The Investor
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Summer 2021

2021 Investment Outlook – Ireland & the World

As successful vaccine rollouts continue, the global economy is experiencing a strong recovery from last year's Covid-19 induced recession, with growth expected to remain strong throughout the remainder of 2021 and into 2022.

The outlook for growth was generally positive at the beginning of the year, with the global economy expected to grow by 5% in 2021. These forecasts were quickly revised higher as additional fiscal stimulus was implemented, particularly in the US.

After a shaky start, the successful rollout of vaccines facilitated the reopening of economies and provided a significant boost to the growth outlook. The result has been that global growth forecasts for this year have been raised by 1.5% to 6.5% with US forecasts rising by over 3% to 6.7%. In Europe, the slower rollout of vaccines and extended lockdowns have caused the recovery in growth to lag that seen elsewhere. Nevertheless, corporate sentiment in Europe has risen to multi-year highs across several indicators, suggesting a very strong rebound in growth through the middle of the year.

Looking forward, the risk of sustained higher inflation potentially represents the biggest risk to global growth and investment markets, as it could force central banks to tighten policy much earlier and more aggressively than currently expected. Fears of a sustained rise in inflation have been evident due to the unprecedented levels of policy stimulus, strong growth and recent spikes in global inflation readings. However, while the risks of higher inflation are greater than they have been for several decades, it is likely that the rise will be transitory and will ease in 2022.

Equities continued to do well in the first half of 2021, rising over 13% year to date in local currency terms and over 15% in euro terms. The rally in equities has been supported by additional fiscal stimulus, continued accommodative monetary policies among the major central banks and the successful vaccination rollout across developed regions.

Equity markets have experienced a number of modest corrections over the last six months, associated with retail investor induced volatility in January and the rise in bond yields since year end. However, global equities have recovered from these setbacks to reach new all time highs in late June, boosted by a positive economic and earnings backdrop, attractive relative valuations and a supportive policy environment.

Following last year's contraction of -3.6% the global economy is expected to grow 6.5% this year and 4.5% in 2022. A delayed vaccine rollout in emerging markets, combined with renewed rises in Covid-19 cases, has meant growth in developed regions has exceeded that of emerging markets in the first half of 2021, even as Europe suffered a double dip recession due to extended lockdowns.

Unprecedented levels of fiscal and monetary stimulus are expected to remain supportive of growth even though they will be reduced next year. Strong consumer balance sheets with large levels of excess savings accumulated during the pandemic should boost consumption. Positive growth momentum will be maintained as successful vaccination rollouts continue, with a relative catch up in growth across emerging market regions expected in the second half of the year. This should result in a relatively synchronised global recovery.

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World GDP Forecasts

	2019	2020 (estimated)	2021 (forecast)	2022 (forecast)
World	2.6%	-3.6%	6.5%	4.5%
Ireland	5.6%	3.4%	6.2%	4.7%
United Kingdom	1.5%	-9.8%	7.9%	5.5%
Eurozone	1.3%	-6.7%	5.0%	4.9%
United States	2.2%	-3.5%	6.7%	4.0%
Japan	0.3%	-4.7%	2.7%	3.9%
China	6.0%	2.3%	8.5%	5.6%

Source: Bloomberg 30.06.21

2021 Investment Outlook – Ireland & the World

Ireland

Ireland was a rare exception in the global economy in 2020, with GDP growing 3.4% as strength in the multinational and trade sectors offset weakness in domestic demand. Despite the severe lockdown in the first quarter of this year, the Irish economy has again performed extremely well in absolute and relative terms so far in 2021.

Provisional figures show Irish GDP grew 7.8% in the first quarter of 2021, again supported by the multinational and trade sectors. The industrial sector (excluding construction) grew 12.8% in the quarter and the information and communications sector grew 19.1%. Ireland has gained from its exposure in areas such as the technology and pharmaceutical sectors which have continued to perform relatively well during the pandemic period.

Other more domestic sectors have continued to suffer, with construction down -23.4% in quarter one and activity in distribution, transport, hotels and restaurants down -9.9%. Personal consumption was weak in the first quarter, falling -5.1%, although this was a significant improvement compared to the first lockdown in 2020 when consumption fell by over 20%. Government expenditure also continued to provide support, rising 1.1% in the quarter.

