

Private  
Clients

# Market Perspectives

September 2021



## Foreword

**Financial markets remain upbeat despite concerns over the pace of the economic recovery and the timing of a tapering in US central bank asset purchases.**

The anticipated pace of recovery has slowed in recent weeks. The persistent Delta coronavirus variant is lifting infection rates with some governments reintroducing lockdowns. While recovery may be slower than initially hoped, prospects remain encouraging. We expect the global economy to grow by 6.2% this year and by 4.7% next year.

Global growth prospects affect equities. Companies' second-quarter earnings data shot the lights out. As such, our base case S&P 500 earnings estimates have been raised to \$195 and \$216 for 2021 and 2022, respectively. The US remains our market of choice and we prefer quality companies in technology, healthcare and some industrial sectors.

Turning to fixed income, prospects for UK rate rises look weaker despite signs of a more hawkish Bank of England. Indeed, the central bank does not anticipate rate hikes beyond 0.5% before 2024. That said, if inflation becomes more sustainable, the yield gap between US and UK 10-year bonds may close, or even disappear.

With rates likely to remain low for some time, it may be time to invest outside of public debt markets. Private credit offers a chance to boost returns while investing in companies with less levered balance sheets than seen in traditional bond markets. In complementing traditional bond strategies with private credit, manager selection is key.

As European wildfires highlight climate change risks for investors, what might November's UN COP26 climate talks achieve? While obtaining consensus may be tough, the talks can help encourage a greener economic recovery. For those investors that can transition their investment portfolio to a zero-carbon world, a brighter future beckons.

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



## Contents

- 4 Brighter prospects for world economy despite summer storms
- 6 US stock markets hit new highs, but they can go higher still
- 8 Is lift-off in UK bond yields a step closer?
- 10 Managing foreign currency risk in your portfolio
- 13 Chasing yield in private credit markets
- 15 Countdown to COP26: the event every investor should be watching
- 17 Eight factors to sharpen in improving your investment decision-making
- 19 Indian private markets appeal with economic recovery on track

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## Brighter prospects for world economy despite summer storms

The global economy appears set to grow at above-trend rates this year and next despite accelerating COVID-19 infection levels, a surge in inflation and the effects of climate change. With a return to wide-spread lockdowns seeming unlikely and with disruptions to supply chains and labour markets set to ease the recovery looks assured.

Predictions that the global economy would enjoy an unencumbered path to freedom always seemed overly optimistic. Over the past few weeks our expectations of a turbulent and uneven recovery have come to fruition as the Delta variant, surging inflation and consequences of extreme weather events took their toll on activity.

However, we remain positive around the outlook for the global economy and expect governments and central banks to make only tentative steps towards policy normalisation in the coming months.

### Delta variant hits Chinese economic activity

The Delta variant of coronavirus was formally labelled as a strain of concern in May. It has since been detected in more than 100 countries, becoming the dominant strain of new cases worldwide. The variant is more transmissible than previous strains and has proved better equipped at overcoming both vaccinated and acquired immunity.

China's zero-tolerance approach has encouraged authorities to impose stringent restrictions to combat the Delta threat, despite a relatively low number of COVID-19 cases and improving vaccination rates.

**“China's zero-tolerance approach has encouraged authorities to impose stringent restrictions to combat the Delta threat”**

Many cities have suspended entry to travellers from medium-to-high risks areas, officials have partially closed the Ningbo-Zhoushan port (the world's third-busiest container port) and shut highways in high-risk regions (such as Jiangsu and Henan provinces). The measures are impacting supply chains (China's container shipping costs hit new records in August) and consumer confidence.

China's July activity data reflected this loss of momentum with retail sales, industrial production and fixed asset investment all falling short of expectations. To reflect the shock from the Delta outbreak, we lowered our gross domestic product growth forecasts by 100 basis points (bp) for the third quarter to 4.6% year on year (y/y), and to 8.2% y/y (or 30bp) for 2021.

### But it seems different this time

Despite the Delta wave clearly creating additional medical risk, there are significant differences from previous surges. While existing vaccinations may be less effective against contracting the virus, there appears to be a break in the chain between case rates and severe illness.

Hospitalisations and death rates have risen more slowly compared with previous surges in viral infections. This suggests the aggressive restrictions imposed in China, Australia and New Zealand will not automatically be replicated elsewhere, beyond those that are pursuing a zero-COVID-19 strategy.

### Inflation elevated, for now

Inflation readings have surged over the summer months to multi-decade highs (from the low base levels of last summer). This creates additional uncertainty for businesses and consumers and ramps up pressure on policymakers to tighten policy. Supply bottlenecks, ultra-accommodative monetary policy, additional stimulus packages and booming commodity prices have all added to short-term price pressures.

Elevated inflationary prints have been encouraging more investors to question whether the central bankers' definition of transitory was still credible. In the UK, the Bank of England now projects that the consumer price index (CPI) will peak at 4% by the end of this year. In the US we forecast that CPI will approach 6% in November.

However, there are plenty of reasons to believe that price pressures will ease going into 2022 with commodity prices expected to stabilise, supply shortages ease and global demand to rebalance into services from goods.

Wage inflation is one area that policymakers will be evaluating carefully as economies further reopen and job-protection schemes are unwound. Labour shortages due to factors such as fears over the virus, childcare issues and forced self-isolation have each put upward pressure on wages. Expectations are that these pressures should also dissipate, as inactive younger and older workers return to the workforce. The speed of the “back to work” rate will play a crucial role in the pace of wage inflation in the coming months.

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#### Central banks to stay accommodative

Despite the current eye-catching headline inflation figures, we anticipate that central banks will remain accommodative over the next 18 months as inflation starts to fall back towards target levels next year. The US Federal Reserve, European Central Bank and Bank of England look set to keep interest rates on hold through next year.

Quantitative tightening (QT) is likely as central banks start to taper their asset purchase schemes. Reducing asset purchases is likely to be implemented in a controlled and transparent way to avoid disrupting the recovery and unnerving financial markets.

We predict that the Federal Open Markets Committee will either formally announce, or firmly signal, tapering at the September rate-setting meeting. The formal reduction of the rate of purchases would then commence in November, with proportional paring of Treasuries (\$10 billion) and mortgage-backed securities (\$5 billion) per meeting. This would be consistent with concluding the asset-purchase programme in September of next year.

