RICE HALL JAMES
& ASSOCIATES, LLC

Market Review
Third Quarter 2024

Stocks continued their strong advance in the third quarter of 2024, propelled by the beginning of the (monetary) easing cycle. But it took a convoluted path to get there.

The market initially rallied sharply as inflationary pressures quelled, priming investors for the first interest rate cut since 2020. The enthusiasm, however, wobbled in August amid a pronounced deterioration in labor market data. This prompted worries that the inevitable policy response would be too little too late to stave off recession. The concern (and confusion) was also amplified by a sharp appreciation in the Japanese Yen, which abruptly forced traders out of long-held positions, and by unprecedented developments in the U.S. Presidential election, including a change in the Democratic nominee.

With tensions running high, however, the Federal Reserve pulled a rabbit out of its hat. After teasing investors for months, the central bank cut interest rates by a dramatic 50 basis points; this marked the first “jumbo” rate cut in a non-recessionary economy. The aggressive start to the easing cycle alleviated investor angst, and pressed the S&P 500 to new record highs. The accompanying Summary of Economic Projections infers another 50 basis points in rate cuts this year, and 100 basis points in rate cuts in 2025.

When all was said and done, the Large- and Small-Cap benchmarks increased 5.89% and 9.27%, respectively. The S&P 500 still leads markedly for the year, returning 22.08% versus 11.17% for the Russell 2000. Nevertheless, we were extremely encouraged by the broadening participation in the rally, which was evident on multiple levels. In addition to the Small Cap outperformance, the equal-weighted S&P 500 outgained the more traditional capitalization-weighted index in all three months of the quarter. Value outperformed Growth on both ends of the market capitalization spectrum. The Nasdaq Composite lagged in the period, due in part to increasing concern about the sustainability of AI investments and the prospect for future returns on the massive spend.

At this point, the obvious question for investors is will the large, but belated policy shift be sufficient to stave-off a further deterioration in the domestic economy? The more pertinent issue for our team, however, is can Small Cap continue to outperform going forward? Although we don’t expect the path to be linear, we believe the answer is “yes” on both accounts.

After an extended period of significantly lagging returns, the rationale for Small Cap outperformance going forward is fundamentally grounded and straight forward. As a result of the underperformance, we believe Small Cap valuations are reasonable on an absolute basis, and attractive relative to Large Cap stocks. Because our viewpoint is that there are “pockets of strength in the economy” rather than a “strong economy”, we are convinced that structurally lower interest rates are appropriate and necessary, and will help to broaden the recovery in the economy, earnings, and markets. Over time, the lower cost of borrowing, coupled with an improving business environment, may incentivize businesses of all sizes to push harder for growth – both organically and through acquisition –thus reinvigorating investor enthusiasm for small company ingenuity and innovation in the process.

To be clear, there is a long, winding road ahead to get from here to there. The team is also uncomfortable with the level of complacency that has crept back in the market amid such blatant political and geopolitical risk. But we believe that the extreme Small Cap outperformance in July was the first shot across the bow in a long progression that will force many investment plans to reevaluate their asset allocation and positioning. We are excited about the increased investor focus again on a huge investable universe in which we continue to see substantial opportunity for recovery, growth, and valuation expansion.

Sources: *FactSet, GICS Sector Classification, Federal Reserve, Nikkei Asia, BBC News*

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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 Nasdaq Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.

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

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.

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