The Investor

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Summer 2022

2022 Investment Outlook – Ireland & the World

The Irish and global investment markets are in a very different place compared to the start of the year, with global central banks being forced to respond to inflation remaining persistently high.

Over the first half of 2022, markets have been faced with the highest inflation in over 40 years, the most aggressive policy pivot from central banks in a generation to combat the higher than expected inflation, the largest sell off in bond markets in several decades and the outbreak of the greatest military conflict in Europe since World War II. All of this has resulted in global growth forecasts being reduced from 4.2% to 3% for 2022 and to 2.6% in 2023.

Investors entered the year positve on the global growth outlook, with the impact of Covid-19 fading as economies reopened. Consumer balance sheets appeared strong and business sentiment was upbeat, all of which suggested growth would remain robust. While inflation surprised to the upside in 2021, it was expected to moderate over the course of this year, thus limiting the amount of monetary policy tightening required by central banks.

Having reached new all time highs early in January, global equities began to turn downwards when the US Federal Reserve suggested it would need to tighten monetary policy more than it had previously been guiding. This was in response to inflation remaining persistently higher than anticipated. Other central banks, including the European Central Bank (ECB), followed suit. This change in policy stance accelerated the rise in global bond yields which had been grinding higher throughout 2021. The higher bond yields pushed equities lower, while equities were also negatively impacted by the higher interest rate backdrop.

The Russian invasion of Ukraine exacerbated inflationary pressures given Russia's importance in the production of gas and oil and many other commodities including metals, food and fertilisers. The crisis also resulted in negative contagion for global growth, particularly in Europe given its dependence on Russian gas and relatively close proximity to the conflict.

The consequences of the above developments are that global equities have fallen -17.5% in local currency terms year to date and -12.9% in Euro terms. The US officially entered a bear market this year, falling over 20% from its January peak and experiencing the worst first six months of the year since 1970. European sovereign bonds had their worst start to the year on record.

Looking forward, uncertainty over the economic outlook remains elevated with several outcomes possible. Potential upside to consensus growth forecasts comes from factors such as:

* *A faster moderation in inflation*
* *Repair of global supply chains*
* *A benign resolution in Ukraine*
* *Strong consumer backdrop due to healthy labour markets and excess savings*
* *Stimulus in China and the control of Covid-19*

A shorter economic cycle with slower growth now seems likely, with the level of growth being determined by the scale of tightening necessary to control inflation and how quickly geopolitical issues and supply bottlenecks can be resolved.

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World GDP Forecasts

	2020	2021	2022 (forecast)	2023 (forecast)
World	-3.6%	6.0%	3.0%	2.6%
Ireland	5.8%	13.7%	6.8%	4.8%
United Kingdom	-9.4%	7.2%	3.4%	1.1%
Eurozone	-6.4%	5.4%	2.8%	1.9%
United States	-3.4%	5.7%	2.4%	1.9%
Japan	-4.6%	1.8%	1.7%	1.8%
China	2.2%	8.1%	3.9%	5.2%

Source: Bloomberg 30.06.2022

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Ireland

The Irish economy has continued to perform well, both in absolute and relative terms. Having grown by 13.7% in 2021, Irish GDP grew 10.8% in quarter one of this year, with growth of 6.8% forecast for 2022 overall. Irish GDP is however distorted by several factors which often overstate the true level of growth in the economy. The performance of the multinational and trade sectors, for example, contributes to a misleading picture of growth. Modified domestic demand is seen as providing a truer reflection of growth and this grew 6.5% last year, a strong level of growth but well below the headline GDP level of 13.7%. In quarter one, modified domestic demand contracted by -1% but is forecast to grow 4.4% for the year as a whole.

