



Private  
Bank

# Outlook 2021



## Foreword



This has been a tumultuous year. One that has seen the fastest gross domestic product contraction and paciest bull-to-bear equity descent, then ascent, since World War Two.

While volatility may be less elevated next year, financial markets and the economy could remain at the mercy of COVID-19 developments, especially on a fast vaccine rollout. The main question is over the pace of recovery. We expect a growth rate of close to 5% in 2021. That said, some areas of the economic landscape may change dramatically. High government debt levels are a legacy to manage carefully and inflation is a risk to monitor.

Turning to financial markets, in a world characterised by record low rates and high equity valuations, the five-year expected total returns on equities and bonds are likely to be lower than previously. Following the firepower unleashed by leading central banks this year, rates fell further into negative territory, weighing on prospective bond returns. European and US high yield bonds, on a very selective basis and in the most resilient part of the market, may be worth considering, alongside US inflation-linked bonds, to hedge positive inflation surprises.

And in equities, coronavirus is shuffling the cards, accelerating structural trends. The rise of technology companies, aided by home working and online retail sales, reflects the attractions of growth. While valuations may deter some, equities seem fairly valued in the context of low rates. We are constructive on prospects for the asset class, preferring high-quality companies and an active approach.

From a portfolio perspective, the pandemic showed the limitations of only relying on equities and government bonds. We see value in adding alternative assets such as private markets, gold or hedge funds to a portfolio to diversify and improve its risk-return profile.

Another area of interest is sustainability, as pandemic recovery plans from governments have a sustainable bias. Companies too are being drawn to opportunities available, and potential growth prospects, from transitioning to a low-carbon world. Similarly, including environmental, social and governance (ESG) considerations in asset selection can boost returns. The momentum behind investing sustainably, and with ESG considerations, suggests that increasingly investors agree.

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## Global outlook: reshaping a post-pandemic world

The role of governments, central banks and companies may be radically reshaped by COVID-19 and the economic turmoil inflicted.

At the start of 2020, we, like the majority of forecasters, were cautiously optimistic about the economic prospects for the year. Many of 2019's dark clouds, including the US-Sino trade war, political and social instability in Europe and Brexit, appeared diminished. The consumer looked in great shape, helped by historically low unemployment and above-inflation pay growth. Central banks were accommodative and policymakers promised fiscal support when required to extend the cycle. While geopolitical uncertainty remained, growth looked like being marginally higher compared to 2019 (see figure one).

### The pandemic shock

However, as is often the case, it was a factor that resided relatively low down in our risk matrix that was to have the most profound effect on society since the Second World War. The COVID-19 pandemic has resulted in tens of millions of infections and more than a million deaths around the world.

The scale of the outbreak has placed enormous pressure on national health services. Governments have been forced to impose aggressive measures including social distancing, self-isolation and restrictions on travel in an effort to contain the spread of the disease. Meanwhile, the locking down of economies resulted in a record drop in activity, surging unemployment, permanent losses in output and temporarily slower potential growth. The damage to the world's major economies is four times greater than the 2009 financial crisis, estimates the Organisation for Economic Cooperation and Development.

The controlled lifting of restrictions has helped to alleviate some of the economic pressures, with a number of economies registering a robust rebound in activity through the summer. However, activity is likely to be vulnerable to surges in infections triggering further restrictions. As a result, the global economy may shrink by 3.5% in 2020; the deepest contraction since the Great Depression.

**Figure 1: Growth forecasts**

Real GDP growth forecasts, year on year (%), for some economies 2019-2021

Real GDP, % year-on-year, calendar-year average			
	2019	2020F	2021F
<b>Global</b>	3.1	-3.5	4.8
<b>Advanced</b>	1.6	-5.4	3.5
<b>Emerging</b>	4.1	-2.3	5.6
<b>US</b>	2.2	-3.5	4.5
<b>Eurozone</b>	1.3	-7.2	2.6
<b>UK</b>	1.5	-11.0	3.8
<b>China</b>	6.1	2.2	6.9
<b>Japan</b>	0.7	-5.6	2.2
<b>Brazil</b>	1.1	-4.4	3.5
<b>India</b>	4.8	-6.5	7.1
<b>Russia</b>	1.3	-4.1	3.1

Note: Weights used for real GDP are based on IMF PPP-based GDP (5-year centred moving averages).

Source: Barclays Research, Barclays Private Bank

### Liquidity and fiscal largesse

The scale of the hit to the economy encouraged central banks to slash interest rates to new lows and inject unprecedented amounts of liquidity into the financial system. Governments have embarked on an extraordinary fiscal response such as allowing companies to furlough staff as well as pledging vast sums in loans, grants and credit guarantees.

In March, the leaders of leading economies, the G20, committed to do whatever it takes and use all available policy tools to minimise the impact from the pandemic. They promised to inject over \$5 trillion<sup>1</sup> into the global economy to counteract the social, economic and financial impacts of the pandemic. As the true impact of the crisis has developed, so has governments' willingness to ramp up the measures to deal with the damage, with the International Monetary Fund (IMF) forecasting the total has surged closer to the \$11.7 trillion mark, almost 12% of global output<sup>2</sup>.

While governments found innovative fiscal solutions, they have come at a price. The IMF estimates that sovereign debt in advanced economies will rise by a staggering 20 percentage points to 125% of GDP, and by more than 10 percentage points in emerging economies to 65% of GDP, by the end of 2021<sup>3</sup>.

#### Now for the bounce?

Future growth prospects will undoubtedly be determined by the lifespan, intensity and geographical spread of the virus. A true "normalisation" of activity will probably only occur when a vaccine has been developed. Given the time required to develop, test and distribute a safe and effective vaccine, it is unlikely to be widely available before the second half of 2021 at the earliest.

Hopes of a vaccine have been boosted by the recent clinical trial results. When a vaccine has been approved, vaccine hesitancy (listed by WHO as one of the top ten medical threats in 2019) still may infringe upon the combined effort to arrest the disease.

Given the size of the contraction this year, hopes of a vaccine and the vast level of stimulus instigated by policymakers, we project a significant recovery in 2021, with growth of 4.8%. However, certain sectors (such as airlines, hospitality and retail) may take many years to recover.

#### Positioning for a post-pandemic world

As investors look beyond COVID-19, we think that there are likely to be permanent changes to the role of the state, working patterns and corporate responsibility.

Governments around the world have intervened in society, the economy and financial markets like never before. It's implausible to think that they will be able to roll back from these positions in the near future. Elevated levels of state involvement and regulation are likely to be a long-term consequence. We would also expect weaker levels of globalisation as countries seek to establish independence in key strategic areas.

Technology continues to provide the solution to many of the challenges created by COVID-19 restrictions. Faster adoption rates have propelled the sector's role in nearly every aspect of society. As both businesses and consumers embrace localisation, digitalisation and electrification, technology's position looks set to become far more imbedded in life after the pandemic.

Environmental, Social and Governance (ESG) funds have seen strong inflows during the pandemic as investors seemingly expect companies to be rewarded for adopting a more balanced approach to their role and impact on society.

#### Focus on the long term

While coronavirus has had a distressing impact this year, the global economy and financial markets are incredibly resilient, with growth being the norm rather than the exception. Output will expand as demand from rising populations increases and improvements in human and physical capital and technology boosts productivity. The resulting long-term economic expansion should drive corporate earnings growth and asset appreciation over time.

**"Given the size of the contraction this year...we project a significant recovery in 2021, with growth of 4.8%"**

<sup>1</sup> G20 leaders' statement, Extraordinary G20 leaders' summit statement on COVID-19, 26 March 2020, [https://g20.org/en/media/Documents/G20\\_Extraordinary%20G20%20Leaders%E2%80%99%20Summit\\_Statement\\_EN%20\(3\).pdf](https://g20.org/en/media/Documents/G20_Extraordinary%20G20%20Leaders%E2%80%99%20Summit_Statement_EN%20(3).pdf)

<sup>2</sup> Column: Savings stash squares brutal second-wave rescue costs – Mike Dolan, Reuters, 21 October 2020, <https://uk.reuters.com/article/global-savings/column-savings-stash-squares-brutal-second-wave-rescue-costs-mike-dolan-idUSL8N2HA5HA>

<sup>3</sup> World economic outlook: a long and difficult ascent, Chapter 1: Global prospects and policies, IMF, October 2020, <https://www.imf.org/en/Publications/WEO/Issues/2020/09/30/world-economic-outlook-october-2020>



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## US outlook: a new dawn beckons

After the turmoil of coronavirus, soaring unemployment and a rancorous presidential election, a period of renewal and steady growth may lie ahead.

The US economy has battled through a difficult year as activity was ravaged by the coronavirus at the same time as social unrest and a divisive presidential election. The strict lockdown measures imposed due to the virus halted economic activity for a time. Second-quarter gross domestic product (GDP) contracted at its fastest pace on record, shrinking by 31.4% quarter on quarter (q/q) on an annualised basis<sup>1</sup>.

Despite this, the economy roared back at record speed in the third quarter, expanding by 33.1% q/q<sup>2</sup>. The surge in activity was driven by the relaxation of restrictions, stimulus fuelled consumer spending and sizable gains in exports. The US housing market boomed, with residential investment climbing at its fastest pace since 1983. Business investment has been particularly upbeat, registering an astonishing 70% q/q improvement. This corporate spending partially reflects the requirement to address the challenges and protocols created by the pandemic. It also suggests that companies are confident enough to commit to capital spending plans.

### Tight presidential race

The presidential election was much tighter than many pollsters predicted and the “Blue Wave” failed to emerge. While the balance of power in the US Senate will ultimately be determined by run-off elections in Georgia in January, Republicans are expected to maintain control.

The close race and split legislature could crimp the new administration’s ability to fully implement its domestic policy agenda. Aggressive tax hikes may need to be tempered, the regulatory risk overhanging the technology sector is expected to ease and a tighter, more focused stimulus package is anticipated to be agreed.

**Figure 1: US economic forecasts**

US economic forecasts, year on year (%), 2019-2021

US economic forecasts, year on year (%)			
	2019	2020F	2021F
GDP growth y/y (%)	2.2	-3.5	4.5
CPI inflation (%)	1.8	1.2	1.8
Unemployment rate (%)	3.7	8.1	5.5
Gross public debt (% of GDP)	108.2	131.7	135.1
Private consumption (%)	2.4	-3.8	4.8

Note: All data are calendar-year averages, except gross public debt, which is an end-year figure.

Source: Barclays Research, Barclays Private Bank

We still, however, expect Joe Biden to push ahead with his broad policy objectives including measures to invigorate the middle class, commitments to affordable healthcare and developing workers’ rights. The president-elect is also expected to place a greater emphasis on global policy areas such as climate change, international institutions and the promotion of shared values.

### The consumer makes a comeback

Personal consumption is the primary driver of the US economy, comprising around 70% of GDP<sup>3</sup>. In March access to services was significantly reduced due to business closures, social distancing and stay-at-home orders. The huge increase in unemployment caused by the pandemic also slashed disposable income for many households, the most important determinant of consumer spending.

<sup>1</sup> Gross Domestic Product, Third Quarter 2020 (Advance Estimate), BEA, 29 October 2020, <https://www.bea.gov/news/2020/gross-domestic-product-third-quarter-2020-advance-estimate>

<sup>2</sup> Gross Domestic Product, Third Quarter 2020 (Advance Estimate), BEA, 29 October 2020, <https://www.bea.gov/news/2020/gross-domestic-product-third-quarter-2020-advance-estimate>

<sup>3</sup> Consumer spending and U.S. employment from the 2007–2009 recession through 2022, US Bureau of Labor Statistics, October 2014, <https://www.bls.gov/opub/mlr/2014/article/consumer-spending-and-us-employment-from-the-recession-through-2022.htm>

With less income, households cut back expenditure with consumer spending slumping by 33% in the second quarter.

A mixture of re-opening economies and pent-up demand helped retail sales and consumer confidence rebound through the summer. Retail spending was also supported by the stimulus of the Coronavirus Aid, Relief and Economic Security (CARES) Act, which paid households \$267bn during March and April. Consumer spending surged 41% in Q3. The Consumer Confidence Index recovered to 101.3 in September<sup>4</sup>, up significantly from August, although the index is significantly lower than the February level of 130.7<sup>5</sup>.

#### Labour market

The strength of the labour market directly filters through to consumption levels. Before the pandemic the US unemployment rate was at a multi-decade low of 3.5%. The locking down of the economy triggered a surge in job losses, with the unemployment rate hitting 14.7% in April<sup>6</sup>, the highest since the Great Depression. The labour market has since experienced a rapid recovery, although it seems to be losing some momentum now. We expect the US unemployment rate to finish this year at 6.5% and at 5% by the end of 2021.

The increase in unemployment and consumer debt from the pandemic will keep consumer spending suppressed among some groups for a significant amount of time. Although, we do expect private consumption growth of 4.8% in 2021, which would recover most of the contraction from this year.

#### All-action Fed

The US Federal Reserve (Fed) has aligned its forward guidance with its aim to achieve maximum employment and 2% average inflation. The central bank has effectively vowed to keep rates close to zero through 2023, as its preferred core inflation measure is projected to remain below 2%, with no period of overshoot over the next three years. For 2021 we estimate that the US core personal consumption expenditures price index will average 1.5%.

The aggressive policy measures and framework review demonstrates that the Fed is willing to do whatever it can to support the US economy. Fed Chair Jerome Powell stated they still have additional ammunition if required including lending tools, its balance sheet and further forward guidance. Given the risks to the recovery and potential fiscal shortfall, the Fed is likely to increase its monthly bond-buying programme, from the current \$120bn level, and include a broader range of securities.

#### Sizeable fiscal response

With the US economy facing the biggest economic downturn since the Great Depression, a considerable increase in stimulus has been unavoidable. The bulk of this has come from the CARES Act. The largest rescue package in the country's history, amounting to more than \$2 trillion<sup>7</sup>, the legislation is aimed at protecting citizens from the public health and economic impact. As a result of the measures, US public debt has rocketed to 132% of GDP this year from 108% in 2019. An additional stimulus package may also follow early next year, possibly of the order of \$500m, putting further on the already record budget deficit.

#### Steady recovery

The immediate US growth profile still remains uncertain and will inevitably depend upon the ability of authorities to tame the virus and push ahead with additional fiscal stimulus. The outlook for 2021 suggests a year of steady recovery as companies rehire workers, consumer spending rebounds and activity is supported by overwhelming monetary and fiscal policy. From the low base of 2020 we forecast that the US economy will grow by 4.5% next year.

<sup>4</sup> Consumer Confidence Survey, The Conference Board, November 2020, <https://conference-board.org/data/consumerconfidence.cfm>

<sup>5</sup> Consumer confidence rises less than expected in February, CNBC, 25 February 2020, <https://www.cnbc.com/2020/02/25/us-consumer-confidence-february-2020.html>

<sup>6</sup> Unemployment rate rises to record high 14.7 percent in April 2020, US Bureau of Labor Statistics, 13 May 2020, <https://www.bls.gov/opub/ted/2020/unemployment-rate-rises-to-record-high-14-point-7-percent-in-april-2020.htm>

<sup>7</sup> The CARES Act Works for All Americans, US Department of the Treasury, November 2020, <https://home.treasury.gov/policy-issues/cares13>





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## European outlook: a green recovery plan

As the European Central Bank struggles to simulate growth at a time of plunging demand, can innovative fiscal measures take up the slack and deliver a greener post-pandemic recovery?

The eurozone entered its deepest recession since World War Two this year, amid the initial economic shock from soaring COVID-19 infections, posting a double-digit contraction in the second quarter from the prior one. The following quarter's recovery was led by France and Spain, driven by pent-up household demand, business investment and net trade. However, varying degrees of fresh lockdowns, disrupted global trade and pressure on domestic demand adds to the risk of a double-dip recession occurring. The outlook for the economy in large measure seems to rest on coronavirus developments.

