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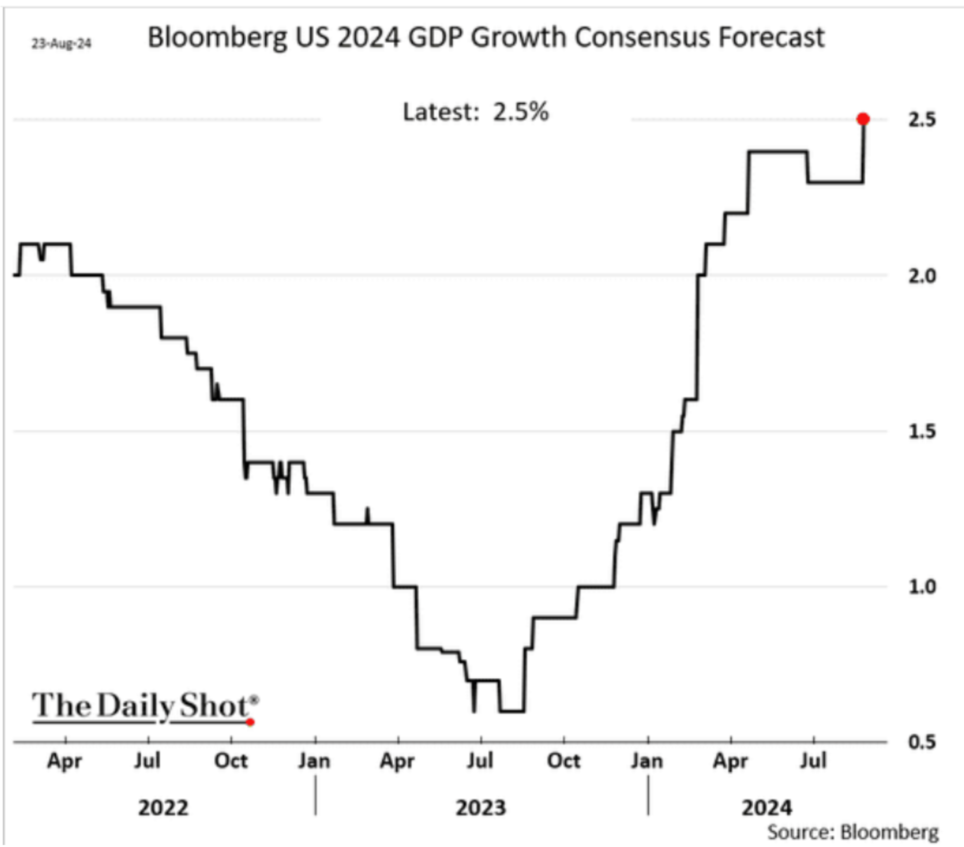
What To Expect When You're Expecting...

It's tempting to think that US stocks are struggling with earnings, but that's not quite right. The real issue here is expectations. Markets are brimming with optimism—banking on 3% real GDP growth in the second half of 2024, a 16% year-over-year surge in earnings by the end of 2025, and an AI-driven future that somehow justifies 21x earnings multiples. These sky-high expectations set the stage for disappointment. And when expectations are this lofty, there's not much room for error.

