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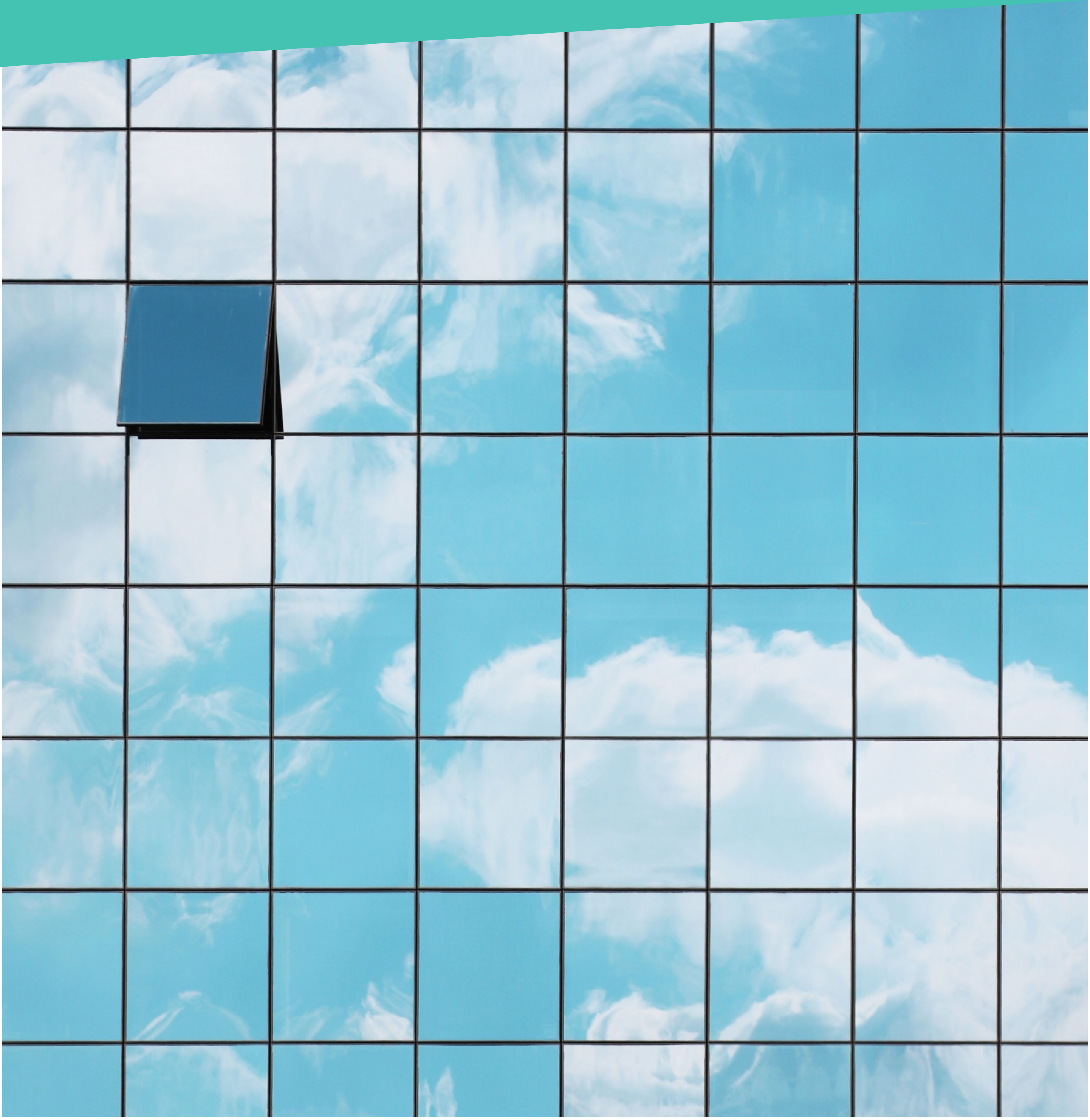
Irish Life

INVESTMENT OUTLOOK

2021



Irish Life Investment Managers Limited (ILIM) is part of the Great West Lifeco group of companies, global leaders in financial services. We have €85.3 billion* in assets under management on behalf of our domestic and international clients who trust, believe and invest in our award-winning investment capabilities. In return, we aim to deliver top-class service and products to our customers, both domestically and internationally.

ILIM is the appointed investment manager to Irish Life Assurance plc and manages the Irish Life flagship multi asset funds.

*Source: ILIM, correct as at 30/11/2020

As a proud ambassador for the UN-supported Principles for Responsible Investment, ILIM is a leader in driving ESG investing in Ireland – influencing positive change in environmental, social and governance issues to create more socially conscious and sustainable long-term investor returns.

European Pensions AWARDS 2019
WINNER
Passive Manager of the Year

KPMG
Irish Independent
PROPERTY INDUSTRY EXCELLENCE AWARDS
2019
PROPERTY INVESTMENT/ FUND MANAGER AWARD

GRESB 2020

European Pensions AWARDS 2018
WINNER
Passive Manager of the Year

Irish Pensions AWARDS 2020
WINNER
Investment Manager of the Year

Irish Pensions AWARDS 2019
WINNER
Investment Manager of the Year

Irish Pensions AWARDS 2018
WINNER
Passive Manager of the Year

Irish Pensions AWARDS 2018
WINNER
Property Manager of the Year

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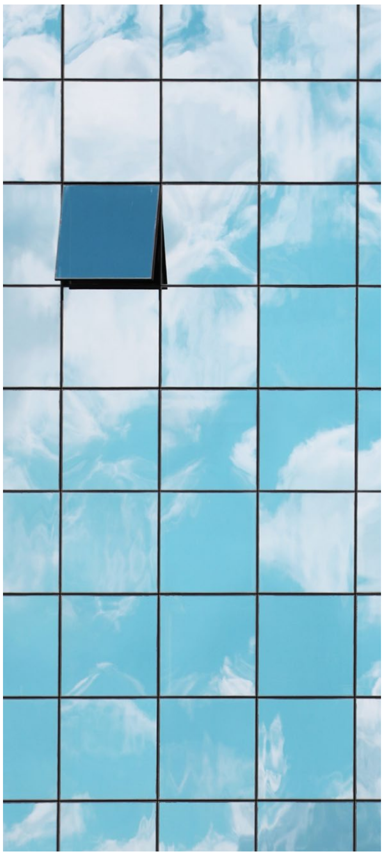


Anthony MacGuinness
Deputy Chief Investment Officer and
Head of Quantitative Strategies

Sandra Rockett
Director – Wealth &
Corporate Distribution

INTRODUCTION

As we come to the end of 2020, we look back on a year that has been very challenging. The Covid-19 pandemic has taken its toll on people's health all over the world, and required authorities to take action on an unprecedented scale to support the global economy.

This Investment Outlook reviews the major themes of 2020 that have impacted global equities, bonds, alternative assets and Irish property. With contributions from our in-house fund managers and chief investment strategist, we also examine the likely drivers of markets in 2021. We thank you once again for your support in 2020, and wish you the best for the year ahead.

EXECUTIVE SUMMARY

- We expect economies to recover in 2021, as effective vaccines are rolled out and policy support continues
- Despite surging debt levels and fiscal deficits globally, interest rates are likely to remain low for an extended period, helped by low inflation and accommodative monetary policies from central banks
- Although this creates a supportive environment for equities and 'growth' assets in general, we should not underestimate the risks that lie ahead, given the unprecedented nature of both the shock and the policy response
- Sustainability issues have come to the fore, both in terms of political agendas and global alignment of views on the urgency for action on climate change.

KEY THEMES FOR 2021 AND BEYOND

We have identified the following key themes, which will have a significant effect on portfolios over the coming year. We are incorporating these views into our discretionary assets and multi-asset funds for the benefit of our clients.

