Thackray Report

Small Cap Barometer Not a Positive Reading

April 26, 2021 Written by Brooke Thackray

The small cap sector outperformed the S&P 500 from March 2020 until March 2021– Recently small caps have been underperforming– what does this mean?

The small cap sector is providing a good read on the investment climate in the markets. The relative strength of the small cap sector compared to the S&P 500 has been a good "tell" on the overall strength of the market as the economy has improved in 2020 and 2021. From the COVID-19 bottom in the stock market in late March 2020 until mid-March 2021, small caps have been performing equal to or better than the S&P 500, this has been a sign of strength for the S&P 500. Recently, the small cap sector has been underperforming the S&P 500, even as the S&P 500 has managed to climb even higher. Does this mean that the small cap sector is no longer a good barometer for the S&P 500?

As the COVID-19 pandemic unfolded, in early 2020 ①, the small cap sector underperformed the S&P 500. Investors exited small caps at a much faster rate than large caps as large caps are generally better capitalized and have less risk. In late March of 2020 as the S&P 500 bottomed ②, the small cap sector managed to outperform the S&P 500 in fits and starts until early June. Small caps outperforming off a bottom is a good thing and a sign of strength.

From June 2020 to October 2020 ③, the small cap sector performed approximately equal to the S&P 500 as it climbed slowly higher. When the small cap sector performs at market or better than market in the summer months, this is a sign that the market is healthy with the potential to move higher. From the end of October 2020 to mid-March 2021 ④, the small cap sector strongly outperformed the S&P 500 as the market went to full risk-on mode and COVID-19 vaccine trials initially rolled out and then the emergency approved vaccines started to be distributed to the population. From mid-March to present ⑤, the small cap sector has been underperforming the S&P 500. This shift took place as investors shifted to less risk and favored some of the defensive sectors. Essentially, the small cap sector's relative performance compared to the S&P 500 has been acting as a barometer for the broad stock market.

So far, the small cap sector's underperformance has not translated into a negative absolute performance for the S&P 500. This is not surprising. First, the small cap sector became extremely stretched during its strong seasonal period form mid-December 2020 to mid-March 2021 and turned down on a relative basis as its strong seasonal period ended. Second, the small cap sector's underperformance does not mean that the small cap sector is necessarily forecasting a correction in the overall stock market. The small cap sector often underperforms the S&P 500 as the S&P 500 heads higher. A problem could arise if the small cap sector starts to turn lower on an absolute basis.

Currently, the small cap sector is in a consolidation pattern, moving sideways on an absolute basis (top panel of graph). It is too early to read into this development and state that it is a topping pattern and the next move is down. It is possible that the Relative Strength Index (RSI) (last panel on graph) is giving us a clue as it has been diverging absolute price action of the small cap sector. Since February of this year, the RSI has been trending lower as small caps have been flat, which increases the odds that the small cap sector will resolve the divergence by moving lower.

In order to get a "read" on the health of the overall stock market, monitor these three market movements over the next few weeks:

(1) If the small cap sector resumes its outperformance of the S&P 500, then this will be supportive of the market at least "holding in," or moving higher. This is also true if the S&P 500 moves lower, but the small cap sector outperforms. This is often an indication of a shallow move lower in the S&P 500 before moving higher.

(2) If the small cap sector continues to underperform and the S&P 500 moves higher. This often translates into a rally without a lot of strength. Although the S&P 500 market could move higher, it is susceptible to a correction.

(3) If the small cap sector moves lower and the S&P 500 follows, this will probably be bad news. A falling small cap sector is often a sign of investors losing their risk appetite. If the large caps are not picking up the slack, then this will indicate that investors are more interested in leaving the market than hiding in large caps.

On a seasonal basis, over the long-term (1979 to 2020), the small cap sector on average tends to slightly outperform the large cap sector (Russell 1000) in the month of May. In June, the small cap sector tends to perform equal to large caps and in July underperform large caps (Thackray's 2021 Investor's Guide). Given that the small cap sector tends to perform at market or slightly better than market over the next two months, its relative performance to the market should be a good indicator of market health.

It is important to also track the direction of interest rates. The bottom of panel of the graph above shows the movement of the yield on the US Treasury 10 Year Note. It is evident that the direction of yields is somewhat correlated to the performance of the small cap sector

compared the S&P 500 in the COVID-19 pandemic. As yields have fallen, small caps have tended to underperform the S&P 500 and vice versa. This makes sense. One of the reasons yields rise is stronger economic growth, which benefits small caps more than large caps. Another reason is that the small cap sector has a larger percentage of financial companies compared to the S&P 500 and rising rates helps to push up the financial sector.

The direction of interest rates is not always indicative of market health as interest rates can rise and fall for many reasons, including Federal Reserve artificial manipulation. Currently, the relationship between small cap's relative performance compared to the S&P 500 is closely tracking interest rate movements and has been throughout the pandemic. As such, monitoring interest rate movements will help anticipate small cap relative performance compared to the S&P 500 and the overall health of the market.

Even if you do not invest or plan to invest in small caps, the sector's performance can be used as a barometer to help establish the appropriate risk-reward level in the market. Combining seasonal trends for the stock market with monitoring the small cap sector's performance can also help to boost the probability of success. Given that the stock market is about to transition into the six-month unfavorable period for stocks (May 6 to October 27), a weaker reading from the "small cap barometer," should be given more weight in a risk-reward allocation in a portfolio.