The Small-Cap Rotation Is Focused on Fixed vs. Floating Debt Exposure

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Key Takeaways

- The market has shifted from large-cap growth stocks to small-cap value stocks due to changes in policy rate expectations.
- The primary driver of this shift is the anticipated rate cuts by the Federal Reserve following a soft CPI report in July.
- Because small caps tend to skew more toward floating rate liabilities, they stand to benefit as the interest rate environment becomes friendlier.

If you're ever in doubt about the sheer market moving power of the Federal Reserve, the action of the last few weeks should solidify your convictions.

The stock market has witnessed a sharp leadership reversal from large-cap growth stocks to small-cap value plays this summer.

I think the number one driver of the action is the turn in policy rate expectations.

At one point in late July, I calculated a 15-session performance differential of nearly 21 percentage points between the large-cap Russell 1000 Growth and small-cap Russell 2000 Value indexes, a record that exceeded even the violent action of the dot-com comeuppance.

In recent sessions, the action has been more wishy-washy, as everything decided to plunge together when volatility went spiking in early August. But even amid that action, there is a ton of curiosity in this market with respect to the age-old small versus large battle.

We can debate how much of the rotation into small-cap value has to do with the ebbs and flows of public sentiment for the presidential candidates, not to mention the fact that a lot of the wild action came in the heart of earnings season. But in my opinion the key reason large caps have suddenly started underperforming small caps is the repricing of the outlook for Fed Funds. That began almost precisely on July 11, when the Street woke up to a surprisingly soft CPI report.

You don't see this too often, but the recent action is visible on long-term charts (figure 1).

Figure 1: Russell 1000 Growth Relative to Russell 2000 Value



Source: Refinitiv, as of 8/7/24, using total return indexes. You cannot directly invest in an index.

The rationale is clear, at least to me: investors have been scouring the market for companies who stand to benefit the most from a Fed-induced easing of their debt burdens.

Look at the setup. At the top of the market, what do we find? Silicon Valley giants with cash hoards that earn more than 5% in t-bills. Down in microcaps, it is often the opposite: many firms have floating rate obligations—bank loans—and business models that would absolutely crave 50 or 100 basis points (bps) of respite on the debt side.

This is a small versus large situation. According to Voya, about 30% of small caps' debt was variable rate in 2023, while among large caps it was just 8%. After the CPI report, strategists stopped talking about "higher for longer" interest rates and started thinking along the lines of a series of 25-bps cuts, maybe even a couple 50s, starting perhaps as soon as the September 18 Fed meeting.

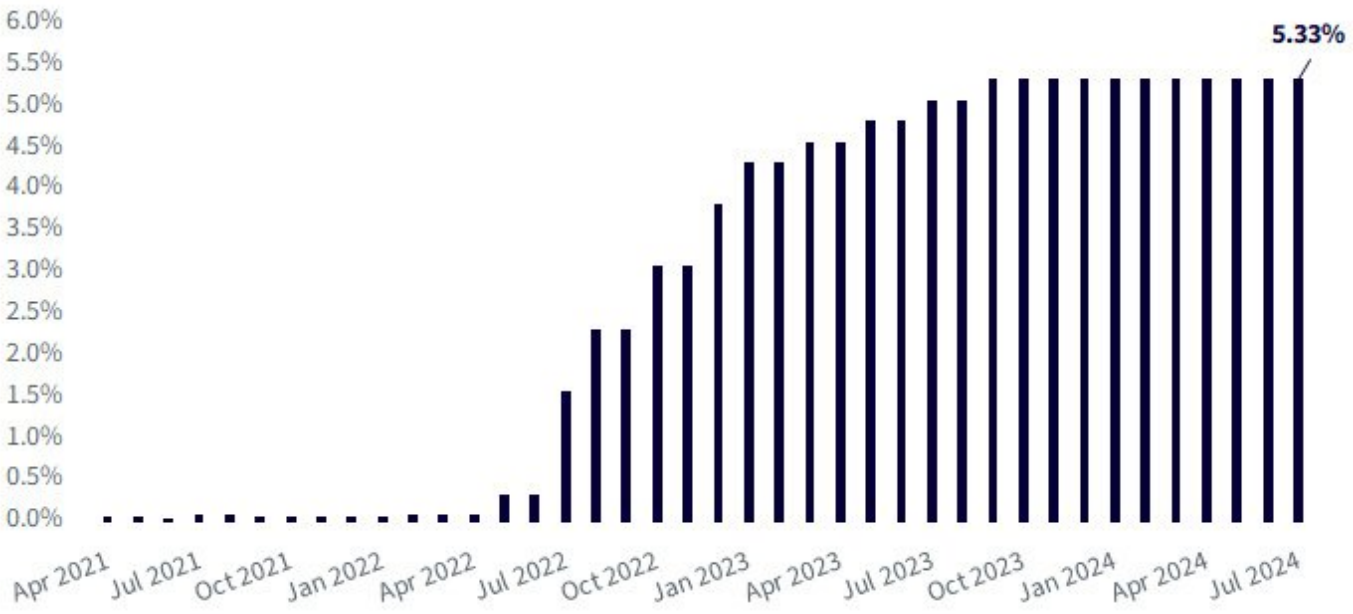
No group aches for rate cuts more than the laundry list of regional banks who populate mid- and small-cap value indexes.

