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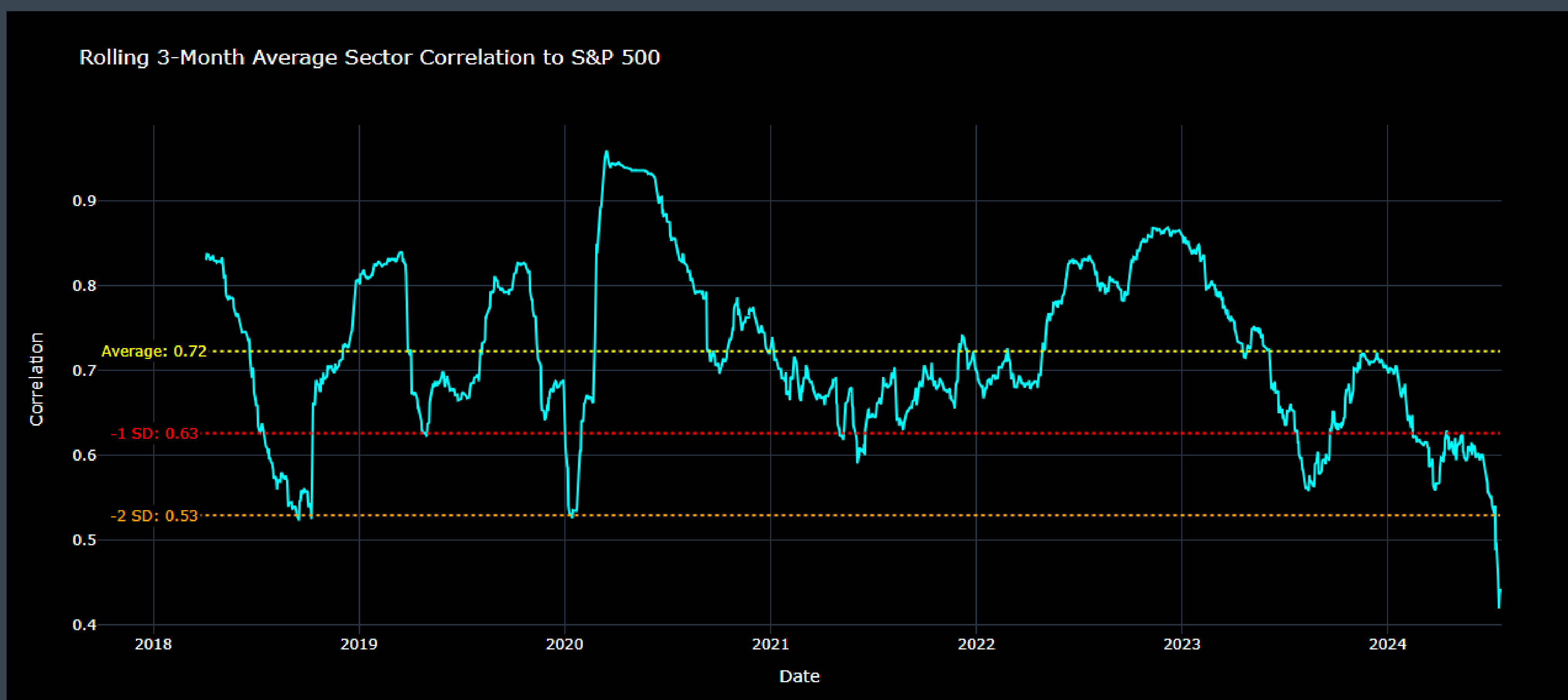
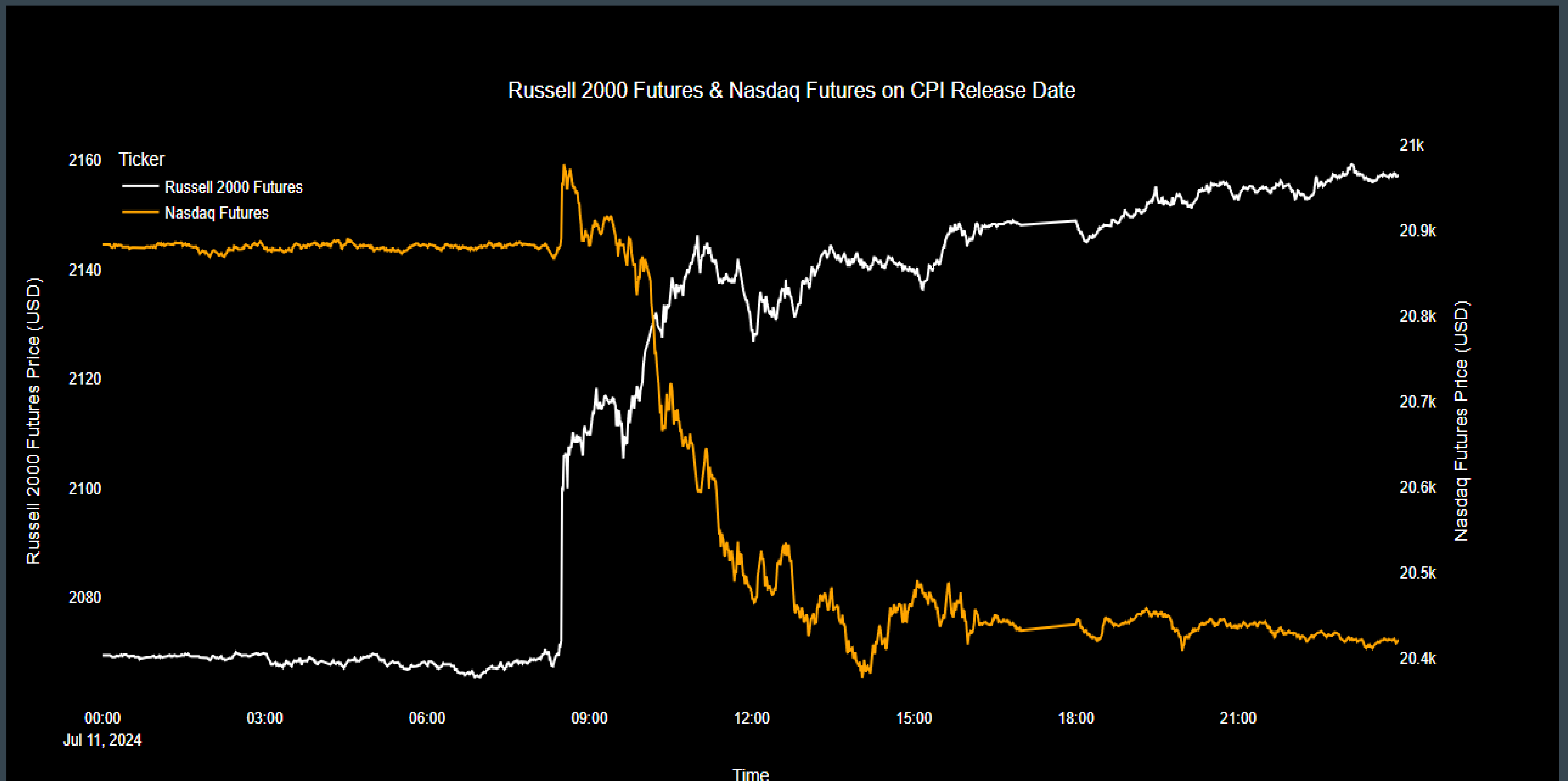
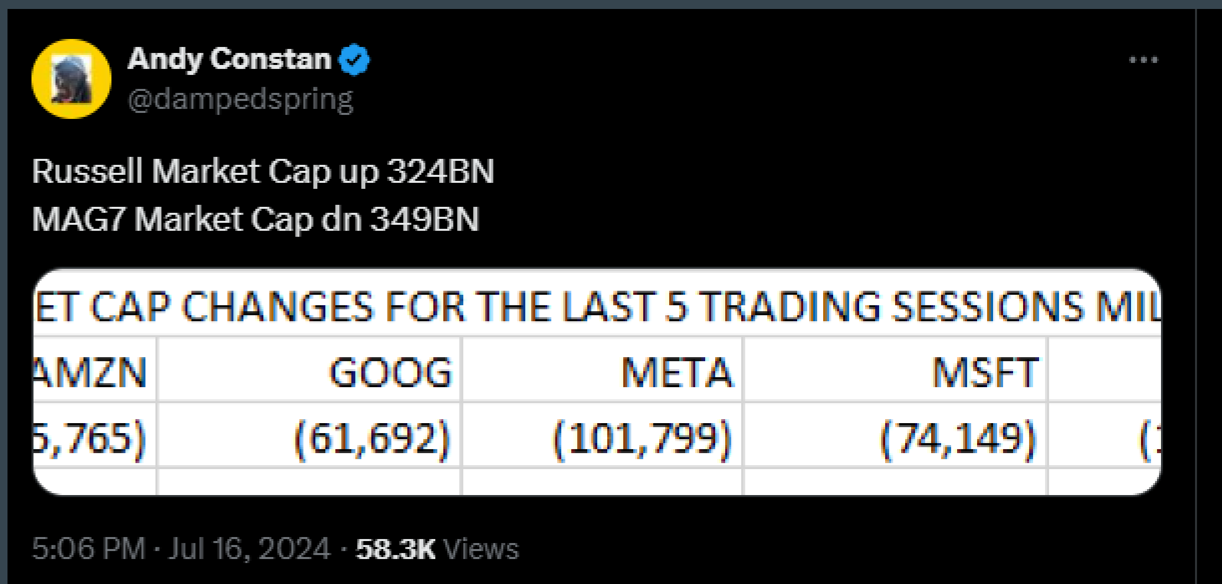
There are many indicators that one can look at to gauge investors' tolerance for risk in the current environment. One key measure is their overall exposure to equities versus cash or fixed income. The Volatility Index (VIX), often referred to as a fear gauge, indicates the extent to which investors are purchasing protection for their portfolios. Credit spreads reveal how much risk investors are willing to take when lending to companies with greater default risk, and the compensation they demand for that risk. Sector correlations provide another valuable indicator of risk within the equity markets. When correlations are low, there is little relationship between the movements of each sector, and money tends to rotate based on economic data or news of the day. However, when these correlations move toward 1, it signals heightened risk and increases the probability of a market selloff. In downturns, all assets tend to fall together, resulting in high correlations between sectors. The average correlation between sectors going back to 2018 is 0.72, which is relatively high but understandable since stocks often move together to some extent. Currently, the correlation between sectors is 0.41, which is over 2 standard deviations below the average. This indicates that investors are not overly concerned about looming risks in the market landscape.




