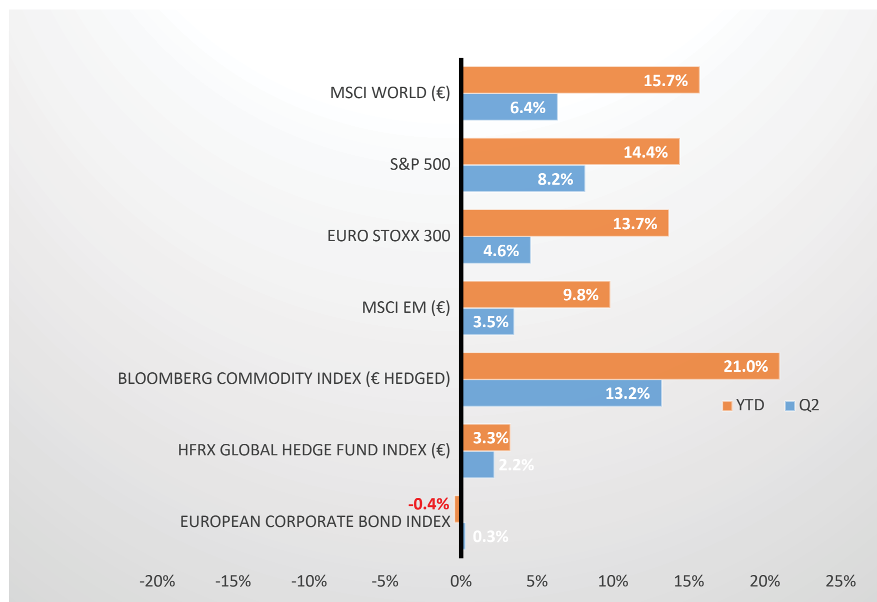
QUARTER 2 2021 INVESTMENT MARKET REVIEW AND OUTLOOK

AIB PRIVATE BANKING

INVESTMENT MARKET REVIEW

Throughout the second quarter of the year we saw vaccination programmes ramp up across developed countries and positive economic sentiment continued to rise. This positive sentiment led to strong equity market returns and new record highs being reached. The S&P 500 grew 8.2% over the quarter and is up 14.4% year to date whilst the corresponding returns for the NASDAQ are 9.5% and 13% year to date. In Europe, where vaccination rollout has been slower, we saw positive returns across all markets and this is anticipated to continue as the rate of vaccination increases. The Eurostoxx 300 returned 4.6% in the quarter and has grown 13.7% year to date. Overall Developed markets grew by 15.7% in euro terms with Emerging markets underperforming somewhat in the quarter. COVID cases rose to catastrophic levels in India with numbers hitting over 300k per day and a state of emergency was declared in Japan as they dealt with a surge in cases. The MSCI Emerging Market index grew 3.5% in the quarter and 9.8% year to date.

ASSET CLASS PERFORMANCE - Q2 AND 2021



Inflation worries continued to bubble under the surface throughout the quarter although comments from the FED, the Bank of England and the ECB have quelled a lot of the initial worries that caused volatility in Q1. An assumption that the FED will look to increase rates sooner than expected caused some market volatility over the quarter but the FED maintains that the easing of fiscal stimulus and rate increases will only occur if the economy is strong enough to stand on its own. Inflation and unemployment goals will also have to be achieved before any easing of fiscal policy occurs. While inflation is less of a worry in the Eurozone (easing to 1.9% in June from the 2.5 year high of 2% seen in May), ECB president Christine Lagarde echoed the FED's sentiment re inflation targets.

Throughout the quarter we saw the more developed economies report strong recovery figures as lockdown restrictions lifted and activity levels picked up. The US and UK are leading the way with manufacturing and PMI data continuing to reflect strong growth levels. The US Composite PMI fell to 63.9 in June (from 68.7 in May) but nonetheless signalled historic elevated expansion in output across the private sector. European PMIs continue to lag although they beat estimates in June coming in at a record high of 63.4, marking its 12th successive month of expansion.

On an asset class basis the biggest growth was in the Commodity sector with oil prices (Crude and Brent) up 55% and 48% respectively to finish out the quarter trading over the $75 mark. Continued positive sentiment surrounding global economic recovery, alongside supply worries, have led to a sharp increase in oil prices. Having cut oil supplies during the height of the global pandemic OPEC+ held talks over the quarter regarding increasing supply as demand recovers. However no formal decision was reached and markets are still awaiting an outcome. Equities continued to perform well in the second quarter however the switch from growth to value which we saw in Q1 has not continued into Q2 as growth outperformed value stocks.

