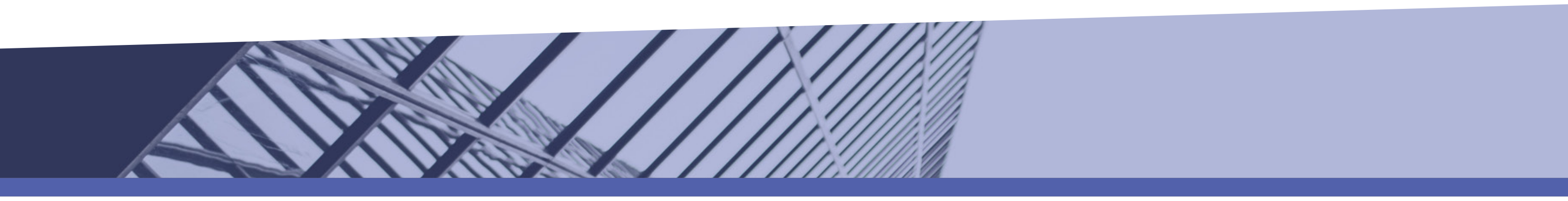


GAINS FOR EQUITIES AND BONDS, DESPITE TRADE WOES

Despite a mid-quarter fall due to the collapse of trade talks between the US and China, and the surprise threat of tariffs on all Mexican exports to the US, equity markets gained during the quarter, reaching new all-time highs in late June. Equity markets recovered from their mid-quarter lows as central banks became less hawkish in response to deteriorating economic data and heightened risks around trade tensions. In bond markets, eurozone sovereign bonds outperformed equities as core government bond yields fell to new all-time lows.

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

Key quarterly themes

- Equities shake off trade concerns
- Eurozone sovereign bonds outperform equities
- Central banks become more accommodative

Global earnings bolster stocks

Better-than-expected first quarter earnings supported equity markets early in the quarter, as did more positive economic newsflow. In the US, earnings grew 4% year on year (6% ahead of forecasts), while in Europe, earnings were up 1%. European earnings were 2% ahead of expectations. In Japan, earnings grew 1% year on year, but were 8% below expectations. Given the slowing economic momentum and rising trade tensions, companies tended to revise their earnings forecasts lower. Overall, consensus expectations for earnings growth in 2019 slipped from around 5% to 4% by quarter-end.

US Fed – investors price in rate cuts

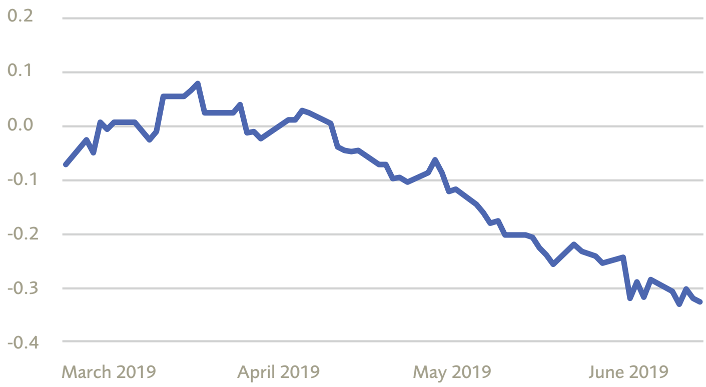
The Fed formally changed its guidance in March, indicating that it no longer plans to raise rates in 2019. But investors assumed that future policy would be more accommodative, after several Fed members highlighted downside risks to inflation. They also appeared comfortable with allowing inflation to run above its 2% target to as high as 2.5%. In June, following some softer US economic releases and perceived increased risks to growth from rising trade tensions, the Fed indicated that interest rates could be cut later this year. At the June policy meeting, Fed Chairman Jerome Powell outlined how recent economic developments had strengthened the case for more accommodative policy. He said the Fed was monitoring downside risks to growth and indicated that it would act appropriately to sustain the current economic expansion. While leaving rates unchanged, there was a strong suggestion that rates would be cut later in the year, when eight out of 17 Fed members indicated that they expected lower rates before year-end. Seven of those indicated that they expected two rate cuts before year-end. Investors are now discounting 100 basis points (bps) of US interest-rate cuts by the end of 2020.

