Private Bank

Market Perspectives

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BARCLAYS

Foreword

The accelerating spread of the Covid-19 pandemic dominates financial market sentiment. After sharp falls in equities, there are tentative signs that a bottom in valuations is near.

The epicentre of the pandemic is moving from Europe to the US. Unprecedented fiscal and monetary measures from the US, eurozone and elsewhere, to counter the economic fallout, are welcome. A short, but historically deep, recession seems unavoidable. However, the fiscal responses suggest that the potential effect on output may be partially mitigated.

Assessing Covid-19's likely effect on earnings is close to impossible, though most coming downgrades seem to be already reflected in valuations. The rebound in markets may be violent. That said, caution seems warranted for now. As ever, quality remains key while uncertainty is so high.

The emergency interest rate cuts from central banks suggest that rates could be lower for longer. Searching for sectors least exposed to the effects of the virus is key. In this respect, telecommunications, utilities and pharmaceuticals' credits seem more insulated than most.

With volatility elevated, diversifying into private markets may be worth considering. Data suggests that the asset class tends to outperform public markets the most during a period of crisis.

The oil price plunged below $30 a barrel in March, as the market was hit by Saudi Arabia and Russia ramping up production and the pandemic slashing prospective demand. The price is unlikely to recover much in the short term. Indeed, the market is set to remain imbalanced for most of the year.

The crash in oil prices may limit the attractions of renewable energy and the speed of transition to a low-carbon world. But the direction of travel is clear. The short-term challenges sparked by the pandemic may be a chance to allocate more to clean energy assets and diversify portfolio assets.

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Economy suffering coronavirus growth shock

As the medical and economic scars of the coronavirus outbreak are felt, what could be the implications for the global economy and growth prospects?

While the coronavirus outbreak is foremost a medical crisis, it clearly has widespread implications for the global economy and in turn financial markets.

Containing Covid-19's spread

In early March the World Health Organisation officially declared Covid-19 a global pandemic, though the organisation stated that the spread of the virus can be slowed, or even reversed, through implementing robust containment and control activities. Evidence from China suggests that this works, where the number of newly infected daily cases has fallen from thousands in January and February to zero new organic cases by mid-March. Although the rapid expansion of cases in Europe continues to scare public health officials.

Mitigation measures have led to significant disruption to the regular functioning of the global economy. Countries have closed borders and global travel has grounded to a halt. Officials have enforced the closing of schools, restaurants and sporting events. They have encouraged social distancing and unprecedented numbers of people have been forced to change their working patterns.

Economic impact

The magnitude of the economic effect will be determined by the disruption to supply chains and the reduction in demand. Certain sectors are more vulnerable than others to the initial shock caused by the Covid-19 pandemic, including travel, retail and events. On the industrial side, manufacturing has been under pressure, but is likely to recover more quickly. This pattern has been observed in leading economic indicators, where services has been much more affected than manufacturing.

Central banks and governments have reacted aggressively to support economies and stabilise markets. The former slashed interest rates to historically low levels, restarted quantitative easing programmes and injected massive amounts of liquidity into the system. Meanwhile, the latter instigated substantial fiscal policies aimed at reducing the risk of the medical crisis turning into a financial one that could have long-lasting implications for global growth prospects.

Policymakers learnt a number of lessons during the 2008 financial crisis, including the importance of acting early and in size. As we have seen by the speed and scale of the policy response to Covid-19, officials are hoping not to repeat past mistakes. While the measures will not solve the immediate medical concerns and resulting disruption, they will support long-term demand and perhaps, more importantly, will provide much needed liquidity for companies and financial markets.

> "Policymakers learnt a number of lessons… including the importance of acting early and in size"

Radical cuts to growth forecasts

Given the sheer scale of the disruption it's no surprise that economists have been forced to make radical reductions to their global growth forecasts. We project significantly weaker levels of activity in the first half of 2020. Certain regions, such as China and Europe, are likely to be hit harder than others.

China is an important component of the global economy, accounting for about one-third of global growth and 16% of gross domestic product (GDP). Recent retail sales and industrial output figures showed that the Chinese economy ground to a halt in February. We expect the economy to contract by 8% in the first three months of 2020.

While the government has been implementing a more proactive fiscal stance and looser monetary policy to help stimulate growth, it's been in a less aggressive fashion than seen in previous bouts of weakness.

Recent reports suggest that Coronavirus-related restrictions are starting to be eased and manufacturing operations are now coming back on stream. That said, we

still predict growth of just 1.3% for 2020, substantially less than the 6.1% growth rate achieved in 2019.

Epicentre now in Europe

Europe has been hit hard too, with Italy experiencing more deaths than seen in China. Europe's open and export-orientated economies remain vulnerable to weaker external demand. European growth has been supported by loose financial conditions, improving labour markets and somewhat healthy domestic demand. However, with more countries moving into lockdown, household consumption will inevitably take a hit.

We now see the bloc entering a technical recession in the first half of the year. The European Central Bank has dramatically increased its asset purchase programme and improved its loan programme to the banking sector. However, coordinated fiscal support and structural reform is the key to limiting further damage to the economy. We forecast a 5.5% contraction in GDP growth this year compared to growth of 1.2% in 2019.

US feels the heat

Hopes that the more insulated, domestically-focused US economy could be sheltered from the impact of the coronavirus have quickly evaporated as more preventative containment measures have been introduced. Survey data for March suggests that there was a sharp drop off in restaurant visits, hotel bookings and domestic airline travel. There has also been a big jump in initial unemployment insurance claims and a sharp fall in readings from the available regional manufacturing surveys.

> "Even if the authorities deliver on the fiscal promises, we now expect the US economy to contract by 0.6% this year"

The fiscal response by US officials has been relatively slow. However, Congress and the White House finally agreed a $2tn spending package on 25 March, amounting to 10% of GDP. Half of that package consists of permanent fiscal transfers to the private sector. The package consists of a $1,200 cash payment to individuals, grants to small businesses, maintaining their payroll, and a temporary increase in unemployment insurance payment to cover 100% of lost wages for four months.

Even with the aforementioned measures, we now expect the US economy to contract by 0.6% this year, including a 7% reduction in the second quarter.

