

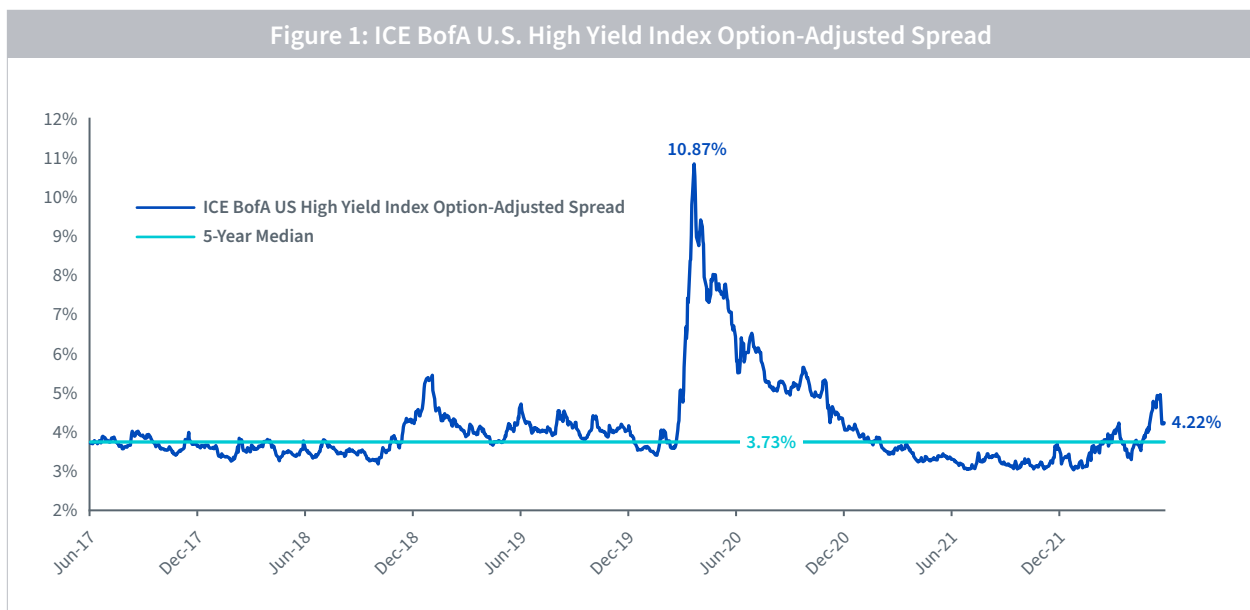
WHERE IS A RECESSION BEING PRICED IN? U.S. Small Caps

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With the S&P 500 Index flirting with bear-market territory, headlines are proclaiming a recession is being priced in.

But at what probability?

High-yield credit spreads—commonly viewed as a leading indicator of economic slowdowns—have spiked higher by 112 basis points since the start of the year.



Source: WisdomTree, FRED, ICE, 6/1/17-5/31/22. You cannot invest directly in an index.

If we look to valuations on the S&P 500, the picture looks more benign, even after a decline of 14% from its high. Undoubtedly, recession risk has picked up but seems to us far from pricing it as a foregone conclusion.

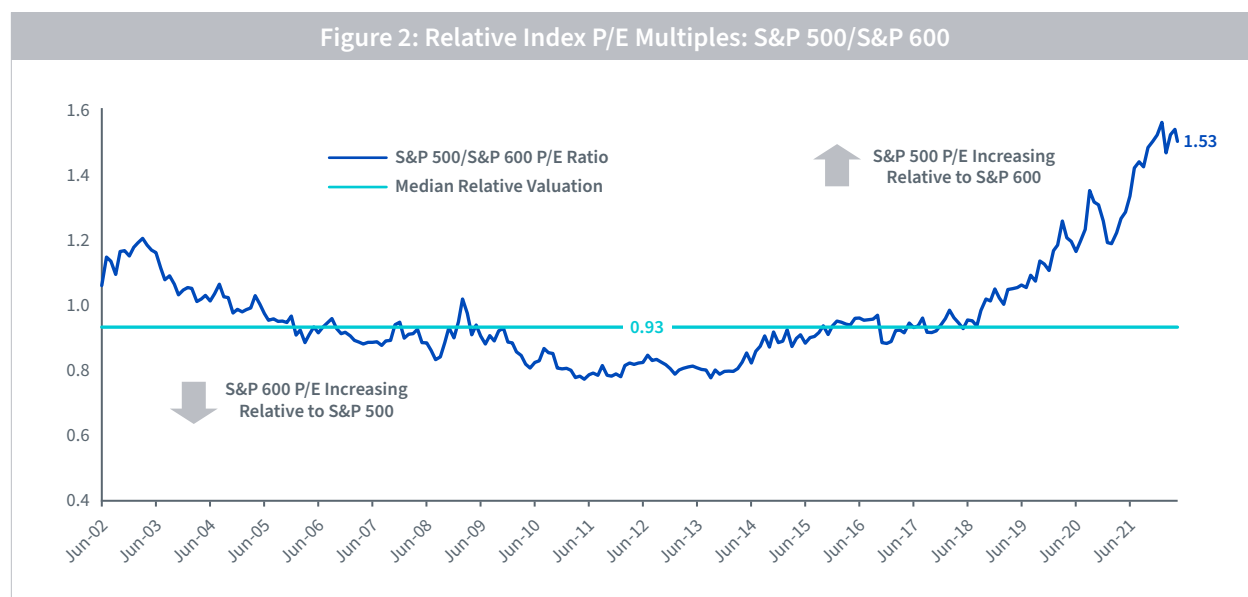
The current forward price-to-earnings (P/E) ratio on the S&P 500 (17.9x) is above its 20-year historical median of 16x. Assuming a recession began with the negative GDP growth in the first quarter and equities have eclipsed peak earnings for the cycle, one might expect a meaningfully lower multiple on the index.

For context, amid the recession induced by the global financial crisis, the average of the S&P 500 P/E ratio was a far lower 13x¹.

Going down the size spectrum in U.S. equities, valuations are signaling a far more dire outlook.

At the end of 2019, prior to the Covid-19 pandemic, the S&P 500 was trading at a modest P/E premium of 11% to the S&P 600.

Fast forward to May 2022 and the P/E on the S&P 500 is 17.9x and the S&P 600 11.7x—a roughly 50% valuation premium for large over small. Historically, the S&P 500 has traded at a median 7% discount to the S&P 600 on P/E.



Sources: WisdomTree, S&P, FactSet, 6/28/02–5/31/22. Price-to-earnings uses forward 12-month earnings excluding negative earners. You cannot invest directly in an index.

What seems clear to us is that investors expect the challenge of the Federal Reserve successfully navigating a “soft landing” for the U.S. economy to weigh more heavily on small-cap earnings than large-cap earnings. As a result, valuations for small caps, relative to large caps, are more fully discounting a recessionary headwind.

Investors who **a)** are searching for attractive valuation opportunities and have a sufficiently long time horizon to withstand normal business cycle gyrations, or **b)** who assume a potential economic slowdown will be more mild than valuations imply, may want to consider an over-weight allocation to small caps.

¹ Using December 2007–June 2009 timeline for the Great Recession.

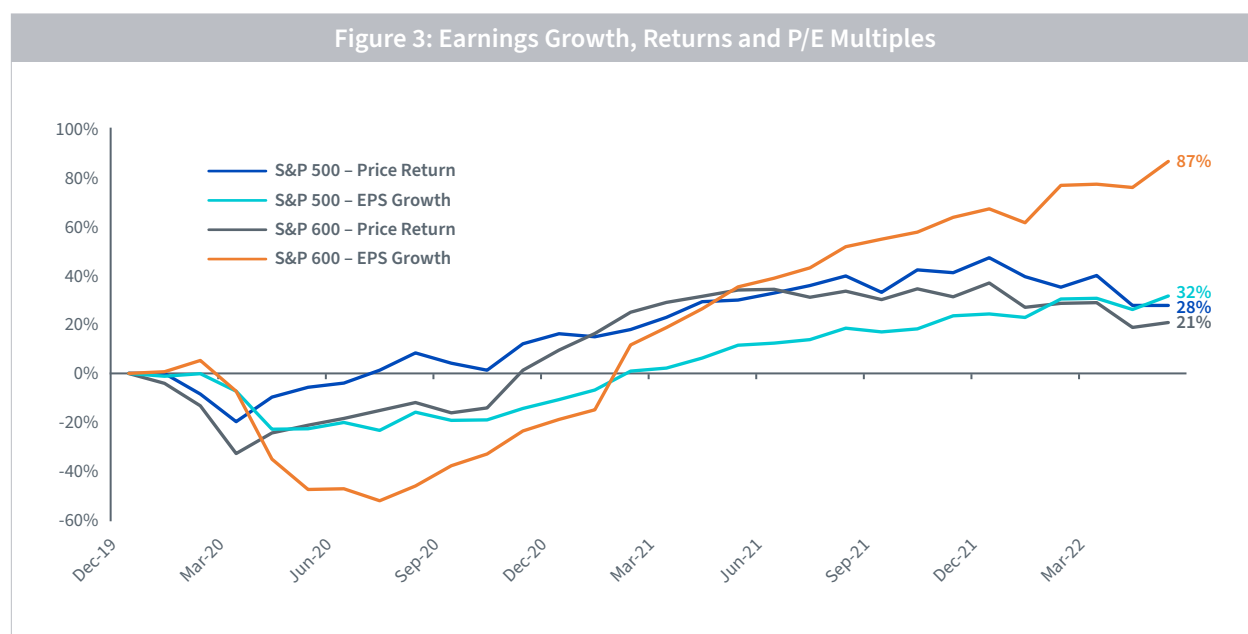
EARNINGS GROWTH, RETURNS AND P/E MULTIPLES

