WEALTH MANAGEMENT

Weekly Market Update

July 22, 2024

Rotation

Equity market leadership has experienced a dramatic shift in recent weeks.

Executive Summary

- The recent equity market shift saw a move away from the mega-cap "Magnificent 7" to a broader market performance following the June CPI report.
- Small-cap stocks experienced a significant rally, with the Russell 2000 index gaining approximately 11.5% over five trading days, signaling potential market turns and strong future returns.
- Small caps are trading at attractive valuations and have higher exposure to sectors like financials and healthcare, positioning them well if the market rally broadens beyond the tech sector.

Though previous rate cutting cycles have largely been unkind to small caps, the non-recessionary easing of 1995 bodes well for the space. We continue to look for two Fed rate cuts in the second half of this year, providing the potential for further tailwinds as the U.S. economy avoids recession.

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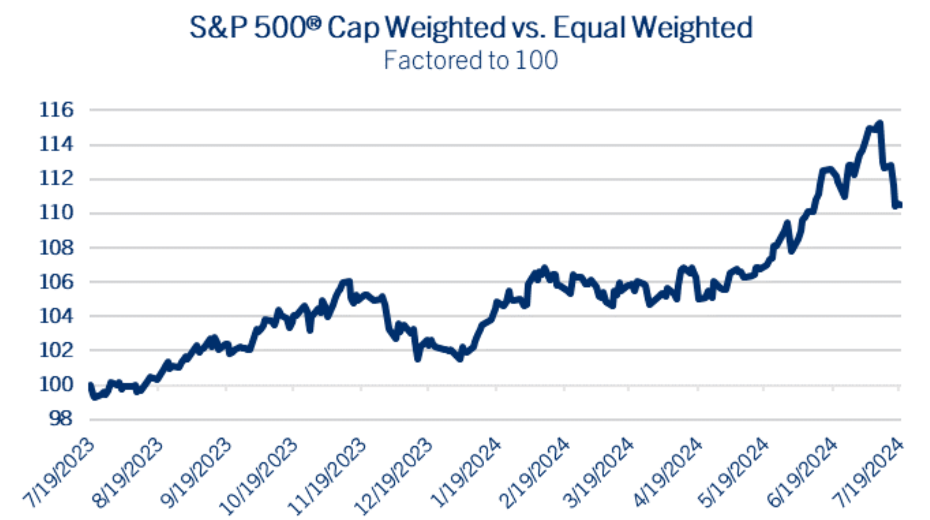
Rotation

Equity market leadership has experienced a dramatic shift in recent weeks.

In the first half of the year, the market was dominated by the mega-cap "Magnificent 7," which contributed over half of the S&P 500®'s 15.3% total return. This trend changed following the June CPI report, which showed the first month-over-month decline in prices since 2020. This report sparked a rotation in equities, with investors reallocating from this year's outperformers to laggards, leading to a more balanced performance across the equity market. See chart: S&P 500® Cap Weighted vs Equal Weighted



Source: Bloomberg L.P.

The impact of this rotation is most evident in the strong rally of small-cap stocks.

The benchmark Russell 2000 index, which had been nearly flat in the first half of the year, surged approximately 11.5% over five trading days from July 9 to July 16. This rally ranks among the top 0.2% of all five-day periods since the index's inception. Historically, such momentum shifts have often signaled significant market turns and strong future returns. See table: Forward Russell 2000 Performance

Forward Russell 2000 Performance
After 5-Day Change in Top 1%

	+ 3 Months	+6 Months	+12 Months
Average	8.1%	14.6%	28.0%
Median	9.0%	14.5%	23.1%
% Positive	73.7%	78.9%	82.1%

Source: Strategas Research Partners

Catalysts

Indeed, several catalysts that have propelled small caps higher may continue.

Messaging from the Fed following June's CPI report underscores the increasing confidence that monetary policymakers will be able to cut rates this year. Small-cap stocks stand to benefit more than large cap stocks from lower interest rates as roughly 40% of companies in the Russell 2000 index are unprofitable and thus more dependent on capital market financing to fund operations.