US-Chinese trade – an uneasy truce

Until early May, it looked like China and the US were making significant progress on trade and that a deal was imminent. This optimism faded in early May, however, when President Trump announced that the trade talks had broken down – he claimed that China had failed to adhere to previous commitments made during negotiations. As a result, the US increased tariffs on $200bn of Chinese imports from 10% to 25%, prompting China to retaliate by increasing tariffs on imports from the US. The situation deteriorated rapidly, with both sides adopting more entrenched positions. The dispute broadened beyond simply trade to include more ideological issues; the US appeared to adopt a policy of containment of China's growing political and economic influence. Concerns about the negative consequences of a failure to resolve the trade dispute intensified fears of a global slowdown. At a meeting between President's Trump and Xi at the G20 gathering in Japan, both sides agreed to restart negotiations. It was also agreed that the ban on US companies selling products to Huawei, the Chinese telecoms company, would be lifted. Meanwhile, China agreed to increase agricultural imports from the US.

CHART OF THE QUARTER

German 10-year bond yield



Source: ILIM, Bloomberg. Data is accurate as at 30 June 2019

New tariffs on Mexico?

Trade concerns were exacerbated in late May when President Trump threatened to impose tariffs of up to 25% on all Mexican exports to the US, unless Mexico agreed to curtail the number of people crossing the US/Mexico border. A compromise was reached, with the tariffs being postponed as the Mexican authorities promised to commit more resources to reducing the flow of people to the US. The US has, however, indicated that it will review progress in 45 and 90 days. If satisfactory improvements have not been made, then the threat of tariffs could be reintroduced.

MARKET ROUND-UP

Equities

Over the quarter, the MSCI AC World equity benchmark rose 3.4% (2.3% in euro terms), while the Pacific Basin ex Japan rose 5.8% (3.7% in in euro terms). Australia outperformed, aided by becoming the first G10 country to cut interest rates this year. While macro data was mixed, some key economic releases for the region exceeded expectations during the quarter. European ex UK equities rose 4.9% (4.9% in in euro terms), supported by speculation of more policy easing by the European Central Bank (ECB) and the increased attractiveness of equities relative to bonds as core sovereign bond yields hit new all-time lows. Japan lagged, falling -1.6% (-0.4% in in euro terms), as the stronger yen negatively affected exporters. Weak business sentiment surveys and concerns over the potential negative impact of the planned VAT increase in October also contributed to the negative returns. Emerging markets underperformed too, rising 0.3% (-0.7% in in euro terms) on the back of rising trade tensions.

Bonds

The ICE BofA Merrill Lynch Eurozone > 5-year sovereign bond benchmark rose 5.0%. The German 10-year yield ended the quarter in negative territory at new all-time lows of -0.33% as economic sentiment readings disappointed, suggesting that growth would be subdued. Continued low levels of inflation and the decline in inflation expectations to new all-time lows led ECB President Mario Draghi to suggest that the central bank could cut interest rates and restart asset purchases. This also contributed to lower yields. Peripheral yield spreads continued to narrow, given the attractive yield pick-up available in an environment of declining yields. Suggestions that the ECB could restart asset purchases also added to the downward pressure on peripheral spreads. At quarter-end, Spanish 10-year spreads against Germany had fallen to 73bps, while Portuguese spreads had declined to 80bps. Despite a stand-off with the EU in relation to fiscal targets, Italian spreads also narrowed to 243bps over the quarter.

Currencies

Over the first half of the quarter, the euro generally continued to weaken against the US dollar, with EUR/USD falling to a low of 1.1134. However, the euro ended the quarter higher, with EUR/USD rising to 1.1373 as the dollar weakened; markets discounted 100bps of rate cuts by the Fed before the end of 2020.

