Economic Growth is Persistent

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The Small Cap trade began to cool off this week as IWM has now seen a consolidation between $218 and $225. This sideways action allows the index to alleviate overbought conditions before potentially moving higher. The key level to watch on the downside is $215, which represents support and was tested intraday on Monday. Prior to this rally, Small Caps had underperformed the S&P 500 more significantly than at any point in the last four years. We continue to believe that this movement is more about positioning rather than fundamental shifts, but we will delve deeper into this later in the article.

Using the MAGS ETF, which equal weights the Mag 7 stocks, it has now broken below its 50-day moving average and is showing some downside momentum. These stocks have been on a straight upward trajectory since last November, and the recent short squeeze that sparked the selloff provided managers with an opportunity to take profits. We are currently in the midst of earnings season, with some of the Mag 7 already reporting. Google, for example, has reported, and the market reacted negatively to some of the CEO's comments regarding AI. He mentioned that not making significant investments in AI poses a large risk, which we agree with, but also noted that there isn't a clear payoff yet in terms of monetizing AI. This highlights a broader issue with the AI hype—there are no new products emerging from all the capital expenditures, and the real payoff has been in productivity, which is difficult to quantify. As we move through the rest of the earnings season, it will be interesting to see the guidance provided by these companies and how the market reacts. S&P 500 earnings are projected to be more supported by the rest of the market (the other 493 companies) as the growth rates for the Mag 7 earnings slow down.

There are now only 2 of the 7 stocks that remain above their 50-day moving averages. Apple is one of them, and they report earnings next week. Apple has experienced flat revenue growth over the last few years, with most of their returns driven by expanded margins and multiple expansion. The other is Tesla, which was at one point one of the worst-performing stocks in the S&P 500 year to date.

% Deviation from 50-Day Moving Average (Mag 7)

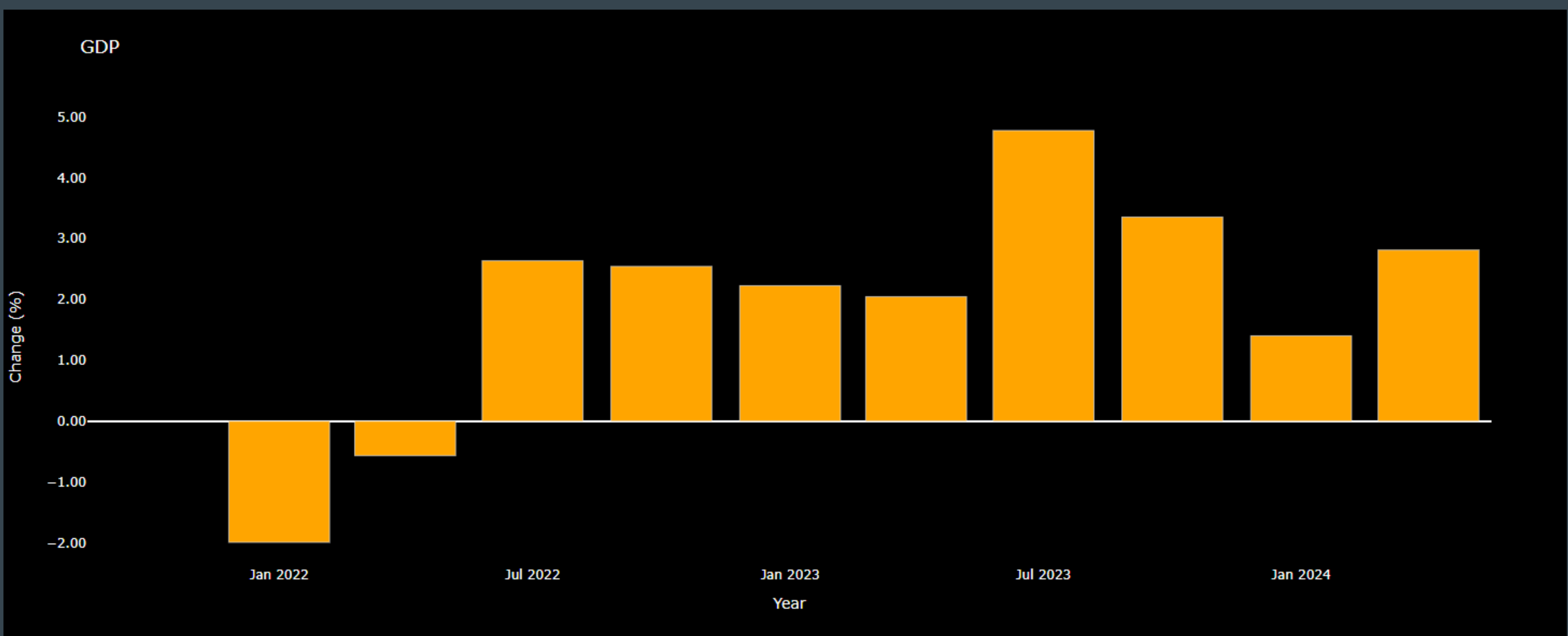
Deviation (%)

