U.S. Small Caps: Reasons for Optimism Despite Recession Risk

Since reaching an all-time high on November 8, 2021, U.S. small capitalization stocks, as defined by the Russell 2000® Index, fell 26.06% during the peak through April 2023 period. This period also includes a -31.92% peak-to-trough return from the November 2021 top to the June 16, 2022 bottom. Further, small caps have underperformed large-cap and mid-cap companies, as defined by the Russell 1000® Index, by 14.53% from the small-cap peak over the same time period.

In our view, this noteworthy drawdown and relative underperformance versus large caps and mid caps has been driven by a combination of elevated inflation, rising interest rates, regional bank deposit instability, and recession fears.

As the probability of a U.S. recession in 2023 or 2024 has increased, we believe it's reasonable to question whether further downside exists for small caps on an absolute and relative basis. While the onset, magnitude, and duration of a recession is unknown, several historical datapoints may signal favorable near-term conditions for small-cap returns.

Historical Return and Valuation Data

An examination of peak-to-trough returns and trailing 12-month price-to-earnings (P/E) multiples during previous recessions suggests that small caps have largely priced-in the possibility of an imminent recession.

The chart below illustrates historical peak-to-trough performance for small caps during the previous six U.S. recessions, as well as performance in the ensuing one-year and three-year periods after small caps bottomed. While the Russell 2000 Index lost over 38% on average during these peak-to-trough drawdown periods, the index gained on average over 88% and 118% during the following one-year and three-year periods, respectively.

Recession Start Month[1]	Recession End Month[1]	Russell 2000 Peak Date	Russell 2000 Trough Date	Russell 2000 Peak to Trough Return	Russell 2000 1 Year Return After Trough	Russell 2000 3 Year Return After Trough
January 1980	July 1980	02.08.1980	03.27.1980	-26.26%	81.42%	152.79%
July 1981	November 1982	06.15.1981	08.12.1982	-26.18%	99.09%	113.07%
July 1990	March 1991	10.09.1989	10.31.1990	-32.54%	58.64%	130.00%
March 2001	November 2001	03.09.2000	10.09.2002	-44.12%	61.64%	104.37%
December 2007	June 2009	07.13.2007	03.09.2009	-58.89%	97.90%	129.42%
February 2020	April 2020	01.16.2020	03.18.2020	-41.72%	131.59%	80.79%
Observation						
Average	-	-	-	-38.29%	88.38%	118.41%
Median	-	-	-	-37.13%	89.66%	121.25%
Current Period	-	11.08.2021	06.16.2022	-31.92%	-	-

It's also worth noting that the most recent Russell 2000 peak-to-trough loss is less than the long-term average but consistent with drawdowns that occurred during recessions in the early 1980s when the Fed was also aggressively hiking interest rates to fight inflation.

History shows that small caps typically underperform large caps and mid caps in the immediate periods leading up to a recession. However, significant small-cap outperformance often occurs in the subsequent periods. For example, the Russell 2000 underperformed the Russell 1000 by approximately 8.50% on average during peak-to-trough drawdown periods but outperformed by roughly 32.50% on average during the subsequent one-year and three-year periods.

[1]Per National Bureau of Economic Research (NBER). Source: Morningstar Direct.
Chart is for illustrative purposes only. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. Past performance is not indicative of future results.

U.S. Small Caps: Reasons for Optimism Despite Recession Risk

Recession Start Month[1]	Recession End Month[1]	Russell 2000 Peak Date	Russell 2000 Trough Date	R2000 vs. R1000 during R2000 Peak to Trough Period	R2000 1 Year Relative Performance vs. R1000 after R2000 Trough	R2000 3 Year Relative Performance vs. R1000 after R2000 Trough
January 1980	July 1980	02.08.1980	03.27.1980	-9.03%	35.76%	70.52%
July 1981	November 1982	06.15.1981	08.12.1982	-6.46%	30.74%	3.54%
July 1990	March 1991	10.09.1989	10.31.1990	-17.96%	22.06%	55.01%
March 2001	November 2001	03.09.2000	10.09.2002	-0.54%	23.85%	37.23%
December 2007	June 2009	07.13.2007	03.09.2009	-4.03%	23.40%	20.21%
February 2020	April 2020	01.16.2020	03.18.2020	-13.10%	59.36%	8.44%
Observation						
Average	-	-	-	-8.52%	32.53%	32.49%
Median	-	-	-	-7.75%	27.30%	28.72%
Current Period	-	11.08.2021	06.16.2022	-8.84%	-	-

In addition, the Russell 2000's trailing 12-month P/E ratio (TTM P/E), as calculated by Morningstar, appears to be in attractive territory on both absolute and relative bases versus large caps and mid caps. The chart below captures TTM P/E multiples for the Russell 2000 and Russell 1000 dating back to November 1999[2], including trough multiples during the past three U.S. recessions.

