Goodbody

Wealth Management Quarterly Report
Q1 2023

WEALTH MATTERS

WHAT TO DO IN A STICKY SITUATION?

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What to do in a sticky situation?

Joe Prendergast, Global Strategic Advisor

Welcome to the Q1 2023 edition of Wealth Matters. This quarter we are focusing on recent changes to the treatment of employer pension contributions into a PRSA and our view on inflation in 2023.

Our Economist Shaun McDonnell has taken a timely and detailed look at the likely course of inflation in coming months and years. While inflation is currently falling back from its 2022 peak, Shaun warns us on page 9 that any easing of underlying inflation back to central bank targets may take longer than currently expected by markets.

Consequently, central banks are likely to keep interest rates at higher levels for longer. This sticky scenario poses a difficult backdrop for financial markets, as higher than expected inflation and interest rates usually mean poor rewards for risk assets (all else equal).

> *Investors need to consider this outlook carefully, as it has meaningful impact for strategy. Inflation is a well-known destroyer of the purchasing power of cash.*

Inflation is thus often a motivation for investors seeking real returns (ie. a total return that beats inflation). Among the major asset classes, equity markets have returned by far the largest real returns in the long-run but can be highly volatile in the short and medium-term.

Moreover, stocks tend to be particularly volatile when inflation is high. Bonds, which typically lock in a fixed interest rate for a medium to long-term horizon, can also be notably vulnerable at such times, at least until yields have reset high enough to offset likely future inflation.

So, what to do? This depends in part on the objective and time horizon of the investor. Firstly, as 2022 demonstrated, cash can act as a relatively safe asset in the short-term even when its value is being eroded by inflation, because stocks and bonds can fare badly during times of elevated inflation. No (or even a small negative) return is better than a sharp drawdown in capital value. In fact, for a risk averse investor who targets matching inflation only, without any additional real return, holding Treasury bills (short-dated government paper which tracks central bank interest rates) has proven to be an effective strategy in the short to medium-term. Over longer-term history, however, almost any other diversified strategy (in stocks or bonds) ultimately beats cash or Treasury bills.

If inflation proves sticky and central banks keep interest rates higher for longer, as Shaun McDonnell fears, investors can benefit from the short to medium term preservation aspect of cash and the long-term real return potential of equities by holding a clear preference for short-maturity high grade government and corporate bonds on the one hand and a moderate amount of defensive equity on the other. While short-maturity bonds are more volatile than cash and are not considered a cash substitute due to their higher-than-cash volatility, they are relatively safe assets on the broader risk spectrum.

> *High grade government bills and bonds, like German and Irish, are indeed among the safest assets available in terms of credit risk but they still offer significantly positive yields.*

Corporate investment grade bonds have generally higher risk than governments, but also additional yield, even at short maturities. Equities meanwhile are not a good inflation hedge in the short-term, but they have the strongest and most consistent real return in the long-term. Beneath broad asset allocation, equity sector selection may add inflation hedging potential via tilts in favour of sectors with pricing power, and away from structurally or cyclically challenged sectors. Today, more defensive sectors such as healthcare and consumer staples are seen as most attractive in this regard.

> *Overall, as Goodbody Economist Shaun McDonnell reminds us on page 9, staying cautious on equities and preferring fixed income makes sense, as sticky core inflation limits the potential for financial markets to benefit from falling headline inflation.*

Finance Act 2022 - New Opportunities for Business Owners

Changes introduced in the Finance Act 2022 have opened up a significant opportunity for an employer to be able to make pension contributions on behalf of an employee or director (see below). Our pensions and technical experts are very happy to help you set up a new PRSA and navigate how to best capture opportunities arising from these changes.

Speed read

Effective from 1 January 2023, Finance Act 2022 abolished the Benefit-in-kind charge for employer contributions to employee PRSAs and the treatment of employer PRSA contributions as an employee contribution.

Notably, it does not apply any of the limits that apply to employer contributions to occupational pensions which restrict the level of employer funding such that it is reasonable in terms of salary, length of service and by reference to existing pension arrangements and scheme funding levels. This difference can be illustrated by way of the following example.

