Private Bank

Market Perspectives

April 2019

BARCLAYS

Welcome

Welcome to the first edition of "Market Perspectives", the monthly investment strategy publication from Barclays Private Bank and Overseas Services. It aims to highlight our latest key investment themes in the context of market trends, as well as our current views across main asset classes.

This issue looks at how yields and carry can improve total returns at a time when we are late in the cycle and price performance may be modest. Similarly, in the wake of an inversion in the US bond yield curve in March, many investors are asking if this is a recession signal. While we doubt a recession will occur in the next 12 months, a late-cycle investing article looks at the types of potential investment opportunities available at this stage of the cycle.

With inflationary pressures seemingly subdued in major economies, we also consider the implications of a potential increase in inflation catching markets off guard. Finally, we also discuss the growing interest in sustainable investing. There is increasing research showing that a focus on companies' sustainability factors can help investors build more resilient portfolios.

After a strong start to the year by most equity markets, we articulate why we think it is too early to reduce equity exposure, despite higher volatility levels. Finally, in fixed income markets, we believe that with the Federal Reserve likely on a pause in its hiking cycle this year and next, more stable returns are likely than in 2018. We hope you enjoy the first Market Perspectives issue and find it useful.

Yours

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No lack of opportunities despite low returns

Despite a challenging time for markets over the last year, the next recession looks at least a year away and investment opportunities can still be found.

The world economy remains on shaky ground. Expectations of when the next recession will occur will be key to market sentiment and investment decisions this year.

After the slowdown experienced late last year, the most recent manufacturing indicators suggest that the recovery is still fragile and the ongoing trade tensions are not helping the overall confidence level. China's latest stimulus is not yet visible in the data and European economic figures, especially for sectors exposed to global trade, are not encouraging. However, other areas of the economy, such as consumption and construction, are holding up and suggest a temporary manufacturing slowdown.

The uncertainty surrounding the economy would probably be worse were it not for the US Federal Reserve (Fed) signalling a slower pace of rate hikes than was expected earlier in the year. Indeed, the market is currently pricing for a US rate cut at some point this year. We think rates will be held for the foreseeable future. In any case, increased expectations that major central banks will keep rates low for longer than was expected are lengthening the economic cycle even further. That said, economic growth is unlikely to be spectacular in the next couple of years.

A more tactical and differentiated market

While central banks are sustaining the economic cycle, it is undeniable that the cycle has been long. March's inversion of the yield curve, when 3-month US bond yields exceeded 10-year bond yields, is one of the signs that it is late in the cycle and the risk of recession is rising.

We would not assign as much weight to the inversion on this occasion. The yield demanded by bond investors to tie up money in long-maturity bonds is extremely low. Quantitative easing has also artificially compressed the spread between the short-end and the long-end of the yield curve.

Investing in a late-cycle environment is our first thematic. There is likely to be more dispersion between the performance of individual stocks and sectors. We think that simply buying exposure to an equity index is not likely to deliver much return.

Instead, we think that a market-neutral, active strategy still offers potential upside as differentiation between companies is likely to increase. With heightened volatility likely, companies exposed to structural growth seem well placed. The capacity for companies with strong balance sheets to deliver consistently good growth is another factor worth looking for.

Another theme to bear in mind for the next few months is carry and yields. We think that price returns are going to be modest across asset classes. With lacklustre growth and valuations which already fully price the expected growth, most asset classes are unlikely to see strong returns.

Yields and carry are needed if investors want to achieve higher total returns in their portfolio. In equities, we think that companies capable of growing dividends are the best way to get exposed to that theme. In fixed income, emerging markets hard currency bonds are worth considering, especially now that the Fed has turned more cautious.

The Fed's pivot is happening at a time when the US labour market looks very tight, with unemployment close to lows last seen in the 1970s. Wage growth has remained subdued but has started to move higher in the recent months. While it is still at relatively low levels, we cannot rule out an inflation surprise in the second half of the year. We are not expecting high single-digit inflation growth. But even if inflation moves up by one or two percentage points, this would have investment implications.

This is the basis for our third investment theme. The most important takeaway on this theme is to stay invested rather than holding too much cash. Exiting markets too early, especially if inflation starts to rise, is painful. Inflation-linked bonds are a possibility.

Equities with pricing power or demand that is little affected by price changes could also be considered. Finally, if real rates start to fall, this should support gold prices. The latter also provides a hedge should markets start pricing in a recession at some point, something that happened last December.

Episodes when market expectations change on when the next recession is likely may provide good investment opportunities. This is our last investment theme. Markets will be more focused on recession risks. This creates tactical opportunities which could be short-term but may offer the chance to enhance performance.

Emerging market prospects looking better

From an asset class perspective, we find that emerging markets (EM) assets continue to be the more attractive on a broad basis. Differentiation between emerging markets will be key. Keeping that limitation in mind, we think that EM assets, both equities and fixed income, are generally more attractive than developed world assets.

In equities, we think that the US and EM together offer the best combination. Japan, Europe and the UK are facing different headwinds which make them less attractive at the aggregate level. Nonetheless, opportunities persist in those markets from a bottom-up perspective.

In fixed income, high yield markets are looking fully priced and investments should be considered selectively. While investment – grade debt has seen a large increase in BBB-rated bonds in the last few years, triggering a deterioration of the average rating, the outlook appears supportive. Although the volatility in EM fixed income is going to be challenging at times, the yield spreads should provide some cushion for what should be short-lived events.

> "Increased expectations that major central banks will keep rates low for longer are lengthening the economic cycle even further."

Investing in a late cycle

This economic cycle will shortly be the longest on record, but a recession seems unlikely to occur in the next 12 months. In this article, we look at potential investment opportunities this late in the cycle.

Global output is set to expand for a record 10 consecutive years in June. While growth in some regions has slowed in that period (for instance, Europe in 2012 and China in 2015), the strength of the US economy has kept the world out of a recession so far.

Economic data, such as leading indicators, the yield curve or real rates suggest we are late in the cycle but not yet close to a recession. Furthermore, real rates remain relatively low by historical standards (see below), being barely positive in the US while still negative in most other regions in the developed world.

