

Private
Bank

Market Perspectives

April 2021



Foreword

Hopes of a recovery seem to be growing. But so are fears of higher inflation levels, intermittently hitting equity and bond valuations in the process. In this Market Perspectives we look at the potential effects of a sustained jump in prices on economies and financial markets.

With vaccine rollouts going well, especially in the US and UK, we now expect the global economy to grow by 6.4% this year, up from 5.6% in January. Inflation expectations are rising and, while they have stayed put for now, central banks may hike interest rates sooner than expected. Investors should beware. Even moderate price rises can damage wealth preservation assumptions.

Equities are likely to be volatile this year as the spectre of inflation lurks. Moderate price rises may not be much of an issue. But the effect on sectors differs. Investing actively in quality companies, especially those with pricing power, seems even more relevant should inflation, and rates, climb.

Turning to bonds, long-end yields have risen more quickly in recent weeks, as inflation concerns gather pace. Recent eras of rising inflation indicate that yields and inflation need not move in tandem. That said, in looking to manage inflation risk, inflation-linked bonds seem the most obvious way to hedge the risk. High yield bonds may also be worth considering in this respect.

Inflation is visible in commodities, where prices have started the year with a bang, aided by brighter economic forecasts. Commodities producers can benefit as price takers, their future being highly dependant on the outlook for raw materials. While wary of gold's role as an inflation hedge, it tends to be a useful diversifier.

Turning to sustainable investing, as its popularity grows, so does the danger of selecting inappropriate products to meet the goals desired. Over egging sustainability credentials, or greenwashing, is a concern. But much can be done to avoid falling for it. As investors become more aware of sustainability approaches, the risk of greenwashing may drop, and with it, investment in the area can be secured.

**Jean-Damien Marie
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Inflation: up, up and away?

With hopes rising of a relatively swift, vaccine-fueled recovery for some of the largest economies this year, does the prospect of a bounce in prices beckon? We look at inflation prospects and what these might mean for policymakers and investors.

A shockwave has reverberated through financial markets since February as the unleashing of pent-up demand, overwhelming fiscal support and surging commodity prices encouraged several economists to hike their inflation forecasts. Similarly, government bond yields have climbed as investors reevaluated central banks' commitment to maintaining interest rates at historically low levels for a prolonged period.

Investors must now gauge if the anticipated rise in inflation is persistent, whether it will result in higher interest rates and consider the need to adjust portfolios to mitigate the risk.

Recovery hopes strengthened

Inflation expectations have been rising as confidence in the speed and magnitude of the recovery climbs. Lower levels of reported coronavirus cases have allowed governments to plan for the gradual easing of restrictions.

Most importantly, the administering vaccines around much of the world has accelerated the timeframe for the normalisation of activity. The vaccine rollout should reduce new infections, help revive service industries and eventually help to restore employment prospects. We now project that the global economy will grow at 6.4% this year, up from a 5.6% forecast in January.

“The administering vaccines around much of the world has accelerated the timeframe for the normalisation of activity”

Building price pressures

Inflation expectations have been boosted by the scale of the global fiscal response. The International Monetary Fund

estimated in January that governments have committed \$14tn to saving lives and livelihoods¹.

President Biden's \$1.9tn relief bill, the second largest stimulus package in US history, was passed in mid-March². The bill includes direct cheques to consumers, extension of unemployment benefits and funds for vaccination distribution programmes. The aid should temporarily supplement income and government spending while the economy is being weighed down by the pandemic.

Spotlight on commodities

Accelerating commodity prices can quickly influence inflation projections given their high weighting in consumer price indexes. The anticipated robust recovery (particularly in commodity-intensive economies such as China), aggressive infrastructure investment and the climate change agenda have conspired to push energy, metal and agricultural prices higher.

“The anticipated robust recovery...aggressive infrastructure investment and the climate change agenda have conspired to push energy, metal and agricultural prices higher”

The total return on the Bloomberg Commodity Index is 34% over the past year. Investment houses are increasingly predicting a commodities supercycle is playing out. If commodity prices maintain their upward trajectory they would push both consumer and producer prices higher, particularly in countries that have to import vast amount of raw materials.

¹ Government support is vital as countries race to vaccinate, IMF, January 2021 <https://blogs.imf.org/2021/01/28/government-support-is-vital-as-countries-race-to-vaccinate/>

² House gives final approval to Biden's \$1.9 trillion pandemic relief bill, The New York Times <https://www.nytimes.com/live/2021/03/10/us/joe-biden-news>

Inflation is also being driven higher by a range of technical factors. Disruption in global trade caused by coronavirus protocols has resulted in supply bottlenecks, pushing up costs in areas such as container shipping. Countries, such as Germany, have reversed VAT cuts introduced at the start of the pandemic and there have been delays to key selling seasons. Relatively small increases in prices can also result in dramatic inflation movements due to low base levels.

Inflation set to climb

Given the broad range of both demand pull and cost push inflationary pressures, it's perhaps no surprise that year-on-year inflation prints could significantly rise over the course of this year. For the UK, Europe and US headline inflation is projected to be one percentage point higher this year than in 2020.

“For the UK, Europe and US, headline inflation is projected to be one percentage point higher than in 2020”

Are pricing pressures temporary or sustainable?

A number of factors suggest that the inflationary pressure being seen is transitory. Unemployment rates are elevated compared to pre-pandemic levels, yet the wage growth often associated with core inflationary pressures has not been seen. The rapid digitisation and ongoing investment in technology is also expected to keep wage growth muted, even when labour markets recover.

Furthermore, the level of spare capacity in many economies remains high compared to the start of the recession which should help anchor inflationary pressures.

While the medical prognosis has improved, the arresting of the coronavirus outbreak is far from assured. The road to freedom could still be infringed upon by regional differences in vaccination rates. Unknown vaccine efficacy levels against future variants could also affect the recovery in demand and, in turn, price pressures.

Inflation forecasts

Barclays forecasts that the core personal consumption expenditures (PCE) index, the US Federal Reserve's (Fed) preferred measure of US inflation, will hit 2.2% in the second quarter of this year, easing back to 1.8% in the third quarter and 1.9% in the fourth one and then averaging 1.8% in 2022.

In Europe inflation forecasts have risen, but weak underlying consumer prices pressure from the fragile labour market is expected to keep inflation subdued in the medium term. The euro area CPI will likely average 1.5% this year and drop to 1.1% in 2022. In the UK our inflation projections are for CPI to average 1.9% this year and 1.8% next.

Is tighter monetary policy on the horizon?

Given that inflation forecasts remain below central banks' mandated levels, the impact of stronger inflationary pressures on monetary policy is likely to be more muted than recent movements in bond yields suggest. We forecast that the Fed, European Central Bank and Bank of England will keep rates on hold this year and next. Central bankers will, however, closely monitor rising yields and may want to discourage an unwarranted tightening of financial conditions.

In order to cap the rise in yields, policymakers still have a range of tools available, including implementing a higher bond purchase rate, buying longer dated bonds while simultaneously selling bonds with shorter maturities (known as Operation Twist) and, if required, the introduction of formal yield control measures.

Investors beware

In order to preserve the long-term purchasing power of their wealth, investors need to generate a return that is equal to or preferably higher than inflation. While it appears that inflation rates are currently not sufficiently concerning to worry central banks, even moderate price rises can start to cause meaningful damage to wealth preservation assumptions. For those seeking protection, there are a wide range of options available to mitigate inflation risk by using equities, fixed income and precious metals.



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

Can equities weather a hike in inflation?

Fears of a sustained rise in inflation has hit sentiment for equities, despite a vaccine-driven recovery moving closer. But the impact of inflation on earnings expectations affects sectors, and companies, differently. We look at the potential winners and losers. That said, investing in “quality” companies over the long term can help to ride out any inflation-induced turbulence.

A year ago, much of the world was in lockdown. Today, vaccines are being quickly administered in many developed economies and several are planning their grand reopening. This stark difference in the macroeconomic backdrop means that earnings comparisons with last year will be undoubtedly strong. One variable in particular has grabbed the headline, causing some concern for investors: inflation.

