RICE HALL JAMES
& ASSOCIATES, LLC

Market Review
Third Quarter 2017

The third quarter provided a good microcosm of the post-election pattern of the small-cap bull market, and the opportunities and challenges it presents for investors.

In the U.S., the S&P 500 and Russell 2000 indices rallied during the 3rd quarter 4.5% and 5.7% respectively, and are now up 14.2% and 10.9% year-to-date. The majority of returns, however, were generated in the last month of the quarter, and the drivers of performance in September were very different than in July and August.

In the first two months of the quarter, stock market returns were paltry, reflecting angst around violent protests and (nuclear) military provocations, along with an element of investor fatigue amid high earnings expectations. But, while returns were nominal, almost all of the gains during the period came from two industries – *Health Car*e and *Technology* – with a particular emphasis on the fastest-growing, highest-priced companies in those areas.

In September, however, the script started to change as different pieces fell into place to reignite the cyclical "reflation trade".

The sentiment started with strong economic data, which included the best Gross Domestic Product (GDP) report in two years, and the best manufacturing survey in six years, in successive weeks. It was also furthered later in the month by a well-toned Federal Open Market Committee (FOMC) communiqué that growth was strong and inflation understated, along with assurances that policymakers could shrink the Fed's (Federal Reserve) $4.5 trillion balance sheet in a slow unwind unlikely to disrupt financial markets.

But, the biggest impetus for the (reflationary) pivot was President Trump's tax reform outline and speech. Among the most notable highlights of the proposed reform is the reduction in the number of tax brackets to 3 from 7, with individual tax rates set at 12%, 25%, and 35%. More importantly for financial markets, the plan would lower the corporate tax rate to 20% from 35%, and would allow companies to immediately write off investment in new equipment.

The end result was a fervent rally that led to over 5% gains in small cap indices in September, and culminated in over a week of record highs into quarter-end. The market response was familiar, with a sharp rotation into the broad-based cyclicals such as *Materials*, *Industrials*, and *Financials* stocks, while the high P/E growth stocks that drove performance earlier in the quarter (and year) lagged.

At this point, the obvious question for investors is does the reflation trade have legs, or is it more likely to stall-out as the latest in a long line of sharp, but short cyclical advances? This is important for two reasons. After eight years of a powerful bull market, genuine cyclical strength could push investors to get more broadly invested, which would help to widen an uncomfortably narrow and expensive market. In addition, the proposed tax reform would provide a significant (8-10%) jolt to after-tax profits, making valuation somewhat more palatable.

In small-cap, an extended cyclical advance also has the potential to reconnect the market with earnings, cash flows, and valuation. This would be a welcome development in a year in which Biotech has led the market higher (again), and is up over 50% year-to-date. Our take is that the prospects for improved economic traction along with some element of tax reform are better now than at any time in the recent past, but are far from a foregone conclusion.

Sources: *FactSet, Wall Street Research, Briefing.com, GICS Sector Classification*

Past performance in no guarantee of future results. This commentary represents the opinions of Rice Hall James as of the date of this presentation, and is subject to change without notice. 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. An investor cannot invest directly in an index. 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 below for a description of each index used in this presentation.

S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. S&P 500 is part of a series of S&P U.S. indices that can be used as building blocks for portfolio construction.

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 10% of the total market capitalization of that index. It includes approximately 2000 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 Global Industry Classification Standard ("GICS") was developed by and is the exclusive property and a service mark of MSCI Inc. ("MSCI") and Standard & Poor's Financial Services LLC ("S&P") and is licensed for use by Rice Hall James & Associates, LLC. Neither MSCI, S&P, nor any other party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability and fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling the GICS or any GICS classification have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

Index Definition Sources: *Standard & Poor's; Russell Investments*

Mutual fund investing involves risk including the possible loss of principal. There are specific risks inherent in small cap investing, such as greater share volatility as compared to other funds that invest in stocks of companies with larger and potentially more stable market capitalizations. Products of technology and biotech companies may be subject to severe competition and rapid obsolescence.

To determine if a Fund is an appropriate investment for you, carefully consider the Fund's investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Fund's full and summary prospectuses, which may be obtained on the website at www.rhjfunds.com or by calling 1-866-474-5669. Please read it carefully before investing.

Rice Hall James Funds are distributed by SEI Investments Distribution Co., 1 Freedom Valley Dr., Oaks, PA 19456, which is not affiliated with the advisor.