Overweight US Small-Cap Equities/Underweight US Equities

Recommended since April 30, 2022

Investment thesis: We expect small-cap equities will outperform their large-cap counterparts in the United States given their historically large valuation discount. Profit growth has disappointed in recent years and hurt performance, but recent results and forecasts are encouraging. Downside risk exists for small-cap equities should growth disappoint, or inflation rise. However, as strong recent performance suggests, there could also be more upside for small companies from Fed easing and for sectors like industrials if efforts to boost US manufacturing bear fruit.

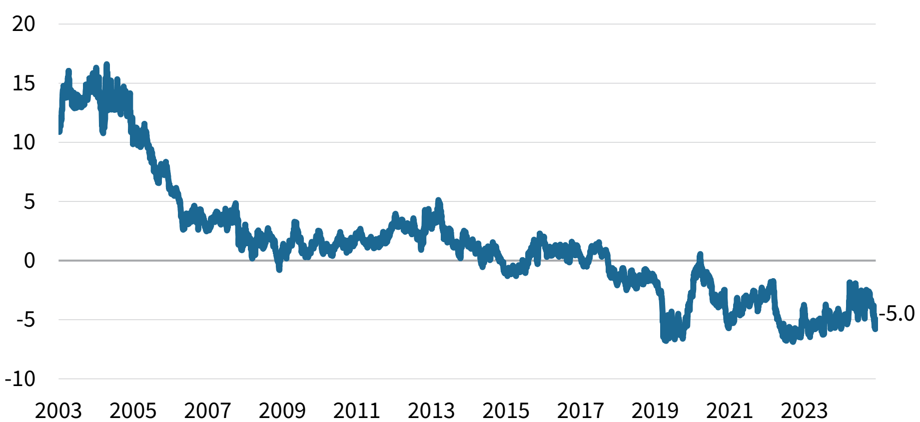
Key support 1: US small-cap valuations are steeply discounted relative to US mid- to large-cap equities. The S&P 600® Index trades at a 52% discount to the MSCI US Index using normalized price-to-cash earnings multiples, close to a historical low dating back to 2004. Small caps also trade at more than a 30% discount using forward P/E ratios whereas historically they have traded at close to an 11% premium.

Key support 2: Small-cap earnings have been weak in recent years, hurting relative performance, but pressure on margins from tight labor markets is fading. The S&P 600® Index posted healthy earnings growth in 3Q and 2026 expected growth of 16% may exceed that of the S&P 500 Index. Tariffs are a headwind for certain small-cap sectors, but Fed easing should be an offset.

Key risks: Small-cap companies have lower margins and higher debt levels than larger-cap stocks, making them more vulnerable to an economic slowdown. Strong earnings growth may continue to underpin performance of mega-cap tech stocks and impact relative small-cap performance. Persistent inflationary pressures could slow Fed easing and spur renewed concern about debt affordability. Geopolitics could underpin demand for higher quality large-cap stocks at the expense of small-cap peers, perpetuating the current valuation discount.

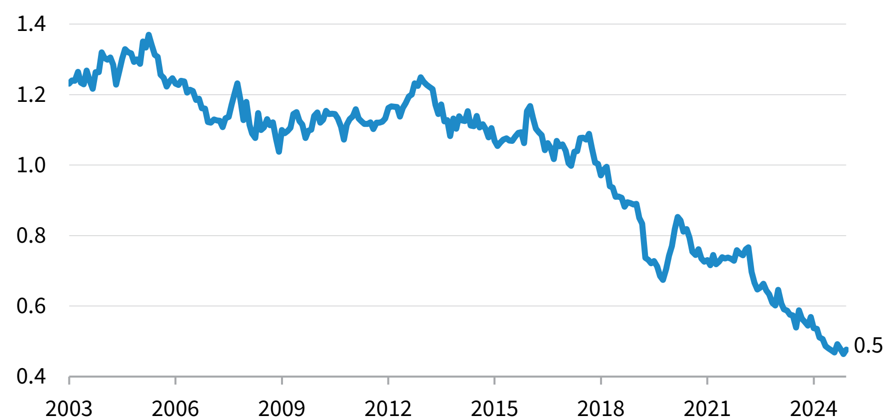
5-yr excess return S&P 600® vs MSCI US

December 31, 2003 – November 30, 2025 • Rolling 5-yr relative AACR (%)



Relative normalized P/E ratio: S&P 600® vs MSCI US

December 31, 2003 – November 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.