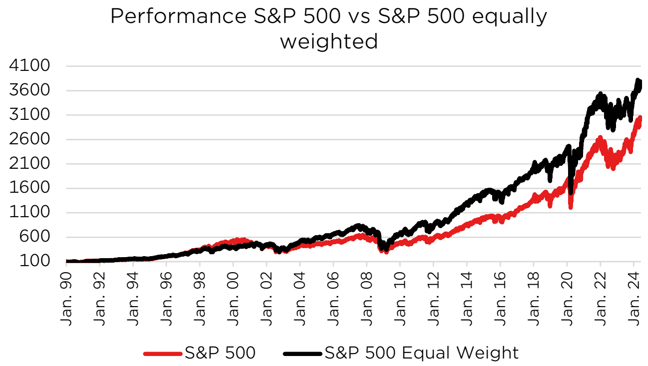
7 June 2024

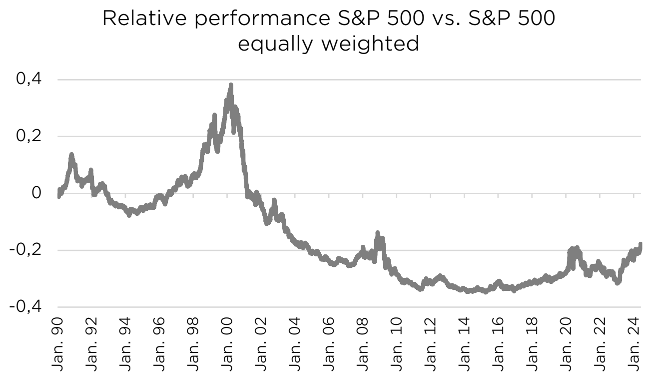
Interest rate cuts in sight: Performance booster for small caps?

Yesterday was a historic day - for the first time in its history, the European Central Bank is heralding an interest rate cut cycle before the US Federal Reserve. In the past, this was different because the US economic cycle generally ran ahead of the European economic cycle and US monetary policy therefore set the tone due to fundamental correlations. The whole situation is currently a little more complex. The interest rate cut in Europe and the interest rate cut expected in the USA during the second half of the year are not primarily the result of recessionary tendencies, but are linked to falling inflation rates. The previous interest rate hikes were also less due to good economic data than to massively rising inflation rates, often as a late consequence of the coronavirus pandemic. Now, one could argue for a long time about whether such a sharp rise in key interest rates in such a short time was necessary at all, as many of the reasons behind the rise in inflation were more exogenous in nature and could not be adequately countered by high key interest rates. On the other hand, there were (and still are) justified concerns about second-round effects, which can certainly be mitigated by higher key interest rates. It is also often argued that the ECB's monetary policy was perhaps even a little too restrictive for the Eurozone, meaning that countermeasures are more than appropriate. This argument is also supported by the development of the M1 monetary aggregate, which has recently declined massively in Europe, while a sideways movement has been observed in the US. While the ECB has now taken the first step towards a cycle of interest rate cuts, this is likely to take a few more months in the USA. Inflation rates in the US have not fallen quite as sharply as many had hoped, and the Fed may not see any incentive to intervene indirectly and unintentionally in the election campaign through its actions before the election. In December, however, there is a good chance that the US Federal Reserve will also start to cut interest rates, especially as the US economy has recently stuttered a little - in any case, there can be no talk of an exuberant economy. Purchasing managers' indices, consumer confidence, retail sales and US exports, as well as the Philadelphia Fed Index and US building permits, have recently pointed more towards the south and would support an imminent interest rate cut. If interest rate cuts are now also introduced in the USA and a global cycle of interest rate cuts gets underway, it could be argued that this could be an important performance driver for smaller companies in particular. This is because in the last two years, very large companies in particular, with their huge cash positions, have benefited from the high interest rates, while many smaller companies, which rely more heavily on debt financing, have suffered more from the high interest rates. Interest rates for corporate bonds and bank loans have risen significantly over the past two years, which has made the refinancing costs of smaller companies more expensive than average compared to large caps.

