A REFLATION SHOCK: THE CATALYST FOR SMALL AND MID CAP VALUE?

Jeff Weniger — Head of Equity Strategy
02/23/2021

It is an understatement to say that 2020 was tough for value investors.

Stocks in the Energy, Materials and yield-sensitive Financials sectors were left wanting last year. That meant pain for reflation-heavy small- and mid-cap stocks, owing to their sizable weights in those groups. Our small and mid cap dividend-oriented value index (in teal in figure 1) are particularly heavy in them

Figure 1: Sector Weights, Reflation Beneficiaries

	SPY SPDR S&P 500 ETF	DLN Large Cap Value
Energy	2.6%	0.4%
Basic Materials	2.7%	2.6%
Financials	10.9%	12.7%
Total	**16.2%**	**15.7%**
	IWR iShares Russell Mid Cap ETF	**DON Mid Cap Value**
Energy	2.8%	3.7%
Basic Materials	5.5%	9.9%
Financials	11.4%	25.8%
Total	**19.7%**	**39.4%**
	IWM iShares Russell 2000 ETF	**DES Small Cap Value**
Energy	2.4%	1.6%
Basic Materials	4.1%	9.0%
Financials	14.9%	25.6%
Total	**21.4%**	**36.2%**

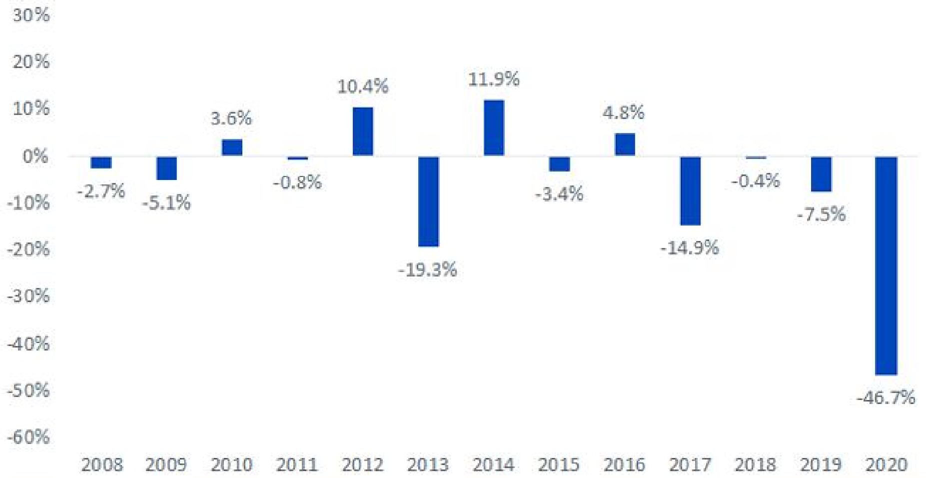
Sources: SSgA, iShares, WisdomTree, as of 1/19/21.

For definitions of indexes in the chart, please visit our glossary.

Aside from the post-March bounce back in just about every asset class, disinflationary themes still dominated our Covid-19-focused world.

The underperformance by dividend payers last year was brutal. Here is what happened in small caps.

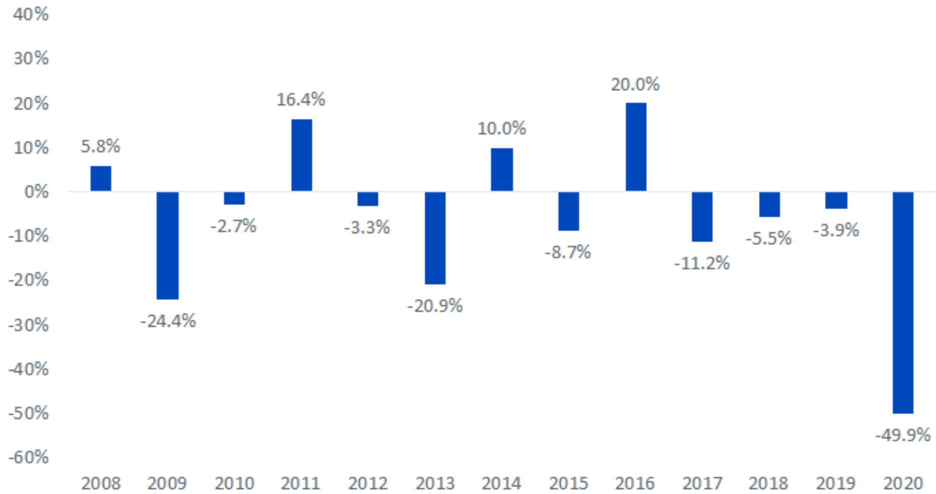
Figure 2: Return of Top Dividend Yield Quintile Minus Return of Non-Payers, Russell 2000 Index



