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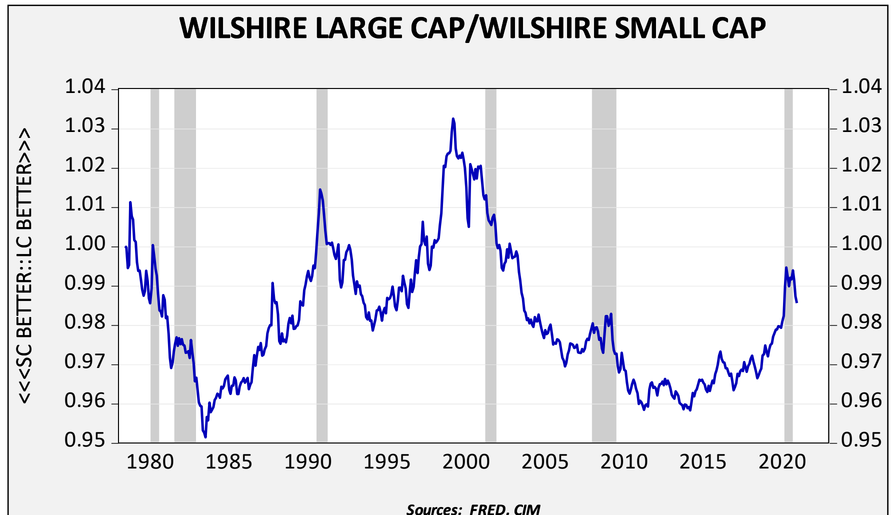
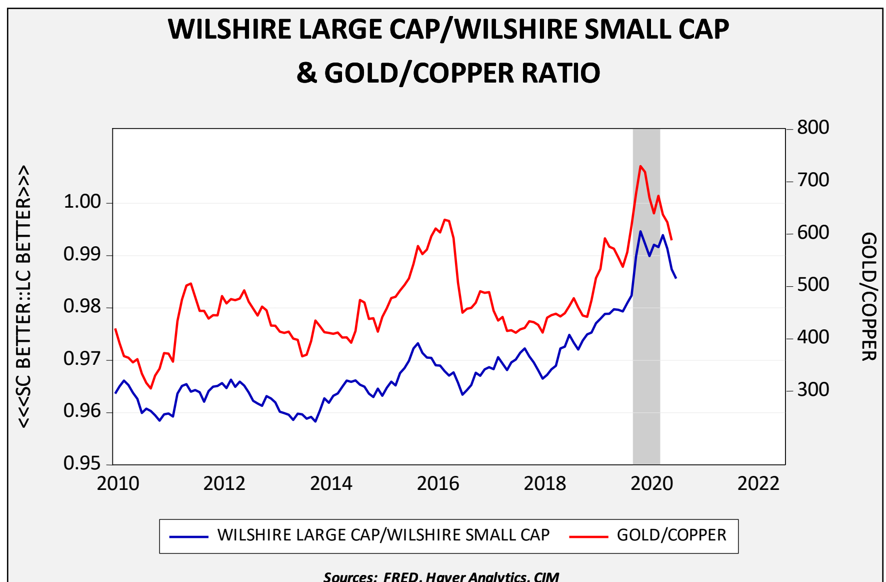
The Case for Small Caps

To measure market capitalization, we use the Wilshire Large Cap and Wilshire Small Cap indices. The following chart shows the log-transformed ratio.



