TRIVARIATE RESEARCH

US Equities
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Level Set: Agreement and Pushback

We published our year-ahead outlook last Monday, January 6th (see here), and spoke with many investors about our market views over the last week. While we were not surprised by some of the pushback we received, we were surprised about areas where we DID NOT receive much pushback. We thought we would address both the feedback and pushback in today's Level Set.

Will Gross Margins Matter?

One of our assertions that surprisingly did not receive much pushback was our view that gross margins have less potential to be a driver of excess return in 2025 than we have observed over the past three years. As the interest rate and economic cycles mature, driving margin expansion will become more challenging for many companies. We have witnessed a period where gross margin expansion has worked as a signal more than at any other time in the last twenty years (see below). The 20% of companies with the fastest gross margin growth outperformed those with the most gross margin decline by 18% in 2024. We wouldn't be surprised to see this be far worse at distinguishing winners from losers going forward. Not a single investor pushed back on this concept, and many agree that revenue growth and acceleration will likely matter more in the next few quarters. We aren't sure what to make of this lack of pushback regarding a major change in one of our multi-year central investment theses, but many including ourselves think we need to see top-line growth to validate the sizable stock moves--and resulting valuations--in the 2H of 2024.

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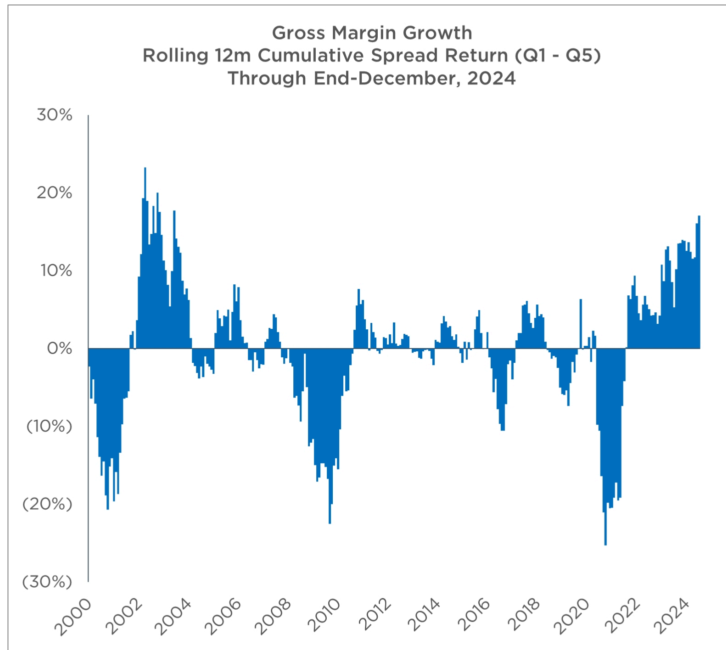
Gross Margin Growth Was Just Its Most Effective in 20 Years



