fundstrat

Evidence-based research.
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THE SMALLEST OF SMALL CAPS ARE WINNING

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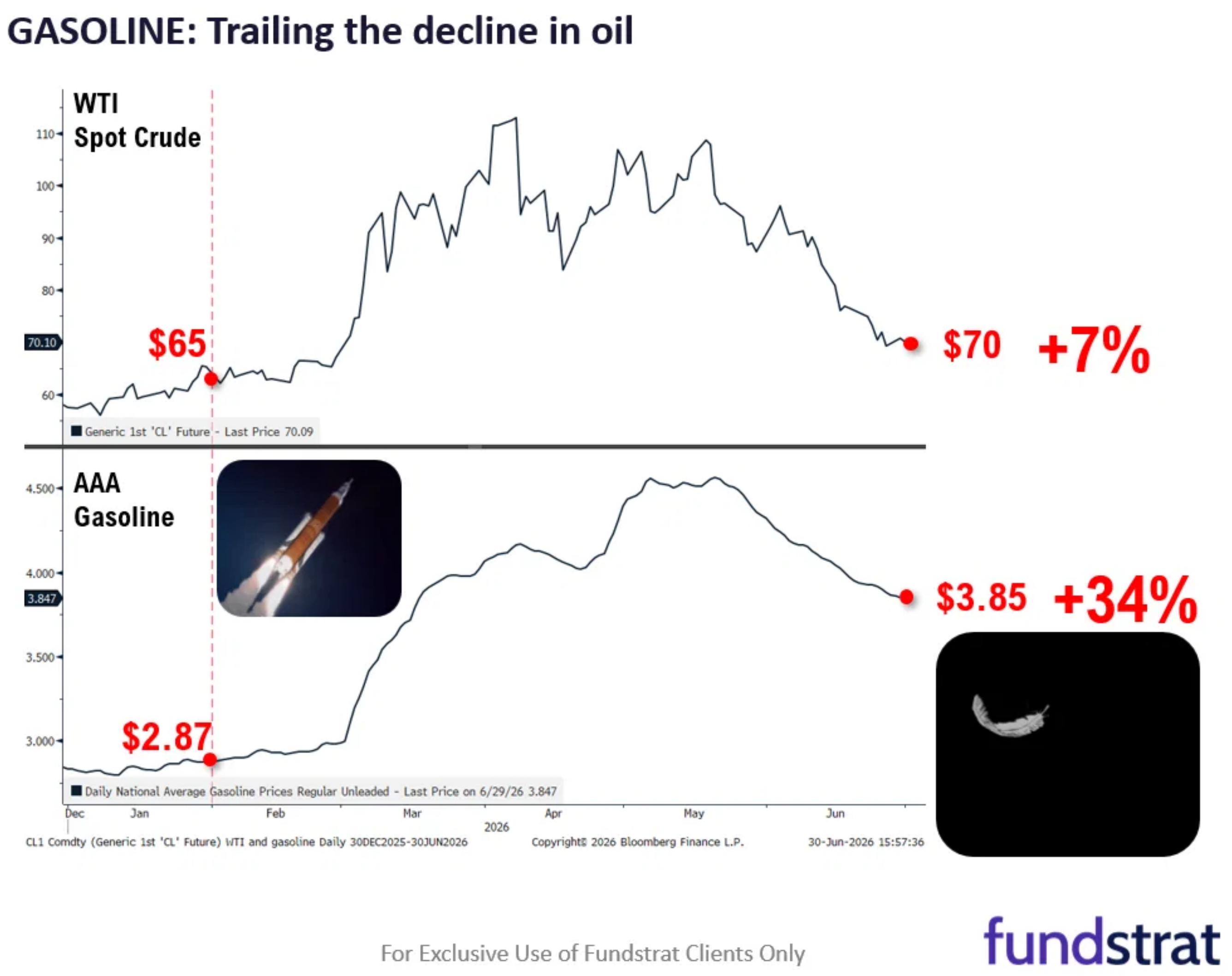
"Success is the sum of small efforts, repeated day-in and day-out." — Robert Collier

Chart of the Day



Good morning!

The smallest of small caps are leading the market’s charge in a sign of how speculation is running rampant.

The Russell Microcap index has gained 25% this year, beating the small-cap benchmark Russell 2000’s gain of 20%, which just posted its best first half of the year since 2001. Both indexes have outpaced the S&P 500’s 9.1% gain and the Nasdaq composite’s 11% advance.

The microcap index posted its best first half of the year relative to the S&P 500 on record, data going back to 2006 show.

Companies in the microcap index include the smallest 1,000 companies in the Russell 2000 and up to the next 1,000 smallest eligible ones from the Russell 3000E. They have a median market value of about $304 million, compared with $1.12 billion for those in the Russell 2000. As one would guess, the smallest of small caps contain a greater number of unprofitable companies than the Russell 2000.

Small-caps rallying is typically seen as a bullish sign for the U.S. economy because a majority of them tend to earn most of their revenue domestically, but that historical relationship has decoupled some in recent years. Their performance instead can be viewed as a sign of froth in the market.

Known for gaining or declining ahead of the broader market, small caps bested returns posted by their larger peers coming out of the Covid-19 pandemic, as the economy emerged from the lockdowns. That victory, however, was short-lasting. In the years following, small-caps lagged behind the tech-heavy large-cap index, thanks to widespread adoption of AI, which included everything from building data centers to memory chips to developing new types of software.

The outsize spending was a big reason why the U.S. economy defied all odds to grow, yet it didn't benefit small caps until late last year. One wouldn't be too far off to suggest that small caps have become trend followers rather than trendsetters.

