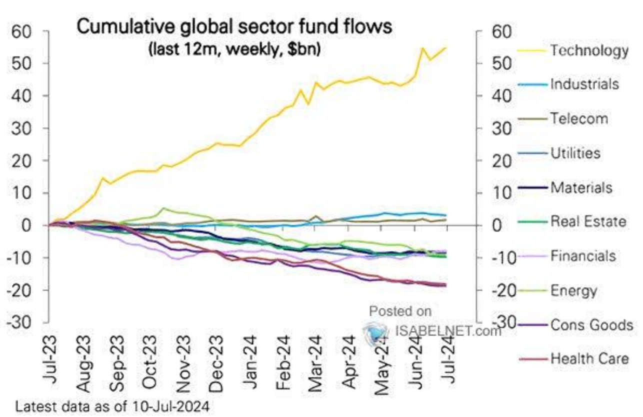
Is the Rotation Under Way?

Q2 2024 Commentary

Since the bottom of the correction in 2022, we have moved the narrow leadership of FANG (Facebook, Amazon, Netflix, and Google) stocks to the magnificent seven. These seven are all mega-cap growth names that we highlighted last quarter. The artificial intelligence (AI) trade has been the hot common theme again this quarter. We highlighted the importance of remaining disciplined even when the market forces don't reward sound diversification. If you have been investing in anything other than technology recently, you are swimming upstream with a strong current against you (see sector flows below).

Figure 88: Sector fund flows



Source : EPFR, Haver Analytics, Deutsche Bank Asset Allocation

The term "smart money" has generally implied the institutional money managers that have years of experience and resources will often be a step ahead of the traditional individual investor. However, with the internet, the ease of many small investors pouring into their favorite tech stock is moving the market in ways never seen in the past. Often after a social-media outlet hype, the result can be major market moves in a particular issue based on millions of very small investors concentrating into a theme. The GameStop incident of a few years ago illustrated that as a flood sub $1,000 investments took the multi-billion dollar hedge fund managers to the proverbial woodshed as they pumped up the stock, to the detriment of the "smart money" short sales (betting on it to drop). Even if the investment thesis is based on unsound or irrational logic, the outcome still comes down to supply and demand for a security. A large volume of trades can bid any security higher or lower, just like a frenzy of bidders at an auction.

Remember the frenzy in cryptocurrency and Non-fungible Tokens (NFT) in 2019? The frenzy ended as fast as it began, and most of those prices plummeted or went bankrupt. The difference with this melt up is that the tech companies are primarily large and very profitable, like Nvidia (chipmaker). However, even though most of these magnificent seven stocks are profitable, the market valuations have become meteoric and the small investor could be contributing.

There is an old saying that trees don't grow to the sky. which implies that at some point there is an end to the hyperbolic rise resulting from a bubble in any commodity or security sector.

YTD

	Value	Blend	Growth
Large	6.6%	15.3%	20.7%
Mid	4.5%	5.0%	6.0%
Small	-0.8%	1.7%	4.4%

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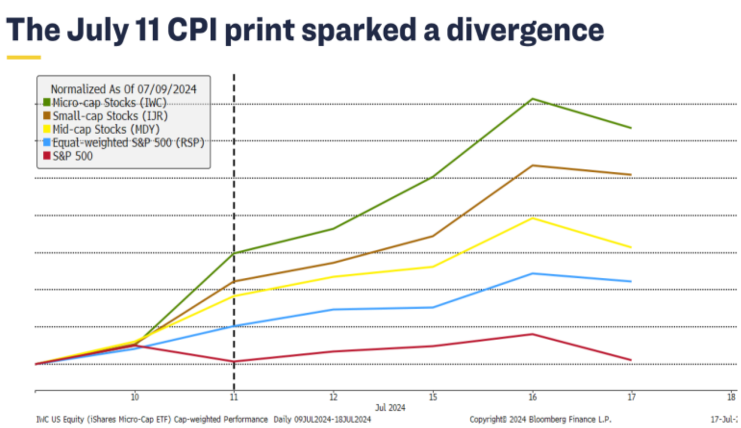
The performance and valuation dichotomy between the large company high growth equities (mainly technology) and value stock – small and mid-cap – is significant (see above).

Both small and medium size companies perform better when interest rates decline as their ability to use debt to operate becomes more cost-efficient. As signs that inflation is finally cooling and interest rates trending lower, a recent rotation may be the beginning of something for significance. The chart below shows the early July outperformance of small cap equities. With so many investors (large and small) bidding up the few popular large cap technology names over the past year, the test of time will show us if they all head for the door at once to sell if they see weakness, or if an orderly rotation will occur.



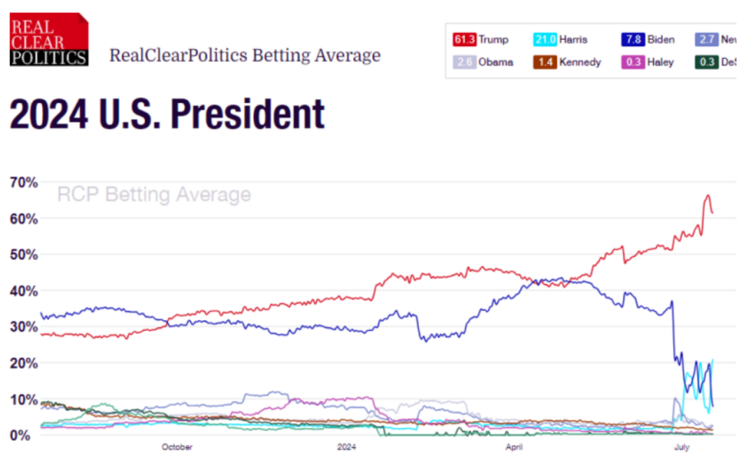
Source: Eventide Asset Management, Bloomberg Finance L.P. Used with permission of Bloomberg Finance L.P.

Source: FactSet, Refinitiv Datastream, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management.
All calculations are cumulative total return, including dividends reinvested for the stated period. Since market peak represents period from 2/19/2020 to 6/30/2024. Since market low represents period from 3/23/2020 to 6/30/2024. Returns are cumulative returns, not annualized. For all time periods, total return is based on Russell style indices except for the large blend category, which is based on the S&P 500 Index. Past performance is not indicative of future returns. The price-to-earnings is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM) and is provided by FactSet Market Aggregates and J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of June 30, 2024.

Important to remember is diversification across asset classes and style. The market will usually revert to more reasonable valuation over time.

The fall will surely bring more surprises with interest rates, economy, and of course, the election. Things are changing rapidly even since I began writing this commentary. The recent events have implied a Trump victory, and the question of a sweep or a split house persisting is at stake. The markets have typically preferred a split house. It is no surprise that politicians getting their party's complete agenda without resistance in not optimal. Trump policy would favor energy, small caps, and banks, and be less favorable to big tech. Stay tuned!

Who will be the Next President?



Source: https://www.realclearpolitics.com/elections/betting-odds/2024/president/, As of July 18, 2024.

We will continue to monitor the economic indicators, market valuation, and election news.

We appreciate your continued confidence and trust!

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Keep in mind that individuals cannot invest directly in any index, and index performance does not include transaction costs or other fees, which will affect actual investment performance.

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