Wealth Management Quarterly Report
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WEALTH MATTERS

Sentiment, fundamentals and expectations

Joe Prendergast, Global Strategic Advisor

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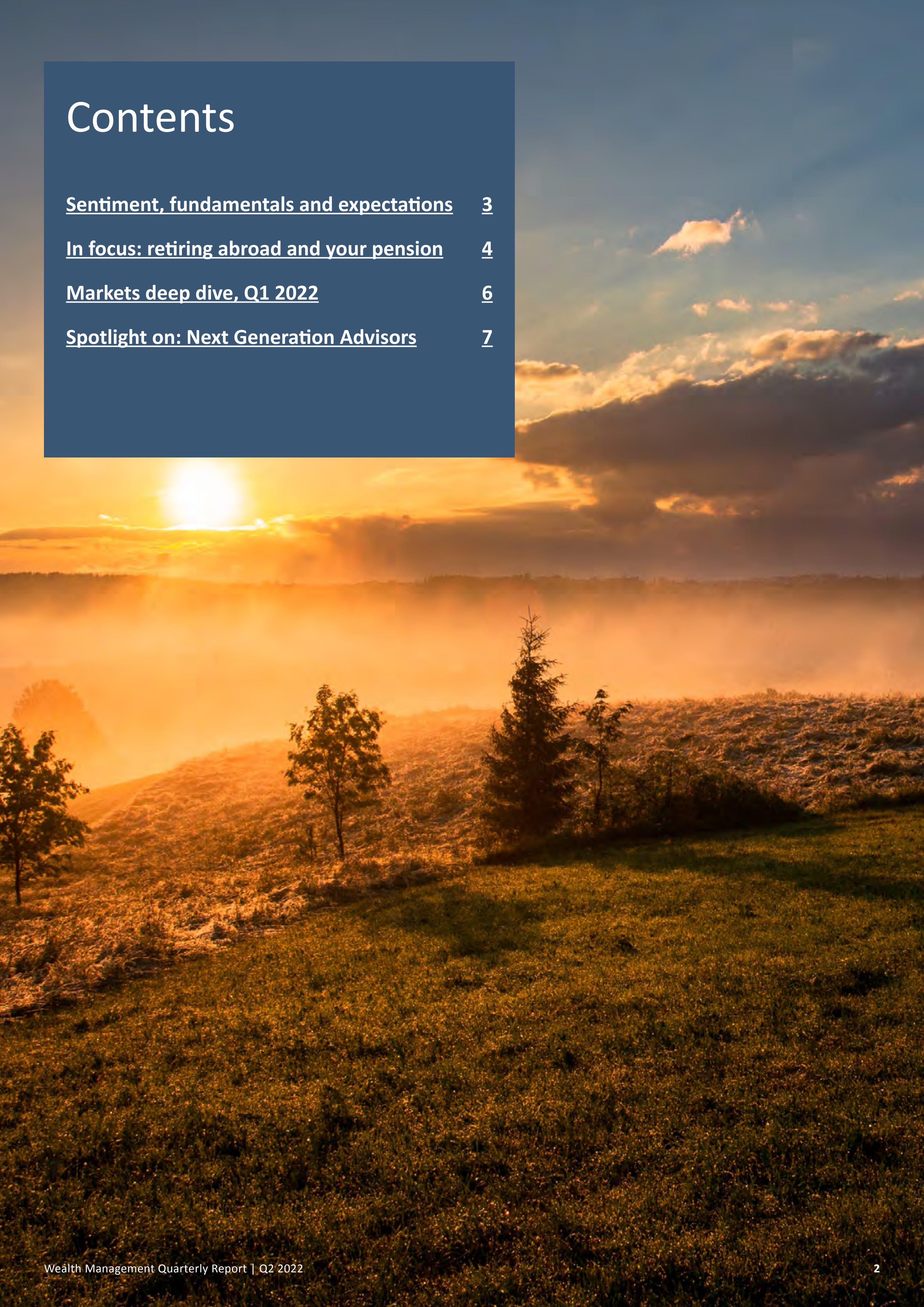

Sentiment, fundamentals and expectations

Joe Prendergast, Global Strategic Advisor

We've seen much turbulence in financial markets amid high inflation, interest rate concerns and the war in Ukraine. Equities have rebounded, supported by earnings fundamentals, but elevated valuations and higher bond yields suggest some rebalancing of equity weights in portfolios is now warranted.

