Private Clients

Market Perspectives

June 2021

BARCLAYS

Foreword

Euphoria has subsided in financial markets and renewed signs of inflationary pressures are challenging investors' assesmment of the outlook. While we are positive over the medium term, volatility is rising and tougher times may lie ahead for risk assets.

In this context, consumer confidence remains a bright spot in large economies, aided by vaccine rollouts and easing of restrictions. With incomes holding up well through the pandemic and bulging excess savings, we see opportunities in consumer discretionary and services providers as pent-up demand gradually comes through.

Equities seem to be at a tipping point after recovering from last March's pandemic lows. What happens next may depend on inflation. In this context, active management, diversification and investing in quality companies appeals. Further, exposure to private markets and options could help to hedge the risk of volatility spikes.

Similarly, in fixed income all eyes are on the recent jump in inflation and how the US Federal Reserve (Fed) responds to it. The Fed's patient approach may lead to more volatility. While we could see rates as high as 2% temporarily, a 1.6-1.7% range is more likely in our view. With the prospect of higher prices, inflation-linked bonds seem like an attractive long-term proposition.

After an 18% surge in the Bloomberg spot commodity index this year, talk of a potential commodity supercycle abounds. Base metals appear to be driving the resurgence in prices. Metals like copper and platinum are leading the charge, aided by their usage in renewable energies. The outlook for copper prices looks particularly favourable, whether this is a supercycle or not.

Finally, sustainable investing is as popular as ever. Inflows into sustainable European funds hit a record €120bn in the first quarter of the year, according to Moody's. If there is a fly in the ointment, it's a haphazard use of different terms, like ethical or sustainable. Consistent usage and a focus on helping investors to find opportunities in terms of financial and sustainability outcomes seems a sensible approach.

Jean-Damien Marie
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Can consumers drive the post-COVID recovery?

Positioning portfolios for the post-pandemic economic recovery seems vital. Growth prospects appear encouraging. Starved of spending opportunities, consumers look set to hit the high street. But sectors likely to prosper may not be those that have suffered most.

The global economy suffered its worst performance since the Great Depression last year. A slump in household demand was a key element of the contraction as lockdown restrictions were implemented. However, there are increasing hopes that the reopening of economies and unleashing of pent-up demand will generate a powerful consumer-led recovery.

Steady personal incomes and cash hoarding

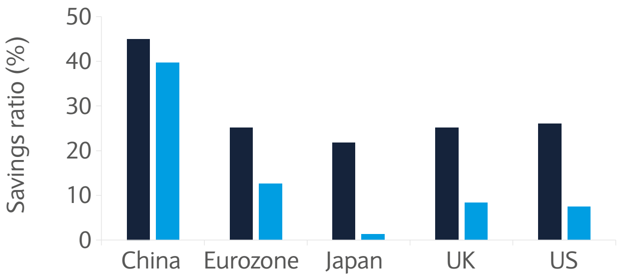
Despite the dramatic fall in output last year, personal incomes have remained relatively steady during the COVID-19 pandemic. Household balance sheets were stabilised by government job retention schemes, extended unemployment benefits and stimulus cheques.

Personal incomes in the US surged 21% in March, month on month (m/m), reflecting the changes in government social benefits. Additionally, historically low interest rates allowed home owners to refinance their properties and reduce monthly payments.

Consumers in the world economy are estimated to have accumulated excess savings of nearly $5.4tn according to credit rating agency Moody's data[1].

There are three major reasons why the cash hoard has developed. Firstly, forced savings: the closing of non-essential retail, as well as travel and leisure options, stopped consumers' ability to spend their money even if they wanted to. Secondly, higher precautionary savings: nervous consumers have been concerned about rising unemployment so have been increasing their financial safety net. Thirdly, the fiscal transfer: the rise in household savings is the counterpart to government deficits.

Figure 1: Savings ratio soars during the pandemic
The peak savings ratio in 2020 compared with its ten-year average for China, the eurozone, Japan, UK and US



■ Savings ratio (peak in 2020)
■ Savings ratio (10-year average before 2020)

Sources: Datastream

Excess savings: where's the money?

With an extra $2.6tn (12% as a share of GDP) squirreled away in bank accounts, the US is estimated to account for the large portion of the excess savings. Concerns around the medical and economic outlook in Europe encouraged people to save their money at record rates last year (see figure 1). The European household saving rate surged to 25% between April and June last year. Indeed, savings ratios were much higher last year than their average in the ten years to December 2019 in many leading economies.

[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

The accumulated savings are not spread evenly across income groups. Higher earning households have saved considerably more than less wealthy ones. This may infringe on growth prospects, as wealthier households' marginal propensity to consume tends to be considerably less than their poorer counterparts.

Rising consumer confidence

Improving sentiment surrounding vaccination programmes, the reopening of the services sector and the flow of fiscal stimulus has been reflected in recent retail sales and consumer confidence data. US retail sales boomed in March, rising 10.7% m/m and remaining at the same elevated level in April. Similarly, the Conference Board's index of consumer confidence rose to a fresh one-year high in April.

UK consumers are also feeling more positive. The GFK UK consumer confidence index recently rose to its highest level since the UK economy went into lockdown in March 2020. Eurozone retail sales registered an impressive rise in March too, up 2.7% m/m, equating to a 12% annual increase.

Risks to the consumer recovery

There are still reasons why households may hold their money for a while longer. More cautious households might use the money to pay down debt or increase their safety net until the pandemic finishes or labour market conditions improve.

If coronavirus variants reduce vaccine efficacy rates and the recovery starts to stall, then consumer confidence could quickly deteriorate again.

The labour market recovery is key to consumption growth. As such, the return to work rate will be closely monitored by economists as governments withdraw furlough programmes. Rising price pressures could also reduce real disposable incomes and raise fears of an earlier hike in rates than expected.

Encouraging growth prospects

Moody's estimates that the global figure for additional savings since the pandemic is more than 6% of gross domestic product[2]. If consumers were to spend a third of that, it would boost global output by two percentage points both this year and next.

The Bank of England has raised its 2021 growth forecast to a post-war high of 7.25%. This stronger growth profile is partly on the assumption that UK consumers will spend more of their £200bn of accumulated wealth than previously projected over the next year. Barclays Investment Bank forecasts that private consumption in the US will grow 8.1% this year, helping to propel growth in the world's largest economy to above 7% in 2021.

We are of the view that the global vaccination programmes will help to arrest the virus, central bankers will look through any short-term spike in inflation and labour markets will recover (albeit at an uneven pace). Consequently, consumer confidence should continue to improve and support growth prospects.

Sectors where consumers likely to spend

When trying to capitalise on the global consumers' war chest, investors may gravitate around the consumer discretionary sector. However, globally, this sector has already doubled from its pre-pandemic levels, raising questions as to where opportunities might lie.

With most households confined to home and so less likely to consume services, it is not surprising to see online retailers, home improvement stores and luxury companies being the main contributors to this outperformance. On the other hand, many companies exposed to the travel and leisure industry, including restaurants, have lagged significantly.

With economies reopening, international travel gradually resuming and consumers starting to spend more on services, these would appear to be well positioned to benefit. On the goods side, apparel will most likely enjoy the strongest rebound as consumers feel the need to buy clothes again.

Focus on balance sheets, not price charts

For all the opportunities in the recovery, we don't think the market has missed something here. The fact that the shares of many travel-exposed companies remain well below their pre-pandemic level is, in part, justified in our opinion. Indeed, many had to raise capital, either equity or debt, to survive over the past twelve months.

As a result, while revenues and profits for travel-exposed companies may recover relatively quickly, the shift in their capital structure justifies lower valuations. In this context, we believe investors need to proceed with caution and avoid bottom fishing.

In consumer discretionary, services providers with solid balance sheets look preferable. Alternatively, investors should consider payments companies, as they stand to benefit irrespective of where the money is spent. Finally, in case consumers decide not to spend but to invest, asset managers could profit.

[2] 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

Julien Lafargue, CFA, London UK, Chief Market Strategist

Positioning for more volatile equity markets

With economic warning signs flashing and inflationary pressures building, volatility may spike. Equities appear to face a tougher few months too. Investing in private markets, to improve diversification, and volatility-related options may be part of the answer.

We suggested that investors should reduce cyclical exposure in portfolios as the pace of the recovery was likely to slow in May's Market Perspectives. Since then, volatility has picked up, global equity markets have been range-bound and the macroeconomic data have deteriorated versus elevated expectations.

We expect more of the same during the next few months and see benefits in thinking differently than usual when constructing portfolios.

More challenging period as warning signs flash

As expected, while the macroeconomic picture remains encouraging in absolute terms, recent data have failed to match expectations, especially in the US. Worse, some parts of the global economy are flashing warning signs as inflationary pressures build faster than expected (see figure 1).

Furthermore, the shine has started to come off of previously very popular and speculative assets such as cryptocurrencies and special purpose acquisition companies. As the widespread euphoria dissipates, the next few months may prove more challenging.

Focus on inflation

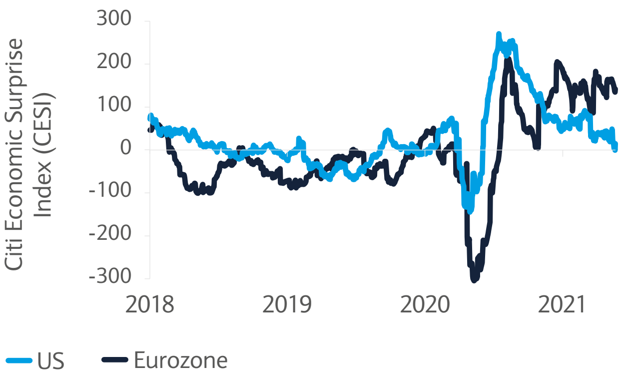
Equities find themselves at a tipping point following their rally from the pandemic lows seen last March. What happens next will likely be decided by inflation and whether, as the US Federal Reserve expects, the recent jump in consumer prices will be "transitory".

