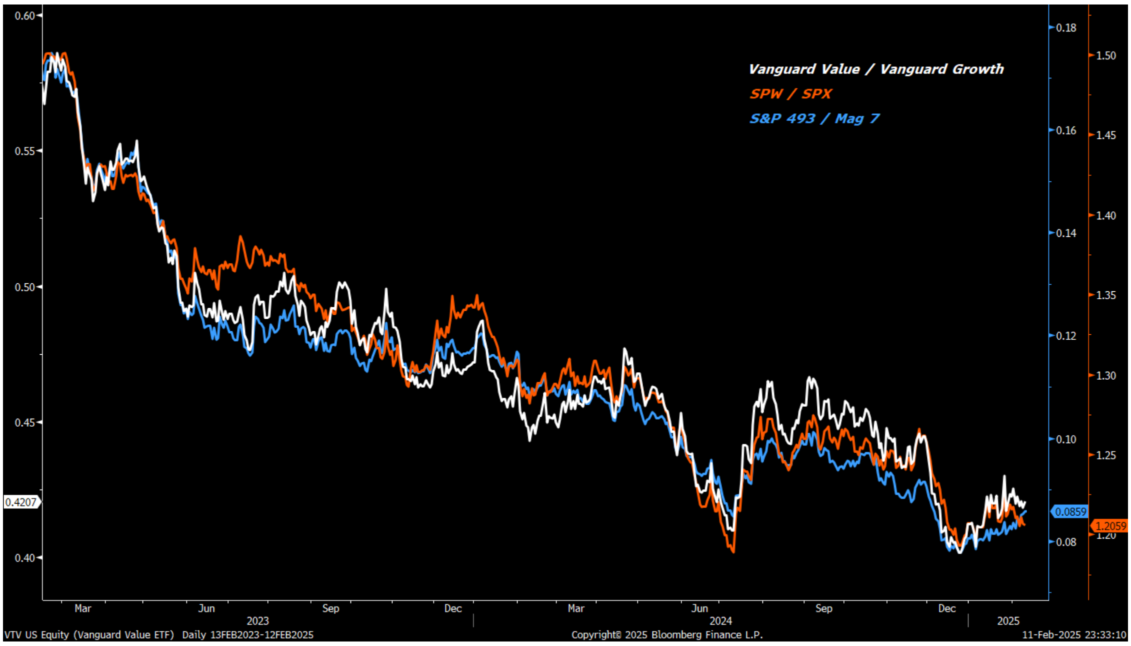
12th February 2025

Summary

This year, a major market shift has been the rotation under the surface of the headline indices:

- Value has outperformed Growth
- Equal-weighted S&P 500 has outperformed market-cap weighted
- The S&P 493 has outperformed the Magnificent 7

These rotations have rebounded from multi-year lows – but they are one in the same. This begs the question - can this broadening market trend be sustained? Further, what macro factors need to align? **Bottom-line, real rates remain the key risk for the broader market outside of the defensive megacap growth stocks**



