



# Market Perspectives

March 2023



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# Foreword

Welcome to our March edition of Market Perspectives, which aims to provide much-needed clarity around the recent rally in risk assets, reopening of China's economy and surprisingly positive US macro data already seen this year.

The rally in equity markets seen since October is probably on its last legs, until more clarity emerges on interest rate, economic growth and inflation prospects. Going forward, investors need to differentiate between those sectors where the rally is justified and those where it is not.

Turning to bonds, the rates market seems confident that inflation will cool from multi-decade highs quickly. Time will tell. The speed by which the US policy rate peaks, and the length of time it remains there, will be vital to sentiment. With recent economic data being surprisingly resilient, central banks are likely to bear down on inflation by keeping rates at their peak for longer than initially expected.

The temperature is rising among governments to attract green investments to their economies and secure jobs, and long-term growth. After last year's landmark Inflation Reduction Act from the US, the EU has responded with its Green Deal Industrial Plan. Some sectors stand to profit more than most from such largesse. But as the geopolitical battle heats up, the prospect of a greener, cleaner world moves closer.

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**



# Will a Chinese economic rebound help power global growth?

As China's economy reopens after a long period under a zero-COVID policy, early signs of a bounce in growth are encouraging.



For nearly three years, China enforced some of the strictest COVID-19 restrictions anywhere in the world. Its leadership had been unwavering in its commitment to the aggressive containment tactic, until a few months ago, despite most other countries accepting the virus as being endemic.

China's rationale for sticking with the coronavirus suppression policy was based on lower efficacy rates for its domestically produced vaccine and poor vaccination rates amongst vulnerable groups, specifically the elderly. Authorities continued to proclaim that the restrictions were required to prevent the health service from being overwhelmed and to avoid a surge in death rates.

At the end of last year, however, the authorities abruptly abandoned their pledge to maintain the economically damaging zero-COVID strategy. Officials stopped the restrictive quarantine rules, finished mass testing and ended the practice of snap city-wide lockdowns.

After more than one thousand days, authorities have finally reopened China's borders and international travel has resumed. The dramatic policy pivot should be positive for domestic activity, international supply chains and global growth prospects.

## FEARS OVER ENDING ZERO-COVID POLICY UNFOUNDED

The removal of the restrictions saw China suffer the world's largest COVID wave, driven primarily by the highly transmissible Omicron variant. At the end of last year, daily infection rates surged into the tens of millions. However, official data suggest that hospitalisations have proved to be manageable and fears of millions of deaths have thankfully proved to be unfounded (albeit data transparency remains a source of debate).

We believe that the point of peak infections, following the Chinese New Year celebrations which always trigger huge amounts of people migration, has now passed and the population is approaching herd immunity status.

## REOPENING CHINA'S ECONOMY

Historically, China's growth has been driven by an expansion of credit and investment, although more recently, exports and property have become the main drivers. As we see the economy reopen from the depths of the pandemic, we would expect a broader-based recovery, with a strong emphasis on improving levels of domestic consumption.

The removal of travel and leisure restrictions has led to an unleashing of pent-up demand across the services sector. Recent mobility data have highlighted the sharp recovery in transportation usage and recreational visits. January's services purchasing managers' index (PMI) report demonstrated a strong rebound, with the index back above the expansion line, at 52.9 in January from 48 in December<sup>1</sup>. We forecast that services output will more than triple this year compared to 2022, with growth of 7%.

<sup>1</sup> China Jan services activity expands for the first time in five months – Caixin PMI, Reuters, 3 February 2023 <https://www.reuters.com/world/china/china-jan-services-activity-expands-first-time-five-months-caixin-pmi-2023-02-03/>



Retail sales are expected to recover and grow by 9-10%, following last year's period of stagnation. In the medium term, more household debt and slowing real income growth among the middle classes could constrain demand. Balance sheets of wealthy households continue to look healthy, which should be positive for overseas spending as international travel resumes.

Beyond the reversal of COVID-19 restrictions, authorities are promoting growth by initiating a comprehensive plan to shore up the property market and pledging to offer a more supportive monetary and fiscal backdrop.

### HOUSING MARKET

The Chinese housing market has slumped over the past year as developers defaulted on their debt, investment dried up and buyers boycotted mortgage payments.

Given the importance of the housing market to the economy (around one-quarter of gross domestic product), policymakers have instigated a broad range of measures to prop up the sector. The latest initiatives include credit support for housing developers, financial assistance to ensure the successful completion of projects and the loosening of restrictions on property purchases. Whilst unlikely to be an instant panacea for the troubled sector, we think that the responses will start to stabilise the market. That said, property investment and homes sales are still likely to contract by around 5% this year.

Credit expansion and infrastructure investment should continue to support growth. The People's Bank of China has urged banks to front load loans to the real economy. Credit growth should hold up, at around 9.5% in 2023 and infrastructure investment will probably remain robust with growth of around 6-8%. That said, manufacturing investment may moderate in coming quarters as spare capacity levels are elevated.

**"We believe that the point of peak infections, following the Chinese New Year celebrations, has now past and the population is approaching herd immunity status"**

### INFLATION OUTLOOK CRUCIAL

Last year saw the People's Bank of China cut policy rates, reduce the reserve requirement ratios, and relax credit criteria. The central bank has indicated that it will keep monetary policy relatively loose, in an effort to further aid the recovery, and expectations have been rising that further pro-growth policies will be announced at The National People's Congress scheduled to take place in March.

The extent of future policy support will, in part, be determined by the inflation profile. China's consumer price index (CPI) rose to 2.1% y/y in January compared to 1.8% y/y in December. The acceleration in inflationary pressures was driven by rising food prices and increased demand across the service sector as the economy reopened and consumers celebrated the Lunar New Year.

The recovery in demand and impact of low base levels from the second half of 2022 suggest that CPI will continue to rise through the year. We forecast that CPI will have risen to 3.2% in the final three months of 2022 and average 2.5% in 2023. That said, we do not see the same acceleration in producer prices, given the slower manufacturing recovery and continued pressure on exports, meaning the producer price index could remain in deflation through the first half of this year.

Whilst we assume policymakers will remain accommodative, any signs that inflation is starting to move ahead of projections could create a more constrained fiscal backdrop.

### GEOPOLITICAL TENSIONS BUT HOPE FOR THE GLOBAL ECONOMY

China's recovery path and its long-term plans to become a technology leader could be hit by escalating diplomatic tensions between China and the West. The US and China have clashed over trade tariffs, data transparency and in February over 'spy' balloons above America.

Meanwhile, the governments of Japan and Netherlands have reportedly agreed with the US to impose tough restrictions on the exports of advanced-semiconductor production equipment to Chinese companies. Despite the current hostilities, trade between the US and China accelerated to a total of \$691 billion<sup>2</sup> last year. However, a further souring of the relationship between the two superpowers could impact growth prospects.

Considering the rapid reopening of the economy, the stabilising housing market and ongoing policy support, we have upgraded our GDP growth forecast for this year to 5.3%. Leaving aside the geopolitical tensions that exist, long term, China should transition to become a more sustainable, high-tech, domestically focused economy which would be positive for its people and investors in the region.

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

<sup>2</sup> 2022: US trade in goods with China, Census Bureau, February 2023 <https://www.census.gov/foreign-trade/balance/c5700.html>

# UK economy: Foxtrot instead of Boogie Woogie

Recent UK economic data seem to have provided some reasons to be more more cheerful. But as the Bank of England has pointed out, smaller policy steps may not result in a light-footed "Boogie Woogie" strategy.



## RECESSION POSTPONED

UK economic data seems to have provided more optimism of late, not least for the Bank of England (BoE). While UK gross domestic product (GDP) declined by 0.5% in December<sup>1</sup>, growth in the fourth quarter was flat, and not negative as widely feared.

A technical recession (two consecutive quarters of falling output) was averted due to a rebound in the quarter, following the additional holiday due to the Queen's funeral in September. The latest data confirm growth of 4% in 2022. Still, the overall economic output is 0.5% below its pre-pandemic level. Despite averting a recession on this occasion, the risk of further periods of contraction remains.

## FRAGILE GROWTH FOUNDATIONS

The UK consumer, in the midst of a cost-of-living squeeze not seen for many decades, remains vulnerable. Despite a small technical rebound in January, year-by-year retail sales were down 5.6% year-on-year, reflecting the precarious state of affairs.

Meanwhile, domestic industry is sending mixed signals. The manufacturing purchasing managers' indices (PMI) are in contractionary territory, while the PMI for services has rebounded into expansionary territory. So, while recent upbeat economic data may be welcome, the possibility of weaker UK growth remains high. A decline in GDP by 0.5% seems likely this year over 2022.

For now, the biggest threat to the outlook remains inflation. Recent monthly data hint that the worst may be over (see chart, p6). UK headline inflation, as measured by the consumer prices index, moderated to 10.1% in January from 10.5% in December.

Meanwhile, core inflation, excluding energy and food costs, retreated to 5.8% year-on-year from 6.3% in December, a trend the BoE may be particularly pleased about. Still, at 10.1%, inflation remains very high by historical standards, or in comparison to the eurozone or the US.

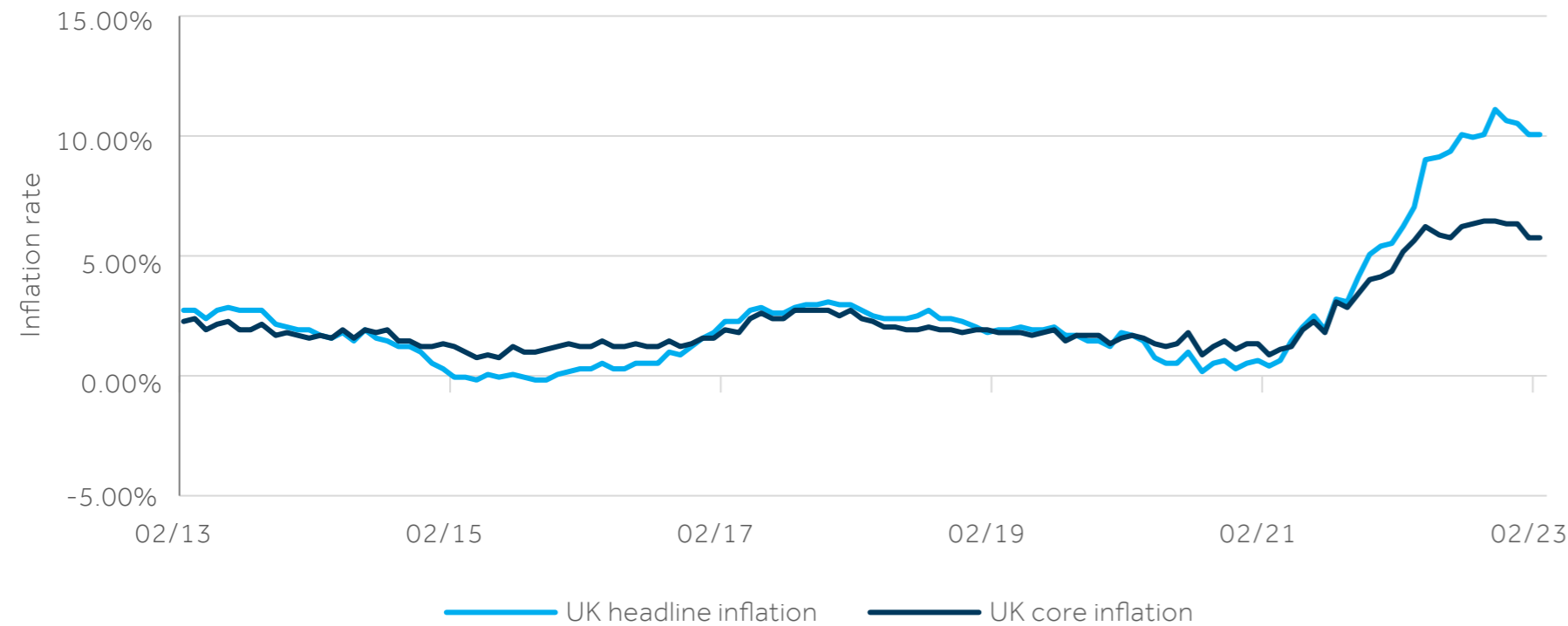
"The economy's vulnerabilities... mean that the central bank may need to hike rates in smaller steps and tread carefully"

<sup>1</sup> GDP monthly estimate, UK: December 2022, Office for National Statistics, 10 February 2023 <https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/december2022>



### UK INFLATION SHOWS SIGNS OF SLOWING

The headline and core consumer prices index rates over the last decade UK inflation



Sources: Bloomberg, Barclays Private Bank, February 2023

### TIGHT JOB MARKET IS A CONCERN

The job market remains a key factor in the outlook for inflation in services. The UK market remains tight, and tighter than in many other developed economies. While total wage growth may have eased in December, driven by base effects, regular pay growth (without bonuses) rose to 6.7% (based on the average for the previous three months, on a year-by-year basis)<sup>2</sup>.

