Flash Economics

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The revenge of small caps?

Since the end of 2022, small caps indices (companies with a low market capitalization) have been underperforming large caps indices (companies with a high market capitalization) both in the United States and in Europe. However, the opposite trend has been building since the spring.

We wonder here what the decisive factors in the outperformance or underperformance of small caps compared to large caps in the United States and Europe might be.

These could include :

- The level of interest rates, as small companies have more debt than large ones;
- The low level of international diversification of small caps' sales, which is a drag in periods of low growth (in the United States and Europe);
- The competition from private equity, which delivers high returns from the medium-sized companies in which it is invested;
- The existence of monopolistic positions for large groups, which increase their profitability; in addition, large companies spend more on research and development than small companies, which contributes to higher profit margins for large companies.

In the most recent period, during which we have witnessed a recovery of small caps indices compared to large caps, the anticipated fall in interest rates and the worsening outlook for technology stocks may have played a role.

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The stock market performance of small caps was lower than that of large caps from the second half of 2022 to June 2024 in the United States and Eurozone

Chart 1a compares the S&P500 index (large caps) and the MSCI Small Cap 1750 index for the United States.

Chart 1A
United States: Stock Market Indices
(100 : 01.01.2010)

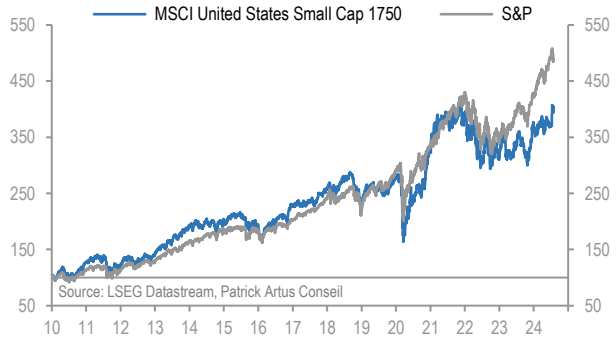
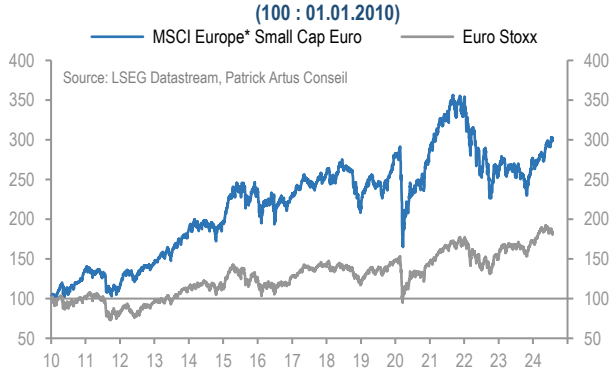


Chart 1b compares the Euro Stoxx 50 index (large caps of the Eurozone) and the MSCI Europe Small Cap index (European small caps).

Chart 1B
Euro zone : Stock Market Indices
(100 : 01.01.2010)



(*) Excluding United Kingdom and Switzerland

We observe the decline in small cap indices compared to that of large caps between the second half of 2022 and June 2024. We wonder about the possible reasons for the underperformance of small caps from the 2nd half of 2022 to June 2024.

Four possible explanations for the underperformance of small caps

1. Rising interest rates

The rise in short-term and long-term interest rates began in spring 2022 in the United States and the Eurozone (**Charts 2a, 2b**).

