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COLUMBUS CIRCLE
INVESTORS

General Outlook	
Markets	Mirror, Mirror at Broad and Wall
Global Economy	Hope Springs Eternal
Monetary Policy	Patience is a Virtue
Interest Rates	Inversion Excursion
Topical Theme	5G - Full Speed Ahead
Outlook	Check, Please

Investment Environment

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Markets: Mirror, Mirror at Broad and Wall

Domestic equites sharply reversed the negative returns from the prior three month period, as the S&P 500 registered its most significant quarterly increase since 2009 and its best first quarter gain since 1998. Results were even more impressive down the market cap spectrum, as the Russell 2000 registered its strongest first quarter since 1991, and small and midcap stocks outpaced their large cap brethren despite fading a bit in the final month. Returns were primarily valuation driven, as price-earnings (P-E) multiples expanded to nearly the same degree with which they had compressed just three months earlier. Investor enthusiasm driving these higher valuations was centered on restored confidence in the Federal Reserve (Fed) and its ability to support the economy based on accommodative comments made intermittently throughout the quarter. Growth stocks again outdistanced value equities (due to the uncertain macroeconomic environment that persisted through much of the quarter), and CCI strategies experienced quarterly returns that were a mirror image of Q4 2018, exceeding their respective benchmarks and producing competitive peer ranking results.

Equity Markets (% Total Return)			
	First Quarter 2019		
	Growth	**Index**	**Value**
Russell 1000	16.10	14.00	11.93
Russell Mid Cap	19.62	16.54	14.37
Russell 2500	18.99	15.82	13.12
Russell 2000	17.14	14.58	11.93
Russell Microcap	16.00	13.10	10.44
S&P 500		13.65	
International*		10.13	
Emerging Markets**		9.95	
Gold Price Change %		0.77	

* MSCI EAFE in U.S. $ ** MSCI EMF in U.S. $

Source: FactSet (Indices)/Bloomberg (Gold Price Change%)

Despite celebrating the tenth anniversary of this historic bull market rally in early March, investors remained generally cautious even with the most recent advance. Market pundits have postulated that liquidity still remains challenged, and the post-Christmas recovery has been largely driven by short covering, modest re-leveraging, buybacks, and portfolio repositioning from extremely conservative levels. This leaves room for further market advances if traditional institutional and retail investors become re-engaged and carry the baton forward. Historical precedent provides some tailwinds for the optimists as the sharp upward spike in the P-E multiple experienced through early February has only happened a dozen times since 1990 and often occurs around major market bottoms, according to Cornerstone Macro.[1] In addition, an Evercore-ISI analysis of market corrections since 1984 (where the magnitude of decline was similar to 2018) shows that after the initial two month recovery burst off the bottom, the S&P 500 still moved higher by another 9%, on average, over the ensuing six months.[2] The mosaic for a continued advance would likely include sustained confidence in the Fed, steady to improved global economies (particularly Europe and China), stability in forward earnings revisions, and lack of geopolitical disruption.

Global Economy: Hope Springs Eternal

Recently, investors have assessed the global economic landscape with a renewed optimism, intermittently rallying cyclical stocks despite a global manufacturing purchasing managers index (PMI) that hit a 32-month low in February. Although there are several positive factors, such as strong employment, stable credit conditions, favorable bank lending, controlled inflation, and increased productivity that provide the foundation for a growing economy and the March PMI stabilized, some market participants appear to be viewing the world through rose-colored lenses. In the U.S. the PMI has moderated since last Fall and China now hovers near 50. Worse, the economies of Japan and the Eurozone (particularly Germany) have fallen below the 50 level that divides expansion from contraction. Additionally, factors such as the fallout from trade wars, deteriorating worldwide business confidence, and the dissipating effect of monetary policy stimulus have yet to be resolved.

Some of the positives cited by cyclical bulls could best be described as early stage green shoots. For instance, the Chinese government has enacted a series of monetary and fiscal policies intended to strengthen its sluggish economy (Cornerstone Macro counts 73 actions since last summer[3]). Chief among these actions have been dramatic bank reserve cuts to stimulate lending, sizable consumer and corporate tax cuts, and bond issuance programs to facilitate infrastructure investment. While these may ultimately bear fruit, it may be premature to cite recent improvements in Chinese data as proof of economic improvement when they might just be attributable to a seasonal uplift following the Chinese New Year. Additionally, prolonged U.S.-China trade negotiations need to be resolved before a green light is given to a Chinese recovery.

Germany also presents problems as its economy rather quickly became among the world's weakest. Although there have also been some recent signs of improvement, including increased auto production, and improved business and consumer confidence, gains in broader economic data are lacking and may be dependent on China's improvement because of its substantial imports from Germany. As a result, German government bond yields fell below zero, dragging down U.S. government bond yields in the process and trading below Japanese government bond yields for just the third time in the last thirty years, hardly a sign of economic strength.

