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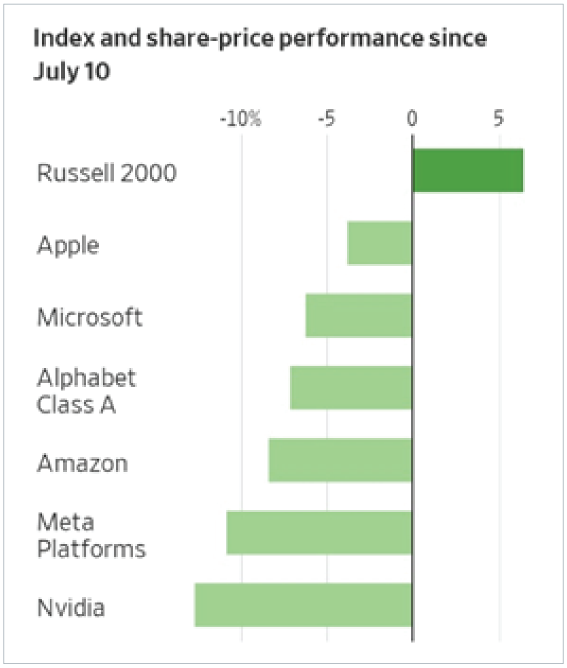
Is This a Durable Rotation?

Earning's season is never boring, and at this point in the economic cycle, it is fascinating!

The Federal Reserve recently signaled it will not hesitate to reduce short term rates in advance of any signs of economic weakness, and avoid any perception of 'waiting too long'. In their latest "Beige Book," underlying data had recessionary thumbprints all over it. It may not be evident in all of the broader government data releases, but the anecdotal evidence is powerful. Fully five of the twelve Districts recorded "flat or declining activity" versus two in the last go-around six weeks ago. This is the exact number (5) we had on our hands in January 2008 and March 2001.

Additionally, the market has seen meaningful rotation from the Mega Cap Tech names of the 'Magnificent 7*', to other parts of the market which have lagged in year to date total return – such as US Small Cap and US Large Cap Value.



