

# Mid-Year Outlook 2024

Distractions, distortions  
and decisions, decisions

 **BARCLAYS** | Private Bank

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## Contributors:

**Julien Lafargue**, CFA, London UK, Chief Market Strategist

**Nikola Vasiljevic**, Ph.D, Zurich Switzerland, Head of Quantitative Strategy

**Henk Potts**, London UK, Market Strategist EMEA

**Lukas Gehrig**, Zurich Switzerland, Quantitative Strategist

**Michel Vernier**, CFA, London UK, Head of Fixed Income Strategy

**Dorothee Deck**, London UK, Head of Cross Asset Strategy

**Alexander Joshi**, London UK, Head of Behavioural Finance

**Damian Payiatakis**, London UK, Head of Sustainable & Impact Investing

**Iain Martin**, London UK, Investment Writer

**Luke Mayberry**, London UK, Investment Analyst

# Foreword

Welcome to our “Mid-Year Outlook”, the investment strategy update from Barclays Private Bank.

In the following chapters, we look at the different paths being followed by leading central banks on the timing for rate cuts in the US, Europe and UK, and assess the implications for bonds and equities.

With around half the world heading to the polls this year, we also examine just how much of an effect election results could have on prospects for financial markets.

And beyond our usual wide-ranging asset class and financial market analysis, we highlight what investors might do to better position their portfolios for climate-change risk.

As always, we hope you enjoy the articles, and we thank you for entrusting us with your investments.

**Jean-Damien Marie**  
**Head of Investments, Private Bank & Wealth Management**



# A year of distractions, distortions and decisions

With a US election in the offing, interest rates likely to be higher for longer and slower economic growth, what lies ahead for investors this year?

The first half of 2024 was filled with uncertainty on many fronts: economic, geopolitics and markets being three. Unfortunately, the rest of the year is unlikely to be any clearer, amid key general elections in the UK and US, mounting geopolitical tensions and central bank indecisiveness.

Yet, to the surprise of many commentators, equity markets have climbed the 'wall of worry', registering numerous all-time highs. Even Chinese stocks have experienced a revival. As such, it's critical to differentiate between the macroeconomic outlook and market sentiment. Sometimes, as seen frequently this year, bad economic news can be good news for investors.

## MORE OF THE SAME?

So, what to expect for the rest of this year and beyond? While uncertainty won't fade completely (there is always something to worry about), the macroeconomic mists should clear somewhat. First, and foremost, inflation will probably continue to grind lower. Similarly, growth is likely to normalise.

This means weaker US growth, but a more supportive momentum in the eurozone and UK. In turn, this should allow the leading central banks to finally initiate a normalisation of their own, by gradually lowering interest rates.

There are obviously risks around our central scenario. Inflation could prove even more sticky than anticipated, or an economic shock could send prices higher. Similarly, after a couple of years of tight monetary policy, evidence might emerge of businesses and consumers finally starting to feel the pinch, driving growth lower and possibly triggering a contraction. While either scenario appears to be a relatively low risk, investors shouldn't ignore them.

## IS DIVERSIFICATION REALLY A 'FREE LUNCH'?

The above risks are why we remain laser focused – and examined one hundred years of data for one of this year's chapters – on the importance of appropriate diversification at both the portfolio and the asset class level. Continued uncertainty and demanding valuations, especially on the equity side, will require investors to be equally driven by upside potential and risk management.

Security selection is likely to drive most of the portfolio gains in the coming months, rather than acting as a 'tide that lifts all boats'. Here, we still prefer higher-quality exposure on the equity and the fixed income side, while introducing short-term, or tactical, sector and regional tilts.

Meanwhile, risk management is not a matter of being invested or not. It's about finding opportunities that can produce attractive returns for a given level of risk. On that note, and with bulging fiscal deficits in many top-ten economies, investors should be mindful of allocations to what they consider to be 'risk free' investments. Even cash, as seen from the recent explosion in inflation rates, isn't riskless after taking into account the purchasing-power erosion that higher prices can inflict on your wealth.

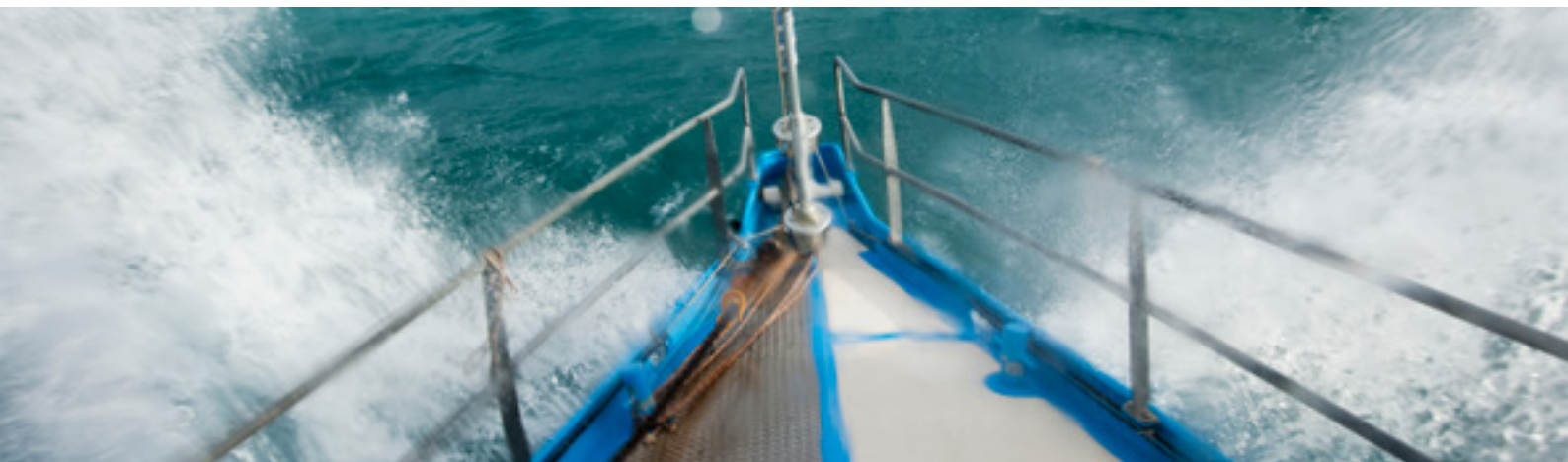
Similarly, the need for incorporating climate risk in the assessment of portfolios' long-term exposures is becoming ever more relevant but also more complicated. A disciplined, all-encompassing approach to sustainable investing appears to be essential to truly account for the challenges raised by the ongoing energy transition away from fossil fuels.

## KEEP FOCUSED AND AVOID NEEDLESS DISTRACTIONS

Staying invested remains, in our view, the key to meeting your long-term goals. While this might be a big year for elections, not least in the US, it's important to remember that economic activity has a much larger influence on markets than politicians. Indeed, whoever next resides at the White House or at 10 Downing Street will likely have their policies heavily guided by the shape of the global economy, in addition to financial markets. With sizable fiscal deficits, the scope for turning on the spending taps will be limited.

In summary, there is a long list of possible distractions this year that may occasionally distort financial markets, possibly creating opportunities for investors. But beyond that, the most important decision over the remainder of 2024 is: how to best position my portfolio to reach my long-term goals? This bumper publication should provide useful and timely insights in the search for an answer.

**Author: Julien Lafargue, London UK,  
Chief Market Strategist**



## Global economy resilient in the face of headwinds

With signs of a global slowdown becoming louder, can growth survive the mounting geopolitical risks that lie ahead?

ECONOMIC FORECASTS, YEAR-ON-YEAR (% , F=FORECAST)						
	GDP			CPI		
	2023	2024F	2025F	2023	2024F	2025F
Global	3.2	3.1	3.0	3.9	2.6	2.4
Advanced	1.6	1.4	1.5	4.7	2.8	2.2
Emerging	4.4	4.3	4.0	2.8	2.2	2.7
US	2.5	2.5	1.6	4.1	3.1	2.3
Eurozone	0.5	0.7	1.3	5.4	2.3	2.1
UK	0.1	0.8	1.0	7.3	2.6	2.0
China	5.2	5.0	4.0	0.2	0.3	2.0
Japan	1.9	0.0	1.2	3.3	2.7	2.1
Brazil	2.9	1.9	1.7	4.6	4.0	3.4
India	7.7	7.0	7.2	5.7	4.7	4.8
Russia	3.6	2.0	1.3	5.9	6.6	4.1

Sources: Barclays Investment Bank, Barclays Private Bank, June 2024

**Please note: All data referenced in this article are sourced from Bloomberg unless otherwise stated, and is accurate at the time of publishing.**

Six months into 2024 and much has changed in the world but our assessment of the global economy has barely budged. Over the rest of the year, weaker growth, softer inflation and so lower interest rates all appears to be on the cards.

At the margin, there seem to be some mild positives for the outlook in China though more caution about the US growth profile. While out of recession, the eurozone and UK economies will likely remain subdued in the coming quarters.

However, geopolitical risk is to the fore, with electorates in the US, eurozone, India and UK having just been to the polls or due to go. The potential impact of the elections could have profound consequences. So, where does that leave the global economy?

### INFLATION OUTLOOK

A mixture of base effects, easing energy prices, restrictive monetary policy and fewer supply-side restrictions has helped to curb price pressures. However, recent falls in the consumer price index (CPI) have proved to be more 'sticky' than many economists had anticipated.

We forecast that global consumer prices will rise by 2.6% this year, and 2.4% in 2025. The slower decline in CPI is likely to influence the pace of policy shifts, with interest rates likely to stay higher for longer in several key regions.

**"This year is a seminal political period"**

## GEOPOLITICAL RISK

Financial markets face a particularly precarious six months in terms of geopolitical events. However, the extent to which they might influence sentiment and growth remains to be seen. Ukrainian and Middle Eastern conflicts continue to impact commodity markets and global supply chains. Growth-sapping trade tariffs are also re-emerging.

This year is a seminal political period. Following elections in India, and across the European Union, and with countries like the US and UK to follow, nearly half the world's population is set to vote. This could have profound implications for global stability, international diplomacy and economic policy.

With the backdrop of so much uncertainty, policymakers face a difficult period. The conflicting forces of dovish monetary policy versus a more constrained fiscal backdrop, particularly in the United States, will muddy the policy trajectory.

After years of economic support through the financial crisis, the pandemic and the energy crisis, government coffers are now exhausted and future provisions are likely to be limited. Meanwhile, lower interest rates should be supportive of economic activity, but will not be enough to boost the growth outlook quickly.

## THE END OF THE US EXCEPTIONALISM?

The world's biggest economy appears to be slowing, after a strong 2023. Several indicators suggest the speed bumps seen in the first five months may be no accident. Indeed, the US consumer seems to have exhausted the excess savings accumulated during the COVID-19 pandemic, when the government doled out support, while the job market has softened.

In addition, the US consumer may be running on fumes. We forecast that domestic private consumption growth will slow over the next 18 months, from 2.5% in 2024 to 1.6% in 2025. Meanwhile, US unemployment is likely to climb, but could peak at 4%, which still remains low by historical standards.

Despite more signs of US inflation moderating this year, price pressures remain elevated, specifically in the services sector. We expect CPI to remain above the 2% targeted level over the next 18 months, reaching 3.1% in December and 2.3% by the end of 2025 (see table).

Concerns that it will take longer for inflation to sustainably return to the central bank's 2% target has supported a postponement of the start of the rate-cutting cycle. Disappointing investors along the way. We now expect the US Federal Reserve (Fed) to cut rates by just a quarter point this year, meaning the federal funds target range will be at 5-5.25% at year end. However, a larger, one point reduction in rates is expected in 2025.

For all the above concerns, anticipated US growth of 2.5% this year and 1.6% next would still be better than most of its developed peers.

Inevitably, the upcoming presidential election makes forecasting even harder than usual. Our outlook is based on our perception of the US economy, and its momentum at this point in time.

However, the next US president could introduce legislation that changes the path for growth, inflation and interest rates. Rather than getting caught in largely irrelevant guesswork, our focus is on identifying the areas of the US economy that are likely to be most immune from political gyrations.

## EUROPE ON THE MEND?

The eurozone appears to be accelerating from a precarious starting point: a technical recession – or at least a long period of stagnation. The bloc's composite purchasing managers' index (PMI) hit 52.3 in May, helped by a recovery in manufacturing and expanding services sector. Meanwhile, the unemployment rate continues to hover around its historical low level of 6.5%.

European price pressures have significantly eased over the past year. Although, headline inflation in May ticked up to 2.6% year on year (y/y), compared to 2.4% April. Meanwhile, core CPI, which excludes volatile items like energy and food, rose to 2.9% y/y. Further disinflation seems likely in coming months. The mixture of soft core goods inflation and lower energy prices has prompted us to trim our headline inflation projection. It now stands at an average of 2.3% in 2024 and 2.1% in 2025.

In turn, lower inflation should pave the way for interest rate cuts. After starting the rate-cutting cycle in June, we expect further quarter-point cuts in September and December assuming price rises ease. In addition, more cuts are anticipated next year, with the deposit rate potentially finishing 2025 at 2.5%.

Despite the positive progress seen so far, gross domestic product (GDP) growth is likely to remain tepid and the anticipated easing in European Central Bank policy shouldn't be seen as a sign of economic strength.

## THE UK AT A TURNING POINT?

Like the eurozone, the UK economy seems to be finding a second wind. The country returned to growth in the first three months of the year. Activity rebounded with the fastest spurt in quarterly growth since 2021. This was driven by strong demand for services and a recovering manufacturing sector. After a downturn last year, consumers were back in spending mood, as wages growth outpaced inflation.

As elsewhere, after a period of exceptional strength, the UK labour market has finally started to weaken. The unemployment rate rose to 4.3% in the three months to the end of March, compared to a 3.5% low recorded in August 2022.

