Market Commentary May 2015

Investment Markets in May 2015

Highlights

- A sharp rise in bond yields in the first half of May led to increased volatility in equity markets.
- European sovereign bond yields fell back at month end as the ECB said that growth indicators in the Eurozone warranted acceleration of its bond buying programme over the summer.
- US equities made further gains.
- Japanese equities were very strong in May, reflecting stronger than expected economic data.
- Oil prices continue to recover.

Investment Market Performance

	Year to Date		May - 2015	
Index	**In local Currency (%)**	**In € %**	**In local Currency (%)**	**In € %**
ISEQ Index	20.1%	20.1%	3.8%	3.8%
FTSE 100	6.4%	15.0%	0.3%	2.1%
Eurostoxx 50 Index	13.5%	13.5%	-1.2%	-1.2%
S&P 500	2.4%	12.9%	1.0%	3.3%
Nikkei 225	17.8%	25.7%	5.3%	3.8%
FTSE All-World	4.3%	15.0%	-0.3%	1.8%
Oil	13.2%	24.8%	1.1%	3.3%
Eurozone Government Bonds		1.5%		-1.5%
USD / Euro		10.1%		2.1%
GBP / Euro		8.1%		1.8%

Source: Bloomberg

Bond Market Correction Unlikely to Continue in the Short Term

April and May saw the first significant upward movement in global bond yields in some time. Low and negatively yielding Eurozone bonds saw the most significant falls in value. A slight improvement in European economic data caused investors to question the consensus outlook of economic stagnation for the single currency area over the coming years.

German 10 Year Government Bond Yields over the Last Two Years

Source: Bloomberg

The upward movement in yields has resulted in a fall in value of between 0.5% and 2.5% in many of the bonds and bond ETFs we review. These declines are modest, however, in comparison with the gains of the last 18 months and are, we believe, unlikely to continue. While the recent improvement in Eurozone economic data appears to reflect the benefits of the weaker euro and lower oil prices, the structural challenges facing the core Eurozone economies remain in place. The most significant of these is demographics, with an aging and declining population acting as a significant headwind for economic growth in Europe in the medium term. Specific threats to short term sentiment towards the Eurozone, such as a possible Greek default and exit from the single currency, have also not diminished.

The outlook for interest rates for the Eurozone remains exceptionally benign with few forecasting any movement in rates over the next two years.

Credit Suisse – Interest Rate Change Expectations 1 Year Out

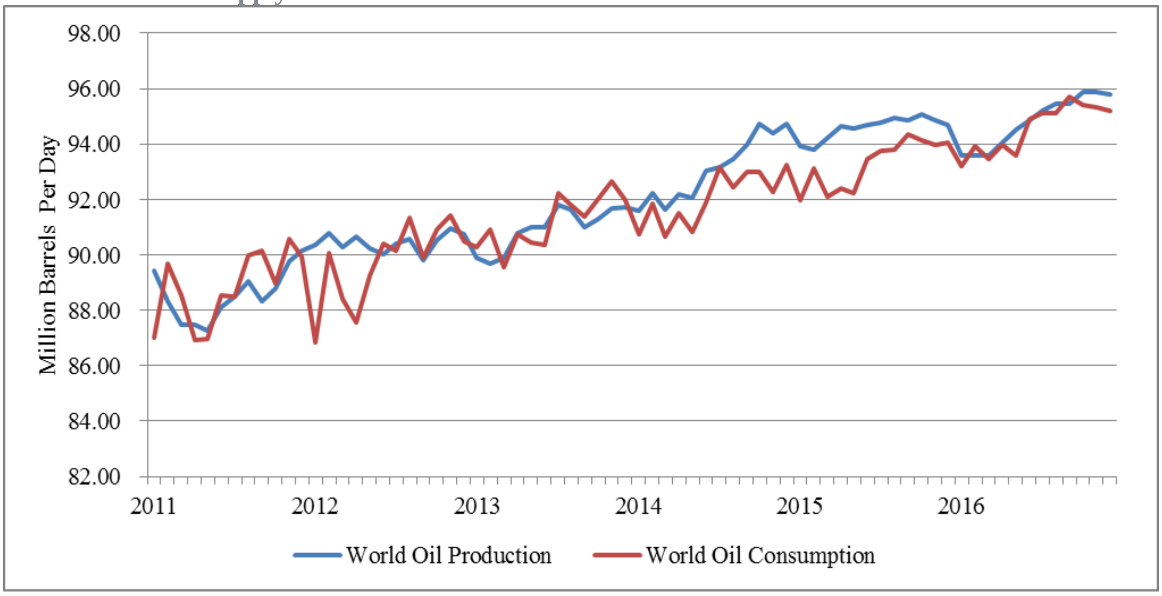
Source: Bloomberg and Credit Suisse

The most significant threat to bond prices in the medium term is a sudden rise in interest rate expectations, reflecting higher than expected inflation. We see the threat here as being a more long term issue with Eurozone inflation remaining close to zero even with the recent recovery in oil and food prices.

