Elevated asset valuations are a recurring topic in investors’ discussions and contribute to markets’ nervousness. As next month’s US vote gets closer, volatility may climb. President Donald Trump appears to be hinting at more of the same if he is elected. Meanwhile, healthcare reform, higher tax rates and climate change initiatives may be on the cards if former Vice President Joe Biden wins. The Democrats appear to lead in the polls. But the outcome looks too close to call, leaving aside the risk of a contested election, a recipe that markets generally dislike.

While equity valuations might be elevated from an absolute point of view, the asset class remains attractive on a relative basis. But with potential flashpoints such as nagging pandemic developments, the US election and intensifying Brexit trade negotiations, equities are likely to remain volatile in the next few months. However, staying invested, while focusing on diversification and active management to help try to improve the risk/reward trade off, still appeals.

In bond markets, the US Federal Reserve and coronavirus developments are likely to remain the primary drivers, rather than November’s presidential vote if history is a guide. While the central bank’s revised inflation-targeting approach may encourage higher inflation ultimately, short-term rates could remain low for some time.

Another market feeling the heat from the pandemic is oil. Reopening economies and positive supply cut developments have largely been a tailwind for the commodity since July. While the oil price has likely passed its initial fast pace of recovery, the commodity is likely to be range-bound in the near term as supply cuts continue to partially counter weaker demand.

Away from the oil market, companies are increasingly transitioning towards a low-carbon world. Carbon footprinting has emerged as a useful tool to help show the potential transition risks potentially lurking in portfolios. We look at how the tool can help investors to find an investment strategy that can prepare for these challenges and potentially improve returns.

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US election tensions

The US election campaign is heating up with only weeks to go. The pandemic, recession and protests are likely to help shape the race for the White House. With the outcome too close to call and risk of a contested result, more financial market volatility seems a given as the US election nears.

President Donald Trump’s 2016 victory surprised most pollsters and sent a shockwave through the political establishment in the US. This time, the polls put the Democratic challenger, former Vice President Joe Biden, in the lead though the gap between the two leading candidates is small. Investors will be watching closely to see if Trump can secure a second term or if there is a change in control of the White House and either house of Congress.

The 2020 US election is scheduled for Tuesday, 3 November 2020 and its result will affect economic, tax and regulatory policy agendas in the US. Since 1900, only five incumbent leaders seeking re-election have lost. Three of those five who were not re-elected campaigned against the backdrop of an election-year recession (Hoover in 1932, Carter in 1980 and Bush in 1992).

Since 1900, only five incumbent leaders seeking re-election have lost

A few key themes have emerged during the 2020 campaign. Based on recent polling data, former Vice President Biden appears well positioned, with many electoral paths to the White House. However, investors should remain alert given possible polling shifts in key swing states and the effect of the COVID-19 outbreak on public sentiment and the president’s approval rating. The virus could also affect voter turnout and/or drive a higher percentage of voting to mail-in ballots, possibly delaying the final tally until after election night. In terms of Congress, the polls suggest that the Democrats will retain the House, while the Senate is a toss-up.

Key battlegrounds

In the US presidential electoral system, instead of the national popular vote determining the winner, the outcome is determined by who receives a majority (270) of the votes of the electors in the Electoral College. The allocation of electors – one for every member of a state’s congressional delegation – increases the political influence of less populated and certain battleground or “swing” states when compared with their representation in the popular vote.

The president’s particular success at the last election was in flipping reliably Democratic-leaning states, including Pennsylvania, Michigan and Wisconsin, to the Republican column for the first time in 25 years. Trump’s “America First” message in 2016 resonated with the electorate in these “Rust Belt” states. President Trump won those battleground states by a narrow margin (less than 1% of the vote in each case) indicating that small shifts in part of the electorate could change the outcome this year.

Reliable Republican voting grounds

There are a number of states that have traditionally been reliably Republican that may be in play in 2020, driven in part by demographic shifts, including Arizona, Georgia, North Carolina and Iowa, all of which also have key Senate races.

As in recent elections, Florida and Ohio are also likely to be key, President Trump won both states in 2016 and the path to the White House may run through both of them this year.
Economic policies
If Biden wins the election, given his announced policies and comments, we would expect him to outline a series of emergency stabilisation policies related to COVID-19. Biden’s policies in general are also likely to be punctuated by a more federally driven approach and one that adopts a more active regulatory posture, in line with previous Democratic administrations. He could also embrace a multilateral approach to trade policy that focuses on strengthening and expanding the post-World War Two global order.

