BoI Investment Markets

Global 'Wrap Up'

1st Quarter 2019

Bank of Ireland

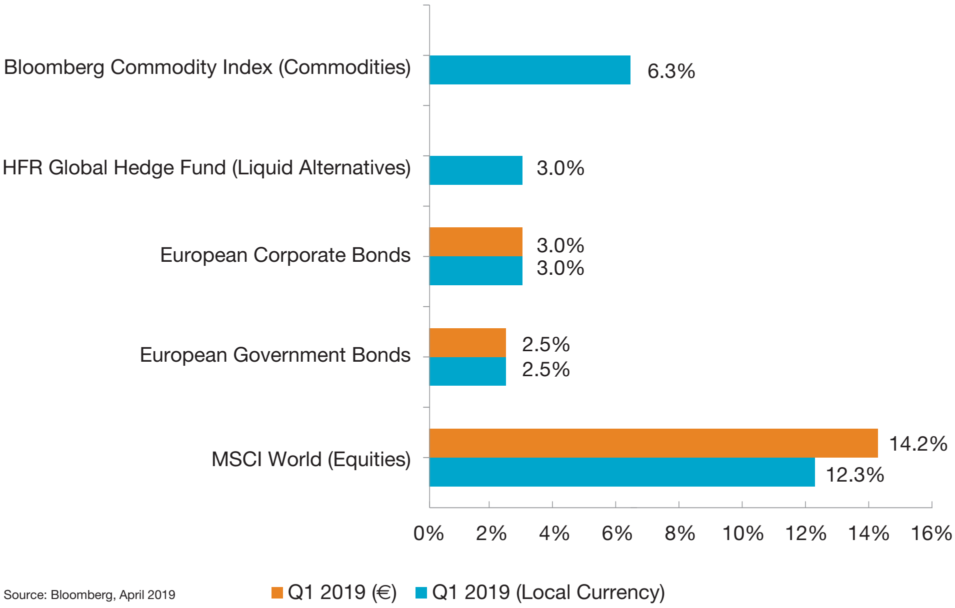
Tom McCabe,

Global Investment Strategist

Markets rebound on Fed pivot, trade optimism

What a difference three months makes! After a bruising final quarter of 2018 when stock markets lost 11%, investors would understandably have been nervous about what lay ahead for 2019. However, what they've seen so far this year has been a really powerful market rally across most markets as we can see in chart 1. The key driver of the performance turnaround was an unwinding of two concerns that dogged markets continuously in 2018; the outlook for US-Sino trade and the worry that further US interest rates increases could choke off its economic recovery.