The outlook for the Irish economy over the remainder of 2021 appears promising. Economic reopening is expected to continue throughout the summer months even if the pace is likely to be somewhat slower than initially anticipated due to the recent emergence of the Delta variant of Covid-19. Activity, spending and sentiment all appear to be recovering strongly as restrictions are eased.

The labour market has been negatively impacted by the pandemic but it is improving. Official unemployment has risen from 4.8% pre Covid-19 to 7.8% currently, although adjusted unemployment, which accounts for those using income supports, has risen to 21.9%. Numbers using the Pandemic Unemployment Payment (PUP) scheme have fallen from a February peak of 479,000 to 245,000 as the economy has reopened. Numbers employed are expected to continue to grow over the remainder of the year with unemployment forecast to fall below 7% by year end.

One of the risks faced by the Irish economy is the recently proposed changes to global corporate tax. Plans to base tax payments on where sales occur could result in losses of up to €2bn per annum in corporate tax receipts. However, the government has already planned for this eventuality and included it in its longer term budget planning, and this should be manageable.

Overall, Irish GDP is likely to grow over 6% this year with continued strength in the multinational and trade sectors. This year, domestic demand is also expected to make a positive contribution, with consumption recovering as the economy continues to reopen. Government spending also continues to provide support, with an expected fiscal deficit of 3.8% of GDP compared to 5% in 2020.

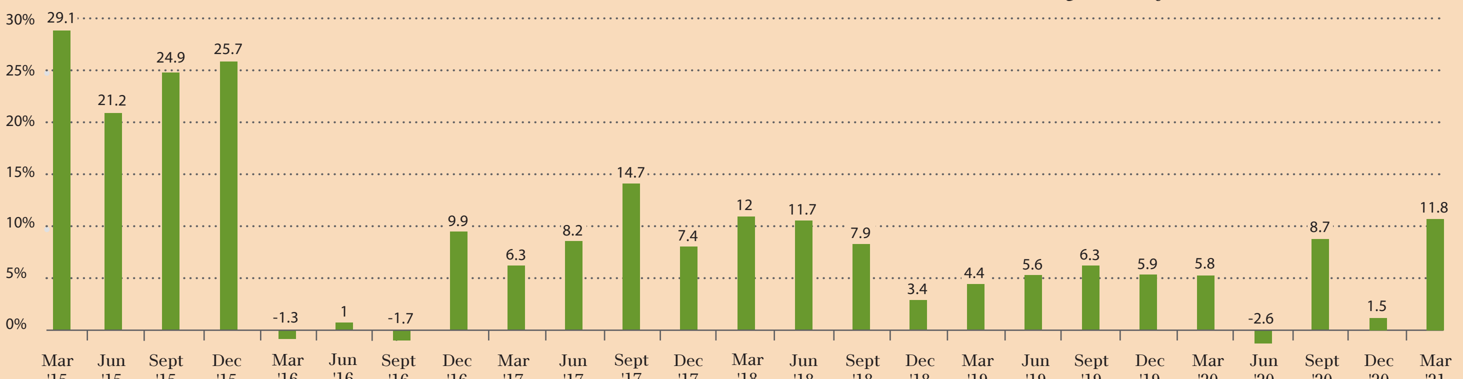
Europe

Europe suffered a second wave of Covid-19 at the end of last year and in the early part of 2021 which resulted in renewed restrictions and lockdowns. This caused a double dip recession with two consecutive quarters of negative growth in quarter four of 2020 and the first quarter of this year.

The initial slow pace of vaccine rollout across Europe also meant that restrictions were extended throughout the first quarter and into quarter two. This resulted in Europe once again lagging the global economy at the beginning of the year, as the Eurozone contracted at an annualised rate of -1.3% over the first three months of 2021. A sharp acceleration in vaccine rollouts during quarter two enabled the reopening of European economies and has led to the start of what is expected to be a significant rebound in growth through the middle of the year.

The economy has also received support from additional fiscal stimulus introduced by governments across Europe, with planned fiscal deficits rising by around 3% since the beginning of the year. In coming months, the level of support is expected to increase further as the EU Recovery Fund begins to disburse its €750bn of funds. Overall, the Eurozone economy is expected to grow 5% in 2021, which would be a very positive outcome given the poor start to the year.

