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Small Caps 2025 Outlook

Presented by the BMO GAM Fundamental Equities Team

BMO Global Asset Management

INTRODUCTION

Tailwinds set to return for small caps in 2025

Valentin Padure
Portfolio Manager, Fundamental Equities

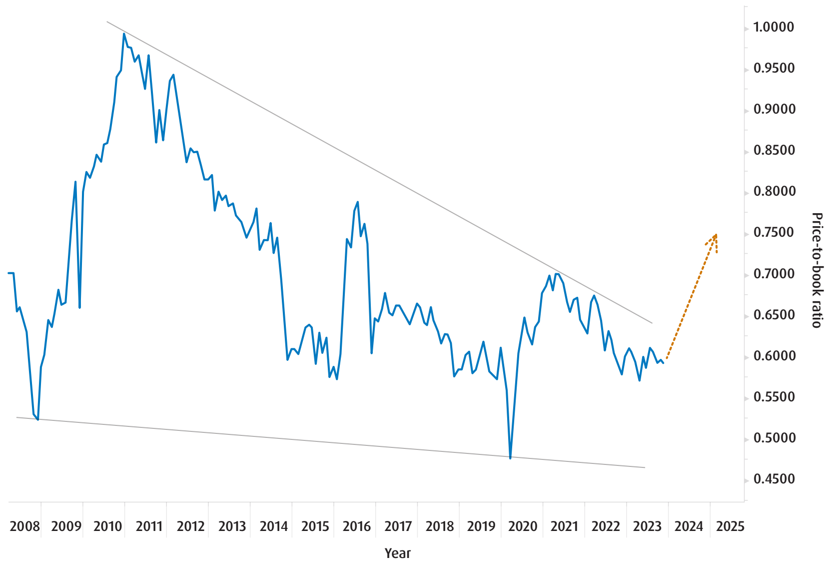
We are bullish on small-cap equities for 2025, as we believe many factors which were headwinds for the asset class over the past few years are finally abating. To better understand our outlook, it makes sense to reflect on what has transpired over the last few years.

Small-cap equities have been in a recessionary environment since 2021, mainly driven by the historic rise in interest rates. Interest rates have essentially risen from zero to six percent in a very short time horizon, which placed increased pressure on the small cap market. Interest rates have a disproportionate impact on small caps due to the perceived high-risk nature of the asset class and because smaller cap companies generally have lower access to capital and rely more on debt capital.

Small caps are often leading indicators—meaning they underperform heading into recessions and outperform in recovery scenarios. In addition, quality growth companies (a focus for the BMO small cap strategy) underperformed during this period, as their long-term cash flows are now being discounted at higher rates. We believe higher quality companies are fundamentally better positioned to withstand volatility in rates and the economy, leading to an even larger dislocation between sentiment and fundamentals.

Private Equity firms have been acquiring small cap companies at an alarming rate over the last 12 months, corroborating the compelling opportunities we are seeing for quality businesses.[1] In the **BMO Canadian Small Cap Equity Fund**, we have had three takeouts this year (Park Lawn, Neighbourly Pharmacy and Altius Renewable Royalties). We believe if small cap valuations don't significantly re-rate, we will continue to see more takeouts in small cap.

Canada small caps relative to large caps price-to-book ratio



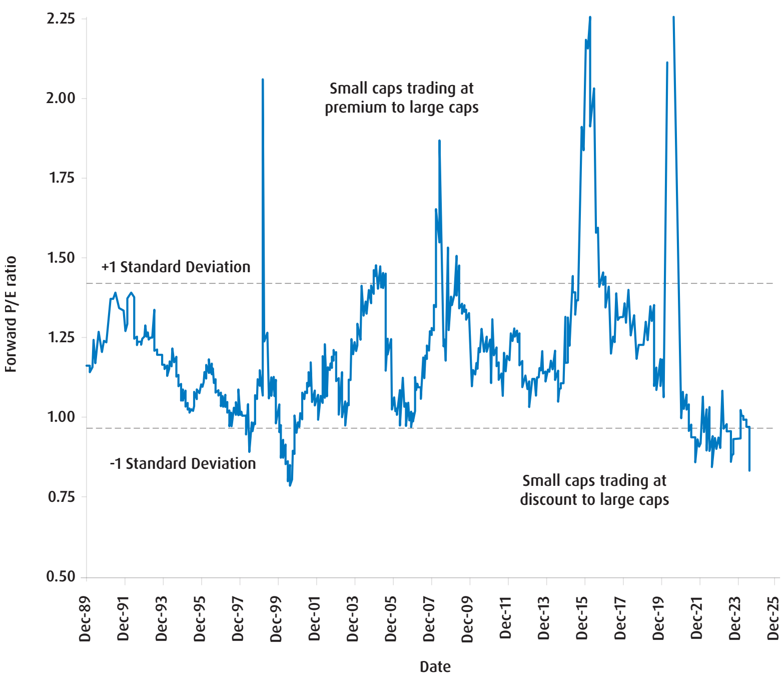
Source: Bloomberg, Stifel Research, January 2024.

