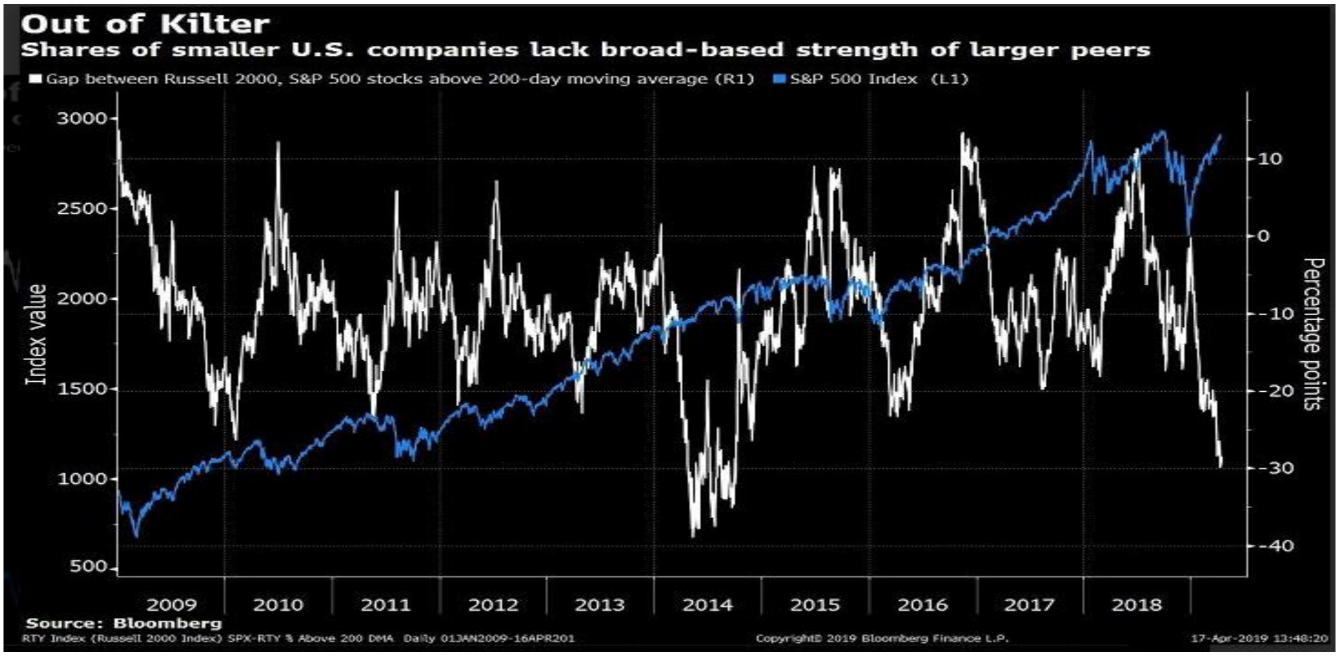
OUT OF KILTER…

U.S equities continue to perform strongly in 2019, much to the surprise of many prognosticators (though fortunately not for readers of the Global Investment Letter). The nature of the recent advance is, however, unusual from a historical perspective, in keeping with our oft-repeated observation that we live in unusual times. I thought it might be of interest to look at one unusual aspect of the current rally via the chart below.

