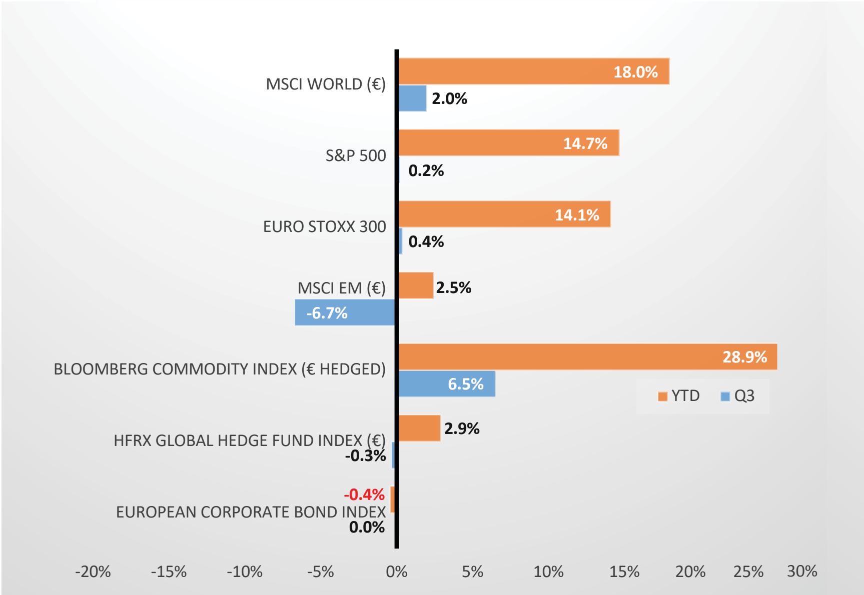
QUARTER 3 2021 INVESTMENT MARKET REVIEW AND OUTLOOK

AIB PRIVATE BANKING

INVESTMENT MARKET REVIEW

The beginning of the third quarter mimicked that of the first and second quarters of 2021 with continued positive economic recovery across developed markets. However as the summer progressed, markets experienced volatility relating to increasing inflation, supply chain constraints, labour shortages and higher COVID infection rates.

ASSET CLASS PERFORMANCE - Q3 AND 2021



US inflation peaked in July at 5.4% spurring tapering rhetoric from the Fed who announced that it was considering slowing down bond purchases from as early as November this year with a rate rise potentially happening as early as 2022. The European Central Bank (ECB) announced a reduction in the pace of its asset purchases, but in contrast to the Fed, stressed that this was not the beginning of a process of tapering purchases down to zero, nor did it mention increasing interest rates at this time. Despite worries lingering in the economy, the summer saw strong earnings growth on both sides of the Atlantic and most global indices registered their seventh consecutive month of gains following July's Q2 earnings reports. In August we also saw Biden's $1tn Infrastructure plan pass, which lifted US equity indices. In September markets softened somewhat, although developed markets closed out the quarter in positive territory, up 2% in euro terms. Returns were boosted by a strengthening of the US$ (up 2.3% versus the euro) and Japanese Yen which lifted returns in euro terms.

Emerging markets fell by 6.7% in the quarter (in euro terms) with China leading the decline. In July Beijing moved to ban private tutoring businesses from making profits, which sent worries through the market that they may impose such restrictions on other businesses. This led to a selloff in US stocks particularly in the Tech sector. In September property giant Evergrande was on the brink of collapse as it struggled under the weight of its c,$300bn debt. The market feared that its collapse could spill outside of Chinese borders and affect the global market at levels similar to when Lehman crashed in 2008. The jitters contributed to global market declines however fears were quelled somewhat on hopes that the Chinese government would facilitate an orderly restructure of the company and markets began to recover in the days following the news.

Despite the volatility in September equities have registered strong gains for the year. On a regional basis in Q3 developed markets outperformed emerging markets while Europe outperformed the US over the quarter. Growth stocks outperformed value while larger cap companies outperformed small caps.

For a second quarter commodities experienced the biggest growth with oil prices up c.2% at just over US$75 (West Texas Intermediate). Oil has continued on its bull run throughout the summer as global supply remains lower than demand. In July hurricane Ida hit the US and this caused OPEC+ to ramp up production as non OPEC+ providers continued to miss supply targets.

