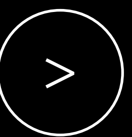
Market Perspectives

April 2022



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Foreword

Welcome to our latest edition of *Market Perspectives*, which aims to provide much-needed context and clarity, at a time when volatility and uncertainty weigh on investors' minds.

This year's surge in oil prices can be found in elevated inflation levels and has led to economists rushing to reassess global growth forecasts. For instance, Barclays Investment Bank now assumes global growth of 3.4% this year, down from 4.3% in January. In this month's report, we look at what the effect of soaring crude costs may have on equities, bonds, and other asset classes.

Understanding the effects of oil price shocks on equities matters. Over the last 50 years, global markets typically troughed seven months after such shocks start. While energy and basic materials tend to perform well, technology usually takes the biggest hit. But the good news is that the economy is better placed to withstand such events now, than it was in the 1970s.

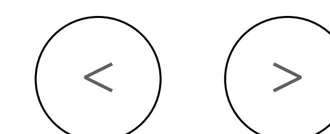
Bonds have suffered this year as elevated inflation persists and leading central banks remain hawkish. In this context, a defensive positioning in medium-term bonds appeals most, but we're starting to find more opportunities for yield generation.

Beyond our usual asset class and financial market analysis, you'll also find our latest sustainability insights.

Companies are increasingly pledging to fight climate change by producing net-zero carbon emissions by 2050. But the devil is in the detail. Taking a look into the commitments made can help to unearth those businesses set to be net-zero pioneers, and well-placed to profit from the transition to a low-carbon world.

As always, we hope you enjoy the report and we thank you for entrusting us with your investments.

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



Russia-Ukraine crisis - What's at stake for the global economy?

As the conflict between Ukraine and Russia causes commodity prices to soar, what might the conflict mean for global growth and inflation, central banks, and living standards?

SHIFTING PRIORITIES

Russia's decision to invade Ukraine in February sent a shockwave through the global economy and financial markets. The rapid escalation in military action has been characterised as the biggest security issue in Europe since the second world war, and could result in serious implications for the global order.

Given the possible impact that the conflict could have on commodity markets, trade, and confidence levels, its unsurprising that economists, including at Barclays Investment Bank, have been rushing to downgrade their growth forecasts and increase their inflation projections.

RUSSIA'S IMPACT ON THE ENERGY MARKET

Commodity markets continue to be at the epicentre of the disruption in global financial markets. At more than 11 million barrels per day (mbpd), Russia is the world's third largest crude producer and the biggest exporter of oil to global markets, 60% of which goes to Europe. The region imports around 40% of its gas from Russia and about 25% of its petroleum products. Ukrainian pipelines are the second most important route, accounting for around one-third of the flows into the continent.

In the early days of the conflict, energy prices soared as traders feared a supply shock might develop. Markets rapidly reacted to the sanctioning of Russian energy exports, potential damage to infrastructure, and the risk of Russia reducing flows. Brent crude spiked to $139 a barrel on 8 March, its highest level in nearly 14 years.

However, oil prices have since eased on speculation that key gulf producers would increase production levels to mitigate some of the shortfall. Its estimated that Saudi Arabia, Kuwait, and the United Arab Emirates have a combined excess capacity of 2-2.5 mbpd.

The US also has the ability to increase production levels, as an elevated oil price makes its shale producers increasingly profitable. Reports that America is also reviewing oil trading sanctions on Venezuela, which if removed could add around a further 600,000 barrels of oil per day to the market.

Relief for stretched crude markets could also come in the form of a revival of the Iranian nuclear deal. Iran holds the world's second largest gas reserves and is ranked number four for crude reserves. Reactivating the seven-year-old deal could result in 60-80 million barrels (mb) of oil being released quickly to the market, and pave the way for one mbpd of crude to be added to the global market over the next six to 12 months.

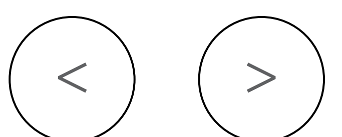
EFFECT ON SOFT COMMODITIES

Soft commodities are also reacting to the potential supply disruption. Russia and Ukraine produce vast quantities of wheat, corn, and sunflower oil, with a combined production estimated at 12% of globally traded calories[1].

Russia is also the world's largest producer of potash and nitrogen fertilisers, used by farmers around the world to improve crop yields. In the first two weeks of March, wheat prices surged around 50% and corn jumped to its highest level in close to a decade. The upward surge in the price of essential ingredients could have meaningful ramifications for both inflation and food security, particularly in developing nations.

POTENTIAL WIDER ECONOMIC REPERCUSSIONS

Persistently higher commodity prices and the potential rationing of energy could hit industrial production levels, corporate profitability, and real household disposable incomes. The exact impact on growth still remains difficult to quantify and depends on the duration of the conflict, extent of disruption to energy supply chains, and effect on business and consumer confidence.



[1] "There are solutions to the food crisis. But ploughing up Britain isn't one of them, The Guardian, 16 March 2022 https://www.theguardian.com/commentisfree/2022/mar/16/food-crisis-britain-prices-russia-ukraine-rewilding

In order to reflect the heightened level of uncertainty, Barclays Investment Bank has downgraded its global growth forecast to 3.3% for this year, from 4.3% at the start of the year. With Europe's growth profile remaining the most vulnerable to the conflict, we cut the region's growth projection by 1.7 percentage points, to 2.4% for 2022.

REACTION OF CENTRAL BANKS TO COMMODITIES SHOCK

Higher commodity prices add further complexity to the balancing act being performed by leading central bankers. As seen during the coronavirus pandemic, a supply shock risks adding to price pressures and stoking inflation. The increase in energy and food prices can also quickly develop into secondary effects, especially in respect of wages.

We now expect global inflation to average 5.6% this year, compared to 3.2% in 2021. However, the trade shock emanating from the crisis also increases the downside risks to growth. We believe that central banks have enough flexibility to react to weakening activity through policy adjustments, while acknowledging the need to curb inflation.

The March European Central Bank meeting sought to achieve a balanced approach by unexpectedly deciding to slow its bond buying from the start of May. While on rates, officials now say any hikes will be "gradual" and take place "sometime after" bond purchases end, rather than "shortly" after. We anticipate that the central bank will end its quantitative easing (QE) programme in June/July, although we expect rate hikes to be postponed until 2023.

BANK OF ENGLAND CARRIES ON HIKING

While the UK is less directly exposed to the economic consequences of events in Ukraine, rising energy costs are pushing inflation expectations higher, as the power regulator increases its price caps. The Bank of England expects inflation will hit 8% in the second quarter (Q2) of this year, and warns that peak inflation may only come in Q4. Stronger-than-expected growth and tightening labour markets are also putting pressure on the central bank to reduce its accommodative stance.

At last month's rate meeting, the Monetary Policy Committee (MPC) raised UK base rates for the third consecutive meeting. The increase to 0.75% marks the fastest pace of tightening since 1997.

We envisage a further 25 basis point (bp) increase will be delivered at the May rate meeting, putting the UK base rate at 1%. However, as consumers and businesses tackle higher energy bills, increasing taxes, and rising interest rates (in what could be the biggest annual reduction in spending power seen by households since the 1970's), some of the wind may be taken out of the Bank of England's tightening sails. We suspect that the MPC will embark on a period observation to assess the incoming data, with rates on hold from mid-year.

BUSINESS AS USUAL FOR THE FED

Despite the US Federal Reserve (Fed) downgrading its growth forecast for this year, to 2.8% from 4%, it's no surprise that the central bank pushed ahead with policy normalisation at its March rate-setting meeting, given that inflation is approaching 8% (a forty-year high) and unemployment is below 4%.

The Federal Open Markets Committee (FOMC) expressed its determination to use its tools to return the economy to price stability after participants ratcheted up their personal consumption expenditures (PCE) inflation projections. The ramping up of inflation expectations has been driven by policymaker's expectations that geopolitical developments are likely to extend the duration of supply bottlenecks, and signs that price pressures are starting to spread more broadly across services.

The US central bank hiked the Fed funds rate by 25bp in March, marking the first increase since 2018. Given the relatively hawkish tone arising from the statement, we now expect to see hikes at each of the remaining six meetings. This would equate to seven quarter point hikes in total this year.

We think that the tightening process will continue until mid-2023, with the terminal rate for the Fed funds rate being 2.25% -2.5%, which is 75bp higher and six months earlier than we anticipated at the start of the year.

RUSSIAN ECONOMY TO FEEL THE CHILL

At this stage, the true magnitude of the economic disruption to the global economy from the conflict between Ukraine and Russia remains difficult to fully gauge. We can, however, confidently predict that the size and the scope of the sanctions on Russia announced by the West will continue to impact its economy and population's living standards profoundly.

The unprecedented set of restrictions have sought to isolate Russia's economy and expel it from the global financial system. The country's foreign exchange reserves have been frozen and its banks banned from using the Swift global payments system. The Russian economy faces an economic crisis that will inevitably lead to a deep recession. Its output is forecast to contract by more than 10% this year. The credit rating agencies have downgraded Russian sovereign debt to junk status, and warned that default could be imminent.

An avalanche of global brands has announced their exodus from Russia, and the rouble has slumped from 83 against the dollar to an all-time low of 139. Its domestic stock market has collapsed and index provider MSCI has removed Russian stocks from its emerging market indices.

