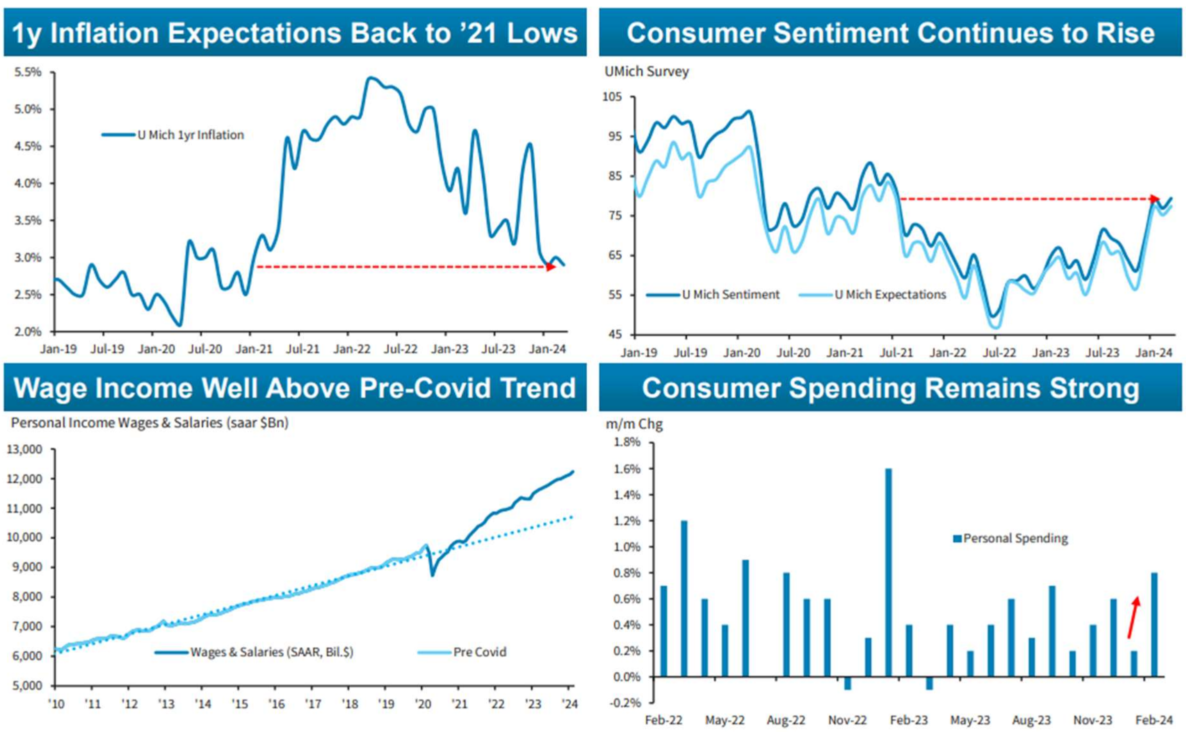
Cramer Rosenthal McGlynn

1Q 2024 – Market Commentary

The market experienced a healthy consolidation in January after the torrid rally in November and December. With an improved outlook for U.S. economic growth and continued strong employment, the rally reignited in February and March. The market also benefited from the easing of financial conditions, which started in late 2023 as interest rates declined and credit spreads narrowed meaningfully. And despite the recent bouts of monthly inflation volatility, longer term inflation expectations have remained anchored, and the U.S. consumer remained resilient as spending was strong, sentiment was healthy, and wages were tracking ahead of inflation (see graphs below). We believe a healthy economy and U.S consumer are the building blocks for a broadening out of market returns despite the handwringing of when the Federal Reserve will start to cut interest rates. We also expect small and mid-cap value stocks' extreme neglect today will continue to reverse as the market better appreciates their long-term growth drivers as well as their acute valuation discount.



Source for all charts: Bloomberg, BEA, Barclays Research.

