Overweight US Small-Cap Equities vs US Equities

Recommended Since April 30, 2022

INVESTMENT THESIS: We expect small-cap equities will outperform their mid- to large-cap counterparts in the United States given their historically large valuation discount. Profit growth has disappointed in recent years and hurt performance, yet this sets the stage for a strong expected rebound when the cycle turns. Downside risk exists for small-cap equities should growth slow due to tariffs. However, there could also be more upside for small companies from expected Fed cuts and for small-cap sectors like industrials if efforts to boost US manufacturing bear fruit.

- **KEY SUPPORT #1:** US small-cap valuations are steeply discounted relative to US mid- to large-cap equities. The S&P 600® Index trades at a 52% discount to the MSCI US Index's 23.8x normalized price-to-cash earnings multiple, a historical low dating back to 2004. Large-cap stocks also trade at higher forward price-to-earnings ratios than small caps. The 22.6x MSCI US Index forward P/E is 45% higher than that for small-cap stocks, whereas historically large caps have traded at a 10% discount.

- **KEY SUPPORT #2:** The S&P 600® Index represents a higher quality subset of smaller businesses that should weather an economic slowdown better than less profitable peers. These companies may also benefit from some of President Trump's initiatives, such as deregulation and tax cuts. Tariffs create concerns around margins for small-cap companies in sectors like consumer discretionary, but domestically centered companies in other sectors like financials may be more insulated. Some sectors (e.g., industrials) may benefit if demand rises for domestically produced goods.

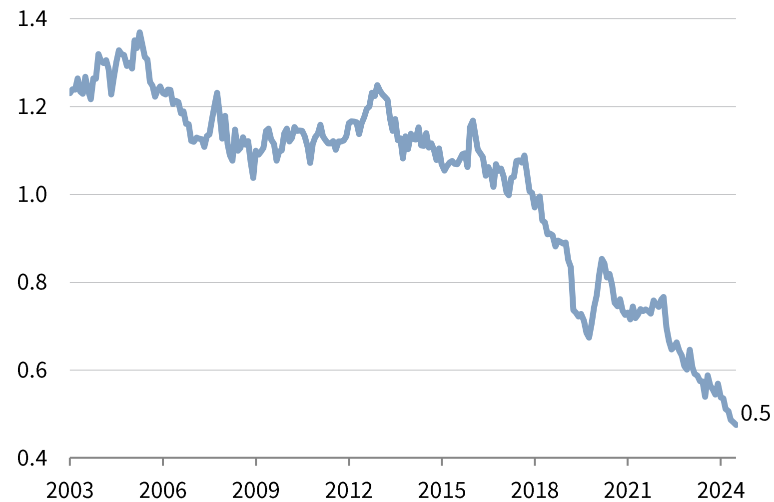
- **KEY RISKS:** Small-cap companies have lower margins, higher debt levels, and tend to be more cyclical than larger-cap stocks, making them more vulnerable to an economic slowdown. Ongoing demand for mega-cap tech stocks could weigh on relative small-cap performance. Recession concerns around tariff policy could also see a flight to higher quality, defensive large-cap stocks at the expense of small-cap peers, perpetuating the current valuation discount.

5-YR EXCESS RETURN S&P 600® VS MSCI USA

December 31, 2003 – June 30, 2025 • Rolling 5-Yr Relative AACR (%)

RELATIVE NORMALIZED P/E RATIO: S&P 600® VS MSCI USA

December 31, 2003 – June 30, 2025



Sources: FactSet Research Systems, MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Excess return data are daily. The cyclically adjusted price-to-cash earnings (CAPCE) ratio is calculated by dividing the inflation-adjusted index price by trailing ten-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. S&P does not calculate a cash earnings metric; cash flow is used as a proxy.