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INSIGHT

ISSUE 10

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Weighing up the pros and cons

TOP TRUMP

Winners and losers from the seismic US election result

INVESTMENT OUTLOOK

Taking advantage of opportunities in 2017

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BUCKLEYKIELY
WEALTH MANAGEMENT
Independent Financial Advisors

WELCOME

Welcome to the first issue of *Insight* for 2017 from Buckley Kiely Wealth Management. After a game-changing 2016, the investment environment was not only mixed but characterised by uneven global growth and political events such as Brexit and the US elections. Looking ahead to this year, gradual repair of the global economy and greater political clarity in the USA should allow investors to take advantage of opportunities in 2017. However, political events could again trigger further turbulence this year, but central banks will probably continue to suppress market risk. On page 03, we look at how in such an environment, market corrections can offer opportunities for appropriate investors.

With many defined benefit schemes underfunded, employers are offering enticements to exit – but there are risks. It's a reflection of how much the pension landscape is shifting that growing numbers of defined benefit pension scheme members are willing to consider exiting before they reach retirement in return for a higher transfer value. On the face of it, it seems absurd to even consider opting out of a defined benefit pension scheme, even if you don't work for the company anymore. After all, it's the most valuable type of pension scheme – as far as employees are concerned – as the company is promising a guaranteed income in retirement. Find out more on page 06.

After a long and brutal US presidential election campaign, Donald Trump emerged victorious, winning 279 electoral votes and 47.5% of the popular vote. Republicans also maintained majorities in the House and the Senate. His inauguration is scheduled for Friday 20 January. Trump will be sworn in as the 45th President of the United States on the steps of the US Capitol at noon, when current president Barack Obama's term expires. Initially, the clear winners of this seismic election result appear to be US infrastructure and business. Trump has pledged to rebuild roads, rail, hospitals and schools, and promised US corporations will pay no more than 15% tax on profits: the biggest concession since Reagan's tenure. Read the full article on page 08.

The full list of the articles featured in this issue appears opposite. We hope you enjoy reading this issue and find it informative. To discuss any of the articles featured, please contact us.

Kind Regards,

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After a game-changing 2016, the investment environment was not only mixed but characterised by uneven global growth and political events such as Brexit and the US elections.

Looking ahead to this year, gradual repair of the global economy and greater political clarity in the USA should allow investors to take advantage of opportunities in 2017. However, political events could again trigger further turbulence this year, but central banks will probably continue to suppress market risk. In such an environment, market corrections can offer opportunities for appropriate investors.

FISCAL EXPANSION

Global growth should improve somewhat in 2017 but remain well below pre-crisis levels. The differentials between countries are likely to stay pronounced, not least as high debt limits the leeway for fiscal expansion in the weaker economies. Commodity price stabilisation in 2016 suggested that inflation should edge up. With the inflation upturn more advanced, the US Federal Reserve is likely to raise rates further, albeit cautiously. Other central banks should maintain a more accommodative stance but shift away from mechanical balance sheet expansion.

Interest will be given to watching US policy and investment plans to see how these are going to be delivered. Within Europe, there will be continued key Brexit negotiations that will impact on economies and corporate profitability. Overriding that, in 2016 there was a very strong US dollar, so it will be interesting to see how this plays out for international companies.

IMPORTANT FACTORS

The price of oil will again be very important. It recovered gently in 2016, and it will be interesting to see whether supply contracts and whether we see a rise in the price – both of which tend to dent global growth. Undoubtedly, there will be a lot of important factors that will have a bearing in 2017, and trying to judge how they all interact will be the key to making investment decisions.

Some analysts expect global growth to improve in 2017, though any acceleration is likely to be limited. Due to stabilising commodity prices and the advanced US business cycle, inflation should edge higher but not pose a threat.

LONGER-TERM GROWTH

The Eurozone, the USA and Japan should see continued moderate economic growth. The longer-term growth outlook for the UK is clouded, as Brexit could depress investment. The path to Brexit will continue to dominate the headlines and take up a great deal of political energy. An important consideration for the markets is how and when the European Central Bank chooses to normalise its monetary policy. It also promises to be an eventful year in the broader (EMEA) region.

Due to the divergence between a slightly tighter Fed and a still very accommodative ECB, the EUR is unlikely to make gains against the USD. The GBP should stabilise given its drop below fair value in 2016.

EQUITY VALUATIONS

US earnings growth is needed to sustain higher equity valuations. With fewer buybacks, rising yields and earnings expectations vulnerable to disappointment, the S&P 500 total returns are expected to be in the region of 3–5% in 2017. Non-US investors will need to look out for further bouts of dollar weakness to offer opportunities to accumulate the US currency and add asset exposure for yield and potential currency gains through 2017.

