Biweekly Investment Insights: Micro Tailwinds vs. Macro Headwinds

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Focusing on Q2 Earnings Through the Top-Down Cross Currents

- Markets balancing an ongoing stabilization & re-acceleration in EPS metrics versus softening U.S. economic trends which has further opened the door for a Fed cut
- Solid Q2 earnings season amidst staggering AI-related capex forecasts from the "hyperscalers". But Q2 EPS misses are being punished more than average

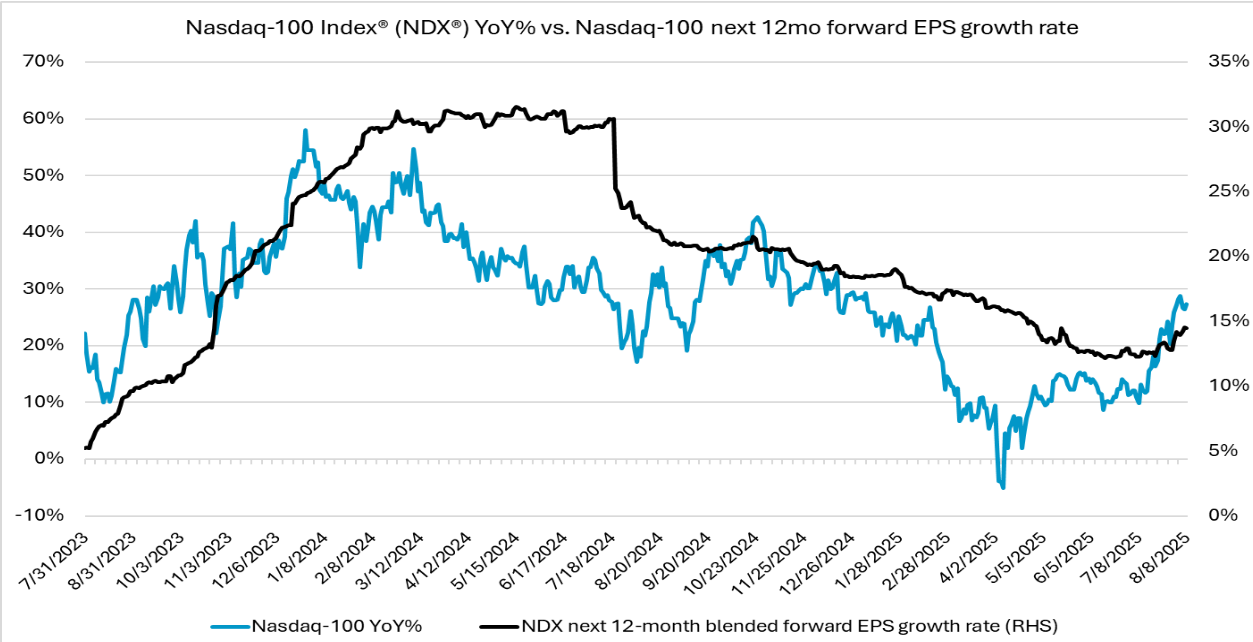
Summary

The resilience of the U.S. economy despite increased macro volatility and policy uncertainties has been the steady surprise for the markets in 2025. That said, while the economy remains broadly stable, ongoing uncertainties and the lagged softening of economic activity has filtered through to recent "Tier 1" economic reports—e.g., July's much weaker non-farm payrolls report. While there are signs of tariff-driven inflation in the July PPI report as wholesale inflation rose by the most in three years and in the July CPI report (e.g., core goods inflation rose 1.2% year-over-year, a two-year high), the CPI was broadly in-line with expectations. Layering in this latest CPI report, the markets are close to fully pricing in a 25 basis point Federal Reserve rate cut in September as its employment mandate is seemingly outweighing its inflation mandate. Although the July payrolls report indicates that companies are cautious as they are hiring less given persisting trade tariff concerns, they are not laying off workers en masse.

