Goodbody

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WEALTH MATTERS

Can the dollar stay strong?

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Contents

Can the dollar stay strong? 3

In focus: Long-term themes driving demand for global real estate 4

Markets deep dive, Q3 2022 6

Let's talk business exit planning 7

Can the dollar stay strong?

Joe Prendergast, Global Strategic Advisor

In the first three quarters of 2022, the dollar appreciated by almost 14% against the euro. As we approach year-end, the outlook for the US dollar is a critical variable. Will it stay strong?

The US dollar has been one of the few bright spots for the euro-based global investor in 2022. From the first of January to the end of the third quarter, the dollar appreciated by nearly 14% versus the euro. Only the year 2000 has seen a weaker performance in the first three quarters of any year since the euro's inception.

Without the dollar's rise things would have been even worse in 2022 for the euro-based investor. For example, the dollar has contributed a near 4% cushion for total portfolio returns for an investor following our moderate risk asset allocation, comprising 50% global equities and 50% euro-denominated fixed income. The outlook for the dollar is thus a critical variable for the remainder of the year.

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Will the dollar stay strong? This is a far from trivial question as the drivers of currency performance are not well identified. To be sure, the dollar's real effective exchange rate index (a measure of its broad strength in inflation-adjusted terms) is already near its previous peak level from 2002. This high valuation raises concern but is not by itself a trigger for imminent reversal.

Interest rate differentials are also widely cited as a driving force, but the relationship here is not stable. The Federal Reserve's last round of rate hikes that initiated in December 2015 coincided more with dollar weakness than strength. The tightening in 2022 has been quite the opposite, so far.

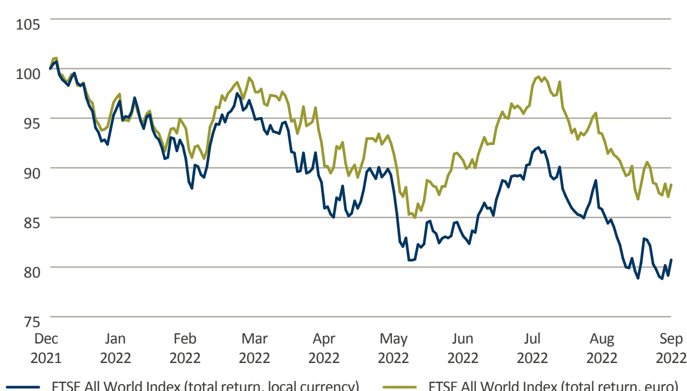
> *Investors should however anticipate some potential interruption to dollar strength in December – typically the weakest month of the year for the dollar.*

A more compelling driving force may be the cycle in the world economy, with slowing global growth generally driving dollar appreciation – no matter which way relative interest rates are headed at the time. If history is a guide, the current rise of global recession risks suggests the dollar could stay strong for a little longer.

Investors should however anticipate some potential interruption to dollar strength in December – typically the weakest month of the year for the dollar. Not since 2016 has the dollar risen in the month of December, with an average fall of 1.4% versus the euro since the single currency's inception.

To the degree that investor perceptions of US interest rates are helping the dollar at this time, the potential peaking of inflation and interest rate expectations in the fourth quarter – highlighted by our Chief Investment Officer Bernard Swords in the markets' deep dive on page six – could coincide with at least a temporary dollar peak into December. If so, any seasonal decline in the dollar may be accompanied by a year-end rally in both bond and equity markets.

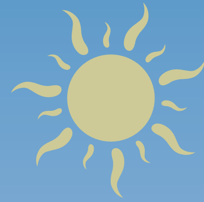
Figure 1. World equities 2022 – in euro and local currency terms



