AVALAN

WEALTH MANAGEMENT INSIGHTS

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What the Summer Market Rotation Means for Investors

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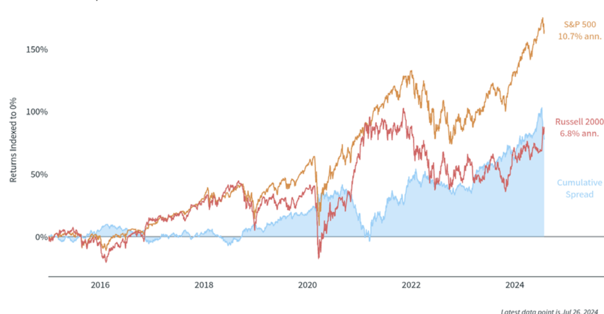
AVALAN's Key Takeaway:

The market rotation from large caps, especially technology and artificial intelligence stocks, and into other areas such as small caps, has driven market uncertainty higher. Rather than overreacting to these moves, investors should instead maintain a long-term perspective and focus on their strategic asset allocations.

As the summer heats up, the stock market is experiencing its own heat wave in the form of rising volatility. Market uncertainty has climbed as investors rotate out of large cap technology stocks and into a broader array of sectors and styles, including small caps. Since their respective peaks in mid-July, the Nasdaq Composite Index has declined 7% and the S&P 500 is down about 4%. Meanwhile, the Russell 2000 index of small cap stocks has jumped over 11% since early July. What's driving this rotation and how can investors maintain perspective on upcoming events?

Investors are rotating away from large cap technology stocks



Stock market swings are never pleasant, and it's difficult to know whether they are the result of short-term shifts or long-term trends. The presidential election is approaching and investors have many questions about what this might mean for economic policy and their portfolios. Geopolitical tensions are flaring as well, especially in the Middle East. At the same time, corporate earnings are healthy, consumer spending is resilient, and GDP growth remains robust. Through all this, most investors expect the Fed to begin cutting rates in just a couple of months.

In theory, lower rates should be positive for most parts of the market. So why has there been a "market rotation" rather than a continuation of the "everything rally" that we've experienced on and off over the past decade?

While it's important to not overreact to market movements over a few days or weeks, it's clear that investors are beginning to question the rally among artificial intelligence stocks. The Magnificent 7 stocks, for instance, have experienced a historic bull run of nearly 170% since the beginning of 2023, far outpacing broader market indices. By definition, market runs can't last forever, so it was inevitable that a pullback would eventually occur – the hard part is knowing exactly when.

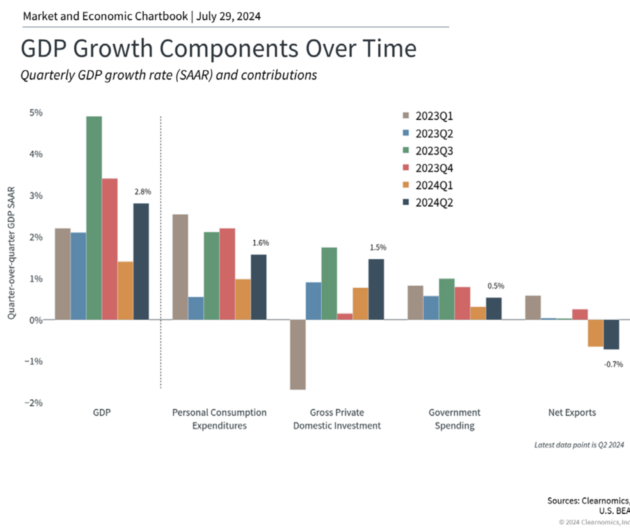
There are also growing questions around the billions of dollars large companies are investing in AI and whether there will be a sufficient return on these investments. This speaks to the fact that not all good ideas make for good investments, since the latter depend on paying a reasonable price.

Additionally, small caps have performed well because they tend to be more sensitive to interest rates and economic growth. This is because smaller companies tend to have less flexible financing options than large or mega cap ones, and thus benefit more when rates decline.