This ultimately leaves the markets and companies at an inflection point: the health of corporate earnings, driven by secular themes such as AI, juxtaposed by companies attempting to manage U.S. import tariffs at an effective rate in the 15% to 20% range (per The Budget Lab at Yale University; the highest since 1934) and signs of a softer U.S. economy and labor market amidst expectations for a sticky inflation backdrop—though the inflation debate continues. We have seen risk assets mostly look through the frenetic pace of trade policy noise and other policy-related disruptions YTD. Investors were focused on the signal through the noise in what has been a healthy Q2 earnings season and, admittedly, incredible AI-related capex plans from mega cap tech companies—a key underpinning of the AI and, increasingly, parts of the U.S. economy. If there is a blemish it's that companies missing EPS estimates have seen larger-than-average drawdowns.

Stepping back, appreciating the fundamental reasons to resist this powerful equity rally (e.g., yet to be realized impacts from trade and fiscal policies, concerns around weaker economic activity, elevated valuations, market complacency as equity volatility is at YTD lows), the medium-term outlook remains broadly supportive for risk assets. While September is historically the weakest month for equities, looking ahead, favorable earnings trends and the AI revolution, supportive financial conditions and the expected Fed easing, fiscal stimulus filtering through via the recent tax cut legislation, and a slowing but still steady economic backdrop are the key underpinnings for equities we're continuing to monitor.

Biweekly Chart in Focus: Equities Quickly Priced in the Stabilization of Forward EPS Growth Rates Following Their Downshift Amidst H1 2025 Peak Policy Uncertainties



Source: Bloomberg. Notes: NDX next 12-month blended forward EPS growth rate is calculated using a weighted average (based on the weight of the company within the index) of the current fiscal year (1FY) and the next fiscal year (2FY) earnings estimates. This approach smooths out fiscal year transitions by considering both fiscal years. The calculation is typically done on a bottom-up basis, meaning it aggregates the earnings estimates of individual index constituents to derive the overall index estimate. The YoY% change is then calculated based on these aggregated estimates. The calculation is done using point-in-time data, meaning it reflects the estimates as they were known at a specific date.

Details

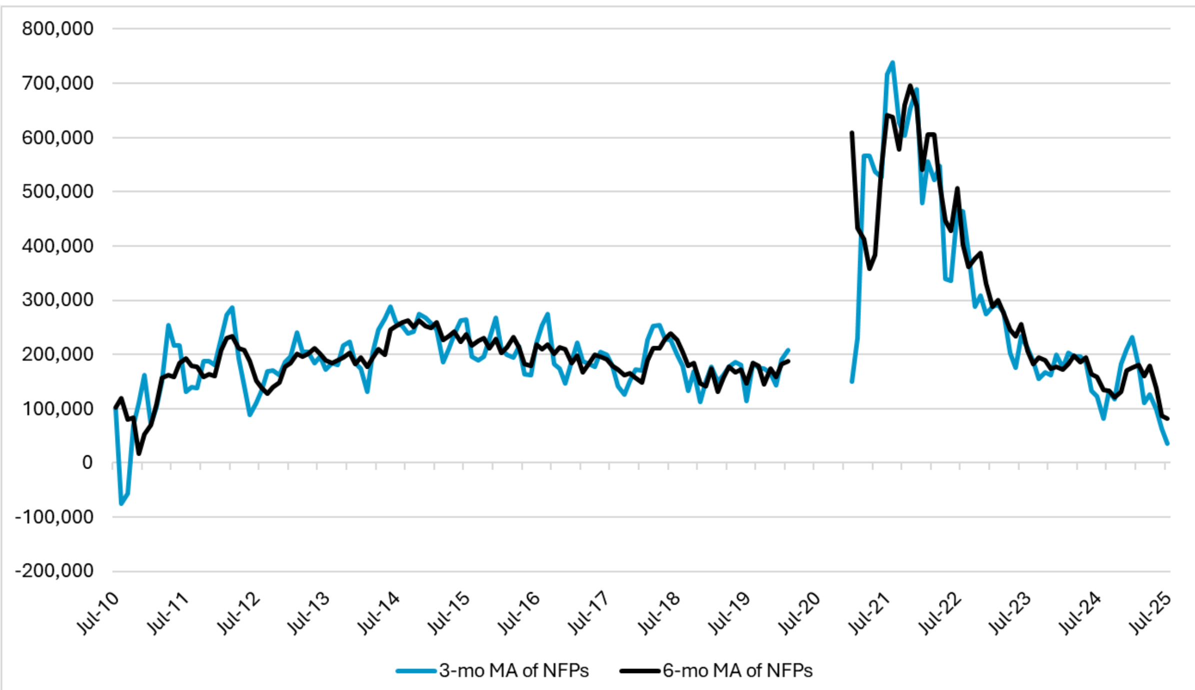
An Improved Earnings Landscape Amidst a Softening Labor Market

