

# FOLLOWING THE FUNDAMENTALS

1ST QUARTER 2026: ISSUE 37

A Quarterly Market Update from The Volrath Castle Group at Morgan Stanley

## ARE THE HAVE-NOTS THAWING OUT... PART 2

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Over the past 12-18 months, a consistent theme of our quarterly updates has centered around the “The Haves vs the Have-Nots” and the divergence we have seen between large and small companies in the US. Small companies have faced several headwinds the past few years including inflation, lack of labor supply, and higher interest rates that we believe have led to this divergence.

We believe those headwinds led to significant outperformance for the S&P 500 vs the Russell 2000 the past few years. Observing performance from 12/31/21 thru 12/31/24, the S&P 500 returned 23.40% while the Russell 2000 returned -0.67%.(ThomsonOne) However, as small business optimism has improved, that performance gap started to close in 2025. While the S&P 500 still outperformed the Russell 2000 in calendar year 2025, the results were much closer with the S&P 500 returning 16.39% and the Russell 2000 returning 11.41%. (ThomsonOne)

In this edition of our quarterly update, we re-visit this topic and why we believe recent optimism from small business could continue to close the gap between the Haves and the Have-Nots.

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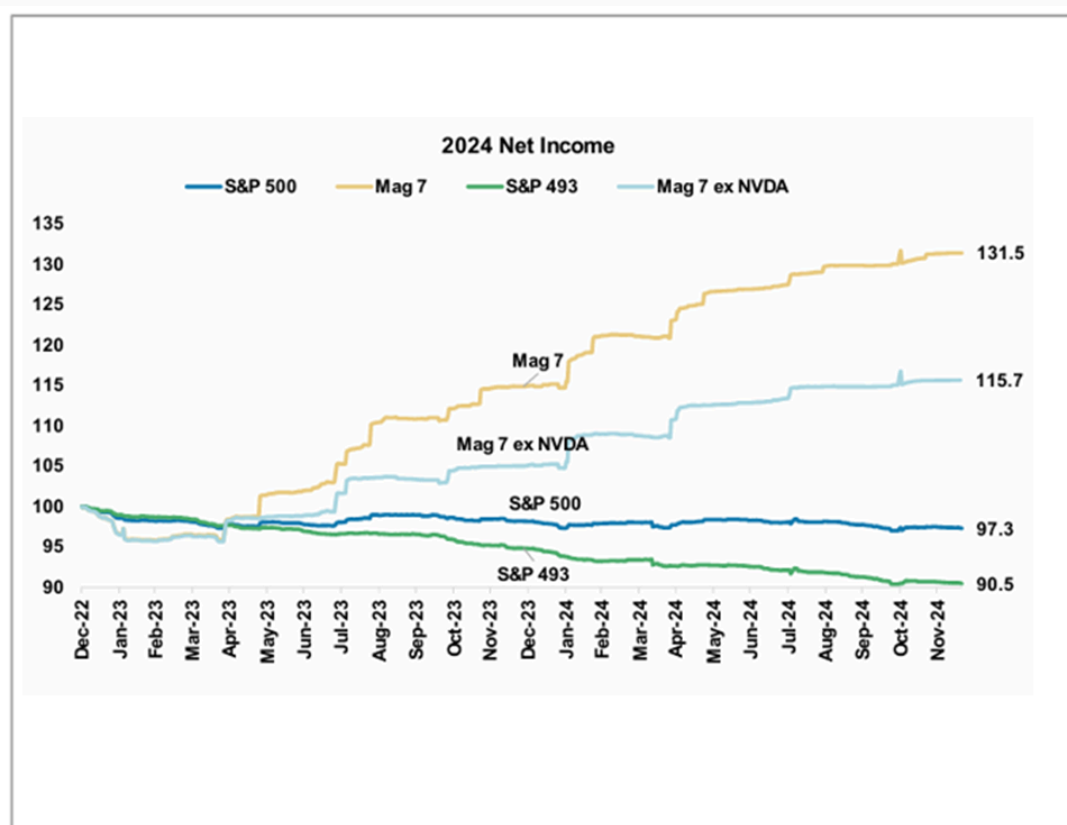
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# THE HAVES VS THE HAVE-NOTS

