US Micro Cap Equity Market Review & Outlook

Market Sentiment Observations

The consensus view from a year-end survey of institutional investors by Evercore ISI is that the S&P 500 Index will reach 2200 by the end of 2017 (the S&P 500 stands at 2277 as I write this). Additionally, their most recent hedge fund survey is at a neutral level, showing neither bullish nor bearish sentiment. Finally, following 2016, a year that saw investors take $148 billion out of equity mutual funds, investors have taken $8 billion out of equity mutual funds and ETFs in the first three weeks of January. From a contrarian perspective, these data points suggest investors are not overly bullish.

Valuation Observations: Absolute

On an absolute level, as measured by the Russell 2000 Index, the US small cap stock price/earnings multiple is above its historical average at 20.5 times 2017 expected earnings. However, an argument can be made that current multiples are not overstated if corporate tax rate cuts are enacted.

For example, when factoring in corporate tax rate reductions for 2017, price/earnings (P/E) multiples fall sharply. So, arguably, part of the market's advance since the US election simply reflects the expectation that lower corporate tax rates (the US has the highest corporate tax rates in the OECD) will boost forward earnings significantly, all else being equal. Exhibit 1:

Exhibit 1: US Small Cap Equity P/E, pre- and post-expected corporate tax cuts

Forward P/E Ratio:	**20.5x**
Russell 2000 as of 31 December 2016	1357.1
2016's Earnings	$57.75
Projected 2017 Earnings	$66.20
Earnings at 22% Tax	$78.94
P/E at 22% Tax	**17.2x**
Earnings at 15% Tax	$86.03
P/E at 15 Tax	**15.8x**

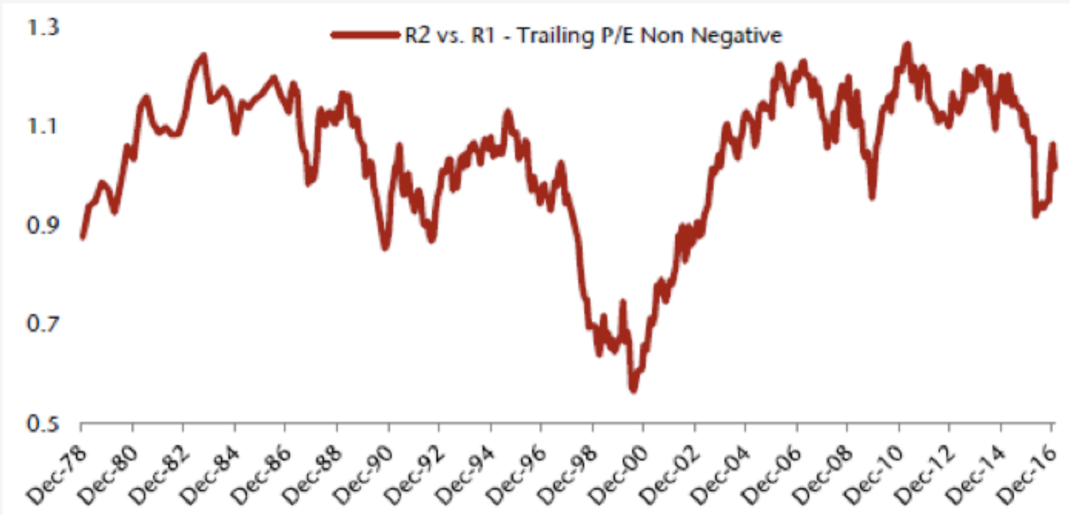
Source: Jefferies

Also, the current market multiples reflect positive dynamics, such as the new pro-business environment in Washington DC (a significant positive change), the low interest rate environment (even as rates rise and normalize) and the potential for higher economic growth (US GDP) that is now anticipated to occur versus the post-global financial crisis trend of approximately 2% per year. Above all else, the direction of earnings (EPS) growth historically matters more than valuation for micro and small caps, and we are seeing signs of an EPS inflection.

Valuation Observations: Relative

Relative to large caps, US small cap stock valuations have actually come down during the past few years (Exhibit 2).

Exhibit 2: Russell 2000 Index versus Russell 1000 Index, relative trailing P/E



Source: FactSet, Russell Investment Group, Jefferies

As shown in Exhibit 3, small caps continue to trade at a discount to large caps based on price-to-book value, price-to-sales and P/E-to-growth. It's also worth noting that US small caps still trade near (or below in the case of price/sales) their historical long-term medians on four of the five valuation metrics.

