SPECIAL REPORT

November 27, 2024

Margins And Multiples: Active Management Required

- Prepare for a volatile phase in the equity bull market. "Buy and hold" will be far from optimal.
- Widespread positive bottom line surprises in Q3 fit with both our "macro calm" baseline scenario and cycle-on-cycle operating margin comparisons.
- Limited room for earnings multiple expansion, with the possible exception of a Big Tech mania. But the Trump agenda limits multiple compression.
- Small caps indirectly benefit from weakness abroad.
- Too soon to accumulate energy stocks, despite supportive Trump policies.

Chart 1 Crosscurrents Facing An Overbought Market

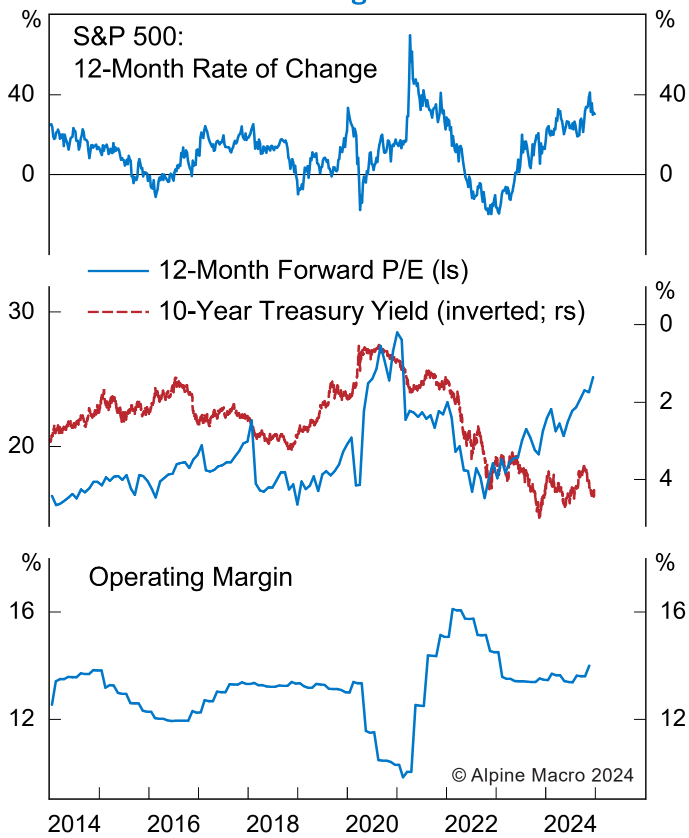


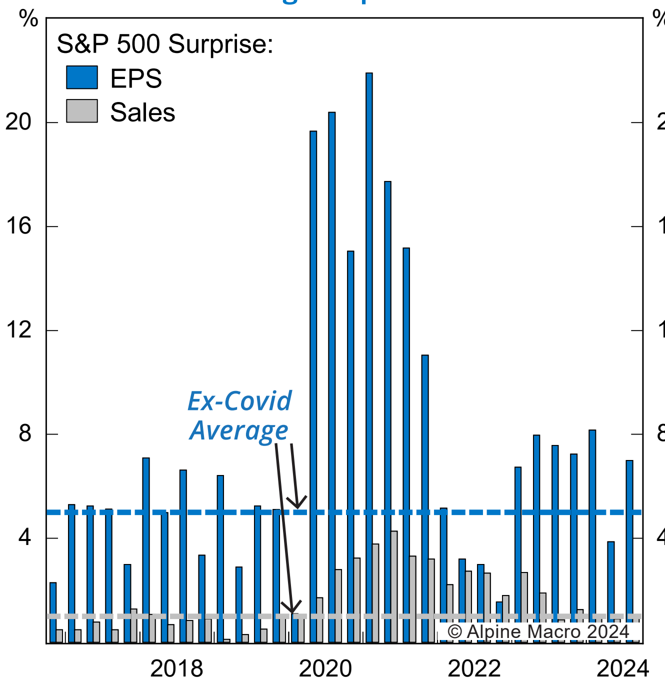
Chart 1 shows the crosscurrents buffeting equity markets. The S&P 500 already is up 32% over the past 12 months and the forward P/E ratio is 9 points above its post-pandemic low in September 2022, even though bond yields are higher than they were back then (shown inverted). However, operating margins are holding up and should benefit from the business-friendly Trump 2.0 agenda.

