Private Bank

Market Perspectives

June 2020

Foreword

Financial markets have continued to recover from March's sell-off as the daily number of COVID-19 infections and deaths in Europe fall and on optimism of finding a vaccine. In this edition, we take stock of the impact of the pandemic on the asset classes we cover.

The increasing geopolitical tensions around the world seem to have been largely ignored. Intensifying spats between the US and China raise risks around their "phase-one" trade accord. That said, an all-out trade war looks unlikely. With an American election due and Brexit trade deal negotiations rumbling on, volatility is likely to remain elevated.

The COVID-19 crisis is likely to reshape trends in equities. For one, the threat of a pandemic might be taken more seriously, probably increasing the risk premium for the asset class. Dividend payouts may be out, as mounting debt piles are more frowned on. However, quality stocks, especially technology and healthcare, should be the winners. If nothing else, diversification seems key.

The spectre of negative interest rates is haunting bond markets as the UK Treasury issued negative-yielding debt for the first time. With Brexit uncertainty on the horizon too, they cannot be ruled out. Meanwhile, in the US the rates curve suggests rates will remain positive, at least in the short term.

More supply cuts and better demand, as quarantining is eased in China, helped the oil price to recover ground in May. That said, oil is likely to be rangebound in the near term due to large inventories. Meanwhile, gold remains popular. Rising geopolitical risks and the chance of a second wave of COVID-19 infections mean that the price looks set to climb further.

COVID-19 seems set to stoke more interest in sustainable investments. Sustainable-focused equity funds saw strong inflows in the first quarter of the year, while outperforming equities. And sustainable bond supply hit a record last year. Companies with business models that address sustainability trends, such as moves to a low-carbon economy and artificial intelligence, stand to do well.

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Tensions nearing breaking point?

Financial markets have largely ignored rising geopolitical tensions involving the world's leading economies. Will the tensions boil over and leave the global economy set to suffer the consequences of more fragmented trading relationships?

The devastating impact of COVID-19, and the associated ratcheting up of geopolitical tensions, is likely to create an uncomfortable backdrop for investors for the rest of the year and into next.

Coming into this year we always felt confrontational international relations could infringe upon global growth prospects. The social and economic consequences of the pandemic may magnify existing fault lines, and permanently shift trade trends and transnational cooperation.

Financial markets seem to be focusing on three major areas of tension: the US-China trading relationship, the cohesiveness of the European Union (EU) and the conclusion of Britain's transition out of the EU.

US-China relations heat up

Fear of an aggressive trade war between the US and China undermined sentiment for much of 2019. The escalating measures proposed by the world's two largest economies challenged decades of rising international trade that helped to power growth.

Just as last year was drawing to a close, President Donald Trump surprised analysts by announcing that the US and China had agreed to an initial "phase-one" trade deal. In a collective sigh of relief, economists raised their growth forecasts and investors pushed equities to record highs.

The deal was always going to be vulnerable to this being a US election year, adding to uncertainty for financial markets. The devastating medical and economic ramifications of the COVID-19 outbreak have once again played on tensions between America and China, questioning the stability of the agreement.

The pandemic's disruption means that it is very unlikely that the latter superpower will meet its commitments to buy US products at the start of the year, further souring the relationship.

> "The social and economic consequences of the pandemic may magnify existing fault lines and permanently shift trade trends and transnational cooperation"

Donald Trump became increasingly vocal about China's response to the outbreak in May. He announced measures including breaking off trade ties, restrictions on investment flows and modifying supply chains.

In addition, the Senate passed legislation that may prohibit the trading of foreign equity issues on American exchanges if the Public Company Accounting Oversight Board is denied access to historical financial data. However, this move does not "ban" Chinese stocks from trading in the US.

The blame game is just starting and may further heat up in the coming months. Meaningful measures and initiatives are being announced by both countries in the skirmishes. But for now, a full-blown trade war looks unlikely.

Europe: united future or fragmentation?

In order for the European project to work, greater levels of integration and cooperation are required. It is all the more important for member states to consider the collective good in times of economic dislocation.

In the early days of the coronavirus, European leaders focused on stability and stimulus at a national level. This country-centric approach risked alienating weaker members, which have less fiscal ammunition available to limit the impact of the pandemic on their economies. This has led to increased concerns that the EU could begin to fragment.

However, in an unexpected uniting gesture, the German chancellor, Angela Merkel, and French president, Emmanuel Macron, announced a joint proposal for the bloc's recovery. The two leaders suggested setting up a €750bn recovery fund as part of the next EU long-term budget,

to be disbursed as direct grants to sectors and regions most impacted by the crisis. The scheme would be financed by direct borrowings by the European Commission from markets and repaid via a long-term binding repayment plan.

The plan includes proposals to establish a green recovery roadmap for each industrial sector and increase the EU's 2030 target for greenhouse gas emissions reductions. It also takes a significant step in outlining the future of the EU in the long run. The plan suggests a review of competition rules to create "European champions", signalling a geopolitical commitment to a more interventionist industrial policy.

The plan still needs to get approval from other member states and there is a good chance that it could be radically amended. That said, it still represents a significant step change, particularly for Germany, which has previously rejected the notion of nations sharing debt.

"The plan [European recovery fund]…represents a significant step change, particularly for Germany, which has previously rejected the notion of nations sharing debt"

Fraught Brexit negotiations

Boris Johnson's Conservatives came to power in December pledging to "Get Brexit Done". Britain officially left the European Union on 31 January and formally entered a transition period.

