



Mid-Year Outlook:

A World in Transition

June 2022

 **BARCLAYS** | Private Bank



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Contributors:

Henk Potts, London UK, Market Strategist EMEA
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, Head of Behavioural Finance
Damian Payiatakis, London UK, Head of Sustainable & Impact Investing
Iain Martin, London UK, Investment Writer

Foreword

Welcome to our Mid-Year Outlook, which casts an eye over an unusually volatile start to the year and analyses whether better times might lie ahead for investors over the rest of the year.

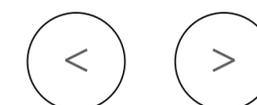
In the face of surging inflation and central banks kicking off rate-hiking cycles, global growth will likely almost halve this year over last. The combination of a worsening growth outlook and tighter financial conditions have depressed investors' sentiment to a point rarely seen outside of recessions. At the asset class level, while equity valuations have normalised uncertainty persists as to what 2022 and 2023 earnings may look like. Similarly, bonds haven't played their role as diversifiers, leaving investors exposed.

As you'll see throughout this publication, we believe that there are reasons to be optimistic. Yet, volatility will likely persist and we remain primarily focused on portfolio diversification, while looking for select opportunities when they present themselves, whether it's in traditional or alternative markets, and public or private ones.. This, in our opinion, is the best way to appropriately balance risks and rewards, and to protect and grow wealth.

Environmental, social, and governance (ESG) considerations remain at the heart of what we do and this publication explores the increasingly important topic of energy transition in Europe. While this may represent a significant source of uncertainty for some, we see it as a clear and unique opportunity for investors to play their part in building a more resilient and sustainable future in the region.

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**



Investment outlook: recalibrating our views

The first six months of 2022 have been testing for investors, as the post-lockdown reopening euphoria led to a painful hangover. While we are not out of the woods yet, the road ahead is, in our view, gradually opening up. Many opportunities are emerging too. However, the watchword for the next six months remains one of caution, and ensuring portfolios are diversified properly to achieve their long-term goals.



The first six months of the year has been challenging, to say the least. The normalisation process we highlighted in November's [Outlook 2022](#) happened much faster than expected as major central banks woke up to the risk of runaway inflation. The war in Ukraine also significantly changed the mood that was prevailing at the start of the year.

A MORE CHALLENGING ENVIRONMENT

With financial markets bouncing around violently, cross-asset class correlations shifting, and a striking lack of visibility, the one element that hasn't normalised is volatility. This, we thought, would be a key feature of 2022 and one that might require investors to diversify beyond a traditional 60/40 split between equities and bonds. On this particular topic our view hasn't changed.

However, looking to the second half of the year, we acknowledge that the macro backdrop has deteriorated. We now expect lower growth and higher inflation, globally, for the remainder of the year. The next few months will likely see central banks remaining hawkish, as they try to restore credibility before eventually confronting the reality of a weakening economic momentum.

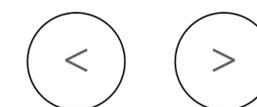
BUT THERE IS REASON FOR HOPE

That being said, contrary to the markets' prevalent "doom and gloom" mood, our outlook remains constructive. Although growth is slowing and could even turn negative temporarily in parts of the world, it should remain broadly in line with trend this year and next on a global basis. Similarly, inflationary pressures seem to be peaking. Sure, the return to "normal" isn't going to happen overnight, but data suggest the worst is most likely behind us.

Importantly, and after the difficult last few months, much bad news appears to be already in the price. Markets tend to be forward looking and to react to the second derivative (that is, the rate of change) and not to levels. In other words, slow but steady growth tends to be much more supportive than when it is high but decelerating.

NO QUICK FIX

The wall of worry facing investors is steep and, unfortunately, will likely to take some time to surmount. Indeed, whether it's the risk of a policy mistake, geopolitical tensions and their consequences, or the slowdown in China, none have a quick



or straightforward solution. Instead, it will probably take months for investors to become more comfortable around these issues.

As a result, market gyrations will likely persist, challenging investors' resolve. In this context, it's critical to tone down the noise and let long-term plans and goals dictate portfolio allocation.

FINDING RETURNS

With both bonds and equities having suffered losses so far this year, achieving investment goals is becoming tougher. While we expect both asset classes to recover, investors will need to find additional sources of returns in the months and years ahead.

In our view, private markets should be considered as a prime candidate for this. Giving up portfolio liquidity may be daunting, but it can boost returns (due to the meaningful reward available through their illiquidity premium) and preventing rushed, and possibly ill-advised, investment decisions.

Similarly, in the apparent chaos, there are pockets of calm that offer the visibility investors crave. Whether it's the ongoing energy transition, the growing digitalisation of our economies, or the need for improved infrastructure, focusing on such secular themes can be a source of both returns and peace for investors.

Author Julien Lafargue, Chief Market Strategist

Barclays Private Bank's views (please see our [asset allocation](#) page for more details):

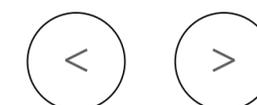
Inflation: We are at, or near, peak inflation and prices increases. While inflation is likely to remain above pre-pandemic levels, it should gradually moderate in the coming months.

Recession: A mild recession is possible in the US and probably in parts of Europe. Yet, a temporary period of contraction isn't necessarily the precursor to a crisis.

Rates: Central banks are trying to restore their credibility and the era of free, abundant liquidity is probably over. That being said, with inflationary pressure gradually abating, we believe that the hawkishness seen from central banks in the first half of the year won't be repeated.

Fixed income: With the recent increase in yields, opportunities are emerging to lock in rates. We remain mindful of possible further spread widening in credit and would proceed with caution, especially in high yield debt. BB-rated bonds appear to offer the most attractive risk-reward.

Equities: Volatility will likely continue until the growth and inflation outlook improves. Although earnings expectations appear too optimistic, upcoming downgrades are already reflected in valuations. In this context, diversification remains key. We see opportunities in both cyclicals (banks and industrials) and defensives (healthcare).



US economy shines – and reveals its growing potential

Despite being buffeted by soaring prices, the economic effects of the war in Ukraine, and persisting supply-chain troubles, America's economy seems to be weathering these pressures on growth better than other developed countries.



US economic forecasts, year on year (%)			
	2021	2022F	2023F
GDP growth	5.7	3	1.7
CPI inflation	4.7	7.7	2.7
Unemployment rate	5.4	3.6	3.7
Gross public debt (% of GDP)	128.8	124.6	123.7
Private consumption	7.9	3.1	1.7

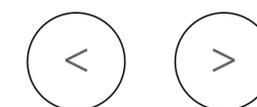
Source: Barclays Research, Barclays Private Bank, May 2022

The US economy continues to be resilient in the face of weakening external demand, inflation at multi-decade highs, tightening financial conditions, and challenges to the global supply chain. While growth unexpectedly contracted in the first three months of the year, the underlying picture of the world's largest economy still looks assured, as household consumption remains robust and labour markets improve.

At first glance, the advanced estimate of first-quarter (Q1) US gross domestic product (GDP) was much weaker than expected. In fact, activity declined by 1.4% on an annualised rate. This was significantly lower than the 6.9% growth recorded in the fourth quarter of 2021, and was the first drop in output seen since mid-2020, when COVID-19 restrictions decimated activity.

Nevertheless, many economists dismissed the report as an indicator of an imminent recession, given the contraction was primarily driven by weaker trade and a slower inventory build. Reduced external demand, due to moderating growth elsewhere, led to a 5.9% decline in exports from the US.

Concerns over supply shortages, due to disruption in China and the war in Ukraine, encouraged companies to front-load imports, resulting in a widening of the trade deficit. Inventory data tend to be volatile. After a strong build in the fourth quarter, companies appeared cautious to increase their stock further in Q1.



CONSUMERS KEEPS SPENDING

Domestic activity remained positive this year, robust personal consumption, encouraging growth in business investment, and stronger housing investment.

Personal-consumption expenditures (PCE), accounting for more than two-thirds of economic activity, rose 1.1% month-on-month (m/m) in March. Even after adjusting for inflation, real personal spending was positive, at 0.2% m/m. The acceleration in spending was driven by higher demand for goods and services.

In service spending, momentum has picked as US COVID-19 caseloads decline, encouraging people to travel, dine out, and to stay in hotels more. More spending was also seen in healthcare, recreation, and transportations services.

The outlook for consumer spending remains underpinned by healthy labour markets, excess savings, and a decrease in saving rates.

LABOUR MARKET

US unemployment has fallen to 3.6%, a rate last seen in February 2020¹, and represents a remarkable improvement on 14.7% peak registered in April 2020, early in the pandemic (see chart). Non-farm payroll data shows that America's economy has created more than 390,000 jobs per month over the past year. Average hourly earnings rose 5.2% y/y in May, helping to offset the attrition in household purchasing power.

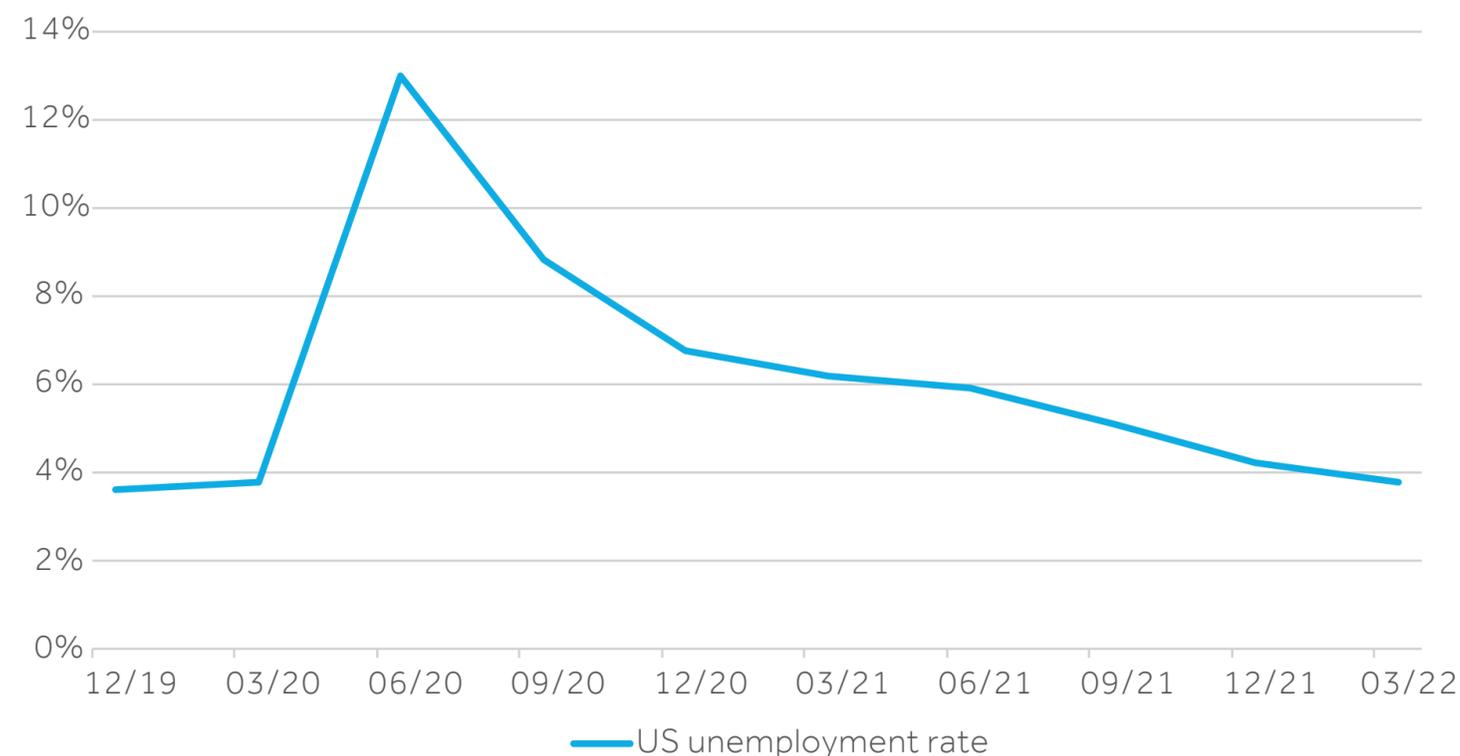
The major disappointment in the labour reports continues to be the slow recovery in the supply of jobs. While the participation rate improved to 62.3% in May, it is still below the pre-pandemic level of 63.4%².

SAVING RATE

With spending outpacing income gains, it is clear that consumers feel confident enough to dip into the extra funds built up during the course of the pandemic. In April, the savings rate dropped to 4.4%, comfortably below pre-pandemic levels³. With excess saving of around \$2.5 trillion and only a moderate pace of erosion, we expect private consumption to grow at 3% this year and be supportive of growth.

US UNEMPLOYMENT RETURNS TO PRE-PANDEMIC LEVELS

Rise and fall of the US unemployment rate since 2020



Sources: Bloomberg, Barclays Private Bank, May 2022

¹ Statement by US Secretary of Labor Walsh on May jobs report, US Department of Labor, 3 June 2022 <https://www.dol.gov/newsroom/releases/osec/osec20220603>

² Employment situation summary, US Bureau of Labor Statistics, 6 May 2022 <https://www.bls.gov/news.release/empsit.nr0.htm>

³ Personal savings rate, BEA, 27 May 2022 <https://www.dol.gov/newsroom/releases/osec/osec20220603>

BUSINESS INVESTMENT

Business investment is also an important contributor to growth. New orders for capital goods rose by a larger-than-expected amount at the end of the first quarter, following a decline in February. In an effort to boost productivity and offset labour shortages, higher energy costs, and supply-chain disruption, companies are turning to machinery. Strong demand for communications and electrical equipment, was confirmed by robust increases in durable goods orders.

We expect gross private investment (a measure of the amount a company will invest domestically) to accelerate in the second half of the year and average 9% in 2022.

HOUSING

US home prices continued to surge in the first quarter of the year. The Case-Shiller US Home price index rose 20.6% y/y in May. All 20 major cities reported robust growth, led by those in the south and southeast⁴. Investment in housing remains strong, with the number of homes that began construction (housing starts) jumping by 3.9% y/y in March, driven by growth in the multi-family segment⁵.

While a shortage of materials and skilled labour may hold back momentum in the short term, the fundamentals for US housing remain stable, despite increasing concerns over higher interest rates and affordability. Buyers' balance sheets seem healthy, labour is slowly returning, and post-pandemic changes expected in living arrangements should continue to be positive for the sector.

INFLATION

Hopes that US inflation had peaked in March were shattered after the consumer price index (CPI) surged to 8.6% in May, its fastest pace since 1981, driven by the rising cost of fuel, food, and shelter as a result of the war in Ukraine and the reopening of the economy. Energy prices jumped 34.6% from a year earlier, which was the most since 2005, while grocery prices rose 11.9% over the same period, the fastest rate of increase since 1979. The only respite for policymakers was a moderation in the core inflation reading.

INFLATION SET TO MODERATE

While we have raised our US annual inflation projection for this year to 7.7%, we anticipate that price pressures will begin to ease into year end, driven by base effects, a gradual reopening in China, and the unwinding of core goods inflation (see table, p5).

We forecast that CPI will decline to 6% at year-end, and will then trend lower next year to average 2.7%.

FED POLICY

With the number of unemployed heading back towards pre-pandemic lows and sky-high inflation, it is unsurprising that the US Federal Reserve increased the intensity of its policy normalisation timetable.

After ramping up the pace of rate hikes to 50 basis points (bp) in May, we expect similar increases at the June and July meetings. After which, weaker price pressure should allow the Federal Open Markets Committee to revert back to increases of 25bp at the remaining meetings through January 2023. This would put the terminal rate for the tightening cycle at 2.75-3%.

The Fed also announced that they will begin the balance sheet run-off process in June. The central bank will allow its holdings of Treasuries and mortgage-backed securities to decline at a pace of \$47 billion per month, rising to \$95 billion by September. The upgraded pace of policy tightening suggests that committee members will wait for tangible evidence that inflation is under control and starting to decline before relaxing its tightening narrative.

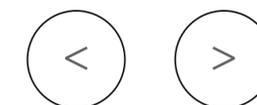
GROWTH LOOKS SECURE, FOR NOW

The growth profile for the US economy remains intact, despite the broad range of global economic pressures and the impact of higher interest rates. Given the improving outlook in respect of COVID-19, strength in labour markets, and positive consumer spending, we anticipate that the economy will grow at 3% this year before easing to 1.7% in 2023.

Author: Henk Potts, London UK, Market Strategist EMEA

⁴S&P Corelogic Case-Shiller index shows annual home price gains increased to 19.8% in February, S&P Global, 26 April 2022 https://www.spglobal.com/spdji/en/documents/indexnews/announcements/20220426-1452067/1452067_cshomeprice-release-0426.pdf

⁵Monthly new residential construction, March 2022, US Census Bureau, 19 April 2022 <https://www.census.gov/construction/nrc/pdf/newresconst.pdf>



Chinese economy facing a wall of worry

Economic growth has tumbled of late, in the face of a housing market crash, poor consumer sentiment, a rigorous zero-COVID policy, and weakening global output, and shows few signs of a quick recovery. The authorities are loosening policy and turning on the spending taps in response to the downturn. But can they do enough to help the economy meet the official growth target this year?



China economic forecasts, year on year (%)			
	2021	2022F	2023F
GDP growth	8.1	3.3	5.3
CPI Inflation	0.9	2.3	2
Unemployment rate	5.2	5.4	5.1
Consumption	5.3	2.7	3.3

Source: Barclays Research, Barclays Private Bank, May 2022

Chinese growth has slumped over the course of the past year. The government's commitment to its zero-COVID strategy, downturn in the property market, and regulatory crackdown have conspired to slash gross domestic product (GDP) growth to 4.8%¹ in the first-quarter (Q1) of the year compared to 18% in the same period last year.

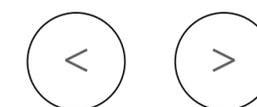
There is mounting concern now over the ability of the world's second-largest economy to achieve its official 5.5% growth target in 2022 (see table).

ZERO-COVID STRATEGY

While governments around the world have adopted strategies that see societies trying to live with coronavirus, this is certainly not the case in China. Even the most minor outbreaks are met with a strict regime of mandatory testing, enforced quarantine periods, and citywide lockdowns when required. Around a quarter of the Chinese population are estimated to be the subject of varying degrees of lockdown, with Beijing, joining Shanghai among others, imposing restrictions at the end of April.

The Chinese authorities' rationale for imposing the strategy is driven by concerns that the Omicron variant could overwhelm its health system. A system left exposed by elderly vaccination rates that remain low and by the efficacy of its domestically produced vaccine being below that of international rivals' alternatives.

The size and scale of the lockdowns have begun to infringe on China's aspiration to drive growth through domestic consumption. Retail sales contracted by 11% in April compared with the previous year (see chart, p9). The official unemployment rate rose to 6.1%, its highest level since February 2020. Future household consumption could also be constrained by rising unemployment and higher levels of debt.



¹ China Q1 GDP tops forecast, but March weakness raises outlook risks, Reuters, 18 April <https://www.reuters.com/world/china/chinas-q1-gdp-expands-48-yy-better-than-fcast-risks-outlook-abound-2022-04-18/>

HOUSING MARKET UNDER PRESSURE

Chinese authorities have introduced measures such as loosening credit controls and allowing more bond issuance in an attempt to ease the pressure on its property market. These policy adjustments appear to be having only a minor impact. Data from the National Bureau of Statistics showed that property sales fell 26% (by value) year-on-year (y/y) in March, while housing starts also declined 22%, following the 12% reduction registered in January and February.

Private developers have pulled back from buying new land and property investment turned negative at the end of the first quarter. The crash in the property market has serious implications for Chinese growth, given that it accounts for around 25% of GDP when construction, land sales, and other related activity is taken into account.

REGULATORY CRACKDOWN

China has embarked on a broad-based regulatory crackdown of its technology sector over the last year. The purpose of the overhaul is to safeguard consumers while protecting data and national security. Authorities have introduced online time limits for under-aged gamers, as well as new rules that govern the way technology companies use "recommendation" algorithms. The increase in oversight has spooked shareholders in some of the largest technology companies and discouraged investment.

POSITIVES

While service and consumption remains under pressure, industrial production, exports, and fixed asset investment have been far more resilient.

A new "closed-loop system" appears to have limited the impact of strict lockdowns on manufacturing. Under the arrangement workers are required to stay in "bubbles" that restrict their movements, even when outside the factory. An easing of logistical disruption should allow industrial production to return to growth in the coming months, but weakening external demand and increasing competition from rival Asian economies could limit the pace of progression.

Investment in infrastructure continues to be a pillar of growth in China. Fixed asset investment surged 9.3% in Q1 and local governments have planned investments on 71,000 major projects this year, which continue to be funded through the issuance of special bonds.

FALLS IN CHINESE RETAIL SALES ACCELERATE

Chinese retail sales plunge over the last year



Sources: National Bureau of Statistics of China, Barclays Private Bank, May 2022

EXPORT DEMAND RESILIENT

While domestic demand has been weakening, export demand remains resilient despite the tough year-on-year comparisons. Chinese export growth came in at a higher than expected 14.7% in March². This was the 18th consecutive month of double-digit increases.

Outbreaks of COVID-19 in overseas countries helped to boost demand for masks and medical-related exports, which accounted for 13 percentage points of the export growth. Alongside medical supplies, demand for technology also continues to be positive.

EXTERNAL CONSUMER CONFIDENCE TAKES A HIT

Weakening international consumer confidence is hitting demand for home appliances, semiconductors, and mechanical and electrical products. Specifically, the rising cost-of-living pressures in the EU and the UK is starting to weigh on export growth to those economies.

IMPORTS SLOW

Weakness in housing construction, softening domestic demand, and higher commodity prices have led to significant slowdown in imports. Imports of copper (-8.7% y/y) and iron ore (-14.5% y/y) plummeted in March, while the volume of coal imports plunged 40% and crude imports by 14%. The reduced demand from the world's largest importer of base metals and energy could start to ease supply-demand pressures in global markets.

