A Unique Mind On The Markets

EQUITY STRATEGY

December 11, 2024

Four For '25: Equity Outlook Positioning

Investors should gear up for what we expect to be a volatile but lucrative 2025 year for U.S. equities, characterized by a reset of expectations that ultimately gives way to new highs as strong fundamental and technical tailwinds prevail.

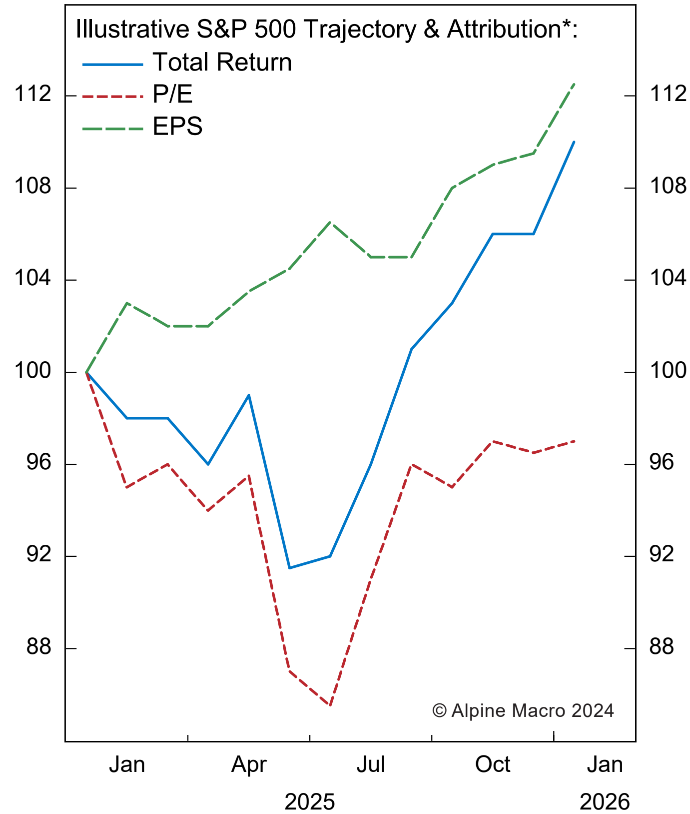
In our view, three major themes will power the path forward for stocks in the coming year: **A) Strong nominal growth with positive mix-shift from inflation to real output, B) Broadening of margin expansion beyond Mega Tech, and C) Policy crosscurrents spanning trade, immigration, taxes, and regulation.**

We expect each of these themes to mature in an uneven manner, which should introduce bouts of episodic volatility, but ultimately the culmination of these views is positive for risk assets, and U.S. cyclical exposures.

A synthesis of Alpine Macro's base views within the context of these drivers helps us identify four conviction equity strategy elements for 2025:

1. **Bullish Drive Toward SPX 7,000**
2. **Overweight Small Caps**
3. **Discretionary Over Staples**
4. **Showtime For Domestic Value**

Chart 1 Earnings Will Likely Drive The Bus For Returns



*All series are Alpine Macro calculations, rebased to Jan 2025 = 100

Drive Towards SPX 7,000

There are more probable pathways for the S&P 500 to advance closer towards 7,000 as opposed to retesting 5,000 or even lower, as our confidence in the earnings power of U.S. large cap equities will more than offset any multiple compression over the intermediate term.

Ultimately, the landing spot for equities involves a fundamental component such as corporate profits and the application of a valuation multiple. The former is generally more projectable than the latter, barring a major shift in the trajectory of economic growth and margins, or the productive ability for businesses to convert revenues to the bottom-line.

Chart 1 illustrates a potential roadmap for equities to churn closer to the next milestone.

Alpine Macro's base case outlook for the nominal backdrop suggests top-line growth in the 4-6% range going forward, meanwhile it's our high conviction assertion that profit margins will continue to expand given secular, cyclical, and potentially legislative tailwinds.

The leveraged power of margins is perhaps understated as every incremental 50bps of profit margin expansion, or compression, is worth approximately $10 of earnings per share (EPS) for the S&P 500 while the same shift in revenue growth translates into just $1-2 of profits. **Table 1** illustrates the projected sensitivity of profits to each variable.

