THIS SUMMER POSES A HEADWIND FOR STOCKS WITH DISTANT EARNINGS

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With all eyes on the year-long run-up in small caps, it may be wise to note how many companies in the asset class are not turning a profit.

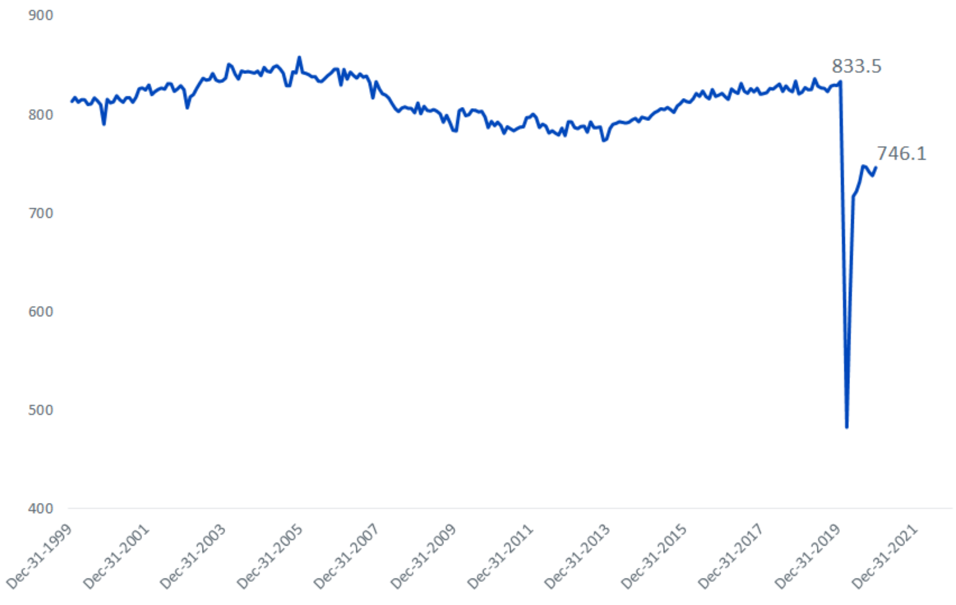
A particularly egregious violator: stocks in the Russell 2000 Growth Index. Companies with negative earnings comprise 43% of its market capitalization. Its value counterpart is not much better: 31% of the Russell 2000 Value is in negative earners, while the Russell 2000 itself has 38% with income statement red ink.

Many such stocks may not be prepared for a bullseye date: July 29, when the Q2 GDP report is published.

Look, Americans are getting back to it. I personally have flights booked. Normal life.

Though many of us are working from home—and thus logging zero commuting miles—just look at the action on the roads. If you are like me, you even caught a traffic jam or two in recent weeks. In January, the latest month for which we have data, the number of vehicle miles traveled was 54.6% higher than in April 2020, the most "ghost town" traffic month on record. In February, March and April, the volumes were most certainly even higher.

Figure 1: U.S. Monthly Per Capita Vehicle Miles Driven



Sources: St. Louis Fed, BEA, U.S. Federal Highway Administration, 1/31/00–1/31/21

Stimulus money hit bank accounts in mid-March, so some of Americans' new spending will show up in the Q1 GDP data. But another large chunk will come out of wallets in Q2, especially as it appears that herd immunity may be achieved by late spring or early summer.

