Emerald Advisers, LLC
Growth Opportunities

Q2 2020 | Economic & Portfolio Commentary

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"V Shaped Recovery Takes Shape – Survival of the Fittest and Biggest?"

Quarterly Summary

We titled last quarter's commentary "The Day the Earth Stood Still," highlighting how economic activity literally ground to a halt in early March. What a difference a quarter makes. After the S&P 500 was down (34%) through March 23rd, equity prices never looked back and finished the second quarter broadly positive, with our benchmark Russell 3000 Growth index experiencing a very positive quarter. Emerald All Cap Growth portfolios outperformed for both the quarter and YTD. We benefited from strong performance in Consumer Discretionary and Staples, Energy, Materials, and Producer Durables. Healthcare led the pack, with a number of names benefitting from stronger than anticipated drug launches.

Strategist Ed Yardeni coins the massive market rally that started on March 24th the "Mother of All Melt Ups". This melt-up certainly caught us, as well as most investors by surprise, as traders looked past drastically lower 2020 earnings estimates and almost universal company forward guidance withdrawals, and instead focused on unprecedented Fed-induced liquidity and positive vaccine and antibody news from pharmaceutical and biotech companies. Growth stocks were the star of the show, leading value by over +1300 bps for the quarter, as large FAANGM, cloud computing, cybersecurity, and biotech names led for the quarter and YTD, as shown in the following Furey Research chart showing small cap market leaders and laggards through June 23, 2020.

Key Points:

- Emerald All Cap Growth portfolios outperformed for both the quarter and YTD. We benefited from strong performance in Consumer Discretionary and Staples, Energy, Materials, and Producer Durables. Healthcare led the pack, with a number of names benefitting from stronger than anticipated drug launches.

- Portfolios also benefited from our barbell approach to construction whereby we owned a number of names that were beneficiaries of the virus impact, offset by purchases of stocks that benefit from the economy reopening.

- As always, Emerald's core is our tried and true 10-step fundamental research process employed by our seasoned investment team. The COVID crisis has made research related travel virtually impossible, but our team has stepped up our virtual meetings and communication efforts resulting in greater inter- and intra-company communication.

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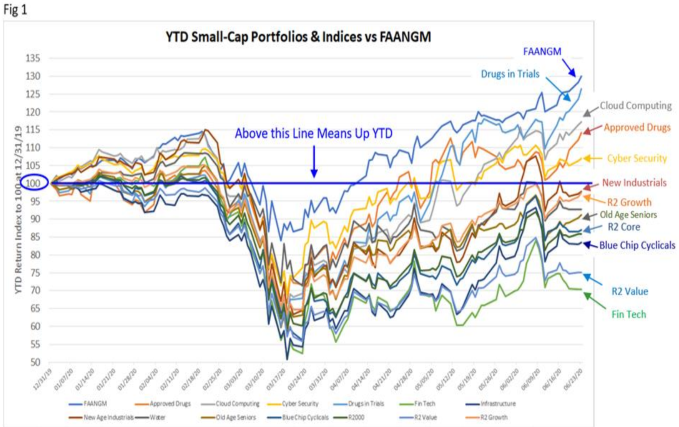
Fig 1



Source: Furey Research Partners and FactSet. Data through mid-day June 23rd.

This growth stock outperformance continues the last decade's trend of growth outperforming value, as investors have been willing to pay very high multiples for secular growers, given low interest rates, low inflation and FOMO (fear of missing out). Beyond sales growth, other factors influencing performance for the quarter included ROE, with lower ROE stocks advancing the most; and P/E, with the highest P/E and non-earners performing the best for the quarter.

From an economic perspective, dramatic governmental fiscal and monetary stimulus assuaged the truly devastating economic impact of the virus. Through mid-May, over 36 million Americans had filed for unemployment compensation, with the civilian unemployment rate peaking at 14.7% in April. Other economic indicators plummeted through the end of April, with Retail Sales down (14.7%), Industrial Production dropping (12.5%) and ISM Manufacturing collapsing to (41.5). As an illustration of the magnitude of the virus-driven economic decline, Real GDP is projected to drop (5%) in Q1 and (32.5%) in Q2 2020. In addition, Factset projects S&P 500 earnings to decline (43.8%) in Q2 and (21.5%) for 2020. These dire economic trends started to reverse in May, when the economy started perking up as selected states pushed reopening plans regardless of the virus' severity, and the aforementioned economic measures all started to improve, with the ISM Manufacturing Index reversing course and registering readings of +43.1% and +52.6% respectively in May and June. The Civilian Unemployment rate improved to +13.3% in May and +11.1% in June. Currently the Citigroup Economic Surprise Index is at a record level.

