Small Cap Equity Commentary

October, 2019

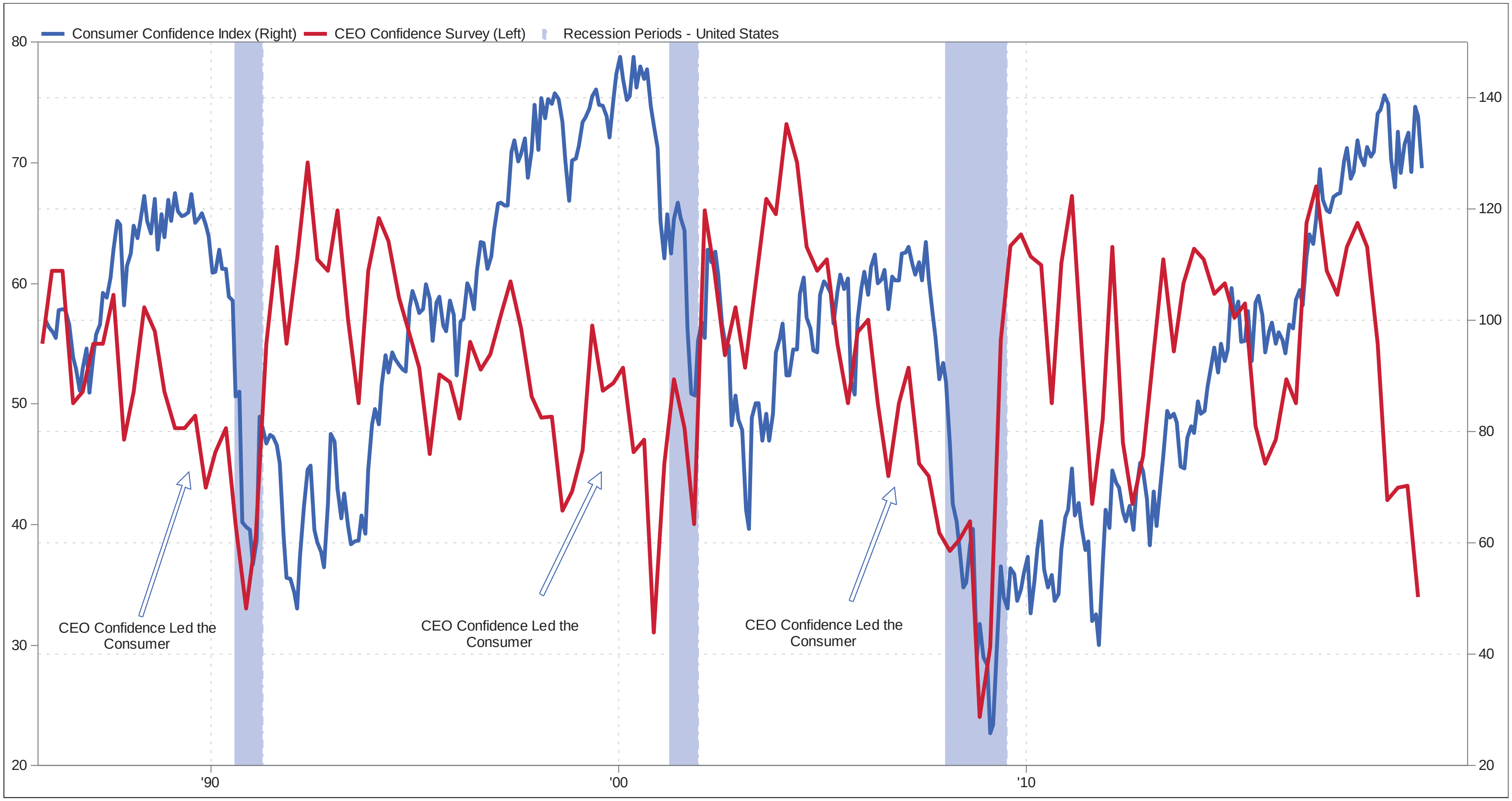
For the third time of this expansion, growth expectations have fallen again, and the 10-year Treasury has dropped below 1.5%. The question is whether this is just slowdown #3 and we should be expecting something similar to the rebound that we saw in 2013 and 2016, or is this one different?

