

# Effects of Tight Monetary Policy have Started to Materialize. Will the Great Rotation Continue?



## Russell 2000 Posts Best July Since 2022

Amid easing inflation, underwhelming technology-related earnings, and increased probabilities of Fed interest rate cuts, equity markets witnessed a meaningful rotation in July in which smaller, value-oriented stocks outperformed large-cap growth. The Russell 2000, an index that tracks small-caps, gained over 10%, posting its best month since December, as well as its best July since 2022. US mid-caps (+5.9%) and US value (+4.7%) were also among the best performers. Bonds fared well as 7-10 year US Treasuries were up 2.9%, investment grade corporates rose 2.4%, and the US Aggregate Bond Index increased 2.3%. Aside from gold (+5.4%), commodities struggled as broad-based commodities were down 3.7%, crude oil decreased 2.3%, and silver fell 0.7%.

Exhibit 1: Trailing Returns as of July 31, 2024

Index/ETF	1-Mo	3-Mo	YTD	1-Y	3-Y	5-Y
<b>Equities</b>						
US Small-Caps (SPSM)	10.79%	13.69%	10.01%	14.09%	4.05%	10.01%
US Mid-Caps (SPMD)	5.89%	8.73%	12.30%	15.32%	6.31%	11.30%
US Value (SPYV)	4.72%	7.04%	10.67%	16.56%	10.91%	12.51%
International Developed Equities (SPDW)	2.96%	6.08%	8.07%	10.59%	2.45%	7.48%
Broad-based Emerging Markets (SPEM)	1.22%	5.89%	8.97%	7.75%	-0.67%	4.62%
US Large-Caps (SPY)	1.21%	10.08%	16.62%	21.96%	9.50%	14.92%
US Growth (SPYG)	-1.36%	12.58%	21.86%	26.77%	7.54%	16.25%
<b>US Fixed Income</b>						
US Treasury 7-10 Year (IEF)	2.90%	6.02%	1.38%	3.71%	-4.36%	-0.82%
Investment Grade Corporate Bonds (SPBO)	2.40%	5.00%	2.14%	6.87%	-2.57%	1.14%
US Aggregate Bond Index (SPAB)	2.28%	5.03%	1.67%	5.01%	-2.67%	0.12%
High Yield Credit (JNK)	2.24%	4.35%	4.63%	10.50%	1.41%	3.15%
Treasury Inflation Protected Notes (SPIP)	1.81%	4.39%	3.22%	4.11%	-2.00%	2.18%
Municipal Bonds (MUB)	1.31%	2.04%	0.81%	4.04%	-0.55%	1.20%
<b>Commodities</b>						
Gold (GLD)	5.37%	6.93%	18.51%	24.18%	10.07%	11.20%
Silver (SLV)	-0.68%	9.73%	21.17%	16.27%	3.75%	11.65%
Crude Oil (USO)	-2.32%	-0.82%	16.64%	6.23%	15.32%	-4.19%
Broad-based Commodities (BCI)	-3.69%	-3.31%	1.14%	-5.34%	3.04%	6.16%

Source: FactSet. Data as of July 31, 2024. 1Y, 3Y, and 5Y numbers are annualized.

## Fed Holds Rates Steady but Hints at September Cut

The Federal Reserve kept interest rates unchanged at the July FOMC meeting, leaving the fed funds rate at the 5.25–5.50% range. Consumer Price Index (CPI) and Personal Consumption Expenditure (PCE) reports for June showed disinflationary progress, but policymakers expressed they still need “greater confidence” that inflation is sustainably moving towards the 2% target before lowering interest rates. However, Fed Chairman Jerome Powell stated if inflation continues to ease and economic health follows the same path, a rate cut “could be on the table at the September meeting.” The Fed’s statement also revealed inflation is now viewed as only “somewhat elevated,” improving from “elevated” in previous statements. Additionally, officials noted they are “attentive to the risks to both sides” of the dual mandate, acknowledging the moderation that has taken place in the labor market, and that both inflation and employment goals have come more into balance. Currently, a 100% chance for the first rate cut to occur in September is priced in per the CME FedWatch Tool.

