Overweight Developed Markets ex US Small Caps/Underweight 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. As a result, they have recently underperformed amid a supply side–driven rise in energy prices and interest rates, after outperforming in 2025 and early 2026 due to their domestic orientation during concerns over US tariff policy.

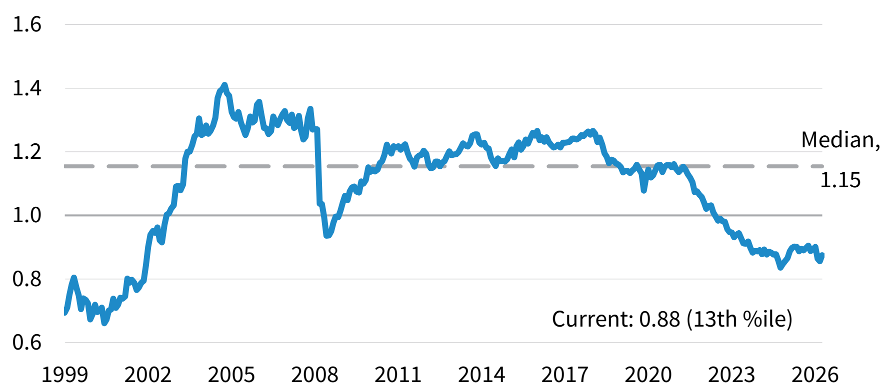
Key support 1: DM ex US small-cap equities trade at a 12% discount to their mid-/large-cap peers, according to our preferred normalized earnings multiple, compared to their typical 15% premium. Small caps have consistently outperformed mid-/large caps over subsequent three-year periods when starting valuations traded at a discount. The more modest valuation profile of small caps should limit downside risk were a slowdown to eventuate and support outperformance on a subsequent economic rebound. The recent reversal in momentum suggests positioning should not be a headwind to further appreciation.

Key support 2: The fundamental outlook should support performance. While US tariff policy and the Iran War have increased uncertainty, non-US economic growth is expected to rebound in the coming years, which typically supports small caps. Further, small caps are more domestically oriented than large caps, providing a buffer from further trade disruptions. On earnings, analysts expect EPS growth of 19% in the next 12 months, compared to about 12% 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, given they are cyclically oriented and have higher leverage, lower profitability, and usually underperform during broader equity market drawdowns. Beyond a cyclical slowdown, an exogenous shock, such as a protracted war in Iran, would also likely be a headwind. Alongside growth downgrades, the inflationary impact of energy price increases and currency drag from lower USD revenue exposure would weigh on relative performance, though a large materials overweight may provide mitigation.

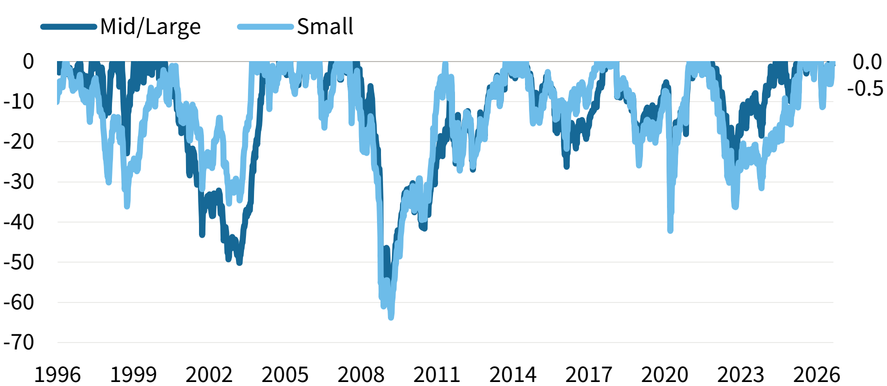
Relative normalized valuations: DM ex US small vs large/mid cap

May 31, 1999 – August 31, 2026



Drawdown from rolling 3-yr high: DM ex US equity

January 1, 1993 – August 31, 2026 • 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.