Emerald Advisers, LLC
All Cap Growth

Q2 2019 | Economic & Portfolio Commentary

David A. Volpe, CFA
Portfolio Manager

Stephen L. Amsterdam
Associate Portfolio Manager

Joseph Hovorka
Associate Portfolio Manager

"Positive Relative and Absolute Performance Despite Slowing Economy"

Quarterly Summary

Emerald All Cap Growth portfolios' performance roughly matched that of the Russell 3000 Growth index for the 2nd quarter. Strong Q2 performance in Healthcare, Materials and Producer Durables was offset by weaker performance in the Consumer Discretionary, Energy and Technology sectors. Trade and interest rate issues were front and center for the quarter, with names that had perceived exposure to China underperforming, along with many of those in economically sensitive sectors and industries. Larger names in the benchmark substantially outperformed smaller constituents, non-earners beat earners and growth outperformed value for both the quarter and year-to-date. For the quarter, Emerald portfolios had strong stock selection with above-benchmark performance in names from virtually every sector. Emerald portfolios continued to benefit from holding securities that are expected to grow earnings almost 200 basis points above the benchmark, but trade at or below the benchmark constituents on virtually every valuation metric.

From an economic and monetary perspective, metrics such as Real GDP, ISM Manufacturing, Consumer Confidence, Leading Economic Indicators, Freight, Architectural Billings and Dodge Momentum all softened as the quarter progressed based on trade, interest rate and economic uncertainty. Productivity measures were strong keeping inflation in check. Corporate earnings, although weak, did exceed low expectations, but earnings revisions across the board were negative due to tariffs and uncertainty surrounding trade rhetoric. Despite reasonable, albeit slowing employment and wage growth, the yield

Key Points:

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- Emerald portfolios continued to benefit from holding securities that are expected to grow earnings almost 200 basis points above the benchmark, but trade at or below the benchmark constituents on virtually every valuation metric.

- Our expectation is that some of the beaten up cyclical growth sectors and industries like Energy, Financials and Materials will begin to outperform with Fed rate cuts and the reinvigoration of growth. We continue to focus on companies with great management teams, above benchmark growth and significant competitive differentiation.

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curve inverted during the quarter as investors gravitated towards risk-free assets.

Market Outlook

With the Russell 3000 Growth benchmark up 21.41% YTD some might question any optimism about equities in the near term. We take the other side of the argument as we think investors should focus on the old axiom: "Don't fight the Fed." By remaining tight in 2018, as well as sending mixed and confusing messages, the Fed almost drove the economy into recession through their disregard for the inversion of the yield curve and persistently low inflation. Even with encouraging employment numbers, it seems clear the Fed knows it needs to loosen monetary policy to battle historically low inflation, to spur growth and reinvigorate the yield curve. At this point, we expect 25 basis point Federal Funds rate reductions at the July and September Fed meetings. Canaccord Genuity strategist Tony Dwyer likens current market and economic conditions to 1995 when the Fed reduced rates and started an economic reacceleration leading to extraordinary market gains.

At Emerald we have long held the belief that earnings drive stock prices. While many were predicting an earnings recession in 2019, it seems we have narrowly skirted that market negative event as S&P 500 Q1 2019 earnings came in roughly flat after being revised upward throughout the last earnings season. If Q2 S&P 500 earnings follow the same upward revision pattern, Evercore ISI strategist Ed Hyman posits Q2 2019 earnings will likely end with 2% year-over-year growth, which is certainly not strong, but not in recession territory. Clearly earnings weakness is the risk to the market as we enter the Q2 earnings season; however, company balance sheets are in good shape and high yield credit spreads have remained relatively tame, with lower than normal default rates (JP Morgan Asset Management). We will continue to monitor corporate spreads and defaults, as well as employment and jobless claims data as early indicators of recessionary conditions, but at this time these factors are not pointing to an economic contraction.

As mentioned above, Emerald portfolios were impacted by holding a number of names that, while fundamentally strong, were negatively affected by trade issues. With the recent suspension of additional tariffs at the G20 summit, we think we are moving slowly towards some type of trade resolution with China that would provide a positive catalyst for selected portfolio companies. Our thought is that once the trade fears start to wane, capital spending will begin to reaccelerate from current subdued levels. In terms of portfolio positioning, portfolios are overweight Healthcare, Energy and Materials, equal weight Consumer Discretionary and underweight Consumer Staples, Producer Durables, Financial Services and Technology. We have added to the software and service area in Technology given the growth of the benchmark in that industry and are feeling more confident than we been have in a long time that our overweight to Energy will begin to pay off. Portfolios are smaller than the benchmark in market cap, but still large at over $200bn and with a median market cap 2x the benchmark's weighting. Portfolios are expected to grow earnings almost 200 bps faster than the benchmark (16.92% vs. 15.04% – a level consistent with past quarters). Importantly, Emerald All Cap Growth portfolios also continue to trade cheaper than the benchmark on every valuation metric, a phenomenon we have seen for the past two years that we think will change through P/E expansion based on reinvigorated economic strength.

Even with underperformance year-to-date of smaller, growthier benchmark constituents, Emerald All Cap Growth portfolios have held their own and are ahead of the index performance over the time period. Our expectation is that some of the beaten up cyclical growth sectors and industries like Energy, Financials and Materials will begin to outperform with Fed rate cuts and the reinvigoration of growth. We continue to focus on companies with great management teams, above benchmark growth and significant competitive differentiation. We added several new smaller names towards the end of the quarter and continue to add to small caps after quarter end as we think the small cap underperformance vs. large caps by 1300 basis points over the last year is not sustainable particularly given upcoming Fed rate cuts. Jefferies strategist Steven DeSanctis notes that valuations are very compelling for small caps and suggests small caps beat large by over 600 basis points in the year following this type of valuation disparity.

We feel very good about Emerald's ability to continue to grow and thrive in this difficult environment for active managers. Emerald's staff continuity and longevity is strong, as is our commitment to fundamental bottom-up research. To that end, we think our deep dive, bottom-up research model is becoming more and more advantaged as trading dollars dry up, the sell side continues to shrink its research efforts, and regulations like MiFID II makes its way to the U.S. shores. We believe that firms like Emerald with large, proprietary research teams will be advantaged as less true fundamental research is conducted by the Street. The Emerald advantage will become more apparent as the Street's research cut-backs cause markets – particularly small and mid-cap markets – to become less efficient and price discovery gravitates to fewer and fewer equity players.

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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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Contact Us

Phone: 1-800-722-4123
info@teamemerald.com
3175 Oregon Pike
Leola, PA 17540

King of Prussia, PA
Pittsburgh, PA
Cleveland, OH

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