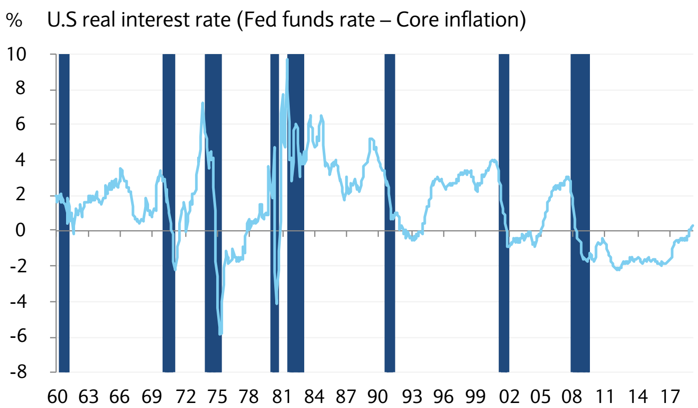
The shape of the yield curve, which was much talked about in the second half of last year, was back in the headlines in March as the yield on 3-month bonds exceeded 10-year bond yields, so inverting the curve.

Past episodes of yield curve inversions would suggest that risks of a recession in the next 12–18 months are high.

We would discount this indicator in the current environment. The yield demanded by bond investors to tie up money in long-maturity bonds is extremely low and quantitative easing artificially compressed the spread between the short-end and the long-end of the yield curve. In any case, an inversion of the yield curve still suggests another recession is at least a year away.

Recessions are usually triggered by central banks raising interest rates to keep inflation under control while pushing real rates above the economy's real growth potential, by extreme structural imbalances in an economy or a combination of both.

With major central banks likely to raise interest rates more slowly than had been expected towards the end of last year and no imminent signs of imbalances tilting the economy into recession, we believe it is too early to exit financial markets due to recession fears. Those worries are likely to create more volatility.



Source: Bloomberg, IBES

Any set of adverse economic data would likely push markets to start pricing a recession, as happened last December. However, from an investment perspective, it is generally more costly to be too early exiting markets ahead of a recession than exiting too late. So if it pays to stay invested, what performs well at this stage of the cycle?

How to invest late in the cycle

Before delving into specific developments for equities and fixed income markets in the current cycle, it is useful to have a broad understanding of what this stage of the cycle typically means for asset class performance in general.

History tells us that commodities, inflation-linked bonds (ILB) and emerging market bonds tend to do well while investment grade debt (or credit) usually underperforms other asset classes. The historically positive performance of ILB is partially linked to the rise in commodity prices, notably oil prices, as strong demand outpaces supply. This increase in commodity prices looks less likely this time around considering the supply/demand dynamic in oil markets. That said, a short-term increase in commodity prices due to geopolitical tensions cannot be ruled out.

Switching from passive to active strategies in equities

While no two economic cycles are the same, equity markets typically perform relatively well up to the very end of the cycle. As such, we believe it is worth staying invested but being more selective about exposure to equities rather than doing so through passive benchmark investment.

Volatility tends to flare up sporadically and financial markets constantly reassess the risks of a recession. This suggests investing with a quality bias, to select companies that can better withstand volatile episodes.

Another angle is to look at 'growth' companies, especially those exposed to secular growth such, as healthcare and software. The more cyclical part of the equity markets (such as autos and semiconductors) are more at risk late in the economic cycle. In this cycle, with central banks providing ample liquidity and more investors invested in riskier assets than usual, the difference in the performance among sectors and stocks has been lower than the norm.

This trend is likely to reverse at this late stage of the cycle. As the investment environment shifts and price dispersion intensifies, active strategies may make more sense than index investing. Similarly, strategies aimed at minimising the risk of sharp downturns in markets may have more of a role to play.

Adjusting to the end of a bull market in fixed income

As mentioned earlier, market dynamics at this late stage of the cycle are rarely identical. In past decades, bond market performance was substantially influenced by a bull market driven by a prolonged downward trend in interest rates.

In recent years the bond markets have finally approached the 0% mark and, in the case of 10-year German bunds, still trade close to that level. The most common pattern late in a cycle, however, is inflation, a wages are driven higher and the commodity market can't cope with the strong demand. This latter factor is less likely to happen at the moment.

Persistent elevated inflation levels generally favour emerging market (EM) bonds. The majority of EM countries are net exporters of energy and commodities, and improving fiscal balances should generally support flows into their respective markets.

But not all countries are equal. While Brazil and Russia are the most prominent profiteers, Turkey and India are among the net importers. EM bonds are usually well positioned at this stage of the cycle for a different reason. In this phase, the hiking cycle of central banks approaches its peak, helping to support EM capital inflows.

Although credit is not the most natural harbour during this period, price volatility for high-grade bonds should be limited as the risk for default or large downgrades looks relatively low by historical standards. At the same time the pressure of further rate hikes is easing. Furthermore, a peak or consolidation in rates would start to work in favour of holders of medium to longer dated high-grade bonds.

Enhancing total returns with yields

As we expect asset class returns to be relatively muted considering current valuations and the macroeconomic outlook, yields and carry have a role to play in attempts to boost total returns.

The strongest price performance for equity markets usually happens towards the end of a recession, as financial markets start to discount the coming recovery. At that time, earnings expectations are overly pessimistic and the market prices out any future growth prospects, while the equity risk premium, (or the additional compensation sought for taking equity risk over the risk-free return offered by – say – 10-year Treasuries) is at its highest. In such conditions, it is not unusual to see equity markets deliver 20% to 30% price returns over a few months.

For government bonds, price performance plays, on average, a much smaller role in total return than for equities. However, price return usually contributes the most to total return at the start of a recessionary episode. This generally leads investors to invest in relatively low risk assets and push up government bond prices. Meanwhile, central banks tend to cut rates and inject liquidity in the economy, also contributing to higher prices by pushing yields lower.

Carry and yields enhance total returns

We neither expect a strong expansion nor a recession this year and therefore equity and fixed-income markets are unlikely to see strong price performance contribution to total return.

We forecast low to mid single-digit price return for equities. In addition, current valuations across most asset classes look fair to expensive and do not leave much room for price appreciation at those levels without meaningful fundamental support. Of course, there might be opportunities for strong price return if and when financial markets start pricing a higher probability of a recession. This is what happened in the final quarter of 2018, when markets feared that a Chinese slowdown and rising trade tensions would tilt the global economy into recession. While we expect more volatility, it is difficult to predict when volatile events will occur.

Waiting for the best buying opportunity to emerge before investing does not come without cost: the longer investors wait for the ultimate interest rate level or entry point to be reached, the higher the expected return has to be in order to make up for the period of low return. In financial markets, this concept is expressed by forward rates and used in the foreign exchange (FX) and rates market in particular. Forward rates tell you how much the rate at a target date has to be if you choose to wait and invest in the lower yielding alternative in the meantime. This lower yielding alternative naturally would offer shorter maturities, lower yielding currency or higher quality bonds.

