THE **CAMBRIDGE** WEEKLY

22 July 2024

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Shock, rotation, growth?

Last week was an astounding week. Capital markets took the attempted assassination of Donald Trump as practical confirmation of his victory in the upcoming presidential election. Equities moved to price in his expected agenda of tax cuts and deregulation, expectations he bolstered with his speech at the Republican National Convention. Stocks of small and mid-cap US companies particularly benefitted – a continuation of the rotation that started the previous week.

Then, last Friday, we saw what many are calling the largest IT outage in history. Disruption was widespread impacting many trading systems. This has inevitably caused market disruption but, as of yet, not so much price volatility. Still, some traders will be badly affected and losses will be hard to assess before IT infrastructure is back online.

Funnily enough, after the ups and downs, many stock indices ended last historic week not far off where they started.

IT failure could hurt tech.

Thankfully, our own internal systems do not appear to be directly affected by the global IT outage. But the economic, financial and human impacts could be large. Health services, flights and financial transactions have been hit. UK financial regulators are trying to assess the scale of the problem, but it is clear that some people and firms encountered difficulty accessing funds or settling trades. This increases the short-term risk in affected investment positions, since traders might be unable to close certain positions, therefore exposing them to downside they did not account for.

After sudden shocks like this, risks can feel stark, but they are often recovered once the disruption subsides. It is likely to add some extra pressure to big tech stocks like Microsoft – whose systems are at the centre of the outage. Big tech has already been struggling over the last few weeks, thanks to the market rotation from big to small cap (which we discuss below and in a separate article). Investors appear in the mood to look for bad news regarding the mega-caps, and a global IT disaster certainly fits the bill.

As long-term investors, our focus is more on what this episode might mean for the future. While the cause seems to be a malfunction rather than any attack, we suspect more resources will go towards bolstering cybersecurity – both for companies and governments. Interestingly, we had already started looking more closely at the cybersecurity sector, following Google's announcement of a $23 billion bid for start-up firm Wiz, and this only adds more reason. (Ironically, Wiz is only four years old; its founders sold a very similar business to Microsoft for $320 million in 2015!). One possible long-term effect could be a reduction in the openness of the global internet – analogous to the raising of international trade barriers in recent years. We will have to watch this space.

Trump's predictions accelerate rotation.

Donald Trump surviving an assassination attempt has pushed the former president from election favoured to presumptive winner – at least according to markets' reaction. It has done something which previously seemed impossible for the divisive Trump: make him sympathetic to undecided voters – for now at least. The narrative we are seeing is that, unlike a few weeks ago, it does not matter who the Democrats choose as a replacement – most likely Vice President Kamala Harris.

Stock prices for small and (particularly) mid cap companies have benefitted massively from the news. There is a perception that a decisive lead for Trump reduces uncertainty about what might happen in November. That might sound odd, considering that Trump is by his very nature a wild card, but markets feel confident that a second term – potentially accompanied by Republican victories in the Senate and House of Representatives – will mean another round of corporate and personal tax cuts. The Russell 2000, America's main small-cap index, had its strongest week since 2000 in response.

We welcome this shift away from the previously dominant tech mega-caps, but have a few niggling worries about markets' assessment. While Trump is clearly now favourite for the White House, a lot can happen before November, and it is not clear why his success should mean success for House Republicans. A second Trump term will also bring many uncertainties.

The most important from our perspective is fiscal policy and bond markets. Debt and deficits are already very stretched, and Trump would certainly look to stretch them further. This could have some nasty effects on US markets. Falling bond yields last week suggest that markets are not worried about this, but that could quickly change. We write about market rotation in a separate article.

Is momentum the dominant driver of markets?

