



**RAHEEL SIDDIQUI**

Senior Research Analyst, Global Equity Research

NEUBERGER BERMAN

# Equity Market Outlook 3Q 2024

## We remain constructive on stocks amid tentative signs of a broadening market

Financial headlines suggest that vigorous debate has returned to equity markets. In our 3Q Equity Market Outlook, we highlight key aspects of this shift and discuss what they might portend for markets over the next six to 12 months. Specifically:

- We observe that corporate earnings (rather than PE multiples) have primarily driven market returns year-to-date; most sectors have seen positive future earnings revisions; and we expect the global industrial rebound to strengthen.
- We believe intensifying market distortions substantiate our 2Q concerns about big tech's potential underperformance in the medium term relative to selective cyclical and defensive stocks.
- We expect elevated volatility around the U.S. presidential election in the second half of the year.
- We will closely monitor inflation and its effect on real disposable personal income (RDPI): If RDPI deteriorates, consumption growth could suffer; if it improves, we believe economic growth would accelerate and likely embolden equity markets.
- **Portfolio Considerations:** We recommend overweighting Energy, Materials, Industrials, Financials, Consumer Staples, Health Care and Utilities, while underweighting Information Technology, Communication Services and Consumer Discretionary. We also maintain portfolio factor shifts from growth to value, and from large cap to small cap. Finally, we advise tactical regional shifts in Japan (from overweight to market weight) and China (from underweight to overweight).

# Investment Themes and Views<sup>1</sup>

We have retooled the methodology behind our equity recommendations to provide more actionable guidance for active asset allocators and portfolio managers. Our updated methodology—based on return/risk ratio cycles, which this paper discusses in greater detail—is designed to assess developing risk and opportunity cycles at the index and sub-component levels (countries, sectors, regions and styles) and be more responsive to changes in market sentiment. The targeted investment horizon for these recommendations is approximately 12 months, but we expect more frequent adjustments at the sub-index level.

U.S.	POSITIONING	KEY REGIONS & MARKETS	POSITIONING
<b>S&amp;P 500<sup>2</sup></b>	<b>Overweight</b>	<b>MSCI ACWI<sup>2</sup></b>	<b>Overweight</b>
Communication Services	Underweight	EAFE	Underweight
Consumer Discretionary	Underweight	EM	Underweight
Consumer Staples	Overweight	Europe	Underweight
Energy	Overweight	US	Overweight
Financials	Overweight	Japan	Market Weight
Health Care	Overweight	China	Overweight
Industrials	Overweight	India	Overweight
Information Technology	Underweight		
Materials	Overweight		
Utilities	Overweight		

<sup>1</sup> For illustrative and discussion purposes only. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. The firm and its portfolio managers may take positions contrary to any views and themes expressed.

<sup>2</sup> Benchmark.

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## Reasons for Optimism

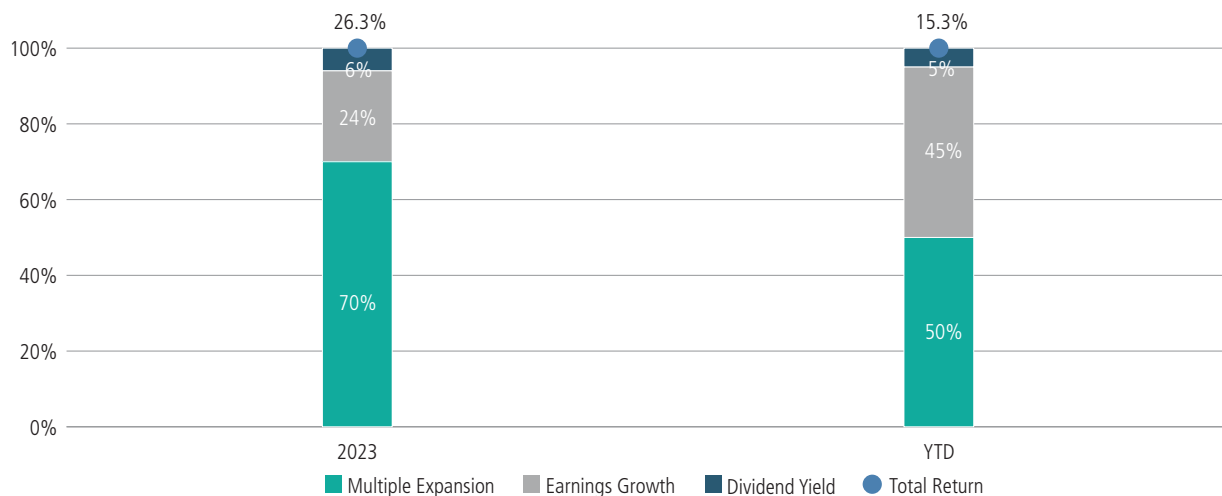
We remain constructive on equities based on three general observations: 1) investors' renewed focus on corporate earnings; 2) the gradual broadening of the stock market; and 3) the continuing global industrial rebound.