The eurozone is a relatively open economy that has profited from growing international trade links over the past two decades. The European Central Bank (ECB) estimates that "extra-euro area" trade in goods and services amounts to around half of the bloc's gross domestic product (GDP).

Weaker international demand and disruption to trading routes as a direct result of the pandemic is expected to reduce Europe's trade with the rest of the world by a weighty 10% this year, according to data from the European Union (EU). Manufacturing has been hit hard, particularly transportation and electrical equipment.

### Unemployment set to soar

Higher levels of unemployment resulting from the economic contraction seen this year will inevitably weigh on household consumption levels. Nervousness around the labour market has pushed savings intentions to their highest level on record. Labour markets in the eurozone tend to fluctuate less than seen in the US due to a broad mix of legal protections for workers and the power of the unions in the region.

The eurozone unemployment rate was 7.9% before the pandemic took hold. The number of workers without jobs has jumped significantly since August. With support measures being gradually unwound, unemployment levels may rise dramatically into the year end. We expect a

**Figure 1: Eurozone economic forecasts**

Eurozone economic forecasts, year on year (%), 2019-2021

Eurozone economic forecasts, year on year (%)			
	2019	2020F	2021F
GDP growth y/y (%)	1.3	-7.2	2.6
CPI inflation (%)	1.2	0.2	0.4
Unemployment rate (%)	7.6	8.1	9.5
Gross public debt (% of GDP)	86.2	105.6	110.2
Private consumption (%)	1.3	-8.0	2.4

Note: All data are calendar-year averages, except gross public debt, which is an end-year figure.

Source: Barclays Research, Barclays Private Bank

eurozone unemployment rate of 9.1% by the end of 2020, remaining elevated through 2021 to finish at 9.4%.

### Subdued inflationary pressures

The eurozone's inflation figures turned negative in August for the first time in four years, highlighting the lacklustre demand seen in the bloc. Consumer price inflation (CPI) was -0.2% while core inflation, which strips out the volatile food and energy component, hit a record low. Looking beyond the seasonal and technical factors, subdued eurozone inflation is likely next year too, with weakness in labour markets and household disposable income anchoring core inflation at depressed levels.

Moreover, autumn's resurgence of COVID-19 cases in Europe poses a meaningful risk to the consumer demand recovery and could create additional downward pressure. Inflation should trend up in 2021 as base effects recede, but we expect that CPI will average 0.4% next year, well below the target level.

### ECB fires another bazooka

The ECB has taken aggressive measures to stabilise the economy and provide favourable financing facilities to businesses and households, which is helping to support demand. With European rates already deep in negative territory, the central bank has limited room for manoeuvre. As such, the deposit rate may remain at -0.5% for the next two years with the bank's Governing Council focusing on providing liquidity support.

ECB president Christine Lagarde fired her own big bazooka over the summer. In June, the Pandemic Emergency Purchase Programme was increased by €600bn. The total of announced purchases was €1.35 trillion<sup>1</sup> at the end of October, much larger than seen in the euro crisis early in the last decade. That said, with a rapidly deteriorating health situation, a faltering recovery and subdued inflation outlook means that the ECB may have to take additional measures. In October the bank unusually pre-committed to recalibrate its instruments at December's meeting in an effort to avoid unwarranted tightening of financial conditions.

The ECB is expected to extend its bond-buying programme by €500bn and commit to reinvestment until mid-2023. Its refinancing operation has undeniably helped liquidity and financing conditions. The targeted longer-term refinancing operations (TLTROs) rate can be cut further below -1% to encourage greater bank lending to the real economy if needed too. While the bank is proving to be resourceful, its limited policy tool kit means that it has struggled to reflate the economy and stimulate the required growth, a burden that increasingly sits with fiscal policymakers.

“Growth prospects will be determined by the path of the pandemic, resilience of the labour market and efficacy of the coordinated fiscal and monetary response”

### Debt binge to aid recovery fund

The extraordinary measures instigated by European officials will impact eurozone debt levels. The debt to GDP ratio is likely to hit 106% this year, from 86% in 2019.

The establishment of the European recovery fund by the European Commission (EC) is considered a significant step change for the bloc. The fund comprises of €390bn of grants and €360bn of low interest loans<sup>2</sup>. The plan proposes establishing a green recovery roadmap for each industrial sector and meeting the EU's 2050 target for greenhouse gas emissions reductions. The proposal also takes a significant step in outlining the future of the EU in the long run with money made available for digitalising the economy and investing in research and innovation.

The EC plans to borrow the money to finance the recovery fund, using guarantees from the EU's long-term budget as security and seemingly embracing shared debt liability. The proposal not only supports weak economies (particularly southern European ones) but commits to much greater levels of fiscal integration; a decision that reduces concerns about the fragmentation risk of the EU. While the European Council and Parliament are still negotiating the specific details of the fiscal package, speed is of the essence as political infighting could result in expensive implementation delays.

### Eurozone recovery prospects

The eurozone is likely to contract in the final quarter of the year, taking the annual slump in activity to -7.2% in our view. Growth prospects will be determined by the path of the pandemic, resilience of the labour market and efficacy of the coordinated fiscal and monetary response. We expect the 27-member bloc to grow by 2.6% next year, which would be a poor performance when viewed through the lens of the low base of 2020.

<sup>1</sup> Monetary policy decisions, European Central Bank, 4 June 2020, <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.mp200604-a307d3429c.en.html>

<sup>2</sup> Europe clinches massive stimulus deal to bind continent together, Bloomberg, 21 July 2020, <https://www.bloomberg.com/news/articles/2020-07-21/eu-leaders-reach-deal-on-750-billion-euro-virus-recovery-fund>



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## China outlook: year of the bounce

China looks set to be the only major economy to expand in 2020. While US trade tensions will be key to sentiment and growth, the country is on track to become a more consumption-led economy.

China was first to feel the effects of coronavirus late last year and by February Wuhan had become the focal point of an emerging global health crisis. However, the country's active and aggressive response has limited the impact on the state and helped to avoid a technical recession (or output shrinking in two consecutive quarters).

China's centrally planned government introduced strict measures to reduce the spread of the virus. These included the cordoning off of infected provinces, forced isolation of suspected cases and introducing a stringent track and trace system. Authorities quickly closed schools and officials rigorously enforced a stay at home policy. The nation has seen less than 100,000 cases of COVID-19 and less than 5,000 deaths, according to John Hopkins University, an extraordinarily low figure given its population<sup>1</sup>.

After contracting in the first quarter, the world's second largest economy returned to growth in the next one. Recent data suggests that a persisting recovery through the summer and towards the year end. In the first nine months of this year output was up by 0.7%<sup>2</sup>.

### Strong bounce in activity

Beneath the headline numbers, the true shape of China's recovery is starting to emerge. Factory output has been the driving force behind the improvement in growth prospects. Industrial production is now back to pre-pandemic levels. Recent data has suggested that the V-shaped recovery has been broadening out with an acceleration in retail sales.

While fixed asset investment has been weaker than expected, property investment has outperformed despite policies to cool the sector. Export levels have improved over the past few months, up 9.9% y/y in September<sup>3</sup>,

Figure 1: China economic forecasts

Chinese economic forecasts, year on year (%), 2019-2021

China economic forecasts, year on year (%)			
	2019	2020F	2021F
GDP growth (%)	6.1	2.2	6.9
CPI inflation (%)	2.9	2.7	2.0
Unemployment rate (%)	5.2	5.7	5.4
Consumption (%)	3.5	-1.3	4.5

Note: All data are calendar-year averages, except gross public debt, which is an end-year figure.

Source: Barclays Research, Barclays Private Bank, November 2020

as its major trading partners have lifted coronavirus trade restrictions.

### Restrained policy response

China's policy response has been relatively restrained compared to other major economies. Although the People's Bank of China has made cuts in selective banks' reserve requirement ratios (RRR). In order to support the economy and with an eye on consumption, the central bank delivered a bigger than expected short-term liquidity injection in August.

However, future policy action is likely to be constrained. The stronger than anticipated recovery, along with concerns over creating asset bubbles and financial imbalances, has encouraged policymakers to consider withdrawing the stimulus, although policy rates and RRR are likely to remain on hold for some time.

<sup>1</sup> Coronavirus Resource Centre, John Hopkins University, November 2020, <https://coronavirus.jhu.edu/region/china>

<sup>2</sup> China's economic recovery quickens as consumption returns, Reuters, 19 October 2020, <https://uk.reuters.com/article/us-china-economy-gdp/chinas-economic-recovery-quickens-as-consumption-returns-idUKKBN27404Z>

<sup>3</sup> China Sept exports rise 9.9% y/y, imports surge 13.2%, Reuters, 13 October 2020, <https://uk.reuters.com/article/china-economy-trade/china-sept-exports-rise-9-9-y-y-imports-surge-13-2-idUKB9N2G502G>

### Risks to growth

There are a number of risks that could impede China's growth prospects. As with other countries, activity remains vulnerable to flare ups of COVID-19. That said, officials have proved very adept at isolating and containing outbreaks.

Elevated debt levels could also restrain the country's growth prospects. The Institute of International Finance estimates that China's total corporate, household and government debt is more than 300% of GDP<sup>4</sup>. Authorities have tried to rein in borrowing growth in recent years, particularly in the shadow banking sector. However, slower expansion resulting from the trade war with the US and the economic ramifications of coronavirus, has led to a loosening in lending policy once again.

### “Elevated debt levels could also restrain growth prospects”

China is the world's largest exporting nation with total exports estimated at more than \$2.6 trillion in 2019<sup>5</sup>, accounting for 18.4% of GDP<sup>6</sup>. As such it remains vulnerable to future travel restrictions, weaker global demand and geopolitical tensions.

### US trading relations are key

The trading relationship between the US and China remains an important component of both sentiment and future economic progression. The review of the first phase of the trade deal was unexpectedly constructive and has provided a source of stability in an otherwise strained relationship.

China appears committed to instigating the key elements of the deal including greater protection for intellectual property rights, eliminating the forced transfer of technology and opening up local markets for US financial services companies. While the disruption from coronavirus has infringed on the state's ability to buy an additional \$200bn of US agricultural products, they have promised to ramp up the purchase rate.

The new Biden administration is expected to take a multilateral approach to American trade negotiations, which should help to alleviate some of the direct pressure on the relationship between the two superpowers.

### Growth strategy

For the first time since the 1990's China has not set an official growth target for this year, but we envisage it will grow at 2.2% and is likely to be the only major region to grow this year. Next year growth of 6.9% is pencilled in (see figure one).

At the fifth plenary session of the 19th Communist Party Committee, China unveiled its latest five-year economic and development plan. The strategy provides the outlook for China's policy agenda and goals between 2021 and 2025. There are commitments to focus on the quality and sustainability of growth rather than the headline speed and to modernise supply chains and upgrade industry to focus on high-end manufacturing.

The leadership also wants to achieve higher quality employment and improving household income broadly in line with economic growth. Moreover, the state plans to develop new strategic industries, improve services and transportation as well as quicken energy and digitalisation developments. The fifth plenum places a high priority on innovation and technology self-reliance, boosting domestic demand and green growth.

### Aiming for the top spot

Over the past four decades, China's opening-up policy has created a private sector and resulted in a remarkable growth rate of 9.4%. China looks set to further transition away from its reliance on cheap labour and low-end manufacturing to focus on becoming a responsible, high-tech, domestic consumption-led nation. In turn, this could help propel it to be the world's largest economy over the next decade.

<sup>4</sup> Sharp spike in debt ratios, Global Debt Monitor, Institute of International Finance, 16 July 2020, [https://www.iif.com/Portals/0/Files/content/Research/Global%20Debt%20Monitor\\_July2020.pdf](https://www.iif.com/Portals/0/Files/content/Research/Global%20Debt%20Monitor_July2020.pdf)

<sup>5</sup> China exports, Macrotrends, November 2020, <https://www.macrotrends.net/countries/CHN/china/exports>

<sup>6</sup> Exports of goods and services (% of GDP), World Bank DataBank, November 2020, <https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS>



Henk Potts, London UK, Market Strategist EMEA

## UK outlook: post-Brexit and pandemic bounce?

With output contracting sharply, a renewed surge in COVID-19 infections and uncertainty over a Brexit trade deal with the EU, can the UK economy bounce back next year?

This was supposed to be a seminal year for the UK economy as it left the European Union (EU) on 31 January and entered into an 11-month transition period. Its fortunes were expected to be determined by the negotiations surrounding its future trading relationship with the 27-country bloc. While the UK's medium-term growth prospects will be influenced by the shape of any deal, COVID-19 now defines the UK's growth profile.

The UK has been particularly hard hit by the pandemic, registering a record number of deaths in Europe and the worst second-quarter contraction of any major economy in the bloc. The decline was widespread. The peak to trough decline in gross domestic product (GDP) between February and April was 25.6%. Hospitality saw the biggest drop in productivity and business investment.

### Labour market suffers

The UK labour market is projected to be one of the biggest casualties of the economic disruption. The long-awaited pick-up in unemployment started to show in figures released in August and are projected to accelerate aggressively over the next few months. Figures from the Office for National Statistics (ONS) show UK job cuts jumped the most on record in the three months through August. The most disturbing element was the sharp drop in the number of employees on payrolls in September compared to March.

In September, the UK's unemployment rate rose to 4.5%, the highest since 2017, according to the ONS. The worst is expected to come as the furlough scheme is eventually replaced by the less accommodative jobs support scheme. We believe that the unemployment rate may peak at over 8% in the next few months. That said, the labour market should recover in 2021. We expect the unemployment rate to be 7.6% by next December, still higher than at the start of the pandemic when the rate was 3.9%.

Figure 1: UK economic forecasts

UK economic forecasts, year on year (%), 2019-2021

UK economic forecasts, year on year (%)			
	2019	2020F	2021F
GDP growth y/y (%)	1.3	-11.0	3.8
CPI inflation (%)	1.8	0.7	1.5
Unemployment rate (%)	3.8	4.6	7.8
Gross public debt (% of GDP)	86.4	95.0	99.7
Private consumption (%)	0.9	-14.1	4.1

Note: All data are calendar-year averages, except gross public debt, which is an end-year figure.

Source: Barclays Research, Barclays Private Bank, November 2020

### Aggressive policy response

Policymakers, along with other countries, have responded to the economic challenges by aggressively loosening monetary conditions and unveiling a wide-ranging fiscal package.

The dramatic fall in output prompted the chancellor to open the spending taps and turn his back on a decade of austerity. The government injected hundreds of billions of pounds into the economy, primarily aimed at tackling the fallout from the outbreak. The funds have been channelled through accelerated infrastructure projects through the recovery phase, loan guarantees to businesses and furlough schemes to help stem soaring unemployment claims.

The expansive actions have seen an unmatched rise in peacetime borrowing. As a result, we predict UK debt to surge from 86% of GDP last year to 95% in 2020.

### Time for negative rates?

Since the start of the pandemic, the monetary policy committee (MPC) has cut interest rates to a record low of 0.1% and ramped up its bond-buying programme to £895bn. The Bank of England has extended the timeframe for purchases until the end of next year. The potential for an extensive contraction, lacklustre inflation expectations and continued Brexit uncertainty, has encouraged the MPC to signal that it was prepared to add yet more stimulus and would consider negative interest rates.

We anticipate that the central bank will reduce the bank rate to zero, lower the capital requirements for banks and offer even more dovish guidance. In order to encourage lending, especially to small and medium-sized enterprises, a cut in the Term Funding Rate to -50 basis points may also be on the cards. Given the broad range of unintended consequences the introduction of a negative bank rate remains unlikely, but is still possible if the UK's growth profile dramatically deteriorates.

### Brexit: down to the wire

Boris Johnson's Conservatives came to power in December 2019 pledging to "Get Brexit Done". Nevertheless, the path to a comprehensive trade agreement has been far from smooth, with a number of areas of contention delaying definitive progress. The UK and EU continue to clash over a number of areas including fishing rights, state-aid rules and regulations, level playing field commitments and the Northern Ireland protocol.

