Private Clients

Market Perspectives

May 2020

BARCLAYS

Foreword

Financial markets have recovered somewhat following a sharp sell-off, with the level of COVID-19 infections and timing of any vaccine dominating sentiment.

Equity and bond markets seem to be taking radically different views on inflation expectations. Valuations in the former suggest a quick, strong pickup in activity, and presumably inflation. However, those in bond markets hint at a long period of low inflation. The difference matters. Given the uncertainty, hedging against inflation by investing in inflation-linked debt or gold may make sense.

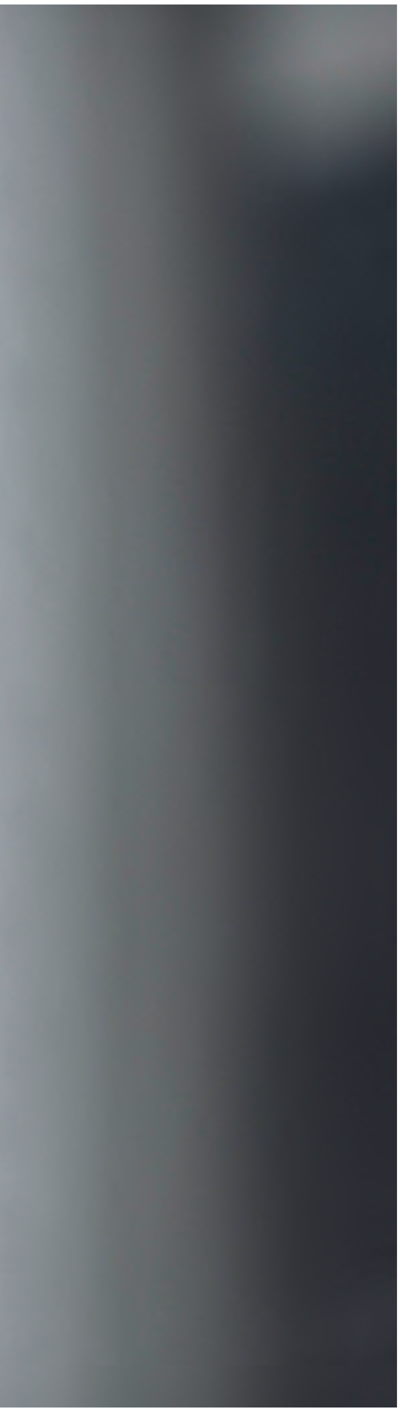
The strong rebound in stock markets may reflect overoptimistic sentiment, given the uncertainties over the pandemic and size of the coming recession. While equities are unlikely to revisit March's lows in the short term, we expect them to take a breather and let fundamentals resync with valuations. As such, diversification should assume more importance to eke out returns.

Meanwhile, emerging markets had the second largest monthly outflow of capital since October 2008 in March as investors fled from risk assets. While emerging market debt valuations may seem attractive, spreads are elevated and the asset class may face heightened volatility for some time. As such, asset selection is likely to assume more importance than usual.

The sight of the oil price in negative territory for the first time in April and a very steep oil curve highlighted the extreme nature of the supply and demand issues facing the industry. Oil producers are unlikely to cut supply sufficiently soon. while uncertain in quantity, the demand destruction the pandemic will cause is likely to top any supply cut implemented.

Government debt is set to soar in order to fund measures being taken to resuscitate the economy. That means that less money may be available to tackle climate change risk. But the risk remains. The challenge facing investors is to position portfolios for the transition to a low-carbon economy while being aware of the fresh opportunities created by the extra government spending.

Jean-Damien Marie
and Andre Portelli,
Co-Heads of Investment, Private Bank



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COVID-19 crisis: Japanification or high inflation?

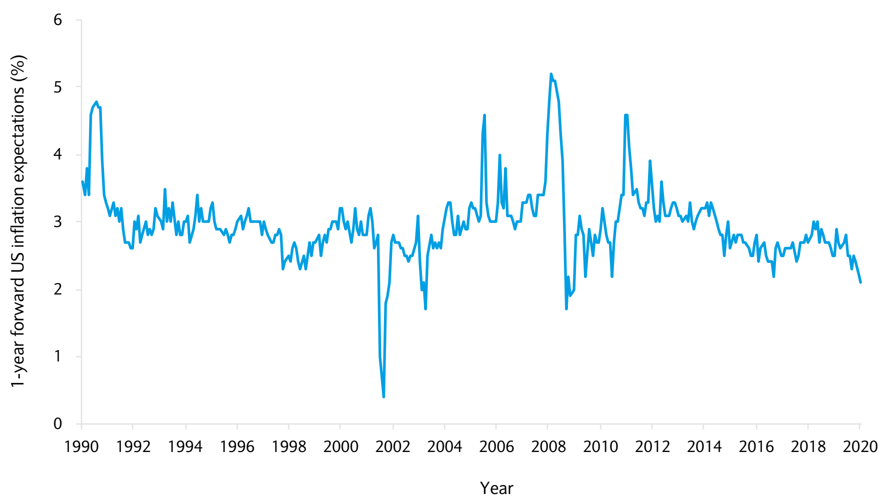
In the wake of the COVID-19 pandemic, should investors be positioning for a Japan-type long period of deflation and low growth, or a surge in inflation?

In the short-term, the COVID-19 induced recession should have a deflationary effect on the global economy. As is the case with every recession, weaker activity, coupled with excess production capacity, usually causes price growth to slow, if not deflate. On this occasion, the compounding effect of sharply lower commodity prices is also set to depress headline inflation.

The above view is widely shared among US households, another worrying sign. The University of Michigan runs a monthly consumer sentiment index, based on a nationally representative survey, and assesses inflation expectations for the following 12 months. With this at 2.1%, the index has reached its lowest level since March 2009.

US inflation expectations take a tumble

The chart shows inflation expectations, for the next 12 months, since 1990. These are now at levels last seen in 2008



Source: Refinitiv, University of Michigan

Will monetary stimulus help avoid deflation?

In the space of a month, central banks responded to the pandemic by cutting interest rates and setting up programmes to pump more liquidity into the economy. For instance, the US Federal Reserve's (Fed) balance sheet ballooned by $1.7tn. To put that into perspective, it took almost three years for the Fed's balance sheet to expand that much between 2008 and 2011, in response to the Great Financial Crisis.

At the time, many economists feared that the quantitative easing would generate inflation. While US inflation never topped the 2.5% inflation target in the aftermath of the crisis, the size of the current monetary injection in the developed world is much higher than what was seen at the time.

