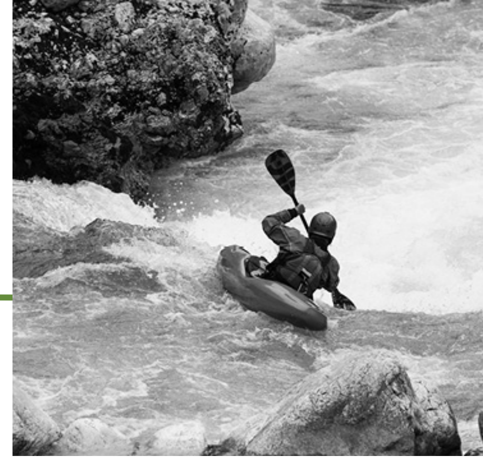
MARKET SIGHT LINES



The Speed of Market Rotation: Staying the Course

By Michael O'Keeffe, *Chief Investment Officer*

Last week, we talked about how the cap-weighted S&P 500 is up big this year and last, driven by artificial intelligence (AI) optimism and the strong performance of the "Magnificent Seven" larger tech-oriented stocks. We discussed recency bias, or the often incorrect belief that recent events, like this market dominance, will continue and how such bias can spell trouble during a market rotation. To be a little more specific, the article was written on July 10, and, somewhat to my surprise, such an equity rotation may have begun, at least for the last week. In this Sight|Lines, we further discuss the potential for a stock market rotation and use the market shifts of the last week to illustrate how quickly a meaningful rotation can occur.

THE TAKEAWAY: DON'T CHASE STRONG EQUITY PERFORMANCE, AS ROTATIONS CAN OCCUR QUICKLY

Big tech-oriented stocks in the U.S. have been driving the market higher, but over the last week or so, that trend has reversed, illustrating how quickly a rotation can occur. In summary:

- The cap-weighted S&P 500 has performed well this year and last, driven by AI optimism.
- Many Wall Street strategists are predicting a stock market correction in the U.S., with a focus on possible weakness in the big tech-oriented stocks, like those measured by the Magnificent Seven Index.
- Especially in periods with a potential for market rotation, investors should seek to avoid recency bias, or the idea that going forward things will just remain the same.
- Investors with a diversified, "equal-weighted" equity strategy, often used by active managers, should stay the course rather than be discouraged by recent underperformance.
- Specific investment segments, like the cap-weighted S&P 500, can sometimes dominate, but a meaningful rotation away from dominance can happen quickly.
- We saw a glimpse of that over the last week, illustrating that capitulating to recency bias and chasing performance right before a market rotation can erode investment results.

IN-DEPTH: DON'T CHASE THE RECENTLY STRONG-PERFORMING EQUITY STRATEGIES OR SEGMENTS, AS ROTATIONS CAN OCCUR QUICKLY, ERODING RETURNS

Last week, we discussed how the big tech-oriented stocks have driven the cap-weighted S&P 500 higher, but that we were setting up for a rotation. Coincidentally, the beginning of such a rotation may have begun over the last week, illustrating how chasing performance can erode returns. Going deeper:

- The cap-weighted S&P 500 has performed well this year, driven by AI optimism:
  - The Magnificent Seven Index was up 51% through July 10.
  - The cap-weighted S&P 500 returned 19% over the same period.
- With elevated price levels and a slowing economy, stock performance may cool:
  - Many Wall Street strategists, including Stifel's Barry Bannister, expect a market correction.
  - Recent winners, like the cap-weighted S&P 500 and Magnificent Seven, could lead markets lower, like in 2022.
- Specific investment segments, like the cap-weighted S&P 500, can sometimes dominate, but a meaningful rotation away from dominance can happen quickly, and we saw a glimpse of that over the last week:
  - The Magnificent Seven Index fell 7.2% from July 10 through July 17.
  - The cap-weighted S&P 500 fell 0.8% over the same period.
  - The equal-weighted S&P 500 returned 5.7% through July 10, then rose 3.5% over the last week.
  - As another illustration of a big move, the Bloomberg U.S. 2000, a small cap index, returned only 0.8% through July 10, but rebounded 8.8% from July 10 through July 17.
- Let's consider an investor who was watching the strong performance of the cap-weighted S&P 500 and capitulated on July 10, switching from an equal-weighted approach to the cap-weighted approach:
  - The cap-weighted S&P 500 beat the equal-weighted S&P 500 by 13.3% year to date, through July 10.
  - The pattern reversed, with the equal-weighted S&P 500 beating the cap-weighted S&P 500 by 4.3% from July 10 through July 17, making up about a third of the underperformance in just one week.
  - So, here are year-to-date results through July 17 for the three strategies:
    - The cap-weighted S&P 500 returned 18.1%.
    - The equal-weighted S&P 500 returned 9.4%.
    - A strategy switching from the equal-weighted to cap-weighted S&P 500 on July 10 would have returned 4.8%, eroding the "stay the course" equal-weighted return by 4.6%.
- This example illustrates how Investors with a diversified, "equal-weighted" equity strategy should avoid recency bias and stay the course rather than be discouraged by recent underperformance.

CONCLUSION

To be clear, I am not a big fan of focusing on very short-term performance, especially when investors are seeking to time the market – a tough thing to do. But after discussing the potential for a market rotation just last week, I felt compelled to continue on the same topic, as such a possible rotation presented itself since then. By looking at the numbers – the size and direction of the shifts – we are able to illustrate how capitulating and switching to a strong-performing segment right before a rotation can really erode investment performance.

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Asset allocation and diversification do not ensure a profit and may not protect against loss. Dollar-cost averaging does not assure a profit or protect against a loss. Investors should consider their ability to continue investing during periods of falling prices. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The S&P 500 Equal Weight Index is the equal-weight version of the widely regarded Standard & Poor's 500 Index, which is generally considered representative of the U.S. large capitalization market. The index has the same constituents as the capitalization-weighted S&P 500, but each company in the index is allocated a fixed weight of 0.20% at each quarterly rebalancing. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The Bloomberg U.S. 2000 Total Return Index is a float market-cap-weighted benchmark of the lower 2,000 in capitalization of the Bloomberg U.S. 3000 Index. The Bloomberg Magnificent Seven Total Return Index is an equal-dollar weighted equity benchmark consisting of a fixed basket of seven widely-traded companies classified in the United States and representing the Communications, Consumer Discretionary and Technology sectors as defined by Bloomberg Industry Classification System (BICS).

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