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. Weak earnings growth in recent years had weighed on performance, but small caps have outperformed large-cap peers since second half 2025 as earnings have rebounded. Downside risk exists for small-cap equities should earnings disappoint or geopolitical stress rise. However, as 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.

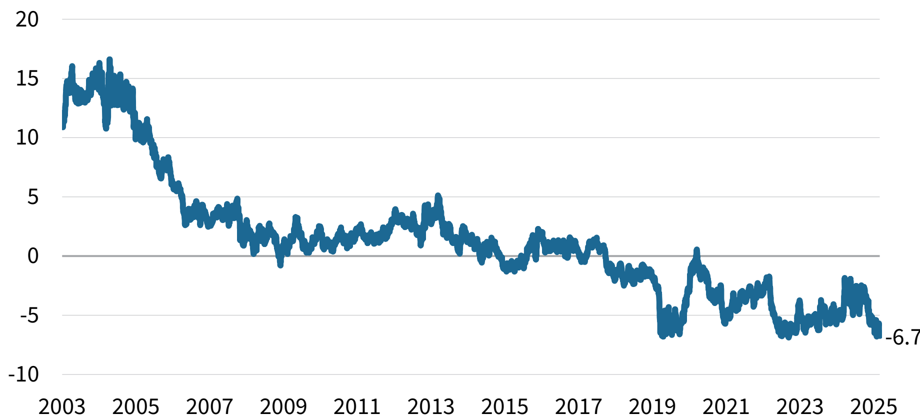
Key support 1: US small-cap valuations are steeply discounted relative to US mid- to large-cap equities. The S&P 600® Index trades near a 50% discount to the MSCI US Index using normalized price-to-cash earnings multiples. Small caps also trade near a 25% discount using forward P/E ratios whereas historically they traded at a premium.

Key support 2: Small-cap earnings have been weak in recent years, hurting relative performance, but are rebounding off a low base. The S&P 600® Index saw earnings grow 9% in 2025 and forecasted full-year 2026 growth (about 13%) is even higher though trails that for 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. Persistent inflationary pressures could slow Fed easing and spur renewed concern about debt affordability. Geopolitical shocks—such as the current Iran War—could both spur inflation (and thus slow Fed easing) as well as boost demand for higher quality large-cap stocks at the expense of small-cap peers, perpetuating the current valuation discount.

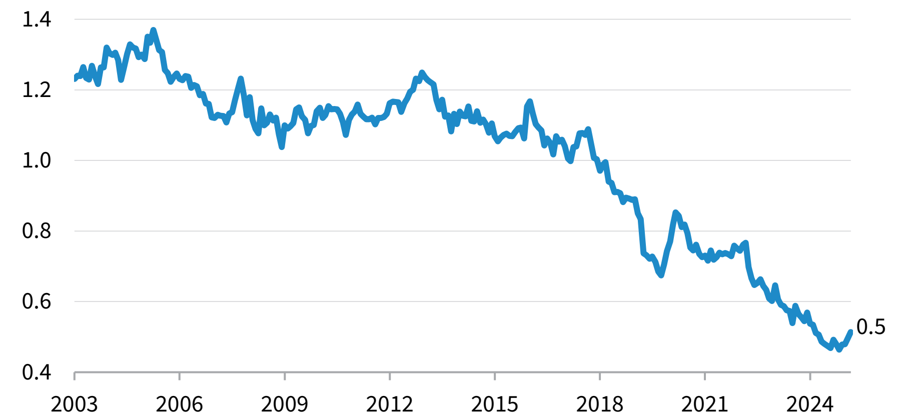
5-yr excess return S&P 600® vs MSCI US

December 31, 2003 – February 28, 2026 • Rolling 5-yr relative AACR (%)



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

December 31, 2003 – February 28, 2026



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.

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