Chart 2A
United States: Interest rate on 10-year government bonds and Fed Funds rate (as %)

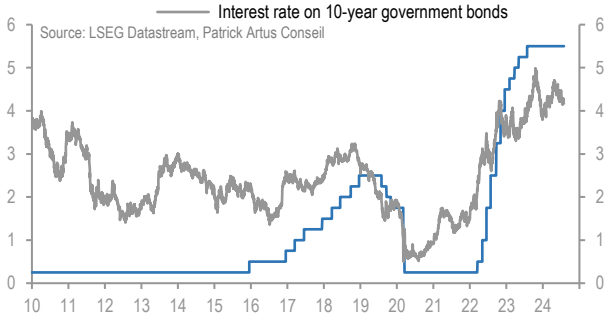
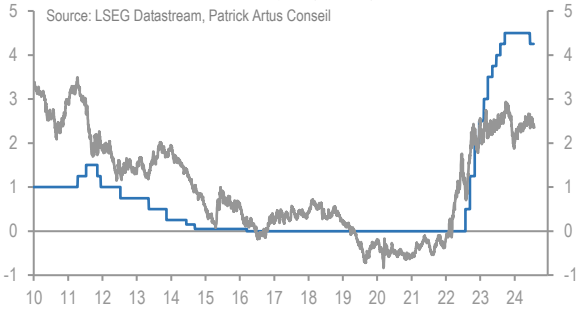


Chart 2b
Euro zone : Interest rate on 10-year government bonds and euro repo rate (as %)

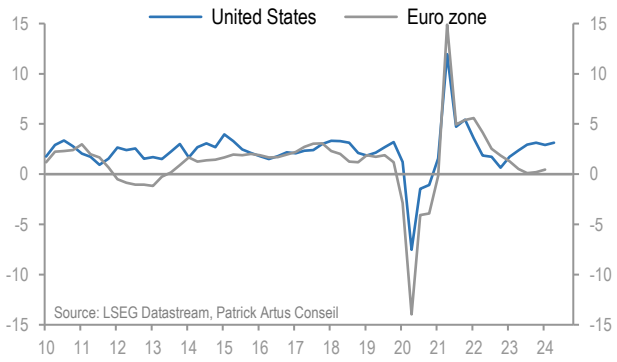


As small caps are highly leveraged, their financial position deteriorates when interest rates rise. Comparing **Charts 1a and 2a** and **Charts 1b and 2b**, we see that the decline in small caps indices matches the rise in interest rates.

2. Weak international diversification of small caps' sales

The international diversification of the revenue of small caps is much lower than that of large caps. This implies that **a slowdown in growth in the United States affects small cap stock indices more than large cap stock indices in the United States, and that a slowdown in growth in the Eurozone affects small cap stock indices more than large cap stock indices in the Eurozone.** This has been mainly observed (**Chart 3**) in the Eurozone, for example during the Eurozone crisis of 2011 to 2014.

Chart 3
Real GDP (Y/Y as %)



3. Competition from private equity

The performance of private equity is very high; over the last twenty years, the return on private equity has been 14.5% in the United States[1] and 14.2% in Europe[2].

This strong performance of private equity **encourages investors to hold companies via private equity funds rather than listed shares.**

4. Monopolistic position and R&D expenditure

Large companies are more likely to enjoy monopolistic positions than small companies, which means that their profitability is greater.

Furthermore, **large companies carry out most of the research and development** (in 2021 in France, for example, large companies spent €19.7 billion on R&D, medium-sized companies €9.1 billion and SMEs €6.4 billion), which helps explain the levels of **profit margins**.

In France, these margin rates are 28% for large companies, 27% for medium-sized companies and 24% for SMEs[3].

The higher profitability of large companies when compared to small companies contributes to a higher stock market valuation for large caps than for small caps.

Summary: outlook

Small cap indices have fallen relative to large cap indices from the second half of 2022 to June 2024 in the United States and the Eurozone. We believe that investors prefer to invest in large caps for several structural reasons:

- Weak international diversification of small businesses' sales;
- Competition from private equity, which offers high returns;
- Monopolistic position of large companies;
- Higher investment in R&D and higher profitability of large companies.

The recovery in small cap indices since June 2024 is probably due to the prospect of lower interest rates and the correction of excessive optimism about the results of technology companies.

[1] Source: Cambridge Associates
[2] Source: EY
[3] Banque de France, monthly bulletin November, December 2023

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