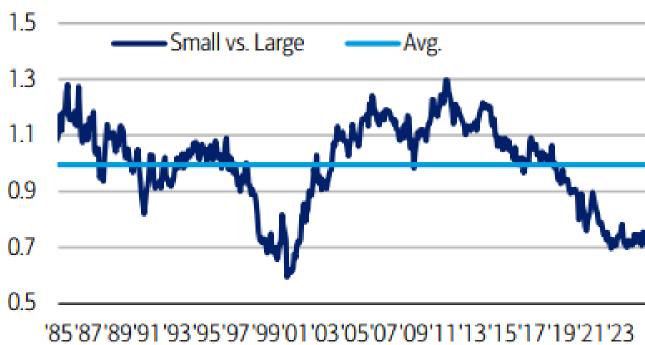
Cramer Rosenthal McGlynn

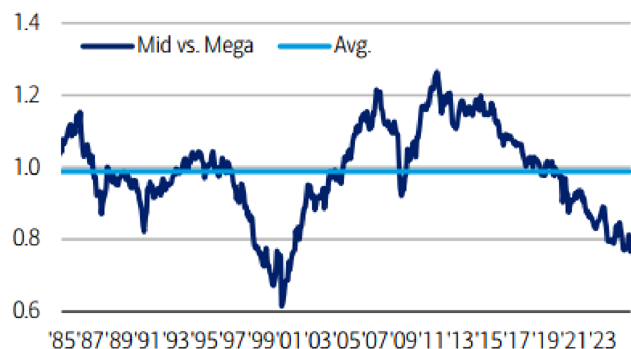
## 4Q 2024 – Market Commentary

The fourth quarter was highlighted by the Federal Reserve's first easing since the pandemic, over four years ago, as well as the "Red Wave" that ushered in the return of President Trump, a feat not accomplished since Grover Cleveland in 1892. As quickly as the capital markets cheered these watershed events, a hawkish outlook by the Fed at its December meeting, along with unsubstantiated inflationary concerns about President-elect Trump's potential policy changes to tariffs, taxes, and immigration, caused the bond market to sell-off. The 10-year Treasury yield rose from 4.15% in early December to nearly 4.80%, with some pundits expecting yields to reach 5% in short order. While the market's initial view of rapid rate cuts and further fiscal stimulus would have been highly beneficial to markets, particularly small and mid-cap value stocks, in the short term, that level of stimulus is not necessary in our current soft (no) landing outlook. Rather, it most likely would have resulted in unbridled risk taking and potential market over-exuberance, which we know is not a long-term sustainable formula. We believe a more measured approach to normalizing monetary policy, a smaller government, and less regulation are long-term tailwinds for the market. Coupled with the current macro backdrop of tight credit spreads, a steepening of the yield curve, normalizing inflation, and improving M&A activity, you have a constructive environment for investing in small and mid-cap value stocks. In addition, we believe the market is coming to the realization that this is not Trump 1.0 again where all cyclical stocks go up. Rather, we believe stock selection will be critical, as we don't expect interest rates to return to zero any time soon, and bond vigilantes will curtail excessive government spending. As has been the case over our 50-year history, we continue to believe investing in companies that fit within the center of the Venn diagram of change, neglect, and value that have strong management teams who can effectively improve the returns of their businesses will drive compelling long-term returns over this and future cycles. We also believe that investing in the pond of small and mid-cap stocks today provides the opportunity to generate inherently higher future potential returns as this part of the market trades at an extraordinary valuation discount to large cap stocks (see charts below).

**Small caps remain historically cheap vs. large cap**
Relative Forward P/E: Russell 2000 vs Russell 1000, 1985-12/31/2024