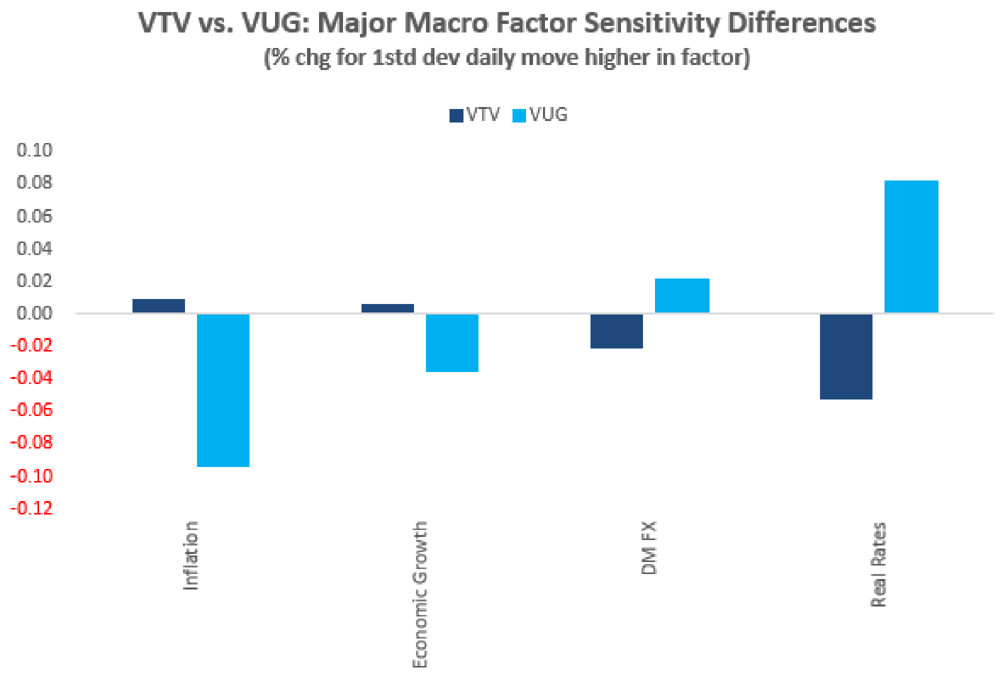
<u>Details</u>

1. Qi's Risk Model – Today, Value vs. Growth Have Divergent Needs:

The revelation from Qi's Risk Model is that Value and Growth have distinct and divergent needs. In turn, this has ramifications for the hope of higher market breadth i.e. SPW vs. SPX and 493 vs. Mag 7:

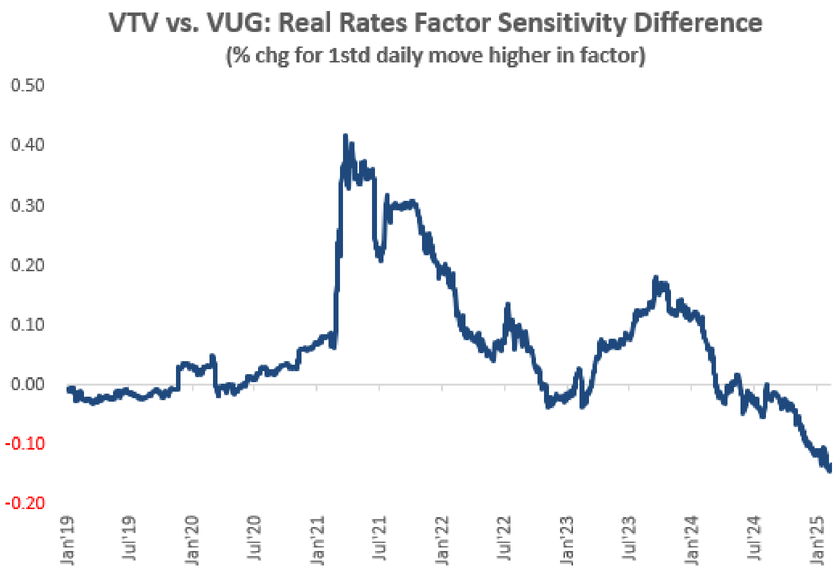
Value wants a Goldilocks environment: A weaker dollar, lower real rates, and higher nominal GDP growth.

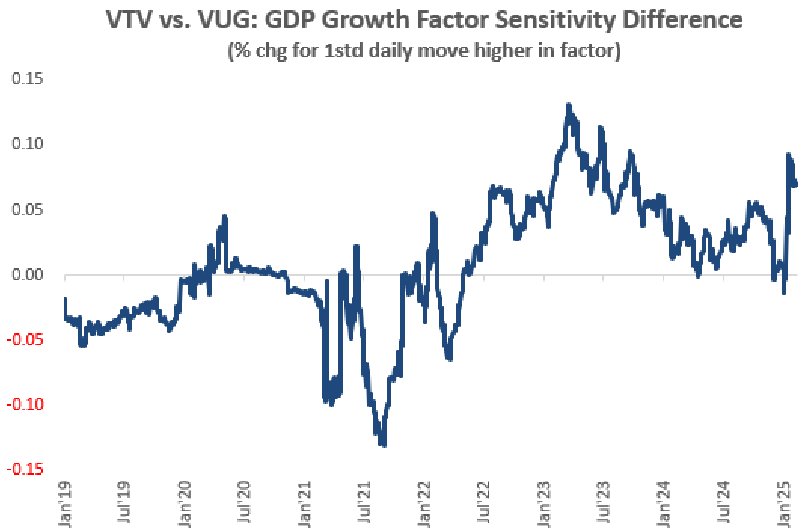
Growth has no issue with tighter FCIs: It wants a stronger dollar, higher real rates, and lower nominal GDP growth. As we confirm below, the hypothesis is that this is driven by a thematic bet on the secular AI narrative, which counterbalances the traditional macro risks like tighter FCIs / lower growth.



