

Market commentary, December 18, 2023

Trend reversal ahead for small and mid caps?

It's no secret that small and mid-cap stocks have fallen well behind the total market since the outbreak of the coronavirus pandemic. The STOXX 50 index, which represents the 50 largest blue chips in Europe, has advanced 17% during the past two years, whereas the small and mid-cap stocks within the eurozone have shed 11% of their value (data as of Dec. 13, 2023).

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War in Ukraine, a surge in inflation and the steepest rise in interest rates in decades are all factors that led to a widespread risk-off mindset in equity markets. Small and mid-cap stocks were hit the hardest by these developments and they dropped to deeply oversold levels. These market segments always give up the most ground in times of turbulence due to their lower market liquidity and certain challenges in accessing external financing. Valuation multiples are therefore at the historically low levels last seen at the height of the financial crisis in late 2008. Small and mid caps are actually trading at a discount to large caps. This indicates that considerable pessimism has already been priced in.

Comeback potential

Indeed, it does look like small and mid caps could deliver much better returns going forward. The strong performance of European small caps since the end of October is an initial indication of this. Their 13% gain during this time eclipsed the performance of the STOXX 50 index, which advanced only 6%. There is a good chance that small and mid caps will continue to gain ground over large caps. This scenario is supported by the significant decline in inflationary pressure, which suggests that neither the Fed nor the ECB are likely to tighten their monetary policy any further. Meanwhile the general economic environment appears to be relatively stable. In our baseline scenario we anticipate a soft landing in the US and a gradual improvement in economic growth in Europe during the second half of 2024. Macro stability in China and the expected winding down of inventory destocking could also add some tailwind to the anticipated trend reversal in small and mid caps. But there are also risks. A possible recession, new geopolitical challenges or a resurgence of inflation could put the small-cap comeback on pause.

Focus on companies with potential

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Conclusions

A new capex boom driven by both business strategy and government policy is sweeping the western world. This global infrastructure investment cycle is a mega trend that will stay with us for at least the next decade. Companies that sell the best shovels for this new “gold rush”, be it in the form of innovative technology, must-have services or smart solutions – for example from logistics providers, energy infrastructure companies, or Internet-of-Things specialists – will clearly benefit the most.

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