Given our top-line expectations, which are consistent with consensus, coupled with our expectation for wider-than-expected margins we'd expect corporate profits to settle above current estimates towards $280 per share for 2025 and north of $310 in 2026.

An application of the prevailing market multiple of 22.5x to our earnings estimate would infer an S&P 500 level right at 7,000 although we acknowledge

Profit Margin Callout

Margin expansion remains in early stages having just recovered about 1/5 of the average trough-to-peak during upcycles. Three main drivers should continue to push margins higher:

1. Cyclical: Steady pricing power and demand across most sectors coupled with declining unit input costs from labor, materials, and energy

2. Secular: Compositional shift towards asset-lite and productivity enabled business models

3. Policy: Lower taxes & regulation, the former of which is responsible for ~ 25% of margin improvement (**Chart 2**)

Chart 2 Tax Intensity Nearly Cut In Half

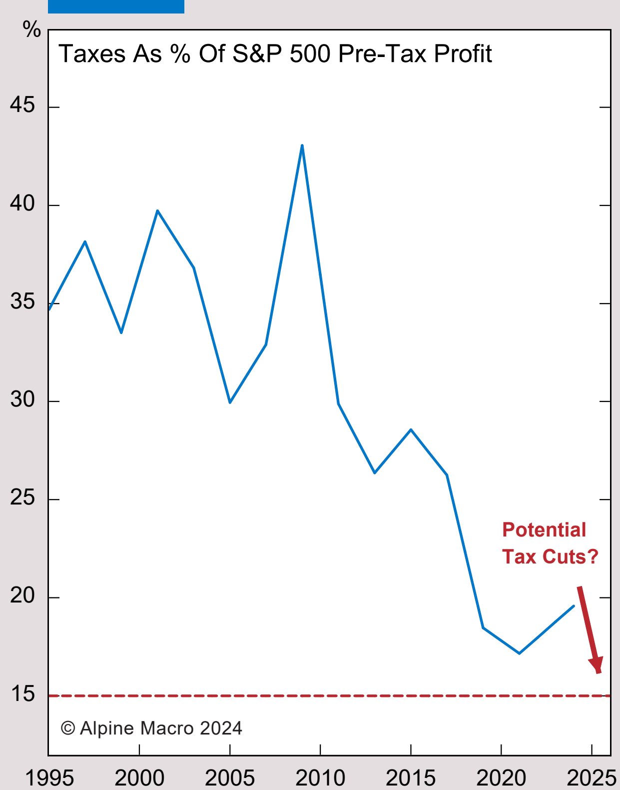


Table 1 Margins Are Major EPS Fulcrum

2025 S&P 500 EPS Scenario Analysis:		Revenue Growth (%) 4.0%	4.5%	5.0%	5.5%	6.0%	6.5%
Margins (%)	12.5%	$244	$245	$246	$247	$248	$250
	13.0%	$254	$255	$256	$257	$258	$260
	13.5%	$263	$265	$266	$267	$268	$270
	14.0%	$273	$274	$276	$277	$278	$280
	14.5%	$283	$284	$285	$287	$288	$290
	15.0%	$293	$294	$295	$297	$298	$300

Note: Projections based on consensus CY24 revenue

that valuation is rich and pinpointing a "fair value" multiple with accuracy is a fool's errand, hence we evaluate probable ranges.

An average of implied S&P 500 values with expected 2026 earnings of $310-315 per share and a forward multiple ranging from 20-23x, which would encompass a slightly conservative array of scenarios tilting towards a dialing back of risk relative to a slight "melt up," produces a price level of approximately 6,700.

If the general validity of these projections proves accurate or investor animal spirits foster "mania" conditions the drive to SPX 7,000 will come into focus over the next 12-18 months.

Biggy Smalls

The recent outperformance of Small Caps represents the early innings for what we expect will be a major mean-reversion move higher as the segment stands to benefit more from cyclical growth tailwinds and public policy shifts in D.C. Animal spirits are building as evidenced by a sharp uptick in small business optimism.

