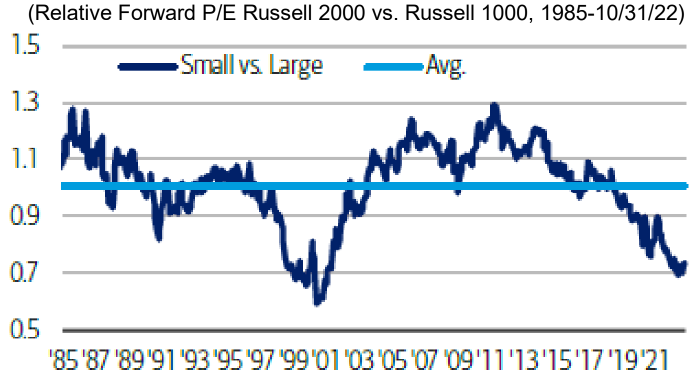
4Q 2022 – Market Commentary

2022 was one of the worst years for the market over the last few decades. The market also ended on a weak note, selling-off in December after staging a rally earlier in the quarter. Last year was a normalization period for the market as fiscal and monetary accommodation was being removed from the system. Interestingly, the market correction was mainly driven by P/E multiple compression as the discount rate normalized due to the dramatic rise in interest rates. We still expect earnings to be reset lower for the market as demand normalizes and margins are pressured. This is the unpleasant part of a normal market cycle. But, as history has shown us, these market inflections tend to lead to regime changes and new leadership in the market. We see multiple reasons to be bullish on small to mid-cap stocks over the next few years which, by the way, is a part of the market that's woefully underinvested versus history. This is an exciting time to be an active manager down cap.

Small caps trading at extreme discount vs large caps only ever seen once before during the Tech Bubble

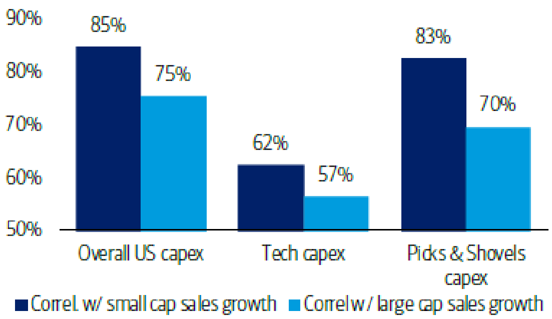
(Relative Forward P/E Russell 2000 vs. Russell 1000, 1985-10/31/22)



Source: BofA US Equity & Quant Strategy, Russell Investment Group, I/B/E/S, Compustat

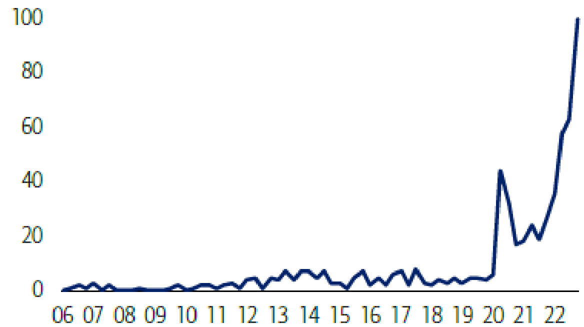
We see multiple vectors of demand drivers for domestic small to mid-cap stocks. After enduring tariff wars between the U.S. and China, a global pandemic, and Russia's war against Ukraine, CEOs are being forced to rethink their global supply chains. Just-in-time manufacturing is being replaced with safety stock and re-shoring or near-shoring efforts. More focus is being placed on certainty of production and delivery than the lowest cost available. We believe this is a long-term positive for domestic oriented businesses. In addition, the U.S. government has also woken up to the fact they need to work in partnership with businesses to ensure the availability of strategically important products. Over the past 18 months, Congress has passed several important pieces of legislation to support this effort including the $1 trillion Infrastructure Investment and Jobs Act, the CHIPS and Science Act ($52 billion for domestic semiconductor manufacturing), and $740 billion Inflation Reduction Act ($369 billion allocated to clean energy funding). These bills should spur cap ex spending in the U.S., which will provide a multi-year growth tail wind for domestic oriented businesses, which we believe will disproportionately benefit small and mid-cap stocks.

