

Private
Bank

Market Perspectives

May 2019



BARCLAYS



Foreword

In the May edition of “Market Perspectives” we take a closer look at the situation in Europe. Although surveys indicate that the sentiment towards the European Union is the most positive it has been in almost a decade, the coming European parliamentary elections at the end of May could see a large gain from populist parties. This could slow European Union reforms. But we believe the real risk comes from Italy.

In our fixed income article we take a closer look at what markets are currently pricing and highlight the risks that lie ahead.

We also review our three investment themes. In relation to the “late-cycle investing” theme we take a closer look at what investing in “quality” means for equities. And while there is no consensus on this, our take is to focus on cash flow rather than pure leverage. Equally, quality does not mean a preference for defensives over cyclical.

As part of our “enhancing total return with yields” theme we highlighted last month our preference for emerging markets hard currency sovereign bonds. This month, we take a closer look at this universe and share our thoughts on potential investing opportunities in major emerging markets.

We also take a look at what the large increase in the oil price this year means for our “inflation surprise” theme. And it is not as straightforward as the difference between calculating headline inflation and core inflation. Changes in the oil price seem to have a broader impact on inflation.

Finally, we start a new series in our Market Perspectives that aims to introduce and discuss broad topics in financial markets. The first article looks at the benefit of secondary funds in private capital markets.

We hope you enjoy reading this edition of Market Perspectives.

Yours

A handwritten signature in black ink, appearing to read 'JC Gerard', written over a horizontal line.

Jean-Christophe Gerard
Head of Investments Private Bank and
Interim Head of Private Bank EMEA



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Contributors

- Gerald Moser, Chief Market Strategist – gerald.moser@barclays.com
- Julien Lafargue, Head of Equity Strategy – julien.lafargue@barclays.com
- Michel Vernier, Head of Fixed Income Strategy – michel.vernier@barclays.com



Gerald Moser, Chief Market Strategist – gerald.moser@barclays.com

Monthly Focus: a resurgence of political risks in Europe?

May's EU parliamentary elections will test how much anti-EU political parties are gaining ground, especially in Italy.

Between 23 and 26 May 2019, more than 500 million people in 28 countries will be voting to elect the 751 members of the European Parliament. That is, if the UK participates in the European election.

With the European Council agreeing to extend Article 50 to 31 October, it looks increasingly likely that the UK will be taking part in the coming European election as an agreement on a Brexit deal between the UK government and the UK parliament seems out of reach before the election date.

In that case, May's European elections will test the latest state of the mood among UK voters. The latest polls suggest that Brexit will be a polarising topic and traditional political parties are coming under pressure from new movements seizing this opportunity.

Eurosceptic parties to gain the most

But what is observable in the UK is also visible in a wider anti-EU sentiment that may influence continental politics.

The increasing popularity of anti-EU political parties in recent years, initially stoked by the political reaction to accommodate a surge of migrants to European shores in 2015, may further complicate policymaking.

The Rassemblement National in France, the UK's newly created Brexit party and Germany's Alternative für Deutschland party are all polling strongly ahead of the European elections, with the former two at about 20% in the most recent polls.

Broadly speaking, Eurosceptic and anti-immigration parties look set to make the greatest gains. There is often much apathy among voters towards the election and turnout is generally low, which tends to favour more extreme political parties. A large coalition of EU-sceptics parties could influence EU foreign policy, budgets and eurozone reforms.

But for all the political gains made by more right-wing and nationalist parties in recent years, trust in the EU among its citizens has been at its highest since 2010, ahead of Europe's sovereign debt crisis in 2011-13, over the last two years as per the latest Eurobarometer (November 2018). And the percentage of people with a positive image of the EU is at a 10-year high. Those contradictions highlight the increasing polarisation of the post-globalisation world.

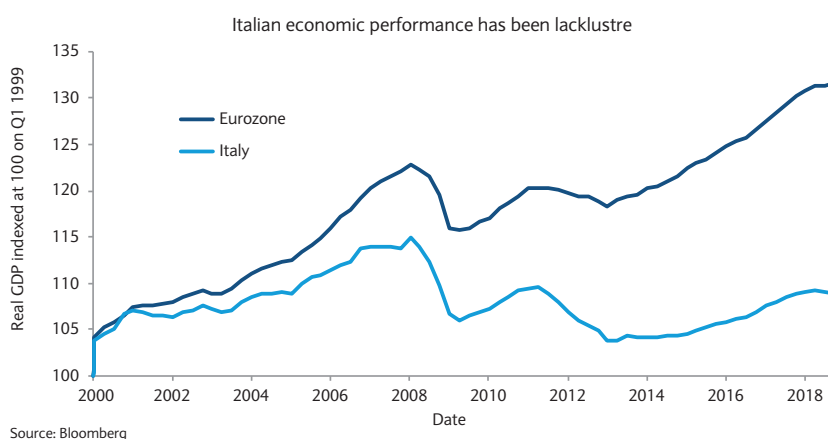
An Italian crisis remains the largest risk for Europe

The resurgence of populism in the eurozone is most visible in Italy. With the League party and the Five-Star Movement currently polling at 30-35% and 20-25% respectively, Italy is the only country where Eurosceptic parties are set to win the European elections.

