



Market Perspectives

February 2022



Contents

Riding out the inflation storm	3
Will ballooning inflation and Omicron slow global growth to a trickle?	5
Can equities outperform in a rate-hiking cycle?	8
US bonds: bridging the gap	11
Putting a shine on your portfolio with mid-market private equities	14
How well anchored are US inflation expectations?	17
Getting your portfolio climate-ready in 2022	20
When the going gets tough, the tough stay invested	22
Multi-asset portfolio allocation	25

Contributors:

Julien Lafargue, CFA, London UK, Chief Market Strategist
Dorothee Deck, London UK, Cross Asset Strategist
Michel Vernier, CFA, London UK, Head of Fixed Income Strategy
Nikola Vasiljevic, Zurich Switzerland Head of Quantitative Strategy
Lukas Gehrig, Zurich Switzerland Quantitative Strategist
Alexander Joshi, London UK, Behavioural Finance Specialist
Damian Payiatakis, London UK, Head of Sustainable & Impact Investing
Henk Potts, London UK, Market Strategist EMEA

Foreword

The year kicked off with financial markets particularly volatile, as galloping prices and the timing of rate hikes focused investors' minds. In this issue of Market Perspectives, we look at the implications of elevated inflation, and the US Federal Reserve's (Fed) nearing rate-hiking cycle, for equities, bonds, and other asset classes.

Starting with the global economy, we remain confident that growth will be above the long-term trend this year, despite the prospect of higher rates and elevated consumer prices. Indeed, inflation is likely to peak soon, before slowing in the second half of the year, as COVID-19 restrictions ease and supply-chain disruptions fade.

In equities, cyclicals have done better than some more defensive areas, such as technology. This trend will probably last until the market realises that there is a trade-off between higher rates and growth. That said, investors shouldn't fear hikes, as many equity markets and sectors tend to perform well in this environment. In sector terms, a value tilt remains appealing for now, as financials, energy, industrials, and basic materials tend to outperform in a tightening cycle. By contrast, healthcare, consumer staples, and technology are likely to lag.

Turning to fixed income, bond yields jolted higher after the Fed's surprising switch to a more hawkish stance in December. The US central bank may hike as much as three times this year. Volatility in debt markets looks a certainty, as the outlook for inflation and interest rates clears. As such, five-year bonds appear to offer the most value along the yield curve.

Away from public markets, private markets offer a much-needed chance to diversify portfolios, and limit the potential for elevated inflation to harm your wealth. Mid-market private equity (or companies worth between \$100 million and \$500 million) particularly look attractive. They haven't been subject to the same hype as other segments of the market. Additionally, the companies tend to better navigate environments where inflationary pressures threaten profitability.

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

Riding out the inflation storm

With inflation hitting multi-decade highs, how long this period of elevated prices lasts matters for investors. We look at various inflation scenarios, what this may mean for asset classes, and the optimal asset allocation as inflation finds its post-pandemic norm.



When we published our *Outlook 2022* in November, we listed the top five risks investors should monitor. Inflation was number one. At that time, wage pressures were still muted, but since then they have increased. In the US, the Bureau of Labor Statistics' employment cost index for civilian workers was up 4% in the fourth quarter, year on year. This stickier component of the inflation basket suggests that the recent burst in inflation isn't as transitory as may have been thought.

Equally, to this point, there is no reason to believe that the US consumer price index (CPI) will continue to climb. In December, the headline CPI increased 7% year-on-year, a 40-year high¹. Energy costs were a key contributor, as oil and gas prices soared compared to a year ago.

When stripping out these volatile components, and looking at the month-on-month trend, core inflation appears to have stabilised somewhat (+0.5% in December, stable versus November). Our view remains that we may see the peak in year-on-year US inflation by March or April.

HOW MUCH OF A RISK IS INFLATION?

After peaking, we would expect inflation to "normalise" gradually. Normalising does not mean returning to pre-pandemic levels, at least not in the short or medium term. Similarly, gradually means that this process will take quarters and not months. In fact, we expect US inflation to still be above 2.5% (and therefore the US Federal Reserve's (Fed) own target) by the end of this year.

Some investors have a much more aggressive view on inflation, expecting prices to rise at an annual rate of at least 4% for the rest of this year or longer. Obviously, if such a scenario occurs, it would have significant implications for investors. With that in mind, we looked at various inflation regimes and the potential implications for various asset classes.

WHAT DOES THIS MEAN FOR INVESTORS?

Unfortunately, looking at past data isn't necessarily a great indication for what a period of elevated inflation might mean for investors in the aftermath of a pandemic. The last time CPI was above 7% in the US was in the early 1980s. However, this was at that time when inflation was moderating, having peaked at more than 14% in 1980. Similarly, the US Fed funds rate jumped as high as 20% in 1981 compared to 0.25% at the time of writing.

In addition, the world is a very different place compared to 40 years ago: the worldwide web was still being developed; IBM, AT&T, and Exxon were the biggest components of the S&P 500 index; and China exported goods worth around 6% of its gross domestic product, compared to 18% today.

Yet, history is the only hard data that forecasters can rely on to try and form views about the future. With that in mind, after looking at how various asset classes tend to respond to inflation surprises, we have looked at inflation's dynamics over the last 20 years and how inflation has impacted returns across classes. Our analysis shows that:

- With inflation, like with any other trend, the starting point matters: a 4% CPI rate has different implications if the starting point was 1% or 7%.
- There is a "sweet spot" for inflation. Anything too high (above 4%) or too low (such as in deflationary eras) narrows the universe of investments likely to generate positive returns.
- Real and riskier assets tend to do better in periods when inflation is in the upper-range of this sweet spot (or between 2% and 4%).

¹ Consumer prices reached a 40-year high in December—here's what's more expensive, CNBC, 12 January 2022 <https://www.cnbc.com/2022/01/12/consumer-prices-continued-to-rise-in-december-reaching-a-40-year-high.html>

THE ASSET CLASSES SUITED TO DIFFERENT INFLATION SCENARIOS

Given the typical reaction of various asset classes to inflation, we look at the optimal asset allocation for portfolios under three different scenarios for prices (see table):

- If, as we expect, inflation moderates and settles in a slightly higher range than experienced over the past 10 years, equities should continue to outperform bonds, with the latter still contributing positively to performance. In this scenario, diversification is key. Other asset classes, including commodities, hedge funds and private markets can play an important role in maximising returns and limiting risks
- If, on the other hand, inflation was to revert to pre-pandemic levels, commodities would likely underperform, with fixed income returns likely to jump substantially
- Finally, if like many investors fear, inflation remains elevated for an extended period of time, there may be few places to hide. Commodities and inflation-linked bonds would then play a key role in trying to mitigate the pressure on returns from both equities and credit instruments.

THE INFLUENCE OF CENTRAL BANK POLICY AND INFLATION EXPECTATIONS

Of course, any change in inflation does not happen in a vacuum. With mandates to maintain price stability, central banks may respond to changing consumer prices by tweaking interest rates. They will be particularly attentive to inflation expectations. This is why we assessed whether these expectations have become unanchored [link to quant article]. In addition, as central banks' main policy tool to influence inflation remains interest rates, we believe it's important to analyse the impact rate changes may have on, and within, both equities and fixed income markets.

While adjustments can be made to portfolios, in order to prepare for or protect against higher inflation, the reality is that current circumstances are unique, and historical playbooks may be inappropriate this time around. In such unusual times, investors may simply want to turn to what has been the most reliable source of returns over the long term: staying invested.

Author: Julien Lafargue, CFA, London UK, Chief Market Strategist

ANNUALISED AVERAGE MONTHLY TOTAL RETURN BY INFLATION REGIME*, BY ASSET CLASS

	up to 0%	0% to 2%	2% to 3%	3% to 4%	above 4%	avg. 2001-2021
Bloomberg US Treasury Bills	1.2%	1.4%	1.4%	1.7%	2.0%	1.4%
Bloomberg Global Aggregate Treasuries (Hedged USD)	7.1%	5.5%	2.6%	3.0%	4.3%	4.2%
Bloomberg Global Aggregate Corporate (Hedged USD)	10.0%	6.1%	3.0%	4.8%	5.4%	5.2%
Bloomberg Global High Yield (Hedged USD)	8.7%	8.1%	9.5%	5.9%	7.4%	8.1%
MSCI World Net	2.9%	8.2%	9.9%	5.7%	9.1%	7.9%
MSCI Emerging Markets Net	12.0%	17.6%	11.2%	17.7%	-2.6%	10.8%
Bloomberg Commodity Index	-11.2%	-12.9%	15.4%	11.9%	3.3%	2.1%
MSCI World Real Estate Net	-1.9%	13.7%	8.3%	10.4%	10.3%	9.1%
HFRX Global Hedge Funds	2.2%	2.2%	2.3%	5.0%	1.5%	2.5%
US TIPS	4.7%	1.1%	5.4%	7.4%	10.4%	5.5%
Distribution of observations	10.8%	24.3%	30.3%	14.7%	19.9%	

*Inflation regimes are determined by the three-month trailing average of annualised month-on-month seasonally-adjusted headline consumer price index

Sources: Bloomberg, Barclays Private Bank, January 2022

Will ballooning inflation and Omicron slow global growth to a trickle?

After chalking up the fastest post-recession growth rate on record last year, the global economy faces three key risks this year – surging inflation in many developed economies, the path of the COVID-19 pandemic, and political tensions.

While the economy is expected to keep growing this year, the outcomes of these risks will dictate the pace of recovery.



The global economy grew by 6% last year, its fastest post-recession growth rate in nearly eight decades. As we assess the prospects for this year, further expansion seems on the cards.

Policy levels remain supportive, the service sector has further room to recover, and inventories need to be restocked. Furthermore, we anticipate that employment will strengthen and saving rates normalise, which should be positive for domestic consumption, and in turn growth prospects. Consequently, we predict above-trend GDP growth of 4.3% in 2022 (see table).

While we are positive on the outlook for the global economy, there are risks (such as inflation, medical, and political) that may limit the pace of the recovery.

INFLATIONARY PRESSURES

Upward inflationary pressures have been both much higher and longer than anticipated during the last year. Central bankers have abandoned their “transitory” narrative, as supply-chain bottlenecks took longer to resolve, energy prices surged, and tighter labour markets pushed up wages.

Nevertheless, inflation is likely to decelerate from the second half of the year, as restrictions are removed in many large economies, and capacity increases, leaving aside the risk of a vaccine-resistant variant emerging. Commodity prices are expected to stabilise, and labour supply should also improve and take some of the heat out of wage inflation.

REAL GROSS DOMESTIC PRODUCT GROWTH FORECASTS, YEAR ON YEAR (%)

	2020A		2021F		2022F		2023F	
	Real GDP growth	Inflation rate	Real GDP growth	Inflation rate	Real GDP growth	Inflation rate	Real GDP growth	Inflation rate
Global	-3.2	1.6	6.0	3.2	4.3	4.1	3.7	2.3
Advanced	-4.9	0.7	5.0	3.3	3.8	4.1	2.4	1.7
Emerging	-1.9	2.9	6.7	3.1	4.6	4.2	4.6	3.1
Region								
US	-3.5	1.3	5.6	4.7	3.8	5.0	2.4	1.9
Euro area	-6.8	0.3	5.3	2.6	4.0	3.7	2.9	1.5
UK	-10.1	0.9	7.2	2.6	4.0	4.7	1.5	1.9
China	2.3	2.5	8.1	1.0	4.7	2.0	5.3	2.0
Japan	-5.1	-	1.6	-0.2	3.4	0.9	1.0	0.7
Brazil	-4.5	3.2	4.5	8.3	0.3	8.1	1.5	3.9
India	-7.1	4.8	7.9	5.1	7.6	4.8	6.7	5.0
Russia	-3.5	3.4	4.0	6.7	2.6	6.8	2.0	4.6

Note: Weights used for real GDP are based on IMF PPP-based GDP (5-year centred moving averages).

