

What Will Light a Fire under Small Caps?

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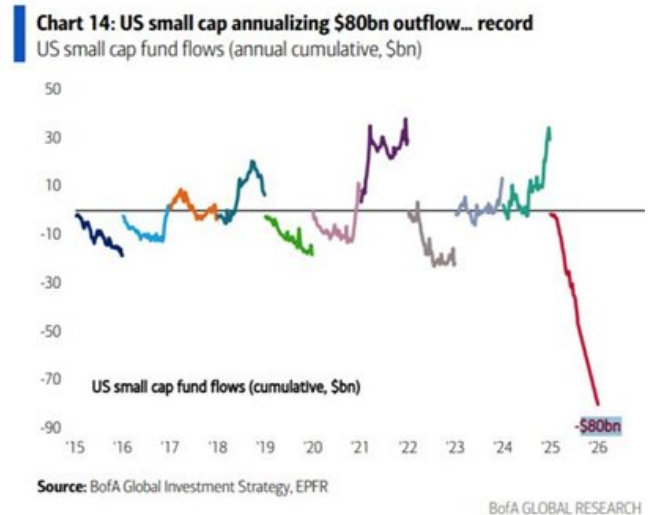
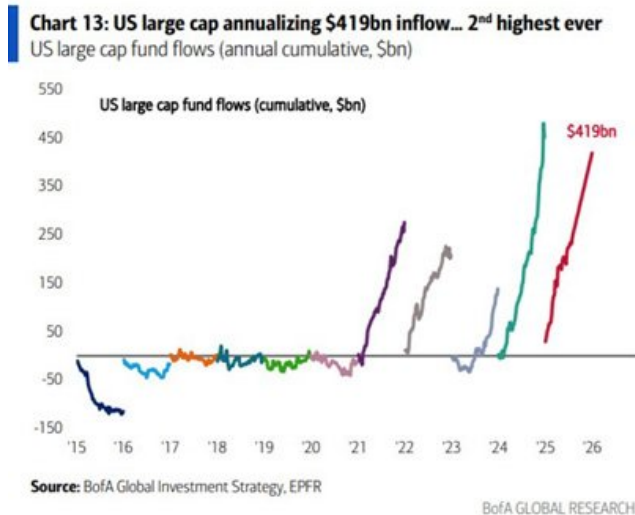
Key Takeaways

- Despite lagging the broader market, U.S. small caps now trade at a 21.8% valuation discount to large caps, levels last seen before major relative rallies in the 1970s and early 2000s.
- With rate cuts, Jay Powell could set up a reversal that swings fortunes in favor of small caps.
- Investors should consider focusing less on dollar predictions and more on small caps' sensitivity to falling rates.

The house of pain continues with small caps, at least on a relative basis. Year-to-date, the [S&P 600 index](#) has posted a 3.0% gain, so it's not like money is being burned. But still, even the Bloomberg Aggregate Bond index is up 4.9% YTD and the S&P 500 is up 10.9%.¹

BofA's fund flow data tells a thousand words.

Figure 1: A Tale of Two Asset Classes



Source: BofA Global Research, July 2025.

We're at a moment of truth with large versus small, too. When I plot the S&P 100 relative to the big, broad Wilshire 5000 index, it is making its third attempt at resistance levels that date to the 1990s. If recent action holds, this would mark an important breakout for large caps.

