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 interest rates rise. However, as recent performance suggests, there could also be more upside for small caps as investors seek to diversify portfolios away from heavily concentrated large-cap indexes.

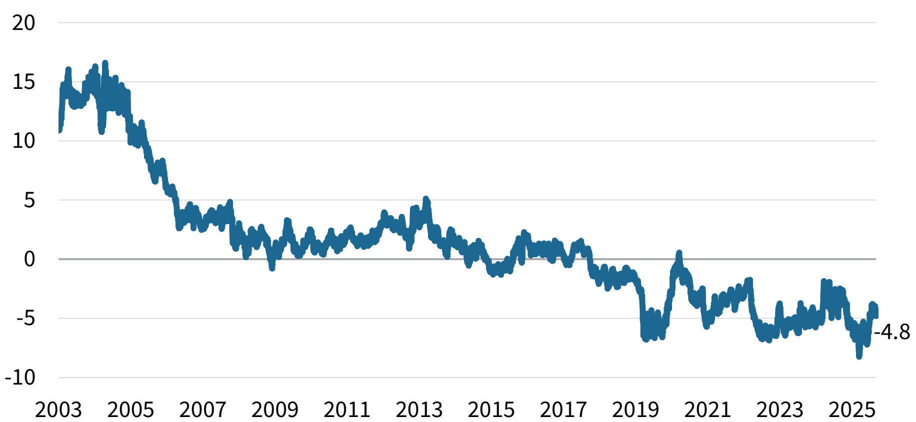
Key support 1: US small-cap valuations are steeply discounted relative to US large-cap equities. The S&P 600® Index trades near a 50% discount to the MSCI US Index using normalized price-to-cash earnings multiples. Small caps also trade at more than a 20% discount using forward P/E ratios whereas historically they traded at a premium.

Key support 2: Small-cap earnings have been weak in recent years, hurting relative performance, but are rebounding. Forecasted full-year 2026 earnings growth for the S&P 600® Index is around 19% and should see similar profit growth next year.

Key risks: Small-cap companies have lower margins and higher debt levels than larger-cap stocks. This makes them more vulnerable both to economic slowdowns, as well as inflationary pressures, which could cause the Federal Reserve to hike rates and raise borrowing costs. Large-cap stocks, while more expensive, have higher weightings to technology companies benefiting from the AI-investment boom, which in turn has generated stronger earnings growth and could continue to underpin investor demand.

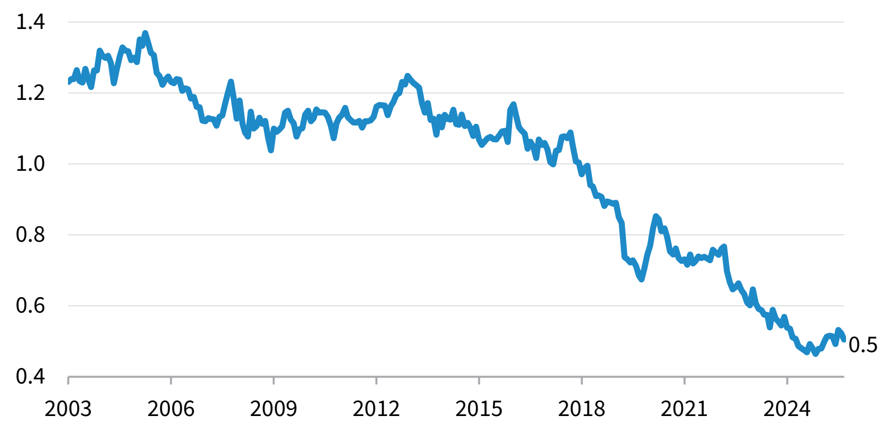
5-yr excess return S&P 600® vs MSCI US

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



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

December 31, 2003 – August 31, 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.