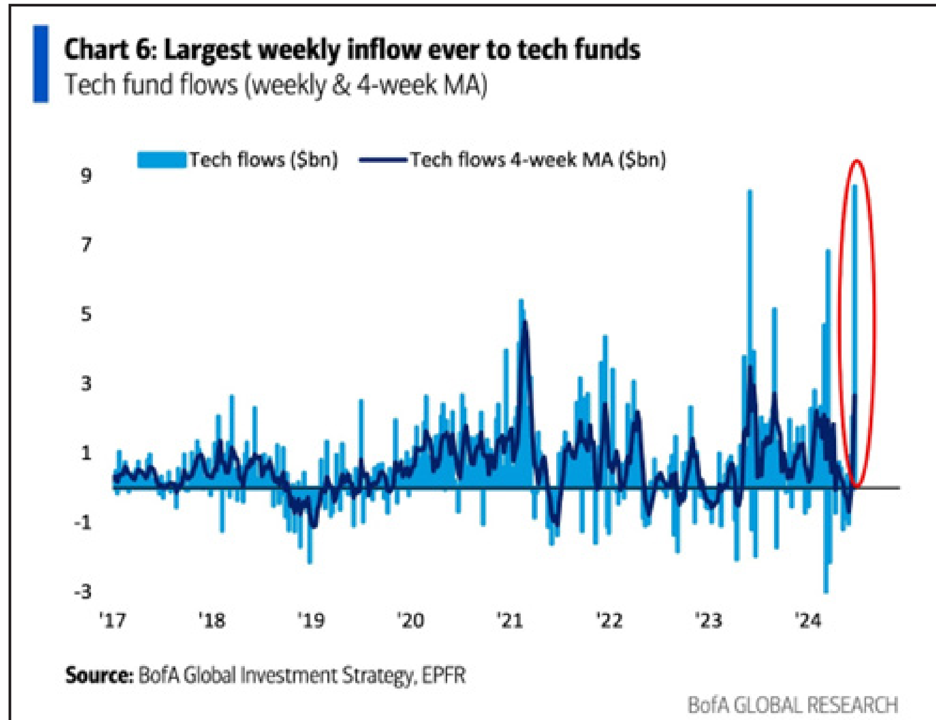
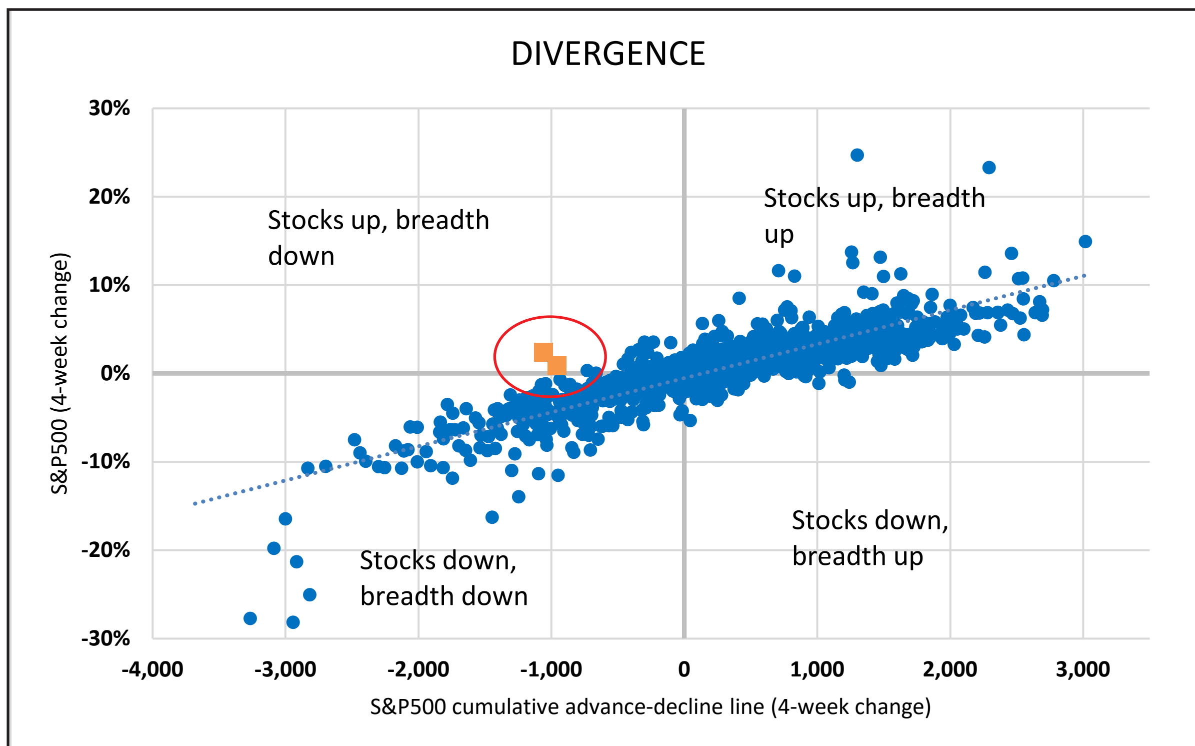
Divergence and Concentration Point to Extremes

