ACTIVE INSIGHTS

Putnam INVESTMENTS

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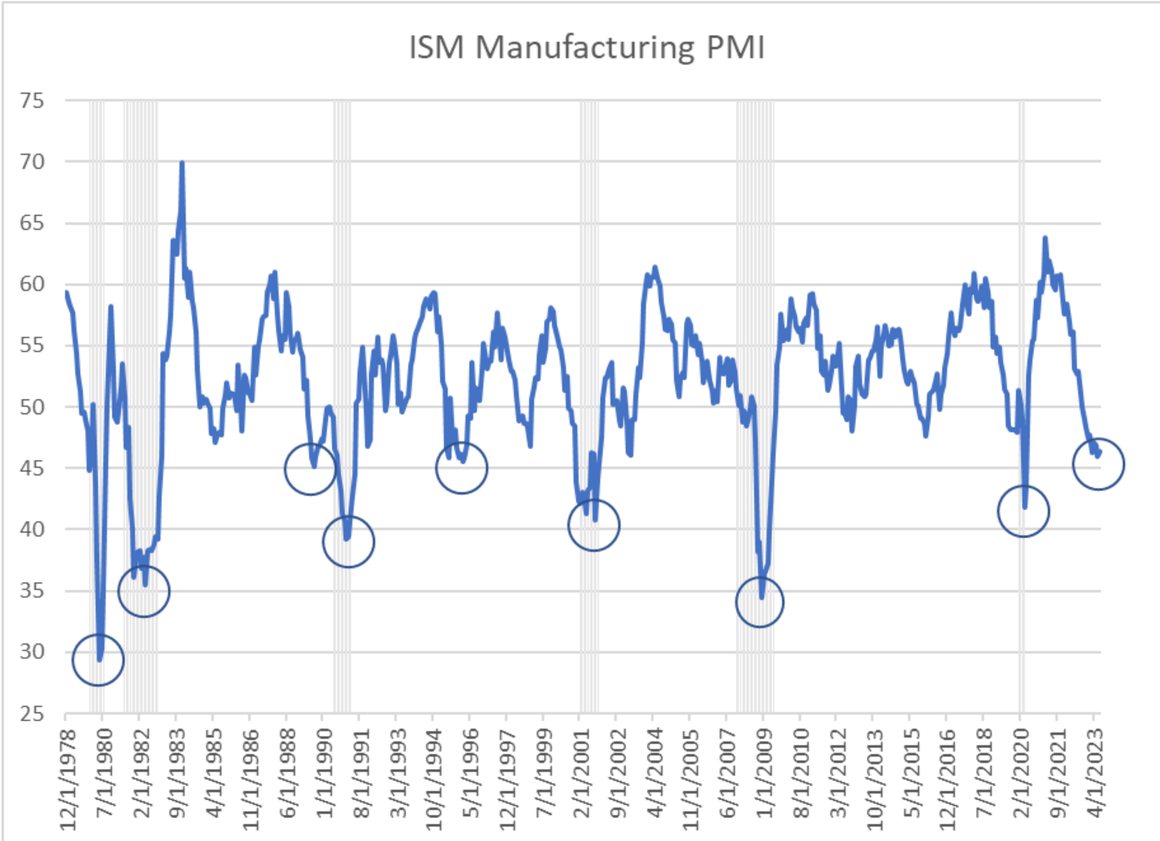
The investment case for small-cap stocks

The stage of the economic cycle, Federal Reserve policy, fundamentals, valuation, and recent performance, all play an important role in the absolute and relative performance of small-cap stocks. In this paper, we examine these factors and attempt to quantify the opportunity that we believe exists in the small-cap space.

