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MARKET SIGHT LINES

Markets Are Poised for Rotation: What To Do, and Not To Do

By Michael O'Keeffe, *Chief Investment Officer*

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" (M7) larger tech-oriented stocks. At the same time, hawkish Federal Reserve (Fed) policy has kept short-term interest rates elevated, allowing cash investments to generate strong income. At times like these, investors can be susceptible to recency bias, or the often incorrect belief that recent events will continue. Such bias can spell trouble during a market rotation. In this week's Sight|Lines, we discuss the potential for both a bond market and stock market rotation, and why some actions may be warranted while other actions may not.

THE TAKEAWAY: START PUTTING CASH TO WORK, BUT DON'T CHASE RECENT EQUITY PERFORMANCE

We're setting up for rotation in the bond and stock markets, so look to methodically invest built-up cash, but don't chase equity performance. In summary:

- Invested cash yields have remained above 5% for some time, and the cap-weighted S&P 500 has performed well this year and last, driven by AI optimism.
- That said, the Fed is signaling potential rate cuts later this year, and many Wall Street strategists are predicting a stock market correction in the U.S.
- In periods with the strong potential for market rotation, investors should seek to avoid recency bias, or the idea that things will just remain as they are going forward.
- For investors who have built up large cash positions, this could be a good time to clarify the purpose of such cash – and begin a multi-step process for putting cash to work.
- Investors with a more diversified, "equal-weighted" equity strategy, often used by active managers, should not be discouraged by recent underperformance.
- Individuals with a strong recency bias may chase performance right before a market rotation, often eroding longer-term investment results.

IN-DEPTH: USE A DISCPLINED APPROACH TO PUT CASH TO WORK, BUT DON'T CHASE THE RECENTLY STRONG-PERFORMING EQUITY STRATEGIES OR SEGMENTS

We're setting up for possible market rotations – falling rates and stock market weakness, so this is a good time to methodically invest built-up cash, while not chasing equity performance. Going deeper:

- Recency bias would have us believe the yield on cash, as well as the performance of the M7 and cap-weighted S&P 500, may continue going forward, but we're setting up for a rotation.
    - Nvidia is up 165% year-to-date, and the Bloomberg Magnificent Seven Index is up 49%.
    - Equal-weighted strategies, as well as active managers not investing in or underweighting these strong performers, have underperformed over the period.
- We see potential for market interest rates to move lower, especially shorter-term rates:
    - Fed projections call for a 0.25% cut this year and a 1% cut next year, with fed funds futures signaling a market view of cuts totaling 0.5% this year and 0.75% next year.
    - Cash yields tend to fall as the Fed cuts rates.
- 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 M7, could lead markets lower, like in 2022.
    - Exhibit 1 shows performance dominance rotates between the cap-weighted and equal-weighted S&P 500.
    - The same pattern is often evident with skilled managers able to deliver long-term investment success, wherein the strategy underperforms in the short term for structural reasons, only to rebound and still deliver good long-term results.
- For investors who have built up large cash positions, consider the purpose of such cash:
    - If the cash will be spent immediately, stay in cash-oriented investments.
    - For liquidity needs 1-5 years out, align bond maturity with needs to lock in current yields.
    - Cash earmarked for a long-term strategy can be invested over 6-12 months:
        - For bonds, consider dollar-cost averaging in the shorter 6-month horizon.
        - For stocks, consider dollar-cost averaging in the longer 12-month horizon, accelerating the process on market weakness.
- To review an important concept, investors should avoid recency bias:
    - Avoid high levels of cash with the expectation of higher cash yields for longer, as cash rates will likely come down.
    - Avoid chasing performance, like overweighting strong recent performers like the M7, or shifting an equal-weighted strategy, including active management, to a cap-weighted one on the belief the latter will always perform better.

CONCLUSION

Cash investments and the cap-weighted S&P 500 have been strong performers of late. Recency bias would have us believe these two trends will continue. But investors should work to keep recency bias in check, focus on what to do – and what not to do – as markets set up for a possible rotation.

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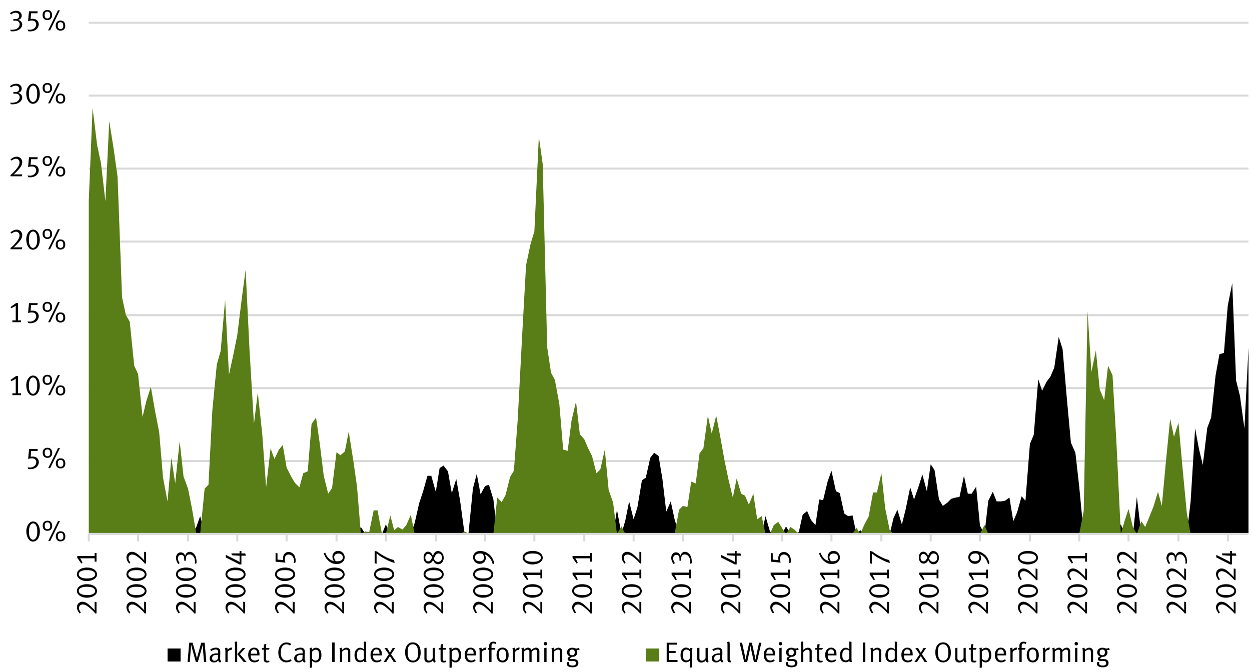
Exhibit 1. S&P 500 Market Cap versus Equal Weight Relative Performance
Rolling monthly year over year total returns



Source: Stifel CIO Office via Bloomberg as of June 30, 2024