

Smaller Cap Stocks:

Understanding Historical Trends and Future Opportunities

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Introduction

The development of generative Artificial Intelligence (AI) has progressed very quickly in the US since the start of 2023 and a handful of mega cap stocks which have benefitted from its development and its use have performed exceptionally well. AI like the Internet marks a long-term transformative breakthrough and has the potential to continue to support the US and global stock market upwards.

However, it is clear that valuations have become stretched. Recently, the Magnificent 7's 12-month forward price-earnings (P/E) ratio was 32x while the rest of the S&P 500 was trading at 18x. As a result, investors are more vulnerable to disappointing earnings or news flow concerning these stocks.

It is worth remembering that markets can quickly reverse when earnings disappoint. For example, the P/E ratio of the S&P 500's seven largest stocks reached a high level of 36x in late 2021. In the first half of 2022, the market levelled out and their combined P/E fell to 24x by June 2022. In other words, excessive valuations mean that exceptionally good news is required to avoid a pronounced market reversal.

As interest rates start to fall, this presents an opportunity for smaller cap stocks to outperform which have lagged the market lately. A rebound of smaller cap stocks has started to unfold in recent weeks where we have seen the biggest switch out of the tech-heavy Nasdaq into the smaller-cap Russell 2000 since 1979, driven by expectations of lower future interest rates and disappointing tech-related news.

In this paper, we analyse the historical performance of smaller cap stocks across various market regimes. By doing this, we aim to uncover the drivers of smaller cap stock performance and how these stocks have responded to changing market conditions. Additionally, we outline the potential outlook for smaller cap stocks in the context of current economic trends and evolving market dynamics.

Smaller cap stocks through the ages

From the late 1990s to the late 2010s, there has been a general upwards trend in the excess returns of smaller cap stocks in the MSCI ACWI universe. There are noticeable periods of higher volatility accompanying major economic events such as in the early 2000s during the dot-com bubble, the global financial crisis in 2008 and the Covid-19 pandemic in 2020. Below we analyse the major market regimes illustrated in Figures 1 and 2 in more detail.

Late 1990s to Early 2000s (Dot-com Bubble and Burst)

The late 1990s saw a rapid rise of smaller cap stocks driven by technology and internet-related companies. In other words, this was quite different to the recent AI-related rally, where smaller cap stocks underperformed their larger cap peers. This can be attributed to the fact that many internet-based companies during the dot-com bubble had very low earnings and often had unproven business models. In contrast, today's AI rally is driven by tested companies with significant earnings, established business models and high investments in AI. Therefore, the recent rally has been less speculative in nature and backed to a greater extent by fundamentals. In addition, the current economic environment is characterised by high inflation and interest rates while monetary policy in the late 1990s was more accommodative, supporting smaller cap stocks which tend to be vulnerable to higher borrowing costs.

Mid-2000s to 2008 (Pre-Crisis Growth and Financial Crisis)

Leading up to the 2008 financial crisis, smaller cap stocks experienced significant growth amidst favourable economic conditions and market liquidity. Smaller cap stocks are generally sensitive to economic conditions and often rely on consumer spending, which rose during this period. In addition, investors' risk appetite tends to rise during periods of economic growth which makes them more willing to invest in riskier smaller cap stocks. However, the global financial crisis led to a severe economic downturn. In the aftermath, smaller cap stocks had reduced access to capital and investors fled to the safety of larger cap stocks which resulted in a sharp decline in smaller cap share price performance.

Figure 1: Cumulative Excess Returns of Smaller Cap Stocks versus MSCI ACWI



Past performance does not predict future returns.

Source: HSBC Asset Management as of end of June 2024. in USD, MSCI. Cumulative returns are calculated using daily returns in USD. Cumulative multivariate factor returns based on long & short MSCI ACWI Universe, based on local currency for each stock. Any views expressed were held at the time of preparation and are subject to change without notice.

Post-2008 Recovery to 2020 (Recovery, Quantitative Easing and Bull Market)

Extensive monetary stimulus in the form of quantitative easing and low interest rates enabled a recovery and bull market following the global financial crisis. The low-interest rate environment led to a broad-based market rally, with smaller cap stocks benefitting amidst the improved economic outlook at the time.

Smaller cap stocks reached a peak around 2011 but then declined for several reasons. In 2011, the Eurozone debt crisis intensified, raising concerns about the stability of the financial system which raised market volatility. The Fed also hinted at reducing its asset purchases which heightened market uncertainty, leading to worries about liquidity and rising borrowing costs. Finally, post-2011, there were signs of a potential economic slowdown with reduced emerging market growth rates and more muted developed market growth. This combination of factors led to the subsequent decline of smaller cap stocks post-2011.

However, smaller cap stocks managed to rebound in 2019-2020 with 2019 being characterised by the Fed adopting a more dovish stance which raised liquidity as well as the U.S.-China trade war easing which bolstered market sentiment. This drove capital into smaller cap stocks. The onset of the Covid-19 pandemic led to unprecedented monetary and fiscal stimulus measures which further increased liquidity and economic support which in turn fuelled a strong recovery in risk assets, including smaller cap stocks.

