VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Out of favour but full of potential

For Professional Investors only
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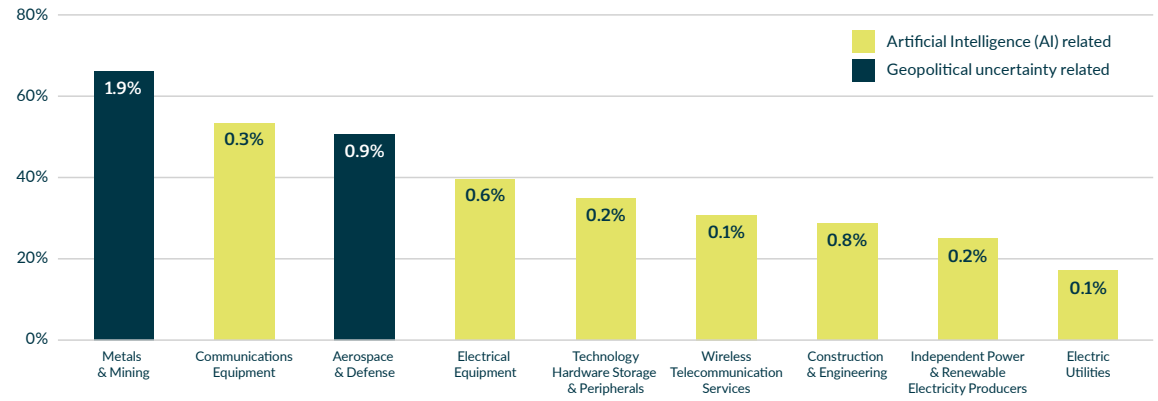
Why cyclical small-caps deserve a second look

Discomfort in asymmetry

Turning points rarely come with headlines. They build quietly. For most of the past year, momentum has dominated global equity markets. In the large-cap universe, a handful of 'mega caps' have driven returns on the back of a strong belief in the Artificial Intelligence opportunity. Within the small-cap universe, 10% of the industry groups related to the same dominant themes have driven 100% of the index return year-to-date. As a result, smaller companies tied to the broader economy have been left behind in this shift (Figure 1 and 2). The dominant momentum factor has further amplified this extreme market positioning. There is a discomfort with owning out-of-favour names when these market shifts occur, though the material asymmetry in the risk-reward opportunity is often the signal long-term investors seek.

Figure 1: Top 10% industry groups drive 100% of YTD performance

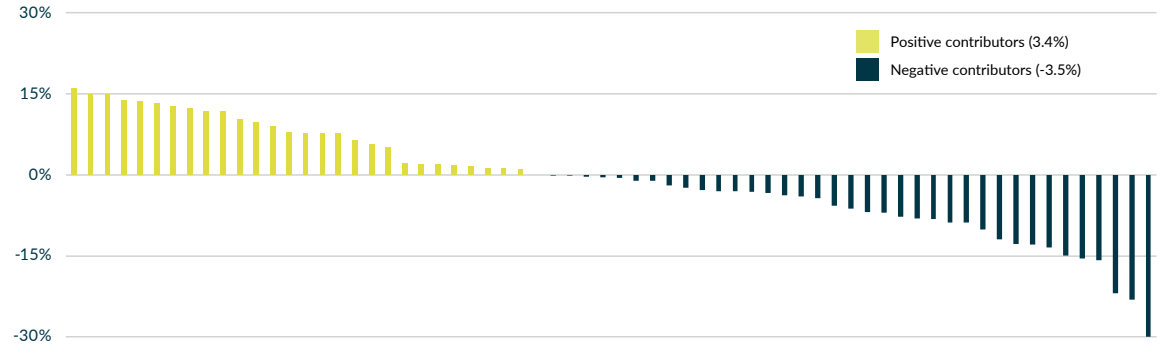
MSCI World Small-cap index total return 5.0% YTD
Top 10% performing industry groups YTD performance and contribution to return



Source: Van Lanschot Kempen, FactSet, for the period 31/12/2024 to 23/10/2025. (*) Total return MSCI World Small cap index is 5.0% which equals 5.0% for the top 10% performing sectors. YTD is year-to-date.

Figure 2: Other 90% of benchmark impacted by cyclical headwinds

MSCI World Small-cap index excluding top 10% industry groups YTD performance and contribution to return



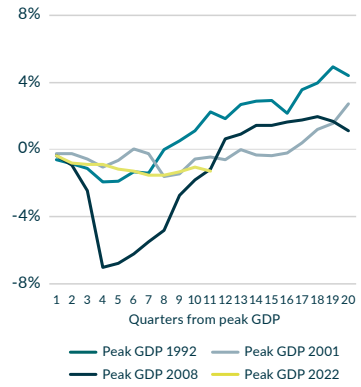
Source: Van Lanschot Kempen, FactSet, for the period 31/12/2024 to 23/10/2025. Total return MSCI World Small cap index is 5.0% which equals 5.0% for the top 10% performing sectors

Cyclical sectors have endured a prolonged downcycle

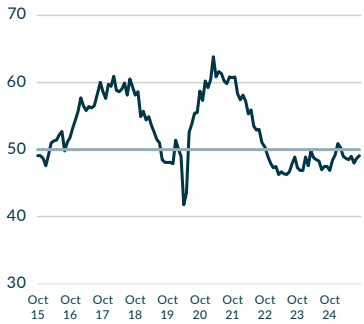
We are observing some prolonged downcycles. Industrial activity in Europe, the same in the US, as well as weak consumer confidence in the US have all been under pressure for longer than in previous recessions (Figure 3). These have weighed heavily on cyclical small-caps.