Just over a week ago, CPI for the month of June was released, sparking a rally in small-cap stocks. The report showed deflation in the month-over-month reading on the headline number. In looking further into what drove the initial move, we examined futures and the 1-minute charts for the day for the Nasdaq and Russell 2000. At 8:30 AM, with the release of the CPI report, the Russell 2000 and Nasdaq went in opposite directions. This divergence indicates that the trade was largely algorithmic in nature. Many firms were short the small-cap index, which has been in a consolidation range for over a year, and long on the Tech names, which have driven the market higher since November 2023. This initial move was likely short covering of those trades as the assumption was that a negative print would send yields lower and yield-sensitive stocks higher.

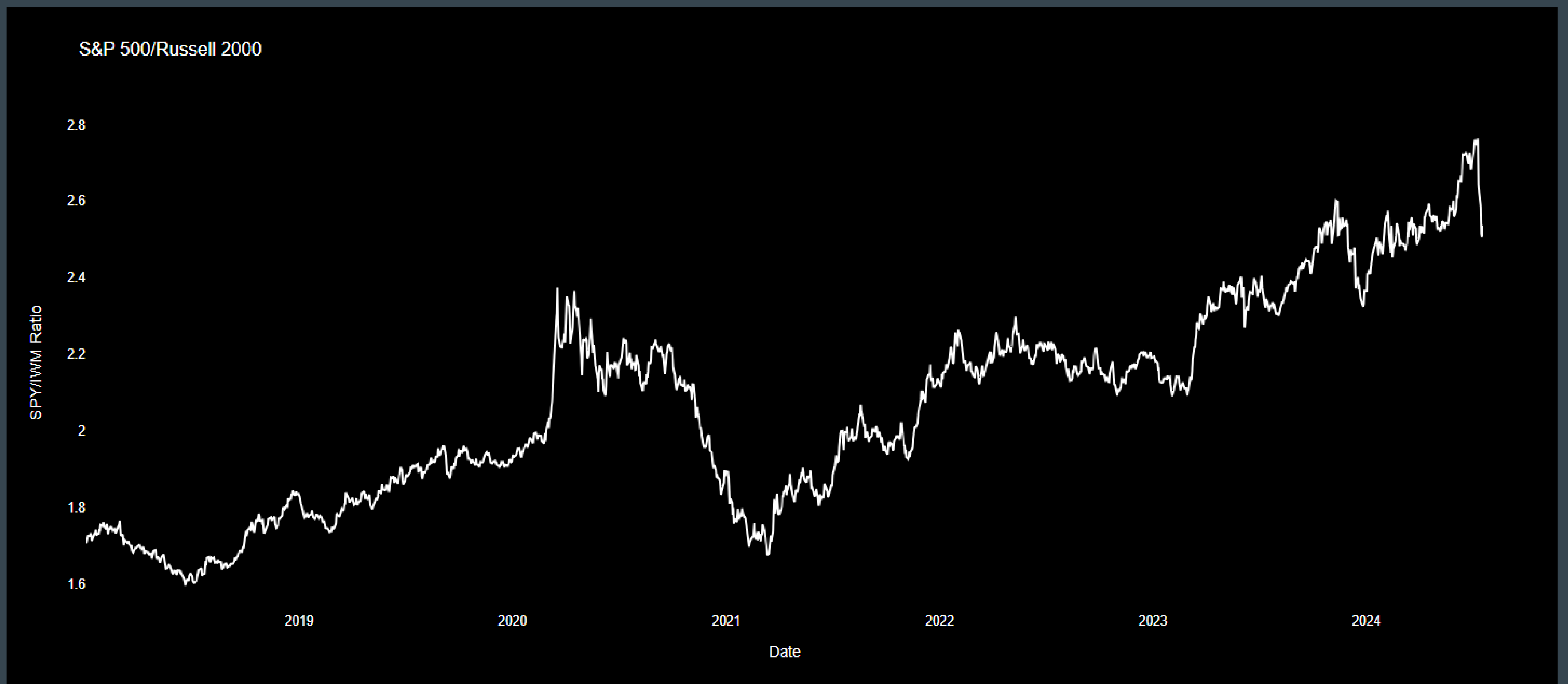



That was just the start of the rally that took place, as the Russell 2000 had its greatest outperformance of the S&P 500 through a week in recent history. On July 16th, Andy Constan tweeted a picture of the market cap change that took place in the Russell 2000 and the Mag 7 stocks. The Russell gained $324 billion in market cap, while the Mag 7 lost $349 billion. So, money was clearly moving from large to small in a quick change in positioning. There has now been follow-through, and the changes in market cap don't match up any longer because there are further knock-on effects, but the start of this seems to smell of short covering based on this data.



