Equity Insights

THE 2025 PICTON REPORT

Is MOMO Turning into FOMO?

Be Ready for What's Brewing

Momentum has led style factor returns in 2024. Unlike the late 1990s, momentum is not expensive relative to other style dynamics, and the diversity of the sector has improved to include non-technology companies. Today's momentum stocks also have better fundamentals and significantly better profitability than those in the dot-com bubble.

However, as investors chase performance in the late stages of 2024, there is a growing risk that momentum has become increasingly crowded. MOMO (Momentum of Missing Out) may have morphed into FOMO (Fear of Missing Out), raising the risks of a large correction in 2025. Higher inflation and a less dovish Fed policy than the market currently expects could be catalysts for an unwind.

We believe the backdrop of an uncertain macroeconomic environment, volatile interest rates, and changes in market structure have created favourable conditions for long-short strategies.

A Year of Momentum

2024 has been a strong year for equity markets, with the S&P 500 index up 25% and the S&P/TSX Composite index up 22%. Momentum has led style factor returns as winners have kept winning, with stocks in the highest quintile of nine-month price momentum, outperforming the market by 23 percentage points over the past 12 months. Momentum's strong outperformance resembles the late 1990s, leaving some investors to question if it will be sustained.

> *There is a growing risk that momentum has become* ***increasingly crowded***.

Our View

Unlike the late 1990s, momentum is not expensive relative to other style dynamics, and the sector diversity of the high momentum has widened beyond technology. Stocks in the top quintile of price momentum as of December 20 have capitalization-weighted free cash flow margins of 25%. This compares quite favourably with the peak of the dot-com bubble when the same figure was negative 2%[1].

Today's momentum stocks simply have better fundamentals and significantly better profitability than that prior era. However, as investors chase performance in the late stages of 2024, there is a growing risk that momentum has become increasingly crowded, which could lead to heightened volatility and potential market corrections.

[1]Source: National Bureau of Economic Research, Empirical Research Partners Analysis.

Paying up for Growth

While overall equity valuations for the S&P 500 are rich from a historic perspective, there has been significant divergence between valuation expansion for growth compared to value stocks (Figure 1).

Investors in 2024 have been paying up for growth exposure as highlighted by the expanding forward P/E points per percentage point of differential in growth (Figure 2).

This increase in premiums for growth stocks has been driven by a combination of macro uncertainty and AI hype.

> *Investors should be **cautious** of the potential for a valuation reset.*

Our View

The Fed's current rate-cutting campaign is potentially fueling exuberance in equity markets as it's leading to higher multiples.

However, this window of exuberance may be limited. There are growing risks of a pull-forward in the timeline of structural inflationary forces, which could change the narrative on central bank easing in 2025.