Moderately higher prices ahead

Powerful base effects, higher oil prices, supply chain disruptions (for items like semiconductors and freight) and a strong recovery have pushed inflation expectations higher. In the US, economists polled by Bloomberg anticipates that the consumer price index (CPI) will reach 3% in the second quarter and average 2.4% in 2021.

While this marks a sharp acceleration from recent trends, it is far from hyperinflation. In fact, in 2018, US inflation was 2.5%. In addition, the personal consumption expenditures (PCE) indicator, the US Federal Reserve’s preferred measure of inflation, shows more muted price pressures.

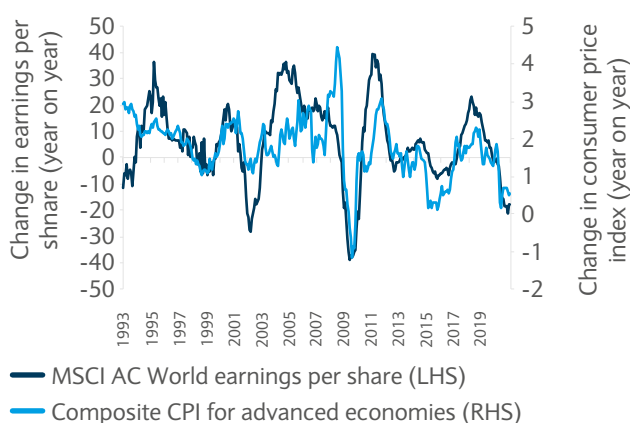
The central bank expects the PCE to reach 2.2% this year and 2.0% next year. So while we are likely to see higher US prices in coming months, there seems little to worry about, in our opinion.

Mainly a US issue

Interestingly, inflation dynamics appear more muted outside America. In the eurozone, the consensus expects CPI of 1.5% this year. While this is much higher than the 0.3% recorded in 2020, it is still well below the European Central Bank’s target of 2%. Globally, inflation looks like being around 2.8% this year, below last year’s 3.2%.

Earnings move in tandem with inflation

The trend in the composite consumer prices index for advanced economies and the MSCI AC World earnings per share since 1993



Sources: Haver, Refinitiv, Barclays Private Banks, March 2021

A healthy development

Although it might sit at the top of several investors’ concerns, moderate and controlled inflation may not be much of an issue. In fact, from both a macroeconomic and financial markets’ perspective, higher prices can be much healthier than much lower ones: deflation. As such, slightly higher CPI should be welcomed as the reflection of a strong recovery.

Historically, equities have performed well when inflation was in the 2-3% range (see chart). This is because higher prices typically mean more sales as these are recorded in nominal terms. Unfortunately, in the current context of extremely low interest rates and extended equity valuations, a sudden rise in inflation could cause short-term volatility.

How higher prices can affect equities

Inflation can influence equities in two ways. First, while companies' revenues should increase following higher selling prices, the result on profits could be negative if input costs rise faster. In this context, pricing power is essential to counteract the risk of margin compression.

The second risk equities face is related to interest rates. If inflation is accompanied by higher real bond yields, the discount rate applied to future cash flows will increase, compressing valuations, all else being equal. With companies offering strong and steady growth being most at risk of a change in the discount rate, this phenomenon could fuel the sector rotation we've seen this year.

Keeping an eye on the equity risk premium

We highlighted the relationship between interest rates and equity valuations in February's Market Perspectives. At that time, we argued that, all else equal, a yield of 1.6% on US 10-year government bonds could push the equity risk premium (ERP), to levels consistent with negative equity returns over the next five years.

Since then, the strong fourth-quarter earnings season helped to support the earnings yield. At current valuations, the ERP would fall below its 40th percentile (250 basis points) when 10-year bond yields approach 2%, leaving some room for manoeuvre (see table).

Looking beneath the surface

While interest rates may not pose an immediate risk to equities, this year's sharp rise in bond yields has triggered significant sector moves. As an investment style, "value" has finally started to outperform (the MSCI World Value is outperforming its growth counterpart by 10% this year, as at 26 March 2021). However, this is negligible in light of the divergence that has occurred at the industry and stock level.

"While interest rates may not pose an immediate risk to equities, this year's sharp rise in bond yields has triggered significant sector moves"

S&P 500 equity risk premium in 2021

	31 January	26 March
S&P 500 level	3,850	3,974
S&P 500 earnings per share (\$)	169	180
SPX price-to-earnings ratio	22.7	22.1
Earnings yield	4.4%	4.5%
10-year government bond yield	1.10%	1.67%
Equity risk premium (basis points)	331	285

Sources: Barclays Private Bank, Bloomberg. March 2021

While the 25% gain in energy shares this year, as of 26 March, is more a function of the stronger oil price, financials (+14% in the same period) and banks in particular (+20%) have been key beneficiaries of higher interest rates. By comparison, defensive, bond-proxy, sectors such as utilities and consumer staples have lagged (flat over the same period). While we would expect this rotation to fade, it reinforces our conviction that investors should ensure appropriate diversification.

Quality and pricing power

Fundamentally, we continue to think that owning "quality" companies makes sense over the long term. While they may initially struggle against their value peers in a strong recovery scenario, over time, they are likely to deliver better risk-adjusted returns. Remember that quality is not synonymous with "defensive" or technology assets and maintaining some exposure to cyclicalities in portfolios seems preferable, in our view.

With the prospect of higher inflation seemingly looming, investors might also focus on companies, industries and sectors offering pricing power. Below, we list the most likely impact of higher prices at the sector and industry level, helping to find potential winners and losers should inflation climb. However, the outcome could vary for each company within each sector. This makes active management even more relevant.

Sector	Expected impact of higher inflation and interest rates
Consumer discretionary	<p>Luxury is probably one of the sectors with the highest pricing power.</p> <p>Car manufacturers, unlike part suppliers, tend to have little ability to increase prices and material expenses can account for almost two-thirds of revenues for some companies. In addition, they can be victims of both temporary (say freight costs and semiconductor shortages) and secular (say electrification and digitalisation) factors pushing up costs.</p> <p>Leisure tends to have limited exposure to inflation. In travel, airlines can often pass on higher oil prices to consumers but this takes time. On the other hand, asset-light hotel management companies appear better positioned than travel companies given their lack of exposure to labour and property price inflation.</p>
Consumer staples	<p>Food/household good producers tend to have some pricing power. However, because of heightened competition, their ability to pass on costs has weakened recently. To be sustainable and rewarded, price increases should happen with added value (such as a health-focused product or having a sustainability angle). So if pricing power returns, it is likely to be a function of this innovation rather than simple pass-through effects.</p> <p>For distributors (such as supermarkets) inflation is usually positive. Again, though, their ability to pass on cost increases through higher prices may be limited, especially when unemployment levels are elevated.</p> <p>Tobacco companies (and to some extent producers of alcoholic drinks) typically have strong pricing power given the inelasticity of demand for their products.</p>
Energy and materials	<p>As commodity producers, these sectors can profit from higher raw materials prices. However, they have no pricing power. In fact, they are price takers and can only realise the market price of the underlying commodity they produce. Pricing power appears further down the value chain. Chemicals companies, in particular, have frequently been able to increase prices over time as they add value to – and represent a key link in – the manufacturing process.</p>
Financials	<p>There isn't much pricing power in this sector (with the exception of some insurance companies). Yet, the sector remains an "inflation play" because higher inflation typically brings higher interest rates and a steeper yield curve. However, this environment could be negative for non-life insurers as it could boost costs of general insurance claims and challenge their bond-proxy status.</p>
Healthcare	<p>Healthcare isn't really exposed to "macroeconomic" inflation. There is certainly some pricing power driven by innovation but, ultimately, the regulatory framework is key in allowing healthcare companies to increase prices. From a valuation perspective, more than interest rates, investor sentiment is a risk as healthcare could lag in a recovery scenario.</p>
Industrials	<p>Because of the value added they provide, most specialised industrial companies should be able to hike prices. However, this may take a couple of quarters to materialise. Infrastructure plays could benefit from higher inflation as their revenue is often indexed to economic growth and inflation trends. However, higher interest rates would likely challenge their valuations.</p>
Technology	<p>Inflation, as it is generally driven by input costs, should have limited impact on companies producing software. Hardware producers are likely to be more impacted, especially in light of the shortage of semiconductors being experienced of late. Semiconductor manufacturers have already started to boost prices but they also are ramping up capital expenditure to meet increased demand. While the manufacturers have strong pricing power, with most share prices having doubled in the last two years, it may be too late to play the "inflation" theme through this industry.</p>
Telecoms	<p>In Europe in particular, the high degree of competition among operators makes telecommunications a highly deflationary business with very limited ability to raise prices. Mobile tower companies tend to be better positioned as they usually have more protection from inflationary pressures but valuations may suffer from higher interest rates.</p>
Utilities	<p>The impact will probably be mixed at best as even companies with indexation built into their revenue allowances may see their share prices struggle due to their negative correlation to bond yields.</p>



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

Dispelling the great rates and inflation myth

The relationship between yields and inflation is not as obvious as it might appear. At the same time yields often follow central bank messaging but can also deviate substantially. What does history tell us about periods of higher inflation and which bond segments might perform best at such times?

