

Private
Bank

Market Perspectives

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Foreword

Elevated financial market valuations continue to price for a relatively swift vaccine-driven recovery this year, despite the lurking downside risks. However there is much that could spook investors, not least a vaccine-resistant new COVID-19 variant or surprise hike in US rates.

With the vaccine rollout going well, economic growth seems likely to pick up much of the ground lost by last year's slump. Both the UK and US may be able to achieve herd immunity in the second quarter, setting the scene for a splurge in consumption and healthier employment prospects. The authorities face a difficult balancing act in judging the appropriate level of support as recovery takes hold.

Encouraging vaccine rollout news helped equities start the year with a bang. Fourth-quarter company earnings are also beating consensus by a surprising amount. We have raised our fair value estimate for equities towards a bull case scenario. But much can still go wrong. This suggests favouring "quality" companies with resilient free cash flows and attractive growth prospects.

Conversely to equities, this has been a tough year so far for bond investors with sell-offs and rate spikes. Yields are rising ahead of anticipated recovery that may spark inflation fears and may trend slightly higher yet. That said, the market seems heavily focused on upside risk, suggesting more yield spikes. At the same time potential economic uncertainty and central bank policy commitment should not be ignored.

Turning to sustainable investing, renewable energy indices have strongly outperformed their standard peers in the last year, a period of high uncertainty. Environmental, social and governance funds joined the outperformance party, on a smaller scale. But is this being a sign of frothy valuations and investor over-exuberance? Perhaps. But despite the downside risks, sustainable investing has the hallmarks of a long-term structural shift, supported by governments, rather than a bubble.

For all the optimism, potential downside risks lurk. The probability of extreme, tail risk, events occurring should be borne in mind when managing portfolio risk. Hedging offers one route to help manage tail risk at a time when bouts of heightened volatility look likely. In doing so, investors might consider employing hedge fund managers with robust processes and proven investment methodologies.

**Jean-Damien Marie
and Andre Portelli,**
Co-Heads of Investment, Private Bank

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Recovery prospects: hopes and risks

With high hopes of a strong, vaccine-driven bounce this year, what risks might dash a quick return to normal, whether health-related or otherwise?

Last year was truly traumatic as the pandemic-induced slump resulted in the worst economic contraction since the Great Depression. Nonetheless, with vaccination rates rapidly rising, economies reopening and policymakers maintaining their accommodative stance, this looks set to be a year of recovery with global growth of 6.0%.

Herd immunity is the key

The speed and shape of the recovery will inevitably be dependent on arresting the coronavirus pandemic. While lockdown measures have helped to reduce infections, hospital admissions, intensive care occupancy levels and coronavirus deaths in a number of countries, the effectiveness of vaccination programmes will be key to normalising activity. Achieving herd immunity status should quickly translate into accelerating activity as economies fully reopen, consumption rises and employment prospects improve.

Early data shows that the vaccine rollout in advanced economies has been outpacing those in developing economies. We believe that both the UK and US may be able to achieve herd immunity in the second quarter of the year, with Europe achieving that status by the end of the third quarter. While certain countries have achieved impressive vaccination rates, namely Israel and the United Arab Emirates, there are also some noticeable laggards in Africa and Latin America.

Policy support

Economic conditions this year should be supported by policymakers to help ensure the recovery. In most major regions we would predict that central banks will keep interest rates down at historically low levels over the next couple of years. If the speed of the recovery allows, a tapering of asset purchase programmes might start in 2022, but this should only occur in a targeted and controlled way to avoid any “tantrums” playing out.

On the fiscal side, a number of countries, most notably the US, are embarking upon additional packages aimed at controlling the virus and supporting growth. That said, we would expect some of the emergency measures, such as furlough programmes, to be scaled back as the recovery develops.

Emerging market growth to outperform

We expect emerging markets to grow and outperform advanced economies this year. China’s latest figures provide further evidence of a V-shaped recovery. Its strong growth profile has been driven by encouraging export demand, robust factory output, rising domestic retail sales and steady fixed asset investment. As such, we expect China to grow at 8.4% this year.

Beyond China we think that India will register impressive growth of 10.4% this year as consumer spending increases, credit availability improves and labour markets stabilise as the rural recovery broadens out to urban centres.

Advanced economies to bounce

This should be a positive year for the US with growth coming in at 6.4%. The acceleration of the vaccine rollout should reduce new cases and help revive the all-important service sector. Furthermore, President Joe Biden’s additional stimulus programme is likely to boost consumption and provide support for low paid workers, small businesses and state services.

In the UK, the recovery is likely to be a little more subdued than in America this year, although the economy is still likely to grow by 4.0%. The rapid vaccination programme should encourage a rebound in household spending through the summer, but growth prospects may be held back by Brexit friction weighing on supply chains and exports.

For Europe, the bloc looks set to officially register a double-dip recession in the first three months of the year as lockdowns weigh on household consumption and bottlenecks in global supply chains risk disrupting the so far resilient manufacturing sector. There should be a mild improvement in the second quarter as vaccinations and the warmer weather eases restrictions. The second half of the year looks stronger; as the region inches towards herd immunity and benefits from higher public investment. For Europe we forecast full-year growth of 3.8%.

Potential risks

While remaining optimistic about growth prospects for this year, a range of factors could infringe on short and long-term growth prospects. These include a significant deterioration in the healthcare environment, forced policy reversal and unemployment remaining at elevated levels.

“While remaining optimistic about growth prospects for this year, a range of factors could infringe on short and long-term growth prospects”

Health warning

The immediate risk to our forecasts stems from how well the pandemic is controlled. Our positive outlook is primarily based on the vaccination programme being progressively effective in halting the transmission of the virus.