Annual pay growth in the private sector is steaming ahead, at 7.3%, and is at an all-time high, ignoring recent distortions to the figures caused by the pandemic. This trend, along with the rise in public sector wages (4.5%) and potential for strikes in the sector to push wage hikes higher still, is what the BoE may be most concerned about at this point.

With a significantly smaller pool of workers since the pandemic and an unemployment rate at 3.7% (see chart), job vacancies are still far above the range seen over the last 20 years.

### SOME WAY TO GO

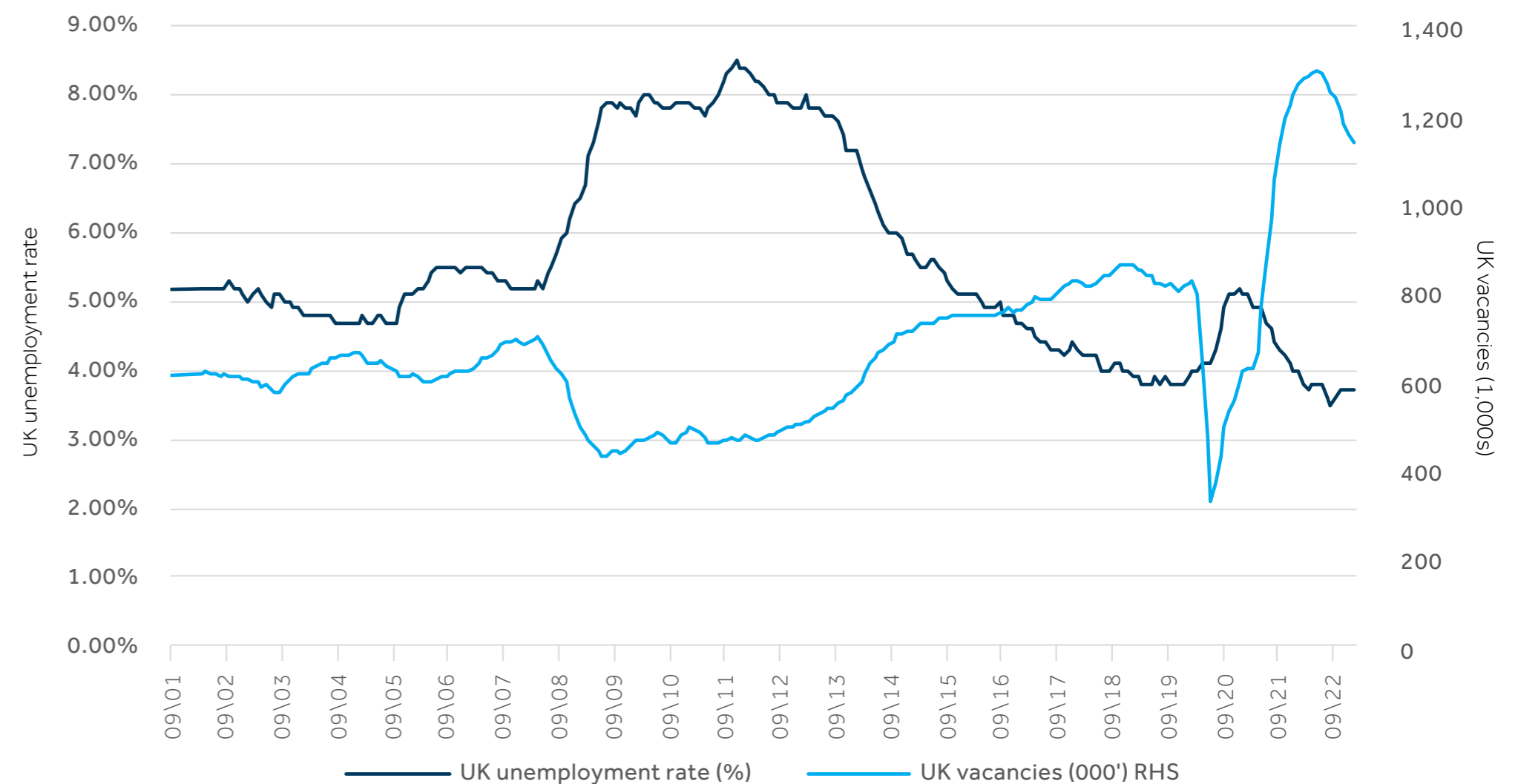
During the last Monetary Policy Committee (MPC) meeting the BoE emphasised that it will act more on the basis of incoming data. However, it is still too early, in our view, to say that inflation at 10.1% has been vanquished. After all, the pace of price rises remains a long way from the BoE's 2% target. BoE member Catherine Mann pointed out in a recent speech: "The consequences of under tightening far outweigh, in my opinion, the alternative."

<sup>2</sup> Average weekly earnings in Great Britain: February 2023, Office for National Statistics, 14 February 2023 <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/february2023>

<sup>3</sup> Bank of England rate-setter urges more hikes to avoid 'policy boogie', Sky News, 6 February 2023 <https://news.sky.com/story/bank-of-england-rate-setter-urges-more-hikes-to-avoid-policy-boogie-12804611>

### UK LABOUR MARKET REMAINS TIGHT

The UK unemployment rate and vacancies, as a percentage of jobs rate, are at unusual levels, based on those seen in last two decades



Sources: ONS, Barclays Private Bank, February 2023

For now, the BoE is likely to focus on inflation. But the economy's vulnerabilities, not least from a sharp consolidation in the domestic housing market as mortgage-holders cope with higher rates, mean that the central bank may need to hike rates in smaller steps and tread carefully.

The central bank will probably make at least one more hike (if not two) this year. The market prices in a peak in the base rate at around 4.5% in September. Mann prefers a more determined and decisive path in the BoE's rate-hiking dance: "A tighten-stop-tighten-loosen policy boogie looks too much like fine-tuning to be good monetary policy," she said<sup>3</sup>.

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

# What to make of the cyclical rotation?

Risk assets, and equities in particular, have rallied strongly from their October lows, on the back of an improving growth and inflation outlook. While the performance of global equities, as an asset class, appears to be consistent with the current level of economic activity, the relative performance of cyclicals against defensives has overshot its historical relationship with the business cycle. Does this disconnect point to a potential investment opportunity, or is it fundamentally justified?



In recent months, economic growth has been stronger than anticipated while inflation has cooled faster than expected. This has triggered powerful rallies in risk assets, with global equity markets now pricing in a soft landing for the economy, as opposed to a mild recession back in October. The sustainability of this rally remains unknown, and until there is clear evidence that activity has troughed and rates have peaked, consolidation at the index level is more likely.

In the meantime, and following the substantial moves in asset prices in the past four months, this article looks under the surface and attempts to identify areas of the equity market that appear mispriced and could represent attractive investment opportunities.

The article also takes a step back from the current uncertainty and puts the rally in risk assets into an historical context. It highlights pockets of the equity market which appear to have lagged their historical relationship with trends in economic activity. It also discusses potential reasons why that might be the case, and whether those areas represent attractive investment opportunities or, instead, only reflect their vulnerability in a world where rates are likely to be higher for longer.

## HISTORICALLY, TROUGHS IN THE ISM MANUFACTURING INDEX HAVE BEEN FOLLOWED BY POWERFUL RALLIES IN RISK ASSETS

### Performance across assets

Global equities have returned 32% on average in the year following a trough in the ISM Manufacturing Index, outperforming US 10-year Treasuries by 26%, based on data since 1975 (see chart, p8). Asia ex Japan and UK equities generally outperformed those in Japan, the eurozone and the US.

Commodities also had a strong run, up 18% on average, led by oil (+40%) and copper (+22%), while gold made more modest gains (+4%). Meanwhile, US high yield credit outperformed investment grade by a large margin (up +21% vs +10%, respectively). The US dollar was broadly flat against its major trading partners.

