The Investor

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2021 Investment Outlook – Ireland & the World

As Covid-19 is contained with the aid of effective vaccines, economies exit recession and uncertainty is reduced, equities should follow the usual post-recession recovery path and continue to generate strong returns over the next year.

2020 proved to be an extraordinary year for the global economy and investment markets. Having begun the year on a firm footing following a trade agreement between the US and China, the global economy suddenly fell into recession in the first quarter due to the outbreak of Covid-19. Restrictions put in place across the world to contain the spread of the virus turned what had been a healthy expansion into a sudden, sharp recession with activity grinding to a halt. The global economy experienced one of the most sudden and severe recessions ever seen as growth contracted at an annualised rate of almost 20% in quarter two. The recession however also proved to be one of the shortest ever witnessed, essentially spanning just two months through March and April with a recovery beginning in May as economies began to reopen from lockdowns and Covid-19 case numbers began to decline.

The recovery was boosted by unprecedented levels of fiscal and monetary support from global authorities which were introduced to combat the impact of Covid-19. With significant levels of pent up demand following lockdowns, the global economy surged at an historic annualised rate of 38% in quarter three. Growth momentum slowed again in quarter four as fiscal supports in the US faded and restrictions were reintroduced in many regions on the back of a second wave of the virus. While the aggressive and unprecedented fiscal and monetary stimulus measures announced by global authorities facilitated a recovery from May onwards, the scale of the damage inflicted between March and April will have resulted in the global economy contracting by around 4% in 2020 with China being the only major region generating positive growth in 2020 as it emerged from the crisis earlier than others.

Equities experienced a tumultuous year in 2020 as markets suffered one of the fastest ever bear market corrections, followed by one of the quickest recoveries, with markets reaching new all time highs at year end.

Equity markets started the year positively, reaching new all time highs as growth seemed set to surprise to the upside, initial economic releases remained strong and central banks continued to maintain accommodative policy stances. Equities however then entered a bear market, falling over 32% in just five weeks from mid February on concerns over the potential economic fallout from the Covid-19 outbreak.

Having bottomed in late March, equity markets rallied very quickly, supported by the stimulus measures announced by global authorities. The large levels of liquidity provided by central banks were a key contributor to the rebound in equity markets. The faster than anticipated reopening of economies and stronger than expected recovery in growth also supported markets, as did medical advancements in terms of treatments and potential vaccines for the virus.

By year end equity markets had recovered to reach new all time highs. Late in the year the removal of US election related uncertainty eased investor anxieties, while confirmation of high efficacy rates in several successful vaccine trials also boosted hopes that economic activity could return close to normal over the course of 2021. The eventual agreement of the $900bn US fiscal package and a trade deal between the EU and UK which avoided a worst case 'no deal Brexit' were also positive for markets.

World GDP Forecasts

	2019	2020 (estimated)	2021 (forecast)	2022 (forecast)
World	2.6%	-4.0%	5.8%	4.4%
Ireland	5.6%	2.0%	4.8%	3.3%
United Kingdom	1.5%	-10.2%	5.9%	6.7%
Eurozone	1.3%	-7.2%	4.6%	5.1%
United States	2.2%	-3.4%	5.5%	3.7%
Japan	0.3%	-5.2%	3.0%	2.7%
China	6.0%	2.1%	9.2%	5.5%

Source: Bloomberg 31.12.20

2021 Investment Outlook – Ireland & the World

Ireland

The Irish economy has been relatively strong in recent years, significantly outperforming the Eurozone and global economies. Similar to elsewhere, Ireland entered a sudden and severe recession in early 2020 due to the restrictions put in place to contain the spread of Covid-19. The recovery since then however has been much stronger than initially anticipated. With surprisingly strong growth in quarter three, GDP for the year as a whole will likely have grown about 2%, significantly better than the -10% contraction expected in April and the -7% contraction expected in the Eurozone overall.