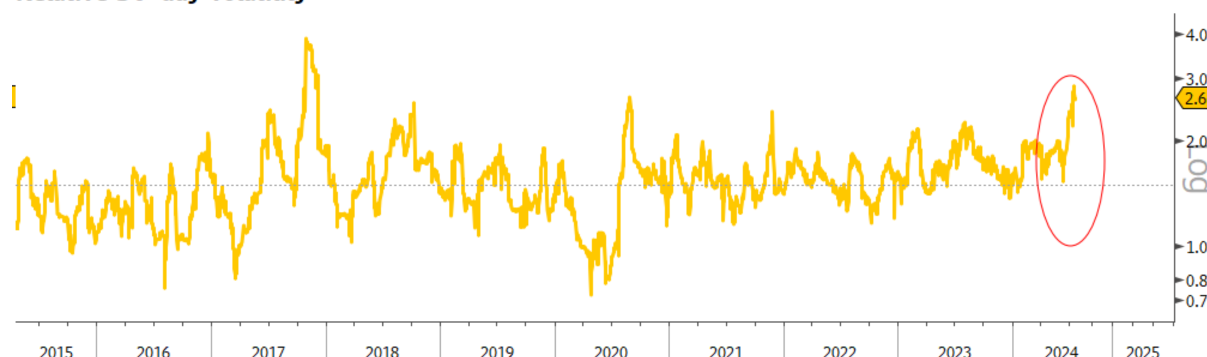
The large-to-small cap rotation is mostly a momentum story: small caps have gained it and the mega-caps have lost it. In fact, we have noticed over the last few years that *price* momentum – assets gaining/losing because investors are buoyed by previous gains/losses – has become one of the most important market drivers over the short-to-medium term. We cannot explain precisely why that is, but we suspect it has something to do with the massive growth in algorithmic trading – supported in recent years by generative AI.

AI trading might now have such a presence in stock markets that it can drive a momentum trade worth trillions into a few mega-caps – then just as easily reverse that. It is not the only explanation of course (the prevalence of retail investors, for whom recent price movements are pretty much the only accessible information, could be another). Like all areas where AI's presence is growing exponentially, the biggest concern is that market behaviour could become increasingly detached from what anyone would reasonably expect.

Nvidia itself – the undisputed winner from the AI boom – could be a prime example. It has become one of the world's most valuable companies after incredible share price growth, but it is ultimately a risky stock (albeit an extremely profitable one in recent years). With its historical volatility, you would normally expect investors to give Nvidia a reasonably high-risk premium (the amount of return demanded for a given level of risk) but its price to the next twelve months' expected earnings remains around 40 times.

Indeed, the top ten US tech stocks have become the mainstays of the overall US market. These stocks (as calculated by Bloomberg) now form over 30% of the S&P 500, up from 10% in 2015. Yet they have also become more volatile, relative to the overall index, as the next chart shows:

US top 10 tech stocks vs. S&P 500
Relative 30-day volatility



Source: Tatton IM, Bloomberg, S&P: G1825

B10TSP Index (Bloomberg US Top 10 Tech Select Price Return Index) US top10 tech v SPX vol Daily 19APR2015-19JUL2025 Copyright© 2024 Bloomberg Finance L.P. 19-Jul-2024 13:49:48

Trends like that might now flip around if the great rotation continues. But one worry we have with this is that, because the mega-caps have become so huge, their losses are now outweighing the gains made by smaller caps – as we see in aggregate losses for the S&P 500. That could have a negative effect on overall market conditions, and therefore consumers (through the so-called 'balance sheet effect'). There are still many positives, and greater market equality would be good for the long-term but, for now, we should be wary.

Small cap rotation

Last week was a booming week for US stocks. Or rather, for *some* US stocks. The Russell 2000, America's main small-cap index, jumped more than 11% from the previous Friday to Wednesday. The S&P 500 – the large-cap index often treated by international investors as synonymous with the US stock market – had a much more muted performance and is slightly down. The technology-heavy Nasdaq index, meanwhile, fell more than 2% last week. The previous Thursday's sell-off was mostly recovered in the early part of last week, but big tech stocks have been unable to push ahead.