In the aforementioned Eurobarometer survey, Italy was among the countries where the positive opinion on the EU was the lowest. However, this survey also highlighted that Italian citizens were mostly concerned with the economic situation and unemployment.

While immigration was the major preoccupation of respondents across almost all countries, in no other country within the EU was unemployment and the economic situation as important issues as in Italy.

Looking at the performance of the Italian economy in the past 20 years, those worries are understandable. It has lagged the rest of the eurozone, with the gap growing ever so large since the European debt crisis in 2011-2013.



Italian politics

In the March 2018, Italian parliamentary elections, the Five-star Movement won the ballot with populist promises to improve Italians' economic performance. But since then, Italy has gone through a short recession – the third one since 2009 – and unemployment is still above 10%, actually ticking up to 10.6% in Q4 2018.

The Five-star Movement has been blamed for this situation and the Lega is set to become the most popular party in the European election in May. This could upset the fragile balance in the current governing coalition and general elections later this year could not be ruled out.

“The resurgence of populism in the eurozone is most visible in Italy.”

Political instability and sluggish economic growth are likely to create renewed pressure at some point on Italian assets. We discuss in more details that topic in our fixed-income article, as this asset class is more exposed to the Italian risk than Italian equities which have a broader multinational exposure.



Julien Lafargue, Head of Equity Strategy – julien.lafargue@barclays.com

Investing in a late cycle: assessing quality

High volatility in the fourth quarter of 2018 and worrying signs about the economic cycle have been a supportive backdrop for quality stocks. But picking quality is more than investing in defensives.

In very uncertain macroeconomic times, investors often seek reassurance by sticking to “safer” assets. In the world of equities, “quality” stocks are usually seen as the preferred hideout in turbulent times.

The combination of high volatility in the fourth quarter of 2018 and worrying signs about the economic cycle (weakening leading indicators, inverted yield curve) has proven to be a supportive backdrop for quality stocks.

Indeed, one index tracking higher quality companies (more on that below), has outperformed the broader US market by close to 500 basis points in the last six months.

This begs the question: is this trend set to continue?

The short answer, in our view, would be along the lines of “yes but...”. Yes, because we believe that over the medium term, owning well run, growing companies is

a better strategy than betting on those operating in challenged industries and exhibiting weaker fundamentals.

For this reason, in our first edition of “Market Perspectives”, we argued that one should favour quality stocks this late in the economic cycle. But we see two main caveats to this view.

First, if as we expect economic growth rebounds after a difficult first quarter, low(er) quality stocks could stage a short-term rebound, boosted by renewed investor optimism and light positioning.

Second, the perception of quality is highly subjective and may mean different things to different investors. A closer look at a couple of quality indices devised by two leading providers (MSCI and Standard & Poor's) illustrates this point. MSCI defines quality as a combination of high return on equity (ROE), stable year-over-year earnings growth and low financial leverage.

On the other hand, S&P screens stocks based on ROE, accruals ratio and financial leverage. The result is that only six of the top ten holdings in each of these two indices overlap. Even more strikingly, the energy sector is completely excluded by MSCI while it represents 7% of the S&P's index.

While we won't debate here on the merits (or lack thereof) of these two distinct approaches, we think that looking at past financial performance may not be the best way to predict future results.

For example, a track record of low financial leverage may be a reliable indicator of a prudent approach to balance sheet management. However, it may also point to inefficiencies, especially when interest rates are likely to stay low. As there is no consensus or scientific way to assess quality, its performance will be hard to judge.

So what do we, at Barclays Private Bank, mean when we say that we favour quality?

First, because companies and the world they operate in change constantly, we believe that adopting a forward-looking, and active approach makes more sense than screen-based, passive options.

Second, we believe that quality is not a synonym for defensiveness. So we believe that cyclical sectors should not be excluded.

Lastly, from a more technical stand point, we believe that focusing on a company's ability to generate cash flow is more relevant than its leverage in the current environment.

