DAVY

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MarketWatch

Winter is coming

Editor’s note

Welcome to the latest edition of MarketWatch.

As we enter the final quarter of 2022, the economic and investment challenges have become even more daunting than we imagined at the start of the year. Consumers and businesses are struggling with the highest inflation in 40 years and households face a cost-of-living crisis coming into the winter.

Central banks have made it clear that they are focused on bringing consumer price inflation down towards their 2% target, by reducing the quantity of money flowing around the system, and by rapidly increasing the cost of money, i.e. interest rates. They acknowledge that this will hurt growth and employment prospects, and as a result, many fear that winter is also coming for the economy.

As for financial markets, which are anticipatory by nature, it feels as if winter is already here. The sharp rise in interest rates has driven up bond yields, producing the worst returns to high-grade bonds in decades. The fear of recession has driven global stocks into a bear market (down 20%). Higher yields and the flight for safety have pushed investors into US dollars, causing the euro and sterling to fall to multi-decade lows.

In this edition of MarketWatch, we update our outlook for the economy and the markets for the remainder of 2022. We explore whether we really are facing an economic and investment winter, and how severe it might be. As usual, the reality does not always match the headlines, and it varies by region. We look at the prospects for corporate earnings, the housing market, and European currencies. In summary, we find that our global investment outlook may be over-dampened by the difficult local economic environment.

Should you have any questions in relation to the content within this quarter’s edition, please contact your Davy Adviser.

Donough Kilmurray
Chief Investment Officer

Warning: Forecasts are not a reliable indicator of future performance.

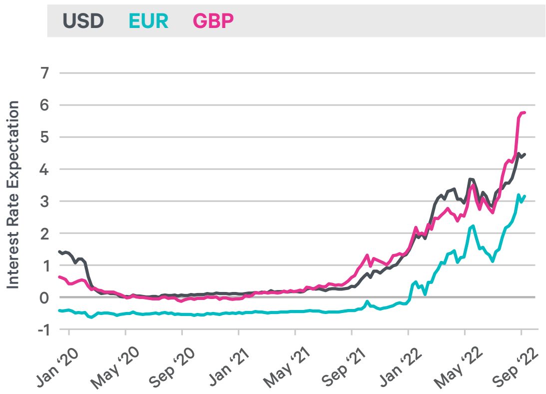
Global & regional outlook

Donough Kilmurray
Chief Investment Officer

Winter is coming

Earlier in the year, we advised readers not to fear the oncoming interest rate hikes, as we believed that central banks would strike a balance between cooling the economy and avoiding a recession. How things have changed! As inflation has stayed stubbornly high, central bankers have toughened their stance, driving interest rate expectations higher and financial markets lower, turning a cold winter for households into a cold winter for the economy and financial markets.

Figure 1: Market expectations for interest rates jumped in 2022



Source: Bloomberg; One month rate, one year forward

Don't fight the Fed

Time and time again over recent decades, markets would face a crisis, crunch the numbers and conclude that we were doomed. Then the US Federal Reserve (the Fed) would take out its monetary firehose, and flood the system with cheap money. If cutting interest rates wasn't enough, they would buy bonds or find other ways to get funds flowing and the economy going again. With ingenuity and unlimited firepower, no problem was too big that it couldn't be solved by determined central bank action, and we learned not to bet against them.

Of course, we know now that this has created the opposite problem of too much money, unfortunately at the same time as the supply of goods and workers has shrunk. While nobody knows where and when inflation will be stopped, the market again underestimated the Fed's resolve to achieve its objective. Although the sharp index declines in September indicate that repeated warnings from the Fed may have finally sunk in.

What will make the Fed relax? It wants to see below-par growth, a softer job market, and of course inflation itself to come down. Perversely, good news for the economy is bad news for the market, as the stronger the growth, the more the Fed will have to tighten policy. Chairman Powell acknowledges this dilemma, repeating the word "pain" when describing the necessary adjustments.

Looking at the drivers of consumer inflation, we see that while US price growth comes more from goods and services, which the Fed can influence by slowing activity, the largest driver of inflation in the Eurozone, i.e. energy prices, is outside the control of the European Central Bank. The Bank of England faces a mixed situation, where price caps have so far slowed energy inflation but Brexit constraints have made goods and services more expensive.

Is winter coming for the economy?

Although we talk about economic cycles, recessions are not periodic or seasonal. Their timing depends on many factors, like government and central bank policy, and the current environment has other unusual features, like the post-COVID-19 supply hangover, the energy crisis, and the war in Ukraine.

First let's look at the United States, the world's largest and most important economy. Here recession models, which are built by looking at past contractions, suggest that the size of the

adjustments required to cool down today's inflation and job market would have caused a recession in the past. However, the unusual strength of the labour market and household balance sheets, and the resilience of corporate earnings, suggest that if it does come, any US winter will be mild.

Unfortunately, the situation is more difficult in Europe. There is the risk that energy inflation is overtaken by energy shortages. Government solutions range from expensive price caps, as in the UK, to elaborate pricing mechanisms that will be tricky to implement across countries with different energy resources. Either way, governments must decide how far they are willing to stretch their fiscal credibility to cushion the hit to their populations. Looser budgets will likely mean higher interest rates across Europe and the UK, where economies are already more cyclical and rate-sensitive than the US. Unless the war ends or inflation comes down sooner than expected, some recession is likely, with the severity depending on government intervention.

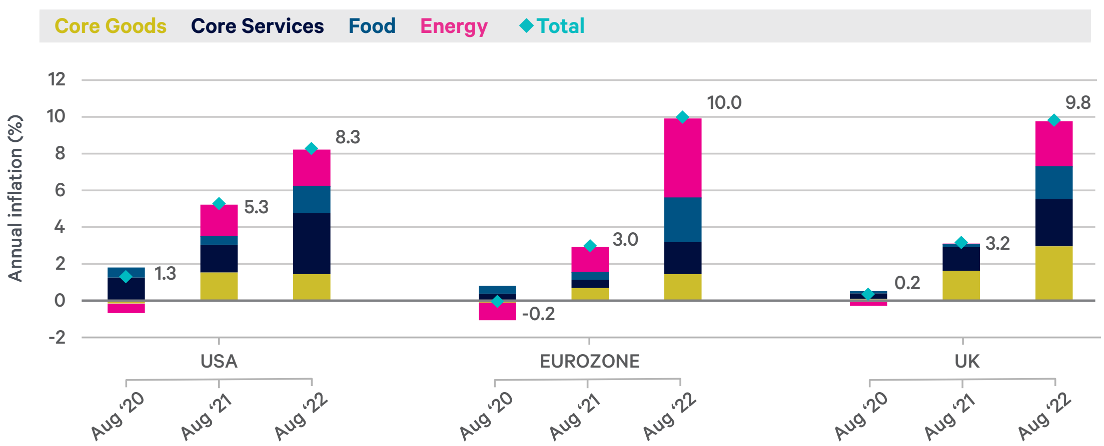
Is winter coming for investors?

As far as markets are concerned, winter is already here. Stocks have fallen into a bear market, i.e. down 20%, and bonds are suffering their worst year since reliable records began. The only question now is how severe and how long this winter will be.

Driven by interest rates, government bond yields have surged by an enormous 3-4% in the past year. The yield gap, or credit spread, between government and corporate bonds widened on the fear of recession and defaults. Higher yields caused prices to tumble, especially for longer-term bonds, and unlike the 1970s, low-starting yields meant there was no income cushion to offset the price declines.

As for stocks, the history of US recessions shows that corporate earnings typically fall by 10-20% and valuation multiples fall by 10-20%, causing a median market drop of 25-30%. The US market has already reached this range, despite there being no recession yet. Unusually, earnings have

Figure 2: Drivers of consumer price inflation



Source: US: Bureau of Economic Analysis; Eurozone; Eurostat; UK: Office for National Statistics

risen through this bear market, with all the decline coming from falling valuations. European equities, which were less expensive, have seen smaller declines, especially in the UK.

Other significant casualties in recessions tend to be commodity prices. We see this already in industrial metals and did see it with oil until OPEC (Organization of the Petroleum Exporting Countries) decided to reduce production. It is also not unusual in a tough macro environment for the US dollar to strengthen, especially if the US economy is weathering the downturn better than other countries. This time transatlantic exchange rates have also been hit by the war in eastern Europe and the confusion over the new UK government policies.

The investment outlook from here

The rapid adjustment in bond yields has brought them back up to levels last seen over ten years ago. While there is still some upward risk to yields as central banks struggle to contain inflation, most of the worst damage is probably done by now.

Therefore, in our discretionary portfolios, we are gradually reducing our long-standing tactical underweight to bonds and bond duration.

Considering equity markets, we outline three broad paths:

1. We don't get a recession, in which case stocks have overreacted and should bounce from here.
2. We get a mild recession, which is consistent with where the market has moved to. Some more downside is possible, especially if inflation stays high, but the skew of returns from here is upwards.
3. We get a severe recession. In this case, there is more downside for sure, as earnings will decline and valuations can fall further.

Our view is that paths (1) and (2) are much more likely than path (3), especially in the US, and therefore we have increased our US equity allocation on a tactical basis (12-month horizon).

