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Market View
Market rotation amid shifts in tech dominance

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Author Sanjay Rijhsinghani

At a glance

- Shift in market dynamics: a significant sell-off in high-valued AI stocks, including the 'Magnificent Seven,' led to a 20% decline from their peaks. Meanwhile, the Russell 2000 and S&P 500 Equal-Weighted index outperformed, indicating a notable rotation into previously neglected sectors.

- Economic indicators and inflation impact: easing inflation and potential Fed rate cuts have bolstered investor confidence, benefiting smaller companies, banks and real estate.
- AI surge not sustainable: recent geopolitical tensions and revised AI growth expectations have tempered the tech sector's exuberance.

If the first half of the year was all about the extreme concentration in the S&P 500's gains, the market moves after 10th July showed just how important diversification is for long-term investors.

Apart from the brief period in the second quarter where market breadth threatened to widen with more stocks delivering returns, most of this year's gains can be attributed to just a few stocks, underscoring how concentrated the S&P 500 has been this year. Nvidia alone added USD 1 trillion in market cap in the first half of the year and accounted for a staggering 35%[1] of the S&P 500's gains through June, propelling the index to new records. The chipmaker's exponential growth is driven by ongoing exuberance over artificial intelligence (AI) and appears set to continue benefiting from increased demand for its chips in training and running AI models like ChatGPT.

However, there are encouraging signs that we are beginning to see a reversal of the concentration in equity markets. Whether due to concerns about the US economy stalling or the implosion of the yen carry trade – where investors borrow in Yen and purchase US assets and equities - as the Japanese currency rallied some 18%[2] in the space of three weeks, it seemed that investors needed an excuse to sell off the highly valued AI and Magnificent Seven stocks. July marked the month when the Magnificent Seven stocks finally fell from their highs, declining by over 20%[3] from their peak on July 10th. Fortunately, at least initially, the sell-off in Mega Tech resulted in investors purchasing assets and sectors that had been unloved since the start of the year. Meanwhile, the Russell 2000 (small-cap US index) and S&P 500 Equal-Weighted index outperformed the S&P 500 by over 5% since the Magnificent Seven peaked, underscoring the extreme rotation (moving of investments into a different area of the stock market) that has occurred since 10th July. The Russell 2000 had its best day of the year on 11th July, after the release of the inflation report, rising 3.6% that day[4].

In recent months, the 'stickier' nature of inflation has meant that the US Federal Reserve (Fed) has been reluctant to cut interest rates.

However, recent monthly inflation data in the US has seen inflation moderate. The Consumer Price Index (CPI) release on 11th July showed a slight decline in June from the prior month. This

CPI reading indicated inflation concerns are all but over and has provided the Fed an opportunity for its first rate cut in four years this September. This appears to have given investors confidence that interest rate cuts could bolster the economy amid softer growth expectations. As a result, bonds have rallied (further evidence of investors moving out of mega tech and broadening the rally) and the share price of companies that stand to benefit from declining interest rates, such as smaller companies, banks and real estate have all experienced rallies while the big tech companies have stumbled, paving the way for the equity rotation we are now witnessing.

In addition to lower inflation benefiting sectors outside the Magnificent Seven, some negative news regarding AI has also adversely impacted stock prices of certain technology companies.

Republican presidential nominee Donald Trump fuelled the latest technology sell-off in mid-July after stating that Taiwan should pay the US for its defence, which sent the benchmark Philadelphia Semiconductor index down as much as 28%[5] from its peak, before recovering in recent sessions. Taiwan, home to many chipmakers, plays a crucial role in the global chip supply chain, with these companies supplying advanced processors that power everything from AI applications to jets.

At the start of this year, tech companies were optimistic, telling the market that AI would substantially boost sales and earnings for the foreseeable future. However, more recently, we have seen a marked change in messaging from these very same tech businesses – they are now suggesting that the AI pay-off will take longer than initially expected. Additionally, companies like Intel and Microsoft have announced significant job cuts, further questioning the short-term 'hype' around AI related companies.

Recent weeks have reaffirmed our view that diversification is the best way to preserve and grow investor capital. Whilst US companies and technology will undoubtedly continue to drive equities for the foreseeable future, we remain focused on investing in a diverse range of quality companies. We believe this is essential for all long-term investors, as AI will benefit a growing number of companies. Although the dominance of some mega tech companies may be starting to diminish, few expect the tech rally to fade completely. It is more likely that other companies will catch up as borrowing costs decrease, ultimately bolstering the economy.

[1] Bloomberg

[2] Bloomberg

[3] Bloomberg

[4] Bloomberg

[5] Bloomberg