



2018

January Newsletter



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Introduction

In this publication we take a brief look over how the market performed in 2017, what the year ahead may offer and an update on **Irish Commercial Property Funds**. We touch on **Investor Psychology** when it comes to investing in markets and look at **alternative investment options** such as Gold.

One of the key lessons learned from 2017 when we look at markets is profits are more important than politics. In the latter part of 2016 there was an air of pessimism with market analysts forecasting stagnation. Since then company profits have taken off (in particular in the US) and now analysis would seem overly optimistic.



Another way of making the same point is to tell you that the successful investors act continuously on a plan - tuning away the fads and fears of the moment (Bitcoin being a prime example) and not reacting continually (and randomly) to economic and market "news". There will always be news as paper doesn't refuse ink!



At some point an event will cause a market reversal. It is well worth reiterating, the nature of our philosophy of advice. We don't forecast the economy. We make no attempt to time markets. We cannot, nor, I'm convinced, can anyone else - consistently project future relative performance of specific investments based on past performance.



In light of this I have included an article we published last year on "**Choosing your Investment Strategy**". In a nutshell, we are financial planners rather than clairvoyants. Our highest-value services are planning and behavioural coaching - putting a **solid investment** plan in place. We help clients avoid overreacting to market events both negative and positive.



For investors, staying the course of an investment or financial plan has never been as difficult. There is a plethora of instant news. The media infatuation for 'clicks', 'likes' and 'shares' encourages extreme and fear-inducing news stories. Eventually this type of news simply turns into 'noise'. The noise can affect rational decision making - if you let it.



However, it is prudent as investors to ask ourselves what could upset a positive outlook. We now have a possible currency war with the Trump administration's devaluation of the dollar. In addition we have historically-low credit yields and the notable absence of inflation worldwide. There are geopolitical risks on the horizon, including Brexit, potential instability in Europe and US relations with North Korea, China and Mexico.



Market Overview

In 2017 the US Dow Jones Index closed above 25,000 for the first time ever and recorded its fastest thousand-point rise (36 days). The global economy is enjoying its best synchronised performance in ten years, the US has just signed into legislation the first meaningful tax reform in thirty years and central banks continue with a broadly accommodative monetary stance, at least compared to history.



The global economy, with the exception of the UK, is going through a period of rare synchronised expansion. Corporate profits are rising, trade is expanding, and growth is robust in the US, Europe and beyond. Asia is benefiting from this global phenomenon and a continued uplift in China. Japanese equities, in particular, are finding a 'sweet spot' due to increased strength in corporate earnings and evidence of ongoing corporate reform driving better returns for shareholders. On a monetary policy level, despite the US Federal Reserve modestly tightening in the US, and the Bank of England raising rates for the first time in a decade, global monetary policy remains very accommodating.

China Slowdown

Given the size of the economy, China is arguably the biggest risk to global markets and it has been a key driver of volatility in recent years. Yet economic growth in the region remains steady (at a slower and more sustainable pace), disposable income is growing at a two-year high (driving consumption as the dominant component of GDP growth), Chinese industrial profits are growing firmly, and investment outflows have fallen as domestic investors take up the baton.



China and its investors appear to have accepted the country's need to rebalance its economy. However, this journey will not be without its bumps in the road. We note, for example, that while both headline exports and imports are rising firmly, the current account surplus is being eroded. Also, China has for some time been juggling with the paradox of pursuing a controlled exchange rate, free capital movement, and an independent monetary policy simultaneously – its 'trilemma'. There are clear flashpoints for this to come to the fore over the next five years, but we do not believe this is a near-term risk.

Outlook

The macro-economic backdrop is still supportive for equities with expected moderate price rises driven by continued strong fundamentals and earnings growth. But there is unlikely to be much upside in markets because valuations are too rich, although that's not to say investors should avoid the asset class entirely. With an absence of monetary tightening or large-scale fiscal changes on the horizon, Asia, Japan and Europe currently appear to be the best areas to take cyclical exposure to global growth.

