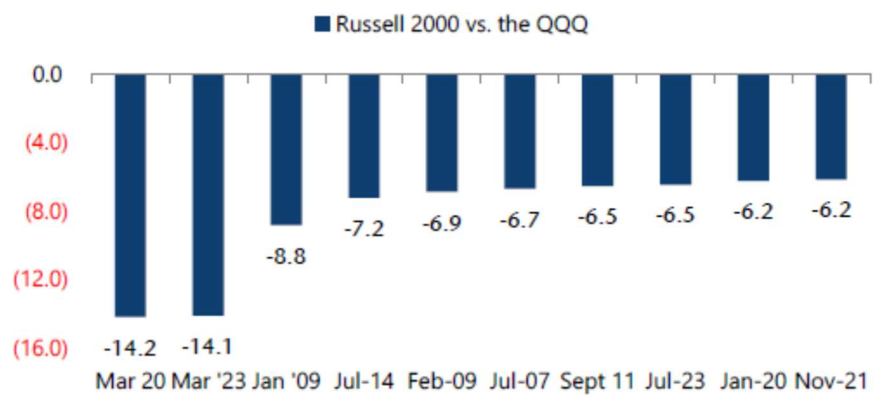
1Q 2023 – Market Commentary

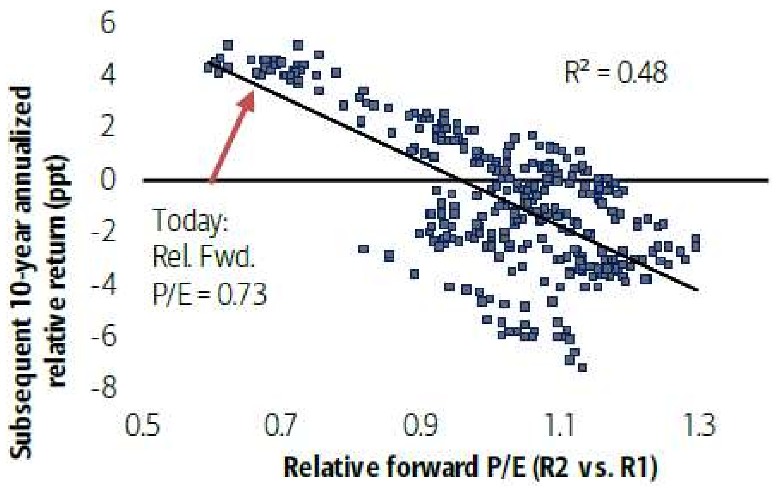
Déjà vu all over again! The market started 2023 on a positive note with a rally in January following lackluster performance in 2022. However, the banking crisis triggered by the failure of Silicon Valley Bank and Signature Bank in early March turned the market on its head. Investors then ran the old playbook from the 2020 COVID crisis and sold small and mid-cap value stocks to hide in the perceived safe haven of large cap technology stocks. In March 2023, the Nasdaq 100 Index (QQQ) outperformed the Russell 2000 by over 1400 bps, a relative performance that rivaled the height of COVID in March 2020. Over the next 12 months, small and mid-caps and value stocks went on to outperform their large cap and growth stock brethren from the bottom of the market in March 2020. Over the short term, we believe small and mid-cap stocks are more accurately reflecting a potential economic slowdown than large cap growth stocks. Over the medium and long-term, we believe drivers of value creation for small and mid-cap stocks remain firmly in place: deglobalization, reorientation of supply chains, infrastructure spending, falling inflation, etc. Despite what will likely be a volatile near-term for the market, as the long and variable lags from higher interest rates and tighter financial conditions filter through the economy, data indicates small caps are priced today to potentially generate a double-digit ten-year annualized return compared to a low single-digit return for large caps (source: BofA US Equity & Quant Strategy, Factset).

