

Private
Clients

Market Perspectives

June 2019





Foreword

We believe potential investment opportunities are emerging in the face of increasingly negative market sentiment.

Escalating trade tensions between the world's two largest economies and rising fears among investors of an economic slowdown saw global equities fall by 6.2% in May. However, we think that the current consolidation provides a tactical opportunity for investors. We doubt a recession is likely this year and expect a resolution to the US-China trade wars.

Despite rising trade tensions, we believe that equities are likely to be supported by a belief that the US and Chinese leaders, along with the head of the US Federal Reserve, will act to underpin market valuations in times of stress.

Meanwhile, in the current environment we expect longer term rates to be kept low for longer. There is a risk that the worsening trade dispute between the US and China will push inflation higher in the second half of the year.

That said, at this late stage of the cycle we still see few warning signs of an imminent recession, including the recent inversion of the US yield curve.

At a time of low rates and in a period of market consolidation, we believe that collecting volatility premiums can be a useful way for investors to enhance total returns.

So overall our outlook for the economy and markets are relatively upbeat, despite the recent period of negative sentiment.

Yours

A handwritten signature in black ink, appearing to read 'J. Gerard', written over a horizontal line.

Jean-Christophe Gerard
Head of Investments Private Bank and
Interim Head of Private Bank EMEA



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Market consolidation provides opportunities

Are seemingly misplaced fears over US-China trade tensions and the threat of a recession presenting tactical investment opportunities?

Trade tensions unsettle markets

After entering May at a high for the year, the equity market seemed to have followed the old adage “Sell in May and go away”.

However, this year the loss of 6.2% in global equity markets in May, had nothing to do with seasonality. Trade tensions escalated rapidly between the US and China, manufacturing data in the US, Germany and Japan disappointed, despite low expectations and there were signs that the US Federal Reserve (Fed) might be less dovish than expected.

The aforementioned events also impacted other markets, with credit spreads widening, 10-year US Treasury yields going back down to 2.1% – the lowest level since 2017 – and oil prices falling 16%.

A tactical opportunity

As we highlighted in our first “Market Perspectives” back in April, it is typical to see higher volatility as the economic cycle moves to a later stage, which is where we are currently. We also warned of geopolitical tensions being a catalyst for a pick-up in realised volatility. In that sense, as expected, the market is less about momentum and more about tactical opportunities at the moment. For this reason, we highlighted tactical opportunities as a key investment theme for the year.

We think that the current consolidation provides one of those opportunities. Indeed, we continue to assume that a recession is unlikely and that there will be some form of resolution to trade tensions. In that scenario, which is our base case, the potential rewards are starting to look increasingly attractive.

While risks remain, we think that the mood has turned too negative on risky assets, especially equities. In that area, technology has probably suffered disproportionately, as have Asia ex-Japan equities. Selective fixed income emerging markets are also attractive. The current discount applied to those areas of financial markets seems unwarranted.

The net bullish reading in the American Association of Individual Investors is close to its multi-year lows, reached in December 2018. This extreme negative sentiment in retail investors is usually a sign that the turn is close as capitulations happened. While the timing of a turn is always difficult, over a three-to six-month horizon, we would expect financial markets to regain composure and make back the recent loss.

From an investment strategy perspective, we continue to have a positive bias towards late-cycle positioning. Quality and active management should do well in such market conditions.

Finally, the current trade tensions might impact inflation, increasing the risks of inflation moving higher from currently low expectations. However, additional volatility also provides opportunities for yield enhancement strategies, another investment theme we are monitoring closely.





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The risk of an inflation surprise

While the latest inflation numbers in major economies remain muted, escalating trade tensions between the US and China could increase the risk of higher inflation in the second half of 2019.

Higher trade tariffs could push inflation higher

Several economic studies suggest that the current trade war between the US and China could lead to higher inflation.

Reports conducted by independent institutions, such as the National Bureau of Economic Research or regional Federal Banks in the US, suggest that imposing a 25% tariff on all Chinese imports would likely increase US inflation by 50 basis points (bps) to 100 bps in the short term. This conclusion is based on analysis conducted after the first wave of tariffs in 2018, which impacted products such as solar panels, washing machines and steel.