Even if a peace treaty between Ukraine and Russia can be agreed, restrictions on trade and sanctions on the latter's financial system are likely to remain in place for some time. While Russia may seek to forge improved trading relationships with regions beyond the sanctioning countries, this is likely to take a considerable amount of time to achieve and is unlikely to readdress the economic consequences of its disconnection from Western nations.

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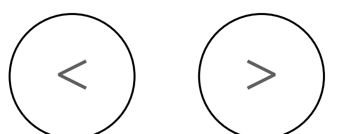


How much do oil shocks really affect equity markets?

Economies, and financial markets, face an oil shock. Oil prices and equity returns have typically moved in opposite directions in the past, when supply factors drove extreme increases in energy costs. This article identifies supply-side oil price shocks and what they mean for equity investors, based on the last 50 years of data. Despite the recent sharp spike in oil prices, there are reasons to believe that many developed market economies are more resilient to oil price shocks today than they were in previous decades.

Oil prices are seven-times higher than they were two years ago. Volatility is high, with the price of Brent crude moving from $97 a barrel on 24 February, before the invasion of Ukraine by Russia, to $128 on 8 March, then dipping below $100 in mid-March, only to shoot above $120 again towards the end of March.

The situation between Russia and Ukraine remains highly unpredictable, and until there is more clarity on the geopolitical front, energy prices, and commodities in general, are likely to remain highly volatile.

More to the point, if the energy crisis deepens or becomes more entrenched, it may trigger a recession. The growth/inflation dynamics had already started to deteriorate in December, after leading central banks took a more hawkish stance. The invasion of Ukraine further exacerbated those risks.

The longer that energy prices remain elevated, the more likely they are to impact growth, through lower disposable incomes, weaker corporate margins, reduced or delayed capital expenditure programmes, and ultimately higher unemployment.

THE SPEED AND MAGNITUDE OF ENERGY PRICE INCREASES MATTER, AS WELL AS THEIR DRIVERS

Since the global financial crisis in 2007/08, equity returns have generally been positively correlated with the price of oil, with gently-rising energy prices tending to coincide with periods of stronger economic activity. However, sharp and sustained hikes in the cost of oil have often led to recessions, especially when they were driven by supply shocks, as seen since late December.

While it is impossible to predict how the situation in Ukraine will change, or how long it will last, it is a risk that cannot be ignored. We explore how financial markets have behaved in supply-driven shocks in the past (excluding the current one), and highlight which areas of the market have been the best and worst performers.

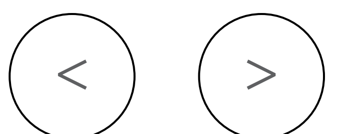
While most of the increase in the oil price since April 2020 was driven by a recovery in demand, as the economy reopened after pandemic lockdowns, the most recent spike, from late December to early March, was mostly driven by supply factors, according to data from the Federal Reserve Bank of New York (New York Fed). Market prices reflected fears that the oil supply could be disrupted, rather than an actual drop in production.

During this short eleven-week period, the price of Brent surged by 73%. Predominantly supply-driven shocks this large are scarce. The last was in the Gulf War in 1990. In order to include both sizeable and more recent shocks in the following analysis, our required minimum cumulative price increase was set to 20%.

IDENTIFYING AND CLASSIFYING SUPPLY SHOCKS

In our analysis, to identify oil supply-shock periods, we computed cumulative price increases until a peak or plateau was reached. If the front-month contract price for Brent lay at or below the value ten days prior, we stopped measuring the cumulative increase and restarted at 0%. For an additional robustness check, we ran this analysis on both Brent and West Texas Intermediate prices, and excluded shocks that were only observed in one data series. These consolidated increases of over 20% were then combined with data from the New York Fed's oil price dynamics report[1].

The report uses market data at daily frequency intervals to break down oil price moves. The idea is to use market background knowledge to classify shocks. For instance, during a supply-driven shock, currencies of oil importers tend to depreciate and cyclical stocks generally underperform defensive stocks. However, demand shocks tend to be accompanied by higher interest rates and the depreciation of safe-haven currencies.

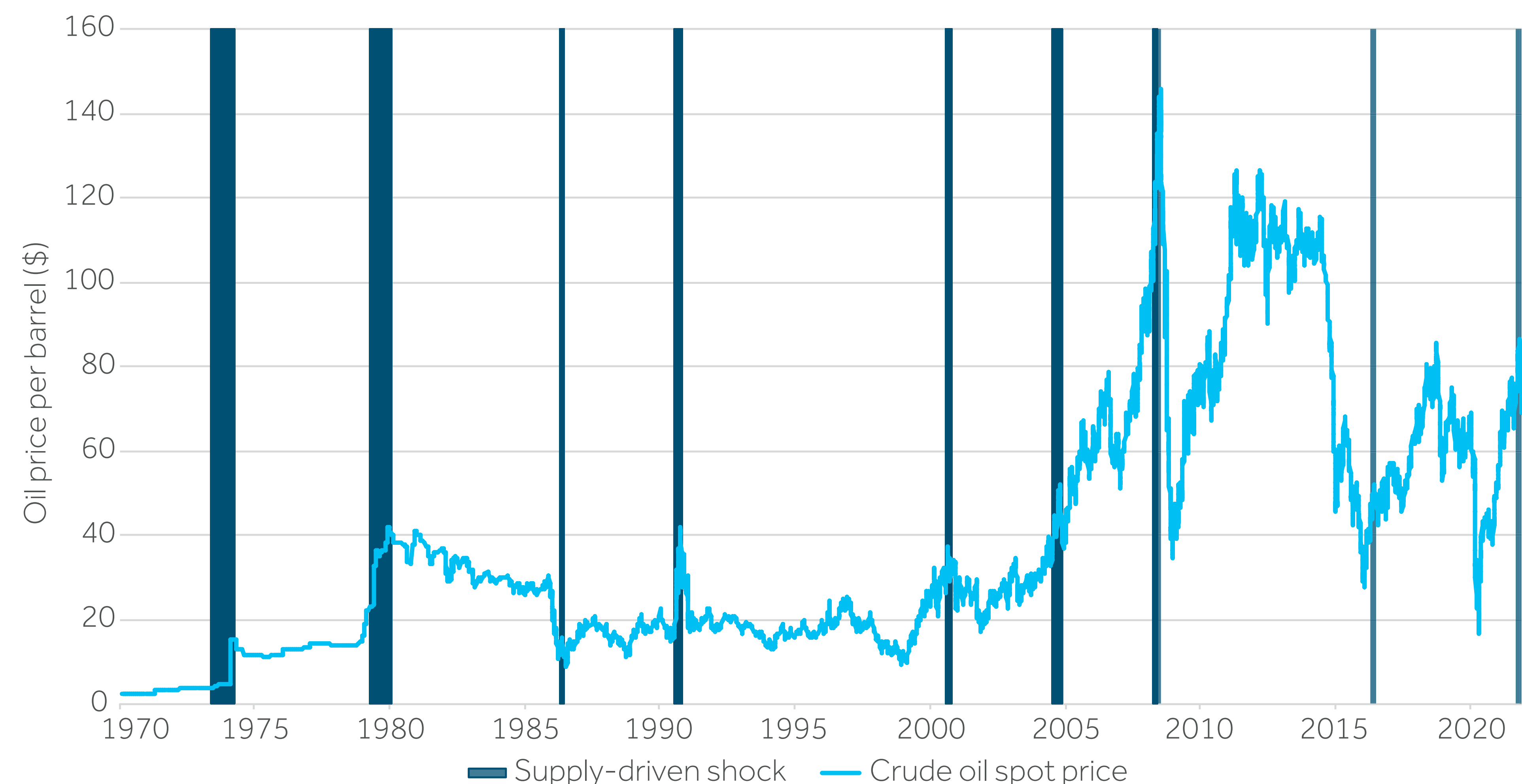


[1] Oil price dynamics report, Federal Reserve Bank of New York, 28 February 2022 https://www.newyorkfed.org/research/policy/oil_price_dynamics_report

"Shock" periods were classified as supply-driven ones when the New York Fed model attributed at least two-thirds of the increase during the identified shock periods to supply factors. While the New York Fed data is not available for 1973 and 1979, these oil shocks are well known to have been caused by supply restrictions following conflicts. This left us with ten supply-driven shocks, which on average lasted five months, and peaked at a 79% increase over the starting price (see chart).

SUPPLY-DRIVEN OIL SHOCKS IN THE LAST 50 YEARS

Spot (front-month) oil prices and periods of supply-driven price increases of at least 20%



Sources: Federal Reserve Bank of New York, Refinitiv, Barclays Private Bank, March 2022

Note:The periods identified as shocks: 1 June 1973 to 28 February 1974, 2 April 1979 to 31 December 1979, 30 April 1986 to 19 May 1986, 10 July 1990 to 9 October 1990, 3 August 2000 to 20 September 2000, 5 July 2004 to 22 October 2004, 1 April 2008 to 3 July 2008, 7 April 2016 to 8 June 2016, 26 August 2021 to 26 October 2021, and 21 December 2021 to 8 March 2022.

