EQUITIES | MARKETS AND ECONOMY

US small-cap cyclicals move higher on election, virus news

By: Mike McLean, CFA | & J. Griffith Noble, CFA | November 19, 2020

Boston - Several market rotations occurred in October: US small-cap stock indexes outpaced US large-cap index returns, value strategies outperformed growth, and investors turned from the tech sector to more cyclical areas of the market. Following US elections, stocks rallied higher, boosted in part by the absence of a "blue wave" — higher corporate tax hikes and major health care reform are less likely with a divided government.

Market pivots on election results

Post-election, it first appeared that tech and growth stocks had resumed the leadership they carried throughout much of the year —until Pfizer's promising vaccine news on November 9. Since then, small-cap value stocks have staged a sharp rally amid high day-to-day volatility. Month-to-date, value stocks have a slight performance edge, but growth stocks lead value by 25% in the Russell 2000 year-to-date. At this point, we haven't made any changes to our strategies related to the election outcome, and don't have any plans to do so. We see significant long-term, relative-value opportunity in small-cap core strategies, which, given their mix of value and growth stocks, have lagged pure growth strategies substantially year-to-date.

Long-term trends bode well for core strategies

It has been a strong earnings season for companies across sectors and market-cap ranges. Companies are seeing sequential top-line sales improve from a weak Q2, and are benefiting from significant cost-structure adjustments that were made in response to COVID-19. Auto dealers and auto-parts suppliers are among the groups benefiting from this dynamic, and we have recently added names in these areas to our portfolios.

While another large-scale, multi-trillion-dollar stimulus package appears unlikely, we do think Congress will pass a scaled-down version at some point. It's worth noting that the roll-off of prior stimulus hasn't been a problem for the market or US economy thus far, but we are watching that. We continue to monitor the benefit of fiscal and monetary programs, the trajectory of the virus, and US economic response, but remain most focused on long-term opportunities in quality businesses that in our view are attractively valued.

As we look out six months, we think the US economy will continue to recover from COVID-19, particularly on the welcome news of the positive Pfizer and Moderna large phase 3 trial vaccine results. Beyond the market's near-term volatility, we believe US economic recovery is likely to favor cyclicals in a more balanced, core strategy over expensive growth stocks. We have been moving our small-cap strategies in this direction, where we see significant relative value as we look ahead to 2021 and beyond.

Bottom line: With major corporate tax hikes most likely off the table and efficacious vaccines in sight, we believe investors will increasingly turn from expensive, small-cap growth stocks to more cyclical, value stocks. We see a lot of potential for balanced small-cap core strategies in the months ahead.

Russell 2000 Index is an unmanaged index of 2,000 US small-cap stocks.

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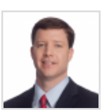

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