Source: Barclays Research, Barclays Private Bank, January 2022

MEDICAL RISKS

The path of the pandemic is uncertain. The Omicron variant, and resurrection of restrictions, are a reminder that coronavirus spikes will continue as the world slowly transitions from pandemic to endemic.

However, we do not anticipate a return to the previous intense, widespread lockdowns enforced in early 2020. Coronavirus vaccinations have proved successful, and have been adapted to meet new challenges. We should also recognise how much better households and businesses have coped with tighter restrictions, which should reduce the impact of any renewed curbs on physical interaction.

GEOPOLITICAL TENSIONS

A range of possible political outcomes exist which could upset the global equilibrium. The world is closely watching the rising tensions between the West and Russia over Ukraine and Nato expansion. This year's political calendar may impact the direction of policy.

In Europe, the main focus will be on the French presidential election in April, with Emmanuel Macron seeking a second term. In the US, November's mid-term elections will see all 435 members of the House of Representatives up for re-election. One-third (34) of US senators will also face the electorate, including Democrats in competitive districts in Arizona, Georgia, and Nevada. The outcome of these races may affect the passage of President Biden's policy agenda.

US INFLATION TO PEAK IN APRIL

The US growth rate has slowed from its post-pandemic peak. Supply-chain disruption, Omicron restrictions, and inflationary pressures have contributed to weaker levels of industrial production and softer consumer sentiment.

We expect supply constraints to ease, and domestic consumption levels to improve, this year. The outlook for the US consumer remains positive, given the huge accumulation of excess savings, strong underlying demand, and healthy labour market (the unemployment rate fell to 3.9% in December, its lowest level since the start of the pandemic¹).

Inflation continues to be a major concern for the US Federal Reserve (Fed). The consumer price index (CPI) surged to 7% in December, the largest annual gain since June 1982². Price pressures are emanating from shelter, used cars, and food. Energy prices, a strong contributor to inflationary pressures over the past year, eased in December for the first time since April, as domestic gasoline prices fell compared to the prior month.

With supply bottlenecks taking longer to resolve, and services inflation set to be anchored by the increase in housing costs, we now expect US CPI to peak at 7.4% in April.

With CPI in excess of 7% and unemployment below 4%, there seem to be few obstacles that will stop the Fed from hiking in March. We can, however, expect the hysteria around inflation to calm through the second half of the year. By the end of the year, we expect US CPI to be around 2.5%. The rapid deceleration should begin to be reflected in rate-hiking expectations, discouraging those economists predicting five or six hikes this year, with three increases being far more likely.

CHINA GROWTH PROSPECTS UNDER PRESSURE

Activity in China decelerated to 4% year-on-year (y/y) in the fourth quarter (Q4), ahead of the 3.6% forecast. That said, the growth figure was its weakest since Q2 2020, and down on the 4.9% registered in the previous quarter³.

China's growth profile has come under pressure from a range of factors, including the slump in the property market, energy shortages, and its commitment to the zero-COVID strategy. In December, property investment dropped 13.9% year on year, and retail sales rose by only 1.7%, compared to 3.9% in the earlier month.

With the two main drivers of growth, property and exports, expected to slow further this year and only a modest recovery in consumption, we look for growth to moderate to 4.7% in 2022, from 8.1% last year.

While other central banks are hiking rates to combat inflation, the People's Bank of China surprised the markets in January by cutting the cost of medium-term loans for the first time since April 2020. Given the weaker outlook, we anticipate additional easing in the next few months, including a further reduction in the reserve requirement ratio, and another 10-20 basis points (bp) of policy rate cuts in the first-half of the year.

STALLING EUROPEAN RECOVERY PUSHES BACK RATE-HIKE EXPECTATIONS

The recovery in Europe is thought to have stalled once again at the end of last year, as Omicron weighed on economic activity. Renewed restrictions sapped consumer confidence, hitting the hospitality and entertainment sectors. Supply-chain disruptions added to the contraction of activity in the important manufacturing sector.

On the positive side, the seasonally-adjusted eurozone unemployment rate fell to a record low of 7% in January⁴, substantially below the 8.2% jobless figure registered in December 2020. Europe, specifically Spain and Italy, should

¹ The employment situation – December 2021, Bureau of Labour Statistics, 7 January 2022 <https://www.bls.gov/news.release/pdf/empst.pdf>

² Consumer prices reached a 40-year high in December—here's what's more expensive, CNBC, 12 January 2022 <https://www.cnbc.com/2022/01/12/consumer-prices-continued-to-rise-in-december-reaching-a-40-year-high.html>

³ China tops forecasts with 8.1% growth in 2021 but headwinds loom, Reuters, 17 January 2022 <https://www.reuters.com/markets/asia/chinas-q4-2021-gdp-grow-faster-than-expected-2022-01-17/>

⁴ Euro area unemployment at 7.0%. Eurostat, 1 February 2022 <https://ec.europa.eu/eurostat/documents/2995521/14233878/3-01022022-AP-EN.pdf/cfe71acd-ef6c-b52b-085f-838598dd9a88>

benefit from disbursements from the €750 billion recovery fund⁵. While we have downgraded our Q1 growth forecast, the scaling back of restrictions and easing of supply-side bottlenecks should allow the recovery to resume.

As with other regions, we have increased our projection for eurozone inflation this year, given the surge in energy prices and increase in food inflation. We now expect the harmonised index of consumer prices to average 3.7% in 2022, before slipping to 1.5% in 2023. Despite the relatively hawkish tone emerging from the February Governing Council meeting, we still do not expect the European Central Bank (ECB) to raise rates this year. However, the expected increase in 2023-2024 inflation forecasts, which are due to be published at the March meeting, suggests that rate-hiking expectations may be brought forward from previous projections. We now expect a 25bp increase at both the March 2023 and September 2023 meetings.

UK INFLATION TO EASE, WITH TWO RATE HIKES BY JUNE

In November, the UK economy finally surpassed its pre-pandemic level, as output recovered more quickly than anticipated⁶. The UK labour market is strong, unemployment having fallen to 4.1%, and job vacancies reaching a record high of 1.25 million⁷. In addition, the service sector has bounced; consumers have been spending, and construction and manufacturing activity have smashed growth forecasts.

We expect data for December and January to show some weakness, given the imposition of restrictions for the Omicron variant, after which the recovery should resume. Our projection is for the UK economy to grow at 4% this year. However, looking into 2023, the combination of Brexit, tax hikes, and higher interest rates suggest that the UK's growth profile may come under pressure again.

Higher fuel prices, rising goods costs, and escalating food expenditure are driving up UK inflation. CPI is now expected to peak above 7% in April (as Ofgem ups price caps), before decelerating into year end, although still printing above 3% in December. Elevated inflation and labour market tightness encouraged the Bank of England to hike rates by 15bp in December 2021 and 25bp in February. We expect two further 25bp hikes by the middle of this year, putting the base rate at 1% in May, after which we expect a policy pause.

Author: Henk Potts, London UK, Market Strategist EMEA

⁵ Long-term EU budget 2021-2027 and recovery package, European Council, October 2021 <https://www.consilium.europa.eu/en/policies/the-eu-budget/long-term-eubudget-2021-2027/#>

⁶ UK economy surpasses pre-pandemic size with November surge, Bloomberg, 14 January 2022 <https://www.bloomberg.com/news/articles/2022-01-14/u-k-economy-grew-stronger-than-expected-before-omicron-hit>

⁷ UK jobs market improves again with jump in employment, Bloomberg, 18 January 2022 <https://www.bloomberg.com/news/articles/2022-01-18/u-k-labor-market-improves-again-with-jump-in-employment>

Can equities outperform in a rate-hiking cycle?

With the US Federal Reserve on the cusp of launching a rate-hiking cycle, the potential impact of tighter policy on your portfolio is key. We look at how equities have performed in previous cycles, and what this might mean for portfolio positioning.



This year has already seen some sharp price moves and violent rotations in equities. The rotations were triggered by a large rise in yields, following more hawkish signs from the US Federal Reserve (Fed) and other central banks, in response to persistent inflationary pressures and tight labour markets.

Investors, and central bankers, were further reassured by growing signs that the Omicron variant appears to be less virulent than previous strains of the virus, and less of a threat for economies.

JUMP IN TREASURY YIELDS AND INFLATION SPOOKS INVESTORS

US 10-year yields hit 1.87% in mid-January, from 1.33% in early December, and were close to their pre-pandemic level. The market is now pricing in five rate hikes in the next 12 months, starting in March. Bond yields in other areas, including Germany, have also repriced sharply higher. As a result, long-duration assets have been hit hard, catching many by surprise. In equities, there was a powerful rotation to value from growth, and to cyclicals from defensives.

Until we see inflation convincingly peaking, we believe those rotations have more legs, this favours a pro-cyclical stance in portfolios, as well as a value tilt, reiterating the views expressed in our *Outlook 2022*. Historically, the main beneficiaries of higher yields and inflation have been financials, energy, industrials, and basic materials. We believe that those sectors remain well positioned in the near term. They are more heavily concentrated in value indices and non-US markets.

In contrast, the sectors that tend to be most negatively correlated with yields and inflation include telecoms, healthcare, utilities, consumer staples and technology. Despite recent underperformance, we believe that group of companies will remain vulnerable in the near term, as these sectors are more defensive, have longer duration assets, and are more heavily concentrated in growth indices and the US market.

CONCERNS ABOUT OVER-AGGRESSIVE POLICY TIGHTENING

One of the main concerns at present is the risk that excessive policy tightening could derail growth, and lead to a market sell-off, or even a bear market. Our view is that a lot of the repricing has already been done on the fixed income side, and that inflation should decline progressively in the second half of the year, as supply constraints ease, and demand shifts to services from manufactured goods.

While the path of policy normalisation currently priced in by the market is faster and more aggressive than we initially anticipated, yields seem unlikely to reach a level that will hurt the economy, or derail markets. Yields remain low by historical standards, and certainly well below the above-trend growth that we expect globally in the next couple of years.

In addition, the equities' earnings yield still significantly exceeds bond yields, supporting the continued outperformance of stocks versus bonds, and encouraging the "There is no alternative" (Tina) mindset to prevail. Finally, the macro backdrop remains favourable, with global activity supported by large excess savings, accommodative financial conditions, an expected pickup in capital expenditure, and restocking.

FED HIKING CYCLES – A HISTORY

In order to address investors' concerns that the upcoming hiking cycle could present a major risk for stocks, we look at how equity markets have performed in the four previous hiking cycles, stretching back to 1994.

While there have been nine hiking cycles from the US Federal Reserve (Fed) since the 1970s, our analysis focuses on the last four (February 1994, June 1999, June 2004, and December 2015). Markets were very different back in the 1970s and 1980s, and as a result, offer less useful comparisons for investors today.