### Renewed Focus on Earnings

While an increase in price-to-earnings (P/E) multiples drove much of the stock market's rise in 2023, fundamentals have made a strong comeback in the first half of 2024. As figure 1 shows, 70% of the S&P 500's total return in 2023 came from expanding P/E multiples, and just 24% from earnings growth; thus far in 2024, that split is much more even, 50% to 45%.

**FIGURE 1: EARNINGS HAVE CONTRIBUTED MORE TO EQUITY RETURNS IN 2024 THAN IN 2023**

S&P 500 Return Decomposition



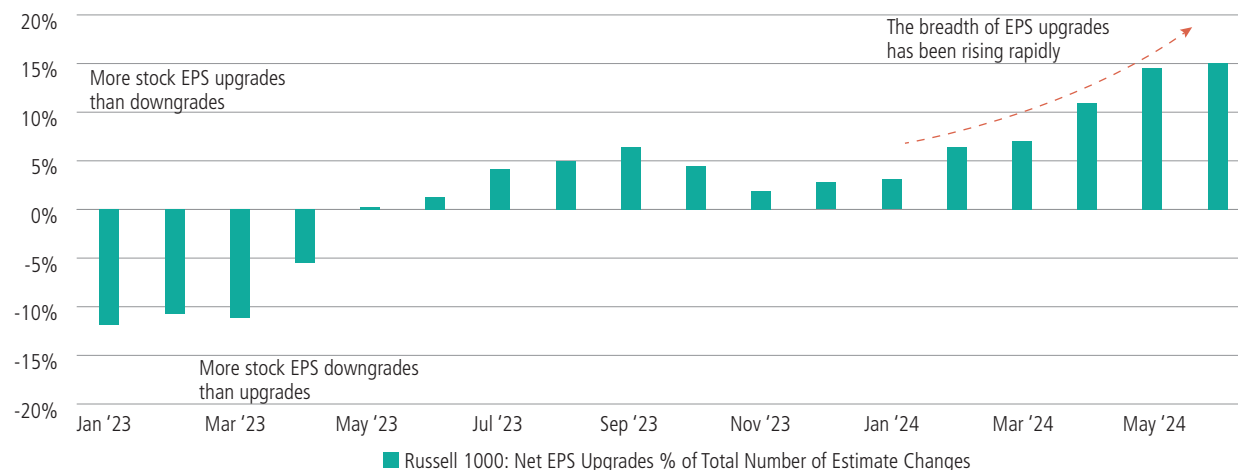
Source: Neuberger Berman Research and FactSet. Data as of June 28, 2024. **Past performance is not indicative of future results.**

Why might a renewed focus on earnings be good news for stocks? We find that earnings-driven markets tend to be anchored by improving economic and corporate fundamentals, whereas P/E multiple-driven markets are often led by sentiment and liquidity. Furthermore, we notice that earnings-driven markets tend to be less volatile and engage more investors who have longer investment horizons, which can add to a bull market's longevity.

### Solid Earnings Are Underpinning a Broadening Stock Market

Another reason for optimism, in our view, is that we saw positive earnings revisions spread across many sectors during the first half of 2024. As shown in figure 2, the net percentage of companies within the Russell 1000 with positive earnings revisions has been rising rapidly since the beginning of the year. Furthermore, by the end of May, nine out of 11 sectors within the S&P 500 had seen net positive earnings revisions, versus just one—Technology—at the end of 2023.<sup>1</sup>

<sup>1</sup> Neuberger Berman Research and Mill Street Research. Data as of May 31, 2024.

