Private Bank

Market Perspectives

September 2019

BARCLAYS

Foreword

Risk assets sold off in August as yield inversion in the US rates curve raised fears that a recession was near. That said, bull market corrections are common, the largest correction in any year being around 10% since 1988. We believe the economic cycle is far from over and urge investors to stay invested.

With increasing geopolitical tensions and recession worries, volatility is back at levels rarely seen this year. A systemic volatility strategy may be one solution in such conditions. The strategy usually performs best when volatility is high, aiding portfolio diversification as risk assets underperform.

Heightened political uncertainty, trade tensions and a late-cycle growth slowdown cloud sentiment towards Europe. For now, we remain cautious. However, there are investment opportunities. If policymakers can get their act together, the outlook for Europe could be very promising.

Financial markets increasingly priced in a no-deal Brexit in August. The political drama is likely to further hit economic confidence and sentiment in UK markets, especially sterling. However, recent commitments to more government spending may alleviate the effects of any recession.

Surging levels of financial leverage has helped make BBB-rated bonds the largest segment of the investment grade debt market. However, as fears mount of higher default rates, many doubt the outlook for the bonds. Despite the risks, we believe BBB-rated debt has many appealing features to offer investors.

Despite August's sudden correction, US equities have traded in a relatively tight range for much of the year. US-China trade tensions show little sign of a deal being struck soon. That leaves central banks as the best drivers of delivering the ambitious policy mix markets need to break decisively higher.

The oil price entered a bear market in August, from its April peak, partly in response to global growth worries and trade tensions. The potential for supply shocks in coming months and plans to extend production cuts hint at a recovery in the oil price. That said, intermittent drops in the price are likely.

Jean-Damien Marie
and Andre Portelli,
Co-heads of Private Bank Investments

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Market corrections do not equal recessions

Placing too much faith in financial markets' ability to call a recession can lead to a bad investment strategy. So, should investors take heed of the latest bout of extreme market pessimism, or ignore it and stay invested?

Financial markets more volatile than the economy

Paul Samuelson, an American economist recipient of the Nobel Prize in Economics in 1970, once famously said: "The stock market has forecast nine of the last five recessions." His point was that financial markets are prone to extreme behaviour. Sentiment can shift from too pessimistic to too optimistic relatively quickly, and this can lead to investors positioning for a recession which ultimately does not materialise in the short term.

The above behaviour creates so-called "bull market corrections", when growth-driven assets experience a fall in an overall up-trending market. August's market movements, with equities selling-off and the 2-10-year yield curve inverting, bear the hallmark of a coming recession. However, we think it is too early to call for an end of the current cycle.

Market jitters return

Over the last month, growth-sensitive asset classes, such as commodities and equities, suffered from a second drawdown this year, the first sell-off occurring in May. On each occasion, global equities lost around 6% in value.

In our "Market Perspectives" back in April, we highlighted that we expected this year to be challenging with a few sell-offs creating tactical opportunities. While we have already had two market drawdowns, we think more jitters may shake financial markets later in the year. But this would likely be triggered by geopolitical tensions rather than the start of a recession.

Anatomy of bull market corrections

Although bull market corrections are stressful and can shake convictions, they are not uncommon. In fact, since 1988, and excluding years when there was a recession, the average largest correction in any year is around 10%.

The trigger of corrections can be difficult to identify: they may be caused by a string of bad economic data, geopolitical tensions, profit taking after a strong market performance or central bank actions. Even in hindsight, it is sometimes difficult to explain violent market sell-offs.

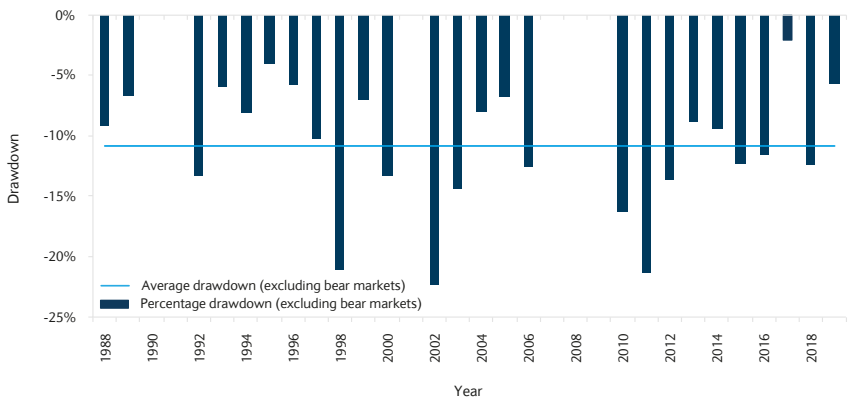
Another feature of corrections is that they are short-lived. They normally last one to three months and markets usually recover equally rapidly. As identifying catalysts for corrections is hard to identify, and they are often short-lived, it becomes clear that it is extremely difficult to time a bull market correction. In that respect, when we mention tactical opportunities, we refer to opportunities for investors that are not yet invested as well as volatility-based opportunities.

