

KEY TAKEAWAYS

We believe small caps are becoming an increasingly attractive tactical opportunity amid policy skepticism in Washington, D.C.

Loss of confidence in policymakers' ability to achieve tax reform has created an opportunity in small caps, in our view, should a tax deal be reached in Washington, D.C.

The potential for the U.S. dollar to reverse recent losses may also provide a boost to small cap performance.

Risks include failure to reach a tax deal, the age of the business cycle, and elevated valuations.

July 31 2017

IS POLICY SKEPTICISM CREATING A SMALL CAP OPPORTUNITY?

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We believe small caps are becoming an increasingly attractive tactical opportunity. The primary reason for our optimism is the amount of skepticism toward the Trump administration's ability to move its policy agenda forward, particularly with regard to tax reform. Small cap stocks benefit disproportionately from a lower corporate tax rate because of their more domestic focus. We still think tax reform will be passed in early 2018 despite widespread skepticism, though likely a slimmer version than the Trump administration and congressional leaders have proposed. Here we discuss the opportunity in small cap stocks that may be developing as skepticism builds.

POLICY UPSIDE

Small caps have underperformed their large cap counterparts in 2017 but performance has been improving since the end of May. Year to date, the small cap Russell 2000's 5.6% advance trails that of the large cap Russell 1000 (+10.5%),

1 STOCKS BEST POSITIONED TO BENEFIT FROM TAX REFORM HAVE BEEN LAGGING

● Strategas Policy High Tax Portfolio Relative to the Low Tax Portfolio, 100=06/01/16



Source: LPL Research, Strategas Research Partners 07/25/17

Performance of stocks with high tax rates relative to stocks with low tax rates. A rising line indicates the market is favoring stocks with high tax rates. A falling line indicates the market is favoring stocks with low tax rates. Past performance is no guarantee of future results.

although small caps have outperformed large by 2% since the end of May. At a macro level, we believe one of the biggest reasons for the underperformance is the market's skepticism toward policymakers' ability to enact corporate tax reform and other pro-growth policies proposed by the Trump administration and congressional leaders. Unsuccessful attempts by Senate Republicans to repeal and replace the Affordable Care Act to date have no doubt added to the market's pessimistic view.

Figure 1 highlights this waning confidence in tax reform's prospects. The chart represents the relative performance of stocks with high tax rates relative to stocks with low tax rates, from our friends at Strategas Research Partners. A rising line indicates the market is favoring stocks with high tax rates that are positioned to benefit most from a lower rate, while a falling line indicates the market is favoring stocks with low tax rates that benefit less from a lower rate.

Why do smaller companies like tax reform more? Simply put, smaller market cap companies generally have higher tax rates than their larger cap brethren—we estimate an average of about 5 percentage points higher—mostly because smaller companies generate a higher proportion of their earnings in the U.S. (earnings overseas pay lower tax rates). That means that smaller, more domestic-focused companies have more to gain from a potentially lower U.S. corporate tax rate, which we expect to make it through Congress and be signed by President Trump in early 2018—though it won't be easy ([discussed here last week](#)). Our optimism, though somewhat guarded, toward a potential tax deal suggests small caps may be poised to further close the performance gap with large caps in the coming months.

We should note that while we do expect a tax deal to get done, it may end up being a simple tax cut and not full reform. It is also important to keep in mind that a federal budget for 2018 must be finished first which won't be easy and is probably the biggest impediment to any changes to tax laws at this point.

CURRENCY SIGNALS

We believe the potential for the U.S. dollar to reverse recent weakness is another reason that small caps are worth consideration as a tactical idea at this time. Given that geographic exposure is a key distinction between large and small cap companies, it is not surprising that foreign currencies tend to exhibit correlation with the relative performance of small caps versus large. We estimate that roughly 20–25% of small cap companies' revenue comes from overseas markets, while the number for large caps is in the 35–40% range. Because of their more domestic focus, small cap stocks tend to (though not always) do better in strong U.S. dollar environments. A weak dollar helps multi-nationals more because they earn more revenue in foreign currencies that gets translated back into more dollars.

This relationship has been especially tight this year as shown in **Figure 2**, which charts the relative strength of small cap stocks versus large (blue line) against the trade-weighted U.S. Dollar Index (yellow line). Small caps and the dollar have moved closely together using this view, which covers the eight months leading up to the election in November 2016 and the eight months since.

This tight correlation is not particularly surprising given small caps and the U.S. dollar are both widely considered so-called "Trump trades." Small cap performance has been and will likely continue to be dependent on prospects for tax reform. Foreign trade and other policies proposed and championed by the Trump administration tend to be positive for the U.S. dollar (even though the pro-U.S. dollar border adjustment tax is now off the table). More growth means more inflation, in theory, which tends to put upward pressure on interest rates, which in turn makes the U.S. dollar more attractive for foreign investors. Bottom line, the dollar is in some ways a barometer on the market's confidence in the Trump administration's ability to achieve its agenda.

