Private Clients

Market Perspectives

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Foreword

What does the rest of the year have in store for buoyant financial markets as danger signs emerge, such as resurgent inflation? This issue of Market Perspectives looks to answer this question while putting the first half of 2021 in context.

The economy has bounced strongly this year, driven by consumer spending, low rates and fiscal largesse. An encouraging vaccine rollout is a prop, but the risk of a virus-resistant variant remains and with inflationary pressures building, all eyes are on central banks.

In the markets, equities, and corporate earnings, have shot the lights out. To go even higher, earnings and US monetary policy are key, but alpha is likely to be the main driver of returns as uncertainty looms. We like quality equities and prefer the US and emerging markets over Europe and Japan.

Turning to bonds, the US Federal Reserve does not expect to raise rates until 2023, but its hand may be forced sooner. Even when rates rise, history suggests that bond yields need not. BB-bonds and higher quality BBB-bonds look particularly attractive for those after more yield as high-yield default risk drops more quickly than expected.

In the megatrend that is sustainability, flows into sustainable investing funds remain strong. But the market is relatively immature and challenges, like greenwashing, lurk. Outperformance is not a given. Investors positioning portfolios for short-term challenges are likely to be well positioned for the long term. Any downturn in green investments may provide opportunities, if the associated potential volatility is acceptable.

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Can the global economy sustain its strong rebound?

The economy has had a strong start to the year. Its momentum is likely to persist into next year, driven by consumer expenditure and supported by a government spending splurge and accommodative monetary policy.

The outlook for the speed and magnitude of the economic recovery seems far better now than it looked at the start of the year as activity rose from the coronavirus ashes of 2020. As expected, the shape of the recovery has been simultaneously robust, turbulent and uneven.

Our enhanced growth trajectory forecast is driven by a range of factors including the improving health situation, relaxation of restrictions, ongoing aggressive policy support and the strength of the consumer. We expect growth to be an impressive 6.3% this year now, having forecast it would be around 4.8% in January. The strong momentum is likely to continue through 2022 with growth of 4.6% that year (see chart).

Vaccine programmes underpin growth prospects

As we referenced in our Outlook 2021, growth prospects will undoubtedly be determined by the lifespan, intensity and geographical spread of the virus. The vaccine outlook has improved over the past six months and there seems likely to be a material improvement in preventing the spread of the virus in the coming months.

There are now seven coronavirus vaccines approved for use in at least one country. The number of global vaccinations has surpassed the total number of confirmed cases. Nearly 2.5bn doses have been administered, with Israel, UAE, US and the UK among countries with some of the highest percentage of their population vaccinated.

The UK and US is expected to achieve herd immunity (thought to be around 70% of the population vaccinated) in the third quarter with Europe inching towards that status by year end.

Ongoing vaccine challenges

Notwithstanding the medical progress, it is important to recognise that there are still a number of vaccine unknowns, including the length of immunity, efficacy against future mutations as well as possible side effects.

Real GDP, % year on year

	2020	2021F	2022F
Global	-3.3	6.3	4.6
Advanced	-5.1	5.7	3.9
Emerging	-1.9	6.8	5.1
United States	-3.5	7.1	3.8
Euroarea	-6.7	4.6	4.4
United Kingdom	-9.8	6.7	4.2
China	2.3	8.4	5.5
Japan	-4.7	2.6	2.6
Brazil	-4.1	4.8	1.9
India	-7.1	8.2	8.2
Russia	-3.1	3.5	1.7

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

The path to the normalisation of activity could be impeded by vaccine hesitancy and difficulties around global distribution. A pandemic requires a global solution and vaccination data continues to show that inoculation rates in many countries remain low.

The fiscal flood continues

Despite last year's record rise in peacetime government borrowing, policymakers seem ready to pull even harder on the fiscal lever in the second half of this year.

Most notably, Joe Biden's administration in the US has argued for $4tn in new federal spending and tax credits over eight years. The Organisation for Economic Co-operation and Development (OECD) estimates that the stimulus plan will add one percentage point to global growth. A significant amount.

While a number of long-term investment packages continue to be negotiated, some of the emergency fiscal measures, such as furlough programmes, are likely to taper off this year.

Uneven labour market recovery

Following the withdrawal of job retention schemes, the return to work rate will be of particular interest to economists.

The labour market recovery is expected to be uneven across regions. US unemployment has fallen dramatically over the past few months, despite some recent loss of momentum. Similarly, in the UK the extension of the furlough programme and faster reopening of the economy has reduced our forecast of peak unemployment. Conversely, we anticipate that eurozone unemployment will be elevated for some time.

Power of the consumer

The reopening of service sectors, high saving rates and the unleashing of pent-up demand is expected to generate a powerful consumer-led recovery over the next year.

The mixture of forced savings, higher precautionary savings, rebate cheques and ultra-low interest rates provide consumers with considerable financial firepower. If even only a small percentage of the accumulated wealth is spent over the next year, it would lift growth prospects significantly.

The threat of inflation

Inflation forecasts have been rising this year as low base levels from last year. Supply bottlenecks, ultra-accommodative monetary policy, additional stimulus packages and surging commodity prices all add to short-term price pressures.

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

However, many factors suggest that the inflationary pressure is transitory in nature. The level of spare capacity in many economies remains high compared to before the pandemic which should help anchor inflationary pressures. Wage growth, often associated with accelerating core inflation, is not materialising due to the amount of slack in the labour market. Rapid digitisation and investment in technology is also likely to keep wage growth muted, even when labour markets recover.

Is tighter monetary policy on the horizon?

The impact of stronger inflation on monetary policy may be more benign than recent hikes in bond yields suggest, considering that medium-term inflation forecasts remain below central banks' mandated target levels. As such, the US Federal Reserve, European Central Bank and Bank of England will probably keep rates at historically low levels this year and next. Nonetheless, with price pressures becoming more ingrained than forecast, there is clearly pressure on central banks to begin to consider tapering asset-purchase programmes in coming months.

Fiscal consolidation to be postponed

The fiscal policy response, and its timing, has been key to the economic recovery. Without the aggressive and innovative solutions taken by many governments, the economic scarring from the pandemic would have been worse.

How readily businesses and consumers adapt to the withdrawal of emergency support measures will play a key role in determining the rate of recovery. Eventually, public finances will need to be put back to a sustainable path. Higher taxes and substantial cuts in government spending seem inevitable, although this process is unlikely to start until the recovery is assured.

Henk Potts, London UK, Market Strategist EMEA

US shines as a beacon of economic recovery

The US economy is firing on all cylinders and activity is back at pre-pandemic levels. Buoyant consumer spending, ambitious government spending programmes and low rates are likely to keep the growth engines running for some time yet.

The US economy has expanded for the three quarters since October. A robust start to the year delivered growth of 6.4% between January and March with output returning to pre-pandemic levels in the second quarter.

The rapidly improving vaccination programme, healthy consumer spending and the proposed massive multi-year stimulus plan has encouraged us to raise our US growth forecast for this year (see table).

Improving public health situation

Coronavirus has taken a devastating toll on America, with more than half a million deaths recorded. However, the approval and administering of vaccines since December has lifted inoculation rates recently. With nearly 300m doses administered and close to 40% of the population fully vaccinated, hospitalisations and death rates have fallen dramatically, allowing authorities to ease restrictions.

US consumers fired-up and ready to spend

A mixture of improving labour market conditions, pent-up demand and $2.6tn of excess savings are helping to boost consumer confidence and retail sales. Personal consumption expenditure grew at an annualised rate of 10.7% in the first quarter, its second strongest pace since the 1960s. Both headline and core sales are now substantially higher than their pre-pandemic levels. We expect private consumption growth of 8% this year, helping to propel the recovery.

Remarkable labour market recovery

The strength of the labour market directly affects consumption levels. Pre-pandemic, the US unemployment rate was at a multi-decade low of 3.5%. The locking down of the economy triggered a surge in job loses, with the unemployment rate hitting 14.7% in April 2020, the highest since the Great Depression.

United States

	2020	2021F	2022F
GDP growth y/y (%)	-3.5	7.1	3.8
CPI inflation (%)	1.2	4.0	2.8
Unemployment rate (%)	8.1	5.5	4.2
Gross public debt (% of GDP)	132.5	133.6	127.7
Private consumption (%)	-3.9	8.1	3.2

Source: Barclays Research, Barclays Private Bank

Despite the recent slowing, the US labour market has recovered remarkably over the past year, with an unemployment rate back to 5.8% in May. As economic conditions normalise, we expect the rate to finish this year at 4.6% and next year at 4.1%.

Robust business confidence and booming housing market

With a 16.7% increase in spending on equipment in the first quarter, fixed business investment is supporting growth. This corporate spending partially reflects the requirement to address the challenges and protocols created by the pandemic. It also suggests that companies are confident enough to commit to capital spending plans.

The US housing market has continued to demonstrate considerable strength over the last year. The S&P Case-Shiller 20-city composite index rose 13.3% in March[2], on a year-on-year basis, the tenth consecutive month of accelerating home prices and the largest gain in over 15 years. That said, future gains may be constrained by rising material costs as well as land and labour shortages, the latter of which is showing signs of holding back activity.

