
THREE POSSIBLE CATALYSTS FOR A SMALL-CAP RECOVERY

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One of our key expectations for equity markets in 2023 is an eventual recovery in U.S. [small caps](#), which have had an inordinate amount of [recession](#) risk priced into their [valuations](#) since the middle of last year. Once the [Fed](#) begins to slow its aggressive [rate hike](#) campaign and eventually pivots toward policy easing, risk assets like small caps may catch a tailwind from improved sentiment and a broader equity market recovery.

Below are three potential catalysts that may precede small-cap outperformance based on current readings of the broader market.

1. Deep Discounts Relative to History

In early 2021, the [price-to-earnings \(P/E\)](#) and [forward P/E ratios](#) (both excluding negative earners) of the small-cap core, [value](#) and [growth](#) markets peaked, with most rising comfortably above their long-term averages. Since then, valuations have compressed, with both measures across all three investment styles remaining about two standard deviations below their long-term averages.

Russell 2000				
Metric	12/31/22 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	11.3x	18.2x	-38.1%	98.8%
Fwd. P/E	12.5x	16.9x	-26.3%	96.8%
P/B	1.8x	2.0x	-9.7%	72.6%
P/S	1.1x	1.1x	4.4%	41.2%

Russell 2000 Value				
Metric	12/31/22 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	9.7x	15.5x	-37.3%	98.4%
Fwd. P/E	10.9x	15.0x	-27.1%	96.4%
P/B	1.2x	1.4x	-13.3%	79.1%
P/S	0.9x	0.8x	8.8%	33.5%

Russell 2000 Growth				
Metric	12/31/22 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	13.7x	22.6x	-39.5%	98.0%
Fwd. P/E	14.6x	19.7x	-25.8%	95.2%
P/B	3.5x	3.6x	-2.5%	52.1%
P/S	1.5x	1.5x	-5.0%	56.9%

Sources: WisdomTree, FactSet, as of 12/31/22. You cannot invest directly in an index.

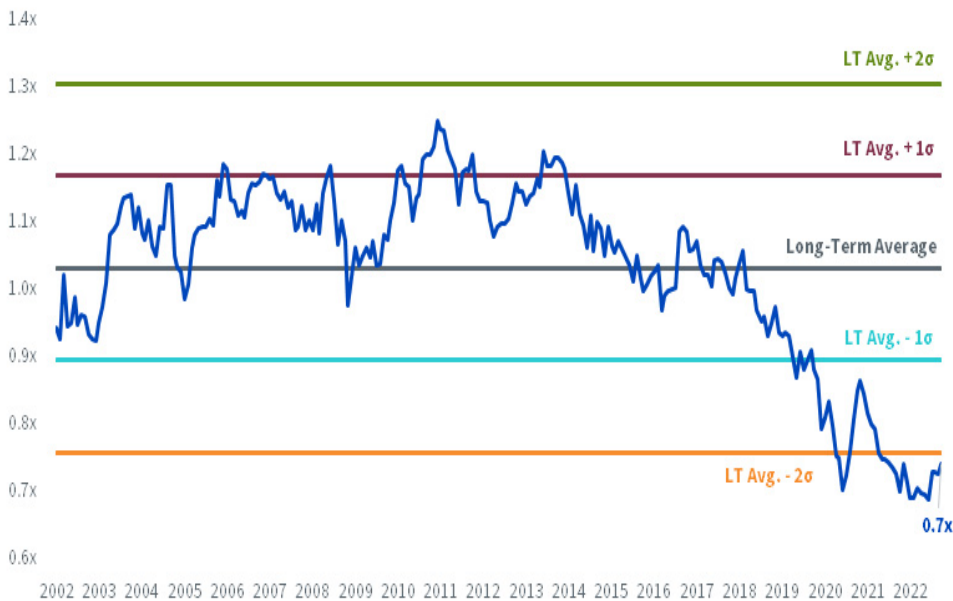
These are historically deep [discounts](#), as both metrics across the three styles are within the top 5% of cheapest valuations since the beginning of our data history in 2002. Similarly, multiples this low have not been observed since the depths of the [global financial crisis](#) in early 2009, which presaged an enduring, secular [bull market](#) thereafter.

