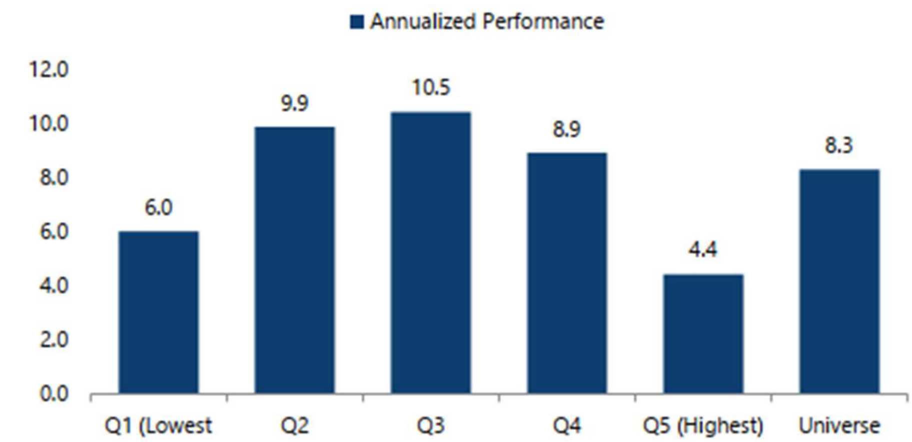
3Q25 Market Commentary

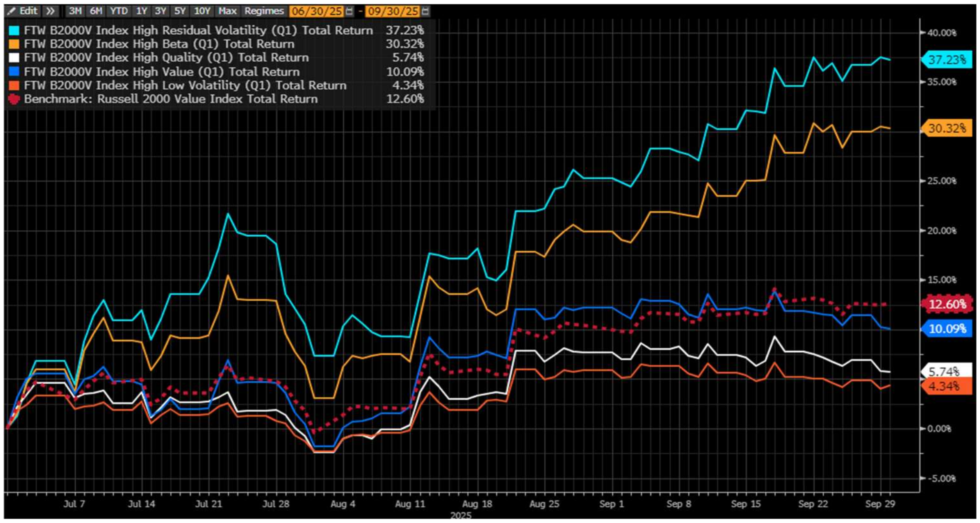
The market rally continued this quarter with smaller cap stocks outperforming larger cap stocks. As we discussed last quarter, the signing of the One Big Beautiful Bill (OBBB) on July 4th ushered in President Trump's pro-growth agenda. That was coupled with a pivot by Chair Powell at the Federal Reserve's Jackson Hole conference in August towards a more dovish stance given the recent weakening in payroll data was enough to propel the market higher. We witnessed other important economic and political developments during the quarter, but the real story underlying the market in 3Q25 was the rally in high beta, non-earners. This is a group of stocks active managers are typically meaningfully underweight given their poor long-term historical performance (see chart below). We have experienced bouts of high beta stock rallies in the past following bear markets, but the speed and magnitude of this move was nearly unprecedented, particularly without experiencing a recession first. It has been a tough environment for active managers, as, according to Jeffries, only 22% of active U.S. equity managers and only 12% of active U.S. small cap equity managers are ahead of their benchmarks year-to-date through September 30th. While we and our active management peers are not happy with our performance relative to our benchmarks this quarter or this year, we know that these rallies by high beta, non-earners have historically not lasted long, and active managers typically produce strong alpha over the ensuing 12 months. In addition, we expect faster GDP growth in 2026, lower interest rates, an eventual easing of inflation, additional domestic manufacturing expansion, and lower taxes will provide a strong tailwind to earnings growth for small and mid-cap companies and allow for the market to broaden out.

