Market Perspectives

September 2022

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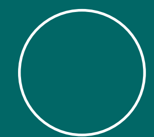

Contents

Global growth prospects sour 3

Timing the bottom of bear markets 6

Catching peak bond yields 10

As many global equity investors depart sterling, should you? 13

Three reasons why ESG factors should matter to alpha-driven investors 17

What are you holding? 19

Can Indian equities and bonds offer investors some respite in highly uncertain times? 21

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Foreword

Welcome to our latest edition of Market Perspectives, which aims to provide much-needed context and clarity, in a period when rate-setting policy and uncertainty weigh on investors' minds.

Financial markets have started the second half of the year on a better footing, amid hopes that surging inflation may be about to slow, along with the pace of rate hikes in the US. That said, we have cut our growth forecast to 2.9% for the global economy this year, with price and rate rises hurting businesses and consumers. In equities, following a surprisingly decent earnings season and bounce in markets, we believe that earnings downgrades may still be needed.

In bond markets, more spread volatility looks likely as central banks drain liquidity by selling their debt holdings, leaving spreads at the mercy of macro data. We remain very cautious and selective, especially towards high yield and emerging market bonds. Starting to lock in yields now seems the preferable option, as opposed to remaining on the sidelines until the absolute peak in spread levels.

With interest rate policy so much on investors' minds, we look at exchange-rate risk. In particular, as many international investors having ditched sterling in recent years, we analyse whether UK equity investors should hedge their currency exposure.

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

Don't be fooled by the recent criticism of environmental, social, and governance (ESG) factors over their role and value for investors. We look at three reasons why ESG factors could help to boost portfolio performance. As the potential implications of climate change, for one, become more apparent, the real question for investors is how well the factors are being incorporated into their processes, rather than whether they are.

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

Global growth prospects sour

The global economy is being battered by weaker growth, soaring inflation, and rampant central bankers. Recession risk abounds, with the eurozone looking most exposed, given its links to Russian gas supplies. Can any leading economy avoid a "hard" landing?

The toxic combination of a de-anchoring of inflation expectations, concerns over energy security, and a sharper slowdown in China, has substantially increased the risks around the economic outlook.

Price pressures have proved to be far more ferocious than previously forecast, compelling central bankers to tighten policy rates both earlier and more aggressively than had been anticipated. This mixture of surging inflation and tightening financial conditions has led to a slump in business and consumer confidence.

After an expected contraction by the global economy in the second quarter (Q2), we have been forced to slash our growth estimates for many of the major regions for this year, and now expect the global economy to expand at just 2.8% in 2022.

> "We have been forced to slash our growth estimates for many of the major regions for this year, and now expect the global economy to expand at just 2.8% in 2022"

While we have clearly become more sanguine on global growth prospects, we acknowledge that labour markets remain robust, consumers and corporate balance sheets still look healthy, and the service sector continues to have plenty of room to recover. We maintain the view that if the global economy should dip into recession, it will likely prove to be relatively shallow and short-lived.

INFLATION TO PEAK IN THE COMING MONTHS

Given the scale of the pandemic stimulus packages and the unleashing of pent-up demand as economies reopened, we were acutely aware that inflationary pressures would materialise. The ramifications of the war in Ukraine on commodity markets and the impact of Chinese COVID-19 restrictions on supply chains have multiplied the magnitude of these pressures to multi-decade highs. We now anticipate that global consumer prices will average 6.6% this year, compared to 3.2% in 2021.

Nevertheless, we expect inflation to peak over the coming months as tighter monetary policy moderates demand, commodity prices stabilise, inventory levels improve, and an easing of restrictions plus increase in capacity help to resolve supply constraints.

Another reason to be optimistic around the inflation outlook is the lack of a severe wage-price spiral. Pay hikes have remained substantially below inflation, by and large, and show signs of moderating. These elements, along with a range of technical and statistical factors, encouraged us to estimate that global consumer price pressures will subside and average 3.6% in 2023.

An easing of inflation expectations should help to take some of the intensity out of the rate-hiking narrative that's been dominating the headlines, allowing policymakers to orchestrate a softer economic landing than many economists predict.

IS THE US IN RECESSION?

Whether America suffered a recession in the first half of this year really depends on the definition used and who you ask.

The depth and diffusion of the downturn are the two areas that economists have largely focused on. So far, the scale of the loss in economic output has been relatively small, at -1.6% in the first quarter and -0.6% in the second one. The contraction in Q2 included weakness in inventory build, residential and business investment, and less government spending.

Recession deniers clutch to evidence that US household consumption remains positive and labour markets are robust. Consumer spending rose 1% in Q2, including a noticeable switch from goods into services, a trend that we would expect to continue in the quarters ahead. Unemployment fell to a half century low of 3.5% in July and 22 million jobs have been added since hitting the pandemic low in April 2020.

WARNING SIGNS

The consumer continues to be the driving force behind the American economy. Strong labour markets and excess personal savings have helped to cushion demand, but consumer confidence and retail sales are showing signs of real anguish. Meanwhile, higher mortgage rates and elevated prices have led to a dramatic weakening in underlying housing market conditions. We forecast growth in the US economy will slow from 1.6% this year to 0.6% in 2023.

> "Higher mortgage rates and elevated prices have led to a dramatic weakening in underlying housing market conditions. We forecast growth in the US economy will slow from 1.6% this year to 0.6% in 2023"

AMERICAN INFLATION AND POLICY

July's inflation reading finally produced the long-awaited moderation. The headline consumer price index (CPI) eased to 8.5% from the 9.1% registered in June[1]. We expect this trend to continue and fall to 6% in December, before averaging 2.9% in 2023.

While the US Federal Reserve (Fed) has kept its immediate policy options open, the central bank indicated that it will likely become appropriate to slow the pace of increases as risks between inflation and economic weakness begin to level out.

We forecast the Federal Open Markets Committee rate-setting body will step down to a 50 basis point (bp) hike in September, after a 75bp move in July, followed by 25bp increments in November and December. The final increase is now projected to be the last in the hiking cycle with the target range at 3.25-3.5%. As we look further out, an easing of inflation expectations and concerns about the impact of tightening financial conditions suggests that rate cuts could be on the cards by Q3 2023.

EUROPE ON THE BRINK

Hopes of a vigorous European recovery at the start of the year have been ruined by the ramifications of the war in Ukraine, supply bottlenecks from China, and record price pressures. Growth forecasts have been slashed, inflation projections ramped up, and recession risk has risen.

Persistent inflation coupled with the sharp tightening of credit conditions and business pessimism all point to weaker economic activity after the summer, followed by a technical recession, or output shrinking for two consecutive quarters, through the winter months.

[1] Consumer price index – July 2022, Bureau of Labor Statistics, 10 August 2022 https://www.bls.gov/news.release/pdf/cpi.pdf

We maintain a cynical view of eurozone growth, based on energy security risks, weaker domestic demand, slower industrial output, and less investment. While we pencil in anaemic growth of just 0.7% for next year, the risks remain sharply skewed to the downside, with the depth of any European recession likely to be determined by the flow of Russian gas.

ECB TO KEEP HIKING DESPITE RECESSION RISK

With eurozone inflation not set to peak until September, at 9.5%, the pressure on the European Central Bank (ECB) continues. We expect the Governing Council to use the small window before a recession to prove that they are determined to tame inflation and normalise policy.

We now forecast a more aggressive policy path consisting of increases of 75bp in September, 50bp in October, and 25bp in December. We don't envisage further hikes in 2023, as activity data turns increasingly negative through the turn of the year.

CHINA SET FOR A SUBPAR YEAR

After growth of just 0.4% in Q1, China's growth profile weakened again in July, as the world's second largest economy struggles with the consequences of its pursuit of a zero-COVID strategy and the property market slump. Policymakers have clearly become more concerned about the depth and breadth of the slowdown with retail sales, youth unemployment, and property investment all falling short of economists' expectations.

