Private Bank

# Market Perspectives

July 2020

# Foreword

**Financial markets seem to be largely ignoring risks of a second wave of COVID-19 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. As November's US election nears, volatility might climb. Equity markets are one area where American election fears could be felt first. Election uncertainty is likely to increasingly influence sentiment and volatility. We expect healthcare, technology, financial and energy stocks to be particularly affected as more election details emerge.

Companies potentially affected by climate-change initiatives may also profit, or come under pressure from, the election. With the EC's Green Deal targeting a sustainable pandemic recovery, we examine potential investment opportunities that may arise from moves to a carbon-neutral world.

In fixed income, rarely have investor concerns about low interest rates appeared more justified. Banks are usually particularly exposed to such risks. While some banks will struggle, especially if debt defaults are higher than the market expects, the sector looks far more resilient than it was a decade ago.

Allocating more to private markets may be one way to diversify away some of the pandemic risks found in public markets. For instance, if the global financial crisis is any guide, deep valuation discounts on secondary assets, caused by the COVID-19 outbreak, may soon offer more attractive opportunities in that segment.

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# Pricing for election risk

Elevated equity valuations suggest a V-shaped recovery is on the way. This seems questionable. One risk is the US election. As the election race heats up, what might it mean for investors?

Equities have been very resilient in the last couple of months, shrugging off worsening macroeconomic data. The consensus continues to expect a quick, V-shaped, recovery. We are more circumspect. Indeed, in addition to the pandemic, the US presidential election is likely to soon become another source of potential volatility.

## Not entirely irrational

It may be confusing to see equities near their highs when the world is facing its largest economic shock since the Great Depression. But this kind of decoupling is not unusual. In fact, something similar occurred in 2009.

While US unemployment peaked only in the third quarter of 2009, the S&P 500 index touched its low point in March, six months earlier. By the time the proportion of unemployed people peaked, US equities had already jumped 60% from their lows. This is what appears to be happening this time round, just at a faster pace. If the consensus is right and companies experience a V-shaped recovery in the next 12 to 18 months, then it may not be so irrational to see equities at current levels.

## It's not just about COVID-19

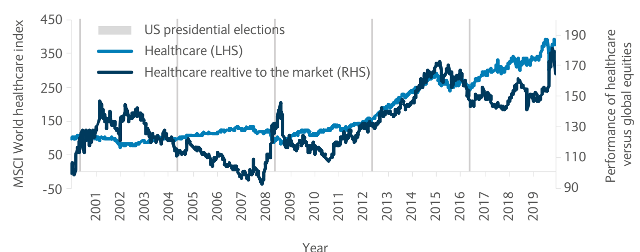
The above V-shaped scenario needs two important assumptions. First, as we discussed last month, one has to believe that the "new normal" will be very similar to the pre-pandemic world, at both the macro and micro levels.

This means that economies will be able to generate the same level of output and that companies will be capable of producing the same earnings as before, whatever COVID-19 measures are in place. While not impossible, we remain sceptical given the significant increase in government debt and the stress balance sheets have come under.

Second, a V-shaped recovery scenario implies that no surprises will spoil the party. Again, this appears optimistic in light of the upcoming known unknowns (US presidential election or EU-UK trade deal) and any other event that

**In the long run, US elections are not likely to affect healthcare much**

The performance of healthcare equities, and their performance relative to global equities, since 2000




Sources: Bloomberg, Barclays Private Bank. Data as of June 2020

might challenge the status-quo (geopolitical tensions, natural disasters or oil price crash just to name a few).

## Headline risk is high

As the presidential campaign gets underway, we expect further announcements on potential policies in coming weeks. These, combined with the usual pre-election polls, will likely shift investor sentiment and drive volatility higher. At the sector level, we expect healthcare, technology, financials and energy to be in the eye of any potential storm. Some construction companies may also profit from any infrastructure-spending proposals.

## Focus on the long term

In the run up to the US election, we are not inclined to change to our views. We expect short-term opportunities to present themselves as the two candidates unveil more details on their respective political agenda and sentiment shifts. But until then, we believe that investors should remain focused on their long-term goals, using portfolio diversification as a hedge against uncertainty.

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# More resilient bank bonds, but not all is equal

Predicting loss provisions amid COVID-19 is not an easy job for banks. But higher capital ratios, a more conservative risk management approach and strict regulations suggests that the banking sector is more resilient than before.

## Trapped bond yields

Bond investors are rightly concerned about low yields and the threat of yields trending higher. Rarely has this been more justified than now.

