MERRION INVESTMENT MANAGERS | CANTOR Fitzgerald

Strategy & Outlook

MARKET UPDATE

NOVEMBER 2021

October: A strong month for equity markets, up 5.4% in euro terms, growth outperforming value (+6.1% vs +3.9%), US outperforming Europe (+7.2% vs +4.7%), emerging markets underperforming significantly, but still positive for the month (+1.2%), and yield curves twisting (short-dated yields higher, long dated yields lower).

Most of the action occurred in the latter half of the month, a dip in markets mid-month being bought aggressively with strong breadth and key indices closing above the 50-day moving average. The strength of the buying was driven in part by benign inflation data from the US and a strong start to earnings season, which has continued, the elevated earnings beat rate helping to offset broader macro concerns on inflation and supply chain issues. Bearish positioning probably exacerbated the move, indicators like the total put/call ratio close to the highest in over a year and short positions in technology stocks close to the all-time high of July 2008.

Much has been written about the supply chains and the spike in inflation, finding its way on to a recent cover of The Economist (The Shortage Economy) and Barron's (Cargo Crunch). But the supply chain disruptions are not all about supply. Supply chains are delivering more than ever, but they cannot keep up with the demand. The Port of LA, much in the news because of the backlog of ships there, had its busiest September ever, and year-to-date cargo volume is 26% higher than in 2020. Recent luxury company commentary suggested a bounce back in demand in China during September, following a weak August (COVID-related). Over Golden Week, duty free sales in Hainan were +75% in 1-6 October on the prior year, and over 300% higher vs 2019. Apple has cut iPhone 13 production goals for the remainder of the year from 90mln to 80mln as suppliers Broadcom and Texas Instruments cannot meet demand. TSMC said "we are witnessing a structural increase in underlying semiconductor demand".

Morgan Stanley's latest CIO survey shows a re-acceleration in 2021 IT budget growth expectations and a positive 2022 outlook, with the trajectory of increasing IT budget growth expectations back on track, CIOs now expecting budgets to grow +4.4% in 2021, up from last quarter's reading of c. 3.8%. IT investment has accelerated exponentially this cycle. This is disinflationary.

So, demand is strong and some parts of the supply chains are curtailed. This adds to short term inflationary pressures. The investment cycle suggests disinflationary pressures on the way in the medium term. Adding spice to the mix is the Chinese property market, Evergrande Group saying its real estate sales plunged about 97% during peak home-buying season, worsening its liquidity crisis as it terminated talks to sell a property management unit for $2.6bln, although the group has managed to avoid default by paying offshore bond coupons before the final deadline. The slowdown in China's property market coupled with the lack of any significant response from the authorities raises concerns about the impact on Chinese growth, with knock-on effects on elevated commodity prices and global inflation expectations.

Indeed, the prices of some commodities have fallen significantly (lumber, European gas prices, steel etc) at a time when the market pricing of future inflation and central bank rate hikes has risen. Bond markets have seen short-dated yields rise, long dated yields fall, and inflation expectations rise. This means long dated real yields are much lower, bond markets thus pricing in more hawkish central banks yet higher inflation, and much slower growth. The ECB and the Federal Reserve are sticking with "team transitory" when it comes to inflation, though they admit that inflation may remain elevated for a little longer than they had initially thought. The Bank of England has broken ranks, signalling it may have to act on rising inflation. Nobody can tell the future. Either inflation is transitory, or it is not. But if central banks hike rates because of a fear of inflation, they may well damage the economic recovery significantly. If they are wrong, and inflation becomes embedded, that at least is an easier problem to fix.

Positioning: Having entered the month at the upper end of our range for growth assets, we reduced growth asset exposure towards the end of the month, the focus of this reduction being emerging markets. Our concerns over Chinese property and commodities, coupled with some very big moves in the bond market have prompted this tactical move. Adding to those short-term concerns, weakening breadth in the US market, a 5%-plus rally month to date (and almost 24% year-t0-date), a clear break to all-time highs, put-call ratio flipping from fearful a month ago to complacent now, active investors' exposure rising dramatically over the last four weeks, a number of technical sell signals being triggered, and taking some risk off the table in the short term is the prudent course of action.

This is a tactical move, results season has been very strong, particularly for companies we favour, and our medium-term view remains positive.

We currently stand just above the neutral point.

In defensive assets, we have added long-dated German bonds and US Treasuries, adding significantly to our bond exposure.

WARNING: Past performance is not a reliable guide to future performance.

WARNING: The value of your investment may go down as well as up.

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