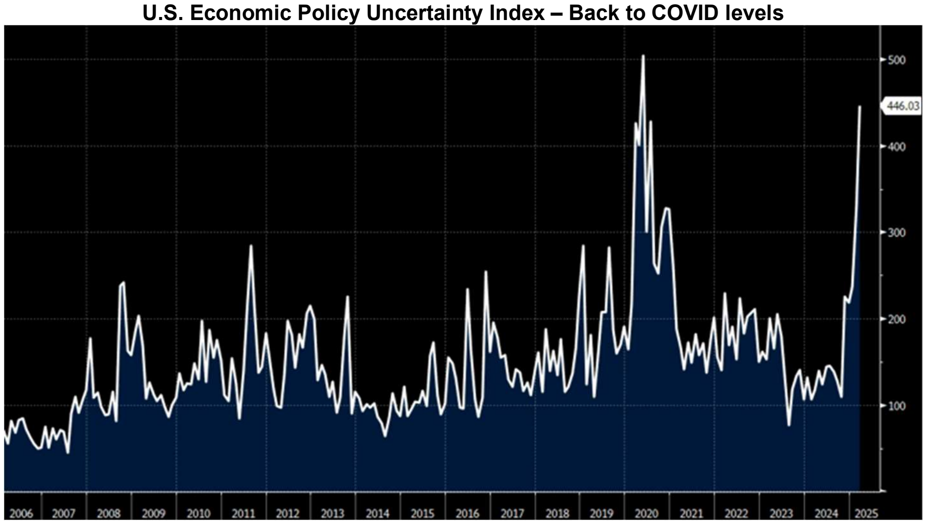
1Q 2025 – Market Commentary

This was the worst start to a new year for the U.S. markets since COVID hit in 2020. But, as Marko Kolanovic, the former JPMorgan Chase strategist, describes it "this situation is similar in price/vol action, but is fundamentally different than COVID. Its one-man made. The analogy would be that in COVID we had the vaccine but didn't want to give it out due to price negotiations. It is not as bad as not having the vaccine". This year equities sold off as "uncertainty" regarding tariffs gripped the market. The "uncertainty" stems from President Trump not being definitive on the level and duration of the proposed and speculated tariffs. This makes it more challenging for CEOs to manage and forecast their businesses. As has been the case in the past, a rise in "uncertainty" tends to result in lower economic growth (less cap ex, less lending, less hiring, less M&A, etc.). This "uncertainty" has also shortened the market's investing time horizon, and the market is now rewarding stocks and sectors that have more certainty to their businesses, such as the low volatility sectors of utilities, staples, and REITs. At CRM, we invest in companies undergoing change, which by its nature is uncertain. While the market does not appreciate uncertainty today, we believe this market pullback is creating highly attractive long-term alpha opportunities similar to other market dislocation periods in the past. Historically, these periods of uncertainty do not last for an extended period. As has been the case throughout our over 50-year history, we continue to believe that investing in companies which have strong management teams that can effectively improve the returns of their businesses should drive compelling long-term returns over this and future cycles. We also believe that investing in small and mid-cap stocks today provides the opportunity to generate inherently higher future potential returns as this part of the market trades at an absolute valuation discount to its long-term average and at an extraordinary discount relative to large cap stocks.