Exhibit 3: Valuation metrics, US Small Caps (R2000) versus US Large Caps (R1000)

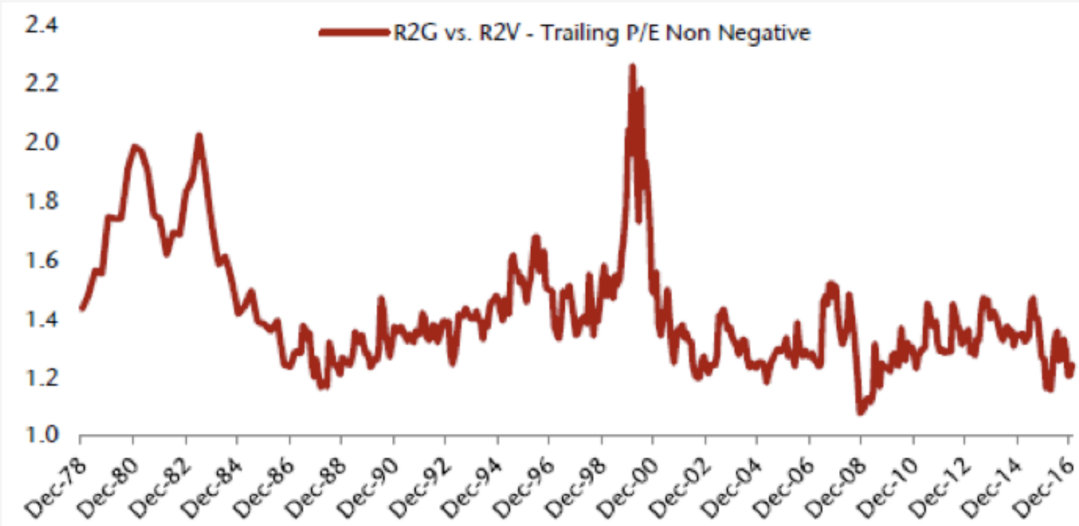
	Relative Valuation				% Difference From		
Valuation Metric	As of Nov-16	Max	Min	Long-Term Median	Max	Min	Long-Term Median
P/E (Trailing Excluding Negative Earnings)	1.10	1.27	0.55	1.07	-13.9%	100.1%	2.4%
P/E (On I/B/E/S Forecast)	1.09	1.34	0.59	1.07	-18.9%	82.8%	1.9%
Price/Book	0.81	1.12	0.46	0.80	-27.8%	75.6%	1.0%
Price/Sales	0.73	1.02	0.43	0.79	-28.7%	67.6%	-8.2%
P/E To Growth	0.88	1.06	0.51	0.77	-17.1%	71.8%	14.6%

Note: The valuation data are for the Russell 2000 relative to the Russell 1000 going back to 1985.

Source: BofA Merrill Lynch

Also, note that the absolute valuation of the Russell 2000 Value Index has never been as high as it is right now. Importantly, growth stocks (the Russell 2000 Growth Index) have become cheap relative to value stocks (Exhibit 4).

Exhibit 4: Russell 2000 Growth Index versus Russell 2000 Value Index, trailing P/E



Source: FactSet, Russell Investment Group, Jefferies

This has occurred despite small cap growth outperforming small cap value in seven of the last ten years. Growth typically trades at a premium to value, but today's valuations of growth are cheaper versus the long-term median for five of six key metrics (Exhibit 5).

Exhibit 5: Relative valuations of Russell 2000 Growth versus Value indices

	Russell 2000 Growth vs. Value		
Valuation Metric	**Current**	**LT Avg**	**% Diff**
Trailing P/E (Non Negative)	1.24	1.39	-10.5
Forward P/E	1.18	1.39	-15.6
Price to Book	1.94	2.45	-20.7
Price to Sales	1.34	1.57	-14.4
Price to Cash Flow*	1.34	1.81	-25.8
P/E to Growth	0.84	0.82	1.9

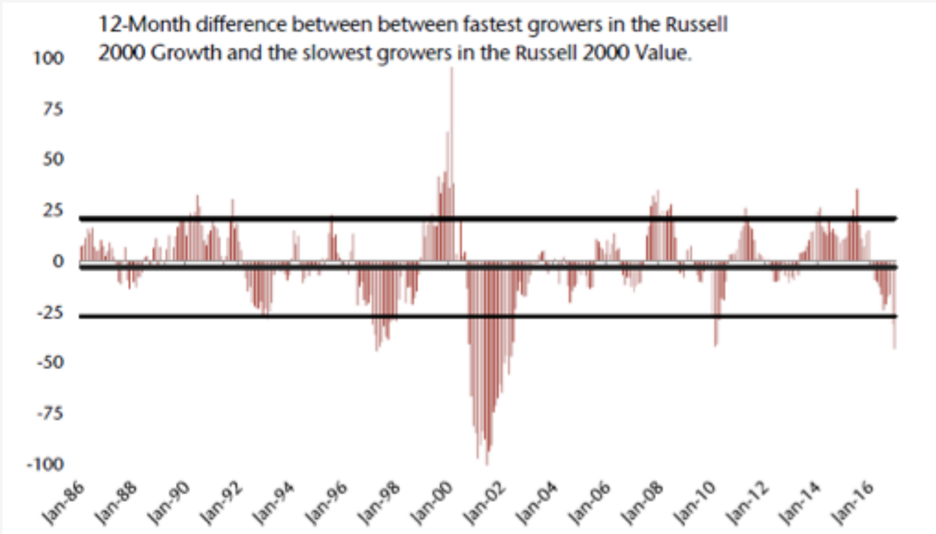
*Price to cash flow started in 2002.