STABLE GROWTH

Asia should look forward to stable growth in 2017, underpinned by a structural transition from manufactured exports to services-based consumption. A supportive confluence of firming economic growth, reasonable valuations and improving profitability have lead many commentators to suggest that emerging Asian equities should perform well in 2017, possibly outperforming their global counterparts.

After a prolonged period of weakness, there are signs of a moderate growth improvement in Latin America, while inflation is retreating. Central banks should be able to ease policy, albeit cautiously. Still fairly high real interest rates bode well for continued gains in Latin American fixed income. The outlook for Latin American equities looks more muted than in other emerging markets given fairly high valuations. ■

BUILDING THE INVESTMENT PORTFOLIO THAT SUITS YOU

By understanding your financial goals, we can proactively help you build the investment portfolio that meets your aims and objectives. Ultimately, you choose the level of advice that you need, and we work with you in a way that suits you. To find out more, please contact us.

MARKET COMMENTARY

Financial markets are recalibrating expectations for 2017

The end of 2016 saw mixed equity market returns across regions towards the end of 2016. The results of the US presidential election spurred the S&P 500 higher, hitting an all-time peak of 2,213 towards the end of the year before closing up 73 points at 2,199. In contrast, UK markets retreated slightly, closing down 170 points at 6,784. The FTSEurofirst moved up 12 points to 1,350, regaining previously lost ground. Asia and EM produced negative returns in sterling terms, hindered by a bounce in the pound. Bond markets were also weak, with ten-year yields rising 17bp to 1.42%.

Global economic activity has improved as the result of a small increase in world trade and an associated upturn in manufacturing. The US continues to perform strongly, whereas Japan is weak – although both are in line with expectations. Chinese, eurozone and UK activity is ahead of expectations, albeit that the latter is slowing and the full ramifications of the decision to leave the European Union have yet to be seen. The Trump election victory was a surprise to financial markets and potentially heralds a sea change in the global economic order were the rhetoric on protectionism enacted. Markets suspect the latter will be limited and the US – and to a lesser extent the rest of the world – will benefit from a series of reflationary measures including tax cuts and infrastructure spending. Rebuilding America would likely boost the demand for commodities and capital goods – many of which are only available from outside the US, so global trade should benefit.

BOOST TO ECONOMIC ACTIVITY

The Republican control of both the House of Representatives and the Senate suggests the boost to economic activity will be enacted without delay in Q1 2017, adding to the upturn in activity which was already underway in Q3. Ongoing consumer strength has been boosted by a modest upturn in capital expenditure, stronger agricultural exports and inventories. While the prospect of fiscally driven reflation is good news for nominal GDP, it is potentially bad news for inflation which, in the US at least, had already been showing some small signs of edging up. The dampening effect of lower energy prices on headline inflation is beginning to fade, so CPI could soon be 2.5% or more. The real issue is labour costs where – against the very low inflation background and below 5% unemployment – wages have already been rising 2% per annum. It is therefore easy to envisage a situation where wages are rising 4% by 2018.

Stronger-than-expected Chinese activity and Yen strength that boosted GDP in 2016 will both likely reverse this year. Over time, Japan also faces the structural threat from China moving up the value chain. The upturn in nominal wages hasn't dislodged the reliance on bonuses, and consumers remain relatively cautious. Yield targeting by the Bank of Japan will help keep ten-year yields depressed and act as a dampener on the Yen.

FISCAL STIMULUS

Markets have been once again wrong-footed by geo-political events. The populist vote is rejecting austerity and current policy in favour of fiscal stimulus; hardly surprising given the median US household is no better off than 20 years ago, but perhaps ignorant of the longer-term consequences of inadequately resourced care and pensions. After last year's surprise Brexit vote, sterling and bond yields fell as markets feared a slump. Contrast this with the surprise Trump victory, which has seen the US dollar strengthen and bond yields rise sharply. In both cases, equities have fared surprisingly well and accelerated a global reflation trade that had already been underway since the start of July. Most significant has been the sector rotation out of defensives and high yield bond proxies into cyclicals, most notably financials. Government bond yields are up as inflation prospects have turned, and the near certainty of the second US rate rise in December has boosted the US dollar. Yields may have over-reacted in the short term but are only back to levels seen in the early part of last year, so the trend remains upward. Emerging markets have succumbed to profit taking after an exceptional year and on fears of US protectionism. In the energy space, oil prices received a boost, with OPEC agreeing a production cut of 1.2 million barrels per day – around 4% of current output. This has pushed Brent crude above $50 per barrel, but it remains to be seen how much of the proposal is actually adhered to.

