KAR | Kayne Anderson Rudnick Investment Management

Market Review Commentary

3Q 2024

Market Review

The U.S. equity market pushed higher in the third quarter, with the S&P 500 Index advancing 5.89%, bringing its year-to-date return to 22.08%. Large cap value stocks, as measured by the Russell 1000 Value Index, rose a strong 9.43% in the third quarter, bringing the year-to-date return to 16.68%. Large cap growth stocks, measured by the Russell 1000 Growth Index, gained 3.19% for the quarter and 24.55% year-to-date. Small capitalization stocks outperformed their larger cap counterparts this quarter as the Russell 2000 Index rose 9.27%, while still trailing for the year, increasing 11.17%. International developed markets also delivered positive returns with the MSCI EAFE Index appreciating 7.26% in the third quarter and 12.99% for the year-to-date. Emerging markets continue to perform better than developed international markets with the MSCI Emerging Markets Index increasing 8.72% for the quarter and 16.86% year-to-date.

With the bond market betting the Fed would cut interest rates, the Bloomberg U.S. Aggregate Bond Index returned 5.20% for the quarter, making the year-to-date return positive at 4.45%. High yield bonds, as measured by the ICE BofA U.S. High Yield Index, returned 5.28% for the quarter and 8.03% year-to-date. Municipal bonds, measured by the Bloomberg Municipal Bond Index, rose 2.71% this quarter and 2.30% for the year.

In this commentary, we focus on five questions we believe are on investors' minds as we enter the fourth quarter of 2024.

1. U.S. stocks had a strong third quarter, especially small and mid caps. Why did the broader market rebound?

The much hoped for broadening of the market began in earnest in July this year, as encouraging inflation data gave the Fed the breathing room to discuss cutting interest rates. Seeing that light at the end of the Fed's restrictive policy tunnel, we believe investors were eager to buy stocks that had been hurt the most by rising interest rates and were therefore expected to feel the most relief when the Fed shifted gears.

Many of these smaller, more cyclical companies had been struggling with both rising costs and higher interest rates. Many had higher levels of floating rate debt pushing up their borrowing costs. From our perspective, these companies should benefit from a decline in rates (although we note the descent may be slow). However, we would not characterize this enthusiasm as a high-quality rally.

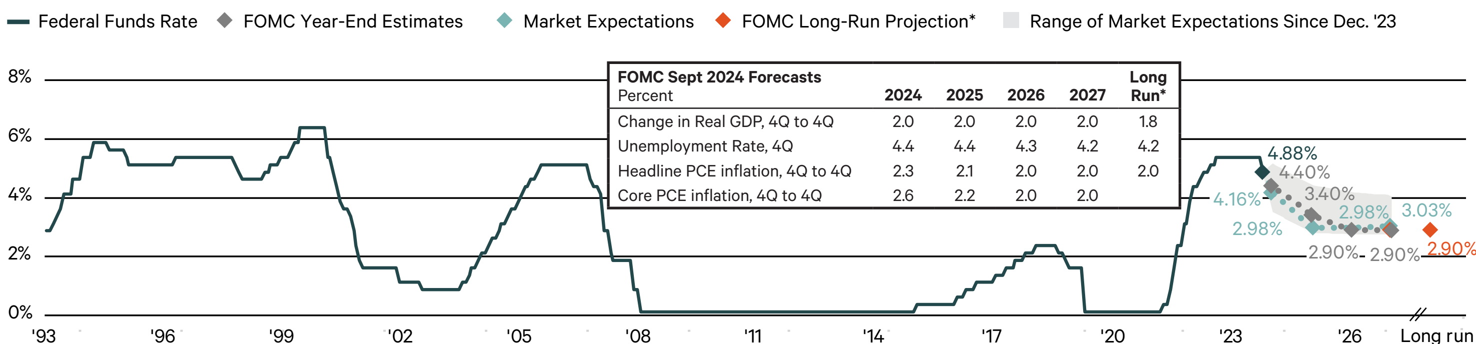
Investor excitement faded in August and September, but smaller capitalization stocks still ended the quarter with higher returns than large caps, and value stocks outperformed growth. A broader market is generally thought of as being a healthier market, as we all know the benefits of diversification. Whether these gains are sustainable will depend on third quarter earnings and the earnings guidance companies provide for the year ahead.

