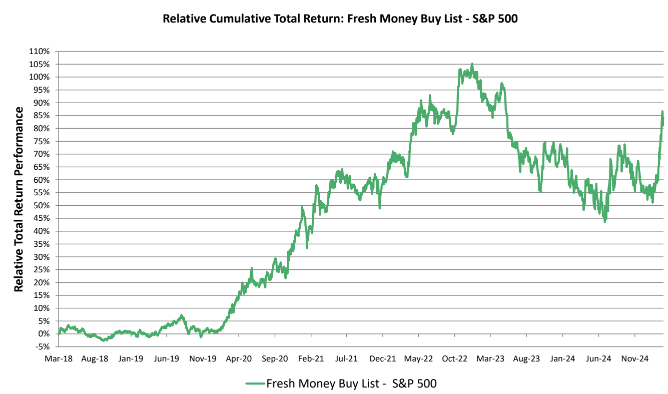
Source: Bloomberg, Morgan Stanley Research

Exhibit 12: Fresh Money Buy List & S&P 500 Cumulative Total Return



Source: Bloomberg, Morgan Stanley Research

Exhibit 13: Fresh Money Buy List / S&P 500 Cumulative Relative Return

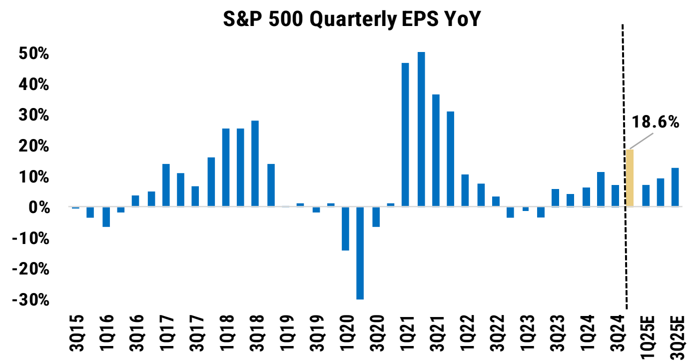


Source: Bloomberg, Morgan Stanley Research

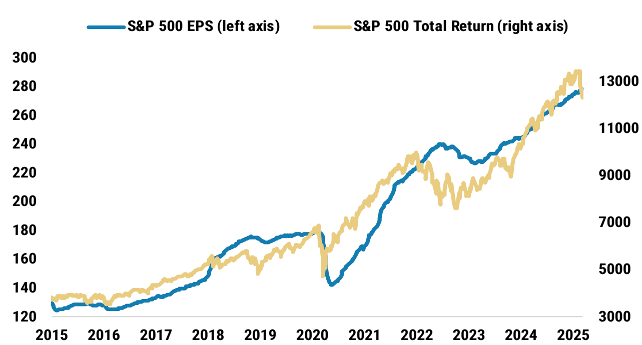
Weekly Charts to Watch

Exhibit 14: US Earnings Snapshot

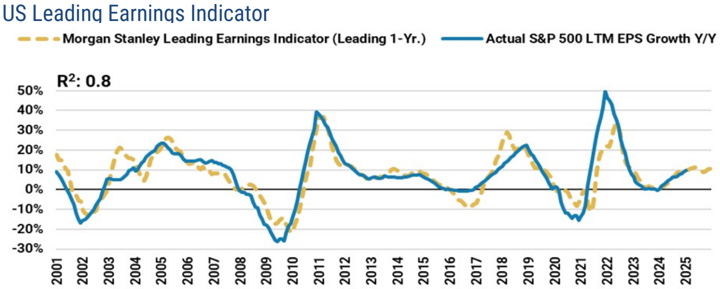
S&P 500 Y/Y EPS Growth



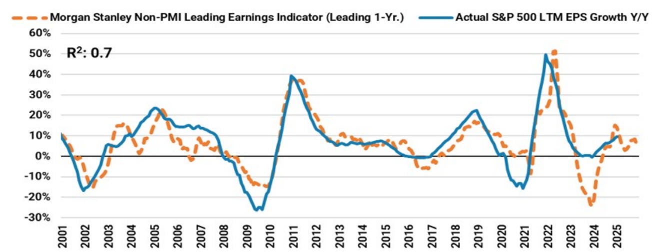
S&P 500 NTM EPS vs. Total Return Level



US Leading Earnings Indicator



US Non-PMI Leading Earnings Indicator



Source: Refinitiv, FactSet, Morgan Stanley Research. Top: As of Mar 14, 2025. Bottom left as of Jan. 31, 2025. Bottom right as of Dec. 31, 2024. The LEI is a top down macro indicator consisting of the Inventory/Sales ratio, ISM Manufacturing PMI, ISM Manufacturing Employment PMI, Consumer Confidence and credit spreads. MS Non-PMI Leading Earnings Indicator inputs: Philadelphia Fed economic activity, Creighton U. business confidence, Chicago Fed supplier deliveries, Atlanta Fed wage tracker (inverse signal), NFIB small bus. most important problem inflation (inverse signal), and Brave-Butters-Kelley cycle component of monthly GDP. Weightings are fixed over time.

Exhibit 15: Morgan Stanley US Equity Strategy Forecast Table