Worth noting is that the two lines in [Figure 2](#) have diverged some in recent weeks, with small cap performance improving while the dollar has weakened further. This divergence raises these questions: how fast will this relationship reconnect? And, how will it reconnect? Will small cap performance roll over or will the U.S. dollar begin to rally? Our bias is that a stronger dollar is likely to shoulder more of the load, rather than small caps rolling over, as the relationship is reestablished.

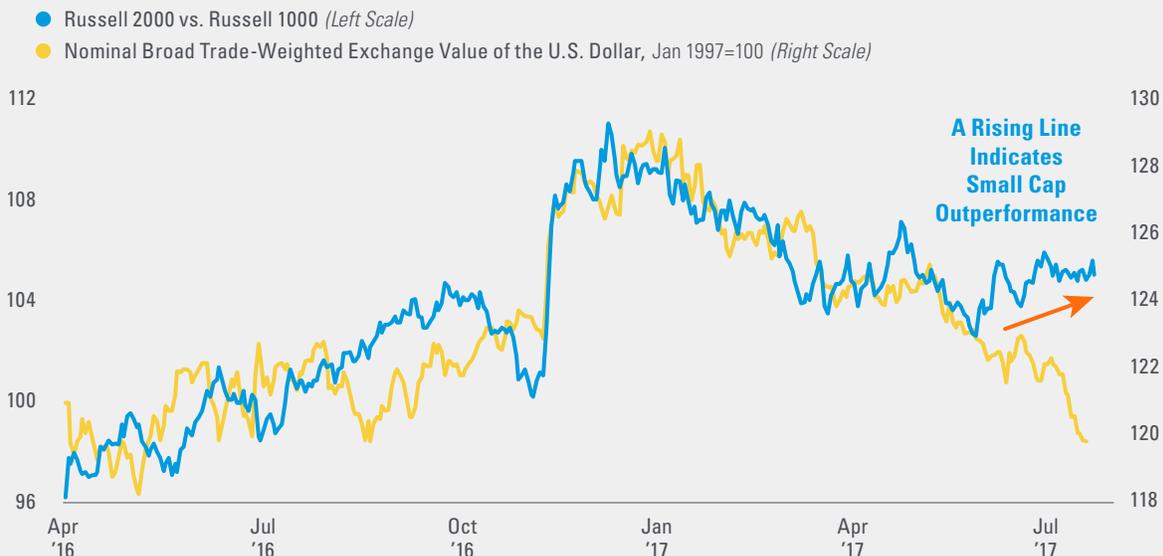
RISKS

The biggest risks to consider with small caps in our view, beyond a tax deal not getting done are: 1) the age of the business cycle — small caps have historically not performed as well during the latter stages of an economic expansion, 2) should the

broad market correct, small caps may potentially correct more given their greater economic and stock market sensitivity, and 3) valuations are on the high side, though we would argue that large cap valuations are also on the high side and therefore, on a relative basis we view small caps as fairly valued.

We should also point out that repatriation, which is likely to be part of any tax agreement, is more pro-large cap. Larger companies have more cash overseas and therefore benefit more from a lower (potentially very low) tax rate on overseas cash brought back into the U.S. Should the market grow increasingly optimistic that this policy will be enacted, though confidence is already high for this particular element of the tax equation, we would likely see increased investor enthusiasm for large cap companies with the most cash.

2 SMALL CAP PERFORMANCE MAY IMPROVE FURTHER SHOULD THE U.S. DOLLAR STABILIZE



Source: LPL Research, Haver Analytics 07/25/17

The Russell 1000 Index measures the performance of the large cap segment of the U.S. equity universe. The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe. Indexes are unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

BOTTOM LINE

We believe the policy pessimism still reflected in small cap stocks sets up a potential tactical opportunity. We are not in the typical sweet spot of the economic cycle and we certainly would not characterize small cap stocks as attractively valued. But should a tax deal in Washington, D.C. be reached, which we continue to believe is more likely than not, we would expect small caps to build on improved performance in recent weeks. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Small cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the small cap market may adversely affect the value of these investments.

Tactical strategies may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently. The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Dollar Spot Index (BBDXY) tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar.

The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index.

The Russell 1000 Index measures the performance of the large cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

The Strategas High Tax-Low Tax Index reflects the relative performance of stocks that Strategas believes are best positioned to benefit from corporate tax reform. A rising line indicates the market is pricing in higher expectations for tax reform, while a falling line indicates the market is pricing in a lower probability of tax reform.

This research material has been prepared by LPL Financial LLC.

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RES 5998 0717 | Tracking #1-629999 (Exp. 07/18)