Example:

- **Owner / Director aged 55**
- **Current salary €40,000**
- **Past service of 10 years**
- **Planned retirement at age 60**
- **The business has substantial profits and large cash deposits**

	Company Pension Scheme	Personal Retirement Savings Account (PRSA)
Maximum tax allowable employer pension contribution in 2023	A tax allowable pension contribution of up to €288,000 could be made by the employer for the employee/director.	A tax allowable PRSA payment of any figure up to **€2,000,000** could be made by the employer for the employee / director.
Further pension payments	Additional payments up to €576,000 could be made by the employer but tax relief would be spread over the following 5 years.	If the full **€2,000,000** is not paid in 2023, the shortfall could be paid at any point over the following 5 years and qualify for tax relief in the year of payment.

Background

Prior to 1 January 2023, an employer contribution paid to a PRSA for an employee was a Benefit-in-kind (BIK) event for income tax purposes and treated as if it was a personal PRSA contribution by the employee. As such, tax relief was limited by certain age-related factors and an earnings limit of €115,000 p.a. This is no longer the case, and these employer payments are now exempt from a BIK charge and are not treated as personal contributions.

What does this mean for a business owner who either wants to boost his or her existing pension fund or is considering pension funding for the first time?

Business owners can now make unlimited PRSA contributions on behalf of an employee or a director of the business, including themselves, if at the time of the payment they are in receipt of Schedule E income. The maximum tax-efficient pension fund is €2,000,000 per person and this will act as a limit of sorts.

These PRSA contributions will be exempt from a BIK income tax charge and will be fully allowable as an expense of the employer in the year in which the contribution is made. This differs greatly to the treatment afforded to employer contributions into a traditional pension scheme, where there are restrictive limits and often a need to spread tax-relief over a number of years.

Is it possible for an individual to make personal payments into the same PRSA and qualify for income tax-relief?

The short answer is yes. The level of PRSA contribution paid by an employer will not prevent an employee or director from making personal contributions. The table in the next column sets out the maximum personal contributions allowable.

Age Attained in Tax Year	Maximum Personal Contributions
Under 30	15% of Salary*
30 - 39	20% of Salary*
40 – 49	25% of Salary*
50 – 54	30% of Salary*
55 – 59	35% of Salary*
60 and over	40% of Salary*

**Max salary on which relief is allowed is €115,000*

Can salary be sacrificed for an employer PRSA contribution and is there a minimum period of service required?

There have been no changes to existing salary sacrifice legislation and if the employer PRSA contribution is funded by a corresponding reduction in the employee's or director's contractual remuneration then a BIK charge will arise equal to the level of remuneration forgone. It is our view that to avail of the enhanced funding opportunity for PRSAs, a genuine employment should exist, with a contract of employment, defined duties and an appropriate salary.

In summary, we would recommend that you contact us to learn more about this PRSA opportunity. While the absence of employer funding limits for PRSAs is great news, given the other potential restrictions that apply such as the €2,000,000 limit and salary sacrifice rules, it would be important to seek advice from the Goodbody Pensions Team.

Before 2023

Before 1 January 2023 an employer contribution paid to a PRSA for an employee was a Benefit-in-kind (BIK) for income tax purposes and treated as if it was a personal PRSA contribution by the employee. As such, tax relief was limited by certain age-related factors and an earnings limit of €115,000 p.a. Prior to 1 January 2023, pension schemes rather than PRSAs were used for pension funding as outlined below.

2013

Johnny starts a business at age 45. He pays himself a salary of €40,000 pa but there are no cash reserves in the company early on and hence no pension contributions are made for him by the company.

2023

By now, Johnny is age 55 and his business is profitable, and he is keen to catch up, so the company makes a contribution to his pension fund for 2023. This is calculated by reference to his salary and years of service, so the max contribution is €288,000 for 2023.

2023-2028

Johnny's Pension

Additional payments up to €576,000 related to the unfunded 10 years' service between 2013-2023 could be made by the company but tax relief would be spread over the following 5 years.

Johnny's Spouse

Johnny's wife, Mary is age 53 and has worked in the business for 6 years with a salary of €20,000 pa. She also wants to catch up on pension funding. The company can make a contribution of €100,000 for her in 2023. This is calculated by reference to salary and years of service. In addition, the company can make a further contribution for her of €50,000 a year for years 2 to 7.