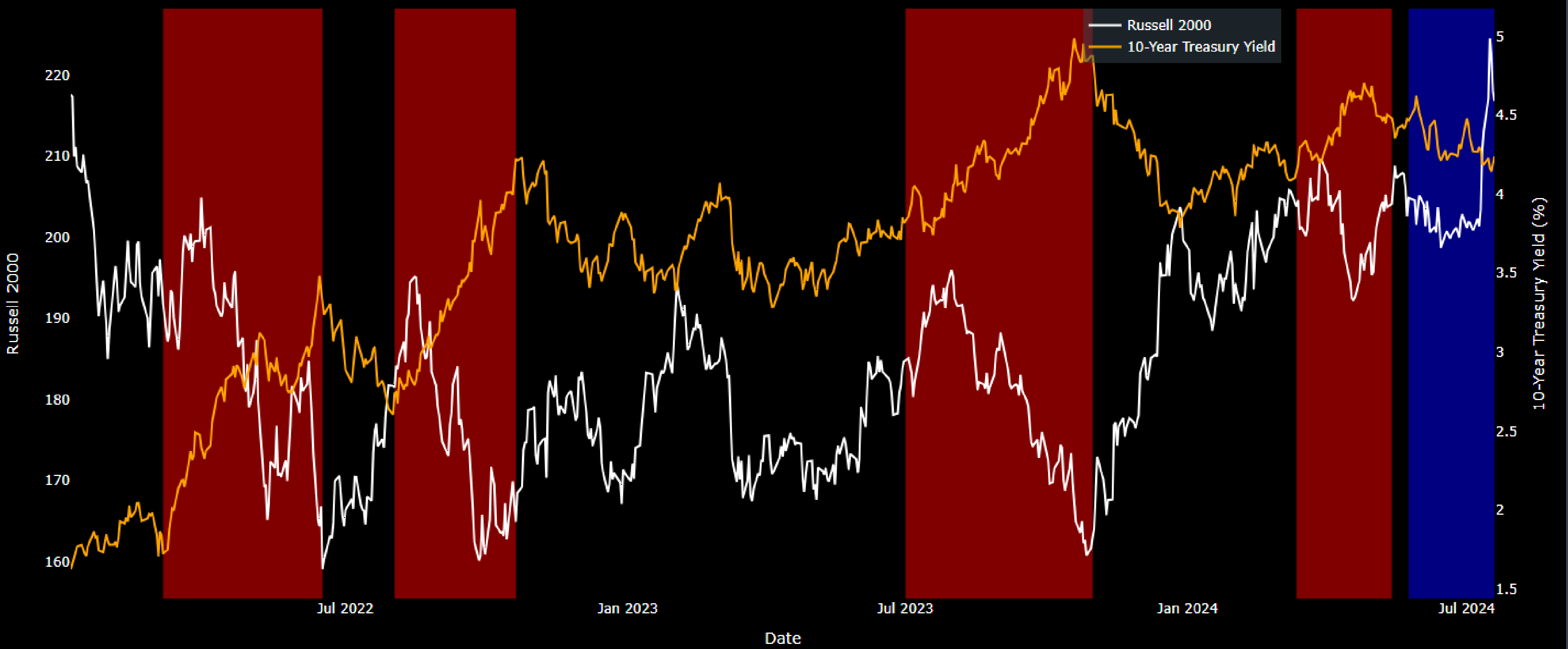

In looking at CFTC data on futures positioning, we also found that there was a considerable net short position of 75,000 contracts. While not record levels, since January the positioning has gone from neutral to gradually more short on the index. As of Friday, that positioning has lightened up to 47,000 contracts net short.

The Russell 2000 has struggled to get out of its own way since it peaked back in 2021 and has been a large underperformer relative to the S&P 500 during this time. The recent rally helped it regain some of that underperformance, but it still has a long way to go, and the underlying conditions are not in its favor, which we will touch on in a minute. Back in March of 2020, the S&P 500 peaked relative to the Russell 2000, and we had about a year where the Russell showed relative strength but ultimately gave all of that back and more. This could be a setup for a similar situation.



