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More gains ahead for US stocks?

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Allison Nathan: The S&P 500 has staged a huge roughly 25% rally since the start of the year. How much more upside should investors expect, and what could drive those gains?

David Kostin: The idea that the economy is growing suggests that, if fair value is around the current level, then the forward trajectory of the index is going to be driven by earnings as opposed to a valuation expansion.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges. Today, I'm sitting down with David Kostin and Ryan Hammond from our US Portfolios Strategy team in Goldman Sachs Research. They recently boosted their year-end and 12-month targets for the S&P 500. Let's find out why. David, Ryan, thanks for joining us.

David Kostin: Thank you, Allison.

Ryan Hammond: Thank you.

Allison Nathan: So David, we spoke to you earlier this year. The S&P has been on nothing but a tear, minus a bit of a blip in August. But if we think about where we are today at new record highs again, you know, what have been the primary drivers of this rally, especially in recent months?

David Kostin: I think you can think about the rally, Allison, in two ways. The first is it's been equally driven by earnings growth and valuation expansion, and that is different from calendar 2023 when it was almost about 75% of that return came from an increase in valuation. So the first part of it is earnings in valuation.

The second is the largest stocks in the market, they get all of the visibility often known by the term Magnificent Seven. Those stocks are up 36% this year. The typical stock is up around 17%. So in aggregate, as you pointed out, the index level is up around 25% as we speak today, and that's driven in part by these biggest stocks that help lift the overall index.

Allison Nathan: And if we think about earnings, are they doing better than we expected coming into the year? Is this just a reflection of the strength of the economy? Or what's driving that earnings growth? Ryan?

Ryan Hammond: Yeah. An economy that's growing usually means earnings are growing. But part of the reason why we upgraded our S&P 500 price targets was because of better earnings growth than we previously assumed. So our previous forecast was for 6% earnings growth in 2025. We raised that to 11% earnings growth, both on the back of solid economic data but also some micro factors related to semiconductors, these mega cap tech stocks that David mentioned, and some one-time charges that are affecting earnings in 2024.

Allison Nathan: So we're feeling pretty good about how companies are performing in terms of earnings. So when we think about this strong earnings growth that led us to upgrade our earnings forecast for this year, again, we talked about economic expansion being a key driver. Does that mean that the consumer is in good shape, people are just buying more things, the economy is buoyant?

David Kostin: Well, as we look out into the next year, we have an overall macro view that the economy is growing. The unemployment rate is staying low. The Federal Reserve is cutting interest rates along with central banks around the world. That is a supportive backdrop for equities, generally speaking. And that is a key input as one of the assumptions in our overall earnings model.

Valuation, with the idea of interest rates staying relatively close to the current level, maybe the 10-year US treasury yield rising to around a little over 4% in the coming year, that is consistent with, in our models, a level of the S&P 500 in a year's time around 6,300, which would be about 8% higher than the current level of the market.

Allison Nathan: But if we look at valuations, Ryan, today, there's been a lot of concern I think going into this year that valuations were looking stretched. I mean, isn't that more the case today now that we're sitting at record high levels?

Ryan Hammond: Yes. There's no doubt that valuations are high relative to history. Or if you look at them relative to interest rates, they're also historically stretched. And even if you look at the typical stock, they're relatively stretched.

So for some context, the S&P 500, the cap weighted index trades at 22 times forward earnings. That's in the 95th percentile versus history. The only times you've had higher valuations were in COVID and the tech bubble. But even if you look at the equal weight S&P 500, which controls for some of the big megacap tech stocks, that trades at 17 times, which also ranks in the 95th percentile versus history. So large cap equity valuations are stretched versus history.

But our macro model, as David mentioned, growth that is solid, a Federal Reserve that is able to start cutting, inflation that is largely near the Fed's target, our model suggests that valuations are actually roughly in line with fair value based on that macro backdrop. You know, a big part of that valuation premium of the cap weighted index is the fact that those megacap tech stocks have faster growth, higher margins, stronger balance sheets, and that commands a valuation premium that pushes the aggregate index valuation up.