Velocity of circulation is key

But the key to determine whether liquidity injections will be inflationary is the speed at which the money circulates in the economy, the so-called velocity. In periods of stress and uncertainty, cash becomes king and households, as well as companies, tend to hoard cash. The increase in savings means that velocity of circulation falls and this lack of money is compensated for through an additional injection from central banks.

Banks, through loans and credit, are a key agent when it comes to money circulation. In 2009 banks increased their capital buffers and restructured non-performing loans, or those on which the borrower is late making payments on.

This time, regulators are focusing on reducing the burden on banks in order to aid the flow of money in the economy. However, once a recovery starts, and the velocity begins to increase, there is a risk that the stock of money will be too large than is needed in the economy. This would likely cause inflation to rise. But considering the short-term risk of deflation, central banks are not worrying about this potential outcome.

What about the supply hit?

Rather than the earlier, monetarist, approach to inflation, another way is to look at inflation through the lens of a supply-demand mechanism.

The fiscal measures being put in place around the world are mostly aimed at supporting demand, through loans, grants or social security benefits. This is happening when supply has been drastically reduced as most companies have reduced, or stopped, their activity. While most households are likely to increase their savings in the current uncertain environment and reduce their consumption, this reduction in demand should be assessed in relation to the likely fall in supply too.

Pandemic-related factors could trigger inflation pressure

COVID-19 is likely to reshape the way many businesses operate. Supply-chains will likely need to be reassessed and reliance on a single source for production inputs will probably be abandoned. Globalisation has helped cut inflation rates over the past 30 years. Any degree of reversal of globalisation would probably increase costs for most companies. A long period of social distancing could also make it more expensive to run a consumer-focused business, as the space per consumer has to be increased (think of business like restaurants, airlines and shopping centres).

Finally, a recent Working Paper from the Federal Reserve Bank of San Francisco paper, looking at the long-run economic consequences of pandemics, highlights that real wages tend to be somewhat elevated following pandemics.

Turning a blind eye

In most developed countries, the amount of debt as a share of economic output may supersede that seen during periods of war.

There is a key difference between wars and pandemics. While growth in the aftermath of a war is usually strong, as large investments are needed to replace destroyed capital, pandemic recovery does not call for such a response. While strong growth helped to reduce the debt pile after world war two, growth is unlikely to be strong enough to meaningfully reduce government debt this time around. For this reason, it is possible that authorities could turn a blind eye to inflation so it eats away at the, nominal, debt level.

What are financial markets expecting?

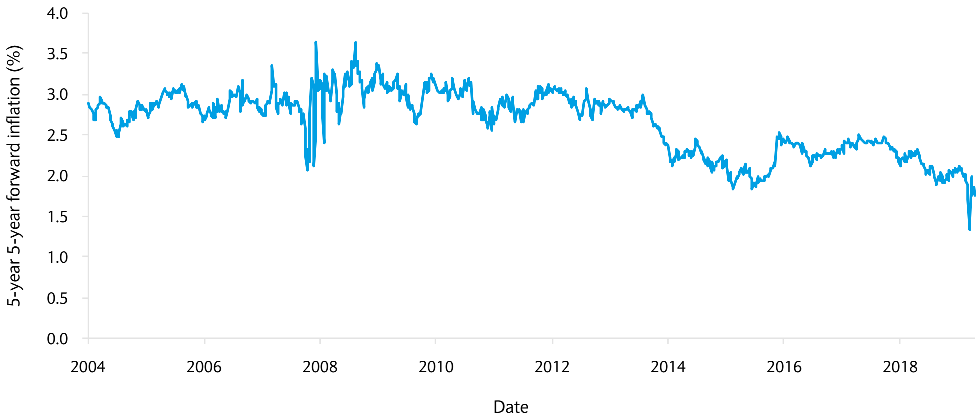
Equity and fixed income markets are taking a different view on inflation prospects. Equity prices have strongly rebounded since sharp falls seen in early March, seemingly discounting a quick, strong pickup in activity. Meanwhile, fixed income markets suggest that inflation will remain low for a long time.

The five-year, five-year forward inflation measure for the US, which measures what the market expects the inflation outlook to be over a five-year period, in five years' time, reached an all-time low in March. The indicator implies that the market expect inflation to be low for the next decade (see chart).

While it is nigh on impossible to forecast long-term inflation, there are currently arguments in favour of adding marginal protection against inflation to a portfolio. Inflation-linked bonds, gold, infrastructure and real estate are among asset classes that have typically provided the best hedge against inflation.

Future inflation expectations fall in wake of COVID-19 pandemic

The chart shows inflation expectations in five years' time for the following 5-year period, based on 5Y5Y inflation swaps, since 2004



Source: Bloomberg

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Time for a break

Equities have recovered strongly from their COVID-19-inspired depths seen in March. But is the worst of the pandemic behind us? With the outlook for company earnings and the economy so unclear, diversifying portfolios seems more important than ever.

Stock markets have rebounded strongly since the end of March, when we argued that, down 30% from their peak, equities were already reflecting most of the earnings downgrades that should be expected in a recessionary environment. With the risk-reward of stocks now less attractive, in our opinion, diversification remains key.

Fundamentals remain clouded

As companies continue reporting first-quarter earnings, indications of 2020 earnings remain blurred. While year-to-date profits expectations have been lowered by 16% in the US and 19% in Europe, the degree of confidence in these number is low. At the same time, 2021 earnings have seen limited revisions, leaving the "bottom-up" consensus expecting 2021 profits to recoup all the drawdown from 2020 and then grow some. Indeed, according to Refinitiv data as at 20 April, companies in the S&P 500 are forecast to generate earnings per share of $172 in 2021 versus $160 in 2019. Similarly, in Europe, earnings are expected to grow by around 5% over the same time period. This more "V-shaped" recovery appears optimistic.

Pick your multiple

Even if we knew what earnings would look like this year and next, equity investors would need to decide which valuation multiple to apply in deciding the worth of companies. As a guideline, the following table shows the upside potential to the S&P500 (from 2,800) based on both earnings and valuations. In other words, at current levels, the US equity market is trading at around a multiple of 16.5 times earnings for the 6% growth expected.

Importantly, over the last 35 years, the index has traded at an average of 14.3 times the earnings expected in 18 months' time. This number is the same if we look just at the last 10 years and exclude the "dot-com" bubble of two decades ago. In order to see further upside in the short term, fundamentally speaking investors should be willing to pay more than one standard deviation above the 10-year average, or should expect earnings to be more than 10% higher in 2021 compared with 2019. Again, while financial markets can overshoot fundamentals in the short term, we are sceptical of such a scenario.

Science holds the key

While equities could move higher, there appears to be limited short-term catalysts for this to happen. Indeed, with a V-shaped economic recovery already priced in, we believe that the positive catalyst would have to come from science in the form of a vaccine to COVID-19.

