Market commentary

Today’s equity market environment reminds me of a quote from the legendary daredevil, Evel Knievel, who said “anybody can jump a motorcycle, the trouble begins when you try to land it.” Over the last few quarters, we’ve discussed the lagged effects of monetary policy and, in particular, whether or not the Fed could successfully reduce inflation without creating a recession or material slowdown in economic activity. Generally, negative impacts of a Fed tightening cycle happen 12-24 months after significant monetary policy changes have been implemented. Accordingly, we are now at the point of the cycle where the rubber truly meets the road, and over the next few quarters we will have much more clarity related to growth and growth expectations.

Entering the year, we would have expected a much slower macro environment based on the historical linkages between Fed policy and future economic growth. But the environment proved more resilient than initially anticipated, as both earnings growth and economic activity, though slower on the margin, exceeded expectations. Part of this resiliency was created by fiscal and monetary stimulus which produced over $2 trillion in excess savings for the consumer. Excess savings, along with solid employment formation and rising wages, have buoyed the consumer and, at the very least, delayed the traditional lagged impacts of Fed policy. However, levels of inflation remain persistently high, which not only produces fodder for the Fed to keep interest rates higher for longer, but also introduces incremental recessionary fears adding more uncertainty to growth forecasts.

Equity market review

MESIROW EQUITY MANAGEMENT STRATEGIES
AUM: $1.0B as of September 30, 2023

- Small Cap Value
- Small Cap Core
- SMID Cap Value
- SMID Cap Core

“We believe the key to generating consistent investment returns is the selection of investment opportunities that possess attractive valuations and demonstrate identifiable catalysts that are expected to generate accelerating earnings and cash flow growth.”

Kathryn A. Vorisek
Head of Equity Management, Portfolio Manager

Leo Harmon, CFA, CAIA
Chief Investment Officer, Portfolio Manager

Andrew Hadland, CFA
Director of Research, Portfolio Manager

INVESTMENT OBJECTIVES
- Generate attractive risk-adjusted returns
- Consistently outperform the benchmark over a market cycle
- Participate in rising markets and protect capital in down market

Past performance is not indicative of future results. Please see disclosures at the end of this commentary for additional, important information.
Interest rates to stay higher for longer as Fed battles inflation

As the quarter commenced, equity markets were in the midst of a significant rally as company earnings reports were much better than anticipated, employment gains continued to show strength, the panic related to the banking liquidity crisis diminished and the prospects of a potential recession were reduced and/or pushed into the future by many market participants. However, the reality of incessantly higher interest rates, slower marginal growth and the Fed intimating that rates will remain “higher for longer” (Figure 1) caused a sharp correction in prices in the latter part of the quarter, leading to the following results:

<table>
<thead>
<tr>
<th>Index</th>
<th>3Q2023</th>
<th>YTD 2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 2000 Value Index</td>
<td>-2.96%</td>
<td>-0.53%</td>
</tr>
<tr>
<td>Russell 2000 Index</td>
<td>-5.13%</td>
<td>2.54%</td>
</tr>
<tr>
<td>Russell 2500 Value Index</td>
<td>-3.66%</td>
<td>1.95%</td>
</tr>
<tr>
<td>Russell 2500 Index</td>
<td>-4.78%</td>
<td>3.59%</td>
</tr>
</tbody>
</table>


The Energy sector dominated in the third quarter

For the quarter, market leadership was driven by some inflationary characteristics: Energy was by far the best performing sector (Figure 2) and one of only two to produce positive returns, boosted by the rise in oil prices (Figure 3). Materials, Financials and Consumer Staples also outperformed the market.

Small cap underperformance attributed to seven large companies

Healthcare and Technology were the worst performing sectors of the market, reversing some of the significant gains from traditional growth in the first half of the year.

As a result, value indices were able to outperform growth. However, the broader rally into small cap stocks reversed as large cap modestly outperformed despite the retracement in large technology stock names. Year to date, large cap performance continues to be driven by several of the largest, mostly tech-related companies with small cap performance closer to parity when these companies are excluded (Figure 4).
High quality factors regained the upper hand in the third quarter

After trailing the market over the first half of the year, higher quality attributes returned to prominence in the third quarter as profitable companies significantly outperformed their unprofitable counterparts (Figure 5).

