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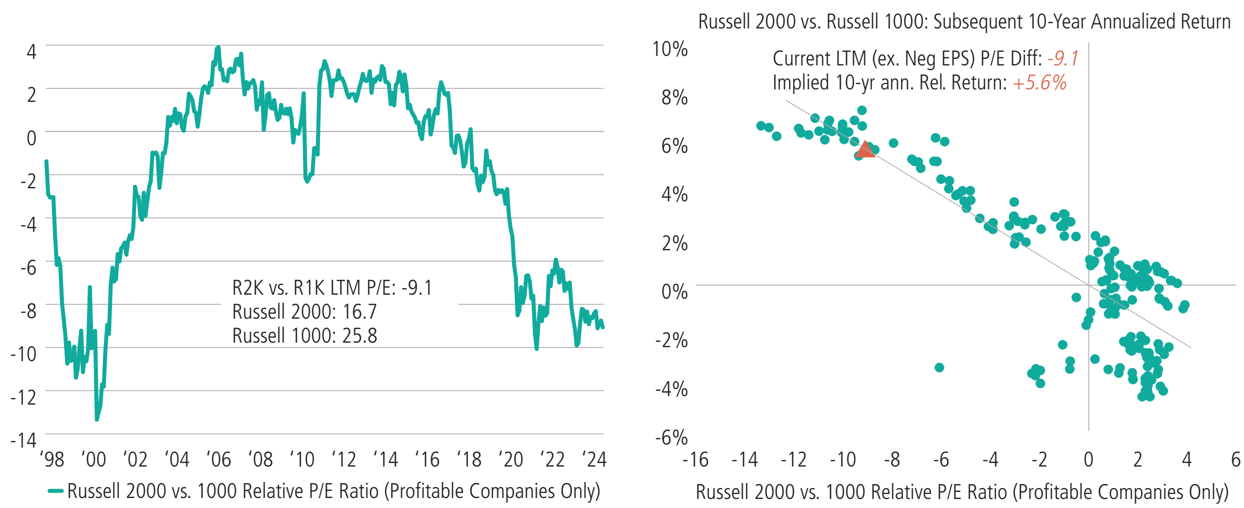
Small Caps: The Next Cycle Is Upon Us

U.S. small cap equities are at an important juncture: Not only has the valuation gap between small and large-cap stocks grown exceptionally wide by historical measures, but also numerous small-cap macro tailwinds appear to be gathering force. In this report, we demonstrate why we think small caps appear poised to outperform their large-cap peers over the near- to mid-term. We believe the relative size of the two categories implies that a mere 1% reallocation from large to small caps could boost small cap returns by 20%.

Historically Favorable Relative Valuations

Profitable small caps have rarely been this attractively valued relative to large caps, in our view. As shown on the left side of figure 1, profitable small caps currently trade at a historically extreme discount to large caps based on their trailing 12-month price-to-earnings ratio—a level seen less than 10% of the time since 1998.

FIGURE 1: SMALL CAPS ARE TRADING AT DEEP DISCOUNTS TO LARGE CAPS, POTENTIALLY SETTING THE STAGE FOR ATTRACTIVE OUTPERFORMANCE OVER THE NEXT DECADE



Source: Neuberger Berman Research and FactSet. Data as of September 30, 2024. For illustrative purposes only. Indices are unmanaged and are not available for direct investment. **Past performance is not indicative of future results.**

At current levels, history suggests that high-quality small caps have the potential to significantly outperform large caps over the next decade, in our view. As shown on the right side of figure 1, regressing the valuation differentials between the Russell 2000 (excluding unprofitable members) and the Russell 1000 against their subsequent relative 10-year annualized returns since 1998 implies that *high-quality members of the Russell 2000 have the potential to outpace the Russell 1000 by as much as 5.6% a year over the next 10 years.* As with any analysis based on past performance, this estimate must be taken with a grain of salt. Yet even sizing it down by half and compounding over a decade still conveys the scope of small caps' potential outperformance.

