

Strategy Matters

Small beginnings: Is it time to buy Small caps?

European Small caps are down 16% since Jan-22, in total returns, while Large caps already got back to their January 2022 level ([Exhibit 1](#)). Small caps' 12-month forward P/E ratio has derated 36% over the period, tracking the evolution of bond yields and the worries associated to their leverage. They currently trade at par to large caps, for the first time since the GFC ([Exhibit 3](#)).

Bond yields have now peaked and our [economists](#) expect economic growth to pick up, so is it time to buy Small caps on expectations of an extension of their end-of-2023 rally?

We argue that improving economic growth should drive the outperformance of Small caps, and that their low relative valuation is a tailwind, as our macro model suggests. This echoes the recent views of our US colleagues: [US Macroscope: Low valuations and a healthy growth outlook signal more upside for small-caps](#).

We highlight a Pure Growth screen for Small and Mid caps (SMIDs) in [Exhibit 21](#). These companies are expected to grow their revenues faster than others, have not had any negative revenue growth over the past two years, and have derated the most among European SMIDs.

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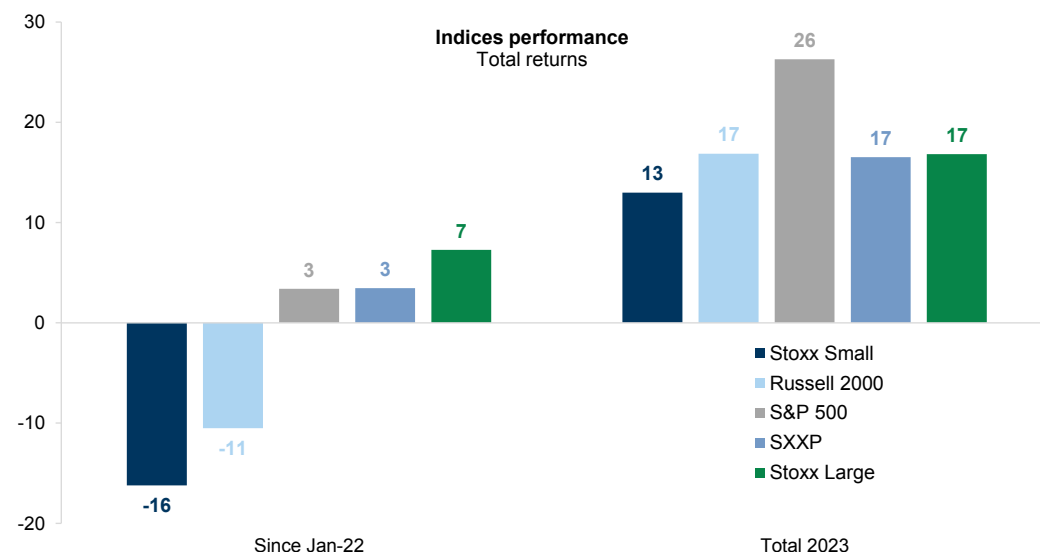
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Exhibit 1: Small caps are still 16% below their January 2022 level

Total returns (%)



Source: Datastream, Goldman Sachs Global Investment Research

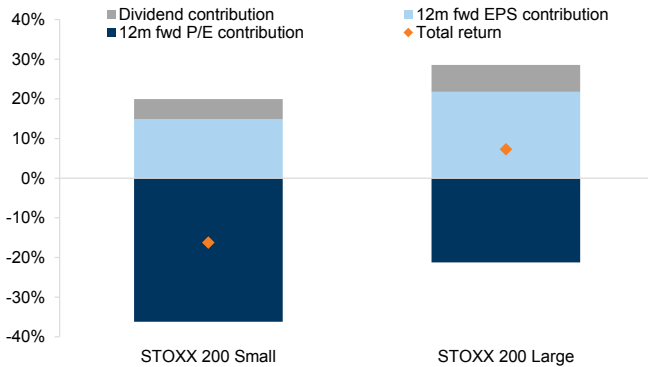
1. Rising rates and the economic downturn: The worst combination for Small caps

Since January 2022, **Small caps' 12-month forward P/E ratio has derated 36% as interest rates have risen (Exhibit 2), and their profits have lagged the market as economic growth has been lackluster (Exhibit 2)**. Small caps underperformed Large caps by more than 20% in price performance, twice as much as what our macro model would have suggested. Their valuation is now at a decade low (Exhibit 3). Our macro model predicts the relative performance of Small caps based on changes in economic growth, in interest rates and based on relative valuations at the outset of the period. Since 2022, **it is mainly rates rather than growth which have driven the performance of Small caps (Exhibit 4)**, as our US colleagues [have found](#). The beta of Small caps to changes in our [Current Activity Indicator \(CAI\)](#) has turned statistically insignificant since 2022, as concerns about financial leverage due to rising interest rates have become dominant. While Small caps are not especially indebted, about 50% of their debt is floating, making them particularly sensitive to rising interest rates, as we show in [Strategy Espresso: The Wall of Debt \(Exhibit 5\)](#).

From here, as bond yields stay flat, **we believe that Small caps will be driven by growth again**, and that their historically low valuation provides a tailwind, or at least a buffer in case activity improves slower than what our economists expect.

Exhibit 2: Small caps have derated more than 30% since the start of the Fed hiking cycle

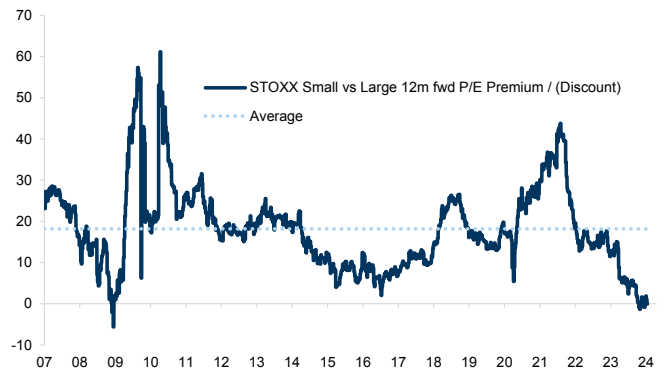
Return Contribution since January 2022



Source: Datastream, STOXX, Goldman Sachs Global Investment Research

Exhibit 3: Small caps trade at par to Large caps for the first time since the Global Financial Crisis