POLICY RESPONSE

In response to the rapidly slowing economy, the People's Bank of China cut lending rates, reduced the reserve requirement ratio, and relaxed its credit policy. The central bank pledged, at its Q1 Monetary Policy Committee meeting, to provide more substantial support for the real economy, especially for small- and medium-sized enterprises, green, and agricultural financing.

We also expect more focus on the implementation of monetary policy by expanding the scale of new loans, lowering real interest rates on bank loans, and easier access to market financing for the private sector.

Credit growth in April increased 10.2% y/y, reflecting further fiscal easing through the front-loading of government bond issuance. However, the reading was weaker than in March due to a large fall in new loans and decrease in corporate bonds. A sustained improvement in credit growth is doubtful, given the authorities' commitment to keep the macro leverage ratio broadly stable.

The Government Work Report vows to stabilise land and house prices and to roll out city-specific housing measures. While the loosening of policy will take time, we still expect an easing of regulatory and macro prudential policies, including lowering payment ratios, cutting mortgage rates, and relaxing home-purchase restrictions to help restore some confidence in the battered sector.

GROWTH TARGET LOOKS AMBITIOUS

The government's official target of 5.5% growth for this year still looks ambitious, even though it's lower than the "above 6%" level for 2021. China's commitment to zero-COVID is expected to prolong the weakness in consumption and services. The deterioration in the housing market, dampening of external demand, and lack of aggressive fiscal and monetary stimulus, suggests that expansion of closer to 3.3% is far more likely this year.

Author: Henk Potts, London UK, Market Strategist EMEA

² China's exports growth hits 2 year-low as virus curbs hit factories, Reuters, 9 May 2022 <https://www.reuters.com/world/china/chinas-april-exports-slow-imports-unchanged-amid-expanding-virus-curbs-2022-05-09/>



Can Europe stand the economic heat of the Russia-Ukraine conflict?

Europe's economy is being battered by surging inflation, supply bottlenecks, and the economic fallout from the war in Ukraine. As politicians grapple with cutting reliance on Russian fuel while keeping the lights on at home, is an energy shock about to tip the continent into recession?



Eurozone economic forecasts, year on year (%)			
	2021	2022F	2023F
GDP growth	5.4	2.3	0.5
CPI Inflation	2.6	7.1	2.8
Unemployment rate	7.7	7	7.3
Gross public debt (% of GDP)	98.3	97.1	95.7
Private consumption	3.5	2.5	1.8

Source: Barclays Research, Barclays Private Bank, May 2022

Hopes of a vigorous European recovery early this year have been ruined by the ramifications of the conflict in Ukraine, impact of renewed COVID-19 restrictions, record high price rises, and supply-chain disruptions. Growth forecasts have been slashed, inflation projections ramped up, and recession risk is rising.

Concerns that Europe's growth profile could tumble and inhibit the European Central Bank's ability to normalise policy, pushed the euro to its lowest level against the dollar in five years at the start of the second quarter.

WAR IN UKRAINE

Russia's decision to launch a full-scale invasion of the country has been described as the biggest security issue to face Europe since the second world war. The clash has far reaching economic consequences for the region, including the potential rationing of energy, surging price pressures, and additional policy complications.

The starkest risk, from an economic perspective, is through the energy channel. In 2021, Europe imported 155 billion cubic metres of natural gas from Russia¹, equating to around 40% of its consumption. The region also imported close to 25% of its petroleum products².

Fears that Russia will weaponise its energy reserves have been elevated to near crisis levels, after Gazprom announced in April that it would suspend gas flows to Poland and Bulgaria until the two countries paid for the fuel in roubles. The European Union (EU) has refused Moscow's demands for payments in the Russian currency, stating that it would violate sanctions and help prolong the war.

¹ How Europe can cut natural gas imports from Russia significantly within a year, IEA, 3 March 2022 <https://www.iea.org/news/how-europe-can-cut-natural-gas-imports-from-russia-significantly-within-a-year>

² EU leaders wrangle with issue of oil and gas imports from Russia at summit, The Guardian, 24 March 2022 <https://www.theguardian.com/world/2022/mar/24/eu-leaders-oil-gas-imports-russia-ukraine>

BALANCING MORALS WITH ENERGY SECURITY

European leaders will try to manage the difficult balancing act of securing the energy needs of their economies, while also applying pressure on President Vladimir Putin to end the war. European lawmakers have begun to outline plans to introduce a phased embargo on Russian oil over the next six months.

Meanwhile, Putin appreciates his timeframe to apply maximum economic leverage is before Europe can establish alternative sources of fuel. Consequently, either Russia reducing the flow of gas or Europe imposing a full embargo risks a significant energy supply shortfall and much higher commodity prices.

The consequences of either rationing or sanctioning could weaken manufacturing output, household disposable incomes, and corporate profitability levels. Another supply shock would probably add to broader price pressures, thereby further stoking inflation.

WORST CASE SCENARIO

Barclays Investment Bank estimates that under a more extreme scenario, aggressive rationing, soaring energy prices (Dutch gas futures up 200%, oil up around 40%), and hit to confidence levels could throw the eurozone into recession, with gross domestic product (GDP) tanking by around five percentage points.

COVID-19 RESTRICTIONS

Europe's battle with COVID-19 has proved to be a protracted one. Renewed restrictions imposed at the end of last year as a result of the Delta and Omicron variants continued into the first quarter (Q1)³, undermining demand, particularly in high-contact sectors.

The supply of labour also worsened as sickness rates soared. Eurozone GDP grew at an anaemic 0.3% quarter-on-quarter rate in Q1, which reflected weaker consumption that was only partially offset by stronger investment and the robust order backlog for manufacturers. On a regional basis, the Italian economy contracted, the French one stagnated, while Germany's barely avoided a recession.

On a more encouraging note, businesses and households have adapted to the restrictions as the year has progressed, allowing activity levels to pick up. The significant easing in coronavirus rules over the past couple of months has already seen a jump in mobility, according to Google data. This trend is expected to continue through the rest of the year, assuming the medical outlook doesn't worsen.

INDUSTRIAL OUTPUT

Due to the adverse effects of the war in Ukraine, supply bottlenecks in China, and an expected reduction in investments, the outlook for European manufacturing remains gloomy. Higher fuel prices have seen input costs surge in many sectors, particularly the most energy-intensive ones, including metals, chemicals, and cement. The shortage of semiconductors, and other components, has weighed on the production of computers, electronics, and autos, among others.

As companies overcome logistical constraints and capacity increases, supply chains should slowly improve. The extended lockdowns in China, however, suggest that the unravelling of these hurdles to output will take considerably longer than previously estimated, and continue to weigh on European industrial production.

UNEMPLOYMENT

Labour markets in Europe have continued to improve with the recovery from the pandemic (see table, p11). In March, eurozone unemployment hit a record low, with the jobless rate falling to 6.8% compared to 8.2% the same month the previous year⁴. Tight labour markets and rapid inflation has emboldened powerful union leaders to demand higher wages to offset the increased cost of living. While settlements, so far, have lagged behind price increases, the risk of an inflationary spiral seems to be rising.

INFLATION

Eurozone inflation hit a record high of 8.1% year-on-year (y/y) in May⁵, boosted by a sharp increase in energy component prices, while the preliminary reading for May points to an even greater 8.1% increase. Cost-side pressures have also been driving food inflation. The April reading is unlikely to represent the peak, despite many countries having cut taxes or offered rebates to offset the immediate impact of higher fuel prices.

³ GDP up by 0.2% in the euro area and by 0.4% in the EU, Eurostat, 31 May 2022 <https://ec.europa.eu/eurostat/documents/2995521/14497760/2-29042022-BP-EN.pdf/b2bac77e-f630-a6cd-4190-5e891a85331b>

⁴ Euro area unemployment at 6.8%, Eurostat, 3 May 2022 <https://ec.europa.eu/eurostat/documents/2995521/14613608/3-03052022-AP-EN.pdf/36631a07-778c-efb0-01f2-8a052bde985e?t=1651561306689>

⁵ Inflation in the euro area, Eurostat, 29 April https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Inflation_in_the_euro_area

Given the recent rise in energy futures, ongoing supply disruption from China, and elevated soft commodity prices, we tentatively forecast that eurozone inflation will peak at 8.5% y/y in September. After the summer, the base effects from the oil price surge from late last year should start to ease annual comparisons.

Stagflation is a term that keeps many-a-central banker awake at night. Despite decelerating growth prospects, policymakers have signalled the need to speed up the tightening timetable for interest rates in an effort to curb inflation. Officials have already indicated that net-asset purchases under the asset-purchase programme (APP) will be concluded at the end of June, which paves the way for the first rate hike in July.

Fears of a wage-price spiral and/or a de-anchoring of inflation expectations, have also encouraged members of the Governing Council to pre-commit to an additional hike of at least 25bp at the September meeting, although we believe that 50bp is more likely. Our current expectation is that the ECB will then raise rates by another 25bp at the October meeting, after which we anticipate a pause in policy with the deposit rate at 50bp, as growth and inflation starts to trend lower.

We now expect the first ECB rate hike (25bp) will occur in July followed by a further quarter-of-one-percent increase in at the September, October, and December meetings. There is also a possibility that the central bank will raise policy rates one more time in the first quarter of next year before pausing, as growth and inflation starts to trend lower. We do, however, remain cognisant that the hiking cycle could be delayed or slowed should economic activity significantly weaken.

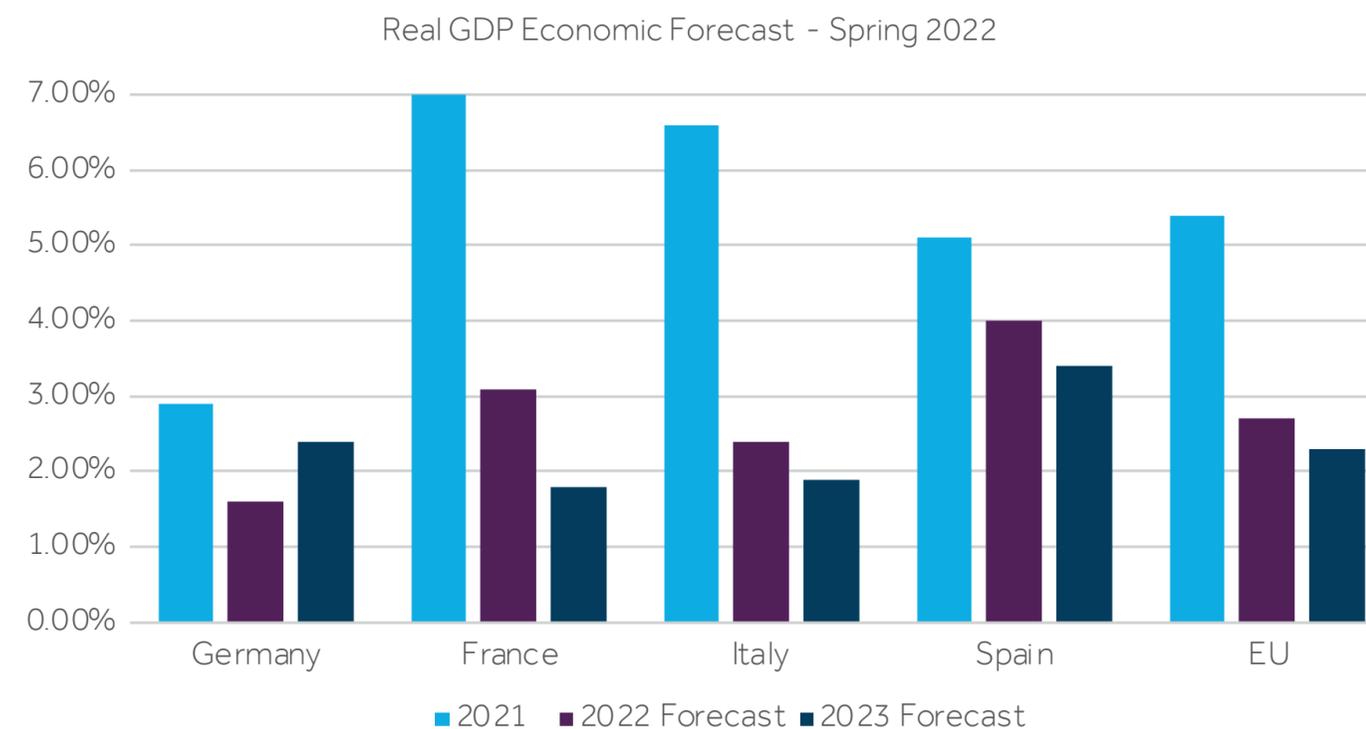
GROWTH PROSPECTS

Europe's immediate growth prospects are likely to be determined by the flow of energy, level of supply-chain improvement, and the path of monetary policy. We expect that Q2 growth will be relatively flat, before a more meaningful recovery in the second half of the year. However, the very clear and present danger to energy supplies means that our 2.3% growth forecast for this year could rapidly contract, possibly into a recession. That said, economic expansion in the bloc is uneven (see chart).

Author: Henk Potts, London UK, Market Strategist EMEA

THE EUROZONE'S UNEVEN GROWTH PROFILE

Eurozone growth trends in Germany, France, Italy, Spain, and the bloc



Sources: Bloomberg, Barclays Private Bank, May 2022

Why the UK recovery may be nearing the end of the road

With runaway inflation, rising rates, and weakening global growth, the UK economy faces a hangover as the engines of last year's strong recovery – buoyant consumer spending and a rampant housing market – begin to splutter. Will the authorities' priorities be tackling inflation or engineering a soft landing?



UK economic forecasts, year on year (%)			
	2021	2022F	2023F
GDP growth	7.4	3.5	1
CPI Inflation	2.6	7.9	4.1
Unemployment rate	4.5	4	4.4
Gross public debt (% of GDP)	94.7	92.2	92
Private consumption	6.2	4.3	0.7

Source: Barclays Research, Barclays Private Bank, May 2022

After enjoying one of the strongest recovery rates in the developed world in 2021, the UK economy looks set to stall over the next 18 months. A combination of surging inflation, higher interest rates, tight labour markets, and the rising tax burden are expected to hit growth prospects.

UK INFLATION AT MULTI-DECADE HIGHS

UK inflation jumped to 9% in April¹, with the headline consumer price index (CPI) hitting its highest level since 1982. Price pressures continue to emanate from transport, where petrol prices increased to a record £1.618 a litre; the average increase on motor fuels over the past year rose to 31.4%. Hospitality was the other major upward contributor, with the reopening trade continuing to push up prices for accommodation and the cost of alcoholic drinks in restaurants and pubs. Elsewhere, prices strengthened in food, housing, and household goods and services.

Price pressures are more pronounced and longer-lasting than previously projected. Updated energy expectations suggest that Ofgem price caps will be considerably higher than previously modelled. We also expect restaurant and accommodation inflation to remain robust, as lockdown restrictions disappear. By contrast, there are signs that second hand car prices continued to level off in April.

The Bank of England (BoE) now forecasts that the 40% increase in the regulatory price cap due later this year will drive CPI inflation to 10% in October². While double-digit inflation maybe a short-lived spike, we expect inflation to stay above the 2% target over the forecast horizon, possibly even through 2025.

¹ Consumer price inflation, UK: March 2022, Office for National Statistics, 13 April <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/march2022>

² Monetary Policy Report, May 2022, Bank of England, 5 May 2022 <https://www.bankofengland.co.uk/monetary-policy-report/2022/may-2022>

TIGHTER POLICY LIKELY

At the Monetary Policy Committee's (MPC) May meeting, the BoE increased interest rates by 25 basis points (bp), taking the bank rate up to 1%. This hike was considered to be the last increase from a policy normalisation perspective. That said, the MPC has become far more concerned about the level and persistence of inflation, second-round effects on wages, and rising inflation expectations, therefore we expect further policy increases in the coming months.

We forecast 25bp hikes at both the June and August rate-setting meetings, putting the bank rate at 1.5% in the summer, despite the faltering growth prospects.

HIGHER TAXES

The UK tax burden is set to rise to its highest levels in eight decades over the next couple of years (see chart). The government has enacted, or announced, hikes to corporation tax, increases in national insurance contributions, and frozen income tax thresholds. From next April, corporation tax will rise to 25% from 19%. The freezing of the threshold for the higher rate of income tax will also push the number of people paying the 40% charge to its highest level.

The overall tax burden is anticipated to rise substantially over the next four years. Tax as a percentage of gross domestic product will increase to 36% in 2026/27 from 33% in 2019/20, which would mark the highest level seen since the 1940s.

LABOUR MARKET FEELS THE HEAT

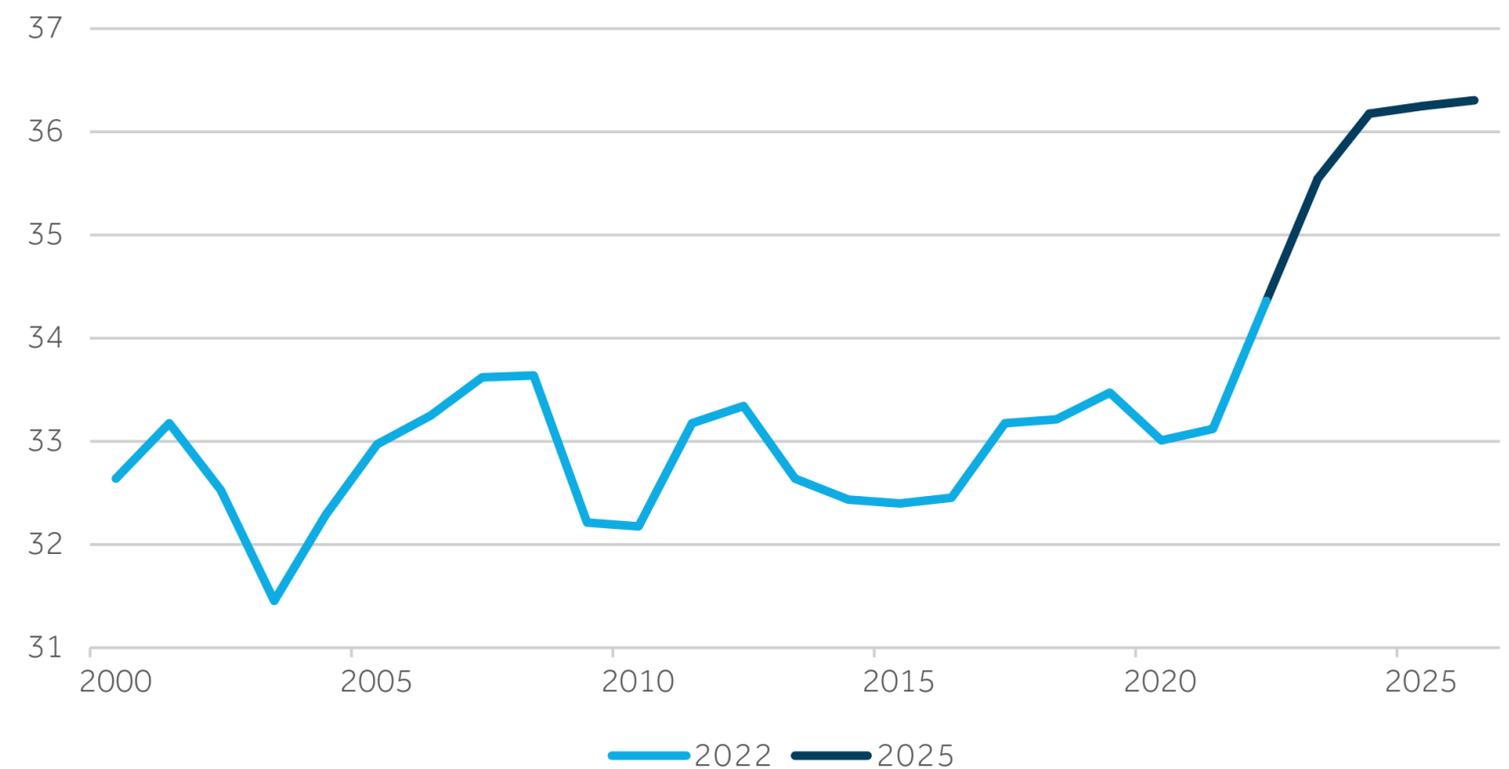
The UK's labour market recovery from the depths of the pandemic has been extraordinary. However, the shortage of workers is now inhibiting firms' ability to grow and risks further fuelling inflation.

The unemployment rate in the quarter to March fell to 3.7%³, the lowest recorded since 1973. The number of job vacancies rose to a new record of just below 1.3 million in March. Meanwhile, on the back of the tight employment market, growth in average total pay surged to 7% from 5.6% in February⁴.

We expect wage growth to remain elevated as workers demand higher salaries to offset the surge in inflation. We estimate that average weekly earnings will grow by around 5-6% this year. Although, even with this increase, real wages (adjusted for inflation) will continue to be squeezed.

SHARE OF UK TAXES TO GDP CLIMBS TO MULTI-DECADE HIGH

UK taxes as a percentage of gross domestic product since 2000



Source: Office for Budgetary Responsibility, Barclays Private Bank, May 2022

³ Employment in the UK: May 2022, 14 June 2022 <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/employmentintheuk/may2022>

⁴ Labour market overview, UK April 2022, Office for National Statistics, 12 April 2022 <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/april2022>

COST OF LIVING PRESSURES ARE SQUEEZING THE CONSUMER

The independent watchdog the Office for Budget Responsibility now forecasts a 2.2% drop in real income over the next year. This would represent the largest hit to living standards in any financial year since records began in 1956⁵.

The squeeze in the cost of living is affecting consumer confidence and spending habits. In data that spans nearly 50 years, in May the GFK consumer confidence index plummeted to minus 40, a record low. The Office for National Statistics stated that retail sales volumes fell 1.2%⁶, adding to the decline seen in February. The fall was led by a reduction in spending at online retailers.

There are also signs that consumers are cutting back on travel due to the record high price of fuel at the pumps. Google mobility data, which offers a real-time snapshot of activity, shows footfall at UK retailers has flat-lined since mid-February. While much of the weakness can be attributed to the pressures on consumers' disposable income, wealthier households seem to be switching some of their discretionary spend to travel and hospitality from goods.

