

ClearBridge

A Franklin Templeton Company

AOR Update: The Great Rotation?

1 August 2024

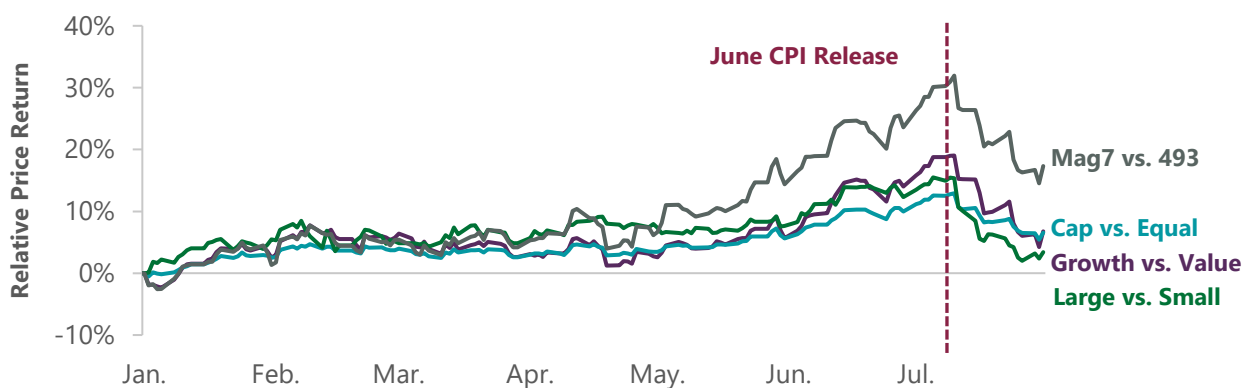
Key Takeaways

- ▶ Equity markets experienced one of the most severe rotations in years in July, with small cap and value stocks surging and mega cap tech stocks selling off.
- ▶ A key question for investors is whether this move continues or fades out similar to previous rotations. Several of the five primary catalysts that sparked the recent leadership shift may persist over the coming quarters.
- ▶ While a growth scare could spark a retracement of this rotation, we ultimately expect a pickup in economic growth which should favour small cap, value and cyclicals. The potential for frenetic trading highlights the importance of maintaining a diversified portfolio. Active managers have an advantage over passive benchmarks, given their ability to sidestep areas of potential overvaluation.

Softer Inflation Reading Sparks Meaningful Leadership Shift

Equity markets experienced one of the most severe rotations in years in July, with previous laggards like small cap and value stocks becoming leaders and previous leaders like mega cap tech stocks becoming laggards. The S&P 500 Index ended +1.2% higher on the month, a statistic which belies the turmoil that occurred beneath the surface. While the first part of the month saw a continuation of the leadership that dominated markets in the first half of 2024, the CPI release on the morning of July 11 marked a turning point. Since their peak the day prior, the Magnificent Seven stocks are down 9.4% while the Russell 2000 is up 9.9%. Further, the S&P 500 equal-weight index outpaced the cap-weighted version by 5.6% and the Russell 1000 Value Index outpaced the Russell 1000 Growth Index by just over 10%.

Exhibit 1: 2024 Equity Market Leadership



Data as of 31 July 2024. Source: S&P, Russell, UBS, and Bloomberg. Note: Mag7 vs. 493 is the UBS Magnificent 7 relative price return vs. UBS S&P ex Magnificent 7; Cap vs. Equal is the S&P 500 relative price return vs. S&P 500 Equal Weight; Large vs. Small is the Russell 1000 relative price return vs. Russell 2000; Growth vs. Value is the Russell 1000 Growth relative price return vs. Russell 1000 Value.

This shift has taken many investors by surprise and, while we view the broadening of market leadership as a healthy dynamic, the key question looking forward is will this move persist or fade out in a manner similar to several previous rotations in the last few years. We believe it is informative to analyse the five primary catalysts that sparked the rotation and to then formulate a view regarding which dynamics may have already fully played out and which may have greater durability in the coming months.

