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MARKET PULSE

June 2018

Small Caps' Turn

The story of 2018 so far has been the return of volatility and the generally underwhelming returns by global equity markets. But this headline story has allowed another story to fly more under the radar — the comeback of US small cap stocks, which have posted gains of 7.5% year to date through May, besting their large cap brethren by over five percentage points.

Horizon	Russell 2000®	Russell 1000®	Relative Performance
Month-to-date	7.1%	3.2%	3.9%
Quarter-to-date	7.9%	2.9%	5.0%
Year-to-date	7.5%	2.2%	5.3%
From Feb. 2018	7.6%	0.0%	7.6%

As of 5/30/2018.
Source: Bloomberg, QMA.
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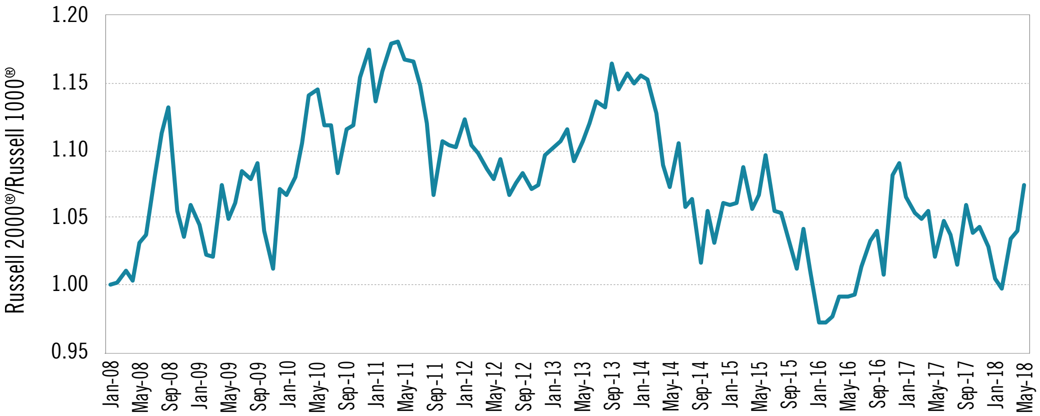
Past performance is not a guarantee or reliable indicator of future results.

Relative Performance of Russell 2000® and Russell 1000® (2008 — 2018)



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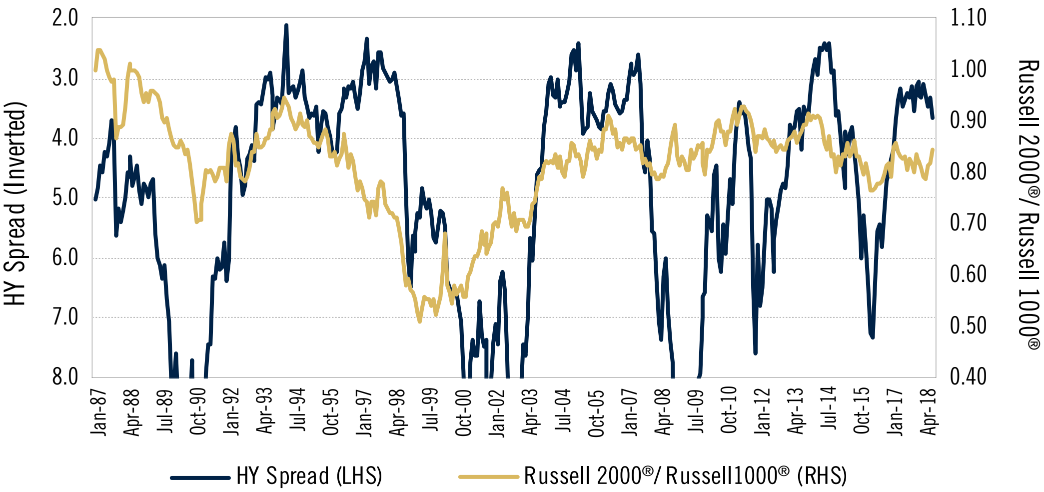
Investing involves risk and the value of investments can fall as well as rise.

QMA's Global Multi-Asset Solutions team added exposure to small caps in a number of its portfolios back in March, soon after the first wave of market routs and just as small cap relative performance began to improve. When forecasting the relative performance of asset classes, we emphasize quantitative analysis of "three pillars": business cycle, valuation and fundamentals, and market sentiment. We augment this with qualitative analysis of more transient factors such as related policy issues. Despite the recent rally and some potential headwinds, we believe the outperformance of small caps should continue. Here is a brief look at why.

Business Cycle

Most economists and market commentators agree that the business cycle is in its later stages, but as we have noted in other recent pieces, our recession dashboard indicates a broad economic downturn is still not likely in the next 12 months. Late cycles are associated with strong economic growth, rising inflation and US Federal Reserve rate hikes. Small caps tend to do well in this kind of environment until it is apparent that growth is slowing. The small cap index is heavily weighted toward Financials, which benefit from rising rates, and Cyclicals, which respond positively to a robust economy. The main factor to watch is the credit cycle: Small caps are more indebted than large caps, so a widening in credit spreads could trigger default risk. In fact, the relative performance of small vs. large is closely correlated with high-yield spreads. So far this year, spreads have been ticking up, but overall the level is still low on a historical basis. While spreads are not a major concern yet, we are monitoring them carefully.

