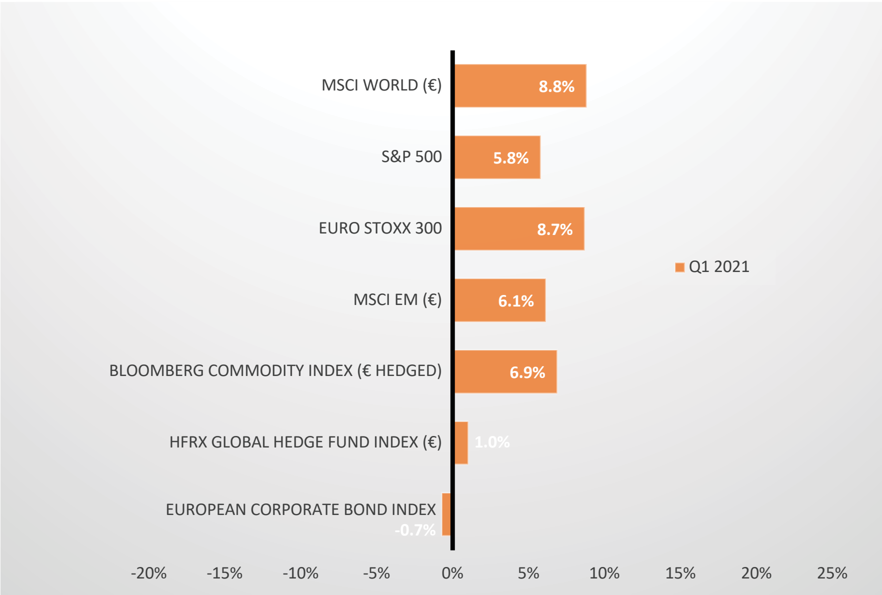
QUARTER 1 2021 INVESTMENT MARKET REVIEW AND OUTLOOK

AIB PRIVATE BANKING

INVESTMENT MARKET REVIEW

The first quarter of the year saw a continued surge in equity markets driven by two main themes - higher than expected fiscal stimulus in the US and successful vaccination roll-outs in many countries. These two themes resulted in a cyclical swing to the wider market with the Dow and S&P500 in the US hitting new record highs, up 8.3% and 6.2% respectively since the start of the year with March being their best month since November 2020. This was in contrast to the growth of the NASDAQ which slowed to just 3% having recorded a phenomenal return last year. Global developed equity markets performed well, increasing by c.9% in € terms. Eurozone equities grew by a similar amount despite the slower pace of its vaccine roll-out. Emerging markets rose by over 6% in € terms, helped by China which is now outpacing its pre-pandemic economic growth rate.

ASSET CLASS PERFORMANCE - Q1 2021



In the quarter, newly elected US President Biden announced that 100m Americans would be vaccinated in his first 100 days in office – a target which was subsequently doubled to 200m given the success of the US vaccination programme. In March the largest stimulus package on record, $1.9tn, was signed into law, which represents almost 9% of US GDP. Before quarter-end, President Biden also announced details of a $2.5tn Infrastructure Plan to be phased in over 8 years. The size of these fiscal stimulus packages created some concern amongst investors that inflation would begin to tick up and that interest rates would increase quicker than previously expected, which would be potentially damaging to equity markets.

Inflation worries spread globally and we saw some market volatility that has since been placated by central bank commentary. Fed Chair, Jerome Powell reaffirmed that the Fed is keeping a close eye on inflation and that there will need to be strong improvement in the underlying economy and unemployment figures before we see a rise in interest rates.

Despite Powell's comments, we saw bond yields creep up in the quarter. Yields on the US 10 year Treasury rose 0.8% to finish out the quarter at 1.77%. This hit Big Tech stocks hardest as these type of growth stocks are more sensitive to rising bond yields as a result of expected future cash flows having to be discounted at higher interest rates. This helped lead a sectoral shift away from Growth and Big Tech stocks to the wider market and more traditional value stocks with Industrials, Financials & Energy stocks leading the gains. Value stocks were up almost 15% in the quarter while growth stocks were +6.4% (in euro terms).

Business surveys improved by March, with manufacturing expanding in Europe, the US and UK. The US services sector has continued to perform well, but the most notable improvement was in the UK services sector, with businesses noting improving consumer confidence and signs of pent-up demand. The European services sector has been lagging behind due to slower vaccination roll-out and rises in COVID cases leading to some countries reintroducing lockdown measures.