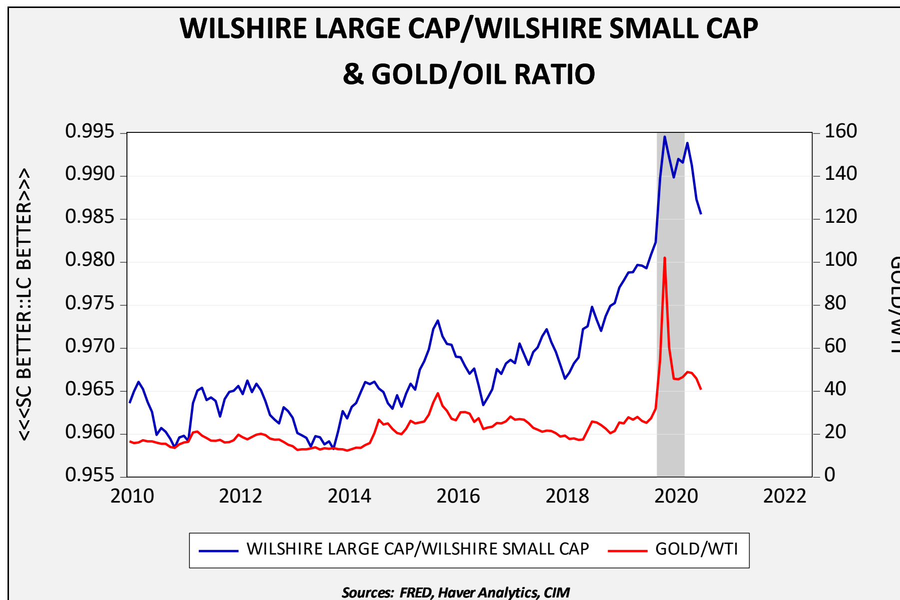
On this chart, a rising number indicates stronger large caps relative to small caps. In general, small caps tend to outperform coming out of recessions, which are shown on the chart with gray bars. The basic idea is that, going into recession, investors tend to prefer large cap stocks for the safety. Larger companies have better access to capital and can generally garner more resources to "weather the storm." As the business cycle improves, smaller firms that have made it through the downturn are usually attractively priced and thus recover faster. Since we believe the recession is already over, we would expect smaller caps to outperform and, as the above chart suggests, there is evidence that this outperformance has already started.

Over the last business cycle, a couple of other cyclical indicators are supporting the case for small caps.



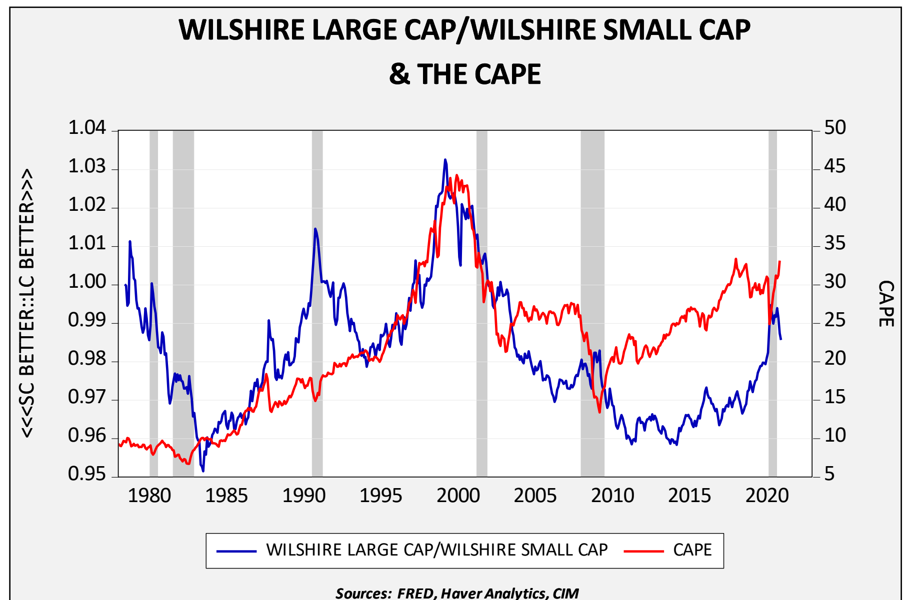
A rising gold price relative to copper suggests a weakening economic cycle and flight-to-safety. Although the prior history isn't conclusive, since 2010 the pattern is rather clear. And, the recent rise in copper prices relative to gold, an indication of economic recovery, is supportive for small caps relative to large caps.

The gold/oil ratio shows similar results, although with a bit less fit.



