CORNERSTONE
INVESTMENT PARTNERS, LLC

Small Cap Market Review

Q4 2022

Brighter Days to End the Year

While 2022 proved highly volatile and downwardly biased for the market, the final quarter of the year saw stocks move higher as investors cheered slowing inflation data as a sign that peak inflation may now be in the rearview mirror. With CPI peaking at 9.1% in June and trending lower to 7.1% in November, there is indeed good reason to believe that the worst for inflation may be behind us. Lower oil prices, lower commodity prices, as well as an easing of recent supply chain pressure, should all help to lessen the rate of inflation in the coming months. Given this more positive backdrop, expectations for the path of interest rates from the futures market call for a peaking of rates sometime in the middle of 2023, with rates potentially even being cut before the end of the year. However, there remains a disconnect between the market and the current Fed Dot Plots, which suggest rates at a higher level than the futures market for both 2023 and 2024. As this year has shown, the trajectory for the markets in 2023 may hang in the balance based on who proves to be correct.

But Storm Clouds Remain

The goal of the Federal Reserve's recent monetary policy actions is clear– less economic demand for goods and services lowers inflation, but it takes time to flow through the economy. We are quick to point out that slowing inflation does not mean either that the problem has been solved (inflation rates remain at very high absolute levels), nor does it mean that we have felt the full effects of higher interest rates on the economy. For example, while we have started to see cracks in the housing market, home affordability remains at record lows as home prices still are significantly elevated versus pre-COVID levels. We have also seen leading indicators start to turn negative, the yield curve invert, and an increasing number of companies announce layoffs. All these signs point to the possibility of more economic trouble ahead. Of course, the question is how bad does it get and how much pain is already priced in, as clearly a fair bit of pain has been priced in already.

Stocks Likely to Follow Estimates

With forward P/E multiples for the market overall back at roughly average levels, it seems likely that the trajectory of earnings will be a more significant driver of stock prices next year. Over the last few months, we have seen estimates for 2023 and 2024 fall, but without many companies providing their outlook yet and without realized 1Q results, visibility remains low. In addition to uncertainty around the economic outlook, currency exchange rates are also playing a big role this year given the strengthening of the dollar. 2023 estimates are also currently baking in slower EPS growth in the first half of the year and then stronger growth in the back half of the year, which always warrants extra caution, as it could be a recipe for disappointment if it reflects hope more than logic. As we might expect, the variability of earnings estimates remains quite wide, and therefore we could see a lot of adjustments as we head into 2023. What this means to us practically, is we continue to be 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. Story stocks at lofty valuations without cash flows may yet be in for more pain as we saw in 2022.

Staying Vigilant and Patient

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 continue to confirm that our portfolio remains composed of high-caliber companies at discounts to the market, and have been excited to uncover some new opportunities this year that have been shaken loose by the recent market volatility. We remain excited about all of our stocks over a 2+ year time horizon but recognize that the next year contains elevated uncertainty. While uncomfortable, this uncertainty can set up significant opportunities for future returns.