The pandemic has understandably reduced the focus on the trade negotiations. The third round of talks on the future relationship between the UK and EU concluded last week. Key areas of contention include "level playing field" commitments, the governance of the agreement and cooperation in criminal and judicial matters.

One of the biggest issues which still requires resolving is the so-called Northern Ireland Protocol. The protocol aims to avoid a hard border on the island of Ireland but is being interpreted in different ways. The UK fears that the arrangement may be an infringement on its sovereignty and a risk to the integrity of the Union. The EU is concerned about the issue of single market integrity.

Extension to the transition period

The UK government continues to rule out requesting an extension to the transition period that is due to end on 31 December. The British prime minister seems to believe that extending the talks would simply prolong the negotiations and create even more uncertainty.

Under the Withdrawal Agreement, any extension needs to be agreed by 1 July. If no settlement can be reached, then the UK will start to trade with the EU under World Trade Organization rules come 2021.

There continues to be speculation about what might happen towards the end of the year. There is the possibility of a short technical 'implementation' extension if an agreement hasn't been reached in time. But, with only one round of negotiations left before the high-level stocktaking meeting in June, the risk of a potential stalemate before the summer is clearly increasing.

Economic pragmatism should prevail

Rising geopolitical tensions may clog up the arteries of global trade, so reducing growth prospects. The hope is that economic pragmatism will eventually prevail. However, in the world of international diplomacy, nothing should be taken for granted.

"The hope is that economic pragmatism will eventually prevail. However…nothing should be taken for granted"

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When tomorrow comes

As quarantine measures ease and economies restart, shaping a post-COVID-19 world can start. Many industries may be scarred for good, but "quality" companies look set to outperform and trade at a premium.

A fascinating feature of the effect of the coronavirus pandemic is the way that equities seemed to have dismissed 2020 and looked to 2021.

In the eyes of most investors, tomorrow will be different but, according to the bottom-up consensus, earnings won't. Consensus points to earnings recouping all they are expected to lose this year in 2021.

This implies either a return to a semblance of pre-pandemic normality — likely requiring a vaccine — or a way to recuperate lost ground despite social distancing and other COVID-19-related challenges. Seeing any of this materialise in the very short term appears unlikely, in our opinion.

Short-term memory bias

Over the medium term though, we can envisage a few changes. The financial crisis of 2008 left many wondering what the next bubble to pop would be. This time, pandemics are likely to feature in several investors' biggest risks list.

"This time, pandemics are likely to feature in several investors' biggest risks list"

Yet, risk of another global health crisis on the scale of COVID-19 in the near future is low, statistically speaking. Indeed, as a society, we are probably better prepared to tackle one now than was the case this time. However, short-term memory bias — assuming that what has just happened will occur again — will likely translate into a higher risk premium for equities. While hard to gauge, this could cap company valuations for the time being, at least in some sectors.

Lower returns ahead

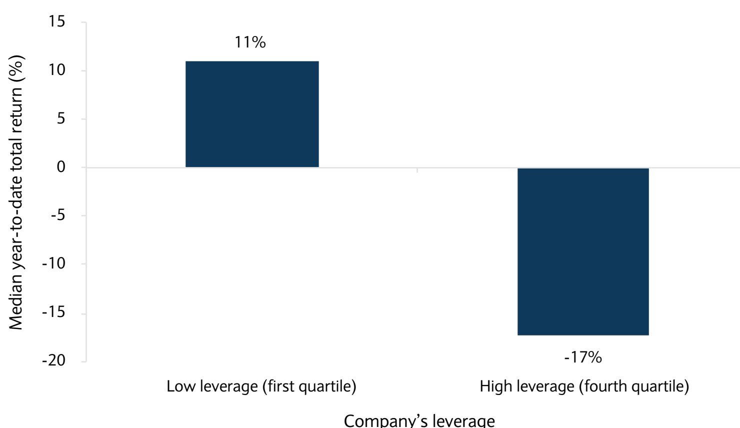
In a world where low interest rates have enabled most companies to thrive, the COVID-19 crisis has exposed some weaknesses that had been underappreciated. First and foremost, leverage is likely to be a renewed focus of interest for investors.

In recent years companies have often been penalised for not increasing debt-to-equity levels enough to take advantage of widely available, and cheap, funding. Balance sheet strength will likely be a bigger priority for investors now.

"In a world where low interest rates have enabled most companies to thrive, the COVID-19 crisis has exposed some weaknesses that had been underappreciated"

High-leverage companies have underperformed

The chart shows median year-to-date total returns for companies in the highest quartile, by leverage, have underperformed those in the lowest quartile this year so far



Sources: HOLT, Barclays Private Bank. 25 May 2020

Note: Leverage is measured using HOLT's definition as a percentage of current market capitalization. The universe comprises all companies covered by HOLT in developped markets, excluding financials and regulated utilities, and with a current market capitalization >$10bn.

For companies this means a possible reversal of the recent trend by which debt was used to compensate equity holders and support share prices. Moreover, shareholders may be asked to support bondholders with more equity-to-debt swaps likely. There would be clear repercussions for company returns, both in the form of lower dividends and share buybacks. Furthermore, depressed return on equity could then weigh on valuations.

Growth and selectivity to fore

In the space of four months, COVID-19 has accelerated many trends like never before. Retail space, for example, has been under growing pressure from online rivals for years. In February, before the epidemic took off in America, online shopping in the US outsold general merchandise for the first time. With most stores forced to close during lockdown, the dominance of online has been reinforced, transforming a long-term process into an existential threat almost overnight.

