MERRION INVESTMENT MANAGERS

Strategy & Outlook MARKET UPDATE

November 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 unfortunately not improved over the last month. The prolonged period of uncertainty over trade has clearly had a significant dampening effect on global growth. Whilst this has been felt most severely in the manufacturing sector, the duration of the uncertainty appears to be impacting on the much larger service sector. This is concerning as one area of strength in the global economy this year has been the consumption. The US consumer has been remarkably resilient, contributing more than 100% to the last two quarters of US GDP growth (other components being a drag on growth). Steady employment gains and moderate wage growth have clearly lent support, but the prolonged weakness in global manufacturing now appears to be spilling over into the service sector of the economy and labour markets. Weakness in business investment, corporate profits and elevated corporate debt loads is also a concern.

Valuation Analysis

Equity markets are close to or slightly above all-time highs, yet earnings estimates continue to slide lower and remain in a negative trend. Estimates for next year remain too optimistic, leaving an unsustainable gap between likely earnings growth and earnings multiples. Valuations remain close to the highs of the last decade - the US market trades on a PE of 17.5x, Europe on 14.7x, China on 11.2x and Japan on 13.5x. At these valuation levels, markets have priced a durable recovery in earnings, implicitly implying that the worst of the global growth downturn is behind us. At issue is when this turn in growth and earnings is likely to occur – markets have rallied very strongly off the lows from last December, predicated on a trade resolution and a second half revival in both growth and corporate earnings. This expectation has now been pushed out to 2020.

Technical Analysis

Entering November, 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" which has been in play since January 2018. Many of the major European indices are trading near longer term resistance levels. A number of sentiment indicators are at levels that coincided with prior market pullbacks such as 1) Investors Intelligence % Bulls, 2) DSI (Daily Sentiment Index) & 3) US equity put-call ratios. The fact that the net short in the VIX (Volatility Index) is back to the highs of last few years also highlights complacent investor sentiment. Furthermore, there have been numerous TD Sequential 13 sell signals recorded in the past two weeks across global markets, sectors and single stocks which points to exhaustion of the recent rallies in the shorter term.

The outlook for US bond yields remains negative, suggesting a re-test of the recent lows near 1.5% initially which should see defensive stocks outperform cyclical stocks / financials from this juncture. The dollar Index remains in an uptrend after bouncing from oversold and holding the rising 200 day moving average. Gold and the gold miners look interesting here post recent consolidations.Seasonality is more positive from early November with the period from November to January the strongest 3-month period of any so if indices break out, with market breadth confirming, then the technical view will turn more constructive into year end.

Summary

In summary then, the outlook remains concerning - economic growth remains on a weakening trend, valuations remain unattractive, and the technical outlook advises caution. Equity markets, having reached fresh highs on many major indices on hopes of Federal Reserve action and trade headlines at a time when earnings are under pressure look overvalued. There is of course some hope that the truce in the trade war extends, although accepting a temporary freeze in hostilities that the Trump administration can claim is a victory suggests that even the bulls have given up on any lasting deal. Brexit remains unresolved, though at least there is an agreement, which may be passed once the UK elections are completed in December. But once again we would remind readers that the withdrawal agreement negotiation was the easy part. Ultimately though, if the actions from the Federal Reserve are successful in maintaining the expansion and we get a clear move towards a resolution on trade, earnings expectations will no longer look so optimistic nor valuations so expensive.

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