As we wrote the previous week, that is a complete contrast to what we have seen for most of this year. US stocks (as measured by the S&P) have had a fantastic 2024 so far, gaining nearly 20% year-to-date, but that positivity is so concentrated in just the handful of mega-cap tech stocks that make up the 'Magnificent 7' (Mag7 – Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla). As of last month, a single company accounted for a third of the S&P's year-to-date returns: the all-conquering Nvidia.

Interest rate expectations ignited this switchover. June's weaker than expected inflation readings, released the previous week, confirmed to markets that the Federal Reserve would lower its target policy rate (the overnight Federal Funds rate) by September. Indeed, bond markets have started to suggest that the Fed could cut rates at its meeting this month. Comments from Fed officials since the inflation data have not diminished this view.

An environment of rate cuts may not seem like the best time for investors to rotate from large to small cap. Inflation is falling as part of a softening in nominal economic growth – and small-caps are generally thought to be more sensitive to cyclical swings than larger companies. Long-term 'growth' stocks like tech,

on the other hand, are usually considered more sensitive to interest rates and bond yields, since these influence the risk-reward trade-offs that determine equity valuations.

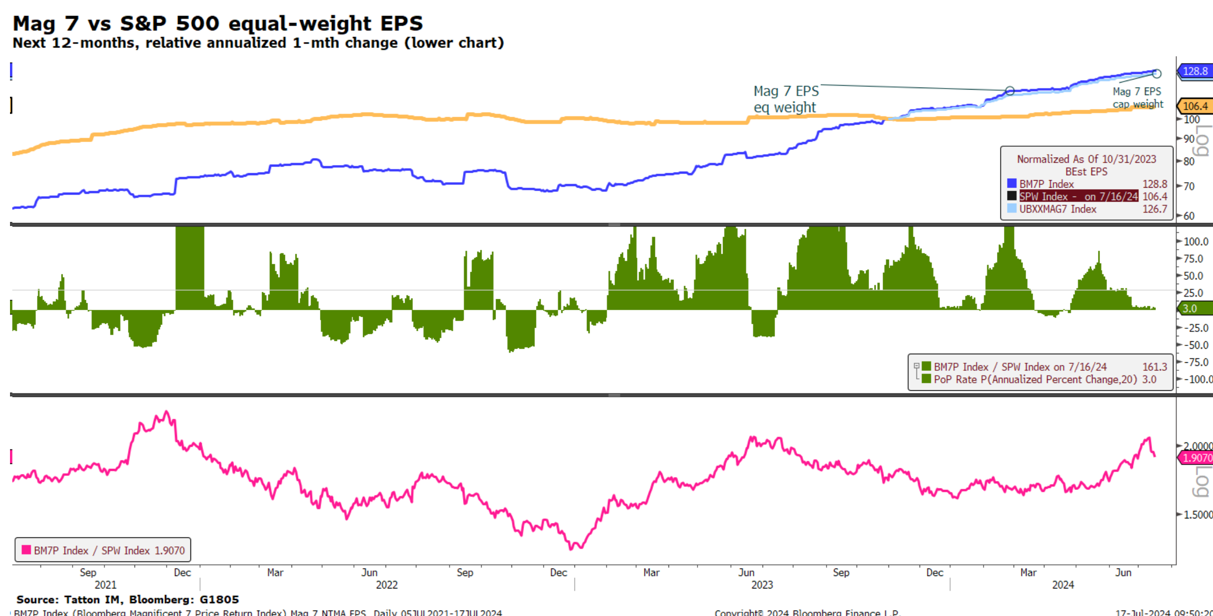
Going against this standard rationale, markets clearly think that rate cuts will be a big enough boon for small firms that any negatives from weaker *current* growth will be outweighed. One reason for this might be that rate sensitivity (i.e. how a firm's earnings or valuation reacts to interest rate changes) is not uniform across *nominal* rate levels. In other words, rates being so high plausibly makes firms more sensitive to upcoming rate expectations because the current rate imposes such a high borrowing cost – whereas these changes could be ignored in the low-rate era because their cost impact was minimal.