The upward trend of long-end yields, which started in August, has accelerated since February. The move is a natural response to the brighter economic outlook and positive news on the vaccine rollout front, hinting at an inflationary recovery as seen during many post-crisis periods. In addition, uncertainty seems remarkably high, partly expressed by rising real yields (or yields adjusted for expected inflation) and in the elevated implied-rate volatility levels.

Fed is not helping

The uncertainty of late has been amplified by the apparent relaxed attitude of the US Federal Reserve (Fed) to the rate rise and prospects of higher inflation.

Fed governor Jerome Powell had a sobering message during March's Federal Open Market Committee meeting for investors, who expected a stronger commitment from

the Fed to tame yields: "The fundamental change in our framework is that we're not going to act pre-emptively based on forecasts, for the most part, and we're going to wait to see actual data. I think it will take people time to adjust to that, and the only way we can really build the credibility of that is by doing that."

With this the rate market seems torn between higher inflation and uncertainties in the early stage of the recovery.

With higher inflation expected in the coming months, concerns over a more permanent environment of high-inflation grow. Surprisingly, the historical relationship between rates and inflation does not always support the traditional framework: higher inflation leading to higher yields. The last nine spells of higher trending inflation (see table) provide some further insights.

Inflation and yield patterns during rising inflation eras

	Year	CPI low	CPI peak	CPI rate change	10-year yield change during inflation rise	10-year yield change 6m prior to inflation rise
Philips curve policy error	1961	0.7%	6.0%	5.3%	3.6%	0.2%
End of Bretton Woods	1972	2.9%	12.3%	9.4%	1.0%	0.4%
Oil embargo	1976	4.9%	14.8%	9.9%	5.8%	-1.1%
End of Volcker regime	1986	1.1%	6.3%	5.2%	1.4%	-0.1%
Phase of high trend growth	1998	1.4%	3.8%	2.4%	0.4%	-0.5%
Internet bubble recovery	2002	1.1%	3.3%	2.1%	-0.4%	0.0%
Build-up of housing bubble	2006	1.3%	3.9%	2.6%	1.0%	-0.5%
Credit crisis recovery	2009	-2.1%	3.9%	6.0%	-1.6%	0.8%
Trump reflation	2015	0.0%	2.9%	3.0%	1.0%	0.1%
Covid V-shape (until today)	2020	0.1%	1.7%	1.6%	1.0%	-1.2%

Back to the future?

While history doesn't repeat itself and the timeframe does not consider post-war periods, the past 60 years provide many examples of different inflationary environments. The first three periods of higher trending inflation can arguably be summarised as the era of great inflation. The era was caused by a multitude of factors, like a lack of understanding about the interaction between unemployment and inflation (so-called Philips curve), the end of the Bretton Woods (gold standard) system and external factors, like excessive oil price increases (oil embargo).

The periods thereafter were caused by asset bubbles, high trend growth, reflation policy and various other factors. What is notable from a bond investor perspective, is the rather loose relationship between the degree of inflation and the shift in long-end bond yields.

While rates moved up substantially in sympathy with inflation from 1976, yields barely mirrored its change in 1972. It could be argued that rates may have already anticipated higher inflation prior to the inflation realisation phase. But quite the opposite seemed to be the case, as on five occasions yields did not seem to anticipate the turning point of inflation.

Long-end yields rarely mirrored inflation rates

The often muted reaction in yields confirms the view that yields are ultimately driven by many factors, such as trend growth, central bank policy, supply and demand, investor preferences or the regulatory environment. It also shows that inflation, if caused by external input factors, can also dampen the growth outlook, which in turn may lead to lower yields rather than higher ones.

Policy rates leading the way

The central bank policy rate is another influential factor for the long end of the curve, given the shape of the curve reflects the market's expectation for future policy rates. Here, the often quoted yield curve steepness provides some insights. Re-occurring patterns and mean reversion observed in the yield curve steepness over time may help to assess the current situation.

While steepness can be measured at various points on the curve (say 10-year versus two-year yields, or versus 3-month or 30-year yields versus five-year yields) the chart simply looks at the difference between the 10 year and the Fed's policy rate.

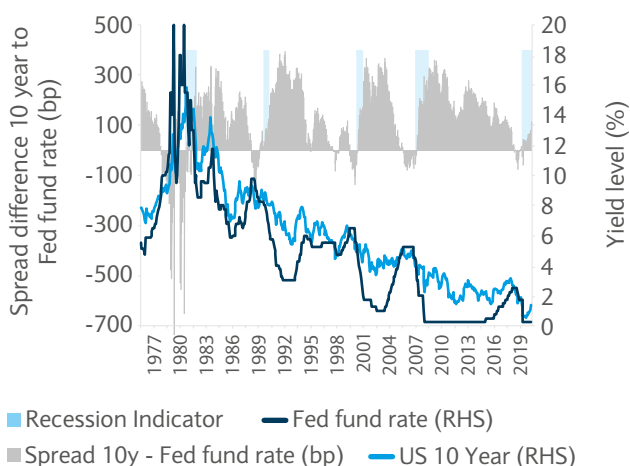
Since 1962 this difference peaked at around 370 basis points (bp) on three occasions 1992 / 2002 / 2009 while most of the times 290bp represented the maximum point. The sharp steepening during the three aforementioned periods, as much as during most periods, was entirely induced by policy rate cuts, and (contrary to common believe) not by higher trending rates.

Long end rarely causes steepening

While a steepening to 370bp as seen in the past cannot be ruled out this time, it becomes clear that by applying the historical pattern while ignoring the common cause for steepening may lead to false conclusions. In fact, the often quoted 1970/1980 period showed that elevated inflation caused the Fed to act while the long end only followed, leading to a deeply inverted curve on both occasions, not a steepening curve.

Steepening a result of lower central bank rates

Trend in 10-year to Fed fund rate spread, US 10-year yield and Fed fund rate since 1976



How can previous patterns best be applied to the current situation? The curve's steepness is currently around 170bp, of which 50bp was induced by Fed rate cuts and 120bp was caused by the rise at the long end. Historically, rising rates at the longer end of the curve led to a maximum of 180bp additional steepening in 2008 while in 2013 it was 130bp and in 2016 it was 120bp.

The above illustrates that there is a limit to what extent the long end differs from the prevailing Fed policy rate. Given the central bank's commitment to keep rates unchanged through to 2023, the scope for further steepening appears limited.

Rate volatility unlikely to disappear

Admittedly, with the Fed seemingly less concerned about the long end of the curve at this stage, this may lead to further spikes beyond what may seem justified, considering the expectation of a gradual rise in inflation but not an excessive one. As outlined above, the rule that higher inflation leads to a steeper curve, which in turn is caused by higher yields at the long end, can safely be challenged given historical patterns.

In a scenario of an unexpected elevated and persistent inflation, it seems more likely that the Fed may change its course (not the first time) and start the hiking cycle earlier, and by more, than anticipated. This would lead to higher trending rates at the short end but not at the longer end (or flattening). While this is a possibility, it seems less likely for now in our view.

Bond segments: mitigating inflation risk

Within the bond market inflation-linked bonds, floating rate bonds and high yield bonds are examples of bond segments that can help to mitigate inflation risk to a certain extent. However, none of the segments is a perfect hedge and additional risk and bond-specific factors should be considered.

