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Monday Morning Musings

Good Things Don't Always Come in Small Packages

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- **Small caps stocks have underperformed sharply year to date but there's more to come.** The Russell 2000 has fared quite poorly this year, as the S&P 500 has outpaced the Russell 2000 by more than 800 bps thus far in 2014. Unfortunately for small cap investors, there are several reasons to believe that more relative weakness is likely in the next year without necessarily arguing a "risk off" mindset.

- **Valuation is a key hindrance.** The premium being paid for small caps versus their large cap brethren suggests a much higher probability than normal that the S&P 500 continues to lead. Indeed, there's a better than 70% chance that large caps outperform when the small-to-large P/E differential is one to two standard deviations above average as compared with a traditionally less than 50% likelihood. Admittedly, valuation alone is not a good timing mechanism but it does highlight the preferential treatment that small caps have received the past few years.

- **Global economic recovery generally helps bigger companies as the international component of sales is greater.** A turn in Asia (especially China), the US and Europe would favor larger cap stocks simply due to their greater international revenue exposure versus mid-caps or small caps. Thus, if one considers the EPS impact of sales rebounds to overhead cost absorption variances, it is fully understandable that investors shift their attention or emphasis towards more attractively valued big multinationals.

- **A proprietary lead indicator contends that small caps could stay under significant pressure.** When reviewing several hundred economic series correlation with subsequent relative index performance, nine factors were used to build a proprietary lead indicator. The model has been arguing for a shift to large cap outperformance. The model still suggests that further underperformance is quite likely and it generates impressive quantitative support.

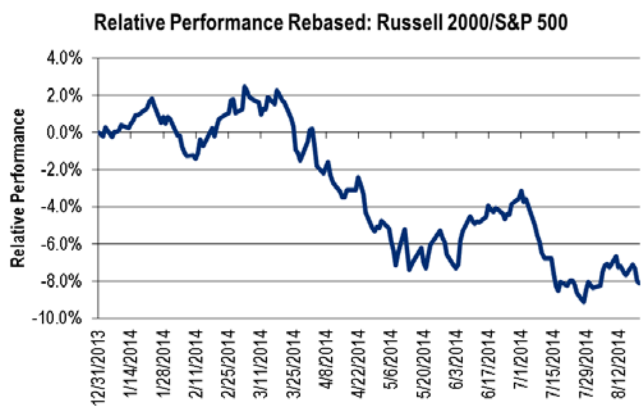
- **Shifts in high yield spreads also provides rationale for small cap challenges.** A widening in junk bond credit spreads historically has indicated a need to shift size style investing. Thus, high yield bond fund outflows have triggered a sharp move in credit spreads, which normally led to pressure on small caps. However, this kind of change does not mean that investors are backing away from risk as the evidence for that claim is missing, particularly strength in emerging markets.

- **Credit conditions further sustain large over small caps.** The Fed's senior loan officers' survey also suggests that large cap names can outperform their smaller peers if history is any guide. Indeed, the latest data from the central bank shows continued easing of lending standards providing yet another sign for S&P 500 outperformance.

When Large Makes One's Wallet Larger

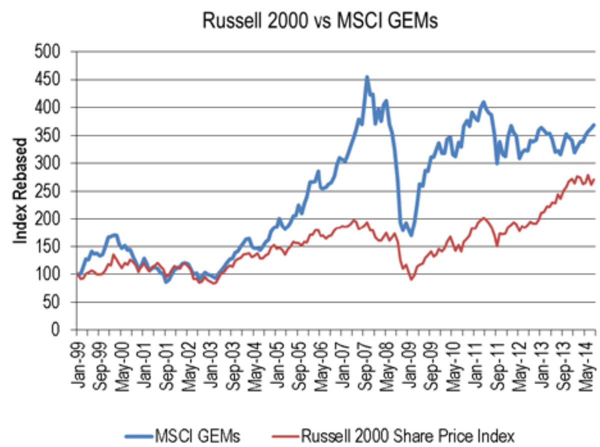
There's been a fair amount of noise being made that a risk-off mentality has emerged this year given small cap underperformance and most recently the widening of high yield credit spreads. As such, it is posited that this newfound disaffection with the Russell 2000 or S&P 600 must imply something sinister or ominous about the broader equity markets with some cited the proverbial "canary in the coal mine" analogy. Yet, people seem to forget that stocks can rally and quite fiercely with large cap leadership – one just needs to recall the more than tripling of the S&P 500 from late 1994 to the peak in 2000, as an example. More critically, it is less than important that small caps have underperformed large caps by more than 800 basis points in 2014 thus far (see Figure 1), but there are a number of reliable indicators suggesting that more underperformance is on the way and it is not about risk per se as emerging markets have rebounded even as the Russell is still lagging (see Figure 2).

