Irish Life
Investment Managers

Irish Life Investment Managers are part of the Great-West Lifeco group of companies, global leaders in financial services, and have over €42 billion* in assets under management on behalf of our Irish and International clients. We strive to combine our expertise and experience with diligence and dedication, to continually meet your evolving needs.

With the 2014 finishing line in sight, this second instalment of the Retail Investment Outlook reflects on a hugely successful first year for our flagship Multi Asset Portfolio Funds (MAPS), and how they are relevant for investors now more than ever. We also share some valuable insights from our investment team on the property, bond and equity markets and examine where the pit falls and opportunities may lie on the road ahead. Lastly, we look at global and domestic markets year-to-date and what to expect as we head into 2015.

Source: ILIM, correct as at 15/09/2014.

# RETAIL INVESTMENT OUTLOOK 2014 - TAKE TWO

For adviser use only

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# Introduction

It would be unreasonable to expect global stock markets to perform in 2014 the same way they did in 2013. The super normal returns seen around the globe in both equities and bonds was, in every sense, exceptional. However, the returns this year are far from  low with most international stock markets heading for mid to high single digit returns, although Emerging Markets are on course to do somewhat better. All things considered, I think most investors will be happy they have yet another year of positive returns under their belts.

The initial burst of optimism that occurs almost every January was short lived this year with nervousness around US markets and the strong run in share prices into the year-end prompting a bout of profit taking. That is not really surprising when you consider some stock markets were up over 50% in the previous 12 months. Global stock markets recovered over the remainder of the first quarter, reassured that weakness in the US was largely driven by weather related factors and some temporary inventory build-up. The ongoing tapering of the bond repurchase programme is now well embedded in investors' minds and no longer impacting significantly on sentiment. Indeed, the market is now more focussed on interest rate announcements from the US Federal Reserve, who are mindful of investor expectations and market sensitivities. Currently, it is not envisaged that rates will increase until 2015, and even then, they are unlikely to rise either quickly or back to the levels prior to the crisis. Investors appear to like that message.

The Bank of England UK toyed with the idea of raising rates at the back end of 2014 but ultimately they too have pushed that possibility back into 2015. This was largely driven by a weakening inflation number (back below 2%) and cooling housing and labour markets.

It is interesting to note that the Eurozone is now at odds with both the US and UK in terms of their monetary and fiscal policy objectives. The European Central Bank (ECB) cut rates to an all-time low in July on the back of a Eurozone inflation reading of just 0.4%, with a further cut in September. They now find themselves in the unusual position of charging banks for the privilege of depositing money with them. Furthermore, they are examining the possibility of reducing bond purchases ( also known as a quantitative easing programme , such as QE3) in the US. These measures are designed to pump money in economies in an effort to support growth throughout the Eurozone, both peripheral and core countries, and stimulate some inflation. Conversely, the US and UK are looking to withdraw from support programmes and increase interest rates as their economies are showing signs of stable growth and are close to inflation targets. It may be that the quicker and more aggressive intervention in the US, and to a lesser extent the UK, has seen their economies turn around before the Eurozone, but it by no means certain. Markets are currently pricing in at least 3 years before the ECB look to raise interest rates.

Separately, it is also interesting to note two other phenomena at play in 2014. The first is the performance of the Emerging Markets. Over the course of 2013, many investors left the emerging markets believing the growth story had played out, prices were too high, the commodity cycle was over and the highly important US economy was far from out of the woods. Those concerns meant a significant underperformance relative to the wider equity markets. However, that served to rebase prices down and as global investor confidence recovered, Emerging Markets came back with a bang. They struggled in the first quarter of 2014, along with developed markets but were not subject to the sustained selling they have previously been subject to at the first signs of a market wobble. More importantly, when markets turn positive just before the summer, they performed very strongly and have in fact outperformed the developed markets by some margin year to date. Valuations look reasonable and there is plenty to be positive about, but let us not forget, these are still emerging markets, so expect a bumpy journey. The second point of interest for me comes back to the old adage "sell in May and go away, come back for Labour Day". Year in, year out, that has largely proven to be a wise move – sell up before the summer lull and buy back in September. It is difficult to definitively account for the success of this strategy other than people are on holidays over the summer and volumes, liquidity and news flow tend to fall off. In contrast this year, markets rose in May and kept on rising, pausing briefly at the end of July/early August before continuing their rise. It would appear that the buyers were keen to stay in touch with markets over the summer months and thought valuations were compelling – none more so than in the Emerging Markets.

So, the scene is well and truly set for the final quarter. Equities are heading for another good year as confidence returns, prompted by the coordinated efforts of the global central banks who seem to have the cut their cloth to perfection in their respective jurisdictions. There have been several events that threatened to destabilise global markets but none have to date, whether in the US, Ukraine/ Russia, Iraq or anywhere else. That is a sign of growing underlying investor confidence. Somewhat ironically, we have also seen another strong year for bond markets, which typically reflects a nervous investor mind-set. On closer inspection however, there looks to be two distinct driving forces. Firstly, in the peripheral Eurozone countries, like Ireland, 10 year yields have moved strongly lower (now under 2%) reflecting renewed confidence in their ability to make a full recovery. Secondly, in the case of the core economies, like Germany, 10 year yields have been driven under 1%. Why are yields continuing to fall? Well, for as long as the ECB keep cutting rates, bonds across the board will appear increasingly attractive, in the short term at least. In the case of the German 10 year rate, there is always a segment of the market looking for protection in the event that the situation between Russia and the Ukraine deteriorates, for example, even at current yields. The more medium term oriented investors appear to be saying they still see value in the recovering peripheral economies and have invested there for growth. Indeed, in the event that the ECB engages in a quantitative easing (QE) programme, it is likely to be delivered by buying sovereign bonds, core and peripheral, which could force yields even lower. It is also worth considering what might happen if Eastern Europe destabilises any further as we come in winter and access to oil and gas lines becomes even more important. Separately, there is also the potential impact of the European wide bank stress test, the results of which are due in October. These could impact on equity and bond markets, positively or negatively.