Investor Psychology

Fear Of Missing Out

Sentiment indicators currently point to a greater degree of optimism. For those who have missed out on a nine-year bull market, there is a “**fear of missing out**” mentality building. This could see markets push even higher in the short term before there is any meaningful correction.



Until recently, there have been very few signs of over-optimism embedded in market psychology. Indeed, most sentiment indicators have expressed a high degree of scepticism surrounding the long bull market. The role played by central banks in driving down interest rates (and pushing up asset prices) has attracted particular attention. However, the recovery in the global economy has taken many by surprise and has added a huge amount of fundamental support to the strong rise in equity markets already seen.



Market Indicators suggest we may be entering the last leg of the current **bull market** (upward movement in share prices). In this phase of the market, valuations play second fiddle to the feeling that you need to be “**in the market**”. This usually evolves into a euphoria that eventually leads to a rollover in markets. To quote Sir John Templeton: “**Bull markets are born on pessimism, grow on scepticism, mature on optimism, and die on euphoria.**” We may well be nearing the end of this cycle with the euphoria phase now supporting equity values.



The nature of successful investing, as I see it, is the practice of **rationality under uncertainty**. We’ll never have all the information we want, in terms of what’s about to happen, because we invest in and for an essentially unknowable future. Therefore, we practice the principles of **long-term investing** that have most reliably yielded favourable long-term results over time: planning; a rational optimism based on experience; patience and discipline. These will continue to be the fundamental building blocks of our investment advice in 2018 and beyond.



Commercial Property Overview

After another positive year in the Irish property market, it is time to take stock and give some thought to where the market is at and what may be coming down the tracks. Investment volumes in the Irish Commercial Property market for 2017 are expected to come in somewhere between €2bn and €2.5bn (with an average investment size of only €7m). This is significantly below the 2016 level of €4.5bn (although ahead of the 10-year average of €1.8bn).



The decline in volumes is due to the slowdown in the flow of investment grade stock coming to the market.

There is still significant demand from **international investors** waiting on the side-lines for larger ticket size properties to come to market. This demand may continue to drive prices up during 2018 (putting downward pressure on yields) particularly in the prime investment space. International investors are impressed with the quality of the prime office stock in particular, and are attracted to the longer leases achieved in Ireland relative to our European counterparts.

The Economy

The performance of a property market is hugely dependent on **economic fundamentals**. The Irish economy continues to perform exceptionally well, with GDP growth expected to come in close to 4.8% for 2017, and is forecast at circa 4.5% for 2018, the fastest pace in Europe. Unemployment is now 6%, down from 15.2% in 2012 (the European average is 8.9%). Expanding employment, wage growth, tax cuts (although relatively minor) and weak consumer price index (CPI) inflation are all boosting real income, which in turn, is driving the domestic economy.