We forecast that the jobless rate will peak at 4.6% by the turn of the year. This may not bode well for domestic consumption levels, but should result in lower levels of pay growth, which in turn should help to ease the UK's inflation profile.

Turning to UK inflation, the headline rate eased to 2.3% in April, with core CPI hitting 3.9%, with the deceleration weaker than anticipated. While progress towards the 2% targeted level may take longer than expected, the slowdown should prove to be comforting enough for policymakers to start cutting rates this year and into next. We forecast that inflation will average 2.6% this year and be bang on target at 2% in 2025.

Lacklustre levels of growth, rising unemployment and inflation that's close to the 2% target should give the Bank of England plenty of scope to consider cutting interest rates, despite the political uncertainty over the result of July's election. The Monetary Policy Committee is expected to cut in August, November and December this year, with three further cuts in 2025, so taking the Bank Rate to 3.75% by August 2025.

Economic activity levels are expected to remain below potential, with growth of 0.8% forecast for this year and 1% in 2025. Whatever the result of the election, the new administration's room for manoeuvre will be constrained by having limited fiscal headroom.

## CAN CHINA DEFY THE GLOOM?

The economy has seen signs of revival this year, but the recovery remains mixed and structural issues continue to weigh on the outlook. The 5.3% growth witnessed in the first quarter was better than expected. However, more recent data suggests that momentum has already slowed.

On the positive side, stronger global demand has fuelled a revival in industrial production and exports. Exports returned to growth in April with industrial production advancing 6.7% y/y, from 4.5% in March.

In contrast, the key drivers of retail sales, the housing market and infrastructure investment, continue to act as a drag. Retail sales grew by 2.3% in April due to weaker discretionary goods sales and a contraction in car sales. Consumer demand remains under pressure, with softer wealth dynamics and a weaker labour market.

Meanwhile, the real estate sector continues to be a cause for concern, with property investment slumping by 10.5% in April and house prices still heading lower.

## "The world's biggest economy appears to be slowing...Speed bumps seen in the first five months may be no accident"

The Chinese authorities have embarked on a series of supportive policies, particularly for the ailing housing market. More innovative solutions may still be needed to stop the sector being a brake on economic expansion and for social stability.

Given the positive start to the year, China seems to be on course to achieve its 5% growth target for 2024. However, weaker domestic consumption, a softer labour market and tumbling property investment hints at a fragile recovery.

## A RESILIENT YEAR AHEAD

Considering the plethora of challenges that face the global economy, forecast expansion of 3.1% this year, and around 3.0% in 2025, would be encouraging. Our focus in the second half of the year is on the resilience of the recovery, progress with slowing price rises and the speed of rate cuts.

If inflation measures return to targeted levels and central banks reduce borrowing costs, this should be another positive. However, the ongoing geopolitical tensions, reduced consumer firepower and fiscal restraints are likely to constrain the speed of the recovery for some time.

**Author: Henk Potts, London UK, Market Strategist EMEA**



# Stay defensive and focus on 'alpha' opportunities

With economic growth slowing and many equity markets at all-time highs, can the rally be sustained, and how should investors be positioned?

**Please note: This article is more technical in nature than our typical articles, and may require some background knowledge and experience in investing to understand the themes that we explore below.**

**All data referenced in this article is sourced from LSEG Datastream unless otherwise stated, and is accurate at the time of publishing.**

Global equities have continued to march higher this year, unphased by rising yields and heightened geopolitical tensions. Apart from a 5% pullback in early April, which was quickly reversed, stock markets have gone up almost in a straight line. They are now back to all-time highs, 26% above their October lows.

## CONTEXT BEHIND THE RECENT RALLY AND PERFORMANCE DRIVERS

The strong performance of equities in 2024 is remarkable, considering the sharp repricing in rate expectations in recent months. At the start of the year, the market was pricing in six or seven US rate cuts in 2024. But following higher-than-expected inflation prints, and more hawkish communication by the US Federal Reserve (Fed), those expectations have been slashed, with the market now expecting only one or two cuts this year. Over this period, US 10-year yields have jumped from 3.8% in December to 4.4% at the time of writing.

The rally has been driven primarily by re-rated valuations, in anticipation of improved earnings momentum. Although some regions appear to be more expensive than others, global equity valuations are elevated by historical standards, trading at 17.6 times their forward earnings, over 20% above their 20-year average.

Those valuation multiples look vulnerable if the growth/inflation mix deteriorates, which is one of the key risks the market is focusing on at present (see chart, page 9). This means that a significant increase in corporate earnings is now required to justify the recent moves in equity prices, and for the rally to be sustained.

## WHAT THE MARKET IS PRICING IN

While the debate has shifted drastically from fears of a 'hard landing' of the economy at the start of last year, to hopes of a 'soft landing' or even a 'no-landing' at the beginning of this year, the market seems to be positioned for the most optimistic outcome. Global equity prices appear to be discounting a 'no-landing' scenario, where economic activity reaccelerates significantly in the coming months.

Based on historical relationships with business surveys and corporate earnings, global equities are pricing in a strong recovery in the manufacturing cycle, consistent with above-trend gross domestic product (GDP) growth, as well as a 15% to 20% jump in global earnings this year.

## HOW LIKELY IS THIS SCENARIO?

Equity markets appear overly complacent on the economic outlook. The US manufacturing sector has been in contraction territory for the past 19 months. While there were tentative signs of stabilisation during March, those were not sustained in April and May. Similarly, the earnings growth discounted by the market is approximately twice as high as the 8% average growth reported globally over the past 50 years. It is also significantly ahead of analysts' forecasts of a 10% increase in earnings this year.

In contrast, our base case scenario is more conservative. It assumes a modest slowdown in global growth over the next couple of years, and a normalisation of inflation towards central banks' targets.

We project global GDP growth to decelerate from 3.2% in 2023 to 3.1% in 2024 and 3.0% in 2025 (below trend growth of 3.4% since 1980). We also expect the global rate of inflation to moderate from 3.9% in 2023, to 2.6% in 2024 and 2.4% in 2025.

Historically, our growth expectations have been consistent with flattish earnings growth globally. This is backed up by the historical relationships with business surveys and bank lending standards.



## EQUITY VALUATIONS TEND TO COMPRESS WITH NEGATIVE GROWTH/INFLATION SURPRISES

Six-month change in global equities' trailing price-to-earnings ratio, compared with the spread between Citi's global economic surprise and inflation surprise indicators over the past 20 years



Sources: LSEG Datastream, Barclays Private Bank, May 2024

### UNCERTAINTY AROUND THE ECONOMIC OUTLOOK

As mentioned previously, the most probable outcome is one where global growth decelerates (but does not collapse), inflation normalises (with bumps along the way) and yields decline.

However, the path for central banks to deliver a 'soft landing' is very narrow. If policy rates are kept restrictive for too long, in order to rein in inflation, they could push the economy into a recession. Alternatively, if rates are cut too soon, to protect the economy, inflation could re-accelerate. Both scenarios would be negative for risk assets, and equities in particular. The situation is further complicated by a swathe of elections this year, not least in the US, as well as heightened geopolitical tensions.

## "We...favour the more defensive parts of the economy"

### WHAT MIGHT THIS MEAN FOR EQUITY PORTFOLIO POSITIONING?

While the upside potential for equity markets appears limited at the index level, 'alpha' opportunities can still be found at the stock, sector, style and regional levels.

#### 1) At the stock level

There has been a significant increase in the dispersion of returns in recent months, with investors paying more attention to company fundamentals than macroeconomic drivers. This seems likely to persist, with more differentiation in share price performance expected, particularly during earnings seasons.

At a time of slowing growth, disinflation and elevated interest rates, we would continue to focus on quality companies. That is, those with a high return on equity, solid balance sheets, low financial leverage and stable earnings through the business cycle. Investors need to be selective, as quality companies have outperformed strongly in recent months and now trade at a significant premium to historical levels. The MSCI World Quality index has returned 32% in the past year versus 25% for the broader market.

Another option is to maintain exposure to structural growth trends, which tend to be less correlated with market moves. Certain themes continue to attract a lot of interest, including the adoption of artificial intelligence within the wider economy, as well as security in its various forms (whether related to cyber, food or defence).

## 2) At the sector level

At the sector level, we continue to favour the more defensive parts of the economy, which have lagged in the recent rally, and tend to outperform the broader market in periods of slowing growth and declining yields. Amongst those, utility and consumer-staples stocks remain reasonably priced, despite a strong rerating in the case of utilities in the past three months. They trade at a discount to history (especially in Europe), offer a superior dividend yield and analysts' earnings expectations look conservative.

However, given the high level of economic and political uncertainty, it also makes sense to maintain some exposure to select deep-value cyclicals, which should behave as a hedge if global growth proves to be more resilient than anticipated.

Global energy stocks are particularly well positioned in that context, as they trade at a deep discount to history, and offer the best dividend yield amongst the 11 Global Industry Classification Standard sectors (4.0% forward dividend yields versus 2.0% for the MSCI All Country World Index). They can also be an attractive hedge against any escalation of geopolitical tensions, rising oil prices and inflation in general.

## 3) At the regional level

At the regional level, we continue to favour UK stocks for their defensive tilt, undemanding valuations and attractive dividend yield.

We also see a short-term window for eurozone equities to outperform their US peers over the remainder of the year (see chart), although we would be more neutral over a longer investment horizon. Two catalysts should help drive this short period of outperformance:

- The divergence in central bank policies, with the European Central Bank likely to cut rates before the Fed this year;
- A reversal in growth momentum, with economic activity improving from a low base in the eurozone and decelerating from an elevated level in the US.

Relative valuations are also supportive, with eurozone equities trading at a 36% discount to their US peers, compared with a 21% discount on average in the past 20 years (based on forward price-to-earnings multiples). This is 2.3x standard deviations below the long-run average (see chart on page 11).

## EUROZONE EQUITIES TEND TO OUTPERFORM THEIR US PEERS WHEN ECONOMIC ACTIVITY IN THE BLOC SURPRISES MORE POSITIVELY THAN IN THE US

Six-month change in the relative performance of eurozone equities versus US peers in local currency, compared with the difference between Citi's economic surprise indicator in the eurozone and the US over the last 10 year



Sources: LSEG Datastream, Barclays Private Bank, May 2024

## EUROZONE EQUITIES TRADE AT A SIGNIFICANT DISCOUNT RELATIVE TO THEIR US PEERS

Eurozone equities' valuation discount to US equities, based on forward price-to-earnings ratio, over the past 20 years



Sources: LSEG Datastream, Barclays Private Bank, May 2024

### IN SUMMARY

With global growth slowing and equity markets trading at all-time highs, the upside potential looks limited at the index level. Having said that, attractive opportunities still exist, under the surface. As the economy slows and vulnerabilities are exposed, investors are likely to become more discriminating.

A renewed focus on company fundamentals should help unlock undervalued assets. At this stage of the cycle, and given the level of uncertainty, a defensive tilt in portfolios seems warranted, alongside selective exposure to deep-value cyclicals.

**Author: Dorothee Deck, London UK, Head of Cross Asset Strategy**



## Bond market road map: the path(s) ahead

Lower growth and lower inflation should provide a favourable path for bonds, but what happens if the great moderation does not materialise?

**Please note: This article is more technical in nature than our typical articles, and may require some background knowledge and experience in investing to understand the themes that we explore below.**

**Please note: All data referenced in this article are sourced from Bloomberg unless otherwise stated, and is accurate at the time of publishing.**

After a solid but not exceptional year in 2023, returns across the major bond segments varied from -5.8% for ultra-long-dated US Treasuries, to almost 2.5% for US high yield and emerging market bonds this year. Dollar- and euro-denominated investment grade debt returned -1.8% and -0.2% respectively.

More resilient growth, particularly in the US, and persistent core inflation, as seen lately in the UK, have once again pushed out the timeline for policy rate cuts. This, in turn, led to a re-pricing in the rate market.

### RATE CUTS POSTPONED

The US economy seems to be heading for a 'soft-landing' while the eurozone and the UK should see a moderate pick up in gross domestic product (GDP) growth (what might be called the great convergence) and lower inflation, as analysed in our Macro chapter, '[Global economy readies for storms ahead](#)'.

A rate cut by the US Federal Reserve (Fed) towards the end of this year seems likely, while three cuts may be on the cards in the UK and eurozone in 2024. The forthcoming cutting cycle could see the Fed, Bank of England (BoE) and European Central Bank (ECB) bring down their policy rates to 4.25%, 3.75% and 2.5% (deposit rate) respectively, though this would be higher than seen during previous cutting cycles.

Moderate growth and lower trending inflation, that is a climate that is not too cold and not too hot, seems to be favourable for bonds.

As examined in our article earlier this year, '[The right temperature for corporate credit?](#)', investment grade credit seems to perform particularly well against government debt if annual GDP growth is between one to two percent, as seen in the US since 1948.

It could be argued that the above is all priced into the market already. First, the rate market implies moderate cuts rather than hikes, as shown by a mildly inverted yield curve (based on the US 10-year yield minus that on the two-year being -0.3%). Second, spreads (yield premium to government bonds) among US investment grade (of below 90 basis points (bp)) and US high yield bonds (close to 300bp), for example, are close to their tightest levels recorded in the last 20 years.

### DOES EXPENSIVE PRICING RESULT IN NO OR NEGATIVE RETURNS CONSEQUENTLY?

No is the short answer. Rich pricing exposes mark-to-market values to volatility, should "things" not materialise as implied. But the main feature of bonds is that they deliver returns through coupon or yield and carry, rather than price gains. Investment grade yields in the US, eurozone and the UK are 100bp away from their recent highs, at 5.5%, 3.8% and 5.5% respectively. However, they are still at levels last seen fifteen years ago, showing plenty of yield still left (see chart, page 13).