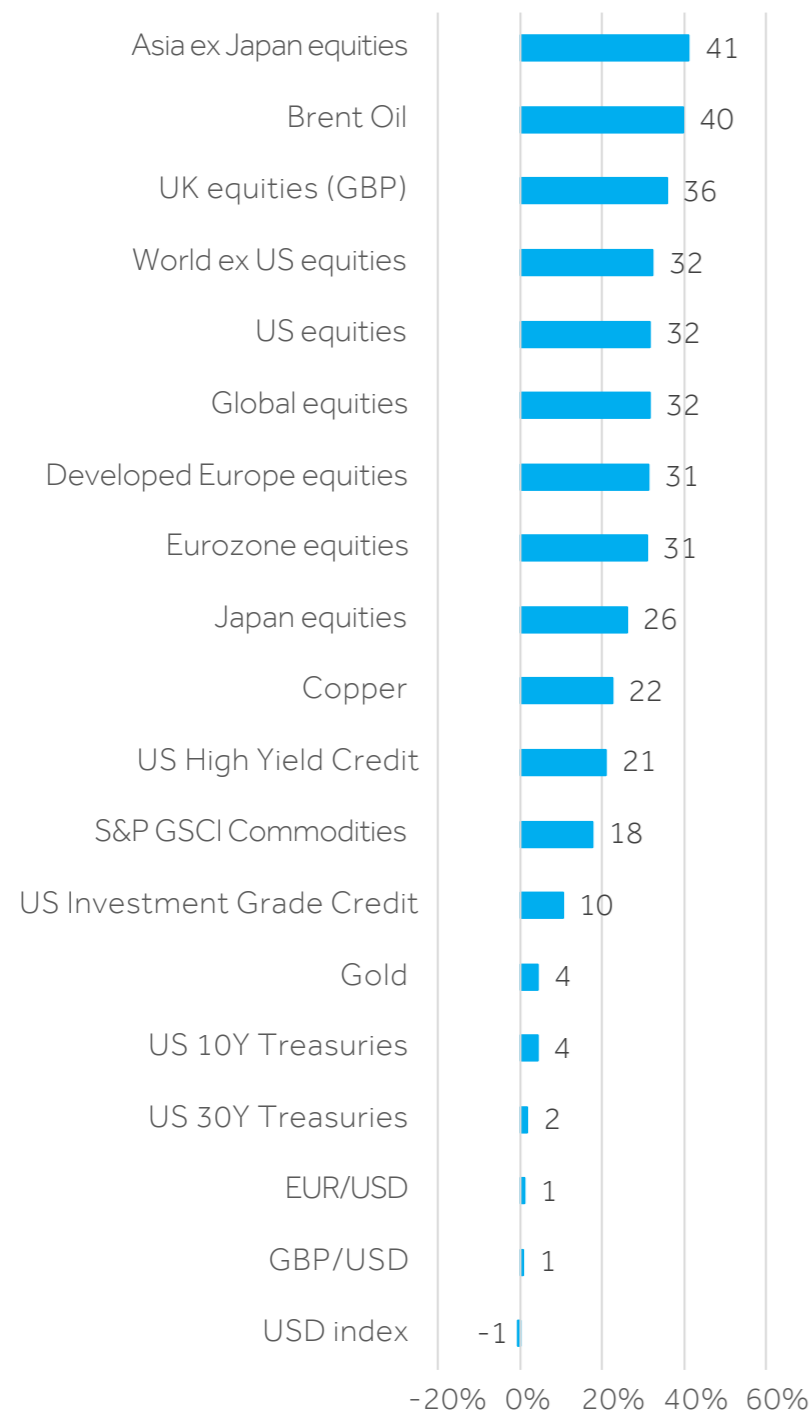
### Performance of equities

Equities generally troughed one month before the bottom in the ISM index, both in the US and Europe. They performed strongly in the year following a trough, but below average in the subsequent year. The S&P 500 returned 30%, on average, in the first year and 6% in the second year (see chart on the right, p8). Meanwhile, the MSCI Europe gained 27% in the first year and 6% in the second year (in local currency terms).

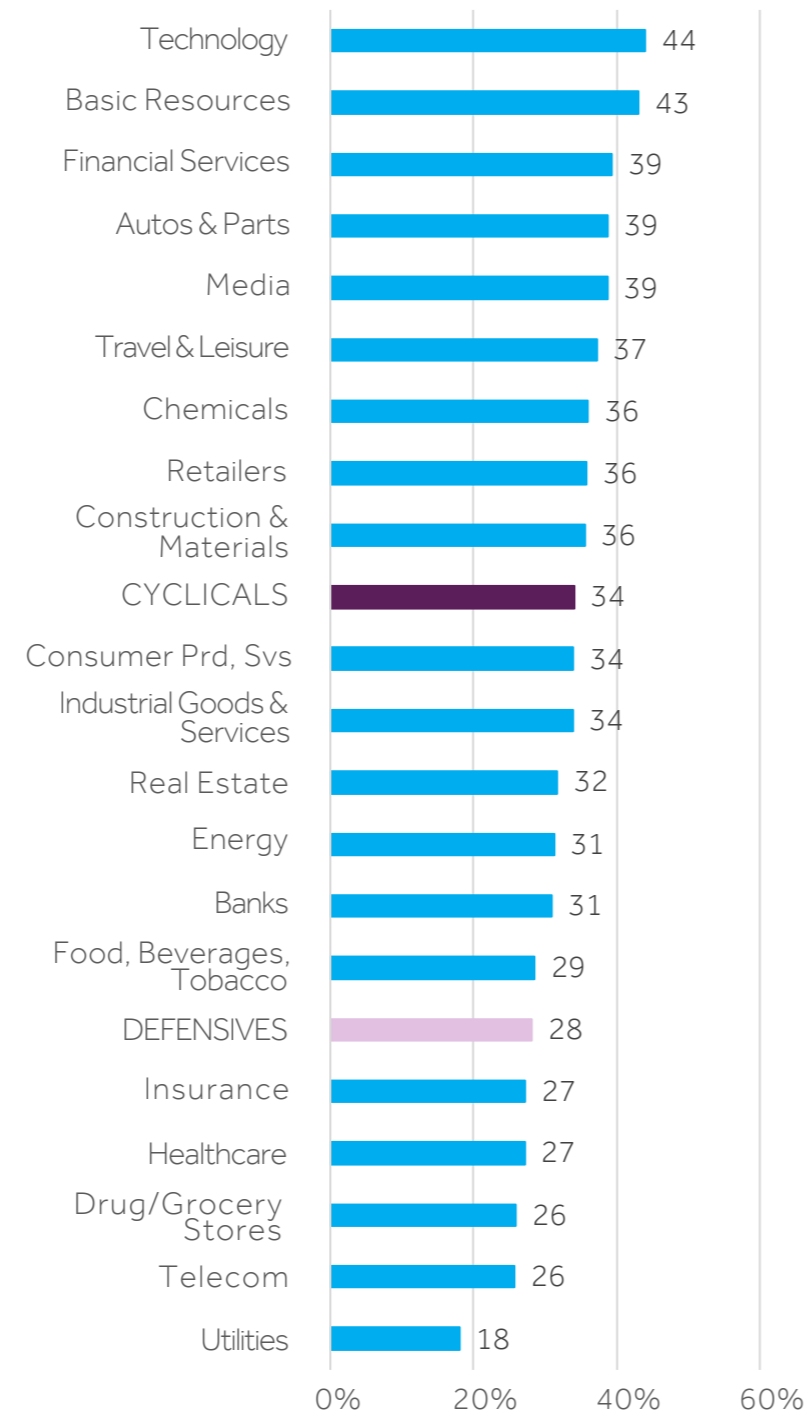
**TROUGHS IN THE ISM MANUFACTURING INDEX ARE USUALLY FOLLOWED BY STRONG RALLIES IN RISK ASSETS**

Average performance across assets and within global equity markets in the year following a trough in the ISM Manufacturing Index since 1975 (total returns %)

Performance across assets



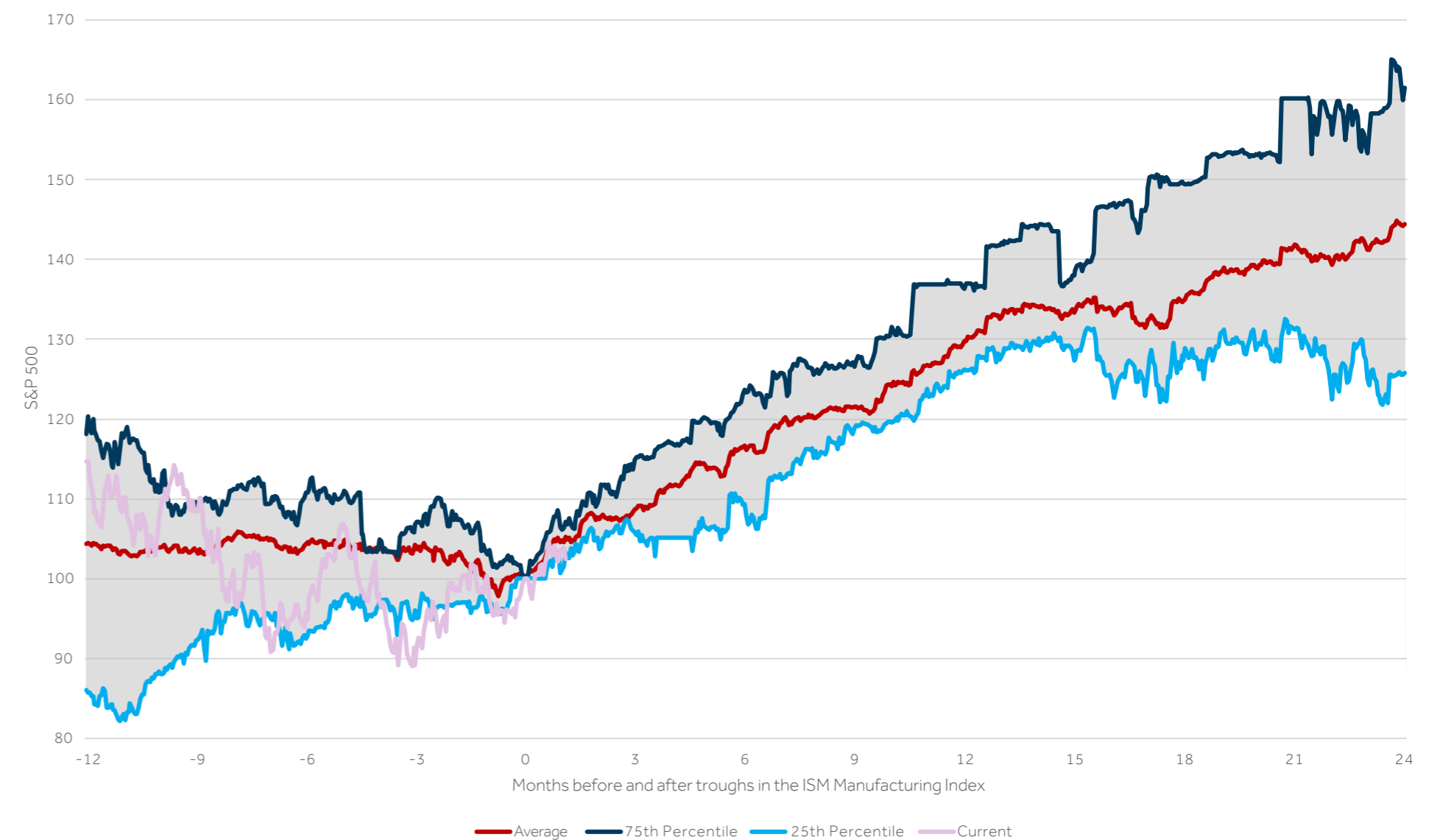
Performance within global equities



Sources: Refinitiv Datastream, Barclays Private Bank, January 2023

**US EQUITIES USUALLY TROUGH ONE MONTH BEFORE THE ISM MANUFACTURING INDEX DOES, AND POST STRONG RETURNS IN THE SUBSEQUENT YEAR**

S&P 500 index total performance in the months around troughs in the ISM Manufacturing index, indexed to 100 at the date of the trough, since 1974



Sources: Refinitiv Datastream, Barclays Private Bank, February 2023

Within the equity market globally, there were also powerful cyclical rotations. Cyclical sectors returned 34% on average in the first year, outperforming the more defensive ones by 5%. However, both groups performed in line with each other in the following year.



The best performing sectors in the 12 months following the trough were technology (+44% on average), basic resources (+43%), financial services, autos and media (all up +39%), while the main laggards were typically defensives such as utilities (+18%), telecoms (+26%), food retail (+26%) and healthcare (+27%).

### Direction of policy rates matters

The direction of policy rates has typically had a significant impact on the strength of equity rallies following ISM troughs. In analysing the rallies, cycles are split into four stages, depending on whether the ISM Manufacturing Index was above or below 50, and whether it was rising or falling. Two scenarios were also considered: one when US 2-year Treasury yields were increasing, and the other when they were declining.

Unsurprisingly, we found that market rebounds from ISM troughs tended to be weaker when associated with rising yields, based on data since 1980. Monthly returns in recovery phases (ISM Manufacturing Index below 50 and rising) averaged 2.0% when yields were declining, but only 0.9% when they were rising.

A similar, but less pronounced, tendency occurred in mid-cycle phases, when the ISM Manufacturing Index was above 50 and rising. Monthly returns in those phases averaged 1.5% when yields were declining, and 1.3% when they were rising.

### HOW DOES THE RECENT EQUITY RALLY AND SECTOR ROTATION COMPARE WITH PREVIOUS ONES?

When compared against previous rebounds around ISM troughs, the recent rally is particularly sharp and violent, especially given that a trough in the ISM Manufacturing Index has not been reached yet (see earlier chart).