Figure 3: Starting inflation level does not determine the next 10 year's real equity returns

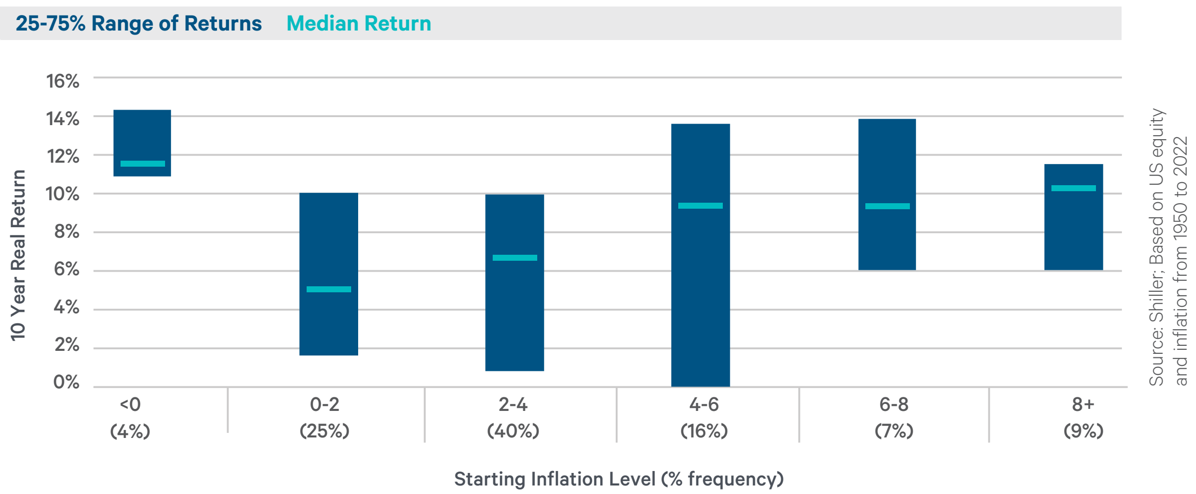


Figure 4: Equity valuations are generally low compared to the past 22 years

	Price to Forward Earnings		Price to Trailing 10 Year Earnings	
	Multiple	Percentile since 2000	Multiple	Percentile since 2000
World	12.9	19%	19.5	31%
USA	15.4	38%	29.4	69%
Eurozone	10.5	12%	14.5	29%
UK	9.1	4%	16.3	44%
Emerging Markets	11.3	31%	14.5	31%

Source: DataStream, Davy calculations

Looking further ahead, beyond our tactical horizon, what do higher inflation and interest rates mean for real asset returns for the rest of the 2020s? The era of cheap money is over for consumers and businesses, and higher economic volatility may mean lower valuations for stocks than what was enjoyed in the Goldilocks years. At the same time, investors will face a higher inflation hurdle.

To investigate the potential influence of inflation, we filter historical real US equity returns by initial inflation levels. Figure 3 shows there is no strong relationship between starting inflation levels and subsequent returns. If anything, high initial inflation was associated with stronger returns, as high interest rates were eventually reduced, spurring growth.

The most significant predictor of long-term returns is valuation, and here the bear market has left multiples at or below their average levels for this century (see Figure 4), still leaving some room for upcoming earnings to disappoint.

Conclusion

After winter, even a tough winter, comes spring. As financial markets are anticipatory, they decline before the economy does, and recover before it does. Our current tactical stance is to increase our US equity allocation, but hedge the US dollar exposure, and reduce our underweight to duration in bonds.

Our longer-term strategic view is that asset prices have adjusted to create more reasonable return prospects for financial assets, and even though the road will be bumpy and inflation may remain above target for some time, the risk-reward ratio is now more favourable than it has been for many years.

Warning: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up. These products may be affected by changes in currency exchange rates.

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Conall MacCoille
Chief Economist

Irish economic outlook

We have recently revised our forecast for Irish GDP (Gross Domestic Product) growth in 2022 upwards to 8.7%. Once again, Irish export growth has beaten expectations, reflecting the buoyant multinational sector. However, the tailwind from relaxed COVID-19 restrictions has also helped activity in indigenous sectors. Notably, despite fears of surging energy prices and double-digit CPI (Consumer Price Index) inflation, Irish consumer spending grew 1.8% in Q2 2022, as households spent more on services.

The economy clearly had enormous momentum in early 2022. Employment rose by 2% in the first half of this year to a fresh high of 2.55 million, an exceptional performance. Remarkably, the level of employment is now already 8% above pre-pandemic levels, the labour market benefitting from inward migration flows and rising participation. Hence, not only corporation taxes but also the performance of income taxes and VAT have beaten budgetary expectations and a budget surplus is now likely this year.

However, clouds are now on the horizon. Both the Euro area and UK economies are expected to be in recession by the end of the year. The uncertainty created by the war in Ukraine was always likely to hurt investment. However, the closure of the Nord Stream 1 pipeline has led to the worst-case scenario for energy supply being realised. As in other countries, Irish households will now inevitably be hit by rising energy bills this winter, likely leading them to rein in spending.

Hence, we have recently revised our forecast for Irish GDP growth in 2023 down to 3.5%.

There are already signs that activity is slowing down. Ireland's manufacturing (51.5) and services (54.7) PMI (Purchasing Managers Index) readings have softened in recent months. The construction (46.9) PMI has pointed to a contraction in the sector for several months, particularly exposed to supply-chain disruption and cost pressures.

Ireland's unemployment rate hit a fresh low of 4.3% in August. So some slowdown in the breakneck pace of jobs growth was inevitable as labour shortages were eventually felt. Notably, the Central Statistic Office's measure of employees derived from Revenue tax data, though often volatile fell 0.3% in June and 1.2% in July. We still expect that Irish employment will still rise by 1% in 2023.

Crucially, we expect the export sector will continue to perform well, helping to keep Irish GDP growth in positive territory. Our forecast is for Irish exports to grow by 7% in 2023, helped by the buoyant multinational sector, but also by their defensive nature concentrated in agri-food, information and communications technology, medical-technology and pharmaceuticals.

This protection from the export sector was very much evident in 2020. Despite a near "double-digit" decline in global trade that year, Irish exports managed to expand by 14% in 2020. This performance didn't entirely reflect multinational companies. The traditional manufacturing sector saw output expand by 6.7% in 2020.

Dealing with the big squeeze from energy prices

The average household energy bill looks set to rise to close to €4,000 from early October, up from circa €2,000 in just twelve months and likely pushing Irish CPI inflation into double-digit territory. This represents an enormous hit to households' purchasing power. It should be remembered that CPI inflation, excluding energy, was 5.9% in August – so a broad range of price rises are being felt.

Dealing with cost-of-living issues was clearly the main focus of Budget 2023's enormous €11bn package, worth 4% of gross national incomes. This included €4bn to support households this winter. For example, €600 of electricity price credits and a range of double, or once-off, welfare payments will be made this winter. In addition, income tax changes will add €831 for all those earning €40,000 or above. The key social welfare payments will rise by €12 per week. There is also the €500 rent credit. The strategy here was clearly to help a broad range of households.

Businesses will also receive help with their energy bills for the next six months. A new scheme will meet 40% of the increase in firm's energy bills up to a cap of €10,000 per month and is expected to cost just over €1bn.

However, Budget 2023 was far less forthcoming on how public services will be maintained in the face of cost pressures. These pressures could lead to spending over-runs. Crucially, the government has secured agreement, albeit not yet ratification on the new public sector pay deal.

However, the budget for capital expenditure was left unchanged in Budget 2023, despite clear construction cost inflation. Implementation of the National Development Plan (NDP) could well be one casualty of the cost and Budgetary pressures now emerging.

Nonetheless, we believe the official Department of Finance projections for the Budget balance in 2022 are too conservative given the buoyant performance of tax receipts so far this year. We expect the Irish government will run a surplus of €3bn (0.7% of GDP) in 2022, rising to €8bn (1.6% of GDP) in 2023. Of course, these projected surpluses could be diluted if high energy prices persist and Irish politicians decide to provide further support to households' incomes in 2023.

House price inflation to slow

MyHome asking prices fell by 1% in Q3 2022 with the annual rate of inflation slowing to 7.8%. It now seems clear that stretched valuations, economic uncertainty, and the prospect of the ECB raising rates rapidly in the coming months are finally starting to be felt. We expect that Irish house prices will rise by 6% in the year to December 2022, slowing from current double-digit rates of inflation.

A key point here is that Irish house prices have been held back by the Central Bank's mortgage lending rules. Leverage and debt service ratios on new lending are still at historically low levels. So housing demand should stay resilient, despite ECB rate hikes. There is also enormous pent-up demand. So we expect Irish house prices are unlikely to see persistent price falls and will rise by 3% in 2023.

Conall MacCoille
Chief Economist

UK economic outlook

UK on brink of recession

The current consensus forecast is that UK GDP (Gross Domestic Product) will contract by -0.3% in 2023, with inflation of 7% next year, the highest amongst the G7 economies. The UK is now expected to enter a technical recession of two quarters of negative growth through the turn of the year, with only a modest recovery expected in the second half of 2023.

The latest GDP data show that activity in the UK economy in the second quarter was still a little below its pre-pandemic level – lagging behind other economies where the recovery is close to complete. However, UK GDP growth appears to have ground to a halt over the summer.

In September, the manufacturing PMI (Purchasing Managers Index) had fallen to 47.3, signalling a deep contraction, in sync with the broader European sector. However, the services PMI fell below the 50 no-change level for the first time in September, to 49.2, a 22-month low. Firms blamed economic uncertainty and cost-price pressures for hurting demand. It appears the UK economy was already contracting, even before what promises to be a very difficult winter.