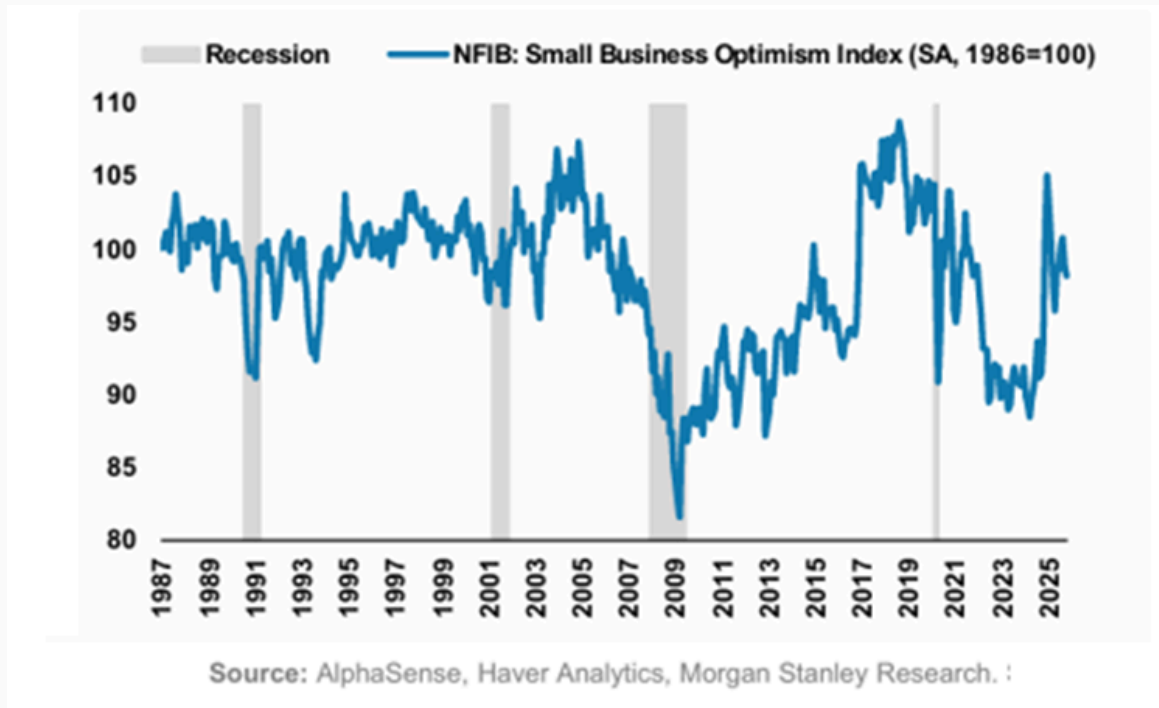
As previously mentioned, we believe high inflation, lack of labor supply, and higher interest rates are some of the many headwinds that have faced small companies in the US. In our 1<sup>st</sup> quarter 2025 update, we shared the below chart that we believe helps to explain the previous outperformance of the large companies when compared to small. In 2024, the net income growth of the S&P 500 was concentrated to the “Mag 7”, a group of 7 mega-cap companies while the rest of the “S&P 493” saw their net income contract by nearly 10%.



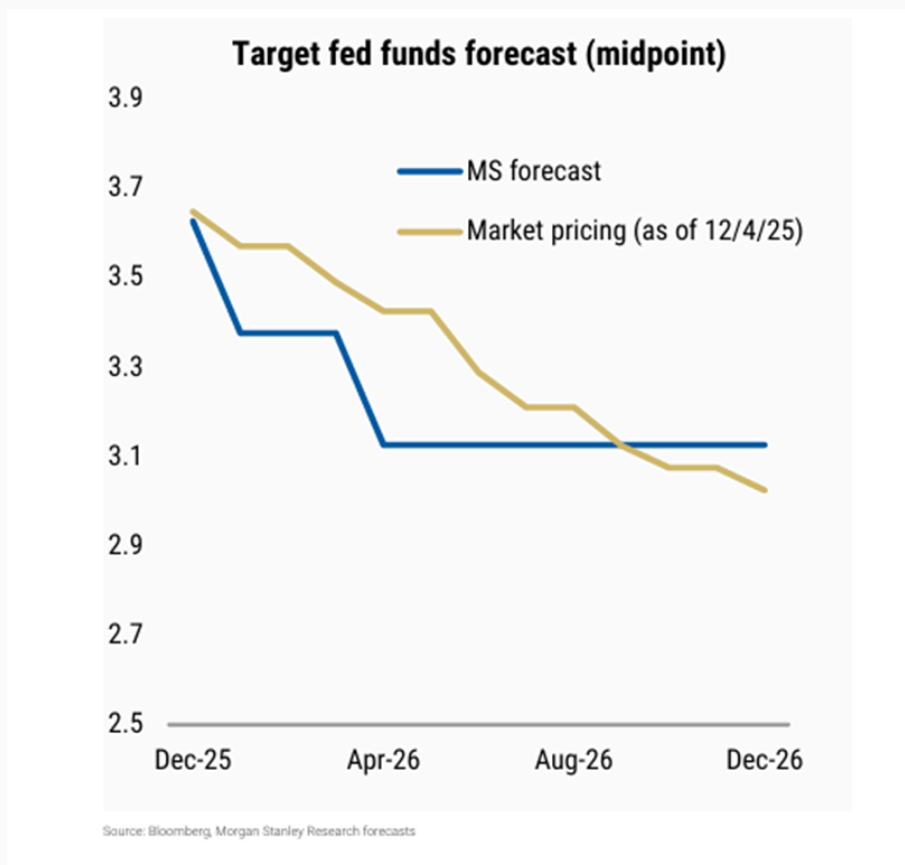
Source: FactSet, Bloomberg, Morgan Stanley Research. As of Dec. 31, 2024.

