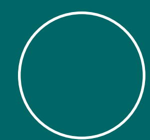
Market Perspectives

February 2023

BARCLAYS | Private Bank



Contents

Has the global economy weathered the worst of the storm? 3

Why the rally in equities looks overdone 6

Bridging the yield gap 10

Private credit: when money isn't free anymore 13

US inflation is no 1970s retro act (for now) 15

How ESG can help investors navigate the year ahead 18

Do you need to change your investment behaviours in 2023? 21

Multi-asset portfolio allocation 23

Contributors:

Henk Potts, London UK, Market Strategist EMEA
Julien Lafargue, CFA, London UK, Chief Market Strategist
Dorothée Deck, London UK, Cross Asset Strategist
Michel Vernier, CFA, London UK, Head of Fixed Income Strategy
Nikola Vasiljevic, PhD, Zurich Switzerland, Head of Quantitative Strategy
Lukas Gehrig, Zurich Switzerland, Quantitative Strategist
Alexander Joshi, London UK, Head of Behavioural Finance
Damian Payiatakis, London UK, Head of Sustainable & Impact Investing
Luke Mayberry, London UK, Investment Analyst
Iain Martin, London UK, Investment Writer

Foreword

Welcome to our first edition of Market Perspectives for 2023, which aims to provide much-needed context and clarity for the year ahead.

Equity markets, and risk assets in general, have kicked off the year by powering ahead. While there are growing hopes that inflation has peaked, and that central banks will start to ease rate hiking, we remain prudent given the elevated uncertainty.

In the short term, the climate lends itself better to bonds than stocks.

Speaking about fixed income, the peak in interest rates in this cycle may be lower than expected, after the astonishing speed and size of last year's rate hikes. Yet, here again uncertainty abounds.

Beyond our usual asset class and financial market analysis, you'll also find our latest sustainability insights, hot-on-the-heels of our latest 'Investing for Global Impact' campaign.

One topic permeates most of the common top risks facing us: environmental, social and governance (ESG) issues. We look at what you can do to include ESG factors in investments decisions, so as to spot opportunities while minimising portfolio risk and boosting returns.

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

Has the global economy weathered the worst of the storm?

After a tough year for the global economy, this year looks like being equally as challenging. However, with US and European inflation showing signs of easing in the US and Europe and China reopening its economy after COVID-19 restrictions, will more positive economic news improve the mood among investors?

This year looks set to be another challenging one for the global economy. The combination of heightened geopolitical tensions, tighter financial conditions and the impact of elevated inflation on consumption, are likely to weigh on growth prospects. Further risks to output could also emanate from the prolonged period of price pressures generated by wage increases, an extended energy shock and a flare up of the pandemic.

Given the probability of slowing activity in both Europe and the UK, and flat performance from the US, we expect advanced economies to struggle to generate much growth this year. At a global level, we forecast that expansion will remain positive, albeit at just 2.2%, as China recovers from a depressed 2022 while the Indian economy grows at an impressive 5.2%.

If global gross domestic product (GDP) increases as we expect this year, it would be the third weakest result for the economy in the past thirty years, outside of the contractions of 2009 and 2020.

While growth forecasts remain constrained, activity has been more resilient than expected in recent months. Household output has been cushioned by excess savings and robust labour markets. Consumer, corporate and financial balance sheets still look healthy while the service sector has been recovering as the bounce back from the pandemic continues. China's decision to abandon its zero-COVID strategy late last year should also boost domestic activity and improve global supply chains.

INFLATION SET TO BECOME MORE DIGESTIBLE

The trajectory of inflation will be a big driver of sentiment, activity and policy this year. We believe that the peak in global price pressures is now behind us and inflation will continue to moderate over the coming months.

Hikes in goods prices have now eased as a result of elevated inventory levels, the relaxation of COVID restrictions and rising capacity. Further disinflationary pressures should emerge from weaker demand (higher interest rates), improving labour market conditions and stabilising commodity prices.

Whilst we expect inflation to remain above targeted levels in many regions in 2023, the data is likely to become increasingly digestible over the next couple of years. We forecast that the global consumer price index (CPI) will average 4.4% this year, and 2.9% in 2024, compared to the 7% surge registered in 2022.

THE END OF THE HIKING CYCLE IS WITHIN SIGHT

With leading central banks having instigated the steepest tightening cycle in four decades last year, much of the heavy interest rate lifting appears to have been done. If, as expected, inflation moderates, it should take some of the pressure off central bankers to continue to push rates deeper into restrictive territory, thereby reducing the risk of a policy-induced harsh recession.

"The depth of the [global] recession is still expected to be a relatively shallow one and economic sentiment is likely to improve as inflation eases, central banks eventually turn dovish and growth troughs"

US GROWTH TO REMAIN SUBDUED

Slowing consumer demand, a softening housing market and depressed levels of confidence are expected to lead to a subdued growth profile for the US economy in 2023. We expect private consumption growth to weaken to 1.3% as unemployment rises and consumer purchasing power continues to be eroded by higher interest rates and inflation. We forecast that US unemployment will rise steadily from its current low base, of 3.5%, to finish the year at 4.8%.

On a positive note, US inflation is moderating. December's CPI data was down by 0.1% month-on-month, the first decline in two and half years. Whilst the annual 6.5% reading continues to be more than three times the target, it has decelerated for six consecutive months and is back to its lowest level since October 2021. We expect the moderation trend to continue, with US CPI averaging 2.4% in the final quarter of this year.

The US Federal Reserve (Fed) hiked by 25 basis points (bp) at the start of February, following a string of 75bp hikes and a 50bp increase in December. The fed funds target range now stands at 4.5%-4.75%, the highest rate since December 2007. Having raised rates for eight consecutive meetings, and by an astonishing 425bp in 2022, we predict that the Federal Open Markets Committee (FOMC) will conclude the hiking cycle this year.