The same forces mean that the need for office space may be permanently impaired, global supply chains may be more at risk and spending on healthcare could ramp up exponentially. As a result, some business models now appear challenged, while others seem ideally positioned to profit.

From an investment perspective, we can draw two conclusions. First, it is likely that the premium commanded by companies with "future-proof" business models will keep expanding and so growth is likely to outperform value over the long term. Second, selectivity (or active management) can help position portfolios well for what might lie ahead.

Stick with quality and diversify

A post-COVID-19 world is likely to be a place where aggregate equity valuations are capped. However, increasing disparities are likely at the company level between the haves and the have-nots.

It's likely to be a world where quality, earnings visibility and balance sheet strength are sought-after attributes. Shareholder returns, in the form of buybacks and dividends, may also take a backseat. Finally, it's a world where additional risks, such as mounting debt burdens, possible return of inflation or government involvement in some businesses, may need to be taken into account and diversified away.

"A post-COVID-19 world is likely to be a place where aggregate equity valuations are capped. However, increasing disparities are likely at the company level between the haves and the have-nots"

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Navigating bonds post pandemic

More sub-zero yielding bonds, debt and fallen angels. Navigating the bond world beyond COVID-19 will likely put risk management, selection and diversification at a premium.

Will UK rates turn negative?

The UK Treasury issued £3.75bn of July 2023 of gilts at a yield of -0.003%, the first sub-zero rated issue, on 20 May. Will negative yielding bonds, as seen in much of Europe, become a common feature in the sterling bond market? This very much depends on the scale and length of the COVID-19 crisis and preferred response of the Bank of England (BOE).

For now, two to four-year gilts have a sub-zero yield and are pricing in a slight possibility of a negative base rate in the future. The pricing was spurred by recent comments from BOE members, such as governor Andrew Bailey. He said that “we do not rule things out as a matter of principle”. Additionally, deputy governor Dave Ramsden thinks that it would be “perfectly reasonable to have an open mind”, when it comes to negative rates.

Potential drawbacks

While the headline inflation rate is only 0.8%, the prospect of record unemployment rates and a slump in retail sales could justify further rate cuts.

That said, the central bank is aware of the possible drawbacks of negative rates, such as the detrimental effects on savings and bank profitability. For instance, lower rates have only partly been passed on to households so far, with mortgage rates being sticky. The European Central Bank had also failed to revive inflation using negative rates even before the pandemic.

A rate cut to 0%, or lower, in the existing term-funding scheme and additional quantitative easing (QE) seem to be likely options. However, negative rate policy could be revisited and should not be ruled out given the additional uncertainty around Brexit.

The Fed can’t control everything

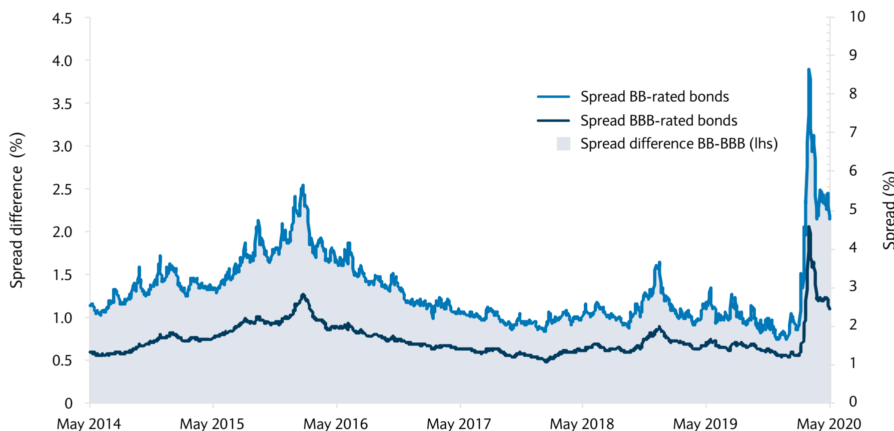
Negative rate policy is being debated much in the US. But the rate curve, compared to the UK, has a relatively normal slope that does not suggest sub-zero rates in the short term. While US Federal Reserve (Fed) governor Jerome Powell has not ruled out negative rates, he seems more averse to them. He recently said that they are “probably not an appropriate or useful policy” and that the effectiveness of negative rates is “very mixed”.

The Fed has bought roughly $2tn of US treasuries and mortgage-backed securities in the last two months through its quantitative easing programme. While the pace will likely slow, aggressive bond buying will remain a preferred tool. As a further step, the central bank could introduce “forward guidance” or even more active yield-curve control at various points of the curve.

Since the significant drop in the US ten-year rates in March, yields have started to increase, to above 0.8%, in the latest move. Market participants are trying to calibrate the risk between the low, or even negative, rates induced by a recession and the risk of

Spread between BBB and BB-rated bonds spikes

The chart shows that the spread between yields on BBB and BB-rated bonds has widened significantly since February



Source: Bloomberg

significant rate rises resulting from the vast amount of US government debt issuance. This year the debt deficit is expected to rise to approximately $4tn and remain at over $2tn next year.

US bond demand is dead, long live US bond buyers

The debt deficit has so far been covered by the issuance of shorter dated treasury bills. The composition of the bonds will soon likely include longer maturities that have been underpinned by the recent US 20-year treasury issuance. Will demand keep up with the large supply?

The Fed has already decreased momentum and will taper at some point. However, demand should stay elevated among institutional investors (locking in yields), central banks (managing currency) and households (higher saving rates).

