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SMALL CAP STOCKS: POISED FOR OUTPERFORMANCE

HIGHLIGHTS

- In recent years, small cap stocks have largely been overshadowed by their large cap counterparts, with investors focusing on the impressive gains of mega-cap technology names.
- The outlook for small cap stocks looks constructive, supported by the prospect of robust earnings growth, attractive valuations, improving market breadth, and a favorable economic backdrop.
- International small caps may also be worth a look based on prospects for superior earnings growth against a backdrop of attractive valuations.

REVISITING THE CASE FOR SMALL CAPS

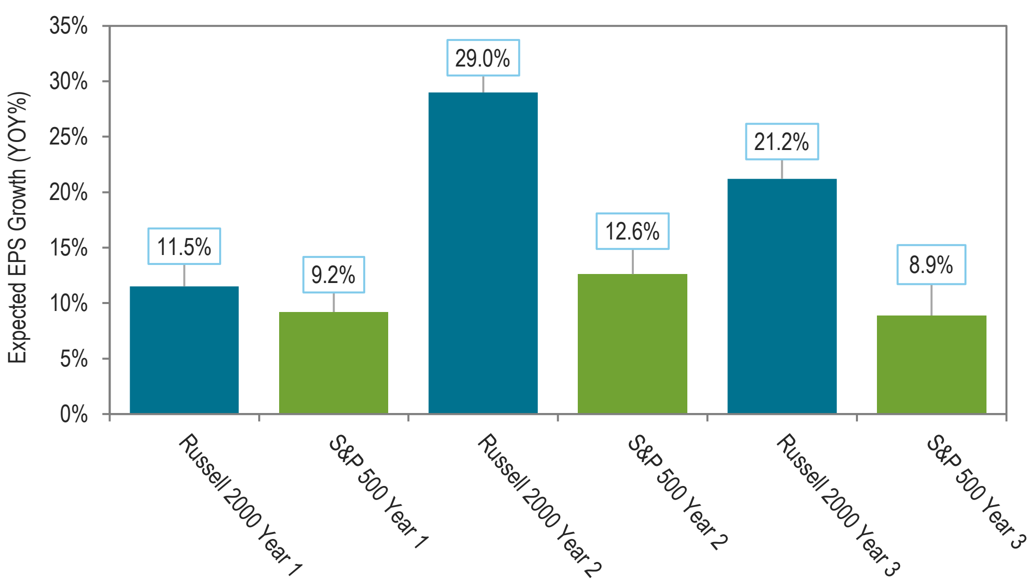
As investors seek opportunities in the current market landscape, small cap stocks have emerged as a potentially overlooked and undervalued asset class. Despite recent challenges, the outlook for US small caps in the coming years looks increasingly constructive. This piece will explore the key reasons behind the optimistic outlook and why investors should consider allocating to small caps.

REASONS FOR FAVORABLE SMALL CAP OUTLOOK

1. **Earnings Recovery and Growth:** Small cap earnings are expected to rebound strongly next year, with growth rates potentially outpacing their large cap counterparts **(Figure 1)**. As the economy recovers from a Fed-induced slowdown, smaller companies are well-positioned to benefit from the uptick in consumer spending and business activity. The improving profit picture bodes well for small cap performance.

FIGURE 1

Advantage, Small Caps:
Russell 2000 vs S&P 500 Projected EPS Growth



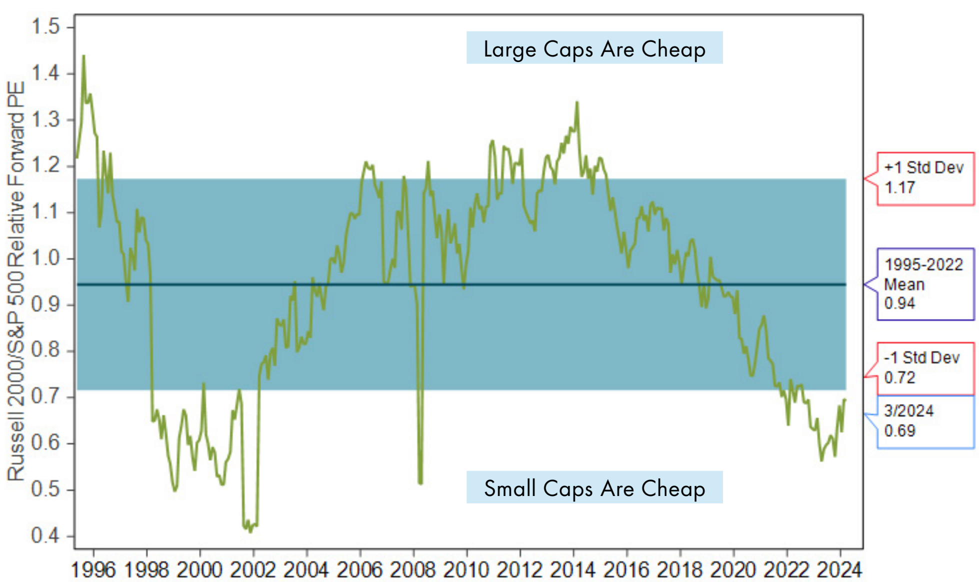
Note: Data based on Bloomberg's analyst surveys as of April 16, 2024
Sources: GW&K Investment Management, Bloomberg, and Macrobond