However, it is important to recognise that there are still a number of vaccine unknowns including, the length of immunity, efficacy against future mutations and possible side effects. A reduction in efficacy rates would impede the road to normalisation and hit business and consumer confidence; delaying the recovery.

Early policy withdrawal

Continued fiscal policy support is a vital element of our projected robust growth forecasts. The distribution of the European Recovery Fund is essential for the region’s growth prospects. However, political infighting, poorly coordinated investment priorities and slow progress on commitments to economic reforms risk disbursement delays.

That said, government debt levels have risen substantially as a result of the fiscal response. Fiscally conservative lawmakers may demand that future stimulus packages are scaled back. Longer term, nations’ finances will eventually need to be put back onto a sustainable path. To achieve this, governments may be forced to raise taxes and reduce spending, thereby diminishing growth potential.

Balancing act for central banks

A robust recovery, rising commodity prices and ultra-accommodative policy could be a perfect recipe for higher inflation levels. If sustainable inflation projections begin to spike above central bank targets, it will increase pressure on them to exit their “emergency” policy posture. The resulting tightening of financial conditions would quickly filter through to a weaker growth profile.

In view of the recovery, along with concerns over creating asset bubbles and financial imbalances, China is expected to be the first major country to consider withdrawing its stimulus, albeit only gradually. Conversely, a worsening of growth prospects may force central banks to introduce negative rates, which could lead to a broad range of unintended negative consequences.

Elevated unemployment

Labour markets have been particularly hit by the pandemic, particularly in the service sector. Its recovery will have a significant impact on consumption levels. Countries with the most flexible labour markets are likely to benefit from a relatively quick return to pre-pandemic employment levels, while those with stringent labour laws and powerful unions could see unemployment rates elevated for some time.

While the outlook remains positive, there are many dangers that could derail the global economy. Health officials and financial policymakers will need to balance protecting the public, ensuring the recovery and averting future imbalances to achieve long-term sustainable growth.



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

Equity bulls in charge

High hopes of a vaccine-driven recovery and encouraging reported earnings have powered many equity markets to record levels. Given potential vaccine problems, timing of fiscal and monetary policy retreats and threats of inflation, are valuations overstretched?

We started the year with a constructive but somewhat cautious outlook, expecting more muted returns. Two months in and global equities have already jumped as much as 6%, pushing towards our bull case scenario. Given possible surprises lying ahead, the risk-reward remains balanced but the road is likely to be bumpy.

Strong earnings season

While we expected companies to post better-than-expected results in the final three months of 2020 (Q4), we have been positively surprised by the magnitude of the beats. In the US, with more than 80% of companies surpassing the consensus' forecast, fourth-quarter earnings growth is on track to reach 3.5% versus an 8% decline expected initially. This is an amazing outcome given that COVID-19 did not exist a year ago. Indeed, expected earnings for the following twelve months are picking up (see chart).

In Europe, the picture is more mixed as, despite an 18% positive average surprise, Q4 earnings have contracted by at least 15%. Most of this difference can be explained by the significant divergence in index composition, Europe being much more exposed to the energy and financial sectors and less to technology.

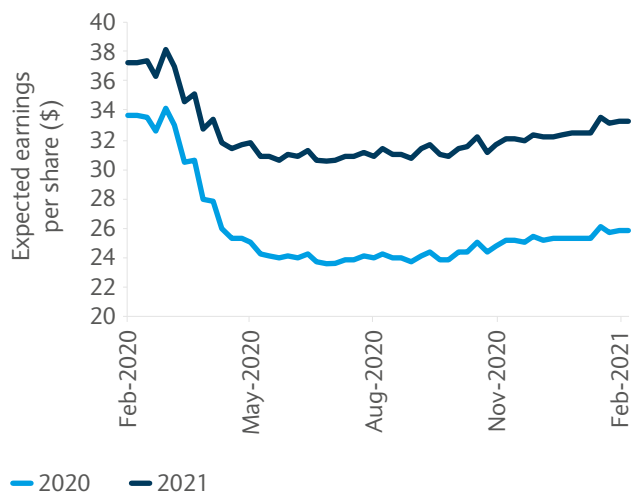
Bull market scenario?

Back in November, we highlighted a fair value for the S&P 500 at around 3,700. At the time, much better fundamentals seemed required to justify upside from that level. With much stronger-than-expected Q4 earnings, this year's numbers have a more solid base on which to grow.

As a result, our estimate of equity markets' fair value has moved a few percentage points higher, closer to the initial bull case (in the 3,900-4,000 range on the S&P 500). This point estimate assumes recovery throughout the year, supported by accommodative monetary and fiscal policies and a successful COVID-19 vaccination campaign in the most of the developed world.

Earnings per share on the mend

MSCI AC World expected earnings per share since February 2020



Sources: Refinitiv, Barclays Private Bank, February 2021

What could go wrong

The above assumptions are optimistic and leave the door open to disappointment should any of them fail to deliver. At the top of the "wall of worry" is inflation. Indeed, the topic has attracted much attention in the last few months. The combination of base effects, recovery, higher commodity prices and stress in some value chains (semiconductors in particular) point to a potentially sharp increase in prices ahead. The prices paid by US manufacturers already seem to be climbing (see chart, p6).

While a temporary surge in inflation could be managed, the real risk lies with a sustained rise in prices. Though moderate inflation (as opposed to deflation risk) may be welcome, persisting negative interest rates in Europe and very low ones in the US are not appropriate for a world

where the Phillips curve, or inverse relationship between inflation and unemployment, re-establishes itself.

Recalibrating monetary policy to prevent the economy from overheating would require central banks to adopt a much tighter stance, possibly putting pressure on equity valuations as finally there would be an alternative to stocks.

Fiscal fears

Outside of the obvious risk of seeing the pandemic becoming a feature of the world we live in for years, preventing a full recovery, the other possible issue worth highlighting is linked to fiscal stimulus.