The outlook for household consumption will be driven by the balance between the pent-up demand, following the easing of restrictions, and the higher cost of living. The reduction in spending is likely to be at a slower pace than we would normally assume at a time of elevated inflation, given the excess savings that were built up during the pandemic.

That said, weakening leading indicators and lower levels of confidence may encourage consumers to hold onto their savings for longer. We see private consumption growth slow to 0.7% in 2023 from 4.9% this year.

HOT HOUSING MARKET

After booming in the post-pandemic world, the UK housing market continues to deliver impressive price growth, despite the stamp duty land tax reverting to its October 2021 levels. Recent data from lender Nationwide showed that house prices climbed 12.1% year-on-year in April, although that was lower than in March.

This moderating trend is expected to continue through this year, as rising mortgage rates (due to increases in the bank rate) and declining real incomes reduce momentum. Furthermore, the BoE lending survey suggests that banks are starting to tighten the availability of secured credit.

The Royal Institute of Chartered Surveyors survey in March, showed early signs of softening, with the balance between buyers' enquires and instructions falling to levels not seen since late 2020. The survey also showed that measures of excess demand in the rental sector have weakened as well. The easing of these indicators would be consistent with flat house price growth by the end of the year.

Nevertheless, in the medium term we continue to believe that the UK housing market will be underpinned by structural supply and demand imbalances (for instance, inventories remain close to their lows), robust labour markets, and less demand from international buyers (particularly if sterling remains weak).

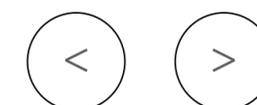
RECOVERY TO GO INTO REVERSE

With the economic recovery phase continuing to play out at the start year, UK growth is still expected to be a very respectable 3.5% in 2022. However, the headline figure masks the deterioration forecast in the latter half of the year and into 2023. The accumulation of substantial headwinds has encouraged the central bank to forecast that the UK economy will contract by 0.25% next year, which is more pessimistic than our forecast of 1% growth (see table, p15), but the risks are very much skewed to the downside.

Author: Henk Potts, London UK, Market Strategist EMEA

⁵Developments in the outlook for household living standards, Office for Budget Responsibility, March 2022 <https://obr.uk/box/developments-in-the-outlook-for-household-living-standards/>

⁶Retail sales, Great Britain: March 2022, Office for National Statistics, 22 April 2022 <https://www.ons.gov.uk/businessindustryandtrade/retailindustry/bulletins/retailsales/march2022>



Market dislocations create opportunities for equity investors

It's been a challenging start of the year, as market attention shifted from inflation to growth dynamics, amid increasingly hawkish central banks. While markets are likely to remain highly volatile in the near term, we believe the recent sell-off has created opportunities for long-term investors. The prevailing uncertainty warrants increased diversification and selectivity in portfolios.



Given the high level of uncertainty in the outlook for economic growth and inflation, equity markets will likely remain volatile in the short term. However, on a 12-month view, we expect equities to rebound and outperform bonds. Following the recent market sell-off, equity valuations have normalised. If, as we expect, inflation moderates in the second half of the year and growth expectations stabilise, this creates opportunities for longer-term investors, who can weather market turbulence in the coming months.

WHAT'S CHANGED?

Since we published November's *Outlook 2022*, the environment for risk assets has deteriorated. Central banks have become increasingly hawkish, as inflation has been higher, and more persistent, than expected. The demand-driven, post-pandemic rise in prices has been further exacerbated by the war in Ukraine and China's COVID-related lockdowns. As a result, growth expectations have been cut and inflation forecasts lifted.

Today, the main concern for investors is whether the US Federal Reserve and other central banks will be able to engineer a soft landing and bring inflation down to their target level, without triggering a major growth shock or even a recession.

AN UNCERTAIN MACRO OUTLOOK

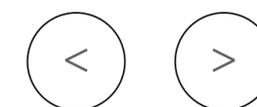
The outlook for growth and inflation remains highly uncertain at present, given the binary nature of the forces at play.

The geopolitical situation in Russia and Ukraine could improve in the coming weeks, but the economic impact of the sanctions on the former will very much depend on their details and will likely have a longer-lasting impact.

Similarly, it is hard to predict how the COVID-19 situation will evolve in China. Beijing remains committed to its zero-COVID policy, and until the economy fully reopens, the lockdowns will continue to weigh on activity and global supply chains. The Chinese government signalled that it will step up support for the economy. However, the size of the stimulus will be key and its effectiveness will depend on the level of restrictions.

MARKET REACTION

Unsurprisingly, given the worsening of the macro outlook, the equity market reaction has been brutal. Global stocks have declined by 17% so far this year, underperforming bonds by 4%.



The dispersion of returns has also been striking, with high valuation and long-duration assets being hit the most, due to their sensitivity to rising yields. In the MSCI World index, consumer discretionary, technology, and communication services have lost 23% to 30% of their value. By contrast, energy has gained 42%. At the style level, value has outperformed growth by 26%.

It is important to note that the market pullback has been driven by multiple contraction, as earnings have remained resilient, so far.

WHERE DO WE GO FROM HERE?

In the near term, and until we get more clarity on growth and inflation prospects, equity markets are likely to remain highly volatile. However, over the longer term, downside risks appear limited.

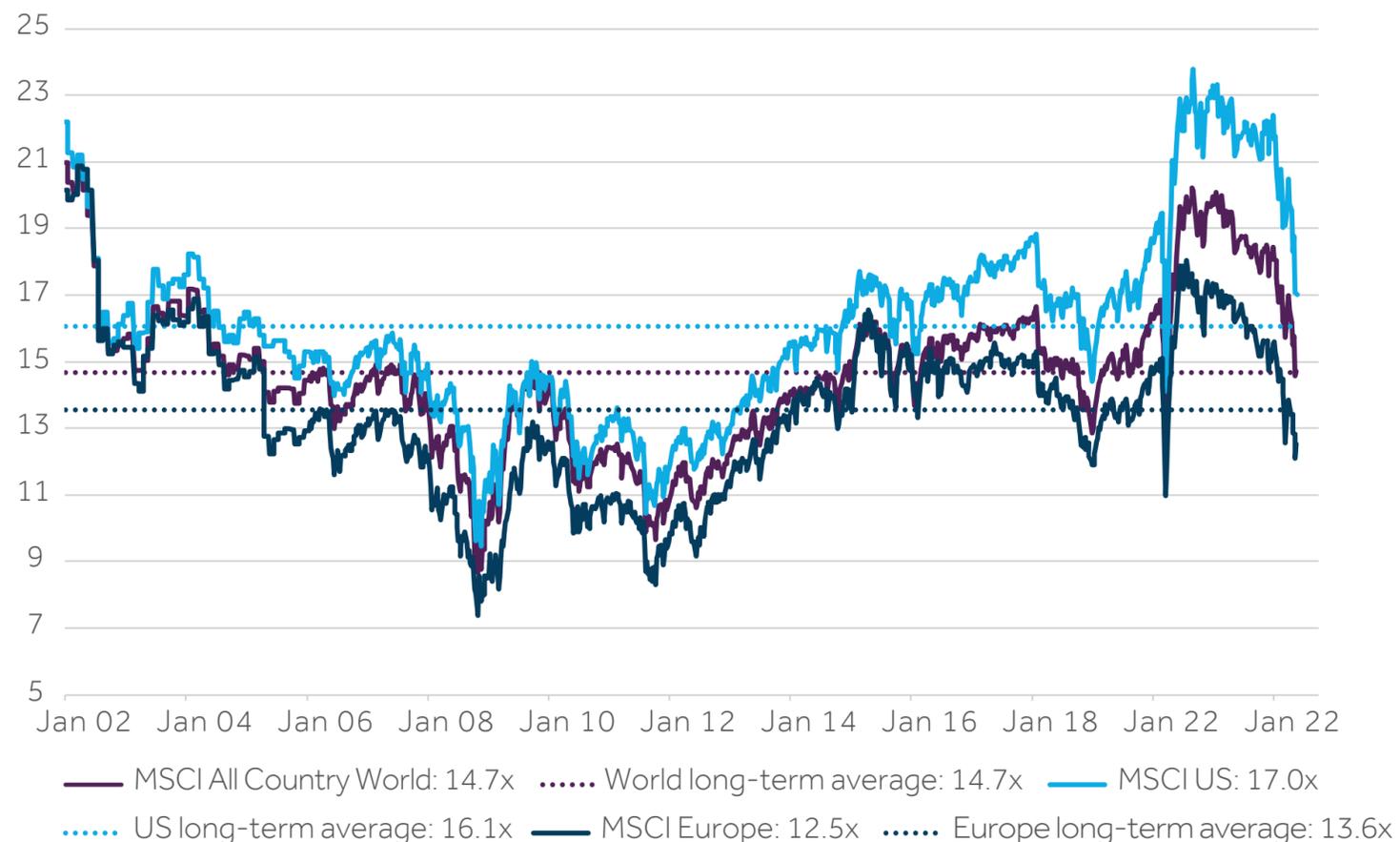
Valuations: Global equity valuations have declined significantly in recent months, and are now back in line with their long-run averages, in absolute terms and relative to bonds.

- Equities are now trading on a forward price-to-earnings multiple of 14.7 globally, down from 18.4 at the start of the year, and in line with their 20-year average (see chart).
- Similarly, the global equity risk premium (ERP) is essentially in line with its 20-year average, at 3.9%. We believe this premium is adequate to compensate investors for owning stocks relative to bonds, especially in a high inflationary environment. We note that the ERP is significantly more attractive in Europe than in the US, at 6.9% vs 3.0% respectively at present.

For stocks to re-rate over the coming months, we would need to see an improvement in the mix of growth and inflation. Until then, the upside potential for equity markets relies on the resilience of corporate earnings.

GLOBAL EQUITY VALUATIONS HAVE NORMALISED

MSCI regional indices' forward 12-month price-to-earnings multiples for the US, Europe and world have weakened significantly this year



Sources: Refinitiv, Barclays Private Bank, May 2022



Earnings: We believe that consensus earnings forecasts are too optimistic and will need to come down, to reflect the increased headwinds, not least elevated inflation, that companies are facing. However, we expect earnings growth to remain positive this year.

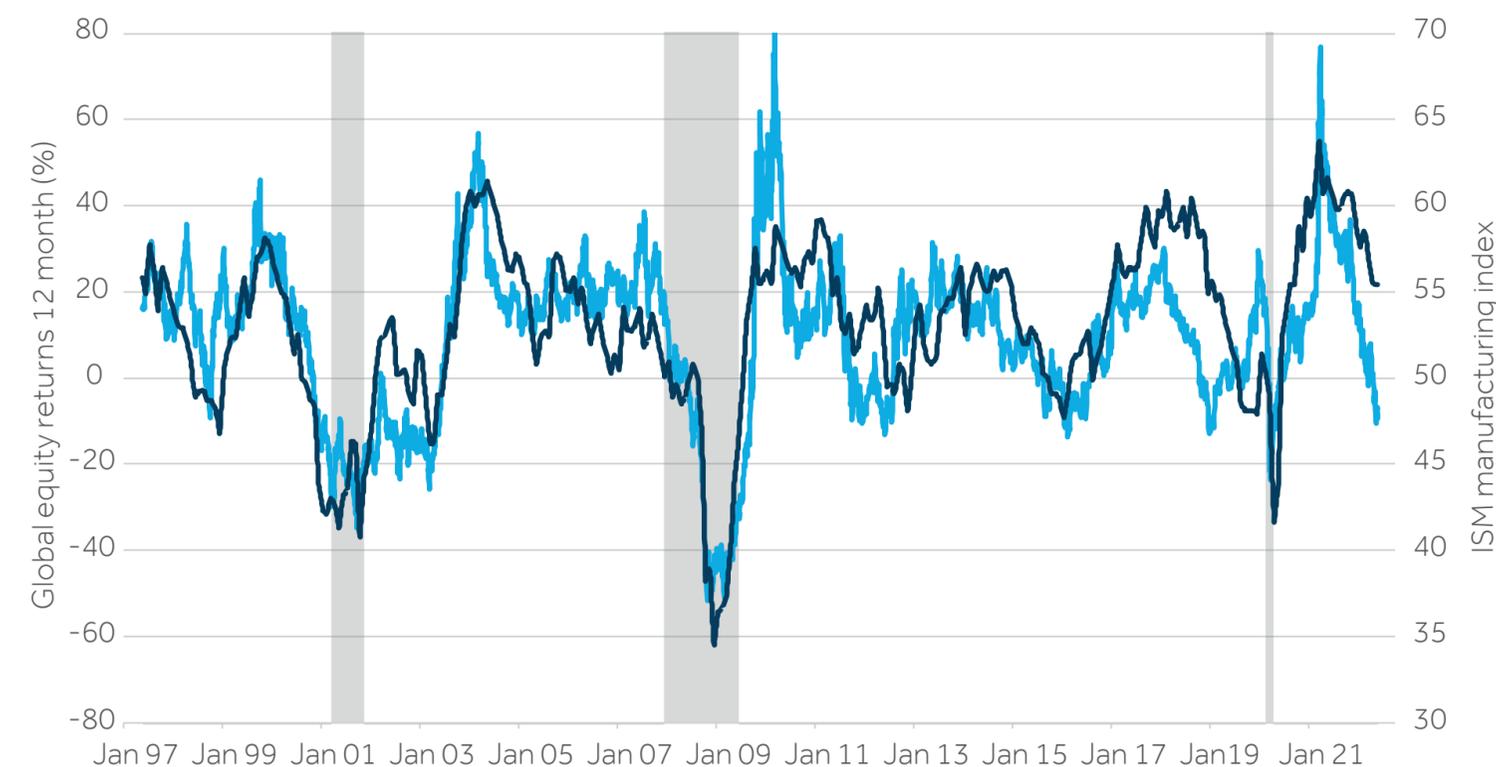
- Bottom-up analysts currently expect earnings to grow by 11% this year globally and by 8% next year.
- However, during the first-quarter earnings season, companies have been more cautious on their outlook for growth and inflation, and their objective has clearly shifted to margin preservation rather than expansion.
- In the past 12 months, margins have been the main contributor to earnings growth. But they are now close to all-time highs (earnings before interest and tax margins are now at 12.8% for non-financial companies globally), which means that it will become increasingly difficult for companies to protect margins if inflationary pressures persist.
- While first-quarter earnings have generally been resilient in the US and Europe, growth has largely been driven by the commodity sectors. Excluding energy and materials, earnings expansion would have been up only 2.0% in the US (versus 9.4% in aggregate for the S&P 500) and down 8.9% in Europe (against 10.8% in aggregate for the STOXX Europe 600).

What's priced in: Encouragingly though, after the recent pullback, a lot of bad news already seems to be priced in. At current levels, and on our numbers, global equities are discounting around a 4% decline in earnings this year, well below the 11% increase expected by analysts.

- Such a decline in earnings would be consistent with a sharp slowdown, and an Institute for Supply Management index reading just below 50 by year-end (where a reading below 50 suggests an economic contraction), but not a recession (see chart).
- In the past 50 years, global earnings have declined by 24% on average, year-on-year, around recessions (ranging from -10% in 1982 to -40% in 2009).
- Should a prolonged recession materialise, which is not our base case, there would be more downside risk to equity prices.
- For context, over the same period, previous recessions have led to average peak-to-trough drawdowns of 36% (ranging from -15% in 1980 to -60% in 2009), which lasted 12 months on average. This compares with a 17% drawdown for global equities from their early January peak, at the time of writing.

GLOBAL EQUITIES ARE DISCOUNTING A SHARP SLOWDOWN IN ACTIVITY

The 12-month change in global equity returns implies a significant decline in the ISM manufacturing index



Source: Refinitiv, Barclays Private Bank, May 2022

To summarise, we expect earnings growth to be revised down in the coming months, but to remain positive. Based on fundamentals alone and assuming low-to-mid-single digit growth in earnings, combined with flat to modestly higher price-to-earnings (PE) multiples, global equities could generate mid-to-high-single digit total returns in the next 12 months. In the near term though, the growth / inflation mix remains highly uncertain and equity market volatility is likely to persist.

INVESTMENT IMPLICATIONS

Given our macro outlook, we prefer to stay invested, but position portfolios for an extended period of high volatility and keep some hedges in place. The current uncertainty warrants increased diversification across sectors, regions, and styles.

As such, we favour a mix of defensive and cyclical assets, in a barbell strategy, to reduce downside risk in case of another sell-off, while also taking advantage of undervalued opportunities in dislocated parts of the market.

Within defensives, we prefer sectors with predictable earnings, stable margins, and strong pricing power. Our preferred sector in the defensive space remains healthcare.

The healthcare sector has rerated significantly already, from an 8% discount to the market at the start of the year, to an 8% premium today (based on forward price-to-earnings multiples and the MSCI World Healthcare and MSCI World indexes), slightly above its 20-year average. However, we see room for a further rerating in a risk-off phase, and believe that the sector would also be supported by its more resilient earnings stream.

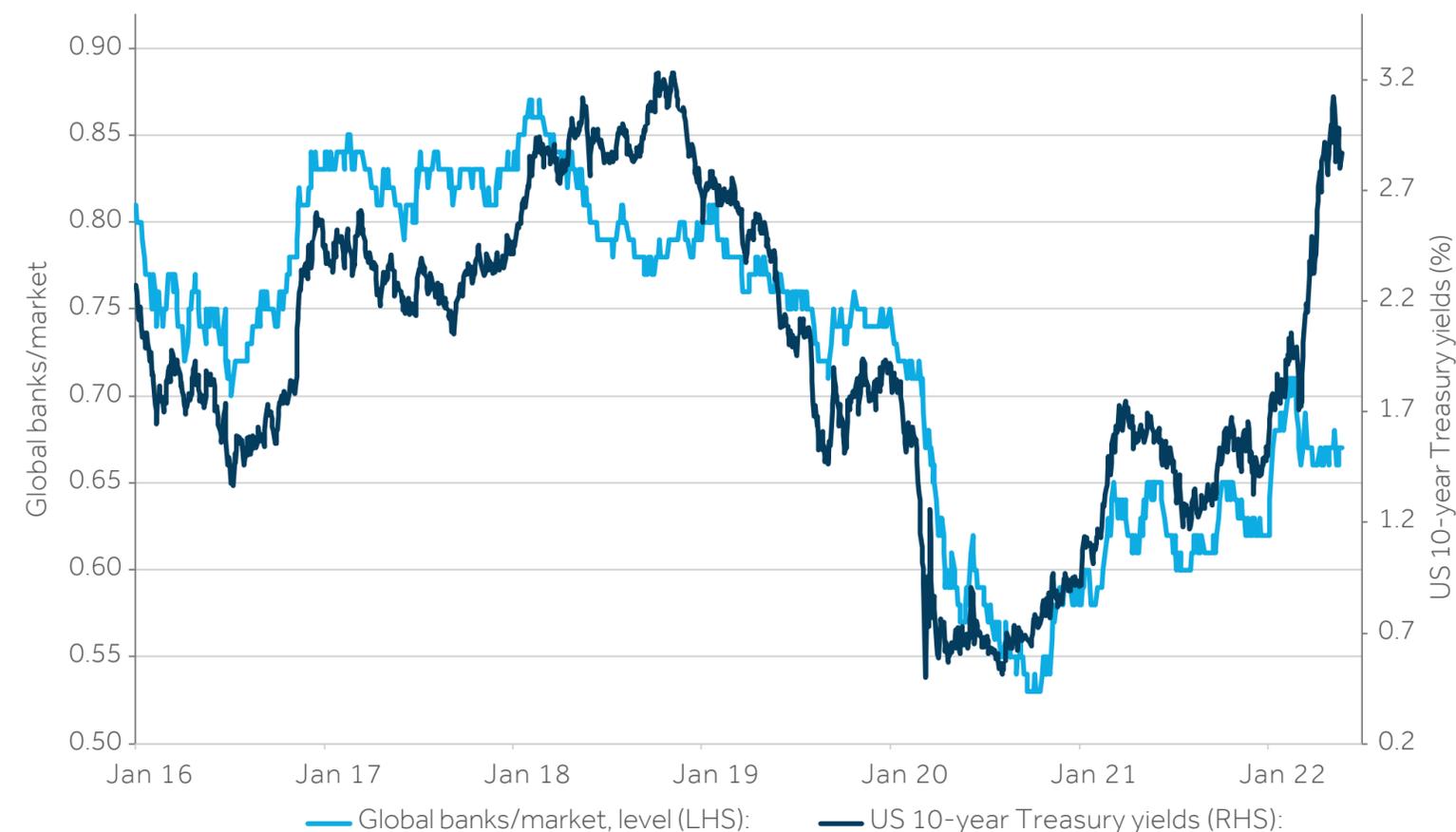
Within cyclicals, we favour sectors which have overreacted (or underreacted) to the recent change in the economic environment, and now appear fundamentally undervalued. More specifically, we look for sectors which have overshot their historical relationship with activity on the downside (proxied by the ISM manufacturing), or sectors which have failed to reflect the substantial rise in yields in recent months and now offer some catch-up potential. This approach highlights industrials and banks as particularly attractive at the moment.

Both sectors were highlighted in November's *Outlook 2022*, and the investment rationale remains in place.

- Industrials: Global industrials have suffered from their strong correlation with activity, as growth expectations have been cut. The sector has underperformed the broader market by 6% since July last year, discounting a significant slowdown which seems overdone at this stage. If growth expectations stabilise as we expect, this underperformance should reverse. Industrials are also likely to benefit from an increase in capital expenditure programmes in the coming months (including in the fields of energy independence, defence and green initiatives), and they trade at a small discount to the market compared to their long-term average.

GLOBAL BANKS' OUTPERFORMANCE APPEARS RELATIVELY MUTED THIS YEAR CONSIDERING THE SHARP RISE IN BOND YIELDS

The performance of global banks versus the equity market and US 10-year Treasury yields



Sources: Refinitiv, Barclays Private Bank, May 2022

- Banks: The 8% outperformance of the banking sector this year appears relatively muted, considering the sharp rise in bond yields (see chart, p20). Historically, banks have tended to outperform in periods of rising yields, often associated with improving economic momentum. Stronger loan growth, wider net interest margins, and better asset quality generally lead to stronger profitability.

