Stock Market "Rotation"? Not Yet!

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During the past few weeks, the stock market has been experiencing a correction or a retracement of some of the gains made since March. The characteristics of this bull market have been concentrated in large capitalization growth stocks and many investors are asking whether the weakness in these stocks is a sign that there is going to be a change in market leadership away from large growth and into value or foreign stocks. One of the ways that a rotation can be monitored is if there is a broad change in the relative strength of stocks i.e. are the strong stocks losing momentum and are the weak stocks gaining strength? If such a rotation is taking place, the technical characteristics of stocks are not enough to make the decision that such a change is underway. There must be some fundamental justification for the change.

If the Coronavirus is a continuing threat to the normal functioning of the economy, there will not be a rotation out of growth and into value stocks. The rationale for this statement is that the large companies -- especially those that fit our "survival of the fittest" theme -- will be the beneficiaries of businesses that were forced to close due to forced lockdowns. Last week's news focused on the claim that 85-90% of restaurants in New York City could not pay their rent indicating that time is running out for these smaller businesses. Then the question is: Will commercial properties that depend on lease/rent payments also find themselves in a deteriorating financial circumstance? Will large banks be impacted by a decline in cash flows from real estate companies that they lend to? Unless there is a major change in these fundamentals, there will be a segment of the economy that will remain under pressure even with the discovery and implementation of a vaccine program.

The financial sector of the stock market continues to under-perform and major questions remain about the outlook for a rebound in bank earnings. Government bailout programs have impacted the demand for loans and the negligible interest rate spread between loans and deposits adds fuel to the fire. The airlines are another market segment that are at the edge of the cliff without major government assistance. With the resurgence of the virus in Europe, will U.S. carriers be able to withstand the loss of major international travel until the ban is lifted?

Another major sector that is unlikely to rotate into positive territory is energy. The price of oil has rallied back into the low $40 per barrel range from a low of $16 per barrel this year but sluggishness in world demand threatens to push the price lower in coming weeks and months. U.S. oil and gas output remains strong as drilling becomes more efficient. Foreign producers are holding back their oil from markets to maintain current price levels, but their economies are suffering from lower volume as well as lower prices. Each time oil rallies up into the mid-to-high $40s range, more product comes to market. The higher the price goes in the short-term, the greater the increase in production and then down comes the price. In that environment there are few long-term investors who see a profitable future.

The bottom line is that there is no rotation in stocks—yet—only some profit-taking among squeamish traders who are cashing in on short-term profits. The volatility around the election may cloud the investment waters but after there is an outcome, the growth stock thesis is likely to remain intact.

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