Yes, they are high versus history. There's other places in the market that you can find value like in midcaps or small-cap equities. But our macro models do suggest that they can stay around these levels through the end of this year.

David Kostin: And the idea that the economy is growing suggests that, if fair value is around the current level, then the forward trajectory of the index is going to be driven by earnings as opposed to a valuation expansion. I think that's an important conclusion that we reached in our research.

Allison Nathan: Right. So you're not expecting further expansion in valuation. So is this really just a play on the economy? Essentially, if the economy holds up, we expect it to hold up, companies are going to perform well?

David Kostin: That is a reasonable and reductive perspective on the idea of the overall US equity market. On the other hand, as Ryan indicated, one of the most compelling opportunity sets, we find, is in midcap stocks because, if the overall index level is at fair value, where are things that are undervalued? And we would identify midcap stocks. You could think of the S&P 400 index midcap stocks, anywhere from $5 billion to $25 billion in market cap. Those companies are expected to have similar kind of growth rates but traded at 15 times forward earnings as opposed to 22 times for the overall S&P 500 index. We think that's a much better opportunity at the valuation level, and they have historically had much greater torque to the idea of the Fed cutting interest rates. Over three months, over a year's time horizon, they've tended to outperform. And they have a long-term track record of outperformance. So within the market, the opportunity set, midcaps we think is most attractive.

Allison Nathan: So there are pockets of the overall market where you can see valuation expansion. Let's talk about the other side of the spectrum. You mentioned it, that the stocks that have driven the rally, the very large cap stocks. Where are we today in terms of them driving these results? And how much will they contribute to the forward outlook?

Ryan Hammond: Yeah. So there's no doubt that those stocks have powered the aggregate index higher. You know, just one stock, Nvidia alone accounts for more than 20% of this year's S&P 500 return. Just one stock. But I think that does mask a little bit of what has gone on throughout the course of the year.

Market breadth, a measure of how concentrated returns are by a given group of stocks, has ebbed and flowed throughout this year. In the beginning part of the year when AI optimism was really moving to a high, those stocks powered the market higher and market breadth was quite narrow. But over the summer, you did start to see the equal weight index outperform the cap-weighted index. In other words, the typical stock has started to participate in this year's rally.

And so both the typical stock and the aggregate index are up on the year, delivering pretty healthy returns. And so I think that breadth is now roughly in line with historical averages based on our typical measures of that.

Now, I would say, taking a step back, concentration is still a huge issue facing the market. The sixth largest megacap tech stocks today make up 30% of S&P market cap. And so the trajectory of those companies will be an important factor in considering the forward path over the next 12 months. But today, breadth looks relatively healthy from our perspective.

Allison Nathan: And Ryan, you've done a lot of work on the AI sector in particular, and we think about that theme as driving the market. But some doubts have been raised about the potential of the technology and whether companies along the different phases of its development will actually perform. Where are we in that cycle and where is the most opportunity relative to the AI theme today?

Ryan Hammond: Yeah. So our research has really focused on four phases of the AI trade. Nvidia was the clearest near-term winner from the development of the technology, phase one. Then we identified phase two as being those infrastructure stocks involved in the build-out of that technology. That could be utility companies to power some of those data centers, the other technology hardware companies to build them out. And then phase three was companies that have revenues that are exposed to AI. They have AI-enabled revenues that can monetize this technology. And then phase four was every company using this technology to become more productive and increase their sales or margins at their company.

From our conversations with clients and I think from the performance perspective, you can see the most confidence and conviction among investors in phase two, the infrastructure. Hyperscalers, these leading mega cap tech stocks, are spending billions of dollars on this technology, and therefore investors have a lot of confidence that this technology will get built. So anything exposed to that phase two infrastructure has done quite well this year.

