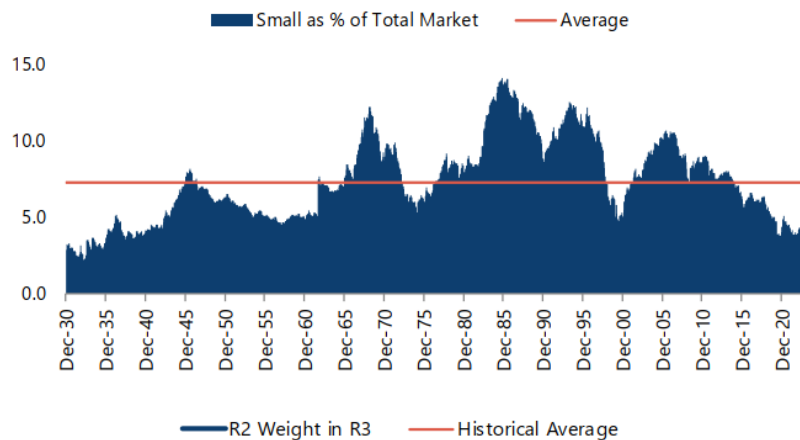
Cramer Rosenthal McGlynn

3Q 2024 – Market Commentary

After one of the fastest and sharpest tightening periods in U.S. monetary history, the Federal Reserve finally reversed course at the end of September and announced their first easing action since the pandemic over four years ago. This was a watershed event and we expect it will usher in new market leadership, as we have seen in the past. During this most recent tightening period, small and mid-cap companies more acutely endured the fundamental burden of higher inflation (both raw materials and labor) and higher funding costs compared to large cap companies, but now those headwinds appear to be turning into tailwinds. By their construct, small and mid-cap companies tend to thrive in an environment that appears to be unfolding, including tight/tightening credit spreads, a steepening of the yield curve, declining inflation, lower interest rates (i.e. lower borrowing costs), resolution of political uncertainty (post-election relief), and improving M&A activity. These positive externalities should translate into an acceleration in earnings growth for small and mid-cap companies over the next few years and allow them to outgrow their large cap brethren for the first time in years. We believe these factors will propel the small and mid-cap stocks to close the extraordinary valuation discount they are trading at today relative to large cap stocks. We believe investors are offsides, as this impending change in market leadership to small and mid-cap stocks is set to occur in an environment in which investors have their lowest allocation to down cap strategies going back decades. If investors were to sell just 1% of the S&P 500 Index, represented by the SPY ETF, and rotate it into small/mid or small value stocks, this would represent buying approximately 8.3% of the Russell 2500 Value index and 22.6% of the Russell 2000 Value index, respectively.

Small is less than 4% of the US equity market, and the R2 is only 5.3% of the R3, close to a new low



Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies

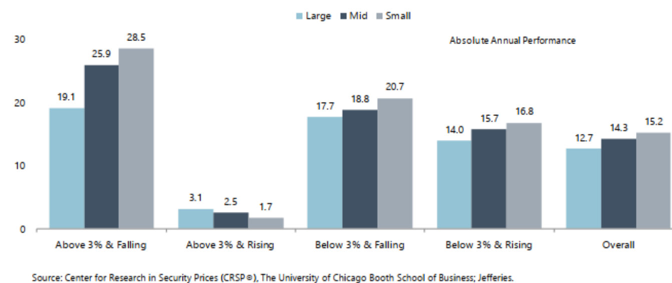
Reallocation from S&P 500 to Russell 2500 Value and Russell 2000 Value

Index	$ Billions	1% of S&P 500
Russell 2000 Value Index (RUJ)	1,934	23%
Russell 2500 Value Index (R2500V)	5,257	8%
SP500	43,748	1%

*Source: Bloomberg

The Federal Reserve finally pivoted to easing this quarter, which should be a tailwind for small and mid-cap companies. The tug of war between higher inflation and slowing employment finally came into better balance this quarter, which provided cover for the Fed to start to normalize interest rates. With the rapid decline in real rates, the Fed would have been tightening monetary policy if they didn't cut interest rates. There will continue to be market debate about the pace of future rate cuts and the r-star, or the level of neutral rates. Either way, a falling interest rate environment and a decline in the rate of inflation below 3% are both positive macro drivers for small and mid-cap companies (see chart below) given their shorter duration liability structure and higher leverage profile compared to large cap companies.