Commodities

Commodities fell -1.4% (-2.8% in euro terms). West Texas Intermediate (WTI) oil fell -2.8%. Oil initially fell due to increasing growth concerns related to the breakdown of trade talks between the US and China and general deterioration in economic data. The oil price subsequently recovered most of these earlier losses as tensions rose between the US and Iran.

MARKET SNAPSHOT

Market returns

Equity indices (€)	QTD % return	YTD % return	2018 % return
MSCI Ireland	3.43	17.49	-21.24
MSCI United Kingdom	-0.49	13.38	-9.77
MSCI Europe ex UK	4.93	18.21	-10.10
MSCI North America	2.86	19.38	-0.41
MSCI Japan	-0.37	8.38	-8.17
MSCI EM (Emerging Markets)	-0.67	11.20	-9.92
MSCI AC World	2.34	17.04	-4.34
10-year sovereign bond yields (€)	**Yield last month (%)**	**2018 yield**	**2017 yield**
US	2.01	2.68	2.41
Germany	-0.33	0.24	0.43
UK	0.83	1.28	1.19
Japan	-0.16	0.00	0.05
Ireland	0.17	0.90	0.67
Italy	2.10	2.74	2.02
Greece	2.45	4.40	4.12
Portugal	0.47	1.72	1.57
Spain	0.40	1.42	1.57
Commodities ($)	**QTD % return**	**YTD % return**	**2018 % return**
Oil (WTI)	-2.78	28.76	-24.84
Gold (Oz)	9.33	10.33	-2.14
S&P Goldman Sachs Commodity Index	-1.42	13.34	-11.34
FX rates	**YTD**	**2018**	**2017**
U.S. dollar per euro	1.14	1.15	1.20
British pounds per euro	0.90	0.90	0.89
U.S. dollar per British pounds	1.27	1.28	1.35

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2019

GLOBAL ECONOMIC HIGHLIGHTS

Economic data was relatively positive early in the quarter, as GDP releases exceeded expectations. The global economy grew 3.0% (annualised) in the first quarter, despite the drag caused by the US government shutdown, which lasted through most of January. Chinese data also continued to show signs of improvement as key activity releases rose further.

By quarter-end, however, there was a noticeable deterioration in economic newsflow. The global composite purchasing managers' index (PMI) fell to levels consistent with growth of only 2.4%. Meanwhile, manufacturing readings remained weak and at their lowest level since 2012. Having been relatively resilient over the last year, non-manufacturing PMIs also began to deteriorate, with output expectations in the sector falling to new all-time lows.

Regional US manufacturing indices in June were significantly weaker than expected, while the German IFO expectations reading fell sharply. In the US, consumer confidence fell sharply to its lowest level in 18 months, while the labour market showed signs of slowing, with unemployment claims rising and non-farm payrolls well below expectations. But not all releases were disappointing – industrial production, retail sales and durable goods orders exceeded expectations in the US towards quarter-end.

Chinese data continued to ease through May and June, with manufacturing PMI indices moving below 50, which indicates a contraction. Meanwhile, fixed-asset investment and industrial production gave up some earlier gains. Japanese sentiment surveys generally disappointed, while UK economic releases suggested a flat to possibly negative GDP in the second quarter. While recent data has deteriorated, the immediate avoidance of further escalation in the US/China trade war and increased prospects for further policy loosening by central banks should provide support to the global economy. Ideally, this should enable growth of 2.7% this year, although that would represent a slowing of growth compared to the first quarter.

THE ILIM VIEW – LOOKING AHEAD

Equity markets have rebounded strongly in the year to date, reaching new all-time highs in late June as the recessionary fears evident at the end of 2018 receded. The main contributor to equity-market gains was central banks' move to more accommodative policy, driven in particular by the Fed.

At the end of 2018, the Fed was still indicating that it intended to raise interest rates twice in 2019. But early in the new year, Fed policymakers began to suggest that they could afford to be patient and flexible in relation to future interest-rate decisions. Investors interpreted these comments as meaning the Fed would not raise interest rates at all in 2019. This was confirmed in March, when the Fed formally changed its guidance and indicated its intention to leave interest rates unchanged through the year. Later, as US economic data showed renewed signs of slowing, US/China trade talks collapsed and US inflation remained well below the Fed's 2% target, the Fed suggested that the case for additional policy accommodation had strengthened. While leaving rates unchanged at the June meeting, individual Fed members' interest-rate forecasts for the remainder of 2019 and 2020 suggested that cuts were increasingly likely. As a result, investors are now discounting 100bps of US interest-rate cuts by the end of 2020.

