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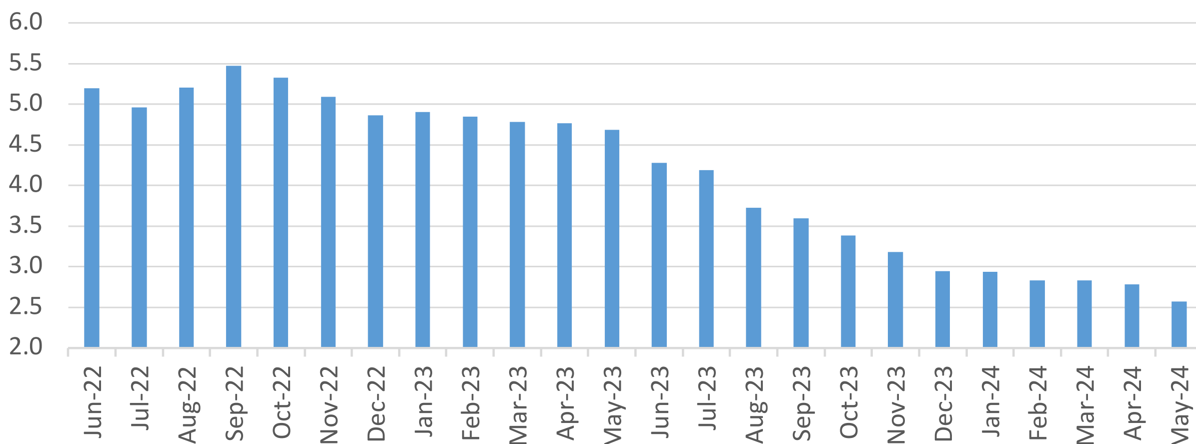
Prospector Partners Quarterly Commentary

While too early to declare victory, the historically elusive "soft landing" is becoming the base case for investors. The U.S. economy continues to grow, albeit at a slower pace, despite a Federal Reserve tightening cycle which has recently passed its two-year mark.

Anecdotally, the cumulative impact of inflation we have all felt these past several years is causing consumers to tighten their belts, trade down from premium to discount items, and lean more heavily on credit cards when making purchases. Overall consumer sentiment remains relatively poor given the aforementioned inflationary environment. The lower-end consumer continues to be impacted more acutely than the well-to-do… who continue to, in large part, drive the economy. Indeed, affluent Americans have seen a dramatic increase in household wealth since prior to the pandemic, as housing values have skyrocketed, the stock market has rallied, and their excess cash earns substantially more than during the days of "zero interest-rate policy."

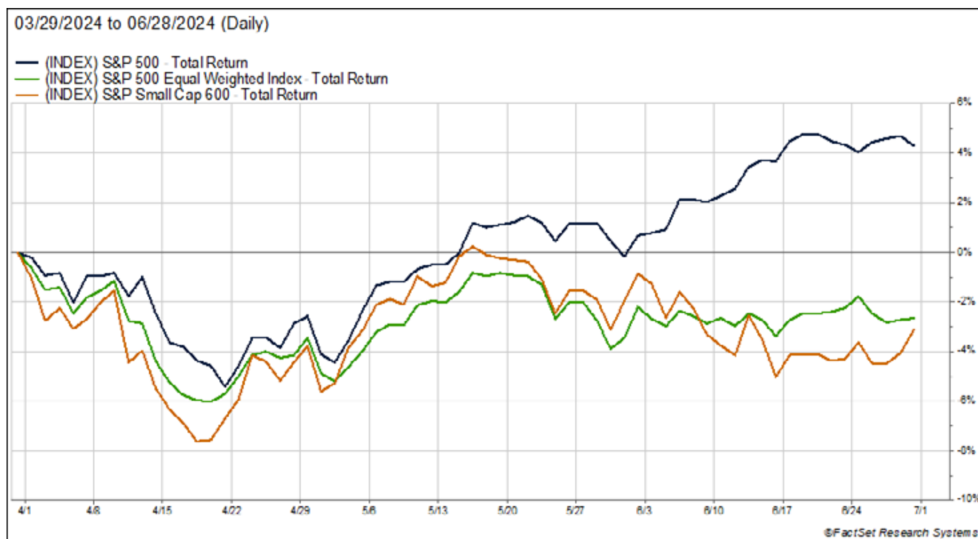


Source: FactSet

The Personal Consumption Expenditures (PCE) Index, provided by the Bureau of Economic Analysis, is a measure of the prices U.S. consumers pay for goods and services.

