Zurich Investments

Reaching Peak Exposure

Investment Outlook 2019

INSIDE

World Review of 2018

Slowing global growth weighs

Source: Zurich Life International Equity Fund

Key Highlights

Equities – exposure liable to have peaked, but remains our preferred asset class

Fixed Income – a possible safe haven, but little upside potential

Strong headwinds are present in global markets, as the global economy moves through the cycle

Positive equity bull market battered by a trio of policy concerns; worries over China, corporate bond markets and low inflation trouble investors.

Dear Investor,

This time last year we thought that typical late cycle market volatility might emerge during 2018 especially since the previous year had been eerily calm. That volatility did in fact materialise, initially driven by trade concerns, but later in the year was energised by other factors. We kept large equity positions during the year which was reasonable given the size of the better performing US equity market in our portfolios and the dearth of defensive alternatives. A bias to buy on dips was broadly correct but the battering that equity markets endured in the fourth quarter has challenged that view.

The heading on this letter summarises what we think is on the minds of anxious investors at the moment and we've reflected these in some of our downside risks for the year ahead. The trio of policy concerns are all US-centred, namely US trade policy, US fiscal policy and US monetary policy. Trade was an obvious issue last year and remains so, albeit that the worst-case scenario of a downward spiral of retaliatory measures has not yet emerged, with China trying to position itself as a defender of the global trading system which is reluctantly responding to a US-initiated trade fight. The US tax cuts added unnecessary stimulus to a strong US economy and worsend the long-term debt profile of the US and reduced the fiscal buffers that are needed to deal with any economic slowdown whenever it comes.

While the US tax cuts were a boost to US corporates and consumers, trade and allied political spats have raised the risk premium and deterred animal spirits. In the background there has been some old-fashioned tightening of financial conditions, as US interest rates were normalised by a series of Fed hikes during the year. But with inflation failing to rise very much despite the strong real economic expansion in the US – the structural forces that have kept inflation low for many years now remain intact – investors think that the Fed may be on the verge of a policy error; an error that sees short term interest rates rising too much and the Fed unwinding its program of quantitative easing too rapidly.

Low inflation is also the flip-side of limited corporate pricing power and this in unhelpful for corporates who are very sensitive to the economic cycle or who have high levels of debt – and in some cases both. Hence the costs of borrowing in the riskier parts of the corporate bond markets have risen, especially in the US and Europe, and this tends to be a negative signal for equity investors. Low inflation supports low bond yields in what are perceived as the safer sovereign markets, hence German bonds remained ultra-expensive.

Equity investors could have coped with a slowdown in the Chinese economy – its historic stellar growth rates are at an end – but the trade developments have raised investors' risk premium on China more than we would have expected twelve months ago. Additionally the Chinese policy response has been different this time with less desire and capacity for impactful credit expansion – in fact it wants the opposite because debt levels are already 'excessive' – and more reliance on slower acting stimulus measures.

So while several market risk indicators are in the troublesome zone, it's still important not to simply extrapolate the last quarter and assume that the coming year will be a mirror image. The oil price is roughly 40% off its 2018 peak and economically sensitive copper around 20% from its 2018 peak – both of which are negative growth signals – but oil weakness is also akin to a tax cut given its pervasive use by consumers and companies. The broad consensus is that while there will be some slowing of global growth in 2019, overall growth should still be above trend – a view backed up by key surveys of forward looking indicators – and major market recessionary signals are still weak. But investors, who are sensitive to both rates of change and their second derivatives, do not seem comfortable that 2019's growth trajectory is fully reflected in equity valuations or that the negative momentum of growth indicators of the past few months has abated.

In the shorter term concerns about the pace of Fed hikes, trade fights and the growth outlook can be negated, risk premiums can be lowered, positive sentiment can re-emerge and equities rally. That would not be a shock over the next few months. But structural factors such as high debt and expansive central bank interventions, both of which put us into unchartered territory, will remain a concern regardless. That overall backdrop means we must be flexible.

For now we are holding our current equity and other asset positioning in our portfolios given the more attractive valuations in many equity markets. However, we acknowledge that current exposures are likely the peak for this cycle – hence the front page graphic and title – and our bias is more to sell into any strength than further buy any dips.

