

LAST WEEK SUMMARY

Last week was a historic moment for US stock markets, as major indices reached multiple all-time highs amid rising expectations of rate cuts from the Federal Reserve. The week's narrative was dominated by encouraging inflation data and persistent labor market weakness, which collectively bolstered the case for imminent monetary policy easing. The Nasdaq closed the week up **2%**, followed by the S&P 500 at **+1.6%** and the Dow Jones at **+0.95%**. Market momentum progressively built throughout the week, with the Nasdaq reaching an all-time high on Monday, fueled by Broadcom's rally, followed by all three major indices, which set new records on Tuesday. Consumer price index data for August showed a slight increase in annual inflation, from 2.7% to 2.9%, largely meeting expectations and easing concerns about lingering price pressures. Furthermore, the unexpected drop in producer prices cemented a 90% probability that the Fed will cut rates at its next meeting on September 17. Thursday saw the most significant performance of the week, with

A 1.4% Dow rally to over 46,000 for the first time ever, while the Russell 2000 gained 1.8%, demonstrating broad-based market strength. The rally followed the release of August Consumer Price Index data, which showed a moderate increase in annual inflation from 2.7% to 2.9%, largely meeting expectations, while weekly jobless claims unexpectedly rose to 263,000, the highest level since October 2021. A deteriorating labor market took center stage this week as revised employment figures revealed that 911,000 fewer jobs were created than initially reported for the 12 months ending March 2025. This significant downward revision, combined with rising jobless claims and cooling employment conditions, provided the Federal Reserve with substantial justification to ease monetary policy absent inflation concerns. The combination of disinflationary trends and a weak labor market created what markets interpreted as an ideal environment for Fed accommodation. Financial markets responded positively, decisive to the

evolving economic outlook. Bond yields fell throughout the week as traders positioned themselves for rate cuts, while the dollar weakened against major currencies. Gold continued its rally above record levels, supported by dovish monetary expectations and lingering geopolitical tensions. Bitcoin soared to \$116,000, reflecting increased risk appetite and optimism about rate cuts. Corporate earnings provided additional support to the market, with Oracle forecasting significant artificial intelligence-driven growth after reporting strong results, while UnitedHealth confirmed its 2025 earnings outlook. Technology stocks particularly benefited from expectations of lower funding costs, with small-cap stocks showing renewed strength due to attractive valuations and an accelerating earnings outlook.

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Asset Class	U	N	O
Renta Fija			■
Renta Variable		■	
Alternativos		■	
Regions (Equity)	U	N	O
North America		■	
Europe		■	
Emerging Markets		■	
Japan		■	

Equity Sectors	U	N	O
Consumer Staples			■
Health Care			■
Telcom Services		■	
Utilities		■	
Consumer Disc.	■		
Energy		■	
Financials		■	
Industrials		■	
Technology		■	
Real Estate		■	
Materials		■	

August payrolls were worse than expected, with only 22,000 jobs created compared to the 75,000 forecast. This figure will undoubtedly change investors' minds about what the Federal Reserve should do and is clearly a warning sign regarding economic dynamics. A more dovish tone from the market is now expected, which is indirectly positive for bonds and gold and negative for the dollar. As for the equity market, after a rise of more than 34% since the April lows, it is now time for a short-term correction.

Ultimately, the Fed has the tools to avoid a recession, so we believe the stock market should show some resilience and find an attractive low after the next short-term consolidation. For more defensive investors, one solution could be to take profits and reduce exposure.

THE TOPIC OF THE WEEK

Small caps are becoming attractive

In our last report on small caps, published in January, we mentioned some headwinds for the first half of this year, and that's precisely what happened until early April and the famous "Liberation Day." At that time, we mentioned the fact that the Russell index was technically in decline.

Fundamentally, the segment struggled to perform its usual outperformance role as companies were penalized by a high interest rate environment and poor cash management following the COVID period. **After a sharp underperformance of small caps between January and April, the segment has recovered nicely and outperformed the S&P 500 from April 8th until now (Chart 1). Technically speaking, the Russell 200 is now near its November 2024 high and very well-oriented (Chart 2).**

Small-cap companies have been negatively impacted by the post-COVID situation. Unlike large companies, which had easy access to credit through direct recourse to bond markets, small businesses relied on bank loans, most of which are variable-rate. With the rapid rise in interest rates, their financing costs increased instantly, exacerbating their financial vulnerability. Now that the slowdown in the economic situation has been confirmed following the weak nonfarm payrolls figures for August, the likelihood of further interest rate cuts by the Fed has increased, which should indirectly benefit small-caps in the future.

