BoI Investment Markets

Global 'Wrap Up'

3rd Quarter 2018

Bank of Ireland

Investment Markets

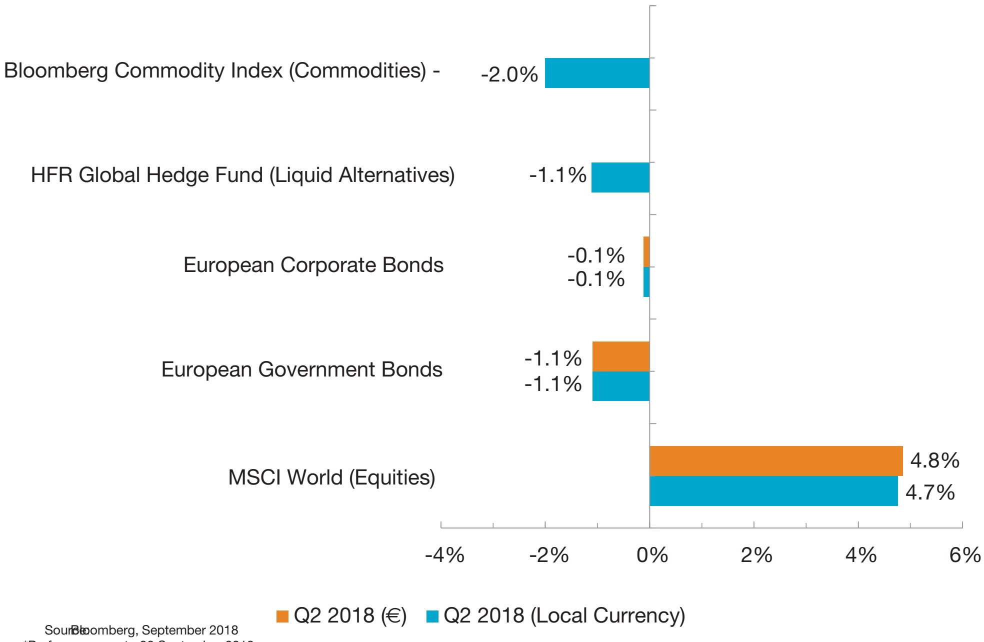
Tom McCabe,

Global Investment Strategist

Equities negotiate tricky quarter for investors

Market conditions remained choppy in the third quarter of 2018, buffeted by news on trade relations between the US and China and by volatility in emerging markets as the Turkish lira and Argentinian peso were heavily punished. Chart 1 shows that it was a tricky period for investors with a number of asset classes posting negative returns. However the equity market again proved resilient, moving ahead by 5% in euro terms.

