The Investor
Summer 2020

2020 Investment Outlook – Ireland & the World

Once the current difficulties and uncertainties associated with COVID-19 are eventually overcome, equity markets will grapple with a new growth cycle which could herald the opportunity for strong returns over the medium to long term.

The first half of 2020 proved to be an extraordinary period for the global economy and investment markets with the sudden onset of one of the most severe but shortest retrenchments in market valuations ever experienced following the outbreak of COVID-19. This in turn contributed to significant volatility and outsized moves in investment markets.

Global equities experienced the quickest bear market in history as markets fell almost 33% in less than five weeks. Following unprecedented levels of fiscal and monetary stimulus and growing hopes for a rapid recovery in the global economy as COVID-19 restrictions began to be lifted, equities experienced one of the fastest ever rallies. This resulted in equity markets only being down mid single digits for the year by the end of June.

Sovereign bond yields collapsed to new historic lows in early March with the sudden onset of recession. Yields rose modestly as sentiment around growth eventually improved and the expected additional supply of bonds on the back of increased fiscal stimulus weighed on yields. Increased levels of asset purchases, however, prevented yields moving back to their early year levels. Overall this resulted in positive returns from high quality sovereign bonds over the period. Corporate bonds initially suffered falls on fears of rising defaults in the recessionary backdrop but, similar to equities, rallied following central bank intervention to support the market and help prevent widespread bankruptcies.

The picture at the beginning of the year was significantly different, as continued improvement in economic news flow appeared to build on the progress which had been made in late 2019 around the US/China trade war and the avoidance of a 'no deal Brexit'. This backdrop suggested global growth would surprise to the upside in 2020 and equity markets responded positively, hitting new all time highs in January and early February.

When news of the COVID-19 virus first emerged in mid January, equity markets suffered only a modest setback of about 3.5% as investors assumed the impact of the virus on the global economy and markets would be relatively shallow and transitory, similar to that experienced with the outbreak of SARS in 2003. As China began to successfully contain the virus in early February following the introduction of widespread lockdowns across the Chinese economy, investors became more comfortable with the idea that the fallout from the virus would be relatively limited and equity markets again rose to new all time highs by the middle of February.

The economic and equity market outlook is now much brighter than was the case at the time of the market trough in late March. This is due to the scale of policy support from fiscal and monetary authorities and improving visibility around the growth backdrop following the progress made by reopening economies after the March and April lockdowns.

Nevertheless, uncertainties remain over the pace of the recovery in growth in the second half of the year and into 2021. There are also some concerns over the recent rise in US COVID-19 case numbers as the economy opens up. Equities, however, continue to be supported by the ongoing provision of liquidity by central banks and remain attractive on a relative valuation basis compared to bonds and cash given the extremely low yields currently available on these assets.

World GDP Forecasts

	2018	2019	2020 (forecast)	2021 (forecast)
World	3.2%	2.6%	-4.0%	5.2%
Ireland	8.4%	5.6%	-7.5%	6.0%
United Kingdom	1.3%	1.4%	-9.2%	7.2%
Eurozone	1.9%	1.2%	-6.4%	6.2%
United States	2.9%	2.3%	-4.7%	2.9%
Japan	0.3%	0.7%	-5.6%	2.6%
China	6.7%	6.1%	2.0%	8.6%

Source: Bloomberg 30.06.20

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Ireland

The most recent data for Ireland suggests the economy bottomed in April and a recovery has begun as the economy has started to reopen. As elsewhere, Ireland entered a recession in the first half of the year as restrictions were implemented to contain the spread of COVID-19 which resulted in a sharp contraction in the economy. With the restrictions only imposed from the middle of March, Irish GDP in the first quarter was relatively strong in a global and European context, growing 4.6% year on year.

Data releases in Ireland tend to be delayed relative to elsewhere so that there is still limited hard economic data covering the period since the virus began to impact the economy. Those data points which have been made available, however, highlight the depth of the economic contraction in April when restrictions were at their most severe.

Headline unemployment only rose from 4.8% before the COVID-19 outbreak to 5.6% in May although the Central Statistics Office (CSO) estimated an adjusted unemployment rate of 28.2% for April when account was taken of those using the income subsidy supports introduced during the crisis.