Several key questions for investors arise from these confusing crosscurrents. Is the equity uptrend intact? Will volatility increase? Finally, will the uptrend remain limited mainly to Big Tech or broaden to other laggards that have begun to move up since mid-year?

This *Special Report* revisits our research on multiples and margins to provide answers to these questions. Similar research gave us the conviction to keep riding the bull market over the past two years.[1]

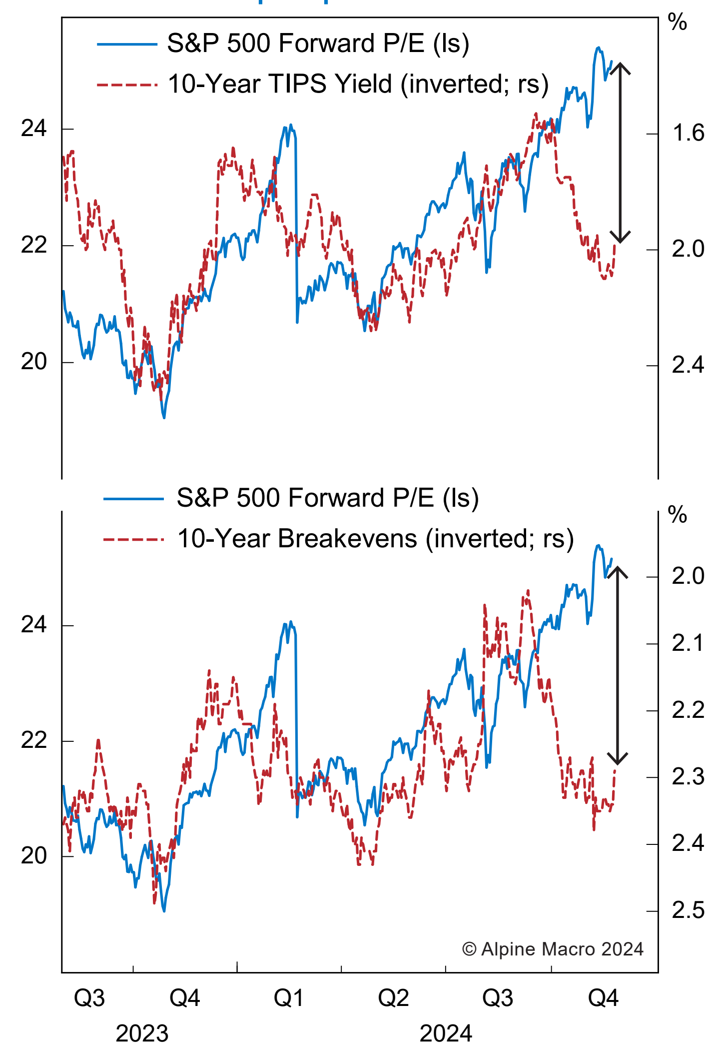
1 Alpine Macro *Monthly Special Reports* "Bad Margin News = Good Equity News?" (October 28, 2022) and "Moderate Downside In Margins And Upside In Multiples" (December 28, 2023).

Chart 2 Boring Economy Underpins Earnings Surprises



Note: Horizontal dotted lines denote averages;
source: Bloomberg Finance L.P.

Chart 3 Bond Yields Constrain Multiple Upside



Much has changed in the interim, but our view remains that the equity bull is not over, and that Big Tech remains a bubble candidate. The uptrend may even broaden, though it will also be volatile and prone to vicious corrections. Small caps are an excellent play on continued U.S. economic outperformance that underpins real yields and the dollar, as discussed in Monday's *U.S. Themes & Strategy*.[2]

Macro Calm, Margins And Multiples

Broadly-based positive Q3 earnings surprises, including for small cap companies, are consistent with our "macro calm" baseline scenario, in which both economic growth and inflation are "boring" (Chart 2). Domestic-oriented companies are especially well positioned, because they are less vulnerable to a strong dollar and weak demand in the rest of the world.