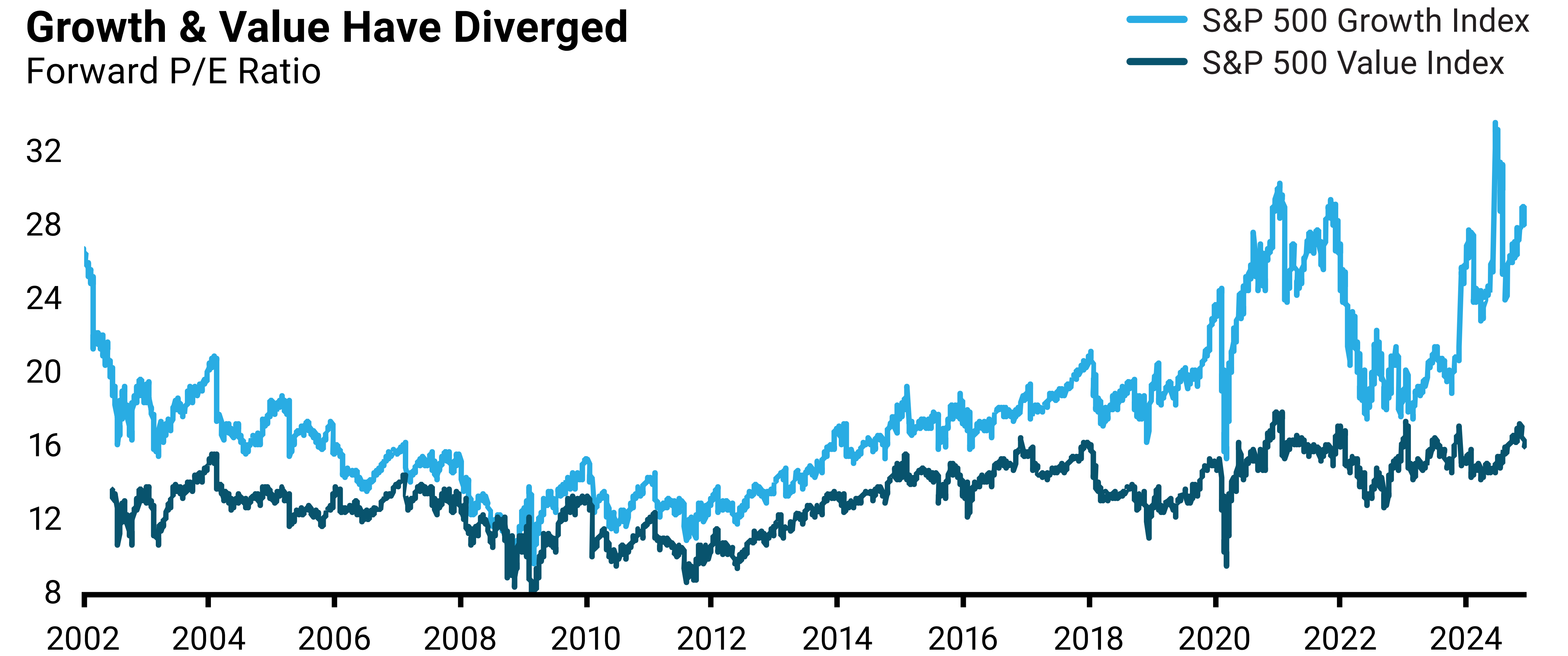
This shift in monetary policy expectations could lead to a reassessment of growth stock valuations, particularly if interest rates remain higher for longer than currently anticipated.

Investors should be cautious of the potential for a valuation reset if the macroeconomic environment shifts unexpectedly.

