



Market Review
Second Quarter 2021

The second quarter marked the grand reopening of the U.S. economy with over half of the adult population vaccinated and low COVID-19 incidence, hospitalizations, and deaths. It also continued the fifth straight quarterly gain for the major domestic indices.

While almost all markets rallied, the big winner in the period was large cap growth. The S&P 500 gained 8.6% versus 4.3% for the Russell 2000. In a sharp reversal from the first three months, the S&P 500 Growth trounced the S&P 500 Value by 7.0%. Although small cap value (+4.6%) technically fared better than small cap growth (+3.9%), all the momentum was on the growth side into quarter end. Coincident with the pivot was an unexpected decline in the 10-year U.S. Treasury bond yield from 1.74% to 1.45%; the conventional wisdom remains that lower bond yields support higher equity valuations.

On one hand, the reversal in favor of large cap and growth wasn't surprising considering the extreme underperformance in the prior period. But it wasn't intuitive why bonds rallied (yields declined), or why investors would temper on the prospects for a broad-based recovery. We believe there were three primary factors that drove the shift.

First, while the signs of inflation were rampant and borne out in the pricing data, the April and May employment reports were shockingly weak. Because of its dual mandate, this provided the Federal Reserve with cover to preserve a (credible) dovish posture longer than investors believed possible. More specifically, April nonfarm payrolls increased by 278,000 jobs, which was wildly below Wall Street forecasts for 1 million additions to the workforce. This made it easier for debt and equity investors to tolerate the subsequent largest monthly increase in the CPI since 1982; after an initial spike in response to the inflation report, bond yields quickly settled lower.

Second, with the momentum at its back, the Federal Reserve was masterful in its communication and navigation. While Chairman Powell was steadfast that it was premature to think about removing accommodation, multiple committee members opined it was time to talk about tapering. This "engineered dissent" pushed the inflation debate further to the back burner while planting the seed that a change in policy course was close at hand. As a result, the central bank was able to deliver a more hawkish communique in June without derailing the bond market rally.

Lastly, inflation concerns were assuaged by a pullback in commodity prices in May and June, which was aided by a crackdown on speculation by Beijing. The trend reinforced the Federal Reserve's mantra that the increase in inflation was temporary. It also catalyzed a new narrative of "peak inflation and peak growth" that attempted to explain the pullback in yields and pivot to growth equities.

The irony, however, is that since the Fed started to discuss the importance of tightening policy, its actions have gone in the opposite direction. In May, M2 swelled by \$250 billion, which translates into a \$3 trillion annualized rate. The central bank's balance sheet has risen in 17 of the past 21 weeks to \$8 trillion currently, and grew at an accelerating pace in June. The contradiction in sentiment and action doesn't sit well for many reasons.

In re-embracing aggressive growth, we think equity investors are taking their cue from the decline in bond yields, which is a manipulated outcome, not a market-driven signal. The inconsistency is also a stark reminder of just how difficult the actual tapering process – phasing Federal Reserve purchases out of the long-end of the bond market – is going to be. The stretch for returns in hard-to-value and unproven areas such as early-stage biotech, cryptocurrencies, blank check listings, and meme stocks provides evidence every day that we remain in a liquidity-driven market.

As bottom-up, valuation-sensitive growth investors, we remain encouraged that the majority of our holdings are still early in their earnings recovery and growth trajectory, regardless of recent concerns about the reopening recovery. While not fixed income experts, it's hard to fathom why market forces wouldn't drive bond yields higher over time. Any sustained bounce in yields in a period in which low interest rates have become the go-to justification for extreme valuations and speculative investments could be quite sobering.



RICE HALL JAMES & ASSOCIATES, LLC

Total Nonfarm Payroll, is a measure of the number of U.S. workers in the economy that excludes proprietors, private household employees, unpaid volunteers, farm employees, and the unincorporated self-employed. This measure accounts for approximately 80 percent of the workers who contribute to Gross Domestic Product (GDP).

M2 consists of M1 plus (1) small-denomination time deposits (time deposits in amounts of less than \$100,000) less IRA and Keogh balances at depository institutions; and (2) balances in retail MMFs less IRA and Keogh balances at MMFs. Seasonally adjusted M2 is constructed by summing savings deposits (before May 2020), small-denomination time deposits, and retail MMFs, each seasonally adjusted separately, and adding this result to seasonally adjusted M1.

M1 consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (3) other liquid deposits, consisting of OCDs and savings deposits (including money market deposit accounts). Seasonally adjusted M1 is constructed by summing currency, demand deposits, and OCDs (before May 2020) or other liquid deposits (beginning May 2020), each seasonally adjusted separately.

Sources: FactSet, U.S Bureau of Labor Statistics, Briefing.com, Furey Investment Partners, Wolfe Research, Federal Reserve Bank of St. Louis

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. 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.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

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.

S&P 500 Growth: S&P Style Indices divide the complete market capitalization of each parent index into growth and value segments. S&P 500 growth stocks are measured using three factors: sales growth, the ratio of earnings change to price, and momentum. Constituents are drawn from the S&P 500®.

S&P 500 Value: S&P Style Indices divide the complete market capitalization of each parent index into growth and value segments. S&P 500 value stocks are measured using the ratios of book value, earnings, and sales to price. Constituents are drawn from the S&P 500®.

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.

Index Definition Sources: S&P Global, FTSE Russell

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