Small caps are particularly correlated with "Picks & Shovels" capex
US qrtly YoY capex growth vs. Russell 2000 YoY sales growth 1986-3Q22



Source: FactSet, Haver Analytics, BofA US Equity & US Quant Strategy

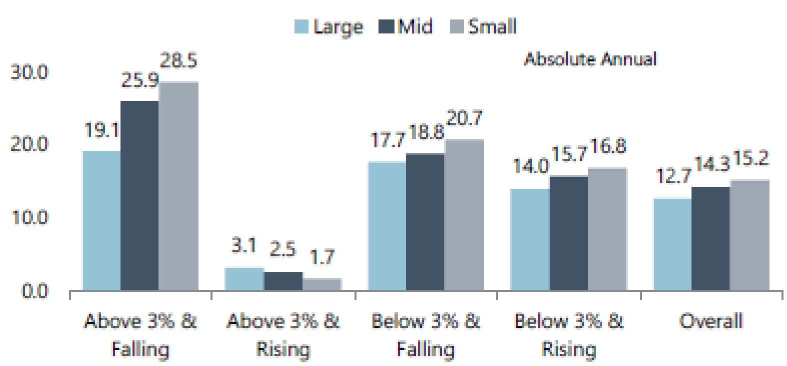
Mentions of re-shoring on earnings calls have skyrocketed
Companies mentions of re/near/on-shoring (100=max; 2006-11/04/22)



Source: AlphaSense, BofA Global Research

Inflation, although moderating from near term peak levels, remained higher than expected in 2022, which is highly constructive for small and mid-cap stocks. Goods inflation has led the recent declines in overall inflation as supply chains have been normalizing and consumer demand has shifted from goods to services. We still expect services inflation, the largest component of overall inflation, to remain sticky on the way down due to the robust labor market. Although recent indicators have pointed to a modest reduction in the labor costs (i.e., slower growth in December's Average Hourly Earnings), the pandemic has likely resulted in a change in the percentage of profits shared with employees. The lack of labor availability due to health issues or immigration changes will likely slow the rebalancing necessary to return labor cost growth to a level more consistent with 2% inflation. We can debate the length of time to achieve labor market equilibrium, but history tells us when inflation is above 3% but falling, this is a highly attractive market for small and mid-cap stocks.

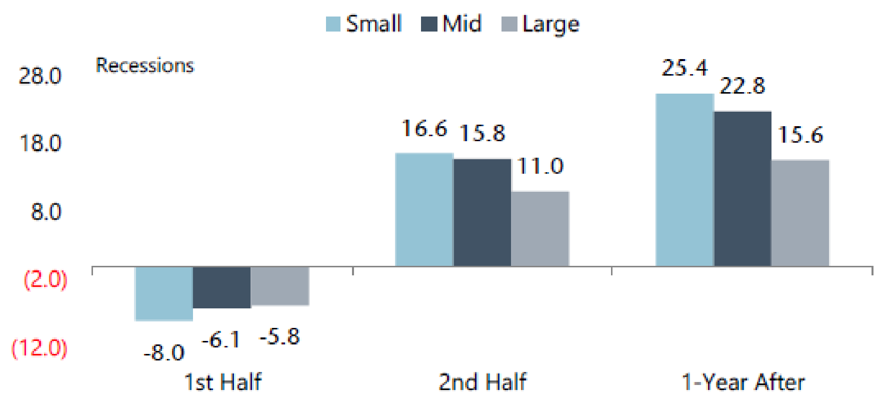
2023 could be the best inflation environment for small and mid-cap stocks (Inflation above 3% but falling)