FIGURE 1

Growth & Value Have Diverged

Forward P/E Ratio

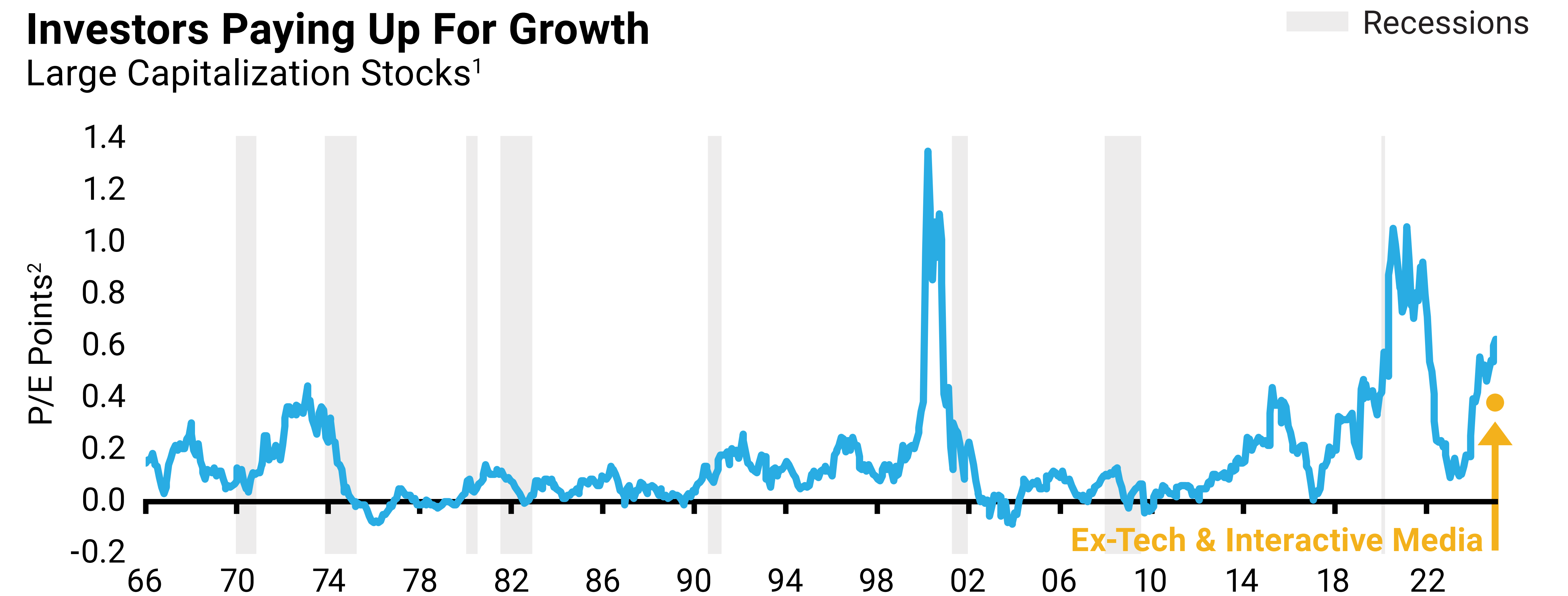


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. 2002 to 2024.

FIGURE 2

Investors Paying Up For Growth

Large Capitalization Stocks[1]



Source: National Bureau of Economic Research, Empirical Research Partners Analysis. [1]Excludes financials. [2]Impact of a one-point differential in revenue growth on forward P/E/ ratios. Based on cross-sectional regression of forward-P/E ratios onto trend revenue growth over the prior two years. Trailing PEs are used before 1977.

Are investors still on the sidelines?

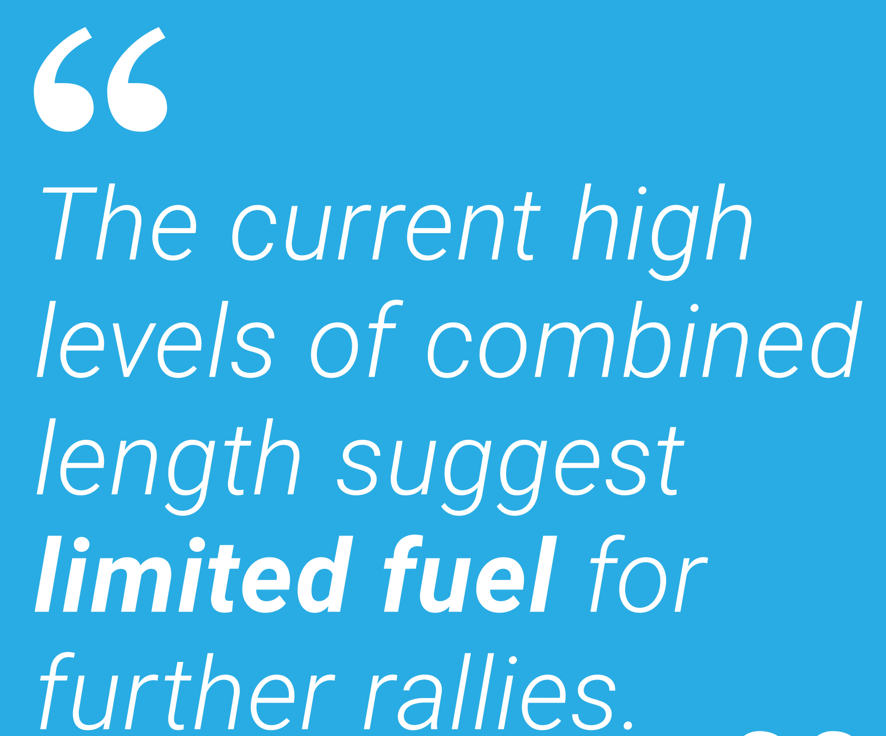
Our View

We see extended North American equity positioning across multiple cohorts heading into 2025.

Commodity Trading Advisors (CTAs) are generally holding near-maximum lengths in major equity index futures, while volatility-targeting funds have significantly increased their equity weights since the summer, coinciding with a sharp decline in volatility.

North American hedge funds are generally maintaining gross weights and long/short ratios around the 90th percentile and CFTC E-Mini S&P500 Asset Manager Net Total Futures Positioning is at nearly all-time highs (as of Dec 20).

While there's no apparent catalyst for a positioning unwind, the current high levels of combined length suggest limited fuel for further rallies.



A challenging backdrop for most active managers, but a strong opportunity set for others

Much of the equity market narrative has focused on the concentration of market leadership, with the top 10 companies outperforming the broader S&P 500 by 218% over the past decade. This dominance has made it challenging to manage portfolios against market-cap weighted benchmarks.

According to the S&P Indices vs. Active Funds (SPIVA) mid-year 2024 report, 85% of active U.S. large-cap equity funds underperformed the S&P 500 index over the last 10 years.

