Market Commentary

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Is It Time to Broaden Our Focus?

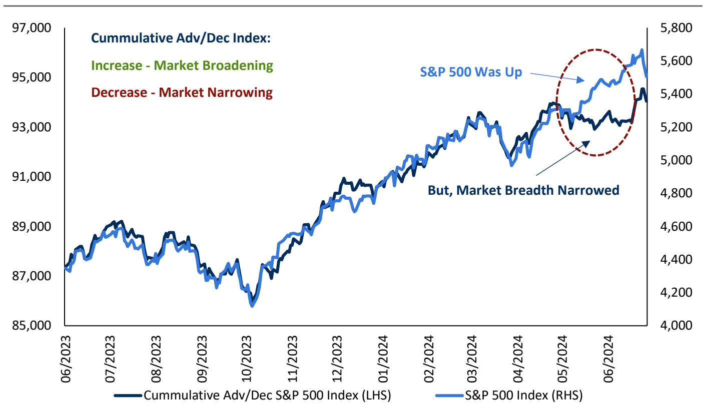
Just as a spotlight moves across different performers on stage to showcase their unique talents, market rotation shifts focus among various sectors and asset classes based on their performance and potential. For the past two years, the Magnificent Seven and semiconductor firms have been the stars, with Nvidia taking a leading role, delivering exceptional performances to the rhythm of the A.I. theme. Meanwhile, other performers, such as rate-sensitive sectors and small-cap stocks, have played supporting roles or waited in the wings. In early to mid-July, these previously sidelined sectors stepped into the limelight, gaining some audience attention after striving for recognition since last October. The question now is: Should we continue to spotlight the current stars, or is it time to use a wide angle light to broaden our focus and explore these emerging sectors?

How the spotlight transitions (whether it is fast, slow, or choppy from here) depends mainly on two factors: (1) central bank rate decisions and (2) future earnings expectations; with both being ultimately driven by the macroeconomic backdrop. Given our soft landing expectations, with two rate cuts by the end of 2024 in the U.S., we expect resilient earnings across most of the defensive and rate-sensitive sectors in S&P 500 to support the continuation of sector rotation from mega-cap tech to these sectors. As for small-cap stocks, we need to see more fundamental improvement in their earnings to be convinced that they are ready to outperform for an extended period.

The variations in market breadth of the S&P 500 year-to-date have really been driven by anticipation of Fed rate decisions and uncertainty about the U.S. (and global) economy. In Charts 1 and 2, market breadth is illustrated by the cumulative advance/decline line ("A/D line"), which represents the cumulative total of advancing stocks minus declining stocks. An upward trend in the A/D line indicates a broadening market (a net increase in advancing stocks), while a downward trend signifies a narrowing market.

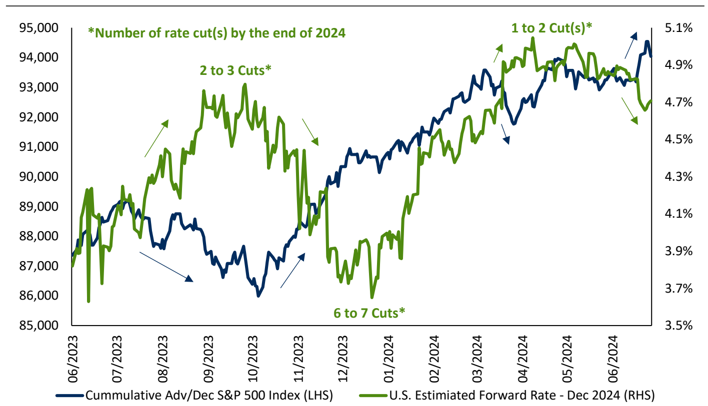
From last October to early March, both the A/D line and the S&P 500 were rising, indicating a broadly bullish market with more stocks contributing to the rally (Chart 1). The trend then became a bit choppy over the next month, but both the A/D line and the S&P 500 still moved in the same direction. However, in early May, we saw a significant divergence: the S&P 500 continued to climb while the A/D line declined. This suggested a very narrow market, where a few stocks, notably the Magnificent Seven, drove the index higher even as most stocks fell, potentially signaling a reversal of the upward trend. Fortunately, the June CPI reports released in early to mid-July provided more certainty about potential rate cuts this year, triggering a broader market rally.

