EQUITIES SHAKE OFF TRADE FEARS, WHILE BONDS RETREAT

Growing trade concerns were a drag on equities. But this influence was offset by positive earnings and improved US economic data. Overall, equities recovered from their earlier losses, while eurozone sovereign bonds reversed some of their first-quarter gains. The euro was weak, as the European Central Bank (ECB) was much more dovish in its policy guidance than had been expected. This meant that equity gains were stronger in euro terms. Despite lower German yields, eurozone sovereign bonds declined because peripheral (particularly Italian) spreads rose.

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

Key quarterly themes

- Trade fears intensify, but equities gain
- Central banks move towards policy normalisation
- Italian politics sparks a sell-off in May, but markets recover

Trade unease intensifies

Trade issues dominated during the quarter. Sentiment oscillated, depending on the latest developments or comments on potential trade restrictions. Overall, though, concerns grew that the increasing 'tit-for-tat' nature of tariff announcements could escalate into a global trade war. This outcome would obviously have negative repercussions for global growth. Equities reacted skittishly to any perceived escalation in trade tensions.

Global growth supports stocks

Equities shook off trade worries to post gains, buoyed by positive global growth. The US economy was a particular bright spot, with estimated growth of 4% (annualised) in quarter two. In 2018 to date, global growth has been less synchronised than it was in 2017, with European growth particularly strong. That said, global growth still looks set to grow in line with 2017 at around 3.4%, with an increased contribution from the US. Towards quarter-end, there were some tentative signs of stabilisation in European growth, as PMIs recovered.

Company earnings – on the rise

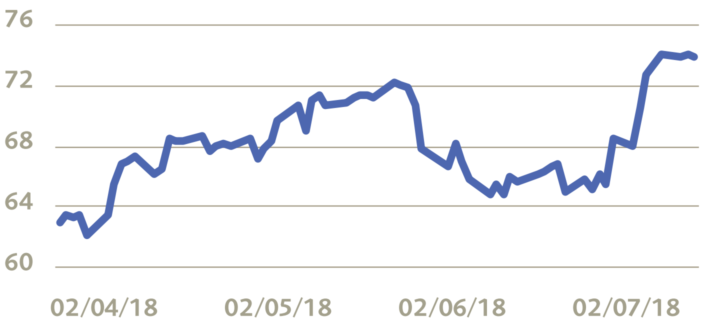
At the close of last year, the consensus forecast for global earnings growth in 2018 was 10%. Since then, earnings forecasts have been upgraded to over 16%. This is due to US corporate tax rates being lowered to 21%, and a buoyant first-quarter global earnings reporting season, in which results exceeded expectations across most regions. This trend also supported equities over the quarter.

Central banks 'normalise' policy

Policy announcements from global central banks were mixed through the quarter. The US Fed raised interest rates for the seventh time this cycle and indicated that there would be two more rate hikes in 2018. The ECB announced that asset purchases will end in December, although they're set to continue past September at a reduced rate of €15bn per month. Its guidance on interest rates, however, was more dovish than expected. Policymakers hinted that rates will not rise until the summer of 2019 at least, or until inflation is on a sustainable path to its 2% target. The Bank of England left monetary policy unchanged, backtracking on guidance for a rate rise in May. By quarter-end, however, policymakers hinted that the next rate rise would occur before year-end.

CHART OF THE QUARTER

WTI Oil US$



Source: ILIM, Bloomberg. Data is accurate as at 30 June 2018

Politics in the fray – again

In Italy, the president refused to endorse a candidate as finance minster who was deemed eurosceptic. This prompted ire from the Five Star and Northern League parties, who had proposed the candidate. Fears grew of a possible Italian exit from the EU and euro, and Italian spreads against Germany rose significantly. The appointment of a compromise candidate who made reassuring statements regarding Italy's intentions to remain in the EU eased tensions and lowered Italian spreads. Elsewhere, the US/North Korean summit achieved little of substance, but the notion of more negotiations reassured markets. In Brexit negotiations, little progress was made, with the Irish border issue a bone of contention. Divisions in UK politics also contributed to uncertainty regarding the eventual timing and format of the UK's exit from the EU. In Germany, Angela Merkel faced opposition from her interior minister, who threatened to resign over migration policies. Ultimately, a compromise between the two was reached.

