Investment Markets

Global 'Wrap Up'

2nd Quarter 2019

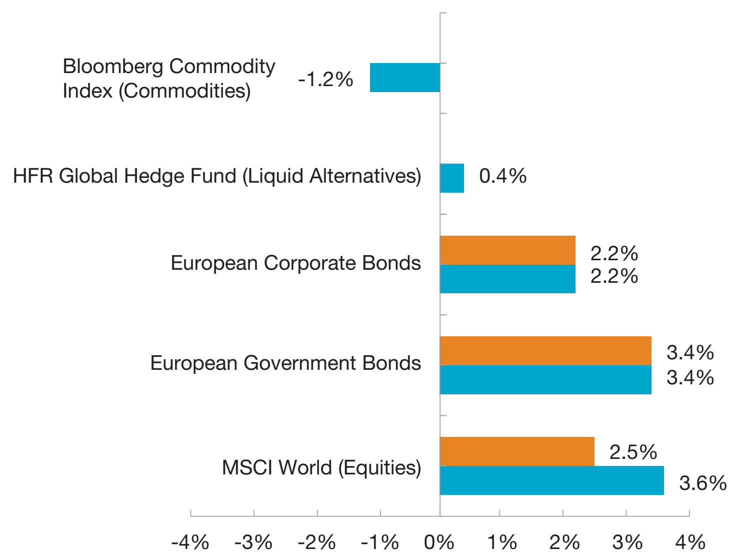
Tom McCabe,

Global Investment Strategist

Central Bank u-turn outweighs disappointing trade news

Investment markets continued to perform in the second quarter with most markets posting solid gains (chart 1). The advance was a little more stop start though, punctuated by further trade war concerns in the middle of the period. President Trump's decision in April to increase tariff rates from 10% to 25% on $200 Billion of Chinese exports was disappointing, leading to a mid quarter pause in the rally. However, yet again central banks came to investors' aid. The European Central Bank finally acknowledged the seriousness of the region's slowdown and reversed course, hinting that looser monetary policy could well be on the way in the second half of the year. The US Federal Reserve followed up on this message which led investors to price in aggressive US interest rate cuts before the end of 2019 as we can see in chart 2 on the next page.

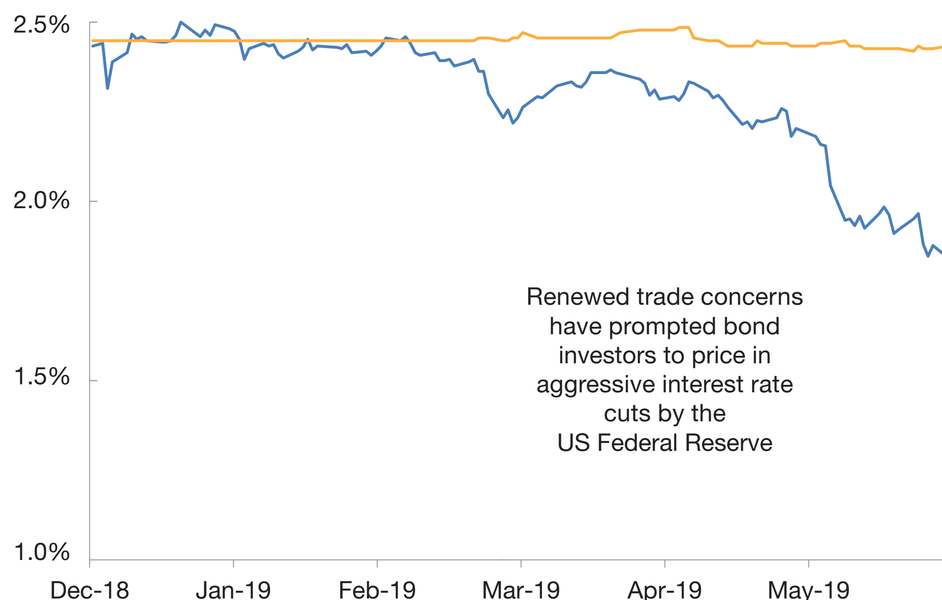
Chart 1: Investment Performance Q2 2019*



*Source: Bloomberg, * Perfoamcnes up to 28 June 2019*

Q2 to date 2019 (€) Q2 to date 2019 (Local Currency)

Chart 2: US Interest rate expectations drop on renewed trade concerns



Source: Bloomberg, Bank of Ireland Investment Markets, June 2019.

