November 2018

Small/SMID Cap Market Outlook

We continue to be positive on the outlook for smaller cap growth stocks for the remainder of 2018 and into 2019. We believe the unique confluence of events that occurred in 2017 power a case for multiyear outperformance for this asset class.

As I write this, the overall market is undergoing a correction sparked by a "crisis of confidence" in the global economic outlook and the prospect of earnings growth for 2019. While we are no experts on larger capitalization stocks, many of the issues cited as "headwinds"—a slowdown in Europe, issues in the emerging market economies, rising labor and material costs that cannot be offset by price increases—strike us as being issues primarily of size. The global world economic outlook is more uncertain, given the sharp rise in the dollar and the Federal Reserve tightening campaign, the advent of Brexit, and the turmoil in the Middle East. Smaller capitalization stocks tend to be more domestically focused; they tend to have less overseas exposure, and those that have overseas exposure tend to be "transformational" or "secular" in the products and services they offer. Given that profile, they tend to have a lot lower correlation to overall global economic conditions than do their larger cap brethren. Thus, theoretically they should be able to weather whatever global economic storms appear a bit better than the larger capitalization, more globally oriented stocks.

While small capitalization growth stocks, as measured by the Russell 2000 Growth Index, have outperformed the S&P 500 year to date, they have also corrected more sharply. Recently, many pundits have pointed to the drivers of growth outperformance—specifically the Healthcare, Consumer Discretionary, and Information Technology sectors—as signs of a dangerous concentration into growth stocks. We view it a bit differently. The strong performance from these sectors, we believe, reflects the strong growth drivers that are powering parts of the economy. Specifically, Technology is benefitting from an uptick in capital spending, as corporations focus on moving processes to the cloud and updating their informational capabilities to drive sales and profits. Healthcare is experiencing a very strong profit cycle, driven by the increasing consumerization of healthcare and very strong new product innovation from the medical device companies. In contrast, Industrial stocks have struggled, as automotive output has peaked as vehicle sales have peaked; construction has slowed across the country, and the Industrial sector has been weighed down with increasing tensions over tariffs. Profits in the Energy sector have also been hampered, as the commodity has been in a trading range for most of the year and the rest of the world has not kept pace with the U.S.'s strong economic growth.

When we wrote our Small Cap Outlook in January, we envisioned an acceleration in the domestic economy occurring against a backdrop of synchronized global growth. It now appears, as we look into 2019, that the rest of the world is experiencing a synchronized global slowdown. Some question whether or not the domestic economy can continue to grow as the rest of the world slows. While we think it likely that growth slows from its current 3%+, we do not at this point see a recession in the near future. The Tax Reform Act was of significant benefit to many of the smaller public companies, as they tend to be among the highest corporate tax payers. We believe that this benefit will be both short term (reflecting the reduction in the actual tax rate) as well as long term, as many of the companies will, we believe, reinvest some of those benefits in their businesses to accelerate growth. However, the specter of a trade war has created a more nuanced economic backdrop, and the extent to which this escalates and its final impact is difficult to forecast. From our conversations with the managements of smaller companies, it will impact certain industries more than others. For those who rely on parts from China, it will require a restructuring of the supply chain. While the impact may be far less on smaller companies than on larger companies, there will still be some impact. It is unclear to us how much of that is realized by investors at this point, since there are so many unknowns. Will companies raise prices, or will they absorb the added costs? If they raise prices, what does that do to inflation, and will that cause the Federal Reserve to raise interest rates at a faster rate? There is also more political uncertainty; if the midterm elections result in the Democrats retaking the House, it is unclear what impact that may have on the legislative agenda. While much is unknown at this point, one thing seems clear to us: while the investment backdrop may remain positive, it may not be as positive as it was a year ago for certain sectors or select stocks. On the other hand, there are areas that might have a more positive backdrop in 2019 than they had in 2018. Again, we think a more nuanced investment backdrop points towards more dispersion among returns from individual stocks, which we believe will make 2019, as it had made 2018, a stock picker's market.

2017 was an unusual year in that there were no major pullbacks or corrections in the market; 2018 has so far proven to be a more normal year, with several "normal" 5-10% correction(s) occurring. We expected a little more volatility because there are a few more unknowns and the macroeconomic backdrop is not be as favorable in 2018 as it was in 2017. However, given the positive multiyear scenario that appears to be developing, we think any corrections would be buying opportunities in smaller capitalization stocks.

Contact Us:
info@lisanticap.com
www.lisanticap.com
www.lisantismallcap.com

475 Park Avenue South, 9th Floor
New York, NY 10016
(917) 386-6266

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Past performance is not indicative of future results. Investments in small companies carry greater risk than is customarily associated with larger companies for various reasons such as narrower markets, limited financial resources and less liquid stock. The views expressed reflect those of the portfolio manager as of the date noted. The portfolio manager's views are subject to change at any time based on market and other various conditions.

About Lisanti Capital Growth:

Lisanti Capital Growth, LLC (Lisanti), founded by Mary Lisanti, is a certified woman-owned and managed SEC registered investment advisor specializing in U.S. small- and small/mid-cap (SMID) equity growth investing. In September 2017, Dinosaur Group Holdings, LLC, the parent company of DCM Advisors, LLC (DCM), an affiliated registered investment advisor, acquired a minority interest in Lisanti. Lisanti manages separately managed accounts and is the investment adviser to the Lisanti Small Cap Growth Fund (ASCGX). DCM is an SEC registered investment advisory firm providing asset management and wealth advisory services to institutions, registered investment advisors, family offices and high net worth individuals.