Eaton Vance Management

Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

The views expressed in these posts are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance strategy. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.

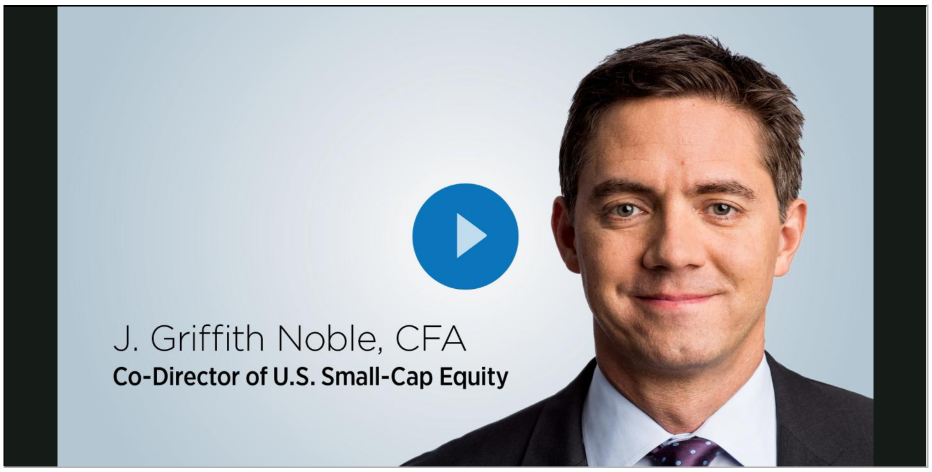
JULY 27, 2020

Equities

2020 Mid-Year Outlook: US Small Caps

J. Griffith Noble, CFA
Co-Director of US Small Cap Equity
Eaton Vance Management

Boston - Significant opportunity remains in the "quality" small-cap space.



"Businesses create value for shareholders by generating strong returns on capital, and the market should return to rewarding those companies, in our opinion, that create this value."

It's been a remarkable year in the equity markets thus far, and in small cap in particular, with the largest and fastest sell-off in history followed by what's been a record rebound. Volatility hasn't been equitable to all areas of small cap, and relative opportunities have emerged.

To start, year to date, small growth has outperformed significantly, marking the fifth year it's bested value. Valuations for small growth are close to levels seen at the peak of the tech bubble, depending on the measures you use. Micro cap, as defined by the lowest quintile of market cap in the Russell 2000, and low quality as measured by the lowest quintile of ROE (return on equity) have both outperformed from below by over 20 percentage points, and high leverage has also outperformed dramatically.

To put this all together, quality to starting to look very attractive. Over the past 25 years, the top two quintiles of return on capital significantly outperformed the Russell 2000. They've also had the added benefit of lower volatility and downside protection.

Businesses create value for shareholders by generating strong returns on capital, and the market should return to rewarding those companies, in our opinion, that create this value. Opportunity in quality comes with the optionality of better downside protection if the recent rally improves premature.

We believe the recent run up in the market warrants some caution, and five things we're monitoring closely are: first, massive fiscal and monetary programs that have propped up the economy, and it remains to be seen if they can hand the baton off to self-sustaining growth.

Second, leverage continues to be very high. Before the downturn, corporate debt was at an all time high, and with large scale debt issuances and underfunded pensions, the problem's only gotten worse.

Third, the election. Fourth, valuation. Now the recent performance of growth, tech and healthcare are all key areas of risk.

Lastly, the virus. The increases we're seeing in infection rates are likely to continue, and what will the consumer and governmental response be to that?

With all the volatility and extremes in performance, we continue to use quality as our compass. We believe it's important to acknowledge there's still a wide range of potential economic outcomes, and we continue to take advantage of opportunities and also adjust to risks as they emerge.

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

About Risk: *The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. The value of equity securities is sensitive to stock market volatility. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, more established companies.*