# Emerald Advisers, LLC
# Mid Cap Growth

Q4 2019 | Economic & Portfolio Commentary

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## "Fed and Trade Drive Markets Sharply Higher"

### Quarterly Summary

Emerald Mid Cap Growth portfolios experienced strong absolute performance for the quarter, but trailed the benchmark modestly, as stock selection in the Technology sector detracted from returns. For the year the story was similar- with very strong absolute returns, but underperformance vs. the benchmark mainly due to stock selection in the Technology sector and difficulty finding differentiation between stocks with most mid-cap growth equities registering 30%+ rates of return. For both the quarter and the year growth stocks significantly outperformed value across the market cap spectrum, with the Russell Mid Cap Growth index outperforming the Russell Mid Cap Value index 35.47% vs. 27.06% for the year. Large Cap stocks also outperformed small for the year with the Russell 1000 Growth index exceeding the performance of all other domestic indices impressively, up 36.39% vs. 28.48% for the Russell 2000 Growth. Smaller stocks did outperform in the 4$^{th}$ quarter with the Russell Microcap index putting up the best U.S index return at 13.45% for the quarter. It is interesting to note that 2019 market gains were all about P/E multiple expansion as, according to Jefferies strategist Steven DeSanctis, earnings look to be down 7% for small caps and flat for large for the full year. Low P/E companies, highly shorted names and selected beaten up stocks led for the quarter, reversing leadership from the low-volatility, high growth momentum names that led for the year.

Markets rose sharply for the quarter and the year spurred by clear Fed signaling of continued loose monetary policy and a December announcement of a Phase One trade deal between the world's two economic superpowers: the US and China. GDP forecasts towards the beginning of the quarter were estimated at 1.5%, below the rate experienced in prior quarters. This slowdown, in part, was based on a weaker Institute for Supply Management (ISM) Manufacturing Index

## Key Points:

- Emerald Mid Cap Growth portfolios experienced strong absolute performance for the quarter, but trailed the benchmark modestly, as stock selection in the Technology sector detracted from returns.
- We believe that 2020 should turn out to be a better year for active management and stock picking given the inefficiencies and liquidity flow induced distortions that passive management and cheap money have produced in the market.
- The Emerald Mid Cap Growth team remains committed to investing in the best domestic growth companies. Given the market's current valuation distortions, we think the set up for 2020 is positive for active management, cyclicals and small caps, as well as selected Healthcare and Technology stocks.

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that suggested the production side of the economy was in contraction. In fact, December was the fifth consecutive month of contraction for that indicator, a slowdown not seen since late 2015/early 2016. Historically, this type of economic contraction suggested the economy as a whole could be in recession and the early fourth quarter GDP estimates suggested the past was repeating itself. However, as the quarter progressed the GDP forecast increased from 1.5% to the current consensus of 2.2%. In addition, other construction related measures such as the Dodge Momentum Index and the Architectural Billing Index re-gained positive territory, thus providing a favorable set-up for 2020.

What accounted for the increased expectations? The US consumer, the service sector, and the Federal Reserve. Employment growth in October and November came in better than expected. This, along with the ISM Services measurement, remained in expansion mode. A better than expected payroll survey and a still expanding service sector helped to soften the concerns from the disappointing manufacturing and industrial data. The weaker than expected ISM manufacturing data can be attributed to the trade issues with China and the EU, as well as the ongoing issues with Boeing. In addition to the stable employment picture, the Federal Reserve took action to address the liquidity (more than $350 billion in US Treasury bill purchases) and funding concerns (banking reserves) that began to develop in September. This action was a mirror image of December 2018 when the Federal Reserve was tightening financial conditions, causing equity markets to fall. In addition, the expectation of a US/Chinese Phase One trade agreement being signed in January helped to give investors comfort that ongoing trade related economic weakness would dissipate and turn from a headwind to a tail wind.

