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COLUMBUS CIRCLE
INVESTORS

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Investment Environment

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Markets: Crowd Control

Equity markets were mixed, with mid and large cap indices posting modest advances and overshadowing the low single digit declines further down the market cap spectrum. Higher quality and greater yielding stocks generally outperformed, while fundamental metrics such as projected growth, earnings momentum, and upward estimate revisions lagged. Investors remained focused on U.S.-China trade negotiations, struggling global economies, moderating corporate earnings growth, and interest rate yield curves. Each of these focal points became more volatile during the quarter, along with heightened global political uncertainty and sharp leadership reversals, creating a challenging environment for active portfolio management. This is typical of temporary periods of aggressive tactical repositioning and speculative pursuit of companies leveraged to an economic recovery that has shown few signs of improvement. According to Bank of America analysis of Growth managers,[1] only 15% of large cap, 32% of mid cap, and 50% of small cap managers outperformed during the turbulent third quarter.

The most dramatic development of the last three months was the violent leadership reversal that transpired in early September, reminiscent of the extreme moves off the March 2009 trough. Momentum stocks had become extremely overcrowded in terms of common ownership among fund managers, and the valuation disparities between Growth and Value stocks had reached historical proportions (widest since 2000). The positive breakthrough in U.S.-China trade negotiations and better than feared economic data surged

Equity Markets (% Total Return)

	Third Quarter 2019				Year to Date 2019		
	Growth	Index	Value		Growth	Index	Value
Russell 1000	1.49	1.42	1.36	Russell 1000	23.30	20.53	17.81
Russell Mid Cap	(0.67)	0.48	1.22	Russell Mid Cap	25.23	21.93	19.47
Russell 2500	(3.18)	(1.28)	0.13	Russell 2500	19.97	17.72	15.41
Russell 2000	(4.17)	(2.40)	(0.57)	Russell 2000	15.34	14.18	12.82
Russell Microcap	(10.05)	(5.45)	(1.98)	Russell Microcap	4.79	7.92	9.78
S&P 500		1.70		S&P 500		20.55	
International*		(1.00)		International*		13.35	
Emerging Markets**		(4.11)		Emerging Markets**		6.22	
Gold Price Change %		4.47		Gold Price Change %		14.81	

* MSCI EAFE in U.S. $ ** MSCI EMF in U.S. $ Source: FactSet (Indices)/Bloomberg (Gold Price Change%)

interest rates higher, sparking a sharp factor rotation from defensive momentum to cyclical value. This reaction was part of a five standard deviation event architected through a series of computer-driven investment actions that were made with little regard for fundamental merit. The Federal Reserve's second monetary easing continued to perpetuate the pro-cyclical rally as speculation for a recovery mounted, prompting investors to increasingly favor portfolio holdings with additional economic sensitivity despite a lack of validating data. This phenomenon was not confined to U.S. markets, as European, Canadian, Australian and Latin American stocks also experienced massive drawdowns.

The ferocity of this reversal was demonstrated through a Jefferies analysis[2] that showed the top 10 crowded small cap growth names outperformed the Russell 2000 Growth Index by over 300 basis points in the June 30th to August 31st time frame, only to reverse course and underperform by over 300 basis points during September. A Bernstein analysis[3] further highlighted the sharpness of this leadership shift, and showed that the 30 least crowded names in the S&P 500 generated over 650 basis points of positive alpha in September, with 87% of them exceeding the benchmark returns. History shows that severe leadership reversals (such as the one away from momentum stocks) often persist for up to 6-9 months; however, given the significant magnitude of the current change (relative to history) it appears more likely that investors will experience a more compressed reversion period this time around. Importantly, the momentum and growth factor baskets no longer maintain extremely similar holdings or the same historical correlation, and performance of the two has decoupled over the last year. In fact, they have started to become inversely correlated as the momentum basket contains many more bond proxies that are most sensitive to declining interest rates. Therefore, growth companies (which are the focus of CCI's investment discipline) should not necessarily experience detrimental performance from any prolonged sluggishness of momentum stocks from this factor reversal.

Economy: Domestic Problems

International economies have been deteriorating for several quarters, but the U.S. Manufacturing Purchasing Manager Index's (PMI) recent plummet below the 50 threshold (delineating economic contraction and expansion) fueled renewed recessionary concerns. September's 47.8 reading published by the Institute for Supply Management (ISM) was the lowest since the Financial Crisis in 2009, and the six month cumulative decline was the sharpest since March 2009. The PMI data mirrored the earlier interest rate yield curve inversion in suggesting a further economic slowdown, and this, combined with the trade uncertainty, political ambiguity and other geopolitical tensions (e.g., Iran, Hong Kong Protests, Brexit, etc.), prompted market pundits to notably increase their recession probabilities. This economic deterioration is hardly conducive to value and cyclical stocks leading the market (as happened during the quarter), as secular growth stocks are not as reliant on macro level tailwinds in achieving positive momentum in their businesses.