In addition, a likely slowing of global growth in coming months suggests that somewhat lower rates are on the cards providing additional price gains. Admittedly, every cycle is different, and the current environment has enough potential to deliver alternative scenarios. However, some are hard to quantify (like the US or UK elections), while others are difficult to judge what the impact will be (like fiscal policy or geopolitical conflicts). Not least because historical relationships between economic outcomes and asset returns appear to have been shaken up over the last three years.

## SPREADS TIGHT BUT YIELDS ARE HIGH

US investment grade (IG) yields decomposed to rate and spread (to Treasuries) component



Sources: Bloomberg, Barclays Private Bank, May 2024

### CONSIDERING ALTERNATIVE PATHS

Given the higher uncertainty over future rate paths, it's worth examining alternative scenarios, and their possible implications. One would be if the major economies avoid a landing at all or see some growth acceleration. Such a possibility seems more likely to occur in the US, compared to the EU or UK for example. Fed chair Powell would likely delay the easing cycle or would even have to add an additional hike or even two in such a scenario.

Higher rate volatility would be on the agenda in particular if the new US government further stretches the fiscal boundaries raising debt supply concerns. A test of the recent highs for the US 10-year Treasury yields, at 5%, and renewed spread volatility could be possible outcomes.

Given the positive fiscal impulse for the economy, higher spreads would unlikely persist and would mainly be seen in the loan market, as a result of higher funding costs.

According to ratings agency Moody's, companies at the lower end of the rating scale in the US must refinance around \$393 billion of debt over the next three years (55% of the total). Overall, a no landing and persistent inflation scenario would favour inflation-linked bonds. But also shorter-term BB-rated bonds should do relatively well (despite expected volatility).

### MARKETS ARE IGNORING CYCLES

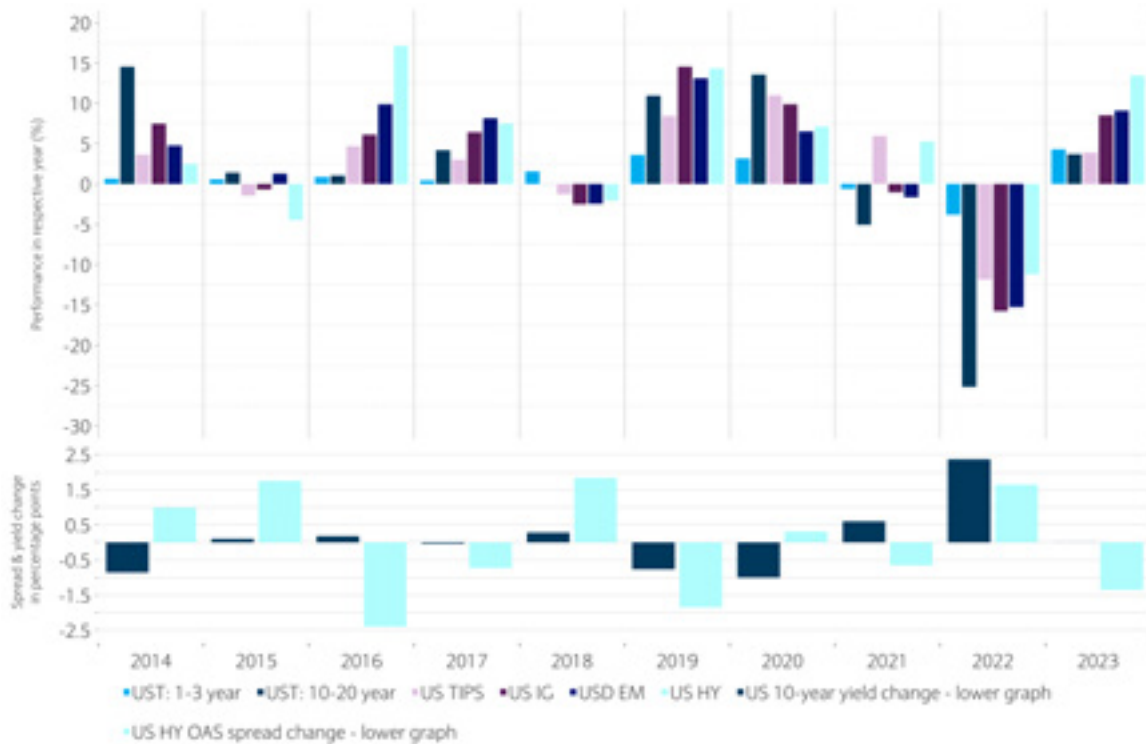
Another alternative scenario, would be that of a recession, which does not seem to be priced in by the market. Again, this is not to be confused with a larger crisis, be it macroeconomic or geopolitical in nature, but simply a deeper economic downturn with a substantial rise in the unemployment rate, as seen so often during cycles.

Traditionally, central banks respond to downturns with deep rate cuts, regularly more so than implied by the rate market. Real policy rates of -1% to less than -1.5%, as seen in 2001 or 2008, appear to be plausible, which could translate to nominal policy rates of lower than 2% in the case of the Fed. Consequently, nominal long-term bonds would outperform while spreads would materially widen; potentially for a prolonged period. This is in anticipation of surging defaults among speculative grade credit given the historically strong relationship between defaults and unemployment. Meanwhile, investment grade bonds should deliver more stable performance, owing to their closer link to rates levels.

**"A rate cut by the Fed towards the end of this year seems likely"**

### EVERY BOND SEGMENT HAS ITS PLACE

Change in performance of US Treasuries (UST), Treasury inflation-protected securities (TIPS), investment grade (IG), high yield (HY) debt and US-dollar-denominated emerging market (EM) debt, over the last decade



Sources: Bloomberg, Barclays Private Bank, May 2024

### SHORT-TERM BONDS HAVE UNDERPERFORMED SIGNIFICANTLY

The performance of various sectors of the US bond market, and US dollar-denominated emerging market debt, shows that shorter-term maturities have lagged



Sources: Bloomberg, Barclays Private Bank, May 2024

## "FANATICALLY" DIVERSIFIED

The fact that the bond market is already priced for a soft landing does not suggest it is inappropriate to position for such a path. It just reduces the likelihood of exceptional short-term outperformance. As mentioned above, reasonable carry returns could still be achieved.

Admittedly, the level of uncertainty seems high at this stage. Even Nobel laureate in economics Paul Krugman attested: "On interest rates I am fanatically confused."<sup>1</sup> Alternative or adverse scenarios, as laid out above, can best be addressed via diversified and active strategies engaging in various parts of the bond market and by avoiding outright extreme positioning (such as being invested in just long-term bonds, or maintaining a focus on high yield bonds only).

A mix of medium-term investment grade bonds in combination with other segments, like high yield (BB-rated), emerging markets and some inflation-linked bonds, seems to be a reasonable approach to meet the potential paths to come, as history has shown (see chart at the bottom of page 14). Sticking to short-term 'safe-haven' debt over a long period to face all possible scenarios, meanwhile, seems to be a more questionable strategy.

**Author: Michel Vernier, CFA, London UK, Head of Fixed Income Strategy**

<sup>1</sup> Krugman says he's 'fanatically confused' on where rates are going, Bloomberg, 21 May 2024



## A century of diversification – was it worth it?

After an inflation shock and soaring financial market uncertainty, this article offers fresh insights into the impact of price rises on portfolio returns across core asset classes, underscoring the significance of diversification for long-term investors

**Please note: This article is more technical in nature than our typical articles, and may require some background knowledge and experience in investing to understand the themes that we explore below.**

Since 2020's COVID-19 pandemic, an initial period of economic slowdown, as well as soaring inflation and aggressive interest rate hikes, have all been replaced by a retreat in inflation and strong earnings growth, fuelled by artificial intelligence fever that has powered US equities higher.

Amid elevated uncertainty and diverging global signals, many investors now focus primarily on short-term macroeconomic data, geopolitical events and monetary policy. How wise is this approach?

### ZOOMING OUT ONE HUNDRED YEARS

Making sound long-term investment decisions is not simple. It requires understanding trends and the relationships between different asset classes, and their sensitivity to macroeconomic factors, over the desired investment horizon.

While history might not repeat itself, this article looks at what a century of returns in US equity and bond markets can teach investors.

### A CENTURY OF FEARS AND HOPES

Since the Roaring Twenties, investors have been hit by the impact of numerous wars, market crashes, seismic geopolitical shifts, economic upheaval and pandemics. However, through the gloom, the world has seen groundbreaking technological advancements and explosive growth.

So, what has the effect of the above turmoil had on the performance and risk of financial markets? Our analysis, which covers the last century<sup>1</sup> in nominal terms, shows that the annualised cumulative total returns over the full sample were 3.3% for Treasury bills, 4.6% for Treasury bonds, 6.8% for US corporate bonds and 10.4% for American stocks. This hierarchy of average returns is consistent across shorter investment horizons and aligns with the market risk of each asset class, measured by annual-return volatility (approximately 3%, 8%, 8% and 19%, respectively).

Staying invested over this hundred-year period, which is admittedly a challenging concept for many investors, would have seen an excess annualised return over cash of about 7%. This is unsurprising, as stocks are the key driver in long-term wealth creation. The flipside is that in doing so, investors are exposed to both volatility and potential intermittent losses.

### THE SPECTRE OF WEALTH EROSION

When investing over shorter periods of time, many people view money in nominal rather than real terms, ignoring the corrosive effects of inflation on portfolio returns. Given that price rises can reduce the buying power of their wealth, investors should consider how much cash is not being deployed, especially over the long term (see chart, at the top of page 17).

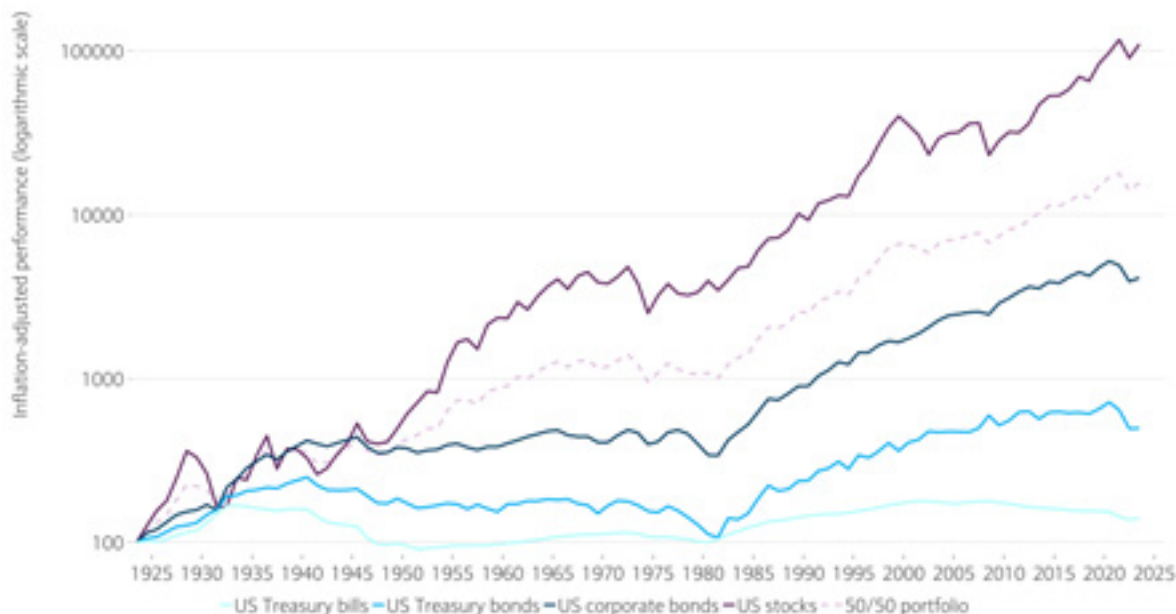
The dangers of focusing on nominal performance are clear when discovering that the inflation rate has averaged about 2.9% since 1923. The average real return on Treasury bills was barely positive, offering minimal real wealth growth. In contrast, Treasury bonds' real growth was 3.5 times faster and corporate bonds' growth was almost 30 times quicker. Stocks, however, outpaced Treasury bills by an astronomical 788 times, roughly equivalent to the number of planet Earths that could fit inside Saturn.

<sup>1</sup>Our dataset comprises one hundred annual fixed income, equity and inflation observations. For fixed income, we collected yields on 3-month US Treasury bills, 10-year US Treasury bonds and 10-year US corporate bonds (investment grade with an average Moody's credit rating of Baa). For equities, we gathered prices, dividends, and earnings for the S&P Composite Index. The dataset also includes annual inflation rates, calculated using the US consumer price index for all urban consumers. The data is sourced from the St Louis Fed's Federal Reserve Economic Data, US Bureau of Economic Analysis and the websites of Professor Robert Shiller (Yale University) and Professor Aswath Damodaran (New York University).



