



by ADAM GROSSMAN, CFA

THE WRITING TEAM

ADAM GROSSMAN, CFA
Global Equity CIO | Partner

CHRIS KONSTANTINOS, CFA
Managing Partner |
Chief Investment Strategist

KEVIN NICHOLSON, CFA
Global Fixed Income CIO | Partner

ROD SMYTH
Vice Chairman

DAN ZOLET, CFA
Associate Portfolio Manager

SUMMARY

- Higher short rates have dragged down small-cap... but rate policy is becoming more favorable.
- We believe some sectors will recover faster than others – earnings will be the key.
- Our team is cautiously weighing small-caps against other value-oriented investments.

09.16.2025

US Small-Cap... Lower Rates to the Rescue?

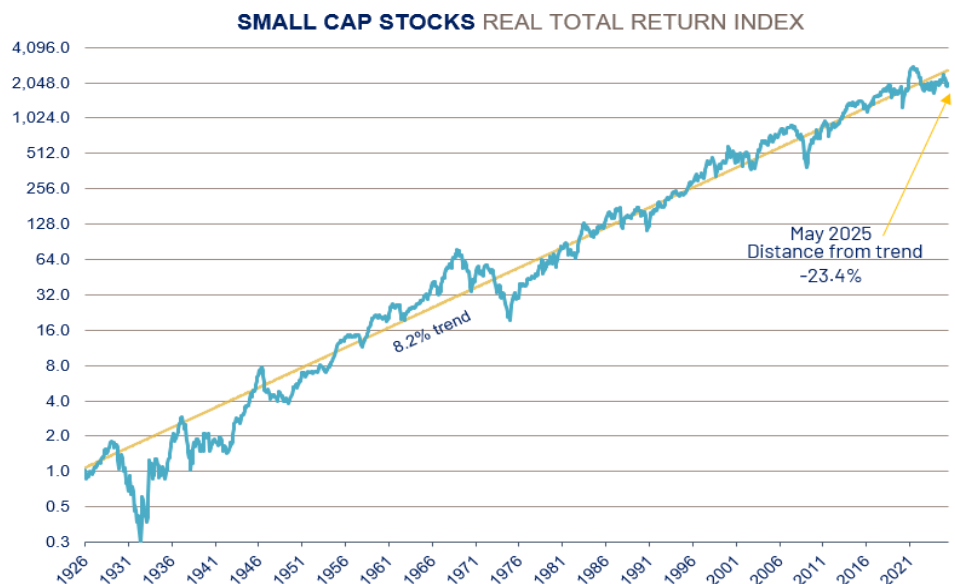
Decrease in Interest Rates a Tailwind for Small-Cap

In 2024, we wrote a [Strategic View](#) outlining some of the structural headwinds that high interest rates created for US small-cap stocks, and concluded they were likely to face challenges, despite their seemingly attractive valuation – a classic ‘value trap’. As we contemplate the Federal Reserve imminently lowering interest rates, we wanted to provide an update on this topic. Below we explain why a rate cut cycle may be a potential tailwind for small-cap earnings and returns. We also provide some guidance for selection within the asset class.

Economic Resiliency Matters for the Stock Market

Since the Great Financial Crisis of 2008, the dominant economic backdrop has been one of low economic growth and low interest rates. We believe this type of environment is ideal for growth-oriented companies and market segments like US large-cap. This is because large-cap indices tend to be stocked with companies that are scaled enough to generate large profits off small amounts of economic growth. This, along with the strength of software-as-a-service, cloud computing and artificial intelligence (AI) are the primary drivers of large-cap dominance over the decade and a half. Most of the other major equity asset classes we follow – such as US small-cap and international – tend to have more “value-oriented” companies.

