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Focus

Navigating the Rotation from Mega-Caps to Mid-Caps: An Economic Perspective

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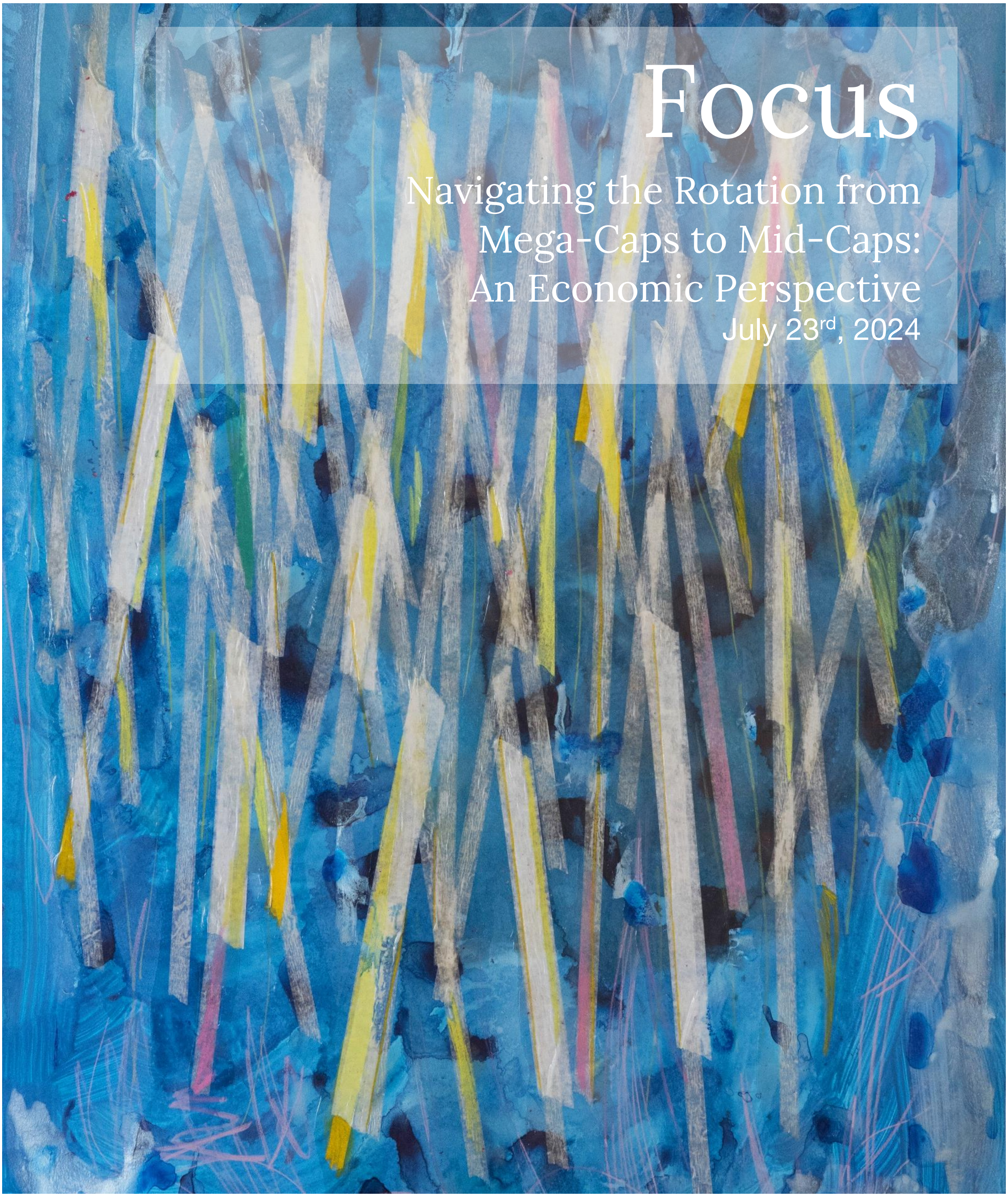
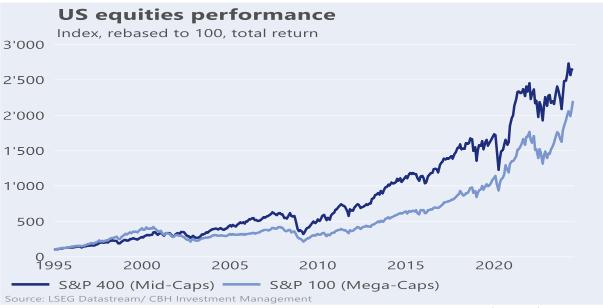


