Emerald Advisers, LLC
Mid Cap Growth

Q2 2022 | Economic & Portfolio Commentary

"The Great Multiple Contraction – Fed Turns from Friend to Enemy"

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Quarterly Summary

Emerald Mid Cap Growth portfolios modestly outperformed our Russell Mid Cap Growth index for the quarter, building on our year-to-date outperformance. Consumer Discretionary, Energy and Healthcare names outperformed, offsetting the underperformance in the Consumer Staples, Materials, Financials and Technology sectors. Equities had their worst start to the year since 1970, as inflation worries and late quarter economic growth concerns depressed multiples at a breakneck pace, with the S&P 500 forward P/E dropping to a below average 16x. Small and Midcap growth stocks continued to underperform large and value equities, as investors continued their risk off positioning in the face of an ever more strident Fed and weakness showing up in various segments of economic growth.

Investors' main focus for the quarter was inflation, with PCE inflation showing a full 1% month over month increase in May equating to an 8.6% increase from the prior year – the highest readings since 1981. Economic news became more consequential as the quarter progressed, as positively, the Civilian Unemployment rate stayed steady at just 3.6%, as did Initial Unemployment Claims which ticked up modestly to 235,000. Average hourly earnings continued to march higher (although below inflation) and ISM Manufacturing, Non-Manufacturing, Architectural Billings and Dodge Momentum indices all showing continued, albeit weakening, strength. On the negative side, retail sales, real GDP, industrial production and the Leading Economic Index (LEI) all showed weakness. Consumer confidence measures were particularly weak registering their worst readings in over 40 years. The U.S. Dollar continued to strengthen, a harbinger of future corporate earnings weakness, and the money supply abruptly slowed as the Federal Reserve drained liquidity from the

Key Points:

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- Emerald portfolios were overweight the Energy and Industrials sectors, and underweight the Consumer Staples, Financials, Healthcare and Technology sectors.

- We have positioned the portfolio through the use of our ten step research process in industries and stocks that we believe will be able to grow, or at least protect earnings in most market environments. We believe our portfolio positioning with exposure to cyclicals, domestically exposed names and inflation protected segments will benefit our portfolios as the market bottoms.

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system. Worker productivity slumped late in the quarter.

As noted above, large cap stocks outperformed both small and mid, and value continued to outpace growth equity performance. Energy, Consumer Staples and Utilities were the best performing index sectors for the quarter, with the Technology and Consumer Discretionary sectors significantly underperforming. High Yield spreads widened during the quarter and now stand at 6%, which is above the long-term average, despite a lack of credit issues. Profit margins receded a bit, but forward earnings estimates for 2022 actually increased during the quarter despite the aforementioned economic challenges. High ROE midcaps outperformed as did low P/E and higher dividend paying stocks. High growth midcaps were by far the worst performing cohort. Valuation dispersion remained at historically high levels.

Portfolio Review

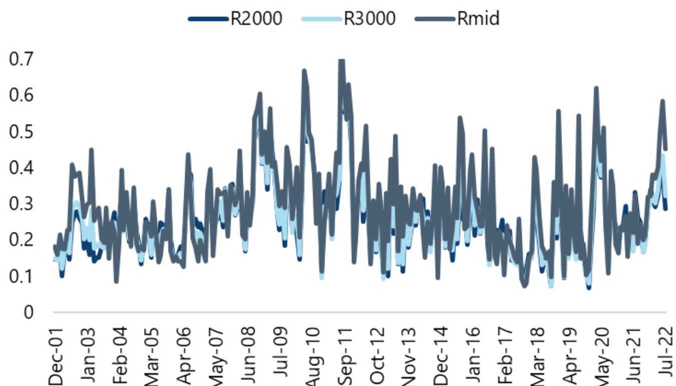
As noted above, Emerald Mid Cap Growth portfolios outperformed moderately for the quarter and added to our year-to-date outperformance. Security selection in the Healthcare and Consumer Discretionary sectors contributed to outperformance, as did our continued overweighting of the Energy sector. Conversely, security selection was challenged in Materials, Consumer Staples, Financials, Industrials and Technology. Emerald portfolios were smaller than the benchmark with a weighted average market cap of $18.7Bn vs. $21.5Bn for the Russell Midcap Growth and have a higher projected growth rate than the benchmark with an estimated 3-5 year EPS growth rate[1] of 23.32% for the portfolio vs. 19.23% for the Russell Midcap Growth Index. Portfolios were also more cyclically biased which penalized performance given investors' economic growth concerns. Despite showing substantially greater estimated growth than the benchmark, portfolios traded generally in-line with the index on most valuation metrics.

