SEASPRAY PRIVATE
Creating Investment Solutions

MONTHLY INVESTMENT UPDATE: DECEMBER 2021

Introduction

Since we released our Q3 Investment Update at the beginning of October, risk assets have rallied fairly convincingly, with the main equity indices around the globe reaching new all-time highs and with Europe even seeing six consecutive weeks of higher trade up until the middle of the month. This bounce in prices has been followed by what has been a relatively sharp pullback on the back of news of the new Omicron Covid-19 variant, and has been accelerated by some more hawkish comments from Fed Chair Jerome Powell than we have been used to in recent times. The emergence of the Omicron strain represents a potential risk for the outlook for the global economy and in this regard, will potentially have considerable implications for the upcoming central bank policy meetings for the ECB, Fed, and BOE in the middle of December.

As you will read in the following pages, we remain positive on equity markets over the medium and long terms, despite recent price volatility, as low interest rates, remarkably loose financial conditions and positive corporate commentary outweigh inflationary fears, geopolitical concerns, and recent Covid worries. We acknowledge that concerns surrounding supply chain constraints also remain in the minds of investors at present, and quite possibly even more so now that we have Omicron to contend with. However, it is important to remember that the positive demand story underlying this factor will bode well for the medium and the long run.

In this Update we ask the question: Has the economic recovery peaked? Yes and no. We are still seeing strong growth, albeit at a slowing pace as the months go on and we leave behind the recovery phase. So yes, the rate of growth is probably peaking. This does not mean that the recovery is over, but rather that it will continue at a slower pace.

With the extraordinary pandemic-era stimulus now being pared back, inflation running at multi-decade highs, many stock market index's near their record highs, rampant energy prices, and a new variant about which we are still learning, investors are naturally worried that we might be about to see equity markets slide lower from here. However, the big picture economic data is ticking along fine, jobs are plentiful again, corporate earnings are doing surprisingly well and long-term interest rates remain at all-time lows.

Amid our optimistic bias for the medium to long term, we believe that opportunities will continue to present themselves within specific asset classes as we move through the final month of the year and into 2022. At Seaspray we carry out our own thorough, team-based research to help us find what we believe to be the best investment opportunities for our clients. Whatever their priorities – from income and growth to sustainable investing - our experience in these areas allow us to target a wide range of outcomes in this regard.

	1 Month	3 Month	YTD	1 Year
Equity Indices				
S&P 500	-0.5%	3.3%	25.6%	26.4%
DAX	-1.8%	-1.0%	14.9%	18.7%
EuroStoxx 50	-2.3%	0.3%	19.8%	20.7%
ISEQ	-2.9%	-6.2%	12.4%	10.3%
FTSE	0.5%	2.0%	13.5%	11.8%
Nikkei 225	-3.6%	-4.1%	3.7%	7.5%
Multi-Asset Funds				
Aviva Cautious (Risk 3)	-0.9%	-0.2%	4.6%	5.7%
Irish Life MAPS 3	-1.2%	-0.1%	8.4%	9.3%
New Ireland iFunds 3	-0.5%	0.1%	2.9%	3.5%
New Ireland PRIME 3	-0.9%	0.9%	7.8%	8.3%
Zurich Prisma 3	-0.9%	0.5%	7.1%	7.8%
Aviva Strategic (Risk 4)	-1.5%	0.2%	10.4%	11.9%
Irish Life MAPS 4	-1.4%	0.2%	12.4%	13.8%
New Ireland iFunds 4	-0.8%	0.7%	8.0%	8.9%
New Ireland PRIME 4	-1.3%	1.8%	15.0%	15.8%
Zurich Prisma 4	-1.7%	1.2%	15.1%	16.6%
Aviva Dynamic (Risk 5)	-1.8%	0.6%	15.2%	17.2%
Irish Life MAPS 5	-1.6%	0.5%	15.0%	16.5%
New Ireland iFunds 5	-1.4%	1.5%	14.5%	15.7%
New Ireland PRIME 5	-2.1%	2.4%	20.5%	21.6%
Zurich Prisma 5	-2.3%	1.6%	21.0%	23.2%
Currencies				
EUR/USD	-2.9%	-5.2%	-8.9%	-7.0%
EUR/GBP	-0.5%	-0.9%	-4.8%	-6.2%
GBP/USD	-2.4%	-4.3%	-3.2%	-0.9%
USD/JPY	0.3%	3.5%	10.0%	9.1%
Fixed Income				
US 10yr	-0.01	0.07	0.53	0.52
German 10yr	-0.13	-0.06	0.20	0.21
Irish 10yr	-0.13	-0.02	0.36	0.33
UK 10yr	-0.13	-0.01	0.53	0.45
Commodities				
Gold	-2.6%	-2.3%	-6.9%	-5.7%
WTI Crude Oil	-12.3%	4.6%	48.1%	57.6%

Source: Seaspray Financial Services, December 2021

Global Economy

Growth

As vaccine coverage has continued to improve across the globe, we see investors' attention moving away from Covid-19 and towards the post-pandemic process of normalisation. Persistent supply chain constraints however are weighing on the path of the recovery and are now feeding fears of longer lasting inflationary pressures. Despite this dynamic, we view the prospect of economic stagflation as unlikely. The general growth outlook remains firmly underpinned by huge levels of pent-up demand, solid corporate balance sheets and robust investment intentions.

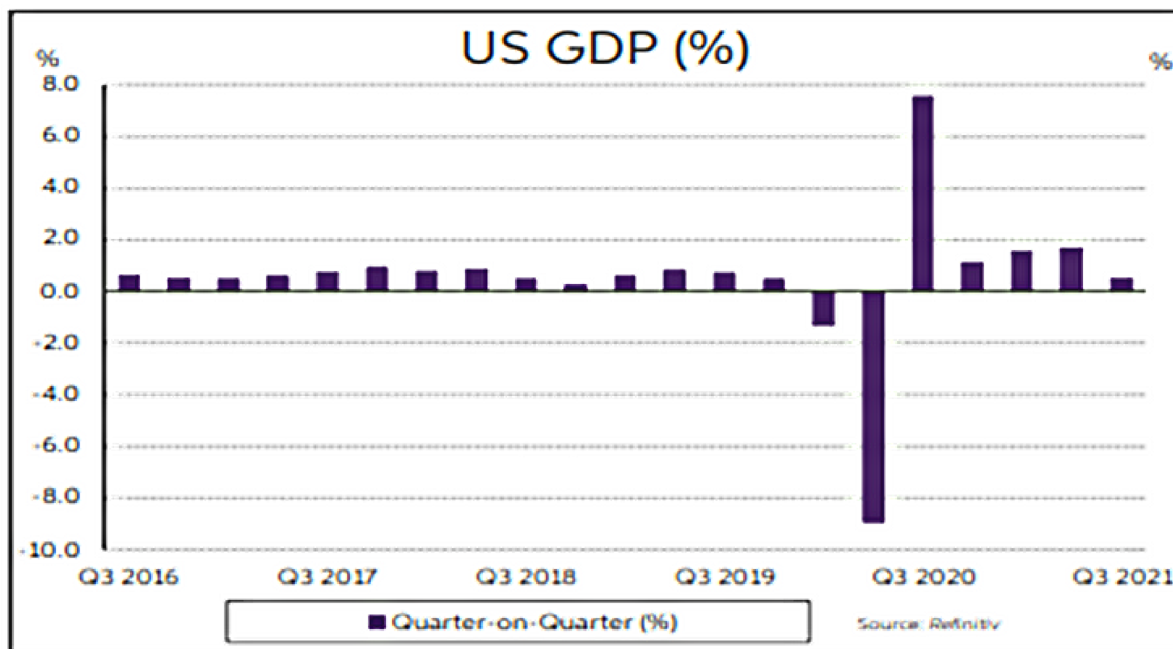
We saw mixed results from the Eurozone's biggest nations when third-quarter GDP figures were released at the end of October, with the region as a whole seeing growth of 2.2% q/q during the July to September period. This compares with analysts' expectations for 2.1% and the previous quarter's 2.0% preliminary result. We note that this is the region's fastest pace of growth in a full year, and comes in at 3.7% when compared with Q3 last year (vs 3.5% forecasts). Covid case numbers have only picked-up recently in the EU, while labour market constraints are not as evident as elsewhere. Growth, though, is set to slow down in the final quarter of the year, owing to the recent reimposition of restrictions due to the marked rise in Covid cases along with the emergence of Omicron, and also as supply chain disruptions take more of a toll on activity. Having said this, the Eurozone should still benefit from the effective support of the European recovery fund over the coming quarters.