When tariffs are imposed on finished goods, consumer prices for this product will likely increase to compensate, at least partly, for the

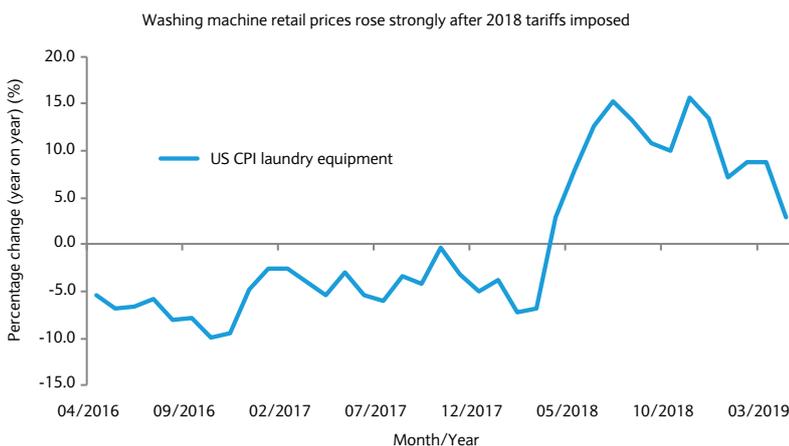
higher cost of import. For example, in January 2018, the US imposed 20% tariffs on the first 1.2m washing machines imported, with tariffs on all additional imported washing machines being imposed at 50%. In the ensuing months, the US laundry equipment inflation jumped by around 15% as companies passed on some of the costs of these tariffs to the consumer.

Consumers pay the price of a trade war

Similarly in 2018 steel prices rose, giving some insights into the impact on inflation from increased import duty on intermediary goods. In this case, companies which buy steel as an intermediary good in their production process had to choose between either increasing the cost of their final products, passing it to their consumers, or lower their margins and absorb it themselves. It seems that a majority of the extra costs were passed on to the consumers.

The 2018 tariff increases also shows that Chinese companies were reluctant to slash margins to remain competitive and instead took the risks of losing market share. And while Chinese imports to the US fell modestly initially, they did not collapse until early 2019. This is because domestic producers also increased their prices. For example, with the tariff on steel increasing the cost of steel coming from abroad, US steel producers could also increase their prices. As both price and cost increased proportionally, margins remained relatively healthy and firms remained competitive. In such a scenario, the impact of higher prices falls on consumers.

We recommend looking for companies with a strong brand, pricing powers and product demand not dramatically affected by a price increase. We also see opportunities in US inflation-linked bonds.



“Imposing a 25% tariff on all Chinese imports would likely increase US inflation by 50 bps to 100 bps in the short term.”



Henk Potts, Senior Investment Strategist – henk.potts@barclays.com

Time to seek shelter?

With intensifying geopolitical tensions hitting economic growth expectations, just how near is the next recession?

Timing recessions is a question that economists are often tasked with, but find one of the most difficult to answer.

History is littered with examples of factors that can cause the global economy to contract. These include shocks (1973, oil crisis) structural imbalances (1929, Great Depression and 2007, financial crisis), restrictive monetary policy (1990, aggressive rate hikes) and irrational exuberance (2000, dot-com bubble). The list is as varied as it is long and should be a reminder why predicting the nature and timing of a recession is such a difficult assignment.

Recession warnings

A number of storm clouds have accumulated over the past couple of years that have encouraged some market participants to question if this decade-long economic expansion is set to end soon.

Leading the inventory of current hazards are trade wars and their implications for global growth. Fears of higher US interest rates, political and social instability in Europe, emerging market pressures and Brexit also continue to be disruptive forces.

Reasons to be optimistic

Despite the darker macroeconomic backdrop, recent data releases have been ahead of consensus predictions. US GDP expanded by 3.2% year on year in the first quarter (Q1), the strongest start to the year since 2015. Strong investment in Spain, buoyant consumer spending in France and rebounding GDP in Italy helped European growth recover. Q1 eurozone growth was twice the pace achieved in the final three months of last year. Even the Brexit-impacted UK economy grew at a relatively healthy pace helped by employment growth, wage increases, credit expansion and the weak currency.