## ARE THE HAVE-NOTS THAWING OUT?

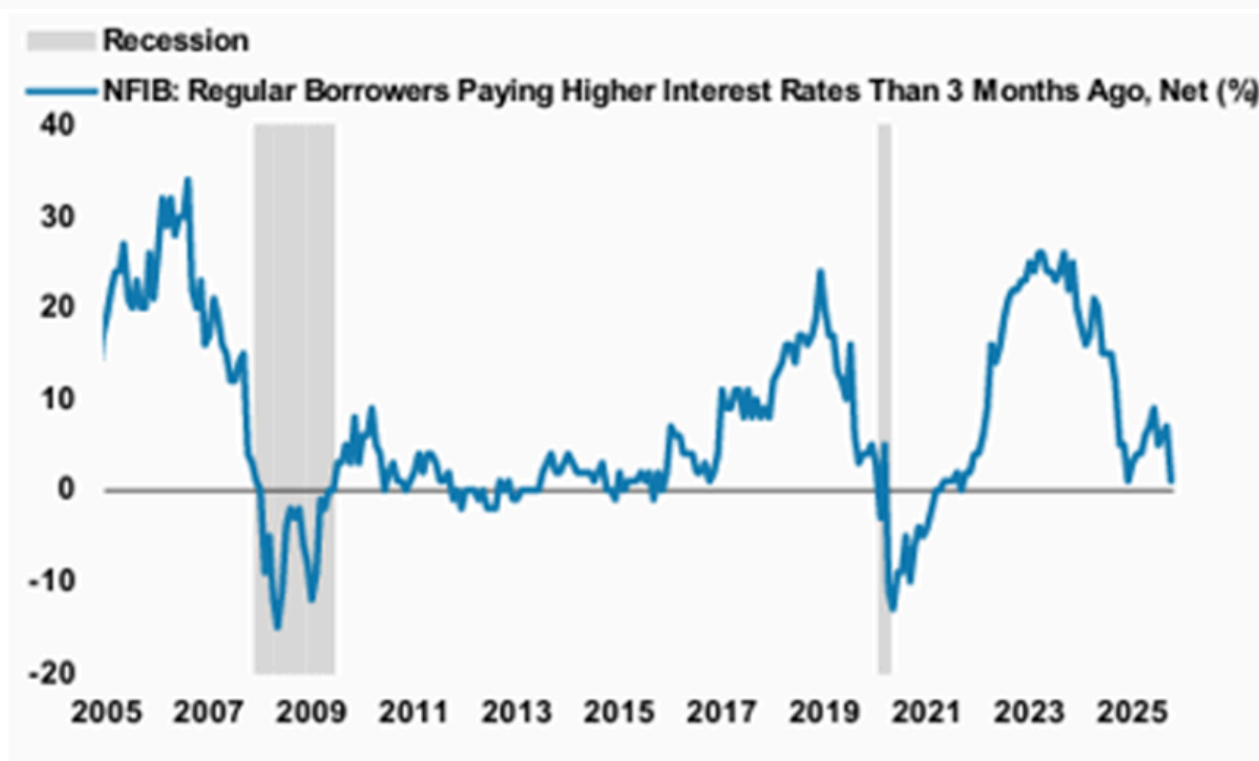
With the headwinds small businesses have been facing the past few years, the Small Business Optimism Index had been hovering at levels only seen during and after the Great Financial Crisis of 2008-2009. However, this data point got a major boost the past 12 months. As seen below, the Small Business Optimism Index has sustained much higher levels of optimism throughout 2025.