The heart of Biden’s policy agenda – tax reform and fiscal expansion, mainly related to healthcare, infrastructure and climate/energy – could depend largely on the outcome of the Senate. If the Democrats win control, they may consider eliminating or limiting the legislative filibuster. If some form of the filibuster remains, a Biden administration would likely rely on the budget reconciliation process, which has limitations, to pass portions of his policy agenda. If the GOP retains the Senate, a divided Congress might stall much of a Biden administration’s legislative priorities.

If Trump is re-elected and has to contend with a divided Congress or if the Democrats control both chambers, we would expect the administration to continue to focus on deregulation and trade policy reforms in line with its “America First” stance. His potential legislative agenda – a Tax Cut 2.0 and a possible infrastructure programme – could be negotiated, but will be challenging, given the obstacles in Congress and the fluid economic conditions.

As more details emerge on each candidate’s platform, the financial markets may start differentiating between potential sectors and companies that would benefit from stated policy agendas. This is likely to result in greater volatility and dispersion at the stock level.

Contested election
With a higher than normal number of absentee and mail-in ballots expected, there is a heightened possibility of ballot disputes, delayed results and legal challenges. Both parties have already filed dozens of lawsuits alleging voter suppression, fraud or rigged elections. Coupled with a deeply polarised electorate and the prospects of weeks of uncertainty, risks that could undermine the 2020 election process and its results are mounting.

Key dates in the election process may serve as deadlines for disputes. The electoral college delegations are scheduled to meet on 14 December 2020 and deliver the official results by 23 December so that Congress can ratify the vote on 6 January 2021. The terms of the president and vice president then expire on 20 January 2021. Absent an extraordinary situation, we assume that these dates will remain key markers in the election season.

Too close to call
While former Vice President Biden maintains some polling advantages, the election is far from certain. Given the unpredictable medical and economic backdrop, the effects of possible legal challenges, polling error rates in key swing states and the popular vote/electoral college split, this may be one of the most volatile US election seasons in recent history.

“This may be one of the most volatile US election seasons in recent history”
Uncertainty abounds

While volatility is unlikely to fade and risks remain, we look for potential ways to benefit from staying invested in equities in the current environment.

While uncertainty is par for the course in equity markets, rarely have investors faced so many potential flashpoints clouding the outlook. Although a “wait and see” approach may feel more comfortable to some, constructing diversified portfolios and employing active management could help unearth attractive opportunities in highly uncertain times.

A higher volatility regime
One way to measure investors’ hesitation is through implied volatility. The most widely followed volatility indicator, the VIX (see chart), has remained stubbornly elevated despite stock market indices reaching all-time highs. Indeed, since 2012, the VIX, or “fear index”, has largely been stuck in a range between 10 and 20 points.

After briefly spiking to levels comparable to 2008 when the COVID-19 pandemic hit, the VIX appears to have stalled in a new range that is 10 points higher than norm seen in the previous eight years, reflecting how much more uncertainty is being perceived. In addition, when looking at the VIX curve, the market appears to be pricing an even higher level of volatility over the next three months, pointing to possible concerns over the outcome of the US presidential election.

Dreading the presidential election
The 2020 US presidential race is shaping up to be one of the most contentious votes in recent history. The increasing polarisation of US politics in recent years has caused some commentators to envisage scenarios of continued political gridlocks or a contested election.

Without venturing the probability one should assign to these outcomes, election day, 3 November, may mark a period of more uncertainty rather its end. Over the medium term though, the impact of political events on financial markets remains relatively minimal and should not be seen as a determining factor when considering asset allocation decisions.

Pondering a post-coronavirus world
Another key question mark for investors revolves around the world after the COVID-19 crisis subsides. Whether it is about the timing of any vaccine becoming available, the continued popularity or not of homeworking and online shopping or if a period of deglobalisation is under way, the pandemic has completely reshuffled the cards. This leaves investors wondering what’s to come next?

While the world will undoubtedly be different in some aspects (like even larger government indebtedness), there are also secular trends that should be unaffected: the increased usage of digitalisation, the shifting shape of demographics or the impact of climate change on policy should continue unabated, providing investors with some degree of long-term visibility.
Questioning earnings forecast

While long-term trends can be resilient anchors for portfolios, most investors still pay (too much) attention to shorter term developments, often in trying to time their entry points accordingly. Here, earnings growth trends are a key determinant and, on this front too, uncertainty runs high.