UK tries to limit the downside

The UK's growth prospects will also be determined by its ability to contain Covid-19, the success of fiscal and monetary stimuli and negotiations on a Brexit trade deal. The Bank of England has cut rates to 0.1% (below the level of the 2008 financial crisis) and increased its asset purchases. The central bank introduced a term funding scheme that supports lending for small and medium-sized businesses and lessened the counter cyclical buffer which reduces the capital that banks have to hold. These measures should make credit cheaper and more available.

In a coordinated approach, the chancellor has outlined a massive £330bn worth of government-backed loans, which equates to 15% of GDP. There are also grants and tax cuts for struggling companies, plus support for airlines, shops and the hospitality industry. While these are broad range of measures, they are unlikely to stop the UK economy shrinking this year. We expect the economy to contract by 1.1% in 2020 compared to growth of 1.4% in 2019.

Growth bounce in 2021?

There's little doubt 2020 will prove to be a miserable year for the global economy, we are now predicting growth of -0.3% compared to 3.2% in 2019. Economists regard growth of less than 2% a global recession.

Mitigation measures are unlikely to eradicate the virus, but will give health systems time to prepare and researchers time to identify effective treatments and develop vaccines. The most effective approach to deal with the disruption of the coronavirus is the global coordination of medical, monetary and fiscal measures.

Inevitably, the outlook for global growth will remain tilted to the downside until the peak of the virus can be determined. The expectations are that this could occur in a few weeks and so we could see early signs of a recovery in the second half of 2020. On this assumption, the outlook for 2021 looks considerably brighter and we predict that the global economy will bounce back with growth of 4.4%.

Implications for financial markets

From a market perspective, the economic impact is certainly one of the main factors that will matter. But markets usually anticipate the economic data. The speed and magnitude of the fall seen in the past month already reflects part of the damage that the global economy is likely to suffer in the next few months.

This fall translated in valuations moving from expensive to attractive. While this is a necessary condition, it is not a sufficient one for markets to bounce back. The swift measures announced by the monetary and fiscal authorities in March should help to soften the blow, but the uncertainty regarding the duration of the crisis remains a drag on markets.

While a lot of conditions are in place for markets to rebound, the key missing factor, at the time of writing, is an inflection in the speed at which the virus is propagating in Europe and the US. As long as this cannot be assessed with more certainty, either through successful containment measures, new drugs or a large-scale testing plan, financial markets are likely to reprice the risks daily based on the latest outbreak numbers.

> "The key missing factor… is an inflection in the speed at which the virus is propagating in Europe and the US"

Continue to focus on quality

As volatility is likely to stay elevated in the medium term, we believe that long-term investors should avoid a passive approach.

While value and "beaten down" sectors or companies will likely outperform in a recovery scenario, we remain convinced that focusing on quality and appropriate diversification is the best strategy to weather potential further sell-off without compromising the large upside which could materialise once fears subside.

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Post Covid-19, what could 2021 earnings look like?

The spreading coronavirus pandemic has savaged equity valuations despite unprecedented fiscal and monetary responses around the world. What can equity investors do as the pandemic unfolds to prepare for an eventual rebound in earnings and valuations?

No consensus

For long-term investors, the trajectory of earnings matters much more than the short-term gyrations in valuations. However, at this point in the spread of the coronavirus pandemic, making assumptions on future profit growth is almost impossible. Even companies are withdrawing 2020 guidance by the dozen.

When it comes to global equities, the bottom-up consensus forecast points to 6.5% earnings growth in 2020 and 11.5% in 2021. These numbers should be bluntly ignored. Looking at top-down strategists, revisions have been numerous in the past few weeks and numbers currently range between a 5% decline to a 20% drop in earnings this year. Few venture to say a word about 2021.

History as a guide

We face an unprecedented situation and history may not be a reliable guide this time around. Yet, this is what most investors will look to in the search for some guidance. Considering the last 30 years, global equities have suffered three major earnings drawdowns (1992, 2000 and 2008). In these periods, earnings, on a trailing basis, contracted by around 35%.

While investors usually rely on forward looking measures, in current circumstances, we believe this is too subjective. Based on this measure, it suggests that having dropped around 30% from their peak, market valuations already reflect most upcoming downgrades.

It's all about the rebound

Unfortunately, attractive valuations are usually not sufficient to justify a rally. In addition, investors need to see the light at the end of the tunnel, in the form of an earnings recovery, before a sustained bounce is likely.

Based on the information available, one could reasonably assume that, once the Covid-19 pandemic is under control, economic activity will gradually return to normal (as seems to be happening in China). Thanks to a significantly depressed base, year-on-year profit growth should then be meaningful. We are unlikely to make up for all the economic damage caused by the coronavirus outbreak due to some lag effects (unemployment staying durably more elevated for example). Nonetheless, it appears reasonable to anticipate a strong recovery in earnings.

"Based on this measure, it suggests that having dropped around 30% from their recent peak, market valuations already reflect most upcoming downgrades"

Magnitude and timing

The magnitude of the eventual rebound remains uncertain and so does its timing. Here, again, we can turn to history for clues but because of the unique nature of the threat we face, any indication is to be taken with a pinch of salt.

Never have we seen such a violent bear market (appearing in just 16 days from peak), nor the level of stimulus central banks and governments have already committed to. Still, it usually takes a few years (around 3.5 on average) for earnings to recoup their drawdowns. While this number may not bode well for 2021 earnings, it also means that, based on historical patterns, earnings could grow at a compound rate of around 15% in the next three years.

Doubts remain around valuations

While earnings dictate long-term upside potential in equities, valuations move in tandem with the short-term price action and are influenced by many factors. As such, we are, just like valuations, tempted to revert back to the mean which, in the case of global equities, is around 15.5 times forward earnings and 18.2x trailing.

Assuming earnings collapse by 35% before recovering half of these losses by the end of 2021, then the market appears fairly valued in our opinion. However, this simple

exercise does not take into account that several trillions dollars-worth of stimulus has been pumped into the economy and that interest rates are as depressed as ever. This would suggest that valuations have room to stay above their historical average for the foreseeable future.

Time for value?

While some investors may prefer to hide in the current environment, some are on the hunt for bargains. Usually their attention is focused on the sectors and companies that have been most exposed to the threat that caused the initial sell-off.

This would have been technology in 2000 or banks and real estate in 2009. Indeed, "value" stocks, whose earnings are likely to be erased during a recession, tend to enjoy the strongest initial rebound. However, looking at what happened in the US in 2009, in order to benefit from this outperformance of value, good timing was essential (see chart).

