

Rethinking Market Leadership

THE POTENTIAL OPPORTUNITY FOR SMALL CAPS

US small caps may be on the upswing. After several years of relative underperformance, we believe the asset class could be approaching an inflection point. A combination of macroeconomic, earnings, valuation, and structural factors, which have historically been supportive of small-cap companies, alongside new catalysts suggests market leadership could broaden beyond a narrow group of mega-cap companies.

George C. Saffaye
Global Investment Strategist
BNY Investments Newton

We highlight **five drivers** that, in our view, support a more constructive outlook:

1

Beyond Mega Caps: Earnings Breadth Broadens

Earnings breadth appears to be improving, which may provide a more supportive backdrop for smaller companies. Key indicators include net estimate revisions and the share of companies beating expectations.

2

Earnings Reset: Scope for Stabilization

After several years of margin pressure and estimate downgrades, small-cap earnings trends may stabilize as cost pressures moderate and revenue growth broadens.

3

Valuation Gap: Wide Discounts, Selective Opportunity

Small caps trade at a notable discount on common measures (e.g., forward price-to-earnings (P/E) and price/sales (P/S) ratios, as of February 2026).¹ Historically, wider gaps have sometimes preceded mean reversion.

4

Policy Tailwinds: Deregulation, Deals, and Domestic Investment

Reduced regulatory friction and a more constructive deal environment may be relatively supportive for smaller, domestically focused businesses.

5

Interest Expense: A Key Headwind May Be Easing

Moderating interest expense growth may reduce a key earnings drag for some small caps and support operating leverage.

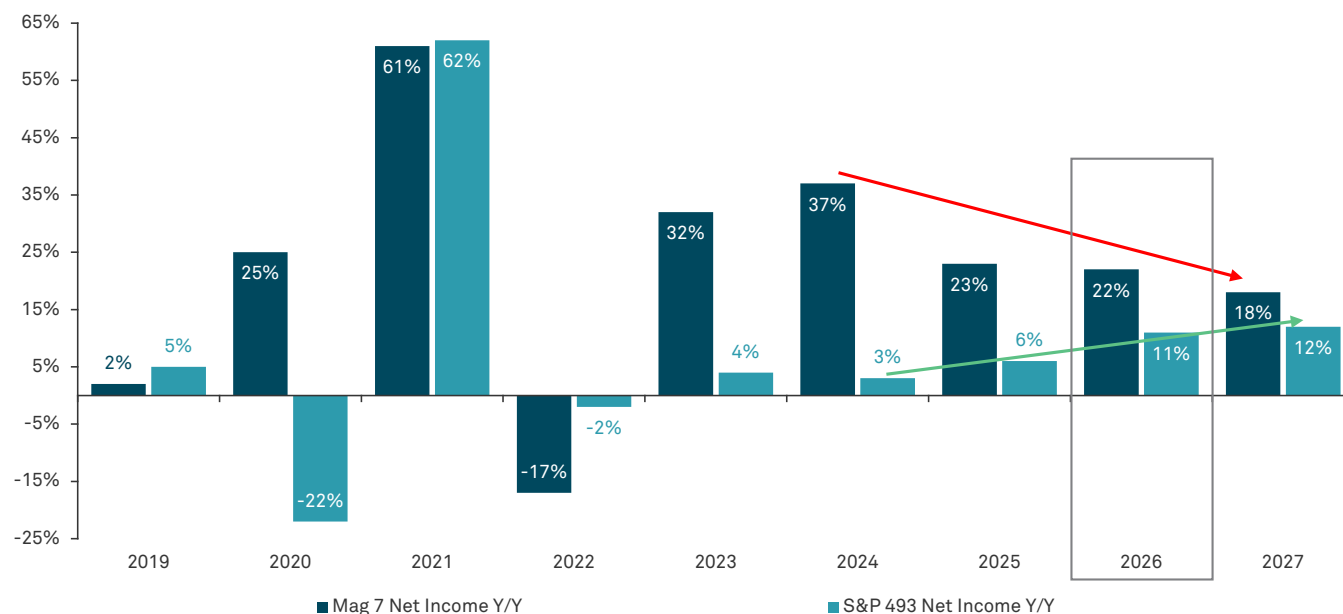
Taken together, these factors suggest we are entering an important phase for US small-cap equities, with broader participation and improving fundamentals as potential tailwinds.