Quarterly earnings figures have lost some of their relevance in the wake of the pandemic as exemplified by 85% of US companies beating consensus expectations in the second quarter. As such, the third-quarter numbers might not be considered too relevant, although another way-better-than-expected quarter may be seen.

Looking further ahead, despite all the uncertainty surrounding the US election, the shape of the economic recovery and the timeline for a possible COVID-19 vaccine, the consensus still expects 2021 earnings to be back at 2019 levels (see chart). While possible, this projection appears to be more the result of analysts refraining from updating their models and passing on 2020 cuts rather than the reflection of strong conviction about 2021 numbers. Without clear guidance from many companies, and analysts alike, investors can be left guessing what aggregate earnings growth will look like.

Fearing elevated valuations

Doubts surrounding companies’ ability to generate earnings have ripple effects on investors’ ability to value them, adding to the present level of uncertainty. Indeed, with equities trading at 20-year high valuation multiples (on dubious earnings forecast), there are growing concerns that a bubble may be forming and that a correction is nearing.

As we’ve explained previously, we believe that the current backdrop of low interest rates and interventionist central banks, justify moving to a relative rather than absolute-valuation framework and, in this context, equities seem to be the most attractive asset class.

Indeed, even if, on aggregate, US companies generate no year-on-year earnings growth in 2021 (against the +27% currently expected), the equity risk premium would be north of 300 basis points, in line with its 2017-2018 levels and well above the -200bps reached in the lead up to the popping of the dot-com bubble.

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Balancing risks and rewards

As we’ve established, there is no shortage of reasons for investors to sit tight and wait for better days to put their capital to work. Yet, we believe this approach could be detrimental to long-term wealth preservation, especially when real interest rates are negative. Risks are inherent to investing and waiting for the “all clear” may result in getting involved at the top of the market.

Rather, the focus should be to manage those risks in order to reap the highest possible rewards. Encouragingly, whether it’s through the VIX or the equity risk premium, it appears that the market is pricing some of the risks likely to occur in the coming months. As such, staying invested appeals at this juncture, while focusing on diversification and active management to help try to improve the risk/reward trade off.

“With equities trading at 20-year high valuation multiples...there are growing concerns that a bubble may be forming and that a correction is nearing”
Election results rarely impact bonds

With a US election nearing during COVID-19 and all eyes on central bank policy, what next for rates, bond market volatility and spreads?

September saw much of the market attention focused on central banks. Despite the lack of further action in the month, investors received very important messages from the central banks. As mentioned in our weekly on the 18 September the message from the US Federal Reserve (Fed), the European Central Bank and the Bank of England alike is loud and clear: if you wait for higher yields, you might get disappointed.

The Fed revealed the results of its largely anticipated new policy framework and followed up with further details during September’s Federal Open Market Committee meeting. The new framework leaves more room for the central bank to keep rates lower even in periods when inflation rises above the 2% target (if preceded by a period when inflation was below the target) leaving the possibility of inflation overheating.

However, according to the Fed’s projections inflation is not expected to hit the 2% mark before the end of 2023. There is a risk that inflation takes longer to reach that target rate, suggesting that short-term rates may be stuck at low levels for some time.

Where next for rates?
The market reaction has been revealing. Since April, rates have stayed in a relatively narrow band accompanied by ultra-low rate volatility.

The yield on 30-year bonds has attempted to break above a 1.5% resistance level, but failed. The steepening, which has been most pronounced in the 30-year to 5-year segment of the market, may have lost some steam of late, but the idea of a steepening seems compelling. Rates are anchored at the short end, while long-end rates are exposed to treasury supply risk, potentially higher US inflation, in the wake of the Fed’s more relaxed attitude towards inflation targeting, and perhaps a V-shaped recovery.

We believe that a steepening move may only be temporary for now. As long as the levels of uncertainty about the recovery, the unemployment rate and size of state-support initiatives remain high, a sustainable increase in yields seems unlikely.

Elections and the bond market
Might the US presidential election be a catalyst for higher yields, as seen in 2016? We looked at prior rate movements in American election years to see if any pattern exists (see chart). That said, basing investment decisions on the anticipated result of an election can be risky.

