RATHBONES

Weekly Digest

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Equities earn their keep

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Markets trusted earnings to do the heavy lifting, as AI profits powered equities despite fears of froth, tail risks, and recession.

Quick take:

- Earnings have driven much of the latest equity rally, with AI investment doing most of the heavy lifting.
- Chipmakers are enjoying a profits boom, but well-anticipated good news can still leave share prices vulnerable.
- Markets remain in the no-recession camp, though an AI shock or sharper slowdown could quickly test that confidence.

Every three months, the investment world goes a bit mad for the quarterly corporate reporting season. It gives investors an up-to-date picture of how companies are faring, especially in volatile times. But it also encourages short-term thinking and vast duplication in previewing, collating, and instantly analysing the numbers.

For Nvidia, Bloomberg lists no fewer than 95 research analysts, of whom 95% are buyers. There is one lonely seller! And that's before the myriad bloggers and podcasters chip in. Yes, the volume gets turned up to 11 for these few weeks.

Strong earnings momentum

The build-up to this earnings season has been encouraging. It's rare to see earnings revisions – analysts' upgrades to expected company profits – rise so strongly at this stage of a market or economic cycle. The current global positive balance of 20 (number of upgrades versus number of downgrades) has only been surpassed twice in the last decade: during Trump's 2017–18 corporate tax cuts and the post-Covid recovery in 2021. This time, the main component is the once-in-a-generation AI-related investment boom.

Earnings have grown strongly since the current bull market cycle began in late 2022. Indeed, they explain about three-quarters of global equity market returns since then. That compares reported 2023 'earnings' for the MSCI All-Countries World index ($38.6) with the latest 2027 estimate

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($68.1) – 75% earnings growth versus an index return of 104%. For all the concerns about markets being close to all-time highs, that's a valid reason – and one that the gloomier prognosticators often overlook.

As ever, there are plenty of arguments to counter the bulls. The key point is that AI-related capex – capital spending on data centres, chips, and other infrastructure – may prove unsustainable, as I discussed last week. The jury will remain out on that for a while: there's an understandable lag between investment and widespread adoption, but the trends remain positive.

Meanwhile, the profits accruing to the recipients of the spending aren't yet being recognised in the profit-and-loss accounts of the spenders, mainly the data-centre-building hyperscalers. Instead, the spending is capitalised on their balance sheets and then depreciated over time, under normal accounting conventions. Still, the scale is remarkable: more than $5tn by 2030, even on conservative forecasts.

Travelling and arriving

Then there is the huge windfall being gathered by makers of memory chips, which are in short supply. Last week, the South Korean company Samsung reported a 1,800% year-on-year increase in profits. Even so, it fell foul of the well-known financial market phenomenon of 'travelling and arriving' – when a share price rises ahead of expected good news, only to fall once that news arrives. The good results were so well anticipated, and its shares were so buoyed by a speculative mania in South Korea, that they fell 16% in two days (and have declined further since). Persistent demand and lengthy supply lags should grant the main chipmakers license to print money for at least a couple more years. But we also recognise that markets discount the future well in advance, and so will always be looking for a reason to call the top. It leads to greater volatility in markets that are already structurally prone to wilder short-term gyrations. The key for us is to back what we believe are sustainable, longer-term trends.

Gr-AI-t expectations

Looking at the US, where the tone will be set, we should expect some big share price movements. Speculative leveraged trading vehicles, herd behaviour, and easy access to products and platforms have amplified share price volatility on earnings days. Some of the intra-day moves may shock, but they shouldn't surprise. We don't want to be too influenced by short-term share price movements.

S&P 500 EPS growth was 27% in Q1, or 17% when excluding some one-off private stake revaluations (OpenAI/Anthropic). Still five percentage points ahead of

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estimates. The consensus forecast expects 22% year-on-year growth in Q2.

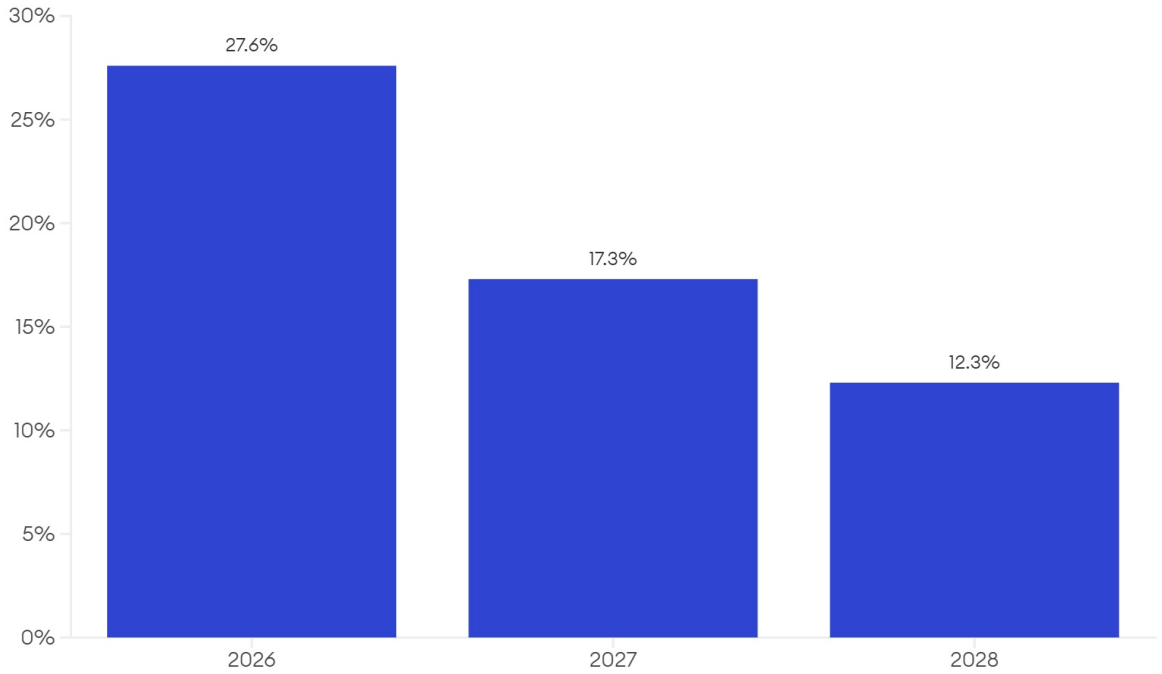
AI infrastructure stocks are expected to contribute nearly 60% of the growth this quarter, with Micron and NVIDIA accounting for more than 40% together. The top 10 account for almost three-quarters of Q2 growth and 58% of this calendar year. The non-AI balance in the top 10 comes from four Energy stocks. We should be grateful if, as currently forecast, the Energy stocks contribute nothing to EPS growth in 2027. If they do, something will have gone horribly wrong elsewhere.