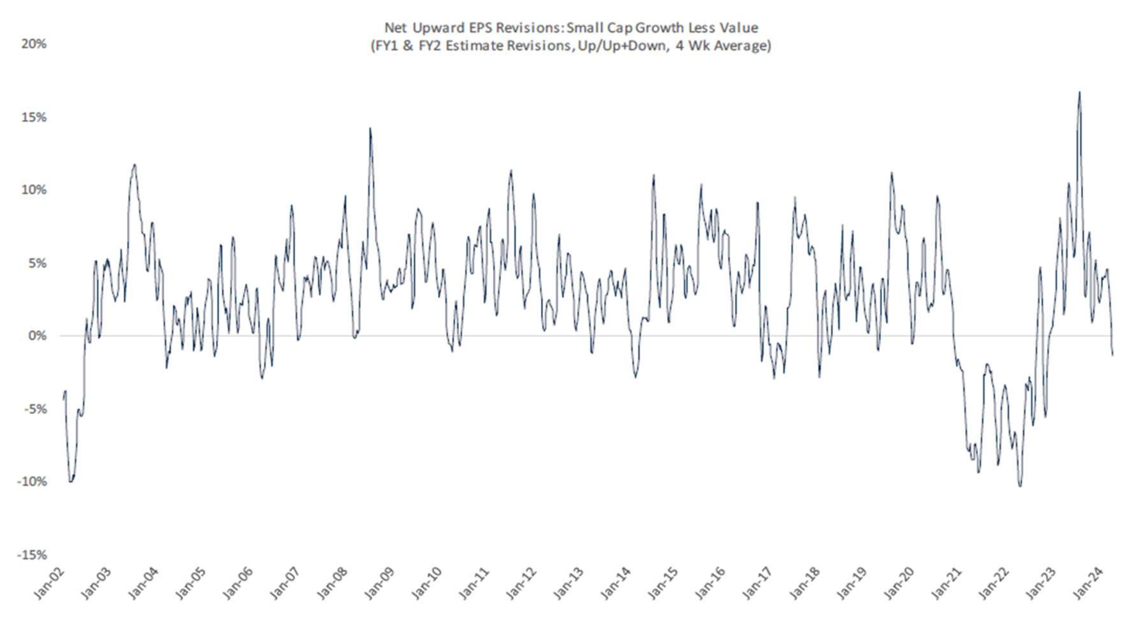
When will the Fed cut? This was the question that investors debated in the first quarter as inflation reports came in higher than expected after witnessing lower than expected inflation reports for most of 2023. Futures markets have gone from pricing in 7 rate cuts in 2024 just a few months ago to projecting less than 2 cuts today. We will pass on opining on the date of the first rate cut; rather, we believe the important takeaway is that the Fed is done tightening and will be lowering interest rates at some point in the future. Historically, an easing cycle has been highly beneficial to small and mid-cap stocks given their shorter duration liability structure and higher leverage profile compared to large cap companies (see table below). In addition, the U.S. economy, which was written off at the beginning of last year, consistently surprised to the upside in 2023 due to the strength of the consumer and elevated manufacturing construction investments. A healthy economic backdrop coupled with a narrowing of high yield spreads to historically tight levels by early 2024 is constructive for small and mid-cap stocks.

		First Three Months			First Six Months			First 9 Months			First 12 Months		
Start	**End**	**Small Caps**	**Mid Caps**	**Large Caps**	**Small Caps**	**Mid Caps**	**Large Caps**	**Small Caps**	**Mid Caps**	**Large Caps**	**Small Caps**	**Mid Caps**	**Large Caps**
Nov-57	May-58	4.3	4.2	-1.3	15.5	15.1	7.5	29.7	28.3	17.3	47.9	44.7	29.7
May-60	Jun-61	3.4	4.1	3.0	-1.7	2.4	1.4	18.9	22.1	16.4	33.3	32.8	22.6
Apr-67	Oct-67	12.7	8.9	0.9	14.3	7.7	0.8	24.2	10.0	-0.7	32.6	17.3	5.6
Nov-70	Dec-72	22.7	19.2	10.9	28.4	25.4	15.1	26.7	26.5	15.7	16.2	18.7	11.5
Dec-74	Jul-77	43.4	36.9	21.0	72.7	63.5	39.8	53.3	43.8	23.8	60.9	57.1	34.0
May-80	Aug-80	21.9	16.6	11.1	36.7	31.5	30.2	35.0	29.1	21.0	53.1	43.7	22.0
Nov-81	Aug-87	-9.7	-9.9	-9.9	-8.3	-9.5	-9.5	-1.8	-2.8	-2.1	26.2	19.9	14.1
Dec-90	Feb-94	27.5	21.5	14.1	27.7	22.5	13.3	39.2	30.8	20.1	48.6	41.9	31.2
Jul-95	Feb-97	-1.8	1.7	5.1	5.6	8.5	15.2	19.7	18.0	19.1	8.1	9.0	17.3
Sep-98	May-99	18.2	19.9	22.3	11.5	17.4	29.0	32.8	34.2	36.9	27.3	26.0	27.9
Jan-01	May-04	-5.9	-6.2	-9.3	-2.8	-7.2	-12.3	-13.5	-18.5	-23.1	-1.2	-8.1	-17.9
Sep-07	Nov-15	-4.9	-5.0	-2.2	-14.8	-14.1	-11.4	-15.9	-11.4	-13.9	-18.1	-20.8	-21.2
Aug-19	**Mar-22**	**9.5**	**7.4**	**7.9**	**0.0**	**-1.5**	**2.7**	-1.9	-2.5	7.8	11.6	9.6	26.4
Average		**10.9**	**9.2**	**5.6**	**14.2**	**12.4**	**9.4**	**19.0**	**16.0**	**10.6**	**26.6**	**22.4**	**15.6**
Median		**9.5**	**7.4**	**5.1**	**11.5**	**8.5**	**7.5**	**24.2**	**22.1**	**16.4**	**27.3**	**19.9**	**22.0**

