Small/Mid Cap Strategy Year Ahead

2024: Small caps are just getting started

Small Cap

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Small/Mid Cap Research
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View Transcript

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More outperformance likely: 5 reasons to buy SMID caps

We believe the small cap leadership that began in 4Q is far from over – and think that 2024 could be the first year that small beats large in almost a decade (since 2016). 1) Profits are bottoming – small typically wins (and profits matters more for relative returns than GDP). 2) Macro support: Fed cuts, less rate risk and key SMID cap macro indicators are inflecting. 3) Improving breadth: small caps have historically led following narrow markets (and 2023 was a record breaking year for bad breadth). 4) 25% valuation mean revision opportunity: small caps are the only size segment that's still cheap…and trade at a remarkable 25% historical discount to large caps. 5) Less risk for the biggest parts of small (BofA analysts have gotten more optimistic on Banks, Biotech etc.). Bonus: election years tend to see double-digit small cap returns and outperformance vs large.

But stick with Value/SMEARNERS, not low quality/growth

We favor Value>Growth (profits recovery, Fed cuts, cheaper, higher quality). And stick with SMEARNERS – small cap earners that have less duration risk – and cash return strategies (which tend to fare well in both downturns/recoveries). Cyclicals (led by Energy & Financials) outrank defensives in our work (Utilities/Real Estate weakest). Health Care looks better than a year ago (better rank in quant work, M&A pick-up, light positioning) – but its historically low quality exposure keeps it from being among our favored areas.

Contrary to belief, 'buy small caps' isn't already consensus

While sentiment has gotten more bullish on small caps - evidenced in flows and investor surveys – we see more room to run, with fund positioning in small caps just beginning to rise off historic lows and last year's fund flows only offsetting the prior year's outflows.

And a bad January doesn't necessarily mean a bad year

Despite Jan. effects previously evident, small more frequently lags large in Jan. in recent decades; "As goes Jan, so goes the year" for small vs large is also no longer consistent.

We like mid caps, too – but less upside on valuation

Mid caps have historically performed similarly to small caps following periods of narrow breadth, profits troughs and when the Fed has started cutting. Flows have not yet begun to recover here. But we see less upside on valuation (expensive vs. history and vs. small).

Risks to watch: rates/refi risk, VIX, goods vs. services

Refinancing remains the biggest risk for small caps if rates were to stay high. We see risks largely priced in at the index level, but sectors like Real Estate remain at risk. A reversal in services vs. goods spend would be a headwind, as would a 2H VIX pickup.

Other themes: M&A, capex, Election 2024

While a broad-based M&A pick-up is likely challenged (see inside), a recent pick-up in deals in several key areas like Health Care could continue, helping sector returns. We see continued support for capex (US Strategy Year Ahead), benefiting small>large, especially SMID Industrials/Tech. Also inside: a historical guide to small caps and elections.

Small Cap 2024 Year Ahead Outlook

We believe the outperformance of small vs. large caps that began in 4Q is not over yet – and expect small to beat large for the first year since 2016. Key reasons follow – plus: our SMID cap investor's roadmap to styles, sectors, and themes in 2024.

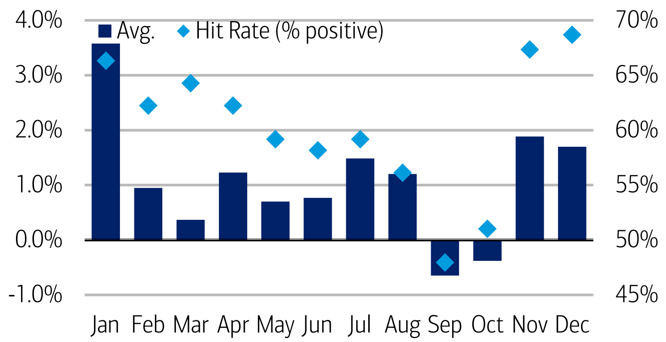
First, one elephant in the room: what about the Jan effect?

Weak January no longer a harbinger of doom

Perhaps because investors began to anticipate it, the "January effect" in small caps has no longer been evident in recent decades. Much ado was made of the fact that small caps outperformed large caps in January with a 70%+ hit rate since 1926. But this effect has waned, with small caps outperforming in <50% of January months since 1979 and only 40% of January months over the last 10 and 20 years. Similarly, the rule "As goes January, so goes the year," also failed to exhibit consistent results in recent decades for small vs. large caps.

Exhibit 1: Over the long term, small caps have seen the higher average performance in January...

Small cap total returns by month: 1926-present (based on Russell 2000 index since 1979 and CRSP small cap returns 1926-1978)



Source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: CRSP, Bloomberg, BofA US Equity & US Quant Strategy

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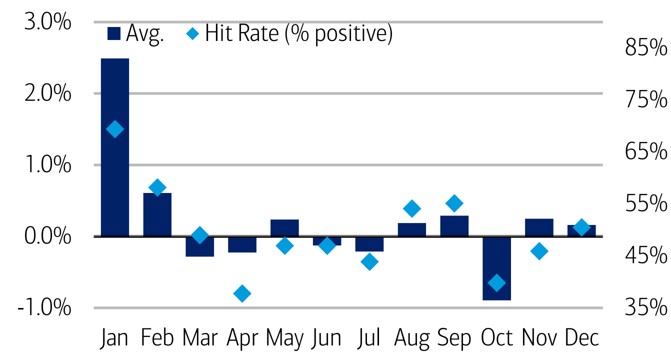
Exhibit 2: Since 1929, small cap January effect appears to be effective

Relative total return performance of small caps vs. large caps by month, 1926-present (based on Russell 2000 vs. Russell 1000 index since 1979 and CRSP small vs. large cap returns 1926-1978)



Source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: CRSP, Bloomberg, BofA US Equity & US Quant Strategy

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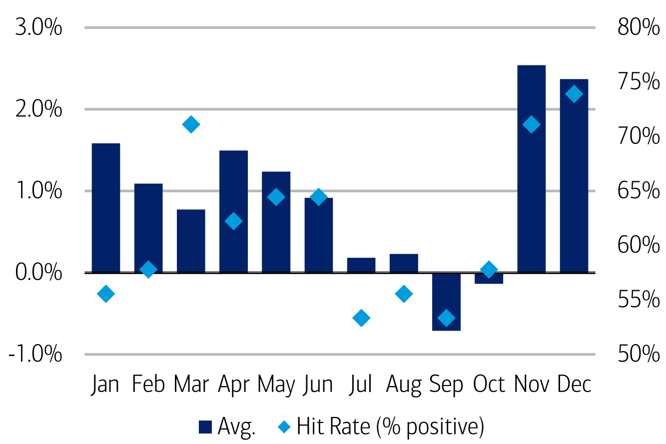
Exhibit 3: January no longer the strongest month for small caps when considering the last four decades' data

Russell 2000 total return performance by month, 1979-present



Source: Bloomberg, BofA US Equity & US Quant Strategy

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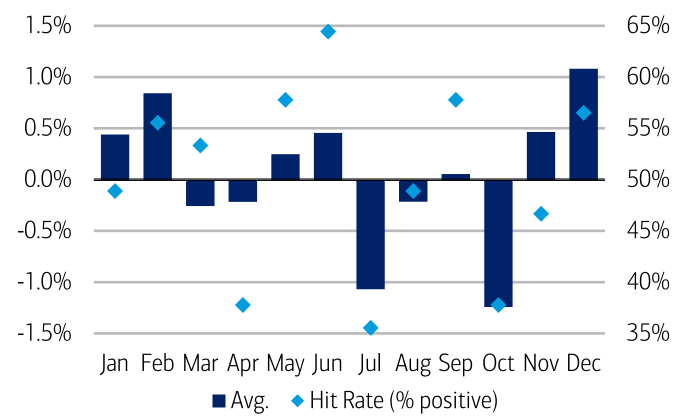
Exhibit 4: Since 1979, small caps have outperformed in January less than half of the time

Relative total return performance of Russell 2000 vs. Russell 2000 by month, 1979-present



Source: Bloomberg, BofA US Equity & US Quant Strategy

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Exhibit 5: Small caps typically outperformed for the year when they outperformed in January, but this hasn't held up over the past two decades
Relative performance of small vs. large for the full year based on what happened in January: 1926-present and shorter time frames

	Relative Full-Year Performance of Small vs. Large Caps				
When small outperformed large	**Full history (since 1926)**	**Last 40 years**	**Last 30 years**	**Last 20 years**	**Last 10 years**
Avg	6%	2%	2%	-1%	-4%
Median	3%	2%	3%	1%	-6%
Hit Rate	60%	61%	62%	50%	20%
	Relative Full-Year Performance of Small vs. Large Caps				
When small underperformed large	**Full history (since 1926)**	**Last 40 years**	**Last 30 years**	**Last 20 years**	**Last 10 years**
Avg	-4%	-3%	-3%	0%	-2%
Median	-5%	-5%	-5%	-2%	-5%
Hit Rate	38%	32%	29%	33%	20%
	Relative Full-Year Performance of Small vs. Large Caps				
All years since 1926	**Full history (since 1926)**	**Last 40 years**	**Last 30 years**	**Last 20 years**	**Last 10 years**
Avg	3%	-1%	-1%	-1%	-3%
Median	1%	-1%	-1%	-1%	-6%
Hit Rate	52%	43%	41%	36%	17%

Based on Russell indices since 1979; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: CRSP, Bloomberg, BofA US Equity & US Quant Strategy

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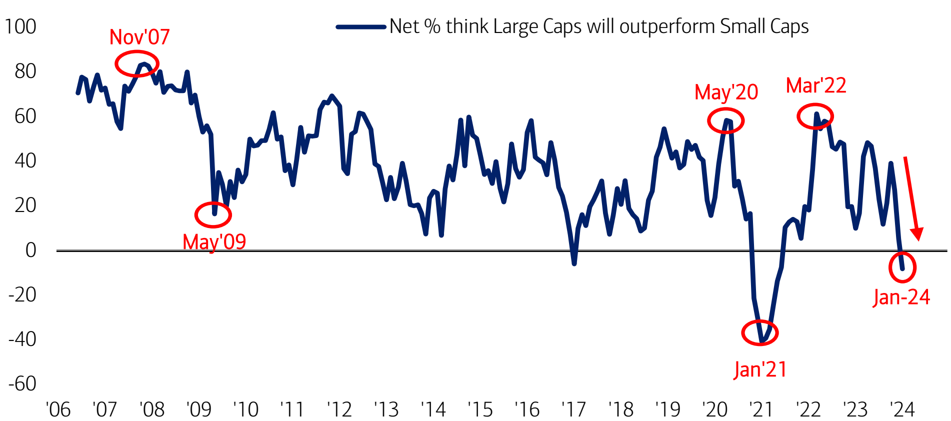
Elephant #2: "isn't 'buy small caps' already consensus?

Sentiment in small caps is improving - but investors are still underweight

As Savita Subramanian highlights in Five FAQs, falling cash yields have historically led to more money being allocated to equities, and both institutional and individual investors are sitting on high cash levels. And the area where investors are still significantly underpositioned is small caps.

Positioning and flows have certainly gotten more positive, but it's early innings – the latest Global Fund Manager Survey now suggests that investors expect small caps to outperform large caps over the next 12 months – but this is the first time they are more relatively bullish on small since 2021. 2023 also saw small cap inflows based on both EPFR Global fund flows data and BofA Equity Client flows– but EPFR small cap fund flows in 2023 as a percentage of market cap barely offset the prior year's outflows (and mid cap flows have remained persistently negative), while BofA client flows into small caps as a percentage of market cap were positive for the last two years, but much lesser than large cap flows. And importantly, multi-cap fund managers remain persistently underweight small caps, with positioning up just slightly off of record lows as of 4Q.

Chart 6: For the first time since Jun'21 large caps expected to underperform small caps
Net % FMS investors who think large caps will outperform small caps in the next 12 months



Source: BofA Global Fund Manager Survey

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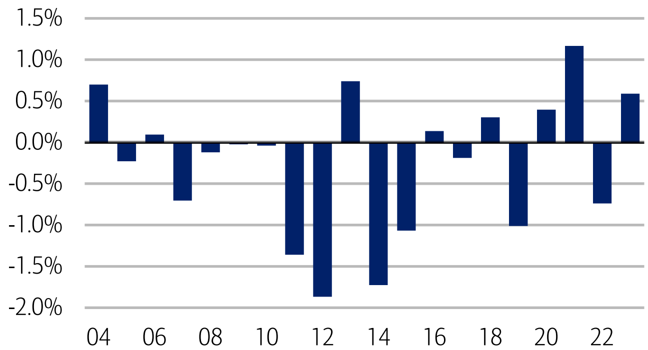
Exhibit 7: Small cap '23 inflows barely offset the prior year's outflows
US small cap fund flows, 2004-2023 by year as a % of market cap



Source: EPFR Global

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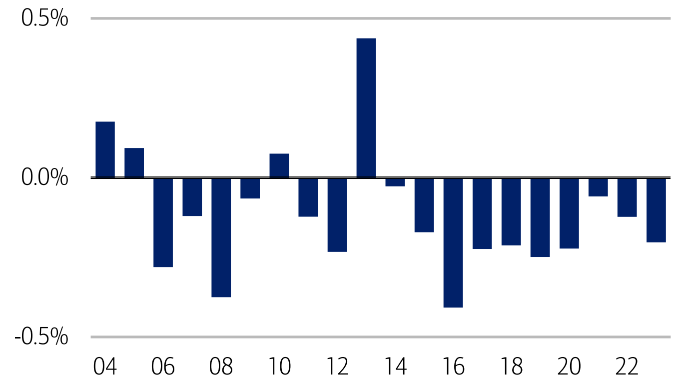
Exhibit 8: Flows remain persistently negative for mid caps
US mid cap fund flows, 2004-2023 by year as a % of market cap



Source: EPFR Global

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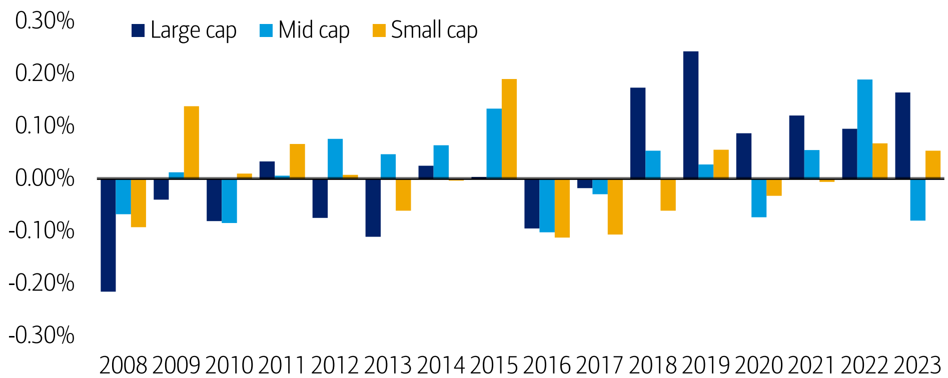
Exhibit 9: BofA clients have been net buyers of small caps the last two years, but flows as a % of market cap have paled in comparison to large cap flows as a % of market cap
BofA Securities Client flows into large vs. mid vs. small caps by year as a % of market cap, 2008-2023



Source: BofA Securities

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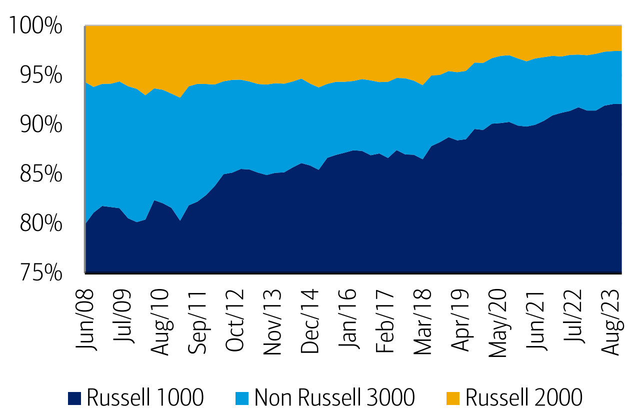
Exhibit 10: Small caps have been a shrinking share of active holdings
% of multi-cap manager holdings by size segment, 2Q08-4Q23



Source: FactSet, BofA US Equity & US Quant Strategy

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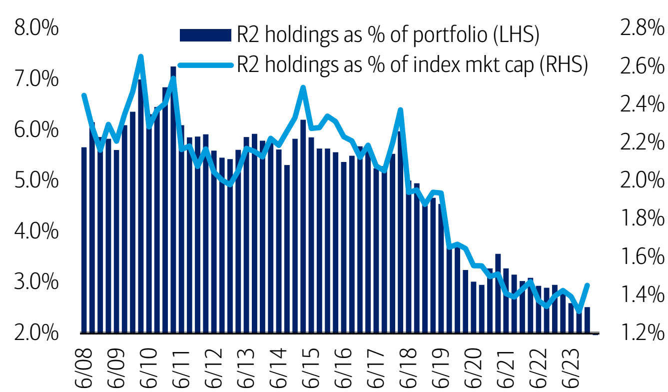
Exhibit 11: Multi-cap funds' positioning in small caps is just off record lows
Multi-cap managers' holdings of Russell 2000 stocks as a percentage of total portfolio holdings and as a percent of Russell 2000 market cap, 2Q08-4Q23



Source: FactSet, BofA US Equity & US Quant Strategy

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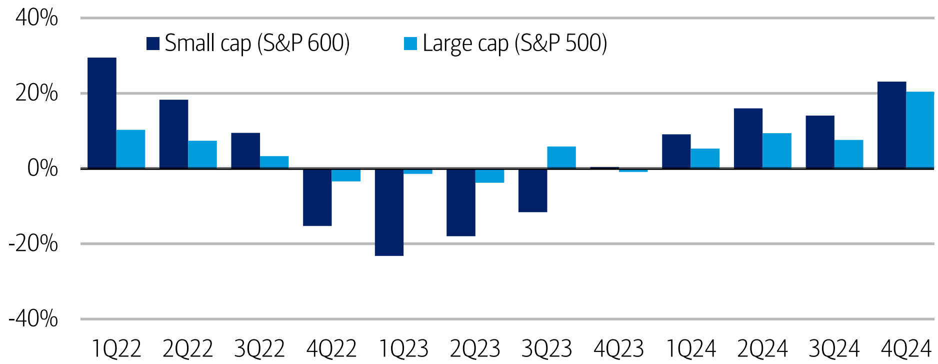
Key reasons to overweight small caps

Earnings recovery backdrop bullish for small caps

Earnings recession now behind us? Faster earnings growth expected in small

We expect overall corporate profits to have bottomed in 2023. While large cap profits growth already turned positive in 3Q23 YoY, small cap profits growth is expected to turn positive in 4Q23 and outpace large cap profits growth for the remainder of the year.

Exhibit 12: Small caps expected to see better earnings growth than large caps from 4Q23-4Q24
Quarterly y/y bottom up EPS growth trajectory for S&P 600 vs S&P 500 (Consensus estimates 3Q23 onward)



Source: BofA Equity & Quant Strategy, FactSet

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Historically, the turn in large cap profits growth has been followed by the turn in small cap profits growth, typically with a one quarter lead.

Exhibit 13: Large vs. small cap profits cycles are correlated, with a one-quarter lead
Correlation between S&P 500 LTM YoY earnings growth and Russell 2000 ex-outliers LTM YoY earnings growth, 1986-present

	Correlation: large vs. small cap profits growth
2qtr lead	0.55
1qtr lead	0.57
Coincident	0.52
1 qtr lag	0.37
2 qtr lag	0.27

Source: FactSet, BofA US Equity & Quant Strategy

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Exhibit 14: Russell 2000 LTM profits growth typically troughs 1-2 quarters after S&P 500 LTM profits growth troughs
S&P 500 trailing YoY profits growth troughs and time until Russell 2000 profits growth (incl./excl. outliers) troughed, 1988-present

	Number of subsequent qtrs until small cap profits growth trough	
S&P 500 profits growth trough	R2000	R2000 ex-outliers
2Q90	1	2
4Q91	0 (same)	0 (same)
1Q99	3	3
1Q02	4	4
4Q09	-1	-1
3Q16	4	2
4Q20	1	0
Avg.	1.7	1.4
Median	1.0	2.0

Source: FactSet, BofA US Equity & Quant Strategy

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Profits backdrop matters more for small vs. large than GDP backdrop

As highlighted in the US Equity Strategy Year Ahead, the best environment for equities historically has been in backdrops of accelerating EPS growth but decelerating GDP growth (an environment we/our economists forecast for 2024). While less common than when EPS and GDP growth are both improving/deteriorating (13% of all quarters since 1950), small cap returns have been strongest in these backdrops (+19% on avg. with positive returns 87% of the time; Exhibit 15) – similar to the case with S&P 500 returns.

