# *Fidelity Viewpoints*®: Market Sense

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**TRANSCRIPT**

**SPEAKERS:**

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**HEATHER HEGEDUS:** Hi, everybody. Thank you so much for making the time to join us for another episode of *MarketSense*. I'm Heather Hegedus with Fidelity. Right now, all eyes are on earnings season. A second quarter earnings reporting getting underway today. Investors are also keeping a close watch right now on inflation after some key inflation data came in today below expectations. That might take a little bit of pressure off the fed, but also, of course, renewed tensions with Iran are pushing oil prices higher once again. So certainly, a very interesting market that we are watching right now.

And to help us break down the headlines and what this all might mean for investors, we are thrilled to welcome back Jurrien Timmer, fresh off a very big trip. Of course, he's Fidelity's Director of Global Macro. And we're going to talk to you about that trip in a minute, Jurrien. But we also want to welcome to the show today, Jennifer Fo Cardillo. She's a portfolio manager here at Fidelity who manages Fidelity Stocks Selector Small Cap Fund.

And we wanted to talk about small caps today because they are showing just impressive momentum as of late. They've posted their strongest start to a year since 1991. So we are talking in more than 30 years. Excited to have you both on the show. Jen, excited to have you on the show for the first time. Welcome to *MarketSense*.

**JENNIFER FO CARDILLO:** Thanks for having me. Glad to be here.

**JURRIEN TIMMER:** Great to see both of you. Happy to be back.

**HEATHER:** Let's get started. We got a lot to talk about. And today is Tuesday, July 14. As I mentioned, Jurrien, fresh off of a whirlwind trip. You spent three weeks on a tour across Asia. You spoke with investors from a wide range of markets and backgrounds and perspectives. So just first of all, I'd be fascinated to hear about what stood out to you most on that trip and what international investors who you spoke with wanted to talk about. What's on their minds?

**JURRIEN:** Yeah, so I was in Asia-Pacific for three weeks. Korea, Japan, Beijing, Shanghai, Taiwan, Hong Kong met with all the central banks, sovereign wealth funds, big banks, insurance companies, et cetera. So all institutional level meetings. And it was very interesting because as different as all these countries are and their priorities are, the conversation did always end up basically in the same three places.

One, of course, about AI, is it a boom? Is it a bubble? How do I make money off of it? How do I protect myself if it collapses? So that paradox of human emotions playing out certainly across the board, especially in places like South Korea, where of course, the semiconductors are a very big part of the market as well as Taiwan.

The other part or question was about, the Kevin Warsh Fed. And of course, Mr. Warsh has been on the tape all day today.

**HEATHER:** Speaking before Congress today. Yep.

**JURRIEN:** Yeah. But this was shortly after the FOMC meeting. And what can be expected? And of course, there were—I met with several central banks, so they are obviously keenly interested in knowing what's going to happen to treasuries and the dollar, et cetera. And then third, which I found very interesting because we don't really get that topic here so much in the United States, but a lot of interest in gold.

And why is it not behaving the way it should be right now? Because gold has been weaker and it just shows you that in Asia, where countries don't have the luxury of being in the world's dominant reserve currency, gold is inevitably much a bigger part of the mix than it might be here stateside. So those were the three major topics. But all in all, an exhausting but very rewarding trip.

**HEATHER:** I bet it was exhausting. I don't how you do it, Jurrien, but doesn't really—That's interesting. It doesn't really sound that different from the conversations we're hearing from American investors. AI obviously dominating the conversation, but also the Fed, the strength of the dollar, gold. And just a quick plug there. You had mentioned South Korea and Taiwan and we're going to have our emerging markets PM extraordinaire John Dance on our show next week. So that's going to be an interesting conversation.

He's in Asia right now too so we're going to be talking to him about that region of the world next week. But as I mentioned off the top of the show, Jurrien, back here at home, quarter two earnings season is underway right now and the bar is already set pretty high after that really strong, surprisingly strong quarter one. What are you going to be watching from this?