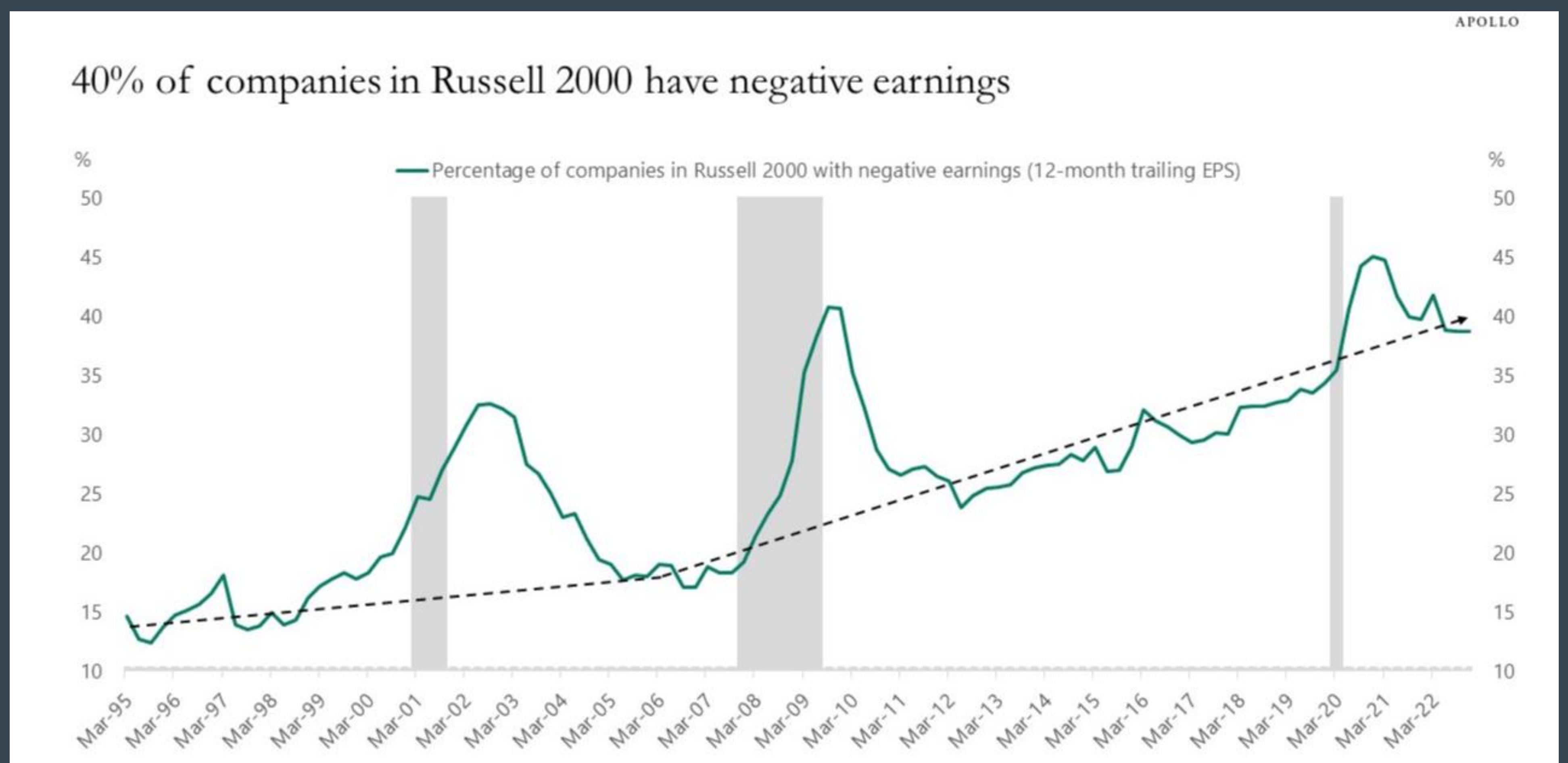

The market has continued to interpret low inflation data as good news, guiding yields lower. It has also taken bad news as good news by lowering yields and putting a bid under stocks. Since mid-2023, the rolling 25-day correlation between the Russell 2000 and 10-year yields has been negative. Consequently, lower yields, for any reason, have exerted buying pressure on small caps.

This relationship becomes more pronounced when looking at the Russell 2000 and 10-year yields charted together. The 10-year yield has now come within ~20 basis points of having a 3 handle, which would further alleviate the debt burden on small caps. The red highlights periods of rising rates, and the blue highlights the current period of falling rates. The parabolic move in the index isn't solely the result of yields, but they have significantly contributed to the current rally.




The recent rally has pushed the Russell 2000 into overbought territory, and Thursday and Friday of this week we saw a pullback. Look for initial support at around $211 if the pullback continues. We tend to believe that the short squeeze pushed the index higher, and further buying pressure came in after it broke out of its consolidation range. However, we do not foresee a push to new highs for this index yet. What followed the rally in small caps was broader participation within the rest of the S&P 500, and the Equal Weight Index broke to new highs. That rotation seems like it will have legs and is more likely to be sustained at this current period than small caps.

Small caps need a reacceleration of growth in the broader economy to continue rallying. We did see some positive data come out in reports for Industrial Production and Capacity Utilization. Industrial production was the only indicator in the NBER's list of recession indicators that they track that was negative year over year. The month-over-month print of 0.6% pushed it back into positive