[1] Moody's, Hot start for high yield, 22 April 2021 https://www.moodysanalytics.com/-/media/article/2021/weekly-market-outlook-hot-start-for-high-yield.pdf

[2] S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index, June 2021 "https://www.spglobal.com/spdji/en/indices/indicators/sp-corelogic-case-shiller-20-city-composite-home-price-nsa-index/%23overview" https://www.spglobal.com/spdji/en/indices/indicators/sp-corelogic-case-shiller-20-city-composite-home-price-nsa-index/#overview

Biden administration is looking to reshape America

President Joe Biden's victory and Democrat victories in the Senate runoff elections has created a moderate "blue wave" which is having a significant impact on domestic policy.

The president quickly enacted his ambitious $1.9tn relief plan. Its aim is threefold: control the virus, lift consumption and provide support for low paid workers, small businesses and state services.

President Biden has also turned his attention to the economic recovery with his once in a generation investment plan. The president seeks nearly $4tn in new federal spending and tax credits over eight years for his two-part stimulus programme. The spending is focused on a range of areas from surface transportation to elderly care to education. If fully enacted, the president's American Jobs Plan (AJP) and American Families Plan (AFP) would reshape domestic spending, tax and broader domestic policy.

Part one of his "Build Back Better" initiative, the AJP, focuses on infrastructure and climate-related policies and comes with a $2.6tn price tag. Key measures include hundreds of billions of dollars for transportation, strengthening the electricity grid, boosting green energy, expanding high speed internet and funding for electric vehicle charging stations.

The second part of his recovery programme, the $1.8tn AFP, comprises of the expansion/extension of child care, paid leave, pre-school and college tuition along with the modernisation of the welfare and social security safety net.

Stimulus comes at a price

To fund these policies, the president proposes raising taxes on higher-income households and corporations over 15 years.

For corporates. Biden has called for the tax rate to rise to 28% from 21%. The legislation would also impose a 15% corporate minimum tax and impose penalties on companies that move assets/jobs offshore. For individuals, the top tax rate would go to 39.6% from 37%. For households earning more than $1m a year, the rate for dividends and capital gains would also rise to the higher rate.

Impact of stimulus and tax reform

The aggressive stimulus packages should support immediate and long-term growth prospects. They are designed to help revive the service sector, restore employment prospects and restructure the US economy to meet current and future economic and environmental challenges.

While the corporate tax reform will create a short-term headwind for companies, the proposed rate is still substantially less than the 35% rate it was before Donald Trump's administration. Increased taxes could also be offset by the higher growth trajectory. A global minimum tax would help to stop profit shifting and discourage competition among countries developing into a race to the bottom. With the personal tax increase focused on wealthy households, the impact on overall consumption projections is limited.

Fed to look through transitory inflation

Base effects from the low readings a year ago, supply-chain bottlenecks in many industries and rising commodity prices have pushed inflation forecasts higher. The consumer price index (CPI) for May came in at 5%, its highest level since 2008. We expect the US Federal Reserve's (Fed) preferred measure of price pressure, core PCE inflation, to peak over the next couple of months then start to drift lower through next year, averaging 2.0%.

The Fed has aligned its forward guidance with the intention to achieve maximum employment and 2% average inflation over time. This should give the central bank the flexibility to look through any above target inflation outcomes this year and keep rates on hold into 2023.

Given the magnitude of the recovery in both growth and inflation, the call for the tapering of asset purchases is getting louder. We expect the central bank to announce a tapering of asset purchases at their September meeting and begin slowing purchases at the November meeting. The reduction of purchases is likely to occur in a targeted and controlled way to avoid any tantrums playing out.

Spectacular rebound

While the growth rate may top out in the second quarter, the outlook for the remainder of 2021 suggests a period of vigorous recovery as companies rehire workers, consumer spending rebounds and activity is supported by overwhelming monetary and fiscal policy. From 2020's low base, we forecast that the US economy will grow by 7.1% this year followed by 3.8% next.

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Is China's roaring revival on its last legs?

Chinese economic growth leads the pack in the coronavirus era. However, price pressures are rising and domestic demand weakening. Add in US-Sino trading relations and growth may slow sharply this year.

China was the only major economy to generate positive growth, of 2.3% (see table), during 2020, an aggressive response helping it avoid much of the economic impact from coronavirus restrictions. The recovery advanced ahead of its main heavyweight peers, with output surpassing its pre-pandemic level at the end of last year. The early reopening of its economy, rapid industrial production and booming exports resulted in a record breaking annualised growth rate of 18.3% in the first quarter.

Recent data, however, suggests that China's ability to maintain its extraordinary growth profile may prove to be a tougher task than some economists have previously projected. Price pressures are rising, domestic demand is struggling to keep pace with exports and policymakers are seeking to cool credit growth, in an effort to avoid financial imbalances.

Manufacturing and exporting lead the recovery

Exports account for around 19% of gross domestic product (GDP) and have been a key driver of growth over the past few quarters. Rising demand has been stimulated by the recovering global economy, coronavirus-related exports (masks and medical equipment) and IT supplies due to more people working from home.

However, export growth slowed in May and missed analysts' forecasts as supply-chain bottlenecks, record high shipping costs and rising raw material prices started to dampen demand for Chinese products. The strengthening yuan is also likely to exacerbate the easing of export growth in the second half of this year.

The manufacturing the purchasing managers' index (PMI) remained in expansionary territory in May. But beneath the headline numbers, there were also signs of weakness. The PMI breakdown showed a moderation in new orders, a deterioration in delivery times and a weakening in the employment index.

China

	2020	2021F	2022F
GDP growth y/y (%)	2.3	8.4	5.5
CPI inflation (%)	2.5	1.4	2.3
Unemployment rate (%)	5.7	5.4	5.2
Consumption (%)	-1	5.5	3.8

Source: Barclays Research, Barclays Private Bank

Price pressures are building

Surging commodity prices drove China's factory gate inflation in May to the highest levels since 2008. The producer price index surged to 9% year-on-year last month, following a gain of 6.8% in April. Local commodity prices were driven up by stronger global demand as well as domestic hoarding and speculation.

Concerned Chinese authorities are introducing restrictions on commodity trading activities and considering price caps and releasing strategic reserves to improve supply and curb price growth. As the world's largest exporter, accelerating producer prices in China matters, possibly indicating future global inflationary pressures.

Thus far, producers appear to have been absorbing rising input costs, squeezing margins rather than passing them onto consumers. While, consumer inflation has been picking up from low levels over the past couple of months, May's headline consumer price index (CPI) print was still relatively subdued at 1.3%.

We forecast that the upward trend in core/services inflation will continue as China gradually lifts COVID-19 containment measures and consumer sentiment improves. CPI is forecast to peak at 2.7% in the final three months of the year (Q4) before easing back to a 2.3% average in 2022.

Softer recovery in consumer spending

The pace of recovery in the service sector and consumption has been more sluggish than previously anticipated. May's Labour Day holiday spending data showed a pick-up in tourist spending, restaurant bookings and ride-hailing services, but consumer spending was still down 23% on 2019 levels.

It appears that structural factors have been holding back the consumption recovery. House prices in tier one cities have risen by more than 10% over the past year, forcing potential buyers to increase their saving rates to save for higher deposits. Despite improving, urban unemployment is elevated compared to pre-pandemic levels and household real disposable income has not returned to the pre-pandemic growth rate.

As we look into the second half of the year, consumption should benefit from the tailwinds of deferred spending and households' accumulated savings. The shift in expenditure to domestic markets from overseas, as international travel restrictions remain in place, should boost demand.

Real estate demand remains robust

The Chinese property market staged a V-shaped recovery in 2020. Property investment increased by 7% after 10% growth in 2019. Surging home prices, increased household leverage and concerns about a property bubble encouraged the authorities to introduce a range of tightening measures.

The limiting of mortgage loans and imposing of restrictions on home purchases, among other factors, could infringe on demand. Although, long-term demand for residential property should still be sustained by limited investment channels, slower, but still solid, household income growth and ongoing urbanisation (the urbanisation ratio has increased from 50% of the population in 2010 to 61% in 2019, according to Barclays Investment Bank), limited investment channels and slower, but still solid, household income growth.

Moderating credit growth

Outstanding total social financing, a measure of credit and liquidity in the Chinese economy, has been moderating over the past few months. The slowdown in credit growth can be attributed to a range of factors, including base effects and the impact of tighter credit policy announced in March. Curtailed bank loan growth, reduced government bond issuance, contracting shadow financing and slower corporate bond financing growth are all expected to further reduce credit growth through the second half of the year.

US-Sino relationship remains fraught

The relationship between China and the US remains tense and is a risk to growth prospects. While there are areas of cooperation (such as nuclear non-proliferation and climate change), tariffs, restrictions on dual-use technologies and expanded restricted entities lists will likely remain in place.

The weighted-average tariff on Chinese exports to the US has increased to approximately 19% from around 3% at the start of 2018. China has acknowledged its high-dependence on overseas demand and initiated the "internal circulation" strategy which will see it increasingly focus on domestic production, distribution and consumption to drive growth.