Within the economy there has been a divergence between the domestic and the international sectors with a two speed economy emerging. Despite the positive GDP outcome expected in 2020, domestic demand will probably have fallen by around -4% to -5%, with the positive growth due to strong performance in the trade and multinational sectors.

With Ireland being a relatively open economy with exports accounting for a large share of GDP, it might have been expected to suffer in a global recessionary environment. However, Ireland's export base is relatively defensive, with pharmaceutical related products accounting for around one third of goods exports while technology accounts for over 40% of services exports. Both sectors experienced strong growth during the year which will have resulted in mid to high single digit growth in total exports.

With imports falling due to weaker investment and consumption, the contribution from net trade was a strong positive feature in 2020. Similarly, the multinational sector experienced positive growth in 2020, centred on operations in the pharmaceutical and IT sectors while more traditional sectors, particularly on the services side, struggled last year.

In terms of the labour market, unofficial unemployment rose only to 7.2% from 4.8% pre Covid-19. However adjusted unemployment, which takes account of those using the Pandemic Unemployment Payment (PUP) scheme, rose to a peak of 30.4% before declining to 15.9% as the economy began to reopen. Following the more recent lockdowns, unadjusted unemployment has risen again to 20.4% as numbers on the PUP scheme have risen. Despite the damage to the labour market, consumption has held up better than expected, bolstered by the income support schemes and the fact that consumer balance sheets were healthy before the virus outbreak.

Looking at 2021, the eventual agreement of a trade deal between the EU and UK has avoided a worst case 'no deal Brexit' and has removed a significant risk to Irish growth. While the extension of lockdowns will result in a weak growth backdrop in the first quarter, the strong fundamentals and trends evident at the end of the year combined with the benefits from the rollout of vaccines should result in a strong rebound in growth through the middle of the year. This would result in GDP growth of 3% to 4%.

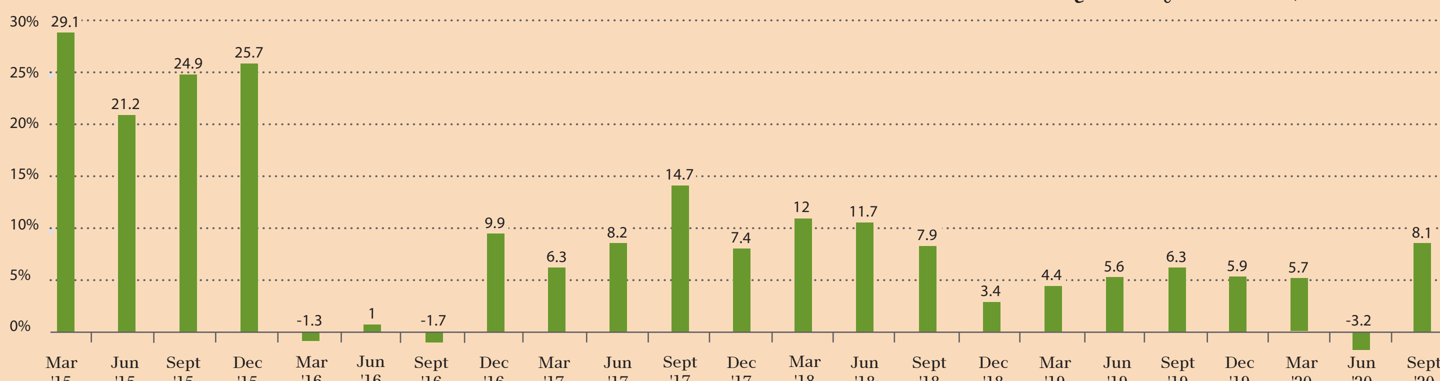
Europe

As elsewhere, the Eurozone entered a severe recession in 2020 as lockdowns were imposed and growth for the year is expected to have contracted by over 7%. GDP in the Eurozone fell at an annualised rate of -13.6% in quarter one and -39.4% in quarter two. As economies reopened through the summer, the Eurozone recovered strongly in quarter three with GDP growing a staggering 60% on an annualised basis.