On our most recent market update call, one participant asked if the equity market declines observed in February were not just driven by sentiment, rather than fundamentals? In the face of Russia's large-scale invasion of Ukraine, which will have major strategic implications for years to come, it is hard to see how this could be the case. Economic growth will surely slow, energy prices and inflation are elevated, and uncertainty is high. Yet, the market rebounded strongly into the end of the first quarter. The S&P500 index is down just 3.5% from its record high at year-end and has returned more than 6% since the date of the invasion. Euro area equities have not fared as well but still have retraced all losses made since the invasion began.

One fundamental factor underpinning this robustness is the ongoing upward trend in current and expected corporate earnings growth. In contrast to the devastation of Ukraine, equity analysts are not as yet projecting any serious dent in the global earnings outlook for large- and mid-sized corporates.

Secondly, while world economic growth is indeed likely to slow, led by Europe, we are coming from a position of above-trend growth, so this may not mean a recession. A slowdown without recession would be good news for the interest rate outlook, as well as for the sustainability of earnings and equity markets.

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This constructive fundamental scenario does however depend upon some moderation of inflation and most especially inflation expectations. Until very recently, long-term inflation expectations remained well anchored, with German 10-year inflation expectations (as measured by inflation-linked bonds) holding notably below the European Central Bank's (ECB's) target 2% rate. But in the first quarter of this year German inflation expectations have broken higher and now exceed 2.5%. This may not seem dramatic, but the ECB is well aware that controlling inflation expectations is critical at this stage, to avoid risk of a self-fulfilling inflationary spiral. We thus need to be braced for interest rate rises ahead, meaning potentially more market volatility ahead even as economic growth remains above trend in 2022.

> The rebound in equity markets in March may provide a favourable opportunity to rebalance portfolios – reducing equities while increasing bonds and even cash near term.

In this context, the instability in equity markets this year is more than just sentiment. Fundamentals in the form of earnings and growth are good, but they are at risk now of weakening while interest rates rise further. As our Chief Investment Officer Bernard Swords outlines on page six, bond markets already now reflect a significant amount of tightening ahead, so the rebound in equity markets in March may provide a favourable opportunity to rebalance portfolios – reducing equities while increasing bonds and even cash near term.

The most important things to watch in the second quarter will be energy prices and inflation expectations. A decline in both could boost bonds and equities, while a further, prolonged rise seems likely to hurt equities more than bonds. Investment Analyst Niamh O'Leary examines the risks from the inflation factor and its potential impact on bond markets and beyond on page seven.

We also take a look at options for overseas pensions in this edition of our quarterly. On the following page, Martin O'Hora, Director of Goodbody Pensioneer Trustees, explains some of the financial attractions of retirement in a sunnier climate, with Malta as a case study.

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IN FOCUS

Retiring abroad and your pension

Retiring abroad is becoming increasingly popular. A warmer climate, great cuisine and a change in lifestyle can be found in many expat locations, including Spain and Malta. However, in recent years, more and more people are retiring overseas for financial reasons. Here we explore the financial implications of doing so.

Martin O'Hora, Director, Goodbody Pensioneer Trustees

In recent years, there has been an increase in the number of foreign pension transfers. This has been driven by changes to the treatment of large pension funds, as well as a succession of harsh budgets since the financial crisis, which resulted in the introduction of the Universal Social Charge, the Pensions Levy, and reduced thresholds for maturing pension funds (see the timeline below).

Some pension advisers and tax consultants will tell you that you can move your pension fund to another EU member state under the freedom of movement, labour and capital regulations. However, at Goodbody, we generally recommend that you only consider moving your pension fund abroad if you intend to move overseas yourself.

If you decide to retire overseas and transfer your pension, Revenue requires you to sign a declaration that states:

- The transfer conforms to pension transfer regulations and Revenue transfer rules; and
- It is for "bona fide" reasons and not primarily for the purpose of circumventing pension tax legislation and Revenue pension rules and conditions.

Another important consideration is timing. If possible, you should move your pension fund before you retire and before you reach the €2m threshold. There are no provisions in legislation which allow an approved retirement fund to transfer abroad. It would be considered a once-off income drawdown by Revenue and taxed accordingly.

State pensions and defined benefit pensions cannot be transferred abroad. However, your tax liability will be determined by your residency, and you may be able to reclaim tax deducted if you are residing abroad. The people who can benefit most from this are those who have accumulated large pension funds in company pension schemes – these pension funds could potentially transfer and reap the rewards.

In our case study, we explore why Malta has become a popular destination for pension transfers.

Case study: retiring in Malta

With a warm climate, high standard of living, and affordable day-to-day costs, Malta is a prime destination for those who want to retire abroad – and in recent years, the country has become a popular destination for pension transfers.

