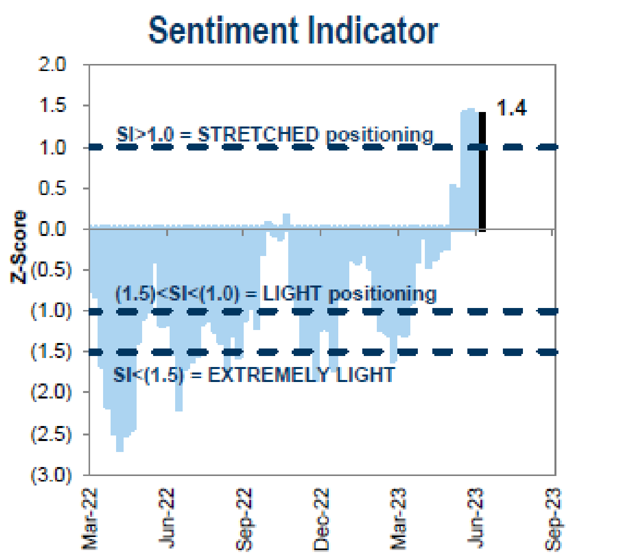
2Q 2022 – Market Commentary

Hard landing, soft landing, no landing. We seem to have gone through the gamut of permutations in the first six months of this year. Economic data, the yield curve, credit spreads, commodities, volatility measures, and market positioning/sentiment have flashed conflicting signals. As we know, the long and variable lag of Federal Reserve rate increases are hard to predict when and how they will impact the economy. In addition, we endured and successfully navigated the political cliff walk of the debt ceiling, which allowed the U.S. government to avoid default and a credit downgrade. Interestingly, many of the "crises" we witnessed this year (bank failures, debt ceiling, recession, etc.) have resolved themselves in a positive way, which has fueled the market rally this year. With these successful resolutions and a more positive investor sentiment today, we expect the market to broaden out with better participation from small and mid-cap stocks. Although we have seen non-earners, high beta, and non-revenue companies outperform recently, we caution against unbridled risk taking. As we have done in the past, we believe taking the appropriate level of risk for the return generated is important throughout an economic cycle and is particularly warranted today.



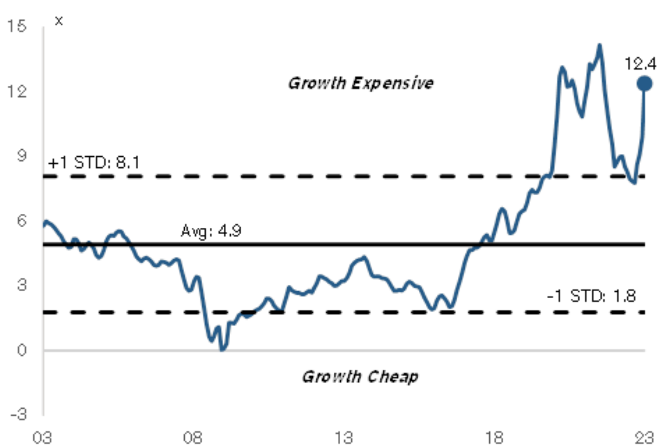
Note: Sentiment Indicator measures stock positioning across retail, institutional, and foreign investors versus the past 12 months. Readings below -1.0 or above +1.0 indicate extreme positions that are significant in predicting future returns.

Source: Haver, EPFR, FactSet, CFTC, and Goldman Sachs Global Investment Research.

It's hard to discuss the market performance and the outlook for 2023 without touching on Generative Artificial Intelligence (AI), which has captivated the attention of investors and the media this year. ChatGPT, a natural language processing tool driven by AI technology, has been quickly adopted, particularly by school aged children to the chagrin of their teachers. Nvidia shocked the market when they provided a revenue outlook 50% higher than street expectations due to outsized AI demand for their coveted Graphics Processing Units (GPUs). Is this the dawn of the next mega cycle? We'll avoid making a prediction. As you can imagine, AI is a difficult investing theme for a true value manager such as CRM. Not to discount the potential impact of AI, but we believe value managers also have a mega cycle occurring right in front of them, with much less fanfare on CNBC. It's the recently passed Infrastructure Investment and Jobs Act (IIJA), the CHIPS and Science Act, and the Inflation Reduction Act (IRA). We see these $2 trillion+ bills providing a multi-year growth tail wind for small and mid-cap value stocks, the "picks and shovels" companies, which tend to be more domestically oriented. These bills should spur capital expenditure spending in the U.S. as efforts are made to re-shore and near shore our critical supply chains. The public/private partnership implementation model should have a multiplier effect on the headline dollars allocated by the U.S. government. If the elevated conference call references and news articles are any early indication, we believe this is shaping up to be a once in a generation opportunity.

