

US small caps beyond the interest rate debate

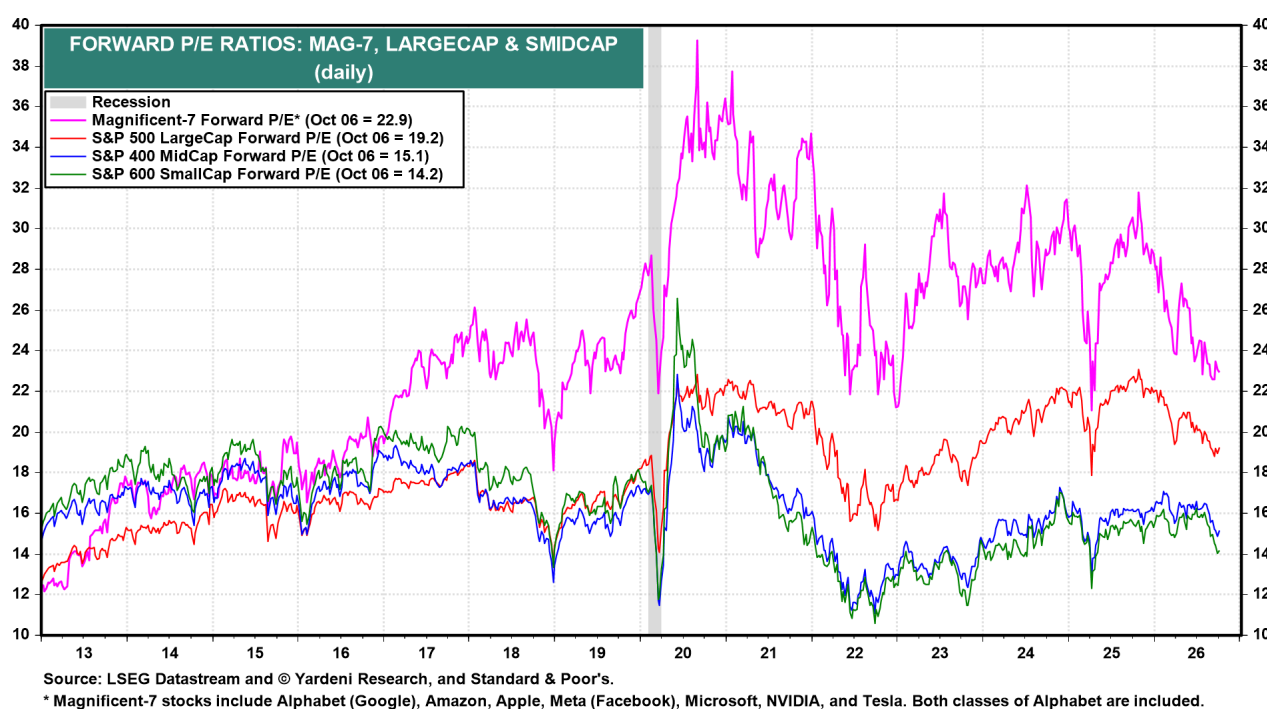
An allocation perspective for institutional investors | 9 October 2026

Higher rates are a valid reason to question small-cap earnings. They are not a sufficient reason to exclude the asset class. Starting valuations, funding needs and the source of growth deserve equal attention.

Our view is that investors should consider building selective US small-cap exposure. The opportunity combines lower valuations in parts of the market with investment in AI, power, defence and infrastructure. A broader rise in productivity could add a second source of growth over time.

- Valuation provides room for upside, but the discount depends on the index and the companies selected.
- The 1970s show that high rates can coexist with strong small-cap returns. They also show how painful the path can be.
- The strongest case is for companies that can fund growth, deliver cash earnings and benefit from real customer spending.

1 Small caps trade below large caps and the Magnificent Seven



Source: Yardeni Research / LSEG Datastream / S&P. Forward P/E, 6 October 2026.

The S&P 600 stood at 14.2 times forward earnings versus 19.2 times for the S&P 500: a discount of about 26%. This supports a closer look at smaller companies. It does not establish that every small-cap strategy is cheap.

The decision is whether the earnings opportunity compensates for the risk. Waiting for lower rates may reduce uncertainty, but it may also mean paying a higher price once confidence returns.

Valuations are attractive but index choice matters

2 Two small-cap indices can tell different valuation stories



Source: Yardeni Research / LSEG Datastream. Forward P/E, 1 October 2026.