The uncertainty for equity investors is that "macro calm" is a mixed blessing for multiples and margins:

- **Flat bond yields constrain multiple expansion:** Until recently, forward earnings multiples have correlated closely with both the real and expected inflation components of long-term interest rates (Chart 3, shown inverted). So far in Q4, multiples

2 Alpine Macro *U.S. Themes & Strategy* "Self-Regulating Markets And The Trump Factor" (November 25, 2024).

Chart 4 **Multiples About Right At 4% Yield**

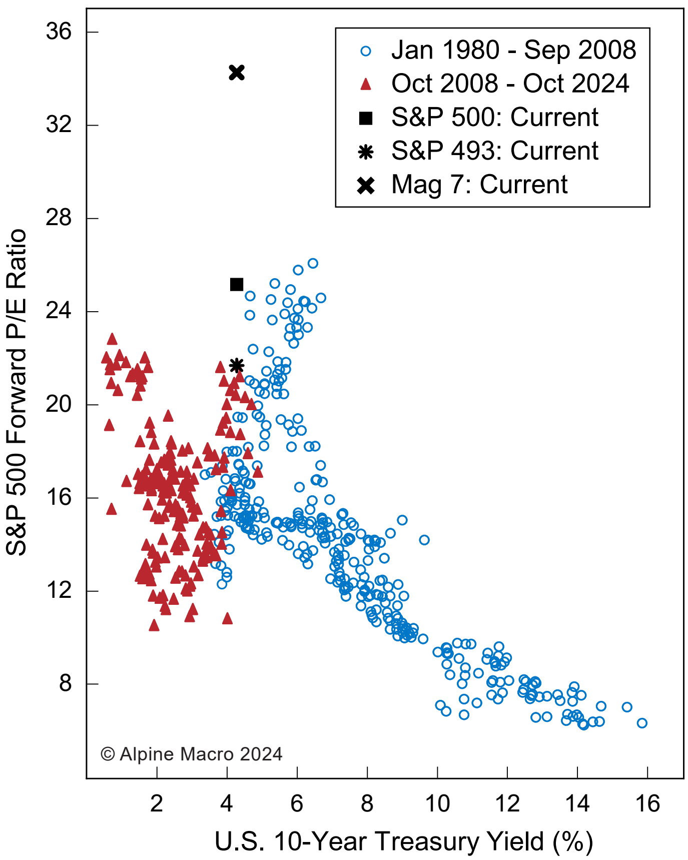
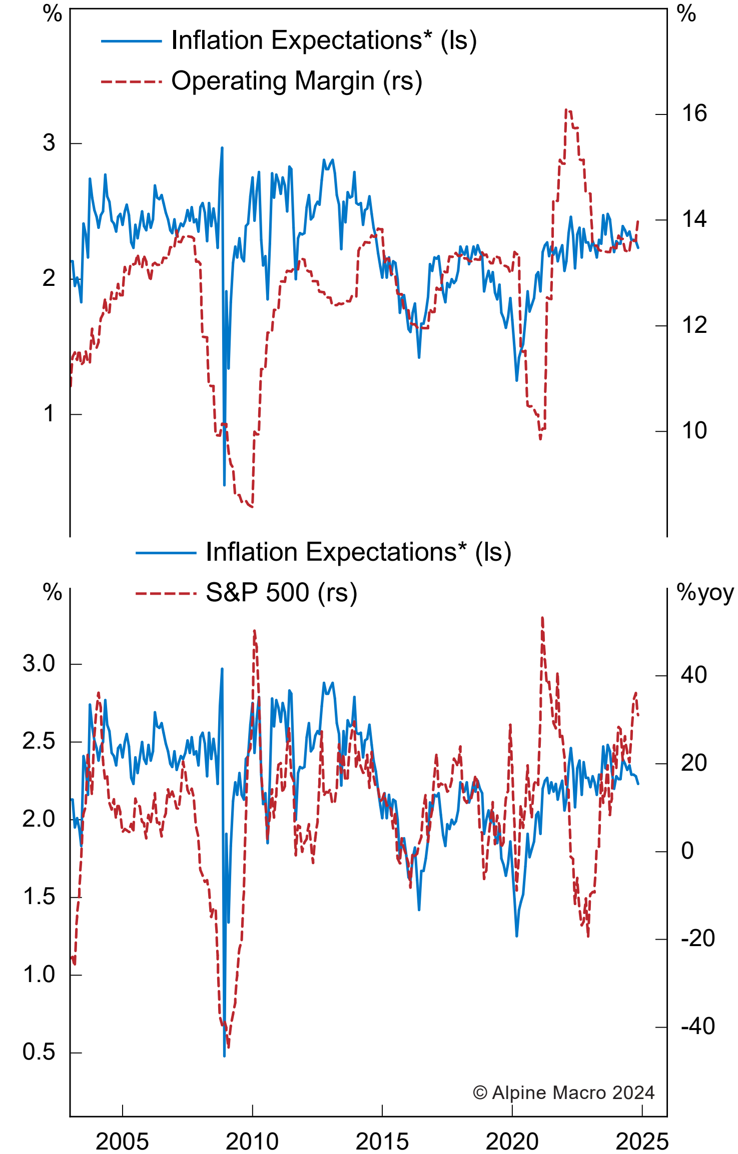