Chart 1: Small-Cap Trading Below Long-Term Trend



Source: RiverFront Investment Group, calculated based on data from CRSP 1925 US Indices Database ©2025 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Data from Jan 1926 through May 2025. Past performance is no guarantee of future results. It is not possible to invest directly in an index. RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. Blue line represents the Small Cap Real Return Index. Yellow line represents the Annualized Real Trend Line of Small Cap Real Total Return Index according to Price Matters®. Shown for illustrative purposes only, not indicative of RiverFront portfolio performance. Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed. The chart above uses a logarithmic scale. Line movements will be dampened/subdued based on the exponential y-axis.

Value-oriented companies tend to struggle in lower economic growth environments due to larger fixed costs and lower profit margins. The upside of these types of businesses is they tend to grow earnings faster in an environment of elevated economic growth, moderate inflation, and a steep yield curve. Due to the COVID-driven inflation spike in 2021, we abruptly jumped to an environment of high interest rates. This is a backdrop which is hostile to all equity markets, but especially to small-caps, in our view.

Fortunately, inflation has slowly come back under control, and it appears the path is now set for the Federal Reserve to lower short interest rates. We would expect a “value rotation” if this rate increase can occur without re-igniting inflation, or if a recession does not start.

Our [Price Matters®](#) framework (Chart 1, page 1 above) suggests small-caps have a faster long-term historical return trend (8.2% per annum, versus 6.4% for large-caps) and currently are trading at -23.4% below that trend vs +37% above trend for Large Caps. This suggests to us that, looking out over the next decade, small-caps are likely to have a higher total return than large-caps. However, we believe that value is a ‘condition’ and not necessarily a ‘catalyst’ for better returns, if not supported by growing corporate earnings. The high interest environment we have weathered since 2022 has proved particularly challenging for small cap earnings. We believe it will improve, however, if interest rates continue to decline.

Why US Small-Caps Are Impacted More by Higher Short-Term Interest Rates

While higher rates impact all indebted companies to some degree, higher interest rates tend to affect small-cap companies more acutely than large-cap companies. Comparing small-cap companies to their large-cap counterparts, we observe three general tendencies:

1. **Small-caps tend to use more debt than large-caps:** Small-caps tend to have higher debt as a percentage of assets and lower coverage of debt payments as a multiple of their earnings. This means they may be more susceptible to credit issues.
2. **Small-caps tend to borrow at higher rates:** The average credit quality of large cap companies in the S&P 500 is BBB+, which is considered ‘investment grade’. However, the average credit rating for all companies in the US is BB, a lower-quality rating that is ‘speculative grade’ or high-yield. This suggests that small-caps are typically forced to borrow at higher rates than large, due to small-caps’ higher perceived risk.
3. **Small-caps tend to borrow for shorter periods than large-caps:** High yield bonds tend to have shorter maturities, and a larger proportion of debt for smaller companies in floating rate loan products. This means that small-caps are more susceptible to rising rates and refinancing risk.

An additional wrinkle has been the shock that the rapid increase in interest rates caused the small-cap banking system to seize up abruptly in early 2023. Faced with a backdrop of higher rates, small-cap banks face challenges due to many of their listed assets being “underwater” – whether they are treasury bonds or commercial real estate. This provides both a direct headwind for small-cap banks, and an indirect headwind for all smaller companies that rely on these banks to fuel growth – they are restricting lending when it is needed the most.

While we believe rates are unlikely to fall back to 2020 levels, we do believe that lower interest rates can relieve some of those underwater assets. This will help some companies directly, and it unlocks parts of the balance sheet of smaller banks for lending. While it would be premature to give any kind of “all clear” for investors in small-cap banks, we can now see a possible path forward for small-cap companies to begin unlocking some of their earnings potential. We can see some areas where this is occurring through looking at earnings of small-cap companies.

Bottom-Up View: Small-Cap Earnings are Slowly Improving

Solely focusing on valuations while ignoring earnings and macro catalysts can lead to owning “value traps” with disappointing returns. When we see a macro thesis being borne out in the positive earnings growth of companies, we see that as a powerful signal. While the Federal Reserve is now likely to further lower interest rates in the quarters ahead, here are some themes we wanted to highlight where earnings are already improving. This is a slightly deeper dive into what we explored a few weeks

ago in our [Q2 earnings recap](#).

