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-/large-cap counterparts, given their low relative valuations, rebounding performance momentum, and favorable economic and earnings growth outlook. DM ex US small caps perform best during economic upswings, where non-US economic growth is expected to rebound in the coming years after slowing in 2024.

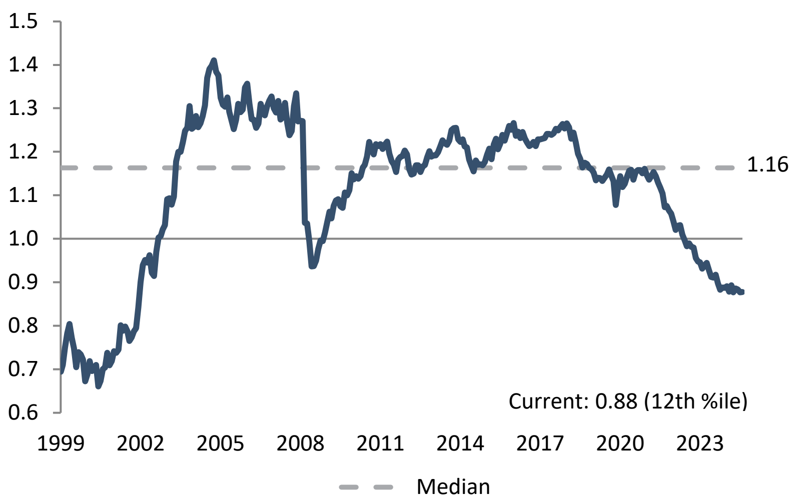
- **KEY SUPPORT #1:** DM ex US small-cap equities trade at a 12% *discount* to their mid-/large-cap peers, according to our preferred normalized earnings multiple, compared to their typical 16% *premium.* Historically, small caps consistently outperformed mid-/large caps over subsequent three-year periods when starting valuations traded at a discount. Small caps are more than adequately priced for an economic downturn scenario and now trade at cheaper relative valuations than during the Global Financial Crisis. These valuation levels are particularly attractive as they appear to be disconnected from underlying fundamentals.

- **KEY SUPPORT #2:** Rebounding momentum and an improving fundamental outlook suggest that DM ex US small caps are primed to outperform. Near-term momentum has improved at the margin but suggests further room to run. Indeed, small-cap price levels remain 13% below their three-year peak, whereas large caps recovered more quickly. Analysts expect EPS growth of 14% in the next 12 months, compared to 7% for the mid- and large-cap universe. The expected earnings outperformance is broadly based across geographies and sectors.

- **KEY RISKS:** Small caps have higher leverage, lower profitability, and are prone to larger drawdowns in a risk-off scenario. Indeed, small caps lagged during the August global equity sell-off, which was exacerbated by an unwind of extended short positioning against the Japanese yen. The currency had appreciated sharply due in part to Bank of Japan policy normalization, which is expected to continue in the coming months. Still, yen appreciation has been associated with small-cap outperformance due to pressure on large/mid-caps.

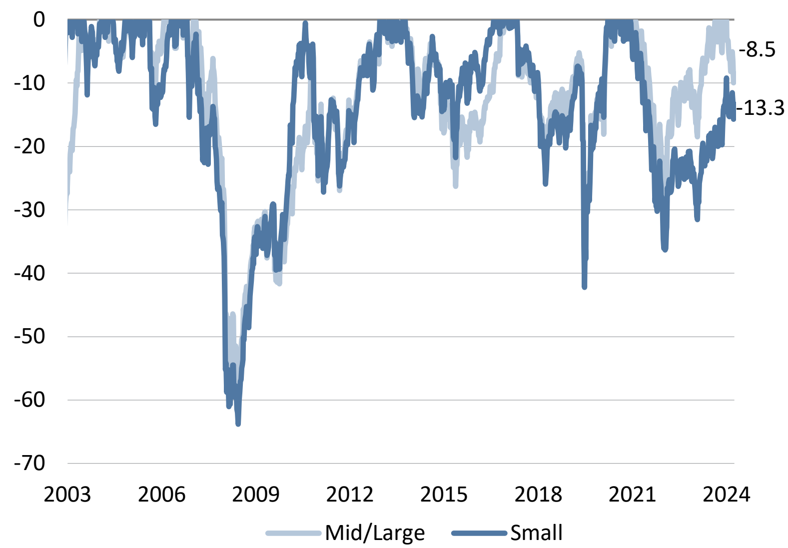
RELATIVE NORMALIZED VALUATIONS: DM EX US SC VS LARGE/MID CAP

May 31, 1999 – December 31, 2024



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

January 1, 1993 – December 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.