However, the recent rise in yields was driven by increased inflation expectations and hawkish central banks, as opposed to stronger growth. Once inflation starts to moderate and growth concerns abate, we would expect the sector performance to catch up with yields. Despite a significant rerating since the end of 2020, global banks still trade at a large discount to the market, relative to history (-1.3 standard deviations below their 20-year average).

With regards to the energy sector, we would not allocate new money to it at current levels, following its phenomenal run (the MSCI World Energy index is up 38% year-to-date). However, for investors who already have some exposure to the sector, it might be worth maintaining the position as a hedge against inflation and geopolitical risk. The sector would obviously be at risk of a de-escalation of tensions between Russia and Ukraine, and any significant decline in the oil price.

At the style level, we continue to favour cyclicals over defensives and see opportunities in small caps for similar reasons. Both discount an overly bearish economic outlook, have disconnected from the recent rise in yields, and are trading at steep valuation discounts.

At the regional level, and based on our sector views, we would look for opportunities in non-US equities, and European stocks in particular. While European equities underperformed the US by 10% in the immediate aftermath of Russia's invasion of Ukraine, they quickly recovered and are now up by 17% relative to the US since the beginning of March, in local currency terms (+13% in relative terms in USD). Despite the recent re-rating, European equities continue to trade at a substantial discount against their US peers, based on forward PEs (-1.7 standard deviations below their 20-year average).

At the stock level, and given the lack of clear direction in the near term, we would focus on secular growth stories, which are less correlated with market moves.

Author: Dorothee Deck, Cross Asset Strategist

Is the worst of the fixed income storm over?

Losses within the bond market have intensified this year. However, the second half could provide opportunities on rates, along with in credit. Until then, a defensive portfolio positioning seems justified.



RATES AND SPREADS VOLATILITY TO REMAIN

It's been another challenging year for bonds with most segments of the market having produced negative returns, so far. Higher rates in anticipation of aggressive rate hikes, especially by the US Federal Reserve (Fed), have been the main driver for the losses. Adding to investors' woes, spreads, which usually perform well in periods of rising rates, have widened and could continue to do so over the rest of the year.

While the traditional negative correlation between rates and spreads seems to have been somewhat restored of late, we believe that the period of higher spreads and volatile rates is not over yet.

In this environment, some imagination is needed to find pockets of value in the bond market.

CENTRAL BANK POLICY DRIVES BOND MARKETS

We pointed out in November's *Outlook 2022* that central bank policy will be one of the main drivers for bond market performance this year. At least the anticipated upcoming rate moves have been well signalled by the Fed, which has hinted at 50 basis point (bp) hikes in June and July, and 25bp in the remaining meetings this year. This should lead to a 2.75% upper target fed rate by the end of the year. Meanwhile, forward money market rates imply a peak at around 3.4% by September 2023, before trending towards a neutral rate of around 2.5%.

We have outlined before that the Fed seems to have split the rate-rising exercise into two halves: deal with inflation now, and adjust the rate path afterwards depending on incoming data. As long as this remains the case, the probability of seeing a policy rate above 3% next year shouldn't be discounted.

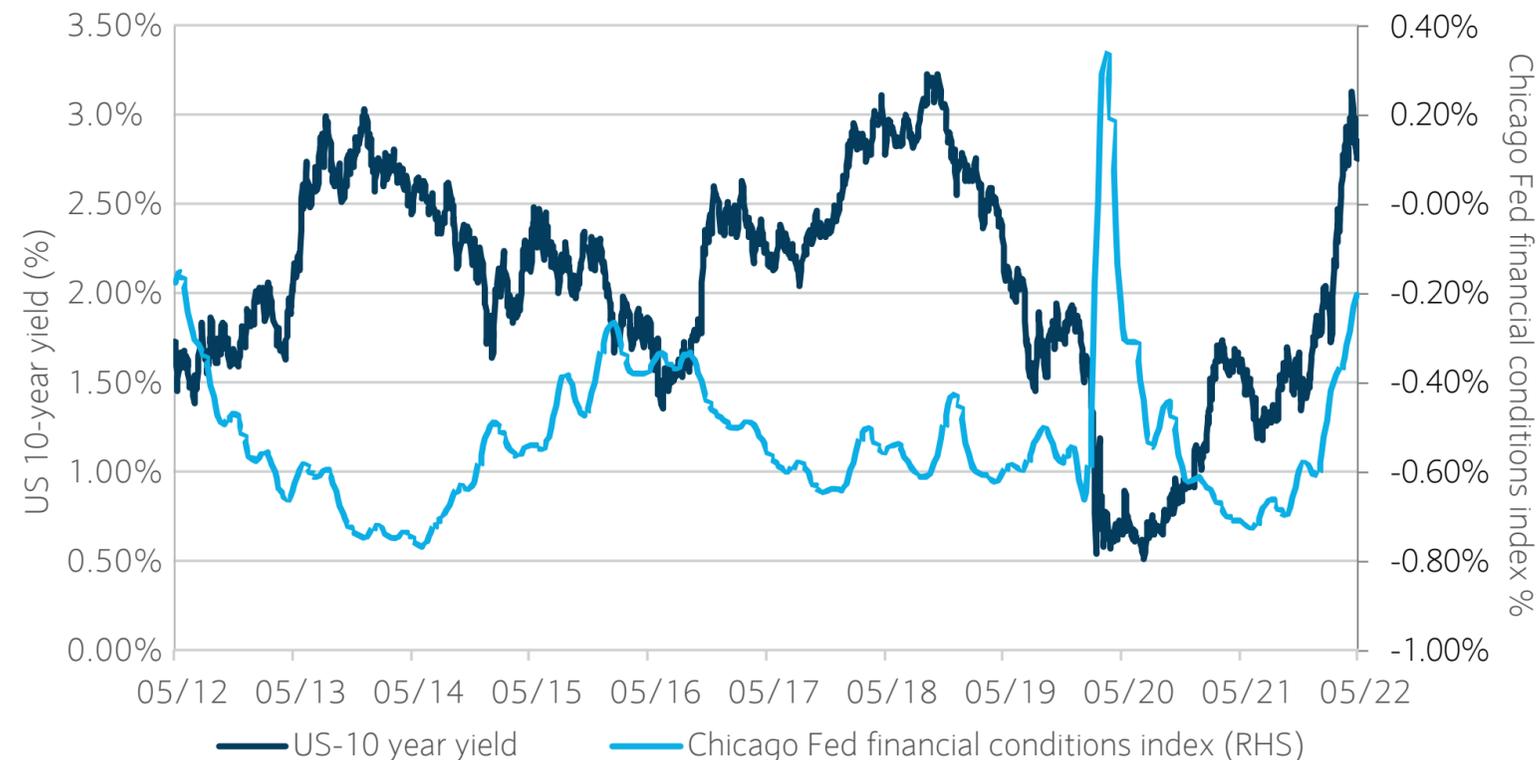
A SLOWING IN INFLATION SEEMS ON THE HORIZON

The market has already pared back rate-hike expectations in recognition of a spike in volatility for riskier assets and heightened growth uncertainties. This has led to the most restrictive level of financial conditions for 10 years (excluding during the early phase of the COVID-19 pandemic), according to the Chicago financial conditions index (see chart, p23). That said, the Fed reminded investors in May that it will raise rates until there is "clear and convincing" evidence that inflation is in retreat.

The latest US inflation data show signs of slowing price rises in areas of the market that have been particularly impacted by the pandemic, such as the cost of used cars. This, together with base effects, could cause inflation to moderate towards the end of this year.

FINANCIAL CONDITIONS INDEX TIGHTENS AS YIELDS RISE

Chicago Fed financial conditions index (where positive values tend to be associated with tighter-than-average financial conditions, and negative values easier conditions) tightens this year, as yields rise



Sources: Bloomberg, Barclays Private Bank, May 2022

¹Personal income and outlays, March 2022, Bureau of Economic Analysis, 29 April 2022 <https://www.bea.gov/sites/default/files/2022-04/pi0322.pdf>

²Treasury Term Premia: 1960-Present, 12 May 2014, Federal Reserve Bank of New York https://www.newyorkfed.org/errors/404?item=%2fresearch%2fdata_indicators%2fterm-premia-tabs%23%2finteractive&ser=extranet%5cAnonymous&site=nyFrbPublic

³Statement regarding plans for reducing SOMA holdings of Treasury securities, agency debt, and agency mortgage-backed securities, Federal Reserve Bank of New York, 4 May 2022 https://www.newyorkfed.org/research/data_indicators/term-premia-tabs#/interactive

BUT INFLATION UNCERTAINTY REMAINS, FOR NOW

The Fed forecasts that its preferred inflation measure, core personal consumption expenditure, will drop to 2.1% by the end of next year from 5.2% in March¹. This looks ambitious. It would not be the first time that inflation proves stickier than initially expected.

While the market and the Fed continues to debate where the neutral rate for US interest rates lies, we believe that this discussion seems premature, given the above. Looking at the 5-year, 5-year forward OIS swap, it appears that the market is adjusting its expectation upwards, from just over 2% in March to over 2.6% now.

Until we reach the "neutral haven" (if ever), we believe that the risk of higher rates remains to the upside, at least temporarily.

THE GREAT UNWIND AND THE TERM PREMIUM

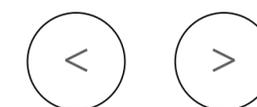
Apart from longer-term inflation expectations, which have moderated since April, we believe that term premium will drive longer-end rates in coming months.

Term premium, as measured by Adrian Crump & Moench², stands at -0.2%, compared to -1.11% in June 2020². Recent growth concerns and safe-haven investment flows following the start of the war in Ukraine have slowed the rise of the term premium. However, supply uncertainty, due to the reduction in the Fed's balance sheet, could add to the upward pressure.

The US central bank has laid out the forecast for shrinking its balance sheet, and will start to let fixed income securities mature, capped at \$47.5 billion, in June. This cap will then increase to \$95 billion in September³. While the endpoint has not been confirmed, given the pace of reduction, the balance sheet could deflate by \$500 billion this year and \$3 trillion by end of 2025.

LOCK-IN OPPORTUNITIES AHEAD

Given this backdrop, rates have the potential to climb towards 3.5% should the moderation in inflation take longer than anticipated, and with central bank bond sales coming into effect. However, we also believe that inflation will moderate over the rest of the year and that the recent rise in rates implies some for the balance sheet unwind. This, together with subdued growth, should limit excessive rate rises in the long term, increasing the appeal of adding to duration and locking in higher rates at the longer end, should (10-year) rates spike over 3%.



DIFFERENT PLAYBOOK FOR UK AND EU RATES

By comparison, UK and EU rates may be capped due to the limited capacity of the domestic economies to absorb higher financing costs. While the Bank of England (BoE) started the rate-hiking cycle before the Fed and the European Central Bank (ECB), the path may not be as aggressive.

BoE governor Andrew Bailey was brutally honest in May, acknowledging that record-high inflation will take its toll, especially on the consumer. The central bank is likely to raise rates towards 1.5% as a minimum this year, but may hesitate to hike into the next recession. The bond market will be torn between inflation and stagnation risks, leaving room for a wider range outcome for UK rates. By the end of the year, should growth risks translate into lower inflation, rates could decline again.

Eurozone growth seems equally challenged, but more from manufacturing being hit by worsening supply bottlenecks. That said, the ECB president, Christine Lagarde, has already prepared the market for rate hikes that are likely to start in July and continue until the end of the year. While the market is priced for more hikes, the central bank needs to keep an eye on financial conditions. Tighter financial conditions could be a problem, especially for Italy, for example.

Given the market is priced for several rate hikes, which has pushed the front-end of the curve well into positive territory, there seems to be an opportunity to lock in short-term positive yields.

HEADWIND FOR CREDIT MARKETS

Following rises in interest rates and wider spreads, yields appear more appealing in credit markets. But the risk for further spread widening, especially for higher beta issuers, remains high. Indeed, even after the move, most credit segments still trade close to their long-term average. Given the stage of the cycle and margin pressures facing cyclical issuers, this average pricing does not seem to be justified. Aggressive hikes, an unwinding of central bank bond purchases, and a weakening economy do not usually bode well for credit.

As we highlighted in our April *Market Perspectives*, spreads tend to widen at the end of a yield curve flattening cycle. As for the magnitude, US investment grade spreads are usually pushed towards 180bp during global recessions (in the absence of a crisis). While we don't see such an extreme scenario, it wouldn't be surprising to see wider spreads still, especially for higher beta issuers. This is why we think higher-quality bonds should perform better than those regarded as riskier alternatives.

FOCUS ON BOND MATURITY AND CREDIT QUALITY

In this context, shorter-dated investment grade bonds should provide the most stable returns, relative to high yield, emerging markets, or longer-duration bonds. We also take more comfort in the higher entry yields. The average investment grade yield for US bonds is 4.3%, according to the Bloomberg index. Apart from the pandemic peak (driven by spreads) and in 2018 (Fed U-turn), these yields were only achieved in 2010 (in the aftermath of the global financial crisis).

Despite the headwinds, especially for investment grade issuers, balance sheets remain healthy. Net debt to earnings before interest and amortisation, or Ebitda, has declined from 2020's peak, and interest coverage is still at high levels. In addition, established issuers have been able to extend their term funding during the depressed rate environment and cash levels are higher still.

BBB AND FINANCIALS IN FOCUS

These elements are evident in the increased credit supply observed year-to-date. While a defensive approach favouring non-cyclicals and financials appears preferable, in the absence of any sudden major stress, BBB-rated bonds are likely to deliver higher excess returns than A-rated bonds, in our opinion. Indeed, BBB issuers should maintain a more prudent balance sheet strategy, so as to avoid a downgrade while M&A risk could lead to higher supply risk within the A-rated bond segment.

EUROPEAN HIGH YIELD WITH MORE RISK

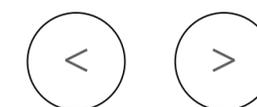
In Europe, margin pressures from higher input costs and lower growth, could get worse and so bargain hunting looks premature. However, investment grade bond spreads are becoming more appealing.

Interestingly, the ratio between European high yield and investment grade spreads is at historical lows (see chart, p25). Yet, unlike high yield, European investment grade bond spreads are at a 10-year high of 160bp (ignoring the early stages of the pandemic). Spreads for both segments have more potential to widen but this risk is significantly greater in high yield, in our opinion. As such, better entry points may arise later in the year.

"Unlike high yield, European investment grade bond spreads are at a 10-year high of 160bp (ignoring the early stages of the pandemic)"

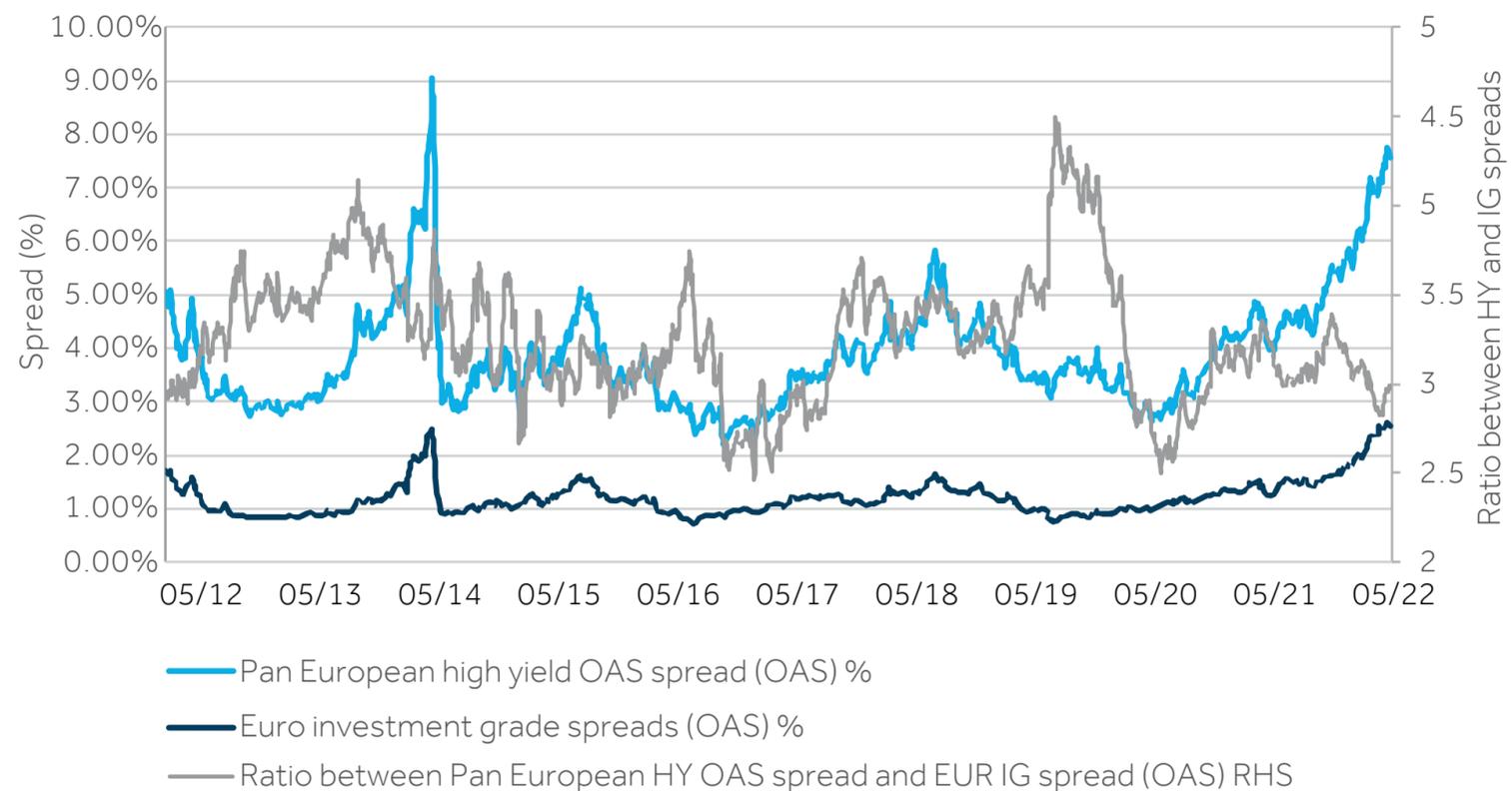
UK CORPORATE BONDS FACE LIQUIDITY CHALLENGES

Apart from the economic troubles, liquidity, or the lack of it, appears to be the biggest risk for UK corporate bonds. The BoE is to unwind its corporate bond holding of £20 billion, likely starting in September. Given the small size of the domestic corporate bond market, additional supply constraints could place additional upward pressure on spreads.



EUROPEAN INVESTMENT GRADE SPREADS AT LONG-TERM LOWS

Trends in European high yield (HY) and investment grade (IG) spreads plus the ratio between the two since 2012



Sources: Bloomberg, Barclays Private Bank, May 2022

NOT READY FOR HIGH YIELD YET

The average yield for US junk bonds, according to Bloomberg, stands at over 7.8%, a level last seen in June 2020. But an average spread of around 450bp does not seem appropriate in the current environment and given a combination of leverage risk and operational risk.

With higher yields, lower demand, and margin pressure on the horizon, we see upside risk to spreads. And while default rates have fallen to 2% for global speculative issuers, the rating agency Moody's expects rates to hit 2.7% by December and 3% by next April.

Meanwhile, the ratio of American and European distressed debt is still low in an historical context, even if it has risen of late. This is likely to increase, pressuring spreads more. Levels of 550bp or more, leading to yields of close to 9%, would offer much more attractive entry points.

FAVOUR BB-RATED BONDS

For now, we favour BB-rated bonds from less cyclical sectors in high yield or financial subordinated bonds. The ratio of potential fallen angels (investment grade issuers downgraded to high yield status) to potential rising stars (high yield issuers upgraded to investment grade status) is still falling, while the rate for rising stars is likely to climb to 11.9%, according to Moody's. This should provide a positive backdrop for this segment.

In summary, with the environment likely to remain tough for bond investors, a defensive portfolio positioning appears justified for the time being. That said, spread and yield opportunities will likely materialise in the second half of this year.

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

In search of an illiquidity premia harvest in private equity

Holding private equity investments can allow an illiquidity premium to be harvested, potentially boosting portfolio performance. But what exactly is the illiquidity premium and how can it be exploited? We explore historical estimates for this premium, analyse its trends over time, and discuss how best investors can incorporate private equity among their holdings.



The liquidity of a financial market helps oil the pace at which deals are made, the volumes that can be digested, and the spreads that are paid. Market liquidity is not a binary distinction. While public equities are traded every second, corporate bonds may be traded only daily, municipal bonds usually twice a year, and institutional real estate around every decade¹.

The value of liquidity is most apparent when it comes to buying or selling an asset. For instance, in illiquid markets, a sale may incur high search costs (to find a buyer), transaction costs, and the trade itself could hit the price. A tightening of financial conditions would exacerbate all these issues and make selling illiquid assets in distressed markets a very poor choice. It is for these reasons that investors can demand an illiquidity premium for holding such assets. In other words: they get rewarded for providing liquidity to an illiquid market.

There are several ways to obtain the premium. You could invest in inherently illiquid assets, like real estate or private market funds; focus on illiquid parts of broader markets, such as less liquid bonds; act as a market maker; or simply rebalance your diversified portfolio frequently, which provides liquidity to sought-after assets and absorbs liquidity for assets that recently sold off.

In the remainder of this article we focus on the illiquidity premia harvested from private equity (PE) funds. This includes looking at how to measure such premia, analyse changes in them over time, and address volatility in conjunction with liquidity.