The fear of record government debt piles (over $4.5tn is expected in the US this year) and the prospect that central banks will need to reduce the amount of sovereign debt on the balance sheet (which seems likely to increase towards $10tn by year end). However, for now we believe that disinflationary tendencies and aggressive central bank policy globally will keep rates lower. While potential news of a vaccine could lead to a sharp rise in yields, it remains to be seen whether an economic recovery will make good the lost ground and quickly lift inflation beyond central banks' inflation targets.

Meanwhile, yields of investment grade bonds have reversed sharply as spreads pulled back remarkably from the 400 basis points (bp) above treasury yields seen in March. The tightening move was recently accelerated by the US Federal Reserve's decision to start buying single-line corporate bonds through its Secondary Market Corporate Credit Facility.

## The financial sector

In our last edition we focused on the BBB-rated pool of the investment grade bond market. This time we take a closer look at the financial sector. This is by far the largest sector across various markets, with roughly a 40% market share in corporate investment grade debt (by value).

Our conclusion is that banks look much more resilient than was the case in 2008, so any parallels between the credit crisis and now largely do not apply. However, there may be potential distress in the sector. So a closer look at the main drivers of such distress is warranted.

## Will realised losses exceed earmarked losses?

First-quarter earnings numbers have declined sharply for many banks around the world, even leading to losses for a minority. The profit decline was largely caused by loan loss provisions. But the almost impossible task of estimating impairments is reflected in the large dispersion of provisions reported by banks. For instance, European banks posted provisions ranging from around 30bp of outstanding loans up to 250bp. In the US, provisioning in the first three months of the year alone was already ranging from around 80% to 250% of the full 2019 provisioning.

> "European banks posted [first-quarter] provisions ranging from around 30bp of outstanding loans up to 250bp"

Banks must also consider the quality of the loan book. In Europe, non-performing loans are the lowest seen since 2007 (2.3%) so far. However, non-performing loans are likely to increase substantially and vary from bank to bank. The biggest sensitivity will be around the small and medium enterprise (SME) loan book and non-secured consumer financing.

While depressed yields are likely to weigh on net interest margin, this time it is likely to be the US banks that need to adapt. Overall, a drop in earnings by around 50% on average can be expected this year. But as discussed the dispersion between banks' earnings should be wide. On the positive side, earnings from capital markets are likely to rise for some banks, due to increased volatility and trading as well as a substantial rise of syndication fees on the back of record bond issuance.

## Equity ratios with ample cushion

Core equity tier 1 capital ratios (CET 1) ratios are expected to fall as risk weighted assets (RWA) will increase substantially. This is due to larger "revolver loan" commitments as well as an increase in corporate loans. Meanwhile, state guarantees given to troubled sectors should lead to some RWA relief for banks in the coming quarters.

It will be difficult to assess the magnitude of RWA inflation overall. The latest Bank of England stress tests for UK banks (including COVID-19 assumptions) for example model for a 33% increase in RWA over the next two years. But even with this increase, regulatory buffer requirements would be met by most, given the comfortable capital ratio levels banks maintain nowadays.

In the US the latest COVID-19 stress test, conducted by the Fed, attested ample capital buffers for most of the US banks even under a more severe scenario. The quality of bank balance sheet differs, but high capital ratios and a generally more conservative approach to risk management makes the sector appear more resilient, in our view.

### Are bank bonds fallen angel candidates?

Firstly, it depends on the quality of the bank and secondly it depends on the debt instrument of the respective bank. Since the credit crisis of 2007-2008, a major overhaul by the regulators globally led to various types of bank bonds issued. The bonds aim to help make potential bank resolution easier, and to avoid using taxpayer money for potential bailouts.

While senior preferred bonds are mostly pari-passu to the most senior unsecured debt (deposits and counterparty transactions) in a bank balance sheets, senior non-preferred or Tier 2 bonds are subordinated and are bail-in-able if needed. The same is true for the most junior, part additional Tier 1 bank bonds, which usually are rated as high yield by most banks.

### Not all bonds are equal

Bond ratings reflect the risk various bond rankings of one issuer carry. For a single A rated bank, this could mean that respective senior non preferred or Tier 2 bonds are rated in the BBB space and therefore at risk of falling into "junk" status should the company's A rating be downgraded.

While we are constructive on bank bonds, the diverse nature of the sector, reflected by the quality and types of bonds used by different issuers, suggests that thorough selection is needed in order to capture attractive opportunities.