Separately in an Irish context, momentum in the property market has remained positive throughout the year and looks set for a strong finish into the year end and on into 2015. Given the strong yield and capital growth characteristics of Irish commercial property to date, it is likely to be of increasing importance in terms of overall portfolio returns. This may be a particular focus for some investors with significant bond exposure who are finding it difficult to generate meaningful income or capital growth at current prices.

So, although we have global equity and bond markets rising at the same time, equities still look like the preferred risk/return option heading into the final quarter 2014, alongside the much revitalised Irish commercial property market. Valuations are attractive, especially versus bonds and the earnings backdrop for companies is improving all the time and yields in commercial property continue to compress. Global sentiment surveys for businesses and consumers alike are trending higher and government finances appear to be steadily getting stronger with an end to austerity in sight in some instances. So, in summary, the positive news flow and market confidence look set to continue for the near term and are likely to deliver further equity market and Irish commercial property gains as a result. Bonds appear to have limited upside but given the unpredictable nature of global markets and geo-political influences, still have a defensive role to play in a portfolio approach.

**David Haslam**
*Head of Retail, ILIM*

Irish Life celebrates its 75th birthday this year having first opened its doors for business in 1939 - a time when national tensions were high in Europe and the US was trying to emerge from nearly a decade of depression post the greatest stock market crash of all time in 1929. Does this sound even vaguely familiar? It should. A quick look back over the last number of years on this side of the Atlantic reveals various political upheavals with governments overthrown in North Africa, riots and protests across Europe, armed forces mobilised in the eastern bloc as the sovereignty of a nation came under threat from Russia and rising tensions in the middle-east...all post 2008, the greatest financial crisis of our times. Interesting comparison? Well, there's more. Back in the 1930's, the US government responded to the crisis with similar austerity measures to those in place today. Interest rates were cut from nearly 6% in 1930, to 1.5% by 1939 while the top personal tax rate moved in the opposite direction, from 25% to a jaw dropping 78% over the same period, in an effort to fund the recovery. Roll the clock forward and post the market crash of 2008, global interest rates have fallen to all-time lows and personal tax rates (amongst others) have increased significantly. That is more than just a coincidence. History, like investment markets, moves in cycles. The great British statesman and philosopher, Edmund Burke, is often quoted as saying "those who don't know history are destined to repeat it". In other words, experience is only beneficial when we learn from it.

In recent decades, access to global stock markets has evolved and improved significantly. Buying investment products has never been easier and is seldom more than a call or a mouse-click away. The complexity of investment products has increased in tandem, both at institutional and retail levels, with new products and strategies being developed all the time. So, while there is no doubt that investors today have significantly greater choice, knowing what choice to make has, ironically, probably become more difficult.

In May 2013, Irish Life launched their Multi Asset Portfolio Funds, or MAPS, developed by Irish Life Investment Managers (ILIM) to help make that choice easier. We leveraged our expertise, global relationships and 75 years of experience to deliver a simple yet sophisticated suite of five risk-rated funds, which means one for every level of risk from very cautious to very adventurous. They are multi-asset, investing in a large variety of equities, bonds, property and cash. They are also multi-strategy so the funds can benefit from a range of market circumstances, positive or negative. Lastly, they are multi-manager, so investors benefit not only from ILIM's expertise but also from world class alternative investment specialists chosen by ILIM.

Back in 1996, ILIM pioneered a lasting change in the managed fund landscape in Ireland with the introduction of indexation. On the back of our significant success, experience and capability in that field, we are using indexation as a core building block for MAPS. We have also introduced the Dynamic Share to Cash (DSC) model with these funds which is underpinned by award winning investment processes. It is unique to ILIM and aims to reduce investors' exposure to stressed markets by selling risky assets and investing in cash at the appropriate time. It is extremely innovative, took over two years to research the 100 years of market data it is based on, and fully endorsed by ILIM, Irish Life and our new parents, Great West Lifeco.

These funds significantly simplify the investing process which starts by helping people understand their individual risk appetite and then identifying the appropriate MAP fund accordingly. These funds are easy to access, easy to understand, performing strongly and delivering on expectations. At the time of writing, the returns for the last year are in the table below.

| Fund | MAP2 | MAP3 | MAP4 | MAP5 | MAP6 |
|---|---|---|---|---|---|
| 1 year Performance | +6.4% | +8.7% | +13.2% | +15.9% | +19.1% |

*Source MoneyMate. Gross performance from 3/9/2013 – 3/9/2014.

Over the course of that period, we have seen many factors impact on investment markets for better or worse – government policy, global economics, weather, interest rates and lots more. Nobody can predict the future or what markets will do next but the need to invest in real and diversified assets is greater than ever. Global central banks have committed to maintaining low interest rates for the foreseeable future which heightens the need to embrace some risk to generate reasonable returns – staying in deposits is no longer a medium term investment strategy. MAPS will help manage the certainty of uncertainty during your investment journey, with DSC as a unique extra layer of protection. Most of all, you can take comfort from the fact that MAPS represents the very best of what Ireland's largest, most successful and most experienced investment manager has to offer. We learn as we go and we've been around just that little bit longer...

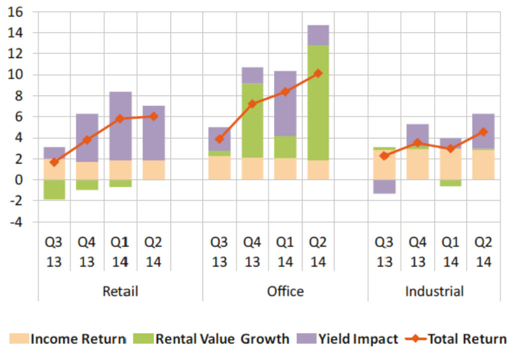
**David Haslam**
*Head of Retail, ILIM*

# Irish Commercial Property - Recovery gathers pace in 2014

As activity levels and returns in the Irish property market continue apace, mid-year 2014 is an interesting time to reflect on the key trends that have emerged and assess how the recovery may continue to unfold.

