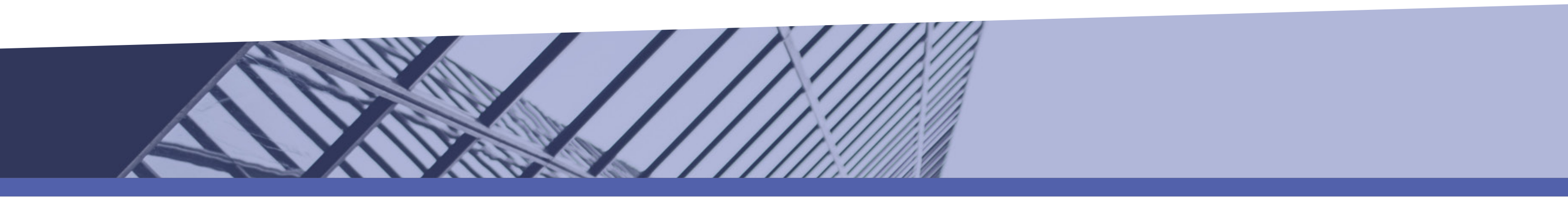

STOCKS RALLY BEFORE RUNNING OUT OF STEAM

Equity markets rallied during the third quarter, reaching new all-time highs in early September before investors took profits. The rebound was supported by accommodative monetary policies from global central banks, a strong recovery in global growth and growing hopes for a Covid-19 vaccine before year-end. Markets later declined from their early September highs on signs that global growth momentum was slowing and fears over the potential for a contested or delayed US presidential election result in November.

Lenny McLoughlin
Chief Investment Strategist, Irish Life Investment Managers Limited (ILIM)

Global economy regains its footing

As the global economy began to reopen faster than initially expected, growth rebounded extremely quickly. Following a record decline in global growth of around 20% (annualised) in the second quarter, the global economy is estimated to have grown at an annualised rate of around 36% in the third quarter. The savings accumulated by consumers in the second quarter, boosted by income subsidies provided by fiscal authorities, enabled consumption to rebound strongly. Consequently, global retail sales have risen back to pre-Covid levels, as pent-up demand from lockdowns was met. Some service parts of the economy, such as those in the leisure, entertainment, tourism and restaurant areas, have been slower to recover, however. Industrial production has also rebounded, but is still globally approximately 7% below pre-Covid levels.

Covid-19 – vaccine hopes temper virus fears

Over the third quarter, new daily cases of Covid-19 reached new highs at over 300,000 globally. Individual regions saw numbers rise above levels reached in March and April, particularly in the US and more recently in Spain and France. While case numbers have risen to new highs, the mortality rate has been significantly lower than earlier in the year, which has resulted in less stress on healthcare systems. This, in turn, has reduced the need for more restrictive lockdowns. Hospitalisations and mortality rates are now lower, due to the more widespread nature of testing, improved treatments for the virus and the fact most infections are now occurring in younger, healthier age groups. These developments and increasing hopes that a vaccine will be approved before year-end have reduced the impact of the rise in case numbers on investment markets. Several vaccines are currently in late-stage trials, and reports suggest that at least one of these will be approved soon and could become available to the general public next year.

CHART OF THE QUARTER

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 30 September 2020.

Political risk on the rise

In the US Presidential race, Joe Biden remains ahead of President Trump in the polls. But political risks have increased as President Trump failed to commit to a peaceful transfer of power in the event of a defeat. Meanwhile, sensitivities around the appointment of a replacement judge to the Supreme Court added to the political uncertainty. A contested or delayed election result could give rise to uncertainty and volatility in markets around the time of the election. This concern contributed to the pullback in equities in late September. In the event of a Biden victory combined with the Democrats gaining control of Congress, investors will closely monitor tax proposals in the areas of corporate, dividend and capital gains taxes. A Trump victory could refocus attention on US relationships with international peers, in particular the trade war with China.

In relation to Brexit, fears of a hard 'no deal' outcome rose as the UK introduced legislation that reneges on previous commitments made in the withdrawal agreement. Rhetoric through the quarter suggested both sides remain far apart in key disputed areas, with the UK suggesting that while it would prefer to have a trade deal, it is comfortable not having one if the compromises required to reach a deal are seen as too great.