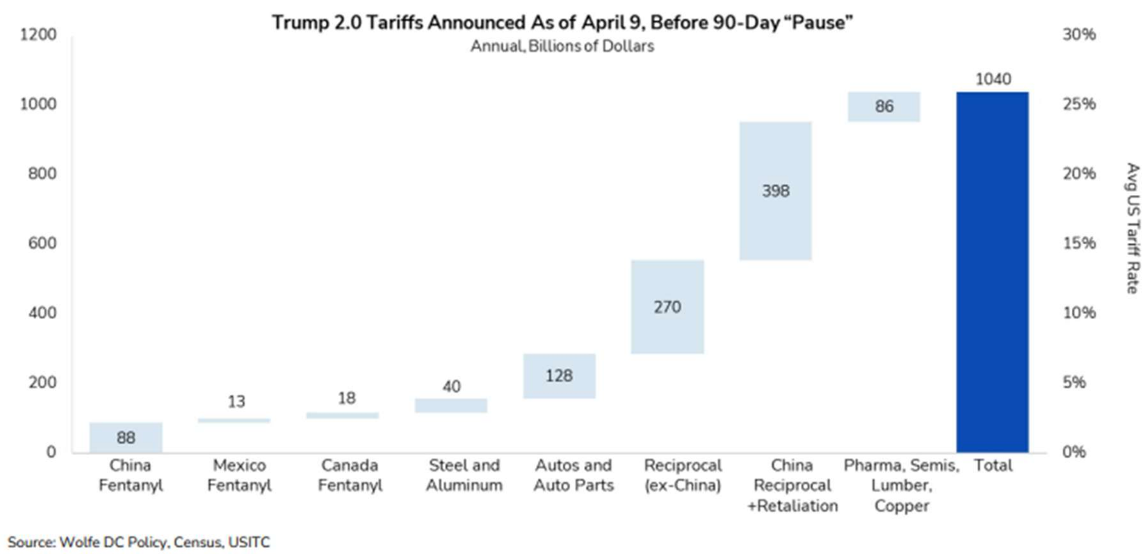
U.S. Economic Policy Uncertainty Index – Back to COVID levels



Source: Bloomberg

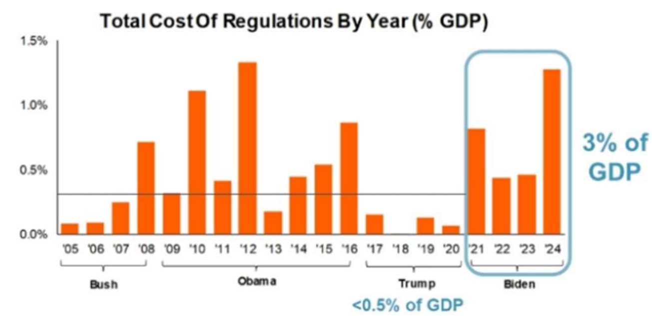
One of President Trump's primary goals is reorienting trade policies to reduce the U.S.'s trade deficits with other countries that have ballooned over the past few decades, particularly since China was admitted to the World Trade Organization (WTO) in late 2001. President Trump's tariff proposals could be described as a continuation of the actions taken by President Biden when he announced the Infrastructure Investment and Jobs Act (IIJA), the Inflation Reduction Act (IRA), and Creating Helpful Incentives to Produce Semiconductors Act (CHIPS), which were designed to bring manufacturing back to the U.S. The difference being President Biden used a carrot (incentives and grants) while President Trump is using a stick (tariffs) to accomplish similar goals. The other big difference is President Biden's policies significantly grew the U.S. government's debt to finance these programs while President Trump will look to reduce our debt, in part, through tariffs. What President Biden and Trump share is their support of Industrial Policy for the U.S., which is a sharp pivot from previous administrations' policy of free trade. As Webster defines it, Industrial Policy refers to a government's deliberate course of action to shape the economy by targeting specific industries or economic activities. This is typically achieved through various tools like subsidies, tax breaks, infrastructure investments, and regulations designed to support research and development. This notion of Industrial Policy is most reflective in the sectoral tariffs launched and proposed by the Trump administration. While we understand the long-term benefits from this policy change, tariffs in the short-term have been disruptive to U.S economic growth, and if not calibrated properly could push us into a recession. We are encouraged by recent de-escalation signals from the new administration and expect there will be bilateral agreements announced with various countries over the course of 2025, which should reduce the economic burden of the currently announced tariffs.