Price-to-Earnings Ratio (TTM)[3]

Time Period: 11.01.1999 to 04.30.2023

[1]Per National Bureau of Economic Research (NBER). [2]The oldest available datapoint in Morningstar Direct. [3]Morningstar generates the P/E ratio (TTM) figure on a monthly basis based on the most-recent portfolio holdings submitted by the index and statistics gleaned from internal equities databases. Companies with negative P/Es are excluded from the calculation, and any P/E greater than 60 is capped at 60 in the calculation of the average.

Top and bottom chart source: Morningstar Direct. Charts are for illustrative purposes only. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. Past performance is not indicative of future results.

STERLING CAPITAL

U.S. Small Caps: Reasons for Optimism Despite Recession Risk

As of April 30, 2023, the Russell 2000's TTM P/E was 11.07x, according to Morningstar's calculation methodology[1]. Since November 1999, the Russell 2000's TTM P/E has only been lower in four month-end periods, three of which occurred in early 2009 during the Global Financial Crisis (GFC). The last time this metric was below 11.00x was March 2009, which coincided with the GFC bear market bottom. In this case, the Russell 2000 experienced substantial gains over the following one-year and three-year periods.

	P/E Ratio (TTM) March 2009	**1 Year Return 04.01.2009 03.31.2010**	**3 Year Return 04.01.2009 03.31.2012**
Russell 2000	10.83	62.67%	104.37%

Further, the TTM P/E differential between the Russell 2000 and Russell 1000 is currently in extreme territory. As of April 30, 2023, the Russell 1000's TTM P/E of 20.72x was almost twice as high as the Russell 2000's 11.07x TTM P/E. November 2000 was the last time this spread was higher, and the Russell 2000 significantly outperformed the Russell 1000 during the following one-year and three-year periods as TTM P/E multiples converged.

	P/E Ratio (TTM) November 2000	**1 Year Return 12.01.2000 11.30.2001**	**3 Year Return 12.01.2000 11.30.2003**
Russell 2000	13.12	4.82%	27.72%
Russell 1000	23.03	-12.33%	-13.95%
Russell 2000 vs. Russell 1000	-9.91	17.14%	41.66%

Portfolio Positioning

While the data above supports a positive near-term outlook for small caps, it does not serve as the primary basis for the tactical overweight to U.S. small caps reflected in Sterling Capital Advisory Solutions client portfolios as of April 2023.

The Sterling Capital Advisory Solutions Team utilizes proprietary quantitative models that are tested to help identify factors that have historically been predictive of future asset class returns. In addition, this approach is used to avoid emotional and cognitive biases that we believe tend to lead to poor investment decisions. One-year asset class return forecasts are produced by the models, and these forecasts are considered within a detailed risk framework to determine tactical net of benchmark portfolio asset class weights.

For U.S. small caps, relative book-to-market and relative sales-to-firm value ratios are among the variables that have historically been a predictor of one-year forward-looking returns. As of April 2023, these metrics are above historical averages and contribute to positive relative one-year return expectations for small caps. As a result, a 3.25% net-of-benchmark overweight to U.S small caps (as a percentage of the total equity allocation) was reflected in client portfolios as of April 2023.

[1]Morningstar generates the P/E ratio (TTM) figure on a monthly basis based on the most-recent portfolio holdings submitted by the index and statistics gleaned from internal equities databases. Companies with negative P/Es are excluded from the calculation, and any P/E greater than 60 is capped at 60 in the calculation of the average.

STERLING CAPITAL

U.S. Small Caps: Reasons for Optimism Despite Recession Risk

Summary

Historically, periods of outsized small-cap losses and underperformance relative to large caps and mid caps are typically followed by periods of above-average returns and outperformance, especially when performance challenges coincide with a recession. Will the current period follow this pattern?