Following the recent reintroduction of lockdowns in many European countries to combat the renewed rise in Covid-19 case numbers, the Eurozone economy will have contracted again in quarter four at an annualised rate of around 9%. With restrictions in many countries being extended as case numbers have surged and health care systems have come under increasing pressure, growth in the first quarter could again be negative. This could result in two consecutive quarters of negative growth whereby the Eurozone would experience another technical recession.

While growth in quarter one of 2021 is likely to be weak, the economy should rebound from late quarter one as economies reopen and the positive impact of vaccine distribution is felt. For the year, the Eurozone economy is expected to grow just under 5% in 2021. However, this will still leave growth well below the level at the end of 2019, resulting in the Eurozone economy lagging the global recovery.

Irish Quarterly GDP Year/Year Growth



Source: Bloomberg 31.12.20

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United States

With the US entering a severe recession in the first half of 2020, the economy is expected to have contracted in 2020 by about 3.5%, even with the strong rebound in growth in the second half of the year. Quarter three saw a record growth rate of 33.4% on an annualised basis as the economy rebounded from the April low. Unprecedented levels of fiscal and monetary stimulus support to offset the impact of Covid-19 should continue to contribute to positive growth in 2021.

The US launched one of the largest stimulus programmes to combat the impact of Covid-19. The most recent package was a $900bn programme agreed in December which included one off payments of $600 to individuals and supplementary unemployment benefit payments of $300 which will last until the end of March. With the Democrats having won control of the Senate and Congress following success in the Senate runoff elections in early January, an additional stimulus package of $1trn to $1.5trn is now expected in the coming weeks. Combined, these two programmes amount to over 10% of US GDP and are estimated to add over 1.5% to US growth in 2021 and a further 0.5% in 2022.

Despite increasing levels of restrictions during the latter part of 2020, US growth has remained solid, albeit with some signs of slowing momentum towards the end of the year. In December the labour market softened although unemployment at 6.7% remained well below its peak of 14.8%. Retail sales were down -1.1% in November on the back of the softer labour market and expiration of supplementary unemployment benefits. Nevertheless, given the earlier strength, quarter four GDP will likely have grown 5% annualised. Looking at 2021, growth in quarter one is expected to be around 2.3% with growth for the year around 5.5%.

*Index**

FTSE All World Equity Index

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

Source: Bloomberg 31.12.20

China

China has been relatively successful in terms of containing the virus with the result that the economy has recovered strongly and is expected to have been the only major economic region to experience growth in 2020. GDP is estimated to have risen by 2% last year.

As new case numbers began to decline in late February 2020, restrictions slowly began to relax and the economy started to reopen. The authorities increased the level of fiscal stimulus to support the economy during the reopening period with the fiscal deficit forecast to have risen from 4.9% of GDP in 2019 to 6.7% last year. Monetary authorities also provided support by lowering interest rates and injecting significant levels of liquidity into the system.

China's recovery was aided by the fact that during quarter two, it was one of the few places in the world where the manufacturing sector was open and hence was able to meet demand for goods across the world. Exports also benefitted as China is a key supplier of medical equipment for which there was a significant rise in demand due to the virus. As a result, the trade sector has performed extremely well with Chinese exports growing 18.1% at the end of last year. The recovery is expected to extend further into 2021 with growth of over 9% expected this year.

Japan

The Japanese government has announced very large fiscal stimulus measures to aid the economy due to the Covid-19 outbreak while the Bank of Japan has also announced increases in monetary support. As elsewhere, the Japanese economy is expected to contract over the year as a whole. Quarter one GDP fell -2.3% on an annualised basis while quarter two GDP contracted at -28.8%. The economy recovered strongly in quarter three with GDP growing 22.9%. For the year, the Japanese economy is estimated to have contracted by over 5%.