**FIGURE 2: THE BREADTH OF POSITIVE EARNINGS REVISIONS HAS RISEN DRAMATICALLY**

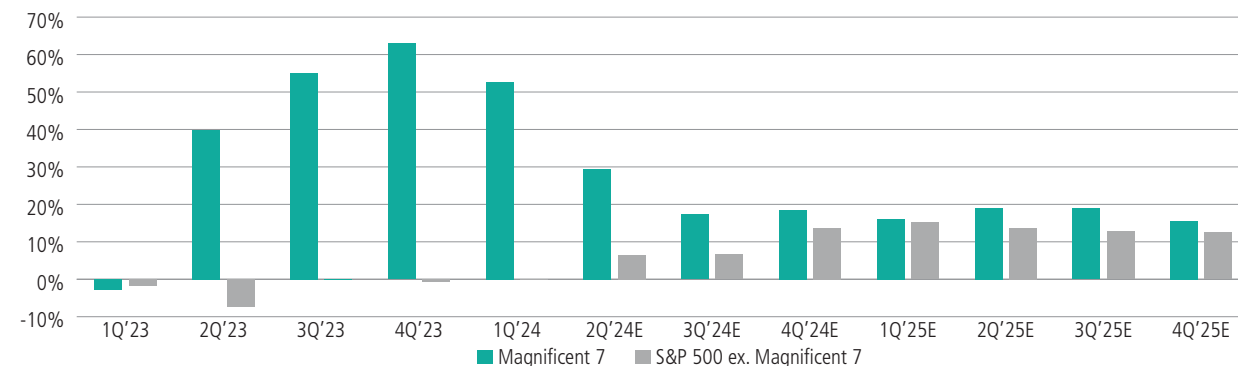
Source: Neuberger Berman Research and FactSet. Data as of June 28, 2024. Indexes are unmanaged and are not available for direct investment. **Past performance is not indicative of future results.** Please see additional disclosures at the end of this presentation.

In the near future, we expect further corporate earnings growth across sectors, fueled by rising household net worth, a supportive labor market, positive fiscal impulse and reviving global industrial production (more on that below).

Notably, rising earnings breadth across the stock market has narrowed the growth gap between the Magnificent 7 (Microsoft, Amazon, Meta, Apple, Alphabet, Nvidia and Tesla) and the other 493 stocks in the S&P 500. As of 4Q 2023, the Mag 7's growth has been moderating while the rest have picked up. As shown in figure 3, the earnings growth gap between the Mag 7 and the rest peaked at 64% in 4Q 2023 and has begun trending in favor of the S&P 493, which is much more reasonably valued in our view. For most of 2023, the Mag 7 were valued at a growth-scarcity premium, which we expect will be chipped away as growth broadens.

**FIGURE 3: BROADER GROWTH MEANS THE MAG 7 IS NO LONGER THE "ONLY GAME IN TOWN"**

Quarterly Earnings Growth (y/y)



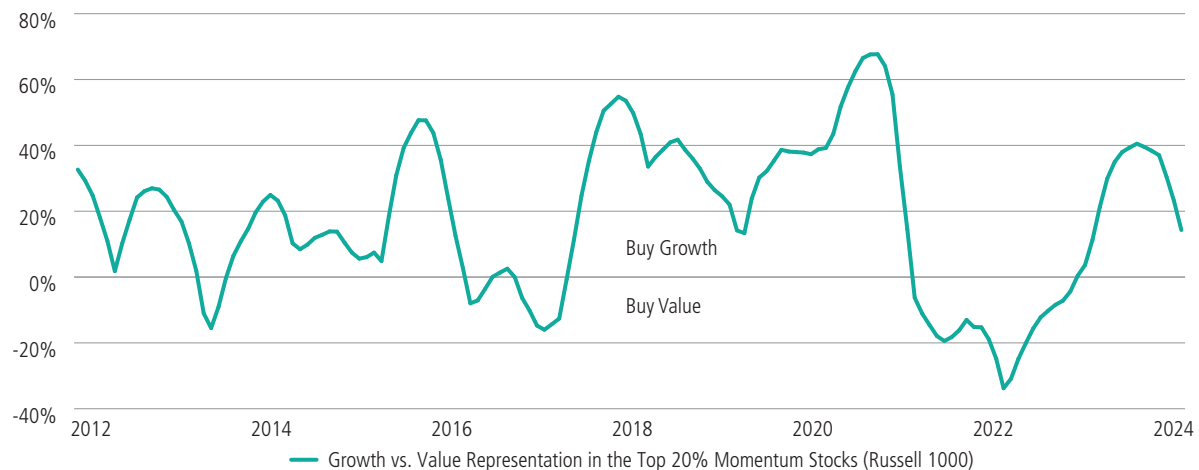
Source: BofA and FactSet. Data as of May 31, 2024. Indexes are unmanaged and are not available for direct investment. **Past performance is not indicative of future results.**

Should this transition continue, we believe it could reduce the appeal of the Mag 7 (and the valuation premium they command), thereby increasing the relative attraction of the broader market.

