MERRION INVESTMENT MANAGERS

CANTOR Fitzgerald

Strategy & Outlook MARKET UPDATE

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It (still) remains difficult to see how the ongoing trade friction between the US and China, Brexit uncertainty and geopolitical risks in the Middle East is a positive for economic momentum, despite the apparent willingness of central banks to ease monetary policy. Given the extraordinary rally in equity markets since the beginning of the year valuations remain unattractive, particularly given ongoing downgrades to earnings estimates. Overall, this makes risk-reward unfavourable.

Medium term the only area of apparent support for the global economy in the form of dovishness from central banks, but as ECB President Draghi acknowledged at the last ECB meeting, there is a limit to the effectiveness of monetary policy. It is worth reiterating that the market rally in the first half of the year was predicated on a second half revival of economic fortunes globally, and a subsequent turn in earnings expectations. We are now well past the mid-point of the year, economic data remains weak, earnings estimates continue their downtrend but still look highly optimistic.

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 over the last month. With interest rates globally already very low or negative, there is a limit to how much monetary policy can do, and it remains the case that 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 (yet another) rapidly approaching Brexit deadline create significant headwinds to the chances of a near-term revival. Global PMI indicators continue to suggest weakness in the months ahead, as do flat / inverted yield curves, with bond markets pricing an even more pessimistic outcome than a month ago for global growth and global inflation. We have been saying for some months that the removal of the two main headwinds to global growth (Brexit and the trade war) would no doubt be a positive for the global economic outlook, but unfortunately both have taken a significant turn for the worse.

Valuation Analysis: Despite August's sell-off, equity markets have maintained most of their year-to-date gains and are within shouting distance of all-time highs. However, earnings estimates have been revised down substantially, are still in a negative trend, and estimates for next year look wildly optimistic to us, leaving an unsustainable gap between likely earnings growth and earnings multiples. Valuations - still close to the highs of the last decade whilst margins, earnings and growth are under pressure - look unattractive. The US market trades on a PE of 16.9x, Europe on 13.9x, China on 11.0x and Japan on 12.0x. Given the poor outlook for both global growth and earnings, equity markets will struggle to maintain these multiples.

Technical Analysis: The outlook from our technical analysis remains cautious. Although headline index levels have so far held the support provided by the low in May, the market internals are very concerning. At a broad level, these internals include the outperformance of defensive sectors over cyclical sectors. More specifically, the renewed outperformance of consumer staples and utilities and the ongoing underperformance of Europe's banks and global energy are a major cause for concern. Furthermore, the collapse in bond yields globally, particularly at the long end of bond markets confirms the negative message from the equity market internals discussed above.

Summary: The economic outlook remains weak, valuations are unattractive, and the technical outlook advises caution. Equity market strength year-to-date leaves markets close to all-time highs on major indices, with valuations at close to decade-highs. The year-to-date gains have been predicated on the expectation of a second half revival in economic growth and earnings, in turn predicated on a resolution of the trade conflict. This outcome looks unlikely, and if anything has become even less likely over the last month, with both trade tensions and the likelihood of an imminent hard Brexit increasing.

Positioning: We therefore remain defensively positioned, underweight growth assets (at the lower end of permitted ranges) and with a defensive bias within those growth assets. Our concerns have been growing over the last few months, and recent developments only serve to further heighten those concerns.

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