## A CENTURY OF REAL GROWTH

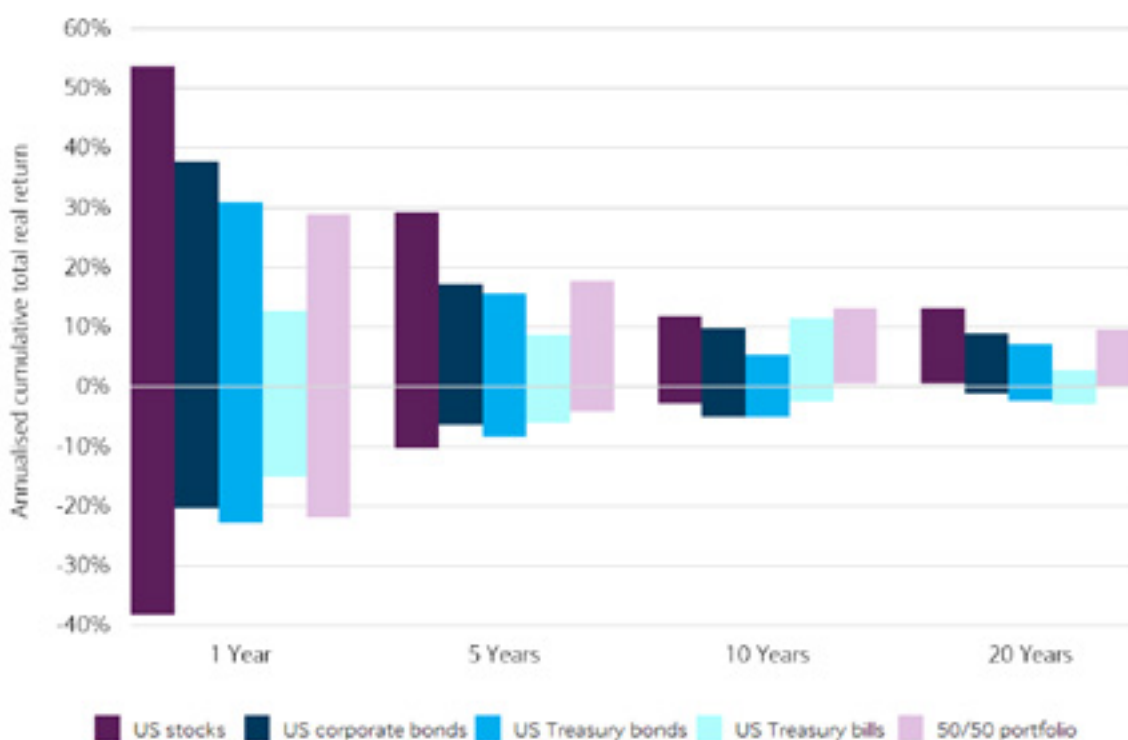
The inflation-adjusted performance for US Treasury bills, Treasury bonds, corporate bonds stocks and a hypothetical 50/50 asset mix between equities and fixed income (30% of the entire portfolio invested in Treasuries, 15% in corporate bonds and 5% in Treasury bills). The full sample comprises total return from 1924 to 2023. All time series are rebased at 100 at the end of 1923



Sources: Federal Reserve Economic Data at St Louis Fed, US Bureau of Economic Analysis, the websites of Prof. Robert Shiller (Yale University) and Prof. Aswath Damodaran (New York University), Barclays Private Bank, May 2024.

## A CENTURY OF VARIATION IN TOTAL REAL RETURNS

The dispersion of annualised total real returns for US Treasury bills, Treasury bonds, corporate bonds, stocks and a hypothetical 50/50 asset mix between equities and fixed income (30% of the entire portfolio is allocated to Treasury bonds, 15% to corporate bonds, and 5% to Treasury bills) for holding periods from one to twenty years. The bottom (top) of each bar shows the minimum (maximum) annualised total real return for a given asset class and investment horizon, observed over a period from 1924 to 2023



Sources: Federal Reserve Economic Data at St. Louis Fed, US Bureau of Economic Analysis, the websites of Prof. Robert Shiller (Yale University) and Prof. Aswath Damodaran (New York University), Barclays Private Bank, May 2024

## COMPOSURE IS REWARDED BY A RISK TWIST

When taking a comprehensive view of temporal and cross-asset investment aspects, two crucial elements emerge:

First, investors typically do not consider investments over a century, so let's focus on more plausible horizons, ranging from one to twenty years. Second, asset classes behave differently over short-term (one-year) versus long-term (ten- or twenty-year) periods (see chart at the bottom of page 17).

We now explore the range of annualised cumulative total real returns for the four mentioned asset classes over one, five, ten and twenty years. Additionally, a simple 50/50 portfolio comprising 50% stocks and 50% fixed income is included in the analysis.

To mimic real-world portfolios, 30% of the entire portfolio is allocated to Treasury bonds, 15% to corporate bonds and 5% to Treasury bills.

Over a one-year investment horizon, stocks displayed the largest dispersion in real returns. The maximum upside and downside swings for corporate bonds were reduced by approximately one quarter compared to stocks. Both stocks and corporate bonds posted positive real returns about 75% of the time. Surprisingly, the real returns for Treasury bills and bonds, despite their lower volatility, were positive only 55% and 61% of the time, respectively.

Moving to five- and ten-year horizons, the extremes are compressed. While the percentage of positive real returns

remains steady for Treasury bills and bonds, it increases to 85% for both stocks and corporate bonds.

Finally, stocks delivered positive real returns in all twenty-year periods from 1924 to 2023. Corporate bonds closely followed, with the success ratio of 93%, while only two-thirds of inflation-adjusted outcomes were favourable for Treasury bills and bonds.

The ordering of the extreme positive outcomes among asset classes aligns with the established full-sample hierarchy. However, the rankings of the largest negative real returns are reversed. Strangely, if risk is defined as the worst inflation-adjusted outcome over a certain period, Treasury bills were the riskiest asset class over a twenty-year investment horizon.

Last but not least, a hypothetical 50/50 portfolio showed similar real return dispersion to US Treasury bonds and corporate bonds over one- and five-year horizons, while aligning more closely with stocks over longer investment horizons.

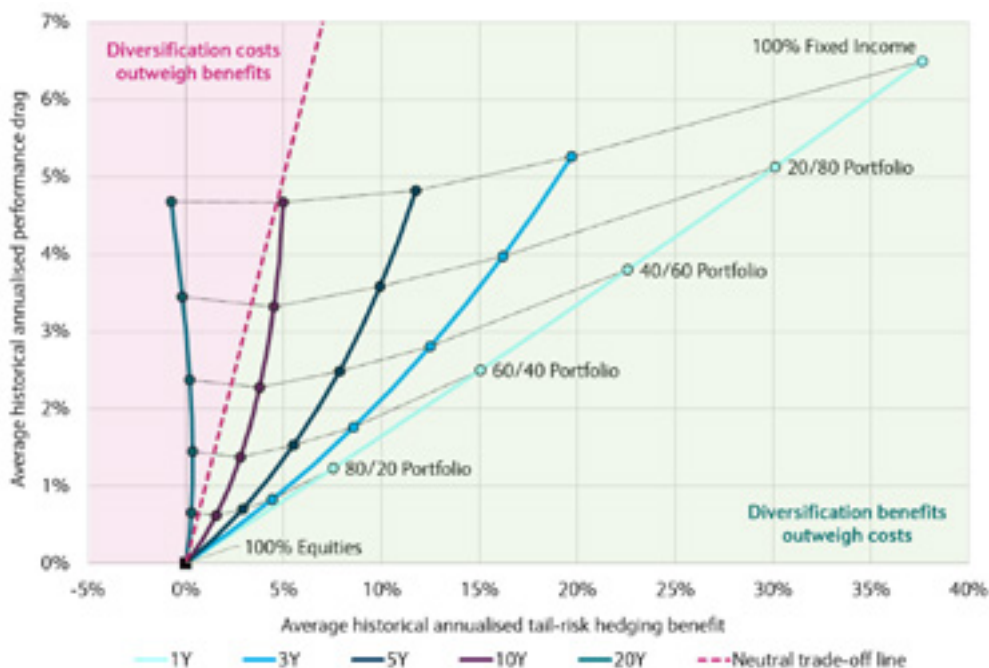
## DIVERSIFICATION OR "DIWORSIFICATION"?

The above analysis indicates that diversification significantly reduces portfolio risk by drawing on the strengths of both fixed income and equity worlds. Furthermore, it does so efficiently across various holding periods.

While managing overall portfolio risk is important, the risk of heavy losses from exceptional events (often known as tail risk) is arguably the most critical. For many investors, it can be difficult to remain calm in times of market crashes, whether in equity or bond markets.

## A CENTENARY CASE FOR DIVERSIFICATION

The trade-off between diversification benefits and costs of adding fixed income to equities in a portfolio over investment horizons ranging from one to twenty years



Sources: Federal Reserve Economic Data at St. Louis Fed, US Bureau of Economic Analysis, the websites of Prof. Robert Shiller (Yale University) and Prof. Aswath Damodaran (New York University), Barclays Private Bank, May 2024

Two key questions arise. Does cross-asset diversification remain effective during market meltdowns, or do the assumed benefits vanish when they are needed the most, leading to the phenomenon known as “diworsification”? And if diversification offers protection, is it truly a ‘free lunch’?

In the chart at the bottom of page 18, each solid line represents a different holding period, and shows the trade-off between tail-risk hedging benefits and performance costs for different asset allocation mixes between equities and fixed income. Irrespective of the overall fixed income weight in the portfolio, 60% of the fixed income segment is allocated to US Treasury bonds, 30% to US corporate bonds and 10% to US Treasury bills. Selected portfolio mixes are highlighted on each line.

The identical portfolio mixes for different holding periods are connected by dotted black lines. The dashed red line separates the region in which diversification benefits outweigh costs (shaded green area) from the region where the opposite holds (shaded red area).

The portfolio allocated 100% in US stocks is marked by a black square, and is associated with zero benefits and cost due to the lack of diversification in fixed income (it represents a benchmark for measurement of diversification effects).

### IS DIVERSIFICATION A FREE LUNCH?

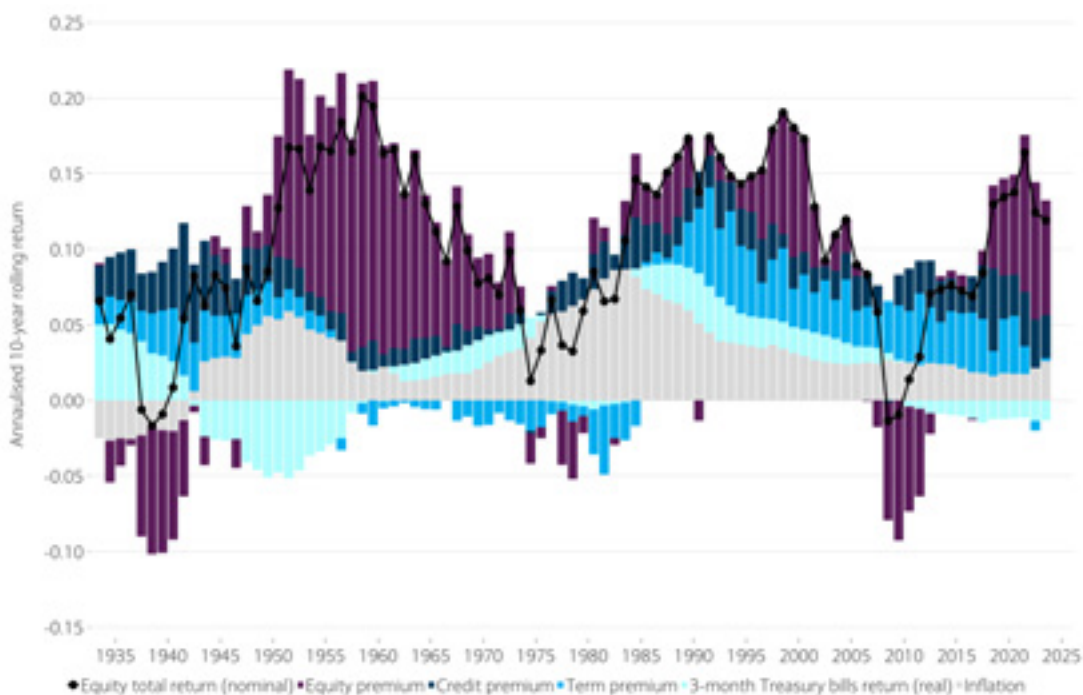
To address the free-lunch question, let’s look at the trade-off between diversification benefits and costs of adding fixed income to equities in a portfolio over investment horizons ranging from one to twenty years. The tail-risk hedging potential and modelled diversification benefits are calculated based on the average percentage of wealth preserved in the ten worst equity market outcomes. Diversification costs are measured as the average historical annualised performance drag, or the opportunity cost of not being 100% invested in stocks.

Our results (see last chart at the bottom of page 18) indicate that, regardless of the share of fixed income in the portfolio, both diversification benefits and costs steadily drop with the holding period (except for the twenty-year horizon, where there is a marginal uptick in diversification costs). Importantly, benefits erode more quickly, resulting in an inverse relationship between the benefit-cost ratio and the holding period.

Overall, the average diversification benefit-cost ratio is favourable for holding periods up to ten years. For the longest considered horizon, investors would have been better off sticking with equities only. Finally, for any holding period, the marginal utility of increasing the percentage of fixed income in a portfolio regularly decreases, and at an accelerating rate.

### MACRO REGIMES DRIVE LONG-TERM RISK PREMIA

The decomposition of the annualised ten-year rolling total nominal return for US stocks between inflation, the real return of Treasury bills and US term, credit and equity premia from 1933 to 2023. The data points are sampled on annual frequency from 1924 to 2023. Since the first estimates are calculated using observations from 1924 to 1933, our sample commences in 1933 for this analysis



Sources: Federal Reserve Economic Data at St. Louis Fed, US Bureau of Economic Analysis, the websites of Prof. Robert Shiller (Yale University) and Prof. Aswath Damodaran (New York University), Barclays Private Bank, May 2024

These results corroborate the adage that investors should avoid putting all of their eggs in one basket. The last century's data suggests that diversification is alive and well, whether over tactical (up to one year) and strategic (up to ten years) horizons.

A word of caution. Despite the above finding, when many investors rush to exit their positions simultaneously – typically seen during a market sell-off – price swings and potential losses can be exacerbated. Moreover, the heightened risk and uncertainty may scare them off from re-investing in equities and profiting from the market recovery.

Diversifying between equities and fixed income investments not only aids portfolio risk management, but helps investors to remain invested during adverse market shocks.

## FOUR SHADES OF DIVERSIFICATION

It is important to stress that our findings hold on average, and cannot be guaranteed in every situation. Correlations can change rapidly with unexpected consequences. Macroeconomic regimes, secular trends and exogenous shocks (such as geopolitical flare ups, natural disasters and pandemics) have often jolted risk premia over the last century. Sometimes, such shifts persisted for many years, as has been seen since the global financial crisis (GFC) of 2007-09.