S&P500 earnings growth/valuations multiple sensitivities

The table shows the downside and upside potential of US equities, based on an S&P 500 index of 2800, over a range of earnings growth/valuations multiples between 2019 and 2021

S&P 500 earnings growth (%) \ Valuation multiple	14	14.5	15	15.5	16	16.5	17	17.5	18	18.5	19
0%	-22%	-19%	-16%	-13%	-11%	-8%	-5%	-2%	1%	3%	6%
2%	-20%	-17%	-15%	-12%	-9%	-6%	-3%	0%	3%	5%	8%
4%	-19%	-16%	-13%	-10%	-7%	-4%	-1%	2%	5%	7%	10%
6%	-17%	-14%	-11%	-8%	-5%	-2%	1%	4%	7%	10%	13%
8%	-16%	-13%	-10%	-6%	-3%	0%	3%	6%	9%	12%	15%
10%	-14%	-11%	-8%	-5%	-2%	1%	4%	8%	11%	14%	17%
12%	-12%	-9%	-6%	-3%	0%	3%	6%	9%	13%	16%	19%
14%	-11%	-8%	-4%	-1%	2%	5%	8%	11%	15%	18%	21%

Source: Refinitiv, Barclays Private Bank, April 2020

"Indeed, with a V-shaped economic recovery already priced in, we believe that the positive catalyst would have to come from science in the form of a vaccine to COVID-19"

While various drugs are showing promising results in early trials, a cure may not necessarily allow things to return to normal quickly. For one thing, social distancing measures (and the associated strain on some companies' ability to operate) are likely to remain in place to avoid another wave of contamination.

To really put this pandemic behind us, a vaccine may be needed. Unfortunately, despite an unprecedented concerted effort globally, if successful, a vaccine is unlikely to widely available before the middle of 2021.

A lot could go wrong still

In the meantime, the risks are numerous. A second wave of infection may occur once quarantine measures are lifted. If severe, containment could be re-instated, harshly damaging any hope of a quick recovery. At the same time, the long-term effects of this crisis are still unknown. While this recession could be one of the shortest in history, it may also be one of the worst.

With many companies scrambling for funding, banks setting aside billions in provisions for future defaults and millions of employees being furloughed, it is possible that the situation won't normalise for months. As such, the economy in general, and consumption in particular, is unlikely to recover swiftly. Finally, political uncertainty could resurface with a US election still scheduled for November and Brexit set to become an economic reality by the end of the year.

A range bound view

While we do not expect equities to revisit March's lows (unless a second wave of infections forces the developed world back into containment), we believe that the market is likely to take a breather in coming weeks and let fundamentals resync with current valuations. This is also justified by investors' sentiment which seems much more "neutral" today, far from the doom and gloom of late March but still relatively cautious given the ongoing uncertainty. As such, we expect equities to remain volatile in a relatively wide trading range.

A time to diversify

With volatility elevated, diversifying multi-asset portfolios is key to protect and enhance returns. We continue to see merit in using less directional strategies to extract alpha, or outperformance, while being less correlated with other asset classes and to improve the overall risk/reward profile of portfolios.

Within equities, we maintain our preference for "quality" and cash-generative companies and sectors such as healthcare, and parts of consumer discretionary and industrials.

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Emerging market debt: action stations

Emerging market bond yields seem attractive on paper, but risk remains high, given the COVID-19 crisis, and is unevenly spread among countries. While there are opportunities available in the region, selection will be key.

The poor economic prospects and ultra-loose monetary policy in the wake of the COVID-19 pandemic has depressed global rates. In the US, yields on bonds with short maturities are anchored close to the US Federal Reserve's (Fed) target rate while the 10-year yield is poised to trend even lower again. Fears of a significant rate sell off, perhaps caused by a ballooning fiscal balance and a resulting oversupply of bonds, seem premature at this stage.

The Fed will likely absorb a large part of the debt supply for some time. After the credit crisis in 2008, for example, the Fed only began communicating its intention to scale back bond purchases in 2013, sparking the "taper tantrum" rates sell-off. The overall trend in rates in the medium term will likely be dominated by large disinflationary pressures caused by very high unemployment rates, a lack of pricing power and lower energy prices. Only in the longer run longer dated bonds could potentially be exposed to inflationary pressures.

In our April Market Perspectives, we focused on developed market corporate bonds, risks in various sectors and the BBB segment in particular, in light of the COVID-19 pandemic. We also discussed the effect of the recent Fed bond facilities. In this edition we take a closer look at emerging market bonds.

Emerging market outflows

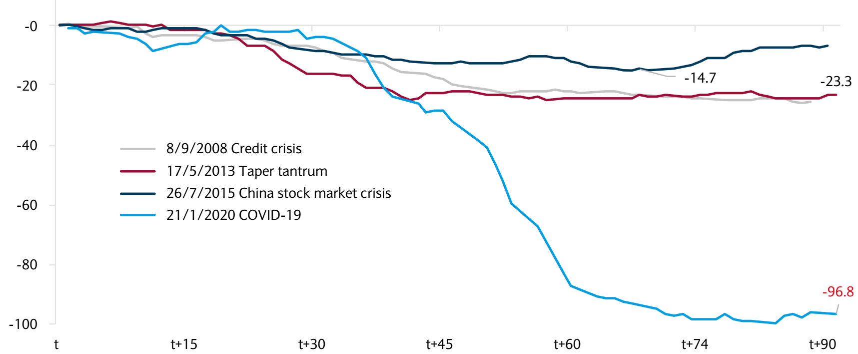
The asset class witnessed $31bn of outflows in March, the second largest monthly outflow since October 2008, as investors exited risk assets. That said, outflows from emerging market (EM) equities have topped those from EM debt each month this year and are substantially higher than those out of EM debt. A whopping $96.8bn has been withdrawn from EM equity and fixed income assets combined by non-emerging market residents, exceeding those seen in previous crises (see chart) by some margin.

In April the level of capital flows out of emerging market assets declined, somewhat, while the average difference (or spread) between US dollar-denominated EM bonds compared to US treasuries fell to 620 basis points, with the average yield of the former being 6.7%. Still, both the spread and average bond yield are at the highest levels since 2008. The difference in yields on offer from bonds in different regions or countries (or spread dispersion) is also very high, being a reminder that risk within the EM segment varies substantially

Despite relatively appealing yield levels, the risk of further substantial spread widening looks as high as ever, in part due to potential refinancing challenges and unsustainable deficits in some EM countries. The proportion of bonds trading at distressed prices among EM high yield-rated issuers is 36% and half of Asian high yield bonds are trading with a spread wider than 1,000 bp.

