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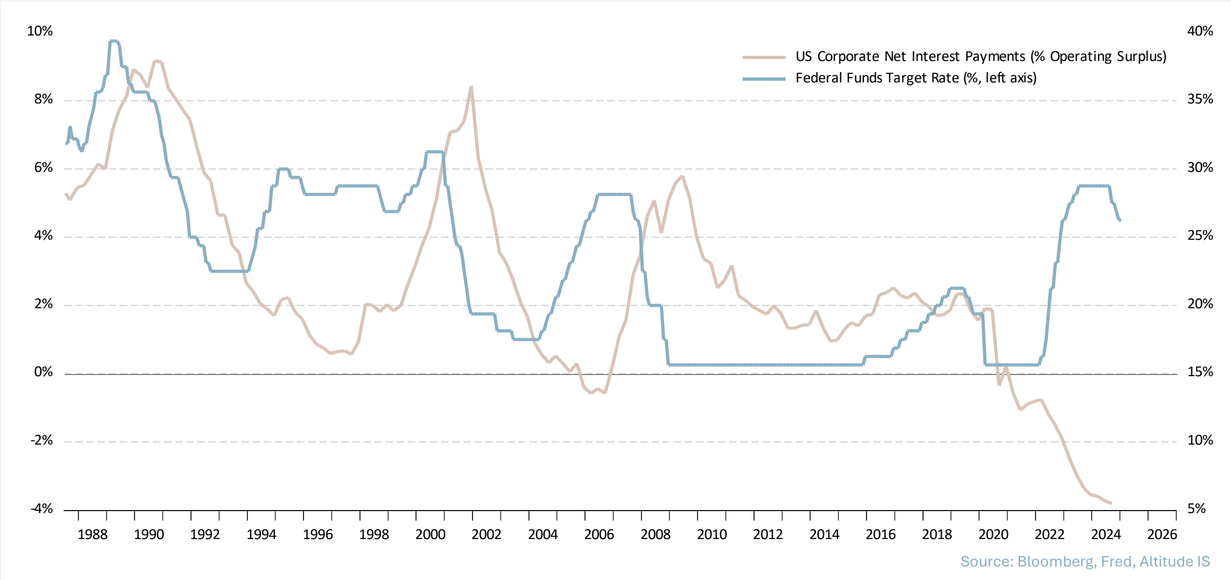
"SMALL OR LARGE CAPS? IT'S TIME TO COMPROMISE"

- During the pandemic, large companies took on long-term debt at lower cost
- As a result, they appear to be immune to rising interest rates
- This is not the case for small businesses, whose earnings are plummeting
- In the meantime, mid caps could benefit from Trump's economic policy

CHART OF THE WEEK: "Is the Fed's monetary transmission mechanism broken?



FINANCIAL MARKETS ANALYSIS

Traditionally, higher interest rates lead to higher interest payments, which in turn lead to more defaults. In recent years, however, the situation seems to have been different. The number of bankruptcies did indeed peak in 2024, but interest charges do not seem to have acted as a transmission belt.

This is particularly visible in the United States, where the data is sufficiently numerous and of sufficient quality to document the phenomenon, but it is also true in Europe. Between 2022 and 2023, the Federal Reserve raised the cost of money at a sustained rate. It then maintained its key rates at the high level of 5.50% until September 2024, the date of the first easing. Despite this, interest charges paid by companies do not appear to have risen (see Chart of the Week). Has the monetary transmission mechanism broken down? What has happened? Yet corporate bankruptcy filings are at record levels (see Fig. 2), particularly in the consumer, industrial and healthcare sectors (see Fig. 3). How is this possible?