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

The negative earnings revision cycle has begun. There are several pressures that will drive 2023 results downward including lower demand, higher interest rates, and less of a benefit from pricing. Since the second of half of 2022, small and mid-cap stocks have witnessed a sharper negative estimate revision cycle compared to large caps. Excluding the outsized energy sector contribution, the market now expects small and mid- caps' estimates for 2023 to be flat to down while consensus still believe large cap stocks will generate positive earnings growth. As has been the case in the past, the market moves more quickly to revise small and mid-cap companies' estimates compared to their larger cap brethren. As we have experienced in past cycles, stocks tend to rally before the trough in earnings, so the investor seeking outsized returns needs to be invested prior to the turn. In addition, history again shows us, that coming out of an economic slowdown, the small and mid-caps stocks lead the market.

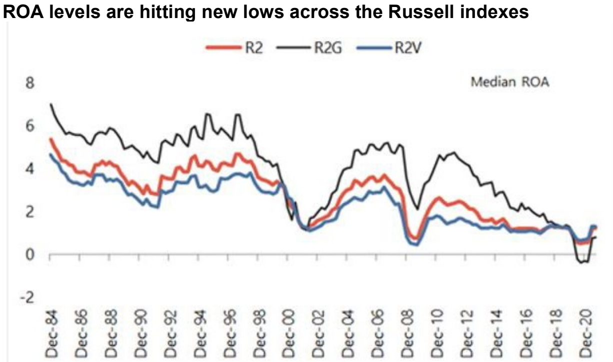
Coming out of a recession, small and mid- caps lead the market



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

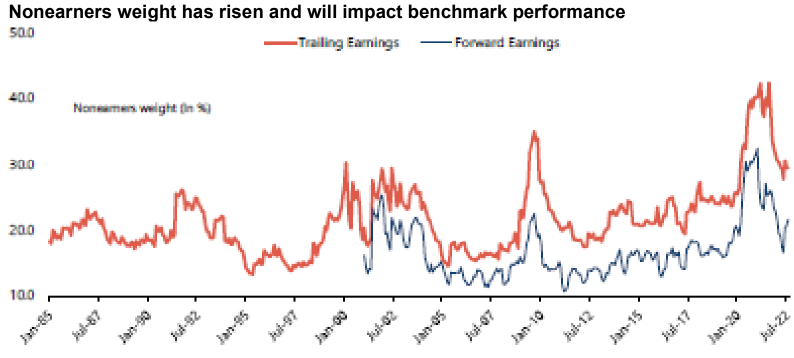
At the same time, we continue to caution against relying on passive strategies to gain exposure to small and mid-cap stocks. As we have discussed in the past, the quality of market indices has declined dramatically over the past few years as newly formed SPACs, meme stocks, and non-profitable/non-revenue companies have become a greater percentage of the market. This creates an increasingly attractive market opportunity for nimble, active managers.

ROA levels are hitting new lows across the Russell indexes



Source: FactSet; FTSE Russell; Jefferies

Nonearners weight has risen and will impact benchmark performance



Source: FactSet; FTSE Russell; Jefferies

This was the third worst year for the Russell 2000 Value and the fourth worst year for the Russell Mid Cap Value index since 1979. Historically, small and mid-cap stocks tend to rally in the subsequent year after large downturns. The market sell-off has uncovered tremendous value for patient long-term investors. We believe investors should favor relative value, actively managed strategies with portfolios constructed with companies that have healthy balance sheets and growing market shares. We believe the small and mid-cap stocks have been more severely impacted during this sell-off and are extremely neglected today. This group, which tends to be more domestically oriented, should benefit from the re-shoring and near-shoring of supply chains that have failed many companies over the past few years.   We also note that historically the best backdrop for small and mid-cap stocks tends to be when inflation is above 3% and declining, which appears to be the environment we are headed into. In sum, this appears to be a very attractive market for nimble, active managers in the small and mid cap value space.