We believe one of the primary reasons that the Small Business Optimism Index has improved the last few years is because the Federal Reserve began lowering interest rates at their September 2024 meeting and has continued cutting rates throughout 2025. As seen below, Morgan Stanley economists expect the rate cuts to continue in 2026 and for the Federal Funds rate to end the year between 3.00%-3.25%.

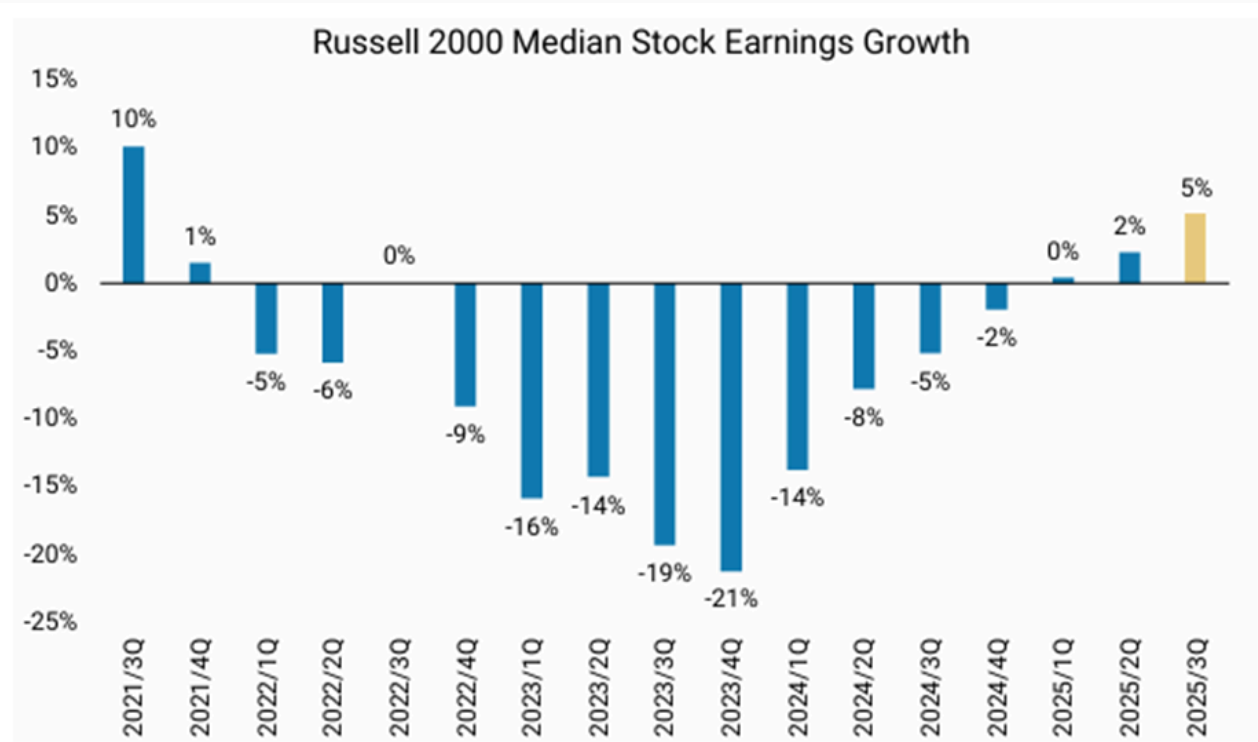


When digging into the NFIB Small Business Survey further, we see that the percentage of small businesses reporting they are paying higher interest rates than they were 3 months ago has declined significantly as the Federal Reserve has been lowering rates. If Morgan Stanley economists are correct, and the Federal Reserve continues to cut rates throughout 2026, we believe this trend will continue for small businesses.



Source: Haver Analytics, Morgan Stanley Research.

With interest rates trending lower and as other headwinds facing small businesses continue to fade, earnings for companies in the Russell 2000 have begun to inflect positively. Throughout 2022-2024, earnings for the median Russell 2000 company were flat to negative and contracted as much as -21% in 4<sup>th</sup> quarter of 2023, however the past 2 quarters have reported positive earnings growth for the median company of the index.



Source: Compustat, Morgan Stanley Research.

# MORGAN STANLEY UPGRADE

The positive earnings momentum can also be seen in the price performance of the indices as well. As earnings for companies in the Russell 2000 were turning positive the 2<sup>nd</sup> half of 2025, so was the relative performance of small cap stocks vs large caps stocks. We believe that many of the factors discussed in this update led to Morgan Stanley analysts upgrading their view on small cap stock performance on December 8<sup>th</sup>, 2025.