TYPICAL IMPACT OF SUPPLY-DRIVEN SHOCKS ON THE ECONOMY

Unsurprisingly, we found that the macro environment generally deteriorated during supply-driven oil price increases. The Institute for Supply Management manufacturing index typically declined from 55.0 at the beginning of the rise in oil prices, to 48.2 after nine months (t+9m), recovering thereafter to 52.5 after two years (or at t+24m). The annual change in the US consumer price index rose from 4.3%, on average, at t0, to 5.5% at t+6m, before trending down to 4.7% after two years.

By contrast, the US unemployment rate steadily deteriorated over the period studied, from 5.3% on average initially, to 6.7% at t+24m. Similarly, the US 10-year Treasury yield rose by some 120 basis points over the same period. Such a move would obviously have bigger repercussions with a starting point at 2% compared to 10% or 15%.

IN A BETTER PLACE TO DEAL WITH THE CRISIS, THIS TIME

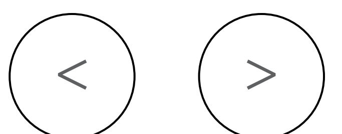
There are several reasons why the global economy is probably more resilient today than it was back in the 1970s and 1980s. Yet, the geopolitical situation complicates the environment, and adds to the level of uncertainty.

- The world is significantly less energy intensive than it was in earlier decades, especially in advanced economies. Today, for example, the US generates almost three times as much output for every unit of energy consumed than it did in 1970. For Europe, that figure is more than two times
- Economies have also come into this supply-shock crisis with strong economic momentum and above-trend growth
- In addition, US and European consumers have accumulated large excess savings, following the fiscal support provided to people during the coronavirus pandemic. This means that they should be able to absorb higher energy costs more easily
- And finally, we see the potential for more fiscal measures to mitigate the impact of high commodity prices on the consumer.

TYPICAL IMPACT ON MARKETS

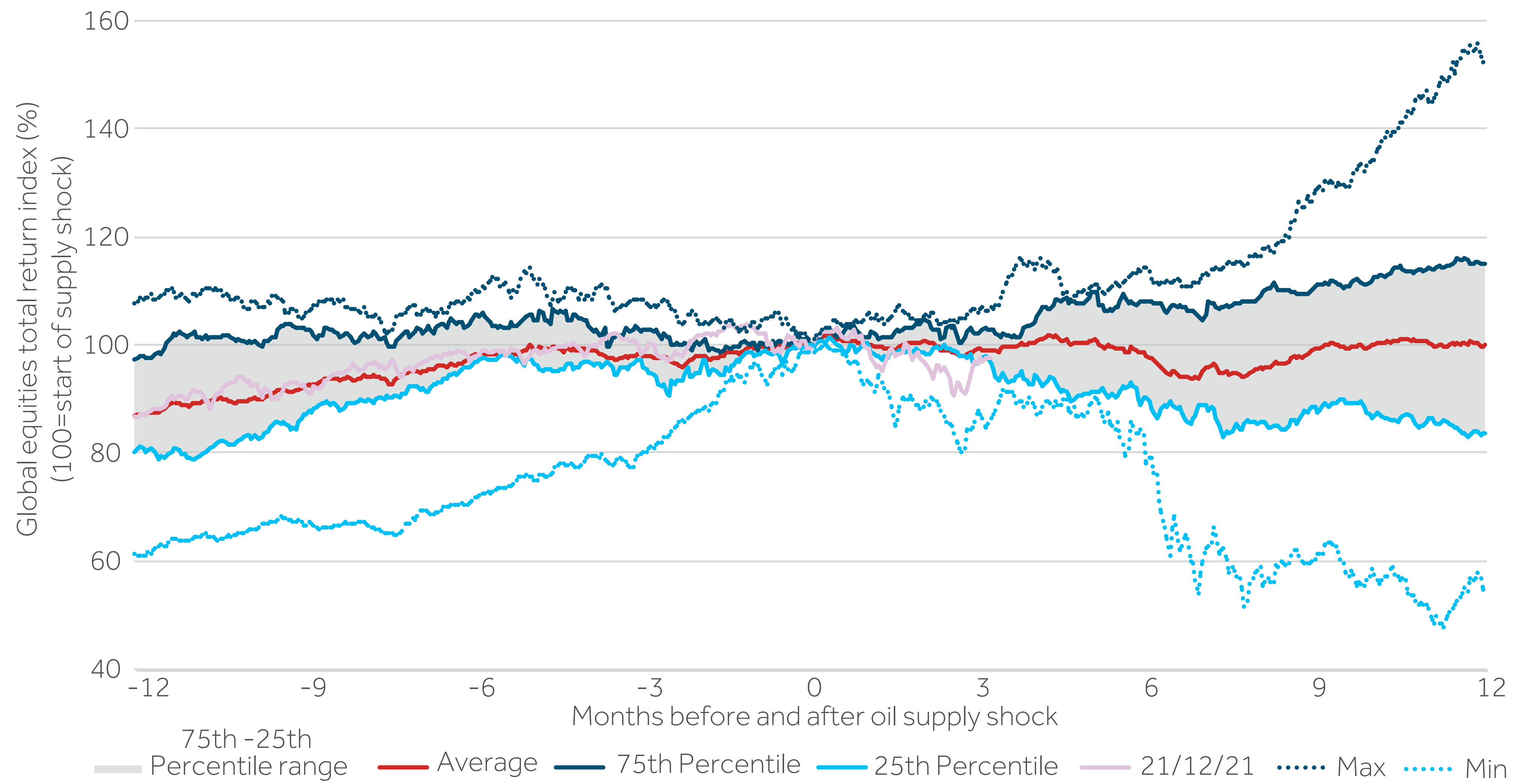
Global equity markets typically troughed seven months after the start of a supply-driven shock, with an average drawdown of -7%, before recovering their losses within nine months (see chart, p13)

The worst individual drawdown was seen in March 2009, when equities fell 52% from the start of the previous shock in April 2008. However, this was at the low point of the global financial crisis, a period when equity markets were driven more by the financial crisis than the preceding oil shock. The second-worst drawdown was seen in October 1974, 16 months after the start of the shock, and saw global equities decline by -39%.



GLOBAL EQUITY PERFORMANCE AROUND SUPPLY-DRIVEN OIL SHOCKS

Distribution of global equity returns in the months before and after supply-driven oil shocks



Sources: Refinitiv, Barclays Private Bank, March 2022

GOLD TENDS TO PERFORM WELL IN OIL SUPPLY SHOCKS

Historically, gold has been a very strong performer in the months following oil supply shocks (see chart). On average, the precious metal climbed 25% twelve months after the start of the shocks (t+12m), and was up by 39% at t+18m. The price of gold peaked at +42% on average, 20 months after the start of the shocks.

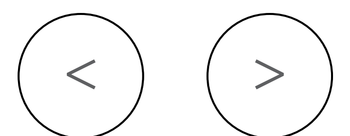
As such, gold has acted as an attractive hedge in multi-asset portfolios, when equities were weak. Seven months after the start of the shocks, when global equities were at their average low point (down -7%), gold was up +7%.

Copper generally outperformed global equities in the year following a shock (up +12% at t+12m), but it was a less consistent diversifier and significantly underperformed gold.

GOLD TYPICALLY SHINES AROUND OIL SHOCKS

Average price/total return indices for gold, copper, and global equities in the three months before, and 24 months after, oil supply shocks (beginning of supply shock=100)

