Stock Market Rotation in 2026: Dynamics, Drivers and Strategic Implications

A few months into 2026, global equity markets are undergoing one of the most significant leadership rotations seen since the early stages of the post-pandemic bull cycle. After several years of dominance by a narrow set of U.S.-based mega-capitalization technology and artificial intelligence (AI) infrastructure players, leadership in 2026 has shifted toward a broader, more cyclical set of sectors. Along with this trend, markets are also experiencing changes in leadership across market capitalizations, styles, and geographies. For instance, over the last year markets have seen U.S. small cap stocks outperform large cap stocks, international stocks outperform U.S. stocks, and value stocks outperform growth stocks. Such trends represent reversals of longer-dated performance trends where markets have largely been driven by large, U.S. growth stocks. Given the constantly evolving investment landscape, such trends highlight the importance of diversification for institutional investors.

Exhibit 1 highlights near-term and longer-term performance of representative indexes across capitalization, style and geography.

Exhibit 1

Capitalization	1 Year	3 Year	5 Year
S&P 500 Index (Large Cap)	18.9%	21.7%	14.2%
Russell 2000 Index (Small Cap)	24.7%	13.2%	5.0%
Style	**1 Year**	**3 Year**	**5 Year**
Russell 1000 Growth Index (Growth)	16.8%	26.0%	14.4%
Russell 1000 Value Index (Value)	20.0%	15.9%	11.8%
Geography	**1 Year**	**3 Year**	**5 Year**
Russell 3000 Index (U.S.)	18.8%	20.8%	12.8%
MSCI ACWI ex U.S. Index (International)	38.2%	19.8%	9.8%

Source: Factset as of 2/27/2026. Green highlights indicate outperformance.

Over a one-year time frame market leadership has shifted significantly to small cap, value, and international equities, rewarding patient investors that maintained diversified public equity allocations. What's been driving such changes? The macroeconomic picture has certainly played a role in shaping the current environment, and factors as divergent global monetary policy, inflationary pressures, currency fluctuations, market sentiment, and valuations have also influenced recent equity performance.

Reasons for Change in Market Leadership

1. **Valuations** – Lower valuations in small cap, value, and international equities, when compared to large cap, growth and U.S. equities, have enticed asset flows from investors looking for more attractively priced assets. While the rise of AI has driven exceptional growth in tech stocks, concerns over their resulting high valuations have weighed on recent returns and accelerated interest in small cap and value equities. From a geographic standpoint, the relative valuation premium of U.S. stocks over international stocks still remains more than one standard deviation above long-term average despite significant outperformance from international equity in 2025 **(Exhibit 2)**.

Exhibit 2

Source: Factset as of 2/28/2026.

2. **Global Monetary Policy** – Divergent monetary policies across regions have also influenced recent equity returns. As inflation has eased, central banks around the world have chosen different paths in reducing borrowing costs. While Europe and parts of Asia were aggressive with rate cutting and loosening monetary policy as inflation slowed, the United States has been more methodical, enacting three 25 basis point cuts in 2025. Thus, the more stimulative economic environment overseas has played a role in strengthening recent international equity returns.
3. **Currency Effects** –The weakening U.S. dollar has enhanced the competitiveness of international equities, also boosting their performance. U.S.-based investors allocating dollars internationally benefited from a weaker dollar when converting local currency returns back into dollars. In fact, over the last year currency effects have boosted international equity returns to U.S. investors by over eight percentage points when compared to equivalent returns in local currencies **(Exhibit 3)**.

Exhibit 3

Index	1 Year	5 Year
MSCI ACWI ex US Index USD	38.2%	9.8%
MSCI ACWI ex US Index LCL	30.1%	11.8%

Source: Factset as of 2/27/2026. Green highlights indicate outperformance

4. **Economic Cycle** – U.S. small-cap companies are more sensitive to economic cycles, benefitting from growing consumer spending, economic growth, and business activity. While predictions vary, the U.S. economy, as measured by gross domestic product (GDP), is forecasted to grow in a range of 2.0% to 2.5% in 2026, representing a moderate expansion. Such an environment provides a better backdrop for small companies' profitability relative to a slowing or recessionary environment.
5. **Market Sentiment** – Market leadership has also rotated based on current sentiment. There have been signs of a degree of AI "fatigue" setting in; for instance, some of the large US growth tech stocks that had previously

driven markets have seen stock prices stagnate since late 2025 based on concerns of future profitability relative to the vast amounts of development spending such companies have incurred. At the same time a strategy known as the “HALO” trade (Heavy Assets, Low Obsolescence) has taken hold in 2026. Such defensive rotation focuses on stocks with physical assets that are less likely to be disrupted by AI, benefiting sectors like energy, utilities, materials and industrials.

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The changing dynamics of market leadership underscore the importance of diversification in institutional investment portfolios. By allocating assets across different capitalizations, styles, and geographies, investors can reduce risks and capitalize on opportunities in various market conditions. As the investment landscape continues to evolve, maintaining a strategic and diversified approach will be essential for achieving long-term return and risk goals.