The Investor
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2016 Investment Outlook – Ireland & the World

The world economy continues to stumble along with no great upward momentum. That said, it has demonstrated impressive resilience to negative shocks in recent years, and may do so again following "Brexit".

The first quarter of 2016 was manic for financial markets to say the least. It all started on the very first trading day of the year after new circuit breakers were triggered when the Shanghai Composite Index (SHCOMP) fell 7%. The rest of the first week saw oil drop to a 12 year low with the SHCOMP closing on January 7 after just 15 minutes trading, having dropped another 7%.

The second week did not start well either. Chinese stocks continued to tumble, accompanied by a massive jump in the Hong Kong overnight rate for the yuan. Oil continued to drop. But then as he always does, Mario Draghi rode to the rescue at the January European Central Bank (ECB) meeting in week three by suggesting that the Central Bank could inject more stimulus in March. The ECB duly obliged with further major monetary stimulus and the pick up in oil prices appeared to have steadied stock markets until Britain shocked the world with its momentus decision to exit the EU. Stock markets have fallen sharply since, and the investment outlook remains clouded in uncertainty for the second half of the year.

The impact of the "Brexit" vote, a 52% to 48% decision to leave the European Union, caught markets off balance. The UK has abruptly shifted from being one of the most politically stable countries in the world to facing major questions in the weeks, months and years ahead over its unity, leadership and economy.

However, this should not obscure the fact that there are other risks that threaten an anaemic global economy. Significant questions hang over the EU's future:

- Does it seek to address the democratic deficit which was a factor in the "Brexit" vote?
- Are there any other countries that may opt to hold a similar referendum?

Meanwhile, China's shaky economy, along with upcoming elections in Japan, Russia and the United States may also affect growth.

While it is easy to fall into fear and loathing over world economic prospects, one must remember that the UK's departure is a process and that nothing is going to happen in the short term. The dust is settling and central bankers and policymakers are now scrambling. Significantly the "Brexit" vote was not a Lehman Brothers moment with the risk of a jump to default outcome. It is only one more political risk factor that markets tend to downplay, but political risk is now very much woven into the narrative through the rest of this year and next. This is indeed a shock, but not a showstopper. There is going to be a day after tomorrow, but wearing seat belts is probably a good idea for the immediate future.

Of course, the investment landscape remains littered with potential problems and disequilibria, meaning risk assets and the global economy are still more vulnerable to adverse events than in past cycles. Even so, the world economy has now had two years to digest the collapse in commodity prices and the surge in the US dollar, as well as mounting concerns over China growth, such that conditions and sentiment are gradually re-stabilising. However, sentiment is likely to remain cautious in the aftermath of "Brexit". Investors will need clear data validation that the global economic recovery can be sustained, which will take time and is likely to proceed in fits and starts.

World GDP Forecasts

	2014 (actual)	2015 (actual)	2016 (forecast)	2017 (forecast)
World	3.3%	3.3%	2.9%	2.9%
Ireland	5.2%	7.8%*	4.8%	3.8%
United Kingdom	3.0%	2.3%	1.0%	0.5%
Eurozone	0.9%	1.6%	1.5%	1.2%
United States	2.4%	2.4%	2.0%	2.4%
Japan	-0.1%	0.5%	0.7%	0.8%
China	7.4%	6.9%	6.5%	6.4%

* *The Irish economy grew by 26.3% when coporate inversions are included.*

Source: Merrion 30.06.2016

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Current Irish GDP Forecasts

	2016 (forecast)	2017 (forecast)
Department of Finance	4.9%	3.9%
Central Bank of Ireland	5.1%	4.2%
ESRI	4.6%	4.2%
IBEC	4.6%	3.9%
IMF	5.0%	3.6%
European Commission	4.9%	3.7%
OECD	5.0%	3.4%

Source: Merrion 30.06.2016

Ireland

Ireland's economy grew by 26.3% last year and not the 7.8% initially estimated after the level of capital assets included on the state's balance sheet was revised dramatically, according to the Central Statistics Office (CSO). An increase in the number of aircraft imported into Ireland for international leasing and the reclassifications of entire balance sheets, for example through corporate inversions into Ireland, were among the main reasons given by the CSO. Such "inversions" have increased in recent years. Companies have sought to slash their tax bills by re-domiciling overseas, with their core operations and management usually remaining in the original jurisdiction even as they claim a new tax home.

The main indicator of the health of an economy is its unemployment rate, and while Ireland's has improved sharply (now just under 8%) post the financial crisis, it is still well above where it was during the "Celtic Tiger" era. As was evident during the recent election campaign there is a disconnect between the views of the Government and the ordinary man and woman in the street with regard to the economy, and these latest numbers will only add to the sense of "fantasy". Although the numbers look great on the surface, there is a real credibility issue here.

Analysts and commentators continuously question the reliability of high single digit Chinese GDP growth. They are going to have a field day with the latest Irish data! The figures couldn't come at a worse time as economic analysts try to gauge the impact on Ireland from "Brexit", and this is going to become much more difficult after the revised numbers for last year. The new GDP numbers won't help policymakers either, as more and more people will be looking for a piece of this "super growth pie", likely leading to overly aggressive demands on the wage front, which if granted will do far more damage than good to the economy in the long run.

