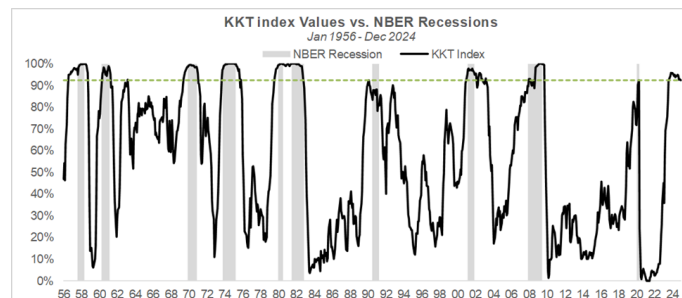


The following contains a brief discussion of the equity markets from Senior Quantitative Analyst, Charles Clavel, CFA.

The Human Factor

What difference a year makes... Jay Powell went from being "D.J. Jay", who forward guided an upcoming refill of the punch bowl, to the Grinch that stole the Santa Clause rally. In late 2023, the Fed started communicating about an upcoming rate cutting cycle, providing a substantial boost to investor sentiment and financial markets. It finally pulled the trigger in September, with a total of 100 bps of cuts until the end of 2024. However, the Fed seems to be having second thoughts lately, as indicated by the hawkish tone to their December rate cut. The just-released minutes of the December meeting reveal that **FOMC participants are getting concerned that the disinflationary trend that started in the summer of 2022 may have stalled** and that they were trying to gauge the impact on inflation of the upcoming administration's economic policies. Recent data points – for example, last month's PPI release or the latest ISM Services inflation index value – are consistent with inflation being stickier than expected. In last month's note, we warned that the disinflationary trend may be reversing, consistent with an inflection point in the 18-month lagged M2 monetary aggregate.

This dis-inflationary trend has been coincident with a deceleration in the economy, if not an outright recession. The KKT index, which measures the relative proximity of current economic conditions to recessions vs. periods of robust growth, has had readings consistent with a recession since late 2023, but has started to decline slightly since September. **If indeed economic growth starts to improve – which would likely be the case if the Trump administration is able to implement pro-growth policies in the next few months - a rise in inflation is likely to follow soon thereafter.**



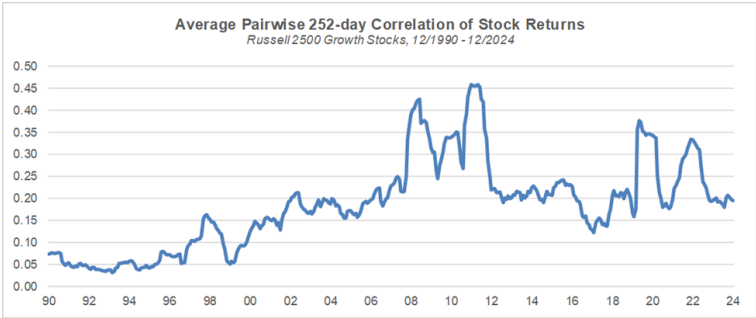
Source: St Louis Fed's ALFRED database, Robert Shiller's data (<http://www.econ.yale.edu/~shiller/data.htm>), Bloomberg, SIMG Analysis. The methodology behind the KKT model is explained in the research paper below: A NEW INDEX OF THE BUSINESS CYCLE by William Kinlaw, Mark Kritzman, and David Turkington.

Given the upside inflation risk, the Fed may consider waiting before making further cuts. However, other factors may force its hand and lead to more policy easing. First, **the dollar's strength** – driven in part by the Fed's hiking cycle – **is causing macro-economic strains in the rest of the world**, because of the USD's reserve currency status and the large amounts of USD denominated debt owed by non-US borrowers. A strong dollar thus increases the likelihood that the Fed may have to intervene to preserve the stability of the global financial system. One particular issue that emerged in recent weeks is the rapidly declining confidence in government observed in several countries in the Western sphere of influence, which manifested itself in government collapses and/or high-profile resignations in France, Germany, Canada, and South Korea, primarily over issues related to budget deficits.