David Warren
Chief Investment Officer

2018 – The Year in Review

Markets throughout 2018 can be characterised as a standoff between fundamentals, specifically economic and earnings data - and geopolitical concerns, focused on the escalating global trade tensions, namely between the US and China. 2018 proved to be a more volatile investment landscape than in previous years, as the global economy continues to move through the market cycle.

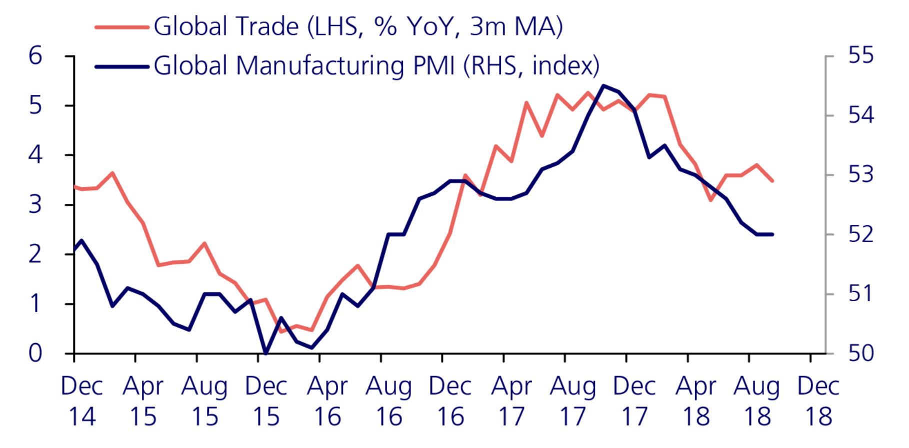
2018 has most certainly seen the return of volatility to risk assets, particularly in equity markets. The year began with a surge in January before stronger-than-expected US wage growth shook markets at the start of February, as concerns about tighter monetary policy came to the fore. Tariff posturing as an issue escalated throughout the year, and hit risk asset prices at a number of junctures; with December seeing the biggest falls. Within Europe, political risk was heightened once again, with Brexit, Italian fiscal policy, and French social unrest all evident.

Economic growth expectations remained above long-term averages in 2018, but did begin to trend downwards from previous years. Earnings overall remained positive, but there has been some deterioration in growth expectations, especially in the second half of the year. The global economic environment continues to evolve and faces headwinds going forward. The slowing pace of central bank stimulus and its ultimate reduction has led to increased volatility and dispersion in a number of asset classes, namely equities and fixed income. Diverging interest rates worldwide remain a key theme in markets; and whilst the overall macro backdrop remains positive, it is less synchronised than at previous points in the cycle.

Within equities, the influential US market was the best performer and helped to drag the global index into positive territory for large tracts of the year. This narrative was also replicated at a sector level with Technology leading the way for most of the year, before being overtaken by Healthcare in Q4, with heightened volatility present across all regions. This also resulted in bond markets experiencing some reprieve from what had been a move higher in yields. German 10 year bund yields have fallen this year, moving from 0.42% to 0.24% over the course of 2018.

The ECB confirmed the conclusion of balance sheet expansion under its Quantitative Easing programme. However it maintains a dovish policy stance, with the first rate hike expected to be approximately 12 months away. US 10 year yields have risen this year, as the Fed continues to carefully tread the path of tighter monetary policy with four interest rate hikes throughout the year. However, whilst the benchmark yield did hit 3.25%, it retraced on trade tension worries, and the subsequent slowing growth expectations.

Global growth has potential but should stabalise



Source: Markit, CPB, Bloomberg

2019 – Our Outlook Summary

Equities continue to be our preferred asset class versus fixed income and cash on a relative basis. Fundamental economic growth remains positive, albeit at a slowing pace. A series of lagging and leading economic indicators continue to signal the expansion of the global economy, and this helps to fuel earnings and spur corporate capital expenditure. Overall, global growth and inflation are likely to remain positive, but more modest than in previous years. However, this positive fundamental backdrop contrasts with the increased geopolitical risks evident globally and there are increasing risks and headwinds for the global economy.

We remain cautious in our outlook on European sovereign debt. The gradual withdrawal of accommodative monetary policy makes the long-term return prospects unattractive. As we move through the latter stages of the economic cycle, a cautious, selective approach is warranted and a divergence in the economic fortunes of various countries is becoming more apparent.

