Emerald Advisers, LLC
Diversified Small Cap Growth

Q2 2019 | Economic & Portfolio Commentary

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Global Economic Slowdown Causes FED to Change Path

Market Update

The path of broad market returns proved more volatile in the second quarter as the market adjusted to changing trade rhetoric and decelerating trends in global economic growth. Despite the month-to-month intra-quarter volatility, the market managed to forge ahead, as the promise of the Federal Reserve standing at the ready to "act as appropriate to sustain the expansion" enabled the market to advance despite ongoing uncertainty surrounding the trade dispute with China and broadly weakening domestic and global economic statistics. This resiliency, enabled the S&P 500 to gain 4.30% for the second quarter on the back of the index's best June performance since 1955 (+6.9% price return, 7.05% total return), according to a recent report from Savita Subramanian of Bank of America Merrill Lynch. The strong second quarter performance capped what was the best first half performance for the S&P 500 since 1997 (+17.4% on a price return basis and 18.5% on a total return basis), according to the same report.

While the broad market in aggregate continued to advance there were sizeable divergences in performance. From a capitalization perspective, small capitalization stocks meaningfully underperformed their large capitalization counterparts. The Russell 2000 advanced at only half the rate of the S&P 500, gaining a more meager 2.10% for the quarter. The underperformance of small caps marked a reversal from the first quarter where smaller capitalization led their larger capitalization brethren. It is noteworthy that this migration, in part, occurred in conjunction with the significant relative outperformance of those companies with greater foreign exposure. Within the Russell 2000 Growth index, according to a recent report from Steve DeSanctis at Jefferies, those companies with greater than 20% of sales outside of the U.S. gained 4.35% for the quarter, whereas those with less than 20% of sales outside of the U.S. gained a more modest 1.87%. This shift toward favoring non-U.S. sources of revenue was particularly magnified during the month of June with those companies with greater than 20% of sales garnered from foreign sources gaining 10% and those with less than 20% of sales from foreign sources gaining a more modest 6.44%. Interestingly this performance seemed to correlate most directly with the weakening of the U.S. Dollar.

At the sector level, performance within the Russell 2000 Growth was fairly

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 healthcare, financial services and consumer staples sectors offset relative underperformance within the technology sector.
- As we enter the third quarter of 2019, the portfolio held the largest active exposures in the technology, consumer discretionary, financial services and utilities sectors.
- While 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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bifurcated with the producer durables and materials sectors gaining 8.82% and 6.41% respectively, whereas the technology and healthcare sectors lagged gaining a much more modest 1.28% and 0.41% respectively. Energy remained the worst performing sector within the benchmark, declining by 8.97% for the second quarter. Interestingly, despite the shift in sector leadership away from technology and healthcare, growth as a style continued to outperform. Within the Russell 2000, the Russell 2000 Growth gained 2.75% outpacing the 1.38% gain posted by the Russell 2000 Value index. The second quarter's relative outperformance pushed the gap for the year to approximately 689 bps, with the Russell 2000 Growth returning 20.36% to the Russell 2000 Value's return of 13.47%.

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 healthcare, financial services and consumer staples sectors offset relative underperformance within the technology sector.

Performance within the healthcare sector was the largest source of positive contribution for the period driven by outperformance within the biotechnology and medical & dental instrument industries.

Performance within the financial services sector also contributed positively to return driven by stock selection within the banking, consumer lending and multi-line insurance industries.

Outside of the aforementioned, the portfolio also achieved a modestly positive contribution to return within the consumer staples sector driven by relative outperformance within the food industry.

Partially offsetting the aforementioned strength was underperformance within the technology sector. After a strong start to 2019, relative performance within the technology sector lagged during the quarter largely as a result of stock selection within both the electronic entertainment and software industries. Outside of the software industry, the portfolio also experienced challenging performance within the electronic entertainment industry.

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

- The technology sector remained an overweight position exiting the second quarter. 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. Secular trends such as 5G and industrial IoT (internet of things) are gaining traction 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, to 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 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. There were 10 drugs approved by the FDA during the second quarter bringing the year-to-date total to 16 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.

Market Outlook

A synchronized slowdown in global manufacturing is again weighing on the outlook for global growth. After what appeared to be a stabilizing global growth backdrop during the first quarter, trends have again turned lower as trade tensions and the likely tail effects of 2018 rate increases have collectively weighed on global manufacturing PMIs, industrial production, business confidence, the outlook for capital expenditures and forward earnings growth across the globe.

Despite this weakening economic backdrop, recent commentary from Federal Reserve Chair Jerome Powell noting that the Federal Reserve is ready to act "as appropriate to sustain the expansion" has given the market cover to advance. Domestically the futures market is currently pricing in approximately 75 bps of Fed rate cuts by the end of 2019 and 35 bps in 2020 with a July rate cut fully priced into expectations. The Federal Reserve is not alone in its dovish tilt, The People's Bank of China has been in easing mode since the back half of 2018 and more recently worsening trends in Europe have similarly tilted the European Central Bank in the direction of easing. This migration toward a synchronized global easing cycle has supported equity markets while at the same time bond yields across the globe have succumbed to significant bouts of pressure, with the U.S. 10-year Treasury breaking below 2% on a transient basis and the German 10-year Bund moving further into negative territory.

The perceived trade truce between the U.S. and China following the G-20 meeting has helped to put trade concerns on the back burner. While it may be true that an escalation in trade tensions has been avoided at least in the near-term, the trade headwind to economic growth has not abated. Uncertainty surrounding trade is having an indisputably negative impact on manufacturing activity, business confidence, business investment and earnings growth.

The deceleration in economic activity across the globe has resulted in a downward revision to forward earnings growth. Consensus S&P 500 2019 earnings estimates have been cut from $174 to $166 (-4%), according to a July 1, 2019 report from David Kostin of Goldman Sachs. While there has been little focus on the compression in the earnings outlook to date, we believe the direction of earnings and management's forward outlook will play an increasingly important role in the market narrative as we move through the third quarter.

It is difficult to see from this vantage point how these points of market uncertainty coalesce neatly into one visible indisputable path for the market. As a result we expect market volatility to reassert itself over the coming weeks as the market handicaps the direction of forward earnings growth, adjusts rate expectations around incoming economic data, and assesses the progress of further trade discussions with China. That being said, as we look around the globe, we believe the U.S. economy will continue to demonstrate its resiliency, and remain the strongest of the developed market economies. Within this backdrop of a slowing but still growing U.S. economy, we believe growth stocks remain particularly well positioned to maintain their path of outperformance, as earnings growth proves to be increasingly scarce.

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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