The key reason why economies and markets have been able to recover so quickly from the pandemic shock is the unparalleled government bail outs offered during the crisis. For now, the taps remain open and the commitment to do “whatever it takes” is intact. However, as the debt burden and budget deficits balloon, at some point governments may have to pull the plug.

It may seem premature to think about fiscal retrenchment. But if and when stimulus is reversed, whether due to political or market (perhaps rising bond yields) pressures, the real impact of the pandemic could be felt.

The result would be a surge in bankruptcies, a spike in unemployment rates and a much bleaker outlook for companies. This would compromise current expectations for a strong earnings recovery and force asset prices to drop. Such a miscalculation might be met with additional monetary support eventually but it would certainly leave a mark.

What could go right

Much positive news already seems to be discounted by the market and in our fair value estimate. We see two main upside risks though.

The first one relies on even stronger-than-anticipated earnings growth. As January’s US retail sales figures suggested (up 5.3% month on month versus 1.0% expected), pent-up demand might be significantly higher than initially thought.

The second upside risk could be a faster-than-expected return to normal as COVID-19 becomes nothing more than a regular flu. That said, this appears an unlikely scenario in the short term. However, science has shown it can deliver results at an unprecedented pace. The combination of vaccines capable of fighting variants of the virus and better treatments for infected people could allow some of the most affected areas of the economy (travel and leisure in particular) to recover ahead of plan.

Bounce in prices for US manufacturers

ISM manufacturing prices paid index since 2005 shows strong rebound in 2020



Sources: ISM, Barclays Private Bank. February 2021

The unknown unknown

The above-mentioned possible catalysts are known unknowns and can be more easily factored in by market participants. The real risk lies in events that few, if any, see coming. The COVID-19 pandemic was an extreme example of this, but such curveballs are frequent.

Earlier this year, the Reddit-based retail investors frenzy caused some short-lived volatility as hedge funds were forced to reduce their gross exposure. Thankfully, this phenomenon did not last for long but it shows that surprises can result in significant volatility.

Because “black swan” events are unpredictable, risks are largely impossible to discount and can only be mitigated via proper diversification. This is why we encourage investors to adopt a balanced approach when building portfolios.

Getting active

Although the upside at the index level may be limited, investment opportunities can be found. Indeed, with elevated expectations and limited visibility, significant dispersion at both the sector and the stock level seems likely.

Wider dispersion in returns calls for a more active approach to investing, using stock picking to unearth alpha in a world where beta might be less relevant. Our focus remains on “quality” investing, favouring resilient free cash flow generation and attractive medium-term growth prospects.



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

Risk of rising real yields seems real

Rate spikes have already materialised this year. We take a closer look at the risk of further spikes in coming months and what this means for investors.

This year has seen bond sell-offs and rate spikes, as envisaged in our Outlook 2021 in November. At first, the rise in yields was down to higher breakeven yields, which reflects the market implied expectations for higher inflation. But most recently real yields (yields adjusted for inflation expectations) have also started to pick up.

What is the risk that both higher trending breakeven yields as well as higher real yields push yields well beyond pre-pandemic levels?

Money and debt

One of the potential drivers of inflation is the rise in debt. The US fiscal deficit has risen to over 16% of gross domestic product and is ultimately likely to be more than twice the deficit seen during the 2008 global financial crisis and the biggest seen since the second world war.

But as pointed out in our recent publications, higher debt does not necessarily lead to higher inflation. In fact, during recent debt surges, as witnessed in 2000 or 2008 for example, a rise in debt was followed by lower trending inflation. This time, the record growth in money supply may also be a factor.

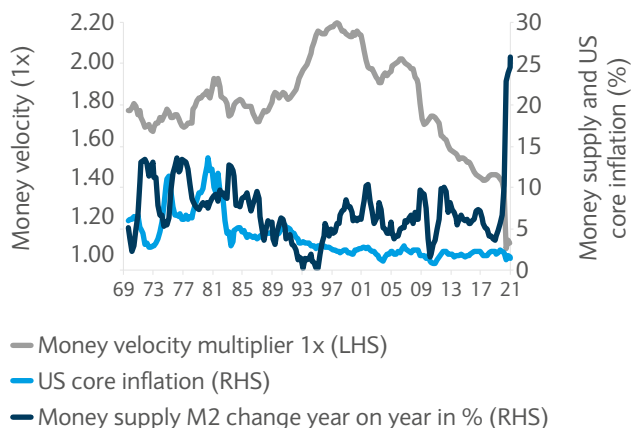
Money supply, as shown by the indicator M2, has surged by over 26% year on year, the largest spike since World War Two. The US Federal Reserve (Fed) has provided abundant liquidity by absorbing the surge in US debt on its balance sheet, creating a huge supply of liquidity.

“Money supply, as shown by the indicator M2, has surged by over 26% year on year, the largest spike since World War Two”

During the 1980s, the growth rate in the money supply jumped to 13.5% of GDP, leading to excessive inflation. But according to Nobel Prize economists Milton Friedman and Anna Schwartz, there can be a large lack of response of

Money supply, velocity and inflation

The trend in the money velocity multiplier, US core inflation and M2 money supply since 1969



Sources: Refinitiv, Barclays Private Bank, February 2021

economic growth and inflation to money supply expansion and the outcome can be variable (see chart).

Not so fast at this point

In order for money supply to become inflationary, money velocity (or the turnover of money in the economy) must remain relatively stable. But rather than being used in exchange for goods and services, cash is being held on deposits by households and companies alike. This has seen a collapse, of the already multi-year declining velocity, to a multiple of 1.2 times turnover. By contrast, during the 1980s the multiple remained relatively stable at around 1.75 times.