Tighter monetary policy is beginning to bite in parts of the global economy. Over the past years central banks have engaged in massive interventions in the markets and the withdrawal, or diminishing of that stimulus, may provide headwinds for global equities during the year ahead. Trade concerns could also continue to weigh on sentiment.

However at least some of this negativity is already discounted in market prices with global equities trading at a discount to their historical averages and bond yields at very low levels, particularly in core Europe. For example, at the beginning of 2019, equities are trading at approximately 13x projected 2019 earnings currently, with German 10 year bund yields yielding close to 0.24%, still an extreme level historically.

We are biased towards risk assets at the moment, despite the diminished potential when compared to previous points in the cycle, but continue to emphasise a dynamic approach to investment since volatility remains elevated. Volatility will likely be a feature of the investment cycle for the period ahead and as the year progresses, it may be appropriate to position for a change in the trajectory of the economic cycle.

> “Whilst an all-out trade war is not the base case scenario it remains a threat and risks in this regard are growing.”

Upside risks to outlook

- The Trump administration becomes more conciliatory in trade talks.
- Monetary policy easing if market concerns deepen
- Fiscal package and/or monetary easing from China
- Clean Brexit boosts European confidence

Downside risks to outlook

- Trade wars
- Chinese economy continues to slow
- European politics, in particular Brexit, France, and Italy.
- Policy error (fiscal or monetary misstep)

Equities Outlook

Global Equities trade at a discount to their historical averages and with bond yields still at very low levels (particularly in core Europe where they're at an extreme), relative valuations continue to favour equities. Earnings momentum has weakened of late for a variety of reasons; such as a weaker Chinese economy and escalating trade tensions. The Chinese government has introduced a number of monetary and fiscal measures to stabilise their economic growth rate, while the US and Chinese authorities are attempting to resolve their trade issues post the G20 meeting in November. A risk premium in relation to geopolitical events is evident in equity markets currently.

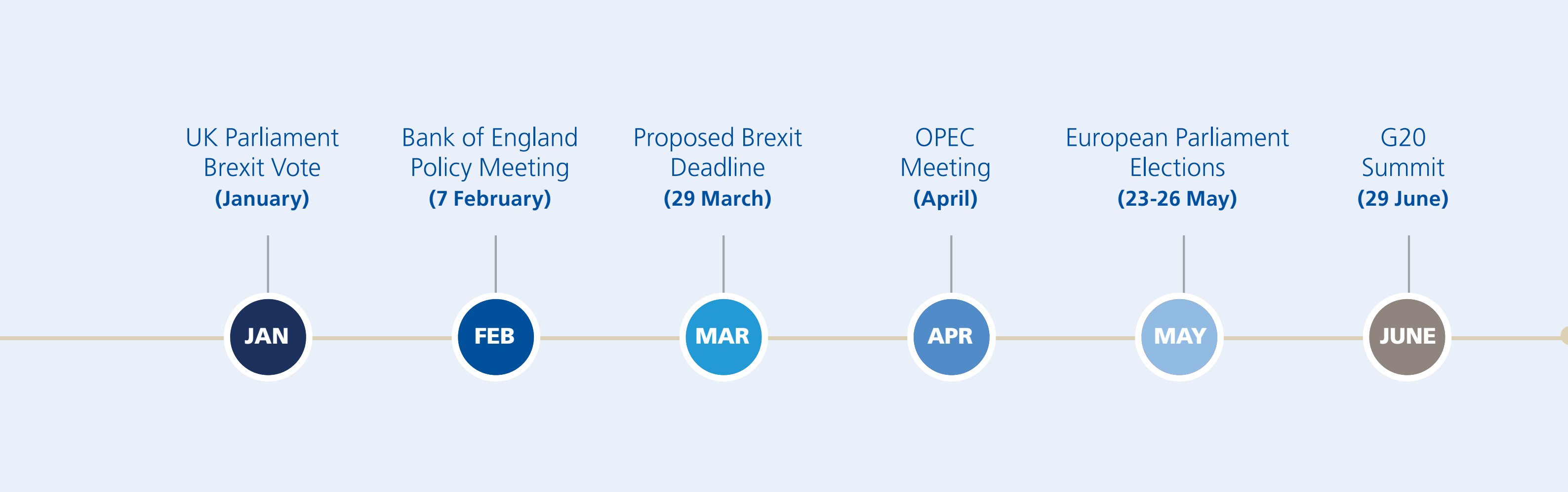
Asia is our preferred region as we enter 2019, as Asian equities trade at a discount to their historical averages whilst Chinese economic growth is expected to stabilise going forward due to fiscal and monetary measures taken by the Chinese authorities. Global earnings growth estimates for 2019 of circa 8% should be realistic if these measures prove effective, and a trade dispute resolution could ignite both business and investor appetites.

