Private Bank

Market Perspectives

March 2020

BARCLAYS

Foreword

The growing spread of the coronavirus outbreak is the main driver of financial markets for now. Sizeable falls and heightened volatility have been see in most asset classes. There remains little clarity on the likely effect on global output of the outbreak. That said, a deep global recession looks unlikely at this stage.

The coronavirus epidemic has added to the downward pressure on elevated consensus earnings expectations for 2020. We believe that global earnings will, at best, grow by mid-single digits this year. However, opportunities to add value remain and having a diversified portfolio is key.

In the fixed income world, the rise in volatility has seen a rush to bonds and pushed US 10-year treasuries to a record low. In turn, with the US Federal Reserve cutting interest rates by 50 basis points, central banks are expected to keep rates lower for longer in the wake of the economic effect of the coronavirus.

In contrast to substantial moves in commodity markets, especially gold and oil prices, private markets have been little affected by the reaction to the virus. Short of a severe recession they should continue to perform well, highlighting the attractions of diversifying portfolios with exposure to private markets.

In the rush to place more emphasis on sustainability in investment strategies, green bonds are increasingly popular. Yields and spreads on the bonds compare favourably with conventional ones. With more regulators promoting such financing and a growing, wide base of investors and issuers, green bonds appear here to stay.

Finally, one of the biggest factors facing investors in a move to a low carbon world is identifying the transition risk in their portfolios. Oil producers and other high-carbon emitters are clearly most exposed, but so are many others to some degree. As climate change-related risk grows, so the potential transition risks mount.

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The private markets hedge

The outbreak of the coronavirus and its potential drag on growth has hit many asset classes, most notably oil. Meanwhile, private markets have been largely unscathed. With more periods of elevated volatility likely this year, exposure to private markets may help limit the impact of such turbulence on portfolios.

Alternative assets are probably reacting most to the expanding coronavirus epidemic. Indeed, at one end of the spectrum there is commodities, a globalised, short-term driven asset class, while at the other end private market investments are unaffected by this, relatively short-term, disruption.

Oil and gold's diverging reaction

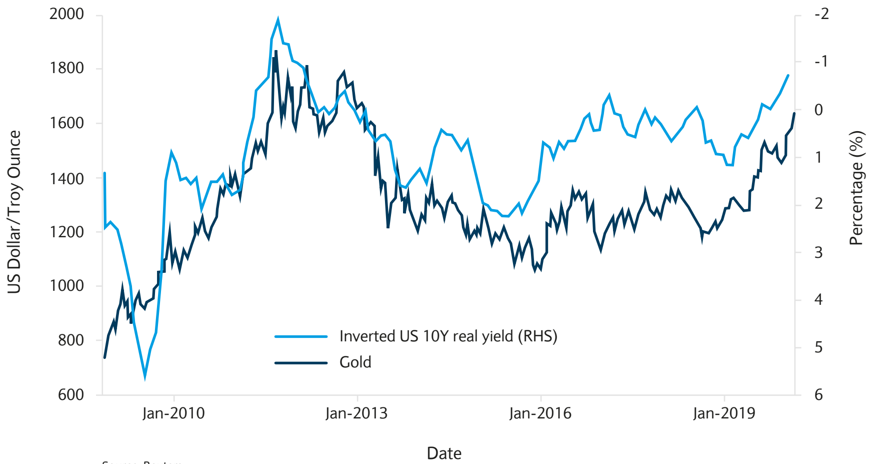
Commodity assets have diverged of late between those exposed to growth and precious metals. The oil market remains very exposed to any growth scare. The balance between supply and demand for oil is fragile at the moment. While tensions in the Middle East in January pushed prices higher as the market worried about reduced supply, the coronavirus outbreak has seen China's demand for the commodity plunge. As China is the largest buyer of oil in the world, this explains the large fall in oil prices in the last few weeks.

Contrary to other financial markets like equities or bonds, the oil price reflects the true supply and demand situation for the underlying commodity at any point in time. It does not trade on anticipation of more fiscal stimulus or monetary easing.

In the short-term, we do not expect prices to rebound strongly. But with fiscal stimulus being announced by various governments and the Organisation of Petroleum Exporting Countries and allied producers (known as OPEC+) potentially reducing output in the short term, the oil market is set to be back in balance later in the year.

The opportunity cost of holding gold falls

The chart shows that the gold price has closely tracked moves in US 10-year bond yields over the last decade, so that when yields fall, the gold price rises and vice versa. As yields fall, so does the opportunity cost of holding a non-yielding asset like the yellow metal



Source: Reuters

We pointed out in our Outlook 2020, in November, that gold should offer welcome diversification in a portfolio context in case of uncertainty affecting financial markets. While the oil market has suffered from the coronavirus outbreak, gold benefited from the uncertainty the virus created in regards to economic growth. The fall in US real yields also helped push gold prices higher. We continue to like the commodity as a strategic diversification in a portfolio, adding protection against uncertainty and geopolitical risks.