Sell-side analysts and investors, respectively, were left in the unenviable position of attempting to model the potential impact to earnings from trade tariff policies and to price these dynamics into equities. While the changes in the Nasdaq-100's 12-month forward EPS growth rate are not as volatile as those in equities, per the chart above, they have trended together directionally over the past two years as earnings are ultimately the driver of equity returns over the longer-term. The forward EPS growth rate was 19% at the end of January 2025, fell to a low of nearly 12% by mid-June, and is now at 14.5%. With the stabilization and improvement in the earnings outlook, equities have reacted accordingly from their April 8th lows. This is also evident in other earnings indicators such as Morgan Stanley's S&P 500 Index earnings revisions breadth which tracks the number of positive analyst revisions minus the number of negative analyst revisions, divided by the total number of revisions. This ratio plummeted to around -25% in the April time frame—the lowest since the end of 2022 during the most aggressive Fed rate hiking cycle in 40 years—but rapidly reversed course as it is now 16% as the worst-case scenarios of the trade policy implications on earnings receded.

The slowdown in U.S. economic activity was largely expected given the lagged nature of macro data relative to markets having the "luxury" of pricing in this dynamic in real-time. However, the much weaker than expected July nonfarm payrolls report (73,000 versus expectations 105,000) and the simultaneously announced net revisions of -258,000 to the May and June reports was a notable negative surprise and has quickly changed the narrative around the U.S. labor market. The unemployment rate remains at a very healthy 4.2%. But it increased by only 0.1% due to the labor force participation rate dipping to 62.2%—its lowest since November 2022, likely driven by the impact from immigration policies.

Per Figure 2 below, excluding the extremely volatile Covid-19 period of March to December 2020, the July employment data took the smoothed out 3-month moving average of monthly net new hires to its lowest since September 2010 (35,300) and the 6-month moving average to its weakest since January 2011 (81,000). As such, following, first, the weaker jobs report and, now, the broadly benign July CPI report, the markets are pricing in nearly a 100% chance of a 25 basis point Fed rate cut at the next meeting and around 60 basis points in total cuts in 2025 (as of this writing). Though this is not a certainty as there is still another month of jobs and inflation data to digest prior to the Fed meeting on September 17th, the markets are voting on the expected direction of travel.

Figure 2: 3-Month & 6-Month Moving Averages of U.S. Non-Farm Payrolls, Excluding March – December 2020 (Covid-19 Time Frame)



