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US INSIGHT

Shining into 2019: US Small Caps

Key takeaways:

1) Steadily rising rates could extend the current economic expansion.
2) US tax reforms to invigorate corporate health
3) Domestic focus leads to less tariff impact or USD fluctuations
4) Mid-term elections have seasonally been positive
5) Active management mitigates risks

The Russell 2000 Index has harnessed the domestic economic recovery and outpaced both US and international equities over the last two years ***[Chart 1]***. This is even more remarkable considering the backdrop of rising trade tensions, emerging market instability and perennial questions on valuations.

While there is no crystal ball to tell us how US small caps will perform going forward, here are four themes that may keep the asset class shining into 2019.

Theme #1 – Steady rates, steady growth

The US economy is strong, there is no disputing that. From a broad based on contributing industries, Gross Domestic Product (GDP) growth has been rising constantly and measuredly. That means prices are rising steadily but not too quickly to cause inflation fears. The Fed's measure of inflation has been reached and unemployment is at an all time low. When this happens, businesses start to increase wages which ultimately leads to rising discretionary spending. The increasing financial security translates into a feel-good factor which has caused both small businesses ***[Chart 2]*** and consumers to be optimistic.

While investors are concerned about the rising rate environment, smaller companies thrive. When the Fed raises rates, it acknowledges a growing economy and gradually introduces higher rates to curb market exuberance which can threaten the stability and longevity of an economic upswing. Smaller companies are more reliant on domestic economic conditions, therefore when the economy can prolong its expansion, US small companies are more confident and tend to do well. When the 10-Year Treasury yield was rising, the Russell 2000 Index outperformed the large-cap Russell 1000 in 70% of trailing monthly rolling one-year periods for the 20-year period ended 30 June 2018, with an average one-year return of 23.8% versus 19.2% for large-cap ***[Chart 3]***.

Theme #2 - Invigorating US tax reforms

One of the directives of the current US administration was to enhance the competitive nature of US domestic companies. This was made possible when the effective tax rate for Russell 2000 companies was reduced from 32% to 21%*, effectively reducing the tax burden of smaller companies by over a third. This new law is boosting earnings and resulting in more reinvestment into the business through capital expenditure, employee development, inventory, increased purchase of raw materials etc. Small US companies are in rude corporate health at the moment. Russell 2000 earnings growth is expected to accelerate over 20% in the next 24 months. ***[Chart 4]***. This boost in earnings could lend further support to valuation conscious investors.

CHART 1 : US Small Caps outperform

Equity returns, USD, Ending 31 August 2018

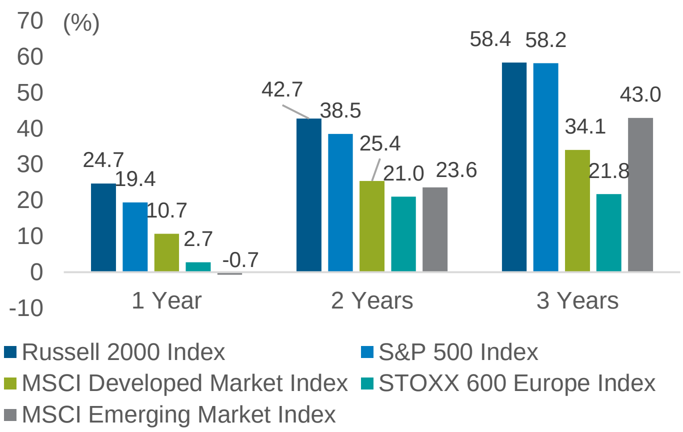

Chart 1 Sources: Legg Mason, Bloomberg as at 31 August 2018.

CHART 2 : No shortage of confidence for small business

Small Business Optimism (Seasonally Adjusted 1986 = 100)

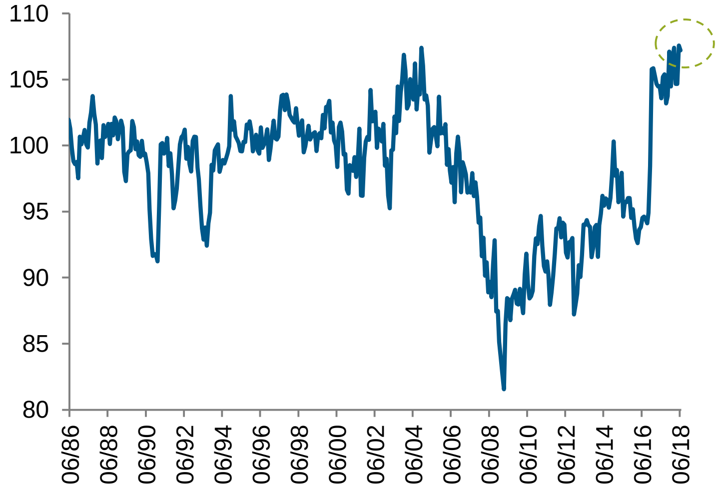

Chart 2 Sources: Legg Mason, National Federation of Independent Business, as at 30 June 2018.