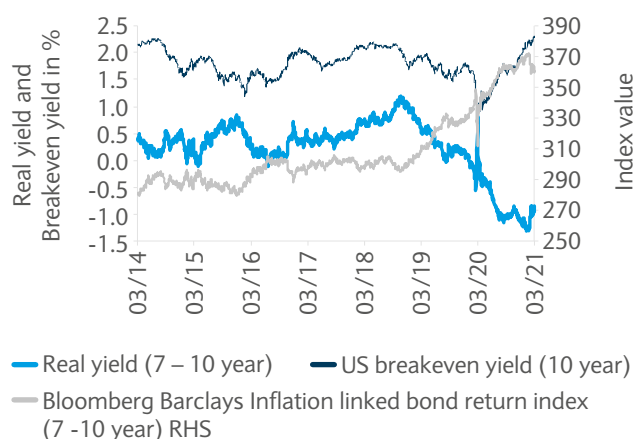
Inflation-linked bonds: the almost perfect hedge

Inflation-linked bonds seem a first choice to reduce potential inflation risk within bond portfolios for many investors, given that the value of the respective bonds increases in line with the respective inflation index (CPI – consumer price index / RPI – retail price index). As such, the risk of excessive inflation is supposedly eliminated.

Inflation protection comes at a cost, as inflation-linked bonds usually offer a substantial lower yield (currently mostly negative). This yield disadvantage, compared with nominal bonds, is shown in the breakeven yield (implied inflation expectation). In the US, the breakeven inflation yield stands at 2.3%. This means that only if inflation averages above 2.3% or more over the 10-year time horizon will the investment in the respective inflation-linked bonds trump that of the respective nominal bond alternative (see chart below).

Inflation-linked bonds lose when real yields rise

Bloomberg Barclays Inflation linked bond total return index (7-10 year), real yield, US 10-year breakeven yield



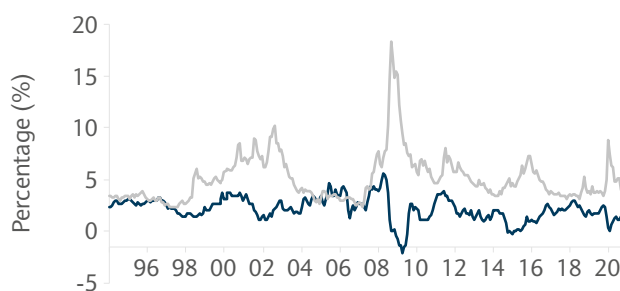
Source: Bloomberg, March 2021

While the above is true from a pure buy-and-hold perspective, the market value of the inflation-linked bonds is impacted by the change in real yields during the respective bond's lifetime. A rise in real yields would lead to a decline in value, even if inflation expectations stay unchanged or increase.

This situation was witnessed in February, when rising real rates led to a decline in inflation-linked bond indices, while breakeven rates continued their upward trend. While inflation-linked bonds can help to mitigate the inflation risk, real rates and breakeven rates are important when assessing their attractiveness.

US high yield spread mirrors US inflation rate

US high yield spreads and the US consumer price index since 1994



— US consumer price index (year on year, %)

— US high yield spreads (%)

Source: Bloomberg, March 2021

Floating rates a less obvious choice now

Floating rate bonds which are linked to a short-term rate index have long been another option to mitigate inflation risk. This is because coupons traditionally trended up with higher trending inflation given the high sensitivity of short-term rates to inflation. That said, floating-rate bonds seem a less obvious choice now given the depressed yields and the Fed's commitment to keep yields low for an extended period.

The dark horse: high yield bonds

High yield bonds appear to be an effective hedge against "good inflation" at least. Brighter economic prospects usually lift inflation expectations and at the same time lead to spread compression within high yield bonds given that high yield issuers are disproportionately reliant on a constructive economic backdrop. Spreads mirror inflation (negative correlation) well (see above chart), suggesting that high yield bonds are a good way to protect against higher inflation. However, spreads and lower trending defaults do not always go hand in hand with higher trending inflation. Excessive inflation can equally be detrimental.



Nikola Vasiljevic, Zurich, Switzerland, Head of Quantitative Strategy

The brightest binary star in the investment universe

Equities and bonds represent the two brightest stars in the investment universe, possessing unique and distinct investment characteristics. They can jointly form a core binary system around which other asset classes orbit.

The investment universe has grown immensely over the last three decades. Among assets available, investors can now choose between cash, developed government and investment grade bonds, high yield and emerging market bonds, equities, commodities, real estate, hedge funds, foreign exchange and private markets. If we include derivatives and some less conventional asset classes, the investment opportunity set can be greatly inflated.

Despite the growing complexity, equities and bonds usually remain at the heart of any investment portfolio. In this article we examine their roles from a strategic asset allocation (SAA) perspective.

Equities as growth drivers

Equities offer one of the greatest growth prospects among all asset classes. Generally, corporate growth is generated by investing retained earnings or new capital into profitable business projects.

In the long run, the aggregate earnings growth is inextricably linked with the economic growth. During economic booms and busts, investors' behavioural biases and irrational exuberance often lead to strong market overreactions.

However, diverging trends between the economic and corporate earnings growth tends to have a finite life. Moreover, the long-term aggregate earnings and economic growth are ultimately bounded by the rate of technological progress and the growth of input factors.

Dividends and buybacks

In addition to the growth potential, equities provide a source of income. For much of the last century, dividends were the dominant channel for cash redistribution to shareholders.

Following regulatory and tax changes in the US during 1980s, companies' propensity to repurchase shares increased significantly. In turn, the average dividend payments decreased over time.

Although associated with the US initially, the substitution of dividends with share buybacks has gained traction in much of the world. Currently, the total income return is about 2-4% in developed markets.

Valuation matters

The valuation pillar of equity returns captures the changes in the price/earnings (P/E) ratio, which represents the price that investors are willing to pay per unit of a company's earnings. Due to its tendency to mean revert, many market practitioners use P/E ratios as an indicator of future returns. Historically low (high) values of the ratio are typically interpreted as a sign of high (low) future returns.

There are many definitions of the P/E ratio. The cyclically adjusted price-earnings (CAPE) ratio, which smooths out the cyclical swings in corporate earnings and accounts for the impact of inflation, is one that is commonly used. It can provide better forecasts of stock returns over longer investment horizons to other valuation methods.

In the short term, changes in P/E ratios are primarily driven by investor sentiment. The key long-term factors are the risk-free rate and the 10-year bond yield (or alternatively the term premium), inflation and its volatility as well as changes in the dividend payout policy. For broad equity indices, the sectoral composition can substantially change. Such shifts may create significant structural bias.

Equities for the long run

Equities represent the key driving force of the wealth creation process. Income, growth and valuation components compound over time and reward patient investors in the long run.

For a one-year holding period, the range of US equity returns is extremely wide (two standard deviations bounds span the interval from -20% to 40%, with an average of about 11%). With increasing investment horizons, the likelihood of negative returns steadily decreases.

Since January 1990, US equities have posted only positive returns for holding periods longer than 12 years. Over the longest holding period considered in our example (20 years), the average compound return is approximately 6% (see chart).

Investors that are able to look beyond short-term market fluctuations and remain invested are likely to harvest a material equity risk premium over the long haul.

Fighting the loss aversion

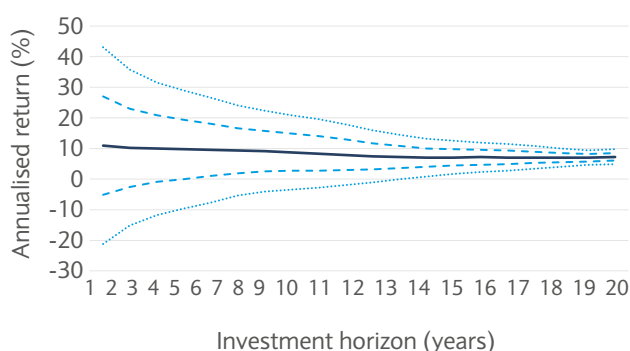
Despite the strong long-term performance of equities, it can be difficult to remain calm in times of stock market crashes. Often, many investors can simultaneously attempt to exit their positions within a short period of time, which exacerbates price swings and their potential losses. Moreover, the elevated risk and uncertainty may discourage them from quickly re-entering equities and profiting from the market recovery.

