Is the ‘great equity rotation’ finally coming?

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Key Takeaways

- 10 July marked the potential start of an equity rotation away from the Magnificent Seven and towards the rest of the market
- This equity rotation is supported by upcoming Fed rate cuts, the earning growth gap between the “Magnificent Seven” and the rest of the market and the probable small-cap rally post-US election
- Such a rotation will force investors to rebalance portfolios towards more diversified portfolios and smaller cap portfolios like the one proposed in this blog

Over the last 18 months, the “Magnificent Seven” have dominated markets’ performance and narrative ad nauseam. For a while, it felt like nothing could stop their march forward, and they would defy gravity for years to come. But in markets, like in life, nothing is forever.

On 10 July, The Magnificent Seven may finally have met a worthy opponent in the form of a strong Consumer Price Index (CPI) print. Since the Bureau of Labor Statistics published a lower-than-expected CPI at +3% year-on-year and core CPI at +3.3%, markets appear to have finally pivoted. In the space of a week, the Russell 2000 jumped 9.2% while the Nasdaq lost -4.2%. In the same period, the S&P 500 equal weight outperformed the S&P 500 by 4.3%.

This rotation away from the Magnificent Seven and towards smaller caps, while impossible to predict in terms of the timing or magnitude, has been a long time coming. **At WisdomTree, we believe a few catalysts may be aligning, leading to the establishment of a wider and longer trend in which the market broadens, the remaining 493 stocks in the S&P 500 as well as small caps rebound and play catch-up with the Magnificent Seven.**