The highest beta and lowest are laggards over time



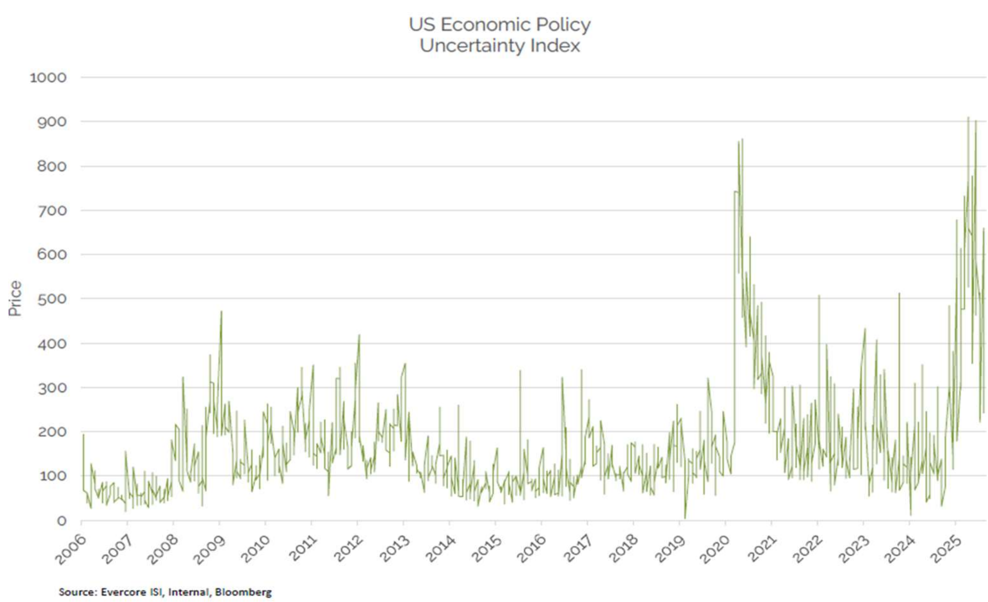
Note: Annualized performance since December 31, 1989 and through September 9/15/2025.
Source: FactSet; FTSE Russell; Jefferies