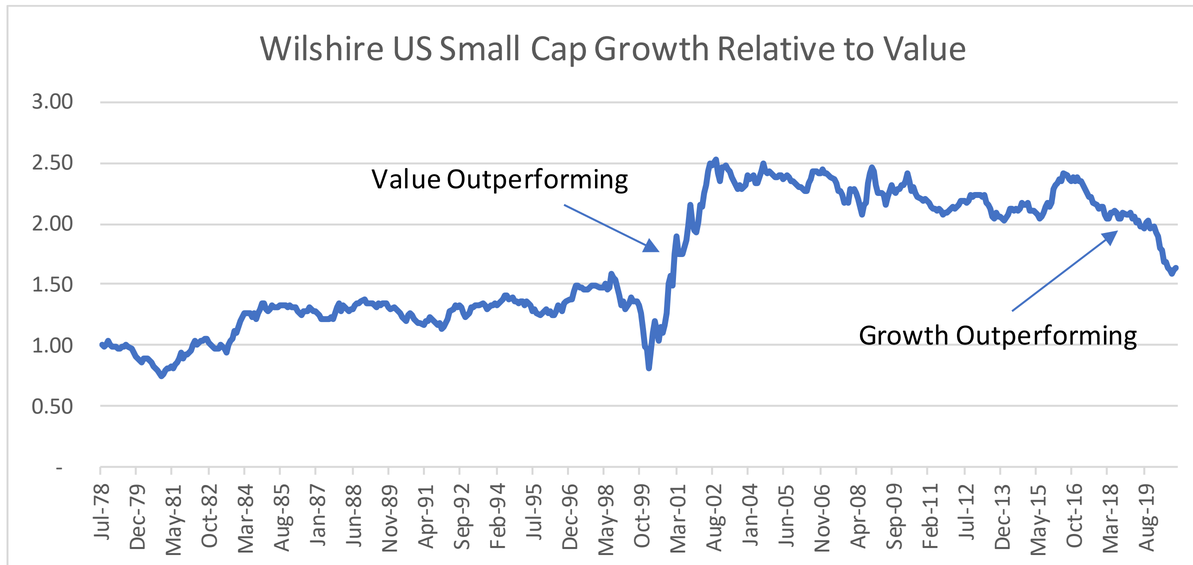
Finally, the capitalization ratio tends to track the overall direction of the market multiple.

This chart overlays the Wilshire Large Cap/Wilshire Small Cap ratio with Shiller's CAPE. The fit isn't perfect, but the overall trend is unmistakable—a rising multiple tends to favor large caps. The current multiple is extended; although not at all-time highs, it is clearly elevated. We would expect some multiple decline going forward as earnings recover, but we don't expect a repeat of the 2000-2005 period when the multiple fell significantly. Policy accommodation is too supportive and inflation too low to bring a major multiple contraction. But, if inflation were to rise more than we would expect, leading to a faster drop in the P/E, small caps would tend to offer better protection relative to large caps.



Finally, if we look back to the late 1990s when growth also dominated, there was no specific event that occurred at the top (March 2000) that triggered the end of the tech bubble. What we do know is that it was an extremely crowded trade that simply ran out of new demand from investors and with no support from valuations it led to precipitous losses for those with concentrated holdings of those stocks.

Historically, valuations have not been the sole driver of inflection points. In this environment, we can point to a few concerns which may stem the tide, although they are more in recognition of issues investors are aware of, yet willing to discount. First, big tech serves the "old" economy businesses, whether it be cloud hosting (MSFT, $214.36; AMZN, $3,162.58; and GOOG, $1,827.99), reliance on advertising spend (FB, $279.70; and GOOG), or reliance on the consumer (AAPL, $122.25; and AMZN). As the economy improves, we could see a reversion to the mean as investors shift from their concerns, which seem to be focused on lockdown risk, and diversify, which will broaden the market. We could also see anti-trust concerns resurface, which had bipartisan interest pre-COVID-19. With that said, it is more likely that the snake we are looking at is not the one that will bite. This is why our focus has always been on fundamentals and valuations.



(Source: Morningstar, Confluence)

Thus, the business cycle and level of the multiple tends to favor smaller capitalization stocks relative to larger capitalization stocks. However, given the unique nature of this recession (pandemic-induced with the accompanying social distancing orders), the normal market preference for large cap stocks in a recession has been both exacerbated and narrowed. It has been narrowed to a focus on those companies thought to benefit especially from the way the economy has been shaped by the pandemic (e.g., online commerce, work-from-home, etc.). This has resulted in an unusually bifurcated market with historically narrow leadership, patterns which have generally been quite negative for small cap stocks.

As COVID-19 recedes in the coming quarters due to vaccines and herd immunities, the incipient economic recovery should gather both strength and breadth. This trend should be quite positive for those market segments that have been on the "wrong side of the COVID-19 trade" in 2020, which includes small cap and value stocks. We believe we saw a precursor of future trends when news hit of the Pfizer (PFE, $40.34)/BioNTech (BNTX, $120.00) vaccine results. We saw money flow quickly into small cap stocks, financials, and many other market segments largely left behind thus far. This action encourages us that the broadening of the recovery post-COVID-19 will mean that small cap stocks will indeed outperform as they traditionally have in post-recession environments.

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