Stay invested

For that reason, we believe that it is better to stay invested through volatile times, as getting market corrections' timing right is nigh on impossible.

"We think it is too early to call for an end of the current cycle."

Bull market corrections are not uncommon



Source: Datastream, Barclays

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When volatility is your friend

August saw markets sell off, recession fears rise and volatility climb. Is a systematic strategy of selling option premium one way to enhance yields while profiting from bouts of heightened volatility?

Prefer alpha over beta

Since April, we have said that markets were likely to be choppy. However, as we are not expecting any recession in the short term, we believe it makes sense to stay invested as markets should trend slowly higher over the medium term.

"We believe it makes sense to stay invested as markets should trend slowly higher this year."

We think that the best investment strategy is to move away from pure market exposure – so-called beta risks – and instead use active management to capture security-specific opportunities both in equities and credit – so-called alpha risks.

Index price returns to be limited

Since April, the MSCI All Country World Index, a global equity benchmark which includes both developed and emerging markets equities, has hardly moved.

While we still believe that global equities should finish the year with a low to mid-single digit price return from April, this would be below the average long-term return from equities. Equally, a global fixed-income benchmark over the same period would have returned less than 5%, and in this case we think that the upside till year-end is even more limited than for equities.

Look for additional yields from volatility

While financial markets have been rocked by geopolitical tensions and increasing fears of a coming recession in recent months, there is one saving grace. Volatility is again looking attractive as a strategy to improve a portfolio total return.

A systematic strategy of selling option premium yields stronger returns when volatility is high. Selling option premium not only helps portfolio performance, it tends to aid portfolio diversification as risk assets typically underperform when volatility is high.

In a way, selling option premium can be seen as a substitute to fixed-income assets. It offers yields, has a different return profile from equities and so offers a different source of alpha that is not linked to index or security-specific selections. It also contributes to diversifying a portfolio. In the current environment, when more than $15tn bonds offer negative returns, enhancing yield by selling option premium is an alternative that we find attractive.

Three golden rules

We would follow three rules to optimise the probability of positive returns in a volatility strategy:

1. Balance the risk and reward. While the premium is larger if it insures against a small fall in the market, this also translates into higher risks.
2. Select short-term contracts. With short-term contracts, the risk of a sharp market sell-off is minimised. Although the contract sold ahead of the sell-off is likely to result in a loss, this should be more than recouped by the new contract sold at a higher premium after the market drawdown.
3. Be systematic. Linked to the example above illustrating the attraction of short-term contracts, we prefer to have a systematic approach as this does not require investors to time the market. Premiums are collected regularly and therefore a loss is usually compensated by the next premium being higher, reflecting a spike in volatility.

"In the current environment, when more than $15tn bonds offer negative returns, enhancing yield by selling option premium is an alternative that we find attractive."

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European delight?

As political uncertainty rages across Europe, trade tensions escalate and growth stutters, the outlook for continent looks bleak. However, is the bull-case for European assets as far away as many think?

The slow-down in global growth being experienced in the current late-cycle environment, coupled with escalating protectionism all over the globe, has weighed on Europe in particular. To make things worse, the region has its own geopolitical issues and an ageing population which are a drag on growth.

Despite all the negatives, we believe a bull case for Europe exists. But in order to get there, we need to see several key pieces fall into place. Below we analyse each piece in turn.

More accommodative monetary policy

First, the European Central Bank (ECB) needs to ease. The ECB has turned increasingly dovish in 2019 due to sluggish domestic growth, pulled down by external headwinds such as escalating trade tensions. In addition, subdued inflation, the ECB's unique mandate, remains well below the "just below 2%" target rate, despite historically low interest rates.

Given the above backdrop, we expect the central bank will implement more easing measures later this month. To be successful, we believe this new round of liquidity injection needs to account for the effect on the banking sector's profitability (for instance, through a tiered reserve system for banks). Very low rates have pressured this key sector of the economy for too long.

Reduced trade tensions and more fiscal spending

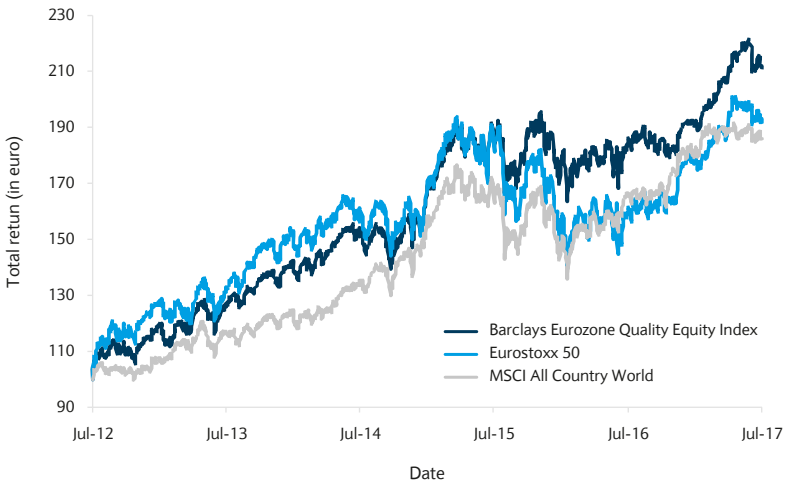
Second, because the eurozone is heavily exposed to international trade, some softening in trade tensions is needed between the US and its trading partners. However, this may not be enough on its own.