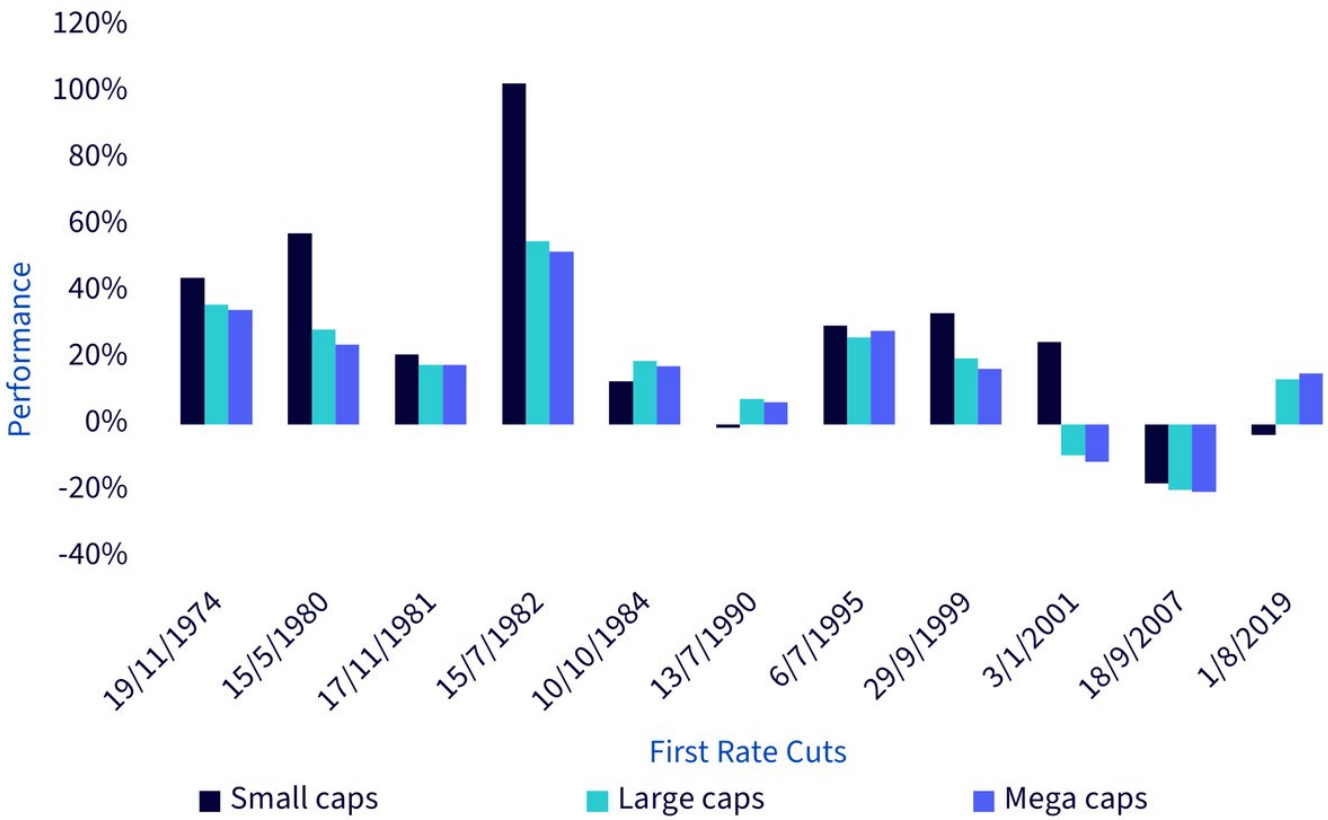
The Fed is finally cutting

Firstly, the Federal Reserve (the Fed) is moving towards its first interest rate cut in September. The markets read the July CPI print as the final confirmation that the Fed needed and reacted accordingly. Rate cuts are economically very beneficial to all companies, even more so to companies that must borrow to invest or are not profitable yet. In other words, it tends to benefit smaller cap companies more.

- In nine out of the last 11 rate cut cycles (Starting in 1974), equities have gained in the first 12 months following the first cut.

- In six of those nine cycles, small caps outperformed large caps and mega caps.
- Also, in the two cycles when equities performed negatively, small caps beat large caps and mega caps as well, even posting positive returns in one of those two instances.