Chart 1: Investment Performance Q3 2018

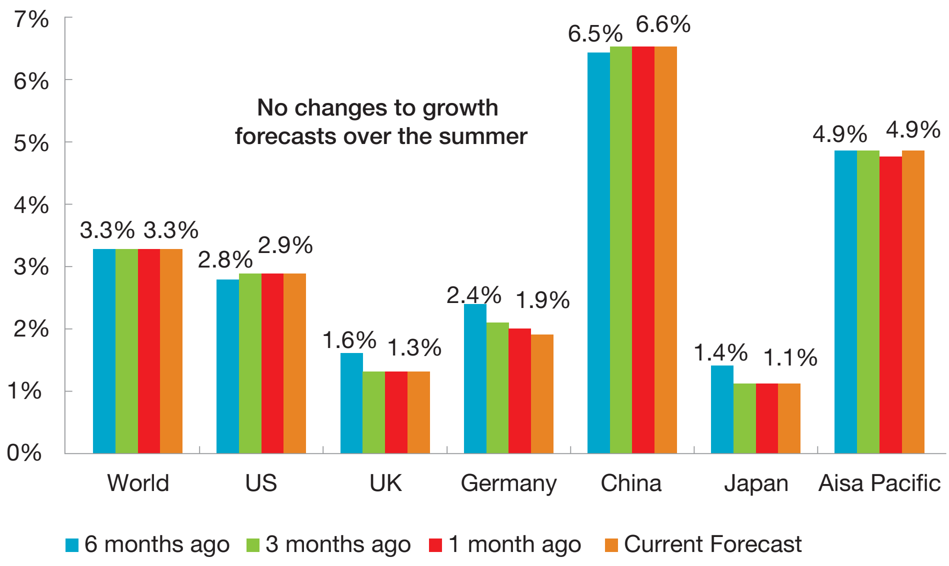


Source: Bloomberg, September 2018
*Performance up to 28 September 2018

The key factor driving the stock market higher in the quarter was continued evidence of growth both in the global economy and in the stock market. The second quarter profit season for stock market companies was a very strong one. According to Factset, profits at S&P 500 companies in the US grew by 25% reflecting improved business conditions and the impact of the US tax cuts enacted at the end of 2017. In Europe, profit growth was more modest but still came in at a very respectable 9.7%. This strong profit growth trend looks set to continue for the rest of the year with Q3 US profits forecast to grow again by 20%.

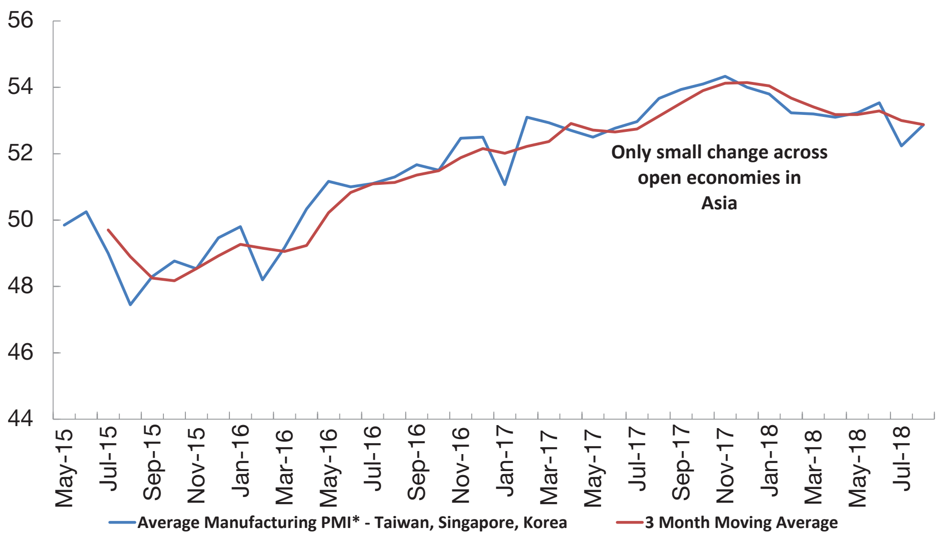
In addition to the strong profit environment the global economy continues to perform well. Chart 2 shows no real change to 2018 global economic growth forecasts over the summer months, despite the regular trade concerns. Global trade patterns have slowed only modestly and this is further validated by chart 3 where we look at PMI readings for Taiwan, Singapore and Korea, economies that are very exposed to global trade. Overall we have seen little change in these readings over the past few months, again suggesting that so far the global economy is handling the trade uncertainty well.

Chart 2: Evolution of 2018 Consensus Economic Growth Forecasts



Source: Consensus Economics, September 2018

Chart 3: Average Manufacturing PMI* - Taiwan, Singapore, Korea



The US economy is very much leading the charge for the global economy right now, mainly thanks to last year's tax cuts. The US grew by 4.2% in Q2 2018, the fastest pace of growth in three years, and many key economic indicators are currently running at multi-year highs. With the economy performing well and stock market profits growing strongly, it's no coincidence that the US stock market has been far and away the best performer so far this year among the major equity markets.

Emerging markets were very much in the news in the quarter, particularly given the backdrop of a rising US dollar, persistent trade concerns and massive currency volatility in Turkey and Argentina. All of this combined to send emerging market equities lower in the period. However generally we believe most emerging market economies are in solid shape and where there are issues such as in Turkey and Argentina this is more down to economic mismanagement plain and simple. Emerging market equities are unlikely to rebound in the short term while these headlines persist. However, in our view episodes such as those in Turkey and Argentina are unlikely to have a wider knock on impact on the global economy or stock market.

