GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee

January 18, 2024

Can small-cap equities go the distance?

Kelly Bogdanova – San Francisco

A rally in the closing months of 2023 highlighted small caps' potential to generate strong returns. But since the start of the new year, the asset class has looked more like an also-ran. We look at whether the asset class has what it takes to deliver wins for investors in 2024.

After sprinting toward the finish line in late 2023 as one of the strongest areas of the U.S. equity market, small-cap indexes have come off the blocks slowly so far this year.

The S&P SmallCap 600 and Russell 2000—the two main small-cap indexes—surged 23.3 percent and 23.8 percent, respectively, from late October 2023 through year's end. This followed a long stretch of disappointing returns and underperformance relative to large-cap indexes like the S&P 500 and Russell 3000.

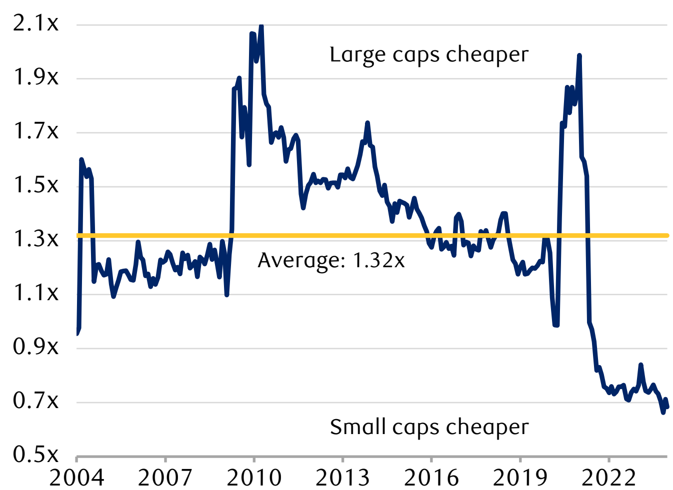
During the rally, money poured into small caps and asset managers hurried into the segment, according to fund flow and positioning data. Views from institutional investors quickly swung from bearish to rather bullish.

RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina wrote, "In December it felt like everyone we met with (including the many varieties of investors who are not focused on small cap investing) wanted to talk about small caps and was constructive on them. We can't remember the last time this happened." This is notable to us because Calvasina was a small-cap specialist earlier in her career.

But in the first three weeks of January, small caps have rapidly given back about one-third of their late-2023 gains and underperformed the S&P 500, prompting a debate about whether the sub-asset class has staying power.

Small caps trade at a deep valuation discount compared to large caps

Ratio of S&P SmallCap 600 to S&P 500 trailing price-to-earnings (SML/SPX P/Es)



Source - RBC Wealth Management, Bloomberg; monthly data through 1/17/24

While it's normal for areas of the market that have rallied sharply to retrace at least some of their gains soon thereafter, the recent pullback underscores our view that patience is needed regarding the small-cap portion of portfolios. We think there are bound to be more fits and starts.

For perspectives on the week from our regional analysts, please see pages 3–4.

For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

Priced (in USD) as of 1/17/24 market close (unless otherwise stated). Produced: 1/18/24 4:00 pm ET; Disseminated: 1/18/24 4:05 pm ET

Small caps have some winning attributes

- **Valuations look attractive.** The S&P SmallCap 600 trades near 20-year lows relative to the S&P 500 on a trailing price-to-earnings (P/E) basis, as the chart on page 1 illustrates. It also trades at a notable relative discount when forward earnings estimates are taken into consideration, and its trailing and forward P/E valuations are below its own historical averages. Based on price-to-sales metrics—which we think are more important for small caps—both indexes look reasonable to us, sitting near their long-term averages.
- **They typically do well during Fed easing cycles.** Since the late 1970s, small caps have tended to trade higher when the Fed cut interest rates and have struggled more often than not when rates rose, according to Calvasina. We think the Fed is likely to start cutting rates in the middle of this year.
- **Balance sheets and funding issues seem better than feared.** Fallout from the Fed's aggressive rate hike cycle weighed on small caps for much of last year, amid concerns that higher rates on debt issuance and loans could meaningfully constrain balance sheets. Small-cap companies are more dependent on external funding than their large-cap peers. But Calvasina's data indicate the debt situation for small-cap companies as a group is better than it could have been, as they have increasingly shifted to long-term funding. The effective interest rate for Russell 2000 companies was between 4.8 percent and 5.1 percent as of December 2023, still well below average funding costs since 1989 and somewhat below the average since 2003.
- **Their portfolio diversification benefits go beyond just size.** Sector weightings differ meaningfully between large-cap and small-cap indexes. Information Technology and Communication Services have much higher weightings in the S&P 500, whereas economically sensitive (cyclical) sectors like Industrials, Financials, Consumer Discretionary, and Real Estate have higher weightings in the small-cap indexes, as the table illustrates. Also, the 10 largest stocks in the S&P 500 represent a significant 30.9 percent of that index (this includes the "Magnificent Seven" tech-oriented stocks), whereas the 10 largest stocks in the S&P SmallCap 600 and Russell 2000 represent only 5.8 percent and 3.3 percent, respectively. Therefore, the latter are much more diversified.