In addition, some of Trump's policies would be easier to implement with lower rates. Reshoring manufacturing, growing domestic energy production, building new data centers etc., will require substantial amounts of capital spending, and lower rates would be a carrot (with tariffs being the stick) to incentivize US corporations to make those investments. Besides, given the recent shift of the Treasury's financing towards short term maturities, **lower Fed funds rates (which drive yields on the short end of the curve) would reduce the Treasury's interest expenditures, making it easier for DOGE to achieve its deficit reduction goals** and would potentially avoid some unpopular austerity measures. History has shown that the pressure on the Fed to be a team player and help the government fulfill its agenda can be stronger than the resolve to fight inflation, and we all know who won between Trump and Powell back in 2018.

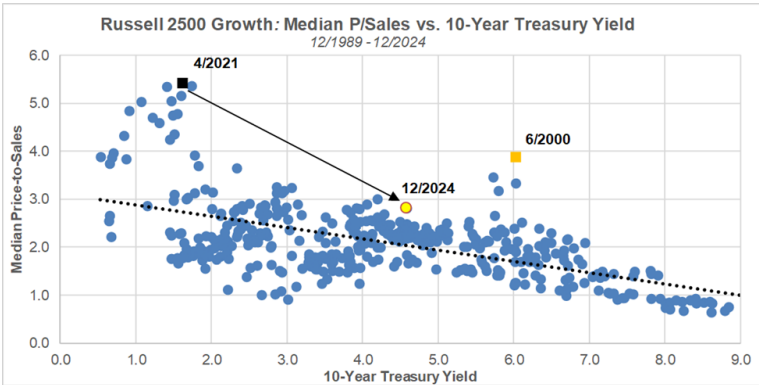
While we are awaiting more detailed policy proposals from the upcoming Trump administration, the market has chosen—up until mid-December—to buy first and ask questions later. The average pairwise correlation of stock returns, which has gone back to pre-COVID levels, indicates that investor sentiment remains quite positive. However, **the implementation of Trump’s agenda may not be as smooth sailing as investors seem to expect.** In fact, it is more akin to landing a jumbo jet with imperfect instruments, under bad weather, and on a short runway. First, Trump’s agenda includes many ambitious goals which will require the passage of complex pieces of legislation. Besides, as I mentioned in a previous piece, the Republican party is not a monolith and looks more like a European style coalition of groups with different, and at times conflicting, perspectives (for example, the recent controversy on H1-B visas revealed stark differences of views on immigration), which will require making compromises, especially given the Republicans’ razor thin majority in the House. In addition, while Trump’s opposition is less vocal than in 2016, it has not gone away. Finally, time is of the essence. Trump only has about a year to get anything passed, since representatives (and some senators) will start focusing on the mid-terms at the end of this year.

As the market finally asks questions and tries to figure out what policies get implemented with what implications, one can expect 2025 to be a more volatile year for financial markets than 2023 or 2024. In addition, **given the likely outsized impact of politics on markets this year, having an edge will require analyzing how the various actors in that political process – with their different personalities– may interact, how effectively they can work together and whose views/agenda will prevail. In other words, I believe the human factor may be more important than the usual macro or quant factors.**



