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MACRO MORNING BRIEFING

July 12, 2024

US Equities 2Q Earnings and 3Q Outlooks

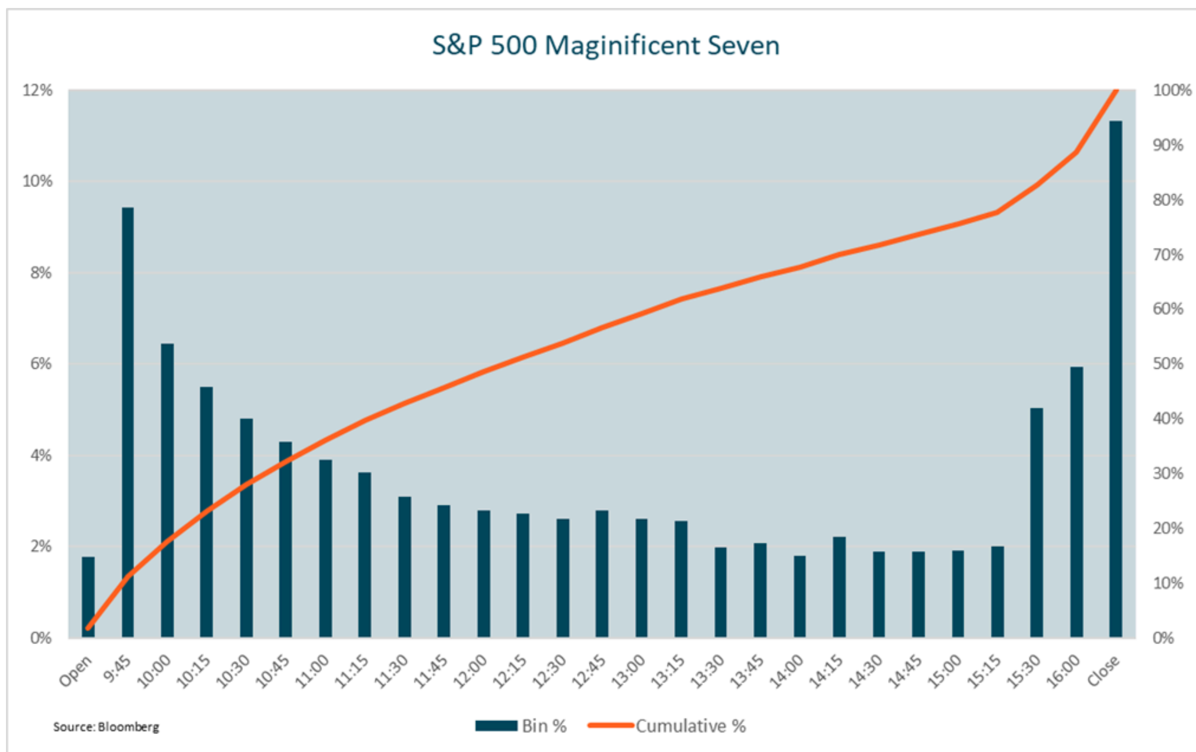
The second quarter earnings outlook has not been pushed down during the usual "confession" period. This increases the risk for dispersion of outcomes as markets punish misses and may not have as much joy for the winners. The secular trends of equities toward lower volatility and more programmatic trading leaves the risks skewed toward negative liquidity surprises. The search for diversity to rotate from US exceptionalism will be an important focal point over the next three weeks of earnings reports. A bottom-up analysis of the macro world looks at odds with the top-down view on growth.

- ETF use – previously a holding tool for active managers before they put money to work in individual names, has become the most significant trend in asset management now. Active ETFs replace other asset management strategies – more money is made in creating an ETF than in performance. This is about the nature of asset management, hedge funds, tax structure and fees, making the shift secular.
- The first and last 30 minutes of trading in markets in the US and Europe represent most of the volume on any given day – suggesting program trading drives outcomes as flows reflect orders. The focus on just a few large-cap names adds to concerns about overall market liquidity.
- The increase in concentration of holdings in the S&P 500 has been a consistent worry for investors throughout 2024. There are a few points about this risk worth considering in 2Q earnings – **the diversification of large tech names begs for sector definitions**. For example, does the size of Amazon's AWS business make it a tech company, or do its high-end retail sales make it

consumer discretionary? What about the new health care rollout and drug sales? Markets struggle now like they did in the 1960s with the conglomerates then being created.