FT has written about this -> U.S. Centricity

Smaller companies should reap the rewards from resilient or accelerating U.S. output coupled with lower unit production costs as pricing power outpaces input costs from labor, materials, and energy. Given the enhanced domestic focus of smaller firms, along with lower economies of scale, these benefits should accrue to them at a magnified rate.

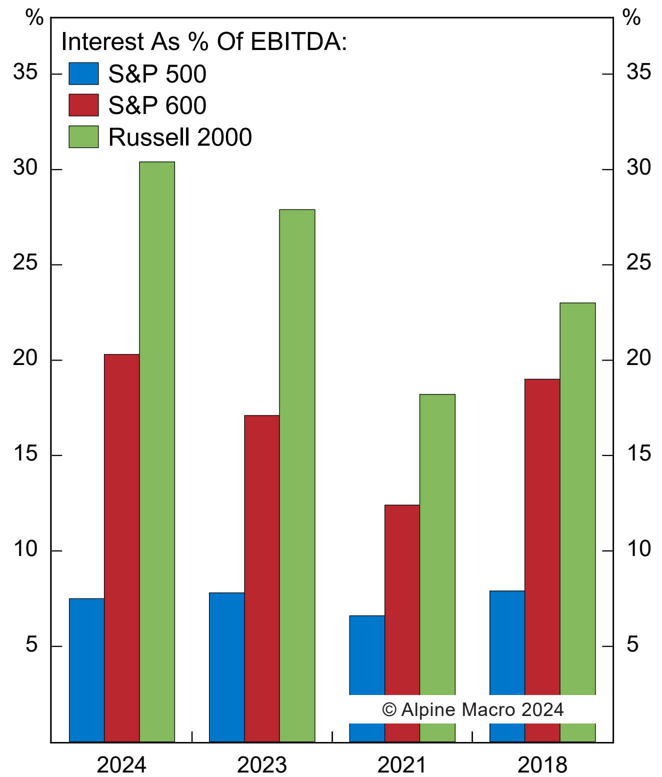
Reductions on the cost of capital are another tangible tailwind for Small Caps which carry a much heavier interest cost burden 3-4x that of Large Caps — in addition to being more exposed to the short end of the yield curve given their more variable and revolving liquidity arrangements (**Chart 3**).

A deep valuation discount for the segment highlights why we view Small Caps as the "mother of all mean-reversion opportunities." Since 2010, the more profitable S&P 600 trades at a 27% discount to its historical average relative to the S&P 500 on a P/E basis and a 30% discount on sales.

If the Small Cap resurgence is to have sustainability there needs to be a fundamental follow-through as the main culprit driving post-COVID underperformance to Large Caps has morphed from valuation to profits. From 2020 through the first half of 2022 the

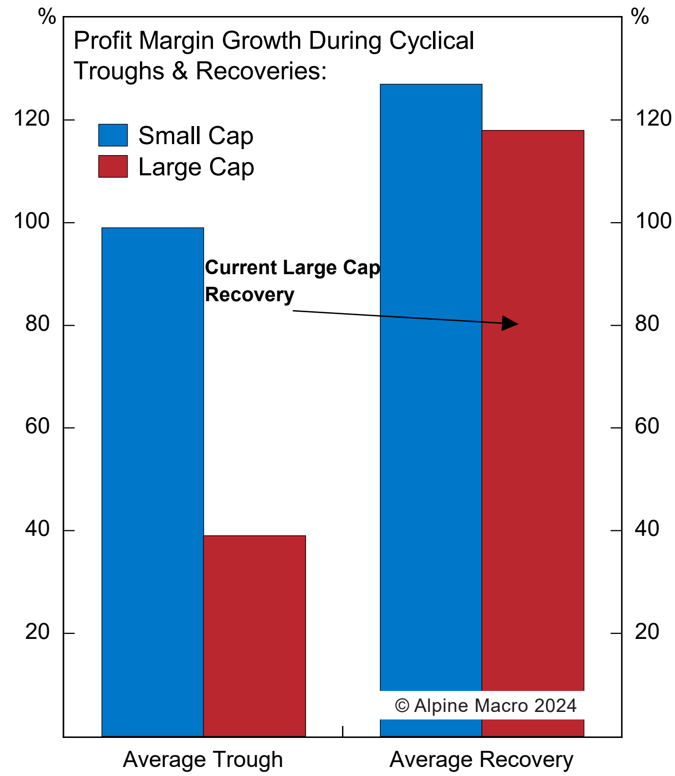
but AM thinks not many rate cuts! hmmmmm