Bottom-up analysts expect earnings growth for the Russell 2000 small cap index to significantly outperform that of the S&P 500 large cap index over the next three years (74% vs 34% cumulatively).

2. **Attractive Valuations:** Small caps are currently trading at a significant discount to large caps, both on a historical basis and relative to their growth prospects **(Figure 2)**. This valuation gap suggests that small caps may be underappreciated by the market, presenting an attractive entry point for investors. As the earnings recovery gathers pace, there is potential for valuation multiple expansion, further supporting small cap returns.

FIGURE 2

Small Caps Are Very Cheap vs Large Caps:
Russell 2000 vs S&P 500 Relative Forward PE Ratio



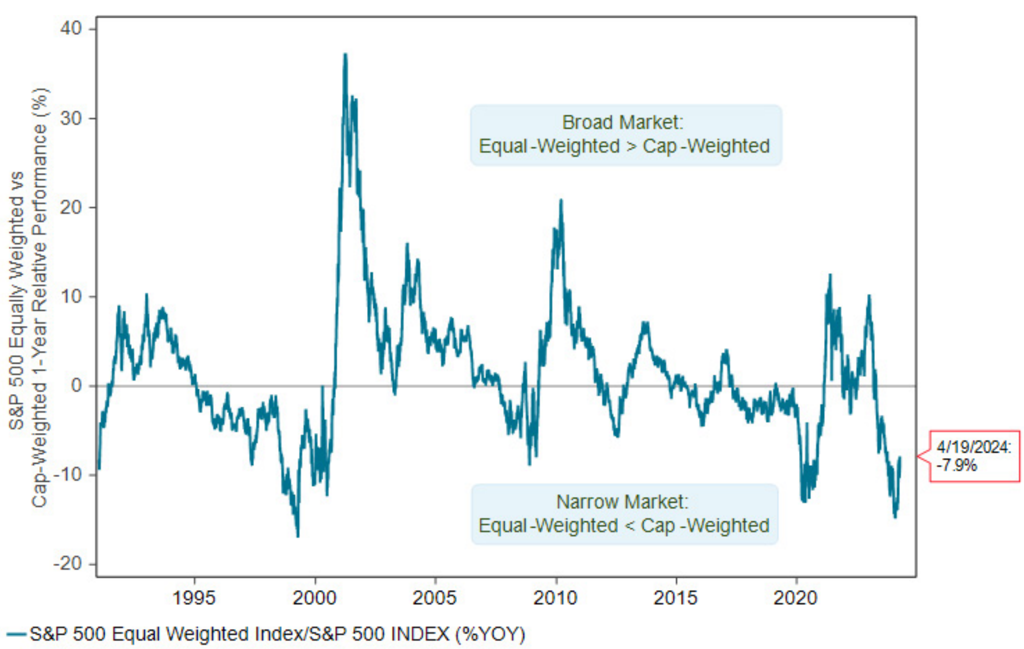
Note: Based on Bloomberg 12-month forward PE ratios excluding unprofitable companies.
Sources: GW&K Investment Management, Bloomberg, and Macrobond

Focusing on profitable firms in the Russell 2000 and the S&P 500 shows that the relative forward PE ratio of the Russell 2000 is trading at a 30% discount to the S&P 500.