Weaker emerging market sentiment was also a likely factor behind commodities struggling in Q3. Despite oil prices powering the energy sector ahead, industrial and precious metals really struggled with both sectors losing around 7%. The stronger dollar also didn't help – the dollar's gain has weighed on gold in particular this year. It lost another 5% in the quarter to leave it with a year to date loss of 9%.

Bond markets continued to struggle to make headway in Q3 as economic growth and inflation trends held up. In addition both the US Federal Reserve and the European Central Bank maintained their forward guidance to investors which had the effect of pushing bond yields higher particularly towards the end of the quarter.

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Equity Market Outlook

Leona Nicholson,

Head of Investment Management

Innovation everywhere – from cannabis drinks to heart sensor watches

Equity markets enjoyed a strong quarter with a 4.8% return. Globally the healthcare sector was the big winner, gaining over 10%. The year to date gains for the global stock market also broadened out beyond the technology sector which is good to see. At the end of the third quarter five of the eleven market sectors were in positive territory for 2018.

In the Consumer sector Coca-Cola* announced it was examining the market for cannabis-related products, adding further legitimacy to the nascent industry, as decriminalisation of the drug spreads across North America. Coca-Cola is not interested in pure cannabis, it is however closely watching the growth of cannabidiol (CBD) as an ingredient in functional wellness beverages. Separately Coke announced it was buying Costa Coffee from Whitbread for £3.9bn and rival PepsiCo* is buying Soda stream for $3.2bn. Both companies are responding to the decline in fizzy drinks served in plastic bottles.

In Healthcare, Merck* topped estimates with its quarterly figures and increased guidance for the full year. Sales of lead drug, cancer medication Keytruda, grew 89% to $1.7bn and now accounts for 16% of total revenues. Group sales rose 5% on a reported basis and 4% on a constant currency (cc) basis to $10.5bn. Adjusted net income increased 3% to $2.9bn and Earnings per Share (EPS) climbed 5% to $1.06.

Johnson & Johnson* second quarter results exceeded forecasts; full year guidance on sales was reduced as a result of currency moves. Pharmaceutical sales increased 20% on a reported basis to $10.4bn and included the impact of J&J's $30bn acquisition of biotech Actelion. Organic sales grew 11% with top contributors to growth including psoriasis medication Stelara and cancer treatments Zytiga, Darzalex and Imbruvica.

In Technology the Apple* investor day was delivered with the expected fanfare. The promotional photographs for the latest Apple Watch show youngsters in athletic poses yet the two key new features of the Series 4 edition of Apple's smartwatch seem squarely aimed at a somewhat older demographic. The new watch has received approval from the US health regulator for sensors and software that can alert the wearer to irregular heart rhythms known as atrial fibrillation. The watch also employs upgraded motion sensors to offer 'fall detection'.

The features are efforts to court the spending power of older customers, using a combination of 'smart home' monitoring technology and wearable devices to promote healthier living and improve elder care'.

In other news Michael Dell, who took his PC company private in 2013, has indicated that Dell will be returning to the public market this quarter.

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, the global stocks are reasonably valued relative to history. We continue to favour global dividend paying companies with strong balance sheets that sell on reasonable valuations with a long track record in delivering returns.

Tom Baragry,

Head of Multi-Manager Funds

Familiar headwinds for bonds in Q3

Bonds endured another tough quarter in Q3 (see table 1) with the government bond sector bearing the brunt of negative performances in the period. This year we anticipated that the combination of solid economic growth, improving inflation and less central bank buying represented key headwinds for government bonds and this was very much in evidence in the third quarter.

