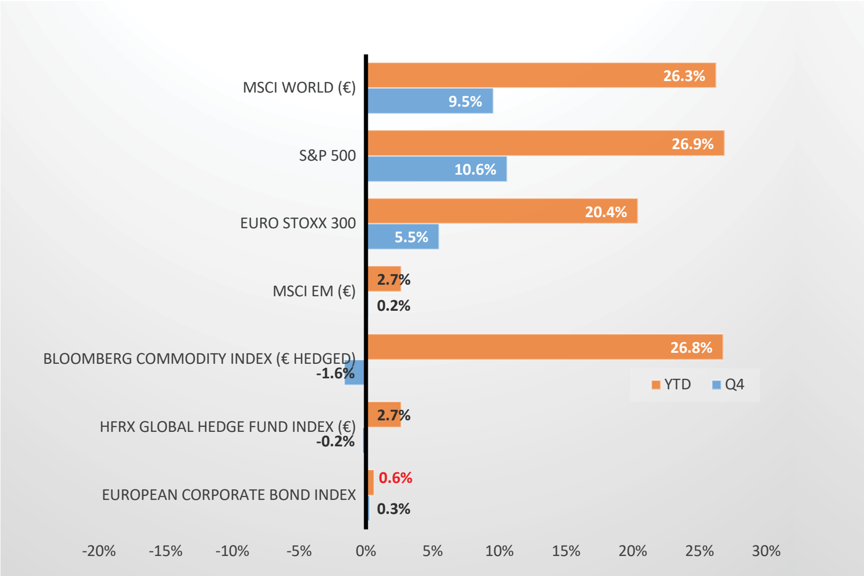
QUARTER 4 2021 INVESTMENT MARKET REVIEW AND OUTLOOK

AIB PRIVATE BANKING

INVESTMENT MARKET REVIEW

The final quarter of the year saw a continuation in the bull market for equities. Markets were bolstered by strong earnings reports and this helped them move higher throughout the quarter and into year-end. World equities advanced by 9.5% in euro terms despite worries surrounding the newest COVID strain, Omicron, which led to increased restrictions in many countries and for governments to push for vaccination roll-outs to be ramped up. US equities outperformed their European counterparts with the S&P500 up 10.6% versus 5.5% for the Eurostoxx 300. Both markets recorded strong gains in 2021 with returns of over 20% for the full year. Emerging Markets equities continued to struggle and were up only marginally in the quarter (0.2%) resulting in a relatively muted return of 2.7% for 2021. Fixed income performance was relatively flat throughout the quarter, as rising inflation rates and the prospect of less accommodating policy from Central Banks in 2022 acted as headwinds. Despite a negative return in Q4 (-1.6%), Commodities finished the year with a healthy return of almost 27% (on a € hedged basis).

ASSET CLASS PERFORMANCE - Q4 AND 2021



In the US, President Biden signed the long awaited Infrastructure Investment and Jobs Act, which is a $1.2 trillion bipartisan infrastructure bill. The bill includes $550 billion of additional spending, 49% of which will be allocated to upgrading America's transportation sector, including ports, airports, railroads, roads, bridges and public transport while 32% will be used to improve water and power infrastructure. The remainder will be spent on broadband (12%) and the environment (7%). The ambitious Build Back Better spending bill ($1.7 trillion) didn't achieve a majority in the Senate in December. However, private sector fundamentals look solid enough to carry US growth next year. US Consumer confidence rose to 70.6 in December up from 67.4 in November as US household liabilities reached their lowest reading since 1973 on the back of the strong performance of financial assets and real estate. This, along with higher household savings, gives the consumer significant capacity to weather volatility in the coming years.

In Europe, equity markets finished out the quarter and the year with strong growth mirroring that of the US. The major difference between the two areas can be seen in the potential for rate rises in 2022. Whilst the Fed has been vocal regarding future rate rises and lowering bond purchases in order to tackle rising inflation, the ECB has not confirmed that it will change its monetary policy stance in 2022. ECB President, Christine Largarde, advised that they will begin to taper bond purchases and end the Pandemic Emergency purchase programme (PEPP) in March 2022 but that they do not envisage rate rises as yet until after 2022. Manufacturing and Services PMI data continue to sit in expansionary territory at 58 and 53.1 respectively. In the UK, unemployment dropped to 4.2% and a new record was hit for job vacancies at 1.2 million. This is a clear indication of increasing labour market tightness that could cause further wage increases, potentially fuelling further price increases. The Bank of England reacted by raising interest rates by 0.15% to 0.25% at its December meeting, despite the rapid spread of Omicron.