Within fixed income US 10 year yields fell from 1.46% at the start of the quarter to a low of 1.18% in August. However market volatility in September led to yields rising to 1.53% by quarter end as investors sold out of equity markets and switched to "more defensive" assets.

Gold prices fell in the quarter, finishing at $1,761 per oz., meaning prices remain over 7% lower year to date.

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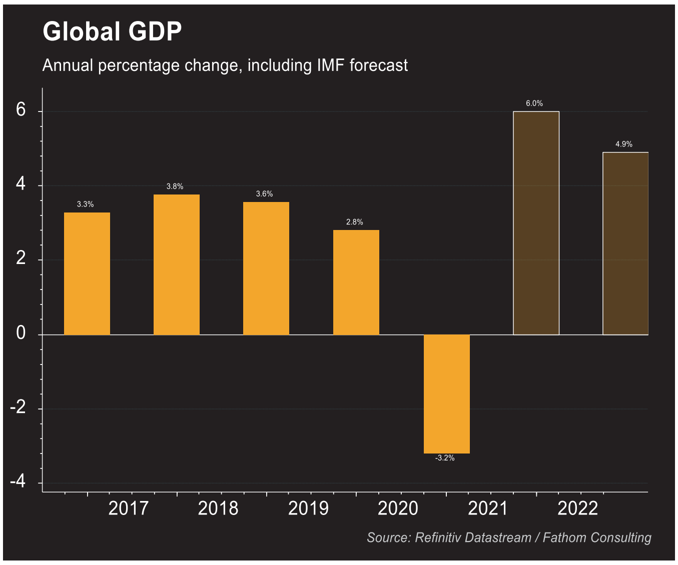
INVESTMENT MARKET OUTLOOK

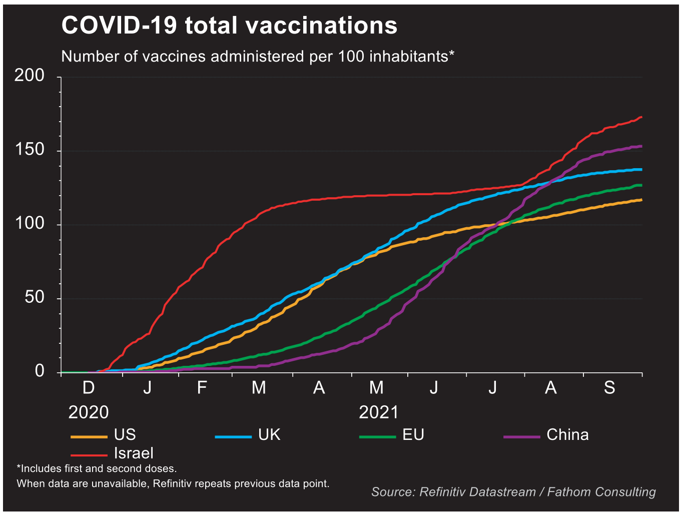
While global economic growth is expected to remain strong by historical standards over the coming quarters and into next year (Graph 1), there has been some recent nervousness among investors in relation to softening growth expectations. This has been driven by factors such as a spike in oil/gas prices, ongoing supply chain disruptions and a slowdown in the Chinese property market. In addition, while solid progress has been made in relation to the COVD 19 vaccination roll-out (Graph 2), there remains countries where new cases are persistently high (i.e. US) and where localised lockdowns are still occurring (i.e. China). On a positive note however, financial conditions remain very accommodating with negative real rates likely to persist in developed economies for a considerable length of time. Interest rates are unlikely to be raised in the US until 2023 and sometime after that in the Eurozone. In addition given that we are still in the post economic recovery phase, with growth well above long term averages, this should provide a healthy backdrop for corporate earnings and profitability for the remainder of 2021 and into 2022. There is the potential for market volatility in the short term as the market digests news in relation to Fed bond tapering and a possible restructure of China's second largest property development company, Evergrande. Overall however the favourable backdrop of strong corporate earnings, high economic growth and continued low interest rates in most major economies should provide a positive and supportive environment for equity markets in the medium term.

