Truist Advisory Services, Inc.

Portfolio Perspective from the Investment Advisory Group

Small caps bouncing off extreme underperformance, but macro environment is still a headwind

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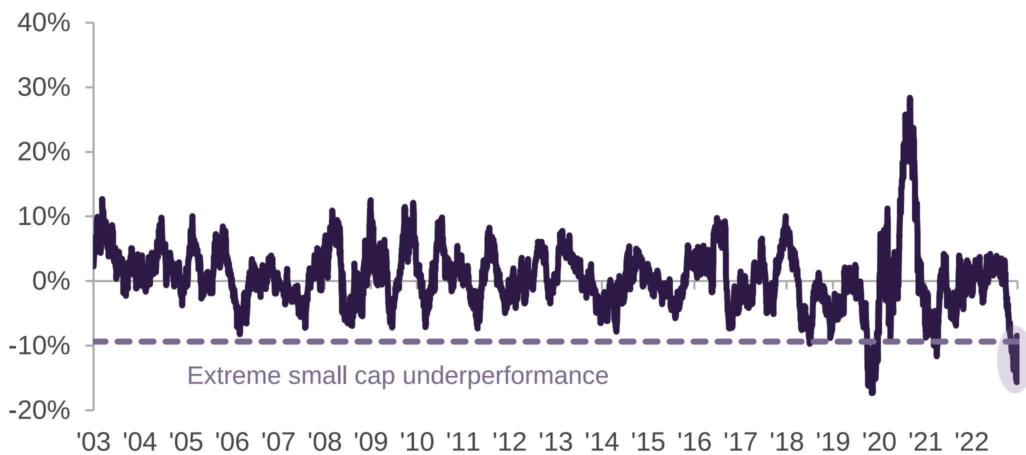
What happened

- Aided by a much larger weighting in the technology sector, large caps are outperforming small and mid caps by a wide margin this year.
- Moreover, heading into June, on a three-month basis, small caps' underperformance reached the second most extreme level in the past 20 years, only surpassed by the early stages of the 2020 pandemic period.
- However, since the beginning of the month, small caps have outperformed large caps by just over 3% as other areas of the market have started showing signs of life.

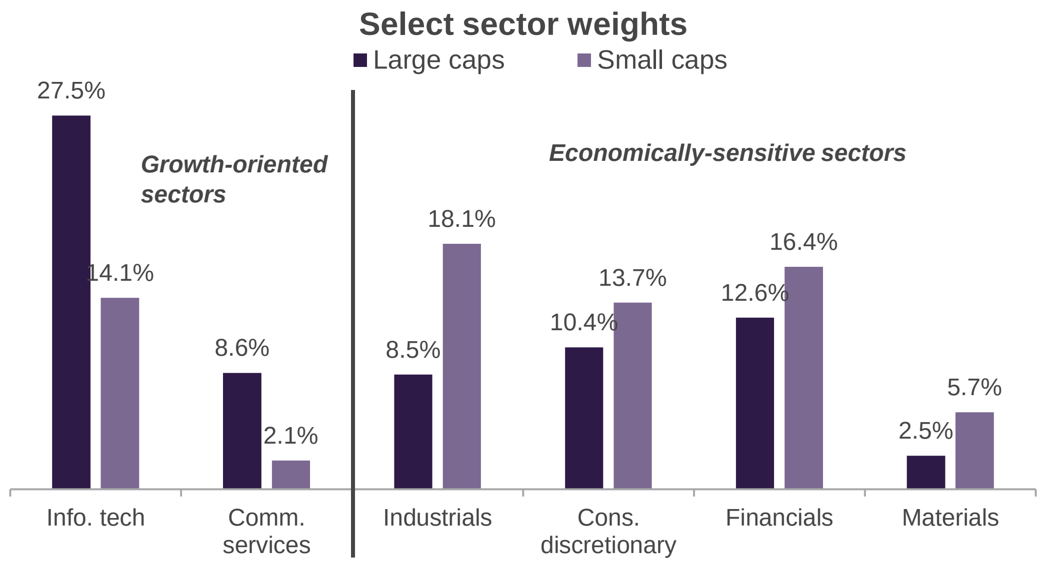
S&P SmallCap 600 minus S&P 500 three-month rolling price return difference



Data source: Truist IAG, FactSet. Past performance does not guarantee future results.