Drifting back to trend growth

China is looking set to cement a remarkable recovery this year with growth of around 8.4%. However, with the comparatives normalising and some clear headwinds developing, it's perhaps no surprise that year-on-year growth rates appear set to moderate over the next eighteen months.

We predict that the country will drift back towards a "new" trend growth rate of 5.5% in 2022, compared with the almost 10% growth rate achieved by the economy since 1978. Over the coming months we will closely monitor data for signs of deterioration, given China's influence on global growth and status as a leading indicator of the recovery.

> "China is looking set to cement a remarkable recovery this year with growth of around 8.4%"

Henk Potts, London UK, Market Strategist EMEA

Can Europe's economy bridge the growth gap?

After a relatively lacklustre economic response to the pandemic, global demand and excess consumer savings suggest the outlook is more encouraging, even if risks remain. Can the EU's recovery fund help boost growth prospects further?

Europe's road to recovery has been less assured than seen elsewhere in the developed world. Elevated coronavirus cases and the relatively lacklustre start to the vaccination programme forced governments to reintroduce restrictions. These stringent constraints have continued to weigh on economic activity.

The services sector has had a turbulent time through the pandemic and bottlenecks in global supply chains have also been disrupting the previously resilient manufacturing sector. The eurozone fell into a double-dip recession in the first quarter: output shrank 0.3% after contracting by 0.7% in the last three months of 2020.

Inoculation rates gather pace

On the positive side, the COVID-19 vaccination campaign has gained momentum over the past couple of months. At the start of June, 40% of the population in the continent's four largest economies had received at least one shot of the vaccine, with weekly vaccinations picking up on improved vaccine supply. That said, inoculation hesitancy might eventually dampen high vaccination rates.

Falling infections, hospitalisations and ICU occupancy rates are paving the way for a gradual reduction of restrictions going into the summer. France has relaxed curfews while Italy and Germany have moved to lower risk tiers.

The EU's Digital COVID Certificate, designed to demonstrate whether the holder has been vaccinated, recently tested or acquired immunity, is scheduled to come into use on 1 July. The "vaccine passport" should help facilitate travel between European states and may also pave the way for tourists from designated safe countries.

Lacklustre consumption

Euro area household consumption declined 2.3% in the first quarter and was still 10% lower than pre-crisis levels. Retail sales rates have fluctuated as lockdowns have come and gone, although the impact of restrictions has become more muted over time as households and firms have learnt to operate in an environment of containment.

Euro area

	2020	2021F	2022F
GDP growth y/y (%)	-6.7	4.6	4.4
CPI inflation (%)	0.3	2.0	1.4
Unemployment rate (%)	8	8.1	8.1
Gross public debt (% of GDP)	100.3	102.9	102.4
Private consumption (%)	-8	1.7	4.8

Source: Barclays Research, Barclays Private Bank

Cautious consumers have increased saving rates to historically high levels over the past year, which when unleashed, should drive near-term consumption as economies reopen. However, surveys suggest that households are still cautious about planning major purchases over the next twelve months, reflecting uncertainty over the pandemic and job prospects.

Demand is also likely to be impacted by negative real disposable income growth in the coming quarters, given the recent acceleration of inflation, even if temporary, and subdued nominal wage growth.

Unemployment to remain elevated

In April the euro area unemployment rate was 8% (up from 7.1% in March 2020), meaning there were 1.4m more unemployed than last April. More than 5% of the bloc's workforce are estimated to still be on furlough schemes and hours worked remains around 7% below pre-COVID-19 levels. We project that unemployment will remain elevated over the next two years, averaging 8.1% both this year and next.

Global demand, business investment and residential construction should provide support.

Rising international demand and an easing of travel barriers are likely to assist euro area exports. This is particularly so for regions that are more open and integrated into the global industrial cycle.

Business investment rebounded in the second half of 2020, but is still around 10 % below its fourth-quarter 2019 peak. Inventory investment is lean, but we anticipate that firms will restock and invest in capital over the coming quarters. Housing investment has been weak, but mortgage demand is increasing and fiscal subsidies have been supporting green energy and residential construction.

Inflationary pressure not sustainable

The reversal of value added tax cuts, rising container shipping pricing and the sharp rebound in energy costs have all conspired to propel inflation readings higher of late. Euro area inflation surged to 2% in May, its highest level in more than two years, with the gauge of price pressures topping the European Central Bank's (ECB) target for the first time since 2018.

As we look beyond one-off, seasonal and technical factors, we expect inflationary pressures to return to more subdued levels. Weakness in labour markets and household disposable income should anchor core inflation at depressed levels. We forecast that the year-on-year consumer price index (CPI) will peak at 2.7% in the fourth quarter of this year, before softening. Next year we project inflation in the euro area will average just 1.4%.

ECB to focus on liquidity support

The relatively sluggish recovery and subdued medium-term inflationary environment suggests that the European Central Bank (ECB) will need to keep rates in negative territory for some time. We expect the deposit rate to remain at -0.5% over the next two years.

The bank's focus is, instead, expected to remain on liquidity support. Its refinancing operation has undeniably helped liquidity and financing conditions. The central bank renewed its commitment to maintain its accelerated bond-buying at June's meeting, despite its improved growth and inflation forecast.

Given the ECB's limited policy options, the burden of reflating the economy and stimulating growth increasingly sits with fiscal policymakers.

European recovery fund aims to boost growth prospects

The recovery fund (Next Generation EU) was heralded as a significant step change for the bloc when it was unveiled last year. The plan allows the European Commission to borrow the money to finance the fund using guarantees from the EU's long-term budget as security, thereby embracing shared debt liability.

The recovery fund promises to mitigate the economic and social impact of the pandemic and make European economies and societies greener, more digital and more resilient. Assuming the near €800bn of EU funding over five years is efficiently and effectively distributed, it could provide a real fillip to Europe's growth prospects. However, political infighting, poorly coordinated investment priorities and slow progress on commitments to economic reforms have seen disbursement delays and risks hindering the recovery.

Growth outlook

While positive growth resumed in the second quarter, a more meaningful recovery in activity seems to have started in June. We forecast growth of 4.6% for 2021 and 4.4% for 2022 (see table, p10) with output returning to pre-crisis levels by the second quarter of next year. Long-term, pronounced economic scarring, the scaling down of support measures and limited future fiscal space may result in a reversal back to a significantly weaker trend growth rate.

Henk Potts, London UK, Market Strategist EMEA

UK investors boosted by healthier economic prospects

A successful vaccine programme and accelerating consumer spending are driving UK growth and lifting sentiment. But with a bulging budget deficit and the risk of a vaccine-resistant virus, how long can the good times last?

The UK economy registered its worst economic performance in more than three centuries in 2020. The 9.8% contraction was worse than the slump after the first world war and considerably worse than the decline recorded in Europe and the United States.

As we have progressed through 2021, we have become more constructive around the speed and shape of the UK's recovery. The successful vaccination programme has allowed the government to provide a road map, albeit delayed, for the reopening of the economy thereby helping to boost both sentiment and activity.

United Kingdom	2020	2021F	2022F
GDP growth y/y (%)	-9.8	6.7	4.2
CPI inflation (%)	0.9	1.9	2.0
Unemployment rate (%)	4.5	5.2	5.4
Gross public debt (% of GDP)	94.6	98.1	99.0
Private consumption (%)	-10.9	4.1	7.0

Source: Barclays Research, Barclays Private Bank

Improving public health situation

Cases in the UK peaked at the start of the year, with a seven-day average of around 59,000 new daily cases. Due to the sharp rise in cases, a third national lockdown was introduced in early January, leading to a steady reduction in cases.

At the end of May, the average had reduced to around 3,000 new daily cases despite higher testing. Hospitalisations and deaths are down 96% and 98% respectively from their January peak at the end of that month too. However, the rise in Delta variant cases since the start of June is a reminder that we can't be complacent about authorities' ability to eradicate the virus.

Sixty-five million vaccinations have been administered since the beginning of June, with nearly 50% of people aged 18 and over having received two doses, substantially above projections at the start of the year.

Brexit disruption dissipates

Our Outlook 2021 last November referenced the risk of a no-deal Brexit. Last minute compromises on fishing and level playing field governance paved the way for the UK and EU to successfully conclude a trade agreement. The deal guarantees tariff-free trade on most goods and creates a platform for future EU-UK cooperation on issues such as crime fighting, energy and data sharing.

The deal's five-year review clause offers an opportunity to develop and broaden the trade agreement. The agreement therefore avoids the scenario of EU-UK trade falling back to the tariffs and quotas foreseen under basic World Trade Organisation (WTO) rules.

We should recognise that even with a trade agreement, the divorce was one of the hardest possible outcomes for the UK. As such, it resulted in significant adjustments for many businesses and supply chains. The government will need to look for progress on trade agreements beyond the EU to recover part of the shortfall.

Chancellor keeps spending

The March budget saw the UK chancellor deliver a series of measures to ensure the recovery and also offer a strategy for putting the nation's finances back onto a sustainable path. He focused his fiscal firepower on supporting the economy, businesses and employment and extended emergency measures. The furlough programme was lengthened until September 2021, a £5bn restart grant scheme was provided for the high street and the hospitality sector and a "super deduction", to reduce tax bills for investments for the next two years, was introduced.

