How attractive are U.S. small-cap stocks?

From the Field
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Key Insights

- U.S. small-cap stocks are attractive, given cheap valuations and an improving earnings outlook.
- However, higher interest rates pose challenges to smaller companies due to higher leverage, thinner margins, and more debt with near-term maturities.

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Relative to history, U.S. small-cap stocks are cheap. The S&P 600 Index's forward price-to-earnings (P/E) ratio was 12.6 as of November 21, 2023. This ratio had only dipped below 13 twice since the turn of the millennium—in 2008, during the global financial crisis, and in 2011, when sovereign debt concerns weighed heavily on global stock valuations (Figure 1).

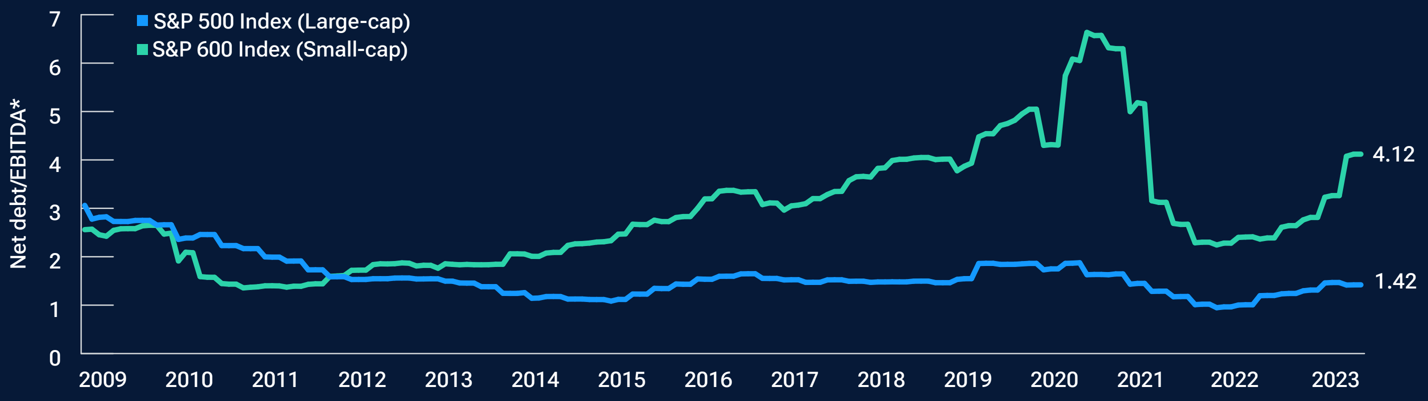
U.S. small-cap valuations are at historically low levels

(Fig. 1) S&P 600 Forward P/E Ratio

January 1, 2000, through November 21, 2023.
Actual outcomes may differ materially from forward estimates.
Sources: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. S&P 600 Index. See Additional Disclosures.

Small-cap companies have higher debt burdens

(Fig. 2) Net debt to EBITBA



January 2009 through October 2023.
Past results are not a reliable indicator of future results.
Sources: Bloomberg Finance L.P., S&P 500 and S&P 600 indices. See Additional Disclosures.
*EBITDA = earnings before interest, taxes, depreciation, and amortization.

In addition to low valuations, an improving earnings outlook may favor small-cap stocks. Despite recession fears, the U.S. economy has proven to be more resilient than expected in 2023. Forward earnings estimates stabilized in June and July, and there are signs of upward momentum as we enter 2024.

However, concerns about higher interest rates pose a notable challenge for U.S. small-cap stocks. A comparison of net debt[1] to EBITDA[2] ratios shows that small-cap companies typically have higher debt burdens than large-cap companies (Figure 2). Operating margins for small companies also stand well below those of large companies. This means that as interest costs increase, small-cap companies have less of a buffer before profit margins turn negative.

Further, data also show that smaller companies have more debt that will mature within the next five years than large companies.[3] Interest costs for small-cap companies are, therefore, likely to increase more quickly, as company bonds will need to be refinanced at higher rates sooner.

Overall, U.S. small-cap stocks offer attractive valuations and an improving earnings outlook, but they are also more sensitive to higher interest rates than large-cap companies. As a result, our Asset Allocation Committee currently holds an overweight position to U.S. small-cap equities. We believe it is prudent to invest in this asset class via actively managed portfolios with a higher quality bias.

[1] Net debt shows how much cash would remain if all debts were paid off and if a company has enough liquidity to meet its debt obligations.
[2] EBITDA = earnings before interest, taxes, depreciation, and amortization.
[3] As of October 26, 2023. Source: T. Rowe Price analysis of companies in the S&P 500 Index and the S&P 600 Index using data from Bloomberg Finance L.P.

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