Chart 5 **Positive Correlations With Inflation Expectations Resuming?**



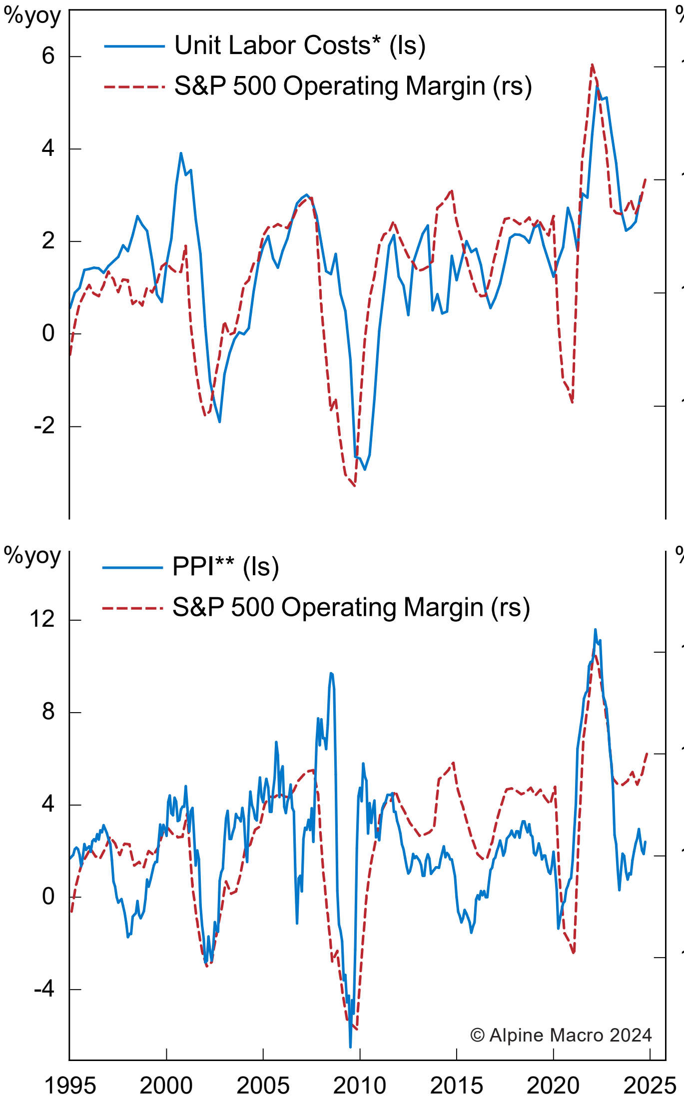
*5-year, 5-year forward inflation expectations

have expanded despite rising yields, but such divergences are not sustainable. Longer-term correlations suggest that "S&P 493" multiples, which exclude Big Tech, may be "about right" with 10-year yields around 4%. However, multiples would be vulnerable if either the earnings multiple or bond yield moves higher from current levels (**Chart 4**).

- **Operating margins correlate with pricing power:** Subdued inflation caps interest rates, but also corporate pricing power, which is the key driver for margins. With the exception of the immediate post-pandemic burst of unanticipated inflation, there is a strong positive correlation between inflation expectations, operating margins and stock prices (**Chart 5**). In fact, margins move with labor costs, not just price inflation, because the latter has much wider swings than the former (**Chart 6**).