Cognisant of the rapidly slowing economy, the People's Bank of China has reduced the reserve requirement ratio, relaxed its credit policy, and unexpectedly cut its policy rate further in August. We anticipate more easing in these policy areas over the rest of the year. However, concerns around leverage levels, a weaker currency, and encouraging inflation are likely to stop policymakers from providing the stimulus required to materially turn around the Chinese economy in the short term.

Given China's determination to eradicate COVID-19 infections, the slow recovery in domestic consumption, and the deep fall in property sales, growth this year is expected to be around 3.1%, someway off the official growth target of 5.5%.

UK ECONOMY STALLS

The UK's impressive economic recovery ground to halt in the second quarter, with output shrinking for the first time since the pandemic. While GDP dipped 0.1% in Q2, this was a substantial softening from the 0.8% gain in Q1. The weakness was attributed to lower levels of household consumption, a slowdown in manufacturing, and lower spending on COVID-19 testing and vaccinations.

The outlook for the UK economy remains gloomy as surging inflation, higher interest rates, and the rising tax burden are all expected to take their toll on growth prospects. While the Bank of England predicts a full-year contraction in 2023, our growth forecast of 0.9% remains a little more optimistic due to an expected fiscal support package in the winter, easing of long-term energy prices, and a less aggressive policy path.

BANK OF ENGLAND TO HIT THE PAUSE AT 2%

Forecasts that UK inflation will peak above 13% in October have encouraged the central bank to raise rates into restrictive territory, with a 50bp increase in August. Given the updated inflation profile, we predict that the Monetary Policy Committee will push ahead with a rate hike of 50bp in September. Furthermore, we now forecast an additional 25bp increase at the November meeting, taking the base rate to 2.5%, after which easing inflation and faltering growth should take some of the wind out of the policymakers' tightening sails.

.**Author: Henk Potts, London UK, Market Strategist EMEA**

[2] GDP first quarterly estimate, UK: April to June 2022, Office for National Statistics, 12 August 2022 https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpfirstquarterlyestimateuk/apriltojune2022

Timing the bottom of bear markets

After a dire start to the year for investors, equity markets have seen a significant rebound. Having bottomed out in June, is history on the side of those that believe the recovery in global equities has more legs?

As the second quarter's earnings season comes to an end, we remain of the view that expectations for this year and possibly next need to come down. This is often pointed to as a reason why equity markets haven't bottomed yet. However, history suggests that investors don't need to wait for the last earnings downgrades to see stocks rebounding.

EARNINGS DRAMA AVOIDED

Companies in the S&P 500 have delivered close to 14% revenue, and 10% earnings, growth in the second quarter, according to Refinitiv. At face value, this looks impressive, given the weakening economic growth and stubbornly elevated inflation at the time. However, focusing on these headline figures can mislead. The energy sector contributed much to overall earnings growth, thanks to soaring oil and gas prices. Excluding energy, earnings growth for the S&P 500 was slightly negative in the second quarter.

The story is broadly similar in Europe. However, with close to half of companies reporting earnings on a bi-annual basis and several currencies to account for, interpreting numbers is always more challenging in the region.

With many base effects from last year still at play and companies and consumers still finding their footing after the COVID-19 pandemic, it's hard to judge whether this earnings season was good or bad. Our initial take is that low expectations meant a drama was avoided, but the overall picture is one of deteriorating fundamentals.

EXPECTATIONS STILL TOO ROSY

As we have argued before, earnings forecasts look too optimistic and are likely to be downgraded later in the year, primarily driven by margins expectations.

Global earnings are still expected to rise by 11% in 2022 and by 6% in 2023, according to consensus forecasts by IBES. The comparable numbers in the US and Europe are +8% and +17% respectively in 2022, and +8% and +2% in 2023. Despite the worsening macro data, those estimates have actually risen in the past six months, mainly driven by the commodity sectors (energy and basic materials).

Business surveys already suggest much lower earnings in coming months (as shown by the ISM Manufacturing New Orders component[1] and the US CEO Business Confidence Survey[2]). Our top-down earnings model is consistent with broadly flat global earnings growth in 2022.

EQUITY MARKETS GENERALLY TROUGH BEFORE ACTIVITY AND EARNINGS

Some market commentators have argued that we won't see a sustainable rebound in the equity market until earnings estimates are reset lower. We disagree for two reasons:

1) On our numbers, the equity market is already discounting a 9% decline in global earnings in 2022.

2) We looked at the past nine equity bear markets in the US, going back to 1966, and found that equity markets generally trough several months ahead of economic activity and corporate earnings.

The table (see p7) shows that the S&P 500 has tended to bottom five months before a trough in the ISM Manufacturing index, on average, within a range of 22 months before and three months after the trough. Only on two occasions did the equity market hit its low after the ISM index did, those being in August 1982 and March 2009.

[1] Manufacturing PMI at 52.8%, July 2022 Manufacturing ISM Report on Business, Institute for Supply Management, 1 August 2022 https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/july/
[2] US CEO Confidence, The Conference Board, 17 August 2022 https://www.conference-board.org/topics/CEO-Confidence/

S&P BEAR MARKETS SINCE 1966

S&P 500 - Market Peak Date	Market Trough Date	Recovery Date	Market Peak to Trough Decline (%)	Market Peak to Trough Duration (Months)	Market Trough to Recovery Duration (Months)	Trailing Earnings Trough Date	Time between Market Trough, and Trough in Trailing Earnings (Months)	ISM Manuf.* Trough Date	Time between Market Trough, and Trough in ISM Manuf. (Months)	Trough in Trailing Earnings YoY Growth (%)	Trough in ISM Manuf.*
Feb-66	Oct-66	May-67	-22%	8	7	NA	NA	Apr-67	-6	NA	42.8
Nov-68	May-70	Mar-72	-36%	18	21	NA	NA	Nov-70	-6	NA	39.7
Jan-73	Oct-74	Jul-80	-48%	21	69	Dec-75	-15	Jan-75	-3	-9%	30.7
Nov-80	Aug-82	Nov-82	-27%	20	3	Mar-83	-8	May-82	3	-7%	35.5
Aug-87	Oct-87	Jul-89	-33%	2	21	Dec-91	-50	Aug-89	-22	-16%	45.1
Jul-90	Oct-90	Mar-91	-20%	3	5	Dec-91	-14	Jan-91	-3	-16%	39.2
Mar-00	Oct-02	May-07	-49%	31	56	Jan-02	9	Apr-03	-6	-18%	46.1
Oct-07	Mar-09	Mar-13	-57%	17	49	Mar-09	-1	Dec-08	3	-31%	34.5
Feb-20	Mar-20	Aug-20	-34%	1	5	Oct-20	-6	Apr-20	-1	-17%	41.6
Jan-22	Jun-22	NA	-24%	5	NA	NA	NA	NA	NA	NA	NA
Average (**)			-36%	13	26		-12		-5	-16%	39.5
Median (**)			-34%	17	21		-8		-3	-16%	39.7

(*) Manufacturing
(**) Excluding 2022 period

Sources: Barclays Private Bank, Refinitiv, Institute for Supply Management, August 2022

While we only have partial data for earnings, the message is generally the same. US equities have tended to trough 12 months ahead of both trailing and forward earnings, based on the past seven and five bear markets, respectively.

We conducted the same analysis in Europe, see chart on p8, and although the data is more mixed, it still shows that the equity market tends to trough before the trough in activity and earnings.

Based on the past eight bear markets in Europe, since 1970, the MSCI European index usually bottomed a month before seen in the ISM Manufacturing index. Since 1987, it has troughed five months ahead of trailing earnings, on average, and in four times out of six it bottomed one or two months before forward earnings estimates.