Perhaps surprisingly, consumption fell -0.7% in the first quarter despite credit and debit card spending being robust, as spending in services rebounded with the reopening of the economy after the lockdowns in late 2021. Government spending was down -0.4% as Covid related expenditure began to reduce. Output in indigenous sectors rose 7.6% in quarter one with strong growth in distribution, transport and hotels. Other sectors in the economy performed as follows:

- *Professional, administration and support services were up 6.3%*
- *Arts and entertainment rose by 3.5%*
- *Finance and insurance sector grew by 6%*
- *Construction spending was down -3.7%*
- *Exports were up 5.2% and imports were down -12.3%*

The labour market has continued to improve as the economy has reopened with unemployment falling from a peak of 31.5% during the height of the Covid-19 pandemic to 4.7%. Consumer balance sheets are strong with household net worth at a record €1trn plus, while household deposits are also at a record €143bn. This is approximately €31bn above pre Covid-19 levels with the amount of excess savings estimated at €23bn.

As elsewhere, inflation has begun to act as a constraint on the economy in terms of squeezing real incomes and consumer spending while also adding to cost pressures for corporates. Inflation has continued to surprise to the upside with headline inflation recently rising to 9.1% and possibly rising further before peaking in late summer. Average inflation in 2022 could be close to the current level before moderating in 2023 to close to 4%.

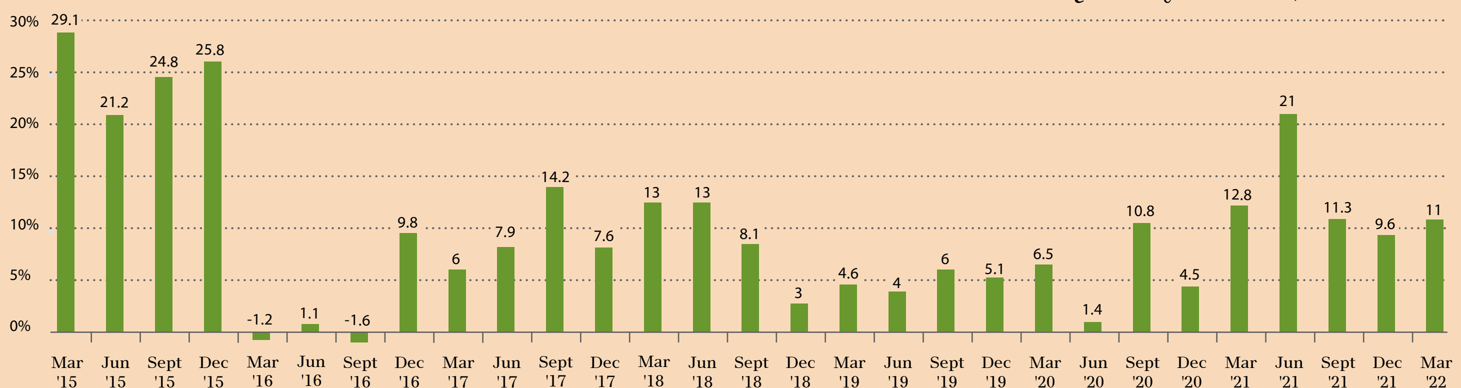
The key risk to growth remains developments in the global economy, with concerns over a possible recession in 2023 given higher inflation, tighter monetary policies and geopolitical events. 'Brexit' also remains an ongoing concern with the UK threatening to revoke the Northern Ireland Protocol. This is a worst case scenario which could result in a trade war between the EU and UK and this would have negative implications for Ireland. It may however take some time before that point is reached and some form of compromise is possible in the meantime.

Europe

The European economy has seen some of the largest downward revisions in growth forecasts this year given its sensitivity to the crisis in Ukraine. Growth forecasts for the Eurozone in 2022 have fallen to 2.8% with risks still seen as being to the downside. Russia supplies up to 35% of gas used in Europe and with gas prices spiking by 118% year to date, combined with the large price rises experienced last year, cost pressures for consumers and corporates across Europe have been intense. The recent significant reduction in gas flows from Russia raises the risk that gas supplies will be further 'weaponised', which would pose additional threats to the already slowing growth backdrop in Europe. If gas supplies were stopped and gas prices settled at the highs seen immediately after the invasion of Ukraine in late February, Europe would likely be plunged into recession.

