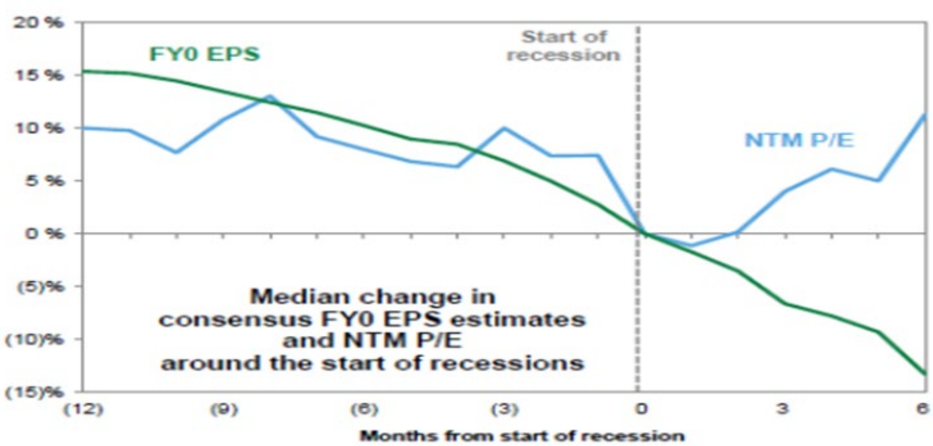
Cramer Rosenthal McGlynn

2Q 2022 – Market Commentary

The market just had one of its worst first half performances in decades. The fear of an economic slowdown manifested itself, as it typically does, in multiple compression for the market, with the S&P 500 next twelve-month P/E declining from 21.4x on December 2021 to 15.8x as of June 2022. As the next couple of earnings seasons are reported, we look for index earnings estimates in aggregate to be revised downward due to lower demand, higher interest rates, a stronger US dollar and less of a benefit from pricing. In such an environment, one can get caught in the negative parade of preannouncements and revised guidance, but we also need to remind ourselves of the value discovery that is unfolding right in front of us. The foundation of the capital markets and corporate balance sheets remain firm. We believe the economy lacks major financial imbalances and labor markets remain robust, which should forestall a more protracted economic slowdown. As we discussed last quarter, we are going through a normalization period following the euphoric phase created from the unprecedented fiscal and monetary accommodation following the pandemic. This can be an unsettling time for investors but also should create new opportunities for nimble, active and long-term focused managers.

Exhibit 3: P/E typically troughs at start of recession while earnings continue to fall
as of July 12, 2022



Source: FactSet, Goldman Sachs Global Investment Research

Inflation has continued to come in higher than expected this year on both a reported and core basis. The volatile energy and food components have been impacted by the war in the Ukraine. At the same time, the core constituents, such as owners' equivalent, have been impacted by the tight housing market. The June CPI print of 9.1% harkens back to the challenges of the 1970s. The pressure is on the Federal Reserve to orchestrate a soft landing and bring inflation back towards its long-term goal of 2%. This is looking more challenging as inflation remains stubbornly high. Importantly, the Federal Reserve needs to balance the potential policy mistakes on both ends: prematurely easing monetary policy in an elevated inflationary environment and over-tightening monetary policy to stamp out headline inflation.

Earnings revision is the next leg of the market normalization. There are several pressures that will drive future results downward over the next couple of quarters including lower demand, higher interest rates, a stronger US dollar and less of a benefit from pricing. Excluding Energy companies, we have already witnessed a 200-300 bps decline in earnings estimates over the past couple of months. We will get additional data points from companies over the next couple of quarters which will help reset expectations and should provide a better base to build off for 2023 and beyond. As we have experienced in past cycles, stocks tend to rally before the trough in earnings.

We believe the U.S. will continue to be the port in the storm for investors. Europe is weighed down by the war in the Ukraine and the possibility that Russia will cut off natural gas supplies later this year. China continues to struggle with its “Zero-Covid” policy which has led to mass testing and lockdowns in major economic centers. In addition, home buyers in China are threatening to not pay their mortgages. Emerging markets are faced with the pressure of a rising US dollar and political unrest in several countries. Despite the valuation correction in the U.S. market, the foundation domestically remains healthy, with financial leverage for corporates and consumers below historical averages, a banking industry that is well capitalized and no industry threatening systemic risk. Lastly, the mid-term elections in the U.S. could result in a split government which has historically been positive for market returns.

The market sell-off has been sharp but it has uncovered tremendous value down the capitalization spectrum. As we have seen in previous economic slowdowns, P/E multiples compress in anticipation of the expected earnings reset for the market. Small and mid-cap stocks have been more impacted during this sell-off and we believe are extremely neglected today. As depicted below, small cap stocks represent less than 4% of the U.S. market. This is below their level in 1999 which marked the beginning of a multiyear period of outperformance for small and mid-cap stocks. This group, which tends to be more domestically oriented, should benefit from the healthier investment environment in the U.S. compared to the rest of the world. In addition, we believe investors should continue to favor relative value, active strategies with portfolios constructed with companies that have healthy balance sheets and growing market shares during this rising interest rate and higher inflationary environment. We also believe the market will reward cash flow generation and low financial leverage. These attributes will serve us well when M&A activity reasserts itself in the future.

Source: Jeffries Research