01

POSITIONING FOR GROWTH OPPORTUNITIES

While rising Covid-19 infection rates are likely to curtail the recovery over the winter months, we expect a strong economic recovery in 2021. To date, governments and monetary authorities have reduced the economic impact of shutdowns, and will look to provide ongoing support to economies hampered by new Covid-19 restrictions through early next year. This, coupled with the positive news of viable vaccines becoming widely available in the coming months, should allow economies to re-open, leading to a robust recovery in the second half of the year. We believe this favourable backdrop will support 'growth' assets, while at the same time enabling yields on government bonds to remain low. This will also support higher equity-market valuations.

02

RATES SET TO BE LOWER FOR LONGER

We expect government bond yields to stay low in 2021, as central banks keep interest rates low for the foreseeable future. Monetary authorities are also expected to maintain their bond-purchase programmes, which will be a strong support for bond markets. This, in turn, will allow governments to finance higher budget deficits and debt burdens stemming from economic-support programmes. Improving growth and increased deficits do pose the risk that longer-dated bond yields may rise, especially if we see rising inflation expectations or further fiscal expansion. However, we believe a fundamental shift to a higher-yield environment is unlikely in the near term. In such a low-yield world, we see value in corporate bonds, better-quality high yield and emerging-market debt. We prefer these to high-quality eurozone government bonds.

03

SUSTAINABILITY

Regulatory and policy responses to sustainability issues are accelerating globally, leading the transition of capital to sustainable investments and meeting client demands for sustainable investment options. We believe that consideration of environmental, social and governance (ESG) factors is an integral part of the risk-management process for all asset classes and that systematically considering ESG issues will lead to more sustainable long-term investment outcomes. We have integrated ESG factors across our discretionary equity and property portfolios, and are extending this approach to fixed income and alternatives over the first quarter of 2021.

04

THE CHALLENGE OF DIVERSIFICATION AND INCOME GENERATION

Although expectations for equity markets are high, we are still mindful of future risks and volatility as the world assesses the lasting impacts of Covid-19 on business models and government finances. Historically, investors have turned to government bonds, as they have acted as a 'safe haven', providing both an income and the prospect of strong positive returns during economic downturns. However, given such low starting yields, government bonds offer little income or limited upside potential and are vulnerable if there was a pickup in inflation, forcing investors to rethink their approach to both diversification and income generation. While higher-quality credit and emerging-market debt markets provide an income uplift versus government bonds, such allocations do come with an associated higher risk, albeit less than equities. We believe this dual diversification and income challenge facing investors supports the case for considering alternatives and real assets, such as real estate and infrastructure. These offer attractive yields and stable income-generating characteristics, while also providing diversification benefits versus more traditional growth assets.

SECTION 1

ECONOMIC OUTLOOK

ECONOMIC OUTLOOK

Lenny McLoughlin
Chief Investment Strategist

THE GLOBAL ECONOMY

2020 was an extraordinary year for the global economy. Having started the year on a strong footing, following the agreement of a trade deal between the US and China, the economy was hit by an unanticipated shock with the outbreak of Covid-19. Restrictions put in place to contain the spread of the virus quickly turned what had been a healthy economic expansion into a sudden, sharp recession. While aggressive and unprecedented fiscal and monetary stimulus measures announced by global authorities helped the economy to recover from May onwards, the scale of the damage inflicted between March and April will result in the global economy contracting by around 4% in 2020.

2021 OUTLOOK

As we look to 2021, the outcome for economic growth will be determined by the path of the virus, stimulus measures and vaccine deployment.

The short-term outlook is uncertain, due to the recent surge in Covid-19 case numbers and the need to reintroduce restrictions in many regions. The new lockdowns have contributed to a slowing of growth during the fourth quarter. Growth is, however, expected to improve through 2021, as stimulus measures and the widespread availability of vaccines boost activity from the second quarter onwards.

The growth path for 2021 can be split into three distinct stages. In the first quarter, economic growth could be weak as containment measures limit activity levels. The second phase, in quarters two and three, should involve a strong rebound in growth as vaccines are made widely available and additional fiscal stimulus measures are introduced. In the latter part of the year and in 2022, growth could settle at a level that is lower than that experienced in the middle of the year, but above the long-term trend. Overall, the global economy is expected to grow by 5% in 2021.

SHORT-TERM GROWTH RISKS

In recent months, there has been a rise in Covid-19 case numbers with the onset of colder weather and the move 'indoors' in the Northern Hemisphere. Restrictions are more stringent in Europe than the US, where the infection rate has tended to lag Europe by about a month.

The Eurozone economy is expected to contract again in the fourth quarter (Q4) at an annualised rate of 9% due to the recent restrictions. The economic impact of the current lockdowns is, however, estimated to be only about half of that experienced during the March/April period. This is due to the manufacturing, construction and education sectors staying open this time round. Retailers and consumers have also adapted to the changed circumstances, with more activity happening online. This too has helped reduce the economic impact of the lockdowns. While some restrictions are likely to be eased ahead of the Christmas period, there is a risk that several will remain in place and could even be tightened in the New Year, if case numbers begin to rise again.

In the US, growth is expected to slow to 1% or below in the first quarter of 2021 (Q1). Consumer behaviour has recently become more cautious against a backdrop of fading fiscal support. Meanwhile, additional restrictions appear increasingly necessary as case numbers continued to surge in late 2020.

TRADE UNDER THE NEW US ADMINISTRATION

The election of Joe Biden as US President is expected to result in an easing of global trade tensions, which would be positive for economic growth.

Although the trade issue has not been a focus of investor attention this year, there had been fears that it could re-emerge if President Trump had been re-elected. There is bi-partisan support in the US to confront China on various issues such as trade, intellectual property protection and forced technology transfers. President-elect Biden, however, is likely to address these in a less confrontational manner. He is expected to adopt a coordinated approach with global allies to tackle China, potentially reducing the uncertainty and tensions associated with these issues in recent years under Trump's presidency. Greater clarity and a more predictable approach to negotiations in these areas would improve corporate confidence and the willingness to invest.

SUMMARY

Following a contraction of 4% in 2020, the global economy is expected to enjoy a strong recovery in 2021, growing by 5%.

A soft patch in early 2021 is possible as Covid-19 continues to circulate, requiring targeted restrictions to be maintained for a period of time. However, support from fiscal and monetary stimulus measures, combined with the widespread availability of vaccines, should be beneficial.

On a regional basis, China and other Asian countries (which have managed the virus better due to more effective testing, tracing and quarantine systems) have outperformed in 2020. This is likely to continue in early 2021, as many developed countries in the Northern Hemisphere struggle to contain the virus in the short term. But the arrival of warmer weather and vaccines could cause this gap to close over the course of 2021. Economic output (measured by GDP) in many Asian countries at the end of 2021 should exceed the levels at the end of 2019, although GDP in many developed countries at the end of 2021 is still likely to be below end-2019 levels.

Risks to the global outlook include a failure to contain the virus, the various vaccines proving to be ineffective, or fiscal and monetary stimulus being reduced. We see a low probability of these occurring, and our base case is that the global economy will grow by 5% in 2021.