Chart 3 Interest Intensity Is 3-4x For Small Caps



Source: Bloomberg Finance L.P.

Chart 4 Small Cap Margins Expand More In Recoveries Than Large Caps



valuation gap favoring Large Caps over Small Caps grew by 42%. Since that period Small Cap valuation growth has outpaced Large Caps but the earnings trajectory lags by 29%.

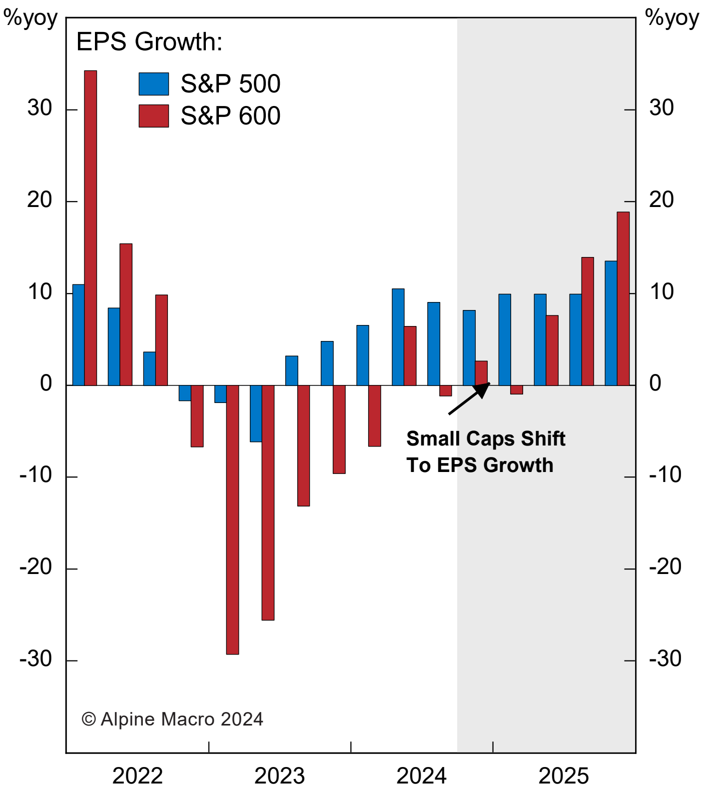
In **Chart 4** we illustrate that the average magnitude of margin expansion for Small Caps following cyclical downturns is greater than for Large Caps. Given that margins are just now troughing for Small Caps the benefits to recovery all lay ahead.

It's "put up or shut up" time for the segment as Q4 is anticipated to be the first in a string of quarters in which Small Caps will post earnings growth before overtaking Large Caps next year (**Chart 5**). Meeting or exceeding expectations would provide proof of concept to the revival.

The new power skew in Washington is a bonus as smaller companies average higher tax rates, endure a heavier regulatory burden, and are insulated from trade spats given their domestic footprint. A pickup in mergers & acquisitions provides an off-ramp for smaller firms, including unprofitable moonshots. A potential downside could come from immigration reform which would prompt labor pressures, especially in lower value, service-oriented industries and construction.

