

## Will Market Speculation Cool As Détente With China Ends?

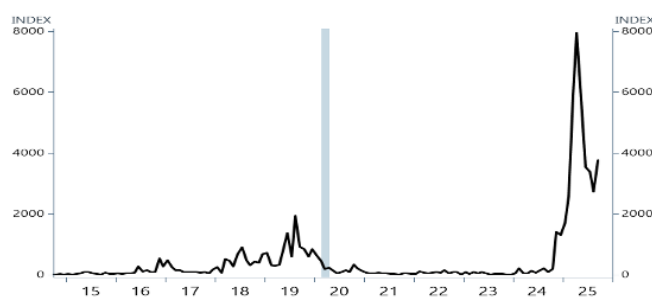
Friday's selloff illustrates the vulnerability of global markets to recurring trade uncertainty (SEE FIGURE 1). President Trump said he is considering a 100% additional tariff on Chinese goods exports and other measures unless President Xi relaxes rare earth export restrictions. The technique of using large threats to influence near term negotiations has become standard procedure for the President and team.

We view restrictions on the export of critical supplies as a larger threat to economic output than the aggregate costs of tariffs. While tariffs are a tax on US consumers, supply chain disruptions have the potential to curtail production and shrink employment for impacted industries with attendant spillover effects. This is why we believe the present 100% tariff threat will lead to a negotiated settlement.

Since April, US tariff collections on Chinese goods have raised about \$80 billion (annualized). The overall increase in all US tariffs is about \$270 billion (0.9% of US GDP). While this is a sizeable tax shared by consumer wallets and corporations, the collections are running 64% lower than estimates published in early April.

Friday's market action, with the US dollar dropping and US shares falling nearly 3%, mirrors early April, 2025. We believed then, as we do now, that the economy is adaptive and resilient. After the scare last April, actual policies adjusted and shares recovered. With this said, we would expect some market complacency that has built up since mid August to unwind before a focus on positive 2026 earnings becomes the dominant narrative for US equities.

FIGURE 1 US TRADE POLICY UNCERTAINTY INDEX



Source: Haver Analytics

## The Rally in Small Caps Overshadows the Better Opportunity in Mid-Caps

Prior to Friday's drop, the small cap Russell 2000 had jumped 40% since the early April collapse on tariff concerns. This beat the 35% gain for US large caps. Looking more closely at that performance, we note that gains in small caps since August have also been skewed toward profitless firms, a cause for concerns as we build 2026 portfolios.

Academic research suggests higher returns for the small cap asset class, particularly after a decade of underperformance. Investors will be sure to note that the world's most valuable companies were once mere startups.

However, a more accurate "lens" to view the rebound in small caps is that recent gains reflect higher volatility of small caps. During the April 2025 swoon, the Russell 2000 dropped nearly 28% from its high vs 19% for the S&P 500. This drop and ensuing recovery created an appearance of outperformance, even as the annual returns of the S&P 500 have been more than double the Russell 2000's over the last 10 years.

As Figure 2 shows, the Russell 2000 index, with roughly 40% of firms unprofitable, has outperformed the S&P 600 since late August. This illustrates a bit of a surge in speculation and risk tolerance. It is a sign of vulnerability for lower quality assets. This came into play Friday, when markets resumed dormant trade fears.

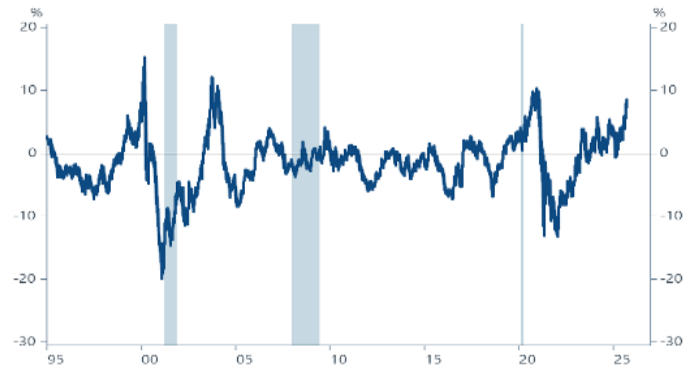
At CIO Group, we would emphasize lower-quality small caps only after an economic contraction and large declines for the asset class. Since 1990, the Russell 2000 has beaten the S&P 500 in the 12 months following a recession by 16.7 percentage points on average. It beat the S&P 500 in all four such cases. Yet the Russell has only done so after suffering much larger losses prior to these gains.