The US economy is expected to grow at a slower rate in 2019 as it faces possibly higher interest rates, the cumulative impact of rate hikes to date, and less fiscal stimulus than in 2018. Expectations for further increases in US interest rates have fallen materially of late due to commentary from US Federal Reserve Chair Jerome Powell suggesting that US interest rates are close to neutral. Rising interest rates throughout 2018 have caused some headwinds for equities including a stronger dollar, higher corporate borrowing rates, and the emergence of US cash as a viable alternative for investors.

US inflation expectations have fallen giving the US Federal Reserve reason to be cautious in their hiking program. We maintain a sizable allocation to US equities and share buybacks should remain a strong support for the US equity market. US consumer confidence remains at elevated levels and unemployment is at very low levels. US equities now trade in line with long-term averages, whilst European equities trade at a circa 14% discount to their long-term average.

However, European equities suffer from a weakening earnings profile, driven in part by their exposure to slowing global trade and emerging markets. Geopolitical issues such as Brexit and the recent concerns about Italian politics and its debt sustainability have weakened investor demand and business and consumer confidence has softened in the region. Should some of these issues resolve in a market friendly way, then European equities are likely to benefit, but we currently maintain a neutral exposure.

Preview of 2019



Fixed Income Outlook

ECB policy rates should remain low for an extended period of time due to low inflation. Although the perception of deflationary risks has diminished, a sustained pickup in inflation remains elusive. Overall, valuations remain unsupportive of most European fixed income instruments as a long-term investment. The price action of global bond markets is consistent with the end of a multi-decade period of falling long-term interest rates, but core Eurozone yields will remain at extremely low levels if and when domestic political worries come back into focus, for example in the UK or Italy. Although price action could be choppy, we maintain that the risk / reward backdrop is now skewed towards the prospect of higher yields.

Inflation is close to historically low levels. There are however some signs of upside wage pressures in the US and Europe. Low levels of inflation are a key focus for market participants and central banks alike. The path of inflation expectations during 2019 has the potential to be a key driver for financial assets. Credit markets struggled in 2018; a key test could arise when the market has to digest sizeable credit outflows.

The flattening of the US yield curve has become a focus for markets and some parts of the curve inverted towards the end of 2018, often, but not always a negative signal for risk assets. US rate expectations are in considerable flux and markets and the Fed are not aligned. While the Fed has said its future policy is 'data dependent' it has also committed to balance sheet contraction and promised higher rates. Investors meanwhile think they may have gone too far already.

The ECB has announced the conclusion of balance sheet expansion and President Mario Draghi's term ends in October 2019 which will usher in a new regime, with the first rate rise in the eurozone envisaged no earlier than Q4 2019. While raising rates from negative to zero or even a small positive should theoretically not be a difficulty, the ECB will nonetheless be sensitive to market reactions to both developments.

Wage Costs

New EU Parliaments President Term Begins **(July)** — JULY

Jackson Hole Symposium **(Late August)** — AUG

US Federal Budget Expires **(30 September)** — SEPT

End of Draghi's Term **(31 October)** — OCT

New EU Commisson President Starts Term **(November)** — NOV

Big 5 Central Banks All Meet **(December)** — DEC

Commodities and Currencies

The US dollar strengthened against the euro in 2018, moving from 1.25 in mid-February to 1.14 in late December. This has been a meaningful driver of returns for euro investors with holdings in overseas assets. The difference between interest rates in the US and Europe has been a clear driver of dollar strength, although signs are emerging that the Fed could be close to a pause in its hiking cycle. Dollar weakness could emerge from this. Sterling remains relatively weak versus the Euro. This may be a good time to get long-term exposure to UK assets.

Gold had a choppy year of trading in 2018, as sentiment towards the precious metal ebbed and flowed. However, it could provide a valuable source of diversification if asset correlations and market volatility remain heightened. After a strong 2017, copper had a torrid year as global growth concerns and trade tensions weighed. Some progress in trade talks between the US and China would benefit prices.