Emerald portfolios were overweight the Energy and Industrials sectors, and underweight the Consumer Staples, Financials, Healthcare and Technology sectors. We materially added to our Healthcare exposure as part of June's Russell reconstitution. We raised cash towards the end of the quarter on hopes of deploying cash at lower levels given Fed tightening and accompanying market volatility.

Market Outlook

A looming recession, runaway inflation, an energy and currency crisis in Europe, a war causing massive supply chain issues, continued China lockdowns, cratering consumer sentiment, profit concerns, a historically strong US dollar and a recently intransigent Fed...Geez, it's a wonder we can even get out of bed in the morning! These are just some of the issues the market is having to deal with on a daily basis; issues that we, as active managers, have to factor into our portfolio construction process. We believe we have formulated the right balance of offense and defense to keep up with and potentially exceed benchmark performance during this extremely volatile and uncertain time. As an active manager closely covering our companies, we oftentimes experience frustrations navigating highly correlated, macro driven markets and have to wait until macro influences subside to exploit the mismatch between earnings estimates and actual results. Following is a Jefferies chart on monthly pairwise stock correlations showing stock correlations peaking in the

quarter to levels last seen during the early pandemic phase – a very tough time for active managers to distinguish themselves – Fortunately Emerald has bucked this trend.

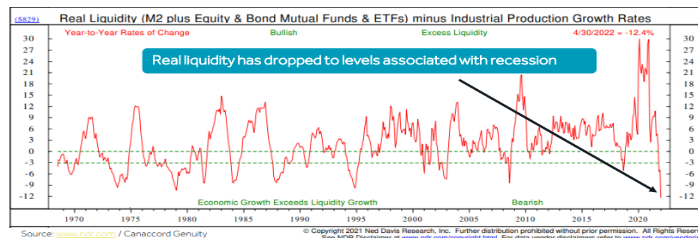


Source: Jefferies

It's not a good use of our time to dwell on our thoughts regarding each of the variables impacting the economy and markets as we could write pages and pages and would probably come to the same erroneous conclusions as most market pundits and strategists who, like us, really can't predict the levels of interest rates, US dollar, GDP etc. However, one variable we did predict well was inflation, as we were very clear in past commentaries and in our portfolio positioning that inflation would NOT be transitory and would be much deeper and protracted than the Fed or most financial pundits predicted. Following is a short passage from our Q1 2022 commentary:

"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."

On a positive note, the five year expected inflation rate has dropped significantly over the past few months from 3.5% to around 2.5%. The Fed may be able to rely on this to some extent to temper their fervor towards rate increases. We also were very clear that supply chain issues would take several quarters to be remedied and that taking away the liquidity punchbowl would have a very detrimental impact on the markets and the economy. See the following chart from Canaccord's Tony Dwyer showing the unprecedented amount of monetary tightening that has occurred in just the past few months.



We noted that we had positioned the portfolio modestly cyclically, with overweights to Energy and Industrials and with a slightly smaller market cap bias than the index. The big divergence between portfolios and the benchmark is in the expected 3-5 year EPS growth, with portfolios estimated to have over 400 basis points more growth than the index. We think our growth and smaller cap bias will help us in the future, as smaller stocks in the midcap index have underperformed the last 18 months and are truly due for a bounce on sentiment and valuation. As noted, we added to our Healthcare exposure late last quarter and more recently, given increases within the index and recession fears and as an offset to some of our cyclical,

growth and smaller cap bias. We also increased our Software exposure by adding to a few of the largest most stable growers in the index.

While we have modestly reduced the portfolio cyclicality in the last month or two, we still believe that selected industries and equities, by virtue of idiosyncratic supply and demand influences, will be able to dramatically increase earnings in 2022 and 2023, even in the face of a mild/moderate recession. This is exemplified by Energy given the massive underinvestment to the sector over the past decade and the relatively inelastic nature of demand. It is currently our view that for the most part energy company earnings estimates still have to be revised upwards from current levels.

As an active midcap growth manager we believe earnings drive stock prices. This is our mantra – something we stress again and again. We have positioned the portfolio through the use of our ten step research process in industries and stocks that we believe will be able to grow, or at least protect earnings in most market environments. We believe our portfolio positioning with exposure to cyclicals, domestically exposed names and inflation protected segments will benefit our portfolios as the market bottoms. We take some solace that during a run of the mill recession, equity markets normally drop 30% from peak, a level we are getting close to at this point in time. Additionally, if inflation does cool and growth does not slow as materially as markets are predicting, we could be getting close to a tradable market bottom. As always, we are confident that Emerald's time-tested fundamental research process will help navigate whatever curveballs the market throws at us and put us in position to outperform over time.

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[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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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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