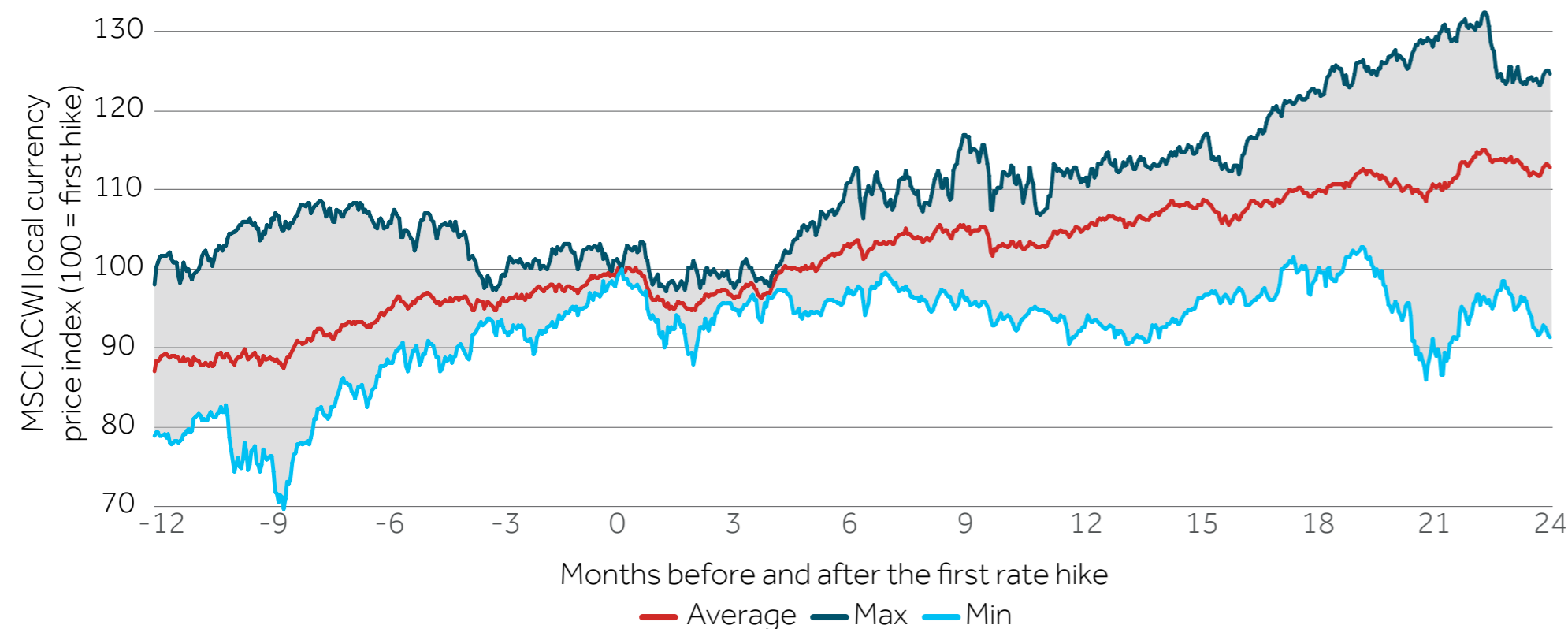
The hiking cycles were much steeper, to combat very high inflation, and the Fed did not communicate explicitly on its policy targets. In the last four hiking cycles, the central bank raised policy rates by only 188 basis points, on average, in the first 12 months, from 2.25% to 4.13%.

EQUITIES TEND TO PERFORM WELL AROUND HIKING CYCLES

Equity markets generally performed well in the months before the first hike, in the US and globally (see chart). They typically saw a mild, short-lived sell-off in the first couple of months following the initial rate hike, but they generally shrugged off the news quickly, and resumed their up-trend as the Fed continued to tighten.

PERFORMANCE OF EQUITIES IN ERAS OF RISING RATES

The performance of the MSCI ACWI local currency price index in the four Fed hiking cycles since 1994, both before and after the first hike



Source: Refinitiv Datastream, Barclays Private Bank, January 2022

Based on local currency MSCI ACWI indices, both US and non-US equities saw a 5% average drawdown in the first two months. However, by the third month, both indices had resumed their up-trend and recovered all their losses within five months of the cycle commencing. Twelve months after the first hike, US and global equities were up 6% and 5% respectively. They were up 16% and 13% respectively, two years after the first hike. The worst drawdown was seen after the December 2015 hike, when global equities lost 12% in the first couple of months.

As always, those numbers should be treated with caution. How equity market react to a hiking cycle depends on many factors, including how well the policy moves were flagged, to what extent they were already priced in, and obviously the level of rates, and the speed and magnitude of policy normalisation.

REGIONAL AND SECTOR RETURNS DURING HIKING CYCLES

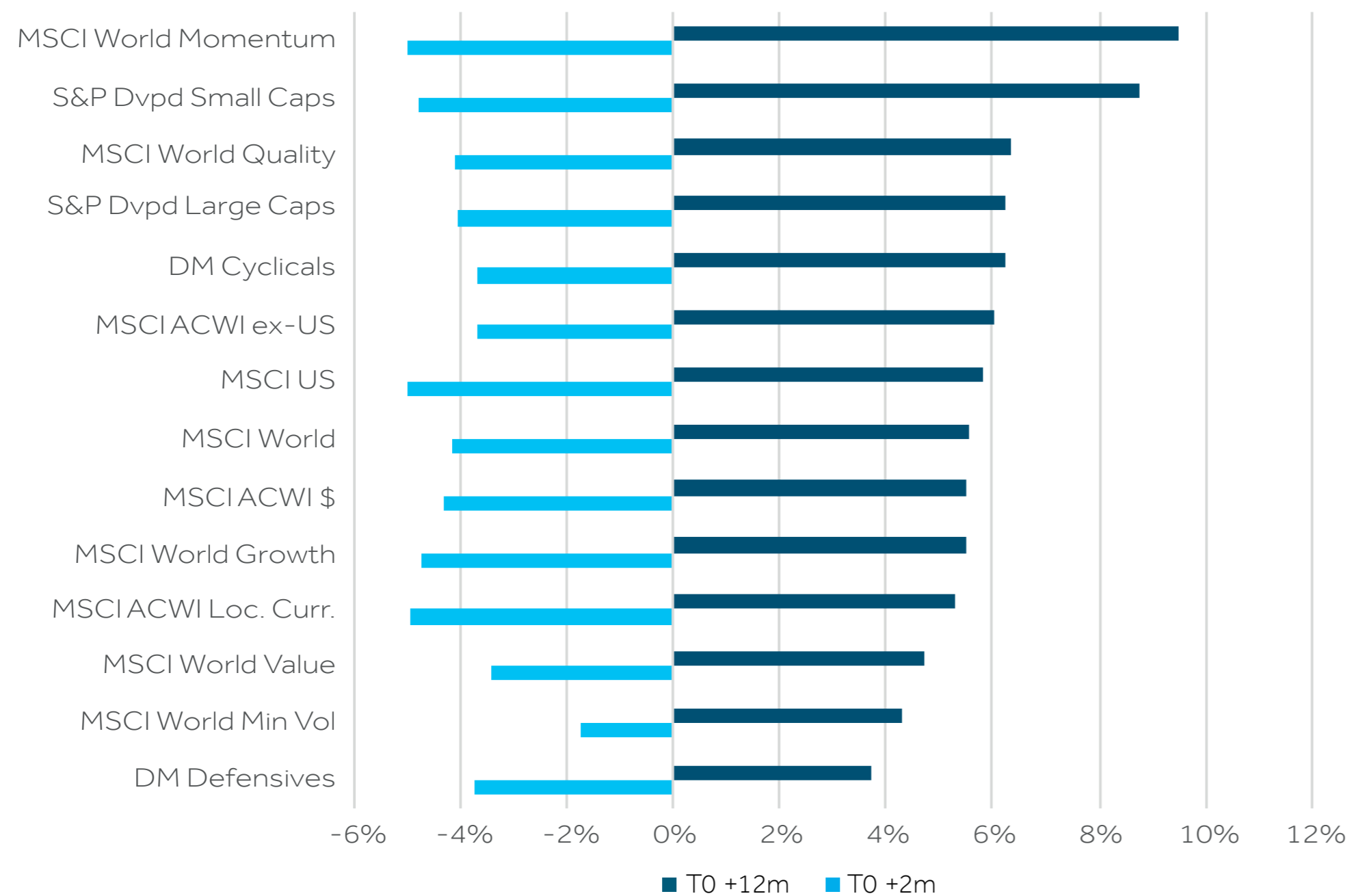
Relative performance within the equity market during rate-hiking periods also provides some interesting readings (see chart on page 10). Non-US equities outperformed the US by 8%, on average, in common currency terms in the first eight months following the Fed's first hike, helped by a weaker USD. Afterwards, relative performance tended to converge, to finish in line after twelve months.

Similarly, developed markets small-cap equities outperformed large caps by 4%, on average, in the first eight months of the cycle. The MSCI World Value and Growth indices performed essentially in line with each other, as was the case for cyclicals versus defensives.

In our chart on page 10, the cyclical and defensive indices mentioned refer to Barclays Private Bank's market-cap weighted indices, denominated in USD. Cyclicals include financials, consumer discretionary, industrials, energy, basic materials, and technology hardware. By contrast, defensives include healthcare, consumer staples, telecoms, utilities, real estate, and software and computer services.

SECTOR, STYLE, AND REGIONAL PERFORMANCE AROUND RATE-HIKING CYCLES

The average performance of several MSCI indices in the first two months and 12 months after the first hike, versus price at the time of the first hike, during the four Fed hiking cycles since 1994. All prices in US dollars unless otherwise stated



Source: Refinitiv Datastream, Barclays Private Bank, January 2022

For all the styles covered, the biggest drawdowns were seen in the first couple of months, varying between -5% for momentum, small caps, and growth, and -2% for minimum volatility, based on monthly readings. By the third month, all indices had resumed their up-trend. Twelve months after the first hike, the best performing indices were momentum and small caps, up 9%, while the main laggards were defensives and minimum volatility, up 4%.

A TIME TO BE DIVERSIFIED AND NIMBLE

Equities have usually performed relatively well in the run up to and during US rate-hiking cycles in the past thirty years. After an initial blip, equities delivered mid-single digit returns in the year following the start of the hiking cycle. We do not expect this cycle to be any different, especially as aggressive tightening by the Fed is already priced in. That being said, we continue to expect increased volatility in the coming months, requiring investors to be diversified and nimble.

Author: Dorothee Deck, London UK, Cross Asset Strategist

US bonds: bridging the gap

The uncertainty over the upcoming policy rate path and a shift in the supply/demand balance in the US Treasury markets seems as high as ever. Pricing suggests that ignoring the noise and focusing on medium-term bonds seems a prudent strategy.



The dominating topic for financial markets so far this year remains the path of central bank policy. In America, since late 2021 the US Federal Reserve (Fed) has adjusted its policy stance which led to a repricing of the US rate curve. The radical change in the Fed's direction has also altered our expectations for the path of policy rate hikes.

We saw two to three hikes this year as possible towards the second quarter in our *Outlook 2022* published in November. However, the change in tone in the Federal Open Market Committee's (FOMC) December and January meetings, suggests that the Fed is now preparing to hike earlier, with three hikes, if not four, this year, starting with the "lift-off" in March.