A relatively steep curve may be a likely scenario result further out. But disinflationary (lower trending inflation), or even deflationary (falling prices), risk will likely dominate in the foreseeable future. Even if US output returned rapidly to around 90% of pre-crisis levels, the recession would still be much worse than seen during the financial crisis in 2008. While the bond market may play a role in a reflationary scenario, yields will likely stay low over the medium term.

Reassessing BBB bonds

Investment grade bonds with medium to longer maturities seem reasonable alternatives to government bonds in this environment. But given record debt levels and the lack of cash flow to maintain the servicing of debt, the risk of downgrades has increased significantly. Selection will be key.

Considering BBB-rated bonds in order to achieve higher yields is usually a sensible option for investment-grade debt in a low-growth environment. However, at a time of no growth or contracting output, this strategy may need reassessing. Net debt of almost three-times operating earnings has been seen in the segment and interest coverage ratios are likely to implode when earnings decline.

Rating agencies are trying to look "through the cycle" and refrain from immediate rating actions. That said, this does not prevent large-scale downgrades should average credit measures deteriorate. S&P Global Ratings reckons that $385bn of non-financial corporate bonds in the US and Europe, the Middle East and Africa are at risk of being downgraded to non-investment grade status. Two years after the 2008 crisis, 20% of BBB bonds had been downgraded to junk.

Beware downgrade risk

This time around the amount of BBB-rated bonds in issue is four times as high as in 2008. When trying to identify potential fallen angel pool (bonds downgraded from investment grade to high yield) investors should first screen for BBB-rated bonds (with a negative outlook in particular) and those trading already like BB-rated and split-rated bonds (where they are rated high yield by one agency and different rating by another). In these three buckets, risk of downgrade is particularly high (see chart) and investment grade mandated portfolios should be aware of the elevated downgrade risk.

"The amount of BBB-rated bonds in issue is four times as high as in 2008"

Price action (or higher yield spreads) is usually pre-empting rating action. In the wider US investment grade index, of over 3,000 bonds, around 230 bonds are already trading wider than 480 basis points, the average of BB-rated bonds. Rating unconstrained and more actively run mandates can take advantage of respective pricing. As always, selection is key. Investment grade constrained mandates will need to adapt for the new world and act even more prudently than in normal times when considering BBB-rated bonds.

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Rise of sustainable bonds

The COVID-19 pandemic will likely lead to a stronger focus on bonds of companies with sustainable strategies and business models. That said, for investors using ESG considerations, ensure coupons and capital repayments are based on a solid foundation.

There was a record supply of green bonds in 2019, lifting their overall stock to over $500bn, not considering those denominated in local emerging market currencies. The overall demand for sustainable investments accelerated too. ESG focused exchanged-traded funds and mutual funds, in both equities and fixed income, saw inflows of over $20bn in 2019, four times as much as the previous years, according to investment researcher Morningstar.

Post COVID-19 era

Issuance of green bonds has been subdued of late. In March 2020 global green issuance was at $3.3bn, down from $16bn in February. Many companies have focused on securing funding for the whole business rather than a specific area, like environmental projects. Besides, stricter budget constraints have been needed, while green bonds usually fund new expansion capital expenditure (capex) plans. But this situation is likely to change once corporates have their contingency plans in place.

The recent pick up in issuance of green bonds confirms the above trend, with issuance in April and May of $16.9bn and $14.6bn respectively. According to the Climate Bond Initiative (CBI), total issuance volume is expected to be $350bn this year, compared to $257.6bn last year. While the number seems ambitious a rising trend of issuance seems very likely.

Pandemic crisis effect

Most governments globally have plans in place that aim for a sustainable recovery. During the recent virtual Petersberg Climate Dialogue, International Monetary Fund head Kristalina Georgieva emphasised this: “If this recovery is to be sustainable—if our world is to become more resilient—we must do everything in our power to promote a “green recovery”.

This was echoed by many leaders including the UN Secretary General, António Guterres. He said that the “recovery from the pandemic offers an opportunity to steer our world on a more sustainable and inclusive path”.

Europe plans to mobilise €1.1tn in the next decade for sustainable investments through its European Green Deal Investment Plan, which is part of the broader “Green Deal”. In addition, Europe has launched a new stimulus programme worth €750bn in response to the COVID-19 crisis, separate from the latter initiative. To access the funds, member states must demonstrate that investments will be in line with the Green Deal.

Sustainability redefined

The pandemic crisis has prompted a broader definition of what can be considered social and sustainable investments. Most recently, the International Capital Market Association refined its sustainable funding definition: “Eligible social projects can include for example COVID-19-related expenditures to increase capacity and efficiency in provisioning healthcare services and equipment, medical research”.

While sovereigns must manage funding discrimination, companies which commit to ESG targets are likely to find it easier to find funding support. This should provide institutional investors with more confidence to invest in the respective issuers.

Can green bonds outperform?

While the green and sustainable bonds markets are more than 10 years old, its popularity has only accelerated in the last few years. This makes it difficult to analyse their performance.

The Bloomberg Barclays MSCI Global Green Bond index has outperformed its conventional counterpart by 2% in excess returns (over comparable sovereign bonds) since 2015. That said, the composition of both indices varies in duration and sectors.

It remains to be seen if green bonds in isolation will automatically lead to outperformance. Green bonds are “use of proceed” bonds and are not secured against any assets. Bond holders are effectively exposed to the same credit risk like holders of a conventional bond of the respective issuer. While increased demand may potentially lead to some price premium in the short term, the expected larger supply may ultimately equalise this.