Despite the negative mood music, we still think that a trade deal is achievable. As such, the most likely outcome is expected to be a very thin trade deal. In practice, while this prioritises trade in goods, it is likely to mean restricted market access for services since the UK would be signing up to fewer obligations.

Failure to secure a deal would put further pressure on the UK economy and businesses. A no-deal Brexit would likely result in companies having to comply with trade barriers, tax changes as well as talent pool and regulatory restrictions. On the positive side, there are signs that the UK has been making early progress on trade agreements with countries outside the EU. Although Europe is the UK's most important trading partner.

### COVID-19 clouds growth outlook

There have been signs of a fragile recovery as the UK economy reopened, after April's low point. Mobility indicators show higher public transport use and driving activity. Electrical power load usage has rapidly recovered from the spring low, activity in the housing market has been robust and retail sales volumes have also been rebounding.

However, we have become less constructive around the prospects for the UK economy and expectations of a quick normalisation have faded. A resurgent virus and the associated intensification of containment measures, along with rising unemployment, higher precautionary savings and at best a thin trade deal with the EU, creates a gloomy backdrop.

We anticipate that output will contract by 11% in 2020 followed by a softer recovery. We forecast growth of 3.8% year on year in 2021, partly reflecting the deep contraction.

“We have become less constructive around the prospects for the UK economy and expectations of a quick normalisation have faded”



Gerald Moser, London UK, Chief Market Strategist; Nikola Vasiljevic, Zurich Switzerland, Head of Quantitative Strategy

## Investment opportunities in a low-return era

In the shadow of coronavirus, bloated government debt levels, low rates and expensive equity valuations, prospective investment returns are likely to be low. What might investors do to position portfolios for a post-pandemic world?

It is impossible to take a view on 2021 without first reviewing this year and its unprecedented events. The economic shock caused by the effects of the pandemic saw far from a typical slowdown. It was much more brutal and sudden than that.

Normally, growing imbalances in some parts of the economy would trigger a readjustment. Depending on the size of the imbalances, it could take six months to two years to reach equilibrium. This time the contraction did not begin with an imbalance, but stemmed from stringent restrictions imposed to tame the COVID-19 pandemic. This meant that relatively stable economies came to a halt almost overnight.

The shock was broad based but disproportionately affected the services sectors compared to a traditional recession which tends to hit manufacturing and industrial production more. Considering the large size of the services sector in developed economies and the sector reliance on labour rather than capital, this shock resulted in a sizeable increase in unemployment.

### Worse than 2008

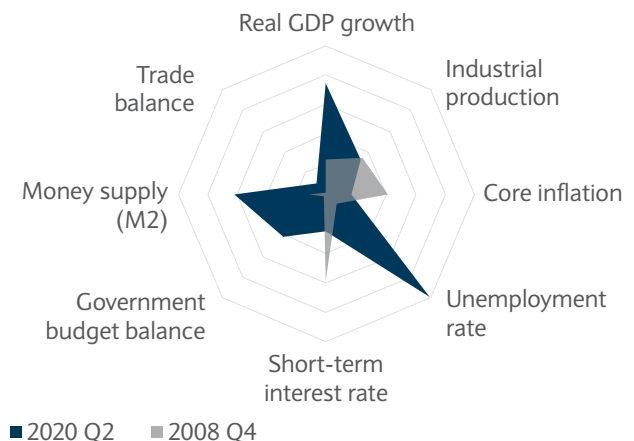
To give an order of comparison of what happened in the second quarter of 2020, we compare key US economic variables in that quarter to the weakest quarter of the 2008 crisis, widely considered the worst shock in living memory at the time (see figure one). The impact on unemployment in this year's quarter is striking in magnitude, though it is the mirror image of the record contraction in real gross domestic product (GDP) growth. With interest rates already at very low levels, one other noticeable difference with 12 years ago is the very swift expansion in quantitative easing by central banks, resulting in an increase in the monetary supply.

### Economic impact of the pandemic

With rising unemployment and lockdown measures, the impact on society was also much larger than anything we have experienced since World War Two. It has profoundly

**Figure 1: Comparing economic shocks**

The relative absolute size of shocks of key US economic variables in the worst quarters of 2020 and 2008



Source: Bloomberg, Barclays Private Bank, November 2020

changed lifestyles and social behaviour of many individuals, and completely altered their routine.

While many effects of the pandemic are expected to be transitory and fully contained in the medium and long term due to the exogenous nature of the shock, there are other changes which are likely to be structural.

**“While many effects of the pandemic are expected to be transitory...there are other changes which are likely to be structural”**

Despite many countries reporting high infection numbers and preparing for new restrictions and lockdowns at the time of writing, a solid, and initially fast-paced, economic upswing is likely once the world finally claims the victory

in the battle against the virus. There is not much question around this, the only unknown is around the timing of this recovery.

### Structural changes post pandemic

But after the rebound, and the economy recovers some, if not all, of this year's lost ground, some areas of the economic landscape are likely to look different from before the pandemic. Inflation risk is a particular case in point.

Over the past three decades, globalisation has increased competitiveness and lowered market costs. Global supply and value chains have immunised open economies from inflation outbursts. Rising populism and geopolitical tensions over the past few years, coupled with falling cost differentials between the developed and emerging economies, increasing inequality in developed countries and the potential fragility of supply chains, could eventually boost inward-oriented economic models.

This focus on domestic demand is likely to be the main feature of China's next five-year plan that should be ratified in the first half of 2021. More broadly, most of the fiscal stimulus in developed countries announced in the wake of the COVID-19 outbreak contains incentives to onshore some of the supply chain and increase domestic manufacturing capacities.

### Government debt

Another legacy from the pandemic crises will be elevated government debt. While the second wave of coronavirus cases that northern hemisphere countries face is likely to push the debt/GDP numbers even higher, it has already increased by around a fifth in the developed world and tenth in the developing world<sup>1</sup>.

At current rates and yield levels, the cost of servicing government debt is lower than it was a year ago, even though debt levels have increased. And while the increased duration offers some protection against a dramatic increase in interest payments in the short term, it increases the vulnerability of economies in the long run. This is particularly true for emerging markets where central banks often don't have enough credibility to implement quantitative easing and have to balance the cost of debt with the need to lure capital flows to finance the debt when setting interest rates levels.

**Figure 2: Expected returns framework**

Building blocks approach for estimation of expected returns for fixed income and equities

Asset class	Building blocks of total returns				
	Income		Growth	Valuation	
Fixed income	Treasury yield	Credit spread	Roll return		Treasury yield curve adjustment Credit spread adjustment
Equities	Dividend yield	Net buyback yield	Real earnings growth	Inflation	Multiple expansion

Source: Barclays Private Bank, November 2020

Awakening of inflationary pressures would likely push interest rates higher, which in turn would raise concerns regarding sovereign debt and fiscal stability. That said, we stress that this is only one potential macroeconomic risk scenario which has low probability over short and medium term. However, given its increasing likelihood and far-reaching consequences over a longer time horizon, it is important to keep this in mind when thinking about 2021 and beyond.

### Technology and sustainability

Finally, technological change and sustainability are two topics which have benefited from the crisis. Social distancing has led more activities, whether work or leisure related, to move online. The pandemic has accelerated the process of digitalisation and virtual experience. This has implications for real estate, transport, retail and leisure among other sectors. Events have put more emphasis on the fragility of our economic system, with its sustainability being more and more questioned. Almost all fiscal spending announced this year has a sustainable bias attached to it and the momentum behind sustainable investments is likely to grow ever stronger.

### Building long-term expectations

While next year should be calmer than this, with more chance of a vaccine becoming available then, uncertainties around the aforementioned structural changes may keep volatility more elevated than before the pandemic. This could affect asset performance. But before assessing prospects for each asset class next year, it is worth considering their long-term return expectations to focus on

<sup>1</sup> World economic outlook: a long and difficult ascent, Chapter 1: Global prospects and policies, IMF, October 2020, <https://www.imf.org/en/Publications/WEO/Issues/2020/09/30/world-economic-outlook-october-2020>



investment prospects and reduce the influence of the short-term market noises (see figure two).

Long-term anticipated total returns can be estimated by adding three fundamental components: income, growth and valuation adjustments. Growth, inflation, fiscal and monetary policy are among the key drivers. A summary of the building blocks is provided in figure two.

#### Lower returns on the horizon?

In an investment world characterised by record low interest rates and high equity valuations, the total returns for the core asset classes over the next five years are expected to be lower than the corresponding past realised returns (see figure three).

#### Bonds

The expected returns for developed market bonds are at the historical minimum due to extremely low yield levels in many countries. Since the income component is the single most important building block for fixed income assets, it is not surprising that falling yields are heavily weighing on bond returns. For example, the nominal yields on 30-year government bonds in the eurozone and Switzerland are negative. Consequently, the expected returns for both government and investment grade bonds are below zero.

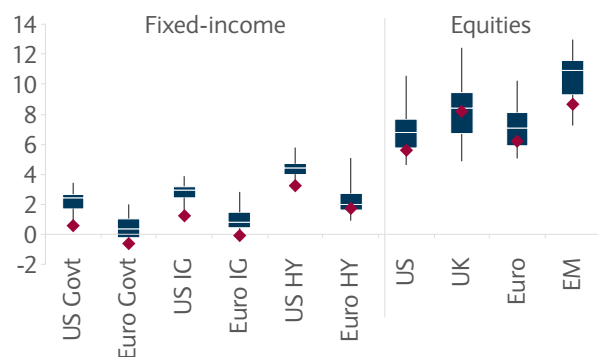
In the US and UK, expected returns remain positive, however recent downward shifts of the yield curve have compressed them below 1%. European and US high yielding bonds offer more attractive returns of about 2-4%. Nevertheless, when adjusted for inflation, the returns for lower quality bonds are also hovering a meagre 1% above zero. Finally, if we consider a scenario in which inflation risks discussed above materialise, fixed income assets could post even lower realised returns.

#### Equities

Equities are also expected to be under pressure, primarily due to stretched valuations. Historically elevated cyclically adjusted price-to-earnings ratio indicates a likely multiple contraction over the next few years, though it is unlikely to materialise meaningfully in 2021 as central banks should remain accommodative. But even if the full reversion to mean for valuations seen in the previous decade is unlikely, due to persist low rates and the changing composition of benchmark indices – with technology's share in the market portfolio steadily increasing – some adjustment looks likely over the next five years.

**Figure 3: Long-term expected returns**

Comparison of current with past expected returns for equities and fixed income



Note: Lower and upper edges of the blue boxes (black lines) represent the 25th and the 75th percentile (minimum and maximum) of the expected returns distribution from March 2012 until September 2020. Expected returns at September 2020 are represented by red dots. The low position of the dots relative to the boxes and lines indicates expected returns in future.

Source: Bloomberg, Barclays Private Bank, November 2020

However, dividends and net buybacks of shares are expected to provide a stable income yield. Overall, our analysis indicates that developed market equities could offer nominal returns of 5-7% annually over the next five years. Emerging markets will likely provide a risk premium of 1-2% on top of that.

#### Equities more appealing than bonds

While anticipated returns may be historically low, equities offer a decent investment opportunity due to their growth component. Compared to bonds, equities can act as a hedge in case of inflation and, with a thorough selection process, can still offer returns closer to historical returns.

The return numbers mentioned previously are at the index level, but when valuation is no longer the main driver of performance, the importance of single-stock investing appears much more evident (see figure four). Looking to next year, central banks seem unlikely to tighten monetary conditions, but there is not much room for expansion either. In that sense, the valuation expansion in equities in recent years, aided by lower rates and an expanding liquidity pool, is unlikely to be a key driver. The onus for returns is now on growth, making it more important to look for where growth is still happening.

We believe that a focus on quality selection and exposure to secular growing trends are the appropriate way to invest in equities. We highlighted four themes where we see incremental growth over the next few years: 1) Globalisation reversion, 2) Building a sustainable world, 3) Smart everything and 4) Demographic shifts. In 2021, we think that the sustainable rhetoric will be front and centre while smart everything is also likely to continue to benefit from infrastructure spending post pandemic.

“In 2021, we think that the sustainable rhetoric will be front and centre while smart everything is also likely to continue to benefit from infrastructure spending post pandemic”

#### Portfolio construction revisited

The low levels of volatility seen prior to the pandemic are unlikely to be repeated soon. While uncertainty levels should decrease compared to last year, somewhat elevated uncertainty may persist due to macro developments, geopolitical risks and the potential structural changes mentioned previously. This means that portfolio construction and, more precisely, the need for diversification becomes more important.

#### Fixed income

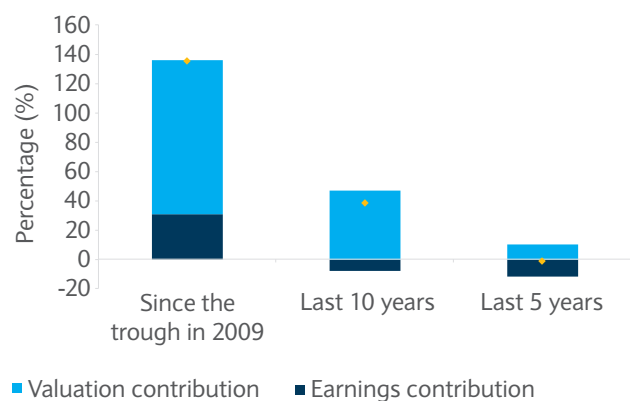
The diversification benefits of bonds have eroded in the low-rate environment. With income return prospects weak and limited capital appreciation potential, the attractiveness and effectiveness of a classical 60-40 portfolio – 60% invested in equities and 40% invested in bonds – have faded. Such a portfolio will likely exhibit lower returns and elevated volatility relative to the historical figures. Therefore, a carefully tailored multi-asset portfolio seems needed more than ever to address the issue of lower return and higher volatility.

Due to inflation risk concerns, inflation-linked bonds could be one of the most important additions to a fixed income bucket which is nominal in nature and as such is unprotected from unexpected spikes in inflation. Credit and illiquidity premia could help to boost expected returns in the fixed-income space.

#### Private markets and hedge funds

More broadly, private markets should continue to play an ever increasing role in a well-diversified portfolio as opportunities remain plentiful in both equity and debt universes. A high-volatility and low-return environment

**Figure 4: Europe price-return decomposition**  
Price-return decomposition between earnings and valuation since 2009



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research, November 2020

could also favour hedge funds. The asset class has suffered in the past decade from relatively low volatility and high returns in public markets. But with lower returns for most asset classes, notably fixed income, hedge funds could again be an attractive option to diversify a portfolio.

Depending on the strategy, hedge funds tend to be more or less correlated to equity markets. But even more so than in public markets, the dispersion in the hedge fund investment universe has increased. This means that active investment approach in this space is of paramount importance for investors looking to generate alpha.

#### Gold

Finally, gold continues to appeal as a solid diversifier in a portfolio. With real rates low, and even negative in some places, the precious metal should continue to offer protection in case of rising volatility without being a drag on performance in quieter periods. Its strong relationship with real rates should also offer protection against positive inflation surprises.



Julien Lafargue, CFA, London UK, Head of Equity Strategy

## Feeling the quality with equities

With muted equity returns on the cards next year in the shadow of the pandemic, a focus on active management and tilt to high-quality companies has much appeal.

This has been a truly exceptional year in, and outside of, financial markets. Equities saw the fastest bear market and an equally rapid recovery, followed by a contested US presidential election. This volatility, associated with a sharp valuation re-rating, left investors hesitant with many preferring to adopt a “wait and see” approach.

On paper, 2021 should be an easier year than this one with mostly positive catalysts on the horizon. However, there seems limited room for significant, broad-based, upside. The new decade may require a nimble approach from investors to make the most of equity markets.