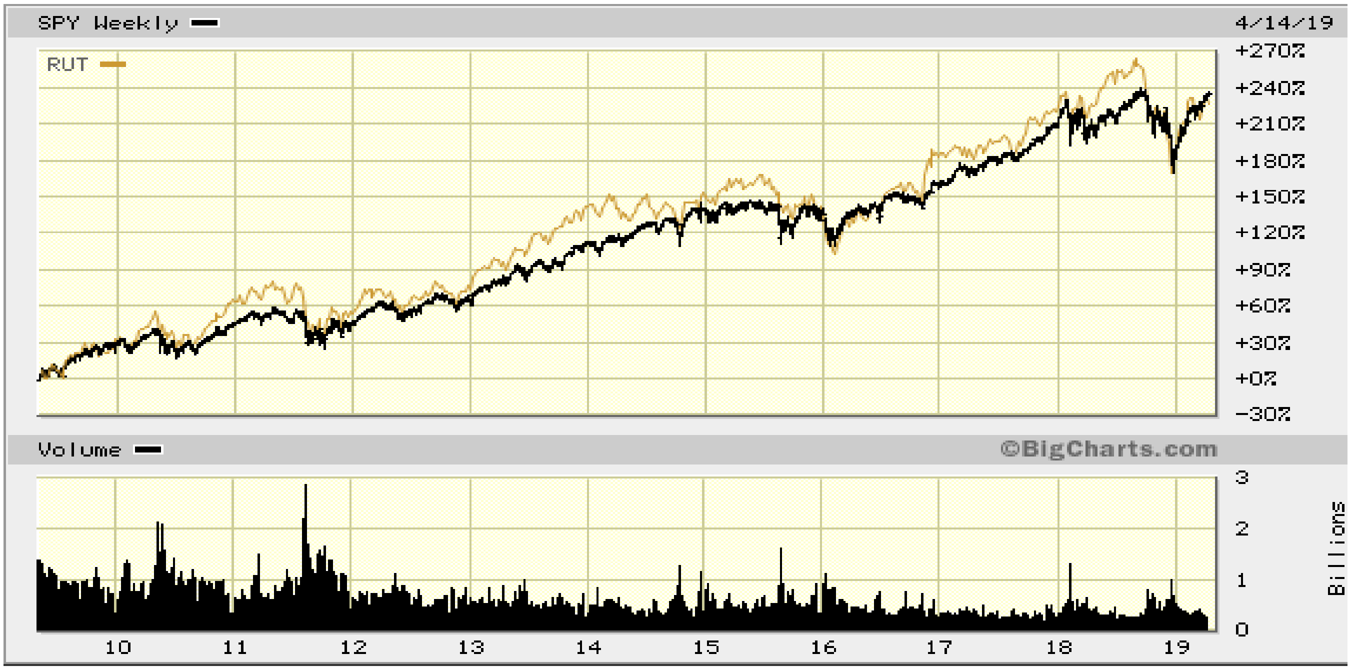


The chart measures the percentage difference of small-cap Russell 2000 stocks trading above their 200-day moving average versus S&P 500 stocks trading similarly. It demonstrates that the relative strength of small-cap versus large-cap stocks has been deteriorating since 2014.

Traditionally, small cap stocks outperform large caps, particularly in bull markets. However, the chart above demonstrates that the number of stocks trading below their 200-day moving averages has been consistently lower in the small cap Russell 200 index over the past 10 years. The inference is that the current long-lived bull market has been driven by an even more narrow group of stocks in the case of the Russell 2000 than the S&P 500.

I believe two factors account for this anomaly. Firstly, the market advance of the past five years has been unusually narrowly focused, being led by the FAANG stocks, all of which have enormous market capitalizations. Second, the ongoing popularity of passive investing is driving capital into large-cap stocks at the expense of smaller companies. Passive investment vehicles, such as index funds, must be composed primarily of large-cap stocks to fulfil their mandate to mirror the broad market returns. The amount of capital directed to passive investment is huge, comprising approximately 40% of invested assets.

The following chart compares the returns of the S&P 500 with the Russell 2000 over the past decade. It confirms that small cap stocks had been outperforming in this long bull market until 2014, after which their relative outperform disappeared.



The leadership role of large-cap tech stocks is a defining characteristic of the current bull market and has become more pronounced in recent years. We expect this phenomenon to continue until the next bear market for the reasons discussed above.

Therefore, the best risk/reward currently remains with large-cap tech-related issues until evidence suggests otherwise. Over time, however, this emphasis on large caps should increase the opportunities to be found in the small-cap sector by making that market relatively less efficient.

Note: Over the past week, we posted a number of articles in the free commentary section of the website. We invite you to have a look.

By Jonathan Baird CFA

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