And interestingly, whether corporate profits are accelerating or decelerating matters more for small vs. large cap relative returns than whether GDP is accelerating or decelerating (Exhibit 16): small caps have outperformed large caps by a wider (and similar ~5ppt) margin in accelerating profits backdrops regardless of whether GDP growth was improving/deteriorating; this compares to ~3ppt of outperformance during decelerating profits backdrops in both accelerating and decelerating GDP backdrops. And the widest margin of outperformance was in accelerating profits with decelerating GDP.

Exhibit 15: Accelerating profits growth despite slowing GDP growth has been the best environment historically for small cap returns
Small cap YoY performance based on EPS and GDP growth backdrops (1950-3Q23)

	Accelerating EPS growth		Decelerating EPS growth	
Small cap returns	**Decel. GDP**	**Accel. GDP**	**Decel. GDP**	**Accel. GDP**
% occurrence	13%	35%	41%	11%
Avg. return	19.0%	15.7%	8.6%	14.4%
Median return	17.8%	17.2%	9.0%	16.3%
Hit rate	87%	75%	63%	82%

Note: Corporate profits backdrop based on S&P 500 EPS growth. Returns based on Russell 2000 from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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Exhibit 16: Profits backdrop has mattered more than GDP backdrop for small vs. large cap returns (and where accelerating EPS with decelerating GDP has seen best historical relative returns)
Small vs. large cap relative YoY performance based on EPS and GDP growth backdrops (1950-3Q23)

	Accelerating EPS growth		Decelerating EPS growth	
Small vs. large returns	**Decel. GDP**	**Accel. GDP**	**Decel. GDP**	**Accel. GDP**
% occurrence	13%	35%	41%	11%
Avg. return	5.3%	5.2%	2.8%	2.9%
Median return	4.5%	3.8%	1.5%	0.5%
Hit rate	61%	64%	53%	55%

Note: Corporate profits backdrop based on S&P 500 EPS growth. Based on Russell 2000 from 1979-present for small caps and S&P 500 for full history for large caps; source for historical small cap returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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Exhibit 17: Small caps typically outperform large caps after US corporate profits growth troughs
Relative performance of small vs. large caps around US corporates profits growth troughs (based on S&P 500 quarterly YoY EPS for profits), 1952-present

Trough Date	-12m	-6m	-3m	+3m	+6m	+12m
Jun-52	-10%	-5%	-4%	1%	-3%	3%
Sep-58	6%	5%	4%	1%	11%	6%
Jun-61	6%	11%	0%	-6%	-8%	-8%
Dec-70	-14%	7%	-4%	11%	8%	6%
Sep-75	13%	4%	0%	-4%	13%	11%
Mar-81	26%	4%	6%	5%	-4%	-4%
Mar-83	12%	16%	7%	9%	2%	-8%
Dec-86	-15%	-11%	-5%	2%	-5%	-16%
Dec-91	13%	-1%	-3%	10%	0%	9%
Dec-98	-31%	-16%	-5%	-10%	-3%	0%
Mar-02	14%	15%	4%	5%	0%	-2%
Sep-09	-3%	10%	4%	-2%	1%	3%
Jun-16	-11%	-2%	1%	5%	11%	7%
Sep-20	-15%	0%	-4%	19%	29%	18%
Avg	**0%**	**3%**	**0%**	**3%**	**4%**	**2%**
Median	**2%**	**4%**	**0%**	**4%**	**1%**	**3%**
Hit Rate	**50%**	**64%**	**43%**	**71%**	**64%**	**64%**

Note: Based on Russell indices for from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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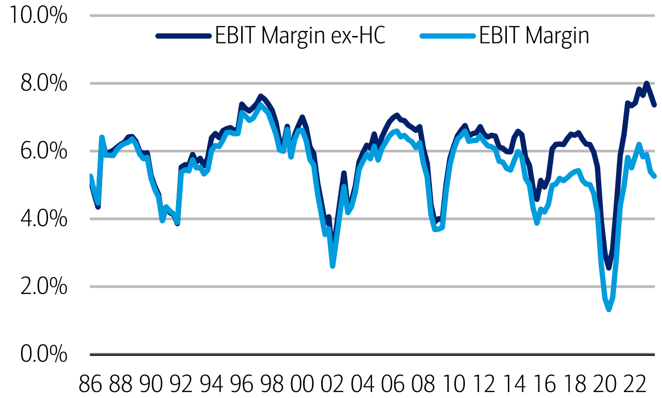
Room for margin expansion

Small cap margins have held up despite the strongest inflationary backdrop since the 70s/80s: EBIT margins ex-Health Care are just off record highs, despite the recent drop in sales growth. Easing inflation and a sales/profits recovery should support margin expansion. Additionally, small cap net margins have less downside risk from peak globalization vs. large cap margins, where offshoring was one of the biggest drivers of the secular expansion in S&P 500 net margins in recent decades.

Our review of earnings season commentary last quarter suggests that small caps are also using artificial intelligence (AI) for both top-line improvements (customer experience, product quality, etc.) and efficiency/productivity (automation, optimize inventory planning, etc.)

Exhibit 18: Small cap EBIT margins are still just off record highs ex-Health Care and have able to sustain high inflation
Russell 2000 non-Financials aggregate EBIT margins, 1986-3Q23



Source: FactSet, BofA US Equity & US Quant Strategy

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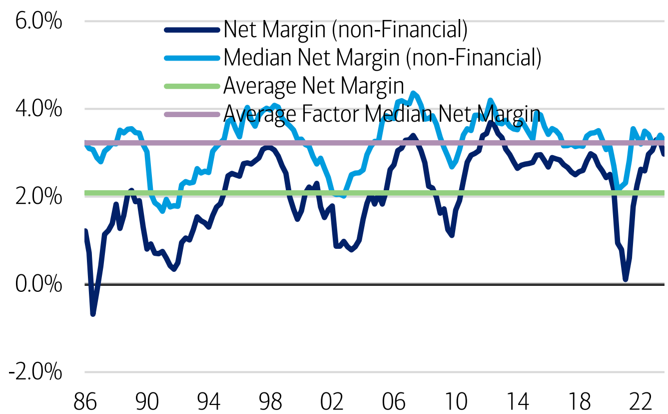
Exhibit 19: Small cap net margins cyclically but not secularly elevated
Russell 2000 quarterly aggregate net and median net earnings from 4/30/1986 – 10/31/2023



Source: FactSet, BofA US Equity & US Quant Strategy

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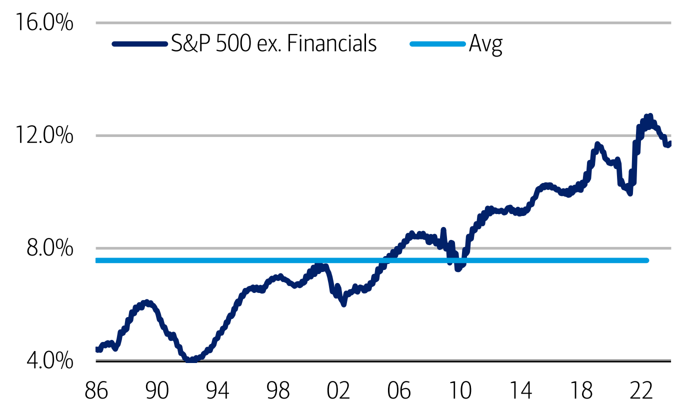
Exhibit 20: Large cap net margins coming off secular peaks
S&P 500 monthly aggregate net margins ex. Financials from 4/30/1986 – 12/31/2023



Source: FactSet, BofA US Equity & US Quant Strategy

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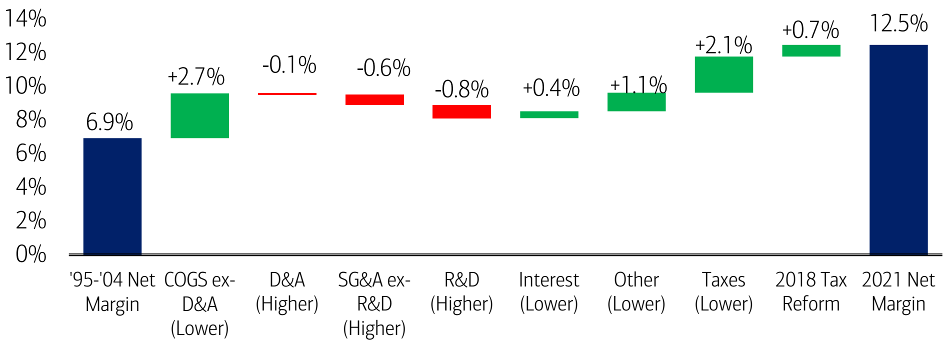
Exhibit 21: Offshoring (lower taxes/lower labor costs) were key benefits to large cap margins
S&P 500 ex-Fins change in net margin contribution from 1995-04 to 2021



Source: FactSet, BofA US Equity & Quantitative Strategy

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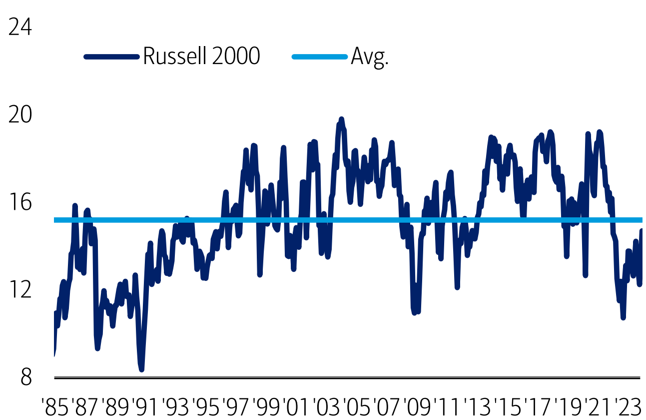
Valuations still have upside

Small caps are the only size segment that's still cheap - and very cheap vs large

For much of 2023, small caps continued to price in a recession that (so far) hasn't surfaced: the Russell 2000's Oct. lows were 33% below the late 2021 peak, in-line with the typical 35% peak-to-trough decline around recessions. But ultimately, with a 4Q rally, multiple expansion drove returns, and valuations across size segments ended the year at their highest levels since early 2022. Yet small caps remain the only size segment that is historically cheap, with the Russell 2000 trading 3% below its long-term average forward P/E by nearly 30% above average for large caps and 13% above for mid caps. And the relative P/E of small vs. large caps was roughly flat on the year, trading 25% below its historical average – suggesting continued catch-up opportunity for small caps.

Exhibit 22: Small cap forward P/E still below the long-term average
Forward P/E: Russell 2000, 1985-12/31/2023



Source: BofA US Equity & Quant Strategy, Russell Investment Group, I/B/E/S, Compustat

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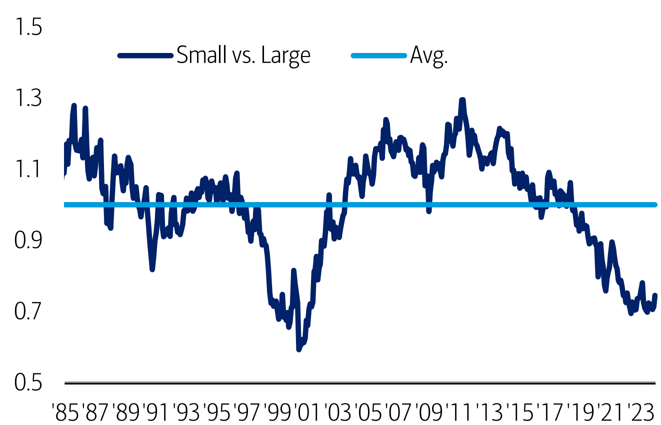
Exhibit 23: Small caps remain very historically cheap vs large caps
Relative Forward P/E: Russell 2000 versus Russell 1000, 1985-12/31/2023



Source: BofA US Equity & Quant Strategy, Russell Investment Group, I/B/E/S, Compustat

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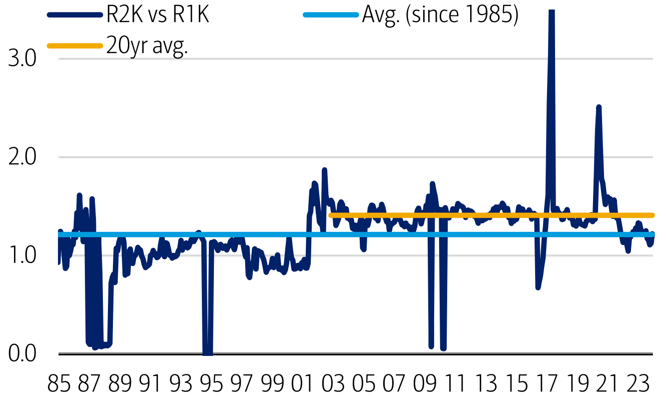
Exhibit 24: Even when including non-earners/outliers, small caps aren't historically expensive vs. large caps (trade 10% below 20yr avg. and in-line with 40yr avg.)
Relative Forward P/E (including nonearners and outliers), 1985-12/31/2023



Source: BofA US Equity & Quant Strategy, FactSet
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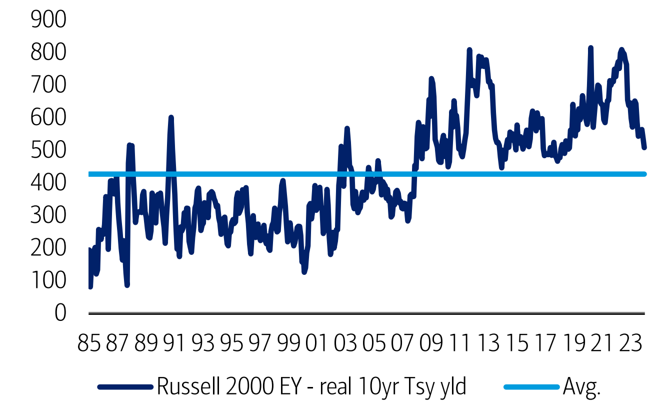
Exhibit 25: Small cap equity risk premium remains still above history but starting to normalize
Russell 2000 forward earnings yield – real 10-year Treasury yield (1985-12/2023)



Source: FactSet, Bloomberg, BofA US Equity & Quant Strategy
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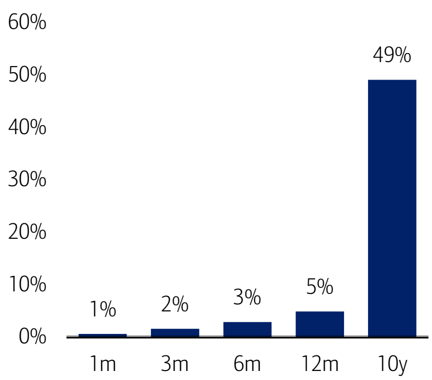
Valuations implying annualized long-term returns of +10% for R2000

Valuations have a higher predictive power on long-run than short-run returns, particularly over a 10-year horizon. Today, P/E multiples continue to imply an attractive return backdrop for the Russell 2000: +10% annualized returns over the next decade, vs. just 3% for the Russell 1000 (see: valuations note). And the last time relative multiples for small vs. large were this low were during the Tech Bubble, following which we saw a great return decade for small caps relative to large caps.

Exhibit 26: Valuations have the highest explanatory power over long-term (ten-year) returns
R^2 of relative forward P/E vs subsequent return spread over various time horizons (since 1985): Russell 2000 vs Russell 1000, as of 12/31/2023



Note: Represents the relationship between the relative forward PE for the Russell 2000 vs the Russell 1000 (since 1979) and subsequent rolling returns differential **Source:** BofA US Equity & Quant Strategy, FactSet
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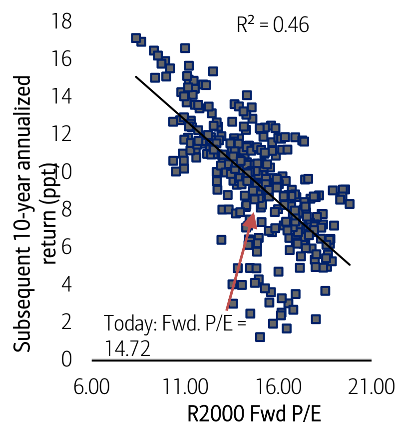
Exhibit 27: The absolute forward P/E for the Russell 2000 suggests double-digit annualized ten-year returns
Russell 2000 forward P/E vs subsequent ten-year annualized returns, 1985-present (as of 12/31/23)



Source: BofA US Equity & Quant Strategy, FactSet
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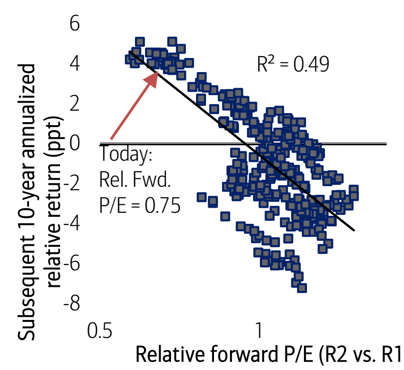
Exhibit 28: Relative multiple suggests that small caps could outperform large caps over the next ten years
Relationship between relative fwd. P/E of Russell 2000 vs Russell 1000 and subsequent 10yr annualized relative returns, 1985 – 12/31/2023



Note: Represents the relationship between the relative forward PE for the Russell 2000 vs the Russell 1000 (since 1979) and subsequent rolling 10-year annualized returns differential.
Source: BofA US Equity & Quant Strategy, FactSet
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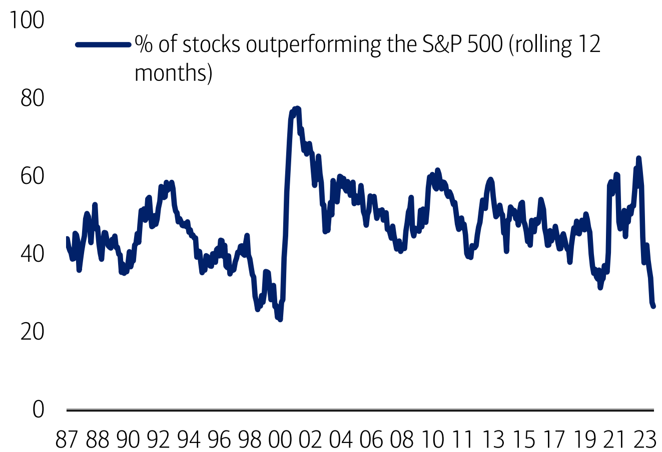
Improving market breadth = bullish for small caps

2023 was the worst year for S&P 500 market breadth in history (just 27% of stocks outperforming the index), and on a rolling 12-month basis, market breadth was near record lows (Exhibit 29). Improving breadth from here (which we expect in 2024 – see US Equity Strategy Year Ahead) should be bullish for small caps, and historically, small cap have outperformed over the next 12 months following periods of very low market breadth (Exhibit 30).

Exhibit 29: Market breadth hit extreme lows in 2023...
% of stocks outperforming the S&P 500 over 12mos, 1987-12/31/23



Source: FactSet, BofA US Equity & Quant Strategy

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Exhibit 30: ...which should be bullish for small caps in 2024
Relative performance of Russell 2000 vs. Russell 1000 over the next 12 months following periods of narrow market breadth (<1 or <2 standard deviations below avg. since 1987)

	Small vs. large N12m rel. perf.		
	Avg.	**Median**	**Hit Rate**
Narrow breadth (<1 st. dev.)	4.0%	2.7%	55%
Very narrow breadth (<2 st. dev.)	9.5%	7.1%	73%
All 12m periods	-0.3%	-0.5%	48%

Source: FactSet, BofA US Equity & Quant Strategy

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Macro: key indicators now bottoming/improving

The macroeconomic indicators that have been most highly correlated with small cap absolute and relative performance have all been bottoming or improving – PMIs (more below), leading indicators, consumer sentiment and small business optimism.