At the trough of earnings expectations in July 2020, estimated earnings on the S&P 600 had dropped by 50% from the end of 2019. S&P 500 estimated earnings were far more resilient, down just 25%.

While most investors are familiar with how select tech giants provided an earnings cushion for large-cap U.S. equities, fewer appreciate the sheer magnitude of the rebound in small-cap earnings.

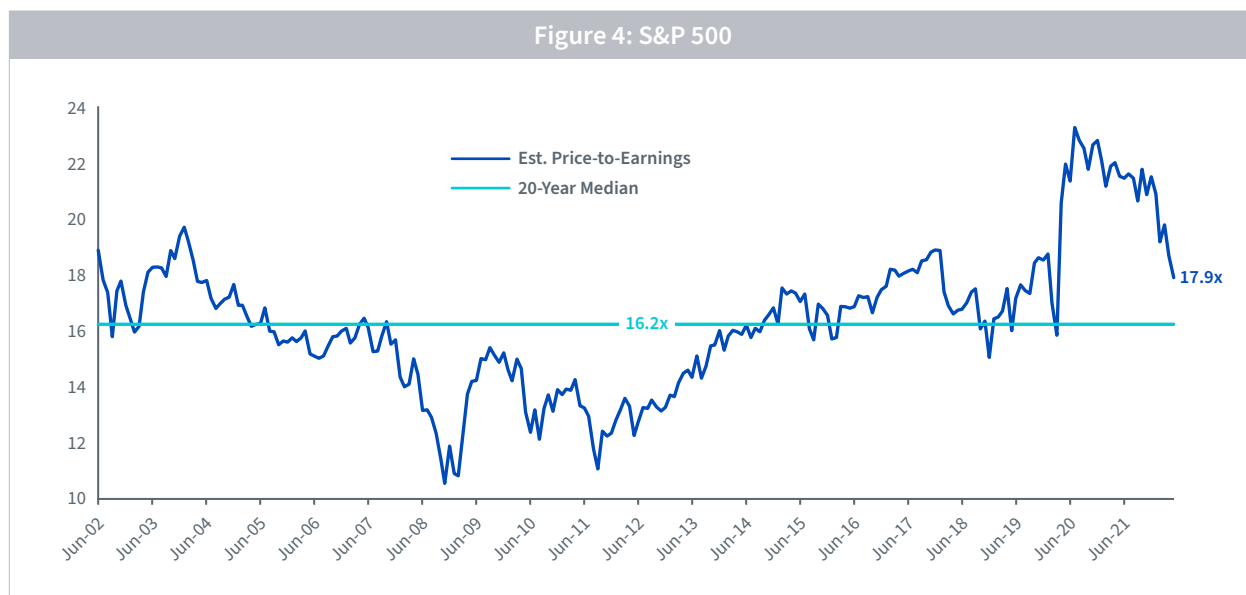
S&P 600 forward earnings estimates are now 87% higher than at the end of 2019, and far higher than the 32% growth for the S&P 500.

Despite superior earnings growth, the S&P 600 return of 21% has lagged the 28% return of the S&P 500.



Sources: WisdomTree, S&P, FactSet, 12/31/19–5/31/22. EPS is forward 12-month earnings per share. You cannot invest directly in an index. Past performance is not indicative of future returns.

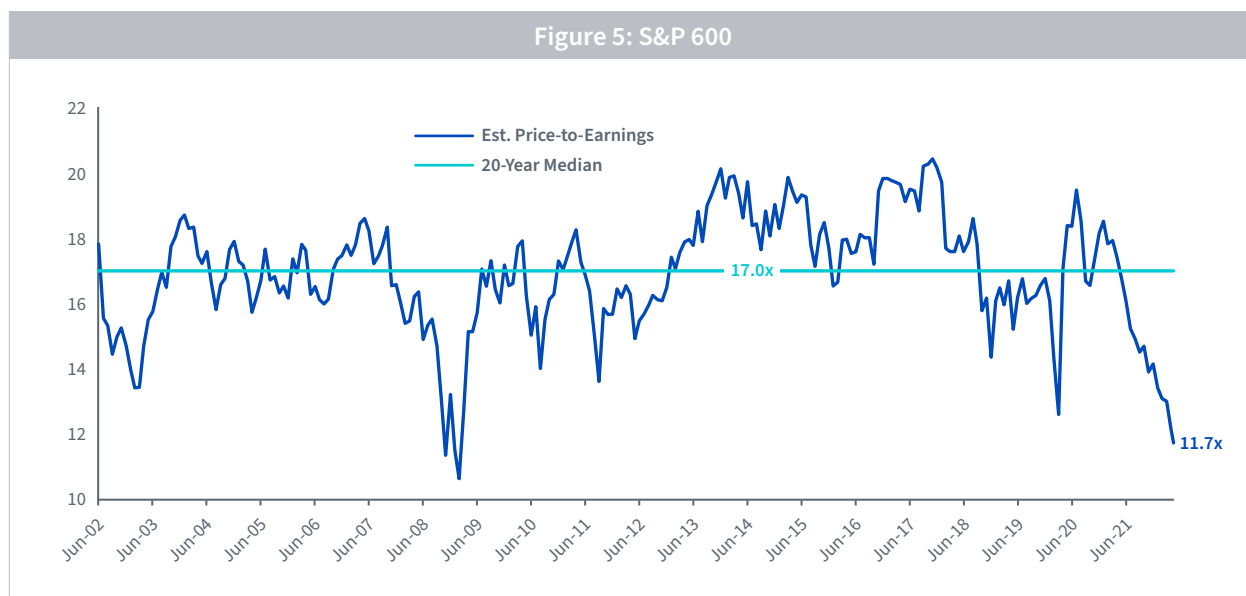
Strong earnings growth has pushed down the multiples of both indexes. The S&P 500 multiple of 17.9x is about 10% above its 20-year median P/E multiple but well below its 20-year peak of 23x from July 2020.



Sources: WisdomTree, S&P, FactSet, 6/28/02–5/31/22. Estimated price-to-earnings excludes negative earners. You cannot invest directly in an index.

The S&P 600 P/E ratio of 11.7x is a greater-than-30% discount to its 20-year historical median P/E of 17x.

The last time small-cap earnings multiples were this depressed was at the bottom of the global financial crisis in early 2009.