### In bubble territory?

With the COVID-19 pandemic triggering a collapse in earnings, markets have relied on multiple expansion to rebound. At the peak, the S&P 500 traded above 23 times forward earnings on a par with the levels reached during the dot-com bubble in the early 2000s. This level was clearly unsustainable and prompted many pundits to call for a correction.

Instead, as we expected, equities “grew into the multiple” as forward earnings started to take into account the recovery anticipated in 2021. As a result, the index is now trading at around 20 times forward earnings, a level that while elevated looks justified.

“The index is now trading at around 20 times forward earnings, a level that while elevated looks justified”

### It's all relative

Indeed, while valuations remain significantly higher than their historical average, they appear fair when taking into account the level of interest rates. At 400 basis points, the equity risk premium (the spread between the earnings yield and the risk-free rate) is bang in line with its 10-year average (see figure one). As long as interest rates remain

**Figure 1: S&P 500 equity risk premium**

The S&P 500 equity risk premium against its long-term and 10-year average since 1998



Sources: Morgan Stanley, Bloomberg, November 2020

anchored at low levels, there seems little reason for the multiple to contract significantly.

At the same time, the market already expects no interest rate hike for at least three years. As such, a dovish surprise is unlikely, making further multiple expansion improbable. With earnings looking like recovering strongly next year, our base case calls for modest multiple contraction.

### Dividends to help

Without re-rating, equity returns should be mainly driven by earnings growth and shareholder income. On the latter, after a pause in recent months, companies are likely to return to rewarding shareholders next year in the form of higher dividends and buybacks. While it may take a couple of years to fully recover to pre-pandemic levels, 2021 is likely to be a much more supportive environment for income investors. However, with a lengthy road to recovery ahead, we believe that the focus should be on the sustainability of the dividends rather than their absolute levels.

### Earnings to rebound strongly

The consensus expects equities to deliver close to 30% year-over-year earnings growth in 2021 (see figure two), leaving earnings per share 5% above 2019 levels. While this may seem optimistic, this year highlighted that many companies can quickly adapt to a challenging environment. Should a vaccine be widely available, governments continue to support economies and buybacks resume, we would not be surprised to see 2021 earnings coming close to match those seen last year. However, wide discrepancies in the pace of the recovery can be expected at the sector and stock level.

“The consensus expects equities to deliver close to 30% year-over-year earnings growth in 2021, leaving earnings per share 5% above 2019 levels”

The combination of modest multiple contraction, solid earnings growth and a boost from buybacks should allow equities to return mid-to-high single digits next year. As an example, assuming the S&P 500 can deliver earnings per share of \$170 in 2021 (versus \$165 in 2019) and its price-to-earnings ratio remains around 19 times, the index’s fair value would lie in the 3,500-3,700 points range.

### The key factors to watch

For the above base case to materialise, positive COVID-19 pandemic developments are needed (with a vaccine becoming available in the second half of 2021 looking more likely after early data from potential candidates). In addition, central banks must continue to take a prudent approach, maintaining their accommodative stance, and governments should signal more fiscal easing. Any deviation in either timeline or stance could have an impact.

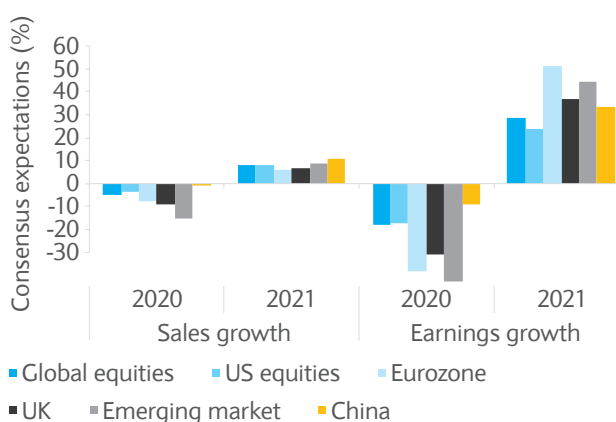
The main wildcard appears to be the science around COVID-19 treatments. While early results have been promising, disappointment could be severe should a vaccine fail to materialise. However, hope will likely remain high until the very last study has proven ineffective and as such any correction on this ground should be relatively short-lived.

### Still prefer US and emerging markets

Even if US and emerging market equity indices have strongly outperformed their European and Japanese peers over the past twelve months, both still look relatively attractive. They seem to offer the most appealing sector mix and potential for growth over the medium term.

**Figure 2: Consensus expectations**

Consensus expectations for sales growth and earnings growth in 2020 and 2021



Source: Bloomberg, Barclays Private Bank, November 2020

The eurozone remains a value play which we would either trade in and out or focus solely on stock picking (rather than investing passively). The UK market, on the other hand, remains hostage to Brexit trade negotiations with the EU. Fortunately, as time passes, whether there is a hard or soft deal, should be welcomed by markets’ participants as visibility increases.

### Neither growth nor value but quality

We doubt there is much merit in the growth versus value debate. While value’s long-lasting underperformance will be regularly interrupted by bouts of outperformance as investors tentatively price a “return to normal”, in the current environment undervalued stocks look unlikely to deliver sustainable superior performance. For this reason, we maintain our preference for “quality” as an investment style. Indeed, in our opinion, companies focused on strengthening their balance sheets and free cash flow generation appear best placed to outperform over the medium term, whether they belong to the growth or value bucket.

### Sector and stock selection essential

The post-pandemic recovery is evolving into a K-shaped one with wide divergences emerging between winners and losers. Consensus earnings expectations best reflect this gap with technology and materials anticipated to grow earnings by around 20% in the 2019-2021 period (see figure three) while profits in energy or real estate could remain significantly below their 2019 levels for years to come.

## “The post-pandemic recovery is evolving into a K-shaped one with wide divergences”

While projected earnings growth numbers are no indication of future returns, it shows the pessimism surrounding certain sectors of the economy. This leaves plenty of room for positive surprises and possibly sharp moves higher for these unloved stocks but, for long-term investors, it also highlights the risks associated with going against fundamentals. Active management still appears to be key to unlocking additional returns.

### Technology, healthcare, consumer and select industrials

At the sector level we have consistently maintained a preference for technology (in its broad interpretation), healthcare, consumer-related industries (with a focus on disrupters) and industrials (with a technology tilt). With the exception of industrials, all of these sectors (defined according to MSCI's GICS methodology) appear to have performed better than the overall market index at the global level. Going into 2021, we see no reason to drastically change this view. While a more volatile year may lie ahead, with leadership likely to change hands, for now we maintain our preferences unchanged, especially for long-term investors.

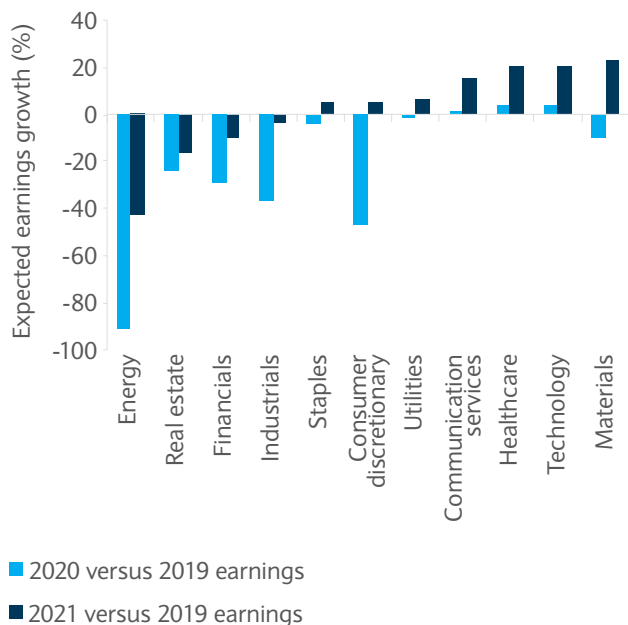
## “While a more volatile year may lie ahead, with leadership likely to change hands... we maintain our preferences unchanged”

### A keen eye on ESG

Environmental, social and governance (ESG) factors are becoming increasingly important. These were (and remain) a key driver of our cautious stance on 2020's worst performing sector: energy. Investors will probably continue to shy away from sectors and stocks exhibiting poor ESG credentials. While companies will most likely address these challenges over time, all else equal, flows will likely continue to favour better-rated stocks and avoid those subject to any controversy. As such, ESG considerations seem worth paying attention to when investing.

Figure 3: K-shaped earnings recovery

Earnings expectations for various sectors compared with 2019



Sources: Refinitiv, Barclays Private Bank, November 2020

### Lower returns warrant active approach

After a challenging year, the outlook for next appears more constructive for equity markets. While valuations remain an obstacle for many investors, stocks, on aggregate, look fairly valued in the context of low rates. With little room for further multiple expansion, we expect more muted returns, reinforcing the importance of taking an active approach.



Michel Vernier, CFA, London UK, Head of Fixed Income Strategy

## Return of a higher yield era?

As central banks cut ultra-low rates even further in response to the economic effects of the pandemic, is the era of higher yields soon to return? In the meantime, how might investors position portfolios in such odd times?

Yields may have started to decline in 2018, accelerated by a US Federal Reserve (Fed) policy U-turn. This year saw more action as the Fed cut the policy rate by another 150 basis points (bp), to 0.25%, in response to one of the biggest crises, on a medical, social and economic level, since World War Two. Global bond yields, whether for emerging market debt, investment grade or high yield, are all anchored around depressed central bank levels.

### Bazookas at the ready

The massive accommodative measures adopted by leading central banks in response to the pandemic, including rate cuts and quantitative-easing programmes, delivered some much-needed medicine. The US high yield market, and emerging market US dollar-denominated bonds, recovered their losses, which peaked at 20% and 15% respectively, in only four months. In the process, are central banks increasing the fragility of global financial markets with their focus on ultra-low rate policy?

### “Are central banks increasing the fragility of global financial markets with their focus on ultra-low rate policy?”

Aggregated G-4 central bank balance sheets surged by roughly 20% to 55% of gross domestic product (GDP) on average, which compares to an average of around 10% to 19% of GDP during 2008’s financial crisis. So what might investors expect next?

Yields of short and medium-term bonds usually follow the Fed’s policy and its anticipated rate path. Moves in two-year yields and even ten-year yields could be explained by the level of real fed fund rates by 91% and 72% respectively in the last 25 years, according to JP Morgan Investment Bank.

### Inflation aspirations never die

The Fed has limited ammunition left. The bank cut rates by 675bp in 1989, 550bp in 2000 and 500bp in 2008 as a response to each crisis. This time’s 150bp trim seems meagre, by comparison, in order to bring inflation back to the target level of 2%. What is left is to assure markets that ultra-low yields will remain until the target is reached, or beyond?

The Fed seems to be willing to let inflation rise beyond the 2% target to compensate for periods when inflation is below 2% under its average inflation target regime introduced in 2020. Applying the new framework to average inflation (three-year rolling) back to 1998, the Fed would have only needed to raise rates once (2006), suggesting that hikes in the foreseeable future are highly unlikely.

We acknowledge that the period since 1998 looks very different to the one since 1980, when inflation peaked at 10% and US 10-year yields hit 15%. Is this a scenario which could be repeated? While a return to a regime where prices are bound to each country’s gold stock is unlikely, the debate about inflation and bond yields is as intense as ever.

### The debt levels and rates conundrum

Could increasing fiscal deficits accompanied by unprecedented quantitative easing operations lead to higher inflation and richer rates eventually. US federal debt held by the public has doubled in the last eight years to \$20 trillion, representing 106% of American GDP. On the other hand, money supply growth is at 20% compared to just 10% in 2008. Such figures were last seen in the 1970s. But as explained in September’s [Market Perspectives](#), elevated debt and money supply alone does not necessarily lead to higher rates.

During 2000, 2008 and this crisis, rates have trended lower not higher with increasing debt levels. This time higher money supply has mainly been a result of higher money demand from corporates and money managers that required, or still require, cash to bridge a period of uncertain cash flows. Finally, money supply must flow into the economy through increased spending and lending in order for it to be inflationary.

#### The secular rates trend: the last crusade

The average interest rate in the last 20 years has been 4% and in the last 40 years was 6%. In that context yields below 2% can appear expensive.

A recent Bank of England study written by Paul Schmelzing collated data going back to 1311 to reconstruct a global nominal and real yield safe-haven curve<sup>1</sup>. According to the economic historian, rates have been in decline for most of that period and have even been negative in 46 instances. The data includes phases of wars, crisis, high debt and pandemics like the Black Death.

According to the study, yields declined by 0.6-1.6bp per year in average. On the back of GDP and yield data, someone 400 years ago might have predicted that rates this century would finally approach 0%. Where does this leave bond investors in the search for income and safe-havens?

#### Lower yields but higher volatility

While a recovery in 2021 seems likely, the scope for a sudden surge in inflation, beyond 2%, appears highly unlikely. Higher unemployment rates, lower capacity utilisation and a little likelihood that output will reach pre-crisis levels suggests that yield levels above 2% are unlikely. However, next year may produce a COVID-19 vaccine or more fiscal commitments that put upward pressure on yields.

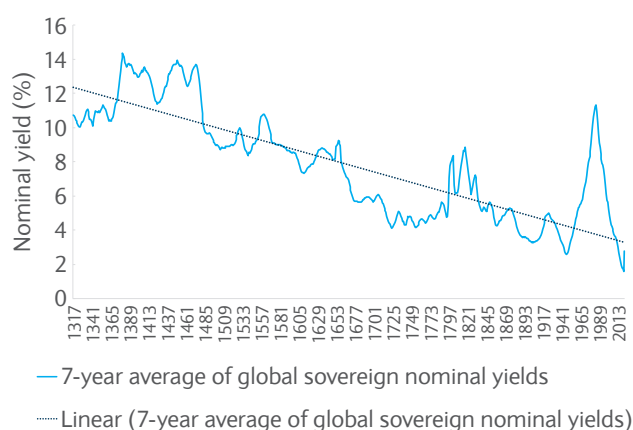
#### Strategies going into 2021 and beyond

Opportunities could occur in higher rate volatility that allow investors to lock into higher yields. At the same time investment grade and high yield bonds offer some income. Two strategies which look appealing in 2021 are:

1. Timing (locking in) and time in the market (accruing)
2. Avoid bonds which will likely lead to losses

**Figure 1: Yields gravitate towards 0%**

The seven-year average of global sovereign nominal yields since 1317



Source: Bank of England, Paul Schmelzing, January 2020. Constructed yield graph on the basis of archived rates from Italy, Germany, UK, US, Holland, France, Japan and Spain.

#### Combining timing and time in the market

A healthy mix of timing the market and time in the market seems attractive. Bond yields may start to react on early signs of a recovery, a marginal increase in inflation and supply risk which is likely to culminate in rate volatility. These may offer opportunities to lock in higher yields (timing) as a basis to provide income in the subsequent period (time in the market).

“Bond yields may start to react on early signs of a recovery”

The approach of locking in yields and accruing can be more effective in the corporate bond market or with emerging market bonds where more spread opportunities are likely to arise during 2021. Back in April we turned more positive on high yield bonds for example when spread levels traded almost at 800bp, just after shortly peaking at over 1,000bp. Investors would have locked in almost 8.5%.

<sup>1</sup> Eight centuries of global real interest rates, R-G, and the 'suprasecular' decline, 1311–2018, Staff Working Paper No. 845, The Bank of England, 3 January 2020, <https://www.bankofengland.co.uk/working-paper/2020/eight-centuries-of-global-real-interest-rates-r-g-and-the-suprasecular-decline-1311-2018>

Spreads are generally mean reverting as traded spread premiums can at times exaggerate implied credit losses. This is often observed during periods of distressed selling (selling at any cost). By applying the described strategy investors might avoid “buying at all costs” (or chasing yields) and “selling at any costs” (or panic selling). Phases of higher volatility in the rates and spread segment are likely to happen again in 2021, even if not to the same extent as seen this year.