And of the most negatively correlated indicators, most have also improved: the net % tightening lending standards in the Senior Loan Officer Survey declined in the latest survey from recent highs, high yield (HY) spreads have continued to narrow (though ticked up slightly in recent weeks), and the VIX has come down to low levels (though also ticked up so far this month).

Exhibit 31: Credit conditions, credit spreads and the VIX are the three most negatively correlated macro indicators with small vs. large performance; PMIs, leading indicators and consumer sentiment are most positively correlated
Historical absolute & relative perf. correlations of Russell 2000 vs. macro variables since 1979 (or longest available history as noted), ranked from most positive to most negative correlations with relative returns

	Rel. Perf. (R2 vs. R1)	Absolute Perf. (R2)		R1 Absolute Perf.
Indicator	**Correlation**	**Correlation**	**Data since**	**Correlation**
US Markit PMI	0.72	0.37	5/31/2008	0.71
ISM Mfg.	0.41	0.55	12/31/1979	0.45
OECD Leading Indicator	0.38	0.69	12/31/1979	0.65
ISM Non-Mfg	0.34	0.67	7/31/1998	0.61
UMich Consumer Sentiment	0.30	0.51	12/31/1979	0.42
CRB Index	0.29	0.34	12/31/1979	0.26
NFIB Small Biz Optimism	0.27	0.51	1/31/1987	0.44
Housing starts	0.26	0.46	12/31/1979	0.44
Conf Board Consumer Confidence	0.19	0.47	12/31/1979	0.51
WTI Oil	0.17	0.22	12/31/1979	0.20
10yr Tsy Yld	0.15	0.00	12/31/1979	-0.04
Yield Curve (10yr-2yr)	0.14	0.02	12/31/1979	-0.10
US Dollar Index (DXY)	0.14	-0.04	12/31/1979	-0.10
Nominal US GDP	0.12	0.26	12/31/1979	0.25
CPI	0.09	0.05	12/31/1979	0.02
Real 10yr yld	0.07	-0.13	1/31/2004	-0.18
2yr Tsy Yld	0.05	-0.01	12/31/1979	0.02
OECD GDP	0.01	0.22	12/31/1979	0.27
Unemployment Rate	0.00	-0.19	12/31/1979	-0.32

Exhibit 31: Credit conditions, credit spreads and the VIX are the three most negatively correlated macro indicators with small vs. large performance; PMIs, leading indicators and consumer sentiment are most positively correlated

Historical absolute & relative perf. correlations of Russell 2000 vs. macro variables since 1979 (or longest available history as noted), ranked from most positive to most negative correlations with relative returns

	Rel. Perf. (R2 vs. R1)	Absolute Perf. (R2)		R1 Absolute Perf.
Fed Funds Rate (effective)	-0.01	0.05	12/31/1979	0.13
Real US GDP	-0.04	0.25	12/31/1979	0.34
Inflation Exp (5yr)	-0.04	0.04	4/30/1991	0.08
Industrial Production	-0.06	0.24	12/31/1979	0.43
Conference Board Coincident Indicators	-0.10	0.24	12/31/1979	0.44
Inflation Exp (1yr)	-0.11	0.01	12/31/1979	0.14
MOVE Index	-0.11	-0.35	4/30/1989	-0.24
Initial Jobless Claims	-0.13	-0.16	12/31/1979	-0.11
IG Credit Spreads	-0.24	-0.62	12/31/1997	-0.49
SLOOS - Net % tightening (Small firms)	-0.28	-0.43	6/30/1991	-0.35
VIX Index	-0.32	-0.53	1/31/1991	-0.25
HY Credit Spreads	-0.33	-0.72	12/31/1997	-0.57
SLOOS - Net % tightening (Lg/Mid-size firms)	-0.36	-0.47	6/30/1991	-0.35

Source: Haver, ICE Data Indices, LLC, Bloomberg, BofA US Equity & Quant Strategy

Note: based on monthly perf. for all indicators except SLOOS (Senior Loan Officer Opinion Survey) and GDP which are qtrly. All analysis since the inception of the Russell indices in 1979, or whenever the macro indicator became available.

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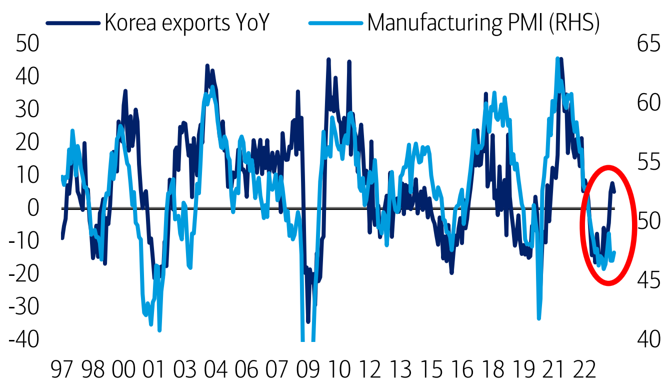
ISM recovery would be bullish for small caps

Out of all the macroeconomic indicators, PMIs have historically been the most positively correlated with small cap absolute and relative performance (table above). And multiple leading indicators have been suggesting an upturn in manufacturing PMIs is likely, including the recent rebound in Korean exports and the rebound in rail freight carloads (Exhibit 32-Exhibit 33). Small cap valuations have also been highly correlated with PMIs and are currently discounting just 50 on the Mfg. ISM. One risk: the Market PMI declined last month despite the improvement in the ISM.

Exhibit 32: Korea exports rebounded recently, pointing to a manufacturing recovery

Korea exports YoY vs. ISM Manufacturing PMI (1997-12/23)



Source: Bloomberg, BofA US Equity & Quant Strategy

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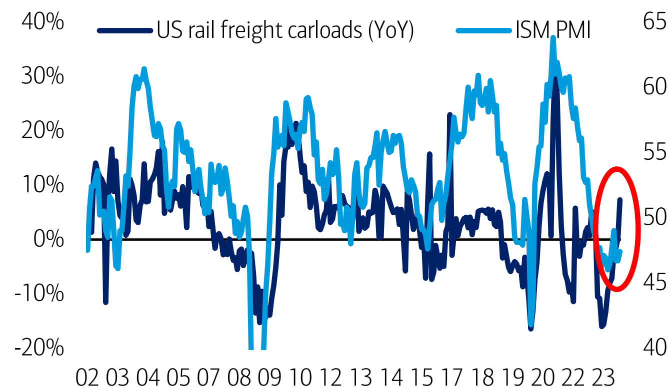
Exhibit 33: Rail freight carloads also sharply rebounded, pointing to a manufacturing recovery

US rail freight carloads YoY vs. ISM Manufacturing PMI (2002-12/23)



Source: Bloomberg, BofA US Equity & Quant Strategy

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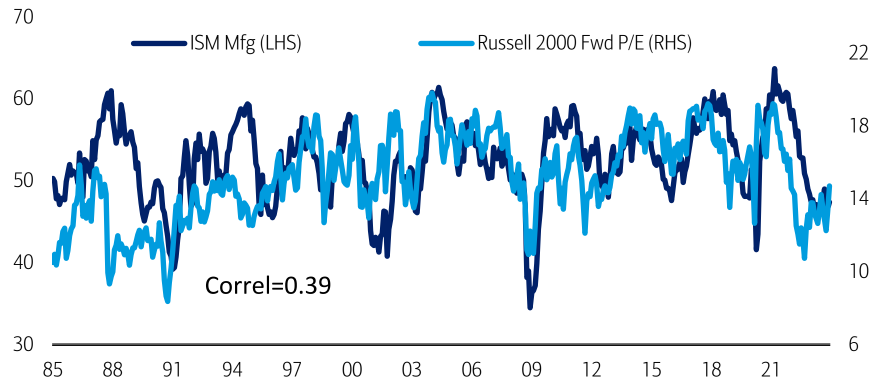
Exhibit 34: Small cap valuations correlated with ISM, and pricing in ISM of 50
Russell 2000 Fwd P/E (LHS) vs ISM Mfg. Index (RHS), 1985-12/2023



Source: Haver Analytics, BofA US Equity & Quant Strategy

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End of hiking cycles typically bullish for small caps…

BofA expects hiking cycle is done, with 100bp of cuts in '24 and 100bp in '25

Small caps have typically outperformed once the hiking cycle is over, which was particularly true in the 1970s/80s (when the Fed had also been hiking to tame high inflation).

Exhibit 35: Small caps typically outperformed, on average, once the Fed stops hiking – which was particularly true in the 70s/early 80s
Relative performance (ppt) of small caps vs. large caps around Fed tightening cycles since 1971 with returns prior to and following the final rate hike

Start of hiking	End of hiking	3m before last hike	6m before last hike	12m before last hike	Full hiking cycle	3m after last hike	6m after last hike	12m after last hike
3/31/1971	8/31/1971	-2%	-1%	14%	-3%	-5%	4%	-10%
3/31/1972	7/31/1973	-3%	-13%	-25%	-26%	5%	5%	2%
3/31/1974	5/31/1974	-6%	3%	3%	-19%	3%	1%	18%
6/30/1975	6/30/1975	5%	33%	23%	N/A	0%	-3%	12%
4/30/1976	5/31/1976	-3%	16%	14%	-11%	-1%	4%	22%
12/31/1976	3/31/1980	-10%	-7%	1%	17%	7%	19%	31%
8/31/1980	5/31/1981	12%	15%	33%	33%	-5%	-6%	-4%
5/31/1983	8/31/1984	-2%	-4%	-7%	-3%	-4%	1%	-1%
12/31/1986	9/30/1987	-2%	-6%	-6%	-3%	-6%	3%	2%
4/30/1988	2/28/1989	3%	-4%	5%	-4%	0%	-6%	-11%
2/28/1994	2/28/1995	-2%	-3%	-7%	-5%	-3%	3%	-5%
6/30/1999	5/31/2000	-20%	1%	-2%	-2%	5%	1%	16%
6/30/2004	6/30/2006	-3%	6%	6%	5%	-4%	-3%	-3%
12/31/2015	12/31/2018	-6%	-10%	-6%	-2%	1%	-2%	-5%
Full history	**Average**	**-3%**	**2%**	**3%**	**-2%**	**-1%**	**2%**	**5%**
	Median	**-3%**	**-2%**	**2%**	**-3%**	**-1%**	**1%**	**0%**
	Hit Rate	**21%**	**43%**	**57%**	**23%**	**43%**	**64%**	**50%**
70s-Early 80s	**Average**	-1%	6%	9%	-2%	1%	3%	10%
	Median	-3%	3%	14%	-7%	0%	4%	12%
	Hit Rate	**29%**	**57%**	**86%**	**33%**	**57%**	**71%**	**71%**

Note: based on Russell 2000 vs. Russell 1000 indices for hiking cycles from 1983-now. Prior to 1981, source of historical returns: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy
Source: CRSP, Bloomberg, BofA Us Equity & US Quant Strategy

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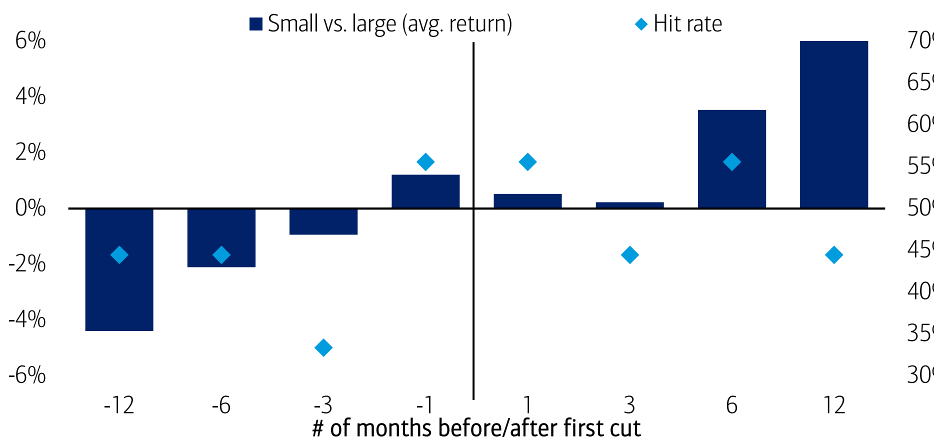
…and Fed rate cuts also typically positive

Small caps have typically outperformed, on average in the one, three, six and 12 months following the first rate cut, which our economists expect in March 2024 – though hit rates are more mixed. Outperformance was particularly strong in the 1970s/early 1980s, a period where the Fed had similarly hiked rates to tame high inflation.

Exhibit 36: Small caps have consistently outperformed after the first Fed cut – more rate sensitive than cyclical

Small caps' relative performance vs. large caps around the first Fed cut since 1926



Source: BofA US Equity & Quant Strategy, Dartmouth data library

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Exhibit 37: Small cap outperformance following Fed easing was most evident in the 1970s/early 1980s

Absolute and relative performance of small caps during Fed rate cutting cycles 1974-present

				Small Cap absolute performance							Relative Performance: Small vs. Large caps						
				Prior to first rate cut			Following first rate cut:			Full easing cycle	Prior to first rate cut			Following first rate cut:			Full easing cycle
First cut	Last cut	# of mos	Econ recession?	-12m	-6m	-3m	+3m	+6m	+12m	Annualized	-12m	-6m	-3m	+3m	+6m	+12m	Annualized
7/31/1974	4/30/1975	9	1	-24%	-20%	-14%	-7%	6%	39%	33%	3%	-3%	0%	1%	11%	27%	20%
4/30/1980	6/30/1980	2	1	7%	4%	-15%	24%	43%	61%	101%	2%	1%	-9%	8%	22%	36%	46%
1/31/1981	12/31/1982	23	1	22%	16%	2%	11%	8%	-5%	10%	10%	9%	1%	8%	7%	3%	5%
10/2/1984	8/19/1986	23		-11%	2%	4%	-2%	11%	9%	18%	-10%	-4%	-3%	-5%	0%	-4%	-6%
10/19/1987	2/10/1988	4		-2%	-17%	-20%	-7%	6%	11%	-14%	4%	4%	7%	-19%	-9%	-13%	-68%
6/5/1989	9/4/1992	39	1	20%	20%	10%	3%	-2%	-1%	3%	-1%	4%	0%	-7%	-11%	-15%	-5%
7/6/1995	11/17/1998	40		19%	16%	10%	5%	11%	19%	10%	-5%	-5%	1%	0%	-1%	0%	-14%
1/3/2001	6/25/2003	30	1	1%	-8%	-4%	-12%	3%	2%	-4%	5%	1%	3%	6%	11%	16%	9%
9/18/2007	12/16/2008	15	1	11%	0%	-4%	-8%	-18%	-16%	-34%	-4%	-6%	-4%	-4%	-3%	8%	0%
8/1/2019	3/15/2020	7	1	-7%	3%	-4%	1%	7%	-5%	-33%	-12%	-6%	-4%	-2%	-4%	-15%	-20%
	Avg.	**19**		**4%**	**2%**	**-4%**	**1%**	**7%**	**11%**	**9%**	**-1%**	**0%**	**-1%**	**-1%**	**2%**	**4%**	**-3%**
	Avg. (recessions only)	**18**		**4%**	**2%**	**-4%**	**2%**	**7%**	**11%**	**11%**	**0%**	**0%**	**-2%**	**2%**	**5%**	**8%**	**8%**
	Median	**19**		**4%**	**2%**	**-4%**	**0%**	**7%**	**6%**	**6%**	**1%**	**-1%**	**0%**	**-1%**	**-1%**	**1%**	**-3%**
	Hit Rate			**60%**	**60%**	**40%**	**50%**	**80%**	**60%**	**60%**	**50%**	**50%**	**40%**	**50%**	**50%**	**50%**	**40%**
	Hit Rate (recessions only)			**71%**	**57%**	**29%**	**57%**	**71%**	**43%**	**57%**	**57%**	**57%**	**29%**	**57%**	**57%**	**71%**	**57%**

Source: BofA US Equity & Quant Strategy, Bloomberg (for Russell 2000 small cap returns in all cycles post-1975 and S&P 500 large cap index returns in all cycles) Haver Analytics, Source of historical returns for small caps in 1974-75 cycle: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy

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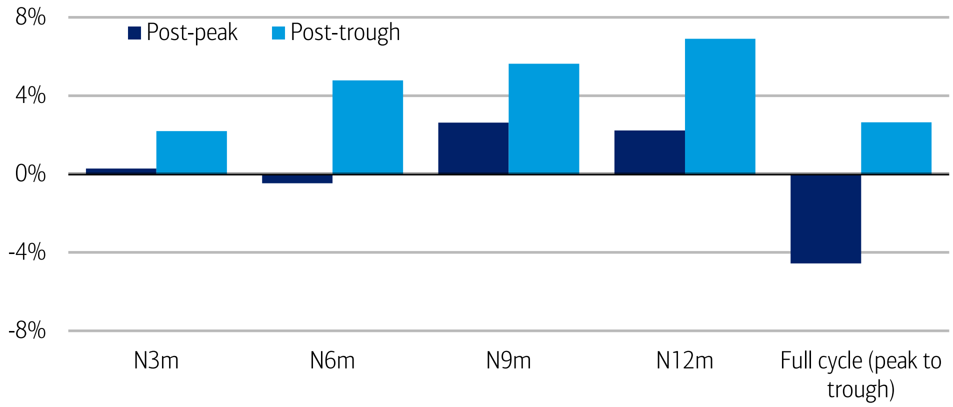
Global Wave trough bullish for small>large

Nigel Tupper's Global Wave has troughed – which has historically been positive for cyclicals and for small caps relative to large caps.

Exhibit 38: Small caps typically outperform large caps following Global Wave troughs
Average subsequent relative performance of the Russell 2000 vs. the Russell 1000 following peaks and troughs in the Global Wave (since 1993, 10 trough-peak cycles)



Source: FactSet, Bloomberg, BofA US Equity & US Quant Strategy

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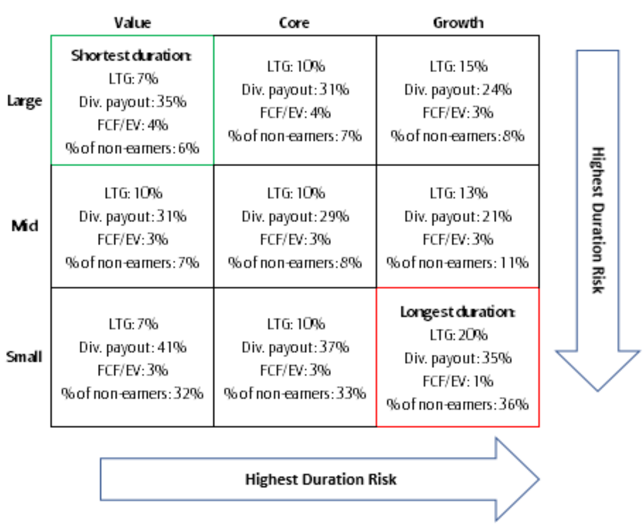
Key risks

Biggest risk to small caps is if rates stay high

If rates are higher for longer, duration risk matters – here large cap value is most attractive, small cap growth least (see [US Equity Strategy Year Ahead] plus more on small cap Value>Growth in the 2024 roadmap section). We continue to prefer the "SMEARNERS", or small cap earners (Russell 2000 ex. non-profitable companies), given duration risks, and companies/sectors with less floating rate/short-term debt given refinancing risks (below).

Exhibit 39: Greatest duration risk in Small Growth, least in Large Value
Russell style & size indices and their current metrics as of 12/31



Source: BofA Equity & Quant Strategy, FactSet

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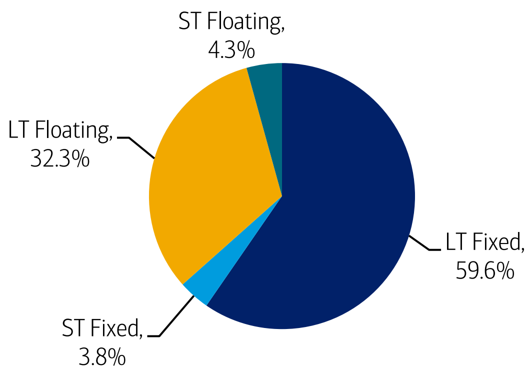
Refinancing risk is the biggest risk to small caps

Small caps see the bulk of their debt maturing over the next five years, with greater short-term and floating-rate risk vs. large caps. According to our HY strategist, "most issuers have levers to pull and glide their debt level to where they are comfortable with the new coupon (HY Strategy Year Ahead). But a pick-up in credit stress/widening of spreads or rates remaining elevated pose risk to many small cap sectors with a high proportion of short-term or floating rate debt.