Figure 1: Historical performance in the 12 months following the first rate cut

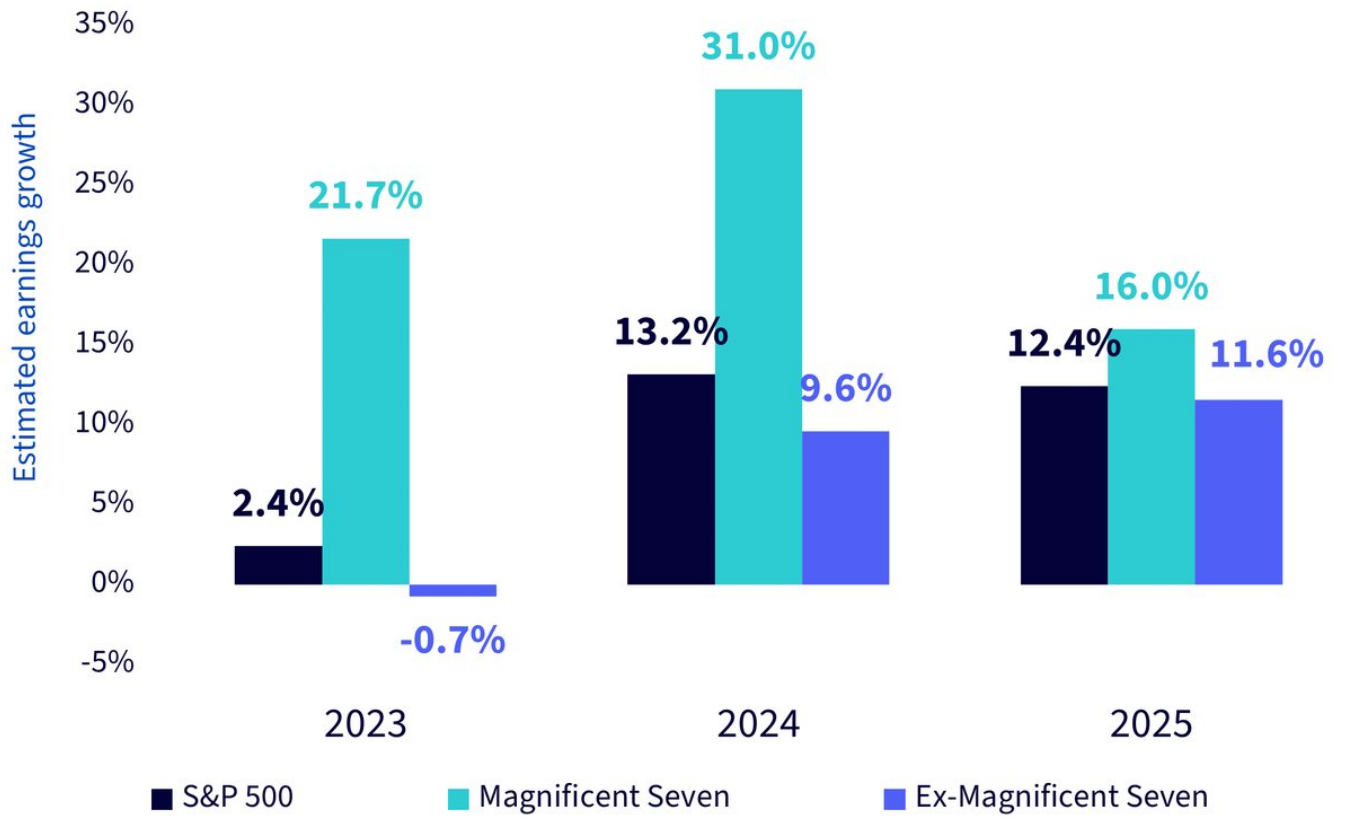


Sources: WisdomTree and Ken French, data as of May 2024, which represents the latest date of available data. Small Caps: Low 30% portfolio. Large Caps: High 30% Portfolio. MegaCaps: high 10% portfolio. Market: all CRSP firms incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ. **Historical performance is not an indication of future performance, and any investments may go down in value.**

The gap in earnings is finally closing

Secondly, the gap in earnings growth expectations between the Magnificent Seven and the rest of the market is closing significantly towards the end of the year. While the Magnificent Seven exhibited much higher earnings growth in 2023 and the first half of 2024, the rest of the market is catching up. Q4 2024 and 2025's estimates are broadly similar across the two groups. This should create opportunities for stocks outside those seven mega caps to capture investors' attention and catch up.