> "High capital ratios and a generally more conservative approach to risk management makes the [banking] sector appear more resilient, in our view"

### Typical hierarchy of bank debt

| | Typical bank debt format | Rating example bank (Moody's methodology) | Comments |
|---|---|---|---|
| | Non-guaranteed deposits/ counterparty contracts | Aa3 | Any household or corporate deposits (not guaranteed by a deposit scheme) or derivatives contract a bank may have with other financial counterparties. |
| | Senior preferred debt | Aa3 | Senior unsecured debt in the format of loans or bonds which can be most compared to the conventional senior bonds seen in the past. |
| Bail-in able debt/total loss absorbing capital (TLAC) | Non-preferred senior debt (NPS) | Baa1 | Debt which in general is senior but in a bank resolution situation forms part of the resolution mass and supports the debt ranked above. Capital will only be "bailed in" after any subordinated debt has been used. Like with senior preferred debt coupons must be paid. Typical format in Europe. In the UK this format can be seen as senior bonds issued out of the respective holding entity (HoldCo bonds). |
| | Subordinated debt (eg Tier 2) | Baa2/Baa3 | Similar to NPS but subordinated to any senior debt in a liquidation and resolution situation. Older formats can have a capital write down trigger while newer formats do not have such a trigger. Can be callable or bullet bonds. Coupons are guaranteed (gone concern principle). |
| | Junior subordinated (eg AT1 / preferred shares) | Ba1 | Most junior part within the debt hierarchy. AT1 debt is issued as going concern capital which means that coupons may be cancelled or reduced if capital and profit requirement are not met and capital can be written off or converted to equities if needed. Such events would not necessarily constitute default. |
| | Common equity tier 1 (CET 1) | | Banks need to hold a minimum amount of CET 1 capital under bank capital adequacy requirements. |

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# Oil rebalances as gold glistens

Easing quarantine measures, improving sentiment and positive supply cut news bodes well for oil. Meanwhile, worrying geopolitical tensions, risks of another round of COVID-19 infections and low interest rates mean that prospects for the yellow metal appear bright.

Sentiment for oil and gold appears to be largely driven by the risks of more coronavirus outbreaks and prospects for a speedy economic recovery from the pandemic. With a vaccine seemingly at least a year away, what is the outlook for both commodities?

The West Texas Intermediate oil price continued its recovery in June, albeit at a slower pace from May, when it doubled. An amalgamation of continued and deeper than expected curbs to supply has supported the commodity. As has improved demand, notably from China and India.

## Supply cuts deepen

OPEC+, a group comprising members of the Organization of the Petroleum Exporting Countries (OPEC) and other leading oil producers such as Russia, is showing its commitment to abide by production cuts in an attempt to put a floor on prices.

On top of the unprecedented combined output cut of 10m barrels per day (mbpd) in May and June, three of the biggest OPEC+ producers (Saudi Arabia, Kuwait and the United Arab Emirates) announced that they would voluntarily cut supply by an additional 1.2mbpd. The group also agreed to defer increasing production to the tune of 2mbpd per month, providing further price support in July.

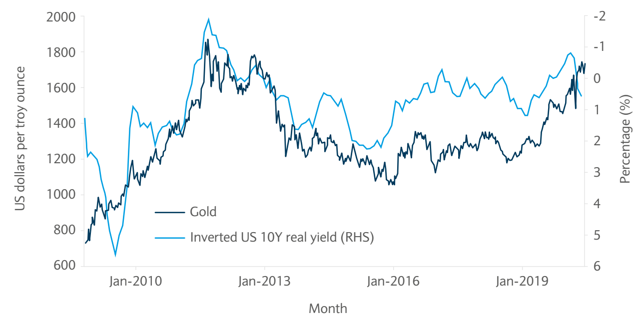
There have been questions around OPEC+'s commitment, as previous agreements have been only loosely implemented at times. However, there are signs that this time may be different. Data providers S&P Global Platts and Argus estimate that compliance for May and June among OPEC+ member countries stood at 85% and 90% respectively.

## Non-OPEC producers reduce production too

Whilst Iran is anticipated to lag production cuts, the group agreed for lagging members to offset production non-compliance in the third quarter. Driving compliance will undoubtedly be the fear of countries such as Saudi Arabia and Russia flexing their muscles and walking away from the table, leading to the price wars we saw previously.

**Getting real with gold**

The relationship between the gold price and the real yield on US 10-year treasuries (inverted) since 2010




Sources: Refinitiv Datastream/Barclays Private Bank

Other oil producers outside of OPEC+ have drastically reduced supply to reflect the deteriorating economics of the oil market. The International Energy Agency estimates that non-OPEC member countries cut production by 4.5mbpd in May.