#### Climate change remains a risk

The floods in Europe and China, record temperatures in North America and extensive wildfires in the US and Greece are among the latest examples of how climate change is impacting the natural environment. It also creates risks for economic growth prospects.

These recent events are a stark reminder that all companies are vulnerable to the physical, legal and reputation risks that accompany climate change. Investors are increasingly screening companies’ environmental, social and governance (ESG) credentials as part of the investment process.

Incorporating ESG in the investment process is expected to gain further momentum with the twenty-sixth United Nations Conference of Parties (COP 26) scheduled for November. Governments will report on the Paris Agreement’s efforts and set new targets in an attempt to reduce the impact of climate change. These new goals could dramatically affect the operating environment for many companies and lead to further inflows into ESG-focused strategies.

#### Global growth outlook remains positive

Notwithstanding the disruptive summer, the outlook for growth remains positive as global vaccination rates rise, economic conditions normalise and policymakers remain accommodative. We expect the global economy to grow by 6.2% this year and by 4.7% next year.



Julien Lafargue, CFA, London UK, Chief Market Strategist

## US stock markets hit new highs, but they can go higher still

Second-quarter earnings shot the lights out, encouraging us to lift our base and bull case scenarios for the S&P 500. Valuations might be expensive by some measures. However, the equity risk premium is far from flashing red. US equities remain most appealing, though valuations face several headwinds in the short term, with COVID-19 infection trends and central bank policy high among them.

After an encouragingly strong second-quarter (Q2) set of earnings figures for American and European companies, our bull case appears to have played out. In addition, revised earnings estimates point to modest upside potential, though overall valuations continue to leave no room for error.

### A strong earnings season

In the US, 87% of S&P 500 companies beat consensus estimates, delivering year-over-year earnings growth of around 94% in Q2, according to data provider Refinitiv. As expected though, this earnings season wasn't as strong as the first quarter with a surprise factor of 16% versus 22% of reporting companies. The result is an equity market that has grinded higher but not to the extent that some may have imagined given the earnings growth produced.

### Bumping up our base case scenario

On the back of these better-than-expected results, the "bottom-up" aggregate earnings per share estimates for the S&P 500 have moved up significantly. The consensus now expects earnings of \$197 compared to \$164 (+20%) at the beginning of the year and, for next year, this number rises to \$215 from \$191 (+12%). This is slightly higher than our initial bull case scenario (\$185 and \$213, respectively).

We are therefore revising our base case earnings estimates to \$195 and \$216 for 2021 and 2022, respectively, corresponding to a year-over-year growth rate of 45% and 10%. In our new bull case scenario, 2022 earnings could reach \$225, a year-over-year progression of 15%.

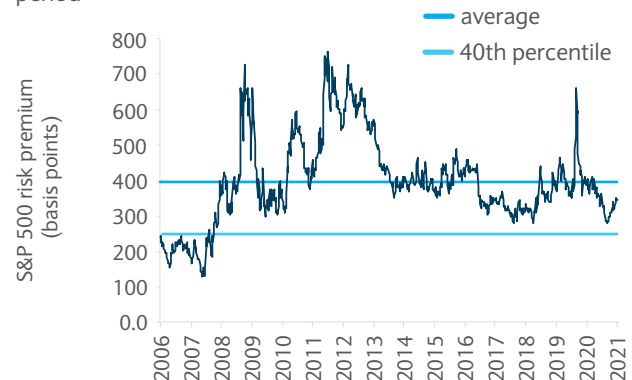
### Multiples are likely to contract further

From a valuation standpoint, we continue to struggle justifying higher multiples. On a twelve-month forward basis, US equities currently trade above 21 times earnings. There seems no room for expansion and valuations may, in fact, contract to a still elevated, but more reasonable, 20 times.

While a valuation multiple on US equities of 20 times stands out as expensive by historical standards, our alternative valuation methodology using equity risk premium is not flashing red (see chart).

### Equity risk premium not flashing red

The equity risk premium, based on S&P 500 valuations, since 2006 against its average and 40th percentile over that period

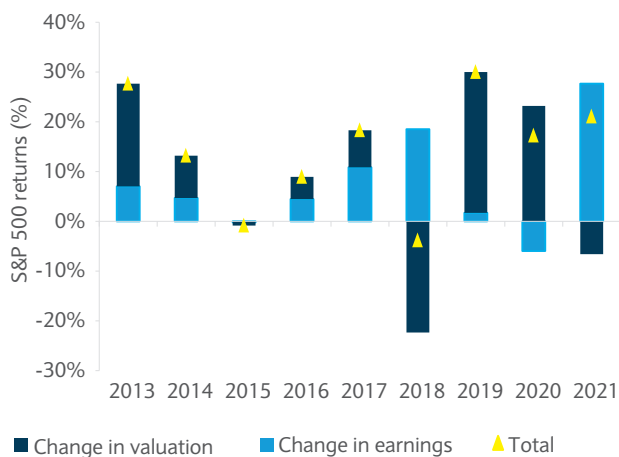


Source: Morgan Stanley, Bloomberg, Barclays Private Bank, August 2021

### Earnings growth needed to push stock prices higher

As a result, earnings growth (and increasingly dividends) will need to do the heavy lifting when it comes to generating upside from current levels (see chart). While growth has been plentiful in the wake of the pandemic, it looks set to be harder to find in coming quarters. This reinforces our preference for higher quality companies. We see them as being well placed to deliver on, or even surpass, earnings expectations, likely key in ensuring upside potential.

**Earnings set to do heavy lifting this year**  
S&P 500 returns since 2013, split by contribution to returns from valuations and earnings



Source: Refinitiv, Barclays Private Bank, August 2021

### Downside risks remain

There appear to be two main downside risks to our base case scenario for US equities. On the earnings side, the evolution of the COVID-19 pandemic overshadows the outlook. While we don't expect a return to widespread and broad-based lockdowns, the "return to normal" will probably be uneven across sectors and geographies. This may put pressure on earnings, especially next year when comparable earnings growth will be much tougher.

On the valuation side, the unprecedented amount of liquidity injected by central banks has been key in supporting equity markets. As this stimulus fades, there is a risk that multiple contraction will accelerate, negating earnings growth.

