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US small-cap outlook remains bright for 2024

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Equity markets have got off to an uncertain start to the year, after a strong rally in the final months of 2023.

Despite a 1.4% rise on Monday, the S&P 500 is close to flat so far this year—with a decline of 0.4% as of 10 January. This mixed performance partly reflects a scaling back of market expectations over the timing and pace of rate cuts by the Federal Reserve. This caution has been most clearly expressed in small-cap stocks, with the Russell 2000 down 2.9% and the S&P Small Cap Index falling 3.2%.

In addition, survey data released on Tuesday from the National Federation of Independent Business (NFIB) suggested small business owners remain pessimistic about future conditions. The reading of 91.9 for the Small Business Optimism Index, while a modest improvement on the prior month, was still the 24th month in a row below its 50-year average of 98. The survey also showed the average interest rate that respondents paid on short-term loans increased to 9.8%, while loan availability tightened.

But despite this cautious start to the year for smaller US companies, we expect them to be a bright spot in markets this year.

Lower rates benefit small-cap companies even more than their larger peers. Investors will be looking for further evidence that price pressures in the US are cooling from this week's release of the consumer price index for December. While headline inflation is expected to nudge higher, core prices excluding food and energy—which are typically more important in shaping Fed policy—are expected to decline further, based on the consensus forecast. Recent data on both the labor market and inflation have been consistent with our base case that the Federal Reserve will implement four 25-basis-point rate cuts in 2024, most likely starting at the May policy meeting.

This should disproportionately benefit smaller companies, since nearly half of the debt held by Russell 2000 companies is floating rate—versus around a tenth for large-cap companies. As a result, Fed rate cuts can quickly start to reduce interest expenses for small-cap companies.

Earnings growth likely to accelerate faster for smaller companies. Similar to large-caps, earnings growth for small-caps should accelerate in 2024. While we do not have an official forecast for small-cap earnings growth, earnings performance for small-caps is highly correlated to large-caps, but with larger swings on the upside and downside. Our expectation for 9% earnings growth for the S&P 500 in 2024 suggests low double-digit earnings growth for the S&P 600 small-cap index. This is a substantial improvement from the roughly 10% decline in S&P 600 profits in 2023.

Relative valuations are attractive for small-caps. The Russell 2000 is trading at a roughly 55% discount to the Russell 1000 versus a 10-year average discount of 32%. The forward price-to-earnings ratio for the S&P 600 index is only 13.6 times, lower than its 10-year average of 17.1 times and a 30% discount to the S&P 500. Whether looking at price-to earnings or price-to-book, relative valuations are still 10% to 15% lower than where they stood right before the regional banking crisis, suggesting still healthy relative upside for small-cap companies in the coming months.

So, to capture more market upside in case of a continued equity market rally, we believe investors should complement core quality stock holdings with tactical exposure to US small-caps.

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