Meanwhile, inflation, although still positive, continues to slowly approach the Fed's 2% target. As can be seen in the chart above, the core Personal Consumption Expenditures (PCE) Index, said to be the central bank's preferred inflation metric, has declined to 2.6% at last reading. Additionally, the jobs market, while still strong, saw the unemployment rate tick above 4% in June for the first time since November of 2021. Should these trends persist, it appears likely the Fed may begin cutting rates sometime this fall.

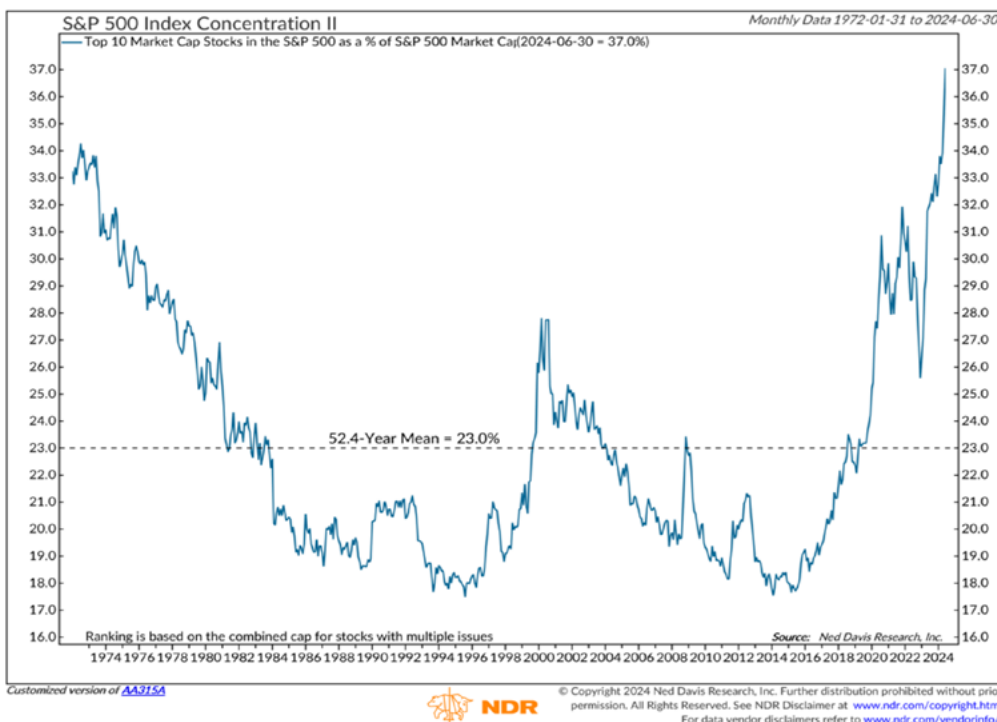
Against this backdrop, "the market" continued to hit new highs on what seemed like a daily basis during the second quarter. The use of quotation marks is intentional, as it is increasingly difficult to discuss the behavior of the stock market in terms of the S&P 500 alone. This is due to the ever-increasing concentration within the benchmark, as the top 10 stocks now constitute an eye-popping 37% of the index's market capitalization — the highest on record. When viewing the market beyond the handful of mega-cap (mostly technology stock) darlings, a significantly different picture emerges. As the chart below depicts, the average stock in the S&P 500 (represented by the S&P 500 Equal-weighted Index) was down during the quarter, with small-cap stocks (S&P Small-Cap 600) faring even worse.



It increasingly appears we are in a period of performance-chasing and FOMO (fear of missing out), as trillions of dollars flow into these handful of growth stocks. In the second quarter alone, NVIDIA Corp., still riding the wave of artificial intelligence exuberance, added over $800 billion in market cap, ending the quarter with a market valuation exceeding $3 trillion.