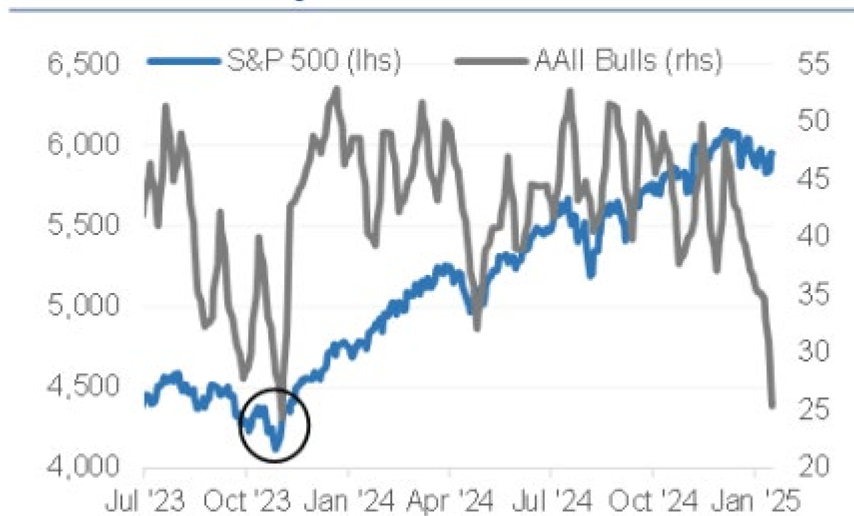

**Mid-caps remain historically inexpensive vs. mega cap**
Relative Forward PE: Russell Midcaps vs Russell Top 200, 1985-12/31/2024




The current Federal Reserve easing cycle should be supportive for responsible small and mid-cap companies, as we don't expect the Fed to return to its ZIRP (Zero Interest Rate Policy), which was in place from 2009-2015 and again in 2020-2021. Rather, we view this cycle as a period of monetary policy normalization from the rapid tightening cycle during 2022-2023 in which Fed funds over the longer term as indicated in the Fed's most recent dot plot are likely to be around 3%. While this approach may not be supportive for over-leveraged companies or index hugging, we believe it's highly constructive for active managers and stock selection. While we concede

that a rise in the 10-year Treasury yield towards or above 5% will constrain equity values, particularly down cap stocks, appropriately capitalized companies can operate productively at those levels. We expect the market to continue to debate the amount of future rate cuts and the r-star, or the level of neutral rates. What we find intriguing is that the recent rise in long-term interest rates has curtailed the heady market expectations such that investor neglect has increased, and we now have a much more constructive investing landscape to add alpha through stock selection. As depicted below, the American Association of Individual Investors (AAII) bulls have gone into hibernation as interest rates have risen, which put the market back to levels seen in the fall of 2023, right before the rally (see chart below).

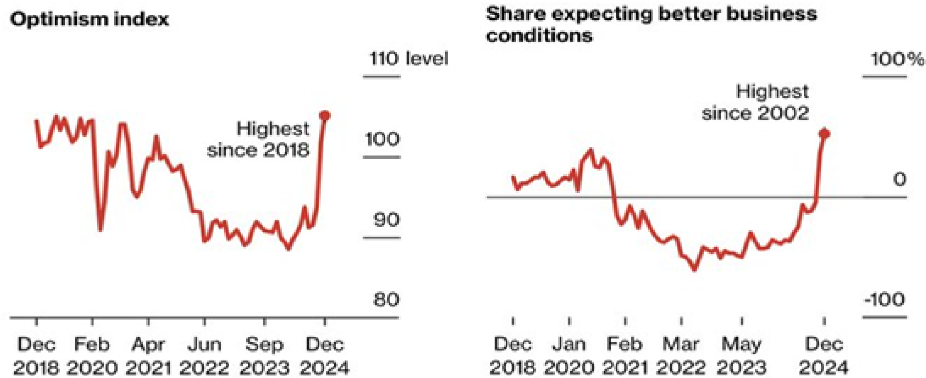
**When Bond Yield Spikes Make Equity Bulls Scarce, the Recipe for a Market Rally Starts to Simmer as the "Wall of Worry" Rebuilds**




*Source: Bloomberg, Evercore ISI Research*

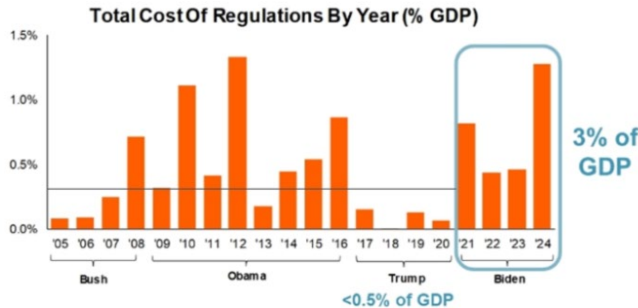
With the change in administration, we expect to see a period of deregulation, which should be supportive for small and mid-cap companies. As discussed in a recent research report from Jefferies, deregulation generally lowers the costs of production and allows capital and labor to share in the savings via lower goods prices, higher wages, and higher profits. Deregulation should end the uncompetitive barriers to entry that favor large cap companies and tend to result in less competition. Regulation, by its nature, benefits the largest companies that can afford the higher burden and blocks competition, as it disadvantages new entrants, which tend to be smaller companies. The Trump 2.0 deregulation policies could lead to a reorienting of winners and losers, which should be highly constructive for small and mid-cap companies. This excitement around deregulation and a more friendly business environment is well represented by the sharp rise in National Federation of Independent Business "Optimism Index" (see charts below).