1. **Cooling Inflation:** The leadership rotation began in force following the release of the June CPI data. A third consecutive softer print helped confirm that the elevated inflation readings from the first quarter were more of an aberration, clearing the way for the Federal Reserve to begin normalising interest rates at its September meeting. This should help reaccelerate U.S. economic growth in 2025 and fully cement the already unfolding soft landing, which should drive superior earnings growth for more cyclical businesses that perform better when GDP is picking up. Small cap and value benchmarks typically have greater exposure to cyclical companies relative to large cap and growth, and are thus positioned to continue to benefit as interest rate policy normalises later in 2024 and into 2025.
2. **Positioning:** Prior to the June CPI data, 2024 had largely been marked by a continuation of the past several years in which the Magnificent Seven (Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, Nvidia and Tesla) dominated equity markets. This multiyear dynamic has drawn strong flows into these names, resulting in skewed positioning, with most investors crowded over to one side of the metaphorical boat. While investors have started to spread out across the rest of the boat, this extreme positioning has not yet been fully unwound. However, the initial round of associated short covering is likely closer to its end, meaning this dynamic is less likely to be a primary driver over the intermediate term.
3. **Market Concentration and Valuation:** The 10 largest S&P 500 constituents accounted for 37.5% of the benchmark coming into the third quarter. This is well ahead of what was seen in the late 1990s and lends to elevated concentration risk. Further, this dynamic has skewed valuations because the 10 largest names traded at 29.3x expected next-12-month earnings while the other 490 were at a much more reasonable 17.8x. Stretched valuations mean less downside protection when the perception of negative news takes hold, and while this valuation gap has narrowed in July, there is further room for both valuation gaps (between the largest names and the rest of the market) to normalise and index concentration to unwind over the next few years.

Exhibit 2: Largest Stocks Distorting Valuations



NTM = Next 12 Months. Data as of 30 June 2024. Source: UBS.

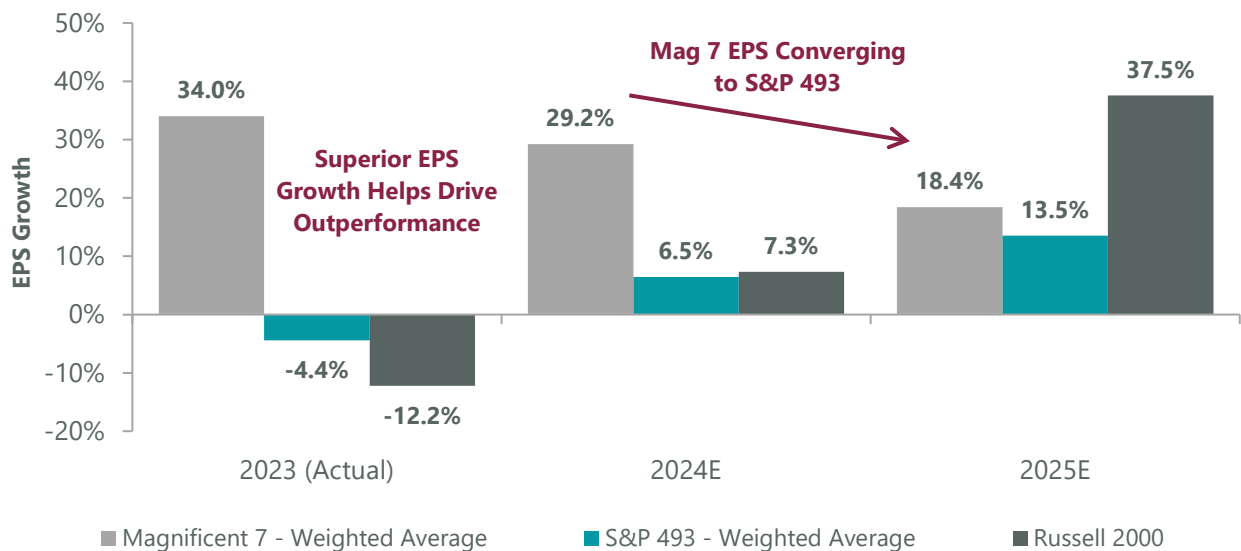
4. An AI Bubble? The early read from second-quarter earnings season was somewhat disappointing, with softer numbers and disappointing guidance from some AI-exposed names in particular amplifying the budding leadership rotation. However, with earnings season now past the halfway mark, more recent reporters have delivered better numbers and more optimistic guidance. While investors may keep questioning if AI mania has been taken too far, profit taking on weakness following a tremendous rally may continue. However, we believe many of these fears are overblown, a view rooted in conversations with our sector research colleagues such as ClearBridge Technology Hardware Analyst Anuj Parikh, who notes solid underlying fundamentals in the space:

“Rapid advances in generative AI and the development of more capable models is contributing to strong adoption of AI infrastructure and services by millions of developers and leading companies across industries as AI enables them to develop better-quality software, find insights from their data and protect their organisations from cybersecurity threats.”

Given this, we do not believe that AI bubble fears currently represent a long-term driver of a leadership rotation.

5. Relative Earnings Growth: Recent market leadership has been largely supported by fundamentals, with the largest S&P 500 names delivering strong EPS growth while the rest of the benchmark and small cap stocks experienced an earnings recession. However, the second quarter is expected to be the last quarter where the Magnificent Seven have a meaningful EPS growth advantage, and they are, in fact, expected to lag going forward. This change in relative fundamentals is beginning to be discounted in earnings multiples, with earnings the primary driver of market returns over longer periods of time. Accordingly, this swing in relative earnings growth — should it play out — could drive a more durable market leadership rotation over the next 12–18 months.

Exhibit 3: Mag 7 Advantage Dissipating



Magnificent 7 data refers to the following set of stocks: Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA), and Tesla (TSLA). Data as of 31 July 2024. Sources: FactSet, Russell, S&P.

Putting this all together, several of the primary drivers behind the recent market leadership rotation have the potential to persist over the coming quarters. Leadership rarely moves in a straight line, and we believe the near term (the next several months) could see an oscillation that favours the previous leadership on the perception of safety if the economy cools further. Ultimately, we believe a soft landing will play out, a view rooted in the signals emanating from the ClearBridge Recession Risk Dashboard, which had no changes this month and remains in green (expansionary) territory.

Exhibit 4: ClearBridge Recession Risk Dashboard

	July 31, 2024	March 31, 2024	December 31, 2023	
Consumer	Housing Permits	●	●	✘
	Job Sentiment	✘	✘	✘
	Jobless Claims	●	●	●
	Retail Sales	●	●	●
	Wage Growth	↑	✘	✘
Business Activity	Commodities	●	●	●
	ISM New Orders	●	●	✘
	Profit Margins	↑	✘	✘
	Truck Shipments	●	●	●
Financial	Credit Spreads	↑	●	●
	Money Supply	●	✘	✘
	Yield Curve	✘	✘	✘
Overall Signal	↑	●	✘	

↑ Expansion ● Caution ✘ Recession

Source: ClearBridge Investments.

While a [growth scare](#) may nip this building leadership rotation in the bud, we believe the economy will ultimately reaccelerate. Our confidence is based on a solid macro foundation, few excesses in the market and a more accommodative Fed. This pickup in economic growth should favour the recent winners, namely small cap, value and cyclical stocks more exposed to an accelerating economy. Potentially frenetic market leadership is a good reminder of the importance of portfolio diversification and periodic rebalancing, particularly following long stretches of out- (or under-) performance. Finally, the events of the past few weeks also serve to highlight the advantage that active managers possess when market concentration reaches extremes, as passive funds are unable to sidestep areas of potential concern in the benchmarks they track.

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