

Large Cap vs. Small Cap Stocks

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Small cap stocks remain overvalued despite underperforming large cap stocks over the past year. The Russell 2000 small cap index's forward P/E is still at 17.1, significantly above the Russell 1000 large cap index's forward P/E of 14.8. With large cap stock earnings growth expected to be faster than small cap's, valuations are likely to continue to favor large caps.

Late in economic and market cycles, large cap stocks tend to outperform small cap stocks. As the economy begins to slow, investors typically move back toward safer bets. This is where we have been: the economy has been slowing, small cap stocks have been underperforming, and money has been going toward large cap stocks.

Recently, many of the economic catalysts for growth have begun shifting back in favor of small cap stocks. Historically, lower bond yields, Fed rate cuts and reduced inflationary pressure have favored small cap stocks. At some point, economic growth should reaccelerate and small cap stocks are likely to outperform. However, this view seems premature. Although small cap stocks look a bit oversold, they had outperformed for six years and a period of under-

performance should be expected. Until small caps become more attractively valued, we won't buck the trend. Long-term relative momentum has clearly rolled over, with large caps significantly outperforming small. In addition, during periods of dollar weakness, large cap stocks tend to outperform.

Bottom Line: Until relative valuation improves and relative momentum shifts, we will lean toward large cap stocks.

MARKET INDICATORS

Valuation	Current Bias	Tendencies
Relative Forward P/E	Large	
Relative Trailing P/E	Large	Watch for valuation extremes
Equity Risk Proxy	Neutral	Baa/EP narrow/not paid for risk/credit peak
Economic/Market Cycle	Current Bias	Tendencies
Economic Cycle	Large	Early cycle small; late cycle large
Market Cycle	Large	6-12 months after bull market peaks favor large
Coincident Indicators	Neutral	High (>2% y-y) and rising favors large
Commodity Prices	Neutral	Rising commodity prices favor small
Inflation Pressure	Small	High and rising favors large
Interest Rates	Small	Rising and high interest rates favor large
Fed Policy	Small	Cutting favors small
Dollar and Bonds	Neutral	Both rising favor small
Price Action	Current Bias	Tendencies
Relative Momentum	Large	Relative strength regression model
Breadth	Large	More stocks outperforming favors small
Trend Indicators	Large	Trend reversal
Volatility	Large	Rising volatility favors large
Seasonality	Large	May-to-October favors large
Reversion to Mean	Neutral	Small-Large y-y rate of change deviation
Ned Davis Research Perspective	Large	Ned Davis LT, IT, ST Model Composite

Sources: Bailard Research, Ned Davis Research, Yardeni Research

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