2. Deep Discounts Relative to Larger Brethren

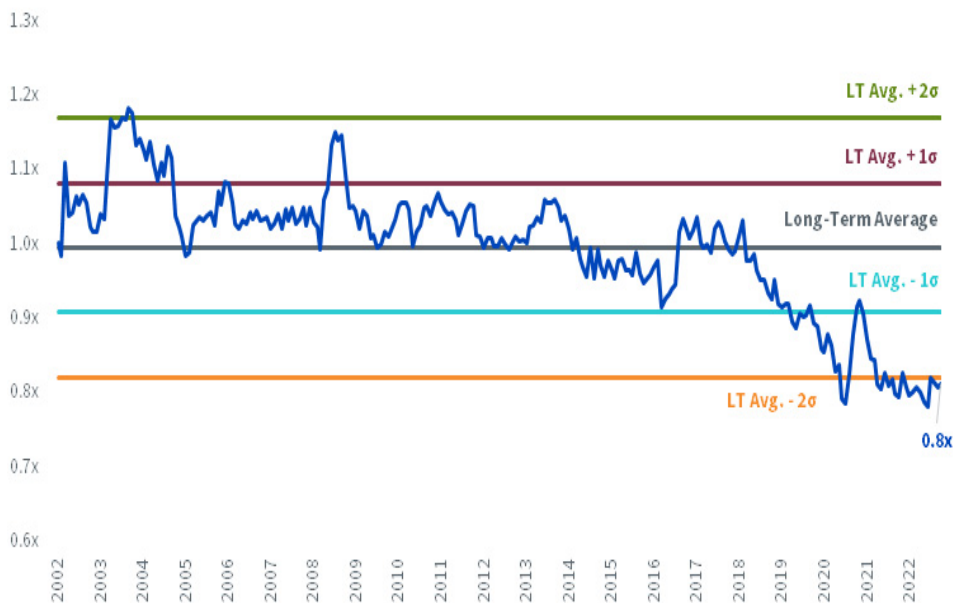
Valuations relative to both [large](#) and [mid-caps](#) have consistently remained more than two [standard deviations](#) below their long-term averages since the second half of 2021 as well. This was primarily due to the economic uncertainty and impending rate hike cycle that markets were forced to confront after the rapid, post-pandemic recovery. Investors who bravely maintained their equity allocations preferred the perceived safety of larger companies at the expense of smaller ones, and the small-cap market suffered disproportionately.

Today, however, markets are becoming more optimistic that the Fed will both pause its [tightening](#) cycle in early 2023 and eventually begin to cut rates by the end of the year or in early 2024. Markets are eagerly anticipating this pivot, and once signaled, we may see an overdue rally in risk assets, especially if weakening economic data forces the Fed to hasten the pace of policy easing.

Russell 2000 Fwd. P/E (ex. Negative Earners) vs. Russell 1000



Russell 2000 Fwd. P/E (ex. Negative Earners) vs. Russell Midcap



Sources: WisdomTree, FactSet, as of 1/20/23. You cannot invest directly in an index. Data represents the forward P/E ratio (excluding negative earners) of the Russell 2000 Index divided by that of the Russell Mid Cap Index.

3. Current Valuations May Precede Outperformance

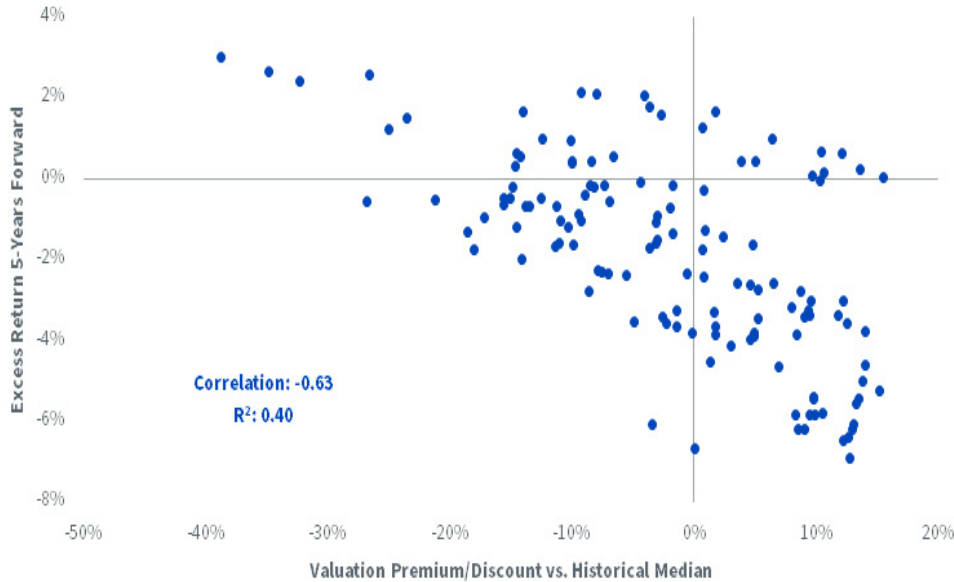
Small caps are a notoriously junky market, inundated with unprofitable companies that then skew broader valuations so dramatically that they become practically meaningless.