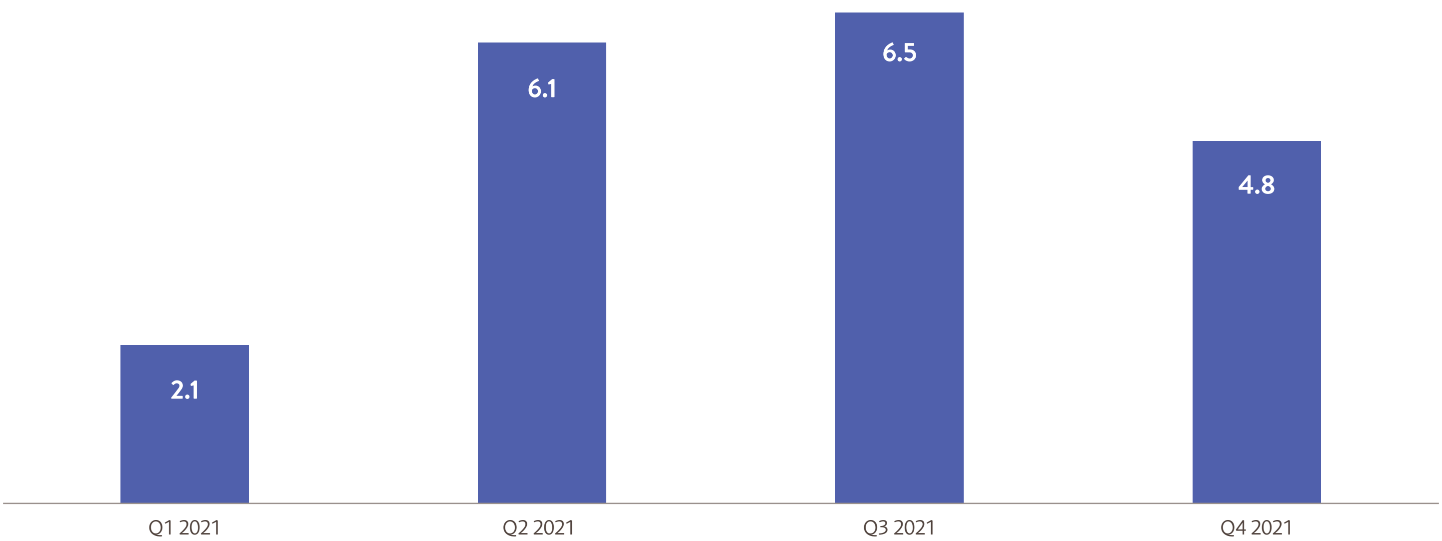
Closer to home, there are risks in relation to a possible 'no deal' Brexit outcome. Our belief is that a narrow trade deal will be agreed between the UK and EU before year-end, which will avoid a worst-case outcome where WTO tariffs are applied to trade between the two regions from 1 January.

Our economic forecasts for 2020 and 2021 for the main regions are detailed below, together with forecast annualised growth rates for the global economy on a quarterly basis in 2021.

	2020 GDP	2021 GDP	2020 CPI	2021 CPI
Global	-4.0%	5.0%	1.1%	1.7%
Developed Markets	-5.3%	3.9%	0.4%	1.0%
US	-3.6%	3.3%	1.1%	1.6%
Eurozone	-7.3%	4.7%	0.2%	0.7%
UK	-11.2%	6.2%	0.9%	1.4%
China	2.0%	8.6%	0.2%	1.8%
Japan	-5.1%	3.0%	-0.3%	0.2%
EM	-2.0%	6.8%	2.0%	2.7%
Ireland	2.0%	5.0%	-0.6%	0.7%

Source: ILIM

GLOBAL ECONOMY ANNUALISED GROWTH RATE



Source: ILIM

SECTION 2

RESPONSIBLE INVESTING

AN ACCELERATING SHIFT IN GLOBAL MARKETS

RESPONSIBLE INVESTING

AN ACCELERATING SHIFT IN GLOBAL MARKETS

Kathy Ryan
Head of Responsible Investment, ILIM

There has been a growing focus in investment markets on sustainability – that is, incorporating sustainability considerations into investment decision-making. Issues such as climate change and how companies are run are becoming increasingly important – not just for society as a whole, but also to investors. It is increasingly evident that from an investment perspective, these issues are creating new risks and will have a financial impact in the future.

The changing regulatory landscape is accelerating a structural shift in global capital, largely driven by the higher prominence of climate change on political agendas and a stronger alignment from global leaders of the need for urgency of action on this key agenda. This will only accelerate the transition of capital to sustainable investments.

A CORE FOCUS ON DELIVERING LONGER-TERM RETURNS

- The Covid-19 crisis has increased the focus on sustainability and highlighted that the corporate management of issues such as human rights, employee wellbeing and community relations have become critical business continuity mechanisms. Consumers are also increasingly starting to shift consumption and purchase decisions away from companies that are not looking after their workforce. In terms of attracting employees, 40% of millennials in the US are choosing jobs based on their employers' sustainability performance.
- Increasingly, a strong integration of sustainability practices has come to define whether industry leaders truly have a sustainable business. Investment in economic activity which pollutes, wastes and is unresponsive to environmental constraints is building financial risk. As environmental and social goals are becoming urgent and supported in law, financial activity that is careless about sustainability performance becomes part of the problem.

PERFORMANCE

Four selected MSCI indexes, representing a range of ESG index-construction approaches, outperformed the parent MSCI index in the first quarter of 2020. Over a five-year period, the Socially Responsible Index (SRI) showed the strongest performance over all periods. This is shown on the chart to the right.

Over a seven-year period (from 2013 to 2020), the top third of companies by ESG ratings outperformed the bottom third by 2.56% per year. According to MSCI, this was primarily driven by higher earnings growth of the higher-rated companies over this time, followed by the higher reinvestment return from dividend payouts and share buybacks.

PERFORMANCE (%)

	MSCI ACWI	ACWI ESG Universal	ACWI ESG Focus	ACWI ESG Leaders	ACWI ESG SRI
YTD	-21.3	-20.1	-20.6	-19.9	-18.4
1 Yr	-10.7	-8.4	-9.2	-8.5	-5.2
3 Yr	2.0	3.0	3.0	3.0	4.9
5 Yr	3.4	4.0	4.3	3.9	5.1

Source: MSCI. Data from 31 March 2015 to 31 March 2020. Returns are annualised for periods longer than a year. The length of long-term returns was constrained by availability of index data.

INVESTOR DEMAND

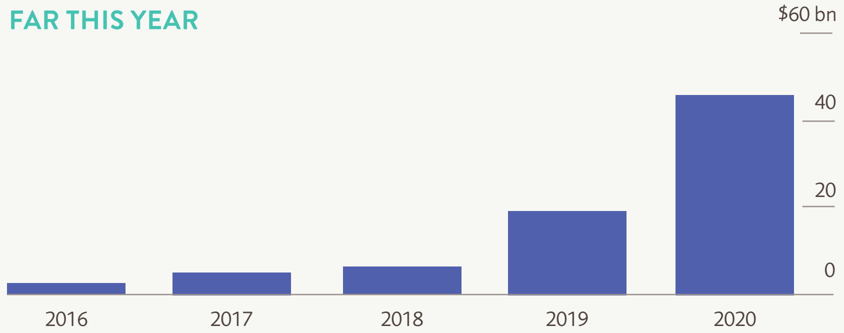
The sustainable funds market continues to grow rapidly. According to Morningstar, it accounted for approximately 13% of the entire funds industry (or $1trillion asset under management) at the end of June 2020.

Inflows into ESG-related exchange traded funds (ETFs) surged to $22bn so far in 2020 – three times the volume reached in 2019, according to Bloomberg. 90% of Irish asset managers now have responsible investment policies in place, according to our State of Play Report 2020.

Furthermore, 58% of people globally think that a lack of visibility of sustainability credentials would undermine their trust in an investment provider, according to a survey by Schroders.

GREEN GIANT

ESG ETF ASSETS HAVE MORE THAN DOUBLED SO FAR THIS YEAR



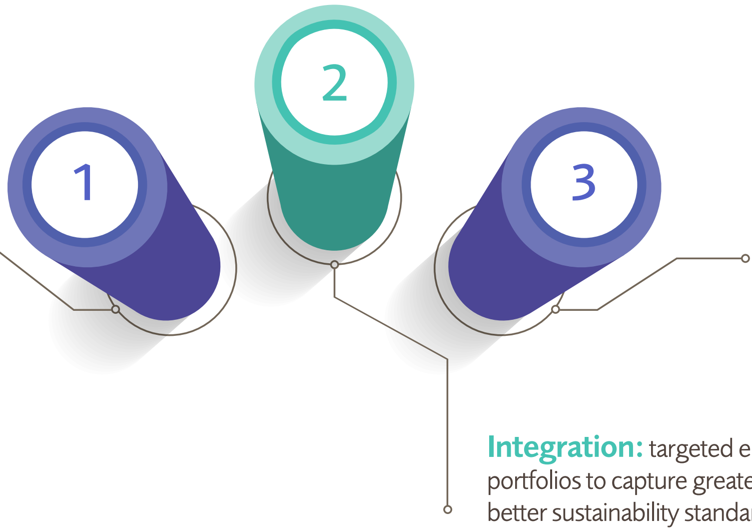
Source: Bloomberg

OUR APPROACH

Our approach is anchored around the objective of delivering sustainable longer-term returns and is underpinned by two key themes. These are:

- the move to a more stakeholder-centric business model, where companies that manage ESG risks better will outperform over time
- the macro global risk of climate change and the trend towards decarbonisation.