From October 1st, the average UK household energy bill will rise to £2,500, pushing UK CPI inflation to a peak of close to 11%. This squeeze on real incomes should lead a further retrenchment in consumer spending, which on its own, is sufficient to push the UK into recession.

A spectacular own goal from the Conservatives*

However, UK households and investors have also been unnerved by Kwasi Kwarteng's "mini-budget" and the consequent volatility and uncertainty it created. Rarely has a fiscal stimulus proved so counter-productive.

Liz Truss is expected to make good on her pledge during her leadership campaign to reverse the 1.5% rise in national insurance contributions and the planned rise in the corporate tax rate to 25%. These moves would in themselves have been sufficient to raise questions on the sustainability of the UK government's fiscal plans, especially in the wake of the plan to cap energy bills, effectively a "blank cheque", leaving the public finances exposed to natural gas prices.

However, Kwasi Kwarteng went far beyond expectations, also pledging to reduce the basic rate of income tax to 19% from April 2023, with the top 45% rate paid by those earning in excess of £150,000 eliminated.

Remarkably, the "mini-budget" entailed £45bn of tax cuts, the biggest package in 50 years. The Institute for Fiscal Studies (IFS) estimated that the UK public sector borrowing would equal almost £200bn, or 7.5% of GDP this budget year 2022/23 – even though the economy is operating close to full capacity.

Investors were clearly unconvinced by the plans at one point, pushing the sterling exchange rate to near parity against the dollar, a trough of $1.037. Although the Sterling exchange has come back, markets still expect the Bank of England will have to raise interest rates close to 6% in early 2023 to bring CPI inflation back to the 2% target.

This risks a marked decline in UK house prices as first-time-buyers' borrowing costs surge – with some commentators now forecasting falls of 5-10% in 2023. The volatility in gilt yields led many mortgage lenders to withdraw products, which will now be repriced at far higher rates. Existing mortgaged households will suffer as their 2-year, or 3-year fixed rate products expire – many possibly seeing their mortgage rates eventually double or triple.
Especially worrying is that the Bank of England was forced to intervene in the gilt market, to address liquidity problems in long-dated gilts that threatened to spiral out of control. The intervention related to "liability driven investments" in the pension fund industry. The Bank of England will purchase £5bn of gilts daily until October 14th but is due to restart the process of reducing the size of its balance sheet from October 31st.

It remains to be seen whether the Bank of England can withdraw its support and recommence gilt sales without triggering further volatility. This poses the danger that investors will eventually see the Bank of England's inflation fighting credentials as compromised by financial stability concerns, leading them to sell sterling.

Don't forget about Brexit

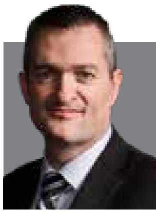
The rationale for the Conservative's tax cutting agenda was that it might help structural improvements in the UK's growth potential. However, there is little economic evidence for this view. The UK's Office for Budgetary Responsibility (OBR) is likely to take a dim view of Liz Truss's assertion she can achieve a 2.5% GDP growth target in a sustainable fashion.

Instead, a reversal on income tax pledges in the November budget looks like the more likely path to restore some modicum of respectability to the fiscal plans. This will require a difficult political U-turn, but this process seems to have already started with the announcement that the 45% top rate will stay in place.

Of course, the biggest impediment to the UK's structural growth prospects is Brexit. The COVID-19 pandemic has largely masked the detrimental impact of leaving the EU single market. However, the UK's poor export performance is increasingly clear. In the rest of the G7 economies, exports have now largely recovered following the disruption in 2020 and 2021. However, UK exports were still 7% below their pre-pandemic level in Q2 2022.

The most obvious policy measure to help the UK's growth prospects would be to negotiate a trade deal with closer ties, and reduced trade frictions with the EU single market. However, for now this option remains firmly off the agenda.

*This article was written at the end of September and since then Chancellor Kwarteng has been replaced.



Aidan Donnelly
Head of Equities, Davy Private Clients

Global equities
'E' is good - or at least good enough!

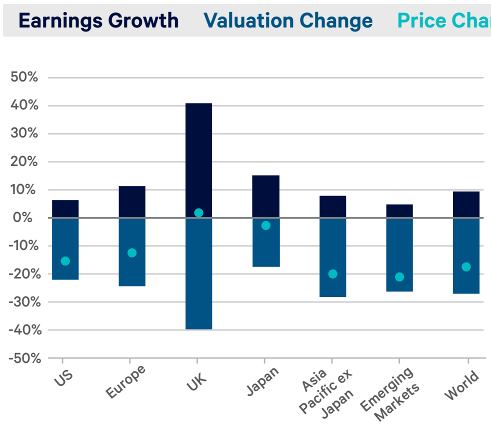
Although there is some debate about it, one school of thought is that fairy tales were cautionary stories passed down through the generations by word of mouth to teach young children about some of the dangers in life. Don't go into the woods alone; don't speak to strangers etc. So far in 2022, investors may feel that they, too, are living in a fairy tale – one where they are Goldilocks and have entered the house of the three bears (Inflation, Interest Rates, and Economic Growth).

Initially, we had to deal with Daddy Bear (Inflation) where the porridge (prices) was "too hot" and needed to be cooled in a hurry as the "heat" proved to be more than just transitory in nature. Then there was Mummy Bear (Interest Rates) that was too cool (low) given the conditions outside, in the labour, goods, services, and energy markets. Monetary authorities have pushed to "normalise" interest rates after the prolonged period of loose financial conditions and quantitative easing (QE). Finally, we come to Baby Bear (Economic Growth) – there is much debate about whether global economic growth will prove to be "just right" and therefore, very palatable for Goldilocks, or whether the actions of central banks cool it too much, creating a bowl of cold sludge!

What has made this year somewhat unusual has been the fact that these same issues have produced negative reactions in many asset markets. Looking at government bond markets, the rise in bond yields over the past nine months looks more or less completely justified based on the state of the economy and the evolution of central bank expectations. However, this had implications for other asset markets with higher yields which explains some of the ongoing strength in the US dollar, and perhaps by extension weakness in commodity markets.

So, what about equity markets? As a rule, elevated bond yields imply downward pressure on equity market valuation multiples – and we have certainly seen that so far in 2022. Figure 1 deconstructs the year-to-date price moves for the main market regions between changes in earnings and changes in the valuation multiple.

Figure 1: Deconstructing 2022 returns



Source: Bloomberg, MSCI; local currency terms

Across every region the de-rating of valuation multiples has been significant for the most part, but doesn't necessarily take account of the absolute multiple that the region is trading on. For example, traditionally cheaper areas like Europe, the UK, and Asia have seen the largest correction in valuation so far this year. Currently, US multiples remain elevated relative to the rest of the world, so some might argue that there remains more room for the downside. That being said, sector composition explains much of this disparity, with the US market obviously enjoying a heavier weighting of the high-multiple tech sector.

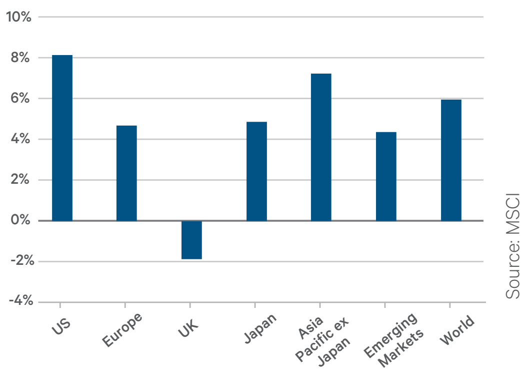
The other point worth noting is that, for the most part, the change in valuations has been greater than that explained solely by a move higher in bond yields.

This begs the question of what else could be going on? The answer lies with Baby Bear!

The debate on the future path of economic growth is inextricably linked to the outlook for corporate profitability. Given the magnitude of valuation compression, it is not unreasonable to conclude that markets are pricing in an earnings recession in 2023. A reduction in earnings would result in forward valuations moving higher, undoing some of the de-rating seen this year.

While this might seem like a logical explanation for the price moves seen so far this year, the rationale breaks down when you look at analysts' and strategists' forecasts for earnings in each of the regions – Figure 2 below gives a good snapshot.

Figure 2: 2023 Earnings growth



The bears will argue that these forecasts have been falling in recent weeks, and while there is no denying this, there is a big difference between reducing growth rates and declining profits. It seems unlikely that the multiple compression can get much worse, though previous experience suggests that it can persist longer than you think. Even if the central banks start easing policy, should the economy and investor sentiment become weak enough.

As investors sit at their desks (with their sun-bleached golden locks after the summer months), Daddy Bear and Mummy Bear may still be in the background, but the focus will be on Baby Bear's breakfast bowl. If economic growth turns out to be not too hot and not too cold, then the outlook for corporate profits could come in close to current forecasts. In which case, the prospects for equity markets would seem brighter into next year, driven by growth in earnings and some valuation expansion. The problem, for now, is that it will take time before we get clarity on how quickly inflation subsides and how low it goes, the terminal level of interest rates in this cycle, and what their impact will be on economic growth.

In the meantime, unlike fairy tales that are passed by word of mouth, no amount of ink will be spared discussing these topics. Therefore, it might be best to choose your reading material wisely!

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Warning: Forecasts are not a reliable indicator of future performance.

Marie Gillespie
Senior Equity Analyst

Home ownership - A Gen-Z fantasy?

