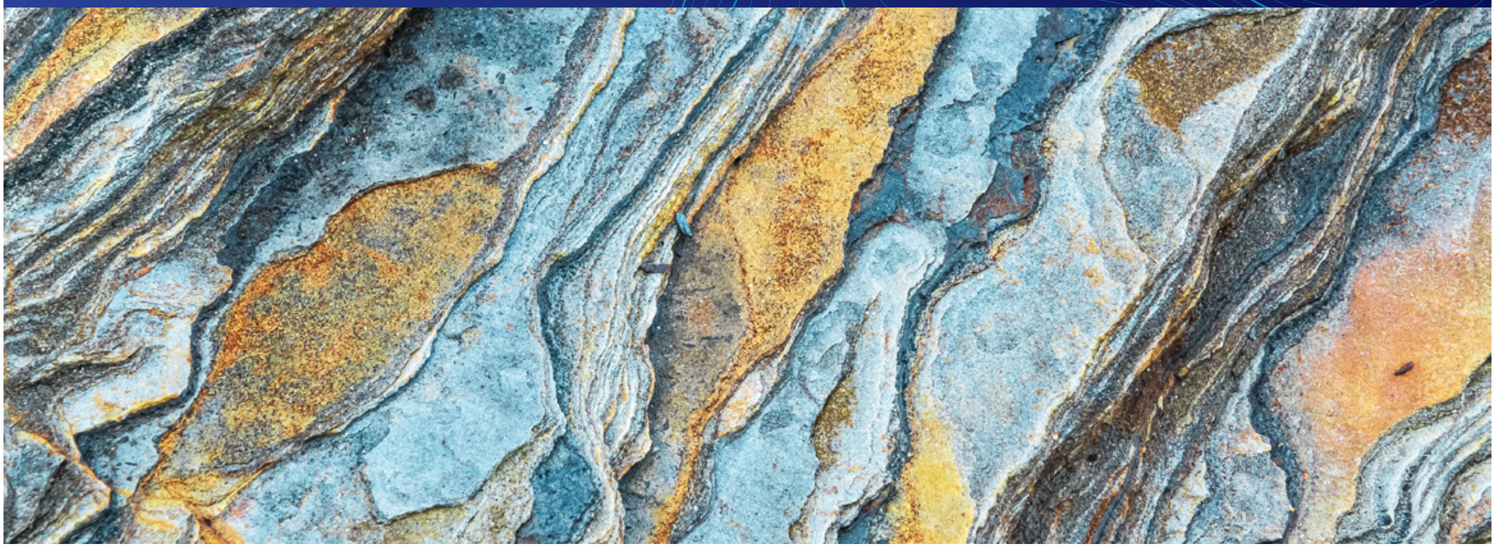

# 2Q26 Small Cap Market Overview

## Smaller stocks surged in the second quarter as easing Middle East tensions buoyed investor confidence.

With a fragile peace reached between the US and Iran, equity markets more than recovered from their first quarter challenges. Though equities in general benefitted from the shift in sentiment, smaller stocks continued to outperform larger names. The Russell 2000 Index advanced 21.5% during the quarter compared to the 15.2% gain of the S&P 500 Index, and its 22.6% first-half gain is the best start to a year since 1991.[1] The Russell 2500 Index and the Russell Midcap Index increased 20.3% and 13.9%, respectively, during the quarter. Growth outperformed value during the quarter across capitalizations.[2]

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### The Beat Goes On

In a theme similar to what we have seen in the large cap space, smaller-stock index performance year-to-date has been quite concentrated, with energy leading the way in the first quarter and tech rebounding in the second. In fact, the magnitude of capital expenditures by hyperscalers—companies like Amazon, Apple, Meta, Microsoft and Oracle that operate massive data centers supporting cloud computing—has been a source of support across markets. Spending on data-center software and information processing equipment relative to GDP now exceeds the dot-com peak, funded primarily out of operating cash flow and, increasingly, debt issuance, and is forecast to continue.[3] Even if new spending were to moderate, the long-term nature of projects like data centers suggests hyperscaler capex may be a source of support for smaller companies supporting the artificial intelligence (AI) infrastructure build.