Chart 1: Performance since April 8: Russell 2000 (+36.3%); S&P 500 (+31.8%)



Chart 2: Russell 2000 Index (2380.95)



THE TOPIC OF THE WEEK

The small-cap segment of the market is currently attracting significant attention due to its attractive valuations and substantial recovery potential. While large-cap stocks have experienced a period of sustained outperformance, driven in part by the AI push, small-cap stocks now present a compelling investment case. Valuation is one of the most persuasive arguments in favor of small caps today. **Looking at forecasts for the next two years, the forward P/E for small caps is just 18.4 times earnings, below the overall market's 20.2 times** (Exhibit 3) and with the largest positive differentials since the 2008 financial crisis. **Taking a closer look at the relative valuation differential, the Russell 2000 Index is at its best relative level in the past decade** (Exhibit 4). This divergence offers a unique opportunity for value-focused investors to acquire stocks at substantial discounts, especially given that large-cap valuations have been inflated by the AI-driven push and the market's preference for perceived stability.

Returning to the difficulties faced by small-cap companies in the wake of COVID, this pressure was amplified by banks' credit-restrictive policies, to the point where there was a large divergence between large- and large-cap earnings momentum between 2023 and 2024. **Analysts have become much more optimistic since April, to the point where projected earnings growth for the next two years is three times higher for small-cap companies than for large-cap companies** (Exhibit 5). Expected ESP growth of 70% for small-cap companies explains the forward PE of 18.4x. We consider this outlook optimistic, yet at the same time quite realistic, as it only takes into account four rate cuts through December 2026. However, a more severe rate cut could end up being associated with a more severe economic slowdown, which could initially hurt small businesses before they are supported by lower interest rates.

Chart 3: Two-year PE: Russell 2000 (18.4 times); S&P 500 (20.2 times)

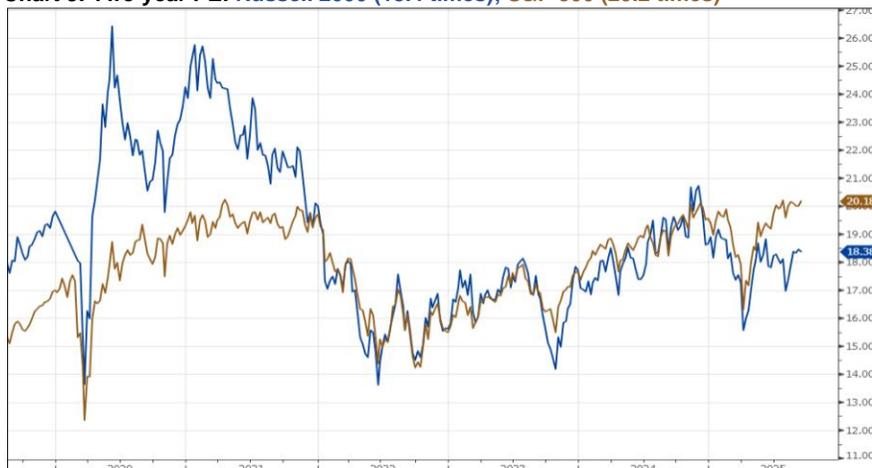
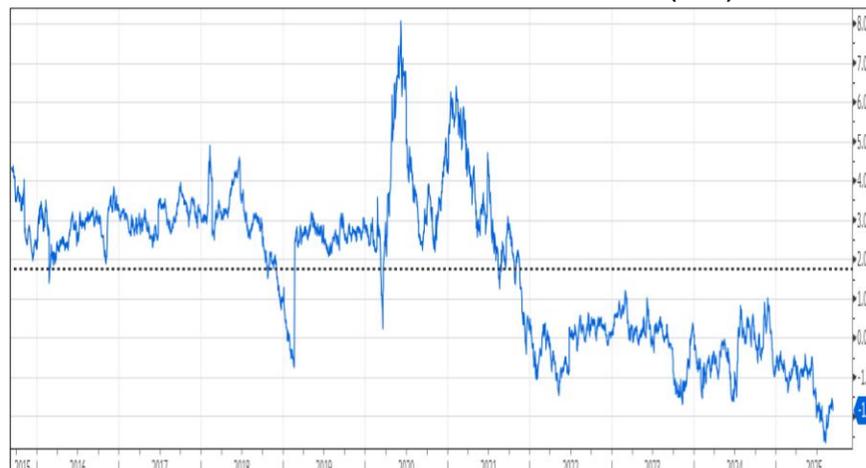
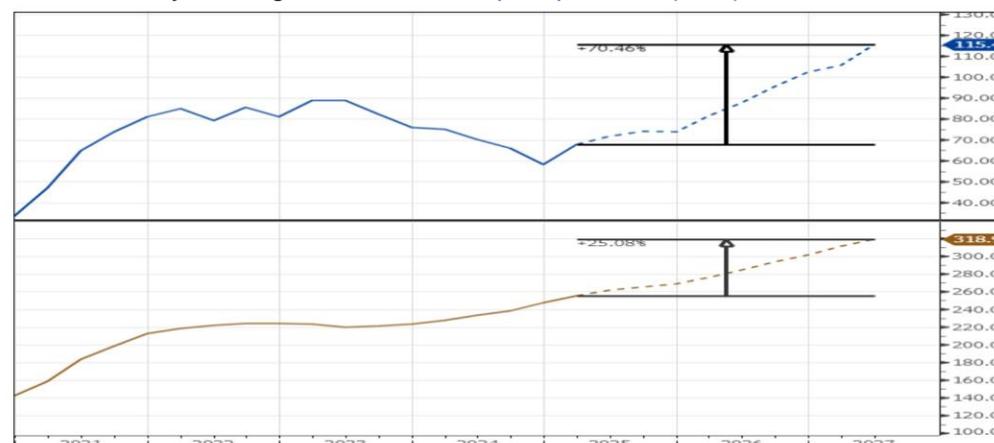