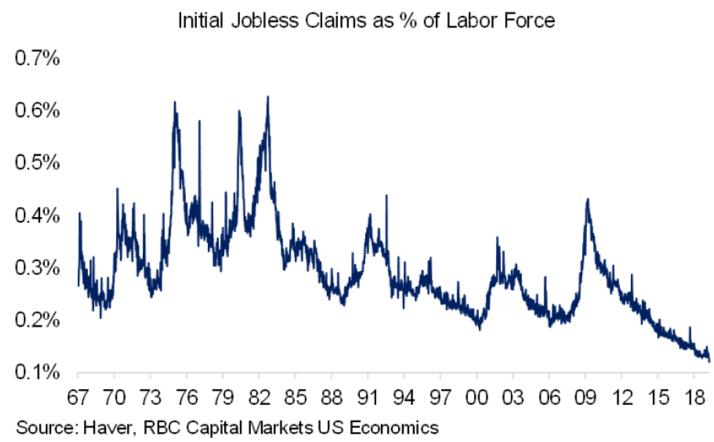
## Portfolio Review

As noted above, Emerald Mid Cap Growth portfolios ended the year strongly, modestly trailing the returns of the strongly performing Russell Mid Cap Growth benchmark for the quarter. Portfolios were very similar to the benchmark in terms of weighted average market capitalization ($20.1 billion vs $20.2 billion for the benchmark). Portfolios were growthier than the benchmark with an estimated 3-5 year EPS growth rate of almost 15.61% vs. 15.37% for the benchmark, and significantly stronger historical growth rates. Even with this higher expected growth rate, portfolios traded in most cases at discounted valuation metrics – a phenomenon we have seen for most of the last three years. For the full year, with so many names in the benchmark up 30% and more, it was hard to find differentiation when most factors such as valuation, yield, profitability and leverage were all up comparably. It was only in growth and size factors that we saw differentiation, with large growth stocks being the best performers.

During 2019, the portfolio was underweight the Technology sector, which detracted from performance because selected large benchmark names performed well, regardless of growth or fundamental metrics as noted above. Additionally, the risk/reward balance was skewed to the downside as stocks with minor earnings disappointments or transient issues were unduly punished in spite of their longer-term fundamental value. Trade issues also played a role in performance, as swift changes in investor sentiment caused major swings in certain names due to rapidly changing geopolitical/trade rhetoric.

## Market Outlook

After the relatively strong quarter and year Emerald and the market experienced, it is a little strange even to us that we remain reasonably bullish about equity returns in 2020. And while we don't have the same amount of exuberance we did in early 2019 given the market's late 2018 pullback, there are still numerous reasons to remain firm in our core underlying positive fundamental thesis. 2019 returns were driven by the Fed's recognition – finally – that they were behind the curve on stimulating inflation, with Core PCE firmly below the Fed's 2% target. Canaccord's Tony Dwyer notes that, "At just 1.69%, the Fed's own 5-year forward Breakeven Inflation Rate suggests the Fed should be more worried about disinflation rather than higher inflation." Last year the Fed finally accepted and admitted this is an issue and made it clear that monetary policy will remain accommodative for the foreseeable future. Beyond an accommodative Fed, other economic factors that tend to be harbingers of an upcoming recession remain reasonably sanguine: Corporate credit spreads have remained at close to record lows and the Chicago Fed NFCI Index is also near historically low financial stress levels. MKM's Michael Darda, who has become more cautionary on the risks of recession, still notes that despite manufacturing being in recession, most of the short term recession forerunners he follows (first time unemployment claims, consumer confidence and temporary help employment) all remain on positive footing.

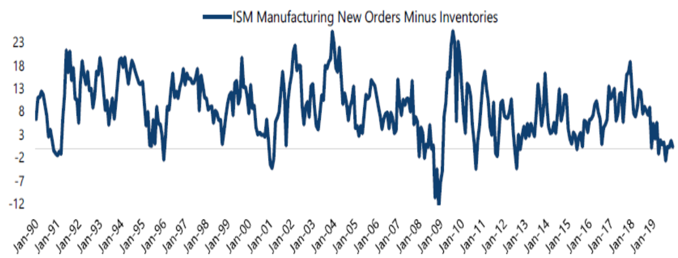



And while the yield curve did invert for a brief period of time this summer, this is a long lead-time indicator pointing to recession in some cases far into the future.