Oil rallied for most of 2018, before selling off in Q4. A bounce into 2019 is likely if global economic growth expectations move higher.

Credit Outlook

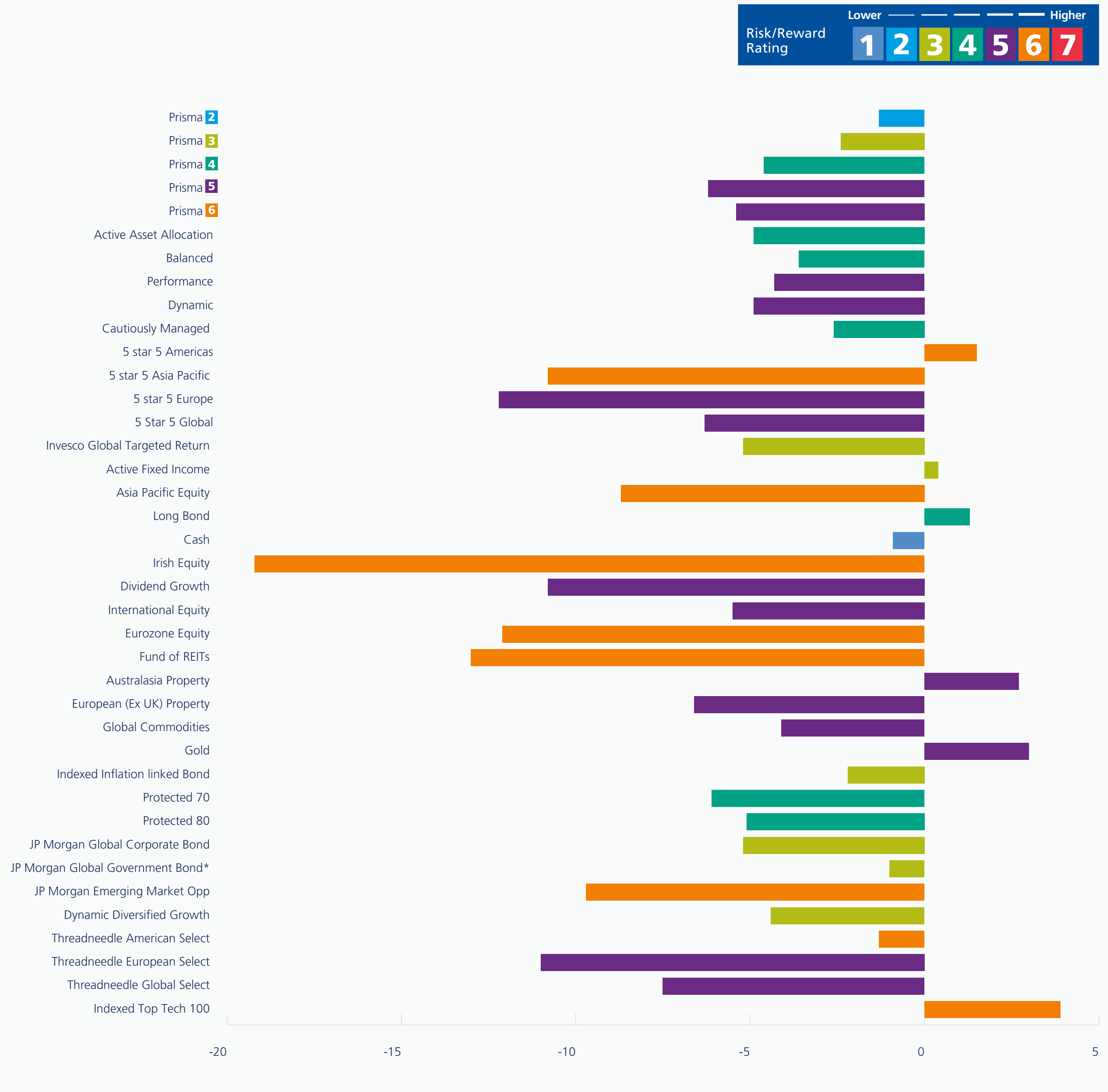
2018 was a challenging year for credit markets as the market faced technical headwinds from fund outflows and the end of central bank balance sheet expansion. Cross-asset volatility picked up from the extremely supressed levels reached during the quantitative easing era. Credit market fundamentals remained robust throughout 2018, thanks to strong corporate earnings. This fundamental picture, however, was not enough to offset the other negative factors and prevent the steady credit spread widening we saw throughout the year. European investment grade credit spreads for example more than doubled year-on-year during 2018. For 2019, it is possible that many of the trends witnessed in 2018 could persist and thus a relatively cautious outlook towards credit markets might continue. The negative technical backdrop may remain as the supply of credit weighs on demand; putting spreads under further widening pressure. We do, however, expect credit spread widening to be relatively contained due to the persistence of relatively strong fundamental factors. Strong corporate earnings should help limit balance sheet deterioration and keep defaults low, even in the face of slowing global growth. With credit spreads now having widened significantly from the historically tight levels reached at the beginning of 2018, we view current credit valuations as more broadly reflective of fundamentals. We expect the spread widening for the year to largely offset the positive carry effect generated from corporate bonds to leave total returns broadly flat.