Returns of cash compared to EM bonds

Strategy	Coupon				Return over period
	Year 1	Year 2	Year 3	Year 4	End of period
Scenario 1: Invest in EM bonds now	5.5	5.5	5.5	5.5	22
Scenario 2: Wait 1 year to invest	2.5	6.5	6.5	6.5	22
Scenario 3: Wait 2 years to invest	2.5	2.5	8.5	8.5	22

Source: Barclays

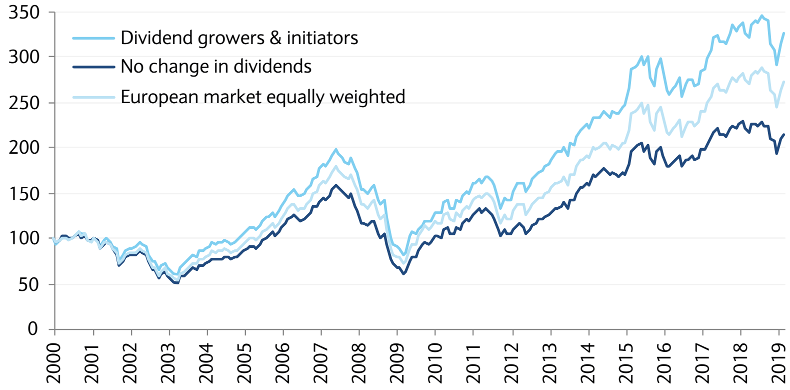
Emerging markets hard currency bonds

As we highlighted in our fixed-income section, we believe that US dollar (USD) emerging market (EM) hard currency bonds seem fairly valued. The following example shows a simple example of how carry can work in investors' favour. Let us assume an investor with an investment horizon of four years decides to park money in USD cash at 2.5% per year instead of investing in USD EM bonds at a yield of 5.5%. The table below, which excludes re-invested coupons (compounding) or changes of US monetary policy and the like, shows that EM bond yields must rise by 100 basis points (bps) in the second year to make up for the lower return in the first year. If investors park the money for two years, the EM bond yields must surge to 8.5% in order to achieve the same return as would be achieved from investing from the beginning.

Focus on dividend growth

In equities, the most obvious factor to look at is dividend yield. Although it may vary between regions and sectors, dividend yield is often a key component of total return over time. Yet, there is a danger of using a higher-than-average yield as an indication of improved future returns. This is particularly true at a time when interest rates may not be the tailwind they have been in recent years. Over the past 10 years, extremely accommodative monetary policies around the world have pushed many companies to use cheap leverage to increase or sustain their dividend payouts despite, in some cases, challenging fundamentals. This leaves them vulnerable should their cost of borrowing rise or their revenues fail to grow fast enough to accommodate higher interest expenses. Some high yielding companies may be "value traps". While dividend yields might look attractive alongside other valuation metrics, the high discount the market is assigning to the company might reflect financial stresses that should warn investors looking to buy those companies.

Performance of European stocks



Source: Goldman Sachs

As such, instead of looking at current yields, we believe that focusing on a company's willingness and ability to grow its dividend over time can be more rewarding. In Europe, for example, dividend growers have outperformed consistently. At the sector level, this suggests avoiding traditional bond proxies, such as regulated utilities or low-growth telecoms, and seeking dividend growers across industrials or healthcare, where the long-term potential appears more supportive. We also believe that, if yield is a primary objective, option strategies can offer a way to mitigate downside risk while benefiting from a more predictable income stream through premiums or coupons.

"In equities, the most obvious factor to look at is dividend yield. Although it may vary between regions and sectors, dividend yield is often a key component of total return over time."

Why inflation could be a surprise

Major central banks have recently signalled a slower pace of rate rises than had been expected. While our economists do not expect a large increase in inflation this year, there is a risk that higher inflation catches markets off guard.

Economic growth and inflation are likely to be around long-term averages in the short term. In response to a growth scare in the fourth quarter (Q4) of last year, and resulting fall in commodity prices, most central banks shifted their focus to growth risks as inflation pressure subsided.

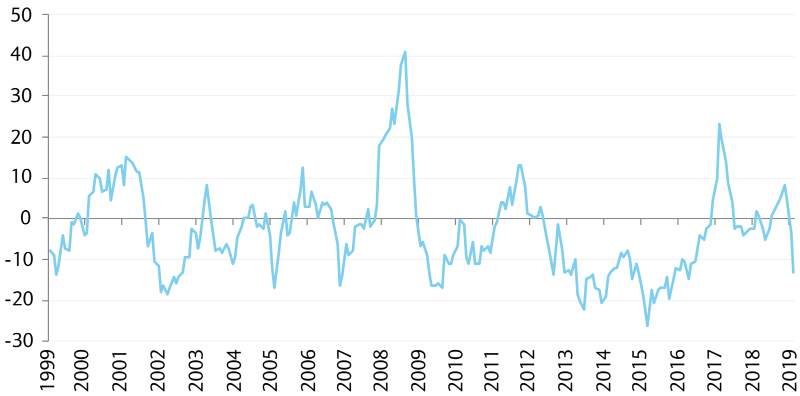
That said, after a long period of relatively subdued inflation and with little sign of a sharp pick-up recently (see chart below), there are many factors that could push inflation higher.

Factors that could drive inflation higher

There are several risks that could trigger higher inflation in the second half of 2019:

- Unemployment rates are low across most developed markets and companies are expressing difficulty finding the right candidate to fill vacancies. This ratio is close to an all-time high in the US small business survey for example (see chart on p12). Although the level of wage inflation remains subdued, the acceleration seen in recent months could persist.
- Most countries in the developed world will increase fiscal spending in the next couple of years, according to the Organisation for Co-operation and Development. Barclays' economists also expect a fiscal stimulus later this year in China, Germany and Japan.
- While we expect trade tensions to ease in the short term, a failure to find an agreement between the US and China would likely trigger a significant increase in the price of goods.
- Commodity prices have rebounded from their lows of late. While still likely to temper year-on-year inflation in the second half of the year at current levels, there is a risk that prices continue to rise.

Citi Global Inflation Surprise Index



Source: Bloomberg

In the longer term, the increasing emerging market (EM) middle class and its expanding purchasing power will lead EMs to no longer export lower inflation but rather higher inflation to the rest of the world. In the developed world, the debate around the use of quantitative easing to finance government deficits is also likely to generate discussions around inflation risks.

Inflation and financial assets

From a financial markets point of view, we look at how portfolios can be positioned to minimise the risk in case of renewed inflation pressures. The main takeaway is that cash holdings should be reduced to the bare minimum to meet liquidity needs.

