Private Bank

Market Perspectives

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BARCLAYS

Foreword

With continued spikes in infections reported in US and European regions and some quarantine measures reintroduced, financial markets remain focused on the risks of a second wave of COVID-19. This uncertain environment saw the dollar weaken against a basket of currencies in July, while gold hit a fresh high.

To support economies, governments are turning on the spending taps, pushing public borrowing levels to levels last seen in the 1940s. Returning government finances to sustainable levels could be tough and whether such largesse can prevent long-term economic scarring from the effects of COVID-19 remains to be seen.

After rebounding sharply, equities have been relatively range-bound in the last couple of months. Sentiment seems to be supported by hopes of a vaccine to COVID-19. Such enthusiasm looks questionable. Furthermore, the market's concentration around a few growth stocks can be interpreted as a warning sign. Yet, hope can be a strong market force. With volatility likely to remain elevated, we continue to rely on active management and private markets to extract alpha.

On the other hand, bond markets appear eerily calm. Despite substantial fiscal and central bank stimulus packages of late, inflation and rates seem set to remain low for some time. As government bond supply climbs and default rates seem likely to rise, risks mount. In searching for carry in such an environment, we focus on investment grade bonds, selective high yield bonds or inflation-linked debt.

Taking a step back from short-term considerations, globalisation reversion, demographic shifts, "smart everything" and building a sustainable world are four long-term, structural themes set to transform society and the economy. In uncertain times, thinking thematically can help shape investment decisions and portfolio construction.

Jean-Damien Marie
and Andre Portelli,
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COVID-19: let's get fiscal

Governments around the world have responded to the pandemic by turning on the spending taps and assuming record debt levels. Some have endorsed green commitments in doing so. But can such largesse prove successful or is it a risky last throw of the dice?

The pandemic is a medical crisis that has hit the global economy and financial markets. The locking down of populations has resulted in an unprecedented drop in activity, surging unemployment, permanent loses in output and temporarily slower potential growth.

The scale of economic risk has encouraged governments to embark upon an exceptional fiscal response, including allowing companies to furlough staff and pledging vast sums in loans, grants and credit guarantees.

In March, the leaders of leading economies, the G20, said they were committed to do whatever it takes and will use all available policy tools to minimise the impact from the pandemic. They promised to inject $5 trillion, 7% of 2019 gross domestic product (GDP), into the global economy to counteract the social, economic and financial impacts of the pandemic. As the true impact of the crisis has developed, so has governments' willingness to ramp up the measures to deal with the damage; economists now estimate the total has surged closer to the $7 trillion mark.

> "They [the G20] promised to inject $5 trillion into the global economy…to counteract the social, economic and financial impacts of the pandemic… economists now estimate the total has surged closer to the $7 trillion mark"

US enters unchartered waters

With the US economy facing the biggest economic downturn since the Great Depression, a considerable increase in stimulus has been unavoidable. The bulk of this comes from the Coronavirus Aid, Relief and Economic Security (CARES) Act. The largest rescue package in the country's history, amounting to more than $2 trillion, the legislation is aimed at protecting citizens from the public health and economic impact.

The major elements include payments to American households of $1,200 per adult and $500 per child on families with an income up to $75,000. The stimulus plan allocates $500bn for loans, grants and guarantees, including $25bn for the airline sector. It provides assistance for small businesses through the Paycheck Protection Programme, allowing them to maintain their payroll and hire back employees who may have been laid off. The Coronavirus Relief Fund provides for payments to state, local and tribal governments. Hospitals, healthcare systems and providers will also receive a substantial increase in funding with a further $27bn for spending on tests, vaccine development and medical treatment devices.

Household and business support

The CARES Act has provided immediate support for households and businesses. US policymakers are also debating further stimulus in the form of infrastructure projects to provide longer term support for the broader economic recovery.

It will come as little surprise that these measures resulted in soaring US debt and deficit levels. The Congressional Budget Office estimates that the federal budget deficit was $863bn in June 2020, compared with $8bn in the same month last year. As a result of the measures, US public debt is likely to rocket to 128% of GDP this year from 108% in 2019.

Europe launches green response

The economic dislocation caused by the pandemic has resulted in Europe suffering its deepest recession since world war two. While a number of individual countries quickly established stimulus programmes, most notably Germany, the step change was establishing of the European recovery fund by the European Commission (EC).

The fund comprises of €390bn of grants and €360bn of low interest loans. The plan proposes establishing a green recovery roadmap for each industrial sector and meeting the EU's 2050 target for greenhouse gas emissions reductions. The proposal also takes a significant step in outlining the future of the EU in the long run with money made available for digitalising the economy and investing in research and innovation.

“The plan proposes establishing a green recovery roadmap for each industrial sector”

Embracing shared debt liability

The EC plan to borrow the money, using guarantees from the EU’s long-term budget as security, embraces shared debt liability. The fund is seen as an important development for the future of the European bloc.

The proposal not only supports battered economies (particularly the most vulnerable southern European ones) but also demonstrates a commitment to much greater levels of fiscal integration; a decision that reduces concerns about the fragmentation risk of the EU. The extraordinary measures instigated by European officials will also have an impact on its debt levels. The euro area debt to GDP ratio is likely to hit 108% this year, from 86% in 2019.

UK suffers more than most

The UK has recorded the highest number of coronavirus deaths in Europe and the economy was quarantined for a prolonged lockdown. Output shrank by a fifth in April and prompted the chancellor to open the spending taps and turn his back on a decade of austerity.

The government injected hundreds of billions of pounds of stimulus into the economy, primarily aimed at tackling the fallout from the outbreak. The funds have been channelled through accelerated infrastructure projects through the recovery phase, loan guarantees to businesses and furlough schemes to help prevent a huge surge in unemployment claims. According to official statistics at the start of July, 9.4m workers had been furloughed, at a cost of nearly £30bn.