Source: Trivariate Research, LP

We Recommend an Overweight in Healthcare and We Have Received Pushback

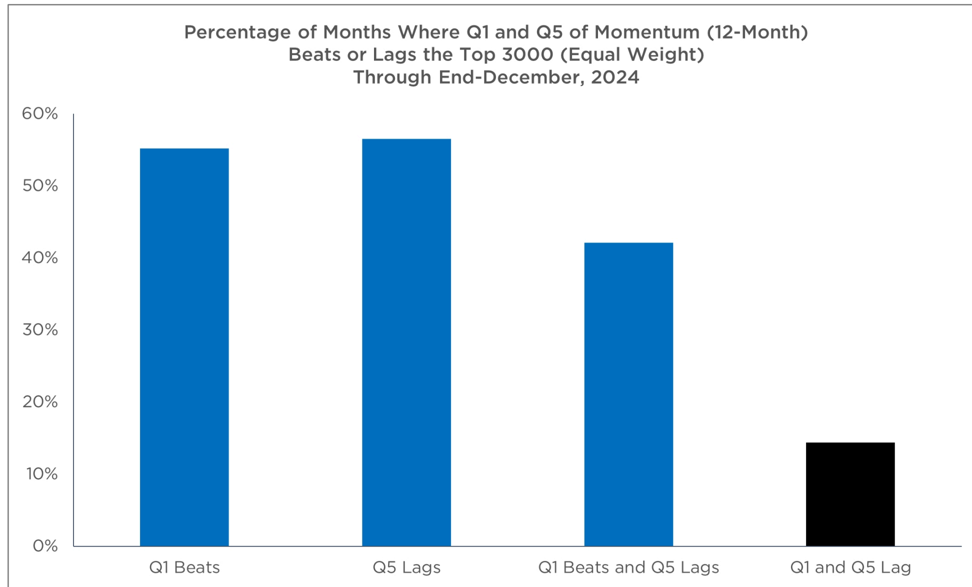
There were some areas where we received investor pushback, however, including our Healthcare overweight. Our recommendation to overweight Healthcare is predicated on the fact that we think earnings estimate achievability is above average for parts of the sector. Furthermore, after the worst two-year relative performance in more than a quarter century, Healthcare appears optically cheap. Historically, revenue growth has been steady, and bottom-up earnings expectations call for double-digit growth in 2025 in nearly all Healthcare sub-industries. We think many of these companies can benefit from margin expansion as they effectively deploy AI analytics, meaning they can grow their revenue without any net hiring over the coming years. Lastly, we see an increase in M&A as very likely, as 5.5% of all Healthcare stocks among the top 1000 US equities by market capitalization typically get a tender offer each year. We believe we will see some multiple expansion following this deal flow.

Several investors have strongly disagreed with this view, citing less potential for effective cost-cutting, pending improvements to government efficiency, less pricing power, and other corrective measures that could meaningfully impair earnings. While we certainly understand the market can predict impending weak fundamentals — in fact that is the crux of our argument when we published a note that 12x earnings is cheap but 6x isn't (see here) — the steadiness of demand, the pricing power, and the potential for cost-cutting and improvement have us excited about margin expansion in Drug Distribution, Hospitals, Managed Care, and Life Sciences, among other parts of Healthcare. We took an AI-for-Healthcare course at M.I.T. in 2024, and came away mesmerized by the productivity potential for the sector. Our judgment is that the risk-reward is skewed positively for the sector.

One line of pushback we received was fascinating. An investor was strongly against price momentum and very cautious on large cap. Technology stocks and some big winners from last year. However, the investor was also short Healthcare. We pointed out that price momentum was typically "two-sided," and that the momentum of Healthcare had been quite bad, but we wanted to investigate how often the top quintile of price momentum fails, and the bottom quintile of price momentum keeps working. Below we show that 55% of the time over the last 25 years stocks that were in the top quintile of 12-month price momentum continue to work over the next month. On the contrary, 57% of the time stocks in the bottom-quintile of 12-month price momentum work the next month. This is likely why traditionally many quantitative models use 12 minus 1-month price momentum, to account for this shorter-term reversal. Over the last 25 years, in 42% of the months we observed both Q1 of price momentum beating the market AND Q5 lagging, which is likely why price momentum overall is a good quantitative factor. Lastly (see black bar below), only 14% of the months in the last 25 years did this investor's "set up" work, meaning the top performing stocks begin to underperform, AND, the bottom-performers from the last year also continue to do poorly. We think

Healthcare performs well in 2025, potentially catalyzed by the JPMorgan Healthcare Conference next week, and the earnings results and guidance that come in the next three weeks.