To revive domestic growth significantly, we believe European governments may need to actively step up their fiscal spending. Germany has continued to be particularly reluctant to provide fiscal stimulus. Meanwhile, the need for such stimulus has never been stronger, given that the bloc's largest economy is now experiencing a significant slowdown.

Currency support needed

Because Europe is an open economy, it needs trade to flow and to remain competitive. As such, a bull case for Europe would require the euro to weaken, or at least not to appreciate much. This seems likely if the ECB acts decisively and injects more liquidity. Ironically, a weaker currency may anger some trading partners, especially the US, potentially ratcheting up trade tensions.

Eurozone stocks soared after Mario Draghi's "whatever it takes" speech in 2012



Source: Bloomberg

Quiet political landscape

Finally, Europe's bull case rests on a stable political landscape. This equilibrium is currently threatened by jitters around Brexit and Italy.

The UK's planned departure from the European Union (EU) is still a big question mark, creating political upheaval for over three years. At this stage all options remain on the table. July's election of Boris Johnson as prime minister makes a no-deal Brexit significantly more likely, although opposition parties are trying their best to prevent this. A general election could delay, or even stop, Brexit altogether. However, the final outcome is still highly uncertain as the 31 October deadline approaches.

Political drama in Italy continues to unfold, with League leader Matteo Salvini having failed for now in his quest for power. The new coalition between the Five Star Movement and the Partito Democratico may provide some temporary stability and boost investor sentiment, supporting the bull case for Europe. However, we would not be surprised to see political risk resurfacing in the medium term.

Hope for bull case Europe

While it is difficult to envisage a scenario where all the above stars align, in our opinion, the bull case for Europe is more likely now than it's been in for a long time. In some ways, the state of play reminds us of the period before the "whatever it takes" pledge to save the euro from ECB president Mario Draghi in 2012. His pledge resulted in European equities outperforming their global peers for the next five years.

For the time being we remain cautious on Europe, but suggest not foregoing the area's assets altogether. Even in the current context, the region still offers opportunities, in particular in high quality stocks. Although lower quality, value shares may outperform, should the bull case materialise we believe that, over the medium term, quality companies will continue to deliver better returns.

> "The bull case for Europe is more likely now than it's been in for a long time."

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Assessing Brexit risk

As markets increasingly prices in a no-deal Brexit and the chances of a UK recession rise, what is the outlook for the UK economy and financial markets?

In 1907, the British poet GK Chesterton wrote in his poem "The Secret People": "Smile at us, pay us, pass us; but do not quite forget. For we are the people of England that never have spoken yet". The poem is a reminder not to take the British public's vote for granted. Too many economists and investment strategists were guilty of that in the run up to the 2016 referendum and have been rushing to change their forecasts ever since.

Britain's vote to leave the European Union (EU) has widespread economic, constitutional and financial market implications. Recent political developments suggest that Britain is inexorably moving towards a general election. As such, a broad range of scenarios could still materialise, including a deal or indeed a second referendum. However, if the polls are to be believed, Boris Johnson may well be returned as prime minster with a working majority, very much keeping the possibility of a no-deal Brexit in play.

Economic outlook looks fragile

Since the start of the year the UK's growth pattern has become more volatile as the risk of a no deal Brexit has developed. In the first three months of the year growth came in at a surprisingly robust 0.5% quarter on quarter (buoyed by stockpiling ahead of the original 31 March Brexit deadline). This was followed by a contraction of 0.2% between April and June (as companies ran down inventory).

Recent data shows that the manufacturing sector is in recession, but that consumer confidence and the services sector remains resilient. So we expect growth for 2019 to come in at 1.1%. However, persisting Brexit uncertainty suggests, the outlook for the UK economy continues to look fragile.

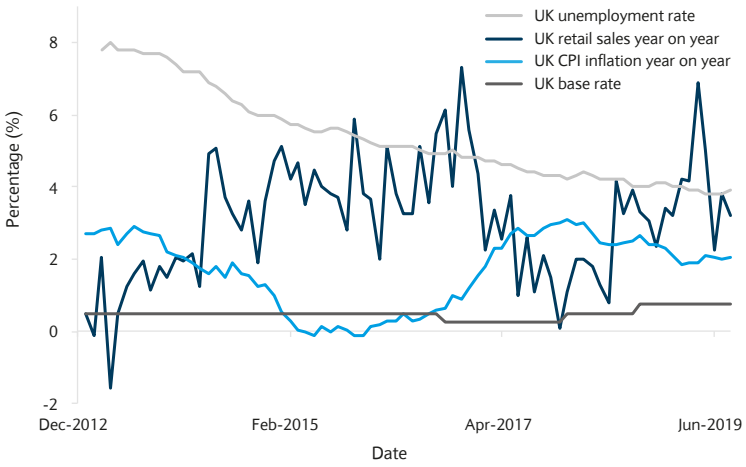
Markets pricing in a no-deal

Since Prime Minister Boris Johnson, a hard-Brexiter, took the keys of Downing Street from Theresa May in July, markets have increasingly priced in the likelihood of a no-deal exit from the EU.