The underperformance by small vs. the QQQ rivaled that of March '20



Source: FactSet; FTSE Russell; Jefferies

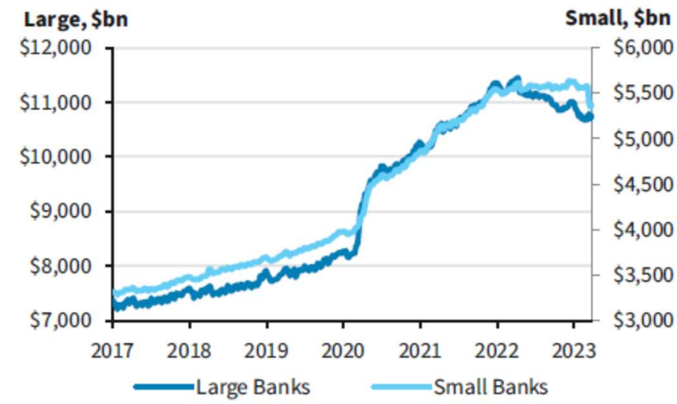
Relative multiple suggests that small caps could outperform large caps over the next ten years
(Relationship between relative fwd. P/E of Russell 2000 vs Russell 1000 and 10 yr annualized relative returns, 1985-3/31/2023)



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

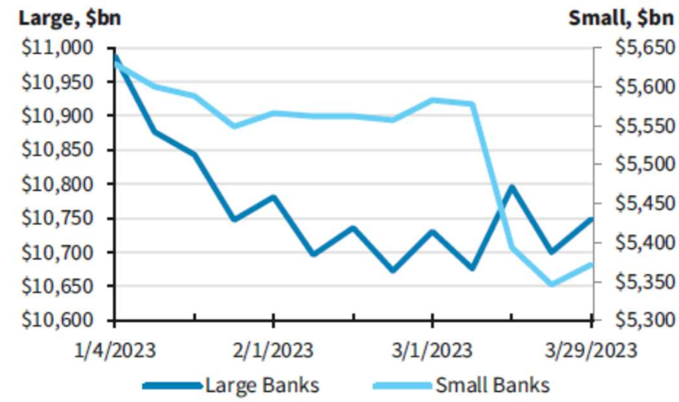
In early March 2023, bank stocks, as represented by the S&P Regional Bank ETF, declined 23% in only 3 trading days following the failures of Silicon Valley Bank and Signature Bank. We believe Silicon Valley and Signature were unique in that they had a disproportionate amount of their funding from uninsured deposits, and those deposits were highly concentrated. These two banks took their outsized deposit growth and purchased vast amounts of investment securities when interest rates were at historically low levels. Then, in March 2022, the Federal Reserve embarked on the fastest interest rate hiking period in over 35 years. This resulted in a significant duration extension for these recently purchased securities. The ensuing liquidity crunch and the concentrated nature of their funding base both worked against these two banks as uninsured depositors withdrew their funds at an unprecedented speed. This deposit run ultimately led to the closure of the two banks by the FDIC and gave rise to a crisis of confidence in the banking industry. Deposit flows for the banking industry have since stabilized (see charts below) and it appears only a small number of banks availed themselves of the Federal Reserve's new emergency lending programs. We expect there will be some sorting out amongst bank stocks during the upcoming earnings seasons as investors better appreciate the uniqueness of these two bank failures.

Total Deposits, 2017 – YTD



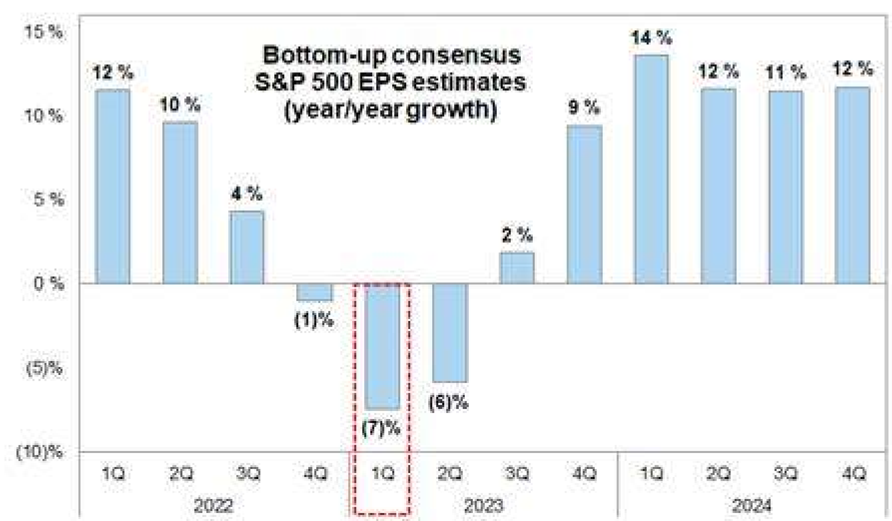
Source: Barclays Research and Federal Reserve