Key staff

A similar exercise could be undertaken for key executives who helped Johnny build the business.

At Retirement

2028	Johnny's pension pot Mary's pension pot	**€864,000** **€400,000**

Note: This example is presented to illustrate the Finance Act 2022 change and it does not constitute investment or tax advice. Given the potential restrictions that apply such as the €2,000,000 Standard Fund Threshold and salary sacrifice rules, it is important to seek advice. Above example does not take account of any potential investment growth.

In 2023: After Finance Act 2022

Effective from 1 January 2023, the Finance Act 2022 introduced some important changes to the treatment of employer pension contributions into a PRSA. Employer payments are now exempt from a BIK charge and are not treated as personal pension contributions. In addition, none of the funding limits outlined opposite apply other than the €2,000,000 threshold.

2013

Johnny starts a business at age 45. He pays himself a salary of €40,000 pa but there are no cash reserves in the company early on and hence no pension contributions are made for him by the company.

2023

Johnny's Pension

By now, Johnny is age 55 and his business is profitable, and he is keen to catch up so the company makes a contribution to his pension fund for 2023. Johnny's employer can now make a contribution of €2,000,000.

Johnny's Spouse

Johnny's wife, Mary is age 53 and has worked in the business for 6 years with a salary of €20,000. She also wants to catch up on funding her pension. The company can make a contribution of €2,000,000 for her in 2023.

Key staff

A similar exercise could be undertaken for key executives who helped Johnny build the business.

2023-2028

If the full €2,000,000 is not paid in 2023, the shortfall could be paid at any point over the following 5 years and qualify for tax relief in the year of payment.

At Retirement

2028 Johnny's pension pot
Mary's pension pot

€2m each

Note: This example is presented to illustrate the Finance Act 2022 change and it does not constitute investment or tax advice. Given the potential restrictions that apply such as the €2,000,000 Standard Fund Threshold and salary sacrifice rules, it is important to seek advice. Above example does not take account of any potential investment growth.

MARKETS DEEP DIVE

On Inflation

Bernard Swords, Chief Investment Officer

For the past year and a half inflation has been a major topic of conversation and concern. Soaring headline inflation was having a significant impact on the real purchasing power of people. Inflation of any level was being viewed as the great 'bogey man'. But we forget that central banks spent most of the 2010's trying to avoid deflation. That period of very low inflation left us with negative interest rates and negative bond yields, not a nice situation for savers trying to build up a 'pot' for future purchases or execute a pension plan. So, the return of some level of inflation is not bad news, in fact in some ways it should be welcomed.

Demand Outweighing Supply

In 2022 we had a rapid acceleration in inflation, but we had an unusual confluence of events that led to this. The Covid-19 pandemic led to a supply shock across all goods production and supply infrastructure while the massive fiscal response meant aggregate demand was supported. If supply is down and slow moving and demand remains unchanged, prices go up at an unusually rapid rate. Then we had the Russian invasion of the Ukraine which delivered an energy and food price shock pushing up headline inflation but also adding to the cost push pressures in core inflation.

Back to the Future - 1985

These influences are now going into reverse. The EU started keeping records in 1985. In Q3 2021, the EU Commission Index of Finished Product Inventory hit an all-time low and the Manufacturing Industry Order Book Index hit an all-time high. Therefore, the Manufacturing sector was seeing record levels of orders at a time when it was running with the lowest level of inventory of the past forty years. That is a recipe for spiking goods price inflation. There has now been a significant turnaround in these indices. The Inventory Index is now back to average levels seen over the last forty years. The New Order Index has further to go to get us back to average but with the European Central Bank (ECB) beginning to ratchet up interest rates we should see some softening in demand which would bring that New Order Index down further. Therefore, as we travel through 2023, we should see supply and demand normalise, which in theory will result in lower goods inflation than we experienced in 2022.

Commodity prices were also a driver of the high inflation that we experienced in 2022 and these are behaving better in 2023. In 2021 the Brent oil price averaged just under $50, in 2022 this jumped 78% to average just under $90. This was a major element of the spike in headline inflation last year. Food prices also contributed to the inflation pressure. The average level of the IMF Commodity Food Index was 15% higher in 2022 than it was in 2021.

