SEGALL BRYANT & HAMILL
ASSET MANAGEMENT

The Active Advantage

Small Cap Sector Themes

What's Played Out and What's to Come

Technology | Industrials | Consumer | Financials

Despite concerns of a looming recession heading into 2023, the U.S. economy has, thus far, shown remarkable resilience in the face of significantly higher interest rates, still elevated inflation, tightening bank lending standards, and slowing business conditions across various sectors and industries. Record backlogs, pent up consumer savings, a solid job market, and U.S. government-related spending all served to bolster economic activity in the first half of 2023. There are many moving parts as the second half unfolds that are continuing to fuel growth in focused areas of our economy. Against this backdrop, our investment professionals for our Small Cap Core, Small Cap Growth, and Small Cap Value strategies continue to monitor the impact of different sectors in the small cap space within the context of their fundamental research approach. What follows is a discussion on how they see different sectors playing out during the remainder of 2023.

Technology

Generative artificial intelligence (AI) emerged as the dominant theme in the Technology sector during the first half of the year. Speculation about its potential to transform industries and create winners and losers abruptly changed investor preferences. The positivity toward generative AI's potential also masked end market weakness in other parts of the technology market that spread through the sector as backlogs began to normalize and corporations increasingly scrutinized their spending. We believe generative AI's impact in the medium term will be greater than other technological advancements over the last 5 to 10 years and have selectively added companies to the portfolio that we believe will benefit. We also recognize the pace of technology adoption is frequently longer than hoped, potentially disappointing now elevated investor expectations which, coupled with soft corporate spend intention and mixed macro datapoints, keeps us tilted toward higher return on invested capital (ROIC) companies within the sector.

— Small Cap Core perspective

The dawn of an AI era hit mainstream awareness with the rapid adoption of OpenAI's ChatGPT in the first half of 2023. Moreover, Nvidia, leading producer of the essential graphics processing semiconductors used in generative AI applications, reported a quarter with guidance for the ages. In its most recent earnings release in mid-August 2023, Nvidia stated that data center revenues hit a new record, up 171% year-over-year to more than $10B in the quarter. A speculative fervor amidst perceived winners from AI adoption set in, while those deemed as losers were punished ruthlessly. Underneath the excitement and promise of what AI will bring for innovation lies a truth likely somewhere in between. Hype cycles often come to a crashing halt for pretenders while ultimately they can create many of the stock market's next great disruptors. The best-returning area of the small cap Technology sector has primarily been the semiconductor industry. We have been overweight this industry this year and remain optimistic about the prospects of cyclical improvement after supply chain normalization.

Additionally, we believe there will be derivative beneficiaries of the AI capex tidal wave that has started, chief among them semiconductor equipment manufacturers. Perceived losers include companies that provide consultative services, back-office applications, or digital development capabilities, as automation from AI could cannibalize current sales or opportunities. We believe this will take a long time to play out, particularly as enterprises will move cautiously before deploying AI broadly across appropriate functions.

Many enterprises will likely require more, not less, guidance from leaders in the technology services supply chain and as such, we believe the market is likely too pessimistic around many of these companies. Current fundamentals across most of the Technology sector have remained under pressure. While valuations have expanded due to cost controls and prospects for stabilizing results, most small technology companies continue to experience near-term setbacks in results, and we remain selective in the sector.

— Small Cap Growth perspective

> "Underneath the excitement and promise of what AI will bring for innovation lies a truth likely somewhere in between."
>
> **— Small Cap Growth**

Industrials

A reversal in many of the housing-related businesses and stocks that came under pressure in 2022 is playing out in 2023. Destocking and rightsizing labor and production levels, while a painful process, have positioned these companies to renew their focus on growth. We are seeing opportunities especially in the composite-related product end markets and certain structural support products. Many commercial and industrial end markets continue to experience robust demand given long-term build cycles, robust backlogs, and easing supply chain issues, despite a continued challenging labor backdrop. However, higher interest rates remain a concern, as we anticipate headwinds over time for commercial real estate, large-scale projects, and equipment purchases that require financing. We are seeing higher financing costs negatively impact demand today in parts of the electrical equipment and machinery industries. Longer term, we remain encouraged by multiple secular drivers around electrification, infrastructure expansion, reshoring parts of manufacturing, and environmental impact projects (such as water treatment) that provide continued growth in the face of economic slowdown concerns in 2023 and beyond. Our fundamentally stable growth investment approach drives our interest in these longer-duration growth opportunities within the Industrials sector.