We capture these themes using three core pillars to incorporate sustainability into our investment solutions. The pillars are:



Exclusions: targeted exclusion of companies which we believe are most exposed to sustainability risk in the future.

Integration: targeted enhancement of investment portfolios to capture greater exposure to companies with better sustainability standards and business models.

Active ownership: targeted use of ownership rights to actively influence and enhance the business practices of the companies in which they invest.

2021: THE YEAR OF ESG REGULATIONS

A Renewed Sustainable Finance Strategy was launched in April 2020 to contribute to the objectives of the European Green Deal Investment Plan, in particular to create an enabling framework for private investors and the public sector to facilitate sustainable investments.

Under the European Sustainable Finance Act, a range of European regulations will be implemented in 2021, such as the new Sustainability-related Disclosure Regulation and Taxonomy Regulation which will create a framework to objectively define responsible investments. These regulations will create more transparency and comparability between responsible investment offerings for investors.

SECTION 3

EQUITY OUTLOOK

EQUITY OUTLOOK

Lenny McLoughlin
Chief Investment Strategist

2020 REVIEW

Equities experienced a tumultuous year in 2020, as markets suffered one of the fastest-ever falls, followed by one of the quickest recoveries – equities reached new all-time highs in the run up to year-end. Concerns over the potential economic fallout from restrictions put in place to contain the spread of Covid-19 caused global equities to fall over 32% in just five weeks from the middle of February. Markets rallied from the March lows as unprecedented levels of fiscal and monetary stimulus provided much-needed support to the global economy. Substantial liquidity provided by central banks was also a key contributor to the rally in markets, as were developments relating to treatments and vaccines to combat the virus. Reduced political uncertainty after the US Presidential election was also a factor behind the recent strength in markets. At the time of writing, despite all the challenges through the year, global equities are up almost 13% in the year to date in local-currency terms and just under 6% in euro terms.

2021 OUTLOOK

- We expect upside of at least mid to high single digits in equities in 2021.
- Equities are supported by: 1) strong economic and earnings growth in 2021 2) the early stages of a new economic and investment cycle 3) attractive relative valuations 4) continued fiscal and monetary stimulus
- Potential risks relate to 1) a resurgence in Covid-19 case numbers 2) vaccines proving to be ineffective in eradicating the virus 3) policy supports fading 4) significant rise in bond yields

Although equities have risen almost 60% from the March lows and are up in double digits in the year to date, we expect upside of at least mid-to-high single digits in 2021.

If 2020 can be described as an abnormal year in equity markets, 2021 is expected to represent a return to normality, with reduced levels of volatility. The recovery in global growth is set to continue in 2021, while consensus forecasts suggest a rebound in earnings of 25% in 2021 and 16% in 2022. Consequently, there is a positive fundamental backdrop for equity markets.

As economies exit 2020's recession and Covid-19 is contained with the aid of effective vaccines, equities should follow the normal post-recession recovery path and continue to generate strong returns over the next year. Even though the stellar gains generated over the last nine months in the initial stages of the recovery from recession are unlikely to be repeated, solid returns can still be expected as we transition into the 'growth' stage of the cycle. Ongoing fiscal and monetary stimulus should also support equity markets in 2021.

Equity markets look expensive in absolute terms. However, equities are extremely attractive on a relative basis, given the low yields available in bonds and cash. Cash holdings globally are high and, given the relative attractiveness of equities, much of the cash sitting on the side lines is expected to make its way into equity markets during 2021.

VALUATIONS

Following the strong rally in equity markets from the March lows combined with the 15% contraction in earnings this year, global equity markets are now trading above long-term averages on most valuation measures.

GLOBAL EQUITIES: 12-MONTH FORWARD PE RATIO

Source: Bloomberg/JP Morgan

Consensus forecasts for earnings growth in 2021 of 25% is consistent with the level of earnings growth seen when exiting a recession. Earnings are forecast to grow by a further 16% in 2022.

Relative valuations suggest equities are extremely attractive and still offer upside, even after the gains seen since the lows in March. There are several ways to measure the relative valuation of equities against bonds; one of these is the earnings yield gap. The earnings yield gap expresses the price-to-earnings (PE) earnings ratio (which measures a stock's value) as a yield, by inversing it and comparing the gap between this yield and the 10-year sovereign bond yield. The chart below shows the earnings yield gap for the S&P 500 index over the last thirty years.

S&P 500 EARNINGS YIELD GAP

Source: Bloomberg

Using the earnings yield gap, if US equities were to trade at the same relative valuation against US 10-year bonds as they did in early 2018, the PE multiple on the S&P 500 would be 27 times, compared to the current level of 22 times. This suggests upside of over 20% in the S&P 500.

So, while equities appear expensive in absolute terms, the higher valuations can be justified in the current environment of low bond yields. The earnings/yield gap relationship shows equities can trade at higher valuation levels and points towards further upside in equity markets.

MONETARY AND FISCAL POLICY

The level of stimulus provided in 2021 will be less than in 2020, but will still be substantial. The balance sheets of central banks in G4 countries are expected to expand by over $3trillion in 2021 (around 7% of GDP). This liquidity will be a major support for equity markets. The commitment by central banks to maintain accommodative policies and to keep interest rates lower for longer should be supportive of equities.

SUMMARY

Following a volatile 2020 which led to large swings in markets, equities are expected to trade more normally in 2021. As a global economic and earnings recovery takes hold and becomes more synchronised across regions in the latter part of the year, 'risk' assets such as equites should benefit, as they tend to do well in the early stages of new growth cycle. As we move from the initial recovery phase we experienced over the last nine months into the growth stage, equity returns are expected to remain strong, even though they are unlikely to match the pace of gains seen during the recovery phase from the March lows.

Despite equities appearing expensive in absolute terms, they are extremely attractive compared to other assets, such as bonds and cash. As a result, they are likely to continue to attract investor flows. Policy measures from both fiscal and monetary authorities will be supportive of equities through 2021, even if not to the same degree that was evident this year.

SECTION 4

FIXED INCOME OUTLOOK

FIXED INCOME OUTLOOK

Niall O'Leary
Head of Indexation, Fixed Income & Credit Solutions

The reaction of central banks to the pandemic helped drive government bond yields to record lows in 2020, despite the high budget deficits resulting from the fiscal support implemented to offset the economic impact of shutdowns. This generated surprisingly high returns in government bonds, given the relatively low level of yields at the start of the year. Realistically, these types of returns cannot be expected again in 2021, but we believe yields will remain low in the medium term because:

- Central banks, notably the US Federal Reserve and the European Central Bank (ECB), have committed to low interest rates for an extended period. And they will not raise interest rates until inflation increases towards or above their targets. There is no sign yet of inflation rising to this extent.
- Quantitative easing, and other pandemic-related bond-buying programmes, will ensure strong demand for government bonds, as will liability hedging by insurance companies and pension funds. There may be some marginal increases in yields, but a fundamental shift to a higher yield environment seems unlikely.

In a low-yield world, investors will reach for yield. With economic activity likely to improve as vaccines are rolled out around the world, we see relative value in investment-grade corporate bonds, high-yield and emerging markets.