The effect of US elections on rates
Rate movements in the two months prior to a presidential election and 12 months thereafter, for the ten contests since 1980

Source: Bloomberg
The last presidential election, in 2016, saw a Republican victory which raised the expectation of more fiscal stimulus, lifting 10-year rates to roughly 2.6%, from around 1.8%, in a short period. This year the focus on the outcome of the US election appears high too.

There seems to be little direct link between the result of the last ten US elections and the movement of rates in the following 12 months. While a Republican victory lifted rates in 2016, by a similar margin to that seen in 1980 under Ronald Reagan, rates declined in the period after the Republican governments of Reagan and George W Bush in 1984 and 2000 respectively. The Democrats had a similarly mixed impact on rates after their wins between 1992 and 2008.

Beware implied volatility
Two things can be observed about the effect of the elections that are worth noting. First implied rate volatility seems significantly higher during the election period and this year it seems the demand for hedging is particularly high. Implied option volatility for 10-year forward swaps, for example, are six times higher than for periods outside of the post-election period. In the past, implied volatility has been only two times higher on average.

Second, when election results were delayed, like in 2000 when votes in Florida had to be counted again, yields trended lower and reflected the demand for safe-haven assets in times of heightened uncertainty over the outcome.

So what next for investors?
What are the takeaways for investors? Rate movements can be mostly explained by inflation expectations, central bank policy and economic leading indicators. Election periods have often fallen in the middle of economic shocks, such as the credit crisis in 2008 or an equity market crisis in 2000, that dominated prospects for yields.

It seems we face a similar situation this year given the COVID-19 crisis: it is likely that the shape of the recovery and news on the medical front will have the greatest impact on yields. However, higher implied rate option premiums or any potential delay in the result this time around might push rate volatility up and see rates trend lower in November.
Oil: a slippery slope

Economies reopening, sentiment improving and positive supply cut news has been a tailwind for oil over the past three months. However, risks of another round of COVID-19 infections and a more prolonged period of recovery than many investors expected may alter the paradigm once more.

The oil market made progress towards recovery in July and August as supply cuts and better than expected economic activity stabilised futures curves while Brent crude topped $40 per barrel.

However, a sustained recovery was always going to hinge on COVID-19 infection rates. Cases are spiking globally, impacting sentiment and increasing the risk of fresh containment measures.

Demand weakens

International Energy Agency (IEA) data shows that global demand fell by 10.5m barrels per day (bpd) between January and July compared to last year. In addition to local quarantine measures and increased teleworking, cautious consumer sentiment has contributed to the aviation sector (a key sector for oil) remaining weak.

These factors have more than offset any uplift from increases in personal mobility data as a result of social distancing. India is a major importer of oil and has continued to see an exponential increase in cases. Indeed, August’s month-on-month growth in oil demand was the weakest since April.

The hit to demand is crucial in determining the commodity’s fate, with September showing Brent crude failing to make further inroads towards a balanced market.

What’s more, Chinese crude buying has slowed sharply in September and October, with unsold barrels now starting to pile up. According to the IEA, this combined with weak refinery margins has meant that inventories are building, with trading houses looking for charter ships in which to store oil.

OPEC production cuts

OPEC+, a group comprising members of the Organization of the Petroleum Exporting Countries (OPEC) and other leading oil producers, agreed to cut production by 9.7mbpd in May and June. Cuts of 7.7mbpd are also in place until the end of the year.

Providing some further support to the oil price has been hurricane Laura in the US. Laura forced precautionary shut-ins and lowered production by 0.4mbpd in August, with a tepid September recovery likely due to hurricane season in the Gulf of Mexico and low American rig counts.

However, despite this, the reduction has failed to meet the sheer magnitude of the demand-side fall. OPEC argues in its monthly report that the pandemic has reduced 2020 demand by a staggering 9.5mbpd.

“The pandemic has reduced 2020 demand by a staggering 9.5mbpd”

COVID-19 is key to unlocking a balanced market

The economic impact of the coronavirus and oil prices across industries like aviation, transportation and tankers will ultimately be determined by the lifespan, intensity and geographic spread of the virus.

While cases are rising at an alarming rate (particularly in Europe), this does not necessarily signal a return to national lockdowns due to the devastating effect that such measures have on economic output. It is worth noting that the recent rise in cases is less pronounced than the initial spike, healthcare systems appear well versed in treating and managing patients and the public are more susceptible to changing social interactions.