During the Conservative leadership campaign, Johnson vowed to renegotiate a better withdrawal agreement with the EU than his predecessor. But the EU remains resolute in refusing to re-open the negotiations.

The prime minister has made the removal of the Irish backstop a precondition of new talks, a demand the remaining EU27 have dismissed, thus putting the two sides at deadlock and increasing the chances of a no-deal.

No-deal Brexit to add to economic fragility



Source: Bloomberg

Higher recession risks

No-deal would have significant implications for the UK economy. Brexit uncertainty is likely to reduce business investment and hold back household consumption. We anticipate that the UK economy would enter a recession in next year under a no-deal, contracting by 0.5% in 2020.

Under the uncertainty and weaker economy of a no-deal, sterling would likely come under renewed pressure. The weaker currency and imposition of tariffs would probably result in a spike in inflation to around 2.8% at the start of the next year. The fall in business confidence could constrain hiring, pushing the UK unemployment rate much higher than the 44-year lows seen this year.

Given the risks of a downturn in the economy and the delicate political backdrop, it's not surprising that the government has been highlighting possible fiscal stimulus measures. The prime minister has trailed potential new initiatives including tax cuts and spending increases for the health service, nationwide broadband, new rail links and no-deal Brexit planning. If implemented, these measures would support growth over the next few years, particularly if a recession occurs.

What a no-deal would mean for businesses

The impact for UK businesses of a no-deal Brexit could be substantial. Companies trading with the continent would face trade barriers like new tariffs, additional customs checks and import/export certifications. Firms would also be subjected to additional regulatory restrictions, limitations on talent pools for new hires and different tax structures. And new trade deals with other jurisdictions would further complicate the picture.

So a no-deal is likely to result in higher costs, increased complexity and potentially radically different business models.

Possible benefits of Brexit

In trying to identify the potential economic benefits of leaving the EU it is worth remembering that much of the referendum debate centred on democracy and sovereignty, which are always hard to quantify.

That said, the UK could profit from reduced payments to the bloc and ultimately greater business flexibility. The country's fisheries industry may also get a boost.

However, the major arguments for leaving the EU are: firstly, the ability to break away from European bureaucracy allowing the UK to strike its own trade agreements; and secondly, if you believe the European project is going to fall apart, then it would advisable to abandon the "sinking ship" as early as possible.'

Investor implications

A no-deal Brexit would have a range of implications for investors. Foreign exchange has primarily been the instruments that traders have used to express concern about Brexit, and we would expect sterling to weaken.

We would anticipate that the FTSE 100 would outperform the more domestically-focused FTSE 250 as exporters benefit from a fall in sterling. The weaker currency should also translate into higher breakeven inflation as imports get more expensive. Finally, the Bank of England would likely cut rates by 50 basis points, with more cuts priced in thus pushing real and nominal rates sharply lower.

While exiting the EU feels like a dramatic moment for the British people, remember that the UK economy accounts for less than 5% of global output and only a small part of our investment universe. As always, the best way to navigate political and economic uncertainty is through a globally balanced diversified portfolio, held for the long term, while taking advantage of tactical opportunities.

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BBB-rated bonds: a cause for concern?

Leverage in the non-financial sector has increased substantially. At the same time the proportion of BBB-rated bonds has surged to become the largest segment of the investment grade bond market. Given the late stage of the cycle and potential for higher default rates, how worried should investors be?

In August's "Market Perspectives" we wrote about the increasing level of leverage prevalent in various segments of the economy. While not a danger in itself, investors should be wary of the areas where excessive leverage could potentially put future returns at risk. One area worth a closer look is the non-financial corporate sector, particularly investment grade BBB-rated issuers.

The size of the BBB-rated bond market soars

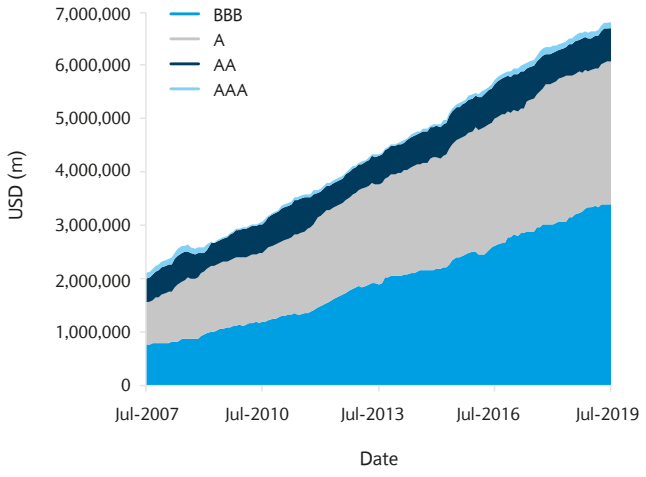
The rise of the lowest rating in the investment grade universe, BBB-rated bonds, since the credit crisis of 2008 confirms the decreasing credit quality of the bond market (see chart). The amount of BBB-rated debt outstanding in the US has almost tripled since 2008, to around $2tn.

