
WILL 2019 BE THE YEAR OF SMALL CAPS (IN EUROPE)?

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I admit it—I was stunned by January’s turnaround in market performance.

It seemed logical to consider a more defensive approach. And if someone had asked me if it was appropriate to over-weight [small-cap](#) equities, I wouldn’t have had the guts to say yes after being shell-shocked by the [VIX](#) spiking to 36 in late December.

But small caps have been off to an incredible start in 2019.

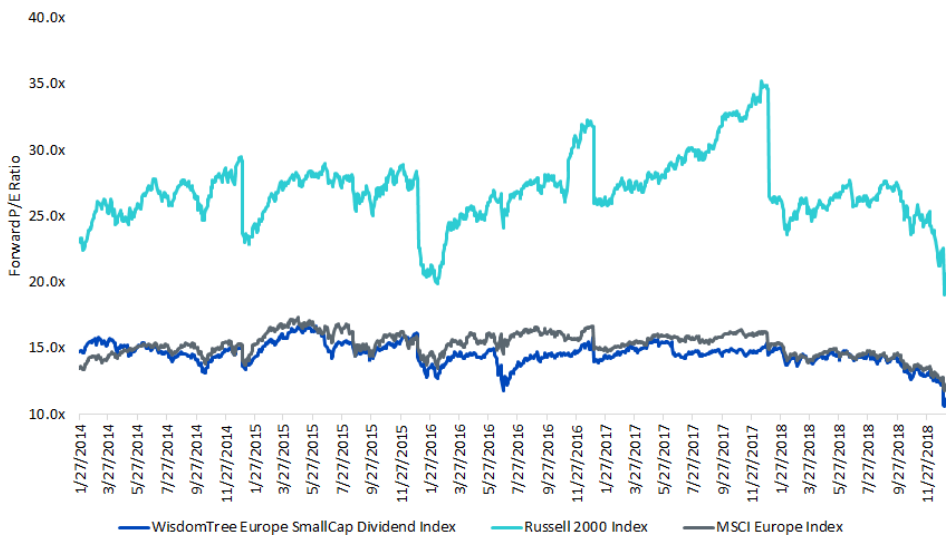
What’s Easy? Slipping into Old Patterns

With the current global backdrop, a U.S. allocation is one of the easiest to create a compelling narrative around. The [Brexit](#) uncertainty in Europe, for example, is enough to buttress this narrative. The [Russell 2000 Index](#) has started 2019 off strongly, delivering a double-digit return in January. There is little question that investors will notice.

But it’s important to remember that small-cap companies tend to be businesses with long-term goals, and U.S. [growth](#) is currently late in its cycle. So, while it may be possible to squeeze further positive performance from small caps, there isn’t much in the way of a [valuation](#) cushion, should conditions deteriorate.

- The lower risk of U.S. small caps should lead to the Russell 2000 Index having a higher [forward P/E](#) multiple—a factor that is not in dispute. The real question is, given the balance of risks, how much higher should the multiple be than, say, that of the [WisdomTree Europe SmallCap Dividend Index](#)? What we see in figure 1 is something on the order of 50%.
- The forward P/E ratios of the WisdomTree Europe SmallCap Dividend Index and the [MSCI Europe Index](#) have been quite similar, with the WisdomTree Index having the current advantage.

Figure 1: European Small Caps Offer a Massive Discount over U.S. Small Caps



Source: Bloomberg, with data from January 25, 2014, to January 25, 2019, a five-year period. Past performance is not indicative of future results. You cannot invest directly in an index.

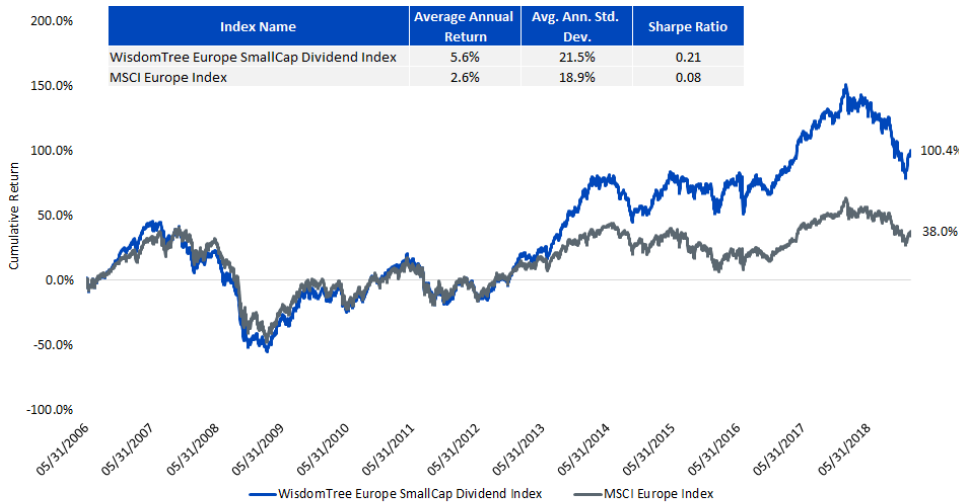
European Small Caps Are Impossible to Ignore