Exhibit 40: 60% of Russell 2000 debt is long-term fixed
Russell 2000 debt by maturity (4Q22)



Source: Bloomberg, FactSet, BofA US Equity & US Quant Strategy

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Exhibit 41: Tech and Staples have the shorted avg. maturity duration
Russell 2000 non-Financial debt: wtd. avg. maturity (as of 4Q22)

Weighted avg debt maturity (yrs)

Sector	Overall
Communication Services	5.0
Consumer Discretionary	4.9
Consumer Staples	2.5
Energy	4.0
Health Care	3.5
Industrials	4.5
Information Technology	2.5
Materials	3.1
Real Estate	3.7
Utilities	11.7
Russell 2000	**4.5**

Source: Bloomberg, FactSet, BofA US Equity & US Quant Strategy

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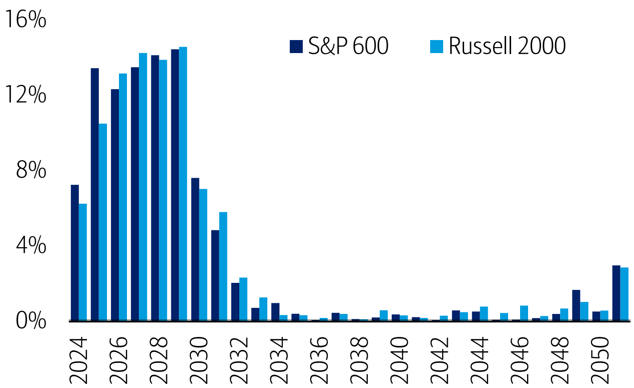
Exhibit 42: Bulk of small cap debt maturing between 2025-2029
% of LT fixed debt maturing each year for S&P 600 / Russell 2000 ex. Fins



Source: Bloomberg, FactSet, BofA US Equity & US Quant Strategy

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Exhibit 43: Our analysis suggests 2%incremental hit to small cap non-Financials EBIT from higher net interest expense in 2024 vs. 2022; impact likely to ramp up after
Increase in Russell 2000 net interest expense relative to current (2022) as a % of '22 EBIT from floating rate date + refi of fixed date coming due

	Change in net interest exp. vs. 2022 (% of 2022 EBIT)				
Sector	**2023**	**2024**	**2025**	**2026**	**2027**
Comm. Svcs.	11.1%	9.2%	13.4%	25.7%	50.1%
Cons. Disc.	2.6%	1.4%	4.9%	9.1%	13.8%
Staples	6.6%	8.0%	17.5%	26.5%	44.1%
Energy	(0.1%)	(0.1%)	2.0%	4.0%	6.4%
Health Care	NM	NM	NM	NM	NM
Industrials	3.8%	4.1%	7.9%	12.9%	16.6%
Tech	(2.2%)	(3.7%)	5.4%	20.0%	31.2%
Materials	2.1%	0.9%	5.4%	8.6%	10.7%
Real Estate	28.9%	36.8%	60.8%	82.0%	103.3%
Utilities	11.3%	15.6%	18.8%	23.0%	28.6%
Russell 2000 ex. Fins	**2.7%**	**2.4%**	**8.9%**	**17.1%**	**26.5%**
ex. Fins & Utilities	**2.4%**	**1.9%**	**8.5%**	**16.9%**	**26.4%**

Source: Bloomberg, BofA US Equity & US Quant Strategy

Exhibit 43: Our analysis suggests 2%incremental hit to small cap non-Financials EBIT from higher net interest expense in 2024 vs. 2022; impact likely to ramp up after

Increase in Russell 2000 net interest expense relative to current (2022) as a % of '22 EBIT from floating rate date + refi of fixed date coming due

Change in net interest exp. vs. 2022 (% of 2022 EBIT)

Note: Uses 3m LIBOR + credit spread (where we assume weighted average of HY and IG spreads based on HY vs. IG weight in small cap debt) for interest expense (using BofA forecasts for Fed Funds rate trajectory through 2024 and then holding at those levels thereafter); BofA cash yield forecasts through 2024 and constant thereafter for interest income.

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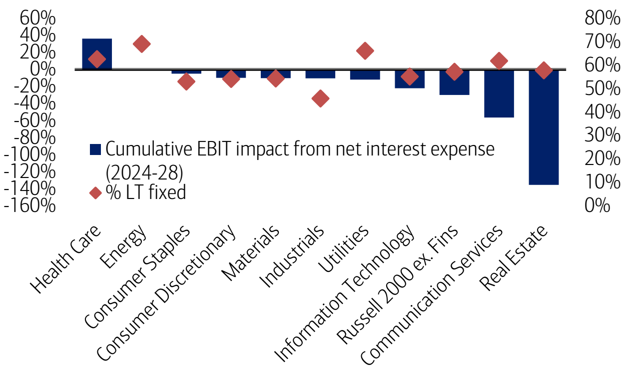
Exhibit 44: Cumulative hit to EBIT over the next 5 years at the current cost of debt = 30%

Cumulative EBIT impact from higher rates over the next 5 years by sector group and % of debt that is long-term fixed



Source: BofA US Equity & Quant Strategy, FactSet

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Exhibit 45: Russell 2000 has seen a bigger decline in P/E than the annualized EPS impact from higher rates

Annualized EPS impact from higher interest rates over next five years and change in fwd P/E since 12/21 (as of 12/23)

Sector	Chg. in P/E since end of 2021	Annualized cumulative EBIT impact from net int. expense (2024-28)	Difference (Chg. in P/E since end of '21 - annualized 5yr impact from higher rates)
Utilities	-19%	-3%	-16%
Communication Services	-28%	-15%	-13%
Health Care	-3%	6%	-10%
Industrials	-11%	-2%	-9%
Materials	-8%	-2%	-5%
Russell 2000 ex. Fins	**-10%**	**-7%**	**-3%**
Information Technology	-6%	-5%	-2%
Consumer Staples	-1%	-1%	0%
Energy	8%	0%	9%
Consumer Discretionary	8%	-2%	10%
Real Estate	-23%	-181%	158%

Source: BofA US Equity & Quant Strategy, FactSet

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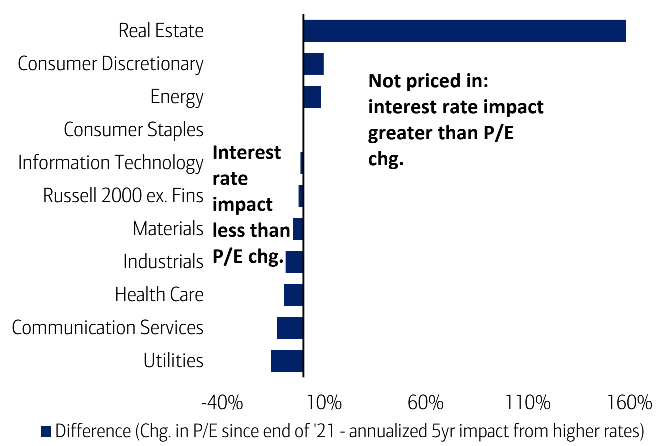
Exhibit 46: Valuations discounting refinancing risks across many sectors, but biggest risks in Real Estate

Spread between annualized EPS impact from higher interest rates and change in fwd P/E since 12/21 (as of 12/23)



Source: BofA US Equity & Quant Strategy, FactSet

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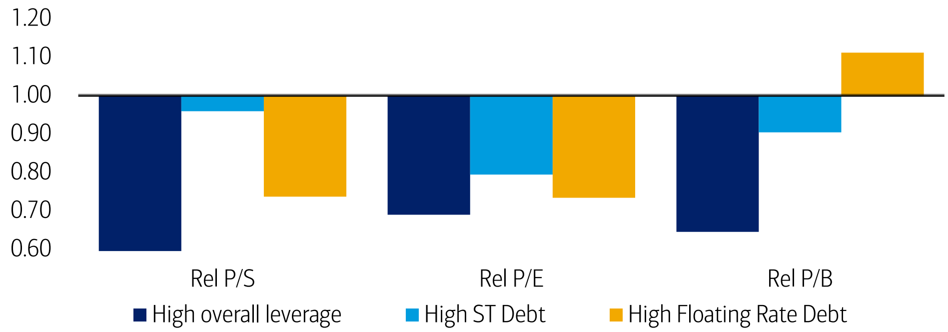
Exhibit 47: Small caps with high short-term debt, high floating-rate debt, and high leverage overall (net debt/EBITDA) are trading at discounts to their industry group peers across metrics

Relative Price/Sales, fwd. P/E and Price/Book of top 100 stocks in Russell 2000 ex-Financials by high net debt/EBITDA, high short-term debt as a % of total debt, and high floating-rate debt as a % of total (as of 1/18/24)



Source: Bloomberg, BofA US Equity & US Quant Strategy

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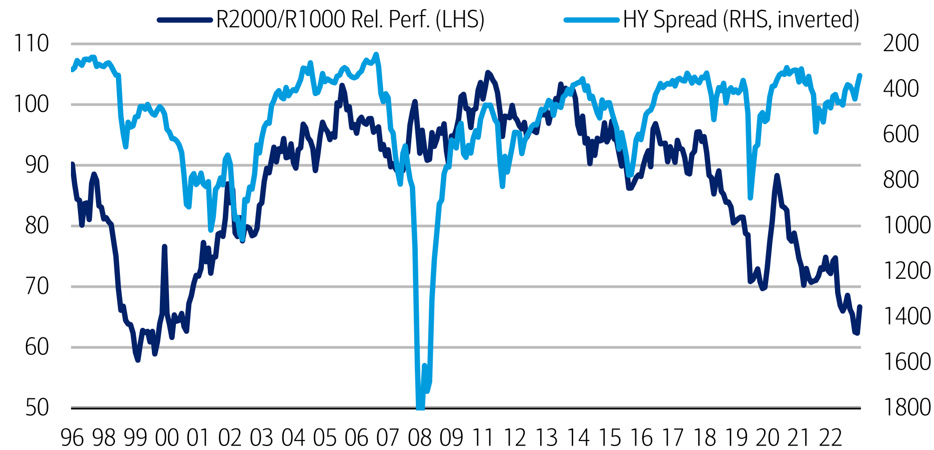
Macro risks: HY spreads, lagged impacts of tightening

Small cap absolute and relative performance is inversely correlated with HY spreads, which have narrowed, but our HY credit strategists targets 425bp given the lagged effects of tighter monetary policy. Meanwhile, their Credit Stress Indicator (CSI) has fallen to 46.7%, its lowest levels since the Fed starting hiking bit outside of the 30th percentile range that they would consider completely "normal". We continue to monitor the CSI.

Exhibit 48: Russell 2000 relative performance is inversely correlated with HY spreads
Russell 2000 vs. Russell 1000 relative performance vs. HY spreads (inverted), 1996-present



Source: BofA US Equity Strategy, Bloomberg

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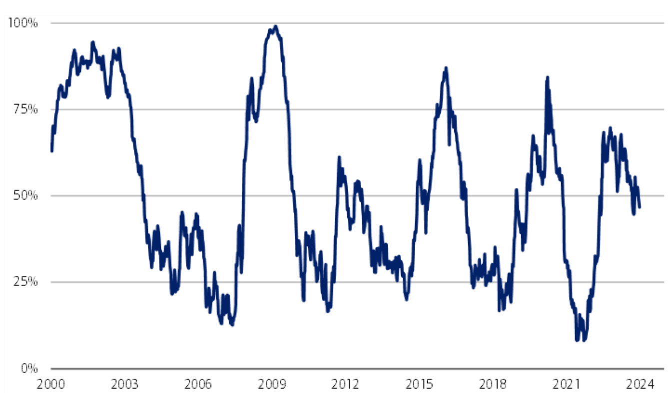
Exhibit 49: Credit Stress Indicator at ~47%
Credit Stress Indicator (CSI) from 2000 -present



Source: BofA Global Research

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Exhibit 50: MOVE index (rate vol) is most stressed component of CSI
Credit Stress Indicator (CSI) components

	Weight	Level	Pctle
Deep Distress	0.15	2.4%	54%
Dispersion	0.15	72%	48%
Diffusion	0.11	133	30%
Credit Access	0.09	38%	61%
Credit Migration	0.09	-3%	40%
Debt Leverage	0.15	4.4x	50%
VIX	0.05	12.4	14%
MOVE	0.06	115	80%
Credit Vol	0.15	0.4%	39%
CSI			**46.7%**
Implied defaults			3.2%

Source: BofA Global Research

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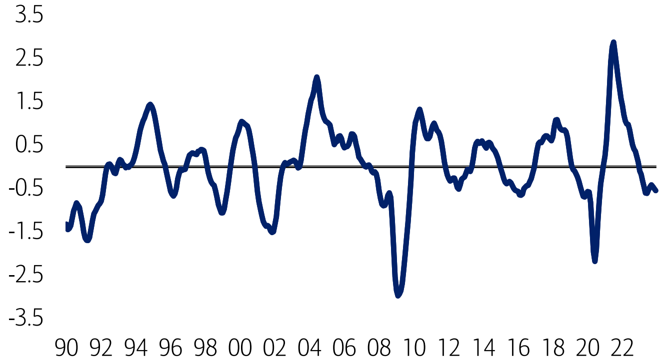
Mixed signals from US Regime Indicator

Early Cycle most (+) phase for small, a shift back to Downturn better for large

Our team's US Regime Indicator – a four-phase macro model to identify where we are in the cycle – has recently trended downward for several months, putting us back in "Downturn" territory after a brief "Recovery/Early Cycle" period. But the underlying components of the indicator have been mixed, with signals from the EPS Revisions Ratio, ISM Manufacturing Survey, Capacity Utilization and High Yield credit spreads all improving in the most recent month while inflation, 10-yr Treasury yield and Leading Indicators declined (and GDP forecasts were unchanged).

Exhibit 51: Macro muddle: US Regime Indicator has recently bounced from Downturn to Recovery and back to Downturn
US Regime Indicator, 1/970-12/2023 (indicator based on smoothed 3m data; 1m signal has improved for two consecutive months)



Source: BofA US Equity & Quant Strategy, Refinitiv, ICE Data Indices, LLC, Institute for Supply Management, Bureau of Labor Statistics, Federal Reserve.
Disclaimer: The indicator identified as the US Regime Indicator above is intended to be an indicative metric only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise be relied upon by third parties for any other purpose, without the written consent of BofA Global Research. This indicator was not created to act as a benchmark. See Appendix of our US Equity Strategy Year Ahead (20 November. 2023 for full details/methodology on the indicator and our monthly Quantitative Profiles report for monthly updates.

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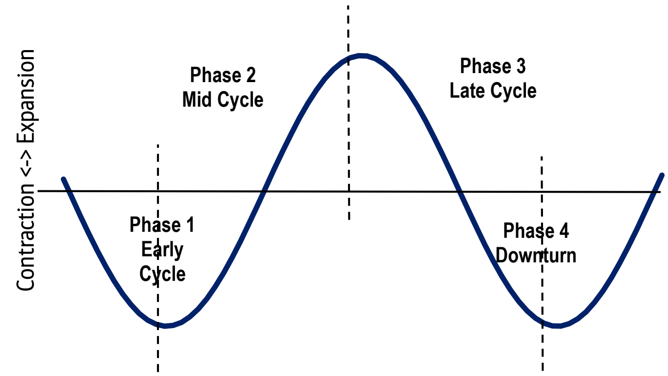
Exhibit 52: Whipsaw risk: Value/Small/Risk outperforms in Recovery, Quality/Low Risk/Large outperforms in Downturns
US Regimes – a heuristic



Source: BofA US Equity & US Quant Strategy

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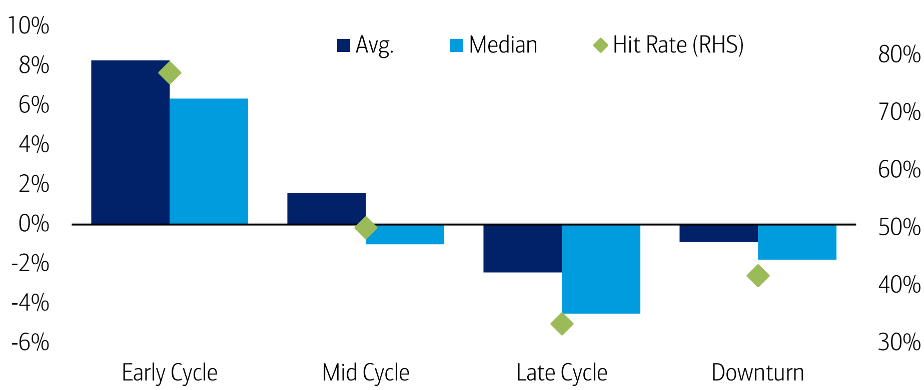
Typically, small caps have outperformed in Recovery periods and underperformed in Downturns – but muddled signals suggest the indicator could continue to oscillate. However, even if we remain in a “Downturn”, small caps have been pricing in this risk more than large caps.

Exhibit 53: Early Cycle typically best phase for small vs. large caps, with small typically lagging large in Downturns
Average and median relative performance of small vs. large caps during the four phases of our US Regime Indicator



Note: Based on Russell indices for from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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Plus: potential risks from trend-following strategies

According to our Derivative research team’s year ahead, many macro investors may have been forced to become “closet CTA investors” the last several years post-COVID amid fundamental uncertainty and a chase for alpha, and crowding in momentum/trend-following strategies has increased. They note CTA returns have become increasingly fragile, and when trends reverse, CTA unwinds can potentially amplify reversals – which they highlighted as a risk to the Russell 2000 last week in their Systematic Flows Monitor (12 January 2024).

Is a steepening yield curve bullish for small caps?

Not necessarily – mixed results

While yield curve inversions have seen small caps subsequently underperform large caps over the subsequent one/three/six/twelve months on average (see: What does an inverted yield curve mean for small caps?), the yield curve shifting back to positive has not necessarily been a bullish signal: small caps have typically seen healthy positive returns, but relative performance vs. large caps has been mixed (though typically positive in the first six months).

Analyzing the various yield curve environments since 1978, bear flatteners and bear steepeners have been the most positive yield curve environments for small caps relative to large caps, while bull steepeners have been worst. Our rates strategists forecast a bull steepening environment – a potential risk to small caps, though this may be mitigated by the fact that a) overall, Financials (a big weight in small caps) have been less sensitive to the yield curve than historically and b) falling short rates mitigates risks from the refinancing of short-term debt.

Exhibit 54: A shift in the yield curve from inverted to positive has been positive for small caps overall…

Small cap returns when yield curve flipped positive from 1950-present

	-12m	-6m	-3m	+3m	+6m	+12m
May-56	12%	4%	1%	4%	2%	9%
Jan-57	10%	1%	5%	1%	2%	-9%
Nov-57	-11%	-16%	-11%	4%	15%	48%
Mar-60	1%	1%	-6%	3%	-2%	27%
Jan-67	3%	10%	25%	13%	27%	41%
Jan-68	41%	10%	9%	7%	11%	32%
Jul-68	22%	11%	4%	12%	18%	-11%
Mar-69	32%	0%	-7%	-11%	-15%	-21%
Aug-70	-26%	-21%	7%	9%	34%	38%
Dec-73	-34%	-3%	-20%	11%	-7%	-26%
Nov-74	-22%	-17%	-3%	25%	52%	52%
May-80	17%	5%	-7%	23%	41%	53%
Oct-81	1%	-11%	-9%	-3%	-5%	11%
May-82	-20%	-10%	0%	1%	31%	76%
Jul-82	-21%	-10%	-9%	27%	50%	89%
Jun-89	11%	14%	6%	6%	1%	1%
Oct-89	14%	1%	-4%	-8%	-5%	-29%
Jul-98	2%	-2%	-13%	-10%	2%	7%
Dec-00	-3%	-6%	-7%	-7%	7%	2%
Mar-06	26%	15%	14%	-5%	-5%	6%
Jul-06	4%	-4%	-8%	10%	15%	12%
Mar-07	6%	11%	2%	4%	1%	-13%
Jun-07	16%	6%	4%	-3%	-8%	-16%
Sep-19	-9%	0%	-2%	10%	-24%	0%
Avg	**3%**	**0%**	**-1%**	**5%**	**10%**	**16%**
Median	**3%**	**0%**	**-3%**	**4%**	**2%**	**8%**
Hit Rate	**67%**	**50%**	**46%**	**71%**	**67%**	**71%**

Note: Based on Russell indices for from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.

Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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Exhibit 55: …while relative performance vs. large caps has been mixed (though they typically outperform in the subsequent six months)

Small vs large cap returns when yield curve flipped positive from 1950-present

	-12m	-6m	-3m	+3m	+6m	+12m
May-56	-12%	3%	0%	-2%	1%	0%
Jan-57	4%	8%	5%	-2%	-7%	-7%
Nov-57	-7%	-6%	-5%	5%	8%	17%
Mar-60	-2%	2%	1%	-1%	-1%	6%
Jan-67	6%	5%	16%	4%	16%	31%
Jan-68	31%	11%	10%	0%	3%	16%
Jul-68	16%	3%	3%	5%	11%	-7%
Mar-69	17%	0%	-5%	-8%	-8%	-12%
Aug-70	-15%	-14%	-1%	1%	13%	13%
Dec-73	-20%	1%	-11%	14%	3%	1%
Nov-74	2%	1%	-2%	7%	18%	16%
May-80	-1%	-2%	-6%	12%	11%	28%
Oct-81	0%	-5%	-4%	-3%	-3%	-6%
May-82	-9%	-1%	0%	-7%	3%	24%
Jul-82	-8%	-2%	-2%	1%	11%	30%
Jun-89	-10%	-3%	-3%	-4%	-12%	-15%
Oct-89	-13%	-10%	-3%	-6%	-4%	-21%
Jul-98	-17%	-17%	-14%	-8%	-13%	-13%
Dec-00	6%	3%	1%	5%	14%	14%
Mar-06	14%	9%	10%	-4%	-9%	-6%
Jul-06	-1%	-5%	-6%	1%	1%	-4%
Mar-07	-6%	4%	1%	-2%	-7%	-8%
Jun-07	-4%	0%	-2%	-5%	-6%	-3%
Sep-19	-13%	-6%	-4%	1%	-11%	-15%
Avg	**-2%**	**-1%**	**-1%**	**0%**	**1%**	**3%**
Median	**-3%**	**0%**	**-2%**	**-1%**	**1%**	**-2%**
Hit Rate	**38%**	**50%**	**42%**	**50%**	**54%**	**46%**

Note: Based on Russell indices for from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.

Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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Exhibit 56: Bull steepeners (short end falling faster than long end) = worst yield curve environment for small vs. large caps

Average returns, median returns and hit rates for Russell 2000 vs. S&P 500 during the four different yield curve environments (1979-present)

Avg. returns	**RTY**	**RTY vs. SPX**
bull-steepener	(0.0%)	(0.5%)
bull-flattener	1.2%	(0.2%)
bear-flattener	0.8%	0.5%
bear-steepener	1.2%	0.4%
Median returns	**RTY**	**RTY vs. SPX**
bull-steepener	0.8%	(0.3%)
bull-flattener	1.1%	(0.1%)
bear-flattener	0.6%	0.2%
bear-steepener	2.2%	0.3%
Hit rate	**RTY**	**RTY vs. SPX**
bull-steepener	53%	38%
bull-flattener	58%	44%
bear-flattener	57%	52%
bear-steepener	63%	53%

Source: Bloomberg, BofA US Equity & US Quant Strategy

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Mid cap outlook

We like mid caps, too – but less upside on valuation

Overall, we prefer SMID>large, and like both small and mid caps – but the former offers greater upside risk on valuation.

Small and mid caps performed similarly well following narrow markets, with small performing slightly better on a hit rate basis. Performance has also been similar for small vs. mid following the start of a Fed cutting cycle, with small typically slightly outperforming over the subsequent 12 months. Performance was also similar for the two size segments following profits growth troughs.

Meanwhile, performance of small vs. mid has been similar to mixed during both Recovery and Downturn phases of our US Regime Indicator (Mid Cycle has been the most consistently positive for small>mid, Late Cycle for mid>small). In times when the Regime Indicator bounced from a short Recovery to a resumed downtrend like today, small caps underperformed near-term (6 months) but led mid caps over the next 12 months.

Exhibit 57: Small caps outperform mid caps the three months after US corporate profits growth troughs but lags six months after

Relative performance of small vs. mid caps around US corporates profits growth troughs (based on S&P 500 quarterly YoY EPS for profits), 1952-present

Trough Date	-12m	-6m	-3m	+3m	+6m	+12m
Jun-52	-4%	-2%	-1%	1%	0%	2%
Sep-58	-3%	2%	2%	0%	4%	2%
Jun-61	-1%	5%	0%	-4%	-4%	-3%
Dec-70	-8%	1%	-3%	5%	2%	-1%
Sep-75	-2%	2%	1%	-4%	4%	2%
Mar-81	5%	-2%	-2%	2%	-4%	-5%
Mar-83	6%	11%	5%	4%	-1%	-5%
Dec-86	-12%	-8%	-3%	3%	-1%	-12%
Dec-91	1%	-3%	-3%	5%	0%	0%
Dec-98	-13%	-8%	-2%	-5%	-1%	3%
Mar-02	4%	4%	0%	1%	-2%	-5%
Sep-09	-6%	-2%	-1%	-2%	-2%	-4%
Jun-16	-7%	-3%	1%	5%	11%	8%
Sep-20	-4%	-2%	-3%	11%	18%	10%
Avg	**-3%**	**0%**	**-1%**	**2%**	**2%**	**-1%**
Median	**-3%**	**-2%**	**-1%**	**2%**	**-1%**	**0%**
Hit Rate	**29%**	**43%**	**36%**	**71%**	**36%**	**50%**

Note: Based on Russell indices for from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.

Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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Exhibit 58: Similar to small caps, mid caps outperform large caps after US corporate profit growths trough

Relative performance of mid vs. large caps around US corporates profits growth troughs (based on S&P 500 quarterly YoY EPS for profits), 1952-present

Trough Date	-12m	-6m	-3m	+3m	+6m	+12m
Jun-52	-6%	-4%	-3%	0%	-2%	1%
Sep-58	9%	3%	2%	1%	7%	4%
Jun-61	7%	6%	0%	-2%	-4%	-5%
Dec-70	-6%	6%	-1%	6%	6%	7%
Sep-75	15%	2%	-1%	1%	9%	9%
Mar-81	21%	6%	8%	3%	0%	1%
Mar-83	7%	6%	2%	5%	3%	-4%
Dec-86	-2%	-3%	-3%	0%	-4%	-4%
Dec-91	12%	2%	0%	5%	0%	9%
Dec-98	-19%	-8%	-3%	-5%	-2%	-3%
Mar-02	10%	11%	4%	4%	3%	3%
Sep-09	3%	12%	5%	0%	3%	7%
Jun-16	-3%	2%	1%	1%	0%	-1%
Sep-20	-11%	3%	-1%	8%	11%	8%
Avg	**3%**	**3%**	**1%**	**2%**	**2%**	**2%**
Median	**5%**	**3%**	**0%**	**1%**	**2%**	**2%**
Hit Rate	**57%**	**79%**	**50%**	**64%**	**71%**	**64%**

Note: Based on Russell indices for from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.

Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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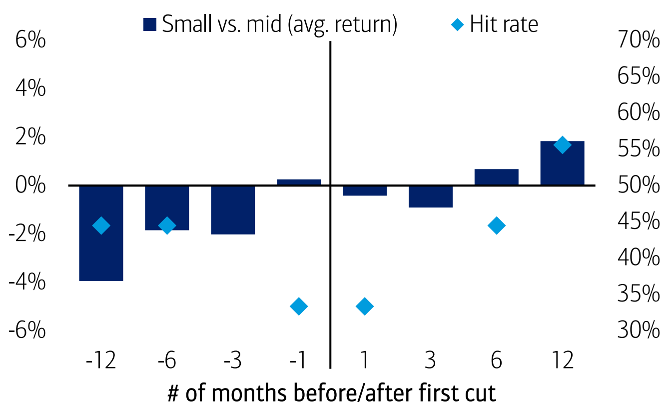
Exhibit 59: Small caps have consistently underperformed mid caps in the 6 months after the first rate cut, but outperform after 12 months

Small cap relative performance vs. mid caps around the first Fed cut since 1926



Source: BofA US Equity & Quant Strategy, Dartmouth data library

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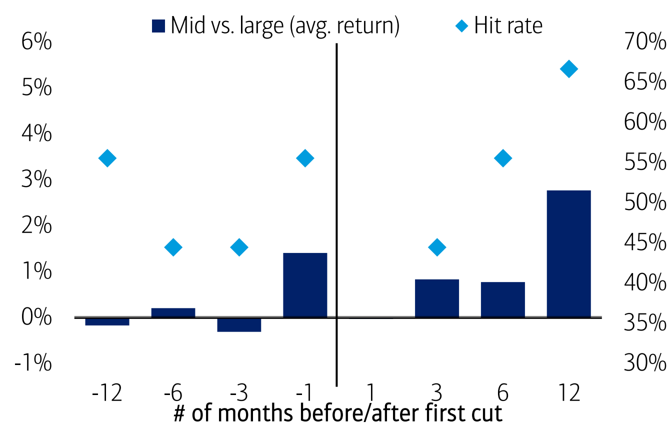
Exhibit 60: Similar to small caps, mid caps have consistently outperformed large caps 3/6/12 mos. after the first Fed cut

Mid caps' relative performance vs. large caps around the first Fed cut since 1926



Source: BofA US Equity & Quant Strategy, Dartmouth data library

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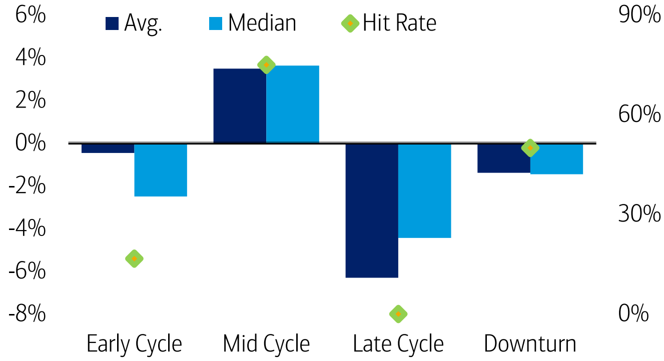
Exhibit 61: Early Cycle and Downturn typically best phase for mid caps vs small caps
Average and median relative performance of small vs. mid caps during the four phases of our US Regime Indicator



Note: Based on Russell indices for from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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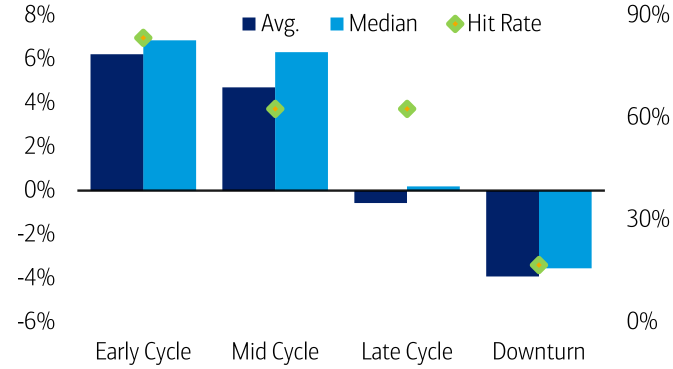
Exhibit 62: Early Cycle typically best phase for mid caps vs large caps, lagging in Downturns
Average and median relative performance of mid vs. large caps during the four phases of our US Regime Indicator



Note: Based on Russell indices for from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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Exhibit 63: Prior "macro muddle" periods (where US Regime Indicator had a brief Recovery after a Downturn then flipped back to Downturn) saw small lag mid initially but outperform over 12mos
End of short-lived Recovery phases in US Regime indicator and subsequent performance of Russell size indices, 1990-present

		Small vs Mid		Small vs. Large		Mid vs. Large
"Macro muddle"	N6m	N12m	N6m	N12m	N6m	N12m
12/31/1992	0%	5%	2%	10%	2%	5%
8/29/2008	-8%	-1%	-11%	-2%	-3%	-1%
5/31/2012	0%	1%	0%	4%	0%	3%
7/31/2015	-4%	-4%	-8%	-4%	-4%	0%
1/31/2020	-4%	13%	-10%	11%	-6%	-2%
Avg	**-3%**	**3%**	**-5%**	**4%**	**-2%**	**1%**
Median	**-4%**	**1%**	**-8%**	**4%**	**-3%**	**0%**
Hit Rate	**0%**	**60%**	**20%**	**60%**	**40%**	**40%**

Source: BofA US Equity & Quant Strategy, Bloomberg

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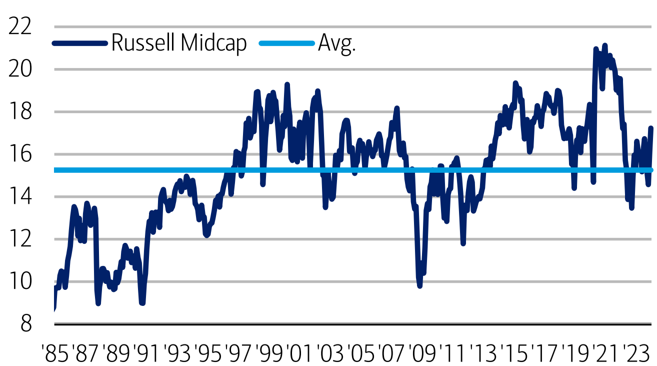
Exhibit 64: Mid-caps trade above long-term average
Russell Midcap Forward P/E, 1985-12/31/2023



Source: BofA US Equity & Quant Strategy, FactSet

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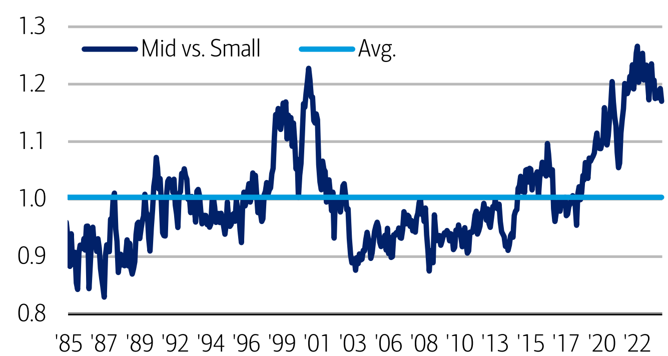
Exhibit 65: Mid-caps trade at a near record premium to small caps
Relative Forward PE of Russell Midcap vs Russell 2000, 1985-12/31/2023



Source: BofA US Equity & Quant Strategy, FactSet

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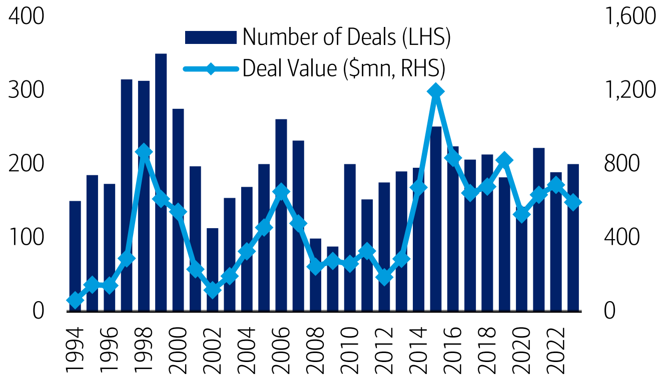
Themes

M&A pick-up bullish for several key SMID cap sectors

M&A has begun to pick up, with the total number of deals in 2023 outpacing 2022 levels, though deal value lower. We see mixed signals going forward: several drivers of M&A cycles aren't supportive of a further pick-up: consensus long-term growth expectations for small caps aren't particularly elevated and slowing US economic growth typically suggests lower deal activity. Meanwhile, attractive relative valuations for small vs. large caps are supportive of a pick-up.

While a broad pick-up in M&A may be challenging, we have started to see a pick-up in several key small cap sectors, notably Health Care – where deal count hit a record high last year, driven by Biotech deals. Financials M&A also started to pick up off lows, though more regulatory clarity is needed for a continued pick-up. Our work suggests that M&A pick-ups are not necessarily correlated to broader small cap outperformance, but a pick-up in deal activity is strongly correlated with sector performance in several sectors, particularly Health Care.

Exhibit 66: US M&A activity picked up in 2023 vs. 2022
US M&A activity (deal count and aggregate deal value in $mn), 1994-2023 (as of 12/31/23)



Source: FactSet, BofA US Equity & US Quant Strategy

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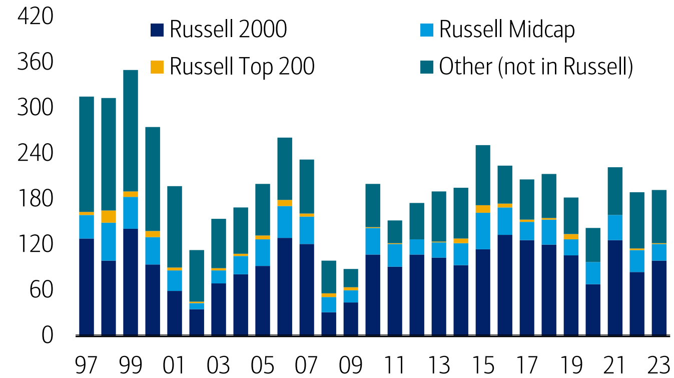
Exhibit 67: M&A deals chiefly in small caps, especially in recent years
# of deals by size segment (based on Russell 3000 deals, 1997-2023 YTD as of 12/31/23)



Source: FactSet, BofA US Equity & US Quant Strategy

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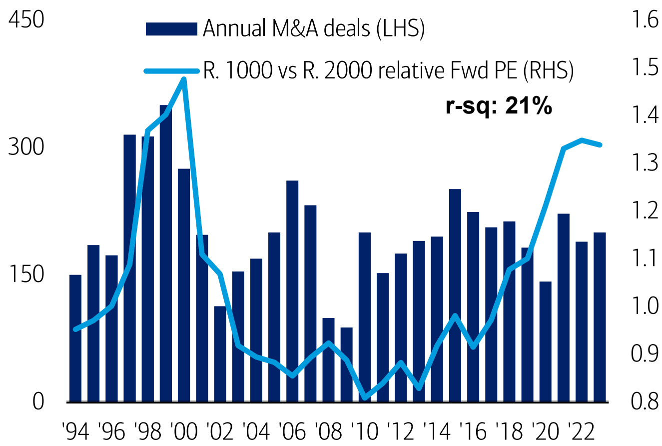
Drivers of M&A cycles

Exhibit 68: Attractive valuations of small vs. large supports M&A
Rel. Fwd PE of Russell 1000/Russell 2000 vs # of annual US M&A deals, 1994-2023 YTD (as of 12/31/23)



Source: BofA US Equity & US Quant Strategy, FactSet

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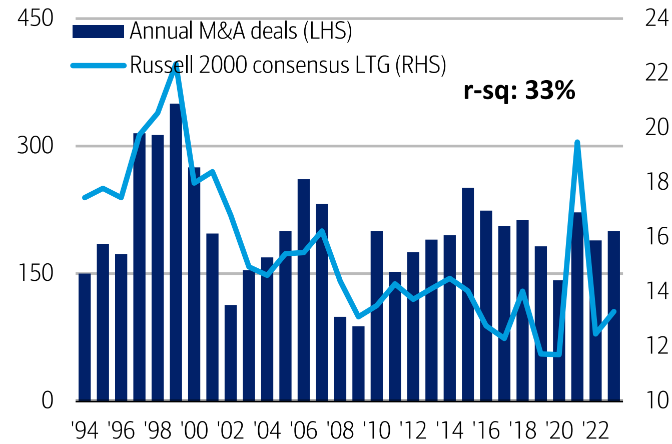
Exhibit 69: Elevated LTG expectations would be supportive for M&A, but currently expectations are closer to average
Russell 2000 consensus long-term growth vs. # of annual US M&A deals, 1994-YTD 2023 (as of 12/31/23)



