MERRION INVESTMENT MANAGERS

CANTOR Fitzgerald

Strategy & Outlook MARKET UPDATE

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Strategy & Outlook What are the three pillars of the Merrion Investment Managers investment process telling us about the outlook as we enter into the second quarter of 2019?

Macro Analysis: The outlook for global growth has deteriorated, despite the dovish tilt from global central banks. It is clear that the combination of Brexit, trade concerns, bad weather and the US government shutdown have had a reasonably large impact. The change in tune from the US Federal Reserve, coupled with the renewed dovish tilt from the ECB and yet more stimulus measures from the Chinese authorities go some way to offset these concerns, but the prolonged period of uncertainty with trade talks taking longer than expected and no clarity whatsoever in terms of the Brexit process muddies the waters in the short-term. A particular concern that remains is the European economy. Whilst employment growth should support the consumer, Italy entered a technical recession in the fourth quarter (two quarters of negative growth) and Germany barely avoided one.

Businesses are more likely to hold off on investment plans in a period of such heightened uncertainty, which means that in the short-term it is difficult to see a renewed upswing in the European economy. If Brexit can at the very least be resolved in a positive way and a trade deal between China and the US concluded this would no doubt be a positive for the global economic outlook, but neither of these outcomes appears imminent. Add to that the possibility of renewed trade tensions between the US and Europe (auto and agriculture related) post conclusion of a Chinese trade deal, and the outlook is clearly more clouded than it was a few months ago.

Valuation Analysis: Equity indices have had a very strong start to the year, and are clearly no longer as cheap as they were, yet valuations do not yet appear stretched. The US market trades on a PE of 16.5x, Europe on 13.7x, China on 11.6x and Japan on 12.2x. If global growth can hold up, these remain attractive multiples for the medium term investor, particularly if earnings can continue to grow. Recent leading indicators of earnings would indicate that the pace of recent downgrades has slowed, but they are still negative. Furthermore, the global equity dividend yield remains high by historical standards, which suggests further upside - over the last 30 years, when the global median dividend yield of stocks was close to the current level (2.41%), global equities averaged a return of +23% in the next 12 months. However there is enough evidence to warrant some short-term caution given continued downgrades, the weaker global economy, trade and Brexit.

Technical Analysis: Having staged an impressive rally off significant support levels in December, the MSCI world in Euro terms is testing resistance from last year's high. Given many indices are now overbought and there are significant bearish divergences the risk reward for equities has decreased since the start of the year. Divergences include the following: the number of stocks above their respective 200 day moving averages is considerably lower than when market traded to similar levels last September; US small cap and mid cap indices have lagged considerably in the recent rally; equal weighted indices have failed to confirm recent price moves in underlying indices; major global indices such as the Dax and Nikkei remain in bearish medium term trends; important economically sensitive sectors such as transports and financials have been relatively weak.

A number of sentiment measures are also no longer supportive include the AAII Bull bear survey, DSI sentiment data, put-call ratios and most worryingly investors are now more short volatility than at market peaks in 2017 and 2018. This is at a time when the MOVE index (interest rate volatility) has rallied over 40% from recent lows.

Technically the market rally was led by pro-risk, pro-cyclical equities, but more recently as we approached resistance, economic concerns resurfaced, global bond yields have fallen, defensive sectors have begun to outperform and market breadth has declined. On the positive side, the overall investor participation still appears quite limited. In fact, what has been most interesting to note from the year to date rally is that it has actually been accompanied by outflows from risk assets. If markets were to break out above resistance levels with breadth confirming, the technical outlook would be more constructive and more investors would likely put money to work. Regionally, emerging markets and the US look more attractive technically compared to Europe, Japan or the UK. On the currency front, the technical outlook for the USD is now more constructive with the USD looking bullish against most currency pairs and this is despite the very dovish Federal Reserve.

Summary: In summary then, valuations remain attractive for the medium term investor, assuming economic growth continues, whilst from the technical perspective equity markets have bounced off significant long-term support, but have approached resistance amid declining breadth. Risks around trade and Brexit are impacting on economic data, and after a very strong start to the year risk reward is no longer as favourable as it was.

Brexit remains the main short-term risk facing markets, with still no clarity on what deal the UK will agree to, or even what sort of deal they want. A long extension, whilst positive in the short-term, merely prolongs the uncertainty for the UK in particular. In the US, the Federal Reserve has managed to move to full dovish mode, and this has assuaged market fears. Their decision to adjust balance-sheet normalisation in light of economic and financial developments adds to the dovish message. Of the other major concerns, the US-China trade issue at this stage appears to be dragging on, rather than getting closer to a resolution, though this could change very quickly. A positive resolution would undoubtedly give a significant boost to sentiment, particularly as concerns about trade between the world's two largest economies have undoubtedly had a material impact on growth expectations. However as mentioned before, there is a not insignificant risk that President Trump's attentions turns towards Europe post conclusion of a deal with China.

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