Following these Q3 GDP releases in Europe, we saw the release of the European Commission's (EC) latest economic forecasts, which are updated four times per year. The report, which covers about 180 variables, projects that the economy will grow faster than was previously expected in 2021 as it continues to recover from the recession. GDP for the 19-nation bloc is now forecast to grow by 5% this year, following last year's 6.5% decline. For 2022, 4.3% growth is now expected, and 2.4% the following year. We note that the commission's forecast six months ago for this year was for just 4.3%.

Global Economy *, contd........*

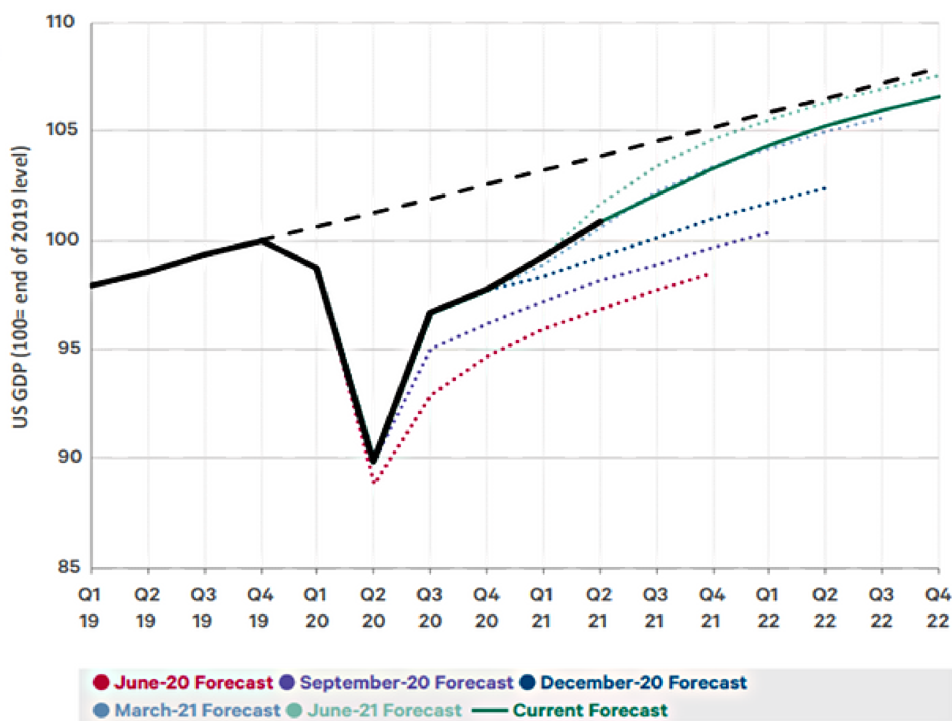
Regarding inflation, the EC is projecting it to reach 2.4% this year, up strongly from last year's 0.3%, and is expected to slow to 2.2% next year and to 1.4% in 2023. This compares to the ECB's most recent inflation projections, from their September meeting, which were for 2.2% this year, 1.7% in 2022, and 1.5% in 2023. "There are three key threats to this positive picture: a marked increase in Covid cases, most acute in areas where vaccinations are relatively low; rising inflation, driven largely by a spike in energy prices; and supply-chain disruptions that are weighing on numerous sectors" said the European Economic Commissioner Paolo Gentiloni. We must also point out that in the Euro area, unemployment fell from 7.4% to 7.3% in October after a m/m decrease of 77,000 and y/y decrease of 1.65m in the number of jobless individuals.

Looking at the United States and United Kingdom, both economies' rebounds have noticeably lost momentum since mid-year. GDP growth slowed to 1.3% in the UK during the third quarter, down from 5.5% during Q2. A marked deceleration was expected after output rebounded sharply in Q2 as the economy reopened, but not on this scale. A sharp rise in Covid case numbers, as well disruptions to supply chains and labour shortages, impeded activity in the July to September period. Similar factors were at work in the US, where quarterly growth slowed to 0.5% (2% y/y) from 1.9% and 1.8% in Q1 and Q2, respectively. The general expectation is that growth will accelerate again in the US during the current quarter, with strong employment reports having come out over recent months. On the other hand, the likelihood is that growth will slow further in the UK, with the Bank of England projecting that GDP will rise by circa 1% in Q4.



Source: Refinitiv, AIB

While US GDP growth disappointed last quarter, we must point out that the region was hurt by a combination of negative effects from Hurricane Ida to persistent supply-side distortions. More timely data over the course of the past month or so has offered encouragement that momentum may now be slowly picking up again. Overall, the US recovery is solid and the economy is approaching full employment with inflationary pressures building. US unemployment fell from 4.6% to 4.2% after adding 210,000 jobs last month.



Source: Bloomberg

Last week we saw the OECD (Organisation for Economic Co-operation and Development) publish its latest set of global economic forecasts, the institution alluded to the fact that Omicron threatens to exacerbate imbalances that are currently slowing growth and boosting inflation, while also delaying the global economy's return to full normality. The OECD only marginally reduced its 2021 targets in terms of growth, stating now that it expects a 5.6% result compared to its September forecast for 5.7%. The organisation projects for 4.5% growth worldwide next year (unchanged vs previous expectations) and 3.2% in 2023. Taking a closer look at the forecasts, the US is now expected to see growth of 5.6% this year (vs prior 6.0% expectations), 3.7% in 2022 (vs previous 3.9%), and 2.4% the following year. The Eurozone is forecast to grow by 5.2% (vs 5.3%), 4.3% next year (vs 4.6%) and by 2.5% in 2023.

Has the economic recovery peaked? Possibly. But, apart from the Q3 bounce off the Q2 bottom last year, the second or third quarter of this year will see the fastest growth rate of the recovery. After this, the gains will more than likely slow down. In light of this, we do accept that the rate of growth is possibly peaking. At Seaspray, we do not believe that the recovery is over, but rather that it will continue at a slower pace, and even this slower pace will be faster than what was traditionally considered normal. After a robust recovery phase, we believe we have now entered the mid-cycle phase of this economic cycle. This is typically the longest phase, with moderate growth, as corporate profitability remains healthy and monetary policy turns increasingly neutral.

