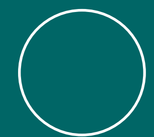
Market Perspectives

April 2023

BARCLAYS | Private Bank



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Foreword

Welcome to our April edition of Market Perspectives, which aims to provide much-needed clarity around the surge in financial market volatility sparked by the capitulation of Silicon Valley Bank (SVB) and Credit Suisse last month. While more sector challenges may emerge in the short term, the risk of mass contagion remains small, and the value of portfolio diversification is clear..

Leaving aside the short-term market stresses, the longer-term picture is more encouraging. Although our updated capital market assumptions point to a recession and relatively weak recovery, we still expect most asset classes to post positive returns over the next five years. This month's report features a special chapter on this topic, as well as pieces on the bond market and commodities.

We look at what was a volatile in debt markets and the credit cycle, while examining the role of commodities as a potential hedge for inflation and geopolitical risk as well as the impact of the reopening of China's economy. You'll also find the latest instalment from our behavioural finance expert, this time on the dangers of so-called 'home bias'.

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

What might stagflation mean for long-term return forecasts?

Find out our updated long-term capital market assumptions, with an analysis that stretches from the cyclical woes facing the global economy to the long-term structural drivers of growth. Framed by low growth and elevated inflation expectations – a mixture hesitantly referred to as stagflation – the article highlights risk and return forecasts across a broad range of asset classes.

At a particularly febrile moment for investors, with heightened geopolitical risk, persistent inflationary pressure and the spectre of a global recession, this article examines our latest five-year outlook for financial markets. At times of market turmoil, it can help to stand back from short-term developments and focus on to longer-term prospects.

Formulating five-year assumptions represents different challenges than those that come with taking a view on what might happen in the next three months: structural changes in economies cannot be ignored, non-price aspects of financial investments, such as dividends, yields and roll return, compound and the role of uncertainty and volatility is more important than over shorter horizons.

GROWTH PROSPECTS: A BUMPY LANDING INTO A SLUGGISH RECOVERY

Early last year, developed market central banks prepared to adjust monetary policy to try and target a soft economic landing. Over 12 months later and the jury is still out on how severe the landing might be.

In gauging prospects for the global economy, it is worth remembering that the interest rate hikes seen towards the end of last year have not yet been fully reflected in the labour market. Once they hit, a recession in developed market economies seems likely to ensue.

Next year, and beyond, is expected to be characterised by a sluggish recovery. Unlike the effect of the COVID-19 pandemic in 2020, when central banks rode to the rescue, this time around monetary policy stimulus may be largely withheld, so as not to reignite inflation. Furthermore, any fiscal stimulus will probably be administered only sparingly, as this could offset the demand destruction that central banks intend by hiking rates.

European economies, which are already suffering a cost-of-living squeeze, should fare worse than the US in the first years of our Capital Market Assumptions (CMA) forecast. Over five years, the average growth rate is projected to be worse than the average for the last ten years. This is also true for emerging markets. However, the reason for this is due to structural drivers weighing on growth rather than a substantial slowdown, which emerging markets should avoid on this occasion.

PARTICIPATION RATES CAN'T COMPENSATE FOR AN AGEING POPULATION

Cyclical woes aside, the longer-term growth outlook remains subdued by the availability of labour. Our estimates for potential growth, which set the anchors for longer-term growth rates, are affected by the demographic shift being seen in most economies.

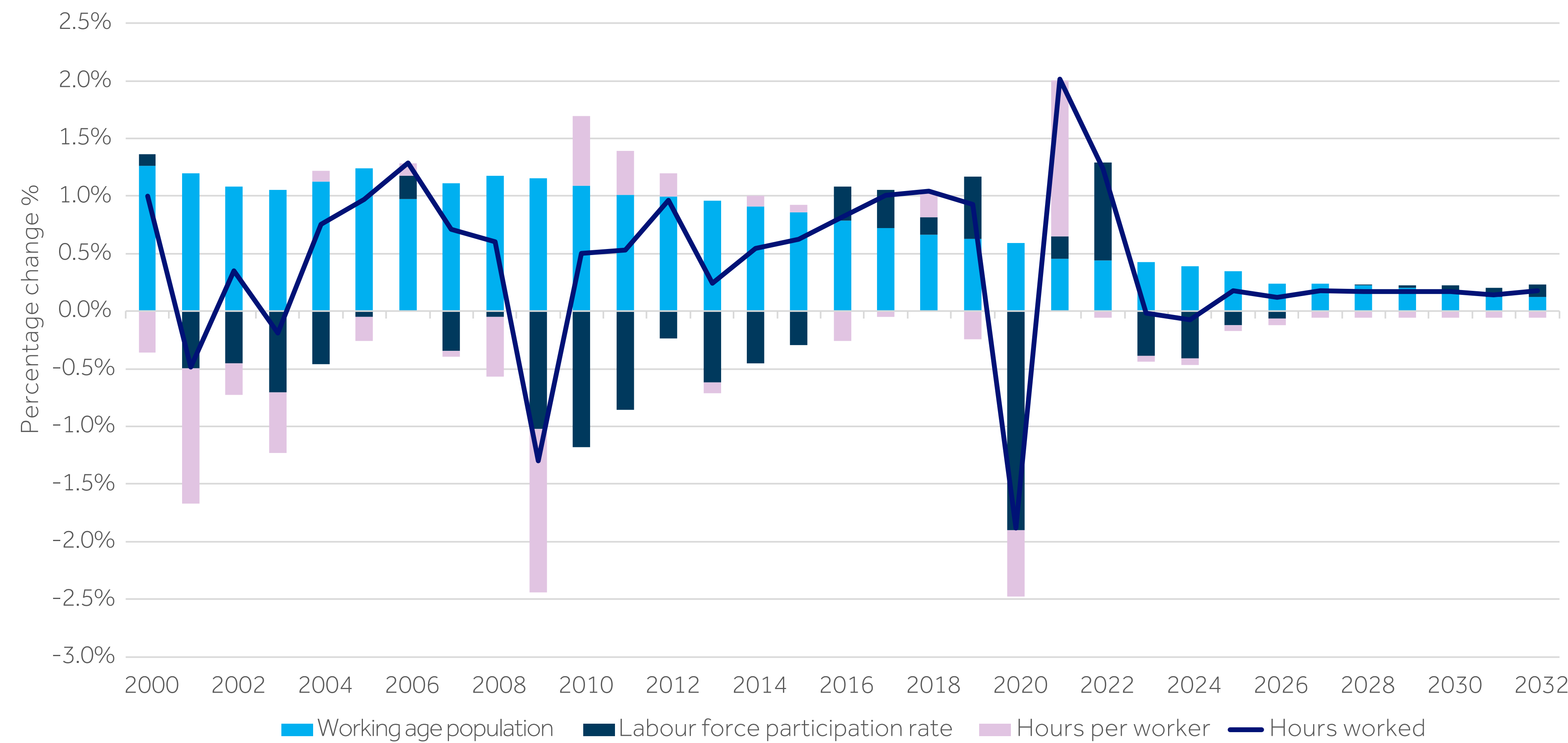
Three factors determine the labour input of an economy: the labour force population, the labour force participation rate and the hours worked per worker.

[1] The labour force participation rate and average hours worked figures displayed are average values across all working age categories. Ageing of the population has an effect on these measures too by shifting the weights of age groups over time. While we project participation rates for every age group and sex individually, we only show aggregate numbers here.

LABOUR INPUT IS RUNNING OUT OF STEAM

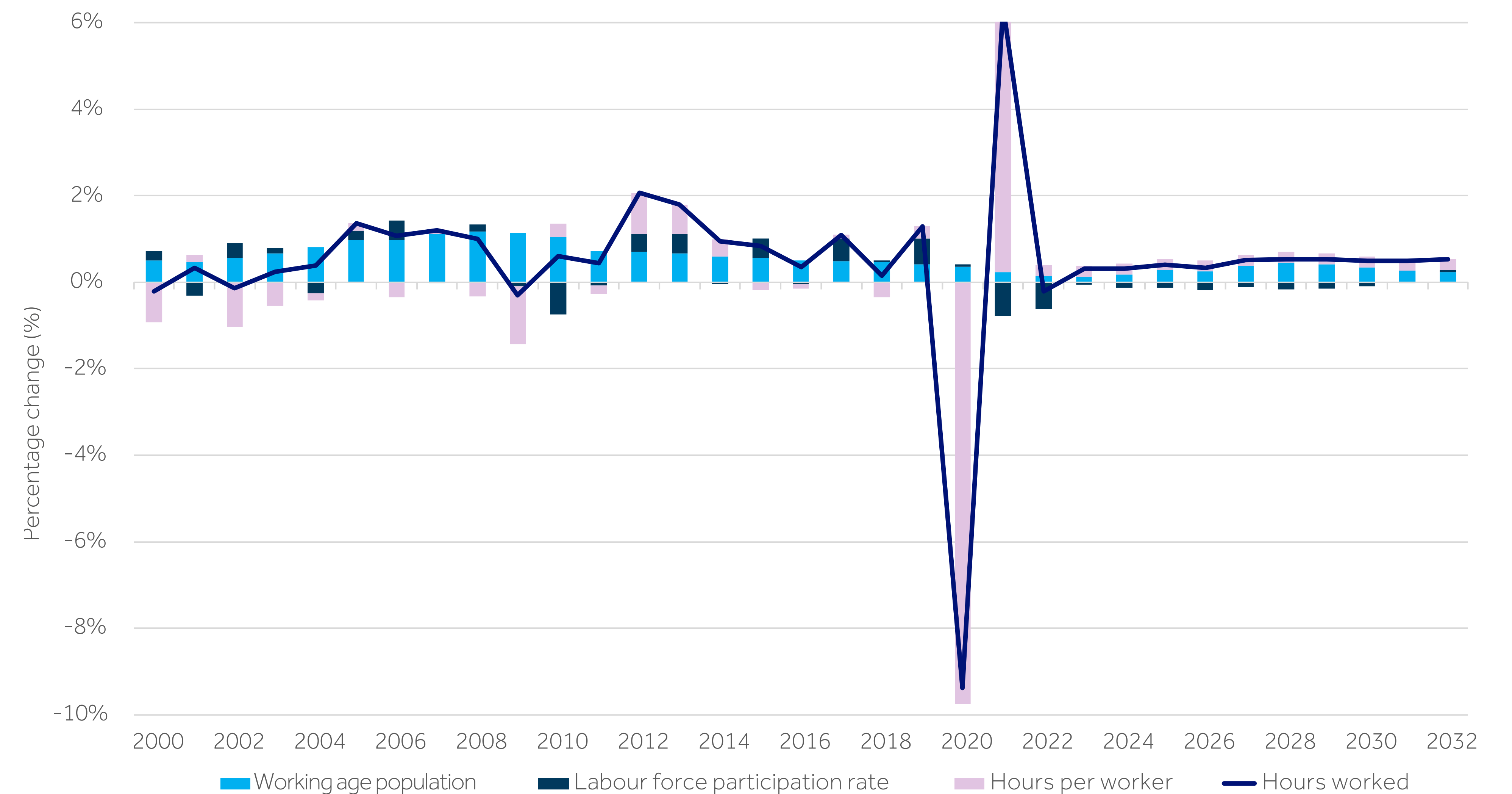
Stacked growth rates of working age population (15-74), labour force participation rate and average hours worked per worker[1] as well as the aggregate growth rate of the labour input (hours total). Own projections from 2022 onwards

In the US



Source: OECD, Barclays Private Bank, March 2023

In the UK



Source: OECD, Barclays Private Bank, March 2023

[1] The labour force participation rate and average hours worked figures displayed are average values across all working age categories. Ageing of the population has an effect on these measures too by shifting the weights of age groups over time. While we project participation rates for every age group and sex individually, we only show aggregate numbers here.