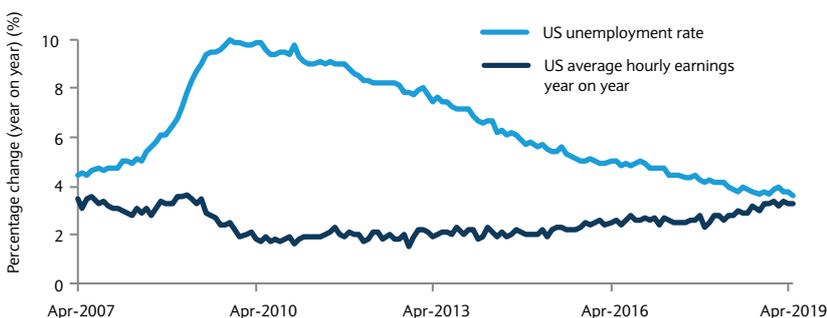
Not all regions of the global economy have grown faster than economists' expectations. China, the world's second largest economy, lost momentum in April. The impact of trade wars and the debt deleveraging programme resulted in industrial production, fixed asset investment and retail sales all slowing more than predicted. However, Chinese authorities are expected to implement further stimulus measures including tax cuts, infrastructure investments and rate cuts in efforts to maintain growth within the official target range of 6 to 6.5%.

Labour market strength

The strength of the labour market suggests that the global economy will continue to grow. US and UK unemployment rates have fallen to historically low levels (rates of 3.6% in the US and 3.8% in the UK are the lowest since 1969 and 1974 respectively). Even in Europe, unemployment fell to 7.7% in April, its lowest level in a decade.

High levels of employment coupled with pay rising above the rate of inflation should continue to support household consumption growth and in turn the economy.

Tight US labour market supports growth



Source: Bloomberg

Monetary policy outlook

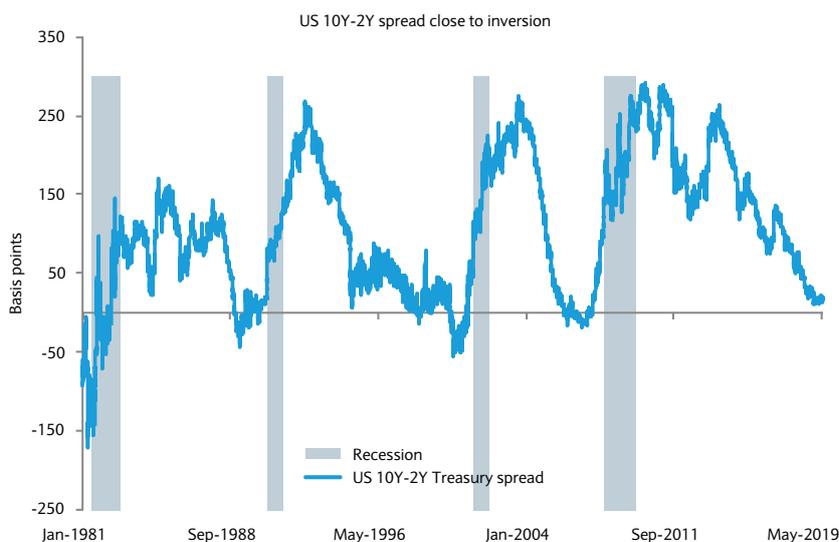
The over-tightening of monetary policy can have a devastating impact for growth prospects. Since the start of the year we have seen a dramatic change in policy expectations. The US Federal Reserve has taken a more patient stance, in a move we think will keep interest rates on hold both this year and next. We are also not forecasting an interest rate hike by the European Central Bank before the end of 2020.

The more benign rate environment has considerably reduced the risk of a central bank policy mistake developing into a recession.

Recession fears overdone

Trade wars have been grabbing the headlines and sharply moved the markets over the past few months. The recent escalation in the US-China dispute has forced analysts to reassess the prevailing view that a peaceful resolution to the dispute was inevitable.

Imposing higher US tariffs on China and the resulting retaliatory action will act as a tax on growth by reducing demand and pushing up consumer and producer prices. However, we don't believe the dispute will be forceful enough to destabilise the global economy.



Source: Bloomberg

The world may have to live with higher tariffs for considerably longer than originally expected, but our view is that economic pragmatism will eventually prevail. This should finally lead to the slow removal of tariffs and this trade and policy uncertainty.