With cash on deposit returning very little at the moment, inflation is the most significant risk for cash holdings. For investors holding cash in the belief of an imminent recession or market downturn, we believe that gold is a more attractive proposition. With the Fed signalling that US rates are firmly on hold, higher inflation would translate into lower real yields. Gold tends to benefit from a fall in real yields as its drawback of not paying income becomes less relevant.

Another hedge against inflation is to invest in physical assets such as property. Compared to financial assets, physical assets have not benefited as much from the flood in liquidity seen since quantitative easing started. However, the increased focus towards infrastructure, fiscal spending and a more even distribution of revenues between capital and labour would make the asset class more appealing.

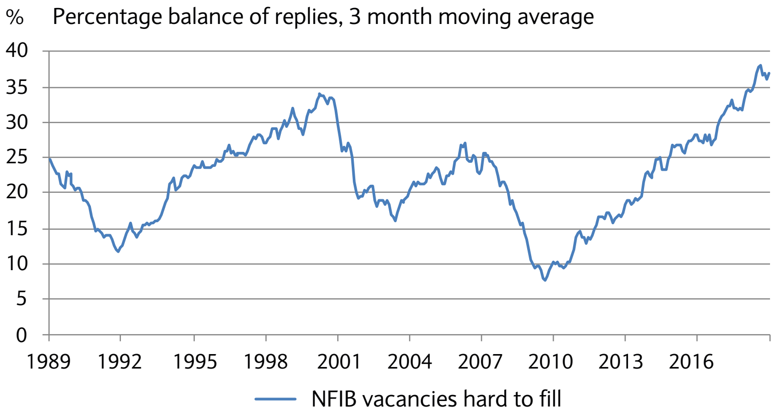
Focus on companies with pricing power and low price sensitivity

As a whole, moderate inflation tends to be positive for equities as it supports revenue growth. That said, the main cause for inflation should be analysed before making investment decisions.

If inflation fears are driven by faster-than-expected wage growth, while companies exposed to consumer spending may benefit, this may be more than offset by higher labour costs. On the other hand, should inflation rise due to higher energy prices, then producers will benefit but many purchasers of energy may suffer.

Some companies may withstand the effects of inflation better than others. We believe companies with strong pricing power (eg luxury brands), low price sensitivity to demand (staples) or inflation-indexed revenues (concessions) look better positioned to do so than many others.

Whatever causes inflation, the sequences of events will be crucial. Indeed, if markets start believing inflation is rising without the support of strong economic growth, investors may question the sustainability of the economic cycle. This could hurt equity markets as, happened in 2018 when yields moved higher as growth started to fade. We would not expect this to happen this time. Instead, we would focus on companies with pricing power, product demand that is little affected by price changes or with inflation-indexed revenues in times of rising inflation.



Source: Bloomberg, National Federation of Independant Business survey, as at March 2019

Focus on US dollar inflation-linked bonds

Fixed income investments and inflation do not usually go hand in hand, given that any unexpected inflation will eat into the nominal coupon and repayment of debt instruments.

Institutional investors, like pension funds, primarily use inflation-linked bonds in order to manage inflation risk.

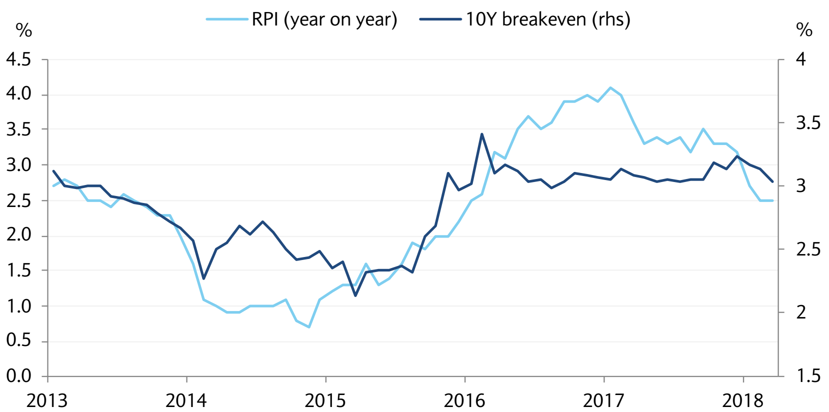
But as with anything in financial markets, the hedge comes with a price tag. In this case it comes in the form of the real yield (nominal yield adjusted for inflation) rather than the higher yield nominal bonds offer.

Breakeven rates are used to assess the relative attractiveness of inflation-adjusted yields compared to the yield of nominal bonds. In the US, 10-year breakevens are just short of 2%: the implied average yearly consumer price index over the next 10 years.

This is similar to the average of the past 20 years but well below the average in the last 40 years for example, in the UK, breakevens have been highly distorted by FX volatility and concerns around Brexit-related inflationary shocks. At 3.2%, the 10-year breakeven does not appear cheap. The UK retail price index (RPI) and consumer price index (CPI) will likely fall further from their 2017 peak, according to the latest BOE forecast update.

With the recent strength in sterling against the US dollar and the diminishing risk of a hard Brexit, it is hard to imagine the RPI shooting up significantly above current breakeven levels (see chart left). For sterling investors, better opportunities in physical assets, such as real estate or infrastructure, are likely to exist.

UK inflation looks set to fall further



Source: Bloomberg

Tactical opportunities

Higher volatility creates opportunities to take a more tactical stance in markets. The aim is to try to capture dislocation within assets when our views differ from markets' pricing.

The current economic cycle has been going on for almost 10 years, partially thanks to the support of major central banks and also thanks to the shallow recovery that has prevented the build-up of large imbalances.

Our own expectation is for the economy to keep on growing at a slow but steady pace. However, with several indicators pointing to the cycle being in a late stage, a string of worst-than-expected economic indicators could easily spook markets and lead to short periods when different asset classes start pricing a higher likelihood of a recession.

Looking at realised volatility in global equities, after reaching an all-time low in 2017, it has crept up in recent months on the back of growth fears (see chart). Current realised volatility levels are not far off those reached around events such as the Long-Term Capital Management crisis in 1998 or the China/energy sell-off in 2015. In volatile times like those, there are more opportunities to be tactical, alongside a core portfolio.

The weak print in the purchasing manager's index – a leading economic growth indicator – in Europe in March coupled with an inversion of the yield curve in the US led equity markets lower for a couple of days. This episode was just short-lived and it is likely that we will see two-three episodes this year lasting a few weeks, during which markets will take a more bearish tone on the back of surprisingly negative data.

Unless we revise our own expectation of "no recession in the horizon", we see the afore mentioned short-term market moves as opportunities to buy into the area of the markets that will have priced the highest probability of a recession.