If inflation drifts below 3% in '25, that too would be good for small caps



Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies.

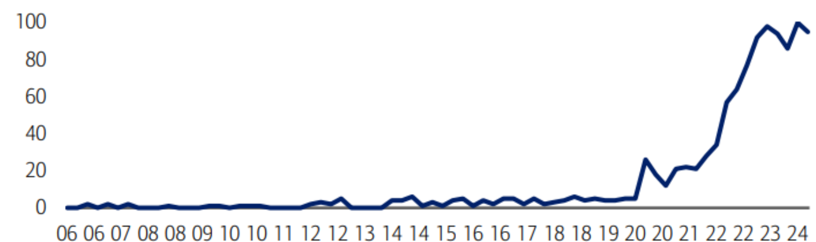
We expect another source of support for small and mid-cap companies will be the reshoring of U.S. manufacturing. After the supply chain disruptions caused by the tariff battle with China during Trump 1.0, the stoppage during Covid, and the conflicts in the Middle East and Russia/Ukraine, we have learned the downfalls of just in time manufacturing and not partnering with like-minded governments. In late 2021 and 2022, Congress passed over $1 trillion in historic bills to support reshoring efforts, including the Infrastructure Investment and Jobs Act (IIJA), the CHIPS and Science Act, and the Inflation Reduction Act (IRA). You would have to go back to the time of FDR to see U.S. government support critical infrastructure at these levels. The investment dollars will be assisting the build out of strategic supply chains and infrastructure in the U.S. over the next few years. We believe small and mid-cap value stocks, the "picks and shovels" companies, which tend to be more domestically oriented will be major beneficiaries. As we can see from the charts below, the level of discussion and actual construction from these bills have ramped up massively since their passage. We expect these dollars will be a tailwind to growth for small and mid-cap companies over the next 3+ years. This doesn't even take into consideration what the next President and Congress will do to further these efforts.

Construction spend on US manufacturing up >50% YoY in 2023

Construction spending on manufacturing ($bn) (as of 5/24)

Source: Haver, BofA US Equity & Quant Strategy

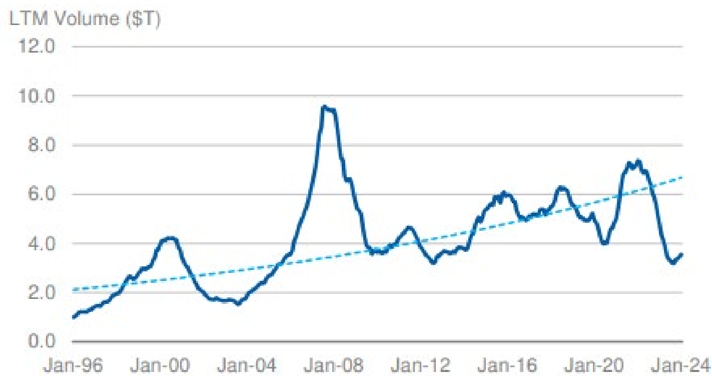
Everyone is talking about reshoring



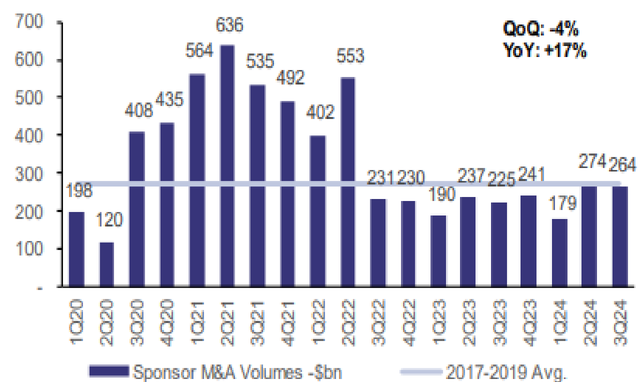
As we have discussed in the past, a resurgence in merger and acquisition (M&A) activity is highly beneficial to small and mid-cap stocks valuations. Although we have seen an improved level of M&A activity this year

compared to the lows of 2022 and 2023, this has been a slower start to a recovery compared to other cycles. This is, in part, due to the below trend sponsor-led transactions, which tend to be more focused on small and mid-cap companies. We believe the recent Fed rate cut and the resolution of the U.S. elections in November will help to reduce market uncertainty and help enhance M&A pipelines into year end. 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 will provide additional support to small and mid-cap stocks. Lastly, we expect the historically large discount small and mid-cap stocks are trading relative to large cap stocks will spur elevated consolidation until that spread narrows.