“Phases of higher volatility in the rates and spread segment are likely to happen again in 2021”

#### Diversify, diversify, diversify

A diversified set up which includes corporate bonds, high yield bonds, sovereign bonds, emerging market bonds and inflation-linked bonds is key for a more robust income. At the same time, avoiding issuers and segments of the markets likely to create losses, either because of negative rates or potential distress, will be key.

While predicting future losses is difficult, some areas of the bond market suggest more caution may be called for given some market trends: such as higher default rates in lower-rated buckets (B-rated bonds and the like) or specific sectors (for example energy and leisure). Below we outline areas that appear unattractive along with those that appear attractive when looking at 2021 and beyond.

#### State of the bond market

Attractive	Our take	Unattractive	Our take
<b>BB-rated bonds of selected sectors</b>	While spreads have tightened, many are trading well above pre-crisis levels. Specifically in telecoms. That said, higher quality car manufacturers may also offer carry opportunities.	<b>Core European sovereign yields</b>	Although the inflation outlook is depressed and the asset class may show some relative appeal from a real yield perspective, negative yields, even for longer durations, make the segment seem unattractive.
<b>Bank senior and bank capital bonds</b>	Fluctuating bank loan provisions and lower profitability are a general negative but bank balance sheets look robust. Despite higher structural risk selected bank capital bonds offer higher return.	<b>UK gilts</b>	Part of the curve is already yielding negative. While gilts have potential to perform should the BOE have to implement negative rates there is at the same time potential that a more positive outcome in Brexit trade negotiations could lead to a yield surge at the longer end.
<b>US inflation linked bonds</b>	While UK linkers (expensive) and EU linkers (lack upside catalyst) do not seem attractive, US inflation-linked bonds combine safe-haven and inflation-hedge attributes.	<b>Emerging market regions with weak credit profiles</b>	For countries like Argentina, Turkey and to some extent India or Oman, the pandemic-induced growth shock is likely to increase their respective vulnerabilities.
<b>Duration in selected high grade bonds</b>	A large part of sovereign bonds fall away as safe-haven investments due to negative rates and we view medium to higher duration bonds in high quality bonds (A- or better) as an appropriate proxy.	<b>US high yield energy sector</b>	Almost half of distressed US BB-rated bonds are found in energy. The default rate within the sector stands at 25% and still seems to be rising. Potential higher volatility in oil could lead to further distress.
<b>EM corporates from stronger regions</b>	We are more cautious within emerging markets but selective carry opportunities seem to exist among corporate bonds in Brazil, Abu Dhabi or Russia, for example.	<b>Leisure and hospitality issuers</b>	Beside energy and transportation the leisure and hospitality sector has been hit severely. Even with a possible vaccine a return to normal if ever seems challenging.
		<b>Single B and lower rated bonds</b>	Many highly leveraged issuers, especially from consumer discretionary or highly cyclical sectors like car suppliers, may not have sufficient cash to withstand further lockdowns.





Jai Lakhani, London UK, Investment Strategist

## Finding an alternatives balance

Producing desired returns in a low-return world with traditional 60-40 equity-bond allocations can be challenging. In searching for a diversified, uncorrelated asset mix, alternatives may be an answer. Is it time to up positions in hedge funds and private markets?

Investors are continuously told that the only free lunch is diversification. While this seems simple enough as a concept, execution can be contentious. Investors, in particular retirement fund allocators, have traditionally followed a 60-40 equity-bond mix, that is 60% to equities and 40% to bonds.

Historically, the two asset classes have been negatively correlated (enhancing diversification) and have navigated portfolios through rocky shores. As discussed in August's [Market Perspectives](#), the 60-40 portfolio – based on S&P 500 and US aggregate bonds – delivered an attractive annual total return of 8.5%, with volatility of 8.8%, from 1992 until 2019. During the same period, equities averaged 9.8% a year but at the cost of substantially higher volatility of 14.4%.

### Lower return environment?

In recent years, sluggish growth, disinflation and an aging population increasing appetite for fixed income has driven rates down. Combined with very accommodative monetary policy and firmly negative real cash rates, we expect government bond returns to be flat or negative over the next five years.

**“We expect government bond returns to be flat or negative over the next five years”**

What's more is that the world order is still struggling to come to terms with handling the pandemic, let alone adapting to a COVID-19 environment. Despite this, equity valuations rebounded. With equity valuations elevated, this could mean that equities also experience limited returns as all of it has to come from growth in earnings.

Over the past seven years the tighter correlation between the two asset classes has eroded the diversification benefits of a 60-40 portfolio (see figure one). With both rates and inflation likely to remain lower for longer and

**Figure 1: Tighter bond-equity correlations**  
Three-year rolling correlations of weekly equity and bond returns since 1992



Source: Refinitiv Datastream, Barclays Private Bank

market volatility heightened, it may be time to question the effectiveness of said allocation.

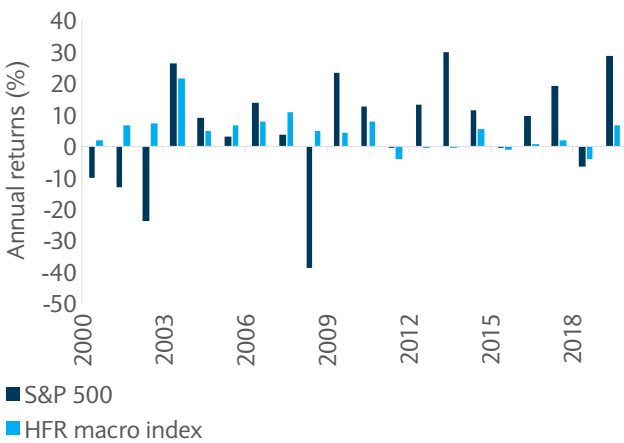
A narrow lens would suggest moving more of the portfolio from fixed income to equity. While this could mean longer term higher returns, it suggests more heightened volatility. Two additions to the allocation may help shelter portfolios over the next decade, other things being equal: hedge funds and private markets.

### Hedge funds

A portfolio allocation to hedge funds could evolve with a spectrum of macro-financial regimes while enhancing diversification gains.

Different hedge fund strategies have more or less correlation with equities. The macro strategy is a case in point (see figure two). But other strategies would also show such properties.

**Figure 2: Macro hedge fund returns**  
The uncorrelated nature of macro hedge fund and US equity returns since 2000



Source: Bloomberg, Barclays Private Bank

While hedge funds offer returns uncorrelated to stocks, this does not mean they replace fixed income in the portfolio allocation. They too can at times struggle when markets are in the red and there is a high premium on manager selection.

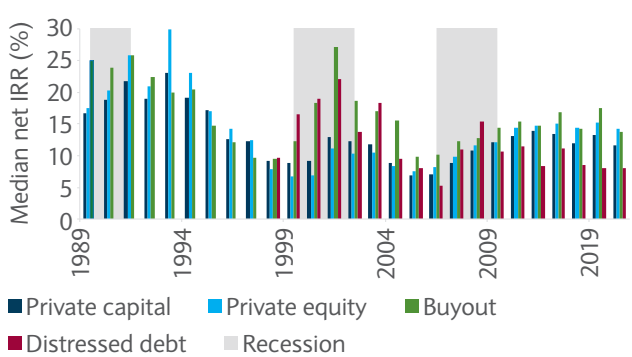
**Private markets**

Another addition to help successfully diversify a portfolio is private markets. Adding private markets to the 60-40 portfolio has shown historically higher returns and lower volatility.

“Another addition to help successfully diversify a portfolio is private markets”

One of the main reasons for this is that during periods of increased volatility in markets, private equity managers have an opportunity to acquire high-quality companies at attractive valuations. It is unsurprising that some of private equity’s strongest vintages have come from investing during economic downturns and adding this to a portfolio could help smooth the cycle (see figure three).

**Figure 3: Private market returns**  
Median net internal rate of return for private market strategies since 1989.



Source: Preqin, Datastream, Barclays Private Bank

Deployed funds are usually focused on individual company characteristics and more bottom-up as opposed to top-down. There is much to be said to accessing innovative companies at an early stage and tapping into growth. Investments are also made over a long-term horizon which not only means investors receive an illiquidity premium, but it also means such investments are more immune from temporary risk sentiment moves.

The next decade will likely entail lower returns and more frequent episodes of heightened market volatility. In this environment, the 60-40 portfolio could come under increased pressure. Asset classes and strategies that offer increased diversification, uncorrelated returns and suit investors over a longer time horizon may be worth considering.

“The next decade will likely entail lower returns and more frequent episodes of heightened market volatility”



Damian Payiatakis, London UK, Head of Sustainable & Impact Investing; Olivia Nyikos, London UK, Responsible Investment Analyst

## Greening the economy

With returns from traditional approaches looking challenging in the short term, it may be time to concentrate on longer term options. Addressing climate change, with renewed focus from governments and companies likely in 2021, can offer attractive growth opportunities, while protecting the planet.

Until COVID-19, climate change was central to the agenda for many governments, companies and people – and increasingly investors too. Rightly, attention has shifted to manage the human and economic hardship facing many as a result of the pandemic.

The immediate crisis and related economic shock, however, takes place in the shade of a long-term environmental challenge. The climate breakdown continues to worsen and will be a critical global challenge in the coming decades. As the pandemic persists and markets struggle, investors shouldn't disregard the need and opportunities to transition to a low-carbon economy.

For investors, focusing on opportunities with a longer time horizon may help them to endure short-term volatility and find growth prospects too.

### Climate change

Climate change seems an inevitable trend in an uncertain world. Greenhouse gas (GHG) emission levels are increasing. Once a distant concern, climate change is now an existential threat and one of the most significant challenges facing current and future generations.

In 2015, countries pledged to transform their development trajectories to set the world on a course towards sustainable development, aiming at limiting global warming to 1.5 to 2 degrees centigrade above pre-industrial levels. Through the Paris Agreement, parties also agreed to a long-term goal for adaptation and outlined their post-2020 climate actions, known as their Nationally Determined Contributions (NDCs)<sup>1</sup>.

Since then, many efforts have been made to fulfil their pledges and achieve their NDCs as agreed. Overall, the current trajectory is still not in line with keeping global warming well below 2 or 1.5 degrees.

While during initial lockdowns carbon emissions precipitously fell as global output shrank, a rebound towards their pre-pandemic levels seems to have begun. Even if emissions do remain suppressed for some time, higher levels are likely without structural change.

### Green economic recovery

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; by decoupling growth and emissions. Though pace remains slow, this is occurring.

Adaptation and mitigation efforts are becoming more deeply embedded in governmental efforts as the profile of climate action raises on national political agendas. Furthermore, and as a response to COVID-19, "greener" stimulus measures have been seen, particularly in Europe. In turn, this may be a sign of things to come in other economies such as India, China or the US.

### Stimulating green growth

In December 2019, the European Commission (EC) unveiled the European Green Deal, laying out the blueprint for the bloc to achieve carbon neutrality by 2050. While the European Green Deal was laid out before the global pandemic, many followed the course set in using the crisis as an opportunity to enable transition to a low-carbon economy through the introduction of "green" stimulus packages.

In May 2020, the European Commission presented a €750bn economic stimulus plan and a revised proposal for the EU's 2021-2027 budget to help mitigate the shock from COVID-19 and pave the way for a sustainable future<sup>2</sup>. In particular, the funds will partly be used to reach the EU's objectives of climate neutrality and digital transformation.

<sup>1</sup> Nationally Determined Contributions (NDCs), United Nations Climate Change, 2020, <https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement/nationally-determined-contributions-ndcs>

<sup>2</sup> Europe's moment: Repair and prepare for the next generation, European Commission, 27 May 2020, [https://ec.europa.eu/commission/presscorner/detail/en/ip\\_20\\_940](https://ec.europa.eu/commission/presscorner/detail/en/ip_20_940)

Part of the package involves strategies to help incentivise private investments – such as the Strategic Investment Facility built into InvestEU to generate investments of up to €150bn in boosting the resilience of strategic sectors linked to the green and digital transition<sup>3</sup>.

#### National initiatives

Among individual EU countries, Germany introduced €36bn climate-cutting and economy-boosting measures, and France pledged €13.5bn at tackling the climate emergency<sup>4</sup>. As part of the package, the allocated green measures include investments into the sustainable transport sector, further development of green technologies (such as hydrogen) to support decarbonisation measures, energy-efficiency improvements for public buildings, efforts to promote the digital and circular economy, nature-based solutions to restore biodiversity and greening the food sector by developing shorter supply chains.

In the UK, an additional £3bn of energy efficiency measures were announced as part of a broader coronavirus stimulus aimed at boosting the economy. The package includes £2bn towards a Green Homes Grant scheme and another £1bn for public buildings to improve energy efficiency<sup>4</sup>. The measures are also aimed at helping the UK meet its ambitious 2050 target for net-zero carbon emissions.

In other parts of the world, China is aiming for its carbon dioxide emissions to peak before 2030 and then to move to carbon neutrality by 2060. The specifics of how the country will reach these goals are not yet clear. Still, it inevitably has to include not only deep cuts in fossil fuel use but ways also to pull carbon out of the atmosphere – for example through afforestation activities and growth of sustainable land carbon sinks.

In the US, the 2020 presidential election outcome may accelerate decarbonisation initiatives. According to the campaign, a Democratic administration would rejoin the Paris Agreement, expand upon it and redirect elements of US foreign policy to encourage other countries to adopt climate-related policies and targets, such as including climate targets in trade agreements. The platform also targets 100% clean energy by 2035 in the power sector. Tools for achieving faster decarbonisation include extensions of tax credits, scaling-up best practices at the state level and providing government support in research.

#### Collective climate efforts

The next year offers a crucial window for countries to capitalise on current frameworks and build on existing climate change momentum. Foremost, the twenty-sixth United Nations Conference of Parties (COP 26) will see governments report on the Paris Agreement's efforts and set new targets. While the conference had to be postponed until 2021, its commitments have not been.

Given its November timing, the full agenda and outcomes of COP26 will arrive late in the year. However, as the NDCs were made "by 2020", we can expect announcements of progress and plans throughout the year. Ongoing discussions around topics such as carbon pricing, greenhouse gas reporting and carbon taxes hint at potential related risks and opportunities.

In addition, the COP26 Private Finance Agenda has been established to ensure that all decisions in private financial systems (not only government-backed) are made considering climate change. The initiative focuses on how climate reporting, risk management and returns can help drive the transition to a net-zero carbon economy.

#### Emerging biodiversity concerns

While most environmental focus has been on climate breakdown, various global efforts are accelerating around biodiversity. The EU has committed to significant biodiversity policy measures. Meanwhile, China expressed the need to balance economic growth with biodiversity policy at the last UN Summit on Biodiversity.

COP26 also has the potential to be a pivotal moment for biodiversity. Delegates will be reviewing progress made towards the Aichi Targets of 2010, setting new goals and standards for nature management for the next decade, which should govern biodiversity under the following three pillars: 1) conservation; 2) sustainable use; and 3) the fair and equitable sharing of benefits from the use of genetic resources.

#### Sector opportunities

Investors who want to use their capital to make a positive contribution to a more sustainable future have a range of investment opportunities. Given the scale of environmental challenges, these tend to also be growth markets for companies with effective solutions. Aligned with our sustainable world structural theme, we highlight three

<sup>3</sup> EU budget for recovery: Kick-starting the EU economy by incentivising private investments, European Commission, 29 May 2020, [https://ec.europa.eu/commission/presscorner/detail/en/mex\\_20\\_970](https://ec.europa.eu/commission/presscorner/detail/en/mex_20_970)

<sup>4</sup> Chancellor set to announce £3bn green investment package, The Guardian, 6 July 2020, <https://www.theguardian.com/politics/2020/jul/06/chancellor-set-to-announce-3bn-green-investment-package>

trends with many entry points for investors.