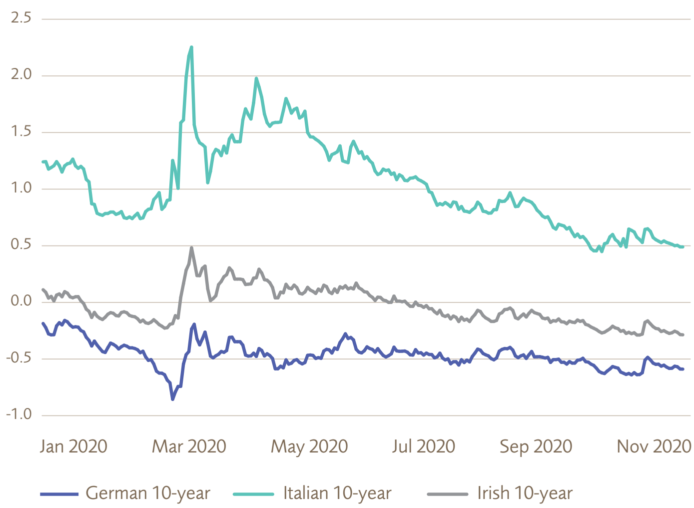
GOVERNMENT BONDS

Once again, developed-market government bonds delivered strong returns in 2020. Markets with higher interest rates at the start of the year, such as the UK and US, outperformed the Eurozone, as there was more room for interest-rate cuts in these markets. In the Eurozone, bond markets went on something of a rollercoaster ride. Peripheral markets, ie Italy and Spain, saw their spreads widen as the first wave of the pandemic took hold. They then recovered as the risk of a debt crisis was forcefully addressed by a combination of ECB support and the EU agreeing a €750bn bailout fund (including grants to the countries most severely affected by the pandemic).

Our expectation is that official interest rates in the US, Eurozone, UK and Japan will not be raised in 2021, and there is the possibility of further cuts in the Eurozone, US and UK. While budget deficits will remain high in 2021, we don't envisage this having a material impact on bond markets, as central banks will continue their bond-buying programmes.

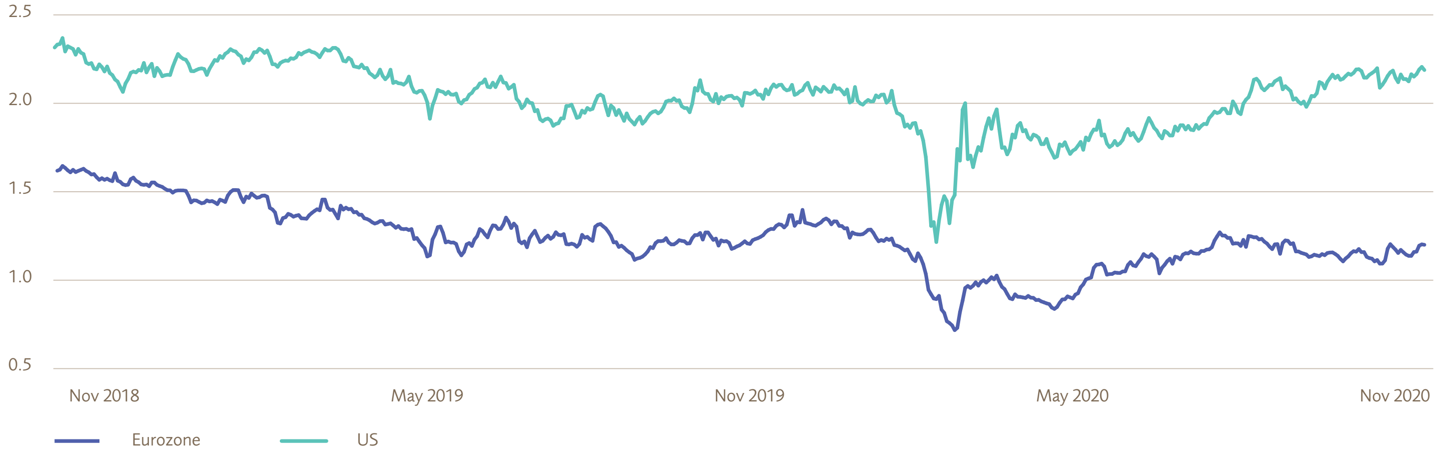
However, there is a risk that longer-dated bond yields could rise, even as shorter-maturity yields are anchored by low interest rates. This could be triggered by concerns around budget deficits, rising inflation expectations or further fiscal expansion. There has already been a significant fiscal response to the pandemic, which has pushed budget deficits wider. Deficits are expected to stay high in 2021, but they haven't really impacted bond yields. Core inflation in the Eurozone has collapsed to an all-time low of 0.2% per annum, and inflation expectations are currently well contained. That said, investors would be well advised to watch for any shift in inflation expectations, as this could push bond yields higher.

EUROZONE GOVERNMENT BOND YIELDS



Source: ILIM, Bloomberg, ICE BofA year-to-date to 27 November 2020.

EUROZONE HEADLINE INFLATION AND EXPECTATIONS

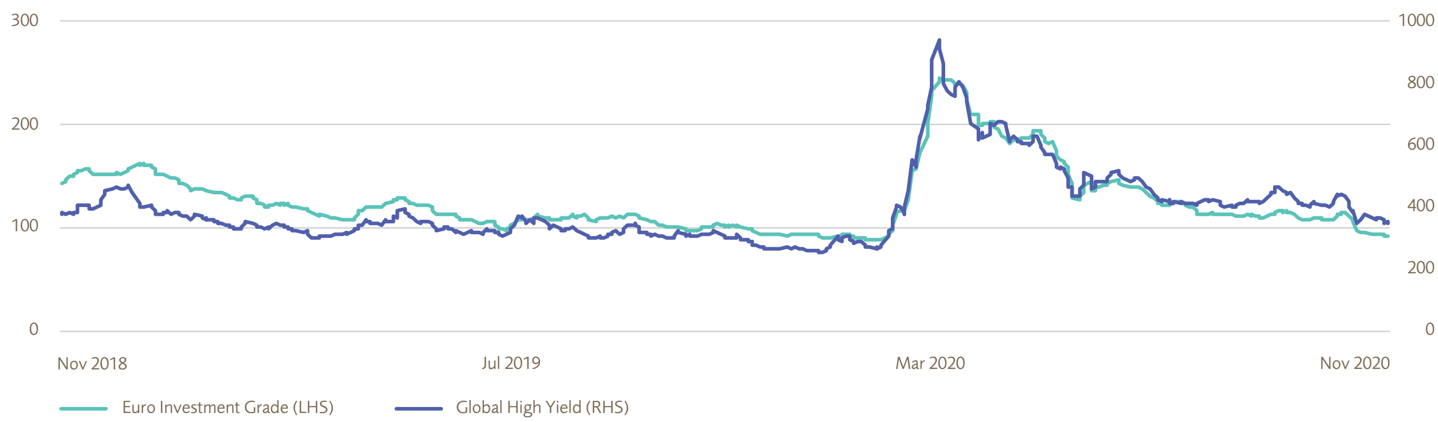


Source: ILIM, Bloomberg as of 27 November 2020. Inflation expectations are based on the forecast rate for five-year inflation rates in five years' time.

CREDIT MARKETS

Credit markets (investment grade and high yield) struggled early in 2020 as economic activity collapsed. Companies in several sectors, such as hospitality, travel and tourism, energy and real estate, were heavily impacted and there was a much higher rate of downgrades from investment grade to high yield. Credit spreads blew out and liquidity collapsed before recovering in parallel with other 'risk' markets, benefiting from central banks buying corporate bonds. Despite credit spreads recovering, both investment-grade and high-yield returns have lagged government bond markets in the year to date.

CREDIT SPREADS



Source: ILIM, ICE BofA, Bloomberg as of 27 November 2020. Credit spreads are measured in basis points.