"Quality" indices vs. S&P 500 index





Gerald Moser, Chief Market Strategist – gerald.moser@barclays.com

The risk of an inflation surprise: rising oil prices

Dovish central banks could prompt higher inflation than forecast.
Is the oil price set to be one source of an upward inflation surprise?

Inflation surprises are one of our investment themes. When assessing the macroeconomic landscape we believe that dovish central banks are likely to be supportive for growth but this could translate into inflation surprising to the upside.

Labour markets are tight in all major developed economies, with the unemployment rate often at multi-decade lows.

In the past, this would typically have led to wage growth and eventually higher inflation, as measured by the consumer price index. This time around, the relationship between low unemployment and wage growth has been weaker.

Some of the explanations for this are more use of technology, the increasing share of the “gig” economy or the lack of bargaining power for workers.

All of these explanations certainly play a role but we think there is a risk that the low unemployment level ultimately pushes wages higher.

Oil matters for inflation

In addition to labour markets, another factor that we highlighted as a risk for inflation is the oil price. There is a distinction in some inflation measurements to correct for a large swing in energy prices which can be volatile.

While headline inflation includes oil and food price changes in addition to shifts in the cost of goods and services, core inflation solely focuses on price changes stemming from the movement in cost of goods and services.

Despite this distinction, an increase in the oil price also influences core inflation through secondary channels. There are many products that include oil prices in their production process and this ultimately leads to a relatively close relationship between core inflation and the oil price.

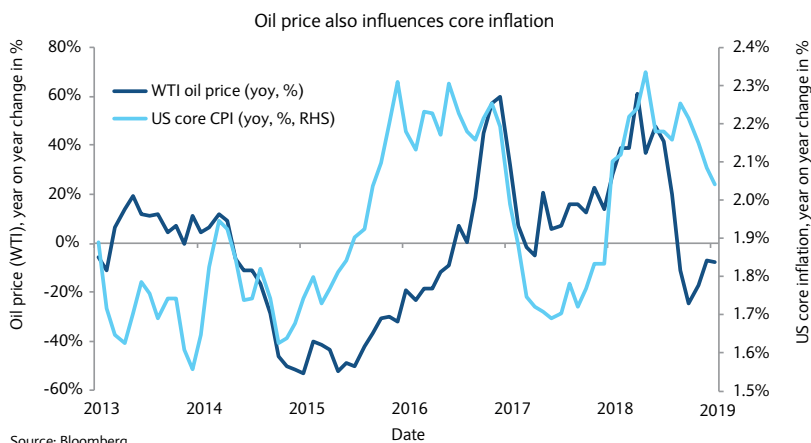
Supply constraints push the oil price higher

The oil price peaked above \$75 per barrel in October last year, before collapsing to below \$45 per barrel in December. This had a deflationary impact on prices. However, a conjunction of supply restraint from the Organisation of the Petroleum Exporting Countries and Russia, unexpected supply constraint in Venezuela and Libya, lower than expected output from shale oil fields in the US and a rebound in demand as economic growth picked up all contributed to the oil price rising by more than 50% since its low in December.

Furthermore, the toughening of US sanctions on Iran, meaning the US will not renew in May the waivers it issued for eight countries to import oil from Iran, is likely to tighten supply further. This may be despite commitments from Saudi Arabia and the United Arab Emirates to step up their output to fill the gap.

The oil price is still slightly below where it was a year ago, hence still moderating overall year-on-year price changes. However, it might soon start to be a positive contributor to inflation, adding one more factor to a potential inflation surprise.

In any case, the consensus was not for the oil price to rise as fast and as high as it already has and this is another factor to take into consideration. We continue to see opportunities in US inflation-linked bonds as well as in gold. With central banks taking a decisively dovish stance, inflation surprises could push real yields lower. The effect would be positive for gold prices.





Michel Vernier, Head of Fixed Income Strategy – michel.vernier@barclays.com

Enhancing total returns with yields: the window for EM bond performance is still open

The global growth outlook and more accommodative US central bank policy should support emerging markets bonds. However, the diversity of countries in the universe means investors need to be selective.

Stable global economic growth and a more accommodative US Federal Reserve should continue to benefit emerging markets (EM) bonds, whose valuations seem currently more attractive relative to comparable developed market bonds resulting in enhanced yield opportunities.

However, investors should be selective due to the diversity of emerging markets which translates to different risk and return profiles as well as different valuations within the EM complex.

While Brazilian and Russian government and corporate bonds in aggregate trade closer to their five-year spread lows, Argentinean, Turkish or Mexican bond spreads are still trading wide for example.