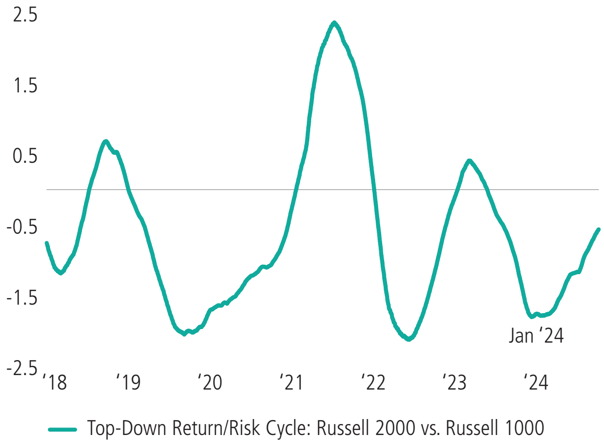
While the relative valuation gap helps us model the potential outperformance of small caps, it tells us little about when shifts in relative market leadership might begin. For help with timing, we turn to a variety of tactical signals and macro factors that tend to drive small-cap performance.

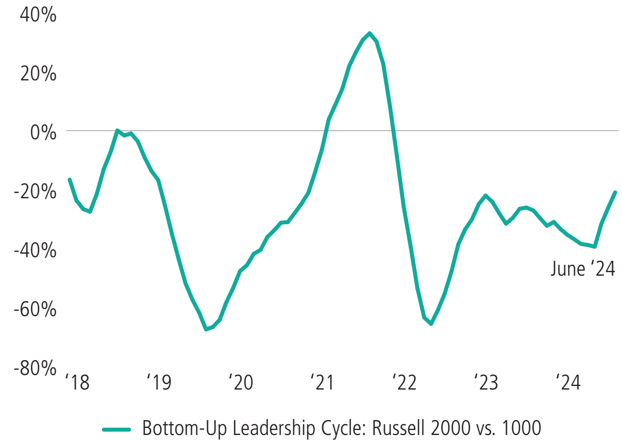
Tactical Signals Favor Small Caps Over Large Caps

Our tactical analysis takes a one- to two-year view of small- versus large-cap performance cycles (see figure 2). The top-down return/risk cycle,[1] shown on the left, measures the 12-month relative risk-adjusted return of investing in small caps vs. large caps. After hitting a trough earlier this year, this signal has been moving in favor of small caps.

Similarly, our bottom-up "leadership cycle" indicator—shown on the right—has been rising since mid-year. A leadership cycle seeks to capture the representation of a particular sector, style or size among winning stocks, and on this measure we believe small caps have begun to gain ground over large caps.

FIGURE 2: TWO PROPRIETARY TACTICAL INDICATORS SUGGEST SMALL CAPS ARE COMING BACK INTO FAVOR





Note: A "Leadership Cycle" is defined as the percentage of stocks (within that sector, style or size) that are among the top quintile of trailing 12-month performance of the relevant universe (such as the Russell 2000 Index) minus the percentage of stocks that are among the bottom quintile of that universe; those percentages are tracked monthly.

Source: Neuberger Berman Research and FactSet, data as of September 30, 2024. For illustrative purposes only. Indices are unmanaged and are not available for direct investment. **Past performance is not indicative of future results.**

Inflection points in these signals tend to lead small versus large-cap performance cycles by several months. We find it encouraging that both signals point to an improving tactical outlook for small caps relative to large caps.

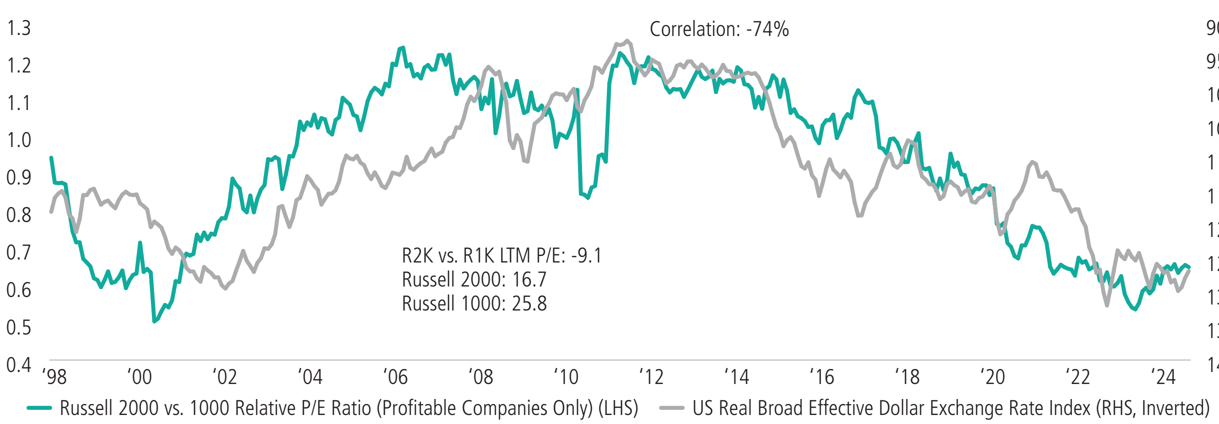
Macro Drivers Favor Small Caps Over Large