Chart 1 - Market Breadth Had Been Improving Until It Went Sideways in Q2



Source: Bloomberg; Raymond James Ltd.; Data as of July 19, 2024.

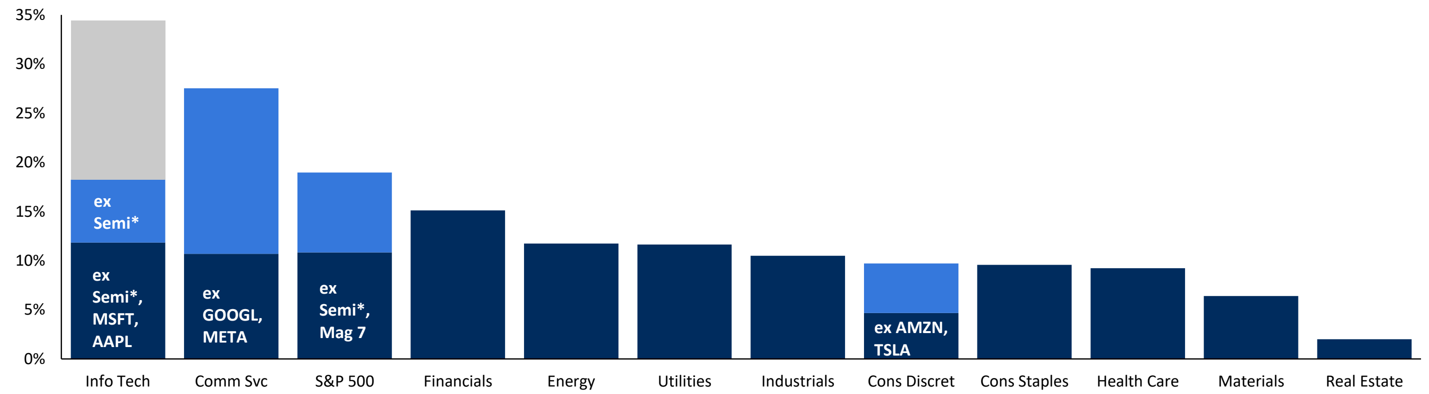
Chart 2 - Rising Uncertainty is the Main Factor Causing Market Narrowing



Source: Bloomberg; Raymond James Ltd.; Data as of July 19, 2024.

In Chart 2, we can see that rising uncertainty was a key factor causing the market to narrow in May. This is illustrated by comparing the A/D line's development over the same period with the estimated forward rate for December 18, the date of the last FOMC meeting this year. The December forward rate serves as a good estimate for the number of rate cuts the market expects in 2024. It's clear that the A/D line and the estimated forward rate tend to move in opposite directions. This occurs because, when the market broadly believes in a soft landing, rather than a recession, and the sooner and more frequently that rate cuts take place, the sooner a new market cycle phase can begin. This is welcome news for the broader market, especially rate-sensitive sectors, which benefit from rate cuts through generally higher earnings and P/E expansion. Consequently, market breadth improved as the estimated forward rate for December moved lower (indicating more cuts) and became choppy or declined as the forward rate moved higher. When rates are expected to remain elevated for longer, capital tends to flow into mega-cap tech stocks amid economic uncertainty. This explains the divergence in market breadth and performance in May when the Fed became more hawkish after disappointing first-quarter inflation reports, bringing the no-cuts scenario back into discussion. Looking ahead, we expect labour market conditions to have an increasing impact on rates. Charts 1 and 2 together indicate that the current rotation into the broader market depends on the certainty surrounding rate expectations and the overall economy.