Among the revenue raising measures was the proposed lifting of the corporation tax rate to 25% from 19% in 2023 and the freezing of personal income allowances from April 2022 to April 2026.

The budget deficit is forecast to rise over the next couple of years. That said, the government appears to be committed to their 2019 manifesto pledge to leave the main revenue raisers of income tax, VAT and national insurance unchanged. The speculation surrounding the introduction of an excess profit tax or a wealth tax proved to be unfounded.

Lower peak unemployment and consumer strength

Household consumption is accelerating, reflecting the effect of the easing of coronavirus restrictions on consumer spending. April retail sales volumes surged 9.2% month on month and were 42% higher than in April 2020, which were affected by the first national lockdown. Non-food stores provided the largest contribution to sales growth and the proportion of online sales declined in all sectors as physical stores reopened.

The Bank of England estimates that consumers have accumulated more than £200bn in excess savings during the pandemic and project that up to 10% of this will be spent in the coming quarters, helping to propel growth.

At the height of the pandemic, economists feared that UK unemployment could surge to around 9%. The extension of the furlough programme and faster reopening of the key service sector allows us to reduce our forecast for peak unemployment to 5.7% in the fourth quarter (Q4). For 2022, we predict unemployment will average 5.4%, still significantly higher than the pre-pandemic average of 3.8% in 2019.

Inflation back below target in 2022

As we have seen in other regions, year-on-year UK inflation prints have registered sharp gains. The consumer price index jumped to 2.1% in May, the highest since July 2019, primarily due to energy-related base effects and rising prices for clothing and footwear. However, there are still few signs higher producer prices are translating into higher consumer prices, with services inflation hovering around historical lows.

We anticipate that inflation will peak below 2.5% in Q4 and then ease back below 2% as base effects rescind and growth rates ease.

Low, but not negative interest rates

The prospect of negative interest rates has all but evaporated, unless the UK's growth profile unexpectedly deteriorates dramatically. The Monetary Policy Committee is likely to maintain the status quo as the recovery plays outs. We expect rates will be held at the historically low rate of 0.1% through 2022.

Risks of an earlier rate hike?

We do not anticipate that the bank rate will rise before the end of next year. However, there are upside risks to that forecast if a significantly stronger recovery materialises and inflation is projected to be sustainably above the 2% mark. Such a scenario could be achieved by a combination of factors: consumers running down accumulated savings at a faster rate; a quicker recovery in labour markets could create wage growth; or businesses start to exert some pricing power in response to the robust demand which could stoke inflation above the target level.

Improving outlook

The bounce in household consumption, lower projected peak unemployment, as well as rising activity from the supportive fiscal package, and reduced Brexit distractions encouraged us to raise our 2021 full-year growth forecast to 6.7%. Looking forward to 2022, we project growth of 4.2%.

Julien Lafargue, CFA, London UK, Chief Market Strategist

Can equities keep partying as Fed removes the punch bowl?

A surge in earnings has led to a strong start to the year for equities. However, with the prospect of tighter monetary policy, the current optimism may be challenged and upside harder to come by. We remain constructive on equities but would increasingly rely on alpha as the main source of returns.

Global equities have returned 10% in 2021, a strong and somewhat unexpected performance. The road ahead will likely be bumpier as the narrative shifts from recovery to expansion (at best) or slowdown (at worst). We remain constructive on equities over the medium term but reiterate our view that the best is probably behind us.

Recessions can be positive for equities

Everything about the COVID-19 crisis has been exceptional, chief among them being the human tragedy. For investors, this is the first time in 50 years that a recession has led to higher equities (see chart).

Gains have not been limited to equities. House prices too rose in most developed markets, another unlikely development when global gross domestic product (GDP) shrank by 3.3% in 2020.

The unprecedented amount of monetary or fiscal support has certainly contributed to this anomaly. Unfortunately, this support will soon stop and the monetary impulse may in fact turn negative as central banks look to normalise policies and governments try and find ways to reverse expanding budget deficits.

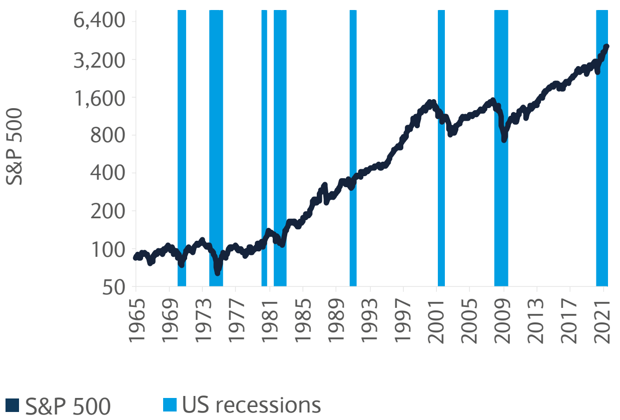
The haves and the have-nots

Although global equities have performed surprisingly well at the headline level this year, this masks wide discrepancies. Staples are up 4% since January while energy is up some 27%, as of 22 June. Over the last 18 months, though, energy shares are still down 12% while the MSCI AC World index is up 25% and technology is 57% higher.

From a factors' perspective, value has done slightly better than growth (+5% on a relative basis this year) but much of these gains took place in the last two weeks of February. Quality, our preferred factor, trails value by just 2%.

With global growth returning to more normal levels and interest rates trending higher, we continue to favour quality over both growth and value.

Recessions can be positive for equities
Performance of the S&P 500 and US economic recessions since 1965



Sources: Bloomberg, NBER, Barclays Private Bank. June 2021

Europe ahead, emerging markets lagging

For once, European indices have outperformed, at least on a year-to-date basis. However, the outperformance remains marginal. The French CAC 40, our preferred European index and the best performing so far in 2021, is up 19%. By contrast, Germany's DAX, Spain's IBEX or Italy's FTSE MIB have all produced similar returns to the S&P 500.

The real stand out is emerging markets, which have lagged significantly, dragged down by poor performance of Chinese markets. Although the world's second largest economy was quick to overcome COVID-19, growth has slowed recently (see "Is China's roaring revival on its last legs", p8). While this may be cause for some concerns, both locally and globally given the importance of China, we believe any slowdown will be temporary and remain constructive on Asian emerging market equities over the medium term.It's all about earnings.

As we highlighted in our Outlook 2021, published in November, any equity upside would have to come from earnings as valuation multiples had little room to expand further. Since then, the MSCI AC World 12-month forward earnings multiple has fallen to 18.7 times earnings from 19.8 times. While this is still significantly above the twenty years' average (14.7 times) and we expect further compression, equities remain attractively valued on a relative basis with the risk premium above 300 basis points (bp).

Earnings, on the other hand, have surprised to the upside with very strong earnings in the last three months of 2020 (Q4) and in Q1. Courtesy of favourable base effects from a year previously, the upcoming second-quarter results are likely to deliver the highest earnings growth in decades. Consensus anticipates an increase of more than 60% year-over-year in the US for the quarter.

Upbeat earnings should provide support to equity markets and could force us to formally convert our original bull case scenario into our new base case. However, this would still result in only modest upside as once we've past this peak for earnings growth, we would expect the consensus to revert back to its usual 10-12% earnings growth forecast.

The Fed is key

We remain convinced that rates will dictate what happens in equity markets. With the US Federal Reserve (Fed) looking to take away the punch bowl and planning to reduce its monthly purchases by the beginning of 2022, there is a risk that equity multiples' compression accelerates if the central bank fails to prevent a rapid increase in interest rates.

As a rule of thumb, and assuming no change in either earnings expectations or the equity-risk premium (320bp), each 25bp move in the US 10-year Treasury yields is worth about one multiple turn on the S&P 500.

Bearing that in mind, we would expect the Fed to proceed with the utmost caution when it comes to monetary policy normalisation.

With the era of unlimited accommodation from central banks about to end (for now), we expect greater volatility ahead.

No change for now

Despite this lingering uncertainty, equities remain well positioned, in our view. Not only do they still offer more upside potential than bonds in an ultra-low (and rising) interest rates environment, they also offer decent protection against higher inflation.

As such, and while we've been arguing that investors should trim cyclical exposure, we maintain our overall preferences within equities. We continue to like quality, and the US and emerging markets over Europe and Japan.

Yet, we see alpha (in respect of sector and stock selection) rather than beta as the main driver of returns. At the sector level, we remain most constructive on broad technology, healthcare, consumer discretionary and parts of the industrials complex.

We also believe that investors might favour uncorrelated strategies as a way to maximise diversification benefits.

> "Despite this lingering uncertainty, equities remain well positioned, in our view....they also offer decent protection against higher inflation"

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

Looking into the Fed's mindset

Yields seem to be taking a breather now, after a significant surge earlier in the year. Even two consecutive months of record inflation prints were not sufficient to lift US rates to new highs. Can a closer look at the Fed's mindset reveal what might drive interest rates next?

Investors seem puzzled why higher debt, the prospect of higher inflation and potentially less monetary accommodation is not lifting bond yields more.

As highlighted in April's Market Perspectives, the relationship between the above factors and yields has been murkier in the past and may not be as obvious in the future. What can bond investors do?