With the cost-of-living crisis continuing to feature in headlines, and the resulting giveaway budget in Ireland, the key topics dominating conversation domestically continue to be energy, inflation, and the dreaded possibility of a recession. The outlook is even worse for any companies with UK exposure, with some earnings forecast to fall for Irish stocks with significant UK exposure going into 2023.

However, amid all this turmoil, one focus that has remained unchanged is the Irish love affair with property. Regardless of what happens in an uncertain world outside, the thinking goes, if you own your home at least you have some security. In this regard, one must have empathy with the younger generation of renters and would-be buyers in Ireland. Buying a house has never been an easy process, but it has now become so difficult that the average age for a first time buyer in Ireland is now 34 years old. It's no wonder when average rents in Ireland stand at a whopping €1,460 a month, and an even more eye-watering €2,260 a month for houses in Dublin. This makes the 10% deposit requirement to purchase a property a very difficult hurdle without the "bank of mum and dad" featuring heavily. Is there light at the end of the tunnel, or are we likely to see a reversion to the tried and tested solution in Ireland – mass emigration from frustrated generations?

From the viewpoint of a would-be first time buyer, one of the most frustrating aspects has to be that it's actually cheaper to buy than rent – if you can scale the deposit hurdle and then be lucky enough to find a property that's within budget (a separate debate). Current "macro-prudential" lending rules in Ireland are for banks to lend a peak 3.5x salary as a mortgage. Assuming that a first time buyer manages to find a home valued at €375,000, has €7,500 deposit saved and takes advantage of both the government's "First Home Shared Equity" and "Help to Buy" scheme, that requires a salary of €75,000 per annum to be able to buy (or €96,500 if availing only the "Help to Buy" scheme alone)*. In repayment terms, that equates to a repayment rate of €1,044 per month on a thirty year mortgage if using both First Home and Help to Buy; or €1,438 if using only the Help to Buy Scheme based on a mortgage interest rate of 2.55%.* This is clearly much more attractive than the aforementioned current crippling rents. What could arguably help is if strict lending limits

*Based on a recent Cairn Homes study validated by Davy Horizons.

were to widen, and indeed macro-prudential lending rules are currently "under review", with results expected to be published in Q4. However, indications so far are that the 3.5x loan to income rule is likely to remain unchanged.

From a listed equity perspective, a number of topics have consistently raised their head with regards to the property market. We all know the statistics – Ireland has a supply-demand imbalance, and a widely accepted need for c. 45,000-50,000 houses to be built every year based upon demographic trends. However, despite the government recognising the clear need for housing in its Economic Budgets and its "Housing for All" scheme, the number of houses built continue to be well below the demand levels.

So what's the hold up and is it going to improve? Well, there are a number of issues currently. Firstly, the planning permission system in Ireland appears to be dysfunctional, with many projects taking years in the planning process. Another issue is rising costs. Whilst the listed housebuilders in Ireland are talking about significant cost inflation rises of between 7-9% this year, the larger housebuilders actually benefit from economies of scale. In fact, the "real" cost rises for the smaller housebuilders are possibly much higher – up to 15% year-on-year in some cases. As a result, it would seem that some of the smaller developers appear to be struggling currently. Furthermore, with interest rates rising, the knock on effect is the price of bank lending also rises, which again hits the smaller developers hard. In particular, the cost required to fund apartments is challenging, from both a cost of financing perspective and also length of time in the planning process.

As with other industries, supply chains are also an issue in construction currently. This can lead to delays, with some products particularly impacted by gas supply, such as bricks, sanitary ware and aluminium products. At the time of writing, there have been some tentative signs of improvement in commodity prices, which will hopefully feed into a reduction in costs going forward. Nonetheless, material prices and availability are likely to remain issues impacting construction over the winter months. However, one bright spot in Ireland at least is the availability of labour. In this instance, the UK's loss is our gain as UK labourers are re-locating to Ireland.

Overall, the tough situation surrounding the supply of housing seems set to remain difficult for the foreseeable future. This could improve if we were to see a resolution to the Ukraine war. We recently interviewed an industry expert to find out some more of the challenges and opportunities for the sector.

This month, we spoke with Margaret Sweeney, the CEO of I-RES (Irish Residential Properties REIT Plc), which is Ireland's leading provider of private residential rental accommodation, to ask her current views on the Irish property market.

Our highlights from the interview are below:

1. **Margaret, for those readers that may not be familiar with a 'REIT' structure, can you tell us a little bit about them?**
   "REITs", or Real Estate Investment Trusts, have been around for over 20 years, and since 2014 in Ireland. The REIT structure is a very common model for real estate funding across Europe and is a feature of nearly every mature property market across the region. Typically, REITS are more liquid than direct property investments as shares can be bought and sold via a stock exchange. I-RES is focused on residential housing but REITs can also be focused on other types of property such as offices, hotels, warehousing, etc. REITs are also obliged to distribute 85% of profits as dividends to shareholders via a twice-yearly payment.

2. **Interest rates and inflation worries continue to dominate the headlines in Ireland. How do these pressures impact I-RES?**
   Energy and other costs are certainly rising, with some cost increases in the construction of buildings particularly notable. However, I-RES has invested in new technology in its business which can help the company to navigate cost pressures. In addition, from a value perspective I-RES still represents good value for tenants, with average rents still 10-12% below market currently. Energy is a particular focus area for us at the moment. We are fortunate to have quite a young portfolio, almost all BER A-C rated. As part of our ESG commitment, we work closely with residents to reduce our usage and impact, and this is particularly important in the context of energy prices.

3. **Can you tell us a bit about the Private Rented Sector (PRS) supply and demand fundamentals in Ireland currently?**
   Ireland is currently experiencing a huge lack of supply in the private rented market, and demographic trends would imply this structural imbalance will continue into the future. Population projections for Ireland suggest that by 2040, there will be an additional one million people in Ireland, all needing accommodation. Whilst estimates suggest that Ireland needs up to 50,000 new homes every year, only circa

20,000 homes are being built currently and this situation is unlikely to improve soon. Another demographic trend is people renting for longer and buying first homes later in life. The average age of a first time buyer in Ireland is now 34 years old, compared to older generations, where first properties were often bought as young as 25.

An imbalance exists in the conversation around commercial landlords in Ireland - however the reality is that the current rental market is made-up of 93% private landlords and just 7% of commercial or corporate landlords, who fund and manage many homes that otherwise might not be in the current housing stock. However, there are a number of smaller landlords exiting the market due to current unfavourable conditions.

4. **How is the legislation surrounding rent caps affecting the market?**
   Rent caps were introduced in Ireland in 2017/2018, with the initial cap being a maximum 4% annual increase in rents, with the figure subsequently being reviewed in July 2021 to be indexed in line with the harmonized index of consumer prices (HICP). Since then, the Government has capped the rent cap increase at a 2% maximum. Rent cap regulation is a blunt structure that has hindered supply and created numerous 'stranded assets' in Ireland. More broad-reaching rent regulation in other jurisdictions has been more successful in ensuring balance across a range of different objectives.

5. **ESG, or Environment, Social and Governance investing, is presenting a number of opportunities and challenges for companies at the moment. Can you tell us about these in an I-RES context?**
   There are a lot of opportunities as a listed company from having a strong ESG rating. For example, bank debt rates are increasingly linked to ESG credentials, which can benefit relatively strong ESG performers. I-RES itself has particularly strong credentials in diversity and inclusion (considered a 'G' , or Governance factor), and also has high integration with local communities (an 'S' – or Social factor). We were recognised at European level last year with a 'Best Practice Leader' in the European Women on Boards Index. However, for the property sector generally, requirements pertaining to the Environmental piece can be more challenging. Lots of capital investment is needed to bring older buildings up to higher energy efficiency standards. However, it's fair to say some governments could do more by recognising the additional expenses that this capital investment requires.

6. **What do you expect Ireland's PRS market to look like into 2023?**
   As touched on earlier, supply is a huge challenge in Ireland. For large scale apartment developments, this is particularly pronounced currently as with costs rising it is extremely difficult to price the likely cost of a future development. Lengthy and difficult planning permission processes (which can be up to 6 years) and detailed design specifications from the outset add significant complexity to scale developments. Furthermore, rising interest rates add to uncertainty over borrowing costs.

WARNING: The opinions expressed in this interview are the views of the interviewee and do not reflect the views and opinions of Davy.

Warning: Forecasts are not a reliable indicator of future performance.

Stephen Grissing
Investment Strategist

Debt, deficits and currencies

Picture a company that consistently incurs expenses in excess of its revenue, forcing it to borrow continually in order to keep its head above water. Does this sound like a company that you would invest in? Governments on the other hand follow a different rulebook, where high levels of debt and budget deficits are common practice. According to data from the OECD (Organisation for Economic Co-operation and Development), nineteen of the G20 members currently run budget deficits, indicating that the government's level of spending exceeds its revenue.

In previous editions of MarketWatch, we identified interest rate differentials and economic outlooks as key drivers of exchange rates. In addition to these two drivers, does the size of a budget deficit or the level of government debt make a currency more vulnerable? Or do they simply not matter? The answer is not a simple yes or no.

Spend, spend, spend

It feels unfair to include a snapshot of economic and financial balances at a time when many governments remain vulnerable, still dealing with the fallout from COVID-19 - akin to a horse racing jockey weighing in just hours after he or she has polished off a generous serving of Christmas dinner. In an attempt to kickstart the economy, government spending often increases at a time when revenue from tax receipts is declining. This is exactly what unfolded at the onset of COVID-19, to an extent that had not been witnessed previously. Increasing the size of a budget deficit is often seen as a necessary evil during these times.

