August 2024 Stock Market Outlook: Small-Cap and Value Stocks Shine

Investor takeaways ahead of easing monetary policy and slowing growth.

David Sekera, CFA • Aug 2, 2024

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Key Takeaways:

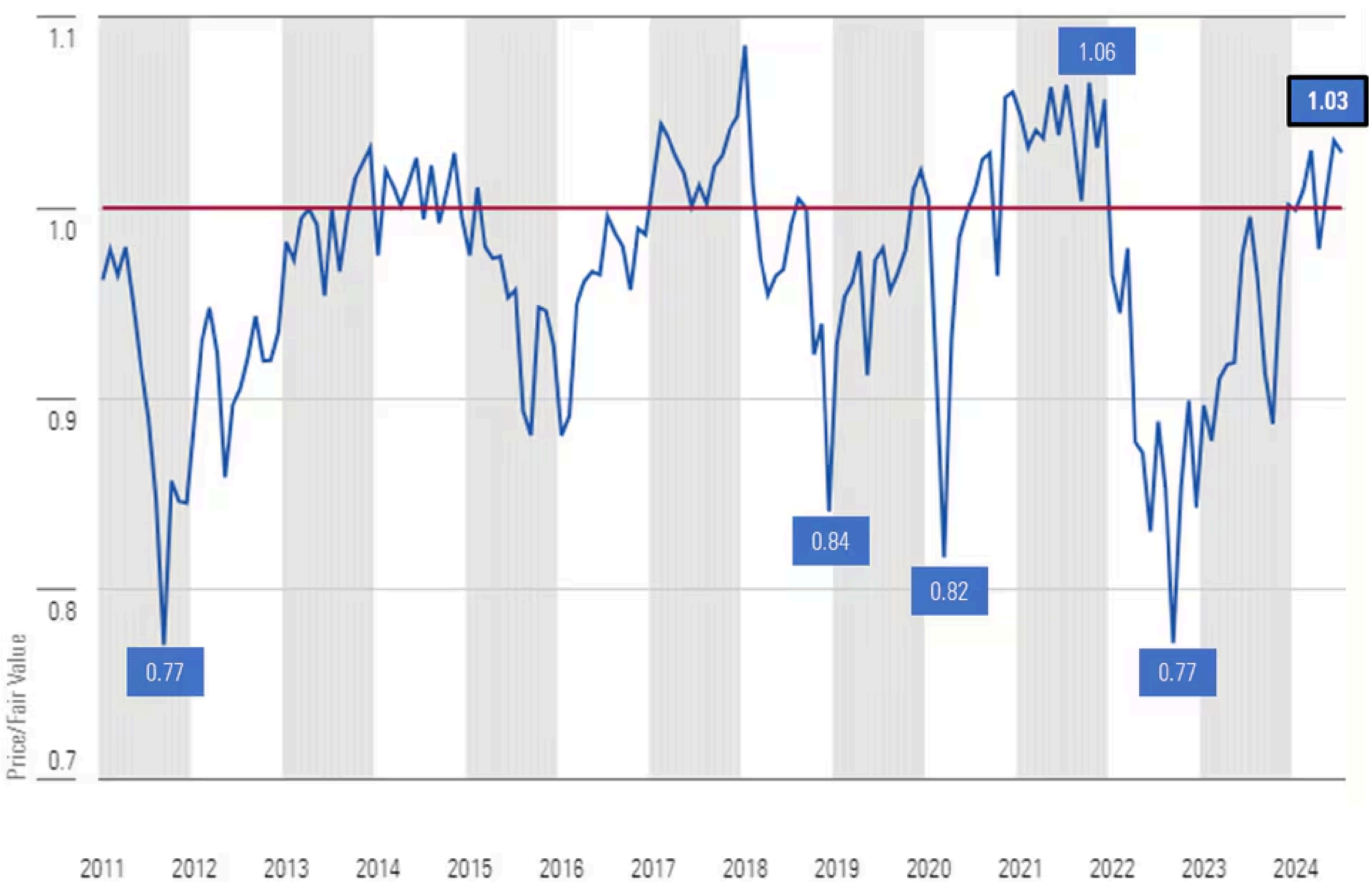
- Long-beleaguered small-cap stocks have finally begun to outperform.

- Investors find value stocks attractive ahead of slowing growth.
- Fed expected to cut in September and yield curve to shift down.