European Credit Spreads Widen

Source: Bloomberg. Graph shows difference in yield between European investment grade credit and high yield credit.

2018 Performance

Challenging End of Year for Markets



Notes: Annual management charges (AMC) apply. The fund performance shown is before the full AMC is applied on your policy. Returns are based on offer/offer performance and do not represent the return achieved by individual policies linked to the fund. ESMA Ratings as at 30/09/18.

Source: Zurich Life as at 31/12/18.

* Performance using the most recent data.

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Calendar Year Performance since 2008

Longer Term Horizon Prevails

	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008
Prisma 2	-1.3	0.3	1.6	1	3.3						
Prisma 3	-2.4	2.2	4.1	2.6	7.1						
Prisma 4	-4.6	5.7	8.5	4.9	14.2						
Prisma 5	-6.2	7.7	11.3	6.2	16						
Prisma 6	-5.4	8.7	9.8	7.9	7.4						
Active Asset Allocation	-4.9	5.9	8.1	4.9	14.6	3.9	10.5	-1.8			
Balanced	-3.6	6.3	6.7	10	15.3	16.1	13.1	-2	11.1	22.3	-30.4
Performance	-4.3	8.3	6.9	10.9	16.1	17.2	12.6	-2.4	11.4	25.8	-35.2
Dynamic	-4.9	8.8	7.4	11.8	15.8	19	13.1	-3.4	12.9	28.1	-37.8
Cautiously Managed	-2.6	3.9	5.1	6.3	18.6	6.7	12.3	3.6	5.3	12.7	
5★5 Americas	1.5	2.1	14.1	11.8	28.8	24.7	10.2	-0.9	14.7	11.1	-22.9
5★5 Asia Pacific	-10.8	23.8	10.4	5.7	9.2	2.6	16.7	-8.5	6.9	47.3	-49.6
5★5 Europe	-12.2	16.4	4.8	17.5	8.6	23.6	28.8	-8	6.4	28.7	-43.9
5★5 Global	-6.3	11.6	4.5	13.3	13.3	17.6	16.2	-6.4	12.3	18	-35.8
Invesco Global Targeted Return	-5.2	-0.1	2.1	1.6							
Active Fixed Income	0.4	-1.1	4.7	1	20.3	2.4	12.8	6.5	1	4.2	12.3
Asia Pacific Equity	-8.7	21.8	11.4	0.8	10.5	1.6	19.6	-9.8			
Long Bond	1.3	-1.7	6.3	1.8	28.2	1.5	14.6	6.3	1.3	3.2	11.6
Cash	-0.9	-0.8	-0.8	-0.5	-0.3	-0.4	-0.5	0.4	-0.2	0.1	3.5
Irish Equity	-19.2	8.7	-0.8	38.5	16	33.7	19.6	5.5	1.1	27.1	-63.8
Dividend Growth	-10.8	3.1	17.3	6	18	20.1	18.9	0	19.1	28	-39.7
International Equity	-5.5	9.3	10	10.7	17.7	20.6	13.5	-3.7	16.9	26	-36.1
Eurozone Equity	-12.1	14.3	5	11.7	4.3	25.5	24	-12.9	7.7	32.3	-39.3
Fund of REITs	-13.0	19.5	-11.2	27.4							
Australasia Property	2.7	3.5	11	2.4	26.1	-10.3	34.5	-14.9	28.2	68.1	-58.3
European (Ex UK) Property	-6.6	14.4	3.9	16.6	20.6	3.8	24.5	-13.2	20.9	36.5	-35.8
Indexed Global Energy and Metals	-4.1	-5.7	21.5	-20.2	-12.4	-5.3	-2.9	0.5	16.4	18	-48.9
Gold	3.0	-2.6	12.3	-2.3	12.8	-31.4	3.4	14	35.4		
Indexed Inflation Linked Bond	-2.2	0.6	3.4	0.1	4.6	-4.4	10.3	-1.8			
Protected 70	-6.1	4.7	1.4	6.4	10.4	13.1	7.5	-6.5			
Protected 80	-5.1	2.2	-0.3	4.2	7.1	9.3	4.4	-5.6			
JP Morgan Global Corporate Bond	-5.2	3.5	3.2	-0.7	7.2	-0.2					
JP Morgan Global Government Bond*	-1.0	0.1	1.3	0.6	8.1	-0.8					
JP Morgan Emerging Market Opp	-9.7	28.6	17.1	-11.5	12.5						
Dynamic Diversified Growth	-4.4	6.8	-2.5	-1.7	5.1	5.9	6.4				
Threadneedle American Select	-1.3	6.3	17.5	9.9	21.3	24.5	15	5.3	20.6	31.7	-37.4
Threadneedle European Select	-11.0	13.9	0.1	13.9	12.9	15.7	26.4	-1.1	26.1	29.9	-41.4
Threadneedle Global Select	-7.5	14.1	9	12.1	17.1	20	13.8	-5.5	22	27.3	-38
Indexed TopTech 100	3.9	15.9	9.8	21.4	34.7	29.9	15.5	6.2	27.6	49.1	-39.2