Investment implications

We will continue to be on recession watch and will monitor leading indicators for warning signs. So far few warning signs are causing us to ring the alarm bell of an immediate recession. Even the much hyped inversion of the US yield curve does not encourage us to hit the panic button. Especially after taking into account the depressing impact of quantitative easing on 10-year Treasury yields and the neutral Fed position.

“So far few warning signs are causing us to ring the alarm bell of an immediate recession.”

This year we can expect moderating, but still reasonably robust, global growth of 3.6%, with the potential for marginal improvement in 2020 to 3.7%. We still recommend that investors maintain their exposure to risk assets. That said, returns are likely to be more subdued and volatility levels higher than we have seen over the past few years.



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Collecting option premium to enhance yield

While dividends play a role in enhancing yield, selling options is another approach worth considering.

As the global stock of negative-yielding fixed income instruments is back to its highs of \$12 trillion and the US 10-year government bond yield hovers close to an 18-month low, the “search for yield” is still very much on.

Yield enhancers

In the equity space, the obvious way to generate additional income is by buying high-dividend yielding stocks. Yet, as we have argued previously, the higher the dividend, the more likely it is to be cut. For this reason, our focus remains primarily on companies offering dividend sustainability and growth potential with a particular attention to free cash flow.

However when trying to enhance yield, we encourage investors to consider alternative strategies to dividend income. At a time when future returns may be more muted,

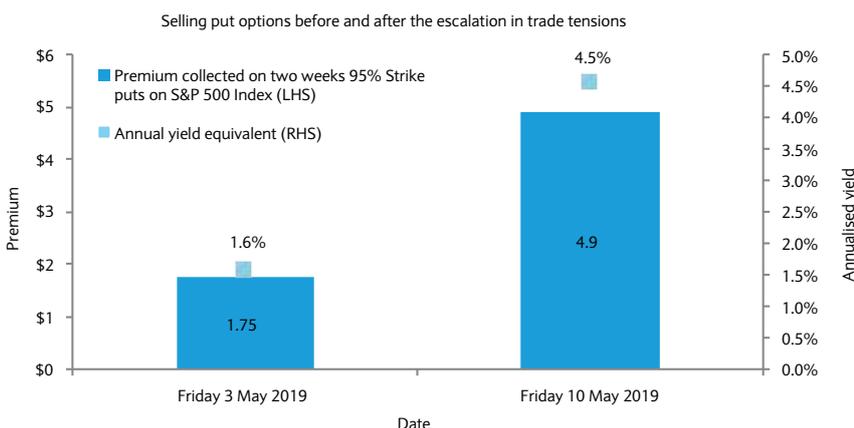
we think one strategy stands out: selling options, and specifically “put” options on owned stock in order to collect regular premiums.

A put option gives owners the right, but not the obligation, to sell a specified amount of an underlying security at a set price within a given timeframe.

Option premiums

In many ways, collecting option premiums is equivalent to taking the role of an insurer: collecting premiums and, from time to time, paying back claims. Of course, insuring someone or something is not without risks. But when done diligently, it can be rewarding. In the world of equities, we believe investors should follow these three rules to maximise their chances of success:

1. Balance the risk and reward appropriately. Insuring someone for the smallest drop in equity markets may yield a significant premium but the probability of claims being made is commensurably higher. We believe that a cushion of around 4 to 5% is more appropriate for a strategy that is, in essence, designed to be relatively defensive.
2. Prefer short-term contracts. While the likelihood of a drop in equity markets is higher over a short period of time than it is over many years, a short-term contract (say two weeks) provides the opportunity to renegotiate the premiums more frequently, allowing potentially higher premium income.
3. Be systematic. The old adage that “it is time in the market and not timing the market” is also true for options strategies. By transacting systematically (for instance every week), you can take advantage of spikes in volatility to collect higher premiums without the need to worry about timing.



“When trying to enhance yield, we encourage investors to consider alternative strategies to dividend income.”



Julien Lafargue, Head of Equity Strategy – julien.lafargue@barclays.com

Equity markets look more attractive

The recent period of consolidation is likely to continue for the time being. Yet the risk/reward profile is becoming more attractive as a few “insurance” policies should limit downside risk.

‘In last month’s “Market Perspectives” we argued that a period of consolidation was likely given limited room for positive surprises. The month of May offered very little optimism. The news flow was negative, with trade tensions turning into an outright trade and technology war and macroeconomic data failing to reassure. Yet, global and US equities are down less than 7% from their peak in late April.’