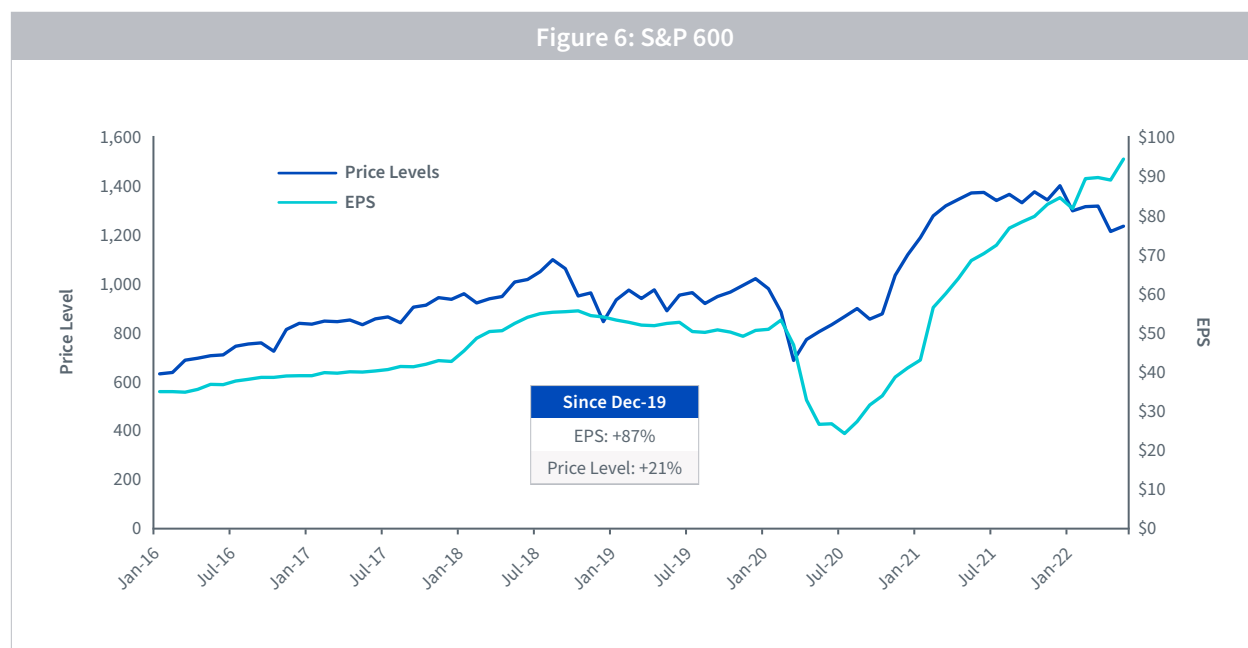


Sources: WisdomTree, S&P, FactSet, 6/28/02–5/31/22. Estimated price-to-earnings excludes negative earners. You cannot invest directly in an index.

SECTOR EARNINGS GROWTH

The combination of surging earnings and plunging valuation multiples implies that investors are skeptical that small caps can maintain current earnings.

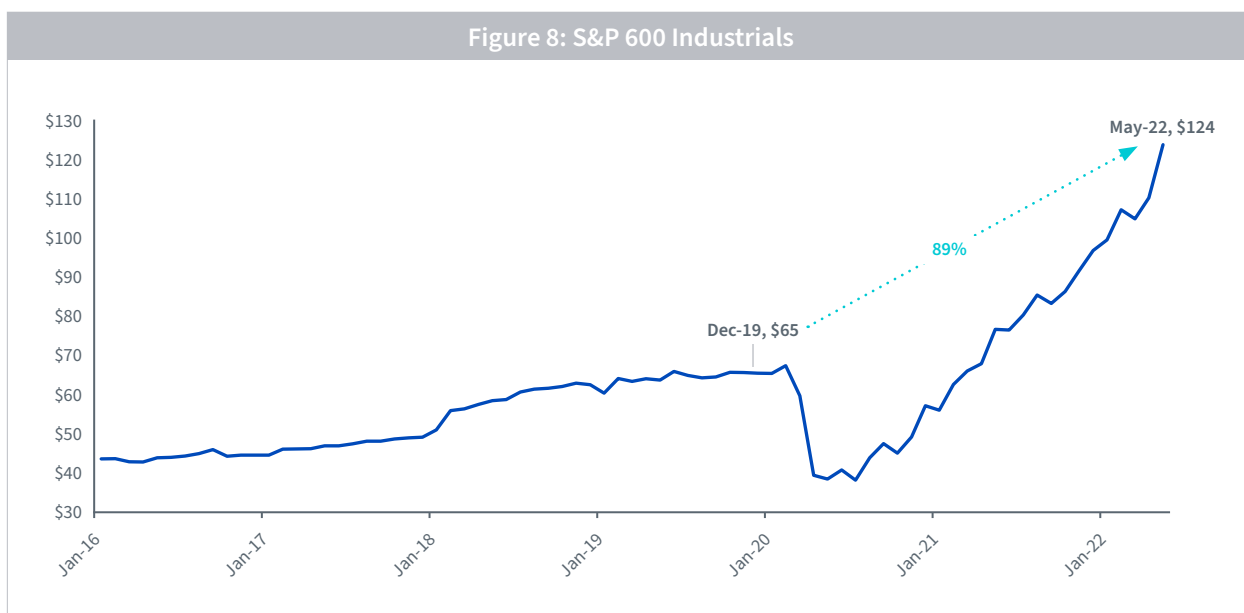
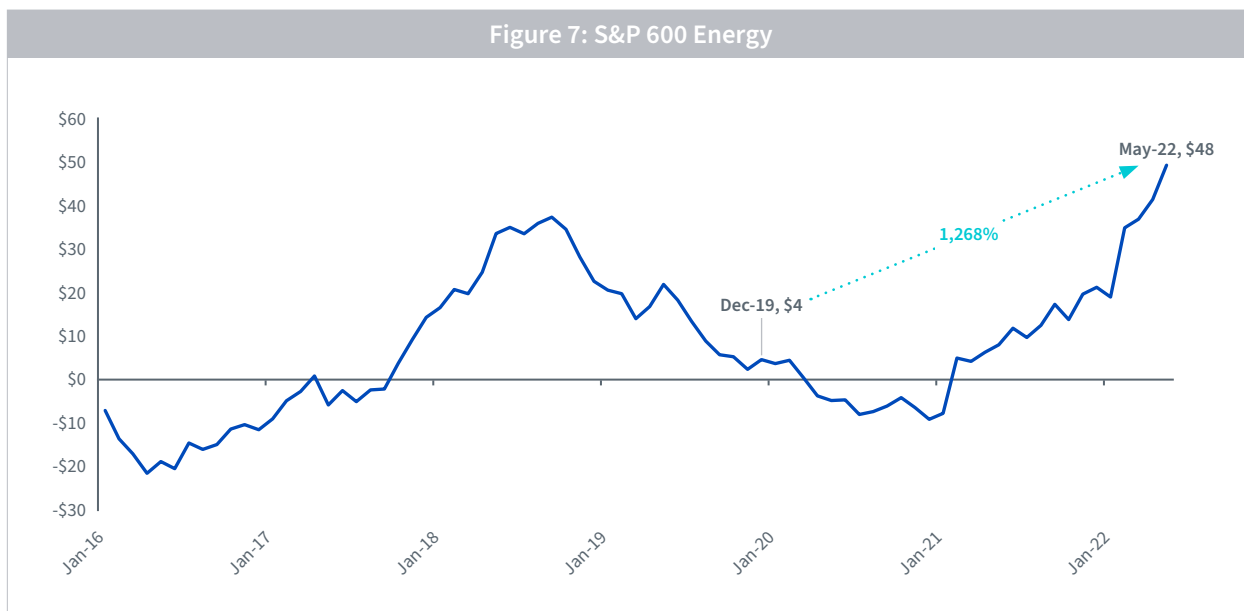
This chart, which includes S&P 600 forward 12-month EPS, indicates a potential tapering in earnings growth for the index but not yet negative growth.



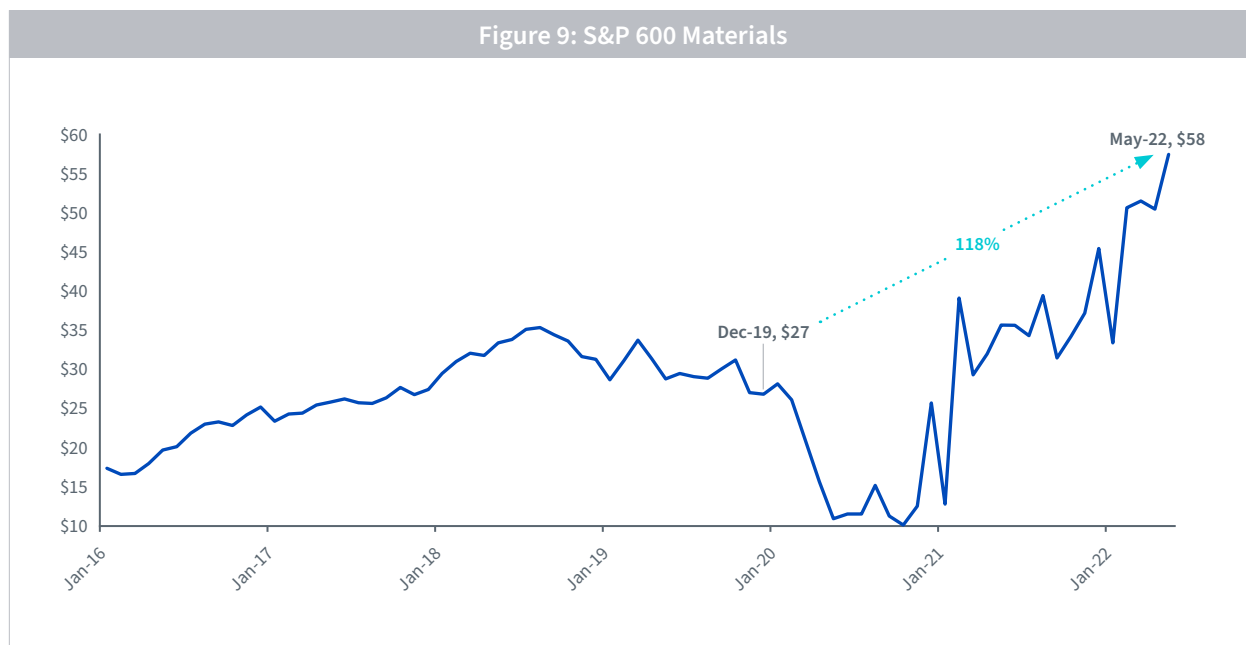
Sources: WisdomTree, S&P, FactSet, 1/31/16–5/31/22. EPS is forward 12-month earnings per share. You cannot invest directly in an index.