Over an extended period, Fed chair, Jerome Powell, defended the policy of letting the economy run "hot", to ensure a wide job market recovery among various income and ethnic groups. This narrative has changed now, as headline inflation remains above 5% for the eighth month.

"One of the two big threats to getting back to maximum employment is actually high inflation," Powell said during a press conference¹. The tapering of current bond purchases is expected to be much quicker than had been expected, opening the door for a first hike in March.

HAS OUR OUTLOOK CHANGED FOR 2022?

In anticipation of the expected rate lift-off, the market has accelerated the flattening process with the two- and five-year point of the yield curve, moving them significantly upwards. A more determined Fed has provided more confidence that inflation can be tamed in the longer run. This increased confidence can be seen by lower trending inflation expectations, as the 10-year breakeven inflation rate consolidated from a 2.75% high to 2.45% in January. Is this the end-game, and what are the probable scenarios from here be?

TWO ESSENTIAL QUESTIONS FOR RATES

The first question to be answered by the bond market concerns the timing of the lift-off, the number of rate hikes, and the likely end-point, or neutral long-term rate. The second question is what are the possible ramifications for the long end of the rate curve once the Fed starts to reduce its Treasury holdings?

"The change in tone...suggests that the Fed is preparing to hike...three, if not four, times this year, starting with the "lift-off" in March"

POLICY RATE END-GAME

Listening to Jerome Powell and his colleagues, it seems that there is much uncertainty over the long-term neutral rate, that is the target policy rate that ensures full employment with inflation kept at bay. The Fed's own "dot plot" forecasts suggest that the rate is 2.5%.

During recent decades, the long-term neutral rate has been revised down consistently, not least because of the disinflationary environment, but also higher systematic bond demand and positive global productivity growth rates. Such a narrative seems broken in the near term. That said, given the excessive wage growth and the prospect of lower bond demand in light of the upcoming balance-sheet reduction, a return towards the historical trend seems likely in the long term.

¹ Jerome Powell Pitches Benevolent Interest-Rate Hikes Again, Bloomberg, 11 January 2022 <https://www.bloomberg.com/opinion/articles/2022-01-11/jerome-powell-pitches-benevolent-interest-rate-hikes-again>

GAUGING THE PACE OF RATE HIKES

The Fed seems to acknowledge that accommodation must be more dynamic along the path towards the “end point”. This is very important, as a potential faster pace of rate hikes does not necessarily indicate a higher end-point.

Comments from Fed member Christopher Waller “If inflation is just stubbornly high through the first half of this year, we’re going to have to do a lot more,” would admittedly suggest a potential higher end-point. Indeed, Powell stated that “if we have to raise interest rates more over time, we will,” in front of the banking committee of the Senate in December.

But a wage growth spiral and commodity cycle is unlikely to run forever and the Fed, like many economists, expects a trend to more balanced supply and demand in the future. While many older workers (over 55 years of age) may not necessarily return to the workforce again, younger ones will do so eventually. Living from savings is not a perpetual game for most. This should ease some of the wage growth pressure.

The Fed is now trying to bridge the gap between a high inflationary period (how long it may last) and the period of lower inflation expected to follow. This separation could give Powell greater power to hike rates faster now. He said: “We would not in any way want to foreclose the idea that the labor market can get even better. But again, with inflation as high as it is we have to make policy in real time, we’ve got to make that assessment in real time.”²

SURPRISES LIKELY

With this in mind, three US rate hikes this year, as suggested by the Fed’s dot plot, seems to be very likely. A fourth increase, as implied by current market pricing, is possible, but not set in stone. The Fed will get inflation data for two more months ahead of the March FOMC meeting.

Higher persistent inflation may open up the potential for a surprise 50bp hike in March. This is not our base case, but only such a move would put a firmer cap on inflation expectations should breakeven yields, along with higher inflation readings in February and March, start to accelerate again. Such a move would potentially shift the rate curve higher, but may not necessarily mean a higher end point, as explained earlier.

IMPACT OF A SHRINKING FED BALANCE SHEET

In January, the FOMC stated that it “expects that reducing the size of the Federal Reserve’s balance sheet will commence after the process of increasing the target range for the federal funds rate has begun”. This implies that the reduction of the balance sheet may start in the first or second quarter of this year.

Given the strong recovery in the economy, and what could be defined as full employment, a balance sheet of over \$8.7 trillion seems hardly justifiable. A run-off, as soon as July, seems more on the cards now. “The balance sheet is much bigger so the runoff can be faster.”, argued Powell.

Around \$1.9 trillion of the Fed’s \$5.6 trillion Treasury holdings mature in 2022 alone. The Fed would still reinvest a substantial portion of maturing debt to ensure a slower pace of runoff, potentially \$15 billion to \$30 billion a month to begin with, before a gradual increase towards \$75 billion a month. This in turn could translate into a \$1.2 trillion reduction by the end of 2023, or potentially \$1.6 trillion if the runoff pace approaches \$100 billion a month, \$1.6 trillion which would need to be absorbed by private demand.

“Around \$1.9 trillion of the Fed’s \$5.6 trillion Treasury holdings mature in 2022 alone”

HIGHER TERM PREMIUM LIKELY

The demand-shift, and the uncertainty over the magnitude, is likely to result in a higher term premium, the additional yield investors demand for holding longer-dated bonds. This term premium is around minus 15bp, being as high as 200bp during the taper tantrum in 2013. A more orchestrated runoff, with still high accommodative policy, warrants only a slight increase in the term premium, potentially well below the 10-year average of around 30bp.

Investors fearing a rate sell-off due to large Treasury supply from the US government which hits the private markets, should take into account that the US Treasury is likely to issue significantly less debt this year than in 2021, given a large bulk of the funding needs were front loaded last year. Secondly, much of the new supply is likely to come in the form of T-bills, which would hardly impact 10-year yields.

² Transcript of Chair Powell’s Press Conference December 15th, 2021, The Fed, 15 December 2021 <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20211215.pdf>

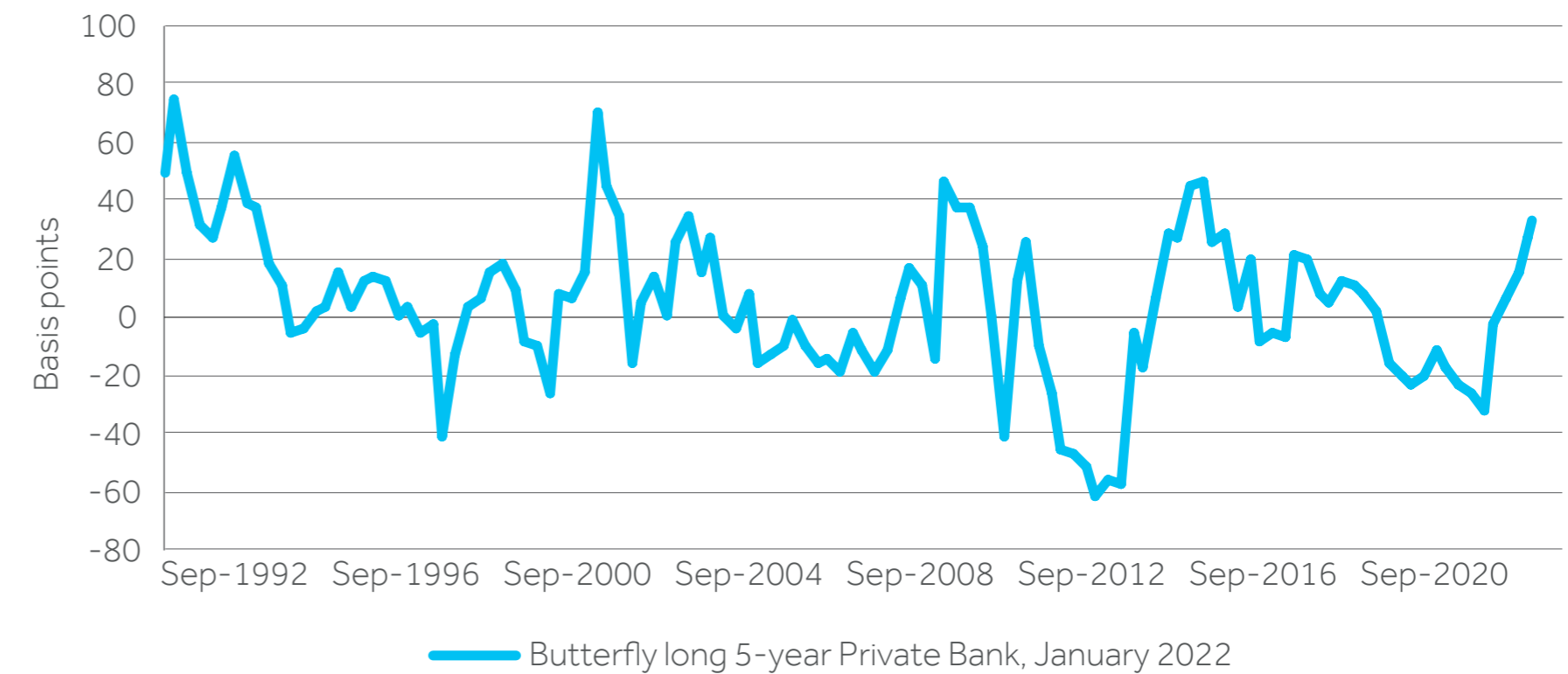
FIVE-YEAR YIELDS WITH VALUE

In the scenario just described, we see a possibility for yields surpassing 2% potentially reaching even 2.25% temporarily. Should inflation abate over time, as we expect, yields of well over 2% seem rich in our view. While uncertainty over the pace and extent of the hiking cycle, as well as over long-end yields, remain, we see the belly of the curve at the 5-year point from a risk/reward perspective. This part of the curve is pricing in four hikes this year, and yields only 25bp less than 10-year bonds.

This pricing is also reflected in the rate butterfly construct, which compares the 5-year yield against that available for the 2- and 10-year yields simultaneously. The butterfly comparison (see chart) shows that medium term 5-year bonds show a level of relative yield advantage seen only seven times in the last 30 years. This, along with medium-term bonds typically being less price sensitive to any potential volatility at the long end, suggests that 5-year debt is likely to provide an attractive risk/reward for investors.

5-YEAR YIELDS OFFER VALUE

The relative performance of 5-year bond yields against those of two-year and 10-year bonds since 1992



Source: Bloomberg, Barclays Private Bank, January 2022

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

Putting a shine on your portfolio with mid-market private equities

Can private markets offer a refuge for investors concerned about the stretched valuations found in many listed equity markets, and inflation hitting multi-decade highs in several economies?



In the current context of heightened volatility, we continue to view private markets as an attractive source of much-needed diversification, especially if inflation remains elevated for some time.

However, as in public markets, excesses and demanding valuations may deter investors. This is understandable. According to alternatives researcher Preqin, total private equity (PE) deal value surpassed \$800 billion in 2021, 70% higher than pre-pandemic levels. In addition, investors have more than \$1.32 trillion of “dry powder” chasing a limited number of targets.