PRIVATE EQUITY: MORE THAN JUST ILLIQUID STOCKS

Private equity funds, by virtue of their complex capital commitment and distribution structure, are difficult to trade and may merit an illiquidity premium. Viewing them as an illiquid alternative to publicly-traded equity indices would, however, be flawed. Private equity funds also require closer attention to managing portfolio liquidity and pose more idiosyncratic risk than broad equity indices – making them suitable for sophisticated investors only.

Unfortunately, measuring liquidity premia from private equity is not straightforward. The difficulty arises from the irregularity of capital calls and then profit distributions that require a portfolio around any private equity investment to first provide, and later absorb, liquidity.

¹ Portfolio choice with illiquid assets, Papanikolaou & Westerfield, Management Science 60, 2014 <https://www.nber.org/papers/w19436>

THE CHALLENGE OF MEASURING ILLIQUIDITY PREMIA IN PRIVATE EQUITY

Traditional metrics, such as total return (price return and dividends), are not appropriate when applied to private equity in this instance. Instead, the world of private markets has created return-like measures, such as the internal rate of return, distribution versus called-capital multiples, as well as so-called public market equivalents. These measures, (see box-out) can be applied when comparing funds. That said, they are less useful when comparing private- and publicly-listed assets.

The closest metric to a total return index would be quarterly appraisal-based indices, such as the one calculated by data provider Prequin. Their quarterly indices combine data on actual capital flows with periodic fund manager appraisals of the remaining value in their fund. This allows the quarterly changes in the value of a fund to be computed. Aggregating this across PE fund vintages, yields one single total-return mimicking index.

In comparing the Prequin index with total return indices from public markets, two implicit assumptions are needed: private equity money is never idle and fund manager appraisals always reflect the "fair" value of the fund. This highlights a couple of important caveats to our findings: first, in order for the no-idle-money assumption to become less problematic, investments need to be staggered across several vintages, such that capital calls and distributions can start to cancel each other out.

Second, agency issues are likely to be larger than in public markets, where reporting standards are higher and investments are potentially open-ended, instead of time-limited to ten to fifteen years.

PE PERFORMANCE METRICS

The internal rate of return (IRR) is a widely used measure that takes into account all capital calls and distributions, and determines the discount rate of future profits (distributions minus calls) that would make an investor indifferent as to whether to buy the fund or not. While capturing the time-aspect of PE investments, the IRR has two well-known drawbacks: it assumes cash-flows received can be reinvested at the same rate of return and it can easily be manipulated by making some cash distributions early on.

Multiples are easy to work out by dividing the sum of distributions by the sum of called capital. Unfortunately, the timing of these transactions is not considered, which makes this measure meaningless for time-aware investors.

Public market equivalents (PMEs) are a more recent addition, introduced by Steven Kaplan and Antoinette Schoar in 2005. They tackle shortcomings of IRR and multiples by discounting future cash flows and capital calls with an investable public market index. In mixing private and public market measures, PMEs implicitly assume that capital calls and distributions face the same volatility as public markets. For PMEs to be instructive, the choice of public market benchmark is important. In our analysis we match geographical focus while controlling for sectoral exposure as much as possible.

CHOICE OF BENCHMARK IS KEY

By comparing annualised total returns from liquid benchmarks with constructed return-like indices from Prequin, we arrive at an initial estimate of the average liquidity premium of 2% to 4% for buyout funds and 3% to 5% for the riskier early-stage venture capital funds, between 2007 and 2021 (see table).

These figures are in line with several academic and financial industry reports² and also happen to be similar to estimates from Ang in 2014 that an investor should require a return of 4% to 6%, in order to lock up capital for a maximum of 10 years.

The choice of benchmark is important, as not all return differences can be attributed to the illiquid nature of PE vehicles. For buyout funds, which make up the largest portion of the private equity universe, their target firms tend to have smaller capitalisations. Therefore, benchmarking them against the S&P 500 would be inappropriate. Also, geographical matching matters, as returns have tended to be higher in US equity markets than in European ones this century.

Private equity: 2007-2021 average illiquidity premium				
	Buyout funds	Venture capital funds (early stage)	MSCI World Small Cap	Russell 3000
Annualised "return"	12%	13.5%	8.2%	10.3%
Premium vs Russell 3000	2%	3.2%		
Premium vs MSCI World Small Cap	4%	5.3%		

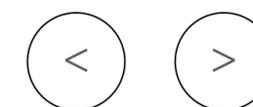
Sources: Prequin, Bloomberg, Barclays Private Bank, September 2021

ILLIQUIDITY PREMIA TRENDING DOWN

To understand more about how changes in illiquidity premia behave over time, we want to control for size, geographical, and sectoral exposures as much as possible. However, appraisal-based valuations are much less volatile than market-based ones, which makes a quarter-by-quarter comparison futile.

As such, we now turn to public market equivalents (PMEs). These discount all capital calls and profit distributions that occur during a fund's lifetime to the inception date, using a chosen public market benchmark. PMEs larger than unity (see chart) suggest that investing in the fund would have been more profitable than investing in the public asset. While not allowing an absolute comparison of returns to be made, some lessons can still be learnt about the changes in the size of the premium.

² See the following reports: Demystifying Illiquid Assets: Expected Returns for Private Equity, Illmanen, Chandra & McQuinn, 2020 <https://www.aqr.com/Insights/Research/White-Papers/Demystifying-Illiquid-Assets-Expected-Returns-for-Private-Equity>; Assessing Risk of Private Equity: What's the Proxy?, Coupe, 2016 http://caia.org/sites/default/files/AIAR_Q3_2016_04_PrivateEquity.pdf

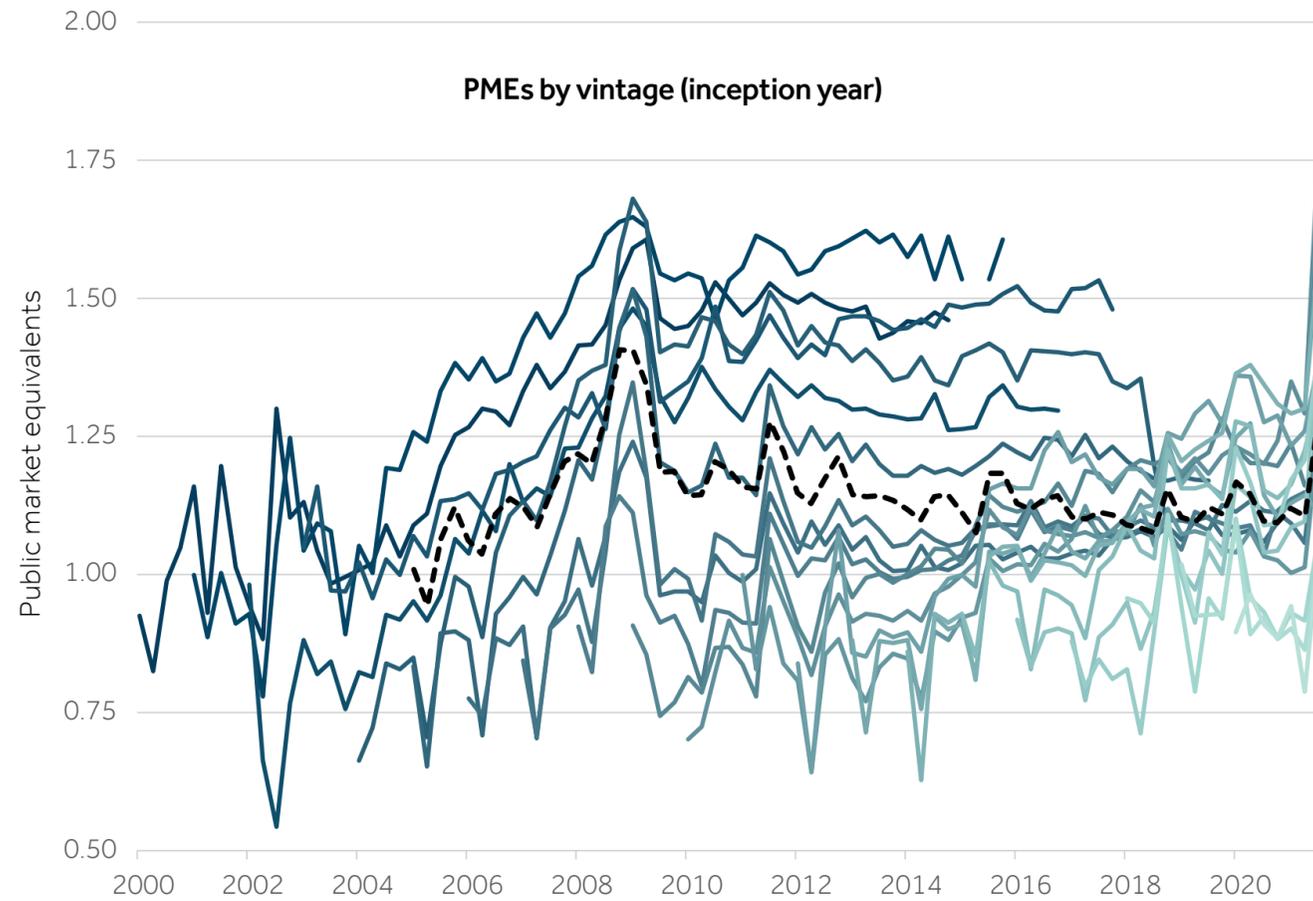


In the left panel (see chart) we display PME by vintage, where we run each vintage for a maximum of 15 years (not all funds are closed after 15 years). The best vintages in the last two decades have been those with inceptions early in the millennium, which ended up with PMEs that were mostly between 1.25 and 1.50. Only more recently have young vintages

emerged with a PME of above 1.25 again. Looking at the simple average across active vintages, the illiquidity premium appears to have come down since the global financial crisis, in 2008, and could be growing again with the latest vintages.

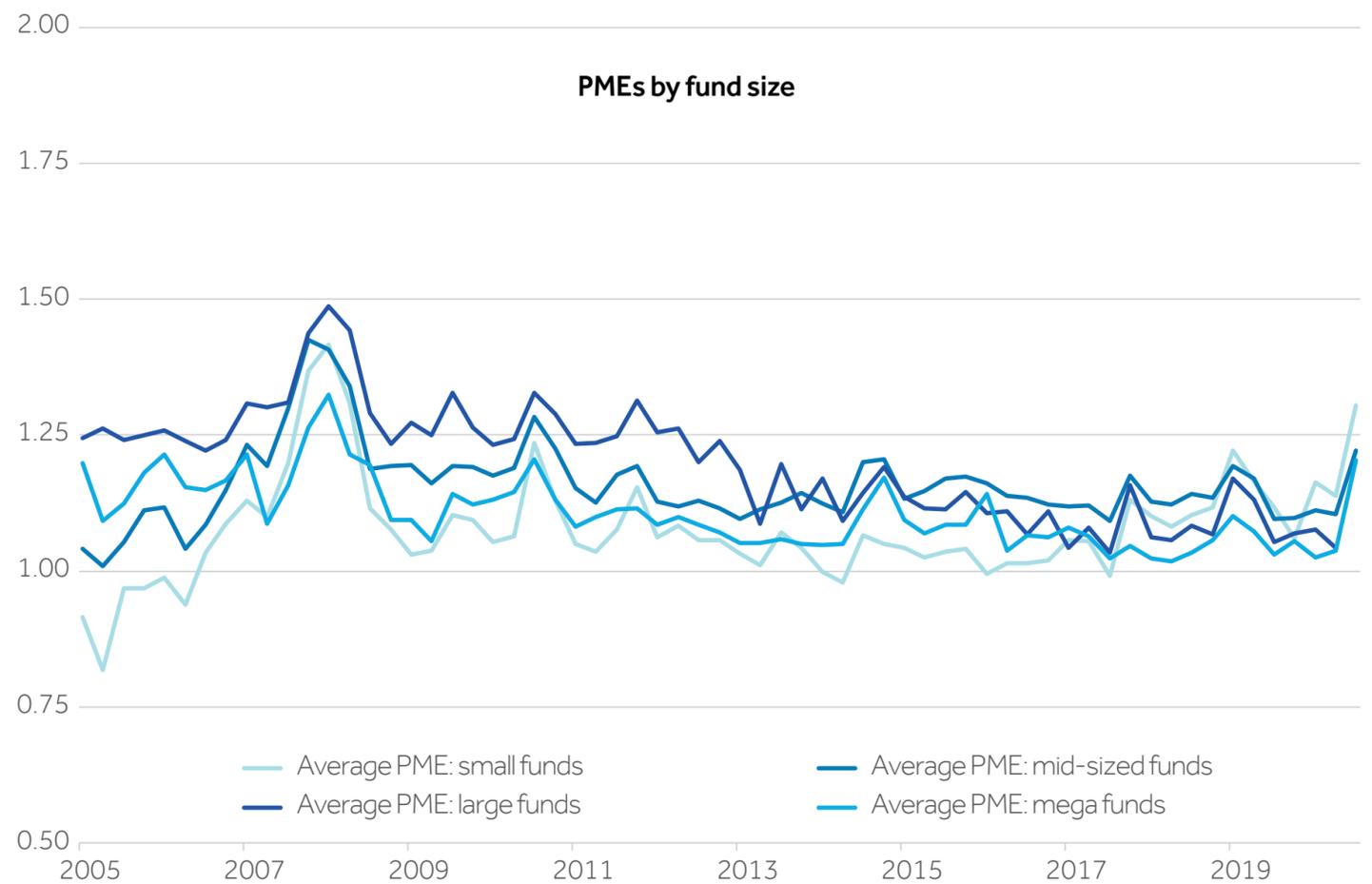
BUYOUT FUNDS READY TO SHAKE OFF A WEAK DECADE

Median public market equivalents for North American buyout funds, using the Russell 3000 as a public benchmark

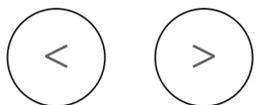


Note: Dark colours reflect older vintages starting from 2000, lightest colour reflects 2021 vintage. Data from 2000 Q1 to 2021 Q3. Dashed line: simple average across vintages

Sources: OECD National Accounts, Barclays Private Bank, April 2022



Note: Average PME across vintage medians by fund size from 2005 to third quarter of 2020. Small funds - ≤ \$500 million, mid-sized funds - ≤ \$1.5 billion, large funds - ≤ \$4.5 billion, mega funds - over \$4.5 billion



AVOIDING MYOPIC INVESTOR DECISIONS

Looking at the average PME (dashed line) we find the typical outperformance of private markets occurs during abrupt market sell-offs. If nobody can sell their investments easily, a self-fulfilling sell-off is much less likely. Moreover, the time right after such a crisis usually offers juicy acquisition targets for buyout funds.

THE MEDIAN FUND MAY STILL NOT CUT IT

As final PMEs are solely based on public market data and actual cash flow transactions, there is less to worry about when it comes to manager appraisal methods diluting our results. However, we assume that capital calls, distributions, and the public benchmark share the same risk.

This is problematic, as returns from a fund with 10 investments are likely to be more volatile than those from an index consisting of 3,000 constituents. Furthermore, part of the capital called is management fees, which represents risk-free liabilities. Taking this into account, Sorensen and others³ notch up the discount factor for capital distributions, given its increased riskiness, and find that depending on the co-movement of the fund with the index, PMEs should be at least 1.2, if not higher, to breakeven versus public stock markets.

With this in mind, the median performance of North American buyout funds over the last decade looks much less appealing. This brings us to the enigma of fund manager performance in private equity, where an often cited study by Kaplan and Schoar suggests that "top quartile" managers outperform the rest with some persistence, and every fund manager wants to be in the top quartile. Likewise, investors want to fill their portfolio with top-quartile funds.

EXPERIENCE HELPS WHEN SELECTING MANAGERS

The less regulated nature of private market reporting complicates sorting the wheat from the chaff in fund manager selection. So we rely on Prequin's own quartile ranking, which assigns funds, by vintage and category, a rank for every reporting period. We then source all reported investments into buyout funds by the 20 most experienced fund investors across all investor groups, as well as the five most experienced for each of the following: public pension fund, private pension fund, sovereign wealth fund, fund of funds, and single family office.

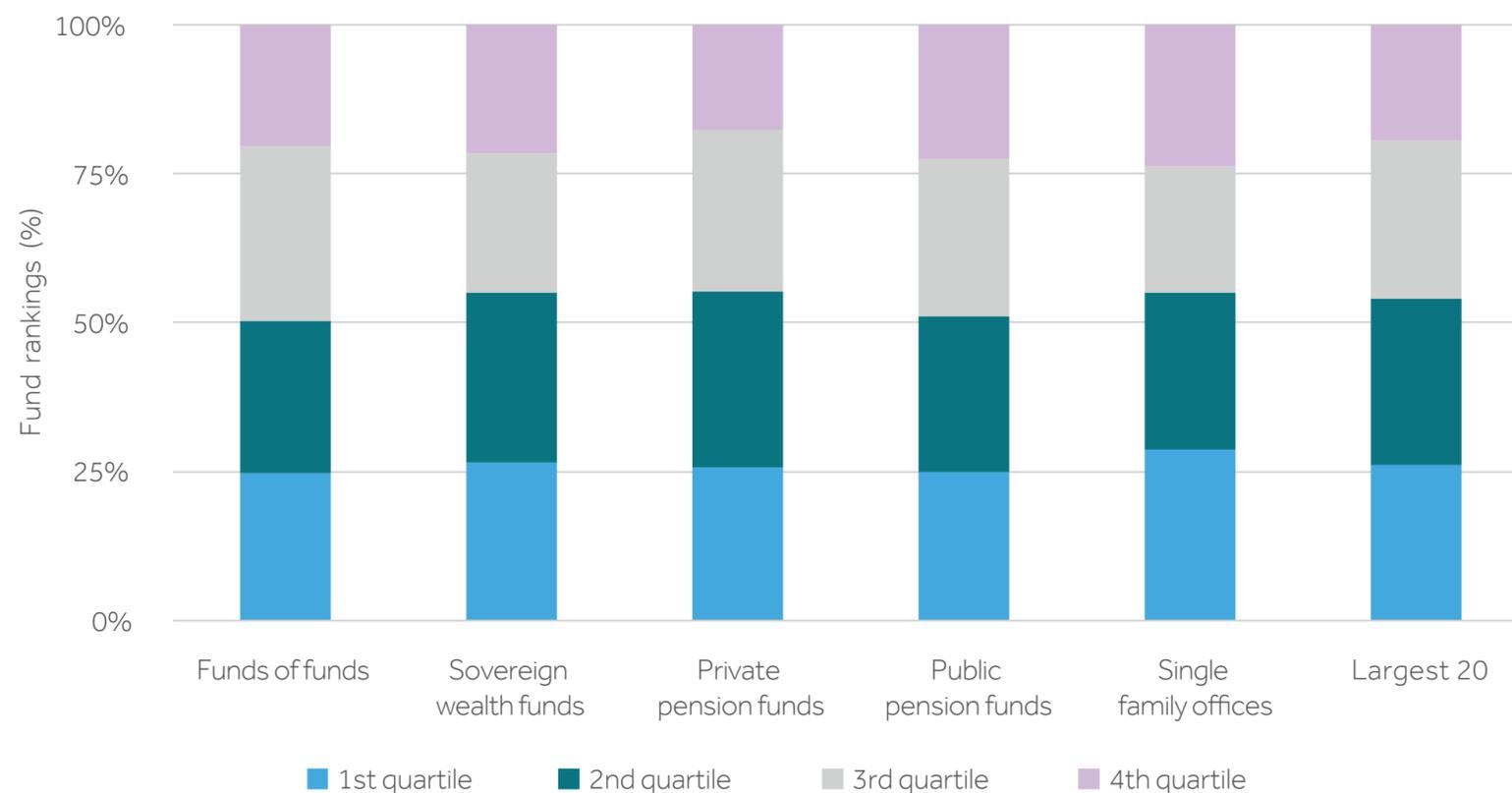
By experience, we mean the number of active and past fund investments. Public pension funds make up most of the top 20 most experienced fund investors. Between them they have reported investments in around 5,400 funds since 1980. As such, we deem it less likely that they selectively reported investments which could bias the results.

Looking at the most recent quartile ranking for each fund, we can then gauge the ability of very experienced investors to cherry-pick first-quartile funds. The good news is that all investor types have invested in what turned out to be first-quartile funds at least 25% of the time (see chart). The bad news is that those who picked first-quartile funds most often, also pick fourth-quartile funds more than 20% of the time.

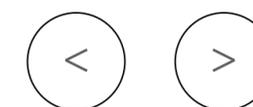
³Valuing private equity, Sorensen, Wang & Yang, Review of Financial Studies 27, 2014 <https://www.nber.org/papers/w19612>.