3. **Scope for Improving Market Breadth:** Recent equity market advances have been extraordinarily narrow, as seen in the notable underperformance of the S&P 500 Equal Weight Index compared to the more familiar cap-weighted S&P 500 Index **(Figure 3)**. That reflects the extreme outperformance over the past year of a handful of mega-cap stocks fueled by investor enthusiasm for the AI revolution. Historically, extremely narrow market advances have been followed by more broad-based market gains and outperformance of small caps, especially over longer horizons like 3 or 5 years **(Figure 4)**.

FIGURE 3

Market Breadth Hit Extreme Lows Recently: S&P Equal-Weighted vs Cap-Weighted Performance (%)

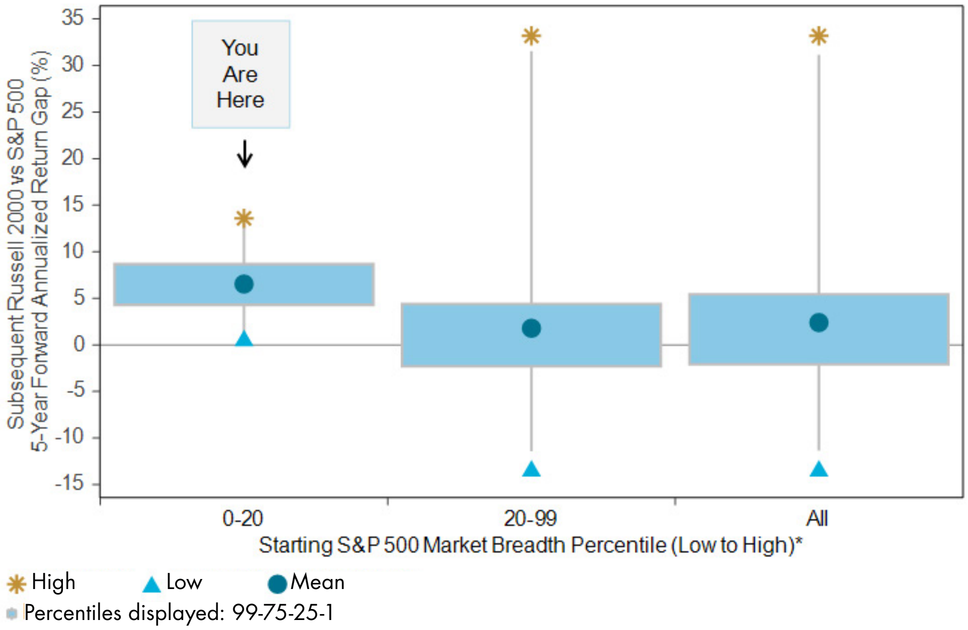


Sources: GW&K Investment Management, Bloomberg, and Macrobond

The recent extreme narrowness of the equity market's recent advance was reflected in notable underperformance of the S&P 500 Equal-Weighted Index vs the familiar S&P 500 Cap-Weighted Index.

FIGURE 4

Narrow Market Breadth in the S&P 500 Historically Preceded Subsequent Small Cap Outperformance (1991 – 2024 data)



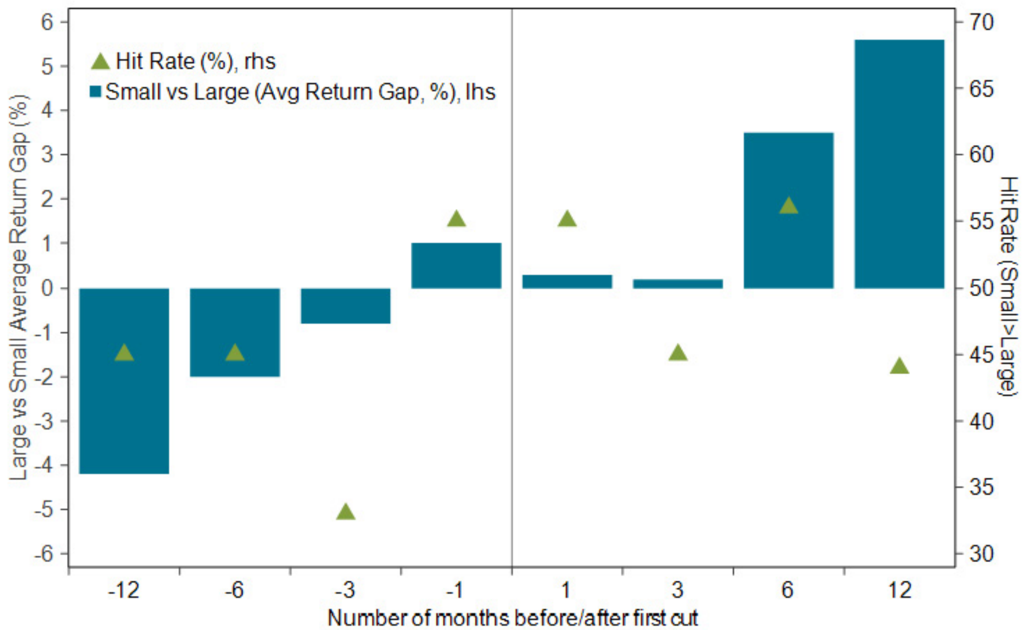
*S&P 500 market breadth based on 1-year gap between S&P 500 Equal Weighted vs Cap-Weighted Indexes
Sources: GW&K Investment Management, IMF, Bloomberg, and Macrobond