A natural response to hearing that the economic recovery may be peaking may be to ask if this means the market could also be peaking. Throughout the last couple of years, we have reiterated to clients that markets by their very nature are forward-looking. They are less concerned with what's happening now, and more driven by changes in expectations for the future. With economic growth forecasts moderating, it's not unreasonable to think that stock market gains will slow down too, and we agree. Importantly though, this is not the same as the market peaking. We are of the belief that risk assets will continue to move higher in the medium and longer terms, but may see more volatility over the next year than we have seen during the rally of the past 20 months.

Inflation

Inflation, especially on the supply-side, remains to be a significant concern for investment markets at present. Data for the month of October has proven that inflation is becoming more engrained and broader in its impact. Even the Fed Chair Jerome Powell seems to have shifted his opinion somewhat, suggesting "The risks are clearly now to longer and more persistent (supply) bottlenecks, and thus to higher inflation". Meanwhile, ECB President Christine Lagarde has indicated that European interest rates will likely not be moving in the year ahead arguing that inflation will recede during 2022. We would like to remind clients that part of a central banker's job is to keep inflation under control, so it is unsurprising that they have consistently stated that price growth will return to more moderate levels in the future. Also, 'transitory' doesn't mean that inflation is not happening at the moment. If for example inflation is 4% now, then falls to 3% next year and 2% in 2023, then you could argue it was transitory in nature. But you would still be 9% worse off in terms of purchasing power had you been sitting cash during this period.

The main story of the last month or so with regard to inflation has been the US CPI (Consumer Price Index) y/y reading that came in at 30-year highs, causing investors to price in a more hawkish Federal Reserve in 2022 and three rate hikes in the US by next December. The main result for October was 6.2% versus the same month one year prior, this being US' largest advance since 1990, and came in ahead of expectations for 5.9% (having lingered at 5.4% for the last four months). On a month-on-month basis, inflation was 0.9% higher versus forecasts for 0.6%.

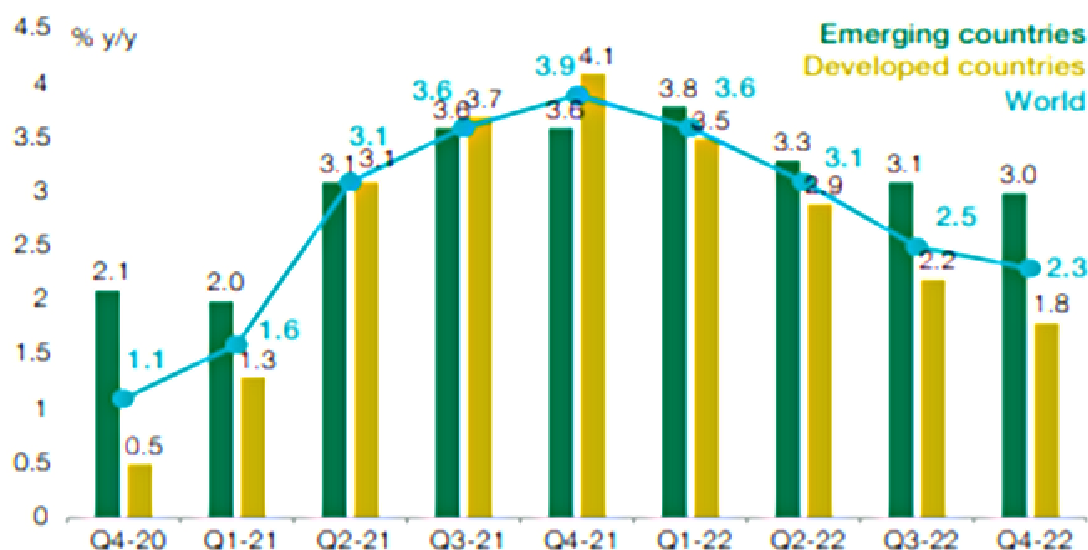
The Core CPI figure, which excludes food and energy prices, was still 4.6% y/y (vs 4.3% forecasts) in what was its biggest increase since 1991, and after remaining steady at 4.0% for the prior two months. M/m, the US saw its Core CPI grow by 0.6% vs estimates for 0.4%. Without a doubt, this latest reading has led some investors to believe that the Fed may have to tighten faster than even they themselves are expecting, even after Jerome Powell urged patience with regard to rate hikes at the central bank's recent meeting.

Inflation*, contd........*

Closer to home, the Eurozone recently registered its own multi-decade high reading, causing some slight concern for the ECB who have continuously underestimated inflationary pressures over the past year. The region's CPI result came in at 4.9% vs November 2020, and against forecasts for 4.5% and the previous month's 4.1% figure. Data from Eurostat indicates that the main drivers of this move were higher energy prices, price pressures as a result of supply chain issues, and tax hikes in certain countries. The Core CPI for the 19-nation bloc came in at 2.6% y/y vs the 2.3% expectations and October's 2.0%.

World inflation close to peak, but scenario points to a progressive decline in 2022

World inflation



Source: JP Morgan, UBP

Our base case is for above-trend economic growth in 2022, with policy rates tightening quite slowly as current inflation risks moderate somewhat. We expect earnings growth to continue, albeit at a more modest pace than in the last few quarters, and equity markets to perform well, albeit with more volatility than we have become used to in recent times. Nevertheless, we cannot ignore current supply chain issues. Even if they prove to be temporary, they are causing investors to reassess the balance of risks and central banks' likely policy reactions. Ultimately, we see it as likely that supply chain issues will ease and inflation fears will moderate, allowing central banks to avoid a sharp, hawkish shift. We would also like to point out that base effects with regard to energy prices and inflation in general will begin to work in the opposite direction than they are at present, leading to lower readings from Q2 2022 onwards.

We do not believe we are seeing the beginning of some sort of runaway inflation, and it is also certainly not stagflation. A fitting description that we read over the past few weeks in relation to the United States was that the region is going through a bout of "M.E.S.S.I." inflation dynamics, meaning 'Moderating Expansion with Sticky Supply-driven Inflation'. This is a rare phenomenon whereby strong, but cooling demand is met by tight, but accelerating supply, leading to temporary, yet sticky inflation. We would also like to point out that moderately higher inflation is not always problematic. Inflation will be helpful in reducing the very high public debt burden post-pandemic (rather than governments reducing spending or increasing taxes).

Equities

Following the first 5% pullback in almost a year during September, equity markets rallied strongly, with many of the main indices trading through record highs last month, until this latest pullback in price. Several headwinds eased through the month of October and into November, while strong earnings reports also provided a boost to markets. However, markets have turned their attention to the virus once more: to renewed lockdowns across much of Europe, and to the possibility that Omicron may be successful in evading the existing vaccines that we have. While booster shots and widespread antigen test use should be sufficient in combatting the spread, we are still heading into winter and markets have one eye on virus developments at present.

With regard to Omicron, we acknowledge that at present the transmissibility and the extent to which this new variant causes serious illness or evades vaccines is still somewhat unclear to us, and there are of course some risks to the downside. We strive to remain objective rather than getting caught up in the noise, remembering that uncertainty can play out to the upside as well as the downside. The knowledge level of scientists and policymakers in relation to battling the virus without disrupting the economy, is at much higher levels than it was at the initial outbreak in 2020. It is important not to forget how the emergence of effective treatments and a reversal of cautionary measures can send markets soaring higher, as we have seen before.

In addition, we would also like to point out that it would fit with historical patterns of previous viruses and pandemics, if Omicron turned out to be a less severe but more transmissible variant than what we have previously seen with Covid. This scenario would cause Omicron to crowd out other more dangerous variants in a relatively quick manner, and could potentially be the catalyst that transforms a deadly pandemic into something more comparable with the seasonal flu. This type of scenario has played out time and time again when humanity encounters a virus-pandemic.