In the context of previous small-cap market corrections that overlapped with a recession, it's important to note that the Russell 2000 Index has never experienced a market cycle trough prior to the beginning of recession. With the U.S. officially not in a recession as of May 2023 and small caps appearing to find a bottom in June 2022, could additional downside in excess of the June 2022 lows be in store for small caps if the economy falls into a recession in the coming months? Has the market accurately discounted a relatively short and mild recession, and correctly priced-in the early stages of a recovery ahead of a recession actually beginning? Since recessions are often declared retroactively, after all relevant economic data is carefully verified and revised, could the U.S. economy already be in a recession? Can a near-term recession ultimately be avoided? Only time will tell.

While it is impossible to definitively answer these questions in real time, we can leverage our objective and time-tested approach to tactical asset allocation return forecasting as a guide for near-term return expectations. As previously discussed, these forecasts indicate that positive returns and relative outperformance for small caps could be on the horizon, and client portfolios should be positioned to capitalize on this perceived opportunity.

Important Information

Brandon Carl, CFA®
Executive Director | Portfolio Manager

Brandon W. Carl, CFA®, Executive Director, joined BB&T Asset Management in 2001 and Sterling Capital Management through merger in 2010. He has investment experience since 2001. Brandon is a portfolio manager on Sterling's Advisory Solutions team with a focus on equity. Previously, he graduated from the BB&T Leadership Development Program and was an equity analyst covering the healthcare and consumer staples sectors for BB&T Asset Management. Brandon received his B.S. in Finance and Management from the University of South Carolina. He holds the Chartered Financial Analyst® designation.

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

The opinions contained in the preceding presentation reflect those of Sterling Capital Management LLC, and not those of Truist Financial Corporation or its executives. The stated opinions are for general information only and are educational in nature. These opinions are not meant to be predictions or an offer of individual or personalized investment advice. They are not intended as an offer or solicitation with respect to the purchase or sale of any security. This information and these opinions are subject to change without notice. All opinions and information herein have been obtained or derived from sources believed to be reliable. Sterling Capital Management LLC does not assume liability for any loss which may result from the reliance by any person upon such information or opinions.

Investment advisory services are available through Sterling Capital Management LLC, an investment adviser registered with the U.S. Securities & Exchange Commission and an independently-operated subsidiary of Truist Financial Corporation. Sterling Capital Management LLC manages customized investment portfolios, provides asset allocation analysis and offers other investment-related services to affluent individuals and businesses. Securities and other investments held in investment management or investment advisory accounts at Sterling Capital Management LLC are not deposits or other obligations of Truist Financial Corporation, Truist Bank or any affiliate, are not guaranteed by Truist Bank or any other bank, are not insured by the FDIC or any other federal government agency, and are subject to investment risk, including possible loss of principal invested.

Sterling Capital does not provide tax or legal advice. You should consult with your individual tax or legal professional before taking any action that may have tax or legal implications.

The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by the CFA Institute, the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.

Technical Terms: the technical terms below are sourced from Corporate Finance Institute, Investopedia and Sterling Capital Management:

Price Earnings Ratio (P/E Ratio) is the relationship between a company's stock price and earnings per share (EPS). It is a popular ratio that gives investors a better sense of the value of the company. The P/E ratio shows the expectations of the market and is the price you must pay per unit of current earnings (or future earnings, as the case may be).

Market cycle refers to economic trends observed during different types of business environments. It is also known as a stock market cycle, wherein a given security, or multiple securities belonging to the same class of assets, perform better than others. It can be because the prevailing market conditions may be suitable for growth according to the business model the securities run on.

Peaks-and-troughs are patterns that are developed by the price action experienced by all securities.

Sales-to-Firm Value Ratio = One-year trailing revenues divided by the sum of a firm's equity market value and principal value of debt.

Relative Sales-to-Firm Value Ratio = Percent difference between the segment nonfinancial sales-to-firm value ratio and the Russell 3000 nonfinancial sales-to-firm value ratio.

Relative Book-to-Market Ratio = Segment nonfinancial book-to-market ratio less the Russell 3000 nonfinancial book-to-market ratio.

A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000® represents approximately 92% of the U.S. market. The Russell 1000® Index is constructed to provide a comprehensive and unbiased barometer for the large-cap segment and is completely reconstituted annually to ensure new and growing equities are included.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

STERLING CAPITAL