We illustrate these dynamics from 1933 to 2023 by decomposing annualised ten-year rolling total nominal performance for US stocks into five complementary sources of return: inflation, real cash return, and term, credit and equity risk premia (see chart at the bottom of page 19)<sup>2</sup>. The analysis shows that the long-term success of different asset classes is strongly dependent on the inflation and growth regimes.

Starting with inflation, our analysis observes four distinct regimes: deflationary (1930-1941), disinflationary (1952-1960 and 1985-1999), stable (2000-2021) and inflationary (1942-1951, 1962-1984 and 2022-2023). While based on ten-year averages and not capturing intermediate fluctuations, the regimes provide insights into longer-term trends that are relevant for strategic investment horizons.

## THE IMPACT OF INFLATION REGIMES

The earliest deflationary period coincided with the Great Depression (1929-1933) and a recession (1937-1938). This was a time when US stocks saw their worst historical drawdown, a staggering -65% in 1933. Real returns for Treasury bills gradually eroded, while Treasury bonds, and especially corporate bonds, held up remarkably well, mitigating losses for diversified investors.

Disinflationary periods generally lifted all assets, with equities and Treasury bonds neck-and-neck for the top spot. Equity premiums peaked in the 1950s and performed well in the 1990s, while term premia took off in the 1980s due to falling rates and remained attractive for almost four decades.

For most of this century, there has been a stable or mildly disinflationary regime. The burst of the dot-com bubble in the early 2000s erased the equity premium. The GFC inflicted one of the worst shocks on stocks and poorly-rated debt.

However, low and relatively stable inflation, coupled with quantitative easing and falling rates in the 2010s, significantly boosted equity and credit premia. This remained stable and historically elevated. Notably, real returns for Treasury bills have been negative ever since.

## "The average diversification benefit-cost ratio is favourable for holding periods up to ten years"

### MIXED SIGNALS

Finally, inflationary periods presented mixed signals for equities, depending on the initial inflation level. Typically, scenarios where inflation accelerated after being low or negative for a period, were favourable for equities, as they coincided with economic recoveries after a recession.

Conversely, when inflation was high and rising rapidly, equities typically suffered. Nominal Treasury bonds exhibit a strong aversion to inflation, resulting in diminishing or even negative term premiums during inflationary episodes. Treasury bills were less reactive due to their lower duration, but their real returns eventually felt the inflation pinch. However, credit premiums tended to be more resilient in such situations, saving the case for diversification with fixed income even during the worst inflation scenarios.

## FORTUNE FAVOURS THE CALM AND COMPOSED

Shifts in risk premia over time should not be neglected. However, they are less problematic for a diversified portfolio with different return sources and factor exposures. This allows investors to focus on the long run and rest easier at night.

We've only touched on the surface, addressing the first two pillars of long-term investments: staying invested and being well-diversified. Crafting an optimal asset mix involves a comprehensive analysis of various factors and their interplay. There's no one-size-fits-all solution for investors, each with their own goals. Discipline and adherence to a structured investment process continue to be fundamental pillars of successful investment strategies.

**Authors: Nikola Vasiljevic, Head of Quantitative Strategy, Zurich, Switzerland; Lukas Gehrig, Quantitative Strategist, Zurich, Switzerland**

<sup>2</sup>In our framework the term premium is determined by the difference in nominal performance between Treasury bonds and bills, while the credit (equity) premium measures the same between corporate and Treasury bonds (equities and corporate bonds). Our analysis begins with the first ten years (1924-1933) of data, thus our sample commences in 1933 for this analysis.



## Making use of climate-risk data

As climate-related disclosures become more prevalent in the financial industry, find out how to understand and use the most prominent metrics when deciding how to invest your portfolio.

**Please note: This article is designed to be thought leadership content, to offer big picture views and analysis of interesting issues and trends that matter to our clients and the world in which we live. It is not designed to be taken as expert advice, investment advice or a recommendation, and any reference to specific companies is therefore not an opinion as to their present or future value or broader ESG credentials. Reliance upon any of the information in this article is at the sole discretion of the reader. Some of the views and issues discussed in this article may derive from third-party research or data which is relied upon by Barclays Private Bank and may not have been validated. Such research and data are made available as additional information for the reader where appropriate.**

The amount of climate-related information available to investors has mushroomed in recent years. But for all the fresh data, is it making much difference to how investors are positioning their portfolios?

The Task Force for Climate-related Financial Disclosures (TCFD) has been a very successful British innovation, and one that is now being adopted in many jurisdictions around the world.

It's so successful in fact, that the original body producing it, declared it was a case of 'mission accomplished' and disbanded. Indeed, the TCFD and their reporting guidelines are now part of the International Financial Reporting Standards (IFRS) reporting framework.

Following the lead of the TCFD guidelines, investors around the globe are receiving reports disclosing information both on how financial institutions are incorporating climate risks and opportunities into their processes, as well as assessments of the climate risks and opportunities inherent in their investments.

**“The applied methodologies can be complex”**

### MORE INFORMATION AVAILABLE

The adoption of climate considerations in reporting standards gives them more weight. It should also lead to more streamlined thinking around the topic.

A small number of providers have become dominant players in generating climate-risk assessments. For example, MSCI and Willis Towers Watson (WTW) have developed tools which produce a host of climate-risk characteristics when prompted with a list of assets.

As an investor, no matter what your stance on climate goals may be, more information should help. This article aims to help you to use TCFD reports most effectively and to add a new lens through which to look at risk and opportunity in a portfolio.

### FOOTPRINTS, COMMITMENTS AND SCENARIOS

The direct or indirect emissions associated with a portfolio are identified in a section of the TCFD reports. This backward-looking information is most useful in helping investors to track their progress towards meeting their climate-transition goals.

An interesting innovation for goal-tracking, introduced by MSCI, is implied temperature rise (ITR). This metric estimates what global warming path the world would be on if the global economy had the same effect as a country. From this, average portfolio ITRs can be estimated.

Forward-looking metrics, such as climate value at risk (climate VaR, MSCI) or climate transition value at risk (CTVAR, WTW), combine company characteristics, the commitments made by the companies and scenario projections on how the world might evolve in models that aim to quantify potential climate risks in a portfolio.

The scenarios are often comparable across providers, as they leverage the same scenario providers<sup>1</sup>. However, the applied methodologies can be complex and difficult to compare.

<sup>1</sup>Chapter 1: Framing, context and methods, Intergovernmental Panel on Climate Change Sixth Assessment Report, and The future is uncertain, the Network for Greening the Financial System climate scenarios, April 2024

## GETTING TO GRIPS WITH THE ASSUMPTIONS

MSCI's climate value at risk, the most prevalent framework in TCFD reports, identifies climate opportunities, transition risks and physical risks. For each aspect, scenario-dependent future costs and gains in relation to the current asset price are estimated.

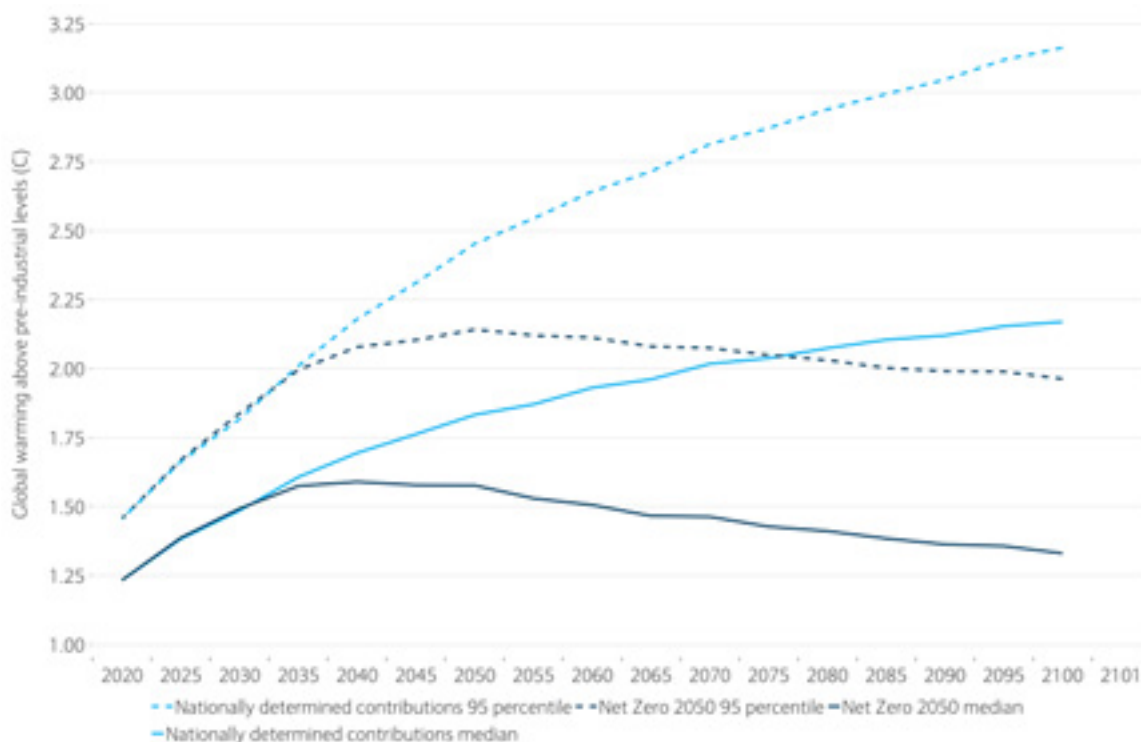
Importantly, the MSCI framework assumes that none of these climate risks are currently reflected in the market valuation of companies. The target horizon for all estimates is 15 years, though the evolution is estimated until 2050 for transition risk, and 2100 for physical risk.

These are important assumptions, as a 15-year investment window is unrealistic for many investors. However, the choice of time horizon is central to using forward-looking estimates, since transition risks are sensitive to policy changes. Physical risks, however, do not materially differ between even the most extreme scenarios (see chart) in the short term, but can vastly differ as time horizons grow beyond ten years.

As such, while physical near-term risks exist, the path of policy is unlikely to change them. This may be one of the reasons why WTW's approach focuses on transition risk. Instead of estimating the potential impact on economies of various climate scenarios, WTW considers what costs would be associated with a transition in order to be in accordance with the Paris Agreement of limiting global warming to 1.5°C above pre-industrial levels (see chart).

## FROM 2035 ONWARDS PHYSICAL SCENARIOS DIVERGE

Median (50%-percentile) and 95%-percentile projections of global warming projections for Network for Greening the Financial System climate scenarios Nationally Determined Contributions and Net Zero 2050



Sources: NGFS Phase 4 Scenarios, Barclays Private Bank, May 2024

## THE VALUE LIES BETWEEN THE ESTIMATES

Turning to MSCI's climate VaR metric: Despite there being a potential cost estimate, the estimate itself is not that insightful. Not only do time horizons not match those of most investors, but there is much uncertainty regarding the likelihood of scenarios and the potential outcomes within scenarios (see previous chart). The usefulness of this approach lies in the ability to compare risk estimates across climate scenarios and to understand in which positions there might be concentrations of a specific climate risk.

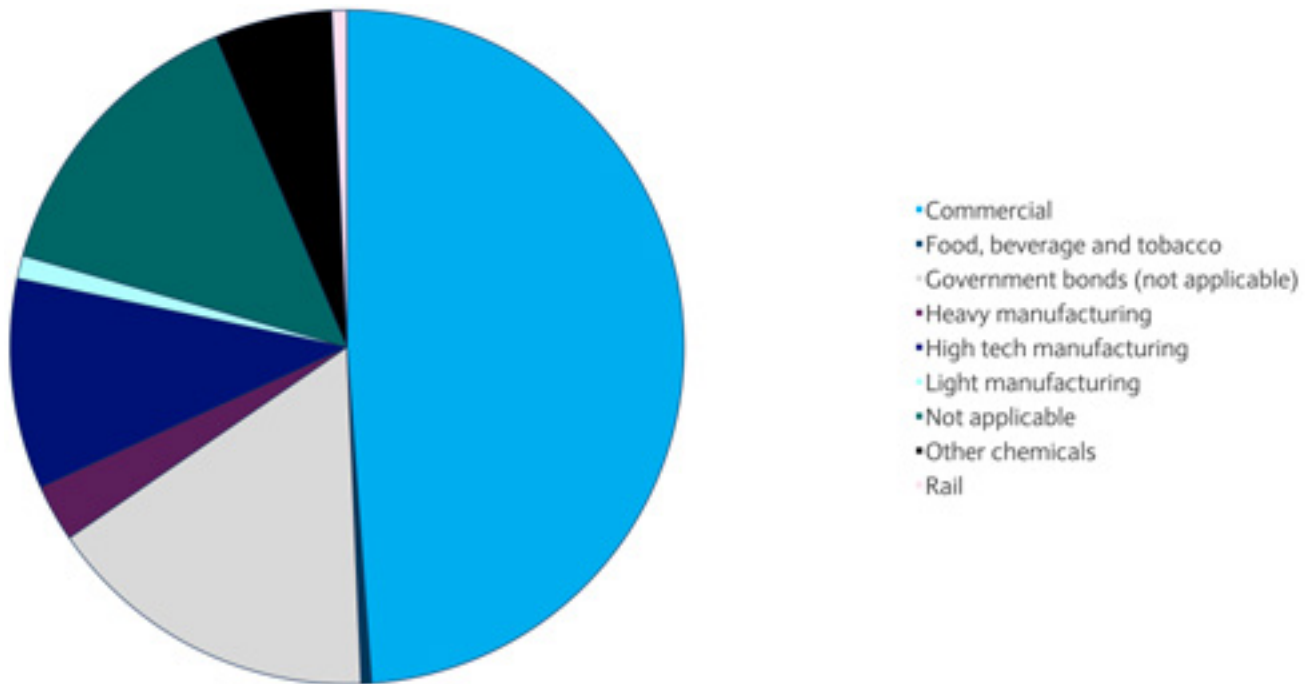
## SWITCHING LENSES

Leaving exact estimates behind, investors equipped with climate-risk estimates can now add another lens to their portfolio analysis. As with any risk, be it geopolitical, concentration or currency related, one can overlay a climate lens to explore the robustness of a portfolio.