This can be explained in the context of the severe drawdowns of last year. Global equities declined by 27% from their peak in January 2022 to their low in October 2022. Since then they have rallied by 14%, erasing close to half of their losses.

Cyclicals have outperformed defensives by around 5% since mid-October, with some of the worst performers in the January to October period leading the rally.

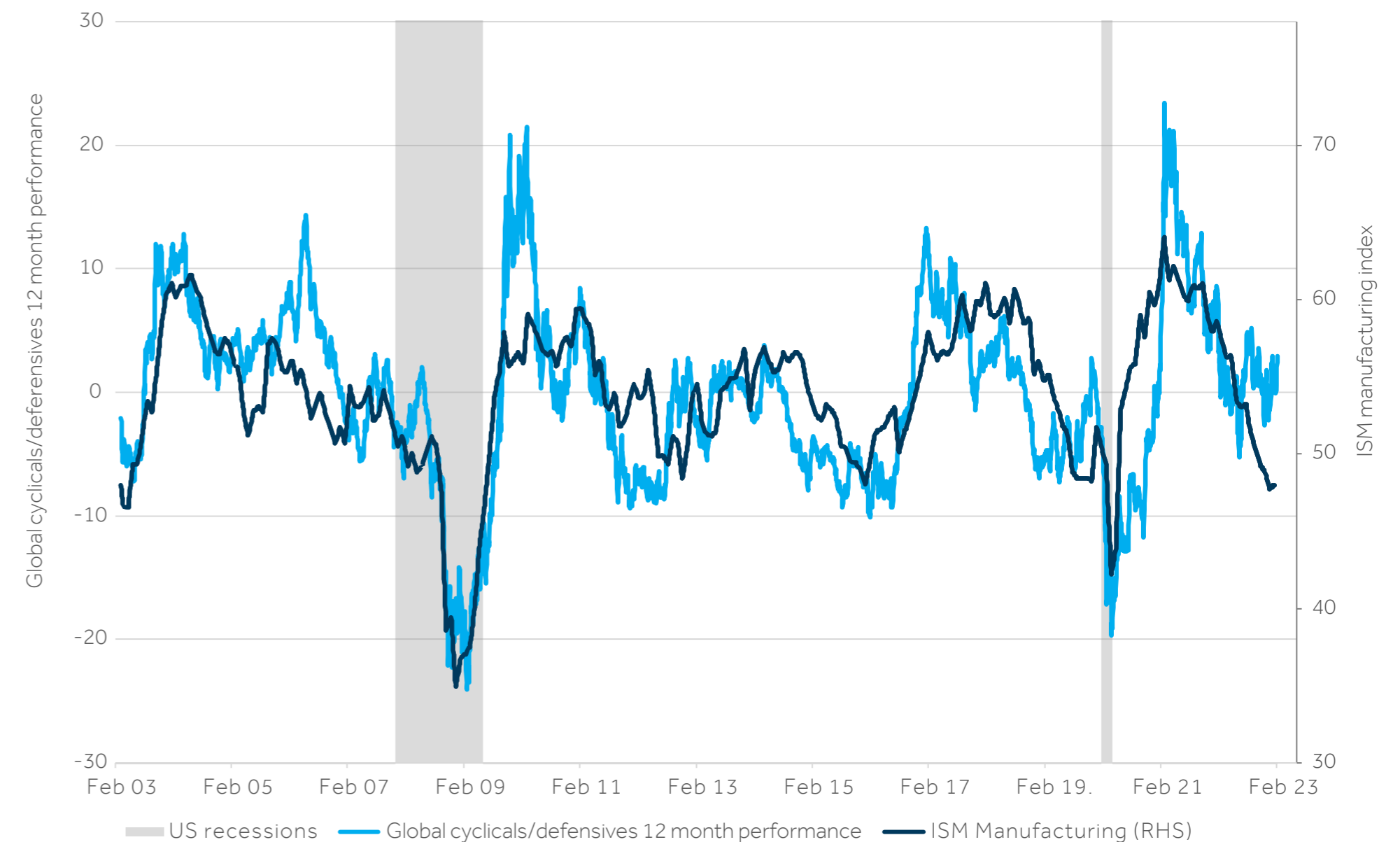
The best performing sectors since October have been industrials, financials, basic materials and technology, all up 17% to 19%. The main laggards have been energy (+1%), followed by consumer staples, healthcare and utilities (all up +11%). Energy was the only sector in positive territory and up strongly in the January to October period, while staples, utilities and healthcare were the sectors that saw the smallest drawdowns.

### THE RELATIVE PERFORMANCE OF CYCLICAL SECTORS AGAINST THE MORE DEFENSIVE ONES APPEARS TO HAVE OVERSHOT THE IMPROVEMENT IN THE GROWTH OUTLOOK

Following the rally, global equity prices seem broadly consistent with the current level of activity, as proxied by the ISM Manufacturing Index. However, the relative performance of cyclicals versus defensives appears to be discounting the start of an economic recovery, which is not yet visible in the survey data (see chart).

## THE RELATIVE PERFORMANCE OF CYCLICAL SECTORS VERSUS DEFENSIVES IN THE PAST YEAR SEEMS PARTICULARLY STRONG, GIVEN THE CURRENT WEAKNESS IN ECONOMIC ACTIVITY

Relative 12-month performance of global cyclicals versus defensives compared with the ISM Manufacturing Index since 2004

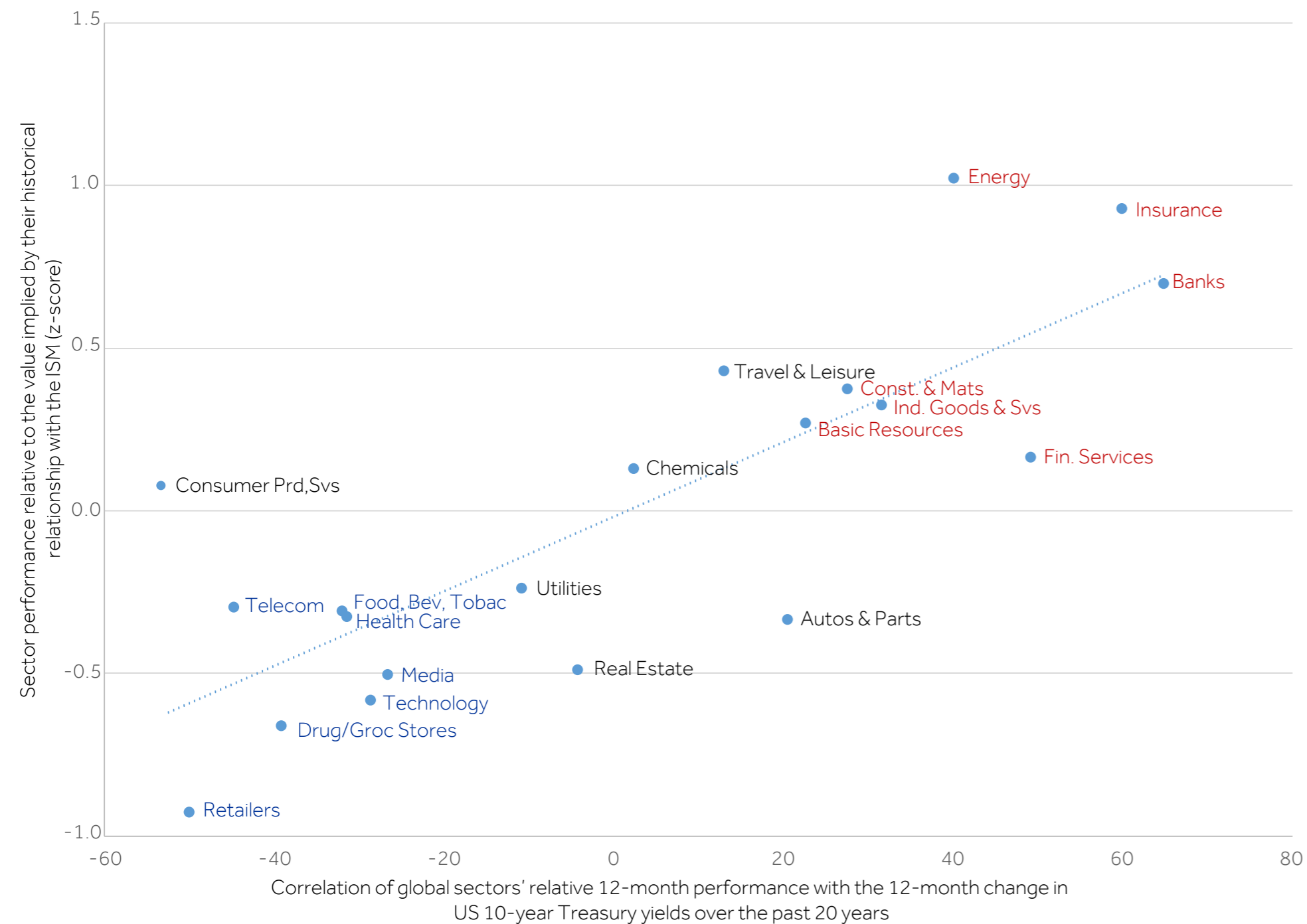


Sources: Refinitiv Datastream, Barclays Private Bank, February 2023

Note: Cyclicals include energy, basic materials, industrials, consumer discretionary, financials and technology hardware. Defensives include healthcare, consumer staples, utilities, telecom, real estate, software and computer services.

## THE SECTORS THAT HAVE LAGGED THEIR HISTORICAL RELATIONSHIP WITH THE ISM TEND TO UNDERPERFORM WHEN RATES ARE RISING

Comparison of global sectors' 12-month performance relative to that implied by the ISM Manufacturing Index, against the correlation of the relative sector's performance with 12-month changes in US 10-year Treasury yields over the past 20 years



Sources: Refinitiv Datastream, Barclays Private Bank, February 2023

Note: Sectors highlighted in red (blue) have seen their price performance overshoot (undershoot) their historical relationship with the ISM, and tend to outperform (underperform) in a rising rate environment

## HOWEVER, THIS APPARENT DISCONNECT IS JUSTIFIED GIVEN THE OUTLOOK FOR MONETARY POLICY

Drilling down to the sector level reveals that sectors which have overshoot (undershoot) their historical relationship to the ISM Manufacturing Index, also tend to outperform (underperform) when interest rates are rising. Their relative performance is positively (negatively) correlated with changes in US 10-year yields (see chart).

The vertical axis in the chart shows how the sectors have performed in the past year, relative to the performance one would expect given their historical relationship with the ISM Manufacturing index over the past 20 years, expressed in z-scores. Positive (negative) z-scores indicate the degree to which they have overshoot (undershoot) the value implied by the index. The horizontal axis shows the correlation between the sector's relative performance and changes in US 10-year yields.

It is apparent that the sectors that have lagged their historical relationship with the ISM Index are also some of the most expensive, long-duration parts of the market: retailers, technology, media, telecoms, consumer staples and healthcare. Their expensive valuations and long-duration cash flows make them particularly vulnerable in a rising rates environment, similar to the one we have experienced in the past couple of years. As long as leading central banks maintain their hawkish stance and the market worries about rates being higher for longer, those sectors are unlikely to catch up with cyclicals and value stocks.