We have been watching the breadth of the market continuously shrink, as global capital appears to have flown into the U.S. markets, to chase the AI frenzy names such as NVIDIA. We have seen that tech funds had large inflows in recent weeks which may have contributed to the run-up in the markets. In fact, Bank of America called the weekly flows into tech funds a record[1].



Outside of these mega cap companies, market breadth as measured by the S&P 500 cumulative advance-decline line has been weakening. Interestingly, while the breadth has been weakening there has been positive performance of the S&P 500. When we look at it relative to history, recent data stands out as outliers.

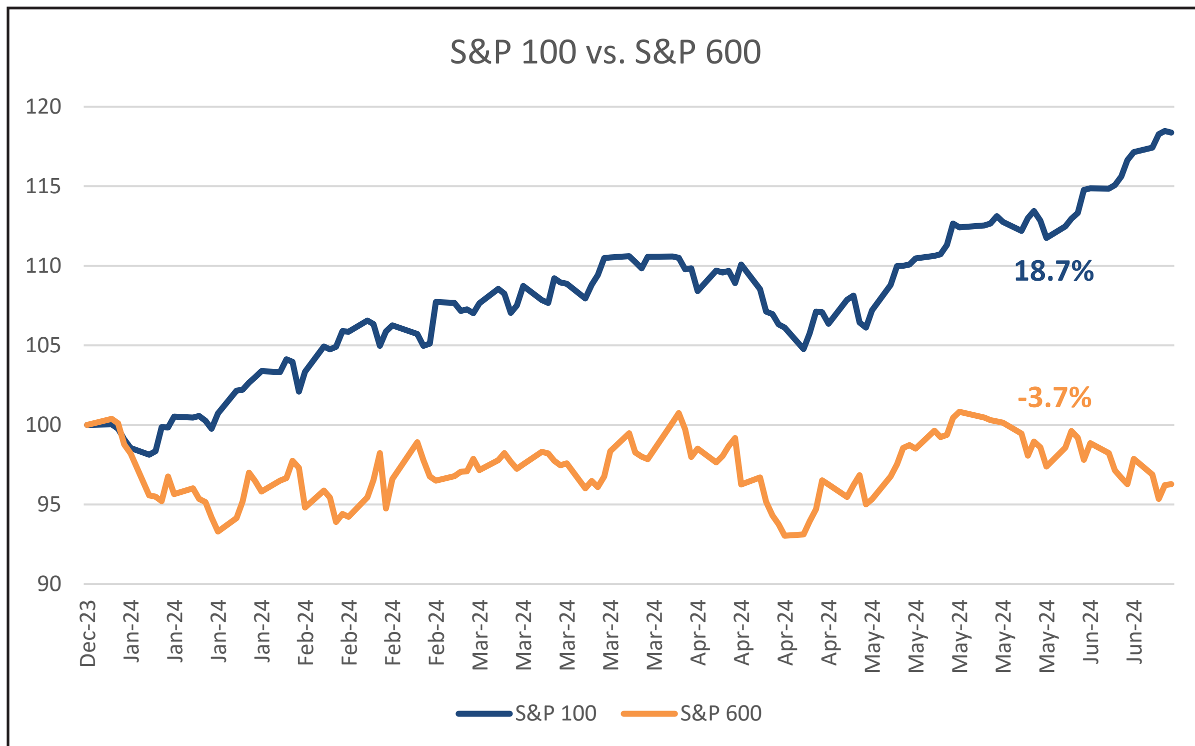


