

Private
Clients

Market Perspectives

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Foreword

After a relatively quiet summer, financial markets finished September worried about the difficulties facing China's second-largest real estate developer, Evergrande, and its potential impact on both the country's growth and international markets. That said, for all the uncertainty, many equity markets remain relatively close to all-time highs.

In equities, the outcome of Democrat proposals to link tax rises with planned large-scale infrastructure seem likely to dampen S&P 500 earnings expectations. However, the net effect on company bottom lines of the proposals is unclear. Analysts are unlikely to adjust their earnings estimates until the law is passed, as occurred with Republican tax cut in 2017. It is a case of wait and see.

Turning to fixed income, corporate bond spreads have narrowed considerably since last year, aided by a splurge in central bank liquidity in response to the pandemic. That said, positive signs on the economic front point to persisting tight high yield spreads, and so to their potential return prospects. Avoiding the highest beta bonds offering the highest spread, in a disciplined investment manner, seems a prudent approach in current circumstances.

As for commodities, surging metals and energy prices are attracting the attention of investors and central bankers alike, as inflationary pressures may threaten the economic recovery. Supply outages, extreme weather and the green energy revolution are among culprits driving up prices. Whatever the future holds, commodities can play a role in hedging inflationary pressures.

Indeed, the future for green energy may be affected by November's COP26 global gathering to tackle climate change. To ensure the successful transition to low-carbon fuels, the use of private capital will be necessary. Direct investments may particularly appeal for some as a way to target once-in-a-generation growth opportunities and influence climate change solutions. At the same time, exposure to green investments can provide diversification benefits to portfolios.

**Jean-Damien Marie
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Are taxing times ahead for US equities?

Higher US corporate taxes seem on the cards as Democrats advance infrastructure spending plans. Are US equities about to suffer as a result and should you adjust equity portfolios?

The Biden administration in the US has made clear that any large-scale infrastructure spending would likely be financed by higher tax rates. With the Democrats trying to advance their political agenda, should investors worry about a possible corporate tax rate hike?

Higher taxes on the horizon

A hike in American taxes looks likely soon, but there is no certainty as to what they would look like. Back in 2017, President Trump cut the US statutory corporate tax rate to 21% from 35%, the highest in the OECD. Current discussions seem to place a revised tax rate in the 25% to 26.5% range, taking away less than half of the deductions introduced four years ago.

For individuals, according to the Democratic proposal, the top marginal income-tax rate may return to 39.6% with a new 3% “surtax” potentially levied on incomes greater than \$5 million. On the other hand, the long-term capital gains tax rate would be set at 25%. These, combined with the existing 3.8% investment-income tax and the surtax, would yield a top individual marginal tax rate of 31.8% at the federal level.

Companies would also face higher taxes on their foreign income with the minimum rate going up from 10.5% to 16.6%, although this would be offset by greater ability to offset foreign tax credits.

Assessing the impact

The Democrats’ razor-thin majority in the Congress means that any plan is likely to be subject to difficult negotiations and the end result could diverge widely from these opening bids. Nevertheless, the most probable outcome is that taxes, both for corporates and individuals, will rise in the short term.

However, any change in the tax code would most likely happen as part of a broader \$3.5 trillion reconciliation bill and therefore be, at least in part, offset by increased government spending. As a result, it is extremely difficult to assess the ultimate net impact of the proposed legislation.

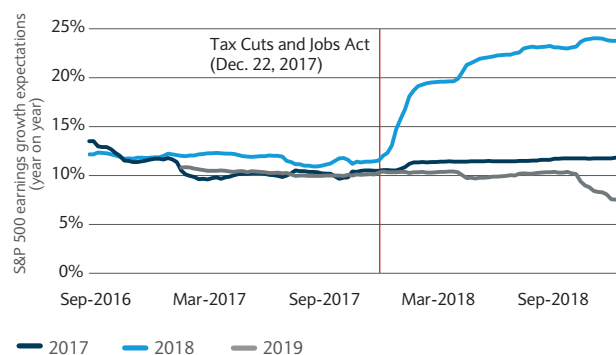
Estimates vary widely

Because of the tedious negotiating process in Washington and the various proposals being floated around by both sides of the aisle, analysts and investors are struggling to model the ultimate impact of proposed tax changes on markets.

At the corporate level, the consensus seems to range from a “worst-case” scenario of an eight percentage point headwind to S&P 500 companies and a “best case” scenario of a mid-single digit hit. Yet, as was the case for the Trump tax cuts (see chart), we would expect analysts to wait until the proposal becomes law before updating their numbers.

Impact of tax cuts on US equities earnings growth expectations

Changes in S&P earnings growth expectations, year on year, between September 2016 and December 2018, a period during which President Trump cut corporate tax rates



Source: Refinitiv, Barclays Private Bank, September 2021

Statutory versus effective

One other reason why modelling the impact of changes in the tax code is so difficult is the number of tax breaks that allow companies to lower their effective tax rate.

In fact, the majority of S&P 500 companies' most recently reported effective tax rates were below the 21% statutory federal rate. As such, a 5% increase in the tax rate is unlikely to translate into a 5% downgrade in earnings. Similarly, the impact would vary sector by sector and company by company.

“A 5% increase in the tax rate is unlikely to translate into a 5% downgrade in earnings. Similarly, the impact would vary sector by sector”

Second round effects

Last but not least, in order to properly assess the impact of higher taxes, the second round effects must be considered. As mentioned previously, the Biden administration's plan is challenging in that it combines a change in both corporate and individuals tax rates while increasing government spending. This may create offsetting factors, all with different timeframes.

For example, higher capital gains taxes could discourage some investors and weigh on stocks' valuations while infrastructure spending may boost long-term growth prospects. Similarly, improved paid family leave and childcare might boost productivity, though this would be negated if lower corporate profits reduced companies' ability to boost capital investments.