If you remove these non-earners, however, there’s a decent relationship between forward P/E ratios relative to their longer-term median and subsequent five-year excess returns versus large caps. Using monthly data back to the beginning of 2007, the greater that the valuation discount to large caps became, the more that small caps exhibited positive rolling excess returns versus large caps over a subsequent five-year period. This is evinced by the -0.63 correlation and [R-squared](#) multiple of 0.4, which imply that a sizable portion of five-year excess returns versus large caps can be explained by

prevailing small-cap valuations relative to their own historical median.

As of January 24, the small-cap market was trading at a 22% discount to its longer-term median. Over our data history, a discount this steep at month-end has helped deliver outperformance over large caps six out of seven times.

Russell 2000 Fwd. P/E (ex. Negative Earners) Premium/Discount vs. Excess Returns against Russell 1000



Sources: WisdomTree, FactSet, as of 12/31/17, which represents the most recent period from which we can calculate performance over the five-year forward period (i.e., ending 12/31/22). You cannot invest directly in an index.

Actionable Ideas for Small-Cap Investing

Much like the broader market, wisdomTree’s U.S. small-cap equity Funds also sport attractive multiples that are heavily discounted by historical standards.

Given recessionary fears and the attendant impact on corporate earnings, the [wisdomTree U.S. SmallCap Fund \(EES\)](#) may withstand market volatility due to its explicit focus on profitable companies while avoiding non-earners. If the historical relationship between multiples when excluding unprofitable companies and outperformance versus large caps is any indicator, [EES](#) could be well-positioned for small-cap allocations during an equity market recovery.

Likewise, we continue to prefer value investing over growth in 2023, building off the success of last year’s reversal of a decade-long market theme. The [wisdomTree U.S. Small Cap Dividend Fund \(DES\)](#) marries size exposure to dividend investing, a key tenet of the value investing ethos, to deliver an income tilt within small-cap allocations.

While we may not know when an equity market recovery will begin, we do know there are prevailing opportunities in small-cap markets to assess in advance.

WisdomTree U.S. SmallCap Fund (EES)				
Metric	12/31/22 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	7.1x	12.8x	-44.7%	98.5%
Fwd. P/E	8.9x	13.3x	-33.0%	97.4%
P/B	1.3x	1.6x	-15.6%	85.8%
P/S	0.6x	0.7x	-15.3%	75.2%

WisdomTree U.S. SmallCap Dividend Fund (DES)				
Metric	12/31/22 Value	Long-Term Avg.	Current Discount	Premium/Discount Percentile Rank (Higher = Better)
P/E	9.8x	17.1x	-42.7%	99.5%
Fwd. P/E	10.3x	16.0x	-35.5%	97.5%
P/B	1.5x	1.7x	-8.1%	67.7%
P/S	0.8x	1.0x	-18.3%	87.4%

Sources: WisdomTree, FactSet, as of 12/31/22. Table represents valuations relative to their long-term average and where they rank relative to history. **The performance quoted represents past performance and does not guarantee future results. The investment return and principal will fluctuate. Investor's Shares, when sold or redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted.**

For the most recent month end and SEC standardized performance, please select the respective ticker: [EES](#), [DES](#).

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For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

View the online version of this article [here](#).

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DEFINITIONS

Small caps: new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Recession: two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Price-to-earnings (P/E) ratio: Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Forward P/E ratio: Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Growth: Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Discount: When the price of an ETF is lower than its NAV.

The Global Financial Crisis: Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

Bullish: a position that benefits when asset prices rise.

Large-Capitalization (Large-Cap): A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Mid-Cap: Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

Standard deviation: measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

Fed tightening: Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

R-squared: Represents the percentage of a fund or security's movements that can be explained by the independent variable.