Figure 3: Cyclical sectors impacted by prolonged downcycle

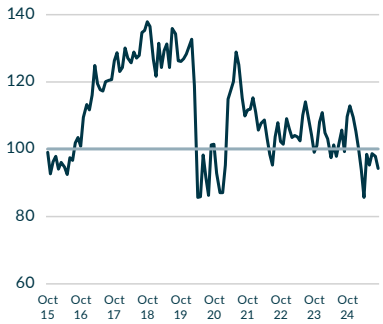
German downcycle has been long
German GDP from peak during recessions, %



US industrials are in a downcycle
ISM manufacturing PMI – US



US consumer is also struggling
US Consumer confidence index

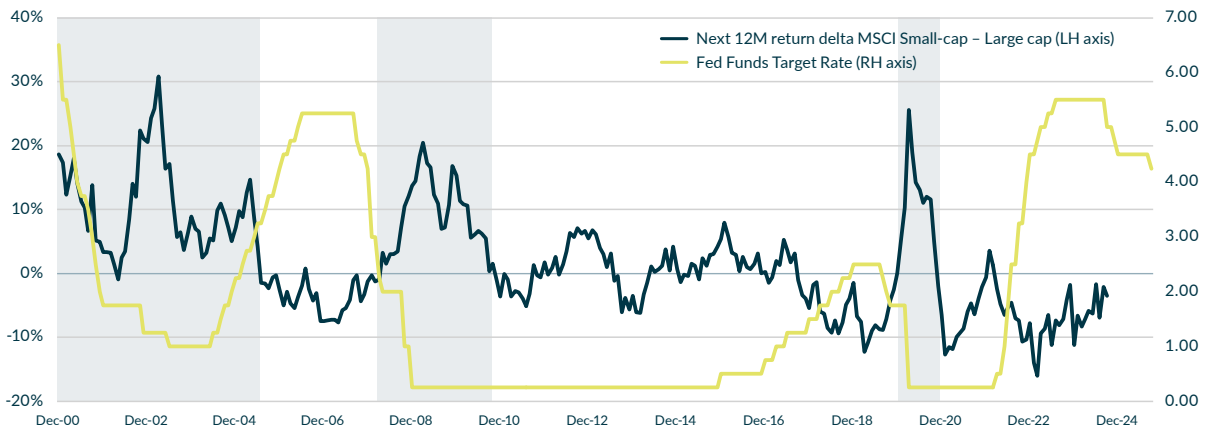


Source: FactSet, Van Lanschot Kempen, data as of 30/09/2025

Rate cut expectations are a significant signal for a change in the prospects of the real economy. For smaller companies, this can translate into easier financing and improving order book. These real-economy signals often mark the early stages of recovery, long before the headlines catch up. If policy rates begin to ease materially, the first evidence can often appear among smaller market caps. Smaller companies are often more sensitive to interest rates, so any easing in policy can have an early impact. Rate cuts have typically been followed by periods of outperformance of small-caps versus large-caps.

Figure 4: Rate cuts historic catalyst for small-cap outperformance

Next 12-months return difference between MSCI World Small Cap index vs. MSCI World index



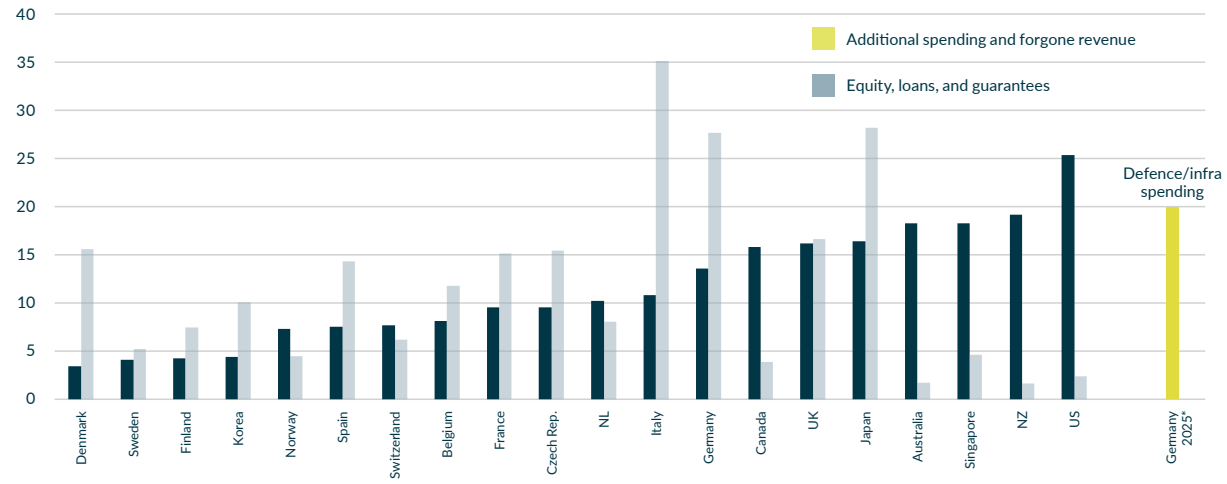
Source: Van Lanschot Kempen, FactSet, MSCI for the period 31/12/2020 (start of MSCI World Small Cap index indexed at 100) to 30/09/2025