But little impact on private markets

The current episode of market stress illustrates the benefit of also adding private investment into a portfolio. Public markets are experiencing heightened volatility as the economic impact of the coronavirus remains uncertain. Meanwhile, private markets are not affected to the same extent. Unless the economy descends into a severe recession, which we think is unlikely at that stage, private markets should continue to fare well.

The current environment might provide opportunities to find better-priced deals for funds with cash to deploy and if the situation deteriorates. For instance, there might be selective opportunities in distressed debt. But in general, periods of heightened volatility strengthen the case for taking a long-term view in a portfolio through an allocation to private markets.

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The UK budget: time to throw caution to the wind?

The UK budget in March may be a trailblazer in the shift towards more fiscal spending, and away from monetary policy, that is underway around the world. How much will the new chancellor flex his muscle?

After ten years of painful spending cuts and austerity, the budget on 11 March is set to provide some fiscal relief to an economy that, arguably, needs such support.

However, the size of fiscal injection, if rules will be put on spending pledges and where spending will occur, is uncertain.

Driving this uncertainty was originally Prime Minister Boris Johnson's February cabinet reshuffle and the departure of Sajid Javid as chancellor. Javid is a fiscal hawk whose desire for a strict rules-based approach to balancing the books appeared at odds with the prime minister.

Adding to the ambiguity has been the outburst of the coronavirus and its detrimental effect on financial markets. This could result in new chancellor Rishi Sunak arguing for more fiscal discretion given unusual circumstances.

Moderate discretion and delayed rules-based approach

Such an option is arguably justifiable in light of low interest rates, subdued inflation and a supply-side shock from Covid-19. Sunak can now use discretion to relax rules, such as ensuring the budget is balanced or in surplus, in five years' time as opposed to in three years.

However, this is a significant break from the norm and its necessity will be questioned given that the current budget as it stands is balanced.

Another option, which appears the most attractive in terms of satisfying the need for fiscal discipline and ensuring chancellor Sunak's independence, is to commit in areas affected by the virus and provide little elsewhere, with the opportunity to do so at the Autumn budget.

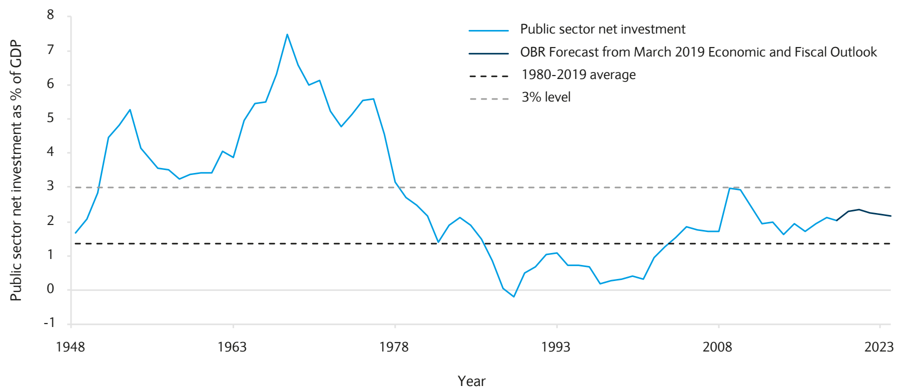
The budget usually happens in Autumn with the March budget this year a result of no Autumn budget last year. Assuming the current Brexit timetable, Sunak will have a much clearer idea of the type of post-Brexit relationship between the UK and European Union and the underlying momentum of the domestic and global economies. Not to mention a much clearer idea on containment of the virus.

Levelling up

While the size of fiscal stimulus remains open to question, an end to austerity for now is reason to cheer and is likely to have a material impact on the UK economy. This will be especially so if the government invests in areas with the highest gross domestic product multipliers, such as spending on health (almost inevitable given the outbreak) and police and investment in public construction focused on "levelling up" disadvantaged regions.

Much needed public sector investment appears to be on the way

The chart shows UK public sector net investment as a percentage of gross domestic product (GDP) since 1948, with the Office of Budget Responsibility's forecast for 2019-23. This is compared with the average level of this measure in the period 1980 to 2019 and Sajid Javid's rule of not spending more than 3% of GDP on infrastructure



Source: Office for Budget Responsibility, Barclays Private Bank

Fiscal spending gains converts

In our Outlook 2020, we anticipated that there would likely be a move towards fiscal stimulus globally given that it has long been required and central banks are running out of room to support the economy. It has been a talking point in the world's largest economy, with the Democrat party announcing a $760bn infrastructure plan.