Here's why. Most EU registered pension schemes can be transferred to a pension scheme in Malta. Interestingly, there is no residency requirement, and so, you can live wherever you wish – but not in Ireland.

In Malta, if you have a pension fund of €2m, your retirement lump sum could be as high as €600,000, whereas in Ireland it would be limited to €440,000.

From our clients' experiences, the retirement lump sum is not the main driver for retiring in Malta, but rather the €2m pensions cap is the main motivation for the move.

After all, a significant number of people are reaching the pensions cap in their 40s and 50s. They want to have the freedom to grow their funds for another 10 or 15 years before they retire. But under an Irish pension scheme, they will face an extra tax of 40% on the excess over the €2m. This is not the case in Malta where there is no limit or cap on the size of your pension fund.

What's more, there is no requirement to draw any income from the remaining fund in the Maltese pension scheme until you need to. Conversely, in Ireland, you must draw a minimum of 4% each year from 60 years onwards. That income is taxed under the PAYE system irrespective of your residency. Quite often, people would prefer not to draw this income as their retirement lump sum will often cover their living expenses for several years.

Goodbody has teamed up with a regulated international pensions firm to assist our clients if they decide to move and the pension fund can be managed here in Dublin. We also recommend clients obtain professional tax advice if they are considering moving abroad as legislation can change and you need to be aware of all of the implications of the move.

2009: Earnings limit for tax relief on pension contributions by an individual is reduced to €150,000.

2010: The maximum pension fund (Standard Fund Threshold) allowed by Revenue is reduced from €5m to €2.3m with the excess taxed at 40%.

2011: The Pensions Levy of 0.6% on all pre-retirement private pension funds is introduced for four years.

2011: The maximum tax-free lump sum payable from private pension funds is reduced from €575,000 to €200,000. The lump sum is taxed at 20% between €200,000 and €575,000.

2011: Earnings limit for tax relief on pension contributions by an individual is reduced to €115,000.

2011: PRSI and USC relief is removed for employee pension contributions.

2014: The maximum pension fund allowed by Revenue is further reduced from €2.3m to €2m.

2014: The Pensions Levy increases to 0.75% and is extended by one year at a reduced rate.

2016: Certain pension funds (vested PRSAs and Personal Pensions) cannot be accessed after age 75.

MARKETS DEEP DIVE

Q1 2022

Bernard Swords, Chief Investment Officer

A turbulent year so far

It has been a traumatic start to 2022 for financial markets with negative returns from both fixed income and equity markets. There have been two major causes of this turbulence. Firstly, there was a change in policy from central banks with the timing of interest rate increases being brought forward and the number being increased in the US and euro area. The second cause of the weakness is the tragedy that is the war in Ukraine. This has led to a further spike in energy prices and some other commodities. As a result, there have been cuts to forecast economic growth rates across all regions with Europe being the hardest hit.

Since the start of the year, there has been a significant rise in bond yields across the world. In the euro area the 10-year yield has risen 70bps to just over 0.5%. The change in central banks' policy has been the primary driver of this. Both in the euro area and the US curbing inflation has become the main priority of central banks as it has remained stubbornly high. The ECB has said that it could raise interest rates this year versus none expected at the start of year and the Federal Reserve is projecting seven rate hikes of 25bps this year as against three to four at the start of the year. Meanwhile, a more clouded outlook for economic growth has led to credit spreads widening.

> *Both in the euro area and the US curbing inflation has become the main priority of central banks as it has remained stubbornly high.*

Our fixed income strategy suffered from the widening in credit spreads due to our overweight position in corporate debt. However, this was more than compensated (relative to our benchmark) by our short duration and the higher running yields that corporate debt provides. Bond markets have moved a lot to price in the new environment and much of the pain is probably behind us. But we would still expect some increase in yields from here. Thus, being short duration still makes sense. Despite the cuts to economic forecasts global growth is expected to remain above trend so there is scope for credit spreads to decline and thus we would maintain our preference for corporate debt.

All eyes on energy markets in the short term

Equities have also weakened but performed better than fixed income in the first quarter, down just over 3% in euro terms. The pivot in central bank policy was not an easy event for equity markets either but they have the offset of the higher nominal growth feeding through into earnings growth. The recent leg up in energy prices is a concern as it reduces potential growth rates while increasing cost bases. In the short-term, it is developments in the energy markets that will determine the direction of equity markets as we try to assess the potential impact on economic growth.