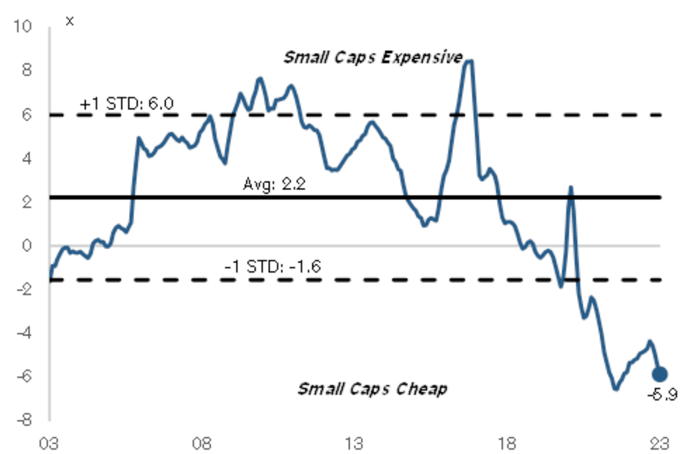
Despite this attractive tailwind, the market has been overly fixated on large cap growth stocks. As has been widely broadcast, seven stocks (AAPL, MSFT, TSLA, AMZN, NVDA, GOOG, and META) have driven the performance of the S&P 500 index year to date. This has resulted in small and mid-cap stocks trading at a multi-decade discount to large cap and particularly mega cap stocks (See charts below). We are not the only ones pointing out this market anomaly. For only the second time in the last 25 years, the Nasdaq-100 is undertaking a special rebalance to reduce the weighting of these seven stocks from 56% of the index to 44%. Given the diversification requirements under the Investment Company Act of 1940, which mandates a "diversified" fund cannot hold more than 25% of its portfolio in positions that each account for greater than 5% of its portfolio, it has become challenging to run a diversified large cap growth mutual fund given significant concentration and large weighting of these seven names.

P/E: Growth minus Value Benchmark



Note: Russell 1000 Growth minus Russell 1000 Value
Source: Russell, Factset, Refinitiv, Credit Suisse

P/E: Small- minus Large-Caps



Note: S&P 600 minus S&P 500
Source: Russell, Factset, Refinitiv, Credit Suisse

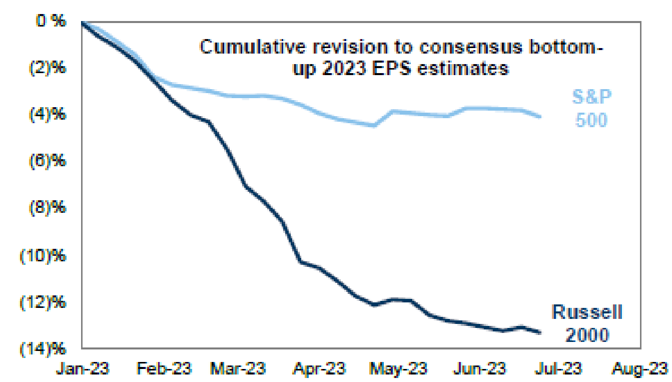
Another attractive vector for small and mid-cap stocks is the likely peak in inflation. Goods deflation has led to the recent declines in overall inflation as supply chains have been normalizing and consumer demand has shifted away from goods. In addition, the front-end indicators for services inflation, the largest component of overall inflation, appear to be peaking. We are seeing asking rents decline year-over-year in multiple cities across the U.S. In addition, the labor market is starting to come off its peak as unemployment claims are rising and average hourly earnings growth is slowing. History tells us an environment in which inflation is above 3% but falling is a highly attractive market for small and mid-cap stocks (See table below).