This is a break from past norms: Over the last decade, higher real rates implied higher economic confidence allowing respite for Value; while tighter FCIs hurt Growth by raising the cost of capital. Today, those reaction functions are different.

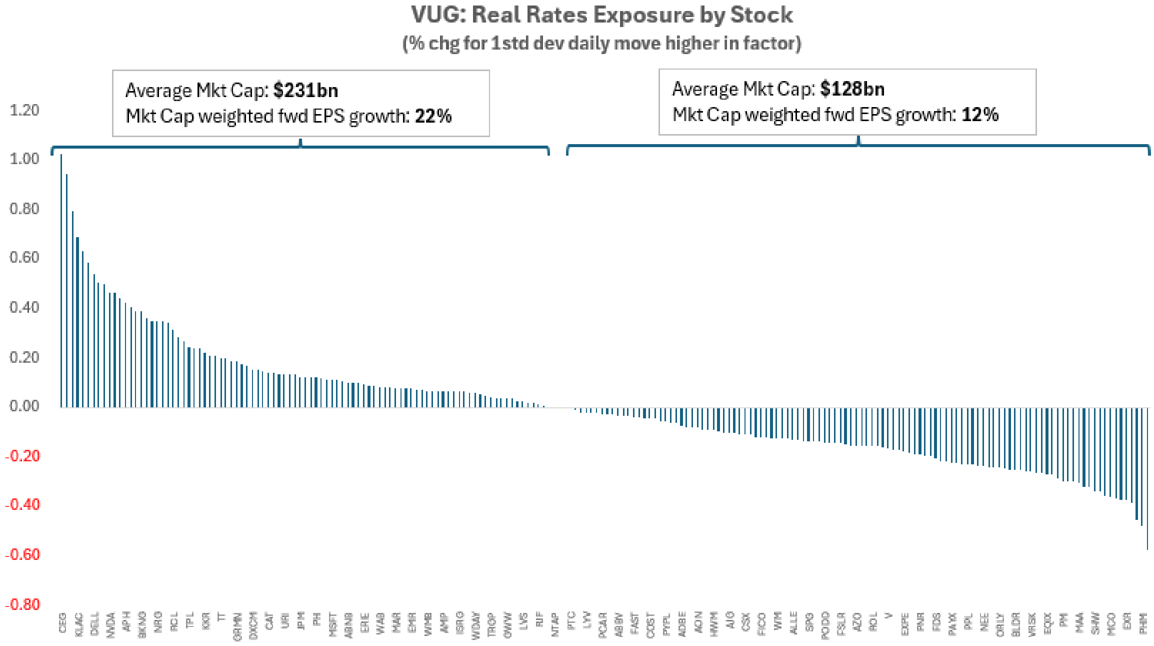
Further, the size of these differences are stark relative to recent history: The negative sensitivity of Value / Growth to real rates is at 5yr lows; the positive sensitivity to economic growth is close to 5yr highs:





2. Digging deeper – MegaCap Tech is the source of Growth's positive real rates sensitivity

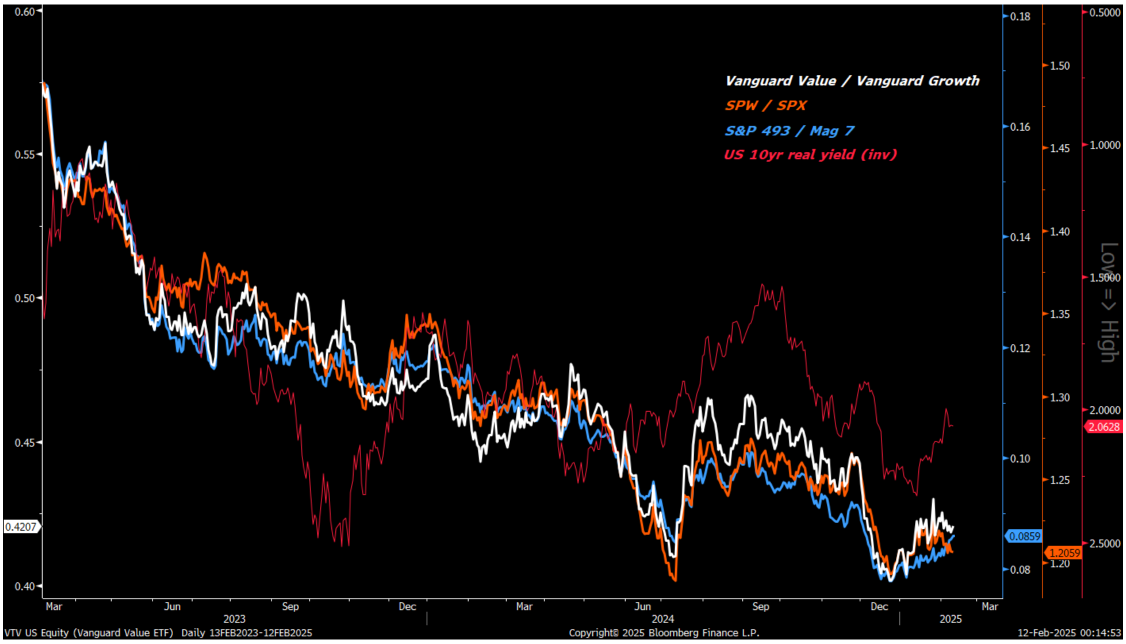
Both the average market cap and forward earnings growth for growth stocks with a positive real rates sensitivity is ~80% higher compared to those with a negative sensitivity. As you can see below, MegaCap Tech's defensive qualities is not representative of the entire Growth universe.

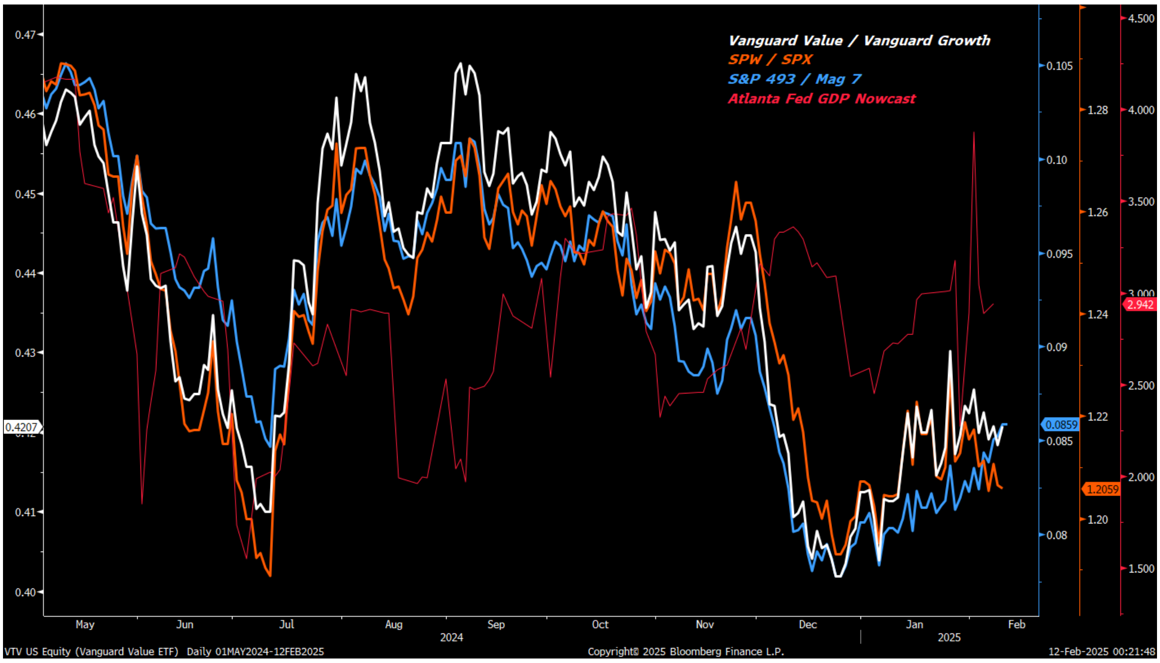


3. Why this matters?

Real rates remain a key risk: The bottom line is that the broader market, outside of the mega cap Growth stocks, still remains highly sensitive to real rates and a Goldilocks outcome.

To empirically make this point, below we show the same chart of the 3 rotations but vs. 10yr real yields (inverted) and vs. the Atlanta Fed GDP Nowcast.





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