While any action will most likely follow the election and any bipartisan initiative may be smaller in scale, the topic of fiscal expenditure is here to stay.

As is potentially the case in the UK, the Covid-19 outbreak might be the catalyst for governments around the world to start spending more to support the economy. Hong Kong, Italy and China have already announced fiscal measures aimed at supporting their economy in the wake of the virus outbreak.

> "The Covid-19 outbreak might be the catalyst for governments around the world to start spending more to support the economy"

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Reality check

The spreading coronavirus outbreak has hit stretched equity valuations, after many markets hit new highs earlier in the year. With more volatility on the cards, where next for equities?

Equities have had a turbulent start to the year. After the impact of the coronavirus epidemic on growth expectations, US attack on Iran and start of the US election race, much has happened since we published Outlook 2020 in November. As such, it makes sense to take stock and reflect on the path forward.

Our message to clients in November's Outlook 2020 was that this would be a year of uncertainty and more modest returns across most asset classes. From an equity perspective, consensus earnings expectations looked too optimistic, even in a scenario where a "phase one" trade truce was soon signed. On valuations, we felt that multiples had limited room to expand given their already elevated level and the myriad risks remaining on the horizon.

Earnings revisions still negative

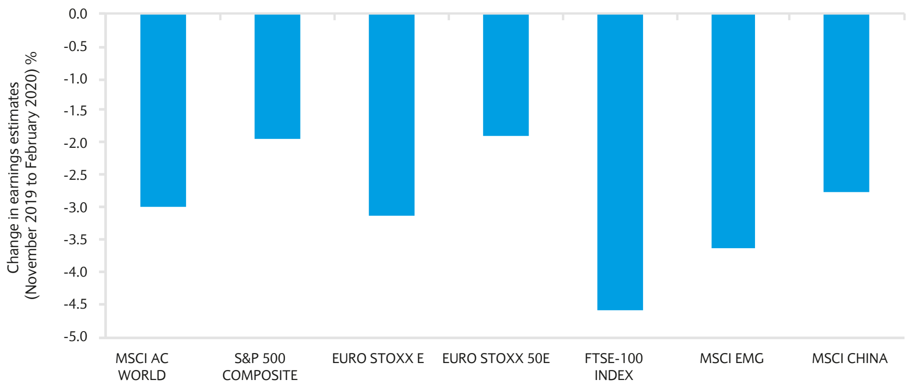
Recent developments reinforce our view that consensus earnings expectations appear too rosy. Depending on the index, 2020 earnings estimates are already 2-3% below their level in November (see graph below). The coronavirus outbreak, a mixed earnings season and lower oil prices all point to further downward pressure on consensus estimates. As such, we still believe that global earnings will, at best, grow by mid-single digits this year.

20x earnings in 2020, really?

The surprise at the beginning of the year came from stock valuations which continued to expand despite earnings expectations being cut. In the US, the forward price-to-earnings multiple for the S&P 500 index has flirted with 20-times (20x) earnings, something seen only during the dot-com bubble of two decades ago. Before the recent sell-off, global equities were 10% more expensive than their 20-year average valuation.

2020 earnings estimates head lower

The chart shows the change in earnings estimates, between November 2019 and February 2020, for equity market indices for the world, the US, Europe, UK, emerging markets and China



Sources: IBES, Barclays Private Bank. February 2020

We were puzzled: multiples typically don't expand this late in an economic cycle, especially when growth is unlikely to re-accelerate. Bulls would point to the low interest rate environment and central banks' support: There Is No Alternative ("TINA") to equities nowadays. We agree that, on a relative basis, stocks remain the most attractive asset class but, on fundamentals alone we could not justify prevailing valuations. Valuations seem more reasonable though, after the recent sell-off.

> "On a relative basis, stocks remain the most attractive asset class but, on fundamentals alone, we can't justify higher valuations"

Anatomy of a rally

Interestingly, the rally early this year felt forced. First, at a sector level, it was clear that investors are not banking on a sharp macroeconomic acceleration. In fact, defensive industries, those expected to perform better in a challenging environment, like utilities and healthcare, were leading the way. Meanwhile cyclical sectors, such as energy, materials or financials, have struggled to post positive returns recently.

Similarly, despite repeated calls for "value" to finally rebound and outperform "growth" assets, the higher quality sectors and stocks have continued to produce the best returns. We see no justification to alter our long-established bias toward quality, given the current backdrop.

Looking outside equity markets, most other asset classes send a cautious message: the US 10-year government bond yield has reached new historical lows while gold has touched a 7-year high.

The rally before the coronavirus wasn't reflective of the kind of euphoria seen in the late 1990s, in our opinion. Instead, it was more the result of central banks' action which, by pumping unprecedented amount of liquidity in the system, has pushed inflation away from the real economy and into financial markets. This environment may not be sustainable over the long term but, for the time being and as long as liquidity is plentiful, valuations should remain above their long-term average.