— Implied US short term interest rates (from January 2020 Fed Funds Future)

— Current US short term interest rates (Fed Funds Rate)

Investors' expectations for interest rate cuts in the second half of the year seem a tad bit optimistic in our view, but action is certainly warranted. With the exception of the strong US performance (3.1% growth) most other GDP reports flattered to deceive in the first quarter. Both the Euro zone and UK economies rebounded but it looked as though Brexit artificially boosted these performances. Although Japanese growth appeared strong at first glance (2.2% annualised growth), private consumption, business investment and exports all weakened – hardly indicative of a robust Japanese or even Asian economy for that matter.

China's first quarter performance was better than many expected but there has been little evidence thus far to suggest that the economy is responding to the stimulus drip feed over the last six months. On top of this, President Trump's decision to increase tariff rates mentioned above puts further pressure on the Chinese economy entering into the second half of the year.

We also saw the softer tone of the world economy come through in other indicators. Oil demand was weak in the first quarter, prompting regular downgrades to oil demand growth forecasts in recent months which now probably stand at their weakest since the beginning of the decade. Again further justification for central banks around the world to act.

The central bank decisions significantly boosted investment markets over the past few weeks and should help stabilise the global economy from its subdued start to the year. A resolution of the trade war between China and the US is a key issue for the economy and global markets over the next few months however. Further tariffs will strengthen the trade headwinds and therefore investors will hope they don't come to pass. If they do, then investors should expect more central bank activity in the second half of the year to minimise the fallout.

This quarter we updated our long term return forecasts for the various asset classes (see table 1). The key finding was that our return forecasts for the riskier asset classes like equities and commercial property remained generally unchanged. However, the long term return outlook for bond markets deteriorated, mainly as a result of the sharp fall in bond yields (resulting in bonds becoming more expensive) in the first half of the year. Unfortunately given the European Central Bank's change of tack in the period, it looks likely that the return outlook for savers will also remain weak for the next couple of years at least.

Table 1: Long Term Nominal Return Expectations

Asset Class	Long Run Return Estimates	10 Year Historic Return (per annum)*
	June 2019	
Global Equities	6.0%	8.7%
Developed Market Government Bonds	1.7%	8.0%
Investment Grade Corporate Bonds	2.9%	8.3%
Commercial Property (Prime Europe)	6.1%	7.8%
Liquid Alternatives (Absolute Return)	3.6%	n/a
Inflation	1.7%	
60/40 Equity/Govt. Bond split	**4.3%**	**8.4%**

Source: Bank of Ireland Investment Markets, Moodys Analytics, June 2019
US Government Bond Historic return from Citi USBIG 7-10 Year Treasury Index
US Corporate Bond Historic return from Citi USBIG Corporate Index
Historic Global Equity returns, source MSCI
Historic Property returns from combination of CBRE Prime EU-15 Capital Value and Rent Indices Q2 2008-Q2 2018
Indicative returns over a ten year period
**Historic 10 year returns based on average 10 year return vintage for respective indices*

