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December 2021
Quarter in review

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MARKETS END 2021 NEAR RECORD HIGHS – BUT RISKS REMAIN

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Global equities recovered from the drawdown experienced late in the third quarter to end the year near record highs. Equities were supported by an improvement in the economic backdrop and a strong earnings reporting season for global corporates, which resulted in further upgrades to earnings estimates. Concerns eased around possible contagion from the Chinese property market, which further contributed to the rebound. Markets remained volatile, however, with fears relating to the highly contagious Covid-19 variant, Omicron, contributing to a minor correction in late November; these fears eased through December. More hawkish central banks gave rise to some uncertainty as policy accommodation began to be reduced in response to continued high inflation readings. However, signs that global supply constraints may be fading and a belief that inflation pressures are close to a peak helped limit the negative impact from tighter monetary policy stances. Political uncertainties relating to President Biden's failed infrastructure proposals in the US and rising Russian/Ukrainian tensions also caused some anxiety for investors.

Omicron less severe than expected

While being highly contagious, initial reports are suggesting the Omicron variant is milder than previous strains of Covid-19; hospitalisations and severe illness appear significantly lower, while booster jabs have been shown to provide high levels of protection against the variant. Case numbers related to Omicron have risen sharply through December. However, there are signs that the spike in cases could be relatively short-lived with case numbers in South Africa having fallen by two thirds in little over two weeks. In the UK, despite a substantial rise in cases, and some increase in hospitalisations, hospital and ventilator occupancy remains manageable. Vaccines and antiviral treatments remain effective at preventing severe infection, while the impact on mobility and growth is expected to be less than previous waves.

Inflation spurs central banks

US headline inflation hit a 39 year high of 6.8% year-on-year in December as price pressure broadened out to stickier components of the price basket, while the unemployment rate fell to 4.2%. The rapid tightening of the US labour market, coupled with persistent inflationary pressures, spurred a reaction from the US Federal Reserve (Fed) in December. At its early December meeting, the Fed announced it would double the pace of tapering to $30 billion per month in January, with purchases ceasing in March. This gives the bank optionality around rate hikes in the first half of 2022. While citing elevated inflation pressures and further improvements in the labour market, Fed officials also projected three rate hikes in 2022, three in 2023 and two in 2024. Elsewhere among central banks, the Bank of England surprised markets and raised interest rates from 0.10% to 0.25%, its first increase in more than three years, in a bid to tame surging inflation which surprised to the upside at 5.1% y/y in November. The European Central Bank (ECB) confirmed that its Pandemic Emergency Purchases Programme (PEPP) would end in March 2022, while announcing the bank's ongoing asset purchase programme (APP) would be bumped up by €90 billion through the remainder of the year to bridge the gap between PEPP and APP. The ECB raised its 2022 inflation forecast sharply, from 1.7% to 3.2%, with ECB President Lagarde saying that "over two thirds" of the upward revision was due to energy.

Political uncertainties

In geopolitics, tensions continue to bubble under the surface on the eastern front of Ukraine; Russia has amassed more than 100,000 troops in response to fears over closer co-operation between Ukraine and Western Allies. A call between the US and Russian leaders in late December marked the latest in a string of diplomatic efforts to defuse an escalating situation, with further talks expected in January. In the US, President Joe Biden failed in his marathon bid to pass his $1.7 trillion Build Back Better Programme ahead of year end as Democratic Senator Joe Manchin refused to back the programme, citing inflation fears, debt sustainability issues and geopolitical risks as reasons for his decision.

CHART OF THE QUARTER

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 31 December 2021

MARKET ROUND-UP

Equities

Over the quarter, the MSCI AC World equity benchmark rose 7.1% (8.8% in €) as the overriding positive economic and earnings backdrop, combined with a belief that the worst of the Covid-19 pandemic might have passed, contributed to gains in equity markets. The US rose 10.1% (12.2% in €) as a strong quarter three earnings season and a rebound in growth to a 7% annualised rate offset a more hawkish Fed. Europe gained 7.0% (7.8% in €) as growth remained strong, despite the renewed rise in Covid case numbers, while it was perceived as a beneficiary of an improving global growth backdrop and a potential easing of supply bottlenecks. Japan fell -0.9% (-2.1% in €) as the economy contracted over the third quarter due to Covid-related restrictions. Meanwhile, emerging markets were down -0.8% (+0.6% in €) and were negatively impacted by a stronger US dollar and tighter US monetary policy.

Bonds

Global bond yields showed little change over the quarter but were volatile. Yields fell on growth concerns related to Omicron before rising into the year-end on tightening central bank policy and easing concerns around the new Covid variant. US 10-year yields rose 2 basis points (bps) from 1.49% to 1.51% as the Fed commenced tapering its asset purchase programme while guiding to three rate hikes for 2022. UK 10-year yields fell 5bps to 0.97% despite the Bank of England's first rate hike in more than three years, with consumer price inflation hitting 5.1% y/y. Japanese 10-year yields were unchanged at 0.07%.

The ICE BofA Merrill Lynch Eurozone > 5-year sovereign bond benchmark fell -0.5% over the quarter with the German 10-year yield rising 2bps to -0.18%. Yields were volatile, initially falling as the ECB pushed back against market expectations of a rate rise in 2022 and on the back of renewed growth concerns related to the emergence of Omicron. Yields rose into year-end as the ECB announced a larger-than-expected reduction in asset purchases from March onwards when the Pandemic Emergency Purchase Programme (PEPP) ends. Easing concerns around the potential economic impact of Omicron also pushed yields higher into year-end. Peripheral spreads widened as investors discounted reduced levels of ECB asset purchases in 2022 while doubts over whether Mario Draghi will remain as Italian Prime Minister added to pressure on Italian bonds. At the end of December, Italian 10-year spreads against Germany were 135bps, while Spanish spreads were 75bps.