Focus on quality

Should our base case play out (limited long lasting impact of coronavirus with a recovery starting in the second half of this year), we would expect value to outperform initially. Financials, energy (assuming a quick recovery in oil prices) and travel and leisure are likely to lead the way.

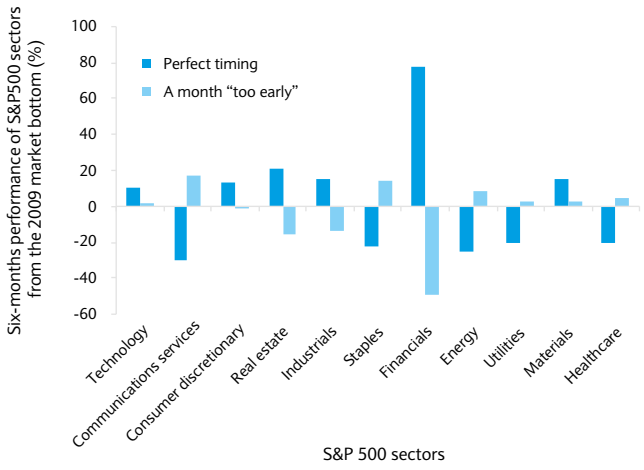
Europe would also likely outperform the US. However, we would see this as a trade rather than a new paradigm. In addition, while we would tilt towards value, we would do so with an eye on quality as the shockwaves from the Covid-19 crisis will likely take time to work their way through.

For the above reasons, proceeding with extreme caution seems warranted when it comes to picking up stocks in airlines or cruise line companies, for example. Many may need to be bailed out and still may not survive in the long run. In our opinion, whether it's value or growth, in recession or expansion, quality remains key to enjoying the long-term potential benefits of compounding growth.

"Whether it's in value or growth, in recession or expansion, quality remains key"

Timing is of the essence when catching a falling knife

The chart shows the performance of various S&P 500 sectors in the six months after the index bottomed in 2009. It also shows the performance, in the following six months, from a month earlier



Sources: Bloomberg, Barclays Private Bank. March 2020

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The Covid-19 outbreak and default rates

Covid-19 brings another dimension to risks for bond investments. While risk is elevated, history taught us that the world does not stop and cannot operate without companies meeting key demands. Risk management is key with bonds still serving as a key diversifier.

What started as measured accommodation and insurance cuts, by the US Federal Reserve (Fed) and other leading central banks, has quickly developed into a crisis response. Rates were cut between scheduled monetary policy meetings by 150 basis points (bp) in two weeks in March (50bp followed by another 100bp in the case of the Fed).

Bond market reaction to the crisis

Recent capital flows clearly illustrate that there are no grey areas in the fixed income market at this point. Capital flows differentiate only between safe-haven bonds and non safe-haven bonds. In situations with very high uncertainty this seems a common pattern. Emerging market, high yield and investment grade bonds have all seen record outflows, wiping out at least eight consecutive months or so of inflows. In the same time, sovereign rates, like the US 10-year treasury yield, fell to unprecedented lows of 30bp on an intraday basis.

While to some extent rates have retraced from the above lows, it is likely that yields along the curve will stay at depressed levels for some time. It seems that the way back to some kind of "normality" will take several quarters rather than months, according to various medical research reports (e.g. from Imperial College London). Uncertainty about the path for the global economy and the virus' financial impact, ultra-low inflation expectations and highly accommodative central banks are likely to keep demand for safe-haven assets, like treasuries, high even if they are non yielding.

> "Capital flows differentiate only between safe-haven bonds and non-safe-haven bonds"

Overview of sector exposure

Higher risk (direct exposure	Moderate risk (some direct and indirect exposure)	Lower risk (mostly indirect exposure
Airlines	Metals and Mining	Pharma
Leisure and Travel	Banks	Communications
Non food retail	Media	Utilities
	Technology (e.g. hardware)	Food retail
	Steel	Construction
	Capital goods	Consumer staples

Central banks step in early

In response to the crisis central banks have revamped quantitative easing again, adding to the demand for sovereign bonds: the US Fed announced unlimited purchases of treasuries and mortgage backed securities.

Meanwhile, the European Central Bank (ECB), through the Pandemic Emergency Purchase Programme (PEPP), announced it would buy €750bn of bonds, which brings the monthly purchases to roughly €115bn. This is a higher run rate than previous peaks.

ECB president Lagarde said that the ECB is: "fully prepared to increase the size of our asset-purchase programmes and adjust their composition, by as much as necessary and for as long as needed". Also the Bank of England has announced a large package by adding £250bn of purchased to make it overall 645bn bond purchases.

If the global credit crisis in 2008 and European bond crisis in 2012 served one purpose, it was to ensure the authorities have tested tools in place to implement when needed. And as a provider of liquidity, central banks brought back the majority of their crisis fighting arsenal.

As a response to signals of stress emerging in the funding market, the Fed substantially increased

its repurchase agreement (repo) operations and interest rate swap lines with other foreign bond markets. At the same time, the Fed acts as a buyer of last resort to release potential stress in the commercial paper (though the commercial paper facility), money market (money market mutual fund liquidity facility) and bond dealing (primary dealer facility) markets. In a latest move the Fed added the asset backed facility (TALF), the primary market corporate credit facility (PMCCF) and the second market corporate support facility (SMCSF).

What to look out for

But it's clear that monetary policy can only treat the symptoms while only governments and medical breakthroughs can help provide the cure. While it seems challenging to confidently allocate capital, we don't believe that this is all black or white. With prudent selection and management, risks should be mitigated. Price dislocations also open up some opportunities. Let's briefly look at the key areas.

Containment measures, and supply chain disruptions, put companies' ability to generate cash flow at risk and are likely to increase pressure on economies. But at the same time, the world and demand has not stopped entirely.

Financial markets will quickly realise that there is a difference between a pharmaceutical issuer and a highly leveraged oil services issuer, for example. Without doubt, the Covid-19 crisis will have severe implications for all sectors and issuers, at least through secondary effects in the long term. At this stage, it seems more relevant, and in some ways easier, to focus on sectors that are directly affected and most exposed.

Focus on directly exposed sectors

The two most directly exposed sectors are travel and leisure, including airlines as well as the oil sector. While most airlines have cut capacity to the minimum in order to curtail costs, much of the sector is unlikely to be able to continue operating without government support. At the same time, many tourist or leisure companies are highly likely to face cash flow drying up.