Figure 2: Earnings growth for US Equities

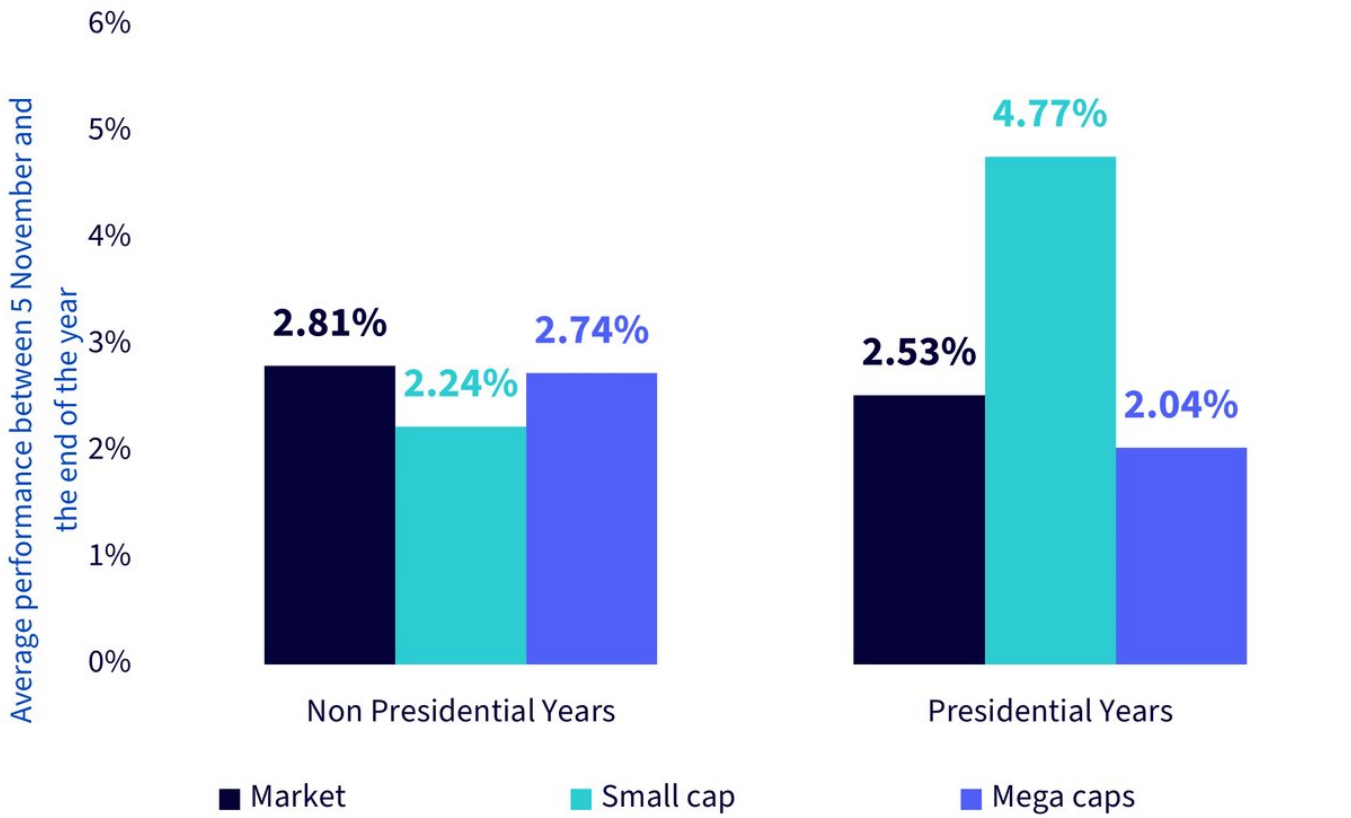


Sources: WisdomTree, FactSet. As of end of June 2024. **Historical performance is not an indication of future performance, and any investments may go down in value.**

The US Presidential election and an end-of-year small cap rally

Finally, the US presidential election creates significant uncertainty that tends to weigh on markets. Historically, once the election's results are known, uncertainty lifts, which very often creates a late-year small cap rally. Figure 3 shows that, after the last 15 elections, small caps returned on average 4.77% until the end of the year, while they only returned 2.24% in non-presidential years. On average, small caps beat the market in presidential years, and mega caps underperformed.

Figure 3: Average performance of US equities in election and non election years



Sources: WisdomTree and Ken French, data as of May 2024, which represents the latest date of available data. Small Caps: Low 30% portfolio. Large Caps: High 30% Portfolio. MegaCaps: high 10% portfolio. Market: all CRSP firms incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ. **Historical performance is not an indication of future performance, and any investments may go down in value.**