But now, as you highlighted, many investors have started to raise some skepticism about the returns on those investments and the ability to monetize AI. And so phase three has really not participated in this rally in recent months. And obviously we still think we're a while away from those productivity gains really coming to fruition in phase four. So from our perspective, it still seems like phase two is really the emphasis with investors, anything involved with infrastructure. But we are getting later in that trade where we start to think earnings will be the primary driver of that rather than valuation and excitement from investors.

Allison Nathan: Right. So they'll have to start to monetize some of that investment in order to see another leg up in, let's say, phase two, relative to this theme at least.

Ryan Hammond: That's right. I think a lot of the rally in those phase two stocks has been valuation driven in anticipation of those earnings coming to utilities companies and technology hardware companies. But now I think investors are really looking to see that. You know, we have third quarter earnings season upcoming. That'll be another important litmus test I think for whether or not you're seeing signs of that in the fundamentals.

Allison Nathan: David, let's talk about third quarter earnings season. It's just kicking off. What are your expectations, and what are investors watching?

David Kostin: Well, I think the best way to think about it is the hurdle for third quarter results is plus 4%. That's 4% year-over-year increase in earnings per share. Put that in context, for the last five or six quarters, you've had around 500 basis points of positive surprise. And so if that trend was to continue, then a 4% increase expectation, increase that by five percentage points, about closer to 9%. And so we'll call that bid-ask somewhere between 4 and 9% would be characterized as a positive earnings season. And I think that's likely where things are going to end up.

So it is important to understand that that is a deceleration from plus 11%, which we saw last quarter. So plus 11% down to expectations around plus 4, with I think a little bit higher than that this quarter.

Ryan Hammond: And on that point, even though we do think that's a relatively low bar for companies to clear for third quarter results, a lot of investor focus will be on the future earnings trajectory of these companies. So 2025 earnings estimates we think will gradually get revised down.

So if you compare our top-down earnings forecast for next year relative to the consensus of bottom-up analysts, we are below those numbers. And we do think you'll start to see some negative revisions to 2025 estimates.

Allison Nathan: And actually, you all just put out 2026 estimates. How much are investors focused on that?

Ryan Hammond: I would say, based on our conversations, still most of the focus is on 2025. But 2026 to us looks more like a trend year, both from an economic perspective. You know, our economists have roughly 2% real GDP growth annual average in 2026. That should lead to modest sales growth, roughly 4% in line with nominal GDP growth. And we have slight margin expansion but not as much as we're expecting to see in 2025. So taking that all together, that's about 7% earnings growth in 2026, a deceleration relative to 2025, but still very healthy from a historical perspective.

Allison Nathan: Right. We're kind of penciling that in, though, at this point. I mean, it does feel a ways away.

Ryan Hammond: Definitely.

Allison Nathan: Okay. And if we think about where we are today in investors' mindset, David, we've talked about all this positive momentum in the economy and in earnings. We'll see what third quarter earnings brings. But are you sensing that investors are just getting a bit uneasy investing at what is now record-high levels on the index?

David Kostin: There is some concern in terms of our conversations with portfolio managers, and most of the discussion is around the risk to inflation and the idea that inflation could be higher than the market our investors are expecting. As a consequence, the Fed might therefore cut interest rates less dramatically than is currently expected in the forward market. And that would have a downward effect on the level of multiple for the S&P 500. So I think the inflation rates and valuation are the areas of most concern.

There is relatively less pushback we get on the subject of earnings and profits for most companies. So it's really a valuation story.

Allison Nathan: Interesting. And if we think about the investor base right now, does everyone own the S&P 500 at this point? I mean, it's been a fantastic trade. You would think that people are exceptionally long. Is that the case? And if so, does that present risk in thinking about the forward outlook.

Ryan Hammond: Yeah, so our tools to measure positioning, our preferred tool is the Sentiment Indicator that we built, which looks at positioning for institutional, retail, foreign investors and compares that relative to history. And so the latest reading on that was 0.4 standard deviations stretched. So usually we're looking for something 1.0 standard deviation in stretch territory or negative 1.0 standard deviation in light territory to say positioning is a very clear headwind or a tailwind.