Figure 1. S&P 500 and Russell 2000 2014 Performance



Source: FactSet and Citi Research – US Equity Strategy

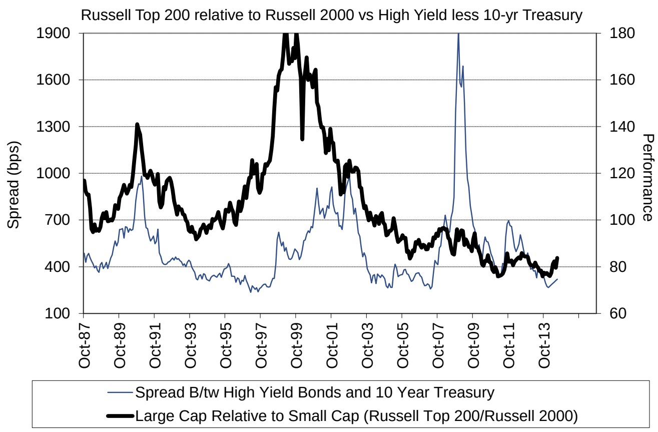
Figure 2. Russell 2000 vs MSCI GEMs



Source: Haver Analytics, Datastream and Citi Research – US Equity Strategy

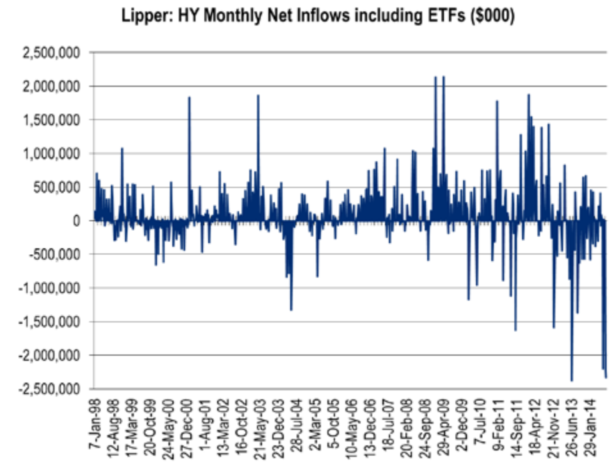
High yield spread widening traditionally has not be a good signal for small caps (see Figure 3) and while much of the blame is being placed on "technicals" coming from junk bond fund outflows (see Figure 4), there is little doubt that the Fed may be raising rates next year and the cyclically related spread narrowing trade already may have occurred as money had been pouring into bond funds for years. Keep in mind that few are banking on a major further gap increase in spreads over the near term even as economic growth strengthens.

Figure 3. Russell Top 200 relative to Russell 2000 vs High Yield less 10-yr Treasury



Source: Haver Analytics and Citi Research – US Equity Strategy

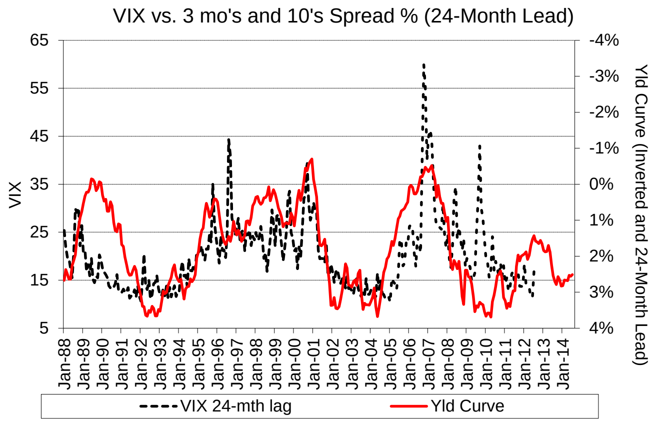
Figure 4. High Yield Monthly Net Inflows including ETFs



