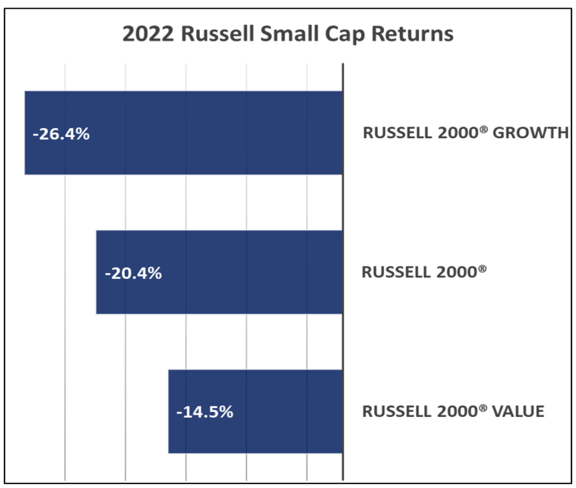
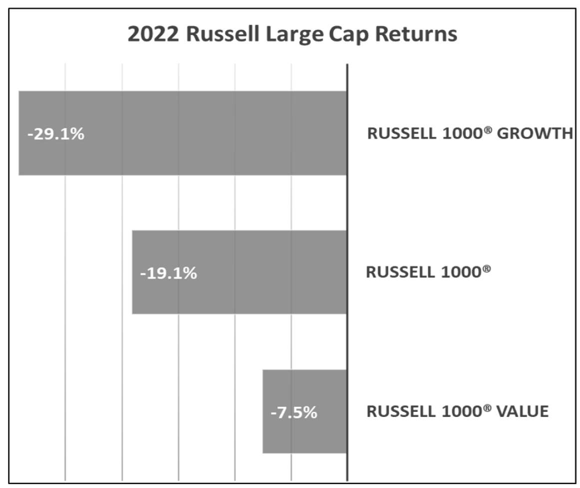
# Rotation into Undervalued Small Cap Value Stocks

As we wrote in "Are Small Company Value Stocks Dead?" in December 2019, growth stocks experienced a prolonged period of outperformance during the post-Financial Crisis era. This outperformance was primarily driven by the Fed's zero-interest rate policy and the resulting low cost of capital, among other factors. With interest rates now well above recent lows, small cap value stocks seem poised to return to favor, especially considering their attractive valuation, both on an absolute basis, and relative to large cap and growth indexes. Of equal importance: If value stocks are on the upswing, how do we at Pacific Ridge choose the companies that we hold in our strategies?

Let's begin with the initial signs of this shift in sentiment toward value that first occurred in 2022. After three consecutive years of US equities generating double digit returns, markets experienced a sharp reversal in 2022. Indexes were down 20% on average, as Russell Value indexes significantly outperformed their Growth counterparts, particularly in large caps.  Sticky inflation, rising interest rates, and the prospects of a recession in 2023 were chief concerns among investors. Additionally, speculative fervor associated with meme stocks and crypto continued to wane over the course of the year.




During the first two months of 2023, equity markets experienced a moderate rebound, driven by optimism that the Fed may be getting inflation under control quickly and would soon be concluding its series of rate hikes. That fueled hopes that the US economy may experience a soft landing or avoid a recession altogether. Indeed, the unemployment rate fell to 3.4%, the lowest level in 55 years, while CPI fell from 7.1% in November 2022 to 6.4% in January 2023.  During this period, growth stocks managed to keep pace and even slightly outperform value stocks. However, this broad-based rally may prove illusory.

Prospects for a soft-landing were shaken in late February as key economic data indicated that the decline in the inflation rate had moderated. Recent readings on consumer spending, combined with the tight labor market, may lead the Fed to keep interest rates at elevated levels longer than expected. This should drive up the cost of capital and will not bode well for growth stocks that more frequently need access to capital. In our review of key economic data and valuation measures, we believe that the stage is set for small value stocks to outperform growth stocks in the coming years.

