

CIO VIEWS: STRATEGY AND PORTFOLIO CONSTRUCTION

Small cap stocks, big earnings expectations

Bottom line up top

Markets to see clearly now that the shutdown's gone? With the end of the record-breaking U.S. government shutdown, investors are entering a new phase of relative clarity. Key economic data about jobs, manufacturing, inflation and more will finally be released after being stuck in limbo during the impasse. It won't happen immediately or all at once, but it will replenish the supply of critical inputs that both the U.S. Federal Reserve and financial markets have been craving.

As the dust settles, however, the view might not be all bright. The shutdown itself exacted a tangible economic cost. Analysts estimate that U.S. fourth quarter GDP growth took a hit of roughly 1.0 to 1.5 percentage points due to worker furloughs, delayed contracts and reduced travel. When the data pipeline fully reopens, markets and policymakers will need to reassess growth momentum, inflation trends and labor market health.

Against this clearer but not yet crystalline backdrop, markets are essentially pricing in a "coin-toss" (55% probability) scenario for a Fed rate cut next month. Fed funds futures foresee a meaningful chance of easing through the first half of 2026 as well (Figure 1), although the Fed's policymaking committee has both hawks and doves among its members.

Stock-a-doodle-doo crowing doesn't mean betting the farm on tech. U.S. equities weathered the shutdown surprisingly well, with the S&P 500 Index returning +2.5% in October and holding steady in the first half of November, albeit with some volatility. A strong earnings season has driven market gains. According to FactSet, year-over-year



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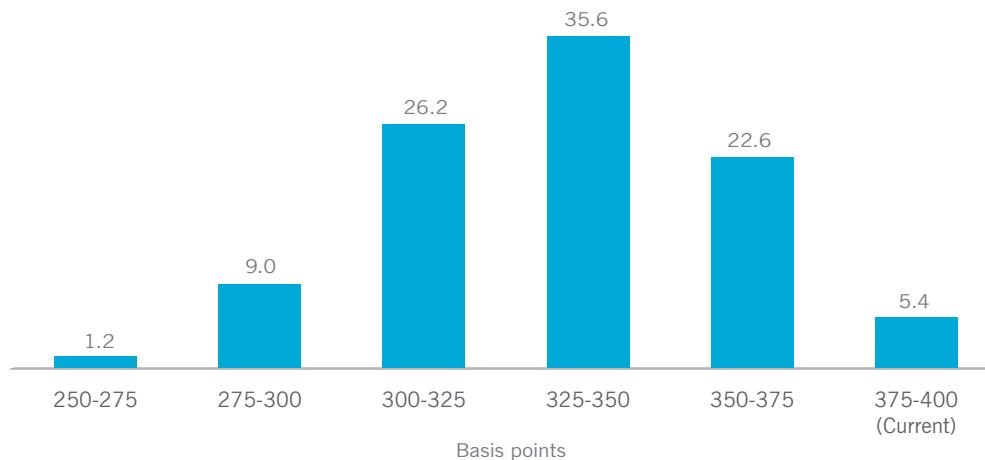
As Head of Equities and Fixed Income, Nuveen's CIO and leader of our Global Investment Committee, Saira drives market and investment insights, delivers client asset allocation views and brings together the firm's most senior investment leaders to deliver our best thinking and actionable investment ideas.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

Investors may want to consider other equity markets that we think stand to benefit from lower rates.

earnings growth for the S&P 500 is estimated at +13.1% for the third quarter, with revenue growth of around +8.3%. Information technology earnings have led the pack with +27.3% growth, supercharged by the semiconductor and semiconductor equipment segment (+49%). AI remains a central theme. The expansion of data centers, semiconductor capital expenditures and enterprise AI rollouts is fueling tech profitability and may underpin a new productivity upcycle. But as sentiment toward the lofty valuations of AI-centric names begins to waver, investors may want to consider other areas of the equity market. We believe that these alternatives stand to benefit from a lower rate environment, improving earnings forecasts and evolving tariff policies.

FIGURE 1: MARKETS ANTICIPATE RATE RELIEF AHEAD

Current market probabilities for the fed funds upper limit in June 2026 (%)



Data source: CME FedWatch, 13 Nov 2025.