In contrast, financials and commodity sectors, such as energy and basic materials, have overshoot their relationship with the ISM index of late. They are both cyclical and value sectors, and tend to outperform in periods of rising interest rates and improving economic momentum. They are generally more sensitive to yields and commodity prices than to the business cycle, and we would expect this to remain the case in the coming months. This is why we maintain a positive stance on the energy and banking sectors, despite those sectors looking extended vs the ISM.

## WHAT THIS MEANS FOR INVESTORS

The recent rally in equities is unlikely to be sustained until we see clear signs that activity has troughed and that interest rates have peaked. Historically, rate cuts (not simply a pause in rate hiking cycles) have been needed for equity markets to rebound in a sustainable way. Until then, consolidation is more likely at the index level.

If the ISM Manufacturing Index does indeed trough in the near term, and the economic momentum improves, we believe the next leg of the rally is unlikely to be as strong as in previous episodes for a number of reasons:

- Global equity valuations are now back in line with their 10-year averages, after the recent rebound;
- Sentiment is no longer depressed; and
- Unless we see a dovish pivot from central banks, rates are likely to be higher for longer than expected, thereby keeping a lid on valuations in the coming months.

In the meantime, the sectors that have lagged in the recent rally are unlikely to catch up, as they tend to be most vulnerable to high interest rates and restrictive monetary policies.

**Author: Dorothee Deck, London UK, Cross Asset Strategist**



# The dangers of complacency

Complacency has been rife in bond markets. First it was the US central bank over its ability to control (transitory) inflation in 2021. Then, during recent months, it has been the rate market presuming that inflation would reduce quickly. Where might the next dose of complacency pop up and what might it mean for bond investors?



## COMPLACENCY AND ERRORS

Back in 2021, it was the US Federal Reserve (Fed) which, in hindsight, was too complacent about its ability to control inflation, arguing for too long that the phase of higher inflation would be transitory. Since then, the central bank has corrected its path and initiated the fastest hiking path for the US policy rate since the 1980s, while maintaining a very hawkish tone: "will keep at it until the job is done," said Fed chair Jerome Powell in September, referring to the 2% inflation target.

From September until the US job market data released early in February, complacency was witnessed in the bond market. The decline in 2-year yields, by one percentage point, in the UK and the US over the same period reflected the market's overconfidence in expecting a rapid decline in inflation already after the first signs that inflation was easing.

During that period, the rate market not only priced in a lower peak policy rate, but also early rate cuts in 2023; this despite the Fed leaning strongly against such euphoria and despite the risk of stickier inflation.

The market's complacency seems to have faded, after recent data pointed to sustained tightness in the US job market, a key driver of future inflation. We have pointed to the risk of a slightly higher peak during the last months and with tighter job market data we see a very good chance of a policy rate of 5.5% at a minimum.

## INFLATION IS LIKELY TO BE STICKIER

The disinflation party (with fast-falling rates and tighter spreads) may gradually come to an end, as the dominating disinflationary pressures from the goods component of inflation run out of steam, while the stickier core inflation components are still to feel the full force of higher rates.

Such a transmission may take some time and the bond market, up until February, seemed to have turned a blind eye towards to this possibility. We pointed to this scenario in [The road to normalisation for bond investors?](#)

"The bond market, meanwhile, seems to expect a different scenario, which appears optimistic on two levels. First, it does not price in the possibility of a higher peak in inflation. Second, the rate market anticipates rate cuts less than six months after the peak, something that we believe is not on the Fed's agenda. Of course, risk of a severe downturn remains, together with the possibility of a partial unwinding of the rate hikes. But to get there, we believe the fed fund rates potentially need to peak even higher than is being priced in at the moment."



## CONTINUED RE-PRICING LIKELY

The next few weeks or months may see more re-pricing of the peak policy rate, which we forecast to be 5.5%, while some upside risk remains. Overnight indexed swaps (OIS) forwards are pricing in a peak rate of 5.25%, with a slight chance of 5.5%.

Meanwhile, the longer end of the yield curve may continue to re-evaluate future rate cuts. During the last three months the rate curve has already priced out roughly two rate cuts by February next year, for example. This transition from complacency to reality (no early cuts) may cause some volatility going forward again.

Does this mean that our preferred theme of locking in yields at this point in time is no longer appropriate?

The answer is no. Although the risk of a somewhat higher peak seems skewed to the upside, the Fed may eventually hit the brakes for fear that the economic repercussions of getting it wrong are too severe. Alternatively, it may be the central bank's almost stubborn (and up until now necessary) hawkishness may prove to be another breeding ground for complacency as overconfidence in being able to cool inflation, while achieving a soft landing for the economy, proves misplaced. Time will tell.

## NEXT COMPLACENCY IN THE MAKING

A soft economic landing and inflation heading back towards its 2% target is a desirable outcome. But previous cycles show inflation only cooled in most cases after a substantial slowdown, if not only after a recession.

As such there seem to be two possible scenarios: The first involves an economic slowdown, with inflation moderating and finally rate cuts towards next year.

The second scenario, which deserves consideration, is one where the economy is more resilient than expected and inflation remains elevated for longer than predicted. In such a case, the Fed may need to add even more hikes than currently anticipated in order to force a slowdown. Dallas Fed President Lorie Logan provided some flavour about the Fed's thinking with regards to such a scenario<sup>1</sup>:

"We must remain prepared to continue rate increases for a longer period than previously anticipated, if such a path is necessary to respond to changes in the economic outlook or to offset any undesired easing in conditions."

But as outlined earlier, the Fed may be complacent to believe that excessively higher policy rates will not take their toll. As such, the pressure to cut rates subsequently to the last scenario, may be even greater. Whichever scenario materialises, it may point to the central bank taking a more accommodative policy stance within the next two years.

"Although the risk of a somewhat higher peak seems skewed to the upside, the Fed may eventually hit the brakes for fear that the economic repercussions of getting it wrong are too severe"

## PEAKS RARELY LAST FOREVER

The following table (p13) examines the last ten rate hiking cycles since 1972. While a discussion about the long equilibrium rate and inflation trend is important, the table makes one point very obvious: Central banks react to economic conditions and hiking and cutting rates are part of the policy process.

Extrapolating from short-term trends rarely works with the presence of cycles. Certainly, each observed cycle has had its own triggers and characteristics. However, rate-hiking cycles do not last forever. While the timing of peak policy rates has varied (also depending on the definition of when a hiking cycle starts and when it ends) the average peak policy rate lasted for only six months on average. More importantly for bond investors, the average policy rate 24 months after rates peaked was only around 60% of the respective peak level on average (see table, p14).

Interestingly, the traditional rate-cycle pattern has been regularly ignored by the rate market in the past. As the next chart shows (see p14 on the left), the 2-year US Treasury yield has been significantly lower than the peak policy rate, three years after the peak was reached, since 1983. In addition, the 2-year rate was significantly lower than the market-implied 2-year rate would be three years after the peak rate was hit.

<sup>1</sup> Restoring price stability, Federal Reserve Bank of Dallas, 14 February 2023 <https://www.dallasfed.org/news/speeches/logan/2023/lkl230214>

