



## 1Q26 Small Cap Market Overview

**While not immune to the shift in investor sentiment during the first quarter, small caps appear to be amid a resurgence following a multi-year period of large cap dominance.**

Risk assets preserved 2025's positive momentum in the early stages of 2026 before the war with Iran ultimately weighed on investor confidence. Throughout the period's volatility, however, the outperformance of smaller stocks relative to large ones was a constant. Though well off its early-quarter peak, the Russell 2000 Index managed to eke out a gain of 0.9% compared to the 4.3% decline of the S&P 500 Index. The Russell 2000 Value Index was even more robust, with a 5.0% advance.<sup>1</sup>

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### **Only the Beginning?**

The strong rally in smaller stocks this quarter—with growth lagging value across capitalizations—reminds us that an awakening beast can roar. Despite this recent show of strength, however, it's perhaps too soon to take a victory lap. Longer-term performance trends remain skewed toward large growth names, with the relative performance of small caps still near previous cyclical troughs. While encouraged by the three-year string of annual gains for smaller stocks and their resilience through the challenges of first quarter 2026, there's still plenty of catching up to do given the long run of large caps.<sup>2</sup>

While the war with Iran may have prompted what appears to be the largest ever physical supply disruption to world oil markets and potentially stymied economic growth, which triggered higher inflation and dampened future earnings growth, we remain constructive on the outlook for small cap stocks. Although geopolitical disruptions may spur management to defer guidance on upcoming quarterly earnings calls, continued strong growth may be in prospect. Published forecasts reflect 73% earnings growth for the Russell 2000 in 2026 and 35% in 2027 compared to 19% and 17%, respectively, for the S&P 500. Small cap revenue growth, too, is forecast to improve over the next several quarters.<sup>3</sup>

1. Source: FactSet; data as of March 31, 2026.  
2. Source: Bloomberg; data as of March 31, 2026.  
3. Source: LSEG I/B/E/S; data as of April 10, 2026.

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Meanwhile, higher energy prices—and the war itself—have created direct beneficiaries. Research indicates providers to oil servicers and chemical processors are well positioned, as are companies with upside exposure to higher chemical, fertilizer and metals prices. Suppliers to defense contractors may also benefit.

While broader tailwinds from low energy prices may be curtailed by the war, at least temporarily, aggressive capex—including for artificial intelligence (AI) infrastructure—could provide an offset. Although software companies at risk of disintermediation have suffered, small cap tech companies supporting the AI-infrastructure build—with very little additional spending needed for research and development—are positioned to flourish. Additionally, semiconductor and semiconductor capital equipment companies are finally reaping the rewards of a long-awaited upturn in the cycle.

The 175 basis point cut in the federal funds rate since September 2024 is generally supportive of small company earnings. Smaller companies tend to be more reliant on short-term, floating-rate debt than large cap names; thus, lower rates provide companies carrying variable-rate debt with hard-dollar savings. Having started 2026 with a dovish tilt—with futures markets then discounting two 25 basis point cuts across the year—the subsequent prospect of oil-shock induced inflation has altered expectations. Absent much tighter financial conditions or substantial deterioration in labor markets, Federal Reserve rate cuts in 2026 may be challenging. That said, even without further dovish action by the Fed in 2026, rates are still substantially lower than in 2022.

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While uncertain macroeconomic environments—and resultant volatile markets—can discourage capital markets activity, initial public offerings (IPOs) this year may nonetheless be robust. Last year is a case in point; deal activity rebounded in 2025, despite tariff volatility and a government shutdown. And despite the challenges of first quarter 2026, 127 companies went public.<sup>4</sup>

This year, a still-vigorous pipeline awaits. Aside from the backlog of mature, high-profile companies, many private equity firms have held smaller portfolio companies longer than optimal, creating pressure to exit and return capital to investors. Additionally, companies that postponed IPOs due to government shutdowns could re-emerge—facilitated by a benign regulatory environment—focused on increased capital access and reduced compliance burdens.<sup>5</sup>

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## Earnings as the Ultimate Arbiter

While fully acknowledging that the valuation gap between smaller company stocks and large could persist for some time before the market recognizes the discrepancy, we believe that solid fundamentals—underpinned by earnings—may ultimately prevail.

Volatility, always prevalent in small cap markets, has increased since the war in Iran. But along with volatility may come opportunity to buy and sell at sometimes distorted valuations. Seasoned through multiple cycles, we continue to do what we've always done: keep our focus on the spreadsheets to understand each company's earnings power while distinguishing between companies that are cheap for a reason from those with solid businesses and catalysts for improvement.

4. Source: Wall Street Horizon; data as of March 31, 2026.

5. Source: Cleary Market Watch; data as of February 5, 2026.

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**Russell 2000® Index** (Gross/Total) measures the performance of the small-cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. A total-return index tracks price changes and reinvestment of distribution income.

**Russell 2000® Value Index** (Gross/Total) measures the performance of the small cap value segment of the US equity universe. It includes those Russell 2000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (two-year) growth and lower sales per share historical growth (five-year). A total-return index tracks price changes and reinvestment of distribution income.

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