The Reciprocal Tariffs are Huge, but They're Just One Element of an Even Larger Tariff Agenda

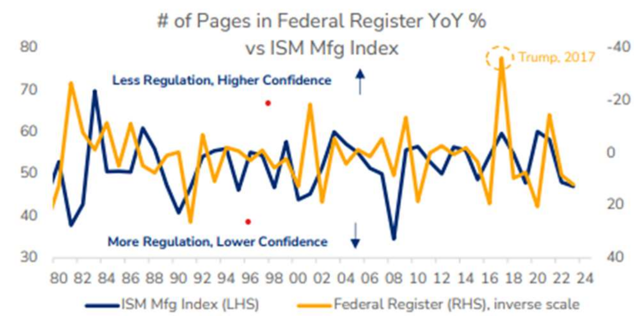


The Federal Reserve began a process at its September 2024 meeting to normalize interest rates after one of its sharpest tightening campaigns during 2022 and 2023. Over a 3-month period, the Federal Reserve lowered short-term interest rates by 100 basis points. The Fed paused its monetary policy normalization cycle in late 2024 as concerns were raised regarding the pace of economic growth and the inflation outlook given the uncertain policies that the new Trump administration would pursue. Today, the Fed remains on hold as they await incoming hard data to gauge the progress towards its goal of 2% core inflation while maintaining a healthy employment market. Unfortunately, we have been getting some mixed messages from the Fed over the past couple of months. On March 7, 2025, Chair Powell spoke at the University of Chicago Booth School of Business U.S. Monetary Policy Forum in New York and indicated the Fed can look through tariff inflation if longer-term inflation expectations are well anchored. Powell volunteered the example of 2019 when the Fed (under his leadership) cut rates three times due to the growth impact of the tariff trade war with China and trade policy uncertainty under the first Trump administration. This was viewed by the market as dovish and supportive of the "Fed put." At a more recent speech to the Economic Club of Chicago on April 16, 2025, Chair Powell appeared to pivot away from his earlier comments and indicated "the inflationary effects could also be more persistent" and "we may find ourselves in the challenging scenario in which our dual-mandate goals are in tension". A more hawkish address. This last speech led President Trump to post on social media that the termination of Chair Powell can't come fast enough. Thankfully, this comment was recently walked back. Despite the "uncertainty" caused by recent Fed speak, we believe the FOMC stands ready to provide monetary support to the economy if it falters further. Fed funds future are currently pricing in three 25 basis point cuts by year-end 2025.

With the market myopically focused on tariffs and the President's spat with the FOMC Chair, we can lose sight of the positive growth policies of the new administration: specifically deregulation, a smaller government, and tax cuts. We expect to hear from Trump's cabinet members and other agency leaders regarding actions that will reduce the regulatory burden on U.S. consumer and small businesses. President Trump signed an Executive Order on January 31, 2025, that codified his new policy to repeal ten existing rules, regulations, or guidance documents for every one new rule, regulation, or guidance. As history has shown us, deregulation lowers the costs of operating a business, allows more competitors to enter a market, and lowers the prices for consumers. Deregulation is more helpful to small and medium sized businesses than large corporations, as it reduces barriers to entry and allows new businesses to emerge and compete with established players. In a National Bureau of Economic Research paper titled "Regulation and Investment" by Alberto Alesina et al, the study finds a significant positive impact of deregulation on investments and a reduction in entry barriers leads to a reduction in the markup of prices over marginal costs and a reduction in the penalty for expanding the capital stock and production. See charts below for the drag that higher regulation has had on GDP and the correlation between higher regulation and lower ISM Manufacturing.