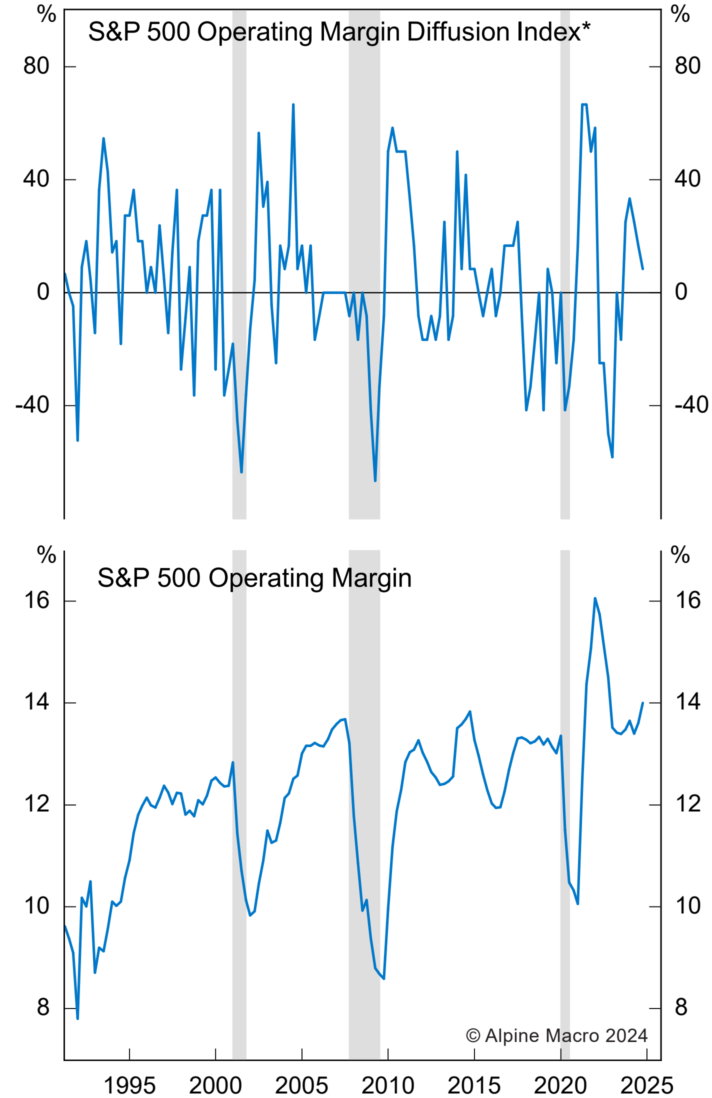
A number of factors point to higher equity prices despite these crosscurrents. First, margin recovery in the current upcycle is only about 1/5th of where

Chart 6 **Good Combination For Margins**



*Shown as 4-quarter moving average
**PPI Final Demand Finished Goods was used pre-2010 and overall PPI Final Demand there after

Chart 7 **Margins Holding Steady**

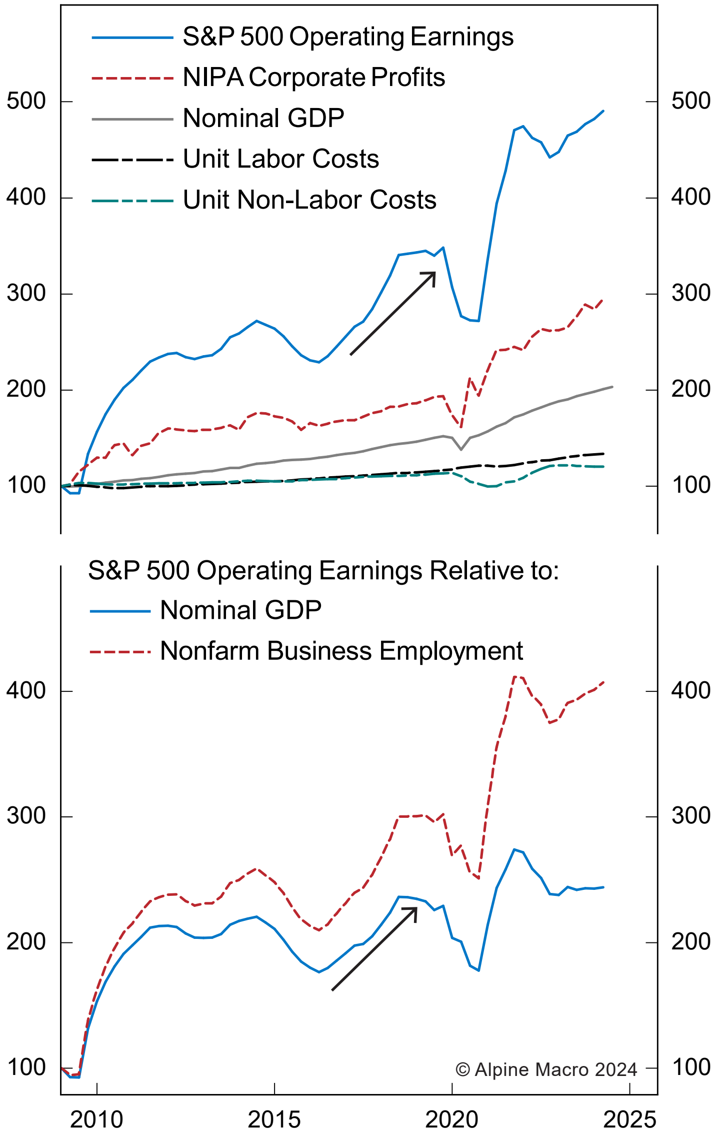


*% of industry group with rising operating margins minus % of sectors with decreasing operating margins
Source: Bloomberg Finance L.P.
Note: Shading denotes U.S. recessions