Putting these factors together, we can see that market liquidity in 2Q around earnings will be an important consideration given the level of prices. The S&P 500 has set 37 record highs so far in 2024 and is on track for its best performance since 2021. The risk of price reversals to earnings misses seems high, but not for all sectors. The chart in Exhibit #1 shows how the S&P 500 shares of the "magnificent seven" names trade significantly more at the open and close than during the day – with the surge in volume by time representing 35% of the day's volume in just the first 30 minutes and last 30 minutes of trading.

Exhibit #1: Volumes show programs beat active trading

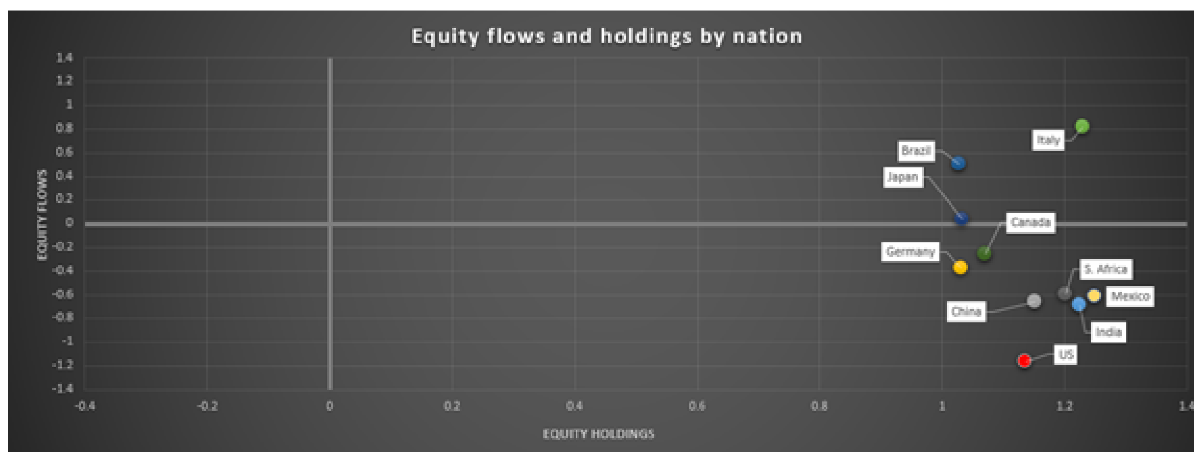


Source: Bloomberg, BNY

The positioning of shares globally according to our iFlow data is long equities in G10 and big emerging markets. The overall mood for risk into earnings has been notable as well, with the indicator up at significant positive levels for nine data in the 99.2% percentile. The S&P 500 has gained 55% since the lows of October 2022 – but 58% of that advance has come from just the top ten stocks in the benchmark. The market

skew in 2024 stands out. The S&P 500 is in its 11th longest stretch without a 2% down day since 1928, according to Ned Davis Research. The risks of further political uncertainty, further economic weakness in China or Germany, more geopolitical risks or natural disasters – all seem underpriced.

