Capital Market Assumptions and Strategic Asset Allocation 2023

SYNOPSIS

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At Barclays Private Bank, we conduct a periodic review of Capital Market Assumptions (CMA) and Strategic Asset Allocation (SAA) to ensure that our long-term investment process reflects our investment thinking, and to help optimise our clients' overall portfolio performance.

This document provides an overview of our outlook for key macroeconomic drivers and the performance of asset classes beyond the typical one-year outlook. Our long-term views cover an investment horizon of five years. Additionally, we summarise the key SAA changes in discretionary mandates.

For Accredited Investors in Singapore.

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Focusing on the long run

We help our clients with their long-term investment goals through a structured and disciplined investment process. This journey starts by understanding their investment needs and objectives – such as liquidity, lifestyle and aspirational goals – as well as their risk tolerance and capacity for loss.

SAA is the bedrock of our investment process, and it represents our preferred long-term positioning in a range of asset classes. The SAA design is guided by our investment philosophy, which revolves around the principles of long-term investing, wealth preservation, international multi-asset class diversification and an optimal risk-return trade-off.

Asset allocation requires reliable estimates of future return and risk. To this end, our CMA represent forward-looking estimates of expected returns, volatilities and correlations over the next five years for a number of asset classes. The asset classes covered include bonds, equities, commodities, real estate, hedge funds, foreign exchange and private markets.

Macroeconomic outlook: Looming recession and sluggish recovery

Starting with the macroeconomic backdrop, the next five years are expected to be characterised by a mild global recession followed by a sluggish recovery. Among the large developed economies in scope, the slowdown is anticipated to be shallowest in the US, and deeper in the eurozone and the UK.

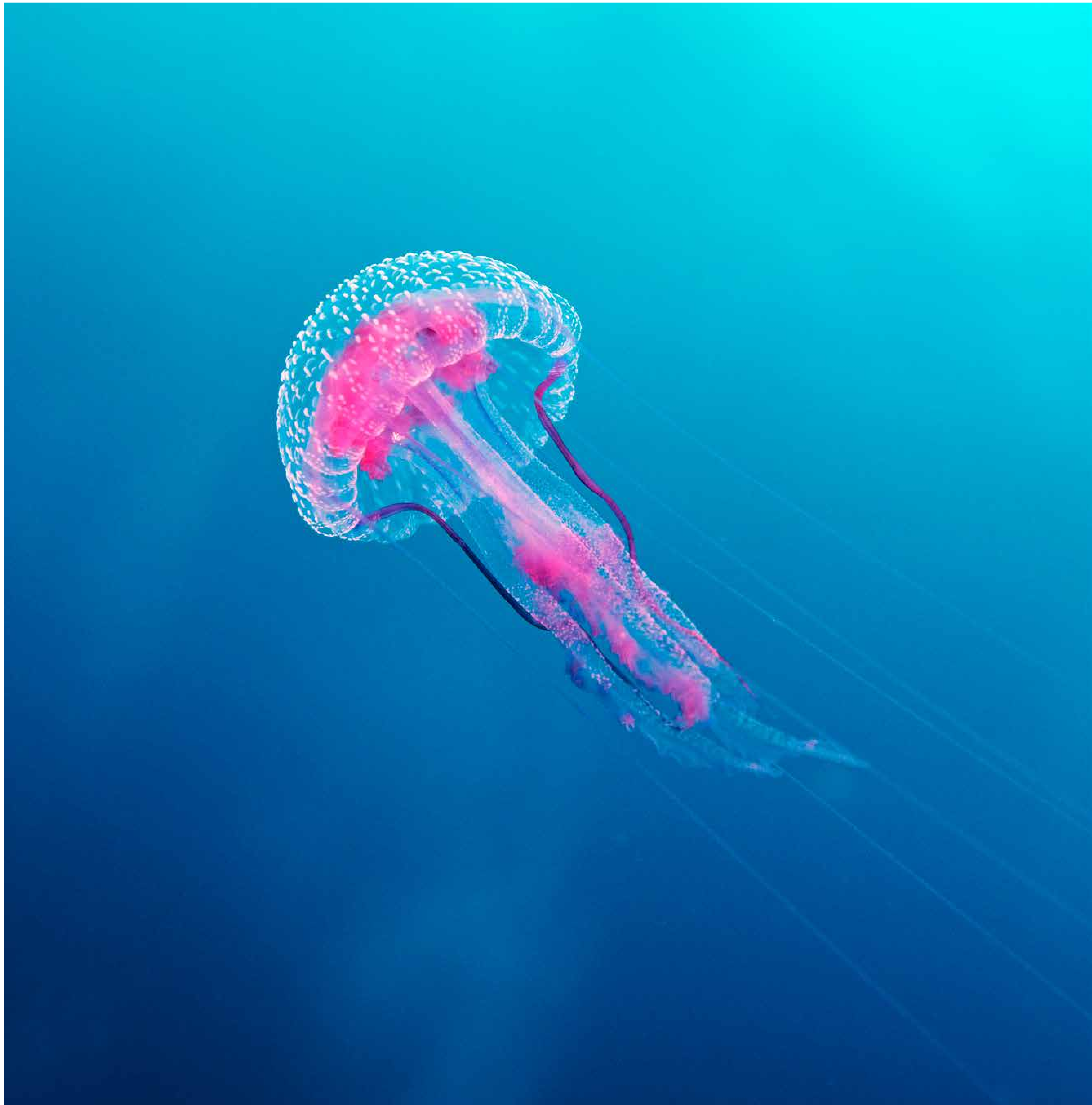
As opposed to the US, European economies are already experiencing a cost-of-living squeeze. This limits policymakers' ability to open the spending taps, as this could endanger the battle against elevated levels of inflation. Monetary policy, which had acted as a substitute for expansive fiscal policy over the last two decades, is expected to remain focused on bringing inflation back to target. This, in turn, should contribute to a slower recovery than seen in recent recessions.

