Emerald Advisers, LLC
Diversified Small Cap Growth

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The FED and Inflation Pressure Results in First Quarter

Market Update

Omicron, inflation, stagflation, recession and war. The market had a lot to digest over the course of the first quarter. Inflation expectations had already been rising when the Russian invasion of Ukraine added rocket fuel to this already smoldering fire, as new supply constraint concerns exerted further upward pressure on commodity prices. Commodity price gains were historic in proportion with oil (WTI) gaining +33% (the best for quarter since 1999) and the Bloomberg Commodity index gaining +28% during the first quarter alone.

This significant upward pressure across the commodities markets and the increasingly hawkish Federal Reserve commentary led to a dramatic repricing of the pace of forward Federal Funds rate increases and the ultimate terminal rate. Treasury yields surged, with the 10-year yield gaining +83 bps, while long term treasuries (-10.17%), and Investment Grade Corporate Bonds (-7.74%) declined, resulting in the worst performance for the bond market in recent history. The 2/10 yield curve flattened, with the slope moving from +79 bps to start the year, to -8bps exiting the first quarter. The narrowing 2/10 spread and the brush with inversion stoked recession/stagflation fears.

Stocks managed to outperform bonds, but that was little solace, given the broad equity market weakness, with the S&P 500 (-4.60%), NASDAQ Composite Index (-8.94%), Russell 1000 (-5.13%) and the Russell 2000 (-7.53%) all posting declines. For the Russell 2000, the magnitude of the retrenchment to start the year was particularly notable as it marked the sixth worst start to a year for the Russell since 1979, according to an April 1, 2021 report from Steve DeSanctis of Jefferies.

From a style perspective, value stocks continued their streak of relative outperformance with the Russell 2000 Value returning (-2.40%) for the quarter and outpacing the Russell 2000 Growth index which declined (-12.63%) for the same period. At the sector level within the Russell 2000 Growth, only the energy sector achieved a positive return during the quarter, surging a very strong (+26.36%), as concerns over structural supply constraints drove the oil higher. Directly counterbalancing the strength in energy, was weakness in the consumer discretionary sector which declined (-17.32%), as surging commodity prices heightened already lingering concerns regarding the durability of

Key Points:

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- The Emerald Diversified Small Cap Growth portfolio outperformed the benchmark for the quarter driven by stock selection within the consumer discretionary, healthcare, industrials, real estate, technology and consumer staples sectors. Partially offsetting the aforementioned was relative underperformance within the financial services sector.
- Entering the second quarter of 2022, the portfolio held the largest active exposures in the financial services and consumer discretionary sectors.
- Emerald remains vigilant and focused on utilizing our fundamental bottom up research process to identify the most attractive growth opportunities within the small capitalization universe.

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consumer spending. The pressure on the technology (-15.16%) and healthcare (-15.18%) sectors also weighed on the Russell 2000 Growth's relative performance. While all aspects of the growth benchmark have been challenged, the pressure on healthcare has been particularly noteworthy, with the healthcare sector of the Russell 2000 Growth now down (-32.32%) for the trailing one year period.

At the constituent level within the Russell 2000 Growth, we believe there were a few noteworthy observations. First, we have been discussing over the better part of the last 12 months the relative underperformance of the fastest growing companies and the non-revenue/non-earnings companies within the Russell 2000 Growth benchmark. Although the best relative performance continues to be in the slowest growing quintiles, we thought it was noteworthy that the magnitude of relative underperformance of the top quintile of growers narrowed substantially during the quarter. According to an April 1, 2022 report from Steve DeSanctis of Jefferies, the top quintile of companies measured by sales growth returned (-12.77%) for the first quarter, reflecting relative underperformance of (-15 bps), which compares favorably to relative underperformance for the same cohort during the fourth quarter of (-669 bps) and the full year of 2021 (-1197 bps). As for the non-revenue generating companies, while the relative underperformance gap improved during the first quarter to (-1398 bps) from (-2028 bps) and (-4632 bps), respectively for the fourth quarter and full year 2021, the gap of relative underperformance remains exceedingly wide. It was also noteworthy, that despite all of the discussion regarding the rotation to quality, the highest ROE quintile (-12.66%) performed only in-line with the index. Whereas the best relative performance was derived from quintile 2 (-10.28%) and quintile 3 (-7.08%), which still lost ground on the quarter but outperformed on a relative basis by 235 bps and 557 bps respectively.

Portfolio Review

The Emerald Diversified Small Cap Growth portfolio outperformed the benchmark for the quarter driven by stock selection within the consumer discretionary, healthcare, industrials, real estate, technology and consumer staples sectors. Partially offsetting the aforementioned was relative underperformance within the financial services sector.