Our View

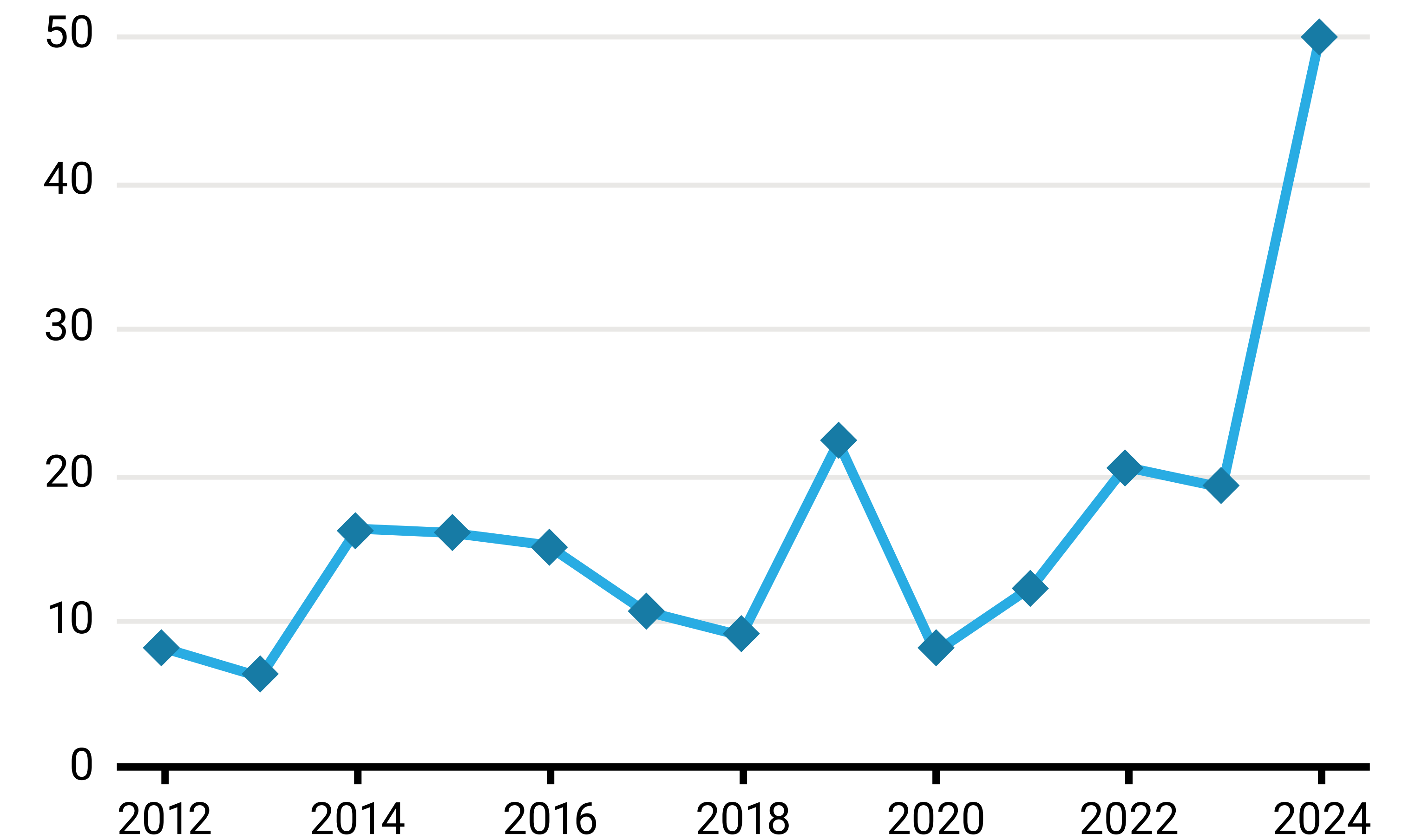
Buy Alpha! This challenging environment for long-only managers contrasts sharply with the opportunities for long-short strategies. The backdrop of an uncertain macroeconomic environment, volatile interest rates, and changes in market structure have created favourable conditions for this approach.

These factors have contributed to reduced correlations (stocks moving less in tandem) and increased dispersions (wider variation in performance), providing skilled long-short managers with enhanced opportunities to generate alpha through security selection (Figures 3 & 4). For example, the spread between the top and bottom performing "Big 6" Canadian banks widened to above 50% in 2024 (Figure 5).