The Russell 2000 and the S&P 600 are not interchangeable. The S&P 600 applies an earnings test when companies enter the index. The broader Russell 2000 includes a wider mix of profitable and loss-making businesses. Sector weights and earnings calculations also differ.

- Compare a portfolio with its own benchmark, using the same date and earnings basis.
- Ask how loss-making companies are treated. Excluding them can materially change the reported P/E.
- Separate a low share price from a low valuation. Falling earnings can make a stock more expensive even after a sell-off.

3 The relative discount also has a historical context



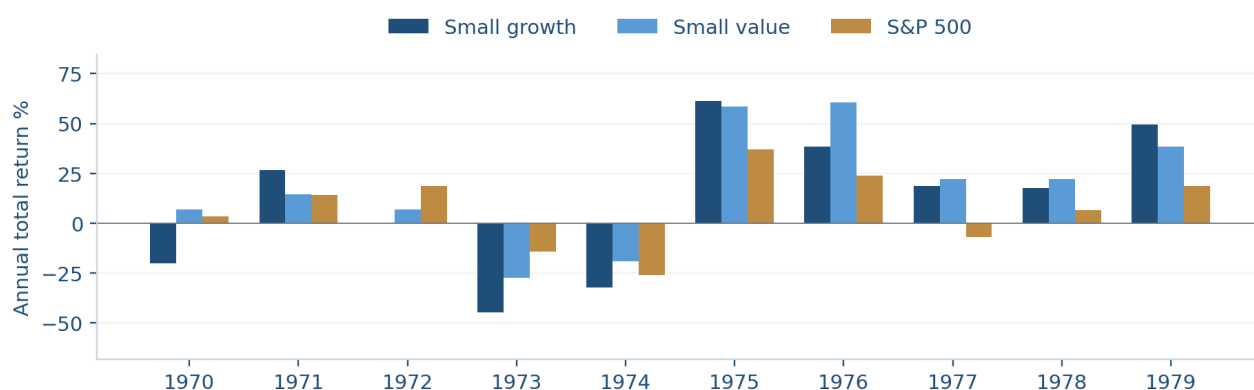
Source: Janus Henderson / Bloomberg, 2 September 2026. S&P 600 relative to S&P 500.

The September comparison showed a 22% discount against a 15-year median premium of 12%. Mean reversion is a potential source of return, not an entitlement. Differences in profitability and sector mix can justify part of the gap.

The 1970s show both the opportunity and the danger

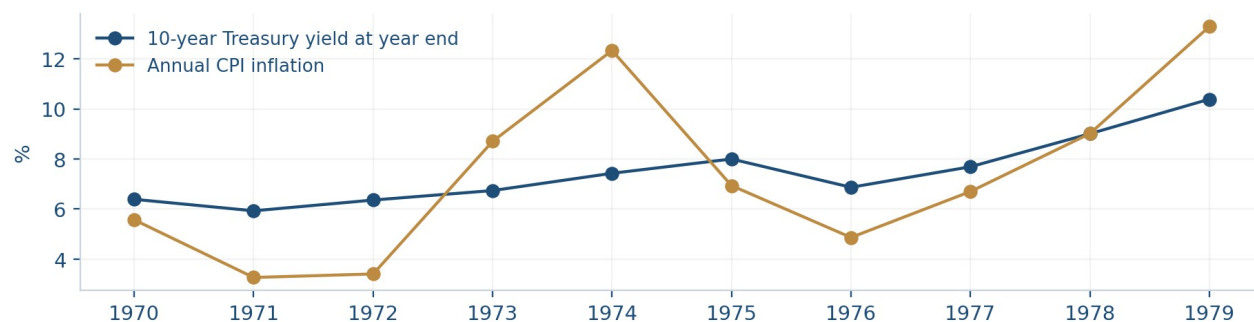
The earlier client question was direct: if Treasury yields move above 5%, does a small-cap allocation still make sense? The 1970s give a useful test. High yields did not prevent strong returns. But buying before the 1973–74 decline produced a very different experience from buying after it.

4 Small growth and small value fell sharply before recovering



Sources: Kenneth French Data Library and Damodaran. Calendar-year nominal USD total returns. Research portfolios; not fund returns.

