INTUITION

Learning Insights

ISSUE 6 2024

In this issue:

Can rotation into small caps be sustained?

July saw a dramatic rotation in the US stock market out of all-conquering megacap tech stocks into small caps. While a market rebalancing would be welcome, gathering economic and political uncertainty point to volatility ahead, which is a headwind for riskier small caps.

For the first half of the year, the upward march of technology stocks, driven by the powerful AI narrative, seemed unstoppable, as tech indexes – led by the megacap-heavy Nasdaq 100 – dramatically outperformed others. But around mid-July the tables turned dramatically, with a violent rotation into small caps and cyclical stocks, leading some market commentators to call for a more meaningful market rotation.

To illustrate the scale and speed of the move, the Russell 2000 index of small caps was at one point outperforming the Nasdaq by 14% in July (a decent performance for any year, let alone month).

What, then, is behind this surge in popularity of smaller cap stocks?

Rates, overpriced AI, & the Trump effect

The initial trigger for the rotation was cooler-than-expected US inflation figures for June (published in July), leading the market to anticipate imminent Fed rate cuts, with the consensus now forecasting 25 bps cuts in both September and December. While rate cuts should theoretically benefit most sectors (including tech), small caps are considered more rate-sensitive than tech giants, which are shielded by large perceived moats and compelling secular growth narratives.

Another factor driving the rotation is growing unease about the benefits of AI and concerns that valuations may have run ahead of themselves. The market worries that AI technology may not deliver productivity gains to justify the high levels of investment and the extraordinary share price growth seen in the sector in the first half of the year.

A third factor was the so-called “Trump trade,” as market participants adjusted their positions based on the prospects of a Donald Trump/Republican sweep in the November elections. The premise is that such an outcome would lead to yield curve steepening, tax cuts, efforts to weaken the dollar, a renewed tariff war exerting upward pressure on inflation, and “reshoring” of industry benefiting smaller domestic-focused businesses over global companies like tech giants.

Importantly, the probability of a Trump/Republican victory has diminished following President Biden’s withdrawal and the revitalization of the Democrats’ campaign by their new candidate Kamala Harris. This narrowing gap adds to uncertainty, suggesting more volatility ahead – an environment in which risky small caps may struggle to sustain their recent gains.

Growth prospects & valuations

Any further rotation into small caps will likely require improved earnings growth prospects. While rate cuts and continued disinflation should theoretically help small caps to that end, the consensus has become less sanguine on the global economy for the balance of the year. This could make life difficult for small caps. Some analysts fear a de-risking that would hurt cyclical small caps while benefiting defensive sectors and bonds, both of which have recently performed well following dramatic underperformance over the past couple of years.

Beyond the US election, a longer-term potential tailwind for small caps is valuation, with them trading at one of the steepest discounts to tech on record. Less reliance on tech-related stocks for earnings growth could be positive in a market heavily skewed toward tech in recent years. However, this depends on improved prospects for a range of sectors rather than a sharp decline in the technology sector’s fortunes.

Intuition *Know-How* has a number of tutorials relevant to the content of this article:

- Equity Markets – An Introduction
- Equity Trading – An Introduction
- Equity Valuation – An Introduction
- Equity Indices
- Equity Returns Analysis
- US Equity Market
- Monetary Policy
- Economic Indicators – An Introduction
- Inflation – An Introduction
- AI & Machine Learning (ML) – Primer

Regulators take aim at greenwashing

Greenwashing – a misleading or deceptive marketing practice used by companies and other organizations to portray themselves or their products and services as environmentally friendly or sustainable – has become so ubiquitous in recent times that regulators have been forced to act. The EU's proposed "green claims" directive is the latest initiative designed to clarify the investment regime around sustainability and ESG with the aim of protecting consumers and investors from greenwashing. Once again, however, its progress promises to be somewhat fraught.

The momentum behind environmental, social, and governance (ESG) has slowed dramatically of late. One critical factor has been the absence of reliable, comparable, and verifiable categorization of investment products, preventing consumers from making fully informed decisions.

This lack of clarity undermines the environmental claims of investment product providers. A 2020 EU study found that over half of such claims were vague, misleading, or unfounded. The prevalence and potential impact of such claims worried regulators who are keen to protect consumers and investors alike by ensuring that "sustainable" products and services sold are accurately described.

EU requirements for substantiating "green claims"

As has often been the case with ESG-related regulation, the EU was one of the first jurisdictions to act. Last year, the European Commission proposed a directive on green claims that requires companies to substantiate their voluntary green claims in business-to-consumer practices.