'Brexit' related uncertainty remains a potential overhang on the Irish economy over the remainder of the year and into 2021. The UK government recently confirmed that the transition period will not be extended beyond the end of this year which poses a risk to Irish growth if a trade deal is not agreed between the EU and UK during 2020. While a full trade deal is unlikely given the time constraints, a worst case outcome of a 'no deal' exit with a move to World Trade Organization (WTO) tariffs at the beginning of 2021 is seen as improbable. It is expected that many of the unresolved issues will roll into further negotiations next year. This would avoid a worst case outcome for the Irish economy in terms of being faced with the possibility of relatively high tariffs on most goods traded with the UK. However, the ongoing uncertainty is likely to continue to act as a drag on the growth outlook until greater clarity around the eventual trade deal is evident.

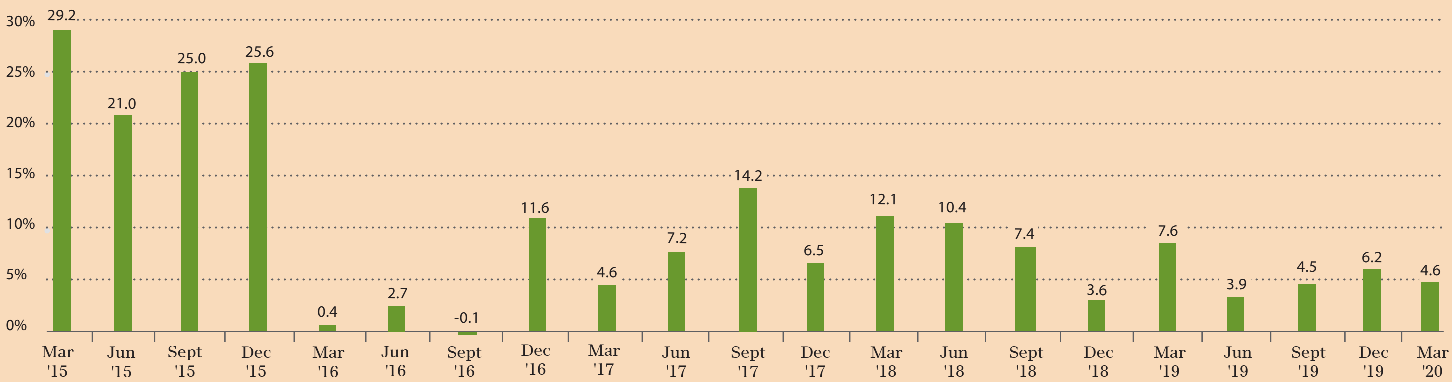
Looking forward, the Irish government has announced a number of measures and schemes to support corporates, employees and the overall economy which will result in a significant increase in the fiscal deficit this year. It has been suggested this could be in the order of 10% of GDP although a better than anticipated fiscal position at the end of May on the back of better than expected tax receipts could mean the deficit might be closer to 8.5% of GDP. The government has forecast a contraction of -10.5% in Irish GDP in 2020 followed by a rebound of 6% in 2021.

Europe

Europe was one of the first regions outside China to experience an outbreak of COVID-19 with Italy and Spain initially becoming the epicentres in Europe around the middle of February. The spread of the virus resulted in restrictions being imposed relatively early in these countries but was quickly followed by others. The outcome of these wide scale lockdowns across Europe was that the region suffered one of the sharpest contractions among the major economic regions. Eurozone growth fell -13.6% in quarter one on an annualised basis, household consumption declined -17.4% and fixed investment was down -16%. With growth continuing to slow into quarter two and only reaching a trough in April, growth is forecast to have been worse in quarter two, contracting at an annualised rate of about -40%.

Since economies began to reopen in May, activity levels seem to have begun to recover. High frequency data such as retail footfall, traffic flows, energy consumption and spending data suggest that the German economy is now operating about 5% below normal levels from a low of about 15% while the rest of Europe is operating at about 85% of normal levels compared to a low of about 60% to 65%. Even with an expected robust recovery in the second half of the year, the Eurozone economy is forecast to contract by around -6.5% in 2020 but rebound by about 6% next year.