The shrinking labour force population of the last decade has been balanced by increasing labour force participation rates in the UK (see chart p4). The US economy also relied on labour force participation increases starting from 2016 but has never really recovered from the declines in them in the aftermath of the global financial crisis.

ARTIFICIAL INTELLIGENCE NEEDS TO BE PUT TO WORK

As the number of workers reaches its limits, technology is stepping up to fill the gaps. Productivity growth – boosted by the integration of artificial Intelligence (AI) into all aspects of the economy – should contribute more strongly to gross domestic product (GDP) growth over the next five to ten years than it has in the last decade.

Total factor productivity, which is where productivity-enhancing advances from AI integration would fall into in our framework, is projected to grow between 0.2% to 1.0% per year, depending on the country. For the UK and the eurozone in particular, this would mark an improvement from what was experienced between 2008 (and the global financial crisis) to 2020 (the pandemic).

INFLATION TO REMAIN ELEVATED

Inflation rates are expected to recede from their multi-decade highs seen in last year, but should remain above central bank targets well into 2024. Over five years, the average inflation rate is projected to lie around the target level for the US and clearly above target for the UK and eurozone.

There are clearly many risks to this forecast: for instance, a resurgence in geopolitical tensions during a cold winter could lead to a second oil price shock in the 2020s. Depending on the bumpiness of the landing, significant demand destruction could pull the rug from under the inflationary drivers.

Structurally, ageing populations and shrinking labour forces should act as a disinflationary force, while increased military spending and rapidly growing government debt would probably be inflationary. On balance, these risks should cancel each other out and therefore, a normalisation appears to be on the horizon.

A quick resolution of inflationary troubles, however, should not be expected and neither can investors afford to be complacent when dealing with inflation in their investment process: As argued in How well anchored are US inflation expectations? expectations have become de-anchored, and it will take more than just a few months of uneventful inflation prints to restore the trust in central banks' ability (and willingness) to rein in inflation.

CMA macro determinants: 2023-2027 average projections

	Real GDP growth (%)	Inflation (%)	Policy rate (%)
US	1.4	2.5	3.1
UK	1.1	3.2	2.9
Eurozone	1.1	2.9	2.2
Switzerland	1.3	1.5	1.0
Emerging markets	4.1	4.5	

Source: Barclays Private Bank, forecasts as of March 2023

POLICY RATES TO STAY RESTRICTIVE

Central bank policy rates are expected to remain in restrictive territory throughout 2023 and, with abating inflationary pressure, be lowered towards the estimates for neutral rates of interest towards the end of the five-year horizon.

The temptation to cut rates significantly as a response to a global slowdown may become large, but wariness of a resurgence in inflation and the high costs of a stop-and-go policy is likely to convince developed market central banks to keep rates in restrictive territory, even during a bumpy landing.

The neutral rates of interest[2] for some of the most important central banks are forecast to lie between 2.5-3.0% for the Bank of England, slightly above 2.0% for the US Federal Reserve, between 1.5-2.0% for the European Central Bank and below 1.0% for Swiss National Bank.

CASH RATES STILL BELOW INFLATION

While most of the macroeconomic outlook has changed compared to two years ago, when we last updated the Capital Market Assumptions, one key characteristic remains in place: cash rates in most currencies are still not expected to compensate for inflation (see chart, p4).

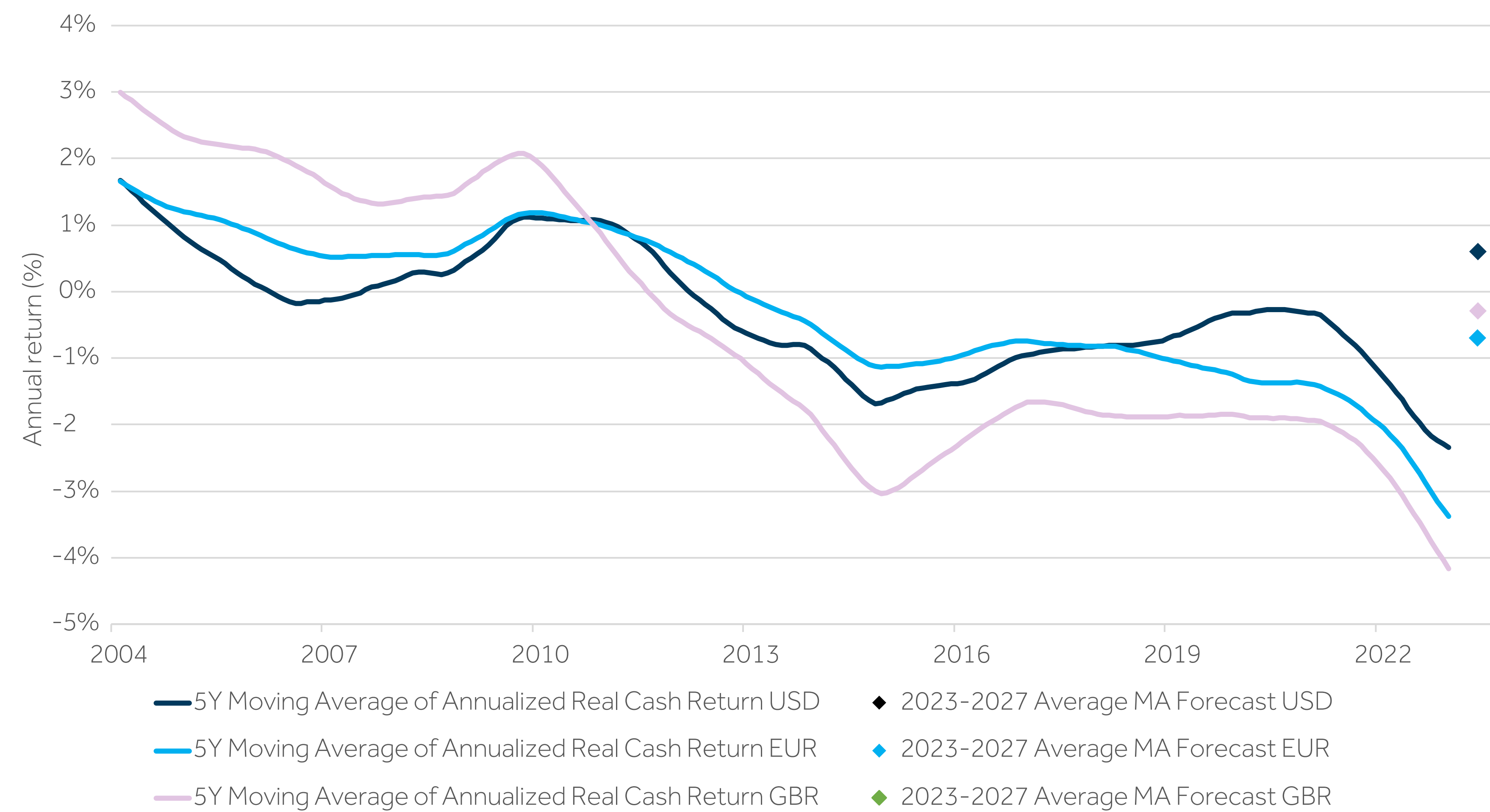
The last period when cash rates outpaced inflation over five years was ended with the global financial crisis and the shift to a regime where inflation was strongly anchored and rates came down. While we might be headed in this direction eventually, the five-year period starting in 2023 should still see negative real cash rates except for the US dollar.

For investors, this is an important reminder that over short investment horizons, of say a few months, cash may be one of the best hiding places from inflationary shocks. But over longer investment horizons holding cash is unlikely to preserve wealth let alone grow it.

[2] The neutral rate of interest is the interest rate a central bank would set if the economy were in an equilibrium and inflation was neither accelerating nor decelerating. It is also referred to as the terminal rate.

EXPECTED REAL CASH RETURNS STILL MOSTLY NEGATIVE

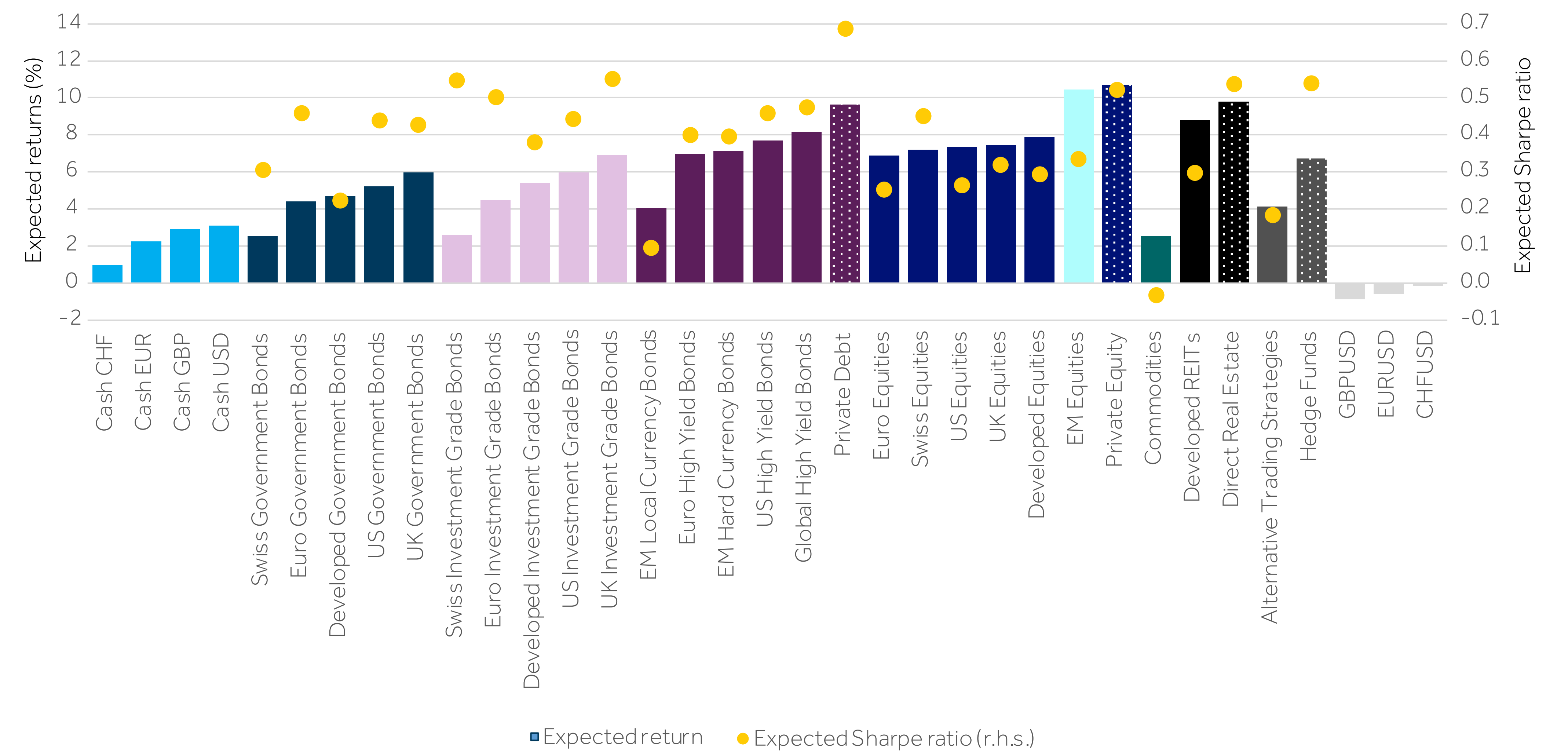
Five-year moving averages of annualised cash index returns minus headline inflation: historic realisations (January 2000- September 2021) and Barclays Private Bank CMA projection (2023-2027)



Source: Bloomberg, Barclays Private Bank. March 2023

BARCLAYS CMA RETURN AND RISK PROJECTIONS

Annualised projections for total returns and Sharpe ratios (expected excess returns over cash relative to expected volatility). Estimates for the period of 2023 to 2027



Source: Barclays Private Bank, March 2023

STAGFLATION: A BOOST TO INCOME RETURNS?

