Private Bank

What if we're wrong?

BARCLAYS

PBOS Investment Division April 2018

Overview

– Indicators tell us that there is more growth to come

– But history tells us recessions can rain from clear blue economic skies

– Nervous investors may seek solace in diversification and higher degrees of capital protection

An unknowable future…

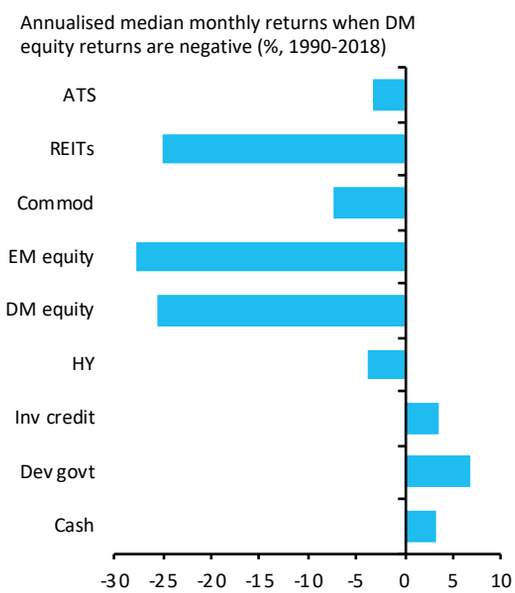
Growth is the norm – most years world output grows because of the simple interaction between new technology and the learning curve. The inference is that we need to find good reasons for betting against that trend, with investors usually being better off assuming continued growth. Broadly speaking, history is on the side of the optimists, and that means investors are best served in the long term by tilting their portfolios towards risk assets such as equities, rather than traditional safe haven assets.

For now, our preferred indicators are telling us that the end of the cycle isn't imminent. Until the signals start flashing amber, we see no reason to deviate from our current pro-cyclical stance. This posture is further compounded by our concern that one of the most popular safe havens, government bonds, may be offering a period of return-free risk rather than risk-free return. Even so, history tells us that recessions can rain from clear blue economic skies. For its part the International Monetary Fund (IMF) has identified several key contributors to recessions across advanced economies since 1960. This taxonomy was only able to identify triggers for half of their sampled recessions with the remaining half caused by idiosyncratic shocks like investment swings due to 'animal spirits' or asset price collapses – an unknowable future indeed.

Diversification

Happily, it is precisely when things go sour, that the value of diversification shines through. By spreading investments across a range of asset and sub asset classes, with varying degrees of sensitivity to the economy, we insulate our portfolios against unforeseen and undesirable outcomes. Having a wider opportunity set allows portfolios to reduce their allocations to developed government bonds without having to sacrifice diversification. Figure 1 illustrates this nicely – during the times when equities have performed poorly, developed government bonds have not been alone in providing some offset.

Figure 1 – Median asset class performance during DM equity drawdowns



Source: FactSet

Capital protection

Accordingly, portfolio diversification shouldn't be viewed in terms of a simplified bi-allocation between equities and developed government bonds, but rather in terms of its beta, or overall relationship to the equity markets. Within our client portfolios, the presence of safe havens and other diversifying assets, plus the proportions in which we own them, have been successful in restraining that beta in both good and bad times. In the current environment we still see short-maturity bonds as the most reliable nominal safe haven, providing liquid and stable ballast in portfolios. We, of course, augment this stable, but low returning core safe haven, with some government bonds, investment grade credit, and alternative assets with a negative beta to equity markets. Furthermore, investors looking to the short term may want to explore investment structures engineered with a higher degree of capital protection.

IBIM7725 May 2018