Chart 3 - YTD Sector Performance and Breakdown of Sectors Containing the "Magnificent Seven" and/or Semiconductor Industry



Source: Bloomberg; Raymond James Ltd.; YTD total returns as of July 15, 2024. *Semiconductor and semiconductor equipment industry group.

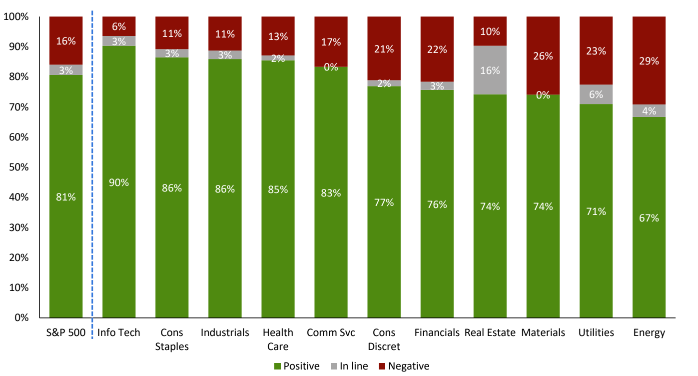
Year-to-date S&P 500 sector performance shows that the rotation into rate-sensitive and defensive sectors is actually well underway, despite a sideways movement in May. Among the sectors without Magnificent Seven stocks, Financials generated the highest year-to-date total return of approximately 15%. While Materials and Real Estate sectors lagged, the remaining sectors delivered solid high single-digit to low double-digit returns (Chart 3). Notably, when excluding the Magnificent Seven and the semiconductor industry ("semi") from their respective sectors, these sectors—despite high A.I. enthusiasm—performed in line with or even underperformed the rate-sensitive sectors. For instance, the Info Tech sector posted a YTD total return of around 34%. Excluding semi, the return drops to approximately 18%, and further excluding MSFT and AAPL, the return is only about 11%. Similarly, the Communication Services sector returned about 27%, but excluding GOOG and META, the return is around 11%. The Consumer Discretionary sector showed a return of 10%, but excluding AMZN and TSLA, it drops to just 5%. These significant differences suggest that investing in the Magnificent Seven and semi stocks is more about risk aversion and capital protection amid rising uncertainty, rather than purely driven by A.I. enthusiasm. Investors are clearly more cautious about A.I. investments this year compared to 2023, as the performance gap between mega-cap tech and other stocks in the same sectors was not as pronounced last year. Moreover, the outperformance of mega-cap tech and semi stocks has masked an ongoing shift from the mid to late market phase.

S&P 500 sector earnings have remained strong, supporting the ongoing rotation. At least 67% of companies in each sector reported a positive earnings surprise in the first quarter of 2024 (Chart 4). However, signs of weakness are emerging as the "long and variable lags" of monetary policy continue to exert downward pressure on consumption and investment. We are also seeing cracks in the labour market, evidenced by the rising unemployment rate and recent discrepancies between official employment measures. It's important to note that U.S. consumer spending is currently driven by higher-income households (the top 50%), who spend about 2.4 times more and earn 4.7 times more than lower-income households (the bottom 50%). The high rate environment has likely benefited their investments and increased their net worth. Although we expect overall consumer spending to soften, higher-income households are likely to help prevent a recession. Ideally, a slowdown in consumer spending and cooling inflation should lead the Fed to lower rates in line with market expectations, which could stabilize the real economy and provide more clarity about where it is heading. If this occurs, earnings might be negatively affected, but not significantly, and we'll get a clearer picture as the second-quarter earnings season progresses. Nonetheless, earnings in defensive sectors are expected to remain relatively resilient, which will further support the sector rotation.