The Residual Volatility and Beta factors dramatically outperformed this quarter

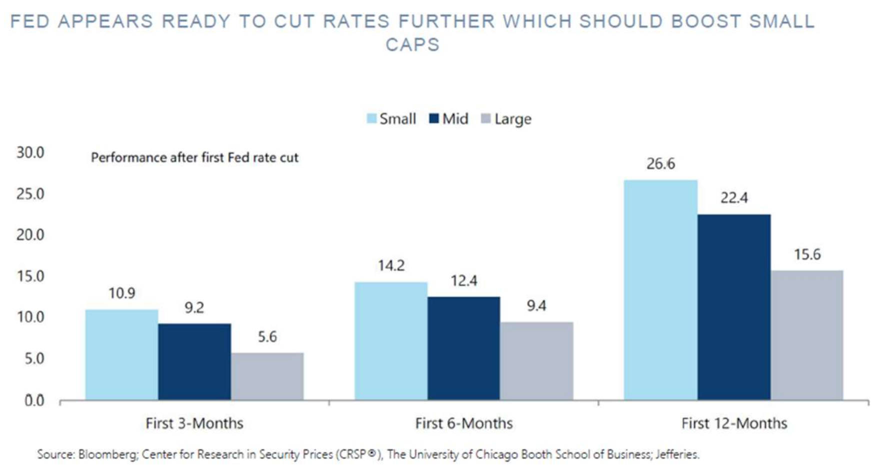


Source: Bloomberg

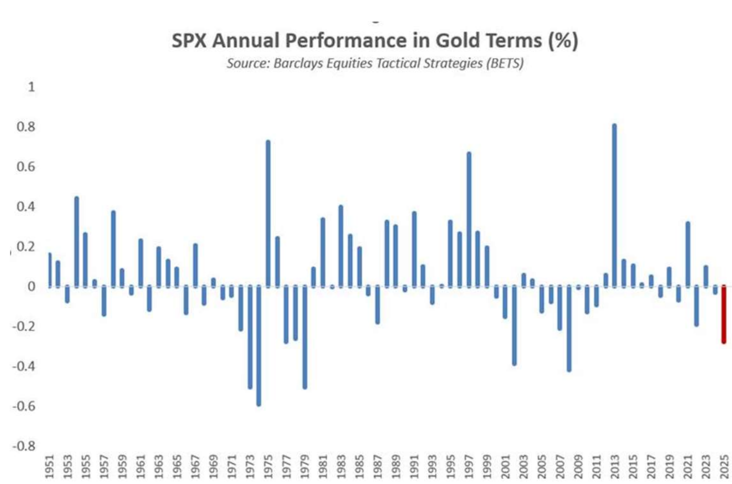
While the peak U.S. economic uncertainty following Liberation Day has passed, we are still at an elevated level relative to recent history. U.S. and China have still not come to a trading agreement and negotiations have just kicked off for the USMCA (United States-Mexico-Canada Agreement). In addition, the Supreme Court will hear arguments on the legality of President Trump's Liberation Day Tariffs under IEEPA (International Emergency Economic Powers Act) on November 5th, which could create a new round of uncertainty for the market. The administration has opened several Section 232 investigations on key critical goods, which could replace the IEEPA tariffs if the Supreme Court determines the President has overstepped his authority. Either way, the capital markets appear to believe the worst is behind us. As a result, we have witnessed a rebound in both equity and debt capital market issuance and merger and acquisition activity, which are positive developments for the U.S. economy as well as U.S. companies. That being said, we will likely have to manage through additional tariff headlines over the short to medium term.



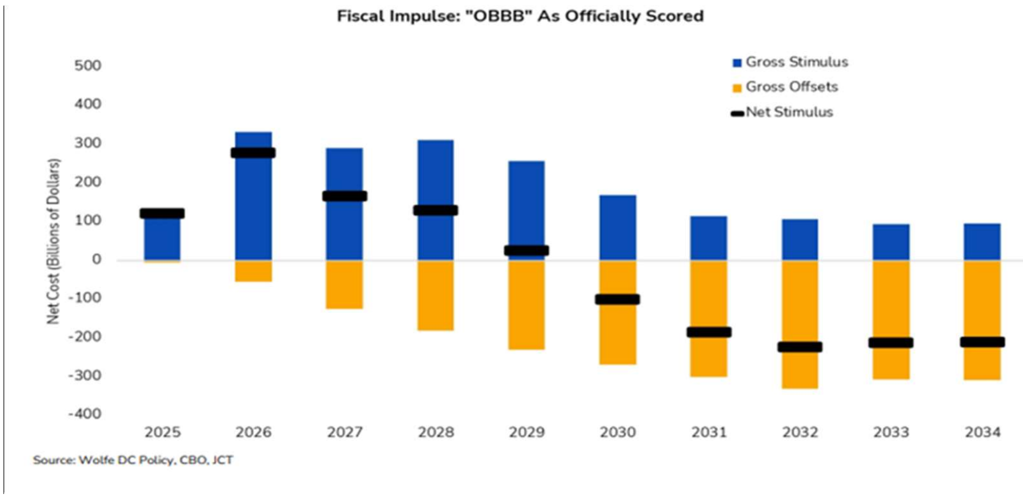
As noted above, Chair Powell and the FOMC (Federal Open Market Committee) made an important pivot this quarter. After much debate during most of 2025 that the Fed's dual mandate of maximum employment and price stability were in conflict given the rise in inflation and the weakening of payrolls, the recent further weakening of employment data pushed the Fed to re-start its easing campaign and cut Fed Funds by 25 basis points at its September 17th meeting. The Fed Funds future market is pricing in two additional 25 basis point cuts this year and three more 25 basis point cuts in 2026. This should put the Fed Funds rate slightly below 3% by the end of 2026. This would be a highly supportive interest rate environment for small and mid-cap companies, which tend to have a higher percentage of variable rate and shorter duration debt compared to their larger cap brethren. History has shown us that small and mid-cap stocks tend to outperform large cap stocks during an interest rate easing cycle (see chart below).