Adjusting our fair value estimate

At a price-to-earnings multiple of 18x earnings, corresponding to a one standard deviation from the historical mean, and based on mid-single digit earnings growth this year, we estimate the US S&P 500 index's fair value to be 3,300-3,400. This is 100 points or so higher than we penciled in last November.

The above change reflects an even lower interest rate environment, with the yield on the US 10-year government bond having dropped close to 80 basis points (bp) in the past four months and the US Federal Reserve announcing a 50 bp cut in interest rates to ease financial conditions following the coronavirus outbreak.

Despite this revision, equity markets' upside remains somewhat limited in our opinion. As such, we continue to focus on risk-adjusted returns and alpha generation.

An even stronger case for active management

When first initiated by various central banks across the world, quantitative easing was seen as the tide that would lift all boats. Eleven years into this bull market and the tide seems to have started to come in, with investors questioning the marginal impact of further stimulus. This change in perception has resulted in significant performance dispersion for equities at the regional, sector and stock level. We expect this trend to persist, creating a much more supportive environment for active managers.

Diversification remains key

In a highly uncertain world, we believe that diversification remains paramount to achieve long-term objectives. The first few months of 2020 have reinforced that some historical cross-asset classes relationships may not hold true anymore with, for example, both equities and gold reaching new or long-term highs respectively.

> "Historical cross-asset classes relationships may not hold true anymore"

From a portfolio perspective, we continue to like assets which offer diversification away from the traditional "60/40" equities and bonds portfolio. This includes commodities, of course, but also real and private assets as well as volatility, which we expect to remain elevated this year.

Bond yields and equities send different signals

The US 10-year government bond yield has fallen since January 2019 while the S&P 500 index has risen

Sources: Bloomberg, Barclays Private Bank. February 2020

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Back to the future

The demand for bonds seems unstoppable in an environment where yields are cursed to stay lower for longer. The bond market is diverse and offers opportunities to lock in yields.

Rates: how low can you go

The US 10-year bond flirted with a yield of 2% in December on the back of robust US economic data and reduced trade uncertainty. Fast forward less than three months and the prospects for higher yields seem all forgotten while the US 10-year and 30-year yields have reached record lows of around 1.03% and 1.60% respectively. The global growth concerns sparked by the escalating Covid-19 virus outbreak have intensified the downward move in rates.

The US Federal Reserve (Fed) responded with an emergency cut of 50 basis points (bp) and justified this as follows: "In light of these risks [the Covid-19 outbreak] and in support of achieving its maximum employment and price stability goals".

The Euro dollar future market is pricing in two more cuts over 12 months. The Fed clearly wanted to avoid a scenario whereby it is running behind market expectations as seen in 2019.

Given that only four 25bp cuts are left to hit the 0% mark, it is likely that the Fed will be prudent in using this ammunition. However, should inflation and inflation expectation remain below the central bank's 2% target, a further cut within the next 12 months should not be ruled out.

Twisting and turning yield curve

For a period of time after the Fed's 25bp cut in October, and subsequent rise in longer dated yields, the long-awaited normalisation of a steep yield curve seemed to have settled in again. However, the recent rate moves brought bond investors back to the harsh reality where the yield curve is inverted at least at the front end of the curve.

The "lower for longer" mantra persists as long as inflation, and inflation expectations, are not picking up towards or beyond the Fed's target. It remains to be seen if a new approach to define the inflation target will change inflation expectations. For now, investors are most sensitised to subdued inflation which will likely keep bond yields lower for longer.

Opportunities in investment grade and emerging market debt

It is not a surprise that as the "goldilocks" scenario persists, where growth is moderate while the risk for substantial higher rates is low, investment grade, emerging market and high yield bonds are performing well. But given the tighter valuations, investors need to be even more selective.

Investment grade bond spreads keep grinding tighter. While some BBB rated companies might see less of a problem from being downgraded to non-investment grade status, the majority of companies have successfully kept their ratings. Other companies have even been upgraded. We feel comfortable holding investment grade debt, but selection will be key.

Emerging market (EM) bond spreads have been remarkably resilient in the wake of the recent uncertainty. Apart from the Asian property sector, most names have held up well with EM bonds recording large weekly inflows, partly over $2bn recently.

> "EM bond spreads have been remarkably resilient"

While spreads on the EM USD hard currency index are below their historical norm (320bp), yield levels are low at 4.6% on average. The flow from riskier assets to safe-haven ones has seen a substantial widening of spreads in the high yield market.

In Europe as well as the US spreads have widened by more than 100bp. Furthermore, with the average yield for US high yield now at around 6%, risk may be better priced and the period of expensive valuations resolved.