A renewed global shock to energy prices following a geopolitical conflict is not our base-case scenario. In the absence of a global recession, emerging market economies are expected to avoid major debt stress. They are likely to manage the challenging global backdrop better than developed markets.

The impact on growth from the transition towards a zero-carbon world is also considered. Carbon taxation and its implications for infrastructure investments are likely to weigh on the productivity of developed economies in the near term, which could impair potential growth in the medium term. The effect of physical damage as a result of climate change on most developed economies is expected to be minimal over the next five years.

Inflation to remain above target

Inflation rates are expected to glide gradually lower from their recent multi-decade highs, but are expected to remain above target into 2024. European economies are balancing a cost-of-living squeeze and government debt on one side, and runaway inflation on the other. This will make it more difficult to normalise inflation rates in the eurozone and the UK, leading to average inflation rates remaining above central bank targets over the five-year horizon.



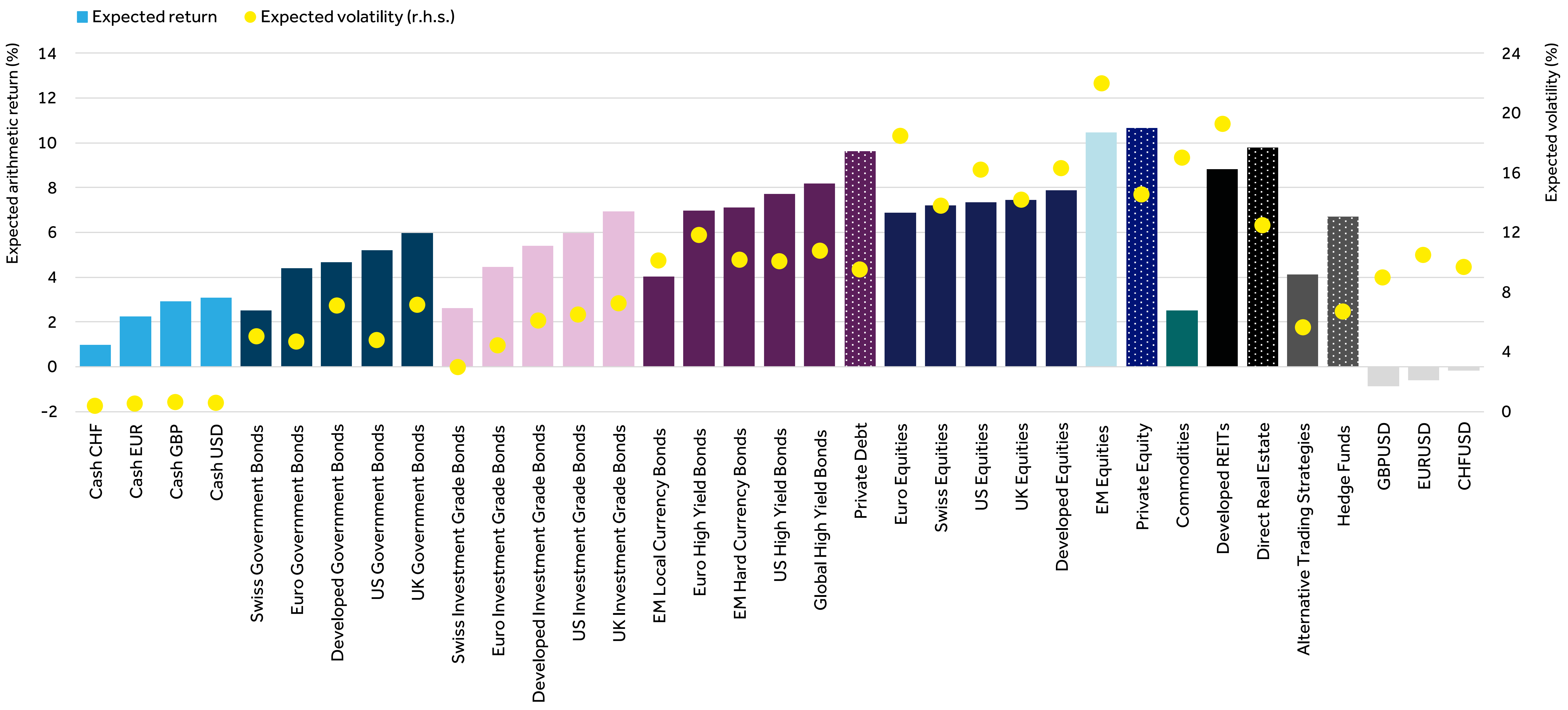
Cash is back, but still outpaced by inflation

Wary of a resurgence in inflation, monetary policy is likely to remain restrictive in the short term. In the absence of a deep global recession, the loosening of monetary policy should play out only gradually. From 2025, central banks are expected to lower policy rates to the respective terminal rates: between 2.5% and 3.0% for the Bank of England, slightly above 2.0% for the US Federal Reserve, between 1.5% and 2% for the European Central Bank, and below 1% for the Swiss National Bank.

As a result, long-term expected cash returns are well above historical averages. In fact, expectations for the next five years are more than double the average return over the last two decades for holdings in the US dollar and euro, and 30% higher for sterling. However, only US dollar cash returns are likely to compensate for inflation. As a result, the overall allocation to cash has been significantly reduced in favour of longer-term debt.

BARCLAYS PRIVATE BANK CMA RETURN AND RISK PROJECTIONS 2023-2027

Annualised projections for total returns (bars) and expected, regime-dependent volatility (markers). Estimates for the period of 2023 to 2027.