Apple Amazon Alphabet Meta Platforms Microsoft NVIDIA Tesla

Stock

The Equal Weight S&P 500 broke out to a new all-time high a week ago and now sits just below that level. This presents a significant opportunity for potential alpha as performance in the market begins to broaden out. There has been a notable deviation between the Equal Weight and Market Cap-weighted indices, and the broadening out of earnings, along with profit-taking in big tech, is expected to benefit the rest of the large-cap sectors.

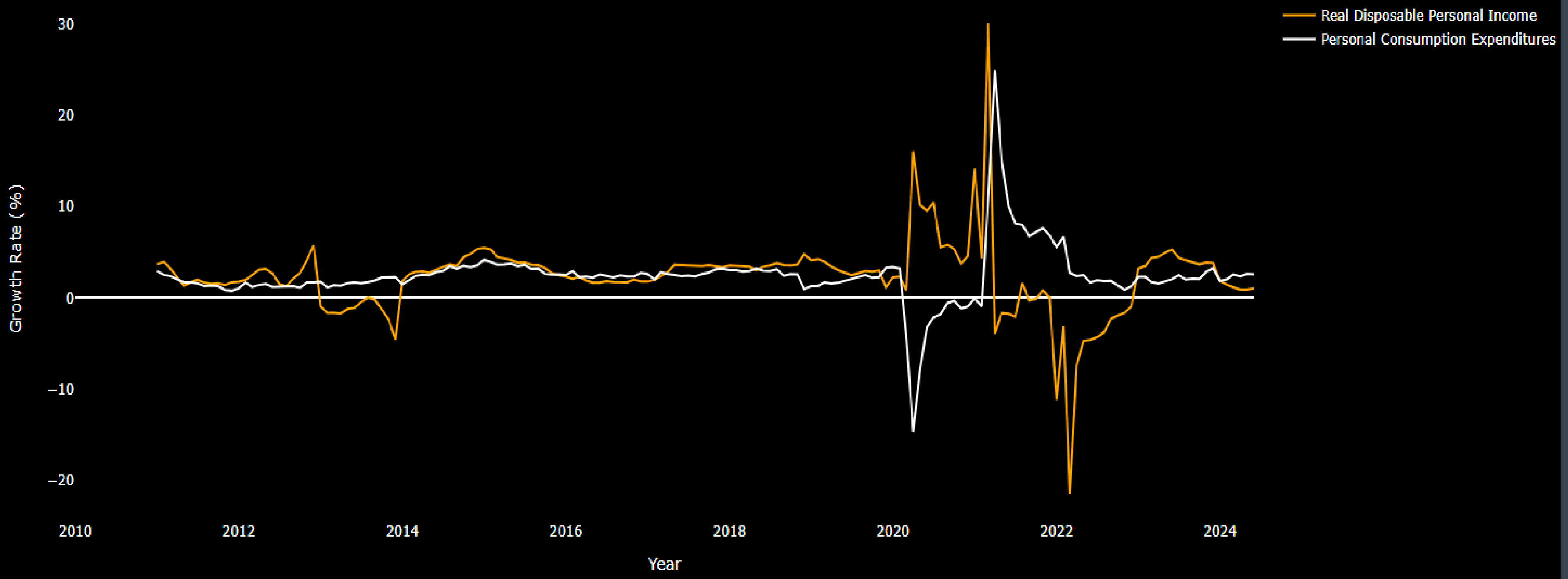
The first look at GDP growth for Q2 came out on Thursday, exceeding expectations at 2.8% annualized growth compared to the anticipated 2%. Notably, 80% of this growth was driven by government spending, inventory build, and consumption. On the surface this supports the argument for Small Caps, which tend to benefit from accelerating GDP growth, higher yields supported by that growth, and stable inflation. Currently, consumption is significantly driven by sustained high asset prices. About 60% of consumption comes from the top 40%, and there is a strong correlation between stock prices and consumer spending. The Beige Book released for Q2 provided more anecdotes from the 12 Federal Reserve Banks, citing slowing or modest growth. It also highlighted that consumers were pushing back against higher prices. We view this as a late-cycle environment still fueled by a 6% deficit being run by the government. Small Caps will not yet benefit from this scenario. As stated above, quality large-cap stocks outside of the Mag 7 will likely be the largest beneficiaries and a true broadening of earnings growth is what to watch for.