Chancellor spends, spends and spends

In the summer statement, the chancellor, Rishi Sunak, confirmed the furlough scheme will end in October. New support measures included a job retention bonus for retaining furloughed workers and a VAT cut, for hospitality, accommodation and attractions, to 5% from 20% for the next six months.

The government is also putting in place funding to cover the national minimum wage for six months and for new jobs for 16-24 year olds. There are also provisions to boost skills and apprenticeships. The chancellor has also made the transition to the green agenda an integral part of the recovery, with funding to make public buildings and housing more environmentally friendly.

The expansive actions taken by the UK government have resulted in an unmatched rise in peacetime borrowing. UK debt may surge from 83% of GDP last year to 101% in 2020.

Innovative, but risky, response

Governments have proved to be both proactive and innovative in devising solutions to deal with the economic ramifications of the pandemic. Without such action the long-term scarring to the global economy would have been much worse and humanitarian damage far greater.

However, the policy initiatives are by no means a risk-free bet. Fiscal deficits and public debt are skyrocketing and government borrowing in many countries is soaring to levels not seen since the 1940s. Servicing that debt has been made possible by historically low interest rates (a function of central banks’ bond-purchasing programmes). However, if public finances are to be put back onto a sustainable path, there will need to be some longer term constraints on fiscal policy, including higher taxes and substantial cuts to government spending.

Nevertheless, in the short term, policymakers are gambling that doubling down on the fiscal response today will boost the trajectory of the recovery, thus making it easier to repay the outstanding markers.

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Thematic thinking

Identifying the structural trends transforming society and the global economy, and investing in these themes early, is key to positioning portfolios for long-term growth. We highlight four themes that seem to offer compelling opportunities in the coming decades and should be considered.

Some speculative investment opportunities have very short time horizons. Other options may be delivered in a few years. But, most investors want to protect and grow their wealth over decades, or even generations.

As events change, so do expectations for the asset classes, sectors and companies that investors might consider when building their portfolios. While the future is unknown, understanding long-term trends likely to shape the world can help investors see beyond periods of uncertainty and build more diversified, resilient portfolios.

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In See beyond: thematic investing we introduce four trends that are expected to fundamentally alter our society in coming decades.

Globalisation reversion

Globalisation is not a new phenomenon and the past 30 years has seen a level of interconnection never seen in the world before. However, more populist, nationalistic tendencies in some of the largest economies, allied with more protectionist policies by some, threaten to reverse globalisation, making the world less interconnected and geopolitical tensions more likely.

The pandemic seems to have exacerbated the situation. With ongoing economic disruption, rising inequality in society and various anti-globalisation movements including trade wars, tension between the west and China plus Brexit in Europe, globalisation appears to have entered a critical phase.

Globalisation is receding and some changes (such as reorganised supply chains and increased intellectual property protection) might take place across countries and industries fairly quickly. That said, a complete reversal of the model created in the last three decades looks highly unlikely. Especially as reversion is likely to create its own challenges that cannot all be overcome and globalisation offers companies and investors opportunities that should not be ignored.

Investing for a sustainable world

Urgent, global challenges in the area of sustainability offer investors access to some of the largest and fastest growing sectors of the economy. Across a range of three environmental and three social themes, we see opportunities to deploy capital while helping attempts to solve global challenges:

1. Climate change and energy needs

2. Reducing environmental footprints

3. Conserving biodiversity and ecological systems

4. Improving growth and employment

5. Improving health and well-being

6. Promoting equity, justice and community

Notably, these themes align with the UN's Sustainable Development Goals (SDGs) which committed 193 countries to social, environmental and economic targets for global development around seventeen shared goals. The SDGs aim to promote prosperity while protecting the planet.

Investors should be looking for companies whose goods and services are directly addressing one or more of these SDGs. The intention should be to invest to help find solutions, not simply avoid detriment.

Those that invest in the right solutions to these long-term trends may find attractive opportunities that may also provide the satisfaction of making a positive difference to our world.

Smart everything

In the next decade, we see an acceleration of technological investment almost everywhere in the world. The combination of artificial intelligence, 5G and the internet of things will fundamentally change the way we live, leading to a data-driven, "smart society".

The opportunities emerging from digital disruption and the shift to a "smarter world" are countless. Efficient processes that bring comfort and connectivity (such as 5G, smart cities and smart transport) at an increased speed might provide the first incentives to investors who consider investing around this theme.

However, the flipside concerns regarding data governance and privacy could either create opportunities (cybersecurity and data centres) or additional risk (data privacy and digital ethics) to different business models and their investments.

A smarter world may not only be more efficient and frugal, but also sustainable in the sense of utilising its "smart ways" to drive positive change and tackle wider problems in the world.

Demographic shifts

Investors who are seeking to benefit from long-term trends, should consider the maxim that "demography is destiny".

We see demographic shifts as both population changes and overarching societal trends, influenced by political, cultural and economic factors. These entail demographic change (for instance, aging populations, inter-generational changes and population growth in emerging markets) and contemporary societal issues such as women's empowerment, diversity and social equity.

We see trends relating to demographics in particular being key source of disruption given their relative predictability compared to those with more exposure to economic shifts and political fragmentation. The changing demographics across age, geography and gender, the world is likely to change the world considerably and in many ways.

Investors can find opportunities in understanding how demographic shifts may change the nature of how we work, live and age as well as how power and wealth might shift between groups.

From vision to action

The four themes we've presented are powerful, transformative forces that are likely to create market trends and opportunities for investors' portfolios over decades. For many investors, thematic ideas complement their core portfolio as "satellite" investments. These satellites can be through public markets or private opportunities. Concentrating on a single theme can help gain greater knowledge of the sector over time, though may increase some cyclical risks.

