Equities in Focus

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Small-Caps: From Laggards to Leaders

For much of the past decade, US equity markets have been dominated by large-cap (especially growth) stocks, leaving small-caps in the shadows. Advisors and clients alike have grown accustomed to the narrative that "bigger is better." But the tide may be turning beyond a head fake rally.

Key Takeaways

1. **A Favorable Policy Backdrop Is in Place**
   Fed easing and the One Big Beautiful Bill Act are key tailwinds.
2. **Small-Caps Benefit Disproportionally from Lower Rates**
   Interest expenses fall on the bank and the variable-rate debt many small companies carry.
3. **Discounted Valuations and Now Earnings Visibility**
   Attractive valuations are *finally* being accompanied by earnings growth expected to surpass large-caps.

A Strong Rotation Indeed

Since June 30, 2025, small-caps have staged a notable comeback, with the Russell 2000 Index returning 22.00% versus the S&P 500 up 12.46% through January 28, 2026. This small-cap comeback has been driven by favorable policy factors, including: the One Big Beautiful Bill Act's depreciation provisions, which could drive increased capital spending by corporations well beyond the AI ecosystem; and the potential for Fed easing, which would lower small-caps' interest expense and lead to easier lending standards from banks, who are more frequent lenders to smaller businesses. As *Display 1* shows, interest expense as a percentage of total debt is much higher for small- versus large-cap stocks, in part explaining small-caps' rate sensitivity. And price-to-earnings multiples tend to get a lift during periods of Fed rate cutting, especially small-cap growth stocks (*Display 2*).

Fundamentals for a Sustained Broadening

Lower interest expenses could provide meaningful relief for these more indebted companies, improving margins and fueling earnings growth. In fact, the year-over-year earnings growth for small-cap stocks is expected to far outstrip that of large-caps, based on sequential consensus forecasts (*Display 3*). For so long, small- and mid-cap stocks have been overshadowed by the AI trade and a bifurcation in nominal earnings growth versus large-cap equities, with small-caps' growth rate being inferior. These elements have led to small-caps trading at a substantial discount to large-cap stocks.

Our View

Attractive valuations are now being accompanied by a vastly improved earnings growth outlook, which if the latter is realized, provides a solid combination that may bolster an enduring equity market broadening. Despite their strong rally, we believe it's not too late to rebalance back into or initiate a position in this long-unloved and less-crowded asset class.

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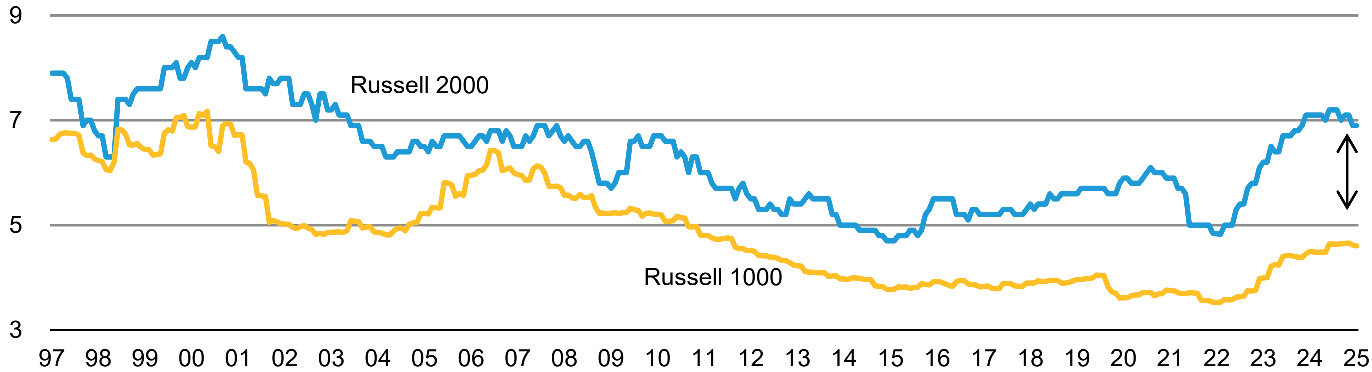
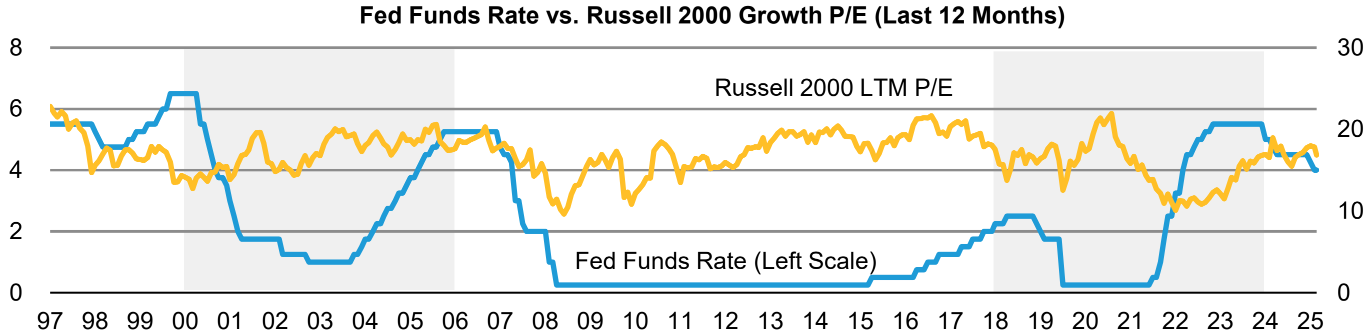
Display 1: Lower Rates Would Provide Relief for the More Indebted Small-Caps
Interest Expense as Percent of Total Debt