FIGURE 5

Canadian Bank Stocks Going Their Own Way

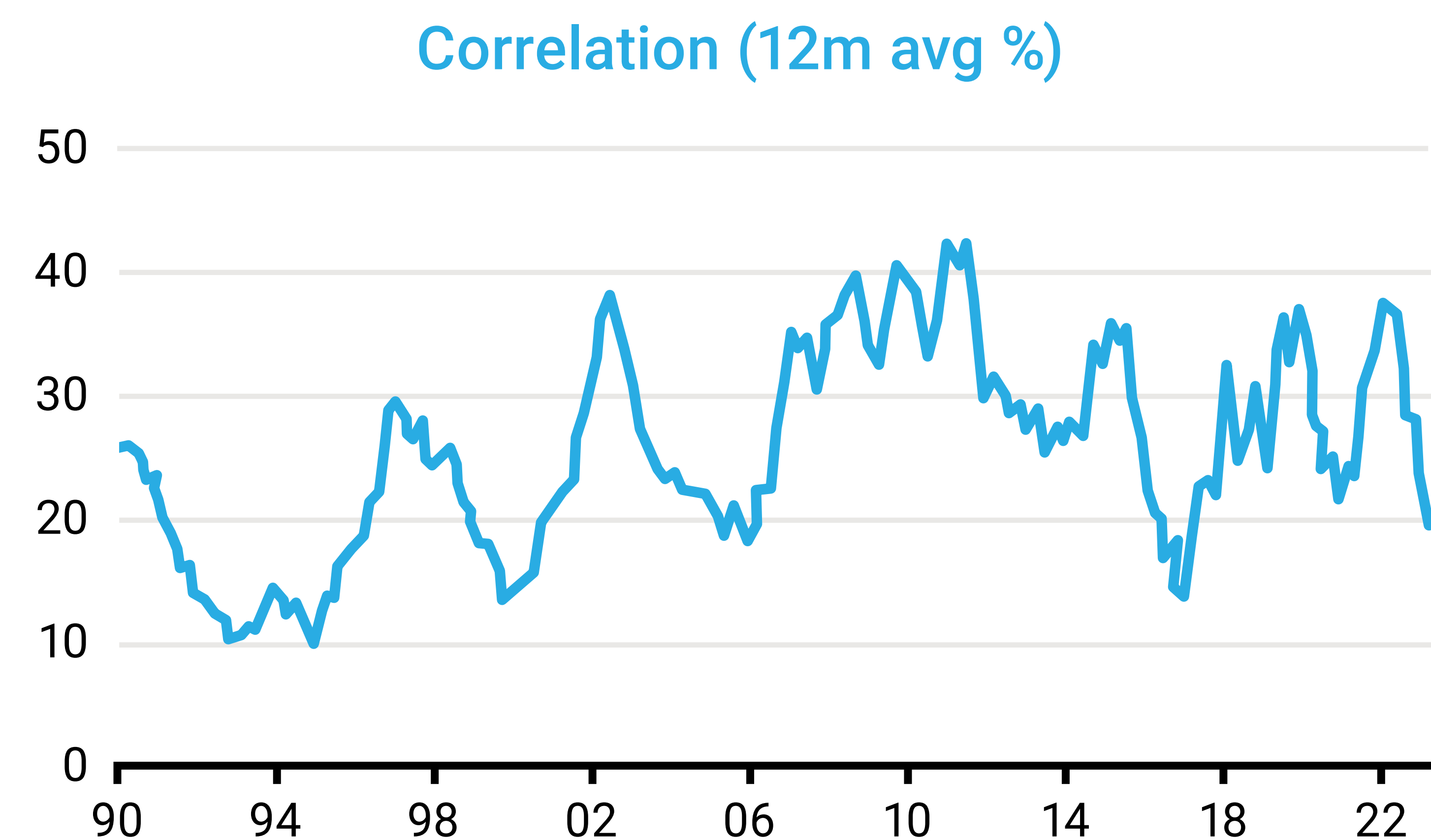
12m Price Differential Between Top & Bottom Performers (%)

