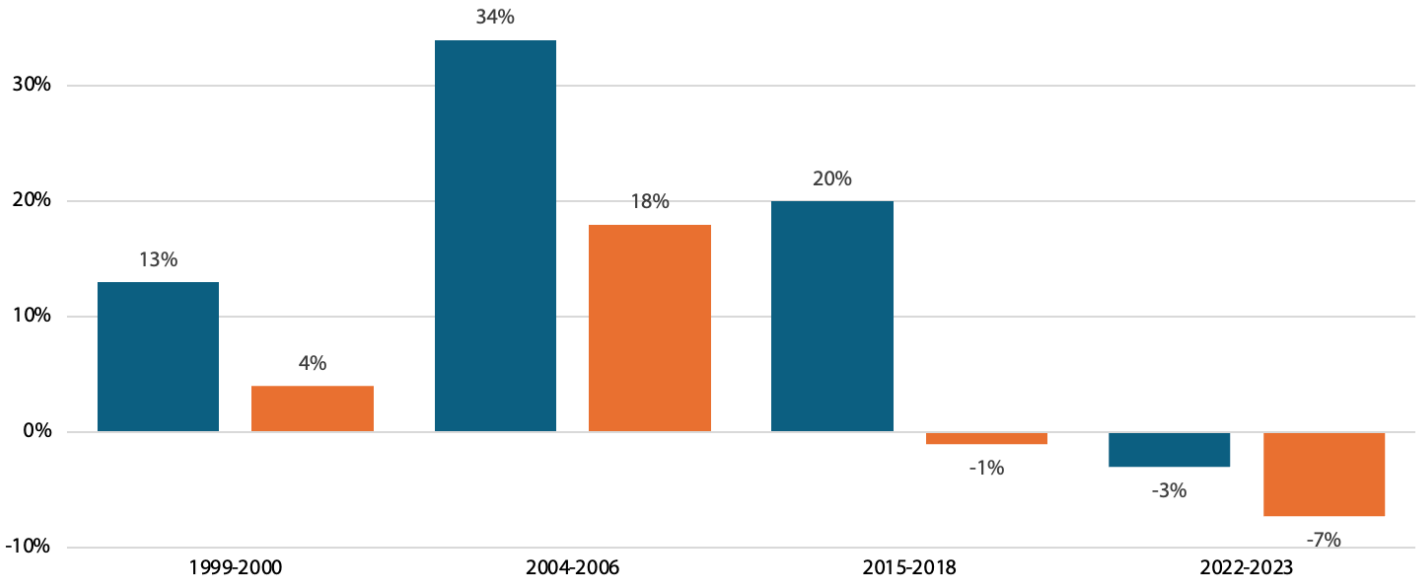
Authors: Erik M. Aarts, CIMA / James Macey, CFA, CAIA / Tim Paulin, CFA / Crit Thomas, CFA, CAIA **November 13, 2026**

Small Cap Performance During Rate Hikes

- With the possibility of further Fed rate hikes, investors have understandably questioned what higher rates could mean for small cap stocks. We looked at the four major hiking cycles since 1999 for some historical perspective.
- Small caps struggled during the aggressive 2022–23 tightening cycle, declining 3% and underperforming the S&P 500 by 7%. That cycle, however, was the most aggressive we've seen in terms of speed and magnitude since the Volker led rate hikes in the early 1980s. If that type of aggressive rate hiking is your base case, that might be a reason to question small cap exposure. We are not in that camp.
- The other three cycles tell a different story. Small caps generated positive returns ranging from 13% to 34%, outperforming large caps in two of the three periods. Rate hikes alone therefore have not historically been a reliable reason to avoid small caps.
- One explanation is that the Fed typically raises rates when economic growth is healthy. Importantly, the opportunity for small caps has not been limited to the tightening period itself. Looking at the 12 months following the final rate hike in each of these four cycles, small caps also delivered positive returns in every instance. This reinforces our view that the earnings backdrop may ultimately matter more than the direction of rates alone.
- **Takeaway:** Higher rates are a risk, but history suggests they need not derail small cap performance. Importantly, higher borrowing costs affect companies differently depending on profitability, leverage and refinancing needs, reinforcing the opportunity for active management. The earnings backdrop is also encouraging: 2027 earnings are expected to grow roughly 16% for the S&P SmallCap 600 index, and revisions have been improving. Looking at third-quarter results, a healthy 67% of companies have exceeded earnings expectations.

Small Caps During Past Rate Hiking Cycles



Source: Bloomberg.

Word About Risk

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