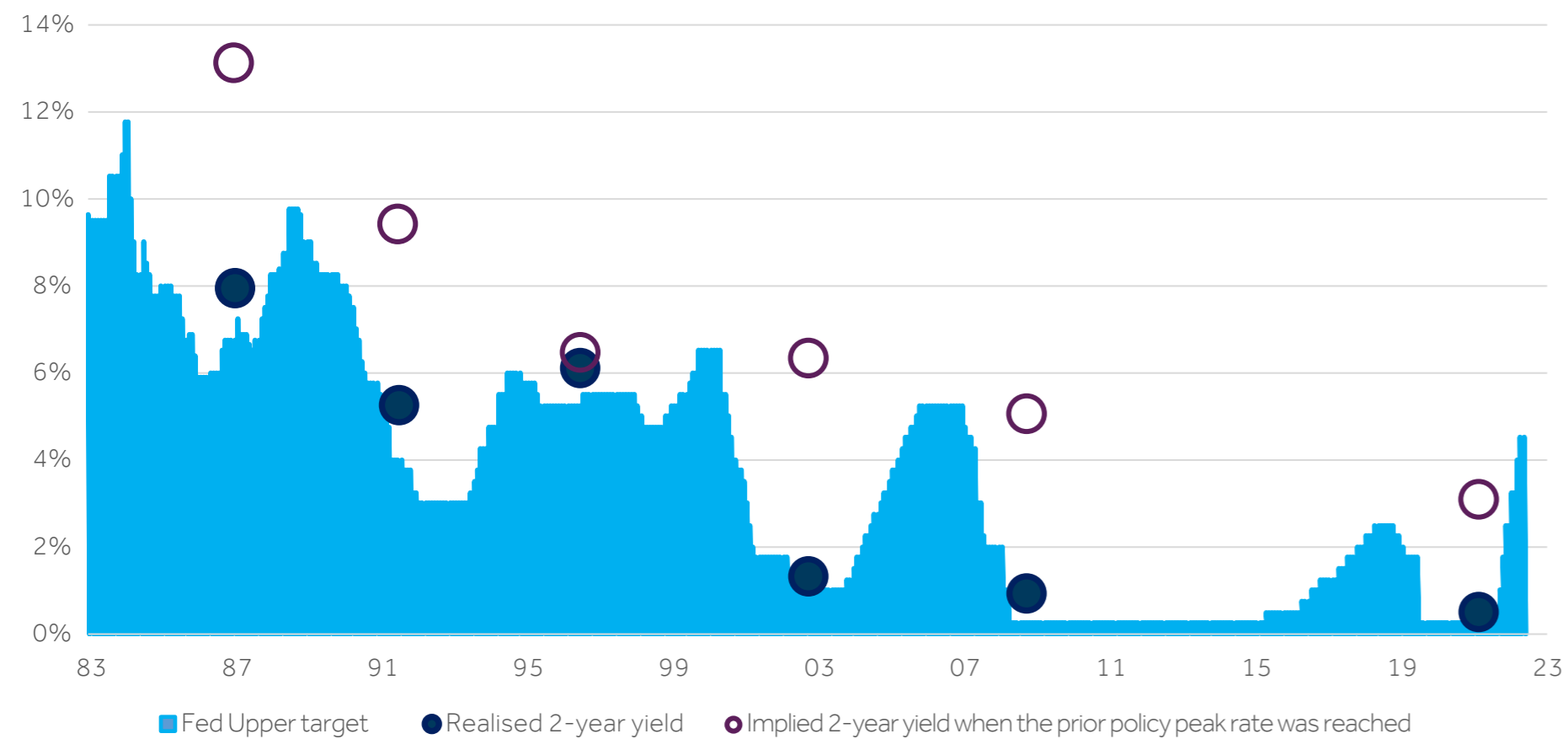


Hiking cycle	Start Hiking Cycle (month)	"End hiking cycle (month)	Duration hiking cycle (months)	Start Fed rate (%)	Peak Fed rate (%)	Absolute hike amount	10-year peak date	10-year peak	First cut	Peak Fed rate duration (months)	Inflation peak date	Inflation peak (%)	24 months post end hiking cycle (rate level)	% of peak level after 24 months
2022 inflation crisis (with assumptions as per implied market pricing in red)	02/2022	10/2023	20	0.250	5.50	5.250	tbc	tbc	tbc	tbc	tbc	tbc	tbc	tbc
US Fed U-turn, Cycle started 2017	11/2015	12/2018	38	0.250	2.250	2.000	31/10/2018	3.061	31/07/2019	8	31/07/2018	2.900	0.250	11%
Hiking cycle which was followed by the great financial crisis in 2008	05/2004	07/2006	26	1.000	5.25	4.250	30/06/2006	5.119	31/08/2007	14	31/07/2008	5.600	2.000	38%
Cycle leading to the TMT stock bubble burst and 9/11 attack in the US which proved a turning point for US rates	05/1999	07/2000	14	4.750	6.500	1.750	31/01/2000	6.442	31/12/2000	6	31/03/2000	3.800	1.750	27%
Fed soft landing manoeuvre	02/1997	03/1997	1	5.250	5.25	0.000	31/08/1996	6.794	31/08/1998	18	31/12/1996	3.300	4.750	90%
Soft landing manoeuvre by the US Fed, followed by a stock market rallye	01/1994	02/1995	13	3.000	5.500	2.500	30/11/1994	7.807	30/06/1995	5	31/12/1996	3.300	5.250	95%
Hiking cycle leading to the 1987 stock market crash	11/1986	03/1989	28	5.880	9.75	3.870	31/10/1987	9.587	31/05/1989	3	31/10/1990	6.300	6.250	64%
First hike after the 1970s inflation and the largest disinflationary move. Very short Fed peak, continuation of the big equity market recovery bull market	04/1983	09/1984	17	8.500	11.750	3.250	30/06/1984	13.804	30/09/1984	1	31/03/1984	4.800	5.880	50%
During hiking cycle the US would already face a larger disinflationary trend	07/1980	06/1981	11	9.500	20.00	10.500	30/09/1981	15.412	30/06/1981	1	30/04/1980	14.700	9.630	48%
Ultimate peak in inflation within the hiking cycle. Start of the equity bull market and large multi year yield decline	11/1976	03/1980	41	5.000	15.000	10.000	31/03/1980	12.722	31/03/1980	1	31/03/1980	14.800	15.000	100%
Inflation peak and 1973 oil crisis	02/1972	06/1974	28	3.500	13.00	9.500	30/09/1975	8.282	30/06/1974	1	31/12/1974	12.300	5.500	42%
<b>Median (does not include current cycle)</b>			<b>22</b>			<b>3.6</b>				<b>4.1</b>				<b>49%</b>
<b>Average (does not include current cycle)</b>			<b>22</b>			<b>4.8</b>				<b>5.9</b>				<b>57%</b>

Sources: Bloomberg, Barclays Private Bank, February 2023

### 2-YEAR YIELD MUCH LOWER THAN IMPLIED RATE THREE YEARS AFTER PEAK POLICY RATE

The evolution in Fed upper target and the difference between the realised 2-year yield and implied 2-year yield when peak rate hit



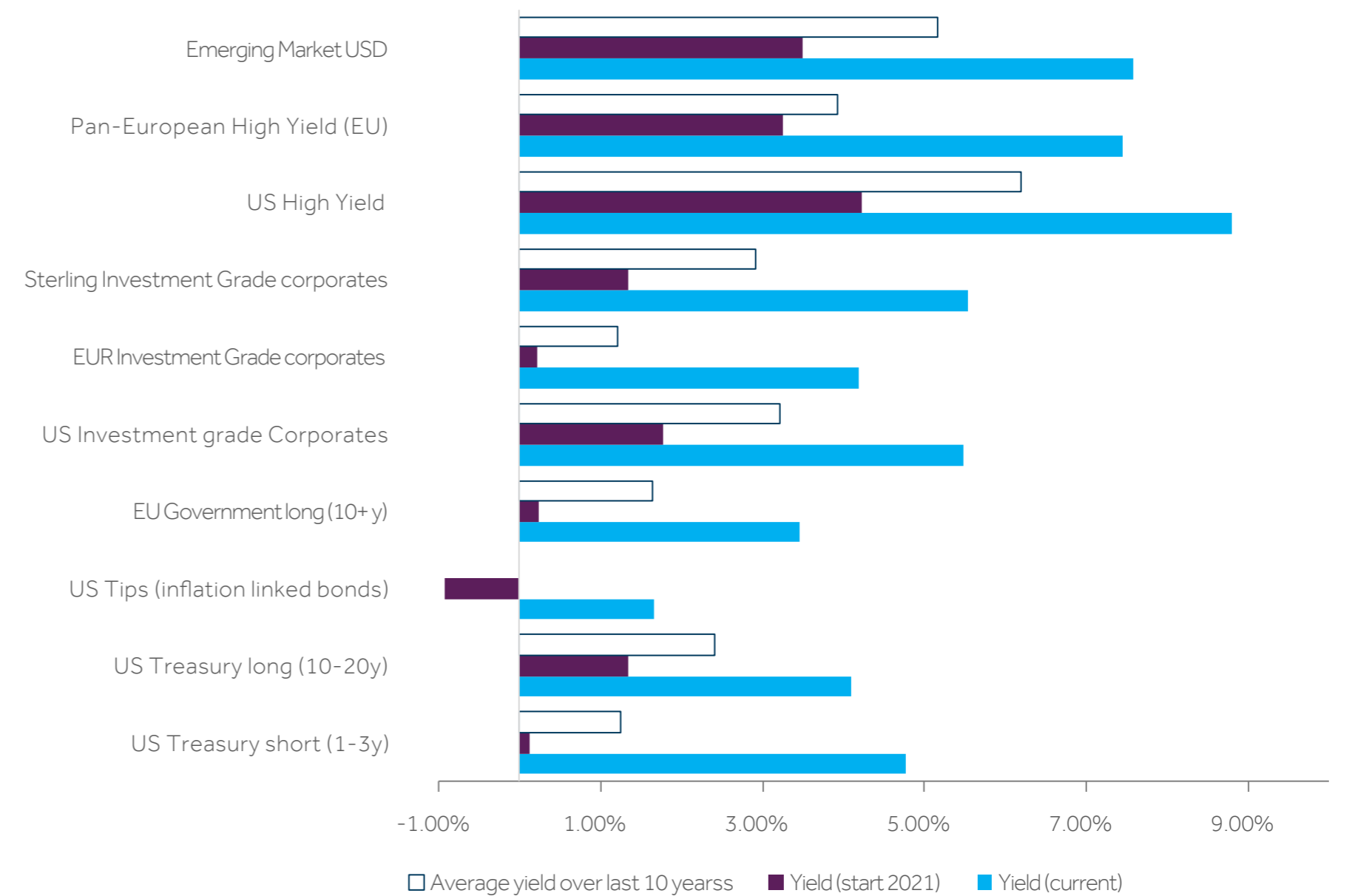
Sources: Bloomberg, Barclays Private Bank, February 2023

### WITH THIS IN MIND WHAT CAN BOND INVESTORS DO?

For now, the risk seems skewed towards a somewhat higher and potentially longer peak (see next chart). Using the current phase of re-pricing (transition from complacency to facing reality) to lock in yields seems a sensible strategy currently. Especially given that rate cuts, even if not this year, are on the way.

### YIELDS AT HISTORICALLY HIGH LEVELS

The rate market's pricing of a variety of types of bonds based on current pricing, that seen at the start of 2021 and the 10-year average



Sources: Bloomberg, Barclays Private Bank, February 2023

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



# EU cuts red tape to go green faster

With its recent announcement of the Green Deal Industrial Plan, the EU responds to the US green stimulus package to accelerate its own net-zero ambitions.



Climate change is no longer principally an environmental issue. Governments also see climate change now as a way to boost their economies and compete with other nations to attract and encourage business investment.

Last August, the US passed the Inflation Reduction Act, the country's most ambitious attempt to create the groundwork through which to cut greenhouse gas emissions by 30% by 2030. Over the next decade, a stimulus worth more than a third-of-a-billion dollars has been committed to advance climate and clean energy goals.

The European Union responded to the US plans by announcing its Green Deal Industrial Plan in February. The plan should accelerate the growth in the industrial capacity for the clean technologies needed in the EU.

So, what is the bloc's plan and what are the signals savvy investors should be looking for from governments' initiatives to accelerate the green transition while growing their economies?

## THE LATEST GREEN EU INITIATIVE

The Green Deal Industrial Plan (GDIP) builds on, and supports, prior initiatives designed to aid the transition of the EU to a low-carbon economy.

Setting an overall vision at the end of 2019, the EU Green Deal aimed to make Europe the first climate-neutral continent by 2050. Following this, the bloc enacted a series of regulatory packages, for example NextGenerationEU, REPowerEU, InvestEU, Innovation Fund, or Fit for 55, to underpin the EU's green ambition.

The GDIP seeks to create a more supportive environment for building and deploying clean-tech manufacturing capacity. It's based on four complementary pillars<sup>1</sup>:

- Making the regulatory environment more predictable and simpler.
- Providing faster access to funding by streamlining state aid rules.
- Boosting training and developing skills to create a green workforce.
- Opening and enhancing trade agreements for more resilient supply chains.

Together these pillars do not primarily add new capital, rather they seek to remove challenges in deploying it.

<sup>1</sup> A Green Deal Industrial Plan for the net-zero age, European Commission, 1 February 2023 [https://commission.europa.eu/system/files/2023-02/COM\\_2023\\_62\\_2\\_EN\\_ACT\\_A%20Green%20Deal%20Industrial%20Plan%20for%20the%20Net-Zero%20Age.pdf](https://commission.europa.eu/system/files/2023-02/COM_2023_62_2_EN_ACT_A%20Green%20Deal%20Industrial%20Plan%20for%20the%20Net-Zero%20Age.pdf)



## HOW DOES IT DIFFER FROM THE US INFLATION REDUCTION ACT?

The GDIP is EU policymakers' initial response to last August's US Inflation Reduction Act<sup>2</sup> (IRA) and, to an extent, Chinese subsidies contained in its Five-Year Plan.

The landmark IRA provides an estimated \$369 billion in federal tax credits, tax breaks and direct subsidies to companies operating in pre-defined sectors around climate and clean energy. Additionally, its "Made in America" provisions encourage manufacturing on US soil, helping to build domestic green industrial capabilities. The initiative is attracting companies from outside the country to consider expanding in the US, whether by relocating existing facilities or through international expansion.

For Europe, the simplicity and scale of the IRA has challenged its efforts to be a pre-eminent leader in sustainability and the transition to net zero. The EU cannot replicate the US approach given that tax policy is determined at national, rather than federal, level and that subsidies can be administered at regional, national and EU levels. Nor can it match the ten-year time horizon, given the bloc's budget cycles are ratified and disbursed over shorter time horizons.

## "The increased geopolitical competition being seen to attract green investment and businesses is likely to gather momentum and help to reshape economies"

### A FOCUS ON INCREASING COMPETITIVENESS

The GDIP aims to "simplify, accelerate and align incentives to preserve competitiveness and attractiveness of the EU"<sup>3</sup>. Without adding common financing, it aims to free and increase the flow of existing capital and to repurpose, not fully utilised, existing funding streams, such as the €250 billion available in the Resilience and Recovery Fund<sup>4</sup>. The plan also aims to streamline bureaucracy, such as speeding up time to permitting renewable project timelines, to help encourage private investments.

Seeing the initial progress of the IRA, the economic growth and environmental transition benefits could be substantial. New manufacturing and service projects in wind, solar, batteries, electric vehicles and energy storage projects have blossomed across the US, since the act was passed in August. By one count, since then over 90 new clean energy projects have been announced, totalling nearly \$90 billion in new investments and 100,000 new green jobs<sup>5</sup>.

## WHERE SHOULD INVESTORS LOOK?

The GDIP is another government initiative that provides significant incentives designed to attract capital for, and investment opportunities in, the transition to clean economy. While each geography has its own nuances and priorities, the overarching theme of addressing climate change and energy needs remains. For example, the GDIP highlights batteries, wind-power, heat pumps, solar energy, hydrogen electrolysers, and carbon capture, utilisation and storage (CCUS).