EXPERIENCED INVESTORS SELECT FIRST-QUARTILE FUNDS 25%-29% OF THE TIME

Distribution of the most recent Prequin quartile rankings, for all funds invested in by the top five of each investor type and the top 20 overall



Sources: Prequin, Barclays Private Bank, September 2021

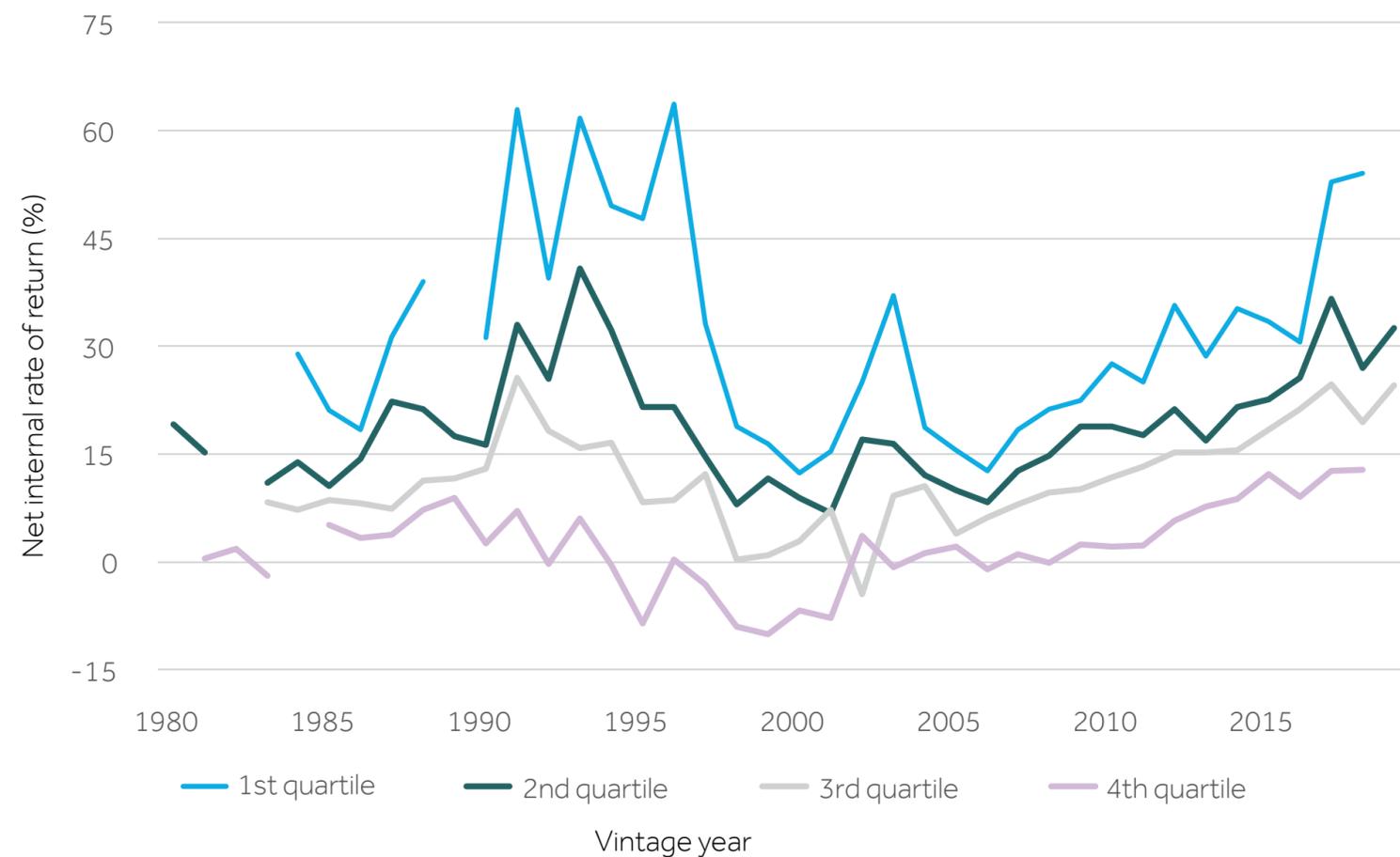


TOP-QUARTILE FUNDS MAY YIELD AN ILLIQUIDITY PREMIUM

Ideally, we would report PME for each quartile in this sample of experienced investors. Unfortunately, the data are not available, which may be down to reporting being mostly voluntary. Therefore, we have to rely on less robust metrics to gauge the difference in the performance across quartiles.

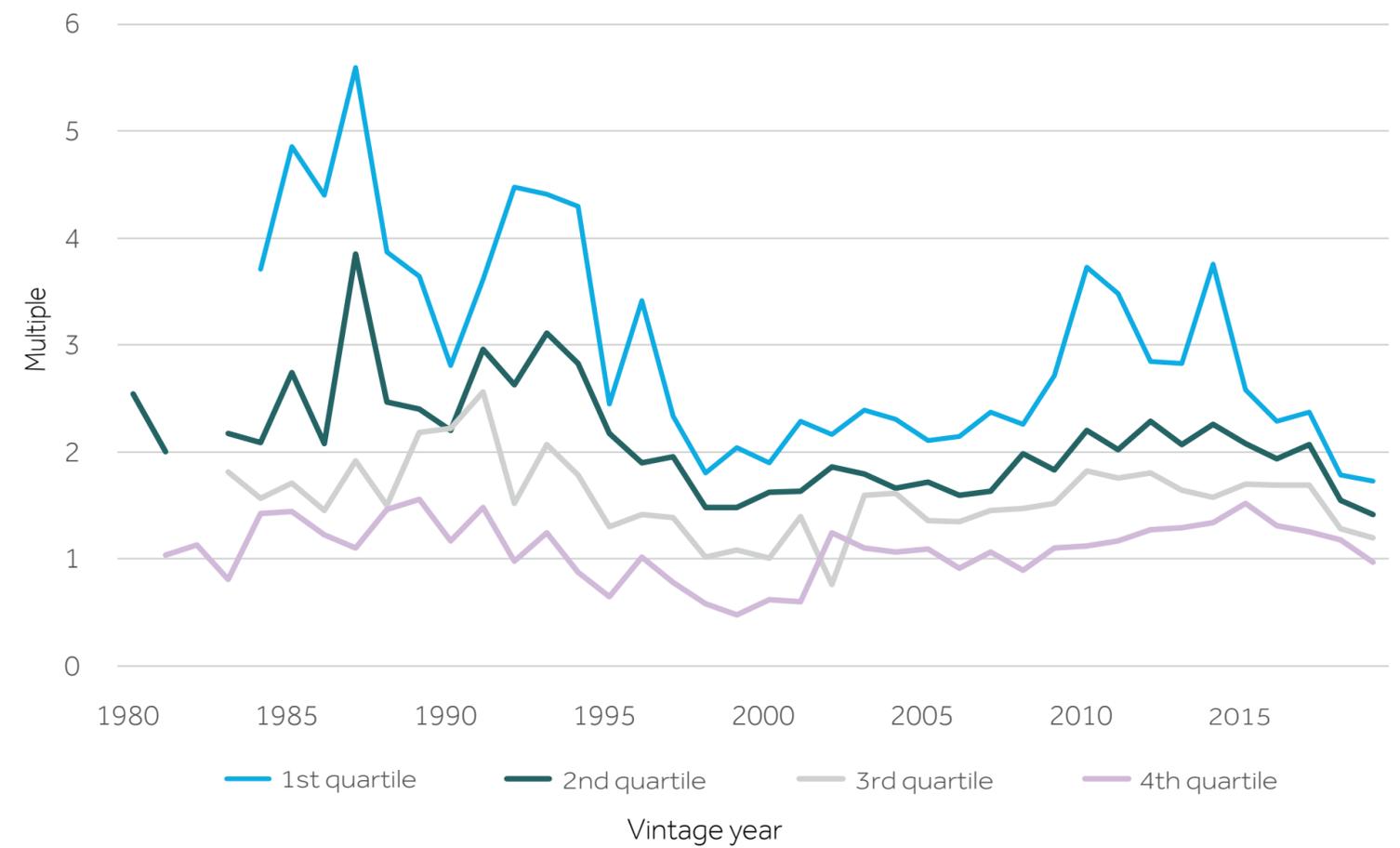
LARGE DISPERSION IN FUND PERFORMANCE

Mean IRR net of fees and capital distributions/calls multiples by Prequin quartile rank for funds, by 20 most experienced buyout fund investors

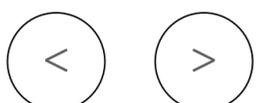


The next chart depicts the internal rate of return net of fees and raw multiples for the (global) buyout funds reported by the 20 most experienced investors. Imagining the median fund to lie somewhere between the mean of the second and the third quartile, it is safe to say that first-quartile funds have – across all vintages – bested the median quite significantly.

For the nineties' vintages, second-quartile funds also outperformed third-quartile funds significantly enough that it is safe to assume that they harvested an illiquidity premium. During the 2010s the case is less clear. For fourth-quartile funds, it is already transparent from raw multiples that investing in a public index would have made the investor better off.



Sources: Prequin, Barclays Private Bank, September 2021

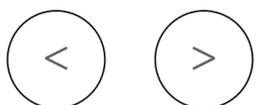


INVESTOR EXPERIENCE IS VERY IDIOSYNCRATIC

The big dispersion in PE fund performance reminds us that the illiquidity premium is a theoretical concept, not a guaranteed payoff. This has two practical implications for investors, the need to diversify across vintages and focus on the fund selection process.

That said, for an investor considering a PE investment, harvesting an illiquidity premium is only one out of many reasons to consider the asset class. For instance, as we touched on in May's [Market Perspectives](#), from a behavioral standpoint: the illiquidity in PE may prevent panic-selling decisions.

Author: Lukas Gehrig, Zurich Switzerland, Quantitative Strategist



European energy transition: from policy to portfolio

What are the implications for investors of the continued, and even increased, support from UK and EU governments for renewable energy?



Decarbonising the global energy system by 2050 is a mammoth undertaking – and a market opportunity.

For investors with shorter-time horizons, even interim 2030 targets seem equally immense. Recent analysis from the International Renewable Energy Agency estimates that \$5.7 trillion of investment in renewables is needed per year until 2030. This would amplify the percentage of renewables to around 40% of energy produced a year from around 14% today¹. Through a different lens, to reach the International Panel on Climate Change recommendations on renewable power, global additions of renewable power would need to triple by 2030².

With the rapid rise in fossil fuel prices in advance of, and exacerbated by, the war in Ukraine, the feasibility of this transition has been brought into question.

As reviewed in May's *Market Perspectives*, European governments have responded by adapting and accelerating their energy transition plans. At the start of the year, their primary focus had been to reduce their energy sector's greenhouse gas emissions to meet their Paris Agreement commitments. Now they are seeking to address simultaneous dilemmas of affordability, security, and sustainability.

Even with the current market challenges, renewable energy remains firmly embedded in their thinking. Thus, the conclusion was that while the journey to a decarbonised energy system may be different than before, the destination and ambition remains the same.

But what do the amendments and accelerations mean for specific renewable energy sources, and for investors?

In this article, we review the trajectory of four of the main energy sources referenced in the EU and UK proposals – offshore wind, onshore wind, hydrogen, and nuclear – to assess what opportunities might lie ahead for investors.

ELECTRICITY PRODUCTION FROM RENEWABLES ALREADY EXCEEDS FOSSIL FUELS IN EUROPE

To answer the above question, we start by considering the current proportion of renewables, as well as the mix of low carbon energy sources.

Across the EU, renewables averaged 39% of energy produced in 2020, with fossil fuels contributing 36% and nuclear 25%³. Within renewable sources, 14% came from wind, 13% hydropower, 6% biofuels and 5% solar. But these averages hide a wide variation across the 27 countries in both percentages of renewable and the mix of sources.

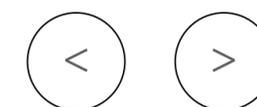
By comparison, during the fourth-quarter of 2021, about 43% of UK energy generation came from renewables (see chart, p33). The breakdown is roughly 13% bioenergy, 14% offshore wind, 12% onshore wind, 2% solar, and 2% hydro. By adding the 15% from nuclear, we can calculate that “low carbon” sources generated 58% of total energy production⁴.

¹ Energy transition holds key to tackle global energy and climate crisis; IRENA, 29 March 2022 <https://www.irena.org/newsroom/pressreleases/2022/Mar/Energy-Transition-Holds-Key-to-Tackle-Global-Energy-and-Climate-Crisis>

² Energy transition holds key to tackle global energy and climate crisis; IRENA, 29 March 2022 <https://www.irena.org/newsroom/pressreleases/2022/Mar/Energy-Transition-Holds-Key-to-Tackle-Global-Energy-and-Climate-Crisis>

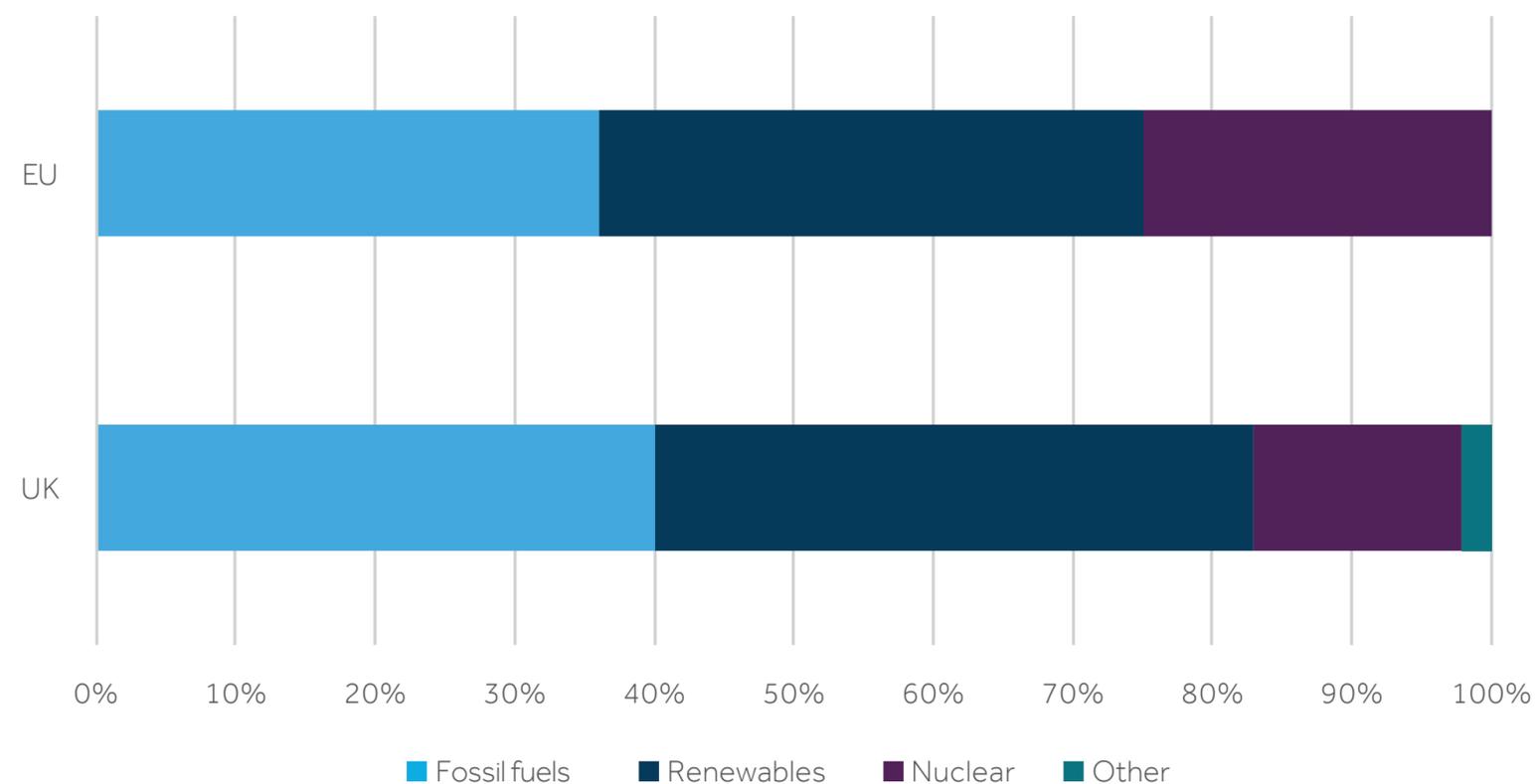
³ Shedding light on energy in the EU, 2022 Interactive edition, May 2022 <https://ec.europa.eu/eurostat/cache/infographs/energy/>

⁴ BEIS, Energy Trends, 31 March 2022 <https://www.gov.uk/government/statistics/electricity-section-5-energy-trends>



SHARE OF ELECTRICITY GENERATED BY TYPE

Analysis of the electricity produced in the EU (2020) and UK (Q4, 2021) by fuel type



Sources: Barclays Analysis; UK BEIS, Energy Trends, March 2022; Eurostat, Complete Energy Balances, January 2022

⁵ Onshore and offshore wind, European Commission, May 2022 https://energy.ec.europa.eu/topics/renewable-energy/onshore-and-offshore-wind_en

⁶ A European Green Deal, European Commission, May 2022 https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

⁷ <https://windeurope.org/intelligence-platform/product/wind-energy-in-europe-2021-statistics-and-the-outlook-for-2022-2026/>

⁸ Wind energy statistics, RenewableUK, May 2022 <https://www.renewableuk.com/page/UKWEDhome>

⁹ Onshore vs offshore energy: what's the difference?, nationalgrid, May 2022 <https://www.nationalgrid.com/stories/energy-explained/onshore-vs-offshore-wind-energy>

¹⁰ Onshore vs offshore energy: what's the difference?, nationalgrid, May 2022 <https://www.nationalgrid.com/stories/energy-explained/onshore-vs-offshore-wind-energy>

¹¹ Wind energy statistics, RenewableUK, May 2022 <https://www.renewableuk.com/page/UKWEDhome>

¹² Wind energy in Europe: 2021 statistics and the outlook for 2022-2026, 24 February 2022 <https://windeurope.org/intelligence-platform/product/wind-energy-in-europe-2021-statistics-and-the-outlook-for-2022-2026/>

Comparing the mix of energy sources, the differences in the approaches and aims of the two governments begin to come into focus. We now review the primary energy sources that were particularly highlighted in the recent UK and EU plans.

EUROPEAN LEADERSHIP IN OFFSHORE WIND ENERGY

Europe is a leader in generating offshore wind energy, as well in the associated industrial sectors. Since building the first offshore windfarm in 1991 in Denmark, the scale and generative capacity have increased, while costs have fallen.

Currently, the EU has 16 gigawatts (GW) of offshore wind capacity⁵. The EU Green New Deal pushes for installed capacity of at least 60 GW by 2030, and 300 GW by 2050. Additionally, it targets at least 1 GW of ocean or floating wind by 2030, rising to 40 GW by 2050⁶. However, recently offshore installed capacity has been subdued with only approximately 1 GW added in 2021, between Denmark and the Netherlands⁷.

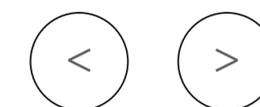
Until recently, with 10.5 megawatt (MW), the UK had more installed offshore wind capacity than any other nation⁸. Later this year, Hornsea Phase 2 will open as the largest offshore wind farm in the world, adding another 1.3 GW to UK capacity⁹ and moving the country towards its target to reach offshore wind energy production of 50 GW by 2030.

For investors, offshore wind is an established, though continually improving, industry. The scale of intended growth across European markets (275% in EU and 380% in UK by 2030) demonstrates its market potential across the lifecycle of construction, manufacturing, and operations, as well as the supply chain. For those looking for earlier stage opportunities, floating wind farms offer the next generation technology to be developed, commercialised, and scaled during this period.

ONSHORE WIND ENERGY FACES ADMINISTRATIVE HEADWINDS

Compared with offshore wind, onshore wind offers lower costs and wider installation, but a more complex and lengthy permitting process. Onshore wind also has a lower capacity factor (so on average it generates less energy per turbine) than offshore counterparts (ranging from 50-300% more MW), due to more variable wind conditions and smaller turbines¹⁰.

There are more than 2,500 operational onshore wind farms, with a total capacity of 14.2 GW, in the UK¹¹. However, growth has slowed considerably since 2017 when the government established three-part approval, which effectively stopped most new capacity addition. As a result, the UK only added 0.3 GW of onshore energy in 2021 for example¹².



One barrier was removed in 2021 to allow windfarms to bid to supply electricity to the grid again. The others are not addressed by "wholesale changes" in the new strategy. Instead, it only opened the opportunity for consultation with local communities wishing to bring forward new projects¹³.

The EU added 11 GW of onshore wind capacity to reach 173 GW at the end of last year¹⁴. However, as WindEurope has analysed, this is less than half of what is needed to stay on track under its 'Fit for 55' package¹⁵. So rather than setting new or additional targets, the EU's REPowerEU strategy added explicit plans to accelerate the permitting process to reduce the cost, complexity, and time to add existing planned capacity.

For investors, onshore wind shares a similar technological foundation to offshore, and the current cost issues around commodity and input prices, and supply-chain disruption. But the permitting process remains a central challenge to expand capacity. However, given installed costs are considerably lower¹⁶, if proposed governmental amendments to permitting are successful, industry growth could rapidly accelerate, making it a much more attractive market (see chart).

THE NUCLEAR ENERGY OPTION

Nuclear power, while not renewable, is a low-carbon solution. It's also seen as a generator of continuous energy with lower operating costs. On the other hand, it has very high capital costs and long lead times, as well as significant environmental effects and risks of disasters. Whether nuclear should form part of the future energy mix flips by each market, based on dimensions of economic, geopolitical, and familiarity.

Currently, nuclear power provides around 15% of the UK's electricity supply from 11 operating reactors. As part of the UK's energy security strategy, the government aims to produce up to 24 GW by 2050. Importantly, the strategy's wording presents "an ambition" with no overall plans for 2030, or 2050; and no site is prepared to move forward yet.