Emerging market capital outflows soar in 2020

The chart shows the accumulated non-resident portfolio outflows of emerging market assets for 2008's credit crisis, 2013's taper tantrum, 2015's Chinese stock and this year's COVID-19 pandemic



Source: Daily capital flows tracker, IIF

While the level of distressed bonds can be a good indicator for future default rates, historically speaking the spread compensation was sufficient to compensate for the losses seen from realised defaults thereafter. The implied compensation is now as high as it was in 2008's credit crisis and is suggestive of a default rate of 9-10% compared to the current rate of 1.5%.

Spotting the weaker countries

Many weaker countries are being uncomfortably exposed by the COVID-19 crisis. EM central banks have cut interest by almost 3,000 bp in aggregate and most countries have announced fiscal support packages.

However, many countries seem to lack urgency in their policy response or simply don't have the financial resources to withstand a larger period of containment.

> "Many countries seem to lack urgency in their policy response or simply don't have the financial resources to withstand a larger period of containment"

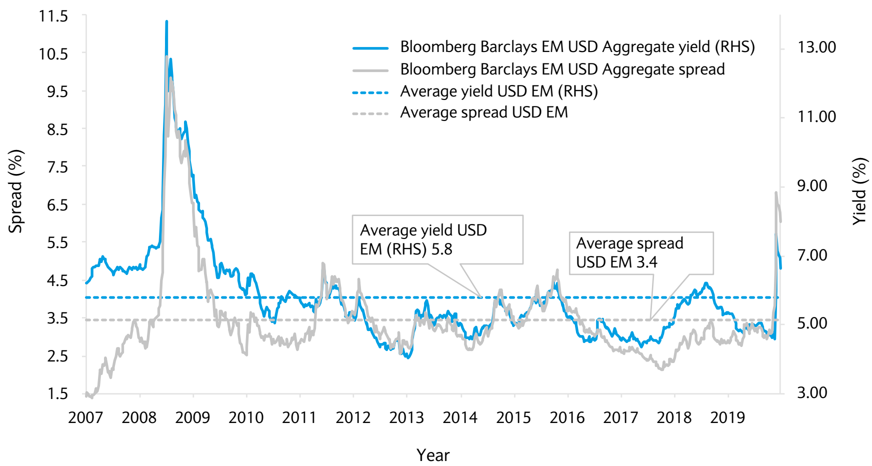
The most prominent examples are Argentina and Lebanon which already announced a restructuring of their foreign bonds resulting in substantial "haircuts" for investors. Those sovereigns where large current account deficits and large debt service payments meet low direct investments and low foreign exchange reserves will be most vulnerable.

While defaults or imminent debt restructuring do not seem that likely, we believe that countries like Sri Lanka, Honduras, Angola or Turkey are particularly exposed which makes respective bonds vulnerable for further volatility. Upcoming bond redemptions in these countries are material in the context of the respective available foreign exchange reserves.

While International Monetary Fund (IMF) support facilities are in place, the fund will focus on the weakest countries, mainly in Africa. The majority of the IMF facilities come with prohibitive conditions and countries like Turkey or South Africa are trying to avoid seeking them.

COVID-19 crisis prompts spike in EM bond yields and spread

The chart shows the yield and spread on emerging market debt since 2007



COVID-19 responses

Emerging market governments, like those in the developed world, are tackling the pandemic in different ways. While Brazil's president is playing down the severity, India (with a population of 1.3bn) is pursuing a full containment strategy without having sufficient testing kits in place. The inconsistency and limited fiscal resources is a concerning combination.

For many EM countries, the COVID-19 crisis means a decline in the crucial revenue contribution made by commodities, especially oil. In judging the impact this is having on economies, it is important to consider factors like the price at which the external balance between imports and exports is at zero (known as the external breakeven price).

An oil price below a country's breakeven price may require a country to take on more debt to fund the deficit. The breakeven level is high for Bahrain, Oman and Qatar and comparatively low in Russia or the United Arab Emirates for example. Substantial sovereign wealth assets for the latter two countries, for example, should help support them through this period.

Focus on selection

While spreads are elevated and potentially cover future default losses, we think EM bonds are likely to face more volatility. Although appealing investment opportunities may arise, selection and active management will be key in order to weather the challenging times ahead.

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Oil and gold markets diverge

With a massive drop in the price and demand for oil piling the pressure on producers, when might a sustained recovery in the price provide some respite? Meanwhile, what next for gold after risk-averse investors returned to the commodity in droves last month?

The COVID-19 outbreak and the costs of containment on global growth has significantly impacted the demand side of the oil market this year.

The Organisation of Petroleum Exporting Countries and allied producers (known as OPEC+) agreed 9.7 million barrels per day (mbpd) production cuts for May and June. However, this does not appear sufficient to offset the staggering fall in demand seen from global quarantine measures designed to counter the effects of the COVID-19 pandemic. Indeed, with many economies idling, demand has collapsed by as much as 30mbpd according to some estimates.

The world of negative oil prices

In a first, oil producers have been paying others to take the commodity off their hands: a barrel of West Texas Intermediate (WTI) oil closed in negative territory on 20 April. What does this strange and significant event mean?

First, the quoted negative price refers to a specific futures contract traded on the New York Mercantile Exchange, which in this case was for May delivery, and reflected the spot price at a given time, not the medium-term outlook for the commodity.

Second, the plunge in prices took place because of a very specific set of factors that are unlikely to reoccur. Indeed, against a backdrop of weak demand, oil suppliers have been seeking to store oil, hoping for prices to recover, once demand stabilises. As a result, Cushing, America's key storage hub and delivery point of the WTI contract, is quickly approaching maximum capacity with inventories having jumped by 50% in just two months, to 61m barrels (compared with a 76m barrel capacity).

Storage concerns

The constraints on oil inventory storage are less urgent for Brent crude, as tankers usually shipping oil around the world can be used as additional storage vessels. This explains why Brent, the other major oil benchmark that is based on oil extracted in the North Sea, was trading above $25 per barrel when the WTI price was negative.

In financial markets, investors with May delivery futures contracts on WTI faced having to take physical delivery of oil in Cushing for barrels that no one wanted and that could not be stored. As such, as the May contract approached expiry, they looked for an exit at (almost) any cost, pushing the price of the futures contract below zero.

Whether oil prices are negative or positive, the longer term outlook for the commodity remains uncertain. The agreed OPEC+ production cuts don't compensate for the demand destruction experienced since March, leaving the market unbalanced and with very large inventories of oil.

Curve ball

In addition, the shape of the oil curve, whereby the price of futures contracts due in a month is significantly lower than those due in three months or later, is a concern. This makes going "long oil", and looking to profit from an increase in the price, a challenging investment proposition.

