CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q2 2023

Far Better Than Feared

Markets entered the quarter on edge as deteriorating estimates, weak macroeconomic data, and high inflation cast a dark shadow over sentiment. **However, economic data have come in significantly better than feared recently, broad market earnings estimates have stopped going down, inflation has continued to moderate, and excitement around AI has driven pockets of enthusiasm.** One way to look at economic data versus expectations is from the Bloomberg US economic surprise index which tracks the degree to which published economic data differ from forecasts. This index has rallied sharply and sits at one of the highest levels in the past decade. Inflation has also continued to soften. After peaking at 9.1% in June, the latest inflation reading came in at 4.0% in May, the lowest in two years.

Narrow Market Fueled By AI Excitement

While more applicable to the broad market, rather than the small cap space, the lack of market breadth this quarter has been stunning and is worth discussing (see our recent thought paper on our website for more detail on this topic). A big driver of this move recently has been excitement around AI and any stock that may benefit from this. That has helped to propel some of the biggest Technology/Communications companies significantly higher and lead the market. For example, while the Russell 1000 and 2000 Value indices had very similar returns this quarter, the core Russell 1000 and Russell 2000 indices were over 300 basis points apart. **But these price moves have come mostly via multiple expansion, as estimates have not moved significantly, and it will be interesting to see if this excitement proves justified by subsequent earnings growth or portends future disappointment.** It is easy to focus just on the positive impacts for AI on corporate valuations, but the small-cap space is made up of companies with more concentrated end markets, suppliers, and customers. As such, there are both opportunities and threats for these companies. The potential for improved efficiency and cost savings are all real possibilities. At the same time there can be real threat of disruption from AI, and **we are thinking deeply about these risks in an effort to mitigate them in our holdings so that what appear to be mispriced stocks do not turn into value traps.**

Questions Remain

While it would be nice to be able to declare victory over an economic hard landing, that would seem premature. Bloomberg's survey of economists shows that 65% are still projecting a recession within one year. Also the NY Fed recession probability model remains extremely elevated and has never given a false signal at such a high level. While headline inflation has slowed, many of the slower-moving components underlying it have not. Much of the recent disinflation has been driven by energy prices, which were down 12% in May, and can be volatile and driven by exogeneous factors. This can be seen in the Atlanta Feds sticky-price CPI, a weighted basket of items that change price relatively slowly, which is still running at over 6% and is only down modestly from peak. **Additionally, there is a large divergence between market prices and leading indicators**

such as ISM new orders, indicating that the market is pricing in a sharp rise in the ISM. Should this not come through, then the broad market is unlikely to continue its recent upward march.

We Continue to Sweat the Small Stuff

We continue to manage our portfolio and positions in the same steady way. We look for mispriced opportunities, good companies, appropriate balance sheets, and strong records of valuation. Much of our outperformance this year and quarter can be attributed to broadly avoiding or being underweight areas of trouble such as banks, office REITs, biotech, companies with high leverage, and AI disrupted businesses. We remain laser focused on fundamentals to ensure that we are confident our companies can withstand a sustained period of economic hardship. This means low leverage, a proven ability to reduce costs, strong free-cash-flows, etc. As we noted last quarter but wish to reiterate, **we are continually examining our portfolio and our convictions to ensure that we hold stocks trading at material discounts to our conservative assessments of their worth. We remain excited about our stocks over a multi-year time horizon.**

Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.