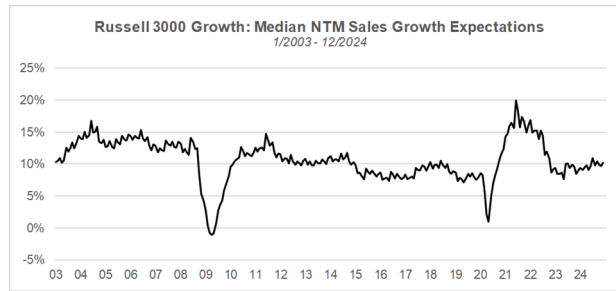
Source: FactSet, SIMG Analysis

Along with the stock market, long term Treasury yields have been rising as investors anticipated and then celebrated Trump’s victory. **The median price-to-sales ratio of small & mid cap growth stocks is now clearly above the historical range given the current level of the 10-year yield.** Over-valued markets often lead to poor subsequent market returns, but valuation measures are not effective market timing indicators. However, **after two great years for equities, it is reasonable to expect at least a regression to the long term mean in 2025** (with significant amounts of volatility, as mentioned above).



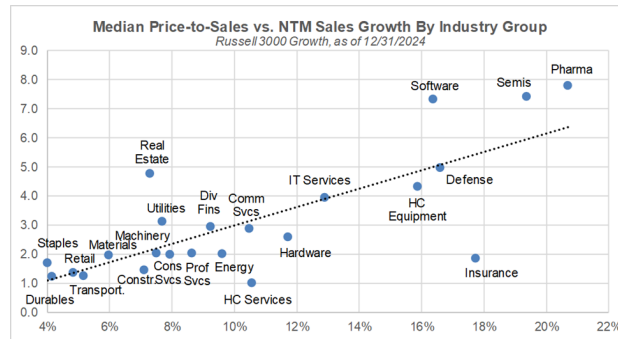
Source: FactSet, SIMG Analysis

Note that overall growth expectations as of the end of 2024 are not especially elevated. The median next 12-month revenue growth expectation for growth stocks is near the median of the historical range since 2003.



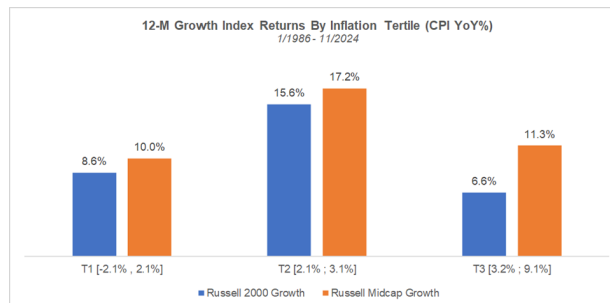
Source: FactSet, SIMG Analysis

A closer look at the industry group level reveals that high growth expectations seem to be concentrated in some industry groups (software, semis, pharma and real estate). Most groups have valuation multiples that are consistent with revenue growth expectations.



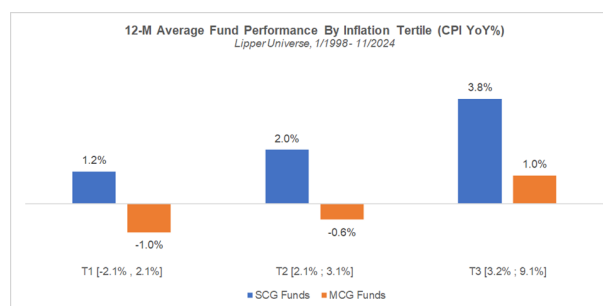
Source: FactSet, SIMG Analysis

As mentioned above and in prior notes, there are reasons to believe that we are in a new macro regime characterized by higher inflation, and it is likely that the “new normal” inflation rate is significantly above the Fed’s 2% target. **Based on the last 40 years’ worth of data, growth indices have performed best when inflation was moderate, in the 2-3% range.** If inflation does rise from current levels, it is likely that the absolute returns to small/mid cap growth indices will, on average, be lower than during the pre-COVID years.



Source: Source: FactSet, Bureau of Labor Statistics, SIMG Analysis

However, **small & mid cap growth funds tend to deliver their best relative performance during the 12-month periods with the highest inflation rates.** The chart below shows the average 12-month relative-to-benchmark returns for small & mid cap growth funds in the Lipper universe by tertile of inflation measured using the CPI YoY %. Relative performance by growth funds is the highest in the third tertile of inflation, in both the small & mid cap growth categories.



