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There Is A Great Gulf Fixed

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At my school there was an annual essay competition to which it was mandatory to submit an entry. We were given the title (as above) and free rein to express our views. I had no idea at the time that the “great gulf fixed” was a biblical reference and wrote something about the conflict between Formula 1 drivers who were having to race in dangerous conditions, and the managers of the sport who were more interested in making money. Not bad, I thought, for a fifteen-year-old. I didn’t win. But it was reasonably prescient, as seen in many of the safety measures now in place to protect drivers, even if it often required tragic incidents to trigger the changes.

Were I given the same essay topic today, I would no doubt choose to write something investment related. The greatest gulf today could be the performance gap between the much vaunted “Magnificent Seven” US companies and most of the rest. One way of looking at this is through the lens of the S&P 500 market capitalisation-weighted index (SPX) and its equal-weighted equivalent (SPW). Those seven companies (Apple, Microsoft, Amazon, Alphabet, Nvidia, Tesla and Meta) currently account for around a quarter of the SPX but would only add up to 1.4% of the SPW, where stock number 500 carries the same weight as the first in the SPX. In this case Alaska Air ($4 billion) is as important as Apple ($2.66 trillion).

So far this year, there is a 13 percentage point (pp) performance gap in favour of the SPX over the SPW. This is the largest gap ever recorded and has made it very difficult for active fund mangers to perform in line with equity benchmarks, mainly because most of them have limits on how much they can hold in a single stock. The last time that the gap was anywhere near this big in favour of SPX was in 1998 when it was 11pp. We were in the foothills of a Tech Boom then, spurred on by rate cuts in the final quarter, but there was also a strong desire to hold big global brand name companies. All of those relative gains were given back and more during the ensuing Tech Bust and recession from 2000 to 2003.

Investing in larger companies didn’t deliver any great safe haven benefits during the financial crisis either, largely owing to the fact that financial companies were amongst the heavyweights. Bigger companies also turned out to be an easier source of liquidity when needed. Furthermore, Tech was still deemed to be a risky cyclical sector, having not acquired the platform status that has turned some of its constituents into seemingly safer investment propositions (although I would argue that there is no company on earth that is entirely recession-proof).

In 2009, the SPX underperformed the SPW by a massive 18pp. This was in the immediate recovery from the financial crisis when companies that had been on the brink of possible extinction rallied back to life. This trend followed through into 2010 with another 5pp of underperformance.

The next decade was relatively dull in terms of relative performance, and it was only during Covid that we saw another big gap opening up when SPX outperformed SPW by 8pp. This reflected the defensive nature of mega-cap Tech during the lockdowns as well as the valuation boost delivered by aggressively loose monetary policy.

And this year? If you had told everyone where real bond yields were going to end up by now, having risen by around 100 basis points, then the majority would have told you that the longer-duration “Magnificent Seven” would struggle to perform. So much for that expectation. The frenzy around Artificial Intelligence (AI), especially, has helped to turbo-charge performance in stocks that have continued to display decent underlying momentum. The continuing flow of money into index funds has also been a tailwind.

But some cracks have started to appear during the current third-quarter results season. Alphabet (parent of Google), Meta (Facebook as was) and Tesla have all fallen back. Microsoft and Amazon fared better. Apple reports later this week. Nvidia is a month later in its reporting cycle.

Can these shares continue to dominate markets in the future? History suggests not. Looking back at the Top 10 biggest stocks in the world over recent decades, 1980 was dominated by Oil companies (6/10); 1990 by Japanese banks (6/10); 2000 by Tech and Telecom stocks (7/10); 2010 by resource companies (5/10) on the back of China’s boom; and 2020 again by Tech (all the Top 7).

Only one company made it into the Top 10 all of those decades, and that was Exxon (which added the Mobil element in 1999. It is still acquiring assets and agreed to buy Pioneer Natural Resources a few weeks ago for around $60bn). That's a red rag to an ESG investor bull if there ever was one. More recently it is Microsoft that has shown the greatest resilience and it's not a stock we would want to bet against given its track record, embedded strengths and AI exposure.

But markets are cyclical by nature. If a small group of large companies is showing the rest of the market a clean pair of heels, then there is a large group of small companies that are under the cosh. The Russell 2000 Index of smaller US companies has effectively gone nowhere in absolute terms in the five and a half years since it reached its current level for the first time. It has given up all the gains it made from its relative trough against the S&P 500 at the peak of the Tech boom in 2000. Here in the UK, the daily email I receive detailing notable share price movements is littered with small cap investment trusts hitting new 52-week lows. Not only are the underlying share prices of the constituents of the funds going down, but discounts to net asset value continue to widen.

Somewhere in this relative performance gap lies opportunity, although not necessarily today. Smaller companies are more at risk from the economic cycle. They tend to have to pay a lot more for their debt than larger companies, and that's unhelpful in a rising interest rate environment. And funds to borrow might not be so easy to access if banks continue to rein in their appetite for lending.

The last specific catalyst for small cap outperformance was "Vaccine Day" in 2020. That was a rare specific catalyst and there is nothing so identifiable today. It is more probable that it will be a change in central bank monetary policy towards loosening that finally changes the mood. That will require at least one of the following things to happen: a meaningful and persistent inflation undershoot; a sharp rise in unemployment and associated economic weakness; or some sort of financial accident.

Until that happens, central banks are likely to keep up the "hair shirt" appearance because the last thing they want is another bout of financial market speculation driving animal spirits into overdrive. But when they do decide to change tack, the speed and scale of interest rate cuts could be as surprising on the way down as it was on the way up.

Another question is what happens to the yield curve because that will also define relative performance. It is quite possible, even probable, that short rates will fall faster than long rates. It would be unusual for the yield curve to become more inverted at that point in the cycle. And markets also have to soak up the growing supply of government bonds to finance still large fiscal deficits and rising interest bills. That "bull steepening" should favour the small caps over their larger brethren.

And as for the conclusion to today's essay? Maybe that gulf is not as fixed as it sometimes appears to be.

Economic Commentary

FTSE 100 weekly winners

Rio Tinto plc	5.5%
Croda International Plc	5.0%
DS Smith Plc	4.7%
Severn Trent Plc	4.3%
BHP Group Ltd	4.1%
Taylor Wimpey plc	4.0%
Barratt Developments PLC	3.8%

FTSE 100 weekly losers

NatWest Group Plc	-16.7%
Standard Chartered PLC	-15.5%
Barclays PLC	-10.8%
Experian PLC	-9.5%
Rentokil Initial plc	-9.3%
Reckitt Benckiser Group plc	-8.2%
Just Eat Takeaway.com N.V.	-7.2%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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