And so from our perspective, it looks like neither a tailwind or a headwind. People have exposure to equities. That has increased in recent weeks as people have gotten more confident about Fed cuts and the state of the economic cycle, but it does not look extreme by historical standards.

David Kostin: Two things can happen at the same time. We see money going into money market mutual funds, inflows into cash. At the same time, equity valuations are rising. Equity index is rising. So from an asset allocation perspective, the weighting of equities in a mixed asset portfolio for the typical individual, households, in mutual funds, pension funds, insurance companies, their asset allocation hasn't really changed. Money goes into cash, equity prices have been rising, and their allocation stays relatively constant.

It is at the highest level in about 70 years, so the allocation to equities is extremely high. To your point, people own the index, the money goes into ETFs, other products that are basically index-light. I think one of the conclusions that we have in our forecast is the idea that perhaps the midcap stocks or an equal weighted index perhaps likely to outperform in the coming year as opposed to the aggregate index where valuations at 22 times earnings are very, very high.

Allison Nathan: I mean, is there any potential buyer of US equities that is underinvested and could come in as new buyers?

Ryan Hammond: We think the main buyer for equities in 2025 will be corporates through corporate buybacks. So we just updated our flow of fund forecast for buyers and sellers of equities in 2025, and we forecast $1 trillion of net buying from corporates, the biggest source of demand. That has been the case for many years, and we think it's going to continue to be the case in 2025.

If you look at the other groups of investors, many of them will be net sellers of equities. Outflows from mutual funds, net selling from mutual funds, net selling from insurance and pension funds. And then really households is one of the more interesting ones, as David mentioned. There's a lot of money sitting in money market funds. Some investors wonder whether or not that money will flow into equities. The historical precedent around Fed cutting cycles suggests that does not always happen. In fact, you do generally see inflows into money market funds still, and so we think households will be on the margin net buyers but relatively small. Really, corporates are the one that we think will be stepping in to buy.

Allison Nathan: So David, how much of this is all going to be impacted by the election? A lot of uncertainty. Are investors pausing ahead of it? And you think that will unwind once the election happens? What are you expecting heading into the end of the year?

David Kostin: So from a tactical perspective, the historical pattern is that equity prices go down heading into an election. Volatility rises and equity prices are weak in the month leading up to the election. And then once the uncertainty is resolved -- by definition, when the election occurs -- the equity market tends to rally. And so if we think about it tactically, perhaps weakness in the coming weeks but ultimately, the end of the year, we would see the S&P 500 index closing at around 6,000. And we look out 12 months, closer to around 6,300. And that's our forecast.

Allison Nathan: So the market seems like it's looking through some of this election uncertainty at this point. What is the biggest risk to your forecast? You mentioned inflation resurging, people questioning whether the Fed is going to cut rates. Is that really the biggest risk you're focusing on?

David Kostin: The biggest proximate risk is undoubtedly geopolitics. So I would say that's the first most present risk. From a fundamental perspective, the US economy seems quite strong. A lot of focus on what the fiscal stimulus is likely to be in China, questions that come up a lot in investor conversations. And the trajectory of economic activity in Europe.

But within the United States, it's actually a pretty optimistic perspective in terms of the unemployment rate staying very low, the economic activity from the GDP growth still pretty strong, and that is what ultimately drives sales and the trajectory of corporate activity.

Allison Nathan: Right. So if the business cycle starts to look like it's faltering again, that's the biggest risk.

David Kostin: That would be a risk, but we don't anticipate that given that CEO confidence has come back, the valuations of the equity market have come back, and so that's a pretty positive backdrop for the market right now.

Allison Nathan: David, Ryan, thanks so much for your time.

David Kostin: Thank you, Allison.

Ryan Hammond: Thank you.

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