Since 2013, the WisdomTree Europe SmallCap Dividend Index has opened up a dramatic performance gap over the MSCI Europe Index. This illustrates an important point, especially since we recognize that when investors look beyond the U.S., they often look only at [large caps](#). The key explanations of this opportunity for small caps in Europe are:

- When risks arise in Europe, they’re frequently expressed through volatile performance by some of the large, systemically important banks. These banks have large market capitalizations, thereby commanding large weights in indexes such as the MSCI Europe Index. By looking to small caps, investors can avoid the systemically important financials, at least in terms of direct index exposure.
- There have been two distinct periods when oil prices dropped significantly over short periods of time. A focus on small caps would tend to tilt away from these larger companies that have had some more difficult periods since 2013.

As investors consider European equities, we’d emphasize the importance of not forgetting the full spectrum of [market capitalization](#).

Figure 2: Long-Term Performance of European Small Caps Has Been Very Strong



Source: Bloomberg, with data from June 1, 2006, to January 25, 2019, the period of live calculation for the WisdomTree Europe SmallCap Dividend Index. Past performance is not indicative of future results. You cannot invest directly in an index.

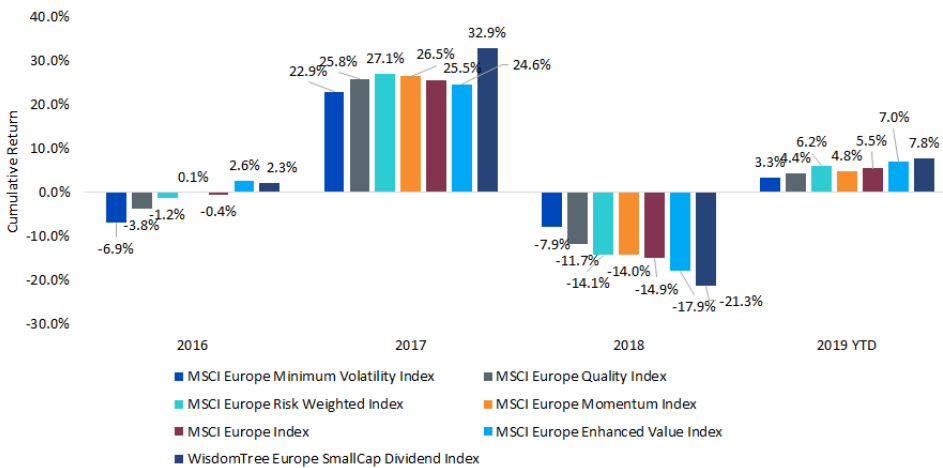
Relief Rally in 2019?

We recognize that we have to face the facts. Global growth is trending slower than it has in recent years, hampered in part by the U.S. tax cut impact from 2017. And sentiment toward Europe’s growth is not particularly strong at present. 2017 was a much better year.

Fortunately, the relationship between economic growth and equity performance is not a simple correlation.

- In 2016, Europe’s equities were searching for footing after such surprises as the Brexit referendum result and Trump’s presidential election victory.
- If every year were like 2017, European equities would dominate people’s portfolio exposures. Economic growth data was accelerating, equity performance was strong, and the European currencies were appreciating against the U.S. dollar.
- It is strange to have to put 2017 and 2018 side by side. In 2018, there was massive deceleration in economic growth prospects for Europe, as well as declining sentiment.
- To be fair, growth isn’t exactly accelerating as we start 2019. But there does appear to be a relief rally underway. It’s intriguing that the WisdomTree Europe SmallCap Dividend Index was the worst performer in 2018, but in 2019, it has started off the most strongly (not to mention the fact that every factor index is positive so far).

Figure 3: Understanding Europe’s Equity Markets through the Factors



Source: Bloomberg, with data from December 31, 2015, to January 25, 2019. Returns include the impact of equity performance as well as respective currency performance against the U.S. dollar. Past performance is not indicative of future results. You cannot invest directly in an index.

Don't Forget about Europe's Small Caps

As we've said before, it's easier to make the case to allocate to the U.S. over Europe today. However, we don't believe investors realize that each of the five major factor-focused indexes of Europe have been positive in January of 2019 after quite a rough year. European small caps have delivered strong performance in the long term and currently offer a large discount over U.S. equities. That's where we see an opportunity.

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.

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DEFINITIONS

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

Brexit: an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Russell 2000 Index: Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

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.

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.

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.

MSCI Europe Index: A free float-adjusted market capitalization-weighted index designed to measure the performance of developed equity markets in Europe.

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.

Market Capitalization: $\text{Market cap} = \text{share prices} \times \text{number of shares outstanding}$. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.