## Recovering demand…

On the demand side, China continues to recover quickly. Customs data showed oil imports in May surging by 19% year on year (y/y). While part of this can be attributed to stockpiling, higher road congestion and conventional car sales suggests end-consumption also picked up. Despite measures to restrict movement in May, India's oil demand recovered to a 23% y/y decline versus a 46% y/y decline in April.

Better than expected economic data from the largest economy, America, is encouraging. With potential for further fiscal stimulus, demand could be further aided as the country increasingly resumes economic activity.

### …means balanced market in the next couple of months

With the recovery faster than expected in China and India, positive initial economic data from the US and most of Europe emerging from lockdown in the next couple of months, the outlook for demand is promising.

Despite those positive developments, the oil price is unlikely to rise as fast as it has since May. The initial strong rebound in demand is likely to hit a ceiling, as activities, like air travel, will take time to normalise. In addition, with prices climbing, there will be incentive for non-OPEC supply to return as OPEC+ starts cutting production less. Finally, inventory levels remain high. For those reasons, we expect oil prices to be range-bound in the near term and also note the uncertainty over a second wave in infections and a flare up in geopolitical tensions.

> "We expect oil prices to be range-bound in the near term"

### Long-term support for gold

Gold has continued to extend its rally from the March low and is up by 17% this year. There seem to be four compelling arguments for the gold price to ascend further over the next twelve months.

Firstly, expectations that interest rates globally will be lower for longer appears to be firmly entrenched. At the June Federal Reserve meeting, Chairman Jerome Powell said that the board were not even "thinking about thinking of raising interest rates", with no rate rises likely until 2022. Given that rates are the opportunity cost of holding gold, a zero-yielding asset, it bodes well for the commodity that real yields appear set to be supressed over the next few years.

Secondly, geopolitical tensions, which have been largely discounted in the backdrop of COVID-19 infections, have started to resurface. Fraught Brexit negotiations, nearing US presidential election and simmering US-China tensions could encourage risk-averse investors to stock up on gold ETF holdings in their portfolio.

> "Fraught Brexit negotiations, nearing US presidential election and simmering US-China tensions could encourage risk-averse investors to stock up on gold ETF holdings in their portfolio"

Third, unprecedented fiscal stimulus and record balance sheet expansions from major central banks could mean a subsequent recovery is accompanied with potentially higher inflation than markets are anticipating. Gold tends to provide somewhat of a hedge against inflationary pressures.

### Pandemic plays

Finally, the commodity could be well positioned whatever the pandemic's outcome. Any short-term underperformance resulting from a successful vaccine or drug for COVID-19 being found, as investors flee gold for riskier assets, could be offset by jewellery demand rebounding, especially in countries such as India and China.

By contrast, should a second wave of infections overwhelm countries' healthcare systems and dent confidence, gold may attract investors looking for safe havens to invest in. The risk of a second wave may be increasing, with more infections being seen in some German and US states and Beijing, the latter returning to strict lockdown.

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# Secondary market opportunity?

If the global financial crisis is a guide, deep valuation discounts and distressed sales sparked by the pandemic may be about to offer attractive opportunities in private markets.

The COVID-19 pandemic has triggered sharp, downward, repricing in public financial markets, while decisive fiscal and monetary stimulus has stabilised public markets for now. But the impact will also be felt in private markets.

We previously highlighted that the pandemic is likely to generate many investment opportunities in distressed debt. The secondary market is another segment which should benefit from the liquidity shock.

## Appealing characteristics

Secondary investing involves buying pre-existing investor commitments to private capital. A secondary investment mitigates some of the risks typically associated with private market investment. For example, secondary funds limit the "blind pool" effect as most of, if not all, the capital has already been called and invested. Also, because part of the capital has already been invested, the so-called J-Curve effect can be mitigated.

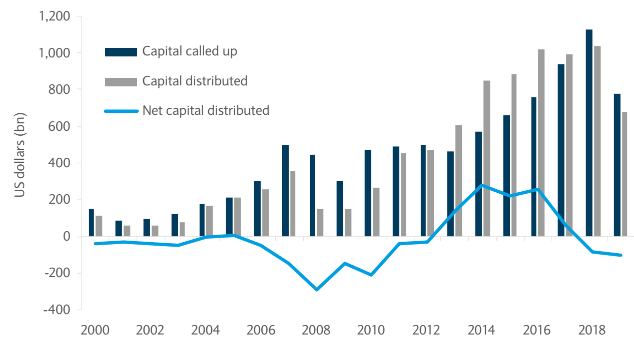
> "A secondary investment mitigates some of the risks typically associated with private market investment"

Secondary investment most often happens when the fund is close to breakeven, as distributions to investors start to match and even outpace capital calls. As such, the return on investment tends to be more certain than for primary fund investment and the duration might also be shorter. According to private markets researcher Prequin, only 1.6% of global secondary funds have historically returned less than the initial investment, rising to 20.4% for global buyout and venture capital ones. Finally, secondary private equity commitments are often available at a discount to their net asset value (NAV).