While there is debate about what transitory really means, economies seem unlikely to enter a period of sustained and higher inflation fueled by a sharp increase in wages (see What next for inflation as the Fed holds steady?, p8).

As such, we remain broadly constructive on equities, especially versus bonds. That said, volatility should remain elevated as central banks are likely to remain patient before committing to their next move.

Figure 1: Less positive economic surprises

The trend in the Citi Economic Surprises Index since 2018. A reading above 50 suggests that economic data have been beating consensus, one below 50 suggests the data has been below consensus



Source: Citi, Bloomberg, Barclays Private Bank. May 2021

Ignore the rotation, focus on quality

Many commentators remain fixated on the "value versus growth" debate and if investors should own one or the other. As we have mentioned previously, we don't believe in this debate. Year-to-date, global value – as illustrated by the MSCI World Value index – has outperformed its growth counterpart by 11%. However most of this outperformance materialised in the three weeks between 15 February and 8 March.

Since then the performance differential between value and growth has not been too significant. This shows how difficult it can be to capture these moves. In addition, on a 10-year basis, growth is still outperforming value by 130%. As such, for long-term investors, sticking with companies offering superior growth appears a more rewarding strategy. Our stance remains unchanged with a strong preference for quality over any other factor.

Positioning for volatility ahead

In the current context, relying on high-conviction active management seems appropriate to navigate what is likely to be an uncertain summer. In addition, with volatility having jumped recently, now seems a good time to revisit portfolio construction and think "outside the box" to improve the risk/reward profile of equity exposure.

In practice, investors might consider three different approaches: improved diversification, increased exposure to private markets and using options.

Improving diversification

With bonds providing little cushion during inflation-driven risk-off moves, the typical 60/40 portfolio is being challenged. Adding uncorrelated assets can help to diversify portfolios further and aim to reduce downside capture.

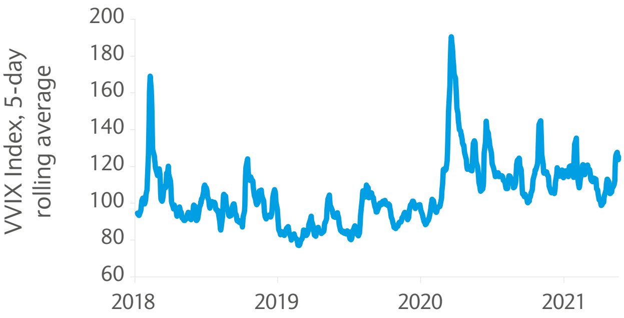
In looking for appropriate uncorrelated assets, certain alternative strategies with limited directional exposure may help. Similarly, maintaining a balanced geographical and sectorial exposure can provide added diversification benefits. Here we reiterate our view around a barbell approach between US and Asian equities together with a focus on healthcare, technology and part of the industrials and consumer discretionary complexes.

Going private

Similarly, when possible, increasing exposure to private markets can help dampen portfolio's volatility by removing the need for immediate mark to market. Additionally, with a much larger opportunity set compared to public equities, private markets can help investors fine-tune their exposure and capitalise on otherwise unavailable opportunities. As a result, it's unsurprising to see that, private assets have tended to contribute positively to overall returns in the long run.

Figure 2: Volatility picking up of late

The performance of the CBOE VVIX Index five-day rolling average since 2018 economic expansion to come, one below 50 hints at a period of contraction



Source: Bloomberg, Barclays Private Bank, May 2021

Note: The VVIX is a volatility of volatility measure in that it represents the expected volatility of the day forward price of the CBOE

Making volatility your friend

While volatility is often feared, we believe that investors should embrace it and look for ways to profit from it. With higher volatility comes investment opportunities, whether in the form of better entry points in high quality stocks or more attractive payouts in options market.

Indeed, as uncertainty abounds and implied volatility increases (see figure 2), so does the value of certain options, all else being equal. This makes it a great time for investors to sell this volatility for a higher premium. Such additional performance can be used to boost portfolio returns or finance protection against a large pull-back in equities.

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

What next for inflation as the Fed holds steady?

Financial markets seem gripped by inflation risk. Default and downgrade risk remain in the early stages of the recovery though the risk seems to have declined. However, rate volatility appears the dominant factor ahead and the Fed's "holding the line" patient approach may lead to more of it.

Inflation print just tip of the iceberg?

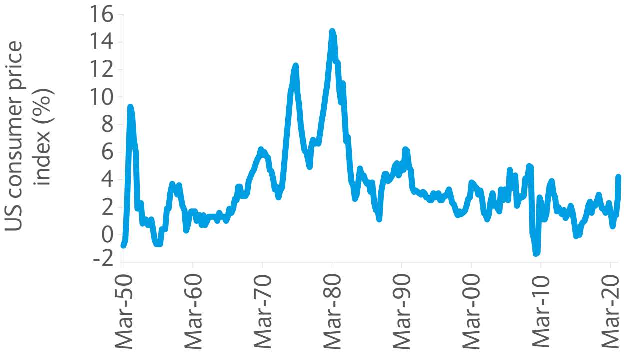
The big bond market puzzle is around the question of whether the recent surge in US inflation, and elsewhere, is transitory or just the beginning of a higher inflation era.

April's US inflation jumped the most since 1981 on a month-on-month comparison (0.92%) and the most since 2008 on an annual basis (4.2%). This was also the biggest overshoot compared to consensus since 1996 (see figure 1). And for the first time since records began, according to Bloomberg, the print was above the highest consensus estimate. It seems that even the most bearish economists have underestimated the inflationary forces in play.

What a high number does not tell, is whether the surge in inflation is transitory or if the acceleration is part of a secular trend change. Given the importance of inflation expectations to the bond market, a closer look at the drivers of it seems justified.

Figure 1: US inflation shoots up in 2021

The trend in US the consumer price index, year on year, since 1950



Sources: Bloomberg

The six main inflation drivers

The April inflation surge was largely driven by a sharp rise in household energy prices, airline fares, lodging from home and the prices for used cars. Various forces appear to have affected the print. Therefore, categorising the inflationary drivers seems warranted to make a better judgement. The following list is by no means exhaustive, and most driver categories are likely to be connected in some way:

1. Base effects
2. Pent-up demand and bottlenecks
3. Business cycle
4. Fiscal and monetary situation
5. Structural changes
6. Environment-related costs

The hike in the energy price component can be easily explained by base effects given the depressed prices witnessed a year ago. These base effects are also likely to be dominant in the next readings and will likely occur in other parts of the economy pushing inflation further up.

The increase in airline fares and lodging from home can be associated with the pent-up demand which is also likely to be a dominant factor in the next quarters as economies are opening up gradually. In the case of airlines, fares would still need to increase by almost 20% before catching up to pre-crisis levels while lodging from home is still another 8% away from its pre-crisis levels.

Pent-up demand is likely to be supported by excess savings of around \$2.6tn in the US[1] and given that around 20% of that cash could be spent in the economy, helping to power the recovery.

[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

Bottlenecks everywhere

Higher demand is meeting supply constraints and the increase in used car prices is a perfect example of that imbalance. Inventories for motor vehicles and parts fell by 16%, according to the Bureau of Economic Analysis. This was exacerbated by the shortage of chips. This shortage directed demand to used vehicles.

Companies have pointed to supply constraints in most industries and it is likely to be a main driver of inflation in the coming quarters. The constraints may also be witnessed in the labour market in coming quarters. Given the US government's relatively generous fiscal aid packages, transition back to employment might be slow, putting pressure on wages (see figure 2).

Backwardation in the commodity markets, whereby spot prices are higher than future prices, is also a proof of the supply bottlenecks at the moment.

Transitory versus persistent

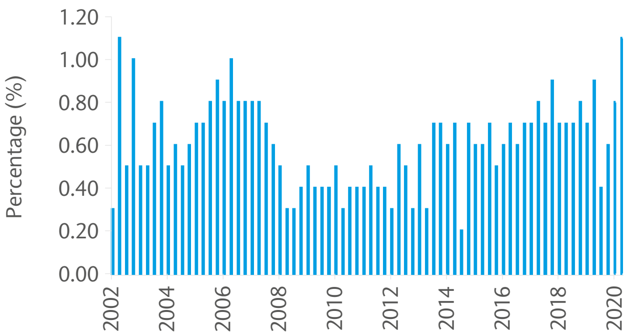
Most of the described inflation factors can be classified as transient in nature as demand should moderate and supply may adjust relatively quickly. Such a rebalancing usually pulls inflation down in the subsequent periods of higher prices, one of the main reasons why most economists and central banks believe inflation towards 2023 will moderate again. Consensus shows the US consumer price index coming back under 3% by the first quarter of next year and averaging 2.3% in 2022, which seems realistic.

In fact, US Fed Vice Chair Richard Clarida reinforced the message in May: "One-time increases in prices are likely to have only transitory effects on underlying inflation, and I expect inflation to return to – or perhaps run somewhat above – our 2% longer-run goal in 2022 and 2023."

There is a risk that that even a temporary period of higher inflation could be amplified by a stronger than anticipated business cycle, the third factor as mentioned earlier. A stronger recovery beyond the catch up to pre-crisis levels has the potential to support consumer demand and economic output building up additional inflationary pressure.