Periods of extremely narrow market advances have been consistently followed by improving market breadth and average small-cap outperformance of 6.5% per year over the next five years.

4. **Monetary Policy and Economic Recovery:** The Federal Reserve has recently dialed back its dovish stance, but potential rate cuts remain on the horizon for this year and next. Lower interest rates and accommodative monetary policy have historically been supportive of small cap stocks **(Figure 5)**. Additionally, as the economy rebounds from tight monetary policy, small caps are likely to benefit from the cyclical upturn, given their greater sensitivity to economic conditions compared to large caps.

FIGURE 5

Small Caps Relative Performance vs Large Caps Around the First Fed Rate Cut Since 1926



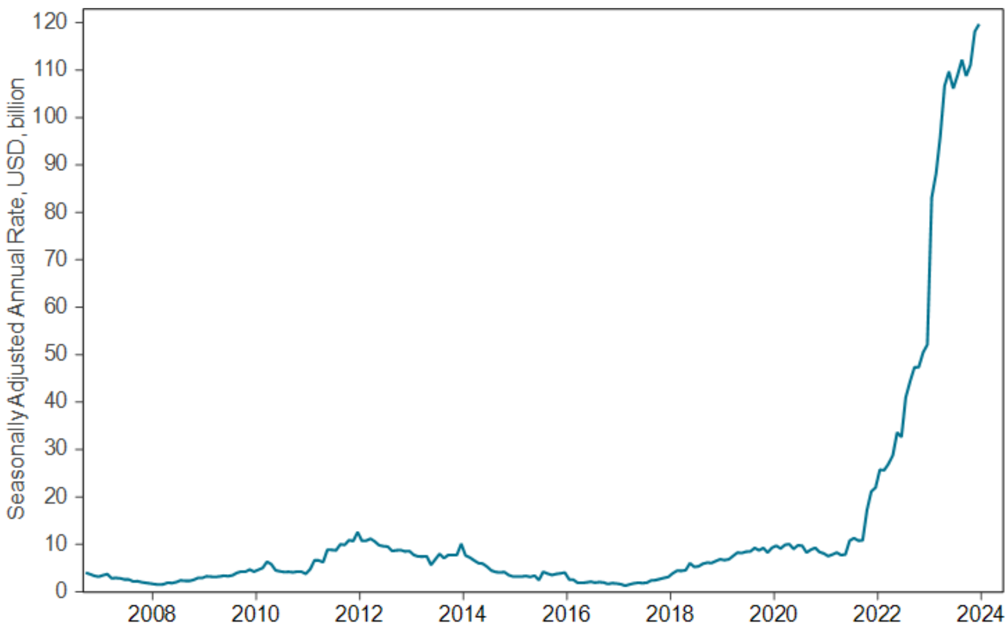
Sources: BofA US Equity & Quant Strategy, Dartmouth Data Library

Based on data going back to 1926, small caps have consistently outperformed large caps after the first Fed rate cut.

5. **Reshoring and Capex Beneficiaries:** The trend of reshoring, or bringing manufacturing back to the US, is expected to continue in the coming years **(Figure 6)**. Small cap companies, particularly those in the industrial and manufacturing sectors, stand to benefit from this shift. Moreover, the anticipated increase in capital spending as businesses invest in expansion and productivity enhancements could provide a boost to small cap earnings.