1

BEYOND MEGA CAPS: EARNINGS BREADTH BROADENS

Equity market leadership has been unusually concentrated in recent years, with a small group of mega-cap companies driving a disproportionate share of earnings growth and returns. More recent results suggest earnings momentum may be broadening, as growth among the largest companies moderates while participation across the rest of the market improves. Historically, periods of widening earnings breadth have often been associated with stronger relative conditions for small- and mid-cap equities.

Magnificent 7 Net Income Growth Slowing; Other 493 Beginning to Accelerate



Source: FactSet, Morgan Stanley Research

If this rotation continues, broader earnings participation could help lessen the impact of concentration on small caps. Earnings breadth matters because it can shift leadership beyond the most crowded, liquid names, potentially improving investor engagement and capital availability as growth expands across sectors and industries.

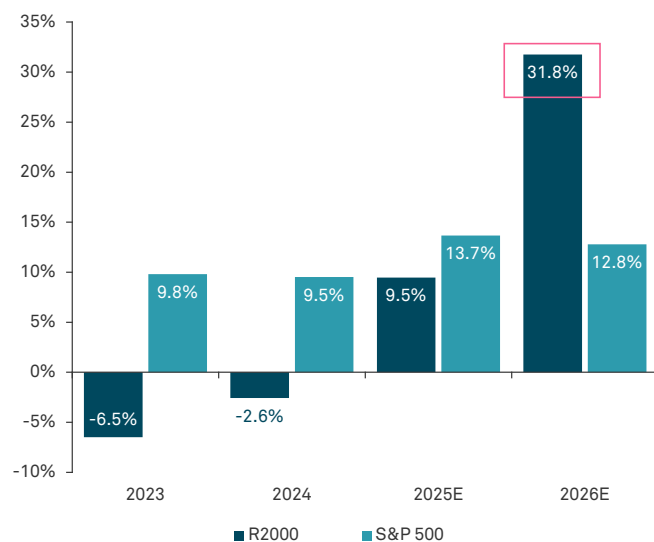
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EARNINGS RESET: SCOPE FOR STABILIZATION

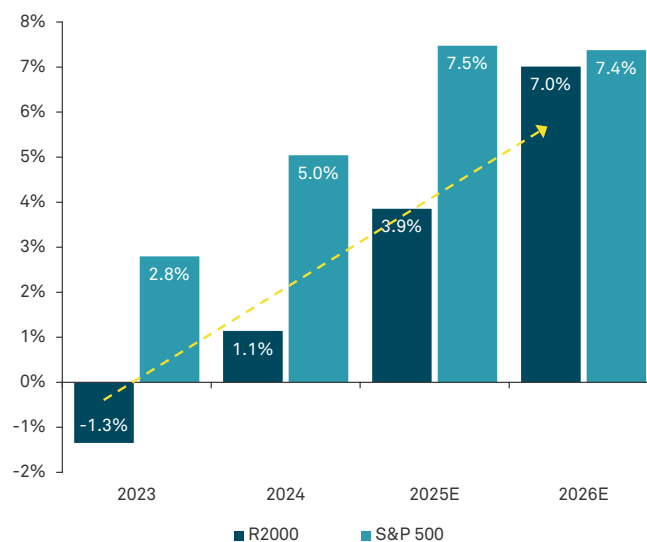
Small-cap earnings have faced a challenging backdrop in recent years, as higher input costs, rising interest expense, and slower top-line growth weighed disproportionately on smaller companies. Looking ahead to 2026, margin pressure may ease as cost inflation moderates and domestic activity supports revenue growth, while prior estimate cuts have reset expectations to more conservative levels.

The Russell 2000 expects stronger 2026E earnings growth and stronger sales growth acceleration. Small caps expect notably stronger earnings growth this year, even after allowing for typical overestimation. Russell 2000 sales growth acceleration is also stronger and closing the relative sales growth gap.

Earnings Growth



Sales Growth



Source: Furey Research Partners and FactSet. based upon our Capitalized Loss Earnings model using historical constituents. Data as of February 26, 2026.

Given operating leverage, even incremental improvement in growth or margins can translate into meaningful earnings sensitivity for small caps. Historically, the period after extended earnings compression has often been more constructive for small caps when growth stabilizes or reaccelerates rather than slipping into recession.

