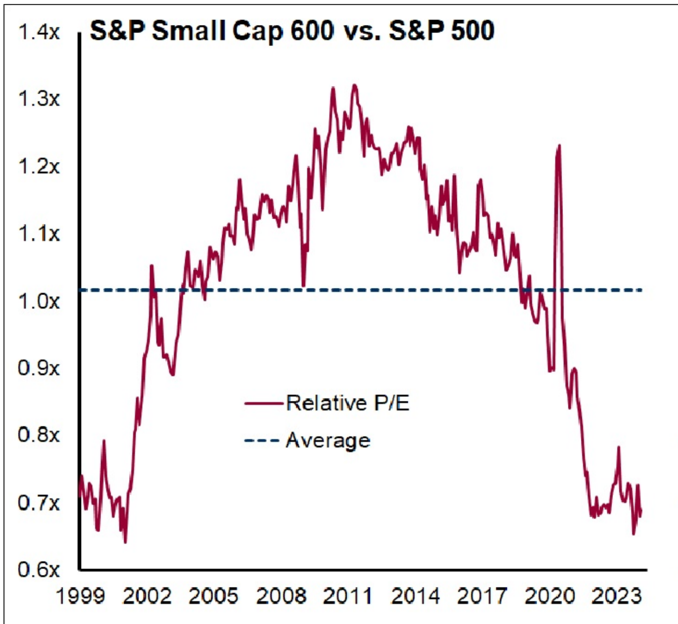

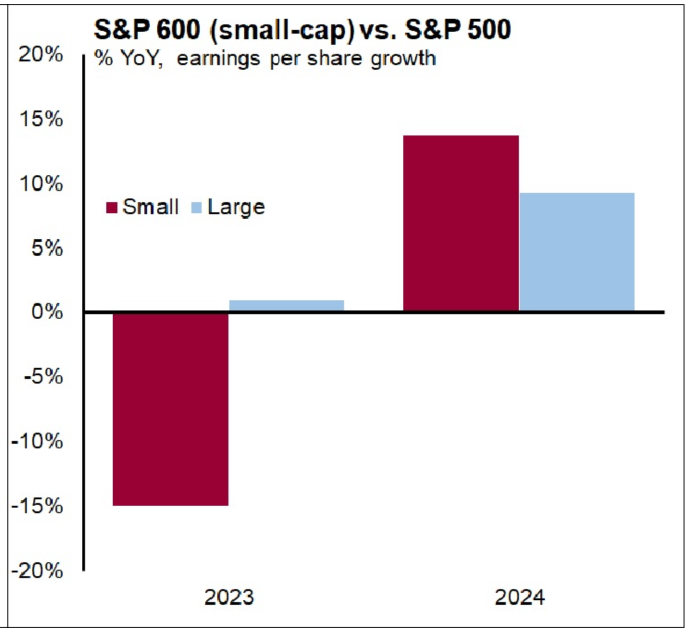

Over the past three years, the Russell 2000 has underperformed the S&P 500 by 45%. Looking ahead, we believe there are multiple factors that support a catch-up in small-caps. (UBS)

Mighty potential among small companies

22 March 2024, 1:51 pm CET, written by UBS Editorial Team

Within US equities, CIO is most preferred small-caps relative to large-caps. In this note, we explain why small-caps have lagged large-caps in recent years, and reiterate why we believe this trend could reverse in the coming months.

What has caused small-cap underperformance?

Over the past three years, the Russell 2000 has underperformed the S&P 500 by 45%. In our view, this relative weakness can be attributed to a few factors:

First of all, the significant rally we've seen in large companies has not been corresponded by small-cap firms. Note that the upward trend in the S&P 500 has been partly due to idiosyncratic factors involving the power of mega-cap companies (e.g., the Magnificent 7), which have been net beneficiaries of the post-pandemic world and also have significant exposure to a unique source of wealth creation—AI. This has powered a surge in profits for the mega-caps that small-caps have not been able to match. In addition, the explosive growth in mega-cap earnings has driven an equally impressive increase in valuations that makes small-cap valuations look very cheap on a relative basis.

Furthermore, small-caps have been disproportionately punished by the Federal Reserve's aggressive path of rate hikes, which has constrained access to capital and increased financing costs.

What do we see going forward?

Looking ahead, we believe there are multiple factors that support a catch-up in small-caps:

To start, small-caps now look quite inexpensive relative to large companies. As a reference, small-caps now trade at a 30% relative P/E discount versus large-caps, while the longer-term average is closer to equilibrium. Thus, we believe the risk-reward is biased to the upside.

Additionally, as the beginning of the Fed easing cycle approaches (CIO expects the first 25bps cut in June) and access to capital continues to improve, the balance sheet and profitability outlook for small-caps should benefit. In fact, bottom-up consensus estimates suggest that small-caps will have stronger earnings per share (EPS) growth this year than large-caps (see chart above in the right). We believe this backdrop will likely be conducive to a rise in small-cap valuations, particularly in the second half of the year, when we see economic growth potentially showing a more resilient trend.

Please see US equity and style, published on 21 March, 2024.

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