Exhibit #2: US holdings vs. flows stand out



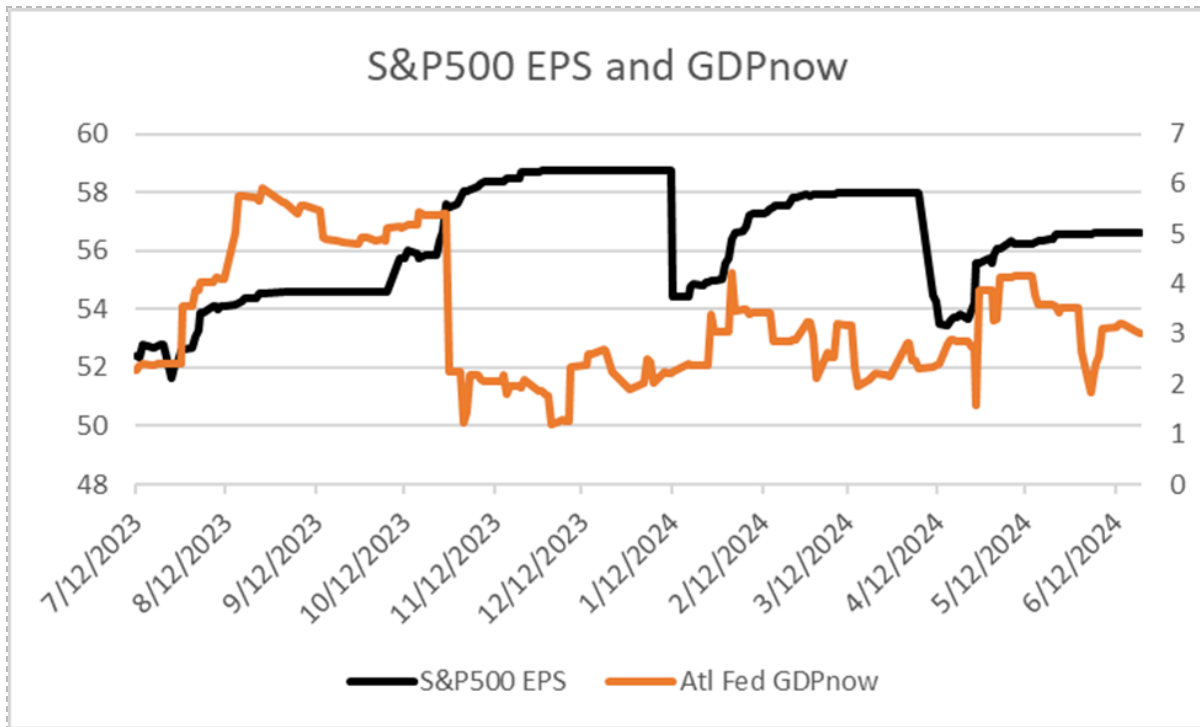
Source: iFlow, BNY

The history of unwinding concentration risk in one sector into others is checkered. Many investors feared a 2007 crash when financials and leverage dominated global shares. Today, many see a similar dependence on IT and AI investments as a risk. For equity rotations to smooth over returns, many expect a shift in both global holdings to “growth” and “value” factors rather than the current chasing of momentum via investments in technology. The real economic cycles at play matter significantly, but because some of the large-cap technology names do more than just technology, sector analysis breaks down. Further, some of the factors, such as value, can shift if big companies increase dividends. The logic of rotation saving stock market performance in a slowing US economic environment will be evaluated in the coming months.

The role of bonds and the US dollar in driving stock market prices is more important than earnings over the longer term. The S&P 500 has posted forward returns of 9.9% in the 12 months immediately following periods of global central bank-coordinated easing. Logically, the September easing expectations for the FOMC are just as important to the S&P 500 3Q outlook as the bottom-up earnings view, but so is the divergence of SNB, Riksbank, ECB and BOC policy in 2Q. Growth of the US

economy against the S&P 500 EPS seems more correlated, but not sufficient to explain price action alone.

Exhibit #3: Growth does matter to earnings



Source: Bloomberg, BNY

A quick primer on rotation

The stock market is divided into 11 sectors, including energy, materials, industrials, consumer discretionary, consumer staples, health care, financials, technology, communication services, utilities and real estate. Sector rotation is an investment strategy that involves moving money between sectors to always stay in the best-performing sectors, often using exchange-traded funds (ETFs) that track specific sectors. The business cycle is divided into four phases: recession, bull market, peak and bear market, with specific sectors outperforming at different points in the cycle.