INTEREST RATES

A turning point in small caps

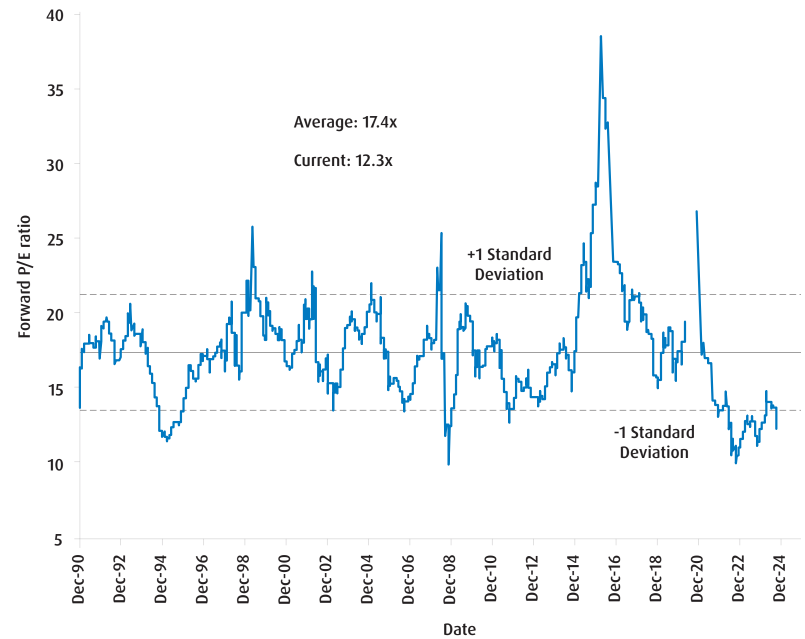
As the tightening cycle came to an end in Canada in the fourth quarter of 2023, we saw a relief in the small cap space in the country. From September 30, 2023 to November 30, 2024, the small cap index gained ~30% vs ~31% for the BMO Canadian Small Cap Equity Fund.[2] While this is encouraging, what gives us confidence in the asset class heading into 2025 is that valuations are still materially below historical averages and its large cap counterparties going back 25 years. We haven't seen these valuations in small cap since the dot-com crash, which we believe is far more draconian than the current market environment.

TSX: Small cap forward P/E ratio relative to large caps



Source: Scotiabank GBM Portfolio Strategy, Bloomberg, LESG.

TSX Small cap forward P/E ratio

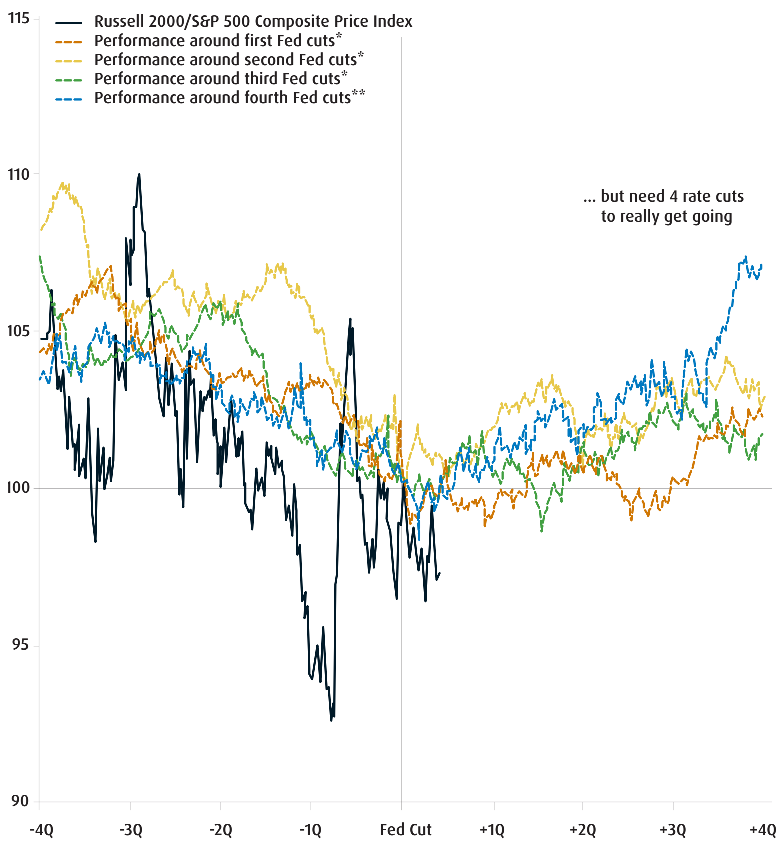


Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

A turning point in small caps (continued)