MSCI EUROPE BEAR MARKETS SINCE 1970

MSCI Europe Market Peak Date	Market Trough Date	Recovery Date	Market Peak to Trough Decline (%)	Market Peak to Trough Duration (Months)	Market Trough to Recovery Duration (Months)	Trailing Earnings Trough Date	Time between Market Trough, and Trough in Trailing Earnings (Months)	ISM Manuf.* Trough Date	Time between Market Trough, and Trough in ISM Manuf. (Months)	Trough in Trailing Earnings YoY Growth (%)	Trough in ISM Manuf.*
Jan-70	May-70	Jul-71	-21%	4	14	NA	NA	Nov-70	-6	NA	39.7
Aug-72	Jan-75	Oct-80	-46%	29	70	Mar-76	NA	Jan-75	0	-26%	30.7
Oct-87	Nov-87	Jul-89	-35%	1	20	Jul-88	-8	Aug-89	-21	9%	45.1
Jul-90	Jan-91	Mar-93	-25%	6	25	Nov-91	-10	Jan-91	0	-31%	39.2
Jul-98	Oct-98	Jul-99	-31%	3	9	Jul-99	-9	Dec-98	-2	-12%	46.8
Sep-00	Mar-03	May-07	-58%	30	50	Mar-02	12	Oct-01	17	-35%	40.8
Jun-07	Mar-09	Oct-17	-57%	21	103	Jul-09	-5	Dec-08	3	-42%	34.5
Feb-20	Mar-20	Apr-21	-34%	1	13	Dec-20	-9	Apr-20	-1	-31%	41.6
Average (**)			-38%	12	38		-5		-1	-24%	39.8
Median (**)			-34%	5	23		-8		-1	-31%	40.3

(*) Manufacturing
(**) Excluding 2022 period

Sources: Barclays Private Bank, Refinitiv, Institute for Supply Management, August 2022

BEAR MARKET RECOVERY TIMES VARY SIGNIFICANTLY

In general, it took 13 months on average for US equities to form a bottom, 36% below the previous peak. It then took another 26 months for investors to recoup their losses, based on our analysis of American bear markets since 1966. Recovery times varied significantly, between three months and six years.

In terms of how long it took for markets to get back to their previous peak, there was no clear pattern (see chart, p9). During those bear markets, trailing earnings typically declined by 16%, within a range of -9% to -31%. The ISM Manufacturing index dropped to 39.5 on average, within a range of 30.7 to 46.1.

> “Recovery times varied significantly, between three months and six years”

In Europe, it took 12 months on average for the MSCI Europe to trough, 38% below the previous peak. Investors needed to wait longer than their US peers to recoup their losses, at 38 months from their trough on average. However, there was much variation, with the bear markets of 1975 and 2009 distorting the average. Trailing earnings typically declined by 24% during those bear markets, while the ISM bottomed at 39.8 on average.

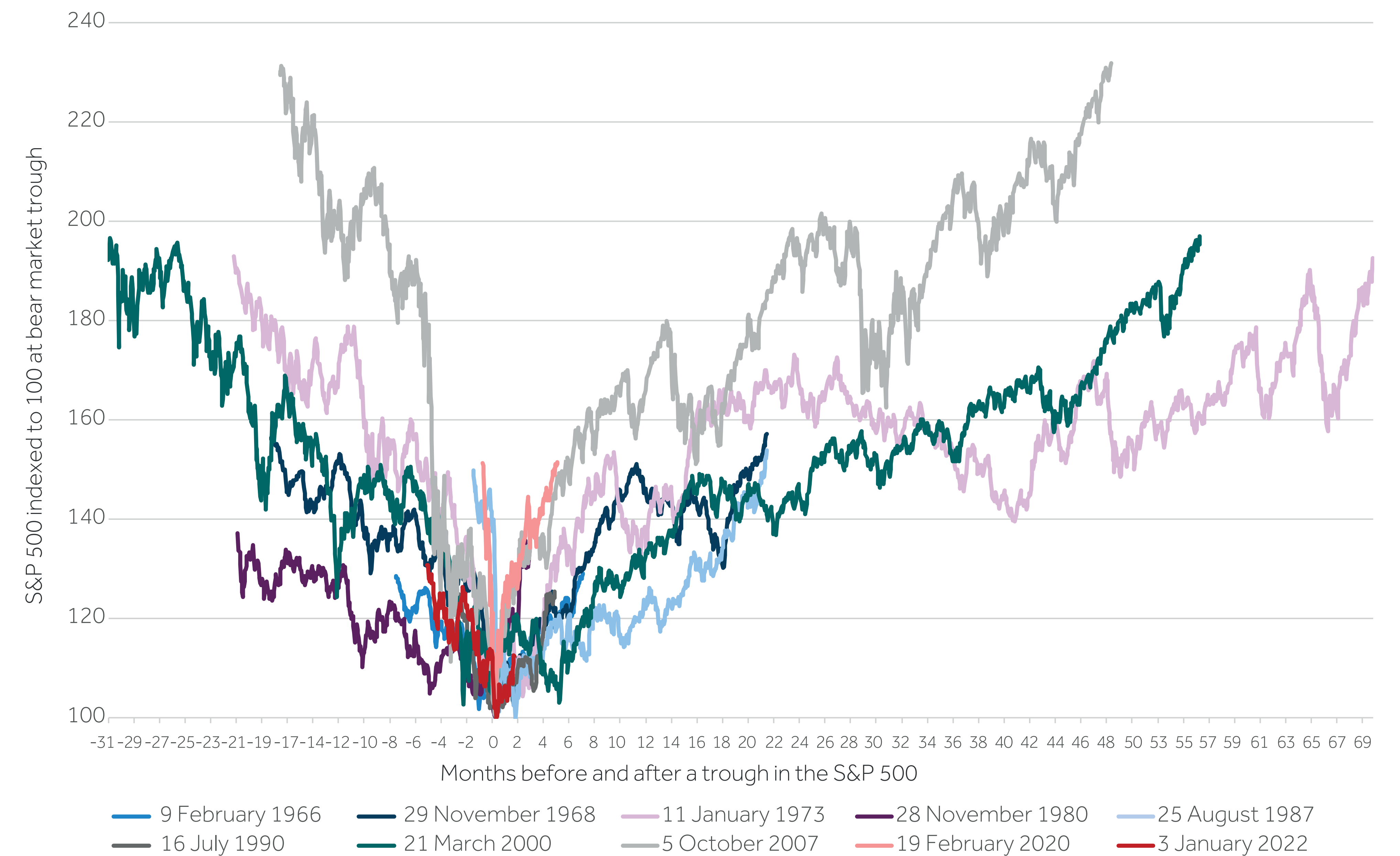
FULL RESET IN EARNINGS EXPECTATIONS NOT NEEDED FOR MARKETS TO REBOUND SUSTAINABLY

US and European equity markets have rebounded by 13% and 8%, respectively, from their June and July lows. Until more clarity emerges on the growth and inflation outlook, markets are likely to remain highly volatile and dominated by headlines. While earnings estimates are likely to be downgraded materially in the coming weeks, we don't believe a full reset is a necessary condition for markets to improve sustainably.

Authors: Dorothée Deck, London UK, Cross Asset Strategist; Julien Lafargue, London UK, Chief Market Strategist

HISTORY OF US BEAR MARKETS SINCE 1966

The variation in the times from the peak to trough, and then time needed to recoup losses, in S&P 500 bear markets since 1966



Sources: Refinitiv, Barclays Private Bank, August 2022

Catching peak bond yields

After the record losses seen in credit markets this year, whether in high yield, investment grade, or emerging markets, investors are licking their wounds. The question now is whether it's worth investing in credit and, if so, when would be a good entry point?

Our stance towards credit has not changed since our *Outlook 2022* in November. The fact that the US Federal Reserve (Fed) continues its strategy of aggressive rate hiking to counter soaring inflation, and so risking a recession, confirms this view. We remain very cautious and selective, especially towards high yield and emerging market bonds.

Further spread widening, even after some recent consolidation, still looks on the cards. While investment grade credit would likely suffer in such a broader widening trend globally, the room for substantially more spread seems comparatively limited, in our view.