Returns from the sector are now hitting record levels (chart on right), albeit coming from a low level. IPD, who measure returns from property valuations, have reported a total return (capital growth plus income return) of 8.5% for quarter 2 (Q2), following a return of 7.2% in quarter 1 (Q1). Income returns continue to represent a strong component of total return, contributing approximately 2% per quarter over recent periods. While capital growth has been the main contributor of these high total returns, it is important to put the numbers in perspective. Since the growth in capital values returned in Q2 2013, the total increase (+16.2%) has recovered only a small portion of the 65% fall in capital values from the peak in 2008. To date, the capital growth has been achieved through yield compression mainly in the office sector and more recently, from the retail sector and strong rental value growth in Dublin city centre offices.

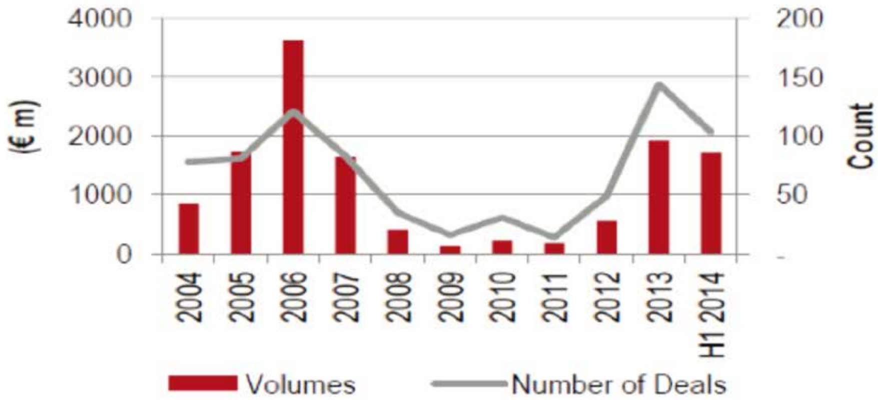
**Returns from the sector**




Source: ILIM 15/9/2014

2014 is on course for a record level of activity, with €1.7bn of Irish investment property deals transacted in the first 6 months of the year, with a strong deal flow pipeline (chart below). There has been no evidence of the traditional summer lull, with on and off market activity showing no signs of abating. The range and depth of buyers continues to expand with new entrants continuing to emerge. Overseas private equity investors, value-add funds and foreign institutional capital allied to domestic REITs, local institutional and private buyers continue to compete for opportunities. The focus for capital is constantly changing as market pricing, occupier fundamentals and the nature of the supply of stock evolves. Seller activity is escalating with supply being fed in from the banks deleveraging, through receivers or consensual borrower sales, allied to stressed sellers and some recycling of stock from early loan sale buyers responding to improving pricing.

**Investment Volumes and No. of Deals**




Source: ILIM 15/9/2014

The following deals give a flavour of market activity year to date across the investor spectrum and asset types.

- Irish Life secured 5 office properties during this period with a combination of high quality core and value add properties, including No.1 Warrington Place Dublin 2, and is currently under offer on a number of prime retail and industrial properties.
- Hibernia and Green REITs have been particularly active, with Green responsible for the largest transaction, a portfolio of offices and a retail park, for €375m from the Cosgrave Property Group. Hibernia have concluded a number of office acquisitions, mainly off market, including Guild House and Forum House in the IFSC and the Observatory and an adjoining site beside existing holdings in the South Docks.

- A third REIT – IRES Irish Residential REIT – has launched and is actively acquiring multi-family residential, an emerging sector on the Irish property investment landscape. They have completed the purchase of the Marker Residences at Grand Canal Dock and are under offer on NAMA's Project Orange, 761 apartments in 4 properties around Dublin.
- While prime and value add offices have attracted the strongest weight of investor demand to date, buoyed by pricing and rental growth prospects, strong interest in retail assets is emerging, highlighted by NAMA's Project Acorn sale of 3 provincial retail centres. There was significant interest from private equity, value add and sector specialists in the portfolio with US private equity firm, Varde, successful in the end. The market is primed for increased activity in the retail sector with Bank of Ireland's Capital Collection, NAMA's Project Parks and a number of shopping centre portfolios coming to the market.
- Loan sale activity continued to be strong during the first half of the year. Following strong activity from NAMA and IBRC in 2013, other banks including Ulster Bank/RBS are actively pursuing their deleveraging agendas. Recent significant loan sales included Project Button (RBS), Project Tower (NAMA) and Project Drive (NAMA), which add up to approximately €2bn. Further loan sale activity is expected as the banks look to escalate their deleveraging plans.

Occupier markets are now trending positively across the market; however the different sectors are at different points in the recovery cycle. Dublin city centre offices are leading the way with strong tenant take up (1million sq. ft in the first half of the year) and scarce availability of quality offices increasing prime rental levels to €40 per sq. ft. Given known tenant requirements and limited availability, we expect prime rents to exceed €45 per sq. ft by year end. The market is reacting to the supply and pricing dynamics with an increased level of refurbished space and new development in the pipeline, however timing for delivery is a number of years out and upward rental pricing pressure is set to continue.

Retail rental values in the prime shopping streets and centres are now stabilising. Retail business models will continue to be challenged by internet sales, margin pressure and changing consumer shopping patterns. Improvements in consumer confidence and spend are impacting on retail turnover and profitability. Evidence is now emerging from a wide range of retailers that they have turned the corner. This is having a direct property impact with few empty units in prime Dublin locations and emerging retailer competition for good units set to improve rents above current recession levels. This is currently Dublin centric and a wider and deeper domestic economic recovery will be required to broaden the geographic impact and generate strong longer term rental growth from the sector.

| Fund | Current | Outlook |
|---|---|---|
| **Liquidity** | • Activity at record levels<br>• Weight of active buyers<br>• Volume of active sellers | ➢ To continue<br>➢ Changing focus/new entrants<br>➢ To continue |
| **Yields** | • Strong yield compression<br>• Lead by offices<br>• High yield gap with bonds | ➢ Prime office to stabilise<br>➢ Retail & industrial to fall<br>➢ To close with risk premium |
| **Rental Growth** | • Office strong with little supply<br>• Retail & industrial prime stabilising | ➢ Strong growth to continue<br>➢ Recover from distressed levels |
| **Income return** | • High & robust at c.7% | ➢ Trending at c.6% |

Source: ILIM 15/9/2014.