### Addressing climate change and energy needs

#### 1. Clean energy (renewables energy sources and value chains, renewable infrastructure)

Reducing GHG emissions from energy production remains a focus for all involved transition efforts. The pandemic-induced slowdown may, in turn, slow the transition to a world mainly powered by clean energy; but the direction of travel is one-way.

Clean energy and associated value chains that accelerate the low-carbon transition are growth markets. Moreover, stimulus to develop green infrastructure not only addresses environmental issues but also helps to support a green recovery and growth. On top of that, cleaner energy players and associated renewable technologies and equipment companies have had a positive year, as investor sentiment appears to shift further towards them. The sector has profited from a push for cleaner fuels from Europe to China; targeting net-zero emissions by 2050 and 2060 respectively.

Investors will have options across the value chain. Even as solar and wind power become the “new normal”, offshore wind, emerging technologies and fuels such as battery storage, biofuels, geothermal and hydrogen seem to be increasingly part of company and state energy transition plans. Even traditional fossil fuel companies are seeking to offer an integrated approach to supplying energy – including renewables, backed up by natural gas with carbon offsets.

Hydrogen is also set to become an important part of this energy mix, offering further opportunities in supply, transport and distribution. Delivering complex solutions at scale will also involve road transport design, digital solutions, procurement and construction management. According to Barclays Research, hydrogen has the potential to transform hard-to-decarbonise parts of the economy and support electrification, helping save up to 15% of annual carbon dioxide emissions by 2050. In addition, the market is forecast to grow eight times over the next 30 years.

#### 2. Energy efficiency – Green building

Construction and heating and cooling buildings account for approximately 36% of global final energy usage<sup>5</sup> – which as temperature bands become more extreme is set to increase with climate change. Finding ways to use less

energy, or existing energy more efficiently, is key to achieving climate targets.

Green buildings or greening of existing buildings will reduce or eliminate negative impacts or even create positive impacts on the climate and natural environment. Through design, construction or operation they can preserve precious natural resources and improve our quality of life through improved energy efficiency, materials efficiency and waste reduction. According to the International Energy Agency (IEA), realising the potential of such buildings could save \$1.1 trillion by 2050.

Beyond upgrading buildings or constructing more efficient ones, there are further opportunities to improve energy efficiency in industrial processes or technology companies, as well as providing devices and sensors that enable this change.

With green stimulus packages being rolled out in response to the pandemic, green building programmes could not only stimulate economic activity and create jobs, but simultaneously achieve environmental and social goals.

### Reducing environmental footprint

#### 1. Sustainable cities

According to the World Bank, urban areas concentrate around 80% of global economic activity. By 2050, two-thirds of the world’s population is expected to live in city environments<sup>6</sup>. Fast-paced urbanisation likely increases both social and environmental pressures. Issues such as water stress, waste management and air pollution increasingly create associated health and economic risks.

To keep pace with the challenges presented by the pandemic, the escalating sustainability commitments and the ongoing urbanisation will require unprecedented investment and innovation. Smart cities and smart city infrastructure, therefore, offer various investment opportunities. Within cities, not only do the buildings need to become smarter, but the infrastructure and economic production (both manufacturing and services) need to evolve. This revolution, sometimes referred to as the “Industry 4.0”, will likely have far-reaching implications: fully automated factories and production lines (changes in the workforce), increasingly digitised consumption, on-demand energy and healthcare services.

<sup>5</sup> Towards a zero-emission, efficient, and resilient buildings and construction sector, Global Status Report 2017, UN environment, [https://www.worldgbc.org/sites/default/files/UNEP%20188\\_GABC\\_en%20%28web%29.pdf](https://www.worldgbc.org/sites/default/files/UNEP%20188_GABC_en%20%28web%29.pdf)

<sup>6</sup> Urban development, Overview, The World Bank, November 2020, <https://www.worldbank.org/en/topic/urbandevelopment/overview>

Beyond consumer-facing smart homes, energy, water and waste management in buildings are increasingly being prioritised to help bridge the existing infrastructure gap. Driven by emerging business models and leapfrog technologies, developments in “edge computing”, or a distributed computing paradigm helping to manage data, and 5G are expected to further accelerate smart infrastructure opportunities; particularly in intelligent building management systems, digital twins, clean energy, smart grids and real-time usage monitoring. While Asia seems to be doing better from an innovation perspective, “older” cities in the West are under pressure to upgrade as well.

## 2. Circular economy

Traditional linear economic models of take-make-use-dispose are becoming neither sustainable nor economical — for consumers, producers and the environment. This has created both an increasing range of organisations utilising circular economy principles and business models to generate new economic value.

In a truly circular economy, economic activity may use natural capital, but also restores overall health of the system. Moving to a more circular economy isn't only about reducing negatives or recycling. Rather, it represents a systemic shift to generate growth and abundance, while providing environmental and societal benefits. A more circular economy can also help reduce the environmental impacts of production and consumption, reduce waste, drive greater resource productivity and address emerging resource security/scarcity issues in the future.

While these principles apply universally, investors can look to sectors which are most resource and waste intensive for the highest potential. This includes electronics and information communications technology; batteries and vehicles; packaging; plastics; textiles; construction and buildings; food; water and nutrients.

In Europe, as part of the European Green Deal, the European Commission's new Circular Economy Action Plan unveiled this year<sup>7</sup> is calling members to shift to a circular economy and adopt the use of incineration and landfill taxes. The

initiative presents opportunities along the entire life cycle of products, targeting their design, promoting circular economy processes, fostering sustainable consumption and aiming to ensure that the resources used are kept in the local economy for as long as possible.

## Conserve biodiversity and ecological systems

### 1. Biodiversity

According to the OECD, the world is highly dependent on rich and varied biodiversity, extracting \$125 trillion in benefits from the ecosystems each year<sup>8</sup>. Before the current trends in population growth and increasing dependency on our ecosystems, much of modern society's growth has been achieved through the use of natural resources. Today, biodiversity is declining at unprecedented speeds, with soil and land degradation rising and available land decreasing. As a result of human activity, 75% of the global land surface has been significantly altered; 66% of oceans are experiencing cumulative deterioration; and over 85% of wetlands have been lost<sup>9</sup>.

In the 2020 World Economic Forum's Global Risks Report, biodiversity loss and ecosystem collapse were named as one of the top five risks in terms of likelihood and impact in the coming ten years. Abundant biodiversity is necessary for many components of life, including the provision of food and medicines. With biodiversity in decline, traditional land economics is quickly being reconsidered and natural capital is increasingly factored in decision-making. Maintaining biodiversity is quickly moving from being ethically motivated towards becoming an economic and regulatory imperative.

While the primary reason for considering biodiversity issues is risk management, understanding sectors (such as palm, soy, cattle and timber) and activities (like excessive land and sea use, land exploitation, climate change, pollution and invasive alien species) most associated with biodiversity loss can help investors identify companies with solutions to these issues.

### Legislation creating new biodiversity markets

In part, legislative drivers and changing consumer demands are creating new markets for organisations

<sup>7</sup> Changing how we produce and consume: New Circular Economy Action Plan shows the way to a climate-neutral, competitive economy of empowered consumers, European Commission, 11 March 2020, [https://ec.europa.eu/commission/presscorner/detail/en/ip\\_20\\_420](https://ec.europa.eu/commission/presscorner/detail/en/ip_20_420)

<sup>8</sup> Biodiversity: Finance and the Economic and Business Case for Action, G7 Environment Ministers' Meeting, 5-6 May 2019, <https://www.oecd.org/environment/resources/biodiversity/G7-report-Biodiversity-Finance-and-the-Economic-and-Business-Case-for-Action.pdf>

<sup>9</sup> UN Report: Nature's Dangerous Decline 'Unprecedented'; Species Extinction Rates 'Accelerating', UN Sustainable Development Goals, May 2019, <https://www.un.org/sustainabledevelopment/blog/2019/05/nature-decline-unprecedented-report/>

to attempt to profit from biodiversity-related goods and services and biodiversity conservation. Extended policies, company pledges to use-certified commodities (in some cases avoidance of particular commodities) and net-zero deforestation commitments reinforce the rationale for considering investment in alternate-land management practices.

As a theme, there is a growing set of opportunities in nature that benefits biodiversity such as reforestation, regenerative agriculture, supply-chain monitoring and product certifications. According to the World Economic Forum, the focus on biodiversity is significant, at an estimated at \$3.6 trillion a year<sup>10</sup>. Focusing on natural capital (commodity certification, regenerative ag-tech and sustainable production and consumption) investors can deploy capital in various commercial opportunities.

Alternatively, sectors such as tourism and recreation have direct links and value associated with addressing biodiversity risk and investing in nature. Agricultural value chains, covered more fully below, provide another range of opportunities. Finally, marketplaces are available, or being established, in areas such as carbon sequestration, maintenance of water quality and supply, pollination, or biomass production.

## 2. Sustainable agriculture

As the world's largest sector, the World Bank estimates the food industry to account for over 10% of global gross domestic product, employing billions of people. With growing populations and expanding economic development and consumption, the natural environment and its limited resources are under increasing strain.

While much of our economic development has been achieved through the mass industrialisation of the global food system, the gains have resulted in declining biodiversity, soil and land degradation, food waste and water scarcity. Eventually, the system will have to change, creating significant opportunities in the sustainable agriculture investment space.

For companies and investors whose goal is to make the global food and agriculture system more sustainable and to create better connectivity between producers and consumers, there are various opportunities available. These include advanced ag-tech, reforestation, regenerative

agriculture (such as precision farming, alternative fertilisers), biodiversity-friendly practices (like vertical farming and lab-grown produce), long-term biotech advances and sustainable production and consumption methods. Companies aiming to reduce greenhouse gas emissions through the use of sustainable agriculture practices by leveraging technology should create further investment opportunities.

With land management and conservation becoming increasingly important, regenerative or circular farming practices (or ag-tech) should provide great opportunities. For instance, the development of alternative green fertilisers and products that enable the restoration of degraded ecosystems and vegetation. Furthermore, supporting the very beginning of the supply chain with innovative technology and ways to improve profitability and optimise costs should also be of importance. Agriculture's future lies in harnessing intelligent technology and precise farming methods that sustainably enhance climate-resilient, higher quality food production.

Due to COVID-19, there has been significant growth in demand for health and wellness products, including food and non-food items. While numerous consumer-ready products exist, other meat-free options (like cell-based meat) still need to gain scale. According to the World Economic Forum, the focus on "planet compatible consumption" offers great investment opportunities; over \$1 trillion by 2030<sup>11</sup>. Companies that invest proactively in sustainable production methods can appeal to consumers and investors that are increasingly aware of biodiversity.

### Green growth of the portfolio

With a variety of stakeholders seeking to support planetary health, companies offering commercial solutions to (unfortunately) growing sustainability issues should expand too. This may make such options appealing for investors seeking portfolio opportunities to explore more actively in 2021, while recognising the long-term nature of most of these investments. In the end, the opportunity to deploy capital in a way that not only can grow assets but also positively contribute to society and the environment could be attractive for many investors.

<sup>10</sup> The Global Risks Report, World Economic Forum, January 2020, [http://www3.weforum.org/docs/WEF\\_Global\\_Risk\\_Report\\_2020.pdf](http://www3.weforum.org/docs/WEF_Global_Risk_Report_2020.pdf)

<sup>11</sup> The Future of Nature and Business. New Nature Economy Report 11, World Economic Forum, July 2020, [http://www3.weforum.org/docs/WEF\\_The\\_Future\\_Of\\_Nature\\_And\\_Business\\_2020.pdf](http://www3.weforum.org/docs/WEF_The_Future_Of_Nature_And_Business_2020.pdf)



Damian Payiatakis, London UK, Head of Sustainable & Impact Investing; Naheeda Chowdhury, London UK, Head of Responsible Investing; Olivia Nyikos, London UK, Responsible Investment Analyst

## Material E, S and G factors in 2021

Facing a tough macroeconomic outlook, holding high-quality companies may be a valuable strategy for investors to take. To improve in selection of these assets, investors should consider the likely material environmental, social and governance factors in 2021 that can protect and grow their portfolios.

During 2020 the increased popularity of sustainable investing, and its encouraging performance, during a period of extreme volatility may mark its turning point for overwhelming adoption across investors.

Within this field, the use of environmental, social and governance (ESG) information has been critical to these shifts, and increasingly part of sophisticated investors' approach to investing. Notably, in October's 2020 edition of Investing for Global Impact, a survey supported by Barclays of over 300 leading individuals, families, and family offices, an overwhelming 96% of respondents integrate ESG considerations into some (35%), the majority (35%) or all (26%) investment decisions.

Here we highlight selected E, S and G issues we expect companies will likely face in 2021 and what each means for investors. Then, we take a step back to review how ESG factors can inform investors decision-making and, the often overlooked fact that there are various ways to incorporate such data into investment processes.

### Material ESG factors: the outlook

Next year we expect to face continued issues from the pandemic and its associated economic and societal implications. Moreover, as we've noted before, reversal of globalisation, trade tensions and climate change will add to challenges.

For investors trying to position and navigate their portfolios through the uncertainty, considering ESG can provide a valuable perspective on the material factors affecting companies in 2021. Therefore, in discussion with our discretionary team and industry peers, a selection of key E, S, and G factors are identified that are likely to be material next year.

Note that these factors are neither static nor exhaustive. But they highlight some of the challenges companies might face and which investors may want to understand (see table).

Environment	Social	Governance
Carbon emissions	Labour management	Corporate governance
Energy efficiency	Diversity and discrimination	Business ethics
Natural resource use	Working conditions	Anti-competitive practices
Hazardous waste management	Employee safety	Corruption and instability
Recycled material use	Product safety	Anti-bribery policy
Clean technology	Fair trade products	Anti-money laundering policy
Green buildings	Advertising ethics	Compensation disclosure
Biodiversity	Human rights policy	Gender diversity of board

### Material "E"nvironmental factors in 2021

The pandemic may have moved environmental awareness down the global agenda as more pressing issues focused our their attention. However, climate breakdown has continued relentlessly and will likely regain pace as output recovers. With hopes of a vaccine being developed and distributed soon, however uncertain this may be, we expect more attention to return to environmental factors, notably in carbon emissions and biodiversity.

**"With hopes of a vaccine being developed and distributed soon...we expect more attention to return to environmental factors, notably in carbon emissions and biodiversity"**

### Carbon emissions

Green government stimulus efforts and the twenty-sixth United Nations Conference of Parties (COP 26), at which governments report on the Paris Agreement's efforts and set new targets, should accelerate climate efforts. In turn, delivering committed climate targets and moving to a



low-carbon economy may generate greater climate-related transition risks for all companies.

Transition risks include policy and legal, technology, market and reputational risks. Thus far, investor focus has been largely on the most carbon-intensive industries. Sectors such as oil and gas or utilities will again be under more pressure to establish and meet transition pathways to align with the Paris Agreement. As well, the risks of legal action, with associated costs or potential payouts, will climb as the potential financial losses and damage arising from climate change grows.

Additionally, previously less visible sectors, such as agriculture, buildings and industry, will be more exposed to similar risks. As governments act to “green” the economy, these industries also face additional costs for their carbon emissions, higher input costs, possible revenue declines from apathetic customers or required abatement to transition to low carbon technologies.

For investors, protecting value in a portfolio starts with an understanding of carbon exposure, usually through carbon footprinting efforts. Thereafter, investors can assess the preparedness of companies to manage these risks, in absolute terms or relative to industry peers.

“For investors, protecting value in a portfolio starts with an understanding of carbon exposure”

#### Biodiversity

Today humanity’s global consumption of “natural capital”, the goods and services provided and replenished by the natural environment, far outstrips its inherent ability to regenerate. This natural capital is reliant on the variety and resilience of all living organisms and their associated ecosystems, in sum, on biodiversity.

Biodiversity is being damaged by direct exploitation, changes to land or sea use, human pollution, climate change, and invasion of previously alien species. The resultant loss of biodiversity means vital ecosystem services which underpin the continuity of society and business, are being eroded.