Governments are no strangers to budget deficits. Take the US for example - data provided by the Congressional Budget Office shows that the US government has run a deficit in 46 of the past 50 years, with the average deficit running at 3.5% of

Figure 1: Economic and financial fundamentals snapshot

	US	Euro Area	UK	Germany	Japan
Budget balance as % GDP (2021)	-15.3	-4.7	-7.9	-3.7	-9.0
General government debt as % GDP	121.1	88.1	99.6	77.0	259.0
Current account balance as % GDP	-4.0	+0.7	-8.3	+4.0	+1.0
Consumer prices, % year-on-year (headline)	8.3%	10.0%	9.9%	10.9%	2.8%

Source: Budget balance as % GDP: OECD as of 2021.
General government debt: US –US Office of Management and Budget, as of 30/06/2022. Euro Area – Eurostat, as of 2021. UK – ONS, as of 31/03/2022. Germany – Deutsche Bundesbank, as of 2021.Japan – OECD, as of 2021.
Current account balance as % GDP: OECD as of Q1 or Q2 2022 subject to availability.

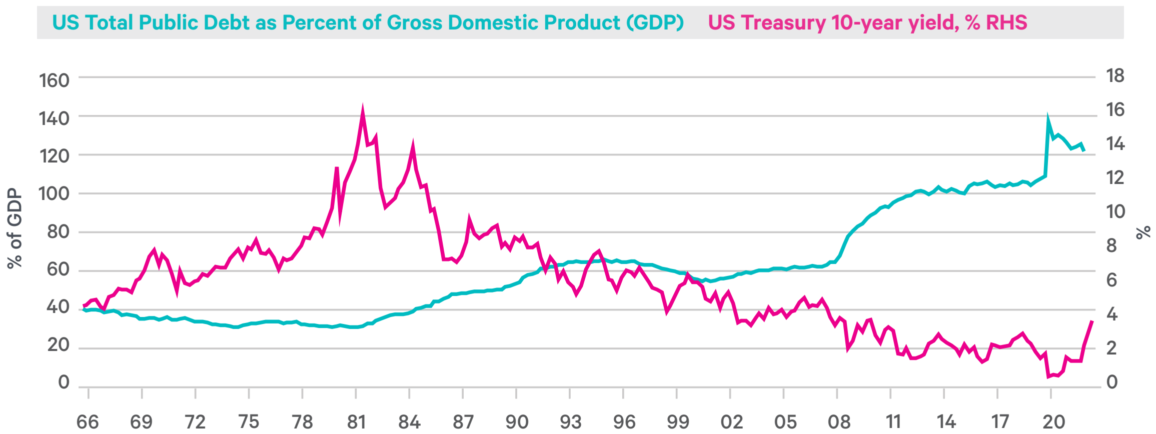
GDP (Gross Domestic Product). The UK does not compare much more favorably, with deficits in 22 of the past 25 years. In the world of budget deficits, size matters. In comparison to history, the current deficits in US and UK are at extreme levels. Going back to the mid-sixties, the previous highest deficit in the US was in 2009 following the Global Financial Crisis at 9.8%.

As annual deficits rack up, the levels of debt required to fund them also increase. Debt levels as a percentage of GDP are close to historic highs for many global governments. The question is often asked – what level does debt need to reach before it becomes a problem? Unfortunately, there is no simple answer to this question either.

The cost of debt

Rather than focus on the amount of government debt, it is the cost of borrowing (bond yields) that has the potential to create a problem. The cost of servicing government debt has fallen over the past few decades, making today's high levels of debt more sustainable. Quantitative easing (QE) and an era of lower interest rates have both contributed.

Figure 2: Declining cost of government borrowing



Source: US Office of Management and Budget. Bank of Governors of the Federal Reserve System, as of 30/09/2022

In the twenty years before 2000, based on quarterly data, the average level of government debt to GDP was 50% in the US, while the cost for the government to borrow for a ten-year period averaged 8.6%. In the 20 years following 2000, average debt to GDP increased to 83% while borrowing costs fell to 3.3%. The US dollar also holds the extraordinary privilege of being the world's reserve currency, which drives demand for its debt, in the form of US Treasury bonds. Foreign investors including global central banks hold $7.7 trillion of the total $29.6 trillion of US Treasuries in circulation as of the end of 2021.

Renowned economist, Larry Summers has argued in recent years that the US government should continue to borrow as long as the economy is growing faster than the cost of servicing the debt. Given the significant moves higher in bond yields recently, Summer's argument may be put to the test in the near future at a time when economic growth is deteriorating.

UK and sterling in the spotlight

In simple terms, a current account deficit is where the total value of the goods and services that a country imports exceeds the total value of the goods and services that it exports. Thanks to Brexit, the UK's current account deficit reached a record 8.3% of GDP in the first quarter, at a time when the country is also running a large budget deficit – a situation known as a twin deficit. A ballooning current account deficit leaves the pound relying heavily on capital inflows from foreigners in order to maintain its value.

When the sustainability of a country's deficits is questioned, and investor confidence weakens, we can see a sharp fall in the value of the country's assets, including its currency. The UK is in danger of this scenario playing out following the announcement of a giveaway budget in September. For now, sterling has stabilised due to intervention from the Bank of England, but the outlook for the currency remains highly uncertain.

Summary

Debt and deficits do not necessarily equate to a weaker currency. Confidence and credibility matter too. The US dollar is an example; it holds the unique and privileged position of being a reserve currency, making it more resilient to structural imbalances. Although Europe has its own issues, its financial fundamentals are relatively healthy at an overall level. For the sterling, however, the likelihood of continued weakness remains elevated due to a precarious combination of deteriorating deficits and fragile investor confidence.

Warning: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up. These products may be affected by changes in currency exchange rates.

Warning: Forecasts are not a reliable indicator of future performance.

Market trends and insights

Bond's Bear Market

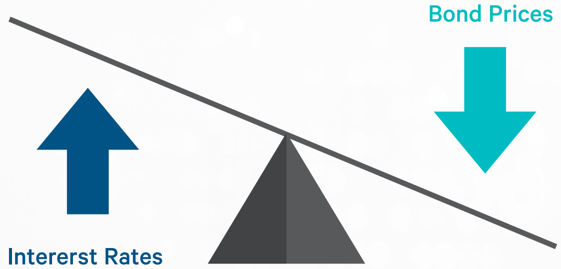
Bond prices and bond yields are inversely related.

When interest rates across the market go up.

Investors then have more options to earn higher rates of interest elsewhere.

Therefore, demand for Bonds with lower 'coupon payments' falls.

Interst Rates vs Bonds



What comprises Corporate Yields?

Treasury or Government Yields

Credit Spread

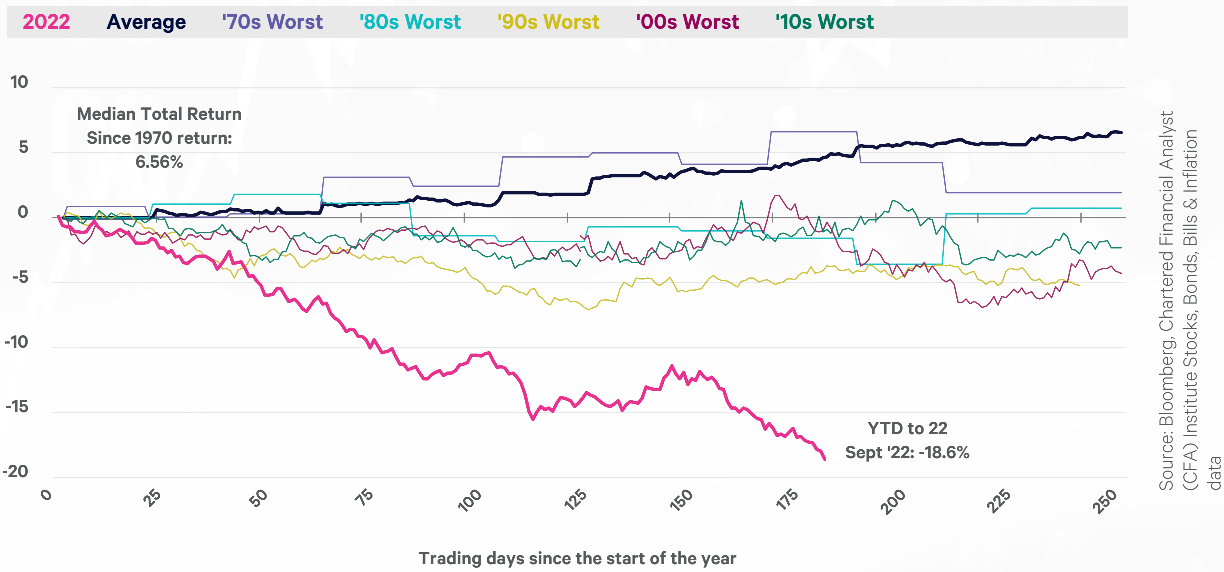
- The credit spread is the compensation for Bonds that are riskier than Government Bonds
- The difference in Yeild between a Government Bond & another bond, for example a corportate bond, of the same maturity

2022 has been exceptionally challenging for bonds. There have been large moves in fixed income markets before, however sizeable yields have cushioned returns.

Figure 1: Government 10 Year Yields: Historical Data

Comparing 2022 fixed income returns with previous years, current price performance is exceptionally weak.