> "For many investors, thematic ideas complement their core portfolio as "satellite" investments"

Alternatively, some investors seek to build their core strategy with one made of several thematic allocations. Investors need to have strong convictions about the themes and a long-term time horizon that may be needed. They will also likely benefit from support in selection and portfolio construction to avoid unintended biases. Finally, some investors, particularly with family businesses, can use thematics as complementary, risk diversification or strategic investment. Here investors thinking can be akin to a corporate venture capital arm seeking to leverage existing business strengths and weaknesses in line with market opportunities.

In the end, these structural changes will shape the trajectory of the global economy, and so influence investors' portfolios and returns too. So even if not investing thematically, it's useful to understand the trends that others may be watching. It is not necessary to invest in every new theme. However, investors should be able to find exciting opportunities to match their long-term ambitions for their portfolios.

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When hope trumps experience

With much hope placed in finding a COVID-19 vaccine soon, is it time to diversify away from crowded trades and focus on quality rather than growth stocks?

On the surface, equity markets have remained extremely resilient in the face of a deteriorating health situation, particularly in the US, since a sell-off in March (see chart). This apparent strength seemingly relies on distant hopes of a vaccine to COVID-19 and a relatively quick economic recovery. As such, we rely increasingly on diversification and our focus on quality to generate returns.

Vaccine hopes

With more than two dozen vaccine candidates undergoing clinical trials, the near constant news on this front has supported markets. Unsuccessful candidates seem to be quickly ignored. Meanwhile, market participants appear to be cheering, sometimes more than once, any positive headlines, even if details are still sparse at this stage.

As we've highlighted in the past, a vaccine represents the main upside risk to our "cautiously optimistic" outlook. We also acknowledge though that there will be a lag between finding one and immunising people around the world. This lag could last anywhere from a few months to several years and will depend on factors such as the strength of antibodies and willingness to be vaccinated.

Although rightly welcoming positive scientific progress, investors should not expect a vaccine to immediately translate into a much stronger economic momentum.

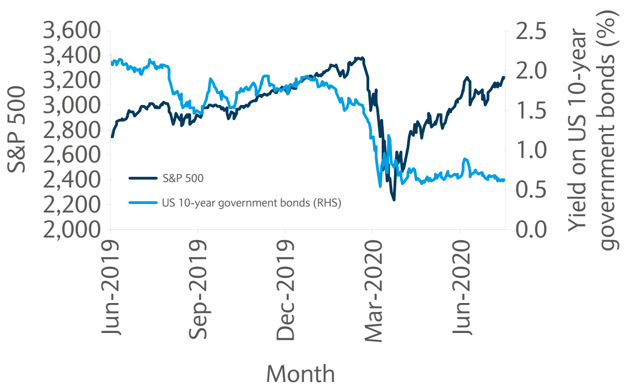
> "Investors should not expect a vaccine to immediately translate into a much stronger economic momentum"

Promise of more fiscal stimulus

The level of support provided by governments during this crisis has been unparalleled. Whether it's via furlough schemes, tax deferrals or outright income payments credited on households' bank accounts, authorities have been able to shield many from job losses and the like for now.

Risk on and risk off

Performance of the S&P 500 and US 10-year government bonds since June 2019



Sources: Bloomberg, Barclays Private Bank. July 2020

In fact, according to several studies, it appears that coronavirus relief measures often pay workers more than work itself. This is obviously unsustainable and benefits are expected to roll over later in the year.

Investors expect governments to maintain some level of support but, even if that's the case, we wonder if it will be enough to avoid a worsening the macroeconomic outlook. Similarly, investors appear excited by the prospects of large infrastructure spending plans coming from both sides of the Atlantic. Here again, we would temper any excitement as, if they ever become reality, these plans are unlikely to translate into increased activity before 2022 at best.

> "We would temper any excitement as…these [infrastructure] plans are unlikely to translate into increased activity before 2022 at best"

Hope for more central bank liquidity

Alongside governments, central banks have intervened like never before to support economies and allowing financial markets to function properly. There is little doubt that this support, both in terms of low interest rates and quantitative easing, will remain active for an extended period of time. But markets are much more responsive to flows rather than stock when it comes to central bank accommodation.

While it now appears that there is virtually no limit to authorities' interventionism, both the US Federal Reserve and the European Central Bank appear willing to "wait and see". The market may ultimately get what it wants, but we can't rule out that this won't happen until a sustained fall in equities or financial conditions tighten too much.

"Growth" as the engine of upside

Reassuringly, the market appears to recognise some of the above risks. Indeed, the performance of various asset classes and equity sectors suggests that a strong recovery is not being banked on.

Gold prices reached new highs and yields on US treasuries are flirting with their March lows. Meanwhile, the equity rally has been driven almost exclusively by a few "growth" stocks exhibiting earnings resilience and limited correlation with the macroeconomic backdrop. On the other hand, some of the more cyclical groups, such as banks or industrials, which should perform best in a recovery, have been notable laggards in the last month.

This narrow market leadership indicates a lack of irrational exuberance among investors while pointing to significant risks should this trend reverse.

Staying mindfully invested

While investors' enthusiasm may be questionable and the reliance on a handful of growth stocks to drive upside is a risk, hope can be a powerful force that should not be ignored.

> "While investors' enthusiasm may be questionable and the reliance on a handful of growth stocks to drive upside is a risk, hope can be a powerful force that should not be ignored"

However, we are increasingly selective in the regions, sectors and stocks being targeted. We believe that diversification is key to avoid being over exposed to crowded trades, such as technology stocks, and missing high-quality under-owned names.