Irish Quarterly GDP Year/Year Growth



Source: Bloomberg 30.06.21

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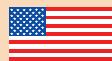


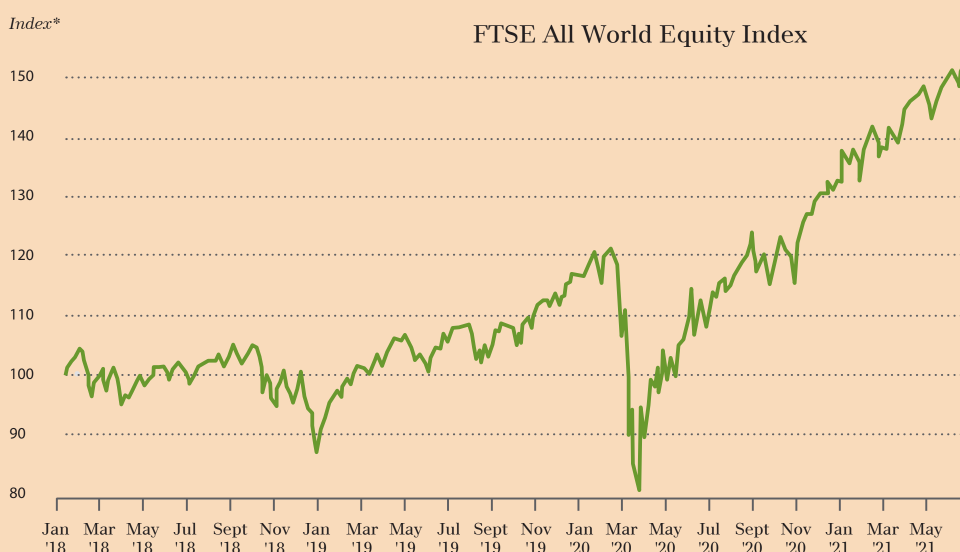
United States

The policy response to Covid-19 in the US was larger and timelier than elsewhere and provided a platform for a quicker and stronger recovery than other developed countries. The US economy shrank by -3.5% last year, less than other developed markets such as the Eurozone and the UK. While the recovery was relatively strong, US authorities were determined to guard against the downside risks to growth posed by Covid-19. In this context, US Congress passed an additional $900bn fiscal package at the end of last year to support growth.

The labour market has continued to improve with 2.4 million jobs added year to date and unemployment has fallen to 5.8%. While the labour market has strengthened, the pace of job gains in some months has been below expectations, likely due to the supplementary unemployment benefit acting as a disincentive for people to seek work. Once these additional benefits end, the pace of job gains is expected to accelerate, particularly with job vacancies at an all time high.

The US Federal Reserve has maintained an accommodative policy stance year to date. This has also supported growth, with asset purchases continuing at a monthly pace of $120bn. It has indicated that it will provide guidance on when it plans to taper these purchases later this year, with a reduction expected to begin in quarter one of 2022. The US Federal Reserve has suggested that interest rates could be raised twice in 2023, most likely in the second half of that year, however, monetary policy is likely to remain relatively loose for the time being.

Overall, the pace of US growth seems close to peaking, with a growth rate of 9% in quarter two. Growth will remain strong in absolute terms, easing to approximately 8.3% in quarter three before slipping to 3% in quarter four. This would result in growth for the year of approximately 6.7%.



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

Source: Bloomberg 30.06.21

China

China was the only major economic region to experience growth in 2020 with GDP rising 2.3%. China's recovery was aided by the fact that post quarter two last year, it was one of the few places in the world where the manufacturing sector was open, hence China could meet demand for goods across the world. Exports benefited further as China is a key supplier of medical equipment, for which there was a significant rise in demand. As a result, the trade sector performed extremely well. The recovery was further supported by an increase in fiscal support during the reopening period. Monetary authorities also provided support by lowering interest rates and injecting significant levels of liquidity into the system.

Having recovered relatively quickly last year, the Chinese pace of recovery has slowed this year. Growth in quarter one this year slipped back to 0.6% although the economy still grew 18.3% year on year. The gradual removal of previous policy supports due to concerns over high debt levels has contributed to a slowing in growth. The Chinese economy is expected to grow 8.5% this year, a solid rate of growth in absolute terms but well below the rates seen in the second half of last year, which exceeded 12%.

Japan

Despite significant levels of monetary and fiscal stimulus in recent years, Japanese GDP growth has remained relatively weak in a global context. The Japanese economy contracted by -4.7% last year, outperforming Europe but lagging the US. The much slower rollout of vaccines in Japan has also meant that a reduction in case numbers has been delayed compared to other regions. As a result, the recovery in growth has once again lagged other developed regions.

