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Equity Market Rotation & the Debt Wall: What Investors Should Know

The narrow equity market experienced over the past few years is increasing the risk profile for investors who remain complacent with their allocation. The S&P 500 Index's performance now depends largely on how just a few of its components perform. Many investors in passive indexes like the S&P 500 may not realize the additional risk this concentration brings.

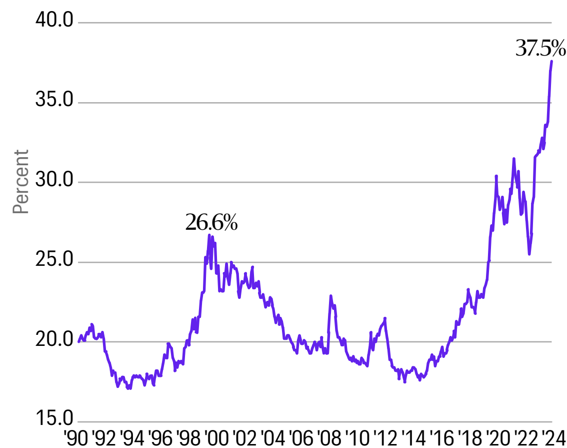
In addition to managing the above risk, a large "wall" of debt that companies carry is set to mature from 2025–2029—and it will require renewal at rates much higher than when the original debt was incurred. This situation will be problematic for weaker companies that lack the cash flow to manage the higher interest rates lying ahead for them. If they can't afford the debt, they'll suffer the consequences—and in turn, so will the companies' investors.

What should investors know about these two concerns for planning ahead?

Significant market concentration could lead to a value rotation

The combined weight of the 10 highest-weighted companies in the S&P 500 Index has reached a historically high level. Because of this, investors in passive strategies that mirror the S&P 500 are now overexposed to a narrow handful of stocks. The situation has also created significant sector and factor concentration.

TOP 10% AS A % WEIGHTING OF S&P 500



Sources: Strategas and Bloomberg Finance LP; data as of 13-Jun-24

While market history doesn't dictate future patterns, it does provide investors with opportunities to take note ("What's being priced in?"), question the status quo, and consider if they're being paid to shift capital to minimize risk and optimize reward. Today's concentration situation strikes us as one of these opportunities.

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How did we get to this elevated concentration level?

By studying previous periods when concentrations were historically high, we've determined that investors tend to coalesce around investment themes based on their prevailing sentiment at the time. Along the sentiment "spectrum," the two most extreme sentiments we've identified—at opposite ends of the spectrum—are *fear* and *exuberance*. When either of these emotions becomes investors' prevailing sentiment, an extremely concentrated market environment can result.

For example, when investors are fearful due to the lack of broad-based economic growth, they tend to seek relative certainty in the biggest businesses that have visible cash flows and reliable growth opportunities. On the other hand, when investors are exuberant, it's generally around a theme. We believe that right now we're experiencing the rare situation of having *both* fear and exuberance underway at the same time—which is exacerbating the magnitude, duration, and risk of this latest market-concentration episode.

Many investors fear that the Federal Reserve (Fed) has waited too long to lower interest rates and we could be on the precipice of slowing growth and rising unemployment. The artificial intelligence (AI) theme, however, has generated significant exuberance, driving higher share prices for the early winners in the AI race.

So what happens from here?

We reviewed market history to learn what happened in previous 12-month periods immediately following times when the S&P 500 crossed the 25% concentration threshold. Since January 1, 2000, there have been 11 occurrences. The methodology we used involved taking a weekly measure of the change in the combined weight of the S&P 500's top 10 holdings. When the combined weight moved from under 25% to over 25% in one week, an "event" was triggered, and we began the clock to measure the 12-month return going forward from that point.

The table below shows that value stocks significantly outperformed growth stocks across all market caps, and the size of the outperformance increased as investors moved down in market capitalization.

As we all know, fear and exuberance aren't permanent, so when one of them (or in today's case, maybe both) fades, the market rotates.

When fear is resolved—which may happen following a Fed rate cut or signs that consumer spending will hold up—investors could shift capital into more cyclical areas of the economy that populate the value indexes.

In contrast, exuberance could fade as the second derivative (the growth rate of the growth rate) slows down, causing investors to question the sustainability of elevated valuations. This in turn can often cause capital to flow out of the overall market (and thus out of the biggest names in the S&P 500) or rotate to a corner of the market where valuations are less demanding.

The exhaustion of the fear and/or greed that has driven this market will trigger a rotation into traditional value stocks, with the greatest rewards being found lower in market capitalization.

