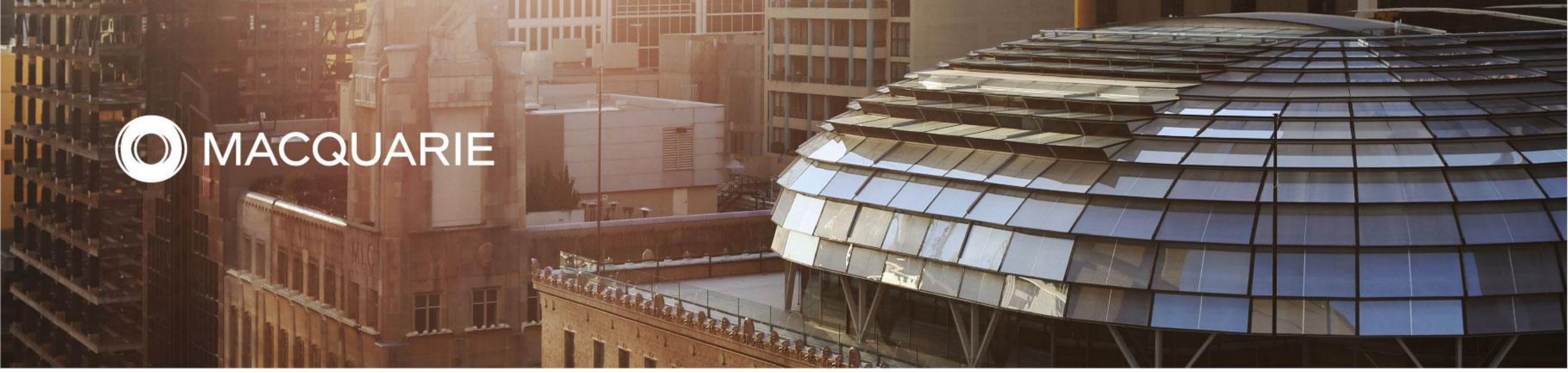


Investment Strategy Update #133

Not time to make a call on small caps

- Globally, size did not matter for most of last year with both global small and large cap benchmark indices falling 15%. Any stock that looked like a Growth stock was thrown out with the bathwater regardless of market capitalisation. This year, size will be more important once macro uncertainties surrounding interest rates and the depth of the downturn are resolved. Until then, investors should stick to benchmark exposures for both size (large vs. small caps) and style (value vs. growth).

- Large cap stocks generally outperform during recession for a number of reasons:

    - They are more liquid and hence tend to be less volatile and sensitive to sentiment swings than small caps.

    - They tend to be industry leaders which gives them pricing power and greater ability to protect margins and earnings.

    - They are less cyclical due to industry dominance. This usually drives outperformance (versus small caps) when the economic cycle is weakening. Lower cyclicality also comes via less cyclical market cap allocations in areas such as consumer discretionary and industrials.

    - They tend to have a cost of capital advantage over small caps due to their size advantage which provides greater protection against rising interest rates.

- However, while broad macroeconomic conditions (sentiment, volatility, liquidity, earnings and pricing power) are stronger tailwinds for global large cap stocks, valuations have moved dramatically in favour of global small caps over the past 12 months, trading at a 20% discount to their LTA. Unfortunately, the same cannot be said for Australian small caps which continue to trade at a premium to Australian large caps of around 15%.

- With uncertainty around inflation, rates and growth still elevated, we don't recommend making a call on size. Both small and large cap stocks have pluses and minus working for and against them. But ultimately, we think investors should wait until there is more transparency on the inflation, rates and economic outlook before being comfortable to position for a sustained improvement.

- When interest rates peak and transparency on the depth/duration of the economic slowdown improves, equities should begin to rally (sustainably) and small cap stocks will be the high beta way to play this risk-on environment. Until then, we think investors will continue to oscillate between size as sentiment ebbs and flows.

Waiting but not ready to move

Successfully navigating markets this year will require investors remain flexible given the potential for a pivot from defensive / quality to more cyclical beneficiaries as the rate cycle peaks and growth bottoms.

At this stage, inflation and interest rate risks remain high, the slowdown in earnings is underway and some way from being completed.

There are few signs that tilting towards growth as an investment style will drive outperformance while the inflation fight remains, and rates have not yet peaked or are in decline. Equally, the threat of recession means a tilt towards value should also be approached with caution given a greater weight in cyclically exposed sectors. Unfortunately, we think the size call is somewhat like the style call and is not strongly tilted to one side given uncertainty around how the cycle proceeds.

What is happening for large vs small Caps?

Globally, size didn't matter last year, with large and small cap stocks performing broadly in line with each other. This was because style dominated performance across size. In other words, it didn't matter whether you were a small cap or large cap stock, the valuation de-rating due to rising interest rates took all growth stocks lower.