Source: Bloomberg

Observations as a Strong Q2 2025 Earnings Season Winds Down

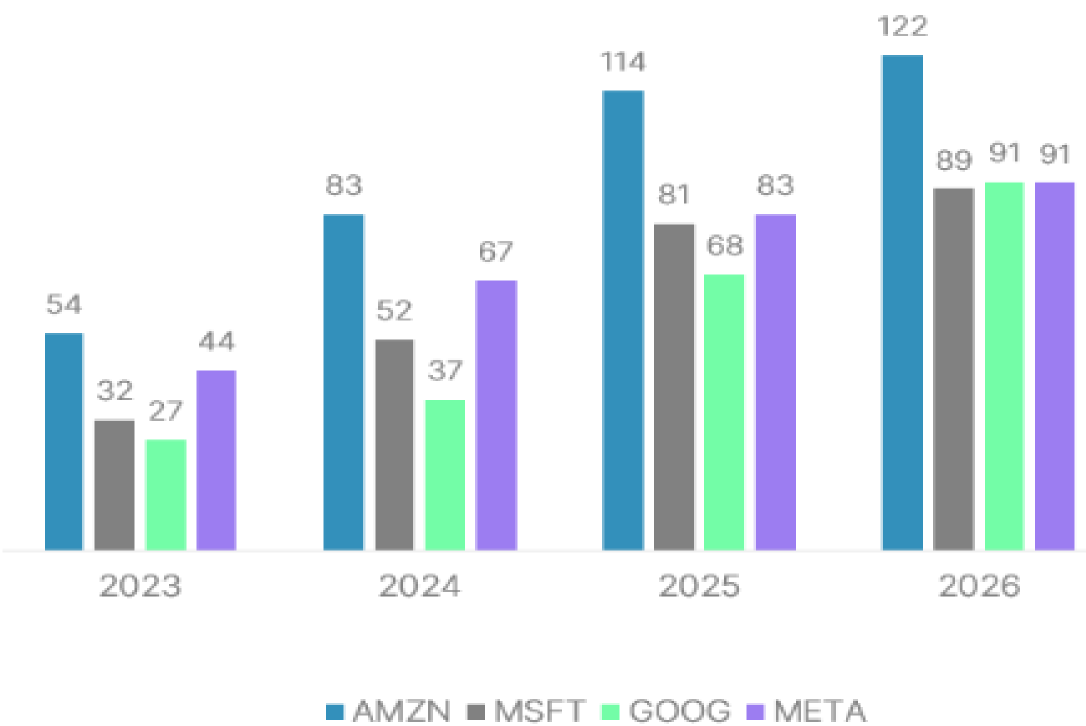
At least for now, though, while we're not seeing the same level of job creation of the past couple of years, we're also not seeing job destruction. Perhaps the weaker employment report came at the "right time" for the markets as it was amidst another important earnings season (then again, aren't all earnings seasons important?). Per the latest Nasdaq-100 Weekly Commentary, the blended year-over-year EPS is 33.7% for Nasdaq-100 companies—markedly higher than the consensus forecast growth rate of 22.4% and the highest since Q4 2023. 88% and 91% of reporting companies have beaten EPS and revenue estimates, respectively (per Nasdaq Index Research via FacSet). The average EPS beat is nearly 11% and the average miss is almost -6%.

Similarly, with over 90% of S&P 500 companies having reported, 81% have reported a positive EPS surprise—above the 5-year (78%) and 10-year (75%) averages—and 81% have reported a positive revenue surprise. The 81% would match the largest share of companies reporting a positive EPS surprise in a quarter since Q3 2023. The greatest contributors to the S&P 500's aggregate EPS of 8.4% above estimates are led by the financial, communication, technology, and consumer discretionary sectors. The blended year-over-year earnings growth rate for the S&P 500 is a strong 11.8%—notably stronger than the low bar of 4.9% estimate at the outset of earnings season. If this were to hold, it would be the third straight quarter of double-digit earnings growth and the fourth out of the last five quarters.

An overarching concern for investors given the permeating uncertainties from shifting trade tariff policies has been company guidance. The markets will continue to look for insights as to whether companies are passing along the pricing increases from higher import costs to the end consumer, if they are absorbing these costs, or if it is some combination—which clearly have implications for corporate margins. While there have been headlines around certain multi-national corporations lowering or pulling forward guidance, the share of S&P 500 companies issuing negative EPS guidance for Q3 2025 is 49%—actually lower than both the 5-year (57%) and 10-year (61%) averages (all S&P 500 Q2 earning metrics per FactSet).