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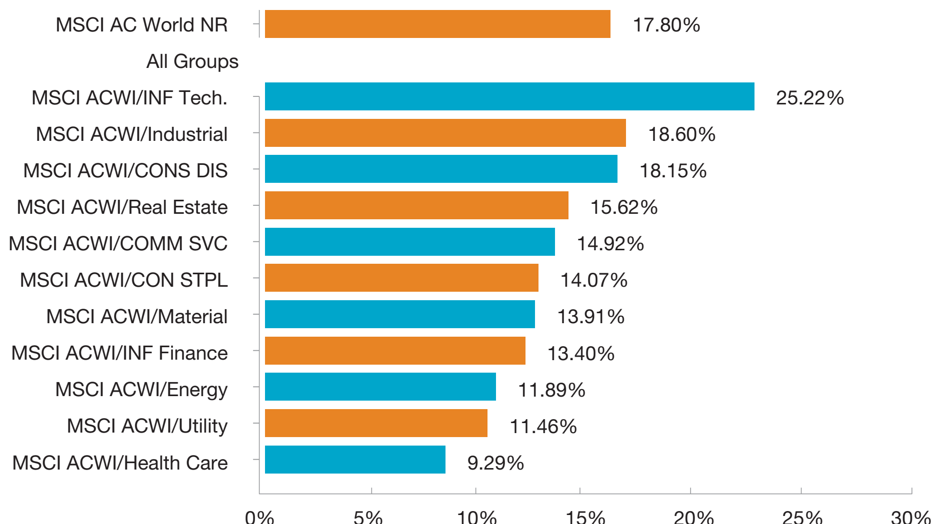
Leona Nicholson,

Head of Investment Management

Equity markets continue to rise

Buoyed by the prospect of lower interest and optimism for a successful outcome to the trade talks equities markets enjoyed another strong quarter with a 2.5% return. Year to date equities are up 17.8%. Technology stocks continued to lead the market, however all sectors are in positive territory year to date.



Source: Bloomberg using MSCI data from 31/12/18 to 30/06/2019

Merger & Acquisition activity continued across all sectors

In the Healthcare sector Abbvie* announcing an agreed $55bn bid for botox maker Allergan* for a combination of cash and shares. Pfizer *agreed to buy biotech Array Biopharma* for $11.4bn focused on small molecule medicines to treat cancer. Merck & Co.* agreed to acquire Antelliq* Group for €3.3bn a privately held maker of animal-monitoring tools. Antelliq* is a leader in digital animal identification, traceability and monitoring solutions, the fastest growing part of the animal health industry. Antelliq* will be a separately operated subsidiary within Merck's animal health division.

Unilever*agreed to acquire niche skincare brand Tatcha. Founded in the US, which accounts for most of its sales, Tatcha has an innovation centre in Japan. Its skincare products are based on a foundation of green tea, rice and algae. The acquisition price was reported to approach $500mn or 5x sales. The transaction fits with Unilever's strategy of shifting focus to personal care; it's one of a number of recent bolt-on deals. Nestle*entered into exclusive negotiations to sell its skin health business for $10.2bn to a consortium led by Private equity firm EQT. It combines a range of clinical and consumer brands. Nestlé's *new CEO Mark Schneider is focusing the group on its core food and beverages portfolio. There is speculation that he may reduce the company's 23% stake in L'Oréal*, which is worth €31bn.

United Technologies* announced it was merging with defence company Raytheon* to form an aerospace and defence giant with $74bn in sales. The all-share deal increases scale and diversification. It brings together United Technologies * Pratt & Whitney fighter jet engines with Raytheon's *missile-defence products and expertise in radars, munitions and cybersecurity. The new group, Raytheon Technologies*, will be a critical supplier of military equipment and will rank as the second-largest defence contractor by revenue after Lockheed Martin*. The deal is expected to close in the first half of 2020 soon after United Technologies* completes the previously announced spin-off of its Otis elevator and Carrier building-systems businesses. There is very little overlap between the two businesses and the balance sheet will be strong so analysts' expect little regulatory and US Department of Defence scrutiny. As a US defence contractor, Raytheon* doesn't sell to China.