Still, the indicators for the early part of 2016 point to another very good year ahead for the Irish economy despite some global headwinds. However, growth in the second half of the year is likely to be weaker than the first after the "Brexit" referendum. Given their high dependence on the UK, the agri-food and tourism sectors look particularly vulnerable in the short term as sterling depreciates and British consumer demand weakens. Down the road, Ireland may benefit from increased foreign direct investment when the UK leaves the EU. But it is all very much up in the air at this juncture and too hard to predict. Meanwhile, the labour market continues to recover with the unemployment rate now just slightly more than half the 15.1% peak in early 2012. Indeed, the jobless rate is likely to be running at close to 7% come the end of this year. Looking at the overall picture, it looks like Irish real GDP growth will be 4.8% this year and 3.8% in 2017.

Europe

Meanwhile, the Eurozone labour market is strengthening, with employment growth in a solid uptrend, and unemployment falling steadily. This should enable consumer spending growth to remain firm or strengthen over the balance of the year. A strengthening Eurozone economy would be a significant boost to the global economic outlook. As with manufacturing, global trade remains a weak spot. Nominal data is somewhat difficult to interpret because of unique commodity price, currency and demand factors, but on balance trade is subtracting from, rather than adding to world growth. US non oil imports, Chinese non commodity imports, and intra euro area trade are likely to gradually revive, which would reinforce other positive global growth trends. That said, trade has consistently surprised on the downside in recent years, warranting caution. China's industrial sector has been stabilising in recent months in response to policy support and a very small increase in housing construction. A continuation of this trend is crucial to enable global investors to gain confidence in the durability of the world economic recovery.

UK economic growth has slowed, and following "Brexit" is now projected to be just 1% in 2016. Uncertainty about the outcome of the referendum undermined growth in the first half of the year. With the UK voting to leave the European Union, growth is projected to weaken in the second half of 2016 before stabilising somewhat in 2017. The unemployment rate has fallen to around 5%. However, the current account deficit has reached 7% of GDP, the highest level on record, increasing vulnerabilities. Fiscal consolidation now looks set to ease, which is appropriate given a weaker economic outlook. Capacity pressures have abated and should remain contained, but the recent exchange rate depreciation will push up prices.

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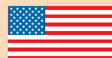

United States

The Federal Reserve is in danger of becoming absurdist. The US Central Bank at its most recent meeting on June 15 decided to hold interest rates steady at 0.25% to 0.50% for the fourth time this year. Fed Chair Janet Yellen and her colleagues seem to be waiting for perfect conditions in global markets. However, that convergence may never happen: there are always uncertainties. The May employment figures were poor at 38,000 new positions, which was much lower than expected. But Yellen herself warned just after the release against putting too much emphasis on a single monthly statistic. This proved to be correct, as June's employment figures at 287,000 new positions exceeded expectations.

The UK's referendum on leaving the EU was potentially a worry, but it had been on the horizon for some time. Another concern could be a steeper than expected slowdown in China. The Fed meeting in September could be complicated by the US Presidential election in November. If unpredictable Republican Donald Trump surges in the polls against Democratic rival Hillary Clinton, investors will get nervous. Moreover, some of the Fed's conditions for further rate increases have been met. The US is nearing full employment with the jobless rate at 4.7%, while wages rose in May for the third straight month. The absence of inflation supports the Fed's stance. The shortage of fiscal initiatives to boost the economy is another reason to err on the side of caution. But growth is steady and Yellen needs to remain credible. Changing the explanation each time the prospect of the next hike recedes isn't sustainable.

In March, the Central Bank scaled back its forecast from four increases this year to two. In the run up to the most recent jobs report, Fed officials including Yellen indicated a hike could come as early as June, but the Fed changes its tone so frequently, it seems every other week the message is different. It is hard to see any US rate increase this year given the Fed's dovish nature.

Indeed, a reversal of last December's 25bps rate increase now looks more likely at some stage over the next six months if financial markets don't stabilise after the "Brexit" vote.

China

China's retail sales will grow about 10% annually from 2016-2020 to reach 48 trillion yuan ($7.18 trillion) by 2020, according to the country's Commerce Ministry. The growth rate would be considerably slower than the 13.9% annual growth rate seen during the five years through 2015. China's economy faces downward pressure, with falling corporate profits impacting individuals' income growth, hurting consumption. Inadequate supply of mid and high end goods also puts a dampener on spending, the Ministry said in a statement discussing the Government's five year plan for commerce. By 2020, China's service trade volume will exceed $1 trillion.

China will have difficulty maintaining the current levels of foreign investment inflows in 2016-2020, while cumulative outbound investment will reach $720bn. Foreign direct investment (FDI) into China jumped 9.7% in June from a year earlier, hitting a 10 month high, according to the latest official data. In the first half of 2016, FDI rose 5.1% from the same period a year earlier to $69.4bn. Overall, though, the economy continues to slow down, posting its weakest GDP growth in 25 years in 2015 at 6.9%. Growth looks set to fall to around 6.5% over the next couple of years.