Conversations at recent family cookouts of how much NVIDIA partygoers owned are reminiscent of similar discussions surrounding Janus Funds during the summer of 1999. We view this as a dangerous set up for many investors, including those who have the bulk of their wealth in index funds. Should we see a rotation out of loved mega-cap stocks, much as we did following the "dotcom bubble," the impact on the market could be dramatic… perhaps even more so than the turn of the century move, given the top-heavy concentration existing today. A recent *Wall Street Journal* article reminded readers that, following the bursting of that tech bubble, small-cap stocks, as represented by the Russell 2000, beat the S&P 500 by 114% through 2014.

An Increasingly Concentrated Bet



It is possible a Fed easing cycle could turn the tide, given the "higher-for-longer" interest rate environment has been extra burdensome on smaller companies. These companies often have less readily available access to capital markets to fund operations and must resort to higher-cost, often floating-rate debt. Should the market begin to discount lower interest rates, smaller-cap companies could see significant relative outperformance.

Indeed, a recent reaction to a softer Consumer Price Index (CPI) reading could be foreshadowing. On July 11, the June CPI fell 0.1% versus forecasts of a 0.1% increase from May. Despite year-over-year inflation coming in at 3%, still above the Fed's 2% target, the lower month-over-month number raised expectations of a Fed rate cut in the coming months, and a powerful rotation ensued. This one-day move saw the "Magnificent 7" mega-cap stocks lose over $500 billion in market value, while the small-cap Russell 2000 gained 3.6% on the day. Was this a proverbial "canary in the coal mine"? Only

time will tell, but we feel Prospector's investment strategies are set up well should market leadership continue to broaden.

Election 2024 — Potential Implications

We are currently in the midst of a U.S. presidential election year. And, while every election cycle brings the potential for unknown outcomes and volatility, this cycle has already had more than its share — from a debate performance by President Biden widely viewed as so disastrous that many called for him to step aside as a candidate, ultimately resulting in his doing just that on July 21, to the recent despicable attempt on former President Trump's life. Our thoughts go out to the former president, his family, and to the families of the bystanders who were horrifically killed and injured in the senseless shooting.

The results in November could have myriad impacts on the U.S. consumer, various industries, and the stock market in general. With the House of Representatives and the U.S. Senate up for grabs with slim majorities, and recent presidential elections resulting in narrow margins of victory, making investment decisions based on an outcome is difficult at this point and, arguably, even imprudent.

Further complicating matters, certain proposals offered by each candidate would require a majority vote in both houses of Congress, while other actions are dependent only on who wins the presidency. While we at Prospector are not making portfolio tilts based on expectations for who will win in November, we, like many, are following events closely. Below are some of the potentially material issues worth watching — each of which could have implications for current or potential portfolio holdings.

Where the parties seem to agree:

In recent years, both the Republicans and Democrats have been, at times, anti-big tech. For example, both President Biden and former President Trump have attacked Section 230 of the Communications Decency Act of 1996, which provides limited federal immunity for content on social media platforms. Any elimination of Section 230 could greatly change social media platforms' ability to exist as currently designed. Additionally, both parties have raised antitrust concerns related to these mega-cap companies. While Trump's concerns were more verbal in nature, the Federal Trade Commission's 21-month delay of Microsoft's acquisition of Activision Blizzard under Biden's administration was a more substantive example of anti-trust concerns. We expect to hear continued "Break up big tech!" proclamations from both parties in coming years. Any resulting actions could have material consequences.

Both parties have also consistently pledged to lower drug prices. Often, pharmacy benefit managers (PBMs) have been the focus of attacks and of congressional hearings. The current administration's Inflation Reduction Act (IRA) contains several provisions attempting to lower drug prices, including giving the federal government the authority to negotiate Medicare prices for a number of drugs, starting in 2026. We expect continued proposals to lower drug prices and potentially modify the PBM model from both parties.