Economic cycles

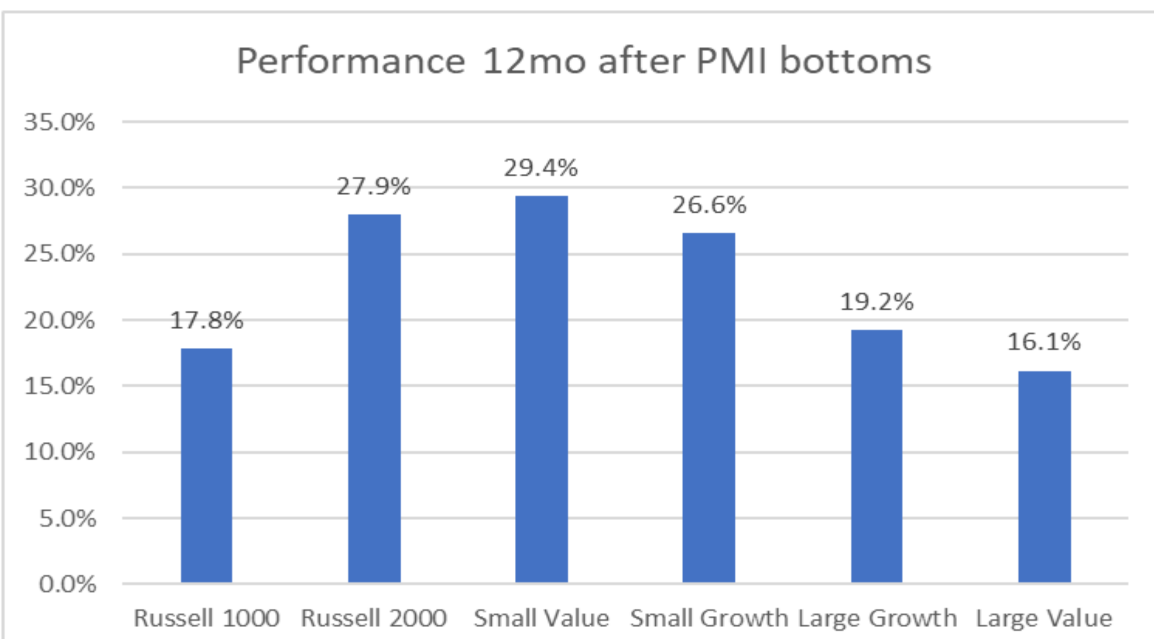
Economic cycles influence small-cap returns. The ISM Manufacturing PMI is useful in measuring the manufacturing sector of the economy. This is a diffusion index. Readings over 50 are indicative of economic expansion, while readings under 50 are associated with economic contraction. Historically, when this data series/index bottoms, it signals a trough in economic activity. Looking back to 1978, we observe that readings under 45 are consistent with troughs in economic activity. The actual depth of the readings is typically associated with the magnitude of a recession. While a recession is certainly possible in this cycle, the U.S. economy has shown remarkable resilience. The ISM Manufacturing PMI index reading in July 2023 was 46, while the August reading was 47.6.

The following chart identifies troughs in the ISM Manufacturing PMI since 1978. Six of the eight troughs were followed by recession, the exceptions being 1987 and 1994. It remains too early to determine if the July reading of 46 is a trough, or if a recession will follow.



Source: Bloomberg, Putnam. Shaded areas indicate recession.

Following troughs in PMI, market performance has been above historical averages across size and style indexes. The strongest historical returns in the 12 months after a trough have occurred in the Russell 2000 Index, led by Small Value.



Source: Bloomberg, Putnam. Small value returns are proxied by the Russell 2000 value index. Small growth returns are proxied by the Russell 2000 growth index. Large growth returns are proxied by the Russell 1000 growth index. Large value returns are proxied by the Russell 1000 value index.

Fed policy

Central bank policy matters when it comes to forward returns for the Russell 2000 Index. Specifically, when the Fed has finished a rate hike cycle, small-cap returns are generally positive in the six and 12-month periods following the last Fed rate hike. On average, the Russell 2000 Index has outperformed the S&P 500 Index following the last rate hike. We believe the Fed is at or near the end of this rate hiking cycle.

Last Rate Hike	S&P 500 6mo Return	Russell 2000 6mo Return	S&P 500 12mo Return	Russell 2000 12mo Return
March 1980	12.11%	18.43%	16.05%	27.13%
December 1980	-2.82%	13.10%	-9.50%	-0.65%
August 1984	7.36%	12.59%	12.71%	13.53%
September 1987	-15.60%	-18.63%	-16.49%	-14.48%
February 1989	21.67%	14.85%	14.90%	1.54%
February 1995	18.97%	20.75%	35.73%	28.44%
May 2000	-6.39%	-4.92%	-12.35%	-1.85%
June 2006	11.43%	10.27%	18.11%	16.71%
December 2018	19.73%	17.91%	30.55%	26.09%
Average	***7.38%***	***9.37%***	***9.97%***	***10.72%***