Fig. 2 - Interest charges and corporate failures

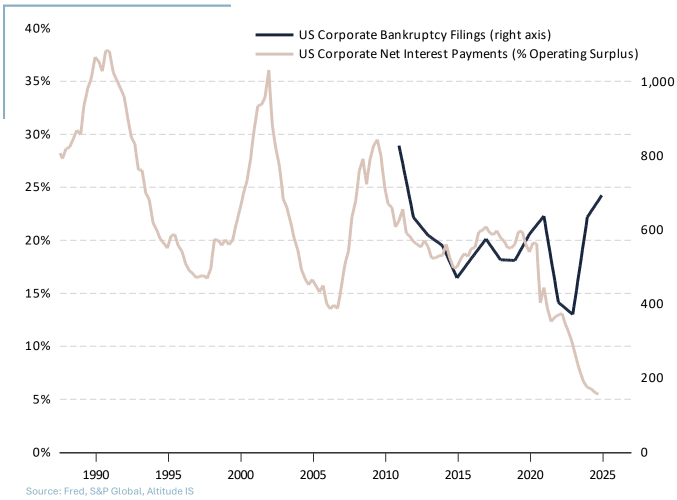
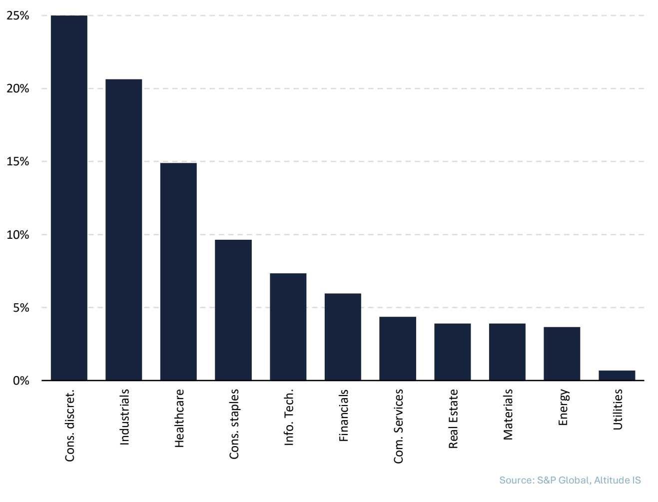


Fig. 3 - Corprate failures, by sector, in 2024



One of the peculiarities of this cycle is that large companies were able to build up substantial cash reserves during the pandemic period. At that time, not only did governments grant them operating facilities and reductions in charges, but central banks allowed them to finance their operations at near-zero rates. Between 2020 and 2021, companies that were able to do so took advantage of the opportunity to refinance a substantial proportion of their debt at fixed rates, on more advantageous terms and with longer maturities than usual. This strategy enabled them to lock in their financing costs. **Since then, they seem immune, as if unaffected by the recessionary impact of a precipitous rise in interest rates.** The tightening of monetary policy will not affect them as long as they do not have to renew their debts. This could be the case for several years yet, as a sizeable proportion of the large fixed-rate loans contracted between 2020 and 2021 remain on the balance sheets of large companies, in the form of deposits.

Ironically, these deposits are at variable rates. Companies are thus able to take advantage of the situation to generate profits, by investing their cash reserves at an interest rate that is significantly higher than the rate at which they borrowed at the time. They are therefore net beneficiaries of the rise in interest rates. They use it to increase their margins and postpone the recession. What a paradox! Interest rates are not working as they should, making the transmission of monetary policy to the real economy ineffective.

If interest charges remain low, why was the number of companies that went bankrupt in 2024 so high? The subtlety lies in the fact that not all companies were able to take advantage of the low-interest rate environment. Unlike large companies, which have easy access to borrowing through direct recourse to the bond markets, small businesses are dependent on bank loans, most of which are at variable rates. With the rapid rise in interest rates, their borrowing costs instantly increased, worsening their financial vulnerability. This pressure has also been amplified by the banks' policy of restricting credit. **If the number of bankruptcies is on the rise, it is mainly down to small businesses.**

During this cycle, the divergence between the earnings momentum of large and small companies has been exacerbated (see Fig. 4). In addition to their low-cost financing strategy, large caps are benefiting structurally from their geographical diversification and their involvement in the artificial intelligence revolution. They are gaining market share and consolidating their status as leaders in their sector. This position enables them to pass on rising costs to consumers easily, without compromising their margins. In contrast, small companies are often concentrated on their domestic market and operate in a highly competitive environment. They have neither economies of scale nor pricing power. Margins, already limited, are now squeezed by high borrowing costs.