A first, helpful tool by MSCI is the re-arrangement of traditional economic industries into so-called emission sectors. A typical balanced multi-asset class portfolio with a focus on capital-light businesses might have emissions exposures that look like those shown in the following pie chart. This re-grouping of traditional industries can already shed light on the climate-risk concentrations, based on the type of climate risk each emission sector might be most exposed to (see chart on page 23).

## EMISSION SECTORS INSTEAD OF INDUSTRIES

MSCI emission sectors for a typical balanced multi-asset class portfolio



Sources: MSCI, Barclays Private Bank, May 2024

### GOING DEEPER GETS MORE INVOLVED

But transition risk is about much more than emissions: TCFD guidelines name policy, legal, technology, market and reputational risks as subcategories. While the mining industry may face significant transition risks in all subcategories, transition risks for the finance industry are concentrated in legal and reputation risk.

Unfortunately, the MSCI transition risk framework does not capture this notion directly and one has to build a scorecard of transition risks and physical risks themselves, as identified in our article, '[Is your portfolio at risk from the low-carbon transition?](#)'

For physical risks, the MSCI model differentiates between slowly evolving chronic risks, that may cause business interruptions, and acute climate risks, which may cause business interruptions as well as damage to assets.

**“Investors...can now add another lens to their portfolio analysis”**

### UNDERSTANDING THE PHYSICAL/TRANSITION RISK TRADE-OFF

TCFD reports often contain a forward-looking model output for an orderly transition scenario like Net-Zero 2050, and compare it with those looking at higher temperatures, such as Nationally Determined Contributions. Using the same typical balanced portfolio, we explore the trade-off between physical risks and transition risks (see chart on page 24).

Perhaps the chart's first interesting observation is that the commercial emission sector, which includes both buildings and services, contributes slightly above 70% of portfolio physical risk, while carrying around the same weight in the sample portfolio<sup>2</sup>.

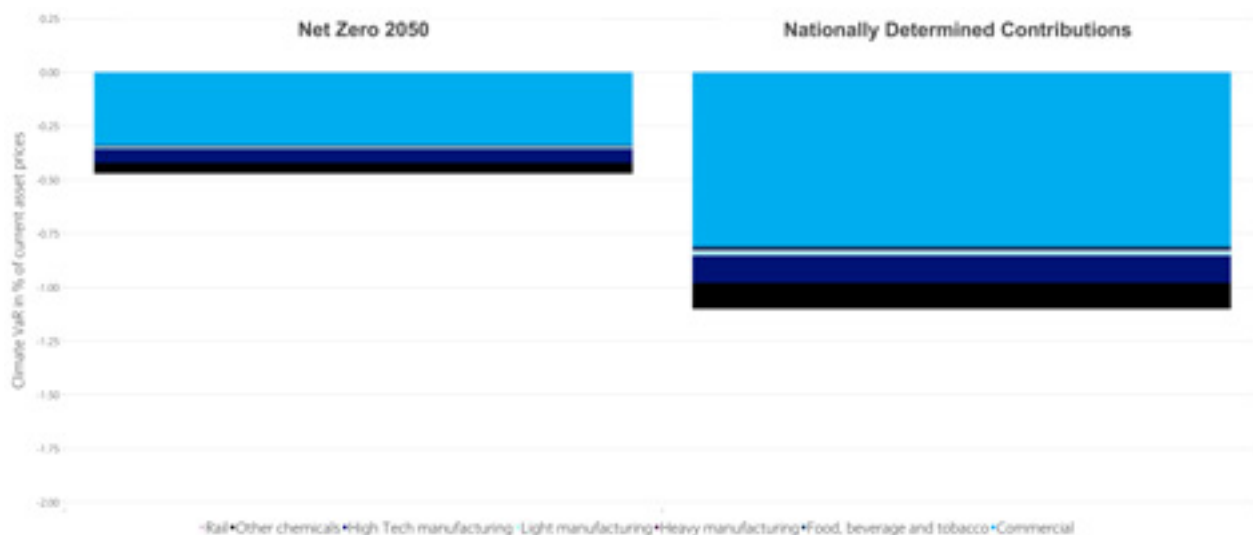
One could say that this exposure is “neutral” towards the physical risk budget and is positive towards the policy-risk budget, as commercial positions only contribute about 50% of policy risk. Second, even though commercial sector exposures can decrease the physical risk exposure, they still carry physical risk. Third, the difference between scenarios is significantly larger for policy risk than it is for physical risk. This implies that policy risks should be re-evaluated more often.

<sup>2</sup>After excluding emission categories “government bonds” and “not applicable”, since there are no climate VaR estimates from MSCI for these sectors.

## TRADE-OFF BETWEEN TRANSITION AND PHYSICAL VALUES AT RISK

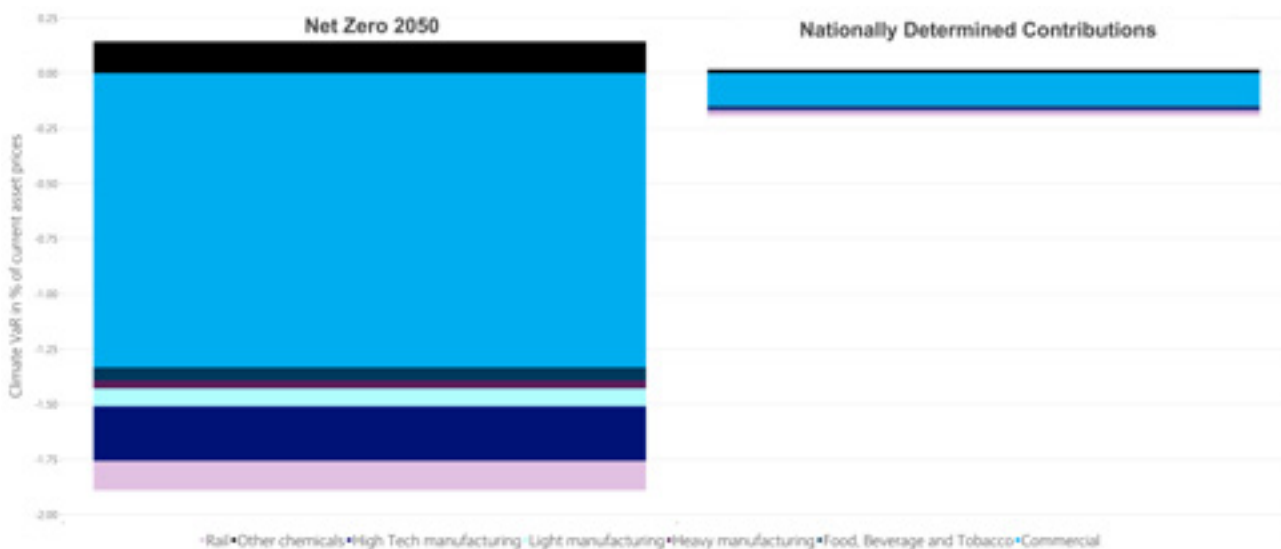
Emission sector breakdown of MSCI climate VaR estimates for NGFS scenarios "Net-Zero-2050" and "Nationally Determined Contributions" on a typical balanced multi-asset class portfolio

### PHYSICAL RISK



Sources: MSCI, Barclays Private Bank, Mar 2024

### AGGREGATED POLICY RISK (TRANSITION RISK PLUS TECHNOLOGY OPPORTUNITIES)



Sources: MSCI, Barclays Private Bank, Mar 2024

### NEW WAYS TO CHALLENGE INVESTMENT IDEAS

Climate-relevant data is much more than just greenhouse gas emissions. Forward-looking metrics can help to identify and manage the different types of climate risks found in an investor's portfolio. However, the risks need to be well-understood.

Climate scenarios open another long-term angle to portfolio analysis and put even more emphasis on the all-important question: what is your investment horizon?

For the near-term, scenario assumptions on policy risk are more important than those on physical risk. The latter depends more on the location of assets and can look vastly different from our shown example for less capital-light strategies that may have more geographical exposure to emerging markets.

**Authors: Lukas Gehrig, Zurich Switzerland, Quantitative Strategist; Nikola Vasiljevic, Zurich, Switzerland, Head of Quantitative Strategy**





# Is your portfolio at risk from the low-carbon transition?

Find out what you can do to prepare your portfolio for the effects of the transition to a greener world.

**Please note: This article is designed to be thought leadership content, to offer big picture views and analysis of interesting issues and trends that matter to our clients and the world in which we live. It is not designed to be taken as expert advice, investment advice or a recommendation, and any reference to specific companies is therefore not an opinion as to their present or future value or broader ESG credentials. Reliance upon any of the information in this article is at the sole discretion of the reader. Some of the views and issues discussed in this article may derive from third-party research or data which is relied upon by Barclays Private Bank and may not have been validated. Such research and data are made available as additional information for the reader where appropriate.**

Climate change is not only an environmental issue; it's an economic one. As such, the global economy needs to transform into a low-carbon one.

Like any structural change, this will have winners and losers. Industries and companies that do not adapt are at risk of decline or disappearing. So too are investors' portfolios holding investments in such sectors.

The financial risks that arise from the shift to a lower-carbon economy give rise to what the Task Force on Climate-Related Financial Disclosures (TCFD)<sup>1</sup>, calls "transition risks" which are complementary to the "physical risks" reviewed in our Market Perspectives publication, in May's article, ['Making portfolios more weather resistant'](#).

Here, this article breaks down why these risks matter from a financial perspective and provides actionable insights to help you to position your portfolio effectively.

## UNDERSTANDING TRANSITION CLIMATE RISKS

Governments, companies and society are all adapting to climate change, some more so than others. Investors should consider the transition risks, and opportunities, that arise from these changes as they seek to protect and grow their wealth and make a positive contribution to our world.

The TCFD identifies four main types of transition risks: policy and legal, technology, market, and reputation<sup>2</sup>.

## POLICY AND LEGAL RISKS

To deliver on their Paris Agreement commitments, governments are adopting regulations and policies designed to reduce carbon emissions or promote adaptation to climate change.

Policy levers include stricter regulations on emissions, carbon pricing or taxes, emissions-trading systems and more climate-related disclosures. As such, firms face the additional costs of compliance or the forgone revenues from not complying.

At the same time, companies and governments are more exposed to litigation from their actions, or lack thereof, relating to climate change. Since 2017, the cumulative number of climate-related court cases has doubled, reaching 2,180 climate-related cases filed in 65 jurisdictions by the end of 2022<sup>3</sup>.

Claims cover a diverse set of causes. For example, historically high emitters are at risk of legal action for contributing to climate change. More broadly, complaints of corporate greenwashing are more common, with the threat to reputation and revenues being ever present.

<sup>1</sup>TCFD, Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017

<sup>2</sup>Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017

<sup>3</sup>Global Climate Litigation Report: 2023 Status Review, United Nations Environment Programme, July 2023

## TECHNOLOGY RISKS

Technological risks arise from the rapid development and deployment of new ways to support moves to a low-carbon economy, in the familiar process of ‘creative destruction’.

Companies that fail to innovate or adapt to new technologies risk becoming obsolete.

Prime examples include shifting energy production from fossil fuels to renewable energy, or automotive firms converting from internal combustion engines to electric drivetrains.

Adoption of new technologies can begin slowly, especially given the competing solutions. Businesses may believe that such proposed solutions are unviable or doubt that they have time to switch. However, once adoption reaches a tipping point and accelerates, they face greater risk of disruption.

## MARKET RISKS

Market risks arise from the increased awareness of climate change and the impact it has on supply and demand for certain commodities, products and services.

Consumers, corporations and governments, not wanting to worsen climate change, are shifting spending to more sustainable options. Conversely, companies with high emissions, or not seen to be making the transition quickly enough, may see less demand or their assets repriced lower.

As well, firms may suffer from increased production costs due

to scarcity, higher demand or to reflect externalities. Input costs, such as for energy, water or natural resources, and output requirements, such as treatment of waste water, could increase as market dynamics change.

## REPUTATION RISKS

Reputational risks concern the perception of companies by consumers, regulators or peers to their attempts to adjust, including how they present themselves to the outside world. In a social media age, such risks can harm a company’s bottom line quickly.

Reputations can be affected on an absolute basis, perhaps an incident for a single company, or on a relative basis, that is how one company compares with others.