Other central banks followed the Fed's lead to adopt more accommodative policy stances. The ECB president, Mario Draghi, recently suggested that interest rates could be cut and asset purchases restarted if economic and inflation fundamentals do not improve in the coming weeks. This policy shift by global central banks helped support equity markets by removing the immediate risk to growth from excessive tightening. It also provides a cushion to growth in the face of the recent weaker economic data.

Much of the recent deterioration evident in economic newsflow is associated with the ongoing uncertainty related to global trade tensions. This has depressed both business confidence and investment spending. While a further escalation of trade tensions between the US and China was avoided at the G20 meeting between President's Trump and Xi, the failure to reach a trade deal means that uncertainty is likely to linger, weighing on activity levels and overall global growth.

Following the 16.3% gains (17.0% in euro terms), in global equities in local-currency terms in the year to date, equity valuation levels have moved close to, or slightly above, long-term averages. Equities are currently trading on a 12-month forward price-to-earnings ratio of 15.1 times, versus a long-term average of 15.6 times.

In terms of the outlook for equity markets for the remainder of 2019, much will depend on developments in the global economy and the level of monetary support provided by global central banks. Global growth exceeded expectations in the first quarter, at 3.0% annualised. However, recent weakness in activity and sentiment readings suggests growth in the rest of the year will be slower, possibly close to 2.7%. With the risk of downward revisions to earnings forecasts in an environment where valuation levels are already close to our target levels, further upside in equity markets from current levels could be limited to low single digits over the next 12 months.

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2019

THE MONTH AHEAD

Economic data and events to watch

1 July	China's Caixin Manufacturing PMI (June) EA & German Market Manufacturing PMI Final (June) US ISM Manufacturing PMI (June)
3 July	US & Canadian Balance of Trade (May) US Markit Services PMI Final (June) US ISM Non-Manufacturing PMI (June)
4 July	Australian Balance of Trade (May)
1 July	US non-farm payrolls (March)
5 July	German Factory Orders Month on Month (May) British Bank of England (BoE) Financial Policy Committee Meeting US Non-Farm payrolls (June)
8 July	German Balance of Trade (May)
9 July	China Foreign Exchange Reserves (June)
10 July	China Inflation Rate Year on Year (June) Great Britain Balance of Trade (May) US Federal Open Market Committee (FOMC) Minutes
11 July	German Inflation Rate Year on Year Final (June) BoE Financial Stability Report US Inflation Rate Year on Year (June)
12 July	China Balance of Trade (June)

15 July	China GDP Growth Rate Year on Year (Q2)
16 July	German/EA ZEW Economic Sentiment Index (July) US Retail Sales Month on Month (June)
17 July	Great Britain Inflation Rate Year on Year (June) EA Inflation Rate Year on Year Final (June)
19 July	US Michigan Consumer Sentiment Preliminary (July)
23 July	EA Consumer Confidence Flash (July)
24 July	German Markit Manufacturing PMI Flash (July)
25 July	German GfK Consumer Confidence (August) German Ifo Business Climate (July) European Central Bank Interest Rate Decision US Durable Goods Orders MoM (June)
26 July	US GDP growth rate Quarter on Quarter Adv (Q2)
30 July	EA Business Confidence (July) German Inflation Rate Year on Year Preliminary (July)
31 July	UK Gfk Consumer Confidence (July) China NBS Manufacturing PMI (July) EA GDP Growth Rate Quarter on Quarter Flash (Q2) US Federal Reserve Interest Rate decisions

Political events

2 July	EU parliament convenes
4 July	Algerian Presidential Election
7 July	Greek Legislative Election
21 July	Ukrainian Parliamentary elections

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2019

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