While the contraction in growth in the first quarter was relatively modest in a global context, the lingering impact of the VAT increase last October continued to act as a drag on growth throughout most of the year. The postponement of the Tokyo Olympics until summer 2021 was also a negative factor for the growth outlook. The event potentially being scaled down will reduce the prospects for a compensating recovery in 2021.

Restrictions in Japan were less severe than elsewhere during quarter four and the Japanese economy is estimated to have grown at an annualised rate of 8% during that quarter. The economy is expected to grow by around 3% in 2021.

Investing in Equities: Growth Versus Value

Growth and value investing are two fundamental approaches to investing, both of which have a place in a diversified investment portfolio. Here we discuss the differences between the two distinct investment styles.

Growth Investing

A growth investment strategy aims to invest in companies that are experiencing a strong upward trend in revenue, cash flows or profitability, where growth is a priority. Instead of paying investors material dividends, the company will reinvest the majority of their profits back into the business to support this growth. Investors in these companies are more concerned with the growth of their capital as opposed to creating an income stream. Typically, growth style investments will offer higher upside potential and therefore are inherently riskier with larger swings in prices. Given the higher level of risk, it is typically better suited to investors with a higher risk tolerance and a longer investment horizon.

Value Investing

A value investment strategy aims to find diamonds in the rough by searching for companies that have a fundamental value greater than their prevailing market valuation. The investor is essentially looking for a long-term bargain. The expectation is that as time progresses the market will begin to appreciate the company's true value and the stock price will increase. Typically value stocks experience less pronounced swings in price and are therefore characterised as being less risky than their growth counterparts.

Value Underperformance

Outperformance of growth over value has been a consistent trend since 2007 and investors are increasingly asking why. Value investing has enduring support from academics and famed investors such as Warren Buffet and Benjamin Graham. The overarching theory is that cheaper stocks will perform better over the longer term, as measured by several different financial metrics such as price to earnings and price to book ratios, in comparison to the broader market.

Annualised 20 Year Return to End 2020	
MSCI World Growth Index	5.1%
MSCI World Value Index	4.1%

Source: Bureau van Dijk 31.12.20

However, recently this has not been the case. The following three points explain some of the reasons for this change in market sentiment.

Technological Advancement

The key beneficiaries of the recent rapid switch to remote working are technology companies such as Microsoft, Amazon and Google which all rank within the top five companies of the MSCI World Growth Index. These companies are referred to as mega cap stocks and over the last decade, an investment portfolio would typically underperform the broader MSCI World Index if it did not hold such stocks.

In comparison, many of the constituents of the MSCI World Value Index have a 'bricks and mortar' style business model. There is some belief in the market that these businesses may never return to previous valuations and are actually correctly valued by the market, even though many value investors may see these as undervalued based on financial metrics compared to the broader market.

Tangible and Intangible Assets

There are two broad categories of fixed assets on any company's balance sheet, namely tangible and intangible assets. Tangible assets are physical in nature, for example property. Intangible assets are non-physical, for example goodwill or brand value. Technology based stocks are known for their fast revenue growth and highly scalable business models where investment is in intangible areas such as IT and Research & Development, areas which are incredibly valuable to any business looking to grow and take market share from their competitors. This will lead these businesses to have very high price to book valuations compared to the broader market, making them look expensive. Given they appear expensive, these companies will typically be excluded from the value indices and by extension by many value investment managers.

A value-based business will look to reward investors each year with an attractive dividend and so will not be investing as much in growing their company, making the business appear cheaper and therefore an attractive investment opportunity.

Migration

Typically, a value company today was once a growth company which now has low growth prospects but consistent strength in revenue and offers investors a good dividend yield. This transition is known as migration. The level of migration has been slowing over the last two decades as mega cap technology companies continue to get bigger and bigger due to the employment of monopolistic tactics by acquiring their competitors.

Summary

A blend of both growth and value investments may be recommended to investors who wish to maintain a diversified investment portfolio. Asset allocation should be reviewed regularly to ensure the portfolio continues to meet the financial needs and objectives of the investor.

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