The chances of a surge in money velocity are high. The US consumer, given unprecedented government support, seems to be in a relatively healthy state. Debt as a percentage of household income is at its lowest since 2000 at 93%, while the personal savings ratio is the highest seen since 1975.

Recent strong US retail sales underpinned the potential for a consumer revival which could be reinforced by the vaccine rollout. However, labour market uncertainty is likely to prevail. Chief economist of the International Monetary Fund, Gita Gopinath, believes that the slack in the global economy is significant and is likely to remain so in many countries in 2021.

The cyclical factor

Another important factor to the outlook for inflation is the recovery being experienced in commodity prices. A higher oil price is likely to push inflation higher soon due to base effects. The recent surge in US producer prices year on year, which was the strongest reading since 2009, illustrates the building pressure facing retail prices.

At least in the US and Germany, for example, rental prices play a large part in the consumer price index (CPI) basket (over 30% and over 20% respectively). So far rental prices have not recovered, but should they recover in the coming quarters this could place upward pressure on inflation.

Not everything leads to inflation

The earlier sections cover monetary and cyclical aspects. Investors also consider secular trends, like potential disruptions or a new shape to global supply chains for example. While this may have the potential to be inflationary, new supply chains and consumer behaviour may equally lead to disinflationary pressures in the longer run.

Increasing automation, an additional secular trend, could potentially improve productivity levels, easing price pressures. At the same time automation can increase unemployment and lead to a dramatic transition process in the labour market, which would likely be disinflationary.

Tell me what I don't know

Looking forward, our base case expects US inflation to peak at short of 3% before moderating at 2.2% during this year. However, the risk of higher inflation in the medium or long-term remains.

Implied expected inflation, as shown by 10-year breakeven yields, has reached 2.15% and is at the highest since 2014 and already above the 30-year average. While breakeven yields may climb further, the risk of a significant surge in breakeven yields seems limited from here.

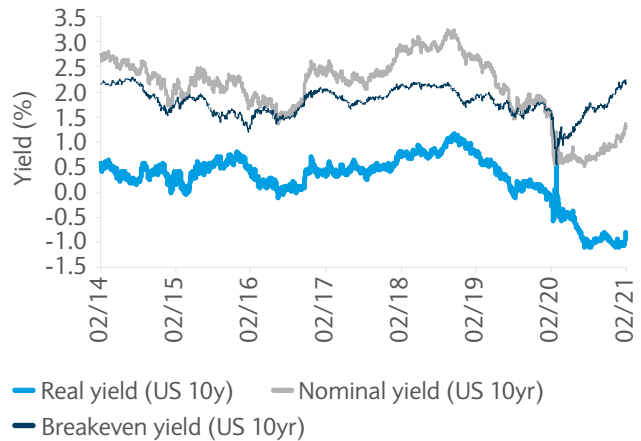
Watch out for real rates

Rather than inflation expectations, a further rise in nominal yields could be driven by real yields, which have started to rise of late (see chart). Real yields are not affected by inflation expectations as they are adjusted for inflation expectation. Instead real yields are impacted by uncertainty over the actual inflation outcome, supply and demand environment and anticipated central bank actions among other factors.

“Rather than inflation expectations, a further rise in nominal yields could be driven by real yields, which have started to rise of late”

Real yields start to rise

The real, nominal and breakeven yields for US 10-year bonds since February 2014



Sources: Refinitiv, Barclays Private Bank, February 2021

The two potential driving forces for real yields are likely to be the outlook for the Fed's monetary policy as well as the supply and demand outlook. The market by now has embraced the central bank's commitment to keep policy rates low for a long period.

The Fed articulates the above commitment through the average inflation target (AIT) approach, which tolerates temporary inflation overshooting as well as the aim to target full employment. As such, the risk that higher short-term rates drive the entire yield curve seems unlikely. But targets are evolving and while the risk seems low, the rate market could be surprised by potential policy change at a later stage.

Don't fight the Fed

The US central bank is very much aware of the consequences of paring back bond purchases. Back in 2013, the surprise announcement of asset-purchase tapering caused real yields to rise by roughly 140bp. This is a scenario that the Fed would like to avoid and so the risk of a repeat this time seems significantly lower.

Biden's growth agenda increases rate risk

A factor worth looking out for from the supply side is the planned infrastructure spending by the US administration over the next four years and potentially beyond. While the amount and funding is still to be determined, we believe it may have the potential to add roughly 30bp to the current US rate path.

Taking the various factors into consideration it seems likely that bond yields may trend slightly higher from here. Especially the long-term infrastructure plan by the US may provide some pressure for rates to move higher. Levels beyond pre-pandemic levels seem less likely. The market seems heavily focused on upside risk, which could lead to further yield spikes. At the same time potential economic uncertainty as well as the Fed's policy commitment should not be ignored.



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

Focusing on the long run

With COVID-19 vaccine rollouts taking place in many countries, hopes of economic normalisation are rising. Expectations of a strong recovery, coupled with ongoing structural changes, call for a review of asset allocation policy.

As investors prepare to position portfolios in a post-pandemic world, we examine the key component of the long-term investment process – strategic asset allocation (SAA). We are in the process of revamping our strategic asset allocation and in this article examine the broad framework of our upcoming SAA.

Strategic asset allocation

SAA is an essential part of our investment process. It is specifically designed to help clients achieve their long-term investment goals, while ensuring a superior risk-adjusted performance over a five-year investment horizon.

“It [SAA] is specifically designed to help clients achieve their long-term investment goals, while ensuring a superior risk-adjusted performance”

The optimal asset mix depends on the investor’s reference currency, ability to take risk, preferences and requirements regarding expected returns, liabilities, foreign currency exposures and investment styles, as well as other objectives. Therefore, investors’ profiles lies at the crux of the investment process.