HISTORICAL INDEX RESULTS SINCE 2000 FOLLOWING PERIODS WHEN S&P 500 TOP-10 CONCENTRATION >25%

INDEX	PERCENTAGE OF TIMES OUTPERFORMING (%)	MEDIAN RETURN DIFFERENTIAL (%)	AVERAGE RETURN DIFFERENTIAL (%)
Russell 1000 Value vs. Russell 1000 Growth	54.50	11.60	10.62
Russell Midcap Value vs. Russell Midcap Growth	81.80	17.63	23.90
Russell 2000 Value vs. Russell 2000 Growth	81.80	25.35	29.11

For Illustrative purposes only. Sources: Allspring research via Maestro, FactSet, and Bloomberg Finance LP

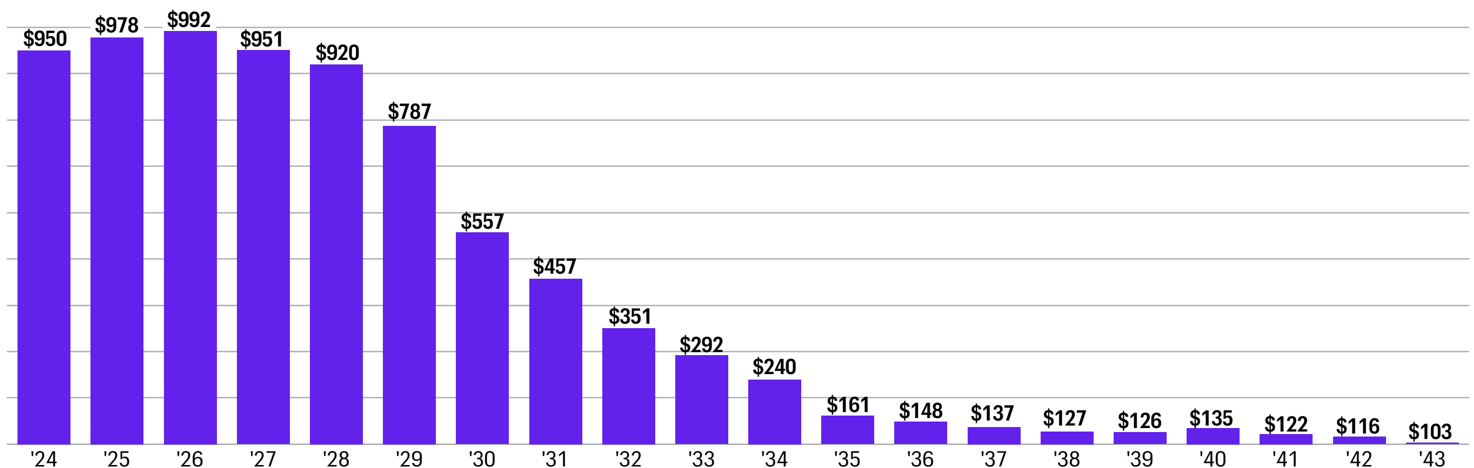
The debt wall's drive to active management

Throughout the 2010s and early 2020s, businesses took advantage of a remarkably low interest rate environment by issuing low-cost debt that funded investments, acquisitions, dividends, and share buybacks. We're all aware, however, that the interest rate landscape has changed markedly since March 2022, when the Fed began hiking rates up to its current target range of 5.25%–5.50%.

Fed members have provided many reasons for why their actions are long and variable, but a significant one that's not commonly mentioned is the maturing of low-cost debt from the prior period.

The chart below shows the maturity profiles of corporate debt due for companies over $250 million in market cap (excluding spread financials). There's a bolus of debt maturing in 2025–2029.

CORPORATE DEBT MATURITY DISTRIBUTION
($ BILLIONS, EXCLUDING SPREAD FINANCIALS)



Sources: Wolfe Research and Bloomberg Finance LP; data as of 15-Jun-24

As that debt comes due, companies will have to either pay it off or roll it into new, likely higher-cost debt. The higher interest expense burden will consume money that was otherwise available for the economic and market catalysts of capital investment, acquisitions, dividends, and stock buybacks. But there are broader and perhaps more significant implications to consider.

One perspective on the Fed's role is that it exists to support the weakest link. By cutting interest rates, the Fed can provide low-cost funding to the businesses that need it the most. This stimulates investments that create job growth, putting cash in the lowest-income consumer's pocket (a cohort that also has the highest propensity to spend a cash influx) and, in turn, drives economic demand for businesses that lack a competitively advantaged product or service to sell in the down phase of an economic cycle. Why does this matter?

If the Fed intentionally supports weak businesses, it's artificially reducing the competitive advantage of the best businesses. Without the Fed's generosity, the weakest businesses would lack access to cheap capital and could be forced to underinvest in research and development or capital expenditures—both of which are engines for cash flow stability and future growth.

Weak businesses could also be forced to slash dividends to fund their higher interest expense. Over many of the past 15 years, this "support system" muted the comparative gains that stronger companies should have been making versus weaker companies.

Most active managers strive to own the best businesses and actively avoid the weaker ones. As it turns out, weak businesses are predominantly found in passive indexes. As a result, passive indexes have had more than a decade of a tailwind relative to active managers, and this might be part of the reason why a number of active managers lagged their benchmarks during that period.

Now that the Fed has normalized interest rates, the artificial support system is gone and the stronger companies should be able to demonstrate their advantages by accelerating the gaps in revenue growth, margin expansion, and shareholder returns relative to their weaker counterparts. This could drive a wider valuation gap between the two groups, thus allowing active management to once again flex the muscle of stock selection to drive relative outperformance.

For further information

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