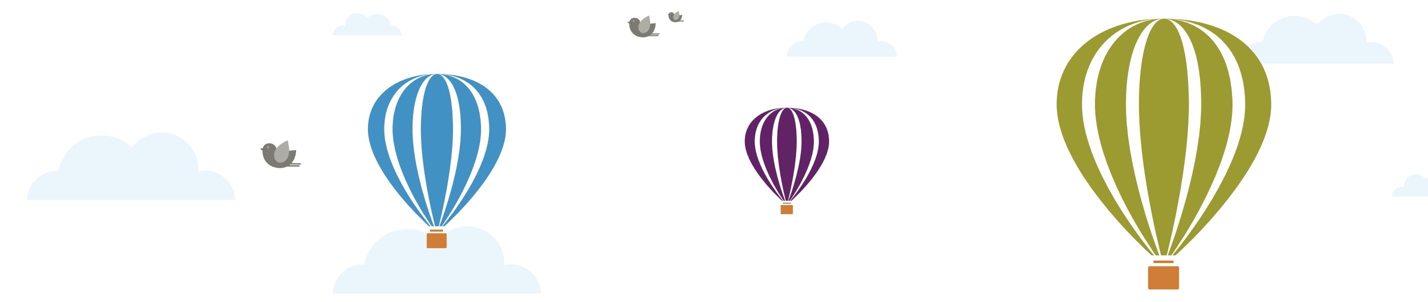
Source: Bloomberg Finance LP, FTSE.

IN FOCUS

Long-term themes driving demand for global real estate



At the Goodbody Investor Summit 2022 recently, we discussed the important role that global real estate can play in a mixed asset portfolio and the opportunity it offers investors to participate in long-term themes. Here we explore the long-term structural demographic drivers impacting the real assets investment landscape.



Investors tend to like property because it's tangible and easy to understand compared to other asset classes. And while investors have traditionally invested in real estate domestically, in recent years there's been a significant increase in the appetite for global real estate to complement domestic allocations.

With a global investable universe of $37 trillion, the global real estate market opens up access to many opportunities to participate in long-term trends; offers diversification benefits; and can generate enhanced returns for investors. In addition, the asset class seeks to deliver high income growth potential and good inflation protection.

Although there are headwinds globally, the outlook for global real estate remains firm, particularly from an inflation protection standpoint. There are a number of sectors within property markets that have strong rental growth: logistics, residential assets and healthcare real estate all have very strong supply and demand imbalances that are driving rental growth, which in turn is matching or protecting against inflationary pressures. And that inflationary protection of real estate will hold up for the long term.

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Long-term structural demographic drivers

Within the global real estate markets, there are three key sectors or themes that have long-term structural demographic drivers:

1. Logistics

Before the pandemic, ecommerce penetration rates were growing consistently globally, but Covid-19 accelerated that growth. Today, ecommerce activity rates remain on an upward trajectory – and that is a long-term trend.

In addition, there has been a reconfiguration of supply chains across the world owing to the pandemic and geopolitical tensions. Companies now want more options in terms of where their goods come from, and they want to hold more inventory closer to their end destination. This results in increased demand for well-located logistics real estate. So, this sector should continue to deliver strong rental growth – and although valuations have increased in the sector, the supply of good-quality logistics is limited.

2. Residential real estate

The living sector – or residential real estate – is considered a defensive asset class and it allows investors to access rental growth. Today, rental demand is increasing owing to record prices which makes home ownership challenging. There is also a lack of good quality affordable housing in major cities around the world.

Residential real estate spans multifamily real estate, such as apartments, single family real estate, such as single houses, as well as student accommodation and senior living. All of these segments have strong demographic drivers which is an attractive dynamic.

3. Healthcare real estate

Healthcare real estate comprises medical offices, particularly in the US, as well as life sciences and research hubs.

Rising life expectancy has affected the pace of populations aging – and as populations age, they spend more money on healthcare as a proportion of their GDP. As a result, healthcare-related assets are – and will be – in demand in terms of occupier fundamentals.

Q3 2022

Bernard Swords, Chief Investment Officer

Contrary to our expectations the third quarter was another down one for asset markets. The causes were the same as in the second quarter, inflation failing to subside leading to further increases in interest rate expectations. Much of the pain was inflicted in the last month following a strong CPI release in the US which showed an increase in inflation after several months of modest declines. Dislocation in the UK gilt market at the end of the quarter added further tensions to already stressed financial markets.

The outlook for economic growth deteriorated again during the quarter with forecasts for the developed world reduced. Global growth is expected to be below 3% for both this year and next which is below trend. Higher energy prices weighing on consumption and the impact of the tighter financial conditions have been the primary drivers of the downgrades. There are fears of a global recession and the probability is now about 50% and rising.