MARKET ROUND-UP

Equities

The MSCI AC World equity benchmark index rose by 2.9% (6.1% in euro terms). The UK rose 9.4% (8.5% in euro terms), despite ongoing Brexit-related uncertainty, as the energy sector benefited from higher oil prices and a rise in corporate activity. The Pacific Basin excluding Japan rose 4.5% (7.3% in euro terms) as export and production data improved, despite softer Chinese economic releases. Emerging markets fell -3.4% (-2.9% in euro terms), negatively impacted by the stronger US dollar. The stronger dollar affected flows into emerging markets and the debt-servicing capacity of companies that have borrowed in US dollars. Relatively weak earnings revisions and softer Chinese data also acted as a drag. Japan lagged too, rising 1.2% (2.4% in euro terms) as economic data disappointed and political scandals damaged sentiment in relation to the longer-term outlook for accommodative monetary and fiscal policies.

Bond markets

The ICE BofA Merrill Lynch Eurozone > 5-year sovereign bond benchmark fell -1.1% during the quarter. German 10-year yields fell to 0.30% due to the flight to safety associated with the Italian political crisis and the dovish interest-rate guidance from the ECB. Italian 10-year yield spreads against Germany rose to 238 basis points (bps), having reached a peak of 320bps in late May at the height of the crisis. Spanish 10-year spreads were also pulled higher by events in Italy, ending the quarter at 102bps. Similarly, Portuguese spreads rose to 148bps. The diminished prospect of the greater EU integration proposed by France's President Macron also contributed to the widening of peripheral spreads.

Currencies and commodities

The euro fell against the US dollar to 1.1684. European economic data softened relative to US data, and the ECB was more dovish than expected in terms of its guidance around the timing of interest-rate rises. In contrast, the US Fed increased its guidance for the expected number of US rate rises during 2018.

Commodities rose 8.0% (13.8% in euro terms). West Texas Intermediate (WTI) oil rose 14.2% as the US withdrew from the Iranian nuclear deal, re-imposing a full set of sanctions on Iran and demanding that all countries cease importing Iranian oil by November. This effectively removed a significant element of oil supply from the market. An agreement by OPEC to increase oil production by up to 1mbl per day over the second half of the year failed to offset the impact of reduced supplies from both Iran and elsewhere, as global oil supplies experienced disruptions in various regions, including Venezuela and Libya.

MARKET SNAPSHOT

Market returns

Equity indices (€)	QTD % return	YTD % return	2017 % return
MSCI Ireland	7.51	-1.01	4.07
MSCI United Kingdom	8.46	1.81	7.49
MSCI Europe ex UK	2.90	-0.61	12.27
MSCI North America	9.15	5.51	6.83
MSCI Japan	2.38	0.95	9.26
MSCI EM (Emerging Markets)	-2.94	-3.84	21.00
MSCI AC World	6.09	2.71	9.47
10-year sovereign bond yields (€)	**Yield last month (%)**	**2017 yield**	**2016 yield**
US	2.86	2.41	2.44
Germany	0.30	0.43	0.20
UK	1.28	1.19	1.09
Japan	0.04	0.05	0.04
Ireland	0.81	0.67	0.76
Italy	2.68	2.02	1.82
Greece	3.96	4.12	7.06
Portugal	1.79	1.57	3.75
Spain	1.32	1.57	1.40
Commodities ($)	**QTD % return**	**YTD % return**	**2017 % return**
Oil (WTI)	14.18	22.72	12.47
Gold (Oz)	-5.16	-4.19	13.68
Goldman Sachs Light Energy Index	2.81	2.41	5.15
FX rates	**YTD**	**2017**	**2016**
U.S. dollar per euro	1.17	1.20	1.05
British pounds per euro	0.88	0.89	0.85
U.S. dollar per British pounds	1.32	1.35	1.24

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2018

ECONOMIC SNAPSHOT

Global economy

At the end of quarter one, there were signs that global economic growth had softened slightly in the first quarter and that growth was less synchronised than it had been in 2017. This continued in the second quarter, with leading measures and sentiment indicators lower than the highs observed in late 2017 and the early months of 2018. However, indicators generally stayed at relatively high levels, consistent with an ongoing level of strong growth. This was apparent in the global PMI readings: these were down from recent highs, but by the end of June, still at levels consistent with growth in the global economy of 3.3%.

US

First-quarter GDP grew 2.0% (annualised) compared with 2.9% in the fourth quarter of 2017. The labour market was generally strong, with non-farm payrolls rising 223000 for the month of May. The unemployment rate fell from 4.1% to 3.8%. Over the quarter, ISM manufacturing slipped from 60.8 to 58.7, still a relatively high level, while services fell from 59.5 to 56.8.

Eurozone

Eurozone economic data was generally softer through the quarter, with lower growth than that evident at the end of 2017. First-quarter GDP across the eurozone grew 0.4% quarter on quarter, and 2.5% year on year. The eurozone composite PMI fell from 55.3 to 54.1, while unemployment fell from 8.6% to 8.4%. Industrial production was down -0.9% year on year at quarter-end.