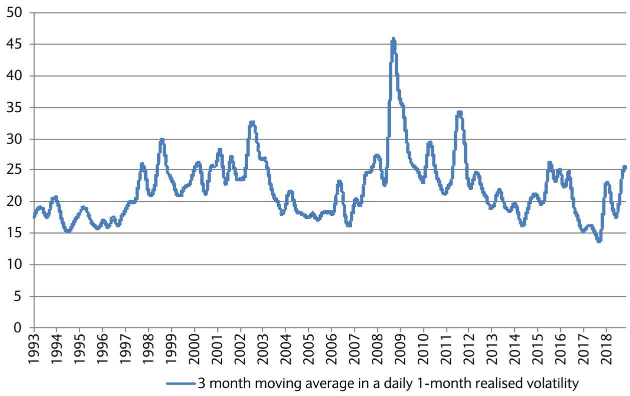
Such opportunities could also arise from geopolitical risks as well. In that case, it is not the actual economic indicators that would unsettle markets but the potential impact on geopolitical tensions, such as trade frictions or financial sanctions, could have. In the past couple of years, there have been a few of those events that have impacted financial market sentiment negatively at times for one or two weeks.

In that case, the dislocation in markets has often been more limited to a couple of sectors, regions or asset classes that were the most affected by the particular geopolitical risk. We will be on the lookout for such localised disclocations in markets.

We expect those opportunities to be shorter-term (one to three months) than all the other themes we are mentioning in this publication. For this reason, we will focus on them in our weekly publications rather than in the future edition of the "Market Perspectives".

"In volatile times there are more opportunities to be tactical."

Volatility on the rise



Source: Bloomberg

Paying attention to sustainability in the current markets

As the cycle ages and investors face a period of lower returns, a focus on non-financial data and sustainability factors can help build more resilient portfolios.

At any point in the economic cycle, investors seek to select the best-performing companies. During its later stages, this challenge is accentuated with the dual aim of capturing the final upside momentum and being well-positioned for any downturn. Achieving both requires deep insight into systemic and company-specific risks and opportunities.

We believe investors who incorporate non-financial data can gain an information advantage to identify these assets and use these sustainability factors to help position portfolios for the forthcoming changes.

New, non-financial data reveals how companies operate

Access to extensive, non-financial data is a relatively new occurrence in the investment industry. Following the financial crisis, regulators and stock markets have begun to require companies to report greater detail about their operating practices. Additionally, global initiatives have encouraged data on specific factors, such as the Taskforce of Climate Related Financial Disclosure, driving companies to report on their exposure to, and mitigation plans for, climate change.

Non-financial data is generally split into three categories: environmental, social and governance (ESG) information. By understanding the ESG policies and practices on topics such as climate change, human capital and labour management, corporate governance, gender diversity, privacy and data security, investors can look deeper than traditional financial reporting to better understand an organisation's long-term risk and return prospects.

While all data may be helpful, it is not of equal value for investors. Material ESG issues differ substantially between industries. For example, resource-intensive industries such as utilities, have different exposure to key environmental and social factors (such as energy efficiency and labour management) than the pharmaceutical sector, where social and governance factors (such as product safety and business ethics) are primary.

Sustainability and improved financial performance

Academics have led the research to identify any link between corporate financial performance and sustainability practices.

One of the foremost studies paired companies with similar characteristics and one key difference – whether they had embedded sustainability into their business model and operating practices. When compared over an 18-year period, the high-sustainability businesses outperformed their low-sustainability counterparts in both accounting terms and share price performance. Their overall conclusion – sustainability can be a source of long-term competitive advantage.

ESG factors for investor consideration

Environment	Social	Governance
Carbon emissions	Labour management	Corporate governance
Energy efficiency	Diversity and discrimination	Business ethics
Natural resource use	Working conditions	Anti-competitive practices
Hazardous waste management	Employee safety	Corruption and instability
Recycled material use	Product safety	Anti-bribery policy
Clean technology	Fair trade products	Anti-money laundering policy
Green buildings	Advertising ethics	Compensation disclosure
Biodiversity programmes	Human rights policy	Gender diversity of board

Source: Barclays

Looking more broadly, Oxford University and Arabesque Partners conducted a review of the existing research through 2015. Across the 200 academic studies and sources, they found a clear indication of how financial performance aligns with good governance, environmental stewardship, and social responsibility, notably:

- 88% of the research shows that solid ESG practices result in better operational performance of firms
- 90% of studies on the costs of capital show that sound sustainability standards lower the costs of capital of companies
- 80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices

While acknowledging there were some negative, and even non-existent, correlations between ESG factors and performance in these studies, the majority highlight the value of sustainability practices to corporate financial performance.

From sustainability data to financial returns

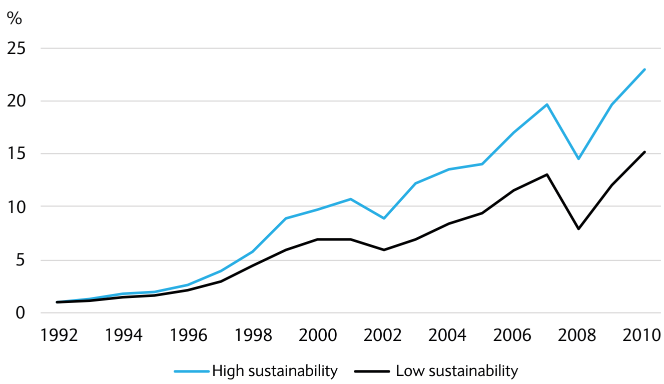
The investment industry is also seeking to use this new sustainability data to generate financial out-performance.

As one of the largest data providers of both financial, and now non-financial information, MSCI researched how ESG characteristics can lead to financially significant effects in the equity markets. Their findings show benefits across three mechanisms for companies with higher ESG ratings:

- Idiosyncratic risk – better management of company-specific risks, and so lower probability of incidents that affect share price, so stocks display lower tail risks
- Valuation – lower exposure to systematic risk factors, so higher valuations
- Cash-flow – more competitive and can generate abnormal returns, so higher profitability and dividends

The more sustainably-managed companies showed a variety of characteristics – higher profitability, higher dividend yield, lower tail risks, less systematic volatility and higher valuations – that investors assessing prospective investments would likely find attractive.

Change of $1 invested in the stock market in value-weighted portfolios



Source: "The impact of organizational process and performance", Management Science, revised February 2017

Using these insights in current market conditions

As wage growth and interest rate rises start to put pressure on profit margins, operational performance becomes more important. For instance, well-managed companies typically maintain their profit margins at higher levels and for longer than weaker companies. This, in turn, can aid their valuations and credit-worthiness.

