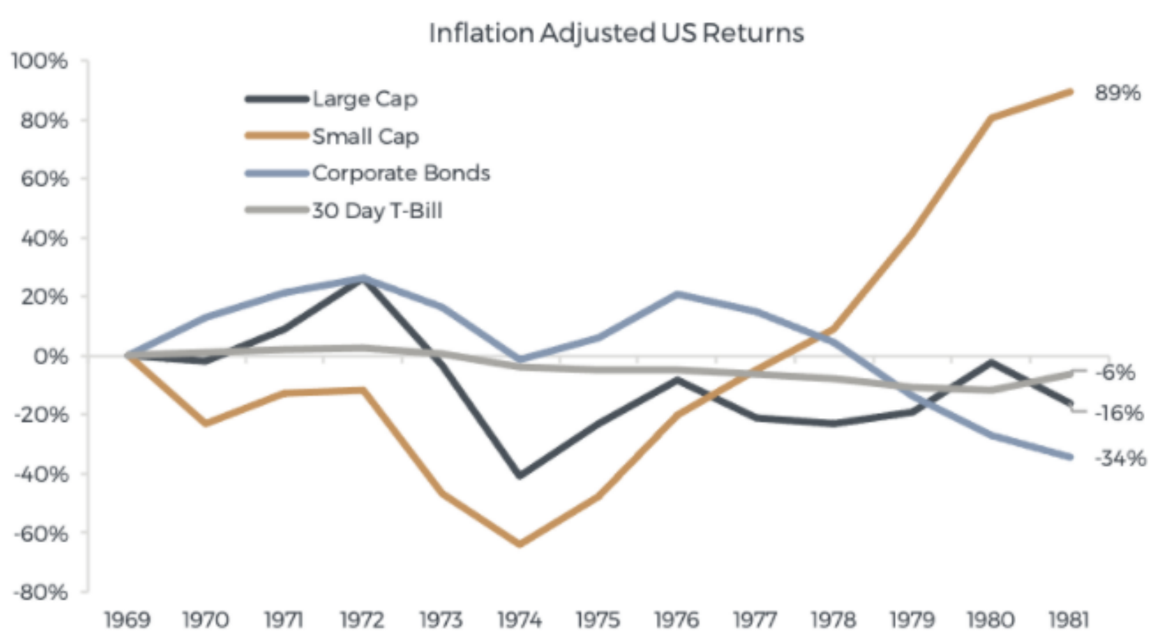
A Case for Small Cap Stocks in an Inflationary Environment

Inflation fears have been ramping up over the past quarters having been underscored yet again by the 9.7% print of the producer price index on February 15, 2022. It is obviously the case now that it is no longer a question of "if" the Federal Reserve will be increasing the Fed funds rate, but by how much and over what period of time. These concerns combined with ongoing global concerns that include the COVID-19 pandemic, the ongoing disruption of global supply chains and the conflict between Russia and Ukraine have resulted in significant volatility as well as a sharp selloff for US equity markets to begin the year.

Clearly investors are worried that rising rates fueled by inflation will dampen corporate growth and earnings which leads to depressed stock prices. For 180 Degree Capital ("TURN"), while we are interested in the direction of the broader markets and global macroeconomic factors, we do so with a focus on how those factors impact the small/microcap markets where we invest.

Interestingly, using history as a guide, we see the current sell-off as an opportunity as it relates to the small/microcap market generally. In fact, the small cap market is the only major asset class to outpace inflation during every decade since the 1930's. Further, going back to 1926, the small cap market is the only major market that has on average been able to outperform inflation even when inflation moves above 5%.



Source: Ibboston @ Harrington, SBBI (2020)

If we drill down further and examine the six most recent cycles of fed funds rate hikes, we see that following an initial selloff, the small cap market consistently produced attractive rates of return for the 12-36 month period following an initial rate increase.

RUSSELL 2000 INDEX RETURNS FOLLOWING FED FUNDS RATE INCREASE

Hike Date	3 months after	12 months after	18 months after	36 months after
2/1/83	n/a	26.97%	5.20%	49.22%
10/1/86	1.75%	29.02%	7.47%	40.02%
2/4/94	-2.54%	-2.69%	16.85%	47.57%
6/30/99	-6.32%	14.32%	7.60%	1.71%
6/30/04	-2.86%	9.45%	15.88%	48.00%
12/15/15	-5.36 %	22.63%	17.55%	9.14%
Averages	-3.07%	16.62%	11.76%	32.61%

Source: Perritt Capital Management

There are a number of likely factors driving this outperformance. For example, many analysts see benefits in the flexibility and maneuverability afforded management in running a smaller enterprise versus a large company during more volatile economic environments. Also, to the extent global factors represent a key driver to the market conditions (which they clearly do now), smaller companies are often more insulated from these impacts. Another reason for small cap outperformance is that smaller companies often produce outsized growth in a growing economy that rising rates imply and are often able to more easily pass on price increases in an inflationary environment.

Taken together, we believe the current fear driven sell off is providing significant opportunities in the small cap market particularly for an investor with a value driven approach.

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