



Market Review
Second Quarter 2023

The second quarter of 2023 was a very strong period for stocks, prompting memories of past bull markets. The distribution of returns, however, was uneven, muddling the picture.

During the period, the S&P 500 Index gained 8.74% versus 5.21% for the Russell 2000 Index. However, the Small Cap increase was confined to the last month of the quarter. Growth outperformed Value on both ends of the market capitalization spectrum, and the year-to-date discrepancy has become extreme. Led by Mega Cap *Technology*, the Nasdaq was the big winner in the period, returning 12.81% for the quarter and an astounding 31.73% for the first six months of the year. This marked the best first half of a year for the Nasdaq since 1983.

Although the quarter finished strong, it began tepidly, fresh off of the failures of Silicon Valley and Signature banks. Not surprisingly, inflation fears became contagion fears, and investors fretted about the prospect of further bank credit tightening into an already slowing economy.

The surprise, however, was the extent to which the rotation out of *Financials* resettled in Mega Cap Technology. After a challenged 2022, this dynamic reestablished these stocks as a “safe haven” in anxious markets. It also provided a ballast of resilience for the S&P 500. Aided by massive cost-cutting programs, the stock market devolved into a tug-of-war between the narrow strength in Technology stocks and the weakness in cyclical sectors. But the psychological advantage was with the cyclical losers.

This all changed abruptly when **NVIDIA Corp. (NVDA)** reported earnings in late May. The company, which is a leading provider of graphics accelerator chipsets that have been repurposed to support AI training and inference models, shocked the stock market when it forecasted that revenue would increase over 50% sequentially in the second quarter. The projection was \$4.0 billion higher than the Wall Street consensus forecast, which is unfathomable for a business that has over thirty covering analysts.

The significance of the report and commentary was two-fold. First, NVIDIA’s outlook validated that Generative AI, which had already captured the awe and imagination of investors, (i) has the potential to be a transformative technology and (ii) will require massive investment. Second, it provided the growth catalyst that investors needed to justify the technology-led advance in the markets up to that point. This enabled the next surge to begin.

Although in most ways not much had changed, all of the positive stock market drivers started to shine a little brighter under the AI halo. While First Republic Bank fell into receivership, the concern about more systemic risk to the financial system lessened. Investors celebrated that earnings revision trends were less negative than in recent periods. The disinflationary trend continued, and was particularly evident in very benign April and May PPI reports. In June, the Federal Reserve opted to hold interest rates steady for the first time after ten consecutive increases.

The stock market advance also started to broaden. Despite persistently weak economic indicators, including eight straight contractionary ISM Manufacturing reports and a massively inverted yield curve, all of the major domestic equity indices rallied sharply in June. But with the increased confidence and appreciation came more signs of froth. By quarter-end, Investors Intelligence Bullish Sentiment had increased to the highest level since November 2021.

At this point, the primary challenge for investors is trying to discern if the incremental improvement in business conditions and growth prospects warrants the sharp increase in share prices. On one hand, we are very concerned about the excessive enthusiasm and expect volatility to increase. But we also believe that the advancement and proliferation of Generative AI will have a much more profound impact on business than other highly-publicized innovations. The fact that we can see the corresponding increase in investment makes it easier to look out beyond the still unfolding tightening cycle and manufacturing malaise.



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The thing that gets us excited, however, is that we believe Small Cap Growth is well-positioned to outperform other sub-segments of the market. As growth investors, we do not think that the innovation in AI is going to be limited to a handful of technology bellwethers. In fact, several of our holdings are already gaining from the same data center investment that has transformed NVIDIA's prospects. We continue to believe that the risk/reward for Small Cap stocks is more favorable than Large Cap.

Sources: FactSet, GICS Sector Classification, NVIDIA Earnings Release, Wall Street Journal, U.S. Bureau of Labor Statistics, Institute of Supply Management, Investors Intelligence – Bullish Sentiment Data, FTSE Russell, Jefferies

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The S&P 500 is widely regarded as the best single gauge of U.S. large cap equities. The index includes 500 leading companies spanning all sectors of the U.S. stock market. It covers approximately 80% of the U.S. equity market capitalization and over 50% of the global equity market.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 7% of the total market capitalization of that index, as of the most recent reconstitution. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small cap opportunity set.

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The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

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Index Definition Sources: Standard & Poor's, FTSE Russell, Nasdaq, Investopedia