Over the last year the government has implemented very large fiscal stimulus measures to support the economy while the Bank of Japan has also announced increases in monetary support. However, their impact has been diluted by renewed outbreaks of Covid-19 and the relatively slow rollout of vaccines to date. The Bank of Japan has left most policy settings unchanged so far this year although it has extended funding and support schemes for corporates until March 2022. It has suggested it will not hesitate to announce new measures if deemed necessary. Despite the Bank of Japan's accommodative policies in recent years, inflation remains in negative territory. Overall, as the pace of vaccine rollout accelerates and restrictions are eased, growth is expected to significantly improve in the second half of the year.

Investing in a Low Interest Rate Environment

Whilst there is no doubt that lower yields reduce the appeal of bonds, the investment case for their inclusion in a balanced portfolio remains present, particularly in a low interest rate environment. In this article, we will provide some background on the various fixed income asset classes.

As the dust begins to settle from a tumultuous 2020, investors should take stock on the major lessons learned over the year. Perhaps the biggest lesson for investors was to maintain a long term focus and not to let short term market movements unduly affect their decision making. In the first quarter of 2020 when nearly all asset classes collapsed in value, bonds proved to be more resilient, with safe haven bonds appreciating in value.

Before Covid-19 hit, market sentiment started to shift, with many holding the view that a low interest rate environment could be here to stay. In response to the pandemic, central banks across the world announced quantitative easing measures at an unprecedented level. With these supportive measures, central banks essentially purchased bonds regardless of the price, thereby helping to support a low yield environment. As the recovery started to take hold, bond yields picked up from their historic lows, although they remained at suppressed levels.

Bonds have always played an important role in a multi-asset portfolio as they offer diversification benefits. They typically offer downside protection when there is a growth asset class sell-off. Benjamin Graham, nicknamed “the father of value investing”, suggested that an investor should always try to keep a minimum of 25% in bonds. Perhaps the strongest investment case for bonds is the lack of viable alternatives. Now more than ever, diversification is key, both at an asset class level but also within the bond universe.

Government Bonds

Investors hold government bonds as they are a safe haven asset. The yield on a popular basket of Eurozone government bonds produced by Merrill Lynch was 0.04% (Merrill Lynch Euro Government Bond Index in June 2021). Whilst current sovereign bond yields may not be particularly impressive, they remain attractive to many investors as they will at least get their investment back on maturity, if indeed the bonds are held to maturity. Government bonds remain an attractive asset to hold in the event of a recession as traditionally they have appreciated in value when equities fall.

"The only investors that shouldn’t diversify are those who are right 100% of the time."

John Templeton, Financial Investment Pioneer

Corporate Bonds

Whilst popular balanced investment strategies of the past involved a simple allocation to local equities and government bonds, investors today now seek more diversification. Indeed, as yields moved lower on government bonds, switching from government bonds to corporate bonds became a popular trade. Corporate bonds offer an enhanced yield over government bonds. This premium means that investors can earn a return of 0.32%, as measured by the Merrill Lynch Large Cap Corporate Bond Index in June 2021.

High Yield Bonds

High yield bonds are typically non-investment grade corporate bonds, which are corporate bonds with a credit rating below BBB. Yields are now at historic lows for high yield bonds, for example, the yield on the Merrill Lynch High Yield Bond Index was 3.3% in June 2021. The problem faced by investors searching for yield in the post Covid-19 world is evident, as less than 3% of the global bond market now yields more than 5%, which is the lowest on record. High yield bonds offer diversification away from typical government bonds. The risk level for high yield bonds is in between government bonds and equities.

Emerging Market Debt

The term emerging market debt is used to describe holdings of a basket of bonds from emerging market countries such as Mexico and Brazil. This is a fixed income area that is gaining in popularity. Many investors now feel a small allocation to emerging market government debt will help to improve the risk adjusted returns of a balanced portfolio. A major investment case for holding in this area is the attractive yields that are still available, with the yield on a popular basket of local currency emerging market government bonds at 4.9% in June 2021 (based on the JP Morgan GBI Emerging Market Global Composite Index).

Conclusion

In this market environment, choosing the right fixed income investments to generate returns may be challenging. As we have entered an unprecedented period of low interest rates, it now seems more important than ever for investors to evaluate the investment opportunities available and choose the investments that best suit their needs.

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