

# U.S. small-cap stocks look like a potentially big opportunity

From the Field  
January 2024



## Key Insights

- The ongoing resilience of the U.S. economy has increased the potential for a soft economic landing in 2024.
- U.S. smaller companies have borne the brunt of heightened risk aversion in recent years and are now trading at an historically wide relative valuation discount.
- Consumer spending trends, onshoring of U.S. industry, and potential pricing power are just some of the factors supporting a positive outlook for U.S. smaller companies.



**Curt Organt**  
*Co-portfolio Manager,  
US Smaller Companies  
Equity Strategy*



**Matt Mahon**  
*Co-portfolio Manager,  
US Smaller Companies  
Equity Strategy*

**A**mid multi-decade high inflation, 18 months of interest rate rises, and ever-present fears of recession, the general resilience of the U.S. economy throughout this time has gone, if not unnoticed, then generally underappreciated by many investors. However, this resilience has been underscored recently with the economy posting strong third-quarter growth far exceeding expectations.

At the same time, inflation has declined, easing pressure on policymakers to hike rates further. The encouraging data raise the potential for an economic soft landing in 2024, defying gloomier predictions that have prevailed for much of the past two years.

## Historically wide valuation discount

For U.S. smaller companies—which have borne the brunt of heightened risk aversion in recent years—this marks a significant turning point. As risk appetite returns, and fundamentals once more prevail over sentiment, the extreme relative valuation discount of smaller companies looks increasingly attractive.

U.S. smaller company stocks have historically traded at a premium to large-caps, reflecting their higher relative risk/return profile. In recent years, however, this valuation trend has reversed—small-cap stocks are not only trading at a discount to their larger counterparts, but the differential has become extreme, widening to levels not seen in decades (Fig. 1).

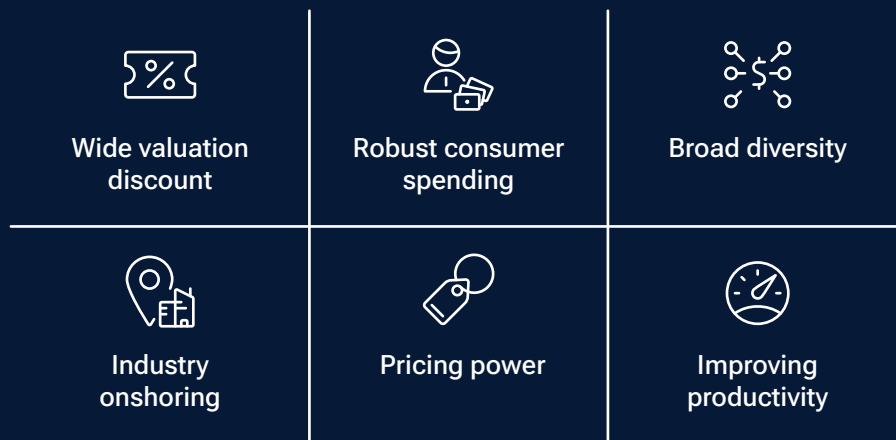
## Robust consumer spending

The U.S. economy expanded by an annualized 4.9% in the third quarter, the fastest pace in nearly two years. Meanwhile, inflation fell to 3.2% in October, marking a spectacular decline from the 40-year high of 9.1% recorded in June 2022.

One of the primary forces behind the economy's resilience has been the continuing strength of consumer spending. A strong jobs market with a high level of employment means U.S. wages are rising, while excess savings are also at historically high levels. Importantly, U.S. consumers are also less immediately exposed to the steep rise in interest rates than many other countries. Most U.S. household mortgages—around 90%—are fixed rate, with a large percentage secured at long-term interest rates well below the high rates available today. In short, individual balance sheets are in better shape than prior to the pandemic, giving consumers the confidence to keep spending.

However, we are also seeing a shift in underlying spending trends, away from goods and into services. This traces back to the COVID pandemic, during which the goods economy remained robust while the services economy effectively shut down.

## An upbeat outlook for U.S. smaller companies



Source: T. Rowe Price.

We are now seeing this imbalance swing the other way, with evidence of a concerted catch-up in services spending. Importantly, with smaller company earnings much more geared to the services economy, this shift should help to fuel favorable relative earnings growth.

