



January 2022 Market Pulse

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JANUARY JITTERS



Lenny McLoughlin
 Chief Investment Strategist,
 Irish Life Investment Managers
 Limited (ILIM)

In January, global equities fell during what was their worst month since March 2020. Having hit new all-time highs in the first few trading days of the year, equities fell and bond yields rose on hawkish guidance from the US Federal Reserve (Fed). The Fed suggested a faster pace of policy tightening than was expected, both in terms of the likely number of interest rate rises during 2022 and the timing and pace of the reduction of the Fed's balance sheet. Rising political tensions over the possibility of Russia invading Ukraine added to uncertainty. At the same time, concerns were also evident on the outlook for growth given the backdrop of rising interest rates, continued high inflation and signs of slowing economic growth.

Tighter Fed policy

In early January, the release of the Fed's December meeting minutes was the initial catalyst for the sell-off in both equities and bonds. The minutes suggested that balance sheet reduction was likely to start shortly after the first interest rate hike, which is expected in March. Given the large size of the Fed's balance sheet at over \$9 trillion, it was also suggested the pace of reduction would need to be faster than in previous cycles. The more hawkish policy stance was confirmed by Fed Chair Jerome Powell as he evidenced the current strength in the US economy and labour market, and the persistence of high inflation. On the back of these comments, market expectations for the number of rate rises in 2022 rose from four to five. The shifting of monetary policy expectations and a subsequent sharp rise in bond yields over a relatively short period contributed to the fall in equity markets, with global equities down over 8% at their lows.

Russia/Ukraine

Despite negotiations between Russia, the US/NATO and several European nations, tensions remain high in relation to a possible invasion of Ukraine. Russia continues to build a large military presence on Ukraine's borders. Russia has made demands, including that Ukraine's application for NATO membership be blocked, and that NATO's military borders are rolled back to those that were in place before the late 1990s. The US and NATO have rejected these demands but have indicated a willingness to

negotiate and offer compromises in other areas. If an invasion were to occur, the greatest risk to global economies and markets would be from an expected sharp rise in commodity prices, with Russia being a major producer of oil, gas, and metals. There could also be some fallout for the global economy from the implementation of economic sanctions on Russia, with Europe being most exposed. Our base case is that an invasion will not occur and that a compromise will ultimately be found, but markets will be closely watching developments on this issue in coming weeks.

Economic growth

On the economic front, fourth quarter GDP releases show the global economy was very strong and grew around 6% on an annualised basis in the fourth quarter, but there are signs that growth has slowed in the early part of this year. Global purchasing managers' indexes (PMIs) fell in January with both manufacturing and services down; weakness was particularly evident in services. This slower momentum is partly due to the Omicron variant having an impact through short-term absenteeism among workers. This is most evident in China, where the 'zero tolerance' approach to Covid-19 has resulted in renewed lockdowns across many cities. The persistence of higher inflation has also negatively affected consumer spending as reflected in falling consumer confidence in many regions.

CHART OF THE MONTH

Global Equities



Source: ILIM, Bloomberg. Data is accurate as at 31 January 2022

MARKET ROUND-UP

Equities

Over the month, the MSCI AC World equity index fell -4.6% (-3.5% in euro terms) on the back of concerns over more aggressive tightening of monetary policy, uncertainty over Russia/Ukraine tensions and some signs of slowing economic growth. Equities recovered from their lows into month-end, following sentiment and technical levels moving to extreme oversold. The UK rose 1.9% (2.4% in euros) and benefited from its relatively large weighting to energy and material stocks, which were supported by higher commodity prices. It is also making good progress in terms of removing Covid-19-related restrictions, which was positive for the growth outlook. Emerging markets outperformed, falling -1.8% (-0.5% in euros), and were helped by policy loosening in China, which should support growth, and attractive relative valuations compared to global equities. The US underperformed and fell -5.7% (-4.3% in euros) on the back of more hawkish guidance from the Fed and the sharp climb in bond yields, which was a negative for the tech sector. Japan fell -5.0% (-3.7% in euros) as its economic recovery continues to lag that of the global economy.

