Small Caps Can Be an Inexpensive Way to Gain Exposure to the US Economy

Multiple favorable trends may explain why Wall Street expects to see the strongest earnings gains come from small caps in 2025.

Insight from sub-adviser Schroders Investment Management

Bob Kaynor, CFA
Head of US Small & Midcap Equities

The US economy emerged from the pandemic with greater strength than most other economies around the globe. That rebound was fueled, in part, by the fiscal stimulus the Biden administration promoted with two major pieces of legislation—the CHIPS (Creating Helpful Incentives to Produce Semiconductors) and Science Act and the Inflation Reduction Act. The US consumer, however, has once again demonstrated a propensity to drive the economy. With a strong labor market and likely policies from the upcoming Trump administration that may support domestic growth, indications suggest investing in the US economy could remain beneficial. However, US equities are expensive, and investors could assume the market has already priced in this growth. The latter point may be true of large-cap US equities, but not most other US companies.

We remain confident that US exceptionalism will continue to reign in 2025, and, for investors, we believe US small- and mid-cap stocks could offer a relatively inexpensive way to participate in the US economy.

Key Points

- Small- and mid-cap stocks may continue to benefit from strong consumer spending and supportive fiscal policies.
- Key trends such as a rebound in mergers and acquisition activity, favorable inflation rates, and increased capital expenditures may create a favorable environment.
- Wall Street forecasts a significant rebound in small-cap earnings starting in the final quarter of 2024, driven by stabilizing interest rates and improving economic conditions.

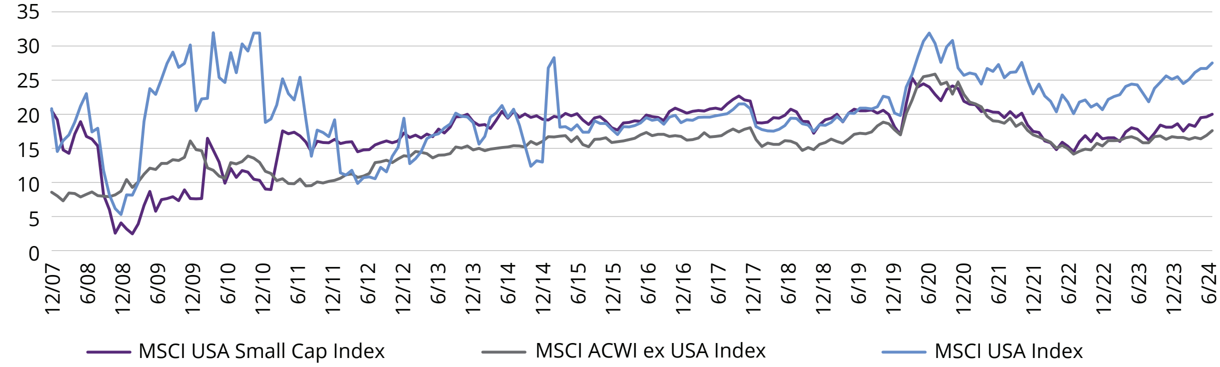
An Inexpensive Way to Gain Exposure to US Economic Strength

Many US large-cap companies compete on the global stage, and their revenues are, therefore, more dependent on the global economy. Small- and mid-cap companies are more likely to have customer bases that are either exclusively or predominantly in the US. For that reason, small- and mid-cap stocks can provide investors with more direct exposure to the US economy. Given how expensive large caps are today, small- and mid-cap stocks can also provide a less expensive way to gain that exposure. As **FIGURE 1** shows, the price differential between small and large caps demonstrates that gaining or increasing exposure to the strong US economy doesn't have to come with a hefty price tag.

FIGURE 1

Small and Mid Caps Remain Cheap Relative to Large Caps

Price-to-Earnings



As of 8/31/24. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. The price-to-earnings ratio measures a company's share price relative to its earnings-per-share and helps assess the relative value of a company's stock. See page 6 for index definitions. Data Sources: Schroders and FactSet.

Key Trends Could Benefit Small- and Mid-Cap Stocks

It's true that small- and mid-cap valuations have been at a discount to large caps for several years. So, what's changing as we head into 2025? Beyond the ongoing strength of the US economy and the pricing considerations, a number of key trends could also work together to create a highly favorable environment for small- and mid-cap stocks.