The fiscal package signed off by the Biden administration of over $4tn ("build back better") is likely to lead to such additional demand. However, most economic and inflation forecasts have already encountered the additional infrastructure stimulus while the stimulus may not be as

Figure 2: Accelerating US wage inflation of late
The quarter-on-quarter change in US private sector wage inflation since 2002



Source: Bloomberg

inflationary given it is spread over several years. Business cycle-related inflationary pressure, as described, would be likely detected in the labour market as well as in shelter price level trends.

Are the 1970s back?

These risks are often highlighted by the so-called "inflationistas" who think that we are entering an era of structurally higher inflation. Some economists, like Larry Summers, have pointed out the combination of excessive monetary growth and high fiscal deficits which is reminiscent of the 1970s, when inflation jumped to over 14%.

As we've previously written, the correlation between a large level of debt, high monetary growth, inflation and higher rates was not obvious in the past and even negative at times. It is also important to stress that the record fiscal deficit is likely to fall again towards 5% by 2023 which would reduce the pressure for rate rises over time.

What is clear though is that apart from the fiscal deficit (Vietnam War, great society programme) monetary policy errors were committed back in the 1970s, which even the Fed acknowledged. First, the central bank did not challenge strongly enough the then prevailing "even-keel policy" which prohibited rate hikes during treasury debt issuance. Second, the Fed and most economists failed to recognise the Philips curve – the trade-off between unemployment and inflation – had broken down, as higher inflation did not lead to higher employment in the end.

Too early to conclude the long-term outlook

Structural changes such as new global supply chains and technological advancements are likely to have an impact on inflation, but it seems less obvious whether these factors are going to be inflationary or disinflationary over the longer term.

In addition, the planned energy transition and increased focus on environmental sustainability may increase inflationary pressures over the long term. But new technologies and processes may equally lead to more efficient production processes which may ultimately put a cap on inflation. We would therefore be cautious to conclude that structural changes and a stronger environmental focus will lead to an excessive inflationary environment.

In conclusion it seems likely that inflation will increase substantially over the coming months due to the transitory effects as described. In addition, there is a risk that cyclical factors may add to the inflationary trend. However, it seems impossible to predict where inflation will be in the long run and if the current environment will lead to a trend change of the disinflationary environment witnessed over the past decades.

Fed is "holding the line"

What can be expected from the central bank and policy rates in this context? In the past, market participants have been sensitised to higher policy rates leading to higher rates along the yield curve. This time the concern is that the Fed is pursuing the strategy of "holding the line" (like in the movie Gladiator) for too long with low rates providing the feeding ground for excessive inflation subsequently.

The Fed defends its positioning by reiterating that inflation and dynamics are well understood today, contrary to the 1970s. Apart from the higher tolerance for inflation, the Fed seems to have a strong focus on the labour market.

In hindsight, the Fed may have accepted that the last hiking cycle was too sharp and quick for the labour market (despite low unemployment rates) given the existing "slack". With this in mind, the central bank will likely hold the line longer than for most market participants liking.

The Fed's envisaged policy rate path, shown in its latest dot plot estimates, does not include a hike in 2023. There is a strong likelihood that with higher inflation, the dot plot for 2023 may show a first rate hike in the coming months given that only two additional voting members would need to envisage a hike. This is unlikely to spur the bond market as the market already implies a first move by March 2023.

Further rate volatility likely

Rates could, however, face renewed volatility as we approach the start of the tapering of the existing bond-buying programme.

The Fed might become more vocal in August/September with first action as early as March/April 2022 and by the latest when the Fed has evidence of "substantial progress" in the labour market. While volatility could lift rates as high as 2% temporarily, a range of 1.6%-1.75% seems more likely in our view.

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

Are inflation-linked bonds the ideal hedge?

With US inflation rising and investors increasingly focusing on inflation risk, investing in inflation-linked bonds appears to be one solution to hedging against higher, persistent inflation.

Inflation-linked bonds in focus

Recently, higher rates have been driven by stronger trending breakeven yields (market-implied inflation). In earlier publications we noted that breakeven rates seem highly correlated with investor sentiment rather than actual inflation.

With the 10-year breakeven inflation rate now at the highest level since 2013, the question is whether the level will be matched by real inflation over the longer term and if inflation-linked bonds are still a good hedge against rising inflation.

Tourists investors have discovered inflation linked bonds

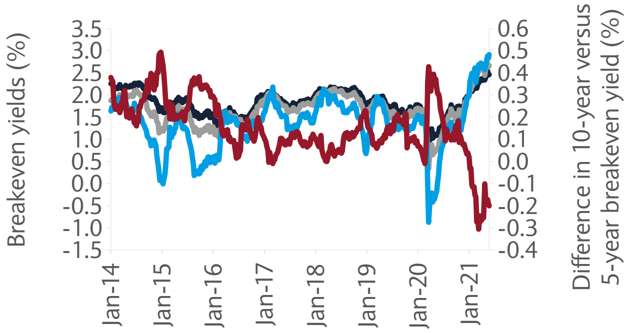
Demand for inflation-linked bonds is typically found from pension funds and asset managers and is generally quite sticky. That said, recent inflows, as indicated by exchange-traded flows, into inflation-linked bonds were also driven by retail and tactical investor demand.

This extra demand has come at a time when the Fed has increased their holdings, now owning around a quarter of US inflation-linked bonds from 10% at the end of 2019. Another sign that the inflation trade, at least in the short term, seems crowded is the fact that inflation swaps volumes have increased by 40% (commonly used among tactical hedge fund investors) compared to pre-crisis levels.

A closer look reveals that even investors seem to be placing more weight on the transitory nature of inflation. While in the past breakeven yields of longer tenors, like 10-year bonds, were trading above the shorter tenors, this year the breakeven yield curve has been inverted (see figure 1). The 2-year breakeven trades roughly 30 basis points (bp) higher than the 10-year breakeven rate, implying that inflation is likely to moderate again. The potential to earn "fast" money by investing in short tenors seems limited.

Figure 1: Breakeven rates inverted

US breakeven yields for 2-year, 5-year and 10-year bonds since 2014



US Breakeven 10 Year (LHS)
US Breakeven 5 Year (LHS)
US Breakeven 2 Year (LHS)
Difference: US Breakeven 10 Year – US Breakeven 5 Year (RHS)

Sources: Bloomberg

Focus on 2.5% inflation threshold

Over the last 20 years breakeven yields seem to have overpriced realised inflation in the following years (see figure 2, p12).

Admittedly realised inflation trended lower in the respective period. If a period of inflation persists of above the central bank target of 2%, 10-year inflation-linked bonds are likely to outperform their nominal counterparts. This is illustrated in the past performance of inflation-linked bonds plotted against nominal government bonds in different periods of inflation over the last 20 years.

An attractive proposition

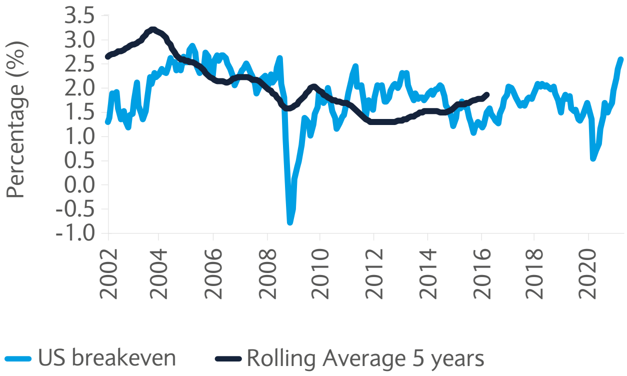
In periods of above-target inflation, some of the investment rationale for inflation-linked bonds lies on their performance against nominal treasuries (see figure 3). The grey-shaded area shows US inflation deducted by 2%, given this was and is until now the average Fed inflation target. Only in periods when inflation averaged persistently well over 2% have inflation-linked bonds outperformed nominal sovereign bonds.

While inflation has only recently started to increase and while it is still not clear whether inflation will stay at around 2.5% or higher for long, inflation-linked bonds are already anticipating such a move. This suggests that inflation-linked bonds are generally rich in pricing.

However, in the longer term, the performance of inflation-linked bonds at least matches sovereign bonds and with the additional potential of "known unknowns" inflation linkers might warrant consideration.

Figure 2: Realised inflation often undershoots expectations

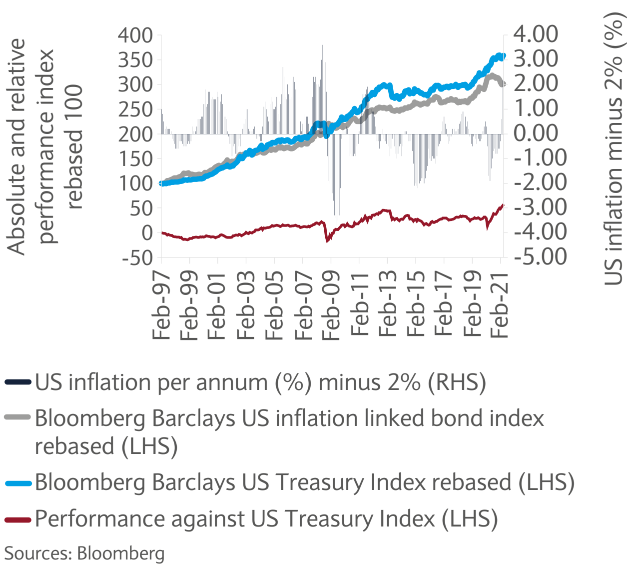
The 10-year breakeven yield versus the rolling average US inflation in subsequent five years, since 2002



Sources: Bloomberg

Figure 3: Linkers outperform mainly in higher inflation phases

Performance of US inflation-linked bonds against treasuries and inflation (excluding the 2% central bank target) since 1997



Sources: Bloomberg

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

Is it time to use leverage in bond investing?