The Great Rotation Begins: Undervalued Small-Cap and Value Stocks Shine

The Morningstar US Market Index, our proxy for the broad US equity market, rose 1.59% in July, yet returns were highly skewed toward small-cap and value stocks. The price/fair value of the US stock market rose as high as 1.07 in mid-July, as stocks peaked—one of its highest readings—but has since retreated to 1.03 as of month-end.

Price/Fair Value of Morningstar's US Equity Research Coverage at Month-End



Source: Morningstar. Data as of July 31, 2024.

The rotation into small-cap and value stocks began shortly after the release of the June Consumer Price Index report. Inflation came in well below expectations and bolstered the markets expectation that the Fed would begin to ease monetary policy starting after its September meeting. Historically, small-cap stocks have tended to outperform in an environment of falling interest rates and easing monetary policy.

As we noted in our Q3 2024 Stock Market Outlook, with valuations for stocks leveraged to artificial intelligence either already fully valued or, in many cases, overvalued, it appears that the AI stock trade is over for now. With investors looking to stay fully invested in the market, yet looking for undervalued areas to redeploy their profits, value stocks have already begun to benefit from this market rotation.

Price/Fair Value by Morningstar Style Box Category

Source: Morningstar. Data as of July 31, 2024.

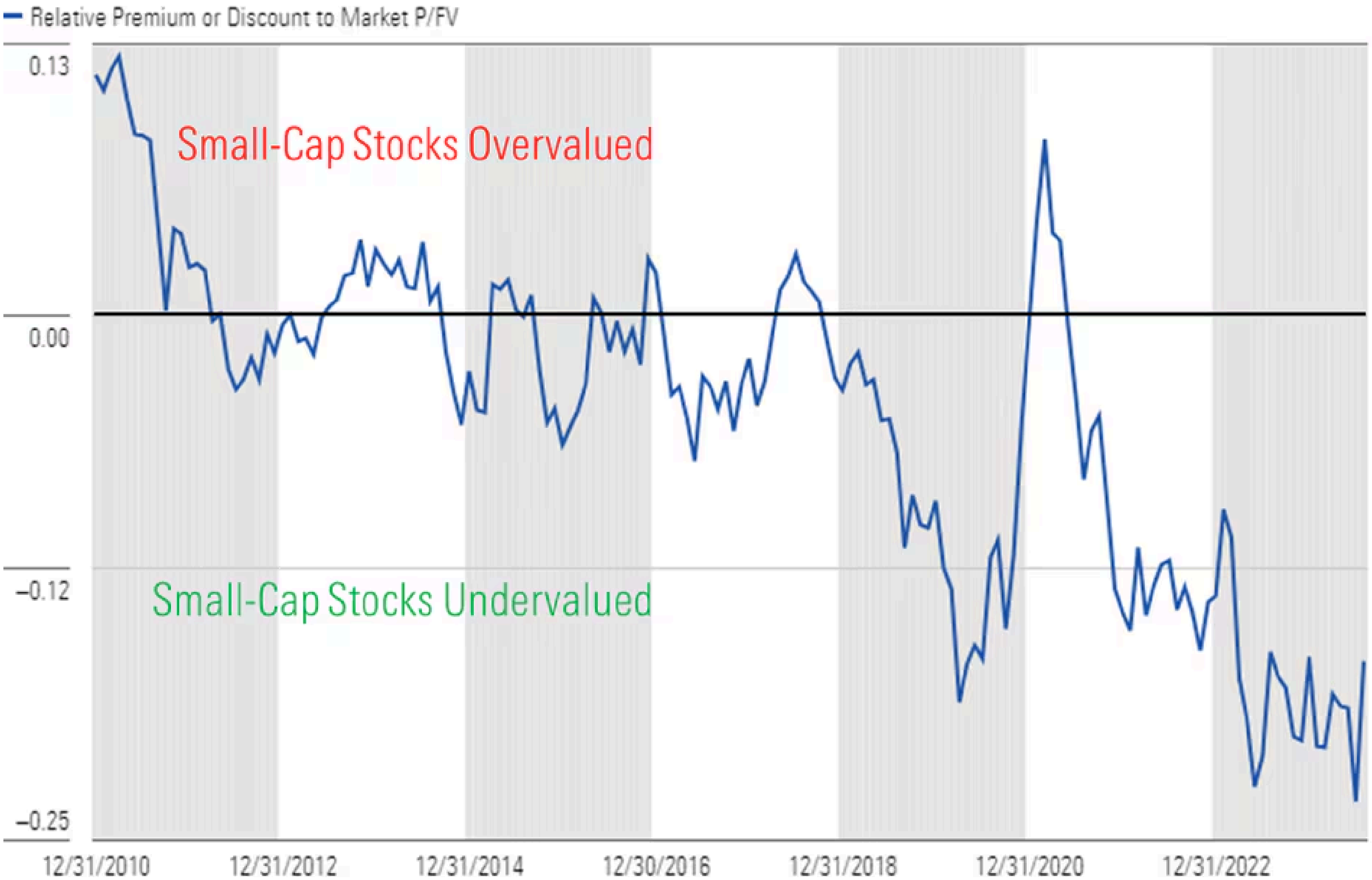
The rotation into small-cap and value stocks has led our valuations by category and sector to begin consolidating toward fair value. At this point, only a handful of sectors are undervalued. With fewer dislocations at the sector level for investors to take advantage of in this period of consolidation, to outperform the market, we think investors will need to look to contrarian investment opportunities. Specifically, we look to those areas that have underperformed, are unloved, and—most importantly—are undervalued. These contrarian plays are often "story stocks," which are typically situations such as emerging turnarounds or other catalysts that may have greater short-term risk, require a greater amount of analysis, and often take time for the story to work out.