Under both the Trump and Biden administrations, tariffs have been used as a way of battling anti-competitive trade tactics by other countries. The Trump administration imposed new tariffs on many Chinese goods, as well as on steel and aluminum from various countries. The Biden administration kept in place and expanded the Chinese tariffs in particular, while easing certain tariffs on other countries. Although the inflationary and overall economic impacts of these tariffs are the

topics of much debate, both parties' recent predilection for tariffs as a trade policy could have material impact on various industries.

Major Bones of Contention:

One of the most contentious topics which must be addressed no matter who wins the presidency is the impending expiration of the Trump tax cuts at the end of 2025. The 2017 Tax Cuts and Jobs Act (TCJA) included a number of items which expire and will most likely lead to much debate as expiration nears. Some of these items include: the higher standard deduction, lower marginal tax rates, the state and local taxes (SALT) deduction limitation, the higher estate tax exemption, etc. Absent a GOP sweep and thus a likely extension, we could see material changes to some or all of the aforementioned items from the TCJA. Additionally, while the corporate tax rate of 21% enacted under the Trump administration does not expire, each party has dramatically different views of where that rate should go. Changes to these policies could have significant effects on both consumers and corporations.

Both the American Rescue Plan Act in 2021 and the IRA in 2022 included subsidies which boosted Affordable Care Act (ACA) enrollment by millions of insureds. These also expire at the end of 2025. The elimination of the subsidies would not only impact insureds, but also healthcare organizations benefiting from increased enrollment. However, despite these being enacted during a Democrat administration, many of the beneficiaries reside in red states and the subsidies are reportedly popular among Republicans surveyed.

The IRA also included clean energy subsidies, which have spurred billions of dollars of investments in projects around the country. Many of these projects are still in the planning stages, and any reversal of the IRA could have meaningful implications on regions of the country and certain companies. However, much as with the ACA subsidies described above, the majority of these projects are slated to benefit Republican majority states. According to a February 2024 *Wall Street Journal* article, "More than three-quarters of these factory and mining investments will go to congressional districts held by Republicans."

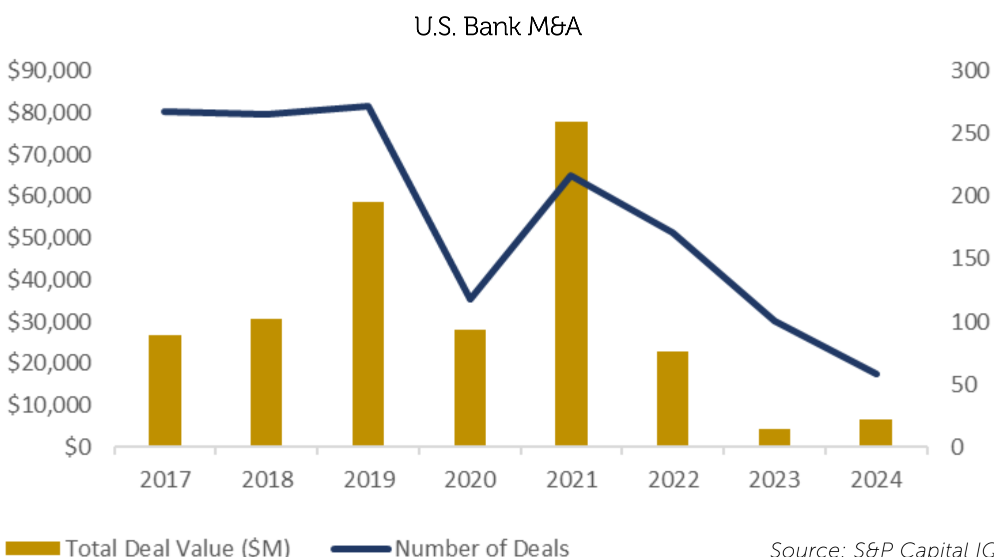
Regulation and Banks:

One of the starkest contrasts between the GOP and Democrats is their stance on regulations — with Republicans believing in a more laissez-faire approach as opposed to the tighter regulatory environment that exists under President Biden and generally favored by the left. For example, over the past several years, many management teams have discussed a more difficult merger & acquisition (M&A) environment given longer reviews by the FTC and other regulatory bodies.