Equities, *contd........*

The outlook for equity markets over the next twelve months is dependent on several factors including the speed of central bank tightening, the slowdown in global growth, inflation prints and expectations, and of course the evolution of the Covid-19 pandemic. As we have alluded to in past updates, equity markets are expensive in absolute terms. However, they undoubtedly still remain attractive in relative terms, given the negative real yields available on other traditional assets such as cash and bonds. The current low level of bond yields, even allowing for the rise this year, justifies higher than average valuations in equities, in our view. We believe global equities can trade on a 12-month forward P/E multiple of 18.5 - 19.5 times one year from now.

Source: Refinitiv, MSCI, UBP

Equity markets still have further to run in this mid-cycle phase, but we remain cognisant that a rise in yields could support a rotation towards more cyclical sectors of the market. The relatively high level of equity dividend yields within many of these sectors also remains an attractive source of income compared to many bonds. In addition, with the COP26 global climate summit having taken place during November (see appendix 1 for Outcomes of COP26), we expect an increased focus in markets on environmental, social and governance (ESG) factors, with a widening gap between winners and losers across sectors. Active management will be key in this regard, as we move through the mid-cycle growth phase.

Equities*, contd........*

In terms of potential risks to markets for December and as we head for the new year, there seems to be two main risks. Firstly, that the Omicron variant turns out to be more transmissible and more virulent, even when vaccinated. And secondly, a scenario whereby Central Banks rush into a tightening cycle and remove stimulus too quickly in the face of persistently high inflation. As the months have gone on, investors seem to have concluded that this second risk is unlikely to occur in the foreseeable future and so have continued to buy into any short-term dips in risk assets. We would tend to agree with this broad view. Central Bank leaders have time and time again over the course of this pandemic reiterated that they will be slow to raise rates and will be very cautious so as not to stifle economic growth and the broader recovery.

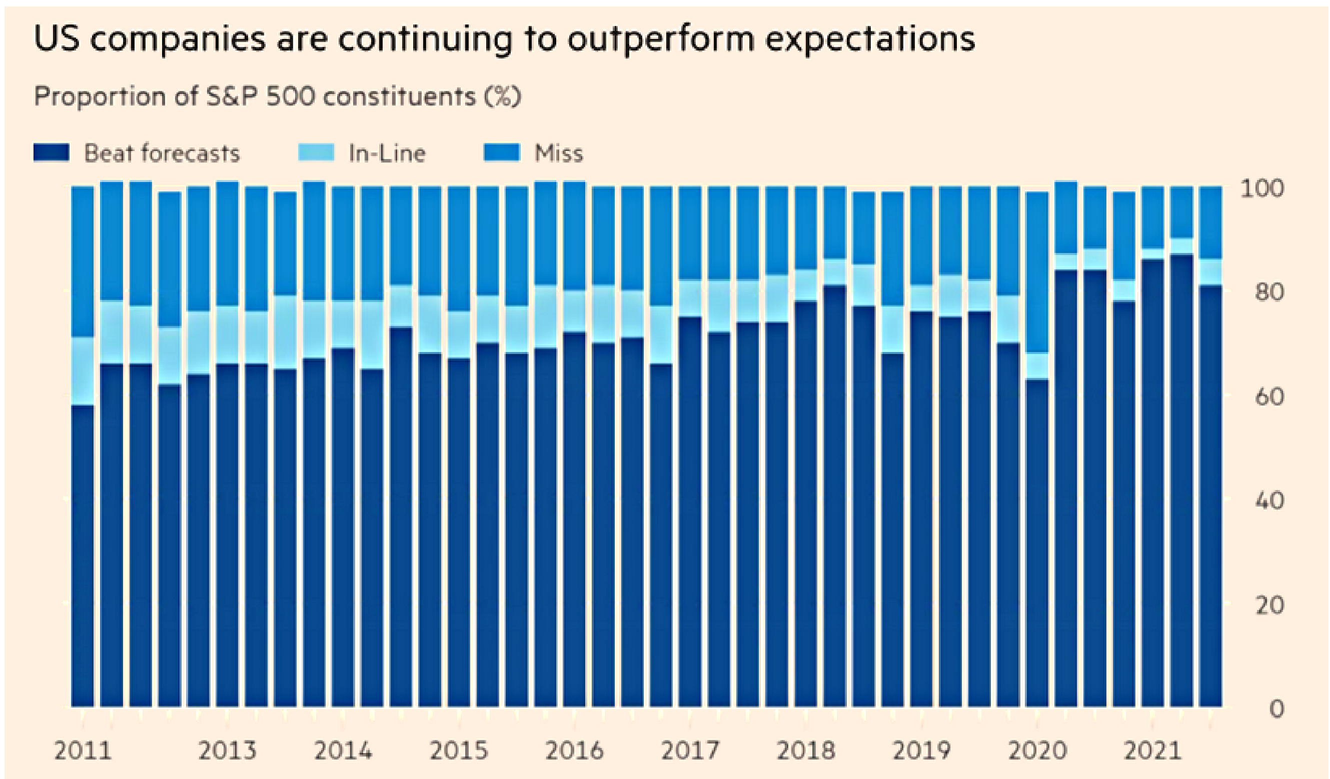
Other risks to equities would include any significant rises in bond yields, which would diminish the relative valuation case for equities, or ongoing inflation and supply chain problems. We reiterate our view that the probability of these occurring is relatively low. However, we must note that given the elevated absolute valuations that we are currently seeing in stock markets we would expect to see some heightened volatility should any of these become significant issues.

Looking at the third-quarter earnings season, we entered that period with investors somewhat concerned about slowing global growth amid inflationary pressures, but most importantly for earnings: the ongoing supply chain issues around the world. We have since seen that solid corporate results from Q3 have indeed alleviated concerns that the slowing global economy combined with input price inflation and supply chain issues would prove to be a serious headwind to profits.

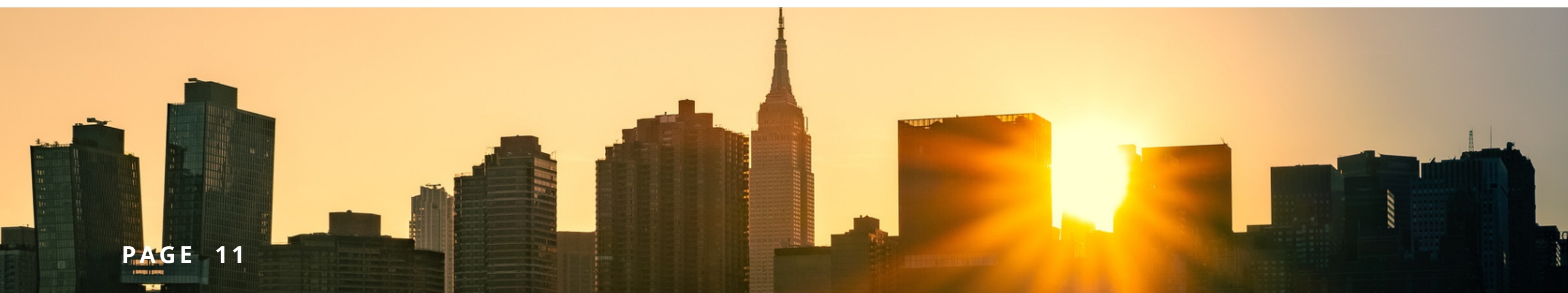
With sales up strongly, companies benefited from firm operating leverage and many have been able to absorb higher costs by raising prices or via efficiency gains. We do note that guidance and comments around margins have been mixed with many companies citing bottlenecks and rising costs, including labour, and this did not really come as a surprise to investors. On the outlook for these supply chain issues, the range of views was wide, with some saying the problem will get better in H1 2022, and others saying it may take longer. Importantly, the tone around demand remained positive.