European investment grade (IG) corporate bonds fell -0.7%, with global high yield credit up 0.4%. Higher sovereign bond yields pulled yields in IG bonds up to 0.62%. Spreads in IG bonds widened to 98bps on growth concerns and lower ECB asset purchases in 2022, while high yield spreads were marginally higher at 280bps.

Currencies and commodities

The euro fell to 1.1370 against the US dollar as the Fed announced asset purchases will end in March while guiding to three interest rate hikes over 2022. Commodities rose 1.5% (3.4% in €) but were volatile through the quarter. Having drifted higher through October and most of November, commodities fell sharply in late November on renewed growth and demand concerns related to the emergence of the Omicron variant. Commodities recovered through December as Omicron related concerns began to fade and the growth outlook for 2022 remained robust. Oil was similarly volatile and was also impacted by the coordinated release of strategic oil reserves by several countries to contain the rise in prices. West Texas Intermediate oil rose 0.2% over the quarter. European gas prices were extremely volatile, impacted by supply/demand imbalance, low storage levels, the failure to approve the Nord Stream 2 gas pipeline and rising Russian/Ukrainian tensions. During the quarter, European gas prices fell -21.5%, having risen over 115% at their peak. At the same time, gold rose 4.0%, benefitting from lower US real yields and rising uncertainty.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	QTD Return (%)	YTD Return (%)	2020 Return (%)
MSCI Ireland	2.54	17.09	5.97
MSCI United Kingdom	7.65	27.53	-17.83
MSCI Europe ex UK	7.77	25.36	2.43
MSCI North America	12.06	36.61	10.64
MSCI Japan	-2.10	9.79	5.42
MSCI EM (Emerging Markets)	0.65	5.20	8.89
MSCI AC World	8.81	28.08	7.18
10-Year Yields	**Yield Last Month (%)**	**2020 Yield (%)**	**2019 Yield (%)**
US	1.51	0.91	1.92
Germany	-0.18	-0.57	-0.19
UK	0.97	0.20	0.82
Japan	0.07	0.02	-0.02
Ireland	0.24	-0.30	0.11
Italy	1.17	0.54	1.41
Greece	1.34	0.63	1.43
Portugal	0.47	0.03	0.43
Spain	0.57	0.05	0.46
FX Rates	**Current**	**2020 Rates**	**2019 Rates**
U.S. Dollar per Euro	1.14	1.22	1.12
British Pounds per Euro	0.84	0.90	0.85
U.S. Dollar per British Pounds	1.35	1.37	1.33
Commodities (USD)	**QTD Return (%)**	**YTD Return (%)**	**2020 Return (%)**
Oil (WTI)	0.24	55.01	-20.54
Gold (Oz)	4.03	-3.44	24.40
S&P Goldman Sachs Commodity Index	1.51	40.35	-23.72

Source: ILIM, Bloomberg. Data is accurate as at 2 January 2022

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THE ILIM VIEW – LOOKING AHEAD

The outlook for equity markets over the next twelve months is dependent on several factors, which include central bank policy, growth, inflation (both expected and realised) and the evolution of the Covid-19 pandemic.

We believe we are still in the early to mid-stage of the current economic cycle, a period which is typically associated with positive equity markets, even though the pace of returns tends to be lower than those experienced in the initial recovery from market lows. Having grown by almost 6% over 2021, global economic growth is expected to slow next year with growth of 4.3%. This, however, remains well above trend growth of 2.7% and exceeds levels experienced in the last cycle, post the Global Financial Crisis.

While equities appear expensive in absolute terms, trading on a 12-month forward P/E multiple of 18.0x, given the forecasted earnings growth in the coming years, the 12-month forward P/E multiple falls nearer to its long-term average of 16.0x. In a low bond yield environment, equities can trade at higher-than-average valuation multiples, and we believe an 18x P/E is justified, which is consistent with at least high single-digit upside in equity markets. Even as monetary stimulus is being reduced, financial conditions remain extremely loose. This is highlighted by real yields, which remain close to historic lows – levels which are consistent with further gains in equities.

Longer term potential risks to the equity outlook include unexpected central bank policy tightening due to the persistence of high inflation, significant rises in bond yields which would diminish the relative valuation case for equities, or the emergence of a vaccine-resistant strain of Covid-19. The probability of these occurring is viewed as being low. The persistence of higher inflation is seen as the greatest risk to markets; however, we expect inflation to ease back to lower levels in 2022 and, while it will probably settle at levels higher than pre-Covid-19, we do not expect it to be high enough to warrant more aggressive tightening of policy by central banks.

While our outlook for equity markets is positive, elevated absolute valuations and the array of short-term risks mean volatility will likely remain a feature in markets in the near term.

THE MONTH AHEAD

Economic data releases

12 January	US inflation rate YoY (December)
14 January	GB balance of trade (November)

Source: ILIM, Trading Economics. Data is accurate as at 31 December 2021

Events to watch

12 January	Global – NATO-Russia Council
13 January	Global – Meeting of the Organization for Security and Cooperation in Europe
17 January	Japan – Bank of Japan meeting
24 January	Italy – Presidential election process starts
25 January	US – Federal Reserve meeting
30 January	Portugal – Parliamentary elections

Source: BlackRock geopolitical calendar. Data is accurate as at 31 December 2021

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