

# Investment Views

AUGUST 2024

## The Great Rotation and UK Pendulum Beginning to Swing?

Anyone who follows stocks markets will be cognisant of the recent dominance of the large cap technology stocks, nicknamed the “Magnificent Seven”. Apple, Microsoft, NVIDIA, Alphabet, Amazon, Meta and Tesla accounted for almost 60% of the S&P 500’s 14.5% gains in the first half of this year.

Excluding those seven stocks, the market would have risen less than 6%. In contrast, the US small-cap stock index, the Russell 2000, rose only 1% during the same period, whilst mid-caps added 5% and the well-known Dow Jones Industrials Average less than 4%. These are meaningful differences, indicating the undue influence of those seven stocks versus the remaining 493, and the heavy weighting of the main US index to the AI theme.

The reasoning behind their meteoric rise, which began in earnest in early 2023, says that the current market leaders will continue to dominate their fields and grow ever more powerful, leaving the rest of the market in the dust. Their cast-iron balances sheets and healthy pace of growth provide plenty of cash for investing heavily in R&D, something competitors simply cannot match. For example, Mark Zuckerberg, Meta’s chief executive and founder, thinks the infrastructure, maintenance and training costs for Llama 4, it’s Large Language Model, might be ten times the amount spent training Llama 3, which was far from inconsequential itself. This exponential growth in required funding shows no signs of slowing down, meaning very few players can really compete. Once delivered, this market-leading product should expand Meta’s user base, resulting in even more cash flow to invest in the next iteration and keep competitors at bay. The advantage of scale becomes ever more difficult to break. All of which leads investors to bid up the stock as they project the future.

At least that was the story until recently. Then, on one day in July, the S&P 500 fell almost 1%, the Nasdaq 2%, but the small cap Russell 2000 index actually gained 3.5%. Another meaningful difference but this time of a different kind. The Russell 2000 then beat the S&P 500 over one seven-day period by the largest margin going back to 1986, as demonstrated by the red line in the chart below rising almost vertically in July. The Russell 1000 Value index also produced its biggest lead over its growth-stock counterpart since April 2001, after the dotcom bubble burst\*.

During a typical “risk-off” pullback in markets, one would expect all segments to decline, just some areas by more than others.



Yet as we move into August, the performance gap between the indices has continued to narrow significantly. So what is going on here? Is it just a blip in the soon-to-resume tech-dominance story, or is it the start of a genuine and longer-term market rotation. The answer has implications for portfolio construction and market performance expectations for the rest of the year.

Most of the headlines lean towards this being the start of the great rotation that markets have been looking for: a broadening of price strength to better reflect the soft-landing being successfully engineered by the Federal Reserve, which is taming inflation without unduly impacting job creation or spending, thus enabling the debt-fuelled party to continue. The Wall Street Journal went as far as to say that a rotation “of historic proportions” is taking shape. If so, the good news is that this is exactly what is needed to sustain healthy equity market returns. Participants have been looking for signs of this for some time, as it would imply confidence in the underlying economy as a whole, not just the richly valued “winner takes all” technology behemoths that will crush all in their path.

In support of that view, one of the catalysts for the rotation was certainly the softer CPI inflation figure released on 11th July. That, plus cooling employment figures, raised hopes for a rate cut by the Federal Reserve as soon as September, which in turn would alleviate the financing costs of the vast majority of American firms that rely on bank financing for access to funds. Only the biggest firms can sell bonds in the capital markets. Everybody else relies on bank financing. So a sign from Central Bankers that we have turned the corner in the fight against inflation, opening the way for longed-for interest rate cuts was welcome. The ensuing rise in small cap stocks was beneficial but despite that, they continue to trade at relatively undemanding valuations. This means that any further good news on the macro front, which increases the probability of additional rate cuts, would mean further gains, at least for small cap stocks relative to the market as a whole.

The bad news is that an economic soft landing would be the exception not the norm, particularly given the steep monetary tightening that has taken place since March 2022. Even then, markets are already pricing in several rate cuts this year, with more to follow next year. This forecast level of cuts will probably only materialise if we see economic weakness. Weakness will impact small cap companies the most, as they often operate single lines of business or sell in single geographies, leaving their profit margins and earnings heavily exposed to the vagaries of the economic cycle. Since both margins and earnings are already high, further progress in the face of a weakening economy would be very challenging indeed.

In fact, small cap stocks do not tend to enjoy their best period when an economy might be about to enter a recession, but

rather when it emerges from one, as their earnings and profits rebound significantly. The operating leverage that has punished them on the way down, buoys them on the way up.

Where does that leave us? In the US, the opportunity does not look sufficiently clear-cut to us. Valuations are reasonable but predicated on profits that already look stretched. Combined with over-enthusiasm around the pace of rate cuts, caution around the Great Rotation is warranted for now, although it is something we are keeping a close eye on. Further evidence that the reason for rate cuts is inflation coming under control rather than the underlying economy really beginning to suffer might change our view. However, data out this week showing the biggest number of job cuts in four years along with a significant decline in manufacturing activity, suggests otherwise. Bad news may be taken as bad news, rather than just opening the way for rate cuts.

In the UK, however, we think the situation is somewhat different. The small cap segment offers good value and now operates in an environment of renewed political certainty and a government with a mandate for growth. The UK should become a more attractive place to do business, the economy is starting to show signs of life, we have seen the first interest rate cut since 2020, equities remain cheap and companies are buying back stock in significant amounts. All this bodes well. It feels as though after everything the UK market has had to deal over the last few years – Brexit, the Scottish referendum, Covid, domestic pension schemes selling down UK stocks for greater international exposure, an “old economy” market with little AI exposure and political turmoil - the pendulum may just be starting its long, if slow, swing back.

\* WSJ, July 22, 2024: A Stock Market Rotation of Historic Proportions Is Taking Shape

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