Equities*, contd........*

Breaking down the results by region, in the US we saw 82% of S&P 500 companies reporting a positive EPS surprise this time around (as can be seen on the graph below), and 75% of names seeing a positive revenue surprise. The index's earnings growth rate came in at 39.6% y/y for the three-month period, well exceeding prior forecasts. Impressively, this result represents the S&P's third highest year-over-year earnings growth rate since 2010. Some of the best earnings momentum continues to be seen across the more cyclical sectors (financials, energy, and materials) but it was much more modest for defensive sectors.

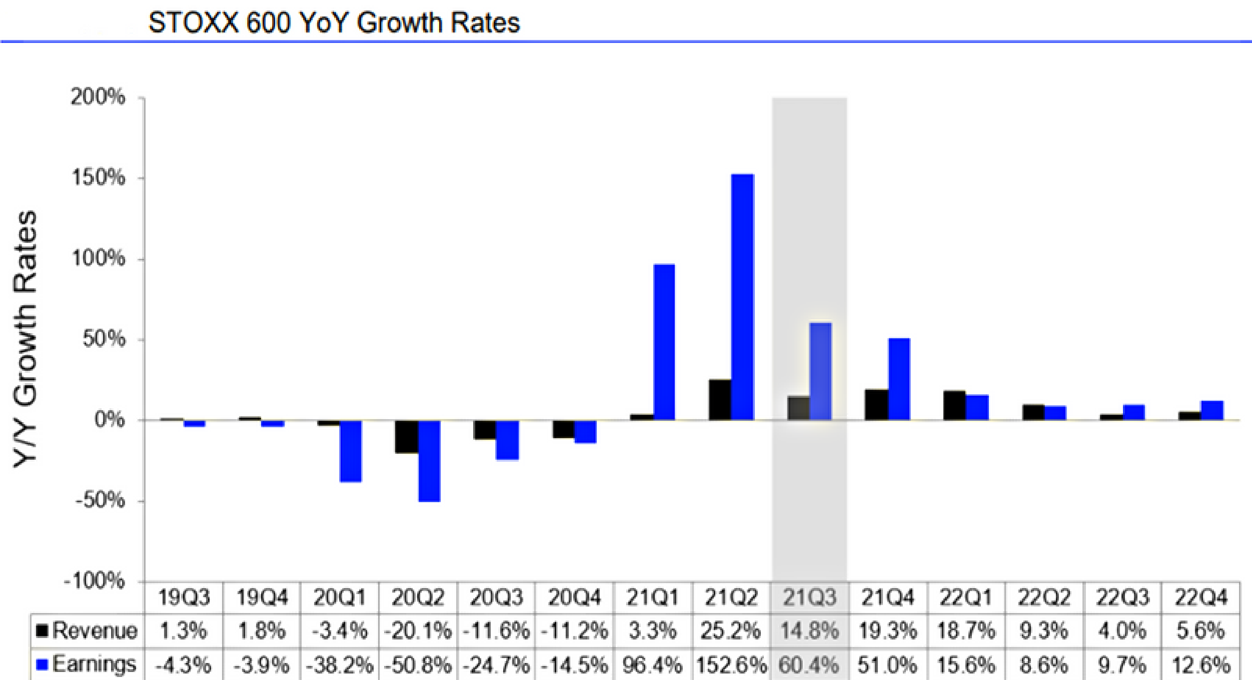


Source: Factset, Financial Times



Equities*, contd........*

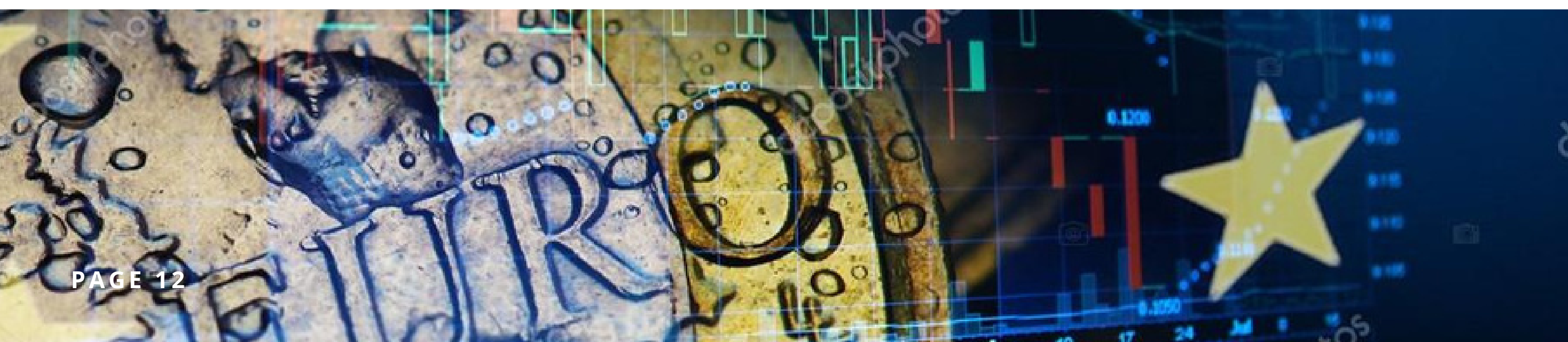
In Europe, earnings have also been strong, with earnings results in the EuroStoxx600 increasing by a whopping 60.4% vs Q3 2020 (below graph). Excluding the energy sector, this y/y figure comes in at about 45% for the third quarter. This strong performance has relieved some fears of margin compression due to recent price inflation, as many companies maintained pricing power and were able to pass input price rises to end customers. 64.5% (vs the average 52%) of the reported companies so far within the index have beaten analysts' expectations with regard to earnings, and over 67% (vs the average 56%) have beaten revenue forecasts.



	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
Revenue	1.3%	1.8%	-3.4%	-20.1%	-11.6%	-11.2%	3.3%	25.2%	14.8%	19.3%	18.7%	9.3%	4.0%	5.6%
Earnings	-4.3%	-3.9%	-38.2%	-50.8%	-24.7%	-14.5%	96.4%	152.6%	60.4%	51.0%	15.6%	8.6%	9.7%	12.6%

Source: Refinitiv,

"Inflation" concerns were mentioned on average nearly three times on each Stoxx 600 earnings call over the season, the highest level on record, with data going back to 2007. At a sector level, inflation mentions were highest among consumer staples, financials, and materials, while supply-chain mentions were most frequent among industrials and tech companies. Banks, autos, and insurance have seen the strongest EPS beats in Q3, while construction materials, travel & leisure and real estate have lagged behind.