territory. Housing Starts and Permits rebounded in June, driven by multi-family units. GDPNOW has now been revised back up to 2.7% on this data for Q2. So, there is resilient growth, but we are still in a late-cycle economy. With stronger growth, small caps will also need lower yields as a large portion of them have floating rate debt. One rate cut is not going to change much in terms of servicing their debt. They also do not have the benefit of passive flows from 401k money that the larger cap stocks within the S&P 500 do. So, there are still headwinds to the story that do not favor the start of a new bull market for these names.



Earnings for the Mag 7 stocks have underpinned the S&P 500 over the last year and a half. Analysts project a deceleration in those earnings for the rest of this year and next. They forecast a broadening out of earnings for the other 493 names. If this plays out, small caps will benefit eventually as a stronger consumer and economy are needed for broad-based earnings growth. However, the current anecdotes from CEOs, as we have highlighted numerous times, point to an environment of less pricing power, a consumer who is pushing back on higher prices, and potential layoffs. Earnings growth for the S&P 500 for 2024 is expected to be 7% and for 2025, 14%. For small caps, 2024 projections are for 3% growth and then 36% in 2025. Thus, all of that growth is projected far out in the future, and any changes to the economic outlook could be a reason for large revisions lower.

**Bloomberg Consensus EPS Growth By Index**

| | 2024E | | 2025E |
|---|---|---|---|
| S&P 500 | 7% | | 14% |
| Magnificent 7 | 46% | → | 20% |
| Equal Weight | 5% | | 12% |
| Russell 1000 Growth | 6% | | 17% |
| Russell 1000 Value | 3% | → | 12% |
| Russell 2000 | 3% | → | 36% |
| MSCI International Developed | -1% | → | 8% |
| MSCI Emerging Markets | 16% | | 16% |

Source: NewEdge Wealth, Bloomberg

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