Market Commentary
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English Version

Insigneo Weekly Dispatch

Millimeters From Chaos

Exploring the underlying currents in U.S. equity markets in light of an uncertain political and economic environment.

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Millimeters From Chaos

Last Saturday, the world witnessed an event that could have scarred the United States in ways not seen since the 1960's. The attempted assassination of former President Donald Trump was a heinous act of violence that, regardless of political inclination, has no place in a democracy. Thankfully, the attempt was unsuccessful; however, the country was literally one turn of the former President's head away from a very different reality.

Saturday's event revealed the heightened political tension in the country. However, it also exposed the instability embedded in the equity markets. In the two trading days following the assassination attempt, the S&P 500 rose close to 1%, the Nasdaq Composite up 0.6%, and the Dow Jones Industrial up almost 2.5%. Why would the markets climb after an assassination attempt? You would think that financial markets would experience major pullbacks in the aftermath of such an event. If former President Trump would have been critically hit, it is highly likely that the markets would have plummeted. However, the market interpreted the failed attempt as a boost to Trump's chances to win the November presidential election. In fact, his odds of winning jumped to 66% on Saturday, the highest in a year, although they have since settled back near the 60% range.

Interestingly, the sectors that drove the markets higher on Monday and Tuesday were not the ones that we have grown accustomed to seeing in the traditional tech-fueled rally. In fact, growth-oriented sectors like Information Technology and Communication Services, sectors that house companies like Nvidia, Meta, Alphabet, and

Microsoft, were some of the worst performing sectors in the S&P 500. Instead, the sectors leading the charge were Industrials, Financials, Energy, and Materials; value-oriented sectors that would most likely benefit from a Trump win in November. The fact that these sectors constitute much larger weights in the Dow Jones Industrial than the Nasdaq Composite, coupled with their vast relative underperformance compared to technology-oriented sectors, would explain why the Dow outperformed the Nasdaq Composite by almost 4 to 1 over this brief period. However, the shift in the markets' dynamics was not limited to sectors, it was also present at the market cap level. In fact, on Monday and Tuesday the Russell 2000, which is comprised of small cap stocks with a median market cap of $3 billion, meaningfully outperformed the large cap-oriented S&P 500, with a median market cap of $250 billion. Small cap stocks jumped 5.38% in just two days, compared to large cap stocks which rose 0.93%, the former outperforming their large cap counterparts by 4.45%. If we compare the Russell 2000 to the Nasdaq Composite, the outperformance gap was even wider, 4.8% to be exact, the widest discrepancy between these two indices since 2001.

However, the markets quickly turned again on Wednesday and Thursday, retreating in a violent manner regardless of market cap or sector tilt. Over the next two days, the Dow Jones Industrial fell 0.7%, the S&P 500 2.2%, the Russell 2000 2.9%, and the Nasdaq Composite 3.5%. Over the four days following the assassination attempt, equity markets swung violently in both directions, highlighting the powerful currents raging under their surface. Interestingly, as of the time of this writing, the traditional leaders of the US equity rally, the S&P 500 and the Nasdaq Composite, were down for the week, while the laggards, namely the Dow Jones Industrial and the Russell 2000, were trending higher. The worst performing sectors in the S&P 500 were Information Technology and Communication Services, while the best performing were Energy and Financials. This could represent the beginning of a shift in leadership from growth to value.

The shifting dynamics under the surface of the markets could be the beginning of a rotation in sectors, market cap, and style. Afterall, the undisputed leader of the market over the past year and a half has been the growth-oriented large cap technology industry. Concentrated in just a handful of stocks, this group has led the market to concentration levels not seen in the past 50 years. In a recent report, J.P. Morgan highlighted that going into last week, the largest twenty companies in the S&P 500 were responsible for 75% of the index's returns for the year. At the same time, the weight of the top 10 stocks in the index reached close to 40%, while their P/E ratios averaged close to 31x, with the P/E ratios of the remaining 490 stocks averaging 17x. Needless to say, concentration risk is abnormally high.

In this light, a rotation in market leadership would be healthy, as rotations lead to expansions of market breadth. Investors have been looking for a broadening of the rally for over a year now, something that has not yet materialized. However, at the individual stock level, we are seeing technology leaders like Nvidia and ASML quietly retreating 15% and 18% off their highs respectively, while small cap stocks come off their lows. If we are seeing the beginning of market rotation, it could potentially lead to the elusive broadening of the rally, an important piece of the puzzle needed for its sustained continuity. However, keeping things in the proper context, this possible shift is based on just one week's worth of data. However, the markets and the media are jumping off their seats to claim the beginning of a sustained rotation. For a rotation and a healthy broadening of the rally to be sustainable, it has to be backed by revenue and earnings growth. According to a study from J.P. Morgan, small cap stocks have seen negative revenue growth every quarter since the first half of last year, coupled with negative earnings growth since the beginning of 2023. True, if the Fed starts cutting rates this year, as we believe that they will, this will lower the cost of capital for small cap companies, potentially increasing earnings and margin growth. However, if the economy does enter a recession, a scenario that we believe has a higher-than-expected probability of occurring, this could lead to lower revenue growth for many companies, including small caps. The timing and pace of Fed rate cuts, combined with the relatively high probability of recession, will dictate if the market dynamics that we have seen this week are truly the beginning of a rotation or the beginning of equity market de-risking. What is clear is that the room for error is narrow and volatility is increasing. The latter was evidenced by a jump in the CBOE Volatility Index, otherwise known as the VIX. This measure of volatility, which has stayed in a relatively narrow range over the past year, is starting to drift higher again.

Given a backdrop filled with uncertainty, what could investors do? First and foremost, keep an eye on the long-term; do not let near-term swings dictate long-term investment policy. However, investors could also smartly implement more tactical strategies, such as protecting portfolio gains by taking some chips off the table or buying "insurance" or "shock absorbers" for their equity positions. This insurance can be implemented in the form of selling call options on appreciated positions or buying long dated put options on the same. Investors can still buy put options at relatively inexpensive prices. The time to buy flood or hurricane insurance is when the skies are still sunny and prices for this type of insurance are low, not when the hurricane is upon us. I have spent most of my life in the Northern part of the United States where snow is a yearly event. Yet it never ceases to amaze me how every year, most people rush to the store to buy rock salt to combat icy sidewalks and driveways only when a snowstorm is just a couple of days away. Personally, I like to buy mine when winter is just beginning, and rock-salt is still widely available. If the snow comes, which it does every year, I am ready. But if it does not, my cost of being prepared is relatively low, compared to the cost of being unprepared.

As the unfortunate events of this past weekend revealed, we were only millimeters away from major chaos. The markets remain highly reactionary. Given the current backdrop, implementing some degree of equity portfolio protection could prove to be the prudent thing to do.

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