The ISM data contrasts with other more positive economic surveys, such as those circulated by the various Federal Reserve Bank (FRB) districts and ISM's competitor Markit, a recognized global information provider. The spread between the ISM and FRB surveys is the widest in four years, while the Markit PMI actually increased in September (compared to the ISM's decline). Explaining some of the disparity between results, key differences between the ISM and Markit surveys include participant size (ISM focuses on medium-large enterprises that are more sensitive to global trade developments) and composition (ISM's higher inventory weight creates inherent volatility, and Markit's larger sample size and increased production/new order focus provides a better signal as evidenced by stronger correlation with GDP). CCI's own economic monitor, which assesses 22 key economic variables, aligns more closely with the FRB and Markit surveys, having mildly advanced from the middle of the modest growth range to the border of significant expansion over the last few months. As the U.S. has been the bedrock for the world economy, its health is key to any global recovery. The increased recessionary angst emanating from some of this recent data seems premature considering their conflicting messages and recent improvement in housing and auto sales, continued strength in employment (unemployment at a 40-year low) and consumer spending. Additionally, cautionary signals, such as widening credit spreads, rampant inflation and spikes in oil prices (which rose 20% or more annually before five of the last six economic downturns), are not present today. Regardless of one's economic viewpoint, historically equity markets generate strong double digit returns after these cautionary signals and leading into recessions.

Monetary Policy: Getting Easier

Accommodative monetary policy accelerated world-wide, with several Central Banks announcing interest rate reductions. Some, including Brazil, Mexico, Indonesia, Philippines and Egypt reduced rates more than once within the quarter in hopes of jumpstarting their respective economies and/or in response to global interest rate declines. The U.S. FRB embarked on its first monetary easing since 2008 with two rate cuts of its own as part of a mid-cycle adjustment to provide insurance against weakness from trade policy uncertainty and sluggish foreign economics. Further, sharp increases in borrowing costs (which are often associated with financial stress) prompted the New York FRB for the first time in a decade to inject emergency liquidity into short-term lending markets via repurchase agreements. These rate spikes were the result of a confluence of extraordinary borrowing needs for Treasury auction settlements, corporate bond issuance, emerging market oil imports, and corporate tax payments. Elsewhere, the Bank of Japan and European Central Bank are expanding their balance sheets through quantitative easing and supporting negative interest rates in hopes of fostering higher inflation and stimulating their struggling economies, but improvements in key leading indicator data have not yet materialized. These synchronized easing actions are essential in addressing the fact that over 70% of Global PMIs are below the critical 50 level, the most since 2012. Further supporting this incremental weakness, the Organization for Economic Cooperation and Development (OECD) recently reduced its 2019 economic growth forecast to +2.9% (compared to May's +3.2% forecast) and the World Trade Organization (WTO) more substantially lowered its 2019 merchandise trade volume projection to +1.2% (versus April's +2.6% estimate). Equity markets typically respond favorably to FRB accommodation as, according to Canaccord Genuity,[4] after two interest rate cuts, the six and twelve month S&P 500 average returns were +11% and +18% in the fifteen easing cycles since 1954.

Politics: Inquiring Minds

Subsequent to the revelations of the President's alleged dealings with the Ukraine President and the associated whistleblower's report regarding foreign aid and investigation of the Biden family, Democrats initiated the fourth impeachment inquiry in this country's history. Conducted under the direction of six House of Representative ("House") committees, this has further heightened partisan politics in the nation's capital and threatens to stonewall until 2021 any attempts to draft or pass legislation or trade policies. Odds of impeachment, which had steadily declined after the Mueller report's release, immediately skyrocketed from about 25% to over 60% and created meaningful uncertainty in the November 2020 election. Investors were suddenly faced with the prospect that the incumbent and his leading opponent at the time might not even make the ballot. This inquiry could permeate investor decision-making for some time, as the investigation will likely ebb and flow for several months prior to potential articles of impeachment being drafted. Further, assuming it passes the House (where a simple majority is needed for passage), it would proceed to trial in the Senate (which, unlike the House, is a Republican majority) where a two-thirds vote would be needed for impeachment. With conflicting market responses during the Nixon and Clinton investigations (declining in the former and rallying in the latter), history has little precedent for the market's reaction during impeachment processes. The most plausible expectation for market direction during and after the review would be a continuation of the trend existent before the impeachment process began, as equities behaved similarly during both the Nixon and Clinton situations.

Outlook: Conflict Management

Equity markets continue to struggle with several simultaneous conflicts, including U.S.-China trade, Growth-Value leadership, Domestic-International economies, and Democrat-Republican political agendas. The resulting pressures on interest rates, corporate earnings and business activity levels has created ample uncertainty… an environment that is typically favorable for the secular growth companies pursued as part of CCI's ***Positive Momentum & Positive Surprise*** investment discipline. We continue to monitor the most important leading indicators for signs pointing to a resolution of these conflicts that might necessitate tactical changes within the respective CCI portfolios but, thus far, there has been scant evidence of economic improvement that would justify the continuance of the sharp reversal in leadership that transpired within the quarter. In the interim, any temporary market drawdowns or speculative rotations towards Value stocks that disproportionately penalize Growth names without a commensurate change in fundamentals will generally be viewed as opportunities to increase our highest conviction ideas at more compelling valuations.

[1] Bank of America, "US Mutual Fund Performance Update," October 3, 2019, pages 3-6.
[2] Jefferies, "SMID Cap Strategy," October 1, 2019, pages 3-5.
[3] Bernstein, "Quantitative Research & US Portfolio Strategy: Is this a good stock pickers' market," October 1, 2019, page 5.
[4] Canaccord Genuity, "Market Strategy: Keep your Eye on the Ball," September 22, 2019, page 1.