Within fixed income the quarter saw US 10 year yields fall from a high of 1.74% on March 31st to 1.45% on June 30th. With continued positivity surrounding recovery and supportive comments from the FED, investor preference switched to more "risky assets." Gold prices performed well in the quarter, finishing at $1785.34 per oz., but remain down 6.7% year to date. In currencies, the US dollar finished the quarter relatively unchanged against the euro while the euro strengthened against sterling as a ramp up in vaccinations continued to aid the reopening of the European economy.

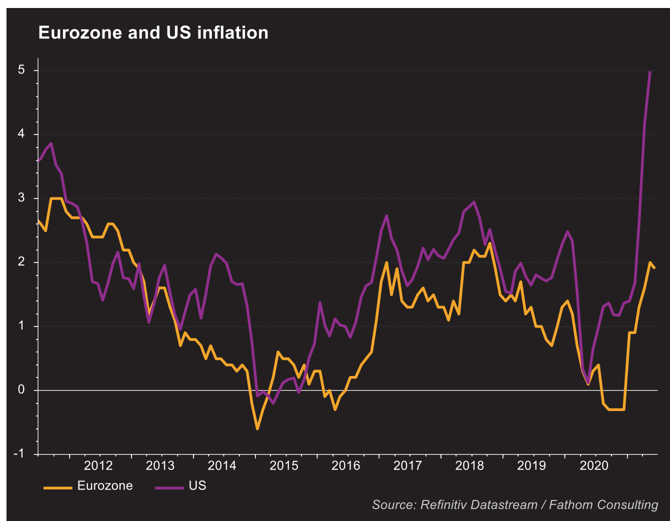
QUARTER 2 2021 INVESTMENT MARKET REVIEW AND OUTLOOK

AIB PRIVATE BANKING

INVESTMENT MARKET OUTLOOK

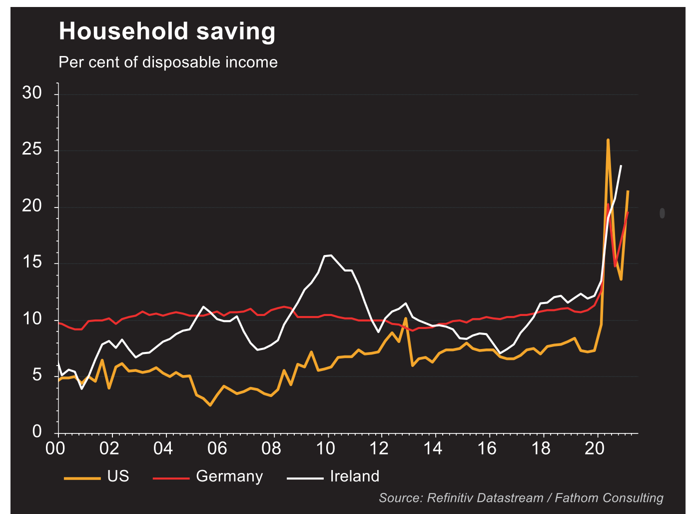
As many major developed market economies have moved towards a more expanded re-opening, the focus of investors has started to shift from COVID case numbers and the pace of vaccination roll-outs to inflation and in particular to concerns that it will be higher and more persistent than originally expected (Graph 1). This is particularly the focus for investors as inflation levels and future expectations will strongly influence the future path of Central Bank monetary policy which in turn will have an important bearing on the direction of equity and bond markets. Other factors such as the spread of the new COVID "Delta" variant, the potential emergence of other new COVID strains, spikes in oil prices and the level of future government stimulus measures will also continue to be watched as they have scope to impact markets and cause volatility. Overall however, for the remainder of 2021, inflation and in particular expectations around its future direction (principally in the US) are likely to be key factors for markets. While there is nervousness among investors in this regard, the general expectation is that while inflation will likely continue to rise over H2 2021, the rise will be transitory. This backdrop, coupled with strong projected economic and corporate earnings growth over the remainder of 2021, should provide a supportive environment for equity markets and other risk assets in the short to medium term.

GRAPH 1



In 2021 we have, to date, seen a very significant rebound in global economic growth and the long term effect of the coronavirus on economies is not expected to be material. Unlike the global financial crisis the COVID crisis did not result in the bursting of any credit or property bubbles which can require a long period of recovery. The recovery has also been significantly helped by the massive government and central bank stimulus measures that we have seen and economic growth in the second half of 2021 should benefit considerably from consumers spending their historically high savings (Graph 2).