This performance divergence between certain countries and sectors within the EM complex has led to opportunities though respective challenges and risks must be considered in the investment case.

Below we highlight a brief overview of selected EM areas together with our view of where spreads adequately price the respective risks:

Brazil

Brazilian bonds on average have recovered since the election in October of the new president, Jair Bolsonaro, who promotes reforms to bring back economic growth after the deep recession back in 2015 and 2016.

Growth and asset prices are highly dependent on the success of the envisaged pension, privatisation and deregulation reforms.

As much as it is likely that pension reforms will be watered down and delayed, we believe Brazilian bonds should be supported by the recovery in growth and the reforms.

While spreads of the sovereign bonds are extremely tight, we see value in the corporate financial sector. The sector benefits from improved business sentiment, solid loan

growth and higher capital levels while bonds pay an additional premium to the respective Brazilian sovereign bonds.

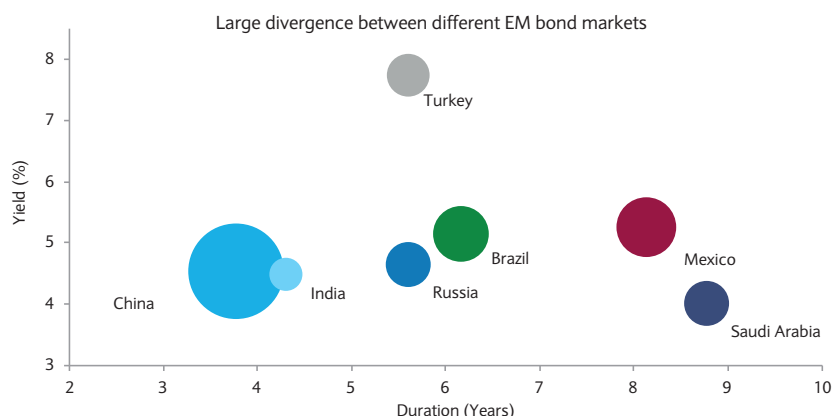
China

Chinese bonds were only recently included in the Bloomberg Aggregate Bond Indices and constitute the largest complex within the Bloomberg Barclays EM USD Aggregate Index. With a market value of over US\$400bn it is larger than Brazil, Mexico and Argentina complex valuations together.

Trade tensions in particular will likely continue to weigh on China's exports which is one of the key reasons for the reduction of the 2019 growth target to 6 – 6.5% by the National People's congress in March.

A more accommodative central bank and announced value-added tax cuts, for example, show the willingness of the government to support domestic growth which shows signs of stabilisation.

Chinese bond spreads on average trade at very tight levels offering only a small yield premium while more value can be found in the high yield property sector on a selective basis due to the higher risk.



Source: Bloomberg (Bloomberg Barclays USD EM hard currency Index: government and corporate bond market of the respective country with average yield / duration information and size of market indicated by the size of the bubbles)

India

The upcoming general elections, of which results are expected on 23 May, get by far the biggest attention at the moment. The market seems to favour the ruling Bharatiya Janata Party (BJP) party led by Narendra Modi with the expectation of further economical reforms.

Meanwhile, the Indian central bank has eased external borrowing regulations and its more dovish stance has already spurred loan and earnings growth for Indian banks recently.

This provides a better basis for further improvement of the banks' asset quality which still suffers from relatively high non-performing loan ratios.

Indian oil refiners in the meantime should benefit from a rangebound trading oil price. Any potential populist measures in order to curb inflation and any potential spike in the oil price on the other hand may hurt the sector.

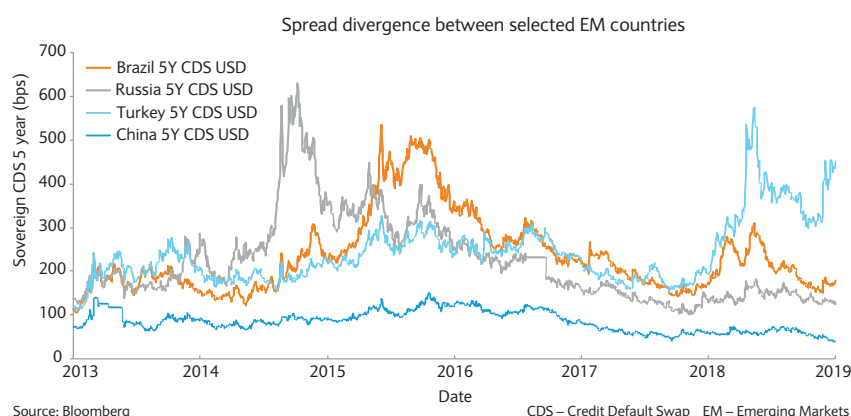
The general election has potential to provide further volatility but spreads compared to other Asian credits already look relatively high and offer entry points.

