CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q3 2024

A Reversal In Market Leadership, But Will It Sustain?

July featured a significant reversal in market leadership from the first half of the year, which then held consistent throughout the rest of the quarter. The equal-weight S&P 500 outperformed the capitalization-weighted index, the Russell 1000 Value outperformed the Russell 1000 Growth, and small cap stocks (Russell 2000) outperformed large-cap stocks. This reversal can also be seen in factor returns. During the third quarter, the Momentum factor (measured over 12 months) lagged by 5.1%, and EPS Growth lagged by 5.0%, while Beta to High Yield spreads added 1.3% and low P/E added 1.0%. It seems that the reason for this reversal was related to expectations for interest rate cuts (and the 10-year Treasury yield significantly declining) and increasing confidence in a soft landing. Yield-seeking led historically low value-creation sectors like Utilities and Real Estate to lead the market, also supporting value benchmarks. If we compare large-cap stocks and small-cap stocks, we can see why there was a divergence in the quarter. In general, small-cap stocks are perceived to have more leverage, more exposure to domestic GDP, and a much higher percentage of the index is not profitable. So, as rates come down, these more highly levered and sometimes unprofitable companies are given a boost as funding costs decline and durations extend, and so their multiples expand faster. In response, many lower-quality companies across the capitalization spectrum saw significant returns. While the portfolio is focused first on companies that are attractively valued, on the whole, we own higher quality, profitable, less levered companies that didn't receive the same level of multiple expansion during the third quarter. We would note that while these reversals that favor lower-quality companies can be sharp, they are generally not sustained. We are confident that the companies creating value will be rewarded over time.

Soft Landing Expectations Rise

The debate over soft vs. hard landing now appears to favor a soft landing, and the market responded to that in a sizeable way during the quarter. The economy appears healthy, with 2Q Real GDP growth revised up to 3%, the Atlanta Fed GDPNow estimate for 3Q GDP holding around 2.5%, and broad market NTM earnings estimates continuing to move higher. As measured by the S&P 500, the broader market has now posted its best start since 1997, and while smaller cap stocks have not kept pace, they are still up double digits. During the quarter the Fed cut interest rates by 50 basis points at its September meeting. This decision was driven by continued moderation in inflation data and a labor market showing signs of slowing down. With GDP growth continuing to be strong, the economic surprise index improving, and the first jobs report in October looking much better than expectations, current Federal Funds rate expectations have decelerated to a flatter path of only 50 basis points of cuts through the end of the year. According to a chart from Goldman Sachs, the median S&P 500 performance when the economy avoids a recession during the next 12 months is up ~13%, and when the economy enters a recession down ~15%. So, as always, the economy's health from here is critical.

Risks That May Lead To A Hard Landing

While the market appears to be pricing in a soft landing, there are always known and unknown risks that could alter that outcome. Recently, we have seen a few such risks, including the US East and Gulf Coast port strikes and the rising tension in the Middle East. While cooler heads prevailed fairly quickly soon after the end of the quarter, the port strike could easily have had a wide-ranging impact on the US economy and put the Fed in a more difficult situation. With the Israeli conflict broadening, oil prices rose to over $80 a barrel, and 10-year Treasury yields

are back over 4%. Next month's US Presidential election means every piece of data will be overanalyzed, over-discussed, and spun to fit each side's worldview, adding fuel to the fire.

Caution During Good Times Is Prudent

There remain existing and emerging risks to be aware of. For example, we are watching the divergence between the high-end consumer, who broadly remains flush with home and market prices at record levels, and the lower-end consumer, who is pressured by continued inflation (remember that disinflation still involves rising prices). Lower-income households have significantly higher inflation expectations, which today hover close to 7%. This is likely driven by what they experience and where they shop, and since rising prices for food, housing, and utilities are particularly impactful, inflation feels even more severe. Consumption is the largest component of GDP in the United States, so we continue to follow up to see if these trends remain consistent or start to move upmarket.

Avoiding Complacency

This natural give and take in the market is why we consider ourselves relative value managers, as the natural uncertainty of the market creates opportunities to find mispriced stocks. We continue to manage our portfolio and positions in the same steady way and recognize that smaller capitalization stocks still remain at historically inexpensive levels versus large cap. We look for mispriced opportunities, good companies, and reasonable balance sheets. We remain laser-focused on fundamentals to ensure that we are confident our companies can withstand a sustained period of economic hardship but, at the same time, participate in strong markets. 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 discounts to our conservative assessments of their worth, and we remain excited about our stocks over a multi-year time horizon.

Sincerely,

The Cornerstone Investment Team

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