This is the ideal inflationary backdrop for small caps

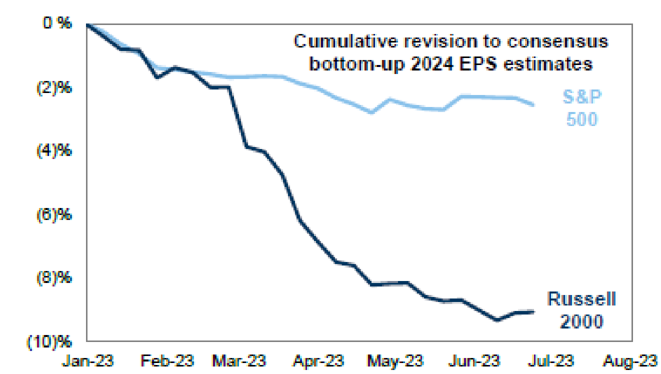
	Annual Return			3Y Returns Annualized			5Y Returns Annualized		
	Large	Mid	Small	Large	Mid	Small	Large	Mid	Small
CPI >3	8.5	10.2	10.4	9.0	11.4	11.6	10.3	12.7	13.0
CPI <3	16.1	17.5	19.0	13.7	14.2	14.9	12.0	12.6	13.1
CPI >3, Rising This Year	3.1	2.5	1.7	8.9	11.1	10.9	8.7	11.0	11.1
CPI >3, Declining This Year	**19.1**	**25.9**	**28.5**	**8.5**	**11.3**	**12.5**	**12.4**	**15.3**	**16.3**
CPI <3, Rising This Year	14.0	15.7	16.8	12.5	13.5	14.9	11.4	12.4	13.5
CPI <3, Declining This Year	17.7	18.8	20.7	14.6	14.7	14.8	12.5	12.7	12.7
Overall	**12.7**	**14.3**	**15.2**	**11.6**	**12.9**	**13.4**	**11.2**	**12.6**	**13.0**

Source: FactSet; FTSE Russell; Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

That being said, we believe the upcoming earnings season could challenge the market's upward trajectory and that stock selection will be key to navigating these choppy waters. We see several pressures that have the potential to hamper 2023 results and the outlook for 2024 including lower demand, higher interest rates, and less of a benefit from pricing. This quarter will likely mark the third quarter in a row of negative year-over-year earnings growth. As has been the case in the past, the market has moved quickly to revise down small and mid-cap companies' estimates ahead of large cap stocks (see charts below). As we have experienced in past cycles, stocks tend to rally before the trough in earnings, so you need to be invested prior to the turn. In addition, history shows us that coming out of an economic slowdown, the small and mid-caps stocks tend to lead the market.



Source: FactSet, Goldman Sachs Global Investment Research



Source: FactSet, Goldman Sachs Global Investment Research

We believe an acceleration in merger and acquisition (M&A) activity could be another catalyst for small and mid-caps stocks. We are beginning to witness green shoots in M&A after a period of subdued activity. In addition, private equity firms have $3.5 trillion of dry powder today and strategic buyers have excess cash on their balance sheet to pursue targets. With improved CEO confidence, narrowing of bid/ask spreads, and tightening credit spreads, the tenets of M&A are looking favorable. We also believe the increased scrutiny from the Federal Trade Commission regarding large cap M&A and the new tax on share buybacks makes small and mid-caps an attractive target for large cap companies looking to grow earnings and deploy their excess capital in a slow growth environment. As we have seen in the past, M&A typically has a 2-3 year downcycle and 5-7 year upcycle and we appear to be on the start of a new upturn.

Despite the underperformance of small vs. large and value vs. growth in 2023, we see multiple long-term drivers for small and mid-cap value stocks. This group, which tends to be more domestically oriented, should benefit from the re-shoring and near shoring of supply chains. Recent legislation (the Infrastructure Investment and

Jobs Act, the CHIPS and Science Act, and the Inflation Reduction Act) are expected to spur cap-ex spending in the U.S., which should provide a multi-year growth tail wind, which we believe will disproportionately benefit small cap stocks. We believe the market is underappreciating these tailwinds with the group trading at a historic discount to large cap growth stocks. As such, we see small and mid-caps as extremely neglected today. We remain focused on companies that have self-help opportunities, healthy balance sheets, and strong market shares that can weather different inflationary and economic environments. We expect stock selection to be a key differentiator as monetary and fiscal accommodation is reduced. Despite the current crosscurrents, we believe this is an attractive market for nimble and disciplined active managers.