Small-Cap and Value Stocks Finally Shine

By capitalization, the Morningstar US Small Cap Index rose 6.88%, edging out the 6.13% index return for the Morningstar US Mid Cap Index and outpacing the paltry 0.51% index return of the Morningstar US Large Cap Index. According to our valuations, small-cap stocks remain significantly undervalued, trading at a 14% discount to our fair value, whereas mid-cap stocks only trade at a 3% discount and large-cap stocks remain overvalued at a 5% premium.

With valuations for small-cap stocks significantly undervalued on both a relative and absolute basis, and the Fed poised to begin easing monetary policy, we suspect small-cap stocks still have a long path of outperformance ahead.

Small-Caps Near Lowest Relative Valuation to Market Valuation Over Past 14 years



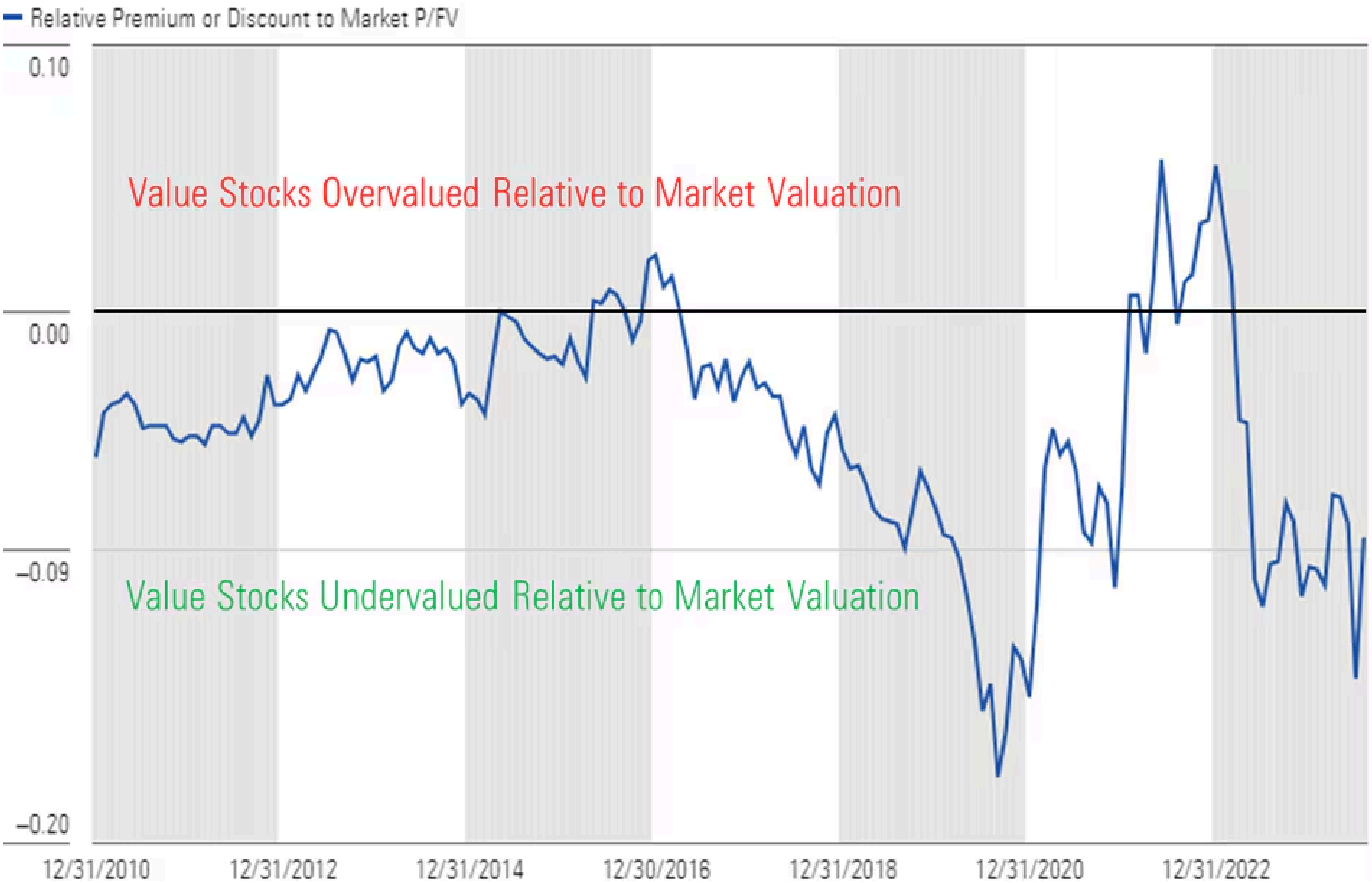
Source: Morningstar. Data as of July 31, 2024.