Commodities grew 6.9% in the quarter on a euro hedged basis led by energy prices which have risen 25% bolstered by strong economic recovery forecasts. Gold prices fell back to $1647 per oz. at quarter-end as investor focus shifted to a more risk-on environment. The US dollar strengthened against the euro from 1.23 to 1.18 at the end of the quarter driven by higher interest rate expectations. Sterling has had a good quarter against the euro finishing at 1.17, aided by the success the UK has had with vaccinations, lower COVID numbers and beginning to re-open the economy.

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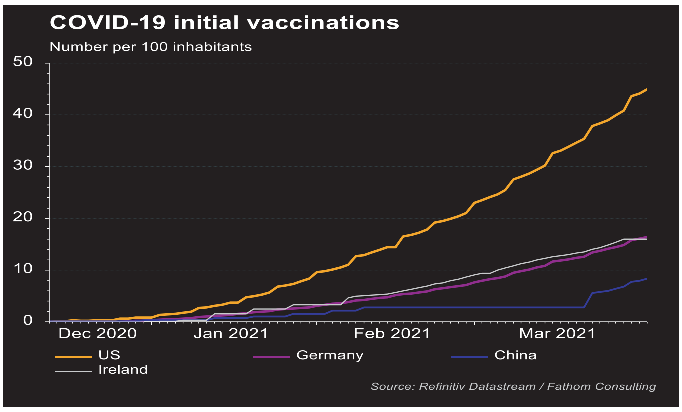
INVESTMENT MARKET OUTLOOK

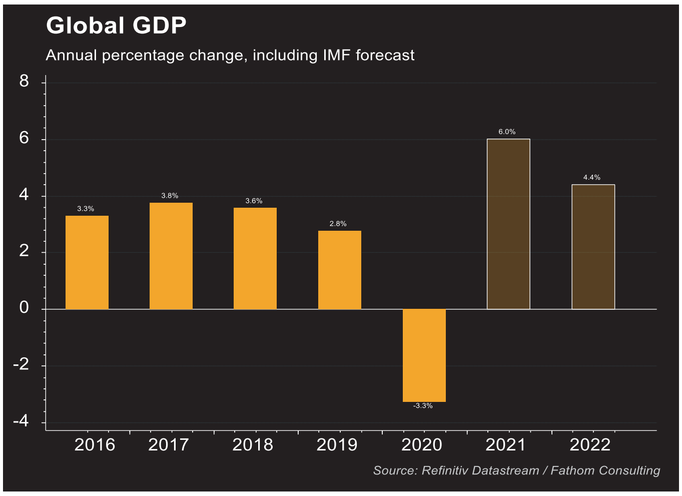
As we progress through 2021 the pace of vaccinations (Graph 1) will continue to be watched as this has become key to the anticipated re-opening of economies. Other factors however will also remain important and these include ongoing government support measures for the economy, favourable Central Bank policies with regard to interest rates and quantitative easing (QE) and finally economic data with a particular focus on growth and inflation data. In the short term, these factors will be significant influencers of market direction. Overall, while there is some nervousness among investors in relation to issues like inflation, tensions between the US and China and the potential for new strains of coronavirus, there is a broad consensus that we are in a strong post-pandemic growth phase and this should provide a favourable environment for risk assets in the short to medium term.

GRAPH 1



While this time last year we were in the grips of the coronavirus pandemic, 2021 is now projected to be one of the strongest on record in terms of global economic growth (Graph 2). Current expectations are for growth of c.6% in the world economy with China and the US leading the way among the major economies, with increases of c.9% and c.7% respectively. While growth year to date has been more muted as lockdown measures remained in place in a number of economies, this is expected to significantly change in Q2 as economies move to a more extended re-opening.

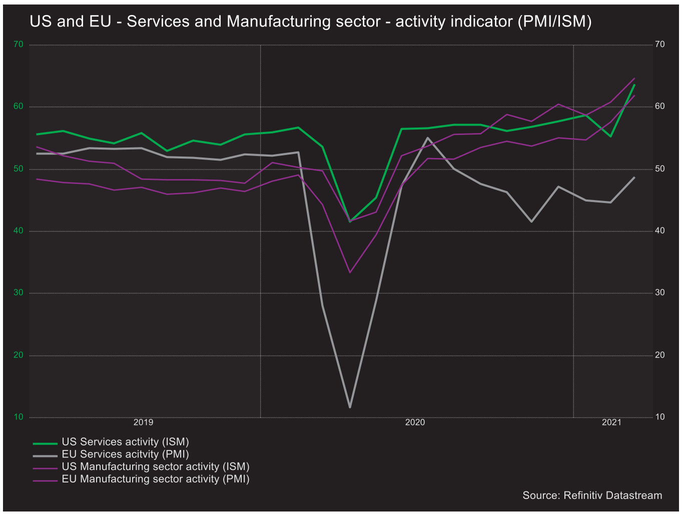
GRAPH 2



Recent economic data has indicated solid momentum in both the manufacturing and services parts of the economies in the US and the EU. While the larger services sector had previously lagged manufacturing, there is evidence that it is starting to catch up, particularly in the US as the economy re-opens and this trend is likely to continue through Q2 (Graph 3).