Portfolio considerations

Over the past few years, U.S. equity market performance has been dominated by a few mega cap technology companies supported by powerful AI tailwinds. This narrow but persistent leadership has led large caps to outperform small caps, often by wide margins. But the attractiveness of an asset class isn't simply a function of recent relative performance. Forward earnings growth estimates, valuations and interest rate expectations are three key reasons to consider allocating to **U.S. small cap equities** in the current environment.

Corporate earnings growth has been the primary driver of stock prices over the long run, and we expect this to continue — particularly as inflation and interest rates normalize. Smaller companies may be poised for an **earnings growth advantage** going forward, after lagging large caps on this metric from late 2022 through 2024 amid rapidly rising interest rates and heightened recession fears. The odds of a recession are

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Earnings, valuations and rate expectations currently lead us to favor allocating to U.S. small cap equities.

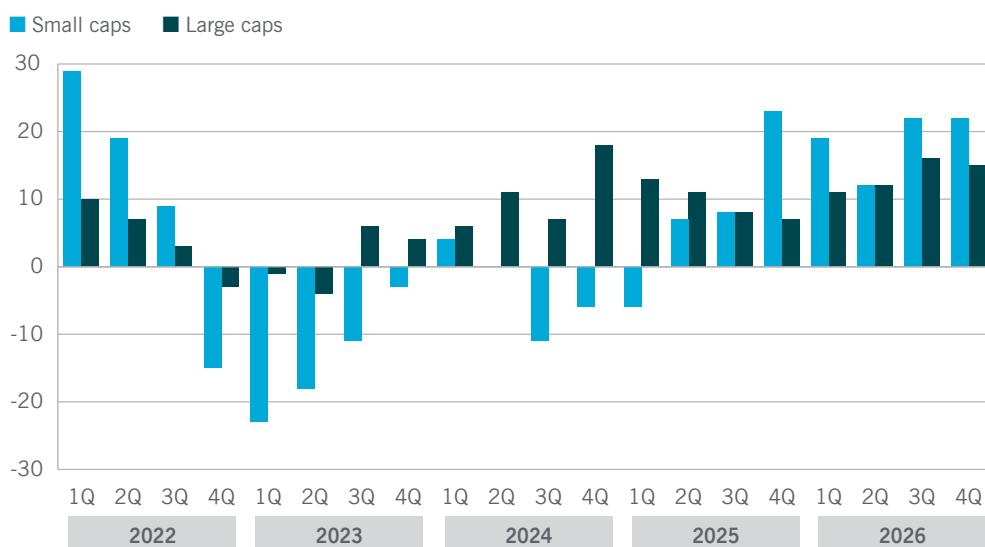
now lower as the economy has proven resilient, productivity has improved and the Fed's priority has shifted more toward supporting employment than fighting inflation — a plus for cyclical areas like small caps. Looking ahead to the remainder of 2025 and 2026, analysts expect earnings to grow faster for smaller companies than for large ones (Figure 2).

In absolute terms, **valuations** for U.S. small caps are in line with their 16.4x average over the past 25 years, as measured by the 12 month forward price-to-earnings (P/E) ratio for the Russell 2000 Index. But after small cap returns trailed those of large caps by nearly 13 percentage points in 2024 and more than four percentage points through 3Q25, the Russell 2000's P/E relative to the large cap Russell 1000 Index is hovering near long-term lows. With large caps looking expensive, valuations currently favor small caps.

Historically, small caps have outperformed large caps following the first move in a Fed easing cycle. Why? Because smaller companies generally **benefit from easing financial conditions**, rely more on short-term variable debt to finance growth and pay higher interest rates on that debt. When the Fed cuts rates, their cost of capital declines. A given small company can refinance at cheaper rates and use the proceeds to expand, which can help boost its stock price. There's no guarantee history will repeat itself, but the Fed's current cycle, which began in September 2024, could serve as a potential catalyst for small caps outperformance down the road.

FIGURE 2: SMALL CAPS MAY HAVE AN EDGE IN 2026

Bottom-up consensus YoY EPS growth by size segment (%)



Data source: FactSet, BofA U.S. Equity and U.S. Quant Strategy, 30 Sep 2025. Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: Small caps: S&P 600; Large caps: S&P 500.

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- guidance on how to turn our insights into action via regular commentary and communications

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Endnotes

Sources

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

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