With lowered expectations for growth and elevated ones for inflation, most developed economies – especially early in the forecast horizon – will find themselves in a stagflationary environment. The implications of this de-synched macro regime for expected asset class returns can be best understood by breaking down returns into their building blocks: income, growth and valuation.

Along with subpar GDP growth, the growth component is muted. This is reflected in soft earnings growth in equities or roll return in fixed income. The prospects for income returns, on the other hand, depend more on inflation and they receive a boost in the form of dividend and net buyback yields in equities or bond yields. Since fixed income returns generally rely more on the income component, they receive a larger boost than equities in such a macroeconomic environment.

GOVERNMENT BONDS: HIGHER RETURNS BUT SMALLER DIVERSIFICATION BENEFITS

The surge in yields seen in 2022 on the back of central bank rate hikes, and the resulting increased income potential, has boosted the attractiveness of fixed income assets. After their worst year in decades, government bonds seem primed to rival the returns of equities in the early years of the forecast horizon and even surpass equities, in terms of risk-adjusted returns.

Supported by attractive yields, government bonds should return between 2.5% and 6.0% a year on average over the next five years, above the historical average of the last two decades. Beyond five years, returns look like moderating, bringing the ten-year expected returns down to 2.0% to 4.75%.

Government bonds have been important pillars of portfolios, even when the return outlook was less encouraging, due to their negative correlation to riskier assets, especially equities. Last year government bonds failed to provide this diversification effect, with an increased correlation between equities and bonds. Indeed, this effect may be hampered again over the next five years, as inflation still poses a risk (see Is asset allocation at a tipping point). As opposed to primarily growth-driven shocks, inflation-driven shocks tend to hurt both equity and bond investments.

HIGH YIELD TO BE CAUGHT UP IN ECONOMIC SLOWDOWN

Investment grade bonds should manage the economic slowdown relatively well and profit, just like government bonds, from elevated yields. European issuers, which face difficult macro conditions, have increased their resilience by adapting their term structure. This is likely to provide a buffer in turbulent periods. Over five years, returns of between 2.5% and 7.0% a year appear possible. Further out, a moderation, like the one in government bonds to between 2.0% and 5.5%, is projected.

High yield and emerging market bonds also profit from the general increase in yield levels. However, with a relatively low number of defaults seen of late and a nearing slowdown, the volatility of high yielding debt is expected to be elevated. Global high yield bonds are forecast to return around 8.2% a year, and hard currency emerging market bonds around 7.1%, over the forecast period. Conversely to government and investment grade bonds, these return expectations are in line with the historical averages over the last two decades.

EQUITIES FREED FROM THE BURDEN OF HIGH VALUATIONS

Equities fell significantly last year and this repricing should come to an end sometime this year, once the bottom in labour markets is reached. Five years out, the outlook is much brighter, as equity valuations are now more reasonably valued. As such, equity returns are predicted to lie between 7.0% and 8.0% a year for developed markets and 10.5% for emerging markets over the forecast period.

Expected equity returns remain close to the averages of the last twenty years except for US equities, which were higher in the past. Compared to the last CMA review, the outlook for equities appears better, as healthier valuations offset the lowered earnings growth estimates.

> "With lowered expectations for growth and elevated ones for inflation, most developed economies – especially early in the forecast horizon – will find themselves in a stagflationary environment"

The fact that equities have lost some of their shine only becomes apparent in comparison with anticipated returns for other asset classes: so-called excess returns[3] for US equities are projected to be 4.0% a year — half the average over the last two decades.

REAL ASSETS: POCKETS OF INFLATION PROTECTION

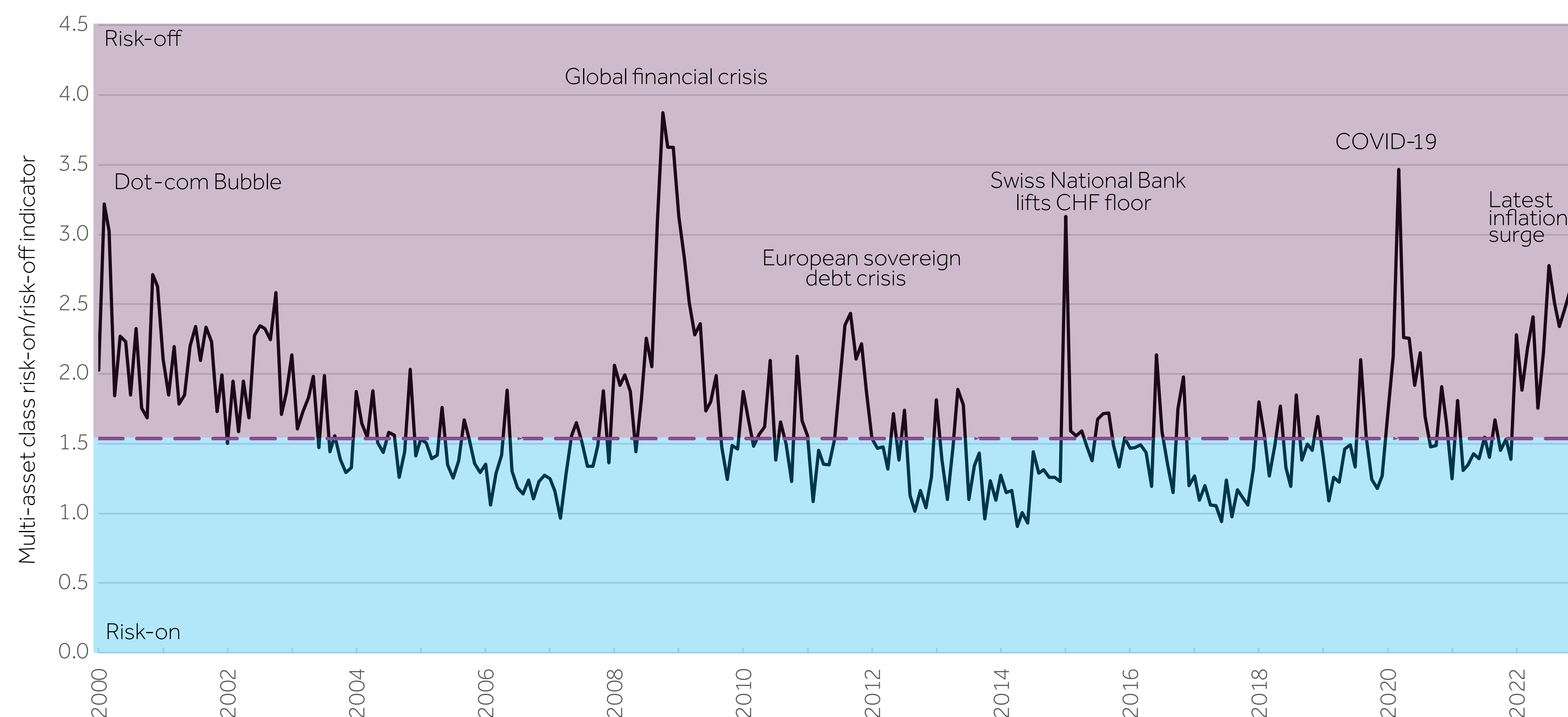
The outlook for private market returns is based on the forecasts for public markets with an illiquidity premium added on top. As such, private equity and private debt projections follow the same logic as their public benchmarks, which leads to expected returns of 10.7% and 9.6% a year, respectively, over the forecast period.

Return projections for directly held real estate over the next five years are 9.8%. One of the appeals of direct real estate to investors is its relatively low correlation to other asset classes. Another reason to invest in direct real estate is its resilience to inflation over the longer term. The illiquidity premia included in these calculations range from 1% for directly held real estate to 3% for private equity.

[3] Returns in excess of cash rates

A BROADER GAUGE FOR MARKET RISK

The multi-asset class risk-on-risk-off indicator is a proxy for "outlierness" of financial markets at monthly frequency. Higher values indicate periods of elevated volatility and correspond to risk-off regimes, and vice versa. The dashed line represents the median and divides the sample into risk-on and risk-off periods. Calculations are based on the historical covariance matrix from January 2000 until December 2022



Source: Bloomberg, Preqin, Barclays Private Bank, March 2023

Commodity returns are projected to be muted over the next five years, and expected to deliver 2.5%. Energy prices should plateau this year before gradually falling while prices for industrial metals should support overall commodity returns as economies recover from recession.

HEIGHTENED VOLATILITY AHEAD

Turning to volatility expectations, after a tough period for investors with several months of elevated volatility, the news may not get much better soon. In forecasting the outlook for volatility, solely relying on historical estimates seems unlikely to reflect our views regarding the risks of investments.

To address this issue, the historical sample was split into equally-sized regimes, called risk-on and risk-off (see chart). The split is based on a statistical measure of the extremity of market moves across all asset classes in scope. This is a richer, and for our purposes, more robust risk gauge than the commonly used VIX index, or fear gauge, which is based on 30-day options on US stocks.

Over the next five years, volatility is likely to be heightened due to the increasing likelihood of a bumpy landing and the still heightened levels of inflation. Hence, more weight is attached to the risk-off sample (60%). Further out, there appears to be no reason to overweight either sample, which leads to a balanced estimate for volatility over ten years.

PORTFOLIO IMPLICATIONS: FOCUS ON CORE COMPONENTS

The CMA form the basis for our strategic asset allocation. The implications of these risk and return expectations for asset allocation in a portfolio will be discussed in more detail at a later date. From the perspective of risk-adjusted return expectations, it is clear that the attractiveness of fixed income has been boosted when compared with cash and alternatives. As such, striking the right balance between equities and bond investments is even more important.

With regards to volatility, the persisting period of elevated, if slowing, inflationary pressure leaves markets vulnerable to additional shocks. The banking turmoil that hit markets in March is yet another reminder for investors of the attraction of being selective in volatile market environments.

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Credit cycle in the wake of the incoming rate tide

After a roller-coaster ride for bond investors in March, and with the collapse of a US bank and rescue of Credit Suisse, what next for debt markets?

Last month, was eventful for the bond market. The US 2-year Treasury yield first climbed to a record 5.1% on 8 March, the highest level since 2007, as markets reacted to tight job market data and a hawkish sounding US Federal Reserve (Fed) chair, Jerome Powell, at the US congress hearing. At its peak, the rate market priced in a terminal rate for the US Fed's policy rate of almost 5.75%.