Corporates respond to the ongoing trade wars

The prospect of more tariffs in the ongoing trade wars has prompted companies to take actions with different outcomes in many cases. John Deere* the world's largest manufacturer of agricultural equipment said that 'ongoing concerns about export-market access, near-term demand for commodities such as soybeans, and a delayed planting season in much of North America are causing farmers to become much more cautious about making major purchases.' Deere* lowered its guidance for the full year.

It was interesting to see that Cisco* the world's largest cyber security company reduced its manufacturing in China in anticipation of higher import tariffs levied in the US. Speculation of a 'splinternet 'continue as Google* blocked Huawei from using its apps on its phones in what some commentators see as the start of two internets. Chinese internet giant Alibaba* did a secondary listing in Hong Kong (their primary listing is in New York). Oracle* has moved research staff to other locations in Asia and out of China. On the other hand Honeywell* has 'no plans to move its operations out of China' where the company has 22 manufacturing locations.

Overall we retain our view that global equities should form a part of a long term portfolio. Currently looking at the forward price earnings ratio, global stocks are reasonably valued relative to history.

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Tom Baragry,

Head of Multi-Manager Funds

Rate cut hopes drive bonds higher

Bond markets continued to rally in the second quarter of the year with table 2 showing that all sectors of the market made solid gains. As with the first quarter, central banks played a key role in fuelling their gains as the US Federal Reserve and European Central Banks dropped heavy hints that they were likely to cut interest rates in the second half of the year. Elsewhere, riskier sectors of the bond market such as emerging market bonds, high yield bonds and investment grade corporate bonds were also helped by a combination of slightly lower credit spreads and a decent performance from riskier asset classes more broadly.

Table 2: Bond Market Performance

	Local Currency	
Index	**Q2 2019**	**YTD 2019**
FTSE WorldBIG Index (Euro hedged)	2.3%	4.6%
FTSE EuroBig Index	2.9%	5.4%
FTSE EuroBIG Sovereign Index	3.4%	6.0%
FTSE EuroBIG Sovereign 10Yr+ Index	7.5%	13.0%
FTSE EuroBIG Corporate Index	2.2%	5.3%
FTSE USBig Treasury Index	3.0%	5.2%
FTSE USBig Mortgage Index	2.1%	4.3%
FTSE US Corporate Index	4.3%	9.6%
FTSE US High Yield Index	2.4%	9.9%
FTSE Global Emerging Sovereign Index	4.7%	11.0%

Source: Bloomberg, FTSE, June 2019

In recent months the US Federal Reserve and European Central Banks have increasingly stressed the downside risks to the world economy arising out of trade war uncertainty. We noted in table 2 above that this led bond investors to price in aggressive interest rate cuts in the US over the next few months. This also pushed longer dated bond yields in the Euro zone into negative territory again with German ten year Bund yields hitting an all time low of -0.33% and French ten year bond yields turning negative for the first time in history (table 3).

Table 3: Government Bond Yields (30 June 2019)

Country	2Yr Yield*	5Yr Yield	10Yr Yield	30Yr Yield
US	1.75%	1.77%	2.01%	2.53%
UK	0.62%	0.63%	0.83%	1.47%
Japan	-0.22%	-0.26%	-0.16%	0.35%
Switzerland	-0.89%	-0.83%	-0.53%	0.01%
Germany	-0.76%	-0.67%	-0.33%	0.26%
Ireland*	-0.50%	-0.40%	0.17%	1.11%

Source: Bloomberg, June 2018
**3 Year Yield for Ireland*

So this leads us to the question of whether the sovereign bond rally can continue into the second half of the year. Overall the sharp falls in government bond yields in the past few months appear a little overdone. Assuming our base case that the current slowdown in the world economy or the trade war between the US and China don't deteriorate further, then the scope for yields to push lower looks limited. On this basis we think it will be difficult for government bonds to back up their strong first half performance.

