

# SMALL/SMID CAP STOCKS: THE OVERLOOKED ASSET CLASS

## Ignore The Politics - Focus on the Policies

Authored By:

**DENNISON "DAN" T. VERU**  
SENIOR PARTNER  
CHIEF INVESTMENT OFFICER

**FRANK GALDI**  
PARTNER  
CHIEF RISK OFFICER &  
DEPUTY CHIEF INVESTMENT OFFICER

**AMRITA THAPA, CFA**  
SENIOR VICE PRESIDENT  
INVESTMENT MANAGEMENT RESEARCH &  
RISK MANAGEMENT

We are struck by the unprecedented political events, in magnitude and quantity, over the last two months for our nation. We believe this period will go down as a historic test for our republic, a test we are confident our nation will pass. Since May 30th, a former president and current candidate for president was convicted of 34 felony counts in a NY court of law while a frail incumbent president alarmed world leaders at the G-7 summit in early June. This was followed by a disastrous debate performance by the sitting president on June 27th. On July 13, the former president and current Republican candidate was nearly assassinated just before his party's unifying convention. And on Sunday, July 21st, the sitting president decided not to run for re-election.

Historian Peter T. Veru, PhD recently noted to our investment team that the nation has in the past faced a similar period of uncertainty. In March 1968, President Johnson shocked the nation and Mrs. Johnson by withdrawing from the presidential race. On April 4th, Martin Luther King was assassinated, and on June 6th, Robert F. Kennedy, the front runner for the Democratic nomination for president, was assassinated. Democrats held an open convention in Chicago, the site of this year's convention. So, while recent events have been troubling, they are not necessarily unprecedented.

The combination of markets beginning to price in a Republican victory along with recent cooling inflation caused a broad rally for stocks in July, especially for the Russell 2000® and 2500™ indexes. Recent (potential) shifting political winds could cause a short-term pause in the small cap trade, but this week's events do not change our bullish long-term outlook for small- and smid-cap stocks for the following reasons:

- 1) Small-caps have been rising because inflation is coming down and unemployment is slowly rising, together which may allow the Federal Reserve to lower interest rates possibly as early as September. The economy is slowing but is not slow and remains resilient.
- 2) The re-shoring of supply chains from China to the U.S. is a long-term trend that is underway no matter which party occupies the White House. Both parties agree China's dominance in the semi-conductor industry is a national security threat. There are obvious policy differences that could have an impact at the sector level, but this trend is generally a tailwind for domestically-focused companies that dominate the small- and smid-cap indexes.
- 3) Recent events within the Democratic Party could result in a reset period that brings new uncertainties around November's election outcome and add to volatility. We are also entering the August, September, and October seasonal period when stocks tend to be more volatile, and a close election could support this possibility.
- 4) Potentially offsetting recent political events is the current administration's willingness to use extraordinary liquidity tools such as the Treasury General Account (TGA). Election years are typically good years for stocks as the party in power seeks to stay in power using market-friendly tools intended to limit broader selling.
- 5) Despite the recent rally, profitable small- and smid-cap stocks are still inexpensive both on an absolute basis and relative to large-cap stocks. Small- and smid-caps are also coming off a multi-year period of slow revenue growth, but a reduction in interest rates could result in a rebound to these companies' revenues and profits.

In conclusion, history shows that presidents have little influence on the direction of stocks. Politics is exciting or disconcerting depending on your perspective, but, as active investors, we believe it is important to focus on policy, not politics, and the macroeconomic factors tied to the business cycle. From our perspective, the U.S. economy is in good shape and has a bright future. However, we do respect that politically this is a turbulent time, but not necessarily unprecedented. Today, our economy is far less cyclical and operates far differently than in the late 60's, and our view is political turmoil should have very limited impact on the long-term case for small- and smid-cap stocks.

## SMALL/SMID CAP CORE EQUITY INVESTMENT TEAM



**MARC SHAPIRO**  
PARTNER,  
SENIOR PORTFOLIO MANAGER,  
CORE EQUITY STRATEGIES



**GARO NORIAN, CFA**  
PARTNER,  
ASSOCIATE PORTFOLIO MANAGER,  
CORE EQUITY STRATEGIES



**DAWN BROCK**  
PARTNER,  
ASSOCIATE PORTFOLIO MANAGER,  
CORE EQUITY STRATEGIES



**CHRISTOPHER MASHIA, CFA**  
SENIOR VICE PRESIDENT,  
CORE EQUITY STRATEGIES

## CONTACT US

Palisade Capital Management, LP  
One Bridge Plaza, Suite 1095  
Fort Lee, New Jersey 07024

Phone: (201) 585-7733  
Fax: (201) 585-7552  
marketing@palcap.com

[palisadecapital.com](http://palisadecapital.com)

Contributing Author: **Allison J. Chase, CIPM**, Vice President, Institutional Client Service & Marketing Analytics

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