MARKET ROUND-UP

Equities

Over the quarter, the MSCI AC World equity benchmark rose 7.1% (3.7% in euro terms). The US rose 9.6% (5.0% in euro terms) as the US Federal Reserve (Fed) indicated that interest rates will not be raised until at least the end of 2023. Policymakers also announced a new average inflation target. Economic growth exceeded expectations throughout the period, resulting in upgrades to third-quarter growth forecasts. Emerging-market equities rose 8.8% (5.1% in euro terms), benefiting from the weaker US dollar – it was positive for flows into emerging-market regions and continued improvement in the Chinese economy. Pacific Basin equities fell -0.7% (-2.3% in euro terms), with Hong Kong weak on the back of rising Covid-19 cases and tensions stemming from new security measures to limit anti-government opposition. Some large-cap bank stocks in Asia were also weak on suspected facilitation of money laundering schemes. The UK fell -4.6% (-4.4% in euro terms) as Brexit-related uncertainty remained a challenge. In addition, the UK economic recovery lagged those evident elsewhere in the world and there was a risk of tighter restrictions to combat a renewed rise in Covid-19 case numbers.

Bonds

The ICE BofA Merrill Lynch Eurozone >5-year sovereign bond benchmark rose 2.5%. German 10-year yields fell to -0.52% as the European Central Bank (ECB) and other central banks maintained accommodative monetary policies and continued to buy large amounts of bonds. Peripheral spreads narrowed as the EU announced a Recovery Fund of €750bn, including €390bn of grants, which is an effective fiscal transfer from the core to peripheral countries and was seen as strengthening the long-term outlook for the Eurozone. Spreads were also supported by the ECB's ongoing asset-purchase programme. By quarter-end, Italian 10-year spreads against Germany had fallen to 139 basis points (bps), Spanish spreads had narrowed to 77bps while Portuguese spreads were at 78bps.

European investment-grade corporate bonds rose 2.0% as yields and spreads fell to 0.59% and 117bps, respectively. Concerns over potential defaults eased as the growth backdrop improved.

Currencies

The euro rose against the US dollar to 1.1722, benefiting from the policy commitment of fiscal transfers to peripheral regions within the EU Recovery Fund. This was seen as reducing risks of a Eurozone breakup. The US dollar was weaker against most currencies after the Fed's guidance that it would not raise interest rates until at least the end of 2023. The US dollar also tends to be regarded as a 'safe haven' currency, so it declined in the more 'risk on' environment evident through the quarter.

Commodities

Commodities rose 4.6% (0.2% in euro terms), supported by a better outlook for demand following the recovery in the global economy from the April trough. West Texas Intermediate (WTI) oil was less volatile than in recent quarters, rising 2.4%. Gold rose 6.4%, supported by the weaker US dollar and falling US real yields, although the price was off the new all-time high reached in early August.

MARKET SNAPSHOT

Market returns

Equity indices (€)	QTD Return (%)	YTD Return (%)	2019 Return (%)
MSCI Ireland	9.81	-2.17	40.60
MSCI United Kingdom	-4.44	-26.69	23.40
MSCI Europe ex UK	1.50	-7.32	28.20
MSCI North America	4.87	1.99	33.90
MSCI Japan	2.56	-4.60	22.30
MSCI EM (Emerging Markets)	5.07	-5.15	21.10
MSCI AC World	3.68	-2.58	29.60
10-year sovereign bond yields (€)	**Yield last month**	**2019 Yield (%)**	**2018 Yield(%)**
US	0.68	1.92	2.68
Germany	-0.52	-0.19	0.24
UK	0.23	0.82	1.28
Japan	0.02	-0.02	0.00
Ireland	-0.16	0.11	0.90
Italy	0.87	1.41	2.74
Greece	1.03	1.43	4.35
Portugal	0.26	0.43	1.71
Spain	0.25	0.46	1.41
Commodities ($)	**QTD Return (%)**	**YTD Return (%)**	**2019 Return (%)**
Oil (WTI)	2.42	-34.13	34.50
Gold (Oz)	6.40	24.63	18.90
S&P Goldman Sachs Commodity Index	4.61	-33.38	17.60
FX rates	**Current**	**2019**	**2018**
U.S. dollar per euro	1.17	1.12	1.15
British pounds per euro	0.91	0.85	0.90
U.S. dollar per British pounds	1.29	1.33	1.28

Source: ILIM, Bloomberg. Data is accurate as at 30 September 2020.

GLOBAL EARNINGS

The second-quarter earnings season was very strong, significantly exceeding expectations and supporting equity markets through the quarter. In the US, while earnings fell -33% year on year, they were 20% ahead of forecasts. In Europe, earnings exceeded forecasts by 23%, although they were down -26% year on year. In Japan, meanwhile, earnings beat forecasts by 24% as they fell -15% year on year. Although earnings were exceeded, consensus earnings forecasts for 2020 were relatively stable at around -18%, while earnings are expected to rebound by c. 28% in 2021. That would leave them around 5% above 2019 levels at the end of next year. Current consensus forecasts are for earnings to grow a further 16% in 2022.