Ultimately, we expect oil prices to be range-bound in the near term as supply cuts partially counter the fall in demand. As producers, businesses and citizens adapt to the new world, some activities will take time to fully normalise, such as air travel. Furthermore, the oil price has likely passed its initial fast pace of recovery.
How green is your portfolio?
Given the inevitable implications of climate change, how can a portfolio’s carbon footprint help investors to manage risks and potentially boost returns?

As climate breakdown accelerates, so too do potential financial risks and opportunities for investors. Currently, the sum of all national plans do not deliver the commitment to keeping temperatures within 2°C of their pre-industrialised levels, let alone the 1.5°C ambition, of the 2015 Paris Agreement. Already the physical effects of climate change continue to intensify, most visibly in this year’s California wildfires.

Next year, nations are scheduled to convene to review their progress and nationally determined contributions at the UN Climate Change Conference – COP26. Given the current trajectory, expanded efforts and pledges will be required to achieve the committed targets.

Understanding transition effects
As governments and industry seem to move to a low-carbon economy, investors may want to increasingly understand both the potential physical impacts as well as the transition risks for portfolios (explained in February’s and March’s Market Perspectives respectively). Carbon footprinting has emerged as a useful tool for investors to inform and implement a portfolio strategy that can prepare for these challenges.

“Carbon footprinting has emerged as a useful tool for investors”

In this article, we review the foundation of carbon footprinting, calculation methodologies and then using carbon footprinting to aid investment decision-making and portfolio positioning.

Foundations of a carbon footprint
Greenhouse gas (GHG) emissions are embedded throughout business and society. Accounting for an activity’s carbon footprint can be useful to understand the nature and relative extent of climate risk and opportunities in an investor’s portfolio.

Carbon footprinting measures the impacts of an activity on global warming by calculating the GHG emissions of these activities – both the direct and indirect emissions. This is done to express key greenhouse gases (such as carbon dioxide, methane and nitrous oxide) as a common unit, allowing easier comparison across different geographies, industries and organisations.

“Carbon footprinting measures the impacts of an activity on global warming by calculating the GHG emissions of these activities”

Emissions are categorised by the GHG Protocol under three distinct categories, generally known as Scope 1, 2, and 3, which helps to systematically define different emission contributors. The categories allow for standardised emissions calculating and reporting, and a better understanding of emissions sources:

Scope 1 – Direct emissions from company-owned and controlled sources. In other words, emissions released as a direct result of a set of core business activities.

- Stationary combustion: all fuels that produce GHG emissions (for instance, fuels and heating sources)
- Fugitive emissions: leaks from GHGs which are often dangerous (such as refrigeration or air conditioning units)
- Process emissions: GHG released during industrial processes and on-site manufacturing (such as, cement manufacturing, factory fumes and chemicals)
- Mobile combustion: all vehicles owned by a company, burning fuel (for instance, cars, vans and trucks. The increasing use of electric vehicles mean that some organisations’ fleets could fall into Scope 2).
Scope 2 – Indirect emissions generated by the electricity purchased and consumed by the organisation. In other words, all emissions from the generation of purchased energy from a utility provider. This covers all GHG emissions released in the atmosphere, from the consumption of purchased electricity, steam, heat and cooling. For most organisations, electricity will be the unique source of Scope 2 emissions.

Scope 3 – Indirect emissions – not included in scope 2 – which are generated from sources that the company does not own or control, covering emissions associated with business travel, procurement, waste and water. These emissions occur in the rest of the value chain, including both upstream and downstream emissions:

- Upstream activities (cradle-to-gate): emissions that occur in the life cycle of a product or material up to the point of sale by the producer.
- Downstream activities: emissions produced in the life cycle of a product after its sale by the producer, including distribution, storage, product-use and end-of-life.

Today most public companies report on the emissions from their primary activities (captured by Scopes 1 and 2) and few reports incorporate disclosures about their upstream and downstream emissions that occur in the value chain. However, Scope 3 emissions often represent a company’s most significant GHG contribution. Calculating Scope 3 emissions is also significantly more complex given scarce and incomplete data and methodology challenges.

While companies and investors do not always have an exact picture of their full footprint, appreciating the fundamental sources and drivers of risk and opportunity can still valuably inform the investment process.

Calculating a carbon footprint
For investors seeking to calculate their portfolio’s carbon footprint, the first step is to understand where emissions specifically come from. At its simplest, the carbon footprint is the sum of a proportional amount of each portfolio company’s emissions (proportional to the amount held in the portfolio). Typically, to calculate the footprint:

Source: GHG Protocol
• Obtain carbon emissions data on companies or projects owned in a portfolio, either from verified disclosure or from estimated/interpreted sources;

• Calculate the total emissions of the owned percentages of each company and add them together resulting in a total owned carbon emissions figure per portfolio; and

• Normalise the results, using factors such as annual revenue or market capitalisation.