it generally tops out during expansions. More specifically, operating margins are up 60 bps from their cyclical trough in October 2023, versus an average increase of 390 bps during cyclical expansions. This is consistent with our operating margin diffusion index holding up above the zero line and the level of margins bottoming at the high end of their pre-pandemic range (**Chart 7**).

Second, equities still should benefit from two rare bullish combinations. The Fed will further cut interest rates into an expanding economy. In addition, flat to lower leading employment indicators and rising productivity point to a margin-bullish combination of steady pricing power and lower input costs, given manageable increases in labor compensation alongside lower commodity prices.

Chart 8 Trump Earnings Bump 2.0?



Note: All series are rebased to Q1 2009 =100

Third, Alpine Macro has written extensively about the potential boost to earnings and business confidence of Trump 2.0.[3] **Chart 8** shows the boost to operating earnings relative to GDP and employment during Trump's first term when he cut corporate taxes. This time around, the positives are deregulation and corporate tax cuts, counterbalanced by a delayed headwind from reduced immigration that will be smaller than what was promised in the heat of the presidential election.

3 Alpine Macro *Global Strategy* "Trump Trade, Fed Policy And Investment Strategy" (November 11, 2024).

Bottom line: Equities have further upside, but they will rely more on rising margins than multiple expansion, with the possible exception of Big Tech (see p. 3). However, we assign low odds to either a bond bear market that would trigger outright multiple compression, or a recession.

Strategy Takeaways

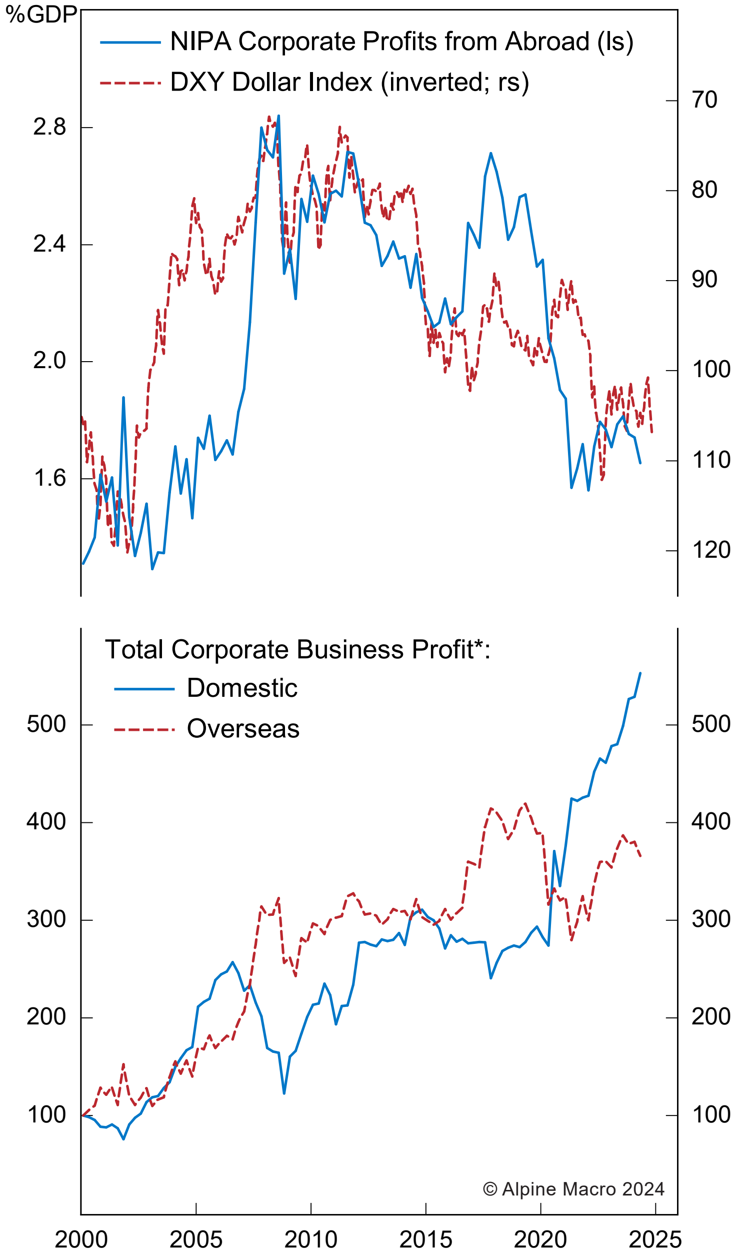
The equity uptrend has become more complex. As a result, a "buy and hold" strategy is suboptimal for equity investors. Getting sectors and style right will generate significant alpha in light of high multiples and limited room for significant Fed easing, barring an economic recession that would hammer earnings.

