Overview

The Bloomberg 2000 Index, a proxy for small cap equities, increased 15.0% in 4Q23 ("4Q"). The end of the Federal Reserve's ("Fed") historic campaign of interest rate increases catalyzed an explosive rally in risk assets for the last two months of 2023. Despite the lagged and variable effects of Fed tightening, the US consumer remains remarkably resilient, evidenced most recently by a solid holiday shopping season. Bearish investor positioning and pessimistic equity valuations (particularly for small caps) added fuel to the fire. The 10-year US Treasury yield nearly surpassed 5.0% in mid-October (4.98%), though plunged to end the year at 3.88% down from 4.59% at the end of 3Q23.

The rally was broad-based with 10 out of 11 sectors in the Bloomberg 2000 Index delivering positive returns, led by Financials, Healthcare and Consumer Discretionary. The worst performing sectors in the index included the Energy, Utilities and Consumer Staples. Small caps outperformed large caps in 4Q, a notable reversal after large caps had dominated year-to-date performance through the end of the third quarter. The spread-to-worst on the JPM US High Yield Index declined from 427 bps at the end of 3Q23 to 377 bps; the lowest level since April 2022. For the full year, the index returned 13.5%, its best year since 2019.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Bloomberg Micro Cap Index, during 4Q as top contributors included the Energy, Consumer Discretionary and Consumer Staples sectors. Within Energy, our underweight to the sector was a strong sector call and performed well as oil prices dropped over 20% during the quarter. An underweight allocation to the worst performing sector in the market was also beneficial during the quarter. Within Consumer Discretionary, our exposure to an auto services company performed well after mentioning a rebounding of auto services activity in their quarterly earnings call. Within Consumer Staples, a food distribution company announced dramatically improved sales to its restaurant clients during the quarter.

Top detractors included the Financials, Utilities and Healthcare sectors. Within Financials, our underweight to regional banks was a negative drag on performance as the group rebounded in light of the Fed ending their rate hiking cycle. Although lower yields will help banks lower their cost of funds, we expect the battle for deposits to continue and banks will only see pressure on cost of funds decline as economic growth slows thus impairing the prospects for loan growth and potentially seeing credit concerns rise as we approach the late stages of the economic growth cycle. Within Utilities, performance detracted as rates aggressively rose to start the quarter, and the sector did not rebound as quickly when rates peaked in the second half of the quarter as the market rewarded more cyclical sectors in a soft-landing economic scenario. We expect yields to continue their decline in 2024, which will be very beneficial to the sector in the coming year. Within Healthcare, our underweight to money losing biotechs detracted from relative performance as biotech merger activity accelerated from big pharma with a number of premium takeouts to end the year. With the boost in performance to close the year, we expect money losers to struggle more with this prolonged higher cost of capital cycle pushing into most of 2024. Acquisition activity should also moderate as valuations received a nice push into the end of the year.

Small to Micro Cap Equity

The Small to Micro Cap Equity strategy slightly underperformed its benchmark, a mix of the Bloomberg 2000 and Bloomberg Micro Cap Indices, during 4Q. Top detractors were the Energy, Healthcare and Information Technology ("IT") sectors. In the Energy sector, an offshore drilling contractor underperformed due to the decline in oil prices amid rising supply. Within Healthcare, a specialty pharmaceutical company focused on treatments for liver disease missed an endpoint for a phase-2 study. Despite the loss of potential revenue, the existing franchise is strong and continues to grow. In our opinion, the company remains in a good funding position. In the IT sector, a maker of analog and mixed signal semiconductors sold off after announcing a new convertible bond offering, which precipitated investor concern that operating fundamentals had deteriorated.

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Small to Micro Cap Equity (cont.)

Top contributors to performance were the Communications Services, Industrials and Real Estate sectors. Within Communications Services, a digital-first marketing and advertising firm divested its specialty health and wellness practice at an attractive valuation thereby reducing balance sheet leverage. In the Industrials sector, a maker of aircraft components reported strong quarterly earnings led by solid aftermarket growth. This places the company on track to hit guidance that seemed aggressive to the Street just one quarter ago. In addition, management has made progress on slowly reducing leverage. Within Real Estate, a diversified real estate services company rallied due to investor optimism that the decline in interest rates could drive a rebound in real estate transactions.

Small Cap Equity

The Small Cap Equity strategy underperformed its benchmark, the Bloomberg 2000 Index during 4Q. Top detractors in the quarter included the Energy, Healthcare and IT sectors. Within Energy, an offshore drilling contractor underperformed due to the decline in oil prices amid rising supply. In Healthcare, a maker of medical devices for minimally invasive spine surgeries underperformed due to concerns that the success of weight loss drugs could reduce procedure demand. However, management has seen little negative impact and contends that most of the conditions its products address stem from traumatic injury or age-related degeneration, not obesity. Within IT, a maker of analog and mixed signal semiconductors sold off after announcing a new convertible bond offering, which precipitated investor concern that operating fundamentals had deteriorated.