Table 1: Bond Market Performance

	Local Currency
Index	Q2 2018
Citi WorldBIG Index (Euro hedged)	-0.8%
Citi EuroBig Index	-0.8%
Citi EuroBIG Sovereign Index	-1.1%
Citi EuroBIG Sovereign 10Yr+ Index	-1.7%
Citi EuroBIG Corporate Index	-0.8%
Citi US Big Treasury Index	-0.6%
Citi US Big Mortgage Index	-0.1%
Citi US Corporate Index	0.9%
Citi US High Yield Index	2.4%
Citi Global Emerging Sovereign Index	2.3%

Source: Bloomberg, FTSE, September 2018

Although growth in Europe and Asia was marginally softer in Q2, the US economy powered ahead dragging US bond yields higher in the process. This trend was cemented late in the quarter with the US Fed again raising interest rates and Fed Chair Powell giving a very upbeat assessment of the US economy. ECB President Mario Draghi also took a leaf out of this book, appearing to emphasise the positives for the Euro zone economy in September, something which also helped push Euro zone yields up. Finally, investor uncertainty around Italy's budget also started to push Italian interest costs higher in recent weeks.

In the riskier parts of the bond market, corporate spreads inched higher over the quarter although the high yield bond market tended to track the strong performance of the equity market. Emerging market bonds have very much been on the back foot for much of this year thanks to investor nervousness around economies like Brazil, Argentina and Turkey in particular. However the sector earned something of a reprieve, posting a 2% gain to leave its 2018 losses at -3.5%.

In recent weeks US bond yields have breached their previous highs, giving rise to fears in some quarters that it could adversely affect the performance of the global economy or markets. In our view higher bond yields reflect a better overall outlook for the economy which should ultimately be seen as a positive for many markets. However in this scenario we believe it will be difficult for government bonds to post positive returns and we are focused on trying to extract returns from other sectors of the bond space.

Table 2: Government Bond Yields (30 September 2018)

Country	2Yr Yield	5Yr Yield	10Yr Yield	30Yr Yield
US	2.82%	2.95%	3.06%	3.21%
UK	0.82%	1.16%	1.57%	1.91%
Japan	-0.12%	-0.07%	0.12%	0.90%
Switzerland	-0.73%	-0.39%	0.01%	0.60%
Germany	-0.53%	-0.09%	0.47%	1.08%
Ireland	-0.44%	0.02%	0.98%	1.77%

Source: Bloomberg, September 2018

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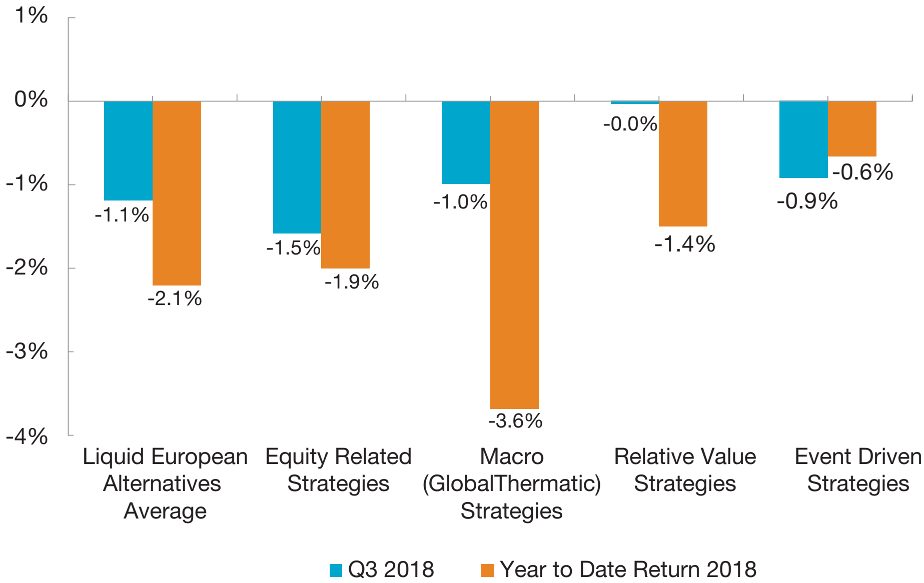
John Byrne,

Senior Investment Manager

Tough quarter for liquid alternatives in Europe

The third quarter of 2018 was a challenging period for liquid alternatives in Europe (see chart 4). The sector's performance has disappointed since concerns about a global trade war emerged in the second quarter, a development that has made overall investment conditions trickier. The European liquid alternatives market returned -1.1% in the 3rd quarter and is down 2.1% year to date. August was the weakest month in Q3 with a negative return of over 1% as emerging market equities struggled. Since the beginning of 2018 liquid alternatives have been hurt by negative returns from some its favoured investments in emerging markets and financial shares.