An SAA review is a comprehensive and highly structured process in which optimal long-term asset allocation policies are defined for each reference currency, investment strategy and risk profile. It consists of two pillars: capital market assumptions and asset allocation policy.

The final set of outputs of the review process comprises expected returns and risks across a wide spectrum of asset classes and optimal asset mixes for various investment profiles. These results constitute a set of performance, risk and allocation benchmarks that are used in the portfolio construction process. Therefore, the SAA represents the backbone of our long-term investments.

Capital market assumptions

Capital market assumptions (CMAs) are forward-looking estimates of expected returns, volatilities and correlations over the next five years for a range of asset classes: cash and short-term bonds, developed government and investment grade bonds, high yield and emerging market bonds, equities, commodities, real estate, hedge funds, foreign exchange and private markets.

Each asset class is carefully selected for inclusion in investment portfolios based on four guiding principles: representativeness, investability, uniqueness of risk-return profile and diversification potential.

Depending on the investment approach (discretionary versus advisory) other criteria such as liquidity are considered as well. This is particularly important for an SAA that includes investments in private markets on top of liquid investments, which represent one of the key additions in our new SAA framework.

CMAs provide a long-term investment compass that helps clients to navigate through shifting landscapes of reward and risk in financial markets. Our future CMA framework will leverage on past information, however it is also conditional on the current stage of the economic cycle and incorporates our views regarding secular trends and possible structural changes. Taking stock of quantitative models and qualitative inputs ensures robust and forward-looking nature of our long-term views.

Expected returns framework

We will construct a five-year outlook to help to decompose expected returns into three components: income, growth and valuation. There are two exceptions to this rule. First, expected returns for hedge funds are estimated using a regression approach. Second, expected returns for private markets are decomposed into expected returns on a public market benchmark and an illiquidity premium.

The starting point in our CMA framework is the observation that all investments are ultimately exposed to the same underlying systematic risks, most notably economic factors. Our forecasts for expected returns and risk parameters are therefore strongly anchored by projected paths of the key macroeconomic variables: short-term interest rates, inflation and real GDP growth.

For example, fixed income and commodities are partially driven by the expected dynamics of short-term interest rates and inflation. On the other hand, expected returns for equities and real estate are closely linked to projected inflation and real GDP growth via the second (growth) pillar of total returns (see table).

The key takeaway is that a building-blocks approach is consistent internally. Expected returns are driven by distinct, clearly identifiable factors which are intuitively combined in a multi-asset class setting. By design, this framework ensures that investors are appropriately compensated for the risks taken. This is usually essential for a robust asset allocation process.

Optimal asset allocation policy

Diversification is the bedrock of any asset allocation and portfolio construction process. In investment circles, it is often said that diversification is the only free lunch.

“Diversification is the bedrock of any asset allocation and portfolio construction process. In investment circles, it is often said that diversification is the only free lunch”

In a portfolio consisting of core asset classes only (perhaps equities and bonds), diversification across sub-asset classes and implementation through a careful selection of funds and individual securities can help to reduce idiosyncratic risks. Investments into alternatives such as commodities, real estate, hedge funds and private assets can further improve portfolio diversification and stabilise returns.

Building a well-diversified portfolio can substantially reduce risks, however the systematic component cannot be eliminated. As such a structured asset allocation process is crucial for constructing investment strategies that can optimally balance out return and risk.

Optimisation engine

When building an asset allocation optimisation engine, two elements come to the forefront: reward and risk. Given a set of optimisation inputs such as expected returns, risk budgets and investment restrictions, our goal is to determine the asset mix which minimises risk or, alternatively, maximises returns.

Asset class	Building blocks of total returns				
	Income		Growth		Valuation
Fixed income	Treasury yield	Credit spread	Roll return		Treasury yield curve adjustment Credit spread adjustment
Equities and REITs	Dividend yield	Net buyback yield	Real earnings growth	Inflation	Multiple expansion
Commodities	Collateral return		Roll return		Spot price adjustment
Hedge funds	Quantitative approach				
Private markets	Public market benchmark			Illiquidity premium	

Source: Barclays Private Bank

The reward is defined as the expected portfolio return. In the SAA world, the aim is to design optimal asset allocation policies over multi-year investment horizons. Therefore, the key assumption in our model is that clients remain invested – and reinvest any interim proceeds they might receive – in their selected strategy over a long period. For this reason, we use expected long-term compound returns as the reward metric.

Understanding risk

In our SAA framework, the risk is defined using a tail risk measure. Although volatility – which measures the standard deviation of return distribution – is the most popular risk metric in the industry, it does not capture the full nature of risk. Indeed, volatility represents a symmetric risk measure that is only well suited to situations where asset returns are normally distributed. This assumption typically does not hold in practice. Extreme market moves are much more frequent than what is expected for normally distributed returns.

It is a well-known fact that – for many asset classes – return distributions are negatively skewed and fat tailed. Moreover, investors may be loss-averse and react differently to down and up markets. To address these concerns, we use expected shortfall as a proxy for risk.

Expected shortfall is a coherent risk measure that can be used to estimate the expected loss in the tail of distribution. Incorporating a tail risk measure into optimisation allows us to extend applications of our model to shorter time horizons and to consider optimal portfolio hedging strategies on tactical basis.

Towards the SAA review

Overall, our new SAA methodology is expected to offer a consistent and portable building-blocks approach for estimating expected long-term returns and risk parameters. It also allows asset allocation optimisation that can be flexibly applied for a broad range of investment strategies and risk profiles.

Over the next few months, as implementation of our new SAA framework approaches, regular deep dives into our thinking when it comes to SAA philosophy will be provided. Some topics covered today, for example risk management, CMA or optimisation, will be addressed in more details as part of this series of articles focusing on our new framework.