Between 9th and 11th March, however, such hawkish fears appeared to have been wiped out, triggered by the troubles facing Silicon Valley Bank (SVB) in the US as well as heightened credit concerns, and finally the takeover of Credit Suisse by UBS in Europe. The US 2-year Treasury yield then recorded another record on 15 March: the largest one-day drop since the Volcker period, named after former Fed chair Paul Volcker, in the early 1980s. The forward rate market dropped the peak policy rate by 100 basis points (bp) to 4.9% during the day.

The magnitude of the move can also be witnessed in the headline measure for interest rate volatility, as measured by the Merrill Lynch Options Volatility Index, or "MOVE", which jumped to the highest level seen in the aftermath of the global financial crisis in 2009 (see chart, p9).

WHAT ARE THE BIGGEST CONCERNS FACING INVESTORS?

Almost a year to the day since the Fed's initial rate hike in 2022, the focus has shifted for the first time from inflation to financial conditions, from macro to micro, from price risk to credit risk. SVB, a US bank that targeted the tech sector, had to realise large capital losses on its Treasury assets as it dealt with a surge in deposit withdrawals from clients. And while sentiment was already very negative, funding spreads of the Credit Suisse blew out to distressed levels on the back of a lack of profitability and investor trust.

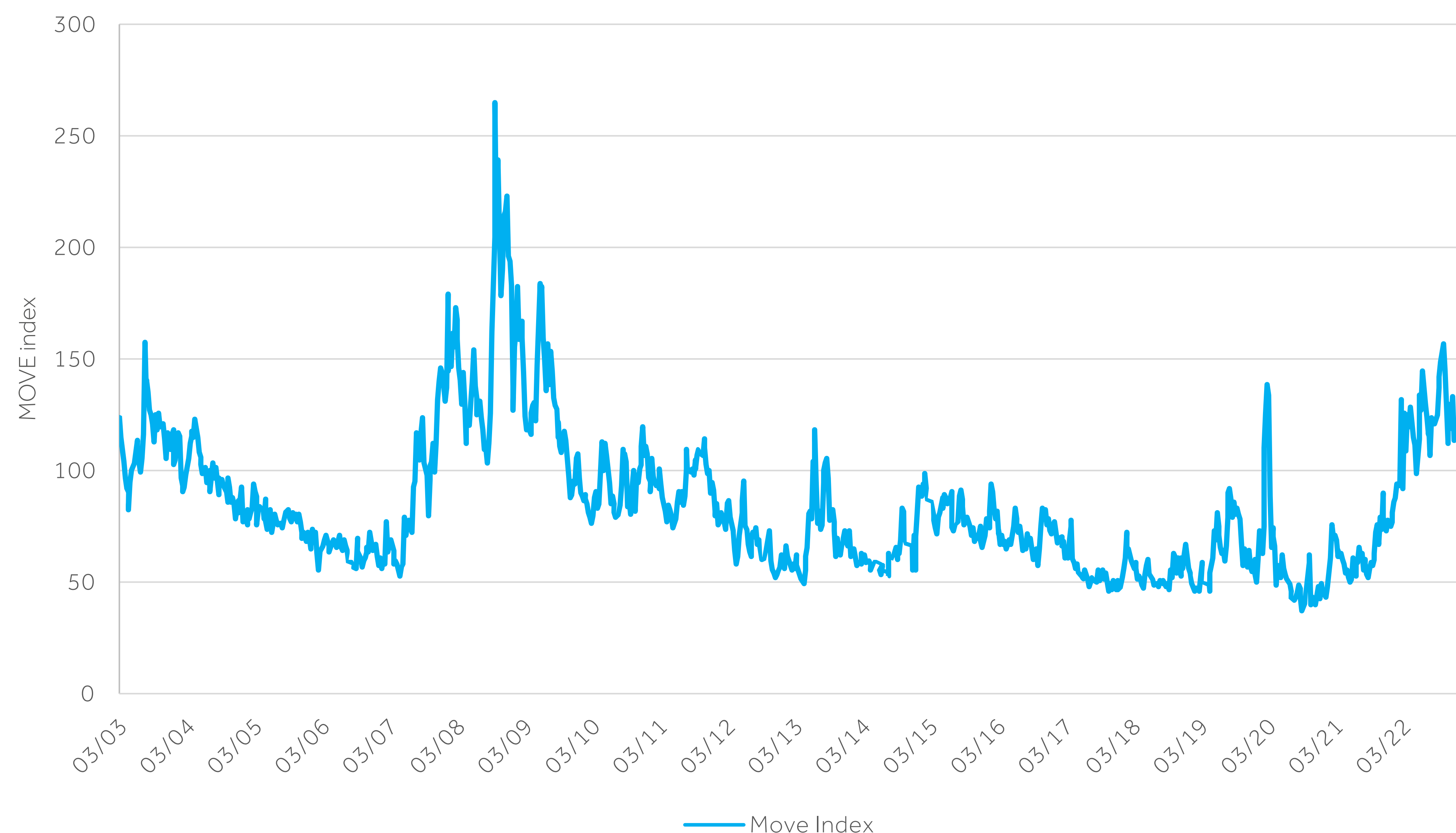
Central banks were quick to act with liquidity facilities and, in the case of Credit Suisse, even with an orchestrated merger (or takeover) with UBS. But question marks remain: are higher interest rates finally taking their toll? And might a banking or credit crisis be around the corner?

ARE RECENT EVENTS CONNECTED?

The reasons for the collapse of SVB and Credit Suisse, and more importantly the trigger, were different in nature in both cases, and worries over any large credit crisis seem to be overstated. While one bank's demise was caused by its excessive growth strategy, apparent lack of risk management and its over-reliance on one sector, the others was sparked by a lack of investor patience with regards to its long-term profitability.

RATE VOLATILITY – MOVE INDEX SPIKED HIGHER IN MARCH

Trends in the Merrill Lynch Options Volatility Index, known as the fear gauge for bond investors, since 2003 show volatility spiked to levels last seen in the global financial crisis



Source: Bloomberg, Barclays Private Bank, March 2023

"The good news is that volatility opens up opportunities to lock in yields...For now, a selective approach seems warranted"

Still, the heightened uncertainty comes at a time of higher interest rates, a shift that had already caught out the UK pension industry's use of liability-driven investments in October, when only a central bank intervention averted greater damage in the domestic bond market and pensions sector. Not only have higher interest rates exposed the mark-to-market value of assets and liabilities on balance sheets, but they have also lowered the barrier for repatriating assets to safe-havens in times of extreme uncertainty.

The good news is that a liquidity mismatch as seen within some domestic US banks and some UK pension funds this time can be mitigated relatively easily by central bank intervention as opposed to a fully blown insolvency crisis, as witnessed in 2008.

FINANCIAL CONDITIONS AT THE FOREFRONT

Some of the dangers of higher interest rates and tighter financial conditions were explored in the recent articles The road to normalisation for bond investors? and The dangers of complacency

The risk and affects of tighter financial conditions was, and still is, a reason for a cautious stance towards high yield bonds: simply said, after all boats were stranded on low interest-rate ground for a decade, they must prove that they can float again when the interest-rate tide comes in again.

Some boats, or business models, were built during the low tide and may not be waterproof. So, contrary to the old saying, not all boats will be lifted with the tide. But, equally, this does not mean that the world is in a full-blown crisis or heading towards one.

REVISITING THE CREDIT CYCLE

Clearly, the recent level of uncertainty should serve as a reminder that financial conditions have become more restrictive, not as a side-effect but because it is ultimately the intention of the central banks as they look to curtail demand in the hope of moderating inflation.

Given current circumstances, the article now turns to look at the credit cycle. The credit cycle is a concept that was most prominently outlined by US economist Hyman Minsky. Credit cycles describe the level of access people and businesses have to credit, which in turn impacts asset price levels. The stage of a credit cycle is typically identified by factors related to the business cycle, as well as corporate fundamentals and financial risk taking.

The classic stages of a credit cycle

The four stages of a typical credit cycle are: expansion, downturn, credit repair and recovery. The global financial crisis is the most obvious example of a downturn or "Minsky moment" in recent decades, while the US saving and loan banking crisis in the late 1980s should also be borne in mind, given events in March.

Outside of a large downturn, it is fair to say that most of the time, as today, credit cycles are in an expansionary phase. The challenge is to identify whether it's a later or earlier stage within the expansion. But as US economist Kenneth Rogoff pointed out in From financial crash to debt crisis, cycles can last for decades and should not be confused with business cycles (although they can coincide).

Vigilance justified

Given that the cost of credit has risen substantially over the past 12 months, it is reasonable to be vigilant and monitor developments. For credit investors, specifically buy-and-hold ones, the most important factor to watch is default rates.

Default rates among speculative bonds have already picked up globally, rising to 4.3% in 2022 from a very low level of 1.8%, and are expected to increase towards 4.4% in 2023, according to rating agency Moody's (the rather limited increase is a result of defaulted Russian bonds dropping out of the rolling 12-month statistic). This would still be well below the peak in default rates seen in the COVID-19 pandemic of 7%, according to Moody's. Thereafter the rate is expected to consolidate according to the rating agency.

Default rates on the up

While a large increase of default rates seems less likely, there still appears to be some upside risk. A scenario in which default rates increase towards 5%, or slightly more, and potentially stay at higher levels for a longer period, seems likely.

Unlike during the recoveries following the pandemic or global financial crisis, the ability of governments and central banks to provide large-scale accommodation is limited this time, as significant rate cuts would undermine efforts to tame inflation.

INTEREST RATE CYCLE AND DEFAULTS

The 25bp hike by the US Federal Reserve and Bank of England, as well as the European Central Bank's 50bp rate move, in March, despite the turmoil in financial markets, seems to amplify policymakers' focus on tackling inflation. As such, more vulnerable credits will face tighter financial conditions on their own. Indeed, US speculative default rates have generally risen in hiking cycles, with the exception of a period between 2015 and 2016; another sign that default rates will probably head higher.

BANKS AND TIGHTER FUNDING LEVELS

Recent events within the US banking sector and Europe may cause financial conditions to tighten further with access to credit from banks becoming more restrictive. The diffusion index of tightening standards for commercial industrial loans for large and medium companies supports this view (see chart, p12).

The index shows the level of tightness in credit conditions indicated by domestic respondents standing at 44.8%. This might not be as tight as seen during the pandemic in 2020, but a level of over 40% was only surpassed four times in the last 35 years (in the late 1980s, 2001, 2008 and 2020). That said, conditions may tighten in coming months.

FUNDING COST ON THE RISE AGAIN

Most companies have termed out their funding during the depressed interest rate levels seen in 2020 and 2021. But the tide seems to have turned. Should interest rates stay higher for some time, funding costs are likely to increase.

At the same time, leverage, as a percentage of US gross domestic product, for example, has retreated but is high by historical standards. In the absence of a deleveraging process, the higher level of leverage might amplify the increase in debt service costs expected in coming months and years.

Service costs (see chart, p12), as a measure of the interest coverage ratio, remain low at companies, but have started to increase, especially among high yield bond issuers. US interest expenses increased by 5.6% in the fourth quarter of 2022, and by almost 11% on a year-on-year basis, according to Bloomberg. If the trend continues, lower earnings could exacerbate the situation among high yield issuers.

WHAT DOES THIS MEAN FOR BONDS?

Credit cycles can span over years or decades and as such we would not go as far as predicting an inflection point at this stage. But the headwinds for credit spreads have risen of late, which justifies a vigilant approach. US investment grade corporate spreads have already surged to 160bp from a recent low at 115bp.

