The Investor
Summer 2019

2019 Investment Outlook – Ireland & the World

Growth in the global economy at the beginning of 2019 proved to be much stronger than anticipated at the end of 2018 as the world economy grew 3% annualised in the first quarter.

At the end of 2018 widespread fears were evident over a possible global recession in 2019. These fears had contributed to sharp falls in equity markets during the fourth quarter and particularly in the last month of the year when the S&P 500 experienced its worst December since 1931, by falling over 9%. However pessimism quickly turned to optimism at the beginning of 2019, mainly due to two factors: firstly, a policy pivot by the US Federal Reserve whereby it decided not to raise interest rates and secondly, growing hope of a trade deal between the US and China.

The policy U-turn by the Federal Reserve was followed by other global central banks with many also adopting more accommodative policy stances. The European Central Bank (ECB) was among these as it pushed back formal guidance for the first interest rate rise to at least the beginning of 2020. This policy shift by global central banks removed a significant risk as it greatly reduced the prospect of higher interest rates and additional policy tightening restraining growth.

Following the significant rebound in equity markets over the early months of the year on the back of improved economic sentiment, markets fell in May with the surprise collapse in trade talks between China and the US. Threats of tariffs on Mexican exports to the US and rising tensions between the US and Iran also contributed to the weakness in equity markets at the time.

In response to the renewed threats from trade in an environment where economic releases had begun to display some signs of a slowdown, the Federal Reserve once more announced a shift in its policy stance in June. It suggested that the case for additional policy accommodation had strengthened following recent economic developments and the persistence of inflation well below its 2% target. It indicated policy would be adjusted appropriately to ensure the economic expansion was maintained and that it would carefully monitor incoming data for signs of economic slowdown. At their policy meeting in June, 8 out of 17 board members forecast rate cuts before year end with 7 members forecasting two rate cuts before the end of the year. As a result, investors are now discounting four interest rate cuts in the US by the end of 2020. This policy shift provided support to equity markets and helped them return to new all time highs before the end of June.

As before, other global central banks followed suit, with the ECB in particular suggesting a much more accommodative policy stance than previously expected. At a forum in Portugal, ECB President Mario Draghi surprised investors by indicating the ECB would consider cutting interest rates and restarting asset purchases if there was no improvement in economic and inflation data in the coming weeks. This provided further support to global equities and European sovereign bond markets where yields continued to reach new all time lows.

Looking to the remainder of 2019, with a trade deal between China and the US unlikely in the short term, trade related uncertainty is expected to linger. As a result, global growth could slow further during the second half of the year. A final resolution of this uncertainty could act as a positive catalyst for both the global economy and equity markets when it occurs.

World GDP Forecasts

	2018 (estimated)	2019 (estimated)	2020 (forecast)	2021 (forecast)
World	3.2%	2.7%	2.7%	2.6%
Ireland	6.7%	4.5%	3.5%	3.0%
United Kingdom	1.4%	1.2%	1.3%	1.6%
Eurozone	1.9%	1.2%	1.3%	1.2%
United States	2.9%	2.5%	1.8%	1.9%
Japan	0.8%	0.7%	0.4%	0.9%
China	6.6%	6.2%	6.0%	5.9%

Source: Bloomberg 30.06.19

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Ireland

Irish economic data has been somewhat mixed of late but the economy has remained relatively resilient in the face of the ongoing 'Brexit' related uncertainty and general weakness evident in the European economy. The most recent GDP figures for Ireland relate to quarter four of 2018 and show the economy grew 0.1% in the quarter or 6.7% for the year.

During 2018 agricultural activities declined 12.9%, however:

- *Net exports rose 13.8%*
- *Capital investment increased 9.8%*
- *Personal consumption grew 3%*
- *Government expenditure rose 6.4%*
- *Domestic demand increased 4.7%*
- *Information and communications grew 30.7%*
- *Construction rose 15.4%*
- *Financial and insurance activities increased 6.7%*

Elsewhere other activity measures generally remain strong even if growth levels have slowed. Numbers on the Live Register continue to decline reaching 194,700 on a seasonally adjusted basis while unemployment has fallen to 4.4%. Numbers employed rose 1.5% in quarter one while average weekly earnings increased 3.4%. Retail sales have been running at mid single digit levels of growth although the most recent release for annual sales excluding autos slipped to just 3.6%. Consumer confidence slipped from the highs of quarter one in 2018 to its lowest level since late 2014 early this year. Although it has rebounded somewhat over the last few months it is still only at levels evident in early 2015.

National residential property price gains have continued to ease, partly in response to the central banks macro prudential limits on mortgage lending with price gains easing to 3.1% in the most recent release. Transactions in the housing market have recovered after a slow start in quarter one which was probably related to uncertainty associated with the scheduled 'Brexit' date of 31st March. The slowdown in activity levels in the Dublin market appears to have been concentrated in the upper end of the market with volumes in the €300-400k category up 18% while volumes in the €500k plus category are down 12%.

The fiscal balance year to date is slightly ahead of target although the mix is somewhat disappointing with corporate tax receipts behind forecast. Income tax receipts, PRSI and VAT are all up mid to high single digits.