Famously, professors Fama and French estimated higher structural returns for smaller firms than larger firms based on empirical data since 1927. The "size premia" makes theoretical sense. Large firms already dominating their industry have

natural growth limitations. However, the data are strongly influenced by returns for smaller firms during the 1930s-1970s. Small cap returns gradually moderated since then. Of course, every industry-leading firm was once an upstart. Measuring returns for firms like Apple and Microsoft from their IPO days is an exercise in “data mining.” That’s why it is unwise to link such returns to a broad index of small caps such as the Russell 2000.

CIO Group is focused on profitable US mid-caps that trade 15% below the trailing valuation of profitable small caps. In fact, in our all-equity model portfolio, we retain an average allocation to small caps and include only those that are profitable. As forward-looking investors, both the earnings outlook and market sentiment for SMID performance get our attention. In order to achieve broader share price gains – beyond large cap Tech – SMID shares will experience the benefits of a brightening economy that the CIO Group anticipates in 2026.

FIGURE 2 RUSSELL 2000/S&P 600 RELATIVE PERFORMANCE (SMALL CAPS INCLUDING UNPROFITABLE VS PROFITABLE)



Source: CIO Group, Haver Analytics

## Concentration Risks vs. Broadening Profits: An Investors Conundrum

Just three American companies (NVDA, MSFT, AAPL) are worth \$12.3 trillion, representing 18% of US indices. This is roughly equal to the market cap of all the publicly traded firms in either Asia or Europe. That’s why prudent investors should have reasonable concerns about concentration risk in their portfolios.

Chipmakers have a long history of cyclical swings and obsolescence. And Apple – today’s consumer tech giant - has had two declines of about 85% within the past four decades. One of the market’s hidden risks is a “near miss” in earnings or projected revenues by any of these three leaders. Another such risk would be unbridled bullishness. For the moment, bullish sentiment is roughly equal to bearish readings in investor polls. This is unlike the late 1990s when bullish investors could not imagine anything going wrong. Today, we are routinely confronted with concerns about the AI bubble and excessive AI investment spending. (See last week’s Bulletin.). Bear markets that correct for high equity returns are driven by fundamental catalysts, particularly falling profits. We don’t see this in the coming year.

Concentration risk is real, regardless of whether you are a bull or bear. Professional investors and speculators lagging index performance have purchased far more call options than puts, a sign of “performance chasing” in 2025. Prior to Friday’s selloff, implied volatility was low (the VIX jumped from 16-22).

A “broadening” of equity market performance to include many smaller shares, industry sectors and regions of the world can be good news if their profits rise accordingly.

This is why we are seeking areas of the market, like profitable mid caps, where we can find growth at a reasonable price. We also look toward these shares as a source of diversification. We expect that corporate profits to have remained resilient and

broadened in the quarter past, beyond the usual “low ball estimates” typical for 3Qs. The estimates for smaller companies in the US look particularly robust (see figure 3).

Consensus estimates for the S&P 600 – an index whose constituents require profitability tests – shows a 106% gain for the final quarter of 2025. While this is still a tad below a record high in profits and is ultimately achievable, it seems premature to assume it will be given the recent macroeconomic headwinds,

At CIO Group, we also have concerns about how highly correlated the largest tech names might be to an increasing share of US industry. Yet an “everything rally” is also a sign of elevated risk.

These observations provide difficult questions to answer without the benefit of hindsight. To date, however, we are not convinced that speculative excesses suggest a lasting peak in markets or the economy.

FIGURE 3 S&P 600 VS EPS AND ESTIMATES Y/Y%



Source: CIO Group, Haver Analytics

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