**JURRIEN:** I'm going to be watching whether those high expectations can be as easily beat as the expectations were the last quarter and the quarters before. We have a fairly typical pattern with earnings season that earnings estimates tend to come down as we get into the quarter, because companies guide down and analysts tweak their estimates, et cetera. And then lo and behold, during earnings season, about 80% of companies beat their estimates.

And it's like the oldest game in town, but it still happens. But what we've seen over the past four quarters or so is that the estimates have been rising, and then companies have been beating them by even more than normal. And so that shows a lot of positive momentum. And I'm sure as Jen will agree, we found that earnings revisions provide a lot of upward momentum or downward depending on which direction they go for stocks.

And so last quarter, the growth estimate coming into the quarter was 14%, and it ended up being 29%. A massive beat which we almost never see. But this quarter, the estimates coming in at 23% so a lot of very high expectations. And that's not to say that companies won't beat those expectations, but my guess is that they won't beat them by as much as they did last quarter.

So it'll be very interesting to see in the weeds for these companies how they do, what the CEO say about their AI budgets and their spend and all of that sort of thing. So we want to see whether the momentum is still going on, on the earnings front.

**HEATHER:** Well, so far, earnings have been one of the standout stories of the year. And another standout story has been the strength that we're seeing in small cap stocks. So I want to segue to that conversation now, Jennifer. And before we dive into what might be driving this, I think it would be helpful if you just level set for our viewers about what constitutes a small cap company, because in this day and age that we live in, I think investors might be surprised to hear that even billion dollar companies can be considered small cap.

**JENNIFER:** Sure. I'd be happy to, Heather. So like you said, just to level set, small cap stocks typically represent companies with market caps ranging from, call it, $300 million on the low end to roughly $10 billion on the high end. The Russell 2000, which is the representative small cap index, is very diverse, spanning a wide range of sectors and industries. Healthcare and financials actually represent the largest sector weights.

Given the domestic focus and breadth of this index with less concentration in tech, small caps behave differently from large caps and can actually provide a diversification boost, improving overall portfolio efficiency. And while there are some small companies that stay small, what I love about this universe is the opportunity to find that next mid and large cap business before the broader market catches on. What we like to call looking for acorns that can become oak trees.

**HEATHER:** I like that analogy. All right. So we've talked for so long about how small caps have been underperforming large caps. But these rotations do tend to be cyclical. And over the past year or so, we've seen small caps showing some signs of life, if that's an appropriate way to put it. What are you seeing right now, and what indications are you seeing about whether this might last, whether this might be durable?

**JENNIFER:** Yeah, I'll be candid, Heather. It has been a rough stretch for small caps. Small caps have disappointed for the past 12 years amid one of the longest stretches of underperformance versus large caps since the Great Depression. But it may only be a matter of time before the small versus large performance cycle once again favors small caps.

And in fact, the trend could already be underway. Over the past year, small caps have actually already been outperforming large caps. Of course, continued outperformance remains to be seen amid ongoing geopolitical uncertainty and worries about inflation, the potential impact on rates. Yet if small caps can overcome these worries, the narrative could change meaningfully.

And what I think makes for an interesting setup for the asset class here is first, small caps are backed by historically attractive valuations relative to large caps, especially when comparing profitable companies. And second, the earnings and sales outlooks are much better than they have been in recent years.

**HEATHER:** Now you mentioned geopolitical uncertainty. We've been talking about inflation today and there perhaps some ongoing macro concerns for small caps. But can you talk on the flip side about some of the economic trends and perhaps even policy developments that might be supportive of small caps right now?

**JENNIFER:** Yeah, that's a great question, Heather. Over the past few years, small caps have faced a number of headwinds. But I think we should be emerging from what has been a nearly three year earnings recession in this asset class. We're now looking at expectations for the fastest small cap earnings growth in four years. So what are the key drivers?