These commodities are behaving much better in 2023. The average Brent oil price so far in 2023 is down 5%, a big reversal from +78% in 2022. The food price index is also down 5% so far in 2023 against the average level in 2022 and 15% down from its peak level. So far this year, the influence of commodity prices turned from inflationary to deflationary and this will bring down headline inflation and reduce the cost push pressures in core inflation.

> *The one concern is how will wage inflation react. According to the European Central Bank, wage inflation in the euro area is expected to run between 4% and 5% in 2023 which could limit how low inflation can go.*

However, this is driven by inflation in 2022 (annual core inflation averaged 4% during 2022 ending the year at 5.2%) so declines here could reduce this pressure as we travel through 2023.

Financial markets are probably expecting euro area core inflation to average between 2% and 3% over the next 5 years. If it proves stickier then the ECB will have to become more restrictive in its policy. Fixed income markets may look through this as a means to get inflation into that target range. This would mean interest rates higher for longer than is currently expected so keeping duration short would provide the best protection. Equities will have more difficulty with this as it will have to come at the cost of lower economic growth and hence profit growth. Consequently, we prefer fixed income assets at the moment.

> *We do believe that inflation will be trending down from here, but we do not think it will reach the levels that we experienced prior to the pandemic. Nor would we like to see that emerge again. From 2000 to 2020 core inflation averaged 1.3% in the euro area and this left us with negative interest rates and negative bond yields, a phenomenon we would not welcome again.*

ARTICLE ON INFLATION

A "sticky" battle ahead

In conversation with Shaun McDonnell, Economist

Inflation has been embedded in the economic system for some time now.

Inflation continues to be the single biggest challenge facing the global economy in 2023. The onset of inflation pressures towards the end of 2021 was driven by a combination of demand-side factors, as households exited lockdowns with substantial savings and a pent-up desire to spend, and blockades to supply, which was shortly followed by the war in Ukraine. The war sparked a global energy and food security crisis that saw the price of energy and food commodities surge. The importance of energy and food as inputs to a plethora of businesses saw management teams pass pricing on to the consumer, doubling down on inflation that had already crept its way into the economic system. This led to a more widespread inflation pressure that was occurring in most sectors of the economy. It was not long before inflation had gotten out of control and was well above the 2% target rate set by central banks.

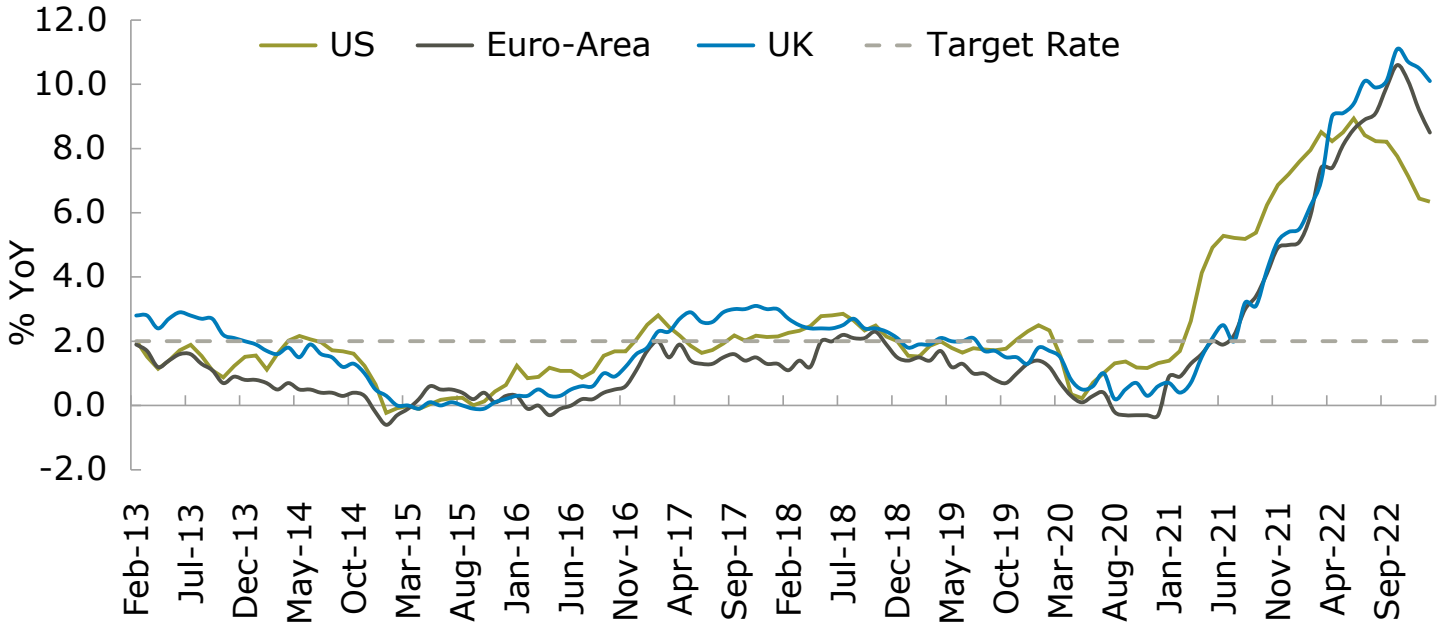
> *The war sparked a global energy and food security crisis that saw the price of energy and food commodities surge.*