Those mitigating factors, compared to a traditional private market investment ("primary investments"), usually come at a cost. Despite the discount to NAV, returns,

**Net capital distributed deeply negative in 2008**

The trend in net capital distributed annually in private markets since 2000




Source: Preqin, Barclays Private Bank

as expressed as a multiple of the capital invested, are lower for secondaries as the investments are typically at more advanced stage than for a primary fund. But the COVID-19 crisis might provide attractive opportunities in the secondary market.

## How do secondaries behave in a crisis?

Every crisis is different. That said, lessons learnt from the global financial crisis in 2008 are likely to be relevant this time around. In 2008, the net capital distributed across private markets went deeply negative. According to data from Preqin, limited partners (LPs) had to collectively pay in around US$300bn that year (see chart).

Some of that capital was called to take advantage of attractive investment opportunities. However, most often general partners (GPs) needed the capital to shore up companies in their portfolio or pay back credit facilities. And with few exit opportunities, this resulted in a large negative net capital for LPs. After several years of positive net capital distribution, the current crisis is likely to result again in a deep negative net capital distribution for LPs.

For some investors caught off guard and with too much exposure, the need for liquidity might be exacerbated. The excessive use of leverage or aggressive over-commitments, notably in the most rewarding but also riskiest parts of private markets like venture capital or leverage buy-out, are the most likely reason to try and sell private market exposure. For those reason, the number of distressed sellers should increase and should result in opportunities in the secondary market.

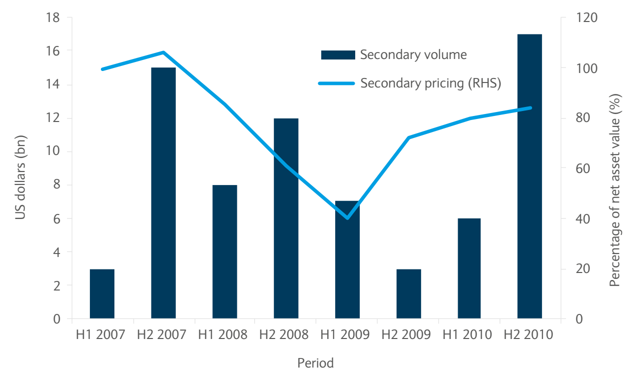
## A strong catalyst for secondaries

Using 2008-2009 as a template suggests that pricing should become attractive in the pandemic. At the height of the global financial crisis, in the first half of 2009, secondary pricing was as low as 40% of the NAV. Two years earlier, pricing was around NAV.

> "At the height of the global financial crisis…secondary pricing was as low as 40% of the NAV. Two years earlier, pricing was around NAV"

Distressed sellers under pressure to liquidate some position and gain liquidity are more likely to offer large discounts to encourage a sale. This is likely to occur again in the latest market shock. But equally, as in 2008-2009, transaction volume may fall in the short term. That said, private markets exposure in institutional portfolios has significantly increased over the last ten years, so the overall opportunity set may actually be bigger than it was in the global financial crisis.

**Are deep discounts in secondary pricing on way?**
The trend in secondary volumes and NAV discounts between 2007 and 2010 (such as during the global financial crisis)




Source: Greenhill Cogent

Transaction volumes are likely to be low until updated valuations are available to reflect how much asset values have been damaged by the crisis. As such, the secondary market is likely to see a surge mostly in 2021 and 2022. But if, as we believe, the aftermath of the global financial crisis is a good blueprint, pricing is likely to remain attractive for a couple of years in secondaries. While any discount might not be as steep as in the midst of the crisis, transactions would still take place at a much more attractive level than the historical average (see chart).

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# Greening the EU stimulus plan

As governments look to restart their economies, investors should be aware that many, like the EU, are seizing the opportunity to integrate climate change into these efforts.

Having reacted to the initial economic shock of the pandemic, governments are starting to look to sizeable fiscal responses to encourage economic recovery. Within this, some are seeking to achieve dual aims of stimulating new growth and delivering their nationally determined climate commitments.