Revisions for 2023 moved lower but outlook for growth improved

Equity markets continue to oscillate in a broad trading range. The rally that began last fall on the prospects of lower interest rates in a “soft landing” environment and accelerated through the second quarter of this year has begun to lose momentum. We believe the markets will continue to be range bound until there is some resolution related to economic growth or earnings forecasts lend some transparency to corporate expectations. Current earnings expectations continue to decline, though consensus earnings forecasts have found some footing and should help drive better results if validated over the next few quarters (Figure 6).

Conclusion

In the meantime, we continue to monitor several factors that may influence our tactical portfolio positioning:

- The Fed’s tolerance for inflation above its 2% baseline
- Incremental economic growth, particularly over the next two quarters
- The impact of higher energy prices
- Timing and duration of a potential recession
- The impact of higher rates on liquidity and credit for both businesses and consumers
- Pricing power and margin stability
- Pace of employment formation
- Earnings revisions and changes in the growth cadence for 2023 and 2024

In many respects, some indicators (higher mortgage rates, negative growth in leading economic indicators, lower money supply and weaker regional surveys) still reflect a level of stress in the environment which can only be mitigated through positive economic growth. In addition, some supportive elements of the market (excess savings) have now been somewhat exhausted. While the Fed’s policy actions in this cycle have, thus far, produced relatively benign results, we are mindful of the lagged affects and will continue to evaluate the environment for opportunities to drive excess performance.
Benchmark definitions:

The Russell 2000 Index offers investors access to the small-cap segment of the US equity universe. 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 Russell 2000 includes the smallest 2000 securities in the Russell 3000.

The Russell 2000 Value Index offers investors access to the small-cap value segment of the US equity universe. The Russell 2000 Value is constructed to provide a comprehensive and unbiased barometer of the small-cap value market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine value probability approximates the aggregate small-cap value manager’s opportunity set.

The Russell 2500 Index measures the performance of the small to mid-cap segment of the US equity universe, commonly referred to as “smid” cap. The Russell 2500 Index is a subset of the Russell 3000 Index. It includes approximately 2500 of the smallest securities based on a combination of their market cap and current index membership.

The Russell 2500 Value Index measures the performance of the small to mid-cap value segment of the US equity universe. It includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2500 Index is constructed to provide a comprehensive and unbiased barometer for the small to mid-cap opportunity set and that the represented companies continue to reflect value characteristics.

(Source: Russell).

The S&P 500 is widely regarded as the best single gauge of large-cap US equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization. Please see the following GIPS disclosure for additional benchmark definitions.

Mesirow refers to Mesirow Financial Holdings, Inc. and its divisions, subsidiaries and affiliates. The Mesirow name and logo are registered service marks of Mesirow Financial Holdings, Inc. © 2023. All rights reserved. Mesirow Equity Management (“MEM”) is a division of Mesirow Institutional Investment Management, Inc. (“MIIM”) an SEC-registered investment advisor. This communication is for institutional use only and may contain privileged and/or confidential information. It is intended solely for the use of the addressee. If this information was received in error, you are strictly prohibited from disclosing, copying, distributing or using any of this information and are requested to contact the sender immediately and destroy the material in its entirety, whether electronic or hardcopy.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture. To learn more, visit mesirow.com and follow us on LinkedIn.

Contact us

portfoliospecialist@mesirow.com | 312.595.7300

Nothing contained herein constitutes an offer to sell or a solicitation of an offer to buy an interest in any Mesirow investment vehicle. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. It should not be assumed that any recommendations incorporated herein will be profitable or will equal past performance. Model, theoretical or hypothetical performance information and results do not reflect actual trading or asset or fund advisory management and the results may not reflect the impact that material economic and market factors may have had, and can reflect the benefit of hindsight, on MEM’s decision-making if MEM were actually managing client’s money. Any chart, graph, or formula should not be used by itself to make any trading or investment decision. Mesirow Institutional Investment Management, Inc. and its affiliated companies and/or individuals may, from time to time, own, have long or short positions in, or options on, or act as a market maker in, any securities discussed herein and may also perform financial advisory or investment banking services for those companies. Mesirow does not provide tax or legal advice. Securities offered through Mesirow Financial, Inc. member FINRA, SIPC.