In addition, the equity VIX has bottomed. Interest rate uncertainty will spur heightened volatility and vicious corrections that could provide excellent entry points.

There are three takeaways from the crosscurrents affecting margins and multiples:

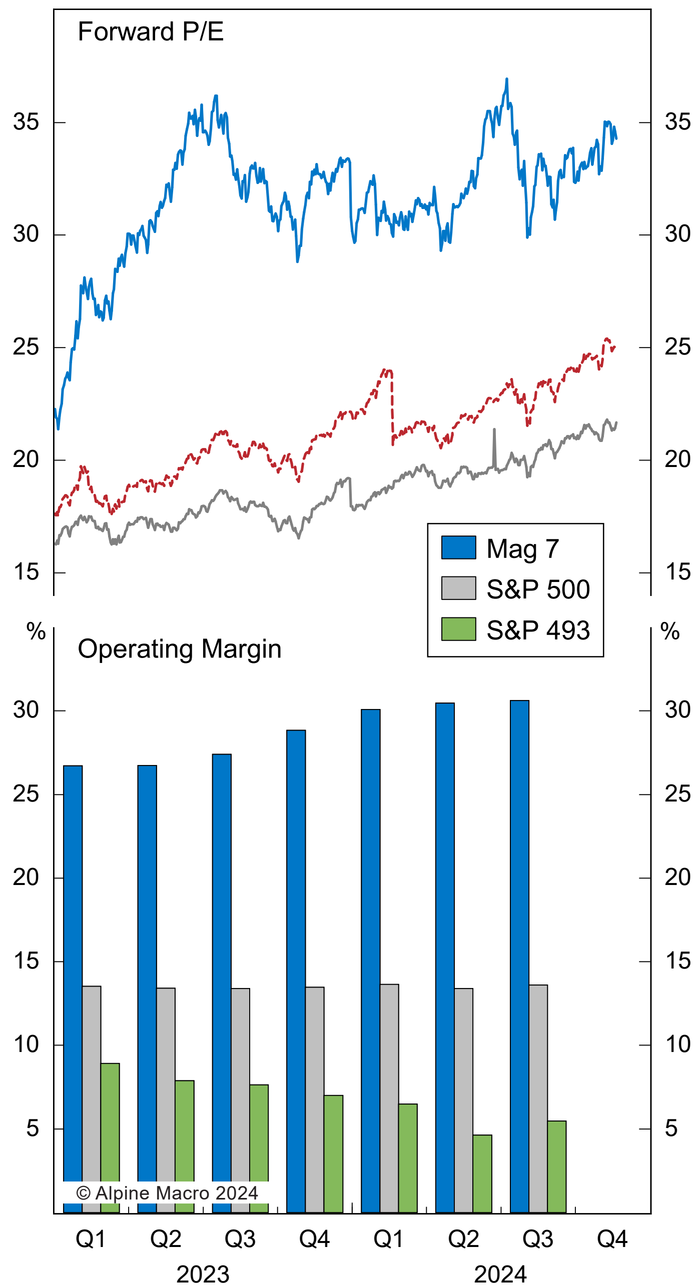
- **Market breadth may well widen:** Small caps have upside as the domestic economy remains robust and interest rates are held in check by softer conditions abroad. Small cap companies generally have less international focus than larger companies. This leaves them more exposed to positive prospective Trump policies while less exposed to negative potential trade implications (**Chart 9**).