Funding sustainable projects has its place in the bonds world

Green, social and sustainability bonds are a proven way to fund specific environmental or social projects. Sovereign and supranational aid will likely continue to focus on dedicated projects and the respective funding. However, time will tell if investors accept that a company can "earmark" a specific "green" or "sustainable" capex investment while its company strategy does not achieve high ESG standards.

Broader ESG consideration likely to gain in importance

An increasing number of investors are taking a responsible investment approach to successfully identify higher-quality bonds. In part, this includes using non-financial data or scores on the environmental, social and governance (ESG) practices of the issuers to inform their investment decision-making. The negative correlation between credit spreads and ESG scores seems to support this trend.

Investors can use a variety of ESG related bond indices, like the Bloomberg Barclays MSCI ESG Sustainability Index. These indices are designed to positively screen issuers from existing Bloomberg Barclays Fixed Income Indexes based on MSCI ESG Ratings, which are an assessment of how well an issuer manages ESG risks relative to its industry peer group.

"An increasing number of investors are taking a responsible investment approach to successfully identify higher-quality bonds"

Type of bond	Feature
General	All bonds are conventional bonds which are priced and traded in the same way as any other comparable conventional bond.
Green and social bond	At least 95% of the proceeds must be earmarked for environmental (green bonds) projects or social (social bonds) projects, which is often tracked by ongoing reporting by the issuer. The bondholder is exposed to the credit risk of the issuer and has no prioritised pledge over any assets.
Sustainability bond	Bonds where the proceeds are exclusively applied to finance or refinance a combination of green and social projects.
Sustainability linked bonds or ESG linked bonds	General corporate purpose issuance that incentivises a borrowers' commitment to sustainability with coupon or interest rate tied to key performance indicator(s) (KPI) or face a punitive jump in interest payments (eg +25 basis points). These indicators could be tied to 1) achieving a specific ESG rating, or 2) sustainability-related KPI (eg percentage of company's clean energy used), or meeting targets for one or multiple of the UN's seventeen SDGs.
Sustainable development goal (SDG) linked bond	Bonds where the issuer has pledged to meet targets for one or many of the UN's seventeen sustainable development goals or face a punitive jump in interest payments.

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Assessing sustainable investing's outperformance

In the face of a pandemic, the case for sustainable investing has been reinforced with its increase in popularity and performance in a period of extreme volatility.

Before the pandemic, sustainable investing was often seen as an innovative approach that was becoming more visible and used by investors. Since this year's elevated volatility and economic uncertainty set in, sustainable strategies' popularity has accelerated and widespread outperformance in the first quarter has been seen relative to traditional equity indices.

It's critical to acknowledge that the concept of sustainable investing varies considerably in meaning, messages and motivations. While the lack of consistency and language and labels used can be confusing, the underlying premise is simple.

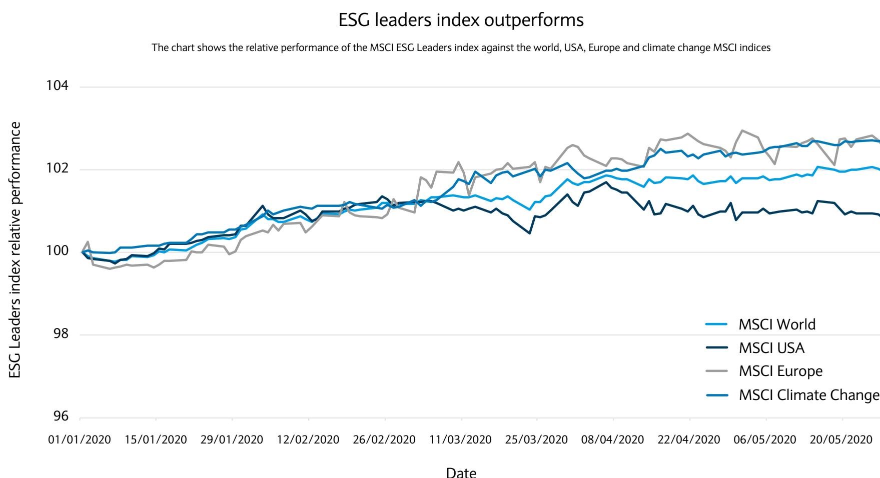
Investment decisions should factor in the impact of how companies operate and of the goods and services they produce. This can be valuable both financially, to protect and grow capital, and to see how investors' capital makes a positive contribution to the world.

Encouraging start to the year

Among the unexpected consequences of COVID-19, the increased asset flows and performance of sustainable investments, most obvious in listed financial markets, may be one of the few positives.

As the pandemic disrupted markets at the start of the year, investors allocated $45.6bn to sustainable-focused funds in the first three months of the year, according to investment researcher Morningstar. This, during the same period, when global outflows reached $384.7bn for the overall fund universe.

At the same time, sustainable strategies broadly have outperformed during this period (see chart), even if they didn't always preserve wealth for investors.



Source: Bloomberg, MSCI, Barclays

Peer analysis

As a starting point, Morningstar analysis found that 51 of 57 sustainable indexes, or 89%, outperformed their broad market equivalents. Separate analysis found that the performance of 70% of sustainable equity funds was in the top half of their respective Morningstar categories.

> "Sustainable investing… on balance, simply performed better than traditional investing during the first three months of the year"

Furthermore, BlackRock research found 94% of a globally-representative selection of widely-analysed sustainable indices outperformed their parent benchmarks during the first quarter of 2020.

Naively some might assume these investment strategies were simply underweight the energy sector to achieve this relative performance. While some environmentally focused funds benefited from this difference, most are sector-neutral. Sustainable investing, practiced across sectors, industries and asset classes, on

balance, simply performed better than traditional investing during the first three months of the year.