As the support from central banks' quantitative easing programmes diminishes, the additional liquidity that has helped lift returns for risky asset classes is likely to wane. In these times, we would expect lower correlations between single stocks and more potential for idiosyncratic risk. Sustainability factors can be valuable to indicate which organisations are less susceptible to these risks.

Overall, we strongly believe in the potential that integrating sustainability data into financial analysis holds for investors at any time to better manage risk and generate long-term returns. At Barclays, we are among a growing, global body of institutional investors that have committed to incorporate these factors into our investment decisions.

In the current environment, we expect investors will need to position for lower market returns, more volatility and tail risks. That said, there will be opportunities for those who use insight from sustainability factors effectively to find attractive investment opportunities and build more resilient portfolios.

Equities outlook: feel the bounce

With global equities off to a strong start this year, can the momentum be sustained and how should investors position themselves for a more volatile environment?

Following a strong rebound in equity markets so far this year, we expect low-to-mid single digit positive returns over the rest of 2019, albeit with higher levels of volatility. Earnings growth will likely slow but remain positive while valuations should be supported, as recession fears are kept in check by low interest rates and low real interest rates. In addition to short term opportunities, we believe three main investment themes are worthy of consideration: investing late in the economic cycle, yield enhancement and inflation risk.

As we enter the later stage of the economic cycle, exposure to secular growth equities (such as healthcare and software) seems preferable to equities offering purely cyclical exposure (such as autos and semiconductors). In addition, the income generated by equities will likely be an important component of total returns in a period of higher price volatility.

At this stage of the cycle, focusing on a company's willingness and ability to grow its dividend appears more relevant than the level of yield it offers. Additionally, fears over inflation risk can be mitigated by exposure to sectors offering pricing power (luxury goods), product demand that is little affected by price changes (staples) or inflation-indexed revenues (concessions).

US equities to the fore

In our opinion, US markets remain best placed over the medium term from a regional perspective. Investors could consider combining US exposure with secular growth opportunities in emerging markets.

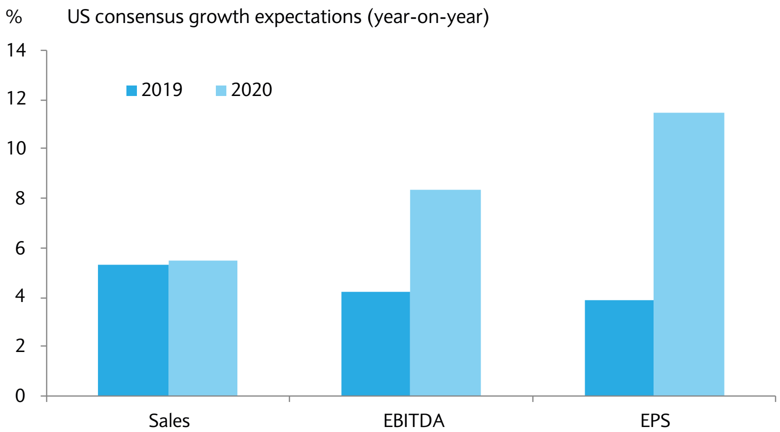
Our base case is for the S&P 500 index to end 2019 at 2900-3000. Following the sharp downward revisions to consensus expectations since October, earnings growth expectations of around 4% in 2019 look more reasonable (see chart below).

In fact, consensus may be too cautious as it implies margin contraction despite mid single digit sales growth. It is very unusual for margins to shrink when the top line is this healthy. As such, we expect 5% earnings growth this year and modest downward revisions to 2020 estimates.

Earnings expectations may be too cautious

We do not expect valuations to expand this late in the economic cycle. Any hopes of multiples' expansion are likely to be offset by renewed fears that the Federal Reserve (Fed) will lift interest rates. Similarly, any short-term market stress should be met by rate cuts or slower-than-planned rate rises from central banks. All in, this means that, despite short-term moves, multiples should stay within their current range.

Although US equities are likely to grind higher over the next three to six months, this cycle has persisted for a long time. The Fed is doing its best to support growth but is reacting to data. This lag raises the chances of inflation risks creeping up or recession fears resurfacing. As such, we prefer to combine 'defensive' and 'growth' exposures in sectors like software, digital content, healthcare and some parts of industrials.



Source: IBES, as at March 2019

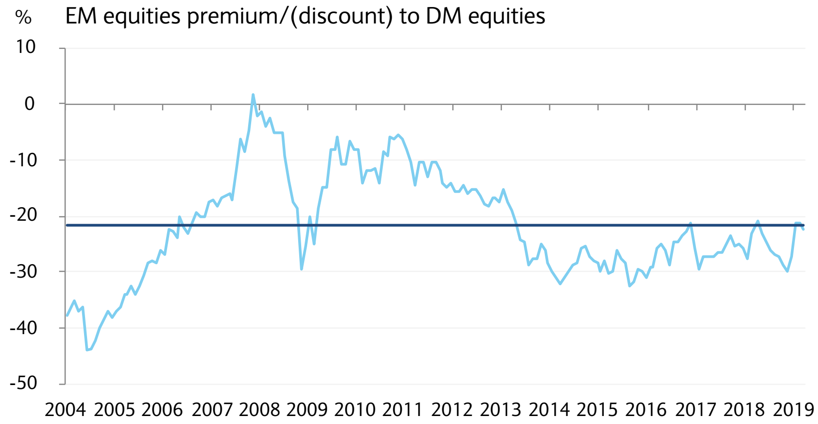
Emerging markets more promising

Outside of the US, we believe that emerging markets offer compelling long-term opportunities, driven by the inexorable rise of the middle class and a shift from investment to consumption. This marks the rationale for combining US and emerging market equities. In the short term, the outlook for emerging markets appears bright, supported by relatively stable US dollar exchange rates, low interest rates and stabilising growth prospects. However, this equilibrium is fragile.

Improving outlook for emerging markets

Within emerging markets, we prefer Asian to Latin American equities. While the growth momentum should be more favourable to the latter, following a significant slowing in 2018, we believe that positive surprises are more likely to come from the east.

Indeed, Chinese authorities have been injecting a large-scale stimulus into their economy for a few quarters. Although its impact has been minimal so far, we expect it will ultimately boost economic activity. Should increased economic momentum coincide with receding trade tensions between China and the US, then consensus expectations in the region appear too low.



