Emerald Advisers, LLC
Diversified Small Cap Growth

Q3 2019 | Economic & Portfolio Commentary

Volatility and Risk Puts Shine on Value

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Market Update

The market had a lot to contend with during the course of the third quarter as trade tensions with China escalated, bond prices rallied, then retreated and rallied again, the 2yr-10yr yield curve inverted then steepened, the devaluation of the Yuan, the persistent strength in the U.S. Dollar, global and domestic economic growth statistics that deteriorated, appeared to stabilize and then deteriorated again, forward earnings growth estimates that have continued to be revised downward, dissention within the Federal Open Market Committee regarding the future direction of interest rates, escalating social unrest in Hong Kong, and last but not least the late September announcement of a Democratic led impeachment inquiry of President Trump.

The fall-out of all of the aforementioned was a meaningful late quarter style rotation which pressured growth stocks and drove meaningful value outperformance. After lagging throughout the first eight months of 2019, Value stocks gained significant ground on their Growth counterpart. Value stocks surged driven by a meaningful factor rotation in the marketplace that took place during the month of September in which investors aggressively sold growth/momentum stocks and rotated to areas of the market that have underperformed and were more value in orientation. The shift occurred in tandem with a significant rally in treasury yields (44 bps in 8 trading days), which was reflective of what we believe was a string of steadying global economic growth statistics, which appeared to indicate some level of stabilization in the global economic outlook. The abruptness and velocity of the shift was notable in its magnitude, with the Russell 2000 Growth underperforming the Russell 2000 Value by 596 bps for the month of September. The magnitude of September's relative outperformance pushed the Russell 2000 Value Index ahead for the third quarter returning (0.57%) versus the Russell 2000 Growth Index which declined by (4.17%).

The Value rotation was particularly painful for the fastest growing companies within the Russell 2000 Growth benchmark. According to a recent report from Steve DeSanctis of Jeffries, the top quartile of companies measured by sales growth declined by 10.09% for the third quarter, meaningfully underperforming the Russell

Key Points:

- The headwinds to growth and challenging stock selection within the Emerald portfolio, led to the portfolio's underperformance relative to the benchmark for the quarter.
- As we enter the fourth quarter of 2019, the portfolio held the largest active exposures in the consumer discretionary and technology sectors.
- Emerald as always remains focused on utilizing our fundamental bottom up research process to identify the most attractive growth opportunities within the small capitalization universe.

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2000 Growth index total return of (4.17%). This represented a meaningful shift in trend as on a year-to-date basis through the third quarter the top quartile of companies measured by sales growth has appreciated by 19.47%, substantially outperforming the Russell 2000 Growth index total return for the period of 15.34%.

Portfolio Review

The headwinds to growth and challenging stock selection within the Emerald portfolio led to the portfolio's underperformance relative to the benchmark for the quarter. At the sector level, relative underperformance within the producer durables, financial services, consumer discretionary and technology sectors offset relative outperformance within the health care, materials, and consumer staples sectors.

Performance within the producer durables sector was the largest detractor to return for the period as a result of both the portfolio's relative underweight position and disappointing stock selection.

Performance within the financial services sector was also a headwind to relative performance due to challenging stock selection within the financial data & systems and consumer lending industries.

The portfolio also experienced stock selection related challenges within the consumer discretionary sector, and more specifically within the education services, leisure time and diversified retail industries.

Performance within the technology sector was similarly challenged by stock selection, as relative underperformance within the electronic entertainment and telecommunications equipment industries weighed on returns.

Partially offsetting the aforementioned weakness was stock selection driven relative outperformance within the healthcare, materials and consumer staples sectors. Within the healthcare sector, both the portfolio's relative underweight position and stock selection contributed to the sector's relative outperformance.

As we enter the fourth quarter of 2019, the portfolio held the largest active exposures in the consumer discretionary and technology sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The overweight position in the consumer discretionary sector is comprised of a diverse subset of companies within the casino & gambling, specialty retail, education services, home building, leisure time, diversified retail, consumer services, apparel & shoes, and restaurant industries. Emerald believes that even amidst a more moderate consumer spending backdrop, that each of these companies is positioned to benefit from company specific initiatives to capture market-share and drive growth.

- The technology sector remained an overweight position exiting the third quarter. Within the sector, the computer software and services industry remains the portfolio's largest total and active exposure. While business investment in aggregate has been slowing, software has remained an area of relative resilience through the first half of 2019. Total software spending, according the Bureau of Economic Analysis and JP Morgan increased by 9.9% for this period, and while this does represent a deceleration from the 11.6% growth in 2018, the category has been resilient relative to spending in total structures which has declined by (2.9%), (down from 2.6% in 2018) and total equipment spending which only grew by 0.3% (down from 5.0% in 2018) over the same period. While we think it is reasonable to assume that software spending in aggregate is likely to decelerate, we continue to believe that spending growth will remain positive as we continue to see a strong secular growth opportunity in enterprise security and vertical software as large corporations work to digitally transform their

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businesses. Within software we remain overweight the security end market given increased vigilance of corporate boards and ongoing upward pressure on security budgets as the threat landscape continues to broaden. We also continue to be optimistic regarding select opportunities within network infrastructure spending as consumer demand for bandwidth continues to drive network upgrades, and at this point, multiple segments (datacenter, telecom and cable companies) are in the early stages of network expansion/evolution. Secular trends such as 5G and industrial IoT (internet of things) continue to build momentum and are expected to see meaningful growth throughout the next several years, with early deployments happening now. Unlike the transition from 3G to 4G wireless networks, the transition to 5G requires a fundamentally different network topology with different equipment and vastly higher semiconductor content. This shift is driving changes throughout the supply chain from semiconductors, to equipment, network testing, and beyond. These market shifts drive investment opportunities. Further defense spending is expected to continue to grow, with bi-partisan support of an expanded budget to address current threats from peer and near-peer adversaries such as Russia and China.