To be clear equity markets are not cheap. The S&P 500 P/E multiple is 18.5x with most of the increase in 2019 coming from multiple expansion, as 12-month forward earnings estimates for the year were virtually unchanged. The good news is that earnings for 2020 are expected to grow moderately, with S&P 500 earnings projected to grow 9.4% with revenues growing 5.4% (Factset). While a pullback at some point in 2020 is almost inevitable given the sharp 2019 run-up in stocks, it is likely given tame inflation, accommodative monetary policy and continued almost full employment, that the market's multiple will at least grow with the level of earnings growth, or greater.

As it relates to the stubbornly weak manufacturing sector, as exemplified by the ISM Manufacturing Index, it seems clear to us that the US will soon be emerging from what some have termed the third mini-recession driven by a weaker dollar, global stimulus cycle, partial trade deal and pro-growth election year rhetoric. The following Jefferies chart shows that inventories have gone through an adjustment and are priced for a rebound.

Inventories have gone through an adjustment; looking for rebound in '20




Source: Bloomberg; Jefferies

We believe that 2020 should turn out to be a better year for active management and stock picking given the inefficiencies and liquidity flow induced distortions that passive management and cheap money have produced in the market. It is unlikely that a large benchmark weight name like Apple will see its share price appreciate 88% almost exclusively on multiple expansion. Fundamentals should come into play and lead investors to strong growth names with less expensive valuations and crowded ownership levels. JP Morgan estimates the rotation out of Momentum and into Value (Cyclical) stocks since August 2019 has only partially corrected (only 40% complete) and the extreme dislocation between selected sectors should be narrowed based on better macro-fundamental data and confirmation of a cyclical recovery. Also the movement away from defensive, low volatility bond proxy names – the bane of our existence the past few years given their strong returns with little growth – should continue as these name remain significantly exposed to duration risk in the form of higher bond yields.

This would be good news to us as well as most active managers, as we have a good shot of outperforming when fundamentals matter. We have maintained our overweight positions in Energy, Materials and Banks as these sectors by-and-large have record short positions, depressed valuations, yet have experienced strong insider buying and obviously benefit from a reflation trade and a weaker US Dollar. Energy in particular has seen at least three years of underperformance and yet sets up as the fastest earnings growth sector for 2020 according to Factset (22% growth estimated for S%P 500 Energy names) and should experience significant positive earnings revisions should WTI oil stay anywhere around its present $60/barrel level. This, along with the fact that long-only PMs have all but abandoned the sector, as evidenced by its record low 4% S&P 500 weighting, gives us confidence that our overweight will finally pay off. We remain underweight Technology and Healthcare looking more for stock selection to drive performances vs. sector exposure. We continue our underweight to Producer Durables as we are more than exposed to domestic and global economic stimulus and expansion in our overweight's to Energy and Materials, with names with better growth rates and lesser valuations.

Looking forward, trade issues appear to be lessening – or at least the market is digesting news in a more rational manner; and the market as a whole seems to have entered 2020 more focused on fundamentals as opposed to 2019. Importantly, we believe some of the delays to technology transitions and secular growth themes witnessed in 2019 and contributing to our Technology underperformance for the quarter and the year are now behind us leading to some of our holdings that were laggards in 2019, becoming leaders in 2020. We continue to assert that our focus on those companies with the best growth profiles and fundamental performance metrics will be rewarded over the longer term, and while staying true to our core investment philosophy created challenges for our technology positioning last year, we believe our positioning in the best growth names will be rewarded in 2020.

The Emerald Mid Cap Growth team remains committed to investing in the best mid-sized domestic growth companies. Given the market's current valuation distortions, we think the set up for 2020 is positive for active management, cyclicals and small and selected mid-capitalization names, as well as selected Healthcare and Technology stocks. There will likely be significant market pullbacks throughout the year based on election rhetoric and results and geopolitical events, but we remain steadfast in our belief that earnings growth drives stock values. We think equity markets will be resilient in 2020 and Emerald's unwavering focus on the best growth companies will lead to outperformance.

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