Fed Rate Cuts Lead to U.S. Microcap Outperformance

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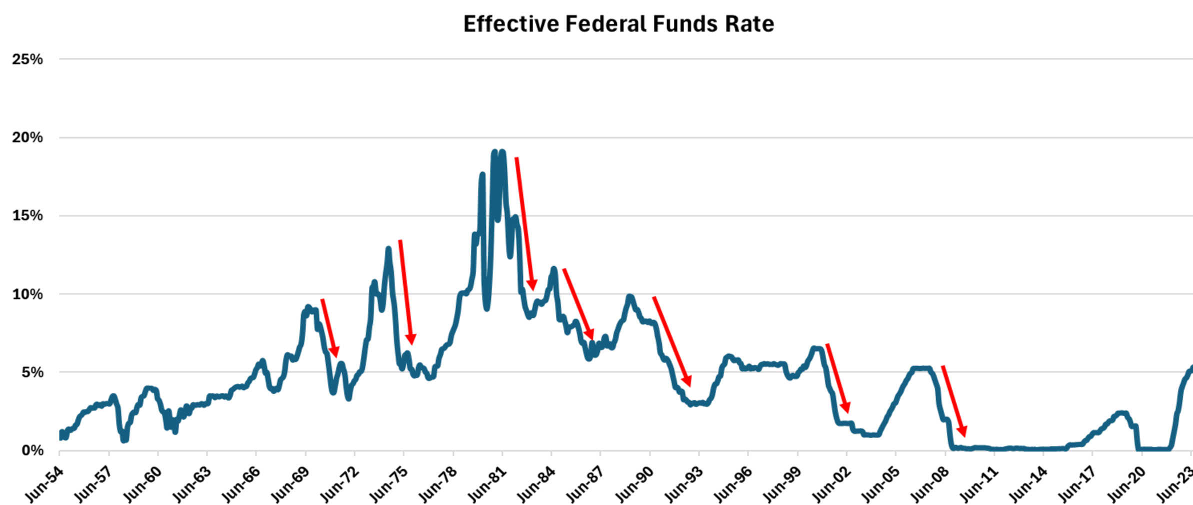
"When will the Federal Reserve begin cutting rates, and what will be the impact on my portfolio?" These have been two of the most critical questions facing investors of late. In terms of timing, one of the few guarantees in this business is that timing will never be perfect, so doing what you can to stack the odds in your favor is often the best alternative. In terms of impact, as microcap specialists we wanted to dig into how microcap has behaved historically during periods of interest rate cuts. As of this writing, the Fed's latest plan is to begin cutting rates this year, with an extended glidepath of cuts planned over the next few years. The current median long run (post-2026) target is sitting at 2.6%. Compared to the current Federal Funds target range (5.25% to 5.50%) – with the effective funds sitting at 5.33% – this implies roughly 2.73% of interest rate cuts over the next three years. Naturally, this leads to the question of which assets are poised to benefit from the upcoming easing cycle. As we demonstrate below, U.S. microcap has historically outperformed during similar rate cut cycles and there are additional economic and fundamental reasons why U.S. microcap is poised to benefit from this upcoming cycle of easing.

Historical Perspective

The Fed has been publishing their Federal Funds Rate since the middle of 1954. Over this 70-year period, there have been seven instances of rate cuts that fit the current glidepath (a -2.73% or more decline over 36 months). These seven instances are highlighted by the red arrows in the below graph, with the line indicating the effective federal funds rate.



Source: Acuitas Investments, Federal Reserve Bank of St. Louis

Methodology

One challenge when assessing how microcap has performed historically is the lack of historical and consistent index data. Afterall, the Russell Microcap Index has been around for less than two decades. One way that we can build a proxy for microcap performance is by using the Fama-French data library, which provides nearly a century of returns. From there, we can try to approximate what a microcap index would have looked like over time. To do this, we looked at what percentage of the market cap weighted Russell Indexes would fall into each Fama-French decile on 6/30/2023 (the last time Russell reconstituted their U.S. indexes), and then simulate historical returns using those weights.

Index's weight in each Fama-French Decile	Russell 1000 Index	Russell Microcap Index
FF Decile 1	76%	0%
FF Decile 2	13%	0%
FF Decile 3	6%	0%
FF Decile 4	3%	0%
FF Decile 5	1%	1%
FF Decile 6	0%	0%
FF Decile 7	0%	5%
FF Decile 8	0%	26%
FF Decile 9	0%	42%
FF Decile 10	0%	26%

Source: Kenneth French data library, FTSE Russell, FactSet, Acuitas Investments. As of June 30, 2023.

For example, on 6/30/2023, 26% of the Russell Microcap Index fell within the smallest Fama-French decile, 42% fell within decile 9, and another 26% in decile 8. For the Large Cap Russell 1000, 76% of the Index fell within the top Fama-French Decile, another 13% in decile 2, and so on. While not perfect, this gives us a decent approximation of how modern-day market cap weighted indexes would have performed throughout history using the Fama-French framework.