While there are various approaches to provide a single carbon footprint measure, carbon intensity is a commonly used one that determines the amount of emissions, in tons of CO₂, that the companies in the portfolio produce for every million dollars of sales, abbreviated as tCO₂e/$m sales.

Off-the-shelf and customised services are available for measuring a portfolio’s carbon footprint. While there are limitations, such as consistency and availability of data, availability across all asset classes, approach to Scope 3 emissions and different estimation methodologies; nonetheless, these tools enable investors to consider not only carbon but also natural capital, fossil fuel reserves and exposure to stranded assets.

Additionally, having a carbon footprint allows investors to compare their results to global benchmarks, identify priority areas for reducing emissions and track progress in making those reductions.

“Having a carbon footprint allows investors to compare their results to global benchmarks, identify priority areas for reducing emissions and track progress”

From footprint to investment pathway
Understanding a portfolio’s footprint can serve as an informed starting point for an investor to create and implement a broader climate change strategy. It provides insight to identify a portfolio’s climate risk exposure to physical and transition risks. It can help consider allocation strategies for creating a lower-carbon portfolio and inform asset selection. It also can support investors to uncover diversifying or growth opportunities in green investments.

“It [A portfolio’s carbon footprint] also can support investors to uncover diversifying or growth opportunities in green investments”

Most importantly, it shows investors their contribution to GHG emissions through their investments. By understanding their current path and serving as a reference point for their investment plans, investors can address climate change on a personal level too. While climate crisis is a global and systemic challenge, it is with collective action that it can be overcome.
The dangers of extrapolation

Taking past performance, building a compelling narrative to explain it and extrapolating forward is a common way for many investors to try and make sense of the world around them. We examine the potential pitfalls of positioning portfolios using this approach and look for better ways to go about it.

An unknowable future
While 2020 has been difficult to predict, this year has highlighted the importance of keeping a firm eye on the probabilities of events occurring when making decisions today. While the future is unknowable, the past is not. One intuitive and common way for investors to anticipate the future is to extrapolate from previous results. This can however create a host of problems.

Why we extrapolate
Human beings do not generally like uncertainty. Extrapolation can help us deal with this. If the future is unknowable, a sensible approach can be to start with what is known. After all, the future builds on the past. However, human beings do not just draw lines to extend past trends forward. We are social animals and part of the stories we tell as well.

Extrapolation in investment often involves taking a significant past performance pattern, constructing a simple narrative to explain it and then considering whether the narrative will apply to the future. Compelling narratives can then be created to justify why past performance has been particularly strong or weak, and then used to predict its continuation.

The pitfalls
When market moves are explained, they are typically explained in a way that suggests the story drives the price. In hindsight, even the most complex events can make perfect sense when the story is explained to us. The problem is these explanations usually come after the event.

Post-rationalisations can be dangerous because extrapolation is circular and narratives can become self-fulfilling. Investment decisions can be made on the basis of events that are not true. Financial markets involve so many moving parts, that in many occasions it is difficult to provide complete explanations for events. Often, even the most experienced investment professionals differ in opinion.

Does the evidence support the story?
Narratives are powerful because they can feel right, especially if there is some evidence to support them. Whether the causal relationship the narrative seeks to explain is strong can become immaterial; what matters is that the story is convincing. Once the link has been forged, it can be hard to break in an investor’s mind. Additionally, the simpler the narrative, the easier it is for it to be understood, shared and to therefore take hold as the prevailing explanation. Therefore, stories which are missing key variables and are extreme simplifications can capture investors’ attention.

Confirmation bias, a natural tendency to seek out, interpret, favour and recall information in a way that confirms and supports one’s prior beliefs or values, can further exacerbate the situation.

Investment mistakes
Simple narratives can be relatively harmless if just being used to explain the past. However, they can be dangerous when used to set future expectations and allocations. They can encourage overconfidence in our predictions. In addition, diversification is often sidelined when holding strong convictions, which may result in over-concentration in an investor’s portfolio. Extreme examples involve people investing in sectors or stocks at the heights of bubbles, when the most believable prevailing narratives about how dizzying heights could be sustained can seduce investors.

