Emerald Advisers, LLC
Diversified Small Cap Growth

Q3 2018 | Economic & Portfolio Commentary

Domestic Earnings Propel Growth

Market Update

The growth vs. value and small vs. large capitalization leadership tug-of-war continued during the third quarter, with large capitalization stocks and growth stocks resuming their respective leadership positions. Large capitalization stocks, as measured by the Russell 1000 advanced 7.42%, outpacing small capitalization stocks, as measured by the Russell 2000 which gained a more modest 3.58%. From a style perspective, growth again outperformed value, with large capitalization growth stocks leading the advance. Within the small capitalization universe the Russell 2000 Growth gained 5.52% to the Russell 2000 Value's 1.60% gain. Growth's relative outperformance was driven largely by a return of relative outperformance within the technology and healthcare sectors, which advanced 9.47% and 7.76% respectively, meaningfully outpacing the aggregate Russell 2000 Growth index return of 5.52%. On the opposite side of the spectrum, both the energy and materials sectors lagged returning a respective (5.20%) and 0.51%.

On a relative basis, Emerald outperformed the benchmark for the quarter driven by stock selection in the healthcare, materials, consumer discretionary, consumer staples and utilities sectors. Relative outperformance in the aforementioned sectors offset relative underperformance within the financial services and producer durables sectors.

Portfolio Review

The healthcare sector was the largest positive contributor to return for the third quarter, driven by stock selection within the biotechnology, medical equipment and healthcare services industries. Stock selection within the materials sector also contributed positively to return. Also contributing positively to performance was stock selection driven relative outperformance within the consumer discretionary, consumer staples and utilities sectors. At the industry level the portfolio experienced the most notable outperformance from holdings within the specialty retail, leisure time, foods, and telecommunications industries.

Partially offsetting the aforementioned was stock selection driven relative underperformance within the financial services and producer durables sectors.

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Key Points:

- On a relative basis, Emerald outperformed the benchmark for the quarter driven by stock selection in the healthcare, materials, consumer discretionary, consumer staples and utilities sectors. Relative outperformance in the aforementioned sectors offset relative underperformance within the financial services and producer durables sectors.

- The healthcare sector was the largest positive contributor to return for the third quarter, driven by stock selection within the biotechnology, medical equipment and healthcare services industries.

- Domestic earnings growth across capitalization sizes was broadly better than expected during the second quarter, and we anticipate ongoing strength in business investment and consumer spending will remain supportive of further positive earnings revisions as we move through the balance of 2018 and into early 2019.

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Within the financial services sector, the portfolio's relative overweight position and stock selection within the banking industry was the primary source of the portfolio's challenging relative performance.

Within the producer durables sector, the portfolio's relative underperformance was driven largely by relative underperformance within the air transport, industrial machinery and trucking industries.

Entering the fourth quarter of 2018, the portfolio held the largest active exposures in the technology, utilities, financial services and consumer discretionary sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

The technology sector was the portfolio's largest relative overweight position exiting the third quarter. Within the sector, the computer software and services industry continues to represent the portfolio's largest exposure as we continue to see a strong secular growth opportunity in enterprise security and vertical software. Software spending is being further supported by increased corporate profitability, increased investment by the financial services industry (20% of technology spending), deregulation and better spending in Europe. Beyond software, Emerald continues to be optimistic regarding network infrastructure spending as consumer demand for bandwidth continues to drive network upgrades, and at this point, multiple segments are in the early stages of network expansion/evolution. Datacenters are upgrading speeds from 25G to 100G as well as laying the foundation for 200G/400G. Telecom and cable companies are driving fiber deeper into their networks to provide customers with faster speeds, which has the potential to change the fundamental architecture of the entire system, and the emergence of 5G/IoT/autonomous vehicles creates another potentially dramatic growth catalyst for network infrastructure.

The portfolio also maintains an overweight position to the utilities sector. Within the utilities sector, Emerald continues to believe that adoption of unified communications among mid-market and enterprise customers remains in the very early stages and that the segment will continue to expand, shifting market leadership from traditional telephony equipment providers to a new group of software/network centric companies.