2. The Federal Reserve began its "initial descent" in September with a 50-basis point cut in the fed funds rate. What are the implications for the broader economy?

We believe investors should keep expectations in check on the impact this initial cut in rates will have on the broader economy. The Fed's 50-basis point rate cut started a descent back to a more normal interest rate level, but a big question is, "what is normal now?" It's important to recognize that the 13-year period of ultra-low or even 0% interest rates was an anomaly. We do not expect a return to those lows, at least not in the foreseeable future. Our current expectation is that the path of interest rates will not look like an inverted V-shaped mountain, where the descent takes us down to where we started. Instead, after the steep increases of the recent past, our current expectation is a gradual decline of rates to a plateau that will likely be 200-300 basis points above our former "normal".

FIGURE 1: FEDERAL FUNDS RATE EXPECTATIONS

FOMC and Market Expectations For the Federal Funds Rate



FOMC Sept 2024 Forecasts Percent	2024	2025	2026	2027	Long Run*
Change in Real GDP, 4Q to 4Q	2.0	2.0	2.0	2.0	1.8
Unemployment Rate, 4Q	4.4	4.4	4.3	4.2	4.2
Headline PCE inflation, 4Q to 4Q	2.3	2.1	2.0	2.0	2.0
Core PCE inflation, 4Q to 4Q	2.6	2.2	2.0	2.0	

*Data presented is as of September 30, 2024 and is obtained from Bloomberg, FactSet, Federal Reserve and J.P. Morgan Asset Management and is assumed to be reliable. Market expectations are based off of USD Overnight Index Swaps. *Long-run projections are the rates of growth, unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy. Forecasts are not a reliable indicator of future performance. Forecasts, projections and other forward-looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections or other forward-looking statements, actual events, results or performance may differ materially from those reflected or contemplated.* ***Past performance is no guarantee of future results.***

3. What are expectations for a "soft landing" versus "hard landing" and the impact on equities of varying market capitalizations?

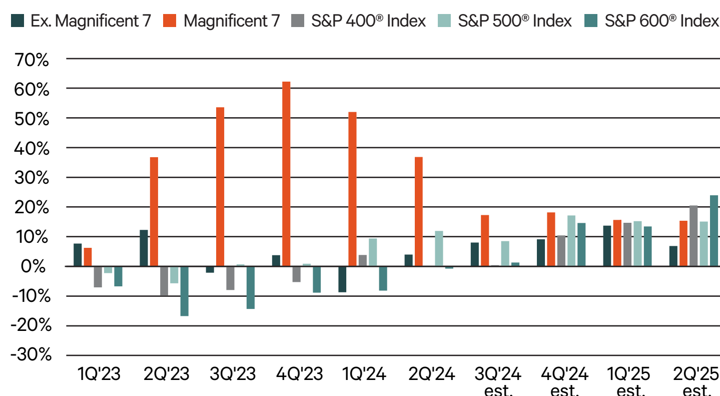
In our view, it is impossible to know whether we are heading for a hard or soft economic landing. At least 30 respected Wall Street economists regularly try to predict U.S. GDP; none are consistently right over time. We say this not to disparage these talented economists, but rather as a reminder of how futile it is to make predictions about the massive, complex U.S. economy and its many variables—some rational, some less so—not to mention geopolitical events that impact markets. We view forecasts as opinions, no matter how sophisticated the models behind them may be.