Figure 2: Global Bonds total return since start of the year versus previous decades' worst years



Note: Data is calculated 1970 - 1990 US Aggregate Bond Total Retuns. 1990 - Present is calculated using Bloomberg Global-Aggregate Total Return Index

Patrick McLaughlin
SRI Multi Asset Portfolio Manager

EU Sustainable Finance Disclosure Regulation (EU SFDR)
What does it mean for investors?

EU Sustainable Finance Action Plan

The European Union (EU) has set a 2030 target for reducing EU Greenhouse Gas (GHG) emissions by 55%. Additionally, it has set a 2050 target for net zero emissions within the EU and has estimated that approximately €2.6trillion will be required by 2030 to deliver these targets. It expects that at least half of the required financing will come from the private sector.

The EU Sustainable Finance Action Plan was developed in 2018 in response to the United Nations 2030 Agenda for Sustainable Development (which led to the UN Sustainable Development Goals) and the December 2015 Paris Agreement on climate change.

The EU Sustainable Finance Action Plan has three main objectives:

- Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth
- Mainstream sustainability into risk management
- Foster transparency and long-termism in financial and economic activity

The main thrust of the action plan is diverting capital toward more sustainable businesses and projects, driving the transition to a low-carbon economy. This capital will be sourced from both public funding and private investors. The regulatory framework provides the basis for the asset management industry to engage with private investors.

Regulatory Framework

The EU has created a regulatory framework for the financial services sector that will assist in delivering these climate targets. Two key parts of this framework are the EU Sustainable Finance Disclosure Regulation (EU SFDR) and the EU Taxonomy.

EU Taxonomy

The EU Taxonomy classifies economic activities as either environmentally sustainable or not. An environmentally sustainable activity does not harm the environment and contributes substantially to tackling climate change.

The Taxonomy regulation remains in development as only two of its six strands are finalised. At present, the list of activities that meet the Taxonomy criteria is quite small. For some context, MSCI conducted a study in June of this year and found that less than 1% of MSCI ACWI (All Country World Index) constituents are estimated to be fully aligned with the Taxonomy.

In addition, only 32% of these companies are estimated to have any alignment (revenue >0%) [2]. This is an indication of the challenge asset managers face in providing solutions that offer a high degree of taxonomy alignment, whilst retaining a diversified approach. Solutions in this space will likely be thematic in nature, meaning they will likely have a narrow focus, be concentrated in nature, and lack the diversification benefits of a broader multi-asset solution.

EU Sustainable Finance Disclosure Regulations (EU SFDR)

The EU Sustainable Finance Disclosure Regulations (EU SFDR) have been developed with the main aim of providing investors with a greater level of transparency surrounding the sustainability characteristics of investment products, allowing investors to understand the impact of their investment choices.

In addition, the regulations seek to provide information to investors in a standardised way and in turn, make it easier for investors to compare sustainable investment strategies. Furthermore, the EU SFDR reduces the ability of product providers to overstate the sustainability credentials of their offerings through branding exercises, in other words, "Greenwashing".

The Impact of EU SFDR

EU SFDR impacts investment managers at both an entity level and a product level. At the entity level, investment managers are required to disclose how sustainability risks are integrated into investment decisions and advice. There is a further requirement to disclose whether the investment manager will consider the negative impacts of their investment decisions and advice. In addition, entities are required to disclose how their remuneration policies maintain consistency with the integration of sustainability risks.

At the product level, the regulations require asset managers and investment managers to classify their investment solutions and make the appropriate disclosures related to each classification.

EU SFDR classifies investment products into three articles:

Article 6 – Products that do not integrate sustainability into the investment process and could potentially include allocations to companies excluded by typical ESG approaches such as tobacco or thermal coal.

Article 8 – Products that promote environmental or social characteristics (E/S characteristics) or a combination of both, provided that the companies in which the investment is made follow good governance practices.

Article 9 –Products that have sustainable investment as its objective. The term sustainable investment is tightly defined. A commitment to an ongoing reduction of Carbon Emissions for example can be defined as sustainable

The required disclosures focus on the following areas:

- The impact that sustainability risks may have on the value of the investment solution provided.
- The negative impacts the investment solution has on sustainability factors.
- The sustainability characteristics of the investment solution and how those characteristics are measured.

Sustainability factors, as defined by the regulations, look at the following broad areas:

Greenhouse Gas Emissions

Biodiversity

Water

Waste

Social and Employee Matters

A brief description of what each of the three areas of disclosure covers is provided below:

1. **The impact that sustainability risks may have on the value of the investment solution provided.** This disclosure outlines whether the investment product considers the risks that Environmental, Social & Governance factors pose to the value of an investment. This is a statement as to the level of integration of sustainability risks into the investment process.

   If the product considers these risks:

   - How does the investment process capture and assess the risks that Environmental, Social and Governance factors pose to investments?
   - What are the likely outcomes of this assessment?
   - Are these assessments binding on the resulting asset allocation?

2. **The negative impacts the investment solution has on sustainability factors.** This disclosure outlines whether the investment product considers the negative impacts it has on sustainability factors. The negative impacts are assessed using the Principal Adverse Impact Indicators (PAIs). EU SFDR identifies eighteen mandatory indicators for Corporate Entities, Sovereigns, and Real Estate under the areas covered by the sustainability factors. In addition, it requires reporting on a further two voluntary indicators drawn from a list of 46. The principal adverse impact indicators can form the basis of an investment manager's ongoing engagement with portfolio companies.

3. **The sustainability characteristics of the investment solution and how those characteristics are measured.**

   This relates directly to solutions classified as Article 8 and Article 9. Asset managers are required to provide a standard disclosure template to investors covering the following:

Article 8 products:

- Whether or not the product has a sustainable investment objective
- What are Environmental and/or Social characteristics promoted by the product?
- What indicators are used to measure attainment?
- Does the product cover Principal Adverse Impacts?
- What are the binding elements used to attain the Environmental or Social characteristics promoted by the product?

Article 9 products:

- Whether or not the product has a sustainable investment objective
- What is the sustainable investment objective of this financial product?
- What sustainability indicators are used to measure the attainment of the sustainable investment objective of this financial product?How do sustainable investments not cause significant harm to any environmental or social sustainable investment objective?
- Does the product cover Principal Adverse Impacts?
- What are the binding elements of the investment strategy used to select the investments to attain the sustainable investment objective?

Current challenges associated with EU SFDR

The European Sustainable Investment Forum (Eurosif) is the leading association promoting sustainable finance at a European Level. Its membership is drawn from asset managers, institutional investors, index providers, and ESG research and analytics providers. In June, they published a report "EU Sustainable Finance & SFDR: making the framework fit for purpose. Eurosif Policy Recommendations for Article 8 & 9 product labels" providing their assessment of the current state of play post the introduction of EU SFDR.

The report illustrated two challenges currently facing the investment industry. It proposes a clearer delineation of what constitutes an Article 8 product and an Article 9 product by introducing minimum requirements for these products. This will help asset managers better classify their investment solutions. It also highlights the current difficulty in defining a Sustainable Investment.

At present, the definition is open to interpretation, which is at odds with providing investors with increased comparability across sustainable investment solutions. It called for greater clarity around the definition.

Within a multi-asset context, where investors are typically investing in several different asset classes to provide a diversification benefit, EU SFDR does pose some challenges. Not all asset classes and instruments fit neatly into EU SFDR classification, examples of asset classes that don't classify under EU SFDR include Cash, Gold, and Structured Products. In addition, Government Bonds and Inflation Linked Bonds in the majority of cases are currently classified as Article 6. A defensively orientated portfolio with a higher allocation to Fixed Income, Gold, and Cash might not look as favorable as a higher risk portfolio when evaluated through an EU SFDR lens.

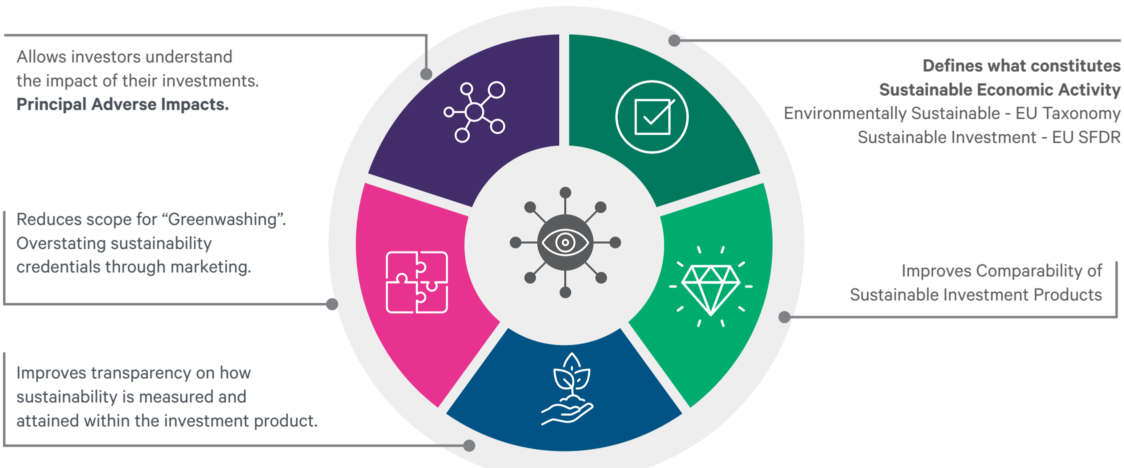
An area to watch is the growing number of downgrades in classification from Article 9 to Article 8. In May, the European Securities and Markets Authority (EMSA) issued a supervisory briefing. The clarifications that ESMA provided around Article 9 suggest that all investments made by an Article 9 product must support its sustainability objectives.