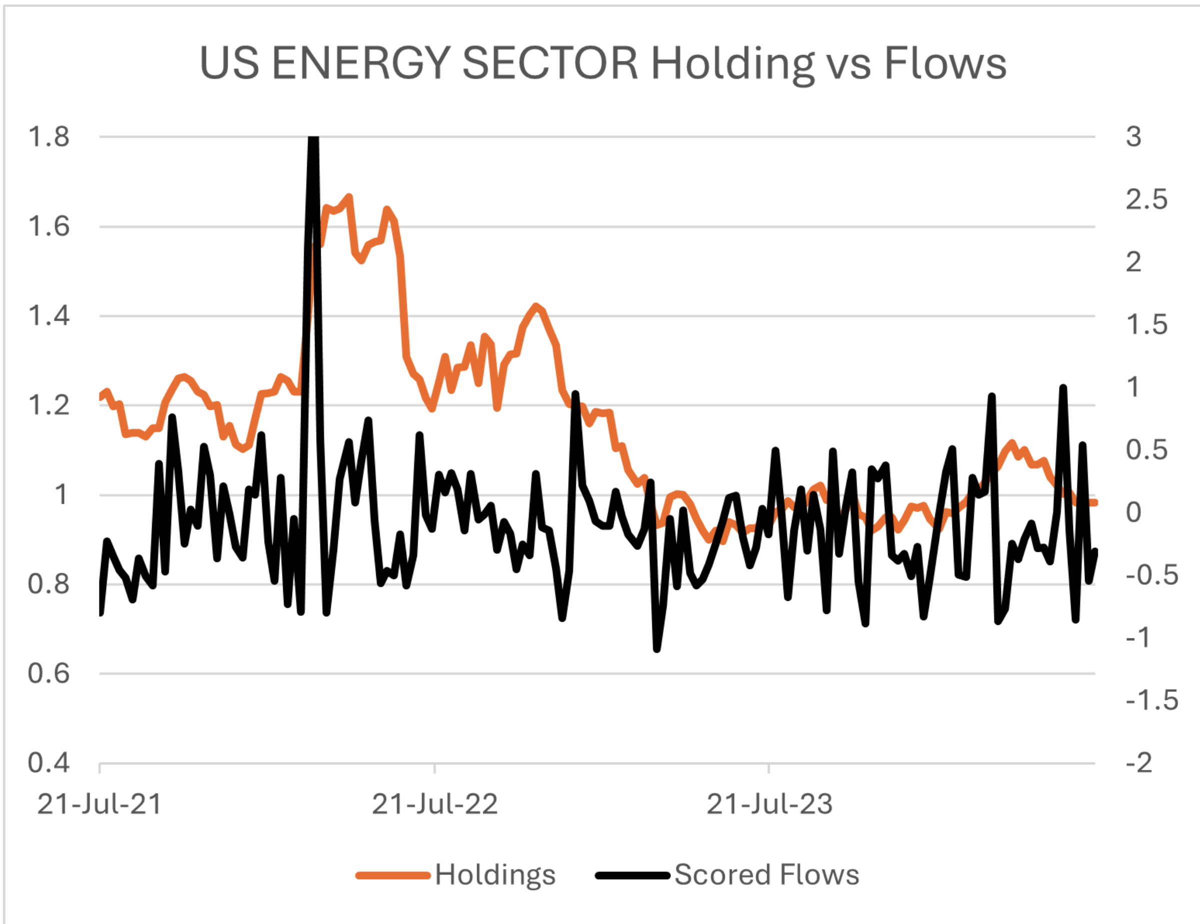
A 2007 study found that sector rotation strategies tend to underperform simpler strategies, calling into question the conventional wisdom of sector rotation as an optimal investment strategy. The US economic cycle is unique due to factors such as pandemic stimulus money, divergence in demand for goods and services, and high inflation countered by higher interest rates. The return to a pre-pandemic labor market but not to below-trend growth or wages has complicated economic outlooks. “Soft-landing” scenarios in sector program strategies are rare. Despite this, traditional patterns of sector performance during different economic phases are still

relevant and may become more important should the economic data point to a larger slowdown or a bumpy landing to US growth.

The risk for markets in 3Q may be in how consumers act when companies try to push through inflation to maintain margins, and how companies shift down their workforce to improve profits. There is a balancing act for risks in the FOMC policy story ahead. The iFlow equity to bond correlation has been volatile – moving from 0.55 positive correlation back to 0.44. Many portfolios work better when stocks are negatively correlated to bonds. The seasonality of this correlation is also part of the story – with July up 2.3% for the S&P 500 over the last 20 years but not anywhere close over the last 50 years. The correlation of this to volatility (VIX and CVIX) is also part of the bigger picture risk for this summer being different than in the last ten years.

Theoretically, we should see a rise in energy sector investment flows in anticipation of higher growth driving higher use. However, this is complicated by the carbon vs. green focus from climate control agreements. Further, we should see more recoveries in the financial sector. But banks are not expected to perform well in 2Q earnings compared to other sectors given net interest income stalls with higher for longer Fed policy and credit card and commercial real estate loan loss provisioning. As we can see from the equity holding of the US energy sector vs. our flows, there is no clear rotation play for the US market going into earnings. The consensus after the next three weeks could be critical, as could the outcome of the US election, with policies over energy important to investment flows and prices ahead.

Exhibit #4: Energy doesn't reflect a rotation play



Source: iFlow, BNY

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Please direct questions or comments to: iFlow@BNY.com

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