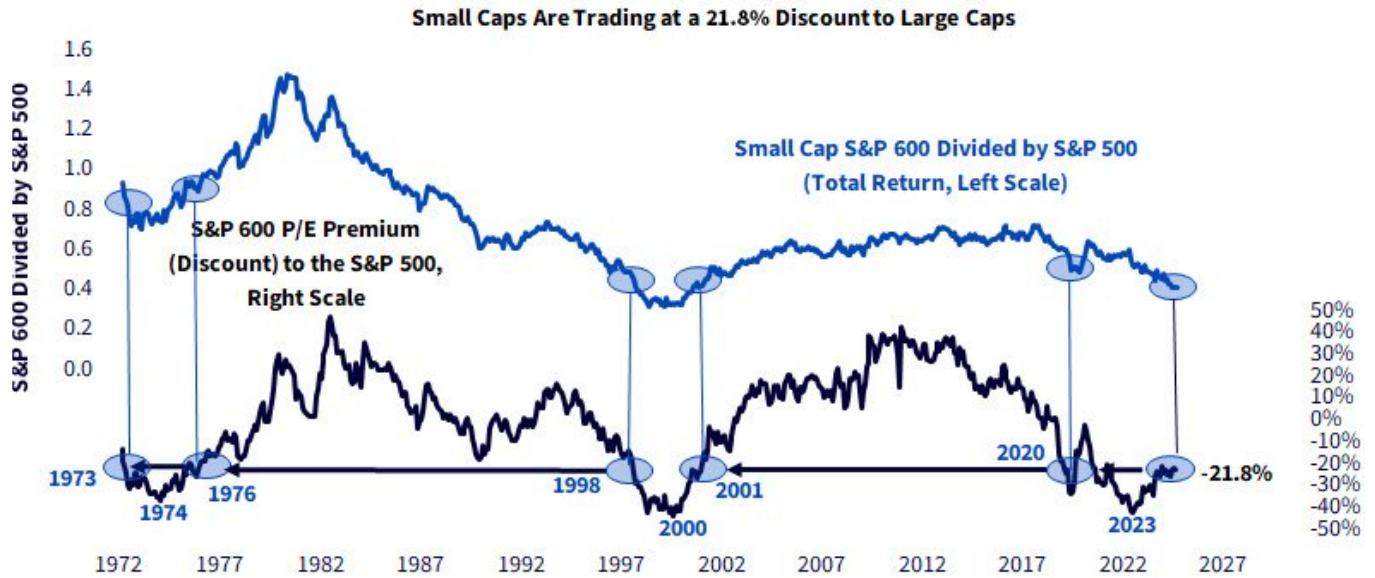
Figure 2: A Moment of Truth



Source: Refinitiv, total return indexes, as of 8/21/25.

Because of small caps' multi-year struggle, the group is trading at a 21.8% discount to large caps on reported earnings (figure 3). It doesn't mean a small-cap resurgence will start tomorrow, but I do find solace in these valuation gaps resembling the situation that manifested in both the mid-1970s and the turn of the century.

Figure 3: Small Caps' Relative Valuations Are Promising



Source: Refinitiv, DataStream reported earnings calculations, 12/31/1972–7/21/2025.

Small caps are cheap, at least relatively, but there is a potential 2026 headwind that we should address.

The S&P 600 index of small caps has an easy hurdle this calendar year, in that the Street is penciling in earnings growth of just 2.7% to the S&P 500's 7.4%, according to Yardeni Research. But for next year, the Street has S&P 600 earnings jumping another 18.8% (the S&P 500 is expected to see earnings growth of 13.9%). Those will probably both be revised down, as usual, but it's still an easier hurdle for large caps than small caps.

As for the Dollar

It's one of the most common questions we get on large versus small. I wish I had some strong view here, but I don't. The problem with the dollar is you must get two things correct to make money:

- First, you have to forecast where the dollar is going, which is as good as heads versus tails
- Then, you must accurately identify what will happen to small and large caps if you get the dollar right

It's easier said than done, as I think figure 4 makes clear. Even if you accurately predict the dollar, good luck making heads or tails out of large and small because of it.

