Cramer Rosenthal McGlynn

3Q 2021 Market Commentary

Pause and digest. After a robust market return in the first half of the year, indices paused and digested several competing factors this quarter. The rise in COVID-19 cases caused by the delta variant during the late summer slowed consumer spending (particularly services) as mobility declined. This focus transitioned to the latest existential threat to the economy and corporate earnings: inflationary pressures. Over the course of the quarter, we witnessed intensifying supply chain disruptions, port congestion and rising inputs and labor costs. These pressures appear to have caused the market to pause and digest their potential impact on GDP and corporate earnings growth rates. A repeated question raised was, how well will companies be able to operate through these headwinds? Despite the dour market tone, the good news is that the supply chain and input cost inflation issues are being driven by stronger-than-expected demand due to a highly liquid and ever-ready to spend consumer, not a 1970's style stagflation.

Market participants have not had to wrestle with the current level of inflationary burden for well over a decade. Companies have had to institute price increases and/or surcharges multiple times this past year. In many cases, there appears to be a lag to these price changes, which we believe will likely lead to temporary gross margin compression. The question on investors' minds is: to what extent are these inflationary costs "transitory", as articulated by Fed officials, or a more persistent, longer-term issue? Our focus has continued to be on companies that have pricing power that can, and have, successfully operated through other periods of rising inflation. We expect low return on equity companies and nonearners, which were the darling of the market earlier this year, to be challenged going forward as they generally lack pricing power, and the associated rising rate environment will stress their already extended balance sheets. All of this should be positive for active managers.

The market also had to absorb a change in tone by the Federal Reserve. The September Federal Reserve Open Market Committee (FOMC) meeting was a pivot away from unabashed accommodation with the indication to start tapering its Quantitative Easing (QE) program, possibly next month. The tapering could be completed by mid-2022, months ahead of market expectations. This shift has led to a rise in interest rates and steepening of the yield curve. Despite the market's uneasiness with the selloff in Treasuries post the FOMC meeting, interest rates are not significantly different than the levels experience at the end of the second quarter of this year. Importantly, the real 10-year Treasury yield is still at a very accommodative negative -90 basis points. Despite all the hand wringing, financial conditions remain constructive.

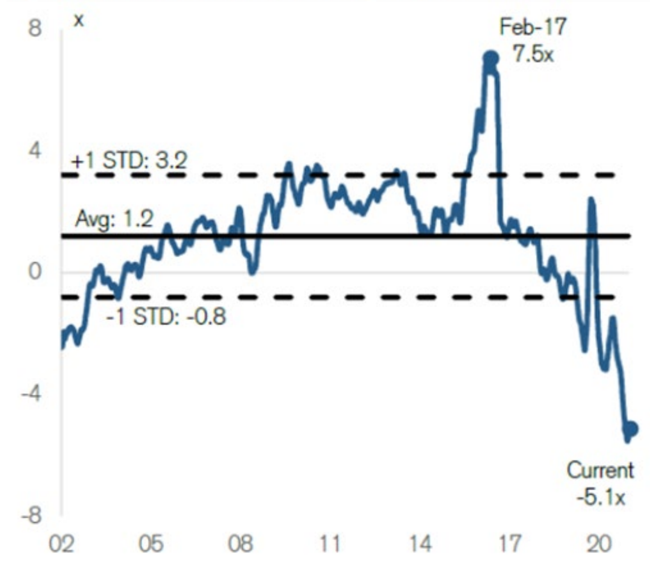
A change in the level of accommodation by the Fed can be a short-term challenge for the market, but the tail risk we are monitoring is, will Jay Powell be reappointed Chair of the Fed by President Biden? Has the recent trading scandal at the Fed, which has resulted in the departure of Dallas Fed Robert Kaplan and Boston Fed Eric Rosengren, tainted Powell's tenure? As history as shown us, the market does not like uncertainty. Transitions at the Fed can be disruptive and can increase the possibility of a policy mistake. On the positive side, we should have more clarity about the leadership at the Fed over the next quarter given Powell's term as Chair ends in February 2022. the last cycle due to the Fed policy changes on inflation and the social agenda to drive higher wages and employment across all U.S. demographics.

The ever-present influence of China on the global economy was also front and center this quarter. China's "common prosperity" policy, which seeks to narrow the wealth gap in the country, has led to crackdowns on a multitude of industries including technology, education, and real estate. The most prominent company in the crosshair this quarter was Evergrande which is now on the brink of collapse. The question is, what level of economic slowdown is the Chinese government willing to absorb to promulgate these social policy changes? This is an evolving and important topic to keep monitoring given China is the second largest economy in the world.

However, the recent tariff war during the Trump administration, coupled with COVID pandemic, has opened the eye of many companies and countries about the need to reposition supply chains away from China and reduce their reliance on them.

Despite the pause and digest attitude by the market this quarter, we remain constructive on small to mid-cap value stocks given their robust earnings potential, attractive valuations, and lowered expectations. Going forward, we believe future stock prices will be driven more by earnings growth than multiple expansion given the reduction in Fed accommodation and the rise in interest rates. In addition, we believe balance sheet strength and pricing power will matter more as companies will have to contend with higher inflation. We also expect the weaker companies bailed out by the Fed during the earlier easing phase will struggle. We believe that we have transitioned from early cycle to mid cycle, which typically heralds a change in market leadership. As indicated in the charts below, we see the greatest opportunity today in the small to mid-cap, value parts of the market at these stocks are trading at significant discounts to their historical levels yet are expected to generate some of fastest earnings growth in the future periods.

Areas of Opportunity – Small vs. Large and Value vs. Growth



Source: Standard & Poor's, FactSet, Refinitiv, Credit Suisse

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