The traditional “Old Economy” sectors of Energy, Industrials and Materials have experienced a torrid pace of earnings growth. The earnings of these sectors are highly volatile and sensitive to economic fluctuations—no better exemplified than by the fact that the Energy sector has experienced aggregate negative earnings twice over the past six years, and over 1,000% earnings growth since the end of 2019.

“OLD ECONOMY” SECTORS EARNINGS PER SHARE (EPS)



Sources: WisdomTree, S&P, FactSet, 1/31/16–5/31/22. EPS is forward 12-month earnings per share. You cannot invest directly in an index.



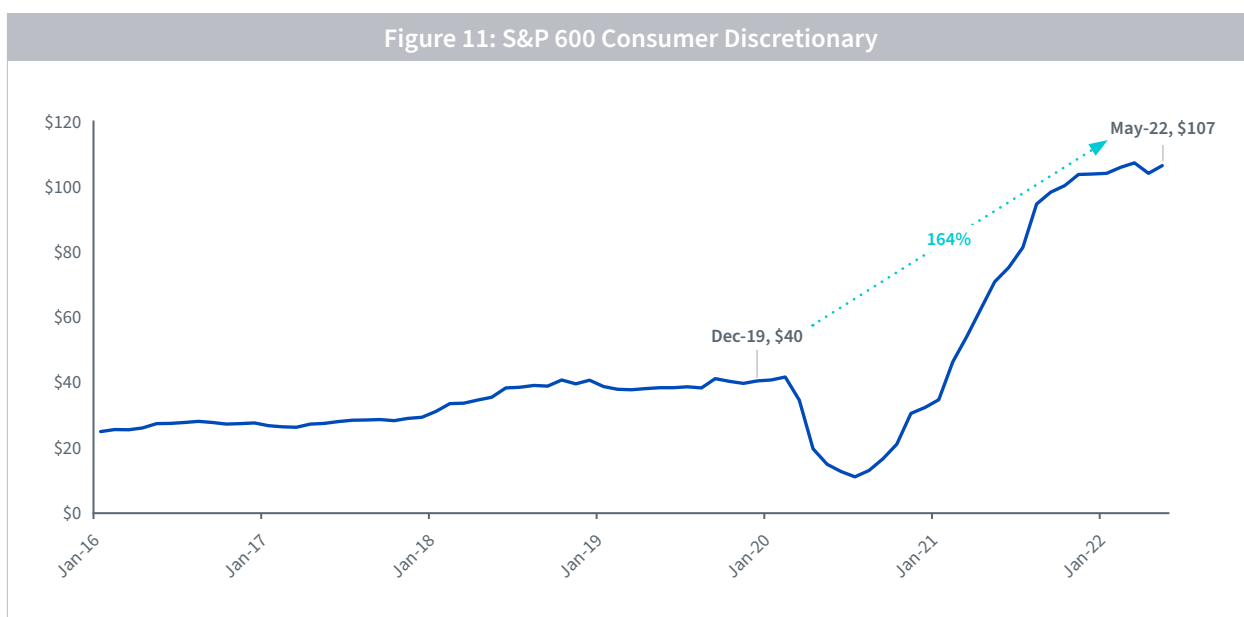
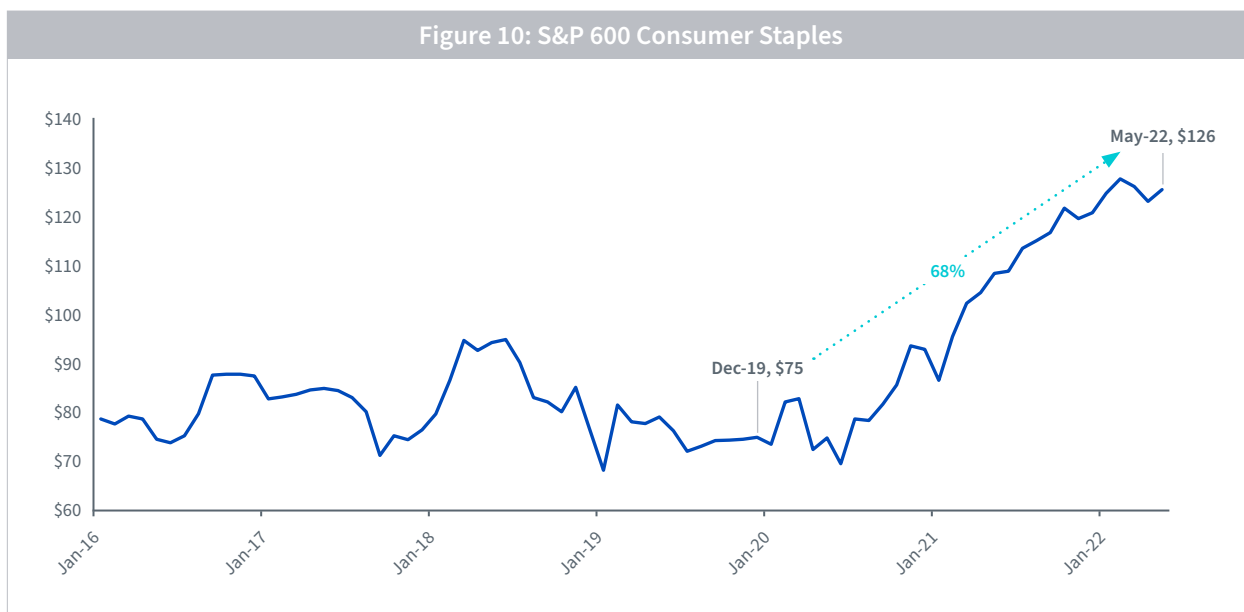
Sources: WisdomTree, S&P, FactSet, 1/31/16–5/31/22. EPS is forward 12-month earnings per share. You cannot invest directly in an index.

The Consumer sectors—Discretionary in particular—have been major beneficiaries of a healthy American consumer. Earnings growth in these sectors has continued nearly unabated for much of the past two years, even in the face of headwinds like rising gas prices and Covid-19 variants.

However, some downward revisions to forward earnings estimates can be seen from the last several months, providing early evidence for those who believe we may have reached “peak earnings” for this cycle.

In recent weeks, earnings reports from large-cap retailers Target and Wal-Mart have sent consumer stocks plummeting across the board as their announcements’ indicated consumers are beginning to pull back in response to higher prices.