As bond investors look for ways to optimise returns for acceptable levels of risk at a time of low rates, leveraged bond investing may be one way to achieve this.

Investing in bonds is increasingly challenging as a result of record low yields in most bond segments (see figure 1). In seeking to improve yields, investors may be tempted to compromise on the quality of their bond investments. This carries extra portfolio risks.

Best of both worlds

By using securities lending, higher returns can potentially be achieved without compromising on the credit quality In addition, securitised lending can provide more portfolio flexibility in managing liquidity, potentially useful at times of heightened volatility and in order to avoid selling investments at distressed prices.

At the same time, additional lending increases loss potential given the leveraged exposure. An understanding of how lending can help and what risks are involved is paramount.

Leverage in this context describes using additional borrowing in order to fund part of the investment portfolio. This results in “leveraged” exposure to the investment portfolio given not only is an investor’s own capital used but also additional borrowed capital, which comes at a cost. Given the leveraged exposure, the loss (risk) and return potential are greater compared to an unlevered portfolio using only own funds. The following sections explain the basics when using borrowing when investing in fixed income portfolios.

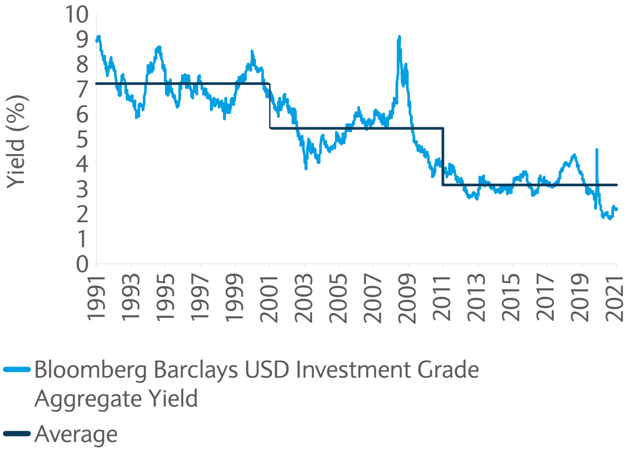
Leveraged bond investing: main considerations

Many factors come into play when combining additional borrowing with bond investments. The key elements include the borrowing allowance which is dependent on the lending value percentage of the bonds serving as collateral. This percentage in turn is determined by the quality and level of liquidity.

Meanwhile, the level of the borrowing cost depends on market rates and the composition of the collateral portfolio.

In this context, rising borrowing costs could have the effect that leveraged returns can decline or even become negative.

Figure 1: The slide in bond yields
Trend in Barclays US aggregate bond index investment grade yields since 1991



Source: Bloomberg

It also seems important to consider the leveraged exposure which can lead to leveraged profits but also to higher loss potential compared to non-levered portfolios.

Portfolio effect

Using leverage does not change the approach of investing as return and risk should always be considered. By using leverage, and by considering the important additional risk factors, portfolio return and flexibility can potentially be increased, helping investors to target their long-term goals despite persisting low rates.

You can find out more about how leveraged investing might help you in our next education series, to be published later in June. The series looks at the basics of the approach and its potential effects on portfolio dynamics while examining the most important factors to consider when using additional borrowing.

Jai Lakhani, CFA, London UK, Investment Strategist

Commodities: remaining selective

Commodities are a hot topic for investors. The demand, supply and inventory dynamics potentially point to the early stages of a supercycle, with base metals such as copper touching all-time highs. Is now the time to invest in commodities?

Commodities are grabbing the headlines. Their performance has been quite extraordinary, with the Bloomberg spot commodity index up 18% this year. Whether or not we are entering a commodities supercycle, is it still worth upping exposure to the asset class?

As we discussed in April's Market Perspectives, a supercycle is an extended period during which prices are well above their long-term trend as a result of unexpected demand. This is often further reinforced by a delayed response on the supply side as producers weigh up the momentum of demand and then ramp up capital expenditure (Capex).

In order to address the question of whether a supercycle is in fact underway, the whole commodities complex should be evaluated.

Dissecting performance

Commodities can be broken down into base metals, energy and soft commodities. Across all three sub-sectors, explaining the strong performance thus far has been exceptional demand as a result of the global recovery, vaccine distribution allowing economies to reopen and, at the same time, weak supply.

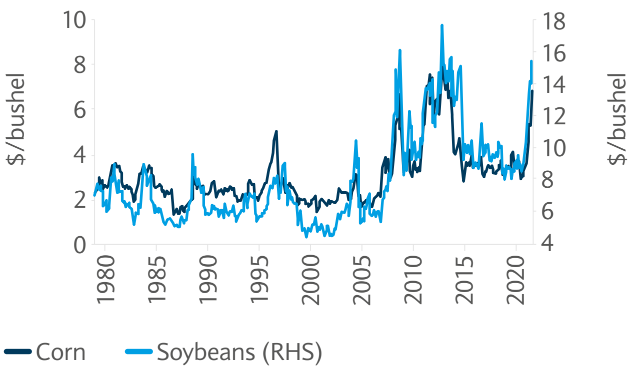
Soft commodities have been boosted by many countries building up food reserves. China drove strong demand for pork, beef, corn and soybeans (see figure 1) while the relatively dry weather in South America lowered crop yields for soybeans and corn.

Remain prudent on oil

On the energy front, oil too has benefitted from the aforementioned demand factors plus OPEC+, the Organization of the Petroleum Exporting Countries and allied oil exporters, committing to cuts in production. Supply restraint has also been seen in the US, with most oil producers guiding to keep output flat this year preferring to reward shareholders rather than expanding capacity. Additional factors contributed including the recent cyber-attack on Colonial Pipeline facilities in May and Texas facing the coldest temperatures in 30 years in February.

Figure 1: Agriculture commodity prices hit multi-year highs

The trend in corn and soybean prices since 1980



Source: Refinitiv Datastream/Barclays Private Bank

We highlighted in April that while we were constructive on oil due to strong demand, supplier restraint and increased regulation on the sector, significant upside appeared limited.

Our conservatism was based on expectations that much higher oil prices would eventually impede the recovery. At the same time, as inventories were becoming stretched, there is increasing incentive for countries such as Russia to deviate from their agreement with OPEC and for US shale producers to bring production back online. Finally, the COVID-19 situation in India was also likely to weigh on demand in the short term.

Brent crude approached $70 a barrel earlier in the second quarter (Q2) but has since moderated to trade at around $65 a barrel. With Brent and West Texas Intermediate likely to average $66 and $62 a barrel respectively for the year, and Brent surpassing the $70 a barrel mark in Q4, we remain prudent.

Base metals lead the charge

At the heart of the recent commodities rally lies base metals. Demand has surged for this group of commodities as countries around the world announce significant infrastructure investments to support the post-COVID-19 economic recovery (see figure 2).

The importance of copper

In addition to this cyclical boost, demand for metals such as copper, platinum, lithium and cobalt has profited from a renewed and increased focus on transitioning to renewable energy.

Copper has experienced one of its strongest bull markets in recent months. The metal is used extensively across domestic and industrial products (see figure 3) and is at the forefront of infrastructure investment, especially around renewable energy. Indeed, copper's ductility, electrical and thermal conductivity and low reactivity make it essential in most green technologies such as geothermal, solar and wind.

Demand-supply imbalances likely

While substantial infrastructure investments from China (which accounts for 58% of global copper demand), the US president's $2.2tn infrastructure spending plan and the upcoming European green deal have boosted demand. Copper supply has also been under pressure.

Supply growth had been broadly flat over the last five years and the pandemic exacerbated the growing imbalances. Chile, the world's largest exporter of copper, suffered from significant coronavirus outbreaks last year and its Escondia mine (the world's largest) saw production drop 8% in the nine months to end of March 2021.

At the same time, with the uncertainty surrounding the shape of the recovery, Capex plummeted last year. Despite the recent surge in demand, energy consultancy Wood Mckenzie notes that producers still lack conviction with regards to capital spending plans. As a result, depleted inventories can now only cover about three weeks' worth of current demand.

While a slowing credit impulse would suggest that demand from China may slow, the metal is still likely to remain in deficit for the foreseeable future. Scrap supply, often seen as a source of supply able to alleviate price pressures, makes up only 25% of total supply and seems unlikely to move the needle.

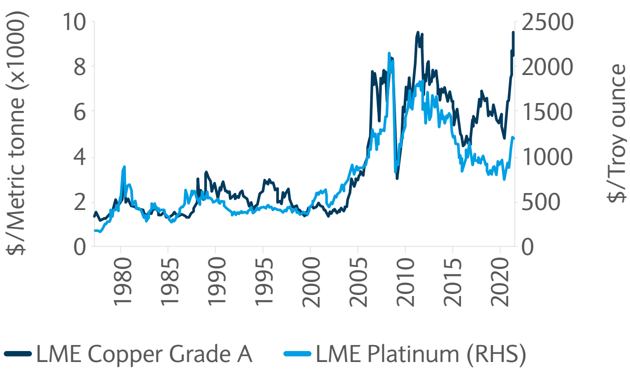
Renewables boost

Furthermore, in the long run, the outlook for copper demand appears favourable. In particular, renewable energies, which account for just 3.5% of total production, are likely to see strong growth. In its road map to net zero emission by 2050 published in May 2021, the International Energy Agency (IEA) suggested that to meet the goal of keeping the rises in global warming below 1.5 centigrade, the value of critical metals would have to be multiplied by more than 10 and that copper alone would see its value increase fivefold[1].