Dispelling the underperformance myth

Underlying the increased capital inflows and favourable investment returns seen this year is something else — a growing realisation of the value of sustainable strategies.

Generally, one argument for sustainable investing has been that companies with more effective operating practices would perform better in the long run. Academic evidence supports these assertions. Industry testing had further demonstrated that companies with better sustainability practices tend to have a lower cost of capital, higher profitability and lower exposure to unexpected and extreme risks (or tail risk). Yet a general suspicion has lingered about whether considering impact compromises financial performance.

Supported during pandemic

Additionally, the argument for sustainable investing extended to bear markets. There is a belief that companies with more flexible production, human capital practices and corporate governance will navigate these periods better than peers.

The challenge has been sustainable investing has broadly emerged following the last financial crisis, with a clear acceleration only in the last three to five years. So the recent downturn is the first opportunity to trial these views in practice and at scale. As the above evidence indicates, sustainable strategies have performed in line with these arguments.

Of course, the usual caveats for performance must be acknowledged. Not all sustainable funds have outperformed their peers. The time period under review is not conclusive, and may not reflect future ones. Not all sustainable investors use the same approach or have the same skill. Taking these, and others, into account, sustainable strategies have successfully withstood this initial test. Moreover, the relative outperformance of sustainable strategies further refutes the myth of underperformance relative to traditional ones.

> "The relative outperformance of sustainable strategies further refutes the myth of underperformance relative to traditional ones"

Sustainability informed selection driving performance

When delving into performance, the benefit can be attributed to selection of companies with better sustainability practices and forward-looking opportunities. Investors who have gleaned insight from non-financial to inform their decisions have been better able to identify more resilient and effective companies during the crisis. Primarily, they have begun to effectively use environmental, social, and governance (ESG) data and ratings to inform their decision-making.

While environmental issues have tended to be the primary interest, the pandemic has brought focus to social issues as a key operational issue. The majority of companies effectively managing the health and safety of their workers, supply chains and labour relations seem to be performing better financially. As well, they are earning recognition and reputational benefits that will serve them after we overcome this pandemic.

Looking ahead

Sustainable investors are looking within and beyond the crisis to identify structural trends that may offer attractive investment opportunities. In the following decade, meaningful areas of interest for long-term investors might include the transition to a low-carbon economy, enabling technology (artificial intelligence, 5G, the internet of things), demographic shifts, "conscious consumerism" and the more effective health and living practices.

Companies with business models and products/services addressing these structural topics are positioned for long-term growth. Sustainable investors are benefiting from identifying these companies as the ones relevant for, and accelerating the move to, the next economic cycle.

The growth in sustainable investing is likely to be reinforced through, and after, the pandemic. Companies are increasingly likely to be judged on their response and treatment of all stakeholders. Fiscal stimulus packages look set to include support for green and social initiatives as the proposed "Next Generation EU" plan demonstrates. Forthcoming regulation will ensure more attention and transparency around companies' climate and social actions.

In the end, the short-term performance and flow figures from the start of the downturn can't be seen as conclusive. However, they indicate the seeming growing belief in the benefit of sustainable investing and a long-term change in how we invest.

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Taking the plunge

As lockdowns ease and social and economic activity resumes, many may have missed the strong bounce seen in financial markets. Many may still be scarred by March's sell-off and cautious about investing again. What can such investors do to comfort themselves that long-term investing still makes sense?

Governments have begun to ease lockdown restrictions, allowing more of life and the economy to slowly restart. Meanwhile, financial markets have recovered strongly from the lows reached in March in anticipation of the easing and hopes of a vaccine.

While most people will be keen to return to many activities, investing their capital may, understandably, not be top of that list. With continued uncertainty around the pandemic and its consequences, including the impact on asset values, investors have understandable cause to hesitate.

The risks of doing nothing

Most investors will have heard the adage that it is "time in the market" and not "timing the market" that matters for long-term returns. But this can be easier said than done in the face of uncertainty. Investing always carries some level of risk. Without it, the reward would likely be meagre.

For individuals and families fearing being invested in markets, this article reviews the consequences of waiting. Furthermore, it looks at how to overcome some of the behavioural hurdles to investing during troubled times and take the plunge.

Providing more comfort

Investing is an emotional business at the best of times. Doing so when markets are crashing can be frightening. Sitting on the side lines may feel safer. More than that, waiting for a lower entry point may intuitively make sense – why pay more for something now if the price is expected to fall further? However, what happens if the expected downside scenarios don't occur or portfolio returns are not as bad as anticipated? The cost of not being invested can be considerable.

While we may not be conscious of it, waiting to take action is an active decision to forego the potential returns from investing, in favour of an alternative. Holding more cash is a common decision for many. However, doing so can reduce wealth, when the effects of inflation are taken into account. Especially over a protracted period. In turn, holding too much cash may jeopardise meeting an investor's long-term goals.