Set fair?

Returning to the bigger picture, earnings growth seems set fair. For the MSCI ACWI, forecasts are for 27.6% year-on-year in 2026, followed by 17.3% and 12.3% in 2027 and 2028, respectively. A curmudgeon would note the slowdown, but it's still growth, nonetheless. The semiconductor-related earnings uplift may be sustainable,

Less boom, still room

MSCI ACWI earnings growth is forecast to slow after 2026



Source: MSCI, Rathbones

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but it's probably not repeatable. It's hard to see equity markets falling if this is the outcome, although some derating – investors paying a lower multiple for the same earnings – wouldn't come as a surprise. Based on these growth expectations, the price/earnings ratio falls from 19.3x in 2026 to 16.4x in 2027 and 14.6x in 2028.

That begs the question, what might upset this rosy scenario? Some sort of AI shock is the biggest risk, at least in terms of reversing current trends and sentiment. This could be a function of underwhelming demand, maybe as consumers baulk at paying a high enough price to cover the delivery costs. Or it could be a supply shock if, for example, open-source models (mainly from China?) flood the market, or if there is a technology breakthrough that renders existing data centre capacity obsolete. We call these low-probability 'tail risks', but they still need monitoring. An optimist would counter that a cheaper and more abundant supply would invoke Jevons' Paradox, whereby consumption expands to new areas as the 'commodity' is more affordable.

The other main risk is a more conventional economic slowdown or even a recession. Such an event requires a trigger, typically a meaningful tightening of monetary policy. Polymarket's betting probability for a US recession in 2026 is a lowly 11%. The Bloomberg consensus for the next twelve months has a 25% probability. I think we can safely say that a recession isn't priced in. Interest rate rises are normally used to dampen inflation (and inflation expectations). Inflation is stickier than central bankers would like, and is being nudged by oil price swings as Middle East news breaks. But market-derived longer-term expectations remain relatively subdued, partly because central bankers keep talking tough on prices. Part of their art is to threaten the big stick but never use it. For now, we remain in the 'no recession' camp, but our opinions are constantly under review.

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Regional highlights

UK. The only data release of note over the last week has been the BRC's estimate of retail sales growth in June. Sales grew by 1.7% year-on-year, below expectations and slower than May's 3.4%. Distortions will have arisen because June's average temperature was 2.5°C above normal, but the underlying trend remains positive, and there are remarkably few ill effects from the war in Iran. One shift we did see last week was in Bank of England interest rate expectations, with an increase back on the cards following the most recent rise in energy costs, driven by renewed hostilities in the Middle East and further disruption to shipping through the Strait of Hormuz.

US. US data was equally scarce. The main release was existing home sales, an area of the economy that remains soggy as mortgage rates remain elevated. The current average 30-year rate is 6.6%, versus the post-global-financial-crisis average of 4.75%. Many homeowners locked in their mortgage at around 3% during the period of extremely low rates and bond yields in 2021 and are reluctant to move and give them up. And so, both supply and demand are subdued. Higher-priced homes are selling better as the well-heeled can cash in their stock market gains. There have been some very large windfalls in places like San Francisco, thanks to SpaceX's listing on the stock market and higher private market valuations for OpenAI and Anthropic. The median sale price in the Bay Area jumped 18% year-on-year to more than $2m. Such a lacklustre national housing market would historically have been associated with a weak economy, but this time the AI-related capex boom is offsetting that drag. Median national home prices have reached a new high, bolstering homeowners' balance sheets.

China. China's consumer inflation slowed more than expected in June to 1.0% year-on-year from 1.2% in May, after remaining unchanged over the past two months. The slowdown was driven mainly by easing energy inflation and, to a lesser extent, softer core inflation. Food inflation also edged down -0.1pp to -1.6% year-on-year in June, mainly reflecting continued weakness in pork prices, which are quite influential on China's inflation rate. China's pork cycle still has further to run despite the government's efforts to reduce production capacity, even though prices have already fallen 15.9% over the last year. More broadly, low inflation continues to reflect excess manufacturing capacity and weak consumer confidence. China's exports continue to drive growth. Exports rose 27.0% year-on-year in June, after climbing 19.4% in May. The consensus expectation was 19.0%. The trade surplus rose to $126bn in June, from $105bn in May. Robust exports of computers and computer parts are being propelled by

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data centre demand. Household appliance shipments were boosted by air conditioner sales in Europe.

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