Investor awareness has begun to crystallise on the importance and value of biodiversity, both intrinsically as well as to the industries which are affecting it (such as

agriculture, mining and transportation) and being affected by it (such as agriculture, textiles and fashion, food and beverage, and tourism). The detractors face similar legal, regulatory, or market risks as stakeholders, governments, and consumers start to hold these industries to account.

Assessing associated risks, ranging from physical risks due to loss of natural material inputs to litigation risks, or policy and regulatory changes, should be considered by investors. More critically than portfolios ensuring continuity of biodiversity, ultimately human society across the globe may depend on it.

#### Material “S”ocial factors in 2021

While undoubtedly material for certain industries, social factors have generally not received the same attention as environmental and governance ones. The comprehensive and pervasive effects of the pandemic across industries and countries seem to have made social factors more universal and a priority for investors.

How companies managed their relationships – with employees, suppliers, customers and in its communities – became immediately evident and comparable. We expect, as the economy attempts to recover, attention to grow next year in two areas in particular, employee safety and labour management.

#### Employee safety and working conditions

Prior to COVID-19, health and safety of employees was often focused on industrial or labour-intensive sectors. However, with the communicability of the virus, more companies seem to be recognising and addressing these social-related issues.

Some industries, or roles, have been able to be delivered remotely, minimising the direct risks of coronavirus. Sectors where remote work isn’t possible, or constrained, have already been forced to adopt health and safety measures to maintain operations. With the hope of reopening economies more permanently in 2021, providing safe working conditions through personal protective equipment, testing and strict sanitisation regimes is essential.

Where interaction between staff and customers is required (for example, in restaurants, hotels, travel, delivery services and the performing arts) the future viability of companies could depend on their ability to maintain protocols.

For investors, assessing a company’s risks associated with workforce continuity, and how they have established and

are managing them, should be factored into due diligence. Moreover, companies successful at looking after their employees will likely garner greater loyalty from employees and other stakeholders. In turn, this will probably yield positive reputational benefits in the longer-term.

#### Labour management

Good labour management practices – simply put, finding the right people, training them and keeping them happy – are crucial for organisations to operate successfully in the longer term. Generally, skilled and engaged employees are more productive. In service industries, good quality employees are directly linked to customer satisfaction. Finally, worker and wider community support can contribute to positive reputational impact.

During the pandemic, unemployment rates have climbed to unprecedented heights and may take years to recover. Many companies have been supported through government bailouts and furlough schemes to retain employees, and eventually these will end. If economic recovery is not sufficiently robust, more workers will be let go.

How companies have managed this process thus far, or if required in the future, will have a meaningful long-term impact on companies. Investors can evaluate a variety of labour practices, such as how employers dealt with contract workers, whether they cut loose employees or kept paying them, whether they used balance sheets or bailouts to fund holding onto employees during shutdowns.

Companies perceived to be laggards risk short-term damage to brand and longer term reputational and financial hits. Those seen as leading should be expected to prosper, perhaps increasing market share or improved employee engagement. For investors, identifying the difference, before it emerges, will matter.

#### Material “G”overnance factors in 2021

Even before the rise of using ESG factors, governance has been a long-standing, non-financial consideration for many investors. It covers a broad range of corporate activities such as board and management structures, shareholder rights management, remuneration and incentives, board diversity, corporate policies and standards, information disclosure and ethical behaviours.

During 2020, these processes have been stretched repeatedly. For example, the pandemic, calls for more gender and racial equity along with social justice and reversal of globalisation. While these issues will continue

into, and beyond, 2021, two aspects are material for investors – the robustness of corporate governance, and alignment of executive remuneration.

#### Corporate governance

Broadly, corporate governance focuses on the system of internal controls and procedures used to manage companies and how employees behave. They provide a framework that defines the rights, roles and responsibilities of various groups within an organisation. It also includes the checks, balances and incentives a company needs to minimise and manage the conflicting interests between internal and external stakeholders.

When faced with external shocks or changing environment, governance should enable the organisation to realign to this shifting landscape. The pandemic has tested companies’ risk and crisis management organisation and practices. Successful companies tended to have sufficient plans in place and adapted quickly to maintain business continuity. Investors that considered such factors in selection will have found out how accurate and effective they have been.

#### “The pandemic has tested companies’ risk and crisis management organisation and practices”

The quality of corporate governance should continue to be a material factor in how well companies can respond to the economic uncertainty and financial challenges to come. With businesses facing increased economic stresses, bondholders and minority shareholders might want to consider the perceived risks and rewards of their positions, based on how much their rights are recognised and protected.

#### Executive remuneration

Executive pay continues to be at the forefront of governance considerations for many investors. With high pay levels relatively common, perhaps regardless of performance, shareholders seem to be taking more collective action in response. Additionally, stakeholders such as employees, the media or government are frequently incited by the quantum and potential misalignments, adding to potential reputational issues.

Structuring and aligning executive compensation in the interests of shareholders, or other stakeholders, is a persistent challenge. While there is general agreement on

the importance of aligning pay with long-term performance and strategy delivery, most plans are predominantly linked to company stock prices. These do not always reflect long-term, and sustainable, value creation or executives' contribution to this end.

In 2020, the divergence of overall capital markets performance relative to the economic downturn has been particularly notable. Many executives waived or donated their compensation in solidarity with the challenges being faced by their employees and wider society. Whether this practice persists next year remains to be seen. However, this principal-agent challenge remains a risk for investors to consider.

A final small note to indicate the growing influence of ESG factors. In a small, but growing, number of companies executive pay is being tied to overall ESG ratings or specific metrics. As this shifts, both the attention and hopefully performance around wider societal factors will increase.

#### Using ESG to select quality investments

Having identified some of the key E, S and G factors for next year, investors have to incorporate them effectively into their investment process.

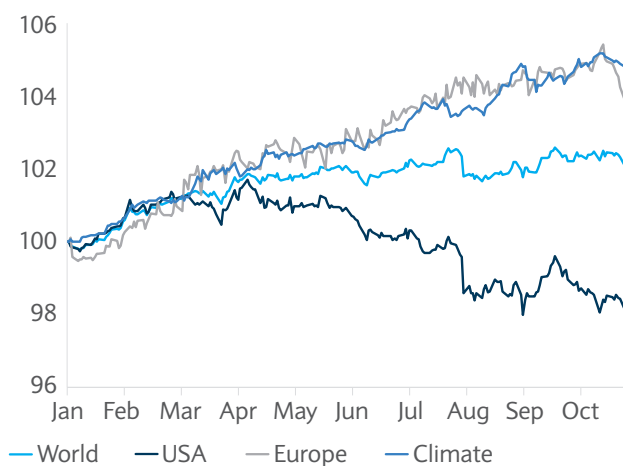
The reality is investors consider a variety of factors when deciding whether to select, or hold, an investment. Adding ESG factors can enhance existing investment processes by including non-financial information – hopefully to make more informed investment decisions.

### “Adding ESG factors can enhance existing investment processes by including non-financial information – hopefully to make more informed investment decisions”

Traditionally investors' primary data points have been financial ones with sources such as annual reports, management presentations and earnings statements. Several traditional performance indicators may be disrupted next year in such unusual times, relying solely on this information may limit the ability to select companies that will perform better in such challenging conditions. Consider how simple incorporation of ESG factors into indices has predominantly outperformed during 2020 (see figure one).

#### Figure 1: ESG assets outperform

The performance of MSCI Leaders index against the World, USA, Europe and Climate change ones in 2020



Source: Bloomberg, MSCI, Barclays Private Bank

#### Non-financial information

At the same time, the amount and variety of information available to investors have swelled. Social media provides signals, for example of consumer sentiment or employee satisfaction, as leading indicators to company health. Satellites provide real-time data so investors can scrutinise car parks or crop fields to assess productivity.

Non-financial data has come to be organised into three general categories – environmental, social or governance, which tend to be abbreviated as ESG. The data span many issues, such as carbon emissions, labour and human rights practices and corporate governance structures.

Critically, ESG metrics are fundamentally about the internal practices of the organisation. They have been established to provide data about how a company operates; and not the outcomes of its goods or services.

It's possible to have the ESG data on any business. Moreover, a company can potentially have very good ESG scores, even if its goods or services (such as tobacco or weapons) may not be acceptable to some investors. Similarly, it's possible to have companies producing goods and services that generally viewed as beneficial for society (say renewable energy or elderly care homes) but are very poor when it comes to the ESG aspects of how they operate.

So while investors can make moral judgements about ESG performance or set certain thresholds or standards for their investment, the primary aim of ESG data is to indicate how well run a company is, not its intrinsic value to society. In fact, the motivation to integrate the data can be primarily financially driven – it serves as another tool to inform decisions that seek the best long-term, risk-adjusted return for investors.

“The primary aim of ESG data is to indicate how well run a company is, not its intrinsic value to society”

#### Financially material ESG factors

The core premise is that by considering ESG factors, an investor can take account of a broader set of data to make a better judgement about the financial performance and longer term value of a company. However, not all factors are equally relevant to all companies.

Given the wide range of ESG issues a company may face, an investor should narrow them to a set that is most relevant and translates into financial performance, impacting either free cash flow or eventually the cost of external financing. This materiality is important to identify which of these factors will influence, positively or negatively, a firm’s business model and value drivers.

Having determined the material ESG factors, investors can identify where a company can be at risk or have an advantage relative to their peers. For example, organisational practices and culture can affect a license to operate, or make a company more/less prone to scandals or fines. By introducing leading environmental sustainability practices, greater operational effectiveness can be achieved. Or greater connection with employees and customers can be made through a company’s market positioning and activities.

#### Diverse approaches to integration

Investors have various options in how they assess and integrate ESG considerations into investment practices. While “ESG investing” is generally discussed as a homogeneous practice, there are substantial differences in investors’ approaches. At the broadest, two methods emerge – screening or incorporation.

Screening on ESG factors relies primarily on using either a single metric or a rating, which are a composite assessment of the relevant data points, calculated through weighing mechanisms. Investors can use the ratings from various agencies (such as MSCI, Sustainalytics, FTSE Russell or Refinitiv) or develop their in-house rating systems. Given the differences in underlying data and methodological calculations, scores don’t necessarily have high correlations between ratings’ providers.

Once having a set of ratings, investors can choose to exclude companies (or negatively screen) based on a particular issue or the overall score of a company. The result is the companies with poor ratings are not included in the portfolio. Alternatively, though similarly, some investors use scores only to select companies rated “best-in-class”, so that selection is relative to the industry peer group rather than all companies.

Passive funds and exchange-traded funds have to rely on screening to integrate ESG considerations. Therefore, an investor is reliant on the underlying data and rating methodology. Even active managers, though, can use screening as a primary filter as part of their investment process and still assert they are using these considerations. Overall, screening provides a lower cost and simple method to integrate such factors.

#### Incorporation

Incorporation is a high-effort and more-nuanced approach, where investors or investment teams include ESG factors into their investment assessment, discussion and decision-making. This can mean using ratings as part of the process, but they also tend to delve into the accompanying qualitative research reports and underlying data to the factors. With an incorporation approach, ESG becomes one of the factors to inform decision-making rather than a rigid, filtering one. Notably, the person in the team that carries out, expresses and considers such factors influences how useful it can be.

At the minimum, the ESG factor can serve as a reference point, so while not explicitly a screen, in some ways a de facto one. Or the information can be an input to the discussion where requested or it is a critical or controversial issue. Alternatively, it might be presented and discussed as a separate item in the process.

Frequently assessments are undertaken and provided by an ESG analyst rather than one of the accountable investment managers. The level of attention and deliberation in the above cases can widely vary from passing to thoughtful. Finally, though least frequently, such considerations can be assimilated into investment discussions, where E, S and G factors may be discussed without even explicitly using the labels.

#### Looking at ESG in 2021 and beyond

With sustainable investing becoming more prevalent, more investors are factoring environmental, social, and governance data into their decision-making.

If investors can use ESG insight to understand better the complexities of associated risks and opportunities in how companies operate, they can position their portfolios accordingly. Additionally, more widespread use of such considerations and requirements to report such data, may help encourage companies to make a positive change in how they operate on these factors.

In what looks like being a low-return era for investors, ESG integration provides additional tools for investors to select companies and build portfolios with the aim of generating long-term returns for 2021 and beyond.

“In...a low-return era for investors, ESG integration provides additional tools for investors to select companies and build portfolios with the aim of generating long-term returns”



Alexander Joshi, London UK, Behavioural Finance Specialist

## Resetting expectations

In the era of COVID-19 the outlook for the world, and investment returns, looks like being radically different than seen of late. At a time of heightened uncertainty, we look to help investors plan for the future from a behavioural perspective.

We may be entering a world of lower returns and weaker growth rates. However, it can be difficult to change our expectations. What can investors do to avoid being disappointed by the long-term performance of their investment strategies?

“What can investors do to avoid being disappointed by the long-term performance of their investment strategies?”

### Why do expectations matter?

Most people can attest to a time they were expecting a gain in some domain, but the outcome was not as large as expected. Despite still being a gain, there can be a feeling of disappointment because it is below expectations; the deviation from the expectation can matter more for utility than the outcome itself.

For investors the implication is that having realistic expectations is important for when it comes to reviewing performance. Investing can be as much about emotions as well as the financials, particularly during difficult market conditions, so it's important that you are satisfied with your investments. Not being so can make it harder during difficult times to stay invested.

More importantly, at a time when many investors will be reviewing performance and planning for the year ahead, misplaced expectations can drive allocation decisions that have long-term implications and may put investment objectives at risk.

### Watch out for behavioural biases

Our past can influence and bias our expectations. Imagine you are selling your home. An emotional attachment to an asset, or anchoring around a particular price level, can influence the price a seller will accept, even when conditions

have changed since the purchase. Indeed, the seller might not buy a similar house for the price being asked for theirs.

The above is an example of the endowment effect, where people's maximum willingness to pay to acquire an object is typically lower than the least amount they're willing to accept, to give up that same object, when they own it.

Behavioural biases, like those inherent in the endowment effect, affect our expectations of anticipated performance in ways which may lead to decisions that may harm our long-term interest. Below we outline some common biases.

### Availability heuristic

Heuristics are mental rules of thumb that allow people to solve problems and make judgments quickly and efficiently, but can lead to cognitive biases in decision-making.

People often overweight information that can be readily available in our minds. When reviewing the performance of a portfolio the more emotive aspects may come to mind, such as a particularly strong narrative like a pharmaceutical company performing particularly well during the pandemic.

The economic data will probably be less likely to appear in your mind at the time, especially when what is important is the outlook, which is difficult to imagine. The likely outcome is an overweighting to the past when making decisions, which can make it difficult to reset for the future.

**Anchoring:** Ask a room full of people to recite the last four digits of their phone number, then quickly estimate the value of a rare trombone. We have a tendency to anchor on an initial piece of information when making subsequent judgements. When reviewing portfolios and looking ahead, there is a natural tendency to anchor around past performance and then revise future expectations up or down. Combine this with the availability bias and this effect tends to be stronger if an investor has experienced those returns for a long time.

Mean reversion: Ask a gambler at a roulette table who's faced a few reds in a row, they might say a black is due soon. But why? Because we expect mean reversion. There can be an acceptance that after a period of particularly strong returns may come some poor ones. Conversely, after a long run of lower returns, an improvement might be anticipated. However, returns don't need to revert to the mean.

#### Past performance doesn't guarantee future performance

Investors will be used to seeing the above disclaimer and intuitively understand that because an investment has performed strongly in the past, does not guarantee this to continue in the future. Knowing this doesn't change the fact that when you are used to experiencing a trend in the past, it can be natural to expect it to continue.

Humans do not generally like uncertainty. Creating narratives and extrapolating into the future helps us to deal with this (see The dangers of extrapolation in October's [Market Perspectives](#)). Strong narratives for continued strong returns may be hard to adjust if a portfolio is made up of high-quality companies with a strong business case (or cases that may appear superior since the pandemic began). So why should an investor expect lower returns?