1. The recovery in M&A activity and IPOs could continue in 2025.

In 2022 and 2023, concerns about a recession, high company valuations, and soaring inflation significantly slowed mergers and acquisitions (M&A) activity and initial public offerings (IPOs). Globally, 2023 was the second-worst year for M&As in a decade.[1] A strong comeback, fostered by less expensive valuations, began in 2024. M&A activity in North America through the first three quarters of 2024, for example, almost surpassed the deal value for all of 2023, and it's on pace to stage a 30% rebound for the year.[2] Stabilizing interest rates and improving economic conditions could fuel an even stronger rebound for M&As and IPOs in 2025.

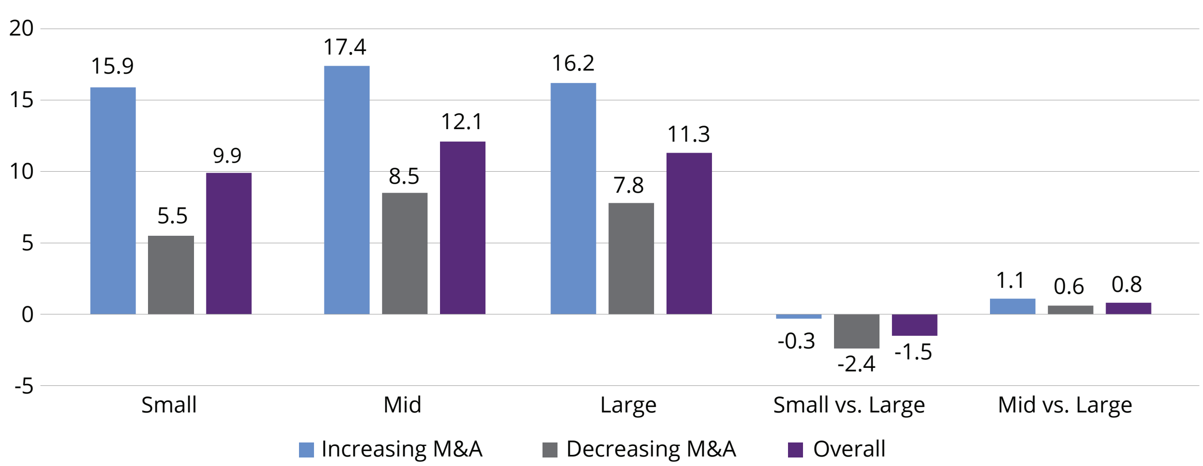
The pickup in M&A activity and IPOs benefits small-cap stocks in multiple ways. Attractive small caps often become acquisition targets, and high-quality companies garnering headlines as they go public increases interest in the small-cap space. Overall, the pick-up in animal spirits demonstrated by greater M&A activity and IPOs delivers the optimism that increases risk appetites, and the confidence investors may need to pursue the potentially stronger growth small caps may deliver.

While a rise in IPOs increases the number of small-cap companies, active managers still must be selective. With newly public companies, in particular, careful consideration is required by those managers who participate in IPOs. While IPOs are renowned for historically delivering initial outperformance, selectivity is still needed to find the companies that can deliver on that promise.

History demonstrates that periods of increasing M&A activity have delivered strong performance for stocks across the capitalization spectrum (**FIGURE 2**). The gains registered by small caps during these periods have been on pace with the returns generated by large caps, and mid caps have outpaced both.

" Stabilizing interest rates and improving economic conditions could fuel an even stronger rebound for M&As and IPOs in 2025.

FIGURE 2
Periods of Rising M&A Activity Have Historically Delivered Strong Equity Returns



Past performance does not guarantee future results. Investors cannot directly invest in indices. Small caps are represented by the Russell 2000 Index. Mid caps are represented by the Russell Midcap Index. Large caps are represented by the Russell 1000 Index. See page 6 for index definitions. Data Source: Schroders.

2. **Inflation is now in a range that has been favorable for small caps.**
While small caps have historically outperformed their large-cap brethren in periods when annual inflation has exceeded 1%, the higher interest rates that come when central banks try to reduce high inflation can be challenging for small companies. Much of their debt is financed with shorter-term and floating-rate instruments.[3] As a result, financing became much more expensive for the small caps when the Federal Reserve (Fed) began hiking rates in early 2022.