From an investment style perspective, we think another shift appears in progress: While growth has been outpacing value at the index level, a closer look leads us to believe that growth stocks could be starting to cede market leadership to value stocks.

In figure 4, the teal line shows that, among the stocks in the top momentum quintile of the Russell 1000 at the end of June, the representation of growth stocks relative to value stocks had grown a lot thinner than at the start of the year. Additionally, policy easing has historically coincided with the outperformance of value versus growth over the following 24 months, and we believe a rate cut later this year or next could accelerate that transition.

**FIGURE 4: GROWTH STOCKS APPEAR TO BE IN THE LATE STAGES OF OUTPERFORMANCE**

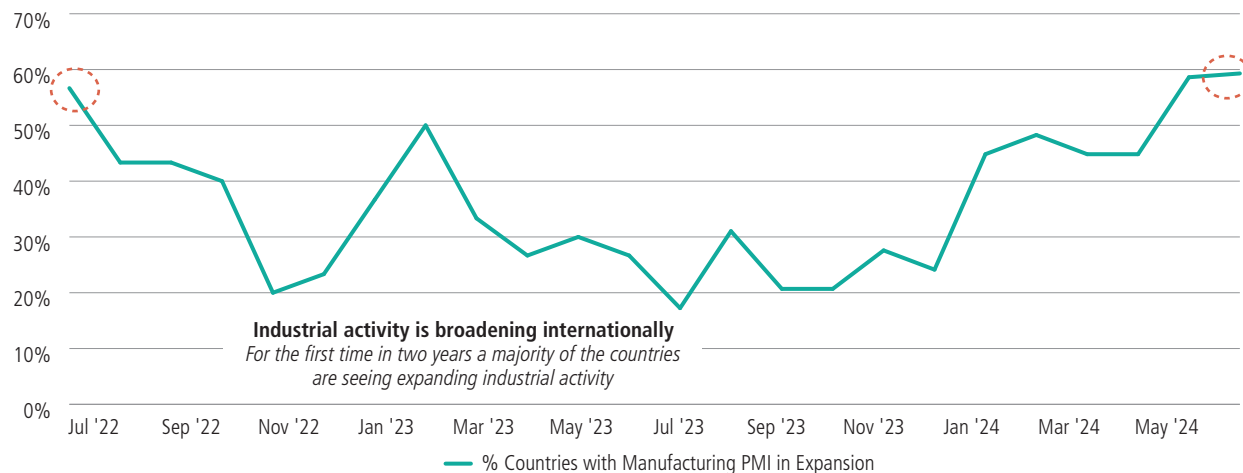


Source: Neuberger Berman Research and FactSet. Data as of June 28, 2024. Indexes are unmanaged and are not available for direct investment. **Past performance is not indicative of future results.**

### Global Industrial Production Continues to Rebound

Yet a third reason we are optimistic is that manufacturing is humming across much of the globe: PMIs are expanding in most countries for the first time in two years (see figure 5); OECD industrial confidence has been soaring;<sup>2</sup> and global new orders are now outpacing the growth in global inventories.<sup>2</sup> This suggests to us that global industrial production could continue to strengthen for the rest of the year.

<sup>2</sup> Source: Neuberger Berman Research and FactSet. Data as of May 31, 2024.

**FIGURE 5: AN INDUSTRIAL REBOUND IS STRENGTHENING AND BROADENING ACROSS THE GLOBE**

Source: Neuberger Berman Research and FactSet. **Past performance is not indicative of future results.** Data as of June 28, 2024.

When global production picks up, we observe goods prices tend to follow, thereby bolstering margins within industrially sensitive sectors. We believe much of this potential margin improvement is not yet priced into these sectors, which is why we recommend overweighting them within portfolios in the near term. At the same time, we find that goods inflation can be a headwind for consumer discretionary stocks, hence our underweight recommendation.