Golden diversifier

Unlike oil, the gold price recovered in April after a difficult month in March, when most financial markets fell. As we argued then, the performance was the result of mass selling of assets in a rush to boost liquidity.

Gold can still be a good diversifier in broad, multi-asset portfolios due to its typical low correlation with many other assets. The price should continue to be supported by exchange-traded fund net purchases from risk-averse investors, very low interest rates, improving the opportunity of holding a non-interest bearing asset like gold, and central banks' actions to lift liquidity. While gold won't drive long-term growth, it should be able to better preserve wealth during periods of turbulence.

"Gold can still be a good diversifier in broad, multi-asset portfolios"

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Merger arbitrage: spreading the love

Hedge funds had a difficult start to 2020 with their average return in March worse than seen in the Great Financial Crisis. With the economy facing a recession, merger arbitrage strategies may offer one way to improve returns while diversifying portfolios.

Hedge funds had one of their worst quarters on record in the first three months of the year, with an average return of – 10%, according to financial data provider Preqin. Performance was hit by the impact of the COVID-19 outbreak and oil price war.

Having protected capital in the first leg of the sell-off in February, most of the negative performance for hedge funds occurred in March (-9%). March's losses were greater than any monthly loss during the 2008 Global Financial Crisis. That said, hedge funds performed much better than public markets, with the S&P 500, for example, falling by 20% in the first-quarter of the year.

Strategy selection is key

Like private capital investment, it is important to think of hedge funds as a collection of distinct strategies rather than a homogeneous asset class. The dispersion of performance between hedge fund strategies, and managers, is much wider than is usually found in public market investment strategies and funds, adjusting for volatility.

While certain strategies will likely suffer as the economic crisis unfolds, other strategies should benefit from dislocations in financial markets. More precisely, with the economy suffering from quarantine measures, we see opportunities in a strategy called "merger arbitrage".

What is merger arbitrage?

A merger is the process by which one company attempts to purchase the shares of another company to acquire a controlling stake. The acquiring entity usually offers a premium to the current share price, hoping to motivate enough investors into selling their shares in the target business.

While the target company share prices tend to jump when the acquisition is announced, the price may then fall to reflect the uncertainty over whether the merger takes place. For instance, large shareholders might fight the acquisition, financing might fall through, regulators could prevent the deal or significantly worse performance by either party could derail the deal.

Merger arbitrage is a strategy that became well known in the late 1960s and early 1970's. The strategy aims to capture the aforementioned spread that exists between the share price of the target company and the acquisition price on announced transactions, while also potentially profiting from other deal-related opportunities.

Historically high spreads to capture

This year's sell-off in equities has affected announced merger transactions, increasing the spread between the acquisition price and the share price of targets. While risks exist of certain transactions failing, we think that selective opportunities provide hedge funds with experienced and seasoned investment teams focusing on merger arbitrage with good prospects. Risks around financing and motivations to complete deals certainly increase in periods of stress.

Furthermore, the longer the coming recession lasts, the more that puts some merger transactions at risk. While the recession is likely to be very severe, we expect the conjunction of government and central bank support and a lifting of confinement measures to lift the global economy out of recession relatively quickly.

Diversification opportunity

Where the acquirer pays with shares, a merger arbitrage strategy focuses on relative value between two stocks. As such, it is partially uncorrelated with the performance of stock markets and provides diversification to an equity portfolio.

After the dislocation in risk markets and the subsequent rally, we believe that merger arbitrage, with the current levels of spreads, offers an attractive risk/reward while also providing diversification benefits.

"After the dislocation in risk markets…merger arbitrage, with the current levels of spreads, offers an attractive risk/reward while also providing diversification benefits"

Gerald Moser, London UK, Chief Market Strategist – gerald.moser@barclays.com

A time to invest in distressed debt?

As the global economy heads towards a sharp recession and many risk assets suffer, distressed debt funds may offer a chance to buoy portfolio returns.

Investing in private markets can make sense during volatile times, with the opportunity a selloff offers for private funds looking to deploy cash. With a sharp, but likely relatively brief, recession beckoning, this is particularly true for a strategy like distressed debt.

What is a distressed debt strategy?

This strategy focuses on acquiring a company's debt at a fraction of its value and working with the company to restructure the overall debt. The acquired debt can be at any level of the entity's capital structure. The debt may be regarded as distressed due to perhaps idiosyncratic reasons, a company may be overleveraged, suffer from a blow to its cash-flow, or an event affecting many companies like a global recession.

A good environment for distressed debt investing

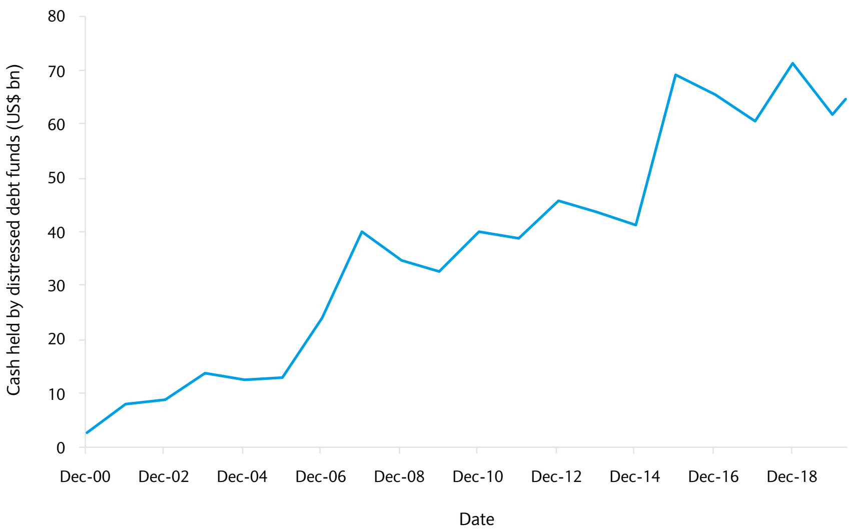
The COVID-19 outbreak has caused many businesses to halt operations. While a traditional recession usually results in a slowdown, the confinement measures put in place to contain the virus have brought activity in some sectors to a complete stop.

Despite the unprecedented fiscal and monetary measures announced globally in recent weeks, many companies will have burned through much of their cash reserves and find it much tougher to service their debt. The tough times are reflected in public markets, with US high yield spreads reaching 1,100 basis points in March. Based on historical data, this suggests that default rates could increase towards 10% from 3% in the first months of 2020.