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Is your portfolio ready for the low-carbon world?

With efforts to address climate change expected to accelerate, investors face the risk of their portfolios not being ready for the transition to a low-carbon economy.

Commitments made in 2015, and progress to them, as part of the Paris Agreement will be reviewed this year at the United Nations Climate Change Conference (known as COP26) in Glasgow. Already we know the current plans do not deliver the two degree centigrade commitment, let alone the 1.5 degree ambition. Furthermore, most countries are not on track to deliver them.

In February's Market Perspectives, we highlighted the physical effects and risks for investors, of not delivering on the above plans. With the increasingly visible physical effects of climate change, and growing public sentiment, countries and companies will be expected to take more action, and faster, to address climate change and reduce carbon emissions. This creates a corollary of transition risks, or the financial risks which could result from the process of adjusting to a low-carbon economy.

Transition risks

Transition risks are not as immediately visible as say a hurricane or moves in average temperatures. They are the more structural and systemic shifts that climate change, and efforts to address it, will have on companies and investors.

Given the potential financial risks, investors need to be increasingly aware and positioned for the implications of the actions taken to achieve climate targets. To help that process, we look at the transition risks that arise from moving towards a greener economy and strategies associated with climate change adaptation and mitigation.

> "Investors need to be increasingly aware and positioned for the implications of the actions taken to achieve climate targets"

Understanding the types of risk

Transition risks arise from the requirement to deliver climate targets and from the process of switching to a low-carbon economy. These are generally categorised as policy and legal, technology, market, and reputational risk. Let's review these in turn.

Policy and legal

Policy changes will either seek to constrain contributors to climate change or promote adapting to its effects. This can range from carbon-pricing mechanisms, emissions-reporting obligations, sustainable land-use practices, phasing out fossil fuel subsidies or encouraging greater energy-efficiency.

Companies that are not prepared for these changes, and fail to mitigate the impacts in a timely manner, face considerable policy risk. Those businesses that avoid or actively lobby against these changes may face potential litigation risks from consumers, investors and governments.

Market

Market risks are created with shifts in supply and demand for certain commodities, products and services. Like the fashion for reducing plastic bags and plastic straws usage, changes in customer behaviour can rapidly affect an industry's viability. Market risks may affect production costs, revenue mix or asset re-pricing.

Technology

Technological innovation is needed to address climate change. For companies, either development of or use of new technologies always comes with certain risks. R&D expenditure may not lead to results. Capital expenditure in the early industry leader may have to be written-off as lower cost technologies are developed.

More significantly, is the risk of not taking action to, for example change existing production to lower emissions options, which can generate greater cost and competitiveness risks.

Reputation

Finally, reputational risk stems from changing social perceptions of an organisation's contribution or detraction to climate change. Consumers are becoming more aware about the impact to the climate of various products.

Customers and communities are more likely to demand – in some cases through strikes or protests – more commitment to the transition to a low-carbon economy from companies. Fast changing social dynamics can be extremely damaging to a company's reputation and negatively affect their license to operate, attract talent, or profitability.

Financial implications of transition risks

The transition to a climate-resilient and low-carbon future carries both risks and opportunities that could unfold gradually or through sudden shocks. Transition risks tend to have a built-in lead time, allowing companies to plan and adjust. However, the frequency of abrupt shocks from physical risks, accelerated policy changes and sudden shifts in social expectations have recently increased.

Efforts to meet climate goals require far-reaching changes to the energy system, carbon-intensive industries and consumer behaviours. Almost all resource-intensive sectors (such as cement, glass and agrochemicals) will need to decarbonise. High-carbon sectors that fail to transition towards a low-carbon environment could end up with substantial stranded assets. While the potential value-at-risk posed by transition risks vary widely, markets have recently started to shun "polluting" industries towards more environmentally-friendly alternatives.

According to the G20 Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD), companies face a range impacts from transition risks. Examples of these are included on page 11.

How investors can respond

In the next few years, transition risk could increase significantly. Besides the implications of physical risks, investors also need to consider how the low-carbon transition could financially impact a variety of sectors and asset types held within their portfolios. There are several proactive practices that can improve investment judgement about climate risks and opportunities.

As no company is immune from climate risk – in one form or another – scenario analysis can be the first step in assessing a portfolios risk and opportunity exposure to transition risk. This step allows to forecast the financial impact of different climate scenarios (for instance, 2C versus 4C), and helps organisations and investors to better understand the climate transition over long term.

For strategic asset allocation, investors can assess the relative implications of climate scenarios on different geographies, asset classes and time horizons.

