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Asset Allocation
Chart of the Month

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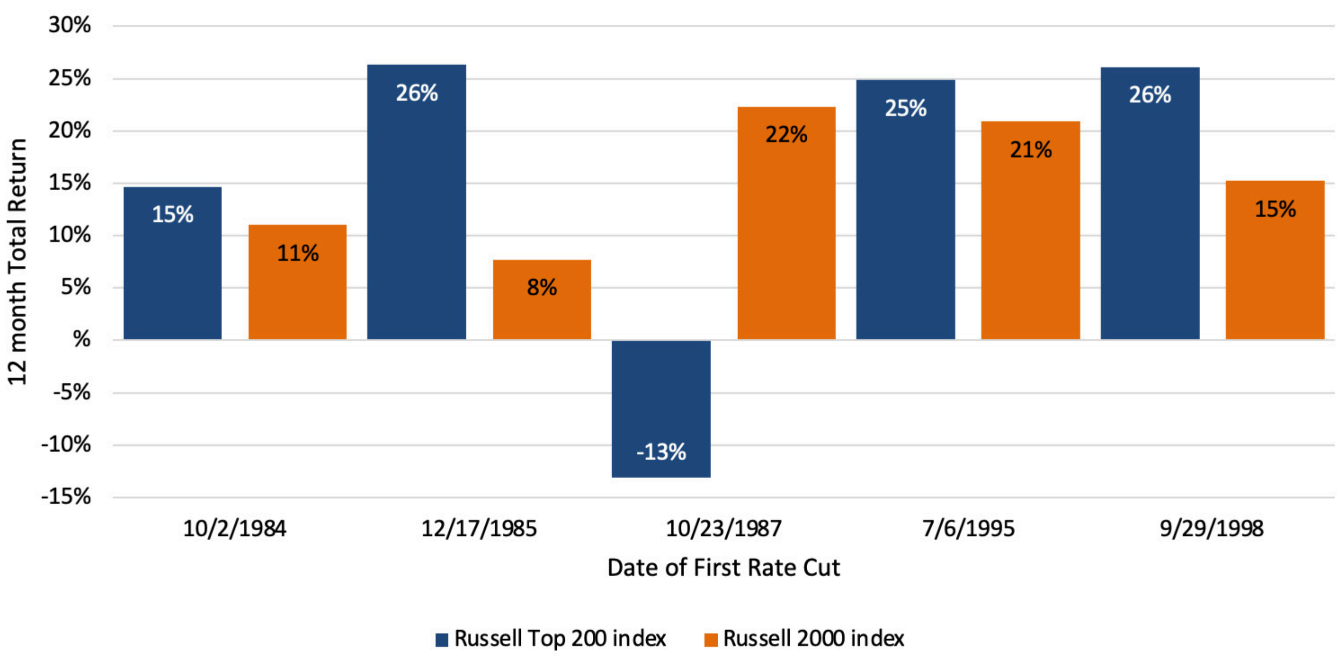
Rate Cuts Likely to Benefit Small Caps

- **Chart.** The Fed restarted cutting rates in September. We don't see a U.S. recession on the horizon. Historically, rate cuts that occur while the economy is expanding have supported equities. Looking back to the early 1980s (the start of our return series), we identify five non-recessionary easing cycles. On average over those cycles, the Russell Top 200 Index returned 15.8% and the Russell 2000 returned 15.4% in the subsequent 12 months. The averages are similar, though the outcomes varied by cycle and small caps were positive in each case.
- **Positioning change.** We removed our small cap underweight as the Fed began cutting again, though it was not just rate cuts that attracted us back to small caps.
- **Earnings trend.** After two years of steady downward revisions, small cap EPS estimates stabilized about five months ago despite softer economic growth and tariff uncertainty, suggesting that the worst may be past. Consensus now expects small cap EPS growth to outpace the S&P 500 in 2026.
- **Cyclical linkage.** Small caps tend to track industrial production, which should benefit from tariffs and OBBBA-related capital expenditure tax incentives in 2026 and beyond.
- **Valuation.** Small caps are the only major U.S. equity asset class trading below their 30-year median valuation range (based on the S&P 600 index).
- **Sentiment.** NFIB small business survey readings have turned more optimistic.
- **Quality tilt in cutting cycles.** According to BofA's U.S. SMID Cap Strategist, rate-cutting cycles tend to favor higher-quality small caps. Notably, the S&P 600 index (which excludes non-earners) has recently underperformed the Russell 2000 by over two standard deviations. This rare divergence has occurred only twice in the past 20+ years, and in both cases the higher-quality S&P 600 index rebounded strongly.
- **Conclusion.** We believe the backdrop for small caps warrants consideration for investors who are looking for diversification and potential outperformance.

Return Following First Rate Cut (no recession)



Source: Bloomberg

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