> "Default rates could increase towards 10% from 3% in the first months of 2020"

Distressed debt funds keep their powder dry

The chart below shows how much distressed debt funds have built their investable cash balances over the last two decades



Cash ready to be deployed

Around 35% of assets under management, for the distressed debt funds tracked by financial data provider Preqin, are held in cash. This amounts to $65bn of cash ready to be deployed.

Anecdotal evidence suggests that institutional investors' appetite for distressed debt funds is increasing as opportunities arise in the sector. Downturns not only offer opportunities in public markets but also in private ones. This is particularly true for distressed debt funds.

While the median net internal rate of return (IRR) for such strategies is usually lower than other private equity or private debt alternatives, the severe crisis seen in 2008 helped distressed debt provide the best net median IRR across all private capital strategies, according to Preqin data.

Enhancing portfolio diversification

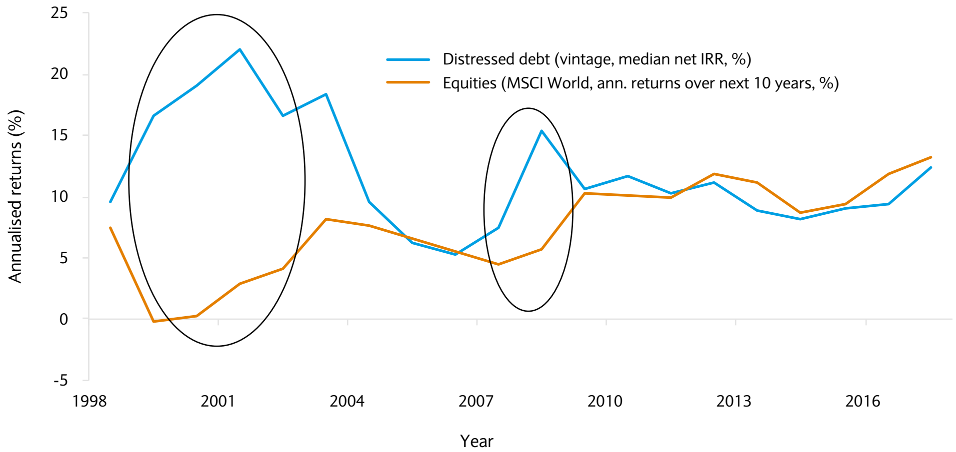
Distressed debt funds can provide welcome diversification to a portfolio in periods of stress, when many asset classes move in lock-step with each other. While traditional portfolios tend to suffer during global recessions, distressed debt assets can prosper during economic downturns.

The distressed debt index is negatively correlated, or moves in the opposite direction, with global equity and commodity indices, two asset classes that are typically impacted the most during a downturn. The performance of equities and commodities since the COVID-19 outbreak confirms this vulnerability.

"The distressed debt index is negatively correlated, or moves in the opposite direction, with global equity and commodity indices, two asset classes that are typically impacted the most during a downturn"

Distressed debt performs best when equities lag

The chart shows the performance of distressed debt and equities since 1998



Source: Preqin, Refinitiv, Barclays Private Bank

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Does climate change still matter?

As the pandemic persists and markets struggle, investors shouldn't disregard the need and opportunities to transition to a low-carbon economy.

Until the coronavirus pandemic hit, climate change was central to the agenda for most governments, companies, and the public – and increasingly for investors. Rightly, attention is now focused on the human and economic effects of COVID-19.

Given market volatility and forthcoming economic hardship facing many, investors may understandably question the importance and influence of climate change on their portfolios. However, the climate breakdown continues to worsen in the background; and, whenever we emerge from the pandemic, will again be a critical, global challenge.

For investors, shifting focus to the longer time horizon of climate change may help them to endure short-term volatility. It may also help them to find valuable opportunities to support rebuilding the economy in a lower carbon and more sustainable way.

A global environmental experiment

An unexpected beneficiary of the mass quarantining and industrial "shut-down" this year is the environment. Though unintended, it hints about a world with fewer emissions. For many, air is tangibly fresher. Even in cities, birdsong fills the skies and the atmosphere is visibly cleaner.

From a multitude of satellite images, we have been shown the reduction in carbon emissions over our cities and countries. A tentative, and already revised, estimate calculates a potential 5.5% drop in carbon dioxide (CO2) emissions compared with 2019.

Continuing on trend would make 2020 the year with the largest ever annual fall in CO2 emissions, larger than any prior economic crisis or period of war.

Climate change marches on

While the current dip in emissions is having positive effects, unfortunately these are both limited and transient. After decades of increasing emissions, the average global temperature has already risen by one degree celsius. Last year, the physical consequences had begun to be more prominent with acute events such as wildfires, hurricanes, flooding, or droughts and as well as chronic changes to local climate or sea levels.

Even with a dip in global fossil CO2 emissions this year, our trajectory is the same and the concentration of CO2 in the atmosphere will continue to rise. In fact, the first quarter of 2020 has been verified as the second warmest on record which stretch back to the 1850s.

Only when total annual emissions are net zero will CO2 concentrations no longer rise – and global warming stabilise. To get on track for the Paris Agreement's 1.5C target, it is estimated that these emissions would need to fall by 7.6% every year during this decade.

Decoupling growth and emissions

As seen in recent months, economic output and greenhouse gas emissions are closely, and positively, correlated. A more useful relationship though is the ratio of these two. Carbon intensity (at the factory, company, country or global level) illustrates the emissions per unit of activity.

Addressing climate change doesn't require a smaller economy, or a decade-long depression. Instead, transition to a low-carbon economy means primarily less emission-intensive growth. Decoupling growth and emissions, though, is obligatory to make this possible.

Economic recovery with less carbon

The United Nation's Conference of Parties (COP) 26, originally planned for November, will see governments report on progress, and new plans, towards this decoupling. While the conference has been postponed until next year, its commitments have not.

For example, having announced the European Green Deal last December, during April the European Commission has been reviewing the list of 2020 priorities. A few elements deemed less essential (e.g. sustainable aviation fuels, empowering the consumer) are expected to be delayed into 2021. While others may be added to this list, the core aspects of climate policies and key initiatives have been maintained.

As countries consider how to restart their economies, many governments see an opportunity to integrate climate change measures into stimulus efforts. The range of potential options is impressive – e.g. carbon targets for industries receiving bailouts, dedicated green infrastructure funding, "clean" energy tax credits or transition support for fossil-fuel workers to the green economy.

"Many governments see an opportunity to integrate climate change measures into stimulus efforts"

Adjusted risks and opportunities

Globally if the aim is to emerge from the pandemic ready to resume a concentrated effort against climate change, it makes sense to steer the recovery towards sustainable companies and green industries. For investors then considerations of risk and opportunities broadly remain consistent – though with some adjustments.