The prospect of higher Inflation for longer continued to worry investors throughout the quarter. In the US Inflation hit 6.8% in November which was the highest reading since June 1982 and was the 9th consecutive month of growth. Inflation, albeit at a lower level, is now expected to be stickier than initially thought back in March of 2021 as a result of rising commodity prices (primarily energy prices), rising demand, wage pressures, supply chain disruptions and a low base effect from last year. The story in Europe is similar with inflation hitting 5% in December, its 6th consecutive monthly increase. In December, three of the four major developed market central banks indicated higher concerns about inflation heading into 2022 than about the economic disruption that may be caused by the Omicron variant. These concerns around inflation and higher interest rates resulted in a relatively flat quarter for Government bond markets with the US 10 year yield little changed at c.1.5% by year end. European sovereign yields also increased marginally, predominantly in peripheral countries, leading to indices falling c.0.5%.

Gold prices rose in the quarter, finishing at $1,822.4 per oz., up 1.6%. Oil prices also firmed closing out the year at $75.20. There were calls from US President Biden and other world leaders for OPEC+ to increase oil production, which is still at muted levels since the beginning of the pandemic and there were indications during Q4 they will begin to boost output in 2022.

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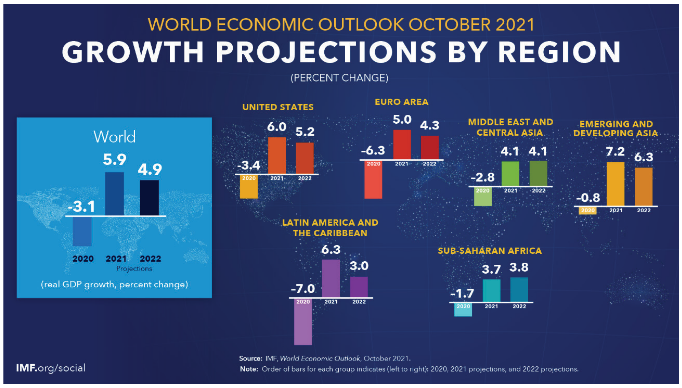
Despite the threat posed to economies by the rapid spread of the Omicron variant, central banks' primary focus has remained on elevated inflation making it increasingly likely that some of the emergency pandemic-related policies will be gradually withdrawn and we have already seen some announcements in this regard. How much tightening is possible depends to a large extent on governments and the restrictions they impose to contain the virus. So far their response is relatively muted and reflective of attempts to use high levels of vaccination to 'live with the virus'.

The emergence of the latest Covid variant reminds us of the uncertainties which remain around the global pandemic. Despite these, 2022 is expected to be another good year for growth as the global economy continues its recovery although it is likely to be at lower levels following an exceptionally strong 2021 as we enter a more mature phase of the economic cycle. It is also expected that the massive support offered by governments and central banks during the pandemic's initial stages will begin to fade. The IMF's forecasts from October predicted global GDP growth of 5.9% for 2021 to be followed by 4.9% growth in 2022 (see chart below), although these estimates may be lowered due to the impact of Omicron. Inflation should moderate from current levels but policymakers and investors face a difficult period in the interim.

GRAPH 1



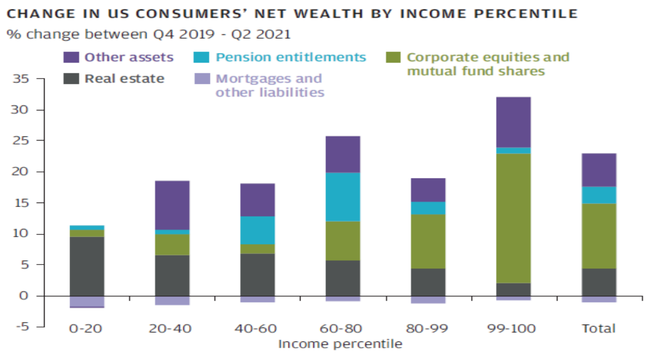
Undoubtedly the withdrawal of emergency levels of support by central banks and governments will play an important role in shaping economic activity in 2022. Although government spending will remain strong, overall fiscal policy will be less supportive. The significant fiscal stimulus policies (government spending and taxation policies designed to support economies over the short term) in response to the pandemic are already winding down in the US. The Bipartisan Infrastructure Deal will start and the larger Build Back Better package currently going through Congress should help, assuming it makes it through the Senate during 2022.