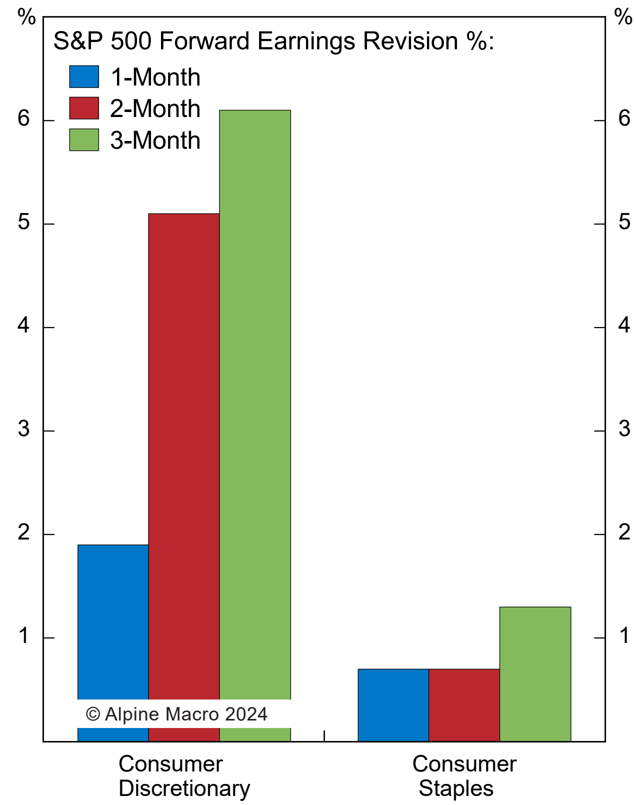
We continue to advocate for a higher quality and profitable focus when allocating within Small Cap, which can be achieved through active management, screening methods, or a focus on the S&P 600, which does a better job in controlling for profitable firms.

Chart 5 The Time Has Come For A Small Cap Earnings Revival



Note: Shaded area denotes estimate period; source: Bloomberg Finance L.P.

Chart 6 Discretionary Momentum Surging Past Staples



Note: Data as of Dec. 10, 2024; source: Bloomberg Finance L.P.

Discretionary Over Staples

One of the more direct ways to express our base case for a resilient consumer-led growth backdrop is by favoring Discretionary exposure relative to Staples, which is congruent with the historical performance trends during Recovery Phases of the cycle.

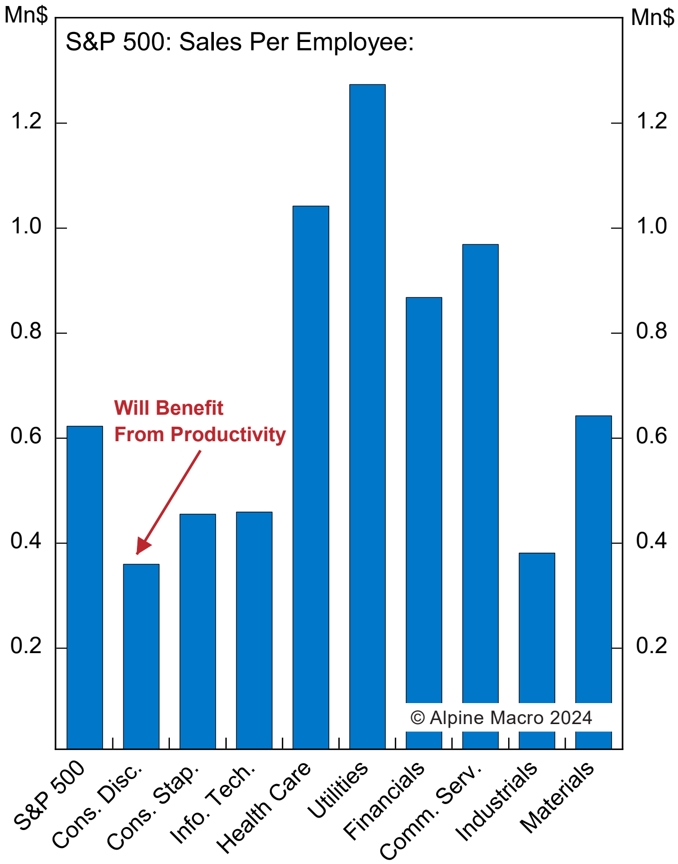
As we wrote in our October strategy report[1], the sector has been the third worst performing during periods of more accommodative policy and abundant profit growth, which is the antithesis of the growth starved environment in which Staples would otherwise be expected to outperform.