Turkey

The country suffers from generally low currency reserves which have been used to defend the Turkish lira in the global currency market in light of the large and growing current account deficit.

Before the election in March populist measures were put into place to stop the slide in the lira and curb very high inflation. But this may only be temporary in nature.

Consensus growth is forecast at 0.2% for 2019 which together with the hard currency US dollar indebtedness bears risks for Turkish corporate issuers. The relatively low leverage, strong liquidity and dollar revenue streams have helped multinational companies in Turkey so far and support the respective bonds.



Turkish banks and specifically government-related banks enjoy the support of the government which recently announced more supportive measures. Banks have built high reserves to deal with the high proportion of non-performing loans and have increased their capital ratios in order to deal with any potential spike in non-performing loans.

The highly vulnerable currency and the economic challenges put the sector generally at risk for further spread volatility. Risk/reward seems balanced and any spread volatility may offer more opportunities.

Russia

Apart from the sanctions from foreign governments, the economy in Russia as well as the credit quality of the major issuers seems relatively healthy.

The Russian economy has shown resilience to the sanctions, growing 2.3% in 2018, mainly helped by exports.

Russia's fiscal surplus of 2% of gross domestic product has led to growing foreign-exchange reserves while a higher oil price should further boost the surplus. Meanwhile, slowing fixed investments and lower growth in consumption, which could be further depressed by the recent VAT hike, point to a slowdown in 2019.

“Chinese bonds were only recently included in the Bloomberg Aggregate Bond Indices.”

Russian government bond spreads are trading close to the 2018 lows (five-year credit default swaps now: 127 basis points) while renewed sanction risk could change the direction quite dramatically again.

Sanctions would most likely have a direct, or at least indirect, impact on the energy and mining sector as well as the bank sector, which make the respective bonds highly vulnerable for repricing.



Gerald Moser, Chief Market Strategist – gerald.moser@barclays.com

Secondary funds: a good alternative

Investing in private capital helps to diversify portfolios away from publicly-traded markets. However, it is key to understand the differences between primary and secondary funds before making such an investment.

Private capital in a nutshell

Private capital is an important piece of an investment puzzle as it allows investors to harvest an illiquidity premium and diversify away from publicly traded markets. But an investment in private capital, of course, is only possible if the liquidity needs are already covered with the rest of the portfolio.

Investments in private markets can be defined according to the target asset (equity and debt), the purpose (leveraged buy-out, infrastructure, real estate, energy and power), the way of investing (direct or fund of funds), the stage of the investment (venture capital or growth capital) or the maturity of the private equity fund (primary or secondary)

In this article, we focus on the differentiation between primary and secondary funds, providing more explanations on secondary investments.

In a traditional primary private capital fund, investors agree to commit capital to a fund which invests this capital based on investment opportunities which are broadly defined according to the categories aforementioned.

The capital can be drawn at any point, usually in the first few years, as fund managers find investment opportunities. But it can take time for the capital to be invested and start generating returns.

This delay in generating any return on investment is called the J-curve effect. It illustrates the general trend for private equity investment to have negative cash flow earlier on before turning into investment gains as the portfolio matures.

Initial negative cash flows come from management fees, investment costs, underperforming investments or investment in non-profitable companies.

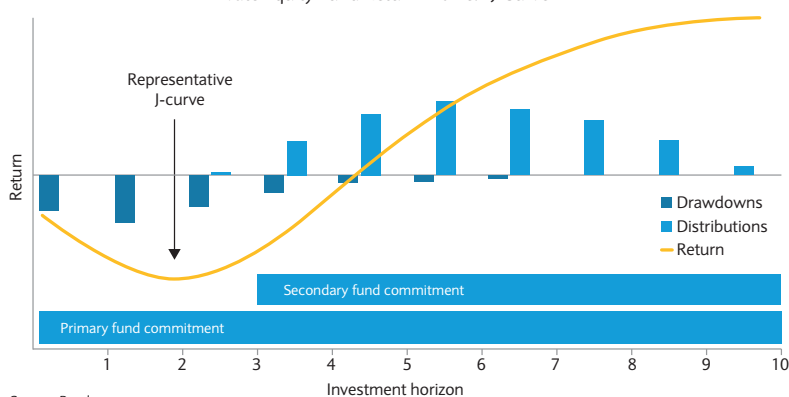
Why consider secondary funds

Investing in private equity can be daunting. It is a long-term investment with limited opportunities to exit it, no visibility on how the funds will be invested (the so-called “blind pool” risk) and no investment control. On top of this, returns are uncertain as committed capital could never be called if fund managers cannot find suitable investment opportunities.