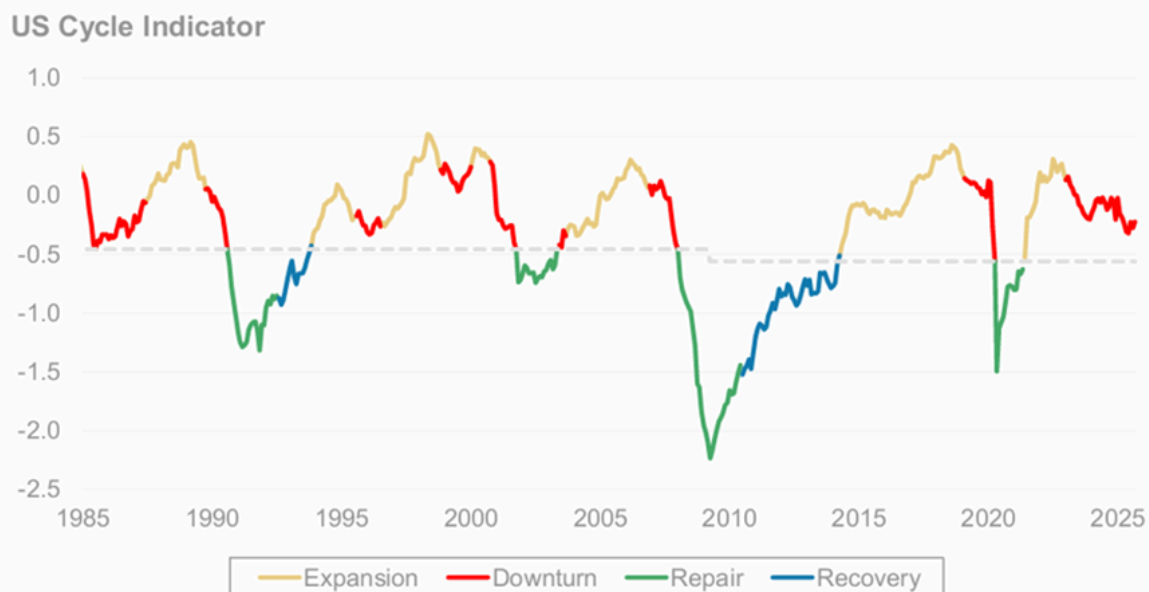


# CONCLUSION

Over the past 12-18 months, we expressed concern that the economic expansion the US was experiencing was largely due to the historically high levels of deficit spending by the government. We believe elevated levels of government spending led to many of the headwinds facing small companies in the US. The lack of labor supply was made worse by large levels of government hiring, high levels of deficit spending added to inflation, and finally, high levels of inflation led to higher interest rates which has disproportionately affected small companies who rely on short term loans to operate.

With the sustained rebound in the Small Business Optimism Index, we are optimistic that the economy can start to experience organic growth that we believe would be positive for smaller companies. We believe we are currently seeing signs of this transition as the median company in the Russell 2000 has shown positive earnings growth for consecutive quarters for the first time since 2021.

Finally, we are optimistic on what the broadening out of company earnings could also mean for the rest of the economy. For the past few years, the Morgan Stanley US Cycle indicator has registered a “downturn” reading. We are hopeful that the sustained positive optimism for small businesses, lower interest rates, and increased productivity and efficiency from the use of artificial intelligence can potentially transition this reading back into “expansion” territory. We believe a successful transition back into “expansion” could allow the Have-Nots to continue to thaw out and finally feel the heat the large caps have felt the past few years.



Source: Bloomberg, LSEG, Haver Analytics, Morgan Stanley Research; Note: For more information on the construction of the cycle indicator, please see [Cross-Asset Dispatches: Improving the Cycle Indicator – Countdown to Downturn \(31 Mar 2019\)](#). Latest datapoint is September 30th, 2025 due to missing data resulting from the US government shutdown.

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Enjoy this content? We'll be hosting our quarterly webinar on Tuesday January 27st at 6:00PM CST. We won't ask you to turn your camera on, but you'll be able to see us! Your name will also be hidden for complete client confidentiality.

Email [allie.girardin@morganstanley.com](mailto:allie.girardin@morganstanley.com) for the Invitation and Registration Link.

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For index, indicator and survey definitions referenced in this report please visit the following: <https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions>

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