Source: Source: FactSet, Bureau of Labor Statistics, SIMG Analysis

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Regarding styles, the best performing cohorts last year were large caps, high quality, and high rate sensitivity stocks (i.e. stocks that benefit when interest rates rise). Despite the strong overall market return, investors seem to have, on balance, favored low volatility, large caps and high quality over the opposite styles, as is typically the case in an environment of slow growth/recession. We also note the meaningful under-performance of stocks with high passive ETF ownership.

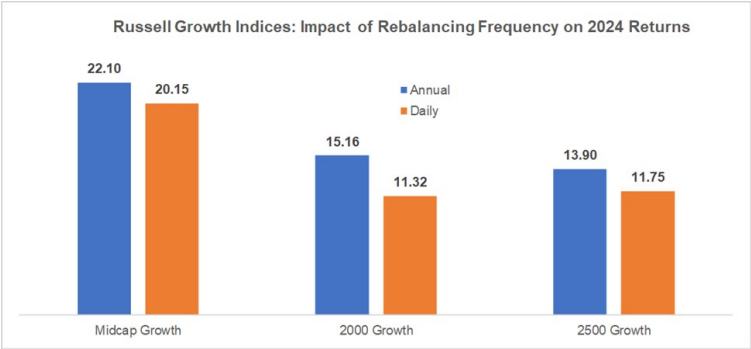
Style Performance, Top or Bottom Quintile vs Market
Russell 3000 Growth Universe, Through 12/31/2024

	High Volatility	Low Volatility	Most Shorted	Least Shorted	Large Caps	Small Caps	Quality	Junk	High Rate Sensitivity	Low Rate Sensitivity	High Passive Ownership	Low Passive Ownership
Jan 2024	(4.3%)	3.4%	(3.6%)	1.2%	3.8%	(2.7%)	3.8%	(1.4%)	3.0%	(0.7%)	(1.1%)	(1.7%)
Feb 2024	8.6%	(2.4%)	3.6%	(2.6%)	(0.9%)	3.7%	(1.5%)	5.9%	(1.0%)	1.1%	(3.6%)	2.8%
Mar 2024	(5.6%)	2.0%	(0.1%)	0.4%	1.5%	(2.7%)	2.7%	(4.0%)	2.5%	(1.0%)	1.3%	(1.3%)
Apr 2024	(4.3%)	3.2%	(3.0%)	1.7%	1.9%	(2.7%)	2.6%	(4.5%)	0.2%	(0.6%)	1.2%	(0.4%)
May 2024	4.8%	(1.6%)	3.0%	(0.6%)	(2.7%)	2.0%	(1.6%)	3.3%	0.8%	(0.1%)	1.3%	1.1%
Jun 2024	(4.9%)	1.4%	(2.5%)	1.5%	3.1%	(3.6%)	1.7%	(3.0%)	2.2%	(1.4%)	(1.2%)	(1.8%)
Jul 2024	1.0%	(1.0%)	2.0%	(0.0%)	(5.8%)	3.2%	(1.2%)	1.7%	(2.6%)	2.5%	1.4%	0.3%
Aug 2024	(4.1%)	2.8%	(3.0%)	1.3%	4.0%	(3.3%)	2.9%	(2.9%)	1.0%	(0.3%)	(0.5%)	(1.9%)
Sep 2024	(1.9%)	0.3%	0.8%	(0.2%)	2.4%	(3.0%)	0.8%	(2.0%)	(0.4%)	0.4%	0.1%	(0.7%)
Oct 2024	4.7%	(2.1%)	2.5%	(0.2%)	(0.4%)	0.7%	(1.4%)	4.2%	3.3%	(1.7%)	(3.1%)	3.5%
Nov 2024	2.8%	(4.0%)	2.5%	(2.2%)	(2.2%)	3.5%	(3.7%)	1.0%	1.8%	(4.9%)	(1.6%)	0.2%
Dec 2024	0.8%	0.3%	(2.0%)	2.4%	0.4%	2.4%	0.9%	(0.8%)	0.2%	0.1%	(0.7%)	3.2%
2024	(2.4%)	2.2%	0.1%	2.6%	5.1%	(2.4%)	5.8%	(2.4%)	11.1%	(6.7%)	(6.5%)	0.1%