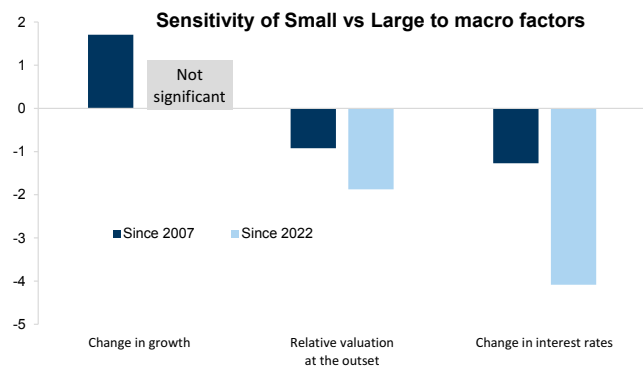
12m fwd P/E Premium / (Discount) STOXX Small vs STOXX Large



Source: IBES, Datastream, Goldman Sachs Global Investment Research

Exhibit 4: Small caps are usually driven by growth rather than rates

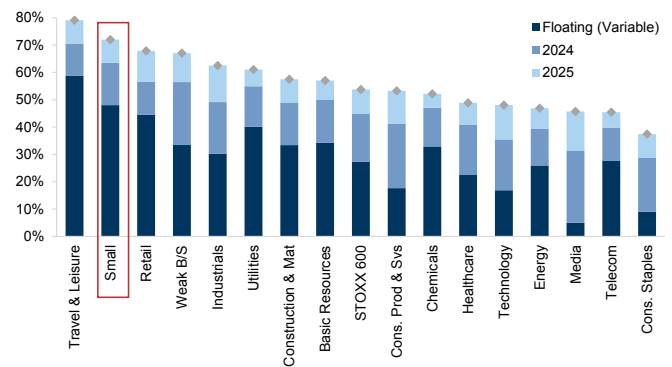
Normalised coefficients. 6m returns of Small vs Large explained by changes in EA Current Activity Indicator, 10y German bond yields and relative valuation at the outset.



Source: Goldman Sachs Global Investment Research

Exhibit 5: Small caps: When you hit the wall of debt

% share of the total debt floating* and refinanced in 2024-2025



*Bloomberg classification of Floating vs. Fixed Debt (%)

Source: Bloomberg, Goldman Sachs Global Investment Research

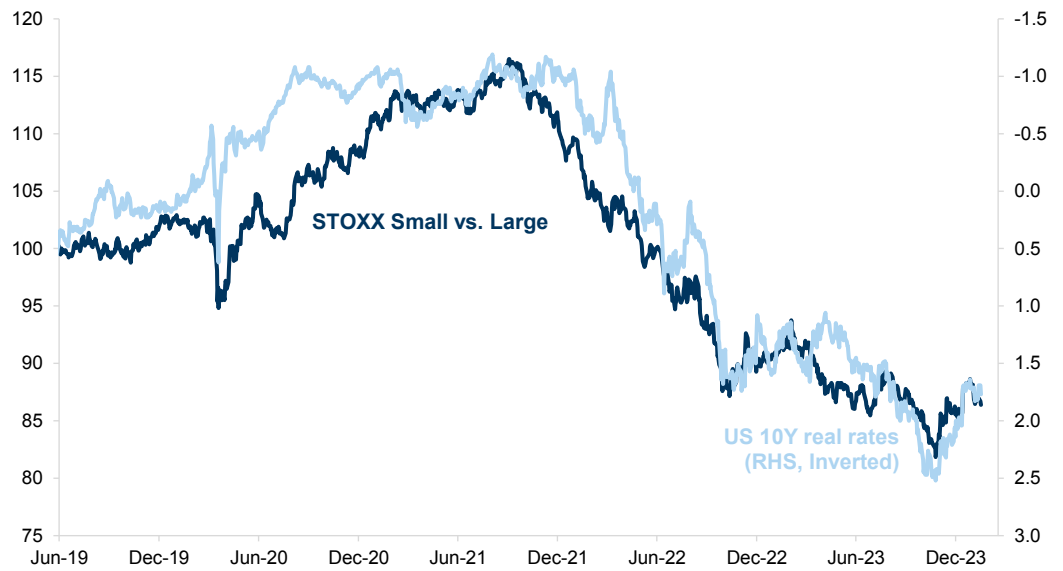
2. Rate relief for Small caps

The derating of Small caps has closely tracked the rise in bond yields (Exhibit 6)

and our rate strategists now think that bond yields have peaked. The Fed and the ECB should embark on their first rate cut in March and April respectively, based on GS forecasts. That said, our policy rate forecast is broadly in line with market pricing, suggesting that most of the fall in bond yields is behind us.

While the rate tailwind for Small caps is probably limited, the accelerating economic growth that our economists expect should provide further upside.

Exhibit 6: The relative derating of Small caps has closely tracked the rise in bond yields
 Price performance STOXX Small vs STOXX Large (indexed to 100 on Jan-19), US 10Y real rates (RHS, Inverted)



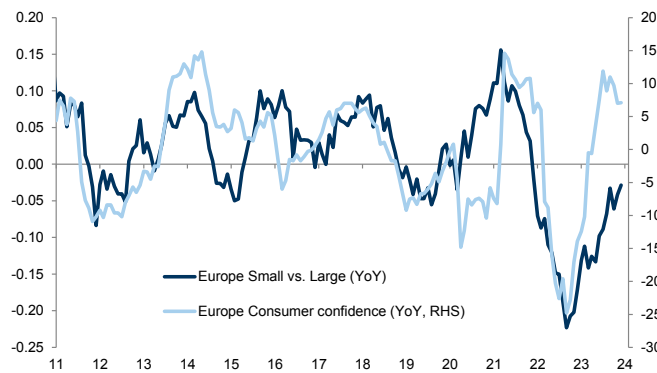
Source: Datastream, Goldman Sachs Global Investment Research

3. Further support from a healthy economic outlook

Consumer confidence (Exhibit 7) and economic growth (Exhibit 8) are very much correlated to the performance of Small caps (see *Strategy Matters - What drives European Small caps? Q&A*). Our economists expect Euro area growth to sequentially pick up in Q1 2024, driven by a rebound in real disposable income.