Three reasons why spreads are still exposed to additional widening stand out

1. Growth risk and inflation
2. Central bank paradigm shift
3. Debt levels and credit quality

1. GROWTH RISK AND INFLATION

After a brief and very sharp recovery in most leading economies and emerging markets, growth is expected to consolidate, in some cases substantially. The International Monetary Fund predicts that global growth will slide from 6.1% in 2021 to 3.2% this year[1], with the risk for growth skewed to the downside. While the US economy has already contracted for two consecutive quarters[2], output in the eurozone and the UK is at high risk of shrinking in the final quarter of this year.

While there has been no notable correlation between spread and economic growth throughout the recent past, the mix of weakening household consumption, margin squeeze, and revenue risk on the corporate side leads us to suspect that the credit quality of issuers may worsen. Indeed, the European Commission's businesses and consumer surveys reveal that 45% of companies in the industrial sector were facing shortages limiting their production in July[3], not a good backdrop.

Additional pressure looms given the potential for energy rationing in continental Europe if gas supplies through the Nordstream 1 pipeline remain restricted. Any rationing would hit energy-intensive sectors like chemicals, concrete, and autos the most. However, consumer cyclical sectors would also be hurt as consumers' spending power is squeezed.

> "Any [energy] rationing would hit energy-intensive sectors like chemicals, concrete, and autos the most"

A stagflationary scenario seems a high possibility in the eurozone. This additional risk is partly reflected in spreads which in respect of high yield (115bp premium) and investment grade bonds (40bp premium) are trading well outside of US spreads, for example. Selective positioning in more defensive sectors and focusing on investment grade seems appropriate as the tail risk remains high.

2. CENTRAL BANK PARADIGM SHIFT

The reason for a weaker correlation between economic output growth and spreads has often been due to central bank intervention with the aim of counteracting further spread widening during difficult phases, as seen during the pandemic in 2020. But such a central bank "put" is vanishing, as the Fed, the Bank of England (BoE), and the European Central Bank (ECB) shrink their balance sheets and let some bonds mature.

[1] Gloomy and More Uncertain, IMF, 26 July 2022
[2] Bureau of Economic Analysis, Gross Domestic Product, 28 July 2022
[3] Economic Sentiment and Employment Expectations markedly down in the EU and the euro area, EC, 28 July 2022

The ECB stands out with a sizeable balance sheet that equates to 80% of the region's gross domestic product. The termination of the central bank's existing APP and PEPP programmes and the prospects of higher rates prompted a significant widening in Italian bond spreads, which at 230 basis points (on the basis of the 10-year yield compared to German 1-year bund yields) are still close to the peak seen in June.

We believe that volatility may intensify in this area and would not be surprised if the market tests the effectiveness of the ECB's new transmission framework, which allows selective bond buying during distressed times.

This is not to say that central bank-induced volatility will only be contained to the eurozone. The BoE is likely to start selling out its APF (asset purchase facility) portfolio from September. Such selling would hit a relatively small and illiquid bond market, which would likely leave spreads exposed in an already vulnerable market.

3. DEBT LEVELS AND CREDIT QUALITY

As much as $305 trillion of equivalent debt has been amassed globally, according to the Institute of International Finance (IIF)[4]. The latest expansion occurred on the back of the pandemic. A typical and healthy repair phase, characterised by deleveraging, has been missing during this very short credit cycle, or perhaps an intermediate stage of a larger credit cycle. The increase in debt was mainly driven by non-financial corporates (up $14 trillion since 2019) and general government borrowing.

Despite the higher debt load, corporate fundamentals appear reasonably healthy. The corporate bond market, in general, is still in a rating-uplift cycle, one supported by improving credit metrics. In the US, for example, the average gross leverage declined to below 2.5 times (debt/EBITDA) while interest coverage is at the top of the range seen over the last 30 years. In addition, larger issuers have been accumulating cash during the pandemic which for now is acting as a cushion.

But this situation is likely to take a turn for the worse and fundamentals for high yield issuers in particular are likely to deteriorate. For example, rating agency Moody's expects that the average interest coverage for B3-rated companies, which are funded mostly with floating rate debt, will fall below one times (that is, insufficient cash to service interest cost) if policy rates were to rise by 300 basis points (bp) in the US this year as seems likely. Another reason to stick to higher-rated credit, in our view. Furthermore, speculative grade default rates globally are likely to rise towards over 3% by next year, with significant upside risk depending on the inflation and growth path.

SPREADS SET TO WIDEN

Every economic slowdown, or recession, is different and it is hard to quantify the magnitude of any consequential spread widening in each bond segment. While inflation and higher rates pose risk, we are unlikely to see similar spread levels as seen during the pandemic. In Europe, investment grade spreads towards 300bp could be possible should we see tighter gas supply, for example. This might lead to spreads heading towards at least 800bp for high yield bonds.

While spread widening seems possible, a widening of this magnitude suggests a very pessimistic scenario. As seen during the European sovereign debt crisis in 2012, US spreads would also likely be impacted in an adverse scenario.

BUT WHAT IF THE WORST IS STILL TO COME?

Where does this leave investors trying to catch the peak of corporate bond yields and fearing that the worst is still to come? Spread widening is one part of the equation, while the path for rates must also be taken into account. And while this year rates and spreads have moved up simultaneously, thereby exacerbating the losses, they rarely trend in line with each other. While not significant, often there is a negative correlation reflecting the traditional framework that higher rates would usually lead to lower spreads, implying a constructive economic outlook.

The peak yield of corporate investment grade bonds has often coincided with the top in rate levels rather than spread levels. Only in distressed scenarios, or in the case of very depressed rate levels, did the peak in spread levels lead to a peak in corporate bond yield levels, like seen during the credit crisis in 2008, or more recently in 2020's pandemic.

> **"The peak yield of corporate investment grade bonds has often coincided with the top in rate levels rather than spread levels"**

[4] Debt in the Time of Geopolitics, Institute of International Finance, 18 May 2022

US SPREADS, RATES, AND CORPORATE BOND YIELDS PEAK

An analysis of US investment grade spreads, yields, and the US 10-year yield, shows that spread shocks have usually led to substantial downside pressure on rates

Sources: Bloomberg, Barclays Private Bank, August 2022

Interestingly, even after the outsized 120bp move in USD investment grade spreads during the pandemic crisis, corporate bond yields were around 4.6% on average. This compares with the 4.4% peak seen in 2018 and the 4.7% seen in July (see chart).

The reason is that spread shocks usually lead to substantial downside pressure on rates. A hint of such a scenario was provided by the recent inversion of the US yield curve, the 2-year/10-year spread in August being at its most inverted since 2000[5], as yields retraced on economic growth worries.

Therefore, starting to lock in yields now while being prepared for further spikes (for top-ups) seems the preferential option, as opposed to remaining on the sidelines until the absolute peak in spread levels.

"Starting to lock in yields now while being prepared for further spikes (for top-ups) seems the preferential option"

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

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[5] What's missing from the bond markets ahead of the CPI, Bloomberg, 10 August 2022

As many global equity investors depart sterling, should you?

The role of sterling has changed from the old days as it loses its safe-haven shine, with implications for those invested in it. With unhedged currency exposure contributing to portfolio performance, we analyse the characteristics of the UK currency versus others and which currency hedging strategy might be most appropriate in a sterling investor's equity portfolio.

News over the last two years has been dominated by a health crisis, sudden drop in economic demand, and Russia's conflict with Ukraine. In this time, financial markets often treated the world economy as one big entity.

This is changing, as divergent, and soaring, inflation, monetary policy, and the resilience of economic activity becomes more apparent at a local level. For an investor, this is a good chance to reflect on exchange rate risks and opportunities.