This is not about value versus growth or cyclicals versus defensives. It is all about finding quality in the form of solid balance sheets, attractive cash flow generation and sound growth prospects wherever it happens to be. For this reason and because we expect both volatility and dispersion to remain elevated, we are incrementally relying on active management and private markets to extract alpha.

> "We are incrementally relying on active management and private markets to extract alpha"

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

When higher debt doesn't lift yields

It is unlikely that all risks occur at the same time, rather a bit of everything: just like at a wedding buffet. Large treasury supply in isolation is unlikely to translate into higher yields. That said, bonds still serve a purpose even though lower returns are likely.

The bond market seems to have entered a period of calm after central banks committed to large-scale monetary support in response to the impact of the pandemic on economies. The support took the form of ultra-low rates, large-scale bond purchases and acceptance of a broad universe of collateral for cheap funding.

The European Central Bank has committed to a €1.35 trillion bond-buying programme. The US Federal Reserve (Fed) increased its balance sheet to over $7 trillion and set aside $750bn for corporate bonds. While the Bank of England agreed £200bn of purchases, lifting the overall asset stock to £745bn. It appears that the focus will next shift towards the real economy.

Five essential questions

The five essential questions not only for bond investors, are:

1. Will the economy rebound quickly with the help from the medical front or will a second wave of infections put a recovery at risk?

2. Are companies able, and willing, to keep workers employed once the furlough schemes end, or will a renewed surge in unemployment weaken consumer spending for a longer period?

3. Will a rise in default rates put the bond market and bank balance sheets in distressed situations?

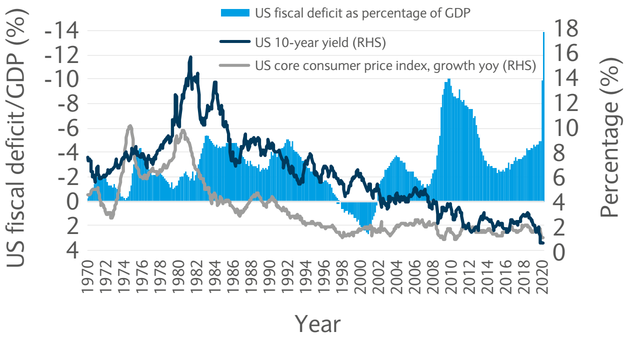
4. Can the bond market cope with the vast debt supply?

5. How might bond market risks be mitigated?

While there are no straightforward answers to the above questions, monitoring key indicators and looking at previous patterns should help. A scenario whereby inflation and yields rise significantly, while the global economy enters a prolonged, and deep, recession that causes large default waves seems the least likely scenario. The result is more likely to be similar to a wedding buffet: a bit of everything.

US fiscal deficit surges, but yields are heading lower

The trend in the US fiscal deficit, US core consumer price index and yield on US ten-year bonds since June 1970



Source: Bloomberg

Economic recovery

China's economy grew by 3.2% between April and June while US retail sales are, an encouraging, 99% of the levels seen at the start of the year. In addition, Google's and Apple's mobility data tracking people's location suggest that a large part of consumption started to pick up again.

But the risk of a rebound of COVID-19 infections, which puts a full recovery in doubt, is unlikely to disappear soon. Meanwhile, many companies have started to announce large job cuts. In the absence of any positive catalysts (such as a vaccine) on the horizon, more job cuts seem inevitable, leading to a weakened consumer and muted wage growth, putting a cap on inflation.

Default stress

Default rates within speculative grade bonds have already started to rise from the multi-year lows, in the US to 5% while 1.8% in Europe. A rise towards 8% in the US, for example, seems likely considering the pattern seen in past crises. As highlighted in July's Market Perspectives, and confirmed by second-quarter earnings, banks have set aside large provisions to cover for a deluge of debt defaults. Meanwhile, stress tests suggest that even in severe scenarios capital buffers are ample.

Debt supply in isolation unlikely to lift yields

The wall of anticipated bond supply and the risk of higher interest rates appears to be one of the biggest concerns among investors. Indeed, the US real rate rose in the early 1980s in line with more US debt.

Various studies, like by Thomas Laubach of the Fed in 2003, suggest that a 1% increase in the deficit leads to a rise of 25 basis points in yields, all else being equal.

> "Various studies suggest that a 1% increase in the deficit leads to a rise of 25 basis points in yields, all else being equal"

The challenge is that things are never equal and cyclicality and demand patterns, as well as inflation expectations, are large drivers of rates. Later in the 1980s, bond yields fell when debt rose in subsequent periods. Yields also trended lower while debt rose in the aftermath of the 2008 credit crisis. In fact, the correlation between inflation and debt has been strongly negative in the last 50 years.

Demand patterns

Demand patterns play another important part in the discussion. Since the credit crisis in 2008 the Fed has become a large buyer of treasuries and holds roughly $3 trillion of T-bills and treasuries in its portfolio while buying roughly $80bn a month. The central bank has indicated that it is likely to step up whenever required, meaning that higher debt as a result of a deepening crisis will likely be met by more bond purchases.

A sudden drop in demand by foreign investors, who own roughly 40% of outstanding US debt, seems unlikely. The reason is that it is in foreign banks' interest to keep the currency low, specifically in a low-growth environment. Meanwhile, banks and pension funds are obliged to buy a large part of the outstanding US debt, given regulatory requirements, to deal with pension deficits and to keep the liquid, high-quality asset portion high.

Will inflation politely decline the Fed's invitation?

Inflation is likely to stay low for the foreseeable future. The market-implied inflation in five years is still below 2%. Only a sudden, and significant, rebound in economic activity, beyond that priced in, combined with increased money supply velocity would change the trend. The Fed may like the idea of letting inflation overheat, but even before the crisis the central bank failed to hit its inflation target of 2% for a sustained period.