Overall, economic activity across the Eurozone looks set to slow in 2022 with growth of 2.8% now expected for the year, with risks of further downgrades as the ECB begins to tighten monetary policy and business and consumer confidence continues to roll over. Further potential fallout from the Ukraine crisis also poses a risk.

Irish Quarterly GDP Year/Year Growth



Source: Bloomberg 30.06.2022

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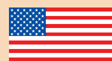

United States

Having enjoyed a very strong rebound in 2021 when the economy grew 5.7%, supported by significant monetary and fiscal stimulus and the boost from reopening, US growth was set to slow but remain firm in 2022.

At the start of the year, the US economy was expected to grow 3.7% in 2022. As elsewhere, forecasts have been cut, although by less than other regions given its relative resilience and reduced sensitivity to events in Ukraine, with growth of 2.4% now expected in 2022. Additional tightening, lower global growth, reduced consumer and business confidence and the drag from higher inflation have all contributed to the slower growth backdrop.

Within the economy, the labour market has continued to stand out as the key area of strength. Unemployment has fallen to 3.6%. Non-farm payrolls grew 2.4m in the first five months of the year as total employment has almost recovered to pre Covid-19 levels. Despite the positive labour market backdrop, consumer confidence has fallen to its lowest level in 70 years.

The US Federal Reserve has outlined its determination to bring inflation back to its target of 2%. It will continue to tighten monetary policy and it has acknowledged there will be economic pain as a consequence of its policy actions.

US GDP growth is expected recover to between 2 and 2.5% over the remaining three quarters of the year, before easing to below 2% in quarter one next year. Thereafter, risks to growth are seen as being to the downside with a rising possibility of recession in the second half of the year.

China

Following a strong rebound in 2021 when it grew 8.1%, the Chinese economy has struggled this year as it has experienced its worst wave of Covid-19 outbreaks since early 2020. The authorities have maintained a 'zero tolerance' policy and lockdowns have been reimposed as the Omicron variant of the virus swept across Beijing, Shanghai and several major production regions. This resulted in a severe contraction in activity levels in quarter two.

Following GDP growth of 1.3% in quarter one, economic data slumped in April resulting in a contraction in the economy of around 5%, although there have been signs of recovery towards the end of quarter two as the economy began to reopen.

The Chinese authorities have announced several support measures to boost growth to try to offset the impact of the shutdowns. Key policy areas focused on have included:

- *VAT and tax cuts or refunds*
- *Housing market supports*
- *Increased lending and reduced interest rates*
- *Increased infrastructure spending*

While the authorities remain committed to the 5.5% growth target this year, given the weakness experienced in quarter two this now seems unrealistic. Consensus now expects growth of 3.9% for the year.

*Rebased to 100 as of 02/01/2018

Source: Bloomberg 30.06.2022

Japan

The recovery in the Japanese economy from the pandemic continues to lag other major regions. Quarter two growth is expected to rebound strongly, up 4% as another round of reopening and a recovery in consumption boost growth. The trade sector continues to struggle, however, and the auto sector, a key part of the industrial sector, continues to be impacted by supply disruptions.

There are several potential risks to the growth outlook in Japan. One such risk centres around the Bank of Japan's policy stance, where if inflation expectations were to rise in the event of persistent inflation, then it would be forced to join other central banks and tighten policy aggressively. Another risk relates to continued disappointing growth in China, with negative consequences for major trading partners in Asia, including Japan. A fading of support for fiscal stimulus and risks of a global recession in 2023 also pose threats to the Japanese economy.

While the economy contracted in quarter one, it is expected to grow at close to a 3% rate in the second half of the year, resulting in growth for the year of approximately 1.7%.

Investing in a Time of War

This article explores the reaction of financial markets to prominent wars over the past century and the repercussions for long term investors. As the invasion of Ukraine continues, equity markets are expected to provide mid to high single digit returns above inflation over the long term.