This alarmed policymakers, who following concession at the end of 2021 that inflation was indeed persistent and no longer considered transitory, began to respond in the only way they could, by tightening monetary policy. This commenced the period of rising interest rates and the reduction of central bank balance sheets via the sale of government debt. But, the beginning of the rate hiking cycle occurred too late. It was not long before inflation reached double-digits (see Chart 1 below). This occurred even as interest rates were on the rise (monetary policy feeds through to households, businesses, governments, and thus, the economy with a lag effect). At this point, forecasters expected all three of these economies to enter recession in 2023 as higher living costs driven by surging energy bills, and higher lending rates, clamped down on household, business, and government budgets.

Recent data has offered up somewhat of a reality check for markets...

Fast forward to the beginning of 2023, and while inflation, interest rates, and recession unequivocally continue to dominate the minds of investors, things are not as bad as they seemed as recently as three months ago. Firstly, it appears to us that inflation has peaked in developed economies leaving the headline rates in the US (6.2%), the Euro area (8.5%) and the UK (10.1%) trending downwards. The recent downward move in inflation saw markets shift their expectations of where interest rates will peak (the terminal rate), ultimately suggesting that central banks would be finished with rate hikes in early 2023 (see Chart 2 next page) and would be beginning the journey of cutting interest rates by year-end in the US and in early 2024 in both the UK and Euro-area, who are at an earlier stage in the economic cycle.

Chart 1. US, Euro-Area, and UK Inflation Rates (%)