Exhibit 7: Small caps tend to outperform with rising consumer confidence

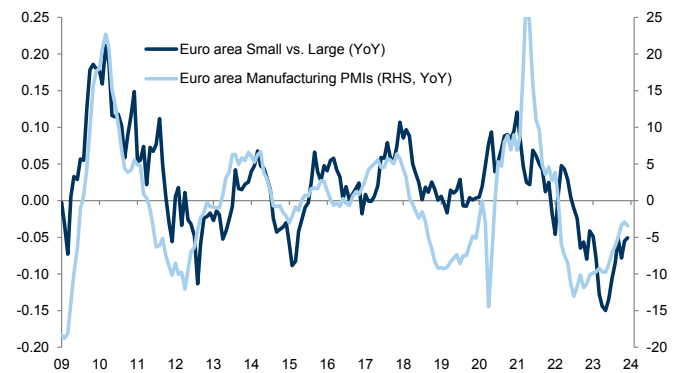
Europe Small vs. Large price index (YoY) and Europe Consumer confidence (YoY, RHS)



Source: Datastream, Bloomberg, Goldman Sachs Global Investment Research

Exhibit 8: Small caps tend to outperform with improving activity data

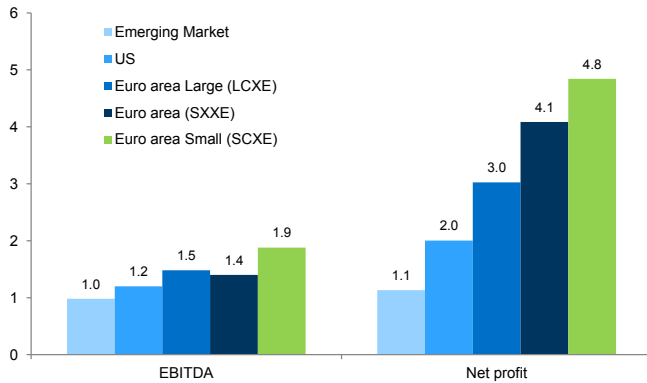
Euro area Small vs. Large price index (YoY) and Euro area Manufacturing PMIs (YoY, RHS)



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 9: Small caps are highly geared operationally

Operational leverage = Median ratio of profit growth to sales growth since 1995



Source: Datastream, Factset, Goldman Sachs Global Investment Research

Exhibit 10: The sector composition of SXXE Small makes it cyclical

Weights based on current market cap, free float adjusted

	Cyclicals – Defensives	Cyclicals	Defensives
MIB	39%	61%	23%
AEX	36%	56%	20%
OMX Stockholm	31%	63%	32%
DAX	27%	54%	27%
Euro Stoxx 50	17%	49%	32%
STOXX Small	15%	47%	32%
OBX Oslo	11%	30%	20%
IBEX	4%	47%	43%
FTSE 100	4%	43%	39%
STOXX 600	1%	41%	41%
STOXX Large	-2%	40%	42%
CAC	-6%	36%	42%
SMI	-49%	16%	65%
OMX Copenhagen	-59%	18%	77%

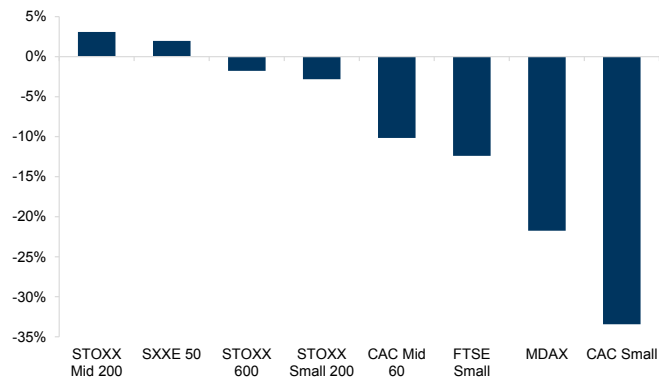
Cyclicals: Autos, Banks, Basic Resources, Financial Svs., Industrial Gds & Svs., Media, Technology, Travel & Leis. Defensives: Consumer Prod. & Svs., Food & Bev., Healthcare, Pers. Care, Drug & Gr. Stores, Retail, Telcos, Utilities.

Source: Datastream, Goldman Sachs Global Investment Research

The bar for positive earnings surprise is very low for Small caps as their 2024 consensus EPS estimate has been significantly revised down since Jan-23. The smaller the companies, the sharper the impact on profit growth: French, German and UK SMIDs faced particularly sharp negative revisions (Exhibit 11). Net income margin of Small caps has fallen by about 100bp since 2021, while that of Large caps remained steady (Exhibit 12).

Exhibit 11: The bar for upside EPS surprise is low

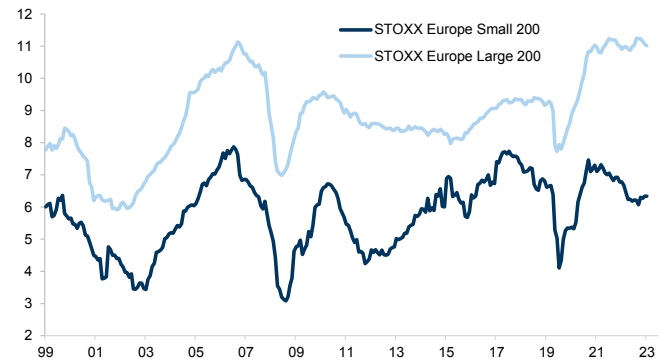
2024E EPS revisions since Jan-23



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 12: Net income margin for Small caps has fallen