Downside protection

We attribute the market’s resilience in May to hopes that someone will step up to prevent sentiment deteriorating further. The three favourite “puts” (insurance against downside moves) are:

- The “Trump put” entails the US president adopting a more accommodating tone with regards to trade negotiations;
- The “Xi put” relies on Chinese authorities supporting their economy (and domestic markets) by way of stimulus injection; and
- The “Powell put” factors in a dovish US Federal Reserve (Fed) in response to either a significant drop in equity markets and/or a marked slowdown in the US economy.

We believe that the Trump put is key to supporting market valuations in the short term. Indeed, President Xi does not face re-election next year and has time on his side. He could potentially tolerate a higher degree of volatility than the US president.

Similarly, any action from the Federal Open Market Committee (FOMC), chaired by Jerome Powell, may be some time off. The FOMC’s policy pivot witnessed in December occurred only after US markets plummeted almost 20%. In addition, the market is already pricing a dovish Fed.

Progress in US-China trade talks critical

While we would not question Trump’s desire to see US equity markets perform well, we believe that, without real progress in the trade talks, the market may soon start questioning the viability of this put. In this sense, the G20 summit on June 28-29 will be crucial. The bar is low for positive surprises and simply avoiding incremental tariffs while releasing some pressure on Chinese technology companies, may be enough to trigger a market rally.

In this context, we remain of the view that, in the short term, US equities will consolidate further in a range between 2,700 and 2,900 with spikes of volatility. Below 2,800 we believe that the risk/reward profile becomes more attractive but see limited upside absent any progress on the trade front.

With increasing political uncertainty in Europe, we maintain our preference for US and emerging markets. The latter in particular appears attractive to us within the context of a 9% pull back since the high of mid-April. In this fast changing environment, active management remains essential in our opinion.



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Will trade tensions trigger a rate cut?

Longer lasting trade tensions could justify more accommodative monetary policy by the US Federal Reserve. Meanwhile, we believe that trade tensions will likely keep longer term rates low for the time being.

Given the latest comments from Chinese and US officials and that both countries could not find an agreement in May, it is now evident that both sides are willing to maintain a hard line in order to push for a better deal.

It has become more likely that the US Federal Reserve (Fed) will adopt a more pro-active stance, making one or two rate cuts likely. Markets, in the meantime, have started to price in several rate cuts over the next 12 months which at this point seems premature.

Rate cut, but no need to fight a recession

First: The Fed's primary inflation indicator, the PCE core deflator, is around 1.6% and below the central bank's long-term target of 2%.

In the past, lower inflation in isolation rarely was a trigger for the Fed to start a full rate cut cycle. In 1990 for example it was the asymmetric downside risk to the economy which led to rate cuts rather than lower inflation. At that time, gross domestic product (GDP) growth was expected to be at -0.5% (Q2) while the Institute for Supply Management (ISM) Index was well under 50, suggesting a contracting economy. The four-week average for initial jobless claims was at 370,000.

This brings us to the second factor: the economy. Today the US economy looks very different than it did in 1990. The ISM purchasing managers' index suggests expansion, real GDP growth, although likely to slow in the second half of the year, is at a healthy 2.9% while the unemployment rate stands at a 49-year low. Of course the big elephant in the room is the trade dispute. And if all announced measures were implemented and persisted over a long period, they would dampen the economic outlook, which the Fed will likely consider in its assessment.

The third factor is financial conditions: The S&P 500 Index is around 7% away from its all-time high. If the Fed looked at the equity market in isolation, it would most likely keep rates at current levels to avoid asset-price inflation.

Meanwhile, the loan survey as well as corporate bond spreads suggest that both consumers and corporates have healthy access to capital. Financial conditions, therefore, would not provide sufficient ammunition for the Fed to make several rate cuts.

Treasury yields to remain low

Although the trade tensions and a slower growth outlook make it more likely that the Fed will cut rates one or two times towards the end of the year, we think that it would take much more for the Fed to enter a full interest rate cutting cycle as priced in by the market.

We believe the momentum of lower Treasury yields will stay as long as the uncertainty around trade tensions persist. In this environment, longer duration provides a natural hedge in diversified portfolios.