Creativity within Excellence

Navigating the Rotation from Mega-Caps to Mid-Caps: An Economic Perspective

US inflation figures for June surpassed market expectations. Prices fell 0.1% on a monthly basis, and the annual rate of inflation slowed to 3%, driven by a decline in energy and vehicle prices. According to a Reuters poll, economists had anticipated a 0.1% monthly increase and a yearly progression of 3.1%. This unexpected data prompted markets to adjust their monetary policy expectations, **increasing the likelihood of a Fed rate cut in September**. Consequently, the 2-year US Treasury yield dropped significantly, and equity markets experienced a notable rotation from Mega-Caps to Small & Mid-Caps (SMID).

While the macroeconomic environment has not undergone a dramatic overnight transformation, this rotation was triggered by the element of surprise. We are approaching the end of the plateau and the potential start of the Fed funds rate cuts. However, the Federal Reserve will maintain a cautious and data-dependent approach. The FOMC requires more than a single positive data point to initiate its easing cycle, but **there are growing arguments for a less restrictive policy stance**. Therefore, the macroeconomic context is becoming more favorable for US Small and Mid-Caps, in our view.



By Small and Mid-Caps, we mean stocks with a market capitalization of between $2 and $10 billion (Mid-Caps) or less than $2 billion (Small-Caps).

1. Soft-Landing Scenario

Firstly, the US economy is still on track for a soft-landing scenario characterized by:

- Slowing yet extremely resilient economic growth, with a sharp decline in the probability of a US recession since the beginning of the year.
- A disinflationary environment, improved productivity, and softened employment conditions.
- Easing financial conditions due to lower interest rates, improved liquidity (as the Fed slows the pace of its balance sheet reduction), and renewed risk appetite among banks.

This narrative supports the fundamental relative outperformance of Small & Mid-Caps.

2. Steepening Yield Curve

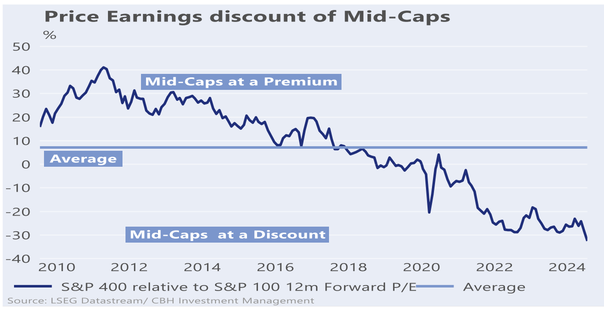
Secondly, a steepening yield curve is anticipated. For the past two years, bond markets have been experiencing an inverted yield curve, with the yield on two-year bonds surpassing that of the benchmark 10-year bonds. Many investors have been betting on a reversal for almost as long, but these bets have been largely unproductive. However, the situation appears to be shifting. Although two-year yields remain higher than 10-year yields, the gap has narrowed to 25 basis points, down from a peak of 51 basis points in late June. Structural changes such as demographic trends, technological advancements, and environmental factors could lead to higher long-term rates. In this scenario, the long end of the yield curve will remain elevated while the short end declines along with the Fed's policy rates. Historically, a steepening yield curve has been associated with strong relative performance for SMID.

3. The Outlook for the US Dollar

Finally, a dollar that remains strong will continue to support SMIDs. Historical correlations show that smaller and more domestically-oriented companies tend to perform better when the dollar appreciates. Despite significant external and fiscal deficits, the dollar has been supported by capital inflows due to attractive yields, persistent geopolitical risks, and robust US economic performance compared to other advanced economies. The US economy benefits from booming capital expenditure, rising productivity, and its shift to a net energy exporter. Overall, upward pressure on the dollar should remain intact in the coming months.

