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ASSET ALLOCATION INSIGHTS

August 2018

The T. Rowe Price Asset Allocation Committee meets regularly to assess market conditions and the relative values of major asset classes over a 6- to 18-month time horizon. This series of Asset Allocation Insights offers a look at specific topics of interest from the committee's recent discussions.

Tax Reform and Solid U.S. Growth Support Small-Caps

KEY POINTS

- While U.S. small-cap valuations are not as compelling as when we initially moved to overweight the category in mid-2017, we still see a number of reasons to maintain an overweight allocation.
- U.S. small-cap stocks generate a smaller proportion of their revenues overseas compared to large multinationals, leaving them less exposed to tariffs or other trade barriers.
- We believe small-caps should benefit from a favorable U.S. growth environment in 2018, supported by the tax cuts enacted last year as well as by higher federal spending.
- A stronger U.S. dollar could also benefit small-caps on a relative basis by potentially reducing the value of foreign earnings for large multinational firms.

Small-cap stocks have outperformed large-cap stocks so far in 2018, and while valuations are not as compelling as when we initially moved to overweight small-caps in mid-2017, we believe there are a number of reasons to maintain an overweight allocation to the asset class relative to large-caps.

Through July 31, 2018, the Russell 2000 Index of small-cap shares returned 9.54% for the year to date, outpacing the 6.40% return of the large-cap Russell 1000 Index. Recent small-cap performance has been broader across sectors and individual stocks relative to large-caps, where a focused set of names in the information technology and consumer discretionary sectors have driven the bulk of the gains. While small-cap valuations are rich relative to history, they nonetheless remain reasonably valued when compared with large-cap stocks.

Most recently, small-cap stocks have benefited from fears of a trade war as the U.S. threatened to impose—or actually put into place—tariffs on imported goods, prompting retaliatory trade restrictions from countries including China. U.S. small-cap stocks generate a meaningfully smaller proportion of their revenues from overseas compared with large multinationals, leaving them less exposed to tariffs that could weigh on trade and profits.

SMALL-CAPS SHOULD BENEFIT FROM A SUPPORTIVE U.S. GROWTH ENVIRONMENT

Small-cap stocks have also benefited from a constructive U.S. economic environment in 2018, supported by fiscal stimulus

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associated with tax cuts enacted at the end of 2017 as well as legislation to expand federal spending passed at the start of 2018. Because smaller companies typically depend more on domestic economic growth to drive earnings than large multinationals do, the U.S. relative growth advantage is likely to benefit domestic small-caps more than large-caps.

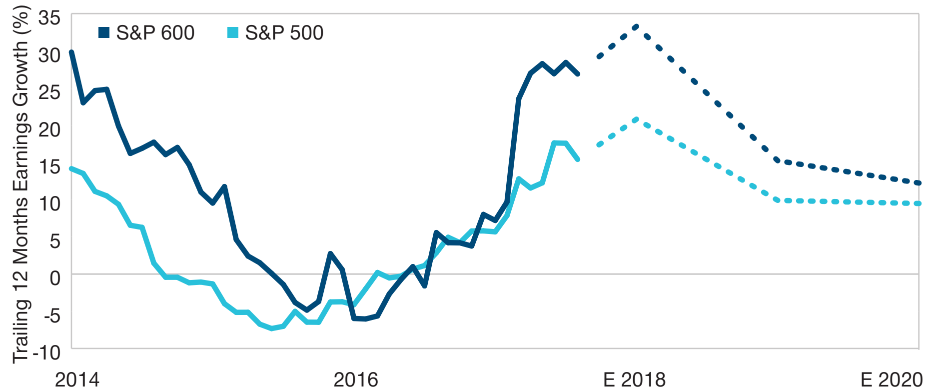
One of the more notable aspects of the recent corporate tax cuts has been the increased cash flow to companies that has been available for capital expenditures, dividends, and buybacks, as well as for potential mergers and acquisitions. "With large-cap companies flush with cash that they have repatriated from overseas as a result of tax reform, many are looking to buy niche players, often in the small-cap space, to solidify or expand their businesses," explains Frank Alonso, small-cap portfolio manager and member of the Asset Allocation Committee.

Similarly, small-caps should benefit if there is an economic tailwind from companies expanding capex as a result of tax reform. T. Rowe Price Chief U.S. Economist Alan Levenson has a positive outlook for capex, saying "business fixed investment grew by 7.7% over the four quarters of 2017 after two years of stagnation the recovery began in the energy sector, but broadened as the year progressed. The solid growth pace continues in 2018, supported by a recovery in corporate profits, which in turn gained fuel with tax reform at the end of last year."

Tax reform and stronger economic expansion have boosted small-cap revenue and earnings growth, with earnings growth rates having started to outpace those of large-caps in late 2017 (Figure 1). Some estimates show that small-cap earnings growth rates may continue to outpace those of large-caps through 2018 and into 2019.

FIGURE 1: Small-Cap vs. Large-Cap EPS Growth

December 2014 Through December 2020



Source: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

IMPACT OF THE U.S. DOLLAR

Against the backdrop of an improving economy into 2018, the Federal Reserve is further along in the process of removing monetary accommodation than other developed market central banks. Stronger U.S. growth and higher interest rates are generally supportive of a stronger U.S. dollar. A stronger dollar is often cited as beneficial for small-cap stocks relative to large-caps as a stronger U.S. dollar can reduce the value of foreign earnings for large-caps; however, an analysis of historical periods characterized by a stronger dollar shows that the track record of relative small-cap outperformance in such environments has been mixed.

WATCHING BUSINESS CYCLE, CREDIT SPREADS, RATES, AND WAGE INFLATION

"The current economic cycle is uncommon in terms of both its extended duration and the muted level of growth relative to prior cycles. Additionally, introducing a fiscal tailwind nearly a decade after the last recession is unprecedented," explains Charles Shriver, multi-asset portfolio manager and a cochair of the Asset Allocation Committee. However, it is not clear that a recession is imminent. Even so, the committee is monitoring data—such as equity market volatility and credit spreads on high yield bonds—that could provide information about the risk environment or the stage of the economic cycle.

Additionally, higher interest rates and wage inflation represent potential headwinds to small-cap stocks. Small-cap companies tend to have higher balance sheet leverage than large-caps, so the potential for higher interest rates provides a reason for increased caution about the asset class. As well, higher wages would also tend to hurt profit margins of domestic small-cap companies more than of larger-cap multinationals that source more of their labor outside the U.S.

While we have been moderating the risk profile of our multi-asset portfolios, our view on small-cap stocks remains favorable. At present, against a constructive backdrop of U.S. economic and earnings growth and with wage increases still relatively muted and risk factors such as high yield credit spreads still relatively close to their narrowest levels in the current economic cycle, we believe this represents a supportive environment for small-cap stocks.

The T. Rowe Price Asset Allocation Committee comprises some of T. Rowe Price's most senior investment professionals. Committee decisions are reflected across our multi-asset portfolios, which accounted for $304.1B U.S. dollars in assets under management[1] as of June 30, 2018. For a broader perspective on asset allocation in our multi-asset portfolios, please see our Asset Allocation Viewpoints.

[1] The combined assets under management by T. Rowe Price Associates, Inc. and its investment advisory affiliates. This figure includes assets that are held outside of T. Rowe Price, but where T. Rowe Price influences trade decisions.

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