Most of the industries highlighted in the GDIP fall into growth sectors. In recent times, these have been out of favour with investors, weighing on performance. In addition, challenges around supply chains, increased interest rates, and political efforts to keep energy affordable have been headwinds. However, this could potentially provide more attractive entry points for investors.

Early-stage companies are leading the development of next-generation decarbonisation technologies. They offer exciting and unique opportunities to invest in innovation and future disruptors, either directly into ventures or via funds. Of course, investors need to accept higher risks and lower liquidity, as explained in [Trends in private markets](#).

Start-ups are not the only ones that will benefit from the competition in green stimulus measures. Many listed companies are adapting their business operations and pivoting their business lines for the green transition.

In Europe, a mix of higher spending and greater integration will support sectors such as energy, mining, autos, utilities, or construction. Notably, not all could be considered "green" today. However, they are likely to be key in transitioning to a net-zero world. As such, to avoid green surprises lurking in their portfolios, investors should be aware of their own sustainability preferences and the investment philosophy of their investment managers.

### MOVING UP A GEAR

The Green Deal Industrial Plan adds another gear to the EU's sustainability momentum. Through faster permitting, more subsidies, improved skills and better trade agreements, the aim is to speed up the growth of Europe's clean-tech industries.

The increased geopolitical competition to attract green investment and businesses is likely to gather momentum and help to reshape economies. As policymakers, businesses and investors seek to capture long-term growth opportunities, they all point to the same direction - to a cleaner, greener world.

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<sup>2</sup> Inflation Reduction Act guidebook, The White House, 15 December 2022 <https://www.whitehouse.gov/cleanenergy/inflation-reduction-act-guidebook/>

<sup>3</sup> Factsheet: the Green Deal Industrial Plan, European Commission, 1 February 2023 [https://ec.europa.eu/commission/presscorner/detail/en/FS\\_23\\_514](https://ec.europa.eu/commission/presscorner/detail/en/FS_23_514)

<sup>4</sup> Statement by President von der Leyen on the Green Deal Industrial Plan, European Commission, 1 February 2023 [https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT\\_23\\_521](https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_23_521)

<sup>5</sup> Clean Energy Boom 100K Report, Climate Power, February 2023 <https://climatepower.us/wp-content/uploads/sites/23/2023/02/Clean-Energy-Boom-100K-Report.pdf>



# How should you think about real estate?

As a boom in many US and UK property markets peters out, and interest rates hit post-financial crisis highs, what is the outlook for investors?



Residential real estate interests many investors. Most own a home, or homes, but several also invest in property. There's a tangible benefit and practical factor at play with owning property; you've also got a place to live or a regular monthly cash flow. There may also be an emotional connection involved too, even to the most hard-nosed investor, that can't be measured.

So, as central banks started to lift interest rates aggressively last year, what has been the effect on the US and UK housing markets, and how might it affect investor behaviour? (European markets were discussed in [Swiss ski properties scale new summits](#) and [Middle Eastern buyers refocus on Europe's most valuable real estate](#)).

## US PROPERTY PRICES ON THE SLIDE

Investors tend to watch the US economy very closely. As the old saying goes — if America sneezes, other economies typically catch a cold. The level of interest rates is an important factor in sentiment in housing markets. Consequently, the US Federal Reserve's aggressive hiking of the policy rate last year, from 0.25% to 4.5%<sup>1</sup>, took the wind out of the domestic property market.

As the base rate rose, so US mortgage rates climbed from 3% to 7% in 2022 and both new and existing home sales dropped, falling 40% from the January 2022 high.

Housing is among the most cyclically sensitive sectors of the American economy, and property prices have started to fall; US house prices are down 2.5% so far from the 2022 peak, according to the S&P CoreLogic Case-Shiller index<sup>2</sup>. Building permits and housing starts are also down 25-30%, though construction employment has held up well.

## UK PROPERTY: A TALE OF TWO MARKETS

Investors around the world tend to have a lot of interest in UK property. It can be regarded as a tale of two markets – London and the rest of the UK, both discussed in detail by Stephen Moroukian, Head of Product and Proposition for Real Estate Financing at Barclays Private Bank, in our [Markets Weekly podcast – 13 February 2023](#).

Across the broader UK property sector, prices have slipped by just shy of 4.5% in the past six months<sup>3</sup>, after years of rapid growth. The average house price in the UK was £281,000 in December having peaked at around £294,000 in August last year. These are similar to levels recorded around March last year, and that's still up 10% to 15% over five years.

This broad UK market is inextricably linked to the health of the mortgage market, and as in the US, mortgage approvals fell significantly in the latter half of last year. Approvals of 35,600 in December<sup>4</sup>, compares to a three-year average of 70,000.

<sup>1</sup> Open Market Operations, US Federal Reserve, April 2023 <https://www.federalreserve.gov/monetarypolicy/openmarket.htm>

<sup>2</sup> US housing market cools with prices down 2.5% from June peak, Bloomberg, 31 January 2023 <https://www.bloomberg.com/news/articles/2023-01-31/us-housing-market-cools-with-prices-down-2-5-from-peak-in-june?leadSource=verify%20wall>

<sup>3</sup> UK House Price Index: December 2022, ONS, 15 February 2023 <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/housepriceindex/december2022>

<sup>4</sup> UK demand for mortgages slumps as interest rates deter buyers, The Guardian, 31 January 2023 <https://www.theguardian.com/money/2023/jan/31/uk-mortgages-interest-rates-buyers-bank-of-england-savings>



## “Many investors have a bias towards familiarity, and real estate is attractive because it feels real — you can touch a house”

### MORTGAGE RATES IN FLUX

Fixed-rate mortgages peaked at 6% to 7% at the height of the UK ‘mini’ budget in September 2022. They are now comfortably falling and widely reported at just under 4% for a five-year period. This is still around double the lows in fixed-rate deals seen two years ago, and mortgage borrowers have shown increased interest in tracker mortgages.

The squeeze on household incomes from the rising cost of living and higher borrowing costs is, however, likely to continue to weigh on demand.

### LONDON: STILL A PRIME LOCATION?

London, and particularly the prime central London (PCL) market, is behaving very differently from the rest of the UK.

As recently covered in [London prime real estate shows its resilience](#), luxury sales are outperforming the wider London housing market. Among the drivers of this discrepancy is a weaker property buyers being less dependent on debt.

There also remains a continued shortage of stock for ‘best-in-class’ property. Lastly, the reopening of London, both to the UK and international buyers, as the COVID-19 pandemic recedes has occurred when the sterling/dollar exchange is favourable for foreign buyers. Indeed, this group of buyers are thought to account for almost half of all real estate purchases in PCL.

With a consistent excess of demand over supply supporting prices, PCL is expected to weather the anticipated market downturn better than most. Some predict a downturn in the area’s luxury market of 3% to 5%, while the country as a whole may see prices correct by around 10-15%.

### REAL ESTATE IN THE CONTEXT OF ASSET ALLOCATION

Notwithstanding that for many people their house is their home, and thus much more than an investment, many investors tend to over-invest in real estate versus a sensible asset allocation for their own financial goals and circumstances.

One downside of such an approach is an over-concentration of property assets in your portfolio. Some may believe that because they are familiar with real estate this reduces the risk of holding it. However, by increasing portfolio concentration the opposite occurs.

Real estate has historically held its own against other asset classes. It is also considered to be one of the best inflation hedges over longer periods (of say at least ten years). As the asset class return map (p19) below shows, real estate has been in the top half of annual performers three-fifths of the time since 2008. It has averaged annual returns of 6.4% compared with 6.8% for listed global equities and 3.7% for investment grade debt. However, over the same time real estate returns have been extremely variable.

When it comes to real estate returns, investors typically focus on house prices and capital gains. However, there are also costs such as insurance and servicing to take into account. As a result, the average market return is difficult to assess.

### REAL ESTATE FUNDS

Due to the capital-intensive nature of real estate investing, its requirement for active management, and the rise in global real estate opportunities, institutions seeking efficient asset management have been gradually investing in specialised real estate funds. The same is now true for retail investors, who can access a much larger selection of real estate mutual funds than before.

Many investors gain real estate exposure via listed Real Estate Investment Trusts (REITs) as well as specific illiquid funds. Equity REITs provide exposure to the income and growth return components that are comparable with those available in public equity, without suffering as much from the same expected compression in valuations. On top of the expected return for listed real estate, illiquid funds offer an illiquidity premium and provide tax benefits and are less correlated with developed market equities.

However, many investors prefer to hold physical real estate, and the illiquidity and nature of the asset class can lead to behavioural biases.

<sup>5</sup> Luxury Mayfair homes are selling at the fastest rate since 2020, Bloomberg, 8 February 2023 <https://uk.news.yahoo.com/luxury-mayfair-homes-selling-fastest-050000332.html>

<sup>6</sup> £5m+ sales performed best in London last year ‘despite mini-budget’, LonRes, 19 January 2023 <https://www.lonres.com/public/resources/press/%C2%A35m-sales-performed-best-london-last-year-%E2%80%98despite-mini-budget%E2%80%99>