Chart 9 Support For Small Caps



*Rebased to Q1 2000=100

Chart 10 Mag 7 Fundamentals Still Robust



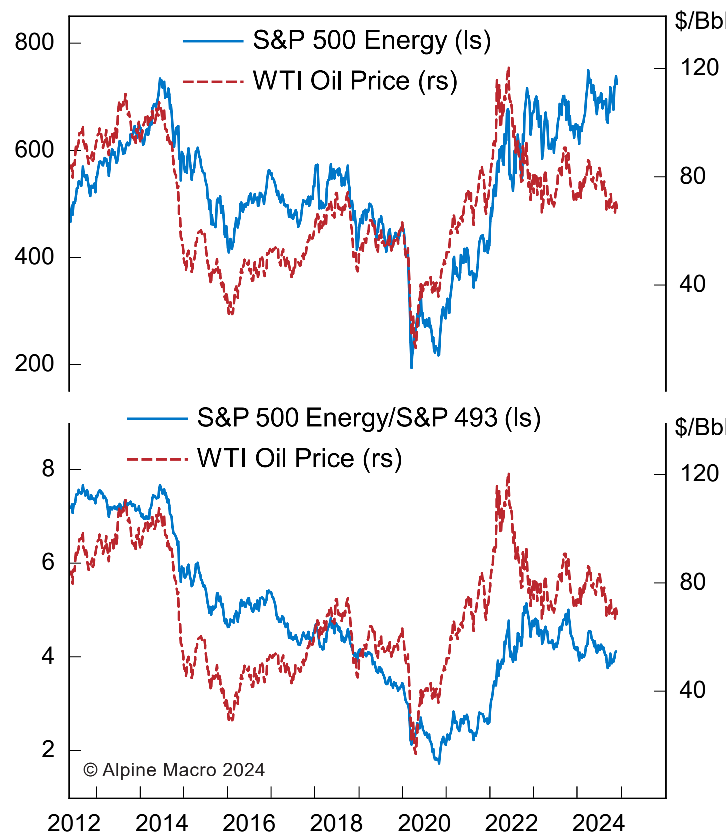
- **Big Tech remains a mania candidate:** Continued margin expansion and strong cash flows, as well as the reduced threat of antitrust action from the incoming Trump Administration, put the conditions in place for a valuation overshoot (**Chart 10**). Margins have expanded significantly and sustainably since the pandemic began (**Table 1**). The desirability of these assets is even more pronounced within the global context of U.S. exceptionalism. That explains why Big Tech have been able to overcome the impact of rising real yields.

Table 1 Big Tech And Energy Margins Have Widened Since Pandemic Began

	Weighting: Current (%)	Weighting: 2014-2019 Average (%)	Operating Margins: Current (%)	Operating Margins: 2014-2019 Average (%)	Operating Margins: March 2020 (%)	Change From March 2020 To Current (% Pts)
Energy	3.4	6.3	12	1.5	2.2	9.8
Materials	2.1	2.8	11.4	10.1	8.5	2.9
Industrials	8.6	9.9	12.3	11.9	11.6	0.7
Consumer Discretionary	10.7	11.9	11	10.2	8.7	2.3
Consumer Staples	5.5	8.6	7.5	9.2	8.4	-0.9
Health Care	10.7	14.4	6.6	10	9.2	-2.6
Financials	13.6	14.6	19	21.5	24.7	-5.7
Information Technology	31.7	21.8	26.7	22.4	22.2	4.5
Communication Services	9	4.4	20.4	17	18.3	2.1
Utilities	2.4	3.2	21	16.9	20.1	0.9
Real Estate	2.1	2.9	23.4	23.7	22.6	0.8
Mag 7	33.3	17.8	30.6	19.1	23.7	6.9
S&P 500 ex. Mag 7	66.7	82.2	5.5	11.2	7.7	-2.2
S&P 500			14	13	13.5	0.5

- **Too soon to boost exposure to energy stocks:** The positive correlation between energy stocks and oil prices has not disappeared, meaning friendly Trump policies to domestic producers will increase supply and weigh on profits (**Chart 11**). Poor oil market action reflects rising U.S. output, OPEC excess capacity and soft Chinese demand.[4] That lends support to ex-energy overall stock margins. We await a shakeout before diving back into energy stocks.

Chart 11 Energy Stocks Vs Crude Prices



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Plus tariffs on canadian crude imports can weigh down on US refinery margins

4 Refer Theme 3 page 8 of Alpine Macro *U.S. Themes & Strategy* "Self-Regulating Markets And The Trump Factor" (November 25, 2024).

A Unique Mind On The Markets