From a macro perspective, the big news in the second quarter was the pronounced shift higher in US interest rate expectations even as those for other major economies generally moderated. One reason for this has been the appointment of Kevin Warsh as chair of the Federal Open Market Committee, replacing Jerome Powell. While Warsh's nomination for the role in March initially had some observers questioning his ability to lead the central bank independent of President Trump's rate-cutting influence, sentiment regarding his credibility has since

1. Source: Furey Research Partners; data as of July 6, 2026.
2. Source: FactSet; data as of July 30, 2026.
3. Source: Reuters; data as of March 17, 2026 (most recent available).

shifted markedly. While it remains to be seen if Warsh's credibility is merely enjoying a honeymoon period to begin his term, his consistently hawkish tone has helped push two-year yields and the dollar higher.

Smaller companies tend to be more reliant on short-term, floating-rate debt than large cap names, so any shift toward tighter policy could have a material impact on the companies in this space. While we view rate hikes as possible based on Warsh's rhetoric, the deliberate lack of formal Fed guidance under the new regime makes policy trajectory difficult to assess. Further, as credible as Warsh may be, he doesn't have the same degree of policy flexibility that many of his predecessors had given today's fiscal situation. The ability to increase interest rates meaningfully in the face of inflationary pressures is likely constrained by the government's need to continually roll over its very large primary deficit at prevailing higher interest rates.

## A Nice Problem to Have

The sharp run-up in certain areas of the portfolio has reinforced to us the critical importance of exercising strict valuation discipline, which we think is a painful but necessary part of evaluating smaller stocks. However, we are excited about undervalued opportunities in sectors like healthcare or consumer staples, as well as where we can identify more idiosyncratic turnarounds.

Smaller stocks in general should find support going forward in resurgent fundamentals. For example, published forecasts reflect 85% earnings growth for the Russell 2000 in 2026 and 44% in 2027 compared to 27% and 18%, respectively, for the S&P 500 Index. Revenue growth, too, is forecast to improve over the next several quarters.[4]

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In addition, the reopening of the initial public offering (IPO) market in recent quarters has increased the number of stocks from which to choose. While mega IPOs like SpaceX get all the headlines, issuers tend to be on the smaller side. There were 65 traditional IPOs in the US market during the first half of 2026, raising about $114 billion, or more than seven times the amount raised in the same period last year; an additional 118 companies, worth $21 billion, came to market via the special purpose acquisition company (SPAC) channel.[5] And a vigorous pipeline remains. 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 reemerge, facilitated by a benign regulatory environment focused on increased capital access and reduced compliance burdens.[6]

4. Source: LSEG I/B/E/S; data as of July 9, 2026.
5. Source: PwC; data as of July 10, 2026.
6. Source: Cleary Market Watch; data as of February 5, 2026 (most recent available).

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**Gross domestic product** (GDP) measures the total value of all economic output in goods and services for an economy.

A **special purpose acquisition company** (SPAC) is a publicly traded company formed solely to acquire or merge with another company and make it public without going through the initial public offering process.

**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 2500™ Index** (Gross/Total) measures the performance of the small to midcap segment of the US equity universe, commonly referred to as "smid" cap. It includes approximately 2,500 of the smallest securities in the Russell 3000® 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 Midcap® Index** (Gross/Total) measures the performance of the midcap segment of the US equity universe. It is a subset of the Russell 1000® Index and includes approximately 800 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.

**S&P 500 Index** (Gross/Total) measures the performance of 500 of the top companies in the leading industries of the US economy and is widely recognized as a proxy for the US market as a whole. A total-return index tracks price changes and reinvestment of distribution income.

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