The gains seen this year in both the microcap index and the Russell 2000 come from mostly companies in the technology sector, benefiting from the same AI wave that has lifted shares of large-cap companies like Micron, Sandisk, and Advanced Micro Devices to monumental heights. (Another sector shared by both the microcap index and the Russell 2000 for their year-to-date outperformance is the healthcare sector.)

There are enough concerns about how the large-cap, profitable players will make money back from the investments they've made into AI, so it becomes tough to view the nascent AI-driven outperformance of unprofitable, small caps as a positive.

The last two times investors piled into small caps didn't pay off. Right after the pandemic, small tech companies, SPACs, and cannabis stocks were all the rage, until they just suddenly weren't. Then in 2022 and 2023, small caps looked like they were about to take off, but it paid much more to be in the Magnificent Seven.

Economic Data Summary: Nonfarm payrolls rose 57,000 in June, well below the 115,000 consensus forecast, making for a sizable miss. For example,the past couple of months have been 148,000 and 129,000. The BLS calls this roughly in line with the 36,000 average pace of the prior 12 months, though the gap is quite bigger. Unemployment held at 4.2%, but overall participation fell 0.3% to 61.5%, which explains the decline in unemployment. In addition to that, the past two months were both revised down by a combined 74,000 jobs.

Wages rose 0.3% in June, which comes out to 3.5% for the year.

This may prove to complicate the overall consensus on interest rates: growth is slowing, but inflation isn't out of the picture to justify a rate cut. The 2-year treasury yield fell after the release, and traders immediately priced in the reduced odds of a hike at the July meeting. — *Kieran McBride*

Share your thoughts

What do you make of the small-cap outperformance? Click here to send us your response.

✍Here's what a reader commented ✍

Q: When do you think Strait of Hormuz ship traffic will return to pre-war levels?

A: If you analyze the primary drivers of the core inflation rate, Financial Services and Housing, as Tom Lee has done, the rate is much less worrisome. Clearly the typical consumer would never point to financial services costs as a big concern. And a very solid argument could be made that the Fed itself is the largest contributor to the cost of housing due to its own policies exacerbating the housing shortage crisis.

Catch up with Fundstrat

As the 2Q comes to an end, equity markets did well, but the market sees a more hawkish Fed. We remain less hawkish than the market and believe truflation being low supports our take. The May increase in NYSE margin debt is the single highest ever and adds to our view that we will see a downturn at some point later this year.

Technical

This week's minor pullback in Semiconductors has not caused the major indices to give way: both $SPX and $QQQ remain within their triangle patterns and the Semis-to-$SPX ratio has not turned lower, so this is a short-term Technology headwind rather than a broader threat.

Crypto

One of the more encouraging developments over the past several sessions has been the continued recovery in STRC. The preferred security has now rebounded from below 72 last Friday to nearly 88, suggesting investors are gradually regaining confidence in Strategy’s balance sheet following Monday’s 8-K.

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Of Interest

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Overnight	
S&P Futures	+34 ▲ point(s) (+0.45% ▲)
overnight range:	-4 ▼ to +46 ▲ point(s)

APAC	
Nikkei	-0.01% ▼
Topix	+0.92% ▲
China SHCOMP	-0.06% ▼
Hang Seng	+1.14% ▲
Korea	-0.46% ▼
Singapore	+0.30% ▲
Australia	-0.15% ▼
India	+0.67% ▲
Taiwan	-0.48% ▼

Europe

Stoxx	50 -0.02% ▼
Stoxx	600 -0.13% ▼
FTSE	100 +0.01% ▲
DAX	+0.26% ▲
CAC	40 +0.27% ▲
Italy	+0.14% ▲
IBEX	-0.68% ▼

FX

Dollar Index (DXY)	+0.21% ▲ to 101.07
EUR/USD	-0.18% ▼ to 1.1416
GBP/USD	-0.10% ▼ to 1.3336
USD/JPY	-0.59% ▼ to 162.29
USD/CNY	-0.20% ▼ to 6.7926
USD/CNH	-0.15% ▼ to 6.7958
USD/CHF	-0.31% ▼ to 0.8058
USD/CAD	-0.20% ▼ to 1.4228
AUD/USD	-0.12% ▼ to 0.6932

UST Term Structure

2Y-3M Spread narrowed	-3.5bps ▼ to 33.6bps
10Y-2Y Spread widened	0.3bps to 34.7bps
30Y-10Y Spread widened	1.1bps to 50.9bps

USD HY OaS

All Sectors	+4.6bps ▲ to 296bps
All Sectors ex-Energy	+1.1bps ▲ 292bps
Cons Disc	-1.4bps ▼ to 437bps
Indu	-0.9bps ▼ to 225bps
Tech	+2.7bps ▲ to 231bps
Comm Srvcs	+0.7bps ▲ to 292bps
Materials	-0.7bps ▼ to 262bps
Energy	+1.5bps ▲ to 275bps
Fin Snr	+0.7bps ▲ to 195bps
Fin Sub	+2.2bps ▲ to 302bps
Cons Staples	+1.7bps ▲ to 462bps
Healthcare	+1.5bps ▲ to 307bps
Utes	+1.4bps ▲ to 208bps *

DATE	TIME	DESCRIPTION	ESTIMATE	LAST
7/6	9:45 AM	Jun F S&P Srvcs PMI	51.3	51.3
7/6	10:00 AM	Jun ISM Srvcs PMI	54	54.5
7/7	8:30 AM	May Trade Balance	-78.5	-55.881
7/7	11:00 AM	Jun NYFed 1yr Inf Exp	n/a	3.46
7/8	2:00 PM	Jun 17 FOMC Minutes	n/a	0
7/9	10:00 AM	Jun Existing Home Sales	4.2	4.17
7/9	10:00 AM	Jun Existing Home Sales m/m	0.85	3.22

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