First, we're finally turning the page on what I call the COVID hangover. Companies have worked through a lot of that excess inventory that they built post-COVID. Underlying demand is beginning to normalize and that's supporting improving order activity. Second, the domestic focus of many of the current administration's priorities, like AI dominance and reshoring, are also supportive.

As companies are looking to localize strategically important industries, whether that's tech or defense, this is a benefit to small caps as 91% of small caps are domestic. Third, these policy initiatives have been further bolstered by, I'm sure you're aware, the tax cuts in One Big Beautiful Bill that's supporting the consumer. But we're also seeing firms utilizing that increased cash flow to accelerate investments in manufacturing, infrastructure, and technology build outs.

And then lastly, I'd note deregulation has also arguably sped up decision making and spurred increased acquisition activity, which has also been supportive of small caps historically.

**HEATHER:** Speaking of potential drivers for small cap stocks, and maybe you take this one, Jurrien, is that we know that small cap companies can be more sensitive to interest rates and borrowing costs by the nature of their composition. But we just got that inflation data this morning that I had mentioned, which came in better than expected. Of course, that's just one data point. But when you think about inflation and the bigger picture, could where we are right now if we continue on this trajectory benefit small cap stocks?

**JURRIEN:** Yes, absolutely. And so the cost of capital tends to be very important for small caps because they tend to have weaker balance sheets than large caps or mega caps. And we saw this, of course, play out in 2022 when interest rates rose all over the world, but especially in the US. And the market got very narrow, very top heavy because the big hyperscalers or the Mag 7, they don't really care quite as much as what happens to interest rates. But smaller companies with weaker balance sheets do.

And so, the Fed has been cutting rates over the last year. There's talk about raising them again. But again, the CPI report today came in very friendly. And so the bond market has been relatively stable for the last year. And I think that adds a tailwind for small caps, because it presumably makes it easier for managers or CEOs to manage their companies in terms of their debt needs and debt financing.

**HEATHER:** I want to talk about AI too, which you had talked on—talked about at the top of the show, Jurrien, about being something that's on international investors' minds. It's on all of our minds, and everybody seems to be searching for the next wave of opportunities when it comes to AI beyond hyperscalers. But I think that when investors first just initially think about AI, they probably think about the Mag 7.

They think about mega-cap tech stocks. I know you're paying attention, though, to a wide range of AI innovation that is happening in small cap companies too. So I was wondering if you could talk about small cap exposure to AI and how they play out in the AI game, so to speak.

**JENNIFER:** Yeah, like you said, AI—it is present in the small cap space, but it is a smaller thematic driver than in large cap. That being said, we have seen a number of success stories here. There are a lot of winners in AI, in the small cap space that we've had the opportunity to participate in.

For example, a cohort of winners have been optical suppliers. They support fast data transfer between GPUs.

Supply here has been really tight. That's driven strong pricing and margin performance. So many of these have actually graduated onto mid cap, going from that acorn to oak tree like we talked about. But several still remain in small cap. Semiconductor capital equipment players that enable more complex chip manufacturing for accelerated computing have also seen strong growth.

And there are also some smaller chip companies themselves that have benefited from new product cycles, addressing some of the unique power needs of AI infrastructure.

**HEATHER:** How about outside of the tech sector, Jen? How are small cap companies contributing to the AI build out beyond just the tech sector itself?

**JENNIFER:** Yeah, you're right. If you think about it, two of the key constraints on data center growth have been skilled labor and power. So you've also been seeing that AI trade come through in industrials, for example, electrical and mechanical contractors that have a strong track record of execution on these really large projects have been very well positioned in this environment.

You've also seen producers of power of any kind, whether it's solar, natural gas, fuel cells, or nuclear. They have all benefited due to the projected shortfall of power given the growing demand from data centers and electrification.