> "In the US there are roughly $32bn of upcoming maturities"

The second, and most exposed, sector is oil, which has been hit by a demand (Covid-19) and supply (increase in oil production by Saudi Arabia) shock at the same time. A West Texas Intermediate oil price below $30 per barrel will be detrimental to all energy companies. However, while major integrated oil companies have comparably lower debt and larger cash on balance sheets, as well as levers to mitigate these challenges, we see the greatest risk in oilfield services companies and partly within pure exploration and production companies.

In the US there are roughly $32bn of upcoming maturities. To meet cash flow requirements and debt servicing needs, exploration companies may cut capital expenditure to the bare minimum, which will hurt service companies. The majority of high yield-rated exploration companies in the US may still have some hedges in place, but with one of the highest breakeven prices (approximately $50 per barrel) among producers, this puts a very large part of the sector at risk.

More shades between black and white

Apart from the above sectors, we see greater risk within the automotive manufacturing sector and sectors that are highly dependent on discretionary spending. Manufacturers and issuers from the non-food retail sectors are also exposed, particularly those that are highly dependent on international supply chains, many of which are disrupted and especially if there is high dependency on China.

Sectors with less immediate exposure seem to be telecommunications, utilities and pharmaceuticals sectors. While some of the business lines and models will also face challenges, the credits in these sectors seem more insulated from default risk.

> "Beside travel and leisure we see the greatest risk in oilfield services companies and partly within pure exploration and production companies"

This time it is not about banks

Banks were at the centre of the credit crisis in 2008, but appear to be outside the main focus in this crisis. Given banks are capital and liquidity providers to the economy, they are inevitably exposed. That said, banks are in a stronger position than was the case in 2008. Core equity capital ratios, for example, are up to three times higher than compared to 2007 prior the credit crisis. In addition, regulations which impose very conservative accounting assumptions, ability to withstand severe stress scenarios and a high threshold to maintain liquidity, have made the sector more resilient.

The same can't be said about a large part of the non-financial corporate sector this time. As we have written many times before, corporate issuers are operating with record levels of leverage. Of $6tn-worth of bonds within the iBOXX USD Corporate index, half of the issuers are rated BBB while $246bn (4.1%) are only a one-notch downgrade apart from a high yield rating. According to historical data, the downgrade risk to high yield status is up to 10 times higher if a company is rated BBB – compared to BBB+.

Investment grade defaults lower

A downgrade may result in higher funding cost for issuers and higher volatility, but it doesn't necessarily translate into defaults. The default rate for investment grade bonds has been relatively contained in the past. Since 1920 the annual average default rate in the Baa/BBB category, for example, was 0.3%. During the credit crisis in 2008 and 2009, the rate peaked in both years at around 1%. The record high was back in the 1931–1935 period, when the rate averaged 1.99%.

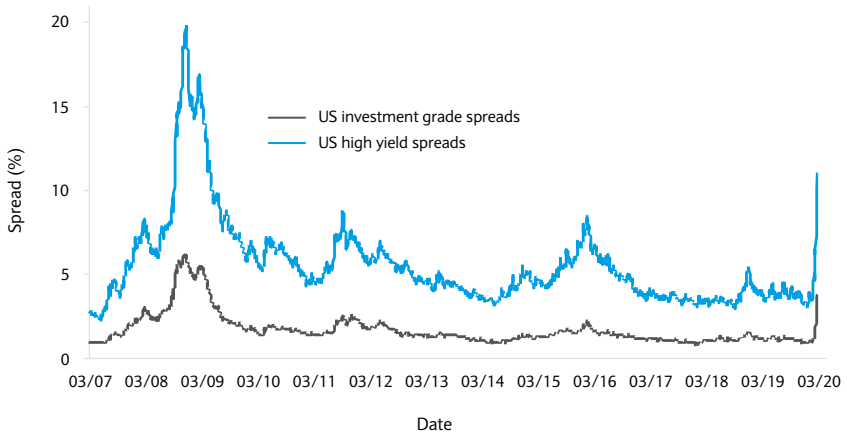
How does this compare to the global high yield market? During the great recession, default rates peaked at over 15% while 2008 saw rates of around 13%. In 2002, default rates peaked at 9%, which may serve as a reasonable worst-case indicator this time, given defaults were also driven by an external shock (that is, the 9/11 terrorist attack).

Spread premiums in both the investment grade and high yield bond markets have widened substantially in March. While risks for credit losses are difficult to quantify on the back of the Covid-19 crisis, it seems that spreads reflect a large part of that risk. Investment grade bond spreads in the US, for example, are averaging over 300bp spread compared to around 600bp in 2009. Spreads of US high yield bonds reached almost 1100bp compared to roughly 2200bp at the peak in 2009.

While the peak in spreads may not have been reached, it appears that more insulated and stable sectors and issuers should not only be able to manage through the crisis, but to offer an attractive risk-reward when taking pricing into consideration.

Spreads substantially wider

The chart shows US investment grade and high yield bond spreads in the thirteen years to March 2020



Source: Bloomberg

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Private markets: calm in a crisis?

Can private market funds offer a refuge for investors looking to outperform while diversifying investments at a time of elevated volatility.

We wrote about the benefit of being invested in private markets in a period of volatility for public markets in March's Market Perspectives. While the situation has worsened in the last month and a global recession is likely, this should mainly affect private debt deals involved with so-called covenant-lite loans.

Covenant-lite loan covenants are less protective than typically seen with traditional loans and the borrowers have more flexibility regarding their obligations. But other areas of the private debt markets, such as special opportunities or distressed debt, are likely to thrive in the current environment.