The proportion of BBB-rated bonds has surged from 23% in 2008 to now over 50% in Europe as well as in the US. The largest drivers of this expansion have been new BBB bond issuance, rating downgrades and new entrants. Corporate issuers have enjoyed an extended period of low rates, which has supported the credit expansion.

Leverage still seems manageable

The high proportion of BBB-rated bonds is primarily a reflection of the record levels of debt within the non-financial corporates' segment. According to the latest International Monetary Fund Financial Stability Report, business financing of non-financial corporates, including loans and debt securities in the US and euro area, has doubled in the last 14 years and stands well over $10tn for each market.

Lower-rated bonds drive growth in face value of US corporate debt



Source: ICE BofAML

"The amount of BBB-rated debt outstanding in the US has almost tripled since 2008, to around $2tn."

Excluding the UK and Germany, the percentage of non-financial debt to gross domestic product (GDP) for most of the countries with large investment grade bond markets is higher than it was before the credit crisis in 2008 (see chart opposite).

Also the balance sheet quality of US BBB-rated issuers has deteriorated somewhat. However, while net leverage (equity/net total debt) has increased in average from 2.1x to 2.6x between 2007 and 2018, the debt service ratio seems relatively healthy, given the low interest charge.

Default rates contained

Repayment of capital and coupon is the primary concern for buy-and-hold investors. So the probability of default is crucial. Investment grade default rates seem relatively contained. At 0.1% in July, the 12 months-trailing default rate in BBB-rated bonds compares with the 0.3% average default rate over the last 99 years. By contrast, the rate for US high yield bonds is 3% (ten times higher).

Importantly, even the credit crisis in 2008 did not push default rates within the BBB-segment, in a 5-year rolling period, over 2.5%. Additionally, during the 1987 crisis the rate peaked at 5%. So while default rates look set to rise, they still seem manageable.

Beware 'fallen-angel' downgrades

The high degree of leverage, and large size of the BBB-bond market, raises questions about the risk of rating downgrades. Although a downgrade within the five-year period does not change the default rate as such, it still may expose investors to more price volatility during the holding period.

The risk of an investment grade bond being downgraded to high yield is known as "fallen angel" risk. Given many large institutional investors are forced to sell fallen angel bonds, due to investment restrictions, a downgrade to high yield status can hit the price substantially.

That said, the ratio of fallen angel bonds within the BBB-rated population is at very low levels compared to the historical average. Since 1983, on average 5.2% of BBB-rated companies have been downgraded to junk status. This rate, however, can fluctuate over time. For example, in 2002 this ratio peaked at just short of 17%.

It is likely that the fallen angel default rate will rise from its current low level. In addition, downgrades are likely to become more frequent in the late-cycle stage of the economy, as companies face lower growth prospects.

BBB-rated bonds remain appealing

Despite the increasing risk, we do not believe that the BBB segment should be shunned for three reasons:

1. Default rates have been contained even during periods of severe crisis, while the average default rate of BB-rated companies, for example, was more than four-times higher than the historical average.

2. Both, liquidity ratios and cash from operations are at healthy levels for the majority of the BBB-rated issuers, while funding rates are unlikely to rise substantially in the near future.

3. As much as lower growth will lead to challenges, companies have several levers to manage leverage. Historically, companies have actively managed the degree of leverage in the balance sheet and have often sacrificed a higher rating in order to optimise the funding crisis.

   While companies have used low interest rates to partly fund a higher dividend pay-out ratio and share buybacks for the equity holders, as well as funding acquisitions, they are likely to adjust their policy before the respective rating is at risk.

"Investment grade default rates seem relatively contained. At 0.1% in July, the 12 months-trailing default rate in BBB-rated bonds compares with the 0.3% average default rate over the last 99 years."

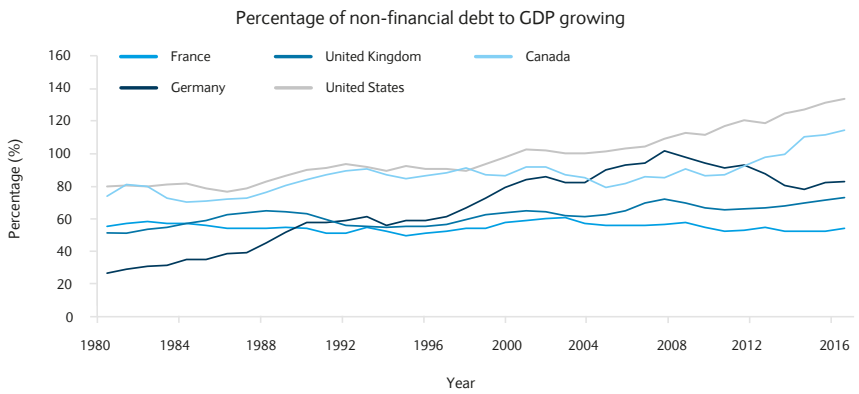
Selection and active management key

As always, we believe that bond selection and active management will remain important. The key factors to watch out for are:

- Issuers from more cyclical sectors like automotives, consumer or energy are naturally more exposed to downgrades than issuers from more defensive sectors;

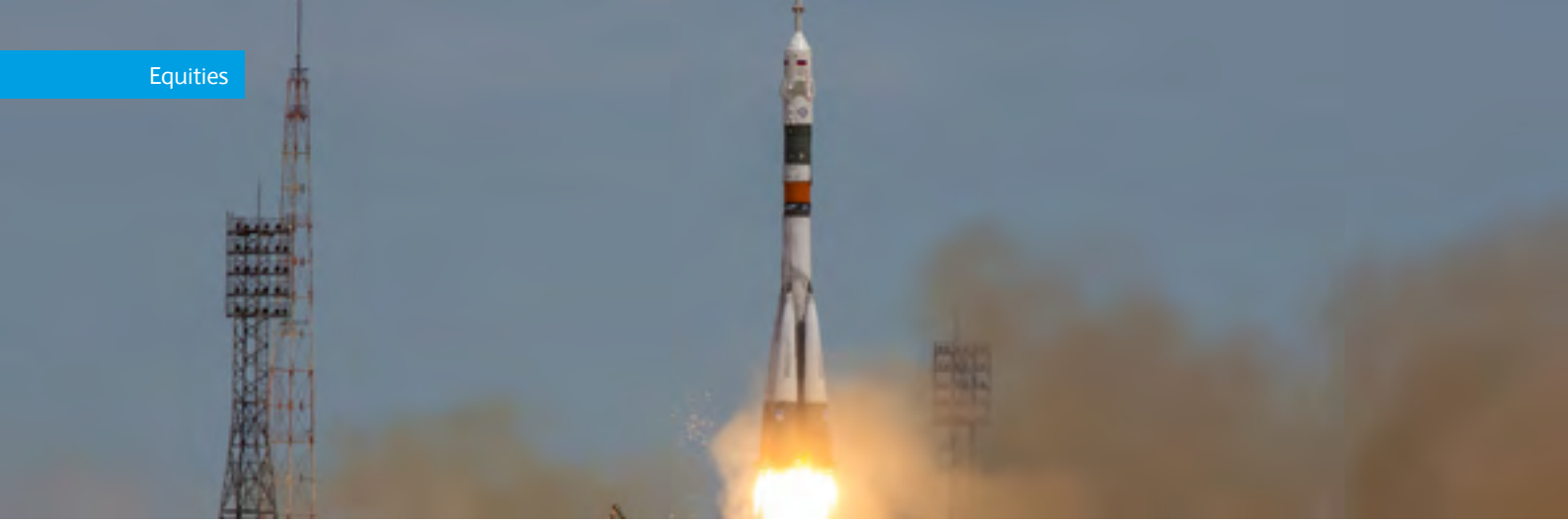
- While leverage in the BBB segment stands at 2.6x on average, around 12% of BBB-rated issuers have a leverage profile that is similar to BB-rated bonds. Furthermore, according to Moody's the likelihood that a BBB-rated company will be downgraded is five times higher than a BBB+-rated company getting downgraded within a year.

- Risk of downgrade or default varies substantially between higher quality BBB-rated issuers (BBB+/Baa1) and lower rated BBB-rated issuer (BBB-/Baa3).



Source: Bloomburg, Barclays Private Bank

"The ratio of fallen angel bonds relative to the BBB-rated population is at very low levels compared to the historical average."



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What's needed to launch equities?

After a sharp correction in US equities during August, strong gains in equity markets seem reliant on central bank policy easing or a positive breakthrough in US-China trade tensions.

Last month we argued that equities were at a tipping point and likely to witness increased volatility as investors' sentiment swings between fears of recession and anticipation of central banks' support. This seems to be occurring. So just how long will equity markets have to wait to break substantially higher?

Upside in equities conditional

Although heightened trade tensions and worrying recessionary signals sent by the fixed income market caused the S&P 500 index to lose 6% peak-to-trough in August, our view remains unchanged. Broad-based upside will only come if we see progress on the trade front and/or a "shock and awe" central bank easing on the monetary policy front.

On the former, it is hard to imagine that a deal between the US and China will be struck soon. A truce would be welcomed but it may come too late to restore business confidence. In this context, equities may see a short-term re-rating on any good news but this will likely be offset by lower earnings growth in the medium term as companies continue to delay investments.

"What really differentiates this cycle from others is the extent of involvement by central banks."

Monetary policy is, in our view, what could help markets break above the current trading range. Yet, expectations already look high, leaving little room for positive surprise. With interest rates making new historical lows, central banks would need to deliver significant easing packages for markets to take notice. This may be in the cards in Europe soon, but it will likely take much longer before it materialises in the US. In this respect, September will clearly be an important month.