## Continued Caution on Mega-Cap Tech

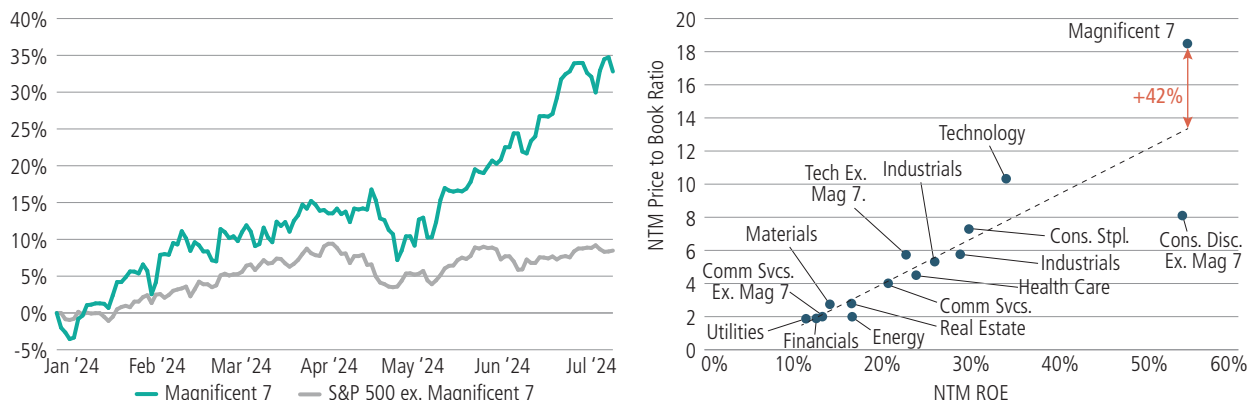
In our [2Q Equity Market Outlook](#), we explored the extreme distortions within and across U.S. equity markets wrought by the Mag 7's recent run-up. We find that many of those distortions not only remain, they have *intensified*, presenting an even greater potential threat when they unwind.

### Mag 7 Valuations Have Moved Even Higher

The artificial intelligence (AI) revolution continues to shine a halo on the Mag 7, which picked up even more steam during May and June. From the start of 2024 through mid-June, this vaunted group advanced 33% versus 10% for the rest of the S&P 500, as shown on the left side of figure 6. Furthermore (as shown on the right), the Mag 7 recently traded at a 44% premium to its theoretically justifiable valuation based on the next-12-month return on equity; at the end of March, that figure stood at a more modest 26%.

**FIGURE 6: THE MAG 7 CONTINUED TO OUTPERFORM AND GROW INCREASINGLY EXPENSIVE**

Total Return (12/31/2023 – 6/25/2024)



Source: Neuberger Berman Research and FactSet. Data as of June 28, 2024. **Past performance is not indicative of future results.**

To us, such a rich valuation implies the need for substantial earnings gains in coming quarters—an impressive feat for a sector already more profitable than any in the S&P 500.

### Tech Carries Even More Weight in the S&P 500

Last quarter, the Tech & Communication Services sector accounted for 38.7% of the S&P 500 by market cap—a level temporarily breached on only three other occasions over the past 60 years.<sup>3</sup> At the end of June, tech's concentration had ticked up even further, to 41.8%.<sup>4</sup> We believe such extreme sector concentrations argue for continued caution given that history has shown they are not only rare, but also relatively short-lived.

### Short Selling Remains Subdued

We find that tech investors remain remarkably complacent relative to those in other sectors. As of mid-June, total short interest in the Communication Services and Technology sectors was the lowest among all 11 sectors in the S&P 500,<sup>5</sup> and short interest across the tech-heavy NASDAQ continued to make all-time lows.<sup>6</sup>

We believe this trend demonstrates a lack of caution and debate—neither signs of fundamentally driven price appreciation. In our experience, healthy debate and skepticism tend to accompany sustainable bull runs rather than a combination of rich valuations, aggressive sentiment and historically stretched earnings expectations.

<sup>3</sup> Source: Neuberger Berman Research and FactSet. Data as of June 28, 2024.

<sup>4</sup> Ibid.

<sup>5</sup> Source: Neuberger Berman Research and FactSet. Data as of June 12, 2024.

<sup>6</sup> Source: J.P. Morgan. Data as of June 19, 2024.