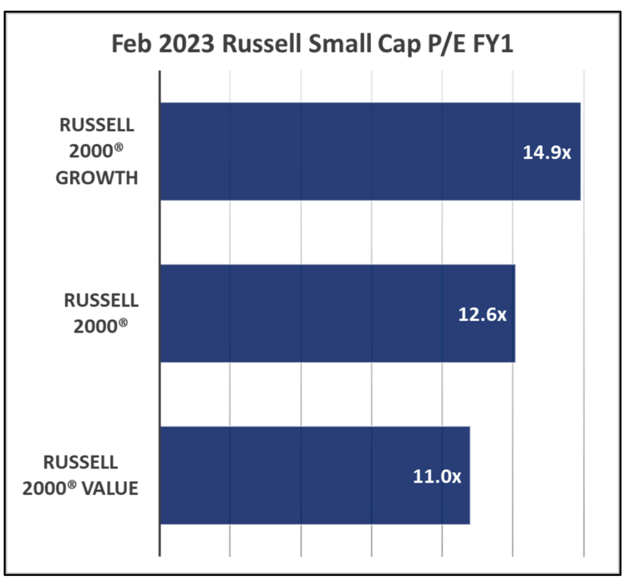
## Recent Economic and Inflation Data

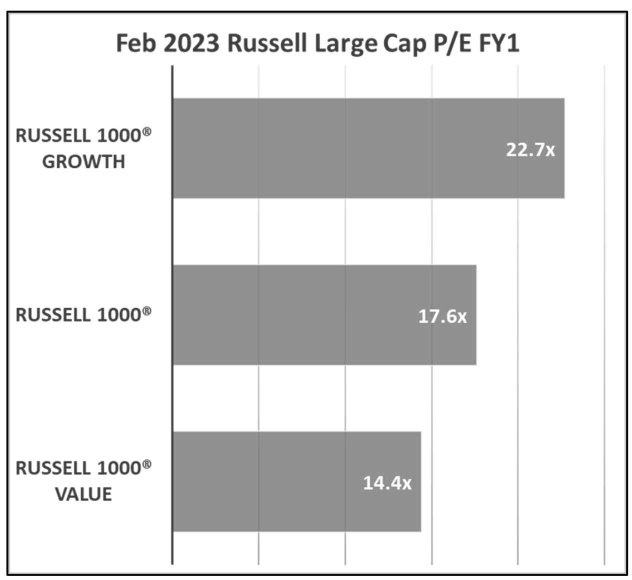
To support our supposition that value stocks may once again outperform growth stocks, consider our "Economic Report Card" below. The yield curve remains significantly inverted, with inflation well above the Federal Reserve's long-term target of ~2%. The Fed is determined to correct this. However, we remain at high risk for a recession later this year. The Fed futures market is currently pricing in a terminal rate between 5.25% to 5.50%. Core PCE, the Fed's preferred measure of inflation, rose 4.7% in January on an annualized basis. There continues to be wage pressure for low-skilled workers, and we are seeing the first significant waves of layoffs for blue chip companies, particularly in the technology sector. These trends point away from companies that have been rapidly growing their employee base and a return to those that traditionally offer investors stability and value.

| Indicator | Current Date | Most Recent | Prior | Status | Trend |
|---|---|---|---|---|---|
| Core PCE Index | 1/31/2023 | 4.7% | 4.4% | - | - |
| Corporate Profits | 9/30/2022 | 0.0% | 4.6% | - | - |
| Employment Cost Index | 12/31/2022 | 5.1% | 5.2% | - | + |
| Federal Funds Rate | 1/31/2023 | 4.50% to 4.75% | 4.25% to 4.50% | - | - |
| Inflation (CPI) | 1/31/2023 | 6.4% | 6.5% | - | + |
| ISM Manufacturing | 2/28/2023 | 47.7% | 47.4% | - | - |
| ISM Service | 2/28/2023 | 55.1% | 55.2% | + | + |
| Real GDP | 12/31/2022 | 2.7% | 3.2% | + | - |
| Retail Sales | 1/31/2023 | 3.0% | -1.1% | + | + |
| Unemployment Rate | 1/31/2023 | 3.4% | 3.5% | + | + |
| US Gov't Debt/GDP | 12/31/2022 | 123.4% | 123.6% | - | - |
| Yield Curve (Spread 1-10yr) | 1/22/2023 | -1.24% | 0.12% | - | - |

## Valuations of Russell Benchmarks

The following chart shows the forward P/E for the major Russell Indexes as of February 28, 2023. The Russell 2000© Value trades at the lowest multiple, while the Russell 1000© Growth Index has the highest P/E at 22.7x. In "Small Cap Value in Rising Interest Rate Environment" (May 2022), we wrote that the valuation measures for small cap value stocks are near historic lows, a situation that continues in 2023. This supports our view that small cap value stocks are poised to return to favor.



## In Summary

Smaller company stocks have long generated outsized returns. However, during the last ten years when interest rates were consistently low, growth stocks were the primary beneficiaries because they benefited from a low cost of capital and a highly speculative market. Inflation changed the landscape and with it, Fed policy on interest rates. As the market begins to price in an extended period of higher interest rates, we believe that smaller value stocks should return to their long-term trend of generating market leading returns.

Having made the case for the return of value stocks to favorability, the focus then turns to the stocks themselves; specifically, which firms we include in our strategies. At PRCP, we employ a contrarian value approach to investing in small, neglected, and under-followed companies. The companies that we favor have low valuations and attractive operating characteristics. We seek out quality companies with strong balance sheets and healthy free cash flow generation, and we look for opportunities at the intersection of Valuation and Quality. (We've written about this in past commentaries on Quality, Valuation, and our investment philosophy).

As we monitor the macro environment, we will continue to seek out companies that conform to our investment philosophy, and ultimately which investments are the best fit for our strategies.

Sincerely,

***Pacific Ridge Capital Partners***