Tapering and hiking plans

What the main driver of rates will be over the rest of the year is likely to be the key question on investors' minds. Presumably the most important factor, for now, seems to be the US Federal Reserve's (Fed) monetary policy and approach going forward. When, and by how much, will the central bank raise policy rates and will the tapering of its bond-buying programme affect yields?

The biggest input factor for the Fed is naturally inflation and this time, more importantly, the nature of it. The central bank has said it expects price rises will, for the most part, be transient in nature rather than persistent.

Higher inflation, as seen recently, is partly explained by base effects from the first half of last year and pent-up demand. The Fed indicated that its policy will see through such a period while the newly implemented average inflation target (AIT), that provides more flexibility on the timing of rate moves, would require higher inflation to make up for undershoots in previous years.

As described in last month's Market Perspectives, the majority of the factors contributing to the rise in inflation are volatile or flexible and are not sticky.

Cutting the inflation noise

The US central bank is likely to focus on the changes of sticky prices, given that these, according to the Atlanta Fed, are more helpful in assessing future inflation. The sticky price CPI (consumer price index) stands currently at 2.4% year on year compared to 2.8% pre-pandemic.

At the same time, the Dallas Fed calculates a trimmed mean personal consumption expenditure. Here, the most volatile components are eliminated or "trimmed" (regardless of which category this occurs in) to gain better insights of underlying trends. As with the sticky price CPI, this measure is still relatively moderate and does not hint at this being a start of a high-inflation era.

Labour market is now a priority

Since the central bankers' Jackson Hole meeting last August, when the Fed's "renewed" dual mandate (inflation and employment) was presented, increasing emphasis has been placed on the job market, which seems to have become the priority lately.

But a lower headline unemployment rate, as such, might not be sufficient to keep inflationary pressures subdued enough for the central bank this time. The central bank may still regret having hiked rates too early in 2015, and by too much, and thus ignoring the slack in the labour market. The Fed chair, Jerome Powell, seems to feel obliged to put things right this time.

To make a better judgement of the labour market slack, Fed member John Williams pointed out recently that the Fed preferably looks at broader measures, like the employment to working population (EPOP) that is similar to the participation rate. According to Williams, the EPOP has recovered well from last year's crisis lows. However, the number is still comparably low at 61%, according to the St Louis Fed, and "translates to about eight and a half million fewer people working"[1], compared to pre-pandemic levels. For now, it remains to be seen if the current lag in recovery is mainly due to workforce supply constraints or slack or a combination of it.

[1] Federal Reserve Bank of New York, The Economic Recovery: Are We There Yet?, 3 May 2021 https://www.newyorkfed.org/newsevents/speeches/2021/wil210503

Fed with additional social mandate

Powell goes even further than Williams. He believes very strongly that monetary policy must support the government's strategy of fighting inequalities among Americans. When referring to the Fed's survey of household economics and decision-making (SHED), he pointed out that the "labour force participation declined around 4 percentage points for Black and Hispanic women compared to 1.6 percentage points for white women and about 2 percentage points for men overall".

The Fed's approach of how to assess inflation and employment numbers are important to obtaining a greater sense when rates might lift off and or for bond-purchase tapering: inflation above 2% and unemployment below 5% or 4% might not be the ultimate trigger for policymakers.

As per the usual playbook, it can be expected that tapering will commence before any rate hikes. The central bank has already acknowledged the economic progress that has been made and may announce tapering in the third or fourth quarter this year. Indeed, it might occur as early as during the Jackson Hole summit on 26-28 August.

Tapering could come earlier

Recent surprisingly low job numbers may be a reason to leave policy accommodative longer, though Jerome Powell expects to see "a labour market that shows low unemployment, high participation, rising wages for people across the spectrum within the next two years". Equally, there are strong arguments for an earlier tapering. For example, the housing market soared by 13% on a year-by-year comparison in March, the highest since 2005. Fed member Robert Kaplan argued, "I don't think the housing market needs the level of support that the Fed is currently providing and I would love to see, sooner (tapering) rather than later."[3]

We believe that the US central bank will communicate well in advance of tapering and the market is fully aware it will happen sooner or later. While the official announcement may cause some volatility, it will likely not spark rising bond yields as seen in 2013. The move has already been well advertised. Reducing bond purchases earlier or later than the market expects will have limited impact in our view.

No rate hikes likely until early 2023

The latest update of the central bank's "dot plot" rate forecasts shows that policymakers see two hikes in 2023 compared to no hikes previously. The dot plot also shows that more Fed members not only favour hikes in 2023 but also in 2022. Jerome Powell noted, however, that "the dots should be taken with a big grain of salt," while discussion about raising rates now are, "highly premature".

The Fed still sees inflation being only slightly above 2% in 2022 and 2023, which would not justify large hikes. Still, should inflation remain stickier, the central bank may consider an earlier rate move. The most likely scenario remains that the Fed will start the hiking cycle towards the first half of 2023.

Beware of political noise

A factor which has not been articulated as much by the markets is political dynamics. US treasury secretary, and former Fed chair, Janet Yellen advocated higher policy rates recently: "If we ended up with a slightly higher interest rate environment it would actually be a plus for society's point of view and the Fed's point of view."[4]

This was the second time that she expressed these views. It seems to prefer the Fed to act quicker to tame any further rate volatility caused by inflationary fears. Interestingly, Powell's term as Fed chair ends in February 2022 which may lead to further rate volatility, should the US administration plump for a candidate likely to act more swiftly and with more determination.

Another myth: hikes cause higher yields

There seem to be plenty of arguments for more interest rate volatility in coming months. At the same time, it is unlikely that US long-end rates will enter a new upward trend on higher possible policy rates. We argued before that while the rate curve may have room to steepen further, it is more

[2] Board of Governors of the Federal Reserve System, Community Development, 3 May 2021 https://www.federalreserve.gov/newsevents/speech/powell20210503a.htm#fn1

[3] Reuters, Fed should talk about taking foot off policy pedal: Kaplan, 3 June, 2021 https://www.reuters.com/article/us-usa-fed-kaplan-idUSKCN2DF22J

[4] Bloomberg, Five things we need to know to start your day, 7 June 2021 https://www.bloomberg.com/news/newsletters/2021-06-06/five-things-you-need-to-know-to-start-your-day

likely that with higher policy rates the curve will start to flatten with long-end yields only marginally trending higher from this point.

During the past six hiking cycles, back to 1983, the long end moved lower (see chart, top right). After we examined the correlation between debt, inflation and yields in April's Market Perspectives, this is another myth which may be of importance to keep in mind.

"5-year yields", says the butterfly

In the current rate environment, it seems that the 5 to 6-year segment of the curve offers an adequate risk-reward. While the duration risk may be relatively contained, compared to long-dated bonds, the steepness up to this point offers higher roll yields (the price gain by holding bonds).

The 5 to 6-year range seems better priced relative to recent history (see chart, bottom right). This can be illustrated by the so-called butterfly spread that compares a position of one unit each of the 2-year and 10-year yields against two units of the 5-year yield. This spread climbed this year to its 10-year average, last, and indeed only, seen one and three years ago.

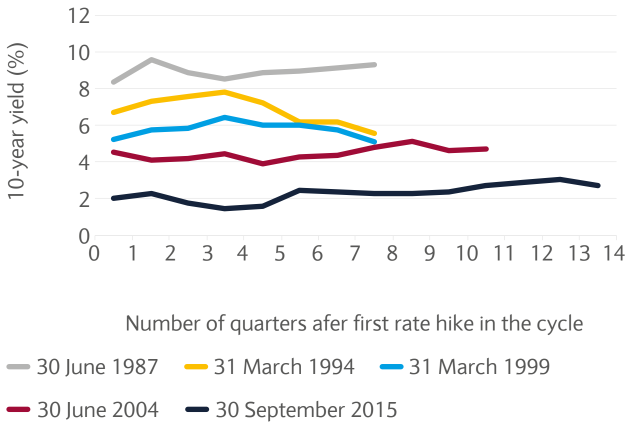
How can investors improve yield?

Depressed yields and rate volatility does not offer the best environment for bond investors. Also, corporate bond yields are at historical lows thanks to an almost unprecedented rally in spreads. Spreads have recovered from where they were at the peak of the pandemic crisis in only 14 months. Indeed, they have reached 20-year tights. From here, further price gains due to spread tightening are limited, if not absent, and carry remains the main performance driver, in our view.

Investment-grade bonds seem expensive at first sight and due to the low spread are most exposed to rate volatility, especially for bonds with long maturities, which appear to offer the least value. Within the investment-grade segment, BBB-rated bonds seem to offer a mix of relatively higher yields combined with improving "technical" factors.