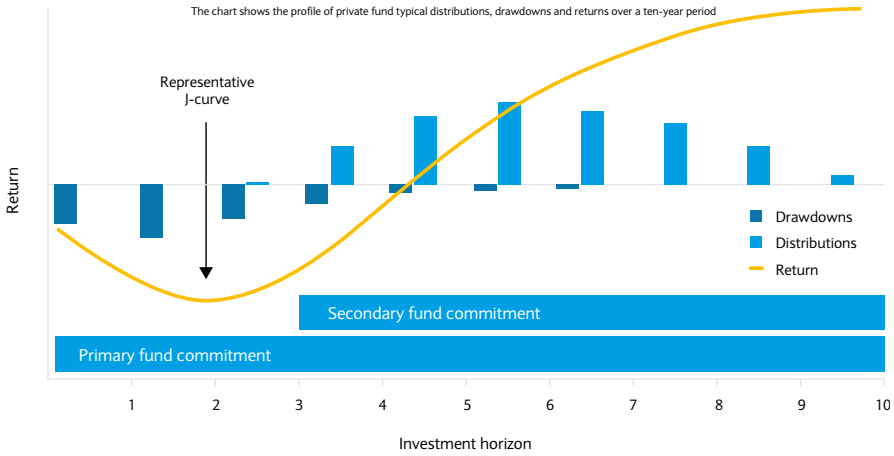
Although private market funds are likely to see their net asset value (NAV) shrink, the reassessment of their investments' value does not happen daily, like occurs in most public markets, but rather quarterly or semi-annually. Considering the speed of the current sell-off, and our expectations of an equally fast bounce once the outbreak is under control, some of the funds may not see write-down to their NAV. This crisis, though extremely violent in magnitude, is likely to be much shorter than a typical structural recession such as the global financial crisis of 2007-2009.

Outperformance during a crisis

Corrections and recessions are not only great investment opportunities for public markets investors. Private market funds also benefit from the lower valuations and dislocation opportunities that a crisis creates.

Private equity fund return profile: "J-curve"

The chart shows the profile of private fund typical distributions, drawdowns and returns over a ten-year period



Source: LVW Advisors, 2013

Data suggests that private markets tend to outperform public markets the most during a period of crisis. Cambridge Analytics' data, using internal rate of returns as the key metric, shows that private equity vintages from 2001, 2003, 2009 or 2011, which correspond to a bottom in equities, have outperformed public markets by more than 11 percentage points on average.

Secondary funds

Secondary funds reduce some of the negative factors usually attached to investing in private markets. Investing in secondaries limits the "blind pool" effect as most of, if not all, the capital has already been called and invested.

As most of the funds are already invested, the "J-curve" is mitigated. Distributions to investors start to match and even outpace capital calls. The return on investment is more certain than for primary fund investment. But those lower risk features, typical from a secondary fund, usually come at a cost.

The return multiple on secondary funds is traditionally lower than it is for primary ones. However, in a period of crisis, secondary funds are often available at a deeper discount to their NAV. This means that the overall multiple return is similar to what primary funds usually achieve, while still providing all the benefits from secondary investing, notably the mitigation of the J-curve.

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Alternatives: oil and gold market hits turbulence

An oil price war and Covid-19 outbreak is increasing pressure on producers around the world that shows little sign of improving soon. When might the market rebalance and the price recover? Gold has also suffered as investors flee financial markets in a flight to liquidity. What next for the precious metal?

The Covid-19 outburst and the costs of containment on global growth has significantly impacted the demand side to the oil market, triggering the Organisation of Petroleum Exporting Countries and allied producers (known as OPEC+) group to hold an emergency meeting on 6 March.

The day before the meeting, oil closed at $51.64 per barrel. While many members of the group wanted to extend agreed production cuts, Russia opposed further cuts given its ability to remain profitable at lower prices to the detriment of its US competitors.

Oil price war

However, this triggered a price war, with Saudi Arabia announcing an increase in output by two million barrels per day (mbpd). Consequently, oil prices quickly fell to their lowest levels since 2017 (at around $30 a barrel) – hitting oil producers' profitability around the world.

Compounding the fall in recent weeks has been Saudi Arabia's decision to increase crude oil exports to 12.3mbpd from April. Oil subsequently dipped as low as $23 a barrel, its lowest since 2003.

Over the very short term, we expect oil prices to remain under pressure as the effects of balancing market forces for supply and demand will likely come with a lag. Given that at current prices, Saudi Arabia cannot use its reserves and borrow from international capital markets, it is likely that the group come back to the table. It is also likely that the US president, Donald Trump, will intervene to prevent small American oil producers filing for bankruptcy.

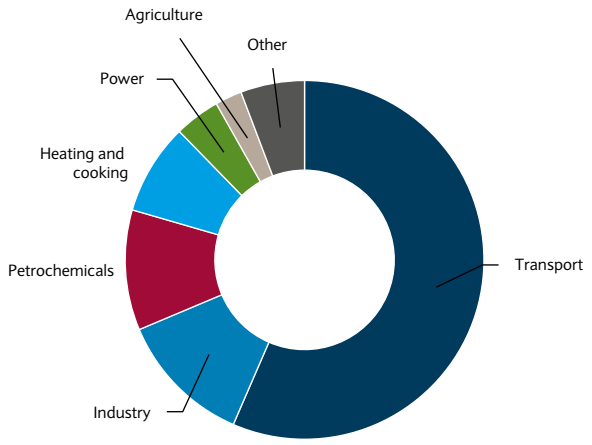
Winners and losers

Countries that rely on oil for a significant proportion of their national budget, such as Russia, Saudi Arabia, Iraq and the United Arab Emirates, will be impeded by the recent production increases and oil price falls. Oil producers will also be forced to slash capital expenditure, reduce drilling and potentially cut dividends. Furthermore, those that are highly leveraged, such as US shale, will pass on the impact to the banks and investors that lent to the sector.

Other industries which are likely to face difficulties include aviation and transportation. Not only do companies in these sectors face a dramatic drop in demand, but also a hedging cost. Due to the volatility of the commodity, many companies tend to hedge their oil requirements in advance and by doing so pay the price they had hedged at (most likely significantly higher) than the price to which oil has plummeted to.

Oil demand in for a tough few quarters

The image below shows how total oil demand estimates for 2017 was split between industry sectors



Source: IEA, BP, Barclays Research, Barclays Private Bank

Suppressed demand set to last

What's more is that restrictions on travel will likely remain for a few quarters. This means that even after contracts are renewed, oil demand will likely remain suppressed while no, or limited, flights/travel are taking place.

More than 55% of oil demand comes from transport, with 12% caused by the aviation industry. Assuming a 50% year-on-year decline in airline traffic worldwide for two quarters, jet-kerosene demand could decline as much as 1.7mbpd.

China in strong position

Countries that are likely to benefit in the upcoming months are those that are the largest importers of energy, such as China, India and Japan. Other winners include consumers and businesses globally through lower input costs and inflation.

With China the largest buyer of oil and their workforce back in action, should there be no resurgence of Covid-19, the country will be in a strong position to leverage the lower price in the upcoming months (see chart).

