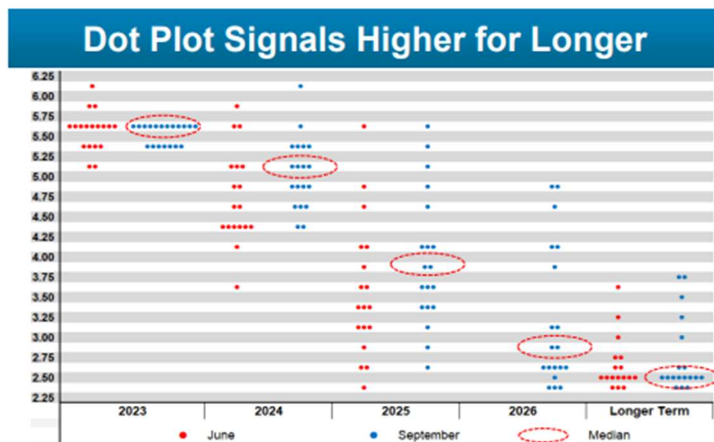
Cramer Rosenthal McGlynn

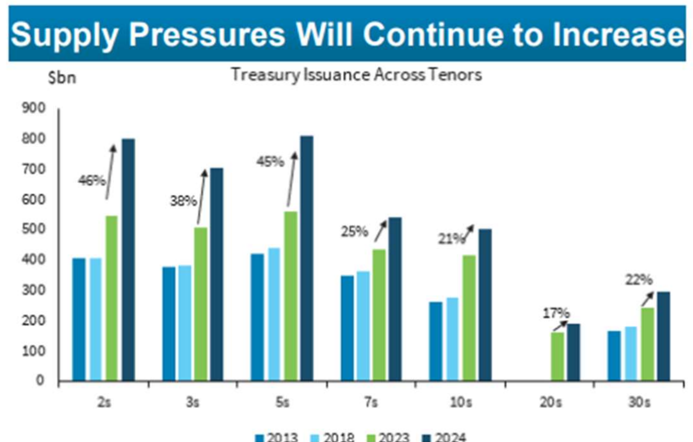
3Q 2023 – Market Commentary

The rally in the magnificent seven stocks, investor frenzy surrounding disruptive products such as Artificial Intelligence and GLP-1 drugs, and geopolitical pressures has propelled large cap growth stocks to trade at an extreme premium to small to mid-cap value stocks. As we have witnessed many times in the past, the headwinds to small and mid-cap value stocks eventually turn to tailwinds, but the timing is challenging to predict. We do know that when you stretch a rubber band this much, it ultimately snaps back. We can appreciate the cautious asset allocations the current market environment has favored, but we believe small and mid-cap value stocks better reflect the current outlook for slower economic growth, higher interest rates, and geopolitical pressures than large cap growth stocks. We remain focused on relative value companies that have self-help opportunities, healthy balance sheets, and strong market shares that can weather different inflationary and economic environments. Inevitably, we expect small and mid-cap value stocks' extreme neglect today will reverse in future periods as the market better appreciates their long-term growth drivers as well as their acute valuation discount.

The Federal Reserve again had a meaningful impact on the market this quarter. The pause in interest rate hikes this quarter did not spur the rally investors had hoped for. Rather, the Federal Reserve's declaration of "high for longer" caused long-end interest rates to spike, which led to a sell-off in the market. From June 30, 2023 to September 30, 2023, the 10-year Treasury yield increased from 3.83% to 4.57% (ultimately, peaking at 4.80% on Oct 6, 2023 – a 16 year high for yields). The rise in long-end rates was also driven by the continued resilience in the jobs markets with the August JOLTs survey (Job Openings and Labor Turnover Survey) showing higher than expected new job openings and the September payroll report posting new job growth well above expectations (the September payroll report also included a meaningful positive revision to prior months' new jobs). Lastly, we can't discount the impact higher Treasury issuance had on the bond market. The U.S. Treasury new issuance supply is spiking in 2023 and 2024 (see graph below) at the same time banks and other traditional Treasury buyers are pulling back from new purchases.



Source: Bloomberg, Fed SEP, Barclays Research



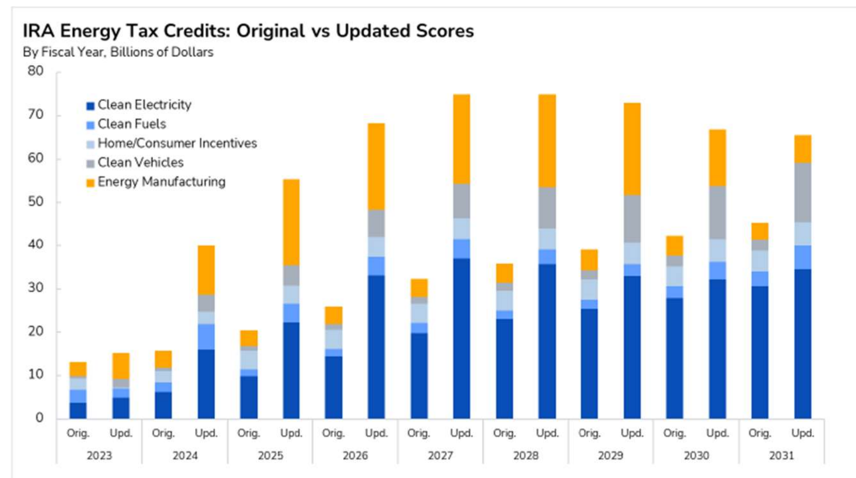
Source: Bloomberg, Haver Analytics, Barclays Research

Another sign of tightness in the labor market has been the increased number of unions striking this year. Union membership has been on the decline since the 1980s. According to the Bureau of Labor Statistics, union membership was 10.1% of the total U.S. wage and salary workers, down from over 20.1% in 1983 when there were 17.7 million employed, waged, and salaried workers in unions. However, 2023 could go down as the biggest year for labor activity in nearly four decades if the United Auto Workers (UAW) expand their work stoppage to their 150,000 members. According to data compiled by Cornell University School of Industrial and Labor Relations, 362,000 workers have gone on strike so far in 2023 compared to only 36,600 in 2021. We

expect the labor wins by the airline, transportation, and other unions will put pressure on wage inflation for years to come, which should be supportive to higher interest rates and value stocks.