## What to Watch for in the Second Half of 2024

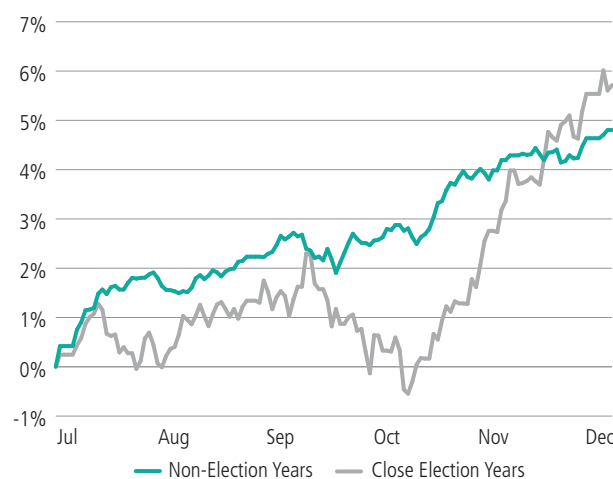
While the equity market is ever rife with sector subplots (see [The Equity Breakdown: Parsing the Key Debate in Five Sectors](#)), we think investors should keep an eye on two broader themes in the second half of the year: 1) higher volatility in the wake of the U.S. presidential election, and 2) weaker consumer spending due to potential further deterioration of real disposable personal incomes.

### Expect Higher Volatility as November's Election Draws Closer

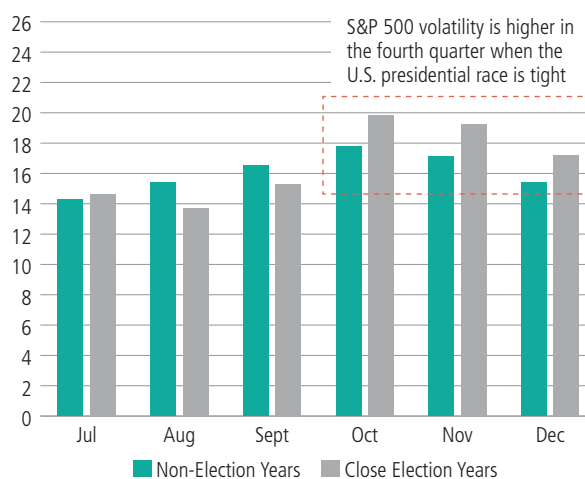
During the fall of an election year, tight races tend to be accompanied by lower returns (see the left side of figure 7) and roughly 10% higher stock market volatility (see the right side) than the same period during a non-election year. We believe higher risk premiums reflect greater uncertainty over contrasting policies and their potential economic impacts.

**FIGURE 7: EXPECT HIGHER VOLATILITY LEADING UP TO AND BEYOND THE NOVEMBER ELECTION**

S&P 500 Median Return (July – December)



S&P 500 Average Volatility (July – December)



Source: Neuberger Berman Research and FactSet. Data as of June 10, 2024. Close election years include 1952, 1960, 1968, 1976, 1980, 2000, 2004, 2008, 2016 and 2020. Non-election years include all years starting in 1952. **Past performance is not indicative of future results.**

No matter who wins the contest, we find the stock market tends to mark a post-election rally as the risk premium eases and valuations catch up to the accumulated earnings improvement. As in the past, we expect the market to exhibit more volatility in the fourth quarter, but eventually tether back to earnings fundamentals, which we see improving during the rest of the year.

