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Small caps: the little engine that could – and does

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As Nuveen's Chief Investment Officer and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas. In addition, she is a portfolio manager for several key investment strategies.

Bottom line up top

Powerful earnings and AI optimism lift U.S. stocks to record levels. The S&P 500 Index hit new all-time highs last week despite continued geopolitical risks in the Middle East. Robust corporate earnings growth and confidence that the transformative potential of AI is becoming more measurable had investors looking past the prolonged closure of the Strait of Hormuz and refocusing on the relative strength of the U.S. economy. Moreover, diplomatic progress between the U.S. and Iran appeared hopeful, even as fears lingered that at least some global economic damage from the conflict will be felt for some time.

Macro snapshots: a series of still frames creating a policy motion picture. Recent U.S. data has captured a view of an economy seemingly able to absorb shocks. On the manufacturing front, the ISM Purchasing Managers Index (PMI) for April held firm at 52.7, and the S&P Manufacturing PMI was even stronger, at 54.5 (readings >50 signal expansion). The recovery in manufacturing activity after three years of weakness is a particularly welcome development for small cap equities, as history shows improving PMIs often lead to a rise in the NFIB Small Business Optimism Index (Figure 1), potentially enhancing the outlook for this segment. Tuesday's NFIB index release will be worth watching closely for signs of resilience.

Consumer sentiment has been depressed, driven by soaring gasoline prices, with the University of Michigan index falling to a new all-time low of 48.2 in May's preliminary print, versus a long-term average of 83.9 since 1978. Consumers' gloomy mood may get a boost from April's nonfarm payrolls report, which on Friday showed the U.S. economy added +115,000 new jobs, crushing consensus forecasts of +67,500, while the unemployment rate held steady at 4.3%.

On balance, the combination of growth and inflation indicators has kept the U.S. Federal Reserve on pause, maintaining the target federal funds rate in a range of 3.50% to 3.75%, but with a hawkish bias. Markets are now pricing in zero Fed rate cuts before year-end, although our current outlook still calls for one 25 basis points (bps) reduction. Outside the U.S., the Reserve Bank of Australia raised its official cash rate by 25 bps, to 4.35%, while the European Central Bank signaled a likely

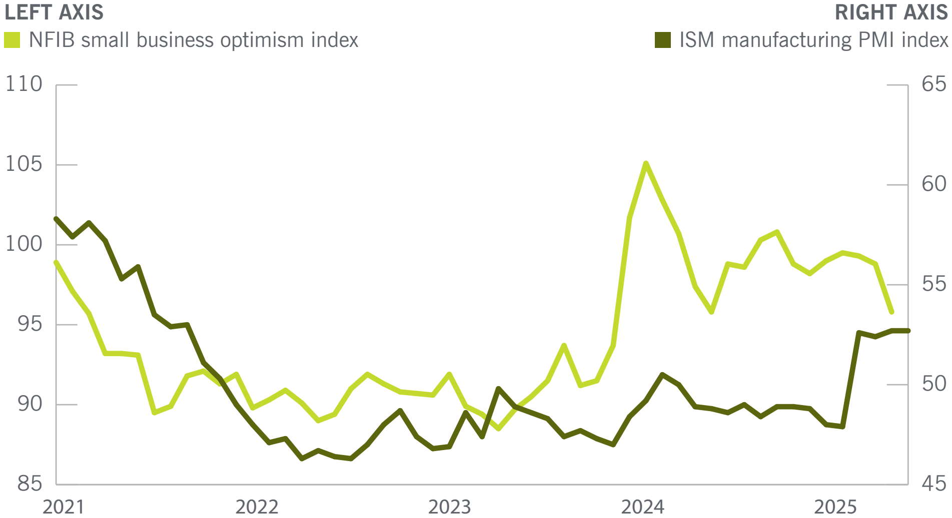
June hike. This week's busy economic calendar brings more data for central banks and financial markets to digest. U.S. headline CPI and PPI reports for April will reveal to what extent the global energy price shock is driving broader inflation. The latest GDP figures for the United Kingdom and the eurozone could also be a gauge of the Iran conflict's initial toll on European economic activity. Lastly, President Trump and Chinese leader Xi Jinping will meet in a high-profile summit, where any tactical trade agreements might help stabilize global sentiment.

Amid the rapidly changing global economic and market backdrop, investors may find it worthwhile to consider diversifying equity holdings into areas offering attractive entry points and long-term return potential.

