EASTERN SHORE
CAPITAL MANAGEMENT
A Division of Moody Aldrich Partners

Smid Cap Equity

Fourth Quarter 2018

COMMENTARY

Eastern Shore exploits a market phenomenon known as the ***Quality Anomaly*** which refers to the consistent mispricing of quality companies that leads to their outperformance over time. The strategy focuses on higher quality stocks which tend to have lower volatility and lower risk of capital loss. The strategy also invests in companies experiencing positive change in quality drivers and prefers those with long runways for future growth. Valuation discipline is used to enhance returns.

Swim at your own risk

We hope everybody had a safe and happy holiday season. This commentary will focus on the businesses we own and some of the themes we are following, but first some context on the current market environment is warranted.

The last month of 2018 was the worst December return since 1931, when the country was in the midst of the Great Depression. In December 2018 we witnessed a breakdown in market structure that gave rise to unabated selling and was entirely disconnected from individual companies' quality fundamentals or valuation.

We felt that the title was an appropriate one as the lifeguards (i.e. the Fed) have left the beach. The so-called Fed Put that has been in place since the global financial crisis of 2008-09 was perceived by many as removed as the Powell Fed has begun the process of true normalization. Accordingly, financial markets are having trouble adjusting to the new reality that the Fed will not intervene every time volatility strikes the equity markets. A caveat is that the Fed would likely react if there are other substantive economic issues outside of market volatility. This co-dependence of markets and the Fed is leading to a painful process of normalization. Early this year Chairman Powell stated that Fed policy can be more flexible and data dependent which appears to have helped calm the markets in these early weeks.

When we look at some of the causes of the fourth quarter 2018 spike in volatility, we see four main reasons:

1. Fed policy: Markets like certainty and transparency with regard to Fed policy. A key market driver in 2019 will likely be the Fed's rigidity regarding rate hikes and its unwinding of QE. The Fed is in a difficult position. It wants to be responsible in restoring some sense of normalcy regarding interest rates and unwinding its massive balance sheet, and it needs ammunition in case the economy eventually needs help. The question remains whether the Fed will go too far too fast. Another issue regarding the Fed is how they are communicating with investors. The spike in volatility started in earnest on October 3rd when Chairman Powell said in an interview that the federal funds rate was a long way off from neutral. He also indicated that they could go beyond neutral: "We may go past neutral. But we're a long way from neutral at this point, probably". He also stated that the wind-down of QE was on autopilot, suggesting that halting the balance sheet run-off of $50B monthly was not an option. Markets interpreted these comments as being more hawkish than anticipated with a potential outcome being a recession in 2019 caused by Fed policy error.

2. China: China is the world's second largest economy. Months of weak data out of China has contributed to slower global growth. The current trade war with the U.S. and its unpredictable duration is weighing on the markets. Clarity on a positive way forward on trade would clearly benefit the markets. China has recently announced some more stimulative policies such as decreasing the reserve requirements for banks to encourage more lending. A slowdown in China is likely to have a greater effect on U.S. multinational companies than domestic small cap companies. It will also likely dampen global inflation giving the Fed more leeway to be flexible with monetary policy.

3. Political uncertainty: We have a new House of Representatives controlled by the Democrats and a Republican Senate and President, so gridlock seems to be the most likely outcome. In the past, this was not necessarily a bad thing but there are so many uncertainties, including investigations/potential impeachment, the President's uncertain trade and tariff policies, and a government shutdown. Again, markets like certainty - and we have anything but that today. The range of outcomes regarding foreign and economic policy is now very broad and the market has been signaling its discomfort.

4. The Economy: It is clear that the U.S. economy is slowing. This is not surprising; our expectation was for very robust growth in 2018 (in both GDP and earnings) as a result of the stimulative tax cuts and deregulation put in place by the Trump Administration, and a return to trend growth post-crisis of 1.5-2.5% GDP. Starting in October and then in December the market became very concerned about economic growth and began pricing in a recession in many sectors and industries, despite a lack of any significant evidence that one was imminent.