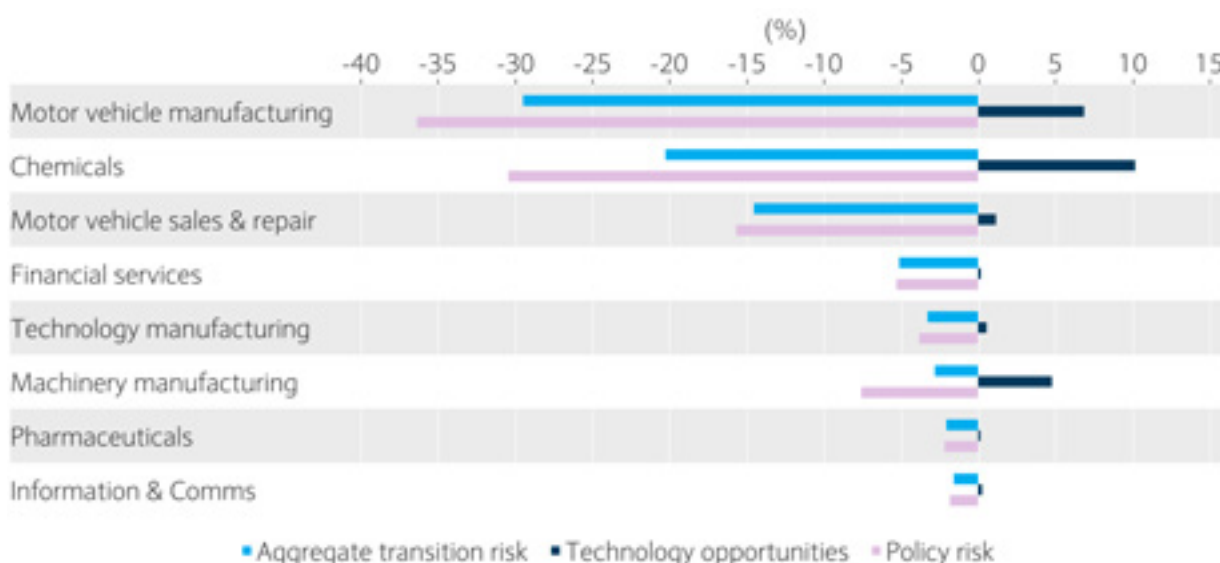
Reputational damage can affect a firm’s attractiveness to clients or suppliers, the degree of engagement from stakeholders and potential stigmatisation. Without reconciling reputational damage, in the worst case, a firm may lose its “license to operate” socially or legally.

## HOW TRANSITION RISK AFFECTS INDUSTRIES

Efforts to transition to a low-carbon economy can affect companies’ revenues and profits (see chart). For example, greener buying preferences or damage to reputation from greenwashing may hit sales. Making required technology changes or paying for emissions will increase costs.

### AGGREGATE VALUE AT RISK IN A 1.5C NET-ZERO TRANSITION SCENARIO

Potential financial impacts by sector of from policy risks and technology opportunities



Sources: MSCI, Barclays Private Bank, May 2024

<sup>4</sup>The chart is based on MSCI Climate Value-at-Risk (CVaR) tool assessing industries in MSCI ACWI Index applying the Networking for Greening Financial System (NGFS) REMIND model of 1.5C Disorderly scenario. CVaR is designed to provide a forward-looking and return-based valuation assessment to measure climate related risks and opportunities in an investment portfolio. The tool aggregates potential future policy costs, and does not explicitly identify market, technology or reputational risks. It does include technology opportunities based on low-carbon patents and revenues held by companies. As a scenario-based, forward-looking model, it does not predict future performance, and only indicates the potential impact of transition risk.

The extent and nature of transition risks, though, will vary by industry. When assessing specific sectors for policy risks and technology opportunities, the aggregate value at risk can be substantial. It will matter more for “hard to abate” sectors that find it tougher to cut their carbon footprint. For example, steel or cement industries face greater transition risks. However, even apparently unrelated industries, such as fashion, food or tourism, will also be affected.

As well, the four transition risks can be intertwined and reinforcing. Generically, a policy risk that requires new technology may add to reputational risk, if a firm does not make progress, thereby affecting consumer demand ( a market risk) and potentially leading to litigation (a legal risk).

The table below summarises some of the transition climate risks for specific industries and their effects on a company’s value chain<sup>5</sup>.

INDUSTRY	ILLUSTRATIVE TRANSITION RISK EFFECTS	POTENTIAL IMPACT ON VALUE CHAIN
Agriculture, Food & Beverage	<p>Policy and Legal: Implementation of stricter agricultural emissions regulations increasing operational costs.</p> <p>Technology: Shift to sustainable farming technologies requiring significant investment.</p> <p>Market: Growing consumer demand for organic and sustainably sourced food products.</p> <p>Reputation: Negative publicity for companies with poor environmental practices affecting brand loyalty.</p>	<p>Supply chain: Increased costs and disruptions due to new compliance requirements.</p> <p>Production: Need for investment in sustainable farming practices and technologies.</p> <p>Distribution: Changes in logistics to support sustainably sourced products.</p> <p>Sales and Marketing: Shift in strategies to highlight sustainability efforts.</p>
Apparel	<p>Policy and Legal: Introduction of regulations on textile waste and water usage.</p> <p>Technology: Adoption of eco-friendly materials and sustainable production methods.</p> <p>Market: Consumer preference shifting towards sustainable and ethical fashion brands.</p> <p>Reputation: Backlash against fast-fashion brands with poor environmental records.</p>	<p>Supply chain: Increased scrutiny on sourcing practices and supplier compliance.</p> <p>Production: Higher costs due to sustainable materials and production processes.</p> <p>Distribution: Enhanced focus on reducing carbon footprint in logistics.</p> <p>Sales and Marketing: Rebranding and marketing to emphasise sustainability credentials.</p>
Tourism	<p>Policy and Legal: New regulations on carbon emissions from travel and tourism.</p> <p>Technology: Investment in sustainable tourism technologies and practices.</p> <p>Market: Shift in consumer preferences towards eco-friendly travel options.</p> <p>Reputation: Destinations known for unsustainable practices losing tourist appeal.</p>	<p>Supply chain: Increased costs due to compliance with new environmental regulations.</p> <p>Operations: Need for investment in sustainable infrastructure and practices.</p> <p>Marketing: Rebranding efforts to attract eco-conscious travellers.</p> <p>Revenue: Potential decline in revenues from regions not adapting to sustainable practices..</p>
Insurance	<p>Policy and Legal: Regulatory changes mandating climate-risk disclosures.</p> <p>Technology: Integration of advanced analytics to assess climate risks.</p> <p>Market: Increased demand for climate-related insurance products.</p> <p>Reputation: Negative perception if insurers fail to address climate risks.</p>	<p>Underwriting: Adjustments in underwriting criteria to account for climate risks.</p> <p>Claims: Increased claims due to climate-related events affecting profitability.</p> <p>Product development: Creation of new insurance products to cover climate risks.</p> <p>Risk management: Enhanced focus on risk assessment and mitigation strategies.</p>

<sup>5</sup>Industry list, illustrative climate effects and potential impacts are representative and not exhaustive.

INDUSTRY	ILLUSTRATIVE TRANSITION RISK EFFECTS	POTENTIAL IMPACT ON VALUE CHAIN
Electric power	<p>Policy and Legal: Stricter emissions regulations and renewable energy mandates.</p> <p>Technology: Transition to renewable energy sources and smart grid technologies.</p> <p>Market: Growing demand for clean energy from consumers and businesses.</p> <p>Reputation: Pressure on companies reliant on fossil fuels to transition to cleaner energy.</p>	<p>Generation: Increased investment in renewable energy infrastructure.</p> <p>Transmission and Distribution: Upgrading grid systems to support renewable integration.</p> <p>Operations: Higher costs and operational changes to reduce carbon footprint.</p> <p>Sales and Marketing: Promoting renewable energy offerings to attract eco-conscious customers.</p>
Oil & Gas and Mining	<p>Policy and Legal: Implementation of carbon pricing and emissions reduction targets.</p> <p>Technology: Shift towards carbon capture and storage technologies.</p> <p>Market: Decline in demand for fossil fuels and increased investment in renewables.</p> <p>Reputation: Growing public and investor scrutiny of environmental practices.</p>	<p>Exploration and production: Increased costs due to regulatory compliance and new technologies.</p> <p>Operations: Diversification into renewable energy sources and sustainable practices.</p> <p>Distribution: Changes in logistics to support reduced carbon footprint.</p> <p>Revenue: Potential revenue decline from reduced fossil fuel demand.</p>
Real estate	<p>Policy and Legal: Stricter building codes and energy efficiency standards.</p> <p>Technology: Adoption of green building technologies and materials.</p> <p>Market: Increased demand for sustainable and energy-efficient properties.</p> <p>Reputation: Negative impact on property values in regions not adapting to sustainability.</p>	<p>Development: Higher costs for incorporating sustainable building practices.</p> <p>Operations: Investment in energy efficiency and renewable energy systems.</p> <p>Valuation: Potential devaluation of properties not meeting sustainability criteria.</p> <p>Marketing and Sales: Promoting green certifications and sustainability features to attract buyers</p>

Sources: Barclays Private Bank, May 2024

## APPROACHES TO ASSESS TRANSITION RISKS IN PORTFOLIOS

To mitigate the transition risks on their portfolios, investors could adopt several practical strategies:

**1. Conduct comprehensive risk assessments:** Evaluate the exposure of investments to transition risks across different sectors, regions and asset classes. Consider all four transition risks as well as their interdependencies. To identify specific risks, assess environmental records, past R&D and capital investments and transition plans to adapt to the transition.

**2. Utilise climate-scenario analysis:** Model potential faster or slower policy change scenarios and assess their impact on potential investment performance. Consider factors such as how orderly, including the speed and consistency, policy changes will be made against the risk of a disorderly process, perhaps one where policies are delayed or divergent.

**3. Assess transition targets, plans and reporting:** Review current sustainability commitments, corporate disclosures on exposure to transition risks and stated transition strategies and pathways. Evaluate transition plans for credibility and assess corporate capabilities to deliver large-scale, business-model transformation programmes.

**4. Monitor regulatory developments:** Stay informed about regulatory changes and policy developments related to climate change. Regularly review how new regulations could affect specific industries, both domestically and for imports, as well as how the changes might drive investment flows.

**5. Integrate climate risk metrics:** Incorporate transition-risk metrics, such as exposure to carbon-related assets or to changes in energy costs or carbon pricing, into investment decision-making processes. Evaluate scale and nature of climate risks on portfolio performance using quantitative tools and models, and adjust asset allocations accordingly.

## PREPARE YOUR PORTFOLIO FOR TOMORROW'S WORLD

Climate transition risks can be more subtle than the physical effects of climate change. However, they can still hit the value of investment portfolios.

The longer governments and companies take to address climate change, and the larger its physical impacts become, the swifter and more severe the action needed will likely be. Furthermore, complacent investors may be more surprised by any sudden action that amplifies transition risks.

Making your portfolio more resilient to transition risks requires actively assessing and anticipating how the world might move to the required low-carbon economy. While impossible to predict perfectly, preparing your portfolio for such a shift should help you to reach your long-term goals more effectively.

**Author: Damian Payiatakis, London UK, Head of Sustainable & Impact Investing**

**“The extent and nature of transition risks...will vary by industry. When assessing specific sectors for policy risks and technology opportunities, the aggregate value at risk can be substantial”**



# Elections or economy – which matters most for investors?

With several momentous votes due this year, beware of your behavioural biases interfering with the best investment approach to take.

This would seem to be a year of heightened political risk for investors' portfolios with a deluge of elections across the world, not least in the US. Indeed, approximately half of the global population is eligible to vote at the polls<sup>1</sup>.

A question on many investors' minds is how do I position my portfolio for the upcoming elections? Should I hold off investing until the outcome of an election is clear before getting invested or making investment decisions?

Elections are difficult to predict. Even if the outcome could be predicted, the market implications of an election result can still be very uncertain. That said, for all the noise, sometimes the effects of votes on valuations can be limited. The best course of action for investors is to stay invested and follow good investing principles, which hold across all periods in time, whether in an election year or not.

## BEWARE OF BEHAVIOURAL BIASES

Before examining the interplay between elections and investing, it's important to be aware of behavioural biases that can affect the way that investors perceive coverage of elections.

Be wary of 'confirmation bias' – when people seek out, and pay more attention to, news and stories which confirm their own pre-existing views or beliefs. Using a personal view on a candidate or the likely impact of them winning an election, and using this as the lens through which to take in information and make investment decisions, can introduce bias and lead to poor results.

It is important to consult a range of sources and viewpoints to ensure that decisions are being made objectively, on the basis of all the information. This includes data or views that might contradict an investor's view on the world.

November's election in the world's largest economy, the US, will be a focal point for many investors in 2024, given its heft in global indexes and thus how exposed investors might be to the region.

## ALL EYES ON WASHINGTON

The political environment in the US, and the media coverage of it, is extremely charged and partisan. But for all the partisanship, and in turn how it affects people's views on the domestic economy and other important issues, what might the effect of the election outcome be on financial markets?