Gold suffers in flight to liquidity

March was also a difficult month for gold. The price of the precious metal struggled as a result of mass selling of assets in a flight to liquidity.

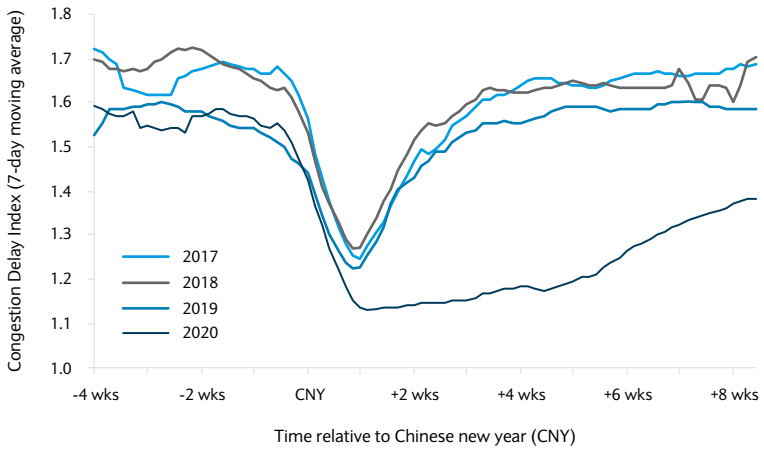
Fundamentally, we believe gold can still be used as a diversification tool within a broad, multi-asset portfolio. It should continue to be supported by exchange-traded fund flows from risk-averse investors, recently cut interest rates globally remaining lower for longer and support from central banks. While gold won't drive long-term growth, it will most likely preserve wealth during periods of turbulence.

The economic impact of the coronavirus and falling oil prices across industries will inevitably be determined by their lifespan, intensity and geographic spread. While the recovery in the gold price may happen sooner than for oil, we continue to believe the latter market is set to be in balance in the latter stages of 2020, likely finding an equilibrium at $31 a barrel for 2020.

"The economic impact of the coronavirus and falling oil prices across industries will inevitably be determined by their lifespan, intensity and geographic spread"

Congestion data suggests an early pick-up in China

The chart shows that how the trend of the Chinese congestion delay index in the eight weeks after the country's new year



Source: WIND, Barclays research, Barclays Private Bank

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Are renewables still attractive with lower oil prices?

With the rapid fall of oil prices, should investors reconsider the renewable energy sector?

In March, oil more than halved, to end the month around $20 a barrel and close to an 18 year low. We currently expect the oil price for 2020 to find an equilibrium at $31 a barrel. Given these levels, questions have been raised about whether this would derail the growth of the renewables sector and our transition toward lower-carbon energy.

Shifting dynamics

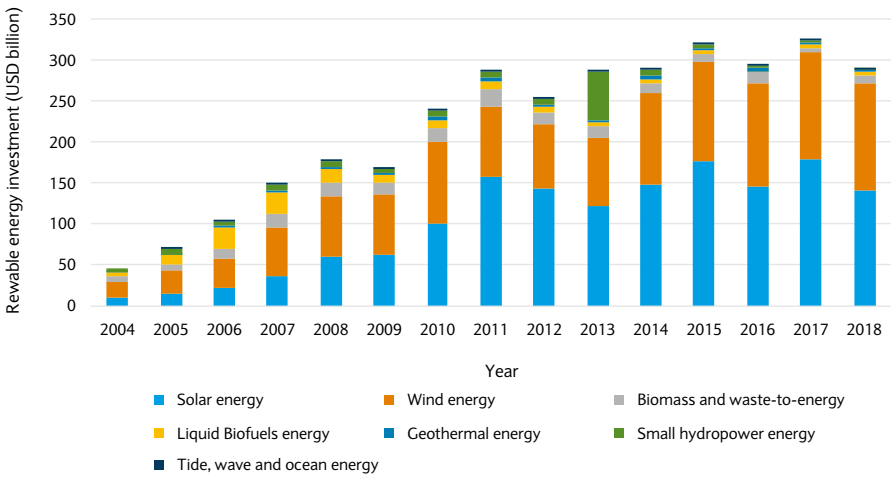
Times and industry dynamics are different from periods of low oil prices during 2008 and 2014-16. Many countries have set out ambitious targets to cut net emissions in the coming decades. Renewables have rapidly grown; gathering momentum in the last decade, in part due to increasing costs of extracting and refining fossil fuels.

But with governments and industries focused on maintaining stability and liquidity, will the benefits of a lower oil price dim the appeal of renewable and energy transition plans? According to Fatih Birol, the head of the International Energy Agency (IEA), the fall in prices "…will definitely put downward pressure on the appetite for a cleaner energy transition" and will be a "good test" of all the climate targets that governments and companies had committed to recently.

Even before both the oil price drop and economic shock of the Covid-19 pandemic, investment in renewable energy has slowed since 2017 (See figure). Traditional assumptions suggest a low oil price is bad news for renewables. However, the dynamics of the energy sector and the environmental emergency we face means this is unlikely to be the case in the long term.

Global trends in renewable energy investment (USD billion)

The chart shows the renewable investment in various energies since 2004



Source: Frankfurt School-UNEP Centre/BNEF. 2018. Global Trends in Renewable Energy Investment 2018

Renewables face an economic, not oil price, slowdown

In the short term, a slowing of the momentum of renewable energy sector is likely – but not primarily due to oil prices, as much as economic difficulties. Oil is predominantly used for transport – cars, trucks and planes – in the form of gasoline or diesel. Then, as a heating oil for heating homes and buildings, there are industrial heating applications. And third, as hydrocarbon gas liquids for feedstock for the petrochemical industry.

In contrast, renewables are used mostly to generate electricity. In the former list, there aren't many sectors where renewables serve as a direct substitute for oil. Where electrification has gained initial traction, for example with electric vehicles (EVs), lower oil prices make EVs less attractive based on fuel efficiency. However, as oil prices rose in 2019, the EV market had already slowed as demand weakened in China and the US.

Amid the Covid-19 outbreak, we should expect further declines in

sales, akin to the rest of the motor industry. However, inevitable policy changes, such as the UK bringing forward its ban on selling new petrol, diesel or hybrid cars to 2035, will shift the dynamics more substantially than lower oil prices.