Secondary investments offer several appealing characteristics which mitigate those risks while still offering most of the advantages of private equity:

- Investing in secondary funds limits the “blind pool” effect as most of, if not all, the capital has already been called and invested.
- Linked to the previous point, the J-curve effect is mitigated. Secondary investment happens when the fund is close to breakeven, ie distributions to investors start to match and even outpace capital calls. The return on investment is therefore more certain than for primary fund investment.
- Secondary funds are often available at a discount to their net asset value. This compensates, partially at least, for the upside for secondary investment usually being lower than for primary funds as the investment happens at a more mature stage of the fund's life.
- Secondary funds also improve the diversification of a private equity portfolio. It is possible to get several vintage years in a portfolio, reducing any risk associated with the timing of the investment and the impact of the economic cycle on performance.

Private Equity Fund Return Profile: “J-Curve”



Source: Barclays



Julien Lafargue, Head of Equity Strategy – julien.lafargue@barclays.com

Equities outlook: time for a spring break?

Encouraging first-quarter earnings have helped global equities to test record highs. So with earnings' forecasts for 2019 set to rise, how should investors position themselves?

With the bounce in returns we expected this year taking global equities close to new all-time highs, we believe it's too early to turn even more constructive. We stick to our key themes and expect some consolidation in the short term.

Equity markets marched higher in April as investors welcomed improving – or at least stabilising – economic data and encouraging signs from companies reporting their first-quarter results.

With regards to the macroeconomic picture, one key development has been the positive news coming out of China with growth in output, retail sales and industrial production all surprising positively.

In last month's "Market Perspectives", we highlighted that China was key in unlocking further upside. With signs that the domestic economy is picking up and a trade deal with

the US looking ever more likely (although its details remaining unknown), we believe that we are one step closer to our "bull case" (ie the S&P 500 index moving above 3000).

Similarly, we previously pointed to the fact that the consensus earnings expectations for 2019 in the US were cautious with projected year-over-year growth of just 3%. Although it's still early in the reporting season, first-quarter results seem to indicate that expectations may move closer to the 5% growth we anticipate.

Yet, despite these positive developments, we think it may be premature to turn significantly more constructive. At this stage, our two main concerns lie with:

- A political agenda that is getting busier (European elections in May and the US presidential election campaign ramping up),

- A market technically approaching overbought levels with suppressed volatility. As such, we would not be surprised to see some consolidation in the short term.

Thematics

April's developments reinforce our conviction around late-cycle investing and yield enhancement as economic activity remains healthy and interest rates are stuck at low levels.

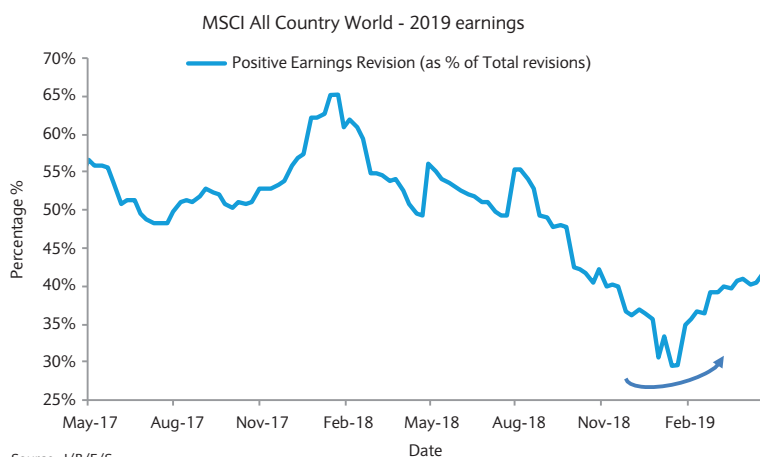
Inflationary pressures may seem even lower after disappointing prints globally but this, in our opinion, makes the risk of an unexpected jump all the more relevant.

"From a sector perspective we remain of the view that it is too early to be defensively positioned."

At the regional level, we maintain our preference for US and emerging markets assets as the growth outlook they offer should allow them to deliver further outperformance compared with their peers.

From a sector perspective, we remain of the view that it is too early to be defensively positioned and advocate focusing on growth opportunities with sectors such as consumer discretionary and communication services in the US or industrials in Europe.

Finally, although political noise may continue to weigh on investor sentiment in the short term, we see merit in owning healthcare over the medium term.