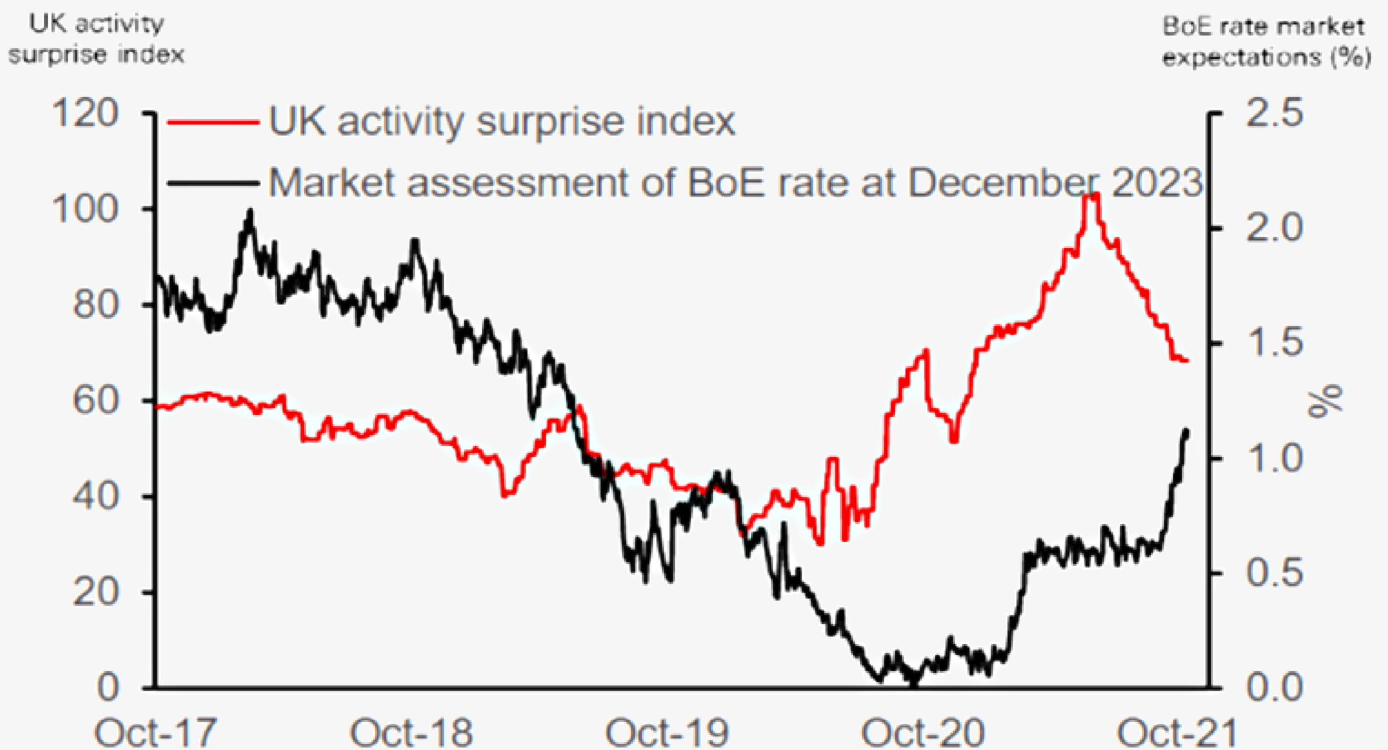
Equities *, contd........*

Despite some bouts of market weakness during September and early-October, and now again in late-November/early-December, we are maintaining our positive medium-longer term outlook for risk assets and would like to reiterate that sentiment as we come into year-end. We continue to advocate that any short-term bouts of volatility should be used to add to or initiate exposure to equities. We believe at Seaspray that strong earnings should continue to support stock markets and especially those companies with high quality earnings and strong pricing power as we encounter higher inflation readings than we have gotten used to for the past decade. We continue to favour the quality equity factor in this regard.

We remain overweight European equities on the back of the broadening restart. While the region is beginning to struggle with rising Covid cases once again, we point out that each wave of the virus (this being most European countries' fourth) is having less of an impact on markets than the prior one. While certain sectors have come under some pressure again, hospitality and travel, markets in general are forward-looking and are seemingly more concerned with European equities' longer-term potential than their shorter-term virus issues. In this regard, we anticipate a successful booster campaign across much of the continent in the coming weeks and months, allowing for a brighter 2022. Valuations in Europe remain attractive relative to history and investor inflows into the region are only just starting to pick up.

Equities, *contd........*

While we are slightly underweight US equities relative to benchmark indices, we acknowledge the role that the region plays, especially in the context of high-quality stocks. However, we see US growth momentum having peaked and expect other regions to be more attractive ways to play the next leg of the restart, notably Europe. Looking at the United Kingdom, we have taken the decision to downgrade the region to a slight underweight. The UK has been hit hard by supply chain issues while rising Covid cases and especially monetary tightening will become headwinds, in our view.

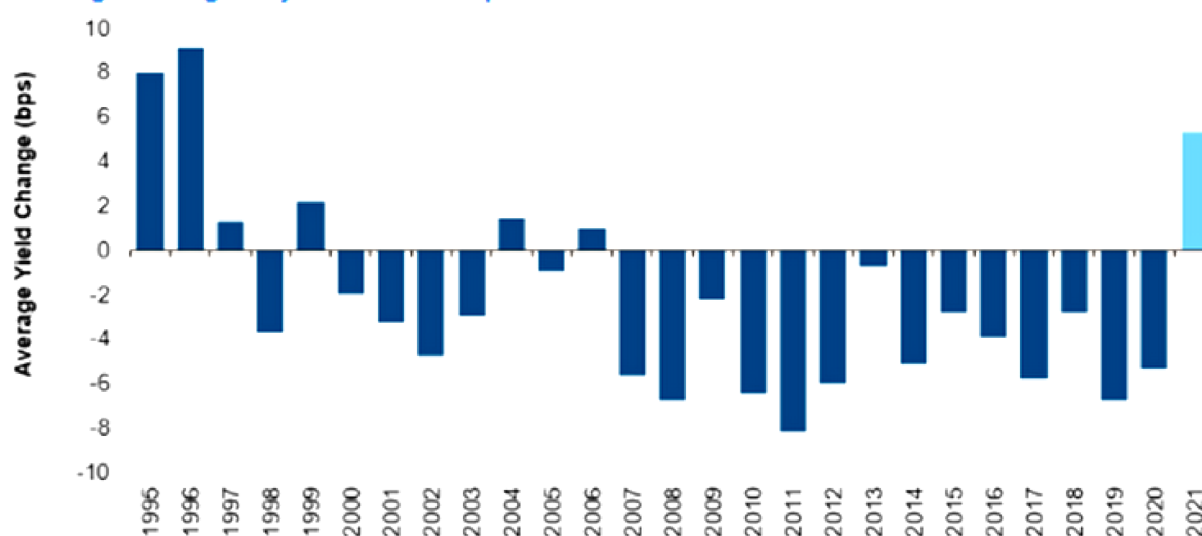


Source: Bloomberg, HSBC Global Private Banking

Bonds

We reiterate our underweight positioning with regard to nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds on a historical basis. In our Q3 Investment Update we spoke about the fact that bond markets are currently seeing a high correlation with equities. In light of this fact, we believe investors must look at opportunities across other asset classes, regions, and within alternative assets to appropriately diversify.

Traditionally, the bond portion of one's portfolio would have appreciated in value when risk assets sold off, thus leading to lower bond yields. On the following chart we can see that this year, for the first time in a meaningful way since the 1990's, we are seeing bond yields increasing when equities pull back, i.e. the underlying bonds are selling off in line with equity markets.



Source: Aviva, LGIM, Bloomberg

We believe that government bond yields will continue to gradually move higher over the months ahead. While shorter maturity bonds are predominantly influenced by near-term central bank interest rate expectations, longer maturity bonds are more forward-looking. Based on current market pricing of US interest rate increases in coming years, we estimate that the current US 10-year yield is approximately 50 basis points too low, at its current 1.45%.