In the May Market Perspectives, we argued that climate change, while less visible, was still a risk and opportunity for investors as well as wider society.

Here we highlight the recent "greener" stimulus approaches by the EU and European countries, which reveals the implication for investors from governmental interventions. As well, it is an indicator where other countries such as India, China or the US, with a presidential change, may go.

## Ambitious climate plans pre-date the pandemic

In December 2019, the European Commission (EC) unveiled the European Green Deal, laying out the blueprint for the bloc to achieve carbon neutrality by 2050.

As a set of policy initiatives, the overarching ambition is for Europe to become the first climate-neutral, industrialised continent in less than thirty years. Its primary method is to review each existing European law on its climate merits. As well, it calls on the EU bloc to restore biodiversity, cut pollution levels and boost the efficient use of resources by moving to a clean, circular economy. Overall, it has targeted to cut greenhouse gas emissions by 50-55% by 2030 compared with 1990 levels.

According to the European Environment Agency, the continent has reduced emissions by roughly a quarter since 1990. However positive this achievement, the results are not enough to put the EU on track to its net zero target by mid-century (see chart). The Green Deal was set out to bridge this gap encouraging more fundamental review of economic activity and disruptive innovation to accelerate decarbonisation.

## Stimulating new, less emission-intensive growth

Of course, the European Green Deal was laid out before the global pandemic. While the pause of most economic activity around the globe gave a glimpse of a less-polluted world, the need for employment and economic activity meant emissions would always rebound. However, rather than simply focus on general economic stimulus, many European governments and the EC have sought to use the crisis as an opportunity to enable their transition to a low-carbon economy.

In France an €8bn incentive programme for battery and electric vehicles has been introduced to help rescue the country's car industry. The underlying aim is to have one million French-made electric cars a year by 2025. Meanwhile, Air France has been asked to cut domestic flights and agree to target becoming the world's "most environmentally friendly" airline, to satisfy the conditions of its government bailout.

Similar initiatives have been put in place in Germany, where subsidies for electric cars of around €2.2bn were announced and carmakers along their suppliers were promised €2bn to aid research and development. Financial aid to Lufthansa has also been tied to environmental goals resulting in the reduction of the national airline's access to free landing slots at major German airports.

## Clean energy

In the clean-energy sector, the German government has also approved its 2030 National Energy and Climate Plan (NECP) and adopted a new National Hydrogen Strategy – both critical in shaping the EU green recovery. The NECP aims for 65% renewable electricity and 30% renewable energy by 2030, while the Hydrogen Strategy aims to make Germany the "global number one" for renewable hydrogen applications and production. To this end the Hydrogen Strategy provides €7bn to ramp up domestic production and related value chains. It also includes €2bn to establish international partnerships, supporting developing countries to scale up their renewable energy capacities.

More widely, the French president, Emmanuel Macron, and German chancellor, Angela Merkel, proposed an EU budget increase of €500bn to fund the Green Deal. This includes proposals to establish a recovery roadmap for each industrial sector and to increase the EU's 2030 reductions target for greenhouse gas emissions. It also takes a significant step in outlining how the region should achieve a more sustainable future in the long run.

Thereafter, the EC launched a €750bn Next Generation EU fund on 27 May, aimed at helping Europe's recovery from the COVID-19 crisis. The proposed fund plans to do so "not only by supporting the recovery but also by investing in our future: The European Green Deal and digitalization," said EC President Ursula von der Leyen.

## Green recovery, green opportunities

While these initiatives do not mean all Green Deal activity continues as initially planned, they demonstrate political willingness not to forgo the climate agenda in the midst of economic recession.

For investors, delving into the Green Deal and associated stimulus packages highlights potential climate risks from policy changes or attractive investment sectors that enable decarbonisation goals. Among the major initiatives in promoting clean-energy technologies, the EC plans to:

- Renovate buildings and infrastructure to increase energy efficiency and build out a more circular economy
- Roll-out more renewable energy projects, especially wind, solar and clean hydrogen energy
- Promote cleaner transport and logistics, including the installation of one million charging points for electric vehicles and a boost for rail travel and clean mobility
- Strengthening the Just Transition Fund to support re-skilling of displaced workers and helping businesses create new economic opportunities.

## Digging deeper

Then, looking a bit more deeply, investors can identify further sub-sectors and priority areas of note. For example, within the recovery plan, building renovation priority will go first to public sector buildings, especially hospitals and schools, social housing and other low-income dwellings. To further support renovation, the Commission aims to revise its relevant state aid rules by next year, to "provide an enabling framework for public authorities to support high-quality renovation".