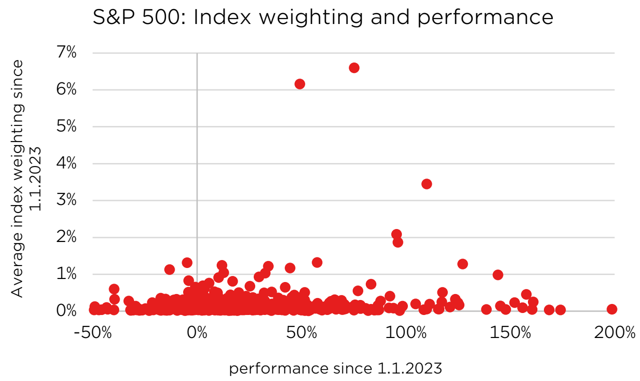
And so it is perhaps no wonder that many large companies have performed dramatically better than small companies over a longer period of time during the current high-interest phase. This was particularly noticeable in the USA. Since the beginning of 2023, the market capitalization-weighted S&P 500 has outperformed the equally weighted S&P 500 by a significant 42 percent. This year, the outperformance of many very large stocks has continued seamlessly; the performance of the "normal" S&P 500 has been more than twice as strong as that of the equally weighted index (13 percent vs. 5 percent).

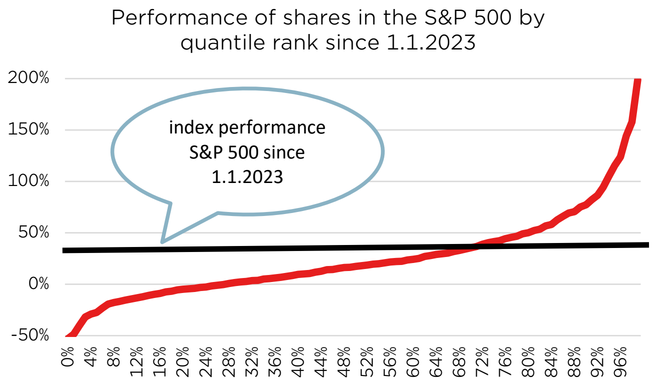
In the long term, this is an atypical development. In the following charts, we have compared the market capitalization-weighted version of the S&P 500 with the equally weighted version. Here you can see that, at least in the period from 2000 to 2016, small caps performed significantly better over the trend. Since 2023, however, there has been a clear reversal, although it is fair to say that large-cap stocks performed dramatically better in relative terms in the period from 1994 to 2000.

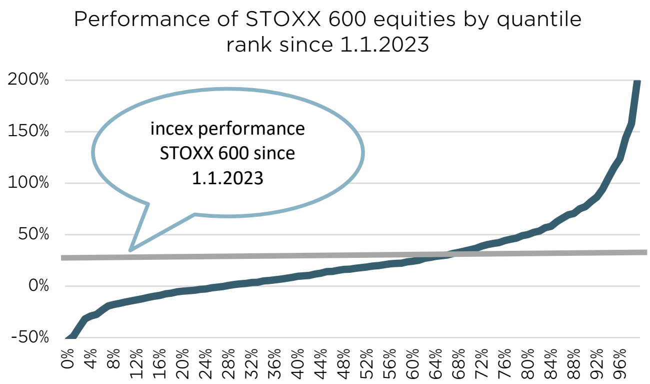




What is therefore characteristic of the current situation is not so much the duration or the extent of the outperformance of large stocks, but the fact that the performance of large indices is ultimately characterized by extremely few stocks. It can be seen here that all stocks with a weighting of two percent or more in the index have actually performed significantly better than the vast majority of stocks since the beginning of 2023 (the median of all stocks here is 17 percent, but the large stocks are over 50 percent). The situation is also illustrated by translating the entire range of performance for the 500 stocks in the S&P 500 since the beginning of 2023 into quantile ranks and comparing this with the index performance. Here it can be seen that only around 25 percent of stocks have outperformed the index - a result that can only be explained by the extreme performance of large stocks. In principle, the same situation can be seen in Europe.







However, a turnaround in interest rates could now be the trigger for this trend to reverse and the current anomaly to disappear. This is because smaller companies, which often have a higher proportion of external capital financing, react more sensitively to interest rates. If the economy picks up again over the next few quarters, this could be the starting signal for a considerable rally in smaller companies, which are usually also more sensitive to the economy.