In the February Market Perspectives we highlighted evidence of the rising frequency and intensity of extreme weather events and their potential implications for investors. Unfortunately, any near-term natural disasters could be made worse by social distancing and already strained governmental budgets.

At the same time, the crisis provides evidence of the reduction in, or estimated, CO2 emissions of organisations for the secondary effects of such disasters, such as disrupted global supply chains. Investors may want to track the businesses that are adapting, and those who aren't, to the impact of the pandemic.

Same opportunities, new priorities

For investors who actively want to support decarbonisation of the economy, the aims, and solutions, to address the climate crisis are similar as they were before the pandemic. In our Outlook 2020, we highlighted five growth markets in a transition to a low-carbon economy – renewable energy, electric mobility, energy efficiency, water and waste management or agriculture.

However, the priority and attractiveness of these themes, and associated the sub-sectors, has shifted and only in the coming months will become clear. In the interim, investors can start by understanding the baseline opportunities of these sectors, and keep a watchful eye on where governmental stimulus and policies, public sentiment, and economic recovery take hold.

Building a better future

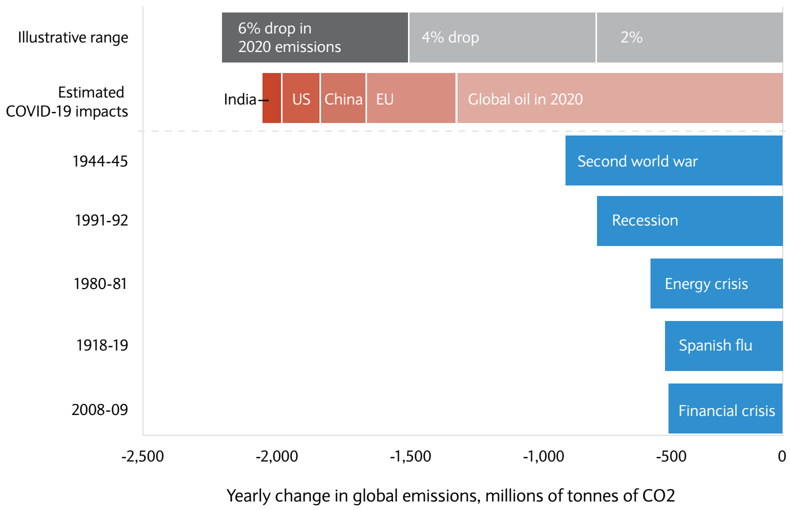
Before the COVID-19, we knew much of the next decade would need to focus on how to decarbonise the energy system and reverse the trend of rising CO2 emissions.

Shortly before publication, we celebrated the fiftieth year of Earth Day, which aims to raise our awareness and action towards the natural environment. During the human tragedy of the pandemic, this year's cleaner skies will be a small, but noteworthy, consolation.

The greater challenge, and opportunity, for investors is to connect their short-term response with long-term portfolio positioning to support a low-carbon economy, which can make us all wealthier and healthier for it.

COVID-19 may trigger largest annual fall in CO2 emissions on record

The chart shows the reduction, or estimated falls, in CO2 emissions



Source: Carbon Brief, April 2020

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Looking beyond the headlines

As the consequences of the coronavirus pandemic unfold, what should investors do in the face of continued uncertainty and the resulting negative headlines?

A sense of eerie calm can be seen in the streets of major cities across the world due to quarantine measures taken by governments to tackle the COVID-19 virus. Meanwhile, turbulence persists in financial markets with a sharp bounce seen in April following March's violent sell-off. In the face of such upheaval, what can investors do to focus on positioning for the long term rather than worrying too much about the short term?

Sentiment can turn quickly

While financial markets have rallied strongly of late, it is too early to get carried away on a wave of excessive optimism. Tentative signs of better infection statistics, despite the surge in cases in the US, and unprecedented amounts of monetary and fiscal stimulus have helped to fuel the rally.

However, without widespread testing, lockdowns are being lifted only gradually and social distancing is set to remain for a long period. Lifting restrictions too quickly risks further waves of infections and deaths. Meanwhile, maintaining lockdowns comes with sizeable economic costs. More swings in sentiment, and associated volatility, seem likely.

Until (and even after) a vaccine is widely available, the pandemic will affect much of daily life and market sentiment. For that, swings in sentiment can be so quick, and spotting highs and lows so difficult, that staying invested over the long haul can be the best strategy.

> "Swings in sentiment can be so quick…that staying invested over the long haul can be the best strategy"

Remember your time horizon

Paying attention to what the media is reporting and the compression of news cycles (together with a similar phenomenon in markets themselves) can exacerbate investors' stress and anxiety. In turn, this can lead to a shortening of investment time horizons. In the context of volatile markets, a shorter time horizon can make investments appear riskier.

Unfortunately, this is just the moment when a calm and rational approach to portfolios is most necessary, as decisions made in response to short-term events can profoundly affect an investor's long-term returns. This can be exacerbated by a tendency to assign more weight to information we can more easily recall, known as "availability heuristic". It creates a risk that investors place less importance on decades of strong market performance while lending more weight than warranted to periods of elevated volatility.

It is natural to expect more volatility for some time in response to a pandemic, when so much is still unknown. While unsettling, investors should remind themselves of their investment time horizon. It is likely to be far longer than that of market commentators fighting for airtime and visibility.

Does it matter for my portfolio?

In uncertain and unprecedented times, markets are likely to overreact. The fear of losses or "losing out" can drive markets to overshoot, either in response to negative or positive news in the short term.

Good investment decision-making requires asking yourself whether market events are likely to affect your ability to reach your long-term goals. Much of the daily news reporting that focuses on a single market, industry, or company will simply not be material to a well-diversified portfolio. As a reminder, a portfolio diversified across asset classes, geographies and sectors, is unlikely to fully experience the impacts of headline market moves.

This is clearer when looking at a specific phenomenon, such as the cost of a barrel of West Texas Intermediate oil turning negative, as seen for the first time in April. While fundamental factors are putting much downward pressure on prices, the dive into negative territory was driven primarily by, unique, technical factors.

Looking beyond

These are indeed unprecedented times. While history may not repeat itself exactly, it frequently rhymes. Diversified investment portfolios, constructed through a structured investment process and focused on the long term, provide a strong foundation for weathering market storms. These same squalls may offer opportunities that active managers can capture.

Markets are mechanisms in judging future prospects. In many cases, it is at the point of ultimate stress for most investors that the early signs of recovery are emerging. Exposure to riskier assets in periods when fear is as elevated as it is at the moment, can provide opportunities for those with cool heads.

The COVID-19 pandemic has created testing times for investors. But for those able to recognise how such events can affect decision-making, and put their money to work in a way that allows them to look beyond periods of uncertainty, it can often be particularly rewarding.

