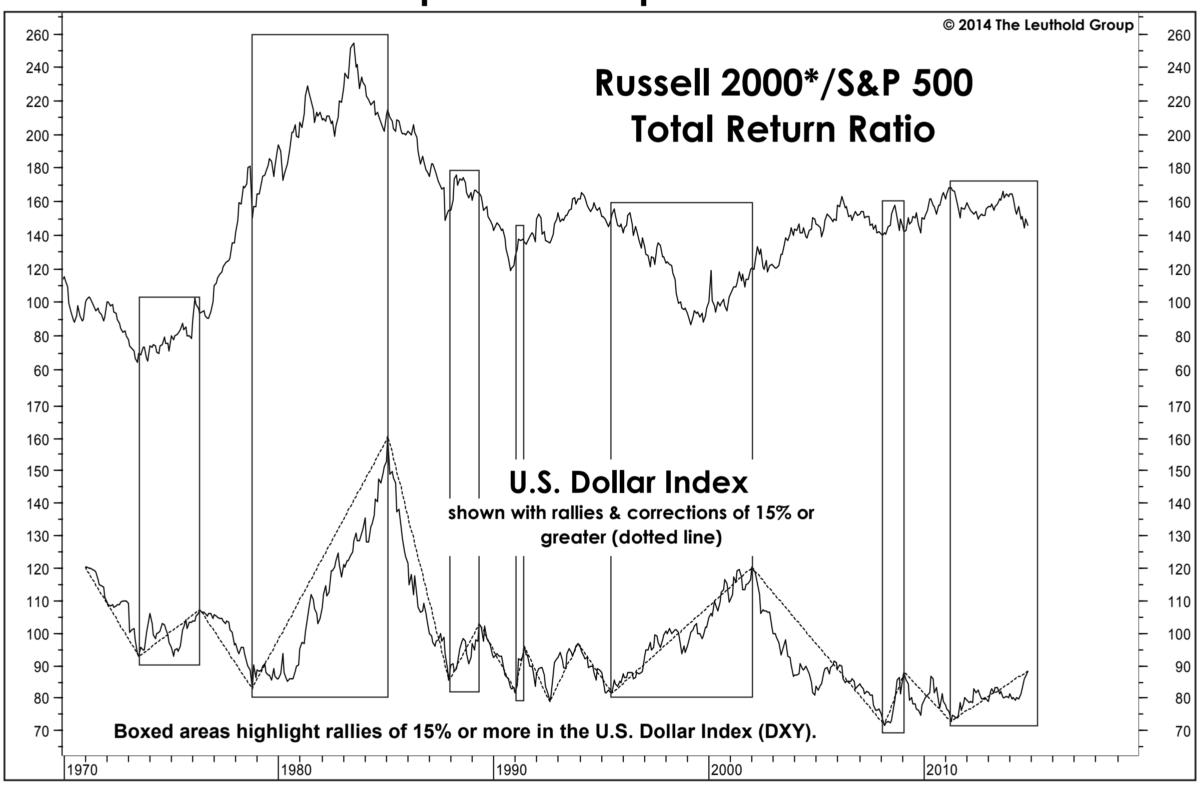
Can The Dollar Save Small Caps?

The dollar's moonshot in recent months has resuscitated a stock market leadership argument we haven't heard for a long time—namely, that <u>Small Cap stocks are better insulated than Large Caps from the loss of competitiveness and the currency translation impact of a stronger buck</u>. Is there merit to this argument, or are Small Cap proponents grasping for straws after a flat year? It turns out there's reasonable support for the Small Cap enthusiasts' view, based on evidence from the U.S. (trade-weighted) Dollar Index. Isolating all dollar swings of 15% or greater since 1971 yielded the following performance results:

- Small Caps *have*, on average, outperformed Large Caps during periods of sustained U.S. dollar strength, generating an annualized total return of +13.6% versus +10.7% for the S&P 500. This 2.9% performance spread is significantly higher than the +0.9% per annum performance edge earned by Small Caps over the full 44-year period. In contrast, Small Caps compounded at just +9.2% during periods of dollar *weakness*, below the S&P 500 figure of +10.4%.

Small Cap Leadership And The Dollar



*Ibbotson Small Company Stock series used from 1970-78.

- While the full-period results support the fundamentalists' argument, the late 1990s stand out as a costly counter-example—with Large Caps clocking Small Caps for five consecutive years (1995 to 1999) despite an historic dollar rally that "should" have favored more domestically-exposed companies (i.e., Small Caps). Recent experience also runs counter to the long-term results; the current U.S. dollar strength kicked off in April 2011—coinciding **to the month** with the cycle's Small Cap relative strength peak. **Overall, we'd grade dollar strength as a mild positive for Small Caps, but not enough to outweigh other factors that continue to point to Large Cap strength** (including relative valuations, looming Fed tightening, and the continued narrowing of market breadth related to bull market age).