Wait and see

With all this uncertainty, the prudent approach is to wait and see rather than shifting portfolio allocation in anticipation of any potential tax changes. While we can establish that tax rates are likely to rise in the US and market participants haven't seemed too worried about this until recently, the rest remains speculation at this point. In addition, the macroeconomic landscape (the outlook for inflation, COVID-19 and central bank policy) is likely to have a much larger influence on markets.

As such, we maintain our view that US earnings growth will slow and that valuations will struggle to expand over the rest of the year. This should translate into more modest upside at the index level and higher volatility overall.

“We maintain our view that US earnings growth will slow and that valuations will struggle to expand”



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

The credit cycle: what next for corporate bonds?

Much attention seems to be being paid to the outlook for the rate market and the US Federal Reserve's game plan when it comes to bond purchases. The outlook for corporate bonds seems equally important. A glimpse through the lens of the credit cycle analysis may provide more insights.

Corporate bonds seem to be one of the last resorts for yield in the bond market. US investment grade bonds have returned over 2.5% in the last twelve months, while US 10-year rates surged from 0.65% to 1.35%. The positive performance may be achieved through the excess return of over 5.3%.

As the name suggests, it is the return more (or less) than that of equivalent government bonds within a given period. This consists of the carry (corporate bond yield premium or spread) and the return resulting from spread compression. Indeed, euro corporate bond investors have been able to lock in a small positive return in the last twelve months despite negative yields, helped by an excess return of almost 3%.

Spreads and the credit cycle

Yield spreads have compressed substantially since the peak of the crisis on the back of early extraordinary monetary support and government guaranty schemes. But are corporate bonds still worth taking the extra risk at current tighter levels? In order to examine the future direction for spreads and corporate bond returns, the following section looks underneath the headline spread levels along with some input factors applied when analysing the credit cycle.

Since spreads of US investment grade and US high yield reached lows in June this year, at 80 basis points (bp) and 270bp respectively, the tightening trend appears to have ended. A deeper look into the European corporate bond market reveals that while the tightening was mostly supported by sectors less exposed to COVID-19 at first, high beta and COVID-19-punished sectors like airlines, autos, energy, lodging and aerospace produced the largest excess return in the last 12 months.

The same can be witnessed through the lens of rating buckets. In the US, high yield CCC-rated bonds have returned roughly 18% in the last year, almost double the

performance of BB-rated bonds. Investors seem to be putting less focus on selection amid the hunt for yield, a typical phenomenon during mid-cycle phases.

Relative attractiveness supports spreads

Past cycles have shown high yield bond spreads, for example, tightening even when the outperformance of riskiest bonds (CCC) starts to reverse. And this time, the continuation of the "grinding tighter period" is mainly led by flows from dedicated bond investors that compare spreads to the next best alternative, being benchmark yields.

Spreads in relation to the very low yield levels suddenly appear more attractive again, as seen in many past crises. This time, US high yield spreads are three-times as high (270bp) as the 5-year US yield (90bp). In 2018 that ratio was one while in 2007 high yield spreads were only half that seen for US 5-year sovereign bond yields. This relative attractiveness of the spreads seems like an important factor keeping them at a relatively tight level during this period.

Spread and yield comparison, as described above, only consider one side of corporate bond markets. In a typical credit cycle analysis, various factors are considered. The following section highlights a few, potentially important, factors in assessing where we are in the credit cycle.

Anatomy of a credit cycle

A credit cycle describes the level of access to credit or funding for households and companies which varies over time and consists of four phases: expansion, downturn, repair and recovery. During the expansion phase there is easy access to funds and companies and households have cash to invest or spend. Asset prices generally surge until reaching peak levels.

With elevated leverage and credit in the system, credit costs can become too high and the asset base is not sufficient to serve these credit costs anymore. This may lead to the often

quoted “Minsky moment” named after the US economist Hyman Minsky (the Lehman banking crisis in 2008 and the current property crisis in China are good examples of such moments). Thereafter, balance sheets are restored and leverage is reduced leading to a recovery.

Is the credit cycle different this time?

It can be argued that the peak of this crisis has passed and that the cycle may transition from the repair to the recovery phase. However, the pandemic-related crisis was triggered by an external factor and may not represent a typical cycle as described above. In any case, examining the contributing factors to the credit cycle may point to what might lie ahead for spreads and corporate bonds.

Credit cycle factors can typically be categorised into three segments: economy, asset quality and liquidity. Factors include default rates, level of bond issuance and use of proceeds, lending surveys, money supply and balance sheet quality.

Liquidity seems the main driver for spreads, though don't forget about the economy

Liquidity can be measured in various ways. For now, it is grabbing much attention among investors. Central banks responded very quickly to the pandemic by providing extraordinary levels of liquidity through balance sheet expansion and increased money supply.

At almost \$8 trillion, the US Federal Reserve's (Fed) balance sheet grew by the highest level ever while growth in money supply ballooned to record levels. The expansion of the Fed's balance sheet led to a prolonged period of spread tightening in the years after 2009 and following 2016 for example. At the same time, a reduction of the balance sheet in 2013 and 2018 led to greater volatility in spreads.

The anticipated tapering of asset purchases by the Fed would potentially withdraw an important support for spreads.

Encouraging recovery signs

Another factor is the state and prospects for the economy. The global economy continues to recover from the crisis. High yield spreads in particular tightened in response to increasing purchasing manager confidence levels.

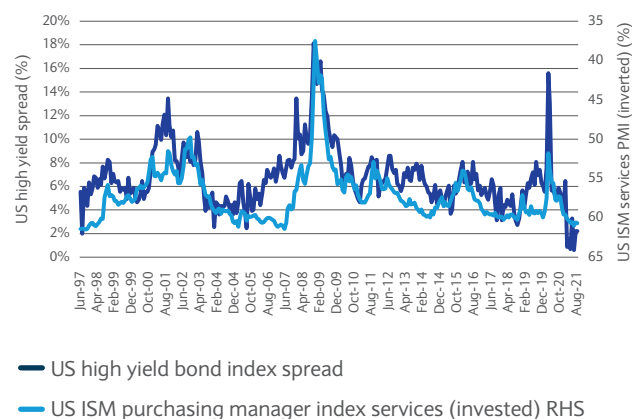
Levels over 60 measured by the US ISM service survey have corresponded with spreads trading close to record tightness in the past. For instance, in 2003 the US ISM services oscillated

at levels around 60 for almost 2.5 years keeping spreads at tight levels. In 2014 this period of high ISM readings and tight spreads lasted one year and in 2017 2.5 years (see chart).