Chart 1: Investment Performance Q1 2019



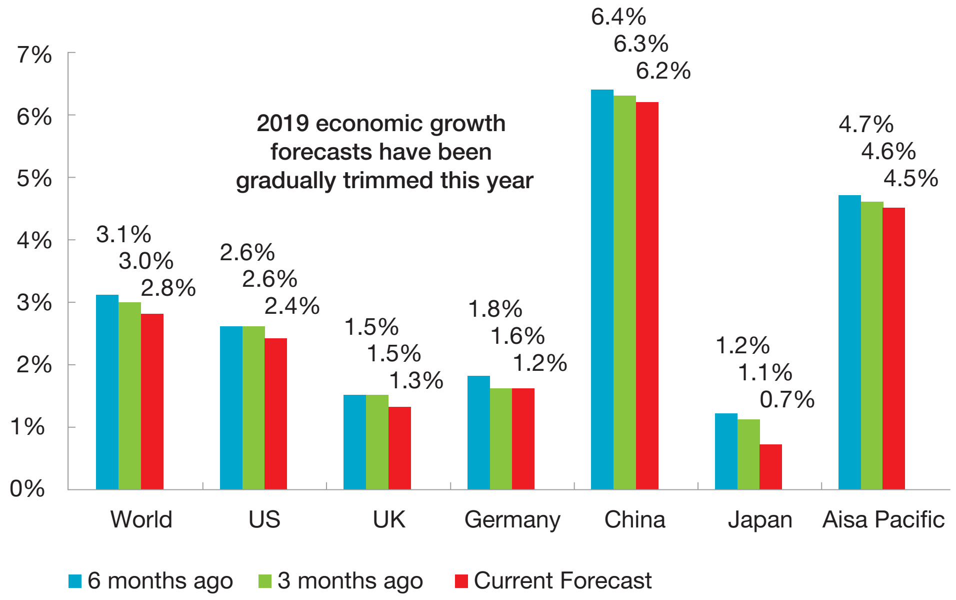
Source: Bloomberg, April 2019

The news on US-Sino trade has been positive in recent months. President Trump initially pushed out his March 1st deadline for increasing tariff rates on Chinese exports to the US which helped investor sentiment. Since then investors have regularly heard that the talks are progressing, albeit with the caveat that little in the way of details have been aired. Overall we remain optimistic that the US and China can arrive at a deal – this may not necessarily be the end of the US trade crusade as President Trump may then turn his attention to the Euro zone. However, if the number one and two economies on the planet could nail down a comprehensive long term deal, we feel it would go a long way to easing the trade worries that have stalked markets over the past year.

We also saw an about turn in the US Federal Reserve's (Fed's) outlook for interest rate increases which boosted markets. The market selloff in the final quarter was a factor here – the increase in market volatility and tightening of financial market conditions in the final quarter of 2018 effectively already increased interest rates for the US, rendering any further Fed action unnecessary. On top of this however we saw more mixed economic growth signals across the US and global economies which caused Fed members to assume no interest rates increases in 2019 compared with recent expectations for two moves. This weaker tone also caused the European Central Bank to abandon any further efforts towards higher interest rates and tighter monetary policy.

Coming into 2019 we had expected growth to soften anyway as the boost from US tax cuts in 2018 wanes and as the long term slowdown in China continued. Since the beginning of the year economic data has also been weaker than expected – we expect the picture to stabilise as the year goes on but for the time being this has led to modest downgrades to growth forecasts for 2019 (see chart 2). In this context, it makes sense that the main central banks are being cautious on their next policy steps.

Chart 2: Evolution of 2019 Consensus Economic Growth Forecasts



Source: Consensus Economics, March 2019

The political backdrop is also making the job of steering central bank policy trickier, particularly in light of the US government shutdown in Q1 and the continuing Brexit uncertainty. In terms of Brexit, the situation remains very fluid but we remain optimistic that the UK's departure will ultimately be orderly, albeit with a qualification that it may take an extension beyond June 30 to agree the details and secure parliamentary approval. From an investors' perspective, with the exception of sterling markets have been completely unmoved by the drama around Brexit so far this year. Barring a no-deal Brexit, we think that will remain the case.

Overall investors have enjoyed an excellent start to 2019. Looking forward, we believe markets are discounting a lot of optimism that a US –Sino trade deal will be done and that interest rates will stay low this year. Assuming we don't get any negative surprises here then the focus should turn back on the economy and market fundamentals for the rest of the year. Although the global economy has begun the year on a softer note, we are optimistic conditions will improve as the year goes on and that this improvement can help risky assets (equities, property and corporate bonds for example) gradually outperform cash and government bonds on a twelve month view.

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Leona Nicholson,

Head of Investment Management

Lower interest rates boost performance and M&A in Q1

Buoyed by the prospect of lower interest and investor optimism on trade, global equity markets enjoyed a bumper quarter with a 14% return. Across the various sectors, technology was the standout performer with a return of 21% followed closely by real estate with 18%. Q1 also marked the ten year anniversary of the stock market's financial crisis low – over this period global equities gained a whopping 297% translating to annualised returns of 14.8%.

Generational lows in interest rates certainly helped equities push higher since 2009 and even now equities continue to feel their benefit. In the first quarter luxury goods company LVMH* and pharma giant Sanofi* both issued bonds with negative yields, guaranteeing investors receive less back than they invested. The generalised decline in bond yields so far this year also helped merger and acquisition (M&A) activity get off to a good start; Bristol Myers* announcing a $74bn agreed bid for Celgene* for a combination of cash and shares while Eli Lilly* also agreed to buy Loxo* for U$8bn in cash. In the US, BB&T* and Suntrust* will merge to form the sixth largest US Bank and in Germany Deutsche Bank* and Commerzbank* are in talks about a possible merger although this faces considerable resistance from employee unions.