5 The recovery did not require a return to low nominal yields



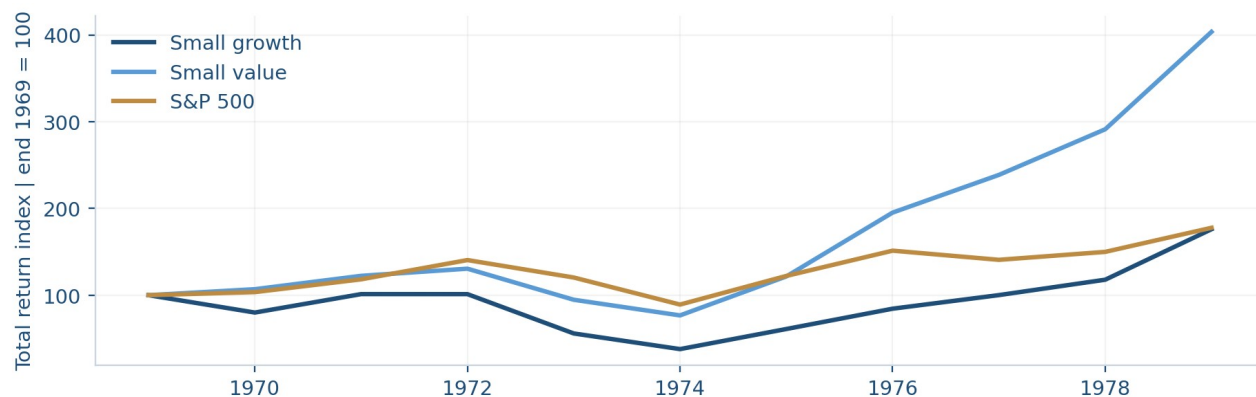
Source: Damodaran workbook, January 2026, drawing on FRED. Treasury yields are year-end observations; CPI is annual inflation.

- The 1973–74 recession, inflation shock and valuation reset hurt small caps severely.
- From 1975, earnings recovery and lower starting prices supported returns even as nominal yields remained high.
- Both growth and value participated. The lesson is broader than a single investment style.

For today, the relevant question is not whether rates are high. It is whether the price already reflects the risk, and whether companies can grow after financing and input costs.

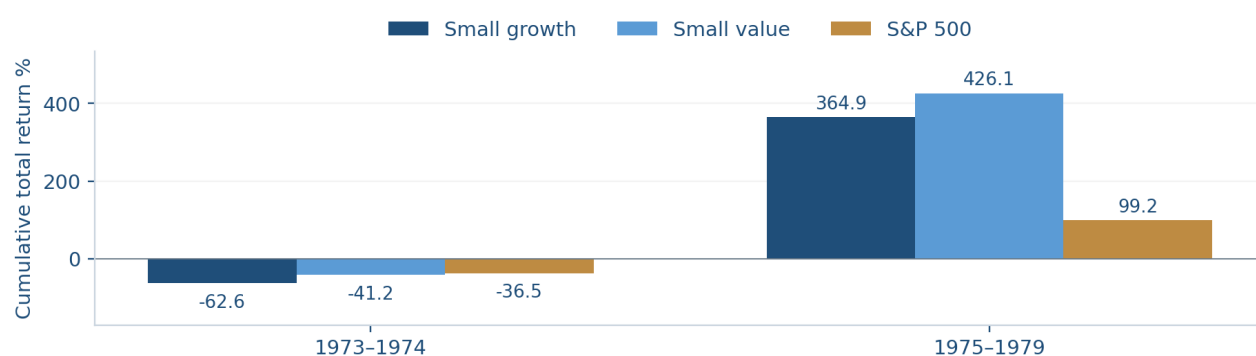
A strong recovery can hide a difficult full cycle

6 The full decade looks different from the rebound alone



Sources: Kenneth French Data Library / Damodaran; Candoris calculations. Dividends reinvested; year-end observations.

7 Starting point made an enormous difference



Sources: Kenneth French Data Library / Damodaran; Candoris calculations. Cumulative nominal USD total returns.

Small growth gained approximately 365% from 1975 to 1979, while small value gained about 426% and the S&P 500 about 99%. Yet small growth had first lost roughly 63% across 1973 and 1974. A rebound statistic on its own is an incomplete investment case.