**“As this [central bank] stimulus fades, there is a risk that multiple contraction will accelerate, negating earnings growth”**

### Walking a fine line

Central banks are in a precarious situation, trying to balance the need for continued support to secure the economic recovery while preventing inflationary pressures from getting out of control. This environment may encourage increased volatility as market sentiment swings from recovery optimism to slowdown pessimism.

However, we remain of the view that central banks will err on the side of caution and favour overstimulating to undue tightening. This should help avoid any long-lasting economic and market weakness.

### US still our preferred market

In a world of scarcer growth, geographically, we maintain our preference for the US and emerging markets. That said, we acknowledge the latter may take longer to recover given the current regulatory pressure coming out of China.

Sector-wise, we see no reason to change our constructive stance on technology (in its broad definition), healthcare and parts of industrials. Opportunities also remain in consumer-oriented stocks, in our view. That said, fundamentals are starting to worsen with retail sales growth stalling in the US and consumer confidence weakening as COVID-19 cases rise.





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

## Is lift-off in UK bond yields a step closer?

A more hawkish Bank of England may imply higher UK rates. However, the prospect of much higher rates in the short term seems far from certain. That said, UK rates have scope to close the rate gap with US counterparts in the longer run, while corporate bonds offer an additional liquidity and credit premium.

### BOE takes a more “hawkish” tone

The timing of when the Bank of England (BOE) starts lifting rates from their record low is a question on many investors' minds. The central bank seemed to take a slightly more hawkish stance on the possibility of such rate hikes last month. But, will the stance be maintained at September's BOE monetary policy meeting?

In August, the BOE signalled the possibility of earlier than previously envisaged rate hikes. Governor Andrew Bailey expected that annual UK inflation would peak at around 4% before moderating again. This in turn would justify monetary normalisation sooner than expected. Bailey stated: “Should the economy evolve broadly in line with the central projections...some modest tightening of monetary policy over the forecast period is likely to be necessary.”

### Treading carefully

In judging interest rate policy, governor Bailey had long placed much emphasis on the monetary support and the downside risks to the UK economy. July's higher-than-expected inflation figure of 2.0% after 2.5% in June, on a year-by-year comparison, had to be acknowledged and the inflation prints are likely to provide the central bank with more confidence in respect of when and how to “normalise” rates.

At the same time, Andrew Bailey sticks to his view of the transitory nature of recent inflation, in line with his counterparts Christine Lagarde at the European Central Bank (ECB) and Jerome Powell at the US Federal Reserve, and says that the central bank is not in a rush to lift rates. The ECB in 2011 demonstrated the dangers of a central bank prematurely hiking rates during a fragile recovery.

### Scope for rate hikes seems limited

As a result of the BOE's slightly more hawkish tone, the rate market pushed up by 15 basis points its expectations of a first rate hike by mid next year, based on forward-implied rates. That said, there seems no conviction for any hikes before 2024 thereafter.

Even the central bank's own inflation forecast would not justify rate hikes beyond 0.5% before 2024. After peaking at 4% in 2021 the central bank expects inflation to moderate to 2.1% in 2022 and fall back below its own 2% inflation target by 2023. Hardly a backdrop for rate normalisation.

It seems too soon to tell whether the higher inflation seen in recent months is part of the transitory environment or a persistent trend. Like in the US (as mentioned in June's Market Perspectives), the evolution of inflation in this cycle is likely to start with the base effects (higher rates due to the lower price levels seen a year ago at that stage of the pandemic) followed by pent-up demand and bottlenecks (as economies catch up with trend growth).

While a more prolonged economic upswing may add to additional inflationary pressures, the state of the recovery is still too early and uncertainties around any pandemic-related setbacks remain prevalent. It seems more likely that the BOE will need to adjust the neutral rate of inflation, or the interest rate thought to be needed so the economy can operate at full employment while keeping inflation at its target rate, to compensate for this uncertainty.

### Opening the door for tapering

The uncertainty around economic prospects and inflation is one of the main reasons why the BOE has lowered the threshold level from which the central bank is mandated to taper the asset-purchase programme to 0.5% from 1.5%.

Rates of 1.5%, for now at least, seem out of reach and the central bank needed to make this adjustment if it ever wants to start normalising its balance sheet. Besides, BOE members like Michael Saunders and Dave Ramsden have been in favour of an earlier cut in asset purchases for some time now.

### Steepening unlikely

If the BOE still keeps policy rates very low while giving itself more freedom to reduce the balance sheet, it may be argued that the rate curve will steepen from here. While higher volatility is a possibility, a substantially steeper curve seems unlikely in our view. Governor Bailey has emphasised that in the first phase of any asset-purchase tapering, the central bank would not sell any bonds but let them mature and not reinvest the proceeds received.

### UK bond yields: playing catch up with the US

UK rates at the long end are likely to be impacted by the global backdrop as seen in the recent past. In addition, the correlation between the US 10-year yield and UK gilt yields has generally been quite high compared with other developed market rates in the past. The exception was 2016, when US rates surged on the back of the “Trump reflation policy”, or policies from the former president aimed at boosting US growth and risking lifting domestic inflation, while UK gilt yields were capped by Brexit uncertainties.

The yield gap opened between US and UK 10-year bonds in 2016 that peaked at 1.6% in August 2018 and now stands at around 0.7% (see chart). US yields have been higher than UK equivalents for the longest period for over 30 years. Should elevated inflation persist in the UK it is likely that this gap would close significantly, if not disappear.

### Credit and liquidity premium

Like in most regions, UK credit spreads seem to have reached their lows and in the case of high yield spreads have started to widen slightly. Less central bank accommodation in the future may result in more muted corporate bond performance. Still, carry returns seem to be an efficient way to gain yield as opposed to taking on longer duration.

UK spreads today, as in the past, trade at a slight premium owing to the market being less liquid and smaller compared to US or European counterparts, which provides opportunities.

### US and UK 10-year yields: mind the gap

The difference between US and UK 10-year yields since 2001 shows US yields are still relatively high



Source: Bloomberg, August 2021



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

## Managing foreign currency risk in your portfolio

International asset allocation has become a more popular way to try and boost performance, and add foreign currency exposure, over the last three decades. But what factors are worth considering when deciding whether to hedge foreign exchange risk?

