Beneath the Surface: Why July's Rotation Doesn't Change Our Thesis

OpenArc CIO Office
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The S&P 500 closed July near 7,500, essentially flat and a whisper below its June record. If that's all you looked at, you'd think nothing happened last month. Underneath, this was one of the more significant sector rotations we've seen in some time, and it's worth understanding why, because it changes nothing about our thesis while telling you a lot about how this market is actually working right now.

Technology and AI infrastructure names declined meaningfully in July. Energy and a broad swath of the rest of the market picked up the slack, which is why the index itself barely moved. Six of eleven sectors rose. The equal-weighted index outperformed the cap-weighted index, and that tends to happen when strength is spreading across the market rather than sitting in a handful of names. We've said for months that the fundamentals backing this rally have been strong, and Q2 continued to show that same story. A genuinely narrow, fragile market doesn't rotate this cleanly into other sectors when its leaders pull back.

What actually happened

The chip, memory, and AI-infrastructure trade got crowded on the way up, the way every hot trade eventually does, and it unwound sharply on the way down. The Nasdaq fell more than 10% from its June high, with semiconductors leading the decline.

South Korea illustrated this most clearly. Samsung and SK Hynix together now make up roughly half the Kospi's weight, up from about a quarter a year ago, so when those two stocks sold off, the index sold off with them. The Kospi fell more than 25% from its June peak. The part worth paying attention to is what happened underneath that: the leveraged, daily-reset ETFs tied to those stocks lost 45% or more in the same month SK Hynix reported record profits, and the AUM across that whole leveraged ETF complex fell from roughly $50 billion at its June peak to around $15 billion by the end of July. That's a leverage problem, not a demand problem. Regulators moved quickly to tighten the rules on those products for the same reason. Memory and AI-hardware demand didn't deteriorate in July. The leverage sitting on top of that demand did, and we think it's worth keeping those two things separate when you're deciding how to read the month.

The clearest example came from an AI-focused fund that had grown to roughly $45 billion and was forced to sell its entire public book to Citadel on July 30 after running something like 4x leverage into the downturn. The fund's underlying thesis, that AI infrastructure demand is real and durable, may still hold up fine. What didn't hold up was the structure around it: too much leverage and too concentrated a book for a month like this one. We keep coming back to that distinction, thesis versus structure, because it's the cleanest way to think about most of what happened in July.

Sources: S&P Dow Jones Indices; FRED (Federal Reserve Bank of St. Louis); Bloomberg; CNBC; Federal Reserve; Korea Exchange; Dynasty Financial Partners.

The Fed is now a real headwind

The Fed left interest rates unchanged at its July 29 meeting. What stood out wasn't the decision itself, it was that three members voted against it because they wanted to raise rates, not cut them. That's a signal the Fed is more worried about inflation than about slowing growth, which is the opposite of what markets like to see when they're hoping for rate cuts down the road. The 10-year closed the month near 4.75%, its highest level since early 2025, and the 30-year pushed above 5.2%, its highest level since 2007, before the Global Financial Crisis. That matters because higher yields make future earnings worth less in today's dollars, and that hits hardest the stocks priced for a lot of growth years down the road, exactly the names that led this market higher over the past couple of years.

We're not going to guess at the Fed's next move. What we'd note is that the rate backdrop has flipped from a tailwind to a headwind over roughly the past year. The Fed cut rates three times in 2025, then paused entering this year, and that pause hardened once the Iran conflict pushed oil and inflation risk back into the conversation. That's a real shift from where things stood twelve months ago. It's also worth remembering we've been near these yield levels before… the last time the 10-year pushed up beyond the mid-4% range was late winter and early spring of 2025, on fiscal deficit concerns rather than Fed policy. The driver is different this time, but the level of noise investors are dealing with is not.

Our view

None of this changes our thesis, and if anything, it gives us more confidence in it.

Broadening participation is a healthy sign. The rotation into energy and other sectors reflects earnings power that exists outside the AI mega-caps. We'd rather see six sectors doing the work than one, and July gave us that.

Leverage unwinds clear out excess, but they don't kill the underlying trend, and it's worth not conflating the two just because they happened in the same month. South Korea's forced deleveraging removed some of the market's most fragile positioning without touching the actual demand for memory or AI infrastructure. We'd rather see that leverage clear now than keep building.

Rates are the variable we're watching most closely. A Fed that stays higher for longer changes the math on the most expensive corners of the market. For us that's a valuation discipline question, not a market-timing one, and it's why we continue to size active risk carefully rather than chase the names that led the last leg up.

One more thing, since it comes up every cycle: an election year can add noise to markets, and we wouldn't be surprised to see some of that noise between now and November. But we don't position around elections. We try to capture long-term, durable themes in our portfolios, and we base our positioning and sizing on things like fundamentals and valuations, managing portfolio risk holistically rather than around any single month or any single event on the calendar. That hasn't changed this month.

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