Encouragingly at a global level, the overall pace of vaccinations is increasing at a steady rate although the roll-out remains uneven across countries. The success seen in the US should allow its economy to return to close to normal levels of operation and facilitate the continuation of the strong and expected economic recovery. The EU has also, albeit belatedly, ramped up its programme and is currently on track to vaccinate c.55% of its population in 2021. Emerging economies such as China are also improving their roll-outs although a significant ramp up is still required in order to catch up with developed economies. Risks however do remain of new strains of the virus emerging that could frustrate the vaccination progress although this has not been the case to date.

GRAPH 3



Other factors which should help support markets in the short term include favourable government and Central Bank actions. In the US, the recently approved US$1.9tn stimulus package should help further boost the existing strong level of US savings and contribute to robust growth in consumer spending during 2021. In addition, the proposed spending plan which will focus on investing in areas like infrastructure, clean energy and broadband should be positive for US economic growth although any associated corporate tax rate increase will likely negatively impact US corporate earnings in 2022.

Central Bank actions should also remain positive for markets with no rate rises expected in the major economies in 2021 and continued QE in the short term at least. There is a particular focus on the Fed given the very strong economic data which have contributed to a spike in US Treasury yields during Q1 (Graph 4). With unemployment in the US currently at 6% and the inflation rate at 1.4%, there is no expected change in the immediate term. However it remains a case of watching this space given that in the coming month's unemployment will continue to fall at a fast rate and inflation will likely show an appreciable rise. While there are expectations that headline inflation will rise to well in excess of the Fed's 2% target in Q2, there is also the expectation that this will be transitory with inflation moderating in H2 2021.

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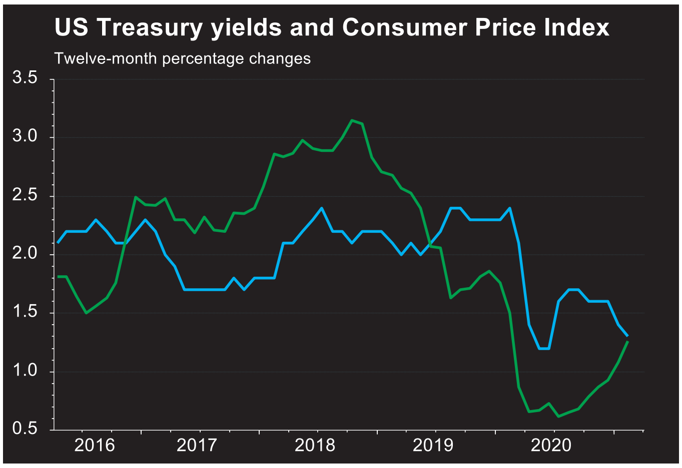
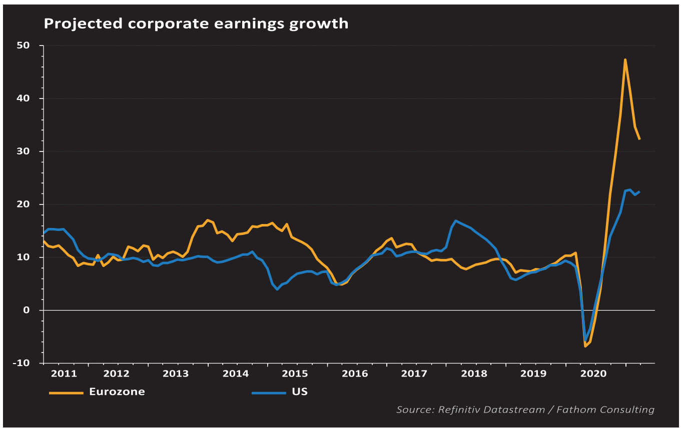
The Fed has indicated that it is comfortable with this and has not changed its guidance in relation to the timing of its indicated first rate rise which is still no sooner than 2024. In addition, the Fed has a high degree of credibility with respect to delivering low and stable inflation with the rate undershooting expectations over the past c.6 years. However markets remain less sanguine in relation to the timing of Fed rate tightening and have currently priced in rate rises commencing in the 3rd quarter of 2022. Ultimately the playout between the Fed and market expectations in regard to the timing and pace of future rate rises will be closely monitored. One area where the Fed may moderate its monetary stimulus in 2021 is through an announcement of a phased reduction in its QE programme. This could occur in H2 2021 with a reduction to commence in Q4 2021 or early 2022. In contrast to the US, the Eurozone, with its projected slower economic growth in 2021 (c.4%) and higher unemployment (c.8%) is not as exposed to a material uptick in inflation. There is likely however to be a moderate but temporary increase during 2021 due to higher oil prices, base effects and tax changes.