Monetary Policy

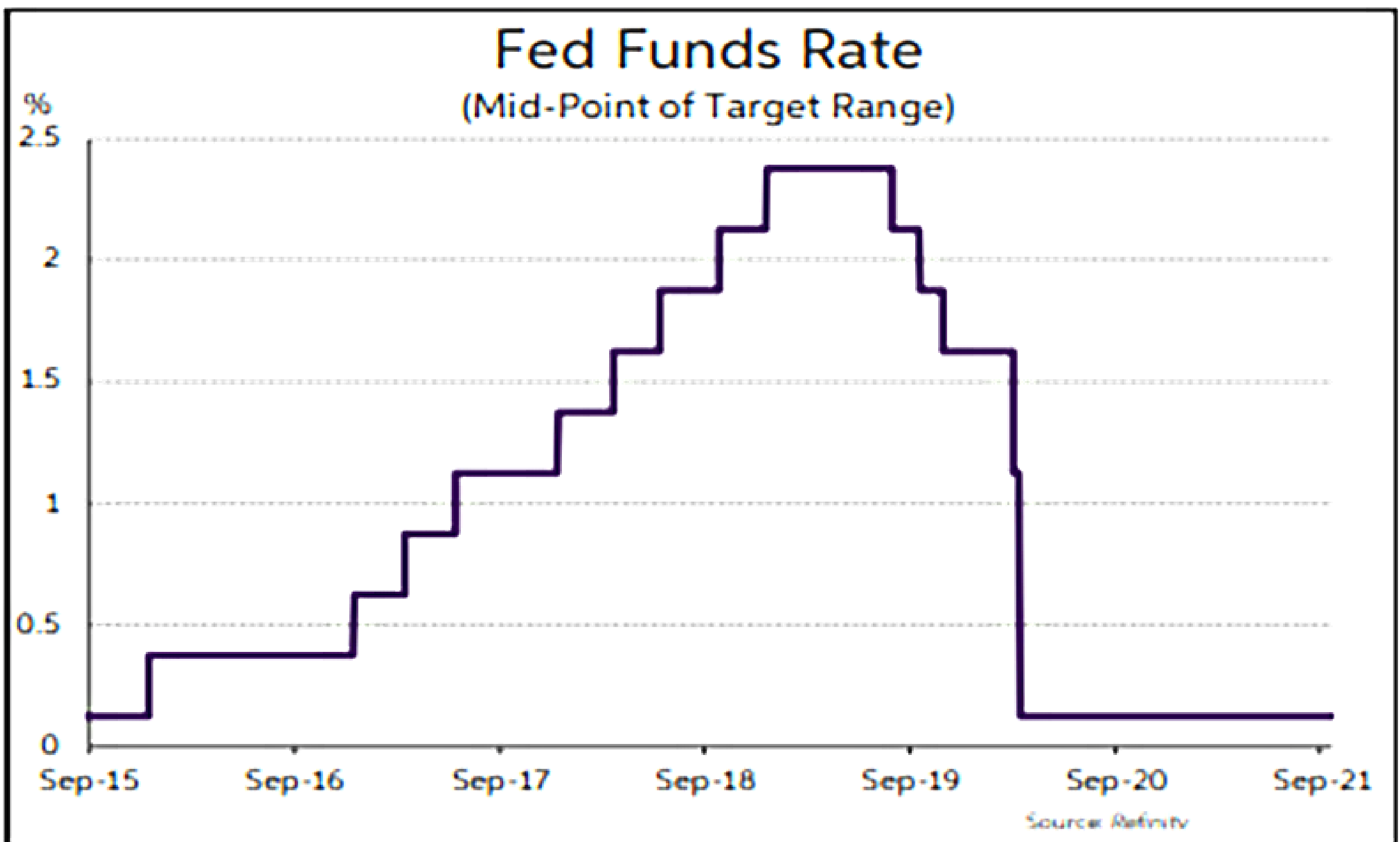
It would be fair to say that much of the market's attention over recent months has been centred around monetary policy and specifically on when some of the main central banks may start to reverse course. This follows their comprehensive provision of monetary stimulus over the course of the pandemic to help their respective economies recover. These measures included rate cuts as well as enormous quantitative easing programmes. Recent policy discussions have been set against a backdrop of a quicker than expected economic rebound. These deliberations though, have been complicated by the fact that the spike higher in inflation in developed regions looks likely to persist for longer than had previously been expected, while at the same time the downside risks to the economic outlook have increased somewhat.

The market is now pricing in higher interest rates as a solution to a problem that is not about too much demand, but is about too little supply. Whilst higher interest rates have historically been used by policymakers to rein in an economy that is running too hot, it will do very little to alleviate the issues of supply where prices, particularly in the energy space, are no longer the result of a booming economy but a broken supply chain. As a result, any tightening of policy may have a bigger impact on financial assets than it will on demand and inflationary bottlenecks. Central bankers are aware of this and have been hesitant to tighten policy too quickly and stifle economic growth in the process of doing so.

Federal Reserve

Last month we saw the Federal Reserve in the US confirm market expectations that they will indeed begin to reduce the pace of their bond purchases during November, as inflation in the region proves persistent, at least for now, and the broader US economy makes a solid recovery from the pandemic. The relatively low volatility and positive market reaction we saw in the aftermath of the release reflects the central bank's painstaking six-month effort to prepare and communicate to investors its plans for the tapering of its massive pandemic-era stimulus "It is appropriate to be patient" said Jerome Powell during his press conference, referencing the fact that the Fed still believes it is far too early to think about hiking rates in the United States. The central bank outlined its plan to reduce its asset purchases by $15 billion per month (which incorporates a $10bn reduction in Treasuries purchases and $5bn in mortgage-backed securities), in line with consensus expectations, and reiterated its plans to have the stimulus entirely withdrawn by the middle of 2022.

The Fed of course kept its main interest rate within its target range of 0.00% - 0.25%, we note there was unanimity within the central bank on the policy announcements. With the Fed having already well communicated its QE tapering, a key focus for the market was on its latest views on inflation and in turn what it implies for the interest rate outlook. The Fed altered its view slightly this time around, now acknowledging that price pressures have outpaced expectations and are likely to continue on for longer due to worsening supply chain bottlenecks. It now states that while inflation is elevated, it largely reflects factors that “are expected to be transitory” whereas in the September statement it did not use the word “expected”. However, the Fed also added to this month’s text that imbalances between supply and demand linked to the pandemic and the re-opening of the economy have played a role in the notable price rises in certain sectors.



Source: Refinitiv, AIB

Federal Reserve*, contd........*

In terms of market expectations, futures contracts are pricing in a more aggressive pace of tightening compared to the Fed's September projections for the next year. The market envisages the first rate hike to come in the US in May. Two additional hikes are now being priced in for the second half of next year, bringing the Fed funds rate to a range of 0.75% - 1.00% by December 2022.

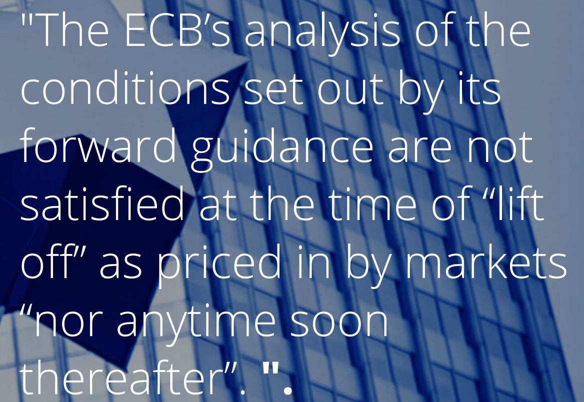
In the post meeting press conference, Powell was asked about his view on market expectations for rate increases next year. In response he stated that the timing of any lifting in interest rates "will be dependent on the economy". He said that "we don't think it is time yet to raise interest rates" and that there is more improvement in the labour market required to reach its goal of maximum employment, but that this objective could perhaps be reached by late next year. The Federal Reserve's final meeting of the year will come on December 14th and 15th, at which point we will be provided with updated projections from policymakers on inflation, interest rates, and the general US economy.

