

Small-cap stocks have led the rally in 2018 so far, outperforming both mid- and large-cap stocks. Small-cap stocks, as represented by the Russell 2000 Index, are handily leading the market, posting a gain of 11.23% versus 5.9% for the S&P 500 as of July 23, 2018. A small-cap company is generally classified as a company with a market capitalization (market value of outstanding shares) of between \$300 million and \$2 billion, whereas a large-cap company carries a market capitalization of more than \$10 billion. Thus, these companies are not exactly your mom and pop shop on the corner, but in the business world, they are still considered small.

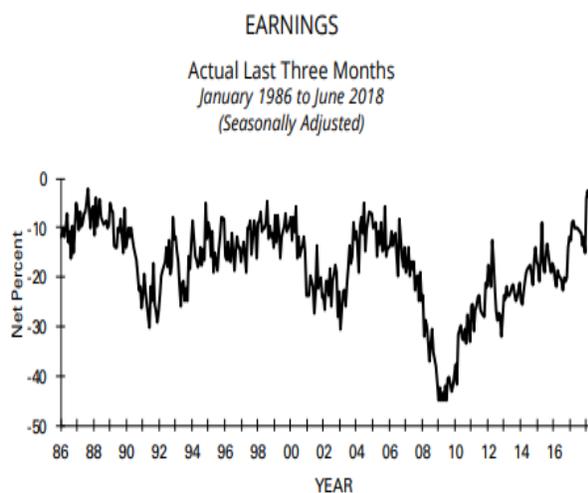
What's driving the rally?

Two primary drivers have contributed to the rally in small-cap stocks this year: the first is tax reform, and the second is insulation from both trade wars and a strong dollar. Let's take a closer look at each of the drivers below.

Tax reform

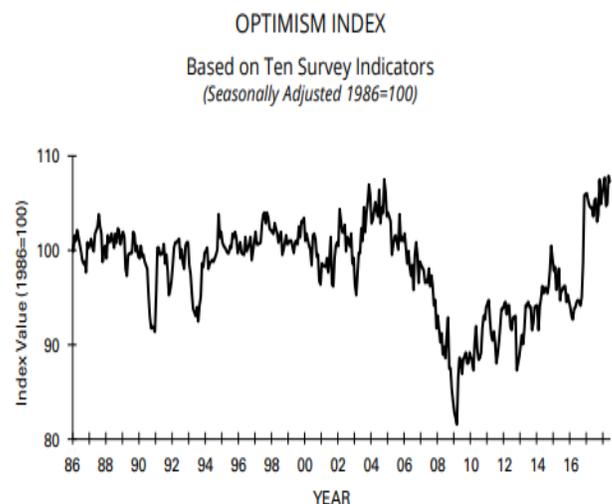
The current administration's stance of loosening rules and regulations while reducing corporate tax rates has been a strong benefit to businesses, specifically smaller business. This is evident in the small business economic trends, as evaluated by the National Federation of Independent Business (NFIB). Prior to the tax cut, companies in the Russell 2000 paid a median effective tax rate of 31.9%, while companies in the S&P 500 paid a median effective tax rate of 28.0%, according to Thomson Reuters data. That means small companies had more to gain as rates came down to 21.0% for everyone. "Small business owners continue to report astounding optimism as they celebrate strong sales, the creation of jobs, and more profits," said NFIB President and CEO Juanita Duggan. "The first six months of the year have been very good to small business thanks to tax cuts, regulatory reform, and policies that help them grow."

SMALL BUSINESS EARNINGS



Source: NFIB Research Foundation as of 06/30/18.

OVERVIEW - SMALL BUSINESS OPTIMISM



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Dollar and trade wars

Trade tensions have dominated the markets this year, but smaller companies have less overseas exposure than larger companies. Small-cap companies in the Russell 2000 Index derive 21% of their sales from overseas markets on average, while the large-cap S&P 500 companies obtain 30% of their sales from outside the U.S., according to data from Bank of America Merrill Lynch. Thus, small-cap companies are more dependent on the domestic economy than larger companies. As a result, small companies are somewhat insulated from the loss of competitiveness and currency translation impact of a stronger dollar. When the dollar is strong, multinational or large-cap corporations lose a competitive edge, as foreign buyers see U.S. goods as more expensive than non-U.S. goods. Insulation from both trade wars and a strong dollar have helped bolster small-cap stocks.

What does this mean for investors?

Investors who wish to participate in the improvements in the U.S. economy and rising dollar could look to small-cap companies with more domestically-driven revenue sources as part of their diversified portfolio.* However, it is important to note that small-cap stocks do carry their own set of risks. Small-cap companies historically have performed well during periods of economic growth. However, if the economy is in a downturn, small-cap companies, which tend to be more highly levered, suffer from lack of access to credit as lending standards are often more stringent for smaller companies. While we don't see a recession on the horizon, we do believe we are in the later stages of economic growth. As such, investors should remain cautious in how they incorporate small caps within their portfolios.

*Diversification does not ensure a profit or guarantee against loss.

Index Definitions

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses.

The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

Russell 2000 The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. The Russell 2000 is by far the most common benchmark for mutual funds that identify themselves as "small-cap".

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556213 07/2018

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07 | 27 | 2018

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