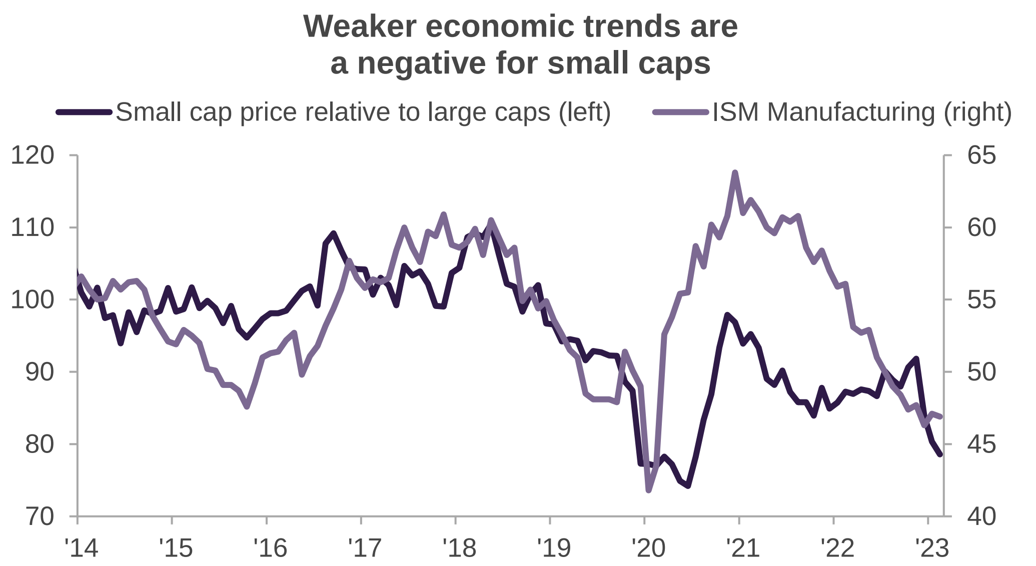
Our take

The improved small cap performance likely has further to go near term given how oversold this asset class had become, yet we maintain a more neutral tactical view. As mentioned, a key driver for the small cap underperformance this year has been a much lower allocation to the technology sector relative to large caps. Small caps also tend to have a much higher allocation to economically-sensitive areas of the market, such as industrials and financials. These sectors have lagged on concerns of an economic slowdown but have also been bouncing recently as investors look for areas that could play catch up.



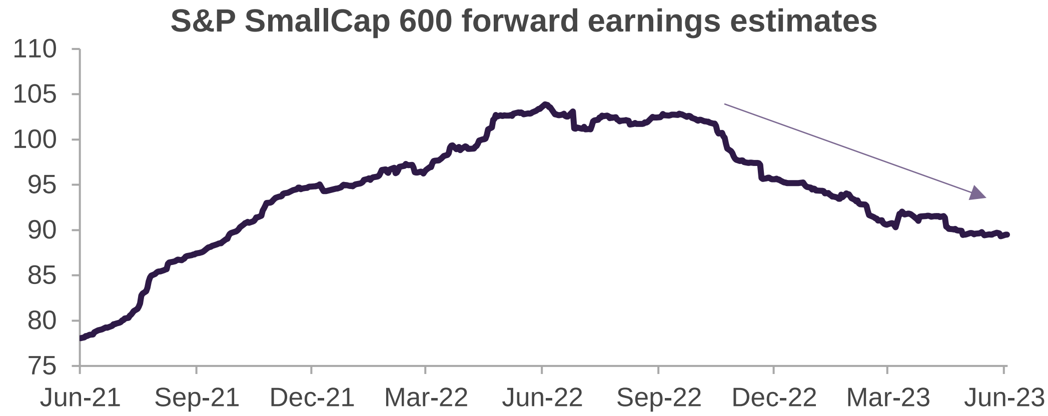
Data source: Truist IAG, BlackRock. Large caps = iShares Core S&P 500 ETF, Small caps = iShares Core S&P Small-Cap ETF