GRAPH 1



The level of corporate earnings growth delivered in 2021 to date has been impressive. The further good news is that this growth is likely to remain very strong for the rest of the year in both the US and Europe. Quarter 3 earnings season kicks off shortly and is expected to show a rise of c.45% in Europe (year on year) with growth of c.30% expected in the US. In previous quarters however forecasted earnings growth has proven to be conservative, with actual results coming in well ahead of forecast. A broadly similar outcome is expected for this quarter albeit not to the same extent as in the first half of the year. For the full year 2021 earnings growth of c.60% and c.40% in Europe and the US respectively is projected. Other markets are also expected to record sizeable earnings increases for the year with Japan and Emerging Markets (Asia) at c.37% and 34% respectively. Sectors such as energy, materials and financial services are expected to show strong profit growth helped by improved pricing and increased demand. There have been some concerns expressed about the ability of companies to deal with the current higher input prices. The expectation however is that these will be either absorbed through improved cost efficiency or passed on to the consumer with the result that profitability is not impacted. The discussion has also moved into corporate earnings for 2022 and the story here is also positive with consensus estimates of c.10% and 9% for the US and Europe respectively.

GRAPH 2



The level of earnings growth projected is high but should be helped by a number of factors. With most global economies now well into their post COVID re-opening, unemployment levels have significantly reduced from their highs (Graph 3) which should be positive for consumer spending (c.70% of the US economy). In addition there remains a historically large level of household savings, in particular in developed economies. In the US for example, savings are currently c.11% of income versus a long term average of c.5%, with an estimated c.US$2.5tn in excess savings accumulated during the pandemic. In Europe during Q2 alone c.€500bn of excess savings were accumulated which should provide a boost to economic growth by strengthening households balance sheets. Increased consumer confidence has also been evident in sentiment surveys with consumers in Europe reporting above average current and future intentions to make major purchases. This bodes well for economic and corporate earnings growth. At a regional level for 2021, economic growth is likely to finish strongest in China (c.8%) with the US and EU next strongest at c.6% and 4% respectively. For 2022 a similar scenario is expected although growth in China is expected to moderate due to a slowing property market, the government's zero tolerance approach to coronavirus and potential spill over effects from the Evergrande financial difficulties. Growth is forecast at c.5.5% for 2022 with the US and EU both projected at c.4.5%.

While there has been much discussion regarding Evergrande and what a potential collapse could do for the Chinese and world economies, there is a general expectation that the central government is unlikely to want to see a disorderly collapse and will work to try to ensure an orderly restructure of the company. It is also estimated that the company's c.US$300bn of debts represent only c.0.2% of total loans to Chinese banks and non-Chinese banks have only limited or no exposure to the company. In addition, the Chinese banking sector is also well capitalised with significantly improved balance sheets and sizeable provisions for potential loan losses.

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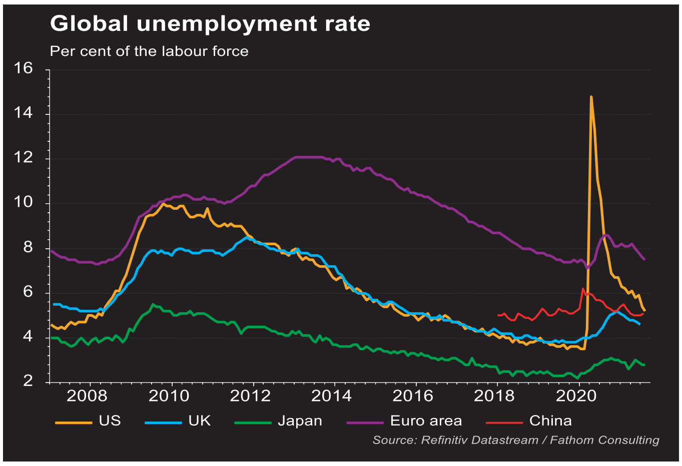
COVID 19 remains an ever-present issue although thankfully it is a broadly diminishing one with fully vaccinated rates at mostly c.60% to 75% in developed economies. While rates for emerging economies are lower, this is expected to improve by end 2021 to c.70% and in developed economies the rate is expected to reach c.80%. This improving situation should facilitate the continued progression to the full re-opening of all economies and the recent announcement of a successful COVID treatment drug should also boost sentiment and help reassure markets. There is some concern that the colder autumn and winter season could lead to a spike in the virus and potential lockdowns but the high level of vaccinations, on-going mask wearing and increased focus on indoor ventilation should reduce the likelihood of this happening.