"Diversified investment portfolios…focused on the long term usually provide a strong foundation for weathering market storms"

Narayan Shroff, India, Director-Investments – narayan.shroff@barclays.com

Seeking refuge in uncertain times

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.

The outlook for the COVID-19 pandemic, containment measures, economy and effectiveness of the monetary and fiscal stimuli remains unclear. As we pass through this dark period, bumpiness in financial markets is likely to be unsettling.

The lows seen in risk assets in March look unlikely to be revisited again in coming months, unless the pandemic worsens significantly or the demand destruction it is causing exceeds our estimations. On the other hand, the potential upside also seems to be capped in the near term, barring “The Great Polarisation” in favour of “quality”.

Positioning

The worsening outlook prompted us to move to being neutral on equities in April, from our previous overweight call. However, we maintained an underweight on cash and ultra-short-term debt to fund the overweight stance on Indian debt. We continue to think of gold and private assets as important diversifiers in portfolios.

Even during particularly volatile times, history shows that staying invested usually pays off and that missing just a few of the strongest daily price gains may impact long-term performance considerably.

India macroeconomic backdrop

The outlook for the country’s gross domestic product (GDP) growth seem to have worsened, given the extension of the quarantine period, along with effects on the mining, agriculture, manufacturing and utility sectors seemingly being higher than we expected.

Furthermore, the recovery to be weaker than we had forecast, given deteriorating global prospects and the rising risk of COVID-19 outbreaks leading to shutdowns at the local level.

The new normal

Monetary policy headroom is available to smoothen the effects of transition on the economy through this painful period. Relief packages and government measures aimed at stimulating growth will also help. Whether they will be sufficient will depend on the ultimate size of the challenge that lies ahead.

In time, the baton will once again be passed to the resilient, high-quality, private businesses to muster a gradual recovery, along with the country’s favourable demographic profile and consumption.

Potential opportunities

There are some tentative signs of the opportunities emerging to position portfolios for the “new normal” beyond the crisis. These include Indian companies likely to benefit from global supply chain displacements and increased interest in participating in the country’s consumer growth story. Deals such as Facebook-Reliance or the role that Indian pharmaceuticals and technology sectors may play in the new normal.

Indian equities

First-quarter earnings announcements are likely to be disregarded by many market participants, especially with many companies continuing to withdraw their near-term guidance. Instead, the market will, over time, look to earnings growth reported for June, as an indicator for 2020 prospects, and on expectations for 2021 and beyond.

Further, consensus downgrades to company earnings for forecasts for the 12 months to 31 March 2021 seem likely, which we think will be mostly flat. On the other hand, FY2022 earnings growth may rebound strongly. Earnings in some pockets of market, like financial services, might take longer to recover, given potential elevated credit costs, if bad loans spike significantly next year.

Volatility and investor flows

Equities recovered somewhat in March and again in late April despite muted investor flows into the asset class, both from Indian and non-Indian institutional investors. However, we see risks that valuations reflect an overly optimistic view on prospects and may be particularly susceptible to disappointments in this low visibility environment.

Volatility, measured by the “fear index” known as the VIX, which had shot up to especially elevated levels in March, cooled off last month but remains high by historical standards. It may take some time before volatility stabilises at more typical levels.

Attractive valuations

Valuations look relatively attractive on an historical basis. Furthermore, the premium that Indian stocks enjoyed over emerging market peers earlier in the year has largely evaporated in the last month. However, the unprecedented nature of the pandemic and the supply and demand shocks created, makes calculating valuation metrics far more difficult, if not impossible.

Valuations for cement producers, as a domestic cyclical play, seem attractive after recent sharp correction in stock prices. Discretionary consumption, such as auto, will take more time to recover as consumers delay their discretionary spend amid uncertainties related to job security or income growth and lenders reduce unsecured consumer lending as credit cost rises.

Focus on quality

We believe investors should remain focused on “quality” names. We define quality as large-caps and largish mid-caps companies with stable earnings growth visibility, ability to efficiently deploy capital, relatively low financial leverage and dynamic and transparent management credentials.

As the economy reopens, these businesses should continue to gain market share and improve operating margins, pricing power and lower their cost of capital. And with lower corporate tax rates, quality businesses should be able to demonstrate resilience in dealing with a changing economic landscape.

Indian debt

The Reserve Bank of India (RBI) continues to take measures to support the economy and financial system. This includes liquidity measures and rate cuts as well as unconventional tools such as Targeted Long-Term Repo Operations (TLTRO) – especially targeted at vulnerable sectors of the economy. The central bank is providing much additional finance to banks and some public financial institutions to support them in lending to small and medium-scale industries with high levels of employment.

The RBI continues to relax regulations regarding asset recognition for banks and non-banking financial companies. This includes asking banks to increase provisioning by 10% of assets that are under a repayment stands still and disallowing some banks from paying dividends in order to conserve capital.

We expect the RBI monetary policy committee to cut repo rates by another 80-90 basis points to bring the rate to around 3.50%. Further measures from the central bank may include special open market operations, TLTROs and other non-conventional steps designed to support the economy and growth. We feel that the measures may particularly benefit gilts and high-quality corporate bonds and the yields on these issuers may compress.

Whatever it takes

In light of a greater probability of higher fiscal slippages, debt up to five years’ maturity is likely to attract more interest from participants than the longer end of the curve. Some relief on the supply of debt, by the government directly placing issuances with the RBI, cannot be ruled out considering the central bank’s desire to do “whatever it takes”.

Credit risk

The biggest risk in debt markets continues to be of worsening credit contagion leading to rising solvency risks, rating downgrades, credit spreads widening and/or liquidity drying up. We have not lost sight of the credit stress in the system even before the current crisis, since the Infrastructure Leasing & Financial Services default in late 2018. Once this period of elevated debt forbearances, moratoriums, bridge financing and court orders restricting rating downgrades is over, the market will be staring at these “cans that have been kicked down the road”.

While credit costs for lower-rated entities may reduce with the RBI’s latest moves, we may see banks remaining generally averse to increasing exposure to lower credits in these uncertain times.

The government may also step in to either provide credit support to banks or provide capital to form a special purpose vehicle that may take leverage to lend to the lower-rated issuers, especially in the vulnerable segment. However, with the latest rout across debt mutual funds, especially funds carrying lower-rated papers, the demand gap is significant to bridge.

Hence, we continue to find “safe and quality” names in debt issuers attractive, a segment of the market that should continue to enjoy increased supply (liquidity) and a lower cost of capital.

> “The potential upside also seems to be capped in the near term, barring “The Great Polarisation” in favour of quality”

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Go further,
Reach higher,
See beyond.