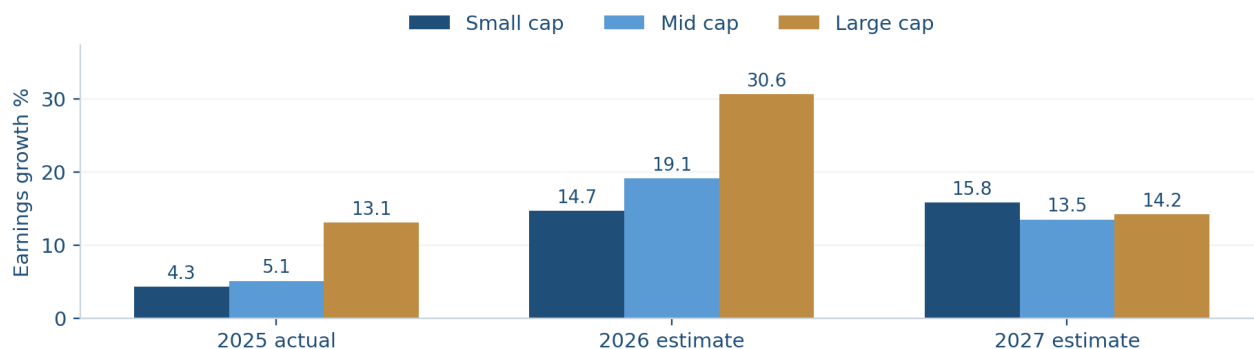
- High inflation is not automatically good for small caps. Pricing power and real profit growth matter.
- Nominal gains can overstate the improvement in purchasing power when inflation is high.
- Research portfolios, today's indices and investable strategies have different rules. These results are historical evidence, not a forecast.

The practical lesson is to own businesses that can survive the weak phase. A company forced to issue equity or sell assets may not fully participate when the cycle improves.

Earnings need to come through after higher financing costs

The asset-class case should not depend on a large forecast number alone. Investors need to know whether growth comes from stronger sales, better margins, a rebound from losses or changes in the index.

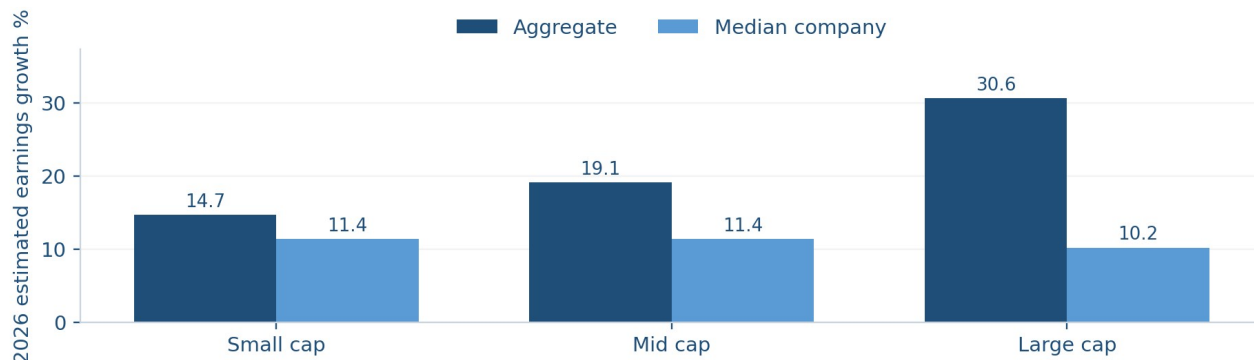
8 The September forecast still points to small-cap growth in 2027



Source: NCG September 2026 research, exhibit 1, estimates dated 25 September. Market-cap groups as reported; not portfolio forecasts.

This estimate shows 15.8% growth for small caps in 2027 against 14.2% for large caps. The advantage is modest. It also shows large caps ahead on aggregate growth in 2026. A credible case for small caps should acknowledge both points.

9 The typical company gives a different view from the aggregate



Source: NCG September 2026 research, exhibit 2. 2026 estimates; median and aggregate calculations differ.