Assessing companies' footprint

For many investors, assessing a company's carbon footprint is also a technique in understanding the impact of certain investments and the relative climate risk due to carbon exposure. Even though carbon footprinting has some limitations (in say consistency and scope of data), by calculating the tonnes of atmospheric carbon dioxide equivalent per million dollars of revenue for an investment, the method facilitates decision making around de-risking.

Finally, investors should also assess whether organisations and their senior executives are actively planning for climate risk and addressing their environmental, social, and governance (ESG) footprints. This can be achieved through active engagement between parties and transparent disclosure of climate-related information beyond published reports and data – in line with the TCFD's recommendations.

Climate-change related risks can quickly add up to hundreds of billions of dollars globally. As the world accelerates its move towards a low-carbon economy, transition risks are rapidly becoming visible. The above methods enable companies and investors prepare accordingly: plan for a number of different scenarios, depending on the extent and impact of global climate change and build more climate-resilient portfolios.

> "As the world accelerates its move towards a low-carbon economy, transition risks are rapidly becoming visible"

Sector	Illustrative transition risks (Short- and long-term)	Potential impact on value chain
Agriculture, Food & Beverage	• Substitution of existing products and services with environmentally friendly products • Shifts in consumer preferences • Mandates on and regulation of existing products and services • Increased pricing of greenhouse gas (GHG) emissions • Costs to transition to lower emissions technology	• Costs to adopt/deploy new practices and processes (eg resulting in price volatility and altered growing conditions) • Disruptions to distribution network, farmers and labor force for raw materials • Reduced demand for goods and services due to shift in consumer preferences (eg increased consumption of alternative proteins) • Increased production costs due to changing input prices (eg energy, water) and output requirements (eg waste treatment)
Apparel	• Shifts in consumer preferences and stigmatisation of certain brands • Increased stakeholder concern or negative stakeholder feedback • Substitution of existing products and services with environmentally friendly products • Costs to transition to lower emissions technology/practices	• Increased production costs due to changing input prices (eg energy, water) and output requirements (eg waste treatment) • Costs to adopt/deploy new practices and processes that are environmentally friendly • Increased costs in supply chain and distribution network, including transport, warehouses, and stores • Shifting revenues (eg decreasing demand for not eco-friendly and sustainable brands)
Tourism	• Shifts in consumer preferences and stigmatization of certain travel methods • Increased pricing of GHG emissions • Mandates on and regulation of existing products and services • Costs to transition to lower emissions technology	• Aviation: restriction on flights, decreased demand for air travel • Transportation: restriction on polluting vehicles and transition to electric vehicles • Costs to adopt/deploy eco-friendly mass transit systems (eg railway, subway, trams) • Shift in travel destination (eg consumers avoiding polluted cities with bad air quality)
Insurance	• Uncertainty in market signals • Mandates on and regulation of different sectors and services • Increased pricing of GHG emissions • Changing customer behaviour	• Increased claims, losses, and liabilities • Difficulty in pricing climate-change related perils (eg new products to address physical climate risks) • Reduced availability and affordability of some types of insurance • Reduced value of investment portfolio
Electric Power	• Increased pricing of GHG emissions • Mandates on and regulation of existing products and services • Exposure to litigation • Stigmatisation of sector • Shifts in consumer preferences	• Costs to adopt/deploy new practices and processes (eg renewables, utility-scale wind and solar farms, nuclear power plants) • Decrease in use of coal-fired and gas-fired power plants • Shift in consumer preference (eg increased demand for near zero-energy buildings & homes) • Increased production costs due to changing input prices and output requirements (eg waste treatment)
Oil & Gas and Mining	• Increased pricing of GHG emissions • Mandates on and regulation of existing products and services • Exposure to litigation • Stigmatisation of sector and shifts in consumer preferences	• Costs to adopt/deploy new practices and processes • Disruptions to distribution network, pipelines and associated midstream infrastructure • Constrained production of resources/reserves • Constrained exploration, processing, refining, and site rehabilitation • Reduced value of investment portfolio

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The new bonds on the block

Green bonds and sustainable bonds have seen more investor focus and new initiatives by Europe and other regions combined with increased demand suggest that this is only the beginning. But how do the bonds compare with conventional debt?

The rise of green and sustainable bonds

Since the European Development Bank issued the first green/climate bond in 2007 the segment has witnessed significant growth. In 2019 approximately $260bn-equivalent of green bonds were issued, 51% more than in 2018. Europe was the largest contributor last year making up 45% of global issues followed by Asia and North America. The wave has recently reached the Middle East and Latin America after Saudi Arabia's Islamic Development Bank and Chile successfully launched green bonds.