Source: Legg Mason, as at 3 September 2018. All data as at 31 July 2018 unless otherwise stated. US Small Caps refer to the Russell 2000 Index unless stated otherwise. *Tax Cuts and Jobs Act of 2017 (Sec. 13001). For the entire Act please visit: https://www.congress.gov/bill/115th-congress/house-bill/1

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Theme #3 – Calm on international trade tensions
Tariff rhetoric has roiled emerging markets and cast a lens of uncertainty over global trade. While the bark of a changing trade regime is generally worse than its bite, the fact is trade tensions do weigh on market sentiment and erode confidence in global growth.

In this inward environment, domestically focused companies have less to worry. As at 31 December 2017, Micro caps derived 14% of sales from abroad while large caps attributed 27% to foreign sources ***[Chart 5]***, making it less impacted by trade tensions or USD fluctuations.

Theme #4 – US Midterm elections
Mid term elections tend to have a positive impact on US equities in general. Dating back to 1950, the fourth quarter has seen significant outperformance when compared to the first three quarters of the year ***[Chart 6]***.

Similarly, since 1950 for 3, 6,12 months after midterm elections, S&P500's performance has been positive except for the 3 months after 2002 (US was in a steel tariff battle with the rest of the world. However, US equities subsequently also gained well into positive territory, 12 months after mid-term elections ***[Chart 6]***.

Active management *IS* risk management
The US Small Cap universe is a lot larger than investors expect. According to Furey Research, as at the end of March 2018, when compared to 500 companies in the S&P 500 index, there are 2,875 micro-cap companies and 791 small cap publicly listed companies. Furey also estimates that small caps are severely under-researched with an average of 5.5 analysts covering a small cap company versus an average of 15.9 per large cap company.

The limited coverage on small caps mean that this asset class is susceptible to information asymmetry and hence benchmark hugging means investors own both the bad and the good. For example, although a rising rate environment bodes generally well for smaller companies, investors need to be wary of the increasing financial leverage employed. Risk-conscious, active managers will be able to identify healthier balance sheets which can be rewarded as borrowing costs rise along with rates and punish poorly disciplined companies.

In summary, even with the multi-period outperformance, there are reasons to believe this US small cap rally could resemble more of a middle-distance run instead of a century sprint. Driven by the themes above, US small caps are poised to retain its sheen beyond 2018…just remember that perhaps now, more than ever, utilizing active management could separate the sheep from the goats.

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CHART 3: Smaller US companies generally thrived when rate were rising

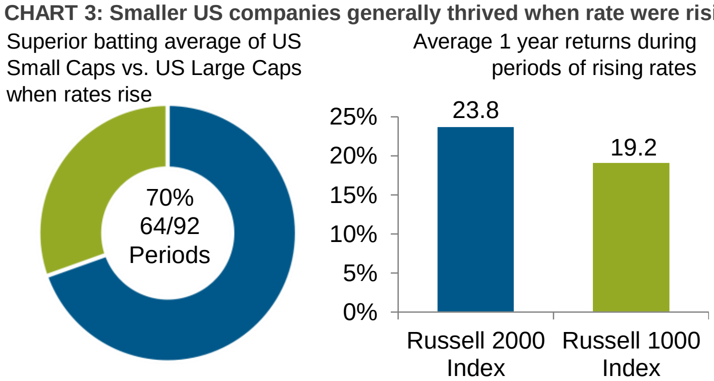


Chart 3 Sources: Legg Mason, Royce & Associates, Frank Russell Company. Russell 2000 vs Russell 1000 Trailing Monthly Rolling 1-Year Returns When 10-Year Treasury Yield rose 92 times (From 30 June 1998 through 30 June 2018)

CHART 4: Russell 2000 earnings expected to outperform US large caps into 2019

Russell 2000 and Russell 1000 year on year (YoY) earnings-per-share growth estimates