Given the maturity of the cycle, we are watching for signs that the breadth of this decline expands, which would put in jeopardy the strong labor market and with it consumer confidence. For perspective, the current 3.5% unemployment rate is at a 50-year low, and since 1969, The Conference Board's Consumer Confidence Index only eclipsed today's level during the late '90's boom. There are two data points that concern us and are worth highlighting. The Conference Board's CEO Confidence report that was published on October 2nd showed a dramatic drop, falling to its lowest level since the first quarter of 2009. Additionally, while most of the current softness in the economy has been concentrated in the manufacturing side of our economy, the employment component of the ISM's Non-Manufacturing report for September has fallen rather quickly to 50.4, or just above the 50 mark that denotes expansion from contraction. The pace of job growth in the US has already decelerated, but remains positive according to the most recent ADP jobs report. The 4-month average addition to private payrolls is down to 135,000, but this is below the 200,000 average monthly pace from 2011 to 2018.

Market sentiment (and CEO confidence to a degree) bounces around with the news, and the headlines during the quarter were eventful to say the least. In September the Federal Reserve cut rates for the second time and said that they likely need to expand their balance sheet. Chicago Federal Reserve Chief Evans recently said that the Fed remains in risk management mode as they reverse their tightening actions of previous years. We have also been following the escalating protests in Hong Kong. Their leader, Carrie Lam, withdrew the extradition bill that initially triggered the protests, but the demonstrators have only intensified their efforts. The protests have occasionally drifted into the public discussions between the US and China and it is not lost on anyone that this is occurring just as the Chinese Communist Party prepares their grand celebration of 70 years in power. In late September, House Speaker Pelosi also announced the formal impeachment inquiry into President Trump. A week earlier there was the attack on the Saudi oil facilities, which put in jeopardy 5% of the global supply. Oil prices jumped more than 15% when markets opened on September 16th. Top it off with the nationwide strike at GM and you have a recipe for low confidence. Let's hope the US consumer does not notice.

Our defensive positioning helped in the quarter, as the market was led by REITs, Utilities and Consumer Staples, while the more cyclical sectors such as Energy and Materials declined. Our top performing stocks were the antenna maker PCTEL (PCTI), the window manufacturer Tecnoglass (TGLS), the boot maker Rocky Brands (RCKY), the surplus liquidator Liquidity Services (LQDT) and the mobile home builder Cavco Industries (CVCO). PCTEL was acquired on the first day of the quarter and in short order it has risen from roughly $4.50 a share to $8.50. As a maker of antennas, PCTEL is looking forward to the investment cycle associated with 5G. Additionally, with no debt and cash equal to 40% of its market value, it looked especially cheap. We also initiated a new position in the largest prosthetics manufacturer, Hanger (HNGR). Its largest competitor has 1% of the market compared to their 20%. The company has spent years digging themselves out of a messy restatement of their financials, which led to the stock delisting from the exchanges. Last fall, the stock relisted and they have been mending their investor relations fences. We think the shares look cheap, the business has stabilized, they are working hard to retell their story and after not having completed an acquisition for years, they are in a position to accretively begin rolling up other manufactures. We did exit several holdings including Healthcare Services Group (HCSG), Cadence Bank (CADE), and Aramark (ARMK). HCSG was a disappointing investment for us as the health of their customers has continued to deteriorate, which has suppressed their ability to grow and has impaired their cash flow. We have been patient, but we do not see the environment improving. Cadence Bank's stock took a hit after they reported a sudden deterioration in credit in their last earnings report. Given the additional pressure from low rates, we chose to sell the stock in September. Lastly, Aramark became the target of an activist investor, so we took that opportunity to exit the position.

We enter the 4th quarter defensively positioned, with more cash than usual. This position is warranted given the factors discussed above, but we are actively looking for individual stocks that are attractively valued, or stocks that will do well given our macro view.



Tyler Pullen, CFA
Portfolio Manager