Bonds

The Eurozone >5-year bond index fell -1.5% as bond yields rose on more hawkish policy guidance from the Fed. European yields also rose, as expectations for the first European Central Bank (ECB) rate rise were brought forward to October. Policy differences were evident among ECB council members, which also suggested that policy could be tightened earlier than current guidance anticipates. The German 10-year yield rose back into positive territory for the first time since 2019, ending the month at 0.01%. Italian 10-year spreads against Germany fell to 128 basis points (bps), with Mario Draghi set to remain as Prime Minister. Spanish 10-year spreads were unchanged at 74bps. Investment grade corporate bonds fell -1.3% as spreads rose 9bps to 107bps, and yields increased 14bps to 0.65%. High yield corporate bonds fell -2.5% as yields rose 83bps to 4.47% and spreads widened 45bps to 325bps. Emerging market local debt rose 1.3% in euro terms during the month as strength in emerging market currencies offset the 23bps rise in yield to 5.85%. Emerging market hard currency debt fell -3.1% (-1.7% in euro terms) as both yields and spreads rose over the period.

Currencies and commodities

The euro fell to 1.1219 against the US dollar, with the dollar rising on expectations of faster policy tightening from the US Fed. Commodities rose +11.6% (+13.3% in euro terms), with WTI oil up +17.2%. Commodity prices were firm on concerns over the Russia/Ukraine crisis, with Russia being a significant producer of several commodities. The country accounts for 17% of global gas production, 12% of global oil and 5-7% of many metals. Oil was also firm on the back of reductions of estimates of excess OPEC capacity and falling inventory levels. European gas prices rose 27.2% during the month. Gold fell -1.8% as real yields rose.

MARKET SNAPSHOT

Market returns (EUR)



Equity Markets (EUR)	MTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	-5.8	-5.8	17.1
MSCI United Kingdom	2.4	2.4	27.5
MSCI Europe ex UK	-4.8	-4.8	25.4
MSCI North America	-4.1	-4.1	36.6
MSCI Japan	-3.7	-3.7	9.8
MSCI EM (Emerging Markets)	-0.5	-0.5	5.2
MSCI AC World	-3.5	-3.5	28.1
10-Year Yields	Yield Last Month (%)	2021 Yield (%)	2020 Yield (%)
US	1.78	1.51	0.91
Germany	0.01	-0.18	-0.57
UK	1.30	0.97	0.20
Japan	0.18	0.07	0.02
Ireland	0.51	0.24	-0.30
Italy	1.29	1.17	0.54
Greece	1.89	1.34	0.63
Portugal	0.67	0.47	0.03
Spain	0.75	0.57	0.05
FX Rates	End last month	2021 Rates	2020 Rates
U.S. Dollar per Euro	1.12	1.14	1.22
British Pounds per Euro	0.83	0.84	0.90
U.S. Dollar per British Pounds	1.34	1.35	1.37
Commodities (USD)	MTD Return (%)	YTD Return (%)	2021 Return (%)
Oil (WTI)	17.2	17.2	55.0
Gold (Oz)	-1.8	-1.8	-3.4
S&P Goldman Sachs Commodity Index	11.6	11.6	40.4

Source: ILIM, Bloomberg. Data is accurate as at 1 February 2022

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THE ILIM VIEW – LOOKING AHEAD



We believe we are still in the early to mid-stage of the current economic cycle, a period which typically is 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% in 2021, the global economy is expected to slow this year, with growth of 4.2%. 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 17x, given forecasted earnings growth, the 12-month forward P/E multiple would fall below its long-term average of 16x if equities remained flat over the next 12 months. 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 double digit upside in equity markets from current levels.

Even as monetary stimulus is being reduced, financial conditions remain loose as highlighted by real yields, which remain close to historic lows. Historically, equities have, on average, continued to

rise in the initial stages of a rate hiking cycle as the economic and earnings backdrop generally remain strong.

The persistence of higher inflation is seen as the greatest risk to markets. However, we expect inflation to ease back to lower levels through the year and, while it will probably settle at levels higher than pre-Covid-19, it is not expected to be high enough to warrant more aggressive central bank policy tightening compared to current guidance.

The most imminent short-term risk to markets relates to the Russia/Ukraine crisis, where Russia’s invasion of Ukraine could result in sharply higher commodity prices and dislocations in the global economy, with Europe being most exposed. Our base case is that a compromise will eventually be reached, which avoids an invasion; but the risks are rising, and this issue will be closely monitored by investors in coming weeks.

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

THE MONTH AHEAD

Economic data releases

3 February	BoE Interest Rate Decision
4 February	US Unemployment Rate and Non Farm Payrolls
8 February	US Balance of Trade (Dec)
10 February	US Inflation Rate (Jan)
11 February	GB GDP YoY (Dec), Balance of Trade (Dec)

Source: ILIM, Trading Economics. Data is accurate as at 31 January 2022

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Contact us

Phone (01) 704 1200

Fax 01 704 1918

Website www.ilim.com

Write to Irish Life Investment Managers, Beresford Court, Beresford Place, Dublin 1

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