

Will 2019 be the year of small caps in Europe

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Christopher Gannatti, CFA

Global Head of Research

I admit, I was stunned by January's turnaround in market performance.

It seemed logical to consider a more defensive approach. And if someone had asked me if it would have been appropriate to overweight small cap equities, I wouldn't have had the guts to do it after being shell shocked by the Cboe Volatility Index (VIX) spiking to 36 in late December¹.

But small caps have been off to an incredible start in 2019.

What's easy? Slipping into old patterns

With the current global backdrop, a US allocation is the easiest to create a compelling narrative around. The Brexit uncertainty in Europe, for example, is enough to buttress this narrative. The Russell 2000 Index has started off 2019 strongly, delivering a 11.2% total return over January². There is little question that investors will notice this.

But, a reminder that small-cap companies tend to be businesses with long-term goals in mind. And US growth is currently late in its cycle. So, while further positive performance may be able to be squeezed from small caps, there isn't much in the way of valuation cushion, should conditions deteriorate.

- The lower risk of US small caps should lead to the Russell 2000 Index having a higher multiple—a factor that is not disputed. The real question is, given the balance of risks, how much higher should the multiple be than, say, that of the WisdomTree Europe SmallCap Dividend Index? What we see in Figure 1 is something on the order of 50%.
- The forward price/earnings (P/E) ratios of the WisdomTree Europe SmallCap Dividend Index and the MSCI Europe Index have been quite similar, with the WisdomTree index having the current advantage.

Figure 1: European small caps offer a discount to US small caps

Source: Bloomberg, with data from 25 January 2014 to 25 January 2019, a five-year period. You cannot invest directly within an Index.

Historical performance is not an indication of future performance and any investments may go down in value.

European small caps are impossible to ignore

Since 2013, the WisdomTree Europe SmallCap Dividend Index has opened a dramatic performance gap over the MSCI Europe Index. The key explanations of this difference are:

- When risks arise in Europe, they're frequently expressed through volatile performance within some of the large, systemically important banks. These banks have large market capitalisation's, thereby commanding large weights in indices like the MSCI Europe Index. By looking to small caps, you avoid the systemically important financials, at least in terms of direct index exposure.
- There have been two distinct periods where oil prices have dropped significantly over shorter periods of time. Focusing on small caps would tend to tilt away from these larger companies that have had some more difficult periods since 2013.

As investors consider European equities, we'd indicate the importance of not forgetting the full spectrum of market capitalisation size.

Figure 2: Long term performance of European small caps has been very strong

Source: Bloomberg, with data from 1 June 2006 to 25 January 2019, the period of live calculation for the WisdomTree Europe SmallCap Dividend Index.

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Relief rally in 2019?

We recognise that we must face the facts. Global growth is trending slower than it has in recent years, pushed in part by the US tax cut impact from 2017. And sentiment toward Europe's growth is not particularly strong at present. 2017 was a much better year.

Fortunately, the relationship between economic growth and equity performance is not a simple correlation.

- In 2016, Europe's equities were searching for footing with such surprises as the Brexit Referendum result and the President Trump election victory.
- If every year were like 2017, European equities would dominate people's portfolio exposures. Economic growth data was accelerating, equity performance was strong, and the currencies of Europe was appreciating against the US Dollar.
- To be fair, growth isn't "accelerating" as we start 2019. But there does appear to be a relief rally underway. It's intriguing that the WisdomTree Europe SmallCap Dividend Index was the worst performer in 2018, but in 2019 it has started off the most strongly (as well as the fact that every factor index is positive so far).

Figure 3: Understanding Europe's equity markets through the factors

Source: Bloomberg, with data from 31 December 2015 to 25 January 2019. Returns include the impact of both equity performance as well as respective currency performance against the euro. You cannot invest directly within an Index.

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Don't forget about Europe's small caps

As we've said before, it's easier to make the case to allocate to the US over Europe today. However, we don't believe investors realise that each of the five major factor-focused indices of Europe have been positive in January of 2019 after quite a rough year. European small caps have delivered strong performance in the long-term, and currently offer a large discount to US equities.

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