Emerald Advisers, LLC
Small Cap Value

Q2 2020 | Economic & Portfolio Commentary

A quick recovery in the stock market despite uneven re-opening of the economy and a worrying spike in COVID-19 cases in many states.

What a remarkable turn-around since the market lows seen in the middle of March. Small caps are up 46% since those lows, and this quarter was the third best ever since the first quarter of 1991, with a performance of +25.4% (Russell 2000). It seems that investors are expecting a continuation of the massive government stimulus, the economy to rebound quickly, and for a vaccine to be available soon.

In 2Q20, with healthcare and technology companies doing well and relatively weak performance by utilities, banks, and real estate, once again the Russell 2000 Growth (R2G) beat the Russell 2000 Value (R2V) index. In addition, small caps have outperformed large caps this quarter, and we believe this should continue as small caps are still historically cheap and will benefit from an improving economy and credit markets.

Portfolio Review

For small caps in 2Q20, Consumer Discretionary and Energy sectors relatively outperformed. The Energy sector recovered nicely from last quarter's steep decline as OPEC significantly reduced output and global economies began to re-open. Also, bond proxies like Utilities and Financial Services, lagged the strong rally. "Low quality" factors such as low share price, low ROE, high leverage, and non-earners performed well, while low valuation, higher quality and profitability factors lagged in 2Q20. The Emerald Small Cap Value portfolio total return was significantly ahead of the Russell 2000 Value Index in the second quarter. Emerald's outperformance was mostly due to stock selection.

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Key Points:

- The Emerald Small Cap Value portfolio total return was significantly ahead of the Russell 2000 Value Index in the second quarter. Emerald's outperformance was mostly due to stock selection.
- At the portfolio holdings level, negative allocation effect in Consumer Discretionary and Energy detracted from performance. However, positive stock selection in Financial Services, Technology, Utilities, and Producer Durables contributed significant alpha to the portfolio.
- As always, we will continue to seek attractive investment opportunities for our clients by focusing on high-quality companies identified and evaluated by our fundamental research and active portfolio management.

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Within the Russell 2000 Value benchmark, Consumer Discretionary, and Energy sectors had very strong performance. Conversely, Utilities and Financial Services sectors had the weakest performance during the quarter.

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This has been another challenging quarter for banks, with broad underperformance for all size segments as they lagged their broad market peers across the board. Additionally, small cap banks underperformed both mid and large caps banks in 2Q20.

We remain cautious on the outlook for banks for the rest of 2020 given the uncertainty of credit quality due to the industry-wide practice of forbearance, as well as the "artificial" strength of the consumer resulting from government transfer payments that have supported the economy. For now, many businesses and households are awash in federal pandemic relief payments. Personal income surged 11% from March to April as a 90% spike in direct government transfers, mostly reflecting relief checks and expanded unemployment insurance, more than offset an 8% decline in employee compensation. Despite the support of a myriad of government programs we believe the U.S. banking industry could see earnings drop by more than 50% in 2020 as net interest margins contract and credit costs increase.

While asset quality is expected to remain strong through the second quarter, we expect elevated provisions for loan losses to reduce earnings. The economic forecast used to project estimated losses under the Current Expected Credit Loss (CECL) model has deteriorated from the first quarter, with unemployment reaching levels not seen since the Great Depression. We believe that community banks that did not adopt CECL did not build their reserves as much as large institutions in the first quarter of 2020, suggesting that they will need to increase provisions even more in the second quarter, thus weighing on returns. We believe that community banks will utilize fee revenue generated from the Paycheck Protection Program (PPP) to offset a portion of rising credit costs.

Given the uncertainty around the economy, government transfer payments, forbearance and credit quality in the second half of 2020, many bank management teams are no longer giving formal guidance for 3Q and 4Q of 2020. As a result, we believe sell side estimates will continue to be a moving target, and increasingly, our fundamental research driven investment process at Emerald combined with our proprietary earnings model can provide us with clarity as we navigate the bank sector for investments that we believe will allow us to outperform the financials sector as a whole.

We continue to invest in high quality companies that generate free cash flow, as well as in financial services enterprises that trade significantly below their terminal value. We believe that these companies should outperform their peers and the market, as the economy bounces back from the short but deep recession brought by the COVID-19 pandemic.