BBB bond yields look attractive

The yield curve on BBB-rated bonds is steep. Longer dated BBB bonds offer an attractive yield pick-up while the longer duration helps in a period of economic uncertainty.

While the US sovereign rate curve is flat or slightly inverted, the BBB-rated corporate bond yield curve is steep by comparison. Here investors can find additional yield pick-up by extending the duration. While one-year USD BBB bonds yield around 2.7% on average, 10-year dated bonds yield roughly 100 basis points (bps) more and 15-year bonds offer a yield pick-up of 155 bps yielding 4.2% in average.

But not only the yield pick-up speaks in favour of longer dated BBB-rated bonds, longer dated BBB bonds also offer diversification benefits: long-dated BBB-rated bonds are exposed to duration risk and credit risk. The latter is primarily expressed by volatility in credit spreads during the investing period. Are these two factors reasons to stay away from investing in this segment of the market? No, we think quite the opposite.

Longer dated bonds in general gain in periods when yields are trending lower on the back of lower inflation expectations usually seen in an economic slowdown. In an environment where yields rise, longer dated bonds decrease in value. Spread premium on BBB bonds compared with investment grade bonds mirrors the above dynamic. Higher confidence in economic growth leads to flows into riskier bonds and compression of the premium. Although the two opposing factors do not eliminate price risk, they lead to lower price volatility on average.

“We believe the momentum of lower Treasury yields will stay as long as the uncertainty around trade tensions persist.”

During December’s sell-off, BBB bond spreads widened disproportionately compared to similar A-rated bonds which resulted in relative attractiveness. Currently, BBB spreads (160 bps) are around 1.65 times higher than comparable A spreads (100 bps), which is at the higher end of the range seen in the last five years.

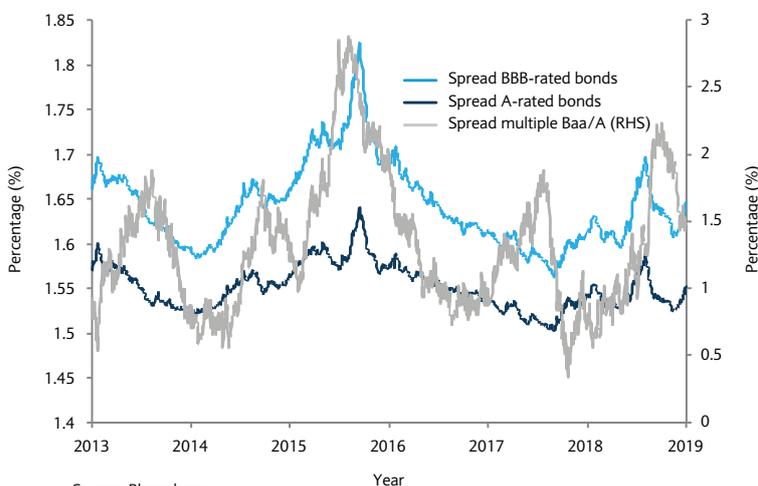
Although leverage has been built up in the corporate sector, the debt service costs compared to operating profits are still very manageable in average. BBB-rated issuers from defensive sectors like utilities and telecom companies, for example, are less exposed to earnings’ volatility during the economic cycle, which is credit positive. The combination of yield pick-up and longer duration, which offers a hedge in an economic downturn, together with manageable credit risk provides an interesting investment opportunity in our view.

BBB bond spreads move inversely to 10-year Treasury yields



Source: Bloomberg

BBB bond spreads look attractive



Source: Bloomberg

809	2730	商品宅配	20008	-0.42	20008	200.10	600
1767	14240	艾靠智电	4495	-0.57	4496	450.1	1447
3454	1939	寒锐钴业	15645	-0.89	156.17	156.44	18299
0.17	3640	金银河	3792	0.20	3792	3799	4769
2330	4799	光库科技	4147	0.10	4147	4148	10868
---	---	维业股份	2091	0.27	2090	209.1	13430
2.14	2015.1	博士眼镜	2345	0.22	234.1	234.4	3608
0.45	4280	捷捷微电	7476	0.46	7476	750.7	25086
829	33343	万兴科技	14289	1.299	14289	---	50137

Tactical asset allocation

‘Barclays Private Clients’ views on the positioning of assets in your portfolio’.