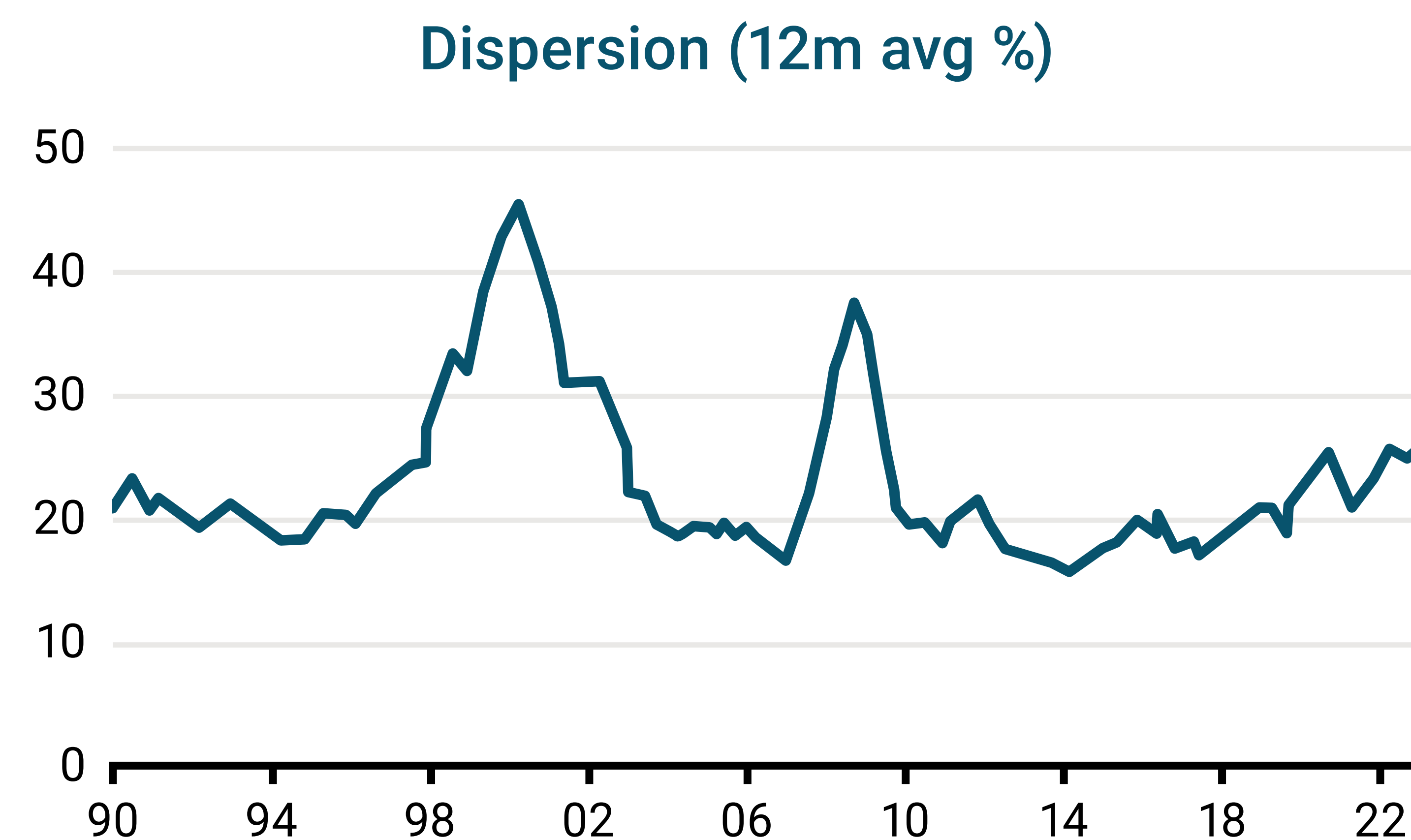


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Dec 31, 2011 to Nov 29, 2024.

FIGURE 3&4

Equity Correlations Have Fallen While Dispersions Have Increased





Source: S&P Dow Jones Indices. Dec 31, 1990, to Nov 29, 2024.

Source: Index Dashboard: Dispersion, Volatility & Correlation, Nov 29, 2024. Link to article.

Dispersion for each index is the annualized, index weighted standard deviation of the index constituents' full month total returns. See "Dispersion: Measuring Market Opportunity" for a formal definition of dispersion and more information on its uses.

Correlation for each index measures the correlation among the daily returns of the index constituents during the month, calculated via the ratio of index variance to the index weighted average constituent variance. See "At the Intersection of Diversification, Volatility and Correlation" for a more detailed explanation of the calculation.

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