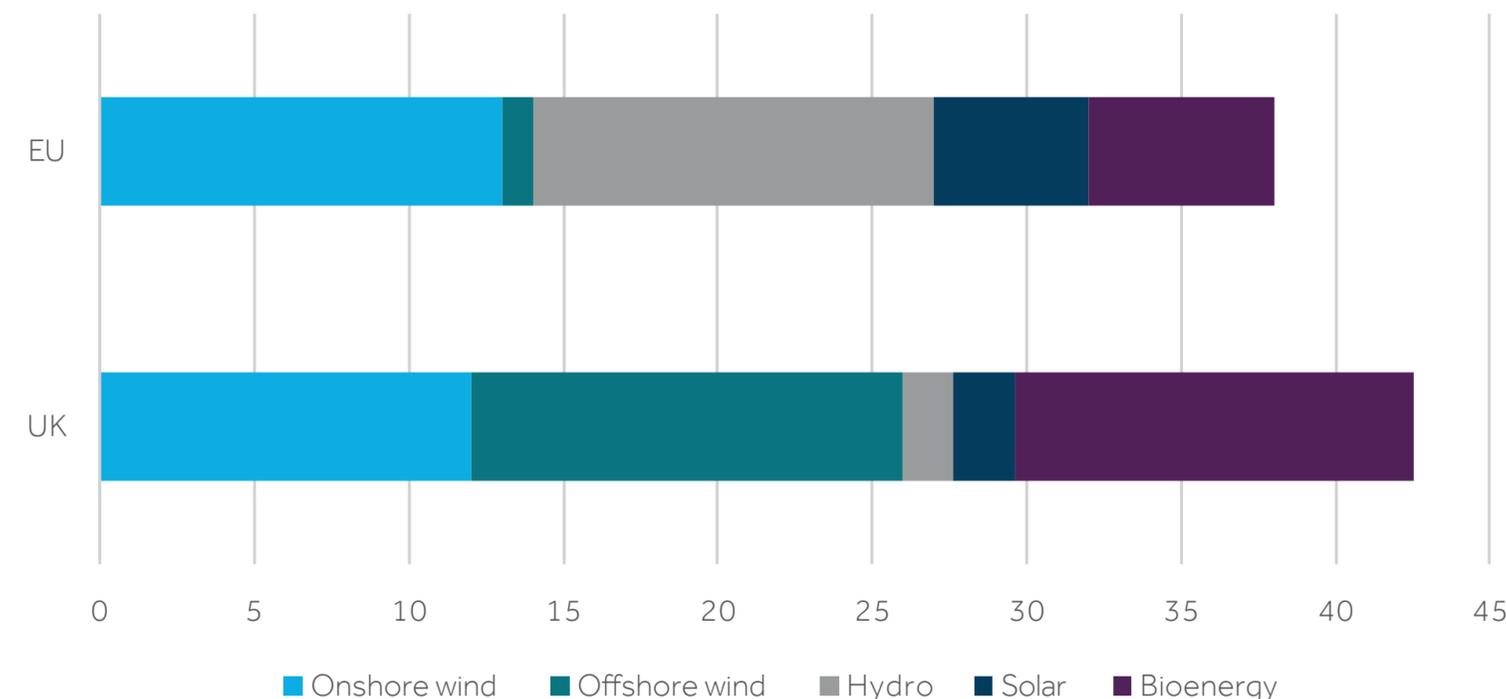
EXECUTION CHALLENGES FOR NUCLEAR

Consider these ambitions in light of the current, and only, new site under construction in the UK, Hinkley Point C, which has been delayed and is massively over budget. Costs are estimated to be between £25-26 billion, up to £8 billion more than originally estimated when approved in 2016, and completion is not expected until 2027.

In comparison, the EU has 103 nuclear power reactors, across 13 states, producing about one-quarter of the electricity generated (100 GW) in the bloc. France alone produced over half of the area's nuclear electricity¹⁷. Neither the EU Green Deal nor the REPowerEU plans include targets for nuclear energy. However, the proposed Green Taxonomy, controversially, has included nuclear as a sustainable economic activity, splitting views across Europe – most significantly between France and Germany.

MIX OF RENEWABLES IN ENERGY PRODUCTION (IN GW)

EU and UK energy produced by renewables, by type



Sources: Barclays Analysis; UK BEIS, Energy Trends, March 2022; Eurostat, Complete Energy Balances, January 2022

¹³ British energy security strategy, HM Government, 7 April 2022 <https://www.gov.uk/government/publications/british-energy-security-strategy/british-energy-security-strategy>

¹⁴ <https://windeurope.org/intelligence-platform/product/wind-energy-in-europe-2021-statistics-and-the-outlook-for-2022-2026/>

¹⁵ Wind energy in Europe: 2021 statistics and the outlook for 2022-2026, 24 February 2022 <https://windeurope.org/intelligence-platform/product/wind-energy-in-europe-2021-statistics-and-the-outlook-for-2022-2026/>

¹⁶ IRENA calculates global average installation costs in 2020 for offshore wind were \$3,185/kW vs for onshore wind \$1,349/kW

¹⁷ Nuclear power in the European Union, World Nuclear Association, 22 March 2022 <https://www.world-nuclear.org/information-library/country-profiles/others/european-union.aspx>

The Taxonomy proposes notable restrictions and conditions in order to characterise a nuclear project as sustainable. These, for example, include the use of accident tolerant fuel for all reactors by 2025 and that a high-level waste repository would need to be operational by 2050 (which could be a challenge, as, for example, Spain began its effort in the 1980s and a site is unlikely to open until 2068)¹⁸. Whether any nuclear site in practice can be labelled as sustainable remains unclear.

For investors, large-scale nuclear is an uncertain opportunity given long lead times and considerable execution risks. Similar to Hinkley Point, the Flamanville 3 plant in France is more than a decade behind its original schedule and quadruple its original costs¹⁹.

A SMALLER EMERGING ALTERNATIVE

Small modular reactors (SMRs) are being proposed to address some of the above issues. However, they remain an emerging technology. The first SMRs will potentially be operational in the next ten years, and seem unlikely to be competitive on cost with large reactors for another 20 years.

Overall, while nuclear has considerable advantages for energy production, it may be difficult for investors to access financially and, perhaps more importantly, environmentally, as its radioactive waste is unsustainable.

HYDROGEN AS THE NEXT GENERATION ENERGY TECHNOLOGY

Foremost, it's important to recognise that hydrogen is not a direct source of energy, rather it serves as an energy carrier, feedstock, or means for energy storage. While abundant at an elemental level, hydrogen needs another source of energy to extract it before it can then be used for electricity production (or other applications).

This energy source, and associated process, determines both the economic and environmental value of the gas. To simplify, different hydrogen processes have been classified into colour categories:

- Most hydrogen today is produced from natural gas which is considered "grey" hydrogen
- "Blue" hydrogen is still made from natural gas, but the CO₂ emitted is captured and stored or reused, thereby lowering emissions
- "Brown/black" hydrogen is produced using coal, though sometimes it also refers to hydrogen produced through gasification
- Finally, "green" hydrogen is produced from using renewable energy sources, which relies on either dedicated renewables capacity or production during peak periods when excess energy is generated.

EU AND UK TARGETS

Both the EU and the UK feature low-carbon hydrogen, or blue and/or green, as a central pillar in their energy transition. However, the challenge is to rapidly ramp up production of this energy source, when it isn't generated at scale at the moment.

The UK first proposed generating 5 GW of low-carbon hydrogen by 2030 in its Ten Point Plan for a Green Industrial Revolution in 2020²⁰. In April, the energy security strategy doubled the UK's target to up to 10 GW by 2030.

The EU has followed a similar path of starting, and then rapidly scaling, its hydrogen plans. In 2020, its strategy set out a target to install at least 6 GW of renewable hydrogen electrolyzers by 2024, and 40 GW by 2030.

The EU's RePowerEU plan now extends the original target to produce 5 million tonnes (mt) of hydrogen by 2030, with an additional 15mt, of which 5mt is to be produced in the EU and 10mt is to be imported. While there is substantial support, the EU has added the requirement that the renewable energy sourced for green hydrogen is additional to existing renewable installations. This means either having specific renewable sites for hydrogen, or excess power from existing renewables that would not have otherwise been used, which could slow adoption.

For investors, hydrogen represents an opportunity to be involved in a next-generation technology with considerable governmental support. While it is an early-stage and rapidly developing field, it also faces technology and execution risks as well as high capital costs to build and scale plants.

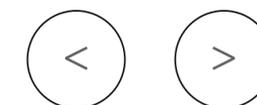
A BRIGHT FUTURE

Based on the UK and EU governmental ambitions for all four energy sources reviewed, these markets could grow rapidly. And while a gap always exists between government ambitions and real-world activity, there is much scope for the private sector to mobilise its capital and entrepreneurial aspirations.

Beyond the sources highlighted above, solar, hydro, and bioenergy also contribute to energy generation. Also, emerging forms of renewable energy, such as ocean (tidal and wave) and geothermal, are providing innovative options for investors. Moreover, to manage the peaks and troughs of demand, energy storage will be required – through batteries and other large-scale energy storage technologies – opening up opportunities in adjacent industries.

Overall, energy transition provides a wide range of entry points, in both stage and types of investment. To some extent, how to invest will depend on how you believe policymakers will effectively address our energy needs. However, investors should look beyond the current reliance and performance of fossil fuel assets. The world will be increasingly powered by renewables; so long-term investors should consider how they might be incorporated in their portfolio.

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



¹⁸ Amid energy crisis, EU fights over whether nuclear is green, Foreign Policy, 13 January 2022 <https://foreignpolicy.com/2022/01/13/nuclear-energy-green-europe-eu-climate/>

¹⁹ EDP announces new delay and higher costs for Flamanville 3 plant, Reuters, 12 January 2022 <https://www.reuters.com/business/energy/edf-announces-new-delay-higher-costs-flamanville-3-reactor-2022-01-12/>

²⁰ The ten point plan for a green industrial revolution, HM Government, 18 November 2020 <https://www.gov.uk/government/publications/the-ten-point-plan-for-a-green-industrial-revolution>

Sticking to the plan

With uncertainty abounding and traditional allocations to equities and bonds struggling to produce desired returns, investors may need to adapt their approach. However, an optimal allocation is only optimal if it is adhered to. We discuss ways to stick to the plan when markets become trickier to navigate.



Investors may need to change how they allocate portfolios in response to the prospect of more muted returns, for example, by perhaps considering allocating to [illiquid assets](#).

However, an optimal asset allocation is only optimal if it is adhered to, across the market cycle. Investors that deviate from their allocations – for example by increasing portfolio turnover in response to uncertainty – can find that they negatively impact their portfolio returns.

In this article, we examine key reasons why investors deviate from the most appropriate asset allocation for them, and discuss ways to stick to your plan even if bumpy markets test your resolve.

HOW DO INVESTORS TEND TO DEVIATE?

The global economy is facing a range of headwinds that have seen sharp falls in many markets this year. Investors aiming to invest more can hold off doing so during particularly volatile periods. For those already invested, actions may typically include reducing the proportion of risk assets in a portfolio, or in extreme cases selling their investments.

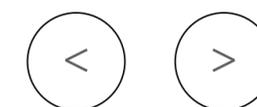
For many investors who want to act in tough times, market timing can look appealing. If an investor believes that the market outlook may worsen, then why not sell and get back in at a lower entry point? The problem is that timing is extremely difficult and its only with hindsight that you guarantee success.

In reality, many investors see markets move against them when they are out of them and then return at higher entry points. Alternatively, they may struggle to be comfortable with redeploying capital (to get a better entry point, the situation needs to have worsened, which emotionally may make it even harder to invest) while inflation eats away at their capital.

WHY DO INVESTORS DEVIATE FROM THE PLAN?

During volatile periods, investors' emotional time horizons can shorten, as the here and now becomes the focal point. A shorter-term perspective can raise the perceived riskiness of investing – the probability of experiencing a loss in short periods is higher – which can lead to actions that may provide short-term comfort, but result in diverting from the plan to protect and grow wealth over the long term.

The risk is that making portfolio decisions in times of emotional stress can exacerbate behavioural biases in decision-making, possibly hitting returns. Bear markets can be the most challenging for investors due to taking poor, reactive decisions that have lasting consequences.



ANXIETY-ADJUSTED RETURNS?

For those not fully comfortable with the idea of holding an investment portfolio through especially volatile times, it may be helpful to think about the concept of 'anxiety-adjusted returns', or the returns that an investor is comfortable with for a given level of emotional pressure.

Given our view that it is time in the market which matters more than market timing for long-term success, the best portfolio for an investor is one that is held across market cycles. Strategies such as phasing-in investments may be a helpful way to be more comfortable with getting invested.

BECOMING MORE COMFORTABLE WITH A PORTFOLIO?

Investors with concerns about the impact that changes in the economic and market outlook might have on portfolios may wonder what can be done to help them stick to their long-term plan.

The key is to make changes to investments while keeping a high enough allocation to risk assets so as to not alter the long-term returns potential of the portfolio.

One such approach is the use of hedging strategies, which allow an investor to stay invested in a way that also reflects (and positions for) concerns about how the core investment strategy will be affected. Use of put options, foreign exchange, and structured products are among examples of approaches that may protect against falling markets.

A core-satellite portfolio approach to investing can allow an investor to strike a balance between a long-term approach to investing, while allowing tactical tilts to the portfolio to be made in the short term. The bulk of the returns are generated by a core asset allocation, and a smaller satellite portfolio allows for more opportunistic trades.

WHAT IS GOOD DIVERSIFICATION?

A well-diversified portfolio can mitigate the impact of tail risks and reduce the volatility of returns. In the face of uncertainty, and risks which we do not even know about, the best protection is probably to invest in a range of assets.

Such a portfolio, for example holding quality companies with strong balance sheets and pricing power, means that events at the macro and market level may not fully affect an investor's own portfolio. Weak economic news can make us fearful about the potential effect on our portfolio performance. However, much of the news may be noise for those that follow a robust investment process which produces a well-diversified portfolio of quality assets built for the long term.

There is also an additional emotional benefit from diversification. By insulating a portfolio from volatility, an investor may insulate themselves from the emotions that volatility can induce, which may make it easier to hold an investment portfolio when things are not going exactly to plan.

Additionally, as discussed in May's *Market Perspectives*, having some illiquidity in a portfolio, perhaps by trying to harvest illiquidity premia by investing in [private markets](#), could support good long-term investment behaviours.

As humans we like familiarity, which is mirrored in many investment portfolios that may be biased towards a particular region, or asset class. Familiarity is typically equated with lower risk ("I know the region"). We remind investors that a home-biased portfolio is more concentrated, which actually increases rather than decreases risk.

WHAT ABOUT CASH?

At a time where there are many possible headwinds for markets, some investors may consider the importance of having an allocation of cash for liquidity needs, but also for protection, as well as possible deployment at attractive entry points.

We remind all investors about the importance of striking the right balance. Too little liquidity can put an investor under pressure during times of market stress, but too much can be costly due to the costs of inflation – both from foregone returns as well as real erosion of capital.

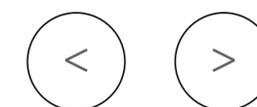
Due to a heightened sense of risk or rising risk aversion for many investors when markets are particularly volatile, many may fear adding to or maintaining risk allocations. The result is holding too little for one's level of risk tolerance and capacity. This could put reaching your goals at risk.

While the future can never be predicted, perhaps some reassurance can be provided by history. Over two consecutive years, equities have outperformed cash and UK government bonds 69% of the time. Over a ten-year period, this rises to 91% (see table, p38).

RECOGNISE THE OPPORTUNITIES

It is important to recognise possible opportunities that arise in different market conditions. Such periods can offer more attractive entry points for investors with a long horizon.

Remember that long-run investment returns would be significantly lower if it wasn't for these more challenging periods. Such periods occur frequently, but should not stop an investor from reaching their long-term goals if they can see them through.



UK equity performance since 1899, versus cash and gilts					
	Number of consecutive years				
	2	3	4	5	10
Outperform cash	83	84	87	89	102
Underperform cash	37	35	31	28	10
Total number of years	120	119	118	117	112
Probability of Equity Outperformance	69%	71%	74%	76%	91%
Outperform Gilts	80	88	88	84	86
Underperform Gilts	40	31	30	33	26
Total number of years	120	119	118	117	112
Probability of Equity Outperformance	67%	74%	75%	72%	77%

Source: Barclays Equity Gilt Study, 2021

A CHECKLIST FOR UNDERSTANDING YOUR PROCLIVITIES?

We end with some considerations for investors as we go into the second half of the year:

- Goals: Keep focussed on your long-term objectives; use these as the lens through which to view market events and your response to them.
- Advisor: A trusted advisor that challenges your thinking and decision-making can provide the space for more reasoned, less impulsive decision-making.
- Checklist: Having a decision-making checklist, taking into account your own individual behavioural proclivities.
- Active management: The dispersion between winners and losers can widen in market sell-offs markets, highlighting the importance of active investment management.

This is a testing time for investors. However, history shows us that those who get, and stay, invested through these periods have the best chance of earning the returns needed to reach their long-term investment objectives.

Author: Alexander Joshi, London UK, Head of Behavioural Finance



Hitting the mark with a more diversified approach

With elevated levels of volatility likely to persist in financial markets this year, inflation and rates climbing, and signs of growth faltering, how should investors allocate portfolio assets? Finding fresh return sources to bolster portfolio performance may be needed, including illiquid markets.



At times of market dislocation, having the right investment process matters. Investors' preferences and risk profiles lie at the crux of the investment process. When allocating assets, several factors must be considered. The optimal asset mix depends on the investor's reference currency, ability to take risk, liquidity needs and preferences, liabilities, foreign currency exposures and investment styles. An investor's objectives, such as specific lifestyle, aspirational, and legacy goals, should be borne in mind too.

A RETURN-TARGET DILEMMA

A common practice for many investors is to set a concrete return target that can help them navigate the investment landscape and adjust their asset allocation accordingly. Typically, the key portfolio performance objective is expressed as an absolute - or relative - return target.

Setting an absolute-return option can be helpful and even necessary sometimes. However, two issues should be addressed before the metric is used to compute the required return for an investment portfolio.

First, defining an absolute-return target might seem arbitrary. However, it is specific for every investor and can be rationalised based on their financial needs, investment goals, and risk profile.

Second, aiming for a fixed return-target can disconnect from macro and financial conditions at times. A more dynamic approach may be preferable – otherwise investors might chase unrealistic expectations or be exposed to unwarranted levels of risk.

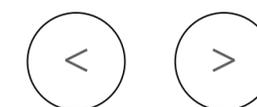
REAL RETURNS IN THE SPOTLIGHT

On balance, a relative-return target might be a better candidate. It can be expressed either as the risk premium or real-return target, or the required return above the risk-free or inflation rate, respectively.

The rest of this article considers the consumer price index-plus (CPI+) approach which is widely used by professional investors. The return target is defined as the sum of the inflation rate – based on the rate of change in the CPI – and a required real-return component (for instance, $CPI+2\%$).

Such an approach is likely to be the most plausible solution over the long term, as preserving the purchasing power, and maintaining your lifestyle, is one of the fundamental goals for any investor.

Moreover, a CPI+ approach lets us compare optimal asset mixes for a given return target across different reference currencies, possibly drawing conclusions in an international setting into the bargain.



STAYING ON COURSE

Defining a return target can help to devise an asset allocation that can assist investors to reach their investment goals. But what does this mean in practice when the framework is tested with real market data?

To address this question, we calculated optimal five-year asset mixes for US dollar-, sterling-, euro-, and the Swiss franc-based investors on a rolling-window basis since 2005. More specifically, we did this based on CPI+2% and CPI+4% return targets (see charts).

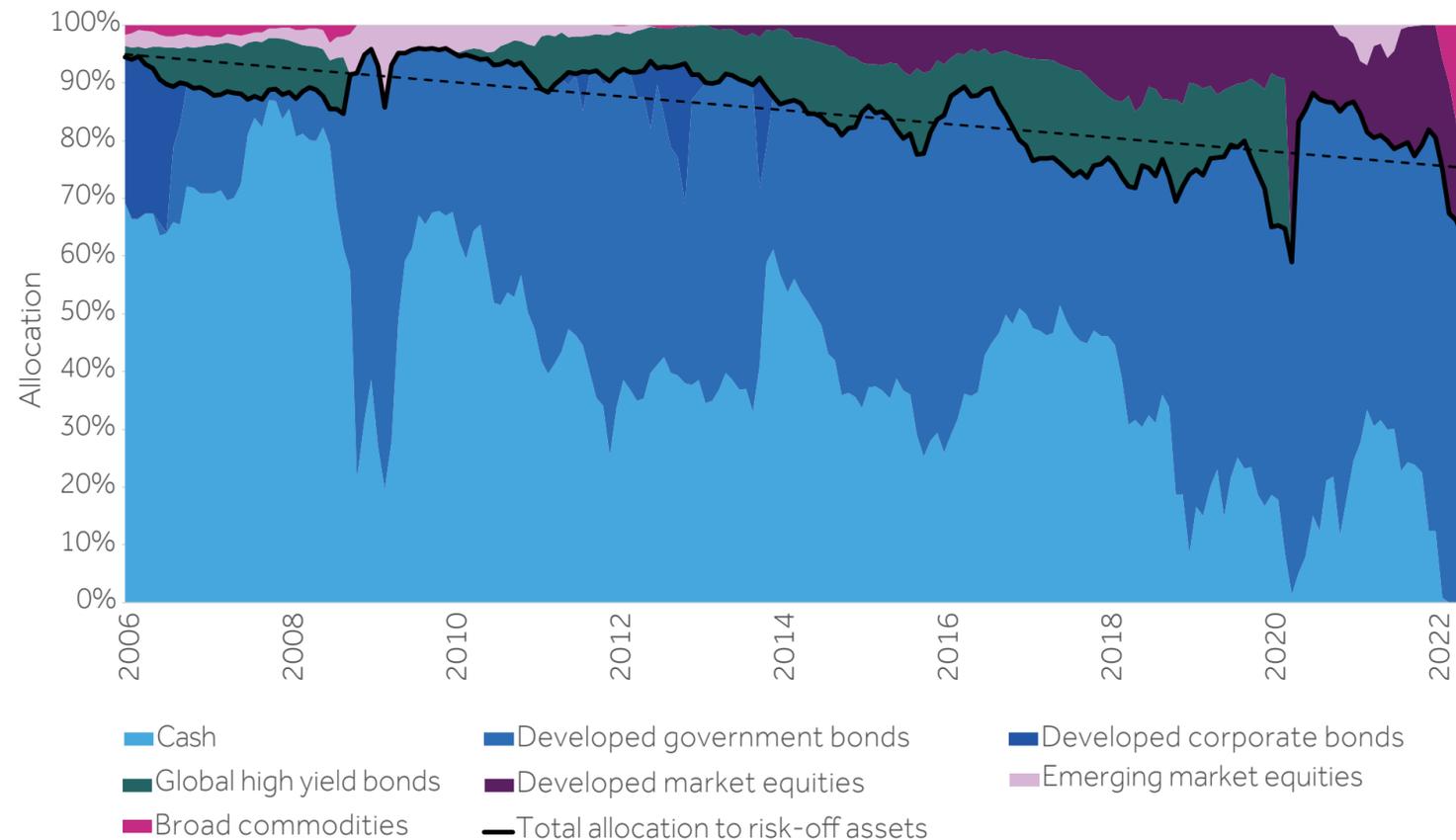
Although we observe some deviations across the board, the optimisation results for the CPI+2% and CPI+4% targets paint a similar picture. As such, average cross-currency allocations provide a good overview of the common trends in return-target-driven asset allocation over the past two decades.