The outlook for the Irish commercial property sector remains positive. There are risks to the continued prosperity of the sector including domestic and international economic growth and sustained investor appetite for the sector. However, current property occupier and investment fundamentals along with wider investment market pricing should support further growth, with rental income likely to continue as an important contributor to returns.

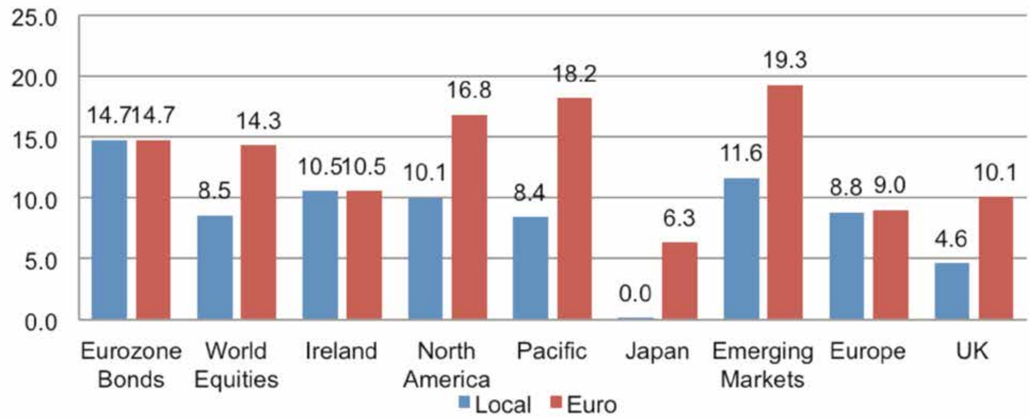
Martin O'Reilly
*Head of Property, ILIM*

# Equity Markets

## Equities – are they still the place to be?

Equity markets have generated positive returns year to date to the beginning of September supported by a slowly improving global economic backdrop, more stable earnings environment, supportive central bank policy measures and continued positive flows into equity funds. Despite the positive returns over the course of the year so far, equities have experienced a couple of periods of profit taking during 2014.

### Equity Market Returns Year To Date




Source: ILIM (as at 4/9/2014)

### FTSE World Equity Index 2014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Source: FTSE 4/9/2014

In late January and early February, concerns arose regarding the possible contagion to the global economy from a feared rise in credit defaults in the Chinese shadow banking sector and the potential for a tightening of credit supply in China with negative implications for Chinese growth. At the same time, renewed concerns over economic and financial fundamentals in emerging markets with the beginning of QE3 tapering in the US added to the concerns about the global growth outlook. However with the Chinese authorities seen as having adequate resources to deal with any domestic issues and with emerging markets proving resilient, markets rebounded with these early fears easing. In late July, markets experienced another bout of weakness following the escalation of geo-political tensions in Ukraine and the Middle East and stronger US economic data which increased the possibility of an earlier than expected US interest rates increase. Markets however have recovered these losses and are back to new highs as hopes increased that tensions in the various global conflicts could be resolved. Global central bank commentary has continued to be supportive, suggesting interest rates will remain at current low levels for some time yet while the ECB has announced additional stimulus measures by further reducing interest rates and announcing an asset purchase programme for private assets consisting of Asset Backed Securities (ABS) and covered bonds. At the same time, general economic and market fundamentals have also remained positive.

## Global Economy

The global economy has rebounded and shown positive momentum post a soft patch in the first quarter (mainly due to weather related weakness in the US), and the pace of growth is expected to improve further through the second half of the year. In the US, growth in Q1 was a negative -2.1% annualised following one of the most severe winters in the last 50 years while inventory build and heath care related spending both rolled over compared to levels at the end of 2013. The second quarter however recovered strongly, growing 4.2% annualised and growth of 3%+ annualised is expected in the second half of the year.

In the UK, growth in the first half of the year was +3.1% on 2013 and looks set to be maintained at these levels in coming quarters, supported by consumption and improving investment.

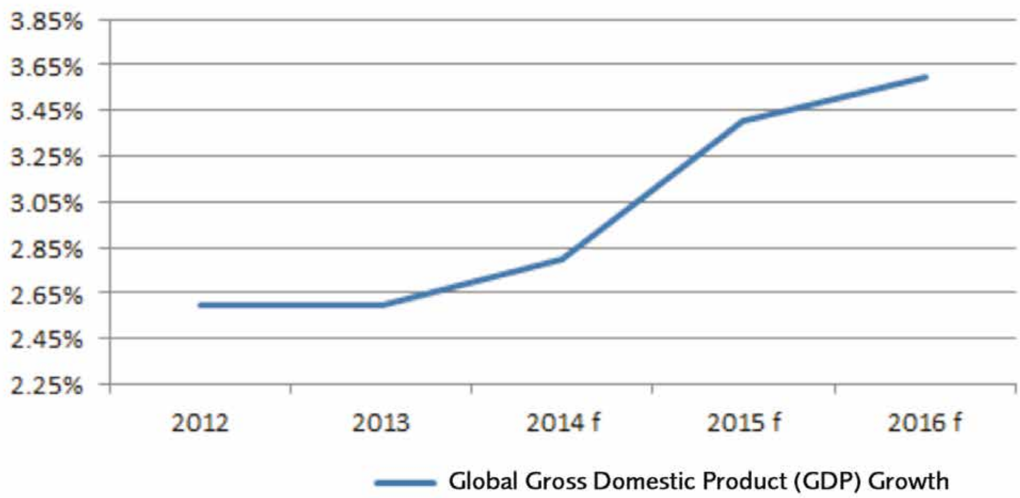
Following the concerns related to difficulties in the Chinese shadow banking sector earlier in the year, a number of mini stimulus packages were implemented which supported the economy and resulted in growth recovering to 7.5% annualised in Q2 compared to 7.4% in Q1.