Sources: Refinitiv, Barclays Private Bank, March 2022

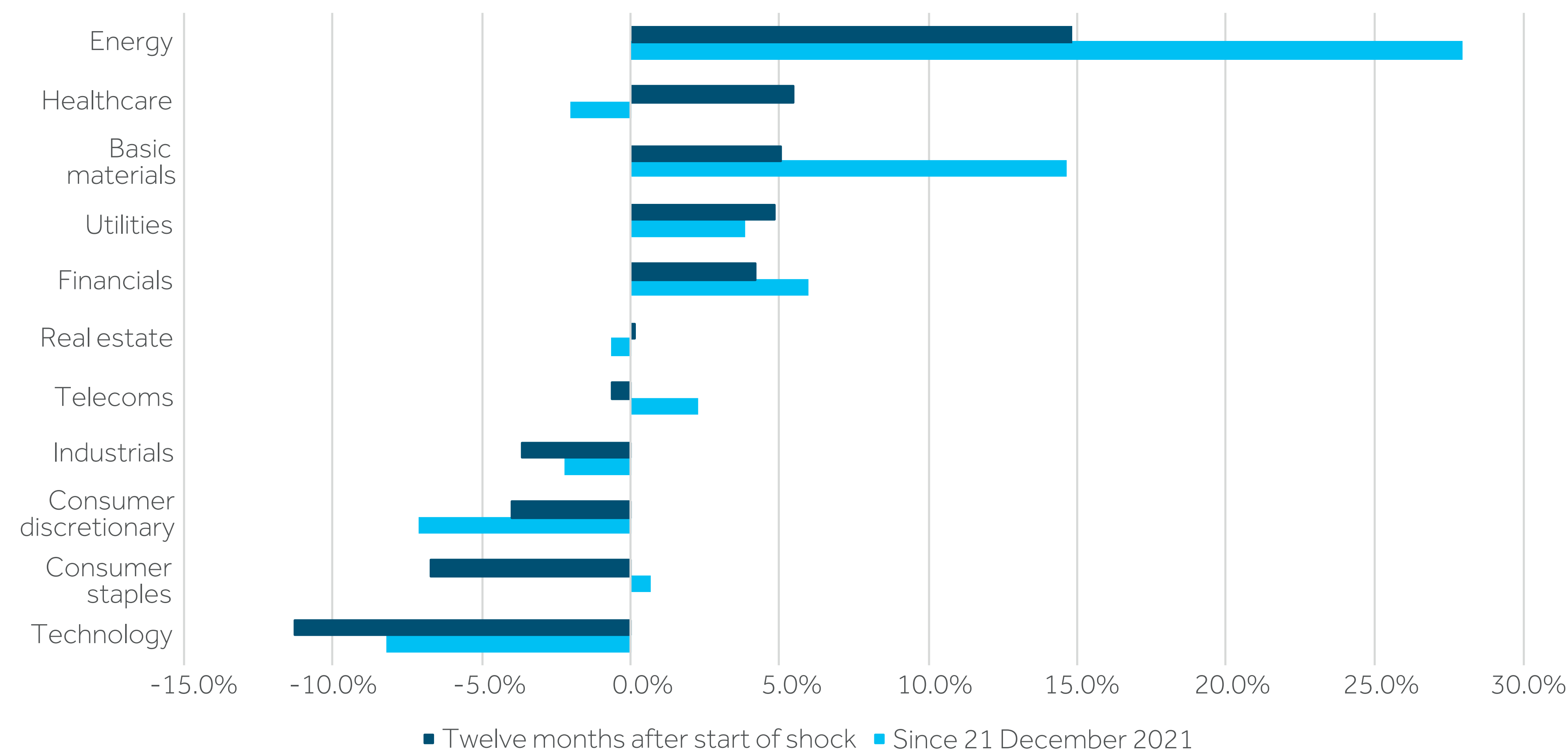


SECTORAL TRENDS DURING OIL SUPPLY SHOCKS

Unsurprisingly, the energy sector was by far the best performer globally in the year following the start of a shock, outperforming the market by 15% on average. As a commodity-driven sector, basic materials also outperformed, by 5% on average, over the same period (see chart).

GLOBAL EQUITY SECTORS' RELATIVE PERFORMANCE IN THE YEAR AFTER OIL SUPPLY SHOCKS

Ranked relative performance of global equity sectors' 12 months after the start of oil supply shocks, versus performance since 21 December 2021



Sources: Refinitiv, Barclays Private Bank, March 2022

As global activity generally deteriorated in the year following those shocks, we were not surprised to see defensive sectors, such as healthcare and utilities, outperform by 6% and 5% respectively after twelve months. Financials outperformed by 4% on average, in the subsequent year, supported by a rise in yields and inflation.

In contrast, technology was the main laggard, underperforming the market by 11% on average at t+12m. The sector tends to underperform in periods of rising yields, due to the long duration of its cash flows.

Consumer staples and consumer discretionary were also notable underperformers, lagging the market by 7% and 4% respectively after twelve months. This probably reflects lower consumer spending activity and weaker corporate margins. Disposable incomes were squeezed by higher commodity prices, while some companies were unable to pass on higher input costs to their customers.

PUTTING THE RECENT SHOCK IN CONTEXT AND SECTOR PREFERENCES

The most recent oil supply-shock was severe, both in term of its magnitude and its impact on markets. At the height of the oil shock on 8 March, the global equity drawdown was slightly worse than seen in similar periods in the past (-10% versus -7% on average at the point of maximum drawdown) and the price of gold had appreciated by 15%. Since then, however, global equity markets have recovered and, at the time of writing, were close to their average performance in previous supply shocks.

The sector rotation since the start of the last shock, on 21 December, has been broadly in line with historical trends in the year following the shocks (the magnitude of the moves cannot be compared as the length of the periods differs). The best performing sector globally was energy, and the worst one was technology. Basic materials, utilities, and financials all outperformed.

We continue to prefer sectors that should profit from higher yields, inflation, and commodity prices, namely financials, industrials, and basic materials. We have become more neutral on energy, following its strong run of late, as other cyclicals seem to offer more value at this point. However, some residual exposure to energy may be kept in the near term, as a hedge against geopolitical risk.

We also reiterate our positive view on the healthcare sector, as history shows that it has outperformed following oil supply shocks. The sector has not reacted yet, and is slightly down relative to the market in the most recent event. However, we note that in previous periods, the sector generally performed in line for the first six months, and then really started to outperform after nine months, as the economic environment deteriorated.

We remain cautious on technology, consumer staples, consumer discretionary, and telecoms, given their historical performance in previous shocks and their negative correlation with yields.

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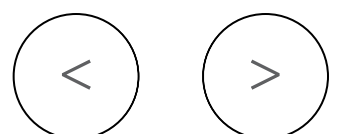


Succeeding with a more defensive approach when investing in bonds

Bond investors face a tough time, with inflation at multi-decade highs for several months now putting upward pressure on global rates, exacerbated by spreads widening. A more defensive approach seems warranted, but opportunities remain.

The war in Ukraine and multi-decade highs in inflation, along with the uncertainty created for growth prospects, adds to the risk for rates and spreads. Unsurprisingly, bonds have not performed well this year so far (see table).

An upward moving US rate curve, driven by the front end, meant that US government bonds have lost 6.4% this year, as measured by the Bloomberg Government bond index. Wider spreads added to the pressure and led to negative excess return within corporate credit and emerging market bonds.

Bond segment	Total return	Excess return ytd
US government bond index	-5.91	-
US Tips (Inflation linked bonds)	-3.08	-
EU government long (10+ years)	-10.10	-0.38
US investment grade corporates	-8.10	-1.49
EUR investment grade corporates	-5.36	-1.43
Sterling investment grade corporates	-6.98	-1.97
US high yield	-5.12	-1.03
Pan European high yield (EU)	-4.38	-1.68
Emerging market USD	-9.80	-3.84

Sources: Bloomberg, Barclays Private Bank, March 2022

CENTRAL BANK POLICY IN FOCUS

We believe that that the challenging environment is likely to persist but a selective and more defensive approach, in terms of duration and credit risk, is likely to lead to stable returns while creating pockets of opportunity.

Coming out of the pandemic, the rate market continues to be driven by central banks' focus on tackling persistently elevated inflation. The US Federal Reserve's (Fed) "dot plot" projection in March reiterated the central bank's determination to fight higher prices. The median forecast places the Fed fund rate at 1.9% by the end of 2022, and points to rates as high as 2.8% in 2023, before moderating in 2024.

REVIVAL OF THE FLAT CURVE

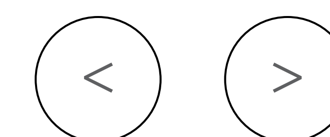
The rate market is pricing in eight hikes this year, and implies a peak for the effective Fed funds rate of over 3% by July 2023. But this level doesn't seem sustainable, with the market implying rate cuts from there. This is a familiar story. In 2019, the rate curve started to invert, indicating that the Fed may have to revise its course, possibly due to a worsening growth outlook.

What followed was a substantial widening in spreads. This time the inversion is already visible in the forward curve, as well as the difference between the 10-year rate and the 5-year rate. Meanwhile, the 2-year rate only sits 20 basis points (bp) below the 10-year rate, and the 30-year and 5-year points, potentially hinting at challenging times for the credit market.