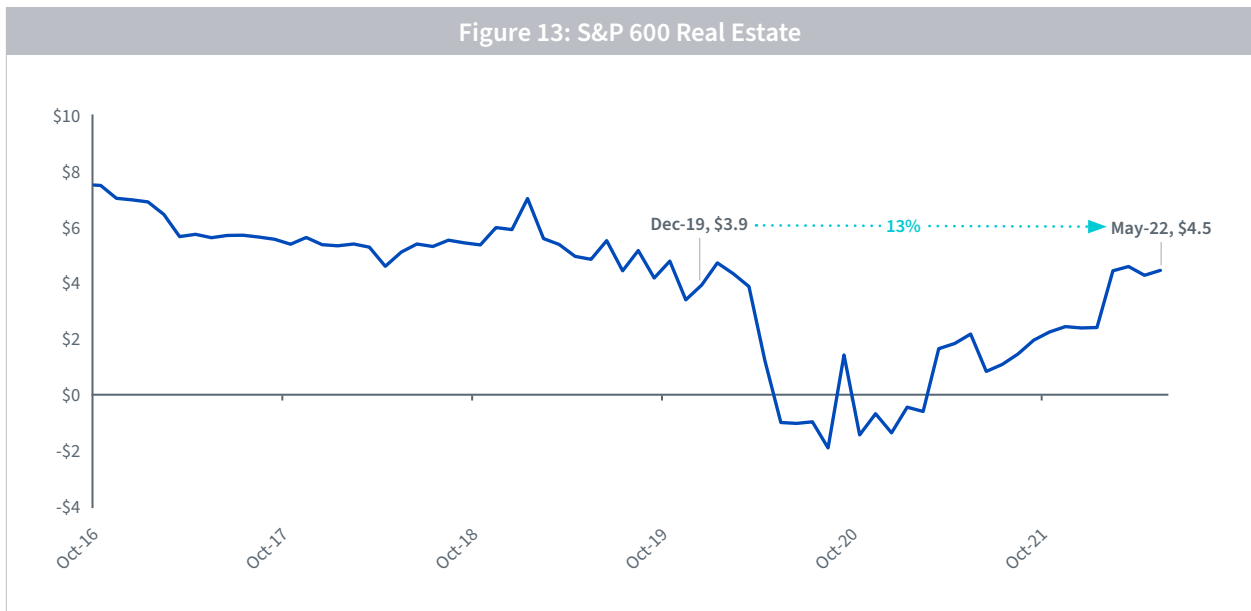
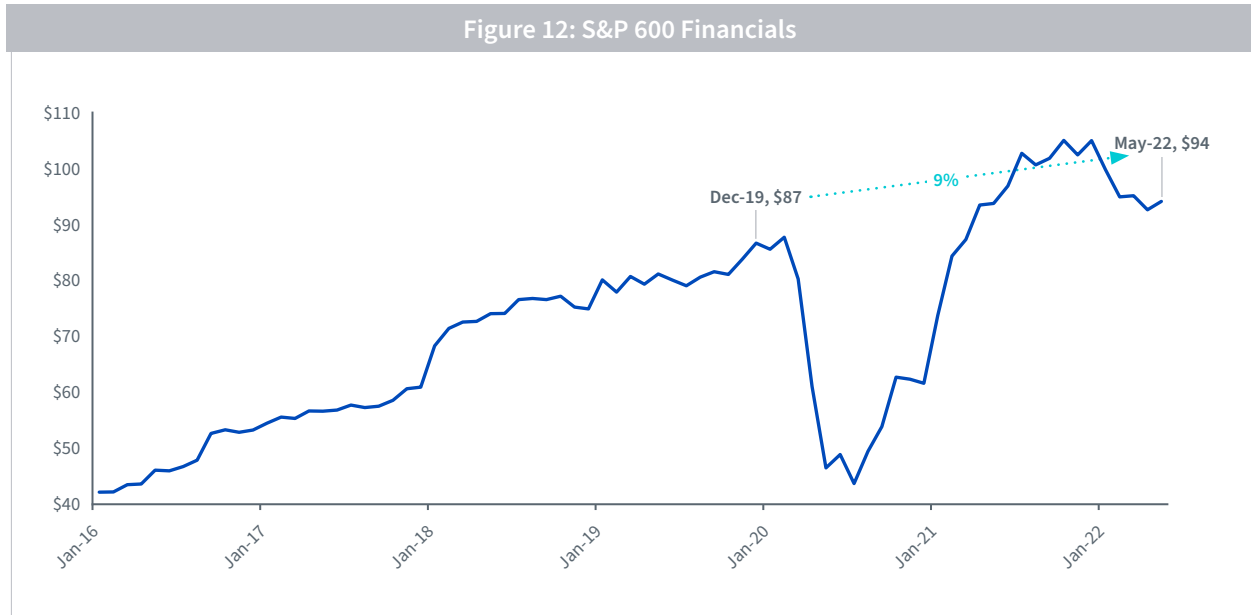
CONSUMER SECTORS EPS



Sources: WisdomTree, S&P, FactSet, 1/31/16–5/31/22. EPS is forward 12-month earnings per share. You cannot invest directly in an index.

The earnings outlook for Financials has arguably been the most dire of late. After a roaring recovery in earnings expectations throughout much of the past few years, earnings growth estimates seem to have rolled over.

FINANCIALS AND REAL ESTATE EPS



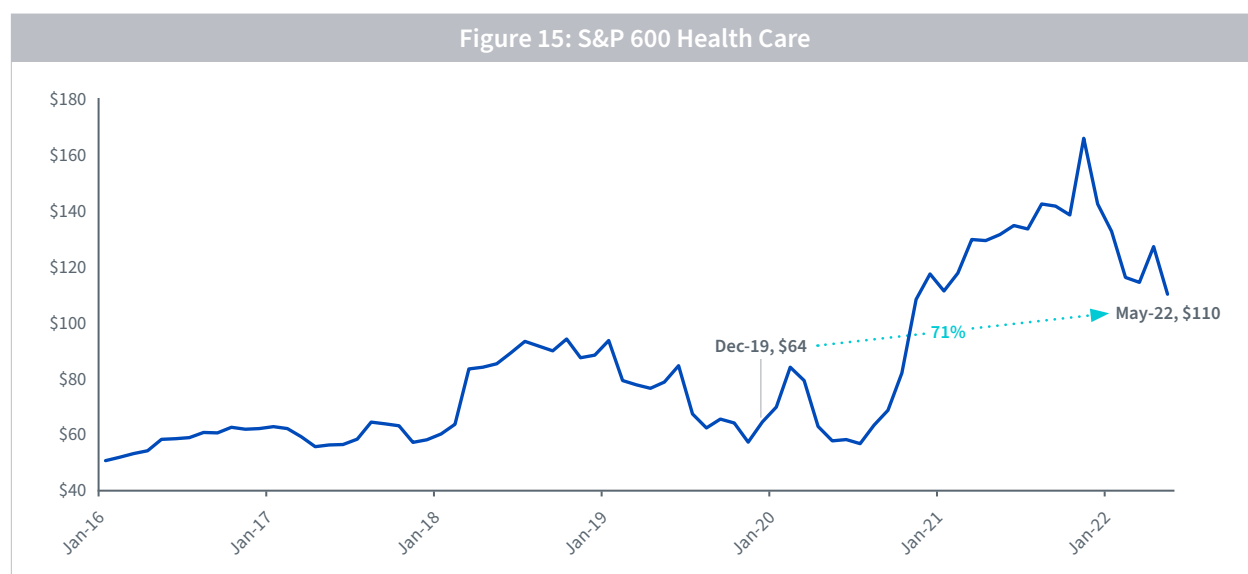
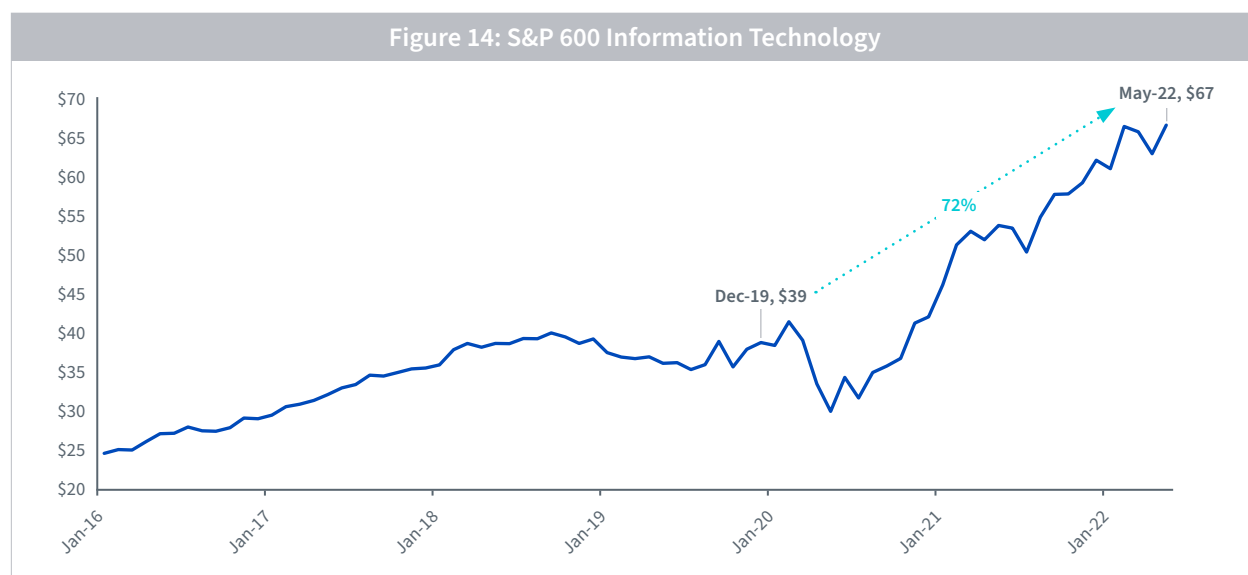
Sources: WisdomTree, S&P, FactSet, 1/31/16–5/31/22. EPS is forward 12-month earnings per share. You cannot invest directly in an index.