While 0.5-0.6% seems to act as a floor for US 10-year treasuries, a sudden rise towards 1.5% or 2% appears unlikely. Achieving carry by considering investment grade bonds, selectively high yield bonds and potentially adding inflation-linked bonds, may be appropriate ways to navigate through the expected low-yield environment.

> "While 0.5-0.6% seems to act as a floor for US 10-year treasuries, a sudden rise towards 1.5% or 2% appears unlikely"

Jai Lakhani, London UK, Investment Strategist – jai.lakhani@barclays.com

Oil recovery hinges on second wave, gold and equities shine

Economies reopening, sentiment improving and positive supply cut news bodes well for oil. Risks of another round of COVID-19 infections could be a headwind for the lubricant, but a tailwind alongside geopolitical tensions and low real interest rates for the yellow metal.

The oil market continued its road to recovery in July. Since April, supply cuts and better than expected economic activity have flattened the Brent and West Texas Intermediate futures curves, with futures prices notably more stable over the past few months.

The futures markets suggest a transformation from a significant surplus in the first half of 2020 to a deficit in the second half of the year. However, a second wave of COVID-19 infections impacting sentiment and re-imposing containment measures could be a headwind.

"The futures markets suggest a transformation from a significant surplus in the first half of 2020 to a deficit in the second half of the year. However, a second wave of COVID-19 infections impacting sentiment and re-imposing containment measures could be a headwind"

Global oil supply falls to nine-year low

OPEC+, a group comprising members of the Organization of the Petroleum Exporting Countries (OPEC) and other leading oil producers such as the US and Canada, is showing its commitment to abide by production cuts in order to put a floor on prices. The OPEC+ compliance rate with the supply agreement was 108% in June, as a result of Saudi Arabia cutting further than the agreement by one million barrels per day (mbpd).

Global oil supply fell by 2.4mbpd in June to a nine-year low of 86.9 mbpd. Since April, world oil output has been cut by nearly 14mbpd. According to the International Energy Agency (IEA), if the OPEC+ cuts agreed remain, global supply could fall by 7.1mbpd in 2020.

However, supply cuts may have hit their peak. OPEC+ are set to ease the 2mpbd cut this month. Given high inventory levels worldwide and a higher oil price, non-OPEC supply could also return simultaneously. US production may have bottomed out and could increase, with the economy for the large part back up and running.

Demand continues to recover

IEA data shows that for the first half of 2020, oil demand fell by a substantial 10.75mbpd. However, high-frequency indicators, as well as economic and mobility data points, suggest that the worst might be over. Encouragingly, China's crude oil imports continued to pick up in June, growing by 34% year on year. With potential for further fiscal stimulus, demand could be furthered as global economic activity resumes.

COVID-19 is key to a balanced market

Supply-side compliance to production cuts and a recovery in demand has helped the oil market to stabilise somewhat. That being said, getting fully back into balance will depend heavily on how damaging any second wave of COVID-19 is. The re-imposition of quarantining in regions in the US and Latin America is a concern.

"Getting fully back into balance will depend heavily on how damaging a second wave of COVID-19 is. The re-imposition of quarantining in regions in the US and Latin America is a concern"

Furthermore, as we mentioned in July, some activities will take time to fully normalise, such as air travel, and the oil price is unlikely to continue to rise as fast as in the initial recovery. Ultimately, we expect oil prices to be range-bound in the near term but the risk of a second wave overwhelming healthcare systems, denting confidence and the shutting down of economies remains an issue that cannot be ignored.

Long-term support for gold even as equities drive higher

Gold continues to extend its rally from the March low (see chart), up 30% so far this year.

In the backdrop of equities recovering and the precious metal breaking the prior all-time high, investors have questioned if the momentum in gold can continue. Indeed, typically, the two tend to move in opposite directions as the yellow metal is added to risk-averse investors' portfolios in times of uncertainty, economic downturns and geopolitical tensions.

In this context, the recent positive correlation between the pair may seem odd. However, we believe it can be explained by the unprecedented levels of fiscal and monetary stimulus introduced globally. This wave of liquidity has kept real interest rates low, reducing the opportunity cost of holding a non-yielding asset like gold. At the same time, although stocks have been grinding higher, this strength can be attributed almost entirely to a few "growth" companies as opposed to a broad-based universe of cyclical industries, pointing to some degree of investors' cautiousness about the outlook.

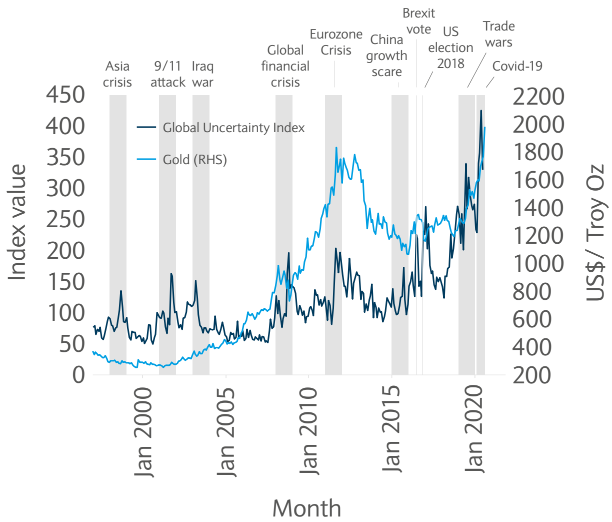
"In the backdrop of equities recovering and the precious metal breaking the prior all-time high, investors have questioned if the momentum in gold can continue"

Useful diversifier

Thus, we do not see the recent equity rally as a reason preventing gold from delivering further strong performance. And with equity markets seemingly ignoring the risks associated with a second wave in COVID-19 infections, a US November presidential election and Brexit negotiations, we see the precious metal as a useful diversifier in a portfolio context.