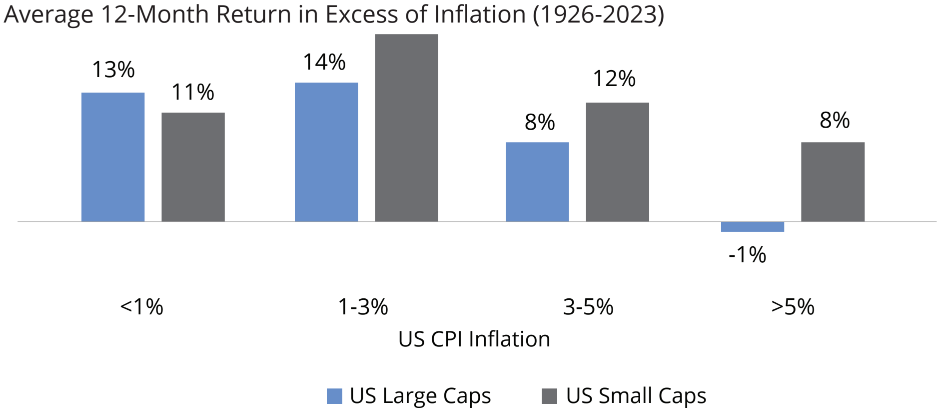
With the declining rate environment that began in the fall of 2024 and is expected to continue through 2025, conditions may now be more favorable. The small-cap companies' debt may become less expensive. Further, the macroeconomic conditions that enabled the Fed to reduce rates—slowing inflation and below-trend growth—have historically been a climate in which small caps can outperform other asset classes, including large-cap stocks, bonds and commodities. With a century of history as evidence, the range that inflation seems to have now settled into (1% to 3%) is one that has historically enabled small caps to deliver exceptional returns (**FIGURE 3**).

> “With the declining rate environment that is expected to continue through 2025, conditions may now be more favorable for small caps.

FIGURE 3

Average Small-Cap Returns Have Been Particularly Strong When Inflation Has Been 1%-3%

Average 12-Month Return in Excess of Inflation (1926-2023)



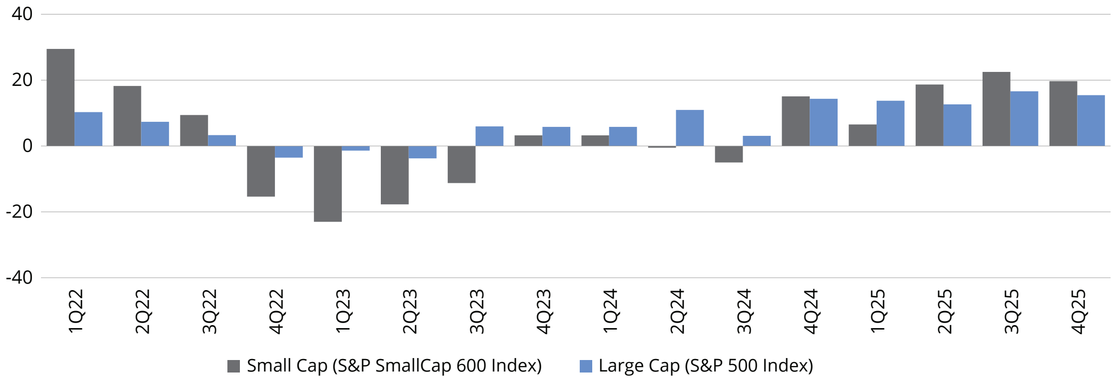
As of 12/31/23. **Past performance does not guarantee future results.** Investors cannot directly invest in indices. Based on rolling 12-month periods. The Consumer Price Index (CPI) is a measure of change in consumer prices as determined by the US Bureau of Labor Statistics. US large caps is represented by Ibbotson SBBI US Large-Cap Stocks Index, which tracks the performance of large-cap stocks in the US market. US small caps is represented by Ibbotson SBBI US Small-Cap Stocks Index, which tracks the performance of small-cap stocks in the US market.
Data Sources: Schroders.