The Mighty U.S. Dollar

We find that multi-year U.S. dollar cycles negatively correlate with the relative valuations between small and large caps (see figure 3). As the USD weakens, small cap valuations tend to rise vs. large caps, and vice versa.[2]

Historically, USD cycles tend to last seven to 10 years. The USD has been in an aging bull cycle for over 13 years and, in our view, appears expensive on many traditional measures.[3] We believe the next bear cycle in the USD, when it begins, could coincide with small caps' relative outperformance implied by the current valuation gap.

FIGURE 3: THE U.S. DOLLAR CYCLES CORRELATE INVERSELY WITH SMALL CAP REVALUATION CYCLES



Source: Neuberger Berman Research and FactSet, data as of September 30, 2024. For illustrative purposes only. Indices are unmanaged and are not available for direct investment. **Past performance is not indicative of future results.**

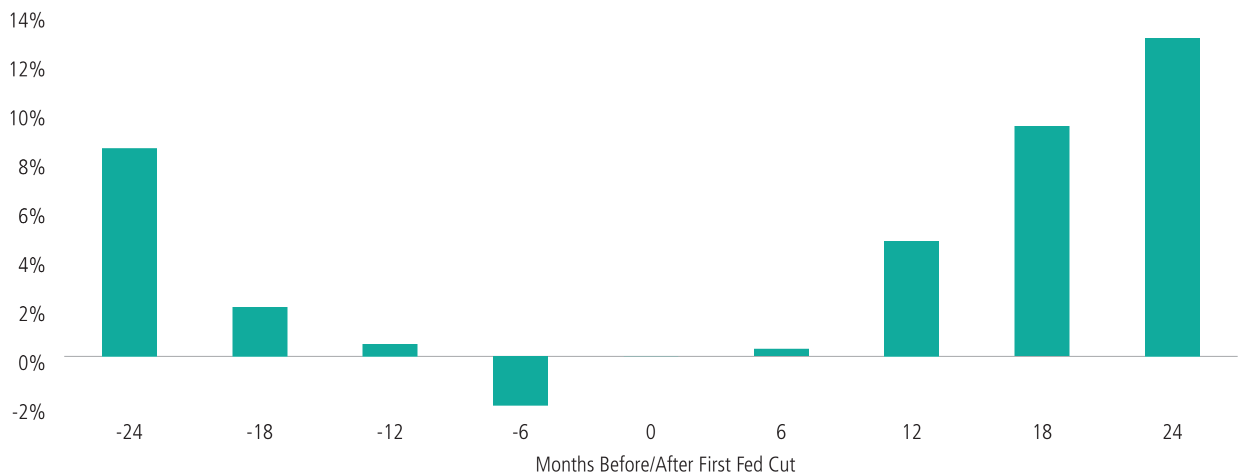
Cost and Availability of Credit

While many small caps have sturdy balance sheets, their debt coverage ratios and credit ratings, in aggregate, tend to be far weaker relative to large caps. Empirically, we observe that small caps' relative performance tends to track the cost and availability of financing.

That's why, as the Federal Reserve embarks on its latest rate-cutting cycle, we believe the Russell 2000 could get a more significant boost from easier monetary conditions than the Russell 1000. Indeed, there is evidence: Since 1957, we find that small caps typically outperform large caps during the six to 24 months following the first rate cut (see figure 4). And over a complete rate-cutting cycle, small caps tend to outperform large caps by a considerable eight percentage points on average.[4]

FIGURE 4: SMALL CAPS TEND TO OUTPERFORM LARGE CAPS DURING INTEREST RATE-CUTTING CYCLES

Small vs. large average return after first Fed cut (1957 – current)



Source: Neuberger Berman Research, Fama French Database, and FactSet. Data as of June 30, 2024. For illustrative purposes only. Indices are unmanaged and are not available for direct investment. **Past performance is not indicative of future results.**

How does the cost and availability of credit affect small caps?