Source: WisdomTree, 12/31/07–12/31/20. Past performance is not indicative of future results. Quintile is any of five equal groups into which a population can be divided.

Not to be outdone, mid-cap companies with zero dividends—often in Tech, Healthcare and Communications Services—outperformed the highest-yielding quintile of stocks by 49.9% last year.

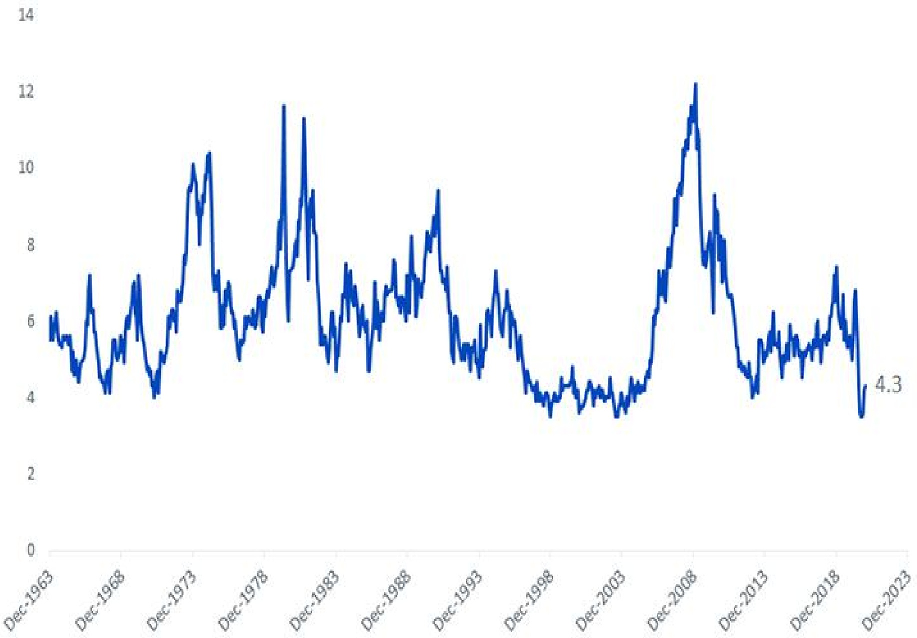
Figure 3: Return of Top Dividend Yield Quintile Minus Return of Non-Payers, Russell Midcap Index



Source: WisdomTree, 12/31/07–12/31/20.

What are the sparks that could provide the catalyst for an embrace of inflationary themes? For one, most housing markets are red hot. It's a sellers' market.

Figure 4: Monthly Supply of New Houses in the U.S. (SA)



