Navigating an Evolving Investment Landscape

Implications for Small Cap Investing

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"The best time to buy a small cap is when everyone thinks it's dead. The worst time? When it's the market's latest obsession." – John Templeton

Short-term thinking dominates in times of uncertainty, often leading investors to overvalue new narratives. Today's market requires strategic adaptation as we navigate diverging monetary policies, geopolitical tensions, and shifting economic forces. The first quarter of 2025 has already introduced significant developments, including the inauguration of Donald Trump, newly proposed international tariffs, and a shift in market sentiment away from the "Magnificent 7." Given this backdrop, the road ahead remains complex.

The Market Context: A Period of Historic Disruption

To understand today's environment, we must acknowledge the seismic shifts of the past few years. One market observer put it well: "The use of the word unprecedented has become unprecedented."

Here are just a few statistics underscoring how extraordinary the past five years have been:

- Economic Volatility: U.S. GDP declined by 28% on an annualized basis quarter-over-quarter in Q2 2020[1] - nearly three times worse than any quarterly contraction since World War II. Since then, GDP has rebounded at an annual rate of 9%.
- Debt Expansion: Fiscal stimulus has contributed to a $13 trillion (56%) increase in U.S. federal debt in just five years (2020-2024)[2].
- Interest Rate Swings: The 10-year Treasury yield hit all-time lows below 1% before surging to 4-5% in 2024[3].
- Market Valuations: By late 2020, U.S. stock valuations reached two-decade highs, fueled by speculative manias in meme stocks, money-losing IPOs, and cryptocurrencies. Today, valuations remain at historically elevated levels[4].
- Consumer Spending Surge: Durable goods consumption rose 35-50% from early 2020 to late - 2023, fueled by government stimulus and pandemic-induced demand shifts[5].

The past decade's playbook no longer applies. Market distortions and compressed cycles now create a challenging investment landscape. Economists remain divided on whether we are entering a new bull market or facing an extended downturn.

The U.S. Economy: A Paradox of Strength and Fragility

Despite strong GDP growth, money supply (M2) and bank credit are contracting—a rare occurrence historically tied to deflationary pressures. M2 declined nearly 4.6% between April 2022 and April 2023, the largest contraction since the 1930's[6]. Similarly, bank credit has shrunk, mirroring post-financial crisis patterns though it is worth noting that non-bank private credit markets are booming fueled by

alternative investment specialists such as Brookfield Asset Management. Credit is the economy's lifeblood; if it is not flowing, sustainable growth becomes questionable.

Other warning signs include:

- A negative national savings rate[7], as consumer spending props up GDP.
- Rising delinquencies on credit cards, auto loans, and consumer loans[8].
- Mortgage applications hit multi-decade lows[9], with 30-year mortgage rates nearing 8%.
- Small business loan rates reached 9.5-10% in 2024.

Meanwhile, the U.S. deficit continues to run at 5% of GDP[11] - a level typically reserved for recessions, not periods of low unemployment. This excessive spending has unnerved bond markets, resulting in heightened volatility in Treasury yields. The key question remains: who will absorb the continued wave of Treasury issuance? Foreign investors are less willing than in previous decades.

Europe: A Slowdown in Motion

Europe's economy faces tightening monetary conditions, persistent inflation, and weak credit growth:

- Monetary Policy: The European Central Bank (ECB) has raised rates aggressively to curb inflation, slowing M3 money supply growth and reducing liquidity[12].
- Credit Conditions: Higher rates have constrained borrowing, particularly for small and medium-sized enterprises (SMEs), which depend heavily on bank lending.
- Inflation: While moderating from its peak, inflation remains above the ECB's 2% target, driven by wage growth and sticky core inflation.
- GDP Growth: Germany has struggled with industrial weakness, but a shift may be underway as the recently elected coalition government is seeking to remove the "debt brake" to allow a major lift in defense and infrastructure spending[13]. Overall, the Eurozone faces subdued growth prospects due to weak external demand and geopolitical uncertainties.

Looking forward, the ECB may shift to a more accommodative stance if inflation eases, but risks remain, including global trade slowdowns, geopolitical instability, and structural weaknesses in key economies.

Japan: A Delicate Balancing Act

Japan's economy contrasts sharply with its Western counterparts, shaped by decades of deflationary policies:

- The Bank of Japan (BoJ) is cautiously ending their ultra-loose monetary policy[14], marking a significant shift after years of near-zero interest rates.

- Inflation has risen above the BoJ's 2% target, but real wage growth remains subdued[15], limiting sustained inflation.
- Bank profitability has suffered from prolonged low interest rates, particularly among regional banks facing shrinking borrower bases.
- While exports remain strong (semiconductors, autos, high-end manufacturing), domestic consumption is a weak link due to an aging population and limited immigration.

Japan's long-term outlook depends on whether it can sustain a stable inflationary environment without disrupting its fragile economic recovery.

Canada: Facing Structural Headwinds

The Canadian economy has stagnated since mid-2024[16], likely slipping into a mild recession. High consumer debt, a wave of mortgage refinancing at elevated rates, and a pull-forward of spending suggest slower growth ahead. Record immigration offers a demographic tailwind but also risks exacerbating inflation and housing affordability challenges.

Implications for Small-Cap Investing

The four-decade trend of declining interest rates has ended. While rates may temporarily decline in a recession, higher structural inflation and government debt levels suggest that ultra-low rates are a thing of the past.

Key takeaways for small-cap investors:

- Debt-laden companies will face tighter margins. Refinancing at higher rates will pressure profits, forcing businesses to adapt.
- Stock buybacks may decline. Capital will likely shift toward debt reduction rather than shareholder returns.
- Geopolitical risks will continue to disrupt supply chains. As European manufacturers have experienced, regional conflicts and trade tensions will impact costs and margins.
- U.S. market valuations leave little margin for error. Elevated multiples increase downside risk, particularly amid earnings disappointments.
- Non-U.S. equities may outperform. Lower valuation starting points in global markets, particularly in Europe and Canada, provide better entry points for long-term investors.

The past decade's winners are unlikely to lead the next cycle. As Warren Buffett put it, "Yesterday's market darlings rarely lead the next decade. Just ask the holders of dot-com stocks in 2000 or Nifty Fifty in 1972."

U.S. equities have significantly outperformed global peers over the past decade, but today they are historically expensive. Canada, in contrast, appears undervalued, with strong franchises offering attractive dividend yields and inflation-hedging advantages via hard assets and commodities.

The Opportunity in Small-Cap Stocks

Within global markets, the dispersion between expensive and cheap businesses remains extreme. This presents fertile ground for discerning investors. Our investment strategies continue to identify high-quality businesses that have undergone significant valuation resets, positioning them well for future gains.

Now is the time to embrace selectivity and discipline. The next decade will not look like the last, and investors must adapt accordingly. Great businesses at reasonable valuations remain the best defense against an unpredictable macro environment.

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