A market-based measure of the cost of corporate borrowing pertinent to small caps is the yield spread between high-yield corporate bonds and U.S. Treasuries. It correlates negatively with the relative performance of small cap stocks—as spreads fall or remain low, small caps tend to outperform large caps, and vice versa. (For additional significant macro relationships, see table 1 in the Appendix.) Bond yield spreads are currently low (in the lowest 10th percentile since 1995) and falling—a potentially favorable setup for the outperformance of small caps, in our view.[5]

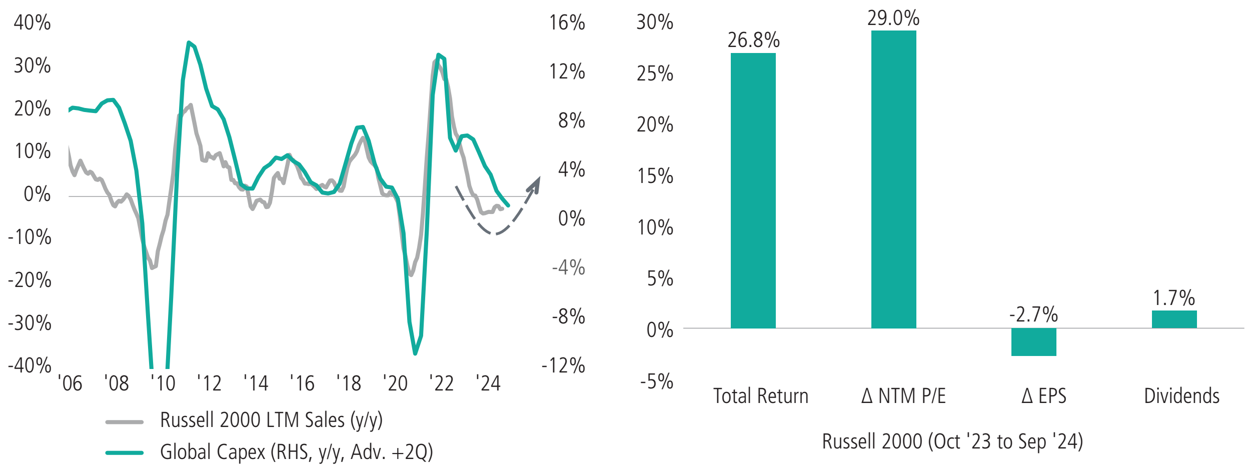
Next, consider the availability of credit, which we find also correlates positively with the relative performance of small caps. According to the Senior Loan Officer Opinion Survey (SLOOS), a key gauge of economy-wide credit conditions, U.S. banks have been loosening their lending standards and increasing credit availability since 3Q 2023.[6] We believe this trend should also support small-cap outperformance.

The Global Capex Cycle

The year-old run of the Russell 2000 has been powered almost exclusively by expanding valuation, while earnings have contracted, causing some investors to question the sustainability of small caps' recent run.[7] However, we think small cap are about to enter their earnings-driven phase.

Global capex growth has been slumping since 2022 (as shown on left side of figure 5), and the top lines of the Russell 2000 have historically exhibited substantial leverage to the corporate capex cycle. We expect capex growth to revive in the months ahead, which could boost the top and bottom lines of the Russell 2000, providing a potentially critical driver of sustainable small cap performance. In our view, as the source of small caps' total return shifts from expanding P/E multiples to rising earnings, more skeptical investors would be drawn off the sidelines (see the right side of figure 5).