Gold: the navigator through uncertainty

The performance of the gold price and US-based Economic Policy Uncertainty's economic policy uncertainty index since 1997. Both climbed to highs for the period under review this year. The index is based on news coverage, the number of federal tax code provisions set to expire in future years and disagreement among economic forecasters as a proxy for "uncertainty"



Source: Refinitiv Datastream/Barclays Private Bank

"With equity markets seemingly ignoring the risks associated with a second wave in COVID-19 infections, we see the precious metal as a useful diversifier in a portfolio context"

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60/40 portfolios: the end of the road?

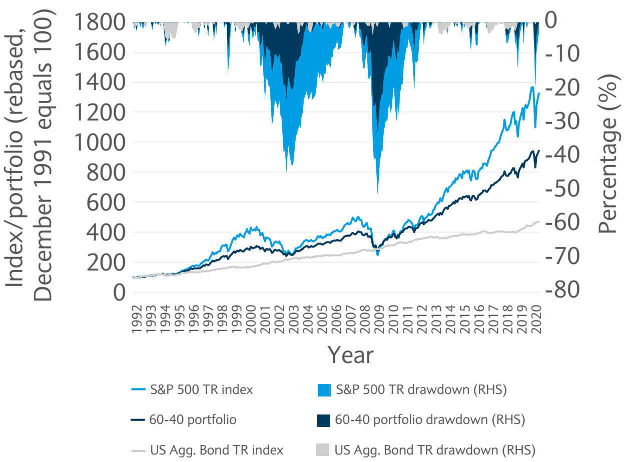
The traditional 60-40 equity-bond portfolio allocation split seems to be less effective in delivering the desired returns for many investors in a low-rate environment and eroding diversification attributes. How might investors allocate portfolios in such a world?

The 60/40 portfolio, or 60% allocated to equities and 40% to bonds, has been one of the cornerstones of investing for many decades. This simple asset mix is widely used as the main benchmark for retirement fund allocations.

From 1992 until 2019, the 60/40 portfolio – based on S&P 500 and US aggregate bonds – delivered an attractive annual total return of 8.5%, with volatility of 8.8%. During the same period, equities averaged 9.8% a year, but at the cost of substantially higher volatility of 14.4%.

The risk-return characteristics of the portfolio were considerably improved by adding exposure to interest rate premium on top of the growth-driven equity premium. Moreover, bonds mitigated losses during the dot-com bubble of 20 years ago and the global financial crisis (see chart). In the end, the 60/40 portfolio approach's maximum drawdown was -32.5%, while equity portfolios' worst drawdown in the period topped out at -51%.

60/40 portfolios show their mettle
Total returns and drawdowns for 60/40 portfolios, the S&P 500 and US aggregate bonds since 1992



Source: Bloomberg

Doubts creep in

There are several reasons why this simple investment strategy has traditionally performed well. First, driven by the stable growth and falling interest rates, equities and bonds have made a strong contribution to total returns. Second, the correlation between equities and bonds has been negative this century. So bonds generally served as an excellent hedging component in a portfolio. Arguably, the negative correlation between both asset classes was a consequence of the low-inflation environment.

Despite the great appeal of the investment thesis behind the 60/40 portfolio, the macro-financial dynamics in recent years – and in particular since the COVID-19 outbreak – raise some doubts about its continued success.

Sluggish growth, low interest rates and uncertainty

In recent years, global growth has slowed. In developed markets, characterised by an aging population, the extraordinary demand for fixed income has helped drive interest rates close to the zero bound. Low, but relatively stable, inflation rates – combined with an extremely accommodative monetary policy – resulted in negative real cash rates.

Political risks and trade tensions fueled volatility outbursts on several occasions. In addition, the world is coming to terms with operating in the era of COVID-19. While economies have already suffered, the full repercussions are yet to be seen. After an initial slump, many equity markets have rebounded to February 2020 valuations. One thing seems clear. The future looks uncertain.

Unbearably light expected returns

Over a longer investment horizon (say ten years) yield levels have generally been a good predictor of future bond returns. Given the low yields on offer today (around 1.25% compared with an average US bond yield of 4.5%

since1992), bonds are likely to provide investors with much lower income for some time, than typically seen in the last 30 years.

Low inflation levels represent yet another drag for nominal bond returns. Interest rates are hovering around zero in many developed markets. This leaves little room for capital gains unless short-term yields march deeply into the negative territory. The long-term outlook for bond returns appears weak.

"This leaves little room for capital gains unless short-term yields march deeply into the negative territory. The long-term outlook for bond returns appears weak"

Turning to equities, lower dividend yields, suppressed growth and relatively high valuations all point to muted returns in coming years. The heightened uncertainty created by the pandemic is likely to persist for a while, which could trigger episodes of elevated market volatility.

Equity-bond correlations

Equity-bond three-year rolling correlations have been particularly pronounced this year (see chart). At the outset of the pandemic, the correlation turned sharply positive for the first time since 2008. Admittedly, the unprecedented nature of the spike might suggest that it is an outlier and correlations may soon revert to negative values.

However, the diversification benefits of 60/40 splits have slowly eroded in the last seven years. Many factors could influence future equity-bond correlation. However, the zero lower bound and inflation risks represent a real concern for the effectiveness of 60/40 portfolio.

"Many factors could influence future equity-bond correlation. However, the zero lower bound and inflation risks represent a real concern for the effectiveness of 60/40 portfolio"

Pandemic triggers strongest bond-equity correlations this century

The trend in three-year rolling correlations of weekly equity and bond returns since 1992

Source: Bloomberg

Every ending is a new beginning

To tackle lower return prospects, some suggest ditching bond holdings for equities. Indeed, this is likely to boost long-term returns. That said, the equity risk exposure would probably increase substantially. But if you can stomach the risk of higher short-term market turbulence, elevated equity allocations might be worth considering.