To investigate the impact of investors' withdrawal from equities after a sell-off, we consider the relative performance of staying-invested versus exiting-the-market strategies over six-month holding periods following the ten worst monthly drawdowns for US equities over the past 30 years. This corresponds to seven distinct crises periods (see table).

Our analysis shows that selling equities immediately after a market crash and staying on the sidelines for the next one to six months is suboptimal compared to the strategy of being invested the whole time. Even over a one-month period, exiting the market is not a clear winner. The wait-and-see approach over two to six months, following the ten largest US equity drawdowns since 1990, resulted in 5-11% relative underperformance on average.

US equity returns and holding periods

The performance of US equities for different investment horizons since 1990



- Average compound return
- - - One standard deviation bandwidth
- Two standard deviations bandwidth

Sources: Bloomberg, Barclays Private Bank, March 2021

Even from a tactical perspective during the periods of worst equity performance and highest uncertainty, the above suggests that it pays to remain invested. The global financial crisis of 2008 is a reminder that for every rule there is an exception. Our results hold only on average, and they merely illustrate that running away from markets is typically a suboptimal decision.

Staying invested usually pays off in sell-offs

Relative performance of staying-invested versus exiting-market strategies in the months following the ten worst US equity drawdowns since 1990

Market Stock	Date	Initial Shock	Performance: Staying Invested (SI) vs. exiting market (EM)					
			1M	2M	3M	4M	5M	6M
The 1990 oil price shock	Aug 1990	-9.2	-5.8	-6.2	1.2	4.2	9.2	16.0
The 1998 Russian financial crisis	Aug 1998	-13.9	8.1	16.9	24.2	30.2	34.3	31.5
The Dot-com bubble	Feb 2001	-9.0	-6.3	0.8	1.3	-0.8	-1.7	-8.4
Stock market downturn of 2002	Sep 2002	-11.3	8.7	14.1	8.2	5.8	4.2	5.1
The global financial crisis	Sep 2008	-9.2	-14.3	-21.1	-20.0	-28.0	-39.2	-30.7
	Oct 2008	-17.1	-7.4	-6.2	-14.9	-27.2	-17.9	-8.4
	Feb 2009	-10.3	10.9	22.1	28.2	28.4	36.1	39.5
Stock market correction of 2018	Dec 2018	-9.1	9.0	12.4	14.3	18.3	11.5	18.4
2020 stock market crash (COVID-19)	Feb 2020	-8.2	-17.6	-1.6	4.4	6.9	13.3	20.7
	Mar 2020	-12.7	15.4	21.2	23.6	29.7	36.9	33.1
Count (SI > EM)			5	6	8	7	7	7
Average Return			0.1	5.2	7.0	6.7	8.7	11.7
Median Return			1.2	6.6	6.3	6.4	8.7	17.2
Standard Deviation			11.7	14.3	16.2	21.4	24.4	22.2
Maximum Return			15.4	22.1	28.2	30.2	36.9	39.5
Minimum Return			-17.6	-21.1	-20.0	-28.0	-39.2	-30.7

Source: Bloomberg, Barclays Private Bank

Government bonds to the rescue

Despite the appeal of equities, in reality the full-speed, risk-on approach can be suboptimal for many investors due to their high risk and loss aversion attitudes, specific investment goals and financial needs.

Government bonds have been a natural candidate as diversifiers in a portfolio. Investors in Treasuries benefit from a stable income stream and high likelihood of repayment of their initial investment. For this reason, they typically exhibit a negative correlation with equities, especially during market downturns. Except for cash and certain hedge fund strategies, there are not many asset classes which can provide such portfolio protection. Having the status of a safe-haven investment, government bonds have established themselves as one of the core asset classes.

US government bonds are characterised by markedly different holding-period return signature compared to US equities. Using the historical returns from January 1990 to February 2021, US Treasuries have consistently posted a positive performance for investment horizons longer than two years (see chart). The average compound return is quite stable across the full holding-period spectrum at around 5.5%.

As such, the steady income and low volatility potential of government bonds, as well as their historical negative correlation with US equities, support their appeal for inclusion in a multi-asset portfolio.

Sources of government bond returns

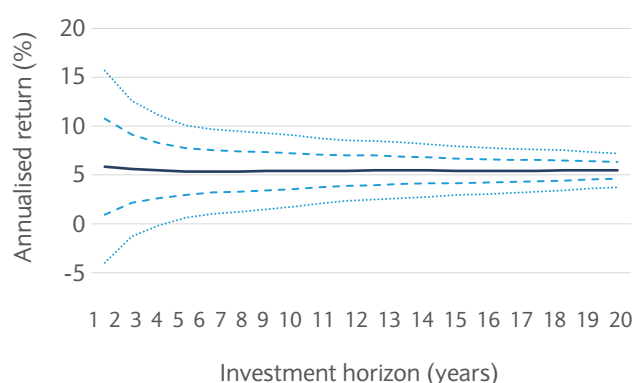
Government bond returns are generated from three sources. First, investors receive an income stream through periodic coupon payments for each bond holding in their portfolios.

Second, as bonds age and roll down the yield curve, a capital gain is generated. Longer-duration bonds provide a compensation for higher uncertainty associated with longer investment horizons. As such, rolldown return is a consequence of the term premium.

Third, valuation adjustments are driven by mark-to-market changes in the spot yield curve. If the interest rates rise (fall) the bond price decreases (increases). This is a consequence of the inverse relationship between the present value of a stream of cash flows and the discount rates. Therefore, investors who trade bonds in the secondary market prior to the maturity are exposed to the interest rate risk.

US government bonds' consistent performance

US government bonds' annualised returns over different time periods of up to 20 years since 1990



— Average compound return
-- One standard deviation bandwidth
... Two standard deviations bandwidth

Sources: Bloomberg, Barclays Private Bank, March 2021

Beyond the core

Equities and government bonds lie at the heart of most portfolios, and they are likely to remain the brightest binary star in the investment universe. However, in a post-pandemic world characterised by a strong recovery and rising interest rates and inflation, some of the historical relationships between asset classes might be put to the test.

At such times, a multi-asset class approach has attractions. It is worth considering additional sources of income such as high-yielding bonds and private markets. Alternative portfolio diversifiers, like hedge funds, can play a role as well. Real assets, like property, tend to provide some protection against the effects of rising inflation. Finally, selection and active management appear to be more important than ever.

Jai Lakhani, CFA, Investment Strategist, London, UK
Nikola Vasiljevic, Zurich, Switzerland, Head of Quantitative Strategy

Hedge funds: putting asymmetry to the test

With volatile equity markets and rising yields pressuring equity risk premiums, hedge funds could be poised to take portfolios from effective diversification to asymmetric-return providers: limiting losses in down markets while participating in gains when markets are rising.

In the March issue of Market Perspectives, we highlighted that although having a well-diversified portfolio might be necessary to manage portfolio volatility, it may not be sufficient in avoiding the least probable, extreme, tail risk. That is, tail risk that lies towards the edges of so-called bell curve distributions of investment returns.

Hedging the left tail

With returns tending to mirror a bell curve distribution but with fatter tails, the left tail, although less probable, corresponds to heavy losses that tend to be greater in frequency, duration and magnitude. Given this, it could be argued that eradicating, or alleviating, the pressures of a left tail scenario could impose on a portfolio, should be a key objective for investors.

While using options (that is, buying puts) eliminates the left tail, it does so at a cost. Dynamic hedging through futures contracts may be less expensive than options, but requires an embedded framework: constant monitoring/adjusting of the portfolio and can also be difficult with regards to timing market corrections.

However, outsourcing the management of tail risks and considering investing in hedge funds with systematic asymmetric returns could be worth considering. For such a strategy to be successful, the first hurdle it must pass is to show that during down markets, the strategy can outperform the market.