Irish Quarterly GDP Year/Year Growth



Source: Bloomberg 30.06.20

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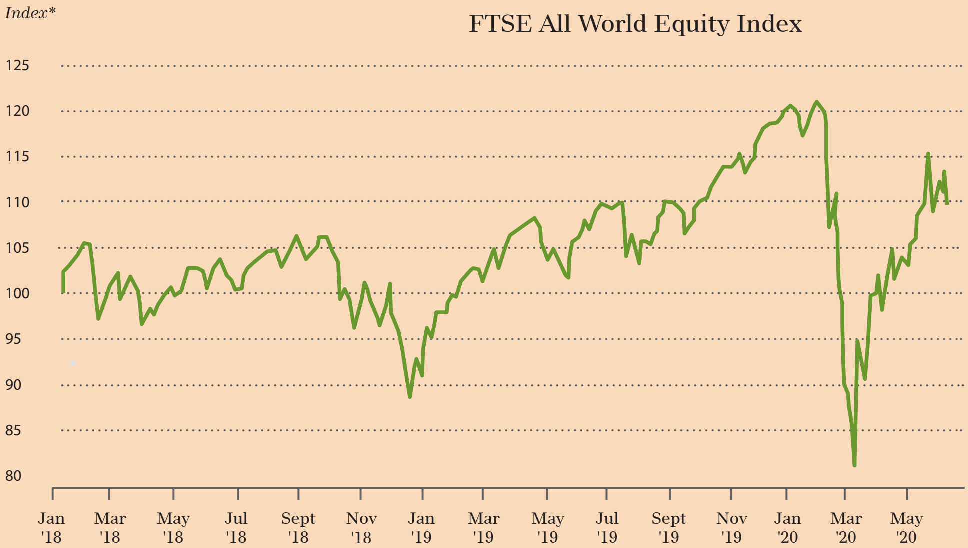

*Rebased to 100 as of 02/01/2018

Source: Bloomberg 30.06.20

United States

The US economy shrank by 5% on an annualised basis in quarter one with consumption down -6.8%. Growth continued to deteriorate into quarter two with industrial production and retail sales registering record month on month drops of -12.5% and -14.7% respectively.

The labour market was particularly weak with unemployment rising to a record high of 14.7% in April although estimates suggested that the true level of unemployment was over 23% at its peak. It is estimated that the economy will have contracted at an annualised rate of -31% in quarter two.

The US launched one of the largest fiscal and monetary stimulus programmes to combat the impact of COVID-19 in an effort to support the economy with the fiscal deficit expected to rise to about 18% of GDP this year. The US Federal Reserve reduced interest rates back to zero and launched an open ended asset purchase programme where it has committed to buy assets for as long as is necessary to ensure a robust economic recovery.

The scale of the support measures with the commitment to do more if necessary, combined with an early reopening of the economy, has resulted in a noticeable pickup in growth in recent data releases. The labour market showed an unexpected rebound in May following the record 20.7m job losses in April, which resulted in unemployment falling to 13.3%. Retail sales rebounded in May while credit card spending has recovered from a low of -40% to a decline of only -11% in the most recent readings. Regional manufacturing indices rebounded strongly in May following record falls in April.

Overall, the strong rebound in the second half of quarter two is expected to continue into quarter three which is expected to see growth of 20% on an annualised basis. For the year, US GDP is expected to fall around -4.7% with a rebound of 2.9% expected in 2021.

China

China was the first major economic region to enter recession as it introduced restrictions in January to contain the spread of COVID-19. With the vast majority of the country in lockdown for almost a month, quarter one GDP collapsed -9.8% quarter on quarter. China was also the first country to come out of recession as restrictions were lifted in late February, just as the rest of the world was moving into lockdown.

Industrial production contracted -13.5% in February although it was growing 3.9% by May. Similarly, retail sales were down -20.5% in February and had recovered to -7.5% by May. The recovery in growth is somewhat uneven, with services and consumer aspects of the economy lagging and still contracting on a year on year basis. Labour income has been hit by the rise in unemployment from 5.2% at the end of 2019 to the current level of 5.9% which could continue to limit the recovery in consumption given the contraction in real disposable income in quarter one, which has not been offset by government subsidies as seen elsewhere.

China is the only major region expected to experience positive growth in quarter two with an annualised growth rate of 48% expected. Even with this strong rebound, growth for the year as a whole is only expected to be about 2%, which is well below the 6% level evident in recent years. A recovery to 8.2% is expected in 2021.

Japan

The Japanese economy performed relatively well in a global context in quarter one, contracting only -2.2% on an annualised basis with consumption down -0.8% and business investment actually up 1.9%. In the early stages of the global COVID-19 outbreak, Japan managed to avoid large scale infections although it subsequently had to introduce nationwide restrictions as the virus spread across the country.