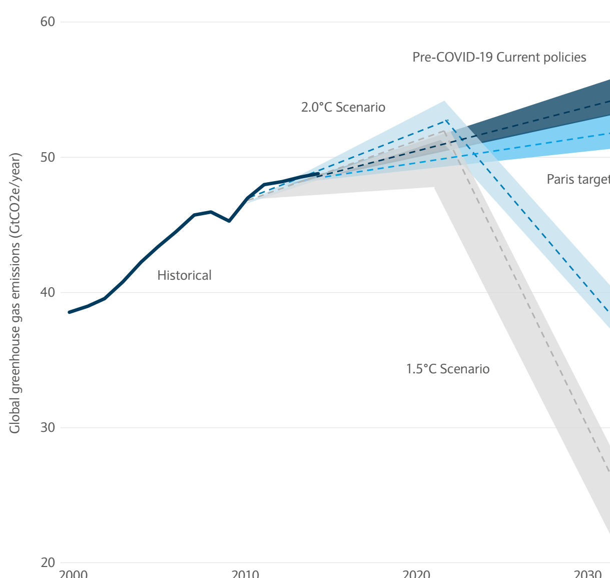
This should be a warning to potential real estate investors of policy risk that would require investment to retrofit buildings to climate resilient standards. Or, alternatively, there will be attractive opportunities in the energy efficiency field given its critical role to deliver the building targets.

## Building back better

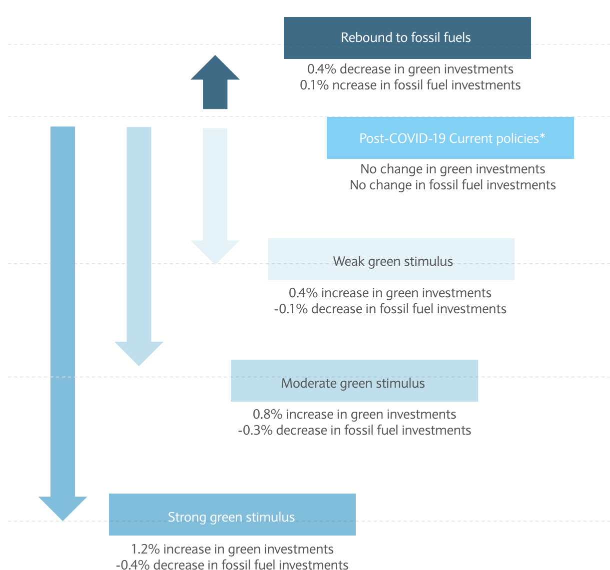
Despite some of the headwinds to Europe's Green Deal and arguments it could do more, the approach of the EC and European countries appears to show the benefits of placing the green agenda at the heart of a region's stimulus.

Not only does it provide support for economic recovery in response to the pandemic; it also shifts economic output to lower carbon intensity in response to the climate breakdown. Clearly a win-win for these countries. And for investors who can position their portfolios effectively, it is an opportunity for the same.

**Pre COVID-19 pandemic**
December 2019 Climate Action Tracker update




**Post COVID-19 response impact** on emissions in 2030 from policy + sustained investment 2020 - 2030




Source: Climate Action Tracker, *Calculated on different basis compared to Pre-COVID method and excludes any announcement of economic recovery measures to date

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# Striking a balance

Are you a trader or an investor? We examine the differences between the trader and investor mindsets, and how striking the right balance between the two may help to maximise long-term investment returns.

Market participants continue to assess the full extent of the potential implications of the pandemic on economies and financial markets. There was a surge of buying in June into a small pocket of the market in companies recently filing for chapter 11 bankruptcy protection. This was partly driven by novice investors signing up to commission-free trading platforms, seemingly chasing large short-term gains. What might be regarded as day traders.

Given the high risk of participating in such markets, where moves are driven by factors other than company and economic fundamentals, this behaviour is more akin to speculating as opposed to investing. While trading and investing are sometimes used interchangeably, they are very different approaches. That said, we explore why a mix of both approaches might be worthwhile for a disciplined investor.

### Tale of two mindsets: the trader

While trading and investing both seek to make financial returns, trading focuses on short-term profits, whereas investing generally aims to provide long-term gains.

> "While trading and investing both seek to make financial returns, trading focuses on short-term profits, whereas investing generally aims to provide long-term gains"

The trading mindset typically involves looking for short-term opportunities, which may be created by changes in economic data and stock market sentiment. This may involve continually evaluating the incentives offered in different parts of the market relative to a range of plausible eventualities.