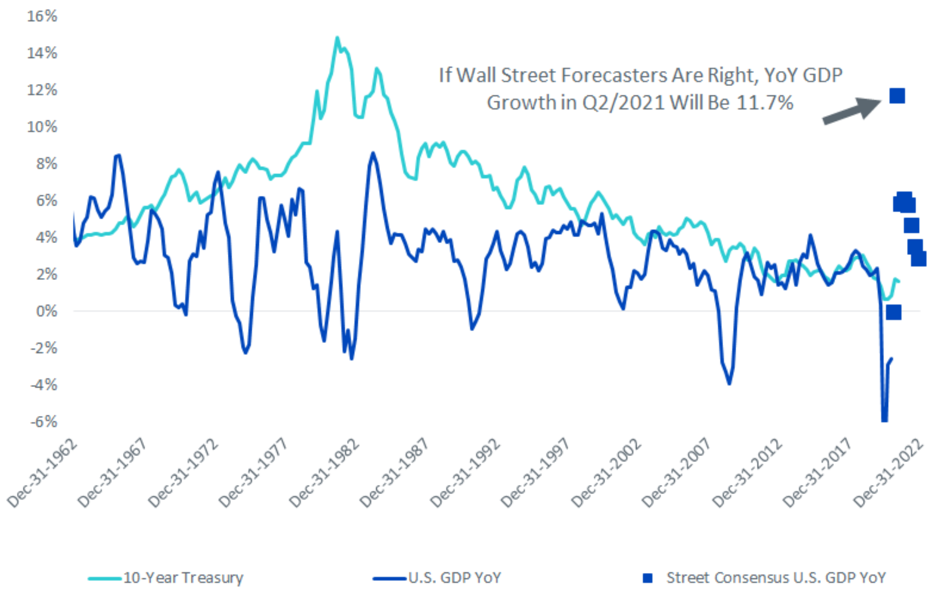
Which brings me to the run-up to July 29, the day of the first estimate of Q2 GDP.

The Street consensus is for quarterly growth of 7.2% at a seasonally adjusted annual rate (SAAR)—a headier pace than the Q1 forecast of +4.8%. Should those growth rates come to fruition, that amounts to year-over-year GDP growth of 11.7%.

In figure 2, notice how the 10-Year Treasury yield has spent the years after the global financial crisis converging toward the real GDP growth rate.

Can the bond market let July 29 bring a double-digit year-over-year GDP jump without letting benchmark Treasuries drift up? Sure, it will be a fleetingly high GDP growth pace—one that will halve by Q3—but this still seems a risk to rate-sensitive equities.

Figure 2: 10-Year Treasury vs. U.S. GDP Growth



Sources: Thomson Reuters Refinitiv, St. Louis Fed, as of 4/14/21, with forecasts to Q4 2022.

Which ones?

Rising rates disproportionately hit the net present value of business ventures with the most distant future cash flows. That describes many of the flashy "no profit now" companies that populate the Russell 2000 Growth Index. Even when you exclude the 43% of that Index's total value that is comprised of companies with negative income, it still trades at a forward P/E ratio of 25.8. That strikes me as a recipe for trouble as July 29 approaches and those firms' "out year" cash flows get discounted at ever higher rates.

Figure 3 shows three WisdomTree strategies in U.S. small cap, ranked along a return on equity (ROE)-based quality spectrum. They may be a way to get in front of an interest rate spike in reaction to or in anticipation of a red-hot Q2 GDP report.

Something to think about in the next traffic jam.

Figure 3: Small Caps Along a Quality Spectrum

Low ROE ⟷ High ROE

	Russell 2000 Value	Russell 2000	Russell 2000 Growth	DES	EES	DGRS
Quality (ROE %)	**1.3%**	**1.4%**	**1.9%**	**9.1%**	**10.8%**	**12.6%**
% Negative Earnings	31.1%	37.2%	42.6%	7.8%	6.8%	0.6%
Est. P/E Ratio	21.3	34.1	76.8	17.6	13.9	16
Est. P/E Ratio Ex-Negative	15.3	18.7	25.8	16.5	13.3	15.9

Source: WisdomTree, as of 3/31/21. The Fund metrics are derived from the Fund's underlying securities compared and should not be considered reflective of any Fund performance. In addition, favorable index metrics may not translate to favorable fund performance.

For standardized performance of the Funds in the chart, please click their respective tickers: DES, EES, DGRS.

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DEFINITIONS

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

Russell 2000 Growth Index : Measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2000 Value Index : measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Monetary stimulus : refers to attempts to use monetary policy like lowering interest rates or quantitative easing to stimulate the economy.

Seasonally Adjusted Annual Rate (SAAR) : A rate adjustment used for economic or business data, such as sales numbers or employment figures, that attempts to remove seasonal variations in the data.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten 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.

Net present value : The difference between the present value of cash inflows and the present value of cash outflows over a period of time. NPV is used in capital budgeting and investment planning to analyze the profitability of a projected investment or project.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.