GRAPH 3



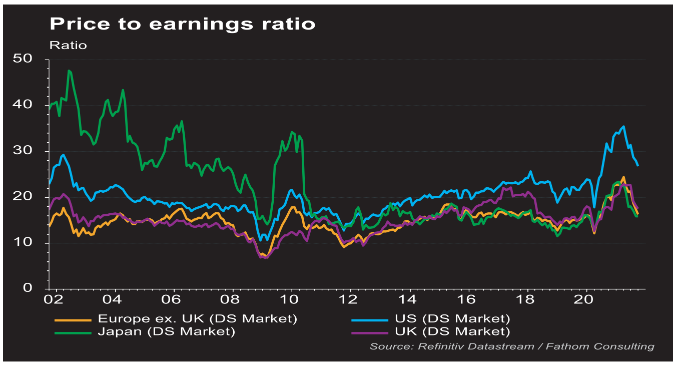
Fiscal stimulus measures should also remain supportive of economic growth albeit not at the same level as in H1 2021. In the US, a c.US$2tn spending programme is currently in negotiation which will see significant investment in the US economy. In the EU, proceeds from the €750bn Recovery and Resilience Facility are now starting to be paid out (c.€1bn allocated to Ireland) with a significant portion of the funds being transferred to member states by mid-2022.

Monetary policy will also remain in expansionary mode although the tapering of bond buying by the Fed will likely commence in late 2021 or early 2022, with the ECB also moderating its QE programme but on a very phased and gradual basis. Despite this reduction, there is still expected to be a net injection by developed market central banks of c.US$1.5tn of new liquidity in 2022 and for a net positive injection of liquidity until 2024. Tapering is also likely to be done on a gradual and phased basis with a projected reduction of c.US$15bn a month from the current US$120bn a month level in the US. This would result in the Fed's quantitative easing programme (QE) finishing by mid-2022. Central Banks in the US and EU have been keen to stress that this policy action is conditional on the economy continuing to make progress with a particular focus in the case of the Fed on employment levels continuing to improve. US unemployment, while having reduced significantly from peak levels in 2020, is still at 5.2%, higher than the pre-COVID level of c.3.5%.

Central Banks have also been keen to separate tapering and rate rise guidance, with Fed Chair Powell currently foreseeing a rate hike no earlier than 2023. Even though the Fed "dot plot" has become more hawkish since Q2, there is an expectation that they will keep rates low relative to their forecasts for inflation and economic growth. This is on the basis that it will be keen to see that US economic growth and employment is on a sure footing and can absorb higher interest rates before it commences increases. It would be well aware of the mistakes that were made by the ECB in 2008 and 2011 when they raised rates in response to higher inflation (linked to oil price rises) and then had to reduce them again shortly after. It is also worth remembering that the long term expected interest rate by the Fed of 2.5% remains well below the 50 year average rate of 5.5%.

Equity markets should also continue to receive support from their attractive dividend yield characteristics relative to deposit rates and bond yields. Dividends should also show solid growth into 2022 as profits continue to rebound. The yield on European markets at c.3% remains well in excess of the region's bond and deposit rates which in many cases are still in negative territory. Yields on US markets while lower at c.1.5% are also still attractive on a relative base. In recent studies (Goldman Sachs), it was estimated that the yield on US sovereign bonds (i.e. 10 year Treasuries) would have to reach 2.3% before the relative bond/equity valuation would be above the long term average. There has also been much discussion in relation to equity market valuations. While valuations using a metric such as price to earnings (P/E ratio) appear expensive, particularly in the US (Graph 4), this is not the case in other markets where, following the pull back in September and also as a result of earnings upgrades, valuations are closer to longer term averages.