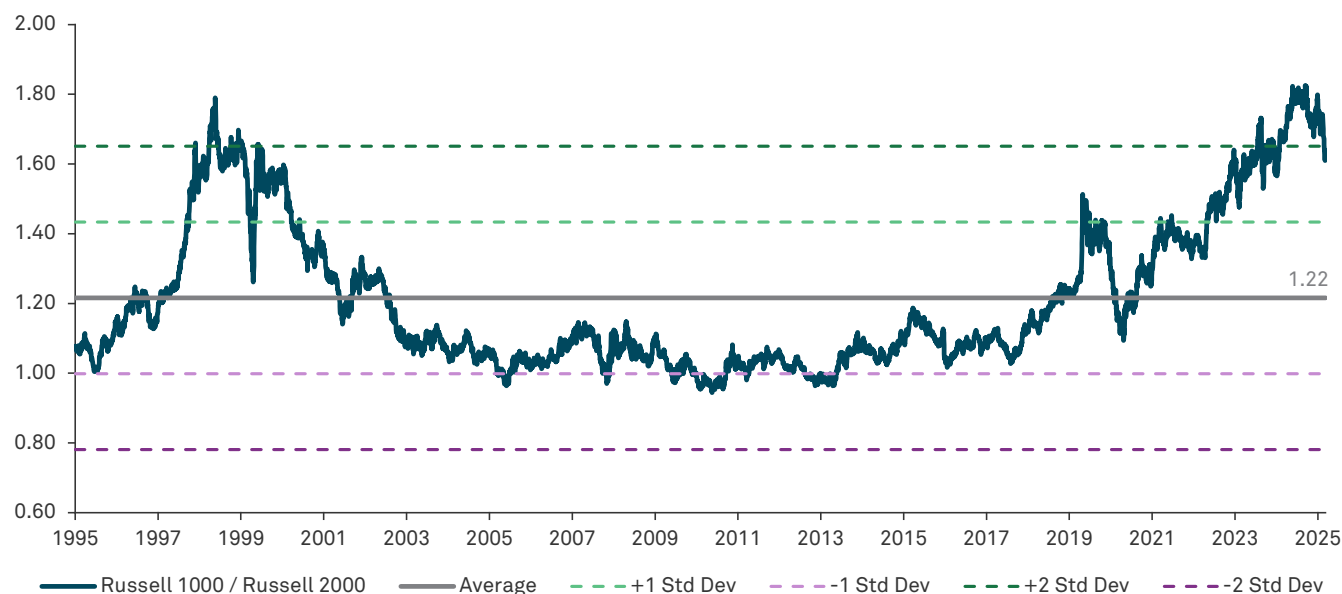
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VALUATION GAP: WIDE DISCOUNTS, SELECTIVE OPPORTUNITY

Valuation is not a reliable timing tool, but it can be an important input to long-term return potential. Small-cap equities currently trade at historically wide discounts versus large caps, reflecting an extended period of underperformance and subdued investor sentiment, with indicators such as the Russell 1000 to Russell 2000 ratio near levels that have previously coincided with inflection points.

US Small Caps have Materially Underperformed Large Caps

Russell 1000 Index / Russell 2000 Index



Source: FactSet, January 2026.

These gaps suggest that a range of commonly cited small-cap risks, such as slower growth, higher rates, and weaker balance sheets, may already be reflected in prices, creating potential upside if earnings growth reaccelerates or sentiment improves. From a portfolio construction perspective, depressed expectations may help reduce downside sensitivity, while any shift toward broader participation and domestically oriented growth could enhance the return opportunity.

