Cramer Rosenthal McGlynn

**1Q 2022 – Market Commentary**

Normalization. After living through extraordinary, unusual, and exigent actions by Congress and the Federal Reserve over the past two years, we are now in the midst of the wind down of these exceptional fiscal and monetary actions. This transition has brought with it new risks and related volatility as the Federal Reserve looks to achieve a soft landing. The normalization will need to occur in the economy, interest rates, inflation, employment, commodities, and earnings, just to names a few. While in the near term we expect mixed signals from the markets, the related volatility should create new opportunities for nimble, active managers.

We look for economic growth in the U.S. to normalize from a red-hot 6% rate in 2021 to about 3% in 2022, slightly above long-term trend. The COVID-19 variants, the war in the Ukraine, snarled supply chains and persistent inflationary pressure have put downward pressure on growth this year. However, consumer and corporate balance sheets are healthy, and the employment picture remains robust. When we drill down into the progression of growth this year, we see quarter over quarter GDP growth slowing from nearly 7% in the fourth quarter of 2021 to an estimated 1% in the first quarter of 2022. This should feel like the economy hitting a pothole going 70 mph. An economic slowdown, for sure, but not a recession. In support of this view, we believe the economy lacks major financial imbalances for a near-term recession and labor markets remain robust.

The Federal Reserve has the unenviable task of normalizing interest rates and shrinking its balance sheet which aims to remove accommodation from the markets. The inflation dragon was unleashed by the extraordinary support provided by Congress and the Federal Reserve post the pandemic, and now the Federal Reserve will have to summon the fortitude of Paul Volcker to slay the dragon once again. We expect the Federal Reserve will move decisively with 50 basis points rate hikes initially, quantitative tapering and jawboning of the markets to normalize inflation. Markets are now pricing in over 225 basis points in hikes from the Federal Reserve by year-end 2022. The strength in the employment market should allow the Federal Reserve to strike early and often against inflation with rapid rate hikes and not fear losing sight of its dual mandate of maximum employment and price stability. The yield curve has already reacted to the anticipated tightening actions by the Federal Reserve and has inverted at multiple points across the curve. This has caused consternation for market participants as an inverted yield curve is thought to be a precursor to economic slowdowns. We would postulate that the market has not absorbed the potential rise of long-term yields from quantitative tapering and the real yield curve, inflation adjusted interest rates, is currently not inverted. Lastly, credit spreads have widened off historic lows but do not appear to be signaling danger ahead.

Commodities have soared this year on the back of the war in the Ukraine and the continued knotted supply chains. Their rate of increase will likely moderate through a combination of a resolution in the war and/or slower global economic growth. Overall, commodities costs have risen about 30-40% this year, but the raw materials closely linked with Russia have climbed the most. Oil prices, as indicated by West Texas Intermediate (WTI), have increased from $75/barrel at the beginning of the year to north of $100 today (WTI nearly reached $125/barrel in early March 2022). Natural gas prices in the U.S. have skyrocketed to nearly $8 per million British thermal units (MMBtu) from less than $4 MMBtu at the beginning of the year, which is a 14-year high! The current global sanctions against Russia and the potential for additional restrictions against Russia's primary export, energy, have raised global energy security concerns and curtailed global supply in the short term.

The current energy insecurity concerns across the world are another indication that global supply chains need to adapt to a new world order. We see the movement towards de-globalization in its infancy. After tariff wars between the U.S. and China, a global pandemic, and a war in the Ukraine, most companies have developed a better understanding of the vulnerability of their historical just-in-time, low-cost foreign supply chains and the importance of securing key inputs. The latest logjam in the global supply chain is being caused by China's "Zero COVID-19" policy which has most recently resulted in the shutdown of Shanghai, the largest city in China with

26 million people. The associated port and factory shutdowns should have continued negative implications in the near term for companies across the globe. The movement towards de-globalization represents a multi-year, multi-trillion opportunity for domestic oriented companies, many of which are small to mid-cap stocks within our opportunity set. The $250 billion Innovation Act of 2022, which has bi-partisan support, is just the first wave of the dollars that will be spent over the coming years to support the acceleration of U.S. technology developments and re-onshoring of critical industries. We anticipate this to be a durable thematic tailwind.

The COVID-19 pandemic created one the fastest and deepest recessions in the history of the U.S. and the world economies. Thankfully, Congress and the Federal Reserve responded swiftly with immense fiscal and monetary stimulus programs. We will leave it up to the historians to decide if the accommodative response to the crisis was too much or lasted too long. In the interim, we anticipate the U.S. will need to undergo a normalization period that will require consumer and corporations to stand on their own. The heady, liquidity fueled days are likely behind us and companies and consumers will now have to operate in a higher interest rate and higher inflationary environment. We believe this will challenge the “growth at any price” stocks and the low return on equity/nonearners that were the mainstay of meme investors over the past few years. This movement towards normalization should favor relative value, active strategies with portfolios constructed with companies that have pricing power, healthy balance sheets and growing market shares. In addition, we think small to mid-cap stocks, which tend to be more domestically oriented, should benefit from a re-onshoring of supply chains. Again, this should be a multi-year, multi-trillion opportunity. Lastly, we believe small to mid-cap stocks are attractively valued today, particularly relative to large cap securities, as they are already pricing in a deceleration of economic growth, yet should have meaningful upside earnings leverage from a reduction in inflationary pressures, increased cap ex spending from de-globalization trends, and should be favorably positioned for an increase in M&A activity over the coming years.