Note: Used Fed Funds from 1954 until 1963, then used the Discount rate from 1963 until 1994 and Fed Funds rate after that.
Source: Federal Reserve Board; Haver Analytics; Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

We also see an improving earnings outlook for small to mid-cap companies as we progress through 2024. Down cap companies' earnings were more negatively impacted by the inflationary pressures and rise in interest rates than larger cap companies in 2023. As such, small and mid-cap value companies should also have the strongest earnings recovery as we advance through 2024. We see the best earnings leverage from certain sub-sectors that have endured recession-like environments in 2023 such as transports, title/housing related companies, merger and acquisition advisory firms, real estate brokerage and auto insurers to name just a few. These groups should enjoy a cyclical, and in some cases a secular, rebound in their earnings outlook over the next few years, which we believe is not fully appreciated by the market.

Value Pulling Ahead of Growth on EPS Revisions within Small Cap



Source: RBC US Equity Strategy, S&P Capital IQ/ClariFI, CIQ estimates, Russell; as of April 10, 2024

Despite the slower than expected start to the year, we remain constructive on a recovery in merger and acquisition (M&A) activity, which historically has been highly supportive for small and mid-cap stocks. As we have seen in the past, M&A typically has a 2 to 3 year downcycle and 5 to 7 year upcycle. This year has kicked off with an acceleration in larger, strategic driven announcements while sponsors have been slower to get out the gate. As indicated below, global M&A volumes are significantly below trend and are set for a cyclical and secular rebound. We view the $2.5 trillion of dry powder private equity has today and the excess capital on strategic buyers' balance sheet as highly constructive for an acceleration in deal activity. We also believe limited partners will continue to pressure sponsors to generate realizations and distributions in order to recycle capital for future fund raising. Lastly, we expect the historically large discount small and mid-cap stocks are trading relative to large cap stocks will spur elevated consolidation until that spread narrows.

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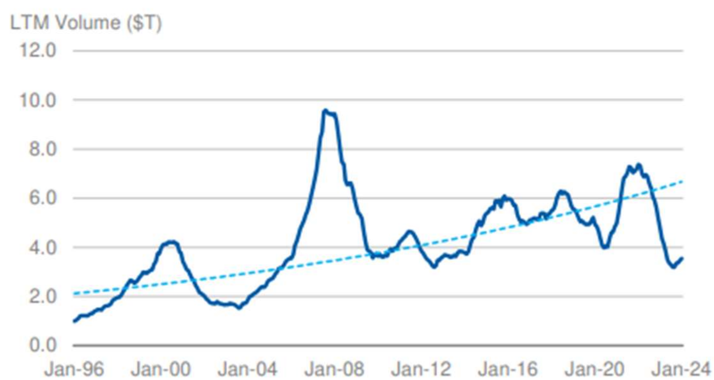
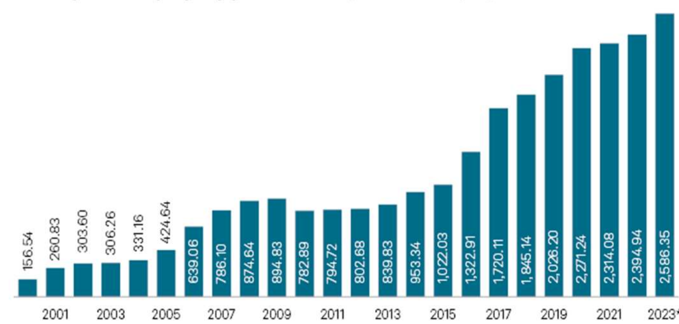


Source: Dealogic, Morgan Stanley Research; Note: Exhibit shows trailing LTM volume of global announced M&A, excluding withdrawn transactions.