Total Deposits, YTD 2023



Source: Barclays Research and Federal Reserve

We expect the upcoming earnings season will be challenging for the market and that stock selection will be key to navigating these choppy waters. We see several pressures that will likely reduce 2023 results, including lower demand, higher interest rates, and less of a benefit from pricing. The first quarter of 2023 will likely see the sharpest decline in earnings for the market and we could be in for an earnings recession. As has been the case in the past, the market has moved quickly to revise down small and mid-cap companies' estimates ahead of large cap stocks. As we have experienced in past cycles, stocks tend to rally before the trough in earnings, so investors need to be invested prior to the turn. In addition, history shows us that coming out of an economic slowdown, small and mid-caps stocks tend to lead the market.



Source: FactSet, Goldman Sachs Global Investment Research

We are also closely monitoring the debt ceiling negotiations in Washington given the tail risk associated with a negative outcome for the markets and the economy. Congress needs to raise the $31.4 trillion debt ceiling by the summer or early fall to avoid a catastrophic default. Since January 2023, the Treasury Department has been using extraordinary measures to manage the debt ceiling, but those efforts will likely be exhausted over the next few months. As has been the case in the past, Congressional approval has come at the eleventh hour but not until after meaningful market volatility. The resolution of the debt ceiling is never an easy process but is likely even more complex today given our highly polarized Congress. There could be a temporary fix by pushing the X-date out closer to the 2024 re-election cycle. We will be closely examining the negotiations in Washington until an agreement is reached.

US CDS 1-Year Spreads Are Well Above 2011 Levels

Source: Bloomberg, Goldman Sachs Global Investment Research

Not to be outmatched in its importance, the student loan cliff is fast approaching. The student loan moratorium is set to end sixty days from June 30, 2023, or sixty days following the Supreme Court's decision regarding the President's forgiveness program. The Supreme Court agreed to hear a case challenging President Biden's power to broadly give student loan debt forgiveness. This case has important ramifications for consumer spending, the budget deficit, and future court challenges given the question of who has standing in the eyes of the court. The student loan forgiveness program could impact over forty million U.S. consumers and cost the federal government over $500 billion. If the Supreme Court rules against President Biden, the re-start of student loan payments will likely result in an $18 billion hit to monthly consumer incomes and could impact income in a similar manner to the tax increases associated with "The Fiscal Cliff" of 2013 (source: Jefferies Equity Research). Consumers have not been required to make payments on their student loans since the beginning of the pandemic, nearly 3 years ago. A ruling against President Biden could trigger a meaningful curtailment in consumer spending and pressure the economy at a perilous time. However, a ruling in favor of the President could trigger a consumer stimulus program that could rival those announced during the pandemic. This is a highly binary event for the markets and the economy.

Not all is doom and gloom. We have likely witnessed the peak in inflation, which is highly constructive for small and mid-cap stocks. Goods deflation has led to the recent declines in overall inflation as supply chains have been normalizing and consumer demand has shifted away from goods. In addition, the front-end indicators for services inflation, the largest component of overall inflation, appear to be peaking. We are seeing asking rents decline year over year in multiple cities across the U.S. In addition, the labor market is starting to come off its peak with unemployment claims being recently revised upward and job openings declining. History tells us an environment in which inflation is above 3% but falling is a highly attractive market for small and mid-cap stocks.

Despite the near-term pressures on the market, we see multiple long-term drivers for small and mid-cap stocks performance. The banking crisis in March 2023 resulted in a flight from small and mid-caps, and particularly value stocks, into the perceived safe haven of large cap technology COVID winners. This sell-off has uncovered tremendous value for patient long-term investors. We remain focused on companies that have self-help opportunities, healthy balance sheets, and strong market shares that can weather different inflationary and economic environments. We believe small and mid-cap stocks have been more 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. 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 are anticipated to spur cap ex spending in the U.S., which should provide a multi-year growth tail wind, which we believe will disproportionately benefit small and mid-cap stocks. In the near term, we expect to see further negative revisions in earnings for the market and expect stock selection to be a key differentiator as monetary and fiscal accommodation is reduced. Despite the current market uncertainty, we believe the short and long-term crosscurrents make this an attractive market for nimble and disciplined active managers.