

Small Cap Equities

Valuations Look Appealing Amid Improving Backdrop

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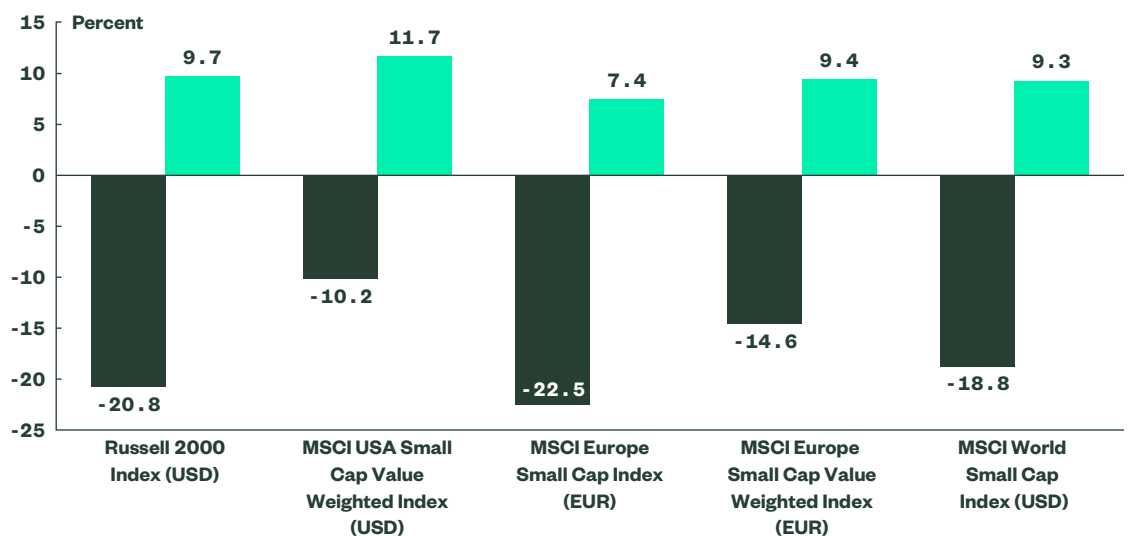
- **Small cap equities saw heavy losses in 2022 but the fall has led to material improvement in valuation metrics on an absolute and relative basis.**
- **While the upcoming economic slowdown is a headwind for cyclical small caps, there have been notable improvements to the macroeconomic backdrop on both growth and inflation fronts.**
- **Investors who expect the positive momentum to continue and who are able to withstand short-term volatility could consider small cap exposures while valuations remain undemanding.**

Performance Has Started to Turn

2022 was a difficult year for equity markets. Small caps declined even more than broad equity markets due to their high risk/reward profile. In Q4 2022 and the start of 2023, we have seen an improvement to sentiment driven by three areas: inflation moderation, acceleration of China reopening, and a relatively mild winter in Europe. There is still a lot of uncertainty related to the rate outlook and the potential for economic slowdown but there have been positive surprises on the inflation and growth fronts (US Q4 YoY growth of +2.9%). If the positive momentum continues, investors who can withstand short-term volatility could consider taking a position in small cap exposures.

