Cramer Rosenthal McGlynn

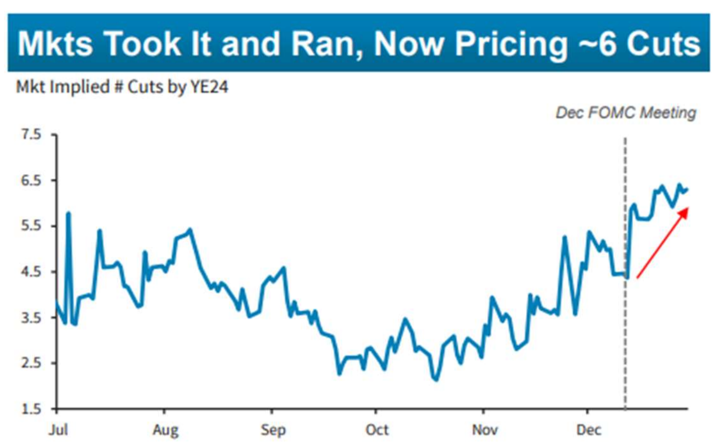
4Q 2023 – Market Commentary

The fourth quarter of 2023 was highlighted by the Federal Reserve's pivot "heard 'round the world". For most of the year, the Federal Reserve viewed the risk as skewed towards not raising rates enough to sustainably cool inflation versus over-tightening and sending the economy into a downturn as the labor market remained healthy despite the rapid rise in interest rates. That all changed at the December Federal Reserve Open Market Committee (FOMC) meeting, when Chair Powell indicated that policymakers were turning their focus to cutting rates as inflation continued to move towards their goal of 2%. This pivot released the market's animal spirits and led to the best December performance for the Russell 2000, and the 12th best fourth quarter return since 1979. As we have witnessed in previous macro-driven rallies, we expect the market to focus more on stock selection in 2024 as the ETF and factor model purchases of 4Q23 subside and micro stories gain in prominence. We were encouraged to see the rally in down cap stocks at the end of year and expect lower interest rates and lower inflation to be highly conducive to this trend continuing. As we have mentioned in the past, market leadership tends to change at macro inflection points. We expect small and mid-cap value stocks' extreme neglect today will continue to reverse as the market better appreciates their long-term growth drivers as well as their acute valuation discount.

What a difference a year makes. A year ago, economists had forecasted GDP to grow 0.3% in 2023 and there was an estimated 70% chance of recession over the next 12 months. In addition, economists had forecasted the unemployment rate to rise to 4.4% in 2023. Fast forward to today, GDP is now expected to grow 2.4% for 2023 and the unemployment rate in 2023 is likely to be flat to 2022 at 3.6%. Despite the banking crisis in March 2023, and then the expectation that the Federal Reserve would keep interest rates higher for longer, the 10-year Treasury yield ended the year flat with 2022 (see table below). Another positive development for the capital markets and the economy this past year was the dramatic narrowing of credit spreads, which finished at their narrowest spreads of the year. Lastly, the market is now pricing in six rate cuts in 2024 following the pivot by the Federal Reserve in late 2023. We will pass on opining on the market rate forecast, other than to say a lower rate environment has historically been highly beneficial to small and mid-cap stocks given their shorter duration liability structure and their high leverage profile to large cap companies.

	29-Dec	Δ Week	Δ Dec	Δ 2023
US Inv Grade	99 bp	-1 bp	-5 bp	-31 bp
US High Yield Px	$93.07	$0.24	$2.94	$6.85
US High Yield OAS	323 bp	-1 bp	-47 bp	-146 bp
US Lev. Loans	$96.21	$0.08	$0.92	$3.77
CDX.IG	57 bp	1 bp	-6 bp	-25 bp
Itraxx Main	58 bp	-1 bp	-10 bp	-33 bp
CDX.HY Px	$105.83	$0.02	$1.93	$5.21
CDX.HY Spread	356 bp	-1 bp	-46 bp	-128 bp
Itraxx Crossover	310 bp	-6 bp	-63 bp	-163 bp
CDX.EM	$97.07	($0.03)	$0.84	$2.91
10yr Treasury	3.88%	-2 bp	-45 bp	0 bp
5yr Treasury	3.85%	-2 bp	-42 bp	-16 bp
2yr Treasury	4.25%	-7 bp	-43 bp	-18 bp
S&P 500	4770	0.3%	4.4%	24.2%
Euro Stoxx 600	479	0.3%	3.8%	12.7%
Dollar Exchange Rate Index	101.33	-0.4%	-2.1%	-2.1%
WTI Crude Oil	71.65	-2.6%	-5.7%	-10.7%
Gold Spot	2063	0.5%	1.3%	13.1%
VIX Index	12.5	-0.6	-0.5	-9.2