- The healthcare sector, while underweight relative to the benchmark, also remains an area of meaningful exposure within the portfolio. At the industry level, the biotechnology industry remains the largest aggregate exposure. We continue to look for innovative therapeutics that can command premium pricing, though we note that competition for small niche patient populations is becoming a challenge. That being said, there continues to be a high-level of successful innovation in the marketplace. There were 14 drugs approved by the FDA during the third quarter bringing the year-to-date total to 27 approvals. As a point of reference, on average the FDA has approved approximately 10.8 drugs per quarter from 2015-2018. Further we also believe there is a developing opportunity in companies that have launched drugs in the past 2-3 years, as it often takes small companies several quarters to get their commercial organization running efficiently. Rounding out the portfolio's healthcare sector exposure are niche opportunities within the healthcare services, medical equipment, medical & dental instruments and pharmaceutical industries. While we continue to see select opportunities within the healthcare sector, our enthusiasm for the broader sector remains guarded as we expect healthcare policy to remain a key point of debate and source of heightened sector volatility over the course of the 2020 Presidential Election Cycle.

Market Outlook

The negative revisions to global growth persisted throughout the third quarter as the global manufacturing slowdown continued to deepen. While data points throughout the early part of September appeared to indicate some level of stabilization in both domestic and global economic growth, the September U.S. ISM Manufacturing Index and U.S. Non-Manufacturing indices both fell meaningfully short of expectations. The manufacturing index pushed further into contraction territory with the reading at 47.8, while the rapid pace of sequential decline in the services index from the August reading (from 56.4 to 52.6) caught investors off-guard, implying a broadening of weakness beyond manufacturing and reigniting recession fears.

The trade stalemate with China, has been gating growth in capital expenditures all year and it appears as if the slowdown in spending that was initially reflecting uncertainty about tariffs is morphing as growing concerns about the sustainability of global growth appear to be causing a broadening slowdown in capital investment. With the services side of the economy now decelerating, the market is becoming increasingly concerned that what was perceived to be a manufacturing only slowdown is on the verge of spreading to consumption. In this regard, the 135K September job growth number combined with 45K upward revisions to prior months pushed the unemployment rate to a 50-year low of 3.5% (lowest rate since December 1969) helped ease the market's anxiety on a near-term basis, there remains a lingering uncertainty. We believe the greatest risk to consumer spending is not jobs but a shock to sentiment/confidence. The consumer, despite low unemployment and a much improved balance sheet, is in our opinion is still suffering from post-traumatic stress disorder in the wake of the last recession. Much like what we witnessed at the end of 2018 when the equity markets came under pressure and early 2019 with the U.S. government shutdown, the consumer was looking beyond their paycheck and appeared increasingly inclined to tap on the spending brake at any sign of caution. While we are not seeing any direct signs of this today this phenomenon is something that we continue to monitor.

That being said, Emerald's base case remains that the U.S growth will continue to slow on the back of weaker business investment (assuming no resolution with China on Trade), but that the consumer will continue to spend albeit at a slower pace than what has been witnessed to date. We believe this is being equally caused by the policy constraints of higher interest rates, contraction of reserves as well as the money supply that the Federal Reserve coordinated in 2018. After having lowered the terminal rate dot plot in prior years the Federal Reserve raised the dot plot for future rates and raised the terminal rate which has contributed to the third "mini-recession" since the Financial Recession of 2008. Emerald remains very concerned that the Federal Reserve continues to be behind the curve in terms of lowering rates. The yield curve inverted in the second and third quarters of this year and the Federal Reserve has not done enough to reverse these recessionary signals. When the Fed Funds Rate is above the 10-year bond yield the Federal Reserve should be more aggressive in lowering rates and reducing the recessionary signal. The "insurance cut" implemented over the summer was too little too late. The Federal Reserve should have taken out more insurance when the yield curve started to invert to counterbalance the negative effect from current and future tariffs and fulfill their stability mandate. As a consequence, we do not believe the Federal Reserve's efforts to lower rates is likely to result in a meaningful uptick in economic growth until the trade dispute with China nears resolution. Even then, we question how quickly global growth can accelerate if growth in China continues to stagnate as the effects the rapid shift of manufacturing outside of China are likely to remain a headwind to growth. Under this scenario and as we look around the globe, we believe the U.S. economy, thanks to the U.S. consumer, will remain the strongest of the developed market economies. Within this backdrop of a slowing but still growing U.S. economy, we believe small capitalization stocks which on a relative P/E of small vs. large capitalization stocks (at 0.9x) trade at a 17-year low to their large capitalization peers (according to a recent report from Jill Carey Hall of Bank of America Merrill Lynch), as well as growth stocks, given the ongoing scarcity of growth in the market, remain particularly well positioned.

From a market perspective as we look to the balance of the year, the wall of worry continues to build. As a result we expect market volatility to remain elevated over the coming weeks as the market digests the third quarter earnings report and guidance, incoming economic data points, dissects commentary from the Federal Reserve, adjusts rate expectations around incoming economic data, assesses the progress of further trade discussions with China and handicaps the potential market impact from the Trump Impeachment Inquiry and the race for the 2020 Presidential election.

Emerald as always remains focused on utilizing our fundamental bottom up research process to identify the most attractive growth opportunities within the small capitalization universe.

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