It is estimated that each megawatt of solar electricity capacity requires five tonnes of copper while onshore and offshore wind farms require 4.3 and 9.6 tonnes per megawatt, respectively.

Figure 2: Base metal prices hit record highs

The performance of copper and platinum prices since 1977



Source: Refinitiv Datastream/Barclays Private Bank

What's more is that there are no real substitutes to copper. Its closest substitute, aluminium, is much less efficient in terms of thermal and electrical conductivity.

Thankfully, from a macroeconomic perspective, copper constitutes only a small share of the global economy and thus, higher prices are unlikely to impede the global recovery or add to inflationary pressures.

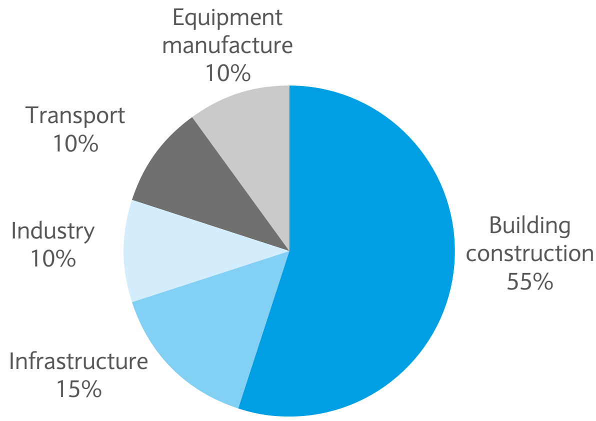
Upbeat outlook for commodities, especially copper

Whether we are entering a supercycle or not remains hard to tell. While demand is strong and exceeding supply, it is likely to be met with increased production over time and so prices should level off eventually.

In the medium term, and regardless of whether we are in a supercycle, there are reasons to be constructive on commodities and particularly around base metals such as copper.

Figure 3: Main uses of copper

The split of copper usage between building construction, infrastructure, industry, transport and equipment manufacture



Sources: Copper Alliance, Barclays Private Bank

[1] IEA, Net zero by 2050, a roadmap for the global energy sector, May 2021 https://www.iea.org/reports/net-zero-by-2050

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Private markets: the ultimate frontier?

As we enter the post-pandemic era for investors, the traditional portfolio of equities and bonds could face some key challenges. For those focused on obtaining longer term returns, could private markets provide a solution?

Continuing to invest in a traditional 60% equities and 40% bonds split may face significant challenges over the next five years. The reasons for this appear to be a combination of strong expectations around the economic recovery, record fiscal stimulus, amid bloated government debt levels, historically low interest rates and the risk of higher inflation.

Historically low yields and rising inflation weigh on expected returns for developed market bonds via two channels – weak income return prospects and limited capital appreciation potential. While accommodative monetary policy should continue to support equity returns, returns will likely face pressure due to uncertainty, peaking economic momentum and expensive valuations.

Thus, the next five-year investment horizon will likely entail lower returns on main asset classes than history suggest.

Stabilising portfolios and fighting inflation

May's Market Perspectives showed that during periods of higher inflation, the correlation between equities and fixed income becomes positive which means from a diversification standpoint, the traditional portfolio could fall short.

Building a well-diversified portfolio can substantially reduce risks and enhance risk-adjusted returns. Therefore, it could be time for investors to rethink their optimal asset allocation policies to address the issue of lower returns and higher uncertainty. The most efficient and flexible way to improve on traditional 60/40 portfolios is to consider inclusion of other asset classes.

In April's Market Perspectives, we showed how the adding of hedge funds to a portfolio could not only protect portfolios during down markets but could add to performance during up markets.

In the May edition, we noted how the inclusion of real assets such as commodities, real estate and infrastructure can provide an inherent hedge against inflation, while also enhancing risk-adjusted performance during inflationary periods.

Reaching the ultimate frontier with private markets

However, for investors who are able and willing to tolerate some illiquidity in their portfolios, private markets can boost returns and improve diversification.

From December 2007 until September 2020, private equity (PE) posted average return of 10.7% per annum (see table, p17). This was the highest return of all considered asset classes. It was ranked among the three best performing asset classes in 10 out of 13 years in the sample. A negative return was recorded only in 2008. In other years, the return on PE varied between 8.0% and 19.6%.

Other private markets also performed well. For example, private debt and infrastructure were in the negative territory only in 2008 and 2009, respectively. As a comparison, listed global equities posted negative returns four times (2008, 2011, 2015 and 2018). The average performance of private debt and infrastructure was similar to that of high yield bonds and listed global equities.

Taking a closer look at 2018, the year when apparently "cash was the king", some liquid markets did lose money. However, all private markets actually displayed positive excess returns.

Differentiating between risk regimes

An average performance provides valuable information and paints the big picture. However, the resolution may not be sharp enough to differentiate between risk regimes.

When deciding on their strategic asset allocation mix, investors are likely to be particularly interested in asset classes which provide protection in down markets and offer attractive returns in up ones.

Asset class returns ranking (2008-2020)

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Average
Infrastructure 21.4%	High Yield Bonds 59.4%	Private Equity 18.1%	Real Estate 10.4%	High Yield Bonds 19.6%	Listed Global Equities 22.8%	Real Estate 13.5%	Infrastructure 11.5%	High Yield Bonds 14.3%	Listed Global Equities 24.0%	Private Equity 10.9%	Listed Global Equities 26.6%	Private Equity 17.1%	Private Equity 10.7%
Government Bonds 10.2%	Listed Global Equities 34.6%	High Yield Bonds 14.8%	Private Equity 8.5%	Listed Global Equities 16.1%	Private Equity 19.6%	Private Equity 11.8%	Real Estate 11.2%	Natural Resources 11.5%	Private Equity 19.2%	Infrastructure 10.0%	Private Equity 15.1%	Listed Global Equities 10.4%	High Yield Bonds 8.5%
Cash 1.7%	Private Debt 24.5%	Private Debt 14.4%	Infrastructure 8.1%	Private Debt 13.6%	Private Debt 15.1%	Infrastructure 10.6%	Private Equity 10.5%	Private Equity 10.6%	Real Estate 14.2%	Real Estate 6.8%	High Yield Bonds 12.6%	Investment Grade Bonds 7.7%	Infrastructure 8.4%
Investment Grade Bonds -8.6%	Investment Grade Bonds 19.2%	Listed Global Equities 12.7%	Natural Resources 8.0%	Private Equity 13.0%	Real Estate 14.3%	Private Debt 9.8%	Private Debt 4.0%	Real Estate 8.8%	Private Debt 12.2%	Private Debt 2.9%	Investment Grade Bonds 11.5%	Government Bonds 5.8%	Listed Global Equities 7.5%
Natural Resources -11.9%	Private Equity 8.0%	Infrastructure 11.0%	Government Bonds 6.3%	Investment Grade Bonds 11.2%	Infrastructure 12.9%	Listed Global Equities 4.2%	Cash 0.1%	Infrastructure 8.6%	High Yield Bonds 10.4%	Natural Resources 2.1%	Infrastructure 10.7%	Private Debt 3.1%	Private Debt 7.1%
Private Equity -23.3%	Government Bonds 2.6%	Natural Resources 9.8%	Investment Grade Bonds 4.3%	Infrastructure 8.7%	Natural Resources 8.2%	Investment Grade Bonds 3.1%	Listed Global Equities -2.4%	Listed Global Equities 7.9%	Infrastructure 10.1%	Cash 1.8%	Real Estate 8.7%	High Yield Bonds 2.9%	Investment Grade Bonds 4.7%
Private Debt -24.6%	Natural Resources 1.8%	Real Estate 6.6%	Private Debt 3.9%	Real Estate 8.5%	High Yield Bonds 7.3%	Natural Resources 2.6%	High Yield Bonds -2.7%	Private Debt 6.6%	Investment Grade Bonds 9.1%	Government Bonds -0.4%	Private Debt 7.3%	Infrastructure 1.9%	Real Estate 3.9%
High Yield Bonds -26.9%	Cash 0.2%	Government Bonds 5.9%	High Yield Bonds 3.1%	Natural Resources 5.3%	Investment Grade Bonds 0.3%	Cash 0.1%	Government Bonds -3.3%	Investment Grade Bonds 4.3%	Natural Resources 8.1%	Investment Grade Bonds -3.6%	Government Bonds 5.6%	Cash 0.8%	Government Bonds 3.0%
Real Estate -29.9%	Infrastructure -16.3%	Investment Grade Bonds 5.8%	Cash 0.1%	Government Bonds 1.8%	Cash 0.1%	High Yield Bonds 0.0%	Investment Grade Bonds -3.6%	Government Bonds 1.7%	Government Bonds 7.3%	High Yield Bonds -4.1%	Natural Resources 3.5%	Real Estate 0.6%	Natural Resources 2.5%
Listed Global Equities -42.2%	Real Estate -22.5%	Cash 0.2%	Listed Global Equities -7.3%	Cash 0.2%	Government Bonds -4.3%	Government Bonds -0.8%	Natural Resources -8.8%	Cash 0.4%	Cash 0.9%	Listed Global Equities -9.4%	Cash 2.2%	Natural Resources -8.2%	Cash 0.7%

Sources: Bloomberg, Preqin, Barclays Private Bank. Data accessed in May 2021, last observation point September 2020.

Figure 1 demonstrates that – since December 2007 – private equity, private debt and infrastructure performed positively over an investment horizon of five years. In fact, their worst five-year stretch (3.3-4.3%) compares favourably with public and other private markets. Historically, high yield bonds and listed global equities hold the pole position in terms of the best consecutive five-year performance (17.8-19.4%), closely followed by private equity and private debt (around 15.7%).