Source: S&P LSTA, Bloomberg, Barclays Research

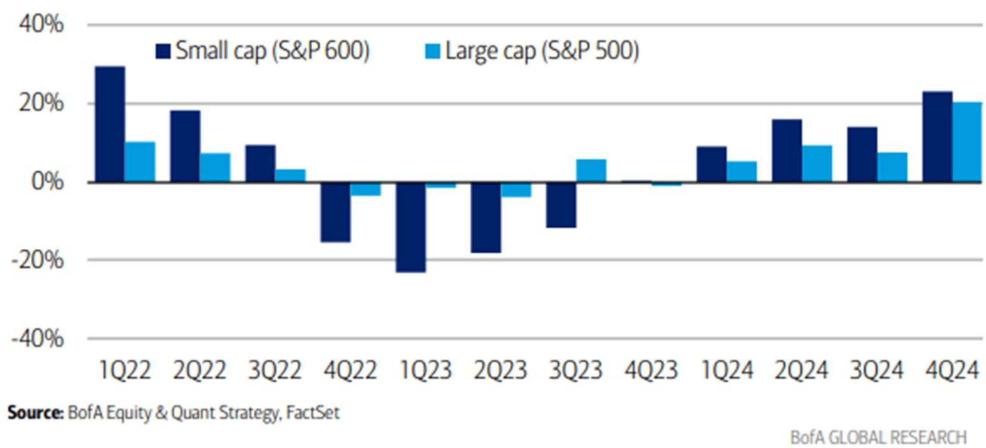


Source: Bloomberg and Barclays Research

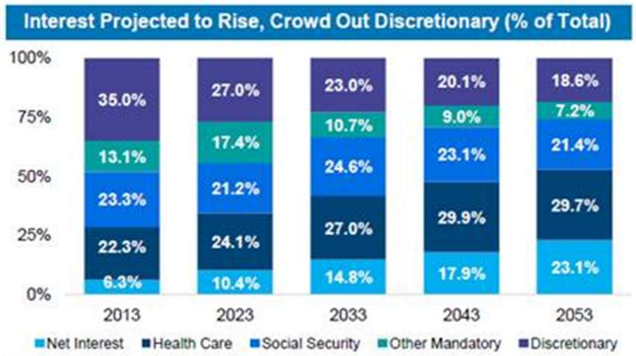
The economists that predicted a recession in 2023 should have said an earnings recession instead of economic recession because that is what we had. As we see from the graph below, the S&P 500 had three consecutive quarters of negative earnings growth, while small caps experienced four consecutive quarters of negative earnings growth starting in the fourth quarter of 2022. Small and mid-cap companies' earnings were more impacted by the inflationary pressures and rise in interest rates than large cap companies. As such, we believe small and mid-cap companies should also have the strongest earnings recovery in 2024. Down cap companies should benefit from easier comparisons, lower interest rates, and a lessening of inflationary pressure this year. As we have seen in previous cycles, the market also reduced earnings expectations for small and mid-caps companies more than large cap companies, due to concerns over macro pressures, which should provide an easier bar for them to clear in 2024.

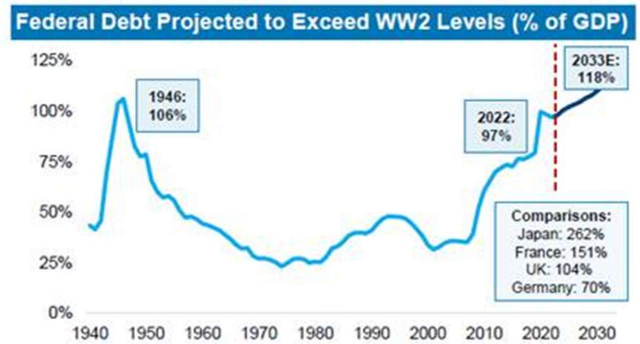
Small caps expected to see better earnings growth than large caps from 4Q23-4Q24

Quarterly y/y bottom up EPS growth trajectory for S&P 600 vs S&P 500 (Consensus estimates 3Q23 onward)