Monetary Policy: Patience is a Virtue

The Federal Reserve had the polar opposite impact on equity markets compared to last quarter's valuation compression, as its commentary produced P-E multiple expansion. Investors embraced the initial January comments regarding removal of the interest rate hiking bias (including two increases forecasted as recently as December 2018), and further rewarded the Fed's March meeting projections of zero interest rate increases for the remainder of the year. Importantly, the Fed pivoted to a qualitative view of being "patient" and "data-dependent" in assessing future economic information, providing welcome relief to investors who, just a few months earlier, had become increasingly fearful that the Fed's pro-actively aggressive monetary policy would plunge the domestic economy into recession. Statements about the near term path of the Fed's balance sheet normalization process coming to end in September also demonstrated consistency with investor expectations. Assuming the Fed's interest rate views remain relatively benign, its next big obstacle will be the upcoming strategic review of its framework for evaluating inflation and any policy outcomes arising from that assessment. The Fed will hold several public events on this topic through early June, comprehensively analyze the issue over the remainder of the year, and announce its conclusions sometime in the first half of 2020.

Interest Rates: Inversion Excursion

In the week following the Fed's March meeting, interest rates plummeted by twenty basis points, causing the inversion of the closely watched three-month to ten-year yield spread for the first time in over a decade. Interest rate yield curve inversions are often key leading indicators of an economic recession, but their predictive value is not fool-proof. This temporary excursion into the land of inversion prompted a pause in the equity market's ascension, and was partially caused by bond market vigilantes attempting to pressure the Fed to cut interest rates to calm investor fears and protect against recession. A more significant cause was the coincident and similar magnitude decline in German ten-year government yields that temporarily reduced U.S. yields to maintain the same relative premium to their sovereign equivalent. This would suggest the inversion was more noise than signal despite the equity market's initial reaction, a viewpoint reinforced by the rapid shift of the yield curve that reversed the brief inversion and returned to a modest steepening formation. Even if the inversion excursion was a recessionary signal, equity markets historically experience another nine months of normal returns before moderating to reflect the higher probability of recession (according to Strategas[4]), and generate above average results for up to thirty months after the initial inversion (per JP Morgan[5]).

Topical Theme: 5G - Full Speed Ahead

Fifth Generation (5G) is the next iteration of wireless technology that offers more than a twenty-fold increase in throughput compared to the current Fourth Generation (4G LTE) technology. According to a report published at the recent Mobile World Congress, network infrastructure upgrades/buildouts and mobile device launches will be accelerating around the world such that 15% of the global mobile industry will operate on 5G technology by 2025[6] and more than $2.2 trillion of productivity benefits will be derived by the global economy in the next fifteen years from 5G technologies.[7] More than $160 billion of capital spending is being deployed annually to roll out this transformative technology that has architectural benefits that supercharge a host of mega technology trends, such as internet of things, artificial intelligence, augmented/virtual reality, factory automation, autonomous vehicles, remote healthcare, and smart buildings/cities. The added revenue streams should enable mobile operators to recoup some of the heightened capex (5G is 1.7x the spend of 4G) through premium pricing, but the majority of the benefits accrue to the equipment and component providers supporting the technology's proliferation. CCI is looking to capitalize on the expansion of 5G technology and has identified it as one of several portfolio investment themes. As a reminder, CCI's investment themes are developed on a bottom-up basis based on common drivers of positive surprise among companies, and themes serve as a supplemental risk management tool unique to our portfolio management framework.

Outlook: Check, Please

Charting the course of the market for the last two quarters loosely yields the shape of the letter V, and plotting a further sustained rally in the markets on this same diagram would form a check mark. With the Federal Reserve seemingly re-settling into its role as market supporter, geopolitical tensions (e.g., trade deliberations with China and Europe, Brexit, etc.), economic uncertainty, and corporate earnings appear to be the most critical variables in determining the fate of this long-standing bull market. The mixed messaging of global economic data alternates between expansion and contraction, but any sustained improvement could trigger a leadership shift to cyclical and more value-oriented equities, and we will remain watchful of this potential development. The interim uncertainty is an environment that is typically beneficial for the CCI ***Positive Momentum & Positive Surprise*** investment discipline because of the focus on companies with attractive secular growth prospects that effectively navigate through fluctuating economic conditions.

After two quarters of extreme volatility, the normalization of valuation multiples should refocus the spotlight on corporate earnings as a prime influence on stock price changes. Overall expectations (using S&P 500 earnings as a proxy) have declined rather precipitously since year-end, as evidenced by first quarter estimates falling by the largest percentage since 2016 and nearly twice the historical average. Within this backdrop, the respective CCI product portfolio upward earnings revision ratios continue to exceed their relevant universes, as has been typical throughout the firm's history. Positive earnings surprises have become scarcer within the market but remained relatively stable across the various CCI portfolios, and companies generating results above consensus were rewarded to a greater than average degree in the most recent financial reporting period. In sum, periods of economic uncertainty, and latter stages of business cycles when earnings growth and positive surprise scarcity is rewarded, are beneficial to our investment philosophy, and we believe any continuation of these trends should benefit future performance across the CCI portfolios.

[1] Cornerstone Macro, "A Chart For The Bulls," February 5, 2019.
[2] Evercore ISI, "Economic Report," February 19, 2019, page 5.
[3] Cornerstone Macro, "Weekly Economic Update," March 22, 2019, page 6.
[4] Strategas, "Technical Strategy – Daily Report," April 1, 2019, page 7.
[5] J.P. Morgan, "Yield Curve Inversion," March 26, 2019, page 2.
[6] GSM Association, "The Mobile Economy 2019," February 2019, page 9.
[7] GSM Association, "The Mobile Economy 2019," February 2019, page 20.