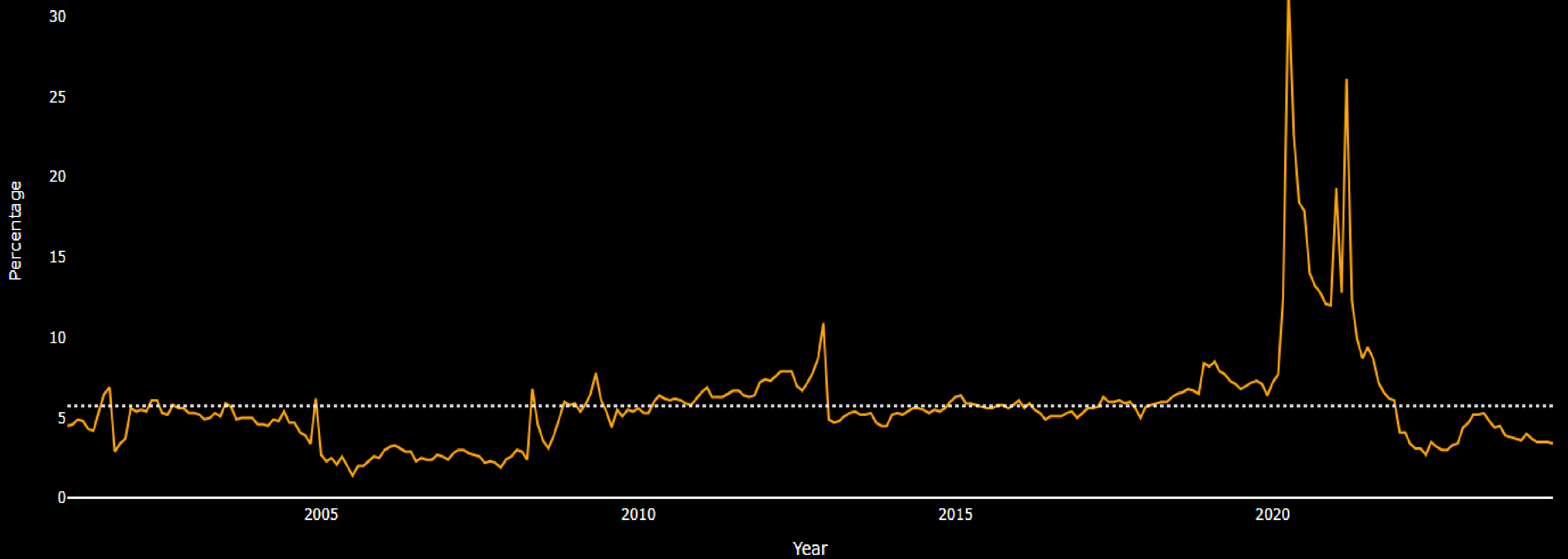
Personal Consumption Expenditures (PCE) was released on Friday, meeting expectations with a 0.1% month-over-month increase. This aligns with the forecast and places the year-over-year measure at 2.5%, slightly below the Federal Reserve's year-end projection of 2.6%. The Fed has indicated that base effects could introduce an upward bias to PCE in the coming months, potentially leading to higher-than-expected readings in August and September.

Core PCE has trended slightly higher, but the year-over-year measure remains unchanged at 2.6% after rounding it. This measure is crucial for the Federal Reserve, which has a year-end projection of 2.8% for Core PCE. Given that the current rate is 0.2% below their projection, it supports the argument for potential rate cuts. The upcoming July Fed meeting is not expected to see any movement, with the first rate cut still anticipated in September.

Real Disposable Personal Income has grown at under 1% year-over-year since March. Throughout 2024, personal consumption has consistently grown at a faster rate, causing a widening gap between the two. This disparity supports the anecdotal evidence from earnings transcripts and Federal Reserve reports indicating that consumers are struggling. For seven months of this year, the growth rate in consumption has been higher than the growth in incomes, highlighting the financial pressures on consumers. This is another reason why we believe we are in an environment where it is prudent to stick to quality. With consumers extended, they will likely stick to essential goods. Companies with strong pricing power or robust balance sheets will be the ones to maintain their margins and meet their debt obligations effectively.



The disparity between personal income and consumption has forced consumers to dip into their savings. Savings rates going back to 2001 have averaged just above 5%. As of June, the savings rate is down to 3.5%. The only other times savings rates dropped this low were in 2022 and around the financial crisis. This trend indicates that people are likely relying on credit for their purchases at a time when credit card interest rates are above 20%.



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