Quarterly growth in Japan has been distorted by the introduction of a 3% sales tax hike on 1st April which pulled activity forward into Q1 and resulted in growth of 6.1% annualised in the first three months of the year. This, however, was reversed in the second quarter when growth was -6.8% annualised. While data remains somewhat mixed, positive growth will be generated in the second half of the year with possible additional stimulus packages potentially pushing growth for the year to +1/1.5%.

The biggest disappointment on a regional basis has been Europe. Following the exit from recession in 2013 and positive momentum at the beginning of the year (sentiment surveys at three year highs and suggesting growth of c. 2% by year end), growth has stalled. The increasing risks of deflation (Eurozone inflation fell to 0.3% year on year in August) and the tensions in Ukraine have negatively impacted sentiment, corporate activity and investment intentions. However, inflation should be close to its lows and unlikely to move into negative deflation. With the global economy recovering, the Eurozone economy is expected to improve in the second half of the year. The recent stimulus measures announced by the ECB including the private asset purchase programme and further reduction in interest rates should improve European growth prospects as will the weakening of the Euro and indications of a greater willingness to lend by banks in European bank lending surveys. Recent signs of a potential ceasefire being agreed in Ukraine should also remove some of the recent headwinds for the European economy. While growth is likely to improve in the second half, growth in the Eurozone will remain modest for the year as a whole, somewhere in the region of 0.9% but should pick up further through 2015.

*Overall, growth in the global economy should continue to improve through the second half of 2014 and continue to trend modestly higher in coming years.*

**Global Gross Domestic Product (GDP) Growth**




Source: Citi 4/9/2014

## Central Bank Policies

Global central bank policies have been supportive of economies and equities in recent years and have remained so in 2014, despite the beginning of QE3 tapering in the US in January.

In the US, the Federal Reserve (Fed) expects to have finished asset purchases under QE3 by October of this year but will maintain low interest rates for a considerable period of time thereafter. The market is currently forecasting US interest rates to rise for the first time around the middle of 2015. Despite momentum in the economy improving and the labour market being strong (unemployment down to 6.1%), the Fed has justified its position on the basis of potential underutilisation of resources in the labour market. It has also indicated that the slower recovery in the housing market and the global geo-political concerns warrant rates being kept at current levels for some time yet. When rates finally begin to rise, it will be gradual and the peak level of rates will be lower than seen in previous cycles.

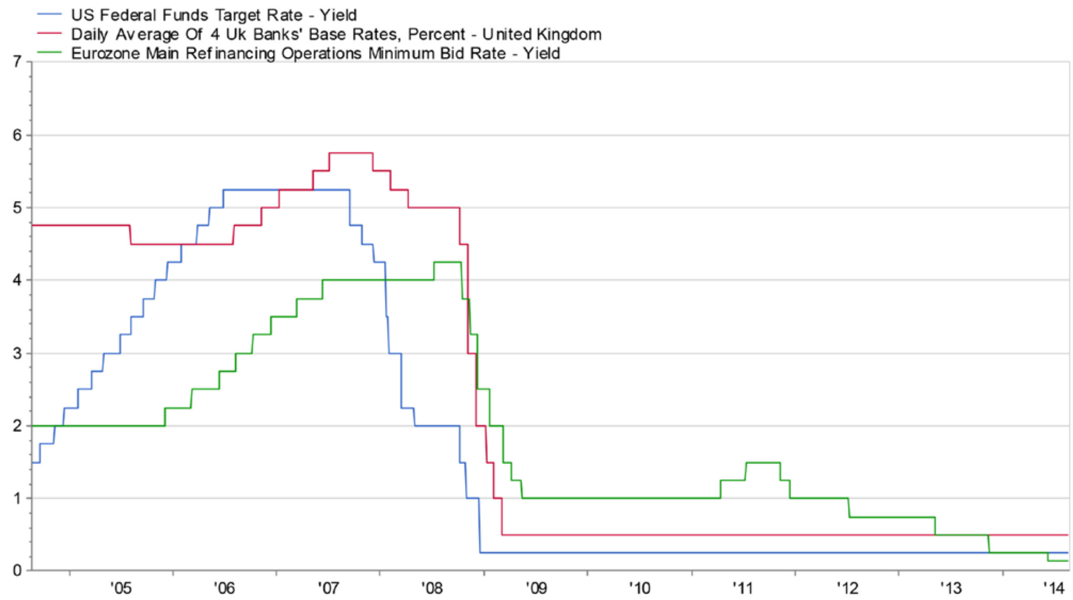
In the UK, given the strong growth in the economy over the last eighteen months, and the fall in unemployment to 6.4%, the market has been expecting an earlier rate rise in the UK than in the US. While the Bank of England in May had hinted that rates might rise in 2014, more recently it has pushed expectations for the first rate rise back to Q1 2015 as both price and wage inflation remain well contained at 1.6% year on year and 0.6% year on year respectively. Similar to the Fed, the Bank of England has indicated that eventual rate rises will be gradual and will not rise to levels in previous periods.

