Emerald Advisers, LLC
Growth Opportunities

Q1 2022 | Economic & Portfolio Commentary

"The Barbell Pumps Us Up"

Quarterly Summary

Led by solid stock selection, Emerald Growth Opportunities portfolios outperformed the Russell 3000 Growth benchmark for the 1st quarter. Our "Flexible Barbell" portfolio construction approach of balancing between small/large, cyclical/secular, international/domestic and high growth/bond proxies (to name a few) performed well in the quarter, as our overweight to cyclicals and reopening plays in Energy, Industrials and Consumer Discretionary contributed to returns. In particular, our focus on names with pricing power and beneficiaries of supply shortages limited our downside in an otherwise dismal quarter, especially for growth portfolios.

Concerns over rising commodity prices and interest rates, runaway inflation, China's Covid-related lockdowns and Russia's invasion of Ukraine finally turned investors sour, causing many to shed equities as the quarter ended. Earnings were certainly not the culprit in 2021 with earnings posting impressive growth: small cap growth companies reported +42.9% earnings growth vs. +32.1% for large cap growth, despite 40 year high inflation and innumerable supply chain challenges. According to JP Morgan, S&P 500 operating margins of +13.4% in Q421 stayed close to multi-decade highs. Interestingly, despite the strong earnings growth, P/E multiples continued their multi-quarter trend of contraction. Revenue growth was strong during the quarter, albeit lower than prior quarters.

On the economic front, across the board employment gains were the star of the quarter, with the civilian unemployment rate dropping to 3.6% in March, nonfarm employment showing consistent growth of around 500,000 jobs per month throughout the quarter and continuing jobless claims at multi-year lows. Average hourly earnings were up, but showed material multi-month declines when adjusted for inflation. Speaking of inflation, the CPI increased +8.4% in March and the longer term inflation outlook surged. Retail sales moved higher, in part inflation driven, and

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Key Points:

- Our "Flexible Barbell" portfolio construction approach of balancing between small/large, cyclical/secular, international/domestic and high growth/bond proxies (to name a few) performed well in the quarter, as our overweight to cyclicals and reopening plays in Energy, Industrials and Consumer Discretionary contributed to returns.
- Portfolios benefited from high stock valuation dispersion and an improvement in earnings breadth, exemplified by the earnings contribution from the top 10 names in the S&P 500 declining meaningfully vs. prior quarters.
- While overall market risk has risen this year with inflation increasing, war in Ukraine escalating, Fed tightening, Covid resurfacing and supply chain challenges, we believe our tried and true "Flexible Barbell" strategy allows us to position the portfolio to find growth opportunities where many other portfolio managers feel compelled to pick a side.

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both housing starts and existing home sales remained strong despite a late quarter surge in mortgage interest rates. Consumer confidence, ISM Manufacturing and Non-Manufacturing all remained positive. From a liquidity perspective, money supply growth started to trail off, while real rates, even considering the recent uptick, still suggest neutral monetary policy at worst.

In terms of returns in our Russell 3000 Growth benchmark, the quarter was all about Energy and Energy-related names, as the Energy sector far outperformed other sectors with a +26.43% return for the quarter. The next best performer, Consumer Staples, returned -1.46% - negative, but much better than the overall benchmark return. There was little dispersion between the other sector returns ranging from Materials at -6.94% to Real Estate at -11.37%. Value materially outperformed growth, with the broad Russell 3000 Value index outperforming Growth -0.85% vs. -9.25%. Large caps similarly beat small on the growth side with the Russell 1000 Growth index outperforming the Russell 2000 Growth benchmark -9.04% to -12.63%. While Value still screens cheap vs. Growth on historical measures, the contraction of Growth's P/E ratio during the past few quarters moved that relationship closer to parity with long-term averages.