CURVE AND SPREADS

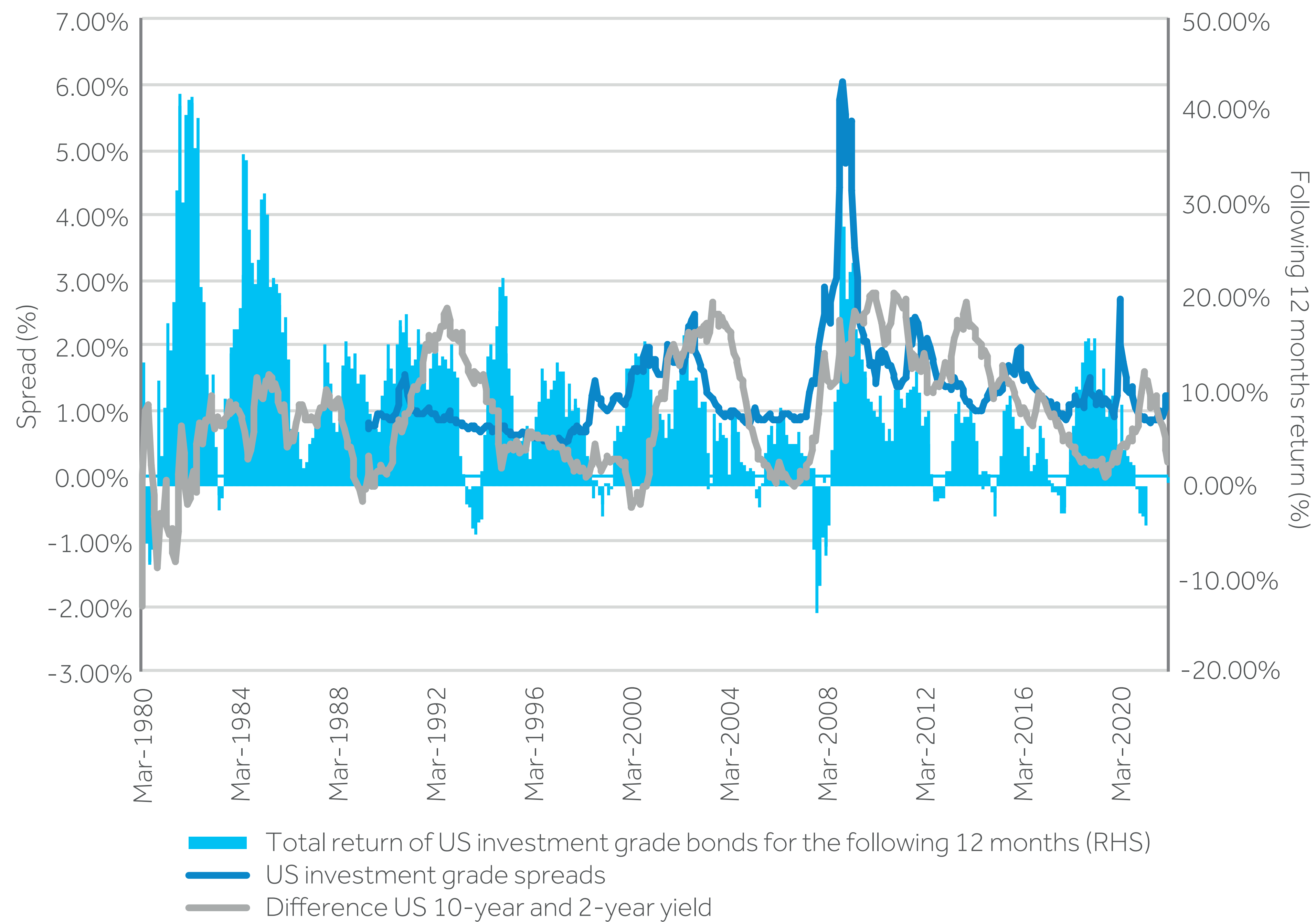
We reported in our *Outlook 2022* that spreads can remain relatively stable during phases of curve flattening. However, when the flattening trend approaches its climax, the performance of corporate bonds tends to be subdued, and is often negative.

While the timing of spread widening varies, the flattest point during a cycle, using the difference between the 10-year and 2-year yield, was often followed by either a continuation or start of spread widening in the corporate bond segment. This could be observed in the subsequent quarters after the flattening inflection points, back in 1989, 2000, 2006, and 2019 (see chart, on p16).



PINPOINTING SPREAD INFLECTION POINTS

The level of US investment grade spreads and the difference between 2-year and 10-year yields in the following twelve months since 1980



Sources: Bloomberg, Barclays Private Bank, March 2022

Although each cycle had different triggers and features: it was at flattening inflection points that central bank rates levelled at, in hindsight, a neutral rate that was too high, while the long end started to "sniff out" growth uncertainties. It is almost ironic that both the rate and the credit markets are very much influenced by the same pension fund buyers, which, at such inflection points, increasingly start to lock in long-end yields while they can. In addition, they often stick to spread risk until the very last moment.

A SOMEWHAT DISTORTED VIEW

It is hard to lean against this recurring pattern in the market which is why we prefer a more defensive approach. Still, some features of this rate cycle look different. First, as highlighted in March's *Market Perspectives*, the short-end of the curve has started to price in aggressive rate hikes at an early stage, and seems to be assured by the Fed's latest rate-path in the dot plot projections.

Usually the rate curve reaches its flattest point when the actual hiking cycle is already at an advanced stage. This time, the Fed started the cycle in March, so it could last well over 15 months from here. In addition, suppressed long-end yields appears to be adding to the flatness of the curve.

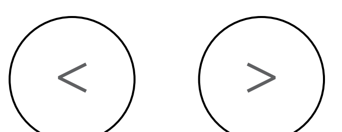
SOME UPWARD PRESSURE FOR THE LONG END

Suppressed long-end yields are probably down for two reasons. One is the substantial demand for long-duration paper by foreign buyers, be it from Japan, Europe, or other lower-yielding areas, and the large-scale bond buying by the Fed. While we do not expect a large sell-off when the Fed stops reinvesting all maturities from its Treasury portfolio, inevitably the market will demand a slightly higher yield premium, all else equal.

The second reason for lower long end yields is the market-implied expectation for a relatively low long-term neutral rate. This is the rate that theoretically supports economic growth while keeping inflation stable, below the Fed's target. While we also see a neutral rate of over 3% as rather unlikely, there seems a higher possibility that the neutral rate discussion is far from over, potentially leading to more volatility at the long end.

1970S WORLD UNLIKELY

Our base case is for higher inflation in the short to medium term, but then for it to moderate as base effects and easing of supply constraints kick in. As such, we do not expect a repeat of the long-lasting stagflation seen in the 1970s. A period that was characterised by a deep curve inversion, high default rate, and tighter financial conditions.



There are thought some parallels between the oil embargo of the 1970s and the current Russian sanctions, which requires close monitoring.

THE IMPACT OF THE CONFLICT BETWEEN UKRAINE AND RUSSIA

According to a latest report by rating agency Moody's, the war in Ukraine is likely to show through three channels: higher commodity prices, sanctions, and security risk, all having implications for growth.

Security risk is likely to persist in various forms, with different outcomes for the bond market. More frequent cyberattacks, pressure on domestic financials following the afflux of Ukrainian refugees, and the increased possibility of longer lasting geopolitical uncertainty, are only some factors to mention.

The conflict also carries stagflationary risks. Indeed, it adds to the challenges facing central banks as they walk on a tight rope between inflationary pressures and downside risk to the growth outlook. While leading central banks remain hawkish, it is not a surprise that the responses from the European Central Bank (ECB), the Fed, and the Bank of England (BoE) differed quite notably. While the Fed seems eager to fight inflation, the ECB, and the (previously more hawkish) BoE, seem to be treading more carefully.

EUROPEAN HIGH YIELD MOST EXPOSED

European bond issuers are clearly more exposed to the risk of higher inflation and worsening growth from the crisis than other regions. First, they face much higher energy input prices, threatening margins for many industrial companies. Second, many cyclical companies may feel second-round impacts, due to the detrimental growth and inflationary pressure facing consumers.

European high yield bonds have already underperformed materially, while US high yield bonds seem less exposed, given the country's smaller dependencies on Ukrainian and Russian commodities. In addition, the energy part of the US market benefits from higher oil prices. This is reflected in the sector's spreads, which are more stable, than the broader US high yield segment, this time around.

FUNDAMENTALS SHOULD BE SUPPORTIVE

The credit fundamentals look more resilient, as the market experiences a broad recovery despite a dampened growth outlook due to events in Ukraine. Leverage is elevated, but has improved lately as earnings growth has picked up.

In US investment grade, leverage has declined to 2.4 times debt/earnings before interest rates, depreciation, and amortisation (Ebitda) from over three times. In addition, more established issuers were able to term out their funding when yields were depressed, meaning that they may have more capacity to absorb higher yields. The interest coverage (earning in relation to debt costs) has also improved and, at 12 times is at its highest level since 2014, compared to less than 10 times at the peak of the pandemic.

A similar picture is evident in the high yield market. Leverage has declined to the lowest levels in almost 10 years, and default rates, according to Moody's, stand at 2%. Global speculative rates are prone to surge, but are likely to stay well below their long-term average of 4.1%. Admittedly, there is a risk that persisting and increasing Western sanctions on Russia push default rates higher, but it seems unlikely to push the bond market into a full blown credit crisis.

AVERAGE MAY NOT BE ENOUGH

Spreads are trading below long-term average levels, and even though the fundamentals may underpin them, they are unlikely to persist, given the elevated level of uncertainty.

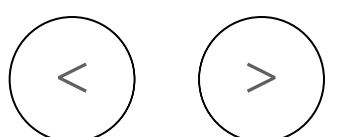
Outside of the pandemic, US high yield spreads hit 530bp in 2018, and 830bp in 2015 during the high yield energy crisis. While it is hard to predict the ultimate spread highs, it is clear that during indiscriminate selling episodes, opportunities will arise in more defensive sectors, such as healthcare, and sectors that can take advantage of higher energy and commodity prices.

OPPORTUNITIES REMAIN

In addition, we believe that contagion risk for the banking sector is limited. A flat curve may not be optimal, but higher rates should ultimately help the sector. Furthermore, coupons, even for subordinated debt, should be relatively stable and provide attractive yield.

Our preferred positioning remains to focus on medium-term duration bonds in the investment grade segment of the market. More defensive high yield names, including selective energy issuers and subordinated financial bonds, also appeal. More broadly speaking, even after the latest retracement in spreads, further widening is possible, if not likely. Although this means more volatility ahead, this will eventually create opportunities to lock in higher yields in the future.

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



Spotting companies that overhype their net-zero pledges

As companies adapt business models to a net-zero emissions world, how can investors spot those likely to be successful in meeting the targets and those set to struggle?

Keeping warming to 1.5 degrees Celsius globally requires globally reaching net-zero carbon emissions by 2050. National carbon commitments to the target now cover around 90% of global gross domestic product. We examine how companies tackle the challenge of aligning policies with the emissions-reduction pathway, and point out what factors might prove worthwhile for investors to keep an eye on.