**Small Business Sentiment Climbs on Trump Optimism**

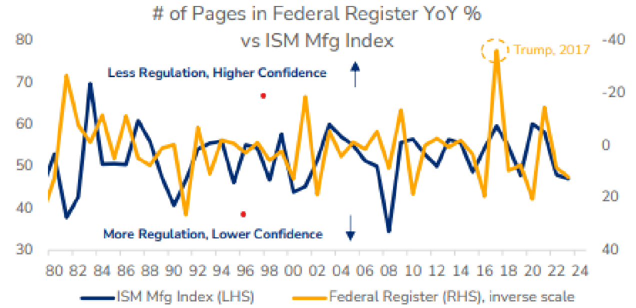



Source: National Federation of Independent Business

We also believe the new administration's goal of a smaller government should translate into faster GDP growth. As we learned in our economics classes, a larger government tends to crowd out the private sector. This larger fiscal spending can result in higher deficits and slower economic growth. As we shrink the government, resources transfer to the private sector and are used more productively and generate higher GDP. See charts below for the drag that higher regulation has had on GDP and the correlation between higher regulation and lower ISM Manufacturing.



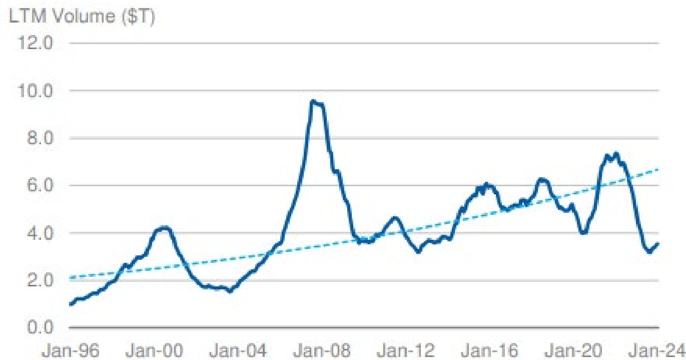

Source: Doug Holtz-Eakin, American Action Forum




Source: Wolfe Research, Haver Analytics as of 2023

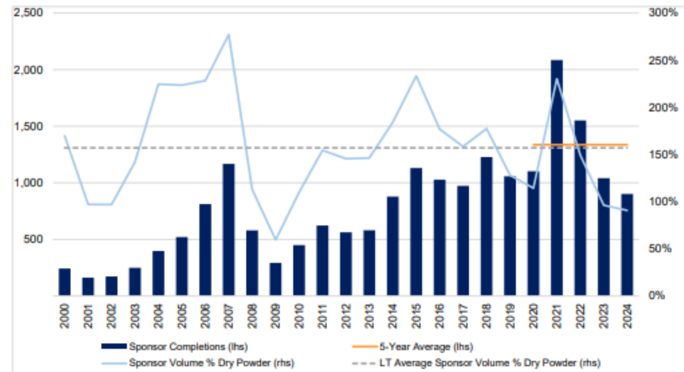
We believe the market is on an upswing for merger and acquisition (M&A) activity, which, historically, has been beneficial to small and mid-cap stocks. While M&A activity improved this year compared to the lows of 2022 and 2023, the recovery has been shallower compared to other cycles due to the below trend sponsor-led transactions, which tend to be more focused on small and mid-cap companies. We believe the new Trump administration and a less combative Federal Trade Commission (FTC) will help to reduce market uncertainty and enhance M&A activity. As indicated below, global M&A volumes are significantly below trend and are set for a cyclical and secular rebound. We view the below trend level of sponsor activity as pent-up activity that should provide additional support to small and mid-cap stocks. Lastly, we expect the historically large discount that small and mid-cap stocks are trading relative to large cap stocks should spur elevated consolidation until that spread narrows.

**Global M&A volumes are significantly below trend.**
**We expect a cyclical and secular rebound.**




Source: Dealogic, Morgan Stanley Research; Note: Exhibit shows trailing LTM volume of global announced M&A, excluding withdrawn transactions.