In the short run, energy companies may slow their recent commitments to position themselves for a low-carbon transition. Pressure to maintain dividends (to attract investors), retain cash (to weather lower demand) and lower revenues (from cheaper oil prices) may mean that there will be less potential investment for renewables. However, given the sector accounts for just 2% of investment in renewables, a near-term slowdown of their investment would not derail financing renewables projects.

"In the short run, oil and gas companies may slow their recent commitments to position themselves for the transition to a low-carbon economy"

Indirect effects may hold up the transition

For power generation, the effect of low oil prices looks more nuanced. Given oil is used in only a small fraction of electricity generation globally, lower prices should have little effect. Only at around $15 per barrel does it become competitive, which is also not profitable for the majority of producers.

However, lower oil prices can affect natural gas prices, which can produce low-cost electricity in existing facilities. With natural gas at lower prices for some time, and without effective storage to address latency issues of renewables, it could emerge as a significant alternative that hinders the installation of new renewables facilities.

Government support for clean energy could also diminish from the oil price and economic shock. Those forced to reallocate spending to address immediate hardship may deprioritise investment for renewables.

Only one direction

With current headwinds, a world mainly powered by clean energy appears to be further away. However, the direction of travel is one-way.

The renewables trend is structural – both from an environmental and an economical perspective. As a new technology, renewables are becoming the lowest cost option to produce energy. Since 2010, both solar and battery costs have dropped by up to 85% and wind costs by up to 49%.

In fact, lower oil prices could accelerate a structural shift away from fossil fuels by energy companies. Historical arguments that investment in renewable energy generates less attractive returns than fossil fuels do not hold at current oil price levels. Moreover, wind and solar projects have lower technical risk and longer term price stability – both which are very attractive at the moment.

With lower revenues, energy companies will struggle to maintain dividend payments, which has supported their attractiveness to investors. Additionally, with governments no longer generating oil tax revenues, there is increased risk of policy changes that strand the companies' reserves. Finally, with lobbying and potential legal risks, the sector is becoming "unloved" by the public unless they accelerate their pivot.

Focus on structural trends

Once our focus on overcoming the pandemic, and its destabilising economic effects, is over then pressures to tackle climate change will re-emerge. Likely, they will increase as we have less time available to mitigate and adapt to its effects.

There is a scenario in which governments focus fiscal stimulus and bailouts with a green "lens" or conditions to accelerate the low-carbon transition. However, it seems unlikely that such a thoughtful approach will be taken given time and political pressures.

Compared to previous years, risk of climate change falling off the political agenda is low, notably with the critical United Nation's Conference of Parties (COP) planned for 2021. The threats posed by climate change will remain for decades – even as oil prices continue to go up and down.

Investors able to see beyond the current economic hardship may see the short-term challenges as a value opportunity to build positions in clean energy. In doing so, they can take advantage of opportunities to diversify their investments as well as reaping the "emotional" returns of positively contributing to our world.

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Maintaining your composure

Volatile markets can test the resilience of even the most composed investors. What should you keep in mind to help weather the current market storms?

These are unsettling times. It is no surprise that the growing ramifications of the coronavirus pandemic have reverberated through financial markets.

Price action across all asset classes has become increasingly erratic. Some of the largest intraday swings on record in equity markets were seen in March, as the decade-long bull run crashed to an abrupt end.

Volatile markets are uncomfortable at the best of times. But they can feel even more so when their main driver is so obvious and experienced first-hand, and dominates hourly news flow.

Emotional call

Holding falling assets, combined with uncertainty over when the bottom will be reached, can take an emotional toll on investors. Staying invested, or even making new investments, as others run for cover requires considerable composure and discipline. It is when markets look most precarious that our behavioural proclivities can lead us astray.

To help investors, we examine some behavioural issues to consider during both present – and future – storms. While the coronavirus will eventually pass, it will not be the last event to cause extreme uncertainty in markets. Both Brexit trade talks and the US elections loom on the horizon as key events for 2020 outside of the virus.

The costs of action

People, as a general rule, don't like uncertainty and it is natural to want to take actions that give us a sense of control. Recent panic buying in supermarkets is an obvious example of this. The prospect of significant financial losses is undoubtedly unnerving. Gaining a sense of control by selling assets, may provide comfort at a time when we have lost control in many aspects of daily life.

While stepping out of the markets may help investors sleep better at night, selling will crystallise paper losses. And any short-term, emotional comfort can come at the expense of long-term gains critical to meet investment objectives. Many of the best days of market performance have followed the worst; and missing just a few of these "best" days will significantly impact cumulative long-term performance.

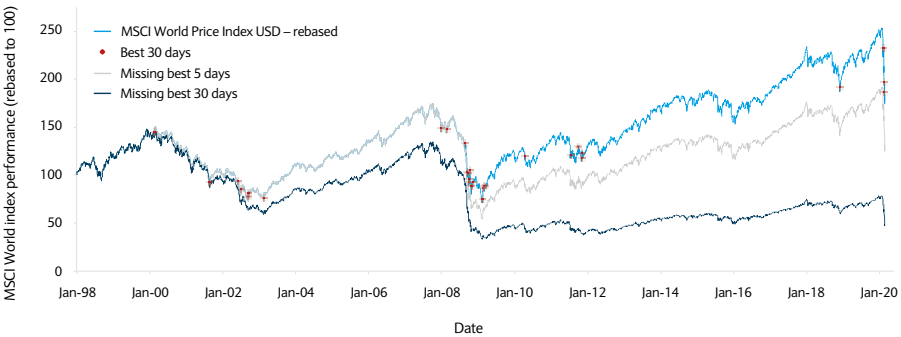
Time in the market is key

History shows us that "time in the market" is more important than "timing the market". Once out of the market for emotional reasons, it can become more difficult for an investor to get back in. Emotionally-driven investors tend to wait until markets are rising enough to feel "safe", which risks missing out on much of the recovery. This is the opposite of the maxim to "buy low, sell high".

Studies into trading behaviour of individual investors have found a significant performance penalty of high portfolio turnover. As renowned US investor Benjamin Graham said, "The investor's chief problem – and even his worst enemy – is likely to be himself."