Despite the potential for further near-term upside, the reason why we are not advising moving to an overweight position is small caps tend to be more levered to the economic cycle, have higher debt levels, and lower operating margins compared to large caps. Indeed, small caps tend to outperform early on during an economic cycle and trail in the latter stages. Our *House View* is the economy, weighed down by the fastest rise in interest rates in 40 years and tightening credit conditions, will remain a challenge to sustainable small cap outperformance.



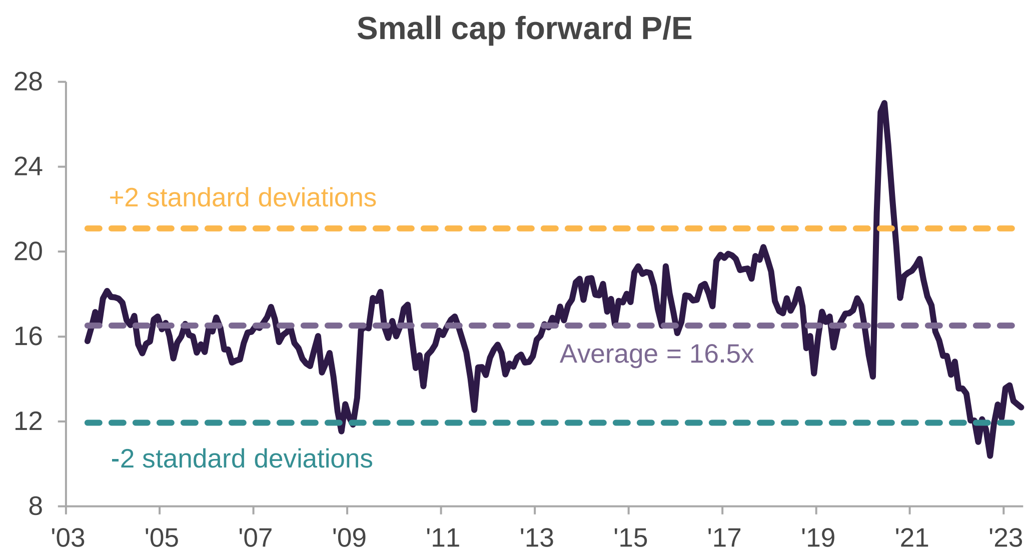
Data source: Truist IAG, FactSet. Past performance does not guarantee future results. Small caps = S&P SmallCap 600, large caps = S&P 500

Forward earnings estimates have been weak since late last year, and relative to large caps, forward earnings are near a two-year low.



Data source: Truist IAG, FactSet. Past performance does not guarantee future results.

Longer term, we are more positive on the prospects for small caps. Indeed, they are one of the more attractive asset classes in our long-term capital market assumptions. Valuations are an important input in this process, and small caps are trading almost two standard deviations below their 20-year average. Thus, as we move to the other side of the economic cycle, we would likely look to boost our outlook.



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Bottom line

While the recent bounce in small caps likely has further to go, on a tactical basis, we remain neutral. Our expectation is that a slowing economy paired with more economically-sensitive characteristics and weaker earnings trends will likely remain headwinds for small caps. In order to get more tactically positive, we would want to see improving earnings trends on an absolute and relative basis and a more positive outlook for economic activity.

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The S&P 600 Small Cap Index which is a measure of the performance of the small-cap segment of the U.S. equity universe

The S&P 500 Index which is an unmanaged index comprised of 500 widely-held securities considered to be representative of the stock market in general.

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