In Europe, the ECB has been behind the curve compared to other central banks in terms of the level of monetary stimulus being provided. It has however become more aggressive this year in response to the rising threat of deflation as inflation has continued to slide to 0.3% year on year, well below the ECB's target level of 2%. In early September it cut interest rates for the second time in three months, moving its main refinancing interest rate to an historic low of 0.05% and implemented a negative deposit rate of -0.2% on funds held by banks with the ECB to encourage them to increase lending levels. It also announced an asset purchase programme for private assets which will be launched in October and will include Asset Backed Securities and covered bonds in an effort to improve the supply of credit and reduce borrowing costs across the Eurozone. Other measures such as the new Targeted Long Term Refinancing Operation (TLTRO) and indications that interest rates are unlikely to rise for the next few years all contribute to a significant increase in the level of monetary stimulus being provided by the ECB. If conditions do not improve sufficiently or quickly, there is the potential for further policy announcements from the ECB including a full sovereign bond asset purchase programme in addition to the private asset purchase programme just recently announced.

Meanwhile, the Bank of Japan is monitoring developments in the economy and the impact of the 3% sales tax increase in April. If its economic objectives are viewed as being threatened, particularly the 2% inflation target, it has indicated that additional policy measures will be announced. The Bank of Japan however is confident of a recovery in the economy in the second half of the year.

*In summary, despite monetary stimulus being reduced in the US (with asset purchases under QE3 set to end in October) monetary policy will remain accommodative with interest rates being kept at current levels for some time yet and remaining low by historic standards even when they do begin to rise. In addition, the increased level of stimulus being provided by the ECB partly offsets the reduction in stimulus from the US Fed with QE3 scheduled to end in October.*

**Central Bank Interest Rates Remain Low**




Source: Factset 4/9/2014

## Equity Market Prospects

Despite the gains year to date, equity markets still offer upside through the remainder of the year. On a valuation basis, global equities are around fair value on 12 month forward looking price to earnings ratios (P/E).

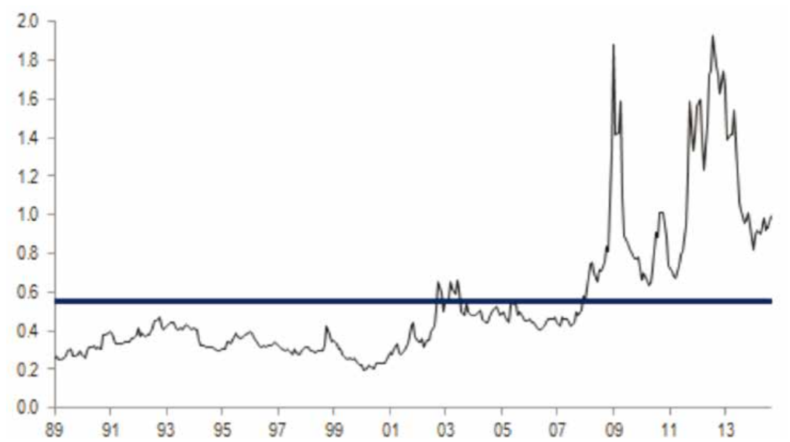
**Global Equity 12 month Forward P/E Multiple**


Source: JP Morgan 4/9/2014

Further upside to equities is likely to come from an improving earnings backdrop. In the recent reporting seasons in the US, Europe and Japan, results exceeded expectations by approx. 5%, 4% and 7% respectively. Recent years earnings forecasts have tended to be downgraded through the year so that global earnings have effectively been flat for the last three years. This year, as the global economy continues to modestly improve, earnings growth has become more evident and widespread. In Europe, despite the slower than expected economic backdrop, earnings still grew 14% year on year in the second quarter. The improving global data has increased confidence that earnings forecasts for 2014 will be met, as evidenced by the reduction in volatility around forecasts. While the emergence of growth is supportive, valuation levels themselves can also continue to move higher as they have done in previous cycles. Low levels of inflation and relatively low interest rates mean P/E multiples have room to move above average levels.

Equities also remain extremely attractive relative to other asset classes, particularly bonds. One way of comparing the valuation of equities relative to bonds is to compare the dividend yield on equities with the yield available from bonds as shown below. Currently the relative yield on equities is significantly greater than the yield available on bonds and is well above the average relative yield between the two asset classes over the longer term.

**Global Equity Dividend Yield Ratio v's Bonds**




Source: JP Morgan 4/9/2014

### Equity Flows

Flows into global retail equity mutual funds have remained positive through 2014, amounting to $97.8bn year to date. Global corporate activity in terms of mergers & acquisitions (M&A) has also been supportive and is up over 50% year on year and at seven year highs. These buying supports have been positive for markets and are expected to remain a feature as investors continue to return to equities given the better potential returns compared to other asset classes. Corporate confidence is also improving which reflects better fundamentals and reduced levels of uncertainty should continue to support further M&A activity.

## Market Risks

One of the potential risks overhanging markets is the move to a tightening interest rate cycle i.e. rising interest rates. Markets however are already discounting the start of rate rises in both the UK and US in 2015 and thus the first rate rises will be no surprise. This is unlike the position in 2013 when markets fell in May in what came known as the 'Taper Tantrum' when the US Fed surprised markets by suggesting that it might begin to taper QE3 before the end of 2013. Markets had not been expecting this and understood that QE3 could be maintained at its level of $85bn of asset purchases per month for some time. Circumstances are different now in that markets are fully expecting rates to rise in 2015, the only uncertainty relates to the exact timing of the first rise.

Rising interest rates themselves are not necessarily negative for markets, as history shows below. The table highlights equity market performance in the UK since the early 1970's 3, 6 and 12 months after the first rate rise in a tightening cycle. Typically, in the first few months after the rate rise, markets tend to be flat as they adjust to the changed monetary environment. Thereafter, markets tend to rise and on average have been up over 10% over the next 12 months as they benefit from the better economic backdrop which contributed to the decision to raise rates in the first instance. A similar pattern of equity performance is evident in the US in rate tightening cycles.

| UK Equities Post Interest Rate Rises | | | |
|---|---|---|---|
| | 3m | 6m | 12m |
| Jun-72 | 7.9 | 7.6 | -6.7 |
| Apr-76 | -8.5 | -28.7 | 5.3 |
| Nov-77 | -2.0 | 0.3 | 7.5 |
| May-84 | -2.3 | 16.7 | 29.4 |
| Feb-88 | 4.1 | 9.6 | 19.7 |
| Sep-94 | -6.3 | -6.8 | 11.1 |
| Nov 03 | 1.9 | 4.2 | 9.2 |
| Average | -0.7 | 0.4 | 10.8 |

*Source Bloomberg. 4/9/2014

On this occasion, with central banks providing greater guidance around rates and with indications that rises will be gradual and peak below prior levels, the uncertainty around the beginning of rate tightening cycles should be much less than in the past which, again, should be more supportive of equities.

