Emerald Advisers, LLC
Small Cap Value

Q4 2018 | Economic & Portfolio Commentary

"Right now, we see the biggest risk in the global economy is one of talking ourselves into the next recession as opposed to the underlying fundamentals taking us there." - Michael Corbat, CEO of Citigroup

Small cap stocks went through an unrelenting bear market correction during the 4th quarter. The Russell 2000 Value index was down 24.8% between 8/31 and 12/24. 2018 was the 2nd worse performance year for the index in the past 20 years. For the second straight year small cap value lagged small cap growth, despite better relative performance in 4Q. Is there a silver lining? Well, according to Furey Research Partners, since 1940, "following the ten other quarters that were worse than 4Q18, small-caps posted +25% average 12-month forward returns with only two periods being negative. And following the nine other years that were worse than 2018, the next year's return also averaged +25% with only three years posting negative returns. Let's hope past is prologue."*(1)*

Portfolio Review

In 4Q, bond proxies (utilities and REITs) outperformed, which represented a headwind for value managers, as they are traditionally underweight these sectors. Additional headwinds to active managers during the quarter came from large ETF outflows, algorithm selling of certain factors without consideration for individual fundamentals, hedge fund redemptions and firings, and Value manager terminations. Also, due to new tax rules, many individual investors have lost meaningful tax deductions from their state and local taxes making stock losses more valuable than in prior years. Within small cap value, companies over $1B in size, with the lowest leverage, and low foreign sales did relatively well during the quarter, while the lowest ROE quintile and loss-making companies underperformed.

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Key Points:

- Within the Russell 2000 Value benchmark, Utilities, Technology, and Financials were all down on an absolute basis, but did relatively better than other sectors.
- At the portfolio holdings level, Negative stock selection in the Financials and Producer Durables sectors, as well as underweight in Utilities, detracted from performance. However, stock selection in Consumer Discretionary and Healthcare contributed positively to the portfolio.
- We believe that the small cap value portfolio is well positioned to benefit from a slowing, yet growing, domestic economy and the eventual turnaround in some of the industries (Energy, Construction, Semiconductors, and Banks) that were particularly hurt in 4Q 2018.

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Within the Russell 2000 Value benchmark, Utilities, Technology, and Financials were all down on an absolute basis, but did relatively better than other sectors. Energy, Healthcare, and Materials significantly underperformed, down -40.7%, -29.5%, and -27.7% respectively in the quarter.

At the portfolio holdings level, Negative stock selection in the Financials and Producer Durables sectors, as well as being underweight in Utilities, detracted from performance. However, stock selection in Consumer Discretionary and Healthcare contributed positively to the portfolio.

As mentioned above, the Energy sector was the worst performer in 4Q, down over 40%. WTI crude dropped almost 40% during the quarter on fears of a global demand slowdown and excess supply. Even OPEC's commitment to remove 1.3 million barrels a day in production from the market in early 2019 failed to curb crude's dramatic decline. The 1.6 – 1.8 million barrel per day increase in US production for the year, as well as the OPEC production ramp up on the expectation of a severe Iran sanction impact caused inventories to rise, leading to investor angst. Natural gas prices moved in opposition to WTI crude prices, ending the quarter almost where they started with just a slight decline. Colder than expected weather in the US for much of the 4th quarter served to bolster prices, with NYMEX natural gas prices hitting almost $5/MMBtu in November. Even this price action, however, failed to support natural gas focused equities.

We entered 2018 believing that higher rates, lenient regulation, lower taxes, and improved economic activity would benefit small and community banks. However, sometime in the 2nd quarter, the talk around blue sky outlooks of rising interest rates, regulatory rollback, lower taxes & an M&A wave dissipated, and was replaced by the gray skies of an inverted yield curve, recession fears, trade war, oil selloff, lower loan growth, CLO exposure, peak credit, peak housing & peak earnings. The "group think" against the Banking sector has removed bids on stocks, creating low P/E multiples for 2019 EPS, even after conservative haircuts to three key fundamental metrics: loan growth, net interest margin, and credit costs. Investors do not trust Street expectations on any bank which requires investors to make their own revisions to 2019 EPS prior to 4Q18 earnings results and management commentary on business activity and customer behavior. We reiterate our belief that many banks can grow tangible book value, maintain strong capital, and show positive progress in 2019. We believe this is a compelling opportunity to buy cheap banks despite an uncertain trading environment with stocks hitting new 52-week lows. The banks are generally better capitalized, more scrutinized and barring a hard landing are positioned to continue to post strong earnings and capital generation with M&A optionality. Banks are trading at 7x forward earnings with a 2%+ ROA! Banks with significant excess capital approaching TBV making the buyback all that more compelling. In our view, it is a tremendous error to shun and avoid Banks given a lack of evidence that the U.S. economic cycle has turned south.