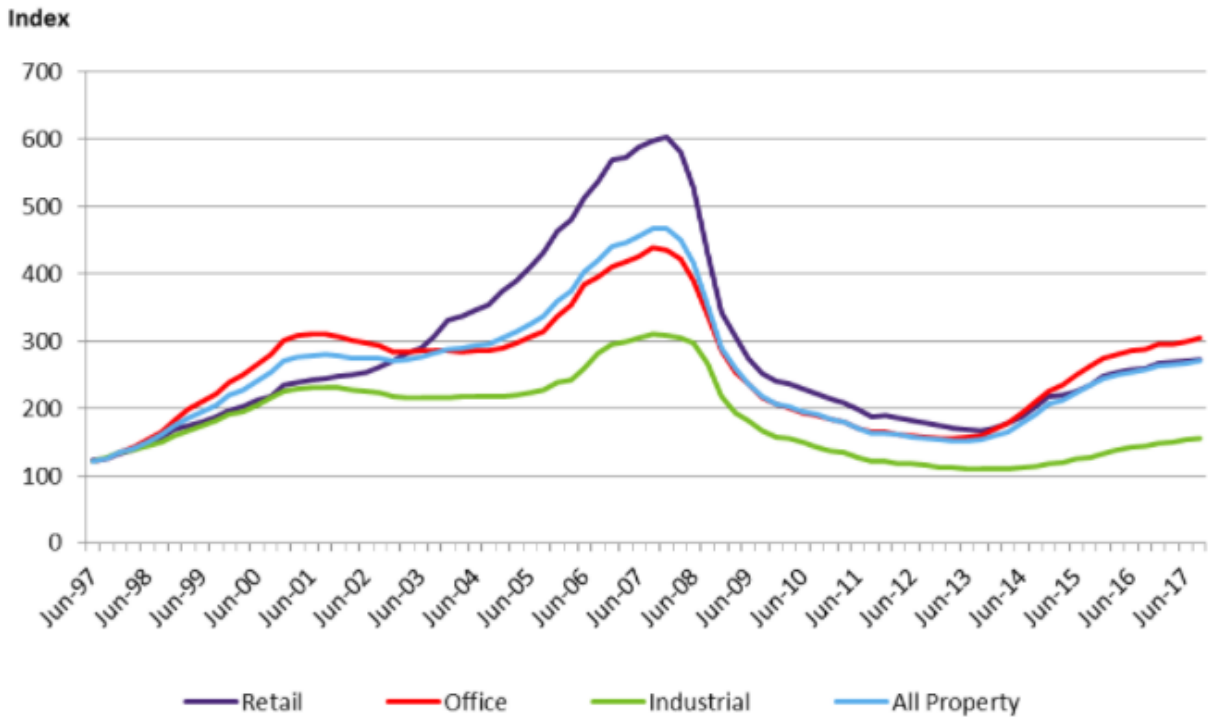
These macro-economic indicators make Ireland a very attractive destination for international investors' capital. However, the continuing housing and accommodation crisis is posing a major problem for companies looking to relocate staff to Ireland, and is negatively impacting our international competitiveness, particularly in the wake of Brexit. Proposed changes to planning guidelines for build-to-rent schemes may help address this issue in 2018 and beyond.

Returns

Investment returns are expected to be mainly driven by **income** going forward. Capital appreciation should drop to a slower pace than recent years. There will be higher capital appreciation in certain sectors of the market, such as industrial, which is expected to outperform the national average in terms of capital appreciation in 2018. The graph below illustrates the capital value growth index up to September 2017, highlighting that all sectors remain significantly below the recent peak levels. We are not implying that the market will get back to those levels, just highlighting that while media speculation is that the market is getting back to "peak levels", this is simply not the case.

Commercial Property Overview

Capital Value Growth Index to Q4 2017 - MSCI



Rent & Yields:

Rent levels are expected to remain relatively stable in the prime **Dublin office sector** (where rents are now close to peak levels – see graph below). Headline rents for prime offices in Dublin 2 are now c.€675 per square metre (psm) (€63 per square foot (psf)) and have remained relatively stable in recent months.