THE SHIFTING ROLE OF CURRENCIES

The value of a currency is driven by many factors: access to natural resources, political stability, or an economy's ability to produce sought-after goods, plus several more. Some currencies are considered to be cyclical because their worth relies on goods that are particularly linked with the economic cycle. Others are dubbed "safe-haven" currencies as they remain attractive when the global risk appetite decreases.

Sterling highlights how the role of currencies can change. It used to act as a safe haven for investors. It does not now. To show this point and the effect it can have, we analyse the ability of the UK currency to act as a safe haven against leading currencies over the last three decades.

STERLING A SAFE HAVEN NO LONGER

In analysing the currency's exchange-rate trends, we applied a well-known concept from economic theory: Uncovered Interest Rate Parity. This postulates that future exchange rate changes are determined by today's differences in interest rates between currency areas.

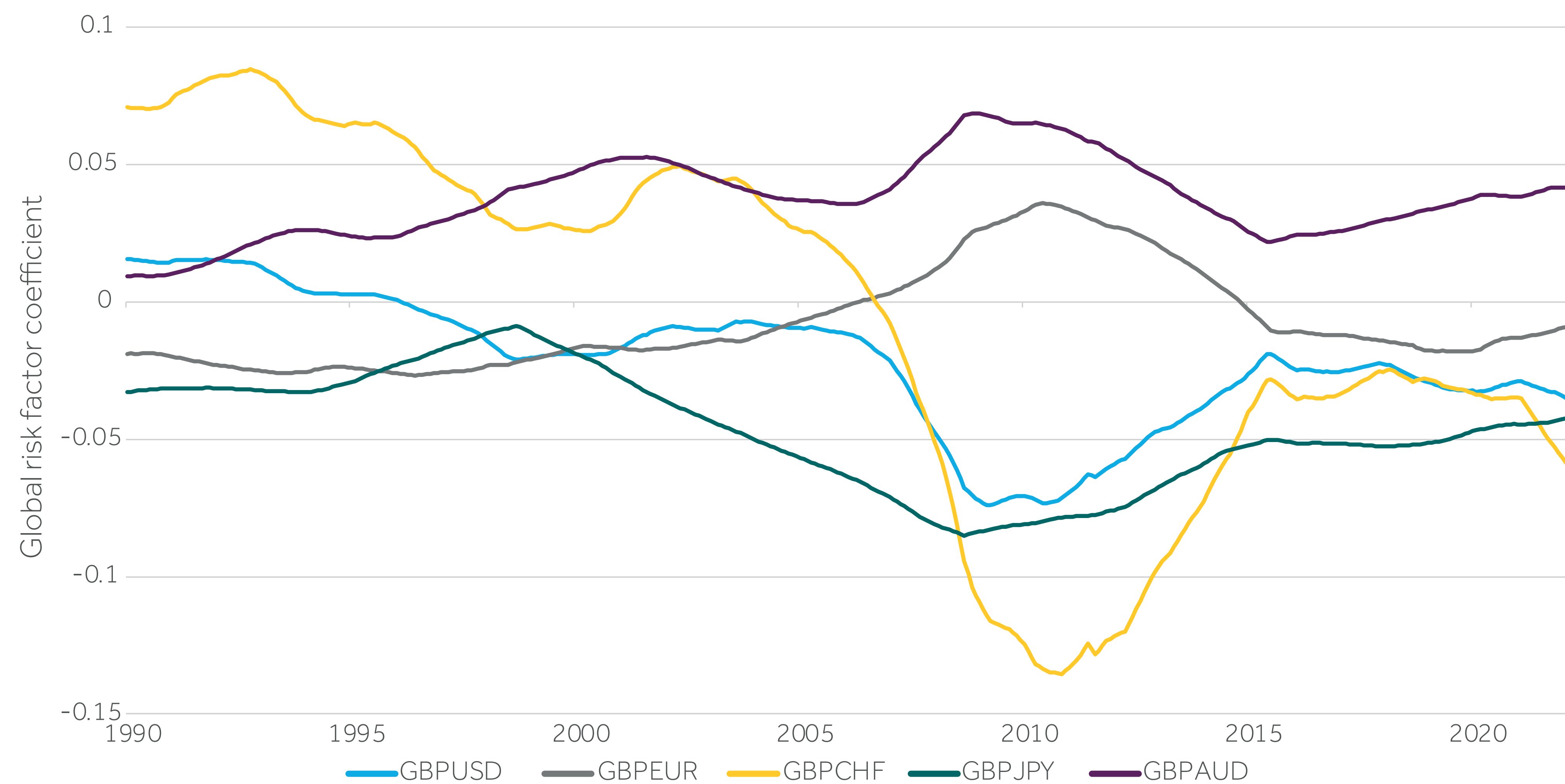
We then add a local currency effect (how sterling performed against other currencies, excluding the one being analysed) and a global risk factor, the option-implied volatility index (VIX), or "fear index", from the Chicago Board Options Exchange.

Our analysis shows that sterling showed safe-haven characteristics against cyclical currencies such as the Australian dollar, generally, and also the Swiss franc, at least until the mid-2000s. The euro and the greenback fared better in turbulent markets during that period. Only the Japanese yen was a clear safe haven for sterling-denominated investors.

However, this changed drastically after 2007: the new triumvirate of safe havens (dollar, yen, and Swiss franc) has proved more resilient to market stress than sterling since then (see chart, p14).

STERLING HAS LOST ITS SAFE-HAVEN CHARACTERISTICS

Time-varying sensitivities of sterling exchange rates on changes in the VIX. Positive values indicate GBP appreciates on increasing global equity risk



Sources: Bloomberg, Barclays Private Bank, July 2022. Note: time-varying coefficients are estimated using a Kalman filter.

Against the three safe havens, a relative month-on-month increase in the VIX of 1% would currently be accompanied by a sterling depreciation in the range of 0.04% to 0.06%, according to our analysis. Increases of 100% in the fear index are not uncommon in stressed markets, which makes these coefficients meaningful in size.

“Against the three safe havens, a relative month-on-month increase in the VIX of 1% would currently be accompanied by a sterling depreciation in the range of 0.04% to 0.06%”

A HOST OF REASONS BUT ONE CONCLUSION

Pinpointing the reasons for the altered role of sterling in currency markets is difficult. Undoubtedly, Brexit has had an impact, whether through drawing attention to UK-specific issues or by actually lowering forecasters' expectations of the economy's prospects.

Knowing that safe-haven characteristics are variable over time, the following conclusions need to be re-evaluated periodically. However, the implications are significant for sterling investors, especially due to the prevalence of USD-denominated assets in global markets.