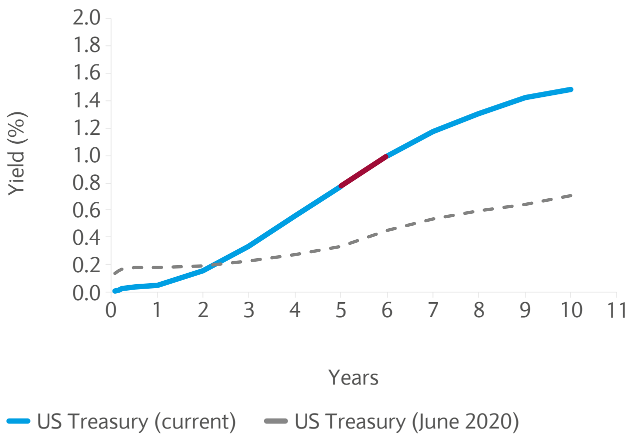
First, fallen-angel risk (or the risk of a downgrade to high yield status) has declined significantly and may account for only $40-50bn of US bonds in the next 12 months. BBB-rated corporate issuers in particular are likely to act more defensively to protect their investment-grade ratings.

Long-end rates rarely rise in rate-hiking cycles
The reaction of 10-year Treasuries to US interest rate hiking cycles since 1983



Source: Bloomberg

US Treasury curve at steepest in 5 to 6-year segment
The US Treasury yield curve in June 2021 and in June 2020



Source: Bloomberg

Second, the recovery and growth in earnings is likely to translate into lower leverage on corporate balance sheets, all else being equal. BBB-rated bonds do not screen as being particularly cheap on absolute and relative spread terms (relative to other rating categories). Compared to the diminished downgrade risk and the low-rate environment, however, they seem preferable within the higher quality bond segment at least.

BB-bonds offer value

Higher carry meanwhile can be earned with BB-rated bonds. The segment, like most, has witnessed significant spread tightening and while spreads appear to be rich, there is probably still more tightening potential.

Default rates within the broader high yield market are declining faster than initially anticipated and are expected to fall as low as 1.8%, according to Moody's. In addition, BB-rated bond spreads are still above pre-pandemic levels compared with BBB-rated bonds or general Treasury yield levels (see chart). Carry flows will likely continue and support this cohort of the market in this environment.

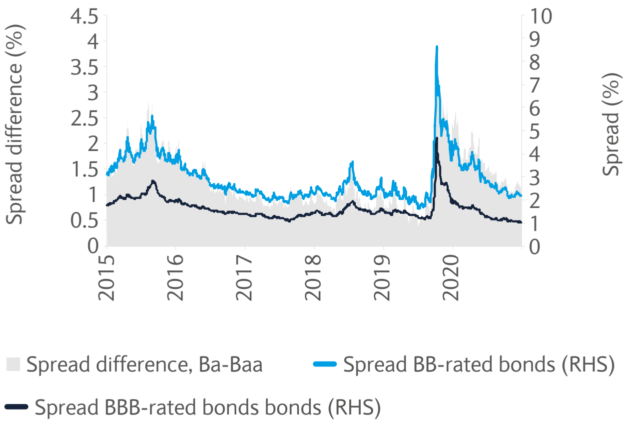
Risks remain and selection is key

At the same time, pockets of risk still exist. While leverage may decline from current levels, it is still close to record levels. Corporate behaviour will be crucial in coming quarters. Not only the quantity of issuance (reaching record levels) is important, but also its quality. Debt-funded dividend and buyback deals are on the rise as well as debt-funded M&A deals. Considering the pipeline of debt deals, funding M&A transactions may be up to 20% of debt issuance, compared to 9% last year.

With this in mind, selection remains key. Especially since corporates with already excessive leverage have increased net debt by 30% since the end of 2019. This group is expanding and represents 17.4% of the high-yield market compared to only 13.5% in 2019. While lower interest rates may help for now, those with less stable cash flow can be easily exposed to more default risk.

Spread premium on BB-rated bonds can compress further

Spread premium for BB-rated and for BBB-rated bonds against Ba-Baa-rated bonds since 2015



Source: Bloomberg

Damian Payiatakis, London UK, Head of Sustainable & Impact Investing

Preparing portfolios for a sustainability storm

While sustainable investing is rapidly growing, challenges are on the horizon. As a megatrend, it will endure. But investors should consider how to position portfolios to get the best from the short-term risks and opportunities.

The mid-point of the year is a natural moment for investors to pause – reflect on the market's progress and trajectory – then set course for the second half of the year.

Sustainable investing, carrying considerable momentum from 2020, has flourished in 2021. With (hopefully) more success overcoming the pandemic and attention from the COP26 global climate summit in November, flows into sustainable investing may accelerate further in coming months.

For investors, sustainability and sustainable investing increasingly have to be part of how they invest. Yet, rapid growth and enthusiasm, in a still immature market, likely means a turbulent period ahead. Investors who understand its principles and practices can position their portfolios to benefit in both the short and long term.

Sustainable investing is here to stay

It is not only the pandemic that is creating a "new normal". Sustainability is both driving, and being driven by, forces that are transforming our lives. Consider some of them.

Governments are embracing, as well as encouraging, sustainability. Foremost, their focus is on climate, with 137 countries having made net zero commitments[1]. But their attention on sustainability now extends to other environmental issues, such as biodiversity or environmental footprint, as well as social issues such as education, structural inequalities or healthcare.

Linked to this, the financial industry faces further sustainability-linked regulations. To ensure the concept is incorporated in investment decisions and corporate reporting, regulators are generally taking a "comply or explain" approach. Translated, this provides a grace period for organisations to conform to new standards. With President Biden's administration executive order in May[2], now every major market has, or will have, some requirements around sustainable disclosures and practices.

Even without this pressure, institutional managers, who control a majority of global investment capital, are committing their businesses to sustainability. Furthermore, meta-research[3], and moreover the lived experience of 2020, demonstrates the materiality of ESG issues on financial performance. In this case, incorporating sustainability becomes a fiduciary duty, not optional add-on.

In wider society, consumer priorities and demographics are shifting. Consumers increasingly care not only about the product or services they receive, but how sustainably these are made or delivered. The voices and values of millennials, now estimated to be 23% of the population[4], and 50% of the workforce[5], are driving social movements and workplace culture.

Even with this cursory listing of these forces, the trajectory of sustainable investing is apparent. It can no longer be questioned as a fad or fashion. Rather, it is integrating into society and therefore, should be in how investing operates.

[1] Energy & Climate Intelligence Unit, Net zero tracker, June 2021 https://eciu.net/netzerotracker

[2] The White House, Executive order on climate-related financial risk, 20 May 2021 https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk/

[3] NYU Stern Centre for Sustainable Business, ESG and financial performance, 10 February 2021https://www.stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/research-initiatives/esg-and-financial-performance

[4] MSCI, Millenials: Demographic change and the impact of a generation, June 2021 https://www.msci.com/documents/1296102/17292317/ThematicIndex-Millenials-cbr-en.pdf/44668168-67fd-88cd-c5f7-855993dce7c4

[5] KPMG, Meet the millennials, February 2017 https://home.kpmg/content/dam/kpmg/uk/pdf/2017/04/Meet-the-Millennials-Secured.pdf

But there are headwinds coming

However, this is not a declaration that sustainable investing is fully established. Instead, it is a warning it may enter a difficult period during the second half of the year. This will be due to several factors.

First, the ongoing, simplistic view that the field is homogenous. Funds that apply ESG filters across all industries are being grouped with highly thematic sector-focused funds. This, as explained in "Unpicking the jargon of sustainable investing" in June's Market Perspectives, will mean that if certain sustainable investments perform poorly, the entire movement may be perceived to be.

Similarly, overreliance on ESG ratings as an absolute and constant determination of quality. High ratings do not bestow permanent sainthood for a company. ESG ratings provide an algorithmic judgement based on backwards-looking, available and generally self-reported data on how well a company manages its materials environmental, social and governance risks.

Even if a company deemed well-run based on ESG factors, this doesn't assure it will be financially successful. Other factors, such industry dynamics, effective strategy and execution, and "in favour" from a market cycle perspective, influence financial performance.

Flows to sustainable funds are not permanent

Second, highly liquid capital that has rapidly flown in, can easy flow out. This raises the question of is there an ESG bubble?, as posed in March's Market Perspectives, particularly the case with sustainability-linked thematics, such as renewables. As MSCI analysed, energy efficient stocks have been a crowded trade, at comparable levels to technology stocks in 1999 dotcom boom[6]. Some of that pressure was released in the pullback seen in the sector since March. But it does demonstrate the momentum and volatility factors that can push sustainable thematics upwards, can also drag them downwards in different market conditions.

Greenwashing risk

Last, the risk of greenwashing is increasing. The multitude of new entrants may have enthusiasm, but not necessarily knowledge or skill to invest effectively. Additionally, marketing of the positive aspects of sustainability may mean investor expectations exceed reality. As we warned in "Greenwashing: caveat emptor" in April's Market Perspectives, without knowledge or a guide, investors may struggle to navigate the field and select the most appropriate products amid the cacophony of sustainable marketing.

These indicators, emerging at the end of 2020 and building during first half of this year, point to challenges ahead. As advocates for both the movement, and our clients, how should investors plan and position their portfolios?

Focus on managing short-term sustainability risks

In the short term, investors can understand and prepare for risks driven by likely structural changes and the impeding market conditions.

For example, analysis of current governmental policies and plans demonstrate we are not on track to meet Paris Agreements of two degrees centigrade, let alone the 1.5 degrees ambition[7]. Governments will have to respond. Addressing climate change is not a campaign pledge that can be quickly dismissed.