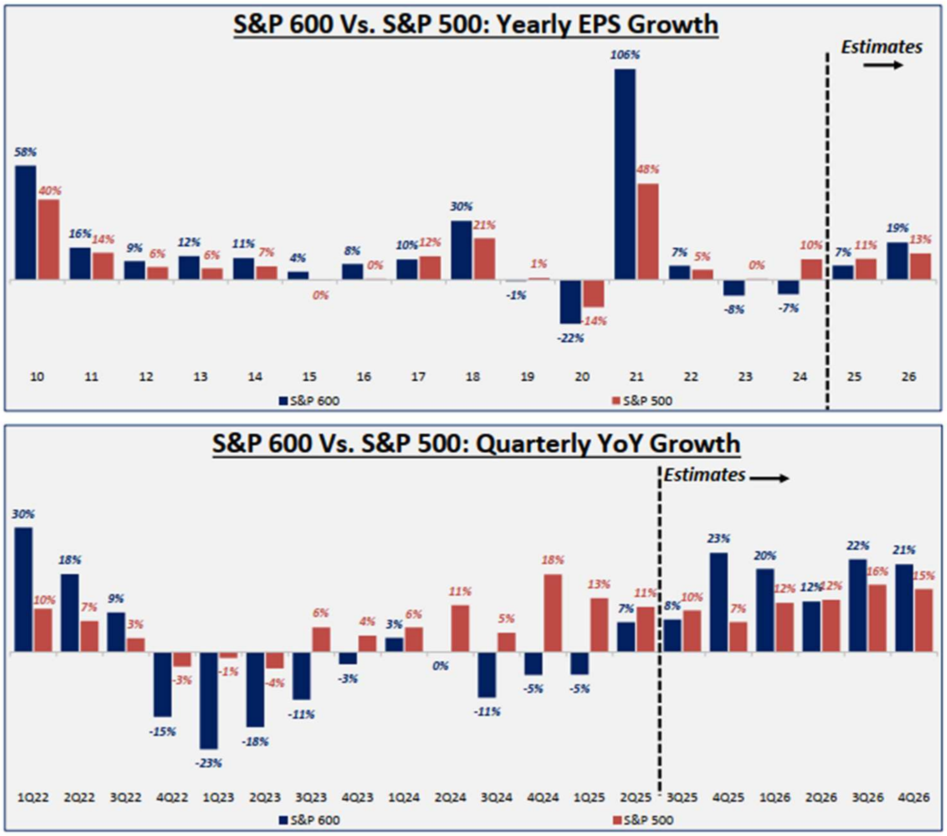
While lower interest rates are generally supportive of the U.S. economy, some market participants believe the Federal Reserve is devaluing the U.S. dollar and the elevated level of fiscal spending is making the deficit untenable. This combination of lower interest rates and rising deficits has some questioning the U.S. dollar's position as the dominate fiat currency. While we tend not to comment on commodities in these market commentaries, the rally in gold prices this year is difficult not to point out. We will not opine on the value of gold today, but we find the following chart instructive to those questioning the rally in stocks' prices as heady. As Barclays points out, the S&P 500 Index is having its worst relative performance compared to gold since 2008 (see chart below). We'll leave the reader to decide which asset class is overvalued today.