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



Sponsor M&A Volume



Source: Dealogic, Company data, Wolfe Research.

For those of you that have just emerged from your darkness retreat, there is a U.S. Congressional and Presidential election next month. There has been significant research written about what the candidates may or may not do if they are elected to office. In addition, the candidates continue to offer new proposals to entice undecided swing state voters. The polls have oscillated back and forth over the past few months, but the Presidential election still appears to be a coin toss at this point. We will reserve our predictions and leave that up to the pundits and talking heads. The key for us is the certainty that accompanies the election results. This will allow the market to better analyze future outcomes and allow companies to better forecast and plan their businesses. This is positive for small and mid-cap stocks as investors, particularly down cap, generally despise uncertainty. As Goldman Sachs points out, the Russell 2000 index tends to outperform the Russell 1000 index during the 3 months following the election by a median of 4.7% (70% hit rate) based on the past ten presidential election cycles.

We continue to construct our portfolios with a balance between the favorable micro and macro factors for small and mid-cap companies as well as the uncertain geopolitical environment that could bubble. The conflicts in the Middle East and Russia/Ukraine, while contained today, could expand into larger regional engagements if not managed appropriately. We continue to stress our holdings for direct and indirect impacts. In addition, China remains a wildcard as it relates to these conflicts as well as its own economic future. There are initial indications China could announce significant fiscal support to spur their economy, but will that be met with higher tariffs on their goods from the U.S. next year? This will likely hinge on the U.S. Presential election. Lastly, we still do not expect a recession here 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.

As we mentioned last quarter, "It's always darkest before the dawn", a phrase written in 1650 by English theologian and historian Thomas Fuller and in one translation means "things always seem the worst before they improve". We continue to believe we are witnessing the dawn of a new day for small and mid- cap stocks following the Federal Reserve's first rate cut in over four years. We have endured one of the most bifurcated markets in our history, which now has small cap stocks trading at their biggest discount to large cap stocks in decades. Not only are down cap stocks trading at historic discounts, but as we pointed out earlier, we believe micro and macro factors will be supportive of their fundamentals, which should allow them to close that valuation gap over the next few years. Importantly, history has shown that Fed easing cycles have sparked outperformance cycles for small cap stocks that have lasted for nearly six years, on average (see table below). We believe this trend will be supported by the multi-year fiscal stimulus from the Infrastructure Investment and Jobs Act (IIJA), the CHIPS and Science Act, and the Inflation Reduction Act (IRA), the lessening of inflationary pressures, the certainty of election results next month, and a recovery in M&A activity, particularly sponsor-led transactions. This is an exciting time to invest in down cap strategies that, as we pointed out earlier, are highly under-allocated to by investors. We still believe stock selection will be important, as the Fed is not likely to return to ZIRP (Zero Interest Rate Policy) and the market is not likely going back to the halcyon days of 2021, when SPACs were being launched on a what seemed like a daily basis. Rather, we continue to construct our portfolios with stocks that have pricing power, healthy balance sheets, are under-earning and have various levers of self-help. These are stocks that generate alpha in various interest rate and inflationary environments and should now enjoy a meaningful tailwind from a more favorable macro backdrop.

Rate cuts have sparked a number of outperformance cycles

		Small Caps		Large Caps		
Period	**Length of Period**	**Cumulative**	**Annualized**	**Cumulative**	**Annualized**	**Excess**
05/32-02/37	4.8	1045.7	67.1	343.3	36.8	30.3
05/40-05/46	6.1	521.8	35.6	166.9	17.8	17.8
01/64-12/68	5.0	210.2	25.9	49.8	8.6	17.3
12/74-06/83	**8.6**	**1089.1**	**33.8**	**236.3**	**15.3**	**18.5**
10/90-02/94	**3.4**	**138.6**	**29.8**	**66.1**	**16.4**	**13.4**
03/99-03/06	7.1	144.2	13.6	6.1	0.9	12.7
02/09-2/14	**5.0**	**288.3**	**31.2**	**174.4**	**22.4**	**8.8**
Average	**5.7**	**491.1**	**33.9**	**149.0**	**16.9**	**17.0**

Source: Federal Reserve Board; Haver Analytics; Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies