MERRION INVESTMENT MANAGERS

Strategy & Outlook MARKET UPDATE

August 2019

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 not improved. With interest rates globally already very low or negative, there is a limit to how much monetary policy can do, and the prolonged period of uncertainty over trade, a significant inventory-build globally in the first half of the year, declining growth in business investment in addition to the seemingly never-ending Brexit saga creates significant headwinds to the chances of that second half revival. Global PMI indicators continue to suggest weakness in the months ahead, as do flat yield curves, with bond markets pricing a very pessimistic outcome for global growth and global inflation. 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. The former appears to have taken a turn for the worse, not better over the last month, whilst the latter is showing no significant progress.

Valuation Analysis: Given the rally in equity markets year-to-date and the continued downgrading of earnings estimates, valuations look unattractive, particularly as we continue to expect further downgrades to earnings. The US market trades on a PE of 17.5x, Europe on 14.0x, China on 11.4x and Japan on 12.6x. 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. Of particular note were the significant downward revisions to corporate profits in the US National Income and Product Accounts, the downward revision being entirely in domestically generated profits. With trade tariffs impacting on the international sector, corporate profits are likely to remain under pressure, particularly as growth slows.

Technical Analysis: The technical outlook for risk assets at the beginning of July was more constructive, as several market breadth measures as well as extreme outflows / sentiment pointed to further equity market upside. As the month progressed, the risk reward deteriorated as US indices such as the S&P 500 and Nasdaq 100 traded up into upper resistance from potential broadening top patterns which combined with a confluence of weekly and daily Demark 13 sell signals. A number of oscillators also pointed to a market that was extremely overbought.

Furthermore, equity market volumes really deteriorated in recent weeks to levels that marked recent shorter-term tops and the number of stocks at new 52-week highs declined on the recent new US market high. Recent sentiment measures also indicate complacency with both the 5 day and 25 day put ratios complacent and buy side positioning in VIX futures reaching max net short levels since 2017.

As 2019 commenced, the extreme bearish market positioning strongly supported our bullish view on equity markets. As of the end of July this extreme positioning seems to have flipped towards extreme bullish positioning which we now view as a headwind for further upside. For example, the NAAIM exposure index is at 96% and Risk Parity Equity Beta, CTA and Hedge Fund equity beta are all near the top end of historical ranges.

It's important to monitor the 2950 level on the S&P 500 as a close below should see further selling as systematic / stop losses could exacerbate a market decline. Over the past decade systematic strategies have tripled in size to a staggering $900bln.

Despite a dovish Federal Reserve, the broader USD index has broken out above the recent trading range and there looks like more upside momentum ahead, particularly against sterling.

Summary: The economic outlook remains weak, valuations are unattractive, and the technical outlook is indicative of a stretched market. Equity market strength year-to-date leaves them at or near all-time highs on major indices. These gains have been predicated on the expectation of a second half revival in economic growth and earnings, an outcome that is looking increasingly less likely, particularly as we approach yet another Brexit deadline, there remains no clarity on trade and there is a significant headwind in terms of inventory build.

With Theresa May being replaced by Boris Johnson, 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 is giving no appearance of nearing a conclusive deal, with just a four-hour meeting to report in the last month. There remains a not insignificant risk that any deal ultimately disappoints, and that President Trump's attentions turn towards Europe post conclusion of a deal with China.

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