Figure 1
**Small Cap Equities:
Performance
Overview**

■ 2022
■ Jan 2023

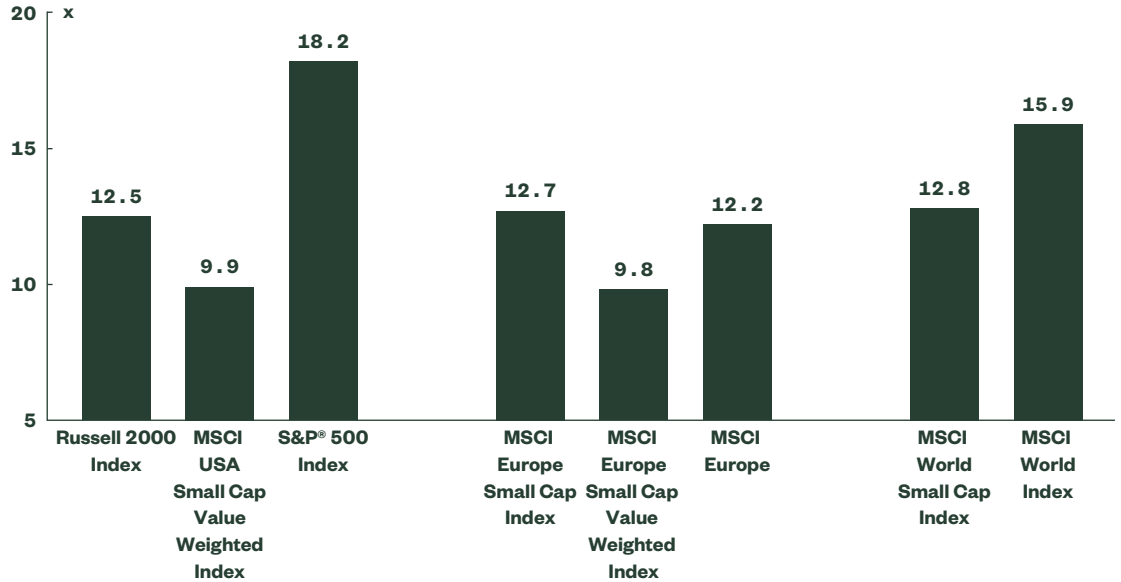


Source: Bloomberg Finance L.P., as of 31 January 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Valuation

While the availability of forward-looking multiples for small cap exposures may not always be comprehensive, the data we have clearly points toward a consistent derating of small cap exposures around the world. Interestingly, Russell 2000 and MSCI World Small Cap indices trade at significant discounts relative to large cap indices. In Europe, the valuation advantage of small cap indices is less clear. Europe is a value region, hence investors who would like to access a value tilt through a small cap exposure may consider the MSCI Europe Small Cap Value Weighted Index.

Figure 2
Small and Large Cap
Price to Earnings
(FY1 Estimates)



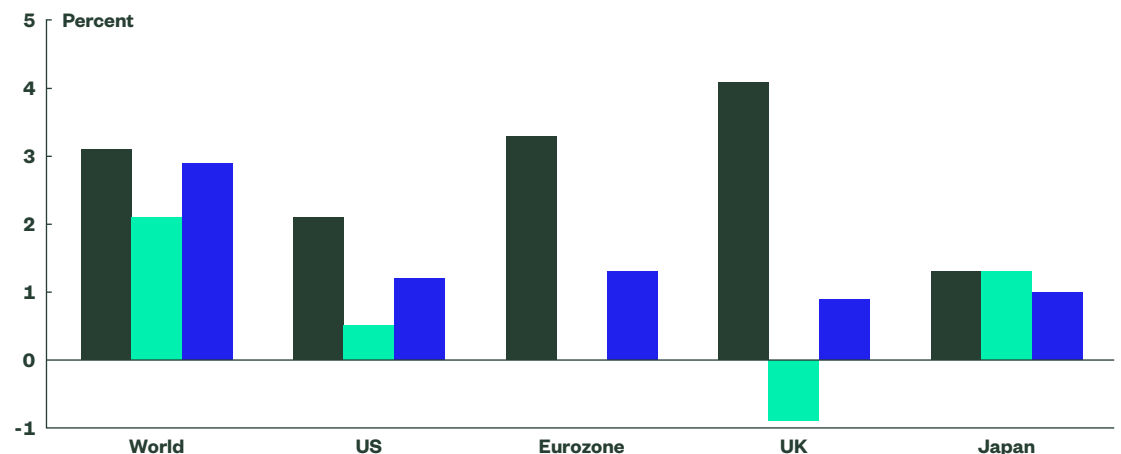
Source: FactSet, as of 31 January 2023. Based on available data. Availability of the data for small cap indices may be limited. Estimates are based on certain analyses and assumptions. There is no guarantee they will be met. Past performance is not a reliable indicator of future performance.

