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December 2024

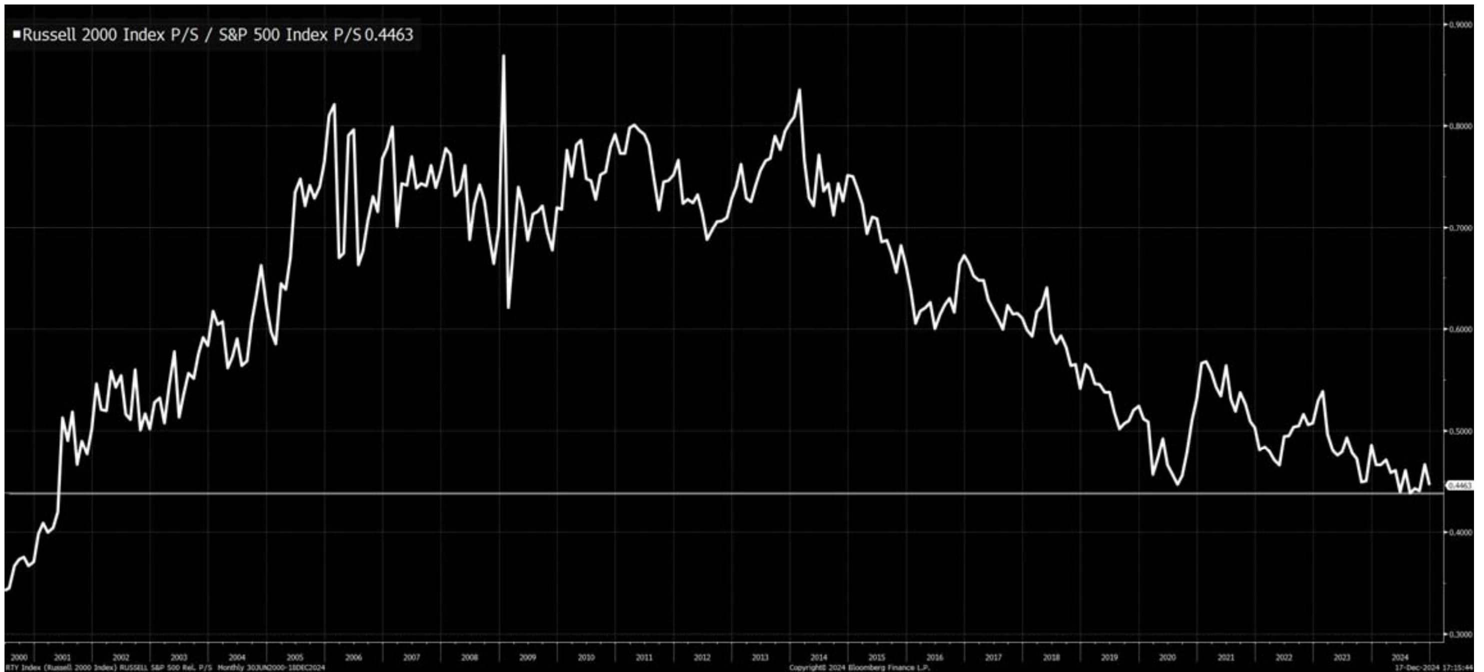
Small-Caps, A Double-Edged Sword

Since the eve of the presidential election on November 4, 2024, the Russell 2000 Index, comprised of smaller companies, has reached a 52-week high. This may be due to investor optimism post-election that the environment will be supportive to these smaller business models, as well as, the underwhelming starting valuations due to their lack of returns more recently. Absolute returns have been driven by the large and mega capitalized parts of the market such as the Magnificent Seven.

Small-cap risk is the type of exposure that has historically outperformed during the early recovery phases of the business cycle. However, there has not been a hard cyclical downturn from which to have an early recovery. There has certainly been a period of high growth by the GDP numbers, but there has also been overall discontent about the distribution of the economic gains. Nonetheless, small-caps were poised to rally and reached a 52-week high as investor sentiment possibly faded recession risk and began to price in a higher probability for a soft landing. While small-cap stocks are supported by these recent tailwinds, they still pose a risk with the economy possibly being in more of a late phase of the business cycle. Without clear signs and awareness of an economic contraction, it is extremely rare to go into early expansion.

It is worth looking at relative valuations between the Russell 2000 and the S&P 500 Index using a price-to-sales multiple rather than a price-to-earnings multiple since roughly 40% of companies in the Russell 2000 are unprofitable and have no earnings. This relative multiple (as seen in the chart) has not been this cheap since 2001. Large-cap investors may also be finding a way to diversify from the historically high price-to-earnings multiple of the S&P 500 Index (22.5x) as the Magnificent Seven has had another extraordinary year. In addition, with the Federal Reserve continuing to cut rates, small-caps may continue to rally.

Investors need to proceed with caution. As stated earlier, roughly 40% of these companies are unprofitable, meaning they generate no income or losses. In the possible event of a slowdown or the Federal Reserve slowing their pace of rate cuts, small-caps will most likely suffer more than the S&P 500 as they may lose policy and consumer support. Investors also need not forget the recent November unemployment print came in at 4.2%, above consensus expectations. Any further uptick may spook the market, increasing the volatility and risk of holding small-caps. We believe broadening out trades should overlay a quality lens when moving down the market capital spectrum.



Source: Bloomberg

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