In the early hours of Thursday 24th February 2022, the president of Russia Vladimir Putin ordered the Russian army to begin a 'military exercise' across the Ukrainian border and an invasion of the independent nation began. It sparked the start of a war between both countries and generated a surge in volatility across all financial markets as the news broke. Additional sanctions applied by the West on Russia with the intent to cripple the Russian economy followed, whilst supply chains experienced considerable disruption, leading to a jump in energy and food prices. The invasion of Ukraine by Russia led to a lot of questions for investors. One of those questions was how financial markets behave in times of war.

World War II (1939—1945)

World War II started in September 1939 when Hitler's Germany invaded Poland. The war all but ended in August 1945 when the US army dropped two atomic bombs on the Japanese cities of Hiroshima and Nagasaki. Data available at the time showed that the initial invasion of Poland saw the S&P 500 rally from 1st September to 2nd October 1939. However, by September 1940, the S&P 500 was down again. Whilst markets ultimately retracted at the start of World War II, inflation shot up as initial panic encouraged households to stock up on essential goods. Whilst gold is traditionally seen as a safe haven asset in times of market uncertainty, gold fell during the first year of this war.

Korean War (1950—1953)

The Korean War was the first military action of the Cold War and started with an invasion of South Korea by the North. The US entered the conflict in 1950 and in that first year the S&P 500 and DJIA rallied. At the time, prosperity in the US was high, with economic growth rising off the back of World War II. Inflation in the US drastically increased as middle-class families had excess wealth, thanks to the rapid growth of the economy. In a similar situation to the beginning of the Covid-19 pandemic, families had access to money at low and favourable rates, which ultimately drove prices up. As the war dragged on, inflation began to stabilise and return to normal.

> *"...the last thing you'd want to do is hold money during a war."*
>
> **Warren Buffett**

Vietnam War (1961—1973)

The war in Vietnam also occurred during the Cold War era, between the communist north and the American backed democratic south. Whilst the war officially started in 1955, the US only got involved in 1961. During that first year of US involvement, both the S&P 500 and DJIA made significant gains. In a similar fashion to World War II and the Korean War, inflation increased in the US during the first year of the Vietnam War. This constant rise in inflation can be seen throughout most war periods, and no doubt in today's market environment the same is true. However, Covid-19 and the disruption caused to supply chains has most likely magnified the extent of inflation today.

Afghanistan War (2001—2021)

Shortly after the 9/11 attacks, the US invaded Afghanistan. Twenty years later, the US eventually left the region and the Taliban has since re-taken control of the country. During the first year of the conflict the S&P 500, DJIA and Nikkei all fell significantly. It is worth noting that stock markets at this time were also highly influenced by the dot com bubble. At the beginning of the invasion gold prices rose considerably as there was a high level of uncertainty in markets after the 9/11 attacks and investors looked for safer assets. Oil markets also had a very strong rise. Interestingly, oil prices retracted shortly after the 9/11 attacks but began to rally as the invasion of Afghanistan commenced. It is perhaps no surprise that with the rise in oil prices, inflation also increased. In a similar fashion to today's market environment, we can clearly see the impact oil prices have on inflation.

Iraq War (2003—2011)

A US led coalition invaded Iraq in an attempt to overthrow the dictator Saddam Hussein in early 2003. For the first year both commodity and equity markets rallied. Gold and oil prices also rose considerably during the period. In other wars, gold lost value or increased by a relatively small amount. Iraq contains some of the world's largest oil reserves and when the war broke out, it caused considerable disruption to oil production. This led to a sharp rise in prices and a corresponding jump in inflation. We can now see a trend emerging: excluding World War II and the Afghanistan War, equities have rallied during war time.

Conclusion

Markets have mixed results during times of war. However, whilst wars have occurred, equities have continued their upward trend. This can offer a high level of comfort for investors during the dreadful times of war.

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