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Tech Stock Rally Leaves Small-Caps Behind

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Shares of large companies are racing past their smaller counterparts again.

The Russell 1000 index of large companies has gained 9.2% this year, beating the 0.7% advance of the small-cap-concentrated Russell 2000. That is the widest outperformance since 1997, when looking at years in which the Russell 1000 has been in positive territory through May 26, Dow Jones Market Data show.

The gains in the large-cap index have been driven largely by a handful of big technology stocks. Among the biggest winners are Facebook parent Meta Platforms and graphics chip maker Nvidia, which have both more than doubled in 2023. Tesla has added 57%, and Apple has climbed 35%.

The small-cap index has been pressured in part by big declines in regional-bank stocks. Valley National Bancorp has fallen 32%, while Independent Bank (Massachusetts) has dropped 46%. Elsewhere, the academic learning platform Chegg, which warned that ChatGPT is eating into its growth, has declined 64%, and the oil-and-gas-drilling company Helmerich & Payne has fallen 34%.

Anxieties over the debt ceiling, a potential recession and lingering inflation have encouraged investors to turn to a trade that has worked for much of the past decade: large-cap tech stocks. Some investors, though, are wary that the stock market's rally is too narrow underneath the surface, leading to doubts about its sustainability if one or more of the market's behemoths were to falter.

"Trees don't grow to the sky. It's hard to imagine how they grow from here," George Patterson, chief investment officer at PGIM Quantitative Solutions, said of large-cap tech stocks. "Yes, they have a lot of cash, but what do you do with it is the question."

Apple and Microsoft continue to dominate the major stock indexes. Their combined weighting in the Russell 1000 has risen to about 13%, the highest level on record, according to Strategas Securities data going back to 1995.

This holiday-shortened trading week, investors are looking to Friday's jobs report to gauge the health of the economy. On Wednesday, they will parse the Federal Reserve's latest compilation of economic anecdotes from around the country, known as the beige book.

Tech stocks emerged as a haven play during the March banking crisis, with investors betting that the collapse of three regional banks would force the Fed to pause its bid to raise interest rates. Lower rates boost the appeal of growth companies, such as tech stocks, which have the potential to generate windfall profits many years in the future.

Investors say the healthy balance sheets of many tech companies leave them better equipped to withstand any downturn in the economy. They worry the same generally can't be said for small-caps, which often fall in economically sensitive sectors, such as energy, materials and financials. Those companies are facing more pressure as regional banks tighten their lending standards.

Bigger companies "have no problem raising capital in an environment like this, but when you get a smaller company, they're going to struggle," said Jack Ablin, chief investment officer and founding partner at Cresset Capital. Within the large-cap space, Ablin said he is focusing on quality companies with high dividends.

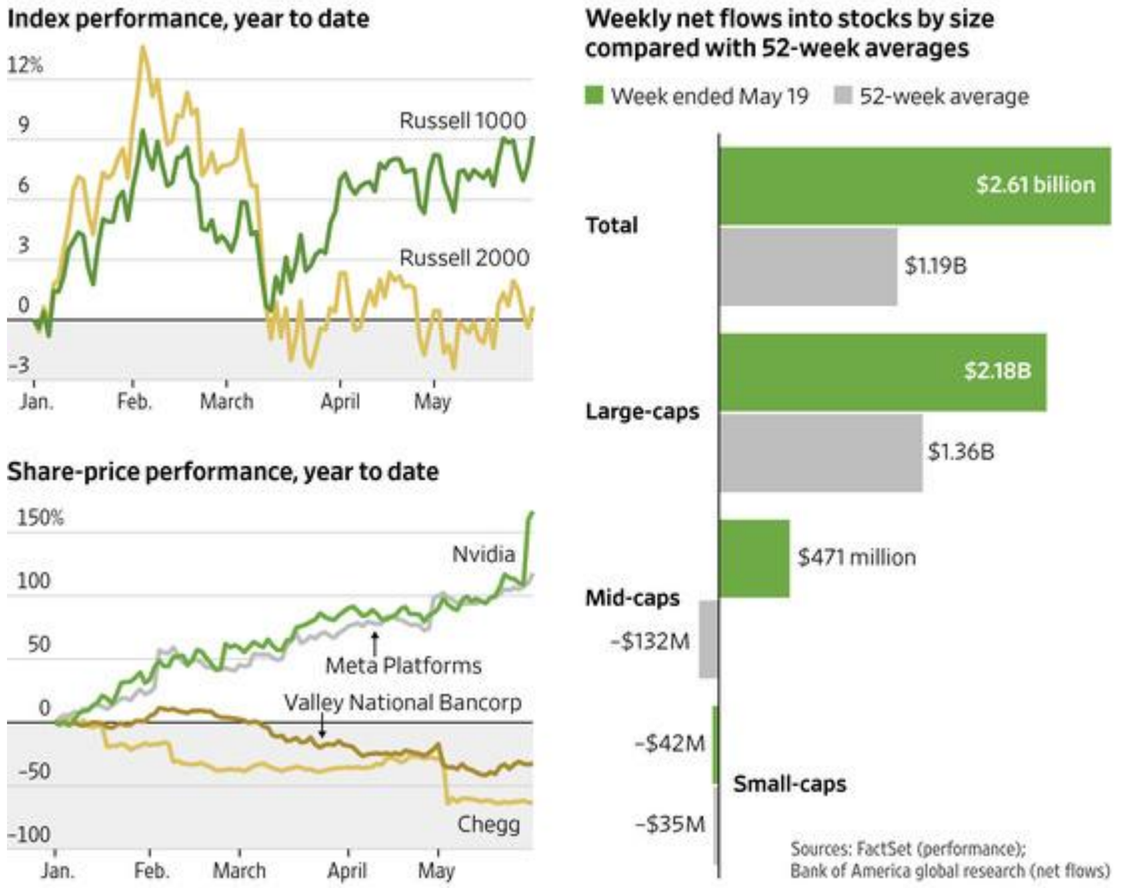
Other investors also appear to be favoring large-caps of late. Investors poured more than $2.6 billion into U.S. stocks on a net basis during the week ended May 19, the largest net inflow since October, Bank of America global research data show. About $2.2 billion of that sum went to large-caps, while small-caps logged net outflows of $42 million.

Adam Hetts, global head of portfolio construction and strategy at Janus Henderson Investors, suggests that investors have small-caps and large-caps in their portfolios because the former are often first to rally in the early stages of an economic recovery. He points to the period after the 2008 financial crisis, when small-caps initially outperformed large-caps.

Plus, small-caps look less expensive than other corners of the market. The Russell 2000 is trading at 12.8 times expected earnings over the next 12 months, below its historical average of 15.8, based on FTSE Russell data going back to 1979, when the index was created.

In comparison, the Russell 1000 trades at about 18 times earnings, above its historical average of 15.8. Meta's multiple is about 20, while Tesla's and Nvidia's are both around 47.

"That's where you'd see the biggest bounce, as we work through the bottom of a potential recession or bear market into a recovery environment," Hetts said of small-caps.



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