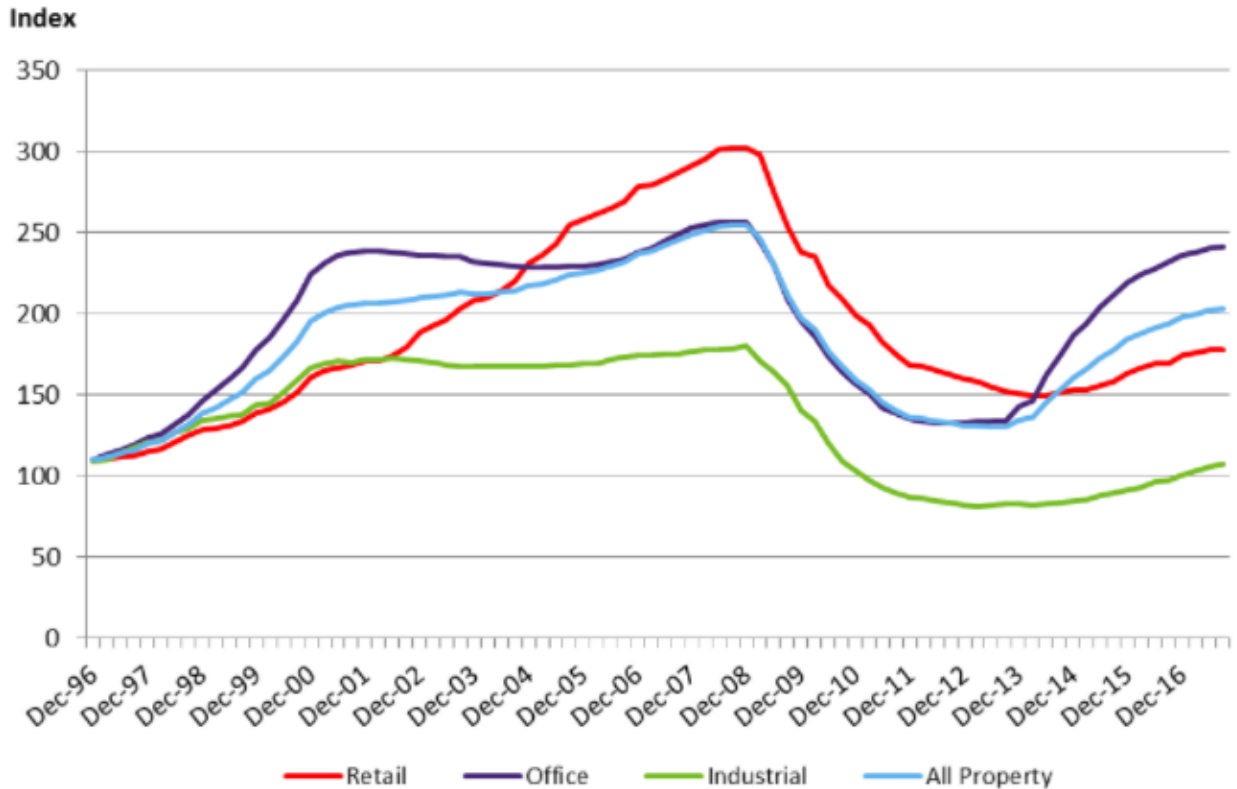
If rental levels get much higher, they may become unsustainable for some businesses in the future, and investors may be exposed to defaults or indeed reducing income returns when the first upward/downward rent reviews take place. The beneficiaries of this will be **Suburban and Provincial offices**, with rental levels expected to increase in 2018 as occupiers seek alternative locations to the city centre, which is now both expensive and in short supply.



Prime retail rents may move up slightly, while secondary retail rents are expected to remain stable. However the **food and beverage (F&B)** sub-sector of the retail sector is seeing increased demand from occupiers (driven by the improving consumer sentiment and increase in disposable income) which in turn, is driving F&B rental levels upwards. F&B though tends to be a fickle industry with a high level of business failures.

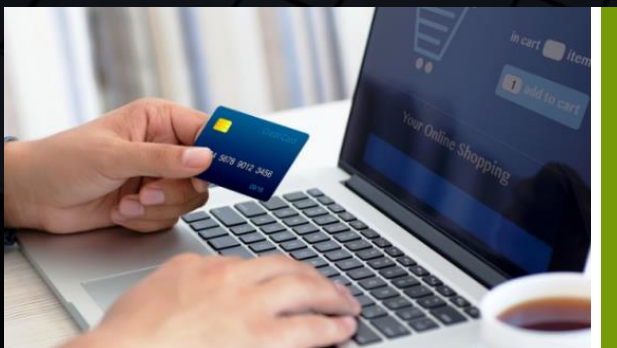
Commercial Property Overview

Rental Value Growth Index to Q4 2017 - MSCI



Industrial (or Logistics) Rental Levels

are expected to rise throughout 2018 (currently circa €110psm or €10.20psf), following a prolonged period of low rents. These rising rental levels coupled with the increasing demand from occupiers for high quality, modern logistics space (mainly driven by the expansion of e-Commerce), is now making speculative industrial development viable.