While extrapolation has its drawbacks, sustained trends should not be ignored. A behavioural pitfall with investing is to view performance relative to when the position was first entered into and if performance has been strong and persistent, to expect a correction. The reality is that the market does not care about when you invested; if the case for the trend is solid, reversion does not have to be inevitable.
Preparing for after the pandemic
Life has changed dramatically as a result of the COVID-19 pandemic, with significant impacts upon many sectors of the economy. Some trends that were underway, such as working from home, have accelerated rapidly this year. As Microsoft chief executive officer, Satya Nadella, succinctly put it: “We’ve seen two years’ worth of digital transformation in two months.” Certain sectors have profited greatly, one being the tech sector which has led the recovery in equities since March’s sell-off.

As we prepare for a transition to a post-pandemic world, there will inevitably be winners and losers. Increased e-commerce adoption for example seems to be here to stay, especially if the pandemic isn’t brought under control rapidly. However, many are predicting long-term structural changes based on events occurring during the pandemic. This is a very unusual, uncertain and short period of time upon which to draw any strong conclusions or make predictions.

The field of behavioural economics shows us that it can be difficult to create lasting behaviour change. While it seems very difficult to imagine things going back to what they were like at the start of 2020, investors should be conscious that our perception is altered when we are in a “hot state” (such as living through the COVID-19 outbreak).

Many behaviours (and thus the implications on sectors) may not be permanently altered once the pandemic is over. When extrapolating, structural changes are often implied when in reality much market behaviour is cyclical.

“When extrapolating, structural changes are often implied when in reality much market behaviour is cyclical”

A way forward
So how should investors be thinking about the future given the present uncertainty? We recommend taking a long-term view of investing, and constructing a well-diversified portfolio of high-quality companies.

Take a broader view based on all available data, avoiding getting caught up with individual stories and remembering that the news can itself be biased and produce noise which may be unhelpful to an investor.

A trusted advisor can help to make sense of competing narratives and reach a point of view that is based on careful rational data analysis and a diversity of views from professionals. When thinking long term, as we have discussed many times in this publication, it becomes clear that a well-diversified portfolio is the best protection for the unknowable future.

Focus on actively selecting quality companies
Narratives that are overly simple view the market as a single entity, or all companies in a sector as identical. We recommend protecting yourself from that thinking and the market reactions (or overreactions) to such narratives can be accomplished through two, interlinked strategies.

While structural changes can lead to even the strongest companies falling out of favour, holding quality companies can protect a portfolio from market shocks. Active management rather than passive exposure to markets also appeals, to ensure that a portfolio consists of the strongest constituent companies best placed to thrive, whatever tomorrow looks like.

The world around us might be in constant flux. However, by understanding and addressing our behavioural biases, portfolios never should be.
Cautiously pushing the boundaries

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

The narrative around the pandemic in India remains the same: increasing numbers of coronavirus cases recorded, a seemingly good rate of recoveries and relatively low mortality rates. While fears of renewed regional lockdowns remain, this is being countered by a strong belief that the government cannot afford the economic impact of stricter containment measures.

Hopes remain high, however justified or not, that with a self-restraint culture, an evolving healthcare system and belief that a successful vaccine can be found and administered at a larger scale soon, revival should sustain. Sentiment is also being aided by signs of improving economic activity, as indicated by high frequency data sets, including mobility and employment figures, and a pick-up in sectors like auto, steel and cement.

Supply restored, but will demand follow?
While any supply side fears seem to have almost abated, including production, supply chains and labour migration, prospects for the recent rise and further revival in demand remain bleak.

Investments, both private and public, are unlikely to pick up significantly in the short term, with:

- demand (both business and consumer) sentiment remaining low,
- high inventory and capacity build up in the economy, and
- fiscal constraints limiting government capital expenditure, which is likely to be more pronounced across state governments and government agencies (while questions remain about the sustainability of increased fiscal support beyond fiscal year 2021).

Indian exports and trade balances are expected to improve over the next few years, especially with the benefits offered by global trade realignments and supply chain diversification, growing demand for technology, healthcare and pharmaceuticals and increased government support to promote exports of agriculture and rural produce. However, these may not be enough to offset the negative impact of an anticipated global slowdown on Indian exports.