Global multi-asset class portfolios provide exposure to growth, inflation, interest rates, credit, equities and commodities. By diversifying across asset classes and geographies, various risk premiums can be harvested. However, investors should be mindful of the underlying risks and carefully tailor their portfolios to strike the right balance of performance and risk. Foreign exchange risk is particularly important when investing internationally.

First, depending on the hedging policy, adverse currency moves can be a drag on performance. Second, “spending” the risk budget on exchange rate risk can prohibit the taking of other, potentially more rewarding sources of risk. Therefore, understanding and appropriately managing this risk is crucial.

### The rise of international asset allocation

More globalisation spurred the growth of international trade from the early 1990s, resulting in stronger economic interconnectedness, and creating new business opportunities in all industries. In parallel, technological progress was the key driver of the unprecedented rate of financial innovation over this period.

At the same time, international asset allocation emerged as a standard form of investment. Based on the International Monetary Fund’s coordinated portfolio investment survey data<sup>1</sup>, the foreign investments in equities around the globe have increased almost six times between 2001 and 2020, to \$29.4 trillion from \$5.2 trillion. During the same period, there was a fourfold increase of foreign investments in debt securities, to \$31.9 trillion from \$7.5 trillion.

Furthermore, since the end of the Bretton Woods system and the removal of the gold standard in 1973, many countries have adopted the floating exchange rate regime. So it comes as no surprise that foreign exchange risk has become a critical component of international asset allocation.

### To hedge or not to hedge

When considering the impact of currencies on portfolio performance and risk, it is critical to assess whether to hedge the currency exposure.

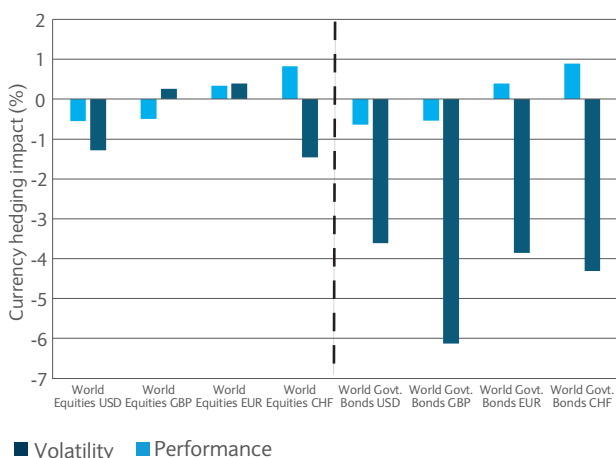
Hedging currency exposure impacts fixed income investments – the volatility is substantially lower if global government bonds are hedged (see chart, left column on p11). On the other hand, the effect of hedging on global equities is much lower and depends on the investor’s reference currency (for instance, hedging is usually preferable in US dollars and Swiss francs compared to euros and sterling).

Our results indicate that it is advisable to treat each asset class separately with regards to the currency hedging decision. The common practice is to fully hedge foreign fixed income investments and leave foreign equities unhedged.

<sup>1</sup> International Monetary Fund, Coordinated portfolio investment survey, 16 March 2021 <https://data.imf.org/?sk=B981B4E3-4E58-467E-9B90-9DE0C3367363>

### Currency hedging impacts assets differently

The impact of hedging world equities and world government bonds into the US dollar, sterling, euro and Swiss franc between January 2002 and June 2021



Source: Bloomberg, Barclays Private Bank, August 2021

### Think strategically, act tactically

The hedging ratio rules defined above are usually applied over strategic investment horizons of five to ten years. In essence, this approach reflects the hedging demand solely based on risk considerations, averaged across different reference currencies. Its main purpose is to help investors to efficiently allocate risk across asset classes and meet their risk budget constraints.

However, foreign exchange markets are characterised by volatility outbursts and short-to-medium-term trends typically driven by macroeconomic and political factors. Such events can generate additional hedging or speculative currency demand that can be met by crafting tactical currency overlay strategies.

To design and implement currency hedging strategies, two points have to be addressed. First, which factors might explain exchange rate returns over short (tactical) and long-term (strategic) investment horizons? The answer depends on the nature of the underlying currencies (for instance, safe-haven versus pro-cyclical ones) and the macroeconomic outlook. Second, take into account hedging costs.

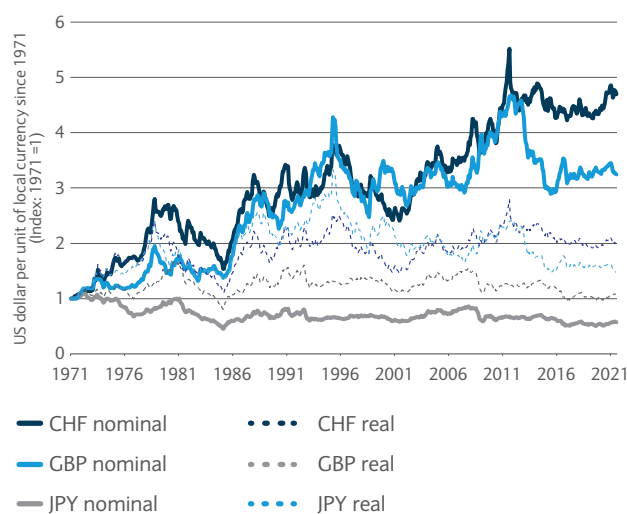
### Inflation differentials drive FX returns

To understand the relation to the macroeconomic backdrop, the theory of relative purchasing power parity (PPP) is useful. The theory seeks to explain moves in exchange rates solely as a reflection of differences in price levels in the respective currency areas. Indeed, most of the persistent changes in nominal exchange rates seem to disappear when looking at real (inflation-adjusted) exchange rates (see chart).

However, relative PPP is far from perfect and some currencies still show trend-like behaviour (see the yen and Swiss franc, for example). Such deviations can be attributed to various economic fundamentals. In the case of these two currencies, persistent accumulation of net foreign assets seemingly accounts for some of the appreciation against the greenback in real terms.

### Inflation explains most of the currency risk

The US dollar per unit of local currency (Index: 1971=1), for the yen (JPY), Swiss franc (CHF) and sterling (GBP), based on nominal and real exchange rates since 1971



Source: Board of Governors of the Federal Reserve System, OECD, Barclays Private Bank, August 2021

### Hedging, but at what cost

For a euro investor hedging a US dollar equity position, the lion's share of the hedging cost can be attributed to the interest rate differential (see chart). In 2018, this was a costly endeavour due to the higher yield levels for the greenback needed to compensate the USD counterparty.

