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COLUMBUS CIRCLE INVESTORS

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Investment Environment

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Markets: Going Through a Phase

For the year, equity markets sprinted to the finish line, with growth indices registering high-single to low-double-digit quarterly returns across the market cap spectrum. The mid-December resolution of the Phase I U.S.-China tariff negotiations, coupled with modestly improving global economic growth, and accommodative monetary policies by central banks around the world, served as the primary catalysts for the sharp advances. Once again, investors speculated that an economic renaissance was afoot, and chose to disregard near-term company fundamentals (that showed scant evidence of any such recovery) and instead focused on stocks with higher price volatility, increased financial leverage and added earnings risk. While Growth outperformed Value at the benchmark level for each market cap segment, Value was one of the strongest factors within each benchmark, outdistancing all traditional growth-oriented factors (e.g., positive surprise, quality, EPS momentum, and upward estimate revisions) with the exception of projected growth. This presented a conundrum for fundamental investors such as CCI, as it would have been necessary to deviate from the stated investment discipline in order to outperform in this speculative rally. The backdrop also provided challenges for many other growth-oriented investment firms, temporarily resulting in below average success rates for active managers.

Continued strong employment, tight credit spreads, controlled inflation, and solid consumer spending served as secondary catalysts driving investor optimism, while corporate earnings growth remained notably absent. According to Strategas,

Equity Markets (% Total Return)							
Fourth Quarter 2019				**Year to Date 2019**			
	Growth	**Index**	**Value**		**Growth**	**Index**	**Value**
Russell 1000	10.62	9.04	7.41	Russell 1000	36.39	31.43	26.54
Russell Mid Cap	8.17	7.06	6.36	Russell Mid Cap	35.47	30.54	27.06
Russell 2500	10.57	8.54	7.07	Russell 2500	32.65	27.77	23.56
Russell 2000	11.39	9.94	8.49	Russell 2000	28.48	25.52	22.39
Russell Microcap	17.69	13.45	10.47	Russell Microcap	23.33	22.43	21.28
S&P 500		9.07		S&P 500		31.49	
International*		8.21		International*		22.66	
Emerging Markets**		11.93		Emerging Markets**		18.88	
Gold Price Change %		3.04		Gold Price Change %		18.31	

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

currently 38% of Russell 2000 companies (a multi-year high) do not generate earnings.[1] As a result, virtually all of the market's gains for the quarter and the year have come from multiple expansion, with forward valuations now near the highs of the last decade. In the fourth quarter, the U.S.-China truce caused a surge in valuation multiples, whereas the Federal Reserve's dovish pivot was the primary culprit earlier in the year. The market euphoria has been predicated on an expectation that the tentative economic recovery will gain sustainable traction and translate into high single-digit earnings growth. These profit forecasts are very sensitive to economic fluctuations, as nearly three-quarters of S&P 500 Index level growth is forecasted to come from cyclical companies, and estimates are most robust for sectors highly leveraged to a recovery (e.g., Energy, Industrials, Consumer Discretionary and Materials).

Economy: Mini Macro

The Global Manufacturing Purchasing Managers' Index (PMI) has been hovering around the expansion/contraction threshold, while the U.S. Manufacturing PMI is suffering through its third mini downturn within the longest running macro recovery on record. The European financial crisis prompted the first downturn during 2011, while a Chinese economic slowdown, precipitous drop in energy prices and initial Federal Reserve ("Fed") tightening caused the second pause in 2015-16. Ultimately, quantitative easing propped up the languishing economy and helped avoid the economic imbalances that historically lead to recessions. China and monetary policy also triggered the latest economic growth moderation, as increased trade friction and excessive Fed interest rate tightening impeded the expansion. Central banks are again performing triage to stem the deterioration, as balance sheets are expanding and monetary policy has become incrementally accommodative.

Domestically, capital spending and industrial production have moderated due, in part, to Boeing's production cutbacks and General Motors' employee strike, but also because of the uncertainty created by volatile trade discussions, political bickering and lackluster export growth opportunities. The equity market surge in December was predicated on speculative anticipation that the Phase I U.S.-China agreement would unleash pent-up demand and ignite the economy, a view partially supported by modest confidence measure improvements for small business, CEO and CFO metrics that often serve as leading indicators for economic trajectory. Subsequent data, however, did not validate the hope that these initial sentiment changes would translate immediately into economic vitality, as December PMI readings for the U.S. and key foreign economies each reversed the month-to-month momentum of the last few periods.