By style, the Morningstar US Value Index rose the most in July, rising 5.70%, whereas the Morningstar US Core Index only rose 3.40% and Morningstar US Growth Index lagged behind at 0.63%.

Yet, even after this surge, the value category remains the most attractive, trading at a 6% discount to fair value. According to our valuations, core stocks remain the most overvalued, at a 9% premium, and growth stocks trade at a 2% premium.

Looking forward, we expect value stocks should continue to outperform. Not only are they undervalued, but they also should perform better in an economic environment where we forecast the rate of economic growth will slow sequentially for the remainder of this year and remain sluggish in the first half of 2025.

Value Stocks Near Lowest Relative Valuation to Market Valuation Over Past 14 Years



Source: Morningstar. Data as of July 31, 2024.

From Out of Favor to Market Darlings: Real Estate, Financials, and Utilities

Just a little over a year ago, US regional banks plummeted following the insolvency of Silicon Valley Bank. The utility sector submerged last fall as interest rates rose. And real estate has long been the most hated asset class on Wall Street. Yet, the market overreacted to the downside in each case, and over the past year, these sectors have at times been some of the most undervalued.

The real estate sector finally found favor as the Morningstar US Real Estate Index was the top-performing sector and rose 7.50% in July. Yet, even after this surge, it remains the most undervalued sector, trading at a 6% discount to fair value. While valuations in urban office space appear to have greater short-term risk, we continue to see opportunities in real estate assets that have defensive characteristics, such as those tied to healthcare facilities (5-star-rated HealthPeak Properties DOC and 4-star Ventas VTR) or triple net lease providers (5-star-rated Realty Income O) that trade at a wide margin of safety from our intrinsic valuation and pay healthy dividends.

The Morningstar US Financial Services Index rose 6.93% last month. However, while many US regional banks such as 4-star rated U.S. Bancorp USB remain undervalued, US regional banks are nowhere near as undervalued as they were a year ago. In fact, a number of stocks among US megabanks and insurance companies have run up too far in our view. As such, overall the financials sector now trades at a 6% premium to our fair values.

With their relatively high dividend yields and their slow but steady earnings growth, utilities are often used by investors as a substitute for fixed income and are negatively correlated with interest rates. It’s no surprise that utilities stocks sold off as interest rates rose in 2023, but as we noted in our 4Q 2023 US Market Outlook, the utilities sector fell to valuations that were near their lowest levels over the past decade. Yet while valuations were low, we also noted that fundamentally the outlook for the sector was as strong as we had ever seen it. At that point, we had already incorporated into our forecasts that the amount of electricity demand growth from data centers would increase a cumulative 46% through 2032.