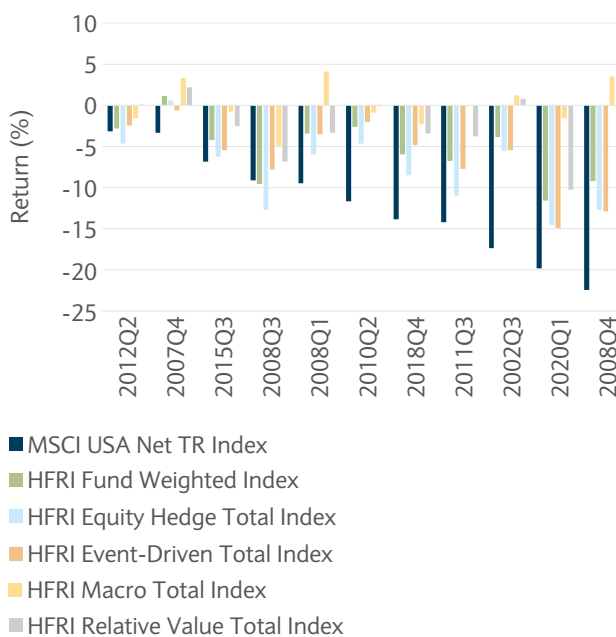
Limiting down-market losses with hedge funds

Looking at the average quarterly returns during down markets for the MSCI USA net total return index and comparing it against hedge fund indices, reveals that the negative return on hedge fund indices was significantly better than seen with equities (see table, p16).

Furthermore, during the six worst down markets since 2000, low beta strategies such as market-neutral have proven their worth in limiting losses and, in some cases, earning a positive return (see chart).

Hedge funds shelter portfolios in some of the worst down markets

The performance of several hedge fund strategies and US equities in periods of market stress between 2002 and 2020



Sources: Bloomberg, Barclays Private Bank, March 2021

Deliberately asymmetric

The second hurdle facing hedge funds is achieving an asymmetric return profile. In other words, protecting investors' wealth during down markets and still participating in the up markets.

Splitting the data into its worst, medium and best average monthly returns for the MSCI USA net total return index and reviewing it against each hedge fund strategy shows us that hedge funds go some way to providing asymmetric returns, even at an index level (see chart, top right, p16).

Average returns in down markets since 2000

MSCI USA Net TR Index	-11.92%
HFRI Fund Weighted Index	-5.37%
HFRI Equity Hedge Total Index	-7.80%
HFRI Event-Driven Total Index	-6.15%
HFRI Macro Total Index	-0.01%
HFRI Relative Value Total Index	-3.46%

Source: Bloomberg, Barclays Private Bank, March 2021

Overall, the data suggests that hedge funds provide protection for down markets without sacrificing significantly on upside returns.

While some low beta strategies, such as the equity hedge total index, were less effective in protecting portfolio valuations during down markets, it is worth noting that hedge funds differ greatly by strategy and within strategies. Each fund tends to be quite heterogeneous. As such, this suggests that investors may be well-served by adding hedge funds to a portfolio while also actively selecting managers with robust processes and proven investment methodologies in low-beta strategies.

Hedge funds for the long run

To understand the role hedge funds can play in a multi-asset class portfolio over the long term, we consider an investment opportunity set comprising core asset classes and hedge funds. In particular, we look at the “efficient frontier” for asset mixes consisting of US equities, US government bonds, and the HFRI Fund Weighted Composite Index (a hedge fund benchmark).

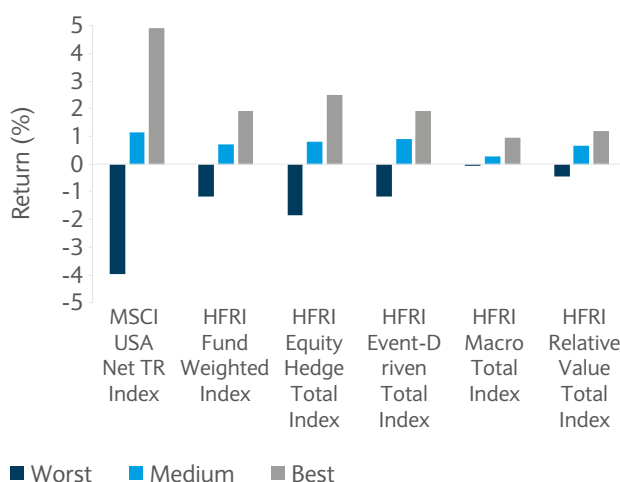
The optimisation engine is based on our new strategic asset allocation framework, which accounts for compounding effects and tail risk. To examine the impact that hedge funds have had on optimal asset allocation policy, we estimate the optimisation input parameters using the last 20 years of data.

The key takeaway is that – at the asset allocation level – hedge funds have improved portfolio returns historically up to 30-40 basis points for a given level of risk. Alternatively, adding hedge funds to equities and government bonds has reduced portfolio volatility by 1-3% and expected shortfall by 1-6%, depending on the efficient frontier segment. The combined effect of return enhancement and risk reduction implies improved portfolio efficiency (see bottom chart).

“The key takeaway is that...hedge funds have improved portfolio returns historically up to 30-40 basis points for a given level of risk”

The asymmetric return profile of hedge funds

The best, worst and medium quarterly returns for several hedge fund strategies and US equities since 2001



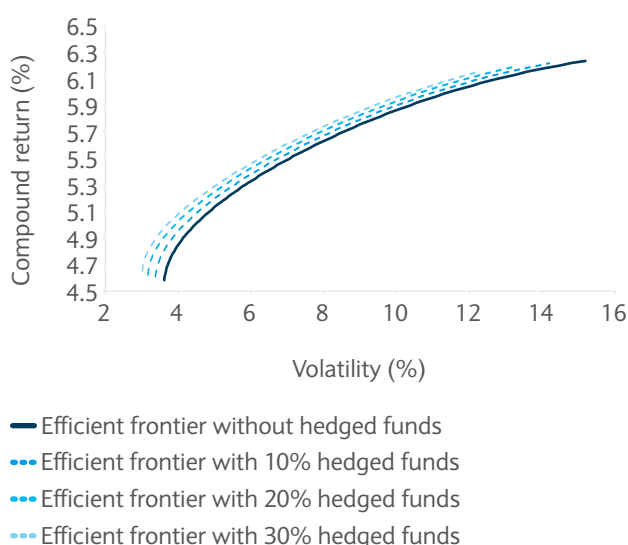
Sources: Bloomberg, Barclays Private Bank, March 2021

Portfolio diversifier and stabiliser

The efficient frontier (see chart below) example illustrates how hedge funds can offer diversification benefits and act as portfolio stabilisers, even over the long term. Clearly, this suggests that hedge funds represent an important element in the optimal asset allocation mosaic.

Adding hedge funds improves risk-adjusted returns

How adding hedge funds to core asset classes can lift returns across the efficient frontier, based on 10%, 20% and 30% hedged funds



Sources: Bloomberg, Barclays Private Bank, March 2021

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

Greenwashing: caveat investor

With rapidly growing supply, and marketing, of sustainable investing products, investors need to be more aware of greenwashing and how to mitigate this risk.

Sustainable investing continues to gather momentum as probably one of the most important investment themes facing investors. The area has gone from one frequently disregarded a few years ago, to one arguably at the start of an “environmental, social and corporate governance (ESG) bubble”, as highlighted in March’s Market Perspectives, augmenting capital flows and valuations.

According to data from Morningstar, in Europe alone, asset managers launched a record number of 505 new sustainable funds and repurposed more than 250 conventional funds¹. Based on this universe, there are now about three times as many sustainable funds as just four years ago.

Varied approaches to sustainable investing

Notably, without a common or agreed definition and terminology, many of those funds use different sustainable approaches and labels. Moreover, with recognition of increased investor demand, marketing of green or sustainable investment credentials has ballooned as well.

However, despite being “on trend”, there is a risk that some investors may be selling the Emperor’s New Clothes. So how can investors understand and avoid the risks of so-called greenwashing?

Corporate greenwashing

Greenwashing refers to the “practice of over-emphasising a company’s environmental credentials, often by misinforming the public or understating potentially harmful activities”².

Historically, greenwashing charges have been levelled at companies who have attempted to position or promote their brand as more environmentally friendly than the

reality of their businesses. Similarly, companies seeking to capitalise on demand for sustainable products have marketed their products with green or healthy labels where underlying processes or materials are not. As these organisations have been called out, their reputations have suffered.