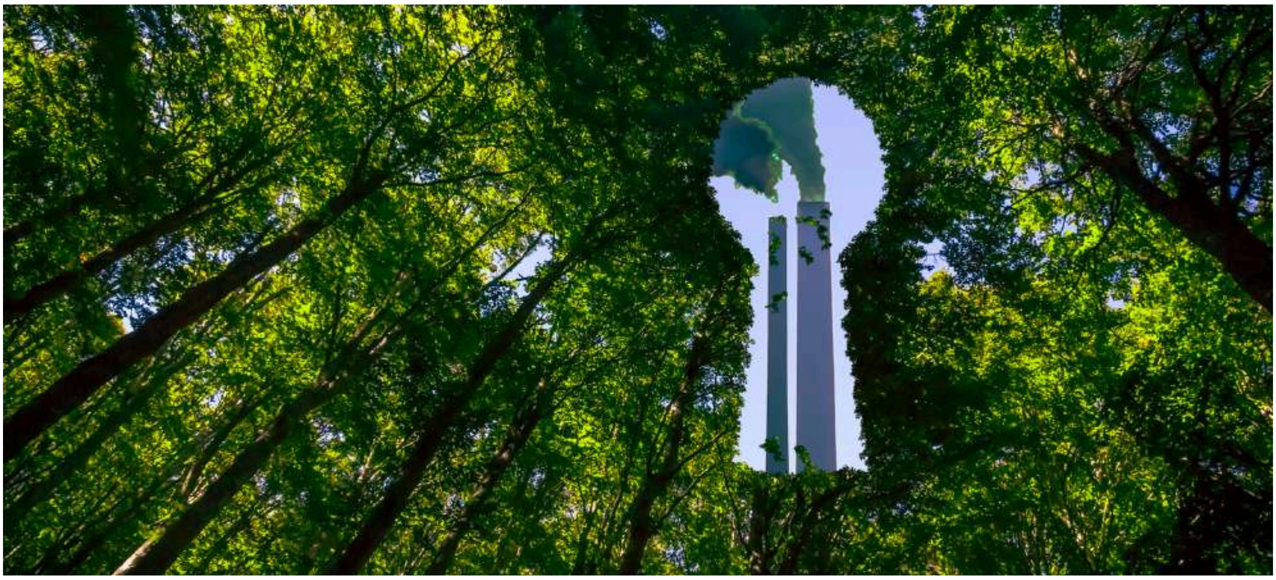
Among the many requirements related to claims, companies must specify if a claim relates to the whole product or just part of it, clarify if it concerns all activities or only some, and base it on widely recognized scientific evidence. They must also take a "lifecycle perspective" that considers the potential environmental impacts of a product over its full lifecycle, as well as ensure that positive achievements do not have harmful impacts on climate change, resource consumption, circularity, pollution, biodiversity, animal welfare, and ecosystems.

Additionally, the directive introduces important requirements in relation to proving climate-related claims, including those involving carbon credits. It obliges companies to report greenhouse gas (GHG) offsets transparently, detailing whether offsets concern emissions reductions or removals and providing information on offset quality.

EU certification & labeling requirements

Companies, processes, or products wishing to certify compliance in the EU with an environmental label must provide transparent information on relevant ownership and decision-making bodies as well as objectives and procedures for monitoring compliance. The directive bans labels that present a rating or score for a product or company based on an aggregated indicator of cumulative environmental impacts unless awarded under environmental labeling schemes set up under EU law.

With the rise of ESG having led to a proliferation of labeling schemes, the directive prohibits the introduction of new publicly owned national or regional environmental labeling schemes (pre-existing schemes may continue if they meet the directive's requirements). For labels from third-country schemes, awarding must be approved by the European Commission.



Concerns over green claims directive

The European Council has adopted its first formal position ("general approach") on the proposed directive – and it has been greeted with some dismay by environmental NGOs. These groups are particularly concerned that the Council has watered down the European Parliament's proposals to restrict how companies use carbon offsets to claim carbon neutrality. Critics argue that the revisions would allow companies to maintain or even increase emissions by purchasing offsets rather than making measurable reductions. Other objections focus on excessive self-assessment and reduced disclosure of evidence for green declarations.

The Council's general approach will form the basis for negotiations with the European Parliament on the final shape of the directive.

FCA's anti-greenwashing rule

Apart from the EU's efforts, the UK's Financial Conduct Authority (FCA) has also introduced an anti-greenwashing rule (effective since end-May). The rule is part of a package of measures on Sustainability Disclosure Requirements (SDR) and investment labels. It applies to financial products and services that FCA-authorized firms make available to UK clients, requiring such firms to ensure that "any reference to the sustainability characteristics of a product or service is consistent with the sustainability characteristics of the product or service, and is fair, clear and not misleading."

The sustainability references are expected to be:

- Correct and capable of being substantiated – products and services should do what they say they do, with appropriate evidence to support any claims.
- Clear and presented in a way that can be understood – claims should be transparent and straightforward, with consideration given to whether all the terms used would be understood by the intended audience and also to any images, logos, and colors used.
- Complete – important information should not be omitted or hidden, and the full lifecycle of the product or service should be considered.

The anti-greenwashing rule is important as it gives the FCA an explicit regulatory framework to challenge firms if the regulator suspects they are making misleading sustainability claims about their products or services.

Conclusion

Greenwashing can have many consequences – misleading consumers and investors, undermining customer trust, and damaging the broader sustainability movement, to mention but a few. The EU's Green Claims Directive and the FCA's anti-greenwashing rule represent important steps toward greater transparency and accountability in the sustainability/ESG investment space.

Intuition *Know-How* has a number of tutorials relevant to the content of this article:

- Sustainability & Sustainable Development
- Greenwashing
- Net Zero
- ESG – Primer
- ESG – An Introduction
- ESG Factors
- Sustainable & Responsible Investing – An Introduction
- Sustainable & Responsible Investing – Strategies
- ESG Data & Ratings – An Introduction
- ESG Data & Ratings – Reporting Frameworks
- Commodities – Emissions