Jai Lakhani, CFA, London, UK Investment Strategist

Hedging downside tail risk

With financial markets pricing for a vaccine-driven recovery this year, volatility is likely to remain elevated given pandemic developments and how soon the economy returns to health. What can investors do to manage portfolio risk?

The first step in portfolio construction is to find the optimal allocation across asset classes that, on average, provides the highest return for a given level of risk.

Traditional portfolio theory shows that returns tend to follow a so-called bell curve distribution, with the most probable returns concentrated around the centre, or the mean return. Less probable returns narrow away towards the edges of the curve where the least probable, but more extreme, returns lie.

Managing risk

While it is important to manage overall risk in a portfolio, tail risk on the left hand side of the curve is arguably the most important as it corresponds to heavy losses. Although it is less likely, these events tend to be more severe in terms of frequency, duration and magnitude of losses than theory would suggest.

Financial markets do not tend to behave “normally” and periods of market stress tend to occur more frequently and globally than investors may expect and theory suggests. It therefore has the potential to wipe out a portfolio’s value and with it prevent investors meeting their objectives.

What tends to be forgotten is that even in a bull market, corrections happen, as highlighted in the alternatives article in Market Perspectives last month, an average correction of 10% each bull year in equity markets. Such downsides are not restricted to equities. Bonds can also experience significant yield volatility, for instance the taper tantrum of 2013, on the surprise tapering of quantitative easing by the US Federal Reserve, and spreads rocketing last year at the height of the pandemic.

Thus, long-term investors may want the risk/return profile of a portfolio to be asymmetric and the left tail thinner. There are three potential avenues that might be considered to achieve this.

Hedge funds to protect left tails

First, options can be used to manage portfolio risk exposure. Buying puts provides insurance and may take out the whole of the damaging left side of the tail of the curve. However, there is a premium to pay for this “left tail”, which is either a cost to the investor or offset by selling calls and giving up some of the potential upside return. It creates asymmetry but at a significant cost.

Second, futures allow a dynamic asset allocation approach to be used. Buying and selling futures contracts can help to shift portfolio asset class allocation in order to participate in any upside and protect against severe losses. Such a strategy is less expensive and more flexible than options.

However, it requires regular portfolio monitoring and a framework embedded into the portfolio. For many focused on investing over a long-time horizon and without constant changes, this could prove taxing and the timing of a correction might still be difficult to judge.

Preferred approach

The final avenue, and our preferred choice, is to externalise the management of tail risks and consider hedge funds with systematic asymmetric returns: low beta strategies such as market neutral, macro multi-strategy or low net long-short equity may all help to reduce the left tail in a portfolio.

By actively selecting managers with robust processes and proven investment methodologies, investors could make the step up from efficient diversification to hedging tail risk and an asymmetric return profile.



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

Is there an ESG bubble?

With increasing capital flowing into sustainable investing, there are suggestions of an emerging bubble. How can investors avoid the froth and find long-term investment opportunities?

In our 2020 Investing for Global Impact research with over 300 leading global families, we found that they planned to almost double their portfolio allocations to sustainable investing in the next five years.

Given the risks of delayed global economic recovery, it may be worth considering what this might mean for the current momentum in sustainable investing.

Popularity grows

As we analysed in Market Perspectives in June, the acceleration into sustainable investing occurred during the initial period of the pandemic when market volatility was particularly elevated. So if economic conditions deteriorate again, it seems unlikely that the current level of flows would be stemmed. Rather, such conditions might encourage more flows from new investors not wanting to miss out again.

Given this, and our more optimistic, base case for decent growth, it highlights the risk that enthusiasm is inflating the sustainability trend without a deeper understanding of the drivers and approaches for such investing. In essence, the emergence of what Nobel Laureate Eugene Fama calls an “irrational strong price increase that implies a predictable strong decline”¹ or more simply, a bubble.

For investors, either committed to investing sustainably or considering starting, we review the potential for this emerging bubble and how to position portfolios for a potential burst.

Sustainable investing bubbles up

By the end of 2020, growth in assets invested sustainably during the year delivered on the phrase that was too

frequently tossed around at the onset of the pandemic, “unprecedented”.

In Europe, Morningstar calculated that sustainable funds grew by 52% last year, crossing the €1tn mark for the first time in December 2020. In the fourth quarter alone, these funds attracted close to €100bn in net new money, absorbing 45% of total funds flows for the region².

As money has flown into the sector, prices have risen accordingly. Moreover, a high commonality and concentration of names in the key holdings of thematic sustainable funds continues to fuel more pricing growth.

Whether these price increases can be supported by future cash flows, remains to be seen. At present, though, the valuation metrics show heightened levels across sustainability-related investments.

Relative outperformance

The Indxx Renewable Energy Index³, which tracks companies involved in producing energy from renewable sources such as wind, solar, hydroelectric, geothermal and biofuels, is trading at 42 times trailing earnings, double the multiple of the MSCI ACWI. That said, the MSCI Europe Energy index, which tracks the largest European companies in the traditional energy sector, is trading around 60 times trailing earnings, nearly three times that of MSCI Europe⁴.

Now, contrast these with the MSCI ESG Leaders Index, which tracks companies from across the world with high environmental, social and governance (ESG) performance relative to their sector peers. It, in fact, has a marginally lower price/earnings ratio compared with its parent MSCI ACWI⁵ with both around 27 times trailing earnings.