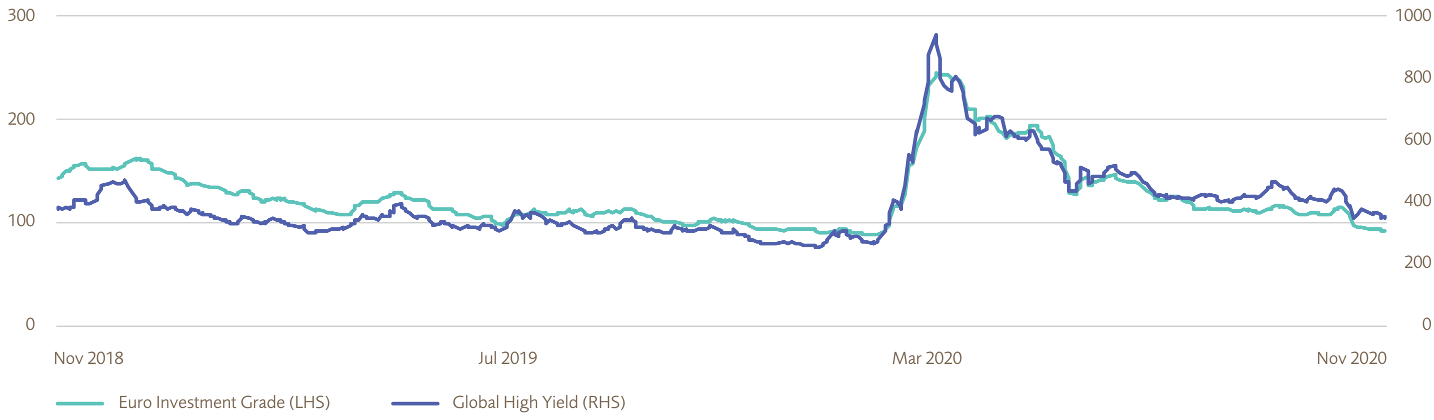
The outlook for credit markets in 2021 is optimistic. Credit markets generally perform well as economic activity expands and corporate profits recover – and this is our outlook for 2021. Arguably, there is greater upside in high yield: credit spreads in high yield are 350 basis points (bps), which is 100bp higher than the lowest levels seen nearly three years ago. This incremental yield should be sufficient to offset any defaults or bankruptcies. The case for investment grade is less compelling based on absolute yields and credit spreads, but we still believe it will outperform government bonds in 2021. Moreover, ongoing buying of investment-grade corporate bonds by the ECB should ensure demand offsets any increased supply or weakness in markets.

EMERGING MARKETS

Emerging-market debt has recovered strongly over the last 7–8 months, but what does 2021 hold? If one were to just consider the yield available in emerging-market debt, the case for this asset class would be weak. Yields in both local- and hard-currency markets are at record lows.

Nonetheless, we still see the potential for competitive returns in both markets, with the case for hard currency more clear-cut than for local. Credit spreads in the hard-currency space are currently around 350bps, which is almost 50bps above the average of the last five years. One argument that can be made against this is that weaker emerging economies could default on their bonds, but we have already seen this. In 2020, Ecuador, Lebanon and Zambia already defaulted, but the JP Morgan ESG EMBI Global Diversified Bond (Euro hedged) Index is still up 2.4%.

EMERGING MARKET DEBT – HARD-CURRENCY CREDIT SPREAD



Source: ILIM, Bloomberg, JP Morgan as of 27 November 2020. Credit spread shown is for the JP Morgan ESG EMBI Global Diversified Bond Index.

The case for local currency hinges more on the weakness of emerging-market currencies (rather than yields or spreads). In 2020, yields in local-currency markets fell to record lows, but total returns are still negative: down -6.4% year-to-date for the JP Morgan GBI-EM Global Diversified Index in euros. This is because the currency return component of the index was -12.5%. Emerging-market currencies have had a weakening bias for a number of years – we believe they are undervalued and represent value. However, we would caution against trying to time a turn in the currency markets. Instead, we would favour an allocation to emerging-market local- currency bonds on a multi-year basis.

SECTION 5

ALTERNATIVES OUTLOOK

ALTERNATIVES AND EXTERNAL MANAGERS

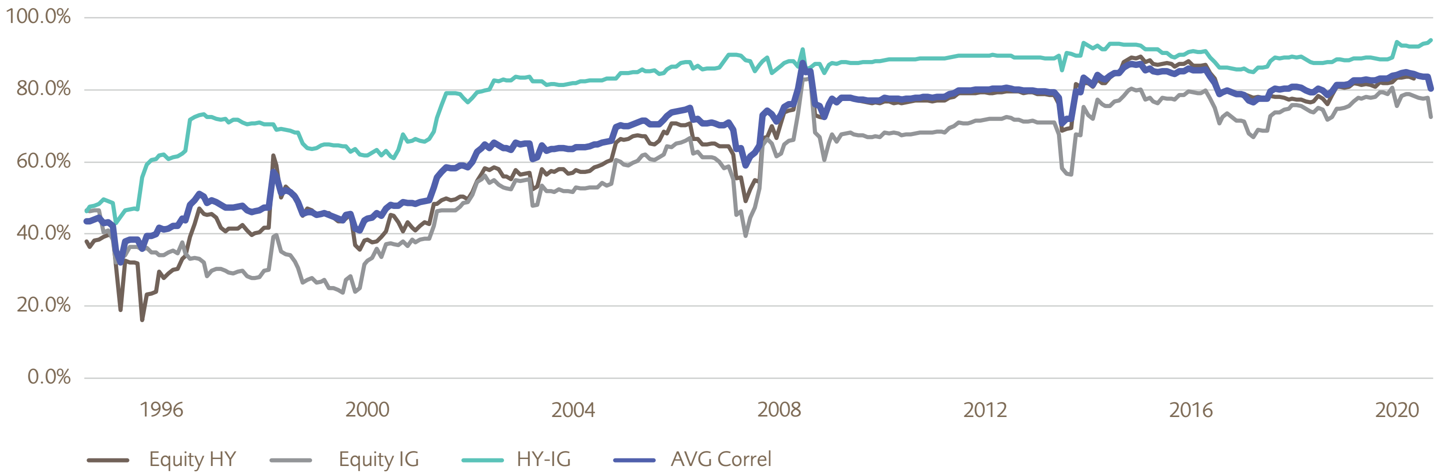
Peter Haran
Head of Alternatives

The last 10 years have been favourable for investors, with equities in particular achieving strong returns. While we are positive on 'risk' assets going into 2021, conditions in capital markets present challenges for investors constructing a well-balanced multi-asset portfolio.

Traditionally, government bonds have played a key role in such portfolios, providing yield while also fulfilling a risk-mitigation role, because they tend to perform strongly when equity markets fall. However, while it is possible that bonds yields could fall further from here, it is questionable if bonds can fulfil that risk-mitigation role in the coming years with yields at or close to all-time lows.

Another issue that needs to be considered is the way in which 'risk' assets have increasingly behaved in a way that sees them rise and fall in value at the same time. In the chart below, we show the rolling five-year correlations between asset classes, which shows that major risk assets have increasingly moved together in a general 'risk on'/'risk off' fashion.

AVERAGE OF 5-YEAR ASSET CLASS CORRELATIONS
USING EQUITIES, INVESTMENT GRADE CREDIT AND HIGH YIELD CREDIT



Source: ILIM, Bloomberg, ICE BofA year-to-date to 27 November 2020.

This is likely due to globalisation and the growing influence of central banks in asset-price performance. This is a phenomenon we experienced in 2020, when there was a huge rally in 'risk' assets following central bank intervention following the market sell-off in Q1.

We believe it is likely that risk asset correlations will be elevated in the coming years. We also believe that bond yields are likely to stay low for an extended period. As a result, in ILIM's alternatives portfolios, we are increasingly focused on investments that deliver yield for our investors through exposures to risks that are not highly correlated to equity markets. The following are examples of the areas in which we are investing or are actively considering investing in 2021.

INFRASTRUCTURE

Private infrastructure funds are less liquid and tend to invest directly in assets such as ports, airports, telecommunication networks, renewables, toll roads and marine terminals. By their nature, these assets tend to be large scale and of strategic importance. Consequently, they were traditionally delivered and owned by governments. However, over the last decade, as governments around the world have faced increasing fiscal constraints, models that involve the private sector have been adopted to achieve key policy outcomes without governments owning or operating these assets. This private sector involvement has resulted in the growth of infrastructure as an asset class that can deliver attractive risk-adjusted returns, by offering the opportunity to own the utilities and facilities that provide essential services and help drive economic growth.