After the collapses of SVB and Signature Bank wreaked havoc on the regionals in spring 2023, many banks had to ratchet interest rates off the zero line to stem what we called "the Bank Walk." That was when your brother, your sister and your neighbor didn't necessarily panic out of their accounts at the Savings & Loan. Instead, they put on their To Do List that they needed to earn 5% on their money, not 0%, so they got around to leaving their regional banking relationship in search of something like inflation-linked Series I savings bonds at Treasury Direct or an online high-yield savings account.

Because they needed to prevent the Bank Walk, many regional banks have spent the last two years offering savings account rates in the 5% area, while in contrast you still to this day only earn a single basis point of

interest in JP Morgan's Chase Savings account. If someone can explain to me how a regional can compete with JPM in such an environment, I'm all ears. But if Jay Powell cuts rates and the money market bogey stops being 5.33%, the regionals' competitive situation improves (figure 2).

Figure 2: Money Market Treasury Yield



Source: FDIC, as of July 2024.

In explaining the appeal of firms like Microsoft in recent years, I don't want to make like cash was the primary driver. Let's get real: artificial intelligence is the real force, especially in the last year or so.

However, grant me that at least part of the appeal of say, Alphabet, has been the optics of the quasi-haven that you get by owning a firm with a big cash buffer. That company has $110 billion of the green stuff on its balance sheet, while Microsoft boasts $80 billion and Apple $67 billion. Because of those cash bases, recent years would sometimes witness investors dumping small caps during panics while the tech giants were being treated like a Swiss vault.

But this summer? A distinctly icy vibe at the top of the S&P 500.

The market's tried-and-true "Magnificent 7 vs. the other 493" trade inside the S&P 500 has been turned on its head. Fidelity's Jurrien Timmer noted that the 13-week correlation between the equal-weighted S&P 500 and the cap-weighted version of that index fell to 36% during the most acute divergence days of late July. "It's normally 99%."

For years, we have been singing the praises of the WisdomTree U.S. SmallCap Fund (EES) and the WisdomTree U.S. SmallCap Dividend Fund (DES) because of their smaller-cap biases relative to the Russell 2000 and S&P 600 indexes. You can see it in figure 3, which highlights the weights in sub-$2 billion companies across the small-cap world, along with color-coding relative to the S&P 500.

Figure 3: Market Cap Composition inside Small Caps

	Note	WisdomTree U.S. SmallCap Fund (EES)	WisdomTree U.S. SmallCap Dividend Fund (DES)	Russell 2000 Index	S&P 600 Index	S&P 500 Index
% Weight Companies With Mkt Cap <$2 bn.	--	67.9%	44.8%	31.3%	30.6%	0.0%
QTD Return (%)	--	4.3%	4.2%	1.8%	3.0%	-4.2%
7/10/24 - 8/6/24	7/10/24 = the day prior to the CPI release	3.8%	3.7%	0.7%	2.2%	-6.9%
6/13/24 - 8/6/24	6/13/24 is the nearby Russell 2000 Low	3.7%	4.3%	1.4%	2.6%	-3.4%

Source: WisdomTree, as of 8/6/24.

Figure 4: Standardized Performance

				Cumulative Returns				Average Annual Total Returns				
Fund/Index Name	Fund Ticker	Expense Ratio	Inception Date	1-Month	3- Month	YTD	Since Inception	1-Year	3-Year	5-Year	10-Year	Since Inception
WisdomTree U.S. SmallCap Fund (NAV)	EES	0.38%	2/23/07	-2.72%	-5.15%	-4.18%	256.93%	6.84%	0.10%	7.27%	7.01%	7.61%
WisdomTree U.S. SmallCap Dividend Fund (NAV)	DES	0.38%	6/16/06	-1.86%	-3.74%	-1.77%	237.06%	11.58%	2.22%	5.86%	6.01%	6.97%
Russell 2000 Index			1/1/84	-0.93%	-3.28%	1.73%	278.20%	10.06%	-2.58%	6.94%	7.00%	7.65%
S&P 600 Index			10/28/94	-7.95%	-0.58%	9.49%	8.70%	8.70%	1.91%	8.36%	8.96%	11.66%
S&P 500 Index			3/4/57	3.58%	2.28%	15.29%	306.17%	24.56%	10.01%	15.05%	12.86%	13.44%

Source: WisdomTree, as of 06/30/24. Past performance is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performances and to download the Fund's prospectus, click the respective ticker: EES, DES.

Something to keep an eye on is the leveraged loan maturity wall, which is not really on the radar just yet because it is more of a 2028 issue. Having plenty of time to figure things out is good news for small caps, because they are the ones who will be paying a ton of the $540 billion worth of debt (figure 5).

Figure 5: Face Value of Leveraged Loans Outstanding, by Maturity Year ($ bn)



Sources: Credit Suisse, Polen Capital, as of 5/31/24.

The ideal setup for the firms who are on the hook for these bank loans is one where the Fed starts cutting rates in September and then continues to do so into 2025. Then the floating-exposed can theoretically come into the market sometime next year or in 2026 to square up their balance sheets. Because of this calendar layout, the market's mindset is clear: firms who need to refinance floating rate debt are "on" while cash rich companies up the cap spectrum are "off."

Now we just need Jay Powell to come through in the clutch.

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