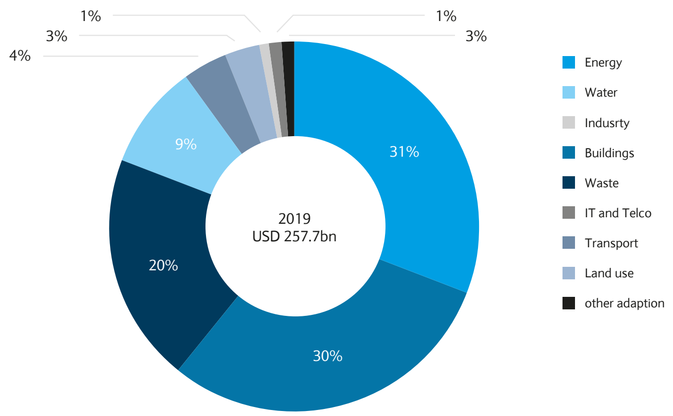
The European Central Bank and the European Commission have made large commitments to sustainable finance and the greater emphasis on these initiatives are being met with growing investor demand. With their increased emphasis on sustainability of investment strategies, private clients and family offices, sovereign wealth funds, and mutual funds will look for more supply of these assets.

Increased demand, more complexity

Combining traditional investment goals with impact goals has become an attractive proposition. In fact, both factors (return and impact) should have never been separated in the first place. While the estimated return (to maturity) of a green bond can be derived from the yield relatively easily, there are challenges when trying to measure the degree of the environmental or social impact.

Energy and buildings the most popular use of green bond proceeds in 2019

The chart shows the nine areas that proceeds from green bond issuance in 2019 was used for



Source: 2019 annual highlights, Climate Bond Initiative

Investors are faced with numerous definitions, different criteria and variations of impact and green bonds: ESG bonds, green bonds, social bonds, sustainability bonds or transition bonds are just a few examples. There is clearly still a need for greater transparency.

What makes a bond green?

"Green bond labelling" is not regulated at this point. Government bodies and associations have already helped to bring more standardisation to the market.

The Green bond principles (GBP) issued by ICMA (International Capital Market Association) in June 2018 or the launch of the new European Union (EU) taxonomy in December 2019 are good examples of the efforts being made. In addition, the bloc's Technical Expert Group on Sustainable Finance (TEG) proposed an EU Green Bond Standard (EU-GBS) which should contribute to further standardisation and increased transparency.

The GBP defines green, social and sustainability bonds as one where the proceeds will be exclusively applied to eligible environmental and/or social projects. At least 95% of the proceeds must be earmarked for such projects which is often tracked by ongoing reporting by the issuer.

The organisation also defines eligible projects using the taxonomy below as a foundation:

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems.

Creating standards builds trust

Issuers who wish to issue a green bond usually work with the respective syndicate bank using the framework of GBP or others. A second opinion provider, like Sustainalitics or Vigeo, subsequently can verify the green label.

Fifty shades of green

Investors still face various challenges as companies have a degree of freedom in the given frameworks and could use "green washing". For instance, the issuer could make misleading claims about the environmental profile of the project funded by the respective bond.

Additionally, investors might find themselves in a dilemma when a green bond is issued by a "not so green" or low ESG profile company. Issuers, like traditional energy companies, can use dedicated funding to accelerate the energy transition process but equally to "de-carbonize" their own production process. For instance, the energy used in order to explore oil. This might be in line with some investor's policy but not for all.

Do green bonds deliver superior returns?

Although there is no evidence that green bonds deliver superior returns compared to conventional bonds, there are some factors that should be considered. Yields or spread premium of bonds are similar to, and in some cases lower than, the yield or spread of conventional bonds. And this should not come as a surprise for the following reason:

While green bonds allocate funds to dedicated projects, the bonds are usually not secured against assets or revenue streams and the investor is ultimately exposed to the same credit risk as holders of conventional bonds. The marginally lower yield of green bonds is a result of the additional demand from dedicated responsible mandates and given the lack of choice of green bonds at this stage.

> "Yields or spread premium of [green] bonds are similar to, and in some cases lower than, the yield or spread of conventional bonds"

Responsible issuers should be less exposed

While the credit quality of green bonds relative to conventional ones is the same, issuers who issue green bonds often put a large emphasis on governance and sustainability when defining their overall company strategy. Such an approach should make any debt of respective issuers more resilient and less exposed to adverse scenarios in the long term.

Where can I find green bonds?

Apart from government-sponsored issuers like Fannie Mae or the European Investment Bank, green bonds are mostly concentrated in three sectors: utilities, bank and real estate investment trusts. But telecommunication or technology companies have been among prominent issuers recently using green bonds to fund energy efficient data centres or networks, for example. Meanwhile an increasing number of passive and active funds offer dedicated green or ESG bond strategies.