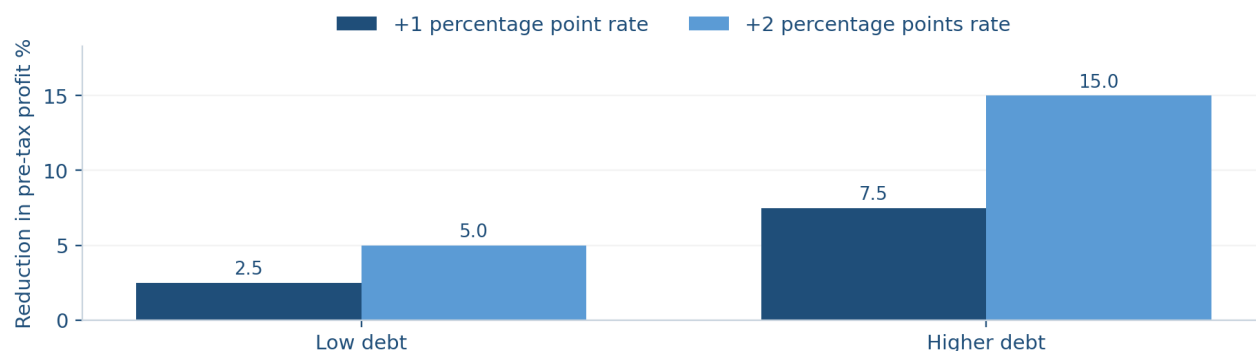
- Watch the direction and breadth of revisions, not only the level of next year's forecast.
- Compare the same index, provider, calculation and forecast date over time.
- Test margins against energy, wages, tariffs and interest costs. Strong sales do not guarantee strong EPS.

The earlier Janus Henderson estimate of 21.8% versus 10.6% used a different August dataset and method. Comparing it directly with these September figures would not establish an earnings downgrade.

Balance sheets decide how much higher rates hurt

There are three separate channels. Floating-rate borrowing becomes more expensive quickly. Fixed-rate debt is affected when it matures. A higher discount rate can reduce equity valuations even when a company has no debt.

10 The same rate increase has very different earnings effects



Source: Candoris illustration, not market data. Pre-tax profit 10; gross debt 50 or 150; 50% reprices. No cash interest offset.

In this example, a one percentage point rate increase cuts pre-tax profit by 2.5% for the lower-debt company and 7.5% for the higher-debt company. A two-point rise doubles the effect. Taxes, hedges, cash interest and the timing of maturities would change the actual outcome.

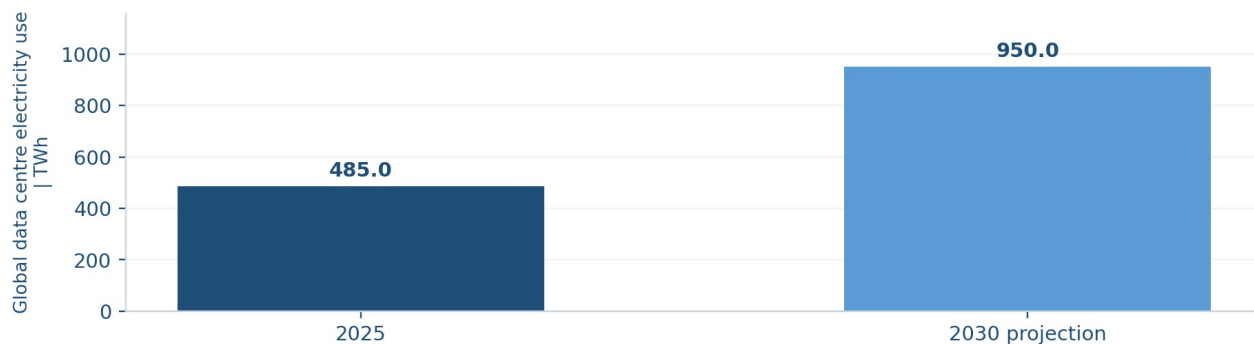
Ask the manager	What the answer tells you
Gross debt and available cash	Net cash is useful, but restricted cash and gross obligations still matter.
Floating-rate share and maturities	How soon higher market rates reach the income statement.
Interest cover and free cash flow	Whether the company can service debt and fund investment internally.
Debt metrics and exclusions	How negative EBITDA, adjusted earnings and portfolio weights affect the headline ratio.

A negative net debt to EBITDA ratio usually means cash exceeds debt when EBITDA is positive. An average ratio can still hide weak holdings. The share of companies with net cash, their portfolio weights and a refinancing schedule are easier to interpret together.

The Belgian client analysis made this distinction clear: leverage data alone cannot validate EPS forecasts. Operating margins and the cost of refinancing must be tested separately.