U.S. Stocks: Not An Earnings Problem, But An Expectations Problem

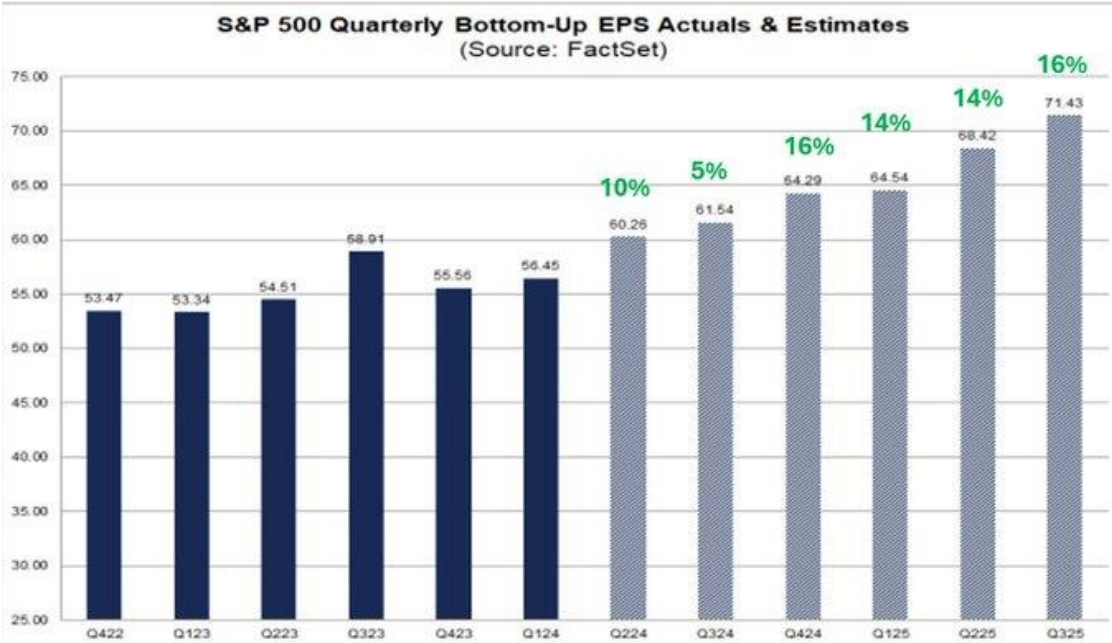
Let's start with the short term. Growth expectations for the US economy remain strong, perhaps a little too strong. If you're aiming for 2.5% growth for the year and already recorded around 2% in the first two quarters, you'll need nearly 3% growth in the second half of 2024. That's pretty ambitious. When the market is pricing in that kind of growth as the baseline, it doesn't leave much cushion for any surprises.



[1]

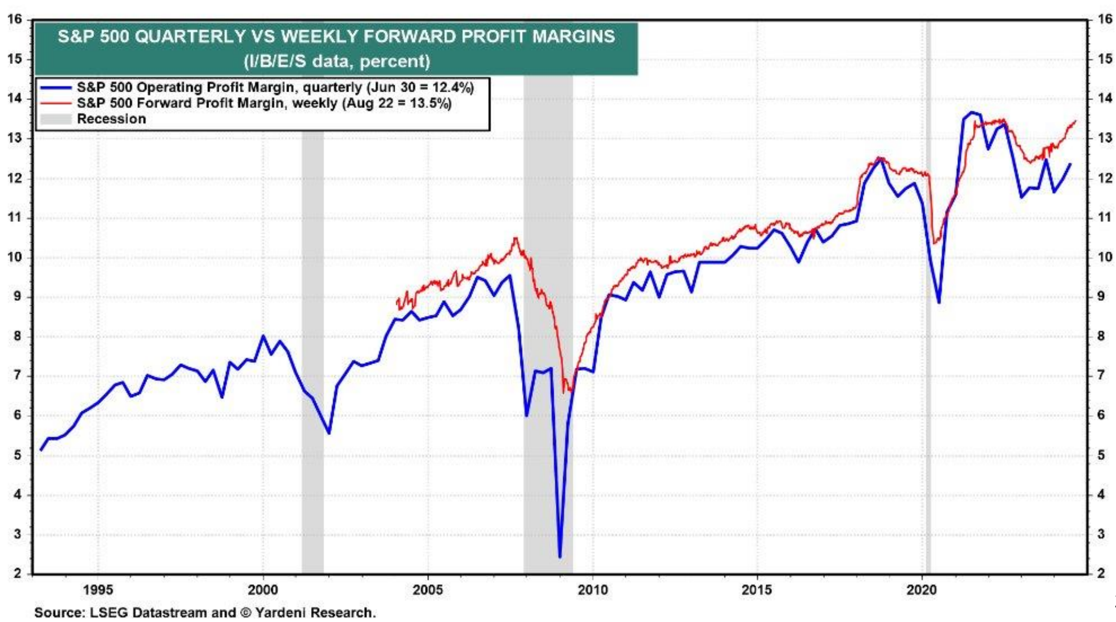
Then we move to the medium term, where earnings expectations are equally elevated. This quarter brought the first meaningful positive earnings growth in a while, which is great. But the forecast calls for a brief lull next quarter, followed by rapid earnings growth through the end of 2025.