FIGURE 6

The Reshoring Boom: Fixed Investment in Computer/Electronic/Electrical Non-residential Manufacturing



Sources: GW&K Investment Management, US Census Bureau, and Macrobond

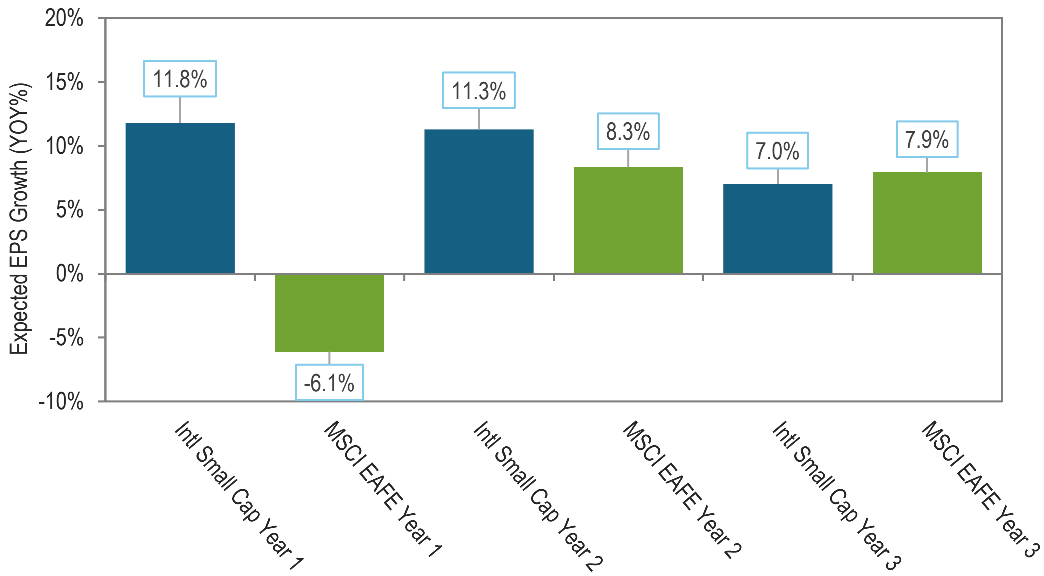
The reshoring boom is spurring growth in US capital spending which could benefit many small cap companies in the industrial sector.

INTERNATIONAL SMALL CAP ALSO DESERVES A LOOK

Many of the same factors that could favor US small caps could also help International small cap stocks outperform their large cap counterparts in the coming years. Bottom-up analyst earnings forecasts for international small cap stocks are less rosy than those for US small caps, but still anticipate faster earnings growth for small caps over the next three years than for large caps **(Figure 7)**.

FIGURE 7

Advantage, International Small Caps:
MSCI EAFE Small Cap vs EAFE Projected EPS Growth



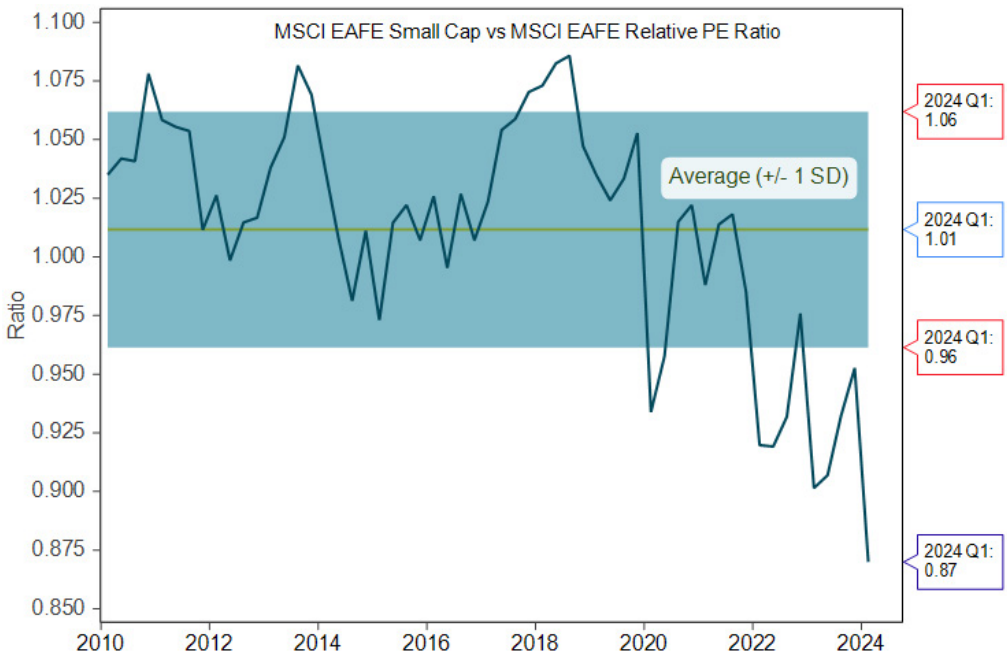
Note: Data based on Bloomberg's analyst surveys as of April 16, 2024
Sources:GW&K Investment Management, Bloomberg, and Macrobond

