

# US small-cap dividend payers: a quality play on 'looming' Fed tightening

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The postponed interest rate hike by the Fed is preventing US small-caps from breaking away from US large-caps. Driving the potential of small-caps to perform better than large-caps is the small-cap's cyclical bias to the US domestic economy and lower interest rate sensitivity.

A more efficient strategy to position around looming Fed tightening may be through dividend-paying small-cap stocks. It's a segment within the US equity market where companies' balance sheets appear to be the least financially leveraged. The quality dividends bring will furthermore reduce volatility of small-cap portfolios, offering a defensive element to a likely; soft, less aggressive tightening cycle.

The momentum of US small-caps is subject to inflationary pressures building as labour supply shortages should eventually drive up wages, fueling a positive cycle of higher income and increased spending. First indications of companies like Wall Mart and Target increasing minimum hourly pay ahead of US Congress' decision to approve President Obama's proposal to raise the minimum wage may be a prelude to a more upbeat US economic assessment by the Fed and compel the Fed to act.

## Fed rate hikes favours small-caps over large-caps

In the last pronounced tightening cycle, prior to the US exiting its QE program in 2014, US small-caps have benefited throughout the duration of successive policy rate hikes. Hence, an end to the +6 year period of near zero policy rates may offer a precedent for small-caps to strengthen and perform better than large caps.

This is shown in chart 1, where two periods of US tightening monetary conditions are overlaid against the relative performance of US small-caps over US large-caps. The first tightening cycle is in the period of 2004 to 2007 (with year 1 to 4 on the x axis referencing this period), when the Fed began raising its policy rate by consecutive 25 basis points (in 17 steps) to 5.25% and US small-caps outperformed US large-caps (see orange lines). Subsequent cuts to the policy rate in late 2007 also reversed the out performance of US small-caps.

The second tightening cycle started in 2013, when the Fed first hinted its readiness to 'taper' its QE program, driving long-dated US Treasuries yields to climb out from their nadir. Following the complete exit of QE in the fall of 2014, the shorter dated US Treasury yields also started to rise and progressively move away from the policy rate as the market's anticipation of the Fed to begin raising its policy rate. However, after more than 2 years into this tightening cycle, the US economic rebound remains incomplete. Marked by the absence of higher wage growth and inflation to accompany an otherwise robust jobs market, the Fed has delayed the rate hike. As a result, while sentiment towards US equities has remained upbeat, US small-caps have yet to break away from US large-caps (see green lines).

## The re-leveraging of large-cap stocks poses vulnerability to Fed tightening

An important driver for the out performance of US small caps over US large caps during the 2004 to 2007 tightening cycle has been the low leverage of small cap stocks. For instance, in 2003 the S&P 600 Small-Cap index's aggregate debt to asset ratio stood at around 27%, 10% less than for the S&P 500. This, combined with a sector bias towards consumer discretionary, industrials and materials driving a US domestic, cyclical equity tilt, has helped US small-caps to better withstand the 425 bps policy rate hike by the Fed over that period and directly benefit from a rebounding US economy.

Following the 2008 credit crisis, US financial sector stocks, towards which the S&P 500 was heavily weighted by 18% at the end of 2007, have significantly cut back on financial leverage. So much so that the leverage ratios of the S&P 500 is now identical to that of the S&P 600 Small-Cap, with debt to asset ratios of around 24% and 23%, respectively. However, when financials are stripped out, the S&P 500 non-financials' have re-leveraged their balance sheets, as evidenced by rising leverage ratios across most sectors in the years, exceeding 2007 levels. Hence, the degree of interest rate sensitivity has not diminished in any way for the large cap segment of the US equity market, quite the contrary. Given the exceptional low interest rate environment at which many US large-cap stocks have re-leveraged, a rise in interest rates could significantly increase their refinancing costs. In particular, for the stocks falling within defensive sectors such as consumer staples, telecoms and utilities, which generally have high leverage ratios, or for the bellwether stocks of US large multinational companies with a global footprint that rely on a weak dollar to drive profits, a weakening profit outlook appears much more likely once the interest rate cycle turns.

### Dividend payers within small-caps have the lowest leverage

Underpinned by less reliance on debt finance, small-cap stocks should be less sensitive to rising borrowing costs. To limit downside risk posed to US small-caps when disappointing macro data may compel investors into large-caps, a basket of dividend paying stocks within the US small-cap universe could offer investors the quality element sought after. The positive signalling effect dividend policies provide comes from the incentive of management to preserve strong balance sheets and from a stable income stream for investors that works to reduce stock price volatility.

Chart 2 shows how such a strategy is expressed in the index of WisdomTree's [US Small-Cap Dividend UCITS ETF \(DESE\)](#). It offers investors exposure to dividend paying US small-cap stocks where the leverage ratios across most sectors are lower than either the S&P 500 or the S&P 600 small-Cap. The low 2014 debt to asset ratio of stock baskets across the defensive and cyclical sector of DESE means that investors can obtain exposure around one of the least interest rate sensitive stock baskets within the US equity market, even where the dividends streams also give the basket the defensiveness required for investors to position around when, not if, the first policy rate hike eventually does occur.

Investors sharing this sentiment may consider the following UCITS ETF: -

- [WisdomTree US SmallCap Dividend UCITS ETF \(DESE\)](#)

*All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.*

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