The Commodity sectors (Energy and Materials) have been the best performing sectors in equity markets this year, with IT (high valuation) and Consumer Discretionary (impact of higher fuel and power bills on discretionary spending) sectors at the bottom. We have two main themes in our equity strategy, the reopening of economies from the Omicron variant, which left us over-weight Consumer Discretionary and the maturing of the economic cycle, which left us underweight the Commodity sectors. While both of these themes underperformed in the first quarter, we continue to believe that this is the best positioning for the remainder of this year. Commodity prices are elevated now, but high prices do lead to other supplies and reduce demand. It can take time, but it usually happens.

Reducing equity exposure

Equity markets fell dramatically post Russia's invasion of Ukraine but have rebounded strongly and now stand above where they were at the start of the invasion. In the meantime, central banks, in particular the Federal Reserve, have become more aggressive in their policy outlook with curbing inflation their primary focus. The world economy is still expected to deliver above trend growth, but the margin is getting finer. Earnings forecasts are still being upgraded but it is all coming from the Commodity sectors. Elsewhere, it is a mix of upgrades and downgrades. This is different to what we have experienced over the last 18 months and a feature we did not expect to see until the second half of this year. The euro area is the region where the growth outlook has become most vulnerable. It is now facing the costs of increased security and adjusting the basis of its energy supply. Consequently, we are reducing our exposure to the region and in particular cyclical exposure in the region. Fixed income markets have had a torrid time as the central banks changed to a more aggressive tack. However, they have moved to price in this new environment and there is scope for some positive returns now.

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SPOTLIGHT ON

Next Generation Advisors

Niamh O'Leary, Investment Analyst

Why is inflation surging?

World inflation rates have turned sharply upwards over the past year, with Irish inflation seeing its highest levels for more than two decades. There are a number of reasons for this surge in inflation, but the primary factors are:

- Increasing energy and commodity prices due to the Russia/Ukraine war.
- Supply/demand mismatch: geopolitical tensions have hampered the recovery in global supply chains post Covid-19 while aggregate global demand rebounded more quickly.
- Lingering effects on the labour market from the pandemic – lower labour force participation means fewer people for the same jobs. In the US, there are a record 1.7 posted job openings for each person who is looking for work.

What has happened historically to financial markets during inflationary periods?

Fixed income tends to be very challenged in the face of inflation. The purchasing power of the fixed cashflows you receive as well as the capital you will get back at maturity are eroded by inflation over the life of the bond. In addition, where inflation is deemed to be too high by central banks, monetary policy generally begins to tighten to combat this. Bond yields and prices are inversely related and so, the rising rates associated with the tightening cause bond prices to decline.

Over longer periods equities can provide a better hedge for inflation but in the short-term equity markets and inflation tend to be negatively correlated. Where there is moderate inflation and no extreme shock equity markets can benefit. This is especially true when it is demand pull inflation as this kind of inflation is generally associated with economic booms, and strong global growth – which is better for equities. Looking at history, it is generally when inflation rises above 4% for a sustained period that equities get into trouble. Where inflation is high and accelerating you see economies overheating, interest rates rising, and heightened uncertainty and volatility.

Should investors worry about inflation – and what are the implications for portfolios?

In short, yes, persistently high inflation would be a worry – but how it impacts portfolios may depend upon the type of inflation being experienced.

Inflation has remained higher than most market participants (including central banks) thought it would be six months ago. This has been largely supply driven and that is potentially more worrying than demand-driven inflation. Supply-driven cost inflation tends to be an issue for equity markets because rising input costs need to be either absorbed into lower profit margins or passed on to consumers. And if consumers are hit by increasing food and energy bills, you will also see some weakness in discretionary spending. Rising costs and shrinking demand ultimately hurt the bottom line for corporates – that's not a good environment for equities.

High and increasing inflation also tends to mean a more aggressive monetary policy from the US Federal Reserve (Fed) – this is where things can become very problematic for markets. The recent spike in energy prices has led to downgrades to global growth forecasts, though they are still above trend. The combination of a Fed aggressively tightening and global growth slowing has historically spelt recession. Should there be further forecast downgrades it would be a serious cause for concern.

How are we positioned in this environment?

We have recently reduced our equity exposure to a neutral level from overweight but we continue to favour high-quality structural growth companies. This is in line with our view that while global growth rates are slowing, they remain above trend.

Currently other traditional asset classes do not represent good relative value in our view. Fixed income markets are becoming more attractive but they are likely to continue to face volatility with rising yields in the near term. However, with cash still offering negative returns we have taken this opportunity to increase our allocation to high quality credit though we remain underweight the asset class.

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