The other major uncertainty impacting markets are the various geo-political issues across the world. Europe in particular has been impacted by the tensions in Ukraine. Given the economic interdependencies between Europe and Russia (45% of Russian exports and 80% of energy exports going to Europe while a third of Europe's energy needs are supplied by Russia) economically it is not in either parties interest for the situation to escalate further to the point where more severe sanctions are imposed. The impact of the sanctions to date is modest but is impacting the Russian economy more. In the case of the recent ban on food imports to Russia, the impact on the overall European economy is only 0.1%. The real risk to the European economy lies in any disruption of energy supplies from Russia but the consequences of this would also have significant implications for the Russian economy. We do not believe the situation will escalate to this level but rather some form of diplomatic resolution will be reached to remove any overhang on markets and recent attempts to negotiate a ceasefire improve the chances of this occurring.

In relation to developments in the Middle East, the risk to markets comes again from potential disruptions to oil supplies. Despite the ongoing conflicts, oil prices have actually fallen in recent weeks as oil reserves in southern Iraq are not seen as being at risk of attack from militants which are based in the north of the country. Recent political and military interventions have probably reduced the risks of any threat to oil reserves in the south. Supplies of oil have actually increased in recent months as facilities in Libya have reopened. With oil prices less likely to spike higher due to developments in the Middle East, the risks to markets are lessened.

### Summary

Equities continue to be supported by an improving economic and earnings backdrop, ongoing accommodative central bank policies and continued positive flows from investor and corporate activity. Valuation levels are also extremely attractive relative to other asset classes and provide scope for further increases in absolute terms. While some risks are evident, we do not believe they will evolve to significantly impact markets. When interest rates do eventually begin to rise, it will be gradual so in the interim equity markets can continue to move higher with modest single digit returns still expected between now and year end.

**Lenny McLaughlin**
*Chief Economist, ILIM*

# Bond Markets

## Strong performers in 2014...what next?

Against all expectations at the end of last year bond markets managed to perform strongly in 2014 so far. The table below shows the yield expectations and yields at mid-August 2014:

| 10 year Government Bond Yield | Dec 2013 | Forecasts for 2014 | 14/08/14 |
|---|---|---|---|
| USA | 3.02% | 3.5% | 2.41% |
| Germany | 1.93% | 2.2% | 1.00% |

*Source ILIM. I6/9/2014

This bond rally happened despite good labour market data in the US, an improvement in leading indicators in the Eurozone, a marginal pick-up in growth in core countries and improvement in the peripheral countries. The chart shows the Eurozone PMI (leading indicator for manufacturing and services) versus the 10 year German yield. It was expected that core bond yields would move up in line with growth expectations in 2014, but so far this relationship has broken down for the period up to August:

**Eurozone PMI Yield/Breakdown**


Source: ILIM 6/9/2014

The main contributors to the lower yields in 2014 were:

- **Weak inflation in core and peripheral countries:** lower than expected inflation readings across the Eurozone showed weakening prices for goods and services and economic growth forecasts reducing as a result. The ECB have a stated target of 2% growth in inflation – in July this year, it had fallen as low as 0.40%.
- **Accommodative Central Bank policies:** the ECB looks set to maintain a low interest rate policy for the foreseeable term. This is to make it affordable for borrowers and give them confidence. To further encourage the banks to lend to individuals and businesses they took the unprecedented step of moving the overnight deposit rate to -0.10%. This is the rate the ECB pays for deposits taken from banks in the Eurozone to mind their money overnight. In effect, they are now charging the banks 0.10% for this facility!
- **Geopolitical risks:** the ongoing tensions between Russia and The Ukraine remain a concern for energy markets in Europe particularly. The oil situation in Iraq has also hit the headlines not to mention the technical default by Argentina on some of its debt obligations.

Over the course of the year Eurozone inflation continued its steady trend downwards reaching 0.4% in July. This is a far cry from the ECB's target of 2% and caused the ECB to cut rates twice in 2014 and openly deliberate quantitative easing (QE). It is partly because of the former, and in spite of the latter, that Eurozone yields have continued to fall over the last 12 months, as seen below.

Merrill Lynch Eurozone >5 yr Government Bond Index yield


Source: ILIM 6/9/2014

## Fixed Income Outlook

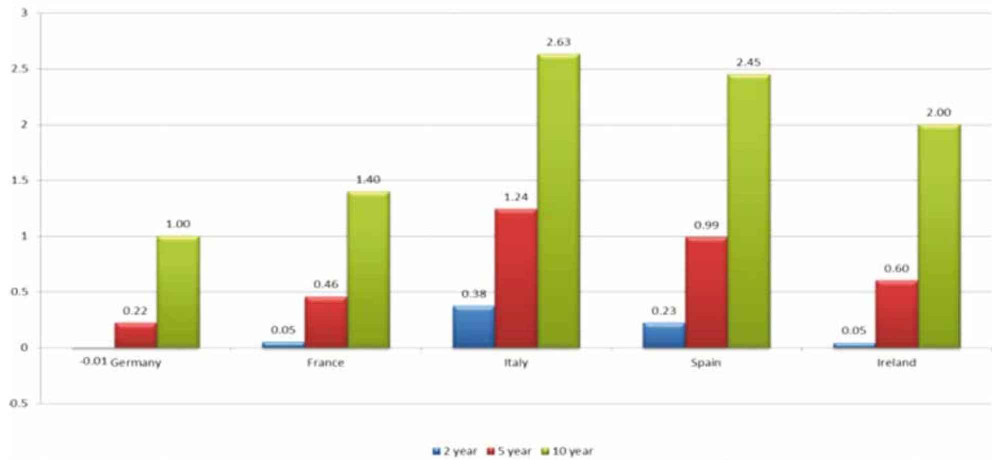
In Q3-2014 the Eurozone economies are suffering from a negative feedback loop from the Ukraine crisis. Given the importance of Russian gas supplies through the Ukraine, core Europe shows again its dependency on a stable and sustainable energy supply. With the possibility of a major disruption in the coming months, both corporates and consumers have started to retrench in Q2 bringing the Eurozone Q2 GDP growth down to 0%. This leaves the ECB with a significant conundrum in the face of low inflation and growth stagnation. The market currently would like to see the ECB engage in full blown quantitative easing, but the ECB is fully aware that factors outside its control may dampen any impact.