Only in a period when both ISM surveys and monetary support declined have spreads started to widen substantially. The ISM survey has been over 60 for only the last six months, potentially leaving room for a period of tighter spreads.

Link between US high yield spreads and US ISM services index

The spread on the US high yield bond index compared with the US services purchasing managers' index since 1997



Source: Bloomberg, September 2021

Debt: the new medication

The third input factor which seems key is the level of leverage. This section focuses on leverage in the corporate sector in particular. The amount of debt outstanding among US investment grade issuers has doubled over the last decade to over \$7 trillion. At the same time the leverage ratio, which compares debt to operating profit, surged from 1.7-times earnings to around 2.7-times earnings. A quarter of the issuers have leverage of more than four-times their respective earnings.

Meanwhile, leverage among high yield issuers declined in the US to 4-times earnings, below the 2008/2019 levels. The decline in leverage within the high yield market in recent months is partly a result of highly leveraged issuers dropping out of the universe as they defaulted during the crisis. Indeed, some larger former investment grade issuers have joined the high yield segment after being downgraded to high yield status (known as fallen angels).

Despite the earnings recovery of late, leverage remains comparatively high. The classical repair phase of the credit cycle, in which leverage after a crisis is reduced substantially, does not seem to have kicked in this time: taking on more cheap debt seems to have been the way out of the crisis for many.

Debt is affordable

It seems to have been affordable and efficient for many corporate issuers to operate on higher debt levels. The average coupon for US high yield issuers, for example, is 5.8%. Investment grade companies can be quick to point to the improved interest cover as earnings are roughly ten times as big as the interest cost. However, a brief look over the longer term reveals that this supposedly high interest cover has deteriorated over the last five years. The question remains how much debt is still affordable?

Positive backdrop supports spreads

For now, the outlook for corporate bonds has improved significantly since the peak of the crisis eighteen months ago, and spreads should still enjoy support from improving economic backdrop and monetary support. Default rates are declining at a fast pace with the trailing 12 months' rate for global speculative issuers 3.3%, from a peak of 6.8%, and is expected to decline further this year according to rating agency Moody's. At the same time, rating upgrades appear to dominate again.

Don't splash the cash

Corporate behaviour is likely to become key. Should companies start to exploit low interest levels by taking on more debt to fund M&A deals and commencing large-scale shareholder distribution via share buybacks or dividends, then the next cycle may start without having gone through the repair phase in this one.

Tight spreads in combination with an overall higher level of leverage warrant a disciplined approach as there is higher risk for volatility. It may involve avoiding the highest beta bonds offering the highest spread. Investment grade bonds, especially with higher duration, look expensive in this context while lower quality high yield bonds seem the most exposed to corrections.

“Should companies start to exploit low interest levels by taking on more debt to fund M&A deals...then the next cycle may start without having gone through the repair phase in this one”



Jai Lakhani, CFA, London UK, Investment Strategist

How much longer might commodities drive inflationary pressures?

Calls for a supercycle emerging in the first quarter of the year, and commodities staging a comeback in the third quarter, keep many investors evaluating the effects of mounting price pressures. Can investors help to hedge portfolio return by investing in commodities?

Charging inflation and factory gate prices have dominated the headlines of late. Although the pace at which prices are rising is slowing, commodities continued to appreciate in the third quarter. This pushed producer prices to a nine-year high in China despite Beijing's best efforts to cool them.

As discussed in previous Market Perspectives, commodities are a big part of the inflation basket for many countries. As such, the recent rally needs to be evaluated against longer term inflationary implications. This helps to better understand whether its impact on inflation might catch investors and central banks off guard and how best investors might be positioned. To answer these questions, we must analyse the drivers behind commodity prices.

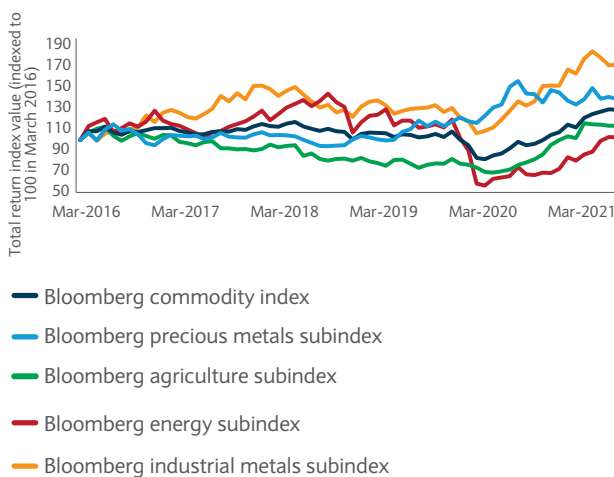
A combination of strong demand, climate change concerns, increased regulation, adverse weather conditions and supply shortages seem to be driving the hike in commodity prices in the last six months (see chart).

Industrial metals lead a multi-year hike in commodity prices

Base metals such as aluminium, nickel and lithium have touched thirteen, seven and three-year highs respectively. The headline grabber, aluminium, has had to face supply-side hurdles such as rising freight costs, shortages in Europe and the US. Meanwhile, production of aluminium ore bauxite has been affected by political disruption in Guinea, the world's second largest producer, as well as a fire forcing a shutdown in a large bauxite refinery in Jamaica.