Source: Bloomberg, Putnam

Fundamental drivers and valuation

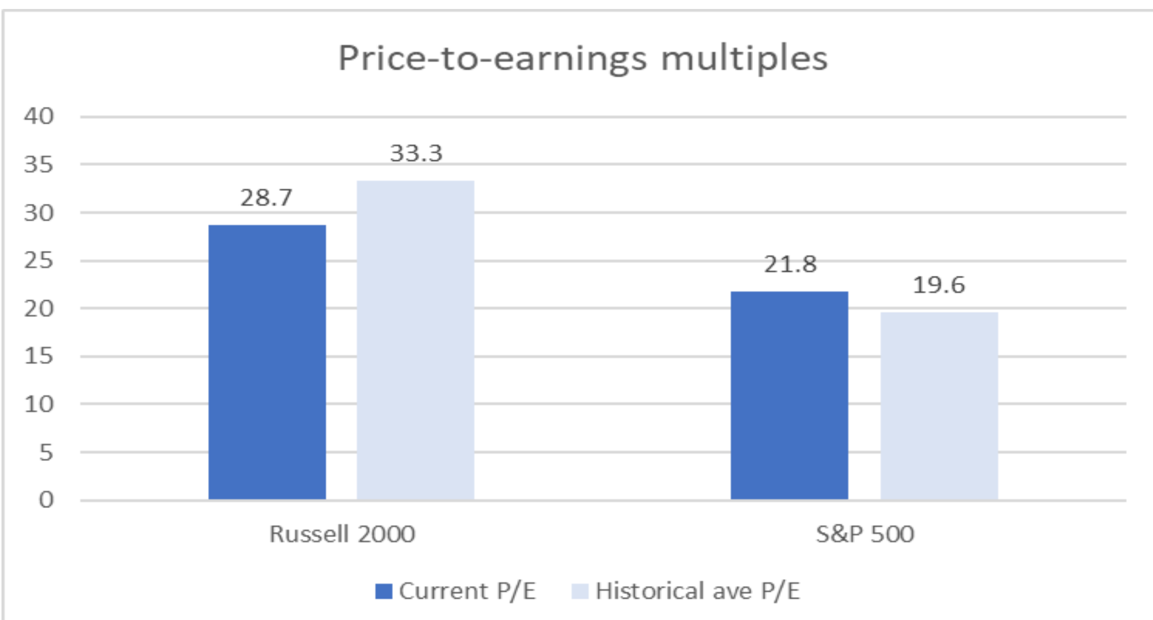
Stock prices are highly correlated with future earnings growth. When comparing the forward looking, bottom-up consensus earnings estimate for the Russell 2000 index versus those of the S&P 500 index, we observe the Russell 2000 index has stronger earnings prospects. Consensus earnings estimates for the Russell 2000 Index indicate 24.7% growth in 2024 relative to 2023, as opposed to 11.11% for the S&P 500 Index. Within the small-cap universe, the strongest earnings prospects come from the growth cohort, with the Russell 2000 Growth Index estimated to grow earnings by 50% in 2024 relative to 2023.

	Russell 2000	Russell 2000 Growth	Russell 2000 Value	S&P 500
2023 EPS Estimate	$76.45	$28.42	$122.43	$221.44
2024 EPS Estimate	$95.33	$42.63	$140.54	$246.05
2024 EPS Growth	24.7%	50%	14.79%	11.11%

Source: Bloomberg, Putnam. As of 9/12/2023

While valuation is not a good short-term timing tool, it can be instructive for investors as they make long term asset allocation decisions. It is also helpful in assessing the risk and reward of certain areas of the market.

The chart below shows the price-to-earnings multiple of the Russell 2000 and S&P 500 as well as its 30-year average. At 28.7 times earnings, the Russell 2000 is trading at a valuation slightly below its longer term average of 33.3. The S&P 500 meanwhile is trading at a multiple slightly higher than its historical average.



Source: Bloomberg, Putnam

The Russell 2000 Index appears to be trading at a reasonable valuation level relative to its historical average.

Recent performance

Historically, when small-cap stocks have negative returns in a calendar year, the following year has seen positive returns 92% of the time with an average return of 19.62%. Moreover, the average annual performance for Russell 2000 index, in a year after a negative year, is over twice that of its average annual performance in all other years. The table below shows negative return years in the Russell 2000 Index and the subsequent year returns, since 1980.

Negative Return Year	Russell 2000 Performance	Subsequent Year
1981	-1.50%	20.66%
1984	-9.59%	27.95%
1987	-10.25%	22.42%
1990	-21.30%	43.35%
1994	-3.26%	26.47%
1998	-3.83%	19.59%
2000	-4.32%	1.02%
2002	-21.58%	45.37%
2007	-2.75%	-34.80%
2008	-34.80%	25.22%
2011	-5.45%	14.64%
2015	-5.71%	19.48%
2018	-12.18%	23.72%
2022	-21.56%	?
Average	-10.50%	19.62%

Source: Bloomberg, Putnam

Conclusion

There are many factors that influence equity returns. The stage of the economic cycle, Fed policy, fundamentals, valuation, and recent performance all need to be considered when making investment decisions. Based on our analysis of these factors, we believe investors should consider allocating capital to small-cap stocks.

The major risk to this view is that the economy and fundamentals within the small-cap universe are not bottoming. If the economy does slow further and enter into a recession, we would expect small-cap stocks to underperform relative to large-cap stocks.

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