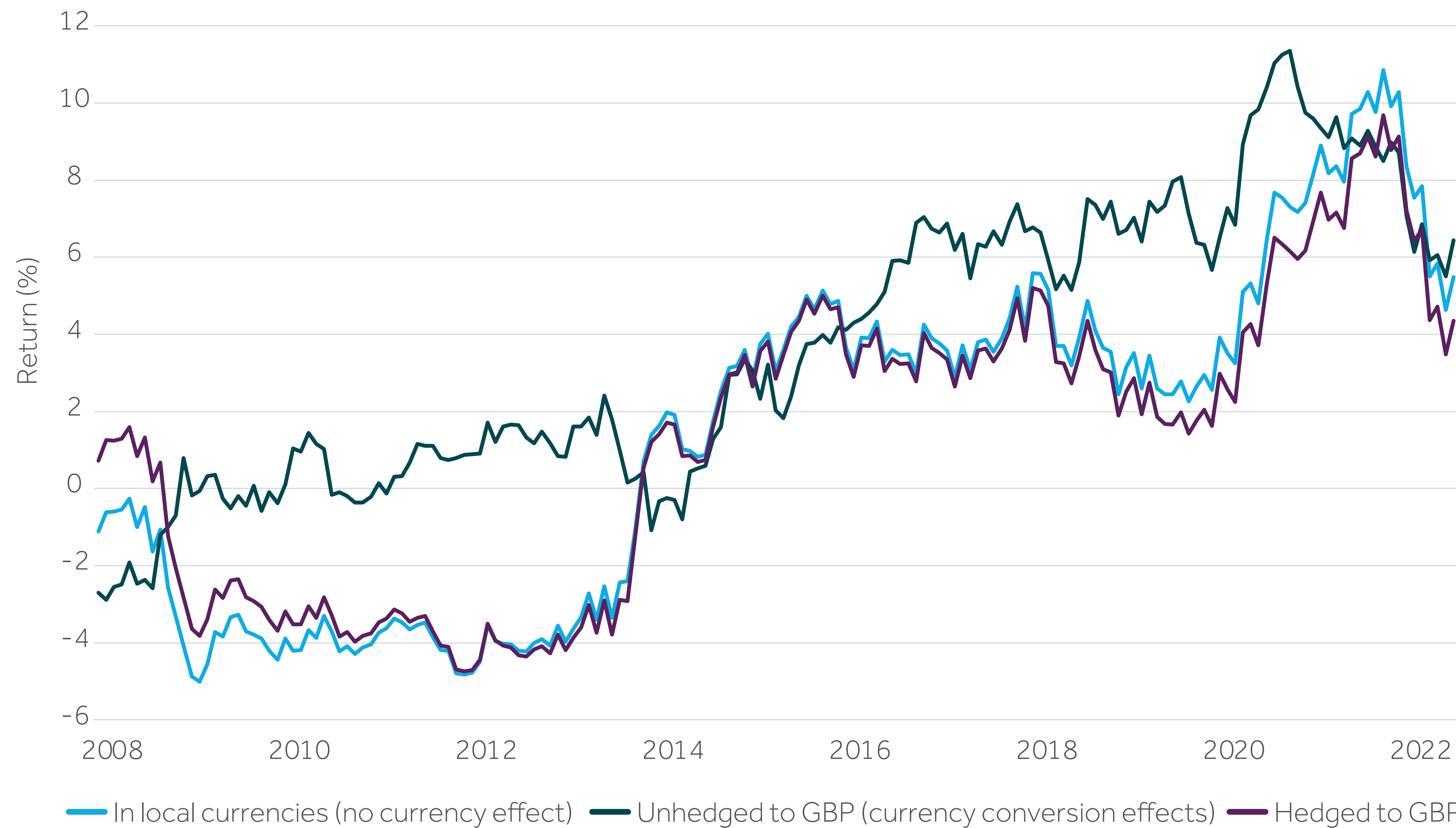
DO NOT HEDGE THE SAFE-HAVEN TRIUMVIRATE

Our analysis might suggest that sterling investors would be best off not hedging any dollar-, yen- or Swiss franc-denominated foreign equity exposure as appreciation against sterling is likely in stressed markets, thus providing a source of return for a sterling investor.

To investigate this, we computed portfolio returns with three different hedging strategies: in local currencies, unhedged but converted to sterling, and fully hedged to the UK currency. We then studied the relative performance of a global equity portfolio versus a domestic one for each hedging strategy respectively. We consider an investment horizon of five years, to make the analysis meaningful to the typical longer-term investor.

OPPORTUNITY COST OF HOME EQUITY BIAS FOR UK INVESTORS

Annualised five-year rolling-window performance of MSCI World net total return index relative to MSCI United Kingdom net total return equity index since January 2008: in local currencies (no currency effect), unhedged (currency conversion effects), and hedged to sterling



Sources: Bloomberg, Barclays Private Bank, July 2022

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Our results indicate that an unhedged global portfolio generally outperformed one that was purely invested domestically. Before 2014, a currency-hedged global portfolio would have underperformed its domestic peer.

Comparing the relative outperformance of the unhedged and hedged portfolios delivers a clear verdict: UK equity investors would have been almost always better off not hedging currency exposure. For some five-year periods, the outperformance of the unhedged portfolio would have been as large as 4% per annum.

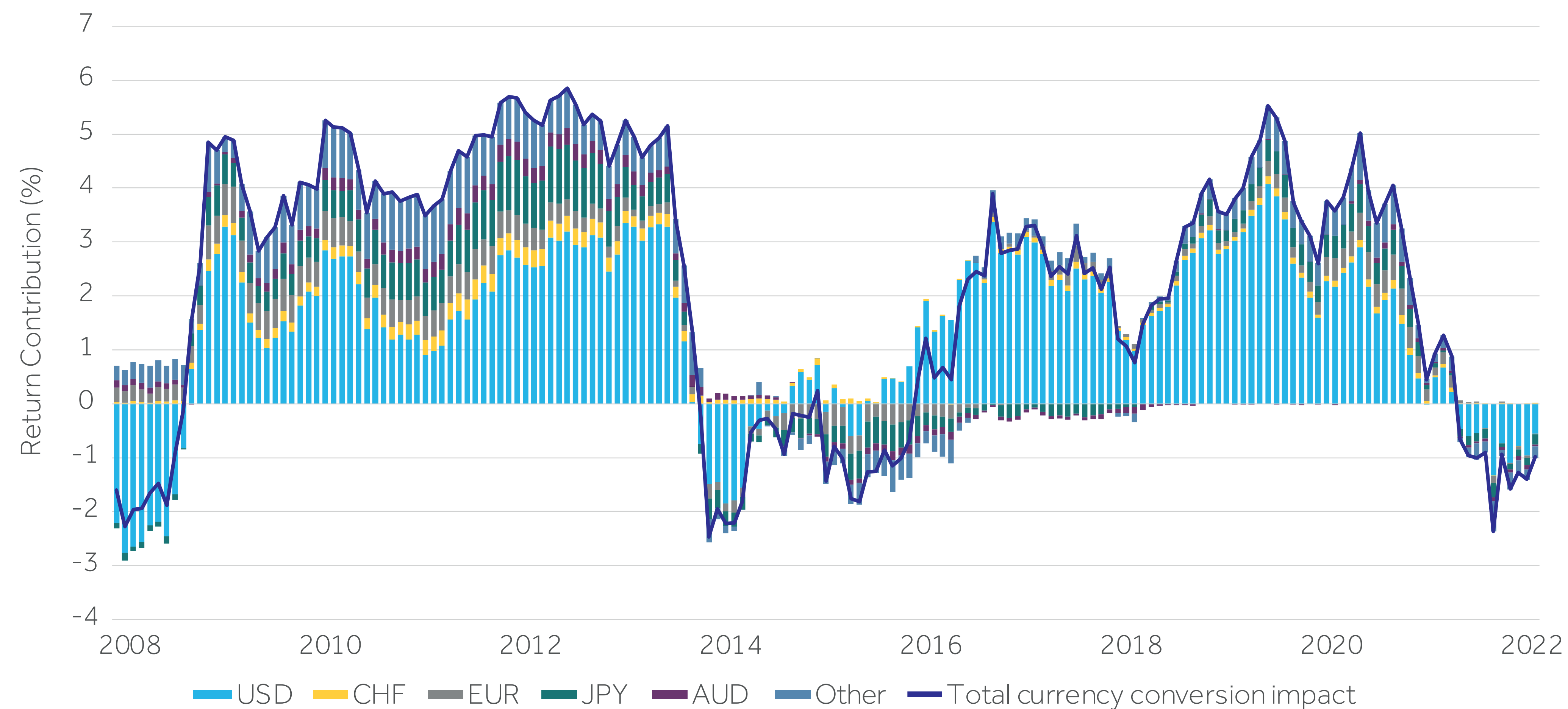
> “UK equity investors would have been almost always better off not hedging currency exposure”

KING DOLLAR

Given the weight of the US market in the global equity portfolio and its safe-haven status, it is little surprise that most of the outperformance of not hedging to sterling comes from the greenback. The following chart (p16) displays the breakdown of the currency-conversion effect – or in other words: moving from the local currency line (light blue) in the chart above to the unhedged to GBP line (green).