Breaking down private markets investing

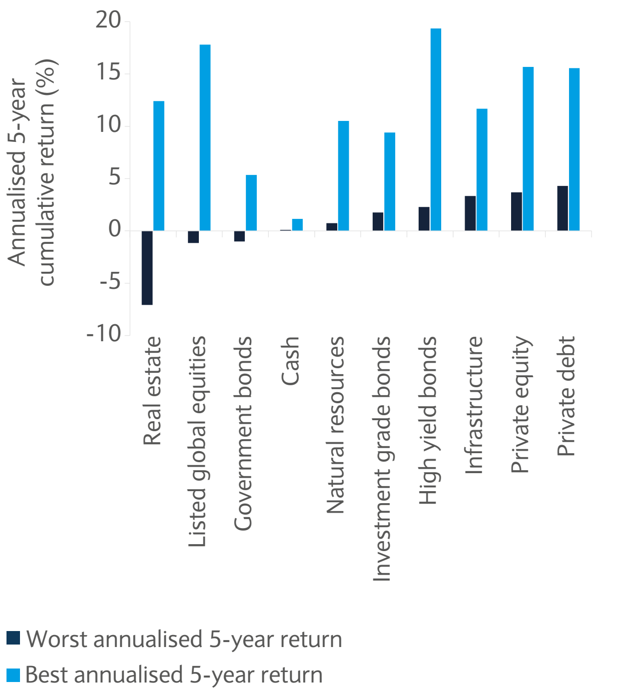
Private market investment represents ownership in privately held companies. Investors can tap into PE market through direct investments or indirectly via funds. The latter require commitments over a longer period of time – for instance, ten years – over which investors deploy capital and receive income and capital distributions.

Liquidity is the fundamental difference between public and private markets. Investing in private markets means investors face systematic illiquidity due to long capital lock-up periods. Historically, the liquidity premium is about 2% on average. Over longer periods of time, the compounding effect boosts the wealth accumulation process.

Figure 2 (see p18) shows the dynamics of the private market premium. Since December 2007, private equity, private debt and infrastructure added on average 4.3%, 1.2%, and 3.0%, respectively, on top of the selected public market benchmarks.

Figure 1: Unlocking return and diversification potential with private markets

The worst and the best annualised five-year returns for public and private markets from December 2007 until September 2020



Sources: Bloomberg, Preqin, Barclays Private Bank. Data accessed in May 2021, last observation point September 2020

Growing asset class

During the past two decades, the growth in private markets has unsurprisingly been quite remarkable.

PE has earned the status of a stand-alone asset class. Active ownership, specific value creation and exposure to different businesses and factors relative to comparable public markets contribute to a unique investment profile and significant diversification benefits.

Despite a volatile fundraising year in 2020, as a result of the pandemic, assets under management (AUM) in private markets grew by 13.2% to a record $8tn (see figure 3), a compound annual growth rate (CAGR) of 12.4% since 2000. PE has been the key driver, growing at a CAGR of 10.9% over the same period.

Given our view in the May's Market Perspectives of smart infrastructure leading returns in the next decade, its CAGR of 24.7% during the same period is worth noting.

Harvesting PE's liquidity premium

We can see quite clearly the appeal private markets have. Over the longer term they provide higher returns, lower volatility and much more exposure to companies than public markets.

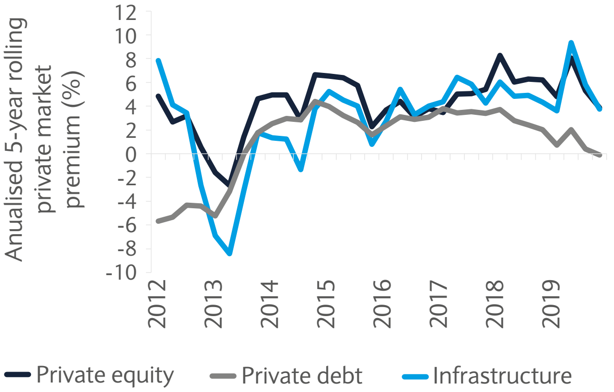
However, one cannot ignore that similar to hedge funds, each investment is very diverse and heterogeneous. High performance dispersion is the key to unlocking alpha generation potential. Skilled managers who have informational advantage and expertise in identifying entrepreneurial skill can significantly enhance returns through the selection process and active management.

The data supports the notion that private markets can diversify portfolios, enhance the risk-return profile and give investors exposure to niche companies. However, private markets are a long-term proposition. In particular, short termism and financial conservatism do not bode well with investments in PE.

Instead, investors with long-term aspirations and liabilities, possess the capacity to hold illiquid assets in their portfolios and can make significant capital commitments, seem best positioned to harvest PE's liquidity premium.

Figure 2: Private market premiums

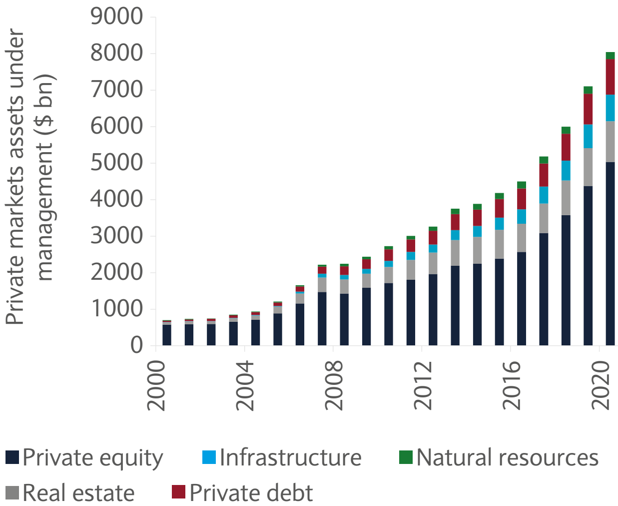
The annualised 5-year rolling private market premium for private equity, private debt and infrastructure between December 2012 and September 2020. The selected public market benchmarks for private equity, private debt and infrastructure are MSCI World AC Net TR Index, Bloomberg Barclays Global High Yield Index and S&P Infrastructure TR Index



Sources: Bloomberg, Preqin, Barclays Private Bank. Data accessed in May 2021, last observation point September 2020.

Figure 3: Private markets AUM rises to record highs

The growth in assets under management (AUM) across private markets sub-categories private equity, real estate, infrastructure, private debt and natural resources



Source: Preqin, Barclays Private Bank

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Unpicking the jargon of sustainable investing

While frequently treated as interchangeable, not all approaches to sustainable investing are identical. As it continues to gather momentum in the investment industry, and investors look to benefit from it, we pause here to clarify this critical point.

After hitting all-time highs during 2020, Morningstar noted that inflows into sustainable European funds broke the quarterly record again in the first three months of this year, attracting €120bn. In addition, 111 new sustainable funds were launched[1].

Unfortunately, most commentators, investors and marketers treat the underlying universe of investments as equivalent and unitary. The terms "ethical", "sustainable", "ESG", "SRI" and the like continue to be used haphazardly when discussing the topic.

The EU Sustainable Finance Directive (SFDR) was intended to clarify the issue, reduce greenwashing and jargon. However, the initial reaction seems to have been to add three more descriptors – Article 6, Article 8 and Article 9 – to many writers' bingo wheels.

Labels, labels everywhere…

The problem of not having a consistent, common language is typical of a rapidly evolving industry in its adolescence. A lack of universally accepted terminology may be an issue; but the greater one is the lack of consistent usage, or lack of effort to be specific.

This is a known and lamented industry challenge. But, it has implications for investors wanting their capital to generate positive outcomes alongside financial returns. This makes it important to explain the differences between the terms and their usage so that investors can make the best selection for their investment and sustainability objectives.

A sustainable thought exercise

To illustrate, let's review a small selection of indices and associated exchange-traded funds (ETFs) that provide exposure to US equities relative to the S&P 500 and are intended to be "sustainable". Importantly, the demonstration does not cover the full spectrum of sustainable products. Here we're just reviewing sustainable investments that use ESG based on their labels and their prospectuses.

A few caveats first for the associated table. While similar, they do have differences; but for ease, we can assume that if you want to invest sustainably into the US mid-to-large cap market, you might pick any one of them. Also, use of these indices or associated funds here is neither an investment recommendation, nor advocacy or criticism for the approach taken by the index provider or manager.

You can't judge a fund by its cover

First, let's start simply with names (see table, p20). Between the (A) MSCI USA SRI ETF, (B) MSCI USA ESG Screened ETF or the (C) MSCI USA ESG Select ETF, which one would you pick as the hypothetical investor? All three would be SFDR Article 8 funds. If you wanted the "most" sustainable one, which would it be? What positive outcome(s) would investing in any of them generate? Which actual investment approaches do they use?

Obviously this won't be immediately clear from names, but it's slightly more complex. For example, let's look at (B), which is "ESG Screened". Does that mean it is screened on ESG criteria? Would that be an overall ESG rating, or across each E, S and G rating? Is that on a best-in-class for each industry or to a minimum level across all industries? Or perhaps the overall score? Or is it first screened on an ethical basis and then uses ESG?

Appreciating these naming challenges starts to demonstrate that simply labelling or saying an investment product uses ESG does not mean they are all identical. These may be easy criticisms, especially as there are limitations on fund names. But stepping back, when talking about the pros, or cons, of "ESG investing" it's not immediately clear what that means.