Source: BofA US Equity & US Quant Strategy, FactSet

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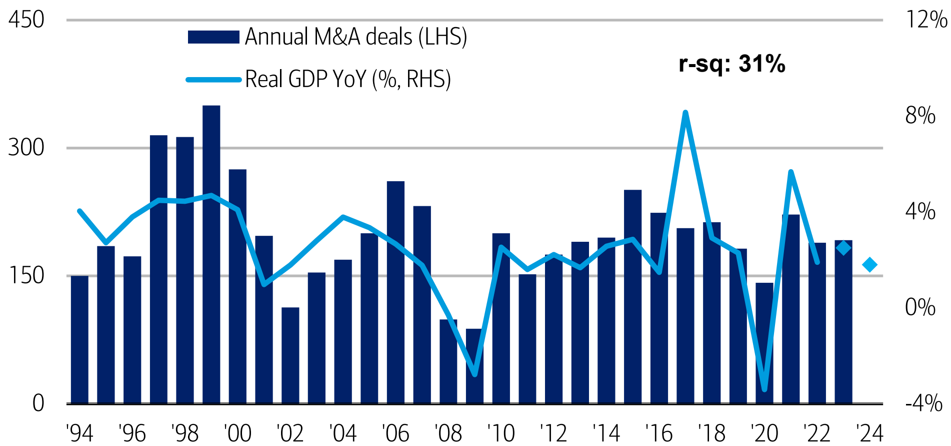
Chart 1: Slowing economic growth typically suggests lower deal activity
Real GDP growth (Y/Y) vs number of annual US M&A deals 1994-2023 (dots = BofA GDP forecasts for '23/'24)



Source: BofA US Equity & US Quant Strategy, FactSet, Mergerstat, BEA

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M&A pick-up isn't necessarily bullish for small caps as a whole…

Exhibit 70: Small caps have actually lagged during heavy M&A years…
Years of above-avg. M&A by deal count and small vs large performance

Year	# of deals	R2000	R1000	Small vs. Large
12/31/1999	350	20%	19%	0%
12/31/1997	315	21%	31%	-10%
12/31/1998	313	-4%	25%	-29%
12/31/2000	275	-4%	-9%	5%
12/31/2006	261	17%	13%	4%
12/31/2015	251	-6%	-1%	-5%
12/31/2007	232	-3%	4%	-7%
12/31/2016	224	19%	10%	10%
12/31/2021	222	14%	25%	-11%
12/31/2018	213	-12%	-7%	-6%
12/31/2017	206	13%	19%	-6%
12/31/2010	200	25%	14%	11%
12/31/2005	200	3%	4%	-1%
Avg:		**8%**	**11%**	**-3%**
Median:		**13%**	**13%**	**-5%**
Hit Rate:		**62%**	**77%**	**38%**

Source: FactSet/Mergerstat, BofA US Equity & US Quant Strategy

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Exhibit 71: …while they have outperformed during light M&A years
Years of below-avg. M&A by deal count and small vs large performance

Year	# of deals	R2000	R1000	Small vs. Large
12/31/2008	99	-35%	-39%	4%
12/31/2002	113	-22%	-23%	1%
12/31/2020	142	18%	19%	-1%
12/31/2011	152	-5%	-1%	-5%
12/31/2003	154	45%	28%	18%
12/31/2004	169	17%	9%	8%
12/31/2012	175	15%	14%	1%
12/31/2019	182	24%	29%	-5%
12/31/2013	190	37%	30%	7%
12/31/2014	195	4%	11%	-8%
12/31/2001	197	1%	-14%	15%
Avg:		**9%**	**6%**	**3%**
Median:		**15%**	**11%**	**1%**
Hit Rate:		**73%**	**64%**	**64%**

Source: FactSet/Mergerstat, BofA US Equity & US Quant Strategy

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…but it is bullish for several small cap sectors, particularly Health Care

Exhibit 72: Health Care, Utilities, Staples, Materials, Tech tend to see better performance in active M&A years
Relative performance and hit rates of Russell 2000 sectors vs. the index in above-average (heavy) vs. below-average (light) M&A years by deal activity (1997-2021)

	Median Rel. Perf.		Hit Rate	
	Heavy M&A	**Light M&A**	**Heavy M&A**	**Light M&A**
Health Care	6%	1%	80%	56%
Tech	6%	3%	71%	58%
Cons. Disc.	-4%	3%	30%	69%
Staples	6%	4%	80%	63%
Energy	-27%	0%	14%	47%
Financials	-2%	1%	33%	59%
Industrials	6%	5%	56%	76%
Materials	6%	0%	57%	53%
Real Estate	2%	4%	50%	60%
Utilities	7%	-3%	80%	31%
Comm. Svcs.	-2%	-4%	50%	31%

Source: FactSet/Mergerstat, BofA US Equity & US Quant Strategy

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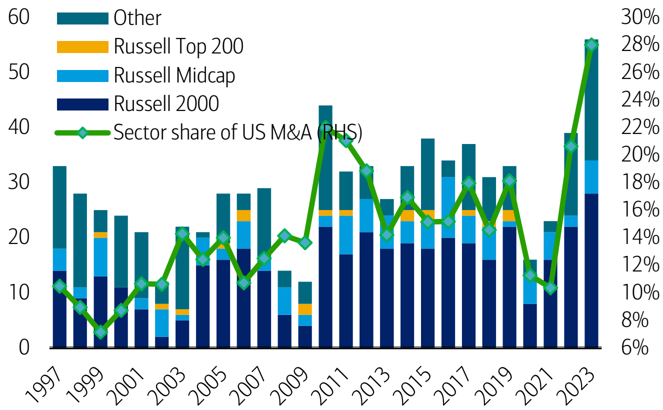
Health Care M&A pick-up bullish for the sector after recent dearth

Exhibit 73: Health Care M&A at a record high…

Health Care M&A deal count (by Russell size index based on target's index membership at time of deal announcement) 1997-12/31/23



Source: FactSet, BofA US Equity & US Quant Strategy

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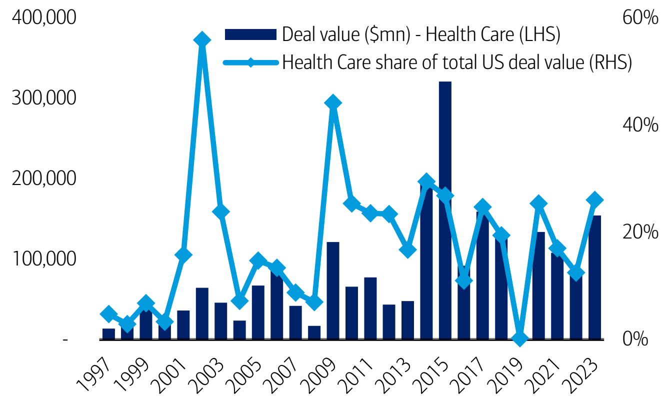
Exhibit 74: and deal value as a % of total has improved

Health Care M&A deal value, $mn (and % of total US deal value), 1997-12/31/23



Source: FactSet, BofA US Equity & US Quant Strategy

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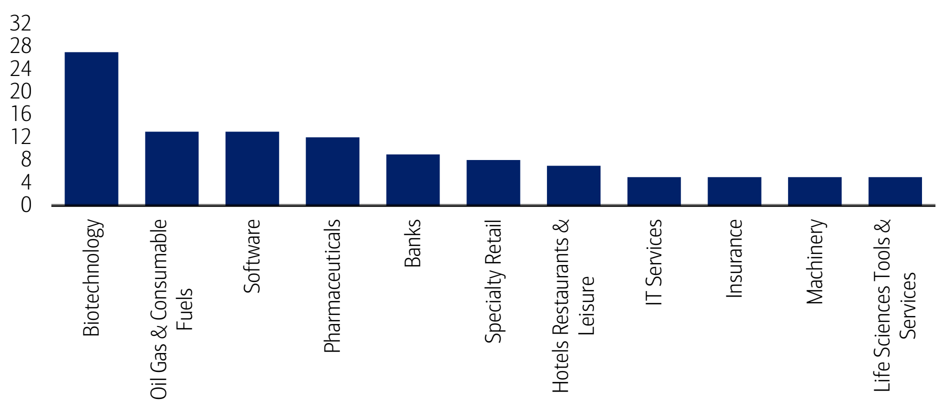
Exhibit 75: Busiest sector for deal activity in 2023 was Biotech

Number of US M&A deals by GICS sector of target in 2023 YTD (as of 12/31/23)



Source: FactSet, BofA US Equity & US Quant Strategy

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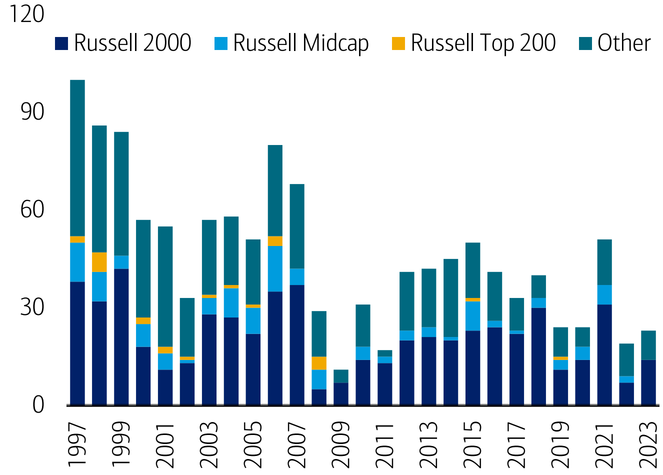
According to our analysts, SMID cap biopharma enters 2024 with an improved backdrop, aided by M&A interest (from large pharma), strong R&D productivity and improving access to capital. And according to our SMID Cap Biotech analyst, strong M&A momentum could continue into 2024 and a more favorable macro backdrop could propel the biotech sector, but full recovery could still take some time (2H24/2025). Focus will remain on high-quality, de-risked assets with strong clinical validation. See: Health Care Year Ahead.

Financials M&A starting to pick up

Exhibit 76: Financials M&A off the lows of 2022

Financials M&A deal count (by Russell size index based on target's index membership at time of deal announcement) 1997-12/31/23



Source: FactSet, BofA US Equity & US Quant Strategy

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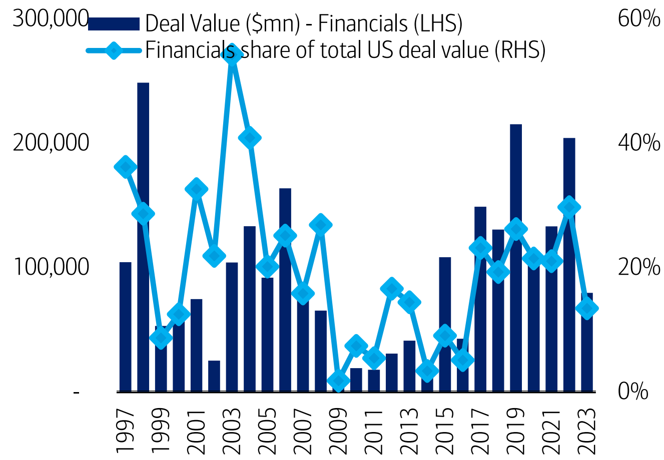
Exhibit 77: and deal value as a % of total has deteriorated to a 7year low

Financials M&A deal value, $mn (and % of total US deal value), 1997-12/31/23



Source: FactSet, BofA US Equity & US Quant Strategy

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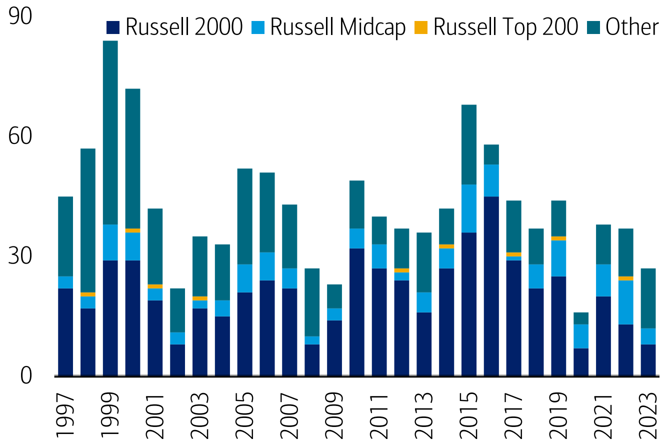
Will Bank M&A pick up? According to Ebrahim Poonawala, yes and no – the regulatory backdrop is not conducive for larger bank M&A, and higher interest rates have been a hurdle. But these could reverse going forward. Per his Banks 2024 Year Ahead: "Regulatory clarity key to reigniting M&A activity. Search for lower cost deposits in a structurally higher rate backdrop, industrial logic of having scale, rising regulatory burden on regional banks…all potential drivers of deal-making.

Meanwhile Tech M&A hasn't yet picked up

Exhibit 78: Tech M&A at its lowest since COVID
Tech M&A deal count (by Russell size index based on target's index membership at time of deal announcement) 1997-12/31/23



Source: FactSet, BofA US Equity & US Quant Strategy
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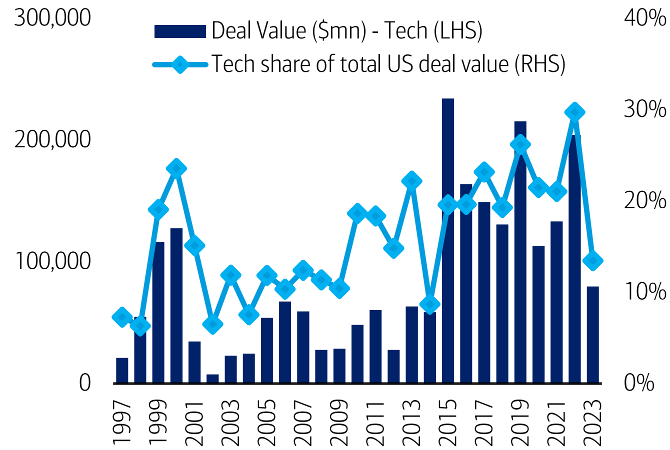
Exhibit 79: and deal value as a % of total has deteriorated to a 10-year low
Tech M&A deal value, $mn (and % of total US deal value), 1997-12/31/23



Source: FactSet, BofA US Equity & US Quant Strategy
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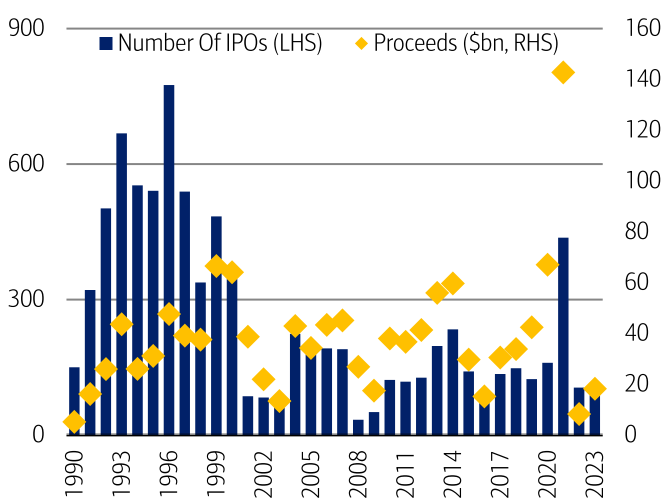
IPOs: slightly better – backdrop still tough

Since 2021's IPO bubble, we've seen IPO activity drop off, with just a slight pick-up in 2023 relative to 2022. IPOs over the last decade were largely in the Health Care sector as well as Tech, but amid the boom of low quality IPOs that underperformed after going public (or de-SPACing) in 2020-21, the sector composition of IPOs has been more evenly spread across sectors the past two years. Investor appetite for low quality stocks in sectors like Health Care has remained limited, though sentiment for the sector overall has improved recently. While less bad vs. 2022, the lack of alpha in the months post-IPO may be a continued deterrent, though lower equity market volatility is conversely a positive for a slow continued improvement in activity relative to recently lows.

Exhibit 80: IPO activity picked up slightly last year but still at low levels
Number of IPOs (LHS) and Proceeds ($bn, RHS) from 1990-present



Note: IPOs of US companies on major US exchanges.
Source: Dealogic data historically, FactSet data for 2021, BofA US Equity & US Quant Strategy
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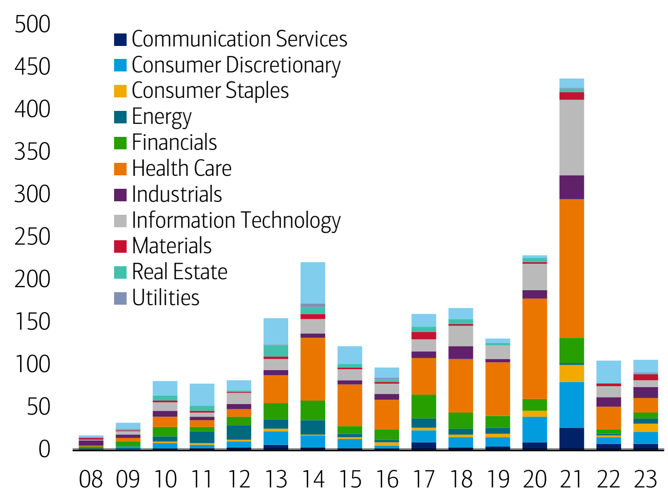
Exhibit 81: Health Care previously made up the bulk of IPO activity, but Health Care IPOs have decline since 2021
Number of IPOs by sector from 1990-present



Note: IPOs of US companies on major US exchanges.
Source: Dealogic data historically, FactSet data for 2021, BofA US Equity & US Quant Strategy
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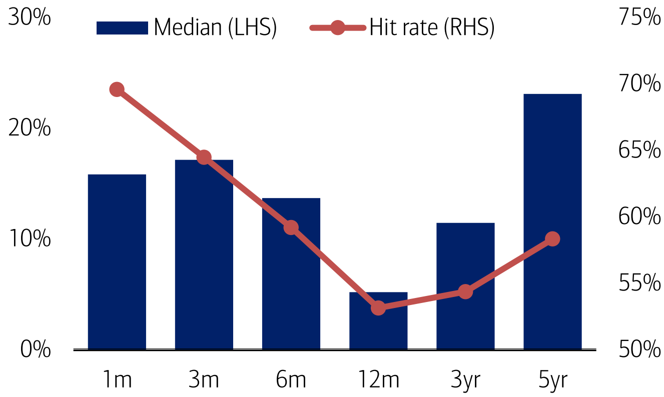
Exhibit 82: Typically IPOs outperform in both the short, medium and long-term
Historical performance of US IPOs (excludes SPACs) over subsequent time periods, 2008-present



Source: FactSet, BofA US Equity & US Quant Strategy

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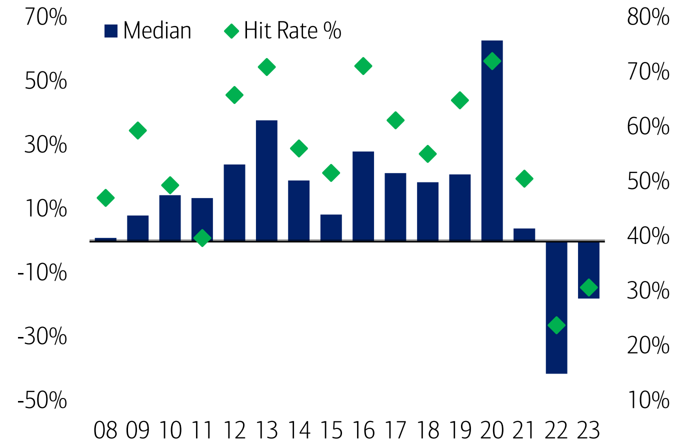
Exhibit 83: But after the IPO bubble of 2020-21, IPOs have underperformed the last two years on a 3-month basis
Median historical 3-month performance of US IPOs (excludes SPACs) from 2008-present



Source: FactSet, BofA US Equity & US Quant Strategy

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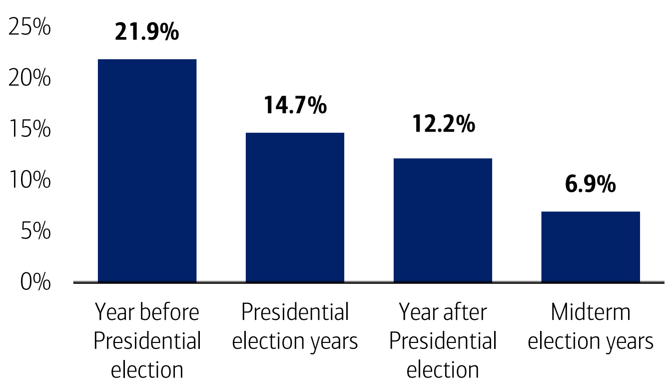
Election 2024 and small caps

Small caps +15% in the average election year

Historically, small caps have returned +15% in Presidential election years, outperforming large caps by nearly 4ppt. This is the second best year of the cycle after the year preceding the election, though 2023 did not follow that historical trend. Midterm election years have typically been weakest for small caps.