The benefits of investing in infrastructure include the degree of regulated income streams from high-quality counterparties often linked to inflation, the potential to offer stable, long-term cash-flows, and the long-term duration of the assets. Many infrastructure assets are the only one of their kind in a particular area, generally because of the significant construction costs involved in such projects. That means these assets tend to have dominant market positions. Also, given the essential nature of these services, user demand patterns for infrastructure assets tend to be relatively stable even in poor economic environments. As a result, infrastructure funds can deliver a strong expected return with defensive characteristics, while delivering a yield to investors.

REINSURANCE

Reinsurance securities offer insurers a way to pass insurance risk on to investors. For example, an insurer may have a portfolio of hurricane property insurance policies in Florida and wish to pass on a portion of this risk, so that in the event of a major hurricane event, they remain solvent. The insurer gives up some of its profits to hedge against insolvency. This type of activity also allows insurers to manage the risks on their balance sheet to improve capital efficiency.

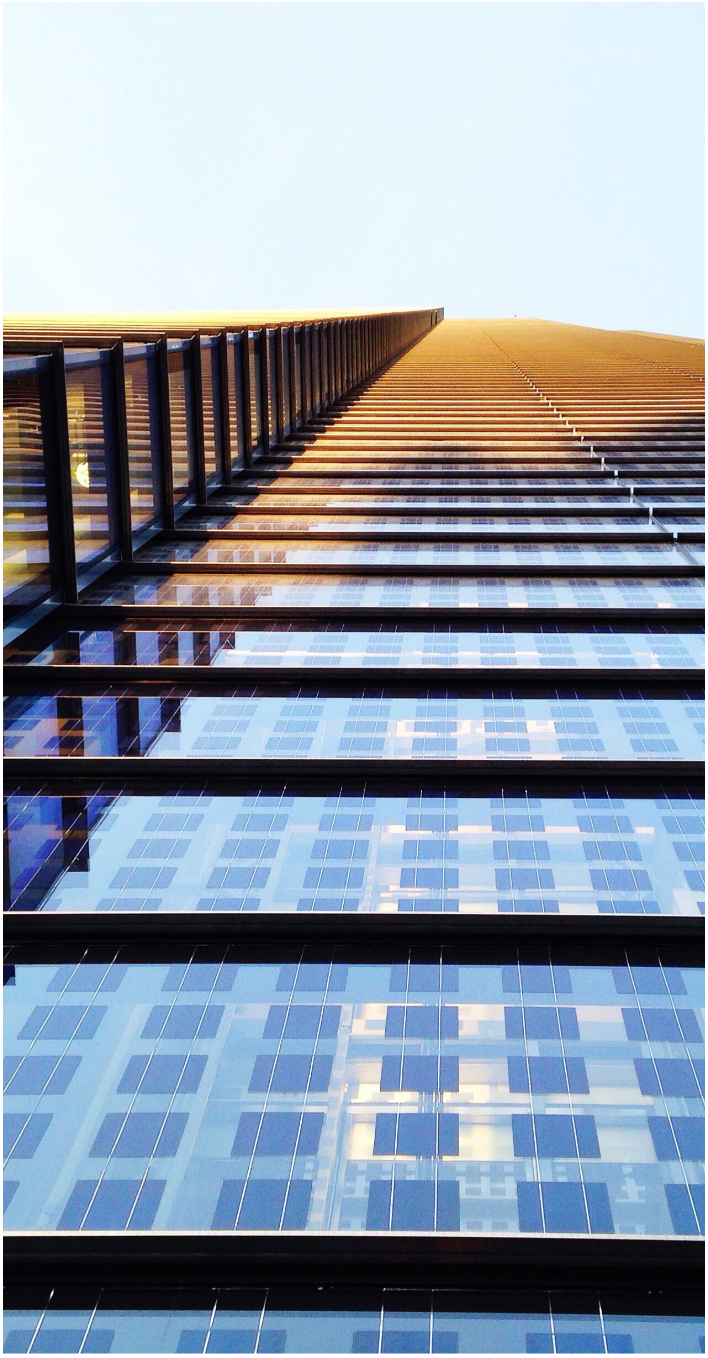
The area of this market we are most interested in, and to which we allocate in our multi-asset portfolios, is the most risk-remote segment. These risks are packaged as tradable bond securities that pay a coupon, typically between 4% and 6%. Whereas a government or corporate bond experiences impairment if there is a default, these securities would become impaired if an insured event resulted in sufficient insured losses.

As well as the strong risk-adjusted yield earned by these securities, the attractiveness of this asset class is that when losses occur they are not the result of credit crises, pandemics, unwinding of asset price bubbles or similar events that generally cause falls in equity and other asset values.

NON-TRADITIONAL CREDIT

Within alternatives, we also seek credit exposures and strategies that can deliver yield outside traditional government and corporate credit markets.

An area we have allocated to in the last year, and where we still see a strong forward-looking yield, is securitised credit – particularly US residential and commercial mortgage-backed securities. These are well developed and sophisticated markets, where managers have various ways to seek returns, including investing in interest-only securities where returns are not driven by the credit quality of the mortgage holder, but by their refinancing behaviour.



SECTION 6

IRISH PROPERTY OUTLOOK

THE PANDEMIC HAS BEEN A SIGNIFICANT DISRUPTOR

Martin O'Reilly
Head of Property

The Covid-19 pandemic severely impacted the Irish property market in 2020, both as a disruptor of market activity and as an accelerator of structural change. However, pricing across all sectors of the market, other than the hard-hit retail segment, has been robust, reflecting the continued attraction of yield to investors. It also reflects the relatively strong occupier fundamentals, in the residential, industrial and office sectors.

The early months of 2020 saw a continuation of the record levels of property investment transaction activity from the prior year, with close to €1bn of deals concluded, and a similar level of sales in play or being launched to the market. Deals in the office and residential private rented sector (PRS) dominated, with international investors attracted to the strong relative growth prospects for these sectors and the availability of new high-quality stock. While retail pricing and retail tenant demand had held up reasonably well, there was little investor appetite for the sector, as concern emerged over the potential impact of online retail. With the onset of the pandemic in March, the investment market stalled, with activity inhibited by travel restrictions and the physical constraint of not being able to inspect properties. There was also investor uncertainty about the future impact of the crisis on pricing and caution among debt-finance providers.

This hiatus persisted through the summer months, with deal activity limited to selective core office transactions that had been launched before Covid, and new residential investments. These included Bishop's Square near St Stephens Green, where Macquarie/ Patrizia paid a yield of 4% for this secure, well-let office investment, and Cualanor in Dun Laoghaire, where German investor DWS acquired this new residential scheme at a -4% yield. September brought an improvement in activity, as Covid-19 numbers stabilised and hope emerged that restrictions would be eased. Over €1bn in pent-up sales were launched in open-market and off-market sale processes. Success levels have been mixed, with strong demand and pricing for core long-leased properties, while short leased or weaker quality properties have seen limited investor demand and opportunistic pricing. Examples of core deal activity in Q4 included French investor Amundi's acquisition of the new office development at 28 Fitzwilliam let to Slack, and German fund Deka's purchase of Baggot Plaza, which is let to Bank of Ireland. The level-five lockdown in November slowed new deal activity, with vendors and purchasers focused on closing existing agreed deals. Total investment volumes for the year are expected to exceed €2bn, which is a reasonable outcome given the challenges the market has faced.

One important consequence of Covid-induced pricing uncertainty and the lack of market transactional activity was the introduction of valuation uncertainty clauses to property valuation certificates. This occurred in most established international property markets and resulted in many property funds being suspended. This qualification was removed for the residential, industrial and office sectors late in the third quarter, as evidence emerged of investor intentions to transact and as deals evidenced pricing levels.