1 Alpine Macro *Equity Strategy* "Pushing Down On Staples" (October 31, 2024).

It's not just normal cyclical perturbations that weigh on Staples, but rather the unique Pandemic tailwinds that the sector enjoyed have evolved into headwinds as the pantry destocking process leads a downtrend in organic sales growth while companies increasingly lose pricing power as consumers downshift to cheaper alternatives in rebellion of higher costs. A mix-shift trend in spending towards less profitable consumables (ex. groceries) adds to pressures.

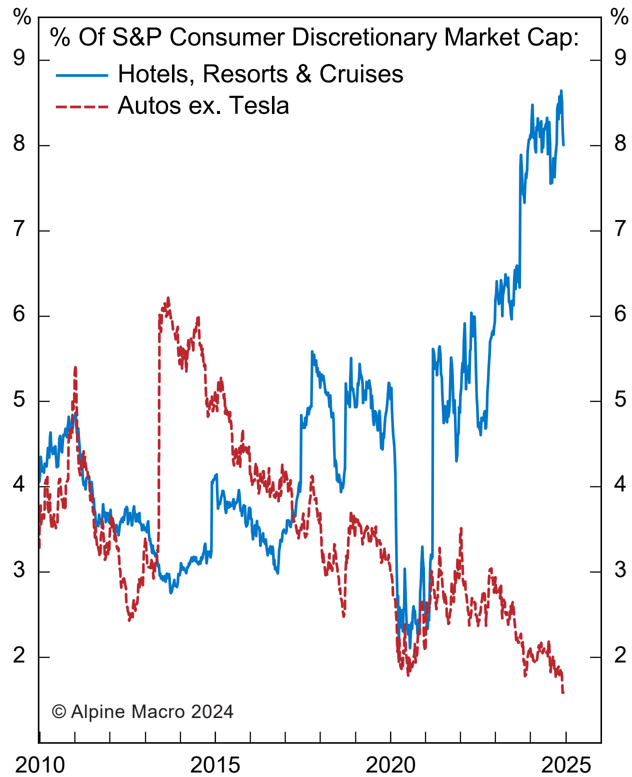
Meanwhile, Consumer Discretionary is on a heater having outperformed the S&P 500 by nearly 20ppts since September as resilient U.S. growth has allayed fears of a consumer slowdown, prompting investors

Chart 7 Discretionary Is The Most Labor-Intensive



Note: Excludes Energy & Real Estate; source: Bloomberg Finance L.P.

Chart 8 Legacy Autos Flail While Leisure Gains Prominence



Source: Bloomberg Finance L.P.

to reduce the probability of downside-risk scenarios and recalibrate expectations higher (**Chart 6**).

It certainly helps that the two largest constituents within the sector have been among the best performing and the leaders with regards to upwards earnings revisions, contributing to a surge in technical and fundamental momentum. However, Discretionary is also outperforming within the Small Cap space, demonstrating fundamental consistency and meaning this isn't a one-trick pony.

The upside for Consumer Discretionary is that it sits at the forefront of rotating consumer demand across various segments of goods and services but resilient, or even accelerating, U.S. nominal growth should ensure that the aggregate spend level remains robust while a jolt to productivity is a major boon for profitability.

As **Chart 7** shows, Discretionary is the most labor-intensive of all sectors making productivity growth and a rightsizing of the labor footprint, a crucial fulcrum for operational leverage.

We see three risks to a more bullish thesis on Discretionary:

1) Potential trade frictions which could disrupt a sector heavily dependent on global supply chains and cross-border transactions

2) Some form of mean-reversion to pockets which have powered gains including the Hotels, Resorts & Cruise industry along with a Mega Tech Auto

3) The furious pace of advance in recent months which has made the sector technically overbought