In contrast, the Eurozone stands out, as fiscal spending is expected to remain strong due to Europe's recovery plan. Stimulus will be slightly less than in 2021, but still significant. Meanwhile, China is expected to keep fiscal stimulus going in 2022 through higher local government borrowing, but some of it will be due to banks being encouraged to lend more.

With regards to monetary support (short-term policies by central banks designed to stimulate economies), we also see a move in a less positive direction in the US and UK. Here central banks are ending pandemic related quantitative easing (QE) programmes which have been used to inject money directly into the financial system. The Fed meeting in December delivered a more hawkish tone than previously with its interest rate forecasts showing 8 hikes between 2022 and 2024. However, its expectation is that inflation can be curbed without stifling economic growth. The Bank of England surprised the market with a rate hike in December citing focus on medium-term inflationary pressures. This increases the odds of the bank rate reaching 0.5% in February. Importantly, however, rates would be rising from a historically low base and are likely to remain negative after inflation. Meanwhile the ECB provided some much needed clarity on the continuation of its Asset Purchase Programme (APP), although the overall level of bond buying will be scaled back considerably in Q2 2022.

These changes should not be surprising as support had to come to an end once the recovery had taken hold. However, for growth to be maintained, a hand-over is required from governments and central banks to the private sector. On this front the consumer is critical and households will be expected to spend the savings they accumulated during lockdowns. In practice this would mean a fall in the savings ratio below its pre-pandemic average (of 7.5% in the US) as excess savings are spent.

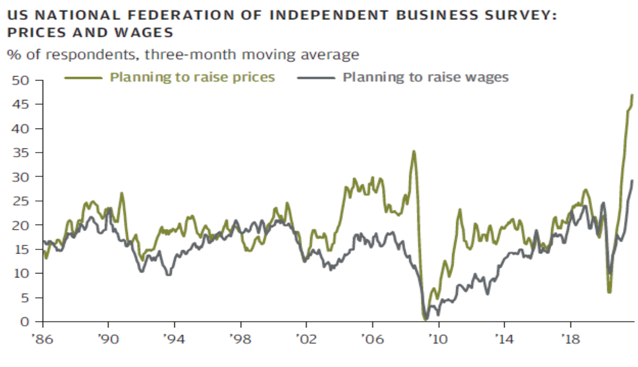
GRAPH 2



Source: US Federal Reserve, J.P. Morgan Asset Management.
Data as of 19 November 2021.

Notwithstanding the backdrop of high and potentially rising inflation in the short term, we still expect global equities to remain resilient for a number of reasons. The prospects for demand should stay strong in 2022, allowing companies to maintain margins even in the face of increased costs. As outlined above, consumer balance sheets look very healthy, with encouraging signs of wage growth, particularly in the US and the UK. For companies, the current environment is making it easier for them to pass costs onto consumers as they are less fearful of being undercut in the knowledge that their competitors are likely facing the same issues of rising input costs. Q3 2021 earnings were encouraging on this front as margins were around record levels across developed markets despite higher input costs.

GRAPH 3



Source: National Federation of Independent Business, Refinitiv Datastream, J.P. Morgan

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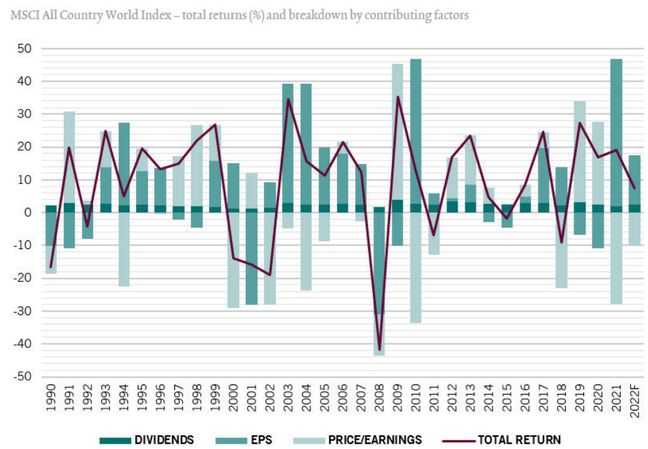
That said, corporate pricing power will vary, both across and within sectors. Margins tend to be much more volatile in cyclical sectors relative to defensives given the higher sensitivity to the health of the economy. We would expect that the relative performance of companies within sectors will be increasingly differentiated based on companies' relative pricing power.