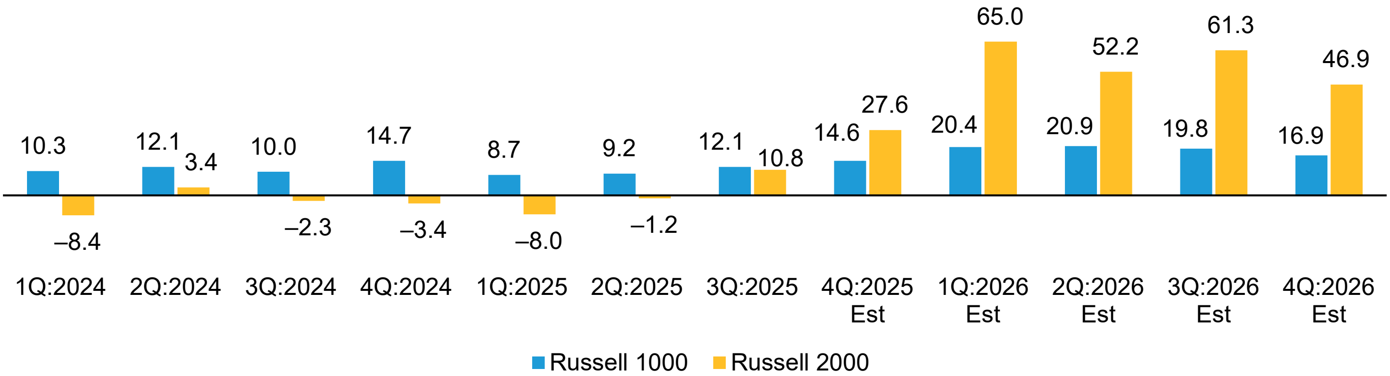
Past performance does not guarantee future results.
As of December 31, 2025
Source: FTSE Russell, Strategas Research Partners and AB

Display 2: An Inverse Relationship Between Valuation and Fed Funds Rate Changes
Small-Cap Growth P/E Multiples Typically Expand During Periods of Fed Easing and Vice Versa



Past performance does not guarantee future results.
LTM: last 12 months; P/E: price-to-earnings
As of December 31, 2025
Source: Federal Reserve Economic Data, FTSE Russell and AB

Display 3: Not All About Rate Cuts—Small-Caps Projected to Have an Earnings Edge
Quarterly EPS Growth



Past performance does not guarantee future results.
EPS: earnings-per-share
As of December 31, 2025
Source: FTSE Russell, Strategas Research Partners and AB