On the other hand the case for corporate bonds appears stronger, especially if central banks' anticipated measures can help stabilise the economic picture. The case for corporate bonds is also enhanced by virtue of the extra yield offered by these bonds, especially in an environment where government bond yields have increasingly turned negative of late. Overall we continue to take a well diversified approach to bonds in our portfolios but we retain a tilt towards non-government bond sectors like corporate bonds.

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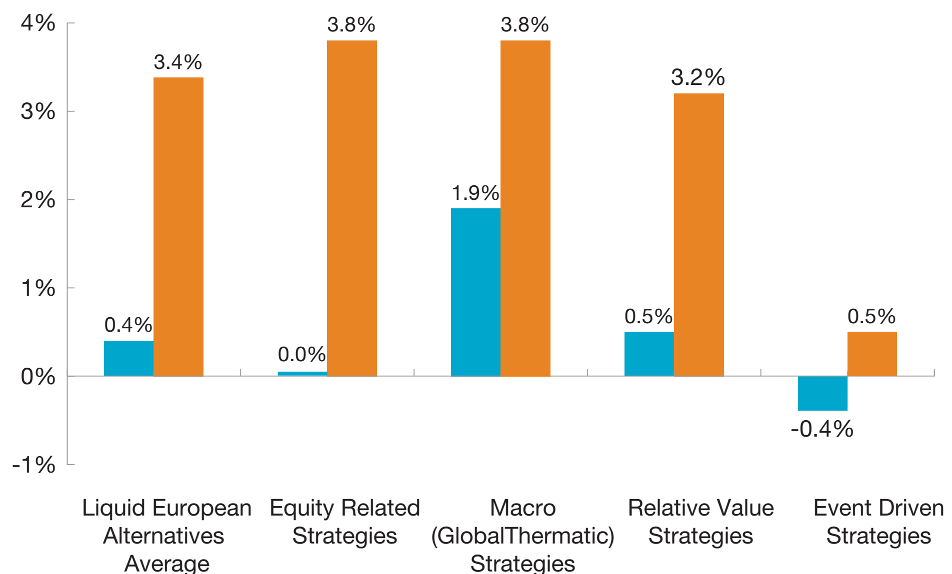
John Byrne,

Senior Investment Manager

Another positive quarter for liquid alternatives

Liquid alternatives in Europe generated a positive return the second quarter, chart 3 shows the performance over the quarter and year to date. Since the end of Q3 2018, liquid alternatives still remain down in value. This is a result of fund managers becoming more defensive and concerned about trade wars, global growth and the impact of monetary policy. In comparison, over the same period equities have generated solid positive returns while global bonds have also performed well. In a recent Bank of America / Merrill Lynch survey, fund managers highlighted that they are the most bearish since the global financial crisis, as result the strong rally in equity markets since the beginning of the year has left many liquid alternative managers behind.

Chart 3: Liquid Alternative Strategy Performances



Source: Bloomberg, June 2019

Q2 2019 1 Year

Global Macro strategies performed well in the in the quarter. This was the main contributor to the positive return of the broader European liquid alternatives index. Global macro strategies tend to position themselves for large global themes, trending in markets are also important for this style of investing. During the quarter, these strategies benefited from strong returns in bond and equity markets. Equity related strategies disappointed, the strategies ended the quarter flat, managers in this space have taken a more defensive stance in recent months and this hurt performance as cyclical sectors generally outperformed more defensive sectors.

The Event Driven style had a more challenging quarter, the style was impacted by increased market volatility in May. Merger Arbitrage, a major part of the Event driven sector, suffered from the increased trade war concerns and volatility. Merger-arbitrage funds seek to profit from M&A activity and the difference between the stock price of a target company when a deal is announced and the price when the transaction is completed. Increased tensions between the US and China resulted in more uncertainty on the likelihood of cross border deals getting approval.

Liquid alternatives still have an important role to play in investor portfolios. Over the medium term, the performance of liquid alternatives has been challenging, we 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.