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Performance Summary *(as of 12/31/2018)*					
	Q4 2018 (%)	1 Year (%)	3 Year* (%)	5 Year* (%)	Since Inception (12/31/2012)* (%)
ESCM Smid Cap Equity (Gross)	-20.8	-10.5	7.2	5.3	10.8
ESCM Smid Cap Equity (Net)	-21.0	-11.2	6.3	4.5	10.0
Russell 2500	-18.5	-10.0	7.3	5.2	9.9

**Performance periods greater than one year are annualized.*

Fourth Quarter 2018 Results

During the fourth quarter of 2018 the Eastern Shore Smid Cap Equity strategy delivered a return of -20.8% (-21.0% net), underperforming the Russell 2500's return of -18.5%. For the year 2018 the strategy returned -10.5% gross of fees (-11.2% net), trailing the Russell 2500's return of -10.0%. Volatility picked up markedly starting in early October, spurred by Fed Chairman Powell's hawkish comments and continued trade rhetoric from the President. The market seems to be pricing in a recession despite scant evidence that we are approaching one. Quality stocks held up well in the third and early fourth quarter, but results were less strong in the deeply negative month of December as high quality businesses in industries deemed more cyclical declined with the rest of the market. Several of our holdings posted very solid third quarter results and have positive 2019 outlooks yet fell 15-20%. Macro influences and sentiment overwhelmed fundamentals and valuation during the final few weeks of 2018.

2018 was a tale of two environments. The first half of the year saw strong returns with low quality, growth and price momentum the dominant factors driving returns. In late August – right around the top of the small cap market – we saw quality companies and those with stronger balance sheets start to outperform. This is the type of environment in which we generally perform well.

The strongest sector contributors to the Smid Cap Equity strategy's relative performance during the quarter were the Materials and Producer Durables sectors. In each area top performers came from a range of industries and did not appear to be thematically linked. Outperforming holdings in Materials included semiconductor production materials firm Cabot Microelectronics (CCMP) and aerospace composite producer Hexcel (HXL). Having no exposure to the underperforming metals and minerals areas also proved advantageous in this sector. Strong performers in Producer Durables included online auction and vehicle remarketing service provider Copart (CPRT) and pest control firm Rollins, Inc. (ROL).

Sector detractors for the quarter include Financial Services and Health Care. Among Financial Services holdings, a few of our bank holdings including SVB Financial Group (SIVB) and Western Alliance Bancorp (WAL) lagged the market for stock-specific reasons. Within Health Care, underperformance by some of the strategy's pharmaceutical and biotech names such as Neurocrine Biosciences (NBIX) and Ligand Pharmaceuticals (LGND) weighed on results for the quarter.

Q4 Top 5 Contributors†		
Security	Avg. Weight (%)	Contribution (%)
Inter Parfums Inc (IPAR)	1.35	0.08
Lamb Weston Holdings Inc	1.51	0.08
Twilio Inc Class A (TWLO)	0.73	0.05
Pool Corporation (POOL)	0.52	0.02
Cash	2.59	0.02

Q4 Top 5 Detractors†		
Security	Avg. Weight (%)	Contribution (%)
Bio-Techne Corporation (TECH)	3.29	-1.02
SVB Financial Group (SIVB)	2.03	-0.93
Neurocrine Biosciences Inc (NBIX)	1.55	-0.74
Oasis Petroleum Inc (OAS)	0.84	-0.72
Broadridge Financial Solutions Inc (BR)	2.11	-0.59

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Outlook

Based on the U.S. and global economic data we track we don't expect the U.S. economy to go into a recession in 2019. The global economy is slowing and the U.S. is slowing back to a trend in GDP growth that will look more like the 2012-2017 period of 1.5-2.5% GDP growth. The December ISM manufacturing and nonmanufacturing numbers were down from November but still indicated expansion. Labor statistics are very solid, and inflation is relatively benign given the strong economy and labor situation.

Earnings growth is slowing as well, which is only natural given the 20+% growth we saw in 2018. Current consensus earnings growth in early January for small, mid & large cap stocks are presented on the following table:

Projected Earnings Growth Jan 2019

	2018	2019	2020
Large – S&P 500	22.7%	7.2%	11.1%
Mid – S&P 400	21.6%	9.4%	11.2%
Small – S&P 400	22.6%	14.6%	15.5%

Analysts tend to be optimistic going into the new year, so we interpret these estimates with a grain of salt. Even so, if we discount the earnings growth figures above by 20-30% we still see small cap companies growing earnings in the high single digits. Given that valuations have contracted significantly since the summer we still see a path to positive returns in 2019 for small cap stocks.