Russell 2000® / Russell 1000® vs. High Yield (HY) Spreads



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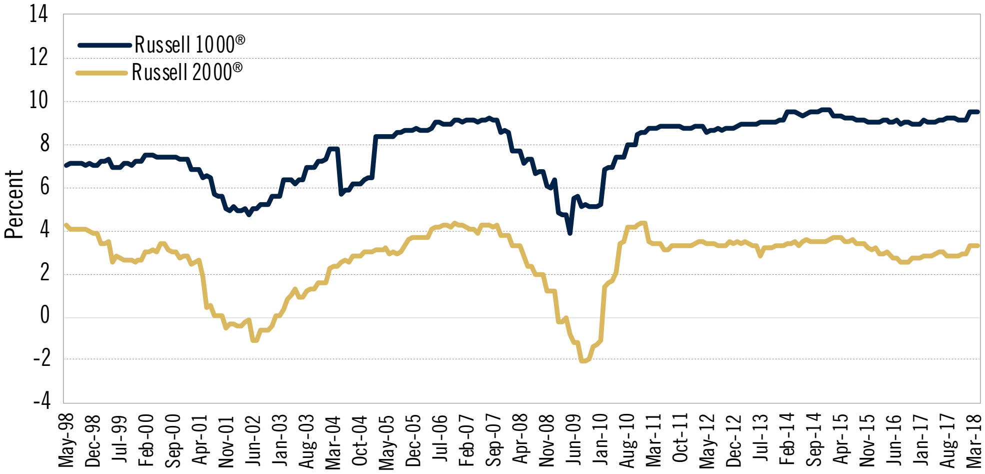
Valuations and Fundamentals

Valuations remain supportive and small caps are trading on par with large, with an average trailing price-to-earnings ratio of just over 19, which is roughly the 20-year average. While not necessarily cheap, this is down from the 21.5 peak back in January. Moreover, empirical analysis suggests that when valuations are between 16 and 20, small outperforms large cap nearly 60% of the time over the next 12 months.

Fundamentals are also strong. Fueled by corporate tax cuts, small cap companies delivered some of their best bottom-line growth in recent memory during the first quarter. Looking ahead, analysts expect 20% earnings per share growth for large and an eye-popping 37% for small caps for the balance of 2018. This is a high hurdle rate for positive surprises for both asset classes. Yet, short of a major policy shock or a surge in the US dollar, we expect earnings for both large and small to remain strong.

Margins are an area of caution given the degree to which late cycles are associated with rising input and labor costs. However, tax reform and moderate inflation have so far helped to keep small cap margins higher than they might have been otherwise.

Net Margins



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Source: FactSet, QMA.
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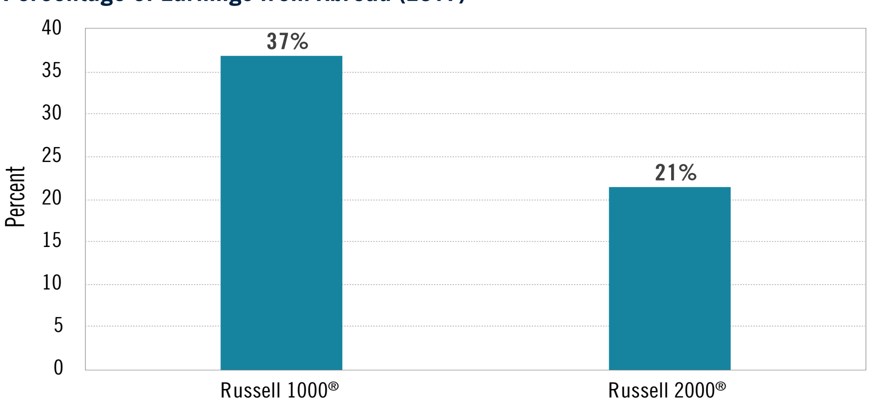
Sentiment

Small caps are a riskier and less liquid asset class and, as a result, tend to do better in risk-on market environments. While still considerably higher than its record low levels of last year, market volatility (as measured by the VIX) had come down from its peak of 37 to 15 at the end of May, eliminating another headwind for small.

Policy

While small is steady on its feet based on the macro climate, valuations and fundamentals, and sentiment, it is recent policy developments that have created the real catalyst for outperformance and become a major tailwind going forward. Recent efforts by the Trump administration to renegotiate trade agreements and impose tariffs on major US trading partners have prompted fear of retaliation and trade wars. As a result, investors have retreated to an asset class more sheltered from international trade — small caps. Furthermore, the recent rebound of the US dollar creates additional support for small cap stocks, which are more insulated from currency effects due to a smaller proportion of earnings derived from abroad. Lastly, recent turmoil in Italy and investors' retreat from international stocks is likely to bring more flows to this largely domestically oriented segment.

Percentage of Earnings from Abroad (2017)



As of 5/30/2018.
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In sum, US small caps remain attractive relative to large caps even after a strong recent run precipitated by moderate valuations, solid fundamentals and the supportive macro climate. Moreover, tariff negotiations and political uncertainty abroad provide additional catalysts for the ongoing outperformance of small cap stocks.

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*As of 3/31/2018.

NOTES TO DISCLOSURE

Sources: QMA, FactSet, Bloomberg.

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