But we think patience is needed

- **Small caps tend to underperform during periods of low GDP growth.** Currently, RBC Economics and the Bloomberg consensus forecast are calling for below-average U.S. GDP growth in 2024. Small-cap stocks typically underperform in such environments because they have a greater share of cyclical stocks, and earnings and revenue growth are harder to come by when the economy is sluggish. They tend to perform better when GDP growth is above trend, especially in the early stages of a growth cycle coming out of a recession.
- **If a hard landing materializes, they could trade back down to previous lows.** The Russell 2000 was fully pricing in a recession at its low point last October, according to Bloomberg Intelligence. If the consensus forecast for slow growth this year is wrong and a recession begins, small-cap indexes could fall back to those lows.

Sector weightings and other characteristics differ meaningfully between large and small caps

	S&P 500 (large cap)	S&P SmallCap 600	Russell 2000 (small cap)
Sector weightings			
Communication Svcs.	8.6%	2.7%	1.4%
Cons. Discretionary	10.9%	14.8%	13.3%
Consumer Staples	6.2%	4.4%	2.8%
Energy	3.9%	4.2%	7.4%
Financials	13.0%	18.5%	16.0%
Health Care	12.6%	10.4%	15.1%
Industrials	8.8%	17.2%	18.4%
Information Tech.	28.9%	12.0%	12.6%
Materials	2.4%	5.9%	3.9%
Real Estate	2.5%	7.7%	6.4%
Utilities	2.3%	2.0%	2.8%
Index characteristics			
Number of constituents (stocks)	503	602	1966
Largest market cap in USD millions	$2,994,371.34	$8,186.53	$14,993.00
Mean market cap in USD millions	$83,594.11	$2,065.95	$3,265.00
Median market cap in USD millions	$33,544.75	$1,742.67	$965.00
Weight of largest constituent	7.1%	0.7%	0.5%
Weight of top 10 constituents	30.9%	5.8%	3.3%
Price ratios*			
P/E current	22.79x	15.58x	29.21x
P/E 20-year average	18.39x	24.01x	38.45x
P/S current	2.57x	0.95x	1.18x
P/S 20-year average	1.78x	1.01x	1.14x

* Price-to-earnings (P/E) and price-to-sales (P/S) data are shown on a trailing basis.

Source - RBC Wealth Management, S&P Dow Jones Indexes, FTSE Russell, iShares, Bloomberg, FactSet. Sector weightings are rounded. Sector weightings and index characteristics as of 12/31/23. Price ratios as of 1/17/24.

It's a long way to the finish line

We still think a moderate Overweight position in U.S. small caps is warranted due to the steeply discounted valuation relative to large caps. But we're cognizant that an unusually wide range of plausible economic outcomes in 2024 could impact small caps' earnings and revenue growth. That's why we think small caps will likely experience ups and downs this year, and investors should take a patient approach.

