MERRION INVESTMENT MANAGERS

CANTOR Fitzgerald

Strategy & Outlook MARKET UPDATE

March 2020

February

February saw global equities rising by almost 7% in the first half of the month before collapsing 15% in the latter part of the month to finish 7.4% lower (and down 7.2% year-to-date). This was the most precipitous decline from an all-time high bar none. Only one week during the GFC was worse. When the Germans invaded France, the market fell only slightly more. There were factors beyond the coronavirus that caused this. It is no coincidence that the market once again peaked and then sold off as the Federal Reserve repo operation began to shrink and liquidity was withdrawn. It is also no coincidence that the market sold off post record retail participation, record passive buying and record low levels of put protection in place. Even after Apple profit warned on the entire Chinese economy being shut complacency was still everywhere. With volatility exploding off the lows market makers withdrew liquidity which caused the market to gap lower on every headline (of which there were plenty) which caused panic as the virus narrative took hold. This two day drop at the start of the last week of the month then triggered a bout of retail selling, culminating in over 125bn of one of the most popular US retail ETFS trading on one day alone (by far the most any security ever listed has ever traded on any day).

The initial move higher in equities at the start of the month was accompanied by significant divergence in the price action across different asset classes. The comfort that equity markets got from Chinese stimulus measures (liquidity injections by the PBOC) and what appeared to be a slow-down in the rate of growth of coronavirus infections was in no way reflected in other assets. Commodities such as iron ore, oil and copper did not reflect the bullish equity price action, nor did global bonds, with yields remaining very low, and emerging market FX also continued to move lower. The mix within equity markets where technology, communication services and utilities led the gains whilst industrials and materials lagged significantly was also quite telling. This defensive mix (which we have been highlighting) has been evident for a number of months even as equity indices reached new highs.

Although the recent focus of markets has been on the coronavirus and its impact, other events over the month are also worth noting. The outcome from the Irish general election remains unclear – it appears that the grand coalition of the left, headed by Sinn Fein, is unlikely to reach the required numbers for a stable government, whilst Fianna Fail have ruled out coalition with Sinn Fein and speculation currently surrounds a coalition of Fianna Fail, Fine Gael and either the Green Party or the Social Democrats. It promises to be a long-drawn out process. In the UK, the resignation of the Chancellor of the Exchequer Sajid Javid has led to speculation of looser fiscal policy in the UK, with an emphasis on infrastructure spending.

Outlook

As we have said before, the acceleration in growth that was priced into equity markets in the first half of 2019 has continuously been pushed out over the last year. Any remaining hope for this growth acceleration this quarter (and possibly next) has now been eradicated by the spread of the virus, fear of further constraints on economic activity, and in particular severe supply chain disruptions.

In addition, the consensus outlook for a rapid rebound in earnings, which we always felt was overly optimistic will likely come under further pressure. The key question for investors at this stage is whether enough has been priced into equity markets after the February collapse. The global equity market now trades on a forward P/E of 15.2x, compared with 16.8x in mid-February, the US market on 17x (vs 19.5x), Europe on 14.4x vs 15.8x and Japan on 13x vs 14.2x. Notwithstanding the expected downgrades to earnings estimates, clearly markets are a lot cheaper than they have been since last summer. Added to the mix is the clear shock to global growth. This raises the possibility over an over reaction by monetary and fiscal authorities, particularly in China, and the risk that authorities over stimulate has clearly risen.

Ultimately though, we remain for now in a low growth, low / zero rate, high risk but highly liquid environment, which means portfolios should continue to be focused on factors such as high quality, sustainable structural growth, positive earnings momentum, strong and growing dividends, regulatory tailwinds not headwinds, and insulation from geopolitical risks. These are the factors which will continue to add value to portfolios over time.

Positioning

The merits of active multi-asset investing came to fore over the last month as the defensive side of our portfolio became the focus. Equity markets, as noted above, have sold off aggressively but our above benchmark holdings in Gold, long dated Bonds (especially US bonds) and our holdings in alternative investments have all produced positive returns so far in this sell off. With our equity holdings continuing to outperform the global equity market this means the funds registered another strong month relative to peers and benchmarks, although of course given the scale of a sell-off in equities, returns on the month were still negative. We have been at the lower end of our asset allocation ranges for a number of months, based on our concerns about economic growth, elevated valuations and technically stretched markets. The moves in bond, commodity and FX markets over the last month (before the equity sell-off) were giving an ominous sign for global growth, and seemed completely at odds with investor sentiment, positioning and general analyst expectations. This encouraged us to maintain our defensive posture within the funds.

However, the funds were extremely active very late in the month. Given the scale of the sell-off, towards the end of the month we moved to a neutral level at the asset allocation level (through high quality names/themes we already like / own). Over the course of the last day of the month we took our asset allocation level to above neutral (mainly through liquid market instruments in the alternative fund).

Three aspects of our investment process combined over a 24-hour period to lead us to these changes. From a valuation perspective the moves in asset classes left the equity risk premium at levels which have preceded a bounce in the last number of equity market sell offs. Even long-term valuation measures in the US such as EV/Sales got back to the average levels they have been at for the last 5 years. (P/Es too but with a raft of downgrades to come in 6 weeks' time it's a pretty irrelevant metric for now). The dividend yield pick-up in stocks over treasuries also reached extreme levels which have preceded bounces. (Roughly two thirds of US stocks yield more than the US ten-year bond yield). This coincided with numerous key technical or market-based indicators we look at giving contrarian buy/bottom signals. These ranged from sentiment indicators to options market pricing. This was all occurring while the federal funds market was beginning to price in action ranging from an emergency intra meeting cut to a 50 basis points cut. We also noted with interest how China and Chinese infrastructure stocks in particular outperformed in the last week of the month as the stimulus measures announced from China appear to be gaining traction already. Subsequent action from the BOJ and BOE will fuel the narrative of "global co-ordinated intervention" from authorities.

The markets will continue to be extremely volatile over the next few weeks and months. The economic impact of Covid-19 is still uncertain, Russia/Nato relations have hit a serious crunch point in Turkey, Brexit negotiations have worsened, and Ireland has no government. The merits of actively managed multi asset funds with a proven investment process continue to be evident as we navigate these uncertain times. We will continue to actively manage our risk and our exposures using all available instruments, asset classes and derivative products available to us for everything from short term tactical trades to long term fundamental holdings.

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