Growth of greenwashing risk

Growing investor awareness and concern over the need to address social and environmental issues is driving more interest in sustainable investing. In responding to this client demand, and a desire to play a positive role, investment houses are seeing a potential commercial benefit.

With a lack of deep knowledge or authentic commitment, there is a risk of greenwashing. As a result, investors may be misled, inadvertently or not, to buy products where the advertised sustainability approach or outcomes does not match the reality.

As an emergent and rapidly evolving field, understanding and evaluating what investment managers are actually doing is difficult. Without experience or a guide, investors can struggle to navigate the field and select the most appropriate managers.

Regulators to the rescue?

Recognising this issue governments, regulators and policymakers are starting to step into the field.

At the forefront, the EU has been focusing on making the financial system more sustainable over the last several years. As part of a series of reforms, it has introduced a classification system, or EU Taxonomy, to determine what counts as green and sustainable activities.

¹ How the EU is helping investors navigate ESG, Morningstar, February 2021 <https://www.morningstar.co.uk/uk/news/209592/how-the-eu-is-helping-investors-navigate-esg.aspx>

² Dictionary of Marketing, Oxford Reference, March 2021 <https://www.oxfordreference.com/view/10.1093/acref/9780199590230.001.0001/acref-9780199590230-e-0795?rskey=SeaYGt&result=794>

Rules have also been initiated for the investment industry, known as the sustainable finance disclosure regulations (SFDR).

SFDR regulations require all asset managers to publish information on how they incorporate sustainability into their investment processes – with the aim of reducing the risk of greenwashing.

These rules create three classifications of funds – “Article 8” products which actively include and promote environmental or social characteristics (sometimes known as “Light Green”); “Article 9” products which have specific sustainable outcomes as part of their objectives (similarly known as “Dark Green”); and “Article 6” which do not actively incorporate sustainability, or at least do not promote it to investors.

While this classification can be helpful, fund managers only started self-categorising their investment products in March. So differences in the approaches to sustainability are likely until all managers start reporting under the SFDR rules, and subsequent industry and regulatory conversations occur.

Taking ownership

With increased disclosures and further industry convergence, investors should find it easier to avoid greenwashing and identify truly sustainable and green investments. However, these changes will take time to implement and normalise.

Moreover, with a preponderance of funds being marketed as sustainable, investors need to know how to find those that are worthy of their capital. Below are some actions investors might take to avoid greenwashing in the interim.

Articulate your preferences

To some extent, sustainability is in the eye of the beholder. Therefore, beyond understanding the different approaches, it is critical to know what investors want from their portfolio. Without this clarity it is easier to accept a greenwashed offering.

In selecting sustainable investments are investors aiming to avoid companies that don’t align with their values? Or are they looking to use ESG factors to identify better run companies? Or, finally, is the investment designed to mitigate climate breakdown, or support the UN Sustainable Development Goals? All these options are valid; each has its own sustainability implications.

Investors should take time to discuss, consider and articulate their preferences. This can be particularly important with family members and intergenerational

considerations. Making this clear with your investment statement or policy helps compare and hopefully match the products you want with the approach they take.

Understand the process, not the presentation

If greenwashing is unintentionally due to the misalignment between what is represented and the reality, investors also have a responsibility to ask enough to confirm their understanding.

What is presented in a marketing document, or even an impact report, is a snapshot of either a moment or period of time. It is often partial and is always backwards looking. Portfolios can have high ESG scores by circumstance rather than planned effort.

Investors should query and challenge to understand the underlying process, not just the outcome presented. Whether investment managers can clearly explain their process, its depth and robustness, is often a simple test to see if there is greenwashing happening.

Trust but verify

We counsel our children, even when the walk signal turns green, to check for themselves before crossing the street. Similarly, simply having any label should not mean that investors relinquish their own insight.

Labelling can make it easier to identify categories of investment approaches; and provide greater visibility and comparability of options. However, the level of skill or quality of an investment manager can’t be determined by a label. Nor whether their approach matches with your aforementioned preferences.

This means investors need to look again before going forward. For example, tagging UN Sustainable Development Goals in presentations has become common practice. Being able to articulate how, and how much, the underlying company has contributed to them less so. As valuable as knowing what’s in the portfolio is why holdings have been sold or what, at the final stage, did not make it in.

Investment in sustainable innovation key

In the end, while our aim has been to help investors to understand and avoid greenwashing, the reality is that not every sustainable outcome occurs as intended.

To solve the urgent social and environmental problems facing economies, innovation on a large scale will be critical, including in the investment sector. Hopefully, the risk of greenwashing will diminish and not prevent the flow of more private capital into those opportunities that can preserve and grow wealth and make a positive contribution to our world.



Alexander Joshi, London UK, Behavioural Finance Specialist

The price of holding cash

As vaccine rollouts go well in many countries, the potential for strong growth and inflation has become a major topic of conversation, especially for bond and equity investors. But what might this mean for cash holdings?

Inflation expectations last month hit their highest level since January 2014, as the US 10-year inflation breakeven rate rose to 2.31%. Despite this, monetary policy looks like remaining accommodative, with the US Federal Reserve reinforcing their forward guidance of no lift in rates through to 2023, despite upgrades to projected activity, unemployment and inflation.

It's not just about what is in your portfolio

The prospect of persistent higher prices might attract much attention in respect of investment portfolios, particularly in light of rising yields for US Treasuries. However, a change in the outlook for inflation also has implications for assets outside of investment portfolios, such as cash holdings.

Inflation can be overlooked in day-to-day spending due to a tendency to view money in nominal rather than real terms, as nominal prices provide a convenient rule of thumb for determining value.

But, holding substantial cash piles over long periods can be a drag on performance as inflation erodes its real value over time. Examining how much cash is not being deployed may be another sensible action for investors thinking about their positioning for stronger inflation.

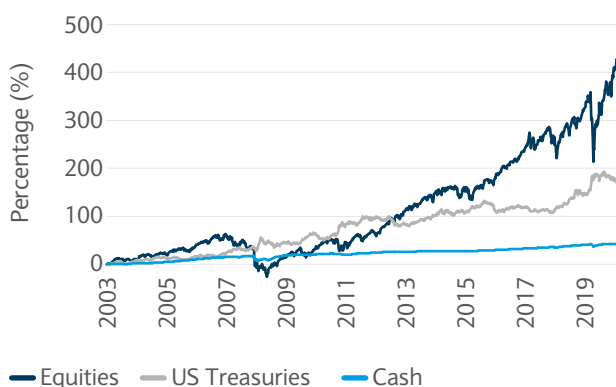
The reasons for holding cash reserves

There are common reasons why investors may be holding cash reserves aside from liquidity for short term needs or contingency. These could include wanting to hold cash back to deploy during a correction; reduced market exposure at the outset of the pandemic which remains on the sidelines due to the rapid recovery; and concern about capital preservation and traditional safe-haven assets.

Holding some cash usually has merits; investment managers typically hold a small proportion of managed assets in cash for diversification purposes or to tactically deploy when a short-term opportunity arises. As such, cash can play a role in maximising returns by allowing an investor to be opportunistic without having to liquidate positions.

Equities have significantly outpaced bonds and cash

Nominal percentage return on funds invested in either cash (US floating rate note), S&P 500 or US Treasuries (10-20 year) since 3 October 2003, income reinvested gross



Sources: Bloomberg, Barclays Private Bank, March 2021

However, with rates so low, an investor could use leverage to get invested. It might pay to borrow cash rather than hold it as an asset in times when cash returns are significantly below the inflation rate, reducing the size of the cash pile required. Structured products are another way of positioning for volatility and corrections without the risks associated with timing when to deploy cash.

Misplaced reasons

While holding some cash for opportunistic reasons may have merit, if used effectively, much of the success of timing entry to the market only comes with hindsight. Event risk is difficult to manage and markets can react differently to what is predicted in response to an event. In practice, cash can end up on the sidelines for much longer than an investor anticipates.

Investors also turn to cash for safety in times of market turbulence. It is worth considering whether cash is being

held for financial reasons or psychological ones. Exiting and moving into cash can provide short-term comfort from volatile markets, but there are costs too.