						MS Top Down EPS Estimates			Bottom Up Consensus EPS Estimates		
	Current Price	MS Next 12M Price Target	MS Next 12M Price Target % to Current	Current P/E	MS Next 12M P/E Target	2024	2025	2026	2024	2025	2026
Bear	5,522	4,600	-17%	20.2x	18.5x	$235	$216	$248	$243	$271	$309
Growth						*7%*	*-8%*	*15%*	*10%*	*12%*	*14%*
Base	5,522	6,500	18%	20.2x	21.5x	$239	$271	$303	$243	$271	$309
Growth						*9%*	*13%*	*12%*	*10%*	*12%*	*14%*
Bull	5,522	7,400	34%	20.2x	22.5x	$244	$281	$329	$243	$271	$309
Growth						*11%*	*15%*	*17%*	*10%*	*12%*	*14%*

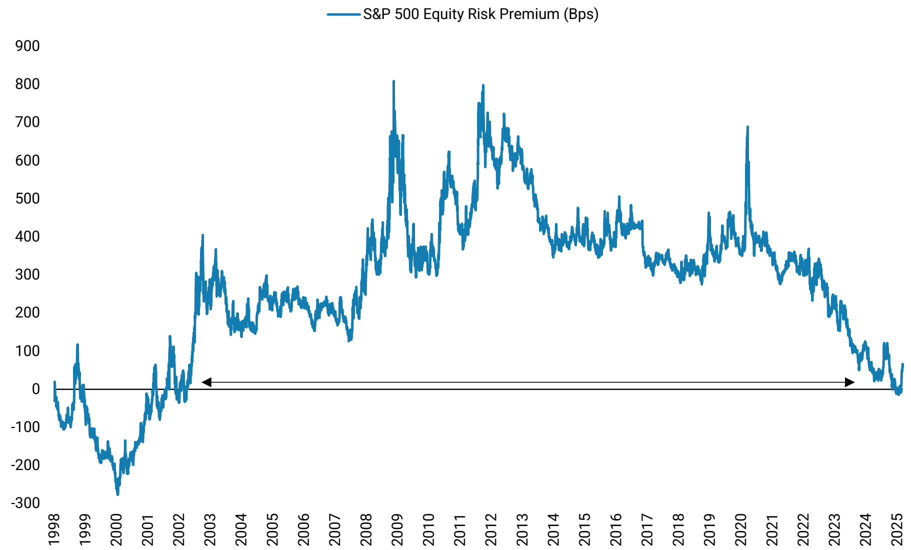
Source: FactSet, Morgan Stanley Research. As previously discussed, we see AI-driven productivity adding an additional 30 bps to 2025 and 2026 net margin for the S&P 500 though we believe risk is skewed to the upside/our bull case in this respect—50 bps of added impact.

Exhibit 16: Sector Ratings

Morgan Stanley Sector Recommendations			
Overweight	Financials	Industrials	Energy
	Utilities		
Neutral	Comm. Services	Health Care	Tech
	Materials	Real Estate	Consumer Services
Underweight	Consumer Discretionary Goods		
	Staples		

Source: Morgan Stanley Research

Exhibit 17: Equity Risk Premium is at 20-year lows at a time when earnings risk is at 20-year highs

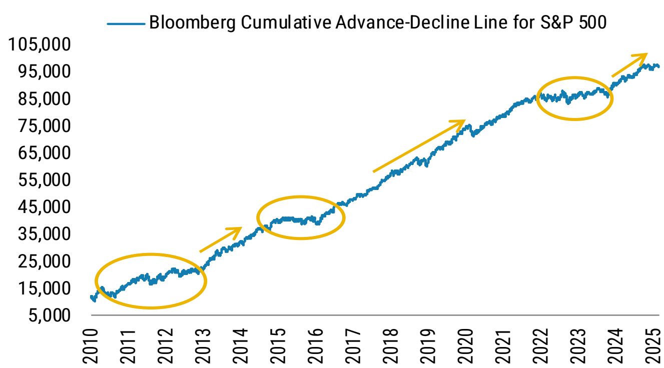


Note: Equity risk premium is calculated as the S&P 500 forward 12M earnings yield minus the nominal 10-Year Treasury.

