Overweight Developed Markets ex US Small Caps vs Developed Markets ex US Equities

Recommended Since September 30, 2023

INVESTMENT THESIS: We expect developed markets (DM) ex US small-cap equities will outperform their mid- to large-cap counterparts, given their low relative valuations, strong earnings growth outlook, and still-weak performance momentum (despite the rally in 4Q 2023). DM ex US small caps perform best during economic upswings—with limited downside during recessions—making the current valuation discount particularly attractive.

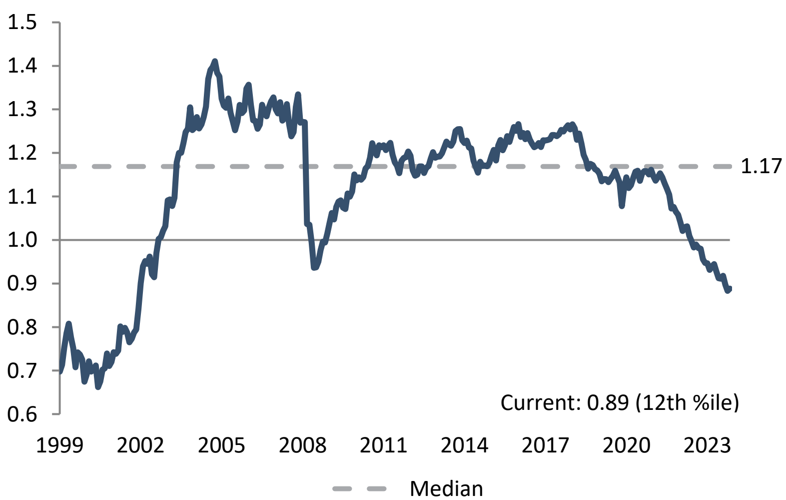
- **KEY SUPPORT #1:** DM ex US small-cap equities trade at enticing valuation levels relative to their mid- and large-cap peers. In fact, small caps trade at an 11% *discount*, according to our preferred normalized earnings multiple, compared to their typical 17% *premium.* On a forward-looking basis, when small-cap valuations were at a discount historically, they consistently outperformed over the subsequent three-year period. Small caps appear adequately priced for an economic downturn, and current levels support outperformance potential during a recovery in economic activity.

- **KEY SUPPORT #2:** The valuation backdrop and earnings growth outlook suggest that DM ex US small caps are primed for a rebound. Although performance was strong in 4Q 2023, upside potential for the trade remains. Analysts expect EPS growth of 14% in the next 12 months, compared to 6% for the mid- and large-cap universe. The expected earnings outperformance is broadly based across geographies and sectors. Small-cap price levels are now around 18% below their three-year peak, whereas large caps have rebounded more quickly (2% below peak). Taken together, we expect the recent performance gap to narrow.

- **KEY RISKS:** Relative to large caps, small caps have higher leverage, lower profitability, and are prone to larger drawdowns in a risk-off scenario. Real estate is the largest sector overweight and is concentrated in Japan. Easy monetary policy has protected performance, but any shift to tightening—such as the Bank of Japan's (BOJ) rate hike in March—could pose a headwind. Still, further monetary tightening by the BOJ is likely to be moderate and gradual.

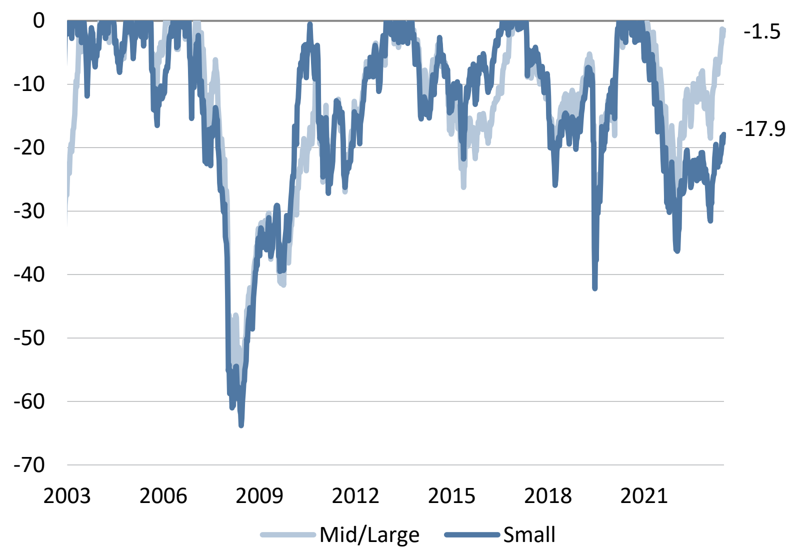
RELATIVE NORMALIZED VALUATIONS: DM EX US SC VS LARGE/MID CAP

May 31, 1999 – March 31, 2024



DRAWDOWN FROM ROLLING 3-YR HIGH: DM EX US EQUITY

January 1, 1993 – March 31, 2024 • US Dollars • Percent (%)



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Relative normalized P/E data are monthly and are based on an adjusted price-to-cash earnings ratio. The cyclically adjusted price-to–cash earnings (CAPCE) ratio is calculated by dividing the inflation-adjusted index price by trailing five-year average inflation–adjusted cash earnings. Cash earnings are defined as net income from continuing operations plus depreciation and amortization expense. MSCI does not publish cash earnings for banks and insurance companies and therefore excludes these two industry groups from index-level cash earnings. Drawdown data are weekly and based on index price levels.