[1] Bloomberg database.



[2]

With revenue growth projected at around 5-6%—not far off from current nominal GDP—achieving over 15% earnings growth means a big surge in profit margins, pushing them to new secular highs. Again, not impossible, but far from easy.



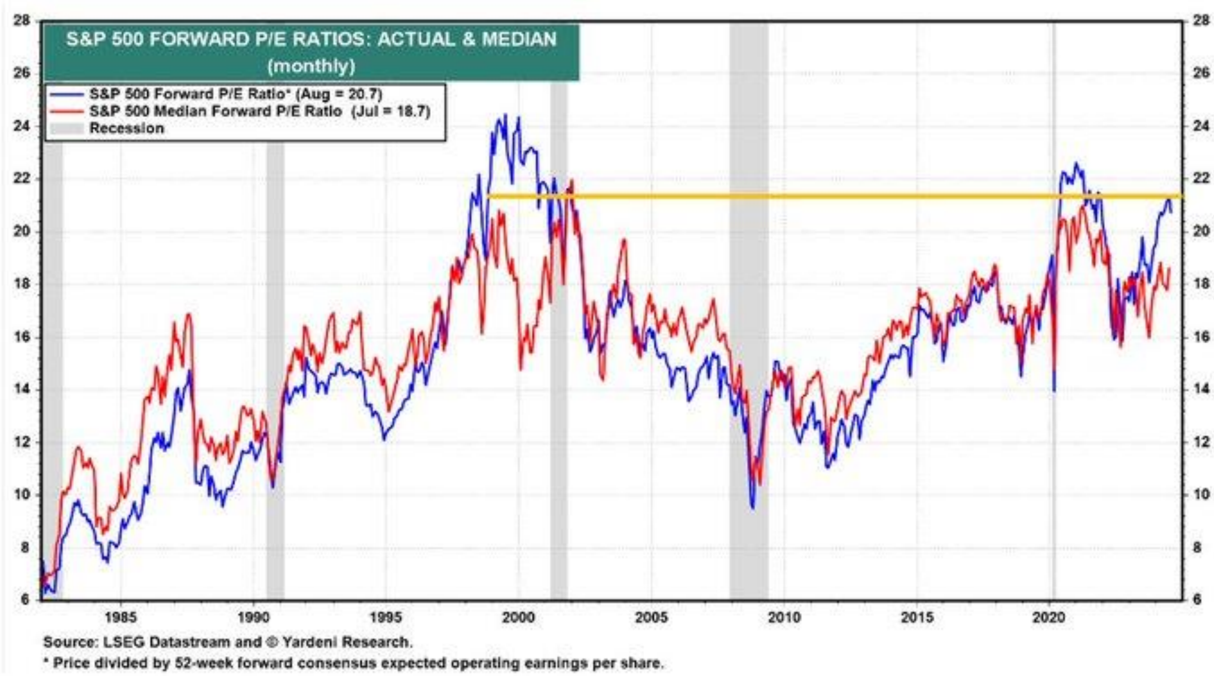
[3]

And then there's the long-term view. Price-to-earnings (PE) ratios are hovering just below all-time highs. Why? The story goes that AI will revolutionize everything, creating a new era of productivity growth and investment. The AI believers argue this is enough to justify those elevated valuations. But even if we buy the premise of an AI boom, the math doesn't quite work out. To get to the double-digit earnings growth

[2] Chart provided by Factset.

[3] Chart provided by Yardeni Research.

rates the techno-optimists are touting for the next decade, you'd need more than just a productivity surge; you'd need profit margins to expand at a rate far beyond anything we've ever seen.