**HEATHER:** All right. Jurrien, let's bring it back in again to talk about valuations and what this might mean for people's portfolios. Small caps have reached historically cheap levels relative to large caps right now. And that's something that we haven't seen in decades. So I'm wondering from you, is that a meaningful signal and how meaningful a signal is it? And how do you see small caps as fitting into a diversified portfolio?

**JURRIEN:** Yeah, it's a great question. And I think they fit quite well. As Jen mentioned, for a very long time, the large cap space, the Mag 7 before that there were called the Fangs, they really dominated the S&P 500 and the overall investing landscape from about 2014 until just a few years ago, and small caps value the equal weighted market instead of the cap weighted market. International stocks were all left behind, trading at much, much cheaper valuations and just not participating.

And fortunately, that has now changed not only for small caps, but for value stocks and for international stocks. It's a much more level playing field now, which is really nice to see because when we're investing, we want to have a diversified portfolio and we want, as much participation from the market as possible. So the combination of not having the concentration risk of the super large multi-trillion dollar companies, lower valuations, and much more breadth coming from earnings, as well as performance is a very nice thing to see after such a long dry run for a lot of the market.

**HEATHER:** Yeah, it sounds like a healthy recipe. And like you said, we want everybody to be able to play in a larger playing field. So we talked so much about all the good happening with small caps right now but we should talk about the rest as well. Jen, can you lay out for us some of the risks that investors might want to keep in mind, just in general when it comes to investing in this particular asset class?

**JENNIFER:** Yeah, Heather, I think that's right to consider the risks as you approach small cap. Quality really does vary in small caps so investors want to be selective here. From a fundamental perspective, if you think about it, there's a wide spectrum, about 40% of the Russell 2000 index components do not generate earnings. Many of these companies are just newer companies earlier in their life cycle. So that's why.

But at the other end, you may find some secularly challenged businesses with too much financial debt. So we want to avoid those companies. And while the small cap space will include many strong performing companies, these are some of the pitfalls that you want to avoid. And for that reason, I think it's an asset class where active management can provide a real advantage. If you think about what my team and I are doing day in and day out, we are doing diligence on tons of companies.

We're building models, meeting management teams, doing channel checks on competitive dynamics. And so I think all of that work should help investors reduce some of that risk of small cap investing.

**HEATHER:** All of that, hopefully, finding those acorns that are going to be turning into the big oak trees, like you said. Any final thoughts from you though, on small cap performance, perhaps in the next 12 to 24 months? Or where do you see things going from here?

**JENNIFER:** Yeah, I would just reiterate that I think the setup is attractive today between we talked about improving fundamentals and an attractive relative starting point evaluation. I would also note that the opportunity set, I think, is particularly attractive in the more profitable, higher quality cohorts of the universe, which is creating a really rich environment for stock picking by active managers like us that have a quality orientation to our strategy.

**HEATHER:** All right. That makes sense and appreciate all of those insights today, Jen. Thank you so much for giving us some food for thought when it comes to small caps. Before we go, we're at the 20 minute mark right now, but we have time for a Timmer's take where we get Jurrien's thoughts on what he's watching in the week ahead. Go ahead, Jurrien.

**JURRIEN:** So it's all earnings all the time. We got started today and it'll come—and it'll be coming in fast and furious over the next few weeks. And we also have the July FOMC meeting, which will be very interesting as the Fed weighs whether to raise rates or not.

**HEATHER:** We will be watching alongside you, Jurrien. Jen, thank you so much for making the time to come on your very first episode. If you would like to read more about the latest happenings in the small cap sector or other sectors as well, you might want to bookmark Fidelity.com/PMInsights. PM being for portfolio manager. So Fidelity.com/PMInsights.

And there you're going to find more thought leadership from Fidelity portfolio managers just like Jen. On behalf of Jen and Jurrien, I'm Heather Hegedus. Thanks so much for your time today. We hope to see you back here next week. Remember, we're on Tuesdays at 2:00 Eastern as well as YouTube and wherever you get your podcasts.

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