Michel Vernier, Head of Fixed Income Strategy – michel.vernier@barclays.com

Fixed income outlook: another Italian drama on the way this summer?

With rising political uncertainty in Italy to the fore, Italian bonds look particularly exposed to higher volatility. So how can investors in sovereigns and Italian banks position themselves at such times?

Italian government bonds

Government bond auctions usually provide a good insight into investor sentiment towards the respective sovereign bond market.

On the 11 April Italy auctioned € 2.5bn of 2022 bonds among others and investors offered to buy 1.62 times more the amount of that bond than sold (bid to cover ratio) at a yield of 1.08%.

The healthy demand was one of the reasons why the Italian 10-year bond yield marked an almost 12-month low at 2.37%.

Yields have fallen a long way since the 3.7% highs seen in October 2018 when Italy clashed with the EU on the back of budget discussions.

Furthermore, since then Italian bonds have been supported by Moody's decision to maintain Italy's BBB – rating

with a stable outlook. However, sentiment can change quickly as seen in the past and we may witness this again in coming weeks or months.

Political uncertainty

Back in February, Italy avoided paying a penalty through the excessive deficit procedure, which is regulated by the EU. However, the presented budget lacks a solid foundation and given the political uncertainty faces implementation risks in Italy.

The initial budget targeted a deficit of 2% of gross domestic product (GDP) in 2019 and 1.8% and 1.5% in the years 2020/2021, based on lowering spending costs, pension reforms as well as value-added tax (VAT) hikes in 2020/2021.

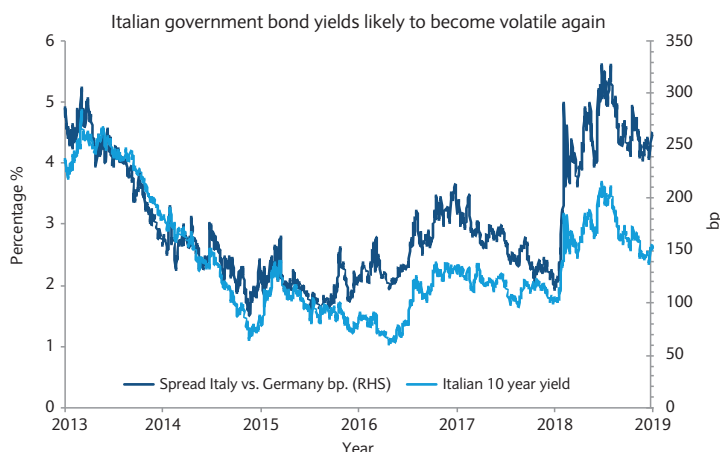
The VAT hike is a very sensitive topic and has most recently been challenged publicly by the Five Star Movement leader and Italy Deputy Prime Minister Luigi Di Maio.

Without an increase in the VAT rate, the budget seems unsustainable and is likely to surge to 3.4% of GDP and breach EU budget rules according to the Bank of Italy. Italy has since revised the budget deficit to 2.4% of GDP for 2019, which still seems out of reach.

Optimistic assumptions

The path to debt reduction is based on a very optimistic growth assumption in our view. Although Italian growth has recovered from the technical recession it experienced in Q4 2018 and Q1 2019, the government's growth assumption is very likely to be revised down from 1% of GDP closer to 0.6% of GDP as projected by the International Monetary Fund. Growth may even head towards the 0.2% of GDP projection of the EU for 2019.

The low volatility in spreads seems to reflect investor's expectation that an agreement will be reached within the Italian parliament as well as between the EU and Italy, which we argue, seems overly optimistic.



Investors may also rely on a change in the government given the recent momentum of the League party which is perceived as more constructive and investor friendly than the current coalition.

Although the odds of an administration change look increasingly likely due to ongoing frictions between the two ruling parties and a wide range of coalition scenarios, trading on the back of the expectation of an investor-friendly government seems premature in our view.

Given that the debate about the budget will likely heat up again in the next two to three months, the overly optimistic growth assumption and the prevailing and increasing political uncertainty, we

Bumpy road ahead: the new budget plan for 2019 must be presented to the EU, which in turn will make an assessment followed by a recommendation over the summer while the European elections in May have the potential for a political shake up.

rather expect investors to demand higher premiums soon for a country which runs record debt levels of 132% of GDP (2018).

Italian banks

Italian bank bonds will likely feel the impact of a potential resurgence of volatility in Italian sovereign bonds. Profitability of Italian banks is disproportionately affected by sovereign spreads.

Firstly, Italian banks have the highest domestic sovereign exposure in Europe with €396bn making up 10.7% of the banks' assets while Spain's banks, for example, holds an average of 7.6%.