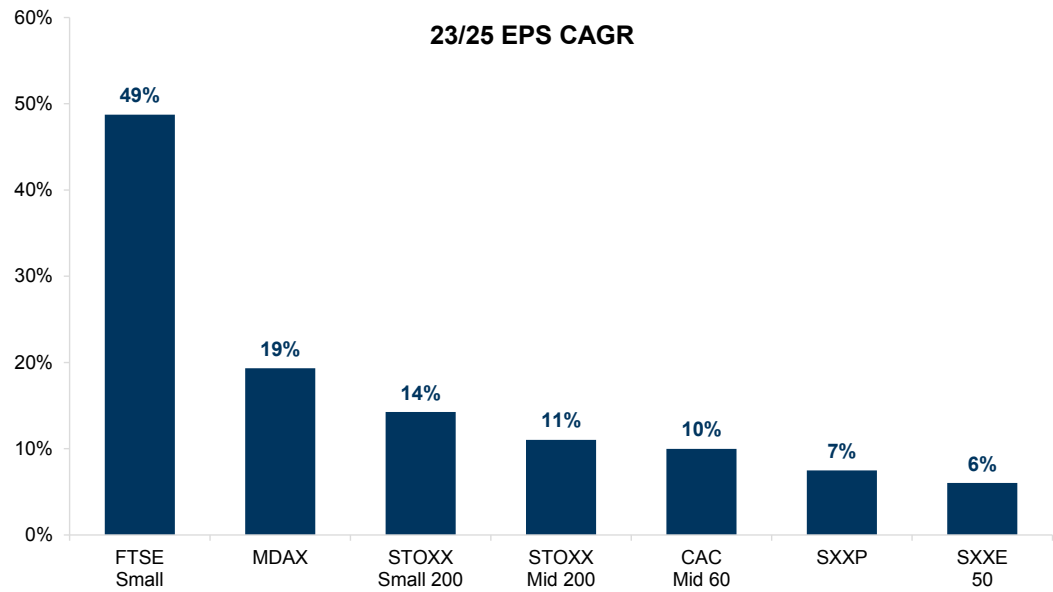
Net Income Margin (%) for STOXX Europe Small 200 and STOXX Europe Large 200



Source: FactSet, STOXX, Goldman Sachs Global Investment Research

In 2024 and 2025, consensus expects annual EPS growth to be roughly twice higher for Small caps than for the SXXP (Exhibit 13).

Exhibit 13: Consensus expects EPS growth to be roughly twice higher for Small caps than for the SXXP
2023/2025 EPS CAGR

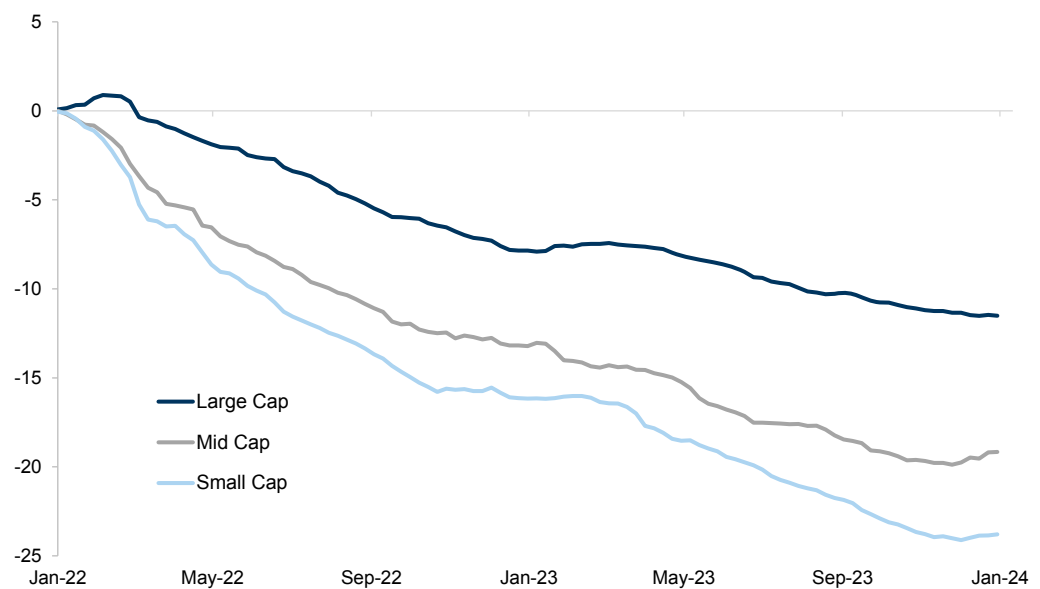


Source: Datastream, Goldman Sachs Global Investment Research

4. Positioning looks attractive

Despite the fact that Small caps have rallied 6% over large caps since their low in October 2023, **cumulative flows into SMID cap funds remain deeply negative, which suggests a very light positioning** (Exhibit 14).

Exhibit 14: Fund flows into European Equity (cumulative %)
EPFR data for Flows into Small, Mid and Large Cap European Equity Funds



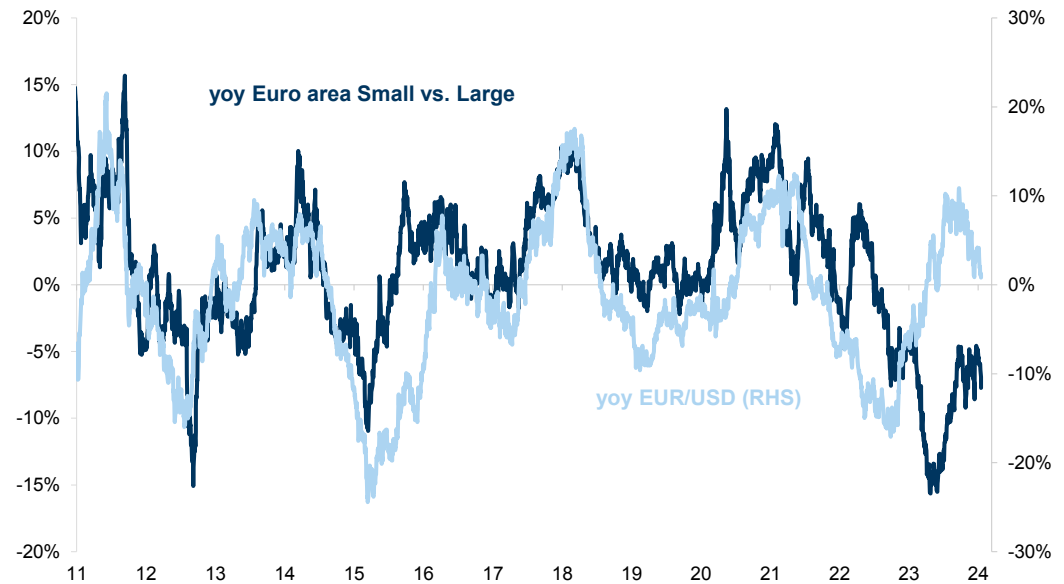
Source: EPFR, Goldman Sachs Global Investment Research

5. A stronger Euro favours Small caps

In 2024, our FX strategists expect the Euro to rise to 1.12, which tends to support Small caps as they derive 60% of their revenues from Europe, versus only 40% for Large caps ([Exhibit 15](#) and [Exhibit 28](#)).