Source: Bloomberg

1 https://www.bloomberg.com/news/articles/2024-06-21/all-roads-lead-to-nvidia-as-tech-sees-record-inflows-says-bofa?sref=a0ud9dKk&embedded-checkout=true

Breadth breakdown can also be seen with the percentage of S&P 500 members above the 200-day moving average. In the last 2 months, we have seen a serious divergence between that metric and the performance of the index.

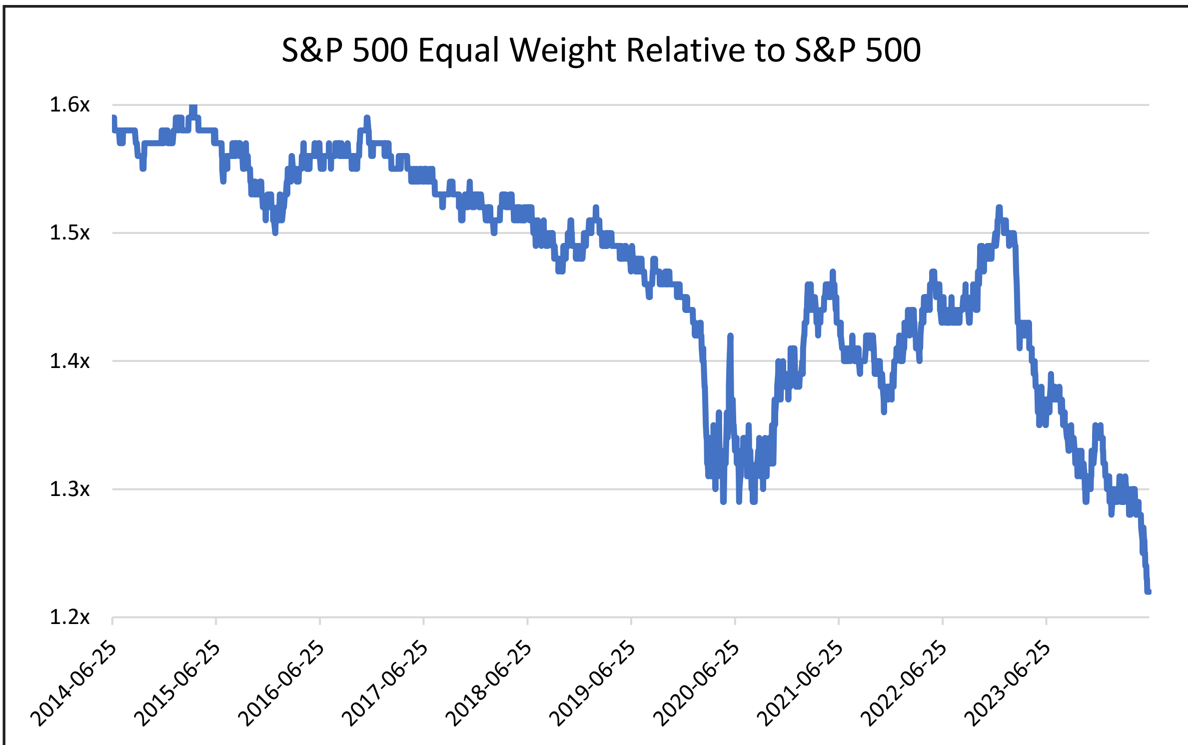
With the money flowing to large cap, we thought it would be appropriate to highlight the pain of being involved in small caps. The S&P 100 (largest stocks in the U.S.) has delivered nearly 20% return in the first half of the year, while S&P 600 (small cap index) is down nearly 4%.



