Small-Cap Stocks Bolstered by Possibility of Interest Rate Cuts

Election news dominated headlines through July and culminated in President Joe Biden declining to seek a second term, instead endorsing Vice President Kamala Harris as the Democratic Party's candidate. The markets don't particularly like uncertainty, but the turbulence that followed this commotion is not likely to linger as more fundamental market forces play out.

"Politics is only one of ten factors in our equity outlook framework and in fact, it ranks pretty far down the list," said Raymond James Chief Investment Officer Larry Adam. "Macro factors and fundamentals are much more important in determining the market's direction."

The market's expectations have been on a rollercoaster regarding the Federal Reserve (Fed) cutting interest rates this year, but with inflation receding and consumer spending beginning to slow, lower rates seem finally in sight. This has bolstered small-cap stocks, which had their best monthly performance in July relative to large-cap stocks since December 2000*.

Historically, small caps outperform in anticipation of and following a first rate cut, and this rally is supported by improvements to corporate earnings. Earnings are on track to rise 10% year over year, turning in the best quarter since the fourth quarter of 2021. Real estate and financials were the best performing sectors. Tech-related sectors underperformed.

Bond yields were lower across the board, led by shorter-term securities, as markets priced in the likelihood of a rate cut.

Employment remained strong in June, with the establishment employment survey showing jobs increasing by 206,000, but the unemployment rate – which comes from the household survey – inched up to 4.1% from 4.0%.

We'll dig into the details below, but first we'll look at the numbers year-to-date:

	12/29/23 Close	7/31/24 Close*	Change Year to Date	% Gain/Loss Year to Date
DJIA	37,689.54	40,842.79	+3,153.25	+8.37%
NASDAQ	15,011.35	17,599.40	+2,588.05	+17.24%
S&P 500	4,769.83	5,522.30	+752.47	+15.78%
MSCI EAFE	2,241.21	2,340.81	+99.60	+4.44%
Russell 2000	2,027.07	2,254.48	+227.41	+11.22%
Bloomberg Aggregate Bond	2,162.21	2,184.96	+22.75	+1.05%

*Performance reflects index values as of market close on July 31, 2024. Bloomberg Aggregate Bond and MSCI EAFE reflect July 30, 2024, closing values.

Market volatility amidst earnings season

The S&P 500, which measures the aggregate performance of the largest U.S. companies, rallied at the end of the month and finished July up 1.2% – within the range of a normal market adjustment. Showing just how starkly market sentiment has shifted, the Russell 2000, which measures the performance of small U.S. companies, returned 9.8% last month.

Earnings season has been as expected so far, with 79% of companies beating earnings by an average surprise of 4.4% – a deceleration from the 7.8% surprise of last quarter.

Treasury yields dropping in anticipation of rate cuts

Treasuries rallied in July, taking yields lower for the month with shorter-term yields falling more than longer yields (the 2-year yield dropped around 34 basis points while the 30-year fell by nine). The curve remains inverted, but with decreased depth – the spread on the two-year/10-year curve, which has been inverted since July 2022, moved from negative 36 basis points to negative 20.

Bloomberg calculations are now pricing in a 25-basis point cut to the fed funds rate in September and another one to two by the end of the year, a sentiment reflected in short-term yields with the one-year Treasury falling by more than 40 basis points since April.

CPI shows first deflationary month in four years

Second-quarter GDP growth came in above consensus at 2.8% annualized, quarter-over-quarter. The economic growth, however, didn't put more pressure on prices, indicating the higher-than-expected inflation readings of the first quarter were likely one-offs.

Inflation, as measured by the Consumer Price Index (CPI) was lower than expected, declining by 0.1% – the first deflationary month since May 2020 – while the year over year rate dropped to 3.0%. Important data from the report to note is the slowdown in shelter costs, which, if sustained, will continue to put downward pressure on the CPI for the remainder of the year, which would be good news for the Fed and the path of monetary policy.

Watching November's election take shape

After last month's shakeup, the markets will be closely monitoring the Democratic National Convention for indications of Vice President Harris' policy priorities. While her platform is expected to largely align with that of the Biden administration, important nuances will likely be clarified around the convention.

Former President Donald Trump's selection of Ohio senator JD Vance as running mate was a key development in July, especially given the importance Trump has historically placed on the policy input of his vice president. Vance's selection seems to confirm an aggressive trade agenda, especially toward China, would continue under a second Trump administration.

Interest rate cuts in Europe, Canada and China; Bank of Japan hikes rates

July's European elections delivered divergent outcomes in France and the U.K., with the host nation of the summer Olympics seeing political fragmentation that could lead to further fiscal policy turbulence. The new U.K. administration, on the other hand, should provide financial markets with a more predictable agenda and a commitment to fiscal discipline.

The European Central Bank, having cut interest rates in June, will be monitoring the French government closely to prevent market conditions from further deterioration.

The Bank of Canada has also cut interest rates – as expected, and for a second successive time – while signaling there may be more cuts in the pipeline, which could allow the economy to grow without risking more inflation.

In response to the conclusions reached at the Chinese Communist Party's Third Plenum, the People's Bank of China cut interest rates for the first time since last summer, providing some reassurance that policymakers and the central bank are taking action to prevent further slowdowns in economic momentum.

The Bank of Japan (BOJ) continues to buck the global easing trend, raising its key interest rate for the second time this year to 0.25% and announced a reduction in its bond buying program. The move signals the BOJ's growing confidence in the recovery.

Iranian election's potential impact on oil prices

The most important election last month as it relates to the energy sector was Iran's. Newly elected President Masoud Pezeshkian ran on a platform of domestic reform and more engagement with the international community. Iranian foreign policy tends to fall within the purview of the Supreme Leader rather than the president, but more pragmatic diplomacy could reduce tensions and the geopolitical risk premium in the oil market. An important test case emerged at the very end of the month, after the political leader of Hamas was killed in Tehran, presumably by Israel. If the Iranian government shows restraint, it would help to avoid further escalation and minimize the risk of all-out war with Israel.

The bottom line

The volatility we're seeing isn't entirely unexpected, considering we've seen only one 5% pullback in the S&P 500 so far in 2024 when we typically see three or four per year – not to mention the uncertainty around the presidential election. Now that we're in the weakest seasonal period of the year, caution is warranted, but this is why we invest long-term.

We will remain committed to the pursuit of your financial goals and thank you for your continued trust in our guidance. If you have any questions about his recap – or anything else – please don't hesitate to reach out.

* FactSet, 7/30/24

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