Consumer sentiment remains key
Domestic consumption, at least for the next two years, remains the key driver for growth in India. However, a question that remains in many people’s mind is “what will support sustainable growth in consumption/demand?” The following important clues may help answer this question:

- Disposable income: while the overall outlook for employment and income is weak, inflation seems to be well behaved and may reduce further
- Consumer sentiment: as sentiment weakens, any pick-up in disposable income could be directed more towards savings than immediate consumption
- Credit demand: higher consumer credit growth remains vital for sustainable domestic growth. Indeed, this factor has been a growth driver for the country with higher penetration levels seen over the last decade. Furthermore, a policy of “lower for longer” interest rates should support a pick-up in credit.

As such, consumer sentiment (in turn dependent on the business, employment and income outlook) remains the most critical factor to watch out for in India. A recovery here can be sharp, considering the highly elastic levers of higher disposable income, increased savings (and with lower savings returns encouraging consumption) and a healthy credit culture. Considering the higher resilience seen in the rural economy, for now, demand may rise faster in rural segments and in discretionary consumption of low value items.
Indian equities
While valuations, especially at the larger, “blue chip” index levels, continue to remain uncomfortably rich, these might need to be evaluated using different lenses now:

- The index composition has changed significantly over the years in favour of companies that have typically had higher price-to-earning (P/E) ratios. So, a comparison with historical P/E ratios using the respective historical index composition could be incorrect.

- While it is difficult to establish a correlation between interest rates and equity valuations, historically low interest rates and a lower for longer outlook should affect the discount rates used by analysts in discounting future cash flows of companies.

- If the composition of the current Nifty 50 or Sensex indices are broken down, any sharp sell-off in these Indian indices, even if also seen in the emerging markets more generally, remains unlikely as:
  - IT and pharma are global favourites, a trend amplified in the pandemic and that is expected to sustain after the COVID-19 crisis passes;
  - some sectors, especially in manufacturing, are expected to profit from a rebalancing of global trade;
  - the largest weighted companies in these indices continue to attract significant capital flows from foreign investors; and
  - financials continue to be the largest weighted sector and have already seen a sharp sell-off over the last few months, making valuations appear somewhat cheaper.

Market breadth expected to improve
We continue to prefer “quality” stocks and believe that this basket will be increasingly influential across various market capitalisations. The recent directive by the Securities and Exchange Board of India aimed at better aligning multi-cap mutual fund portfolios towards mid and small-cap stocks by January 2021, should continue to support smaller capitalised stocks.

Flows to Indian equities should continue to be supportive, both in the primary and secondary markets. With important geopolitical developments globally in coming months, both at home and overseas, investors may need to have a higher appetite for volatility per unit of risk premium. With sharp sector and cyclical rotations possible in equity markets before the year is out, active management and a staggered incremental investment approach appeals.

Fixed income
We expect the Reserve Bank of India (RBI) to continue with its accommodative stance and keep ample market liquidity. With over 115 basis points (bp) of rate cuts behind us, headroom for more rate cuts appears limited to 25-50bp at most. However, the RBI also has an extensive toolkit of measures at its disposal to influence market rates.

Expectations of continued government spending, in the face of lower public revenues is likely to result in fiscal slippage at a consolidated level. In turn, this will probably mean increased supply at the longer end of the yield curve, reinforcing our neutral stance on domestic debt and attractions of high-quality assets at the shorter end of the curve.

Banking on accruals and roll-downs
As India comes out of the debt moratorium, we are likely to see a relative normalisation in the credit environment. However, breaks in supply chains and some demand destruction may lead to increased corporate vulnerability. In line with our views, we prefer high-quality instruments and roll down strategies might be used to take advantage of the shape of the yield curve. Higher accruals and curve steepness can provide partial insulation to any adverse interest rate movements due to higher duration risk.

Quality and liquidity baskets expanding
In the post-moratorium environment, companies that have sound business policies, proven track records, ability to leverage at competitive levels and manage their assets efficiently are likely to be well placed to expand margins and gain market share.

Several such businesses have navigated stressed market conditions by successfully reducing their liabilities as balance sheet sizes shrink. In case of such issuers, an important distinction which emerges, is the relative lack of liquidity caused by lower supply coinciding with a lack of sellers (who prefer to hold on to instruments of these issuers rather than sell at higher yields). Such issuers remain part of our bottom-up approach towards credit, including issuers in sectors which are currently seen as stressed (such as non-banking financial companies).

In a lower for longer rate environment, it may be worth considering increasing the number of issuers that merit inclusion in the “high quality-less liquidity” category and to search for opportunities in this expanded universe in the near future.
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