In the Consumer sector, the UK Competition authority blocked the merger of supermarket giants Asda* and Sainsbury* on dominant market share concerns – together they would account for 29% of the UK grocery market. Marks and Spencer* also announced a joint venture with Ocado* to boost its grocery delivery capability on top of further store closures.

In Healthcare, the Food and Drug Administration approved its first new anti-depression drug for decades. The drug Spravato was developed by Johnson&Johnson* and is based on Ketamine therapy. This novel treatment acts on the glutamate system which processes information and memory. The drug can only be used on adult patients who have already tried other first line treatments. In contrast traditional drugs such as Prozac work on the brain's chemicals such as serotonin, dopamine and norepinephrine.

Image source: FT 2019

In Technology, Samsung* justified its reputation as an innovator with the launch of its first foldable smartphone just ahead of Chinese rival Huawei. The Galaxy Fold is 7.3 inches (seamless) and when folded in half becomes a 4.6inch smartphone. Get ready to open your wallet however as the retail price will be above US$2000. This new foldable was unveiled alongside a range of new devices including its first 5G mobile phone. 5G represents the next generation of mobile technology, is super-fast (100 times faster than 4G) and will be the key enabler of the next generation of digital services and new technologies such as driverless cars (powered by Qualcomm and Intel chips) and data networks.

Overall we retain our view that global equities should form a part of a long term portfolio. Currently looking at the forward price to earnings (P/E) valuations, global stocks are reasonably valued relative to history. The dividend yield of 3% is also attractive, backed by lowly indebted quality companies.

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Tom Baragry,

Head of Multi-Manager Funds

Is the Euro zone turning Japanese?

Bond markets were positive across the board in the first quarter of the year (table1). As noted earlier, the main factor driving the strong gains was falls in sovereign bond yields across most developed markets in response to a softer economic outlook and what looks like a U-turn from the US Federal Reserve on increasing interest rates in 2019. Longer dated government bonds and the riskier sectors of the bond market (emerging market bonds and high yielding and investment grade corporate bonds) were the big winners. In addition to the lower sovereign yields, the strong Q1 performance from equities and a pullback in credit spreads from recent highs pushed those sectors ahead