Exhibit 15: Small caps usually outperform as the Euro strengthens

Euro area Small vs. Large price index (YoY) and EUR/USD (YoY, RHS)



Source: Datastream, Goldman Sachs Global Investment Research

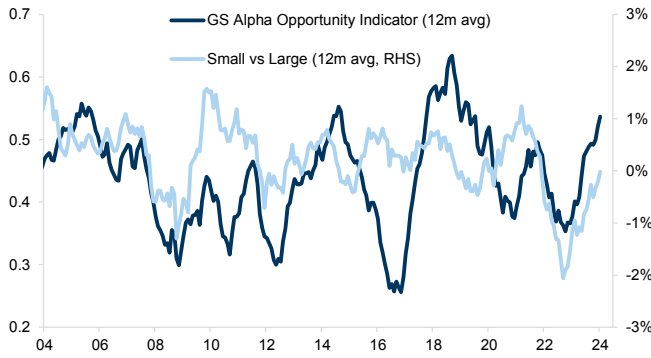
6. M&A and a better alpha opportunity environment should help

Usually, Small caps outperform when alpha opportunities improve ([Exhibit 16](#)), as we argue in *Strategy Espresso: Alpha opportunities to improve further*. This is because a better stock-picking environment tends to be one where economic growth accelerates, market returns are positive, M&A activity picks up and economic policy uncertainty is anchored. All these make an ideal environment for Small caps to outperform.

M&A activity was down 30% in 2023, and as we show in *Strategy Espresso: Positioning in Europe as we start 2024*, lower rates should help to boost both Private Equity demand for listed stocks and M&A activity. This usually supports the outperformance of Small caps which are typically M&A targets, as we explain in *Strategy Matters - Small Caps, Big Problems* ([Exhibit 17](#)).

Exhibit 16: Small caps generally outperform as Alpha opportunities rise

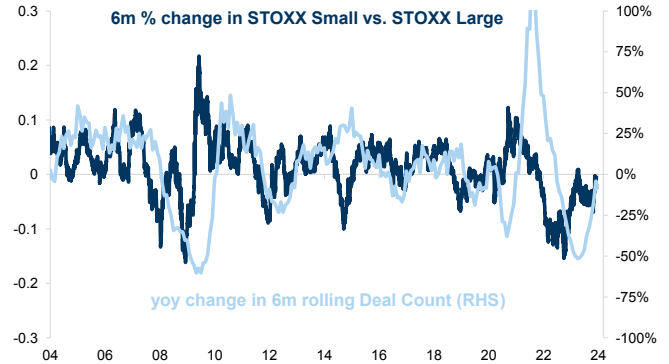
GS Alpha Opportunity Indicator (12m avg) and Small vs Large (12m avg, RHS)



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

Exhibit 17: Small caps tend to outperform when M&A activity picks up

% change in STOXX Small vs. Large and % change in rolling Deal count over 6 months

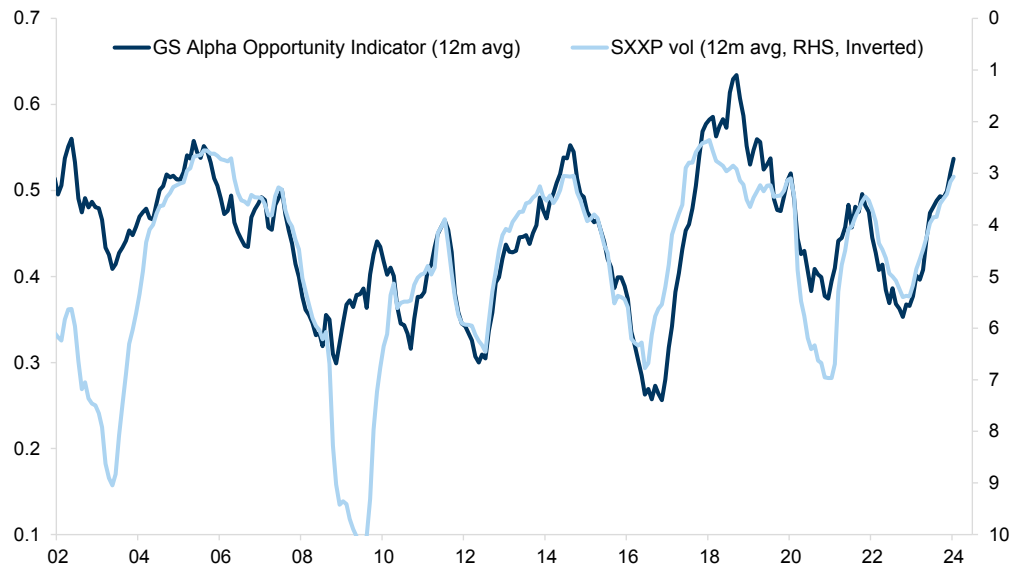


M&A deals in Western Europe, minimum deal value EUR 50 mln.

Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

Exhibit 18: Alpha opportunities rise when SXXP volatility increases

GS Alpha Opportunity Indicator (12m avg) SXXP vol (12m avg, RHS, Inverted)



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

7. Where to find growth within Small caps?

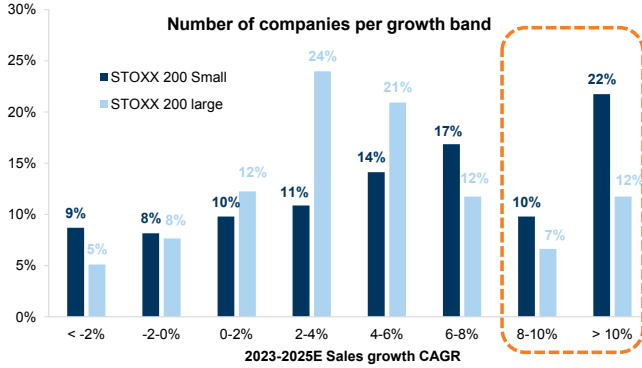
About one-third of Small cap companies are expected to deliver a revenue growth above 8% per annum by 2025, which is twice higher than for Large caps (Exhibit 19).

We derive a **screen of SMID companies (market cap <€10bn) which are expected to grow faster than the market, have not had any negative revenue growth over the past two years, and have seen their valuation contract the most since Jan-22.** We believe that the ‘goldilocks’ outlook of our economists — where economic activity improves and bond yields have peaked — should support the outperformance of these companies, after a particularly sharp derating (Exhibit 20). They offer a mix of cyclical

growth and duration, similarly to our Pure Growth basket (GSSTGROW). Our SMIDs screen is shown in Exhibit 21.