Dr. Christian Jasperneite

Market data

Stock marktes	As of 07.06.2024 09:47	Change versus 31.05.2024 -1 week	06.05.2024 -1 month	06.03.2024 -3 months	06.06.2023 -1 year	29.12.2023 YTD
Dow Jones	38886	0,5%	0,1%	0,6%	15,8%	3,2%
S&P 500	5366	1,7%	3,6%	5,1%	25,3%	12,5%
Nasdaq	17173	2,6%	5,0%	7,1%	29,4%	14,4%
DAX	18582	0,5%	2,2%	4,9%	16,2%	10,9%
MDAX	26945	0,9%	1,4%	3,0%	-0,6%	-0,7%
TecDAX	3448	3,4%	4,8%	0,0%	6,9%	3,3%
EuroStoxx 50	5067	1,7%	2,2%	3,1%	18,0%	12,1%
Stoxx 50	4576	1,9%	4,0%	6,0%	14,5%	11,8%
SMI (Swiss Market Index)	12227	1,9%	7,9%	5,9%	6,6%	9,8%
Nikkei 225	38684	0,5%	1,2%	-3,5%	19,0%	15,6%
Brasilien BOVESPA	122899	0,7%	-4,3%	-4,6%	7,2%	-8,4%
Russland RTS	1135	0,9%	-4,3%	-1,4%	9,4%	4,8%
Indien BSE 30	76407	3,3%	3,4%	3,1%	21,7%	5,8%
China CSI 300	3574	-0,2%	-2,3%	0,6%	-6,1%	4,2%
MSCI Welt	3490	1,3%	2,9%	4,0%	21,3%	10,1%
MSCI Emerging Markets	1073	2,3%	0,6%	4,4%	8,6%	4,8%
Bond markets						
Bund-Future	130,98	164	-26	-250	-382	-624
Bobl-Future	115,78	-16	-129	-68	-167	-350
Schatz-Future	105,34	37	1	17	3	-121
3 Monats Euribor	3,75	-14	-16	-15	28	-13
3M Euribor Future, Dec 2024	3,36	-3	14	36	38	106
3 Monats $ Libor	5,60	-1	1	1	9	1
Fed Funds Future, Dec 2024	4,96	-10	0	39	141	112
10 year US Treasuries	4,30	-20	-19	16	61	43
10 year Bunds	2,56	-7	10	25	19	56
10 year JGB	0,98	-8	8	27	55	36
10 year Swiss Government	0,84	-6	13	10	-6	14
US Treas 10Y Performance	591,13	1,6%	1,9%	-0,4%	-1,1%	-1,6%
Bund 10Y Performance	548,35	0,9%	-0,3%	-1,1%	1,2%	-3,0%
REX Performance Index	440,93	0,9%	-0,1%	-0,2%	0,9%	-1,5%
IBOXX AA, €	3,48	-7	9	12	-15	41
IBOXX BBB, €	4,03	-7	5	5	-52	28
ML US High Yield	8,04	-14	0	13	-63	24
Commodities						
MG Base Metal Index	446,23	-2,3%	1,7%	16,1%	17,1%	14,2%
Crude oil Brent	79,87	-2,4%	-4,3%	-5,0%	4,7%	2,8%
Gold	2372,86	1,8%	2,1%	10,6%	21,1%	14,9%
Silver	31,17	2,8%	13,8%	28,7%	32,2%	28,5%
Aluminium	2594,50	-0,5%	3,3%	18,4%	19,8%	10,6%
Copper	10036,51	1,2%	2,5%	18,3%	20,4%	18,6%
Iron ore	108,50	-7,7%	-9,3%	-7,2%	-0,1%	-20,4%
Freight rates Baltic Dry Index	1869	3,0%	-0,4%	-14,1%	84,0%	-10,7%
Currencies						
EUR/ USD	1,0893	0,4%	1,1%	0,2%	2,0%	-1,4%
EUR/ GBP	0,8509	-0,2%	-0,7%	-0,6%	-1,2%	-1,8%
EUR/ JPY	169,19	-0,8%	2,1%	4,0%	13,5%	8,2%
EUR/ CHF	0,9684	-1,4%	-0,7%	0,7%	-0,1%	4,6%
USD/ CNY	7,2427	0,0%	0,5%	0,6%	1,7%	2,0%
USD/ JPY	155,62	-1,1%	1,1%	4,2%	11,4%	10,3%
USD/ GBP	0,78	-0,5%	-1,7%	-0,4%	-3,0%	-0,4%

Source: Refinitiv Datastream

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