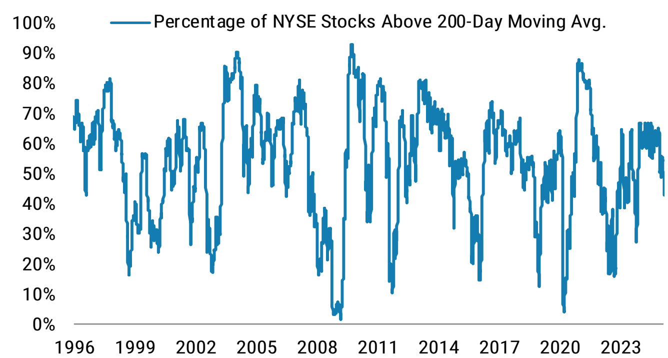
Source: As of Mar 14, 2025. Bloomberg, Morgan Stanley Research

Exhibit 18: US Equity Market Technicals and Financial Conditions

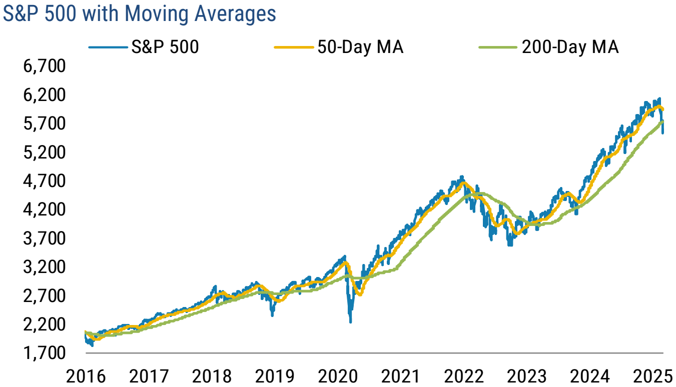
S&P 500 Advance/Decline Line



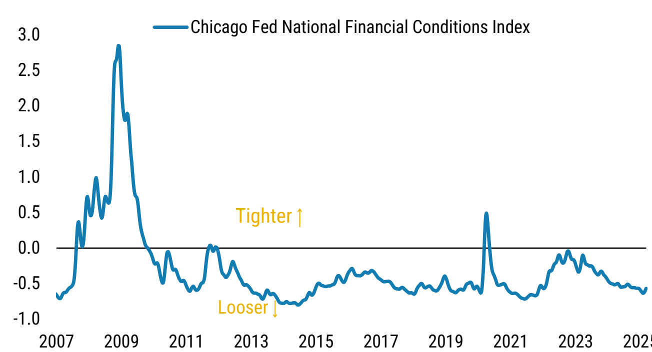
S&P 500 Percent Members Above 200-Day Moving Average



