Emerald Advisers, LLC
Diversified Small Cap Growth

Q1 2019 | Economic & Portfolio Commentary

STRONG RECOVERY

Market Update

The first quarter of 2019 was the strongest quarter for the S&P 500 since the third quarter of 2009, and strongest first quarter since 1998, with the S&P 500 gaining 13.65%. The massive reversal in market sentiment from the record setting fourth quarter market weakness was driven by receding recession fears catalyzed by more dovish Federal Reserve positioning (removal of the dot plots and a tailing off of the balance sheet runoff), more optimism toward a trade resolution with China, greater confidence in stabilization of economic growth in China driven by a massive step up in stimulus by the Chinese central bank and a stabilizing macro-economic outlook in the U.S. as recent domestic data points have led to upward revisions to the first quarter domestic GDP growth forecast.

A stabilizing domestic outlook helped to propel small capitalization stocks with the Russell 2000 gaining 14.6% for the first quarter. This was the best first quarter for the index since 1991 and the best overall quarter since the fourth quarter of 2011, according to a recent report from Steve DeSanctis at Jefferies. From a style perspective small and mid-capitalization growth stocks led the rally with the Russell 2500 Growth and Russell 2000 Growth indices gaining 18.99% and 17.14%, respectively.

Within the Russell 2000 Growth, returns across all economic sectors were broadly positive, with performance within the technology (+23.39%), energy (+21.98%) and healthcare (+18.57%) sectors showing the greatest strength. From a factor perspective, the first quarter of 2019 was a mirror image of the fourth quarter of 2018, as the fastest growing companies measured by sales growth, the non-earners, and the highest beta companies each outperformed the index, reversing the meaningful fourth quarter underperformance.

Portfolio Review

On a relative basis, stock selection drove Emerald's outperformance relative to the benchmark for the quarter. At the sector level, relative outperformance within the technology, consumer discretionary, healthcare, financial services and consumer staples sectors offset relative underperformance within the producer durables, materials and energy sectors.

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Key Points:

- On a relative basis, stock selection drove Emerald's outperformance relative to the benchmark for the quarter. At the sector level, relative outperformance within the technology, consumer discretionary, healthcare, financial services and consumer staples sectors offset relative underperformance within the producer durables, materials and energy sectors.

- Partially offsetting the aforementioned strength was underperformance within the producer durables, materials and energy sectors which were challenged by a combination of the portfolio's relative underweight position and stock selection.

- While it is certainly true that past performance is not indicative of future results, there are enough green shoots in the global economic outlook to provide some confidence that a reacceleration in global growth could be forthcoming.

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Performance within the technology sector was the largest source of relative outperformance during the quarter driven largely by stock selection within the software industry. Outside of software, the portfolio also achieved a positive contribution to return within the communications technology, electronic entertainment and computer technology industries.

Stock selection within the consumer discretionary sector also contributed positively to return reflecting outperformance within the education services, leisure time, diversified retail, and specialty retail industries.

Performance within the healthcare, financial services, and consumer staples sectors also contributed positively to return. Amongst these, the healthcare sector was the largest positive contributor to return, driven largely by stock selection within the medical services, pharmaceuticals, and medical equipment industries. Outside of the healthcare sector, the portfolio also achieved a positive contribution to return within the financial services and consumer staples sectors driven by stock selection within the consumer lending, insurance, banking and foods industries.

Partially offsetting the aforementioned strength was underperformance within the producer durables, materials and energy sectors which were challenged by a combination of the portfolio's relative underweight position and stock selection. That being said, at the stock level within these sectors, there were no material detractors to return.

As we enter the second quarter of 2019, the portfolio held the largest active exposures in the technology, consumer discretionary, and utilities 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 first quarter of 2019. Within the sector, the computer software and services industry remains the portfolio's largest total and active exposure. Emerald continues to see a strong secular growth opportunity in enterprise security and vertical software as we believe that large corporations are behind in their efforts to digitally transform their 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 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.

- The portfolio also exited the quarter with an overweight position in the consumer discretionary sector. The overweight 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 amidst an expansionary consumer backdrop each of these companies is positioned to benefit from company specific initiatives and opportunities.

- The portfolio also maintains a modestly overweight position to the utilities sector. Within the utilities sector, we continue to see attractive opportunities related to the increasing adoption of cloud-based unified communications, growing demand for bandwidth among businesses and consumers, and the preparations for the rollout of 5G networks.

