RICE HALL JAMES
& ASSOCIATES, LLC

Market Review
Second Quarter 2024

The second quarter of 2024 marked yet another period of high valuations in large caps and their continued outperformance relative to small caps. The S&P 500 Index was up 4.28% for the quarter, compared to -3.28% for the Russell 2000 Index, and the large cap index hit new record highs, as well. Specifically, this strength continued to be driven by a narrow set of technology stocks - the so-called “Mag 7”- with this group making up more than half of the S&P 500’s move year-to-date. This is not a new theme (we saw the same in 2023), but it has certainly raised some eyebrows and is prompting ever-growing concern among more fundamentals-oriented investors. Enthusiasm around artificial intelligence (AI) technology continues to overshadow any consideration of economic softness on the horizon.

Despite the Fed signaling otherwise, bond rates have been falling (at least they were until the first Presidential debate last week), reflecting the belief that the Fed will be cutting interest rates soon. Gone are the expectations of three rate cuts this year, but the bond market is clearly anticipating at least one cut – perhaps as soon as September –more likely, December. Various macro data points suggest the economy is slowing. Unemployment has ticked higher, retail sales have come in lower, and the most recent credit card data was weak. May housing starts and building permits were the lowest since June of 2020 and the June ISM Manufacturing read was again contractionary. Though we are not in a recession, the softening is evident.

If the Fed interprets the bearish data as such, we would expect a rate cut or two this year. At the very least, regardless of time horizon, we see future interest rates trending downward and importantly, we believe this is a positive for small cap stocks. Coupled with their significantly more attractive valuation compared to large caps, we see a compelling set up for small caps through the second half of this year and into next. To put a finer point on that statement, the S&P 500 P/E is now trading around 24x forward earnings compared to the P/E on the S&P 600 Index of just over 15x.

In fact, we have seen some indication that the market is starting to agree with us that valuations matter, at least within the small cap segment of the market. The RHJ Small Cap portfolio was up 5.41% this quarter (5.27% net) compared to the Russell 2000 Growth Index, down 2.92% in the quarter. The RHJ Micro Cap portfolio was up 2.74% in the quarter (2.58% net) compared to the Russell Microcap Growth Index, down 5.57% in the quarter. This outperformance in both funds reflected positive stock selection by the team, but the market also clearly favored more “growth at a reasonable price” issues in May, in-line with our valuation-oriented process.

At this point, we are going on over seven years of underperformance of small caps vs. large in the United States. This could end up being the longest period of relative underperformance ever. Meanwhile, technology funds continue to see record inflows; $8.7 billion in the week ended June 19, 2024! The extraordinary run of **Nvidia Corp. (NVDA)** over the last two years has only propelled retail investors to increase exposure to the large cap tech stocks, despite the big moves and expanding multiples. Against a backdrop of softer macro and increasing volatility likely as we near the election, we believe the better opportunities lie in the less expensive, underfollowed small cap part of the market. And as we see rates reverse course and begin to fall, we would expect investors to increasingly look to small caps for better returns.

Sources: *FactSet, GICS Sector Classification, HANetf Ltd., Wall Street Journal, MacroMicro, Jefferies*

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P/E Ratio - The price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share. The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.

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 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.

The ISM Manufacturing Index is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories. Each factor is seasonally adjusted.

The S&P 600 seeks to measure the small-cap segment of the U.S. equity market. The index is designed to measure the performance of 600 small-sized companies in the U.S., reflecting this market segment's distinctive risk and return characteristics.

The Russell 2000® Growth Index measures the performance of the small cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth, and higher sales per share historical growth (5 years). The Russell 2000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the small-cap growth segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell Microcap® Growth Index measures the performance of the micro cap growth segment of the U.S. equity market. It includes Russell Microcap companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth, and higher sales per share historical growth (5 years). The Russell Microcap Growth Index is constructed to provide a comprehensive and unbiased barometer for the micro cap growth segment of the market. The Index is completely reconstituted annually to ensure larger stocks do not distort performance and characteristics of the micro cap opportunity set.

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

Investment Statistic Definition Source: *eVestment Analytics*