Source: Bloomberg

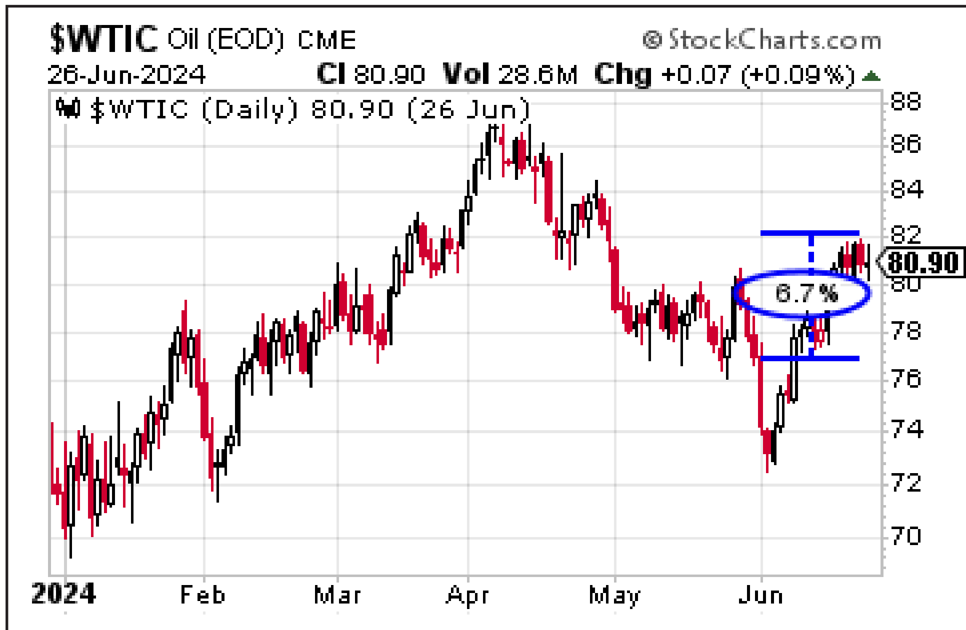
Small caps remain near their record lows vs. the size of the total market which is the potential future opportunity in the space.

This can also be seen not just in large cap vs. small cap, we have seen the S&P 500 Equal Weight Index continue to weaken relative to the S&P 500, with a noticable acceleration in the last month. All of this points to money flowing to the largest cap equities at an accelerating pace.

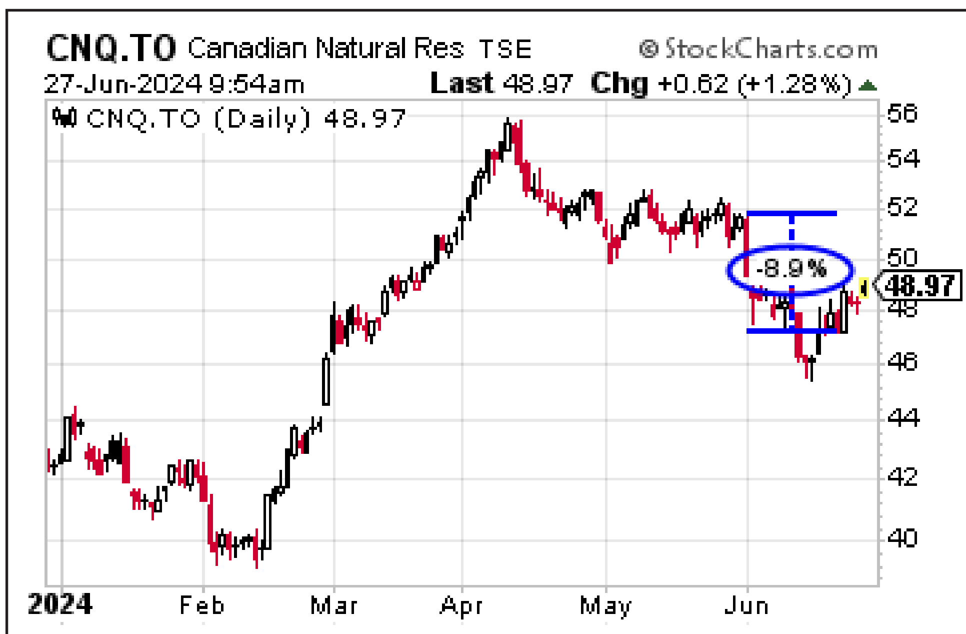


Source: Bloomberg

Its not only the equity markets, we see fairly extreme divergences in places that we traditionally wouldn't. For example, take oil's recent run up from early June, the commodity has run ~6.7%, but CNQ is down ~8.9% . Compared to how we would 'normally' expect markets to work, we would have expected energy stocks to overshoot the commodity rather than completely undershooting.