Source: Lipper and Citi Research – US Credit Strategy

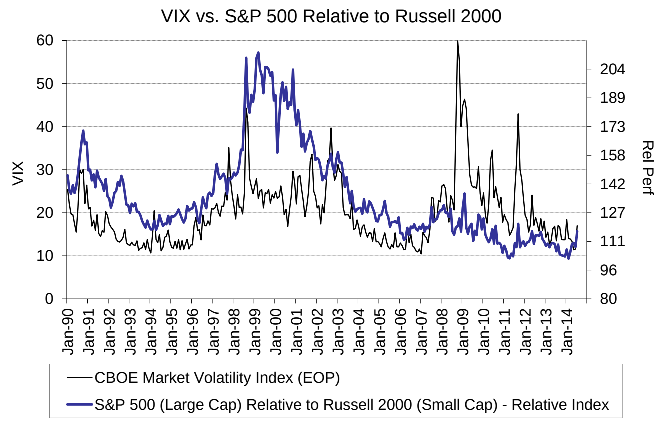
History says that volatility should pick up with a lag given the steep yield curve (see Figure 5) and that historically has not been good news for small cap performance (see Figure 6) but it is also intriguing that expectations for global synchronized economic expansion would be better captured in large cap names versus small or even mid cap indices given their lower international sales exposures (see Figure 7). Interestingly, there appears to be very little correlation between bond yield shifts and relative performance of small compared with large cap stocks but the Fed's C&I lending survey does seem to favor large caps now (see Figure 8).

Figure 5. VIX vs. 3 mo's and 10's Spread % (24-Month Lead)



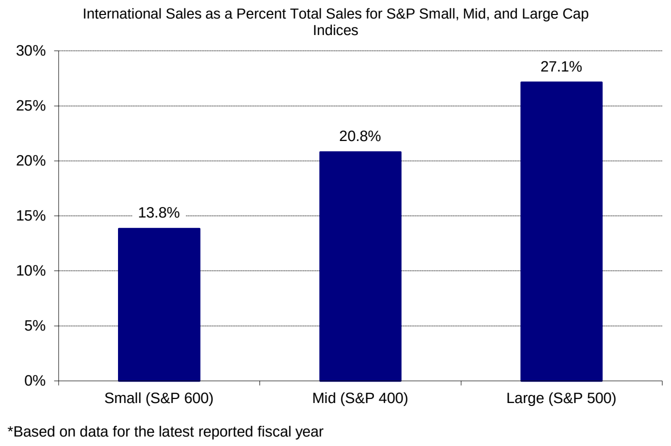
Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 6. VIX vs. S&P 500 Relative to Russell 2000



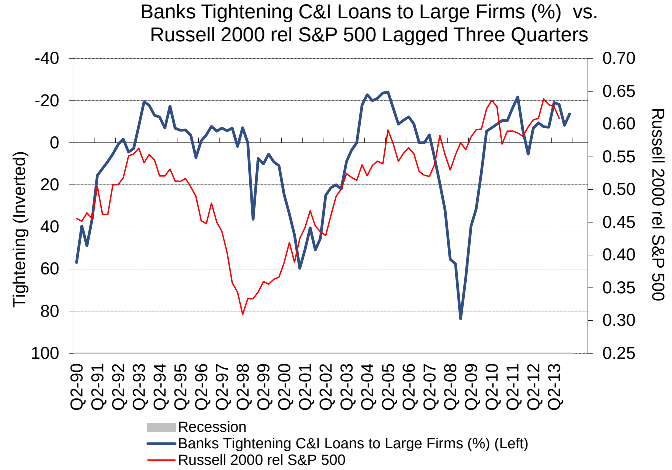
Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 7. Int'l Sales as a % Total Sales (Small, Mid, Large Breakdown)