GRAPH 2



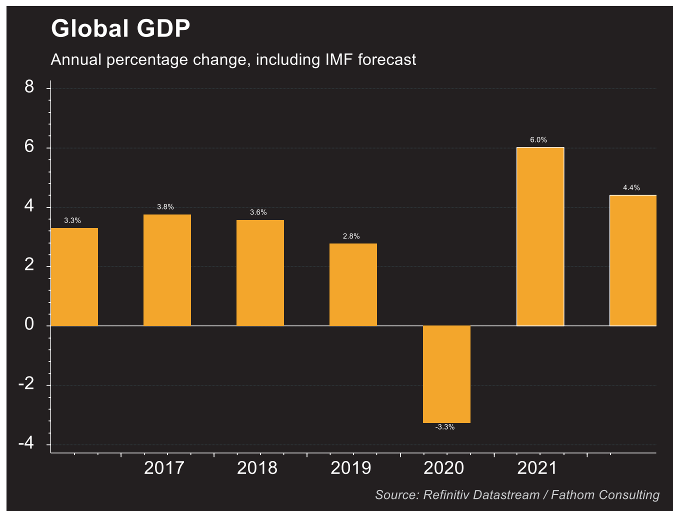
Growth should also be assisted by increased corporate investment and the need to invest in supply chains which in a number of cases were shown over the course of the pandemic to be weaker and less efficient than required. The incentive for higher corporate investment is also helped by the projected higher level of consumer demand and also because there is an element of catch up on investment plans that were paused in 2020. Overall this points to strong economic growth for the remainder of this year and for 2022 (Graph 3) with a moderation after this, as catch up demand fades and corporate investment falls back to more normal levels. At a regional level US economic growth in 2021 is likely to outperform other developed economies with growth of c.7%, reducing to c.5% in 2022. The Eurozone is expected to show growth of c.5% in 2021 with a similar projected rise in 2022. With its economy only now starting to fully re-open, Eurozone growth is likely to be stronger in H2 2021 than in the US, in particular in Q3. In Emerging Economies, China should continue to outperform with its economy growing c.9% in 2021 with a rise of c.6% in 2022.

In relation to the COVID vaccination roll-out, while markets have started to look beyond this as the roll-out has gathered significant pace in the past few months (Graph 4) and economies have started to re-open, it remains important to build on the progress to date given that vaccination is a mitigating factor in reducing the potential serious impact on health of COVID variants. Encouragingly emerging economies, particularly China, have overtaken developed ones in regard to the pace of vaccinations although there are a number of countries such as India, South Africa and Russia that are still struggling in this regard.

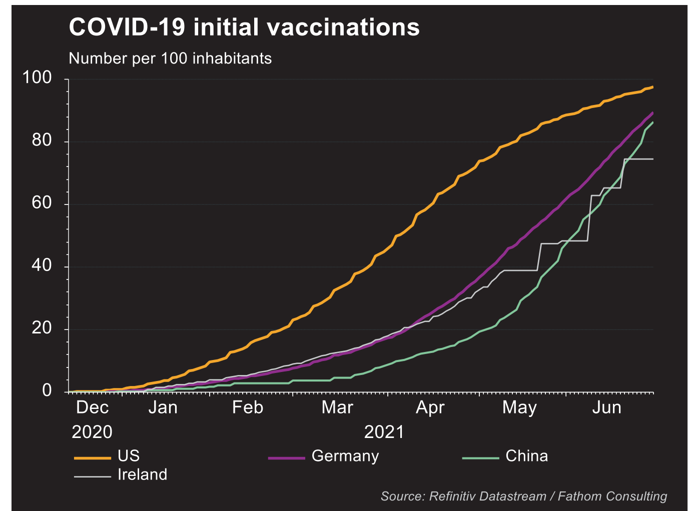
QUARTER 2 2021 INVESTMENT MARKET REVIEW AND OUTLOOK