Market Outlook

In our previous newsletter, we outlined our thoughts on the process for re-opening the economy around the country. The plan contained three phases and was contingent on robust oversight by the authorities utilizing social distancing measures, mass testing, contact tracing, surveillance, and geographical closures when needed to limit spread from hot spots. As these tools become available, a slow and methodical re-opening of businesses and institutions will take place. Back in early May, the White House coronavirus task force in conjunction with the CDC introduced their guidelines for "Opening Up America Again". The parameters discussed in that plan were very similar to the ones we wrote about back in April. Unfortunately, many states decided to quickly move forward with opening their economies prior to meeting the specific gating criteria and preparedness responsibilities required to be satisfied before proceeding to phased opening. Now, the authorities in several states have lost control over the spread of the infection and reacceleration of cases in the U.S. is hitting the economy. According to Jefferies, high-level mobility trends show continued halt in recovery.(1) Overall median time spent at home remains flat since early June, sitting just above 12 hours, though still below the peak of 16 hours in mid-April, and percentage of the population leaving home also stagnant at ~68% (~56% at trough).

The U.S. economy rebounded strongly from the low activity levels measured in April, but there is still a long way to go. It is estimated that even if real GDP would increase by 20% (annualized rate) in 3Q20 over 2Q20, it will be no higher than where it was five years ago.(2) While substantial and quickly deployed monetary and fiscal programs have helped create a bridge to the resumption of activity, it will take several quarters to get back to GDP level seen in 4Q19. We were surprised by the significant rise in retail sales and consumers' robust demand for homes and autos. With business closures in April and May, we believe the enhanced unemployment benefits helped boost the savings rates, and should support continued consumer spending while the labor market shows sustainable improvement.

Despite the concern regarding rising cases across the country, there are some positive data points that make us optimistic regarding the economy in the next twelve months. May and June hiring were much stronger than most had expected and consistent with the robust re-opening rebound. The housing market remains healthy, buoyed by low inventory, fewer existing houses for sale and low mortgage rates. It is our belief that some of the job losses resulting from the decline in the restaurant and hospitality industries can be transitioned to homebuilding where demand continues to be strong. Real retail sales are surging and current level is above pre-COVID-19 levels. Consumer surveys, ISM data and industrial production are all showing an upward trend. Our optimism is also hinging on the prospect of having a therapeutic that will lower adverse reaction to the virus, or a vaccine being available, sometime by the end of this year or early next year.

We believe there will be a massive undertaking by our government and many corporations to on-shore production of many critical products and diversify supply chains away from China. As Barclays noted "The pandemic is likely to reinforce the move towards more protectionism, a diversification of global value chains (GVCs) away from China, and a re-shoring of the production of some goods—

possibly under the pressure of and/or support from governments."(3) COVID-19 revealed the downside risk of globalization, exposing vulnerabilities along supply chains. Without the timely arrival of an intermediate good via air, rail, road or water at its next production location anywhere in the world, the entire supply chain can grind to a halt. We think that inventories will rise as companies make the transition from "just in time" to "just in case". In addition, this trend will be a tailwind for the increase use of automation across many industries in order to become more resilient to similar shocks in the future.

Given the sharp recovery in share prices, we believe investors already priced-in a sharp rebound in revenues and profits. However, during 2Q20 analysts slashed numbers dramatically as corporations withdrew their forward looking guidance. With many uncertainties heading into the second half of the year (potential 2nd COVID-19 wave, elections, unemployment level, escalating tensions with China, etc.), we think for the most part management teams will acknowledge the improving fundamentals of their business, but will refrain from issuing any quantitative guidance. We believe the market will be range bound in the near-term, but will progressively grind higher as positive data is announced on the efforts of vaccine development.

As always, we will continue to seek attractive investment opportunities for our clients by focusing on high-quality companies identified and evaluated by our fundamental research and active portfolio management.

(1) *Jefferies, US Consumer Footfall Monitor: Should I Stay or Should I Go, 17 July, 2020*

(2) *Evercore ISI, Morning Economic Report, 10 July,2020*

(3) *Barclays, The post-COVID economy, 08 July,2020*

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