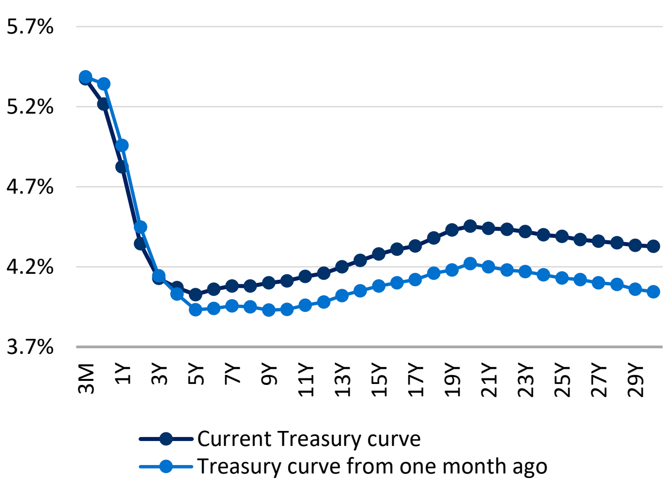
UNITED STATES

Michael Roedl – Minneapolis

- **Treasury yields are climbing higher this week on stronger-than-expected economic data from the Commerce Department's December retail sales report**, which showed consumer spending rising at the fastest pace in three months. Nine of the 13 retail sales categories posted gains, with the largest increases seen in clothing and general merchandise. Control group sales, a key indicator used in the calculation of gross domestic product, rose by 0.8%, the largest increase since July. Nonetheless, in a year where some economists are still calling for a recession, we think the economic landscape appears well-grounded at this point, with consumer confidence gaining momentum and resilient spending for nonessential goods. However, as Americans contend with lingering inflation, elevated borrowing costs, and slowing employment, we think growth will likely slow later this year.

- **The Treasury yield curve is becoming steeper in January**, as the short end of the curve primarily correlates to Fed interest rate policy while yields on the long end of the curve typically correlate to economic data. As illustrated by the chart, the recent shift in Treasury yields is potentially a sign that rate cuts are in the pipeline, with the yield on the 2-year benchmark down about 10 basis points (bps) from a month ago while longer-term Treasury yields on the 10-year and 30-year benchmarks are up 30–35 bps over the same period. **We think the recent upswing in long-term Treasury yields was overdue, given our view that prices on the long end of the curve were overbought in November and December**. On the other hand, Treasury bond prices on the short end of the curve could reverse gains in the near term as markets push back rate-cut expectations to midyear or the back half of 2024—although we think selling pressure could be short-lived if consumer spending pulls back in the months ahead, as we anticipate.

Treasury curve steepening as yields adjust for potential rate cuts in the pipeline



Source - RBC Wealth Management, Bloomberg; "current" data as of 1/18/24, "one month ago" data as of 12/18/23

CANADA

Estefani Ayazo, CFA & Jonathan Laser – Toronto

- **Canadian inflation rose at a faster-than-expected pace in December**, highlighting the prospect of a more volatile path for consumer prices in the near term amid the Bank of Canada's (BoC's) campaign to return inflation back to target. According to Statistics Canada, headline inflation rose 3.4% y/y in December, up from 3.1% y/y in November, mainly driven by a smaller decline in year-over-year gasoline prices. Meanwhile, the BoC's preferred measures of core inflation, core-CPI Trim and core-CPI median, rose to 3.7% y/y and 3.6% y/y, respectively. Shelter inflation remained a large contributor to annual price gains due to rising rents and mortgage interest costs. The uptick in core underlying price pressures suggests that BoC officials may not consider rate cuts as soon as expected by futures markets. Policymakers have repeatedly stressed that the disinflation path is unlikely to follow a linear path. That said, futures markets continue to price in several rate cuts this year while expecting the BoC to hold rates at 5.0% at its next policy meeting later this month.

- **Canadian housing market activity gained momentum**, with home resales rising by 8.7% m/m in December. Ontario and British Columbia were among the provinces that saw the largest increase in housing resale activity last month. Price concessions from sellers and a modest decline in mortgage rates, which have moved sharply higher since the BoC started raising its policy rate in 2022, were supportive factors behind the home sales rebound. Furthermore, housing prices continued to ease as the MLS Home Price Index fell 0.8% m/m in December, the fourth consecutive month of declines. Despite the uptick in housing activity late last year, RBC Economics is forecasting softness to continue in the housing market in H1 2024, followed by an expected recovery in activity if the BoC begins to cut rates this year.