Source: Goodbody, Factset, ONS, BLS, Eurostat

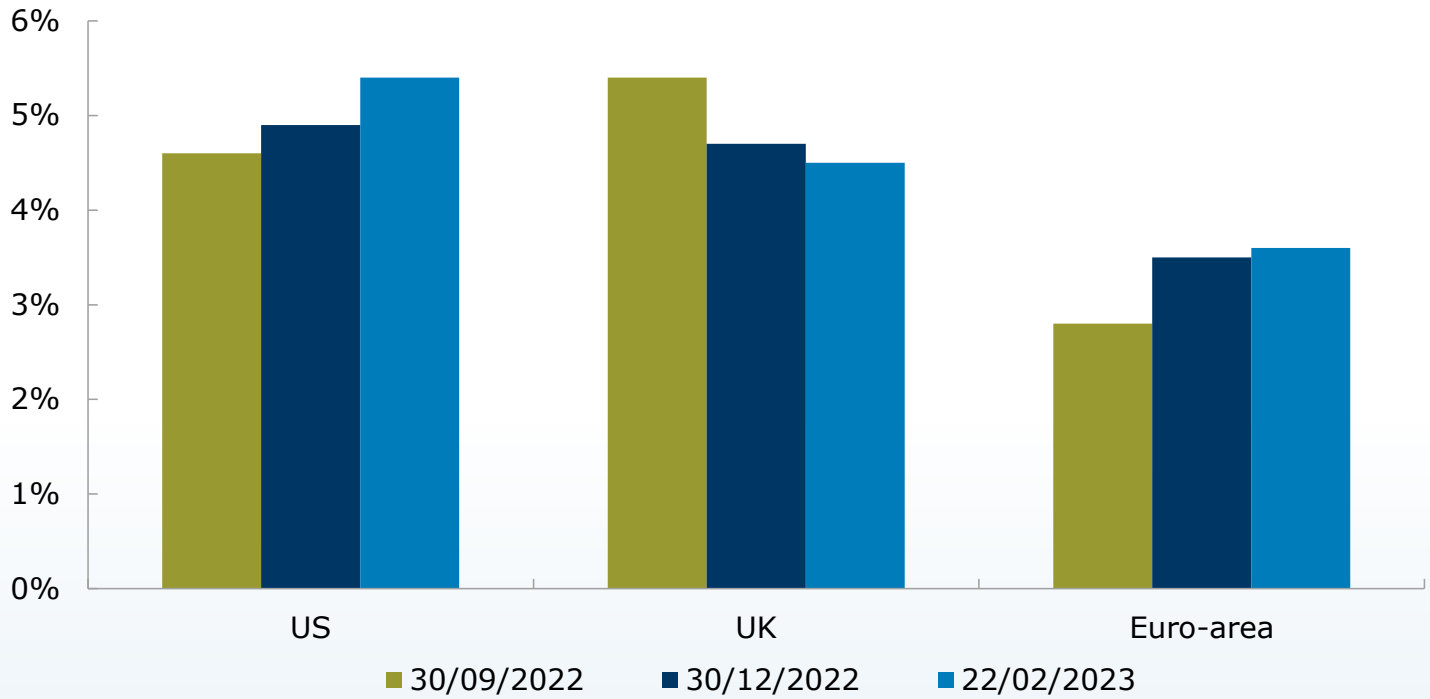
Since then, though, economic data has remained resilient. Labour markets remain tight, with unemployment rates at multi-decade lows. PMIs suggest that private sector output is growing at a better-than-expected pace and consumer spending data (i.e. retail sales and card spending) are all showing healthy readings. Most importantly though, there has been recent upside surprises in US producer price inflation data, upward revisions to CPI figures, and the uptick in inflation expectations on the back of, in our view, a realisation by the market that it is not a foregone conclusion that inflation will simply drift back to 2% in an orderly fashion.

This has led to a move up and out in interest rate expectations. We concur that rates will go higher (i.e. a higher terminal rate) and remain there for longer (i.e. cuts do not occur until later in the cycle) in both the US and the Euro-area. In the UK however, recession expectations and the tumultuous mini-Budget period that saw a spike in rate expectations have both led to a decline in terminal rate expectations. At present, the market expects rate cuts to begin in early 2024 in all three major developed economies. We believe that expectations for rate cuts as soon as in twelve months' time are too optimistic, and there is thus more re-pricing to come on that front.

...that the battle is far from over, and economies could be in a "sticky" situation for a prolonged period

Inflation at a headline level will continue to pare back steadily throughout 2023, but it's not as straightforward as that. There are underlying inflation pressures that tend to stick more than those driven by energy and food. These sticky inflation pressures are represented in core inflation (excluding food and energy), which is driven primarily by the services sector, a sector in which inflation is more concerning due to its labour-intensity, resulting in wage growth pressures, that tend to persist for longer as households base wage expectations on current and expected inflation. While headline inflation in developed economies continues to pull back, core inflation has not budged near as much from peak levels. In the US core inflation is at 5.5% as of January, down from 6.6% in September. In the Euro-area, core inflation is at 7.3% as of January, up from 6.3% in September, and in the UK, core inflation is at 5.8% in January, down from 6.5% in September. Core pressures are due to labour markets that remain tight and are supportive of larger wage increases. It is these components of inflation that central banks will need to see reduce meaningfully before they can decide to begin the journey downward on interest rates. As a result, we expect an easing in inflation to take longer than currently expected by markets, and indeed, central banks, to fall below target, rendering higher interest rates a more permanent theme in the economy moving forward. It is our view that interest rate cuts will not begin until late 2024 at the earliest. Anything sooner than that would require economies to be faced with a deep recession.

Chart 2. Market-Implied Peak in Interests Rate (%)



Source: Goodbody, Factset, ONS, BLS, Eurostat

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