1. **Earnings and revenue have been better than analysts expected:** One of the encouraging signs from our analysis of earnings is that revenue and earnings came in better than analysts expected in the second quarter across the vast majority of the sectors and in the market as a whole. Given the concerns about tariffs impacting small-cap revenues and earnings, this is a very encouraging result.
2. **Growth is positive overall but inconsistent across sectors:** While earnings growth is positive when looking at the broad small-cap market, results appear more mixed on a sector level. Within the traditional cyclical sectors, Energy, Discretionary and Materials seem to be struggling, while Industrials and Financials are growing, as are Technology and Health Care companies. Defensive and interest rate-sensitive companies in Utilities, Communication Services and Real Estate are still underachieving, while Consumer Staples are performing well.
3. **All of these readings are better than previous quarters:** When comparing our results vs. previous quarters, we see consistent improvement. This is critical because it is consistent with our thesis that lower rates and moderating inflation are having a positive impact.

Our takeaway is that the rate cuts in 2024 and the strong economic environment since 2023 has already improved the standing of some small-cap. We will be watching in quarters ahead for further improvement. We also realize that US small-cap, like any other asset class, is made up of lots of different companies and investment themes. We believe that there is a tremendous opportunity to engage in sector and stock selection within US small-cap depending on if an investor wants to seek deeper value or seek some themes that have already turned positive – we think Technology, Industrials and Health Care are all standout sectors to explore deeper.

Conclusion: Tide May be Turning for Small-Cap; We Will Consider Opportunities as Rate Path Becomes Clearer

Our analysis shows potential of a tailwind for US small-cap as Federal Reserve policy becomes more dovish, and some early green shoots in small-cap earnings. While this might seem like a clarion signal to begin adding exposure, there are a few things that give us pause. The first issue is risk and income considerations for our portfolios. Small-caps tend to have higher volatility, and lower dividend yields than their large-cap brethren. Both of these features make them less attractive for a more conservative portfolio allocation, or for investors with income needs. While sector selection and active strategies can mitigate some of that risk, we do tend to view small-caps as being an investment for highly risk-tolerant investors.

The second factor that is giving us pause is the opportunity cost versus other similarly value-oriented equity assets. US large-cap cyclicals are structured to benefit from steep yield curve and elevated economic growth, but are not as dependent on short-term financing. This could make them a safer investment if inflation rears its head and the rate cutting cycle stalls out. Similarly, international equities have cheap valuations, and likely benefit from the same macro backdrop as US small-cap. We also likely see the cut in short rates leading to headwinds for the dollar, which would benefit international equities simply from a currency translation effect.

In conclusion, while US small-cap is an option for us to invest in, we will have to weigh its' risk-reward against other opportunities... even if our preferred economic scenario of lower rates and continued growth comes to pass. We also have to consider the possibility of increased inflation – this could reverse the current trend of lower rates.

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

Important Disclosure Information

The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed.

This report does not provide recipients with information or advice that is sufficient on which to base an investment decision. This report does not take into account the specific investment objectives, financial situation or need of any particular client and may not be suitable for all types of investors. Recipients should consider the contents of this report as a single factor in making an investment decision. Additional fundamental and other analyses would be required to make an investment decision about any individual security identified in this report.

The comments above are subject to change and are not intended as investment recommendations. There is no representation that an investor will or is likely to achieve positive returns, avoid losses or experience returns as discussed for various market classes.

Chartered Financial Analyst is a professional designation given by the CFA Institute (formerly AIMR) that measures the competence and integrity of financial analysts. Candidates are required to pass three levels of exams covering areas such as accounting, economics, ethics, money management and security analysis. Four years of investment/financial career experience are required before one can become a CFA charterholder. Enrollees in the program must hold a bachelor's degree.