#### The new normal: lower returns?

While narratives may make investing exciting, there are many other determinants of investment performance. And many of them point to an environment of lower returns.

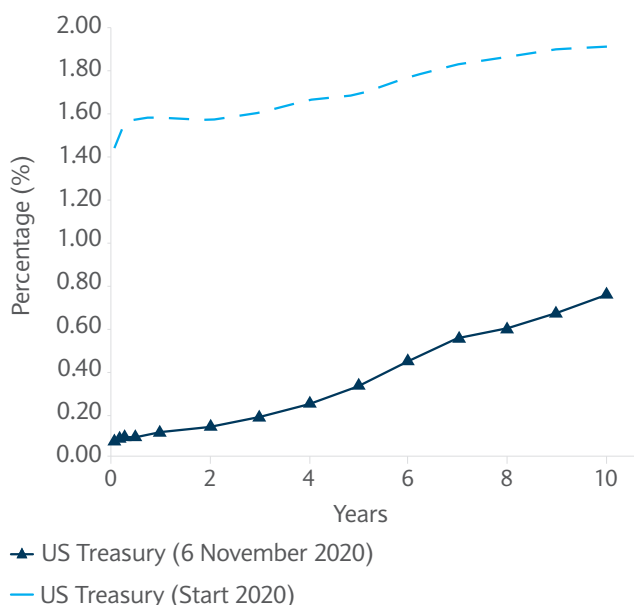
**“And many of them [determinants of investment performance] point to an environment of lower returns”**

High cash rates and investment returns may be features of the past decades for now. A confluence of economic and business trends drove these exceptional returns and some of them, such as globalisation, may be on the retreat or have run their course. Total returns are unlikely to match those of previous ones. Low growth and interest rates are features expected in such a world.

#### Low yields to persist

Bond yields, already at historically low levels, have fallen further this year in response to sizeable policy action from central banks to support the economy in the face of the

**Figure 1: COVID-19 shifts yield curves lower**  
Shift lower in US Treasury yield curve between January and November 2020



Source: Bloomberg, Barclays Private Bank, November 2020

coronavirus pandemic. The banks cut interest rates and expanded their balance sheets with enhanced bond buying, putting further pressure on near zero or negative yields in developed markets.

The US Federal Reserve does not even seem to be thinking about raising rates and yields of close to zero are likely to persist until at least 2023. The Bank of England has cut rates to 0.1% and continues its substantial asset-purchase programme, which it increased in response to the second English lockdown, and is considering how negative interest rates might be implemented as needed. Further accommodation is likely as more restrictive containment measures are implemented across Europe.

The European Central Bank, which has maintained negative rates for the past five years and that stand at -0.5%, plans to run its Pandemic Emergency Purchase Programme until June 2021. At €1.35 trillion<sup>1</sup> the programme is larger than that seen in the euro crisis early in the last decade.

<sup>1</sup> Monetary policy decisions, European Central Bank, 4 June 2020, <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.mp200604-a307d3429c.en.html>

### Time to manage liquidity differently?

As a reminder, with negative interest rates commercial banks are charged interest to keep cash with a central bank, rather than receiving interest. The aim is to feed that cash through the financial system. There is no such thing as a free lunch, and therefore something has to give.

While rates at the long end of the curve may be quite volatile for much of 2021, there are signs that short-end rates are likely to stay low (see figure one). This suggests preparing for a prolonged period of low yields and potentially managing liquidity differently.

“While rates at the long end of the curve may be quite volatile for much of 2021, there are signs that short-end rates are likely to stay low”

### What does this mean for investors?

The message is clear; a resetting of expectations for risk and return is required. Recent returns look unlikely to be repeated over the medium term for low or risk free rates. While resetting expectations is important in trying to avoid disappointment, a lower-rate environment could suggest a need for a change in investor behaviours. Investors may need to work harder to make returns.

The implications of a lower-rate world for reaching existing investment objectives might mean investors need to put more capital to work in financial markets. Additionally, and more importantly, active management of that capital may be preferable to achieve desired returns.

Those saving sufficiently for retirement under historically low rates may be caught short in an era of lower returns. This could require more cautious drawdown strategies with less money withdrawn each year. A lower return era looks like being one involving individuals saving more for retirement, retiring later or consuming less during retirement.

### A new world of opportunities

Investors should consider how their objectives would be affected by negative deposit rates or two-year bond yields. While it may not be a base case, those expecting such a scenario might want to hedge against it.

Although the elevated uncertainty seen this year may fall next year, uncertainty is a staple part of investing. Events will continue to occur which spark bouts of heightened volatility. Despite the modest expected returns in asset classes such as fixed income, diversified portfolios of high-quality companies can protect and grow wealth in different investment environments, for long-term investors remain attractive.

“Despite the modest expected returns in asset classes such as fixed income, diversified portfolios of high-quality companies can protect and grow wealth”





Alexander Joshi, London UK, Behavioural Finance Specialist

## The challenge of navigating uncertainty

This year may have been unusually unpredictable and tough for investors. But every year is full of unexpected events. Well-diversified, actively managed portfolios may be the best protection for 2021.

We expected the biggest risk to financial markets would come from an unexpected event in last year's Outlook 2020. Indeed, the world faced a big unexpected event. A global health crisis in the form of the COVID-19 pandemic induced the fastest ever bear market sell-off and shut down economic activity across the globe. The repercussions will probably be felt for years.

Uncertainty has been elevated this year. How the pandemic evolves remains unknown, with major uncertainty still surrounding almost every aspect from a health, societal, economic and political perspective. Importantly, this applies to developing and deploying a safe, effective vaccine that will be key to the lifting of restrictions and the economic recovery.

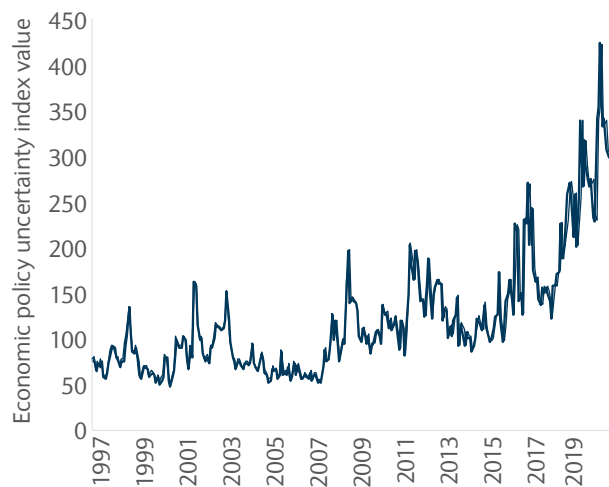
The impacts of this health crisis – an external shock to markets – were initially expected to be transitory. However, they may alter behaviours. A prime example is remote working and its implications for many sectors of the economy. Consumers across the world have reported new shopping habits since the start of the pandemic (63% in the UK, 73% in the US, 86% in China and 96% in India). Globally they are expected to continue these behaviours for some time<sup>1</sup>.

### Every year is uncertain

While 2020 has been an extreme case, with global economic-policy uncertainty rising to its highest level since the index began (see figure one), every year in investing is difficult to predict. When stating that things are more uncertain what is usually implied is that something has changed that makes the future increasingly tough to forecast. But has it? The fact an event that wasn't predicted happened doesn't necessarily mean uncertainty has increased. Instead, unanticipated events illustrate how the uncertainty was understated prior to the event.

**Figure 1: Uncertainty hits a high**

Trend in economic-policy uncertainty since 1997



Source: Economic Policy Uncertainty, Barclays Private Bank

Elevated volatility can make staying invested in the markets challenging for investors. While most of the focus for investors this year has been on the pandemic, geopolitical uncertainty as always waits on the horizon, with the fallout from the US election and Brexit prime candidates of that. All this is against a backdrop of macro themes that will continue, as well as the possibility of any manner of external shocks. Climate change will become an ever-increasing risk too.

Therefore, it could be prudent to hold portfolios that are positioned to protect assets during such periods and help investor weather those storms.

<sup>1</sup> Consumer sentiment and behaviour continue to reflect the uncertainty of the COVID-19 crisis, McKinsey & Company, September 2020, <https://www.mckinsey.com/business-functions/marketing-and-sales/our-insights/a-global-view-of-how-consumer-behavior-is-changing-amid-covid-19>

**Figure 2: Market cycle emotions**  
Typical emotions felt by investors at various stage of the market cycle from boom to bust



Source: Barclays Private Bank

**Staying calm when volatility spikes**

Behavioural biases can manifest themselves throughout a market cycle. They can be especially pronounced during crises, when emotional responses are heightened. Investors typically feel a predictable series of emotions during the course of the cycle (see figure two) making it easier to get invested when markets are rising, but may also induce selling during downturns. This can lead to the opposite of “buy low, sell high”.

Periods of heightened uncertainty, volatility and falling markets can trigger fear and panic and the first instinct of investors may be to sell or reduce risk. Holding falling assets, combined with uncertainty over when the bottom will be reached, can take a toll on investors. This is a natural response; when your portfolio is at risk, your long-term goals are too.

It is when markets look most precarious that our behavioural proclivities can lead us astray. These problems are compounded when volatility rises suddenly like earlier this year, with the VIX, which reflects the volatility implied by options on the S&P 500, rising over 500% in the 4 weeks to its 16 March peak. Only days after US equities reached all-time highs, large parts of the global economy were essentially turned off overnight and previously low unemployment rates shot up. At the index’s low, 23 March 2020, the S&P 500 had plunged by 33.9% from its 19 February top.

**Figure 3: Asset class performance rankings**  
Performance rankings of various asset classes from 2015

	2015	2016	2017	2018	2019	2020 YTD	
Cash	1.29%	14.27%	37.79%	2.38%	28.44%	28.50%	Higher return ↑ ↓ Lower return
Government Bonds	0.32%	11.75%	23.10%	-0.38%	21.91%	7.60%	
Corporate Debt	-0.28%	9.88%	18.38%	-1.15%	18.82%	7.49%	
High Yield	-0.79%	8.14%	13.53%	-1.56%	18.31%	6.90%	
Emerging Market Debt	-2.72%	8.19%	10.43%	-2.46%	13.11%	6.56%	
Developed Market Equities	-3.29%	4.27%	10.36%	-3.57%	12.56%	3.56%	
Emerging Market Equities	-3.56%	4.06%	9.09%	-4.06%	11.51%	1.89%	
Gold	-3.89%	1.65%	8.17%	-5.63%	5.59%	0.64%	
REITs	-10.41%	0.76%	7.29%	-8.19%	2.39%	-9.65%	
Put Writing	-14.61%	0.71%	1.28%	-14.28%	0.52%	-17.73%	

Source: Bloomberg, Barclays Private Bank, 6 November 2020

**Investment process is key**

The speed with which events unfold (and short news cycles) can exacerbate stress levels and anxiety. In turn, this can shorten investment time horizons, which may make investing appear riskier. The biases that manifest themselves, such as the impact of the fear of losses and uncertainty about their size, can affect an investors’ ability to weigh risks and lead to overreactions which can damage wealth aspirations.

While this year seems an extreme example, markets move in cycles and our reactions to them are largely systematic. Being aware of the ways in which we can react to negative news that may not be in our best interests, might not be enough to prevent us repeating them. It is human nature.

Good investing discipline involves being cognisant of and planning for individual behavioural tendencies. A robust investment process which has diversification at its core can help achieve this.

**The case for diversification**

The traditional case for a diversified portfolio is that by investing in many asset classes it should lower portfolio volatility due to imperfect correlations between assets. The overall variability of a portfolio’s returns becomes less than the weighted sum of its constituents. By allocating across assets, the idiosyncratic risks of each are usually diluted.

However, a common criticism of diversification is that this smoothing can fail when most needed. During market sell-offs and melt-ups, assets can move in sync as correlations spike. The market appears to behave as one.

Instead, the aspect of diversification which is more important to consider relates to the performance rankings of asset classes (see figure three), which tend to change year on year and are difficult to predict. A portfolio that is concentrated in a single asset class might be invested in the worst performing one over a given period (as well as, of course, the very best). Conversely, the performance of a diversified allocation should not be at either of the extreme ends of the spectrum. This not only makes financial sense, but also has behavioural benefits.

#### Behavioural protection

Diversification not only insulates an investor from volatility by smoothing out returns. It may also dampen the behavioural reaction in turbulent periods and profit from time in the market. Volatile and falling markets can trigger panicked decision-making, typically involving selling assets. However, much of this might reflect emotional liquidity running low, not financial liquidity. Investors panic. An investment strategy can't be successful if an investor is unable to stick with it consistently. Following a robust investment process, that leads to a diversified portfolio, can help investors stay invested by limiting the emotional reaction to market volatility.

Good investment decision-making requires asking yourself whether events are likely to affect your ability to reach your long-term goals. A diversified portfolio allows an investor to turn down the noise on market commentary when short-term news flow can make suboptimal decisions more likely. A portfolio allocated across asset classes, geographies and sectors is unlikely to fully experience the impact on markets of headline market moves. Investors should also remind themselves of their investment time horizon. It is likely to be far longer than that of market commentators fighting for airtime and visibility.

#### Naive diversification

Not all diversification is created equal. Part of good asset allocation rests on reliable estimates of long-term returns, interactions of asset classes and not high conviction. Good diversification is not just about increasing the number of holdings but involves the necessary sophistication to both protect a portfolio and enhance risk-adjusted returns. This is especially important in a low-return world.

The traditional 60-40 equity-bond portfolio allocation seems to be less effective in delivering the desired returns in a low-rate environment, eroding diversification attributes. Financial markets have become more dynamic and complex systems, making it preferable to build portfolios that provide carefully tailored, multi-factor exposure.

“The traditional 60-40 equity-bond portfolio allocation seems to be less effective in delivering the desired returns in a low-rate environment”

#### Active management

Diversification doesn't just protect an investor, but it may also allow calm investing while others are heading for the exits. Diversification in itself is not an investment strategy. Long-term investing using active management seems an attractive proposition. This means not just investing in the market, but having a long-term focus and investing in high-quality companies. Those with superior and sustainable business models that are expected to outperform for years to come.

Diversification is not just about picking an allocation and leaving it. Investors can still be opportunistic as long as the right balance is found. Following a robust process which balances long-term thinking with generating the core investment returns, while allowing reactive and opportunistic tactical tilts to allocations, can maximise returns and mitigate risks.

A particularly volatile period in an uncertain, post-pandemic world may create potential market dislocations, providing potential opportunities for active managers to capitalise on.



## 2021 key dates

○ Central banks    ○ Geopolitical meetings    ○ International bodies

Month	Central banks	Geopolitical meetings	International bodies
January	20th 2020 US presidential inauguration	21st ECB meeting	27th Fed meeting
February	4th BOE meeting and inflation report		
March	11th ECB meeting	17th Fed meeting	17th Dutch general election
			18th BOE meeting
April	10th Spring meeting of IMF and World Bank	22nd ECB meeting	28th Fed meeting
May	6th BOE meeting and inflation report	6th UK local elections to Welsh and Scottish parliaments, the London assembly and the mayorship of London	18-21st Switzerland 2021 World Economic Annual Forum
June	10th ECB meeting	16th Fed meeting	24th BOE meeting
July	22nd ECB meeting	28th Fed meeting	
August	5th BOE meeting and inflation report		
September	9th ECB meeting	22nd Fed meeting	23rd BOE meeting
October	15-17th Annual meeting of IMF and World Bank in Marrakech	28th ECB meeting	
November	1-12th November: UN climate change conference in Glasgow	3rd Fed meeting	4th BOE meeting and inflation report
December	15th Fed meeting	16th ECB meeting	16th BOE meeting

**Investments can fall as well as rise in value. Your capital or the income generated from your investment may be at risk.**

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