Technology and Health Care—specifically biotechnology—have had tremendous earnings growth over the past few years.

These sectors—big allocations in small-cap growth indexes—also have significant earnings growth expectations to meet, lest they be punished by investors.

Those earnings growth expectations have been reduced in recent months, particularly for Health Care. The latest forward earnings per share number is a 34% decline from peak forward earnings estimates in November of last year as the market has readjusted expectations for many of its high-growth stories.

TECHNOLOGY AND HEALTH CARE EPS



Sources: WisdomTree, S&P, FactSet, 1/31/16–5/31/22. EPS is forward 12-month earnings per share. You cannot invest directly in an index.

THE BOTTOM LINE

Certain sectors—Energy and Industrials, in particular—show no signs of slowing earnings growth. Others, such as Financials and the Consumer sectors, are showing moderating growth expectations.

Nonetheless, small caps appear to be priced for a recession, at least far more so than large caps. While this may or may not be a base case scenario for many investors, it is important to see what appears to be baked into market prices.

For long-term investors, with the time horizon to withstand the normal fluctuations of the business cycle, the 30% discount of small caps relative to the historical median may provoke consideration for a small-cap allocation.

Even if recession seems to be a foregone conclusion consider these two points:

- + The Russell 2000 is currently off 24% from its November 2021 peak. Small caps have historically dropped 36% on average in a recession, meaning the market has already priced in two-thirds of a typical recession²
- + What has worked *within* small caps over the past year—dividends—may be the place to allocate during this volatile market

DIVIDENDS FOR SLOW/NEGATIVE GROWTH BACKDROP

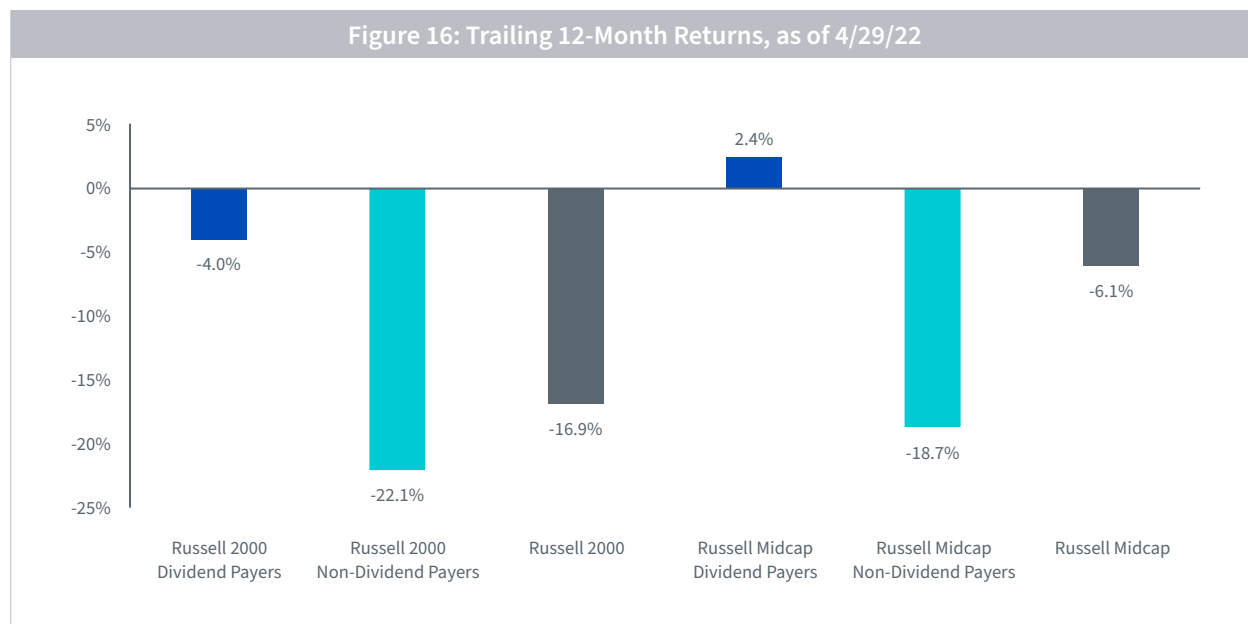
While we have been focusing our attention on the valuations and earnings trends of small caps, a similar picture can be extended for mid-caps.

Many investors do not often think of dividends when it comes to mid- and small-cap companies. This can be a costly oversight.

Consider this:

- + A simple market cap-weighted strategy that bought all Russell 2000 dividend payers would have outperformed the Russell 2000 by 12.9% over the 12 months ended in April (excluding fees and expenses, if applicable)
- + A simple market cap-weighted strategy that bought all Russell Midcap dividend payers would have outperformed the Russell Midcap by 8.5% over the 12 months ended in April (excluding fees and expenses, if applicable)

² Bank of America Research, “Small/Mid-Cap Valuations: For small caps, recession risks now largely discounted,” 5/10/22.



Sources: WisdomTree, FactSet, Russell, 4/30/21–4/29/22. You cannot invest directly in an index. Past performance is not indicative of future returns.

The WisdomTree U.S. MidCap Dividend Index, benchmark to the WisdomTree U.S. MidCap Dividend Fund (DON), and the WisdomTree U.S. SmallCap Dividend Index, benchmark to the WisdomTree U.S. SmallCap Dividend Fund (DES), have each benefited from investors' return to focusing on dividend cash flows over the last 12 months.

Relative to the Russell Midcap Index and the Russell 2000 Index, each WisdomTree Dividend Index has significant under-weight allocations to Information Technology and Health Care—two growth-heavy sectors with very little in dividend payments outside of the large caps.

The WisdomTree Indexes had over-weight allocations in the higher dividend sectors like Financials, Real Estate, Materials and Utilities.

Over the 12 months ended April 2022:

- + The WisdomTree U.S. MidCap Dividend Index outperformed the Russell Midcap Index by **8.84%**
- + The WisdomTree U.S. SmallCap Dividend Index outperformed the Russell 2000 Index by **13.01%**

Figure 17: Mid-Cap Index 1-Year Sector Attribution

Category	Attribution Components				Average Category Weight			Category Performance	
	Allocation	Stock Selection	Interaction	Total Attribution	Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
Communication Services	0.39%	1.91%	-0.48%	1.83%	2.93%	3.99%	-1.06%	3.45%	-35.46%
Health Care	0.69%	2.13%	-1.47%	1.35%	1.90%	11.58%	-9.69%	4.94%	-14.11%
Materials	0.63%	0.33%	0.20%	1.16%	9.74%	5.61%	4.13%	14.98%	8.74%
Energy	1.30%	-0.04%	-0.18%	1.09%	5.24%	3.95%	1.29%	65.59%	65.22%
Consumer Discretionary	0.12%	0.69%	0.01%	0.81%	11.11%	12.34%	-1.23%	-14.39%	-19.29%
Real Estate	0.28%	0.20%	0.03%	0.52%	9.89%	7.99%	1.90%	10.01%	7.43%
Information Technology	0.73%	0.78%	-1.02%	0.49%	4.85%	18.72%	-13.88%	-6.14%	-10.80%
Utilities	0.84%	-0.18%	-0.20%	0.46%	10.15%	4.60%	5.55%	5.37%	9.05%
Financials	0.24%	0.13%	0.05%	0.42%	25.62%	12.42%	13.20%	-3.61%	-4.64%
Consumer Staples	0.25%	0.16%	-0.04%	0.36%	4.13%	3.48%	0.65%	13.45%	7.69%
Industrials	0.14%	0.42%	-0.22%	0.35%	14.45%	15.28%	-0.83%	-8.43%	-11.16%
Other	0.00%	-	-	0.00%	-	0.04%	-0.04%	-	-12.14%
Total	5.61%	6.53%	-3.31%	8.84%	-	-	-	2.73%	-6.10%