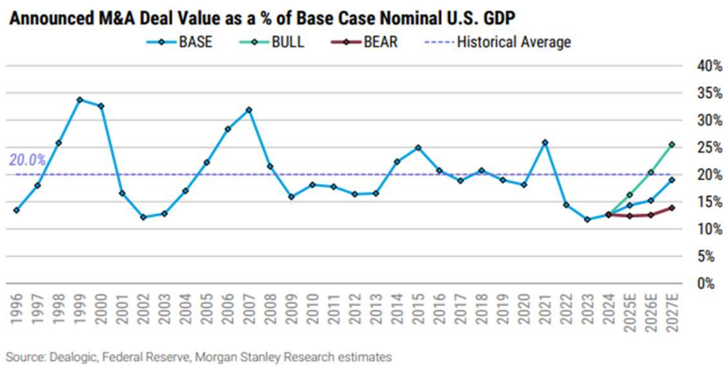


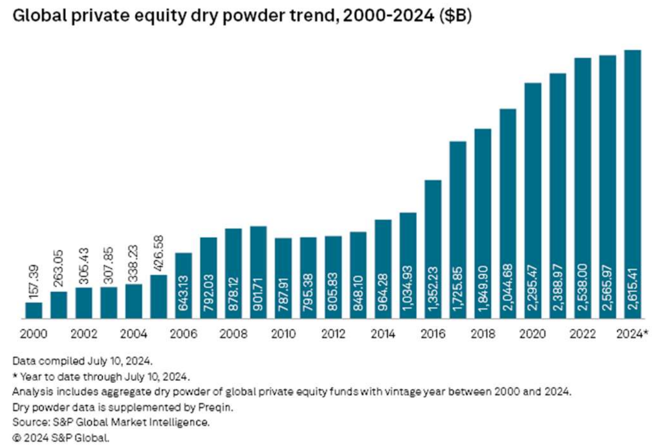
Source: Doug Holtz-Eakin, American Action Forum



Source: Wolfe Research, Haver Analytics as of 2023

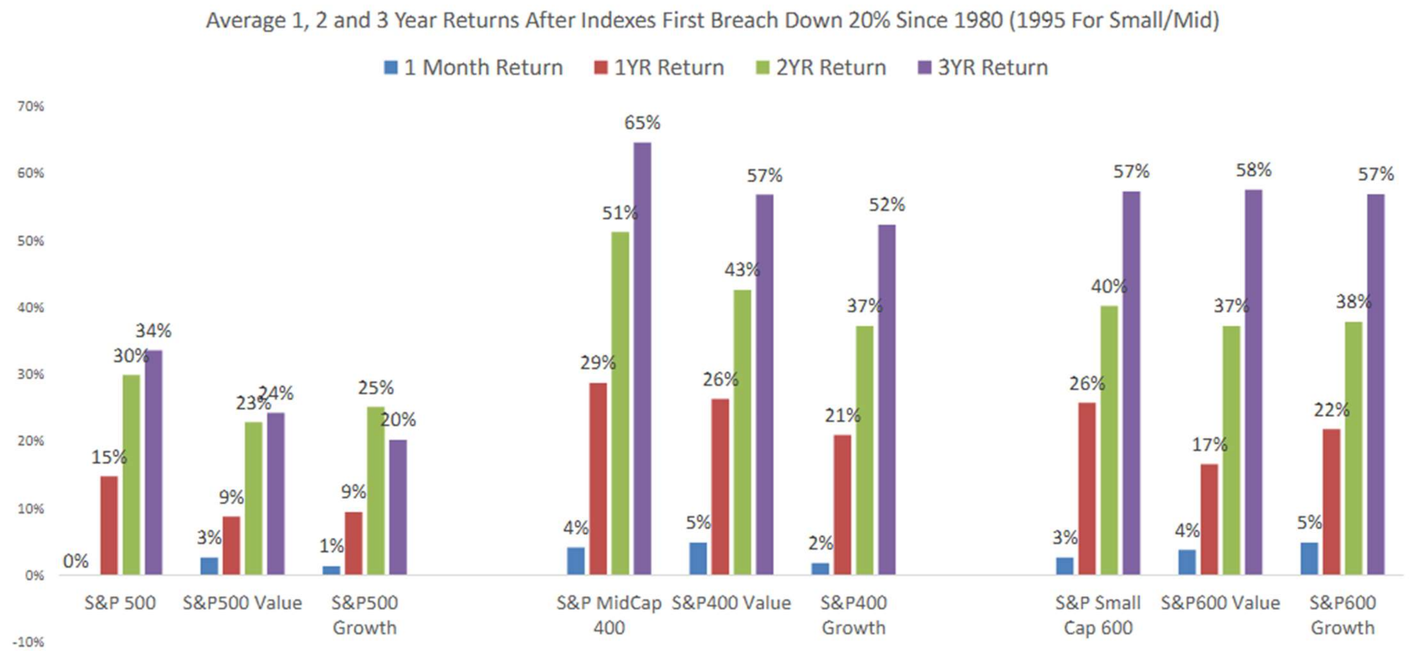
Another area that is stunting market valuations is the low level of merger and acquisition (M&A) activity. We believe there will ultimately be a meaningful improvement in M&A activity, which, historically, has been beneficial to small and mid-cap stocks. While we experienced a modest recovery in transactions in 2024 compared to the historical lows in 2022 and 2023, the recovery has been delayed due to the "uncertainty" created by the tariff discussions. As the CEO of Morgan Stanley recently described it, the M&A market is currently in a "pause, not delete" mode until this uncertainty dissipates. We believe the new Trump administration and a less combative Federal Trade Commission (FTC) will be supportive of a more robust recovery in M&A activity. As indicated below, global M&A volumes are significantly below trend and are poised for a cyclical and secular rebound. We view the below trend of sponsor dry powder as pent-up activity that will provide additional support to small and mid-cap stocks. Lastly, we expect the historically large discount that small and mid-cap stocks are trading relative to large cap stocks will spur elevated consolidation until that spread compresses.