2021 Onwards (Post-Recovery Adjustment)

In 2021, inflation and supply chain disruptions raised input costs and created logistical challenges which adversely impacted smaller cap companies since they generally have less pricing power and flexibility than larger cap stocks. In 2022, central banks responded to signs of rising inflation by shifting to tighter monetary policy which raised borrowing costs for smaller cap companies. Moreover, geopolitical tensions (e.g. the Russia-Ukraine conflict) increased uncertainty and risk aversion amongst investors who gravitated towards larger, more stable companies. The AI-related rally in 2023 and YTD'2024 has been a key driver of market performance, driven by mega cap technology firms whose established market positions and high R&D budgets enabled their leadership in AI. Some niche smaller cap companies specialising in specific AI applications have benefitted but the overall impact on smaller cap stocks has been more tempered.

Figure 2: Cumulative Excess Returns of Smaller Cap Stocks versus MSCI ACWI



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Prospects for smaller cap stocks

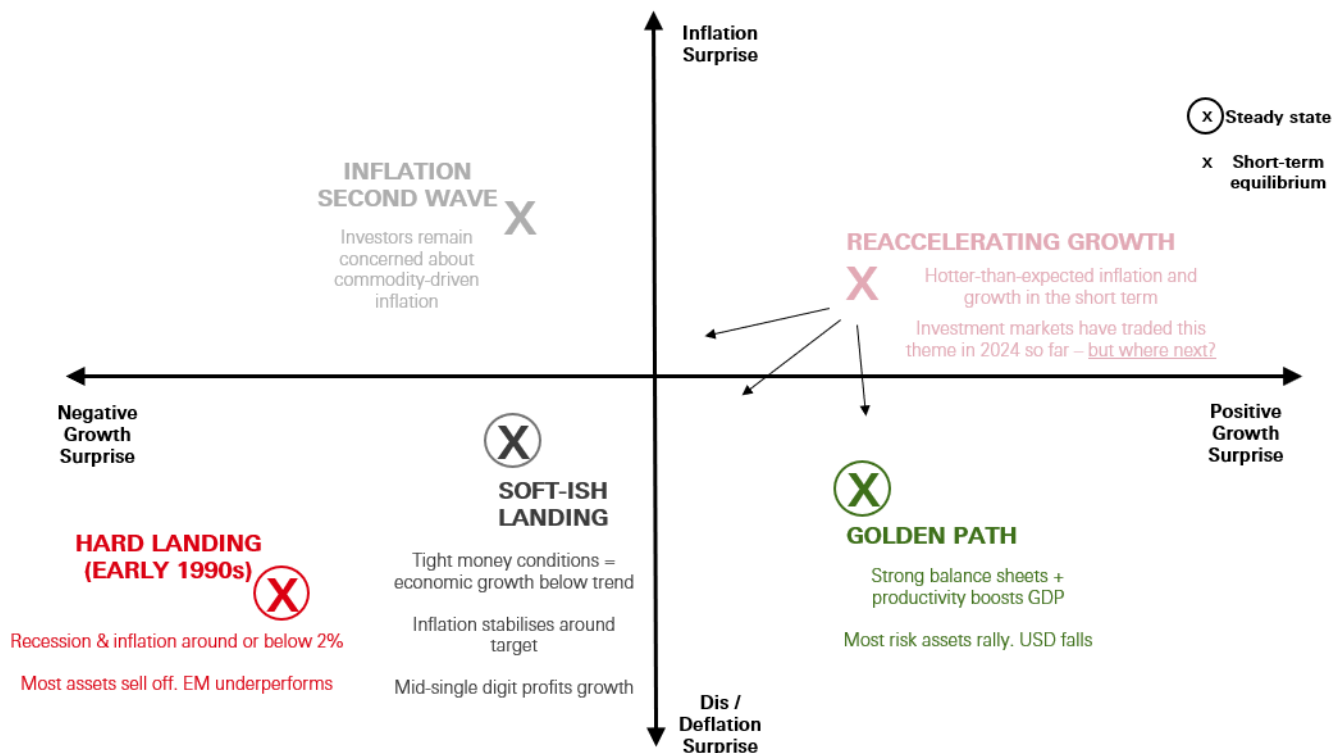
As evidenced in past regimes, the future of smaller cap companies will be influenced by macroeconomic, technological and market factors. There is a possibility that a soft landing does indeed materialise – in other words, a moderate economic slowdown avoiding a recession. A reasonable baseline scenario is a gradual weakening of the labour market and a contained increase in the unemployment rate. This means that inflation may revert to an improving trend, driven by a dampening in services inflation, which will in turn enable central banks to cut rates.

Falling inflation and subsequent decreases in interest rates can create a more favourable environment for smaller cap companies which will benefit from cheaper external financing to fund their growth and operations. Investor sentiment should improve as a result which may increase the demand for riskier smaller cap stocks. These factors coupled with the fact that smaller cap stocks are trading at significantly more attractive valuations compared to larger cap peers, means that smaller cap stocks are well positioned to capture market share and drive revenue growth.

Equally, there are risks stemming from areas such as geopolitics and elections as well as possible policy errors and the possibility for economies to cool faster than expected, due to rates remaining too high for too long. This could result in a mild recession and moderate financial stress.

Therefore, it is important to keep an eye on economic indicators, such as inflation rates and central bank policies. This also underpins the importance of a long-term, diversified approach to managing portfolios which can help to mitigate these risks.

Figure 3: Macro Scenarios 2024



Past performance does not predict future returns. Diversification does not ensure a profit or protect against loss.

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Source: HSBC Asset Management as of June 2024.

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