They also tend to be less globally diversified, and thus more sensitive to domestic growth trends which recent data confirm are quite healthy.

This has resulted in a rotation rather than a broad rally. Still, there are reasons to be optimistic for the overall market. In the long run, bull markets are driven by earnings growth, and corporate earnings among large companies have been quite strong. According to FactSet, with 41% of companies having reported results this earnings season, about 78% have exceeded expectations, resulting in a projected S&P 500 earnings growth rate of 9.8%. Not only is this historically strong, but it also represents a continuation of the earnings recovery that began one year ago.

Economic growth is healthy



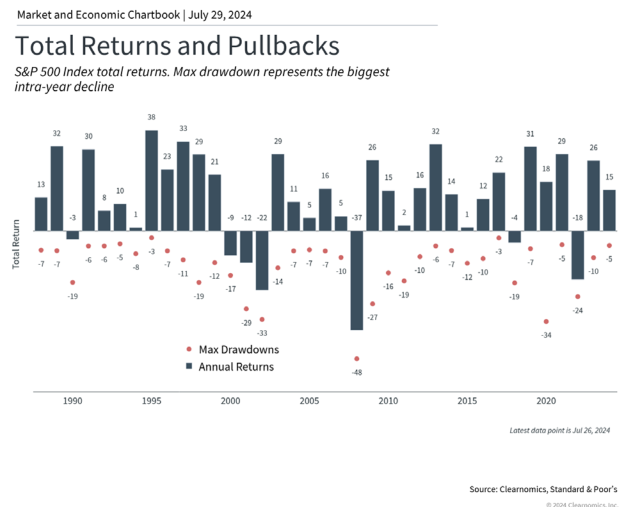
If market rallies are driven by strong earnings, those earnings are in turn driven by a healthy economy. According to last week's GDP report, the economy grew at a rate of 2.8% in the second quarter, exceeding consensus expectations of 2.0%. This is a significant acceleration from the first quarter's 1.4% growth rate. As shown in the accompanying chart, jumps in consumer spending, business investment, and government spending helped drive the headline number, with trade reducing it slightly. Despite high interest rates and fears of an economic slowdown, consumer spending was resilient, contributing 1.6 percentage points to overall GDP.

The Personal Consumption Expenditures index latest report showed that price pressures continue to improve. Overall prices rose only 0.1% in June or 2.5% year over year, a slight deceleration from the prior month, and core inflation increased 2.6%.

Avalan "fact checks" the official PCE ex-food & energy report with the, we believe more accurate, Fed bank alternative calculations of core PCE inflation. And, as usual for this cycle, the alternates tell a much more worrisome story. The Cleveland Fed median PCE came in higher than PCE ex-food and energy for June, while Dallas was close. Both alternates are trending higher than the main core series over 12 months. And the Cleveland core trend has even turned higher this spring, while core PCE has flattened.

The resilience in the economy, despite higher rates, is a good sign for a continued "soft landing."

It's important to maintain a level head during volatile periods



As is always the case, it's important for investors to maintain a longer-term perspective when facing periods of market volatility. This is especially true given the current economic backdrop, which should be positive for the market. Short-term pullbacks and market rotations are both normal and expected as investors evaluate new facts and data.

For example, the accompanying chart shows that the largest decline this year has only been 5%. This is quite low by historical standards, especially when compared to the strong year-to-date gains by the S&P 500 (15%) and Nasdaq (16%). Most years experience far more significant intra-year pullbacks, yet still end in positive territory.

This highlights the importance of always being prepared for stock market volatility. Pullbacks are an unavoidable part of investing, especially with heightened event risk in the coming months. How investors deal with these risks is often far more important than the risks themselves. The current rotation is also a reminder for investors to maintain diversification across a number of market areas, and not focus only on whatever is performing well at the moment. Sticking to these long-term principles is still the best way for investors to achieve their long-term goals.

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