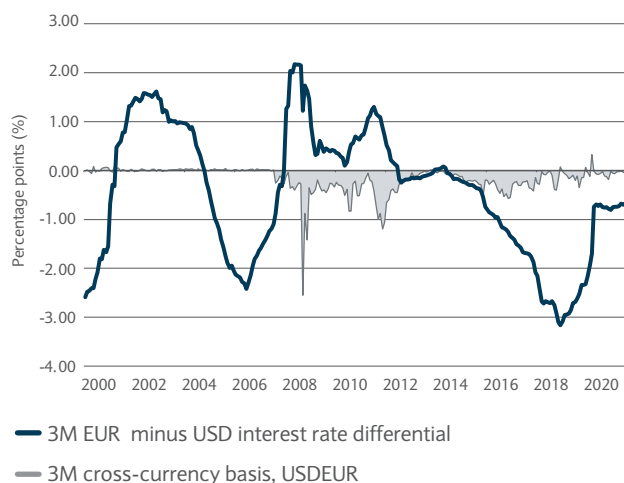
If everybody is trying to hedge the same risk, the price will probably go up. This notion of supply-demand imbalance is shown in the second cost-factor: the cross-currency basis. As a side note, this burst into life in the aftermath of the global financial crisis. During periods of extreme stress, the cross-currency basis can be substantial. Bid-ask spreads for all the hedging transactions form a third cost factor, which adds up over time, especially when using less liquid currencies.

“For a euro investor hedging a US dollar equity position, the lion's share of the hedging cost can be attributed to the interest rate differential”

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### Cost drivers for euro investors hedging US dollar risk

The three-month euro-US dollar interest rate differential and three-month cross-currency basis (monthly data, the more negative, the more expensive hedging is) since 2000



Source: Bloomberg, Barclays Private Bank, August 2021

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Jai Lakhani, CFA, London UK, Investment Strategist

## Chasing yield in private credit markets

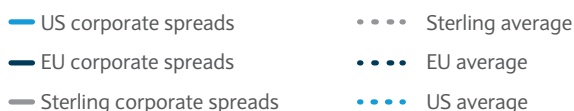
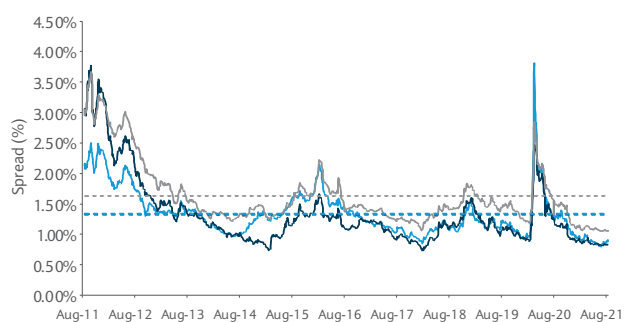
With yields on government bonds anchored to ultra-low levels, is it time to consider investing in private credit markets to obtain higher yield along with less risky returns?

Investors face a predicament when it comes to sourcing high-quality companies that offer an attractive return profile in traditional credit markets, which is an asset class that remains an important component in a diversified portfolio.

Lower for longer interest rates are keeping government yields anchored (albeit with spikes in volatility) and the search for yield is driving down spreads on both investment grade and high yield credit (see chart).

### Spreads on corporate bonds have fallen below 10-year average levels

The spread on US, EU and sterling corporate bonds since 2011



Source: Bloomberg, Barclays Private Bank, August 2021

### Attractive opportunities

Despite the volatility and change in market sentiment in public credit markets, there remain attractive opportunities. First, the reopening of economies, as they continue to emerge from the pandemic and global growth should boost corporate revenues. Second, in the first half of this year, default volumes fell to their lowest levels in decades which could be viewed as justifying tighter spreads.

“In the first half of this year, default volumes fell to their lowest levels in decades which could be viewed as justifying tighter spreads”

It’s also worth pointing out that there is still carry to be had in both investment grade and high yield debt, especially when evaluated against government bonds. However, the importance of active management and selection remains paramount.

This is particularly relevant given bank lending and merger and acquisition (M&A) volumes. Throughout the past two decades, and even more so after the financial crisis, banks have reduced lending to small and medium-sized enterprises. Even with sentiment anticipating a significant recovery, M&A activity has leaned towards large institutional borrowers who have previously accessed capital markets.

### Default levels suggest spreads may be over valued

Consequently, corporates in traditional debt markets may be over-levered. Although default volumes may not reflect this, spreads are arguably rich in light of this. Back in April, we discussed this risk in terms of analysing credit cycles in the 19 April Markets Weekly podcast.

It therefore makes sense for investors to consider other avenues of accessing credit, where they can lend to high-quality businesses and earn returns that adequately compensate the risks taken. There is increasing evidence to suggest that accessing the private credit market is an attractive and complementary solution.

### Obtaining more stable balance sheets

Many smaller businesses or entrepreneurs unable to access credit the traditional way may have much more stable balance sheets without being highly levered. What these organisations require is more specific lending to unlock their growth potential.

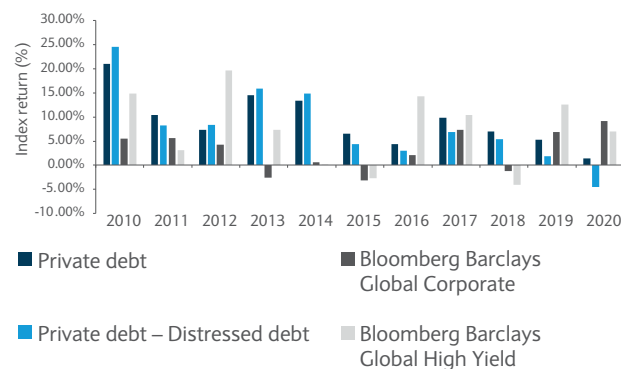
As a result, the concern for these companies is more around the certainty of execution as opposed to the cost. Therefore, private credit managers that select the right firms and arrange bespoke solutions are likely to be rewarded with noticeably higher yields for the same given level of risk in public markets.