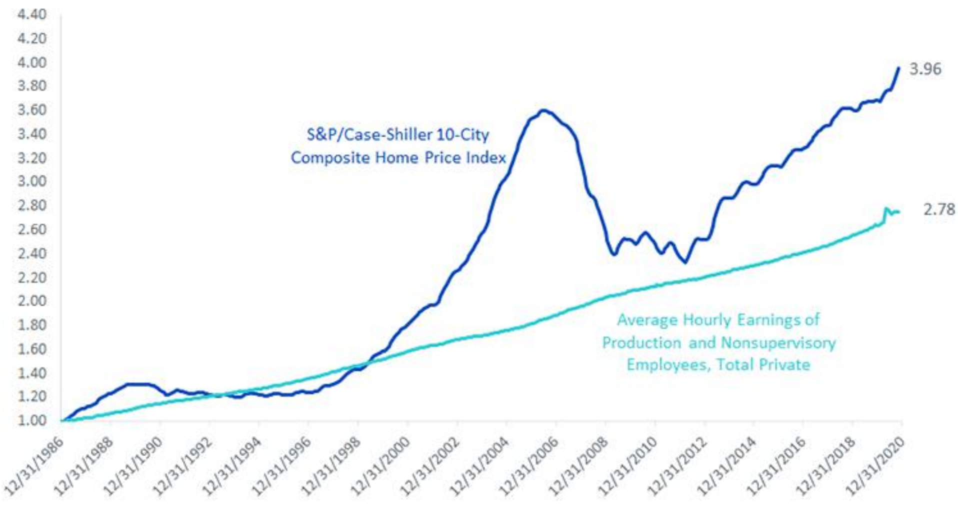
Sources: Census, HUD, as of December 2020.

The S&P/Case-Shiller 10-City Composite Home Price Index is well past the housing bubble peak, at least in non-inflation-adjusted terms. No surprise—Freddie Mac's national average conforming mortgage rate was about 2.75% in January.

The median U.S. existing home price for December was $309,800, a cool doubling off the January 2012 low of $154,600.

Then again, wages need to catch up.

Figure 5: U.S. Home Prices vs. Wages (January 1987 = 1.00)



Sources: Bureau of Labor Statistics, S&P/Case-Shiller, KoyFin, January 1987–November 2020, with wage data through January 2021.

The bond market has an upset stomach.

The breakeven inflation rate is derived from a comparison of the yield on vanilla Treasuries and those of Treasury Inflation-Protected Securities (TIPS). The market's expectation for inflation over the next five years went up through 2% a few weeks ago (figure 6). It's still tame, yes, but running hotter.

Figure 6: U.S. 5-Year Breakeven Inflation Rate

Source: Federal Reserve Bank of St. Louis, as of 2/18/21.

It's a rare bird on the Street that is penciling in anything like an inflation shock. BofA Merrill Lynch, Barclays, Citi and JPMorgan Chase are all forecasting U.S. Consumer Price Inflation of 2.0%–2.4% for 2021. Look at the histogram of yearly inflation readings since 2000 (figure 7). I suspect many investors are ill-prepared for the very real odds of an upside deviation, perhaps into the 3-4% area.

Figure 7: Yearly U.S. Consumer Price Inflation Frequency (January 2000–December 2020)

Suppose inflation starts to boil, or at least simmer, supporting Energy and Materials at the expense of disinflationary Tech.

Interest rates could also rise in that scenario—after all, bondholders will need a larger yield to justify their positions. With the Fed Funds rate pegged to the 0.00%–0.25% range, the attendant yield curve steepening could be accretive to banks' profitability.

With one-quarter of the WisdomTree U.S. MidCap Fund (DON) and the WisdomTree U.S. SmallCap Fund (DES) in Financials—and with both having sizable holdings in Materials—we believe they could be primed for outperformance if our post-Covid-19 world starts witnessing the right-hand side of the histogram.

Important Risks Related to this Article

There are risks associated with investing, including the 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. Please read each Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Reflation : The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes, to bring growth and inflation back up to the long-term trend.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund's weight.

Dividend : A portion of corporate profits paid out to shareholders.

Disinflation : Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

Inflation : Characterized by rising price levels.

S&P/Case-Shiller Home Price Indexes : A group of indexes that tracks changes in home prices throughout the United States. The indexes are based on a constant level of data on properties that have undergone at least two arm's length transactions. Case-Shiller produces indexes representing certain metropolitan statistical areas (MSA) as well as a national index.

Break-even inflation rate : For a given bond maturity, for example five years, the interest rate on the five-year nominal bond minus the interest rate on the five-year inflation adjusted bond; meant to approximate expected inflation over that time frame, in this case five years.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Treasury Inflation-Protected Securities (TIPS) : Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Fed funds target range : the interest rate band the Federal Open Market Committee decides to implement for the federal funds rate.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Steepen : an increase in the spread between short-term interest rates and longer-term rates.