Metals lead the charge in commodities this year

The performance of the Bloomberg commodity index since 2016, along with precious metals, industrial metals, energy and agriculture subindexes



Source: Bloomberg, Barclays Private Bank, September 2021

At the same time, there's also the impact of regulation in China. Authorities are restricting output in the Yunnan province (which accounts for 10% of China's aluminium capacity) from September to December due to electricity supply shortages.

Furthermore, it is worth pointing out that producing aluminium emits a lot of carbon, equivalent to 2% of global emissions. China's focus on reducing its carbon footprint is restricting output further.

The impact of green initiatives

Somewhat paradoxically, although producing aluminium is not climate friendly, the metal itself is used in technologies such as electric vehicles and solar panels. With green demand therefore rising at the same time as supply is declining, it's unsurprising the metal is soaring past the \$3,000 ton mark.

Green demand has also accounted for a lot of the rise in nickel and lithium, largely down to electric vehicle batteries, with demand particularly rising in China. Simultaneously, depleting stocks of lithium battery materials in China and nickel supply falling short despite a 300,000 ton increase of Indonesian nickel supply this year, have supported both metals.

Energy plays its part

On the energy front, oil is recovering strongly this year, natural gas has hit seven-year highs and coal also set a new record.

While the transition to cleaner energy is underway and regulation makes using all three energy sources less favourable, demand remains strong. This even applies to coal, with China and India accounting for 65% of coal use.

Both oil and natural gas supply have been affected by Hurricane Ida in the US. The International Energy Agency estimates that once losses are fully tallied, the events may have cut 30 million barrels of US offshore oil output. Three quarters of natural gas production in the Gulf of Mexico has also been lost.

Natural gas prices already had a boost from weather conditions and technical supply shortages in Russia. A warmer than anticipated summer increased demand through air conditioning. Going into the hurricane, supplies were already stretched in the US, and the prospect of limited additional supply from Russia has led to significantly higher gas prices in Europe.

Oil has also seen support as a result of OPEC+ standing strong against pressures to increase production at its September meeting, in addition to regulatory pressure and increased demand with the vaccination helping economies to reopen.

Soft commodity sectors

In the softs sector, weather has dominated the narrative and resulted in shortages and lower crop yields. Extreme weather conditions in Canada, Europe and Russia have driven wheat and corn futures higher, feeding through

to soybean prices breaking record highs. Hurricane Ida restricted production in 118,000 acres of sugarcane crops in Louisiana, with sugar reaching a four-year high.

Has the rally got more legs and what does this mean for inflation?

Commodity price rises are likely to keep translating into inflationary pressures for some time. Historically, commodities have illustrated their effectiveness as an inflation hedge and could be used to dampen inflationary pressures in a portfolio context.

Our cross asset article shows each commodity subsector positively correlated to rising inflation and positive inflation surprises. However, longer term, there are some drawbacks to the whole commodity complex seeing further uplift.

Output cuts and supply shortages

Restrictions in Chinese output of aluminium will encourage new capacity in other parts of the world. Countries such as Russia, Malaysia and India, along with the Middle East region investing in new capacity, might alleviate price pressures. Also, the production of aluminium can be made greener, which would limit the regulatory constrained output of the metal.

Supply shortages arising from adverse weather conditions tend to be temporary as opposed to a permanent phenomenon. We have seen this historically, especially in the softs sector.

Effect on economic recovery

The potential impact of commodity prices on the health of the economic recovery is a clear risk. That said, further oil price rises seem limited in the short term due to the likely dent in the economic recovery it would cause. Also, higher oil prices may incentivise both members of the wider Organisation of the Petroleum Exporting Countries grouping (OPEC+) like Russia to deviate from the production agreement with other members of the group. Non-OPEC producers such as the US may come back online too.

The knock-on effect of more COVID-19 cases sparking further economic restrictions also hovers in the background.

We anticipate that price pressures may remain, and demand is unlikely to fade for commodities that will be essential for the green revolution and renewable energy. Metals such as lithium, nickel and copper fall into this category.

Lukas Gehrig, Zurich Switzerland, Quantitative Strategist; Nikola Vasiljevic, Zurich, Switzerland, Head of Quantitative Strategy

How to diversify investments whatever the macro weather

Financial markets are far more correlated than they were in the 2000s. This poses challenges for diversification that needs an additional lens to analyse dependencies. General macroeconomic indicators can inform macro-dependent investment decisions.

The best advice for building a robust portfolio has always been to diversify across different asset classes rather than putting all your eggs into one basket.

As we have argued several times in previous Market Perspectives, diversification has become even more important with the increased globalisation of financial markets. It is well known that diversifying investments beyond a simple mix of equities and bonds offers both opportunities and risks that can strengthen the robustness of a portfolio.

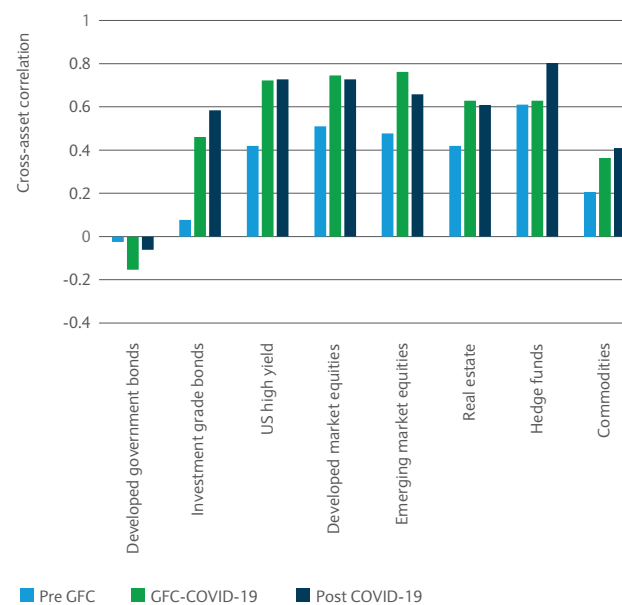
Global financial crisis made its mark

A less well-known fact is that the correlation between asset classes has increased considerably since the early 2000s. Looking at three distinct periods this century, before the global financial crisis (GFC), between then and the pandemic onset and then since, shows the different correlations between the returns on one-out-of-eight key asset classes against the others (see chart). We have chosen the broad asset classes that would be represented in a typical US dollar.