Only 14% of the Time Do Winners Lose, and Losers Keep Losing



Source: Trivariate Research, LP

The Market Can Get to 10000 by 2030

Another area of our Year-Ahead Outlook in which we saw investor pushback was our belief that the S&P500 can get to 10000 before the year 2030. We We suspect it can, and below we show a range of price-to-forward earnings multiples (from 15x to 25x) on the y-axis and a range of per year earnings growth assumptions (from 5% to 15%) from now through 2031 on the x-axis. The cells that populate the table are the year-end 2030 S&P500 price, depending on the earnings growth and valuation assumptions. The black cells show assumptions that justify the S&P500 around 10000 by 2030. For instance, paying 23x a market that grows 9% per year, or 19x a market that grows 12% per year would both yield a 10000 S&P500 by the end of the decade. Several investors suggested to us that the multiple needed to get to 10000 was way too high, and that the equity market is not likely to appreciate that much because the valuation levels today are already excessively elevated. More people argued against the multiple than the EPS growth assumptions during our recent meetings. Several investors suggested to us that 20x a growth rate of 7% yields a market of 7750, which would be just less than 6% per year return over the next half decade. That is possible, but history dictates more upside, as the 100-year, 50-year, 20-year, and 10-year total S&P500 returns are all above 10% per annum.

20x 7% per Year EPS Growth Yields 6% S&P500 Returns per year for 5 Years

Annual EPS Growth Assumptions

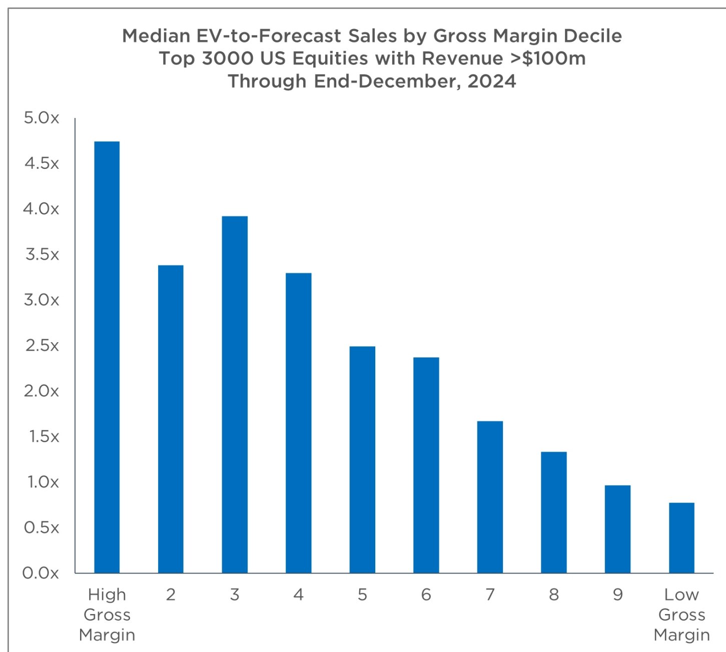
Year-End Price Targets Based on Multiples Applied to 2031 Earnings on Various Growth Assumptions

Price-to-Earnings	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%
15x	5099	5449	5819	6211	6625	7062	7524	8012	8526	9068	9640
16x	5439	5812	6207	6625	7066	7533	8026	8546	9094	9673	10283
17x	5779	6176	6595	7039	7508	8004	8527	9080	9663	10277	10925
18x	6119	6539	6983	7453	7950	8475	9029	9614	10231	10882	11568
19x	6459	6902	7371	7867	8391	8945	9530	10148	10799	11486	12211
20x	6799	7266	7759	8281	8833	9416	10032	10682	11368	12091	12853
21x	7139	7629	8147	8695	9275	9887	10534	11216	11936	12696	13496
22x	7479	7992	8535	9109	9716	10358	11035	11750	12505	13300	14139
23x	7819	8355	8923	9523	10158	10829	11537	12284	13073	13905	14781
24x	8159	8719	9311	9937	10600	11299	12038	12818	13641	14509	15424
25x	8499	9082	9699	10351	11041	11770	12540	13353	14210	15114	16067

Source: Trivariate Research, LP

Our primary answer to this more cautious view of multiples is that there is a strong relationship between margins and multiples. Below we show the pretty clear relationship between enterprise value-to-forecasted sales and gross margin decile. The higher the gross margins, the higher the multiple the market pays, because high margins are a proxy for something that is likely to be sustained into the future.