“Private credit managers that select the right firms and arrange bespoke solutions are likely to be rewarded with noticeably higher yields for the same given level of risk in public markets”

These returns (see chart) might outweigh the risks of investing in private markets. Such risks include the illiquidity premium, the idiosyncratic risk given the more firm-specific solutions provided and the “backstop” risk as a result of private managers not being protected to the same extent as banks are by policymakers.

### Private capital can provide stable and higher returns than traditional credit

Private debt, private distressed debt, Bloomberg Barclays Global Corporate and Bloomberg Barclays Global High Yield index returns since 2010



Source: Bloomberg, Prequin, Barclays Private Bank, August 2021

### Complementary solutions

Ultimately, investing in private credit can provide a complementary solution to traditional credit markets, and achieve a higher return and diversify portfolios. However, manager selection is undoubtedly a key pre-requisite. Managers with the ability to thoroughly evaluate their investments, given the “backstop” risk, perform due diligence and source stable businesses or entrepreneurs and a platform allowing for tailored lending solutions are likely to have the most success.

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

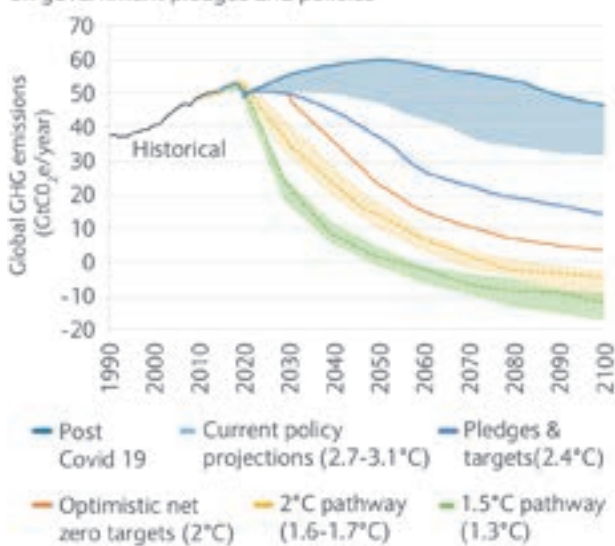
## Countdown to COP26: the event every investor should be watching

With only two months until the COP26 climate talks, as the impact of climate breakdown becomes more visible, what investors should know about this event for their portfolios

In the fight against global warming, time is fast running out. Quick action is needed to avoid the risks of even more frequent extreme weather. Business as usual would mean global temperatures likely climbing by 1.5 degrees Celsius or more beyond pre-industrial levels within two decades, triggering more violent weather patterns.

The sixth Intergovernmental Panel on Climate Change (IPCC) report<sup>1</sup>, published in August, warns that unless action is taken to reduce emissions, the world is on course for a catastrophic climate disaster (see chart).

**Global warming projections**  
Global greenhouse gas emissions since 1990 and projected to 2100 under various emissions reduction scenarios based on government pledges and policies



Source: Climate Action Tracker, May 2021

As the UK prepares to host the UN climate summit in November, the path to limiting global warming to 2 degrees Celsius (and ideally 1.5 degrees) degrees is narrowing.

Commitments from governments, the private sector and investors need to be backed with sufficient action to avert climate warming too much and causing massive changes in how people live while hitting global economic growth.

### What is the climate conference?

The Conference of the Parties (COP) assembles governments, climate experts and campaigners to decide coordinated action to tackle climate change. The goal (involving more than 190 countries that signed up to the United Nations Framework Convention on Climate Change) is to agree and accelerate action on the Paris Agreement<sup>2</sup>.

After being postponed a year due to the COVID-19 pandemic, COP26 will be crucial for making up for lost time and ushering in a green recovery. The aim is to restrict global warming to well below 2.0 degrees Celsius, preferably to 1.5 degrees Celsius, compared to pre-industrial levels – putting the world on a path to reduce climate change and shift towards a low-carbon, more-inclusive society.

### Going beyond climate change

Key topics<sup>3</sup> raised at COP26 will include:

- Adaptation, resilience and “just transition”: Delivering practical solutions to help people, economies and the environment adapt and prepare for the impacts of climate change and address loss and damage
- Nature: Safeguarding nature and ecosystems. Ensuring sustainable land use is part of the action on climate change and the green recovery (such as biodiversity, land and forest conservation, and climate-friendly farming)

<sup>1</sup> IPCC, Climate change 2021: The physical science basis, 7 August 2021 [https://www.ipcc.ch/repphysical science basis, ort/ar6/wg1/downloads/report/IPCC\\_AR6\\_WGI\\_Full\\_Report.pdf](https://www.ipcc.ch/repphysical science basis, ort/ar6/wg1/downloads/report/IPCC_AR6_WGI_Full_Report.pdf)

<sup>2</sup> United Nations Climate Change, The Paris Agreement, August 2021 <https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement>

<sup>3</sup> UN Climate Change Conference UK 2021, Presidency programme, August 2021 <https://ukcop26.org/the-conference/presidency-programme/>



- Energy transition: Accelerating the global transition to clean energy (such as renewables and storage)
- Transport: Accelerating the move to zero-emission transport (for instance, electric vehicles)
- Cities, regions and the built environment: Advancing action in the places we live, from communities, through to cities and regions (circular cities, sustainable buildings and infrastructure)
- Finance: Mobilising public and private finance flows at scale to make the transition to a climate-conscious society and power the shift to a zero carbon economy.

#### Wider implications

With 2021 branded a “make-or-break year” by the UN, COP26 has set out ambitious goals around mitigation, adaptation, finance, and collaboration in the fight against climate change<sup>4</sup>.

As governments, policymakers and regulators act to prevent a climate catastrophe, the implications for businesses and investments are real. To gain further insight, earlier this year we invited sustainable finance expert Dr Ben Caldecott to present a webinar about how investors can navigate this transition to a low-carbon world.

According to Caldecott, the COVID-19 pandemic has accelerated the trend to a more sustainable approach to investing. And with the UN’s climate summit speeding into view, recent shifts in geopolitics may yet see rhetoric translated into real change.

#### How might COP26 affects investors?

As a first step to achieving the climate goals, governments and similar parties to the event are expected to submit updated nationally determined contributions (NDCs) and determine how they will reach net-zero emissions of greenhouse gases. This may result in legislation requiring organisations to reduce greenhouse gas emissions and act as a catalyst for greater ambition from the private sector and investors.