The blue bars represent the years 2000 until the onset of the GFC. Asset classes like government or investment grade bonds and commodities exhibited only benign correlation to the returns of the other asset classes. This implies that they are good diversifiers for riskier assets, such as high yield credit or equities.

Correlations between asset classes have increased

Each bar represents the median correlation of the risk-adjusted excess return over cash (sharpe ratio) to the remaining asset classes. Time spans: Pre GFC (2000-2007), GFC-COVID-19 (2008-2019), Post COVID-19 (January 2020-August 2021)



Source: Bloomberg, Barclays Private Bank, September 2021

Market interventions increased cross-correlations

The green bars, on the chart on p11, for the inter-crisis period show a significant increase in correlation across asset classes. And, while still very short in history, the dark blue bars for the post-COVID-19 period suggest that cross-correlations have risen even more since the outbreak of COVID-19 and the policy responses to it.

This change in correlations, brought about by quantitative easing intended for asset price stabilisation and unprecedented government spending programmes, has undoubtedly made diversification more difficult to achieve.

Macroeconomic regimes can explain asset co-movement

While there are sources of uncorrelated opportunities that can be tapped in private markets, these are tailored solutions, which would be difficult to replicate for many investors. Another popular solution to the above-mentioned diversification problem does not actually introduce new, uncorrelated risks, but seeks to better understand the drivers of the co-movement.

Traditionally, growth and inflation are used as macroeconomic indicators, driving returns in financial markets. Indeed, growth (or surprises therein) can explain a large share of the co-movement of risky assets, while inflation can be cited for outperformance of real assets such as commodities. But there is a third driver: monetary policy (see chart).

The economy in three macroeconomic indicators

Normalised and aggregated changes in macroeconomic time series on industrial production (growth); Consumer price index and Citi Inflation surprise index (inflation); and fed funds rate and US monetary aggregate M2 (monetary policy)



Source: Bloomberg, Barclays Private Bank, August 2021

A question of design

In building these macroeconomic indicators, we made a host of assumptions that can influence any subsequent analysis. We selected well-known US indicators, transformed them to year-on-year change basis (where necessary) and normalised the indicators to a mean of zero and comparable variance.

These indicators work well in explaining co-movement in our key asset classes at a medium-term horizon (say six months), where many single event-shocks not captured by the indicators are smoothed out. A much more reactive set of macroeconomic indicators would be needed to explain co-movement on a monthly, weekly or even daily basis.

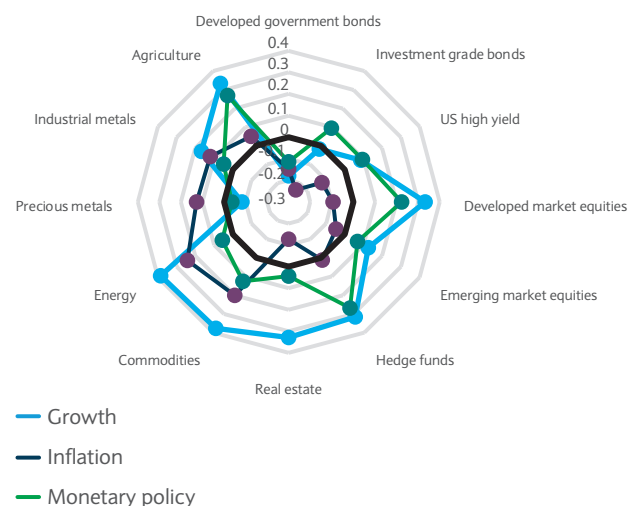
The real, the cyclical or the risky

The chart below visualises the partial correlations between the returns of each asset class and the three macroeconomic indicators. The highlighted black circle marks the zero-line. Points outside of this circle mean positive correlation and vice-versa.

It should come as no surprise that inflation is most negatively correlated with fixed income assets, while being positively correlated with commodities. Growth is most positively related with equities, cyclical commodities and real estate while weighing on returns of gold. Easy monetary policy created an environment where riskier fixed income and equities thrive, while returns on developed government bonds falter.

The macro-sensitivities of asset classes

Partial correlations of six-month returns for each asset class to the three identified macro drivers between January 2000 and August 2021. Partial correlations extract correlation to one factor while removing the influence of the remaining factors.



Source: Bloomberg, Barclays Private Bank, September 2021

Patterns to be exploited with a tactical tilt

The prior analysis shows that asset classes have become more correlated over time and that groups of asset classes (perhaps risky, cyclical or real assets) are associated with specific macro “weather”. We can use this information to help devise a tactical overlay to any given portfolio, overweighting assets that benefit from the current environment.

But there’s more to it

The above macroeconomic indicators have become more correlated over time: especially inflation, which has been more correlated to growth and monetary policy in the last decade. Clearly, when everything is correlated, including the underlying macroeconomic drivers, one would be tempted to focus on the high-returning assets.

However, this correlation of macro indicators may reverse. If so, it may be worth making diversification decisions in a portfolio context dependent on both the prevalence and co-movement of macro indicators. But this is something for a later article in this series.



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

How investors can take their first steps to finding climate-change solutions

As the COP26 gathering of world leaders approaches to tackle climate change, how can investors can not just avoid climate risk, but start to play their role by investing in climate-change solutions?

As we enter the final weeks before the United Nations COP26 starts in Glasgow on 1 November, media coverage and conversations will intensify around governmental actions to address climate change, and efforts to prevent its breakdown.

Many topics may feel distant to observers – how to price carbon emissions, mobilising an already committed \$100 billion per year from developed nations to help less developed countries transition, or improving collaboration between governments and non-state actors.

Global warming: code red

However, the potential implications of these COP26 discussions are enormous. As the UN released the latest Intergovernmental Panel on Climate Change (IPCC) report in August, the Secretary General stated simply that it is “a code red for humanity”¹.