Notes: Annual management charges (AMC) apply. The fund performance shown is before the full AMC is applied on your policy. Returns are based on offer/offer performance and do not represent the return achieved by individual policies linked to the fund.

Source: Zurich Life as at 31/12/18.

* Performance using the most recent data.

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1989
Flagship Multi-asset Funds launched

40
years in Ireland

2013
Prisma Funds launched

€23.5*
billion under management

1st ZURICH — Best Investment Performer 2018

1st ZURICH — Consistent Investment Performance

1st ZURICH — Creative Solutions for Clients

1st ZURICH — Diverse Range and Options of Investment Funds

1st ZURICH — Best Explanation of Risk Attached to Products

1st ZURICH** — Quality Communications and Investment Marketing Material

***Source:** Zurich Life, December 2018
****Source:** Brokers Ireland, December 2018

The Zurich Investment Outlook is produced twice yearly by the team at Zurich Investments, based in Dublin, Ireland. This publication provides an in-depth insight into our current thinking and positioning, and expands on the reasons behind our economic views to our clients and customers.

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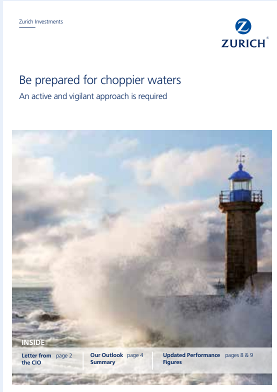
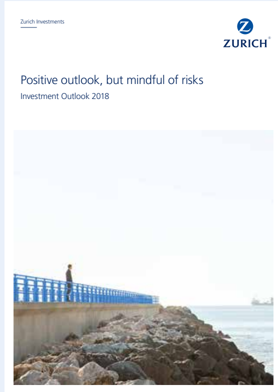
H1 2019

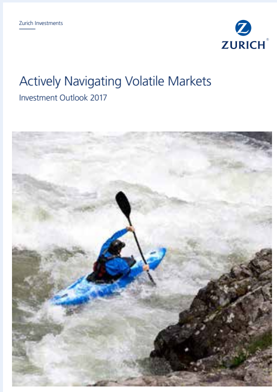


H2 2018

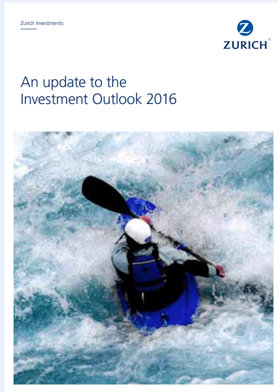


H1 2018

H2 2017



H1 2017



H2 2016

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