Source: Barclays Private Bank, March 2023. Forecasts are not a reliable indicator of future performance. CMA expected returns and volatilities are annualised and given in local currencies (or in USD in the case of asset classes that have exposure to different countries and/or regions). The value of investments can fall as well as rise and you may get back less than you invested

Returns and risk in a stagflationary environment

While the economic outlook over the five-year investment horizon is encouraging, inflation and growth expectations are de-synched, especially at the beginning of this investment horizon. This leads to a mix of elevated inflation and muted growth – a situation often referred to as stagflation.

The implications of a stagflationary environment on expected asset class returns become more apparent when returns are broken down into the building blocks of income, growth and valuation. Growth expectations, which are reflected in earnings growth for equities or roll return in fixed income, are muted.

Income returns, such as dividend and net buyback yields in equities and the level of yield in fixed income, take centre stage in such a macroeconomic environment. As a result, fixed income returns receive a larger boost compared with their historical average. Equity returns, which have a higher reliance on the growth component, do not profit from the expected macro environment.

Unexpected events which entail above-average market volatility are more likely at such times. This is reflected in our regime-dependent projections for volatility: for this update, risk-off periods have received more weight (60%) than risk-on periods.

Fixed income: back at the core of the portfolio

The recent surge in yields, and with it the increased income potential, has boosted the appeal of fixed income assets.

After their worst year in decades, government bonds look primed to rival the returns of equities in the early years of the forecast horizon. Supported by attractive yields, we anticipate that government bonds should return between 2.5% and 6.0% over the next five years, above the historical averages of the last two decades.

Elevated, but still negative, levels of correlation between equities and bonds are expected over the next five years. On balance, this makes bonds a less effective diversifier for equities, which increases the need for exposure to bonds in a portfolio. Combining these two effects, the allocation to government bonds has been increased in the new SAA, mostly at the expense of cash.

Investment grade bonds are anticipated to manage the economic slowdown relatively well early in the forecast horizon. European issuers, which face difficult macroeconomic conditions, have increased their resilience by adapting their term structure. This is likely to provide a buffer in turbulent periods.

High yield and emerging market bonds also profit from the general increase in yield levels. However, with a relatively low number of defaults seen of late and a nearing slowdown, the volatility of high yielding debt is expected to be elevated, limiting its appeal from a portfolio construction perspective. On balance, allocations to both investment grade and high yield bonds have been increased.

Emerging market bonds in local currency have been removed from SAA benchmark portfolios. Potential risks in local currency bonds are even higher than those in the general high yield universe and the returns do not seem to compensate for the risks. As such, there is a focus on the core developed markets and hard currency bonds.

Equities: fairly valued but with muted growth prospects

The expected returns for equities are close to the historical averages of the last 20 years, except for US equities, which were particularly high historically due to stronger earnings growth. As a result of the repricing in 2022, cyclically adjusted price-to-earnings ratios are now in line with historical averages. Therefore, valuation is expected to be only a small part of the overall equity return stream, with the focus on earnings growth.

With a lot of the expected downside already priced in, return projections for equities have been lifted slightly, to between 7.0% and 8.0% for developed markets, and 10.5% for emerging markets. In risk-adjusted terms, equities have lost their edge compared with bonds. However, in portfolio construction, they remain an important counterbalance to the bond portfolio, which is why the allocation to equities has not been reduced.