But as the vast majority (86%) of global private wealth holders in our Investing for Global Impact 2021 research confirmed, we can’t rely solely on governments, or charities and corporations, but well-invested private capital will be essential to address climate change².

Investors, either personally moved or financially astute, may wonder what specific actions they can take in their family portfolios to promote positive change to address climate change.

Setting the framework for action

In April, the Institutional Investor Group for Climate Change published a “Net Zero Investment Framework Implementation Guide”³ to support institutional firms seeking to align their or their clients’ portfolios, with the goals of the Paris Agreement. Like other similar industry initiatives, it is not focused on, nor wholly applicable to, private individuals and family portfolios.

However, many aspects remain relevant and useful. Notably, they all broadly propose a net zero investment strategy should focus on achieving two objectives:

1. Decarbonise investment portfolios through use of science-based assessment and pathways that align with achieving global net zero greenhouse gas (GHG) emissions by 2050.

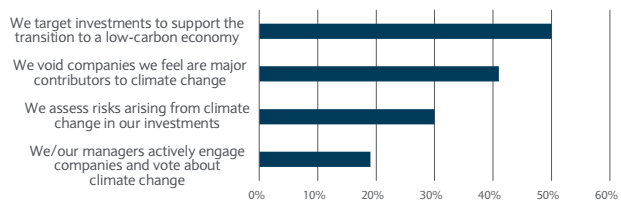
2. Increase investment in the range of “climate solutions” that will support the Paris goals.

For private wealth holders these objectives remain valuable to structure thinking and take action. Decarbonising existing portfolios is a critical element for investors to prepare for the implications of both transition and physical risks on existing and future holdings.

Given both a need and desire to drive change with capital, we focus here on the latter, so opportunities to increase capital allocations to companies providing climate solutions as a more proactive and catalytic approach. Notably, this aligns with the foremost approach of the leading sustainable investors from our research, where 50% said they were “targeting investments to support the transition to a low-carbon economy” (see chart).

How do you factor climate change into your investments?

Common reasons cited by private wealth holders globally as to how they approach investing for climate change



Source: Barclays analysis, Investing for Global Impact 2021, September 2021

1 UN, The secretary general’s statement on the IPCC Working Group 1 Report on the physical science basis of the sixth assessment, 9 August 2021 <https://www.un.org/sg/en/content/secretary-generals-statement-the-ipcc-working-group-1-report-the-physical-science-basis-of-the-sixth-assessment>

2 Barclays Private Bank, Investing for global impact 2021, September 2021 <https://privatebank.barclays.com/campaign0/investing-for-global-impact-2021/>

3 Institutional Investor Group for Climate Change, Net zero investment Framework Implementation Guide, 13 April 2021 <https://www.iigcc.org/resource/net-zero-investment-framework-implementation-guide/>

Deploying capital to innovative opportunities

The International Energy Agency notes that of the technologies that are needed to achieve net zero by 2050, almost half are currently only at demonstration or prototype phase. This means that most of the companies generating solutions to climate change will be seeking early- and growth-stage capital.

As ever, investing in early-stage and growth companies presents particular risks, so is not appropriate for all investors. However, looking again to the research, 70% believe the transition to net zero economy presents “the greatest commercial opportunity of our time”, in agreement with Mark Carney’s view as expressed at the launch of the COP26 Private Finance Agenda on 27 February 2020⁴.

Don’t let scale of options overwhelm

As a systemic problem, many investors may be overwhelmed when trying to decide where best to start deploying capital. But, climate change is not a single issue that will be addressed through a single sector or single investment.

Today there are a range of sectors, geographies and asset classes where climate investments have the potential to generate attractive returns and catalyse solutions. To help investors’ frame the landscape, we previously provided a structure around three broad outcomes in Greening the Economy in our Outlook 2021.

Direct investments have a particular appeal where an investor has strong conviction or time and appetite to support the growth of a company. However, sometimes not having a specific focus may be better for investors at the earlier stage of their journey.

Both funds, and baskets of companies, provide investors with an opportunity to access fast-growing, climate-related companies, and benefit from the selection expertise of the manager, as well as the diversification benefits of holding many companies. In addition, they often provide familiarity with a range of sectors to allow learned experience to dictate further interest and deeper knowledge.

Leverage your own family’s expertise and role

Many investors have existing family businesses that also require “green” technologies to mitigate their emissions or adapt to the physical effects of climate change. Here existing family and business knowledge can be used to identify issues and potential winners in the businesses with leading solutions.

For example, hoteliers will be looking at improving the energy efficiency of their stock or resilience to extreme weather. Those in the auto industry may bring knowledge of where manufacturers are headed with battery technology or charging infrastructure. Agricultural families may be considering precision or regenerative agriculture.

By linking investment opportunities to family interests both the process and, hopefully, the result of the investment will have positive benefits.

“Considering the alternative of inaction both on portfolio and planet level, acting to catalyse solutions can be a way not simply to invest for tomorrow, but influence it”

Taking action

As we know from our behavioural expert, taking investment decisions can be challenging when facing considerable uncertainty, especially when the options are both numerous and complex. However, considering the alternative of inaction both on a portfolio and planet level, acting to catalyse solutions can be a way not simply to invest for tomorrow, but to influence it.

For those interested to learn more about how the leading investors referenced in this article are repositioning their portfolios for climate change, a copy of the Investing for Global Impact report is available to download.

⁴ Bank of England, The Road to Glasgow, 27 February 2020 <https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/the-road-to-glasgow-speech-by-mark-carney.pdf?la=en&hash=DCA8689207770DCBBB179CBADBE3296F7982FDF5>



Alexander Joshi, London UK, Behavioural Finance Specialist

The danger of fearing market corrections too much

Periods of continued positive financial market returns can make investors uneasy and expect a correction to be imminent. But duration of time isn't the driver of the market cycle, and history shows that this shouldn't be a primary concern for investors.