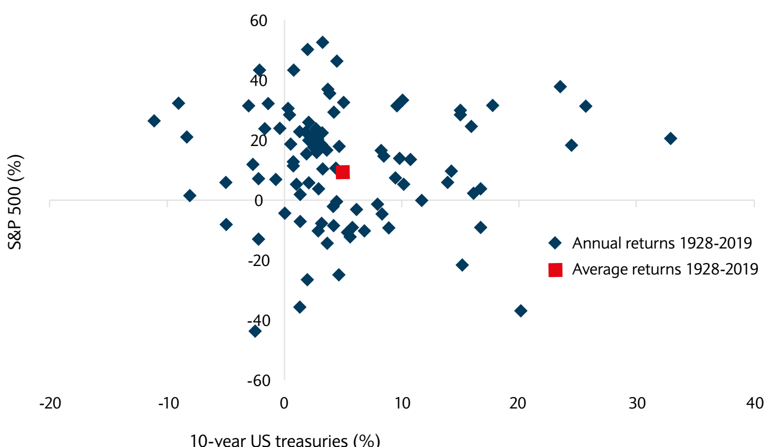
Waiting for lower entry points also requires a degree of accuracy to predict drawdowns and the bottom of a downturn that only hindsight can provide. Phasing in investments gradually over time, can ease the discomfort of buying securities when markets are particularly volatile. Furthermore, purchasing an investment along with a hedging instrument, can reduce investment risk and provide more emotional comfort.

Have a plan

Some investors may be willing to re-enter the market but only at the "right" level. This generally means waiting for markets to fall further. However, falls can affect our perception of risk and decision-making abilities.

Average annual returns are dispersed

The chart shows the average annual returns for the S&P 500 and US 10-year treasury bonds between 1928 and 2019



Source: Federal Reserve Bank of St Louis, Barclays

In the aftermath of market sell-offs, investing can suddenly feel challenging. The aversion to doing something that we later regret can lead us to refrain from taking action. To overcome this bias, the first step is to establish what you think is an asset's right value and discuss the pros and cons of this view with a trusted financial advisor. Then commit to a clear plan outlining the actions that should be taken. Delegating the execution can help to avoid some concerns.

The plan might include different eventualities, to add further emotional comfort. For example, setting rules and timelines for getting invested. Another approach may be to use a structured product that fits your views of the market. This acts as a useful commitment mechanism, by ensuring, ahead of time, that buying or selling of an investment happens at pre-defined levels.

Don't wait for a typical year

Other investors may prefer to wait for a more normal year to continue with their investment activity. But what is a typical year in investing? While 2020 is highly unusual, not least due to the pandemic, every passing year is different from the previous one.

Investors often refer to historical averages and performance returns. An average year comprises, by definition, both good and bad periods. The reality is that almost no single year will deliver each asset classes' average returns.

By expecting a consistent return, an investor may be setting themselves up for an emotional roller coaster. Better than the average makes them feel happy, lower makes them sad. However, investors seeking to preserve and grow their capital aren't investing in only year-long increments, but over many periods.

The long and the short of it

US annual equity and bond returns since 1928 are highly dispersed, with only a few annual returns that are close to the long-run average (see chart on page 14).

By judging and making investment decisions based on a given year can mean missing out on reaching the long-term average returns. Over a longer period, the dispersion of returns falls and become closer to the average (see chart below).

To overcome short-term biases, investors should regularly review their long-term goals and objectives. By keeping a long-term perspective, investors may be more comfortable investing when they know that the evidence is far stronger for long-term averages.

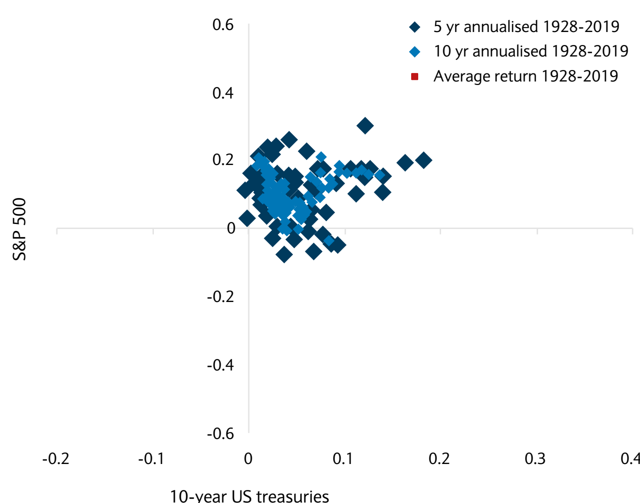
Additionally, we know the best and worst performing asset classes tend to change year to year. Being invested in a diversified portfolio, further increases the likelihood of meeting investment needs.

Investing discipline

Good investing discipline involves being cognisant of, and planning for, individual behavioural tendencies. Thinking long term and diversifying a portfolio reduces its volatility. By extension, the emotional toll that investing in challenging periods induces can impair decision-making. Talking through any concerns with an advisor, and planning around them, should improve the likelihood of investors staying invested and targeting long-term expected returns.

Average five-year and ten-year returns less dispersed

The chart shows the average five-year and ten-year returns for the S&P 500 and US 10-year treasury bonds between 1928 and 2019



Source: Federal Reserve Bank of St Louis, Barclays

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Rangebound oil but gold still shining

As quarantine measures are eased and sentiment improves, 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 look encouraging.

The West Texas Intermediate oil price almost doubled in May, continuing its recovery. A combination of deeper than expected supply cuts from oil producers and better than expected demand, notably from China, aided sentiment towards the commodity.

Sharp supply cut and stronger demand …

OPEC+, a group comprising members of the Organization of the Petroleum Exporting Countries (OPEC) and other leading oil producers such as Russia, had agreed to cut their combined output by almost 10m barrels per day (bpd) in May and June. While unprecedented in magnitude, the move only partially compensated for a fall in demand that topped 20m barrels a day at the peak of the crisis in April.

There have been questions around OPEC+'s commitment as previous agreements have been at times only loosely implemented. Saudi Arabia usually compensated for smaller countries producing more than their quota in such circumstances.