However, the valuation uncertainty provision remains in place for retail properties due to the lack of transactions in this sector and the lack of clarity on investor pricing. In the absence of evidence, valuers have repriced the retail sector based on sentiment, with yield expansion, reductions in rental value and increased void provisions negatively impacting capital values for the sector. The MSCI Index reported a 15.0% fall in retail values for the nine months to end of September, with the fourth-quarter number expected to cause the annual number to fall above 20%.

SECTOR POLARISATION

Physical retailing is being severely affected by the growing move to online shopping and is compounded by the Covid-19 restrictions on non-essential retail. This has dramatically reduced footfall and spending in high streets and shopping centres. This is resulting in low rent-collection rates, business failures, increased vacancies and little tenant demand for shops, which is negatively impacting rental value prospects and consequently investors' appetite for (and pricing of) the sector.

To give some context for pricing adjustments in the sector, the zone A rent for Grafton Street has fallen over the year from c.€600 per square foot to c.€500 per square foot, while the valuation yield on Grafton Street has increased for 3.5% to 4.25% in 2020. While retail operating models are in a state of flux, the dramatic impact of Covid-related restrictions on footfall will pass, and in-store activity and spending will re-emerge. The sector will continue to experience change as it responds to online competition, including shorter, more flexible leases, a focus on sustainable and turnover related rents, and the growing importance of 'experience'-led retailing and brand promotion.

The office leasing market in Dublin in recent years has seen new office take-up by tenants well ahead of its long-term annual average of two and half million square feet. Although strong office occupier demand continued in the first quarter, with one million square feet leased or sold to occupiers, office leasing activity has stalled since the emergence of the pandemic. At that point, the market was well positioned. Prime rents had stabilised at €58 to €62 per square foot, there was a development pipeline of five million square feet, with pre-let agreements in place for over 50% of the space, and a strong active list of new requirements seeking space. Irish Life's Cadenza office development on Earlsfort Terrace, pre-let to Intercom, and 70 St Stephens Green, pre-let to Horizon Pharma, are examples. Most corporate decisions to relocate or expand have been put on hold until clarity emerges on corporate activity and profitability. In addition, businesses are reassessing their office space requirements and operating models in response to the opportunities and challenges that remote working presents, both to employers and employees. We expect this dynamic to take a number of years to evolve. In the meantime, corporate occupiers' short-term focus will be on a scaled return to the office as Covid-19 restrictions are relaxed. The key issues for the broader office market over the short term are: the scale of new occupier requirements from foreign direct investors, potential Brexit-driven requirements, and the scale of tenant 'grey' space made available in the market.


Earlsfort Terrace

THE EMERGING RESIDENTIAL SECTOR

Institutional investment in the residential PRS sector is a relatively new but growing feature of the market in Ireland. However, it is well established in developed economies around the globe. Institutional ownership of residential property schemes gives renters stability of tenure, with a long-term owner whose objective is to continue to hold and make the accommodation available for rent into the future. The sector has been the sector of choice for investors internationally over recent years due to its defensive qualities, which make it a good diversifier from commercial real estate. The Covid-19 challenges have highlighted these defensive qualities, with occupancy levels remaining high, rent collection at near 100% and new leasing continuing at a reasonable pace. With the demand-supply imbalance in the residence sector set to persist, supported by positive demographics, domestic and international investor appetite for the private rented sector in Ireland will continue to grow, supporting pricing in the sector.

Opposite is a photo of Irish Life's residential property acquisition at Harbour road, Dalkey.

Harbour Road, Dalkey

THE OUTLOOK FOR REAL ESTATE REMAINS POSITIVE

Investor demand for real estate in 2021 will persist, based on its high relative yield. However, ongoing uncertainty through at least the first half of the year will promote caution, with demand likely to focus on secure income properties and defensive sectors. In the midst of this caution, we expect to see investors diversify, via increased or new allocations to the residential and industrial sectors in the domestic market, and to European property to mitigate country-specific risk. Demand and supply imbalances in both the residential and industrial sectors point to outperformance relative to the market, while their defensive qualities reduce risk.

Sector polarisation is set to continue, with the out-of-favour retail sector expected to experience further valuation weakness as new leasing evidence emerges in 2021. The shock impact of the pandemic on the sector will pass, with locations providing strong experiential offers and properties with strong local catchments best positioned to recover. However, the increased penetration levels of online shopping will continue to present a formidable challenge to many retailer operating models.

Investors will be cautious on offices in the short term, particularly short-income properties, due to uncertainty over the future impact of flexible working. A reduction in office rental levels from their current highs is expected in 2021, but employment growth thereafter should offset, at least in part, the impact of remote working on corporate space requirements. We expect prime offices with high ESG ratings and strong tenant covenants to perform best.

SECTION 7

MARKET PERFORMANCE & LONG-TERM ASSET CLASS FORECASTS

MARKET PERFORMANCE

Equity and Bond Markets % (in Local Currency)	2015	2016	2017	2018	2019	2020
MSCI AC World (Gross TR)	1.8	9.7	20.4	-7.2	26.9	12.2
ISEQ Overall Return	33.6	-2.7	9.7	-20.5	31.4	3.3
FTSE 100 TR	-1.3	19.1	11.8	-8.5	17.6	-10.5
Euro Stoxx 50 TR	6.4	3.7	9.2	-12.0	29.3	-5.0
S&P 500 TR	1.4	12.0	21.8	-4.4	31.0	15.5
Nasdaq Composite	5.7	7.5	28.2	-3.9	34.5	37.9
Nikkei 225	9.1	0.4	19.1	-10.2	20.0	12.7
MSCI Emerging Markets	-8.0	7.1	27.8	-12.2	13.0	13.8
Eurozone Government Bonds 1–5 yr	1.0	0.9	-0.2	0.0	1.1	0.8

Source: Moneymate

Sovereign 10-year Bond Yields (%)	2015	2016	2017	2018	2019	2020
US	2.2	2.4	2.4	2.7	1.9	0.89
German	0.6	0.2	0.4	0.2	-0.3	-0.63
UK	1.9	1.2	1.2	1.3	0.8	0.18
Japan	0.2	0.0	0.0	0.0	0.0	0.01
Ireland	1.1	0.7	0.7	0.9	0.1	-0.33
Italy	1.6	1.8	2.0	2.8	1.4	0.55
Greece	7.9	7.1	4.1	4.4	1.4	0.58
Portugal	2.5	3.8	1.9	1.7	0.4	0.04
Spain	1.7	1.4	1.6	1.4	0.4	0.0

Source: Bloomberg

Central Bank Rates (%)	2015	2016	2017	2018	2019	2020
ECB	0.05	0.00	0.00	0.00	0.00	0.00
Bank of England	0.50	0.25	0.5	0.75	0.75	0.10
US Federal Reserve	0.50	0.75	1.5	2.5	1.75	0.25

Source: Bloomberg

Foreign Exchange Rates	2015	2016	2017	2018	2019	2020
Euro/Dollar (€/$)	1.09	1.04	1.20	1.15	1.11	1.21
Euro/Sterling (€/£)	0.75	0.84	0.89	0.90	0.85	0.92
Sterling/Dollar (£/$)	1.46	1.24	1.36	1.28	1.30	1.32

Source: Bloomberg

IPD All Property Return % (in Local Currency)	2015	2016	2017	2018	2019	2020
Ireland	25.2	12.6	8.0	9.6	5.3	-0.8
UK	13.3	3.6	10.3	6.2	1.3	-2.9
US	12.5	7.8	7.1	7.5	6.3	0.8

Source: MSCI

Warning: Past performance is not a reliable guide to future performance

2020 figures shown are to 11 December 2020 except in the Property Returns which are to end of Quarter 3 2020.

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Irish Life

CONTACT

PHONE: +353 (0)1 704 1010

EMAIL: customerservice@irishlife.ie | www.ilim.com/about-us/contact-us

WEBSITE: www.ilim.com | www.irishlife.ie

BLOG: http://blog.irishlife.ie

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