All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

There are special risks associated with an investment in real estate and Real Estate Investment Trusts (REITs), including credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative equities include non-traditional equity strategies such as hedged or income enhanced strategies through the use of derivatives. Alternative investment strategies typically carry a higher risk of loss. Hedged products do not insulate a portfolio against losses and there is no guarantee that income enhanced strategies will provide the expected income.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Artificial intelligence (AI) refers to the simulation of human intelligence by software-coded heuristics. Nowadays this code is prevalent in everything from cloud-based, enterprise applications to consumer apps and even embedded firmware.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

U.S Market Cap index information calculated based on data from CRSP 1925 US Indices Database ©2024 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Used as a source for cap-based portfolio research appearing in publications, and by practitioners for benchmarking, the CRSP Cap-Based Portfolio Indices Product data tracks micro, small, mid- and large-cap stocks on monthly and quarterly frequencies. This product is used to track and analyze performance differentials between size-relative portfolios. CRSP ranks all NYSE companies by market capitalization and divides them into ten equally populated portfolios. Alternext and NASDAQ stocks are then placed into the deciles determined by the NYSE breakpoints, based on market capitalization. The series of 10 indices are identified as CRSP 1 through CRSP 10, where CRSP 10 has the largest population and smallest market-capitalization. CRSP portfolios 1-2 represent large cap stocks, portfolios 3-5 represent mid-caps and portfolios 6-10 represent small caps.

The Real Return is the annual percentage return realized on an investment adjusted for inflation. Trend, according to Price Matters® is the slope of an exponential growth function that closely tracks a real (inflation-adjusted) long term Index for that Asset Class. Distance from Trend is the distance of the trend line relative to the current index level expressed as a percentage.

Definitions:

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. Trend, according to Price Matters® is the slope of an exponential growth function that closely tracks a real (inflation-adjusted) long term Index for that Asset Class. Distance from Trend is the distance of the trend line relative to the current index level expressed as a percentage.

Treasury Bonds is represented by the Bloomberg US Treasury Index which measures the performance of the US Treasury bond market.

High-yield bonds (also called junk bonds) are bonds that pay higher interest rates because they have lower credit ratings than investment-grade bonds. High-yield bonds are more likely to default, so they pay a higher yield than investment-grade bonds to compensate investors.

An investment grade credit rating is a rating that indicates that a bond has a relatively low risk of default.

Market capitalization or "market cap" is a simple metric based on stock price. You can calculate a company's market cap by multiplying the number of its shares outstanding by the current price of a single share. A company with 50 million shares and a stock price of \$100 per share would have a market cap of \$5 billion.

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

A recession is a significant, widespread, and prolonged downturn in economic activity. A common rule of thumb is that two consecutive quarters of negative gross domestic product (GDP) growth indicate a recession. However, more complex formulas are also used to determine recessions.

When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios.

RiverFront Investment Group, LLC ("RiverFront"), is a registered investment adviser with the Securities and Exchange Commission. Registration as an investment adviser does not imply any level of skill or expertise. Any discussion of specific securities is provided for informational purposes only and should not be deemed as investment advice or a recommendation to buy or sell any individual security mentioned. RiverFront is affiliated with Robert W. Baird & Co. Incorporated ("Baird"), member FINRA/SIPC, from its minority ownership interest in RiverFront. RiverFront is owned primarily by its employees through RiverFront Investment Holding Group, LLC, the holding company for RiverFront. Baird Financial Corporation (BFC) is a minority owner of RiverFront Investment Holding Group, LLC and therefore an indirect owner of RiverFront. BFC is the parent company of Robert W. Baird & Co. Incorporated, a registered broker/dealer and investment adviser.

To review other risks and more information about RiverFront, please visit the website at riverfrontig.com and the Form ADV, Part 2A. Copyright ©2025 RiverFront Investment Group. All Rights Reserved. ID 4532745