Green vs ESG-linked bonds

The green bond format is only one type of investment in this evolving market. Another format witnessing increasing investor attention recently are bonds linked to the quality of environmental, social or governance (ESG) practices of the corporation, sometimes called sustainability bonds. This type of bond includes a contingent step up in coupon (say 0.25%) should the respective issuer breach any pre-defined key performance indicator thresholds. These can include specific operating practices such as waste or emissions levels, or to an independent ESG rating for the issuer.

This seems like an attractive proposition for investors wanting to consider the overall ESG performance of an issuer rather than focusing only on one part of the company's activities. No matter which format will be established in the future it is already clear that investors, issuers and governments are embracing the initiative. After all its about conscious investment decisions.

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Multi-asset portfolio allocation

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

Cash and short duration bonds: high conviction

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

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

Fixed income: neutral

We see moderate risk-return opportunities in fixed income given the recent spread tightening and late-cycle dynamics. Although sovereign rates are less attractive in the context of a low yield backdrop, they offer true protection in very weak economic environments. For this reason, we maintain a small overweight in developed government bonds.

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

Developed government bonds: high conviction

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

- Although US dollar real rates remain at historically low levels, they are still too attractive to ignore relative to the other developed bond markets. UK and European bond markets have failed to synchronise with US rates due to their own geopolitical challenges. Furthermore, depressed yields make it difficult to find both markets attractive, apart from in respect of managing overall portfolio risk. It was for this reason that we made a small addition to the asset class at the beginning of the year.

Investment grade bonds: neutral

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

- Nevertheless, we remain neutral on the asset class as we expect spread volatility to increase in a late-cycle environment

- Although spreads have tightened significantly since the beginning of this year, we believe further tightening is limited and the asset class will continue to earn carry and so outperform low yielding government bonds, specifically in Europe.

High yield bonds: low conviction

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

- Even following the recent consolidation in riskier assets, high yield bonds look expensive. Spreads are tight by historical standards, which we do not view as attractive in the context of the credit and liquidity risk taken and the returns available from other asset classes. For this reason, we have reduced our exposure at the beginning of the year.

Emerging market bonds: neutral

- The Fed's dovish stance should continue to provide some relief to the largely dollar-denominated emerging markets (EM) debt
- Although downside risks from geopolitical issues provide a headwind to emerging market bonds, credit quality hasn't deteriorated and the economic momentum backdrop remains reasonably positive
- Spreads have tightened since the beginning of the year as investor flows reverted back into EM bonds amid improving sentiment. That said, spreads remain comparatively wide versus high yield bonds and offer a better risk-return profile, as well as opportunities for carry trades. We favour US dollar emerging market hard-currency bonds due to their relatively attractive valuations and therefore, have recently increased our holding in the asset class at the beginning of the year.

Equities: positive

Positioning in high-quality, growth companies through active management is our preference given our view that in late cycle, alpha (actively selecting superior businesses) outperforms beta (passively following the market). While we remain positive, we have modestly cut our positive view to reflect the growing risks to the 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

- Earnings growth is still expansionary, albeit slowing, with growth forecast to be low-to-mid single digits over the year. Healthy fundamentals continue to underpin the investment case for this asset class, while valuations are not excessively stretched compared to history. However, in light of the coronavirus pandemic, we acknowledge the short-term disruption and impact on earnings
- Increasingly accommodative central banks and fairly constructive macro data out of developed economies should continue to support the asset class, even though downside risks from geopolitical issues should limit the upside potential
- We favour active management and selective stock picking of companies with strong balance sheets, although we are agnostic on the geographical allocation of our equity positions. We focus on businesses with high cash returns on capital, with conservative capital structures and ideally an ability to reinvest cash in future growth at equally high rates of return. The US tends to offer us more opportunities to invest in these kind of businesses meaning that North America remains the largest geographical weighting within the equity allocation.

Emerging 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. Therefore, we maintain a neutral position to the asset class
- While markets have grown increasingly cautious, emerging market equities should benefit from attractive valuations. While we remain neutral, we increased our position in the asset class during the month after the virus-induced sell-off.

Other assets: neutral

Alternative asset classes will continue to provide diversification to our portfolio, but are not expected to be the main drivers of returns. Gold is set to benefit from its status as a safe haven in the late cycle, and for this reason we maintained our allocation to the asset class. Conversely, real estate and alternative trading strategies have 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 but we maintain a low conviction as the asset class looks expensive across different regions
- We expect loose monetary policies to favourably impact returns, although the asset class faces structural challenges from the rise of online retailers while weaker economic growth could be a headwind.

Alternative trading strategies: low conviction

- We maintain a low conviction in alternatives due to their high expense and a lack of investment opportunities in this space, although we do favour strategies that have low correlations to equity markets. The limited use of leverage should further cap returns for the asset class
- Nonetheless, sudden spikes in volatility, which are likely to materialise more often in a late-cycle environment, may lift the asset class.

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