U.S. stocks appear expensive based on price-to-earnings (PE) ratios with the most elevated valuations concentrated in some growth segments of the market, which may be more vulnerable to rising rates, particularly if bond yields were to rise more quickly or more sharply than anticipated. More importantly perhaps, average valuations remain very compelling versus bonds. It is estimated that the 10-year Treasury yield (1.5% at December 31st) would have to approach 3% to compete with equities on a risk/reward basis.

The prospects for Emerging Markets equities will also be heavily influenced by Covid and inflation considerations. Higher US rates and tapering could still lead to a stronger dollar and less global liquidity, which may impact some emerging markets that are more reliant on external financing. However most of the large emerging countries have strong current account positions and low external debts and so should be less vulnerable than during previous periods of rising US rates. Some regions are still rolling out vaccines and need periodic restrictions to contain the virus. The most important of these – China – is likely to retain its zero tolerance towards Covid policy until at least after the Winter Olympics in February.

Earnings should remain strong globally as companies look to meet pent-up demand for products and services, see chart below. Consensus estimates currently expect developed market earnings to grow by just over 7% in 2022. This forecast appears relatively undemanding in an environment where above-trend economic growth and supportive policy is expected, despite significant cost pressures. While inflation is a concern and source of volatility, it also makes equities the most compelling choice among the major asset classes.

GRAPH 4



A further potential risk for financial markets is the number of political events in 2022. French President Macron will be looking to secure a second term in the spring, while Italy will also host presidential elections. Meanwhile a loss of control of the House, Senate or both at the midterm elections in November, would drastically limit President Biden's ability to enact domestic legislation. Losing legislative control proved a pivotal moment under both the Obama and Trump administrations. While these events have the potential to generate short-term volatility, the economic recovery is likely to underpin political stability in both France and Italy. In the US, Biden should have already passed his multi-year spending packages so stimulus to the economy will be ongoing and he is less likely to divert his attention to aggressive foreign policy in the way that President Trump did.

In relation to the outlook for other asset classes, Eurozone sovereign bond yields increased slightly in Q4 but still remain expensive with core yields in mostly negative territory. Yields may continue to drift higher in the short term and will also be impacted by the ECB's announced bond tapering during 2022. They should receive support from the ECB's commitment to the Asset Purchase Programme (APP) and this will help offset the ending of bond purchases via the Pandemic Emergency Purchase Programme (PEPP) which is due to finish in March. Corporate bond yields will be influenced by movements in sovereign yields although they should be supported by strong economic growth and corporate earnings. On a relative basis, European markets may offer better prospects compared to the US given the ECB's more dovish stance on interest rates compared to the Fed.

In relation to commodities, energy and in particular gas prices saw significant increases during 2021. The spread of the Omicron variant is likely to dampen global demand somewhat but supply issues had already been prevalent for some commodities, oil being a case in point. In addition commodities have historically provided a hedge against rising inflation, performing best when inflation is above 4.5%, as it is currently. OPEC has agreed to continue ramping up production despite the recent pullback in prices and the negative impact of the latest COVID variant on oil demand. Gold should continue to receive support from consumer buying and also demand from Central Banks that are using gold to diversify their foreign exchange reserves away from the dollar. The prices of industrial metals such as copper, aluminium and nickel are expected to benefit from continued low inventory levels and reasonably strong demand from Developed Markets.

As we enter a more mature phase of the economic cycle equity returns are likely to be more muted but still positive, supported by solid corporate earnings. Inflation is a concern for investors currently and over the medium term we are likely to be in a more inflationary environment compared to the last decade. However, we do not believe that inflation poses a systemic risk for markets yet as the willingness of central banks to start raising rates in response to inflationary pressures should keep inflation under control. While equity and other risk assets may have scope to outperform, as always, it remains important for investors to ensure that their portfolios are broadly and appropriately diversified in order to help protect against potential future volatility and market drawdowns.

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.

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