Furthermore, fresh climate change legislation may boost the appetite for more accountability, transparency and adoption of quantitative and qualitative climate disclosures.

For investors, such disclosures can guide how a company may profit or be hurt by a net-zero economy. Investors looking to make a real impact should be “leaning in” through stewardship to change corporate behaviours, notes Caldecott.

#### Common carbon market

A common carbon market may be one way to deliver on contributions to reach net-zero greenhouse gas emissions.

Suppose there is a compromise made regarding Article 6 of the Paris Agreement<sup>5</sup> (market and non-market approaches) and the framework is given a robust set of rules. In that case, COP26 could open the door to a global carbon market. This could further increase climate ambition globally and give those already using ambitious climate strategies a competitive advantage.

#### Green finance solutions

To deliver on the goals, developed nations committed to mobilising at least \$100 billion in climate finance per year by 2020<sup>6</sup>. By making good on their promise, various investment opportunities are expected to emerge.

COP26 is also expected to unlock further green finance solutions. Initiatives such as the UN-convened Net Zero Banking Alliance<sup>7</sup> are likely to provide investors and organisations with a new rulebook with which to evaluate sustainability. This will signal that share prices, asset valuations and the cost of capital will be affected if urgent climate action is not taken.

According to Caldecott, we have trillions of dollars of assets under management committed to net-zero. Assuming these commitments are credible, they will “help drive demand and shift capital flows in a particular direction” – a sustainable one.

#### Now is the time to act

While climate change brings many investment risks and opportunities, the decisions made in the short term can significantly shape long-term climate trends and risks and opportunities. As such, now seems to be the time to start raising the climate targets of your portfolio. Any delays may be costly.

For those investors that can transition their investment portfolio to a zero-carbon world, a brighter future beckons.

<sup>4</sup> UN UN Climate Change Conference UK 2021, COP26 goals, August 2021 <https://ukcop26.org/cop26-goals/>

<sup>5</sup> IISD Delivering climate ambition through market mechanisms: Capitalizing on Article 6 Piloting Activities, 24 March 2021 <https://sdg.iisd.org/commentary/policy-briefs/delivering-climate-ambition-through-market-mechanisms-capitalizing-on-article-6-piloting-activities/>

<sup>6</sup> UN Climate Change Conference UK 2021, COP26 goals, August 2021 <https://ukcop26.org/cop26-goals/>

<sup>7</sup> UN environment programme, Net-zero banking alliance, August 2021 <https://www.unepfi.org/net-zero-banking/>

Alexander Joshi, London UK, Behavioural Finance Specialist

## Eight factors to sharpen your investment decision-making

As summer comes to an end, we help investors plan for the rest of the year with an eight-point plan to improve investment decision-making.

### Taking time for reflection

With the pace of the global recovery being brought into question by accelerating COVID-19 cases and surging inflation, the summer break is a good time to reflect on many aspects of our lives and investments are no different. When it comes to evaluating investments, both the outcomes and the process that leads to them are important. It's good practice to objectively and periodically review previous decisions with a view to refine future decision-making, and tweak portfolios if necessary.

As with every year, significant events may lie ahead that provide both risks and opportunities for financial markets and your portfolio. These tend to be best navigated by investors with clear minds and processes.

In trying to make the best investment decisions, we believe the following eight considerations can help to sharpen your thinking.

#### 1. Clarify your goals

A good first step is to clarify why you want to protect and grow wealth, and review your finances and existing investments to ensure that they are aligned with this.

Clarity in your holistic objectives, agreed with or communicated to an adviser, can make it easier to align investment decisions to them.

#### 2. Have a plan

Having a goal is important, but creating a specific plan helps to achieve it. One with rationale, timelines and rules for what actions to take in different scenarios is even more valuable.

In recent months, financial markets have been relatively calm with many equity markets setting fresh highs. But sentiment can turn quickly. A plan can be particularly useful in keeping you anchored during difficult market conditions,

when investing may be tougher emotionally. For example, during times when the natural tendency can be to take actions that provide short-term comfort, potentially at the expense of long-term returns, like selling out in the midst of a downturn.

#### 3. Check your cash holdings

Maximising your long-term returns while achieving your objectives is not just about what's in your portfolio, but what is outside it too. Cash also has a role to play. Check it is being put to good use, as holding excessive cash balances can hinder wealth preservation as inflation erodes its real value over time.

At times, holding cash for opportunistic reasons may have merit, if used well, but the success of timing such tactical investments only comes with hindsight. In practice, cash can sit on the sidelines for much longer than an investor anticipates. All the while the foregone returns from investing, which historically have outperformed cash, and the costs of inflation, drag on the value of your wealth.

#### 4. Expect the unexpected

A pandemic, in its second year and with no endpoint in sight, is an event that few investors predicted. But unexpected events don't make the world more uncertain. They simply show us how uncertain it already was.

Investors, their investment processes and portfolios should always be prepared for negative shocks, because swings in the value of investments can occur extremely quickly. A diversified portfolio of quality assets, built to perform in different conditions for the long term, can be a good antidote for periods of heightened uncertainty. Implementing a process that can withstand changing market conditions may make it easier to stay invested and reap the benefits of time in the market.

### 5. Rethink risk

In every edition of Market Perspectives we discuss potential risks to economic growth and financial markets. For many investors, risk is synonymous with volatility. However, while volatility can be uncomfortable, it may not be the most material risk for investors.

When putting capital to work to achieve long-term goals, the most material risk is decisions, or outcomes, that stop you from reaching these goals. By keeping a primary focus on your goals, you can think about market events in the context of whether and how they affect them.

### 6. Recognise your biases and emotions

Periods of market turbulence and downturns can stress investors, perhaps leading to poor long-term decision-making. It is when markets look most precarious that our behavioural proclivities can lead us astray.

Building a decision-making process that is systematic and focussed on identified biases might help to reduce their impact. Delegating decision-making to experts with tried and tested processes and good track records may be advisable.

### 7. Be patient

To maximise overall returns, it can make sense to follow a robust process that balances long-term thinking, to generate the core investment returns, with more reactive and opportunistic short-term tweaks to allocations. This can temper a tendency to act during extreme market events, where a fear of doing nothing induces actions more harmful than staying with the status quo. Behavioural studies show that performance usually suffers through overtrading.