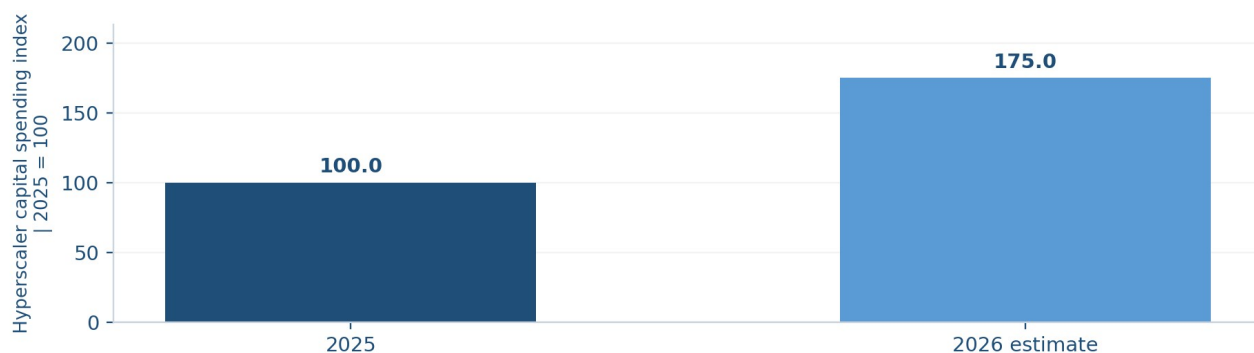
AI investment creates demand beyond the largest technology companies

11 Data centres require much more electricity



Source: IEA, Key Questions on Energy and AI, April 2026. Global central projection; redrawn by Candoris.

12 The investment buildout is still substantial



Source: IEA, April 2026. Hyperscaler capex exceeded USD 400bn in 2025; estimated growth of 75% in 2026. Indexed by Candoris.

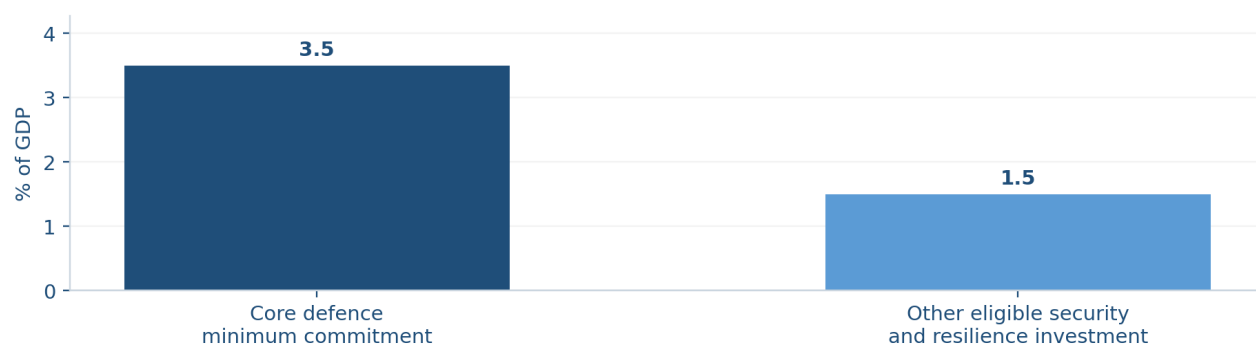
Smaller listed companies can participate through electrical equipment, cooling, testing, specialist construction and components. The opportunity is in supplying the buildout as well as developing AI software. These are potential routes to revenue, not evidence that every supplier will earn attractive returns.

- Follow funded orders and conversion into revenue, rather than announced project values.
- Check customer concentration. A small supplier may depend heavily on a few large buyers.
- Watch cash conversion. Rapid growth can absorb cash through inventories and working capital.
- Power connections, skilled labour and equipment shortages can delay revenue and raise costs.

The same bottleneck can be an opportunity for an equipment supplier and a risk for a project developer. Security selection should distinguish between them.

Defence infrastructure and energy broaden the opportunity

13 Defence commitments extend beyond weapons procurement



Source: NATO, Hague investment commitment. Target for 2035; 3.5% minimum core defence plus up to 1.5% eligible related investment. Not current spending.

Defence programmes, grid upgrades and industrial investment can create multi-year demand. US small caps may benefit through specialist products and services. The link must be established company by company: European spending, for example, does not automatically become revenue for US suppliers.

Investment area	Potential small-cap exposure	Main risk
Defence	Sensors, components, maintenance and secure communications	Budget delays, contract terms and local sourcing
Power and grids	Switchgear, cabling, testing and engineering	Permitting, bottlenecks and costly capacity expansion
Infrastructure	Construction services, materials and automation	Labour costs, project delays and weak cash conversion
Energy	Equipment, services and efficiency technology	Commodity cycles, regulation and overinvestment

An attractive market does not always create an attractive stock. A company can grow sales and still destroy value if it accepts weak contracts, spends too much on capacity or issues shares at the wrong time.