Under updated international financial reporting standards (specifically IFRS9), a large part of these holdings need to be booked at fair value which directly eats into the profitability and capital of the banks should spreads widen.

Secondly, higher funding costs restrict growth, which Italian banks require in order to reduce loss charges on their existing loan book.

The good news is that the large Italian banks were able to reduce the proportion of the non-performing loans significantly due to disposals and securitisation. Loan loss charges have declined by 12% in 2018.

“...we rather expect investors to demand higher premiums soon for a country which runs record debt levels of 132% of GDP (2018).”

However, recent securitisation deals indicate that the mark-to-market value of impaired loans sitting on banks' balance sheets may still be too high. The European Central Bank (ECB) has so far not provided final details about the renewal of the Target Long Term Repurchase Operation (TLTRO III) bank funding operation and Italian banks, as the biggest beneficiaries, will hope that the ECB will be generous.

Investors may prefer to be selective and focus on higher quality within the Italian banking sector.



Tactical asset allocation

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

Cash and short duration bonds: overweight

- Our preference for higher quality, liquid opportunities translates into our preference for short duration bonds, which offer an attractive risk-return trade off in the context of a flat yield curve.

Developed government bonds: neutral

- Sovereign bonds worldwide have been losing their appeal as interest rates edged down amid lower economic growth, inflation and monetary policy expectations. Given this backdrop, we anticipate the asset class to predominantly be a diversifier rather than a major source of returns.
- Although US dollar real rates remain at historical low levels, they are still too attractive to ignore relative to the other developed bond markets. UK and European bond markets failed to synchronise with US rates due to their own geopolitical challenges, and depressed yields make it difficult to find these markets attractive.

Investment grade bonds: neutral

- Improving economic 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 BBB-rated debt issuance.
- Although spreads have tightened significantly since the beginning of this year we believe investment grade bonds will continue to earn some carry and thus outperform low yielding government bonds, specifically in Europe.

High yield bonds: underweight

- While default rates are at historical low levels and corporate fundamentals remain robust, we maintain an underweight exposure to the asset class as margin pressure typically increases late in the economic cycle.
- Following the recent rally in riskier assets, high yield bonds look quite expensive and spreads are tight by historical standards. So we do not view the outlook for the asset class as attractive in the context of the credit and liquidity risk taken and the returns available from other asset classes.

Emerging markets bonds: neutral

- The US Federal Reserve's accommodative stance and a weakening US dollar should continue to provide some relief to the largely dollar-denominated emerging markets (EM) debt.
- Despite lingering political risks in the region, emerging markets debt should get an uplift by a relaxation in the US-China trade spat and the ongoing rebound in energy prices, given their reliance on commodity exports.
- Spreads tightened as investors' flows reverted back into EM bonds amid the current risk-on sentiment, but remain comparatively wide versus high yield bonds. We favour US dollar emerging markets hard-currency bonds thanks to their relatively attractive valuations.

Developed equities: overweight

- Earnings growth is still expansionary, albeit slowing, with growth forecast to be low-to-mid single digits over the year ahead. Healthy fundamentals continue to underpin the investment case for this asset class, while valuations are not excessively stretched compared to history.
- Investor sentiment is gradually improving amid China's renewed stimulus, progress on trade disputes and less restrictive monetary policy, which should support recovery in the rest of the world and lift the asset class further.
- We favour active management and selective stock picking of companies with strong balance sheets, although 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 has tended to offer us more opportunities to invest in these kind of businesses meaning that North America remains the largest geographical weighting within the equity allocation.

Emerging markets equities: neutral

- Emerging markets equities should benefit from attractive valuations and increased appetite for riskier assets driven by optimism around trade tensions and better economic data out of the region.
- We expect fiscal and monetary easing in China to counteract a slowdown in the region and limit downside risk to earnings expectations. Trade tensions still pose a risk but will likely dissipate amid hopes for a breakthrough in trade negotiations between the US and China.

Commodities: neutral

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

ATS: underweight

- We maintain a low conviction in alternatives due to their high expense and a lack of investment opportunities in this space. The limited use of leverage should further cap returns for the asset class.

Neutral: tactical exposure to an asset class which is within +/- 20% of the strategic asset allocation (SAA), capped at +/-3% compared to the SAA, whichever is lower (ie if the SAA for cash is 9%, the neutral range would be +/- 20% of the SAA, or 7.2%-10.8%).

Overweight: tactical exposure to an asset class which is greater than the neutral range.

Underweight: tactical exposure to an asset class which is less than the neutral range.

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