“To maximise overall returns, it can make sense to follow a robust process that balances long-term thinking... and the more reactive and opportunistic short-term tweaks to allocations”

### 8. Look beyond the headlines

We often attach great importance to vivid events that affect us personally; an evolutionary trait designed to protect us from harm. In the face of uncertainty, we use rules of thumb (heuristics) that have provided us with rapid and effective decision-making throughout our evolution. Unfortunately, this can bias decisions if some information is overweighted at the expense of all other information.

For those seeking to protect and grow their wealth, active investment strategies that focus on quality and companies that are well-positioned for long-term trends seem a sensible approach. In investing, every year provides risks, and opportunities, to be capitalised on by investors looking beyond the headlines.

Narayan Shroff, India, Director-Investments

## Indian private markets appeal with economic recovery on track

Despite being buffeted by the Delta variant, India's economic recovery looks secure. Indian equities are fairly valued with the revival in earnings largely priced in. It may be time to seek fresh sources of return and bottom-up stock selection, private assets and credit markets might be the answer. Security selection is key.

India's economic recovery seems to be on track, especially with the onset of the festive season and despite rising COVID-19 infection levels, and the overall threat to global growth of the Delta variant and Chinese crackdowns. As the current pace of recovery continues, we upgrade our gross domestic product growth projection for financial year 2021-22 to 10.2% in India.

The manufacturing, construction and mining sectors are leading the recovery, with consumption of steel and cement remaining robust, driven by higher government spending and exports. Demand for utilities also remains strong, with power consumption above pre-pandemic levels.

In services, fuel demand and financial services seem to be rebounding quickly and are likely to boost growth more meaningfully in coming months. Uneven monsoon rainfall and the spread of the virus deep into rural areas are likely to weigh on farm output, and consequently the agriculture sector.

### Learning to live with COVID-19

Around 35% of the Indian population are likely to be fully vaccinated by the end of October. Furthermore, rising vaccine supply is expected to cover 52% of the population by the end of the year.

Encouragingly, the chief scientist of the World Health Organisation, Dr Soumya Swaminathan, has indicated that India may be entering the stage when the population learns to live with the virus. A time when the spread of it would be limited to particular areas and with predictable rates.

### Much inflation already priced in

With commodity prices cooling of late and a relatively stable Indian currency, concerns over "imported" inflation are abating. Additionally, any input price pressures from imported inflation may not result in higher output or retail prices as demand and pricing power in the economy remain weak.

Much inflation risk seems to be already priced in. With supply constraints likely to ease in the coming months, inflation may undershoot forecasts in the near term.

Of course, any supply shocks resulting from a potential spike in COVID-19 cases or a significant pick-up in demand, putting pressure on output prices and retail inflation, are key risks.

### Accommodative monetary policy to stay

The Reserve Bank of India (RBI) continues to maintain its accommodative monetary policy until it has more clarity on sustainable growth prospects. Given the central bank's recent policy statements, policymakers may be looking at inoculation rates, the global growth outlook and signs of growth in credit and investments.

The RBI's stance to build up foreign currency reserves seems to support keeping Indian rates low, relative to other emerging markets, and help to defend any potential external pressures on the rupee.

The earliest we think the RBI might start hiking the reverse repo rate is December, though repo rate hikes do not appear likely until early next fiscal year. Indeed, only two repo hikes appear to be on the cards at most in 2022, if the rate of inflation slows by then.

### Eye on RBI liquidity management

Additionally, the Indian central bank seems unlikely to aggressively remove liquidity from the system. Indeed, the RBI may prefer to let liquidity naturally reduce as the demand for currency and credit increases.

Any early significant policy move designed to drain liquidity may mean that the operating rate starts moving towards the repo rate from the reverse repo rate. This might indicate that policymakers are more confident about growth persisting.

### Tax revenues

On the fiscal side, the government's capacity to spend remains healthy as tax revenues perk up and plans for more privatisations and asset monetisation are executed. Any correction in crude oil prices and relatively stable rupee may also reduce any pressure to reduce oil taxes.

Beyond a point, a period of broader, better-quality, growth depends on the private sector participating more. With several reforms already announced by the government to boost private investment and the economy opening up, stronger consumer and business sentiment, capital expenditure, and thereby employment and disposable income in the country, seem more likely.

### Indian equities: earnings revival largely priced in; stock selection key

Following a stronger period and higher Indian equity valuations across the broader market, the scope for significant upside has faded. Furthermore, much of the expected earnings revival in stocks due to pent-up demand has likely been priced into valuations.

The benchmark blue chip equity indices may deliver returns more in line with the realised corporate earnings growth trajectory. Given the limited room available for margin expansion due to high commodity prices and wage inflation, perhaps from salary hikes in technology services, this may depend more on the sales growth (credit growth in case of lenders).

Rotations across sectors, themes and market capitalisations are adding to volatility. As such, bottom-up stock selection, active management and appropriate portfolio diversification look key to maximising returns. Any market correction is likely to be short and shallow and to mitigate the potential volatility, staggering allocations and buying on dips might help.

We have more conviction in quality companies across market caps and themes. Mid and small-cap stocks appear favourably priced, with opportunities to build on longer term positions in any corrections. Late-recovery themes, such as in the mobility, travel and tourism sectors, also offer opportunities.

### Unlisted opportunities

Unlisted securities are in demand, especially in late-stage venture capital, private equity and the pre-listing markets. Primary markets look likely to be abuzz for some time, following the progress made by domestic technology and technology-driven businesses in the coronavirus era.

### Global exposure broadens opportunity set

Outside of Indian equities, we continue to see opportunities in US equities through quality companies and active management. Additionally, recent Chinese regulatory crackdowns and equity falls may present an attractive entry point for a medium-term play.

### High-grade Indian corporate bonds to the fore

We continue to recommend keeping core portfolios invested in high-grade corporate bonds of up to 5-year maturities, 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. Also, the term premia available in bonds with maturities of at least six years provides unattractive risk-weighted reward.

### High-yield, structured and private credit

Allocating to mid-yield, high-yield and structured credits at this stage of the broader economic recovery appeals. Among bond segments, the non-AAA one seems preferable at the moment, with a focus on upgrade candidates.

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 credit.

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