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Equity Insight
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Monthly Equity Market Topics

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In brief

- Is the recent strong rebound the start of a lasting rally and a rotation to small caps? While the move may have some legs, there are reasons to question its durability.
- How did change in momentum behind AI and increasing concerns about growth cause the markets to wobble.
- Concentration in the S&P 500 is raising the specter of cognitive dissonance.

Small Caps: Rotation or Rebound?

Following a weaker June US CPI print and dovish comments from US Federal Reserve Chair Jerome Powell, anticipation for a soft landing and a September rate cut has firmed. This led to a sharp rally of over 10% in small caps in four days, beginning on 10 July.[1]

Are small caps back? Will falling rates help? History shows that equity performance can vary significantly during Fed rate-cutting cycles. While each cycle is different, the driving force is typically the strength of the underlying economy. If the rate-cut cycle is a normalization of policy (a soft-landing scenario), markets and riskier cyclical assets typically do fine. However, if the economy deteriorates sharply (a harder-landing scenario), the market typically sells off and riskier, higher-beta assets feel the most pain.

When looking at factor performance in small caps, we typically expect to see quality factors outperform cyclical ones at the start of a Fed rate-cutting cycle. This is an understandable reaction given that the Fed is usually cutting on the back of slowing growth and deteriorating macroeconomic fundamentals. The usual reaction function for investors is to be risk-averse and seek higher-quality, defensive companies, ones that are better positioned to deal with a slowdown or potentially benefit from lower rates. Our expectation is that the quality bias will hold true within the value and growth cohorts and that cyclical growth and value could underperform in the event of a slowdown.

No two cycles are the same and, in this cycle, beginning post-GFC, the Russell 2000® performed pretty much in line with the S&P 500 — until the 2018 sell off. Since then, the S&P 500 has powered ahead — and increasingly so — coming out of COVID, despite a recent period of robust economic growth, which is usually a positive for small caps. One reason small caps have lagged this time is that they have felt more impact from higher interest rates given their greater exposure to floating rates, directly impacting their profitability.

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With their greater, mostly floating rate debt burdens and a longer duration profile, it's not surprising to see small caps (and other riskier segments) rally more aggressively on rate cut expectations following softer inflation data. Coupled with this is the potential easing of concerns over small- to mid-sized banks, which are a large component of the index. Lower rates may reduce some of pressure on CRE loans, and if long-term rates fall too, it will reduce losses on banks' bond holdings. However, rate cuts won't save a poor business model or an over-indebted business.

Our view is that this is more of a rebound than a rotation as the market embraces a soft-landing scenario. And, while it may have some legs, it seems too early to call it a rotation without having higher conviction for a recovery in small-cap earnings and on the likelihood of a soft landing materializing. Near term, small companies still lack earnings momentum. And while this may improve going forward, the jury is still out on whether this will happen at a faster rate than large caps, whose earnings breadth, as we highlighted in the Market Pulse, is broadening beyond the mega-cap tech names.

Longer term, we are more constructive on small caps given their reasonable valuations and the potential for a longer-term earnings recovery as rates normalize. Investors may want to consider being selective, and focused on higher-quality, defensive names with strong free cash flow.

Equity Markets Creak

US shares have fallen for two-straight weeks. In our view, there has been a shift in sentiment after some stocks got a little frothy on the all the AI hoopla. To us, the past two weeks wasn't a broad-based correction but a recalibration of earnings expectations for AI-themed stocks and their adjacencies. While there is no question around the potential for AI and its power hungry and high-end computing needs, questions remain on how (and how quickly) AI will be monetized in the years ahead. These stocks have some of the largest weightings in the index and helped drive it up and before bringing it back down.

Meanwhile, the rest of the stocks in the index have done fine and sectors such as utilities and real estate are benefiting from rate cut expectations. That was until 1 August, when an ugly ISM report sent a further shiver through markets, with only the defensive sectors and Meta holding up. Momentum and sentiment swung against the AI trade, particularly the semiconductor sector, which continues to bear the brunt of the selling pressure as investors grapple with how and when the massive capital expenditures that technology companies are making to build out their AI infrastructure will be monetized.

When momentum turns as quickly as it has, there is always some contagion and technical selling; however, the weak ISM data highlighted a significant softening of manufacturing activity. Seemingly of greatest concern was weakness in the employment component of the index, which was confirmed by soft nonfarm payrolls the next day. While the AI trade may have gotten ahead of itself as valuations ramped up, the idea of gently rising unemployment and moderately slowing growth have been called into question. The data is noisy, and we think it's likely we'll see more market volatility as the market's focus shifts to growth and unemployment and away from inflation and rates.

So far, second quarter earnings have largely confirmed a broadening of earnings growth across the market, which is why, until recently, those non-AI related stocks continued to hold their own. We believe those whose multiples had not expanded on lofty expectations are better positioned to ride out this volatility, but those that disappoint are being punished. It is times like these that durability and stability of earnings are highly prized.

After hitting highs earlier this month, Japan's Topix fell 6% on 2 August on concerns that the impact of a rising yen (following the Bank of Japan rate hike) will have on Japanese corporate earnings.[2] The Financial Times reports that the sell-off may have been accelerated by retail investors exiting a popular leveraged Nikkei 225 ETF which was down 11.5% as well as reports of large selling orders from US and European long-only funds. The surging yen drove a rapid unwind of the carry trade and added fuel to the selloff as leverage was unwound. All this activity produced a spike in volatility as foreigners and local leveraged players exited the market to cover their positions. Systematic processes that use Value At Risk in their models were also forced to quickly reduce risk on the rising volatility, further driving risk markets down.

Despite the weaker PMI and unemployment data, there is no clear evidence the US economy is on a trajectory to a potential recession. In our view landing was always likely to be bumpy and, as market actions tell us, little harder than consensus only a few days ago. Some of this was not unexpected given pockets of the market looked stretched as valuations ran up. Momentum is a powerful factor and typically drives markets to overshoot on the way up and on the way down. Good businesses with long-term durable advantages and robust balance sheets may have no problem weathering these bouts of volatility and their fundamentals may not have materially changed.

Index concentration

A final thought on concentration. We believe having a view on the S&P 500 is not a view on the overall US stock market. In essence, it's a view on a handful of very large companies. Three of these companies, as of the end of June, were roughly the same size as our entire stock market over here in the UK. We think where these companies go, the S&P 500 index will follow, with the rest having little impact. There is some cognitive dissonance at work here, namely a view on the S&P 500 may not be a view on US equities in general.

Heuristic of the month – Confirmation bias

Confirmation bias is our tendency to favor information that is consistent with or confirms our existing beliefs. We feel it's important to stay curious and seek out people or data that challenge your beliefs.

Endnotes

[1] Bloomberg.

[2] Bloomberg.

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