3. **Wall Street is forecasting a bigger rebound in small-cap earnings, starting in Q4 2024 and through much of 2025.**
The developments that made 2023 such a difficult year for small caps (i.e., rate hikes and the ripple effects of the collapse of Silicon Valley Bank) may now be in the rearview mirror. The favorable conditions noted here may explain why a consensus of Wall Street analysts believe that in the fourth quarter of 2024 and for every quarter of 2025 except the first, the rebound in earnings for small caps will exceed the bounce experienced by large caps (**FIGURE 4**).

FIGURE 4

Wall Street Forecasts a Bigger Increase in Earnings for Small Caps

Year-Over-Year Earnings-Per-Share Growth Estimates



FactSet research through 12/31/24; custom earnings-per-share from Q1 2024 forward. Earnings-per-share growth is the projected growth rate in earnings per share for the next five years. See page 6 for index definitions. For illustrative purposes only. Data Sources: FactSet and Schroders.

4. **While the megacap tech stocks have been dominating the AI headlines, we believe many small-cap companies could help propel the AI revolution.**
   Artificial intelligence (AI) needs much more than the sophisticated chips provided by companies like NVIDIA. For example, thermal management solutions are critical to manage the extreme heat generated by those AI chips. Optical communications will provide the high bandwidth, low latency, and large data capabilities that are necessary to support the massive data-processing demands of AI applications. Data storage and management, software development, and cybersecurity are all equally critical. Small-cap companies are often key, and even leading, players in these industries that will both shape and benefit from the growth that the AI revolution generates.
5. **The continued growth of the service sector helps small and mid caps, which operate predominately in this space.**
   While US manufacturing has experienced a rebirth in recent years, helped by federal legislation, the US is primarily a service-oriented economy. In the second-quarter of 2024, private services-producing industries represented 72% of the US GDP.[4] The decades-long shift that started to take a dramatic turn in 1977—when services still accounted for only 54.7% of US GDP—continues to reshape the US economy.[5] While large-cap companies dominate the manufacturing and consumer goods sectors, small-cap companies are often key players in service sectors, so they are among the beneficiaries of this shift.
6. **Reshoring enables more small- and mid-cap companies to step in as reliable suppliers.**
   COVID-19 and the lockdowns at Chinese manufacturers and other suppliers led many companies to reconsider their supply chains. The move to onshoring benefits many small US companies that are replacing global competitors as the suppliers to large US firms.
7. **Small- and mid-cap companies may be prime beneficiaries of the increases in capital expenditures.**
   Capital expenditures (capex) have been increasing for a number of reasons, including the shift to automation, as companies look to lower costs and stay competitive, and the financial support the government is providing key sectors like the semiconductor industry and renewable energy sector through the CHIPS Act and the Inflation Reduction Act. Historically, capex has been highly correlated with small caps' revenue, and the increases may portend growth.

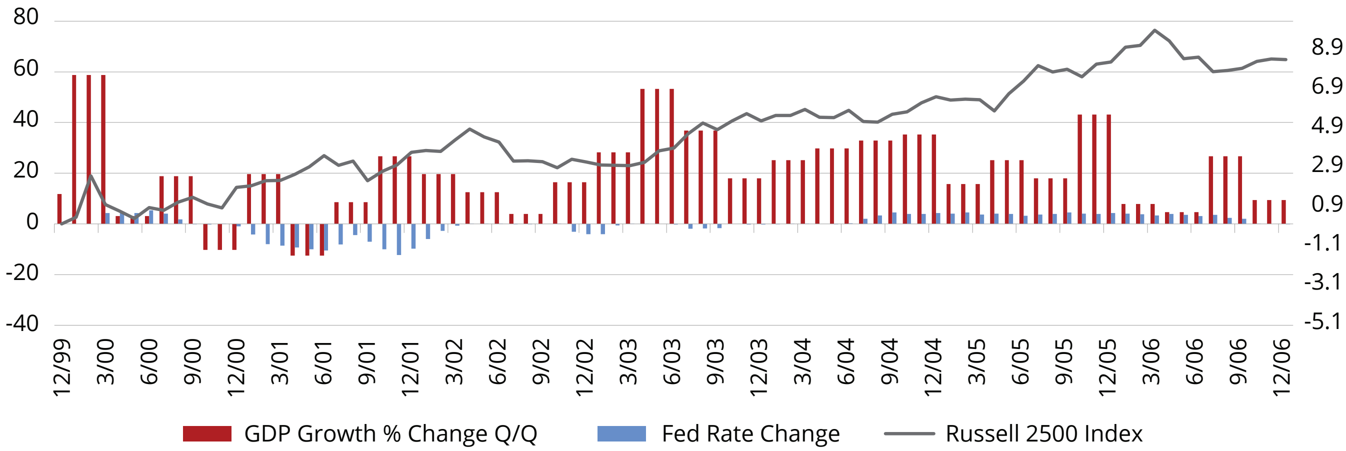
“Small-cap companies are often key, and even leading, players in these industries that will both shape and benefit from the growth that the AI revolution generates.

