

Strategy & Outlook MARKET UPDATE

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 deteriorated further 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 is clear that the prolonged period of uncertainty over trade has had a significant dampening effect on global growth. Global PMI indicators have weakened further and more worryingly for Europe in particular, the weakness in manufacturing (trade related) appears to be seeping out to weakness in the service sector. 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 neither appears any closer to a resolution.

Valuation Analysis

Although equity markets are close to all-time highs, earnings estimates continue to slide lower and remain in a negative trend. Estimates for next year look too 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 17.1x, Europe on 14.3x, China on 11.1x and Japan on 13.1x. Given the poor outlook for both global growth and earnings, equity markets will struggle to maintain these multiples.

Technical Analysis

Entering October, the technical outlook remains cautious with the MSCI World in Euro terms overbought at the top of its trading channel and other major indices such as the S&P 500 trading at resistance from the top of the "Broadening pattern" that has been in play since January 2018.

Some bearish divergences have developed such as the Bloomberg US Financial Conditions Index diverging from the broader equity indices and the US IPO index already rolling over which warns of potential downside for the overall market.

Seasonality remains a headwind with equity markets in pre-election years tending to peak in late September and not bottoming until close to Thanksgiving.

A recent Fund Manager Survey highlighted that European fund manager cash levels are at their lowest level since early 2018 and combined with recent inflows into ETFs and Mutual Funds this would argue that investors are more complacent than many would suggest.

Despite the recent sudden shift from growth stocks into value stocks, the medium-term trend for growth stocks as well as defensive/quality factors remain in play. Government bond yields remain in a downtrend which should continue to support these trends.

The Dollar Index remains strong and is at new year-to-date highs and emerging market currencies including the Chinese renminbi looks poised to underperform which supports the case to remain underweight emerging markets and global stocks with high emerging market exposure. Furthermore, we continue to see price weakness across base metals such as aluminium and copper.

Summary

In summary then, the outlook has not changed over the last month - the economic outlook remains weak, valuations are unattractive, and the technical outlook advises caution. Equity markets are close to all-time highs on major indices, with valuations at close to decade-highs. The hoped-for trade resolution appears unlikely in the short-term, Brexit has yet to be resolved, earnings estimates continue to slide but still look optimistic for next year and technically the market looks stretched and vulnerable to a decline.

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