AIB PRIVATE BANKING

GRAPH 3



GRAPH 4

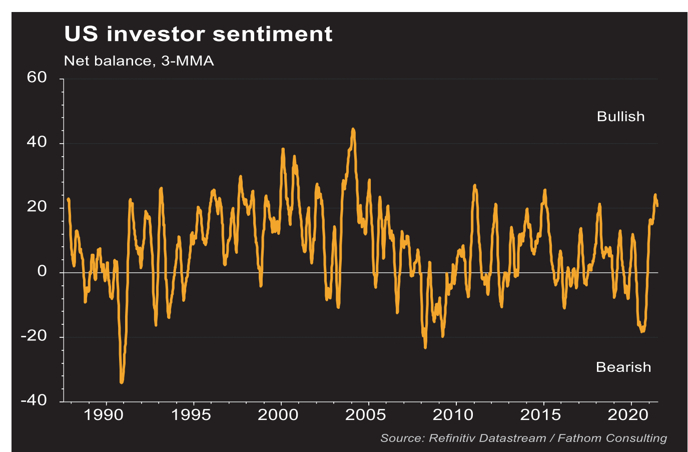


Markets should also receive support from fiscal and monetary policy which are likely to remain accommodative in H2 2021, although in the case of the former we are probably past the peak levels of support, particularly in the US. Policy makers will be increasingly hopeful that economies will be able to function as supports are reduced. While they have effectively committed to helping the economy until the private sector is able to support and sustain a satisfactory level of economic growth, there is a balancing act between too much stimulus measures causing a breakout in inflation expectations to the upside and withdrawing supports too early which could jeopardise the recovery and even trigger a period of austerity. For the moment there appears to be more of an emphasis on the former given that an overheating economy may be easier to correct than one where austerity has taken hold.

Central Bank actions should also remain positive for markets with no rate rises expected in developed economies in 2021 and continued QE over H2 2021 at least. In the US however, the Fed expressed a more hawkish tone in its June meeting, with confirmation that a reduction of QE was discussed and that the expected first rate rise would now take place in 2023 rather than in 2024. Given the strong level of economic growth and an expected fall in US unemployment to 4.5% by year end, it is also expected that bond purchases (currently $120bil per month) will be reduced in early 2022. Any tapering though is expected to be well flagged, perhaps in the September meeting, and also conducted on a phased basis so as not to unsettle markets and cause the "taper tantrum" that occurred in 2013. A key goal of the Fed is to maintain the stability of the financial system so it is likely to be mindful of not reducing QE too quickly. The Fed will be keen that any tapering is seen by markets as more a policy that reduces demand for government bonds than as a policy to slow economic growth or inflation. Similarly while interest rates in the US may start to rise in 2023 (and possibly even in late 2022) the pace of increase is likely to be muted with the Fed indicating that they would be "patient" in waiting to lift rates. The long term policy rate level of 2.5%, which the Fed currently sees as being ultimately reached, is also low by historical norms (50 year average 5.5%). In the Eurozone the path of rate rises and QE reductions is likely to be considerably longer given the more muted inflation and economic growth relative to the US.

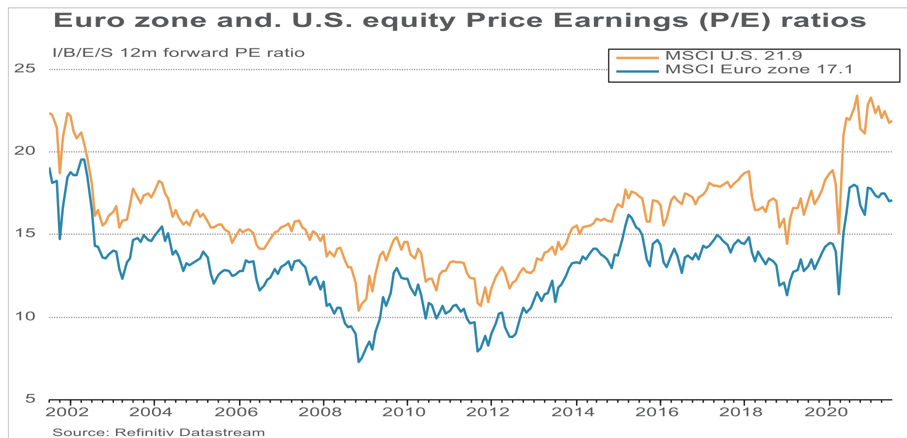
At a corporate level, markets in the short term should benefit from extremely strong earnings growth that is expected to be reported shortly for Q2 2021. Earnings growth of c.64% is expected in the US in Q2 (the highest since Q4 2009) helped by a strong rebound in profitability in the Industrials, Consumer Discretionary and Financials sectors. While this level of quarterly growth is not forecast to continue for H2 2021, a strong overall rise in earnings for 2021 in the US of c. 36% is expected. An even higher growth rate of close to 50% is expected in Europe with c.33% projected for Japan and Asian Emerging Markets. Currently for 2022, earnings growth of c.10% is expected in the US, although this may be revised as we approach year-end. Other factors such as equity dividend yields also remain supportive, with yields on US and European markets of 1.4% and 2.9% respectively, which are well in excess of short term bond yields and cash rates.