Top contributors for the quarter included the Real Estate, Communications Services and Consumer Staples sectors. In the Real Estate sector, a diversified real estate services company rallied due to investor optimism that the decline in interest rates could drive a rebound in real estate transactions. Within Communications Services, an operator of television stations and news multimedia reported a healthy 3Q EBITDA beat on strong cost containment and announced several new regional sports deals. In the Consumer Staples sector, a specialty food distributor serving high-end, independent restaurants reported strong 3Q top line momentum. Investors welcomed a capital allocation strategy shift in which the company will focus on digesting recent acquisitions and capacity growth thereby driving improved margins and free cash flow and announced a new $100m share repurchase authorization.

Small Cap Value Equity

The Small Cap Value Equity strategy underperformed its benchmark, the Bloomberg 2000 Value Index, during 4Q. The top contributor was the IT sector led by solid performance from a laser production company after booking a large contract with the Department of Defense for work on the United States Defense's directed laser initiative.

Top detractors included the Financials, Utilities and Materials sectors. Within Financials, our underweight to regional banks was a negative drag on performance as the group rebounded in light of the Fed ending their rate hiking cycle. Although lower yields will help banks lower their cost of funds, we expect the battle for deposits to continue and banks will only see pressure on cost of funds come down as economic growth slows thus impairing the prospects for loan growth and potentially seeing credit concerns rise as we approach the late stages of the economic growth cycle. Within Utilities, performance detracted as rates aggressively rose to start the quarter and the sector did not rebound as quickly when rates peaked in the second half of the quarter as the market rewarded more cyclical sectors in a soft-landing economic scenario. We expect yields to continue their decline in 2024, which will be beneficial to the sector in the coming year. Within Materials, global growth continued to suffer with Europe and China showing weaker economic growth. With prospects of a weaker dollar, we expect to see a bottom in the group and better performance in 2024.

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Small to Mid Cap Equity

The Small to Mid Cap Equity strategy underperformed its benchmark, the Bloomberg 2500 Index during 4Q. Top detractors included the Energy, Industrials and Materials sectors. In the Energy sector, an offshore drilling contractor underperformed due to the decline in oil prices amid rising supply. Within Industrials, a global manufacturer of equipment used in the production, storage and end-use of hydrocarbons and industrial gases reported a 3Q miss and lowered fiscal year guidance due to accelerated divestitures and customer project timing slippage. In the Materials sector, a producer and distributor of lithium compounds underperformed due to near-term pressure on spot lithium prices, merger integration headwinds and a retreat from automakers on near term EV production targets.

Top contributors in the quarter were the Consumer Discretionary, Consumer Staples and Utilities sectors. Within Consumer Discretionary, a value priced gym franchisor delivered a 3Q beat driven by continued membership growth. Investors are optimistic that easing franchisee capital requirements and new pricing initiatives will improve "4-wall" margins and drive a reacceleration in unit development. In the Consumer Staples sector, a food distributor is taking considerable market share amid steady consumer demand for dining out. Margins are improving due to favorable customer mix while headwinds from food deflation appear to be easing. Within Utilities, outperformance was driven by the allocation effect as the strategy was underweight a sector which underperformed.

Outlook

Virtually overnight, the prevailing market narrative shifted from acute recession fears (driven by a "higher for longer" Fed Funds Rate) to "no landing" euphoria following the Fed's policy pivot. Bulls seemingly get to have their cake and eat it too. If there is no recession, equities still have room to recover to midcycle valuation norms. If any real signs of economic weakness emerge, the Fed has ample dry powder to cut rates which would surely be a positive catalyst for equities. Indeed, there are several reasons for optimism. Inflation is on a glidepath lower and appears to be under control. This was initially evident in the price of goods, which eased as supply chains healed and consumers shifted their focus to spending on experiences.

Subsequently, we are seeing a normalization in the labor market as turnover ebbs and year-over-year wage pressures cool. The consumer remains steadfast buttressed by low unemployment, moderating inflation and the positive wealth effect from strong home prices and double-digit equity market returns in 2023. The recent decline in mortgage rates should stimulate new home construction and help thaw the deep freeze in existing home turnover thereby driving improved spending for home-related goods. Corporate credit fundamentals remain strong with low overall balance sheet leverage, low defaults, ample liquidity and healthy interest coverage.

High yield credit spreads have retreated to an 18-month low. Companies have been able to comfortably tap the high yield market to refinance upcoming maturities and fund acquisitions. Importantly, clarity around the direction of interest rates should enhance business confidence, clearing the way for new growth investments and a pickup in the pace of mergers and acquisitions. We have been making the case for months that small cap equities are historically inexpensive relative to large caps. We believe that the Fed's policy pivot marks a paradigm shift.

Falling interest rates are a tailwind for small cap equity valuations. Reduced near-term recession risks will increase investor confidence in the earnings outlook for small cap companies and should drive a re-rating in valuation and a catch-up trade relative to large caps. We remain mindful of risks both known and unknown, including reduced consumer savings, increased utilization of credit, geopolitical tensions, another contentious election cycle and the potential for inflation to rekindle. We will continue to take our cues from the credit markets and use our differentiated, fully integrated credit and equity research process to identify companies that are improving their capital structures for the benefit of shareholders.

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A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.
PC-EQTYCOM_01082024

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