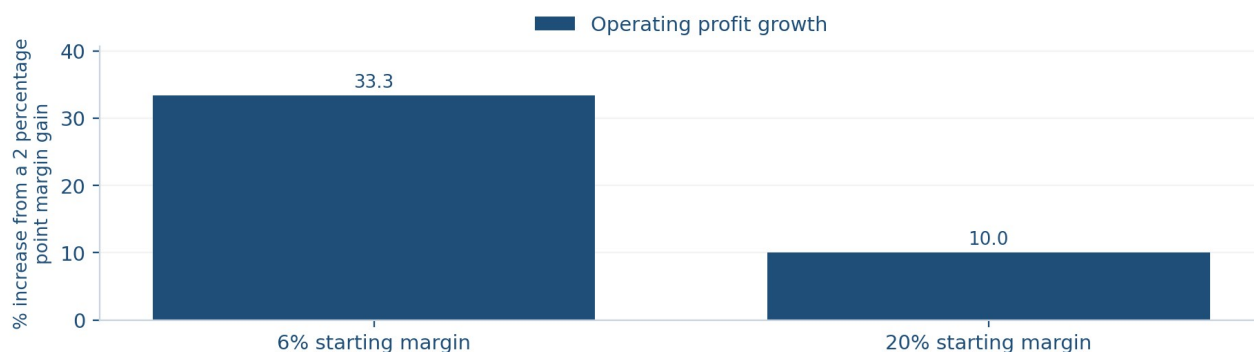
- Prefer visible demand supported by contracts and realistic delivery schedules.
- Look for pricing power, repeat business and returns on invested capital.
- Avoid treating every AI, defence or energy label as a separate source of diversification. Several holdings may depend on the same investment cycle.

Productivity offers a second source of growth over time

Our longer-term thesis is that AI improves productivity, economic growth accelerates and inflation pressure eases. Higher real growth with lower inflation would be a favourable environment for US small-cap growth. The mechanism matters more than the label.

- Better tools can help companies produce more with the same people and capital.
- Lower unit costs can improve margins or allow lower selling prices.
- Broader economic growth can support demand beyond the largest technology companies.

14 A modest margin improvement can have a large profit effect



Source: Candoris illustration. Revenue held constant; operating margin rises from 6% to 8% or from 20% to 22%. Not an AI forecast.

A lower starting margin gives more percentage upside from the same improvement, but also more downside if costs rise. This arithmetic is an opportunity for efficient smaller businesses, not a reason to buy low-quality companies.

The short-term inflation problem remains

AI investment raises demand for chips, power and construction before the productivity gains spread. Energy disruption can add further pressure. In September, Federal Reserve Governor Lisa Cook described this tension and the possibility of modest disinflation over the following years. The timing depends on adoption and on supply growing faster than demand.

Lower inflation does not guarantee lower long-term interest rates. Stronger productivity can raise the return on capital and real yields. The small-cap case should therefore work with stable rates as well as benefit from falling rates.

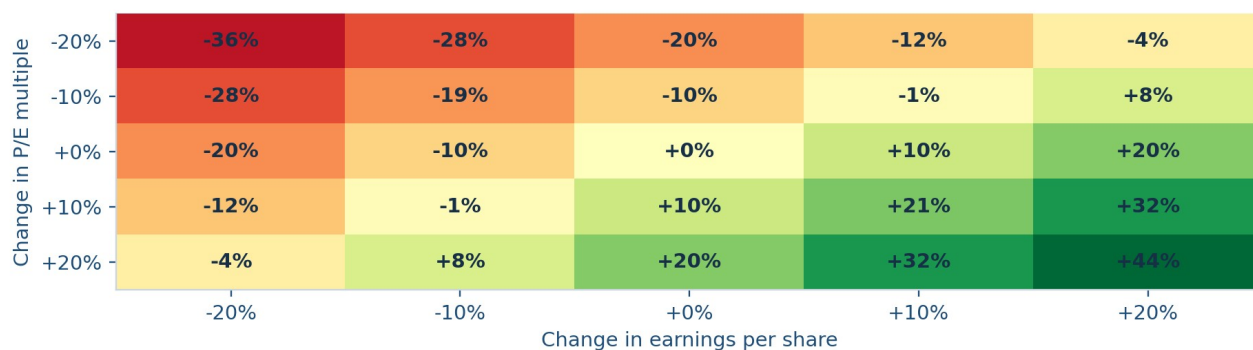
What would weaken the thesis

- Productivity gains remain concentrated in a few large firms.
- AI spending slows before suppliers recover their investment.
- Competition passes all cost savings to customers, leaving little earnings benefit.

