Institutional Flow Not On Summer Vacation Yet, Political Storylines Less A Driver Than Disinflation and Soft Landing

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A Wild Few Weeks in Politics

This summer has already made history, from the most memorable presidential debate since JFK vs. Nixon, to the first president/candidate assassination attempt since Ronald Reagan, and now the unprecedented withdrawal of a sitting president from a race since LBJ, this summer is off to an action-packed start. Wall Street veterans take a certain in telling younger colleagues things like: "Back when I started in this business," "You've never seen real interest rate hikes," or "You've not seen Midnight Run?!" However, it's safe to say that the recent flurry of events has left even the most seasoned among us in uncharted territory. Despite history's tendency to repeat itself, the dramatic developments of the past few weeks will be tough to replicate, marking a truly unique chapter in our collective experience.

The severity of the market rotation since that presidential debate has been palpable. It's arguable whether it can all be solely attributed to the "Trump Trade" considering just how concentrated this market has been in certain factors, but some sentiment metrics have hit historical levels. At one point in the week of July 15, the Russell 2000 beat the S&P 500 over seven days, by the largest margin during a seven-day time period since 1986. Compared the Growth Index, the Russell 1000 Value Index achieved its best performance since 2001.

Continued on next page »

The rotation out of mega cap tech and momentum stocks into value, cyclicals and small caps has taken a brief pause, prompting traders to ponder the sustainability of both small cap outperformance and momentum quant behavior. Keep in mind that momentum quant performance in the first half of the year was rock solid, with systematic trading often creating a self-fulfilling prophecy. For example, value funds poised at key buy-on-dip technical levels can trigger a surge in volume with high conviction, ultimately pushing process to a higher technical ceiling where momentum traders add another wave of volume, propelling the market to fresh highs.

In terms of small caps, optimism and clarity on interest rates have been significant catalysts. As we move into earnings season, consensus calls for an 18% rise in Russell 2000 second-quarter profits, potentially ending a five-quarter streak of year-over-year declines. This optimistic outlook could provide the necessary fuel to sustain small-cap momentum in the coming months.

Coming Up: Disinflation and a Soft Landing

While politics have played some sort of a role in the rotational behavior, the primary drivers are likely to remain signals of disinflation and the soft landing narrative. Keep an eye on implied volatility around key events like FOMC, PCE and CPI releases. As we move into earnings season, particularly for large-tech momentum names, it's important to remember that earnings is rarely a catalyst for volumes in itself.

The most significant story of 2024 has been the resurgence of traditional institutional asset manager, bringing a wave of continuous institutional volumes not seen in over four years. This return has added a healthy dynamic to the market. We're seeing several positive signals: money manager cash positions have declined significantly from historically high levels of 2022 and 2023, correlations are at extreme lows, real price volatility has dropped, and improved liquidity has lowered expected execution costs. We're also seeing improving market breadth. With one stock, NVDA, accounting for 30% of the S&P 500's 15% total return on the year, something has to give.

Summer Vacation Where? Not for Institutional Flows!

The biggest surprise has been the sustainability of the strong institutional flows well into the summer. Both externally and internally to Liquidnet, the data on block seeking through negotiation or algos, coupled with sell-side block activity in the ATS shows that the summer slowdown hasn't started for most. The week of July 15 saw the highest three day stretch in this metric in four years. The FINRA TRF reported volumes continue to steam along at high levels. May provided a boost with another social media-driven effort towards esoteric names. While the sub-dollar category volumes have remained high, unlike the 2021 resurgence, this has largely been institutionally insignificant and isolated to a select corner of the market.

Perhaps most importantly, we can't discount how the increased block appetite is contributing to the sustained heavy TRF data. This improved market health and low volatility have led to three notable effects:

- Rise in dark trading: With a market no longer dominated by market makers bypassing dark venues to trade directly to the market, dark trading activity is on the uptick.
- Increased average trade size: Last year's macroeconomic uncertainty heightened fears of adverse selection, but as the macro picture becomes clearer, we're seeing a renewed appetite for larger trades.
- Narrowing spreads: When volatility hits hard, market maker quoting gets wider to compensate for risk. With reduced volatility, spreads are tightening, reflecting a healthier trading environment.

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So, What's Next?

As the rotation trade loses steam and turns to earnings, the political landscape is set to dominate the news cycle once again. While it may not match the frenzy of the past few weeks, it's certainly going to heat up. Historically, money managers have put less attention towards the "election trade" than one might expect. Factors like tax climate, trade stance, interest rate and dollar goals will come into play. However, it's the improved macroeconomic certainty that has truly driven market action and liquidity throughout 2024.

Looking ahead, the second half of election years have historically been favorable for market performance. Since 1928, the S&P 500 has averaged at 5.2% gain in the third quarter of election years, with positive returns occurring 63% of the time. No matter what happens, we're in for an interesting rest of the summer and captivating lead into the fall.

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