Source: FactSet, SIMG Analysis

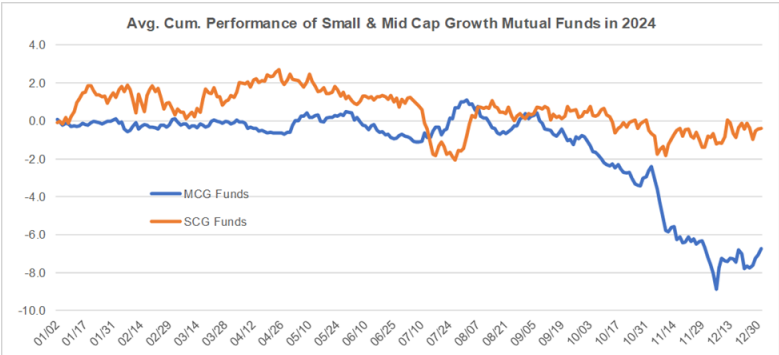
Price momentum has unquestionably been the factor of the year in 2024, fueled by investors’ appetite first for the AI theme, and then for Trump trades. Revenue growth, earnings revisions and profitability factors have also fared well last year, while valuations have done poorly.

Given that Russell indices are only rebalanced annually, some stocks with strong price momentum have remained in the small and mid-cap indices longer than they would have if those indices were rebalanced more frequently. This has made it more difficult for small & mid cap active managers to outperform last year. As shown below, versions of the small and mid-cap growth indices with daily rebalancing (i.e. where the stocks are ranked by market cap and assigned to the various indices daily) have meaningfully under-performed the actual indices in 2024.



Source: FactSet, SIMG Analysis

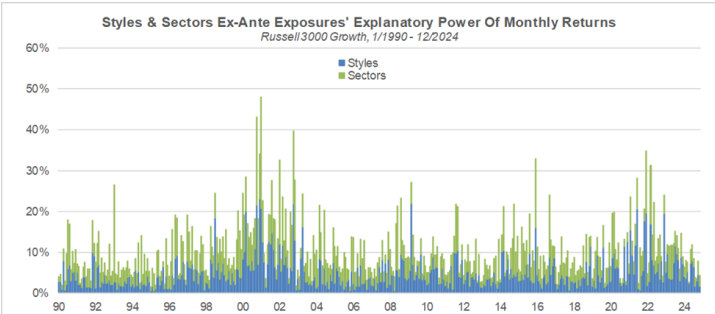
Finally, while the market, as a whole, has been anticipating a Trump victory since September, it seems that many active managers, and especially within the mid cap growth space, had not positioned their portfolios accordingly. The chart below shows the average cumulative relative returns in 2024 of small & mid cap growth funds that are part of the Lipper universe. On average, mid cap growth funds have under-performed substantially from September to mid-December, while at the same time, Trump trades were doing well.



Source: FacgtSet, SIMG Analysis

In the chart above, small and mid cap growth funds are represented, respectively, by the Lipper small and mid cap growth fund universes. For funds with multiple share classes, only the primary share class was included. Funds within each category (SCG or MCG) are equally weighted.

The percentage of cross-sectional monthly return dispersion (within Russell 3000® Growth stocks) that is explained by exposures to styles and sectors has been low in December compared to the historical average. This percentage tends to spike during periods of macroeconomic stress or high market volatility and tends to be low when investors are in risk seeking mode.



Source: FactSet, SIMG Analysis

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