CENTRAL BANKS' ROUND-UP

US Federal Reserve

The US Fed announced a new average inflation target of 2% over the longer term. If inflation goes below 2% for a period, the Fed would then be willing to allow inflation to run moderately above 2% for a while before raising interest rates. It also suggested that it would not raise rates if a tight labour market was evident but was not leading to higher levels of inflation. The policy change means that the Fed will no longer raise rates in anticipation of inflation moving towards its previous target of 2%, but instead wait until inflation has reached 2% and appears set to move above 2% for some time. The Fed subsequently indicated that interest rates will not be raised until at least the end of 2023.

European Central Bank

The ECB highlighted that growth is a concern, while also viewing the inflation outlook as being weak. In this context, it confirmed that it intends to fully use the €1.35 trillion capacity in the Pandemic Emergency Purchase Programme (PEPP) asset-purchase programme, pushing back against previous suggestions that it might not spend the total amount available. Policy was left unchanged over the quarter, with policymakers suggesting they are in a 'wait and see' mode given the current level of economic uncertainty. The bank indicated that it requires more information on the various risks facing the economy before determining the next policy move. However, senior officials including Philip Lane, the ECB's Chief Economist, hinted that additional stimulus might be required to meet the ECB's inflation objectives. The rise in the euro over the quarter became a focus of attention as ECB officials noted their concerns over its impact on growth and inflation.

Bank of England

The Bank of England indicated that a consultation process over the possible move to negative interest rates will begin in the fourth quarter. While there are likely some technical issues to be overcome, the Bank is expected to implement negative rates at some point in 2021.

Bank of Japan

The Bank of Japan left policy unchanged but highlighted its concerns about inflation remaining below its target. It also indicated that further discussions regarding strengthening forward guidance and the possible introduction of additional policy measures will take place in coming meetings.

EQUITY OUTLOOK

The outlook for equity markets over the next 12 months depends on a number of factors including the evolution of Covid-19, the scale of recovery from the first-half recession, the level of stimulus provided by global authorities and the outcome of political events, especially the US Presidential election.

A major threat to the global economy emerged with the outbreak of Covid-19. Severe restrictions on travel and general activity were introduced to contain the virus. But these containment measures brought much of the global economy to a standstill, which resulted in the sudden onset of recession. Our base case is that after a very severe but short recession, the global economy will continue to rebound in the second half of 2020 and in 2021, supported by the large levels of fiscal and monetary stimulus. The expectation of a vaccine at some point next year should also enable activity levels in the global economy to return close to normal over the course of 2021.

Even after the modest correction in equities markets in September, upside in markets in the short term could be limited. This is due to recent concerns that have emerged in relation to the slowing momentum in global growth, delays in passing additional fiscal packages in the US, rising Covid-19 case numbers and growing fears over the potential for a contested or delayed US Presidential election result in November. On a 12–15-month timeframe, however, the outlook is more positive, with upside potential in equity markets of mid to high single digits.

Volatility is expected to stay in equity markets over the next 12 months, and some of the risks outlined above could potentially give rise to sudden market moves in either direction from time to time. Other issues could also contribute to market volatility, including political tensions in the Middle East and North Korea, rising US-China tensions and the potential for fiscal drag as governments face pressure to reduce debt levels following the unprecedented amounts of fiscal stimulus provided this year. Overall, however, given the positive growth backdrop, attractive relative valuations and ongoing provision of liquidity by central banks, equity markets are expected to generate positive returns over the next 12–15 months.

Source: ILIM, Bloomberg. Data is accurate as at 30 September 2020.

THE MONTH AHEAD

Economic data and events to watch

1 October	US personal income (month on month)
2 October	US non-farm payrolls (September)
6 October	Reserve Bank of Australia's interest-rate decision
8 October	Germany's balance of trade (August)
9 October	UK's balance of trade
13 October	German ZEW Economic Sentiment Index (October) US core inflation rate (year on year, September)
15 October	Chinese inflation (year on year, September)
16 October	US retail sales (month on month, September)
19 October	China's GDP growth rate (year on year, quarter three)
21 October	UK inflation rate (year on year, September)
22 October	Germany's GfK consumer confidence (November)
27 October	US durable goods order (month on month, September)
29 October	Japan's consumer confidence (October)
30 October	German GDP (flash, quarter three) Spanish GDP (flash, quarter three)

Political events

15–16 October	Eurogroup Council meeting (EU-UK relations on the agenda)

Source: ILIM, Bloomberg. Data is accurate as at 30 September 2020.

Irish Life

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Figures referenced herein have been sourced from ILIM and Bloomberg. Forecast figures have been prepared by ILIM based on reasonable assumptions, internal data and data sourced from Bloomberg.

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