MERRION INVESTMENT MANAGERS

CANTOR Fitzgerald

Strategy & Outlook MARKET UPDATE

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The dust has settled on what was, by any measure an extremely poor month for global equity markets. Asset classes around the globe suffered moves on a par with the height of the global financial crisis of 2008 and 2009 when global GDP growth went into freefall. At one point, the US market was down by more than 10%, Japan by more than 12%, Europe by 9% and Emerging markets by more than 11%. After such a period of volatility it is only natural to try and take stock of the aftermath, to best assess what has happened and what is the appropriate positioning looking forward. The current economic backdrop is very different from 2008/2009 with global trade indicators continuing to make fresh highs. In fact, consumer confidence and business activity indicators in the world's largest economy, the US, reached their highest level in a decade during Q3. The only material sources of economic concerns stemmed from the auto sector in both Europe and China which was driven by new global emissions regulations in Europe and a crack-down by the authorities on peer to peer lending in China. Despite this strong economic backdrop, markets have become extremely sensitive to the uncertainty created by the politically motivated potential trade war as well as being fearful that a US Federal Reserve intent on normalising monetary policy is going to push the US economy towards a major growth scare or even a recession.

Whilst the US Tax reform was undoubtedly positive for global markets the more recent actions out of the current US administration have increased market volatility noticeably and dented investors' confidence considerably. An adversarial stance towards traditional allies over long standing trade has the potential to undo all the benefits of the pro-business/ pro growth policies which were implemented towards the end of 2017. However it is worth noting significant progress has been made in negotiations with both the EU and NAFTA. Relations between the US and China appeared no better until very recently. However a recent thawing of tensions has emerged, particularly from the US side as President Trump and XI Jinping conducted their first phone call since May last week. Emerging market currency weakness, which was triggered by ongoing trade tensions with the US but rooted in economic mismanagement and a lack of domestic central bank credibility in Argentina and Turkey has subsided somewhat. Italian political risk however remains high as the populist coalition of Italy continues to push the boundaries of what is acceptable within European budgetary rules.

Despite the volatility in asset markets, levels of high corporate profitability continue to be evident. 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 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.

Recent inflation indicators out of the US would suggest that inflation rates will continue to remain elevated but contained. This data is likely to keep the US Federal Reserve on track for normalising policy but does not suggest that they are under pressure to accelerate the rate of tightening anytime soon. Based on the Federal Reserve's own guidance for future interest rate hikes in the coming years, the current hiking cycle is extremely shallow compared to recent prior rate hike cycles. In fact, current real interest rates in the US, after adjusting for inflation, remain extremely low and are currently hovering around 0%. It is for these reasons that we do not expect US central bank policy to have a hugely detrimental effect on US growth as is currently feared by the market.

The portfolios 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 now, after the events of last month 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 events of October brought the absolute valuation to levels that are 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.

Among the risks to the outlook are the political and trade concerns previously outlined in Europe and the US, stalling Brexit negotiations, or a sharp increase in US bond yields that causes financial conditions to tighten too quickly and causes a material growth shock.

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