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Another ramp up in interest rate expectations

Central banks remain in an aggressive mode, and there was a significant increase in interest rate expectations during the quarter. Last June, the European Central Bank (ECB) was forecast to move the policy rate up to 2.0% in 2023 – that has now been increased to 3.0%. In the US, the Federal Reserve was expected to move rates up to 3.5% in 2023 – that has been raised to 4.65%.

Increasing our fixed income exposure

The fixed income markets bore the brunt of the change in the interest rate outlook. The broad euro area bond index delivered -4.6% in the quarter as higher interest rates got priced into the market. We increased our exposure to fixed income as the rising yields allow us to build in higher returns in our portfolios. Our strategy of keeping duration short remained a positive during the quarter and, as a result, our fixed income exposure did deliver better than index returns.

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Figure 2. Another leg up

Source: Bloomberg

Equity markets followed the bond markets. In local currency terms, world equities were down 4.8% but due to weakness in the euro this translated into a return of -0.6%. A stabilisation in bond yields would help equity markets from here. We are approaching the third quarter results season now. There have been some downgrades, but they remain quite modest. Despite this, sentiment around earnings is very low, so a reasonable results season should give a lift to equity markets. We have altered our sector mix downgrading our exposure to Consumer Discretionary as the growth outlook deteriorated. Our main over-weights remain defensive growth with high exposure to Healthcare and Consumer Staples.

We thought the third quarter would be better for markets, but many of the factors that we believed would aid asset markets we view as delayed rather than derailed. There are signs of easing inflationary pressures (lower transport costs, big drops in some commodity prices and a large drop in supply times). If the forecasts for economic activity in the US are correct, then we should be getting some softer data. This would ease interest rate expectations and boost both bonds and equities.

Let's talk business exit planning

In conversation with Ronan Sherlock, Senior Wealth Executive – Team Lead

Let's start with the basics, what is an exit plan?

Every successful business owner starts with a business plan to scale their business. This plan is critical to not only grow their business, but also enhancing their personal financial position. It is common to focus solely on the daily operation and growth of their business, while delaying efficient financial planning to a later point. However, when the business begins to generate surplus cashflow, the development of a strategic exit plan becomes very important to efficiently maximise their personal wealth from the company throughout the lifecycle of the business. An agile plan will address everything from the timeframe you could expect to exit and what tax and pension planning framework you need to establish to execute your plan.

When should a business owner start exit planning?

Every business runs through a particular life cycle from start up, growth, maturity to succession, each taking their very own unique path. When a business becomes profitable and begins to develop affordability to plan for wealth extraction, commencing exit planning discussions is essential at this point. Whether the planning is taking place for an eventual sale, retirement, or both, starting early allows greater scope for the business owner to efficiently exit their business in a stronger financial position. Put simply, the earlier our clients start planning, the better the financial outcome is for them.

How important is it for businesses to focus on managing their personal wealth as their business creates it?

Growing a profitable business will always be the key focus for business owners. It is very common for business owners to delay taking income in the earlier stages as they reinvest all profits to maximise business growth. This can lead to owners accumulating high cash reserves or assets within their business with the intention of dealing with them all together at a later stage. However, from a financial planning perspective, not taking an income throughout the lifecycle of the business will reduce their options to fund a company pension for those years. Revenue and profits will fluctuate from year to year, and as such, it is important to ensure an appropriate level of income extraction is planned for each year.

> *Every business runs through a particular life cycle from start up, growth, maturity to succession, each taking their very own unique path.*

Why are owners often unprepared for an exit?

Many owners do not see a business exit strategy/financial planning as a priority if their perceived time horizon is beyond five years. They are naturally busy seeking to grow and maximise revenue in the short term. While many think they can accurately forecast when they will seek to sell or exit their business, from our experience such sales or acquisitions can present themselves very quickly. This leaves those in ownership with a limited window upon which to plan the most tax efficient exit they can. Our professional recommendation remains to take the time annually to sit with your advisers and ensure you remain on track to meet set milestones, while maintaining optionality with your business exit plan from a time and financial perspective.

What tips would you give business owners when it comes to exit planning?

Getting professional advice early and often is extremely important for all business owners seeking to extract wealth from their business at all stages in its trading. Typically, those who take a balanced approach early in the accumulation phase between reinvesting profits, taking income and effective financial planning for retirement/exit are best placed for an exit. Strong advice will demonstrate clear projections for the business owner and help them maximise reliefs and pension funding as they approach an exit.

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