MiFID II Sustainability Preferences

Finally, in August of this year, a further element of the EU Sustainable Finance Action Plan came into effect. The MiFID II Sustainability Preferences regulations require financial advisers to assess the Sustainability Preferences of clients as part of the Client Suitability Assessment. The regulations outline a framework for assessing these preferences in terms of EU Taxonomy and EU SFDR. As this regulation employs both EU Taxonomy and EU SFDR it also faces similar challenges as those previously outlined, particularly regarding the definition of what constitutes a sustainable investment.

We will continue to keep clients and Advisers up to date with this evolving regulatory landscape and its impacts.

Figure 1: Aims of EU Sustainable Finance Disclosure Regulations



Source: Davy

Masood Baig
Senior Performance Analyst

Portfolio Construction Thinking differently about future diversification

Some of our readers may not have experienced high persistent inflation in their lifetimes. It has not posed a challenge to the investing environment in recent decades. Whether this bout of inflation is fuelled by energy prices, supply constraints, or loose monetary policy is up for debate, but there's no denying it's here.

Bond yields incorporate inflation expectations and an unexpected increase in inflation expectations increases yields and bond prices fall. Due to duration risk, bonds with longer maturities tend to be more sensitive to changes in expectations as there is more uncertainty over a longer period. The short duration bond position in portfolios has protected the portfolios from the full impact of rising inflation expectations and the knock on expectation of rising interest rates.

The negative impact of high inflation on equities could be reflected through shrinking margins, future uncertainty on profitability, or reduction in the multiple paid for stocks.

Portfolio implications

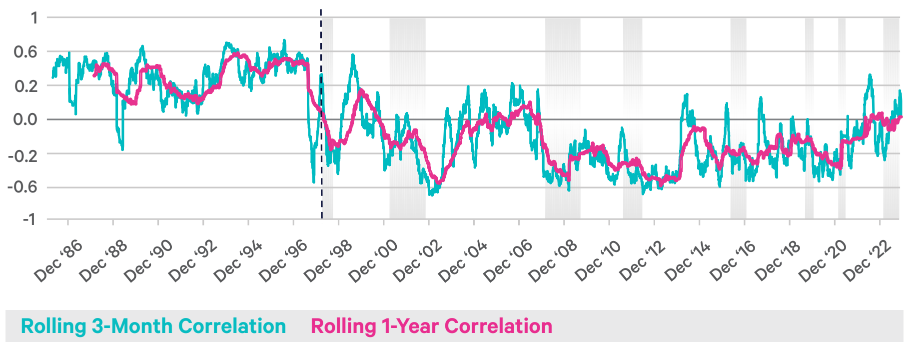
High Inflation and uncertainty around its future has increased the correlation between bonds and equities, making them behave more similarly eroding their diversification properties.

Be it a classic 60/40 or a multi-asset portfolio, stocks and bonds form the major holdings of most investors' portfolios. In the environment of low interest rates and inflation, reliance on diversification from bonds had served investors well. Over the period, central banks intervened when the economy faltered, by pushing interest rates to new lows and subsequently bond prices higher. This made the drawdowns in stocks more palatable and allowed investors to stay invested and on course to meet their financial objectives.

Figure 1 shows how US equities and bonds have behaved in relation to each other over two different time horizons. Although the shorter-term (rolling 3 month correlation) is quite noisy, the longer-term (rolling 1 year correlation) is more stable. The longer-term correlation also indicates both investments have behaved differently over the last two decades.

The shaded regions represent financial crises experienced in the last few decades. From the Asian Financial crises in 1998 to the onset of the COVID-19 pandemic, the correlation between stocks and bonds has been negative during each period of financial stress. Consequently, the portfolio benefited from the diversification provided by bonds.

Figure 1: Rolling 3 month and 1 Year correlation between US Large Cap and Bond (in USD)



Source: Bloomberg, August 2022; MSCI USA (USD), US Corporate and Government Index

More recently, there has been a positive spike in rolling three-month correlations this year and the rolling one-year correlation has also crept in to positive territory. Both asset classes are declining in tandem as central banks raise interest rates to tackle persistently high inflation. Clients have felt this harshly with the drawdown in portfolios. Instead of acting as diversifiers, bonds have suffered worse than equities due to steep rate hikes.

Table 1 shows the worst nine month periods for the US Large cap stock market since 1973 and the subsequent bond index returns and inflation over the same period. Apart from a brief period in 2008, we have to go back to 1974 to find a time period where bonds and stocks were simultaneously negative. Inflation was persistently high during the 1970s (averaging 7.8% annually in the US) and monetary policy was being aggressively tightened in response.

Table 1: Worst nine-month period returns for US large Cap stocks and US Bonds in USD

Date	US Large Cap	US Corp & Gov Index	CPI Index
Feb-09	-46.4%	1.7%	-1.2%
Jan-09	-39.3%	1.4%	-0.9%
Mar-09	-36.6%	2.7%	-2.3%
Sep-74	-36.5%	**-3.2%**	9.3%
Nov-08	-31.8%	**-1.8%**	0.2%
Dec-08	-30.7%	2.4%	-1.0%
Apr-09	-29.8%	2.9%	-2.9%
Sep-02	-28.9%	9.2%	1.9%
Oct-08	-28.7%	**-5.5%**	2.3%
Jul-74	-28.0%	**-4.3%**	8.1%
Nov-74	-27.6%	**-3.2%**	8.9%
Dec-74	-27.4%	0.5%	8.6%
May-09	-26.9%	2.9%	-2.6%
Aug-74	-26.8%	**-4.3%**	8.7%
Oct-74	-24.1%	**-3.2%**	9.0%
Dec-02	-22.9%	11.6%	1.8%
Oct-01	-21.7%	9.5%	1.1%
May-88	-21.5%	5.9%	2.8%
Jun-74	-21.3%	**-4.3%**	8.4%
Oct-02	-21.3%	7.5%	2.0%

Source: Bloomberg, August 2022; MSCI USA (USD), US Corporate and Government Index; CPI: Consumer Price Index

Portfolios need other diversifiers to ensure there is some protection in this environment. That's where the portion of portfolios to assets typically labelled as "alternatives" becomes significant. Alternatives typically refers to hedge funds and real assets like property, infrastructure, and commodities.

Thinking differently about diversification

A stable positive correlation will increase the risk in portfolios going forward. Investors would need to decrease their equity allocation to maintain a similar risk level and consequently lower returns. Allocating a higher weight to less correlated alternatives can dampen the portfolio risk while maintaining future return expectation. Our changes to the portfolios saw increased allocations to Inflation Linked bonds, Gold and Alternative strategies. Inflation-linked bonds are meant to a hedge against rising inflation. However, similar to other bonds, they too are negatively impacted by increasing interest rates. Gold has been one of the few positive returning assets this year (in euro terms). Its increased allocation should help increase diversification.

Illiquid investments like Real Estate and Infrastructure are attractive because of correlation with traditional investments. They also provide steady income. Infrastructure income streams can provide some protection against inflation and have low exposure to short-term GDP (Gross Domestic Product i.e. economic growth) shocks. Illiquid alternatives also provide respite in face of extreme short-term volatility due to their lack of daily mark-to-market pricing which can help investors remain invested and stay the course.

Future role of alternatives in portfolios

The relationship between equities and bond returns has been a primary determinant of risk in portfolios. For the last two decades, the correlation between them has been consistently negative. Historically, bonds have proven to be a reliable source of protection when equities sell-off. However, high uncertainty around inflation has led to positive correlation between stocks and bonds, erasing the diversification protection. The role of alternatives in portfolios will be crucial to maintain the current level of risk in portfolios and add uncorrelated return streams.

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Anna Heaney
Investment Associate

Cost of living
The latest in a list of crises

Crisis fatigue is a response to the prolonged stress that develops due to unexpected or difficult events, such as war, economic depressions, or a pandemic. ***- Medical News Today***

The word 'crisis' has been part of the vernacular for the past several years. To name a few, with the COVID-19 Crisis, the Climate Crisis, and the latest one, the Cost of living Crisis – it's no wonder that anxiety levels have shot up in recent years. As suffering becomes commonplace, we go through a phase of crisis fatigue. This is not the first time the world has faced such challenges but it is the most significant in recent history.

During World War II, to promote strength in the face of adversity, the British government produced posters with the famous mantra "Keep Calm and Carry On", we may need to reach for it now as our resilience is put to the test yet again. Currently, the cost of living crisis is the latest thing to grapple with and though we may want to, it's hard to bury our heads in the sand when our financial potential is being eroded.

On top of this, economic pessimism is beginning to take hold across global economies as we face winter physically and metaphorically. After a long and painful COVID-19-induced hibernation, the brief optimism that prevailed at the beginning of the year has now been worn down and the prospect of the roaring 2020's that we alluded to in a previous MarketWatch edition has been extinguished for now. Geopolitical uncertainty, coupled with soaring prices, is taking its toll on both businesses and consumers, with some having longer lasting effects than others.

A balancing act

The rippling effects of the war in Ukraine and the subsequent energy crisis are affecting people worldwide. According to the UN Development Programme (UNDP), 71 million people in developing countries are falling into poverty as a result of the increased costs of energy and food. Developed countries are struggling too, with inflation figures year on year to September of 8.2% in the US and 10.0 % in the Euro Area – levels not seen for circa 40 years.