4

POLICY TAILWINDS: DEREGULATION, DEALS, AND DOMESTIC INVESTMENT

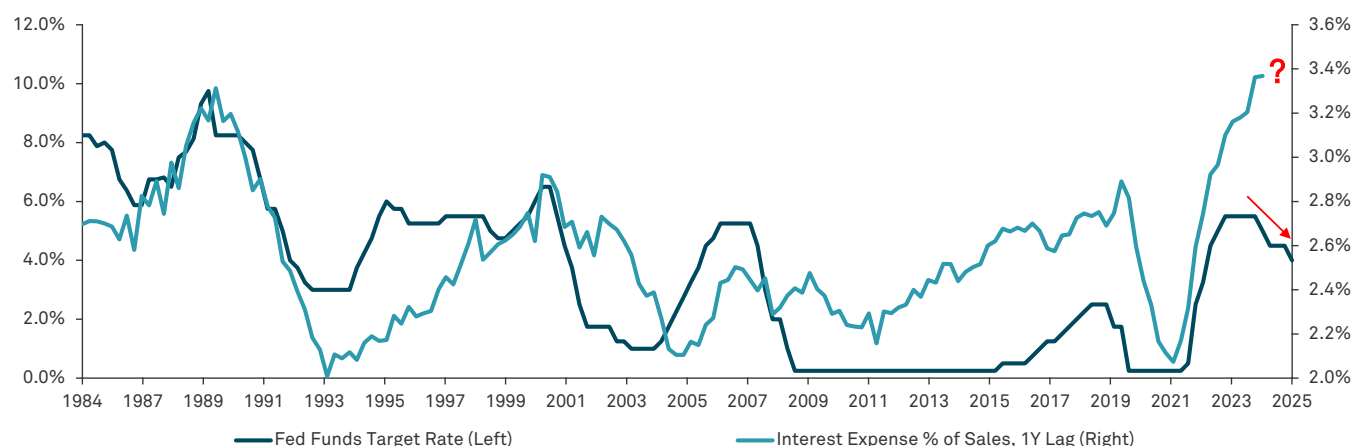
Policy and regulatory dynamics can matter disproportionately for smaller companies, which often have less scale to absorb compliance costs. US-centric growth drivers, including the artificial-intelligence infrastructure buildout, industrial and public-works capital expenditures, and fiscal initiatives, may create a more supportive backdrop for domestically oriented small caps. In addition, deregulation could reduce regulatory complexity and improve the operating environment for select small-cap businesses, while a more streamlined backdrop may support deal making and capital deployment. In that context, merger-and-acquisition activity could rise, with small-cap companies participating as acquirers, niche consolidators, or acquisition candidates—potentially helping surface value, strengthen balance sheets, and improve liquidity in underfollowed segments. Combined, these factors may reinforce the case for selective small-cap exposure into 2026.

5

INTEREST EXPENSE: A KEY HEADWIND MAY BE EASING

Rising interest expense has been a meaningful drag for small-cap earnings in recent years, as higher policy rates increased borrowing costs for many smaller companies with floating rate exposure or nearer term refinancing needs.

Fed Funds and Small-Cap Interest Expense



Source: FRP, FactSet, as of 3Q25.

More recent results suggest this pressure may be stabilizing, with interest expense no longer accelerating materially quarter over quarter (even ahead of any meaningful easing in monetary policy) supported by easier comparisons and balance sheet actions such as debt reduction and refinancing. If interest costs simply stop worsening, it may remove an important drag on margins and improve the potential for operating leverage as revenue growth broadens into 2026.

WHY THE CURRENT BACKDROP MATTERS FOR SMALL CAPS

US small-cap equities entered 2026 from a position of comparatively low expectations and discounted relative valuations following an extended period of underperformance.² At the same time, the macroeconomic and earnings backdrop appears to be evolving in ways that may be more supportive for smaller companies, including the potential for broader earnings participation, continued domestic investment, and policy programs that could benefit select industries.

After sustained outflows in the front-half of 2025, small-cap exchange-traded fund (ETF) flows have shown signs of stabilizing, with net inflows in the latter half of the year, which is noteworthy given small caps' sensitivity to shifts in capital allocation.

In a faster-moving, higher-dispersion market, where small caps are often less efficiently covered and the Russell 2000 includes a meaningful share of non-earners, selectivity may be increasingly important. For long-term investors, this supports consideration of actively managed small-cap growth and value strategies that seek to differentiate higher-quality businesses from those facing more persistent challenges.

Endnotes

1. Source: FactSet, February 2026.
2. Source: FactSet, January 26, 2026.

Important information

Asset allocation and diversification cannot ensure a profit or protect against loss.

All investments involve risk, including the possible loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing.

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

The **S&P 500® Index** is widely regarded as the best single gauge of large-cap US equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization. The **Russell 1000 Index** is a stock market index tracking the performance of approximately 1,000 of the largest US-based companies, representing about 90% to 92% of the total US market capitalization. It is a subset of the Russell 3000 Index and serves as a primary benchmark for large-cap US equities. The **Russell 2000® Index** measures the performance of the small-cap segment of the US 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. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. Investors cannot invest directly in any index.

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