Investors' recent fascination with inexpensive cyclical companies leveraged to a potential meaningful acceleration (that might prove elusive at this stage of the economic cycle) starkly contrasts with CCI's preference for secular growth companies able to prosper under various macro conditions. Reported results for these secular companies, as measured by fundamental momentum and positive surprise, have remained consistently favorable, though investors have passed over their merits by speculating on alternative choices with more volatile track records and greater prevalence of fundamental disappointment. A backdrop of increased macro stability, however, would reign in some of the rampant cyclical speculation and be more conducive to alpha generation for secular growth investors.

Monetary Policy: Third Time is a Charm

The Federal Reserve has been an integral provider of liquidity fueling the decade-old bull market. The Fed's third interest rate cut in October and its more than $400 billion of balance sheet expansion during the last few months helped alleviate constraints in the short-term repurchase agreement ("repo") markets. While monthly repo market liquidity injections will continue at least through the second quarter, the Fed has indicated a willingness to leave monetary policy unchanged for a sustained period based on its perception of stable economic conditions. Such inertia would keep the economy from getting frothy and likely perpetuate an investment environment (more aligned with CCI's investment philosophy) that does not reward deeply cyclical companies to the degree experienced in the fourth quarter. Additionally, the third interest rate cut within a cycle often serves as a pivotal charm for near-term market performance, as equities rise on average by 14% over the next six months (based on data since 1982) so long as the Fed makes no more than one additional reduction.

Politics: The Great Divide

For only the third time in history, the House of Representatives voted to impeach the President. The debate was spirited and contentious, widening the already great divide existing between the two political parties. The final vote was almost entirely along party lines, as 100% of Republicans voted against the articles of impeachment and all but three Democrats voted in favor. A trial within the Senate will commence once the House Speaker forwards the articles, but the Democrats have delayed delivery in hopes of influencing the framework in which the proceedings are conducted. Equities were generally unaffected by this historical moment, as it is widely believed the Senate will vote against impeachment. Perhaps the greater issue is the increased polarization of the combating political parties, and what it means for markets as we go through candidate primaries and as the November election approaches. Divergent political agendas could have different ramifications at the sector and industry level, so developments will be closely monitored and portfolios will be tactically adjusted as necessary.

Outlook: 2020 Vision

Looking ahead to 2020, investors' equity views are poised to remain constructive based on a generally favorable market environment. Absent material changes in the economy, the Federal Reserve's acknowledged pause in monetary policy should foster a landscape where fundamentally-based investment decisions become more commonplace and secular growth stocks are rewarded for their current and future prospects. Absent any unforeseen developments, economies around the world should grind higher, albeit at a more gradual pace than some of the speculative optimists have recently embedded in cyclical stocks.

As November elections approach, the geopolitical backdrop will intermittently impact investor behavior, as the escalating rhetoric may reward and penalize individual industries/sectors, while any intensified conflict with Iran would likely impact risk appetites. Corporate earnings are forecasted to accelerate to mid-high single-digit rates through the year (after being dormant for much of 2019), casting a brighter spotlight on company fundamentals and facilitating more merit-based stock selection rather than factor-based decision-making. Potential risks to this view would include any further trade tensions, a change in the Fed's inflation targeting framework, spreads widening from credit pressures within leveraged or commercial loans, or slackening labor markets that might compromise strong employment trends or pressure wages. Despite the market's strong advance in 2019, history shows further solid gains could still lie ahead. According to MKM Partners[2], since 1950, years following a 20%+ advance by the S&P 500 have averaged just over +11% and BTIG further pinpoints this assessment to the post-1989 period[3], with such analysis showing a next year gain of 14%.

[1] Strategas, "2019 Year in Review," January 3, 2020, page 15.
[2] MKM Partners, "Macro Outlook and Top Picks for 2020," December 18, 2019, page 9.
[3] BTIG, " 2020 Outlook," December 8, 2019, page 5.