FIGURE 5: A GLOBAL CAPEX REVIVAL COULD BOLSTER SMALL CAP EARNINGS GROWTH

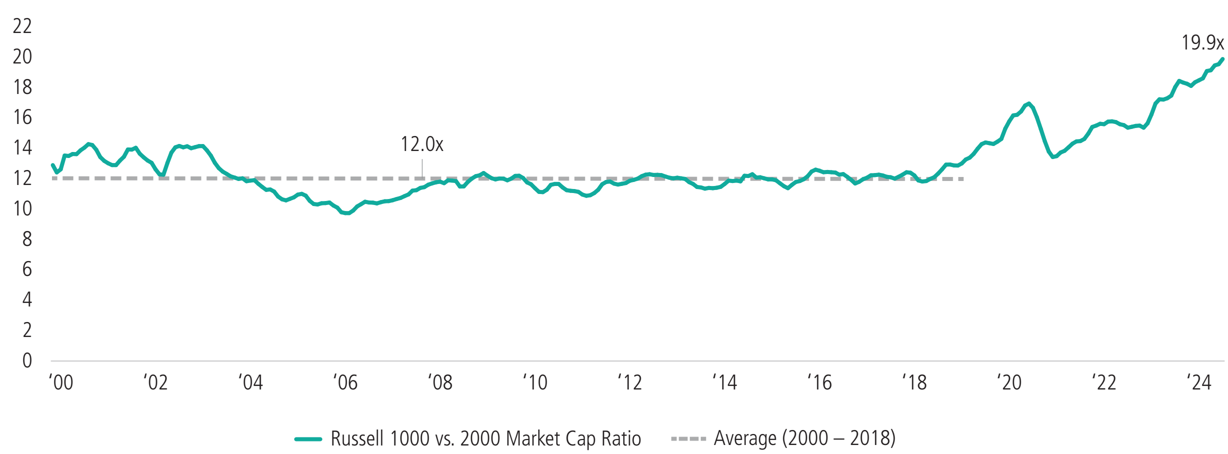


Source: LHS: Neuberger Berman Research, FactSet, and J.P. Morgan. Data as of June 30, 2024. RHS: Neuberger Berman Research and FactSet. Data as of September 30, 2024. For illustrative purposes only. Indices are unmanaged and are not available for direct investment. **Past performance is not indicative of future results.**

The Potential Impact of Relative Size on Relative Returns

The extraordinary run of large caps relative to small caps since 2019 has created a startling dynamic: The market cap of the Russell 1000 stands at $53.5 trillion—nearly 20 times larger than the market cap of the Russell 2000 Index, up from 12 times in 2018 (see figure 6).

FIGURE 6: IN TERMS OF MARKET CAPITALIZATION, THE RUSSELL 1000 NOW DWARFS THE RUSSELL 2000



Source: Neuberger Berman Research and FactSet. Data as of September 30, 2024. For illustrative purposes only.

What does that mean for small caps? *All else equal, if investor sentiment were to shift toward small caps, we believe the relative size of the two categories implies that a mere 1% reallocation from large to small caps could boost small cap returns by 20%.* And given the relative illiquidity premium that small caps command, we expect that figure could be even higher.

Conclusion

We believe we are in the early days of the next bull run in small caps, however many investors disagree and are waiting for more evidence to appear. We get it—being early to a shift in sentiment can come with bouts of volatility and underperformance. Yet given current market dynamics, we think small-cap investors are better off being early than late.

Appendix

TABLE 1: CORRELATIONS OF SMALL CAP VS. LARGE CAP RELATIVE PERFORMANCE WITH SIGNIFICANT MACRO DRIVERS

Macro Drivers of Small vs. Large Caps	Correlation with Russell 2000 vs. Russell 1000
ISM Mfg.	38%
Brent Oil Price	36%
NFIB Small Business Optimism	32%
CRB Industrial Metals	32%
U.S. Industrial Production	18%
U.S. IG Bond Spreads	-20%
SLOOS - Net % Tightening (Small firms)	-27%
U.S. High-Yield Spreads	-28%
Trade-Weighted USD (Nominal, Broad)	-30%
SLOOS - Net % Tightening (Large/Med. firms)	-31%
VIX	-31%

Source: Neuberger Berman Research and FactSet. January 2000 to September 2024. Nothing herein constitutes a prediction or projection of future events or future market behavior.

Endnotes

[1] For more detail on our proprietary risk/return cycle analysis, see our *2Q 2024 Equity Market Outlook*.

[2] Our rationale here: While we believe that while a weaker dollar can compress margins of consumer-facing small caps that often source finished goods overseas but are unable to sufficiently pass on rising import costs to the consumer, industrially sensitive companies—which account for a considerable fraction of the small cap universe—tend to be able to pass along those rising input costs to their industrial customers and thereby protect or even expand their margins. A weakening USD can also signal a pickup in the global credit cycle, which favors the more capital-sensitive industrial sectors served by many small caps. Hence, there is an inverse correlation between the USD and small caps' relative performance.

[3] Source: Neuberger Berman Research. Data as of September 30, 2024.

[4] Source: Neuberger Berman Research and FactSet. Data as of June 30, 2024.

[5] Source: Neuberger Berman Research and FactSet. Data as of September 30, 2024.

[6] Ibid.

[7] Ibid.

Index Definitions

The S&P 500 Index consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe.

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies designed to represent approximately 98% of the investable U.S. equity market.

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