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,

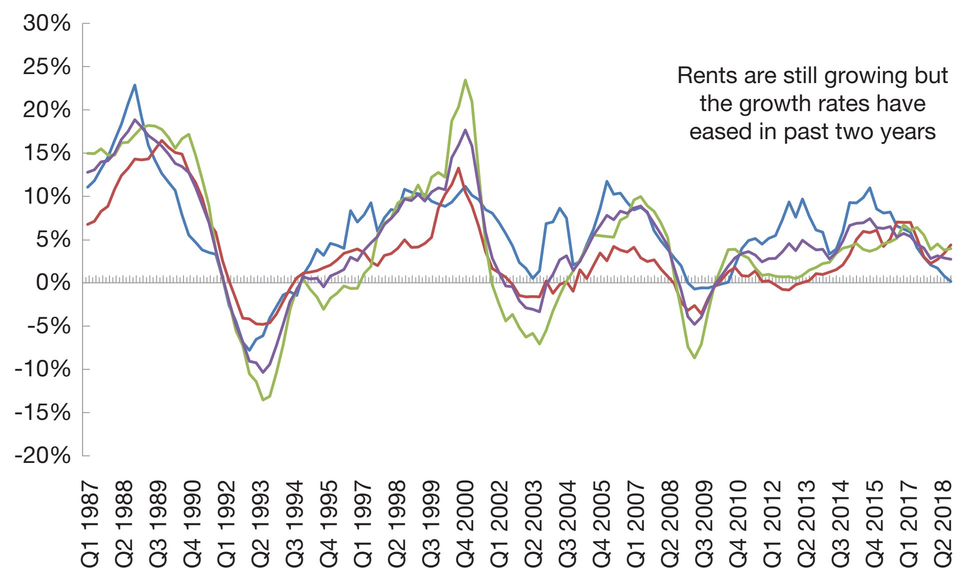
Senior Fund Manager – Real Estate

Growth still visible but momentum easing

Commercial property data in Europe for the first quarter of the year indicated that growth in rents and capital values is still visible but the momentum in property fundamentals is easing as we progress through the latter stages of this economic cycle. The CBRE EU-15 Prime Rent Index (chart 4) rose by 0.5% in Q1 2019 and by 2% over the past twelve months helping push capital values higher by 1.1% in the quarter and by 1.5% over the past year. This progress was underpinned by fairly tight demand/supply conditions in Europe – the EU-15 vacancy rate for commercial property dropped again to 6.9% in Q1, the lowest vacancy rate since Q4 2002. So, underlying conditions should still support commercial property markets grinding higher over the next twelve months, barring any economic shocks of course.

All else equal, this may make real estate a more compelling option for investors over this period, particularly given the sharp fall in bond yields recently and the growing prospect of interest rate cuts rather than hikes in the next twelve months. Investor volumes in Europe were a little softer of late, dropping by 5% in the twelve months to the end of the first quarter. Fewer large transactions were a key reason for this while Brexit uncertainty also made investors a little more circumspect.

Chart 4: Annual Change in CBRE EU-15 Prime Rent Index



Source: CBRE, June 2019

— Retail — Industrial — Office — Combined

U.S. and Asian commercial property markets also showed similar signs of growth and investment volumes slowing in Q1. In Asia's case, this was more pronounced as trade war concerns and general uncertainty around the Chinese economy caused occupier demand to be more muted. Activity in the US market was a little more subdued in Q1 compared to previous quarters but demand still appears positive, backed up the solid US economy. This is probably best exemplified in the industrial sector where the amount of industrial space absorbed rose 17% in 2018.

Table 4: 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	Difficult to see a repeat of first half performance given sharp drop in yields in the period
Corporate Bonds	3	Corporate bonds slightly better positioned than government bonds on a twelve month view
Liquid Alternatives	4	Short term performance has improved but strategies have struggled to capture much of the market upside in 2019
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, June 2019

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