EUROPE

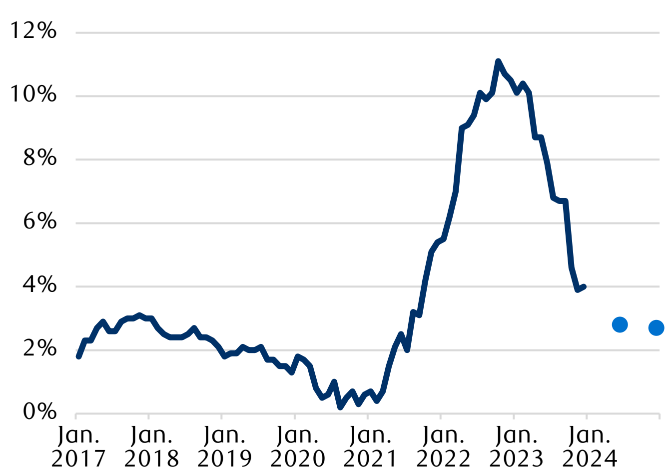
Frédérique Carrier – London

- **The year-end rally**, which pushed the STOXX Europe 600 (including the UK) to reach a 12-month high on Dec. 28, **has continued to peter out**. The index is now more than 3% off its peak. People hoping for early interest rate cuts in both Europe and the UK were disappointed after several central bankers pushed back against the recent market narrative of imminent rate cuts. Markets scaled back their expectations of the first rate cut timing somewhat, assigning a lower probability of a cut in April for the European Central Bank (ECB) and June for the Bank of England (BoE) than they had just a week ago.

- **The ECB is still concerned that services inflation and wage inflation, the latter at over 5% y/y, remain too high.**
- **The BoE has many of the same concerns** as the battle against inflation seems frustratingly slow. After two consecutive months of downward surprises, inflation edged up in December, with the Consumer Prices Index reaching 4% y/y (vs. 3.9% y/y in November and the 3.8% y/y consensus expectation). The BoE may decide to look past this increase because it was mostly due to one-off factors such as the tobacco tax increase.
- Meanwhile, **wage growth is showing signs of improvement,** even though it remains stuck at a high level. The average weekly earnings growth reached 6.5% for the three months to November compared to a year ago, less than the 7.2% posted in October.
- Despite this mixed news, **inflation is below where the BoE thought it would be at this stage**. We think further progress should be made over the next few months as household energy bills are likely to fall in the spring following the recent drop in wholesale gas prices. Indeed, RBC Capital Markets sees inflation falling to 2.8% by midyear.
- **Rate cuts can't come soon enough for the UK government**, which is facing an election. Lower interest rates would reduce the mortgage squeeze on homeowners and give the government much-needed extra headroom to unveil tax cuts or fiscal stimulus at the March budget.

Continued progress on UK inflation

UK Consumer Prices Index



Source - RBC Wealth Management, Bloomberg, RBC Capital Markets forecasts denoted by bright blue dots; data as of 9:00 ET, 1/18/24

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- The Asia Pacific equity market traded lower during the week, dragged down by the Hang Seng Index. **The correction in Greater China equities deepened following a series of weaker-than-expected economic data that suggests China is still facing deflationary pressure, while the property crisis persists**. According to the National Bureau of Statistics (NBS), the Consumer Price Index fell again by 0.3% y/y in December while the Producer Price Index fell for the 15th consecutive month, dropping by 2.7% y/y. Meanwhile, new-home prices in 70 cities, excluding state-subsidized housing, dropped 0.45% m/m in December, the steepest decline since February 2015.
- **China resumed publishing its youth unemployment data in December**, having previously suspended it in June 2023. **Officials said the latest jobless rate was 14.9% for those between 16 and 24 years old**. The new NBS figure excludes students and is lower than the 21.3% unemployment rate in June, which included students and was published before the suspension of the monthly figures. Some economists, however, cautioned that it is hard to determine if the new data suggest an improvement unless historical data are adjusted accordingly. Youth unemployment soared in early 2023 as hiring slowed in several sectors. Regulatory crackdowns in recent years on sectors ranging from technology to finance had a lingering effect on jobs.
- **The Japanese equity market saw the largest weekly inflows since October**, according to a Ministry of Finance report. International investors bought a net US$8.1 billion of Japanese stocks last week. **Foreign demand has propelled Japanese equities to three-decade highs**, making Japan the best-performing developed market year to date. Separately, 2.7 million tourists visited Japan in December, the highest-ever number for the month. Japan welcomed 25 million tourists in 2023, the most since 2019. The record level came despite a smaller number of Chinese tourists, the largest inbound group pre-COVID, with 2.4 million visitors compared to 9.6 million in 2019.