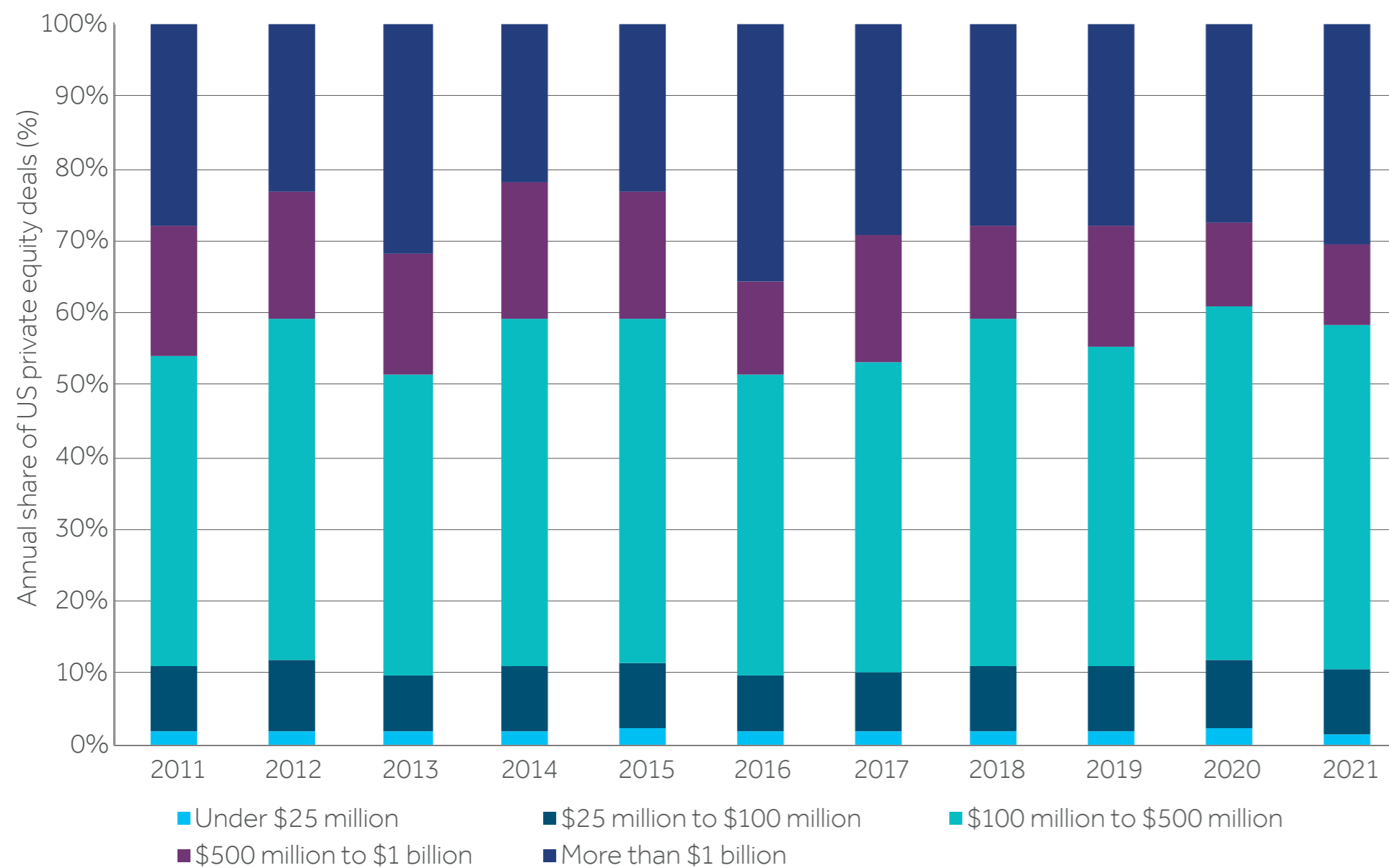
PRIVATE EQUITY MEGA DEALS IN VOGUE

But beyond the headlines, just like with sectors and stocks in listed-equity markets, not all segments of the private equity market saw outsized growth last year. Mega-deals (above \$1 billion) were particularly frequent, with, according to researcher Pitchbook, more than 100 transactions in the US representing 32% of all US PE deal value (see chart on p15).

On the other hand, the share of deals between \$100 million and \$500 million, characterised as mid-market, was stable at around 60%. Similarly, in Europe, where the PE ecosystem is growing ever stronger, deals sized between \$100 million and \$500 million contributed most to the record-breaking deal value (\$755 billion). Unlike in the US though, their share increased somewhat year-over-year.

SHARE OF PRIVATE EQUITY US DEAL VALUE, BY SIZE

The annual value of private equity transactions in the US, by size of deal, since 2011



Source: PitchBook, December 2021

MID-MARKET MANAGERS FACE LESS COMPETITION

Middle-market managers haven't seen the type of inflows that other segments of the private equity universe have experienced in recent years. According to Pitchbook, US mid-market managers had raised \$97 billion as of the third quarter last year, far below the \$150 billion raised in the whole of 2019. As a result, their share in overall capital raised in the US had declined to 48%.

This trend has been constant for a few years now and can be explained by the well documented "strategy drift": as PE managers realise there is significant demand, they may be tempted to raise more money than planned. As a result, some mid-market funds become larger, abandoning their niche and true expertise.

Recent capital raising trends reflect the level to which some middle-market funds have grown. The dry powder amassed by US middle-market funds has risen twofold over the last 10 years, while capital to be invested in the rest of the US PE market expanded fourfold. With a multitude of possible targets, and less capital chasing them, mid-market private equity managers face less competition, when looking to acquire stakes in companies they find attractive.

Similarly, when the time comes to exit an investment, mid-market managers tend to have more options at their disposal, than managers in larger markets. Exiting from a large, or mega, deal often requires PE managers to resort to initial public offerings (IPO), as potential buyers are rare. This leaves them exposed to the inherent volatility of listed markets. On the other hand, smaller-sized deals can be exited by selling the position to larger PE managers that, as we've established, are desperately looking for ways to deploy their vast war chests.

HOW MUCH OF A RISK IS SUSTAINED, HIGHER INFLATION?

Outside of valuations, another key concern for investors is the prospect of higher inflation. Private companies aren't necessarily better positioned than their listed peers to ride out periods of higher prices. They all face the same supply-chain constraints, input costs and labour shortages.

However, whether it's operationally (driving down costs while ensuring pricing power) or financially (deal structuring itself), private equity markets often offer more levers with which to fight inflationary pressures for the underlying investors. This is particularly true in the mid-market, where companies tend to be smaller, can pivot more easily, and may innovate faster.

That being said, even if a company is managed privately, battling inflationary pressures isn't easy, and, just like in the listed market, some sectors and companies may fare better than others. The key to minimising the negative impact of inflation, is to invest primarily in these sectors and business models that naturally allow for higher costs to be passed on to customers.

SPOTTING PRIVATE EQUITY TARGETS

Ultimately, for investors to be resilient in the face of changing market While this process requires detailed due diligence on each potential target company, there are common traits investors (and PE managers) can look for:

- Secular growth drivers: investing in companies benefiting from long-term trends that won't be disrupted by short-term macroeconomic volatility.
- Market positioning: being a market leader or operating in high-barriers-to-entry industries decreases competition, typically improving pricing power.
- Profitability: in an environment when the cost of money (interest rates) is going up, being profitable and exhibiting sustainable levels of leverage reduce a key risk and allow for better visibility over growth potential.
- Sustainability: In addition to the critical environmental, social and governance (ESG) considerations, such as climate-change risk, sustainability also encompasses the company's ability to continuously deliver value for all stakeholders.

While we would apply the above criteria to investments in listed markets, we believe it's even more powerful when applied to private markets, especially in the mid segment.

Author: Julien Lafargue, CFA, London UK, Chief Market Strategist

How well anchored are US inflation expectations?

Steering and anchoring inflation expectations through forward guidance has been the name of the game for central banks since the 1990s. Recent surveys for US inflation expectations suggest that anchors that have held for 20 years may be nudging up. However, quantitative analysis suggests that this shift is too small, so far, to be worrisome for financial markets.

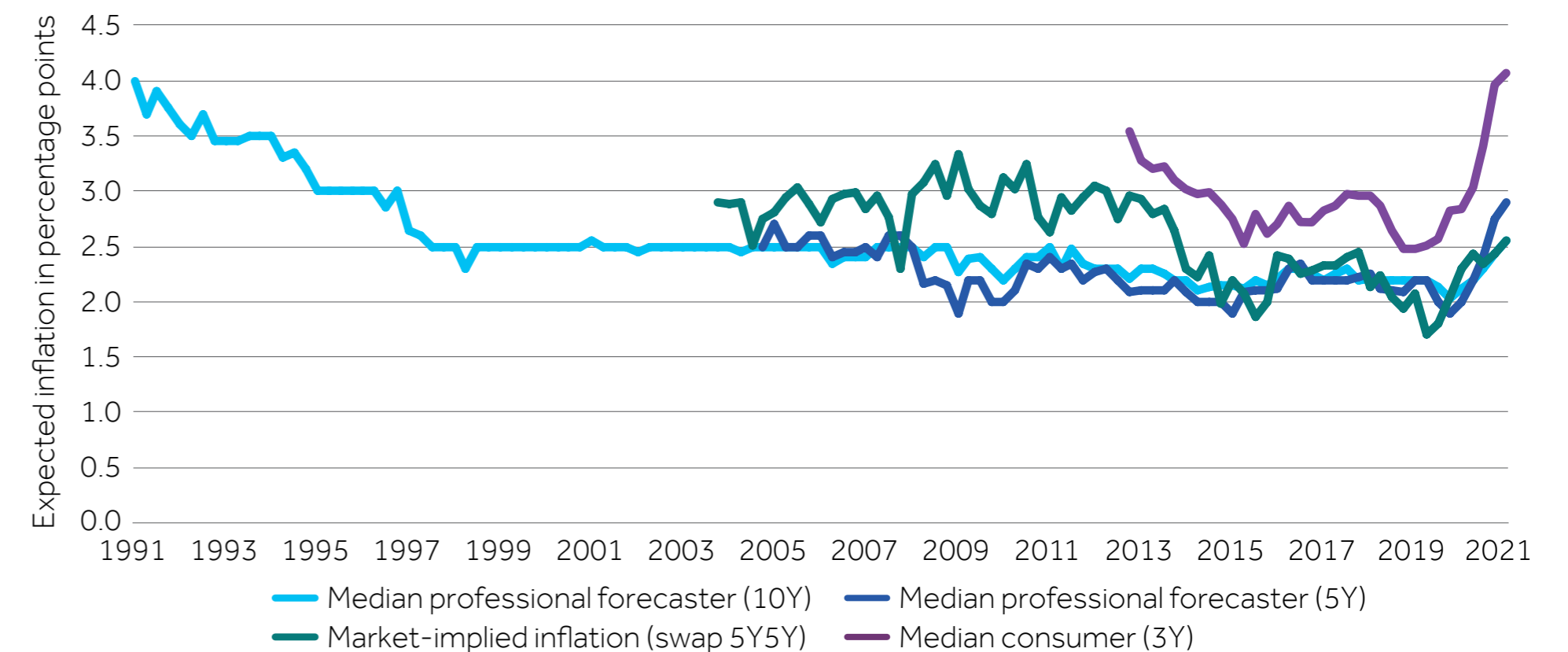


Inflation expectations in financial markets rely heavily on central bank statements. In the US, this success-story for policymakers started in 1994, when the Federal Open Market Committee first issued statements on monetary policy decisions. From 2000, it also provided a risk assessment for the economy, indirectly guiding markets expectations for the likely path of rate moves. Around that time, long-term consumer price index expectations became firmly anchored (see chart).