Wage growth hasn't kept pace with record inflation, considerably weakening purchasing power. However, governments and policymaker intervention has been strong. In an effort to ease the impact of inflation, we've witnessed measures including tax cuts, free and subsidised travel, energy subsidies and caps, cash transfers, and significant raising of interest rates by central banks. In the EuroZone alone, close to €300 billion has already been spent on cost of living measures.

No countries for young men (and women)

Some components of inflation are sticky (longer lasting) e.g. rent and medical care and some are slippery (temporary) e.g. oil prices. The question of how long this period of inflation will last is up for debate but some consequences could be felt for a long time. This includes a demographic cost to the cost of living crisis.

In the UK context, the pain has arguably been worst felt, disproportionately affecting young people. It was reported in July that disposable incomes for the under-30's had fallen by 21.6% year on year (YoY) as youths are grappling with a sharp increase in spending on essentials such as rent, groceries, transport costs and utility bills. A separate study, carried out by the Prince's Trust found that almost half (46%) of UK youths fear not having enough money to buy essentials, while over a third are planning to leave education for employment. With this pressure for survival, the prospect of milestones such as graduating university and eventual home ownership become ever more elusive.

In the Irish case, a recent study by RedC identified that 70% of young people (18-24) are considering emigrating, with 80% fearful for the future. For context, a similar youth poll to the recent RedC one in 2012 found just 51% were contemplating emigrating at that time. Mass emigration of younger generations has both a social and economic impact that can permeate society for generations to come. Emigration isn't anything new, Ireland's long history of it has seen an estimated 10 million people leave since 1800. People leave for either push or pull factors. Previous crises such as famines and economic crashes "pushed" people out. In the past several years, with a healthy economy and high average living standards, people left primarily for "pull" factors such as career opportunities and adventure. The pendulum has swung towards "push" again and many find the prospect of building a life impossible with extortionate costs of living. It's little surprise, as Ireland is the EU's most expensive country, with housing costing as much as 84% more than the bloc's average between 2010 and 2020.

The cost to doing business

Small and medium-sized enterprises/businesses (SMEs/Bs) are also taking a hit from the current situation, at a time when they were recovering post-pandemic. On a global level, Meta's recent Global State of Small Business Report identified input inflation, supply chain disruptions, and threats of recession as top concerns. However, promisingly, they identified a small decrease in SMBs reporting closures and a sizeable increase in the proportion of SMBs reporting higher sales. Close to home, during the COVID-19 period, small, indigenous businesses received an upsurge in support and demand. For lack of alternative options for spending, a greater share of wallet could be dedicated to higher spend on items from local brands – "Support Local" was the call of the day. Now, with rising costs of energy and materials, the environment has become more challenging and 63% of Irish SMEs are concerned about the rising cost of doing business in the year ahead according to Google Ireland.

The opposite of a crisis?

There isn't one word to describe the opposite of crisis, just like there's no one tactic for reacting to it. Undoubtedly, there will be many more to come in the future but whilst "keeping calm and carrying on" may be difficult for our personal resilience, that is exactly the right approach when it comes to your investment portfolio. As investors, we will be facing into challenges but the advice remains the same. With the constant barrage of bad news, it's important to remember that bull markets and bear markets come and go and therefore, it's better to focus on where you are in your life cycle than the economic cycle. We have come through crises before and we continue to hold firm. As long as your financial plan is up to date and reflective of your current situation and goals, the best way to react to this current crisis at hand is to keep calm and...

Market data

Total Return (%) in local currency	2017	2018	2019	2020	2021	YTD
Equities (local currency)						
MSCI All Country Local	19.8	-7.7	26.2	14.2	20.9	-21.7
MSCI World Local	18.5	-7.4	27.3	13.5	24.2	-21.9
MSCI Emerging Markets Local	30.6	-10.1	18.0	19.1	-0.2	-20.8
S&P 500	21.8	-4.4	31.5	18.4	28.7	-23.9
MSCI USA	21.2	-5.0	30.9	20.7	26.5	-25.1
MSCI Eurozone	11.2	-12.2	25.1	-2.2	23.6	-21.9
MSCI UK	11.7	-8.8	16.4	-13.2	19.6	-1.3
MSCI Ireland	3.8	-21.5	40.0	5.6	16.7	-29.5
MSCI Japan	19.7	-15.1	18.5	8.8	13.4	-7.5
MSCI Hong Kong	37.2	-8.5	10.8	5.3	-3.4	-18.9
MSCI China A Share	12.7	-29.3	39.5	31.5	0.9	-21.5
MSCI Germany	12.2	-18.2	23.0	2.3	13.3	-27.6
Equity Indices (in EUR)						
MSCI All Country Local	8.9	-4.8	28.9	6.7	27.5	-13.7
MSCI World Local	7.5	-4.1	30.0	6.3	31.1	-13.4
MSCI Emerging Markets Local	20.6	-10.3	20.6	8.5	4.9	-15.4
S&P 500	6.9	0.4	34.1	8.8	38.2	-11.5
MSCI USA	6.2	-0.6	33.8	10.8	35.9	-13.1
MSCI Eurozone	11.2	-12.2	25.1	-2.2	23.6	-21.9
MSCI UK	7.2	-9.9	23.7	-17.9	27.2	-5.5
MSCI Ireland	3.8	-21.5	40.0	5.6	16.7	-29.5
MSCI Japan	8.9	-8.8	22.4	5.0	9.4	-14.6
MSCI Hong Kong	19.5	-3.2	12.5	-2.8	3.2	-6.3
MSCI China A Share	5.4	-29.8	40.6	28.5	11.8	-18.6
MSCI Germany	12.2	-18.2	23.0	2.3	13.3	-27.6
Global Equity Sectors						
MSCI World Energy	1.1	-13.4	10.3	-32.9	42.0	29.4
MSCI World Materials	21.9	-14.1	22.7	15.2	19.8	-17.2
MSCI World Industrials	20.4	-13.5	27.6	8.2	20.5	-20.6
MSCI World Consumer Disc	20.1	-4.9	26.4	33.8	20.9	-28.3
MSCI World Consumer Staples	12.7	-8.4	22.3	4.6	15.6	-10.6
MSCI World Health Care	16.8	3.6	22.9	11.0	21.9	-13.0
MSCI World Financials	17.5	-14.9	24.9	-5.4	30.4	-17.8
MSCI World Info Tech	36.8	-2.4	47.5	42.4	31.2	-32.9
MSCI World Comms Services	1.1	-8.2	27.2	21.6	15.8	-35.1
MSCI World Utilities	9.6	3.8	22.5	1.9	12.3	-9.7
Government Bond Yields						
US 10 Year	2.44	2.41	2.68	1.92	0.91	1.51
US 2 Year	1.19	1.88	2.49	1.57	0.12	0.73
German 10 Year	0.21	0.43	0.24	-0.19	-0.57	-0.18
German 2 Year	-0.77	-0.63	-0.61	-0.60	-0.70	-0.62
UK 10 Year	1.24	1.19	1.28	0.82	0.20	0.97
UK 2 Year	0.08	0.44	0.75	0.55	-0.16	0.69

Warning: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up. If you invest in this product you may lose some or all of the money you invest. These products may be affected by changes in currency exchange rates.

Total Return (%) in local currency	2017	2018	2019	2020	2021	YTD
Ireland 10 Year	0.75	0.67	0.90	0.12	-0.30	0.25
Italy 10 Year	1.82	2.02	2.74	1.41	0.54	1.17
Spain 10 Year	1.38	1.57	1.42	0.47	0.05	0.57
France 10 Year	0.69	0.79	0.71	0.12	-0.34	0.20
Portugal 10 Year	3.76	1.94	1.72	0.44	0.03	0.47
Bond Indices						
EUR Government Bonds	0.2	0.9	6.3	4.7	-3.4	-16.5
EUR Corporate Bonds	2.4	-1.3	6.2	2.8	-1.0	-14.6
UK Government Bonds	2.0	0.5	7.1	8.9	-5.2	-26.4
UK Corporate Bonds	4.7	-2.7	10.9	7.5	-1.5	-18.6
US Treasury Bonds	2.3	0.9	6.9	8.0	-2.3	-13.1
US Corporate Bonds	6.4	-2.5	14.5	9.9	-1.0	-18.7
Currency Exchange Rates						
EUR-USD	1.20	1.15	1.12	1.22	1.14	0.98
EUR-GBP	0.89	0.90	0.85	0.89	0.84	0.88
GBP-USD	1.35	1.28	1.33	1.37	1.35	1.12
GBP-EUR	1.13	1.11	1.18	1.12	1.19	1.14
Commodities						
Bloomberg Commodity Index	1.7	-11.2	7.7	-3.1	27.1	13.6
Brent Crude Oil	15.5	-15.3	37.7	-35.1	63.0	30.0
WTI Oil	4.1	-20.5	34.1	-60.3	62.2	22.3
Natural Gas	-36.5	4.8	-32.3	-45.9	35.1	94.2
Wheat	-12.5	3.5	9.4	10.3	14.1	14.9
Corn	-11.3	-4.1	-5.5	13.8	40.4	24.7
Soybeans	-6.8	-9.9	0.1	33.5	13.9	15.1

Source: Data is sourced from Bloomberg as at market close September 30th 2022 and returns are based on price indices in local currency terms, unless otherwise stated.

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