

IS A RECESSION BEING PRICED IN FOR U.S. SMALL CAPS?

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With the [S&P 500](#) flirting with [bear market](#) territory, headlines are proclaiming a [recession](#) is 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.

ICE BofA US High Yield Index Option-Adjusted Spread



Sources: 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 it seems to us far from a foregone conclusion.

The current [forward price-to-earnings \(P/E\) ratio](#) on the S&P 500 (17.9 times) sits above its 20-year historical median of 16 times. 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 13 times.¹

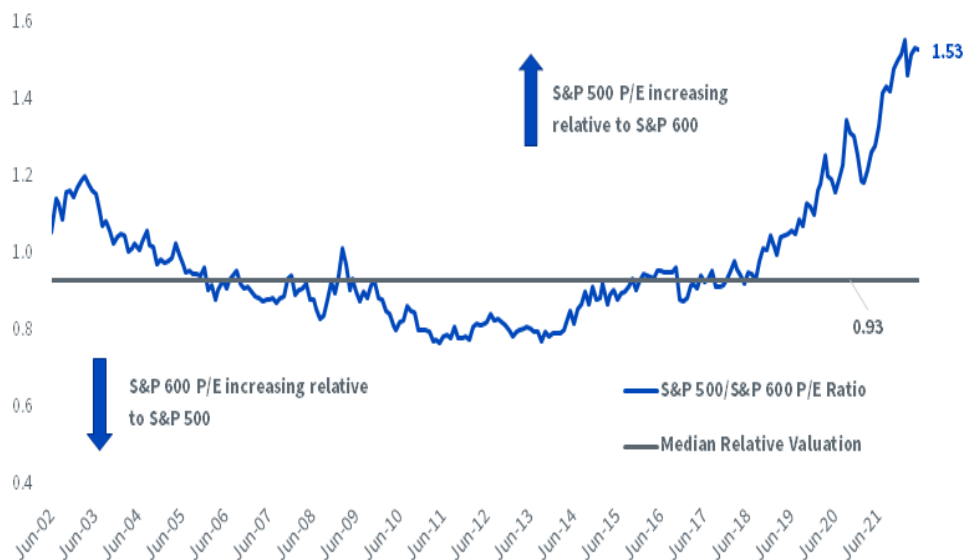
Going down the size spectrum in U.S. equities, valuations are signaling a far more dire outlook.

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 17.9 times and the S&P 600, 11.7 times—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.

Relative Index P/E Multiples: S&P 500/S&P 600



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 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.

For 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, we would suggest an over-weight allocation to small caps.

Earnings Growth, Returns and P/E Multiples

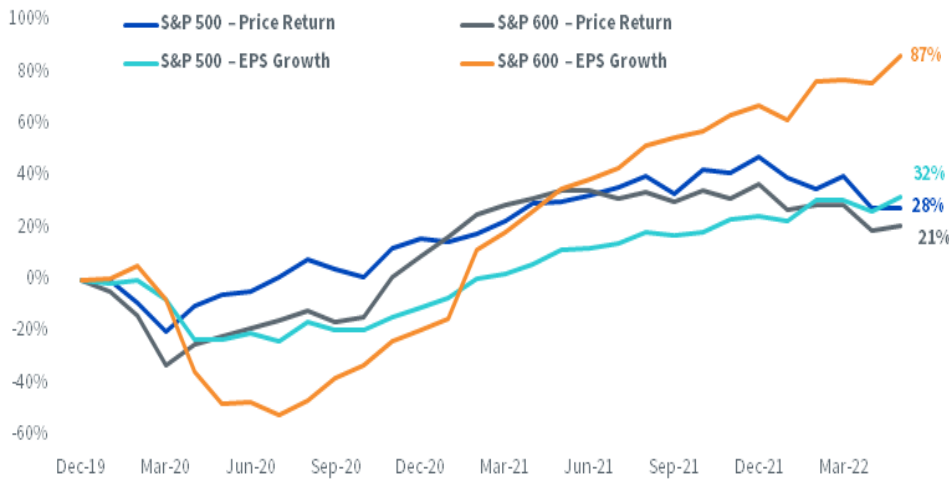
At the trough of earnings expectations in July 2020, estimated earnings on the S&P 600 had dropped by 50% from the end of 2019. S&P 500 estimated earnings were far more resilient, down just 25%.

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.