Exhibit 19: One-third of Small caps are expected to grow faster than 8% per annum by 2025

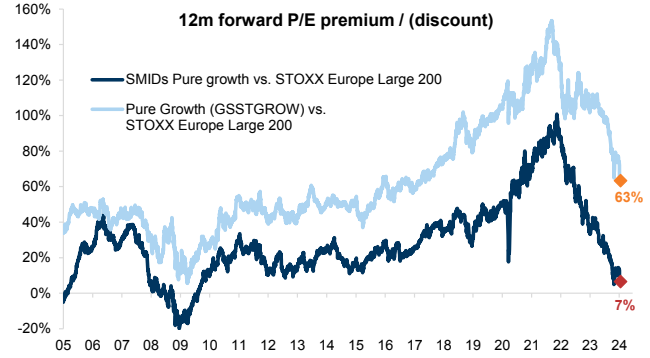
% of companies by sales growth bands - 2023-25E



Source: Factset, Datastream, STOXX, Goldman Sachs Global Investment Research

Exhibit 20: Both our SMIDs Pure Growth screen and Pure Growth basket have de-rated sharply

SMIDs Pure growth and Pure Growth (GSSTGROW) vs STOXX Europe Large 200 12m fwd P/E Premium / (Discount)



Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 21: Our Pure Growth screen for SMIDs

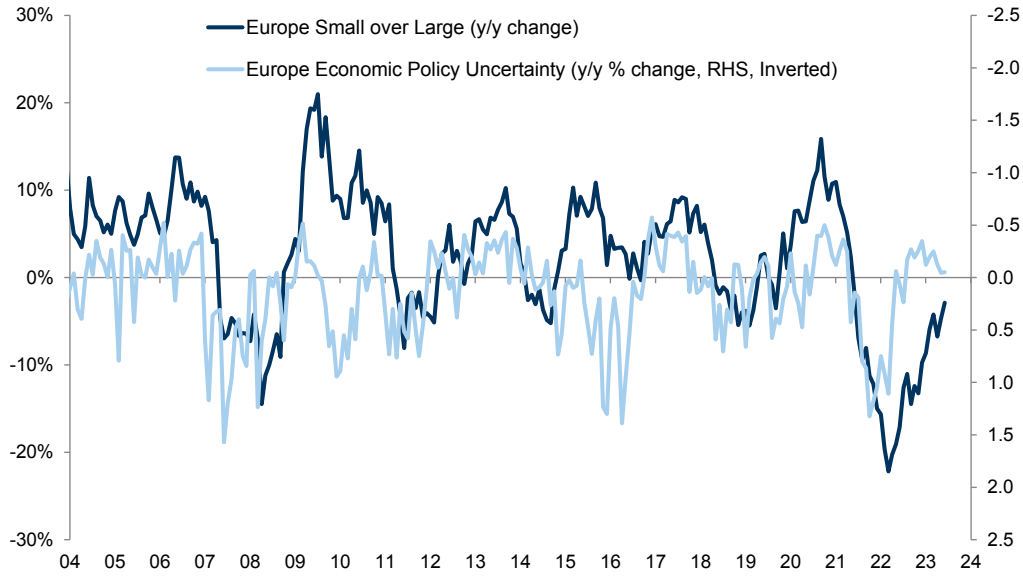
SMIDs Pure Growth Screen								
Company Name	Sector	Country	Market Cap (EUR Bn)	NTM P/E	Valuation Drawdown (since 2022)	Sales Growth (%)		
						CAGR 2025/23	FY 2025	
D'Ieteren Group	Automobiles and Parts	Belgium	9.5	12.0	-39%	9.4	5.8	
Volvo Car	Automobiles and Parts	Sweden	8.7	6.2	-66%	7.3	8.2	
Forvia	Automobiles and Parts	France	4.0	6.7	-28%	5.3	5.9	
Brembo	Automobiles and Parts	Italy	3.7	11.1	-31%	5.9	6.9	
Valeo	Automobiles and Parts	France	3.4	6.6	-50%	6.4	7.1	
Dottikon ES Holding	Chemicals	Switzerland	3.5	31.0	-51%	14.7	13.0	
Eckert & Ziegler Strahlen	Chemicals	Germany	0.9	26.1	-49%	10.3	10.4	
BELIMO Holding	Construction and Materials	Switzerland	6.1	38.3	-31%	8.0	8.8	
Webuild	Construction and Materials	Italy	1.9	9.5	-33%	7.3	6.6	
Maire Tecnimont	Construction and Materials	Italy	1.6	10.1	-26%	19.2	14.8	
PUMA	Consumer Products and Services	Germany	7.6	16.0	-59%	8.7	8.9	
Brunello Cucinelli	Consumer Products and Services	Italy	6.0	45.5	-38%	10.9	10.7	
HUGO BOSS	Consumer Products and Services	Germany	4.7	14.3	-34%	9.2	9.0	
Sixt	Consumer Products and Services	Germany	4.2	13.6	-42%	6.6	7.6	
Watches of Switzerland	Consumer Products and Services	United Kingdom	2.0	12.5	-64%	9.8	13.0	
Keywords Studios	Consumer Products and Services	United Kingdom	1.5	15.6	-57%	11.8	10.0	
TODS	Consumer Products and Services	Italy	1.1	20.7	-91%	5.4	6.3	
Nordex	Energy	Germany	2.5	48.5	-47%	6.3	8.3	
Energean	Energy	United Kingdom	2.2	3.3	-72%	30.0	10.9	
TGS	Energy	Norway	1.6	7.8	-78%	15.6	5.2	
Carl Zeiss Meditec	Health Care	Germany	8.8	32.7	-42%	7.9	9.4	
Amplifon	Health Care	Italy	7.1	29.7	-32%	8.2	8.0	
Evotec	Health Care	Germany	3.8	93.1	-65%	19.2	19.4	
ALK-Abello	Health Care	Denmark	3.0	28.1	-69%	10.3	10.4	
Nexi	Industrial Goods and Services	Italy	9.7	11.7	-53%	7.0	7.2	
Rational	Industrial Goods and Services	Germany	7.9	36.8	-39%	7.0	8.6	
AutoStore Holdings	Industrial Goods and Services	Norway	6.1	30.3	-59%	12.5	16.4	
Azelis Group	Industrial Goods and Services	Belgium	5.4	19.6	-41%	5.7	5.1	
Worldline	Industrial Goods and Services	France	4.4	7.6	-67%	5.5	6.9	
Krones	Industrial Goods and Services	Germany	3.6	12.8	-33%	7.3	6.0	
TOMRA Systems	Industrial Goods and Services	Norway	3.3	33.6	-59%	5.7	11.0	
SES-imagotag	Industrial Goods and Services	France	2.2	28.5	-58%	29.9	29.6	
Alfen	Industrial Goods and Services	Netherlands	1.3	29.8	-51%	25.2	23.8	
Stroeer	Media	Germany	3.0	15.2	-24%	8.1	7.7	
4Imprint Group	Media	United Kingdom	1.5	15.8	-53%	8.5	7.8	
HelloFresh	Personal Care, Drug and Grocery Stores	Germany	2.5	13.0	-72%	7.9	7.8	
JD Sports Fashion	Retail	United Kingdom	9.9	11.0	-57%	8.1	8.4	
Nemetschek	Technology	Germany	9.1	48.7	-46%	12.6	14.8	
Scout24	Technology	Germany	4.8	22.7	-31%	10.7	9.6	
Alten	Technology	France	4.7	15.5	-32%	7.3	7.4	
Reply	Technology	Italy	4.5	21.3	-44%	9.5	9.8	
Melexis	Technology	Belgium	3.7	17.3	-45%	5.9	6.5	
Elmos Semicond	Technology	Germany	1.3	12.2	-43%	8.4	7.9	
Accor	Travel and Leisure	France	9.2	16.7	-74%	5.3	5.3	
Dalata Hotel	Travel and Leisure	Ireland	1.0	11.2	-81%	7.0	6.3	
Elia Group	Utilities	Belgium	8.3	24.5	-17%	16.0	16.3	
Neoen	Utilities	France	4.6	51.1	-33%	24.0	27.7	
Encavis	Utilities	Germany	2.5	28.2	-27%	10.9	12.1	
Solaria Energia	Utilities	Spain	2.3	18.6	-47%	27.7	25.6	
Befesa	Utilities	Germany	1.4	15.1	-25%	6.5	5.2	
Median			3.7	16.3	-46%	8.3	8.5	
Europe SMIDs ex Financials median			1.5	14.1	-22%	4.0	5.3	