S&P 500 with Moving Averages

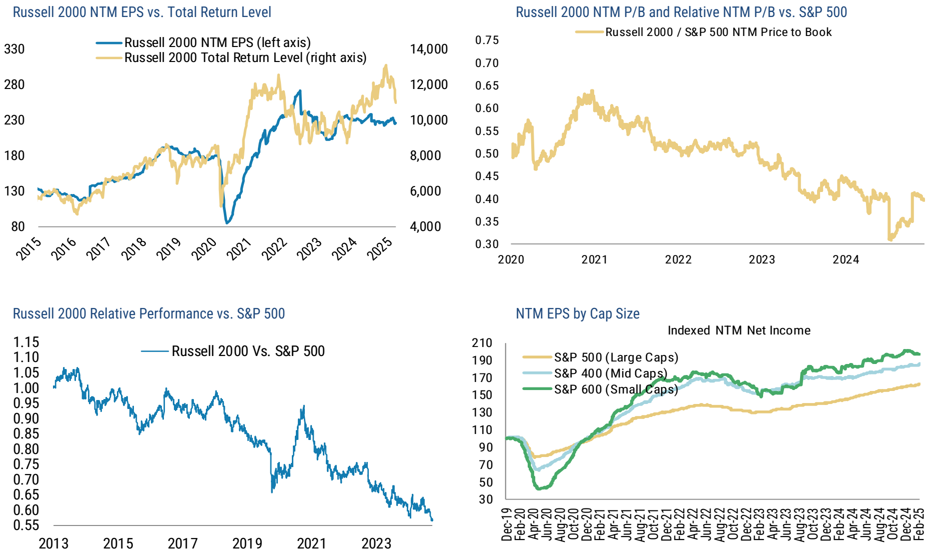


Chicago Fed National Financial Conditions Index



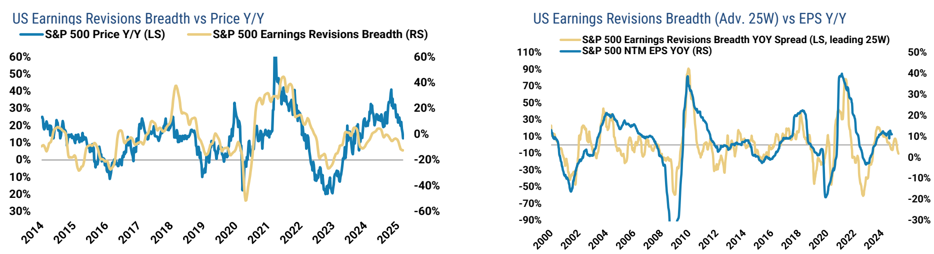
Source: Bloomberg, Morgan Stanley Research. As of Mar 14, 2025

Exhibit 19: US Small Cap Equities



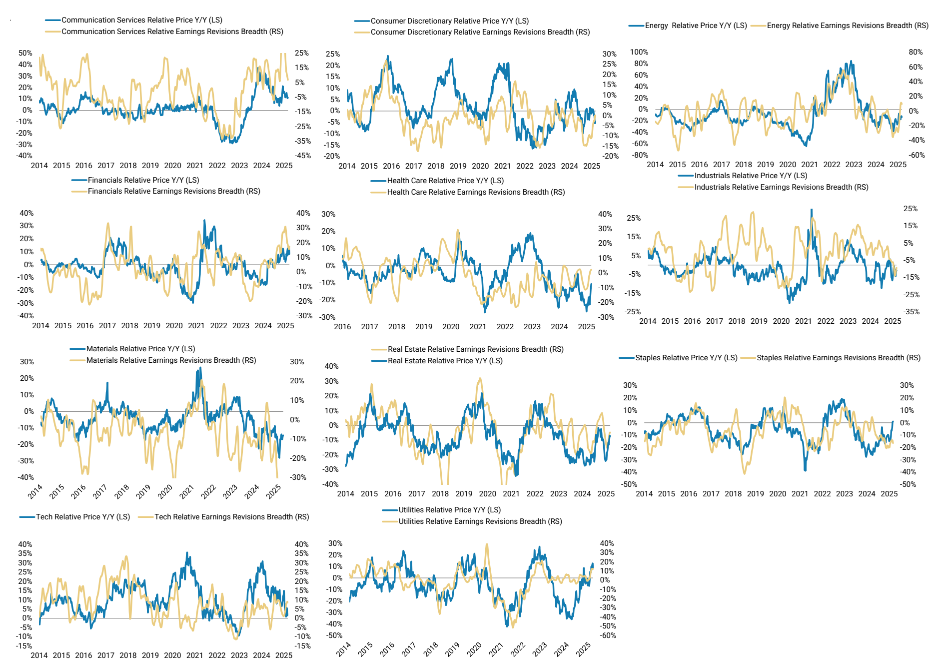
Source: FactSet, Morgan Stanley Research. As of Mar 14, 2025

Exhibit 20: Earnings Revision Breadth Moves with Price but Leads EPS



Source: FactSet, Morgan Stanley Research

Exhibit 21: Earnings Revisions Breadth vs YoY Performance



Source: FactSet, Morgan Stanley Research. As of Mar 14, 2025

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(as of February 28, 2025)

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	Coverage Universe		Investment Banking Clients (IBC)			Other Material Investment Services Clients (MISC)	
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1496	39%	378	45%	25%	695	40%
Equal-weight/Hold	1694	45%	370	45%	22%	810	47%
Not-Rated/Hold	3	0%	0	0%	0%	0	0%
Underweight/Sell	601	16%	83	10%	14%	230	13%
Total	3,794		831			1735	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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