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Stocks Come Full Circle – Time for a Rotation in Market Leadership?

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Global stocks continue to chug higher, up about 8% so far in the third quarter and flat for the year (MSCI All Country World Index).

In the Second Quarter Summary we highlighted the disparity between the returns of growth sectors relative to value sectors, with the outperformance of growth over value being as skewed as it was back in the Tech Bubble of 1999, and the phenomenon continues. As of this writing, the S&P 500 Growth index is up 17% for the year while the S&P Value index is down -12%, resulting in an incredible disparity in returns of 29%! Historically considered the “riskier” corner of the market, sectors such as technology, telecom equipment, healthcare, and biotech have soared past the more cyclical sectors as investors gravitate toward the combination of low debt balance sheets and earnings visibility during the uncertain times. While the temptation to chase what has worked best recently is natural, remember that trees do not grow to the sky.

The infamous six companies comprising the highly touted “FANMAG” stocks by the media (Facebook, Apple, Netflix, Microsoft, Amazon, and Google) now represent 23.5% of the S&P 500. As a “cap weighted” index, the larger a company’s market cap (stock price multiplied by total number of shares outstanding), the larger the position’s benchmark weighting. As trends persist there is a self-perpetuating cycle as companies get bigger, become larger weightings of the indices, are purchased more, attract more buyers, get bigger, become an even larger weighting in the index, and so on. This is one of the reasons the S&P 500 index has been so incredibly hard to beat in recent years. The best performing handful of constituents dominate a quarter of the entire index of 500 companies. Apple alone is 6.5% of the index, which means that unless you are willing to put 6.5% of your portfolio in one stock, then you are underweight and being left behind. Apple is an incredible company, and one that we own (at less than a 6.5% weighting) in many client accounts, but these imbalances cannot go on indefinitely.

If the economy continues to improve and emerge from the grip of the pandemic, then a change in market leadership would likely occur in order to drive gains higher. In this scenario, we would not expect growth stocks to keep pace with other sectors that have plenty of room to run higher just to get back to even for the year. It could also be time for foreign stocks to outperform domestic stocks. For the first time in a long while, our Macro Economic Strategic Allocation (MESA) model is not heavily favoring domestic stocks as an overweight. Investors have flocked to the U.S. stock markets over the past decade because the outperformance has been stunning. In the chart below we compare the S&P 500 (large U.S. stocks) to the MSCI All World ex-USA (stocks across the world except the U.S.). The S&P 500 had the strongest performance in 9 out of 11 years, by an average of over 8%!

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	average*
S&P 500	15.1%	2.1%	16.0%	32.4%	13.7%	1.4%	12.0%	21.8%	-4.4%	31.5%	3.6%	14.2%
MSCI ACWI ex-USA	11.2%	-13.7%	16.8%	15.3%	-3.9%	-5.7%	4.5%	27.2%	-14.2%	21.5%	-5.7%	5.9%
Difference	3.9%	15.8%	-0.8%	17.1%	17.6%	7.0%	7.5%	-5.4%	9.8%	10.0%	9.2%	8.3%

We are not in the business of calling tops and bottoms or reversals in long trends, but based on valuations and the latest economic statistics, the environment is ripe for a shift in the markets to favor other sectors than technology, and other geographies than the United States, to lead us higher.

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