The market is pricing about 65bps of cuts this year, including the first cut in September that is quite likely, and over 100bps in 2025. (UBS)

Will rotation continue or begin to fizzle out?

22 July 2024, 2:41 pm CEST, written by UBS Editorial Team

It's been a stunning reversal across equity markets in July. The leaders in the first half of the year are the relative losers this month, while previous laggards have gone on a tear.

The Nasdaq 100 is down –0.6% in July after rising 16.7%in 1H24 and the comparable returns for the S&P 500 are 0.8% and 15% respectively, while the Russell 2000 small-cap index is 7.6% higher in July after being up only 0.9% in 1H24. Other notable July stars include regional banks (up 14.5%), and baskets of non-profitable tech stocks and the most shorted stocks (both up about 9%).

The question that investors are now asking is whether this rotation will continue for an extended period or fizzle out in the next few weeks. In other words, is this rotation a lasting 180° for the markets, or will performance come full circle with previous winners resuming their leadership? The rotation did stall at the end of last week, which may just be a pause after such a large move. But the overall evidence leans in favor of the latter—a reversal of the reversal—rather than the former.

The case begins by reiterating the ideal macro conditions for financial markets, which entails steady growth at or above 2%, falling inflation, and preemptive Fed insurance rate cuts. For the rotation trade to continue, this ideal macro environment has to be sustained. Recent data has been encouraging on all three fronts. Inflation has been below expectations for the last three months, with CPI annualizing to just over 1%, and the disinflation trend should continue due to declining shelter inflation. Concerns about slowing growth eased after retail sales and industrial production picked up in June, with the Atlanta Fed GDPnow Q2 tracking estimate back up to 2.7%. Finally, Fed officials implicitly endorsed a September rate cut last week by not pushing back against market pricing for one.

But there is a fine line between good macro data and ideal conditions necessary for the rotation trade to be sustained. In particular, investors may be getting ahead of themselves in expecting Fed rate cuts. The market is pricing about 65bps

of cuts this year, including the first cut in September that is quite likely, and over 100bps in 2025. This number of cuts is aggressive, especially if growth remains around 2% and inflation is still above 2%. It's not a lot if growth does slow more notably, but then macro conditions won't be ideal.

One only has to look back to the end of 2023 and 1Q24 to see how macro conditions were ideal for the rotation trade—small caps were on a tear last November and December—only to fade after two months. That's when the market went from pricing nearly seven rate cuts in 2024 as of mid-January to less than two by mid-April. Looking ahead, it's very plausible that the Fed cuts rates only a few times and then pauses if growth and/or inflation are still over 2%. That scenario won't become apparent in the next few weeks, but just the market pricing out some of those cuts may be enough to halt, if not reverse, the rotation trade.

Two other factors to consider in this rotation assessment are investor positioning and the "Trump trade". Positioning has played a significant role in amplifying the rotation trade, since many investors were caught offside. As noted above, the most shorted stocks have been squeezed higher. Call option activity on small-caps has spiked and banks hedging these option positions have exacerbated the move higher. Retail fund flows have also surged into small-cap ETFs. That said, the positioning influence on the rotation trade will soon dissipate, as such technicals usually do after about a month. That puts the onus on ideal macro conditions being sustained for the rotation trade to have a long runway.

The impact of the Trump trade on the market rotation is hard to isolate, and may be even more so in light of **President Biden ending his campaign**, but it's likely limited overall and a distant third factor after economic data and Fed rate cuts in determining the rotation's persistence. For starters, the concept of a Trump trade depends on whether you're focused on fiscal policy, tariffs, or regulation. But reflation is the central aspect of the trade due to expansionary fiscal policy and easier regulation. This is usually positive for equities overall, in our view, especially for cyclically-sensitive stocks, and should lead to higher long-end Treasury yields and USD. Yet since the 27 June Presidential debate, the S&P 500 is nearly flat, the 10-year Treasury yield is 5bps lower, and the USD is about –1.5% lower. This performance reflects good inflation data and earlier Fed rate cuts, not reflation. Since prediction markets already had about a two-thirds probability of Trump winning, we think it seems unlikely that the latest development in the presidential election will benefit the rotation trade.

The bottom line: Our **core investment views** have not changed this month, despite the extreme market rotation. We still recommend that investors position for lower rates, seek quality growth stocks, and seize the AI opportunity. The data needs to be great, not just good, for the rotation to continue—i.e., immaculate disinflation with growth above trend. It's certainly a plausible scenario consistent with a **"Roaring '20s" outcome**, which we conjecture has become increasingly likely. But this outcome requires sustained high productivity growth, and that likely needs AI to fulfill its potential sooner rather than later. This scenario should be good for small-caps and cyclicals in absolute terms, but even better for tech, growth, and momentum stocks, as was the case in the late 1990s. Our **revised year-end price target** for the S&P 500 is 5900 in the base case. Immaculate disinflationary growth skews the outcome towards the bull case of 6500. There will be a rotation trade in that scenario, but from cash and bonds into stocks.

Main contributor - Jason Draho

Original report - **180° or 360°, 22 July 2024.**

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