Japan

Of the major economies, Japan remains the biggest worry at this stage. Japan is in need of further monetary stimulus given the recent re-emergence of deflationary pressures and lacklustre economic momentum, combined with the yen's strengthening bias and soft equity prices. In early June, Prime Minister Shinzo Abe announced that the consumption tax rate hike from 8% to 10%, scheduled for April 2017, will be postponed until October 2019 and that a second supplementary budget will be unveiled over the coming months.

Shinzo Abe's coalition Government and the Bank of Japan are the targets of intense speculation over hopes they will press ahead with at least ¥10 trillion ($98bn) of stimulus, setting off a rally in Japanese equities. Abe was returned to power in the Upper House election on July 10, emerging with an unexpectedly strong majority and the power of constitutional change, defying the trend elsewhere around the world of stronger support for alternative parties and the erosion of mainstream political capital.

The Bank of Japan moved to negative interest rates in January, but any benefits of the contentious policy move have been countered by the appreciation of the yen. Some analysts believe Japan could be ready to test helicopter money, a direct form of stimulus. Any form of stimulus would be good for the Japanese economy and its stock market in the short term.

Market Performance: 01.01.16 to 30.06.16

Market	Index	Local Currency	Euro
World	FTSE (€)	-0.4%	-0.4%
Ireland	ISEQ	-15.3%	-15.3%
UK	FTSE 100	5.4%	-7.3%
Europe	FT/S&P Europe Ex. UK	-8.9%	-8.9%
US	S&P 500	2.9%	0.4%
Japan	Topix	-18.9%	-6.5%
Hong Kong	Hang Seng	-5.1%	-7.0%
Bonds	Merrill Lynch Euro over 5 years	9.2%	9.2%

Source: Bloomberg: 01.01.16 – 30.06.16

Negative Interest Rates

While negative interest rates might seem paradoxical, this apparent intuition has not kept a number of European Central Banks from giving them a try.

The Great Recession ended in June 2009, but seven years later, one of its lasting legacies seems to be anaemic economic growth. The International Monetary Fund (IMF), in its World Economic Outlook report of April 2016, bemoaned the fact that global growth has been "too slow for too long." The IMF cited unfavourable demographic trends, low productivity growth, and the fallout from the global financial crisis as factors hampering growth in the advanced economies.

Many nations have adopted increasingly unconventional monetary policies to stimulate their economies and jumpstart growth. Of these measures, negative interest rates are arguably the most controversial. The Bank of Japan, the European Central Bank and several smaller European authorities have ventured into this once uncharted territory. So sharp has been the reaction that a 10 year German government bond now yields less than zero: an investor who lends to the German government for a decade will lose money.

How do negative rates come about?

Negative interest rates are probably not coming to a Main Street near you in the near future. However, in the Eurozone, Denmark, Sweden, Switzerland and Japan, Central Banks have decided to place a negative rate on commercial banks' excess held on deposit at the Central Bank. In effect, private sector banks have to pay to park their money.

In the case of Sweden, the Central Bank has gone below zero on the rate it lends money to the banks, its main policy tool to raise inflation. The aim in the Eurozone is to stimulate economic growth and to raise inflation, which is also below zero and even further adrift of the European Central Bank's target of below but close to 2%. In Denmark and Switzerland the immediate objective has been to prevent the currency rising too much. The idea of lower and negative interest rates is to discourage investors from buying the local currency, which tends to push its value up. These policy decisions are the actions of Central Banks whose job it is to keep inflation under control and to support economic growth and employment.

How low could rates go?

Investment (as a share of national income) is below its pre-crisis levels in the great majority of rich countries, and by a hefty amount in some cases. If there is less demand for money to fund new investment, the cost of borrowing tends to be lower. So will interest rates go even further into negative territory? Most negative rates are between zero and -1%. To most people, "interest rates" means the rates paid on things like mortgages, car loans or credit cards. These rates are obviously positive and sometimes quite high.

A notable exception is government bonds. The yield on a government bond is, in effect, the amount an investor gets paid for lending to the government. Yields across the developed world have been sinking for years, but the move to negative rates has accelerated the drop. On June 14 2016, the 10 year German government bond slipped to a yield just below zero for the first time. The 10 year bund, as it is known, is the benchmark bond in the Eurozone. The yields now prevailing on government debt are almost certainly the lowest seen in recorded history.

So why would anyone buy a German government bond yielding less than zero?

1. Safety
2. A lack of other options

When short term bank rates are near zero, then perhaps giving your money to Germany for 10 years at -0.18% isn't so bad: at least you will get most of your money back. What's more, there's essentially zero inflation in Europe, and little on the horizon, so your purchasing power won't be too badly dented either.

The bottom line

When the Eurozone inflation rate dropped into deflationary territory at -0.6% in February 2015, European policymakers promised to do whatever it takes to avoid a deflationary spiral. Two years into the experiment, it is still too early to tell if negative interest rates will work, but central bankers say that so far the costs have been manageable. The Bank for International Settlements warned in a March 2016 report of "great uncertainty" if rates stay negative for a prolonged period. However, the fact that such tools have now been tested means they are likely here to stay.

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