European Central Bank

As expected by European investors, the ECB's October meeting was largely uneventful. The central bank left its deposit and refinancing rates unchanged, at –0.5% and 0%, respectively. The most recent policy change from the ECB came at its prior meeting in September, when it announced a recalibration of its Pandemic Emergency Programme (PEPP), stating its intention to reduce the pace of monthly asset purchases to a moderately lower pace in Q4 compared to the middle of next year. The meeting statement pointed to the fact that that the Eurozone economy has continued to recover strongly, although it did acknowledge that "momentum had moderated to some extent". In this regard, the ECB stated that shortages of raw materials, equipment and labour are acting as a headwind to production in some sectors as well as "clouding the outlook" for the next few quarters.

The most recent update to the ECB's macroeconomic forecasts were released at the previous meeting back in September. These projections showed an upward revision to its growth expectations for 2021 to 5.0%, from 4.6%. For 2022 and 2023 its growth projections were left broadly unchanged at 4.6% and 2.1% respectively. The central bank's assessment at October's meeting is that the risks to the economic outlook for the Eurozone remain broadly balanced. Meanwhile, in terms of the key topic of inflation, the ECB commented that they project inflation will rise further in the near term, but that it should fall over the course of 2022.

Source: TradingEconomics.com, Eurostat



European Central Bank *, contd........*

We did see the ECB acknowledge that the recent spike higher in prices will last for longer than they had originally expected. President Lagarde elaborated further on this, discussing that the recent move higher in inflation (shown on the above chart) is mainly due to three factors. Firstly, sharp rises in energy prices, with the second factor relating to the fact that the recovery in demand was outstripping supply. Thirdly, base effects related to the expiry of the German VAT cut. The President emphasised the ECB's assessment was that all three factors would "ease over the course of 2022" and likely fall out of the year-on-year calculation. The ECB revised higher its inflation projections in September. It is anticipating headline inflation to average 2.2% (from 1.9%) this year, and is projecting it at 1.7% (from 1.5%) in 2022 and 1.5% (from 1.4%) in 2023.

Markets are now expecting the ECB to begin hiking rates sooner than previously envisaged. Futures contracts suggest the possibility that the ECB could start to hike rates, albeit gradually, during the second half of next year. At the time of the last Governing Council meeting in September, the market was not discounting a rate hike until late 2023/early 2024. During her press conference after the latest meeting, President Lagarde was asked several times about the hawkish shift in market expectations for Eurozone interest rates. She pushed back strongly against them. The President saying that the ECB's analysis of the conditions set out by its forward guidance are not satisfied at the time of "lift off" as priced in by markets "nor anytime soon thereafter".

Bank of England:

The BOE surprised investors this month when it opted to keep its key official rate unchanged at 0.10% despite consensus forecasts for an increase. This move led bond yields in the UK to see their largest fall in years, yields on 1-year government bonds halving within hours, in what was their biggest move since 2009. Significant market moves were not just limited to bonds however, with the British Pound seeing its biggest one-day fall against the Dollar in over a year. Of the nine voting members at the central bank, seven opted to go for no rate change this time around. Surprisingly, this seven included the Bank of England Governor Andrew Bailey, who had made quite hawkish comments in the weeks leading up to this meeting, leading investors to believe the bank would begin its hiking cycle this month in the face of higher-for-longer inflation. Meanwhile, there was a 6-3 vote on leaving the bond purchasing programme at its current size, three members voting for a reduction from £875b to £855b.

In terms of projections, the central bank is now expecting GDP growth in the UK of 7% this year (down from 7.25%), with 5% in 2022 (down from 6%), and an unchanged 1.5% for 2023. The BOE also revised higher its inflation forecasts, citing supply-side disruptions. CPI is now estimated to come in at 4.25% this year (vs previous 4%), peaking at 5% next April, with an average inflation of 3.5% for 2022. The bank sees inflationary pressures falling off to 2.25% by 2023 and just below 2% the following year. This inflation forecast is based on official rates rising to 1% by Q4 2022 and remaining around this level over the following two years.

Towards the end of September, we heard an interesting comment from BOE Governor Bailey, when he alluded to the fact that central banks should exercise caution when looking to tighten policy this time around, and that supply-side issues are a significant factor at present. “In considering how to use monetary policy, it is also important to understand the nature of the shocks that are causing higher inflation. The shocks that we are seeing are restricting supply in the economy relative to the recovery of demand. This Is important because monetary policy will not increase the supply of semi-conductor chips, it will not increase the amount of wind, and nor will it produce more HGV drivers. Moreover, tightening monetary policy could make things worse in this situation by putting more downward pressure on a weakening recovery of the economy” he said.

Appendix 1

COP26 Outcomes

1) New pledges on methane pollution

More than 100 countries have now joined a U.S. and E.U.-led coalition to cut 30% of methane gas emissions by 2030 from 2020 levels, a significant step towards limiting one of the major culprits of climate change.
The Global Methane Pledge covers countries that account for nearly half of global methane emissions and 70% of global GDP. Methane is 84 times more potent than carbon and doesn't last as long in the atmosphere before it breaks down. This makes it a critical target for combatting climate change quickly while simultaneously minimizing other greenhouse gas emissions.

The pledge includes six of the world's 10 biggest methane emitters — the U.S., Brazil, Indonesia, Nigeria, Pakistan, and Mexico. But China, Russia, and India, which together comprise 35% of global methane emissions, did not join the coalition. "It's going to make a huge difference, not just when it comes to fighting climate change — it's going to improve health, improve food supply and boost economies," President Joe Biden said at the launch of the pledge.

2) An eleventh-hour agreement on coal

The summit negotiations ended with a final deal among nearly 200 nations that for the first-time targeted fossil fuels as the key driver of climate change. The deal, however, contained a last-minute change that some officials called a softening of critical language regarding coal power.

India and China, some of the world's biggest burners of coal, insisted on a last-minute change of fossil fuel language in the pact, switching the words from a "phase out" to a "phase down" of coal. Opposing countries fought the request but ultimately conceded. Some experts, disappointed by the change of language on coal power, said the deal was still better than nothing and provides incremental progress on transitioning from fossil fuels to clean energy.

3) A U.S.-China pledge to slow climate change

The U.S. and China, the world's two largest emitters of carbon, agreed to cooperate this decade to prevent global warming from surpassing 1.5 degrees Celsius and ensure that progress result from the conference. The alliance between the rivals surprised delegates during the summit. The U.S.-China agreement lacks specific details or deadlines but emphasizes that Chinese and American leaders will work to boost clean energy, mitigate deforestation and slash methane emissions.

4) Strengthening 2030 targets to reach 1.5°C goal

Some experts have billed the conference as humanity's last and best chance to support the goal to not surpass 1.5 degrees Celsius of global warming — the temperature target inscribed in the 2015 Paris Accord.
Countries ultimately agreed to submit tougher 2030 targets next year and to put forward long term strategies to aid the transition to net-zero emissions by around mid-century in order to avoid the worst consequences of climate change.

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