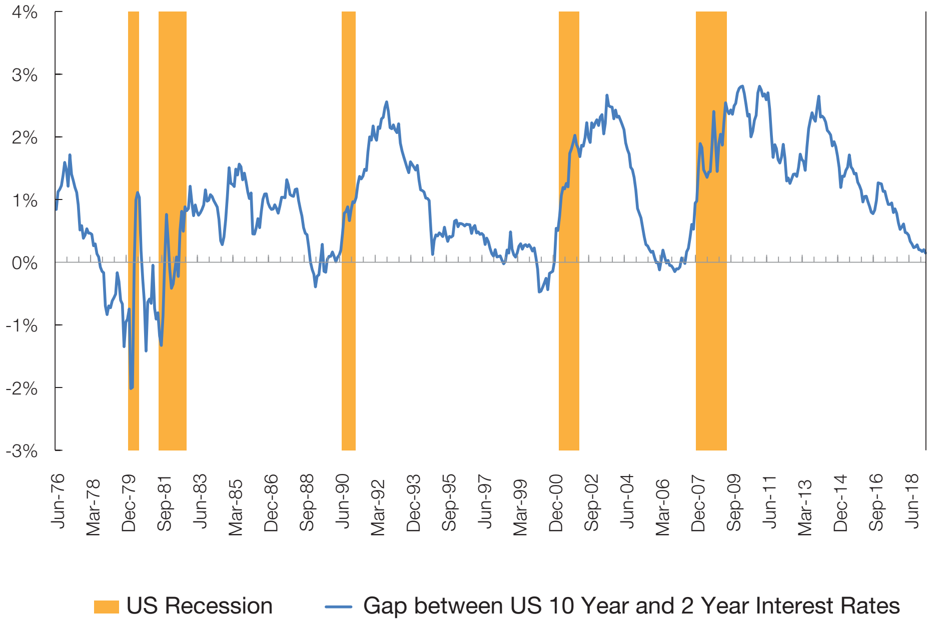
Table 1: Bond Market Performance

	Local Currency
Index	Q1 2019
FTSE WorldBIG Index (Euro hedged)	2.3%
FTSE EuroBig Index	2.5%
FTSE EuroBIG Sovereign Index	2.5%
FTSE EuroBIG Sovereign 10Yr+ Index	5.2%
FTSE EuroBIG Corporate Index	3.0%
FTSE USBig Treasury Index	2.1%
FTSE USBig Mortgage Index	2.2%
FTSE US Corporate Index	5.1%
FTSE US High Yield Index	7.4%
FTSE Global Emerging Sovereign Index	6.1%

Source: Bloomberg, FTSE, April 2019

In the US, the Fed's pivot generated a lot of short term relief for investors. However one by product of its actions was to reduce the gap between short term and long term interest rates. This is known as 'flattening the yield curve' and is important to investors as historically this has been a good predictor of US recessions – chart 3 shows this. So does this mean a recession is around the corner?

Chart 3: The yield curve and US recessions



US growth has slowed of late but we had expected to see this happen in 2019. Overall we see US growth stabilising at lower levels through the year and feel that the Fed's change in strategy should help the US recovery extend for a while longer. Although the yield curve is giving a more uncertain economic signal, we think its strength has been somewhat distorted by the Fed's bond buying program and that at this point it reflects the Fed's policy U-turn more than the short term risk of a US recession.

In the Euro zone growth too has slowed but this slowdown looks more threatening than the one in the US. At present we believe growth will remain low but could improve as the year goes on, particularly if China shows more signs of stabilisation. However, from both a growth and inflation standpoint it is difficult to see the European Central Bank making moves to increase interest rates or tighten monetary policy over the next twelve months.

Overall we are taking a well-diversified approach to bonds in our portfolios, particularly looking to extract returns from non-government bond sectors such as corporate bonds given the low yields on developed market government bonds. We are also avoiding taking significant interest rate risk in the portfolio by holding bonds with an average duration of five years. The backdrop for government bonds looks slightly more promising in the short term given slowing economic data and lower inflation pressures. However in light of the further recent falls in sovereign yields, it is difficult to see a lot of upside barring the global economy slipping into a synchronised slowdown.