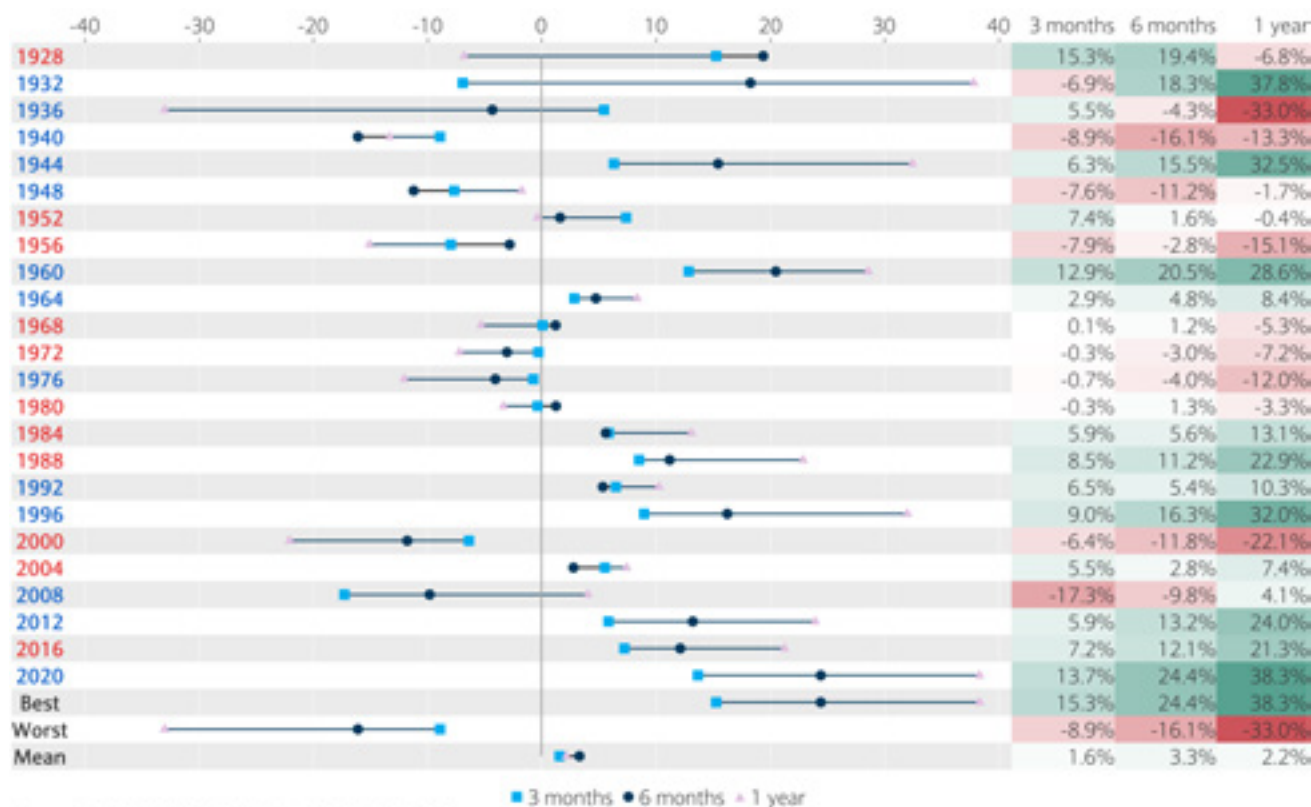
The chart on page 31 shows the outcome of previous US elections, and the subsequent performance of the S&P 500. The data is mixed, showing that the common consensus that one party is unanimously good for investors, and the other bad, is not necessarily the case.

Probably more important than the vote, is the outlook for the global economy, and therefore prospects for the domestic one, for investors. A boom period will be unanimously be better for both parties than a recessionary period, irrespective of domestic policy. As stated in our Macro chapter, '[Global economy readies for storms ahead](#)', US economic activity is likely to slow in coming months.

Additionally, the sectors that might be expected to perform best under a particular party can surprise. For instance, under Joe Biden's presidency the S&P Oil & Gas Exploration and Production Select Industry Index is up 269%, whereas the NASDAQ Clean Edge Green Energy Index is down 29%. Despite climate change initiatives being a central policy priority for the Biden administration, the US oil and gas industry has flourished, with production at record levels and higher energy prices than in 2020.

<sup>1</sup>Your evening briefing: Half the world's population – and GDP – is heading to the polls, Bloomberg, 11 January 2024

## US ELECTIONS AND SUBSEQUENT EQUITY MARKET PERFORMANCE



Sources: S&P Global, Barclays Private Bank, May 2024  
 Note: Red year indicates Republican victory, blue year indicates Democrat victory

### WHAT TO LOOK AT?

What tends to drive markets in the long run is economic growth, and thus economic fundamentals should be the key factor for investors.

Whilst elections will occupy the headlines, it's important to remember that political stories do not always translate into policies, or market events. The test for both US candidates will be on the fiscal side, and whether the market will allow them to follow an accommodative fiscal policy, or whether they will have to be restrictive, with the associated uncertainty if and when the US debt ceiling becomes a sticking point, as it has been in the past.

In the US, the economy is a top priority for voters. Whilst voters pay great attention to economic data when going to the ballots, it's important to recognise that perceptions of the data can differ wildly between voters with different political affiliations.

### ECONOMIC DATA IS SUBJECT TO PERCEPTION

The US has been the strongest performing economy of any other large high-income country since 2019. Growth, jobs and investment have been strong. Inflation has also retreated recently, without a significant rise in unemployment, a fear that had worried some. It has been a period of economic boom, one backed by fiscal spending and high-profile legislation that has supported this performance.

Nonetheless, 57% of voters disapprove of Joe Biden's record<sup>2</sup>. One reason has been soaring inflation until recently; price rises have been higher than those seen for many decades under the Democrats. People who feel poorer under this administration are unlikely to feel much sympathy towards it, whatever the contributing external factors not within its control. People who feel big increases in the price of groceries appear to extrapolate them.

More important is the fact that perceptions of the economy are political, with Republicans seeing a bad economy when their opponents are in power and vice versa. Today, in part due to the media landscape, people do not just have their own opinions and facts are more disputed. The economy they see is not necessarily the one they experience day to day. Rhetoric can matter more than the economic reality. So, what does this mean for investors?

### STICK TO GOOD INVESTING PRINCIPLES

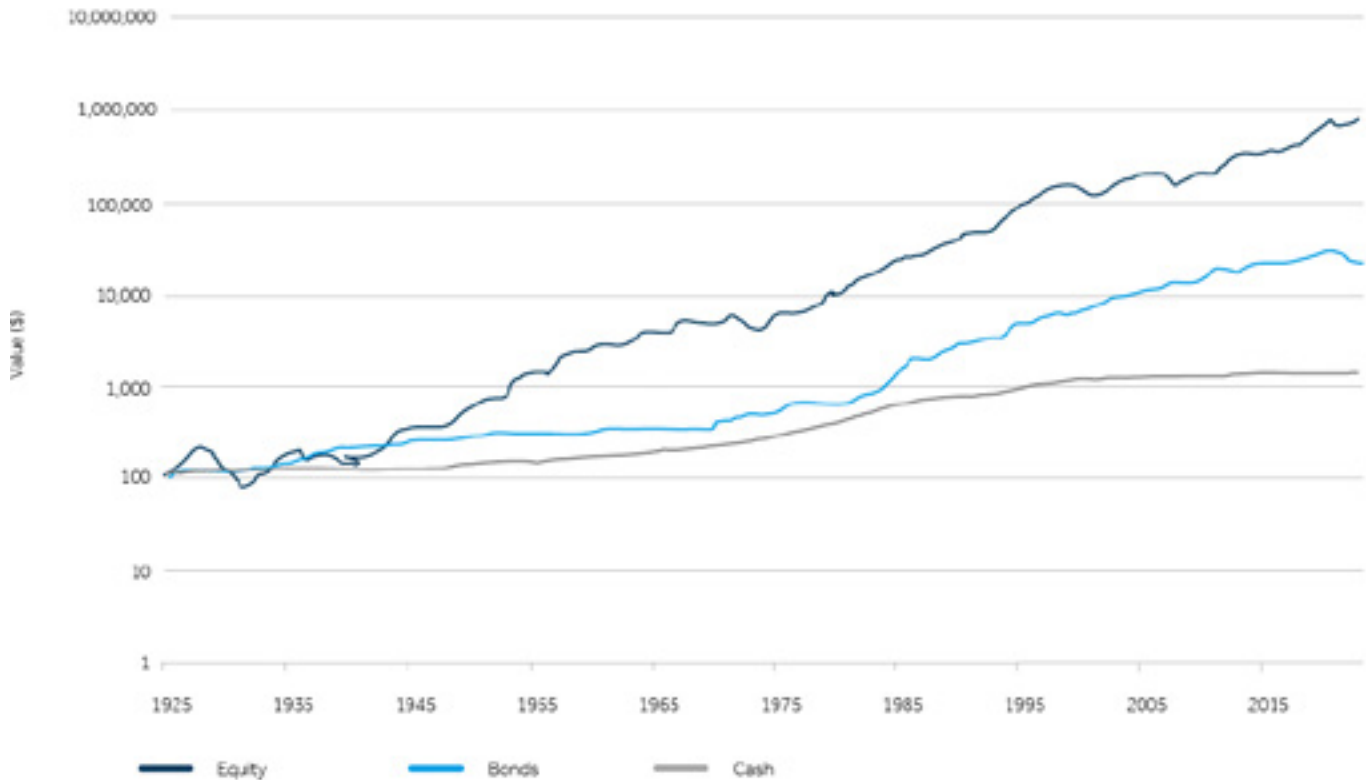
Elections matter for a host of different reasons, be that for domestic politics, society or economics. A new administration can introduce legislation that can alter the path for growth, inflation and potentially interest rates. Thus, they can be significant for financial markets, and investors are right to pay attention to them.

That being said, voters and election results can be unpredictable. Even predictable outcomes can have

<sup>2</sup>CNN poll of polls, CNN, 18 April to 20 May

## THE CASE FOR LONG-TERM INVESTING

Barclavs US total return indices in nominal terms with gross income reinvested



### The growth of \$100 invested in 1925 with income reinvested gross

	Nominal	Real
Equities	\$ 984,858	\$ 57,471
Bonds	\$ 13,299	\$ 776
Cash	\$ 2,293	\$ 134

Sources: CRSP, Barclays Research, Barclays Private Bank, May 2024

unpredictable impacts on markets. Those holding fire on making investment decisions until after an election outcome is clear so that they are acting under less uncertainty, may be disappointed to find that uncertainty is a constant.

In election years, as in others, following tried-and-tested investing principles is likely to be the best way for investors to protect and grow their wealth and that of the next generation. This means getting, and staying invested, so as to reap the rewards from putting capital to work over the long term.

Deploying this capital in a well-diversified portfolio allows investors to better achieve their long-term goals through different market environments and in a smoother manner, from both a financial as well as an emotional standpoint.

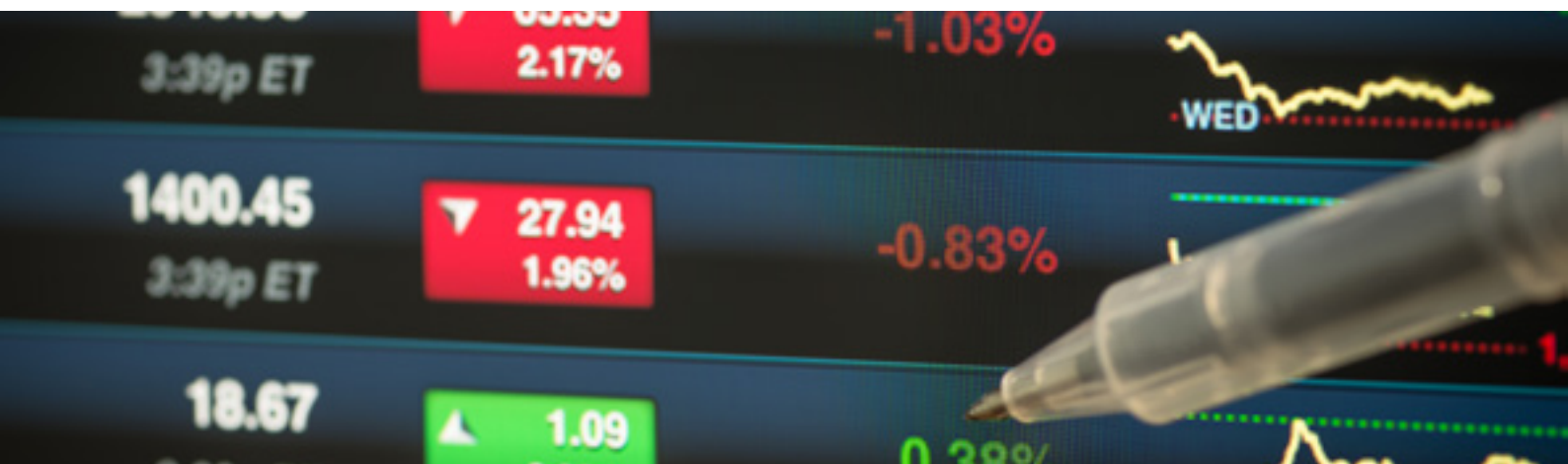
The importance of staying invested through wars, elections and much else besides is seen in the next chart. This shows that the different consequences of choosing to invest \$100 in one of US equities, bonds or cash over the last century.

As can be seen, the power of compound returns is significant. As is the choice between equities and cash.

Please remember, that past performance is never a guide to future performance. You may get back less than you invested.

**Author: Alexander Joshi, Head of Behavioural Finance, London, UK**





## Multi-asset portfolio allocation

Barclays Private Bank discusses asset allocation views for a multi-asset class portfolio. Our views elsewhere in the publication are absolute and in the context of each asset class.

	-		=		+
Cash and short duration bonds					
Fixed income					
Developed market government bonds					
Investment grade bonds					
High yield bonds					
Emerging market bonds					
Equities					
Developed market equities					
Emerging market equities					
Other assets					
Alternative trading strategies					
Commodities					

- denotes a cautious view = denotes a neutral view + denotes a positive view

### CASH AND SHORT DURATION BONDS

- Recent additions to shorter-dated bonds reflect less perceived risk-reward in equity markets and the continued inversion of the yield curve.

### FIXED INCOME

- Value is seen in developed market government bonds, which can also hedge against macroeconomic volatility.
- In credit, the higher-quality segment is preferred, driven by what is considered to be better relative value.
- Exposure is relatively low in high yield, where selection is key, as spreads have room to widen in an adverse scenario.

### EQUITIES

- In line with our long-term investment philosophy, portfolios remain geared towards high-quality, cash-generative and conservatively capitalised businesses.
- As a function of bottom-up selection, more opportunities are found in developed market equities compared to those in emerging markets.

### ALTERNATIVE TRADING STRATEGIES (ATS)

- There are a limited number of opportunities in the ATS universe, as the cost/benefit trade-off can be challenging.
- Our focus is on strategies that offer low correlations to equity markets, so providing diversification benefits.

### COMMODITIES

- As a risk-mitigating asset, gold remains the only direct commodity exposure held in portfolios.
- Elsewhere, we believe that our risk budget is better spent outside of the asset class.

**Author: Julien Lafargue, London UK, Chief Market Strategist**

## [privatebank.barclays.com](http://privatebank.barclays.com)

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