Cash and short duration bonds: neutral

- Our preference for higher quality, liquid opportunities translates into our positioning in short duration bonds, which offer an attractive risk-return trade off in the context of an inverted yield curve.
- Nonetheless, we maintain a neutral exposure to the asset class as real interest rates remain negative in most jurisdictions.

Developed government bonds: neutral

- Developed government bonds worldwide have been losing their appeal, as rates edged down amid lower economic growth, inflation and monetary policy expectations. The ongoing trade spat has further depressed yields, as investors rotated out of risky assets into the safety of sovereign bonds. Given this backdrop, we anticipate the asset class to predominantly be a diversifier rather than a major source of returns.
- Although US dollar real rates remain at historical low levels, they are still too attractive to ignore, relative to the other developed bond markets. UK and European bond markets failed to synchronise with US rates, due to their own geopolitical challenges, and depressed yields make it difficult to find these markets attractive.

Investment grade bonds: neutral

- A benign macro outlook and easing interest rates should be broadly positive for investment grade bonds. Nevertheless, we remain neutral on the asset class, amid mounting concerns over the rising pile of corporate debt and BBB-rated issuance.
- Although spreads have tightened significantly since the beginning of this year, we believe investment grade bonds will continue to earn some carry and thus outperform low yielding government bonds, specifically in Europe.

High yield bonds: underweight

- While default rates are at historical low levels and corporate fundamentals remain robust, we maintain an underweight exposure to the asset class, as margin pressure typically increases late in the economic cycle.
- Following the recent rally in riskier assets, high yield bonds look expensive. Spreads are tight by historical standards, which we do not view as attractive in the context of the credit and liquidity risk taken and the returns available from other asset classes.

Emerging markets bonds: neutral

- The US Federal Reserve’s (Fed) accommodative stance should continue to provide some relief to the largely dollar-denominated emerging markets (EM) debt, despite the recent weakness of local currencies.
- Although choppy energy prices and escalation in trade disputes provided a headwind to emerging markets bonds, credit quality hasn’t deteriorated and the economic momentum backdrop remains reasonably positive.
- Spreads have tightened since the beginning of the year, as investor flows reverted back into EM bonds amid improving sentiment, but remain comparatively wide versus high yield bonds. We favour US dollar-denominated emerging markets hard-currency bonds, due to their relatively attractive valuations.

Developed equities: overweight

- Earnings growth is still expansionary, albeit slowing, with growth forecast to be low-to-mid single digits over the year ahead. Healthy fundamentals continue to underpin the investment case for this asset class, while valuations are not excessively stretched compared to history.
- Although investor sentiment has been tested by renewed trade turmoil, less restrictive central banks and fairly constructive macro data from both sides of the Atlantic should support recovery globally and lift the asset class further.
- We favour active management and selective stock picking of companies with strong balance sheets, although we are agnostic on the geographical allocation of our equity positions. We focus on businesses with high cash returns on capital, with conservative capital structures and ideally an ability to reinvest cash in future growth at equally high rates of return. The US tends to offer us more opportunities to invest in these kind of businesses, meaning that North America remains the largest geographical weighting within the equity allocation.

Emerging markets equities: neutral

- While markets have grown increasingly cautious, following heightened protectionism fears, emerging markets equities should benefit from attractive valuations and steady economic activity out of the region, which will continue to underpin expansionary, albeit softening, growth.
- We expect fiscal and monetary easing in China to counteract a slowdown in the region and limit downside risk to earnings expectations. Trade tensions still pose a risk but will likely dissipate as economic pragmatism should eventually prevail.

Commodities: neutral

- The sole exposure within commodities continues to be our position in gold, which we view as complementary to the other risk mitigating assets in the portfolio, especially in light of the low interest rate environment and global trade fears.
- We find little attraction in this asset class outside of precious metals and find our risk budget better deployed elsewhere.

Alternative trading strategies: underweight

- We maintain a low conviction in alternatives due to their high expense and a lack of investment opportunities in this space. The limited use of leverage should further cap returns for the asset class.
- Nonetheless, the recent spike in volatility caused by renewed trade tensions may lift the asset class, at least in the short term.

Investments can fall as well as rise in value. Your capital or the income generated from your investment may be at risk.

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