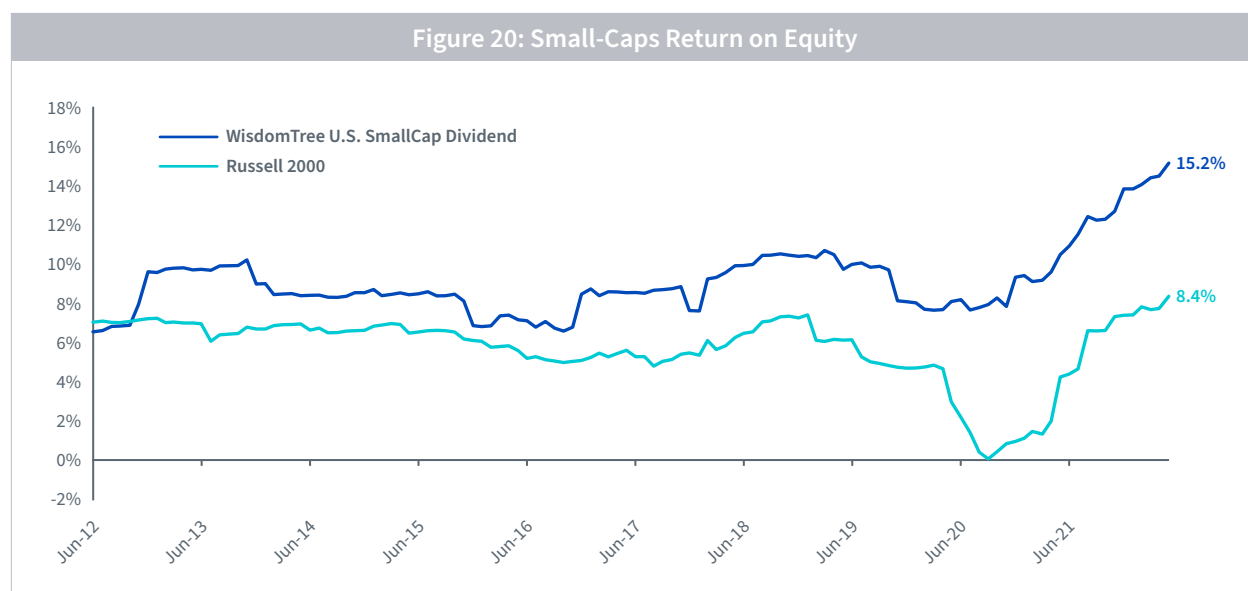
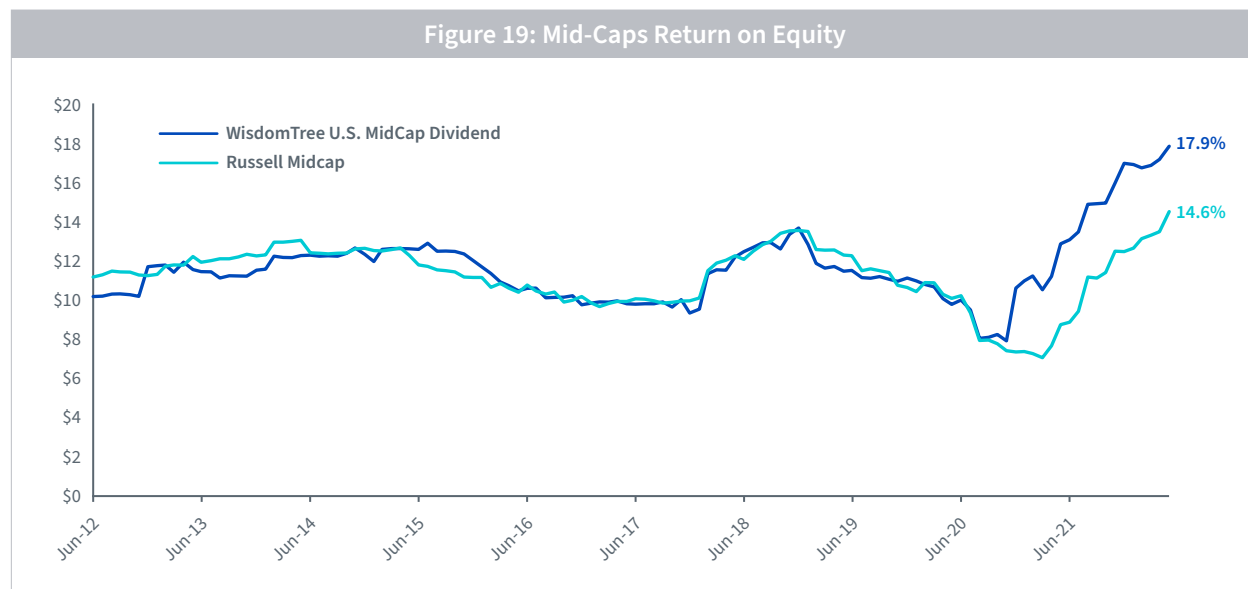
Figure 18: Small-Cap Index 1-Year Sector Attribution

Category	Attribution Components				Average Category Weight			Category Performance	
	Allocation	Stock Selection	Interaction	Total Attribution	Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
Health Care	5.46%	7.24%	-6.21%	6.48%	1.70%	18.82%	-17.12%	-9.81%	-42.72%
Financials	0.80%	0.82%	0.50%	2.12%	26.09%	15.81%	10.28%	-4.65%	-9.94%
Utilities	1.11%	0.24%	0.37%	1.72%	7.27%	2.60%	4.67%	11.97%	1.42%
Real Estate	0.40%	0.70%	0.28%	1.38%	9.92%	7.03%	2.89%	8.56%	-2.49%
Consumer Staples	0.42%	0.26%	0.17%	0.85%	7.54%	3.32%	4.22%	3.05%	-5.04%
Information Technology	-0.04%	2.13%	-1.37%	0.73%	4.71%	13.61%	-8.90%	-1.20%	-17.44%
Communication Services	0.18%	0.52%	-0.14%	0.56%	3.37%	3.30%	0.07%	-12.29%	-25.36%
Materials	0.36%	0.13%	0.03%	0.53%	7.96%	4.04%	3.92%	-0.48%	-5.49%
Industrials	0.27%	0.29%	-0.06%	0.50%	17.52%	15.11%	2.41%	-6.91%	-9.07%
Consumer Discretionary	-0.01%	-0.01%	0.03%	0.01%	11.85%	11.91%	-0.06%	-25.23%	-25.69%
Energy	-1.18%	-1.31%	0.60%	-1.89%	2.08%	4.39%	-2.31%	20.26%	68.25%
Other	0.02%	-	-	0.02%	-	0.07%	-0.07%	-	-57.25%
Total	7.80%	11.01%	-5.80%	13.01%	-	-	-	-3.86%	-16.87%

Sources: WisdomTree, FactSet, Russell, 4/30/21–4/29/22. You cannot invest directly in an index. Past performance is not indicative of future returns.