The consumer discretionary sector was the largest positive contributor to return for the quarter driven largely by stock selection and specifically the portfolio's tilt toward the service-oriented industries within the sector.

The healthcare sector also contributed positively to performance for the quarter. A combination of the portfolio's relative underweight position and stock selection within the biotechnology and healthcare services industries were key sources of upside, and more than offset challenging relative performance within the medical services and pharmaceuticals industries.

Stock selection was also a key driver of relative outperformance within the industrials sector. At the industry level, holdings within the transaction processing, industrial machinery and defense industries were the most noteworthy contributors to return.

Also contributing positively to performance was stock selection driven relative outperformance within the real estate, technology and consumer staples sectors.

We should also note that while Emerald's relative performance within the energy sector was generally neutral to the benchmark, the magnitude of relative outperformance of the Russell 2000 Growth energy sector, as highlighted above, resulted in several of the portfolio's energy holdings falling in the top contributors to portfolio return.

The aforementioned positives were partially offset by relative underperformance within the financial services sector, and more specifically holdings in the banking, investment services and full-line insurance industries.

Entering the second quarter of 2022, the portfolio held the largest active exposures in the financial services and consumer discretionary sectors. Thoughts on those sectors and other notable areas of exposure are highlighted below.

- The financial services sector, comprised of holdings within the bank, full line insurance, investment services, and property and casualty insurance industries, remained the portfolio's largest relative overweight position at quarter-end. Although we remain constructive on the opportunity for loan growth and increased new loan yields, Emerald has been selectively reducing exposure to the banking industry, given continued volatility in rates.

- Emerald also held an overweight position within the consumer discretionary sector at quarter-end. The overweight is comprised of a diverse subset of holdings within the specialty retail, recreational services, recreational products, restaurants, casinos and gambling, and auto parts industries among others. While the market has become increasingly concerned with the outlook for consumer spending given the step up in inflationary pressures, we continue to believe the consumer in aggregate remains healthy, and continue to see select opportunities for those companies offering differentiated products and services the ability to gain market share.

- As it relates to the technology sector, the portfolio exited the quarter with technology sector positioning largely in-line with the benchmark. Within the technology sector, while the semiconductor and software industries continue to represent the portfolio's largest industry exposures, Emerald has selectively been reducing exposure to the more cyclical aspects of the semiconductor industry. As we look into 2022, we continue to believe that the digital transformation of the enterprise that began in earnest during the global pandemic will remain a key driver of investment in ecommerce, digital forms of entertainment, the enterprise technology infrastructure, cybersecurity and cloud-related software opportunities. We also see select opportunities within the semiconductor and semiconductor capital equipment industries in those companies exposed to the growth in semiconductor capacity, new form factors and designs as well 5G, the server upgrade cycle, the automotive recovery, the transition to electric vehicles, growing penetration of advanced driver assistance systems, and data centers.

- The healthcare sector, while underweight relative to the benchmark, also remains an area of considerable nominal exposure within the portfolio. The portfolio's underweight to the healthcare sector is driven largely by the portfolio's relative underweight position to the biotechnology, healthcare services and facilities industries. With respect to the biotechnology industry, while the worst of the valuation compression is likely behind the industry, Emerald continues to believe that many of the headwinds that weighed on performance throughout 2021, are poised to continue to gate relative performance. Specifically we believe the FDA's less accommodative stance to trial design and drug approvals is likely to remain a headwind, as will the significant number of capital raises which we expect to be forthcoming given the depletion in cash balances. Emerald has maintained its underweight position to the biotechnology industry. That being said, we continue to identify selective opportunities within the pharmaceutical and medical equipment industries and have been building exposure to those areas of the healthcare sector.

Market Outlook

Boom to Bust? After a blockbuster 2021 from an economic perspective, unrelenting inflationary pressures, fears of demand destruction and the Federal Reserve's newly minted no holds barred approach to tackle inflation have recession fears percolating. Treasury yields have surged, led by the short-end, as the market has aggressively repriced the Federal Reserve's policy shift. Yield curve inversion remains a key area of focus. Which yield curve to watch, however, remains a source of debate. While the majority of market participants appear to be keying in on the slope of the 2-year/10-year spread, which has been hovering close to inversion, the Federal Reserve remains steadfast on its focus on the shorter duration 3m yield/3m yield 18 months forward spread. This curve, which compares the 3-month T-Bill today to the 3-month T-Bill 18 months forward, in contrast has been aggressively steepening. Other notable economists/strategists have also cast doubt on the prognostication power of the 2/10 spread given the noteworthy technical headwinds (compression of the term premium, Federal Reserve asset buying and long bond yields outside of the U.S.). So rather than utilizing the 2/10 spread, Ed Hyman of Evercore ISI is focused on the 3mo/10 year whereas Ed Yardeni of Yardeni Research is more heavily focused on the spread between the 10-year yield and the federal funds rate. In both cases, the spreads have been widening not compressing, with each currently reflecting a low probability of recession within the next 12 months.

