# Emerald Advisers, LLC
# Mid Cap Growth

Q1 2019 | Economic & Portfolio Commentary

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## "What a Recovery; No Surprise to Us"

### Quarterly Summary

Like the broader U.S. Equity markets, Emerald Mid Cap Growth portfolios bounced back in Q1 after a difficult end to 2018. Portfolios outperformed the Russell Mid Cap Growth benchmark – the best performing major domestic equity index for the quarter (the index rose 19.62% for the quarter, vs. 14.37% for the Russell Mid Cap Value index and 13.65% for the S&P 500 index) - through strong stock selection, particularly in the Consumer, Healthcare and Financial Services sectors. We benefited from our call last year that the U.S. was not going into a Fed/Trade induced recession, and while profit growth would slow early in 2019, economic and earnings growth would still materialize, propelling beaten up equity markets higher.

On the economic front, Real U.S. GDP came in at 2.2% for the quarter and 2.9% for the trailing 12 months. Nonfarm payroll was strong in January and weak in March, but still averaged 160,000 jobs added, while continuing jobless claims remained very low. Average hourly earnings continued to tick up, while other economic indicators like ISM Manufacturing, Consumer Confidence and Capacity Utilization remained in moderate growth mode. Inflation stayed mainly non-existent and retail sales were strong in January but weakened in February. Treasury Rates declined materially throughout the quarter on global growth fears and a rush into the higher yielding U.S debt markets, and money supply growth continued last summer's anemic trend. Hopes of a Chinese-U.S. trade deal began to materialize towards quarter end, and when coupled with the Fed's early quarter dovish pivot from the fear of economic deceleration, it was no surprise that equity markets responded positively.

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## Key Points:

- From a style perspective, growth handily beat value for the quarter… mid cap growth was the best performing domestic equity asset class. Smaller beat large, international beat domestic and both higher beta and higher quality stocks fared well.
- In Emerald's case, we beat the benchmark in six of the eight major economic sectors, with particular strength in Consumer Discretionary, Financials and Healthcare.
- Given the portfolio's excess projected 3-5 year growth rate vs. the benchmark has actually increased over the past few quarters while valuation characteristics have remained steady, we like our positioning going forward and will continue to use pullbacks as opportunities to add to our favorite positions, particularly in the Technology sector.

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## Portfolio Review

For the quarter, Emerald Mid Cap Growth portfolios benefited from being slightly smaller than the benchmark at a $16.9 billion market capitalization and continued their two year trend of trading cheaper than the index on virtually every valuation metric, including P/E using FY 1 and 2, Price/Cashflow, Price/Book and Price /Sales. At the same time portfolios were in the advantageous position of having names with an estimated 3-5 year earnings growth rate materially higher than the benchmark at 18.8% vs.16.4% for the mid cap growth index.

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## Market Outlook

We have maintained a bullish portfolio and market stance since it became clear to us last year that the market's reaction to the Fed, trade and an earnings slowdown was overblown. We deployed cash in Q4 and have been proven right thus far given the first quarter's strong equity recovery. The Fed is clearly on hold at this point as the three rate hike scenario predicted by many for 2019 is far less likely, with a real possibility of a rate cut. We seem to be inching closer to a trade deal with China, although that failing, as well as a continued fall out from Brexit and some global economic slowing is a risk. Recent domestic and Chinese Purchasing Manager figures actually support a bounce off the bottom. Earnings growth, while projected by FactSet to be negative 4.2% in Q1 and flat in Q2, is still nonetheless in growth mode, with 3.6% earnings growth and 4.9% revenue growth projected for the full year (FactSet April 5, 2019). And while the yield curve did momentarily invert and remains extremely flat, we think this is more of a flow of funds phenomenon vs. a precursor of global and domestic economic weakness. As Canaccord Genuity's Tony Dwyer writes: "The drop in the U.S. Treasury yield has been dramatic, but that has been matched by new record daily highs in the Barclay's High Yield Total Return Index." It's hard to make a case for recession when a high yield index is at a record and recent U.S. Weekly Jobless Claims reported fell to their lowest level since 1969. MKM Partners' Michael Darda reinforces this by writing "Proper measures of the curve have not inverted on a monthly average basis and credit markets broadly are suggesting more of a soft-landing scenario… These indicators would be consistent with a Fed that has already achieved a neutral policy stance, if not a bit beyond."

Our continued bullish stance does not mean that we are wearing rose colored glasses. We recognize that low real interest rates were one of the primary reasons for the first quarter's P/E expansion and as Stifel's Barry Bannister comments, earnings growth forecasts could be too optimistic, China's nascent recovery could stall, unemployment could increase and deflation could force a market shock weighing on cyclicals. We have built portfolios with what we call a cyclical growth flavor, but certainly still growth as evidenced by the portfolios' expected 3-5 year EPS growth being 240 basis points ahead of the index. Portfolios remain overweight Consumer Discretionary, Energy and Materials, equal weight Financial Services and Produce Durables and underweight Technology. Investors ask us about our pro cyclical bent and overweight to the chronically underperforming energy sector. We subscribe to JP Morgan's positive stance on cyclicals and particularly Energy: the firm notes that sentiment is terrible for energy, with benchmark weights at record lows; the valuation gap between energy in terms of price/book and low volatility, high momentum sectors is not only at cycle highs, but record highs; and as noted above, global growth, and hence demand, has stabilized and reaccelerated. In addition, the earnings growth rates for our Energy names is significantly above the market overall for the next two years. We benefited last quarter from a couple of well-timed M&A transactions and think that given the values apparent in our own portfolios, this M&A cycle is alive and well. Buy backs are also still in vogue and should add a tailwind to the markets.

We think the last two years have been an anomalous time in terms of the growth vs. value disparity of selected high growth names trading at discounted valuations. Given the portfolio's excess projected 3-5 year growth rate vs. the benchmark has actually increased over the past few quarters while valuation characteristics have remained steady, we like our positioning going forward and will continue to use pullbacks as opportunities to add to our favorite positions, particularly in the Technology sector. Interest rates, inflation and unemployment remain low and the consumer remains optimistic. Administration policy and global economies will be a wild card, but we think the elements are in place (growth in earnings, reasonable valuations) for a continued equity advance in 2019. Through our fundamental bottom-up research process we will look for names with strong growth prospects regardless of sector and industry.

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Emerald is an asset management firm providing research-based portfolio management. We provide growth-oriented and income-producing portfolios for institutions and individuals.

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