Build the allocation around earnings and downside resilience

The evidence supports a selective allocation, with a clear reason for owning each exposure. It does not support waiting for one perfect rate signal or assuming that the whole small-cap index will outperform.

15 Earnings growth can be offset by a lower valuation



Source: Candoris illustration. Price return = $(1 + \text{EPS change}) \times (1 + \text{P/E change}) - 1$. Excludes dividends, fees and currency movements.

Scenario	What it means for the allocation
Growth improves and inflation eases	Broadening earnings and lower financing pressure can support smaller companies.
Growth improves but rates stay high	Cash generation, balance sheets and entry valuation remain decisive.
Inflation persists and growth weakens	Margins, refinancing and equity valuations may all deteriorate together.

- Set the intended role: diversify large-cap exposure, add earnings growth or seek valuation recovery.
- Size the allocation for liquidity needs and drawdown tolerance. Small caps are not a substitute for bond income or capital stability.
- Monitor EPS revisions, order conversion, cash flow and debt maturities. Add on stronger evidence or a better price.
- For European investors, include USD exposure and hedging costs in the comparison.

The strongest reason to act is the combination of selective value and identifiable earnings opportunities. Investors do not need to assume a return to very low rates. They do need companies that can finance growth and turn it into cash.

Sources definitions and chart notes

Prepared by Candoris for institutional discussion. Valuation charts extend to early October 2026. Earnings estimates are dated September. Historical data and longer-term projections have separate dates shown below. No manager or fund recommendation is made in this paper.

1 and 2 Yardeni Research

Stock Market P/E Ratios. LSEG Datastream / S&P data. Figure 1 uses 6 October 2026; figure 2 uses 1 October 2026. Mag-7 is a specific seven-company group, not a general mega-cap index. Forward earnings are estimates. [Source](#)

3 Janus Henderson

The catalysts behind small-cap outperformance, 9 September 2026. Bloomberg valuation chart dated 2 September. The earlier earnings comparison uses Furey / FactSet estimates dated 13 August and is not a like-for-like revision series. [Source](#)

4 6 and 7 Kenneth French Data Library

Six Portfolios Formed on Size and Book-to-Market, annual value-weighted returns. Small growth is Small Low B/M; small value is Small High B/M. Research portfolios use size and book-to-market sorts. They are not investable fund returns. Downloaded 9 October 2026. [Source](#)

4 to 7 Aswath Damodaran

Historical Returns on Stocks, Bonds and Bills, January 2026 workbook. S&P 500 returns include dividends. Treasury observations are year-end yields; CPI is annual inflation. Historical charts compound annual returns and omit within-year drawdowns. [Source](#)

8 and 9 September market research

NCG September small-cap commentary, exhibits 1 and 2, supplied to Candoris. These are asset-class earnings estimates, not fund results. Reproduced and redrawn with the source date retained. No claim is made that these are the latest available consensus estimates.

11 and 12 International Energy Agency

Key Questions on Energy and AI, 16 April 2026. Electricity demand is a central projection. Capex chart indexes reported estimated growth to 2025 = 100; it does not claim an exact USD 400bn base. Redrawn under CC BY 4.0. [Source](#)

13 NATO

Defence investment and NATO's 5% commitment. Political commitments for 2035 are distinct from realised spending and from revenues available to US companies. [Source](#)

AI and inflation Federal Reserve

Lisa D. Cook, An Update on AI and the Economy, 28 September 2026. Used for the distinction between near-term investment pressure and possible later productivity benefits. [Source](#)

Index construction S&P Dow Jones Indices

S&P SmallCap 600 entry criteria include financial viability tests. A positive earnings screen is not a guarantee that every constituent remains profitable. [Source](#)

Earlier client analysis and illustrations

US Small Caps in a Higher Rate Environment, investment note for Maxime Boccart, 30 September 2026. Historical argument and financing framework incorporated; manager-specific material omitted. Charts 10, 14 and 15 are transparent Candoris calculations, not observed returns or forecasts.

Historical returns do not establish causation. Small-cap investing involves equity, liquidity, currency and company-specific risks. Forecasts and illustrative scenarios are not promised returns.