



# Small Caps Stocks: Waiting for Godot?



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### Small Caps Stocks: Waiting for Godot?

Small cap stocks have persistently underperformed large caps for over a decade, but recent trends show signs of a potential turnaround, with small caps beginning to outperform in the short term as valuation gaps narrow and macro conditions shift.

Pro-growth policies such as tax cuts and deregulation, coupled with expectations of lower interest rates, and a historically wide valuation discount are potential catalysts for sustained small cap outperformance in the coming years.

Despite the optimism, near-term volatility is expected due to economic uncertainty and a potentially uneven Fed rate-cutting cycle, although a general pullback could help broaden market participation and support the longevity of the bull market.

In the play, *Waiting for Godot*, the two main protagonists, Vladimir and Estragon, spend their days waiting for the elusive character, Godot. They go about the cycle of their daily lives, going through their ups and downs as Godot appears close to arriving but has not quite done so. If you have not read or seen the play, I will not spoil the ending by revealing when or if Godot ever arrives. However, behaving much like Vladimir and Estragon, investors have been expecting the elusive arrival of the outperformance of small cap stocks. However, in this case, we believe that although it might be a bumpy road to travel, the outperformance of small cap stocks could be on its way. As we can see from Chart 1, Large Cap stocks have outperformed Small Caps over the last 10-, 5-, 3-, and 1-year periods, albeit at a decreasing rate. Even on a year-to-date basis, large caps are still besting their small cap brethren. In fact, over a 10-year period, large cap stocks have outperformed small caps by more than 120%. With this in mind, investors have been waiting for small cap stocks' day in the sun, when the tide turns and they finally outperform large caps, a feat that has proven elusive at best.

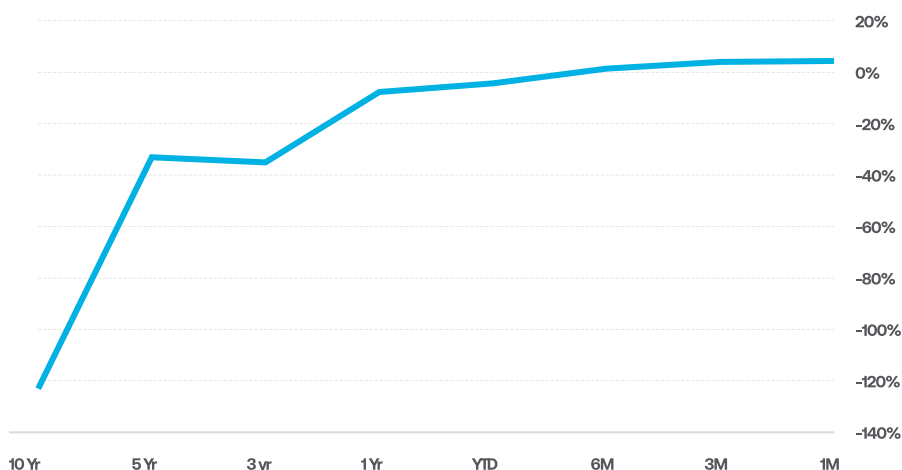
Every year, the promise of small cap outperformance failed to materialize, time and time again. However, 2025 and 2026 may prove to be different. Over the past six months, a trend has started to emerge; small cap equities have finally been able to beat their large cap counterparts, albeit by a meager 1.4%. However, if we focus on the past three- and one-month periods, we see that the rate of outperformance is increasing, as small caps are outperforming to the tune of 4%. Given this developing dynamic, two logical questions emerge: What is propelling this trend? And how sustainable is it?

Truth be told, we are not surprised by the emergence of the current trend. Although we had not been in the camp of strategists calling for small cap outperformance over the past number of years, we saw developments at the end of last year that caused us to take

a more favorable stance on this segment of the market. In our January 2025 Quarterly Report published at the beginning of this year, we wrote a piece titled [Trump 2.0: The Case for Owning Small and Mid-Cap Equities](#), where we analyzed the first Trump administration to try to get a better understanding of the sec-

ond. In this piece, we wrote “What disproportionately helped small and mid-cap stocks over the early part of the first Trump administration was a pro-growth environment, specifically, lower taxes and increased deregulation, two dynamics that are likely to repeat themselves during the second administration.

