The Outlook for U.S. Smaller Companies Looks Increasingly Compelling

Now is not the time to wait on the sidelines.

August 2023

KEY INSIGHTS

- While the U.S. equity market has become increasingly concentrated at the top end over the past decade, smaller-company valuations are at their most compelling levels in decades.
- History shows that as high concentration in the S&P 500 Index begins to unwind, a new cycle of small-cap outperformance usually begins.
- Shifting trends in the U.S. economy are particularly supportive of smaller companies, providing a potential catalyst for higher earnings growth.

Watchful confidence continues to characterize the U.S. equity market as the economy, consumer confidence, and corporate profits all show surprising resilience. One source of worry, however, is the high level of concentration at the top end of the equity market, as investors continue to pile into a handful of richly valued mega-cap companies. In stark contrast, we believe company valuations at the smaller end of the scale are at their most compelling levels in decades. This is creating opportunities to add exposure to high-quality, growth-oriented businesses with the potential to compound returns over time. Now is not the time to wait on the sidelines.

Beware of Large-Cap Concentration Risk

A great deal of ink has been dedicated to explaining how, for more than a decade, the performance of the U.S. equity market has been dominated by a small group of mega-cap, growth-oriented companies. This trend has seen the U.S. equity market become highly concentrated at the top end, with valuations of a small group of large companies increasingly hard to justify. Importantly, history tells us that as high concentration in the S&P 500 Index begins to unwind, a new cycle of small-cap outperformance usually begins. As money is reallocated out of highly concentrated, potentially overvalued names, it must find somewhere to go, and this has tended to be the more attractively valued stocks further down the capitalization scale.

What's more, it shouldn't take a huge amount of capital flowing into the small-cap domain to move the dial significantly. As of June 30, 2023, the five largest stocks alone in the S&P 500 Index had a market capitalization of 3.3x that of the entire smaller-companies

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Russell 2000 Index. So every incremental dollar reallocated into the small-cap sector is a tailwind to relative performance. If even a fraction of the value of the five largest U.S. stocks made its way into smaller companies, the overall impact could be substantial.

The Small-Cap Valuation Story Looks Attractive

U.S. smaller-company stocks have historically traded at a premium to large-caps, a direct reflection of their higher relative risk/return profile. In recent years, however, this valuation trend has reversed; not only are small-cap stocks trading at a discount to their larger counterparts, the discount has reached historically wide levels, effectively detaching from its long-term "normal" range. Over the past 50 years, there have been only two occasions when small-cap stocks have traded at similarly wide relative discounts—during the 1999–2000 dot-com boom and bust and in the 1973 oil crisis.

On an absolute valuation basis, smaller companies are also trading below long-term average levels. This partly reflects the more difficult near-term environment, with smaller companies generally more sensitive to the ups and downs of the U.S. economy. However, current valuation levels also appear to suggest expectations of a potentially protracted U.S. economic recession. This seems an overly bearish outcome, in our view, and one that, at this stage, appears unlikely based on the mosaic of information available.

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Earnings Growth to Drive Smaller Companies Higher

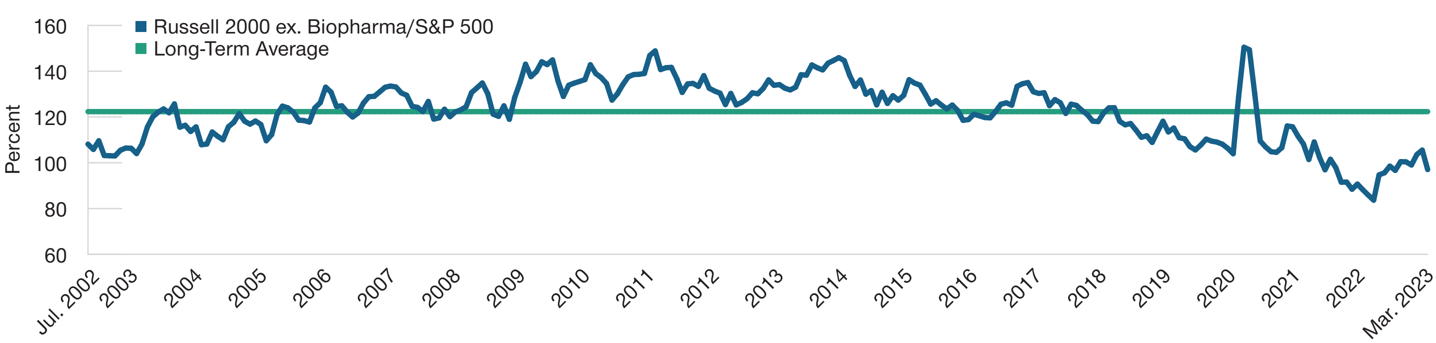
Ultimately, the key question moving forward is: What will be the catalyst that sparks the U.S. smaller-companies segment higher? The simple answer is earnings growth, and the outlook here is positive, with important structural trends providing support:

1. **Services Growth:** Smaller companies are more domestically oriented, and so, better positioned to benefit from shifting trends in the U.S. economy. Notably, consumer spending in the U.S. is moving from goods to services, a trend that is likely to be particularly supportive of smaller-company earnings. During the coronavirus pandemic, the goods economy remained generally healthy, while the services economy all but shut down. This scenario is starting to reverse, and with smaller-company earnings geared much more to the services sector, this should provide a major boost to earnings growth.