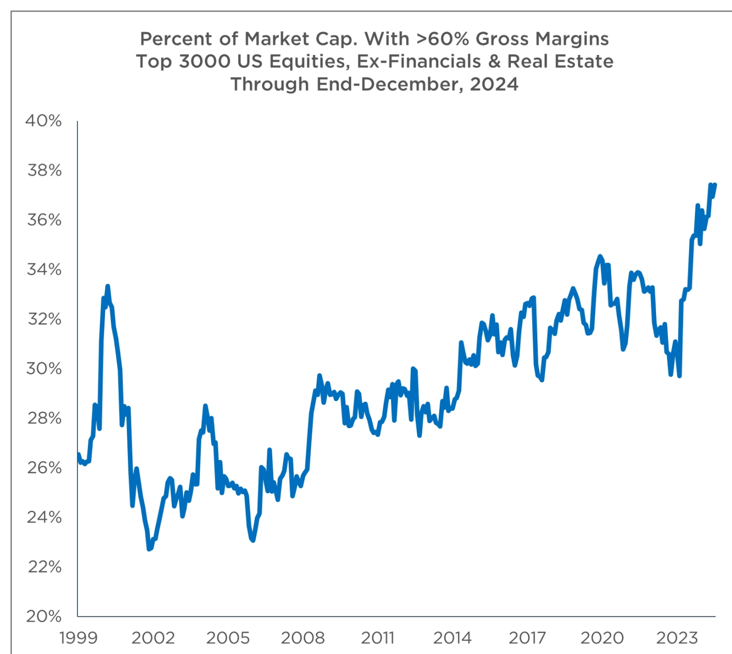
Higher Gross Margins Mean Higher Multiples



Source: Trivariate Research, LP

Hence, if investors think that there will be a much lower multiple paid for US equities in the future than in the past, they are really arguing for much lower margins for most US companies. Right now, the US equity market has more high margin market cap. than any time in the past. Among the top 3000 US equities, 25.4% have greater than 60% gross margins, and that represents the highest percentage (37.4%) of market capitalization ever (see below). That is a major reason why the US stock market is more expensive now than it was during much of its history, and why multiples are likely to oscillate at higher levels in the future than in the past. If you are referencing Schiller PE, or CAPE to inform your analysis, you need to look at these charts and explain why gross margins will revert to long-term averages.

37.4% of the US Equity Market's Cap. Has > 60% Gross Margin



Source: Trivariate Research, LP

CONCLUSION:

In conclusion, when analyzing client feedback from our 2025 Year-Ahead Outlook, there were a number of areas where we were expecting to and did receive pushback, but one area where there was a glaring lack of opposition. The area where there was a surprising lack of pushback was our contention that gross margins won't matter as much to stock picking in 2025 as they did in the past few years, and that differentiation between winners and losers will be defined more by revenue growth acceleration in 2025.

On the other hand, we expected to and did receive ample pushback on our Healthcare overweight recommendation. We understand the stocks have been bad, so this view appears to be contrarian. We will see if contrarian just means "recently wrong" or "consistently wrong" but we think it is unlikely earnings will be as impaired in 2025 as valuations currently imply.

Finally, a number of our clients disagreed with our expectation that long-term, we think multiples for the S&P500 will oscillate at higher levels than they did in the past because the constitution of US equities is much higher margin today than it was historically. Higher margins and higher multiples go hand in hand.

Important Disclosures

Analyst Certification

The analysts, Adam Parker, Maxwell Arnold, Chang Ge, Colin Cooney and Ryan McGovern, responsible for the preparation of this research report certifies that: all the views expressed in this research report accurately reflect the research analyst's personal views.

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