At the same time the US Federal Reserve continues to remain on hold for a prolonged period with its first rate hike not expected before Q3 2015. In the UK, there was speculation that a rate rise could happen in as early as Q4 2014, but that too has been pushed in 2015 with recent inflation readings weakening to well below 2%. Such a benign backdrop will keep Eurozone bond yields well supported in H2-2014 with core bond yields expected to remain near current low levels. As a result, the 10 year German benchmark bond yield is expected to remain in a subdued range of between 0.8% and 1.3% for the coming weeks.

## Eurozone Peripheral Bond Markets

Based on improved economic fundamentals, and upgrades by the rating agencies, all Eurozone peripheral countries have performed extremely well this year. The graph shows current yields for 2, 5 and 10 year bonds in the Eurozone:

Merrill Lynch Eurozone >5 yr Government Bond Index yield




Source: ILIM 6/9/2014

The peripheral rally would be further supported by the ECB if, as expected, the majority of the new TLTRO program finds its way into peripheral Government bonds. Should full blown quantitative easing by the ECB become a reality, the 10 year Italian and Spanish bonds could trade as low as 1% over Germany while the Irish 10yr government bond could reach as low as 0.60% over Germany by year end. To put that in perspective, in August 2013, that gap was 2.32%. As such, the continued reduction in peripheral bond yields could compensate for any upward movement in the core bonds for the remainder of the year.

**Max Plapp**
*Head of Bonds, ILIM*

# Index Performances and Market Data

| Equity Markets (%) | 2009 | 2010 | 2011 | 2012 | 2013 | YTD |
|---|---|---|---|---|---|---|
| ISEQ | 27 | -3 | 0.6 | 14.7 | 35.8 | 6.7 |
| FTSE 100 | 22.1 | 9.0 | -5.6 | 6.0 | 18.7 | 3.9 |
| Euro Stoxx 50 | 23.4 | -0.1 | -17.7 | 13.4 | 21.5 | 4.4 |
| S&P 500 | 23.5 | 12.8 | 0 | 12.4 | 32.4 | 9.9 |
| Nasdaq | 43.9 | 16.9 | -1.8 | 14.1 | 36.9 | 10.6 |
| Nikkei | 19 | -3 | -17.3 | 16.24 | 59.4 | 1.8 |
| MSCI Emerging Markets | 74.5 | 16.4 | -20.4 | 13.8 | -2.3 | 10.1 |
| MSCI World | 23 | 17.2 | -7.62 | 12.1 | 26.3 | 7.8 |

| Sovereign 10yr Bond Yields (%) | 2009 | 2010 | 2011 | 2012 | 2013 | YTD |
|---|---|---|---|---|---|---|
| US | 3.8 | 3.3 | 1.9 | 1.7 | 3.0 | 2.3 |
| German | 3.4 | 3 | 1.8 | 1.4 | 1.9 | 0.9 |
| UK | 4.0 | 3.4 | 2.0 | 1.9 | 3.0 | 2.3 |
| Japan | 1.3 | 1.1 | 1.0 | 0.7 | 0.7 | 0.5 |
| Ireland | 4.8 | 9.1 | 8.4 | 4.5 | 3.4 | 1.8 |
| Italy | 4.1 | 4.8 | 7.1 | 4.6 | 4.1 | 2.4 |
| Greece | 5.8 | 12.5 | 31.7 | 12.7 | 8.2 | 5.7 |
| Portugal | 4.1 | 6.6 | 13.4 | 6.9 | 6.1 | 3.2 |
| Spain | 4.0 | 5.5 | 5.1 | 5.4 | 4.1 | 2.2 |

| Central Bank Rates (%) | 2009 | 2010 | 2011 | 2012 | 2013 | YTD |
|---|---|---|---|---|---|---|
| ECB | 1 | 1 | 1 | 0.75 | 0.25 | 0.15 |
| Bank of England | 0.5 | 0.5 | 0.5 | 0.5 | 0.25 | 0.50 |
| US Federal Reserve | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |

| Foreign Exchange Rates | 2009 | 2010 | 2011 | 2012 | 2013 | YTD |
|---|---|---|---|---|---|---|
| Dollar/Euro ($/€) | 1.43 | 1.34 | 1.30 | 1.31 | 1.37 | 1.31 |
| Sterling/Euro (£/€) | 0.89 | 0.86 | 0.83 | 0.81 | 0.83 | 0.79 |
| Dollar/Sterling ($/£) | 1.61 | 1.56 | 1.55 | 1.61 | 1.65 | 1.66 |

| IPD All Property Return | 2009 | 2010 | 2011 | 2012 | 2013 | YTD |
|---|---|---|---|---|---|---|
| Ireland | -23.2 | -2.4 | -2.4 | 3.1 | End q1 | TBC |
| UK | 2.2 | 14.5 | 8.1 | 2.7 | End q1 | TBC |
| US | -18.7 | 14.8 | 14.5 | 5.3 | End q1 | TBC |

Source: Bloomberg

* Information correct as at 1/9/2014

** Equity market returns are total returns

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