Source: Bloomberg, IBES

Eurozone, UK and Japan: Political and currency concerns

The eurozone remains a market that, broadly speaking, one should buy when everybody else hates it and sell when everybody starts turning positive. Unfortunately, the region's complicated political backdrop and challenged banking sector will likely continue to weigh on market sentiment this year. So, while value is plentiful in Europe, taking a long-term view at the regional level is difficult. Instead, short-term opportunities may offer a better approach. For long-term investors, there are pockets of growth but these are not large enough to have much influence on the broader market.

UK equities have also been victims of political uncertainty. Here, though, the country's equity market has benefited from a natural hedge in the form of a weaker sterling. As around three-quarters of sales by FTSE 100 constituents are earned outside the UK, the index is highly sensitive to currency movements and their impact on company profits. The binary nature of Brexit prevents us from taking a strong view on the UK market at this stage. With investors having avoided investing in the country for some time, we suspect that when inflows return they will be both material and long-lasting.

Japanese equity indices, like the UK's, are guided mainly by currency variations. With an outlook that calls for limited change in the yen/US dollar exchange rate, we struggle to build a high degree of conviction in Japan's Nikkei or Topix indices. Nevertheless, the country continues to improve its corporate governance framework. This should lead to gradually improving shareholder returns which may be better captured by targeting specific companies rather than exposure to the broader market.

"Following a strong rebound in equity markets so far this year, we expect low-to-mid single digit positive returns over the rest of 2019."

Fixed income outlook

A persistently hawkish Federal Reserve led to significant volatility in the major segments in the bond market in 2018. With the Federal Reserve indicating that rates are likely to be held this year, we think that stable returns are more likely to be achieved.

After a very volatile year in 2018, investors looking for stable returns may ask if they will face a similar rollercoaster ride this year. Given that the phase of normalisation of the monetary policy has been halted until further notice, we believe pressure of a significant rate sell-off has eased, which creates opportunities to achieve stable returns.

Rates and government bonds

After the Federal Reserve (Fed) has increased rates nine consecutive times, accumulating 225bps, over the hiking period, Governor Jerome Powell recently indicated that the The Federal Open Market Committee (FOMC) will likely leave policy rates at current levels this year. The future hike path, as projected by the median of the committee member's expectations, has been lowered by 50 bps. over the next two year horizon.

In the last policy for growth and inflation has been revised downwards. In the same time, the FOMC notably changed its tone, compared to previous communications, indicating a more "patient" approach, according to the policy. This for a more sustainable pick-up in inflation.

Given the change in tone and the revised growth forecast, it is hard to see any rate the time being. Market pricing goes even further: Fed fund futures imply a rate cut this year while the US interest rate curve has started to invert, with the months US bond yields trading higher than the 10 year yield.

This pricing seems very pessimistic. The US economy is far away from contraction and the very healthy US job market leaves the possibility for sudden inflationary surprises. Only a small positive surprise is required, for rates to re-price again.

We would prefer an overall neutral to slighter shorter duration in bond portfolios. Given the US rate curve inversion in particular at the 4 to 5 year tenor range, a strategy focusing on the two year and 7 to 8 year part of the curve seems a sensible way to achieve the neutral duration

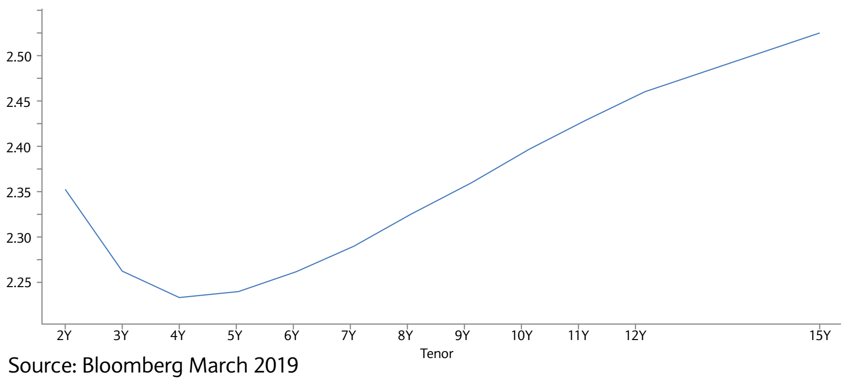
While investors may consider longer duration as too risky, we would highlight that longer dated bonds provide portfolio insurance, should rates trend even lower from here.

UK gilt and European bond markets continue to trade at depressed, yield levels, leaving investors with negative real rates, while exposing them to sudden rate sell-offs as seen back in 2015 with German bunds. In its March meeting, the European Central Bank (ECB) pushed the expectation for a first rate hike to Q4 2020 pointing to risks from world trade, slowing growth in Germany and political risk from Italy. Given the slower growth dynamic and expectations, negative rates will persist for quite some time, as suggested by market implied forward rates. In the UK, Bank of England (BoE), Chairman Mark Carney was not able to build that important rate cushion. Rising Brexit uncertainty forced the bank to lower growth and inflation forecasts most recently, while the policy rate had to be left unchanged at low levels. Although Carney uses excess demand as an excuse to keep rate hikes on the agenda, we believe this seems premature at this stage. Rate hikes are unlikely in the foreseeable future.

Investment grade bonds

Spreads (the difference in yield over an equivalent government bonds) of investment grade bonds as well as high yield and emerging markets, have tightened significantly this year, following the sell-off in December.

The US rate curve is inverted



Source: Bloomberg March 2019

Investment grade bonds in the US and Europe are trading close to the tightest spreads seen in 2018. In the case of US investment grade bonds, spreads are roughly 30 bps away from levels seen in 2008 prior to the credit crisis. Given the already tight spread levels, the room for further compression seems limited.

The credit cycle is getting older and credit risk has increased over the last 10 years. The rise in leverage among non financial issuers has led to a substantial increase in the portion of BBB rated bonds within the investment grade sector. For instance, US 'BBB' rated bonds make up 52% of the investment grade market compared to 40% in 2011. Simply based on the higher proportion, it can be argued that the risk of investment grade bond issuers getting downgraded to high yield or 'junk' status has increased.

With lower growth expectation on both sides of the Atlantic, companies with weak credit profiles will be even more exposed to eventual downgrades. That said, economic data is still robust and specifically larger issuers have improved their funding costs during an extended period of low interest rates.

The majority of the BBB-rated issuers come from defensive sectors like utilities that naturally have relatively high borrowing levels but, at the same time, are less exposed to economic downturns. Furthermore, large companies have various levers available in order to manage and maintain their BBB rating.

At this point we see limited risk of a large downgrade cycle. European investment grade bonds yield substantially higher than comparable German bunds offering relative value, while yields of US investment grade corporate bonds offer attractive absolute yields.