Chart 4: Difference between the Russell 2000 and S&P 500 PE (-1.84)



THE TOPIC OF THE WEEK

Chart 5: Two-year ESP growth: Russell 2000 (+70%); S&P 500 (+25%)



In short, several factors are expected to contribute to small-cap companies' continued outperformance:

- **Attractive valuations:** As we mentioned, small-cap stocks are currently trading in their cheapest quintile since 1990, increasing the historical odds that small-cap stocks will outperform large-cap stocks.
- **Economic slowdown, but no recession:** Small-cap companies tend to be more sensitive to domestic economic cycles and could outperform if the U.S. economy remains resilient. We believe the Federal Reserve has the tools to avoid a recession and lower interest rates more aggressively should the economy need it. In this scenario, small-cap companies should continue to outperform.
- **Tax relief and deregulation should boost profits for smaller companies:** in particular, they could benefit from reduced costs of complying with government regulations. Furthermore, the One Big Beautiful Bill offers improved tax deductions for interest expenses, which should be especially helpful since these companies are often leveraged.
- **Market breadth expansion:** Recent stock market gains have been extraordinarily limited, with small-cap companies notably underperforming. However, lower interest rates are likely to increase market breadth. A broader rally, in which gains are more evenly distributed beyond large-cap stocks, typically indicates healthier market dynamics and can act as a catalyst for small-cap outperformance.

THE TOPIC OF THE WEEK

CONCLUSION

Overall sentiment suggests that the small-cap segment is well positioned for a significant rebound, driven by attractive valuations, improving earnings estimates, an economic slowdown but no recession, and lower interest expenses. **While large-cap companies have outperformed by 3.7% so far through 2025** (Exhibit 6) and by 9% annually over the past five years, the historical trend of small-cap companies—which have outperformed large-cap companies by an average of 4.4% annually between 1926 and the present—suggests strong long-term potential.

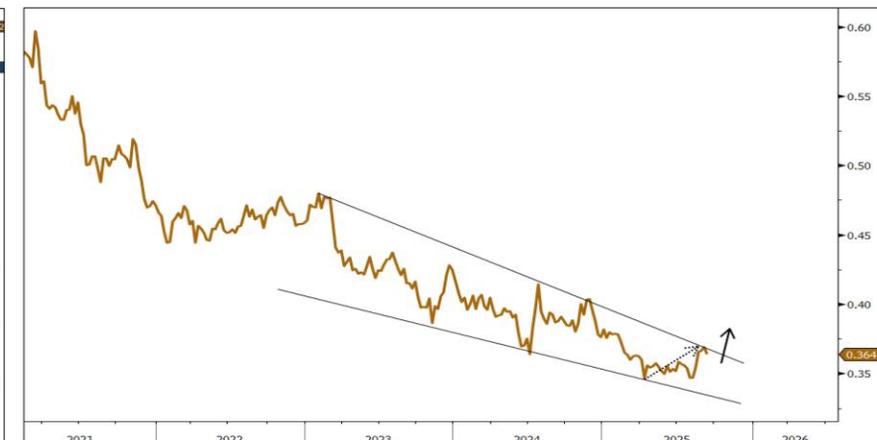
The 2025 investment outlook underscores the potential for small- and mid-cap companies to outperform in the coming years.

In fact, if we look at the relative value of small-cap companies versus large-cap companies, the ratio is on the verge of breaking a downward trend line, which would confirm the start of a sustained relative bull market (Chart 7).

Chart 6: Year-to-date performance: Russell 2000 (+8.22%); S&P 500 (+11.92%)



Chart 7: Russell 2000 vs. S&P 500 Ratio



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