[4]

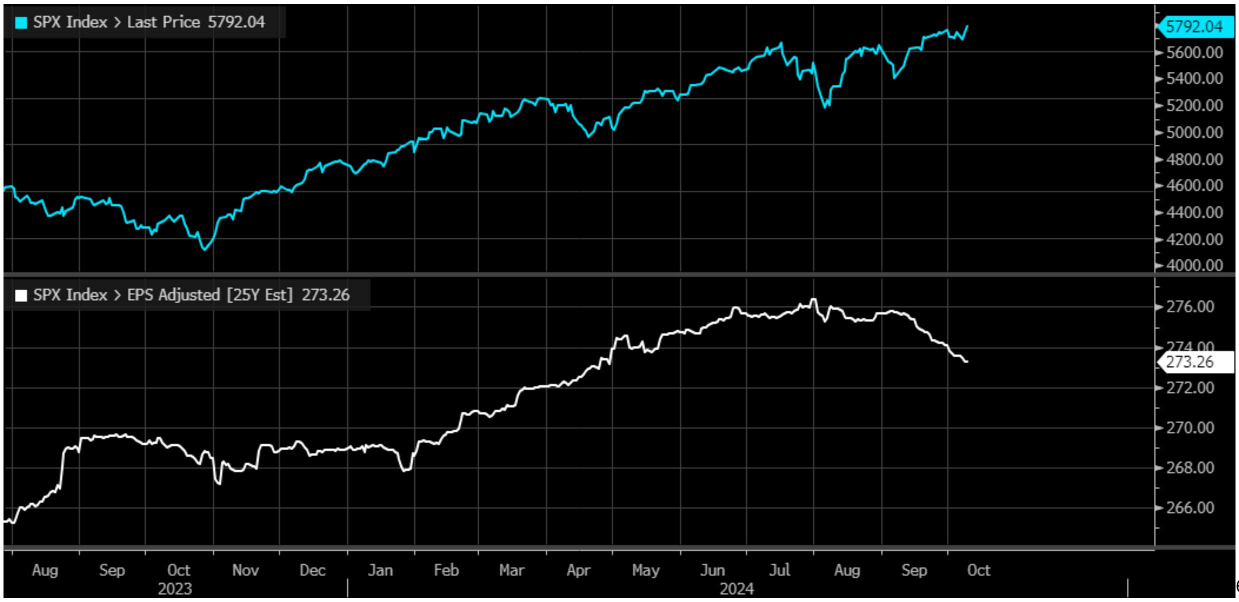
And therein lies the rub. Margin expansion doesn't happen in a vacuum—somebody, usually workers, ends up on the losing side. The idea that corporate margins could expand so dramatically without a major economic shift elsewhere is more than a little optimistic. It would require a massive change in how much another sector is saving or dissaving, and that's no small feat.

What we're seeing now reflects this tension. Since March 2023, when AI mania took hold, the S&P 500 has jumped 40%[5]. That suggests a lot of the AI boom is already priced into the market. When expectations are this inflated, even slight disappointments can lead to sharp corrections. This last earnings season has already shown us that dynamic, with several AI leaders posting weak stock performances, not necessarily because their earnings were bad, but because they didn't quite live up to the hype—or because there are longer-term concerns about profitability.

As we have moved closer to this month's onslot of earnings reports, analysts have begun to dial back their expectations for what 2025 guidance might look like. Expectations at the beginning of October are at their lowest level since April, when the S&P 500 was trading at about 5,100 (vs the 5800 today):

[4] Chart provided by Yardeni Research.

[5] Data provided by Bloomberg database.



[6]

Market returns hinge not just on economic fundamentals but on how those fundamentals measure up against what's already priced in. Buying stocks now means betting that conditions will turn out even better than the already optimistic projections. When markets are banking on solid short-term growth, robust medium-term earnings, and a game-changing AI boom in the long term, it's not hard to imagine a few scenarios where things don't go according to plan.

In essence, being long on stocks today isn't merely a call for a soft landing; it's a wager on a near-perfect growth story from here on out. And with expectations set this high, a little dose of skepticism might be the safest bet of all.

[6] Chart provided by Bloomberg database.

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