Financial markets are recalibrating expectations for 2017, but it is likely nominal GDP estimates will increase for the US and elsewhere. The adjustments to inflation expectations are likely to be more significant coming from such a low base. Fiscal easing – either through lower taxes or higher spending – and deregulation will boost US corporate sales growth. But higher inflation, a steeper yield curve and rising interest rates may squeeze profit margins through higher costs. So there is very much a two-way pull in terms of estimating the impact on corporate profits. A lowering of the effective corporation tax of 28% to a flat 20% could add nearly 10% to US earnings per share, but some of this would be offset by a stronger dollar. The starting valuation for equities also matters in terms of realising future returns, as previous reflation packages have been launched at much lower levels. ■

STEADY CONSUMER SPENDING

Business surveys suggest eurozone activity will accelerate in Q4 as a modest rebound in business investment builds on steady consumer spending. The boost from cheaper energy is waning and credit conditions have tightened a touch, but corporate profits have picked up and net trade is likely to improve in line with global trade trends. Wages are subdued and productivity improving, so companies are well placed to fund investment from their retained earnings. European Central Bank policy remains supportive, but scaling back quantitative easing must be a possibility.

While UK GDP has slowed from previous levels, purchasing manager surveys suggested business activity accelerated in Q4, consumer confidence was high and retail sales increased at over 7% per annum. Spending is likely to ease as the impact of sterling depreciation feeds through to significantly higher goods prices and declining real disposable incomes. As elsewhere, inflation is starting to tick-up but remains at very low levels. Nevertheless, the prospect of another rate cut has faded, and the Autumn Statement, while containing positive messages – including a £23 billion increase in infrastructure spending – is unlikely to provide much of an additional boost as government finances are constrained (far more so than in the US, for example).

THE DEFINED BENEFIT CONUNDRUM

Weighing up the pros and cons

With many DB schemes underfunded, employers are offering enticements to exit – but there are risks. It's a reflection of how much the pension landscape is shifting that growing numbers of defined benefit pension scheme members are willing to consider exiting before they reach retirement in return for a higher transfer value.

On the face of it, it seems absurd to even consider opting out of a defined benefit pension scheme, even if you don't work for the company anymore. After all, it's the most valuable type of pension scheme – as far as employees are concerned – as the company is promising a guaranteed income in retirement.

But of course, there is a reason employers and the pension industry call it the 'defined benefit conundrum'. Most defined benefit schemes (including the ones that are closed to new members) are now underfunded. In fact, recent figures from the HR firm Mercer show the defined benefit pensions 'hole' at Ireland's largest companies doubled in the first seven months of 2016.

So it's easy to see the appeal for the firms in offering members an enhanced transfer value (ETV) in order to get them off their books and reduce their liabilities. Many companies have already been piloting 'ETV exercises' to encourage members to leave their defined benefit scheme by accepting a top-up to their standard transfer value. The decision for members to take the ETV is finely balanced and will ultimately come down to the member weighing up a number of competing interests, and a certain level of crystal ball gazing.

CRYSTAL BALL

Indeed, if you are offered an ETV, it soon becomes clear why you'll need that crystal ball: it will be difficult to ascertain the long-term commitment of the company to maintaining the scheme. After all, there's nothing to stop it winding up a scheme if it remains underfunded.

For most people, it will involve weighing up the pros and cons. Staying in the scheme and drawing a defined benefit pension provides a simple, easy-to-understand stream of income for the rest of your days – but on the assumption that the scheme is still there once you come to retirement age.

If a scheme is underfunded, alarm bells should be raised, particularly so if there is additional concern around the company's ongoing commitment to funding the scheme.

However, even assuming the scheme is underfunded, the conundrum for many is more to do with weighing up the guaranteed income for life versus the 'mortality risk' of staying in a defined benefit scheme – that is, if you and your spouse die, your pension dies with you.

The alternative presented by products such as approved retirement funds (ARFs), whereby you can continue to invest your money after your retirement rather than the DB and annuity route, is becoming more appealing because the pension fund becomes a component of family wealth. Albeit, with an ARF, you do experience investment risk or replace mortality risk with investment risk, but some people are happy to do that because they view their pension pot as part of a family wealth product.

All the same, the onus is firmly on the company to make an ETV offer attractive to ensure a critical mass of uptake. If a company runs an ETV programme with little take-up from members, they will simply incur a lot of consultancy fees for little financial gain. They have to make it attractive for the members.

TRANSFER VALUE

The standard way of calculating a member's transfer value applies a heavy discount to the sum of money available to younger members of the scheme. As a result, some companies are making proportionately higher transfer offers to younger members than those closer to retirement – which might mean a 50% or even a 100% top-up for the numbers to make sense for a younger member.

How much the scheme counts in terms of a member's overall retirement assets is another important consideration. Where a scheme forms the bulk of an individual's retirement assets, it may not make sense to accept the offer unless they have serious concerns over the future of the scheme. But even if the company's commitment to the scheme seems watertight for the moment, it will be a much harder decision if you are still some years away from retirement.