— Small Cap Growth perspective

> "Longer term, we remain encouraged by multiple secular drivers around electrification, infrastructure expansion, reshoring parts of manufacturing, and environmental impact projects."
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> **— Small Cap Growth**

As it relates to Industrials, there are many crosscurrents occurring all at once this year. We have seen significant fiscal stimulus start to emerge more broadly from a multitude of areas including the Inflation Reduction Act (IRA), Infrastructure Bill, CHIPS and Science Act, in addition to the beginning of reshoring/onshoring. Conversely, we are also seeing the Purchasing Managers' Index (PMI) well into contraction territory, not only in the U.S. but globally. Europe still has inflationary struggles to manage and an uncertain energy supply future, while China's recovery has been slower than expected. We believe management teams that can drive better productivity and a leaner cost structure remain poised to be long-term winners in this sector.

— Small Cap Value perspective

Consumer

The surprise of the first half of the year has been the resiliency of new home sales. Paradoxically, the spike in interest rates helped homebuilders rebound faster than expected from the weakness during 2022. Significantly higher interest rates and home prices make affordability less favorable, but higher rates also limit supply, as current homeowners are reluctant to sell because many can't afford to give up the low mortgage rates they currently have. As a result, existing home supply has been suppressed, which has pushed consumers to the new home market and buoyed the homebuilder ecosystem. Additionally, utilizing rate buydowns, homebuilders have lowered the effective mortgage rate by 1% to 2%, driving an incremental affordability advantage over the existing home sales market. Recognizing this, we have added competitively differentiated companies in this space to the portfolio while maintaining concerns about consumer spending overall, due to continuing elevated inflation, the prospect for increasing unemployment as the economy weakens, a lower COVID stimulus buffer, and the looming resumption of student loan repayments. As these potential headwinds to corporate results play out, we expect to shift more aggressively into improving ROIC businesses.

— Small Cap Core perspective

> "Existing home supply has been suppressed which has pushed consumers to the new home market and buoyed the homebuilder ecosystem."
>
> **— Small Cap Core**

Financials

Financials have absorbed a significant amount of stress over the last six months. The Federal Reserve has raised interest rates to a restrictive level to bring down inflation; however, several inflation aspects remain sticky which could keep rates higher for longer. The banks need to reprice their deposits to compete for liquidity (e.g., as investors move cash from bank deposits into higher yielding Treasuries and money market funds) or borrow funds at much higher costs than just a few months ago, which has put pressure on the net interest margins of banks—regional banks in particular. The banks generally have plenty of capital to survive a credit cycle; however, not knowing how severe or how long a credit cycle might be is a challenge for this group. For these reasons, we will continue to monitor the sector for any significant changes.

— Small Cap Value perspective

> "Banks generally have plenty of capital to survive a credit cycle; however, not knowing how severe or how long a credit cycle might be is a challenge for this group."
>
> **— Small Cap Value**

Looking Forward

Despite a challenging market backdrop going forward, we believe attractive opportunities exist in small cap companies in various sectors that exhibit high ROIC, solid balance sheets, and the ability to generate solid free cash flow. A key focus of ours is on management teams that can help their companies not just weather a broad variety of storms but also become stronger organizations. While performance as measured by the stock market can and will fluctuate from quarter-to-quarter and year-to-year, we believe that a process grounded in these philosophical beliefs may provide attractive risk-adjusted returns over the longer term.

Please reach out to your SBH contact with any questions or visit www.sbhic.com to learn more.

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