Recession risks overplayed

Importantly, despite the deafening noise caused by the inversion of the 2-10 years US interest rate curve in August, when the longer-dated 10-year bonds yielded less than the shorter dated 2-year ones, we believe that a recession is still far away.

While we would not completely dismiss this above signal, there are solid arguments as to why "this time is different". We believe this has nothing to do with where interest rates are or that inflationary pressures remain absent.

Why this time is different

What really differentiates this cycle from others, in our opinion, is the extent of involvement by central banks. There is now a buyer of last resort. While this may not prevent the next recession, as it does little to support economic growth, from an equity market perspective it should help soften the blow.

"Monetary policy is, in our view, what could help markets break above the current range. Yet, we believe that expectations are high already, leaving little room for positive surprise."

The involvement of central banks does not mean that the market will not experience significant drawdowns. However, we expect them to be relatively short lived as long as market participants keep faith in central banks' ability to save the day.

Focus on sector and stock opportunities

In terms of investments, this means that staying invested remains the best course of action, in our view. In the short term, equities may struggle to break out of their range and volatility may stay elevated. But as we've learned, going against central banks is often a losing proposition. Instead, we continue to focus on improving the risk-reward profile of portfolios and finding opportunities at the sector and stock-specific level.

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Oil price: reverting to fundamentals?

The sharp fall in the oil price of late reflects weaker growth prospects and rising output. However, will rising risks of supply shocks and a restatement of fundamentals help the oil price recover?

Oil is considered the lubricant of the global economy; as such investors watch the price of crude very closely. Oil is a key cost to businesses. Prices at the pumps influence consumer spending, an elevated oil price can cause a build up in inflationary pressures – putting pressure on interest rates. A high oil price can be thought of as a tax on global growth.

Oil and the global economy

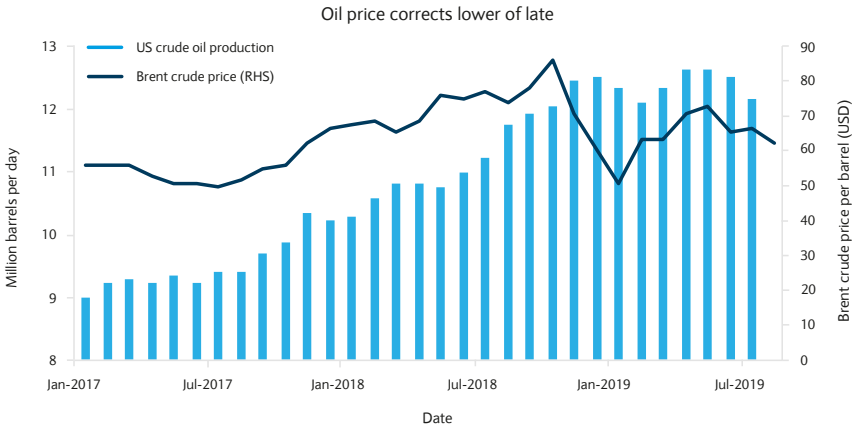
The positive news for the global economy is that the oil price has weakened. Brent recently fell into bear market territory, falling more than 20% from its peak in April.

The negative news is that the reason why crude prices have fallen is partly due to the reduced confidence in the growth outlook. Trade wars, China's weakening growth profile, anaemic expansion in Europe and Brexit risks have encouraged economists to cut their global growth expectations. We forecast that the global economy will continue to grow this year, at a 3.2% clip. However, that would be a marked slowdown from the 3.9% achieved in 2018. As global growth forecasts fall, so do expectations of demand growth.

Output pressure

Along with concerns around the economic outlook, there is downward pressure on oil prices from rising output from non-Organization of the Petroleum Exporting Countries (OPEC). Technological advancements, in areas such as shale extraction, have transformed the production capability of the US, which has gone from being an importer of oil to a net exporter.

The International Energy Agency estimates that the US will produce a record 13m barrels per day (mbpd) of oil next year, overtaking Saudi Arabia as the world's largest producer. Along with the US, other non-OPEC members, such as Brazil, Canada and Norway, have been ramping up production levels.



Source: IEA Short-Term Energy Outlook, August 2019

Potential supply shocks

Iran's seizure of several oil-tankers in the strategic shipping lane of the Strait of Hormuz (one-third of the world's seaborne petroleum is transported through the channel) has raised tensions. If escalated, the tensions could lead to considerable disruption. US sanctions on Iranian oil have taken around 2.7mbpd off the global market for some time. Disorder in the producing regions of Venezuela and Libya has further reduced supply.

In efforts to promote higher prices, OPEC+ (a 21 country alliance of oil producing nations) has agreed to extend production cuts of 1.2mbpd until March 2020. Compliance levels have been unusually high, with members cutting by more than the prescribed amount.

Outlook for investors

In the short term the price of oil is likely to be driven by news headlines, but fundamentals suggest a market in balance over the next 18 months. As such, we forecast that Brent will average $69pb for this year and next.