Figure 4: Predicting This Stuff Isn't Easy

USD Direction: Does it Influence Large Caps vs. Small Caps?											
Year	S&P 500 Return	Russell 2000 Return	Winning Group?	U.S. Dollar Index Return	Dollar Direction?	Year	S&P 500 Return	Russell 2000 Return	Winning Group?	U.S. Dollar Index Return	Dollar Direction?
1989	31.7%	16.3%	Large Caps	0.8%	Up	2007	5.5%	-1.6%	Large Caps	-8.4%	Down
1990	-3.1%	-19.5%	Large Caps	-10.9%	Down	2008	-37.0%	-33.8%	Small Caps	5.8%	Up
1991	30.5%	46.0%	Small Caps	0.5%	Up	2009	26.5%	27.2%	Small Caps	-4.1%	Down
1992	7.6%	18.4%	Small Caps	10.6%	Up	2010	15.1%	26.9%	Small Caps	1.5%	Up
1993	10.1%	18.9%	Small Caps	4.9%	Up	2011	2.1%	-4.2%	Large Caps	1.5%	Up
1994	1.3%	-1.8%	Large Caps	-8.4%	Down	2012	16.0%	16.3%	Small Caps	-0.5%	Down
1995	37.6%	28.5%	Large Caps	-4.5%	Down	2013	32.4%	38.9%	Small Caps	0.3%	Up
1996	23.0%	16.5%	Large Caps	4.0%	Up	2014	13.7%	4.9%	Large Caps	12.8%	Up
1997	33.4%	22.4%	Large Caps	13.0%	Up	2015	1.4%	-4.4%	Large Caps	9.3%	Up
1998	28.6%	-2.5%	Large Caps	-5.5%	Down	2016	12.0%	21.3%	Small Caps	3.6%	Up
1999	21.0%	21.3%	Small Caps	8.2%	Up	2017	21.8%	14.6%	Large Caps	-9.9%	Down
2000	-9.1%	-3.0%	Small Caps	7.5%	Up	2018	-4.4%	-11.0%	Large Caps	4.4%	Up
2001	-11.9%	-2.5%	Small Caps	6.6%	Up	2019	31.5%	25.5%	Large Caps	0.2%	Up
2002	-22.1%	-20.5%	Small Caps	-12.8%	Down	2020	18.4%	20.0%	Small Caps	-6.7%	Down
2003	28.7%	47.3%	Small Caps	-14.7%	Down	2021	28.7%	14.8%	Large Caps	6.7%	Up
2004	10.9%	18.3%	Small Caps	-7.0%	Down	2022	-18.1%	-20.4%	Large Caps	8.6%	Up
2005	4.9%	4.6%	Large Caps	12.8%	Up	2023	26.3%	16.9%	Large Caps	-2.7%	Down
2006	15.8%	18.4%	Small Caps	-8.2%	Down	2024	24.2%	11.5%	Large Caps	7.1%	Up
						2025	8.0%	0.8%	Large Caps	-9.8%	Down

# Years Witnessing:	Large Caps Winning	Small Caps Winning
Dollar Up	12	10
Dollar Down	8	7

Source: Refinitiv, total return indexes, as of 7/30/25.

I have given the "dollar vs. cap size" concept a ton of thought over the years.

The common refrain goes something like this: "If the dollar rises, that is going to be bad for big U.S. multinationals, because their costs will be in expensive dollars and their customers will pay them in weak euros and weak yen. Therefore, if I'm bullish the dollar, I should go for small caps."