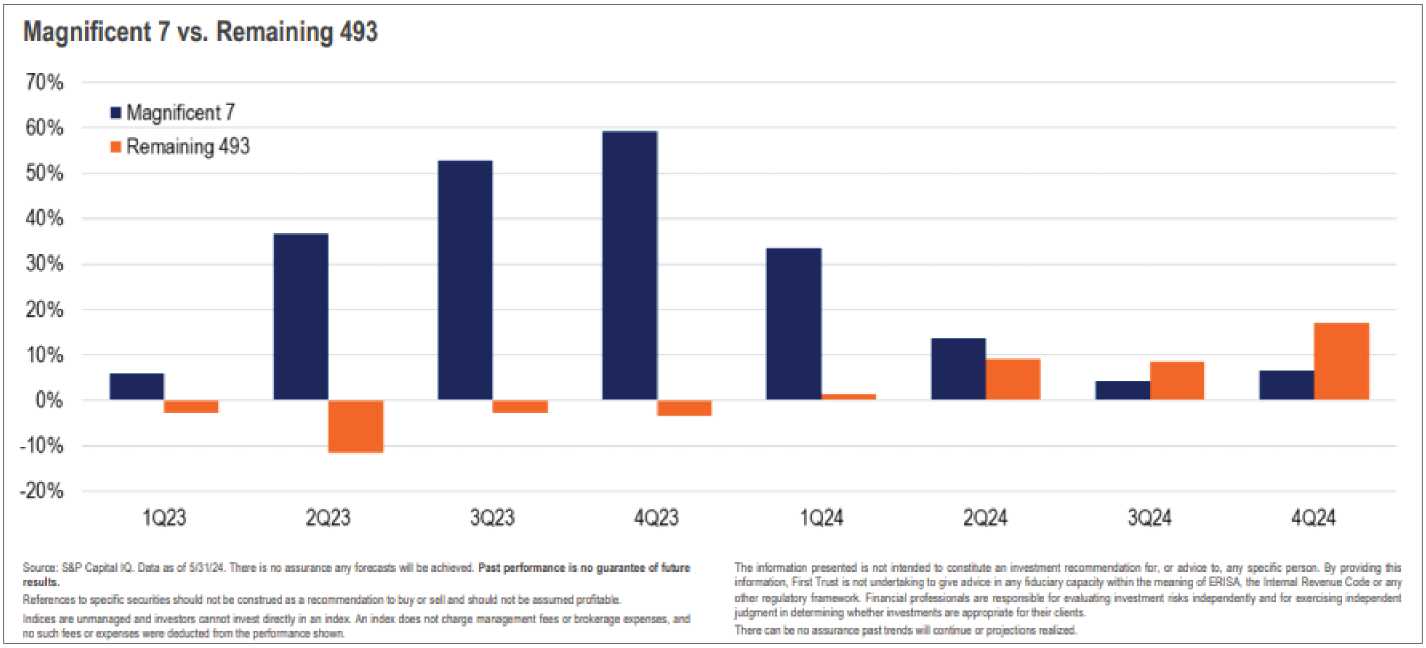
Source: The Wall Street Journal

For example, the Small Cap Index / Russell 2000 (+10.3%) has outperformed the NASDAQ (-0.7%) by +11.1 percentage points over recent market sessions. This is the biggest performance gap between the two on record based on data back to 1990.

This rotation and short term leadership shift may have gone unnoticed if one were not a daily market participant, but we believe this observation could be signs of something more durable.

One risk to be mindful of is the deceleration of earnings growth across the 'Magnificent 7', and the acceleration of earnings for many other equities. The AI-hype (Artificial Intelligence) has been driving a select group names – and the overall markets, given their high concentration of market capitalization.

It's noteworthy and remarkable that the combined market capitalizations of NVIDIA (trading at a 71x P/E) and Apple (trading at a 32x P/E), now exceed the total amount of U.S. Treasury bills outstanding – ~$6 trillion of value in two stocks!



Source: First Trust

After 18 months of 'hope' and 'theory' regarding how much AI would drive earnings growth, investors are starting to ask, "so where is the dough?" Said another way, the longer this tech takes to make people money, the more money it's going to need to make.

Jim Covello, Head of Global Equity Research at Goldman Sachs believes that the combined expenditure of all parts of the generative AI boom — data centers, utilities and applications — will cost a trillion dollars in the next several years alone, and asks one very simple question: "what trillion dollar problem will AI solve?" He notes that "replacing low-wage jobs with tremendously costly technology is basically the polar opposite of the prior technology transitions [he's] witnessed in the last thirty years."

In plain English: generative AI isn't making any money for anybody because it doesn't actually make companies that use it any extra money. Efficiency is useful, but it is not company-defining.

So where do we go from here?

The former Citigroup CEO, Chuck Prince famously said on July 2007, ""As long as the music is playing, you've got to get up and dance. We're still dancing."

Second quarter earnings seasons is just beginning, and we prefer to make investment recommendations based on quantifiable fundamentals. As we have said for quite some time, we believe 'FOMO' (fear of missing out) is again a big component of the narrow rally, particularly in the last two months.

Investors with too little exposure to the Magnificent 7, AI stocks or the information technology sector are tempted to enter the space. They worry about missing out on future gains and falling even further behind their friends. And investors with huge gains in those areas are concerned about selling their winners in case they continue to climb.

Forecasts currently point to a deceleration in the earnings growth rate of information technology earnings and an acceleration of earnings growth from many other sectors as we enter the second half of the year. Staying diversified across the equity markets and not chasing the FOMO trade, in our opinion, will be beneficial in the second half of 2024. We expect the market to continue to broaden as earnings drive stocks throughout the rest of the year.

As we move into the Fall, and as the US Election season 'heats up,' we will be reaching out to share and discuss how these observations and others impact your portfolio and investment decisions.

Note: *The 'Magnificent 7' represents Apple, NVIDIA, Microsoft, Amazon, Alphabet (Google), Tesla, and Meta (Facebook).

If you would like to discuss any of these comments in greater detail, or to learn more about how the current market environment impacts your investment allocation or portfolio, please give us a call at (314) 746 – 2591.

Respectfully yours,

The Aletheia Private Client Group

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