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Investment Institute

Market Commentary

Weekly perspective on current market sentiment — May 24, 2023

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Last week's S&P 500 Index: +1.7%

Cycle basics

Key takeaways

- On a year-to-date basis through May 23, the small-capitalization Russell 2000 Index has underperformed the S&P 500 Index by approximately 7.4%.
- We expect small caps to continue to underperform as the economy slows and recession nears.

The financial media have been chock-full of stories in recent months surrounding the poor performance of small-capitalization U.S. stocks relative to the S&P 500 Index (SPX). We use the Russell 2000 Index (RTY) as our benchmark for domestic small-cap equity performance. On a year-to-date basis, at the time of this writing, the RTY has underperformed the SPX by approximately 7.4%. That is a meaningful gap over a short period of time.

Many market pundits and strategists have been suggesting that investors seek to take advantage of this underperformance by adding to, or in some cases even overweighting, U.S. small caps in their portfolios. While the time will likely come at some point down the road to have a favorable rating on this asset class, our current analysis concludes that the time is not now. Note that we currently hold a Most Unfavorable rating on small-cap equities.

There are a few things we believe investors need to keep in mind when considering small-cap equities. Probably at the top of the list are where we are in the economic cycle and what the outlook over the next 6 – 12 months might look like. Smaller-cap stocks, in general and as tracked by the RTY, tend to be of lesser quality and have riskier profiles than their big-cap brethren as tracked by the SPX. From a high level, compared to better-quality stocks, small caps generally have weaker balance sheets, less reliable cash flow, narrower product lines, less capacity to buy back shares, and, importantly, a tougher time obtaining credit and operating loans.

The last point, access to credit and operating loans, is particularly important now in this current cycle. The Federal Reserve's latest survey of senior loan officers points out that credit standards are tightening. These standards have been getting tighter since the fourth quarter of last year. The recent banking turmoil is likely to further curtail credit growth, especially to smaller companies that tend to rely more on regional banks for loans and lines of credit. The American economy to a great extent runs on the availability of credit. Everything from making payroll to having inventory on hand to buying or leasing equipment depends on the ability to obtain credit, especially for smaller companies. Tougher credit standards can create headwinds for economic growth.

As our regular readers know, we have been recommending that investors take a more defensive portfolio stance since the first quarter of last year. Small-cap equities, as tracked by the RTY, have tended to underperform large-cap stocks (SPX) when the economy is slowing down or heading into a recession as we expect later this year. Small caps tend to be highly tied to the economy, and their earnings are typically hit harder relative to large-cap equities when the economy turns down. We expect small caps to continue to underperform as the economy continues to slow and recession nears.

The good news is that small-cap equities historically tend to begin to outperform as the economy prepares to recover from a slowdown or recession. While that isn't next week or next quarter, we do believe that small caps will likely be in a position for better performance next year.

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets** are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks.

Definitions

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

An index is unmanaged and not available for direct investment.

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