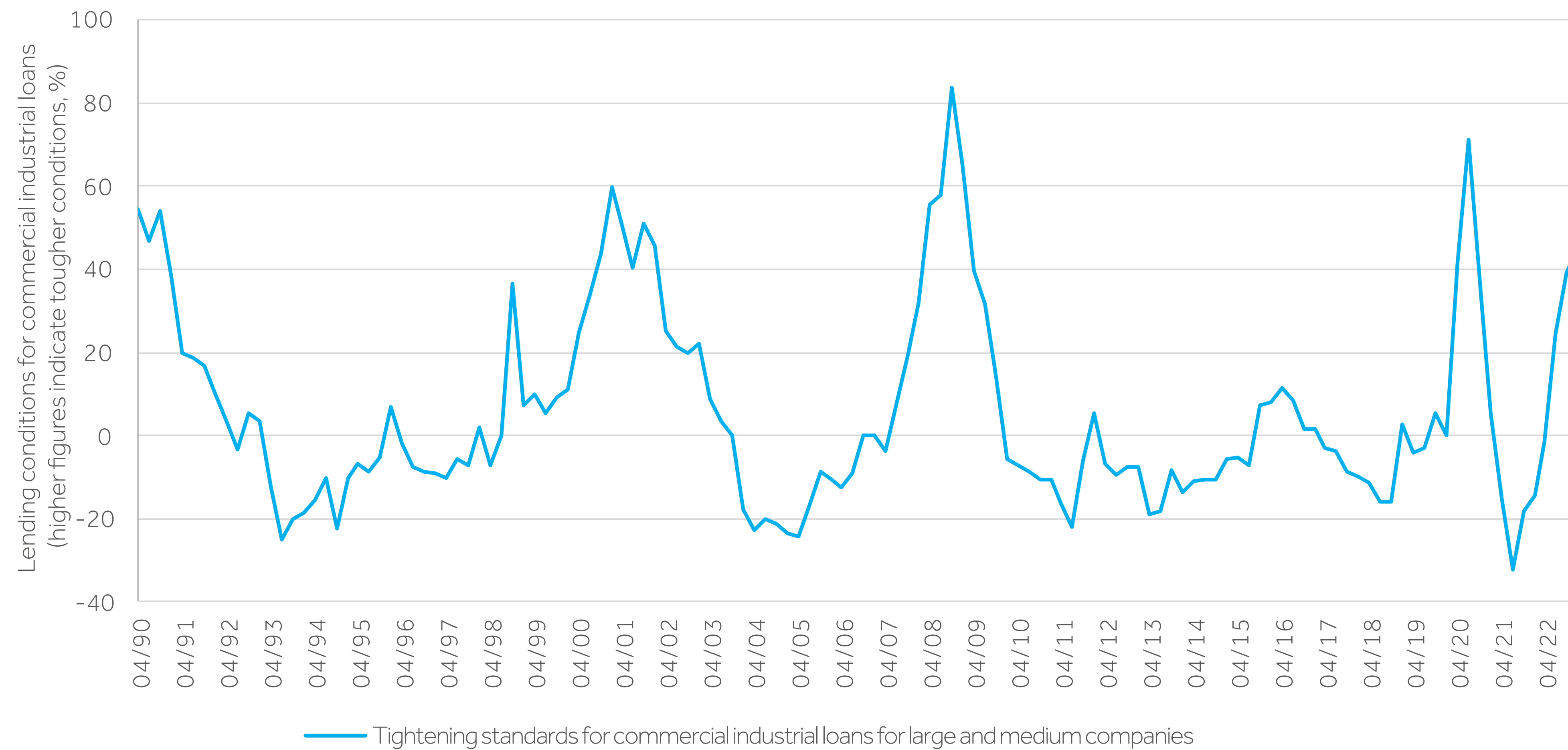
Investment grade spreads have predominantly been impacted by bank bonds and remain elevated for now. But given that the risk of a full-blown banking crisis seems low, spread volatility may remain limited within the investment grade segment. Furthermore, the general trend of corporate bond investment grade yields appears to be towards being lower, given inferior rates over the medium term.

HIGH YIELD BONDS — A SELECTIVE APPROACH APPEARS WARRANTED

High yield bond spreads have surged from 390bp to 510bp of late and seem to better reflect the inherent risk of the bonds at this stage. But lower growth and tighter financial conditions are likely to hurt the most leveraged issuers and further repricing of spreads is likely.

COMPANIES HAVE FOUND IT TOUGHER TO OBTAIN BANK LOANS OF LATE

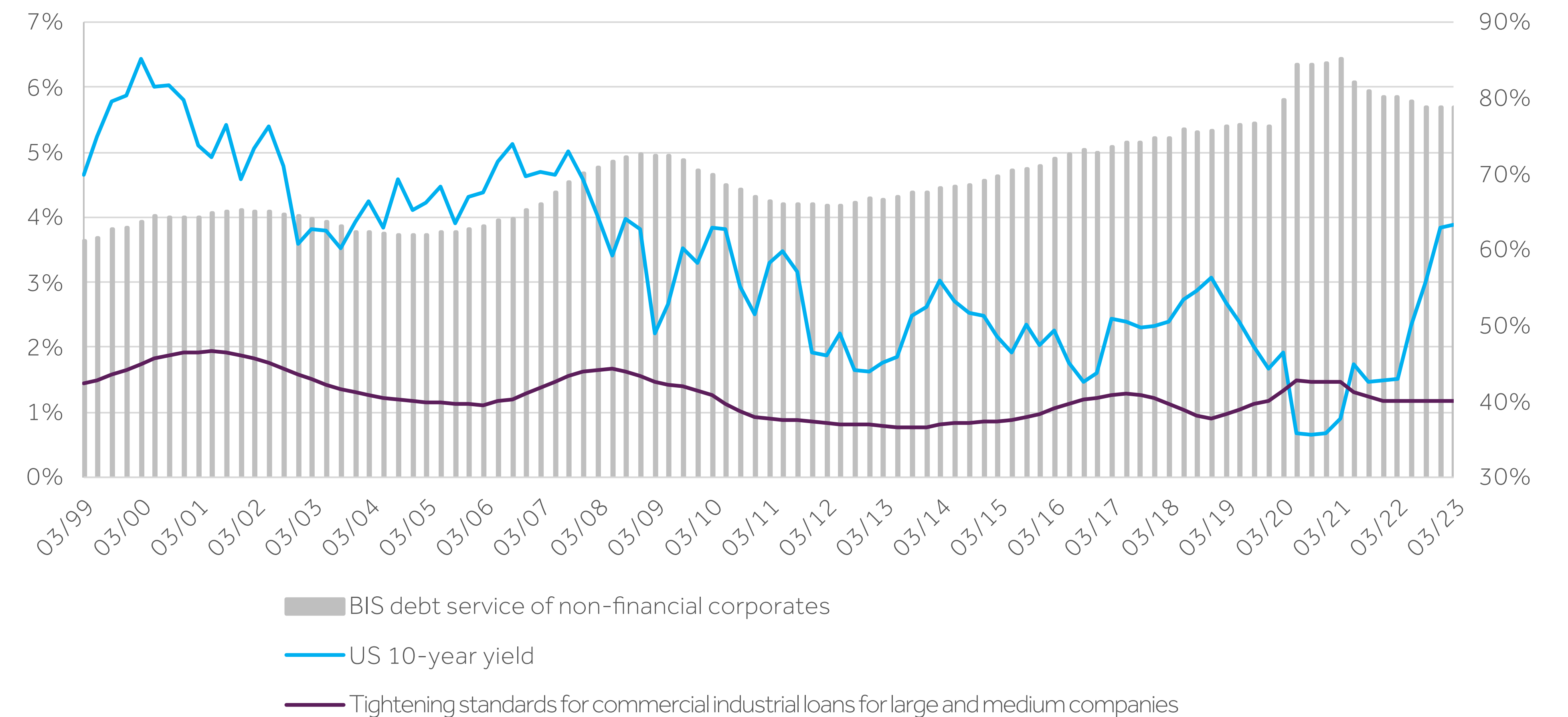
The diffusion index - Tightening standards for commercial industrial loans for large and medium companies since 1990



Source: US Federal Reserve, Barclays Private Bank, March 2023

HEADING: DEBT SERVICE COSTS RELATIVELY HIGH FOR COMMERCIAL COMPANIES

The trend in the BIS debt service ratio of non-financial companies, compared with the US 10-year yield and tightening credit standards for commercial industrial loans for large- and medium-sized companies, since 1999



Source: Bank of International Settlement, Barclays Private Bank, March 2023

The upper limit of the recent range in spreads is around 600bp, which seems to represent a minimum level of likely outcomes in the short term. However, spread levels of over 1,000bp, as seen during the pandemic, seem far less likely.

The average yield of US high yield bonds has surged to 9% from just below 8% in recent weeks, which justify some selectively repositioning bond portfolios. That said, today's highly uncertain backdrop might not justify a very large exposure to the asset class.

As mentioned before, bond market volatility, be it on the rates level or spread levels, is likely to remain fairly elevated for the remainder of 2023. The good news is that volatility creates opportunities to lock in yields. The window to do so within investment grade debt may close within the next few months as yields trend lower. Due to the higher dependency on spreads and the related volatility, opportunities to add more exposure to high yield bonds may emerge. For now, a selective approach seems warranted.

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

Outlook for commodities positive, despite near-term squalls

High inflation, geopolitical uncertainty and the potential hit to demand from any recession have triggered a volatile period for commodity prices. That said, gold retains its shine as a diversifier in times of high inflation and some commodities, like iron ore, have prospered from the reopening of the Chinese economy. So, how does the outlook look for commodity prices?

Broad-based commodity prices have plunged by 24% since their peak on 9 June 2022, as fears of a recession and potential demand destruction gained traction.

Based on the S&P GSCI Commodity price index, the decline was mainly driven by energy (-33%), industrial metals (-9%) and agriculture (-16%), while precious metals added 6% over the period (see chart, p14).

HEDGE AGAINST INFLATION AND GEOPOLITICAL RISK

On a 12-month view, commodities can be particularly helpful in hedging a portfolio against inflation and geopolitical risk.

Commodities have historically been one of the best hedges against inflation.

- Typically, industrial metals have been the best performing commodity in periods of high inflation, between 3% and 5%.
- Precious metals (and gold in particular) have been the best performer in periods of very high inflation (above 5%).

For more details on the sensitivity of commodities and other asset classes to inflation surprises, and to the inflation factor more generally (combining inflation surprises and inflation prints), see *How to diversify portfolios and hedge inflation risk: from commodities to bitcoin (November 2021)*[1] and *How to diversify investments whatever the macro weather (October 2021)*[2].

VOLATILITY IS LIKELY TO PERSIST IN THE NEAR TERM

However, in the near term, commodity prices are likely to remain very volatile, as the growth and inflation outlook remains highly uncertain. Price action is likely to be driven by the news flow around the geopolitical situation and energy supply levels in Europe, as we as the reopening of the Chinese economy, after the government suddenly lifted its zero-COVID policy in December, Beijing's policy support, and the state of global supply chains.