**Well Below Historical Trend of Sponsor Deployment**




*Note: Represents Buyout and Growth Dry Powder.*
*Source: Dealogic, Preqin, and KBW Research*

As we mentioned earlier, we do not believe we are entering a period of unbridled risk taking. Rather, managers still need to monitor their Sharpe ratio and appreciate the uncertain geopolitical environment we invest in. One could hope that the new President can resolve the conflicts in the Middle East and Russia/Ukraine in short order, but we need to be prepared for these conflicts to expand into larger regional engagements if not managed appropriately. We need to remain vigilant to direct and indirect factors that could negatively impact our portfolios. As we are reminded periodically, China remains a wildcard as it relates to these conflicts as well as its own economic future. We could see China potentially announcing significant fiscal support to spur their economy, but will that only be used to offset the pressure from higher U.S. tariffs on their goods? Lastly, we still do not expect an economic slowdown in the U.S. over the next 12 months, but we remain vigilant to changes in macro and micro datapoints that could upset that outlook.

Despite the choppiness the market has shown since the election, we remain constructive on the small and mid-cap value parts of the market. While we could get caught in the debate of how many additional rate cuts the Fed will provide the market, we believe the more important signal was their pivot to easing. We also believe less regulation and a smaller government will 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. This should allow down cap stocks to close the unprecedented discount they currently trade at to large cap stocks. We also believe the America First policies by the new administration will be highly constructive to small and mid-cap companies, which tend to be more domestically oriented than large cap stocks. We expect the lessening of inflationary pressures and a recovery in M&A activity, particularly sponsor-led transactions, will be supportive to the market. We still believe stock selection will be important, as the Fed is not likely to return to ZIRP anytime soon, and the market is not likely to go back to the halcyon days of 2021, when SPACs were being launched on what seemed like a daily basis. Rather, we continue to construct our portfolios with stocks that have pricing power, healthy balance sheets, and areas of self-help. Stocks that are under-earning and generate alpha in various interest rate and inflationary environments should now enjoy a meaningful tailwind from a more favorable macro backdrop. Lastly, we believe this is an opportunistic time to invest in down cap strategies given the inherent higher future potential returns, as this part of the market trades at an extraordinary valuation discount to large cap stocks (see charts below) and is highly under-allocated to by investors.

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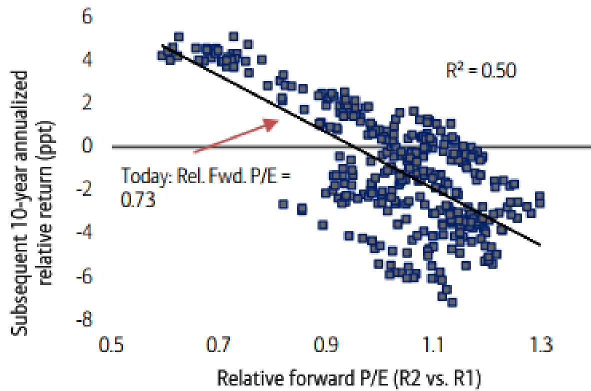
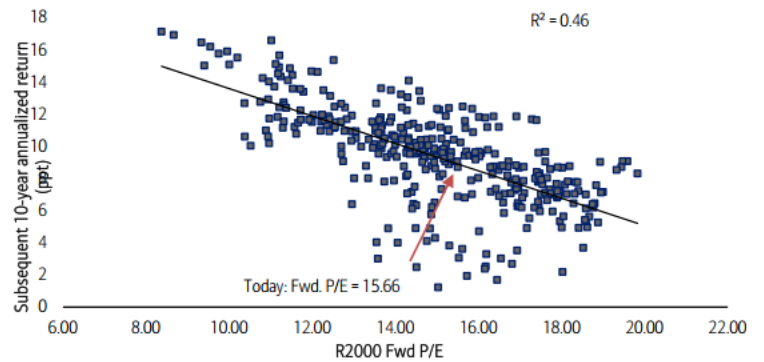
**Relative multiple suggests that small caps could outperform large caps over the next ten years**
Relationship between relative fwd. P/E of Russell 2000 and subsequent 10yr annualized returns, 1985-12/31/2024




Note: Represents the relationship between the relative forward PE for the Russell 2000 vs the Russell 1000 (since 1979) and subsequent rolling 10-year annualized returns differential.
**Source:** BofA US Equity & Quant Strategy, FactSet

**The absolute forward P/E for the Russell 2000 suggests 9% annualized ten-year returns**
Russell 2000 forward P/E vs subsequent returns, 1985-present (as of 11/30/24)




**Source:** BofA US Equity & Quant Strategy, FactSet