Recent surges in anticipated five-year inflation from professional forecasters give rise to questions regarding the strength of inflation anchoring of late, and possible consequences of a weaker anchor.

THE INFLATION ANCHOR MAY BE SLIPPING?

The median reading of surveyed inflation expectations from professional forecasters and consumers, and market-implied inflation expectations of late imply that the inflation anchor is weakening



Source: Federal Reserve Bank of Philadelphia, New York Fed Survey of Consumer Expectations, Bloomberg, Barclays Private Bank, December 2021

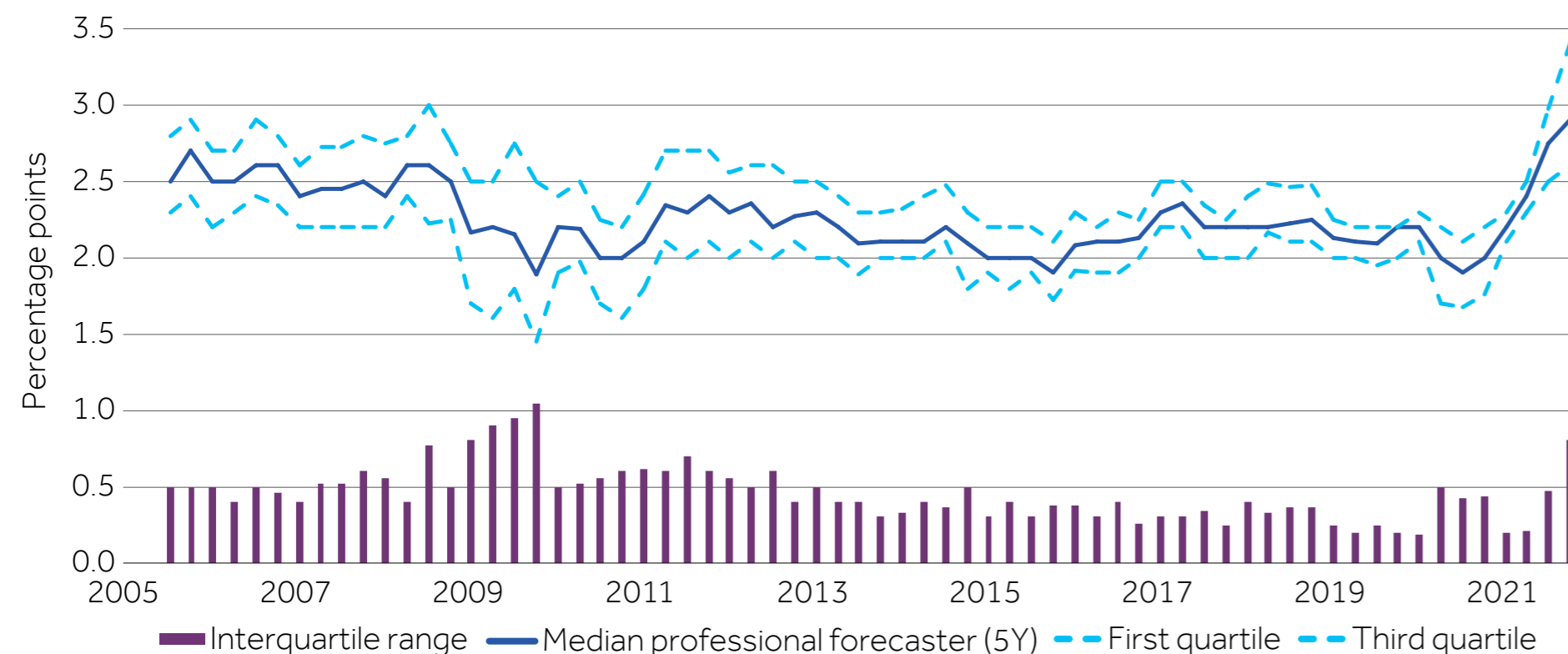
PROFESSIONAL FORECASTERS, CONSUMERS, AND MARKET PARTICIPANTS

There is no one measure for anticipated inflation. Depending on whom you survey (or measure), the answer differs. Survey responses from consumers have historically been up to one percentage point above those of professionals, which makes the recent surge in expectations look even more dramatic. Market-implied data reflect not only “pure” inflation expectations, but also demand for external factors, such as hedging for pension fund portfolios.

All these measures have experienced a recent surge and in the case of the five-year measure, this surge reached highs unseen since the turn of the millennium. The dispersion of forecasts by professionals – measured by the distance between the 25th and 75th percentile – is as high as it was during the global financial crisis. Meanwhile, 10-year expectations have merely been brought back to their pre-global financial crisis measures (see chart).

US LONG-TERM INFLATION EXPECTATIONS BREAK 20-YEAR HIGHS

Five-year ahead inflation expectations from the Survey of Professional Forecasters (25th and 75th quantiles, and median) since 2005



Source: Federal Reserve Bank of Philadelphia, Barclays Private Bank, November 2021

TESTING THE ANCHORS

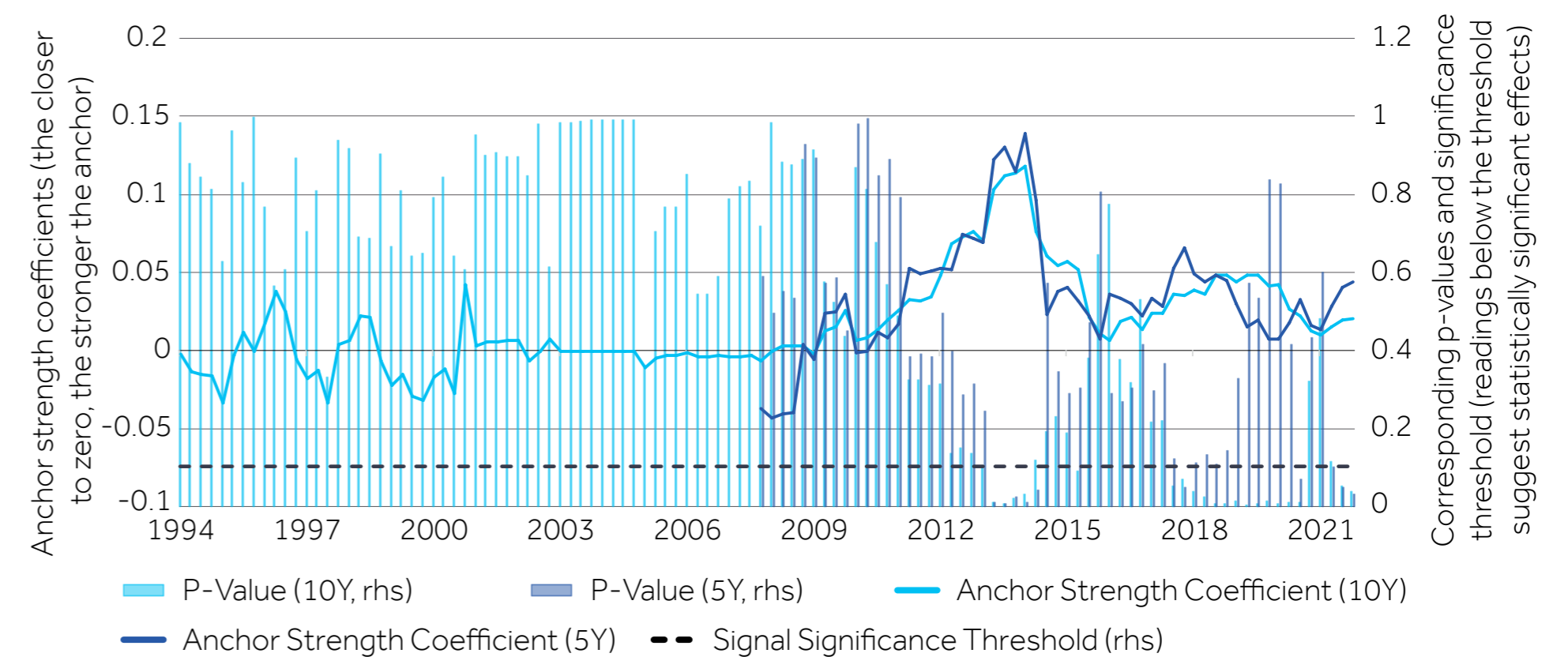
Surveys of inflation expectations suggest that long-term anchors have nudged a little, but not left the ground. Meanwhile, uncertainty around the US inflation rate in five years’ time has grown considerably.

To test the strength of the anchoring, our regression model seeks to explain the quarterly change in professional survey expectations, by surprises against past expectations, while controlling for the economic cycle.

The next chart shows estimates of anchoring coefficients from three-year rolling regressions. A high and statistically significant estimate for the anchoring coefficient indicates that forecasters are revising their long-term inflation expectations based on the latest inflation rates.

ESTIMATING THE STRENGTH OF INFLATION EXPECTATION ANCHORS

Inflation expectations anchoring coefficients and probability (p)-values for five-year and ten-year periods since 1994



Source: Federal Reserve Bank of St. Louis, Barclays Private Bank, November 2021

MODERATE WEAKENING IN ANCHORS STARTED BEFORE 2021

As indicated by the high p-values and low coefficients, inflation expectations were very firmly anchored between 1994 and 2012 before dipping, then reaffirmed in 2015 before weakening again by surprise prints in 2018.

The recent weakening compares to estimates seen in the move started in 2018, when expectations fell by 30 basis points. Though inflation surprises were much more extreme in size, the subsequent recalibration of expectations was proportional.

One likely reason for the gradual weakening of anchors since 2012 lies in the US Federal Reserve's (Fed) balance sheet, which has become another variable for inflation considerations. Given its expansion to gargantuan size since the financial crisis, anchors may be recalibrated more frequently as the balance sheet shrinks.

ANCHORS DRAGGING BACK AND FORTH

On the basis of the proportional reaction of expectations up to surveys taken in the November 2021 for the fourth quarter, and our own view of inflation receding to more manageable levels towards the end of the year, the Fed should not need to rush rate rises. However, CPI continued to surprise to the upside, which may have added dynamic to the de-anchoring process.

A significant de-anchoring of expectations could lead to vastly different outcomes, depending on the stance the policymakers take. The central bank could reinforce the anchor with rigorous interventions. Alternatively, it may let inflation expectations, and realisations, spiral up before stepping on the monetary brakes.

It seems unlikely that the Fed will stand by and watch inflation get too out of hand. While many market participants, including the US Treasury, could profit from higher inflation, the prospect of runaway inflation that requires more abrupt stopping seems very unattractive.

US PHENOMENON ONLY?

So far, our focus has been on US inflation expectations. Surveys for long-term inflation expectations by the European Central Bank also show an upward shift in forecasts. For the eurozone, however, long-term expectations used to be anchored around 1.9%, then fell in 2019, before only returning to the old anchor value with the recent recalibration seen in many countries. For the UK, survey-based measures of inflation expectations by forecasters have risen, but not as dramatically as seen in America.