We believe that the small cap value portfolio is well positioned to benefit from a slowing, yet growing, domestic economy and the eventual turnaround in some of the industries (Energy, Construction, Semiconductors, and Banks) that were particularly hurt in 4Q 2018. We still maintain an overweight in the Financial Services sector, and we continue to search for and invest in high quality companies that generate prodigious amounts of free cash flow.

Market Outlook

The best performing asset class in 2018 was...cash!

The main culprit for the declines in most asset classes throughout the year was tighter financial conditions. The U.S. Treasury increased the supply of bonds to finance the fiscal deficit, at the same time the Fed was reducing its balance sheet, thereby taking out any excess dollars from the financial system. In addition, a strong dollar and rising cash rates created competition for dollar capital. For its part, the Fed's goal in normalizing monetary policy is to remove the excesses associated with extraordinarily accommodative monetary policy of historically low rates and expanded balance sheets. So while QE propelled the stock market higher, squeezed volatility, kept longer-term rates lower and spreads tighter, undoing it should cause the opposite, and thus help in avoiding the next asset bubble at the expense of risk assets. The Fed will be thoughtful and methodical in that process as communicated by Chairman Powell when he participated in a joint interview with his predecessors Janet Yellen and Ben Bernanke at the annual meeting of the American Economic Association in Atlanta. Chairman Powell defended the Fed's commitment to independence, while being patient and prepared to be flexible, stressing that the FOMC is taking a "risk management" approach to policy decisions. He also described market expectations of rate cuts in 2019 as being "well ahead of the data" and a reflection of concerns about global growth, indicating that the Fed will take these concerns "into consideration." What it means to us is that the Fed will pause rate hikes for the next few months as economic data comes in mixed, and trade war implications are still being assessed.

With that said, the consumer is doing very well. Consumer confidence is still elevated, the unemployment rate has fallen, more jobs have been created, income has grown, household net worth has continued to increase, and spending has kept on rising. According to Jefferies *(2)*, the improved job market and higher confidence level boosted household formation. "Private nonfarm payrolls have risen every month since March 2010 and have increased by an average of roughly 190k per month." In addition, the number of job openings has set records in excess of 6.8m in 2018, which bodes well for future hiring.

We don't think that the government shutdown or the trade war with China will have a sustainable negative impact on GDP. It is hard to see either lasting too much longer into 2019. The overall effect will probably be contained to 1Q, as if it were a non-recurring event (such as weather), however, once resolved, we should see a bounce back in the subsequent period. From conversations with management teams of small companies, there is negligible disruption from these issues. Longer term, we expect that companies currently doing business in China, will develop Plan B for manufacturing and sourcing, by moving to countries that can offer cost advantages in addition to trade stability.

Some of the pullback in small caps can be blamed on investors' concerns about weaker earnings growth in 2019 after a spectacular 2018. Furey Research *(3)* estimates R2000 consensus expectations are for 13% 2019 EPS growth, decelerating from 21.8% in 2018, while the R2000 Value consensus expectations are for 11.6% 2019 earnings growth and sales growth of 5.6% (down from 7.8% in 2018). The economy will probably slow down next year, but we do not expect a recession, or even an earnings recession. Markets discounted the worst case scenario in 4Q18, though neither the economy nor earnings were collapsing. The NFIB report for December showed that small businesses are still booming. The small business optimism index fell slightly to 104.4, but this was above expectations of a decline to 103.0. Actual hiring strengthened to the highest reading in six months, job openings are at record high levels, and plans to create new jobs are down only three points from August's record high. The primary issue continues to be "finding qualified labor" for small businesses. NFIB Chief Economist Bill Dunkelberg concluded, that the NFIB surveys of the small business half of the economy have shown no signs of an inflation threat, and in real terms Main Street remains very strong, setting record levels of hiring along the way.

We do not think cash will be the best performing asset class in 2019. Given low valuations, yet strong fundamentals, smaller companies exposed to the domestic economy, who generate ample amounts of cash flow, should perform well in the year ahead. We believe small cap value will rebound with banks, energy, and construction related companies leading the way. We will continue to seek attractive investment opportunities for our clients by focusing on high-quality companies identified and evaluated by our fundamental research and active portfolio management.

(1) Furey Research Partners, Earnings Look Ahead, 11 January, 2019

(2) Jefferies, US 2019: Investing as the Cycle Matures, 09 January, 2019

(3) Furey Research Partners, Earnings Look Ahead, 11 January, 2019

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