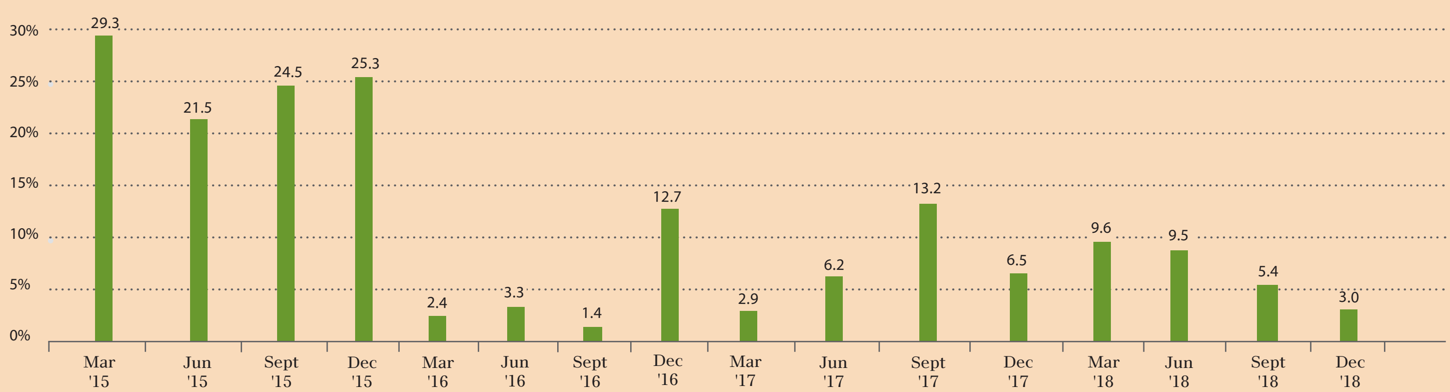
Overall, the outlook for the Irish economy remains relatively strong with consensus forecasts for GDP growth of 4.5% to 5% in 2019 and 3.5% to 4% in 2020 which would again leave Ireland as one of the best performing economies in Europe. The biggest risk to the Irish economy continues to be centred on 'Brexit'. The fiscal position would be expected to deteriorate under a 'hard Brexit' outcome with a deficit of 0.5% to 1.5% of GDP expected in 2020 compared to current expectations of a modest surplus in the case of a 'smooth Brexit' outcome.

Europe

While growth across the Eurozone improved in quarter one and surprised positively at 0.4% quarter on quarter or 1.6% annualised, this still represents a significant slowdown from the 2.7% pace evident in 2017. Leading indicators suggest growth will remain relatively subdued over the remainder of 2019. Europe and especially Germany are sensitive to global trade and given the ongoing uncertainties both have been negatively impacted by the failure to find a resolution to trade disputes. The continued threat of potential auto tariffs has also acted as a drag on European growth given the importance of the sector across the region but particularly in Germany.

Business sentiment readings have improved in France following the hit associated with the 'yellow vest' protests at the end of last year, although French growth is still expected to be only slightly above the Eurozone average at approximately 1.3% in 2019. Italy officially exited recession in quarter one with a positive rate of growth of 0.1% quarter on quarter following two consecutive quarters of negative growth. Ongoing political tensions and controversial policy proposals, however, risk pushing the Italian economy back into recession in the second half of the year. Fiscal stimulus measures in France, Italy and Germany this year are providing some modest support to growth although fiscal stability rules limit room for any substantial easing of fiscal policy. Eurozone growth for the year is forecast at 1.2%.

Irish Quarterly GDP Year/Year Growth

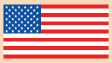


Source: Bloomberg 30.06.19

2019 Investment Outlook – Ireland & the World

**Rebased to 100 as of 02/01/2018*

Source: Bloomberg 30.06.19



United States

The US economy continues to perform well relative to other developed market economies. Having grown 2.9% in 2018 on the back of significant fiscal stimulus, the US economy grew 3.1% annualised in quarter one despite the negative impact of the government shutdown which lasted most of January. The mix of growth in quarter one however was not as strong as suggested by the headline number, with inventories and net trade contributing 0.6% and 0.9% to growth respectively and both expected to reverse somewhat in quarter two and for the remainder of the year. Business equipment spending was down 1% while consumption only grew 0.9% annualised.

Despite the relatively strong start to the year, a number of US economic releases have begun to soften recently and concerns over future growth have risen, particularly with the failure to reach a trade agreement with China. There have been some tentative signs that the labour market could be slowing with initial unemployment claims appearing to have troughed while the most recent monthly nonfarm payrolls release was significantly weaker than expected. Consumer confidence recently suffered one of its largest monthly falls in the current cycle and has fallen back to levels last seen in 2017 while housing related data has been quite mixed despite the significant fall in mortgage rates. Investment spending has also been weak on the back of corporates being less willing to invest in the increasingly uncertain economic environment.

While the US economy is expected to slow through the second half of the year, the increased prospects of rate cuts should limit any slowdown resulting in the US economy still growing approximately 2.5% for the year as a whole.

