CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q4 2024

The Fourth Quarter Mirrored Full Year 2024

When we step back and look at the fourth quarter, it looks almost exactly like the full year of 2024 for the equity markets. Small-caps lagged large-caps, and value stocks lagged their growth counterparts. Return figures illustrate the striking differential: Large Growth (Russell 1000 Growth Index) was up 33.4% for the year, while Small Value (Russell 2000 Value Index) was up only 8.1%. There were fits of outperformance for smaller value-oriented stocks, most specifically directly after the presidential election, but these proved to be short-lived as continued excitement around AI and the expectation for value accruing to the largest players still believed by the market.

A Reasonable Backdrop for Equities

Investor optimism is clearly high as evidenced by the broad market being up significantly for the full year, expanded multiples, and elevated expectations for market appreciation. However, there are plenty of logical reasons for that optimism. U.S. GDP remains solid, with September U.S. Real GDP growth at 2.8% Q/Q, corporate earnings broadly have been healthy with actual results coming in well ahead of expectations, and inflation has continued to moderate. This backdrop has allowed the Fed to begin cutting rates gradually. The market typically performs much better in a slow rate cutting environment (a fast rate cutting environment typically indicates a hard landing and is not conducive for equity values.) This slow rate cutting environment represents the market's current base case today. Should inflation continue to remain moderate and the economy perform well, that gradual path to lower interest rates would remain on track.

Keeping An Eye On The 10 Year

We are keeping an eye on the 10-year Treasury bond, which has moved significantly higher over the last few months. When you look at historical rate cutting campaigns and the subsequent change in 10-Year yields after the Fed starts cutting rates, the current experience stands out. Typically the 10-Year falls or trades sideways; however, today we have a large upward move in the 10-Year. What does this mean? It may signal some nervousness around inflation in the market still. This can also be seen in the TIPS market with a corresponding move higher during the fourth quarter. With the 10-Year closing the year solidly above 4.5% it does create a more difficult backdrop for any additional multiple expansion and higher rates from here would likely put pressure on equity markets.

A New Year, A New Administration

The New Year brings a new administration, which will be sure to create lots of headlines as well as opportunities and uncertainty. In the opportunity camp we likely have growth-friendly policies, less regulation which could improve margins, lower taxes, and a push for domestic production. On the uncertainty side we have potential for heavy use of tariffs, a shift in government spending priorities, volatile trade and foreign policy, as well has changes to immigration policies which may reduce labor supply. At the end of the day what this means to us is that active management will likely be key to success over the next four years.

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

The opinions expressed represent the views of Cornerstone Investment Partners investment. Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.