



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 and favorable fundamental outlook. DM ex US small caps perform best during economic upswings and appear well-priced for a recessionary scenario. Small caps have outperformed in 2025 as their domestic orientation has been in favor amid concerns over US tariff policy.

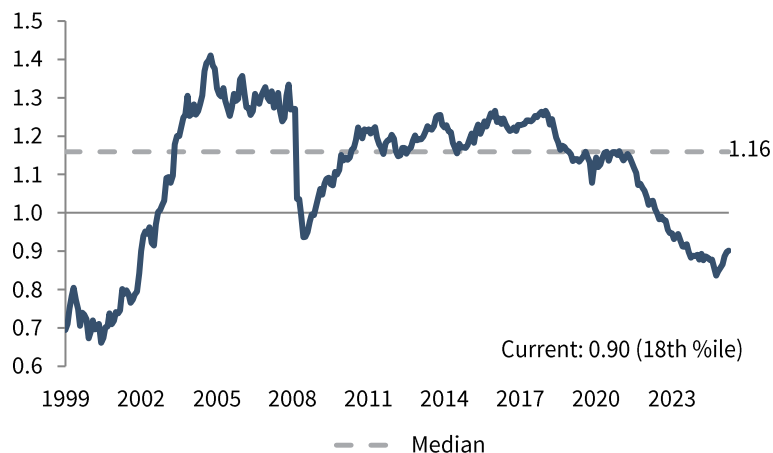
- **KEY SUPPORT #1:** DM ex US small-cap equities trade at a 10% *discount* to their mid-/large-cap peers, according to our preferred normalized earnings multiple, compared to their typical 16% *premium*. Small caps have consistently outperformed mid-/large caps over subsequent three-year periods when starting valuations traded at a discount. Small caps are adequately priced for an economic downturn scenario, which should limit downside risk and support outperformance on a subsequent economic rebound. While momentum has rebounded in 2025, upside potential remains, supported by the current economic environment.

- **KEY SUPPORT #2:** The fundamental outlook stands at odds with prevailing valuations. While US tariff policy has added uncertainty to the outlook, non-US economic growth is expected to rebound in the next several years after slowing in 2024, which should support small cap performance. Further, small caps are more domestically oriented than large caps, providing a buffer from trade disruptions. On earnings, analysts expect EPS growth of 13% 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:** Global economic uncertainty and GDP growth downgrades would likely weigh on small caps as they are cyclically oriented and have higher leverage, lower profitability, and are prone to larger drawdowns than mid-/large-cap peers. Small caps lagged during the August 2024 global equity sell-off, which was exacerbated by an unwind of short Japanese yen positioning. However, yen appreciation has typically been a headwind to large caps, supporting the trade's performance. Further Bank of Japan policy normalization would likely support the yen.

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

May 31, 1999 – August 31, 2025



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

January 1, 1993 – August 31, 2025 • US Dollars • Percent (%)