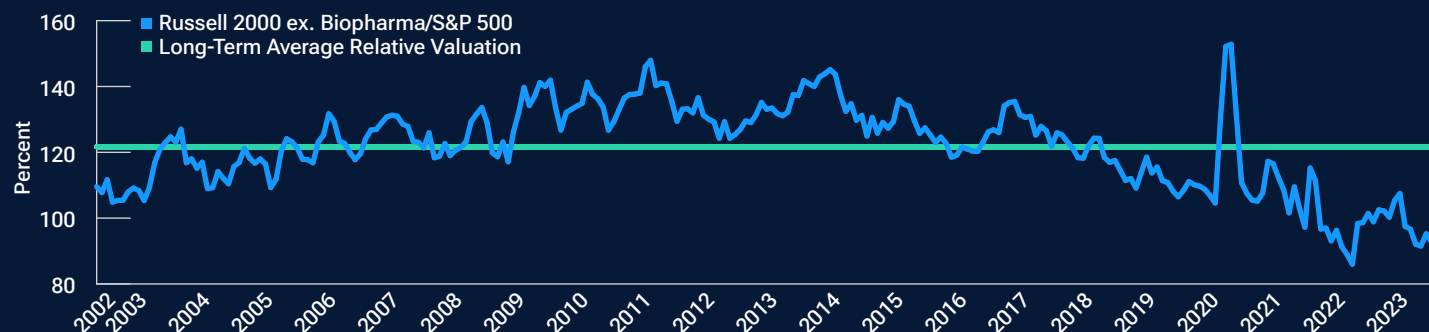
Similarly, U.S. companies, large and small alike, have also moved quickly to downsize or refinance their debt since the pandemic, resulting in generally healthier balance sheets, more cash, and less exposure to interest rate fluctuations.

## Broad diversity in a highly concentrated market

A great deal has been written about the highly concentrated top end of the U.S. equity market. The S&P 500 Index has become increasingly focused in a very small group of mega-cap companies. The so-called Magnificent Seven—Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta—have become so highly priced that they now dwarf the value of many international equity markets.

## U.S. small-cap relative valuations are at multi-decade lows

(Fig. 1) Relative forward (next 12 months) price/earnings ratio



As of September 30, 2023.

Sources: Furey Research Partners, S&P Indices, and LSE Group; analysis by T. Rowe Price (see Additional Disclosures).

Smaller companies offer a much more diversified exposure to the vitality of the U.S. economy and a different risk profile to large-cap investing. The domestic bias of smaller companies, and more balanced exposure at the sector level, means they are often better positioned to benefit from changing trends in the U.S. economy.

## Industry onshoring

The trend toward supply chain localization or “onshoring”/“reshoring” of U.S. industry is gathering pace. We have already seen a sharp rise in manufacturing and construction activity directly attributable to company onshoring/reshoring and this seismic shift is still only in the relatively early stages (Fig. 2). The full impact of new legislation, including the 2022 CHIPS and Science Act and the 2022 Inflation Reduction Act, offering big incentives for businesses to bring operations and personnel back to the U.S., is still yet to be felt. Each contains stipulations regarding the production and procurement of U.S.-made products and components designed to benefit companies that manufacture domestically. Smaller companies, which tend to be more geared to the domestic economy, stand to benefit from this concerted shift away from globalization in favor of more locally driven supply chains.

## Smaller company pricing power

One of the main risks to the positive outlook in 2024 is that inflation recommences its upward trajectory, necessitating further rate increases. We acknowledge that there is secular upward pressure on costs in the energy sector, for example. Rising inflation and higher interest rates would certainly cloud the outlook for smaller companies. However, even if this transpires, there are many smaller companies that display that all-important attribute—pricing power.

Smaller companies are often assumed to be price takers, with limited ability to exert pricing power. In fact, many smaller businesses operate in underserved or niche industries, such as fintech, computer gaming, e-commerce, and green energy, and so command more pricing power than their size might suggest. When these businesses begin to experience inflationary pressure, be it through supply chain bottlenecks, wage increases, or due to rising input costs, they are able to pass on these higher costs to customers, thereby helping to protect their profit margins.

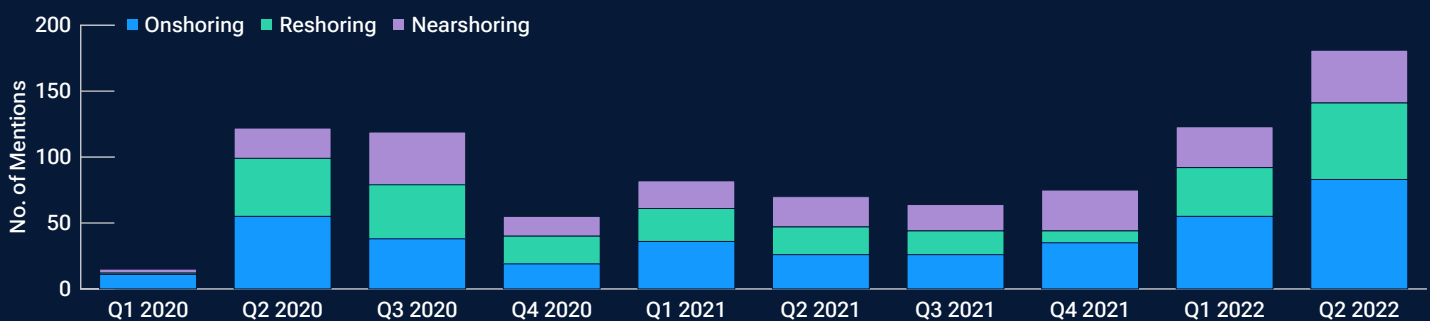
Even if a smaller company cannot control the price of an end product, it is not necessarily powerless to influence its own revenues/profits. For example,

“ Smaller companies offer a much more diversified exposure to the vitality of the U.S. economy....