Obvious plays on the rapid growth of artificial intelligence had already run up earlier this year, and investors have been looking for other ways to play this growth. Recently, we have seen an increase in the number of stories that make the case that the utilities sector will benefit from the heightened demand for electricity. We agree with this thesis, as artificial intelligence computing requires multiple times more electricity to power its semiconductors than traditional computing. However, in our view, if you are just buying utilities today to play this theme, you are already 10 months late to the game. Since the utilities sector bottomed out on Oct. 2, the Morningstar US Utilities Index has risen 33%.

After trading at a deep discount last fall, the utilities sector now trades at a 5% premium to fair value. While sector average may be overvalued, we continue to see a number of attractive stocks in the utilities sector, such as 4-star rated WEC Energy Group WEC and Entergy ETR.

Selloff in AI Stocks Wallops Communications and Technology

Alphabet GOOGL and Meta Platforms META account for almost 70% of the communications sector market capitalization. These two stocks skewed the index average higher earlier in the year, and then their pullback in July skewed the index lower. The Morningstar US Communication Services Index dropped 3.86% in July, which was attributable to those two stocks. Following this pullback, the sector currently trades at a 4% discount to fair value, but in our view, the best opportunities lie among the traditional communications providers, as both Alphabet and Meta are rated 3 stars. We see much better value in AT&T T or Verizon VZ, two 4-star rated stocks that trade at 16% and 24% discounts, respectively, to our valuation and that pay high dividend yields. Among the media names, Comcast CMCSA is rated 4 stars, trades at a 24% discount to fair value, and has a 3.00% dividend yield.

Technology was the second-worst-performing sector in July as the Morningstar US Technology Index dropped 1.55%. An attribution analysis shows that Microsoft MSFT and Nvidia NVDA were responsible for 113 basis points and 83 basis points, respectively, of the decline.

Last month, we noted that, as the broad market valuation was getting to be frothy, much of the overvaluation is concentrated in a few thematic, mega-cap stocks, generally those technology stocks most closely tied to artificial intelligence. Considering that AI stocks are generally at best fairly valued and at worst overvalued, we see much better opportunities elsewhere in the market. Even after accounting for the pullback in the technology sector, it remains overvalued, trading at a 6% premium to fair value.

Morningstar Price/Fair Value by Sector

Cyclical		Sensitive		Defensive	
Basic Materials	0.99	Communication Services	0.96	Consumer Defensive	1.08
Consumer Cyclical	1.00	Energy	0.95	Healthcare	1.01
Financial Services	1.06	Industrials	1.10	Utilities	1.05
Real Estate	0.94	Technology	1.06		

Undervalued			Fairly Valued			Overvalued
< 0.90	> 0.90 to 0.95	> 0.95 to 0.99	> 0.99 to 1.01	> 1.01 to 1.05	> 1.05 to 1.10	> 1.10

Source: Morningstar. Data as of July 31, 2024.

Monetary Policy: What's Next?

Morningstar's US Economics team expects a combination of moderating inflation and slowing economic growth will provide the backdrop for the Fed to begin cutting the federal-funds rate at the September meeting. Our base case projects the federal-funds rate will end 2024 at a range of 4.75% to 5.00%. We also forecast the Fed will continue to cut the federal-funds rate further throughout 2025.

In the longer end of the yield curve, our US Economics team also projects that long-term interest rates will be on a downward path in the second half of 2024 and in 2025. They project the 10-year US Treasury yield will average 4.25% in 2024 and average 3.50% in 2025.

What's an Investor to Do?

Steady as she goes. With the broad equity market trading just a little over fair value, we advocate for investors to position themselves at a market weight within their targeted long-term asset allocations between equity and fixed income. With the rate of economic growth projected to slow for the next few quarters, stock markets could become increasingly volatile this summer and pullbacks could provide an opportunity to move back to overweight equity positions.

Within the equity portion of their portfolio, we continue to see the best valuation in the value category and in small-cap stocks. Undervalued sectors to overweight include real estate, energy, and communications. However, within these sectors, we think individual stock-picking remains vital. Overvalued areas to underweight include industrials, consumer defensive, technology, and financials. Yet even within an overvalued sector, there are often numerous undervalued opportunities for those investors willing to spend the time to look for them.

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