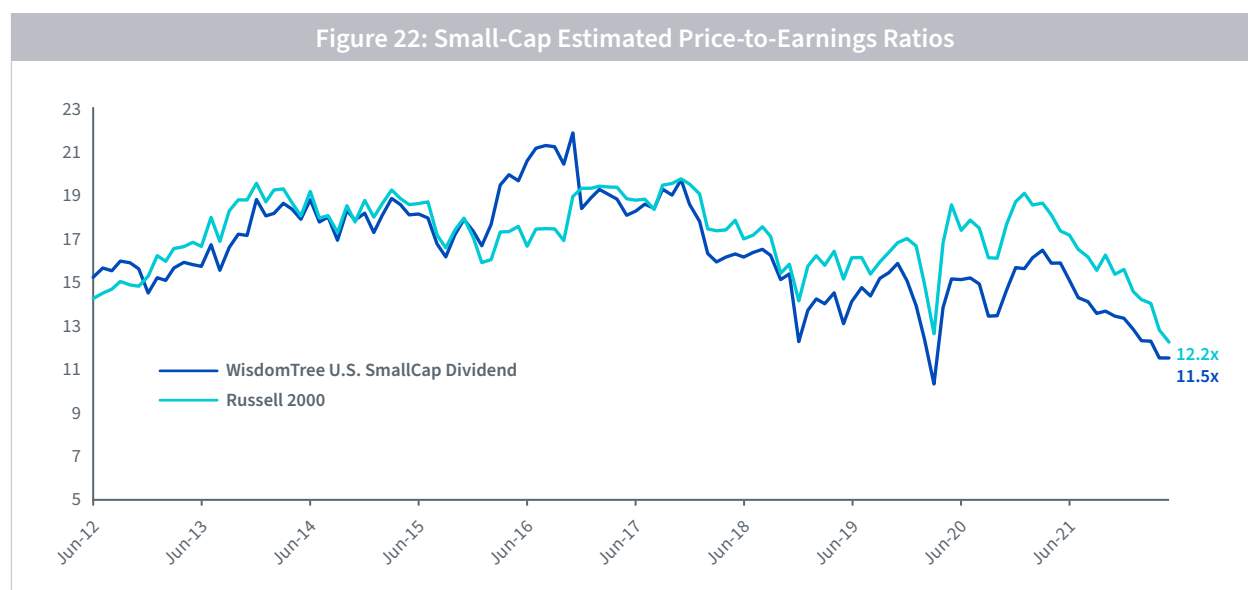
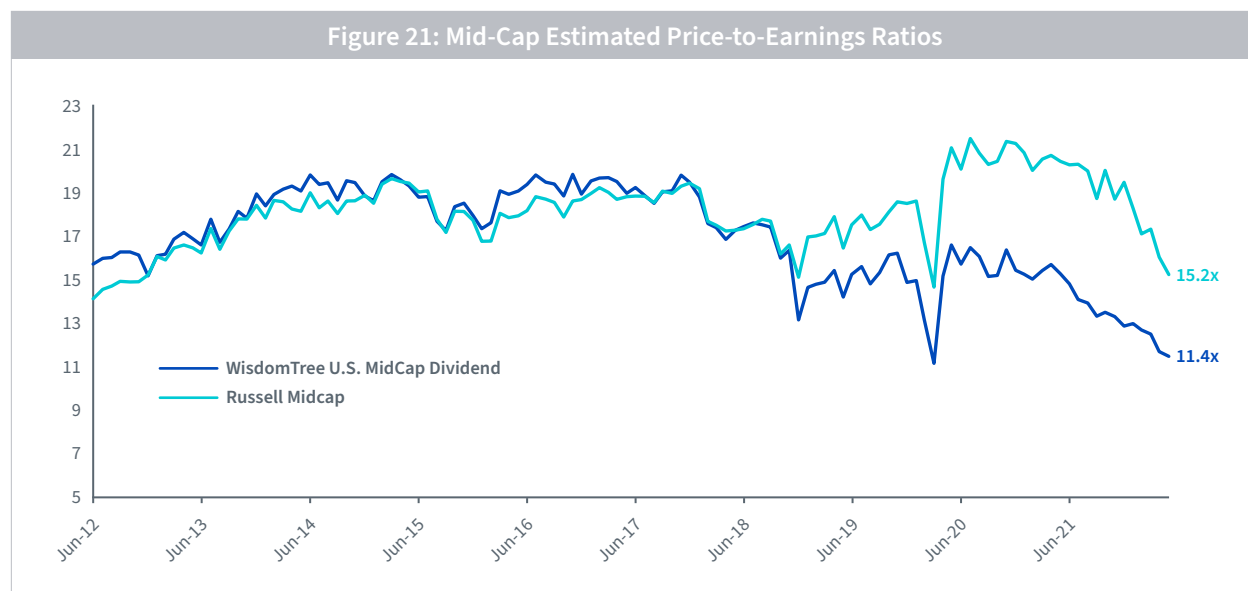
Similar to the strong growth in earnings we saw from the S&P 600, we also see robust earnings growth trends—and premium earnings ratios—from the WisdomTree MidCap and SmallCap Dividend Indexes.

A widening profitability gap has developed between WisdomTree’s Dividend Indexes and the market cap-weighted Russell indexes. As of May 31, 2022, 9.4% of the weight of the Russell Midcap Index was in companies with negative earnings, as was 22.9% of the Russell 2000 Index. This compares to a less-than-3.5% weight in negative earnings for the WisdomTree Dividend Indexes.



Sources: WisdomTree, Russell, FactSet, 6/30/12–5/31/22. You cannot invest directly in an index.

As we've mentioned, market prices suggest the pace of earnings growth will slow (or turn negative). WisdomTree's Dividend Indexes—despite their recent outperformance—have even greater discounts in their P/E ratios than the market cap-weighted Russell indexes.



Sources: WisdomTree, Russell, FactSet, 6/30/12–5/31/22. Estimated price-to-earnings excludes negative earners. You cannot invest directly in an index.

CONCLUSION

Dividends have provided safety amid the volatility this year in U.S. equities. While many investors may ignore dividends outside of large caps, the relative performance among mid- and small-cap dividend payers and non-payers over the past 12 months suggests this can be a mistake.

We anticipate the leadership of companies with strong cash flows and dividend payouts will be sustained. This rising interest rate environment punishes non-dividend-paying story stocks, as the opportunity cost of not having current cash flows is a headwind to non-payers.

For investors interested in allocating to a diversified basket of dividend-paying mid- and small-caps, consider the **WisdomTree U.S. MidCap Dividend Fund (DON)** and the **WisdomTree U.S. SmallCap Dividend Fund (DES)**.

Index Definitions:

ICE BofA U.S. High Yield Index: Tracks the performance of the universe of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. market. 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 2,000 of the smallest securities based on a combination of their market cap and current index membership. Russell Midcap Index: Measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the U.S. economy. S&P 600 Index: An index of small-cap stocks selected by Standard and Poor's. It tracks a broad range of small-sized companies that meet specific liquidity and stability requirements. WisdomTree U.S. MidCap Dividend Index: A fundamentally weighted index that measures the performance of the mid-capitalization segment of the U.S. dividend-paying market. The Index is comprised of the companies that compose the top 75% of the market capitalization of the WisdomTree U.S. Dividend Index after the 300 largest companies have been removed. The index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share. WisdomTree U.S. SmallCap Dividend Index: A fundamentally weighted index measuring the performance of the small-capitalization segment of the U.S. dividend-paying market. The Index is comprised of the companies that compose the bottom 25% of the market capitalization of the WisdomTree U.S. Dividend Index after the 300 largest companies have been removed. The Index is dividend weighted annually to reflect the proportionate share of the aggregate cash dividends each component company is projected to pay in the coming year, based on the most recently declared dividend per share.

Glossary:

Basis point (bp): 1/100th of 1%. **Bear market:** A sustained downturn in market prices, increasing the chances of negative portfolio returns. **Cash flows:** A measure of how much cash a business generates after taking into account all necessary expenses, including net capital expenditures. **Dividends:** A portion of corporate profits paid out to shareholders. **Earnings growth:** Earnings growth is the annual compound annual growth rate of earnings from investments. **Earnings:** Refers to a company's profits in a given quarter or fiscal year. Earnings are a key figure used to determine a stock's value. A company's earnings are used in many common ratios. **Earnings per share (EPS):** Earnings per share is the monetary value of earnings per outstanding share of common stock for a company. **EPS growth:** EPS growth refers to the positive change between earnings per share values reported by the company. In other words, it refers to how much EPS has increased over a defined amount of time. **Estimated P/E ratios:** Share price divided by estimated 12-month earnings per share. Lower numbers indicate an ability to access greater amounts of estimated 12-month earnings per dollar invested. **Federal Reserve (Fed):** The Federal Reserve System is the central banking system of the U.S. **Forward earnings estimates:** Also known as earnings growth estimates, Bloomberg analysts' long-term earnings growth expectations, which encompass the estimated growth in operating earnings per share over the company's next full business cycle, typically three to five years. **Gross domestic product (GDP):** The sum total of all goods and services produced across an economy. **High-yield credit spreads:** Also known as a high-yield bond spread or a credit spread, is the difference in the yield on high-yield bonds and a benchmark bond measure, such as investment-grade or Treasury bonds. High-yield bonds offer higher yields due to default risk. The higher the default risk, the higher the interest paid on these bonds. **Market capitalization:** Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap. **Multiple:** A ratio that is calculated by dividing the market or estimated value of an asset by a specific item on the financial statements. The multiples approach is a comparables analysis method that seeks to value similar companies using the same financial metrics. **Option-adjusted spread (OAS):** Represents a measure of income. Spread represents the portion of the bond's yield that compensates investors for taking credit risk. OAS adjusts the spread to take into account embedded options within the bond (if any). **Price return:** The price return is the rate of return on an investment portfolio, where the return measure takes into account only the capital appreciation of the portfolio, while the income generated by the assets in the portfolio, in the form of interest and dividends, is ignored. **Price-to-earnings (P/E) ratio:** Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested. **Recession:** Two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment. **Size capitalization:** A measure by which a company's size is classified. Large caps are usually classified as companies that have a market cap over \$10 billion. Mid-caps range from \$2 billion to \$10 billion. Small caps are typically new or relatively young companies and have a market cap between \$200 million and \$2 billion. **Valuations:** 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.

Important Information

Investors should consider the investment objectives, risks, charges and expenses of the Funds carefully before investing. A prospectus containing this and other information is available by calling 866.909.9473 or visiting www.wisdomtree.com. Investors should read the prospectus carefully before investing.

There are risks associated with investing, including possible loss of principal.

DON: Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

DES: There are risks associated with investing, including possible loss of principal. Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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