The Market Does Rotate Eventually

Large caps have been on such an extended run since the end of the Global Financial Crisis that it can be easy to forget that the market does rotate. Small caps registered their own run of outperformance from 2000 to 2006, a period that demonstrated their ability to deliver exceptional returns through changing GDP conditions and federal funds regimes, as **FIGURE 5** illustrates. It's a worthwhile reminder that an extended run of outperformance has never represented a permanent change of conditions.

FIGURE 5

Small Caps Have Demonstrated Their Ability to Outperform in a Variety of Growth and Rate Regimes (1999-2006)



Past performance does not guarantee future results. Russell 2500 Index is used to represent small- and mid-cap stocks, and represents total return relative to the S&P 500 Index. See page 6 for index definitions. Indices are unmanaged and not available for direct investment. Data Sources: Schroders.

Favorable Conditions for Small Caps Amid Signs That the Market Is Already Broadening

The large vs. small caps debate that has played out recently has been complicated by the fact that it was really just the Magnificent Seven[6] stocks propelling the market to greater heights in the aftermath of the pandemic. Signs that the market was broadening beyond the Magnificent Seven appeared in 2024. That broadening benefits not only the other constituents of the S&P 500 Index, but also small- and mid-cap stocks. Without the benefits of a crystal ball that might reveal when the inevitable market rotation from large- to small-cap stocks might begin, there are still plenty of signs that suggest small- and mid-cap stocks may warrant investors to consider a reasonable allocation in investors' portfolios in 2025 and beyond.

To learn more about opportunities in small and mid caps, talk to your financial professional.

MSCI ACWI ex USA Index is a broad-based, unmanaged, market capitalization weighted, total return index that measures the performance of both developed and emerging stock markets, excluding the U.S. MSCI index performance is shown net of dividend withholding tax.

MSCI USA Index is a free float-adjusted market capitalization index that is designed to measure the performance of the large and mid-cap segments of the US market.

MSCI USA Small Cap Index is designed to measure the performance of the small-cap segment of the US equity market.

Russell 1000 Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

Russell 2000 Index measures the performance of the small-cap segment of the US equity universe.

Russell 2500 Index measures the performance of the small to mid-cap segment of the US equity universe, commonly referred to as "smid" cap.

Russell MidCap Index measures the performance of the mid-cap segment of the US equity universe.

S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

S&P 600 Index is a market capitalization-weighted price index that tracks the performance of small-cap stocks in the US. It includes companies with market capitalizations ranging from approximately $850 million to $3.7 billion.

[1] PitchBook, "2023 Annual Global M&A Report," 1/23/24.

[2] PitchBook, "Q3 2024 Global M&A Report," 10/23/24.

[3] A floating rate instrument is a debt instrument that has a variable interest rate that is based on a benchmark rate

[4] Federal Reserve Bank of St. Louis, reporting data from the US Bureau of Economic Analysis, "Value added by Industry: Private Services-Producing Industries as a Percentage of GDP," 9/26/24.

[5] Bureau of Economic Analysis, Gross Domestic Product by Industry for 1947-1986: New Estimates Based on the North American Industry Classification System," December 2005.

[6] The Magnificent Seven stocks are a group of high-performing and influential companies in the US stock market: Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla.

Important Risks: Investing involves risk, including the possible loss of principal. • Small- and mid-cap securities can have greater risks and volatility than large-cap securities.