Portfolio Review

As noted above, Emerald Growth Opportunities portfolios bested the Russell 3000 Growth benchmark in the 1st quarter through solid stock selection and portfolio positioning, particularly through over weights in Energy and Consumer Discretionary names. Portfolios benefited from high stock valuation dispersion and an improvement in earnings breadth, exemplified by the earnings contribution from the top 10 names in the S&P 500 declining meaningfully vs. prior quarters. Besides being moderately smaller than the index, at a weighted average market cap of $751bn, portfolios continued to be growthier than the benchmark with estimated 3-5 year EPS growth of +22.03%[1] vs. +17.76%, yet trade at a materially lower valuation levels than the index with FY1 and FY2 PE estimates of 23.26 and 19.28 vs. 26.07 and 23.20 for the Russell 3000 Growth index. Portfolios also traded at a significant discount to the index on Price/Sales, Price/Cashflow and Price/Book valuation metrics. This higher growth and lower valuation set-up is in part due to our emphasis towards Energy and Consumer Discretionary names that are expected to experience strong earnings growth but trade at discounted valuations.

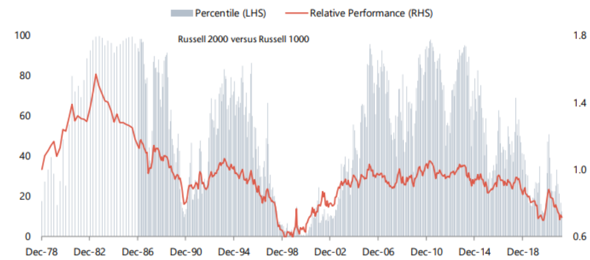
Market Outlook

Sometimes starting off the year with a strong relative quarter makes us nervous, as many of the first quarter winners will trail the losers in subsequent quarter(s) causing us to question whether to materially rejigger portfolio holdings at quarter end. But then some sense of sanity seeps in and we assess why we have certain holdings in the first place and normally that assessment starts with expected earnings growth. We are believers that earnings growth drives stock prices over the longer term, and our portfolios are expected to show earnings growth substantially above the benchmark (+22.03% vs. +17.76%). This earnings growth expectation actually increased vs. the benchmark during the quarter, while at the same time portfolios continued to trade a meaningful valuation discount – normally a good set up, assuming earnings come through.

We think earnings and economic growth will remain strong – at least for the foreseeable future – despite the myriad of challenges facing the economy and markets. We agree with MKM Partner's Strategist Michael Darda who posits that we are not in the throes of a classic growth scare. Many of the classic growth scare indicators such as credit spreads, industrial metals prices and sharp declines in bond yields and inflation expectations that normally accompany slowing growth have just not been apparent in the current market pullback. On the contrary, Darda posits that the problem is valuation compression: that the nearly 20x forward multiple on S&P 500 earnings is not compatible with risk-free rates pushing the 3% threshold. Darda notes the problem is nominal GDP is actually too strong and that the Fed must take action to guide nominal GDP back to more sustainable trend levels so that inflation can ease back to the Fed's target over time.

Going back specifically to earnings, Credit Suisse's Jonathan Golub notes that 2022 EPS estimates have actually risen 2% YTD, with Q1 estimates dropping 1.5% and back half estimates increasing. S&P 500 earnings are expected to grow 4.7% in Q1 2022 and 14.5% ex-financials. Cyclicals, a relatively small part of the index, are expected to grow earnings 47% for the quarter according to Steven DeSanctis from Jefferies. Along with cyclicals, which are expected to grow earnings an eye-popping +380% in 2022, small caps are expected to shine with earnings of +15.6% (22.8% for Growth) vs. just +10.1% for large caps. We have aligned our portfolios with these growth expectations, with portfolios overweight cyclicals such as Energy and energy-related industrials. We are also overweight small caps given that segment's higher expected earnings growth, as well as the recognition that according to DeSanctis, small caps relative valuations vs. large stand at just the 13th percentile of relative valuations – a precursor to better future performance for that asset class.