Global private equity dry powder trend, 2000-2023 ($B)



Data compiled Dec. 1, 2023.
* Year to date through Dec. 1, 2023.
Analysis includes aggregate dry powder of global private equity funds with vintage year between 2000 and 2023.
Dry powder data is supplemented by Preqin.
Source: S&P Global Market Intelligence.
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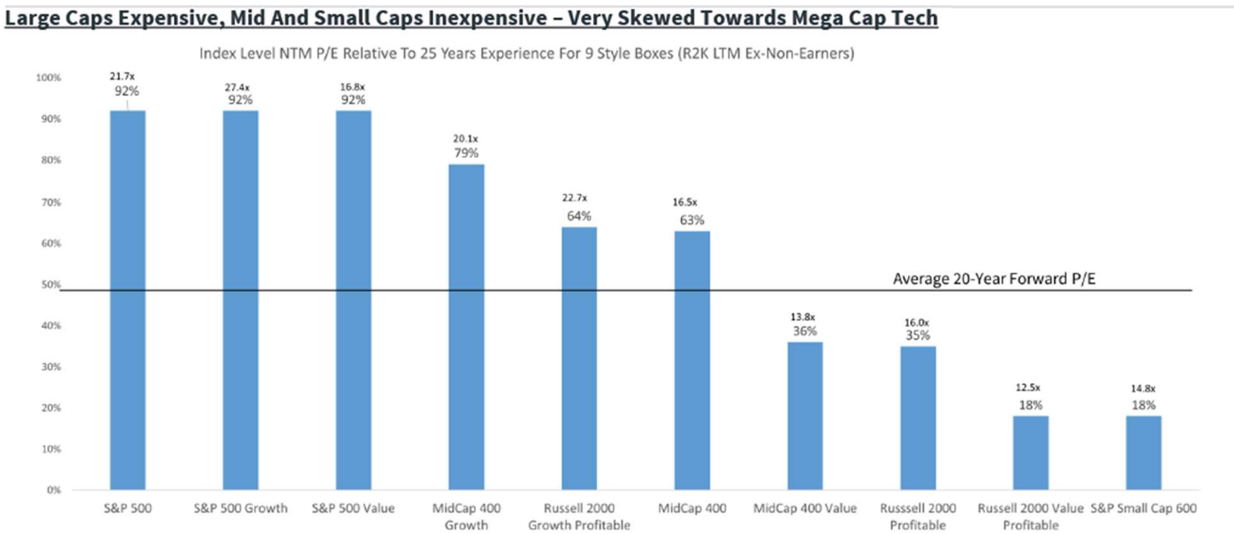
Despite these positive macro and fundamental factors, we continue to be mindful of the geopolitical risks across the globe. The conflict in the Middle East and the Russia/Ukraine war remain a tail risk for the market. The humanitarian crisis is hard to wrap your head around. The market has generally viewed these events to be contained, but more countries could be pulled into these conflicts at a moment's notice. Here at home, the government can best be described as dysfunctional as we careen from one budget crisis to the next. With the slimmest majority in the House of Representatives, a single vote can derail any bill these days. In addition, we have already entered the Presidential general election campaign period, which is early by historical standards. We expect the market will remain uneasy until we get closer to the November election and a presumptive winner comes into view. As we all know, the market hates uncertainty. Yet, that uncertainty will likely create attractive investment opportunities for nimble, active managers.

With continued healthy economic growth, resilient employment and tight credit spreads, the market has shrugged off the outlook of more modest interest rates cuts this year compared to the beginning of the year. Despite the rally, small and mid-cap stocks continue to trade at a significant discount to large cap stocks. After resetting expectations during 2023, we believe small cap stocks are well positioned for a recovery in earnings over the next couple of years. We also believe that small and mid-cap stocks are attractively valued on an absolute and relative basis, and have multiple levers of value creation over the next few years. As we see int the chart below, large cap stocks are trading in the 90th percentile of their historical valuation range while small and mid-cap value stocks are trading well below their historical average. In addition, we are starting to see the green shoots of

M&A resurface, which is typically a positive multi-year tailwind for the group. We continue to focus on stocks with pricing power, healthy balance sheets and areas of self-help which can drive small and mid-cap stocks to grow earnings in various interest rate and inflationary environments.



Source: FactSet, Raymond James research