However, in Australia size was more important, with small cap stocks underperforming large cap stocks. Investors tend to seek shelter in Australia during periods of heightened risk, particularly large cap banks with their attractive dividend yield but also energy and materials during 2022 as geopolitical tensions.

Size & style performance (%)

	US	Australia	World
Large cap			
2022	-16.5	3.3	-15.2
28 year average	7.9	4.9	5.3
Small cap			
2022	-13.9	-9.8	-15.2
28 year average	9.6	4.5	6.6
Growth			
2022	-26.9	-6.2	-24.7
28 year average	9.8	4.3	6.4
Value			
2022	-5.3	8.4	-6.0
28 year average	6.2	4.4	4.4

Source: Factset, MWM Research, March 2023

Rules of thumb for investing by size:

This year higher interest rate and inflation risk are still lingering, and markets are questioning whether both have yet peaked. Last year we learnt that size did not matter against this global backdrop.

Markets are also uncertain about the start, depth and duration of a recession, and this also means that size should not matter until this is resolved.

- **Small cap stocks underperform during a recession** However, they outperformed as interest rates rose in 2021 and H1 2022, when inflation was low and not threatening. Speculation of a decline in rates saw small cap stocks underperform early in the new year.

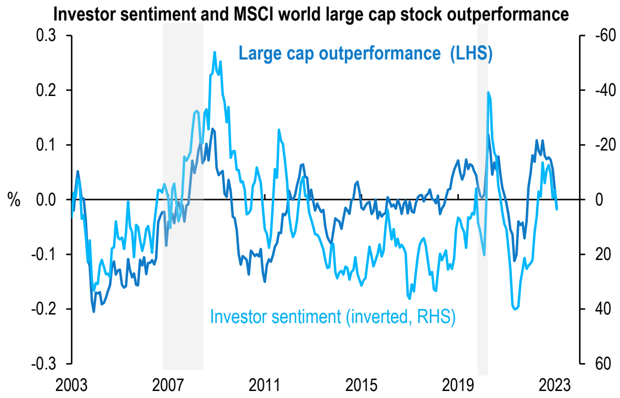
- **Small cap stocks do well in periods of broad margin expansion.** However, when margins are under pressure as they were last year from rising costs, these stocks tend to underperform. Margin pressure is likely to continue this year due to rising costs and slowing demand making it difficult for small cap stocks to outperform for a sustained period.

Global backdrop	Small cap	Large cap
Recession		
Rising interest rates and low inflation		
Falling interest rates and low inflation		
Poor sentiment		
Margin expansion		
Declining interest rates		

Source: Factset, MWM Research, March 2023

- **Large cap stocks, generally do relatively well in recession.** They often have a large market share in their industries and can more easily pass on costs. Large market share also protects revenue even as the macroeconomic backdrop is deteriorating. **Large cap stocks tend to outperform as investor sentiment deteriorates.** During these periods investors seek liquidity and that can easily evaporate during periods of risk-off sentiment. Sentiment improved a little this year at signs inflation was near its peak and large cap names have given up some outperformance. However, in the past month or so markets are again pushing back the expectations of the peak in interest rate.

Large cap stocks thrive when sentiment is weak



Source: Factset, MWM Research, March 2023. Shaded area indicates recession. Outperformance is difference in monthly returns calculated as a 12-month rolling average. Investor sentiment is Sentix investor economic sentiment.

Bringing size out of the tool bag in Australia

Investors in Australia need to think about size differently because of the large sector differences compared to the universe of global stocks.

Australia is traditionally a defensive market because of the large weight the major banks have in the index and their ability to generate strong and relatively stable dividends. Stocks with traditional growth characteristics such as tech have a relatively small weight in the benchmark (2.9%) compared to 20.7% for MSCI world. For example, last year when inflation and interest rates were rising and growth stocks were under pressure, the ASX 300 fell by only 8% from its peak vs MSCI world (21%).