2. **Capital Spending Growth:** Another trend that has accelerated post-pandemic is the rise in U.S. capital spending (capex).

U.S. Small-Cap Relative Valuations Are Around All-Time Lows

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



As of March 31, 2023.
Sources: Furey Research Partners, S&P Indices, and LSE Group; analysis by T. Rowe Price (see Additional Disclosures).

Within the smaller-company domain, what you own is acutely more important than simply owning an allocation.

Smaller-companies' earnings growth is highly correlated to U.S. capex growth due to the largely domestic focus of these businesses. A major initiative is also underway to re-shore U.S. supply chains. The government is providing large incentives to encourage more domestic manufacturing, enshrined in legislation such as the CHIPS and Science Act of 2022. Similarly, the Infrastructure Investment and Jobs Act and the Inflation Reduction Act passed in 2021 and 2022 also provide further tailwinds.

Small-Cap "Zombie Stocks" Warrant Caution

While increasing concentration at the top end of the market has been a feature of the U.S. equity market, a deterioration in quality at the smaller end of the universe is also evident. The number and weight of so-called zombie stocks in the Russell 2000 Index—defined as companies that struggle or are unable to cover interest payments on their debt—have risen to all-time highs. This is particularly relevant today as rising interest rates means higher interest payments for these companies to make.

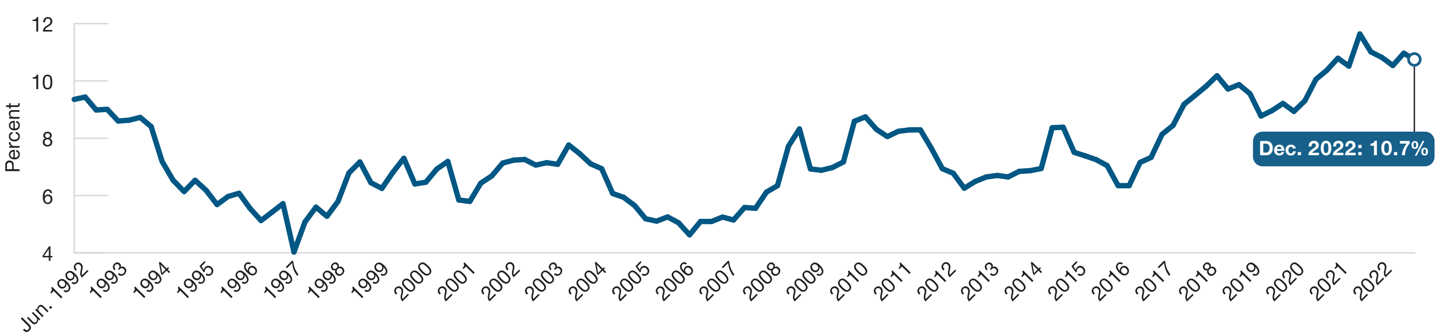
Not all nonearning companies are automatically bad investments. For many small companies, especially those in their early start-up phase, or in nascent markets, it is quite common to have negative earnings until operations improve and consumer recognition and demand for products or services increases. However, we are seeing a rising trend in the number of small-cap zombie companies. As such, this demands a prudent research approach in order to evaluate the growth potential, quality, and scalability of these businesses, which are crucial to their long-term success.

Within the smaller-company domain, what you own is acutely more important than simply owning an allocation. For example, as of December 31, 2022, the weight of zombie companies in the Russell 2000 stood at nearly 11%, almost double the weighting recorded just five years ago in 2017. For investors allocating passively to smaller companies, this is reason for pause as it highlights the high level of exposure to unprofitable zombie companies they are unwittingly paying for.

The case for U.S. smaller companies looks increasingly compelling, in our view. Valuation levels are at once-in-a-generation lows, providing investors with a rare opportunity to access this dynamic, diverse, and growth-oriented area of the equity market. Beyond the valuation story,

Rising Number of Small-Cap Zombie Companies Demands an Active Approach

(Fig. 2) Percentage of zombie stocks in the Russell 2000 Index



As of December 31, 2022.
Zombie company defined as (i) non-financial company with (ii) average 3-year debt greater than 0 and (iii) average 3-year trailing earnings (EBIT) less than 3-year trailing interest expense.
Source: Furey Research Partners, analysis by T. Rowe Price.

shifting trends in the U.S. economy also favor smaller companies, potentially serving as a catalyst for long-term positive earnings growth. The smaller-companies' segment will remain sensitive to the vagaries of the economy and to market sentiment, making an active approach essential in navigating a way forward, but the current weight of evidence suggests a positive long-term outlook for U.S. smaller companies. It's no time to wait on the sidelines.

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