South of the border, the U.S. Federal Reserve (Fed) also pivoted from a tightening to a loosening policy, but its lowering rates at a slower pace. As the graph below shows, while small caps stop underperforming after the first cut, it is not until the fourth cut when we have historically seen more significant outperformance. We believe this could be a catalyst in 2025, as we see continued rate cuts in the U.S., which should be tailwind for small cap markets.

U.S. small caps usually stop underperforming after the first Fed cut

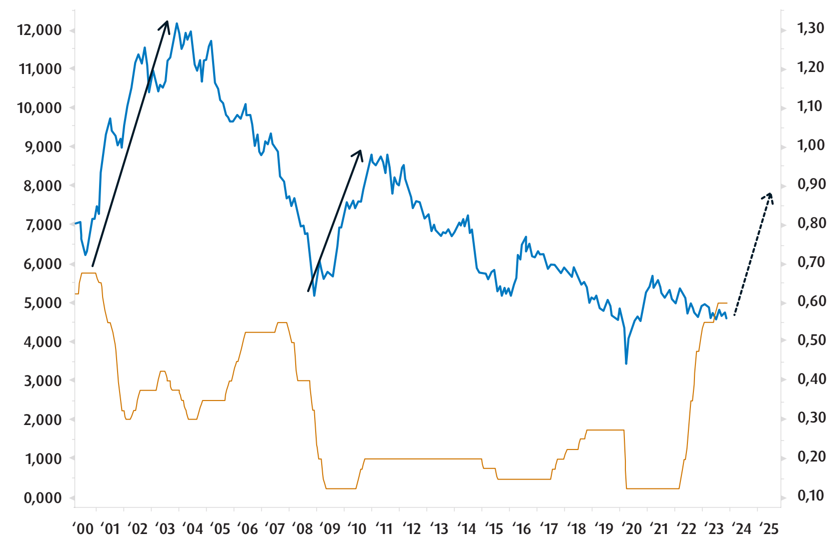


* Since 1980, 10 episodes ** 7 episodes
Note: All episodes rebased to 100

Source: LESG Datastream, Canaccord Genuity estimates.

We see a similar trend in Canada, where over the past three economic cycles, Small Cap equities have outperformed Large Caps after central banks finished tightening.

Canadian small caps relative to larger caps performance (blue)
Bank of Canada overnight rate (orange)



Source: Bloomberg, Stifel Research, as of January 2024.

Positioning for 2025

We believe the main headwinds for small cap are turning into tailwinds, which should be supportive of outperformance in 2025 and beyond. Given the depressed valuations, we see strong asymmetry in the asset class and a positive setup going forward. For the BMO Small Cap Portfolio, our positioning is overweight quality and growth and underweight Energy and Materials. Our underweight in gold could be a headwind, as lower rates are generally supportive gold prices. However, the strategy still has about nine percent exposure to higher quality gold producers, which should generate significantly more cash in that environment. We expect quality and growth to outperform, which should bode well for the BMO Canadian Small Cap Equity Fund given the overweight to both factors.

PERFORMANCE, FOOTNOTES & DISCLAIMERS

Performance (%)

Fund	Year-to-date	1-month	3-month	6-month	1-year	3-year	5-year	10-year	Since inception
BMO Canadian Small Cap Equity Fund - Series F	18.01	3.18	9.54	13.96	24.08	-1.17	8.15	5.50	11.36

As of November 30, 2024. Inception date: November 3, 2008.

[1] National Bank research, September 2024.

[2] Bloomberg, as of November 30, 2024.

Price-to-book ratio: The ratio of a company's market cap (or the value of its shares) to its book value.

Forward P/E ratio: The forward price to earnings ratio is the ratio for valuing a company that measures its current share price relative to its forecasted per-share earnings (EPS).

Standard deviation: A measure of risk in terms of the volatility of returns. It represents the historical level of volatility in returns over set periods. A lower standard deviation means the returns have historically been less volatile and vice-versa. Historical volatility may not be indicative of future volatility.

+1 Standard deviation/-1 Standard deviation: Data points that are one standard deviation above (+) or below (-) the mean.