This quarter, investors with no small or mid cap exposure likely materially underperformed, with the Russell 2000 up 9.27% and the S&P 500 returning 5.89%. Large cap growth indices, where technology companies dominate, returned only 3.19%. We believe this should be a warning for investors with a concentration in mega-cap technology stocks, while small and mid-cap indices trail the S&P 500 year-to-date, in July the Russell 2000 (small cap) Value Index returned 12.19% while the Russell 1000 (large cap) Growth Index declined 1.70%. Inflection points happen quickly and are impossible to predict.

As a reminder, starting in 2000, small caps sizably outperformed the NASDAQ for 21 years on a cumulative basis, across booming economic times and recessions. Only in the last three years has this changed. We largely attribute this recent underperformance to generally weaker small cap earnings. Large cap earnings have been more resilient, as inflation, including rising wages and higher borrowing costs hit small caps harder.

We also note the differences in sector allocations between small, mid, and large caps, and when earnings across sectors hit their lows and started to recover. Large cap earnings troughed much earlier, in the third quarter of 2023; small cap earnings likely did so in the second quarter of this year. We believe it will be more challenging for large caps to grow earnings over the next 12-to-18 months, while small caps have more room to run.

FIGURE 2: YEAR-OVER-YEAR CHANGE IN EARNINGS PER SHARE GROWTH (Large, Mid, Small and Magnificent 7)



Data is as of September 30, 2024. Data is obtained from Strategas and is assumed to be reliable. The S&P 493 represents the S&P 500® Index without the Magnificent 7. The indexes are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. Please see the end of this paper for important information regarding the indexes. The Magnificent 7 stocks include Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. ***Past performance is no guarantee of future results.***

What about technology stocks, where large caps dominate? Even if we exclude the "Magnificent 7," we still see differences in the timing of earnings growth for large, mid, and small cap stocks. Thus, the market has been directionally rational. Of course, markets can be volatile depending on market sentiment—just this quarter small cap value stocks outperformed growth stocks in July, then materially underperformed the next two months.

Our main point here is that while the last three years have been an exception, over the long-term small caps have outperformed large caps. From our perspective, the outlook for small caps in 2025 appears favorable, as earnings growth should be easier to achieve off a lower base, all else being equal, and small cap valuations are below average. No one can predict exactly when earnings growth will resume, but we believe investors should consider having small cap exposure to avoid missing out when it does.

Mid cap companies would be in the middle of the two extremes. Valuations appear fair, and earnings growth is not expected to be as strong as for small cap firms but could grow more quickly than for larger peers.

4. A rising tide does not necessarily lift all boats. What is the role of quality right now?

While we see many positive signs for the economy, such as a still-healthy labor market, strong consumer demand, and increased investment in infrastructure and manufacturing capacity, we also see some headwinds. The current level of deficit spending is more consistent with unemployment in the 7% to 10% range, not the 4% levels we enjoy today.

FIGURE 3: UNEMPLOYMENT RATE AT WIDEST BUDGET DEFICIT

Date	Unemployment Rate (%)	Budget Deficit, % of GDP
COVID Era	14.8%	-14.0%
Global Financial Crisis	10.0%	-10.2%
1982 Recession	10.2%	-5.6%
Early 1990s Recession	7.3%	-5.1%
Mid 1970s Recession	7.9%	-4.6%
Current	**4.2%**	**-6.7%**

Data is as of October 4, 2024. Data is obtained from Strategas and FactSet and is assumed to be reliable.

Companies' pricing power appears to be weakening as consumers push back against price increases, which could challenge profit margins. Bottom line: there is reason for cautious optimism, but we do not think all companies will benefit equally if we do achieve that soft landing.

In our view, investing in quality companies is not just important when storms (which are inevitable in a market cycle) appear on the horizon; we believe quality companies are better able to adapt and pursue new opportunities. We focus the majority of our analysis on seeking to identify companies with the ability to nurture and protect a competitive advantage in all phases of an economic cycle.