Bottom-up analysts expect earnings growth for the MSCI EAFE Small Cap Index to significantly outperform that of the MSCI EAFE Index over the next three years (33% vs 10% cumulatively).

Like their US counterparts, international small caps are also trading at a significant discount to large caps **(Figure 8)**. The implication is that international small caps may be underappreciated by the market, with multiple expansion a logical outcome if they proceed to post superior earnings compared to international large caps.

FIGURE 8

International Small Cap Valuations Are Attractive:
MSCI EAFE Small vs MSCI EAFE Relative P/E Ratio*



*Note: PEs based on Bloomberg's positive estimated P/E next year aggregate
Sources: GW&K Investment Management, Bloomberg, and Macrobond

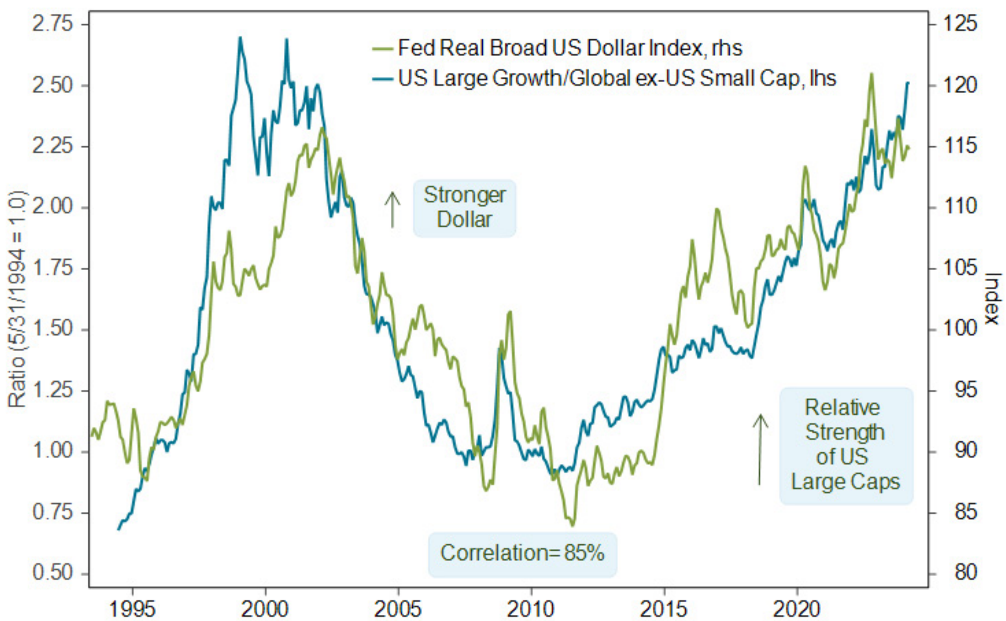
Focusing on profitable firms shows that the relative forward PE ratio of the MSCI EAFE Small Cap Index is trading at a 13% discount to the MSCI EAFE Index of large cap names.

One wild card that could boost the relative performance of international small caps is the value of the US dollar, which we recently argued is overvalued and ripe for a multi-year correction.[1] There has historically been a very strong correlation between dollar strength and outperformance of US large cap stocks relative to international small cap stocks **(Figure 9)**.

[1] See GW&K Global Perspectives, "Is the US Dollar Overvalued," February 2024, https://info.gwkinvest.com/insights/gwk-global-perspectives-is-the-us-dollar-overvalued

FIGURE 9

US Large Growth vs International Small Cap Is Highly Correlated with the Value of the US Dollar



Sources: GW&K Investment Management, MSCI, and Macrobond

A strong dollar tends to favor relative strength of US large caps versus international small caps — and vice versa. A multi-year correction in the value of the US dollar could benefit international small caps.