[1] Morningstar, Sustainable Fund Flows Hit New Record, 5 May 2021 https://www.morningstar.co.uk/uk/news/211923/sustainable-fund-flows-hit-new-record.aspx

Comparing sustainable labels

Name	S&P 500	SUAS iShares MSCI USA SRI UCITS ETF	SASU iShares MSCI USA ESG Screened UCITS ETF	SUSA iShares MSCI USA ESG Select ETF
Investment objective		The fund seeks to track the performance of an index composed of U.S. ESG (environmental, social and governance) screened companies.	The fund seeks to track the performance of an index composed of U.S. companies. The index screens out companies associated with controversial weapons, nuclear weapons, tobacco, thermal coal, oil sands, civilian firearms and those violating United Nations Global Compact principles.	The fund seeks to track the investment results of an index composed of U.S. companies that have positive environmental, social and governance characteristics as identified by the index provider.
Benchmark Index	S&P 500 Index	MSCI USA SRI Select Reduced Fossil Fuel Index	MSCI USA ESG Screened Index	MSCI USA Extended ESG Select Index

Top 10 holdings and weights

1	APPLE INC 5.7%	HOME DEPOT 4.8%	APPLE 6.1%	MICROSOFT 4.8%
2	MICROSOFT CORP 5.3%	PROCTER & GAMBLE 4.7%	MICROSOFT 5.0%	APPLE 4.5%
3	AMAZON 3.9%	WALT DISNEY 4.4%	AMAZON 3.9%	ALPHABET (A) 2.7%
4	FACEBOOK (A) 2.1%	MICROSOFT 4.3%	FACEBOOK (A) 2.1%	HOME DEPOT 1.9%
5	ALPHABET (A) 1.8%	NVIDIA 3.9%	ALPHABET (A) 1.8%	FACEBOOK (A) 1.9%
6	ALPHABET (C) 1.8%	TESLA 3.7%	ALPHABET (C) 1.8%	BLACKROCK 1.7%
7	TESLA 1.5%	PEPSICO 2.9%	TESLA 1.5%	NVIDIA 1.5%
8	BERKSHIRE HATHAWAY (B) 1.5%	SALESFORCE 2.8%	JPMORGAN CHASE & CO 1.4%	ALPHABET (C) 1.5%
9	JPMORGAN CHASE & CO 1.4%	ACCENTURE (A) 2.6%	JOHNSON & JOHNSON 1.3%	ACCENTURE (A) 1.5%
10	JOHNSON & JOHNSON 1.3%	NIKE (B) 2.5%	VISA (A) 1.1%	3M 1.3%

Looking beneath the label

Second, what would you expect the underlying holdings of these "sustainable" indices to be?

Upon review of top 10 holdings in the table, investors newer to the field may be surprised to find such well-known companies, even though that was the segment of the market we had specified. As well, these may not be the firms that immediately come to mind as solving societal issues such as climate change or healthcare (even though some do have business lines addressing these issues). Moreover, some investors may have strong personal views about how "sustainable" or "ethical" these companies are given their experience or what they see on the news.

But ESG is not primarily about making a moral judgement[2]. It's about incorporating the environmental, social and governance risks relevant to the sector and company into investment selection. Primarily it's a risk mitigation tool. So the selected US large or mid-cap companies are ones that, based on the underlying data providers and ratings, are better at managing the ESG risks, or higher performers against their peers[3].

Ultimately, ESG consideration can be applied to any company. It's helpful to think about it as a look into the internal operating practices of an organisation. The aim is to get insight into how well-run is the organisation. This is distinct from considering the implications of the organisation's goods and services externally, where the positive and negative outcomes are also considered.

Focusing too much on the label, not the practices

So even an illicit cocaine cartel could score well in some ESG criteria, hypothetically, if it had environmentally friendly growing practices, paid living wages and had streamlined and clear governance[4].

As exaggerated as the above example is, it shows that investors shouldn't think about investing in "ESG" as categorically generating societal benefits through their portfolio. As well, the reverse that simply because an organisation's trying to "do good" through producing electric vehicles, addressing food waste, or providing education, does not mean this flows to the organisation's operating practices.

Investors shouldn't be surprised to find brand name companies in sustainable investing products where they prioritise ESG considerations. The primary aim is to find the well-run organisations, not necessarily the ones solving the most critical global problems.

This difference, and the rallying of most capital towards ESG, is why many of the field's original advocates are understandably critical. There is a concern that simply by focusing on these ESG operating practices, and not actively putting capital towards solving our global problems, we may be generating a false sense of security or accomplishment.

Only the first step

As this brief case illustrates even with a criteria of investing sustainably for US exposure primarily incorporating ESG considerations (though some had ethical screens as well) can yield very different results. The difference in holdings and weightings will then flow to a divergence in investment performance too.

Notably, all are passive investment products which tend to be the more transparent and detailed about their investment process. Index methodologies are generally available to review. Given time and knowledge, it is possible to decipher how sustainability appears in their investment process and the result in terms of holdings.

With active managers, that process tends to be more opaque as either ESG ratings and/or underlying data is incorporated into discussions and decision-making with varying specificity (as explained further in the second half of our Outlook 2021 article on Material E, S, G factors in 2021).

If we added other sustainable investing funds into the mix, this would diverge even further. For example, these could be sector focused, such as renewable energy, circular economy or healthcare. Or indices or funds where, along with assessing operating practices, they explicitly target companies whose goods and services seek to solve societal problems. When collecting all these different approaches together, it becomes clear that loosely referring to "ESG", "ethical" or "sustainable" funds does not help the industry. Nor investors.

Focus on the investors

While critical here, though primarily of commentators and marketing, the industry is making collective and considerable effort to address terminology issue.

Hopefully, highlighting these differences does not cause readers to throw up their hands up in disgust at the situation, but be more confident to ask for explanations – how does this investment incorporate sustainability? Where does it focus operating practices and/or goods and services? What techniques or approaches does it use? What are the implications?

These questions will help to diminish the risk of getting caught in potential bubbles and greenwashing. They will also help to avoid confusion that having a sustainable label is an indicator of quality, or competence of the underlying manager.

Finally, it's important to note that the above illustration presents sustainable investing from a product perspective. In reality, it starts with investors' financial and sustainability objectives, and only then navigates to investment opportunities. In this way, industry jargon is bypassed and the focus is on helping clients to generate financial returns and societal outcomes in the way that matters to them.

[2] It is possible for investors to use ESG data to make these personal judgments, however the dominant use is for risk management or alpha generation.

[3] Separately different data providers have different data and ratings systems, making it possible for companies to appear to have high ESG ratings in one index and low ones in another.

[4] Though overall ESG rating might suffer, owing at least to issues such as carbon footprint of its transport, employee health & safety practices, or tax payments.

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Learning to shut out market noise

Bias and noise can affect investors' decision-making, and market sentiment can overreact in the short term. Investment success rests on distilling market noise and focusing on what really matters, with diversification key to help investors with this.

In their latest book, Noise: A flaw in human judgement, Nobel laureate Daniel Kahneman and distinguished behavioural economists argue that society has rightly devoted much attention to the problem of bias – predictable errors that incline a person's judgment in a particular direction – but should also pay attention to another type of error: noise.

Consider your bathroom scale. If on average its readings are too high, the scale is biased. If it displays different readings when used several times in quick succession, the scale is noisy. While bias is the average of errors, noise is their variability. Investors may have observed that forecasts of economic outcomes can be notoriously noisy.

What does this mean for investors?

The central tenet of financial markets is the efficient market hypothesis. It states that share prices reflect all information, and with stocks always trading at their fair value it would be impossible to consistently generate alpha and outperform the overall market.

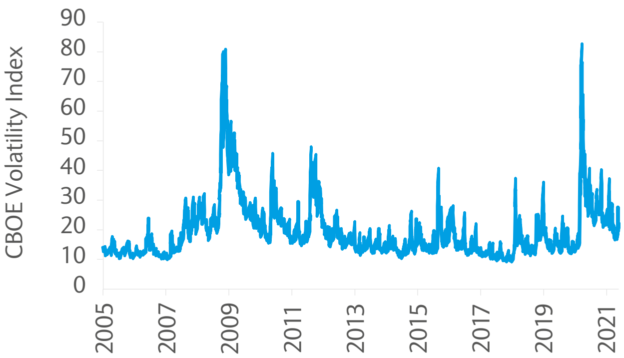
As professional investors we see that inefficiencies and therefore opportunities do exist, due to a range of reasons, including market psychology and human emotion. Market sentiment can become excessively optimistic or pessimistic, which can lead to market overreaction to events and news. This can steer investors off course, as well as provide them with opportunities.

Challenging investing times

We are now entering a potentially challenging period for investors, with the potential for market turbulence. The recovery is underway, spurred by successful vaccination drives, pent-up savings and government support. However, the pandemic is far from over, with daily recorded cases globally still at very high levels and the risk of new variants a concern.

Figure 1: Volatility can spike rapidly

The performance of the VIX since 2005. The VIX is an index representing the market's expectations for volatility over the coming 30 days



Sources: Bloomberg, Barclays Private Bank

Meanwhile, inflation data is prompting a rethink about asset valuations in parts of financial markets. It is imperative for investors to know what, and what not, to focus on.

Distilling the noise

In a world of real time news reporting, there is no shortage of voices trying to grab the attention of investors. Ever shortening news cycles can induce short-term thinking in investors, which can threaten to derail long-term success.

With markets composed of many different individual agents, there is ample opportunity for noise. Successful investment performance, on a continued basis, rests on distilling the noise and focusing on the fundamentals which really matter. Much of the market commentary will not be material to a diversified investment portfolio.

Having a robust investment process and discipline when changes are made to investments, alongside a plan and rules for when changes are made, may be one way for investors to reduce bias and noise in their own decision-making. A robust process can also reduce the impact of external noise on decisions.