Source: Datastream, FactSet, Worldscope, Goldman Sachs Global Investment Research

8. What are the risks?

Slower growth than what our economists expect and renewed policy uncertainty could weigh on Small caps. Small caps are sensitive to economic growth and, historically, the performance of Small vs. Large caps has been negatively correlated with measures of risk such as the Economic Policy Uncertainty Index ([Exhibit 22](#)). Small, as a factor, is positively correlated with risk indices such as our Risk Appetite Indicator (GSRAII) and negatively correlated with credit spreads (i.e., Small caps underperform when spreads widen). Over the past year, higher economic policy uncertainty, which resulted from the invasion of Ukraine and the energy crisis, has reduced, but could increase again.

Exhibit 22: Small caps outperform as policy uncertainty decreases
Europe Small vs Large (YoY change) and Europe Economic Policy Uncertainty (YoY % change, RHS, Inverted)



Source: Haver Analytics, Datastream, Goldman Sachs Global Investment Research

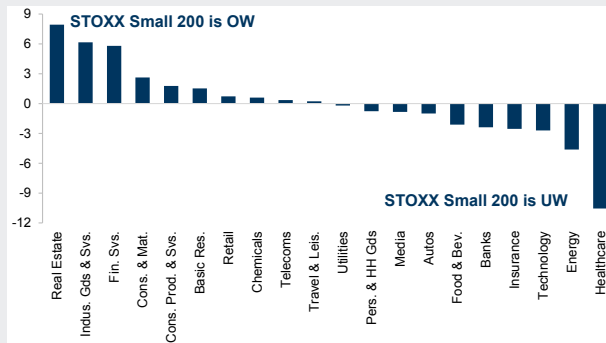
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What are Small caps

STOXX Europe Small (SCXP)

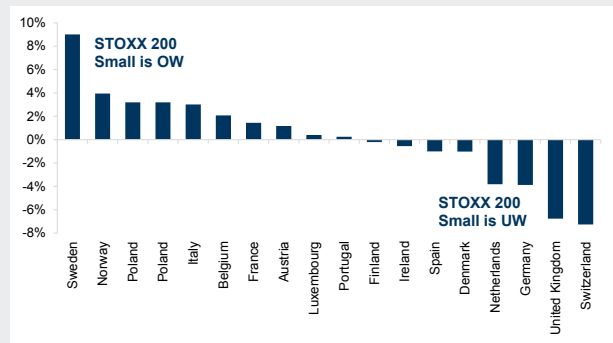
European Small caps are underweight Banks and Energy, as well as Healthcare and Technology relative to European Large caps (Exhibit 23). These are four sectors on which we have been overweight through most of 2023. By contrast, **Small caps are overweight Real Estate and manufacturing sectors** such as Industrial Goods & Services and Construction & Materials, two sectors which have suffered from the rising rate environment and the manufacturing recession. Meanwhile, Nordics are over-represented in Small caps, while Switzerland and the UK are underrepresented (Exhibit 24).

Exhibit 23: Small caps are overexposed to Real Estate, Industrials and Construction, sectors impaired by the rising rate environment and the manufacturing downturn
STOXX 200 Small sector weights minus STOXX 200 Large sector weights



Source: FactSet, STOXX, Goldman Sachs Global Investment Research

Exhibit 24: Nordics are overrepresented in Small caps, while Switzerland and the UK are underrepresented
STOXX 200 Small country weights minus STOXX 200 Large country weights (market cap adjusted)