Source: FactSet and Citi Research – US Equity Strategy

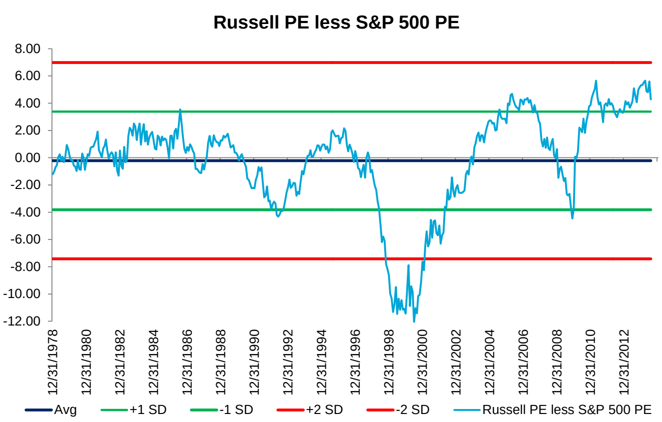
Figure 8. Banks Tightening C&I Loans to Large Firms (%) vs. Russell 2000 rel S&P 500 Lagged Three Quarters



Source: Haver Analytics and Citi Research – US Equity Strategy

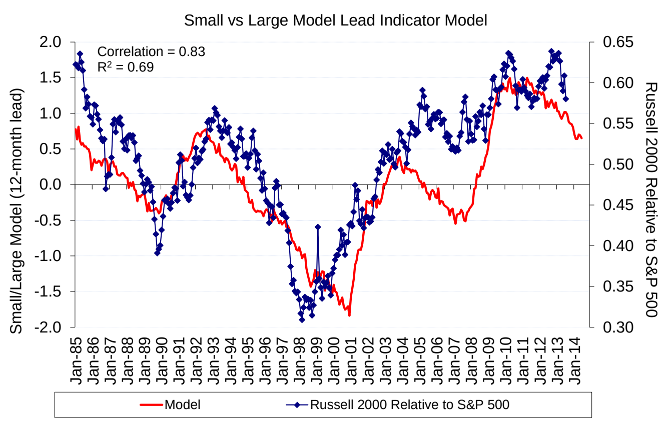
Valuation is a pretty useful indicator as well for relative index performance with the current differential between the Russell 2000 and S&P 500 P/E being at the higher end of the range (see Figure 9) which historically has generated a better than 70% probability of large cap outperformance when the norm is closer to 45%. Moreover, our proprietary lead indicator model with nine factors embedded in it to provide high statistical correlation with subsequent 12-month trading patterns shows further underperformance of small caps being likely (see Figure 10). Keep in mind that two of the nine factors include capacity utilization and consumer confidence with individual correlations found in Figures 11 and 12, yet the combination of the different inputs generates a more robust likelihood for outcomes.

Figure 9. Russell PE less S&P 500 PE



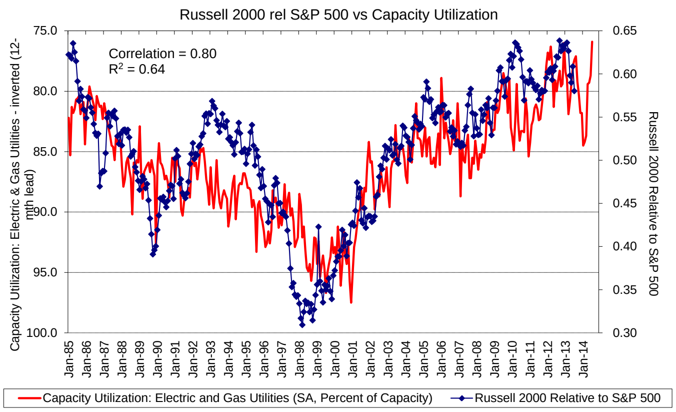
Source: Citi Research – US Equity Strategy