Adapting equity portfolios for the potential great rotation

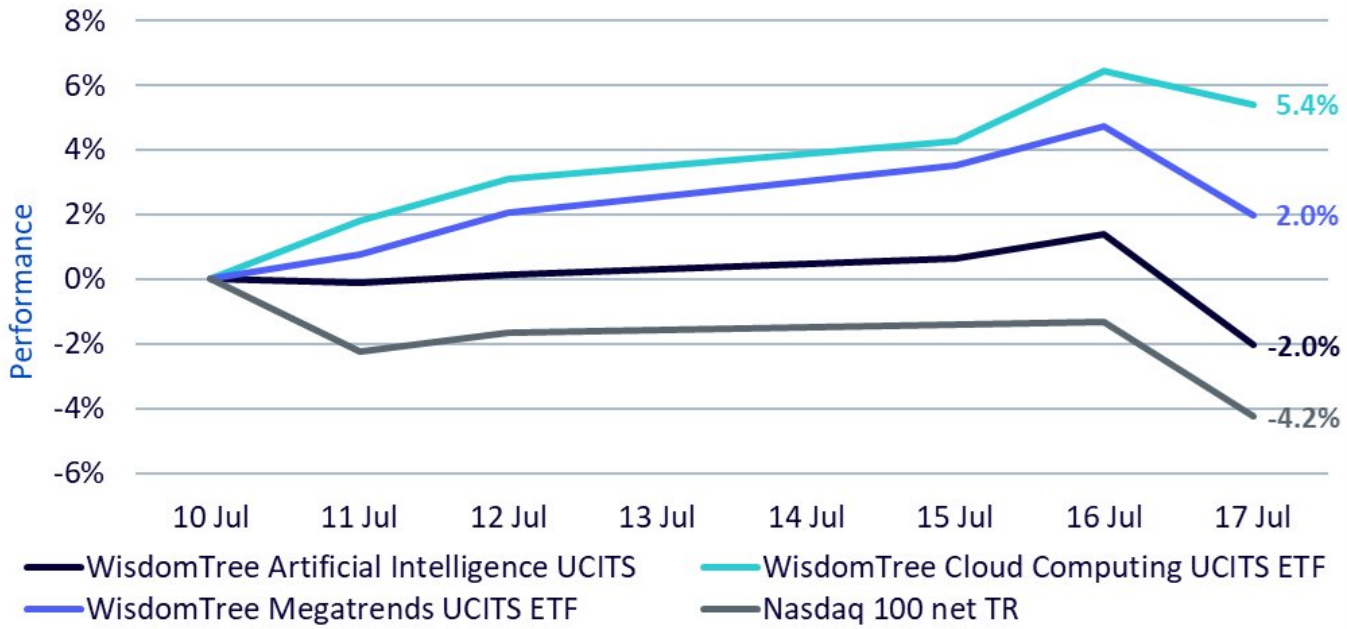
Considering those evolving market conditions, investors may need to consider changing their equity positioning and focusing outside mega caps and the Magnificent Seven. Three potential shifts could be to:

1. Shift investments in the Artificial intelligence (AI) theme from a single-minded focus on Nvidia and semiconductors towards smaller, pure-play companies, particularly software companies. This part of the AI market has suffered compared to Semiconductors in the last eight months, but last week's performance has shown their potential may be awakening. For example, the WisdomTree Artificial Intelligence UCITS ETF, which focuses on pure-play companies that tend to derive most of their revenue from AI, delivered an outperformance of 2.2% over the last week versus the Nasdaq 100[1]. It also outperformed the mega cap-focused Nasdaq Global AI and Big Data index by 1.6% over the period[1]. This rotation toward software could also benefit Cloud and Cybersecurity. The WisdomTree Cloud Computing UCITS ETF jumped 5.4% over the last week, beating the Nasdaq 100 by almost 10%[1].

2. Shift US and Global core equity investments away from Magnificent Seven heavy strategies to more diversified strategies. High-quality, dividend-growing companies tend to deliver good upside capture and defensiveness in uncertain periods. This could help investors weather the uncertainty of the next few months while benefitting from the equity rotation. The WisdomTree US Quality Dividend Growth UCITS ETF and WisdomTree Global Quality Dividend Growth UCITS ETF have both outperformed their market cap-weighted benchmarks by 1.4% and 1.6%, respectively, since 10 July 2024[1].

3. Restart investment into smaller cap companies with a thematic lens. The WisdomTree Megatrends UCITS ETF delivers a diversified portfolio of smaller cap, pure-play thematic companies across 16 themes (from AI to Clean Energy through HealthTech and Aging Population). With less than 5% investment in the Magnificent Seven and less than 50% exposure to large caps, this ETF can deliver high structural growth and exposure to the equity rotation at valuations that are still lower than big tech mega caps. This ETF has outperformed the Nasdaq 100 by 6.22% since the 10 July 2024[1].

Figure 4: WisdomTree Thematic ETFs are benefitting from the equity rotation



Source: WisdomTree, Bloomberg. From 10-17 July 2024. In USD. All indices are net TR. **Historical performance is not an indication of future performance, and any investments may go down in value.**

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