THE CURRENCY IMPACT OF UNHEDGED GLOBAL EQUITIES FOR UK INVESTORS

Annualised five-year rolling-window decomposition of the currency conversion effects for MSCI World net total return index unhedged to GBP since January 2008



Sources: Bloomberg, Barclays Private Bank, July 2022

UK INVESTORS STILL TOO MUCH HOME BIASED?

Our analysis reveals the diversification attractions of a global equity portfolio over a domestically-focused one, and shows that not hedging the currency exposure would have paid off. Have UK investors acted accordingly?

> "Our analysis reveals…that not hedging the currency exposure would have paid off "

Surveys among institutional investors by pensions consultant Mercer suggest that UK investors have upped non-domestic exposure. In 2013, UK institutions allocated 36% of their equity exposure domestically[1], according to the consultant. In the 2019 survey, the latest one, the domestic allocation was reduced to 29%[2].

This still represents a considerable home bias when we compare current market capitalisations from MSCI. However, investing 29% domestically is risky at a time when the UK market represents roughly 5% of the global equity portfolio. With past opportunity costs and our subdued outlook for the UK economy relative to other developed markets in mind, further reducing the home allocation would seem beneficial.

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

[1] TEuropean Asset Allocation Survey 2013, Mercer 5 June 2013 http://info.mercer.com/rs/mercer/images/mercer2013europeanassetallocationsurvey.pdf

[2] European Asset Allocation Survey 2019, Mercer, 3 August 2022 https://info.mercer.com/rs/521-DEV-513/images/ie-2019-european-asset-allocation-survey-2019.pdf

Three reasons why ESG factors should matter to alpha-driven investors

Avoiding environmental, social, and governance factors when making investment decisions can be costly. Their use in asset management is becoming standard practice. As global growth splutters and long-term megatrends reshape society, can ESG help guide investors in the right direction?

Recent criticisms of environmental, social, and governance may make some, less familiar, investors question its role and value.

But don't be fooled by these distractions. Investing using such considerations is becoming conventional.

INVESTMENT MANAGERS USE AN ESG LENS TO ASSESS A COMPANY'S OPERATING PRACTICES

Environmental, social, and governance (ESG) data provides information about how a company operates on non-financial metrics.

Organised into three general categories, ESG metrics span numerous topics, such as carbon emissions, labour practices, and corporate governance structures. These metrics apply to any, and every, business. However, their financial relevance or materiality varies by industry and time.

Investment managers are using the data to assess and make comparisons of these internal operating practices to gain insight into how well an organisation is run. In actual usage, it's primarily a risk mitigation tool.

As such, it should be clear what it isn't. Incorporating ESG considerations is

- Not about being moralistic
- Not about excluding a particular sector (such as fossil fuels)
- Not about thematic investing
- Not going to "save" our world
- Not an umbrella term for all forms of sustainable investing
- Not carried out identically by all investment managers

.

Instead, it's an innovative, and still evolving, improvement to current investing doctrine. Below are three reasons investors should expect its use by their investment managers – with the aim to improve investment outcomes.

1. MANAGERS SHOULD USE EVERY AVAILABLE DATA POINT, INCLUDING ESG DATA, TO IMPROVE THEIR INVESTMENT DECISIONS

Effective investment decision-making requires making a judgement using available data and information. Prior to the arrival of ESG data, investment managers relied only on financial data. They may have had views about topics such as governance, or culture. But there was minimal data to inform or support their views.

Now managers have this data, even if not perfect, to improve their analysis. Moreover, it's sensible for them to assess the risks for a company of, say, climate change in relation to its potential physical effects from extreme weather, preparedness for regulatory changes, or changes in customer preferences.

These are material issues where a changing world has an impact on a company's profits and losses[1].

Any rational investor would want their manager to have, and to use, this additional data to inform their decisions. The alternative? Ignoring it, would disadvantage them in terms of information asymmetry.

2. MANAGERS' FIDUCIARY DUTY REQUIRES INCLUSION OF SUCH FACTORS

As a fiduciary, investment managers are required to act for the benefit of their clients. More specifically, their fiduciary role expects:

- A duty of prudence – to operate with due care, skill and diligence
- A duty of loyalty – to act solely in the interest of beneficiaries, operating impartially and avoiding conflicts of interest

[1] This single materiality, which considers the impact of the world on the company, and the primary focus of investing with ESG factors. It does not consider how companies affect the world.

In 2005, the law firm Freshfields Bruckhaus Deringer was asked to determine the relationship between ESG and fiduciary duty. Their report[2], *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*, concluded that "integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions." [emphasis added]

Since that time, this practice has become widespread, growing empirical and academic evidence is highlighting when and how ESG factors are financially material, and regulatory frameworks around the world have enshrined, and driven further, consideration of them.

At this point, a manager failing to include ESG factors to assess long-term investment value would be failing in their fiduciary duty.

"A manager failing to include ESG factors to assess long-term investment value would be failing in their fiduciary duty"

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3. ESG FACTORS, AS A FRAMEWORK, SHOULD INFORM MANAGERS' BROADER VIEW OF THE MARKETS

Investment managers face, simultaneously, the current period of a deteriorating macroeconomic backdrop while megatrends are driving deeper societal changes. Economic signals and indicators are divergent both in direction and by location.

Managers are looking at significantly different circumstances than they have seen in decades. Markets are reacting with uncertainty and volatility. Here, ESG factors can provide a framework to make sense of wider market conditions and deeper questions being raised. For example:

- How do we solve simultaneous issues of energy security, affordability, environment, and just transition?
- What will be the implications of demographic shifts of the oldest generations living longer, and the younger "Gen Z" one expected to become more than a quarter of the workforce by 2025[3]?
- How will companies be regulated and taxed to account for their role and contribution in society?

As noted before, investing in this manner does not seek to solve the above issues directly. It can decarbonise an investor's portfolio from climate risks, but does not decarbonise the planet. Nonetheless, ESG factors and data can provide greater visibility into wider trends as well as how historically-accepted externalities will be dealt with by companies, citizens, and governments.

Investors are expecting managers to navigate their portfolios through the rough times ahead. ESG factors can't steer the boat. But they serve as tell tales and horizon scans of conditions for savvy managers.

"ESG factors can't steer the boat. But they serve as tell tales and horizon scans of conditions for savvy managers"

GENERATING FINANCIAL VALUE FROM ESG FACTORS RESTS ON SKILL, NOT SIMPLY HAVING THE DATA

The above reasons should remind investors why they should want their managers to use ESG analysis on their behalf. That said, using such considerations doesn't automatically guarantee outperformance for an investment manager.

Consider giving the same violin to a six-year-old and a Royal Philharmonic's first chair. You don't blame the instrument for the quality of the music produced. Exceptional performance in this case, as well as in investing, is driven by the talent and skill in using their instruments.

In the end, the real question for investors shouldn't be "Does the investment manager incorporate ESG considerations?", but "How, and how well, do they?"

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

[2] A legal framework for the integration of environmental, social and governance issues into institutional investment, Freshfields Bruckhaus Deringer for UNEP, 17 October 2005 https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf
[3] Gen Z and the end of the workforce as we know it, World Economic Forum, 19 May 2022 https://www.weforum.org/agenda/2022/05/gen-z-don-t-want-to-work-for-you-here-s-how-to-change-their-mind/

What are you holding?

Against a complex global macro environment, thinking about portfolios at the micro level may help investors to keep focused on the long term.

The global economy is at a delicate juncture, with the risk of a recession rising, inflationary pressures, and central banks with their foot on the rate-rise accelerator. Navigating this as an investor can be challenging.

HAVE WE REACHED THE BOTTOM?

With financial markets and sentiment on edge with each major economic data release, all eyes are on how policymakers will best steer the ship.

If such attention is being given to macro news, individual investors may conclude that they too should be taking such data into account when making investment decisions. Questions such as, Have we reached the bottom?, Where will the market be in six months?, and How will the next inflation reading affect the market? are valid ones to ask. That said, they can lead investors down the path of market timing, which can be a costly and futile endeavour.