**Graph 1: Outperformance of Small Cap Over Large Cap**



Source: Bloomberg, as of 9/4/2025

In fact, small and mid-cap stocks, led most of the way through late 2018, when trade wars with China heated up and investor risk appetite decreased. Interestingly, we now find ourselves in a similar situation, where we expect pro-growth policies to propel markets higher, while tariffs and trade wars could create potential headwinds. The one unknown variable that is present this time, which was not meaningfully present last time, is stubborn inflation” (Viaud, January 2025). Although the uncertainty surrounding tariffs and other political developments has certainly been high, our thesis remains unchanged. **A more business-friendly environment, anchored by lower taxes and increased deregulation, will likely be showcased more clearly in 2026, as portions of the One Big Beautiful Bill begin to take effect. However, unlike in 2018, the current environment is also accentuated by the probability of substantially lower interest rates over the next six to twelve months. Staying true**

to its roots as a discounting mechanism, the stock market has begun pricing in a scenario of lower taxes, lower regulation, and lower interest rates, a dynamic which helps explain small cap’s quiet outperformance in recent months.

However, when it comes to assessing the sustainability of this trend, a more nuanced analysis is required. As we stated above, we believe that lower taxes, lower regulation, and lower rates should help small cap stocks move higher over the next few years. However, the road is unlikely to be bump-free. The effects of changing fiscal policy are likely to be more gradual, but uncertainty surrounding monetary policy is likely to increase near term volatility. As of the time of this writing, the market is pricing in 90% probability that two rate cuts will happen before the end of this year, expecting the first rate cut to happen this month, with 100% odds. In fact, the market is currently expecting

that close to six rate cuts will take place by the end of 2026, in a fairly smooth manner, leaving the Fed funds rate near 3% by the end of next year. As we know, few things in the market ever go smoothly. Warren Buffett said it best when he famously described equity markets as “manic-depressive”, displaying swings between euphoria and despair. **Although we do expect that the Fed will lower rates over the next year, most likely beginning with its September meeting, the path of these cuts may not be as smooth as equity markets expect.**

We have long argued that the current economic cycle has been a unique one, prolonged, not postponed by the advent of artificial intelligence. **Unlike most market cycles that tend to flow in wave-like patterns with defined peaks and troughs, the current cycle appears to be behaving more like a rolling cycle, with different sectors of the economy experiencing their own peaks and troughs at different times.** Much like tossing a rock into an incoming wave at the beach creates different ripples within a larger wave, external factors tossed into this cycle, such as AI and the tariff wars, appear to have created mini cycles within the broader economic cycle. In fact, it can be argued that many sectors in the economy have already experienced their own recessions. During a recent interview with Bloomberg, Mike Wilson, CIO and Chief U.S. Equity Strategist at Morgan Stanley expressed his view that certain industries such as housing, consumer goods, transportation, commodities, and regional banks may already be in recession, stating that we are in a “unique economic cycle” (Wilson, September 2025). We could not agree more. That being said, a unique cycle requires equally unique management by the Fed. We would not be surprised to see a rate cuts this year, coupled with language that leaves the door open to future cuts or future pauses, reflecting the Fed’s increased data dependency. However, the market appears to be expecting the beginning of a

well-defined monetary easing cycle later this month. We believe that although a new monetary easing cycle is at hand, it may not be as well-defined as the market expects, with the rate cut this year, aimed at lending support to the job market, while retaining flexibility in the face of stubborn inflation.

What does this mean for small cap stocks and the market in general? It means that a near-term pullback would not be abnormal, as investors come to terms with the fact that the uniqueness of the current market cycle requires an equally unique monetary easing cycle. History shows that on average, the S&P 500 experiences at least one pullback between 5% and 14% per year. Granted, the 20% tariff-related draw-down experienced earlier this year far exceed that average; however, another pullback would not be out of the norm. During a recent interview with CNBC, market bull Julian Emmanuel, Senior Managing Director at Evercore ISI, indicated that he expects a 7% to 15% pull back in the near term, stating that such “scares are part of innovative-driven bull markets” (Emmanuel, August 2025). It is worth noting that Mr. Emmanuel believes that such a pullback may create an opportunity to buy the dip, a view supported by his bullish S&P 500 price target of 7,750 for the end of 2026. We are in the same camp as Mr. Emmanuel, particularly because **we believe that a near-term pullback could help remove the proverbial froth off the market and may contribute to the broadening out of the bull market.** Currently, the top ten stocks in the S&P 500 comprise over 40% of the index, concentration levels not seen in the last 25 years. A near-term pullback could allow for the dilution of this concentration, broadening out the market’s breath into a larger pool of companies, a condition needed for the sustainability of the longer-term rally, including a rally in small cap stocks.