Missing a few "best" days can significantly harm cumulative returns

The chart shows the performance of the MSCI World index since 1998. It also shows how much performance suffers over that period by missing the five best days for returns, or missing the 30 best days for returns



Source: Bloomberg, Barclays Private Bank, as at 19 March 2020

Focusing on the long term

Given the troubled market conditions, for investors wanting to take some action, one course of action may be to look longer term. This can include reviewing your overall investment objectives and financial situation, checking your portfolio is positioned to reach them over the long term and assessing whether there are new opportunities that can help achieve them. For investors looking to deploy more capital, averaging in over a long period of time remains the most appropriate strategy in the face of continued elevated volatility.

Reframing losses

Many of the actions taken in downturns are driven by the fear of losses. Losses have been shown to have twice as large an impact on us psychologically than equally-sized gains. This is why we do all we can to avoid them. Known as loss aversion, it can lead many investors in turbulent times to sell despite having sufficient liquidity to meet financial commitments.

> "Investors should remember that "losses" are just on paper. They aren't realised unless an investment is sold"

Investors should remember that "losses" are just on paper. They aren't realised unless an investment is sold. It is the future value of investments when they are sold, and not the present value, that is important. Short-term decreases in value are an inevitable feature of holding risky assets – the reason investors can earn a premium is due to the risk of potential losses. One way to look at large decreases is from the point of view of the potential for higher long-term expected returns.

Financial crisis flashbacks

The present environment may bring about memories of the great financial crisis in 2008, which took many years to recover from and may have left lasting emotional scars. The present downturn has been caused by the uncertainty of the impact of a global health crisis, not by imbalances in the financial system. While the effects continue to evolve, fundamentally it is an external shock that is transitory in nature. One that should have a different recovery profile.

While the financial crisis and the global response to it unfolded slowly, markets this time have fallen very quickly, matched by swift monetary and fiscal action. While historically, it's taken an average of 143 days from entering a bear market to the low, this sell-off took markets into bear territory in just 16 trading sessions, as opposed to 136 on average in previous downturns. In this sense, we might expect, if the conditions are in place, an upturn to be quicker than in previous instances – which averaged 63 trading days to exit a bear market.

An unknowable future

While the future is unknown, it may appear even more so presently. This is understandably disconcerting to investors, so adherence to a robust investment process and a considered approach to assessing risks and opportunities is more important than ever.

Market cycles understandably trigger our emotional instincts to protect ourselves, but the best way to avoid impulsive urges that could ultimately prove costly, is to keep our heads and maintain a sense of perspective.

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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

On the back of increased fears over a wider spread of the Covid-19 virus globally, we retain our preference for higher quality, liquid opportunities – which translates into our positioning in short duration bonds.

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 current market 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 maintain a small overweight in developed market government bonds.

In credit, we prefer the higher quality segment. 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 at a time when credit events are on the rise. Emerging market bonds offer opportunities to enhance fixed income returns, given relatively attractive spread levels, but active selection is key.

Developed market government bonds: high conviction

Developed market government bonds worldwide have been losing their appeal as rates edge 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 increased our holding to a small overweight this year.

Although US dollar real rates remain at historically low levels, they are still too attractive to ignore relative to the other developed market bond markets. Amid the Covid-19 outbreak and more pro-active central bank behaviour, UK and European bonds have somewhat synchronised with US rates. However, depressed yields make it difficult to find both markets attractive, apart from in respect of managing portfolio risk.

Investment grade bonds: neutral

Amid the Covid-19 outbreak and recent market sell-off, spread premiums have widened substantially in the last few weeks and, in the medium term, may widen further. Despite supportive central banks, the risk of a sudden spike in downgrades has increased.

However, investment grade-rated companies still look relatively healthy given their high interest coverage and generally low funding costs.

Given spreads are now above their 10-year average, we see room for spread compression, but notwithstanding volatility in the short to medium term as a result of Covid-19.

We remain neutral on the asset class as we expect spread volatility to increase.

High yield bonds: low conviction

In the current economic environment, corporate fundamentals are less robust and default rates are gradually rising, albeit from low levels. Therefore, we maintain low conviction to the asset class as margin pressure may increase in the current volatile environment.

Amid the market turmoil, spreads have widened to historically elevated levels. However, we remain wary of the effect of a significantly lower oil price on energy-related names and the broader economic impact of Covid-19.

Emerging market bonds: neutral

The US Federal Reserve's dovish stance should continue to provide some relief to the largely dollar-denominated emerging market (EM) debt.

Although downside risks from geopolitical issues provide a headwind to emerging market bonds, credit quality hasn't deteriorated and the majority of EM central banks have helped issuers with more accommodative monetary policies.

We favour US dollar emerging market hard-currency bonds due to their relatively attractive valuations and so increased our holding in the asset class at the beginning of the year.

Equities: positive

Positioning in high-quality, growth companies through active management is our preference; alpha (actively selecting superior businesses) outperforms beta (passively following the market). While we remain positive on the longer term prospects for stocks, the near-term view has been clouded by the growing risks to the global economy.

Regionally, we see more compelling opportunities in developed market equities where we maintain high conviction, while we remain neutral on emerging market equities from a risk budgeting perspective. However, not all emerging markets are created equally and so warrant selectivity, with Asia appearing to provide more stable (albeit lower) growth than Latin America.

Developed market equities: high conviction

The impact of the Covid-19 pandemic, and related widespread business shutdowns, means that there is very little visibility on near-term revenue and earnings numbers. Analyst estimates are highly dispersed and need to come down in the short term.

Looking further out, however, market events have created an opportunity for those willing to take a longer term view and be selective.

The rapid and sizeable response of central banks and governments to events means that the policy backdrop will be favourable when a recovery takes hold.

Most importantly, we favour active management and selective stock picking of companies with strong balance sheets. 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 market equities: neutral

Emerging markets have suffered from country specific risks, a strong US dollar and slowdown in the region, particularly in China after the Covid-19 outbreak. Nevertheless, they should benefit from the benign rate environment. We maintain a neutral position to the asset class.

While markets have grown increasingly cautious, emerging market equities should benefit from attractive valuations. We remain neutral and increased our position in the asset class during March after the virus-induced sell-off.

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 asset, and for this reason we maintained 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 – in light of increasing headwinds for the global economy – we maintained our position in. We view this allocation 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, helped by loose monetary policy. That said, we maintain a low conviction due to structural headwinds such as the shift to online retailing, as well as the higher leverage in the sector.

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. However, we 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 volatile environment, may lift the asset class at least in the short term.

Investments can fall as well as rise in value. Your capital or the income generated from your investment may be at risk.

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