Simply by depressing the dollar value of non-US companies' earnings, the strong dollar over the past decade has disadvantaged international small cap stock performance. A reversal of that trend would tend to boost the dollar value of international small caps earnings, especially favoring non-US companies with domestic exposure whose profits are relatively immune to exchange rate fluctuations.

RISKS AND CONSIDERATIONS

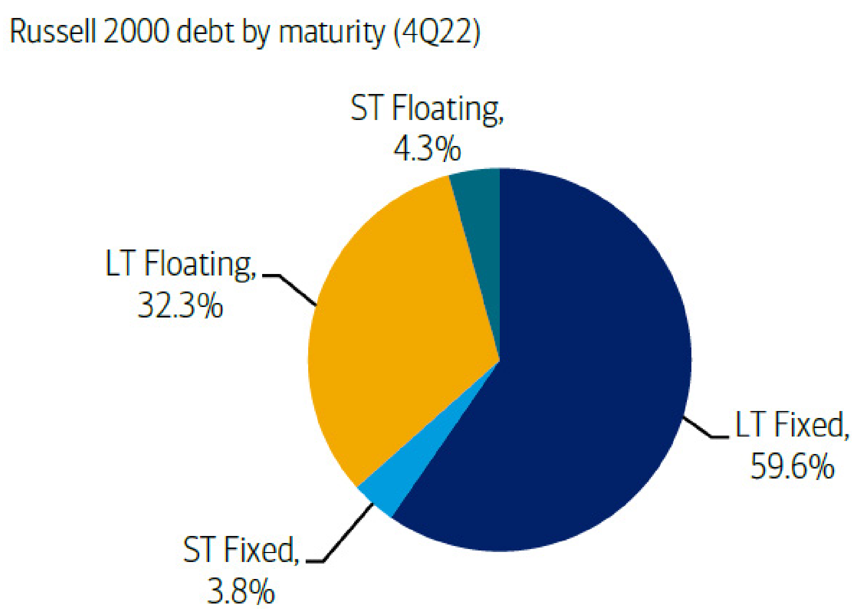
While the outlook for small caps is promising, investors must also be aware of potential risks. One key concern is the impact of rising interest rates on highly leveraged small cap companies. Those with significant debt burdens may face challenges in refinancing or servicing their obligations, which could weigh on their financial performance. Additionally, credit conditions and spreads bear monitoring, as any deterioration could disproportionately affect small caps.

Another risk factor to consider is the potential for increased volatility in the second half of 2024, given the uncertainty surrounding the US presidential election. Small caps have historically been more sensitive to market volatility, and the election outcome could have significant implications for various sectors and industries.

With both major candidates likely to support increased deficit spending, higher-for-longer interest rates could provide a headwind to US small caps, which have roughly 40% of their debt tied to short-term rates **(Figure 10)**. Non-US equities could face a headwind from potential large across-the-board tariff hikes proposed by Donald Trump. That said, the negative impact on non-US firms' export revenues will probably be greater for large cap export firms than for more domestically focused small caps.

FIGURE 10

40% of Russell 2000 Debt Is Tied to Short-Term Rates



Sources: Bloomberg, FactSet, BofA US Equity & US Quant Strategy

Small caps see the bulk of their debt maturing in the next five years and have greater exposure to short-term and floating-rate risk versus large caps.

NAVIGATING THE SMALL CAP LANDSCAPE

To capitalize on the small cap opportunity while mitigating risks, investors should focus on quality companies with strong fundamentals and sustainable growth prospects. Investors should also be selective in their sector allocation within small caps. Sectors such as industrials and consumer discretionary may be well-positioned to benefit from the economic recovery and reshoring trends. However, sectors with higher leverage and interest-rate sensitivity, such as financials and real estate, warrant caution.

CONCLUSION

The outlook for US small cap stocks looks increasingly constructive, supported by the prospect of robust earnings growth, attractive valuations, improving market breadth, and a favorable economic backdrop. While risks such as interest-rate concerns and election-related volatility persist, investors who are selective and focus on quality companies can potentially reap the rewards of small cap outperformance.

As the market enters a new phase of the cycle, small caps are poised to take a leading role. Investors who allocate strategically to this asset class may be well positioned to capitalize on the compelling opportunities that lie ahead.

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