ZEROING IN ON CARBON EMISSION: THERE IS WORK TO DO AND PRESSURE ON COMPANIES IS HIGH

As highlighted in the sixth assessment report of the Intergovernmental Panel on Climate Change (IPCC), published in August 2021, carbon emissions are the main contributor to climate change[1]. With global emission levels at around 35 gigatonnes of CO_2, aligning with the Paris Agreement goal of 1.5 degree Celsius above pre-industrial levels by the target date, is an ambitious goal.

In looking to hit the Paris Agreement goal, 65 carbon pricing initiatives have been implemented globally, and more are likely to follow[2]. Additionally, almost 1,500 institutions say they will divest from fossil fuels, representing $39.2 trillion assets under management[3].

For companies, this transition generates new uncertainties and challenges. Depending on the nature of carbon pricing[4], they face higher costs to tackle carbon emissions. There is also the need for investment towards stronger climate resilience.

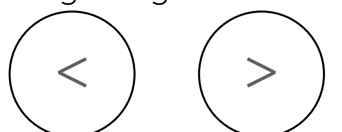
With most of the consequences of the shift to a low-carbon world to come, investors have a tough task in identifying which companies will be successful pioneers in following the emission-reduction pathway.

A crucial building block in doing so will be to investigate companies' plans to reduce emissions. Leveraging the Energy & Climate Intelligence's (ECIU) Net Zero Tracker (NZT) dataset, we look at emission commitments for S&P 500 constituents[5]. The dataset is a collaborative effort involving the Energy and Climate Intelligence Unit, the Data-Driven EnviroLab, the NewClimate Institute, and Oxford Net Zero.

THE MORE THEY EMIT, THE MORE THEY COMMIT

With no global regulation of emissions pledges in place, companies can commit to a variety of targets. The most common are having net-zero emissions, reducing emissions, achieving carbon neutrality, or setting a science-based target.

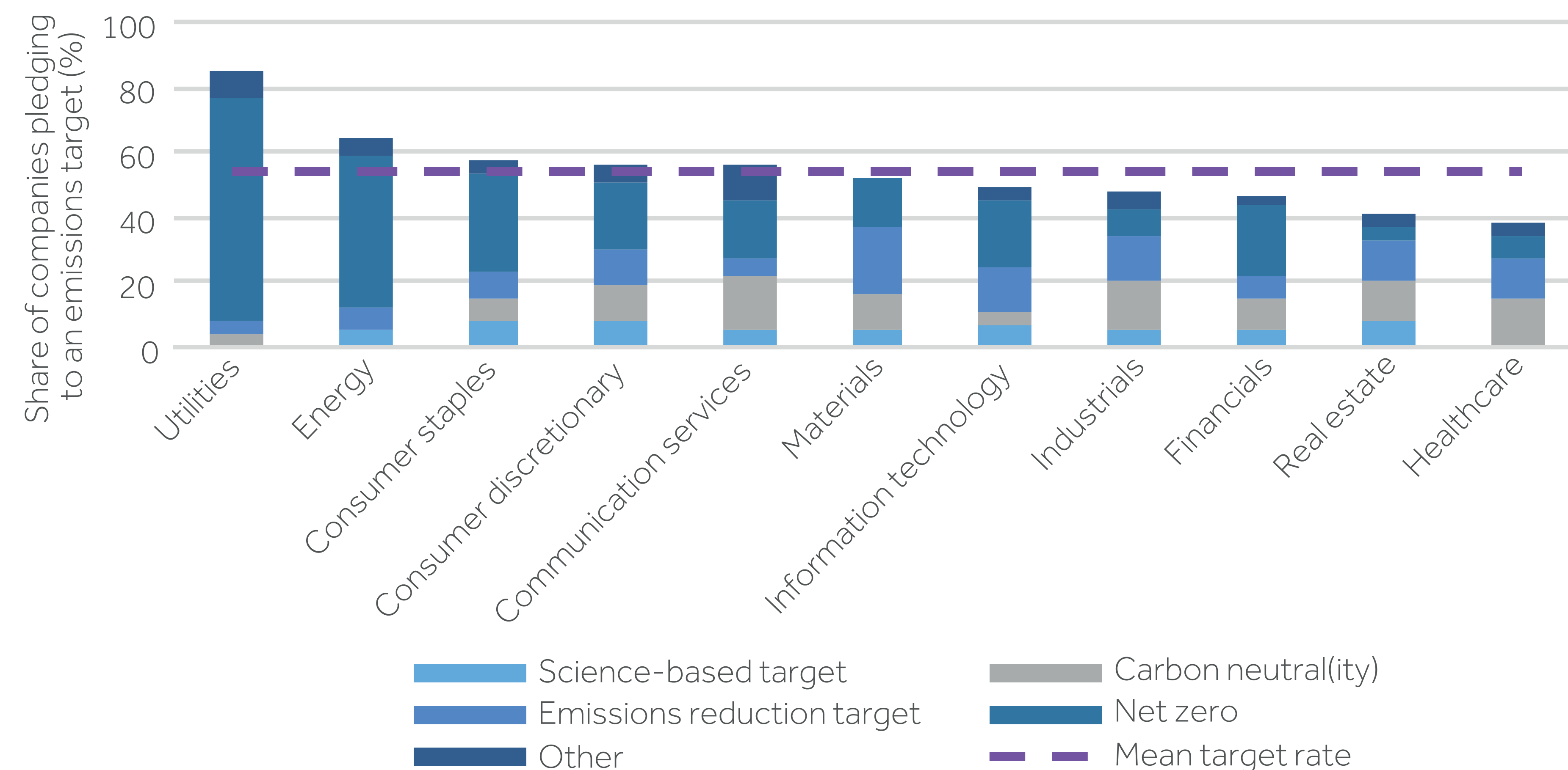
Around half of the companies in the dataset disclose an emissions pledge, out of which 40% promise to achieve net zero (see chart, p19). However, the fraction of companies with emissions pledges varies across sectors. Utilities and energy companies have above-average target rates, while real estate, financials, and healthcare are below the average target rate. Notably, sectors with high emissions rates, namely utilities and energy, have been under more pressure to reduce emissions.



[1] AR6 Synthesis Report: Climate Change 2022, IPCC, August 2021 https://www.ipcc.ch/report/sixth-assessment-report-working-group-i/
[2] Carbon Pricing Dashboard, World Bank, March 2022 https://carbonpricing dashboard.worldbank.org/
[3] After a decade of action, we are making a difference in the fight against climate change, DivestInvest, October 2021 https://www.divestinvest.org/
[4] The main types of carbon pricing include an emissions trading system (ETS), a carbon tax, an offset mechanism, internal carbon pricing or results-based climate finance practice (RBCF) programmes.
[5] The NZT dataset covers the Forbes 2000 companies, of which we analysed 382 of the S&P 500 companies representatively across sectors. Data on the remaining companies is not yet available in the Net Zero Tracker database.

THE SHARE OF COMPANIES WITH EMISSIONS TARGETS VARIES BY SECTOR

Share of companies in the dataset with emissions targets by sector and target type



Sources: Net Zero Tracker, Barclays Private Bank, October 2021

Net zero - All GHG gases emitted into the atmosphere are equivalent to the GHG gases removed

Emissions reduction target - Reduce emissions be certain percentage with respect to baseline year

Carbon neutrality - The amount of carbon dioxide emitted into the atmosphere is equal to the amount of carbon dioxide removed

Science-based target - Set targets in line with the latest climate science deems necessary to meet the goals of the Paris Agreement

Other - Includes zero emissions, climate neutral(ity) or seeing a 1.5-degree Celsius target.

ARE EMISSION TARGETS CREDIBLE?

While setting emissions-reduction goals is important, without appropriate and immediate action they will be hard to achieve. The credibility of those set targets rests on two factors: a target's quality or robustness, and its degree of ambition.

SETTING MORE ROBUST GOALS

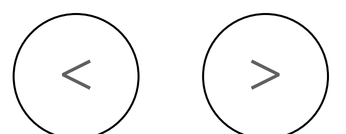
In an effort to make emissions pledges more transparent and robust, academics and experts have developed criteria checklists that the targets should fulfill, such as the NewClimate Institutes' Ten basic criteria for net zero transparency[6] and the United Nations' starting criteria for companies to participate in its Race to Zero campaign[7].

Important quality criteria encompass government indicators, such as the existence of a publicly available plan, setting interim targets to ensure action proceeds in a timely fashion, and committing to publish regular progress reports along with holding the management accountable. Additionally, it is crucial to include details on the coverage of the targets, namely which gasses and emissions scopes are included in the target, and to specify to which extent offsetting is allowed. Offsetting emissions, by paying for emissions cuts or carbon removal, may simply shift emissions to other emitters (see chart, p20).

While having almost half of the companies in the sample committing to emission targets is far better than what's been achieved in previous years, robustness of implementation varies.

There is much room for improvement for companies that do not identify a plan on how to reduce emissions, including interim targets and regular reporting.

Organisations striving for best-in-class in robustness are those including full scope emissions, not using or limiting the use of carbon offsets, and committing to account for delivering on the self-imposed targets to meeting global greenhouse gas emissions targets.