In our view, a more efficient and flexible way to address this issue is to consider inclusion of other asset classes. Financial markets have evolved into highly dynamic and complex systems, and it is necessary to build international portfolios that provide carefully tailored multi-factor exposure. This would allow for more maneuvering space across a spectrum of macro-financial regimes.

In fixed income, high-yielding and emerging market bonds offer credit risk premium and currency carry. Quality and dividend investment styles could provide exposure to "bond-like" equities. Hedge funds typically offer a market-neutral exposure which improves portfolio diversification. Illiquidity premium can be accessed via private equity and debt. Last but not least, to generate alpha, it is crucial to account for secular trends, actively seek opportunities and selectively pick investments for each of the asset classes.

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Looking on the bright side, cautiously

While investors may be easily carried away on a wave of optimism about a stock or sector, maintaining a degree of cautious optimism may be called for during good times.

The start of summer can bring a degree of optimism. This year the mood shift may have been tied to the lifting of quarantining and resumption of many aspects of pre-coronavirus life. Leaving aside the relief of being able to get out and about again, the prudent approach would seem to be to continue exercising caution.

The same applies to businesses. While the resumption of economic activity is welcome, companies should be prepared for the prospect of restrictions being re-imposed. More importantly, however, firms face adapting to what is likely to be a very different world post-pandemic.

Too much of a good thing

Equity markets suffered an unprecedented sell-off, in terms of speed and depth, in the first three months of the year and an equally sharp rebound in the following three months. Large fiscal spending commitments and monetary policy moves, designed to keep money flowing to both businesses and consumers, contributed to setting the ground for the second-quarter recovery.

Historically, it has often paid to have faith in people's ability to overcome problems with innovative solutions. For this reason alone, our base case assumption is that things will eventually return to as they were previously. This includes our belief that a vaccine will be found for this virus and its variants.

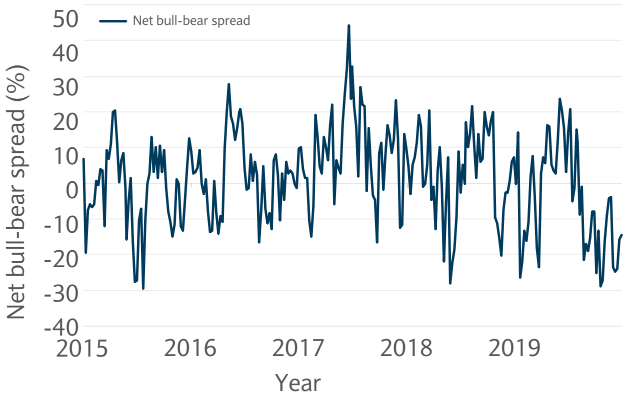
Leaning too far towards an emotion can be dangerous. An overly optimistic lens can help to feed optimism over objective and dispassionate analysis. The confirmation bias might lead to overweighting good news and data points around the easing of lockdowns and paying less attention to the risks associated with further outbreaks until a vaccine is found.

Letting pessimism take hold

The same holds true for pessimism. As the financial markets slid early in the year, pessimism took centre stage in the mainstream and financial media, in turn causing many investors to amplify an undoubtedly severe crisis even further. This led to more defensiveness and risk aversion. It also led many investors to make hasty and costly liquidations or to hesitate in deploying cash into investments. As we have said previously, it is important to be aware of the impact of the news on our decision-making during particularly volatile market periods.

US investor sentiment on the slide

The net bull-bear spread, which shows whether bulls (a positive reading) or bears (a negative reading) are in charge, since 2015. The spread this year slid into deeply bearish territory



Source: Bloomberg, Barclays Private Bank

Sentiment swings

Financial markets seem to be largely ignoring risks of a second wave of COVID-19 infections around the world and looking to a quick, V-shaped, recovery. As some markets near their highs, such optimism may be misplaced. While asset values appear elevated, volatility remains high. With consensus expecting next year's earnings to bounce back to 2019 levels, any developments that indicate a recovery may take longer than is presently expected could hit sentiment.

As November's US election nears and other event-based-risks like Brexit play out, volatility may also climb. Equities are one area where American election fears could be felt first. Election uncertainty is likely to increasingly influence sentiment and volatility.

Sentiment indicators of individual investors (see chart, p16) illustrate that when market sentiment shifts, it can do so rapidly and markedly, as seen earlier this year.

Trading data mirrors this change in sentiment. The ratio of put to call options surged in March, before falling sharply, and recently touched a six-year low (see chart on this page). In many cases, sentiment tends to overreact to, or even feel disconnected from, fundamentals. In some periods, sentiment may be excessively bullish and in others excessively bearish.

Plan in the calm

In periods of stress, investors' time horizons can feel shortened, possibly increasing the perceived riskiness of investing. Indeed, loss aversion can lead to decisions which provide short-term comfort, but put at risk the achievement of long-term investment success. This may transpire in, say, cutting risk at the wrong time, or failing to rotate exposures to maintain strategic exposures.

Given markets and sentiment can quickly alter course, investors can get caught out. For this reason, in periods of relative market calm, when being invested can be more emotionally comfortable, it is a good time to plan for the inevitable bumps along the road. While it is impossible to predict short-term market developments with much certainty, the unpredictability of markets is relatively certain.