Investors should look to implement solutions that allow them to participate in the upside of Brent, while providing protection against moderate intermittent drops in the price.

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Multi-asset portfolio allocation

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

Cash and short duration bonds: high conviction

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

- Although real interest rates remain negative in most jurisdictions, we maintain a high conviction in the asset class from a risk management perspective.

Fixed income: neutral

We see moderate risk-return opportunities in fixed income, given the recent spread tightening and late-cycle dynamics. Although sovereign rates are less attractive in the context of a low yield backdrop, they offer true protection in very weak economic environments. For this reason, we have decided to move to a small overweight in developed government bonds. In credit, we have a preference for the higher-quality segment, given their relative safety and better returns.

We remain cautious on the riskier parts of the corporate debt market as they don't entirely compensate investors for the level of risk taken in a time when credit events may be on the rise. Emerging markets bonds offer opportunities to enhance fixed income returns, given relatively attractive spread levels, but active selection is key.

Developed government bonds: high conviction

- Developed government bonds worldwide have been losing their appeal as rates edged down amid softening economic growth, lower inflation expectations and dovish monetary policies. However, as economic data continues to deteriorate, we see the asset class as a diversifier and increase our holding to a small overweight.

- 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

- Supportive financial conditions and moderate growth should be broadly positive for investment grade bonds and limit the risk of a sudden spike in default risk. Moreover, IG-rated companies still look healthy given their high interest coverage and generally low funding costs.

- Nevertheless, we remain neutral on the asset class amid mounting concerns over the rising pile of corporate debt.

- 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: low conviction

- While default rates are at historically low levels and corporate fundamentals remain robust, we maintain low conviction to the asset class as margin pressure typically increases late in the economic cycle.

- Even following the recent consolidation in riskier assets, high yield bonds look expensive. Spreads are tight by historical standards, which we do not view 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 Fed's dovish stance should continue to provide some relief to the largely dollar-denominated emerging markets (EM) debt.

- Although weakening energy prices and unresolved trade disputes provide a headwind to emerging markets bonds, credit quality hasn't deteriorated and the economic momentum backdrop remains reasonably positive.

- Spreads have tightened since the beginning of the year as investor flows reverted back into EM bonds amid improving sentiment. But EM spreads remain comparatively wide versus high yield bonds and offer a better risk-return profile as well as opportunities for carry trades. We favour US dollar emerging markets hard-currency bonds due to their relatively attractive valuations.

Equities: positive

Positioning in high-quality, growth companies through active management is our preference given our view that in late cycle, alpha (actively selecting superior businesses) outperforms beta (passively following the market). While we remain positive, we have modestly cut our positive view to reflect the growing risks the global economy is facing. Regionally, we see more compelling opportunities in developed market equities where we maintain high conviction, while we remain neutral on emerging markets equities from a risk budgeting perspective. However, not all emerging markets are created equally and thus warrant selectivity, with Asia appearing to provide more stable (albeit lower) growth than Latin America.

Developed market equities: high conviction

- Earnings growth is still expansionary, albeit slowing, with growth forecast to be low-to-mid single digits over the year. Healthy fundamentals continue to underpin the investment case for this asset class, while valuations are not excessively stretched compared to history.

- Increasingly accommodative central banks and fairly constructive macro data out of developed economies should continue to support the asset class, even though downside risks from trade tensions and geopolitical issues should limit stocks' upside potential.

- 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. 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 tends 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

- While markets have grown increasingly cautious following heightened protectionism fears, emerging markets equities should benefit from attractive valuations and steady economic activity out of the region, which will continue to underpin expansionary, albeit softening, growth.

- We expect fiscal and monetary easing in China to counteract a slowdown in the region and limit downside risk to earnings expectations. Nonetheless, we maintain a neutral position as trade tensions still pose a significant risk and tariffs are likely to stay in place for longer than anticipated.

Other assets: neutral

Alternative asset classes will continue to provide diversification to our portfolio, but are not expected to be the main drivers of returns. Gold is set to benefit from its status as a safe haven in the late cycle, and for this reason we increased our allocation to the asset class. Conversely, real estate and alternative trading strategies are underpinned by a weak investment case.

Commodities: high conviction

- The sole exposure within commodities continues to be our position in gold, which we increase slightly this month in light of increasing headwinds for the global economy. We view this position 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.

Real estate: low conviction

- Real estate should continue to provide mild diversification benefits but we maintain a low conviction as the asset class looks expensive across different regions.

- We expect loose monetary policies to favourably impact returns, although the asset class faces structural challenges from the rise of online retailers while weaker economic growth could prove to be a headwind.

Alternative trading strategies: low conviction

- We maintain a low conviction in alternatives due to their high expense and a lack of investment opportunities in this space, although we do favour strategies that have low correlations to equity markets. The limited use of leverage should further cap returns for the asset class.

- Nonetheless, sudden spikes in volatility, which are likely to materialise more often in a late-cycle environment, may lift the asset class at least in the short term.

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