MERRION INVESTMENT MANAGERS

CANTOR Fitzgerald

Strategy & Outlook MARKET UPDATE

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Outlook: What are the three pillars of the Merrion Investment Managers investment process telling us about the outlook?

Macro Analysis: The outlook for global growth has continued to deteriorate. The dovish tilt from the US and European central banks and yet more stimulus measures from the Chinese authorities generated some confidence that sluggish growth at the beginning of the year would mark the low point, but the prolonged period of uncertainty, with trade talks apparently stalled, tariffs rising and rhetoric worsening, in addition to the long-drawn out Brexit saga significantly lowers the probability of that second half revival. Indeed, GDP growth in Q1 appeared at first glance to be stronger than expected in the US (and the UK), but it is very clear that inventory build flattered the numbers significantly, a trend that has been confirmed in many company reports, particularly in the semi-conductor industry. Global PMI indicators suggest ongoing weakness in the months ahead, as do flattening yield curves. We have been saying for some months that 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 (as we have also been saying for some months) neither of these outcomes appears imminent.

Valuation Analysis: Given the rally in equity markets year-to-date and the continued downgrading of earnings estimates, valuations were beginning to look a little stretched a month ago. Despite the drop in equity markets, valuations are not overly attractive. The US market trades on a PE of 16.0x, Europe on 13.5x, China on 10.8x and Japan on 12.1x. Given the weaker outlook for both global growth and earnings, equity markets will struggle to maintain these multiples. Leading indicators of earnings would indicate that the pace of recent downgrades has perhaps slowed, but they are still negative. A feature of the last earnings season was the apparent pick-up in negative operating leverage, with companies' margins being impacted by rising labour and input costs, something which won't be helped by tariffs and the perceived trend towards de-globalisation, no matter how temporary. Inventories have also risen across a number of industries. All of this will continue to pressure what remain quite lofty and elevated margins.

Technical Analysis: The outlook from our technical analysis has deteriorated over the past month with market breadth narrowing further and many indices breaking support levels. The Russell 2000 and Midcap indices which we had highlighted as concerns have started to underperform again and Transports have been notably weak. Although some sentiment measures such as the AAII Bull bear survey are no longer bearish we have yet to see spikes in the put-call ratios / volatility indices that coincide with a tradeable market low.

The view remains constructive on the US dollar against most major pairs and as anticipated this has weighed on emerging markets. Base metals are also trading in downtrends which convey a poor macro demand outlook.

Bond yields globally look like there is further downside which should support more defensive sectors over cyclical sectors. The technology sector which had been one of the leaders has started to underperform with the semiconductor sector notably weak. Many US yield curves have also inverted which warrants a more cautious stance going forward.

A normal pullback should see markets retrace between 38.2% and 61.8% of the prior rally implying further downside to equities. It is also worth highlighting that following US equity first quarter rallies of more than 10%, the median pullback over the next 9 months has been 9%. Many European equity indices look to be forming topping patterns implying downside from current levels.

Summary: In summary then, the economic outlook is uncertain and valuations remain unattractive given weaker economic growth and earnings outlooks and the technical outlook has deteriorated further. Risks around trade and Brexit have been impacting on economic data for some time, and are likely to continue to do so, now with the added headwind of large inventory builds.

With the resignation of Theresa May, the risk of a no-deal Brexit has increased, thus further increasing the uncertainty for the UK, and for Europe. The US-China trade dispute at this stage appears to be escalating rather than edging towards a resolution, though this could change very quickly. Given the escalation over the last month, any resolution at this stage would undoubtedly give a short-term boost to sentiment. However there is a not insignificant risk that any such deal ultimately disappoints, and that President Trump's attentions turn towards Europe post conclusion of a deal with China.

Positioning: Having reduced our overweight position in growth assets back towards a more neutral stance late in the first quarter, we reduced the overweight positions in cyclical sectors and increased exposure to consumer staples over the course of April. Towards the end of the April, we further reduced our exposure to growth assets, moving to an underweight position, reducing our overweight in Emerging Markets and technology, investing some of the proceeds in healthcare in order to reduce the underweight in this sector which had performed very poorly but reached interesting support on a relative basis.

We moved to an even more defensive stance early in May, reducing our growth asset exposure towards the lower end of permitted ranges, reducing cyclical exposure again to give a more defensive bias. We continue to hold this position.

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