The key question to ask is, 'Can I reasonably expect to invest the transfer value and match the level of income the DB scheme would pay without taking excessive risk?' Needless to say, taking the ETV and buying an annuity will almost certainly mean a reduced retirement income compared to the DB pension.

So, leaving a scheme will ultimately involve a higher level of risk and more hands-on management of your money in retirement if you want to make the sums add up.

However, one could challenge the notion that it's a bigger risk. The term 'defined benefit' is arguably slightly misleading as it's a promise of a pension. At least with a defined contribution pension you have the option to upgrade it, you know what you have in your pot, and you know what's there. How does one assess the robustness or otherwise of a promise? That's extremely difficult. ■

ON THE FACE OF IT, IT SEEMS ABSURD TO EVEN CONSIDER OPTING OUT OF A DEFINED BENEFIT PENSION SCHEME, EVEN IF YOU DON'T WORK FOR THE COMPANY ANYMORE. AFTER ALL, IT'S THE MOST VALUABLE TYPE OF PENSION SCHEME – AS FAR AS EMPLOYEES ARE CONCERNED – AS THE COMPANY IS PROMISING A GUARANTEED INCOME IN RETIREMENT.

OBTAIN PROFESSIONAL FINANCIAL ADVICE

For further information, please contact Buckley Kiely Wealth Management on 021 4350777 or email wealth@buckleykiely.ie – we look forward to hearing from you.

TOP TRUMP

Winners and losers from the seismic US election result

After a long and brutal US presidential election campaign, Donald Trump emerged victorious, winning 279 electoral votes and 47.5% of the popular vote. Republicans also maintained majorities in the House and the Senate.

His inauguration is scheduled for Friday 20 January. Trump will be sworn in as the 45th President of the United States on the steps of the US Capitol at noon, when current president Barack Obama's term expires.

WHO ARE THE CLEAR WINNERS?

Initially, the clear winners of this seismic election result appear to be US infrastructure and business. Trump has pledged to rebuild roads, rail, hospitals and schools, and promised US corporations will pay no more than 15% tax on profits: the biggest concession since Reagan's tenure.

Fossil fuel companies could benefit given Trump's disbelief in global warming and promotion of US energy independence. Pharmaceuticals could too, with price controls less of a concern than if Clinton had won. Finally, banks could flourish as regulations are potentially relaxed.

GREATEST IMPACT FOR THE US ECONOMY

Areas of greatest impact for the US economy are increased fiscal spending, an issue with clear bipartisan support and the more negative uncertainty associated with Trump's trade policy. On international trade, there is potentially greater uncertainty as a result of Trump's ability to unilaterally act on tariffs without Congressional approval. This is as far ranging as withdrawals from trade agreements like North Atlantic Free Trade Agreement (NAFTA) or as tactical as his much-talked about China tariffs.

The UK, European and Asian markets initially fell on news of America's election result, but markets then largely recovered. The short-term market reaction reflected this uncertainty, but for investors the long-term outlook is more important.

KEY POINTS TO CONSIDER

First, the US economy that President Trump inherits is in relatively good shape. Economic growth picked up in 2016, while the unemployment rate is close to any economist's definition of full employment. Profits of companies in the S&P 500 rebounded smartly from the oil-and-dollar-induced slump of 2015, and inflation is still moderate. Moreover, the global economy is also showing signs of life, with the global manufacturing purchasing managers' index – a survey of activity in the manufacturing sector – hitting a two-year high towards the end of last year. All of this, absent political uncertainty, would be positive for share prices and negative for bonds.

Second, the uncertainty and volatility following the election will (for now) reduce the probability of US interest rate rises, although the Federal Reserve will want to leave its options open until it can assess the market and economic fallout from the election result.

Third, while the results represented a Republican sweep, actual policy change may be far less dramatic than was proposed by Trump during the campaign. It should be noted that there is a wide gulf between Trump's agenda and that of many 'establishment' Republicans, and the latter may well balk at unfunded tax cuts or spending increases. In addition, both the new president and Congress will likely act more slowly on dismantling the Affordable Care Act or trade agreements until some better alternatives can be found.

VOTERS CHOOSE CHANGE OVER CAUTION

It should also be noted that, as was the case elsewhere in the world last year, voters have chosen change over caution – and politicians tend to respond to what voters want rather than what they need. While the Trump agenda is unlikely to be implemented in full, members of Congress may be willing to go along with some proposals to increase spending, lower taxes, reduce illegal immigration and increase tariffs. If they do so, they may well further stoke inflation in an economy that is already heating up. Longer term, increasing government debt to fund these initiatives has obvious dangers.

In the medium term, a warming economy – further stoked by expansionary fiscal policy – could favour equities over government bonds. In the long term, maintaining a diversified portfolio of investments may be more important than ever. In light of the Brexit vote and the US elections, 2016 proved decisively that populism is a good political strategy – whether it proves to be good for long-term economic fortunes is another question entirely. ■

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