Exhibit 84: Small caps +15% in presidential election years
Average small caps total returns by year, 1928-2020



Source: CRSP,, Bloomberg, BofA US Equity & Quant Strategy Excluding 2008, average for "Presidential election years"

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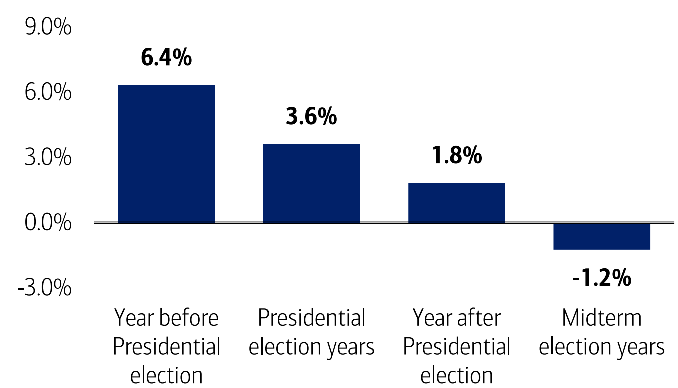
Exhibit 85: Small vs. large cap +4% in presidential election years
Average small vs. large cap relative total returns by year, 1928-2020



Source: CRSP, Bloomberg, BofA US Equity & Quant Strategy Excluding 2008, average for "Presidential election years

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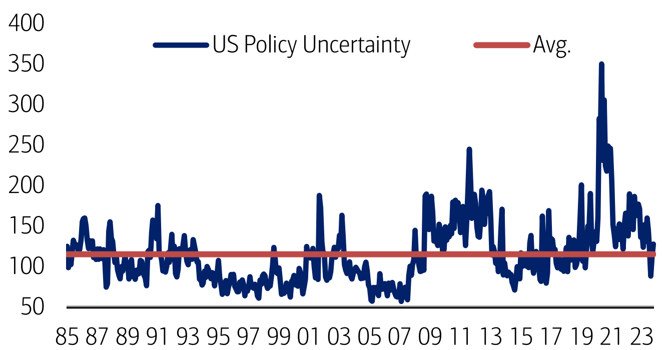
Risk: rise in volatility

Meanwhile, a rise in the VIX ahead of the election would be negative for small caps (one of the most inversely correlated macro indicators with small cap absolute and relative performance), and reason for potentially more caution in 2H24 – though history suggests small caps still end the year up despite the greater political uncertainty.

A pickup in political uncertainty, plus the yield curve's leading relationship to equity market volatility would argue for a higher quality bias come mid-2024 (see: US Equity Strategy Year Ahead).

Exhibit 86: Policy uncertainty spiked into Nov. 2020, Nov 2016, Nov 2012, Nov 2008…
US Economic Policy Uncertainty Index, 1985-today



Source: BofA US Equity & Quantitative Strategy

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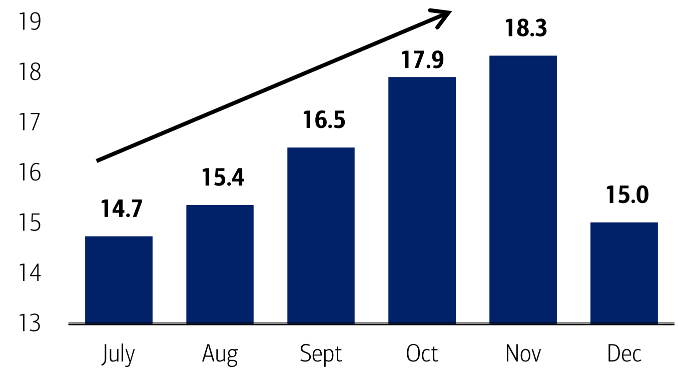
Exhibit 87: 25% increase in volatility from July-Nov of election years
Average monthly volatility (VIX 1990-present, monthly average of daily S&P 500 return volatility 1928-1989) for US election years since 1928



Source: Bloomberg, FactSet, BofA US Equity & Quantitative Strategy

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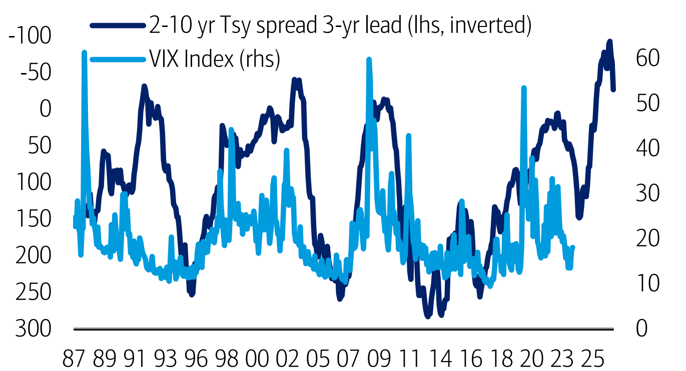
Exhibit 88: The slope of the yield curve indicates a mid-'24 VIX trough
YC 2-10 spread (3yr lead) vs CBOE VIX



Source: BofA US Equity & Quantitative Strategy

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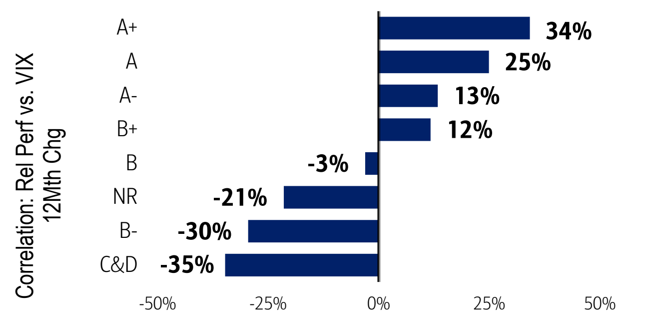
Exhibit 89: High quality stocks tend to outperform when volatility rises
BofA Quality Indices 12-Mth Performance Correlation to 12-mth change in CBOE VIX (1986-present)



Source: FactSet, BofA US Equity & Quantitative Strategy

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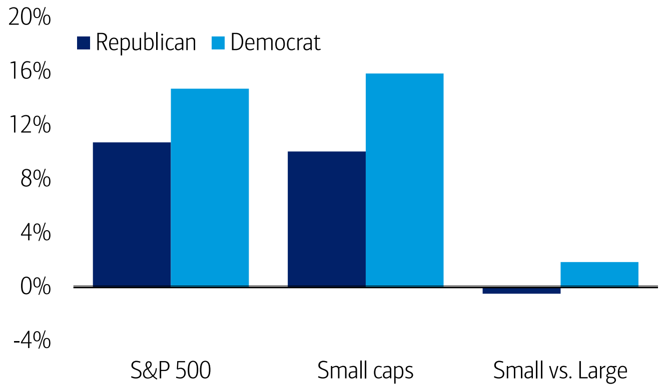
Small caps have historically fared best under Democrats…

(Or when President and Congress were the same party)

Similar to in large caps, small cap returns were historically higher under Democratic presidents than Republican presidents. Meanwhile, they fared best when the President and Congress had the same political party (with Democrat/Democrat the highest returns), followed by Republican/Republican and then both instances of Split Congress.

Exhibit 90: Small caps have historically fared better under Democratic presidents
Average annual returns of small caps and large caps based on President's political party, post WWII era (since 1947)



Note: Small cap returns based on Russell 2000 from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu
Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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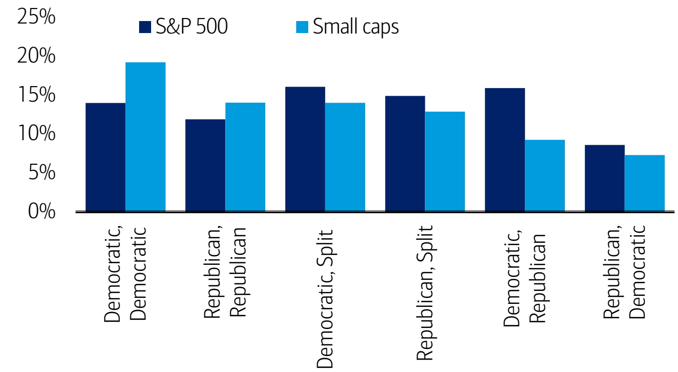
Exhibit 91: Democratic President and Democratic Congress has historically been best return backdrop for small caps, followed by Republican President and Republican Congress
Average annual returns of small caps and large caps based on President's political party and Congress makeup, post WWII era (since 1947)



Note: Small cap returns based on Russell 2000 from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu
Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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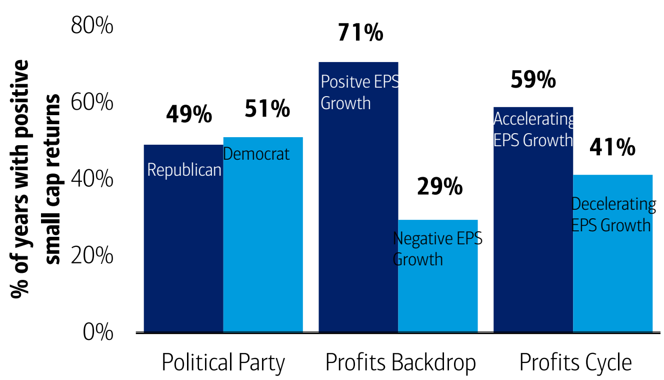
....but similar to in large caps, profits matter more than politics

Overall, the political backdrop has mattered less for small cap absolute and relative returns than the profits backdrop. Similar to in large caps, we observed greater variation in returns based on the phase of the profits cycle than based on the President's political party. We also found that similar results for small vs. large cap relative returns – small caps outperformed in a similar proportion of years regardless of political party, but outperformed much more frequently in years of positive of accelerating US corporate profits growth relative to negative or decelerating growth.

Exhibit 92: US corporate profits have mattered more for small cap returns than the political backdrop...
% of years in the post-WWII (1947-present) era with positive small cap returns based on political party vs the profits backdrop



Note: Small cap returns based on Russell 2000 from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu
Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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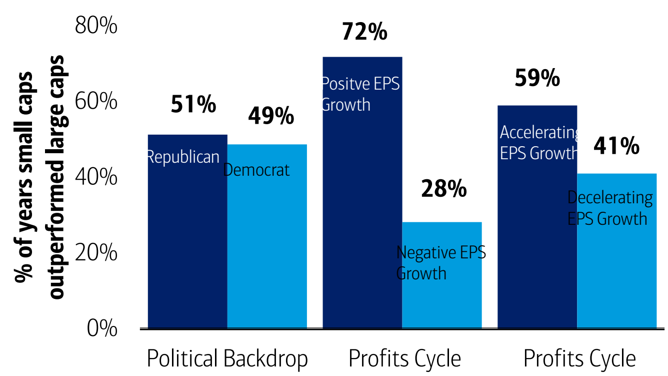
Exhibit 93: ...and US corporate profits have also mattered more for small vs. large relative returns than the political backdrop
% of years in the post-WWII (1947-present) era in which small caps outperformed large caps based on political party vs the profits backdrop



Note: Small cap returns based on Russell 2000 from 1979-present; source for historical returns prior to 1979: CRSP®, Center for Research in Security Prices. Graduate School of Business, The University of Chicago. Used with permission. All rights reserved. www.crsp.uchicago.edu
Performance has been calculated by BofA US Equity & Quant Strategy.
Source: Bloomberg, CRSP, BofA US Equity & US Quant Strategy

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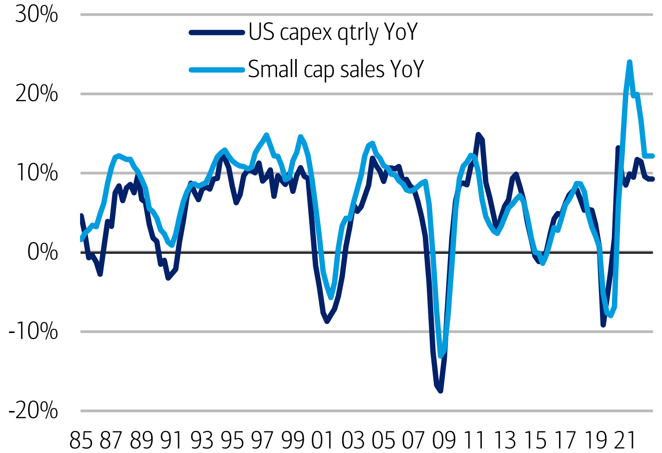
Bipartisan support for re-shoring & mfg. good for small

As highlighted in our US Equity Strategy Year Ahead, a theme that has bi-partisan support is re-shoring/the shift back toward US manufacturing. And as we've written extensively on in the past, re-shoring is particularly bullish for US SMID caps, whose sales are highly correlated with capex cycles.

Exhibit 94: Small caps sales growth is highly correlated with US capex growth....

US quarterly. YoY capex growth vs. Russell 2000 YoY sales growth, 1986-3Q23



Source: FactSet, Haver Analytics, BofA US Equity & US Quant Strategy

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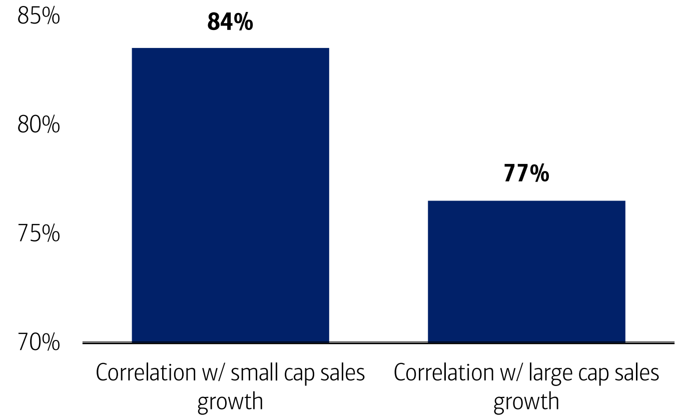
Exhibit 95: ...more so than for large caps

Correlation of US capex growth with small cap (Russell 2000) and large cap (S&P500) sales growth, 1985-present



Correlation w/ small-large cap sales growth spread: 30%

Source: FactSet, Haver Analytics, BofA US Equity & US Quant Strategy

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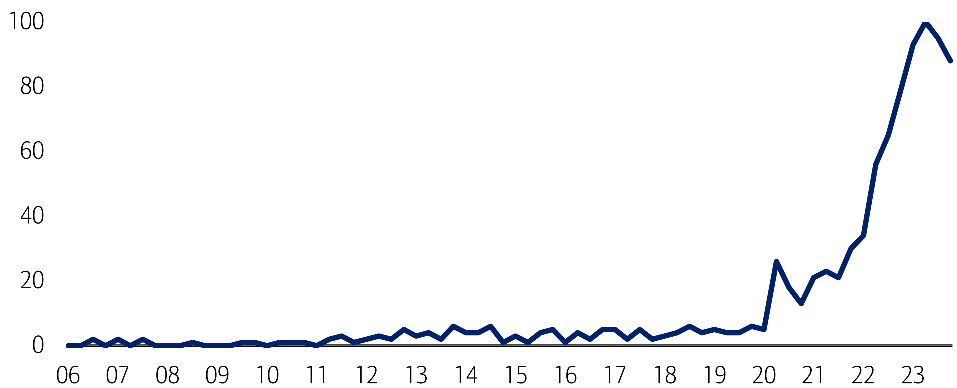
Exhibit 96: Mentions of re-shoring continue to gain momentum

Companies mentions of re-/near-/on-shoring (2006-now as of 12/31/23)



Source: AlphaSense, BofA Global Research

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Style & sectors: 2024 roadmap

Style: Value>Growth

We see multiple reasons to favor small cap Value over Growth:

- **Profits recovery:** the profits cycle has historically been a key driver of Value vs. Growth performance within both small and large caps, and accelerations in US corporative profits growth have been most positive for small cap Value (Exhibit 97).

- **High quality & less duration risk**: The Value benchmark has fewer non-earners and a greater proportion of high quality stocks than the Growth benchmark with small caps (Exhibit 98-Exhibit 99).

- **End of hiking cycle**: Small cap Value has historically outperformed Growth when the Fed is done hiking (Exhibit 100)

- **Valuations**: Small cap Value remains historically inexpensive vs. Growth on most metrics we track (where the avg. premium of Growth vs. Value to history is 9%; Exhibit 101).

Meanwhile, performance of Value vs. Growth has been less consistent than other styles in Downturn regimes (current phase of our US Regime Indicator), while Recovery phases have been most bullish for Value. But with mixed signals from the underlying components of our indicator, it may be less useful for style selection near-term. Additionally, if risk of a US economic recession rises, small cap Value has actually outperformed Growth during US economic recessions.

Exhibit 97: Profits cycle accelerations positive for Value vs. Growth, particularly within small caps
Avg. annualized quarterly performance of Growth vs. Value (based on Fama French data) in periods of accelerating vs. decelerating corporate profits, 1925-present

	Small Value	Small Growth	Relative	Large Value	Large Growth	Relative
Accelerating Profits	24%	13%	10%	19%	13%	6%
Decelerating Profits	14%	12%	2%	12%	10%	2%

Source: FactSet, Fama French (https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html), BofA US Equity & US Quant Strategy

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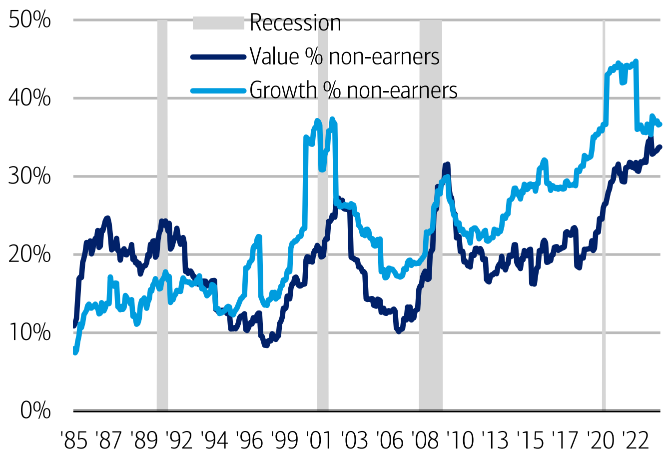
Exhibit 98: More non-earners in the small cap growth benchmark
Russell 2000 Value vs. Russell 2000 Growth: % non-earners (1986-present)



Source: FactSet, BofA US Equity & US Quant Strategy

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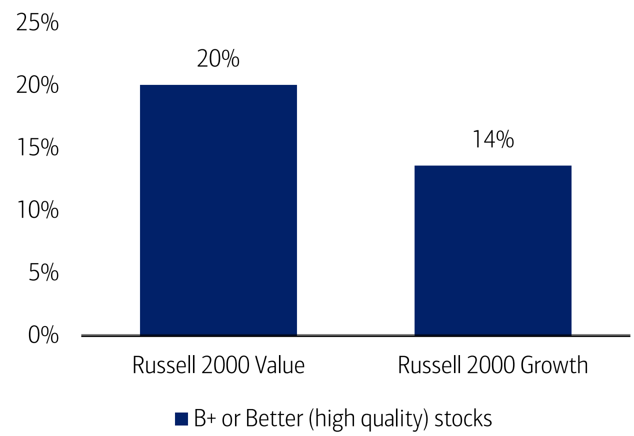
Exhibit 99: Small cap value benchmark has more high quality stocks
Russell 2000 Value vs. Russell 2000 Growth: current % high quality stocks (B+ or Better by S&P Quality Rank)



Source: FactSet, BofA US Equity & US Quant Strategy

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Exhibit 100: Small cap Value consistently outperformed small cap Growth leading into and following the final rate hike
Relative performance (in ppt) of small cap Value vs. small cap Growth around the last Fed rate hike, 1970-present

	3m before last hike	6m before last hike	12m before last hike	3m after last hike	6m after last hike	12m after last hike
Avg	2%	4%	3%	2%	3%	8%
Median	1%	5%	4%	2%	4%	8%
Hit Rate (% times outperformed)	64%	71%	64%	57%	71%	57%