### More Important Than Ever: The Connections Among Inflation, Income and Stocks

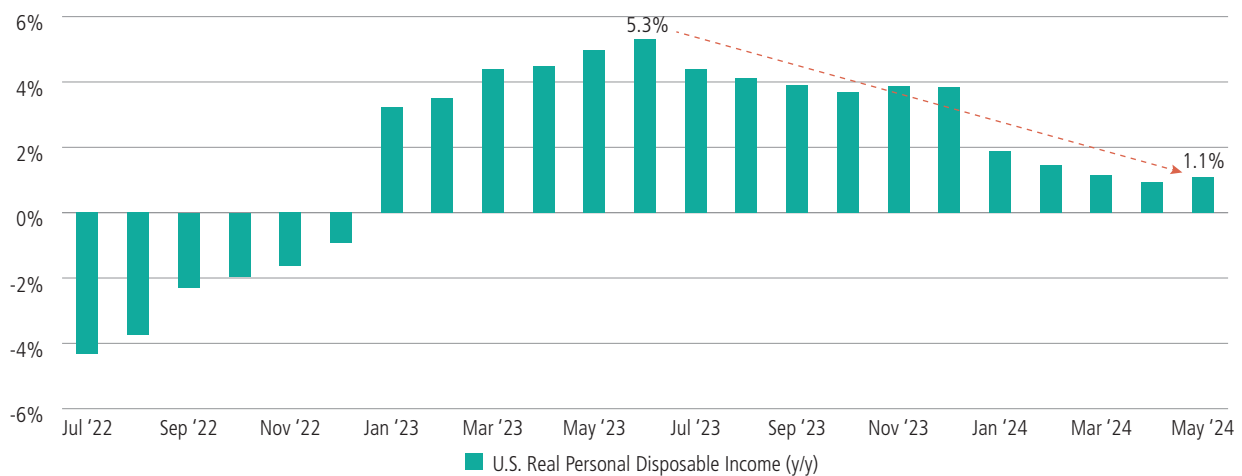
Real disposable personal income (RDPI) is what consumers have after paying taxes, adjusted for inflation. RDPI growth has slowed to an anemic 1% year-over-year. At 75% of GDP, RDPI is a key driver of the U.S. economy.<sup>7</sup> But it becomes even more important when consumer financing, the second most significant source of consumer spending (20% of GDP), is unlikely to come to the rescue.

<sup>7</sup> Neuberger Berman Research and FactSet. Data as of March 31, 2024.



In response to rising financial stress, non-revolving consumer credit growth has stalled and credit card usage—even in the face of higher interest rates—has surged: In a potential sign of simmering desperation, credit card debt has been growing at nearly twice the pace of nominal disposable personal income over the past year. Meanwhile, delinquencies have been rising across credit utilization cohorts,<sup>8</sup> and consumers have been tightening their belts by forgoing non-essential purchases in favor of essentials such as housing, health care and food<sup>9</sup>—a shift that has historically been a harbinger of recession (see figure 9 on next page).

**FIGURE 8: SLOWING GROWTH IN REAL DISPOSAL INCOME COULD DAMPEN THE U.S. ECONOMY, UNLESS INFLATION EASES**



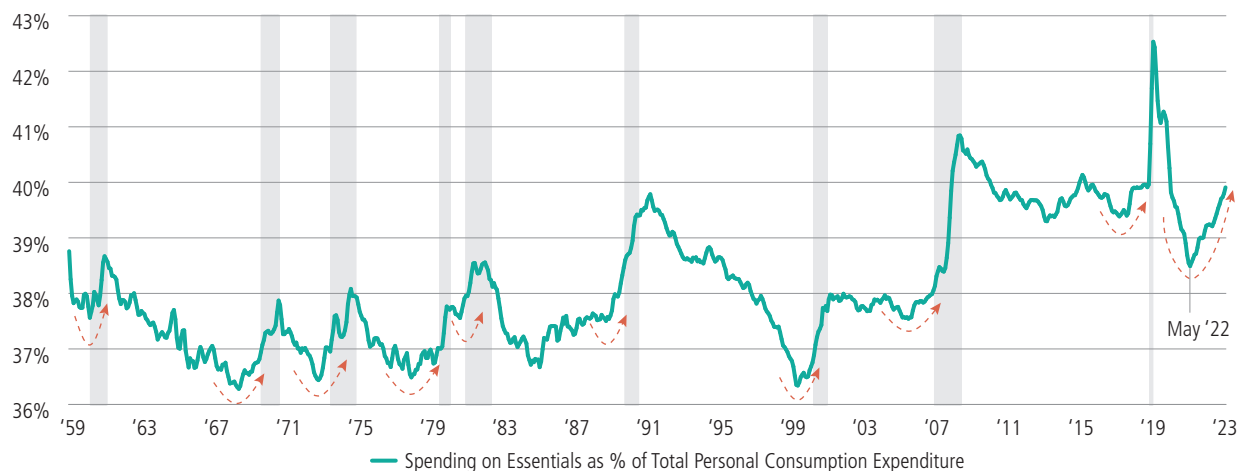
Source: Neuberger Berman Research and FactSet. Data as of May 31, 2024. **Past performance is not indicative of future results.**

If inflation subsides more slowly than income growth in the coming months, RDPI growth could fall closer to zero, potentially curbing consumer spending, slowing the U.S. economy, and ultimately threatening the stock market.