The longer governments delay the more severe the implications. The UN's COP26 in November, and preceding months, provides the ideal backdrop for countries to increase their ambitions. Therefore, investors might review portfolios for the transition risks and carbon intensity in advance of this inevitable policy risk. Separately, as highlighted in "Can the economy sustain its strong rebound" on page 4, investors face the risk of rising inflation and need to reassess investments, and entry points, accordingly.

For specific sustainable themes and sectors, such as renewables, electric vehicles and mobility, much of their valuation is driven by potential growth. In an inflationary environment with higher discount rates and with market rotation, these sectors may fall from favour. This may require patience from investors during a downturn. Or it may provide a more attractive entry point for those who missed an earlier opportunity and find the potential volatility acceptable.

Look to the horizon to set a sustainable course

In the short term, sustainable investing may face a turbulent time. Potentially volatile and inflationary markets, and hype that rises until it pops, may provide a challenging environment.

While this journey is unlikely to be smooth as a megatrend, sustainability has momentum, direction and causal effect. Investors who can prepare themselves and portfolios for any short-term challenges are likely to be well positioned for the long term.

[6] MSCI, The pressure of the crowd: stress testing thematic indexes, 17 May 2021 https://www.msci.com/www/blog-posts/the-pressure-of-the-crowd/02505396213

[7] United Nations Climate Change, NDC Synthesis Report, February 2021 https://unfccc.int/process-and-meetings/the-paris-agreement/nationally-determined-contributions-ndcs/nationally-determined-contributions-ndcs/ndc-synthesis-report

Alexander Joshi, London UK, Behavioural Finance Specialist

Keeping calm in turbulent markets

In uncertain times and fast-changing markets, diversification may protect investors psychologically, helping them to reach their investment goals by avoiding taking rash, unwise actions.

The idea of diversification is to construct a portfolio designed to meet the requirements of an investor through a range of potential outcomes: it should be as forecast-free as possible.

The outlook for financial markets looks more positive than it did this time last year given the extraordinary strides made to fight coronavirus. However, while investors have reason to be optimistic, they should also appreciate that there are risks, related to the pandemic or not. The effect of accelerating inflation, even if transitory, is just one risk that may trigger more volatility later in the year and test investors' nerves.

Unforeseen circumstances can throw off track even the best plans and bring behavioural proclivities that may trigger actions not in one's best interest. Significant negative moves, such as the equity sell-off seen early in the pandemic, can spark selling even when an investor has sufficient liquidity.

Conversely, extreme exuberance, as witnessed this year in certain parts of the equity and cryptocurrency markets, can lead to investors being swept up in speculative bubbles. Even more so with social media bringing together retail investors to join the fray.

The building blocks for successful investing

The key building block for sustained successful investing is a robust investment process that allows well-diversified portfolios to be constructed for different market conditions.

But having the optimal portfolio alone is not enough without sticking to it over the market cycle. Investors also need a calm head and emotional comfort with being invested to stay the course and minimise biases in decision-making. This can prevent panic when times get tough and let you capitalise on opportunities.

Successful investors do not rely on sheer will to overcome biases; they use systems and tools to guide investment decision-making. Diversification is one such tool that, over and above the financial benefits covered in "A bird's eye view on diversification", see p24, can help bring calm and rational actions during the investment journey.

Behavioural diversification benefits

As humans we don't like uncertainty and volatility. They can be uncomfortable to experience and the natural reaction may be to act to minimise them. As volatility increases, so too may the likelihood of paper losses. This, in turn, is likely to decrease holding periods and increase trading behaviour, both of which are correlated with decreased returns.

Actions that may give the investor short-term comfort, such as from selling out of the market to cap the downside, can impact performance over the long term. Reducing holdings during a spike in volatility can lead to missing out on a recovery and growth while the investor waits to get back into the market.

Diversification can provide an "emotional buffer". By protecting a portfolio from the effects of volatility and the risk to investment success of holding relatively few securities, a diversified portfolio may also insulate the investor from being caught up in the emotions they induce. This can help to navigate markets, with a calm head and assurance that financial objectives are secure, even in large market disruptions.

It is not just in response to crises that diversification is useful, but also to counteract subtle behavioural biases that may drag on returns if left unchecked. For example, the home bias – a preference for assets which are familiar (be that geographically, by company, sector, asset class) – can overly concentrate portfolios in the hands of a few stocks.

Creating the foundations to grow your wealth

As we head into the second half of the year, good investment hygiene may involve taking stock of existing investments to ensure you have the right foundations to protect and grow wealth. Do you have a specific plan in place to grow your wealth? Are you following a robust investment process that has led to a diversified portfolio? Are you thinking about your investments in the context of your goals?

Holding a diversified portfolio can let the investor turn down the noise of market commentary, given that some headlines are unlikely to affect the portfolio materially. Remember that the market isn't a single entity that moves as one.

With this calm, investors can look at events and actions in the context of their goals and ask themselves how they are likely to affect their ability to reach these long-term goals.

By helping to avoid the temptation to overreact in response to short-term market moves, a diversified portfolio provides a solid foundation for protecting and growing wealth. Such a strategy may allow you to focus on reaching your investment objectives.

"By helping to avoid the temptation to overreact in response to short-term market moves, a diversified portfolio provides a solid foundation for protecting and growing wealth"

Nikola Vasiljevic, Zurich Switzerland, Head of Quantitative Strategy

A bird's eye view on diversification

The post-pandemic world will likely be challenging, characterised by low rates, elevated inflation risks, rebounding growth, rich equity valuations and structural changes and secular trends. Smart diversification may be one of the key elements for successful investing at such times.

Crafting a well-diversified portfolio is a key tenet for investment success and growing wealth over the long term. Spreading capital across different asset classes can help investors to keep portfolio volatility under control. However, this is only half of the story. To mitigate the impact of potential extreme, tail events it may be worth considering different scenarios and evaluating their impact on portfolio performance.

Investment goals and risk appetite

The investor is at the heart of every asset allocation and portfolio construction decision. Before delving into subtleties of financial markets, clearly defining investment needs and goals can help. For example, investors should specify their reference currency, investment horizon, liquidity requirements, need for steady cash flow, lifestyle requirements and aspirational goals. In addition, a firm understanding of their risk tolerance and risk capacity helps.

All these inputs are equally important to build an optimal portfolio that reflects an investor's needs, risk attitude and investment style. Ultimately, a structured and diligent investment process can help to meet their long-term goals, while navigating risks and opportunities in fast-paced markets. As such, diversification is generally considered at the first stage of any investment process.

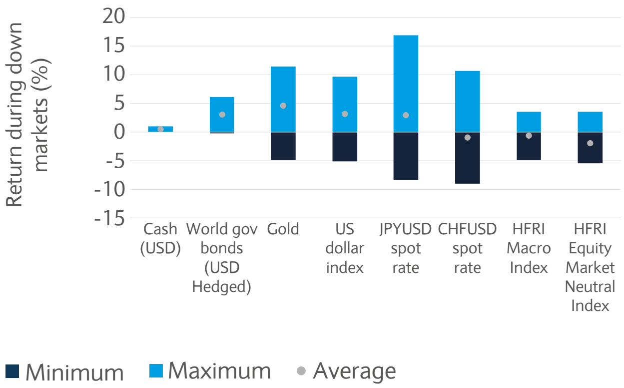
Safe-haven assets

Equities are an essential part of most portfolios, except for the most risk averse clients. Historically, the asset class has provided a hefty premium of 6-7% on top of the returns offered by risk-free assets. However, this excess return usually comes at the cost of higher volatility and large losses during market meltdowns (for instance, many equity markets suffered a drawdown of 40-50% within a short period of time in the global financial crisis of 2008-2009).

To mitigate the risks associated with investments in equities, a range of so-called "safe-haven assets" (or assets expected to provide protection when equities tank) might be considered in a portfolio context. Cash, government bonds, gold, certain currencies and hedge funds are among assets that typically help in down markets.

Traditional safe-haven assets on average shelter portfolios in down markets

The best, worst and average quarterly performance of several safe-haven assets during periods when world equities lost more than 10%, since 2001



Source: Bloomberg, Barclays Private Bank, June 2021

Since 2001, safe-haven assets like government bonds, gold, the US dollar and Japanese yen have averaged positive performance in the quarters when global equities lost more than 10% (see chart).

However, safe-haven assets can disappoint as well. Changing macroeconomic conditions may impact correlations, possibly diminishing their protective power. Moreover, safe-haven assets usually provide low income and represent a drag on performance over longer investment horizons. As such, there is a trade-off between portfolio return and risk.

Is your core protected?

Like equities, government bonds often represent a core part of most portfolios. Investors in Treasuries can earn stable and secure income. For this reason, they typically exhibit a negative correlation with equities, especially during market downturns.

However, the correlation of government bonds with equities can change. Historically, the two asset classes become more correlated as inflation rises. Additionally, the current low-interest rate environment leaves limited scope for capital gains on government bond investments. Indeed, the combination of these macroeconomic factors has led many investors to question the diversification potential of Treasuries of late.