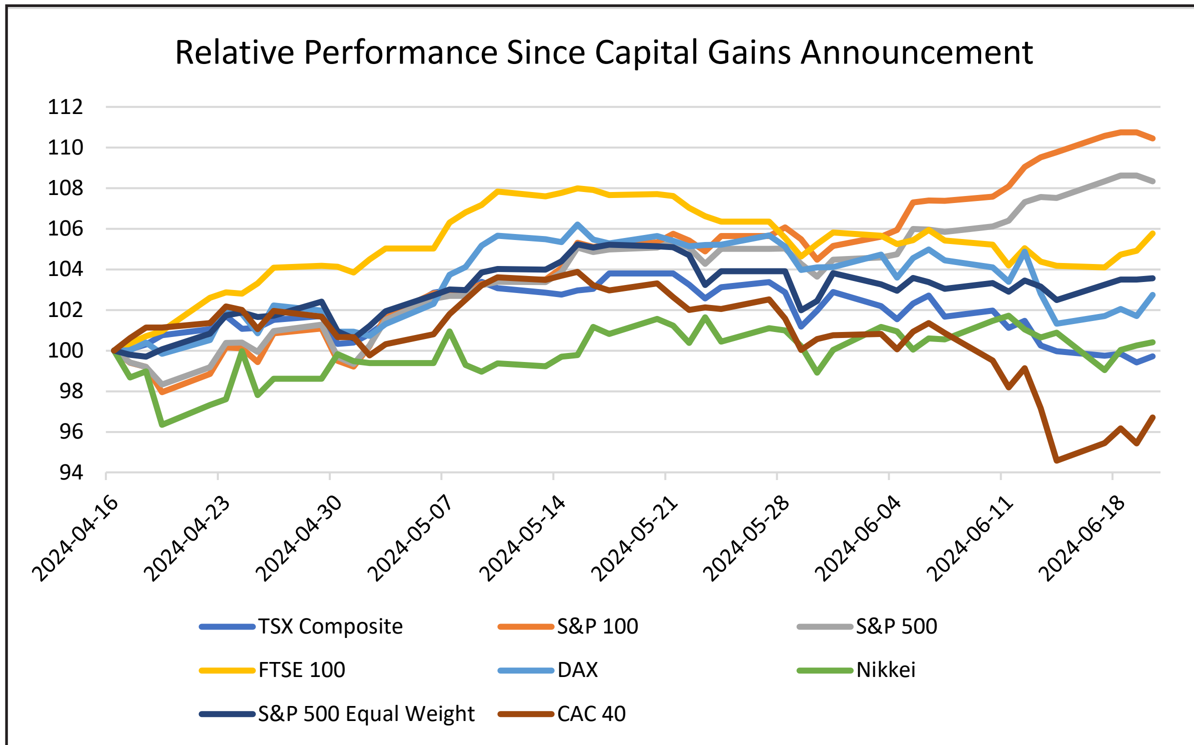


Source: Stockcharts.com



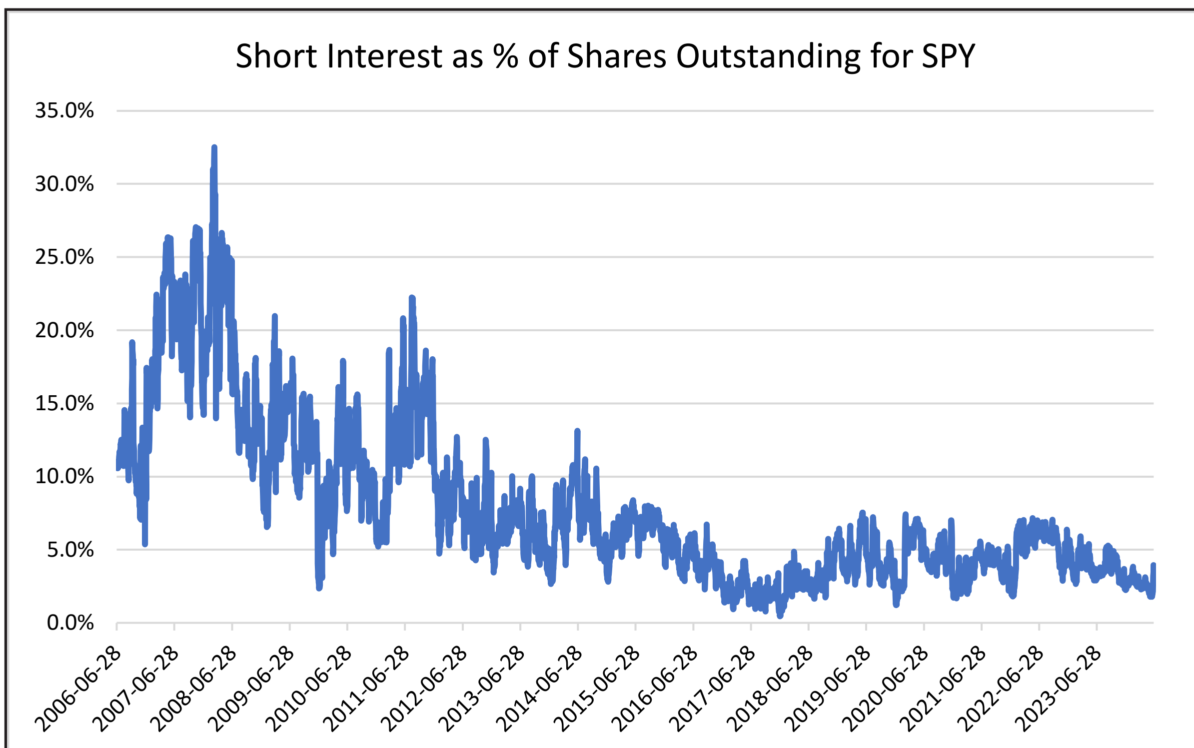
Source: Stockcharts.com

When Canada announced capital gains tax changes on April 16th, we immediately knew there would be consequences. Similar to our non-existent per capita GDP growth, we are also towards the bottom of the pack in terms of equity market performance. Interestingly, we've seen it is not just Canada that has struggled with its equity markets, globally, it appears that most markets are unable to perform anywhere close to the way the U.S. markets have, and this is even more apparent when looking at how the largest cap S&P 100 has performed.



Source: Bloomberg

This extremeness can also be seen in the amount of short interest in the SPY ETF (S&P 500 ETF). Up until June 10, we saw it collapse to near record low levels, outside of the 2017 period when market volatility was near lows.



Source: S3 and Bloomberg

If we look at the median amount of short interest in the S&P 500 constituents, we see that is it hovering near historic lows.

Despite everything that we have seen above which seems extreme, there has not been a market decline of 2.05% or larger for over 377 days. The extremes all appear to be resulting in an upside for certain markets, which generally is cheered by the average investor, whereas we consider it to be a contra indicator and it makes us intrigued about the next move in the market.

Source: https://x.com/Mayhem4Markets/status/1804840799332409490/photo/1

Portfolio Positioning

All of the above divergences feel reasonably extreme to us. These kinds of divergences are going to be felt in the portfolio and we have seen a drawdown caused by some of these factors (small cap pain, reduced breadth, Canada's weakness). To be clear, we consider all of these divergences along with extreme sentiment to be the making of a market top. The economy is weakening fast and we expect a world recession to come soon. Markets decline between 15 to 35 percent on average during a recession. With government deficits high, and the consumer already weak, we believe the next one to be the longest and the deepest, therefore, we believe most of the gain and opportunities will come from the short side for the foreseeable future.

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