4. Challenges and Market Fundamentals

However, the final phase of disinflation is the most challenging. It is a long and complex process, and new setbacks and surprises can arise. While disinflationary forces are in place, the path remains bumpy: a disinflation trajectory for shelter-related items that needs to be confirmed, decelerating wage growth amid sticky services inflation, and a still robust labor market. Additionally, shipping costs and commodity prices remain volatile and sensitive to geopolitical and political events.
Market fundamentals are also supportive. Over the long term, Small & Mid-Caps have outperformed Large-Caps, although this asset class has underperformed since June 2021. If the economy remains strong in 2024, Mid-Caps might surpass Mega-Caps as the market rally widens and valuations become more significant. Mid-Cap stocks are currently undervalued relative to Mega-Caps, with a forward P/E ratio of 16x, placing them in the 30th percentile over the past decade. In contrast, Mega-Caps have a forward P/E ratio of 22x, which is in the 92nd percentile. This creates a valuation gap that falls within the 1st decile of the past ten years. Additionally, Mid-Caps earnings expectations are robust for the next year, with a projected growth of 16.8%, compared to 12.3% for Mega-Caps.



5. Conclusion

We are in a period of considerable uncertainty regarding inflation and the trajectory of interest rates. However, the resilience of the US economy, the disinflation process, easing financial conditions, a steepening yield curve, and attractive earnings expectations all support equities. Given the structural megatrends at play (digital, energy, and demographics), high-quality Large-Cap equities remain our primary focus. Nonetheless, increasing exposure to Mid-Caps could enhance the allocation to US equities.

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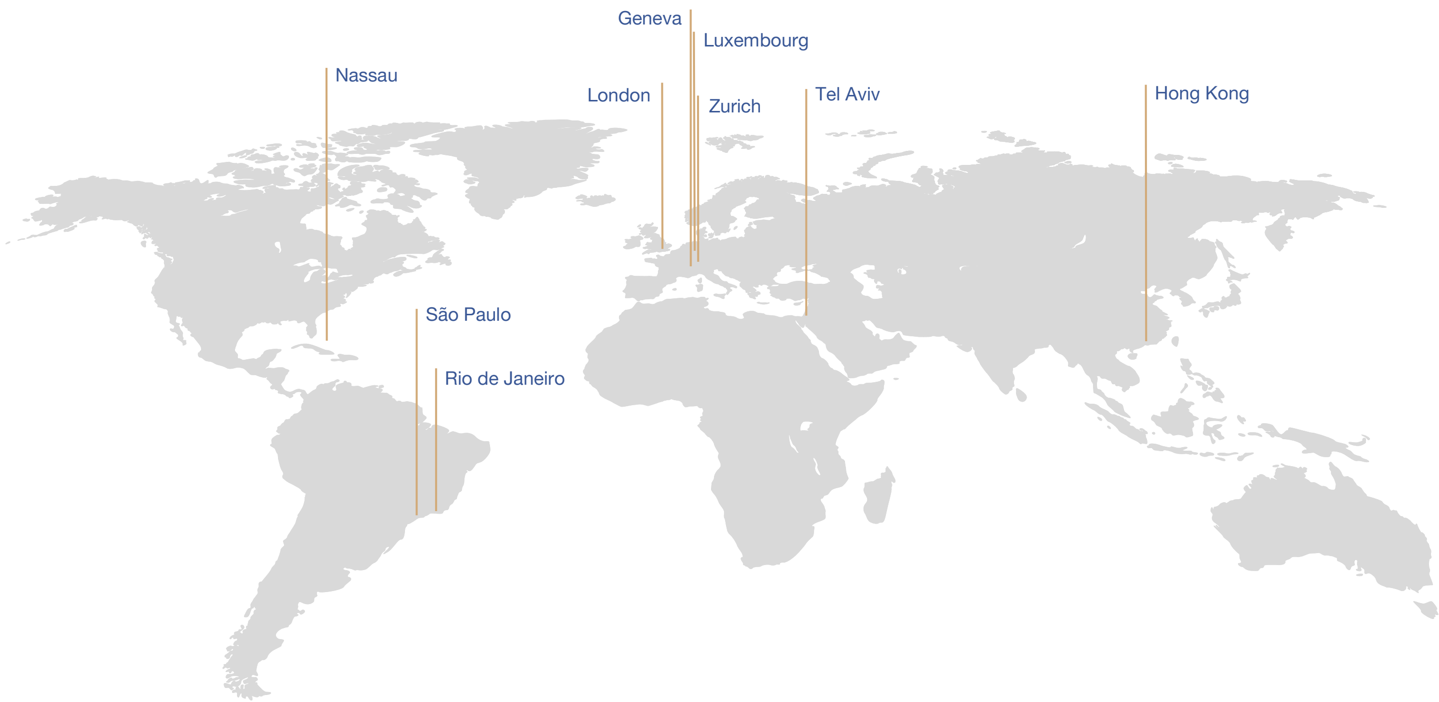

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