Economic Backdrop

We expect markets will gradually turn from inflation worries to growth worries. Slowing growth is the key risk for small cap exposures across the developed world. With that in mind, the economic slowdown seems to be reflected in valuation multiples (as noted above) and the probability of a soft landing, especially in the US, is increasing. Moreover, the impact of Chinese reopening on the global economy may still be underappreciated, particularly from Q2 when we would expect COVID waves to recede. An upside surprise to growth expectations and actual numbers may help risk-on assets, such as small caps in the medium term.

Figure 3
GDP Growth
Forecasts

■ 2022
■ 2023
■ 2024



Source: Bloomberg Finance L.P., as of 31 January 2023 based on consensus forecasts. Forecasts are based on certain analyses and assumptions. There is no guarantee they will be met.

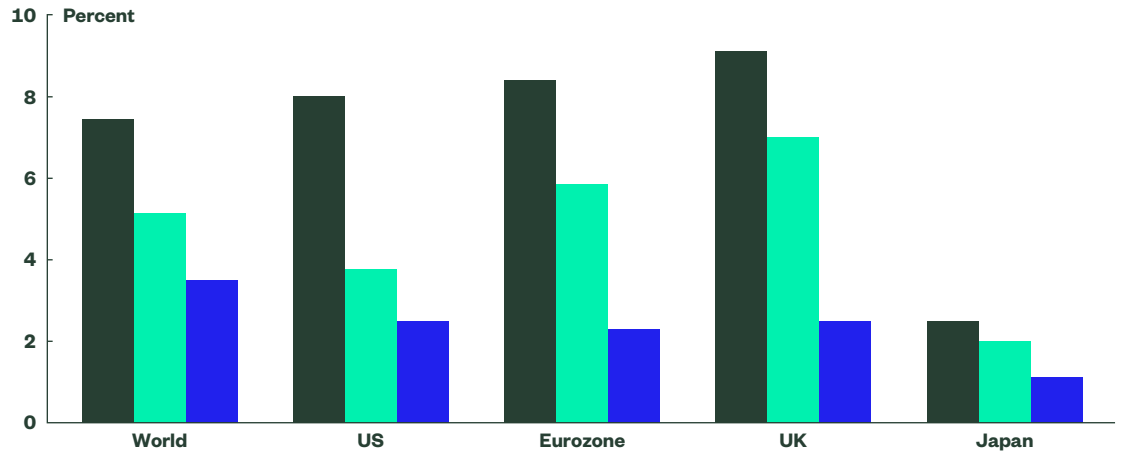
The Battle Against Inflation is Being Won — But the Pace Varies Across Regions

A long-awaited moderation in inflation finally arrived in Q4, although the progress is not linear across regions. The US has been more successful in combatting inflation relative to the eurozone, thanks to more aggressive tightening. That's one of the factors that plays in favour of US small caps relative to Europe. However, we acknowledge that in Europe the disinflation is happening more quickly than many anticipated, with a lower than expected 8.5% print in January.

Supply chain issues, which were the root cause of recent inflation, are easing and China's reopening may be an important factor. In the short run it will likely add to demand but, over the longer term, China is an indispensable part of the solution on the supply side, which should ease pressure on central banks and support risk-on trades.