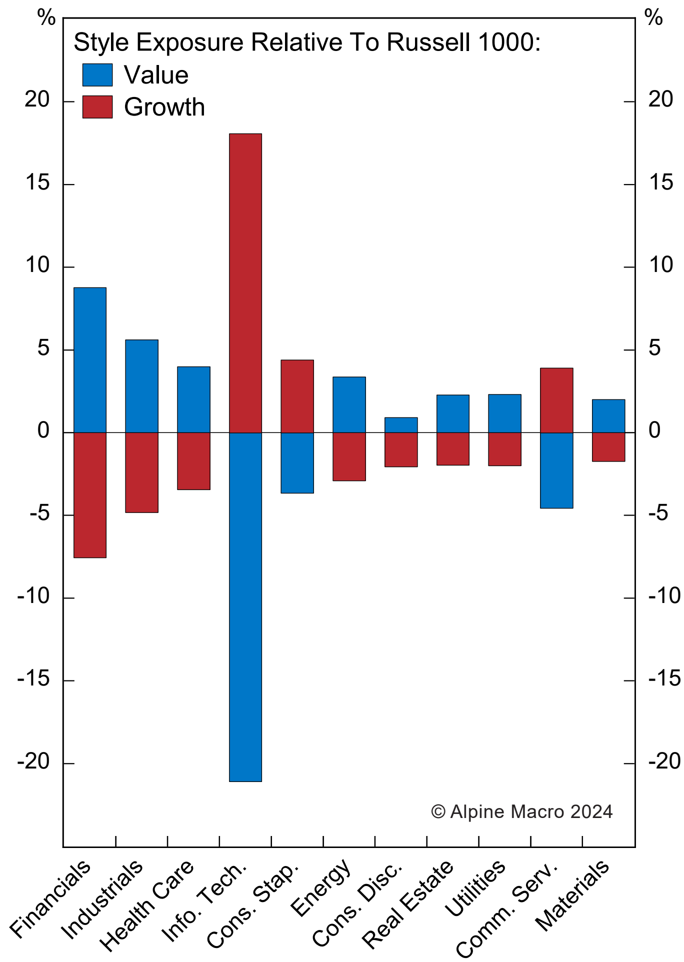
Within Discretionary there's no letup yet in the Hotels, Resorts & Cruise industry while Retailers with strong digital execution serving domestic end-markets are well positioned. Alternatively, we're wary of ex-Mega Tech automotive exposure given weak global demand and policy implications. Restaurants will face margin pressure given labor cost concerns and a race to the bottom in pricing due to "value wars," but Homebuilders could be a source of oversold value as rates settle lower (Chart 8).

Showtime For Domestic Value

If Value is ever going to shine, current conditions are close to ideal for many components as the style and accompanying sectors typically perform well through the Recovery Phase with policy becoming more accommodative and earnings growth broadening.

The fundamental case for Value stems from the benefits of higher nominal growth alongside an inflection higher for productivity which should boost growth and profitability for a style in which each is generally scarcer. However, the dual-track growth trajectory separating the U.S. from other regions means that not all Value sources are primed for outperformance.

Chart 9 Value Is A Play On Financials Vs Tech



Source: Bloomberg Finance L.P.

The rubric for Value segments includes evaluating:

A) **International exposure of revenue and supply chains**

B) **Reliance upon global commodity prices**

C) **Interaction with interest rates**

Companies with a concentrated U.S.-orientation are better positioned to withstand the effects of slower international growth and potential trade snarls while we'd also favor beneficiaries of moderating rates and a steeper yield curve ("bull steepener") consistent with Alpine Macro's base case outlook.

These conditions favor Financials, Real Estate, and Utilities, alongside swaths of Industrials and Health Care as we'd expect them to capture the upside benefits of broadening profit growth alongside lower rates (**Chart 9**).

