Market Review
Third Quarter 2023

After a resounding first half, stocks sold off in the third quarter of 2023. Although the pullback was not surprising, the losses progressively worsened, and the resulting tone was more somber than expected.

During the period, Large- and Small-Cap stocks fell 3.27% and 5.13%, respectively. Because the selling was broad-based, however, the change in trend did not change the narrative for the year. Growth has trounced Value, Large has clobbered Small, and there is a huge discrepancy in the year-to-date returns for the Nasdaq (+26.30%), the S&P 500 (+13.07%), the Equal-Weighted S&P 500 (+1.79%), and the Russell 2000 (+2.54%). Investors remain mired in a very narrow market in which there is a large appetite for Mega Cap Growth, but very little else.

The primary culprit for the selling was of course another sharp increase in bond yields. In the past three months, the 2-Year U.S. Treasury bond yield increased 17 basis points to 5.04%, while the 10-Year U.S. Treasury bond yield climbed 76 basis points to 4.57%. The bond "bear steepening" has left yields perched at their highest levels since 2007. There have been multiple explanations for the shift.

The initial interpretation was that the trend reflected improving growth prospects, which felt apropos in a strong rally. Then, there was concern about rising inflation due to higher oil prices and widely publicized labor negotiations when markets were last sanguine. The more recent - and foreboding - focus has been on the bond market's ability (and willingness) to digest increased issuance stemming from an excessive budget deficit.

No matter the cause, the bottom line is that it is hard not to feel like something is amiss when yields are steadily rising in a period in which the S&P 500 rallied 20.65% through July. The unsettling trend made investors (i) more nervous heading into the September FOMC meeting, and (ii) much more receptive to the central bank's "higher-for-longer" messaging, which was reiterated again in the communique and The Summary of Economic Projections plot. This acquiescence led to steep losses in September as investors reassessed risk and valuation accordingly.

At this point, the obvious question for investors is will the "higher-for-longer" (and risk-off) mindset last? Or, did market participants overreact to a predictable pullback, just in time for inflationary pressures to ease and the bond market trend to reverse?

Although it is not central to our process, our inclination has been to take the Federal Reserve's messaging at face value. As a result, we believe it is appropriate that the U.S. Treasury bond yields and market pricing around the Fed rate path now look more similar to the central bank's own projections. Having said this, we are bullish in the long-term and recognize that the market will inevitably revert to a more constructive "Peak Fed, Peak Inflation" mindset, as it has so many times in the past 18 months.

The more frustrating issue for the team here, however, is what will it take for Small Cap to outperform Large Cap?

While it is always impossible to know when change is going to happen in markets, we are much more optimistic on the prospects for Small Cap than for the broader market. Because the underperformance has been persistent and extreme, our investable universe of high-quality, profitable small growth companies trading at reasonable valuations has swelled. We believe that a broadening in the market, and a reassessment of return profiles, is long overdue and that the increase in the number of stocks that meet our rigid quality, growth, and valuation criteria bodes well for our investment process and the broader asset class.

Sources: *FactSet, GICS Sector Classification*

Past performance is no guarantee of future results. This commentary represents the portfolio managers' opinions as of the date of this presentation, and may change based on market and other conditions. This commentary is provided for informational purposes only and is not intended to forecast future events, guarantee future results, serve as investment advice, or serve as a recommendation to buy or sell any types of securities. Rice Hall James obtained some of the information provided herein from third party sources believed to be reliable but such is not guaranteed. There is a risk of loss from an investment in securities, including the risk of loss of principal. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable or suitable for a particular investor's financial situation or risk tolerance. Any forward looking statements or forecasts are based on assumptions and actual results are expected to vary from any such statements or forecasts. No reliance should be placed on any such statements or forecasts and the information contained in these materials should not solely be relied upon when making any investment decision.

Indices are provided for comparative purposes only. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. An investor cannot invest directly in an index. This is an actively managed strategy that does not invest in all of the securities of an index, and will have some associated concentration risk. Comparisons have limitations because indices may have volatility, investment and other characteristics that may differ from an investment account strategy to which it is compared. Indices are unmanaged, include the reinvestment of dividends, and do not reflect transaction costs, management, or other fees. See the following for a description of each index used in this material.

The Nasdaq Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.

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 S&P 500® Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

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.

The 2 Year Treasury Rate is the yield received for investing in a U.S. government issued treasury security that has a maturity of 2 years.

The 10 Year Treasury Yield is the yield that the government pays investors that purchase the specific security. Purchase of the 10-year note is essentially a loan made to the U.S. government.

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