¹ Two pillars of asset pricing, Eugene Fama, American Economic Review 104, 1467–1485 <https://www.aeaweb.org/articles?id=10.1257/aer.104.6.1467>

² European Sustainable Funds Landscape, Morningstar, February 2021 <https://www.morningstar.com/en-uk/lp/sustainable-funds-landscape>

³ Indxx Renewable Energy Index, Feb 2021, <https://www.indxx.com/indxx-renewable-energy-producers-index-ntr>

⁴ MSCI Europe Energy Index, Feb 2021 <https://www.msci.com/documents/10199/43f0da3c-a77f-45f7-9037-5a7a60184db5>

⁵ MSCI ACWI ESG Leaders Index, Feb 2021, <https://www.msci.com/documents/10199/9a760a3b-4dc0-4059-b33e-fe67eae92460>

Charting the relative performance of these two different sustainability-related indices, compared to a standard benchmark, highlights the outperformance of both indices in the last year. While in both of these comparisons sustainability thinking is incorporated, how it is applied, on a thematic or factor basis, has a material difference on returns (see chart).

More money, more problems?

There are rational, and heartening, reasons for capital flowing into the field. However, one issue is that “ESG”, “sustainable”, and “green” are often used as catch-all buckets for what are very different strategies, sectors and investments.

Assessing the operating practices of a company using ESG data is as applicable to an oil and gas company as a solar energy provider. And a passive ESG fund that tilts market weightings based on ESG scores may hold both types of companies, which could be a surprise to uninformed investors.

Contrastingly, using ESG ratings to create a simple screen to exclude companies that manage relevant operating issues worse than their peers has different investment implications than using the source ESG data in bottom-up company analysis on specific financially material issues. However, both approaches can truthfully, if opaquely, be given a sustainable or ESG label.

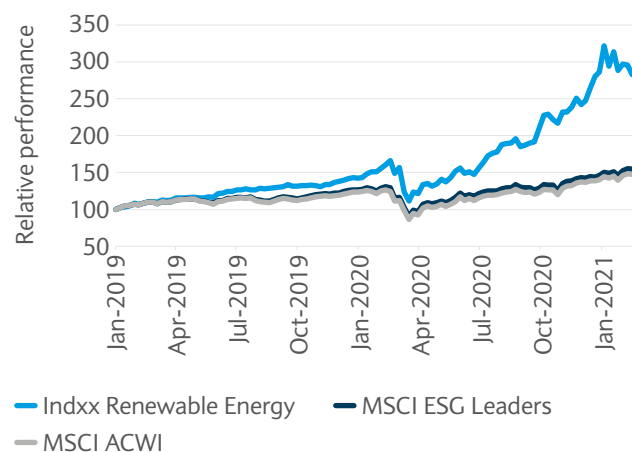
Similarly, “green” investments can focus on projects or companies where goods and services are generating revenues by addressing environmental challenges and/or climate breakdown. Or, guided by the “E” in ESG, they can focus on companies whose business activities, energy consumption and supply chains are more environmentally friendly than competitors, irrespective of their industry sector.

Nuanced field

These examples illustrate the nuanced nature of this field. However, when we look at mainstream reporting and investment flows, they tend to oversimplify the situation. Investors following the herd may be whipping up these

Sustainable investing on a roll

Relative performance of Indxx Renewable Energy, MSCI ESG Leaders and MSCI ACWI indices since 2019



Source: MSCI, Indxx, Barclays Private Bank

flows, and causing funds to appear to have performed well without the holdings supporting the increases.

Additionally, underlying stocks are trading at frothy levels. Notably, “green” companies providing solutions to environmental challenges, in sectors such as electric vehicles and associated fuel cells, renewable energy and waste and water management, are attracting much capital. Given price levels, they seem most at risk of not being able to deliver the long-term returns their earnings multiples suggest.

Bursting the bubble

For investors who want their capital to be invested sustainably, there is a conundrum. If a bubble exists, investing in it serves neither investor portfolio returns or provides the capital to catalyse solutions for our global challenges. Investors might consider three strategies to mitigate hazards or accept the risk associated with the issues.

Understand the terrain

Investors should start by understanding the different approaches to sustainable investing and their implications for both their family's portfolio and preferences around sustainability.

Spend time reading about or discussing the different sustainable investing approaches in the context of your portfolio. In our Outlook 2021, we clarified potential options investors could incorporate in aiming to consider ESG effectively into their investment process and highlighted some of the key E, S and G factors for this year.

Armed with this knowledge, it's easier to spot the hype that creates a bubble and not be confused or caught up by the terminology or marketing in the field.

Use ESG as means to ends

Investors should focus on the use of ESG as a fundamental part of the investment process, not a simplistic filter or shortcut to select funds based on name.

“Investors should focus on the use of ESG as a fundamental part of the investment process, not a simplistic filter”

Within public markets, we see adding ESG factors can help make more informed investment decisions. Within our investment philosophy of preferring higher-quality companies, this provides a useful inspection of the internal operational quality of a business. Investment teams are incorporating ESG to select companies that should be less prone to internal issues and more resilient to external shocks.

In this way, bubbles become more avoidable or immaterial. Notably with active management, where undertaking fundamental analysis determines if a company is valuable to hold over a long term after any pop.

Going for green

Lastly, where green companies in public markets are getting swept upwards in seeming over-exuberance, an alternative is to look for opportunities in direct investments or funds in the private markets.

While not immune to investor excitement, valuations are generally not subject to the same momentum and volatility. As well, being mentally and legally committed to a long-term horizon reduces the risk of selling out at the wrong time and allows your investment time to mature. Moreover, both aspects help to avoid common behavioural biases around bubbles.

Previously we outlined four structural themes facing economies, and more recently delved deeper into Greening the Economy and Smart Cities, where there are entry points for long-term, growth-oriented investors.

From bubble to a tectonic shift

Increasingly global families appear to be allocating more of their portfolios to invest sustainability. Like any exciting investing idea, expectations can exceed reality for a time. It's likely that this is the stage of the cycle for sustainable investing. But, as BlackRock's Larry Fink noted recently in this year's CEO letter⁶, this is a “tectonic shift” that is accelerating, rather than a bubble waiting to pop.