> **Strong corporate earnings are likely the primary driver of further equity market gains from here.**

Figure 1

Rising manufacturing could reignite small business confidence



Data source: Bloomberg, L.P., Dec 2021 to Apr 2026, monthly data.

Portfolio considerations

Current market dynamics and historical context make the case for meaningful exposure to global **small cap equities**. Since the inception of the MSCI World Small Cap Index in December 1998, the asset class has generated an average annualized return of approximately +11.4% during periods when the U.S. fed funds rate held steady or declined, compared to roughly +9.1% when rates rose (Figure 2).

The performance differential is more pronounced when viewed through the lens of the 10-year U.S. Treasury yield: small caps gained +13.7% annualized when the 10-year yield was stable or falling, versus just +5.0% when it increased — a nearly 9 percentage point gap. This bifurcation reflects a dual burden. Rising inflation, typically a driver of higher long-term interest rates, erodes the operating economics of smaller companies, while higher long-term interest rates compress their future cash flows.

Within the U.S., the opportunity in small caps is hard to ignore. After selling off sharply from late February through March, as the Iran conflict drove up inflation expectations and Treasury yields, the U.S. small cap Russell 2000 Index has rebounded decisively (+14%) and leads the broader equity market recovery. One contributing factor may be that U.S. small caps tend to be domestically oriented, with only 25% of Russell 2000 firms deriving more than half of their revenues from non-U.S. sources, versus 37% of S&P 500 companies (source: Bloomberg). This suggests small caps are potentially better insulated from geopolitical disruption and supply chain stress.

Valuations and earnings expectations reinforce U.S. small caps' appeal. Based on FactSet data, the Russell 2000 trades at a forward price-to-earnings ratio of 16.9x, near three-decade lows and well below the 21.3x for the large cap Russell 1000. Additionally, consensus earnings per share growth for the S&P 600 Index, another U.S. small cap benchmark, is projected to outpace that of the S&P 500 through 2026.

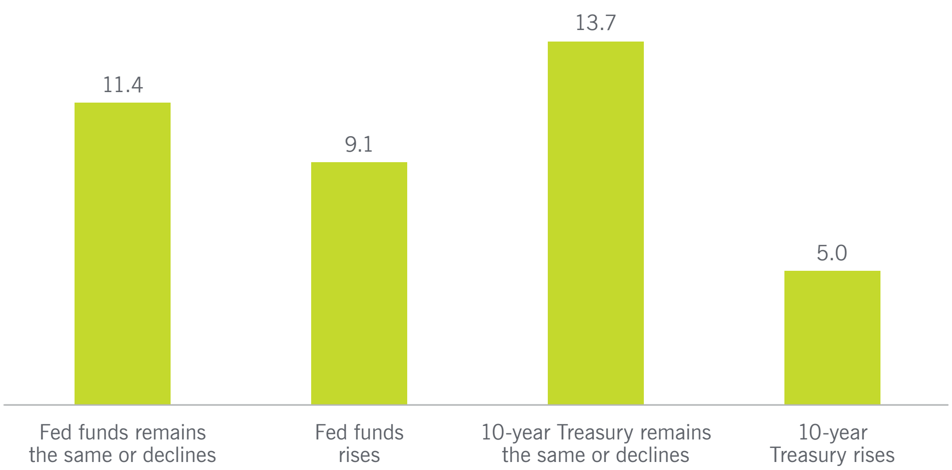
In our view, the balance of opportunity and risk for U.S. small cap equities is as attractive today as it has been in years, making this a good time to consider a strategic long-term allocation to the asset class.

> **Valuations and earnings expectations reinforce the appeal of U.S. small caps.**

Figure 2

Small cap stocks have performed well in lower-rate environments

Average annualized performance in different scenarios (%)



Data source: Bloomberg, L.P., 30 Apr 2026. **Performance data shown represents past performance and does not predict or guarantee future results.** Data depicts global small cap stocks average monthly returns as represented by the **MSCI World Small Cap Net Total Return Index** since inception (31 Dec 1998).

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Regular meetings of the GIC lead to published outlooks that offer:

- macro and asset class views that gain consensus among our investors
- insights from thematic "deep dive" discussions by the GIC and guest experts (markets, risk, geopolitics, demographics, etc.)
- guidance on how to turn our insights into action via regular commentary and communications

For more information, please visit nuveen.com.

Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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