While some cost-push factors are global, the context in which these inflation surprises have come in is not. We have argued before that the US is leading this economic recovery, in part due to the aggressiveness of the monetary and fiscal stimulus in the pandemic. Growth tends to be slower in other developed markets. Therefore, domestic drivers of inflation are, like the recovery, building up more gradually.

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

Getting your portfolio climate-ready in 2022

Following another of the warmest years on record, and more global response from companies and countries, how ready is your portfolio for the intensifying impact of climate change?



Last November, the United Nation's COP26 summit brought much needed global focus to climate change. During that period, heeding the UN Secretary-General's signal that we face a "code red for humanity"¹, many investors may have decided to change how they behave, and the way in which they invest their portfolios this year.

Since then, and perhaps unsurprisingly, global attention on climate change issues has waned. However, like countless new year resolutions, many investors might have found that starting to invest in a climate-friendly manner can be difficult.

Climate change, however, doesn't procrastinate. The World Meteorological Organization (WMO) declared in January that 2021 was one of the planet's seven hottest years since records began². And as the economy rebounds from its pandemic lockdowns, greenhouse gas emissions are accelerating again.

HOW DO I GET STARTED?

Recognising the desire and the hurdles, more investors want help on making their portfolio more climate-ready.

The journey will be unique for each investor and their circumstances. But we've provided a three-stage overview: 1) establish your intentions, 2) take actions with your portfolio, and finally, 3) measure and manage the impact of the results on your investments.

For each, there's a dedicated article and here an overview of the process, together with ideas on starting the conversation with your family and your advisors.

SET YOUR INTENTIONS AND PORTFOLIO STRATEGY

While there are industry initiatives for net-zero commitments, the reality is there is no single end-state or approach for a portfolio to be climate-ready.

Private wealth holders need to decide which destination is right for them. Therefore, the purpose of this stage is to decide what climate impact you want your wealth to.

Thus, the starting point is to decide your motivations, define your portfolio aims, and designing your strategy, as explained in our article *How to start your journey to a climate-ready investment portfolio*³ in September.

This is a critical moment to involve family members (or trustees in the case of charities) and spend time reaching a collective view of your intentions. While some education is likely needed, most important is to share and listen, and then openly discuss the level of your ambition.

Even if full agreement isn't possible, the debate and eventual consensus can help start the process. In the end, it's valuable to document these to serve as a roadmap for your journey, and to set clear expectations with investment managers.

1. Intention:

- Surfacing motivations
- Defining your aims
- Designing strategy



2. Portfolio:

- Investment selection
- Portfolio construction
- Product selection

3. Impact measurement:

- Outcome measurement
- Impact reporting
- Monitoring

¹ Secretary-general calls latest IPCC climate report 'code red for humanity', stressing 'irrefutable' evidence of human influence, United Nations, 9 August 2021 <https://www.un.org/press/en/2021/sgsm20847.doc.htm>

² 2021 one of the seven warmest years on record, WMO consolidated data shows, World Meteorological Organization, 19 January 2022 <https://public.wmo.int/en/media/press-release/2021-one-of-seven-warmest-years-record-wmo-consolidated-data-shows>

³ How to start your journey to a climate-ready investment, Barclays Private Bank, September 2021, <https://privatebank.barclays.com/news-and-insights/2021/september/investing-for-global-impact/start-your-journey-to-a-climate-ready-portfolio/>

TAKE PORTFOLIO ACTION

With a written climate ambition and investment strategy agreed with family or stakeholders, it's time to think about your holdings, future investment selection, and holistic implementation.

A good start is to review your portfolio against your climate ambition – using it as a guide to help categorise, and make decisions, and plans, for the existing investments.

It's worthwhile considering the portfolio's climate impact through one of a variety of metrics and approaches. The aim here is not to be precise, but to understand the climate risks and opportunities that face your portfolio. For example, as new industries are brought within the EU carbon market system, what may be the implications for your holdings in these sectors?

This also helps inform the decisions around future positions in the portfolio. There is an increasingly wide range of climate-related investments, providing ways for investors to create a more sustainable portfolio. Looking for green substitutes for familiar investment types is a good way to get started. It can also help reluctant family members or stakeholders see the transition as steps instead of leaps.

Finally, an important caveat is that the decisions need to be taken in the context of wider family or financial circumstances, as well as the nature of the investments.

To find out more about taking these actions, you can turn to our article *How to turn your climate ambition into portfolio action*⁴ in October.

MANAGE YOUR PORTFOLIO'S CLIMATE IMPACT

Finally, it's valuable to know where you are in relation to your climate ambitions, and be able to take further, informed steps on what to do next.

Our article *How to manage your portfolio's climate impact*⁵ outlines how you can quantify, and act on, How to manage your portfolio's climate impact⁵ outlines how you can quantify, and act on, the impact your portfolio is, and would be, making to the global warming.

Here you'll want to understand the climate metrics available, about how global warming is impacting your portfolio, and how your portfolio is affecting the climate. Then, by assessing the data and reporting for your investments, this can inform your views of current and potential holdings.

It is then up to you to manage the climate risks and opportunities available more actively, various options are available to help you accomplish this. For example, reducing carbon exposure, voting and engagement, or investing in solutions.

In total, this is the role of impact management – the measurement, reporting, and monitoring of your portfolio's impact – to locate your portfolio on the journey and inform your course corrections.

TAKING THE FIRST STEP

Constructing or changing an existing large and diverse portfolio, to account for the risks and opportunities of climate change, might feel like a major undertaking. But it doesn't have to be.

This article provides an overall approach, and is supported by others that include more detail about each part of this process. As ever, taking professional advice for your particular situation will always be beneficial.

Even if we start acting with more urgency, we will experience more effects from climate change for years to come. This means that investors need to adjust their portfolios in preparation.

Moreover, private wealth holders with any green ambitions should be seeking to invest to help mitigate and adapt to climate change. There is no better time to start this journey than today.

Author: Damian Payiatakis, London UK, Head of Sustainable & Impact Investing

⁴How to turn your climate ambition into portfolio action, Barclays Private Bank, October 2021, <https://privatebank.barclays.com/news-and-insights/2021/october/investing-for-global-impact/turn-climate-ambition-into-portfolio-action/>

⁵How to manage your portfolio's climate impact, Barclays Private Bank, November 2021, <https://privatebank.barclays.com/news-and-insights/2021/november/manage-your-portfolios-climate-impact/>

When the going gets tough, the tough stay invested

Creating diverse, resilient portfolios to weather heightened volatility is a key part of successful investing. As rising inflationary pressures buffet financial markets, we look at what can be done to keep the focus on investing for your long-term goals.



It has been a bumpy start to 2022. With inflationary pressures proving to be more persistent than initially anticipated, central banks are becoming increasingly hawkish, and higher interest rate expectations have troubled financial markets.

The year has already seen the 10-year Treasury yield climb substantially. A violent sector rotation to value from growth stocks has seen much dispersion between sectors and styles in equity markets. The S&P 500 and the Nasdaq indices are down significantly, the latter now in correction territory, as the technology sector bears the brunt of the underperformance.

CONCERN IS NATURAL

Investors, buoyed by another positive year for global equities in 2021, may be asking two key questions: 1) does the rotation to value have further legs?, and 2) is it time to make changes to portfolios?

We expect the rotation to persist, with inflation unlikely to peak until later this year, and central banks will continue tightening. That means that a pivot back to long-duration assets, such as growth stocks, may be unlikely in the short term.

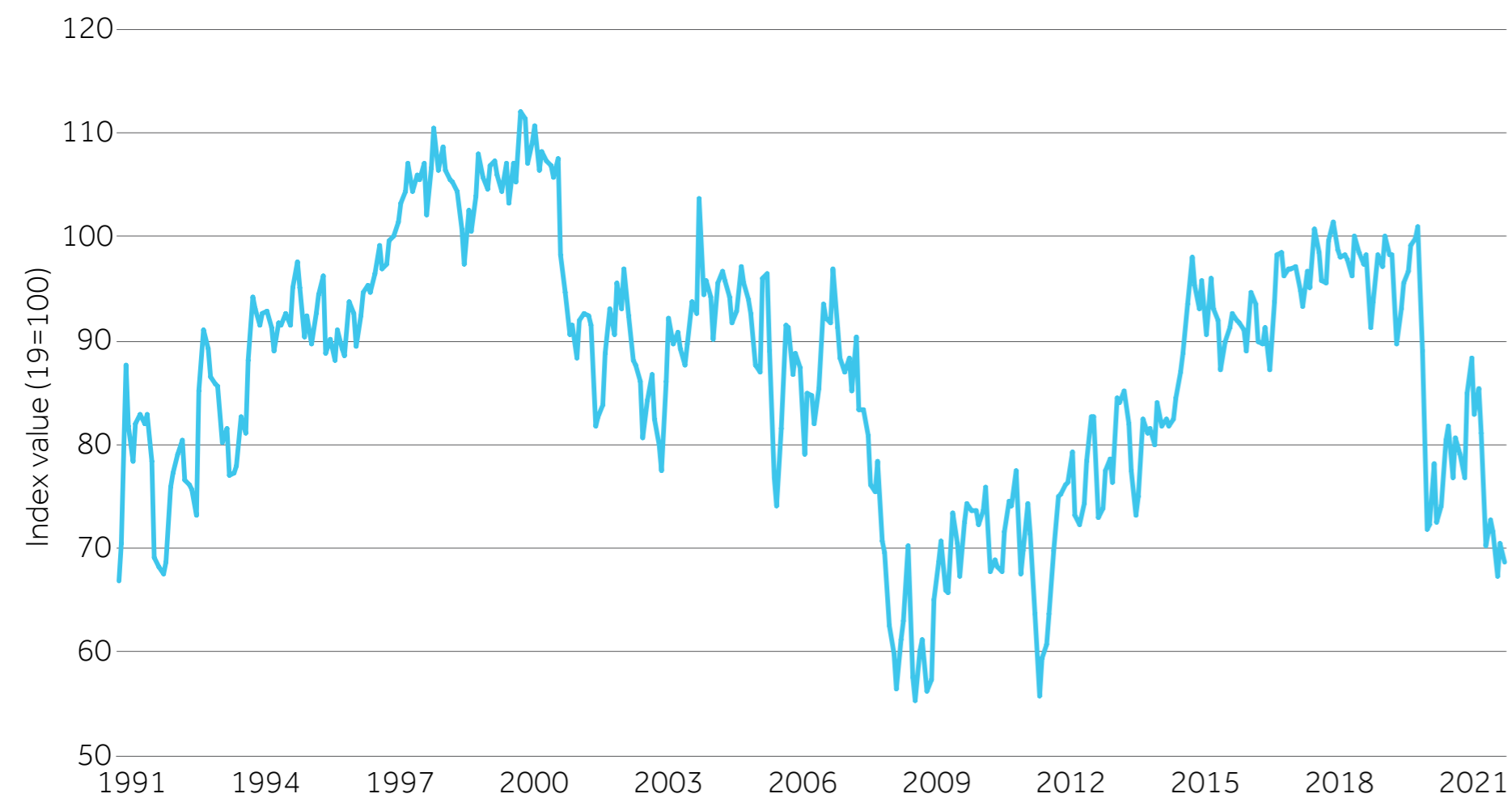
Responding to anticipated portfolio losses in a portfolio by changing investments can seem a natural reaction at such times. Why not act if you can stem underperformance or losses in the short term? Especially if the rotation trade is expected to continue. However, selling out of investments or playing the rotation trade may be a risky strategy.