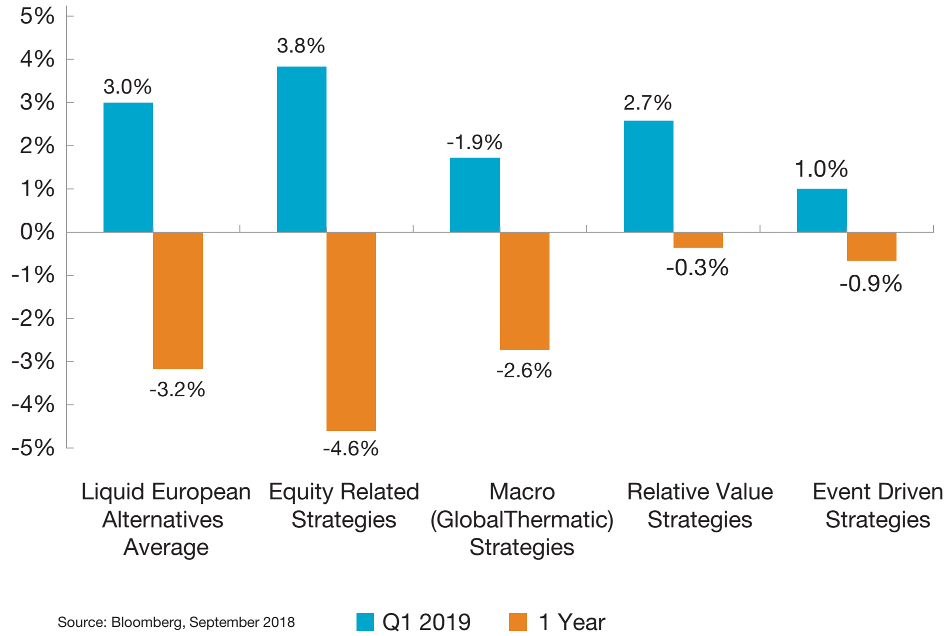
John Byrne,

Senior Investment Manager

Better Q1 for alternatives thanks to market bounce

The first quarter of 2019 was a better quarter for liquid alternatives in Europe as we can see in chart 4. The performance recovered some of the losses during Q4 2018 but still remains down 1.8% over the past two quarters. The performance was helped by the very strong returns seen in equities and bonds. The big challenge for the sector is that its returns over the past twelve months have been weak compared with the more conventional asset classes. Performance over this period has been negatively impacted by weaker returns from some its favoured allocations such as emerging markets and global financial stocks.

Chart 4: Liquid Alternative Strategy Performances



Source: Bloomberg, September 2018

Equity related strategies were the best performing style in the 1st quarter, benefiting from their exposure to positive equity market returns. However the sector only captured a little over 25% of the gain in equity markets, which was slightly disappointing. In attempting to shield investors from more significant losses during the very volatile final quarter of 2018, managers in equity related strategies positioned themselves more defensively. Unfortunately this backfired slightly given the unexpectedly strong Q1 for equities. What worked best for equity related managers in Q1 was their allocations to emerging markets and European equities as both regions performed well.

Relative value strategies also performed well, this type of strategy tends to be characterised by having little overall market exposure, instead trying to generate strong returns from buying undervalued securities (known as 'going long') and selling overvalued securities (known as 'going short'). Increased volatility in markets can often lead to a wider spread of returns, providing managers with a wider opportunity set and increased potential to generate better returns.

Unfortunately currency hedging costs (removing the foreign currency risk of investments in non-Euro currency markets) remain a significant drag on the performance of European liquid alternatives. The cost of hedging is mainly a function of the difference in interest rates between 2 countries and at present the differential between the US and Europe is close to 20 year highs. In the first quarter, the cost came down a little but still remains at very high levels relative to history.

Despite the weaker medium term performance from liquid alternatives we still believe the asset class has a role to play in investor portfolios, one which arguably grows more important as we reach the end of this market cycle. Over the long run we expect liquid alternatives to offer some portfolio protection in periods where risk assets struggle (downturns, recessions) and to participate in gains when the market outlook is a little better. As a result, it shouldn't be directly compared to either equities or bonds.

Generally we see the asset class as a complement to bonds which also aim to protect investors' capital when the economy and markets turn down. Over the past 3 years the assets class has outperformed global bonds (currency hedged) but disappointed relative to the strong returns of equity markets. Over the long run, we think liquid alternatives should generate diversified returns lying somewhere between equities and bonds.

