WEEKLY MARKET COMMENTARY

March 10, 2025

WEEK IN REVIEW

Market indices closed the week lower as markets grappled with the timeframe surrounding tariffs and possible labor market softening.

- The S&P 500 declined by **-3.50%**
- The Dow Jones Industrial Average declined by **-2.65%**
- The tech-heavy Nasdaq declined by **-3.73%**
- The 10-Year Treasury yield closed at **4.32%**

Last week, several key economic indicators were released, providing valuable insights into the health of the economy. The ISM Manufacturing Purchasing Managers' Index (PMI) and Services PMI offered a snapshot of business conditions in the manufacturing and services sectors, respectively. The Manufacturing PMI was higher than forecasted at 52.7, indicating potential expansion in the manufacturing sector. In contrast, the Services PMI was lower than the previous reading at 51, suggesting a contraction in the services sector. The ADP Nonfarm Employment Change report showed a significant decline, coming in at about 50% lower than the previous reading at 77,000, giving an early indication of weakening private-sector employment trends. The initial jobless claims report provided a weekly update on the number of individuals filing for unemployment benefits, showing fewer filings than anticipated. Furthermore, the Average Hourly Earnings report from the Bureau of Labor Statistics provided insights into labor market conditions and wage growth, which increased by 0.3%.

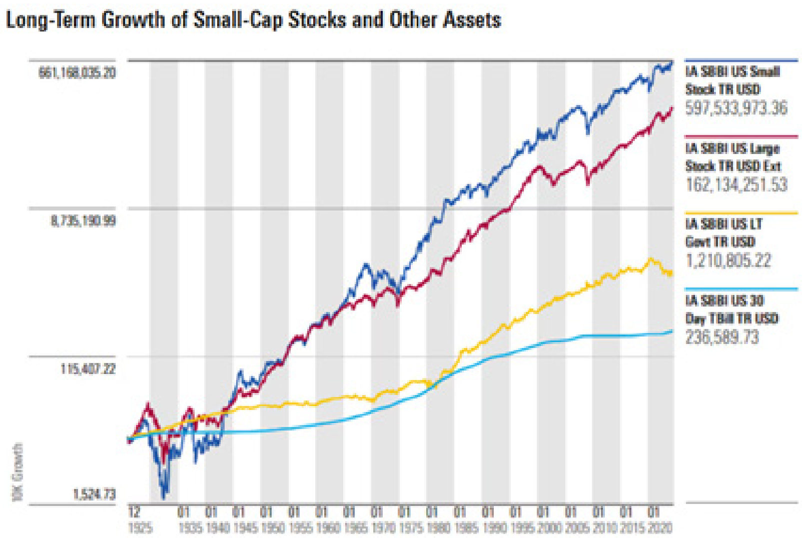
In the energy sector, the Baker Hughes Oil Rig Count was closely watched for insights into drilling activity and future production levels. Friday's reading showed no change from the previous reading. These indicators, along with the analysis of credit spreads, currency trends, and yield curve positioning, helped investors and policymakers assess the overall economic landscape and make informed decisions.

SPOTLIGHT

Small-cap Stocks - Premiums, Global Opportunities, and Recent U.S. Underperformance

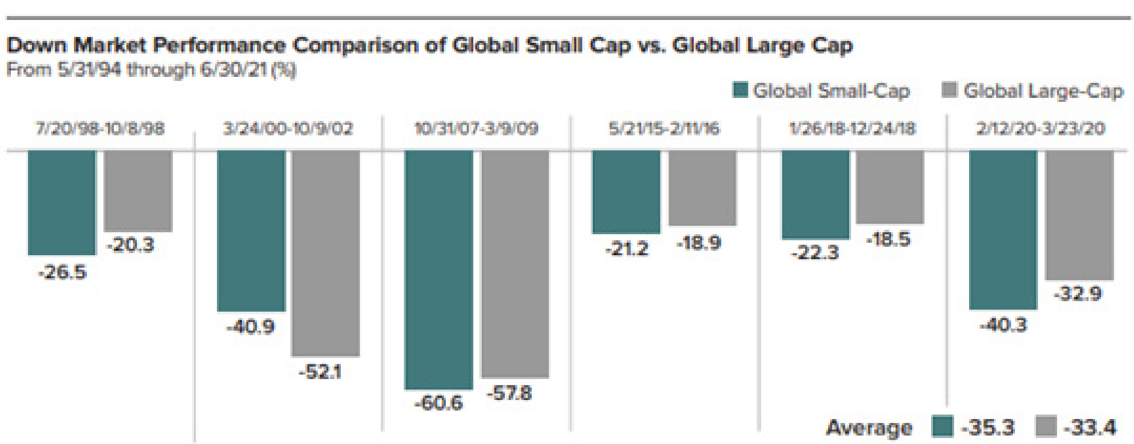
Small-cap stocks have been key to investment portfolios, offering growth and diversification. Historically, they have outperformed larger stocks, a fact often referred to as the size premium. However, they vary across sectors and regions, each with unique risk-reward profiles. This article explores small-cap investing, highlighting global opportunities and recent U.S. underperformance. Understanding these dynamics helps investors make informed decisions and strategically allocate assets for maximum returns.