US and European high yield bonds

The Bloomberg Barclays US High Yield Index and its Pan-European counterpart have performed close to 7% and 5% respectively this year. Is spread volatility likely to return in 2019? We look at default rates, as well as upcoming maturities and would argue that the risk at this moment should be fairly limited.

Global speculative default rates are at historic lows at 2.2% (European default rates being significantly lower) and Moody's expects this rate to fall further over the course of this year. Meanwhile, the upcoming amount of debt maturity seems manageable, partly due to most issuers having extended the debt maturity profile in the period of low interest rates.

Still, investors are likely to get more selective after the broad market rally. It is worth noting that US traditional retailers see increasing competitive challenges, while in Europe the highly leveraged telecom, media and technology sector is set to continue to struggle.

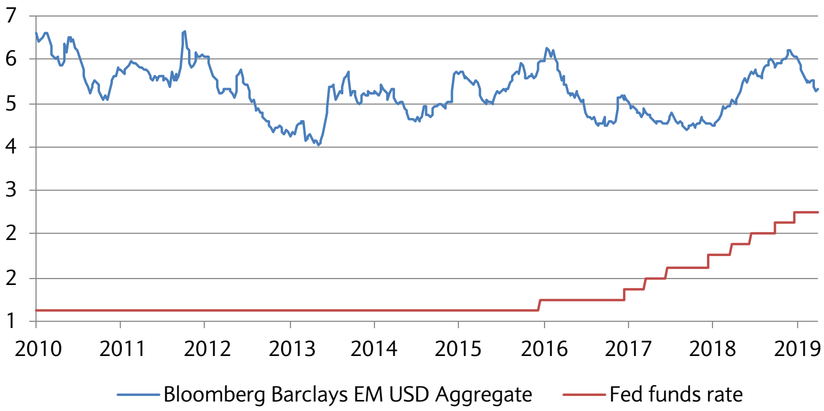
Emerging market bonds

This asset class can be subject to sharp changes in sentiment. On the one hand, the asset class underperforms during phases of global contraction, which usually is accompanied by safe-haven flows. On the other hand, investors tend to exit the emerging market (EM) 'carry' trade (investing in a comparatively higher yielding bond segment), as soon as US rates pick up, which usually can be seen during an economic recovery. During which part of the economic cycle do emerging market bonds perform? We think this is the case in the current late stage of the cycle.

Historically EM capital inflows were highly correlated with the size of central bank balance sheets sheet reduction induced by the tapering of central bank bond purchasing programme, most notably by the Fed, has led to large EM outflows until recently.

With the end of that Fed tapering in sight and the shift to a more accommodative monetary policy in the US, we see further room for a recovery of EM bonds. At around 5.3%, the average yield of US dollar denominated EM from the Bloomberg Barclays USD EM Aggregate hard currency bond index) look reasonable on an absolute and relative basis (see chart). Despite the recent spread tightening, the USD EM Aggregate option adjusted spread (OAS) at around 290 bps trades – well above the comparable US high yield BB bond complex OAS at 236 bps in comparison.

This difference of 54 bps compares with the average spread difference in the last six years of around 20 bps only. Apart from the growth risk and fiscal imbalances in some of the EM countries, the political risk stays elevated (Brazil, Mexico, China). That said, a positive outcome in trade deal negotiations is likely to improve the sentiment towards EM bonds.



Emerging market bond yields look reasonable

Tactical asset allocation

‘Barclays Private Bank views on the positioning of assets in your portfolio’

Cash and short duration bonds: Overweight

- Our preference for better quality, higher liquidity opportunities translates into our conviction for short duration bonds, which are better poised to cope with a flattening yield curve as yields have become more attractive in the short end.

Developed equities: Overweight

- Earnings’ growth is still positive, albeit slowing, with upside forecasted at low-to-mid single digits over the year ahead. Healthy fundamentals and strong balance sheets continue to underpin the investment case for this asset class, while valuations are not excessively stretched compared to historical precedent.
- Investors’ sentiment is gradually improving amid China’s renewed stimulus and progress on Sino-US trade disputes and less restrictive monetary policy, which should support recovery in the rest of the world and lift the asset class further.
- We are agnostic on the geographical allocation of our equity positions. In searching for companies to invest in, we focus on businesses with high cash returns on capital with conservative capital structures and, ideally, an ability to reinvest cash in future growth at equally high rates of return. The US offers us more opportunities to invest in these kind of businesses, meaning that North America remains the largest geographical weighting within the equity allocation.

Developed government bonds: Neutral

- Sovereign bonds worldwide have been losing their appeal as interest rates have remained at historically expensive levels amid lower economic growth, inflation and monetary policy expectations in most parts of the developed world. Given this backdrop, we anticipate the asset class to predominantly be a diversifier rather than a major source of returns.

Investment grade bonds: Neutral

- The recent rebound in bullish sentiment and easing interest rates should be benign for investment grade bonds. Nevertheless, we remain neutral on the asset class amid mounting concerns over the rising pile of corporate debt and deteriorating credit quality.
- Spreads have tightened significantly since the beginning of this year. That said, we believe investment grade bonds will continue to earn some carry and so outperform low yielding government bonds, specifically in Europe.

Emerging markets equities: Neutral

- Emerging markets equities should benefit from benign valuations and increased appetite for riskier assets, driven by cautious optimism around trade tensions and a recovery in economic growth.
- Fiscal and monetary easing in China are in the pipeline to counteract mounting signs of a slowdown in the region. Trade tensions still pose a risk but will likely dissipate amid hopes for a breakthrough in trade negotiations.

Commodities: Neutral

- The sole exposure within commodities continues to be the position in gold which we view as complementary to the other risk-mitigating assets in the portfolio.
- We find little attraction in this asset class outside of precious metals and find our risk budget better deployed elsewhere.

High yield and emerging market bonds: Underweight

- Default rates remain contained and fears of a bruising trade war have receded. Furthermore, lower expectations for US rates tightening and a weakening dollar should provide some relief to the largely dollar-denominated emerging markets’ debt.
- However, following the recent rally in riskier assets, high yield bonds look quite expensive by historical standards. We prefer to hold a minimal exposure to the asset class, as spreads are tight and we do not view high yield as attractive by historical standards in context of the credit risk taken and the returns available from other asset classes.

Real estate: Underweight

- Real estate should continue to provide mild diversification benefits. We anticipate a loose monetary policy to favourably impact returns, although weaker economic growth could prove to be a headwind.

ATS: Underweight

- We maintain a low conviction in ‘alternative’ assets due to high expense and a lack of investment opportunities. We continue to consider the asset class primarily as a diversifier and focus on funds with a low to negative correlation to equities.

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Reach higher,
See beyond.