2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022*	Average
Infrastructure 21.4%	High Yield Bonds 57.7%	Private Equity 18.1%	Real Estate 10.4%	High Yield Bonds 19.2%	Listed Global Equities 22.8%	Real Estate 13.5%	Real Estate 11.2%	High Yield Bonds 15.6%	Listed Global Equities 24.0%	Private Equity 10.9%	Listed Global Equities 26.6%	Private Equity 25.6%	Private Equity 47.5%	Natural Resources 29.9%	Private Equity 12.6%
Government Bonds 9.1%	Listed Global Equities 34.6%	High Yield Bonds 15.1%	Private Equity 8.5%	Listed Global Equities 16.1%	Private Equity 19.6%	Private Equity 12.1%	Private Equity 10.6%	Natural Resources 11.5%	Private Debt 19.2%	Infrastructure 10.1%	Private Equity 15.2%	Listed Global Equities 16.3%	Listed Global Equities 27.4%	Infrastructure 20.0%	Infrastructure 10.0%
Cash 3.4%	Private Debt 24.5%	Private Debt 14.4%	Infrastructure 8.2%	Private Debt 13.6%	Private Debt 15.1%	Infrastructure 10.6%	Infrastructure 10.5%	Private Equity 10.6%	Real Estate 14.2%	Real Estate 6.8%	High Yield Bonds 13.3%	Investment Grade Bonds 8.3%	Real Estate 23.3%	Real Estate 17.2%	Private Debt 8.1%
Investment Grade Bonds -5.1%	Investment Grade Bonds 16.6%	Listed Global Equities 12.7%	Natural Resources 8.0%	Private Equity 13.0%	Real Estate 14.3%	Private Debt 9.8%	Private Debt 4.0%	Real Estate 8.8%	Private Debt 12.2%	Private Debt 2.9%	Investment Grade Bonds 12.5%	Private Debt 2.9%	Private Debt 22.3%	Private Debt 4.5%	High Yield Bonds 7.0%
Natural Resources -11.9%	Private Equity 8.0%	Infrastructure 11.0%	Government Bonds 5.5%	Investment Grade Bonds 10.9%	Infrastructure 12.7%	Government Bonds 8.1%	Government Bonds 1.4%	Infrastructure 8.5%	Infrastructure 10.1%	Government Bonds 2.8%	Infrastructure 10.6%	High Yield Bonds 5.7%	Natural Resources 21.7%	Private Equity 3.5%	Listed Global Equities 6.8%
Private Equity -23.3%	Natural Resources 1.8%	Natural Resources 9.8%	Investment Grade Bonds 4.8%	Infrastructure 8.7%	Natural Resources 8.2%	Investment Grade Bonds 7.6%	Cash 0.4%	Listed Global Equities 7.9%	High Yield Bonds 8.4%	Cash 2.2%	Real Estate 8.7%	Government Bonds 5.1%	Infrastructure 16.4%	Cash 0.9%	Real Estate 6.4%
Private Debt -24.6%	Government Bonds 1.0%	Investment Grade Bonds 7.2%	Private Debt 3.9%	Real Estate 8.5%	High Yield Bonds 6.5%	Listed Global Equities 4.2%	Investment Grade Bonds -0.2%	Private Debt 6.6%	Natural Resources 8.1%	Natural Resources 2.1%	Private Debt 7.3%	Infrastructure 4.7%	High Yield Bonds 9.9%	Government Bonds -10.8%	Natural Resources 5.8%
High Yield Bonds -25.2%	Cash 0.9%	Real Estate -6.6%	High Yield Bonds 3.6%	Natural Resources 5.3%	Cash 0.3%	Natural Resources 2.6%	High Yield Bonds -0.7%	Investment Grade Bonds 6.2%	Investment Grade Bonds 5.7%	Investment Grade Bonds -1.0%	Government Bonds 7.2%	Real Estate 2.0%	Investment Grade Bonds 1.9%	High Yield Bonds -16.6%	Investment Grade Bonds 3.7%
Real Estate -29.9%	Infrastructure -16.3%	Government Bonds 3.6%	Cash 0.3%	Government Bonds 4.5%	Government Bonds 0.1%	High Yield Bonds 2.6%	Listed Global Equities -2.4%	Government Bonds 3.9%	Government Bonds 2.1%	High Yield Bonds -2.7%	Natural Resources 3.5%	Cash 0.7%	Cash 0.1%	Investment Grade Bonds -16.7%	Government Bonds 2.8%
Listed Global Equities -42.2%	Real Estate -22.5%	Cash 0.3%	Listed Global Equities -7.3%	Cash 0.4%	Investment Grade Bonds 0.1%	Cash 0.2%	Natural Resources -8.8%	Cash 0.8%	Cash 1.2%	Listed Global Equities -9.4%	Cash 2.4%	Natural Resources -4.8%	Government Bonds -1.7%	Listed Global Equities -20.7%	Cash 1.0%

Sources: Prequin, Barclays Private Bank, February 2023

## WATCH OUT FOR BEHAVIOURAL BIASES

Successful investing requires being aware of behavioural biases and knowing how to overcome them. Such biases can be particularly prevalent in real estate markets. This is due to a relatively high level of market inefficiency and intermediation relative to say equities and bonds; lower levels of information transparency; and being more emotionally attached to property versus other asset classes due to its tangible nature.

Many investors have a bias towards familiarity, and real estate is attractive because it feels real — you can touch a house whereas the stock market can seem far more uncertain and undefined. Several investors also exhibit a bias called anchoring, or focusing on the capital gain based on the purchase price. This can lead to making selling decisions that are tied to the seller's original purchase price, despite a very different market environment.

## COMPARISONS TO THE STOCK MARKET

Real estate feels real and investments less so, as such it's important to think about what an investment portfolio is at the micro level.

Navigating market turbulence is a concern for many. Investors often think in terms of "the market" and assume that their wealth is tied to its gyrations. However, holding a well-diversified portfolio means that you're not invested in the market but in companies.

When investing across asset classes, sectors and regions, an investor is holding shares in companies across the globe and these businesses create tangible products and services.

Whilst an investor might be less familiar with other asset classes that compose a typical investment portfolio, this does not necessarily imply more risk; quite the contrary. A diversified portfolio usually reduces risk and volatility. That said, real estate also has its idiosyncratic risks, such as those linked to its location or property type.

“Several investors also exhibit a bias called anchoring, or focusing on the capital gain based on the purchase price. This can lead to making selling decisions that are tied to the seller's original purchase price, despite a very different market environment”

## THE IMPORTANCE OF DIVERSIFICATION

Real estate has provided strong long-term financial returns for investors in addition to its intangible benefits and risks. However, it would be extremely risky to hold all your eggs in a real estate basket, or any other single asset class. In striving to protect and grow wealth over the long term for an acceptable level of risk, holding a well-diversified portfolio across asset classes, sectors and geographies is important. Within real estate this could be a mix of residential and commercial real estate, liquid and illiquid, in both public and private markets, spread across geographies.

A strong and robust investment process which leads to a well thought out strategic asset allocation to drive the core returns in a portfolio, using 'satellite' investments for tactical positioning to enhance returns and mitigate risks, seems a sensible approach to follow.

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



# Can India lead the growth pack this year?

Despite concerns around one of the country's largest conglomerates and a surprise uptick in inflation having already hit India's financial markets this year, the long-term signals for domestic equities remain promising. The country is on track to be one of the quickest, if not fastest, growing top-20 economies this year, backed by a government keen to support business.



The outlook for the global economy seems to be improving, with expansion being driven by emerging markets this year. Global growth is forecast to hit 2.9% in 2023 (up 20 basis points (bp) from expectations in October), according to the International Monetary Fund (IMF), with emerging market economies predicted to grow by 4% (up 30bp)<sup>1</sup>. The reopening of China's economy after the removal of its zero-COVID policy last year is largely responsible for the more optimistic growth figures.

The outlook for inflation also appears to be improving. The IMF predicts that inflation of 8.8% last year will soften to 6.6% in 2023 and 4.3% in 2024.

As the global outlook picks up, India looks like remaining one of the strongest expanding economies, among the 20 largest ones, this year, according to Barclays Investment Bank. Turning to the prospects for inflation, the Indian central bank predicts that price growth will moderate to 5.3% in fiscal year (FY) 2024 from 6.5% in FY 2023<sup>2</sup>. That said, the potential demand boost from a revived Chinese economy, and potential boost to commodity prices, might nudge inflation higher.

## INDIAN EQUITIES KEEP SHINING, DESPITE RECENT SQUALLS

Equity markets were boosted by February's Union budget, fears of an increase in capital gains tax proving to be misfounded.

That said, Indian equity investors were shaken by a report on a major Indian conglomerate. Shares related to that group and to those potentially exposed to it, especially in financial services, were sold off. As the short-term mood soured, foreign institutional investors sold more than 340 billion rupees-worth of domestic equities than they bought in the first two months of 2023, according to India's National Securities Depository Limited.

## EARNINGS PROSPECTS LOOK PROMISING

Despite the short-term net selling of Indian equities, the outlook for earnings at Indian companies is encouraging. While growth in sales volumes was muted, fourth-quarter 2022 earnings were better than expected for many domestic groups, with margins improving across most industries.

Financials and autos stocks drove earnings growth, although commodity-related sectors such as energy, metals and mining acted as a drag. At financial companies, results were buoyed by healthier borrowing and improving net interest margins. While earnings at technology groups were generally better than expected, the outlook seems murkier, as a series of job cuts hits the sector and signs are seen that clients may be postponing purchasing decisions.

<sup>1</sup> World Economic Outlook Update, International Monetary Fund, January 2023 [file:///C:/Users/martini5/Downloads/text%20\(2\).pdf](file:///C:/Users/martini5/Downloads/text%20(2).pdf)

<sup>2</sup> Monetary policy statement, 2022-2023 Resolution of Monetary Policy Committee, Reserve Bank of India, 8 February 2023 [https://www.rbi.org.in/Scripts/BS\\_PressReleaseDisplay.aspx?prid=55178](https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=55178)

More domestically-focused companies appear to offer better prospects than those with more international exposure. India's vibrant economic prospects are likely to encourage stronger volume growth, while any normalisation in margins should drive an expansion in earnings growth for local businesses. At the sector level, defence and infrastructure groups, along with those selling capital goods, look well placed to benefit from more capital expenditure.

As the short-term surge in volatility in the equity market eases, investors are likely to focus more on the encouraging earnings outlook and macro data (both domestically and in other leading economies).

### INFLATION SHOCK SHAKES BOND INVESTORS

January's shock increase in the Indian consumer price index (CPI) to 6.5% , up from 5.7% in December, was driven by a significant uptick in food costs in the month, that supports the Reserve Bank of India's continued hawkish stance. While February's inflation data might continue to be above the central bank's 6% upper target limit, the longer-term trend is still lower.

If inflation keeps being stronger than expected, this will increase the risk of another rate hike in April. That said, as core inflation remains more subdued, the latest inflation scare is unlikely to affect the terminal rate.

Despite the long-term downward trend in inflation, bond investors are likely to remain gripped by the volatile geopolitical outlook and persisting recession risks, even if more subdued in recent months, in many leading economies. Should volatility increase, the RBI is ready to provide timely and appropriate support to bond markets, in terms of boosting liquidity and policy flexibility, as and when is deemed appropriate.

### BUT LONG-TERM BOND PROSPECTS REMAIN ENCOURAGING

Medium- and long-term bonds seem preferable at the moment, as does a blend of 3- to 7-year corporate bonds and sovereign debt.

Locking in yields close to policy rate peaks has generally proved to be an assiduous strategy. Given the flattish yield curve, it might be a good time to lock in yields.

**"As the global outlook picks up, India looks like remaining one of the strongest growing economy among the 20 largest ones this year"**

### ASSET ALLOCATION AND DIVERSIFICATION KEY TO NAVIGATE VOLATILITY

After a tough year for investors, 2023 is likely to be another volatile one given the propensity for inflation, growth and central bank policy surprises to rock financial markets. That said, while it may be a struggle, investors should stick to their long-term asset allocation strategy and use any sell-offs as opportunities to rebalance portfolios.

As many equity markets test new highs, the rally seen in risk assets since October may be on its last legs. A continuation in the rally will be more difficult, until more clarity emerges on growth, inflation and the peak in interest rates.

With the surge in COVID-19 deaths in China seen since the removal of the zero-COVID policy last year seemingly having peaked, economic growth in the country is on track to bounce this year. In turn, Chinese equities are performing well against other major equity markets. Domestic policymakers are ready to do more to support the economy and the property market. That said, weaker home sales, slowing exports and restrictions on the imports of US semiconductors remain among the potential risks to growth.

### ALTERNATIVE ASSETS

Given the volatility seen in Indian equity markets and financial markets more generally this year, private markets continue to offer opportunities to diversify portfolios across both private equity and private credit.

With persisting levels of high inflation, investing in real estate investment trusts (REITs) and infrastructure investment trusts (INVITs) could provide a hedge against even higher inflation. Both asset classes tend to perform relatively well in inflationary periods. Indeed, the recent sell-off in REITs and INVITs should also be a tailwind for the asset classes. However, with recent taxation changes, investments in such areas should be considered as long-term in nature.

With another particularly volatile year expected, gold may, as usual, provide a "safe-haven" for investors when volatility spikes. Additionally, the yellow metal can also act as an inflation hedge while helping to diversify portfolios. In the current environment, any escalation in geopolitical risks, recession or weaker earnings is likely to dampen investor sentiment and, in turn, be a positive for the yellow metal.

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<sup>3</sup> India's retail inflation breaches RBI's tolerance level first time since October, Reuters, 13 February 2023 <https://www.reuters.com/world/india/indias-retail-inflation-rises-652-yy-jan-2023-02-13/>



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