The outlook for the world economy and financial markets looks far more positive than it did at the outset of the pandemic, if not as strong as it did a few months ago. Global vaccination efforts have led to an opening in those clouds that cast a shadow across the world last year and markets remain relatively close to their highs.

While the calmer markets seen in recent months may be appreciated far more by investors than previous periods of turbulence, others may fear that crosswinds are due.

It can be uncomfortable to be invested when markets are in a period of sustained positive returns, unhindered by substantial drawdowns and hitting record highs. A correction can feel imminent. Why?

The gambler's fallacy

The gambler's fallacy is a situation when we believe the likelihood of an event occurring is influenced by previous event outcomes. The market might feel due a correction because it has been rallying for long enough.

In the same way that a roulette wheel doesn't have to land on red on the next spin because the last few have all been black, the market doesn't have to correct simply because of a long rally.

What governs the market cycle?

Talking about a market cycle implies a cyclical nature in the market; that the market will go through periods of expansion and contraction with regularity. The predictable cyclical nature of the market can apply well at certain times, such as when a speculative bubble gives way to a crash.

However, expecting the market to correct simply because it has rallied beyond its historical average is the gambler's fallacy.

“Expecting the market to correct simply because it has rallied beyond its historical average is the gambler's fallacy”

It is important to reflect on what drives economic growth, expectations of which in turn drive financial market growth. The engines of economic growth and strong market performance will not stop functioning simply because they have been running smoothly and without interruption for an extended period.

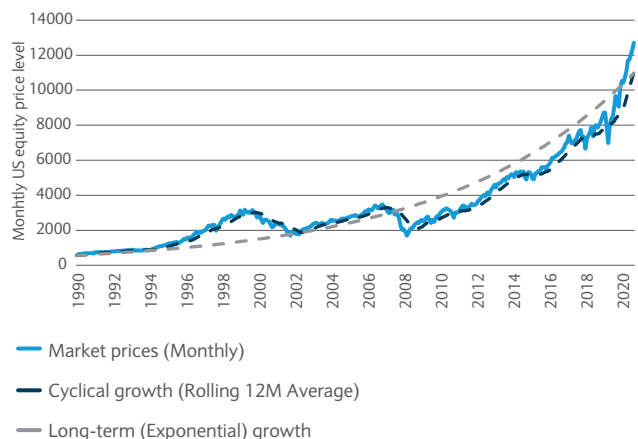
Growth is the norm

While past performance is no indicator of future performance, the historical performance of US equities provides a guide for nervous investors.

1. Growth is the norm and not the exception (see chart): Examining US equity market levels shows a steady upward trend since 1990.

Growth is the norm for US equities

The performance of the MSCI USA Total Return index since 1990 at market prices, the rolling 12-month average and long-term growth rates



Source: Bloomberg, Barclays Private Bank, September 2021

2. Periods of positive returns are more frequent and last longer (see chart below): Examining monthly performance since 1990, we see positive monthly returns occur two-thirds of the time and that the average duration of months of consecutively positive returns are longer than those of negative ones (approximately twice as long).

Furthermore, the maximum length of a string of consecutive up markets is three-times as long as that of down markets. Up markets tend to trend month on month. As we've discussed before, history shows us that the longer the investor's holding period, the higher the probability of a gain.

Up markets outperform down markets in terms of frequency and duration

Comparing monthly returns for the MSCI USA Total Return index by their average, largest, duration length and consecutive monthly runs for up and down markets

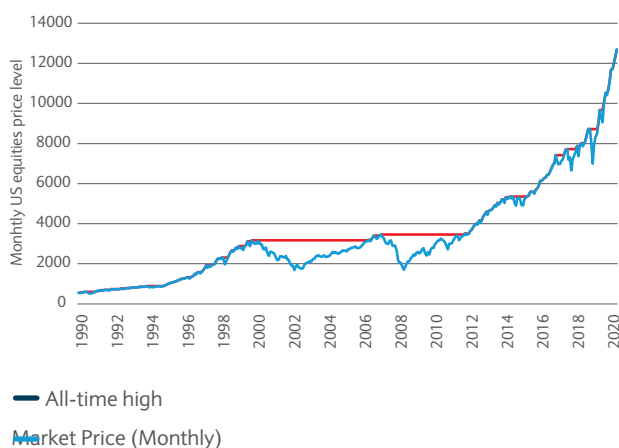
US Equities	Up Market	Down Market
Total count	252	127
Percentage	66.5%	33.5%
Average return	3.1%	-3.8%
Largest return	12.3%	-18.8%
Average duration	3.13	1.61
Max duration	15	5
Average consecutive return	9.5%	-6.1%
Max consecutive return	37.1%	-36.2%

Source: Bloomberg, Barclays Private Bank. US Equities represented by MSCI USA Total Return index. All figures expressed on monthly frequency September 2021

3. Markets have continually reached at all-time highs (see chart on right): The chart shows that it is not uncommon for markets to reach all-time highs, which they have done once every three months on average between 1990 to 2021.

Observed all-time highs for US equities

The number of times that a month has ended at an all-time high on the MSCI USA Total Return index since 1990 shows that a high occurred 34.7% of the time



Source: Bloomberg, Barclays Private Bank September 2021

But there are developments I'm worried about

The previous charts may give investors useful historical context, though this may not be enough to soothe concerns about the current market. While there are risks that could affect market performance, it may be worth taking a broader view around the impact of events.

As we have discussed previously, a diversified portfolio can protect an investor from the impact of events in different parts of the market. Additionally, in investing, as with life in general, too much weight can be placed on potential negative risks that never actually materialise. In the absence of a crystal ball, investors may be better served by taking cues from history.

There is never a perfect time to invest

The risk of events occurring when least expected that might affect the success of your investments always looms on the horizon.

A first step to addressing the fear of such outcomes is to rationally assess them with an advisor and assign likelihoods to them and their likely impact on your portfolio. This may quickly rule out concerns that are unlikely to be material enough to stop you from reaching your goals. By identifying scenarios that may require more attention, portfolios can be adequately positioned to protect yourself in the case that those risks do materialise.