Alternative Real Estate

There has been an increasing focus on the **alternative real estate** sector recently, which includes hotels, healthcare centres, data centres, student housing and the private rental sector "PRS" (or build to rent "BTR" schemes). For Irish investors, this is considered quite a shift away from "standard" real estate investment sectors, with some more cautious investors watching on from the side-lines until these asset classes become more mainstream (like they are in the US and more recently, in the UK) and demonstrable results are available. To date, the investors operating in this space in Ireland are predominantly international players, such as Hines, Kennedy Wilson, Oaktree etc.

Commercial Property Outlook

Different real estate sectors suit different types of investors, depending on their **risk profile**. Long term investors, including some of the large, international players, are seeking a “safe haven” for their equity (income return and preservation of capital). This type of investor will most likely continue to pursue city centre offices, with long leases and high quality tenants.



Investors chasing income will most likely focus on logistics / industrial assets, a sector that typically generates a higher yield and is expanding at present. Those chasing capital value growth (typically sit further up the risk curve) are exploring value-add opportunities, including Dublin suburban office refurbishments, properties with change-of-use potential, provincial locations where there are improving economic fundamentals etc. Right at the top of the risk/reward curve are investors willing to take development risk for potentially significant returns.



As noted above, **industrial assets** are becoming more popular in recent months due to their relatively higher yields and scope for rental growth. Industrial (or logistics) assets usually command longer leases (as the tenants incur very significant fit out costs, particularly when automation is involved). In addition, the tenants requiring large high-tech industrial space are typically good quality tenants, posing minimal credit risk. This sector is seeing significant expansion as a result of the continuing of online shopping, click-and-collect, and increasing consumer expectations, such as same day delivery.



Irish Commercial Property Fund Performance as at 31/12/2017

Fund Provider	YTD	1 year	3 Years	5 Years	10 Years
 AVIVA	10.94%	10.94%	45.78%	113.36%	--
 Irish Life	6.30%	6.31%	38.24%	96.00%	-37.41%
 Friends First	8.61%	8.62%	50.93%	169.25%	14.58%
 Zurich REIT Fund	20.00%	20.00%	36.85%	--	--

Performance figures Presented by MoneyMate

Past performance is not necessarily a guide to future performance.
Unit prices may fall as well as rise.
REIT Fund is an equity fund investing in property.



Put simply Gold is an inflation hedge for a portfolio and offers little value otherwise outside of an element of **diversification**. It's relatively rare and its value doesn't move in line with other assets such as equities or property. While there has been a significant correction (-30%) in the gold price since reaching a peak in August 2011, it still appears to be well above the price that can be justified by long-term US inflationary trends. Short term rallies do occur when the potential for a global crisis looms. In a narrow market this can lead to extreme price moves.



Gold can be an effective inflation hedge and a proven store of value against all currencies over long-term horizons (10 years plus). However, Gold can at times become significantly overvalued against long-term inflationary trends so that it is not an effective short-term (up to 3 years) or even medium-term (3 to 5 years) inflation hedge.



Inflation-linked government bonds do a better job in that regard. Given the similar inflationary trends across the developed economies one can probably conclude the same as regards using gold as a protection against inflation elsewhere in the developed world.

Summary

The current price of the US dollar, at the moment, favours the purchasing of Gold. Excepting, of course, the risk of war impacting on wealth! Good quality equities and property assets, have traditionally, been superior long-term inflationary hedges, as well as offering the opportunities for growth.

How do I buy a gold exposure

There are several ways to buy and own gold:

- By purchasing and taking delivery of physical bullion (bars or coins) via a bullion dealer/broker.
- By purchasing certificates backed by gold bullion and guaranteed by a government.
- By buying shares or units in some collective fund structure that owns gold. Fund structures listed and traded on stock markets that exclusively own gold include investment trusts (closed-ended funds) and exchange-traded commodities (ETCs). Off-market funds can also hold gold. Funds use a global custodian to securely hold the gold bullion owned by the fund.
- Buying into gold producers (mining companies).

In the Irish Market there are several fund options which offer Gold exposure. Irish Life, Zurich Life and Friends First offer such investment options to clients. These funds offer full liquidity. They are designed to accurately track the underlying performance of the commodity index or of the individual commodity or metal.



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