

AI, outsourced tech and a re-opening IPO market



Improving earnings expectations, attractive relative valuations and early signs of broader market leadership suggest the backdrop for US small caps may be shifting, says **Bill Hench**, head of small-cap team and portfolio manager at First Eagle Investments

The conversation around US small caps is beginning to shift. After an extended period in which performance was dominated by a narrow group of large-cap companies, recent market moves suggest a more balanced environment may be emerging. The Russell 2000 index gained 0.9% in the first quarter of 2026, while the S&P 500 index fell 4.3% and the Russell 2500 index rose 2%.

While short-term index performance varies and is not indicative of future results, these trends may point to broadened market participation. In a market where the 10 largest companies accounted for nearly 40% of the S&P 500 index by mid-2025, expanding exposure beyond the largest names may provide access to a richer opportunity set within US equities.

The earnings backdrop for smaller companies is also evolving. While outcomes remain uncertain, some indicators suggest improving momentum, and expectations for earnings growth have supported increased investor interest in smaller companies. In our view, fundamentals, particularly earnings, are an important driver of long-term equity returns. Valuations also warrant attention.

As of late March, the Russell 2000 index traded on a forward price-to-earnings multiple (P/E) of 18x, compared with 21.8x for the S&P 500 index, while the FTSE Russell index traded at a roughly 30% discount relative to the mega-cap Russell Top 200 index.

While valuation gaps can persist for long periods of time and valuation spreads are not indicative of forward performance, rational markets historically have reverted to the mean, erasing unwarranted discrepancies.

Taken together, these dynamics—which have not been simultaneously present for some time—point to a backdrop that may be supportive for small caps. Improving earnings expectations, a meaningful valuation discount and early signs of broader market leadership are beginning to align.

Beyond cyclical considerations, structural developments may influence how smaller companies compete relative to prior cycles, particularly in technology.

The role of outsourced technology

Outsourced software and services have expanded access to tools that historically required significant in-house investment. Cloud computing's on-demand, usage-based model can allow businesses to convert portions of their cost base from fixed to variable, which may reduce working capital needs and narrow some traditional scale advantages.

AI may reinforce that shift

While attention has focused on model developers and hyperscalers, the broader investment cycle may also be relevant. The buildout of data centres, power networks and related infrastructure is contributing to demand across a wider ecosystem. McKinsey suggests meeting global data-centre demand may require nearly \$7trn of investment by decade-end.

For small-cap investors, the opportunity set extends beyond platform leaders. Companies supporting infrastructure and data centre construction may benefit from increased demand. In some cases, higher volumes on an existing platform could support higher margins. We believe certain smaller technology companies with exposure to AI-related infrastructure, as well as selected semiconductor and semiconductor capital equipment businesses, may be positioned to participate in this trend.

Elsewhere, AI adoption may have more incremental effects. In sectors such as healthcare and consumer goods, AI may be used to improve efficiency, inform decision-making and enhance product development. Over time, such applications may influence cost structures and competitiveness.

A reopening IPO market

The initial public offering (IPO) market also bears watching. A sustained recovery could help re-establish a more typical small-cap ecosystem of IPOs after a period in which companies remained private for longer. US IPO activity increased in 2025, and both EY and Renaissance Capital have anticipated a continuing, albeit selective, rebound in 2026.

While cyclical and sensitive to market conditions, a more active IPO market may provide additional valuation reference points, expand the investable universe and support capital formation.

With relatively disciplined balance sheets following a phase of cautious spending and hiring—and with improved demand many smaller companies may benefit from enhanced operating leverage and expanded margins.

Selectivity remains key

For investors, the current environment underscores the breadth of opportunity as well as the importance of selectivity. Small-cap markets have historically been more volatile than larger-cap markets; outcomes can vary widely across companies and market cycles. A long-term, research-driven approach may help identify businesses that are better positioned to navigate changing conditions.

After years of large-cap dominance, interest in smaller companies has increased. US small caps are often more closely tied to domestic economic activity and are widely associated with innovation and economic dynamism. In a market defined by concentration, broadening exposure beyond the largest companies may offer a more varied set of return drivers for long-term investors. **PA**