While there is likely to remain great debate, as to which yield curve is sending the correct message, there is no doubt that the recession probabilities among strategists and market participants have been rising. Deutsche Bank, in early April, was the first major bank to predict a U.S. recession in 2023, and while this is not consensus, sentiment is clearly moving in that direction. An April 4, 2022 Bloomberg survey, for example, revealed that nearly half of its 525 respondents expected a US recession to start next year.

Although fears of 2023 recession have been rising, there is little fundamental evidence to date to support that narrative. High yield spreads are not indicating stress in the credit markets. The US ISM manufacturing and services PMI measures remain firmly in expansionary territory. The February reading of the Conference Board's Leading Economic Index increased sequentially in February, the unemployment rate reached 3.6% in March, the participation rate is ticking up and consumer spending has been demonstrating resiliency both in the face of elevated inflationary pressures in food and energy, and against a strong stimulus induced spending spree of 2021. Further, while inflation induced demand destruction remains top of mind, we thought it was noteworthy that long-term inflation expectations, as measured by the 5yr/5yr forward inflation expectation rate, have flattened out in recent weeks and remain well within the trailing one-year range.

While this admittedly is a different backdrop than what we anticipated entering 2022, we continue to remain cautiously optimistic about the outlook for small capitalization stocks. Interestingly, small capitalization stocks have demonstrated outperformance to large capitalization stocks during both inflationary and stagflationary economic backdrops utilizing the historical analogs of the late-1960's, and over the longer term looking at periods of slowing growth and rising inflation since 1972 according to an April 6, 2022 report from Jill Carey Hall, an Equity and Quant Strategist for BofA Securities.

Earnings growth for small capitalization stocks has been resilient to date, and we believe will continue to demonstrate relative strength. 2022 small capitalization earnings growth is currently forecasted at approximately (+15.6%), and while this is slight downtick from the (+16.2%) expected at the end of the fourth quarter, small caps are still expected to substantially outpace the growth projected for mid-cap (+11.8%) and large capitalization (+10.1%) stocks, according to a April 6, 2022 report from Steve DeSanctis of Jefferies. Although we acknowledge that the mounting inflationary pressures and decelerating economic growth could lead to negative revisions in the near-term, we continue to expect small capitalization earnings to remain less impacted than their larger capitalization peers. We believe this is especially true in light of recent geopolitical events, the impact of rising COVID rates in China and their implications to global growth. According to a recent report from Jill Carey Hall of BofA Securities, only 20% of sales within the Russell 2000 are derived from overseas, which compares favorably to the approximate 28% exposure for the S&P 500. In addition, according to the same report small capitalization stocks are more exposed to services over goods spending, and in that way is more closely aligned to the US economy, which we expect will demonstrate relative resiliency.

Lastly and not insignificantly, small capitalization stocks already appear to be embedding a lot of market concern. The Russell 2000 has corrected (-14.84%) from its November peak, while the Russell 2000 Growth index has fallen (-22.90%) from the index peak in February of 2021. Small capitalization stocks have also meaningfully lagged their large capitalization peers with the Russell 2000 (-5.79%) trailing the Russell 1000 (+13.27%) by more than 1900 basis points over the trailing twelve months. With forward earnings expectations for small caps generally holding firm, the relative valuation for the Russell 2000 has continued to compress and now stands in the 13th percentile of historical valuation relative to the Russell 1000. Further, the Russell 2000 now trades at a discount on six out of six valuation metrics, including trailing P/E, forward P/E, price/book, price to cash flow, price/sales, and P/E to growth, according to an April 6, 2022 report from Steve DeSanctis of Jefferies.

While the risks to this outlook are numerous, the pace and path of monetary policy is likely the most meaningful risk to market returns in the near-term. We believe the volatility that we are seeing to start the year likely persists in the near-term as the market navigates the path of monetary policy adjustments and assesses incoming data on inflation and economic growth. Over and above the aforementioned, we believe the Russian aggression in Ukraine will mark a sea change in the geopolitical risk landscape. There appears to be no near-term resolution to the Russia/Ukraine conflict, U.S. /China tensions look to be rising and it now feels that the more benign geopolitical landscape that we have become accustomed to is behind us.

All that being said, Emerald remains vigilant and focused on utilizing our fundamental bottom up research process to identify the most attractive growth opportunities within the small capitalization universe.

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