GRAPH 5



While there remains a mostly positive consensus towards equity markets, in the short term at least, there are risks with positioning and sentiment indicators at stretched levels and above long term averages (Graph 5). Fund flows into global equities in the first half of 2021 were the highest on record and futures positions are also at all-time highs. This leaves markets subject to potential reversals if economic growth data, corporate earnings, etc. disappoint. Valuations such as price to earnings (P/E) are also at elevated levels following the recent strong returns particularly in the US (Graph 6).

GRAPH 6



In relation to commodities, prices remain supported by ongoing strong economic growth and the likely further uptick in inflation over the coming months. Real interest rates remain negative in most developed economies which is also a support for commodity prices. In addition with large upcoming spends on infrastructure by governments, particularly around making the economy more sustainable, this should also be beneficial for prices. Oil prices, despite their recent strong run, can remain supported by rising demand. There could however be volatility in the short term due to a breakdown in talks among some OPEC+ members in relation to increasing production. While an agreement would likely see higher production it is not expected to be enough to meet growing demand. Gold, following a recent softening, could receive support from higher expected inflation in the short term and lower real interest rates as central banks continue to hold off raising rates in the face of higher inflation. Prices however may be constrained if the US dollar continues to appreciate. Industrial metals such as copper and zinc should benefit from higher economic growth and infrastructure spending although they will continue to be reliant on demand from China which has recently looked to dampen prices.

Other factors such as concern over higher and more persistent inflation, particularly in the US, and uncertainty surrounding the COVID "Delta" variant also remain. Inflation data will be closely watched over H2 although the general view is that while it is likely to show further increases over the next few months, due to supply chain disruptions and base effects, these should diminish in 2022. It is possible however that with continuing strong economic growth expected into next year that US inflation will remain close to or slightly above the Fed target rate of 2%, although this level of inflation should not be a negative factor for equities. Finally President Biden's planned tax rises will also be watched by markets given the knock-on effect that they will have on corporate earnings in 2022.

In relation to the outlook for other asset classes, Eurozone sovereign bond yields remain expensive with yields still in negative territory in many cases. They will continue to be influenced by moves in US Treasury yields, which are expected to increase in H2, but on the other hand they should receive support from ECB purchases (via the Pandemic Emergency Purchase Program (PEPP)) and fears around the spread of the COVID "Delta" variant. Corporate bonds should be supported by expectations around strong economic growth and corporate earnings, low default rates and ongoing purchases by the ECB via its QE programme.

Overall markets should remain supported in the short term by strong global economic and corporate earnings growth. Government and Central Bank policies should also continue to provide a favourable backdrop. Higher than expected inflation is a risk but it is unlikely to reach a level that would undermine equity markets. Overall, while the outlook is broadly favourable, high market valuations and very bullish sentiment makes markets more vulnerable to shocks and increases the risk of sharp corrections. The importance therefore remains for an investor to ensure that their portfolio is broadly and appropriately diversified in order to protect against significant volatility while allowing for the potential of satisfactory risk-adjusted returns over the long term.

Note: The information contained in this report has been compiled from sources that AIB Wealth Solutions deems reliable. Whilst all reasonable care has been taken to ensure that the facts stated are accurate and that the opinions and commentary given are fair and reasonable, AIB Wealth Solutions does not hold itself responsible for the completeness or accuracy of the information provided. Any opinions expressed herein are subject to change without notice. This document is not an offer to sell or a solicitation to buy any security. This publication is for information purposes only and is not an invitation to offer, buy sell or deal.

WARNING: All forms of investment involve some degree of risk. If you do not understand the nature and extent of your exposure to risk you should not invest.

WARNING: The value of your investment may go down as well as up and you may not get back all or any of the capital you invested.

WARNING: Past performance is not a reliable guide to future performance.

WARNING: The return on investments denominated in non-euro currencies may be affected by changes in exchange rates.

Allied Irish Banks, p.l.c. is regulated by the Central Bank of Ireland.