BUT REACTING UPON IT CAN BE RISKY

Making portfolio changes in line with extreme market sentiment (selling when sentiment is bearish, buying when bullish) can be risky, and sentiment can swing wildly. Sentiment is at recessionary levels, with US consumer sentiment at its lowest levels since the outset of the pandemic (see chart on page 23).

US CONSUMER SENTIMENT PLUMMETS TO A PANDEMIC LOW

University of Michigan US consumer sentiment index since 1991



Source: University of Michigan, Barclays Private Bank, January 2022

The market's expectation has turned hawkish, pricing in almost four US rate hikes this year (from less than one back in October), with increasing chatter around the pace at which the central bank runs down its balance sheet. This, however, sits against uncertainty. Risks still remain on the horizon: slowing economic momentum, inflation peaking, consumer sentiment at recessionary levels, and the spectre of more disruptive coronavirus variants.

When a market move has been both quick and sharp, a pullback can be just as violent. As we have discussed in the past, many of the best days of market performance come after the worst ones. So investors that attempt to trade such events can be caught flat-footed.

WHY ARE YOU SELLING?

For those who may be considering selling out of investments in response to market turbulence, it is worth remembering that selling out should not be thought about in isolation. If you do not have a plan for the assets after selling them, a decision to sell implies investing in cash.

When deciding whether to sell assets, you might consider the following questions:

- Are there other assets that I believe will generate superior returns?
- What returns may I miss out on by selling these assets?
- What may I miss out on from holding onto the existing holdings?
- If I don't want to reinvest in the markets, am I more likely to achieve my long-term goals by holding cash or the investments I will be selling?

The final question is an important one in the context of the present inflationary scare. In times of turbulence, cash provides safety. But is safety likely to help you to reach your long-term goals?

IS YOUR CASH WORKING FOR YOU?

If an investor's aim is to primarily protect, and then grow wealth, cash may be an attractive asset. But it is worth noting that the current market moves have been primarily driven by more persistent inflation. In an inflationary environment, a sure way to lose wealth is to hold cash. With higher inflation expected, the drag on wealth will likely be more than in the recent past.

We believe that being invested provides the best chances of achieving your long-term goals. The power of compounding means that missing just a few of the best days of market performance can significantly harm long-term growth.

THE IMPORTANCE OF AN INVESTMENT PHILOSOPHY

Ultimately, for investors to be resilient in the face of changing market conditions, their portfolio should be resilient to such conditions.

We expect quality growth companies to profit investors over the long term, and in various market conditions. The search for such quality businesses involves finding those with above-average growth, healthy cash flows, low gearing, and an ability to reinvest at a high return on invested capital.

While changes in the macro and market landscape can make sectors relatively more or less attractive, we believe that over the long term, quality companies will prevail, outperforming both growth and value stocks.

For long-term investors that still want to act on short-term, tactical opportunities, a core-satellite approach may be an option to consider. In such an approach, the core portfolio aims to generate the bulk of the long-term returns. Meanwhile, a satellite holding takes more opportunistic investments. This approach can strike a balance between trading and investing, and minimise the impact of biases mentioned above.

A strategy, as mentioned in our *Outlook 2022* and seen during the present rotation, would be adopting a cyclical tilt (financials, energy, industrials, and basic materials) in portfolios, and a tilt away from low-growth, low-profitability businesses.

ARE YOU HOLDING THE RIGHT MIX OF ASSETS?

The best preparation for the year ahead for investors is to examine existing portfolios, and ask whether they are holding the right mix of assets to reach their long-term objectives. Additionally, is the portfolio built to withstand different, and maybe challenging, market conditions, and will you be able to see it through?

We continue to reiterate the importance of diversification. By holding quality assets across a range of asset classes, regions, and sectors, an investor's portfolio is designed to be resilient across market conditions. While some assets may fall out of favour occasionally, others may help to smooth returns. Reducing volatility through a diversified portfolio also has behavioural benefits; a portfolio that experiences less volatility can help at an emotional level, and make it easier to hold onto investments even during turbulent conditions.

For those tough enough to stay the course, their resilience will likely be rewarded.

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					

"-" Denotes a cautious view

"=" Denotes a neutral view

"+" Denotes a positive view

CASH AND SHORT DURATION BONDS

- Given the ongoing uncertainty and in order to manage portfolios' 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 the equity space
- In high yield, selection is key, and our exposure is low given the tightness of spreads. We prefer high yield and emerging market (EM) hard currency debt over EM local currency debt, considering the risk facing their economies and currencies.

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)

- We see limited 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's perspective, we believe our risk budget is better spent outside of the asset class.

Author: Julien Lafargue, London UK, Chief Market Strategist

privatebank.barclays.com

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

This document is for information purposes only. It is general in nature and does not take into account specific investment objectives, financial situation, knowledge, experience or particular needs of any particular person. It should not be relied upon in considering the merits of any particular transaction. It does not constitute a prospectus, offer to buy or sell, invitation or solicitation to buy or sell or invest in or refrain from investing in securities or other investment products. It may provide an introductory summary of products or services that we may potentially provide, and you should consider whether any of those may apply to your own circumstances and needs.

It is not intended to provide the sole basis for any evaluation of securities or any other instrument, which may be discussed in it. The information in this document is not investment, tax, legal, accounting, regulatory or other advice, and you should consider seeking advice tailored for your own circumstances, including any impact an investment may have on your personal tax position from your own tax adviser. You have sole responsibility for the management of your tax, accounting, legal and regulatory affairs including making any applicable filings and payments and complying with any applicable laws and regulations. We have not and will not provide you with, and you should obtain your own, independent, tax, accounting, legal and regulatory advice.

Any offer or entry into any transaction with Barclays as a party, requires Barclays' subsequent formal agreement which will be subject inter alia to internal approvals and execution of binding transaction documents. Terms and conditions if any herein are indicative and subject to change and/or negotiation between us. Full details of final terms and conditions will be contained in a prospectus or offering or other document.

Investment products may be subject to investment risks, including, but not limited to, market and currency exchange risks, fluctuations in value and possible loss of principal invested. Where investments are concerned, past performance does not predict or guarantee future performance. Investments can fall as well as rise in value. Your capital or the income generated from your investment may be at risk. The value of any investment may also fluctuate as a result of market changes.

Although any content in this document from other sources is believed to have been obtained from sources which are reliable, we neither represent nor warrant its accuracy or completeness, nor the timeliness or reliability of such information set out herein. Where information in this document has been obtained from third party sources, we believe those sources to be reliable but we do not guarantee the information's accuracy. Information set out herein may be incomplete or condensed. Barclays is not responsible for information stated to be obtained or derived from third party sources or statistical services. Any past or simulated past performance including back-testing, modelling or scenario analysis contained herein is no indication as to future performance. No representation is made as to the accuracy of the assumptions made within, or completeness of, any modelling, scenario analysis or back-testing. You should carry out your own due diligence and verification of such information accordingly. This document may become outdated and/or its contents subject to changes at any time and without prior notice to you, and in that regard, we are under no obligation to update or correct this document or inform you in relation to any such changes to the contents herein. Any estimates and opinions from Barclays as may be included in this document constitute our judgement as of the date of the document and may be subject to change without notice, and we have no obligation to provide revised estimates or opinions.

Unless expressly stated, products are not guaranteed by Barclays Bank PLC or its affiliates or any government entity.

This document is not a product of the Barclays Research department. Any views expressed may differ from those of Barclays Research.

This document is strictly confidential and may be being made available to selected recipients only. It may not be reproduced or disclosed (in whole or in part) to any person without our prior written permission. Barclays or its affiliates may act upon or use material in this publication prior to publication. The manner of distribution of this document and the availability of the products and services may be restricted by law or regulation in certain countries and persons who come into possession of this publication are required to inform themselves of and observe such restrictions.

Barclays Bank PLC ("Barclays"), its affiliates, and their respective directors, employees, and agents ("Barclays Group") make no representation or warranty as to the accuracy, completeness, timeliness or reliability of the contents of this document. To the maximum extent permitted by law, no member of the Barclays Group accepts any liability whatsoever for any direct, indirect or consequential losses (in contract, tort or otherwise) (including, without limitation, any liability arising from fault or negligence on the part of any of them) for any loss whatsoever arising from the use of or reliance on this document or its contents or otherwise arising in connection with it.

The contents of this document have not been reviewed or approved by any regulatory authority.

Barclays offers wealth and investment products and services to its clients through Barclays Bank PLC registered in England and operates in India through its subsidiaries, including Barclays Securities (India) Private Limited (BSIPL), Barclays Wealth Trustees (India) Private Limited (BWTIPL) and Barclays Investments & Loans (India) Private Limited (BILIPL). BSIPL is a company incorporated under the Companies Act, 1956 having CIN U67120MH2006PTC161063. BSIPL is registered and regulated by the Securities and Exchange Board of India (SEBI) as a Portfolio Manager INP000002585, Stock Broker INZ000269539 (member of NSE and BSE), Research Analyst:INH000001519; Depository Participant with the National Securities & Depositories Limited (NSDL): DP ID: IN-DPNSDL- 299-2008, Investment Adviser: INA000000391. BSIPL is also registered as a Mutual Fund Advisor having AMFI ARN No. 53308. The registered office of BSIPL is at 208, Ceejay House, Shivsagar Estate, Dr. A. Besant Road, Worli, Mumbai – 400 018, India. Telephone No: +91 22 67196363. Fax number: +91 22 67196399 Compliance Officer contact details: Name: Mr. Anupam Mohaney, Contact number: +91 22 61754000, E-mail:bsiplcompliance@barcap.com. Investor Grievance E-mail: bsipl.concerns@barcap.com. Website: www.barclays.in/bsipl. BWTIPL is a company incorporated under the Companies Act, 1956 having CIN U93000MH2008PTC188438. BWTIPL is a Corporate Agent (Composite) of (i) HDFC Standard Life Insurance Company Limited and (ii) ICICI Lombard General Insurance Company Limited, under IRDA Registration Code CA0078. The registered office of BWTIPL is at 208, Ceejay House, Shivsagar Estate, Dr. A. Beasant Road, Worli, Mumbai – 400 018, India. Telephone No: +91 22 67196363. Fax number: +91 22 67196399. Email Address for corporate agency (insurance) matters: xrawealthindiainsura@barclayscapital.com, Email Address for other matters: wealthindiatrust@barclays.com. Grievance Officer contact details: Name: Ms. Poonam Mirchandani, Contact number: +91 022 6719 6359, E-mail: bwtipl.concerns@barclays.com Website: www.barclays.in/bwtipl. BILIPL is a company incorporated under the Companies Act, 1913 having CIN U93090MH1937FTC291521. BILIPL is registered and regulated by the Reserve Bank of India (RBI) as a Non Banking Finance Company (NBFC): Registration no.B-13.02176. The registered office of BILIPL is at. Nirlon Knowledge Park, Level 10, Block B-6, Off Western Express Highway, Goregaon (East), Mumbai - 400063, India. Telephone No: +91 22 61754000. Fax number: +91 22 61754099. Grievance Redressal Officer contact details: Name: Mr. Ruzbeh Sutaria, Contact number: +91 22 61754244, Grievance E-mail: billlcompliance@barclayscapital.com. Website: www.barclays.in/billl.