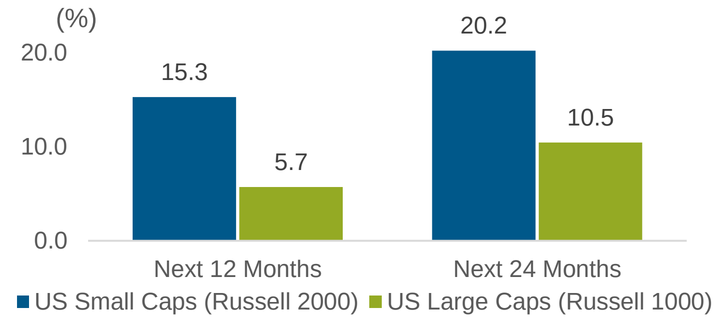


Chart 4 Source: Bloomberg consensus estimates, as at 31 August 2018

CHART 5: US Small Caps less impacted by international sales

Average foreign sales as percentage of total

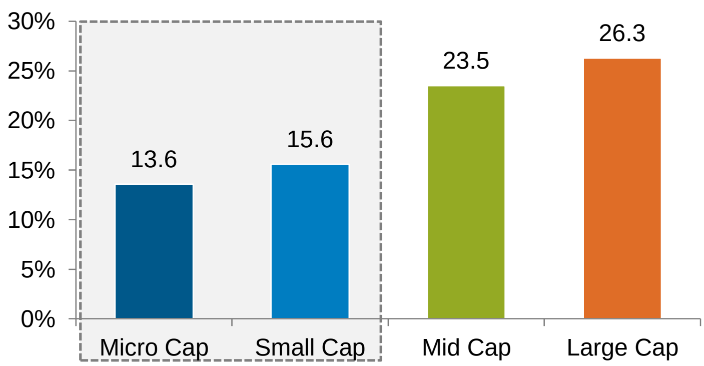
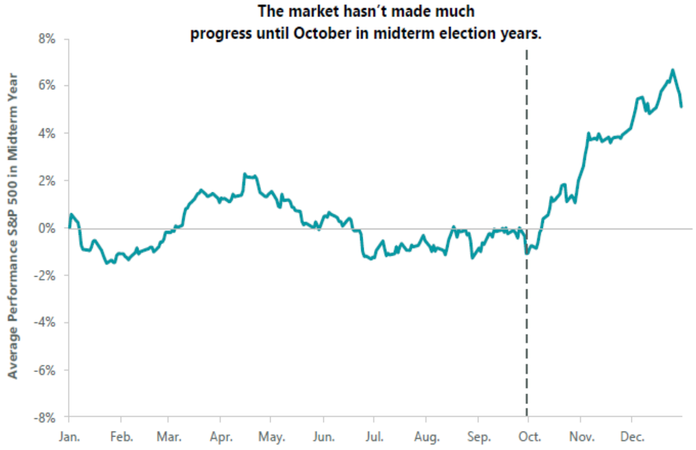


Chart 5 Sources: Legg Mason, Furey Research and FactSet, as at 31 December 2017. Micro-caps: <$500 USD million. Small-caps: $500 USD million - $4 USD billion. Mid-caps: $4 USD billion - $10 USD billion. Large-caps: >$10 USD billion.

CHART 6: US equities (S&P 500) have done well during the fourth quarter of midterm election years….and also done well post the midterm elections



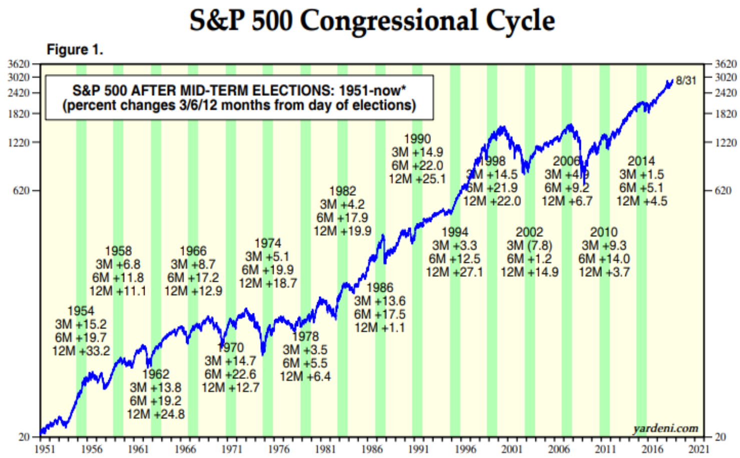


Chart 6 Sources: Left Chart: Legg Mason, Strategas Research Partners, ClearBridge Investments. Data range from 1950 – 2017. Right Chart: S&P 500 Congressional Cycle. Data range from 31 December 1949 to 31 August 2018. Haver Analytics, YRI calculations.

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IMPORTANT INFORMATION:

Source: Legg Mason, as at 3 September 2018. All data as at 31 July 2018 unless otherwise stated.

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