Source: Fama-French (Tuck data library), BofA US Equity & US Quant Strategy

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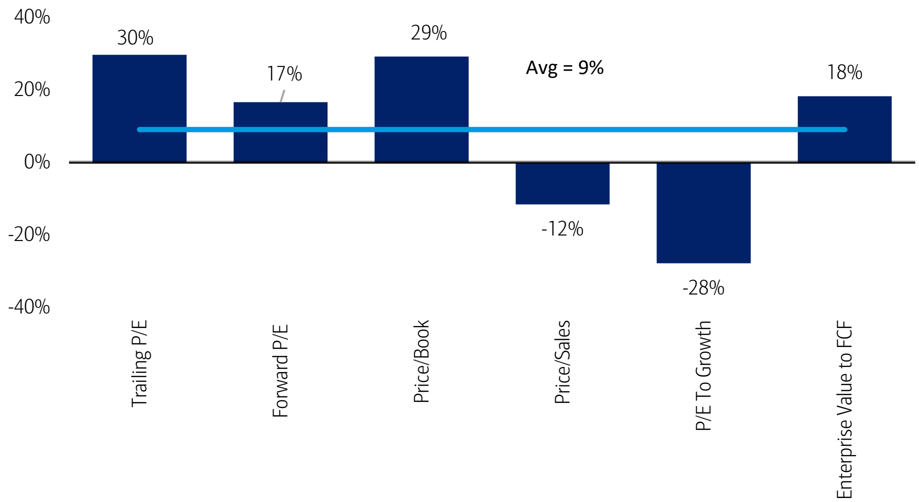
Exhibit 101: Small cap Growth is historically expensive vs Value on four of the six metrics we track
Relative premium (discount) to the historical average multiple for Russell 2000 Growth vs Russell 2000 Value (1985-12/31/2023)



Source: FactSet, BofA US Equity & US Quant Strategy

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Exhibit 102: Small cap styles for different regimes
Small cap factor group performance during phases of our US Regime Indicator (Jan. 1990-present)

Quintile 1 vs. Index

		Valuation	Quality	Liquidity	Growth	Risk	Momentum	Leverage	Cash Deployment	Size
Early Cycle	Median	13%	1%	-1%	2%	2%	0%	-3%	2%	-3%
	Hit Rate	88%	50%	50%	63%	63%	50%	38%	75%	25%
Mid Cycle	Median	4%	2%	3%	3%	5%	2%	1%	-4%	-2%
	Hit Rate	63%	88%	63%	75%	75%	75%	88%	25%	50%
Late Cycle	Median	-1%	6%	1%	0%	-10%	0%	1%	5%	3%
	Hit Rate	38%	100%	50%	50%	13%	63%	63%	75%	88%
Recession	Median	0%	3%	0%	0%	-9%	5%	-2%	5%	3%
	Hit Rate	43%	86%	57%	29%	14%	71%	43%	86%	71%

Quintile 5 vs. Index

		Valuation	Quality	Liquidity	Growth	Risk	Momentum	Leverage	Cash Deployment	Size
Early Cycle	Median	-9%	-7%	-7%	-2%	-3%	4%	-2%	-1%	-2%
	Hit Rate	38%	38%	25%	38%	38%	50%	50%	25%	50%
Mid Cycle	Median	1%	2%	-6%	0%	-6%	-3%	2%	0%	-2%
	Hit Rate	50%	63%	13%	50%	13%	13%	63%	50%	25%
Late Cycle	Median	-9%	-11%	-3%	-7%	6%	-11%	-4%	-2%	-9%
	Hit Rate	13%	0%	13%	13%	63%	0%	38%	25%	0%
Recession	Median	-5%	-8%	-1%	-5%	9%	-12%	-3%	-3%	-5%
	Hit Rate	29%	0%	0%	14%	100%	0%	14%	0%	14%

Quintile 1-Quintile 5

		Valuation	Quality	Liquidity	Growth	Risk	Momentum	Leverage	Cash Deployment	Size
Early Cycle	Median	21%	4%	5%	4%	5%	-6%	5%	5%	-1%
	Hit Rate	88%	50%	75%	63%	63%	50%	75%	75%	50%
Mid Cycle	Median	4%	-4%	8%	6%	12%	6%	-1%	-6%	3%
	Hit Rate	50%	38%	88%	75%	75%	88%	38%	13%	63%
Late Cycle	Median	11%	16%	3%	6%	-17%	12%	3%	8%	16%
	Hit Rate	88%	100%	63%	88%	13%	100%	88%	75%	100%
Recession	Median	2%	8%	1%	7%	-18%	16%	2%	7%	11%
	Hit Rate	71%	100%	86%	86%	0%	100%	71%	100%	71%

Exhibit 102: Small cap styles for different regimes
Small cap factor group performance during phases of our US Regime Indicator (Jan. 1990-present)

Quintile 1 vs. Index

Source: Hit rate = % of periods in which style outperformed the equal-weighted Russell 2000. For complete definitions of our factors, see Appendix in our monthly Small/Mid Cap Factors: a PM's Guide.. Back tested performance is hypothetical in nature and reflects application of the screen and is not intended to be indicative of future performance; Source: FactSet financial data and analytics, BofA US Equity & US Quant Strategy

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Exhibit 103: Even if an economic recession occurred, small cap Value historically beat Growth during the recession
Russell 2000 style groups and median and avg. performance during economic recessions since 1990

Style	Median	Avg
Valuation	15%	22%
Quality	4%	24%
Cash Deployment	4%	8%
Growth	3%	21%
Leverage	3%	16%
Liquidity	3%	30%
Equal-weighted index	**1%**	**15%**
Momentum	1%	19%
Risk	-3%	16%

Source: FactSet, BofA US Equity & US Quant Strategy

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Cash Return factors: hedge against regime whipsaws

Cash return factors (dividends/buybacks) have typically been one of the best-performing small cap styles during both Downturn and Recovery regimes, with dividends or buybacks among the top individual factors in each regime.

Exhibit 104: Top small-cap long factors (Q1 versus index) in Early Cycle (Back-tested)
Annualized performance (Q1-Russell 2000 equal-wtd index) and hit rates of top 15 Russell 2000 factors during Early Cycle regimes since 1990

Q1 vs. Index

Factor	Category	Avg	Median	Hit Rate
CFO/P (LTM)	Valuation	29%	19%	88%
EBITDA/EV	Valuation	17%	11%	88%
Sales/EV	Valuation	17%	12%	88%
Book/Price	Valuation	16%	6%	88%
FCF Yield	Valuation	16%	11%	88%
Forward E/P	Valuation	16%	10%	88%
Trailing E/P	Valuation	11%	9%	88%
FCF/EV	Valuation	10%	9%	88%
FY1/FY0 Growth	Growth	5%	3%	88%
Sales/Price	Valuation	28%	15%	75%
Net Debt/Mkt Cap	Leverage	20%	13%	75%
Cumulative trading volume (-1m)	Liquidity	7%	5%	75%
3M Avg Daily Volume	Liquidity	6%	2%	75%
Dividends: Nonpayer-Payer	Cash Deployment	1%	2%	75%
1M Change 200 Day MA	Momentum	-4%	4%	75%

Source: FactSet, BofA US Equity & US Quant Strategy. Avg = average.
Note: Hit rate = % of periods in which Q1 outperformed Q5. For complete definitions of our factors, please see the Appendix. Back-tested performance is hypothetical in nature and reflects application of the screen and is not intended to be indicative of future performance. Back-tested performance here is the annualized performance during each regime of the US Regime Indicator from January 1990 through the present, based on our top quintile factors of the Russell 2000.

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Exhibit 105: Top small-cap long-short factors (Q1-Q5) in Early Cycle (Back-tested)
Annualized performance (Q1-Q5 spreads and hit rates) of top 15 Russell 2000 factors during Early Cycle regimes since 1990

Q1-Q5

Factor	Category	Avg	Median	Hit Rate
CFO/P (LTM)	Valuation	34%	43%	88%
Sales/Price	Valuation	33%	30%	88%
Book/Price	Valuation	20%	21%	88%
EBITDA/EV	Valuation	18%	24%	88%
FCF Yield	Valuation	11%	24%	88%
Sales/EV	Valuation	21%	25%	75%
Cumulative trading volume (-1m)	Liquidity	20%	14%	75%
Net Debt/Mkt Cap	Leverage	19%	27%	75%
3M Avg Daily Volume	Liquidity	16%	11%	75%
Trailing EG/P	GARP	16%	13%	75%
5Yr Beta	Risk	15%	1%	75%
FCF/EV	Valuation	9%	11%	75%
Net Debt/Equity	Leverage	7%	13%	75%
Forward E/P	Valuation	6%	17%	75%
Share Repurchase	Cash Deployment	6%	16%	75%

Source: FactSet, BofA US Equity & US Quant Strategy
Note: Hit rate = % of periods in which Q1 outperformed Q5. For complete definitions of our factors, please see the Appendix. Back-tested performance is hypothetical in nature and reflects application of the screen and is not intended to be indicative of future performance. Back-tested performance here is the annualized performance during each regime of the US Regime Indicator from January 1990 through the present, based on our top quintile factors of the Russell 2000.

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Exhibit 106: Top small-cap long factors (Q1 versus index) in Downturns (Back-tested)
Annualized performance (Q1-Russell 2000 equal-weighted index) and hit rates of top 15 Russell 2000 factors during Downturn regimes since 1990

Q1	Category	Avg	Median	Hit Rate
Avg 1m price reversal & 12m price return rank	Momentum	7%	4%	100%
Return on Capital	Quality	6%	8%	100%
Share Repurchase	Cash Deployment	6%	3%	100%
10Wk/40Wk MA	Momentum	5%	4%	100%
FCF/EV	Valuation	9%	4%	83%
FCF ROA	Quality	7%	8%	83%
Cash Flow ROIC	Quality	6%	5%	83%
Dividend Yield (Payers Only)	Cash Deployment	6%	2%	83%
Estimate Diffusion	Growth	5%	6%	83%
Dividends: Nonpayer-Payer	Cash Deployment	5%	3%	83%
Dividend Growth	Cash Deployment	5%	3%	83%
1M Change 200 Day MA	Momentum	4%	2%	83%
Cumulative trading volume (-1m)	Liquidity	4%	3%	83%
Earners/Nonearners	Quality	3%	2%	83%
30wk/75wk MA	Momentum	3%	2%	83%

Source: FactSet, BofA US Equity & US Quant Strategy. Avg = average.
Note: Hit rate = % of periods in which Q1 outperformed Q5. For complete definitions of our factors, please see the Appendix. Back-tested performance is hypothetical in nature and reflects application of the screen and is not intended to be indicative of future performance. Back-tested performance here is the annualized performance during each regime of the US Regime Indicator from January 1990 through the present, based on our top quintile factors of the Russell 2000.
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Exhibit 107: Top small-cap long-short factors (Q1-Q5) in Downturns (Back-tested)
Annualized performance (Q1-Q5 spreads and hit rates) of top 15 Russell 2000 factors during Downturn regimes since 1990

Q1-Q5	Category	Avg	Median	Hit Rate
FCF/EV	Valuation	23%	18%	100%
FCF ROA	Quality	22%	21%	100%
Return on Capital	Quality	21%	16%	100%
Avg 1m price reversal & 12m price return rank	Momentum	19%	11%	100%
10Wk/40Wk MA	Momentum	18%	19%	100%
Cash Flow ROIC	Quality	18%	13%	100%
1M Change 200 Day MA	Momentum	18%	17%	100%
Return on Avg Assets LTM	Quality	16%	10%	100%
30wk/75wk MA	Momentum	16%	16%	100%
Share Repurchase	Cash Deployment	15%	7%	100%
9M price change	Momentum	15%	17%	100%
12M Price Change	Momentum	14%	15%	100%
5Wk/30Wk MA	Momentum	13%	16%	100%
FCF Yield	Valuation	21%	16%	83%
Forward E/P	Valuation	19%	7%	83%

Source: FactSet, BofA US Equity & US Quant Strategy
Note: Hit rate = % of periods in which Q1 outperformed Q5. For complete definitions of our factors, please see the Appendix. Back-tested performance is hypothetical in nature and reflects application of the screen and is not intended to be indicative of future performance. Back-tested performance here is the annualized performance during each regime of the US Regime Indicator from January 1990 through the present, based on our top quintile factors of the Russell 2000.
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Sectors: cyclicals>defensives, Health Care looking less bad

Tactical quant ranks suggest favoring Financials & Energy, avoiding REITs/Utes

Our quantitative small cap sector ranks – based on relative valuations, revisions, technicals and BofA analyst upgrades-downgrades – suggest a preference for cyclicals>defensives, with Financials and Energy on top. Energy also looks historically cheap and underowned by small cap funds, and tends to outperform leading into and following Fed rate cuts (table below). For Financials, a better backdrop for Banks is a positive, and small cap Financials are higher quality vs. several decades ago, though we are mindful of credit risks, and would remain focused on larger/higher quality Banks within SMID. The sector is also overweight by funds. Industrials is another cyclical that ranks well, should benefit from an improving ISM, and outperforms during Fed cutting. Funds are overweight the sector, but generally less so than historically.

Less negative on Health Care – but stay selective

Health Care has climbed from the bottom of our small cap ranks (where it stood for the majority of the last few years) to the middle of the pack, driven by improving revision trends and BofA analyst sentiment. A big pick-up in sector M&A has been positive, as highlighted earlier, and fund managers have been very underpositioned in Health Care both relative to the benchmark and vs. history (table below). The worst may be behind us for small cap Health Care, but we would still avoid lower quality non-earners amid duration/rate risks. Another reason for caution around Health Care along with TMT: Our High Yield strategist expects the default rate to increase 1.5x to 3.4%, where "nine out of ten defaults should come from healthcare, retail, cable, and telecom/media/tech (TMT) sectors" (HY Strategy Year Ahead).

Exhibit 108: Financials ranks highest, Utilities lowest
Small cap quantitative sector ranks (11=highest, 1=lowest) as of 12/31/2023

Sector	Combined Rank (highest to lowest)	Valuation Rank	Revisions Rank	Momentum Rank	BofA Sentiment Rank
Financials	11	10	7	6	11

Exhibit 108: Financials ranks highest, Utilities lowest

Small cap quantitative sector ranks (11=highest, 1=lowest) as of 12/31/2023

Sector	Combined Rank (highest to lowest)	Valuation Rank	Revisions Rank	Momentum Rank	BofA Sentiment Rank
Energy	10	11	3	8	10
Communication Services	8	9	8	1	10
Industrials	8	3	11	11	3
Materials	6	6	5	4	10
Consumer Discretionary	6	7	2	9	7
Health Care	5	3	10	2	6
Consumer Staples	3	5	9	5	1
Information Technology	3	1	4	10	5
Real Estate	2	8	1	7	2
Utilities	1	1	6	3	4

Source: BofA US Equity & Quant Strategy, FactSet

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Exhibit 109: Energy has typically outperformed leading into and following Fed rate cuts

% of time sectors outperformed the Russell 2000 around the first Fed cut since 1974

	# of months before/after first cut							
	-12	-6	-3	-1	1	3	6	12
Comm. Svcs.	57%	29%	57%	57%	43%	57%	57%	57%
Cons. Disc.	29%	43%	29%	86%	43%	57%	57%	57%
Staples	57%	43%	71%	57%	14%	43%	14%	14%
Energy	57%	71%	57%	29%	43%	57%	57%	57%
Financials	29%	29%	43%	57%	43%	29%	43%	43%
Health Care	57%	57%	57%	43%	14%	29%	14%	14%
Industrials	57%	71%	43%	43%	71%	57%	57%	57%
Tech	57%	57%	43%	57%	71%	43%	86%	71%
Materials	29%	29%	29%	43%	29%	57%	43%	71%
Real Estate	57%	29%	29%	29%	43%	57%	29%	43%
Utilities	57%	43%	57%	71%	29%	43%	14%	43%

Source: BofA US Equity & Quant Strategy, FactSet, Bloomberg

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Exhibit 110: Small cap funds are underweight Energy, Health Care and Tech both vs. the benchmark and vs history; Discretionary, Materials and Financials are crowded vs the index and vs history

Small cap active fund managers' relative weight the 11 GICS sectors and z-score vs. history since 2018

	Small cap core		Small cap growth		Small cap value	
Sector	Current	Z-score	Current	Z-score	Current	Z-score
Communication Services	0.78	0.25	0.72	0.12	0.70	(0.57)
Consumer Discretionary	1.05	0.70	1.04	0.74	1.29	0.23
Consumer Staples	1.05	(0.95)	0.93	(0.31)	0.98	0.94
Energy	0.84	(1.31)	0.75	(0.93)	1.01	(0.07)
Financials	1.26	0.35	1.66	0.48	0.78	(0.51)
Health Care	0.56	(0.40)	0.82	(0.36)	0.58	(0.76)
Industrials	1.26	(0.41)	1.15	0.42	1.30	(0.64)
Information Technology	0.76	(1.90)	0.94	(1.57)	1.53	1.43
Materials	1.57	0.85	0.87	(0.15)	1.94	0.70
Real Estate	0.94	0.37	1.37	1.99	0.81	0.82
Utilities	0.89	(0.06)	0.38	(0.39)	0.61	0.33

Source: FactSet, BofA US Equity & US Quant Strategy

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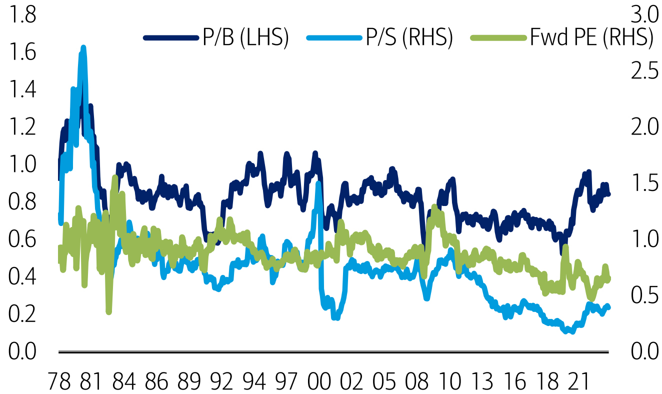
Exhibit 111: Small cap cyclicals: relatively cheap vs defensives on P/E and Price/Sales, less so on Price/Book

Relative median valuation of Russell 2000 cyclical vs defensive sectors (1978-12/2023)



Source: BofA US Equity & Quant Strategy, FactSet

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Appendix

Methodology: US Regime Indicator

Inputs for the US regime indicator include the following eight macroeconomic or top-down variables:

- **Earnings Revision ratio**: Calculated as the ratio between the number of companies in the S&P 500 for which Thomson Financial consensus earnings estimates have been raised versus those that have been lowered. A rising ratio indicates an improving economic cycle.

- **ISM PMI:** ISM PMI Institute for Supply Management Manufacturing Purchasing Managers Index, represented as the Z-Score. The ISM Manufacturing Index monitors economic activity as reported by 300 supply management professionals. The reading of the index above (below) 50 indicated economic expansion (contraction).

- **Inflation**: The 12-month change in the BofA Inflation Composite (see methodology further below), represented as the Z-Score. Rising inflation indicates improving economic conditions.

- **GDP Forecast:** The next 12-month US GDP growth forecast from the Federal Reserve Bank of Philadelphia Survey, represented as the Z-Score.

- **Leading Economic Indicators index**: The 12-month change in the Conference Board US Leading Index of Ten Economic Indicators, represented as a Z-Score. A rising Z-Score indicates improving economic conditions.

- **US Capacity Utilization**: The 12-month change in US capacity utilization, represented as the Z-score. The capacity utilization rate indicates the percentage of total economic capacity currently utilized. Rising capacity utilization implies improving economic conditions. Rising capacity utilization suggests more expanding economic cycle and potentially rising inflationary pressure.

- **10-year US Treasury Bond Yield**: The 12-month change in the bond yield, represented as the Z-Score. Rising yields indicate improving economic conditions.\

- **High Yield corporate bond credit spread**: The 12-month change in the US High Yield credit spread of the ICE BofA US High Yield Index, represented as a Z-score. Falling spreads indicate improving economic conditions.

Disclosures

Important Disclosures

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R1]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R1]Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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