The best way to do that is to adequately diversify a portfolio. It is not a requirement for long-term investment success for an investor to have high conviction views about all market events. By diversifying a portfolio, you don't have to. A portfolio that is well diversified will at times have assets which are performing less well than others, however it is when bad times occur that the value of these assets is realised.

One cannot rule out an event which takes down the entire market, like the pandemic, but financial markets are resilient and it takes an event of serious proportions to do so. An investor of course will not want to invest when such an event is imminent, but their realisation and their timing can be very difficult to predict. With this in mind, it is our belief that getting and staying invested remains the best option for investors looking to reach their goals over the long term.

“It is our belief that getting and staying invested remains the best option for investors looking to reach their goals over the long term”



Narayan Shroff, India, Director-Investments

Why India is standing out from the emerging market pack

While volatility is likely to be elevated, there's growing confidence in the strength of the Indian economic recovery, with diversification key in the months ahead.

Despite nothing being guaranteed when it comes to investing, almost all conditions needed to support a sustained Indian economic recovery seem to be in place.

- The spread of COVID-19 seems well contained, despite the busy festive season being underway
- The inoculation rate in India continues to gain pace, in line with our expectations, demonstrating the availability of and acceptance for vaccines
- The long series of pro-growth reforms introduced by the government over the last few years
- Both fiscal and monetary support continue to provide sufficient, targeted support where needed, as seen with the government's performance-linked incentive schemes this year
- The growing strength of the Reserve Bank of India's (RBI) forex reserves provides the necessary shield to allow a more accommodative policy stance relative to other emerging economies
- With the economic growth gaining pace, supply-side bottlenecks seem to be easing (barring some of the global supply issues such as semiconductor chips)
- The risks to rural growth emanating from the erratic Monsoon season also seem to have abated
- Robust liquidity and capital, both local and global, are available to businesses ranging from blue chips to start-ups continues to be robust
- Pent-up savings have supported the robust recovery in demand, for now.

Tough execution targets

The pace of the government's capital expenditure remains constrained by tough execution targets, and has room for a significant pick up in the second half of this fiscal

year. However, a period of broader, better-quality growth depends on:

- The private sector participating more, with capital expenditure plans getting executed
- Credit growth picking up (the inverse of the deleveraging cycle witnessed across many sectors)
- Employment picking up, especially the big void created in manufacturing, construction, retail, travel and hospitality.

Patience needed

All this will take time, and patience. While policymakers continue to keep a close eye on these economic indicators, equity investors should watch the latest quarterly corporate earnings season underway. We do not see them being disappointed. In fact, the incoming data are likely to support their optimistic outlook.

Any equity market corrections may be short-lived

However, Indian equity valuations, as seen in earlier cyclical bull runs, may start pricing in forward earnings for two or three years out. Valuations also have room to stretch considering the attractive earnings growth profiles of Indian companies, reducing debt levels and historically low cash flow discounting rates. With so much money lying on the sidelines, and with cash and debt yields so low, many may buy on any dip. Therefore, any corrections may be short and shallow.

“With so much money lying on the sidelines, and with cash and debt yields so low, many may buy on any dip. Therefore, any corrections are likely to be short and shallow.”

Volatility may remain elevated

With investors focusing on when and how quickly central banks reduce asset purchases, inflation, the Delta variant, China and valuations, market volatility is expected to remain elevated.

Investors might consider rebalancing opportunities to book some profits in Indian equities back to their neutral allocation levels, and use any dips to stagger fresh allocations. For more discerning investors, buying a portfolio hedge, to extend their portfolio carry of overweight Indian equities, may be a more efficient way of reducing systemic risk, while continuing to benefit from active management alpha.

Quality matters

We continue to have more conviction in quality companies and investment themes. With the recent catch-up by mid and small-cap equities, we have moved to an equal preference across market capitalisation. Among richer valuations and active sector rotations, pockets of satellite opportunities exist in technology, metals (despite recent volatility), select banks and non-banks, real estate, late-recovery themes, travel and tourism sectors.

Unlisted opportunities

Opportunities in unlisted securities continue to attract flows, especially in late-stage venture capital, private equity and the pre-listing markets. Primary markets are likely to be abuzz for years yet, following the progress made by domestic technology and technology-driven businesses in the coronavirus era.

Global exposure broadens opportunity set

Besides the opportunity to invest in non-domestic markets, a more diversified approach can allow investment in opportunities expected to prosper. We see opportunities in US equities through quality companies and active management. That said, room for significant upside, in the near term, may remain muted and volatility high.

High-grade Indian corporate bonds to the fore

Keeping core portfolios invested in high-grade corporate bonds of up to 5-year appeals, ideally through a mix of roll-down strategies and actively-managed portfolios in this segment. The steep rates curve appears to offer enough carry to compensate for any residual duration risk in these portfolios, although volatility is expected to remain high.

High-yield, structured and private credits

Allocating to mid-yield, high-yield and structured credits at this stage of the broader economic recovery seems to have merits. Among bond segments, the non-AAA one seems preferable at the moment, with a focus on rating-upgrade candidates. Although credit spreads are trading at historically tight levels, with demand far outweighing supply, there is little room for error.

In public debt, we target sectors likely to profit from government policies and the domestic economic revival. This includes infrastructure and residential real estate-backed debt and select non-banking financial companies that focus on housing finance and micro, small and medium-sized enterprise lenders.

Also, with the latest set of RBI restrictions on banks and non-banking financial companies and enhanced guidelines on credit mutual funds, more opportunities are available for private debt managers in the mid-market performing credit. With risk appetite in this segment still muted, and traditional participants abstaining, this credit market offers opportunities to build portfolios with an attractive risk premium.

Prudent selection, diversification and monitoring is key when investing in private markets.

“Among bond segments, the non-AAA one seems preferable at the moment, with a focus on rating-upgrade candidates”

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