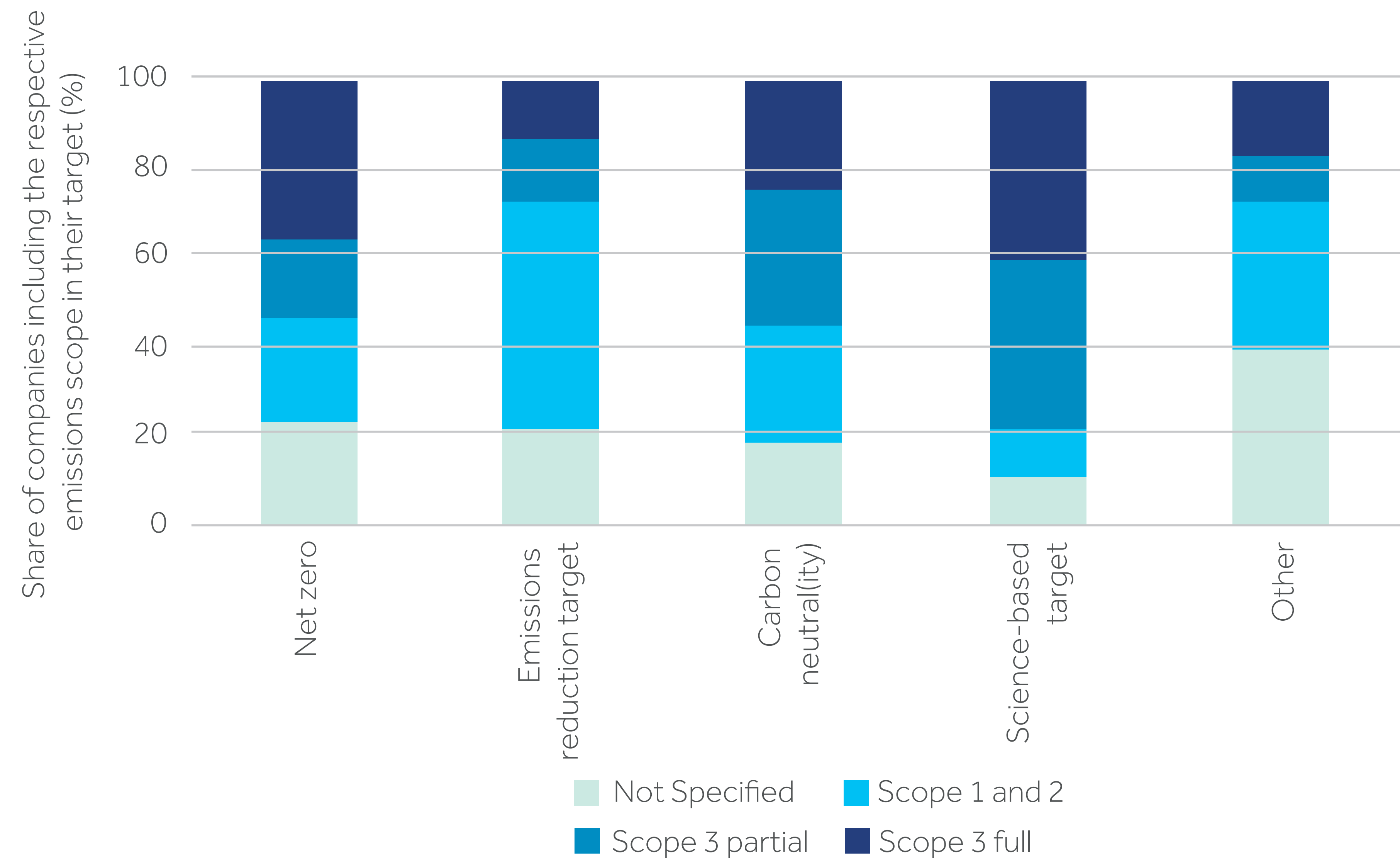


[6] Navigating the nuances of net-zero targets, NewClimate Institute, 22 October 2020 https://newclimate.org/2020/10/22/navigating-the-nuances-of-net-zero-targets/

[7] Race To Zero Campaign, United Nations Climate Change, February 2022 https://unfccc.int/climate-action/race-to-zero-campaign

COMPANIES CAN STAND OUT BY SETTING HIGHER-QUALITY EMISSIONS TARGETS

Share of companies aligned with each robustness criteria



Sources: Net Zero Tracker, Barclays Private Bank, October 2021

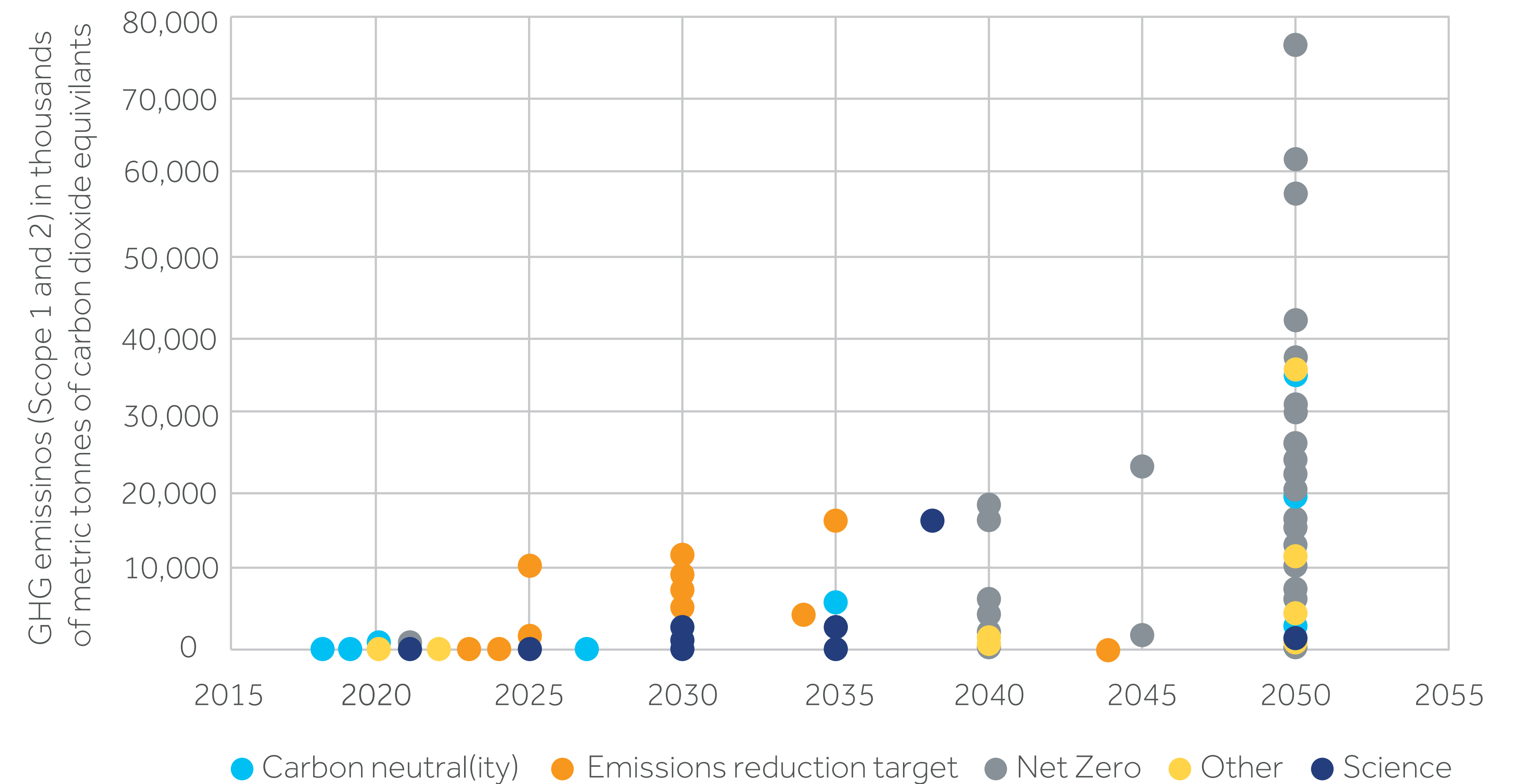
Scope 1: Direct GHG emissions that are from sources owned or controlled by the entity
Scope 2: Indirect GHG emissions associated with the production of electricity, heat or steam by the entity
Scope 3: All other indirect emissions, such as emissions from the extraction and production of purchased materials, fuels, and services, including outsourced activities

MORE AMBITIOUS TARGETS REQUIRE A ROBUST IMPLEMENTATION

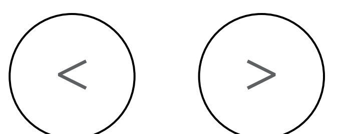
Pledging to cut emissions in the short term is a considerable goal for large emitters, especially those with strict net-zero targets. As such, it may be sensible for such companies to aim for longer time horizons than businesses with lower emissions and simpler reduction targets (see chart).

MEETING NET ZERO NEEDS MORE EFFORT THAN REDUCING EMISSIONS

Target timeline to achieve reduction goals, depending on current and pledged emissions



Sources: Net Zero Tracker, Bloomberg ESG (BESG), Barclays Private Bank, January 2022



ANALYSING COMMITMENTS ADDS INFORMATION TO THIRD-PARTY ESG SCORES

Most third-party environmental, social and governance (ESG) scores have a standardised procedure for ESG criteria. Net zero pledges are voluntary, non-standardised information disclosed by a company.