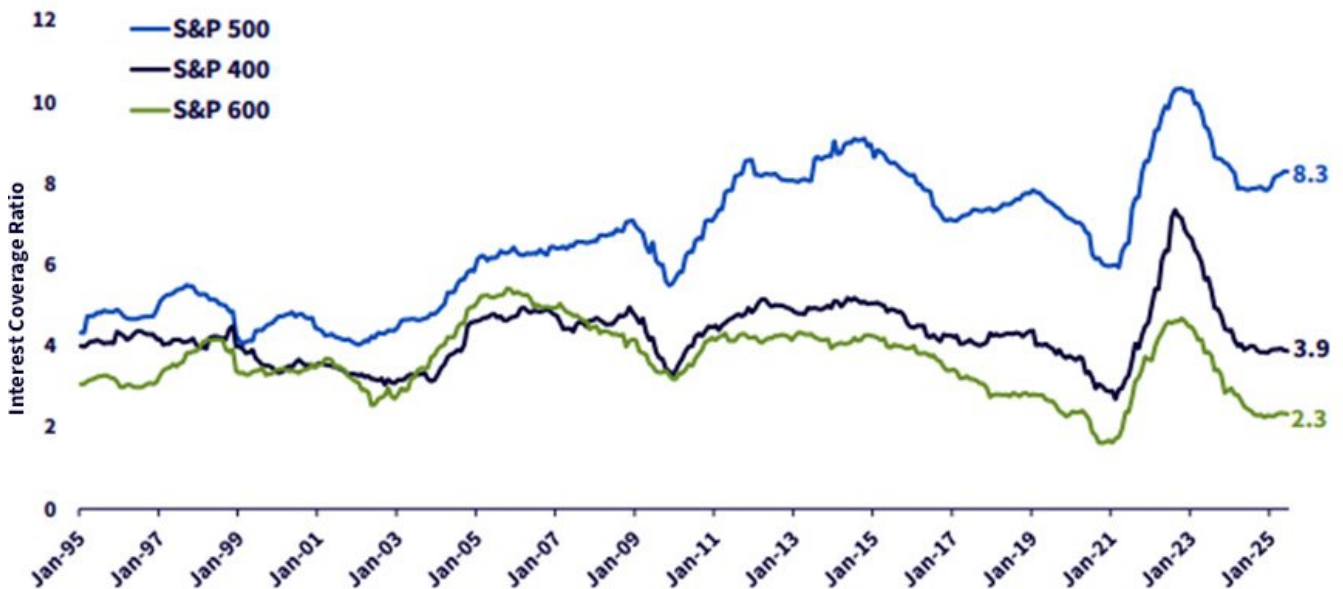
If it were only that simple. Dollar up, give me small caps. Everyone knows that. But it isn't necessarily true.

How about if "dollar up" is happening because some hedge fund is blowing up or a banking institution is dying in real time? In those markets, people are doing wild things like getting diamonds into Swiss safe deposit boxes, emptying ATMs and so on. In that world, where the grab for dollars is on, you probably aren't going to be happy with small caps.

Moral of the story: like small caps because you like small caps, not because of any U.S. dollar forecast that is on your mind.

Now...that doesn't mean you can't engage in some old-fashioned Fed Kremlinology. That work could help small caps because of a narrative that figure 5 lays out. It shows a concept that is intuitive: as a collective, large caps tend to stand on sturdier balance sheet ground than small caps. Interest coverage (earnings before interest and taxes divided by interest expense) is a notably different scene as you move across the cap spectrum.

Figure 5: Interest Coverage Ratio



Source: WisdomTree, as of July 2025.

If the Fed starts cutting rates, that helps not only people and companies with large debt burdens, but also those who are more likely to have floating rate obligations. Both of those descriptors apply more to small caps than large caps. It's something to consider if the Fed starts easing policy.

If you like the charts in this blog post, be sure to check out our new [Daily Charts](#), which features timely charts from various WisdomTree thought leaders.

Figure 6 sorts our four U.S. small-cap Funds by quality (return on equity).

Figure 6: U.S. Small-Cap Fundamentals

	S&P 600	DES	EES	DGRS	QSML
Forward P/E	16.8	14.0	13.3	13.4	17.4
Return on Assets (ROA %)	1.4%	2.0%	1.8%	3.0%	4.7%
Return on Equity (ROE %)	6.8%	9.0%	9.4%	12.5%	12.8%
% Negative Earnings	14.1%	6.6%	9.6%	1.5%	12.0%
30-Day SEC Yield (%)	N/A	3.30%	1.31%	2.59%	0.72%

Source: WisdomTree PATH software, as of 7/31/25. **The performance data quoted represents past performance and is not indicative of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end and standardized performance, click the respective ticker: [DES](#), [EES](#), [DGRS](#), [QSML](#).**

Funds mentioned in figure 6:

- [DES: WisdomTree U.S. SmallCap Dividend Fund](#)
- [EES: WisdomTree U.S. SmallCap Fund](#)
- [DGRS: WisdomTree U.S. SmallCap Quality Dividend Growth Fund](#)
- [QSML: WisdomTree U.S. SmallCap Quality Growth Fund](#)

1 Performance figures from WisdomTree's PATH software, as of 8/27/25.

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 the Fund's prospectus for specific details regarding the Fund's risk profile.