Over the past 20 years, the asset allocations that satisfied our CPI+ objectives, and minimised portfolio volatility, over a five-year investment horizon have been drifting away from cash weightings. Developed government bonds have filled the gap, but the overall shift to holding more low-risk fixed income assets has fallen substantially.

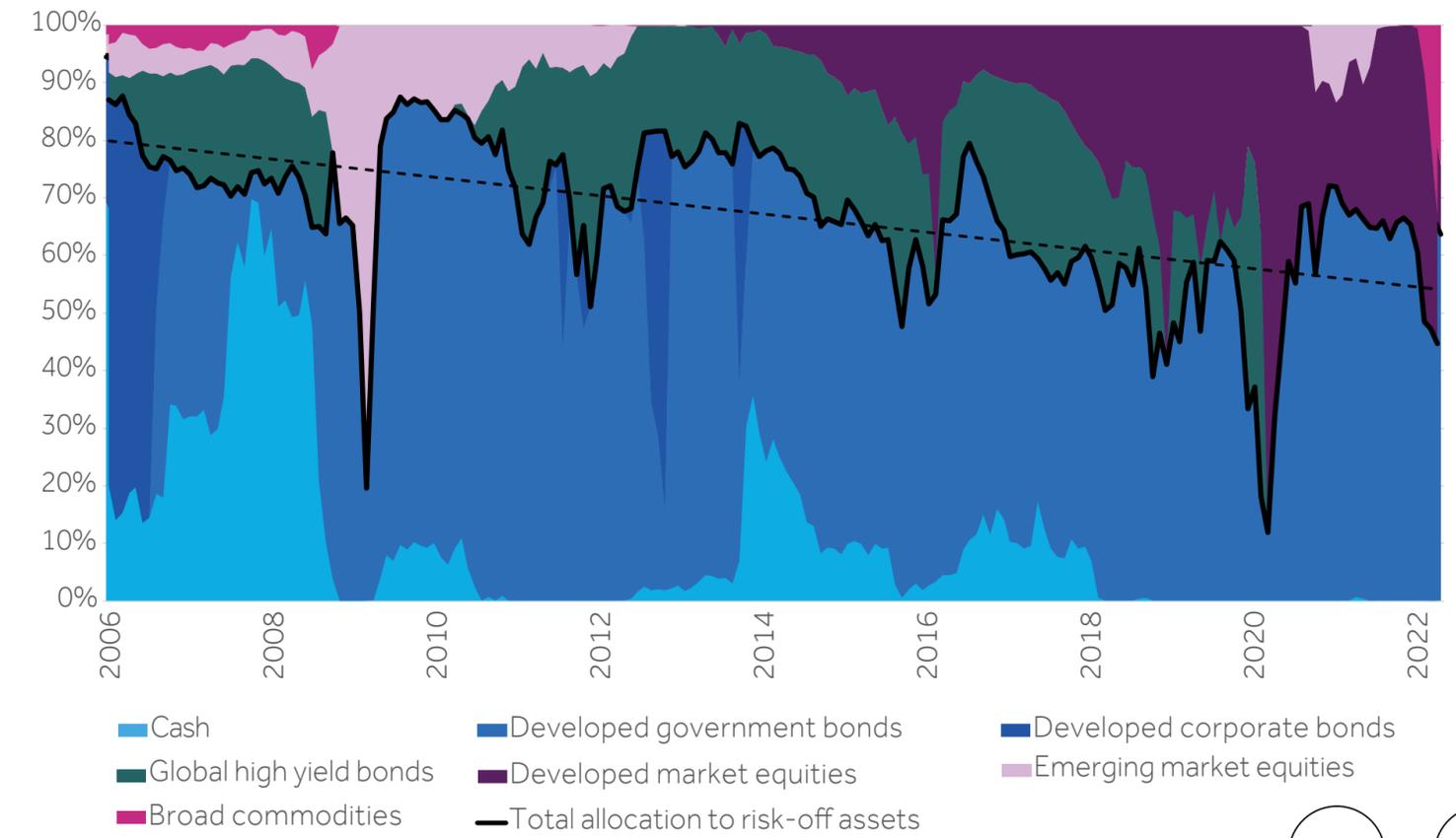
OPTIMAL HISTORICAL FIVE-YEAR ASSET ALLOCATIONS FOR SELECTED CPI+ RETURN TARGETS

The change in the optimal five-year asset allocation for either the CPI+2% or CPI+4% return targets, averaged across corresponding optimal asset mixes for USD-, GBP-, EUR- and CHF-based investors since December 2005. The optimal asset allocations are calculated monthly by minimising the portfolio volatility for a given CPI+ target without short-selling and leverage. Inputs for the optimisation (return targets and asset returns, volatilities, and correlations) are calculated using the five-year rolling-window approach

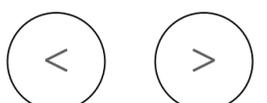
CPI+2% RETURN TARGET



CPI+4% RETURN TARGET



Sources: Bloomberg, Barclays Private Bank, May 2022



More specifically, allocations to cash and developed government bonds and corporate debt have decreased by about a third from its starting level in CPI+2% portfolios since December 2005. For CPI+4% portfolios the decline has been larger, falling by half. Simultaneously, allocations to risk assets, such as high yield bonds, equities, and commodities, have crept up, adding a more risk-on flavour to holdings.

DRIFTING AWAY FROM LOW-YIELDING ASSETS

The changes in the asset mixes highlighted above come as little surprise, given the strong predictive power of yield to maturity for subsequent realised bond returns.

Since cash rates and bond yields have fallen substantially over the last two decades, core fixed income assets have lost much of their power to generate high enough returns to meet certain CPI+ targets.

The yield to maturity for developed government bonds and corporate debt hovered between 2-2.5% at the end of April. These levels – albeit elevated in comparison to the ones observed just twelve months earlier – are still low by historical standards and barely match long-term inflation forecasts.

Based on our analysis, it may take at least another couple years before bond returns make core fixed income assets shine again in a long-term CPI+-oriented portfolio. However, this does not mean that cash and government bonds have no role to play. On the contrary, they remain important “safe-haven” assets.

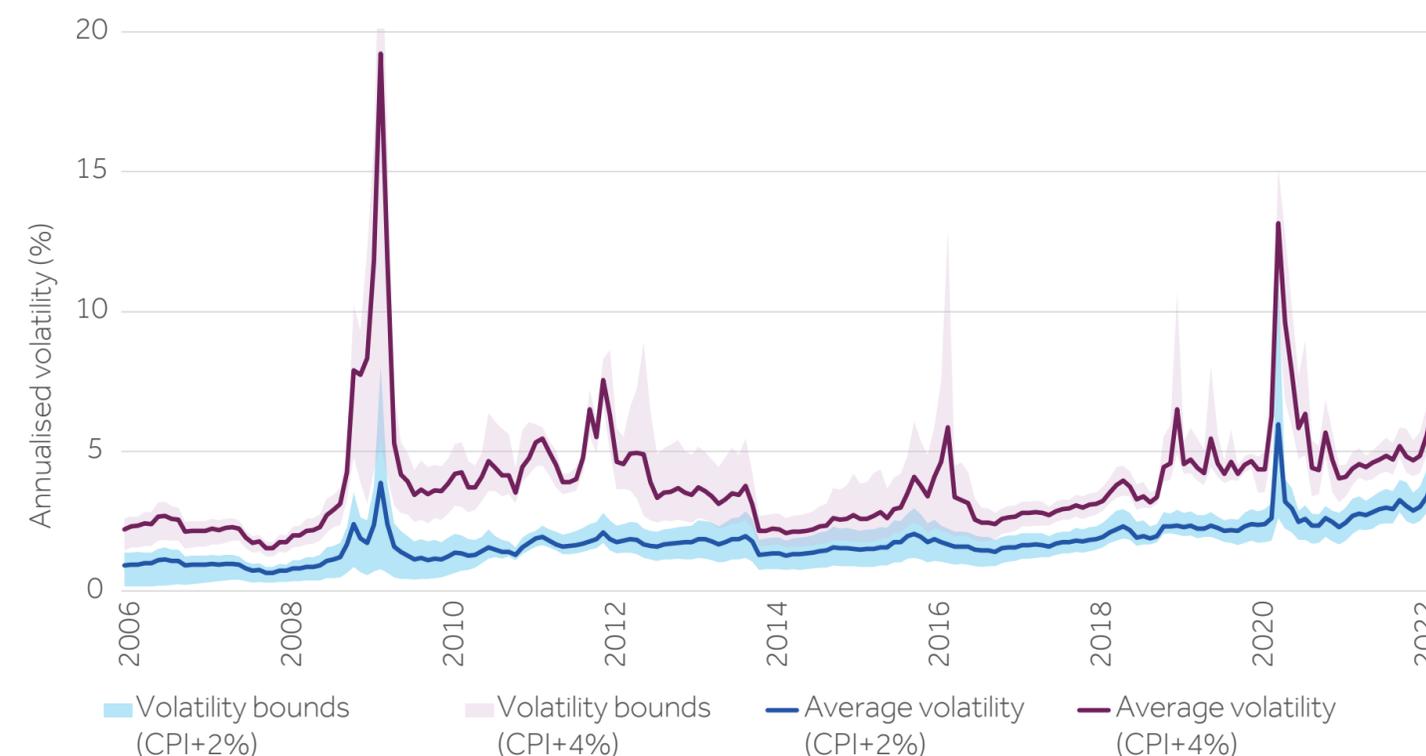
SAME RETURN, MORE RISK

Naturally, drifting away from risk-off assets to meet a return target comes at a cost. The next chart shows the evolution of the optimal portfolio volatility, averaged across the four reference currencies described above. Indeed, the volatility almost quadrupled when using the CPI+2% approach and tripled for the CPI+4% approach between 2005 and 2022.

Admittedly, the starting levels were low (0.9% and 2.2%, under CPI+2% and CPI+4%, respectively) due to the high allocation to cash at the beginning of the sample. Nevertheless, we observe a clear upward trend in volatility, with occasional risk outbursts (which tend to happen around market downturns, given the exposure to risky assets).

VOLATILITY OF OPTIMAL HISTORICAL FIVE-YEAR ASSET ALLOCATIONS

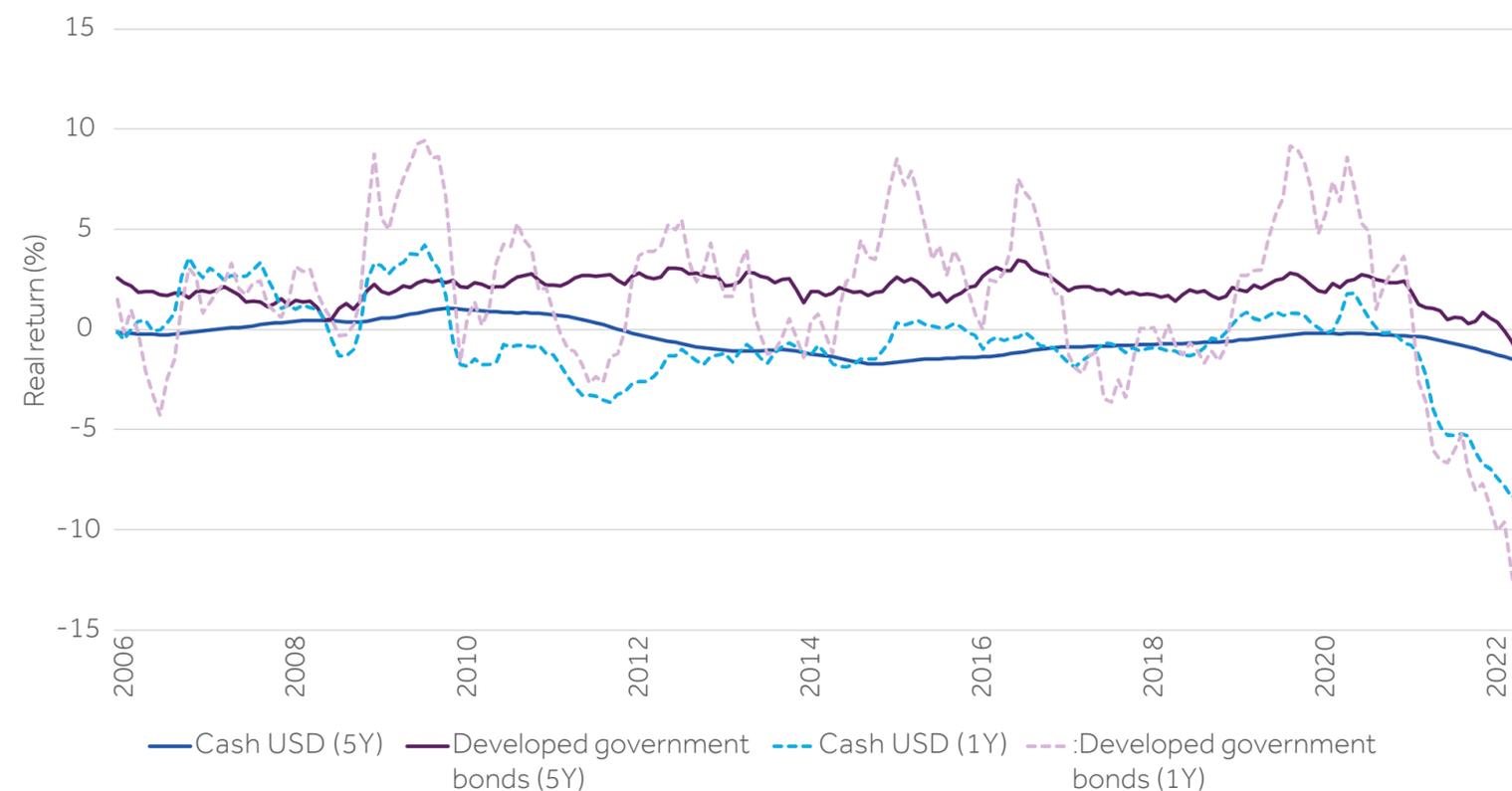
The annualised volatility of the optimal five-year asset allocations for CPI+2% and CPI+4% return targets (or the minimum portfolio volatility level required to achieve a given return target) since December 2005, by month



Sources: Bloomberg, Barclays Private Bank, May 2022

REAL RETURNS FOR USD CASH AND DEVELOPED GOVERNMENT BONDS

One- and five-year rolling-window real returns for USD cash and developed government bonds since December 2005, given on monthly frequency



Sources: Bloomberg, Barclays Private Bank, May 2022

WHAT NEXT FOR THE REAL-RETURN GAP?

Investors have substantially increased their exposure to risk-on assets this century, and in so doing are stomaching more market risk to meet their return targets. Meanwhile, meeting CPI+ objectives is much more difficult during periods when interest rates are low.

We can gain further insights by looking at the real returns for USD cash and developed government bonds over one- and five-year investment horizon (see chart).

First, we observe that five-year real returns are more stable. Year-over-year real returns substantially fluctuate, hence indicating that additional return can be generated through a tactical asset allocation process.

Second, the USD real cash rate has been in the negative territory for more than ten years, whereas the real return for developed government bonds has been mostly range-bound between our two CPI+ return targets.

Last, but not least, real returns have plunged in the last 12 months due to soaring inflation. As such, the real returns for core fixed income assets have become negative, over both shorter (tactical) and longer (strategic) investment horizons.

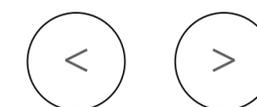
Consequently, reaching CPI+ objectives is likely to be much harder for some time and asset allocations may have to allocate more to risky assets and inflation hedges in particular.

DIVERSIFICATION TO THE RESCUE

Our analysis shows the impact of realised macro-financial trends on CPI+-oriented portfolios over the last two decades. In reality, we have to build forward-looking views regarding return and risk, instead of relying on historical inputs.

To showcase how investors can achieve their return targets in the future, we draw on our five-year capital market assumptions (CMA). We start from cash and gradually move asset allocation toward a traditional 60/40 portfolio of equities and bonds. In a second step, we venture beyond these asset classes, and include commodities, hedge funds, and private markets.

The key message is that investors should build a well-diversified strategic asset allocation to harvest different risk premia while managing the overall portfolio risk.



The next chart shows that public equities and illiquid assets can be key components of portfolios. Private markets appear very desirable in trying to reach a CPI+4% return target. Moreover, due to their relatively low correlation with traditional assets, investing in private markets can reduce portfolio risk as well.

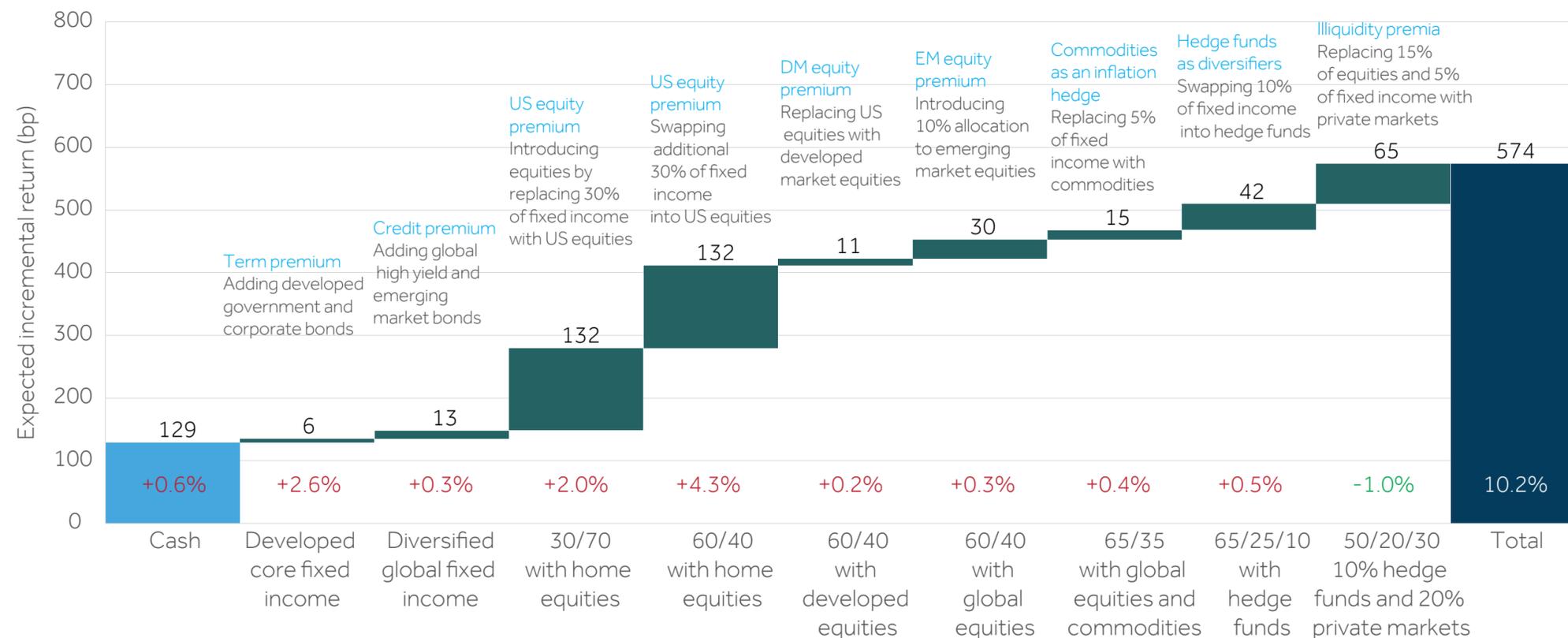
STAYING CALM AND UNLOCKING THE FULL POTENTIAL

Financial markets are in constant flux due to secular trends, economic cycles, and tactical gyrations. Active investors react to economic and market news by revising their expectations and asset allocation policies.

But sometimes uncertainty can be extremely unsettling and lead to hasty and irrational investment decisions. Impatience and bad timing can further hurt portfolio returns and inflict additional emotional pain on investors.

BOOSTING EXPECTED RETURNS WITH A SPECTRUM OF RISK PREMIA

The incremental changes in expected returns for a USD-based investor when moving from cash to an investment strategy that combines traditional liquid assets with hedge funds and private markets. The incremental changes in expected volatility are indicated above the x-axis in red (positive) and green (negative). The starting and final volatility are reported in the bars "Cash" and "Total", respectively. The calculations are based on our five-year CMA, as of November 2021



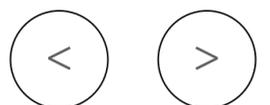
This can be avoided if investors remain composed and disciplined, stick to the plan, and focus on the long-term performance.

CPI+-oriented portfolios have required a gradual increase in allocations to risk-on assets over the last two decades. Elevated inflation levels and our five-year CMA suggest that this will likely be needed for some time yet.

As such, it is critical to be well-diversified across a wide range of risk premia. Additionally, tactical asset allocation and security and fund selection processes, along with foreign currency overlay strategies and smart hedging practices, are likely to be required to unlock enough investment potential to reach your required returns.

Author: Nikola Vasiljevic, Zurich, Switzerland, Head of Quantitative Strategy

Sources: Bloomberg, Barclays Private Bank, May 2022



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

"+" Denotes a positive view

CASH AND SHORT DURATION BONDS

- Given the ongoing uncertainty, and to manage portfolio risks, we still prefer 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 any macroeconomic volatility
- In credit, we prefer the higher quality segment, although, as spreads have recovered remarkably from their highs, our risk budget is directed 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 that faces their economies and currencies.

EQUITIES

- We believe that equities remain relatively more appealing than bonds for now
- Yet, we are highly selective in our allocation
- In line with our long-term investment philosophy, 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.

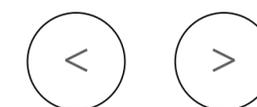
ALTERNATIVE TRADING STRATEGIES (ATS)

- 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 due to their low-correlation to equity markets.

COMMODITIES

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

Author: Julien Lafargue, London UK, Chief Market Strategist



privatebank.barclays.com

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