## Labor Market Loosens

Initial Jobless Claims, a leading economic indicator, have been consistently elevated in recent weeks. As of July 27, 2024, the series notched its highest level since August 2023. The latest Continuing Jobless Claims reading also registered as the highest since November 2021, and both ADP and Nonfarm Payrolls have been weakening, all supporting a loosening in the labor market.

Exhibit 2: Initial Jobless Claims

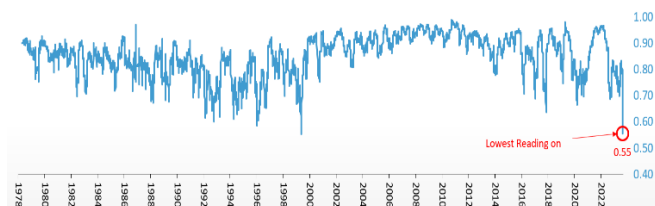


Source: FRED. Data as of August 1, 2024.

## Time to Consider Investing in Small-Caps?

On a 63-day rolling basis, the correlation of large-caps (Russell 1000 Index) relative to small-caps (Russell 2000 Index) recently reached its second-lowest level in history (see Exhibit 3). Including the latter in portfolios can be advantageous as owning asset classes with low correlations can aid in diversification and bring portfolios higher up on the efficient frontier. Simultaneously, small-caps remain historically cheap compared to large-caps as the relative forward P/E of the former recently stood near 73%, offering a 27% discount to large-caps (see Exhibit 4).

### Exhibit 3: Russell 1000 vs. Russell 2000: 63-Day Rolling Correlation



Source: FactSet, Astoria Portfolio Advisors. Data as of July 31, 2024.

### Exhibit 4: Russell 2000 vs. Russell 1000: Forward P/E Ratio



Source: FactSet, Bloomberg, NTAM Global Asset Allocation Quantitative Research

## Highly Concentrated

Concentration risk, as measured by the cumulative market cap of the ten largest stocks in the S&P 500 relative to the total market cap of the index, is near its highest level since 1972.

### Exhibit 5: Top Ten S&P 500 Stocks by Market Cap as % of Total S&P 500 Market Cap



Source: Twitter @MattTopley. Data from S&P Dow Jones Indices as of July 10, 2024.

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## Effects of Tight Monetary Policy have Started to Materialize. Will the Great Rotation Continue?

Within the past month, there has been a sizable rotation out of growth and into value-centric assets. In our view, this 'Great Rotation' needed a catalyst, and we've experienced a few of them: Disinflationary June CPI and PCE reports, changes in the interest rate cycle, 100% probability of a rate cut priced in for September.

From our perspective, the Great Rotation trade is out of secular growth winners, which are stocks that are likely to grow in any environment (good economy, bad economy, high or low inflation) and into lower interest rate beneficiaries (equal weight strategies, value centric assets, and mid/small-cap stocks).

We were bullish heading into 2024 given expected interest rate cuts, cyclical upswing in earnings, etc. This thesis continues to play out.

Moreover, heightened concentration risk remains in market cap weighted strategies. From a factor standpoint, tilting away from market cap can be done via the following:

- Value – tough factor, historically inconsistent risk/reward
- International – carries more risk, and investors tend to be generally reluctant to go abroad
- Small-caps – need a rate cut or two, but we acknowledge the recent bounce
- Equal weight – our preferred method to play the Great Rotation, but we recognize there are many flavors of equal weight

The number one question being asked is, "Is there more left in this rotation?" When observing the extreme valuation difference, price momentum, etc., it seems more than likely that we are just scratching the surface of the Great Rotation trade.

Lastly, with regards to the upcoming US elections, our investment views remain steadfast. The interest rate and macro-economic cycle trump (no pun intended) the political cycle.