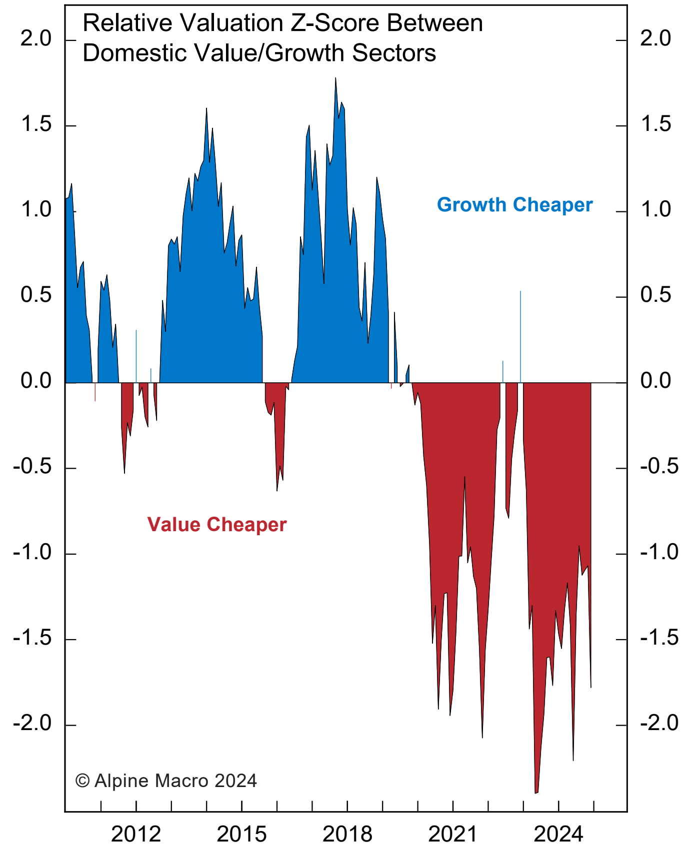
It's worth mentioning that although many of these favorable Value pockets have rallied valuation remains tame relative to Growth and provides a runway of opportunity. **Chart 10** illustrates the discount that persists for preferred Large Cap Value segments relative to Growth.

As noted, investors should avoid segments vulnerable to outsized exposures to international supply dynamics and end markets. These would include food and beverage companies with Staples, legacy Autos and certain retailers within Discretionary, and even components of Semis and Hardware within Information Technology.

It's worth highlighting the unfavorable supply and demand imbalance affecting many commodity markets which could be exacerbated by a U.S. regime waving in additional capacity. This keeps us sidelined from Energy and Materials although interesting opportunities present themselves given regional production cost spreads and drilling activity which could benefit some North American operations and servicers.

To be clear our expectation for these identified Value sections to outperform is driven by their favorable alignment to our outlook and not an indictment against Growth, in fact a prudent asset allocation

Chart 10 Domestic Value Sectors Are Cheap



Note: Domestic Value sectors include Financials, Industrials, Health Care, Real Estate, and Utilities. Growth includes Info. Tech, Comm. Services, Discretionary, and Staples, valuations are market-cap weighted; source: Bloomberg Finance L.P.

technique could involve a barbell of Large Growth with Small Cap to optimize risk-adjusted exposures to quality growth alongside cyclical value.

Conclusion

The two most acute risks to our positioning outlook would be: 1) a rapid deterioration of growth, and/or 2) stubborn inflation putting upward pressure on rates and yields. The culmination of either risk would likely auger for a retreat away from rate-sensitive Cyclical Value towards Defensive Growth, which includes Mega Tech. This is not our base case.

While investors should expect bouts of episodic volatility throughout 2025, the Alpine Macro baseline view calls for a solid form of “goldilocks” conditions that should ultimately propel stocks higher. These conditions will favor U.S. cyclical exposures and present the opportunity to unlock coiled value in segments beyond Mega Tech.

Nick Giorgi
Chief Equity Strategist

Investment Recommendations				
Strategic Recommendations (6 - 12 months)				
Recommendations	**Open Date**	**Performance**		**Active Return**
		Vehicle	**S&P 500**	
Long S&P Industrials	5/29/2024	14.50%	14.53%	-0.03%
Long S&P Utilities	6/12/2024	11.70%	11.27%	0.43%
Long S&P 600	6/24/2024	16.74%	10.73%	6.01%
Short S&P Materials	7/24/2024	1.00%	11.14%	10.14%
Long Regional Banks (KRX)	8/21/2024	17.92%	7.33%	10.59%
Long/Short S&P 500 Healthcare Equipment & Supplies/Providers & Services	10/23/2024	0.20%		0.20%

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