In any case, small-caps were boosted again last week by expectations of a Donald Trump victory in November's presidential election. The former president surviving an attempted assassination has all-but convinced markets that Trump will win in November's presidential election and implement tax cuts and deregulation. This is expected to be positive for growth – much as Trump's 2017 cut did – further boosting the earnings prospects for small and mid-cap firms.

Trump's fiscal expansion could come with big risks. The US debt and deficit are historically high, so growing them from here would require capital inflows – or risk instability. But Trump's foreign policy agenda would arguably constrict the capital flow into the US, making bond volatility more likely. Markets are certainly not showing any of these fears yet – quite the opposite in fact, considering the move down in treasury yields. At least for now, investors are much more excited about the medium-term growth impacts of a second Trump term, than they are worried about long-term fiscal impacts.

Still, rate cuts and a second Trump trade do not explain why the Magnificent 7 stocks should be stagnant – let alone the sell-off seen the previous Thursday. The mega-tech sector will presumably benefit from lower rates, growth and tax cuts too. So, why has the incredible confidence investors showed in the Magnificent 7 dissipated last week?

The story, we think, is a loss of momentum; the relative balance of expected earnings growth – between the previously dominant Magnificent 7 and the rest – has shifted enough to make investors question the mega-caps' huge valuations. After a phenomenal rally in the first half of 2024, there is so much positivity priced into the mega-caps that it is hard to get any more excited about them. Hence, the reflation trade goes toward small caps, and investors have sold some of their Magnificent 7 holdings to crystalise profits.



The chart above shows this. The first line is just the earnings outperformance of the Magnificent 7 versus the equal-weighted S&P 500. The second line shows how this earnings outperformance changes (how much quicker Magnificent 7 profits are rising than the S&P), where the dips mean *underperformance* for the Magnificent 7. As you can see, mega-cap profits are still outpacing small-caps, but only just, and the trend is slowing.

The bottom line shows relative valuations – the ratio of price-to-earnings ratios between the Magnificent 7 and S&P equal-weighted. Mega-cap valuations were actually fairly stable, relative to small and mid-caps, in the early part of this year. But that changed in the last few months, and Magnificent 7 valuations started to look very stretched.

We said a few months ago that stock market concentration on the likes of Nvidia was not a bubble, but more of a solemn recognition that no one can match their stellar profit growth. The difference now is that profits are looking good for the rest too (at least in the short-to-medium term). That has allowed the rotation that many have been clamouring for all year long. That inevitably drags money away from the tech rally – but that could well be a good thing, bringing broad-based growth.

Renminbi strength political, not economic

China is struggling to get out of its slump. Growth slowed in the second quarter of 2024, thanks to weak consumer demand. Official figures suggested GDP was 4.7% higher in the three months to June than in the same period last year. This is China's weakest headline figure since early 2023, but western investors are typically sceptical of official GDP numbers (they have been remarkably stable for the last couple of years, despite a property sector crisis and prolonged deflation).

All other signs suggest that Beijing is struggling to support an economy which has underperformed expectations – albeit lofty ones – for a while. Growth slowed for industrial output and retail sales.

The retail sales number was particularly disappointing (2% against the 3.3% economists' forecasted, and well below the 3.7% reported in May), pointing to weak consumption or consumer confidence. The clearest sign of this weakness – and perhaps the most reliable of China's economic indicators – is near-zero inflation. Year-on-year inflation dropped to 0.2% in June, and month-on-month inflation has been negative since April.

The world's second-largest economy clearly needs more support, but the government is reluctant to give it. The communist party's third plenum – a key meeting for long-term social and economic planning which ran from Monday to Thursday – was remarkably quiet about China's immediate economic challenges or how the party might address them. The Chinese premier Li Qiang suggested at a recent World Economic Forum event that the leadership favours a gradual recovery to the 'bazooka' approach of previous decades.