We continue to monitor the geopolitical environment globally for sources of stress and/or potential easing. Will the new Trump administration be able to broker a resolution to the conflicts in the Middle East and Russia/Ukraine, or should we prepare for these conflicts to expand into larger regional engagements? We need to remain vigilant to direct and indirect factors that could negatively impact our portfolios from these conflicts. As we are reminded periodically, China remains a wildcard as it relates to geopolitical unrest as well as its own economic future. How will China react to the currently proposed tariffs and how will they respond to our global partners? Lastly, we still do not expect a recession in the U.S. over the next 12 months, but we remain vigilant to changes in macro and micro datapoints that could upset that outlook.

Despite the sell-off in the market this year, we remain highly constructive on the small and mid-cap value parts of the market. History has shown us that following a 20% drawdown in the small and mid-cap indices, we tend to experience a 50%+ return over the next three years (see chart below). While the new tariff policies by the Trump administration have increased “uncertainty”, we understand the long-term benefits of a more domestic oriented manufacturing economy and a better balance to global trade. We also believe less regulation and a smaller government will likely be highly productive for the markets. The removal of the regulatory tax across a multitude of industries should create a more level playing field for small and mid-cap companies to effectively compete against large cap companies. In addition, small and mid-cap companies have been in an earnings recession for the past two years due to the negative impact of higher interest rates and higher inflation. The group is poised to benefit from lower interest rates and the re-shoring and near-shoring of critical infrastructure and the reorientation of supply chain that should accelerate domestic growth. We also expect a recovery in M&A activity will be supportive of small and mid-cap stocks. We still believe stock selection will be an important driver of alpha, as the Fed is not likely to return to zero interest rate policy anytime soon. Rather, we continue to construct our portfolios with stocks that have pricing power, healthy balance sheets, and areas of self-help. In other words, stocks that are under-earning and can generate alpha in various interest rates and inflationary environments. While uncertainty clouds the short term-outlook, we believe this is an opportunistic time to invest in down-cap strategies given the inherent higher future potential returns. This part of the market trades at an absolute valuation discount to its historical levels and an extraordinary relative discount to large cap stocks and is highly under-allocated to by investors.



Source: Bloomberg, Factset, Raymond James research