Below are some potentially positive performance drivers for the market in 2019:

The U.S. Consumer: The consumer, which comprises close to 70% of the U.S. economy, is in good shape. The December jobs report was stellar: wage growth was up 0.4% for the month and up 3.2% year-over-year. The participation rate increased, causing the unemployment rate to rise thanks to the inflow of additional workers into the workforce. That is very encouraging as having more people come back into the workforce will ease the country's labor shortage and likely temper wage inflation. This is important as it will help contain inflation overall, perhaps prompting the Fed to be less aggressive with rate increases. We will see tax refunds coming to consumers in the first half of the year and gas prices have declined significantly from last year. Consumer confidence, while down from recent highs, is still very positive. Interest rates have also come down since the fall, leading to lower mortgage rates which could help the stalled housing market. This is a powerful combination that should lead to a decent consumer spending environment in 2019.

The Fed: Given recent comments by Chairman Powell and several Fed Governors regarding flexibility with both rate increases and unwinding QE, we feel it is much less likely that a Fed policy error will cause a recession. Interest rates may stay accommodative for longer. As the global economy slows we see inflation fairly contained as well, giving the Fed more opportunity to be patient regarding interest rates.

Tax cuts and deregulation: Tax cuts and deregulation are structural, not a one-time boost to earnings. As it stands today, the benefits from these will accrue every quarter and year until there are changes through legislative action. Many investors dismiss these as a one-time benefit with no additional value.

While there are many reasons to be positive on the economy and stocks in the new year, there are several risks that we are tracking that could change our thesis materially:

1. **Trade:** A prolonged trade war with China and other countries could negatively affect the U.S. economy as well as consumer and business confidence. This could lead both businesses and consumers to become more cautious and stop spending. This breakdown in confidence could push the U.S. into a recession.

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1. **Fed policy error:** The Fed is often the main factor in recessions as it implements restrictive monetary policy to slow the economy and kill inflation. While inflation has picked up, it is not currently problematic by any measure. We believe that the Fed has been responsible in raising rates to begin the process of normalization. The question remains as to whether rates are at the right level to contain inflation and asset bubbles without harming the economy. Given the message that Powell and other Fed Governors communicated in early January, the risk of a Fed policy error seems greatly diminished from December.

2. **Politics:** Political risk remains significant both domestically and globally. In the U.S. investors are always a Presidential tweet away from temporary chaos. The U.S. now has a divided government, complicating the task of making constructive changes over the next couple of years. On the global front there are many issues that could cause disruptions. Such uncertainty often makes markets uneasy and therefore prone to volatility.

3. **The Global Economy:** It is clear to us that the global economy is slowing. Some of this is being caused by global uncertainty regarding trade and tariffs, Brexit, and other country specific factors. We don't see a global recession forming, just slower growth than we have seen in the past few years. Obviously as we mentioned previously China is a major factor: the Chinese economy is slowing and commodity-related companies such as steel, coal, copper and crude oil would be areas of caution. Trade issues with the U.S. are also weighing on the Chinese economy and sentiment. We anticipate that weakness in China will exert greater influence on larger multinational companies than domestic small-mid caps.

Positioning

During the quarter we made some minor adjustments to the portfolio in light of the changed opportunity set. We decreased our overall Health Care weighting, mainly in pharmaceuticals and biotech. We exited some positions after they performed well and reached our fair value range. We sold a few others that have been more volatile in this environment and will monitor them for a better entry point. None of our sector weightings changed by more than 1.5% during the quarter, but we did make some adjustments beneath the surface. Specifically, we took the opportunity to add to and purchase several established quality names that had been indiscriminately sold in December, turning short term market dis-location to our advantage.

While we expect a moderately positive economy in 2019, the uncertainties mentioned above have elevated volatility and we don't expect it to diminish any time soon. As always we are looking to own as many attractively valued high quality businesses as possible. Please do not hesitate to reach out if you have any questions. Thank you for your support of Eastern Shore.

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The Eastern Shore Capital Management Smid Cap Equity Composite contains all fully discretionary equity accounts managed in the Smid Cap Equity style which seeks capital appreciation through stock selection by investing in 60-90 stocks with market capitalizations approximating those of the Russell 2500 index at purchase. For comparison purposes, the Eastern Shore Capital Management Smid Cap Equity composite performance is measured against Russell 2500 index. There is no minimum account size for this composite. The strategy is managed by Eastern Shore Capital Management, a division of Moody Aldrich Partners, LLC.

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