Relative valuation model is in 13th percentile, we tend to see better performance ahead



Source: FactSet; FTSE Russell; Jefferies

Beyond Cyclicals and small caps, portfolios include many reopening oriented stocks given our belief that 2022 will be a year of consumers transitioning from buying goods to buying experiences and services. In this vein, we are overweight vacation destinations and airlines, hotels, ticket sales, casinos and gaming. We had reduced our weighting in some of these names midway through the first quarter given the spike in oil prices and concerns about an oil price induced recession, but added back to these names late in the quarter and early in the second quarter given a vicious pullback in some of these securities. We have also added to names that we think have the pricing power to weather the current inflationary onslaught such as Healthcare and Staples. Other portfolio additions are companies within the defense and energy-oriented industries that can benefit from enhanced military spending and supply oriented shortages emanating from the war in Ukraine and the conflict's many unintended consequences. We are also looking to add to names with international exposure, as Europe and Asian economies should see a pick-up in future growth post-Covid and as the impact from high energy prices are mitigated over time. Lastly, portfolios benefited from M&A in the first quarter and we would expect substantial Private Equity driven M&A in 2022 with relatively low interest rates and record levels of cash on the sidelines.

We do have to devote some space to inflation with the CPI at near record levels and with the March PPI release of +11.2% y/y growth recording the highest gain ever for that indicator. In prior commentaries we have highlighted the risk to the economy and markets from the Fed's continued intransigence related to inflation – and their continued rosy (and erroneous) commentary regarding inflation's transitory nature. We expressed concerns about how baked-in inflation was becoming in every aspect of the economy. The war in Ukraine just served to reinforce our inflation concerns as energy, food and other goods and service prices spiked. The Fed is now in the unenviable position to walk the fine line battling inflation, while at the same time not pushing the economy into recession. Inflation may be peaking for some goods oriented categories such as used cars and household appliances, but inflation related to wages and shelter both lag and have likely not come near a peak, and thus will be problematic for months to come.

There has been much consternation regarding the inversion of the 2/10 Treasury yield curve. Fortunately, other yield curve measures remain positive and yield curve inversions have rarely been good indicators of market tops, with markets returning on average +15% after yield curve inversions according to Goldman Sachs. We believe our positioning in cyclicals, small caps, service-oriented names, price leaders and lower relative P/E Technology names should mitigate at least some of the risk of inflation in our portfolios. We have been underweight some of the highest value technology and software names given concerns expressed above about P/E multiple contraction and have been adding to our healthcare exposure given that sectors relative immunity form economic cycles.

One fact that has us excited is that small caps now represent less than 4% of the US equity market's capitalization and past history suggests that given small's poor performance vs. large over the past seven years as well as its decreasing market cap, reversion to the mean could take place and ignite a strong small cap relative rally. We took advantage of a similar phenomenon in 2020 when we successfully over weighted Energy when that sector shrank to less than 4% of the capitalization of the S&P 500. It has since nearly doubled in weight.

While overall market risk has risen this year with inflation increasing, war in Ukraine escalating, Fed tightening, Covid resurfacing and supply chain challenges, we believe our tried and true "Flexible Barbell" strategy allows us to position the portfolio to find growth opportunities where many other portfolio managers feel compelled to pick a side. While we will face many challenges this year including the volatility driven by mid-term elections, we are firm believers that the market will move with earning growth which we expect to be substantially positive throughout 2022.

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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.

To learn more about Emerald Advisers, please visit us at teamemerald.com.

[1] *The estimated 3-5 year earnings growth rate is calculated utilizing a pre-calculated mean long-term EPS growth rate estimate for portfolio holdings, as available, provided by FactSet and sourced from brokerage estimate submissions to estimate services (FactSet, IBES, First Call, etc.). The estimated 3-5 year earnings growth rate for the portfolio is then calculated utilizing the weighted average of the individual portfolio holding estimated 3-5 year earnings growth rates. The data is reported is as of the report date.*

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