While many of the impacts from increased regulations are hard to measure, and have impacted many different industries, we believe the banking industry is disproportionately exposed to what happens in November. Under the Biden Administration, regulators have increased the magnitude and severity of their oversight. This has ranged from tougher capital rules under a strict interpretation of Basel III, rhetoric against bank M&A, to limiting fees that banks can charge. During our meetings with bank management teams, a universal complaint we've heard is that regulators today are never satisfied with compliance and systems spending, always demanding more. This applies to the largest and smallest of banking institutions.

In a GOP administration, it is likely the "muzzle" will once again be placed on the regulators, resulting in a stagnation of new regulation. Over time, key regulatory positions will be replaced with "business-friendly" appointees, and we could even see a reversal of some regulation enacted under the current administration. Additionally, we expect a dramatic rebound in bank M&A under the GOP as antitrust rhetoric is rolled back.

Per the chart below, the M&A environment was more robust under the Trump administration. We believe there is pent-up demand for deal making per conversations with managements, which could result in a wave of industry consolidation in future years. Consolidation would enhance the return profile of acquirers, while providing takeout premiums to shareholders of target banks. A more business-friendly administration should also aid loan demand and ensure a favorable tax environment, which disproportionately benefits domestic banks.



Source: S&P Capital IQ

While a GOP victory is a major tailwind for the banking industry, green shoots for the sector still exist if the Dems retain control. At recent conferences, bankers have stated that their commercial client base has growing pent-up loan demand but remain on the sidelines pending clarity on the direction of Federal Reserve policy and the outcome of the election (with Fed Policy cited as the primary driver). Getting past election uncertainty, in conjunction with a Fed that communicates easing inflation and lower rates, should lead to a rebound in loan demand. This environment would also lead to a welcomed easing of funding costs. The combination would aid net interest income under either administration. That said, a GOP presidency would be a "supercharger" for the engine of the banking sector.

Outlook

Since early 2022, the Federal Reserve has aggressively raised interest rates in an effort to lower inflation, causing significant uncertainty within stock and bond markets. While the rate of inflation has subsided and the consensus appears to be that we have reached an end to the Fed hiking cycle, declaring victory could be premature. The U.S. and rest of the world continue to manage the impacts of inflation, higher interest rates, and geopolitical events. In our assessment, there remains a possibility of Federal Reserve policy error and / or recession, though barring extraneous events, we still lean towards slowdown and not recession per se.

The biggest risk right now would seem to be from a "shock to the system" while we continue transitioning from the pandemic economy to a more normalized economy. Certainly, the risk of potential systemic shock that might spread from the Middle East, Eastern Europe, or the South China Sea keeps us up at night. As always, with our bias towards quality, we strive to mitigate any downside, while also participating in the upside.

Meanwhile, heavy fiscal stimulus from already passed U.S. legislation for defense, infrastructure, semiconductors, and energy investment are only in the early stages of being awarded. This fiscal spending will not peak until later in the decade. Relatively high energy costs in Europe, and Germany in particular, make manufacturing here relatively more attractive. Political risk in China makes that country less attractive to do business in. All told, U.S. manufacturing is being called upon to step up.

While unemployment has risen from the lows, the overall jobs market remains healthy. We expect continued housing market pressures as a result of higher interest rates and affordability concerns. However, the shortage of housing after more than a decade of underinvestment following the Great Financial Crisis should prevent a disastrous decline in home prices. Lower-income consumers have been most impacted by the current inflationary environment, but consumer balance sheets remain generally healthy for the majority of Americans, and consumer credit quality remains strong at the moment.

Although what we see argues for a more inflationary and higher interest rate environment than seen in the past 10 years, it also does not argue for a recession. Nonetheless, the unexpected can occur. Should a recession happen in the near term, the factors highlighted above suggest it could be less significant than the previous two recessionary periods. We are also mindful that this is an election year, the result of which could have implications on companies, sectors and the overall economy.

Following years of lower interest rates helping to drive ever-higher growth-stock valuations, we feel value investing is ripe for a period of outperformance. We continue to find opportunities to invest in quality businesses with solid balance sheets and cash flows, whose share prices have detached from our assessment of the fundamentals.

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