Fig. 4 - Earnings of US companies

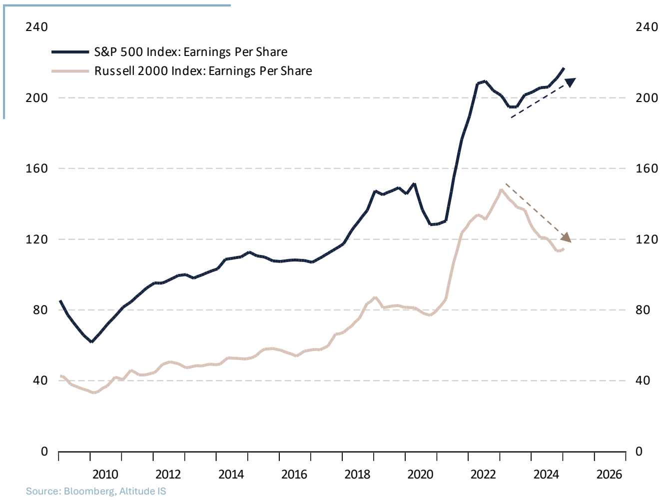
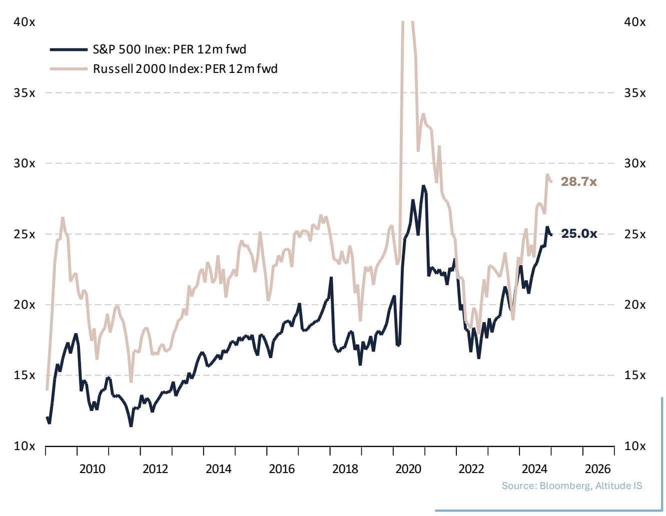