- 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. Although there were only 6 drugs approved by the FDA during the first quarter (vs. 18 drugs approved by FDA during Q4-18), we believe the slower sequential approval rate was a fallout of the government shutdown which delayed the approval process. 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.

Market Outlook

The turn of the calendar to 2019 has brought with it a stabilization in the outlook for global economic growth. After a dramatic slowdown in global manufacturing and industrial production over the course of the second half of 2018 that led to rising recession fears, recent data points both domestically and abroad have led to increasing confidence that the first quarter could represent the trough for both domestic and global economic growth for 2019.

Domestically, the GDP growth has shown signs of reacceleration. According to the Atlanta Fed GDPNow report, domestic GDP growth is now approaching 2.1%, after a series of positive upside surprises to the latest economic metrics. This is substantially better than the 0.3% growth rate that this same report was projecting at the beginning of March. The ISM Manufacturing Index has rebounded, the ISM Services index remains in expansion territory and while retail sales have proven volatile year-to-date, we believe the U.S. consumer remains in good financial position. Consumer confidence remains encouraging, the savings rate at 7% remains high, the debt service ratio is down near a historical low, wage growth is continuing unabated, and unemployment is low and going lower. Jobless claims for the week of March 30th fell to their lowest level since the week of December 5, 1969, according to a recent report from Jefferies. With domestic manufacturing showing signs of stabilization and continued growth in services and consumption we continue to remain optimistic that domestic economic growth should remain above 2% for the balance of 2019.

Recent economic data points from China have similarly showed signs of stabilization with both the March Caixin Manufacturing and Services PMIs coming in better than expected, as stimulus measures enacted by the Chinese government appear to arresting the slowdown experience during the second half of 2018. Data out of Europe, however, remains more mixed. Eurozone manufacturing statistics have continued to disappoint, while the Eurozone Services PMI has continued to demonstrate strength. Germany and the U.K. have been notable sources of weakness, with ongoing manufacturing weakness and the uncertainty surrounding BREXIT remaining headwinds. Encouragingly, to the degree that the rest of the world (U.S., China, emerging markets) continues to demonstrate economic improvement and the U.K. makes an orderly exit, given the more export oriented natures of the Eurozone economies we believe it is unlikely that the Eurozone will weaken further. Further, central banks across the globe have shifted to more accommodative policy, which adds a further leg of support to the stabilization in global growth.

Earnings estimate revisions, both globally and domestically, are beginning to reflect this stabilization. After incurring material downward revisions to 2019 estimates both globally and domestically, where the growth forecast for the S&P 500 for

2019 was revised from 12% to 4%, earnings estimate revisions are starting to stabilize. Domestically the three-month earnings estimate revision ratio, calculated by Bank of America Merrill Lynch, moved up in March for the first time in six months. While the ratio at 0.62 still indicates more estimate cuts than positive revisions, the pace is slowing. The three-month sales revision ratio has also improved to 0.70 from 0.59, after falling throughout last year. Again while this ratio remains below its low-term average of 1.0, the sequential increase in the ratio is demonstrating a slowing in the pace of negative estimate revisions, which we view as encouraging.

The stabilization at a minimum appears supportive of the current expectation for earnings to trough in the first quarter and accelerate through the balance of 2019. We believe a resolution to the trade agreement with China would only further serve to reenergize manufacturing activity/business investment that has decelerated post the slowdown in China that started at the end of last summer.

While recent green shoots as discussed above are encouraging, the outlook for global growth is anything but certain. This list of risk remains long with the failure of stimulus to gain traction in China, a more disruptive than expected BREXIT, a prolonged inversion of the yield curve, the return to a more hawkish commentary from the Federal Reserve and a collapse in trade discussions with China all representing potential sources of downside risk to this nascent recovery.

All things considered and looking to the balance of 2019, while the strong first quarter market returns have investors questioning whether the gains for the year have already been achieved, we continue to believe there is scope for the market to move higher over the balance of year in tandem with positive revisions to both domestic economic and earnings growth. Further, from a historical perspective, according to a recent report from Michael Gibbs of Raymond James, when looking at periods following the strongest first quarter returns over the last 20 years, the average return for the remainder of the year is 8.4%. While it is certainly true that past performance is not indicative of future results, there are enough green shoots in the global economic outlook to provide some confidence that a reacceleration in global growth could be forthcoming. Within this backdrop we continue to believe that the U.S. domestic market will remain the strongest house on the international stage.

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