MERRION INVESTMENT MANAGERS

CANTOR Fitzgerald

Strategy & Outlook MARKET UPDATE

December 2018

November was another volatile month for global asset prices. A strong rally of over 3% off the lows, led by defensive equities over the course of the final week however saw global equities manage to produce a slightly positive month. There were a number of key events in the final days of November that could have profound positive impacts in the coming months. The volatile political and macro backdrop evidenced throughout the course of the year appears to be improving with a number of the key issues appearing a lot closer to being resolved than ever before. These include US monetary policy conditions, global trade tensions and European politics. We address these all below.

As a response to falling inflation expectations, which have tracked the oil price lower recently it would appear the Federal Reserve is now reconsidering plans for gradual rate hike increases into 2019. Although December's Rate hike would appear to be a certainty various Federal Reserve members, including the chairman, have been indicating that any subsequent moves will be very much data dependent. This change in language has seen market expectations begin to price in only one rate hike in 2019. The collapse in oil prices and subsequent fall in inflation expectations has given them the breathing space they required. As one of the key fears amongst equity market participants entering into next year was a Federal Reserve that would over-tighten and kill the economic cycle, this is a key development.

The much anticipated G20 meeting began at the end of the month. Although specific details are still to be worked out, the friendly tone and commentary out of both the US and China indicate a severe de-escalation of the shorter term trade tensions. This decreases the probability of a so called trade war. Longer term issues between the world's two superpowers, especially over intellectual property will remain but the tariff related concerns are the closest they have been to being resolved.

The Italian budget stand-off versus the EU also appears to be de-escalating with the militant stance taken by the coalition in Italy over its budget spend lessening every day. The EU has initiated its excessive deficit procedure. The initial Italian response was however more conciliatory then would have been feared. They have offered to reduce their budget deficit to 2% from 2.4%. This is far closer to the desired level of 1.9% by the Europeans. On a separate note Britain and the EU agreed the text of a withdrawal agreement. Although a positive step, it appears unclear as to how the prime minister can win the approval from Parliament. Although the possibility of a hard Brexit appears to be lessening by the day, particularly in the wake of a European Court ruling that the UK can unilaterally revoke Article 50, the actual solution and future relationship between the two sides appears as uncertain as ever.

Even before these macro positives the corporate backdrop was much more positive than the market pricing would indicate. Despite the volatility in asset markets, high levels of corporate profitability continue to be evident, with all regions likely to record robust earnings growth this year. Analysts' earnings estimates for 2019 remain relatively unscathed, a feat which is much better than the historical norm. Economic indicators, especially those out of the US continue to point towards strong growth in the future. In spite of the numerous political developments over the summer, growth expectations in the US have been revised higher over the course of the year. Wage growth is finally coming through and overall levels of employment remain at historic highs. It is clear however that asset prices globally are increasingly pricing in an end of the global upswing. We feel this is premature. This cycle has been long but it also has been an incredibly shallow recovery by historical standards. Recent policy measures out of China, which constitute both significant fiscal and monetary stimulus, will eventually feed through into not only Asian activity data but will also have a positive effect around the world.

The portfolios continue to hold overweight positions in cyclical sectors such as industrials, energy, materials and technology. These sectors continue to grow their earnings quicker than the overall market, benefitting from both cyclical and structural growth tailwinds. In light of the recent sell off the relative valuation of cyclical sectors versus the market and their more defensive peers have reached extremes usually associated with the depths of recessions. If there is a material slowdown in global growth coming it would appear the equity market has priced a large part of it in. We are underweight positions in defensive sectors such as consumer staples, telecoms and utilities whose valuations are under pressure from rising bond yields. Globally equity markets have now de-rated substantially over the course of 2018 as they have sold off in spite of a strong earnings backdrop. The absolute valuation is at levels that is very compelling based on any reasonable medium term investment horizon. We remain underweight bonds. Within bonds, we have switched some holdings into inflation linked bonds. These will provide protection against future inflation.

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