Fig. 5 - Valuation of US companies

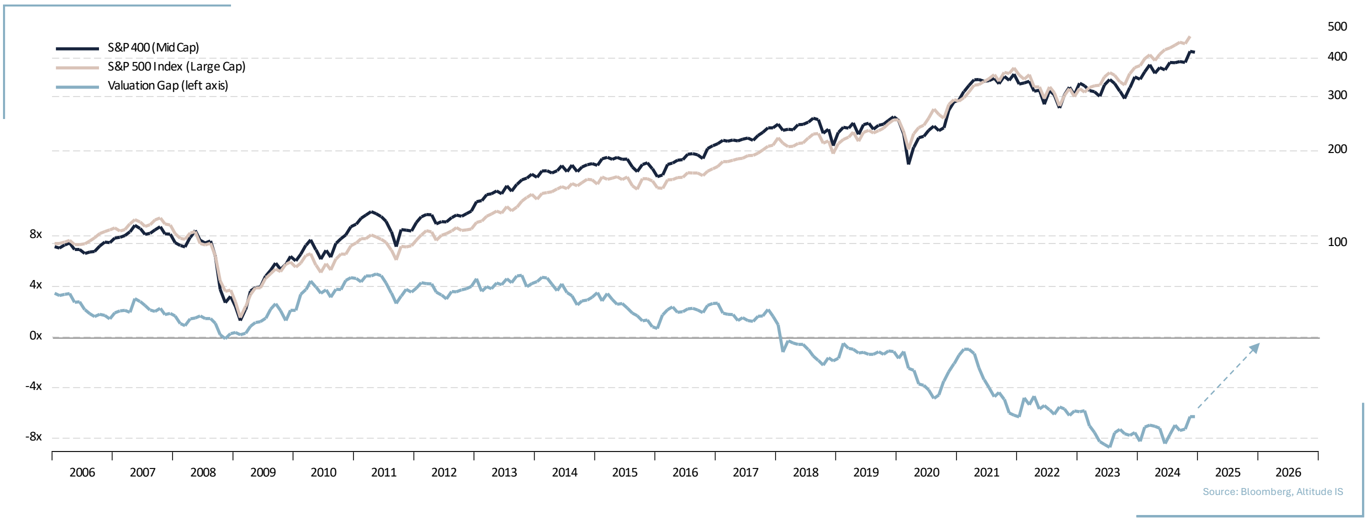


On the stock markets, this polarisation between large and small companies is reflected in their performance relative to each other. Large caps, paradoxically perceived as growth stocks, continue to attract capital. Conversely, **small caps**, considered riskier and less resilient, are neglected. In 2025, they **could continue to underperform, especially as they remain highly valued** (see Fig. 5). If the Fed were to maintain key interest rates "higher for longer" in order to contain inflation, small businesses would continue to face increasing pressure on their financing costs and, ultimately, on their margins. Large companies, on the other hand, would continue to benefit from the low financing costs negotiated between 2020 and 2021 and their ability to navigate an inflationary environment. Their economic resilience and attractiveness to investors would keep them in a favourable position.

For this trend to be reversed, the Fed's disinflation target would first have to be met, and the US central bank would have to start gradually cutting its key rates. Only then, as the economic crisis recedes, will small businesses begin to benefit from lower borrowing costs and accelerating economic momentum, so that their earnings can grow. **It is still too early.**

In the meantime, mid-caps may be able to pull ahead. Less expensive than large caps (see Fig. 6) but better equipped than small caps, they should also benefit fully from the new economic policy planned by Donald Trump. Among the key measures, his proposals to encourage the relocation of industrial activities to the United States, to lower taxes on companies that create domestic jobs, and to strengthen trade barriers for imports, are directly in the interests of mid caps. This policy framework of tax incentives and protectionist measures should enable them to consolidate their competitive position in strategic sectors such as manufacturing, materials and energy.

Fig. 6 - Performance and valuation of US mid caps



Unlike small caps, which often struggle to respond to a surge in demand due to limited production capacity, mid caps can quickly adapt their supply chains to meet these opportunities. Mid caps include Interactive brokers (IBKR), TKO (TKO), Emcor (EME), Pure storage (PSTG), Comfort systems (FIX), Equitable holdings (EQH), Chewy (CHWY), Sprouts farmers market (SFM), Curtiss-wright (CW), Unum (UNM), Mastec (MTZ), Maplebear (CART), Stifel (SF), DT midstream (DTM), Macom (MTSI), Aaon (AAON), or Carpenter technology (CRS).

Conclusion:

Because it follows a period of "free" financing, this atypical cycle gives a significant advantage to large caps. Investors looking to diversify their positions away from these mega caps will not be interested in small caps, whose fundamentals are fragile, but in mid caps, which, as well as being cheap, will benefit more from the MAGA policy that Donald Trump is expected to pursue.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2025 Year-to-Date (%)	2024 (%)	2023 (%)
Equities							
World (MSCI)	872.9	66.94	2.1%	2.0%	3.8%	18.0%	22.8%
USA (S&P 500)	6 101	61.86	1.8%	1.1%	3.8%	25.0%	26.3%
USA (Dow Jones)	44 424	64.37	2.2%	2.7%	4.5%	15.0%	16.2%
USA (Nasdaq)	19 954	57.75	1.7%	-0.4%	3.3%	29.6%	44.7%
Euro Area (DJ EuroStoxx)	527.5	73.75	1.3%	6.7%	5.9%	10.2%	19.5%
UK (FTSE 100)	8 469	64.36	0.0%	4.6%	4.1%	9.6%	7.7%
Switzerland (SMI)	12 267	72.66	2.5%	7.0%	5.9%	7.5%	7.1%
Japan (Nikkei)	39 566	58.63	3.9%	2.4%	0.1%	21.3%	31.0%
Emerging (MSCI)	1 090	58.21	1.9%	0.6%	1.5%	8.0%	10.2%
Brasil (IBOVESPA)	122 447	50.45	0.1%	1.4%	1.8%	-10.4%	22.3%
Mexico (IPC)	51 357	63.45	2.8%	4.2%	3.8%	-11.0%	22.4%
India (SENSEX)	75 407	38.11	-0.6%	-2.8%	-2.4%	9.6%	20.3%
China (CSI)	3 817	48.45	0.7%	-3.6%	-2.4%	18.2%	-9.1%
Com. Services (MSCI World)	131.2	67.07	3.6%	2.5%	5.1%	31.9%	38.1%
Cons. Discretionary (MSCI World)	435.3	63.20	1.7%	-0.1%	3.2%	20.7%	29.5%
Cons. Staples (MSCI World)	273.0	53.60	1.5%	-0.8%	0.1%	4.7%	3.2%
Energy (MSCI World)	252.6	56.20	-2.1%	6.6%	5.2%	2.9%	6.0%
Financials (MSCI World)	188.6	70.98	2.0%	4.1%	4.9%	25.1%	16.4%
Health Care (MSCI World)	365.0	66.63	3.3%	3.8%	4.6%	1.5%	4.1%
Industrials (MSCI World)	399.2	74.07	3.2%	5.2%	6.0%	12.8%	22.5%
Info. Tech. (MSCI World)	788.5	56.90	2.0%	-0.6%	2.5%	31.9%	51.4%
Materials (MSCI World)	322.3	66.61	1.7%	4.4%	5.3%	-7.7%	12.6%
Real Estate (MSCI World)	965	54.77	1.0%	0.8%	1.4%	-0.4%	5.3%
Utilities (MSCI World)	165.2	57.34	0.6%	2.4%	2.8%	12.9%	1.6%
Bonds (Bloomberg)							
World (Aggregate)	3.74%	57.04	0.9%	0.5%	0.5%	-1.7%	5.7%
USA (Sovereign)	4.49%	51.46	0.1%	0.2%	0.1%	0.6%	4.1%
Euro Area (Sovereign)	2.90%	40.98	-0.2%	-1.1%	-1.0%	1.9%	7.1%
Germany (Sovereign)	2.44%	35.31	-0.3%	-1.5%	-1.4%	0.6%	5.6%
UK (Sovereign)	4.60%	53.76	0.2%	0.2%	-0.1%	-3.0%	5.6%
Switzerland (Sovereign)	0.60%	37.71	-0.6%	-1.3%	-1.1%	5.4%	7.9%
Japan (Sovereign)	1.03%	30.20	-0.2%	-1.1%	-0.9%	-2.1%	0.9%
Emerging (Sovereign)	7.01%	58.03	0.5%	0.8%	0.7%	7.0%	11.0%