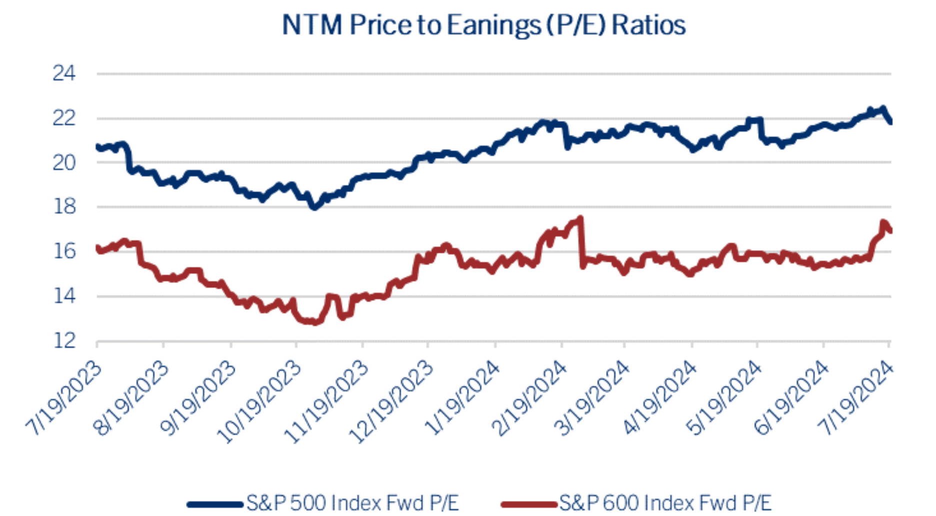
It's important to note that while lower interest rates could benefit small caps, past rate-cutting cycles have been challenging for the Russell 2000 index. Since 1981, the index has averaged a -1.5% return in the 12 months following the first Fed rate cut of a cycle. However, understanding the context of rate cuts is crucial. In six out of seven rate-cutting cycles, the cuts preceded an economic downturn leading to a recession. The exception was 1995, when a recession did not follow, and the index rallied 20.2% over the next year. See table: Russell 2000 Performance During Rate Cut Cycles

Russell 2000 Performance During Rate Cut Cycles		
First Cut	Fwd. 12 Mo. Return	Recession
6/1/1981	-20.99	Yes
10/2/1984	8.93	Yes
6/5/1989	-1.16	Yes
7/6/1995	20.25	**No**
1/3/2001	3.79	Yes
9/18/2007	-15.04	Yes
8/1/2019	-3.15	Yes
Average	**-1.05**	

Source: Bloomberg L.P.

Valuation

Currently, small-cap stocks are trading at attractive valuations compared to their larger counterparts. Large caps are significantly more expensive than their historical averages, making small caps appealing for investors seeking growth opportunities at lower prices. The chart below shows the Price to Earnings (P/E) ratios for the large cap S&P 500® index compared to the small cap S&P 600 Index®. **See chart: NTM Price to Earnings (P/E) Ratios**



Source: Bloomberg L.P.

Part of the reason small caps are trading at lower valuations is due to sector composition.

Small caps have higher exposure to financials, consumer discretionary, energy, and healthcare sectors. In contrast, large caps are heavily weighted towards technology. If the market rally continues to broaden beyond the tech sector, small caps could see significant benefits. However, if the economy slows down, these sectors might face challenges, impacting small cap performance.

The political landscape has also played a role in the small-cap rally. Increasing odds of a Republican administration is seen as a benefit for smaller companies which stand to benefit more from the prospect of lower taxes and less regulation.

Conclusion

The recent rotation into small-cap stocks is driven by a combination of attractive valuations, sector composition, and shifting market dynamics. Given the smaller size and relatively less liquidity of the small cap market, it only takes a small spark to ignite a powerful move in the space.

Though previous rate cutting cycles have largely been unkind to small caps, the non-recessionary easing of 1995 bodes well for small cap stocks. We continue to look for two Fed rate cuts in the second half of this year, providing the potential for further tailwinds as the U.S. economy avoids recession.

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