That is because of president Xi Jinping's long-term deleveraging goals. Past growth spurts, notably in 2008-09 and again in 2015-16, were driven by the expansion of private sector credit. The bubble this inflated had a big hand in problems like China's property crisis, which is why Xi is extremely reluctant to prime the pump again, despite clear signs of stagnation. Beijing has done this dance for years – offering stop-start stimulus when growth figures look bad, without committing to long-term support – and investors have grown a little tired of it.

Deleveraging has certainly not all been in vain. The dynamics between savings, spending and debt – both for households and corporates – are arguably more stable now. Xi's vision is one of Chinese technological self-sufficiency, with growth and production aimed at AI and green technologies rather than old industries. That vision looks more attainable, while background economic conditions are stable if underwhelming.

One of the biggest problems, though, is that this kind of economic realignment is much smoother if export demand grows enough to offset the domestic deleveraging. But demand for Chinese goods has been battered by tariffs and trade wars for years. Mexico recently overtook China as the US' largest trading partner, and trading conditions with the west are only likely to worsen. Donald Trump's pick for Vice President, JD Vance, wants even broader tariffs, while the EU (historically reluctant to impede trade with China) looks set to impose tariffs on Chinese electric vehicles.

Normally, when an economy is struggling and demand for its exports is falling, we would expect the currency to fall in value, making exports more competitive. But Chinese policy has had the opposite effect of keeping the currency strong. In practice, the renminbi is pegged to the US dollar. The People's Bank of China (PBoC) sets an official rate around which a 2% variation is allowed. The PBoC has kept this central rate stable for much of 2024 and not allowed its currency to fall further than the 2% discount, despite an appreciation in the dollar and a dramatic weakening of the Japanese yen. That has the effect of making Chinese exports more expensive in Asia – where most of China's trade is.

We wrote earlier this year that there is pressure on the PBoC to devalue its currency, for these exact reasons. There were signs it would (the bank consistently kept the dollar rate at the weak end of its 2% target range, behaviour which has preceded devaluations in the past) and Chinese consumers acted like it was coming. Chinese buyers have supported global gold prices, for example, as the stable dollar exchange allows them to move money into physical assets – in the fear that they soon will not be able to.

It has not played out like that, however. The PBoC defended the renminbi value, sticking by Xi's announcement at the start of this year that "a strong currency" is one of his top priorities. This tightens things up not just for Chinese exporters, but for the country's financial conditions generally.

The interesting thing is that Beijing's hawkishness does not seem to be a policy stance *in itself*, but rather a consequence of other policy stances that officials feel they cannot change. Economic comparisons suggest the renminbi should weaken, but that would be politically difficult. Domestically, it would vindicate Chinese lack of confidence in their own economy. Internationally, it would impair the perception of the Renminbi as a viable trade and reserve currency and would validate western views of China as an economic manipulator.

There is little doubt that Trump and Vance would jump on any sudden devaluation, and EU lawmakers would likely dial up their tariff talks too. Thus, in terms of selling goods to the west devaluing the renminbi achieves very little for Beijing. Chinese exports might become cheaper, but tariffs or outright bans could well nullify any advantage, merely acting as a western tax on Chinese production. The situation is different among Asian neighbours, of course, but is the Chinese economy detached enough from the west to rely on this trade? In the months and years to come, answering that question will be crucial.