THE COSTS OF BEING TOO INFORMED

Given that over shorter horizons investments are often more volatile, focusing on the short term might make investing seem riskier, which can lead to actions and behaviours which are unhelpful in the long term.

These include the costs of inaction, as investors await certain signals, and attempts to time entry into or exit from markets. The emotional impact of this can also exacerbate behavioural biases, potentially impairing decision-making.

While the idea of paying less attention to the macro environment may feel counterintuitive, we pose a simple question which may help with the exercise – what are you holding in your investment portfolio?

WHAT ARE YOU HOLDING?

While much of the discussion is about the market, we remind investors that your portfolio is not 'the market'. It can be helpful to think about which individual equities you hold. Instead of viewing it as stocks which are highly volatile and subject to swings in sentiment and the macro environment, it could be worth considering what exactly you hold at the micro level.

When your portfolio includes equities, you are holding shares in a selection of individual companies (in a professionally advised or managed portfolio, one would expect these to be better-run individual companies). While the macro environment is important, as that is the one in which these companies operate, it's worth remembering that a particularly unfavourable data release will not stop a strong and well-run company overnight from being well-managed (and likewise in the other direction).

The risk for investors during falling markets is a focus on the short term and a feeling of needing to gain exposure to whatever part of the market has the most momentum. This can result in investors selling structural winners only to buy structural losers.

> “The risk for investors during falling markets is a focus on the short term and a feeling of needing to gain exposure to whatever part of the market has the most momentum”

THE IMPORTANCE OF DIVERSIFICATION

There can be times when certain sectors fall in and out of favour due to a macro changes. For example, concerns over rising inflation and interest rates negatively affecting tech companies towards the end of 2021, or the war in Ukraine lifting energy company earnings in 2022.

Tactical positioning in response to such rotations in the short term can help to enhance returns, but attempting to catch this consistently is simply trying to time the market. Over the long term, we would expect the best-run companies to deliver outsized returns across the business cycle. As such, when building a portfolio, we believe that investors would be best-placed in having core holdings that can be held throughout various market conditions.

Having a well-diversified investment portfolio that spans asset classes, sectors, and quality companies can better protect from the effects of short-term volatility due to the correlations between asset classes. It may also insulate an investor from being caught up in the emotions sparked by portfolio volatility. Together, these can provide a solid foundation for protecting and growing your wealth.

LESS INFORMATION CAN LEAD TO BETTER DECISION-MAKING

The idea of paying less, and not more, attention to news that could hit performance may seem counterintuitive to many investors.

The field of behavioural finance, however, shows that more information may not necessarily improve decision-making. News cycles are far shorter than the long-term investor’s investment horizon. Meanwhile, acting based on short-term signals can be unhelpful.

Short-term market volatility is a near permanent feature of investing in equities. However, despite each of these sell-offs feeling scary, the gradual and persistent improvement in company productivity, profitability, and growth has produced returns for patient investors over the passage of time.

When it comes to news flow, investors should be paying attention to the data and factors that will have a bearing on long-term investment performance. Much of the short-term flow is just noise.

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

Can Indian equities and bonds offer investors some respite in highly uncertain times?

This year has been a wild ride for investors, with an equity sell-off in the first half followed by a modest bounce. Persistently high inflation and aggressive interest rate hikes have largely set the tone for sentiment. Through all the twists and turns, heightened volatility looks guaranteed. However, with the economy in relatively fine fettle, can Indian equity and bond markets outperform other emerging markets?

Indian markets face more global, rather than local, issues. And while geopolitical events continue to have a profound influence on local markets, it's worth keeping an eye on inflation and rate hike concerns over slowing demand and, indeed, the potential for recession.

In line with such worries, the Reserve Bank of India (RBI) is treading with more caution, while keeping its gross domestic product growth and inflation forecasts unchanged. With prices remaining a key priority for the central bank, domestic interest rates are above their pre-pandemic levels, and appear to offer an increasingly attractive investment opportunity.

The difference between inflation and the real interest rate in India and western developed economies, especially the US, has never been so wide (with developed economies facing bigger inflationary headwinds). If this persists, it may encourage more flows into India, supporting the local currency while also leading to relatively less margin pressures on domestic corporates.

UPBEAT SIGNS

High-frequency economic indicators continue to remain robust in India and expectations of the rate cycle peaking, globally and locally, are priced in. The first-quarter earnings season for fiscal year 2023 was broadly in line with consensus and we believe that they should continue to remain supportive over the rest of the year.

While valuations for Indian equities are close to their long-term average, foreign flows into the market, which have rebounded since July, and domestic flows are likely to boost investor sentiment.

INDIAN EQUITY PROSPECTS CONTINUE TO LOOK GOOD

We maintain a tactically overweight stance towards domestic stocks and believe that inflation and the rate hiking cycle are peaking, a view that is being priced into current valuations. Key commodity prices appear to be softening from their recent peaks, including Brent crude (more Iranian oil could lift supply soon, supporting the downward pressure on prices) and industrial metals.

The latest corporate earnings results show little signs for worry, coming in largely as expected for most sectors. Furthermore, the risk of earnings downgrades does not seem strong. We expect earnings growth to remain supportive in the near term.

With the NIFTY 50 index of the largest 50 domestic companies trading at around 20-times its one-year forward price-to-earnings (P/E) ratio, it is not expensive relative to the long-term historical average (especially when factoring in the change in index constituents towards more high P/E companies over this period).

India's NIFTY VIX (the volatility index for the NIFTY 50) has fallen in the last few months to 17-19%, from being in the 23-25% range for much of May, which points to less volatile times ahead.

SUPPORTIVE BROAD-BASED FLOWS

With healthy flows from international investors into Indian equities, after a period of outflows, they should help valuations. The key question is will such investors differentiate between generic emerging market allocations and Indian ones?

We continue to assign equal preference to both large-, mid-, and small-cap stocks. Our preferred sectors are banking and financial services, IT services, materials (such as specialty chemicals), and consumption (including consumer discretionary sectors like automakers).

OVERWEIGHT STANCE ON DEBT

The RBI hiked the repo rate by 50 basis points to 5.40% at August's Monetary Policy Committee meeting in an attempt to rein in inflation and to anchor inflationary expectations. Both remain a concern, along with the broad-based nature of inflation across industries. The central bank also retained its growth and inflation forecasts for this fiscal year at the meeting.

We believe that the cycle may be a relatively short, but intense, one. We seem close to the end of this cycle. Given the RBI's inflation concerns, the peak repo rate may be 5.90%. As such, market sentiment could improve as investors adjust to a "pause mode" in the cycle. In light of this, we have turned tactically overweight debt, up from neutral.

> “Market sentiment could improve as investors adjust to a ‘pause mode’ in the cycle. In light of this, we have turned tactically overweight debt, up from neutral”

While the rate curve for government bonds has flattened as overnight rates increase, the mid- to long-end of the government bonds rate curve continues to offer an appealing term premium.

CORPORATE BONDS INCREASINGLY APPEAL

The spreads between the AAA-rated corporate bonds and "G-secs", or government bonds, have been volatile recently. While the 10-year and longer maturity bonds have seen spreads contract due to consistent demand from domestic institutional investors, the two-year to five-year maturity segment continues to provide good spreads over the G-secs of respective maturities.

As such, we believe that a blend of corporate bonds and sovereign instruments with a portfolio duration of around three to five years may be preferential over a medium- to long-term investment horizon.

For investors with the appropriate risk appetite, bonds rated below AAA are starting to look appealing. While the opportunity may improve in coming months, it may be more prudent to consider capturing the yield on such bonds, on a staggered basis. Feeding in allocations over time may also help ease investors' nerves through a period of near-term volatility for financial markets.

Author: Narayan Shroff, India, Director-Investments

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