Conversely, if inflation were to ebb faster than income growth, we expect that would boost RDPI, potentially stimulate spending, reaccelerate the economy and be a tailwind for the stock market. The impact of this stimulus would be in addition to, and arrive sooner than, the impact of the Fed's anticipated interest rate cuts, which usually take four to eight quarters to take hold in the economy.

<sup>8</sup> Source: TransUnion U.S. Consumer Credit Database. Data as of March 31, 2024.

<sup>9</sup> Source: Neuberger Berman Research and FactSet. Data as of April 30, 2024.

**FIGURE 9: U.S. CONSUMERS HAVE BEEN TIGHTENING BELTS AND FOCUSING ON ESSENTIALS**

Source: Neuberger Berman Research and FactSet. Data as of May 31, 2024. **Past performance is not indicative of future results.**

Note: Essentials include housing, health care and food. Shaded areas represent recessions.

Against this backdrop, we believe investors would be wise to focus on upcoming inflation prints and closely monitor the forward trajectory of RDPI as a meaningful gauge for economic growth. If RDPI continues to deteriorate, consumption growth could suffer; if it improves, economic growth would accelerate and likely embolden the equity market.

Mindful of these risks, we remain optimistic given the broadening of growth within the S&P 500 and the incipient global industrial recovery.

## Portfolio Considerations: U.S. and International

In light of these considerations and in line with our evolving equity return/risk ratio cycle analysis (for more on this framework, see our [2Q Equity Market Outlook](#)), we maintain our stances on the following U.S. sectors and styles, and highlight key changes to suggested weightings in various international markets.

### Sectors (U.S.)

*Overweight:* Energy, Materials, Industrials, Financials, Consumer Staples, Health Care and Utilities.

*Underweight:* Information Technology, Communication Services and Consumer Discretionary.

### Equity Styles

*Overweight:* Value vs. Growth, and Small vs. Large.

### Key Regions and Markets

*Japan (Overweight to Market Weight):* A weakened yen has driven much of this export-driven market's stellar outperformance since 2021. Now, rising inflation has begun to hurt growth, which is pressuring the BoJ to consider hiking interest rates. This could put upward pressure on Japan's currency and potentially dampen its equity markets.

*China (Underweight to Overweight):* While China's economy has shown few sustainable signs of strength, the ongoing revival in global industrial production could be a welcome catalyst for a stock market that has been trading at historically low valuation levels. We suspect that low valuations imply that much of the bad economic news coming out of China may already be priced in. Furthermore, we think Chinese policymakers are more likely to become incrementally supportive of growth to quicken the pace of recovery and buoy consumer confidence. Notably, some Chinese stocks have taken leadership within the MSCI ACWI index, suggesting to us that a transition could be starting to unfold.

*Europe (Maintaining Underweight, but anticipating an upgrade):* Europe is more leveraged to the revival in the global industrial production cycle and has begun easing monetary policy sooner than the U.S. Because European companies tend to be more dependent on bank financing than their U.S. counterparts, we believe interest rate cuts by the ECB could stimulate lending and accelerate growth, likely causing the Euro to weaken against the U.S. dollar. In our view, stronger growth and a weaker Euro could boost both European exports and earnings, thereby supporting Europe's relative performance in a global equity portfolio—but we don't think we are there yet.

*The targeted investment horizon for these recommendations is 12 months, but we expect more frequent changes at the sub-index level in response to changing market dynamics.*

*For detailed recommendations across sectors, factors, style and geographies, see the section titled "Investment Themes and Views."*

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## Index Definitions

The **S&P 500 Index** consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **Russell 1000® Index** measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

The **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years).

The **MSCI ACWI Index** captures large and mid-cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries. DM countries include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the UK and the U.S. EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates. With 2,837 constituents, the index covers approximately 85% of the global investable equity opportunity set.

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## FIRM HEADQUARTERS

New York  
+1 800 223 6448

## REGIONAL HEADQUARTERS

Hong Kong  
+852 3664 8800  
  
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+81 3 5218 1930

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**Neuberger Berman**  
1290 Avenue of the Americas  
New York, NY 10104-0001

[www.nb.com](http://www.nb.com)