For example, in the midst of a sell-off, a trader may feel that the market is too bothered by the negative possible scenarios instead of having a more balanced view of the potential outcomes. A trader may add exposure to stock markets, seeking to prosper from a market reversal once sentiment improves.

### The investor

An investor, on the other hand, may view success in protecting and growing their assets over the long term as being determined by asset allocation and the quality of the assets in that allocation.

The above allocation is generally based on a view of how different investments are likely to perform over the longer term. The approach is built on the premise that a well-diversified portfolio that aims to weather the full range of market conditions can provide an investor with a higher chance of success than trying to avoid the next downturn.

The investor tends to be less focused on short-term events and news flow, which while leading to short-term movements, may not be material to a diversified portfolio held for the long term. As discussed in May's Market Perspectives, a portfolio diversified across asset classes, geographies and sectors, is unlikely to fully experience the impacts of headline market moves.

### The costs of doing too much

While the investor and trader approaches have the potential to create financial gains, in markets, as in all aspects of life, there can be too much of a good thing.

An over-reliance on a trading approach can create risks. Firstly, not every market call will go to plan. Indeed, markets can behave very differently to how we may expect, based on the headlines. Secondly, a trading mindset can introduce behavioural biases into the decision-making process, which while not always visible to the trader, can be a drag on returns.

### The disposition effect

One behavioural bias is the disposition effect – the tendency to hold on to assets that have fallen in value, and sell those that have risen in value. This is usually driven

by not wanting to realise losses while wanting to realise wins. It is motivated by the pain of losses, which has been shown to have twice as large an impact on us than equally sized gains.

The larger number of decisions being taken, over short periods of time, introduces more decision-making points and can increase the likelihood of biases. Behavioural studies show that investors who hold common stocks directly pay a significant penalty for active trading. Overconfidence is often cited to explain high trading levels and the resulting poor performance of some investors. Due to a tendency for people to act in fairly systematic ways, behavioural biases can be exploited by other market participants.

### The costs of doing too little

In his annual letter to Berkshire Hathaway to shareholders in 1996, Warren Buffett remarked that "Our portfolio shows little change: We continue to make more money when snoring than when active. Inactivity strikes us as intelligent behaviour."

While a focus on the long term may protect an investor from the risks associated with making short-term market calls, giving less weight to short-term signals can also create risks. Missing out on potential additional returns from seeking to capitalise on short-term moves may seem like small percentages, however these can compound. Over time, they may have far more significant cumulative impacts on portfolio returns than initially thought.

As asset values change, so asset allocation can shift considerably from what was originally planned by the investor. A buy and hold portfolio can then become less diverse over time on its own, and that is before the potential opportunities for diversification that may be missed.

> "A trading mindset can introduce behavioural biases into the decision-making process, which while not always visible to the trader, can be a drag on returns"

### Striking the right balance

One of the best ways to increase the likelihood of success when investing is to follow a robust process which strikes the right balance between long term thinking to generate the core investment returns, and the more reactive and opportunistic short term tweaks to allocations to maximise overall returns. As well as robust asset allocation, a strong investment process will involve reviewing and selecting the best fund managers for a mix of investment styles, and the right mix of quality funds and securities to most efficiently and effectively implement the allocation views.

A robust investment process creating a diversified portfolio for the long term and investing in quality assets should make it easier to stay invested and reap the benefits of time in the market. It can help an investor to protect themselves from behavioural risks in what may be volatile and unnerving market conditions.

A particularly volatile period in an uncertain, post-pandemic, world may create potential market dislocations. Most likely providing opportunities for active managers to capitalise on. By additionally monitoring current investments with the changing economic and market conditions, portfolio risk can be managed. Additional opportunities to enhance the risk return profile can also be capitalised on, creating the best of both worlds.

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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 coming in from extremely wide levels in April, 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 increasing risk facing EM 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. 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.

Spreads are now above their 10-year average, notwithstanding volatility in the short to medium term as a result of COVID-19. We remain neutral on the asset class as we expect more spread volatility.

## High yield bonds: neutral

Amid the market turmoil, spreads 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 pandemic.

The economic effects of the coronavirus outbreak have significantly increased the risk of default in coming months. That risk increases the longer quarantine measures continue, subduing output. 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 position. 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 increasing risk facing the respective economies and currencies.

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 infection numbers 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) 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 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, 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.

Nevertheless, emerging markets 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 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, 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.

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