UK

Once again, UK economic data generally lagged growth in the global economy. Brexit-related uncertainty continued to act as an overhang, although data releases suggested that growth in quarter two was better than in the first quarter. First-quarter GDP grew 0.2% quarter on quarter. Industrial production was down -0.8% month on month, but was up 1.8% year on year at quarter-end. Meanwhile, retail sales were up 3.9% year on year at quarter-end, compared to 1.5% year on year at the end of quarter one.

Japan

First-quarter GDP fell -0.2% quarter on quarter. Industrial production fell -0.2% month on month, but was up 4.2% year on year at quarter-end. Retail sales fell -1.7% month on month, but were up 0.6% year on year at the end of the period. However, consumer confidence slipped from 44.3 to 43.7. The composite PMI fell from 52.2 to 51.7.

China

Chinese data softened through the quarter. First-quarter GDP grew 1.4% quarter on quarter compared with 1.6% in quarter four, leaving growth up 6.8% year on year. Retail sales growth eased from 9.7% to 8.5% (year on year), while industrial production growth declined from 7.2% to 6.8% year on year. The Caixin composite PMI fell from 53.3 to 52.9.

Ireland

Irish economic data was generally firm, with the economy showing resilience to Brexit-related uncertainty.

During the quarter, numbers on the Live Register fell 10000 to a seasonally adjusted 224900, and unemployment fell from 6.0% to 5.8%. That said, after quarter-end, the June unemployment rate was released at 5.1%. Industrial production remained volatile and was up 9.1% month on month but down -3.8% year on year. At the end of June, overall retail sales rose 4.3% year on year, and were up 4.7% (excluding autos).

THE ILIM VIEW – LOOKING AHEAD

An improving global economic and earnings backdrop supported equity markets in 2017. This is a trend we expect to remain in place through 2018 – despite concerns about trade issues and softer economic data in the first quarter of the year.

Global economic data has been stronger than expected in the last 15–18 months. When combined with leading indicators, this suggests that global growth in 2018 will be approximately 3.4%, significantly above the 2.5–3% range evident from 2010 to 2016. With the expected rise in global earnings and an additional boost to US earnings from the recent reduction in corporate tax to 21%, global earnings are expected to grow by approximately 16% in 2018.

On absolute valuation measures, the significant undervaluation of equities evident immediately after the financial crisis has passed. That said, valuations are slightly below their long-term averages, and do not appear stretched. The positive earnings growth backdrop should enable equities to generate reasonable gains in line with earnings growth, without leading to further rises in valuation multiples. Equities are still very attractive on a relative valuation basis against bonds and cash, given the historically low yields available on these assets.

While the fundamental backdrop remains positive, several risks could potentially affect equity markets. Most notably, these have centred on concerns related to a potential global trade war. Announcements of tariffs of 25% and 10% on US steel and aluminium imports, and subsequent proposals for 25% tariffs on US imports from China, caused equity markets to retreat from their earlier all-time highs. The recent round of 'tit-for-tat' tariff announcements, with more rounds of tariff increases threatened, have added to these concerns. Given the well-known costs associated with a full-blown trade war, we do not believe that such an escalation will ultimately occur. However, the risks around this have obviously increased. We believe there is still a willingness to address the trade issues between global trading partners, with an ultimate agreement and compromises expected, but markets may remain volatile until the eventual outcome is clearer.

In light of these potential risks, bouts of volatility in equity markets like those seen at the end of January are possible during the year. Nevertheless, following the 20% gains in local currency terms in global equities in 2017, we expect gains of high single to double digits in 2018. The path of global growth and earnings, and developments in the various risk factors will determine if (and how) markets vary from this potential return path over the year. Sudden or extreme moves could possibly present investors with opportunities to enhance returns at various points through the year.

THE MONTH AHEAD

Economic data and events to watch

2 July	Unemployment rate (euro area, May)
3 July	Reserve Bank of Australia's interest-rate decision
5 July	Federal Open Market Committee's meeting minutes
6 July	US non-farm payrolls
9 July	Balance of trade (Germany, May)
10 July	ZEW economic sentiment index (Germany, July)
11 July	ECB's non-monetary policy meeting
12 July	Core inflation (June)
13 July	Michigan Consumer Sentiment, preliminary (July)
16 July	Retail sales, month on month (US, June)
18 July	Inflation rate, year on year, (UK, June)
23 July	Euro area consumer confidence, flash (July)
25 July	New home sales (US, June)
30 July	Euro area business confidence (July)

Political events

16 July	US–Russia summit

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2018

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