The costs of holding cash

The first is the opportunity cost – the foregone returns from investing, which historically have outperformed cash (see chart p19). However, holding cash isn't just about foregone gains, but also involves costs – the cost of inflation. Whilst yields have been rising quite significantly in recent weeks, real rates of return have been negative and near historical lows in large parts of developed markets, creating a significant drag on overall portfolio returns for those holding excess cash.

Many investors hold cash because in the short term they have a fear of losses, which is understandable, but holding cash over the long term guarantees a loss as inflation erodes the value of the capital. This cost typically becomes larger the longer the holding period or the higher inflation is.

The table shows how a negative real yield at today's rates would erode the value of \$10m over different periods, and the larger and larger investment returns that would be required to regain the lost value and maintain the purchasing power of the capital. The amounts in the table are based on a real yield of -1.05% (or core inflation of 1.3% and a US Fed funds rate of 0.25%).

Rethinking cash

Holding cash can seem like a passive choice; it's the status quo of not getting invested, and therefore is given less attention than the assets already invested. However, for an investor already in the markets it should be viewed as an active choice to be in cash, just like equities or bonds. It may be worth assessing cash in the same way, thinking about its place in a diversified portfolio of assets and additional dry powder (within reason).

We expect a low rate environment to persist for some time, probably leading to lower returns than has been seen in recent years for a given level of risk. These challenges mean that a passive approach to investing, such as with cash, may see many clients' portfolios disappoint. As such, being active seems as important as ever.

Investors would be wise to keep in mind that there is a cost to not being invested. This cost usually widens at times of higher inflation, creating a drag on portfolio returns.

Inflation erodes cash over time

Time	Erosion of value	Balance (\$)	Return required to regain purchasing power
Initial amount	-	10,000,000	
2 years	-2%	9,791,103	5%
5 years	-5%	9,485,910	12%
10 years	-10%	8,998,249	26%
25 years	-23%	7,680,597	80%

Gerald Moser, London UK, Chief Market Strategist

Multi-asset portfolio allocation

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

Cash and short duration bonds: high conviction

- Given the significant impact of recurring waves of the COVID-19 virus globally, a preference for higher quality and liquid opportunities – which translates into our positioning in short duration bonds – is maintained.
- Although real interest rates remain negative in most jurisdictions, a high conviction in the asset class seems to make sense from a risk management perspective.

Fixed income: low conviction

Only modest opportunities are likely in fixed income given market dynamics. Although sovereign rates appear less attractive in the context of low yields, they offer protection in very weak economic environments. For this reason, a small overweight is maintained in developed market government bonds.

In credit, the higher quality segment most appeals. But as spreads have recovered remarkably from their highs back in March, our risk budget is likely to be allocated in the equity space. In high yield, selection is key, and our exposure is low given the tightness of spreads. We prefer high yield, and emerging market (EM) hard currency debt over EM local currency debt considering the risk facing their economies and currencies.

Developed market government bonds: high conviction

- Developed market government bonds worldwide have been losing their appeal as rates edge down amid softening economic growth, lower inflation expectations and large liquidity injections from major central banks. However, we see the asset class as a diversifier and maintain our holding to a small overweight.
- Although US dollar real rates remain at historically low levels, they are still marginally more attractive relative to the other developed market bond markets. Amid the COVID-19 outbreak and more active central bank behaviour, UK and European bonds have somewhat

synchronised with US rates. However, depressed yields make it difficult to find both markets attractive, apart from in respect of managing portfolio risk.

Investment grade bonds: neutral

- A large contraction in the economy and earnings will likely lead to a substantial increase in leverage ratios and a higher risk of downgrades; specifically among BBB-rated bonds.
- As spreads are now back to tight levels, selection will be key.
- With a potential recovery over the course of 2021 there is still room for spread compression within more cyclical sectors.
- Conviction towards the asset class was reduced recently, with proceeds moved into cash.

High yield bonds: low conviction

- Amid the market turmoil, spreads widened to historically elevated levels before retracing. However, we remain wary of the impact of lower oil prices on energy-related names and the broader economic impact of the COVID-19 pandemic.
- The economic effects of the coronavirus outbreak have significantly increased the risk of default. That risk increases the longer the pandemic continues, subduing economic activity.
- We had previously sought to take advantage of higher spreads in high yield bonds during last year's sell-off, however the impressive recovery since means that spreads over Treasuries are close to their pre-pandemic levels and well below the long-term average.
- Consequently, we have reduced our exposure to the asset class to reflect the lower returns on offer.

- **Emerging market bonds: low conviction**

- Emerging market hard currency debt is preferred to local currency debt considering the risk facing the respective economies and currencies.
- Many EM economies run high debt deficits, low currency reserves and potentially lack capacity to deal with the COVID-19 crisis. The recovery from the pandemic differs within EM and is mostly linked to the infection rates, with Latin America, South Africa, Israel, the Philippines and India under pressure.
- However, the US Federal Reserve's dovish stance should continue to provide some relief to the largely dollar-denominated emerging market debt market.
- Although corporate fundamentals are less robust and default rates are gradually rising, the majority of EM central banks have helped issuers with more accommodative monetary policies. With rising COVID-19 infections starting to affect EM economies and forex, we are more cautious on local currency debt.
- Given downside risks from geopolitical issues, we maintain low conviction to the asset class as margin pressure may increase in the current volatile environment.

Equities: high conviction

Portfolios have been positioned in high quality, conservatively capitalised businesses for the longer term. Valuations remain elevated by historical standards but unlikely to revert back to their mean until central banks' support is dialed down. With a blue-sky scenario (from an earnings' perspective) largely priced in already, we believe upside is limited.

Regionally, we see compelling opportunities in both developed market equities and emerging market equities from a risk budgeting perspective. However, not all emerging markets are created equally and so warrant selectivity, with Asia appearing to provide a broader opportunity set than elsewhere.

- **Developed market equities: high conviction**

- Equity markets have rallied significantly, discounting the positive news surrounding the approval of COVID-19 vaccines and a possible normalisation in the first half of 2021.
- 2021 earnings expectations seem optimistic but easy comparables should allow for a strong recovery. 2022 consensus numbers appear more challenging.
- Further out, market events have created an opportunity for those willing to take a longer term view and be selective.
- The rapid and sizeable response of central banks and governments to events means that policy should be favourable when a recovery takes hold.
- Most importantly, active management and selective stock picking of companies with strong balance sheets is favoured. We focus on businesses with high cash returns on capital, with conservative capital structures and ideally an ability to reinvest cash in future growth at equally high rates of return. The US tends to offer

us more opportunities to invest in such businesses, meaning that North America remains the largest geographical weighting within the equity allocation.

- **Emerging market equities: high conviction**

- Emerging markets have suffered from country specific risks and slowdown in the region, particularly after the impact of COVID-19.
- While the region may suffer significantly for the pandemic in the short term (especially in Latin America), a secular shift from investment to consumption should support growth over the medium term.
- Furthermore, the region should benefit from the benign rate environment.
- Asia seems a more attractive prospect for growth than Latin America.
- While markets appear increasingly cautious, emerging market equities should benefit from attractive valuations. Our position in the asset class was increased in January.

Other assets: low conviction

Alternative asset classes will continue to diversify our portfolio, but are not expected to be the main drivers of returns. Gold is set to benefit from its status as a safe-haven asset, and for this reason we are neutral on the asset class. Conversely, real estate and alternative trading strategies are underpinned by a weak investment case.

- **Commodities: neutral**

- The sole exposure within commodities continues to be our position in gold.
- In light of increasing headwinds for the global economy and despite gold performing less strongly in the past few months, value persists in gold compared to other commodities. This allocation is seen as complementary to the other risk-mitigating assets in the portfolio.
- The asset class has little appeal outside of precious metals and our risk budget can be better deployed elsewhere.

- **Real estate: low conviction**

- Real estate should continue to provide mild diversification benefits, helped by loose monetary policy. That said, we maintain a low conviction due to structural headwinds, such as the shift to online retailing, as well as the higher leverage in the sector.

- **Alternative trading strategies: low conviction**

- The low conviction in alternatives reflects their high expense and a lack of investment opportunities in the space. However, strategies that have low correlations to equity markets, such as merger arbitrage, appear preferable.
- Nonetheless, sudden spikes in volatility, which are likely to materialise more often in a volatile environment, may lift the asset class at least in the short term.

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