Emissions pledges allow the evaluation of carbon emissions risk separate from other criteria that could contribute to third-party ESG scores. However, given the pledges are voluntary disclosures, it is important to carefully consider the robustness of the commitment.

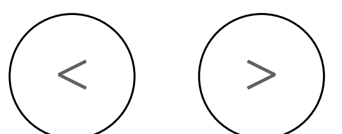
SHORT-TERM UNCERTAINTIES CAN HIDE THE LONG-RUN BENEFIT OF NET-ZERO COMMITMENTS

Companies that do not align with the global-emissions-reduction pathway are likely to face a growing number of carbon-pricing initiatives, investor divestment, and potential shifts in consumer behaviour. For companies that do meet their emissions targets, expected returns in the next 10 to 30 years are likely higher.

In the short run, however, financial outcomes may be heterogeneous. The positive effects of mitigating future carbon risk can remain masked, as initial investments, and hence costs, might be required to implement the emissions targets. Moreover, while uncertainty about future carbon-pricing regulation remains, markets can be more volatile as investors overreact to signals regarding future carbon regulation.

For investors cautious about the environmental impacts and long-run expected returns on their portfolio, tracking net-zero commitments can help find out more about a company's strategic position in the transition to a low-carbon world. That said, it is crucial to consider not only whether a pledge was made, but also how credible it is compared with current emissions, the timeline set and the robustness of implementation.

Authors: Damian Payiatakis, London UK, Head of Sustainable & Impact Investing; Sophia Gläser, London UK, Quantitative Strategy Analyst



Proceed with caution when using market forecasts

In times of uncertainty, investors understandably seek expert views and forecasts to make sense of events. However, people should keep in mind the uncertainty involved in forecasts, and be aware of how using them can influence decision-making.

There is much going on in the world right now, and uncertainty is high. Making sense of events, their likely results, and potential impact on economies, markets, and portfolios is a tough task. People don't like uncertainty, and it is understandable that during times like now we seek more clarity.

As heavy Russian shelling of Ukraine continues despite attempts at peace talks, investors are turning to the outlook for commodities, and particularly the oil price, which has surged in recent weeks. Sharp and sustained increases in the oil price have often led to recessions, especially when driven by supply shocks; so if the energy crisis deepens it could potentially affect the economic recovery. However, the global economy appears more resilient to oil supply shocks today, than it was back in the 1970s and 1980s.

FORECASTS HAVE BENEFITS

Forecasting uses historical data to help predict the direction of future trends. Assumptions are made and a model is created, which takes inputs to generate predictions.

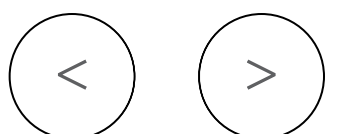
Models don't have to be explicit, they can also be mental models. All investors are consistently forecasting, whether consciously or unconsciously. Even the biggest sceptics of the value of making predictions, inevitably express views about the future when they make an investment decision. By simplifying a problem, forecasting helps us make sense of the world and make decisions.

BUT WE CAN'T PREDICT THE FUTURE

A limitation of a model is that it is built on a finite set of parameters, while reality affords us infinite sources of risks. We cannot predict the future, and so all forecasts will have a degree of uncertainty.

However, this doesn't stop us from trying to do so. Stories help us to understand the world around us, and they may provide a degree of confidence in what might happen. That said, in making judgements and taking decisions in an uncertain world, there are biases that creep in, which can affect how information is processed and forecasts are made. For example:

- Representativeness - when we're trying to assess how likely a certain event is; we often make our decision by assessing how similar it is to an existing mental prototype
- Availability – we overweight events and data points that are more easily recalled in our minds, for instance, dramatic news such as the present conflict



- Overconfidence – our subjective confidence in our own judgments is typically greater than the objective accuracy of those judgments

Investors should be cautious with the weighting given to any one forecast (be that their own, or those made by others) when making investment decisions. This is particularly important for point estimates (such as the predicted level of some commodity prices) without bands of uncertainty around it. The further out a forecast, the larger the confidence intervals around an estimate will be.

FORECASTS CAN INFLUENCE INVESTMENT BEHAVIOURS

All forecasts will have some element of bias in them, but there are also biases in how they are used. A model might show some risks, but not the risks of using it.

The confirmation bias, where extra weight is given to data that confirms pre-existing beliefs and views, can lead investors to place much confidence in particular predictions that coincide with our own world views. Evidence to the contrary gets less attention.

Making decisions based on forecasts, in particular if they are short-term ones, can also lead to unhelpful investment behaviours. Forecasts may lead to a more short-term approach to investing, and also over-trading of assets, in particular if the forecasts being used are subject to considerable, or frequent, revisions.

For those who do want views, market-implied probabilities, which are weights that the market is assigning an event, based on current prices of financial instruments, can give an investor an understanding of the market's aggregate forecast for certain events.

BUT ENSURE PORTFOLIOS ARE DIVERSIFIED

For investors that want the reassurance of views from experts, when faced with considerable uncertainty, it may help to think more about potential scenarios, and the likelihood of them, instead of one absolute view. If we believe that it is possible to forecast markets, it diminishes the perceived need for diversification.

Thinking through different scenarios and positioning a portfolio for a range of outcomes will likely lead to a more diversified portfolio. Whilst an investor may have a strong conviction about the evolution of events and the corresponding direction of markets as a result, a portfolio of quality assets diversified across asset classes, regions, and sectors can help to protect wealth when reality differs from expectations. It can help an investor navigate volatile and unnerving market conditions, and should make it easier to stay invested and reap the benefits of time in the market.

HAVING AN INVESTMENT PHILOSOPHY IS KEY TO SUCCESS

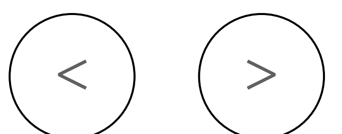
While we recommend caution, this is not to say that investors should not be thinking about changing conditions and where they can provide opportunities.

It is important for investors to be aware of trends which may have lasting impacts on markets and their portfolios. One does not want to miss such trends. However, it is unlikely to be in the long-term interests of an investor to tilt their entire portfolio every time an event is identified that they believe may affect markets. Similarly, for attempting to time the market. Such behaviours have often been shown to have a negative impact on investment returns.

One of the best ways to increase the likelihood of success is to follow a robust investment process, striking the right balance between long-term thinking, to generate the core investment returns, and more opportunistic short-term tweaks to allocations to maximise overall returns. For those looking to capitalise on periods of volatility and uncertainty, one possible avenue to consider involves products structured to profit from volatility, without needing to take a directional view.

Continued volatility in an uncertain world may dislocate markets, most likely providing opportunities for active managers to capitalise on. By additionally monitoring current investments with the changing economic and market conditions, portfolio risk can be managed. Additional opportunities to enhance the risk-return profile can also be captured, creating the best of both worlds.

Author: Alexander Joshi, London UK, Behavioural Finance Specialist



Multi-asset portfolio allocation

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

	-		=		+
Cash and short duration bonds				■	
Fixed income		■			
Developed market government bonds				■	
Investment grade bonds			■		
High yield bonds		■			
Emerging market bonds		■			
Equities					■
Developed market equities					■
Emerging market equities				■	
Other assets		■			
Alternative trading strategies		■			
Commodities			■		
Real estate	■	■	■	■	■

"-" Denotes a cautious view
"=" Denotes a neutral view
"+" Dentotes a positive view

CASH AND SHORT DURATION BONDS

- Given the ongoing uncertainty, and in order to manage portfolio risks, we maintain a preference for higher-quality and liquid opportunities.

FIXED INCOME

- We see only limited opportunities in fixed income
- We maintain a small preference for developed market government bonds as a hedge against possible macroeconomic volatility
- In credit, we prefer the higher-quality segment, although, as spreads have recovered remarkably from their highs, our risk budget is allocated towards equities
- In high yield, selection is key, and our exposure is low, given the tightness of spreads. We prefer high yield and emerging market (EM) hard currency debt over EM local currency debt, considering the risk facing their economies and currencies.

EQUITIES

- We believe that equities remain relatively more appealing than bonds in the current environment
- Yet, we remain highly selective in our allocation
- In line with our long-term investment philosophy, our portfolios remain geared towards high-quality, cash-generative, and conservatively-capitalised businesses
- As a function of our bottom-up selection, we currently see more opportunities in developed market equities compared to their emerging peers.

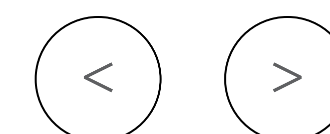
ALTERNATIVE TRADING STRATEGIES (ATS)

- There are a limited number of opportunities in the ATS space, as the cost/benefit trade-off can be challenging
- Our focus is on strategies offering diversification benefits thanks to their low-correlation to equity markets.

COMMODITIES

- As a risk-mitigating asset, gold remains the only direct commodity exposure we hold in portfolios
- From a portfolio management perspective, we believe our risk budget is better spent outside of the asset class.

Author: Julien Lafargue, London UK, Chief Market Strategist



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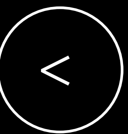

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