Portfolio Review

As noted, Emerald All Cap Growth portfolios beat our Russell 3000 Growth benchmark for both the quarter and YTD with strong stock selection in most sectors leading to the bulk of the outperformance. In addition, we benefited from portfolios being growthier than the benchmark, with an expected EPS growth rate fully +200 basis points above the index at +18.34%. At the same time, portfolio valuation characteristics were similar or cheaper than the benchmark on most measures. Portfolios also benefited from our barbell approach to construction whereby we owned a number of names that were beneficiaries of the virus impact, offset by purchases of stocks that benefit from the economy reopening. This "Flexible" approach to portfolio construction allowed us to add to selected names and industries on weakness and take profits in others that made significant gains during the quarter. We ended the quarter underweight Technology which has become huge in the benchmark at over +42%, modestly underweight Consumer Discretionary, Consumer Staples and Financials and Overweight Healthcare, Materials, and Energy.

2Q20 Sector Allocation

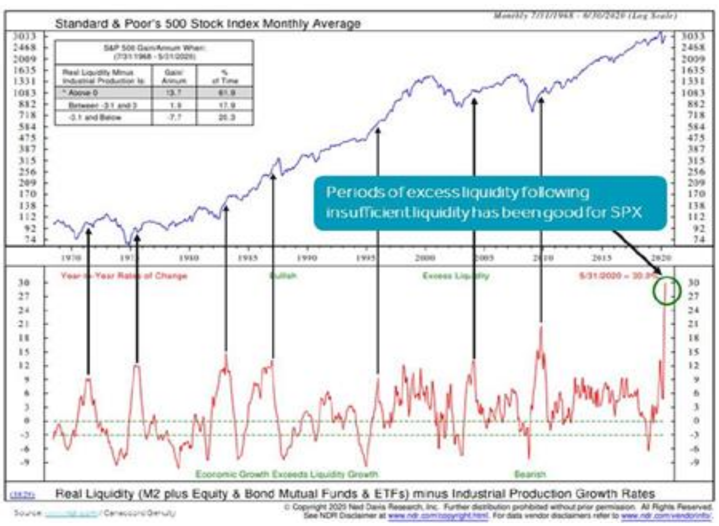
Sector	Growth Opportunities Portfolio	Russell 3000 Growth
Consumer Discretionary	18.1%	18.8%
Consumer Staples	3.1%	3.8%
Energy	2.5%	0.2%
Financial Services	8.0%	10.4%
Health Care	17.0%	15.9%
Materials & Processing	3.5%	1.3%
Producer Durables	6.7%	6.0%
Technology	39.0%	43.3%
Utilities	0%	0.2%
Cash	2.2%	0.0%

Source: Factset, Frank Russell Company

Market Outlook

As noted above, while we outperformed the benchmark for the quarter and YTD due to advantaged stock selection, we were surprised by the market's incredible strength and resilience in the face of dire economic, virus and employment indicators and investor's willingness to look to 2021 and beyond for a true economic and earnings recovery. But the historic monetary and fiscal stimulus since the COVID-19 recession began has been nothing short of breathtaking, and a major factor driving record breaking liquidity, a factor that we considered, but quite frankly, underestimated. See the following Canaccord Genuity illustration highlighting the unprecedented amount of liquidity.

Unprecedented Liquidity



We also underestimated the potential impact of a handful of predominantly Tech names could have on benchmark returns due to their sheer size and the unique set of business realities brought about by the coronavirus. While we remain underweight Technology, particularly software and services, we have been adding substantially to our exposure on any pullbacks. We have also maintained our overweight position to selected industries within Consumer Discretionary that will benefit from the economy reopening. We also aggressively added to our healthcare exposure towards quarter end and into the new quarter given the large increase in the benchmark weighting and our analyst's ability to identify strong growers in that sector.