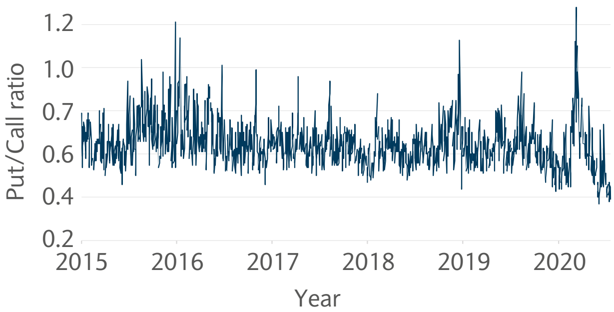
Prepare for risks, but also opportunities

Planning for different eventualities with a trusted advisor can help to weather uncomfortable periods when they arrive. The best protection, however, is to have a long-term investment strategy designed that can perform well in both rising and falling markets. Such an approach may not need much portfolio maintenance during challenging times.

The investment philosophy of our portfolio managers has remained unchanged during the pandemic. The focus is on investing in high-quality businesses for the long term. It has resulted in resilient portfolios capable of outperforming when markets are slipping or charging higher.

Trading behaviour mirroring sentiment

The equity put/call ratio, which shows which the ratio of options trading volumes by those positioning for an equity decline versus an advance



Source: Bloomberg, Barclays Private Bank

Portfolio diversification can help protect against wealth destruction in turbulent times. However, periods of calm may also provide a chance to capitalise on potential future opportunities when they arise. This might include investment structures aiming to profit from volatile periods without taking directional viewpoints. Examples include market volatility or the dispersion of returns between stocks, noting that the pandemic may have introduced long-lasting differentiation between stocks, which could be further exacerbated by upcoming political events such as the US elections and Brexit.

"Periods of calm may also provide a chance to capitalise on potential future opportunities when they arise. This might include investment structures aiming to profit from volatile periods"

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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: neutral

- 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 neutral conviction in the asset class from a risk management perspective.

Fixed income: neutral

We see moderate risk-return opportunities in fixed income given market dynamics. Although sovereign rates appear less attractive in the context of a low-yield backdrop, they offer 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. With spreads recovering remarkably from the highs back in March, we prefer to allocate our risk budget in the equity space. In high yield, selection is key. We prefer high yield and emerging market (EM) hard currency debt over EM local currency debt considering the risk facing their economies and currencies.

- 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 unprecedented liquidity injections from major central banks. However, as economic data continue to deteriorate, we see the asset class as a diversifier and maintain our holding to a small overweight this year.
  - Although US dollar real rates remain at historically low levels, they are still marginally more attractive relative to the other developed market bond markets. Amid the COVID-19 outbreak and more 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
  - A large contraction in the economy and earnings will likely lead to a substantial increase in leverage ratios and a higher risk of downgrades; specifically, among BBB-rated bonds. While higher spread offer opportunities, selection will be key.
  - With central banks announcing large supporting measures, like liquidity facilities or large bond-purchasing programmes, bond spreads have started to retrace again.
  - Notwithstanding volatility in the short to medium term as a result of COVID-19 and increasing fears over a second wave, we remain neutral on the asset class as we expect more spread volatility.
- High yield bonds: neutral
  - Amid the market turmoil, spreads have widened to historically elevated levels before retracing back again. However, we remain wary of the impact of lower oil prices on energy-related names and the broader economic impact of the COVID-19 pandemic.
  - The economic effects of the coronavirus outbreak have significantly increased the risk of default. That risk increases the longer the pandemic continues, subduing economic activity. However, spreads at current levels likely open up selected opportunities in the asset class.
  - Back in April, we increased our position in the asset class twice, closing a long-held large underweight. We wanted to take advantage of wide spreads by historical standards, suggesting potential attractive returns. While still elevated, spreads are less attractive and we prefer to take risks in equities.

- Emerging market bonds: low conviction
  - We prefer emerging market hard currency debt over local currency debt considering the risk facing the respective economies and currencies.
  - Many EM economies run high debt deficits, low currency reserves and potentially lack capacity to deal with the COVID-19 crisis. The recovery from the pandemic differs within EM and is mostly linked to the infection rates with Latin America, South Africa, Israel, the Philippines and India under pressure.
  - However, the US Federal Reserve's dovish stance should continue to provide some relief to the largely dollar-denominated emerging market debt.
  - Although corporate fundamentals are now less robust and default rates are gradually rising, the majority of EM central banks have helped issuers with more accommodative monetary policies. With rising COVID-19 infections starting to affect EM economies and forex, we are more cautious on local currency debt.
  - Despite downside risks from geopolitical issues, we maintain low conviction to the asset class as margin pressure may increase in the current volatile environment.

Equities: positive

Positioning in high-quality, growth companies through active management is our preference; alpha (actively selecting superior businesses) usually 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 (Latam). Sector-wise we like a mix of defensive and growth exposure with a particular focus on quality.

- Developed market equities: high conviction
  - The impact of the pandemic, and related widespread business shutdowns, means that there is very little visibility on near-term revenue and earnings numbers.
  - Earnings will decrease substantially in 2020 but the market will look at 2021 and beyond to price in a recovery.
  - Looking further out, 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 and slowdown in the region, particularly after the COVID-19 outbreak.
  - While the region may suffer significantly for the pandemic in the short term (especially Latam), a secular shift from investment to consumption should support growth over the medium term.
  - Furthermore, the region should benefit from the benign rate environment.
  - While markets have grown increasingly cautious, emerging market equities should benefit from attractive valuations. We remain neutral and increased our position in March after the virus-induced sell-off.

Other assets: low conviction

Alternative asset classes will continue to diversify our portfolio, but are not expected to be the main drivers of returns. Gold should keep 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, in our view.

- 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, such as merger arbitrage.
  - We recently further reduced our conviction, preferring to move into cash and to increase high yield to neutral, where better opportunities exist. 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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