Figure 4
CPI Inflation Forecasts

■ 2022
■ 2023
■ 2024



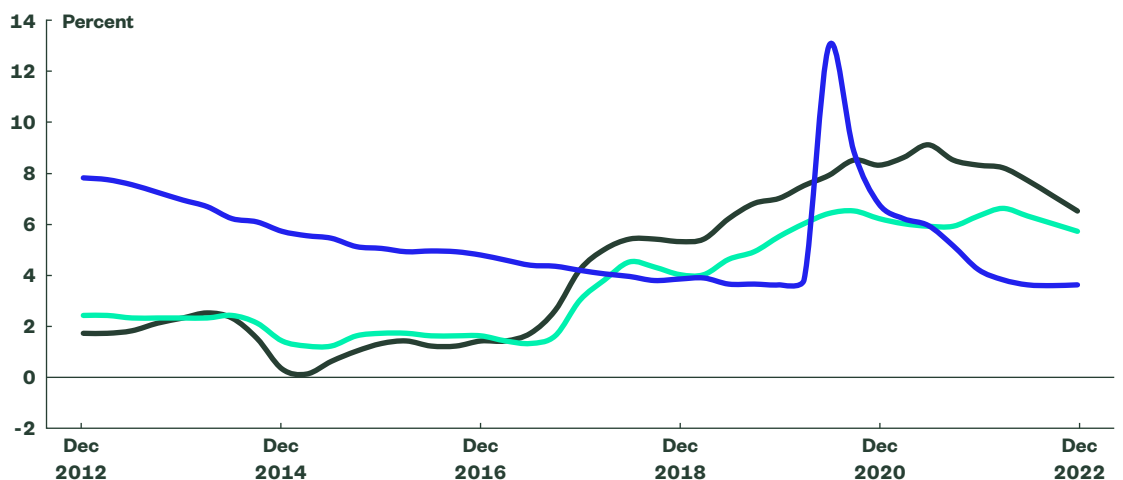
Source: Bloomberg Finance L.P., as of 31 January 2023. Based on consensus forecasts. Forecasts are based on certain analyses and assumptions. There is no guarantee they will be met.

US Small Caps: Resilient Consumers Provide Tailwind

Small caps, relative to larger companies, tend to be more cyclical and more domestic. Constituents of the Russell 2000 Index and MSCI US Small Cap Value Weighted Index generate around 80% of revenue within the US while for S&P 500 Index the corresponding number is 60%. This means small caps face less headwind from the relatively strong US dollar and more support from the remarkably resilient domestic market. The strength of US domestic demand can be seen in the very low unemployment and recent data showing the economy expanded more than expected in Q4 at +2.9% YoY. One dent to that consumer strength was a retail sales number in December, but in our view it does not change the overall picture. Wage inflation recently came in below expectations, which, in conjunction with low unemployment, may allow for a soft landing of the US economy.

Figure 5
US Inflation and Unemployment Data

■ US Headline CPI
■ US Core CPI
■ US Unemployment



Source: Bloomberg Finance L.P., as of 31 December 2022.

Europe Small Caps: Uncertain Outlook and Improvements to the Backdrop

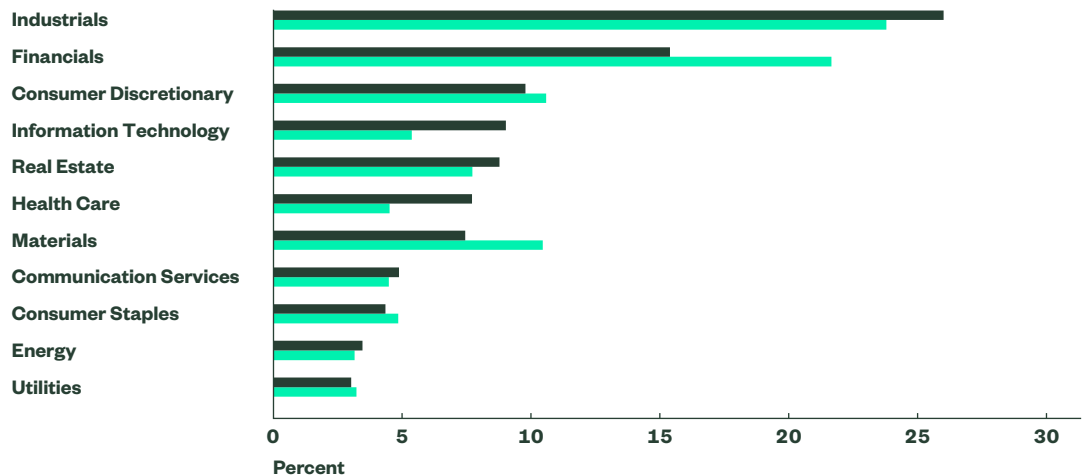
Key risks for European small caps include economic slowdown and the rate outlook. While inflation may have peaked, the eurozone is lagging the US in the tightening cycle and hence the resilience of both business models and consumers may be tested for longer.