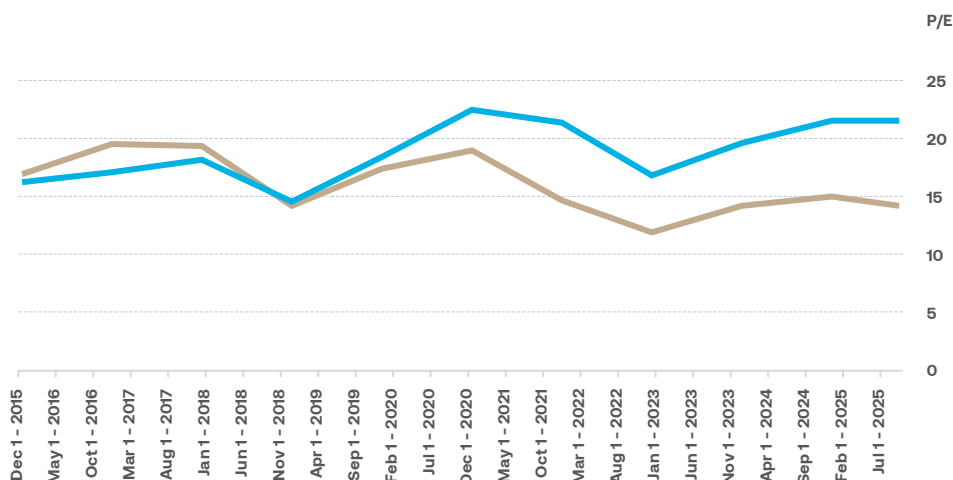
Another factor that we believe will contribute to the sustainability of the emerging outperformance of small cap stocks is their historical valuation discount relative to large caps. Chart 2 shows a 10-year valuation comparison between large and small-cap stocks, represented by the S&P 500 and S&P 600, respectively. As we can see from the chart, before the Covid-19 pandemic, small cap stocks had traded

relatively in line with their large cap brethren. This dynamic changed after the pandemic, where large cap companies meaningfully outpaced small ones, as the former initially provided a higher degree of safety, then grew to house some of the main players in the AI boom.

**Graph 2: Relative Valuation Between Large Cap and Small Cap Equities**

(Based on forward P/E estimates)

— S&P 500  
— S&P 600



Source: Bloomberg, as of 9/4/2025

Based on forward earnings, the current 35% discount between large and small cap stocks represents one of the wider discounts over the past decade. According to a study conducted by T. Rowe Price, when small cap stocks find themselves in the lowest quintile in terms of relative valuation, this group tends to post average forward twelve month returns close to 9%. The study also showed that during monetary easing cycles, small caps tend to post excess returns over the general market to the tune of 5.5%, on average. If the study’s implications hold true, the implementation of a monetary easing cycle, regardless of whichever form it takes, should

provide an additional tailwind for small cap stock outperformance over the next one to three years.

When it comes to small cap stocks, it looks like Godot may very well be on his way. ■



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# House Views Matrix

Global Asset Allocation	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
	<b>Equities</b>	NEUTRAL
<b>Fixed Income</b>	OVERWEIGHT	NEUTRAL
<b>Cash</b>	NEUTRAL	NEUTRAL
<b>US Equities<sup>1</sup></b>	OVERWEIGHT	NEUTRAL
<b>European Equities</b>	NEUTRAL	NEUTRAL
<b>Japanese Equities</b>	OVERWEIGHT	NEUTRAL
<b>Emerging Market Equities</b>	NEUTRAL	NEUTRAL
<b>Chinese Equities</b>	OVERWEIGHT	NEUTRAL
<b>US Treasuries<sup>2</sup></b>	OVERWEIGHT	OVERWEIGHT
<b>Investment Grade Fixed Income</b>	UNDERWEIGHT	UNDERWEIGHT
<b>High Yield Fixed Income</b>	UNDERWEIGHT	UNDERWEIGHT
<b>Emerging Market Sovereign</b>	NEUTRAL	NEUTRAL
<b>US Dollar</b>	NEUTRAL	UNDERWEIGHT
<b>Energy<sup>3</sup></b>	UNDERWEIGHT	UNDERWEIGHT
<b>Precious Metals</b>	OVERWEIGHT	OVERWEIGHT

<sup>1</sup>Relative to global equities in USD

<sup>2</sup>Relative to aggregate fixed income markets in USD

<sup>3</sup>Relative to an overall commodity allocation

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