– Matt Mahon  
Co-portfolio Manager, US Smaller Companies Equity Strategy

## U.S. industry is coming home

(Fig. 2) Supply chain shifts are getting more attention from company management



As of June 30, 2022 (latest available).

Source: Bloomberg data; analysis by T. Rowe Price. U.S. executive mentions of the terms “Onshoring,” “Reshoring,” or “Nearshoring” during quarterly earnings calls and/or conference presentations.

many smaller companies can be critical components within more complicated processes or supply chains. As has been painfully clear in recent years, high demand and limited supply of any component along the supply chain gives pricing power to the component producer. Asset-light companies offering business-critical services/products, look particularly well placed to deliver recurring cash flows and potentially grow their revenues.

---

### A premium for improving productivity

While a more positive economic outlook in 2024 is important for smaller companies at a broad level, improving productivity is likely to be a key driver of topline performance at a company level. With this in mind, there are many good opportunities to be found, often in less studied sectors, which are having a meaningful impact in terms of enabling improved productivity. Some of the most important aspects of our lives, in key areas like financial services, health care, and

agriculture, for example, have not really been reimagined in the way that sectors like technology or communications have. We are seeing significant investment in these areas, and innovative smaller companies are frequently at the forefront of this advancement.

---

### Looking ahead to 2024

The reliance of the U.S. economy, powered by U.S. consumers' resilience has bolstered hopes for a soft-landing scenario in 2024. If this transpires, and recession is avoided, there are many pieces in place to suggest smaller companies can perform well. Relative valuations, versus larger companies, have fallen to historically low levels, despite earnings remaining relatively resilient, and history tells us that small-caps outperformed strongly in an improving economic environment. With powerful onshoring trends and a strong dollar also providing tailwinds, investors may wish to consider adding small-cap exposure, focusing on those businesses driving productivity gains—and/or that command pricing power.

 **Asset-light companies offering business-critical services/products, look particularly well placed to deliver recurring cash flows and potentially grow their revenues.**

– Curt Organt  
Co-portfolio Manager, US Smaller  
Companies Equity Strategy

The specific securities identified and described are for informational purposes only and do not represent recommendations.

---

#### Additional Disclosures

Bloomberg Finance L.P.

The S&P 500 is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates (“SPDJ”) and has been licensed for use by T. Rowe Price. Standard & Poor’s® and S&P® are registered trademarks of Standard & Poor’s Financial Services LLC, a division of S&P Global (“S&P”); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC (“Dow Jones”). T. Rowe Price is not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates, and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500.

London Stock Exchange Group plc and its group undertakings (collectively, the “LSE Group”). © LSE Group 2024. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company’s express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

## INVEST WITH CONFIDENCE™

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

---

### Important Information

**This material is being furnished for general informational and/or marketing purposes only.** The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

**DISCLOSURE CONTINUES ON THE FOLLOWING PAGE.**

---

## Important Information (cont.)

**Australia**—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

**Brunei**—This material can only be delivered to certain specific institutional investors for informational purpose only. Any strategy and/or any products associated with the strategy discussed herein has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

**Canada**—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

**Colombia, Chile, Mexico, Perú, Uruguay**—This material is prepared by T. Rowe Price International Ltd - Warwick Court, 5 Paternoster Square, London, EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority - and issued and distributed by locally authorized distributors only. For professional investors only.

**DIFC**—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

**EEA**—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

**Hong Kong**—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

**Indonesia**—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

**Korea**—This material is intended only to Qualified Professional Investors. Not for further distribution.

**Mainland China**—This material is provided to qualified investors only. No invitation to offer, or offer for, or sale of, the shares will be made in the mainland of the People's Republic of China ("Mainland China", not including the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the Mainland China. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the Mainland China. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the Mainland China that are expressly authorized under the laws and regulations of the Mainland China to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the Mainland China. Potential investors who are resident in the Mainland China are responsible for obtaining the required approvals from all relevant government authorities in the Mainland China, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the Mainland China, or nationals with permanent residence in the Mainland China, or to any corporation, partnership, or other entity incorporated or established in the Mainland China.

**Malaysia**—This material can only be delivered to specific institutional investor. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

**New Zealand**—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

**Philippines**—ANY STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING DISCUSSED HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

**Singapore**—Issued by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

**South Africa**—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), Warwick Court, 5 Paternoster Square, London EC4M 7DX, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: [www.faisombud.co.za](http://www.faisombud.co.za), Email: [info@faisombud.co.za](mailto:info@faisombud.co.za)

**Switzerland**—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

**Taiwan**—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

**Thailand**—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

**UK**—This material is issued and approved by T. Rowe Price International Ltd, Warwick Court, 5 Paternoster Square, London EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

**USA**—Issued in the USA by T. Rowe Price Investment Management, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2024 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.