USA (IG Corp.)	5.35%	52.83	0.3%	0.4%	0.2%	2.1%	8.5%
Euro Area (IG Corp.)	3.34%	45.98	-0.2%	-0.2%	-0.4%	4.7%	8.2%
Emerging (IG Corp.)	6.61%	60.41	0.3%	0.6%	0.5%	7.0%	6.7%
USA (HY Corp.)	7.23%	69.44	0.3%	1.3%	1.2%	8.2%	13.4%
Euro Area (HY Corp.)	5.77%	64.06	0.2%	0.2%	0.1%	8.2%	12.1%
Emerging (HY Corp.)	8.43%	64.46	0.5%	1.1%	1.1%	14.9%	13.1%
World (Convertibles)	454.4	64.86	1.2%	1.9%	3.2%	9.4%	12.3%
USA (Convertibles)	618.7	60.72	0.8%	1.6%	3.4%	10.1%	14.6%
Euro Area (Convertibles)	240.3	76.48	1.8%	3.2%	3.3%	14.7%	7.3%
Switzerland (Convertibles)	245.8	49.67	1.0%	-1.5%	2.1%	-10.5%	5.8%
Japan (Convertibles)	225.3	55.97	1.1%	0.1%	-0.6%	6.4%	7.6%
Hedge Funds (Bloomberg)							
Hedge Funds Industry	1 611	78.32	n.a.	-0.4%	n.a.	11.1%	7.8%
Macro	1 339	62.76	n.a.	-0.4%	n.a.	7.1%	1.6%
Equity Long Only	2 222	68.62	n.a.	-0.6%	n.a.	12.5%	15.9%
Equity Long/Short	1 677	76.09	n.a.	-0.7%	n.a.	14.0%	7.7%
Event Driven	1 723	72.40	n.a.	-1.3%	n.a.	8.5%	7.3%
Fundamental Equity Mkt Neutral	1 651	95.49	n.a.	0.6%	n.a.	12.4%	6.6%
Quantitative Equity Mkt Neutral	1 668	86.39	n.a.	0.4%	n.a.	10.0%	7.8%
Credit	1 597	95.55	n.a.	0.1%	n.a.	8.6%	8.1%
Credit Long/Short	1 626	100.00	n.a.	0.4%	n.a.	9.9%	11.2%
Commodity	1 703	70.39	n.a.	-1.7%	n.a.	9.1%	7.3%
Commodity Trading Advisors	1 338	52.54	n.a.	-0.4%	n.a.	7.6%	-3.6%
Volatility							
VIX	19.23	43.15	-7.0%	4.1%	-14.4%	39.4%	-42.5%
VSTOXX	17.38	41.85	-5.5%	-13.6%	-12.6%	25.3%	-35.0%
Commodities							
Commodities (CRB)	540.5	n.a.	0.2%	0.2%	0.7%	5.1%	-8.0%
Gold (Troy Ounce)	2 759	n.a.	1.9%	5.2%	5.1%	27.2%	13.1%
Silver (Troy Ounce)	30.23	n.a.	-1.0%	2.9%	4.6%	21.5%	-0.7%
Oil (WTI, Barrel)	74.96	n.a.	-3.7%	5.9%	4.5%	0.1%	-10.7%
Oil (Brent, Barrel)	78.81	n.a.	-4.1%	7.6%	6.3%	-4.6%	-4.5%
Currencies (vs USD)							
USD (Dollar Index)	107.63	43.73	-1.6%	-0.3%	-0.8%	7.1%	-2.1%
EUR	1.0475	58.15	0.6%	0.5%	1.2%	-6.2%	3.1%
JPY	155.20	55.48	0.3%	1.7%	1.3%	-10.3%	-7.0%
GBP	1.2450	52.60	1.0%	-1.0%	-0.5%	-1.7%	5.4%
AUD	0.6284	53.13	0.1%	1.1%	1.6%	-9.2%	0.0%
CAD	1.4389	45.73	-0.5%	0.2%	0.0%	-7.9%	2.3%
CHF	0.9037	51.84	0.3%	-0.2%	0.4%	-7.3%	9.9%
CNY	7.2649	58.28	0.1%	0.4%	0.5%	-2.7%	-2.8%
MXN	20.433	50.93	0.3%	-0.5%	1.9%	-18.5%	14.9%
EM (Emerging Index)	1 748.5	69.98	1.2%	0.9%	1.2%	-0.7%	4.8%
XBT	98 872	n.a.	-5.0%	4.7%	5.5%	120.5%	157.0%

Source: Bloomberg, Altitude Investment Solutions — Total Return by asset class (Negative \ Positive Performance)

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