Microcap Has Outperformed Historically

The table below shows how these two approximated indexes performed on average during these seven historical periods of rate cuts. During these periods, on average microcap outperformed large cap across the board. This relationship holds whether we look at the period from peak rates (i.e. the beginning of cuts) to trough (the end of cuts), 24 or 36 months from the peak, and 24 or 36 months from the trough.

Microcap vs Large Cap Performance During Rate Cuts

	Peak to Trough	24m From Peak	36m From Peak	24m From Trough	36m From Trough
Micro	27.5%	19.2%	35.9%	27.8%	46.4%
Large	21.2%	17.4%	32.8%	22.7%	42.6%
Delta	6.3%	1.7%	3.1%	5.1%	3.8%

Source: Acuitas Investments, Kenneth French data library, FactSet, FTSE Russell.

Of course, microcap has outperformed large over the long run (the “small cap premium”), and there have been periods of rate cuts where large cap outperformed micro (hit rate is not 100%). Additionally, the magnitude of the current rate cut path is quite mild on an absolute basis relative to many of the prior rate cuts. That said, the above provides a pretty decent baseline of evidence for us to work with. The post trough outperformance of microcap also implies that the positive impact on microcap stocks is sustained for a period beyond the immediate easing cycle. In our view, while it is no surprise to see that microcap has outperformed large cap during periods of easing in the past, the key driver of where we go from here remains the specific economic

conditions that are driving the rate cuts along with the impact of cuts on small company fundamentals.

Economic and Fundamental Drivers of Microcap Outperformance

On the economic front, this round of upcoming rate cuts is directly tied to the inflation picture in the U.S. As inflation declines, cuts will follow. A reduction in inflation will improve the broader macroeconomic picture and growth prospects for companies. This should drive an increase in investors' appetite for risk assets, which should correspond to greater flows into smaller stocks. Additionally, a more favorable financing environment should provide a tailwind to merger and acquisition activity, which disproportionately benefits microcap over all other market cap tiers (more takeouts occur in microcap, and the premiums paid are far greater).

Floating Rate % Of Total Debt *(ex-Financials)*	
Russell Microcap	50.4%
Russell 1000	10.8%

Source: Acuitas, FactSet, FTSE Russell

In terms of company fundamentals, there are significant reasons why rate cuts benefit microcap companies more than the rest of the market. Excluding the financials sector, over 50% of all debt held across companies in the Russell Microcap Index has a floating rate, which is almost five times more than it is for companies in the Russell 1000 Index (10.8%). This is due to the challenges that smaller companies face when raising financing relative to their larger peers. Rates being cut in half – which is the current long-term projection – would provide significant financial relief for small companies, allowing them to reroute capital that was earmarked for interest payments towards more growth-oriented capital expenditures. Additionally, for the roughly 50% of debt held by smaller companies that is not floating rate, it tends to have shorter-term maturities which further amplifies their sensitivity to changes in interest rates. Shorter maturity debt needs to be refinanced at a greater frequency, which allows these companies to take advantage of periods where rates are declining. Last, credit spread cycles also have a compounding effect on interest rate moves for microcap stocks. As the Fed begins to ease we often see credit spreads decline, which can be a positive for small stocks. In this case, credit spreads have already contracted significantly from their peak, highlighting reduced fear in the market. This spread contraction has historically resulted in the leadership of small stocks but has yet to materialize for a sustained period. We believe that smaller companies are more appealing to investors in this environment and that these factors further enhance the prospects for small stocks.

Key Takeaways

When a declining interest rate environment and favorable economic trends are combined with depressed valuations for microcap and extended valuations for large cap, the explosive potential for microcap outperformance presents a compelling and unusually timely opportunity for investors. While it was perhaps a premature market reaction, we saw early evidence of this coiled spring effect in the fourth quarter. The November 14 inflation report showed a surprise slowdown in inflation, which investors interpreted as a sign the Federal Reserve would be done with their tightening cycle and could begin easing ahead of schedule. The Russell Microcap Index responded accordingly and gained 5.4% on the day, significantly outperforming the 2.1% return

for the Russell 1000 Index. This scenario repeated itself in December when the Fed's December 13 comments – which indicated three potential rate cuts in 2024 – caused the Russell Microcap Index to gain 3.8% on the day and an additional 2.3% on December 14, well ahead of the Russell 1000 Index returns of 1.5% and 0.5%, respectively. Additional forward-looking catalysts that favor microcap include muted impacts from geopolitical issues relative to large cap, the onshoring of supply chains, infrastructure spending, and the M&A environment. Analyst estimates within small and microcap are providing additional optimism, with strong earnings growth expectations throughout 2024. Combined with the backdrop of attractive microcap valuations and the potential for upcoming interest rate cuts, we continue to pound the table that allocators will be rewarded for microcap exposure.

Past performance is not a guarantee of future returns. Investing in securities involves risk of loss that investors should be prepared to bear. Investments in small and microcap companies may be less liquid and prices may fluctuate more than those of larger, more established companies.

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