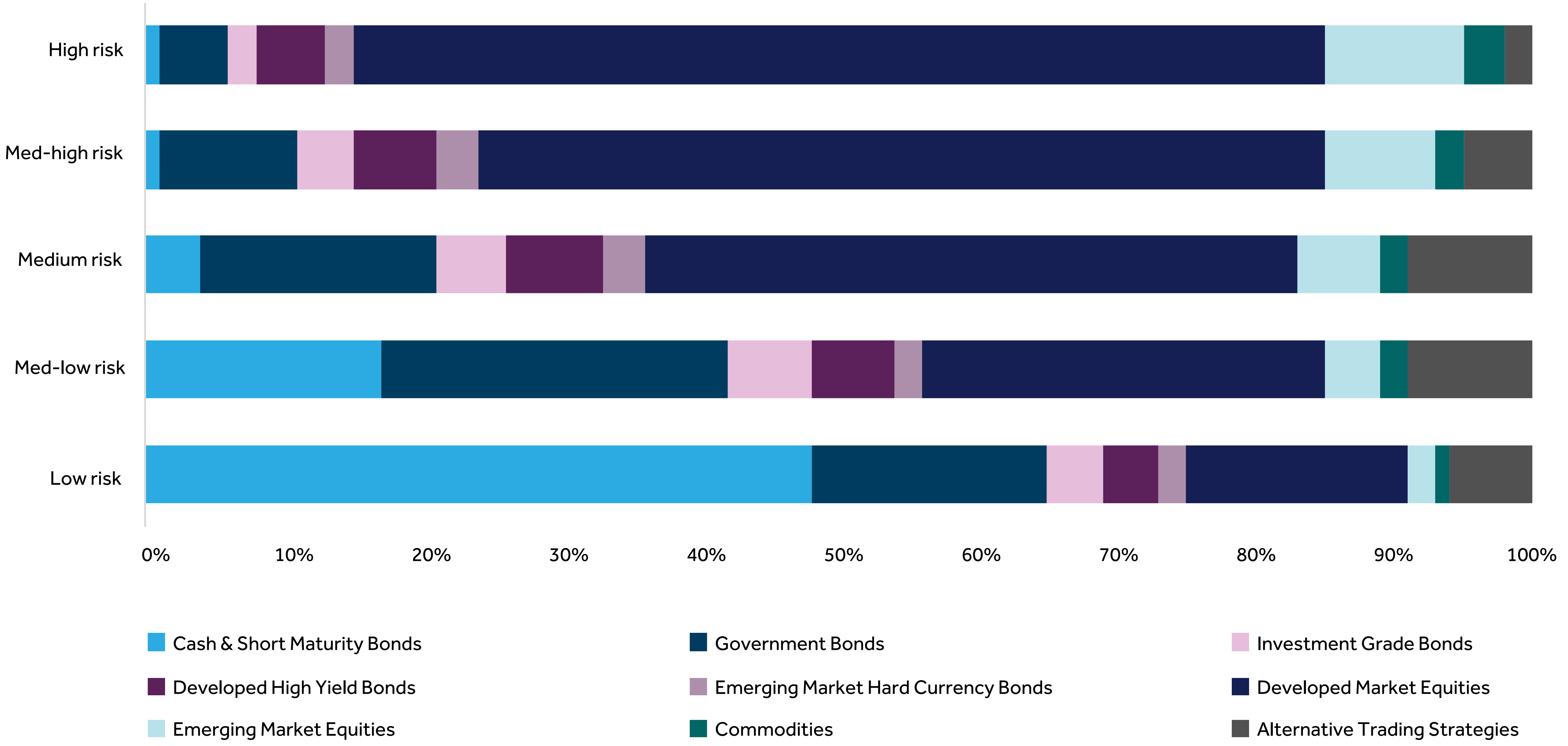
Commodities and alternatives make room for the core portfolio

Energy prices are expected to plateau in 2023 and the expected economic slowdown should weigh on other cyclical commodities. As such, the broad commodity complex is expected to return only 2.5% over the next five years. Alternative trading strategies, the beneficiaries of TINA ('There is no alternative' [to equities]), are forecast to generate returns of 4.1%, which pales compared with the new-found shine of bond returns.

With inflation rates expected to come down and economic growth prospects muted, real assets play a less important role in the new SAA (see figure). Since, at the same time, the core portfolio of bonds and equities provides both return potential and a good level of diversification, the allocation to commodities and alternative trading strategies has been reduced.

BARCLAYS PRIVATE BANK GLOBAL STRATEGIC ASSET ALLOCATION

Global SAA for five risk profiles and reference currencies USD, GDP, EUR and CHF. Colours are aligned with more granular asset classes in the CMA return and risk projections chart.



Source: Barclays Private Bank, March 2023

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