SHORT-TERM RISKS VERSUS LONGER-TERM OPPORTUNITIES

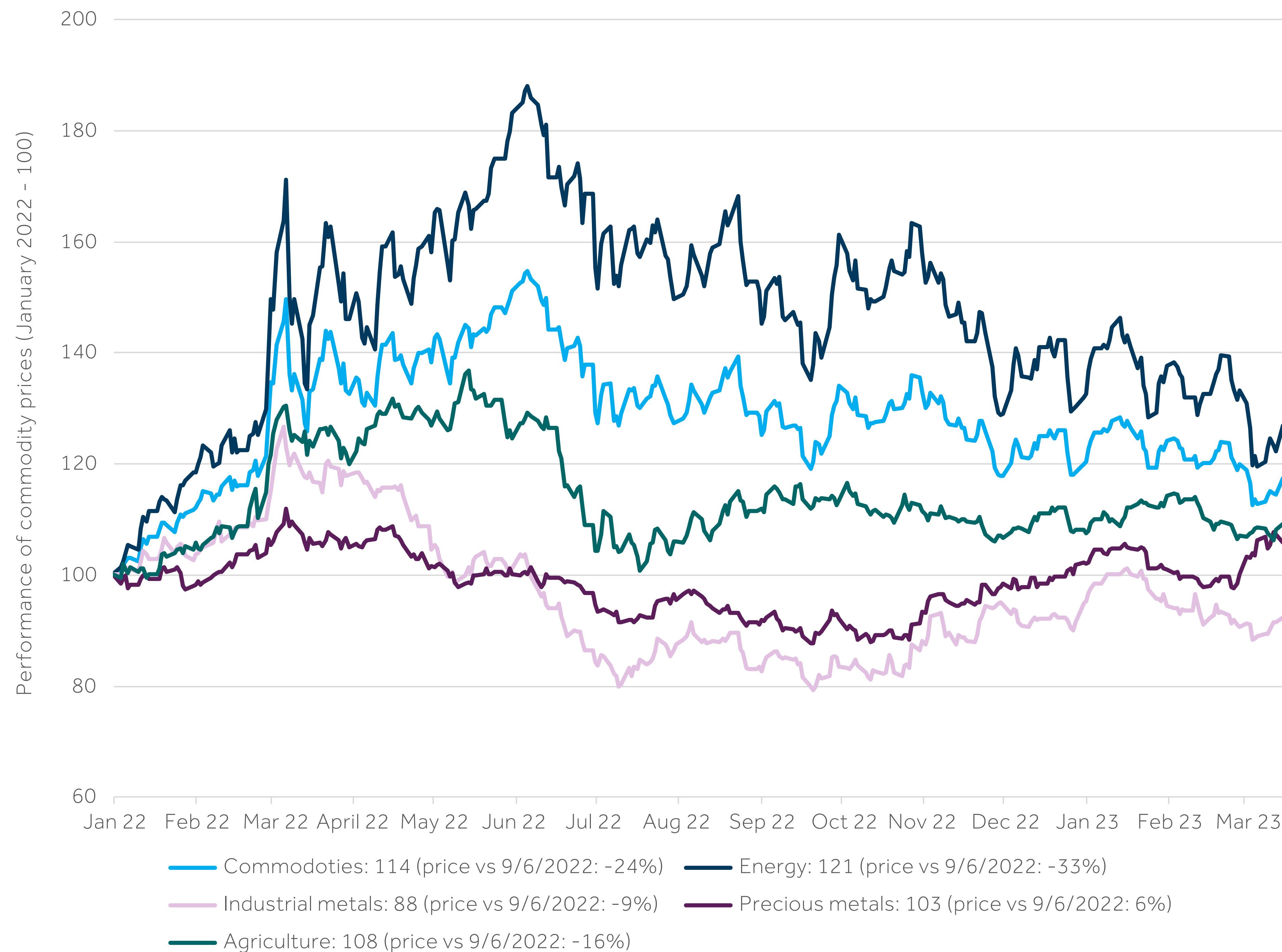
The following section looks at the short-term risks and longer-term opportunities for energy, industrial metals, and precious metals in more detail.

[1] Energy and industrial metals have historically been good hedges in times when inflation surprises to the upside. Precious metals can also provide an upside inflation hedge. Although they do not typically perform as strongly as energy when inflation spikes, precious metals tend to be one of the best choices among commodities when inflation surprises to the downside. This is a reason why gold might be seen as one of the best portfolio diversifiers.

[2] When combining inflation surprises and inflation prints, commodities (especially energy and metals prices) usually react positively to an increase in inflation. Looking at the bigger picture, precious metals generally outperform industrial metals during times of very high inflation, because those are times that are also often associated with tightening monetary policy and negative growth momentum.

COMMODITY PRICES REVERSE SOME OF THE STRONG GAINS POSTED IN THE FIRST HALF OF 2022

Commodity price performance since January 2022, and change seen since 9 June last year



Sources: Refinitiv Datastream, Barclays Private Bank, March 2023

ENERGY: SHORT-TERM VOLATILITY BUT TIGHT SUPPLY SHOULD SUPPORT LONG-TERM PRICES

Energy prices soared between January to mid-June last year, following the EU's embargo on Russian oil supplies and the Organization of the Petroleum Exporting Countries' (Opec) reluctance and inability to increase output. However, prices have since rolled over as the risk of a recession increased, along with potential demand destruction. The price of Brent declined from a peak of $128 a barrel in March 2022, to $78 a barrel in March 2023.

While global demand for oil and gas is at risk from an economic slowdown, energy prices should be supported by tight supplies, geopolitical tensions and rising Chinese demand. The country's domestic and international travel has already rebounded strongly, and is starting to feed through to more demand for oil. Increased restrictions on Russian oil will probably also support the price.

However, in the near term, energy markets are likely to remain highly volatile. Any setback in China's recovery or disappointment in global economic activity would adversely hit energy prices.

There is much uncertainty in the market at present, with futures markets predicting a decline in the price of Brent crude oil, from $78 a barrel in March to $76 a barrel by year-end and $73 a barrel by December 2024. Analysts are more optimistic and anticipate that the price will jump to $90 a barrel by year-end (according to Bloomberg's median forecast on 28 March) with forecasts ranging between $69 and $110 a barrel.

INDUSTRIAL METALS: SHORT-TERM VOLATILITY BUT, SUPPORTED BY STRUCTURAL TRENDS OVER THE LONG TERM

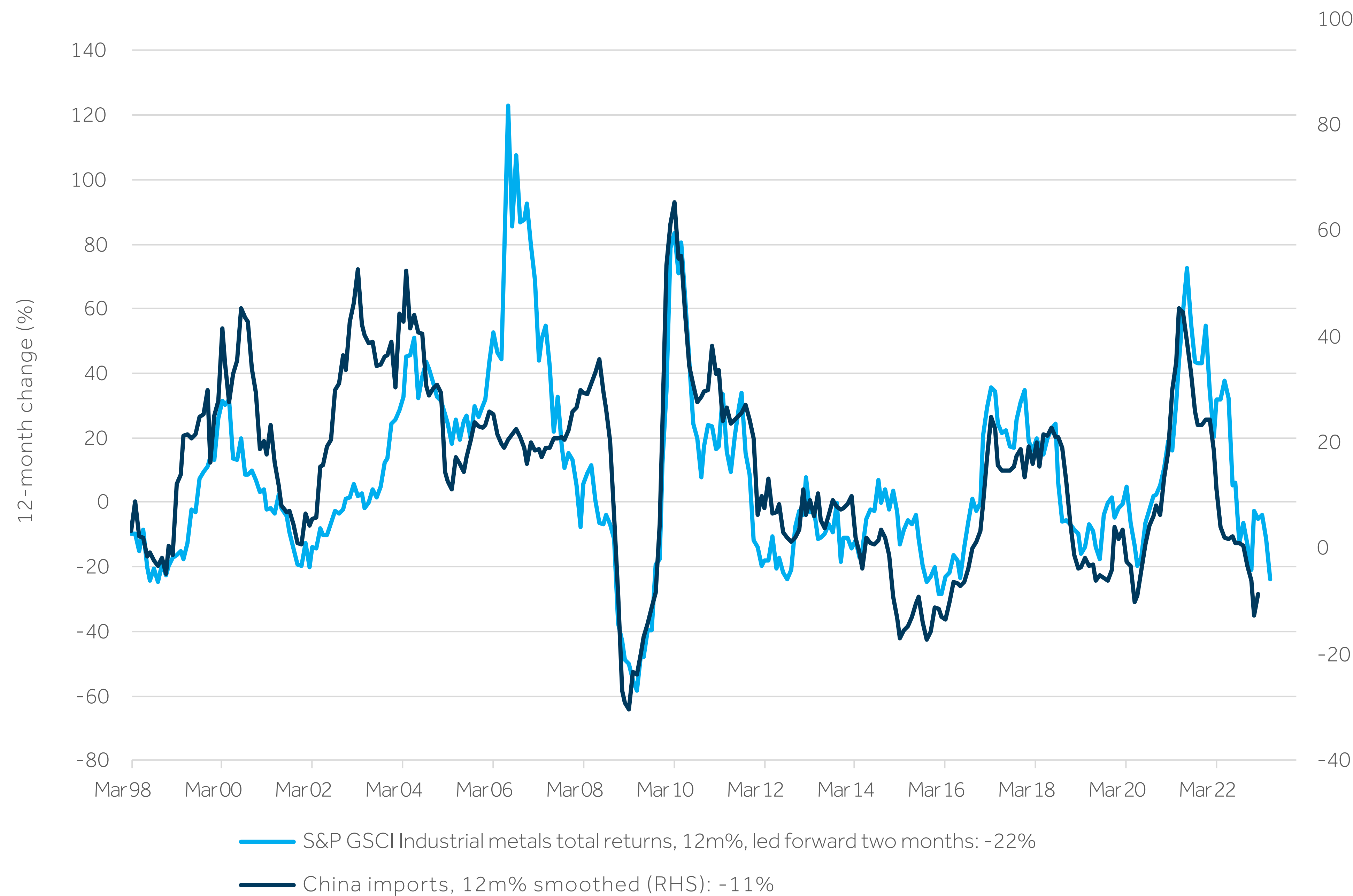
So far, the market has played the China reopening story primarily through industrial metals. They have gained 16% from their September low (on the 28th of the month), with copper and iron ore up as much as 21% and 24%, respectively. There has been little sign of an increase in industrial metal demand yet, but manufacturing activity is expected to pick up through the year.

China represents about 50% of the global demand for metals (and as much as 65% of seaborne iron ore demand), so it is not a surprise to see prices rebound strongly. But it also means that metal prices are very sensitive to Chinese growth (see chart, p15), and they would be vulnerable to any disappointment in the recovery process.

The long-term outlook for industrial metal prices remains underpinned by favourable long-term supply and demand dynamics. Supply is tight, following under-investment from mining companies over many years. Meanwhile, demand should be supported by the energy transition, especially towards renewable sources.