China

Chinese growth surprised to the upside in quarter one, growing at a seasonally adjusted rate of 6.7% compared to growth of 6.6% in 2018. The improvement in growth in the second half of last year and into early 2019 was due to increased levels of monetary and fiscal stimulus introduced to offset the weaker growth in the first half of 2018 and the increasing risks around the trade dispute with the US. However following further strengthening of indicators throughout March and April, most recent releases have begun to suggest that the pickup in growth in quarter one has not been sustained. Growth of industrial production has fallen to its lowest since 1991 while growth in fixed asset investment has rolled over in the last two months and is only just above the lows seen since 1998. Retail sales have been better and have continued to rebound in recent months, supported by tax cuts. Efforts by the authorities to support lending growth have resulted in a stabilisation of lending growth at around 11%.

The trade war is clearly having a negative impact on the Chinese economy in terms of both activity levels and the potential for manufacturing facilities to move out of China to other countries in Asia which are not subject to the US tariffs currently levied on Chinese exports.

Existing stimulus and the potential for additional support measures in the event of further perceived risks to growth should protect China from any significant slowdown with the economy still expected to grow 6.2% for the year.

Japan

Japanese growth has proven to be extremely volatile on a quarterly basis over the last few years, alternating between positive and negative growth as idiosyncratic factors have had a significant impact in individual quarters.

Following growth of 0.8% in 2018, the Japanese economy surprised to the upside in quarter one growing 0.6% or 2.2% annualised, despite a double digit collapse in industrial production and sharp fall in core domestic capital goods shipments. Net trade contributed 1.7% to growth with a large fall in exports offset by an even larger fall in imports.

Japan remains sensitive to the trade related uncertainty given its dependence on Asian growth while a slightly stronger yen has also acted as a drag on exports year to date. The planned increase in VAT from 8% to 10% in October is expected to have a negative impact on the economy despite the proposed fiscal stimulus to ease the negative impact of this rise. The Bank of Japan's reluctance to adopt a more dovish policy stance similar to other global central banks has also acted as a relative drag on the economy. For the year as a whole Japanese growth is again expected to lag that of other developed markets at approximately 0.7%.

Active Versus Passive Investing

Some investors are staunchly committed to either active or passive investment strategies and in recent years the subject has become a widely debated topic. Here we explore the differences between the two investment styles.

Active investing

As the name suggests, active investors carefully select securities they believe will outperform the market. The return generated from outperforming the market is known as 'alpha'. To consistently generate alpha, managers must exploit the inefficiencies in the market and identify both overvalued and undervalued securities. This freedom and flexibility to choose successful securities allows the fund manager to tailor a fund to their client's needs and to find the optimal balance of risk and return to 'beat' the market.

Passive investing

In contrast, passive managers focus on closely tracking an index, as opposed to being actively involved in stock picking. This essentially means that they have a grouping of thousands of securities, proportionate to their market share of the given index. The return generated from this strategy is called 'beta', and it is derived from the average market return. Active managers may also benefit from beta, however passive managers can offer the same beta at lower fees.

Active strategies

Active fund managers have access to a wealth of resources unavailable to the public. Fund managers use their skill, expertise and research capabilities to find value in market inefficiencies. As a result, active management opens up the possibility for above market returns, unlike passive managers who must replicate an index.

Alpha

- *Alpha is a measure of the active return on an investment - the performance of that investment compared with a suitable market index.*

Beta

- *The beta of an investment is a measure of the risk arising from exposure to general market movements as opposed to idiosyncratic factors.*

Whilst passive funds can be rigidly forced to follow a market and adopt its inefficiencies, active funds are more flexible: a skilled manager, for example, can spot and take advantage of an overvalued or undervalued security. Active managers are not limited to aiming for superior returns and they can target a multitude of specific objectives, such as a steady income stream for clients in retirement.

Active managers are potentially less restricted, and can attempt to reduce the impact of market drawdowns where possible. If the manager believes a drawdown is imminent, they have the ability to invest in counter cyclical and defensive assets, which will perform comparatively well during economic drawdown. Unfortunately, the same resources that allow active fund managers to outperform the market can also be their downfall. Extensive research, skilled investors and sophisticated technology can be considerably expensive. While this cost may be worthwhile in inefficient markets, it can be difficult to justify in more efficient ones.

Passive strategies

Passive managers are unable to generate above market returns and rather track the market. This is not to say that passive funds are not effective: the right index can reach double digit returns. Although passive funds do not benefit from alpha, they are free from active risk, thus human error does not enter the equation.

Cost effectiveness is one of the main benefits of passive investing. In addition to lower management costs, transaction costs tend to be lower as trades are only made during periodic rebalancing, to ensure the fund matches the index.

The value of a combined fund

The question of when to employ active versus passive management generally boils down to one question: can the fund manager's performance justify the fees? To answer this question, it is important to consider where skilled active managers can provide the most value. In efficient, developed markets, they may not be worth their high costs. In higher risk, less efficient markets, active managers are truly able to shine. However, in order to balance risk, return and cost, a combination approach employing both investment styles is the most effective strategy.

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