Despite recent underperformance, CIO sees a number of catalysts on the horizon to finally unlock very attractive small-cap valuations. (UBS)

Small-caps & rates—breaking up is hard to do

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After showing some signs of life at the end of last year, small-cap stocks have mostly drifted sideways over the last several weeks. As a result, the Russell 2000 has not kept pace with the strong performance of the S&P 500 to start the year.

Year-to-date the S&P 500 is up 5% while the Russell 2000 is down 1%. Is this going to be another year of small-cap underperformance? We don’t think so.

Recently, the relative performance of small-caps has been unusually, strongly negatively correlated with interest rates (i.e. when rates go up, small-caps underperform large-caps). This is the highest negative correlation between interest rates and small-caps since the launch of the Russell indices in 1979. So the rise in interest rates since the start of the year has probably been one of the main drivers of recent small-cap underperformance.

What also stands out from the chart is that periods of negative correlation tend to be short-lived. We don’t see why this time would be any different. But even if this correlation remains intact, our fixed income team’s outlook for the 10-year Treasury yield to fall to 3.5% by the end of the year should be supportive for small-cap outperformance in the months ahead. Furthermore, the chart shows that it's more common for small-caps to *outperform* when rates are rising (the blue line is usually above 0). Why? If rates are rising, because growth is solid, that should be favorable for small-caps. Perhaps the recent rise in rates hasn't led to small-cap outperformance because the pickup in earnings growth has not yet convincingly come through.

More fundamentally, we think there are a number of catalysts that should benefit small-caps. Most importantly, we expect earnings growth to improve as the year progresses. After a 13% decline in EPS for the small-cap index in 2023, consensus expectations are for 14% growth this year. This makes sense. We expect large-cap earnings growth to pickup in 2024 and

small-cap profit trends are usually closely correlated with large-caps. In fact, small-caps should produce faster earnings growth relative to large-caps. The recent improvement in bank lending standards gives us more confidence in this view.

Small-caps also tend to outperform when the ISM Manufacturing index—a gauge of business sentiment—is rising. The ISM index is off its lows and leading components within the index are signaling more gains ahead. In addition, the prospect for Fed rate cuts should help reduce funding costs, especially considering that small-caps have a heavy reliance on shorter-term floating rate debt.

So, despite recent underperformance, we see a number of catalysts on the horizon to finally unlock very attractive small-cap valuations. And maybe small-caps will be able to break their tether to interest rates.

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