INDUSTRIAL METALS PRICES ARE VERY SENSITIVE TO CHINESE IMPORTS

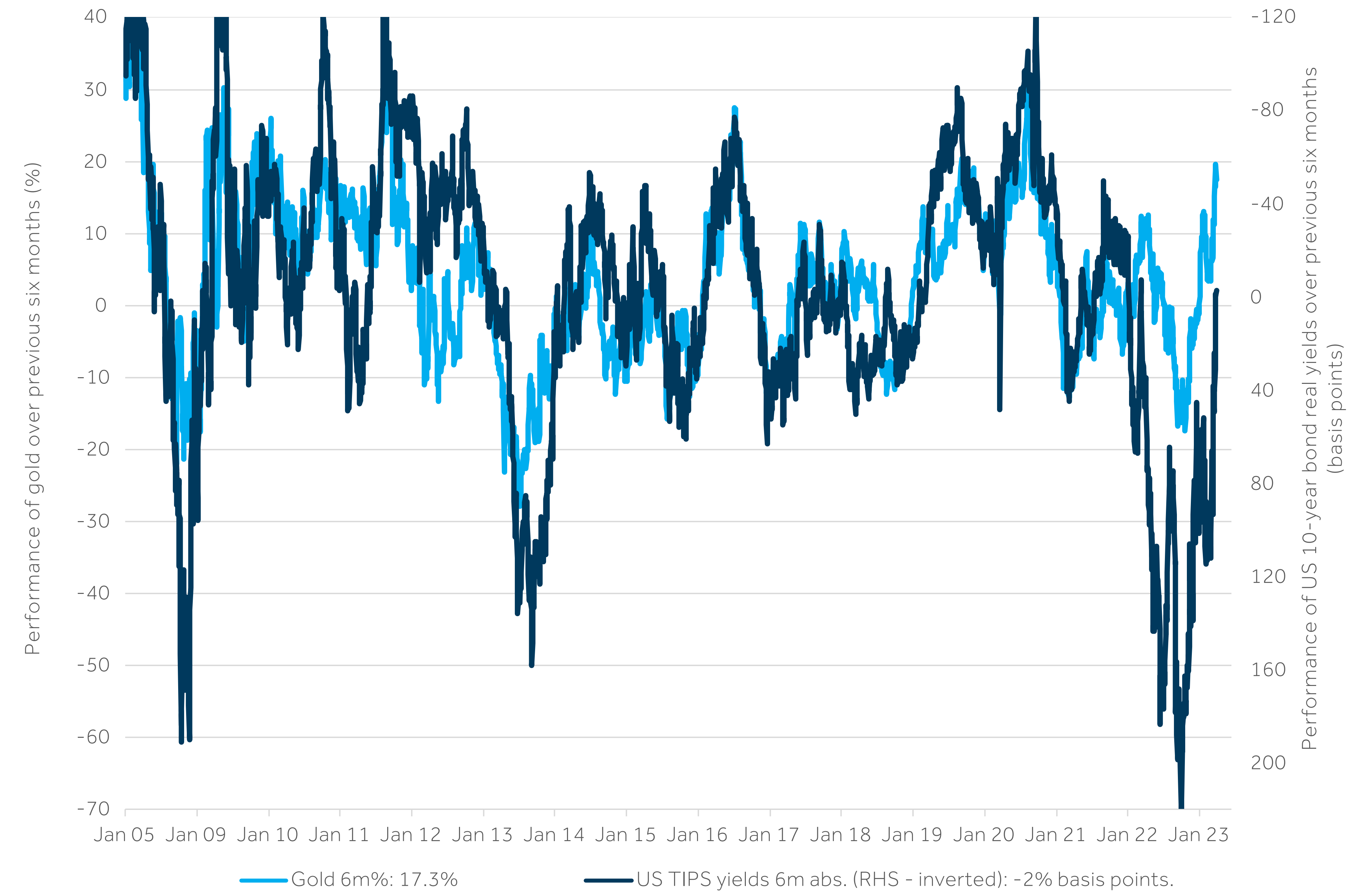
S&P GSCI Industrial metals' 12 month returns, vs annual growth in Chinese imports



Sources: Refinitiv Datastream, Barclays Private Bank, March 2023

GOLD DISCONNECTED FROM REAL YIELDS AFTER RUSSIA INVADED UKRAINE

Six-month change in the price of gold versus the six-month change in US 10-year real yields since 2008



Sources: Refinitiv Datastream, Barclays Private Bank, March 2023

PRECIOUS METALS: ATTRACTIVE DIVERSIFIER WHILE INFLATION AND GEOPOLITICAL RISKS REMAIN, BUT FUNDAMENTALLY EXPENSIVE

In the current environment, gold should continue to play its role as an attractive portfolio diversifier. The appeal of the yellow metal generally endures as long as inflation, recession and geopolitical risks hang over markets.

However, based on its relationship with real yields, gold appears fundamentally expensive and seems to offer limited upside potential from current levels.

Historically, gold has been negatively correlated with real yields (see chart, p15). This relationship broke down in February 2022, after Russia invaded Ukraine, with gold prices remaining resilient in the face of rising real yields. However, prices would be at risk if geopolitical tensions receded and real yields remained elevated.

LONG-TERM COMMODITIES STORY REMAINS INTACT

Summing up, commodities appear to be an attractive hedge against inflation and geopolitical risk over the next 12 months. While industrial metal prices have already benefited from the boost to sentiment seen this year around the re-opening of the Chinese economy, energy prices have seen little benefit yet. With travel being one of the main beneficiaries of the country's re-opening so far, the resulting increase in the demand for oil should act as a tailwind for the oil price.

Author: Dorothee Deck, Cross Asset Strategist

Overcoming home bias when investing

Investing close to home may feel like the right thing to do and provide comfort by investing in familiar businesses. However, such a strategy brings its own risks, not least via over-concentrated portfolio holdings and missed growth opportunities elsewhere.

Market commentary was dominated by discussions on the health of the global banking sector in March, which started with the collapse of a regional US bank (Silicon Valley Bank, or SVB) quickly followed by a rescue acquisition of a Swiss banking giant (Credit Suisse). It would be entirely understandable for investors to ask how this happened and seek to understand the risks of contagion.

Recent troubles in the banking sector highlight the importance of diversification; starting from the (lack of) diversification in SVB's client base, which probably exacerbated its troubles, to the importance of diversified portfolio holdings in the face of elevated market volatility.

However, some investors maintain a strong preference towards what they know and understand, which can bias their portfolios towards particular types of companies, asset classes and regions. This, combined with a tendency to have a general optimism for, and belief in, domestic assets, can fuel a home bias, despite the fact that international diversification can typically be positive from a risk-return perspective.

WHAT IS HOME BIAS?

Home bias involves investors disproportionally allocating more to local assets compared to their share in the global market. It is seen to varying degrees across countries and asset types, and from both individual and professional investors.

For example, in the UK, equity home bias has been estimated to be approximately 25% of an allocation[1], despite UK equities forming just 4% of the global index (see chart, p18). These estimates vary greatly between countries.

WHY DO PEOPLE PREFER TO STAY HOME?

A key behavioural explanation for home bias is that such assets and markets tend to be more familiar, and give us a feeling of control over outcomes. Investors might attach more risk to investing abroad than is deserved simply because overseas companies are less understood.

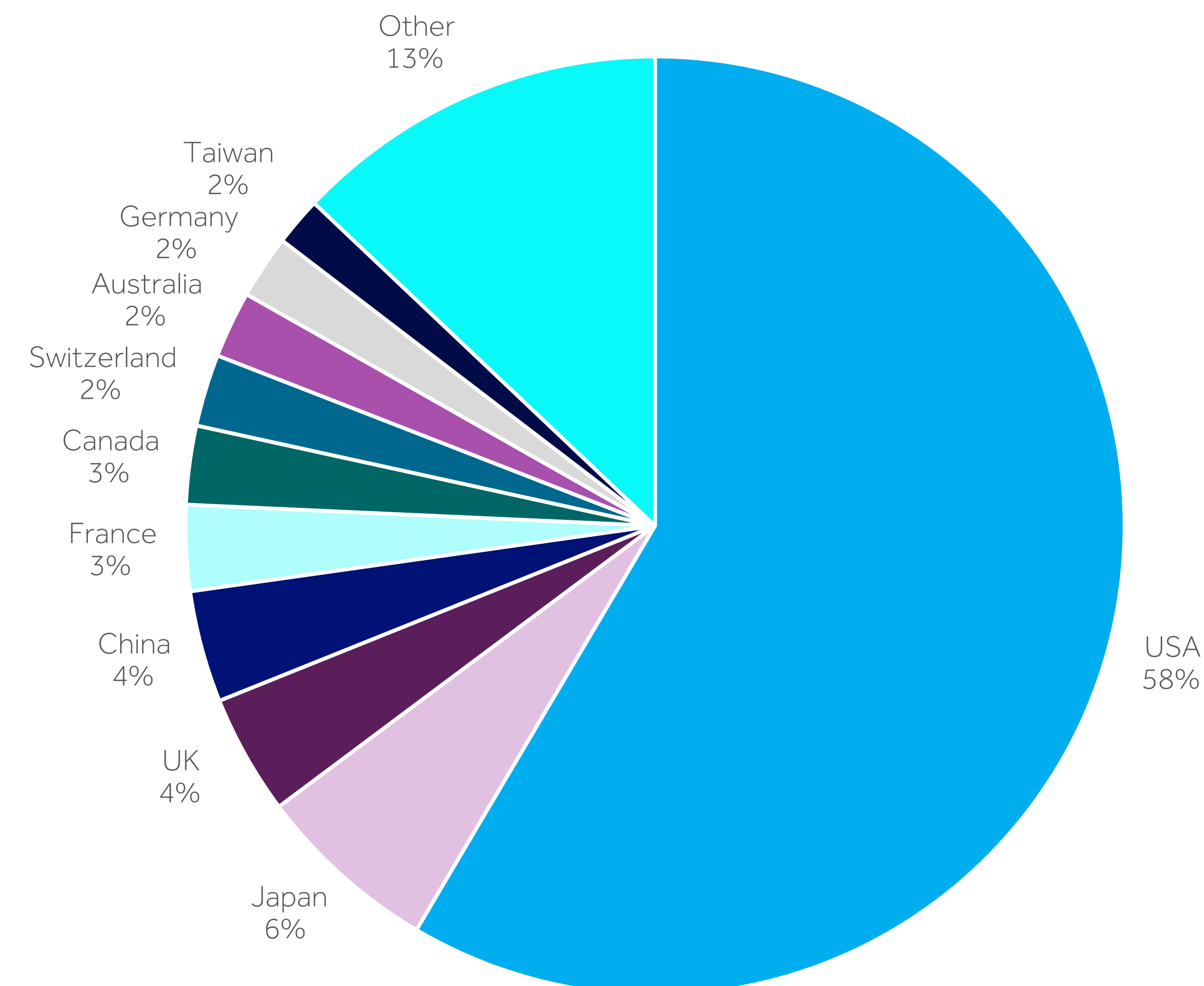
Another reason is our aversion to ambiguity; situations where probabilities are unknown. Past experience can also play a role; investors may think they are better at assessing domestic assets and consequently over-estimate their judgements.

The risk of investing in another currency is also real. Many investors invest locally to trade in their home currency and avoid hedging currency exposure. As such, exhibiting a home bias may be seen as hedging against additional uncertainty.

[1] Global equity investing: The benefits of diversification and sizing your allocation, Vanguard, April 2021 https://corporate.vanguard.com/content/dam/corp/research/pdf/Global-equity-investing-The-benefits-of-diversification-and-sizing-your-allocation-US-ISGGEB_042021_Online.pdf

RELATIVE SIZES OF WORLD STOCK MARKETS

FTSE All-World Index geographical breakdown (by market capitalisation)



Sources: FTSE Russell, Barclays Private Bank, March 2023. Allocations below 1.5% have been grouped into "Other"

GEOGRAPHICAL SEPERATION CAN EXACERBATE BIASES

In challenging market environments investors' focus becomes more short-term and behavioural biases might hit performance. Heightened emotions sometimes make it more challenging to stick to one's long-term investment path.