The dispersion of equity-bond correlations has increased significantly since 2003 for the US, UK, eurozone and Switzerland (see chart, top right). Although equity-bond correlations are negative on average, the current correlation level is close to zero in Switzerland and around 0.1 in the eurozone. Meanwhile, correlations are negative in the US (-0.4) and the UK (-0.2). This shows that the macroeconomic backdrop is an important driver of the interplay between equities and bonds.

The investor's reference currency matters

For those with exposure to global equities, currency effects matter. Our research shows that an investor's reference currency can affect portfolio returns significantly in down markets.

In fact, it is possible to draw a spectrum of currencies, based on their average and tail correlation with global equities, ranging from the safe-haven currencies (such as the US dollar and yen) to their cyclical, commodities-driven peers (such as the Canadian and Australian dollars).

This analysis indicates that currencies play an important role in asset allocation and are an integral part of the diversification mosaic (see chart, bottom right).

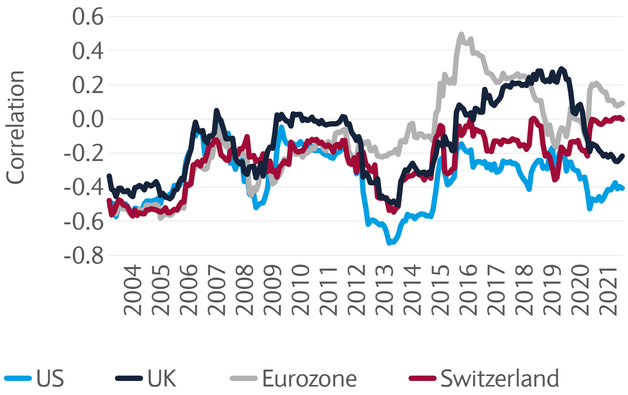
Stay calm and keep diversifying

Diversification lies at the crux of our investment philosophy. Finding an optimal asset mix requires a thorough analysis of many factors and their interconnectedness. However, there is no universal solution. Building a diversified portfolio that can serve investors well across various market regimes is predicated on a firm understanding of their investment goals and risk appetite.

Focusing on the potential long-term performance of portfolios, while keeping an eye on the short term and the potential impact of volatility on investors' behaviour, seems to be the key to successful investing.

Dynamics of equity-bond correlations in developed markets

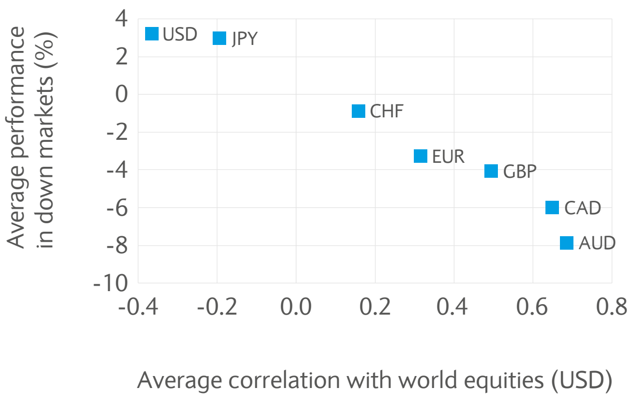
The three-year rolling-window correlations between equities and government bonds for the US, UK, eurozone and Switzerland since 2003



Sources: Bloomberg, Barclays Private Bank, June 2021

Not all currencies are born equal

The average correlation with world equities and performance in periods of down markets for the US dollar, sterling, yen, Swiss franc, euro, Canadian dollar and Australian dollar



Source: Bloomberg, Barclays Private Bank, June 2021

Narayan Shroff, India, Director-Investments

Time to reconsider risk budgets and buckle up for the ride

As the economic recovery evolves and inflation rears its ugly head, investors might consider rebalancing portfolios to match their risk appetite and budgets. A core/satellite approach may help portfolios to weather periods of likely turbulence ahead.

The unprecedented monetary and fiscal support, high liquidity and structurally lower rates have supported the financial market performance in India. However, the constrained economic environment through the waves and ensuing lockdowns and the general risk aversion through this period led to more of a K-shaped recovery. Parts of the market trade at rich valuations while others struggle through the pandemic.

With a sharp economic recovery in sight in the second half of the year, a broader bounce in each asset class may occur.

Also, while inflationary pressures are building, in a structurally lower rates environment, investors may need to take more risk to earn long-term real returns.

Aligned on inflation expectations

The Reserve Bank of India (RBI) may be channelling liquidity and targeting stable interest rates across the curve that are also conducive to sustainable domestic growth. That said, financial markets are likely to remain on a tightrope depending on inflation data and inflationary expectations.

In the near term, the market and policymakers seem to be aligned that inflation is likely to be transient and addressable through counterbalancing factors such as unemployment, stabilising pent-up demand and supply-side catch-ups.

Time to review asset allocation

With the recovery and run-up in Indian equities over the last year or so, it may be time to review asset allocation and rebalance as required. Also, within this allocation, it may be worth increasing the risk allocations in each asset class using a "core/satellite" strategy, with the satellite portion representing higher risk strategies.

To mitigate the potential volatility in satellite portfolios, especially from any risk-off triggers globally or domestic headwinds, we suggest staggering allocations over coming months and maintaining appropriate portfolio diversification.

As an example, an investor who invested at the then peak of India's S&P BSE 500 index of listed companies on 7 January 2008, earned around 6.9% a year compound annual growth rate (CAGR) by 15 June 2021. Instead, investing at the following bottom of the market on 9 March 2009, in the aftermath of the global financial crisis, delivered around 17.5% CAGR over the same period.

While catching the top or bottom of the market may only be possible in the hindsight, staggering investments monthly starting from the top of the market in 2008 until the bottom of it in 2009 produced a CAGR of around 12.5% over the same period.

Active management is key

Active management remains key for core portfolios, due to high valuations and the low margin for errors when pricing in longer projections. For satellite portfolios, the same holds with a large bottom-up universe to select from and a relatively fragile, and evolving, environment, limited visibility, early versus late cyclicals, supply-side catch-ups versus the demand-pull ones and cost pressures among other factors.

Active management in such portfolios is advisable not just for diligence and when selecting how to allocate, but also to monitor and timely exit, rotate or book profits.

Quality in vogue

In Indian equities, we continue to suggest sticking to quality businesses and a resilience bias in the core portfolio. It includes companies that may thrive using their pricing power and adding to market share, even when their margins might come under pressure from:

- Inflation/input costs (such as labour cost) pressures; and
- Financing cost pressures (rates increase as well as spreads widening)

These companies also tend to have a long-term, stable investor base (that is, are well placed to withstand money outflows due to general market risk-off events).

Satellite equity portfolios might comprise of small and mid-cap portfolios and cyclicals (including the pandemic-led late-cyclical sectors like automobiles, retail, leisure, travel and tourism).

Capex cycle
We expect the Capex cycle to kick in faster than some forecast due to formalisation of the economy. While this process had started post demonetisation in 2016, the goods and services tax (GST) implementation in 2017 and India's credit crisis in 2018, the pandemic seems to be accelerating it.

The weaker and vulnerable businesses are giving way to more "organised" ones. This has led to a faster Capex cycle as these organised players need to scale up supplies quickly. Vulnerable companies' idle capacity may not be fully acquired/utilised by stronger peers that would rather create capacity on their "cleaner" books.

Unlisted opportunities
Apart from the small and mid-cap opportunities in the listed universe, opportunities in the unlisted space continue to attract attention, especially in late-stage venture capital, private equity and the pre-listing market. The acceleration in the progress made by domestic technology and tech-enabled businesses during the coronavirus era is expected to keep the primary markets abuzz for years to come.

High-grade corporate debt appeals
In Indian debt, we continue to suggest keeping core portfolios invested in high-grade corporate bonds of up to 5-year maturities, through a mix of actively managed and roll-down strategies. The still steep rates curve seems to offer enough carry to compensate for any residual duration risk in roll-downs.

We reiterate our stance that the RBI will support the bond markets through its policy stance, liquidity and rate stability across yield curves. With the inflation prints and higher bond supply in the market, however, portfolio volatility may remain elevated.

Time to nibble at mid-yield, high-yield and structured credits
With the broader economic recovery, it may be worth building a satellite fixed income portfolio across mid-yield, high-yield and structured credits. Our preference in the non-AAA segment remains towards credit/perception upgrade candidates and in sectors standing to profit from government policies and economic revival. Such sectors include roadways, infrastructure, power and select non-banking financial companies with a focus on housing finance and micro, small and medium enterprise lenders.

Residential real estate-backed debt, by marrying high yields with appreciating collateral values, looks well positioned to profit in the transition phase. Once again, selection, diversification and monitoring remains key.

Global exposure broadens the opportunity set
The different growth profile of the largest economies, especially in recent quarters, highlights the importance of global equity exposure (both across public and private markets) for Indian investors.

Besides the opportunity to participate in external markets, like US equities or Asian emerging markets, the approach can allow you to consider investing in opportunities expected to prosper from the new normal across the technology spectrum. Although not our base case in the short term, such exposures would profit from any rupee depreciation, perhaps caused by worsening inflationary risks.

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Go further,
Reach higher,
See beyond.