Notwithstanding concerns over fiat currencies and deficits, we believe President Trump's goal to bring back manufacturing of critical goods to the U.S. will be highly supportive for small and mid-cap companies, which are the "picks and shovels" of the U.S. economy. While tariffs have been disruptive in the short-term, they could be long-term drivers of domestic economic expansion. In addition, the OBBB reconciliation bill, which includes tax incentives for capex here in the U.S., could drive an additional 100 basis points of domestic GDP growth next year (see chart below).

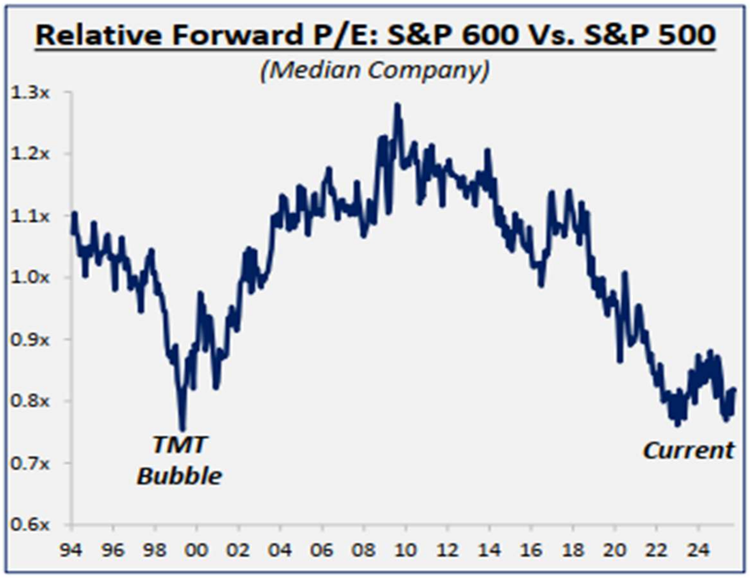


Despite near-term concerns about the recent government shutdown, the real test for President Trump and the Republicans will be the mid-term elections. With less than thirteen months to go, U.S. voters will need to see an improvement in the employment picture and a lessening of inflationary pressure from tariffs. The bottom line for Republicans is the U.S. economy needs to grow faster and broaden out. We expect the administration to push harder on its pro-growth agenda the closer we get to mid-term elections; we believe that is a recipe for better alpha from active management and small and mid-cap stocks. As we discussed last quarter, small and mid-cap companies have been in an earnings recession since 2022. Over the past three years, small and mid-cap companies have absorbed the highest inflation rate and the fastest and steepest Fed tightening since the early 1980s. This year, the group was hindered by the announcement of the largest tariff rate in nearly 100 years on Liberation Day. Going forward, we expect faster GDP growth, lower interest rates, the eventual easing of inflation, additional domestic manufacturing, and lower taxes will provide a strong tailwind to earnings growth for small and mid-cap companies after a 3-year hurricane of headwinds. This earnings acceleration should provide a supportive catalyst for the group.



Sources: Wolfe Research Portfolio Strategy, Standard & Poor's, Bloomberg, and FactSet. Bottom-up consensus estimates.

We remain highly constructive on small and mid-cap stocks from a fundamental and technical perspective. While the new tariff policies by the Trump administration have increased "uncertainty" over the short term, 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 chains, which should accelerate domestic economic growth. We also expect a recovery in M&A activity will be supportive of small and mid-cap stocks. Despite the recent rally in high beta, non-earners, we continue to construct our portfolios with stocks that have pricing power, healthy balance sheets, and areas of self-help that have historically generated higher alpha over market cycles. While uncertainty clouds the short-term outlook, we believe this provides an opportunity to invest in down-cap strategies given the inherent higher future potential returns. The asset class is so neglected at this point, that any sustained rally should see significant momentum in flows from investors who will scramble to reposition their portfolios back into the space, which should in turn provide an additional tailwind to small and mid cap stock prices.



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