Behavioural biases affect all investors to varying degrees. But such biases can be exacerbated for those who are further away from their investments and advisers, as unwelcome market noise can influence views on markets and subsequent actions.

IT'S ALL ABOUT THE COMPANIES

Many investors may think in terms of 'the market' and believe their wealth is tied to its gyrations. It is important to think about investments at a micro level; remember that a diversified portfolio invests in the stocks and bonds of individual companies.

Furthermore, in today's interconnected world, multinational companies have international supply chains and customers, and thus generate much of their revenues outside of the country in which they are listed. However, some investors might avoid investing in a particular country perhaps due to political concerns or growth prospects.

Because of the interconnectedness of companies, this can mean that an investor might still make good investments in those regions, irrespective of those factors. For example, there are still opportunities to be found in the UK equity market, despite the weak growth prospects and recent political upheaval.

WHAT'S IN YOUR POCKET?

One way to think about it is to consider your smartphone. For many it is one designed by a US company and listed on the US stock exchange, assembled in China, with many raw materials, such as rare earth minerals, coming from all over the world. Likewise with cars, which may have been built in Europe but, again, using components coming from around the world.

These two examples of everyday products show the strength of two particular regions as well as the importance of a global exposure. Yet many users of these products may be averse to investing in those regions, due to them being less familiar or geographically distant.

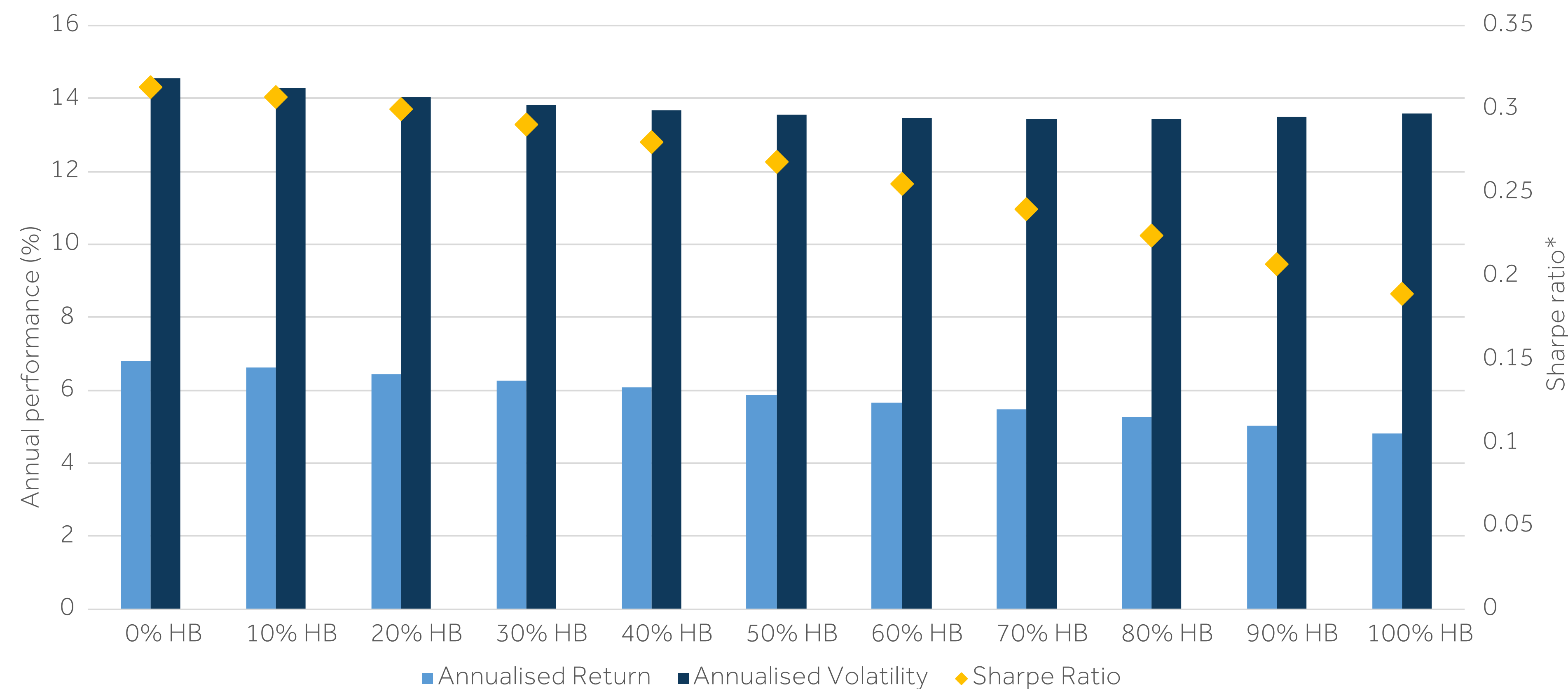
THINK ABOUT THE POTENTIAL EFFECT ON RETURNS

Home bias will likely lead to heavy exposure to certain currencies and sectors in the economy. The implication of a higher concentration in a portfolio is increased risk, as well as a possible drag on returns. By being overly concentrated on one region versus another, an investor can miss out on particular sectors that play an important role in economic growth.

Using the UK as an example, over the past two decades a stronger UK home bias would have resulted in lower risk adjusted returns, as measured by the Sharpe ratio of a global equity portfolio (see chart, p19).

THE IMPACT OF HOME BIAS ON RETURNS

Hypothetical risk-adjusted returns of equity portfolios with different levels of UK home bias (HB), using MSCI ACWI EX UK as the world benchmark and the FTSE 100 as the local one between 1999 and 2023



*The Sharpe ratio divides a portfolio's excess returns by a measure of its volatility to assess risk-adjusted performance

Source: Bloomberg, Barclays Private Bank, March 2023.

Lower risk-adjusted returns occurred partially because of the underperformance of the FTSE 100 relative to the MSCI World and partially because of the depreciation of sterling relative to the US dollar, with much of the variation occurring since 2014 (See As many global investors depart sterling, should you? to find out more about why the UK currency has been losing its role as a safe-haven currency).

The risk-return implications of equity home bias are likely to be more significant the narrower the local stock market that an investor is over-weighting.

> "Investors might think they are better at assessing domestic assets and consequently over-estimate their judgements"

DIVERSIFICATION

So, what is the implication for investors? While having over- or under-exposure to a region may boost returns for some time, for reasons specific to that time period that are likely to be clear only in hindsight, this is unlikely to be in the best interests of long-term investors.

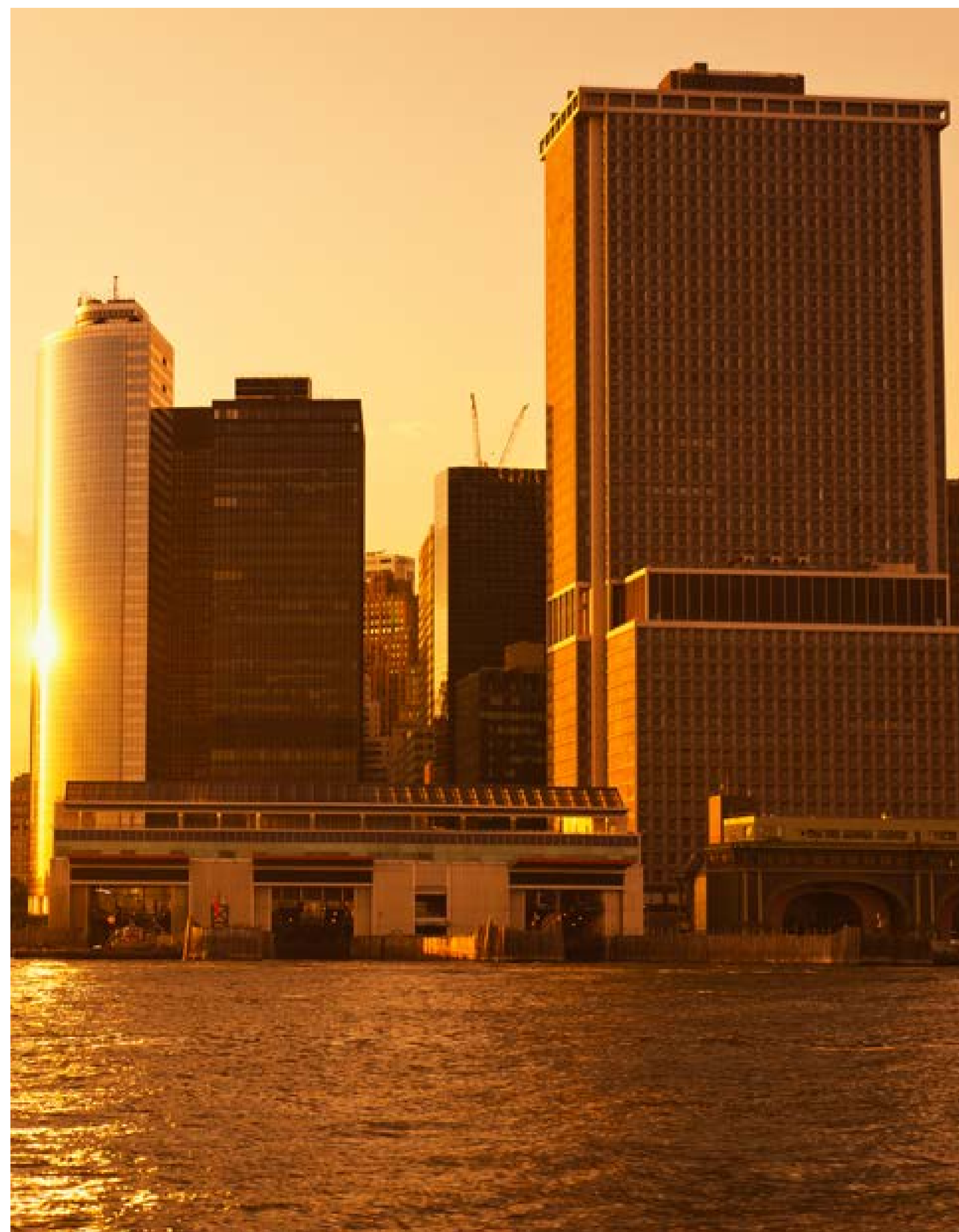
A diversified portfolio should provide the best building blocks for sustained investing success. While diversification is frequently discussed in relation to asset classes, it also applies to regions. Because international markets rarely move in the same direction at the same time, a period of lower returns in one region can be offset by outperformance in others.

The location of a stock's listing should not be the primary driver for inclusion or exclusion in a portfolio. Geographical diversification is important, but this should be considered in relation to a company's wider exposures, such as the location of their customer base and supply chain, rather than the location of their stock exchange.

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

Multi-asset portfolio allocation

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



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

- denotes a cautious view = denotes a neutral view + denotes a positive view

CASH AND SHORT DURATION BONDS

- Given the ongoing level of uncertainty, and to manage portfolio risks, we still prefer higher-quality and liquid opportunities.

FIXED INCOME

- We see increasing opportunities in fixed income
- We maintain a preference for developed market government bonds as a hedge against any macro volatility
- In credit, the higher-quality segment is preferred, while remaining selective elsewhere
- In high yield, where selection is key, our exposure is relatively low, as spreads have room to widen further in an adverse scenario
- We are cautious on the emerging markets segment.

EQUITIES

- We believe that equities remain relatively more appealing than bonds for long-term investors
- 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, more opportunities are seen 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, CFA, London UK, Chief Market Strategist

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