5. Are consensus expectations for 2025 realistic? Should investors be optimistic or concerned?

Given that we believe the future is unknowable, it is hard to gauge whether consensus expectations are realistic, overblown, or too cautious. Insights provided by any

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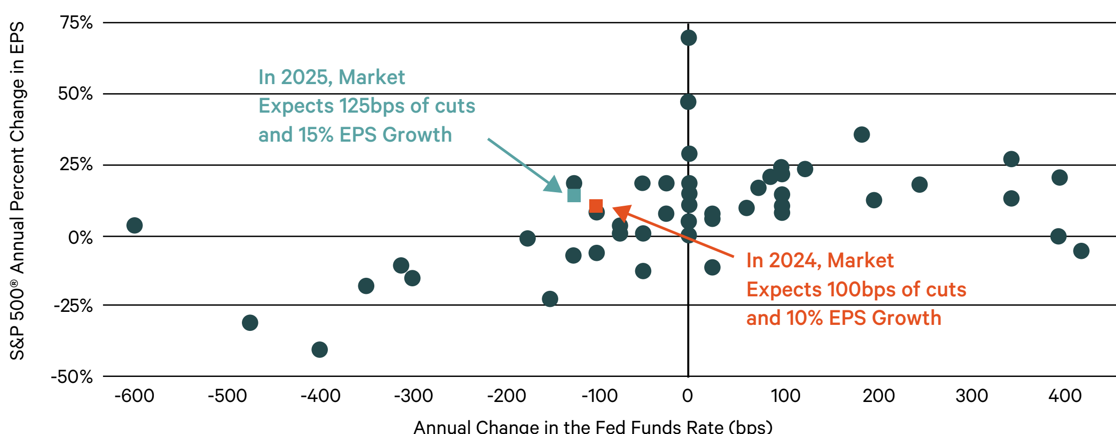
forecast can only be judged with hindsight. Analysts who evaluated Lehman Brothers in 2007 included what they thought was appropriate caution into their forecasts; we now know they were not even close. Trying to gauge the accuracy of consensus expectations gets back to the issue of the timing of earnings growth.

With that said, it's important to think about 2025 in the context of history. Currently, the market is anticipating S&P 500 earnings to grow 10% over 2024 combined with expectations of interest rate cuts over 125 basis points in 2025 (based on prices in the Treasury futures market). We would note that this combination of strong earnings growth and easing monetary policy has only occurred once...in 1984. Fun unrelated fact, Kayne Anderson Rudnick was founded in 1984.

FIGURE 4: ANNUAL CHANGE IN FED FUNDS RATE VS. S&P 500® ANNUAL PERCENT CHANGE IN EPS SINCE 1971



Data is as of October 4, 2024. Data is obtained from Strategas and is assumed to be reliable. The index is not actively managed and does not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. Please see the end of this paper for important information regarding the index. ***Past performance is no guarantee of future results.***

So, while we would characterize the risks and opportunities in the U.S. economy as relatively balanced, we think it is worth noting that the Fed usually cuts rates in response to weak economic conditions. We do not see that weakness today, so we think it's possible investors could be disappointed by a slower pace of rate cuts than is currently forecast. We saw this in January of this year, where the market had priced in seven to eight rate cuts, while the Fed's "dot plot" indicated three was more likely.

Therefore, while we view the economic picture to be relatively balanced between opportunities and risks, we do think valuations could be a risk if lofty investor expectations are not met.

Large-capitalization stocks are represented by the S&P 500® Index which is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The S&P SmallCap 600® (S&P 600) seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. The S&P Mid Cap 400® (S&P 400) provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment. Growth stocks are represented by the Russell 1000® Growth Index which is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Value stocks are represented by the Russell 1000® Value Index which is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Small-capitalization stocks are represented by the Russell 2000® Index which is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. Emerging markets are represented by the MSCI® Emerging Markets (EM) Index which is a free float-adjusted market capitalization index tracking the equity performance of global emerging markets. The Bloomberg U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The ICE BofAML U.S. High Yield Index tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prefunded bonds. This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. ***Past performance is no guarantee of future results.***

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