Market Commentary Blog

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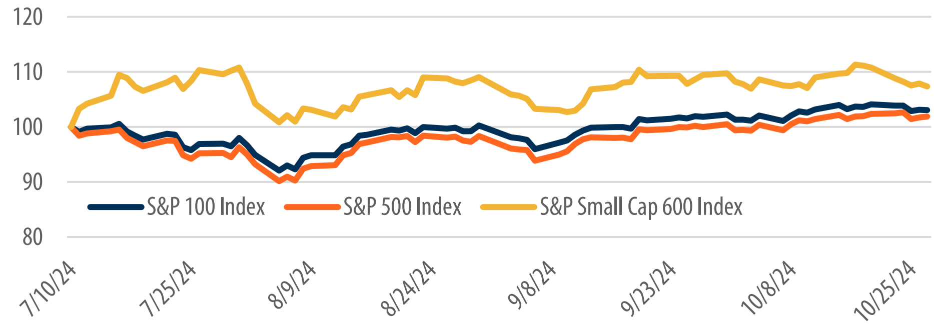
A Tale of Two Market Caps

S&P 100, S&P 500, and S&P Small Cap 600 Indices Daily Price Returns



Source: Bloomberg. Daily observations from 7/10/24 to 10/25/24 normalized to a factor of 100.
Past Performance is no guarantee of future results.

View from the Observation Deck

In a previous post on this topic (click here), we noted that Jerome Powell's July commentary to the Financial Services Committee on 7/10/24 appeared to have set the stage for a dramatic shift in the performance of small cap stocks relative to their large cap counterparts. Today's post serves as an update to our previous observations. The chart above includes the price-only returns of the largest 100 stocks in the S&P 500 Index (the S&P 100 Index), the S&P 500 Index, and the S&P Small Cap 600 Index normalized to a factor of 100.

- On 7/8/24, prior to Powell's address, the federal funds rate futures market indicated there was a 72.0% chance that the Fed would cut its policy rate at its September meeting. That expectation surged following his remarks, rising to 98.0% on 7/23/24.
- As we now know, the Fed cut its policy rate by 50 basis points in September, lowering the federal funds target rate (upper bound) from 5.50% to 5.00%.
- Historically, the Fed's policy rate has nearly matched the rate of inflation.
    - Over the 30-year period ended 9/30/24, the federal funds target rate (upper bound) averaged 2.58% on a monthly basis. Inflation, as measured by the 12-month change in the consumer price index (CPI) averaged 2.5% over the same time frame.
    - The federal funds target rate (upper bound) stood at 5.00% at the end of September, well above September's CPI reading of 2.4%.
- Valuations for small cap stocks appear to be more attractive than their large cap counterparts. In fact, the price to earnings (P/E) ratio of the S&P Small Cap 600 Index currently sits at 16.80 compared to its 10-year average of 24.63 (as of 10/28). For comparison, the P/E ratios of the S&P 100 and S&P 500 Indices stood at 26.41 and 24.97, above their 10-year monthly averages of 21.09 and 21.36 as of the same date. Notably, year-over-year earnings for the S&P Small Cap 600 Index are estimated to decline by 8.53% in 2024 before becoming increasingly favorable the following year. In 2025, earnings are estimated to increase by 16.99% for the S&P Small Cap 600 Index, compared to 13.38% and 13.62%, respectively, for the S&P 100 and S&P 500 Indices.
- For reference, the price only returns for the indices in today's chart were as follows (7/10/24 – 10/25/24): S&P Small Cap 600 Index (7.35%), S&P 500 Index (3.09%), S&P 100 Index (1.89%).

Takeaway

As noted in our previous post on this topic, smaller companies are often more reliant on outside capital than their larger counterparts, who generally operate in a state of going concern. Given that equity valuations can vary based on the cost of raising said capital (internally or externally), we expect further easing in monetary policy to have an outsized impact on small cap valuations relative to other market capitalizations. Another noteworthy point is that the spread between the federal funds target rate (upper bound) and the CPI remains well-above historical norms. We anticipate small cap valuations could benefit from a narrowing of that spread, over time. That said, there are mounting concerns that the Fed's initial cut may have been too deep. Case-in-point: the Bureau of Labor Statistics announced that non-farm payrolls increased by 254,000 in September, well above the consensus expected 150,000. In the U.S., real GDP growth was unrevised at 3.0% in Q2'24, but Gross Domestic Income, an alternative measure of economic activity, was revised upward from 1.3% to 3.4%. Given the Fed's data-dependency, a strong U.S. economic outlook may prove to be a headwind to small cap valuations.