In terms of a near-term outlook, our first thought is that given the market's historic quarterly gains, there needs to be some period of digestion of the advance and summer tends to be that time of the year. In addition to summer malaise, we will have earnings in the next few weeks that may have investors focusing more on company fundamentals. In addition, investors will likely pay more attention to the impact of the upcoming election and have to readdress risks from the reacceleration of COVID-19 cases and potential slowdown/shutdown of reopening activity in affected jurisdictions. Lastly, at some point investors will have to look at valuations which by most measures are stretched certainly in the short term vs. historical averages for selected secular growth stocks.

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	132.9%	140.9%	158.5%
Mid	139.3%	148.5%	192.2%
Small	168.1%	265.3%	-

Source: Factset, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management

We have remained underweight Technology, particularly software and services, in portfolios for the last quarter waiting for some type of real pullback before adding substantial exposure.

We are not negative on the market – on the contrary, many elements conducive to increased equity market valuations are in place, the foremost of which is a very dovish Fed. As our friend Tony Dwyer from Canaccord Genuity notes: "The Fed has literally stated that there is no dollar amount to their support for the credit market until there is a sustained economic recovery." Given lower than required inflation and employment, the Fed seems to be willing to expend any and all of the bullets in their monetary arsenal to improve financial conditions and as a by-product asset prices. In addition Credit Suisse's Jonathan Golub notes that investors have been, and will continue to, pay for tighter credit spreads which dovetails nicely into the Fed's bond buying program and improving economic health.

This commentary would be very lacking if we didn't have some discussion of our views on the impact of the coronavirus on the economy and markets. As noted, we added a number of names that were clearly reopening beneficiaries in March and April. Many of these predominantly Consumer Discretionary names have pulled back markedly given the surge in COVID-19 cases in the Sunbelt and West. We offset this exposure with numerous Technology and Healthcare names that are direct COVID beneficiaries, or that are true secular growers not impacted by the virus. One area we are overweight that should be immune from any COVID effect is the defense industry. Unfortunately, defense names have not worked in the past two months, in some part due to election concerns and perceptions about a "Blue Wave." We are sticking with our overweight at this time, as we think there is little likelihood of any funding cuts for our holdings given the critical programs to which they are tied and the current geopolitical strife involving the U.S. and a growing number of countries. As always we expect to generate most of our returns from stock selection rather than sector positioning, but we always look to get both right.

Beyond liquidity, a directionally improving economy and vaccine and treatment optimism, a factor that has pushed markets higher is the increase in retail investors trading stocks in some respects as a replacement for betting on sports. This phenomena, along with the push by Chinese authorities to invest in equity markets has contributed to recent equity outperformance, as well as clear improvements in Chinese mobility and economic measure.

In addition to the impact of the election and COVID hospitalizations, we see the biggest risk to the market as some geopolitical event related to cybersecurity, military conflict, scandal or some other factor impacting trade and the world economy. US/China relations are at a decades-long low point with the President saying the Phase II of the China trade deal is no longer under consideration and the relationship between the two countries is "severely damaged," a factor that certainly points to a risk in equity prices. In addition to China and the election, another risk to the market is the huge amount of debt taken on by countries and companies globally to pay to fight the virus. Unfortunately, the debt will come due and be paid for in the form of new taxes and sadly, lower future growth. Much academic work has been written on the detrimental effects of high debt levels on economic growth. As noted in the Hoisington Report there is a nonlinear relationship between debt and economic growth, with greater debt/GDP resulting in lower GDP per capita as the debt increases. We will also continue to monitor credit, as an increase in bank reserves and non-performing loans could be a canary in the coal-mine to the broader economic recovery.

As always, Emerald's core is our tried and true 10-step fundamental research process employed by our seasoned investment team. The COVID crisis has made research related travel virtually impossible, but our team has stepped up our virtual meetings and communication efforts resulting in greater inter and intra-company communication. We believe this commitment to fundamental research is now more valuable than ever with companies' withdrawing guidance resulting in larger dispersion amongst sell-side estimates and greater stock volatility. Likewise, we believe Emerald's intense industry and company knowledge gives us an edge vs. the already depleted ranks of sell-side analysts and allows us to take advantage of market dislocations and inefficiencies.

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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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