GRAPH 4



At a corporate level, markets should also receive support from the very strong earnings growth that is expected in 2021. Earnings growth of c.24% is expected in the US in Q1 helped by a strong rebound in profitability in the Consumer Discretionary, Financials and Materials sectors. Attention will also focus on the outlook for the remainder of 2021 given the strong growth that is projected for corporate earnings in 2021 as a whole (Graph 5). An even higher growth rate of 35% is expected in European and Emerging Markets in 2021. At a sectoral level energy, industrial and consumer discretionary companies should see the highest growth in earnings in 2021 following a very challenging 2020. Other factors such as equity dividend yields also remain supportive with yields on US and European markets of 1.5% and 3% respectively which are well in excess of cash rates. In the current environment of higher relative growth and inflation, the recent outperformance of value over growth could continue in the short term although this might be limited as valuations of the former are no longer as compelling.

GRAPH 5



While there is a generally positive consensus towards equity markets, in the short term at least, there are factors that have the capacity to limit returns. Market valuation ratios, such as Price to Earnings (P/E), are in excess of historical averages following the recent strong returns particularly in the US (Graph 6).

GRAPH 6

Challenges also remain in relation to high new coronavirus cases in parts of Europe and a number of Emerging Markets (e.g. India). It will be important that the ramping up of the vaccination programmes in these regions continues so as to ensure a comprehensive re-opening of their economies in the coming months. The trend over Q1 of higher bond yields will also be closely watched particularly in the US. With already high sovereign debt levels and significant further issuance likely to be required in the US and Europe, markets and governments will not want to see a material rise in funding costs. The low interest environment over the last several years has kept interest servicing costs low but a rise in yields would obviously have a negative impact on these costs.

Finally the planned tax increases by President Biden to finance the upcoming infrastructure plan will hurt US corporate profitability with estimates that S&P 500 earnings will be reduced by c.7 to 9% in 2022 if the bill is enacted in full during 2021. Companies in the communications services and IT sectors could be most affected although it is possible that a smaller level of tax rises will be passed and the proposed rate would still be less than the 35% rate prior to 2018. The tax rise would also be mitigated by increased infrastructure spending centred around clean energy and the green economy.

In relation to the outlook for other asset classes, Eurozone sovereign bond yields remain expensive with yields close to historically low levels notwithstanding the increase in 2021 to date. They will continue to be influenced by moves in US Treasury yields but should receive increased support from bond buying by the ECB. The decision to increase the level of bond buying under the Pandemic Emergency Purchase Program (PEPP) from c.€14bn per week in Q1 to c.€20bn in Q2 may also benefit EU corporate bonds. Corporate bonds should also be supported by improved profitability and subsequent lower default rates leaving scope for spreads to potentially moderately narrow during 2021. This year is also likely to see a record issuance of "Green" bonds with c.€400bn expected to be issued as governments/corporates raise capital for environmentally friendly projects/infrastructure in particular.

In relation to commodities, oil prices can remain supported by recovering demand, an expected weakening in the US$ and reduced US shale gas production. Price rises however may be constrained by the decision by OPEC+ to increase production commencing in May and also the prospect of renewed exports from Iran if negotiations between it and the US are successful in regard to re-instating their former nuclear deal. Gold, following a pullback in Q1, could receive support in the short term from higher inflation, low speculative positioning by investors and a weaker US$. Solid global economic growth coupled with a moderation in inflation as 2021 progresses could constrain price appreciation however. Industrial metals such as copper and zinc remain largely dependent on demand from China and prices should benefit from strong economic growth in the region in 2021. Agri commodities may also benefit in this regard with environmental factors like La Nina, which is evident this year, also supportive.

Overall markets should be supported in the short term by strong economic growth as vaccine delivery continues to be ramped up and economies begin to more fully normalise. A strong rebound in corporate earnings should also provide a positive backdrop. Expected benign global Central Bank and government actions should also continue to be a major prop for markets with both expected to continue to look to oversee economic recovery and stability. While the outlook is broadly favourable, it is important that investors do not get complacent, given the historical volatility of markets. The importance remains of holding a portfolio that is appropriately diversified in order to maximise the potential for a satisfactory risk-adjusted return over the long term.

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