Oil

We expect continued recovery in the oil price. Over the past month, crude oil prices have traded either side of $60 per barrel, having rallied from a low of $43 in March. As with any commodity, short term variances in supply and demand are significant determinants of near term pricing. The chart below outlines global crude oil supply and demand from 2011 along with the US Energy Information Administration's forecasted supply and demand levels out to the end of 2016. Supply exceeded demand in mid-2014. Demand for crude oil is, however, expected to come back in line with supply towards the end of 2015 as US shale and higher cost wells output falls.

Global Crude Oil Supply and Demand



Source: US Energy Information Administration, Monthly Energy Review, April 2015

The forecasted narrowing of the gap between supply and demand between now and mid 2016 supports our positive outlook on oil prices.

WTI Crude Oil Price – Last Two Years

Source: Bloomberg

Bank of Ireland

In its Q1Interim Management Statement (IMS) on 29 April, Bank of Ireland updated the market on the effect of declining bond yields on the deficit in its defined benefit pension scheme. They disclosed that the bond yields used as a basis for valuing the scheme's liabilities fell by 80 basis points from 31 December 2014 to 31 March 2015, thereby increasing the pension deficit from just under €1bn to €1.7bn. Although other operating activity remained positive, the pension announcement caused significant concern in markets with the share price falling by 6% on the day of the statement.

The recent increase in Eurozone government bond yields has been reflected in a similar increase in the yields on highly rated corporate bonds which are used to value pension liabilities. This increase in yields, along with the likely strong performance of the pension scheme assets, is likely to have resulted in a reversal of the increase in the pension deficit announced by Bank of Ireland in April. The Q2 IMS is scheduled for 31 July and we expect a positive announcement from the company with regard to pension costs reflecting the recent increase in yields.

Bank of Ireland Share Price over Last Two Years

Source: Bloomberg

Greece

The ongoing negotiations between Greece and its EU/IMF creditors continue to worry markets. Concerns of a Greek default currently centre on the €1.6bn due to the IMF in four instalments, the first €0.3bn of which is due on 5 June. Tensions rise and fall on a daily basis. Greek and EU negotiators have spoken of progress and the expectation that Greece can make good on their IMF June obligations. Insider commentaries, however, often suggest that the two sides are far from reaching any meaningful agreement.

While Greek, Spanish, Portuguese and Italian bond yields have risen in recent weeks, their increase has tracked those of higher rated sovereigns such as Germany and France. Credit spreads, that is the premium required by investors for investing in bonds of a lower quality than German bonds, have remained relatively stable. Grexit talk has primarily been reflected in higher volatility in equity markets and in euro weakness.

Greek 10 year Bond Yields over the last 5 years

Source: Bloomberg

We believe that, unlike previous instalments of the ongoing Greek debt crisis, the euro and European equities may be significant losers were the situation in Greece to deteriorate further.

Agricultural Commodities – An El Nino Year Could See an Increase in Price Volatility

The EL Nino Southern Oscillation (ENSO) cycle describes the fluctuations in temperature between the ocean and the atmosphere in the east-central Equatorial Pacific. The intensity of El Nino events varies significantly from weak temperature increases of 2-3 degrees Celsius with only moderate local effects on weather and climate, to very strong effects on weather and climate with temperature increases of 8-10 degrees. These are commonly known as “super events”, the last of which occurred in 1997.

During an El Nino event, westerly winds weakening across the equator cause warm surface water to move eastward along the equator from the western Pacific to the coast of South America. This can result in drastic rises in rainfall in Central America and western South America in areas that are normally arid. Conversely, El Nino brings drought to Indonesia and Australia. El Nino impacts on atmospheric circulation also. The eastward movement of oceanic and atmospheric heat sources causes unusually severe winter weather at the higher latitudes of North and South America. Regions as far north as the U.S. states of California and Washington can experience longer, colder winters.

The investment asset class most obviously impacted by significant changes in climate is agricultural commodities. Initial indications for this year suggest that temperature increases in the Pacific have been significantly greater than in previous El Nino years, which may suggest the possibility of a so called “super event”. While direct relationships between key El Nino indicators and food commodity prices are difficult to quantify, at a minimum such a development would increase the unpredictability of weather conditions in some of the world’s most important food producing regions putting upward pressure on prices and increasing price volatility.