Chart 4: Liquid Alternative Strategy Performances



Source: Bloomberg, September 2018

Chart 4 shows that none of the main styles of investing generated positive returns in the third quarter. Relative value strategies are the best performing style this year, these tend to be strategies that have little market exposure and attempt to generate returns by positioning long in one security (to benefit from a rise in price) and short in a related strategy (to benefit from a fall in price). This type of investment is known as a 'pair trade'.

Equity related strategies disappointed in the quarter, global equities generated good returns in the quarter but the style failed to capture these gains. The gains for global equities were mainly focused on developed market equities with US equities the biggest contributor to performance, European equities were broadly flat while emerging markets and Asian equities struggled over the quarter. Liquid alternative strategies have tended to favour emerging markets over the past two years and unfortunately this hurt returns as these shares struggled. Value investing is also proving to be challenging and this looks to have impacted some of the strategies.

Currency hedging is also proving to be a headwind for liquid alternatives. The cost of hedging a portfolio of US dollars to euros for the next 12 months is approximately 3% and this is a drag on performance. However, without this currency hedging the performance of these portfolios would be much more volatile.

The performance over the quarter was disappointing given the strong returns from equities but we still believe the asset class has a firm role to play in investors' portfolios. Liquid alternatives are not designed to generate the same return as equities, managers in this space generally target a third to a half the risk of the equity market for their portfolios. Rather, they are designed to complement some of the more traditional portfolio investments such as equities and bonds.

When compared to global bonds (currency hedged), the strategy has strongly outperformed over the past 2 years. Global bonds (currency hedged) have returned -2.2% over the past 2 years while liquid alternatives have returned +1.4% with a little additional risk. Over the long run, we expect liquid alternatives to generate a return between equities and bonds.

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Paul McKee,

Senior Fund Manager – Real Estate

Euro zone real estate story continues, but at a slower pace

Volumes of commercial real estate transactions in Europe have declined since the start of the year from the highs of 2017. The slowdown in the first half of the year was broad-based: activity in all the main commercial sectors fell compared with a year ago. Rental growth remains positive, but there are signs in some countries that it is starting to soften across various sectors. Going forward, forecasts of market returns have been dialled down somewhat from recent previous years, with income now the primary driver of returns going forward.

It is still envisaged that the Eurozone economies should see above trend near term economic growth, and whilst the risk of a no-deal Brexit have increased, it is still, on balance expectation of many commentators, that a UK-EU deal will ultimately be signed at the 11th hour.

We are often asked, with the question of Brexit remaining unresolved, about the merits of real estate investment in the UK. This is a complex question. London is a constantly evolving city that drives the economic fortunes of the rest of the UK. Its robust performance, in the face of the spectre of Brexit, and key infrastructure developments such as The Elizabeth Line demonstrate the strengths and opportunities of this marketplace.

London is one of three global financial hubs, along with New York and Tokyo, whose economy is driven primarily by finance and business services. It is also an important global centre of the legal, insurance, advertising, media and creative industries, such as art and fashion. More than half of the UK's top 100 listed companies and over 100 of Europe's 500 largest companies are headquartered in central London. We see the London market as distinct from the rest of the UK, and believe that opportunities will continue to present themselves to astute investors between now and Brexit deadline, and indeed post agreement.

We believe that investment in prime, dominant assets in the best locations will continue to deliver stable returns over the long term. The recently launched European Real Estate Fund (EREF) can deliver bond like income returns together with capital growth potential with an attractive risk return profile. 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.

Table 3: 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	Rising bond yields beginning to cause government bonds to cheapen up
Corporate Bonds	3	Not much further room for corporate bond spreads to tighten from here
Liquid Alternatives	4	Absolute return strategies producing cash plus type returns are a good substitute for government bonds
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, October 2018

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Warnings

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