The size premium is the higher expected returns associated with smaller companies compared to larger firms over extended periods. This phenomenon is supported by historical data dating back to at least 1998, demonstrating that smaller companies have yielded higher returns in both U.S. and non-U.S. markets. The persistence of the size premium remains even after accounting for invest-ability constraints, indicating that the premium is not merely a result of illiquidity or limited investment capacity. Additionally, academic research identifies a "sweet spot" within the mid-cap and low-size factors, which can be leveraged to construct more efficient portfolios. The robustness of the size premium across different regions and economic regimes, coupled with its validation through academic studies, underscores its significance as a critical factor in investment strategies.



Source: Arnott, "How to Use Small-Cap Stocks in Your Portfolio."

Consequently, when looking to allocate towards small-cap stocks, it's important to recognize that they are not a homogeneous group, as these stocks span various sectors and geographies, each with unique risk-reward profiles. Global small caps, in particular, present compelling risk-reward tradeoffs compared to large caps and emerging markets. Historically, global small caps have delivered higher returns than global large caps, averaging 8.5% versus 5.5% for 10-year periods. Additionally, they have exhibited lower volatility than emerging markets, making them an attractive option for investors seeking growth with manageable risk. Diversification across different countries helps mitigate some of the inherent volatility associated with small caps. Furthermore, international small caps have lower correlations with U.S. large caps, enhancing portfolio diversification and providing a buffer against domestic market fluctuations. However, global small caps are not free of risk, investors must often contend with deeper drawdowns in comparison to large caps. The graph below illustrates recent instances of significant drawdowns observed during periods of economic decline.



Source: Royce Research Financial Professionals, "Global Small-Caps: A World of Overlooked Opportunities."

Small-cap stocks are traditionally seen as procyclical, benefiting from economic upswings. However, their recent underperformance has defied this expectation. Despite periods of significant economic growth, such as in 2021 and the third quarter of 2023, where gross domestic product (GDP) growth was close to 5%, small caps have struggled. This is a stark contrast to their performance during the recovery from the Great Financial Crisis in 2009 and 2010. Over the past decade, the broad U.S. small-cap index has averaged a 6.5% annual return, significantly lower than the 11% return of the broad U.S. equity market. This underperformance, particularly in old economy sectors like financials and industrials, challenges the conventional wisdom that small caps always thrive in growth periods. Investors must now question these traditional rules and pay closer attention to the underlying fundamentals of small-cap stocks.

The recent underperformance of small-cap stocks presents a conundrum for investors. While historical performance suggests a disciplined approach to small-cap allocations, the ever-changing economic l andscape reminds us that past trends cannot predict future outcomes. Investors must carefully consider how they allocate to small-cap stocks, as these decisions could significantly influence future returns. By staying adaptable and informed, investors can navigate the complexities of small-cap investing and position themselves for long-term success.

WEEK AHEAD

The week starts slow with no new economic data on Monday, though it picks up quickly on Tuesday with the Job Openings and Labor Turnover Survey (JOLTS) report, which will provide an early glimpse into the labor market's strength and demand for workers. However, the week's main event is undoubtedly Wednesday's release of the latest Consumer Price Index (CPI) data. Investors and economists will be dissecting the numbers for any signs of changing inflationary trends, as these figures could significantly influence the Federal Reserve's upcoming policy decisions. It's important to note that any effects from recent tariff implementations are unlikely to be reflected in this particular CPI release.

Thursday brings the usual release of initial jobless claims and the Producer Price Index (PPI). The jobless claims data will be particularly interesting to monitor, especially after the surprising spike observed in the previous week. The PPI will offer additional insights into inflationary pressures building within the wholesale sector, complementing the CPI data and providing a more comprehensive view of the overall inflation landscape.

DISCLOSURES

Works Referenced:
Arnott, Amy C. “How to Use Small-Cap Stocks in Your Portfolio.” Morningstar, Inc., June 18, 2024. https://www.morningstar.com/portfolios/how-use-small-cap-stocks-your-portfolio.

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Oberoi, Raina, Anil Rao, Lokesh Mrig, Raman Aylur Subramanian, and MSCI Inc. “ONE SIZE DOES NOT FIT ALL.” MSCI.COM, 2016.
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The Dow Jones Industrial Average (DJIA) is a price-weighted index composed of 30 widely traded blue-chip U.S. common stocks. The S&P 500 is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy. The NASDAQ Composite Index is a market-value weighted index of all common stocks listed on the NASDAQ stock exchange.