Regarding the future performance of the Magnificent Seven and semi stocks, the shift toward defensive sectors doesn't necessarily mean these stocks will underperform the broader market. However, they might face tougher scrutiny, and their investment rationale could change. As mentioned earlier, investors have been crowding into the Magnificent Seven and semi stocks due to their resilience in a high-interest-rate and uncertain environment, thanks to their technology and resources. If economic uncertainty decreases, investors may consider alternative options and will likely scrutinize how A.I. technology is applied and the profitability of these investments. This focus will be crucial for future outperformance.

Moreover, a key risk to watch for is that the market has set very high expectations for the earnings growth of these stocks. Even if their growth surpasses the market average, they could face negative reactions if they only meet or fall short of these aggressive targets. On the other hand, a lower interest rate environment would benefit growth stocks, potentially allowing other companies in the Information Technology, Communication Services, and Consumer Discretionary sectors to better compete with mega-cap tech stocks.

Chart 4 - S&P 500 Earnings Surprise (2/16/2024 - 5/15/2024)



Source: Bloomberg; Raymond James Ltd.

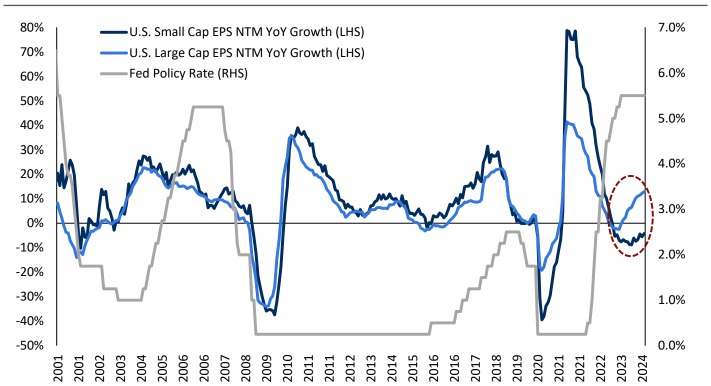
Table 1 - Four Possible Scenarios for How Rotation May Evolve

Rate Decisions	Earnings Growth: Continuing the downward trend	Earnings Growth: Starting to improve from now on
Hold rate for longer	Recent rotation into small-cap stocks likely to be short-lived	May boost market confidence somewhat by demonstrating resilience, but high macroeconomic uncertainty could still hinder the rotation
Two cuts by the end of 2024 (Baseline Est)	Market likely to wait for earnings to bottom out before resuming the rotation	In a Goldilock economy, market enthusiasm about the new phase of the market cycle will gradually build up, supporting the rotation into small-cap stocks

Source: Raymond James Ltd., as of July 19, 2024.

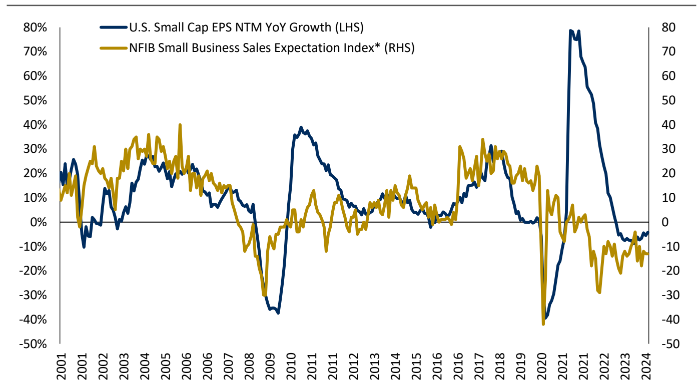
As for small-cap stocks, they experienced a rally from late October 2023 through the end of the year, but they lagged behind large-cap stocks in the first half of 2024. While the recent surge in July is impressive, we're not yet convinced that this outperformance will continue in the long term without further improvements in small-cap earnings. Much like our analysis of the rotation into rate-sensitive and defensive large-cap sectors, small-cap performance will be shaped by the same two key factors: (1) central bank rate decisions and (2) future earnings expectations. Table 1 outlines four possible scenarios. Although small caps are currently trading at attractive valuation multiples, their recent rally is likely to be sustainable only if the Fed cuts rates as expected and if small-cap earnings begin to improve. For both conditions to be met, the U.S. economy must remain in a Goldilocks phase—where well-timed rate cuts stabilize consumer spending and investment without causing significant further economic deterioration.