However, we acknowledge that the backdrop in Europe has improved substantially during the past several weeks, driven by lower natural gas prices, mild winter conditions, and the acceleration of China reopening. These factors support European equities in general and drove the outperformance in the beginning of 2023. In terms of sectors, European small cap indices are also cyclical and overweight industrials, which in Europe may benefit from energy transition, a highly relevant theme given geopolitical uncertainty.

As Europe is a value region, small caps do not provide this value tilt despite underperformance in 2022. Investors searching for a cushion against the uncertain rate outlook could consider the MSCI Europe Small Cap Value Weighted Index, which by design trades at lower multiples.

Figure 6
European Small Caps
Sector Breakdown

■ MSCI Europe Small Cap Index
■ MSCI Europe Small Cap Value Weighted Index



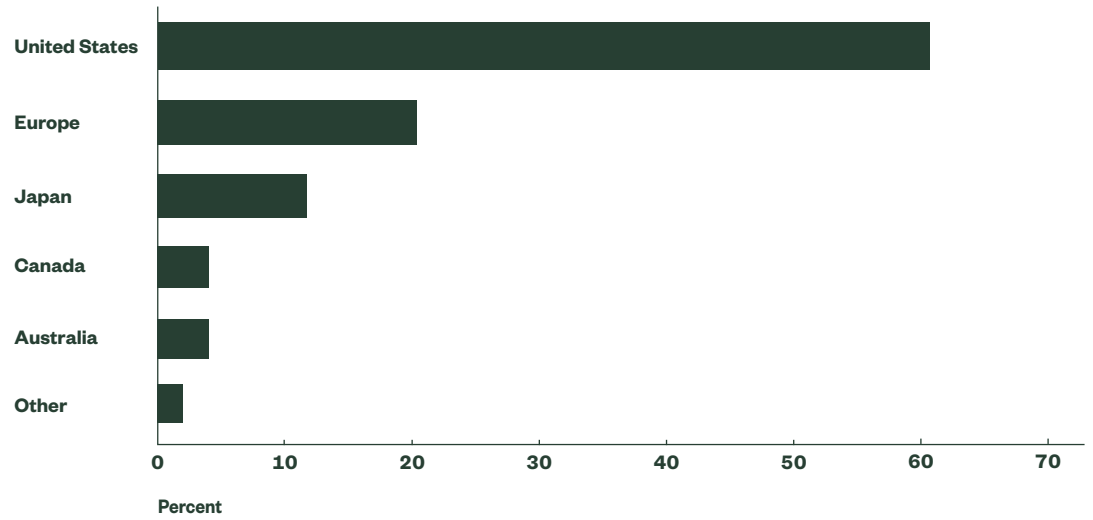
Source: FactSet, as of 31 January 2023. Breakdowns are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

World Small Caps: Valuations More than Compensate for Expected Economic Slowdown

Investing in global, developed market small cap equities allows investors to gain cyclical exposure, combining the merits of smaller companies across the US (60% of the index) and Europe (19%). But there is more to the exposure, as the global index provides access to other developed economies, in particular Japan, Canada and Australia.

These three countries may see an outsized benefit from China reopening. Japan could prosper due to close trade relationships while tailwinds for Canada and Australia may come from upside pressures on commodity prices. Importantly, MSCI World Small Cap provides this valuation discount relative to large caps. This may appeal to investors, as we expect a continuation in China reopening while further moderation in inflation will improve the growth backdrop.

Figure 7
**MSCI World Small
Cap Breakdown
by Region**



Source: FactSet, as of 31 January 2023. Breakdowns are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

How to Access this Theme

SPDR® MSCI World Small Cap UCITS ETF

SPDR® Russell 2000 U.S. Small Cap UCITS ETF

SPDR® MSCI USA Small Cap Value Weighted UCITS ETF

SPDR® MSCI Europe Small Cap UCITS ETF

SPDR® MSCI Europe Small Cap Value Weighted UCITS ETF

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* Pensions & Investments Research Center, as of December 31, 2021.

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