The financial services sector similarly remains an overweight position within the portfolio, although the absolute exposure and relative overweight positioning has been reduced over the course of the third quarter. While still optimistic regarding the loan growth opportunities and strong merger and acquisition backdrop within the small capitalization bank universe, rising deposit costs have narrowed the opportunity set. Logic would lead us to believe that rising rates are a tailwind for bank earnings but that is not always the case. We believe that the "rising rate tailwind" will play out for banks with good core deposit franchises and good core deposit costs. For many years since the financial crisis, deposits were not a concern as banks were awash in low cost deposits. In fact, as the Fed began raising interest rates into 2016, deposit costs and deposit betas remained anemic. In the first quarter of 2018 all that changed as we saw a significant uptick in deposit betas that has continued throughout the first nine months of 2018. As a result of increased deposit costs and competition amongst banks for commercial loans and a LIBOR rate that has not moved much in the first two months of the third quarter, our expectation for the third quarter earnings season is for net interest margins to be at best "flat" if not down one or two basis points for the group. We believe that the remainder of 2018 will continue to see the smaller community banks post good loan growth and indeed return to increased net interest margins in the fourth quarter of 2018. Our theory is that banks with higher loan to deposit ratios will be less aggressive on pricing when competing for loans and typically, increases in deposit costs when there are rate increases lag the increase by about six months. We also remain encouraged by our long term belief that community banks are in the midst of an industry consolidation. Even though trends slowed in the third quarter, this year is set for the most active year since at least 1991. In fact, the third quarter was the fourth strongest quarter since 1991, with 59 deals announced, after the 84 deals announced during the second quarter of 2018, and the 64 deals announced in third quarter of 2017.

The portfolio also exited the quarter with an overweight position in the consumer discretionary sector. The overweight to the consumer discretionary sector is comprised of a diverse subset of companies within the specialty retail, education services, leisure time, diversified retail, consumer services, apparel & shoes, and restaurant industries. Emerald believes that each of these companies is positioned to benefit from company specific initiatives and opportunities.

The healthcare sector also remains an area of meaningful exposure within the portfolio, although the portfolio remains underweight relative to the benchmark. At the industry level, the biotechnology industry remains the largest aggregate exposure. Emerald remains optimistic regarding the ongoing opportunity within the biotechnology industry given the high-level of innovation and the substantive progress being witnessed in drug development amidst what continues to be a very accommodating FDA (21 new drugs were approved during the third quarter and 41 have been approved year-to-date). Rounding out the portfolio's healthcare sector exposure are niche opportunities within the healthcare services, medical equipment, medical & dental instruments and pharmaceutical industries.

Market Outlook

Entering October, the market backdrop appears to be shifting relative to the first nine months of the year. After generally being range bound throughout most of 2018, treasury yields are surging with the 10-year breaching 3.20% for the first time since 2011 and the thirty year bond breaching 3.40%. This sudden and rapid move in treasury yields appears to be driven by stronger than expected domestic economic data (ISM Non-Manufacturing report for September which reached 61.6, setting a record for strength and significantly outpacing consensus of 58.0, and a strong report from ADP on payrolls for the month of September), and incrementally hawkish commentary from Federal Reserve Chairman Powell which collectively led to an upward adjustment to the outlook for rate hikes in 2019. The abrupt sell-off in treasuries October month-to-date has weighed particularly hard on long-duration risk assets (healthcare and technology).

While the abruptness of the shift in yields has weighed on equities over the first few trading days of the fourth quarter and may result in elevated volatility in the near-term, we do not believe this shift has dramatically altered the market narrative. Domestic earnings growth across capitalization sizes was broadly better than expected during the second quarter, and we anticipate ongoing strength in business investment and consumer spending will remain supportive of further positive earnings revisions as we move through the balance of 2018 and into early 2019. Surveys of business confidence are high, employment growth is strong, consumer balance sheets are not extended and consumer confidence is high. Over the past three weeks, consumer comfort surged +3.2 to an elevated 61.2, a new high and in record-high territory. According to Evercore ISI, the last time consumer comfort moved up to this level was in 1998 when real GDP growth was +4.5% year over year. As a result the probability of a domestic recession remains low. Goldman Sachs economics team's recession indicator as of October 4, 2018 suggested just a 6% probability of recession during the next four quarters, and just a 20% likelihood of recession during the next two years. That being said, potential risks to growth remain including the even greater potential for monetary policy overreach than what was apparent at the end of last quarter, the shape of the yield curve, escalating trade tensions, a weakening economic outlook in China, a further slowing of global growth, the direction of the U.S. Dollar, the outcome of the mid-term elections all remaining areas of focus. That being said barring a more significant slowing in global economic growth, Emerald continues to believe that the U.S. expansion is poised to continue.

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