The “long and variable lags” of the Federal Reserve rate hikes also appear to be dampening consumer spending. The housing market has experienced a significant slowdown, with only 1% of all U.S. homes changing hands in the first half of 2023 according to Redfin. A more typical housing turnover rate is 2%, and a more robust market is closer to 4-5%. The current 30-year fixed rate mortgage is nearing 8%, which has created “golden handcuffs” on many existing homeowners who are enjoying their in-place mortgages which, on average, are in the low 3% range. This tax on the consumer is evident in other lending products with home equity lines of credit rates around 9%, used car loans rates are in the mid-teens, and credit card loan rates are north of 20%. This is causing sticker shock for consumers, particularly for large ticket purchases. In addition to this rate pressure, student loan repayments restarted for nearly 40 million Americans in October, many of whom have not made payments in nearly three years since the moratorium was instituted. We expect the pressure from higher rates and the restart of student loan payments will stunt the benefits from the robust job market and the growth in real wages.

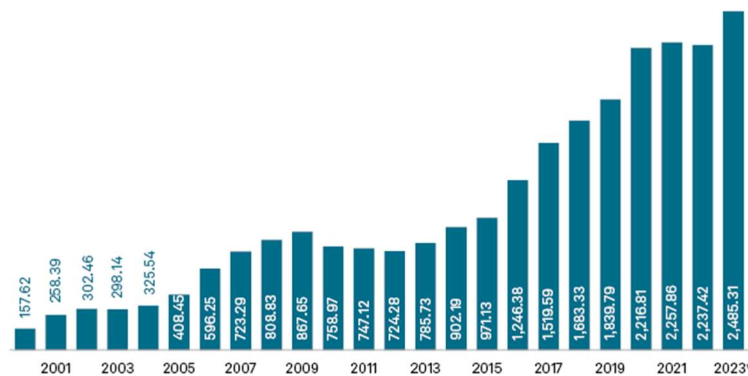
Washington continues to be both a tailwind as well as a headwind for the markets. The U.S. passed some of the largest stimulus bills in our nation’s history in the past two years. The Infrastructure Investment and Jobs Act (IIJA), the CHIPS and Science Act, and the Inflation Reduction Act (IRA) should provide a multi-year growth tailwind and spur capital expenditure spending in the U.S. as efforts are made to re-shore and near shore our critical supply chains. We are highly constructive on the benefits these programs should have on small and mid-cap value stocks - the “picks and shovels” companies - which tend to be more domestically oriented. Interestingly, despite our bullish outlook on these bills, we may be underestimating their impact. As an example, the IRA tax credits for clean energy are uncapped, in certain cases, and their potential impact continues to be revised higher (see graph below). While the funds from these bills are highly supportive to economic growth, the dysfunction that is Washington could still derail the market. We may be facing another disruptive government shutdown in mid-November as Congress only agreed to a 45 day Continuing Resolution on September 30th. In addition, the House of Representatives ousted the Speaker of the House for the first time in U.S. history. We can only hope that cooler heads will prevail and Congress can resolve their issues and start governing again. The good news is that we have a Presidential election coming up next year, which should get government officials focused on what seems to be their most important job, which is getting re-elected.



Source: Wolfe Research US Policy, CBO, JCT

Despite the ups and downs of the capital markets this quarter, we remain constructive long-term on an improvement in merger and acquisition (M&A) activity. According to Dealogic, M&A activity is down by over 50% from its recent peak, which is consistent with prior peak to trough declines of nearly 60%. As we have seen in the past, M&A typically has a 2-3 year downcycle and 5-7 year upcycle. In addition, private equity firms have $2.5 trillion of dry powder today (see graph below) and strategic buyers have excess cash on their balance sheets to pursue targets. Despite the choppy markets today, the building blocks for a robust recovery in M&A can come together quickly. 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.

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



Data compiled July 3, 2023.
* As of July 3, 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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The market pull-back this quarter was due, in part, to concerns about higher interest rates for longer, slower, economic growth inside and outside the U.S., geopolitical pressures, and the uncertainty about a budget deal in Washington. The Federal Reserve's promulgation to keep interest rates higher for longer and the potential slowdown in U.S. consumer spending and economic growth keeps us balanced in our portfolio positioning. The S&P 500 index has rallied 13% year to date through September 30, 2023, but that belies the fact that the equal-weighted S&P 500 index is nearly flat for the year, which is more consistent with the performance of the small and mid-cap value indices. We still view small and mid-cap stocks as attractively valued and well positioned for the potential benefits from the reshoring and near-shoring of supply chains as well as recent legislation (the Infrastructure Investment and Jobs Act, the CHIPS and Science Act, and the Inflation Reduction Act) that should spur cap-ex spending in the U.S. As such, we see small and mid-caps as extremely neglected today. However, we also know the Federal Reserve tightening actions work with long and variable lags. 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. Lastly, we also see a long-term opportunity in the highly neglected, attractively priced small and mid-cap value stocks, which are coiled for a meaningful revaluation compared to large cap growth stocks.