But this time is different. It seems that the most important producers within OPEC+ are complying with the cuts, notably Russia. In addition, the three biggest OPEC+ producers (Saudi Arabia, Kuwait and the United Arab Emirates) also announced that they would voluntarily cut by an additional 1.2m bpd. And while the self-imposed restriction was supposed to be eased to 8m bpd starting in July, there are now talks about keeping the current production level for another few months.

…means balanced market soon

Other oil producers outside of OPEC+ have drastically reduced supply to reflect the deteriorating economics of the oil market. The International Energy Agency reports that supply from outside the alliance was already 3m bpd lower than at the start of the year. The latest trend of rigs in operation, suggests that US production has fallen further (see chart).

With the recovery faster than expected in China, and most of Europe emerging from lockdown in the next couple of months, demand will continue to increase. But despite those positive developments, the oil price is unlikely to continue to rise as fast as it did in May, as large inventories still need to be reduced. We expect it to be rangebound in the near term.

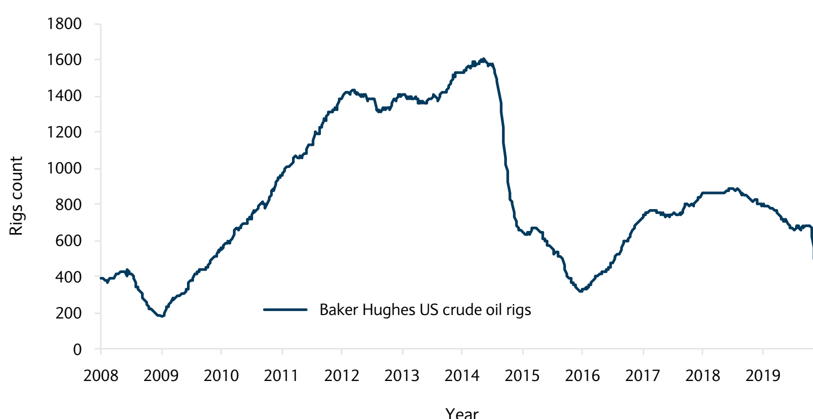
Long-term support for gold

Gold has rallied by 15% from the lows reached in March. We continue to see compelling arguments for the gold price to move higher over the next 12 months.

Positive news on the science of fighting the pandemic, such as a successful vaccine or a drug treatment, might trigger weakness in the short term, as investors flee gold for riskier assets. We believe that geopolitical tensions, chance of another wave of COVID-19 infections, record balance sheet expansions from major central banks and risk of higher inflation all back higher gold prices in the long term.

Contracting rigs count suggests a sharp fall in US oil production

The chart shows the trend in the number of operational US oil rigs since 2008



Source: Baker Hughes

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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 a challenging macro environment and uncertain geopolitical shifts, we retain our preference for higher quality, liquid opportunities – which translates into our positioning in short duration bonds.

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

Fixed income: neutral

We see moderate risk-return opportunities in fixed income given the current market dynamics. Although sovereign rates are less attractive in the context of low yields, they offer protection in very weak economic environments. For this reason, we maintain a small overweight in developed market government bonds.

In credit, the higher quality segment appeals. While spreads are starting to look interesting on an absolute basis, we prefer to allocate our risk budget in the equity space. Within the high yielding space, selection is key. High yield and emerging market (EM) hard currency debt appears more attractive than emerging market (EM) local currency debt, considering the increasing risk facing the EM economy and currencies.

Developed market government bonds: high conviction

Developed market government bonds 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 continues to deteriorate, we see the asset class as a diversifier and maintained a small overweight holding.

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 pandemic 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 when managing portfolio risk.

Investment grade bonds: neutral

While spreads compressed recently, the premiums remain higher than at the start of the year. Despite supportive central banks, the risk of a sudden spike in downgrades has increased. While higher spread may offer opportunities, selection will be key.

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

Given spreads are now above their 10 – year average, we see room for spread compression, but notwithstanding volatility in the short to medium term as a result of COVID-19. We remain neutral on the asset class as we expect spread volatility to increase.

High yield bonds: neutral

Amid the market turmoil, spreads have widened to historically elevated levels, if falling somewhat of late. 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 impact of the coronavirus and the collapse in the oil price has significantly increased the risk of default in coming months. That risk increases, the longer the shutdown continues. However, at current levels spreads likely over-compensate for the eventual default risk.

Considering wide spreads and high yield bond returns, by historical standards, potential returns appeared attractive enough to increase our position in the asset class twice in April. This closed a long-held large underweight in the asset class.

Emerging market bonds: low conviction

We prefer emerging market (EM) hard currency debt over EM local currency debt, considering the increasing risk facing EM economies and currencies.

Although corporate fundamentals are now less robust and default rates are gradually rising, the majority of central banks in emerging economies have helped issuers through more accommodative monetary policies. With COVID-19 starting to affect the economies and currencies, we were more cautious on EM local currency debt.

Despite downside risks from geopolitical issues, we maintain our neutral position 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) is expected to outperform 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 supportive when a recovery takes hold.

Most importantly, we favour active management and selective stock picking of companies with strong balance sheets. We focus on businesses with high cash returns on capital, with conservative capital structures and ideally an ability to reinvest cash in future growth at equally high rates of return. The US tends to offer us more opportunities to invest in these kind of businesses meaning that North America remains the largest geographical weighting within the equity allocation.

Emerging market equities: neutral

Emerging markets have suffered from country specific risks, a strong US dollar and slowdown in the region, particularly in China after the COVID-19 outbreak.

Nevertheless, they should benefit from the benign rate environment. We maintain a neutral position to the asset class.

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

Other assets: neutral

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.

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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