Source: Datastream, Goldman Sachs Global Investment Research

Small caps are not the same in each country

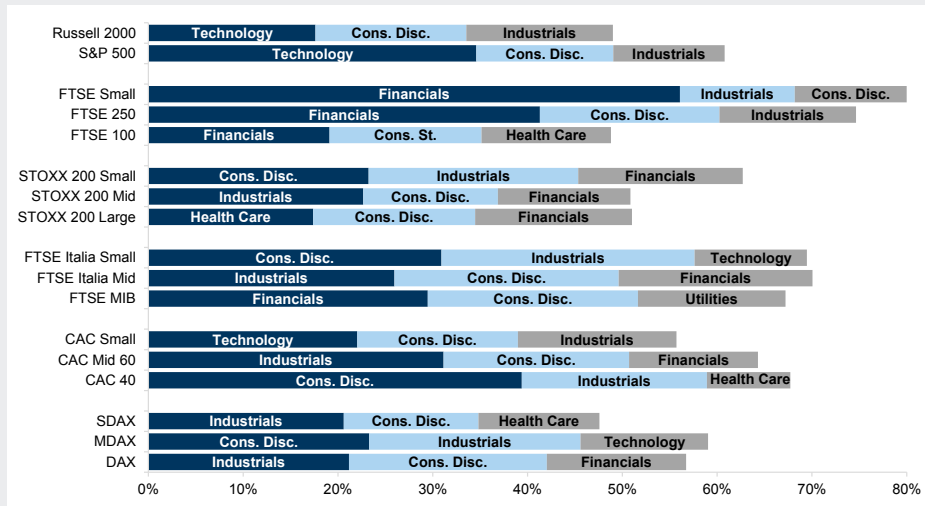
For instance, **the weight of Energy is much larger among French Small caps than UK ones**. Exposure to Tech companies is also larger among French and Italian ones than among UK or broader European Small cap indices (Exhibit 25).

Exhibit 25: Small Cap Indices and STOXX 600 sector breakdown
Weights based on current market cap

	SDAX	CAC Small	FTSE Italia Small	STOXX 200 Small	FTSE Small	Russell 2000	STOXX 600
Basic Materials	3%	1%	3%	5%	2%	3%	5%
Consumer Discretionary	14%	17%	31%	23%	12%	14%	17%
Consumer Staples	6%	1%	8%	7%	1%	3%	9%
Energy	4%	6%	1%	1%	2%	8%	6%
Financials	11%	15%	5%	17%	56%	15%	16%
Health Care	13%	12%	7%	8%	0%	16%	15%
Industrials	21%	17%	27%	22%	12%	18%	16%
Real Estate	11%	5%	3%	6%	11%	6%	1%
Technology	10%	22%	12%	4%	3%	13%	7%
Telecommunications	4%	1%	2%	3%	0%	1%	3%
Utilities	3%	3%	1%	3%	1%	2%	4%

Source: Datastream, STOXX, Goldman Sachs Global Investment Research

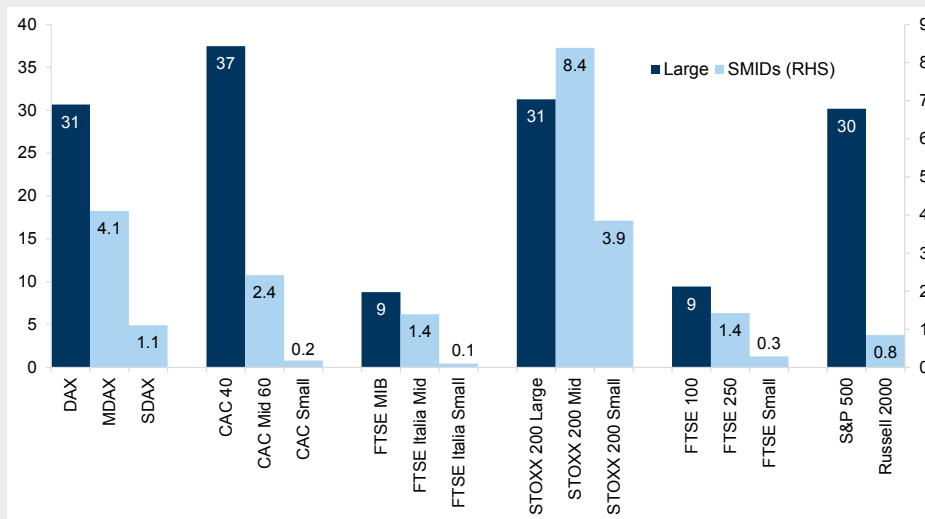
Exhibit 26: Weight of the three largest sectors of each index



Source: Datastream, Goldman Sachs Global Investment Research

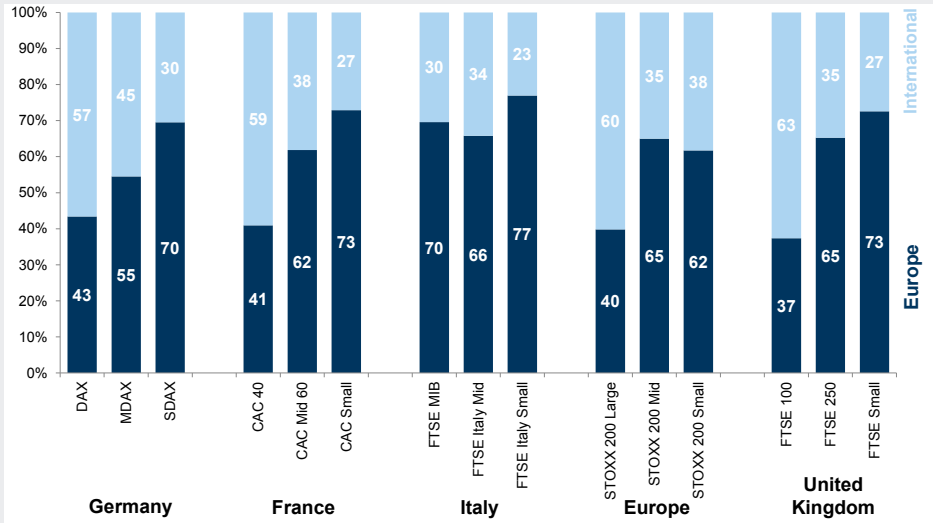
Also, Italian Small caps have the lowest median market cap and, compared to other European indices, they are also the least exposed to the international market (Exhibit 27 and Exhibit 28).

Exhibit 27: Italian Small caps are smaller than German Small caps
Median Market Cap (EUR bn.)



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 28: Italian Small caps are much more domestic than German Small caps
% Domestic Sales Exposure of Large-Mid-Small Cap



Source: FactSet, Goldman Sachs Global Investment Research

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Disclosure Appendix

Reg AC

We, Lilia Peytavin, Peter Oppenheimer, Sharon Bell, Guillaume Jaisson and Marcus von Scheele, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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Disclosures

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