As a proxy for the incredible investment trends occurring in AI by the most innovative companies in the world, collectively, the “Big 4” spenders on AI-related capex (META, MSFT, AMZN, and GOOG) are expected to deploy around $350 billion in 2025 and around $400 billion in 2026. These latest figures for this year came after bumping up their guidance yet again during Q2 earnings season in the face of insatiable demand for AI compute, more than doubling what they spent in 2023 (see Figure 3 below). And this capex from the private sector is filtering through to the broader economy as, per BlackRock, the contribution of technology and software investment to annual U.S. GDP growth is approaching 1% on an annualized basis—the highest on record going back to 1960.

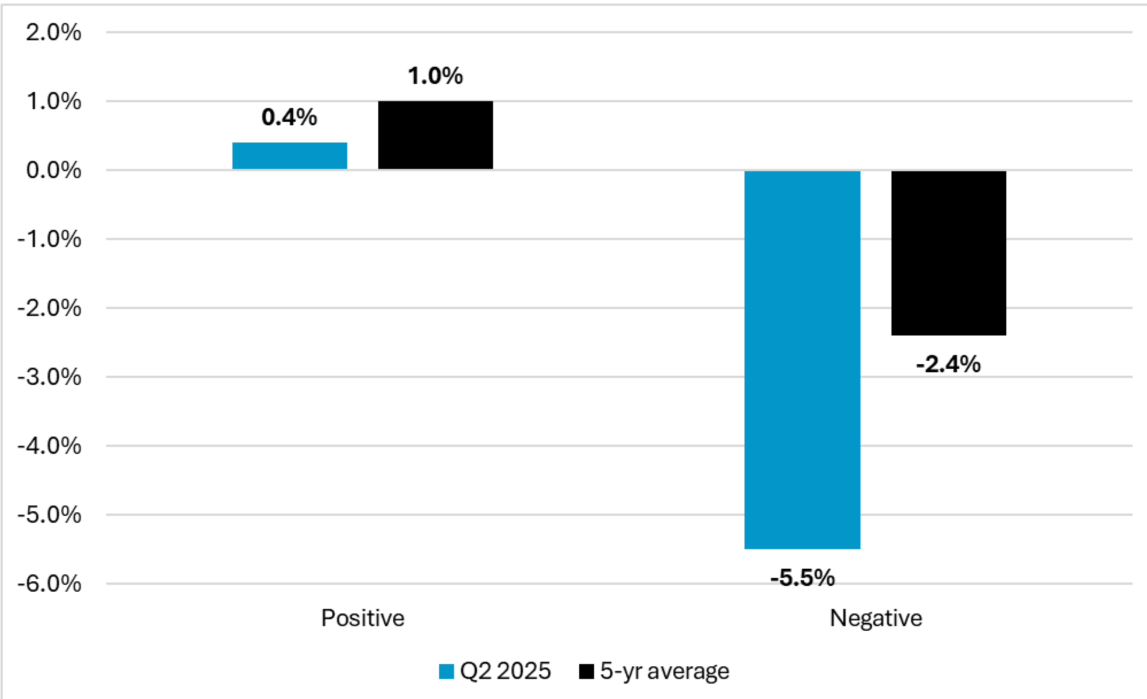
Figure 3: Annual Capex Amongst the “Big 4” AI Spenders ($B)



Source: Bloomberg, Nasdaq Global Indexes. Data as of July 31, 2025

Although the above points to yet another solid earnings season, digging a bit deeper, those companies reporting negative earnings surprises are being punished by the markets notably more than average: the mean drawdown has been -5.5% from the two days prior to the two days post the earnings release versus the 5-year average of -2.4%. This is augmented by companies reporting positive earnings surprises being rewarded with an average price increase of only 0.4% which is less than the 5-year average of 1.0% (Figure 4). The read-through is that with equities still hovering near all-time highs against a backdrop of elevated valuations and given how quickly financial markets flipped from “fear” to “greed”, equities entered Q2 earnings season even more sensitive to earnings misses.

Figure 4: S&P 500 Average Stock Return Based on Q2 EPS Surprise vs. Average Price Change % (2 Days Prior & 2 Days Post Earnings Reports)



Sources: FactSet

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