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22nd July 2024

Global Equity Markets — 19-Jul — Technical — Valuations

Market	Level	% 1 Week	% 1 Week (GBP terms)	Short	Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	8161	-0.6	-0.6	→	⬀	4.0	11.9	11.6	12.7
UK FTSE 250	21096	+0.4	+0.4	↗	⬀	3.4	13.8	12.3	14.0
UK FTSE All-Share	4477	-0.4	-0.4	→	⬀	3.9	12.0	11.7	13.1
FTSE Small x Inv_Tsts	5895	+0.7	+0.7	↗	⬀	4.6	11.8	9.9	10.9
France CAC 40	7544	-1.1	-0.8	⬂	→	3.3	13.6	12.9	14.0
Germany DAX 40	18234	-1.5	-1.2	⬀	⬀	3.0	13.4	12.3	13.0
US Dow	40543	+2.0	+2.5	↗	→	1.8	20.0	18.9	17.2
US S&P 500	5544	-1.6	-1.1	↗	↗	1.3	23.1	21.2	18.1
US NASDAQ comp	17830	-4.5	-4.0	↗	↗	0.7	35.7	29.5	24.5
Japan Nikkei 225	40063	-5.2	-4.4	↗	↗	1.6	23.4	21.5	18.2
World Bloomberg	1895	-1.6	-1.1	↗	↗	2.0	16.4	15.6	14.7
China mainland	3539	+1.9	+2.3	↗	↗	1.8	20.3	18.8	16.8
Emerging Bloomberg	1216	-1.7	-1.2	→	→	2.8	12.1	11.6	12.3

FTSE100 Top 6

Company	%
DS Smith PLC	+5.6
NatWest Group PLC	+3.9
Marks & Spencer Group PLC	+3.5
Barclays PLC	+3.3
J Sainsbury PLC	+2.9
B&M European Value Retail SA	+2.8

S&P Global Top 6

Company (GBP terms)	%
DR Horton Inc	+15.5
Warner Bros Discovery Inc	+15.2
Solventum Corp	+12.7
EPAM Systems Inc	+11.7
UnitedHealth Group Inc	+10.8
Roche Holding AG	+10.4

Global Sectors

Sector	%	Sector	%
Tech	-3.5	Staples	+0.7
Financials	+0.7	Energy	+1.3
Health	-0.7	Materials	-1.8
Discretionary	-2.6	Utilities	-1.4
Industrials	-0.3	Real_Estate	+1.1
Communication:	-2.2		

FTSE 100 Bottom 6

Company	%
Burberry Group PLC	-20.6
Antofagasta PLC	-12.8
Intermediate Capital Group PL	-8.8
Glencore PLC	-7.0
easyJet PLC	-6.7
Rio Tinto PLC	-6.6

S&P Global Bottom 6

Company (GBP terms)	%
Burberry Group PLC	-20.6
Crowdstrike Holdings Inc	-18.0
Charles Schwab Corp/The	-17.4
Domino's Pizza Inc	-16.6
Vistra Corp	-16.4
ASML Holding NV	-15.9

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.13	+0.02
UK Govt 15yr Gilt	+4.40	+0.02
US Govt 10yr Treasury	+4.24	+0.06
France Govt 10yr OAT	+3.13	-0.02
Germany Govt 10yr Bund	+2.47	-0.02
Japan Govt 10yr JGB	+1.03	-0.02

Currencies

Pair	last	%1W
USD per GBP	1.292	-0.3
GBP per EUR	0.842	+0.2
USD per EUR	1.089	-0.1
JPY per USD	157.49	-0.4
CNY per USD	7.280	+0.2
USD per Bitcoin	64,604	+12.1

Commodities

Cmdty	last	%1W
Oil Brent $:bl	84.3	-1.5
Gold $:oz	2401.9	-0.0
Silver $:oz	29.1	-5.3
Copper $:lb	424.4	-7.7
Alumnm $:mt	2402.7	-0.5
S&P soft crops	245.1	-0.9

UK Mortgage Rate Estimates

Rates (LTV c.75%, no fee)	19-Jul	19-Jun
UK BoE base rate	5.25	5.25
2yr fixed	4.99	5.19
3yr fixed	4.75	4.89
5yr fixed	4.28	4.67
10yr fixed	4.75	4.89
Standard variable	7.98	7.93

Prices taken at 2:30pm today and 2:30pm last Friday (where possible).
LTM PE is the index price as a ratio of last 12 months earnings. NTM PE is next 12 months earnings.
Mortgage estimates are derived from sterling swaps markets and moneyfacts.co.uk

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22nd July 2024

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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