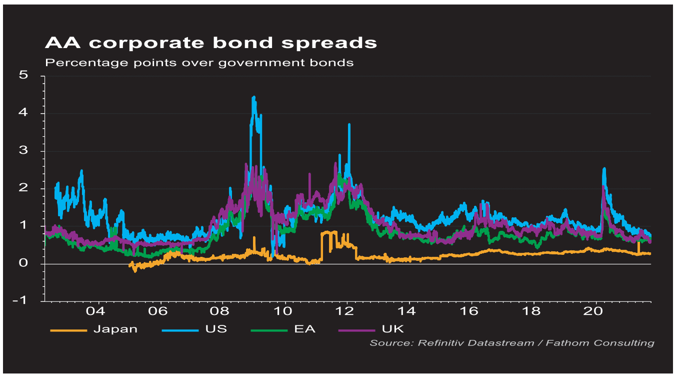
GRAPH 4



While there is a broadly positive consensus towards equity markets over the short to medium term there are a number of issues that have the potential to unsettle markets. The concern over inflation remains, in particular given its potential knock on effect on bond yields, although the rate in the US has shown signs of stabilising with a modest fall last month. Longer term inflation rates also remain well anchored. Headline rates in the US and Europe may firm in the coming months due to a rise in energy prices and the Fed and ECB will monitor this closely. The slowing of China's economic growth, as it is impacted by a slowing property market, power outages, tighter private sector regulation and a likely restructure of Evergrande will also be closely watched by investors. Growth should be helped in the short term by new public infrastructure investment, a relaxation in travel restrictions and ongoing large trade surpluses. Lastly political wranglings in the US and uncertainty over a new German government could impact markets. President Biden is juggling a number of issues including finalising agreement on a new stimulus programme, bringing in planned tax increases and increasing the US debt ceiling. Ultimately agreement is expected on these issues but there may be bumps in the road which have the capacity to unsettle markets. The expected corporate tax rise to c. 26% and an increase in the foreign income tax rate could reduce US earnings by c.4 to 5% in 2022 although this has already been largely anticipated by markets.

In relation to the outlook for other asset classes, Eurozone sovereign bond yields while having firmed in Q3, still remain expensive with core yields in mostly negative territory. Yields may continue to drift higher in the short term and they will also be impacted by ECB comment in relation to anticipated bond tapering during 2022. They should in the meantime receive support from current ECB bond purchases via the Pandemic Emergency Purchase Programme (PEPP). Corporate bond yields will be influenced by movements in sovereign yields although they should be supported by strong economic growth and corporate earnings, low default rates and ongoing purchases by the ECB via its QE programme. European markets may offer better prospects compared to the US given strong profit growth momentum and the ECB's dovishness relative to the Fed. Prices however are expensive compared to long term averages (Graph 5) with spreads over sovereign yields at low levels.

GRAPH 5



In relation to commodities, energy and in particular gas prices have seen large spikes in recent months. The reasons for the rapid rise (unseasonably high demand, supply issues, low stock levels) is expected to abate somewhat in 2022 which may see prices adjust downwards. Oil prices while firmer in Q3 may continue to rally in the short term given strong demand and global supply remaining below consensus forecasts. Prices may moderate in 2022 if a US/Iran deal is reached and supply from shale producers ramps up. Pressure is also increasing on OPEC producers to fully unwind its output cut ahead of its planned timeline of end 2022 and this could impact prices next year. Gold should receive support from consumer buying and also demand from Central Banks that are using gold to diversify their foreign exchange reserves. Concerns regarding inflation would also help prices and the asset remains a good hedge for potential issues in this regard. Industrial metals such as copper and aluminium may also be positively impacted by current low inventory levels and restricted supply due to environmental issues that are hampering production.

Overall the ongoing strong post-COVID global economic recovery, which is contributing to robust earnings growth, should support markets over the remainder of 2021 and into H1 2022. Government and Central Bank policies should also continue to provide a helpful backdrop although not to the same level as in previous quarters. While the outlook is favourable, some nervousness persists due to expected Fed tapering in the short term, slower growth in China and relatively high market valuations. Against this backdrop, while equity and other risk assets may have scope to outperform, it continues to be important for an investor to ensure that their portfolio is broadly and appropriately diversified in order to help protect against potential future volatility and market drawdowns.

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