Figure 10. Small vs Large Model Lead Indicator Model



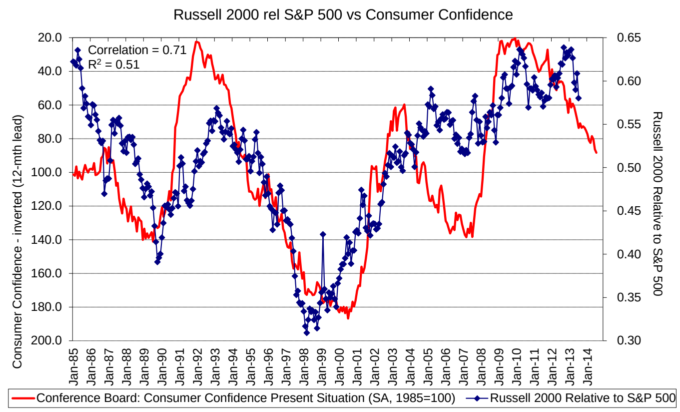
Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 11. Russell 2000 rel S&P 500 vs Capacity Utilization (12-mth lead)



Source: Haver Analytics and Citi Research – US Equity Strategy

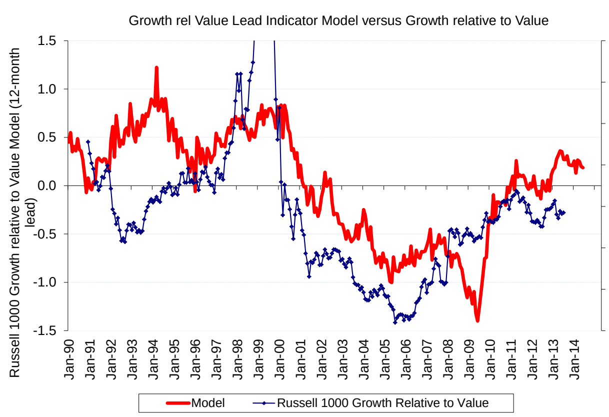
Figure 12. Russell 2000 rel S&P 500 vs Consumer Confidence (12-mth lead)



Source: Haver Analytics and Citi Research – US Equity Strategy

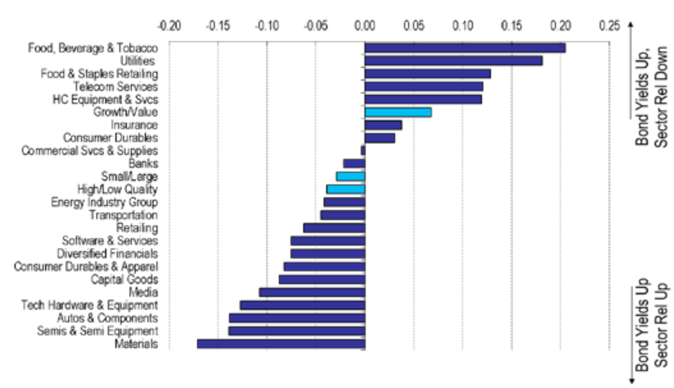
While many hope that the relative weakness in small caps is over and that a rebound is likely, we find that to be a challenging perspective. None of the pieces of data that we have analyzed gets us to that conclusion and indeed there are far more suggestions otherwise. Even the growth value debate is beginning to skew towards value as shown in another lead indicator model (see Figure 13). But, intriguingly, on the bond yield front, there is more positive impact from rising yields for a high quality/low quality skew and more worry for growth relative to value while only modest impact for large/small (see Figure 14). Nonetheless, there is far more data arguing for small cap relative performance concern in the months ahead and that the weak trend experienced in the first half of the year may be sustained. Hence, living large may require staying away from small.

Figure 13. Growth versus Value Lead Indicator Model



Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 14. 20-yr Correlation: Weekly Relative Sector Returns vs 10-yr Treasury



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Appendix A-1

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