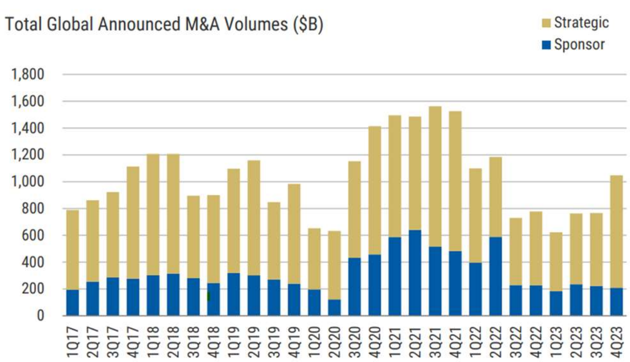
Washington will again be a wildcard for the markets in 2024. On one hand, the Infrastructure Investment and Jobs Act (IIJA), the CHIPS and Science Act, and the Inflation Reduction Act (IRA) should provide a multi-year growth tailwind and spur capital expenditure spending in the U.S., as efforts are made to re-shore and near shore our critical supply chains. We are highly constructive on the benefits these programs will have on small and mid-cap value stocks, more often the "picks and shovels" companies, which tend to be more domestically oriented. On the other hand, Congress has become more dysfunctional this year and has struggled to keep the government open and even pass a budget given the slim majority the Republicans have in the House of Representatives. To top it all off, we have a tight Presidential election later this year, which will distract politicians and have the markets questioning who will be running the government in the future. Will we have four more years of President Biden and the Democrats' agenda or a second term for former President Trump with a focus on tax cuts, tariffs, and border security? Either winner will have to address the rising deficit and federal debt burden the previous administrations saddled the country with.





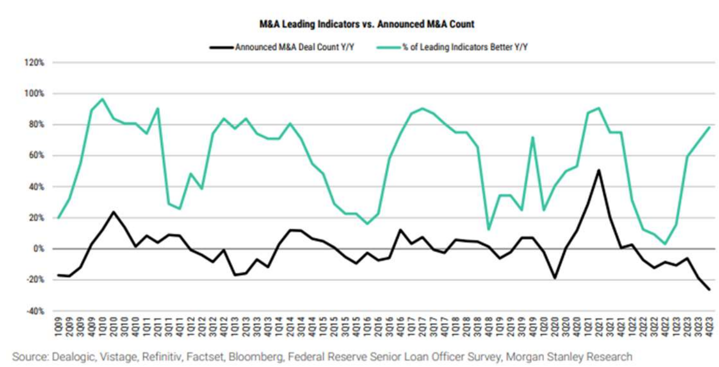
Source: CBO, Committee for a Responsible Federal Budget, IMF, Haver Analytics. Discretionary spending stems from budget authority provided in appropriation acts, Almost all defense spending is discretionary, and about 15% of COVID pandemic-related spending was discretionary. The Budget Control Act of 2011 established caps for FYs 2012-21; no caps were established for subsequent years. Mandatory spending primarily consists of Social Security, Medicare, and Medicaid and is not constrained by the annual appropriations process. Spending is generally determined by law, eligibility rules, and/or benefit formulas.

Despite the uncertainty a Presidential election creates for the markets, we are constructive on a recovery in merger and acquisition (M&A) activity, which historically has been highly supportive for small and mid-cap stocks. As we have seen in the past, M&A typically has a 2-3 year downcycle and 5-7 year upcycle. The market appears to be moving beyond the 50% decline we experienced in 2022 and 2023. As indicated below, Morgan Stanley's leading framework points to an acceleration in deal activity. We believe the building blocks for the next upcycle are firmly in place. We view the approximately $2.5 trillion of dry powder private equity has today and the excess capital on strategic buyers' balance sheet as highly constructive for an acceleration in deal activity. We also believe the increased scrutiny from the Federal Trade Commission regarding large cap M&A and the potential expiration of Trump era tax cuts in 2025 make 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.



Source: Dealogic, Morgan Stanley Research

Morgan Stanley's leading indicator framework (green line) points to an acceleration in deal activity (black line)



The rally that started in November accelerated in December as the Federal Reserve pivoted from its rate tightening campaign to discussing interest rate cuts in 2024. This led to a dramatic decline in market interest rates and more investors embracing the soft-landing narrative. Small and mid-caps outperformed large caps for the month of December and the fourth quarter of 2023 but still trailed for the full year. During the month of December, the 10-year Treasury yield declined from 4.33% to 3.88%, while the 2-year Treasury yield declined from 4.68% to 4.25%. With the softer inflation reports and the pivot by the Federal Reserve, the market is now pricing in six rate cuts by the December 2024 FOMC meeting, which is a stark contrast to the 2-3 implied cuts at the end of October. Despite the rally late in the year, small and mid-caps continue to trade at a significant discount to large cap stocks. We were encouraged to see market performance widen at the end of year. We believe small and mid-cap stocks remain well positioned for a recovery in earnings over the next couple of years.

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We believe small and mid-cap stocks are attractively valued on an absolute and relative basis, and have multiple levers of value creation over the next few years. We are also starting to see the green shoots of M&A resurface, which is typically a positive multi-year tailwind for the group. We continue to focus on stocks with pricing power, healthy balance sheets, and areas of self-help, which can propel small and mid-cap earnings in various interest rate and inflationary environments. Lastly, the Fed rate cuts, whenever they occur in 2024, should be a positive catalyst for small and mid-cap stocks, as we have seen in previous cycles.

Small caps have consistently outperformed after the first Fed cut – more rate sensitive than cyclical
Small caps' relative performance vs. large caps around the first Fed cut since 1926