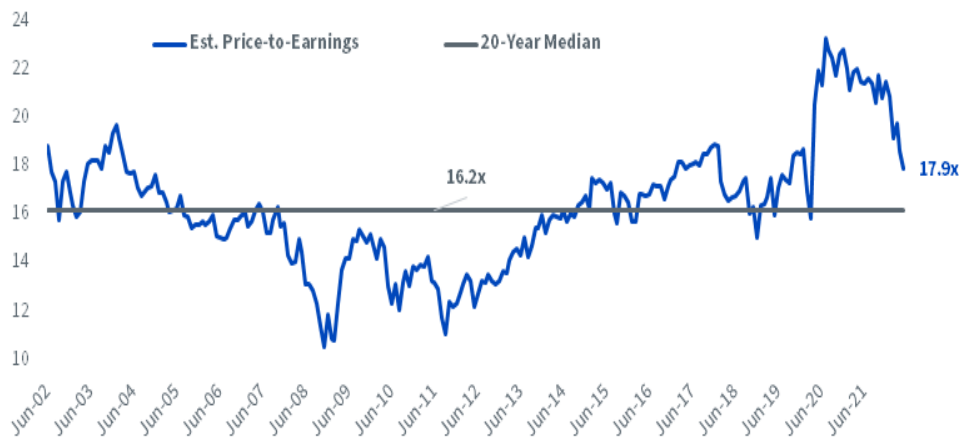
Index Returns and EPS Growth



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 17.9 times is about 10% above its 20-year median P/E multiple but well below its 20-year peak of 23 times from July 2020.

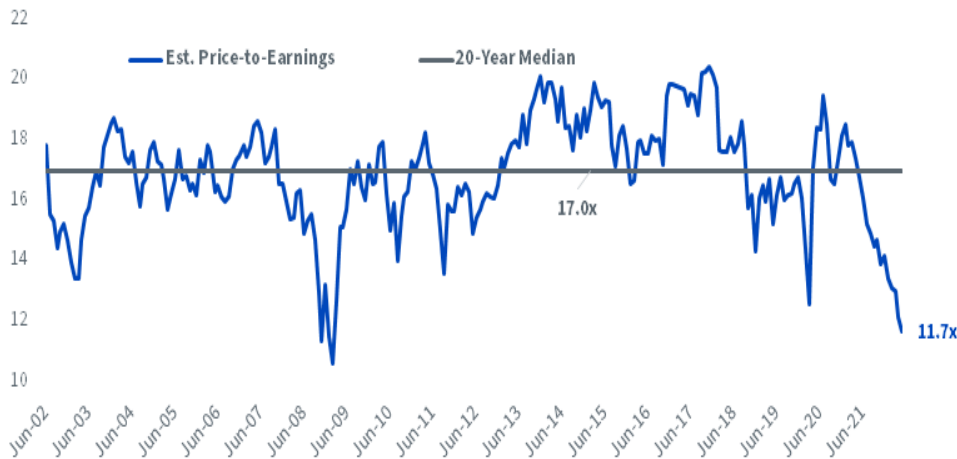
S&P 500



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 11.7 times is a greater than 30% discount to its 20-year historical median P/E of 17 times. The last time small-cap earnings multiples were this depressed was at the bottom of the global financial crisis in early 2009.

S&P 600



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.

Conclusion

The valuation discount for small caps later in an economic cycle is not necessarily unexpected or unwarranted.

Small caps tend to have less diverse businesses than large caps and are more skewed toward economically sensitive sectors like Financials, Materials, Industrials and Consumer cyclicals that tend to have more volatile earnings growth.

Nonetheless, the dire outlook for small-cap earnings implied by valuations may be setting a low bar for small caps to beat—and for investors to prosper from.

Consider this excerpt from Abby Joseph Cohen, former senior investment strategist for Goldman Sachs and current Columbia Business School professor, in a recent *Financial Times* opinion piece:

Valuations are much less extreme than they were and, in some cases, reflect embedded expectations that are quite bleak. It may be less gut-wrenching to invest when the consensus outlook is for sunshine. But the best returns can occur when a less cheerful scenario is reflected in security prices.²

Trends in sector-level earnings growth will be the topic of the next post in a three-part series on small-cap valuations.

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

² Abby Joseph Cohen, "Now is the time for stockpickers in markets," *Financial Times*, 5/24/22.

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.

View the online version of this article [here](#).

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DEFINITIONS

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 United States economy.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Basis point : 1/100th of 1 percent.

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.

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

S&P 600 Index : The S&P 600 is an index of small-cap stocks managed by Standard and Poor's. It tracks a broad range of small-sized companies that meet specific liquidity and stability requirements.

Discount : When the price of an ETF is lower than its NAV.

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

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Valuation : 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.