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Paul McKee,

Senior Fund Manager – Real Estate

Euro zone real estate story remains positive

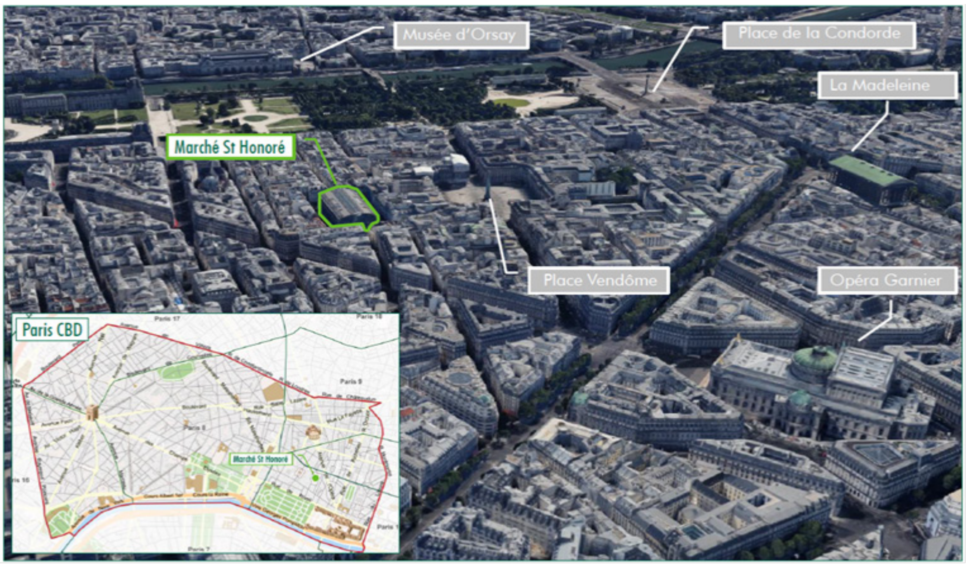
Recent data showed that European real estate investment volumes hit a record high of €312bn in 2018, a slight increase on 2017 (€311bn). In the largest 3 markets, an upturn in French and German investment volumes more than compensated for a slight decline in UK, while in the next 'tier' Spain and Netherlands also provided a significant boost, offsetting weakness in Italy and Sweden. France was one of 5 markets to set a record for annual transaction volumes in 2018, the others being Netherlands, Portugal and Spain.

A really interesting feature of the latest investment volume data was that the Netherlands, Portugal and Spain all saw very significant increases in alternatives (defined as not retail, office or industrial – for example, residential, hotels, healthcare etc.) of 50-80%. Alternative volumes as a whole saw a strong rise in 2018; at the European level, volumes rose from €91.4bn to €100.8bn; this 10.3% gain was outpaced the three mainstream sectors, while the overall total was second only to the office sector. Alternatives investment volume in Europe has now more than doubled in the space of just 5 years.

Highlighting Paris, according to EY's latest 'Europe Attractiveness Survey', Paris is the most attractive city for foreign investors, overtaking London for the first time in more than a decade. The election of President Macron and Brexit were cited as the main reasons for this change of focus. Furthermore, the report highlights that the number of foreign investment projects in France jumped by a third during a recent 12-month period and that together, the UK, Germany and France account for nearly 50% of all foreign projects in Europe. In another well-regarded investor survey, ULI's/PwC's 'Emerging Trends Europe', Paris' prospects rose sharply, climbing 13 places in 4 years. This suggests that the European investment landscape is shifting and that investors are increasingly keen on the French capital, despite low yields.

20% of the European Real Estate Fund (EREF) is located in Paris. One sample asset is Marché St Honoré, an iconic grade A mixed office/retail building in the heart of Paris CBD (1st district) just off Place Vendome. EREF holds a total of 11 retail, office and logistics assets in greater Paris.

We believe that investment in prime, dominant assets in the best locations, such as those held by EREF, will continue to deliver stable returns over the long term. The attributes of property diversification can benefit a wider investment portfolio, with income returns, generated from stable rental cash flows, backed by real assets of bricks and mortar.



Source: CBRE Global Investors, EY, ULI/PwC, Bank of Ireland Investment Markets

Table 2: Updated Investment View*

Asset Class	Scale (1-5)	Comment
Public Equities	4	Global public equities still offer reasonable long term returns in a low inflation environment
Government Bonds	2	Bond rally in Q4/Q1 points to limited short term upside barring an economic slowdown
Corporate Bonds	3	Corporate bonds slightly better positioned than government bonds on a twelve month view
Liquid Alternatives	4	12 month performance has been disapointing, still has a vital long term role to play in portfolios
Property	4	Low interest rate environment favours real assets such as property
Cash	2	Negative rates on Euro zone deposits make cash look unattractive

*Note: Scale (1: Very unfavourable, 2: Unfavourable, 3:Neutral, 4: Favourable, 5 Very Favourable). This is meant to be illustrative only and reflects our broad asset class views over the medium to long term. Any changes to a fund's allocations will also take into account other factors including the fund's investment objective and its particular investment guidelines.

Source: Bank of Ireland Investment Markets, April 2019

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