Australian small versus large cap sector weights

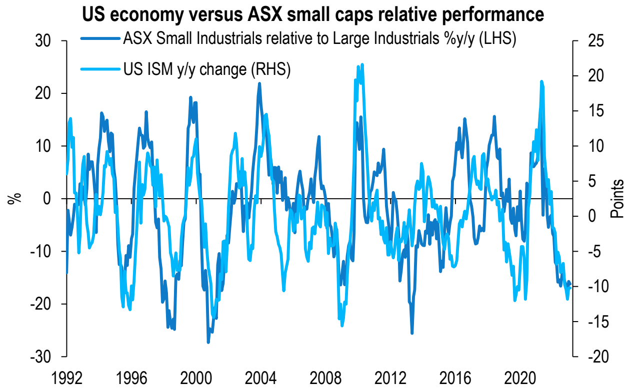
	Small cap	Large cap	Relative
Consumer Discretionary	14.4%	5.6%	8.8%
Real Estate	13.2%	5.3%	7.9%
IT	7.0%	2.5%	4.5%
Industrials	8.0%	5.7%	2.3%
Communication Services	5.2%	3.6%	1.5%
Energy	5.8%	6.2%	-0.4%
Consumer Staples	4.2%	4.8%	-0.6%
Materials	24.8%	25.7%	-0.8%
Utilities	0.0%	1.5%	-1.5%
Health Care	6.4%	10.3%	-3.8%
Financials	11.0%	28.8%	-17.8%

Source: Factset, MWM Research, March 2023

Last year Australian large cap stocks outperformed the local benchmark even though globally size didn't matter. In 2021 when rates and inflation were still low, Australian large cap stocks underperformed the benchmark like their global peers.

If we exclude the impact of the banks on large cap performance, then Australian small cap stocks tend to outperform large cap stocks when global growth is rising. Expectations that the downturn will deepen into recession have already weighed on small cap performance this year.

Australian small caps also do well when economic momentum is positive



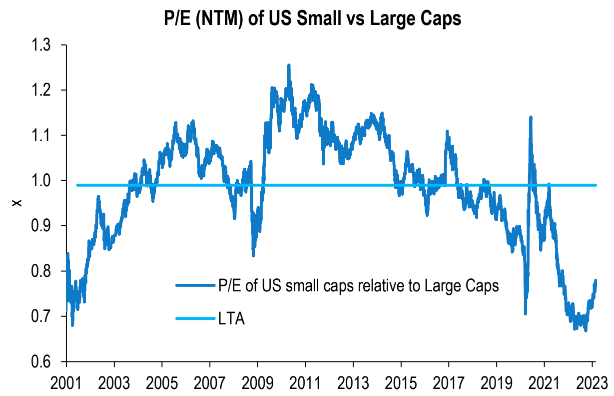
Source: Factset, MWM Research, March 2023.

Note: The US ISM index is a good proxy for US and global economic growth

Valuation

Putting aside macroeconomic, industry and market sentiment, relative valuation can also drive relative performance between small and large cap stocks. At the end of last year, small caps were discounted heavily to large caps - more than any time in the past 20 years. Even though some of this value discount has unwound, valuations will still provide a significant tailwind should the economic or market backdrop turn and become more suited to small caps.

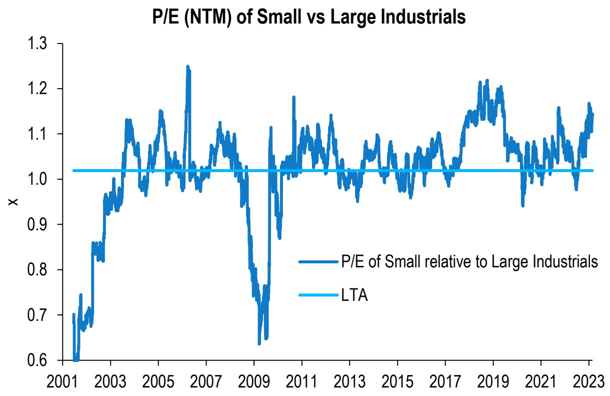
Valuation a tailwind for US small caps



Source: Factset, MWM Research, March 2023

In contrast to global equities, valuation is a headwind for Australian small caps. This means that even if global growth remains resilient in the short-term a lack of valuation support will lower expected returns.

Valuation a headwind for Australian small caps



Source: Factset, MWM Research, March 2023

In summary:

- We expect a global recession that means small caps are likely to consistently underperform, but its timing, depth and duration is difficult to gauge at this stage. More certainty surrounding the recession would be supportive for large cap stocks.

- Going forward, we think small cap stocks will be the high beta way to play the start of a new equity bull market, but before this occurs, we need to be confident that rates have peaked and/or that the growth slowdown will be short and shallow. Until then, it is unlikely that performance will be consistent.

- Looking forward, should the issues around the recession become clearer against a background of interest rates remaining at peak levels, then investors should construct their portfolios with a skew towards large cap stocks.

- We recommend investors stay close to benchmark allocations in both small and large caps and avoid making a strong call on size until economic uncertainties have fallen. For those who are more risk averse, we think global small caps are providing a larger valuation cushion against rates and growth risks than Australian small caps, particularly with the economic and rates cycle lagging the rest of the world.

Please see our "2023 Outlook: Better Days Ahead" for more detail on our investment views, asset allocation and key recommendations.

Macquarie WM Investment Strategy Team

The report was finalised on 6 March 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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