⁶ Larry Fink's 2021 letter to CEOs <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-lette>



Alexander Joshi, London UK, Behavioural Finance Specialist

Staying invested is not always plain sailing

In this edition we have examined the downside and upside risks to the recovery. The key risk on investors' minds should however be the risk to achieving their investment objectives. Staying invested may be the best way to do so.

A much anticipated base case of a strong vaccine-driven recovery this year could be affected by many risks, whether positive or negative. But as with every year in financial markets, events, anticipated or not, may get in the way.

No crystal balls in investing

When setting out the different risks to economic growth and market performance, more or less conviction may be attached to the likelihood of events occurring. Further precision is, however, extremely difficult. Many historical downturns have been hard to predict.

Precise probabilities and timings around events can give a false sense of confidence, which can lead to misplaced conviction that ultimately proves costly. Behaviourally, people also tend to overreact to small probability events, but underreact to medium and large probabilities.

When things don't go according to plan

There will be times when unconsidered or low likelihood risks occur and raise market volatility while negatively affecting the value of held assets. The first rule is not to panic. Market events, particularly those that are unexpected or not in line with one's prior beliefs, can be unsettling. Particularly when a strong conviction was placed on the prior beliefs.

Humans like control, and when it seems to be lost can take actions that help to regain this control. The problem is that what can help achieve this in the short term can come at the expense of the long term. For instance, actions taken that run contrary to maximising returns for a given level of risk over an agreed time horizon.

Remember the possible upside

When the word risk is used in investing, it is primarily used in relation to risks on the downside. But there are also upside risks to the economy and markets.

From the point of view of investor psychology, losses have been shown to have a larger impact on people than an equally-sized gain. Additionally, the desire to avoid losses can be stronger than the hope of making gains, so an investor may assign more weight than they should to negative scenarios and less to positive ones.

While the bounce in markets seen since March can give the impression that all positive news such as the authorities' pandemic support measures must be factored in, and that any surprises must be to the downside, this doesn't necessarily have to be the case. The next big productivity breakthrough, the engine of economic growth and future returns, may appear at any moment and is often impossible to predict.

But risk and uncertainty are uncomfortable

History tells us that getting and staying invested in the market is likely to be the best course of action for an investor seeking to reach their long-term goals, in the face of both downside and upside risks. For it is time in the market, and not market timing, which typically matters most for long-term returns.

However, knowing that there are positive as well as negative risks may not necessarily be reassuring to an investor thinking about getting invested, because inherent in the word risk is that there is uncertainty about the future.

Many believe that waiting for calmer times to get invested is a sensible approach in the face of uncertainty. The problem with this approach is being kept perennially waiting on the sidelines for a moment that does not materialise for a long time. In the meantime, markets may rise higher. Phasing in to the market may be an approach for these cautious investors.

Phasing in investments

For the investor who is nervous about getting invested against an uncertain backdrop, phasing in investments over time may be one way to increase comfort with getting invested. By drip feeding capital into the markets over many months or years, investors may be able to reduce the impact of short-term moves, which may improve the entry point.

We have spoken before about the difficulties of timing the market. In addition, the behavioural challenges of investing and the potential for cognitive biases and emotions to influence decisions can compound the difficulties with timing markets. In investing humility is a valuable trait; investors should accept they not always be able to invest at the optimal time, but should remember that over the course of their likely time horizon this won't be what determines success.

Therefore, phased entry according to defined rules may be a sensible approach. A common approach is to split up a lump sum into equally-sized investments which are made at regular intervals over a period of time, for example monthly. Another is to use market index levels as entry points; this can be an effective way to enter, except if markets continue to rise and capital remains on the sidelines. The key point is to be specific in the plan, and maintain discipline and stick to it.

What risk should investors focus on?

We have outlined potential risks to economic growth and financial markets, on both the downside and upside. We have also considered phasing in to the markets as a way for investors to overcome jitters about short-term volatility.

But what is risk and how should investors think about risk in relation to their own portfolios? Risk is seen by many as a short-term concept – the volatility of an asset over a period of time. While short-term fluctuations in investments can be uncomfortable to weather, this is not the risk which is most material for investors.

For an investor who is putting their capital to work in the markets to achieve particular long-term goals, the risk an investor should focus on is the risk of not reaching said goals.

“For an investor who is putting their capital to work in the markets to achieve particular long-term goals, the risk an investor should focus on is the risk of not reaching said goals”

Focus on the long term

Fluctuations in a portfolio's value over the short term can be troubling for investors. But this is not an adequate concept of risk for many investors. For investors putting their capital to work to achieve particular long-term objectives, risk should be defined as the probability of not meeting those goals.

This isn't to say that events that affect an investor's satisfaction with being invested should be dismissed; having an investment plan that one can stick to is as important as the plan itself. However, investors should remember that to maximise the returns from the capital put at risk in the markets, they should focus on the factors that maximise the chance of meeting their goals and not necessarily on having the smoothest ride.

Investing shouldn't be all plain sailing, and fear of a bumpy ride should not be the barrier to getting invested. The biggest risk of all is not taking one.

Gerald Moser, Zurich Switzerland, Chief Market Strategist

Multi-asset portfolio allocation

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

Cash and short duration bonds: high conviction

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

Fixed income: low conviction

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

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

Developed market government bonds: high conviction

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

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

Investment grade bonds: neutral

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

High yield bonds: low conviction

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

- **Emerging market bonds: low conviction**

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

- **Equities: high conviction**

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

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

- **Developed market equities: high conviction**

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

at equally high rates of return. The US tends to offer us more opportunities to invest in such businesses, meaning that North America remains the largest geographical weighting within the equity allocation.

- **Emerging market equities: high conviction**

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

- **Other assets: low conviction**

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

- **Commodities: neutral**

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

- **Real estate: low conviction**

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

- **Alternative trading strategies: low conviction**

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

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

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