While the contraction in growth in quarter one was relatively modest in a global context, the lingering impact of the VAT increase in October 2019 means the recovery in growth will probably be more gradual than elsewhere. The postponement of the Tokyo Olympics until summer 2021 has also been a negative for the growth outlook, with the risk that only a scaled down version of the competition will be held should COVID-19 related uncertainties remain.

The Japanese economy is forecast to contract at an annualised rate of -30% in quarter two but rebound by 20% in quarter three. For the year as a whole the economy is expected to contract by -5.6% with a rebound of 2.6% expected next year.

Understanding Risk: Equities

Following the phenomenal 2019 returns in equity markets it seemed equities were the only place to be invested. However, every investor needs to consider their investments in the context of the two main principles of risk and reward, rather than thinking simply in terms of reward.

If you have a long time horizon to retirement, equities are likely to be a sensible investment although it is important that investors understand how their retirement account can deviate from year to year or even from day to day. Those investors closer to retirement who plan to use their retirement savings to buy an annuity or fund their tax free lump sum should be more mindful of the risks, given that if things go awry these investors may not have sufficient time for their funds to recover.

Volatility Risk

Volatility risk is a statistical measure, also known as the standard deviation, which shows how much fluctuation there is in the underlying price of an investment over a specified period of time. The more volatile the investment the higher the standard deviation.

In the context of different equity investments, investors expect to be rewarded for accepting higher volatility over the longer term, however, that might not always materialise. In order to evaluate two different equity style investments, it is important to evaluate the risk adjusted return, which is the return divided by the volatility. The higher the risk adjusted return the better the investment rationale for choosing between two investments. Most commonly investors look at historical volatility to determine how risky an investment is, as higher historic volatility is likely to indicate that an investment will be volatile in the future.

Capital Loss Risk

Capital loss is the risk associated with the loss of some or all of your investment due to share prices of the stock you own depreciating below the levels at which you bought the stock.

Although equities will invariably experience some losses over time, by buying and holding a large number of stocks investors can achieve diversification. Therefore, should one company go out of business, the hope is that this will be compensated by positive returns earned elsewhere from the other stocks you hold. This may not always be the case when there is some systemic shock to equity markets, such as coronavirus fears, but over the longer term, holding more stocks should be beneficial.

> *"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets."*
>
> **Peter Lynch, Former Fidelity Magellan Fund Manager**

Currency Risk

Currency risk is the risk associated with holding an investment in a different currency to your own domestic currency. Any income received through dividend payments or capital gains may differ due to the difference between the currency in which the dividends and gains are declared and your domestic currency, for example a US company declaring dividends in US dollars and then translating this back to euro. Currency risk can be reduced by hedging, which offsets currency fluctuations.

Liquidity Risk

Liquidity risk is the risk that you cannot realise your investments in order to get your cash back in a reasonable time frame. This risk would be most prominent in the private equity space for the equity universe of instruments. An investor can mitigate this risk by investing in publicly quoted equities that exist in indexed funds.

Concentration Risk

Concentration risk arises from having all of your eggs in one basket, for example only getting equity exposure through particular regional exposures. Consider an investment tracking the FTSE 100 Index. This would result in a portfolio of the largest listed UK companies but you would only have exposure to 100 companies. Your investment will be highly sensitive to the UK economy and you could miss out on potential returns from companies domiciled in other sectors and regions. To reduce concentration risk the solution is to invest in more stocks which are diversified by geographical allocation, for example an investment that tracks the FTSE World Index which contains 2,592 global companies.

Conclusion

Equities play a fundamental part in any growth portfolio and have delivered positive returns over the longer term. However, before investing into the asset class and in particular niche equity areas investors should be comfortable with the volatility of the asset class. Most importantly those investors that are near to retirement should consider whether they need to look at investments which will preserve capital within their retirement accounts and whether their equity allocation remains appropriate.

Bronagh Traynor
Investment Consultant
btraynor@invesco.ie

* For further information please contact Paddy Swan (pswan@invesco.ie) or Richard White (rwhite@invesco.ie)

Dublin 2 Sandyford Business Centre, Burtonhall Road, Sandyford, Dublin 18, Ireland.
tel +353 1 294 7600 fax +353 1 294 7633

Cork No. 6 Lapp's Quay, Cork, Ireland.
tel +353 21 480 8041 fax +353 21 431 0530

web www.invesco.ie email info@invesco.ie