Note: From March 31, 2016 forward Jefferies estimates

Source: Factset; Russell Investment Group; Jefferies

Moreover, as value stocks have outperformed growth stocks since the second half of 2015, and especially so since the US election, we have seen the fastest growing companies trail the slowest growing ones. As shown in Exhibit 6, this performance gap has reached an historical extreme. On a forward-looking basis, this bodes favorably for the stocks of fast growing companies and for our portfolio, which holds many of the fastest growing names in the US micro/small capitalization range.

Exhibit 6: Gap in performance between the fastest growers and the slowest



Source: FactSet, Russell Investment Group, Jefferies

Looking Forward: Potential Positives and Negatives for Micro Cap Growth

Possible positives include:

» A stronger US economy. Recent economic data has strengthened broadly

» Smaller caps have higher revenue and EPS growth than large caps

» The high yield market has recovered

» Normalizing interest rates due to a stronger economy

» Smaller caps are more levered to corporate tax cuts (the Russell 2000 has a higher median tax rate than the S&P 500)

» With rising corporate/CEO confidence, potential for greater M&A, which is favorable for smaller caps

» Housing market is recovering and still has a long way to go (smaller caps are more levered to this important domestic sector)

» Smaller caps are relatively attractive versus large caps (Exhibit 3)

» Growth is relatively cheap versus value (Exhibit 4 & 5)

» The gap in performance between the fastest and slowest growers is at levels that historically has favored fast growers (Exhibit 6)

Possible negatives include:

» Continued strength in the US dollar, which could dampen overall corporate profits. However the performance history of smaller caps in various high US dollar environments is mixed (there have been both positive and negative periods)

» Slow progress on anticipated passage of pro-growth reforms in Washington DC

» Smaller caps typically (slightly) lag large caps during Federal Reserve tightening cycles but the actual record is mixed, and overall equities rise during the initial and middle stages of tightening cycles

» Increased volatility if US political turmoil rises or if geopolitical turmoil rises globally

Market Outlook

The Trump and Republican congressional victories mark one of the biggest shifts for the market's outlook in years. A pro-business political agenda may usher in a period of higher economic growth through lower taxes, deregulation and fiscal stimulus. Business and consumer optimism is already surging but how this translates into overall spending and corporate earnings will largely determine how equities perform in 2017.

Volatility will likely increase as initial optimism about the Trump administration fades and the market's patience is tested by what has historically been a slow-moving legislative process. The stronger dollar, growing inflation expectations and the Fed's pace of rate increases may also generate market turbulence. Nonetheless, prospects for economic growth have improved with many sectors poised to benefit. While valuations are high and near-term gains may be capped earnings growth is improving and growth equities have become relatively attractive on a historical basis given the dramatic outperformance of value stocks.

Positioning

During the fourth quarter of 2016, we increased the strategy's exposure to banks and other pro-cyclical areas while reducing positions in health care and technology. We still maintain a balanced exposure to stocks with strong, sustainable business models and high growth rates in robust, secularly growing end markets. We believe these stocks are well positioned to appreciate, driven by rising estimates even in a post-election environment that may favor low-growth cyclical industries.

The portfolio is currently overweight energy, industrials, technology, consumer discretionary, consumer staples and financials. Underweights include health care, real estate and telecommunication services, all of which should lag if the new administration's policies accelerate economic growth. Health care remains the strategy's largest absolute weighting.

We have strong conviction in the current fundamentals and outlooks for the holdings in the strategy. We continue to focus on companies with high revenue and earnings visibility, strong end markets and healthy balance sheets. We have an abundant number of well positioned growth companies that are differentiated, innovative and are market leaders, which we believe will continue to exceed forward expectations.

Yours very truly,

Jeff James

Jeff James

About the Author

Jeff James is the portfolio manager of the Driehaus Micro Cap Growth and Small Cap Growth strategies. He has managed the Micro Cap Growth strategy since 1998 and the Small Cap Growth strategy since 2006. Mr. James began his career with Lehman Brothers in 1990. From 1991 to 1997, he worked at the Federal Reserve Bank of Chicago as an analyst. Mr. James received his B.S. in finance from Indiana University in 1990 and his MBA from DePaul University in 1995.

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