MARKET
Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,739.21	-0.6%	-0.6%	20.9%	1.5%
Dow Industrials (DJIA)	37,266.67	-1.1%	-1.1%	10.6%	3.3%
Nasdaq	14,855.62	-1.0%	-1.0%	38.3%	-0.6%
Russell 2000	1,913.17	-5.6%	-5.6%	5.0%	-11.9%
S&P/TSX Comp	20,695.02	-1.3%	-1.3%	4.0%	-1.8%
FTSE All-Share	4,072.19	-3.8%	-3.8%	-3.1%	-3.5%
STOXX Europe 600	467.71	-2.4%	-2.4%	4.9%	-2.4%
EURO STOXX 50	4,403.08	-2.6%	-2.6%	8.5%	3.9%
Hang Seng	15,276.90	-10.4%	-10.4%	-28.4%	-35.7%
Shanghai Comp	2,833.62	-4.8%	-4.8%	-10.6%	-21.1%
Nikkei 225	35,477.75	6.0%	6.0%	35.5%	24.6%
India Sensex	71,500.76	-1.0%	-1.0%	18.9%	18.4%
Singapore Straits Times	3,142.22	-3.0%	-3.0%	-3.7%	-2.6%
Brazil Ibovespa	128,523.83	-4.2%	-4.2%	16.0%	26.1%
Mexican Bolsa IPC	54,704.74	-4.7%	-4.7%	4.5%	3.5%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.104%	22.5	22.5	48.5	234.4
Canada 10-Yr	3.446%	33.6	33.6	33.2	173.3
UK 10-Yr	3.985%	44.8	44.8	42.8	279.5
Germany 10-Yr	2.316%	29.2	29.2	0.8	235.0
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.65%	-0.9%	-0.9%	2.8%	-7.6%
U.S. Investment-Grade Corp	5.18%	-1.0%	-1.0%	5.3%	-7.6%
U.S. High-Yield Corp	7.78%	-0.4%	-0.4%	9.9%	1.5%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	2,006.32	-2.7%	-2.7%	6.9%	11.4%
Silver (spot $/oz)	22.56	-5.2%	-5.2%	-4.4%	0.4%
Copper ($/metric ton)	8,268.00	-2.3%	-2.3%	-7.0%	-13.6%
Oil (WTI spot/bbl)	72.56	1.3%	1.3%	-3.4%	-7.2%
Oil (Brent spot/bbl)	78.07	1.3%	1.3%	-2.5%	-3.5%
Natural Gas ($/mmBtu)	2.87	14.2%	14.2%	-21.1%	-29.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	103.3860	2.0%	2.0%	0.1%	7.7%
CAD/USD	0.7402	-2.0%	-2.0%	-0.6%	-6.2%
USD/CAD	1.3510	2.0%	2.0%	0.6%	6.6%
EUR/USD	1.0882	-1.4%	-1.4%	1.4%	-3.9%
GBP/USD	1.2679	-0.4%	-0.4%	4.3%	-6.6%
AUD/USD	0.6552	-3.8%	-3.8%	-4.9%	-8.6%
USD/JPY	148.2000	5.1%	5.1%	12.1%	28.6%
EUR/JPY	161.2700	3.6%	3.6%	13.6%	23.6%
EUR/GBP	0.8583	-1.0%	-1.0%	-2.8%	2.9%
EUR/CHF	0.9407	1.3%	1.3%	-5.0%	-10.4%
USD/SGD	1.3446	1.8%	1.8%	1.0%	-0.9%
USD/CNY	7.1963	1.4%	1.4%	6.1%	12.9%
USD/MXN	17.2052	1.4%	1.4%	-9.8%	-15.5%
USD/BRL	4.9313	1.5%	1.5%	-5.2%	-13.0%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -2.0% return means the Canadian dollar fell 2.0% vs. the U.S. dollar year to date. USD/JPY 148.20 means 1 U.S. dollar will buy 148.20 yen. USD/JPY 5.1% return means the U.S. dollar rose 5.1% vs. the yen year to date.

Source - Bloomberg; data as of 1/17/24

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As of December 31, 2023

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Outperform]	829	57.17	253	30.52
Hold [Sector Perform]	575	39.66	154	26.78
Sell [Underperform]	46	3.17	6	13.04

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