Europe's potential for a recovery

While the European economy has been under pressure due to trade policy uncertainty with the US, as well as the uncertainties led by the war in Ukraine, the underlying financial health of the European consumer is strong. Sizable fiscal stimulus by Germany and some of the Northern European countries could also start a flywheel that could trigger a long-awaited recovery in Europe. We point out the meaningful scale of the fiscal stimulus in Germany below in Figure 5. Fiscal programmes feed into orders for infrastructure, equipment and services. Any stabilisation in confidence can move revenue from flat to growing and operating leverage amplifies the effect. Past cycles show that this is the phase when smaller companies tend to outpace their larger peers.

Figure 5: German fiscal stimulus catalyst for cyclical performance

Sizing the stimulus after fiscal response to the COVID-19 crisis versus German fiscal stimulus, % of GDP



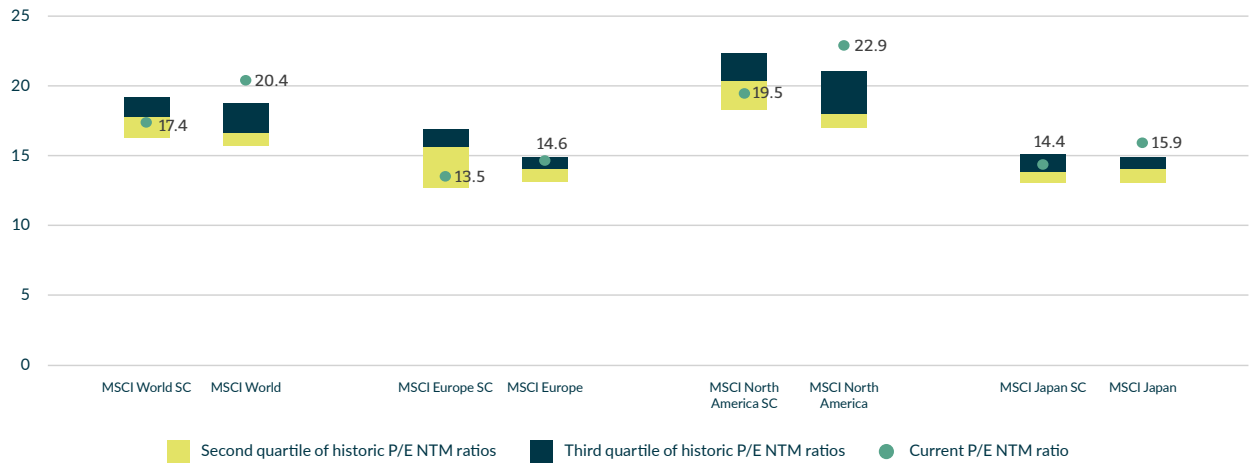
Source: Factset, IMF, Van Lanschot Kempen Investment Management. Germany's proposed debt break reform with defence spending and infrastructure financing, as of 13/03/2025, COVID-19 fiscal response as of June 2021

Valuations suggest risk-reward asymmetry

Across regions, cyclical small-caps trade below their long-term averages, with Europe trading at a wider-than-usual discount to the US. Valuation alone does not turn a cycle, but it shifts the balance of risks. That asymmetry is often where long-term returns are made, as shown in Figure 6.

Figure 6: Small-caps attractively valued vs. history and large caps

P/E for next year (NTM) vs. historic average over the last 10 years



Source: FactSet, Van Lanschot Kempen. Period from 30/09/2015 to 30/09/2025

Positioning for a shift that rarely comes with a headline

The signals are rarely loud, and the timing is never perfect. That said, when policy starts to ease and valuations are compressed, the balance of risk and reward begins to shift. These conditions indicate cyclical small-caps may be soon positioned for a potential shift in fortune.

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Small-cap equities: general risks to take into account when investing in small-cap equity strategies.

Please note that all investments are subject to market fluctuations. Investing in a small-cap equity strategy may be subject to country risk and equity market risks, which could negatively affect the performance. Under unusual market conditions the specific risks can increase significantly. Potential Investors should be aware that changes in the actual and perceived fundamentals of a company may result in changes for the market value of the shares of such company.

The value of your investment may fluctuate, past performance is no guarantee for the future. Do not take unnecessary risks. Before you invest, it is important that you are aware of and are informed about the characteristics and risks of investing. This information can be found in the available documents of the strategy and/or in the agreements that are part of the service you choose or have chosen.

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