Chart 5 - Historical Small-Cap and Large-Cap Earnings Growth Trend



Source: FactSet; Raymond James Ltd.; Data as of July 19, 2024.

Chart 6 - Small Business Sentiment and Small-Cap Earnings Growth



Source: FactSet; Raymond James Ltd.; Data as of July 19, 2024.
*Net percent ("higher" minus "lower") during next three months, seasonally adjusted.

Historically, small-cap stock earnings have been more volatile and inconsistent compared to large-cap stocks', reflecting their greater sensitivity to economic conditions (Chart 5). Year-to-date, small-cap earnings growth outlook has improved somewhat, although it continues to decline, just at a slower pace. In contrast, large-cap earnings growth has been rising since mid-2023, primarily due to the Magnificent Seven. The S&P 493 experienced an earnings recession in 2023 but has shown gradual improvement earlier this year. While small-cap earnings aligned more closely with the S&P 493's trend in 2023, they haven't kept up with the recovery pace seen earlier this year. In previous rate easing cycles, earnings growth didn't bottom out until the end of the easing cycle. Given our expectation of a slowdown rather than a full recession this time, we remain cautiously optimistic about earnings. The Street consensus predicts that in the third quarter, small-cap stocks are set to have their first quarter of positive EPS growth in six quarters. Nevertheless, economic uncertainty will remain high until the rate easing cycle begins, consequently, so will the earnings.

One of the leading indicators of future EPS for small caps is the NFIB Small Business Sales Expectation Index. This index surveys small business owners about their sales expectations for the next three months and is reported as the net percentage of those expecting higher sales versus lower sales (Chart 6). It often precedes small-cap earnings growth trends. In June, the index was at -13%, below the long-term median of 9%, though it has improved from the 2022 low of -29%. Despite this, there hasn't been a significant improvement in sentiment yet. Therefore, we anticipate that the market may choose to wait for earnings to bottom out before fully resuming the rotation into small caps (bottom left quadrant of Table 1) in the coming months.

In addition to the main factors we've discussed, several other considerations could influence market rotation. First, with this being an election year, "Trump trades" have gained considerable attention, but these trends often prove unsustainable. We believe that Fed rate decisions, economic conditions, and earnings growth have a more crucial impact on the market. Second, during broad market recoveries, small-cap stocks often outperform large-cap stocks. However, when the Fed last achieved a soft landing in 1995, rates were lowered by only 75 basis points during that easing cycle, and small caps performed barely in line with large caps. Since small caps are more sensitive to changes in policy rates, the magnitude of the rate cuts will also matter as we forecast the future performance of small caps versus large caps in this rate easing cycle. Third, small-cap indices generally do not gravitate towards technology as much as large-cap indices do, particularly in the semiconductor industry. Therefore, if enthusiasm around A.I. continues to grow, it would provide a strong tailwind for the large-cap indices but not so much for the small-cap indices.

In summary, we believe it's time to selectively shift the spotlight and broaden our focus to opportunities beyond the Magnificent Seven and semi stocks. Our forecasts for Fed rate decisions and earnings growth suggest that the sector rotation into large-cap rate-sensitive and defensive sectors will likely continue. However, we need to see further fundamental improvements in small-cap earnings to be convinced that they are poised for sustained outperformance. Ultimately, as the market gains more confidence in a soft landing for the U.S. economy, these rotations are expected to accelerate. Despite potential market noise and unexpected events, it's important to stay invested and remember that long-term, patient investors have historically been rewarded.

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