Beware of extreme moves

Being aware of the role of noise and aspects of investor psychology can help investors to not get swept up by market sentiment. Sentiment can become extremely bullish or bearish in the short term, and also swing from one end to the other extremely quickly. This is demonstrated by the speed at which the VIX, the widely used volatility index that gauges market sentiment and points to the degree of fear among market participants, can spike during times of market stress (see figure 1, see p22). This is mirrored by investor sentiment indicator data (see figure 2).

Equally striking is the speed at which these elevated levels can fall and how investor positioning closely mirrors sentiment indicators (see figure 3). The implication is that investors that get swept by excessively strong sentiment in a particular direction and act upon it may take actions that are not in their long-term interest; for example, selling during a bout of volatility and a short correction that very quickly fades away.

Investing doesn't have to be difficult, but it is complex

It is important to appreciate the speed and efficiency with which information is priced into markets and their forward-looking nature.

For investors attempting to make sense of events and the reaction of the market to them, reactions can appear to be counter-intuitive, like a pull-back on what appears to be positive news. Forward-looking market participants may be looking more at aspects such as the rate of change of a certain data series than the headline figures (the second derivative).

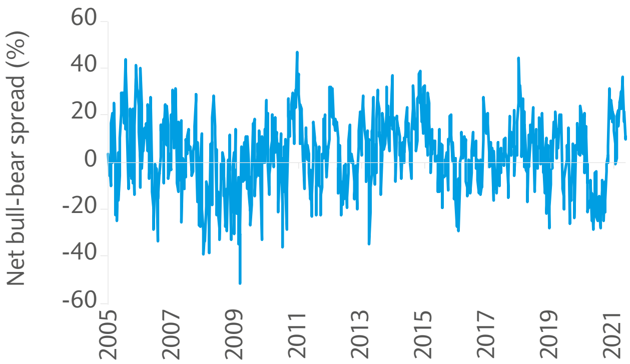
While investing does not have to be difficult, financial markets are complex. Unpicking the drivers of events and understanding causation can be challenging.

We believe that investors may receive the best returns by focusing on having in place the fundamental building blocks for long-term investment success – asset allocation, diversification and active management – than the minutiae of short-term movements. A professional investment adviser can support the investor by making sense of them.

Diversification offers protection

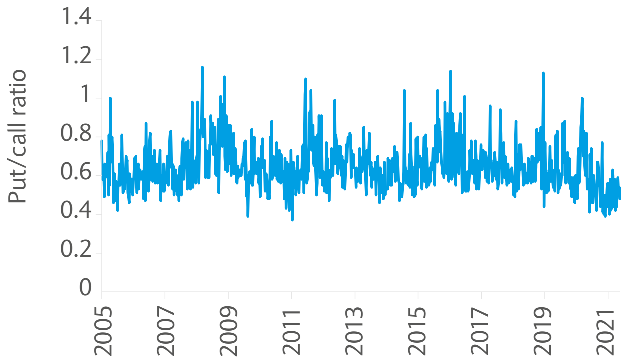
So what can an investor do to protect themselves from the so-called "animal spirits" of markets? The first thing to keep in mind during times of stress (or excessive exuberance) is that the market isn't one single entity that moves as one. Financial markets are composed of many moving parts.

Figure 2: US investor sentiment can swing wildly
The trend in the net bull-bear spread since 2005, showing whether bullish investors (a positive reading) or bearish investors (a negative reading) are in charge



Source: Bloomberg, Barclays Private Bank

Figure 3: Trading behaviour mirroring sentiment
The equity put/call ratio, showing the ratio of options trading volumes by those positioning for a decline, versus an advance, in equities



Source: Bloomberg, Barclays Private Bank

One of the best ways for investors to remind themselves of the market complexity, and be better protected from its effects, is to hold a diverse portfolio of investments that spans asset classes, sectors and quality companies.

A diversified portfolio can better protect from the effects of volatility due to the correlations between asset classes. It may also insulate the investor from being caught up in the emotions induced from experiencing that volatility in the portfolio. Together, these can provide a solid foundation for protecting and growing your wealth.

Narayan Shroff, India, Director-Investments

Indian assets: investing in an inflationary world

As investors prepare for a pick-up in Indian economic activity and sentiment, growing inflationary pressures, even if transitory, are firmly in view. Upping exposure to cyclical equities, corporate debt and real estate may be one way to prepare for this transitory period.

The impact of the second wave of coronavirus on India and the prolonged restrictive measures taken by the state authorities may delay the country's economic recovery. However, the focus on vaccinating the population increases our hope that this may mark the beginning of the end. The second half of the year is likely to see a sharp pick up in business activity and (financial) market sentiment.

Such transition periods are usually difficult to navigate. That said, they often can be rewarding for investors willing to take advantage of the available, fear-led risk premiums. As fears of vaccine availability and efficacy, elongated regional lockdowns, a potential third-wave, smaller business stresses, credit concerns and delays in a sustainable revival in demand linger, opportunities remain in play.

Policy support (both monetary and fiscal), including the recent positive surprise on dividends from the Reserve Bank of India (RBI), as well as systemic liquidity should remain conducive in this period.

With global and local liquidity remaining high, and inflation inching up, getting positive real returns may require increasing risk exposures. Reinvestment risk also remains high with structurally low cash and short-term rates in the country.

Inflation worries may be overplayed

Fuel prices have moderated somewhat recently, but should remain sticky. Food prices are still low and with good monsoons, as forecast, may remain range-bound. The rupee has also held up well during this period and cushioned the effect of imported inflation. However, rising global commodity prices may pose challenges.

As recent purchasing managers' index prints also indicated, surging input costs and wholesale price inflation remains a worry. However, the weak employment and demand conditions through the second wave of COVID-19, and an economy operating below full capacity, should reduce the pass through of input price inflation to retail prices.

Inflation may not be as much of an evil as it is thought, at least in the near term. The Indian central bank, like most others, is likely to look through the coming prints as "transitory" at best. The effects may rather be addressed through counterbalancing factors in the short term and supply-side catch-ups in the medium term. For Indian companies too, reflation has helped top-line growth without much impact on margins, at least for ones with more pricing power.

Keep investing during the transition period

A good mix of investment strategies and ideas that benefit from low rates, and the fiscal and monetary support on one hand and inflation risk on the other, should perform well in the current transition period.

In Indian equities, a selection of quality companies with resilience and pricing power and cyclicals seems to make sense. Similarly, in Indian debt, it may be worth considering a mix of high quality corporate bonds of up to 5-year maturity and select high-yield credits, especially credits collateralised by real assets that generally hold well during high-inflation periods.

Active management to the fore

Active management seems key, especially during this transition period, with sharp sector rotations a regular occurrence. Bottom-up stock selection remains the key driver of alpha amid rich equity valuations.

Exploring the less researched stocks in the small and mid-cap space can be another path to generating alpha. Similarly, credit selection and monitoring is likely to be critical during this transition period. As the economy recovers, potential ratings and/or perception upgrades are likely.

Target global exposure

The different growth profile of the largest economies in the recovery, especially in recent quarters, again 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 China or US equities, one can also take advantage of opportunities benefiting from the new normal across the entire 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.

Real estate approaches "goldilocks" situation

Indian real estate, especially residential property, seems well positioned to recover, supported by many of the right ingredients for growth. These include: a growing and younger working age population; expanding urbanisation; historically low home loan rates; local tax breaks in the sector during the pandemic; better availability of loans to developers supported by the RBI's targeted longer term refinancing operations; preference for bigger and better organised residential premises; and proliferation of home working.

The corrections and consolidation in Indian real estate seen since the credit crisis, additional real estate regulations and the effects of the pandemic have helped to put a cap on a supply glut. With the employment conditions, income and affordability, demand picking up again and amid less oversupply, Indian residential real estate looks poised to gain its share back in the economy over the coming years. Growing expectations of a period of higher inflation may further raise investor interest in the sector.

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

Resilient Indian equities

The resilience displayed by Indian equities, the participation of the broader market in recent up moves and rotations across sectors are not surprising in the context of:

- falling active COVID-19 cases in the country; and
- anticipated gradual easing of restrictions across states over the next few weeks.

Investors are also surprised about the disconnect between the human tragedy of this second wave and the equity market's resilience – the more forward-looking approach taken by the markets may help explain this, with strong earnings growth expected over the next couple of years.

Banks provided more comfort to the market by indicating much less stress in the retail and micro, small and medium enterprise (MSME) segments than some thought. Cyclical recovery should gradually see sectors like automobiles, retail, leisure, travel and tourism participate once more visibility is seen on easing lockdown restrictions.

Our equity portfolio strategy remains largely intact with a mix of quality stocks across market capitalisations and sectors, including cyclicals.

Debt – discretion is warranted

This year is proving trickier than last for Indian bond investors. Our debt investment strategy during this period is oriented towards the right blend of credit and duration positioning with the flexibility to change the mix when needed by maintaining adequate liquidity in the portfolio.

In a lower-for-longer interest rate environment, the search for carry naturally leads to on-boarding more duration and/or credit risk in the portfolio. But there is a distinct slowdown in market interest towards adding credit and/or duration due to the second wave and associated lockdowns, compared with previous quarters.

For now, this sits well with the duration and quality positioning of our debt portfolio strategy. We remain open to judiciously adding credit, but will look for leading indicators to signal that the economic impact of the lockdown is reducing before taking additional credit risk.

Our preferences in the non-AAA segment remains towards credit/perception upgrade candidates and in sectors that stand to benefit from government policies and economic revival such as roadways, infrastructure, power and select non-banking financial companies with a focus on housing finance and MSME lenders.

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