We forecast a string of 25bp increases (March and May) after which we anticipate the central bank will maintain the policy rate of 5%-5.25% through much of the year. Towards the very end of this year, there is the potential for a pivot to an easing stance as inflation continues to moderate, the labour market cools and growth weakens.

CHINA LOOKS TO KICKSTART GROWTH

China had a miserable 2022 by its own standards. Its growth profile slumped due to the rigorous enforcement of COVID-19 restrictions, a collapsing property market and weaker external demand. The world's second largest economy officially grew at just 3% last year, its second lowest rate in half a century, and well short of the official 5.5% growth target.

In contrast to a lacklustre 2022, this year is forecast to be one of recovery. Officials have dramatically reopened the economy, implemented a compressive plan to shore up the housing market and boosted stimulus measures.

In the short term, we expect the world's largest COVID wave to continue to disrupt activity. The peak of infections looks like being in February, following China's Lunar New Year celebrations, and subsequently the economy is likely to gradually recover through the first half of this year.

The earlier than expected reopening of the economy shows that China's new leadership are refocusing on the growth agenda. The expected recovery in consumption and improvement in investment should both help the Chinese economy to grow at 4.8% this year, up from our forecast of 2.2% in November.

EUROPE LOOKS TO TAME INFLATION

European economic data held up better than expected in the last three months of 2022. The mild winter weather, high levels of gas storage (84%)[1] and importing of liquified natural gas (LNG) have helped to reduced fears of an immediate energy supply shock impacting the region. That said, medium-term energy risks persist as we look into the supply and demand dynamic for winter 2023/24.

More broadly, the outlook for European growth is anticipated to be affected by weaker domestic demand, reduced levels of industrial output and lower levels of investment. We expect eurozone GDP to contract by 0.1% this year and that the rate of unemployment will rise to 6.9% by December.

Eurozone inflation decelerated to 9.1% in December and is back into single digits for the first time since August. We forecast that price pressures in the bloc will continue to slowly moderate because of government intervention in energy markets along with weaker gas and electricity prices. Nevertheless, we estimate that price pressures will remain elevated this year (with CPI averaging 5%), as increases in minimum wages and higher pay demands by powerful trade unions create upward pressure on employee compensation.

Despite the weakening backdrop, the European Central Bank (ECB) remains determined to tame inflation and normalise policy. The Governing Council has increased the deposit rate from negative territory (in early summer last year) to 2.5% (at the February meeting). The ECB recently guided that rates will still have to rise significantly, and at a steady pace, to reach levels that are sufficiently restrictive. Therefore, we look for 50bp increases at the March meeting, and forecast a terminal deposit rate of 3%, though risks remain skewed to the upside.

[1] EU hails high gas storage levels despite Russian cuts, The Independent, 4 January 2023 https://www.independent.co.uk/news/ap-brussels-vladimir-putin-ukraine-europe-b2255901.html

"At a global level, we forecast that expansion will remain positive, albeit at just 2.2%, as China recovers from a depressed 2022 while the Indian economy grows at an impressive 5.2%"

UK ECONOMY FEELS THE HEAT

The biggest cost-of-living squeeze in decades, political turmoil and policy confusion have created a particularly negative backdrop for the UK economy. Household consumption has slumped, the manufacturing purchasing managers' index (PMI) is now in contraction territory and the recovery in the service sector is fizzling out.

The UK labour market continues to be restrictively tight with unemployment rates hovering around the lows of the 1970's and vacancy rates remain above the one million mark[2]. The constricted labour market, caused by a decline in participation rates following the pandemic and a reduced supply of workers, because of Brexit, is infringing on staffing needs and pushing up wages.

COST-OF-LIVING SQUEEZE

The outlook for the UK economy remains gloomy as households are forced to confront a plethora of pressures including higher interest rates, rising energy bills and elevated and persistent levels of inflation. Whilst average earnings rose at a record 6.4% in the quarter to the end of November, real wages (adjusted for inflation) fell 2.6% . The Office for Budget Responsibility expects real wages to fall 7% in the two financial years up until 2023/24, which would represent the biggest drop on record, wiping out eight years of growth. The significant increase in taxes announced as part of the Autumn Statement will also weigh on disposable incomes. We expect private consumption will contract by 0.7% in 2023, compared to growth of 4.4% in 2022.

UK inflation remains in double-digit territory (10.5% in December) and is forecast to moderate at a slower pace than other advanced economies. This is in part due to the impact of higher energy bills, lower levels of government assistance and the ongoing disruption to the supply of labour and goods. We forecast that UK CPI will average 7.3% this year.

HIGHER RATES AND A PRONOUNCED UK RECESSION

The Bank of England increased interest rates by 50bp in February, pushing the base rate up to 4.0%, the highest in 15 years. We forecast two further hikes (25bp in both March and May) taking the terminal rate to 4.5%. We predict that the UK economy will experience an interrupted recession, with a peak to trough decline of 1%, including a 0.7% contraction in this calendar year, followed by a sluggish 0.4% recovery in 2024.

MUTED GLOBAL GROWTH PROSPECTS

Given the pressures facing the global economy, growth prospects are expected to remain muted over the next twelve months. The depth of the recession, however, is still expected to be a relatively shallow one. Economic sentiment is likely to improve as inflation eases, central banks eventually turn dovish and growth troughs.

Author: Henk Potts, London UK, Market Strategist EMEA

[2] Labour market overview, UK: January 2023, Office for National Statistics, 17 January 2023 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/january2023

Why the rally in equities looks overdone

Investors have been in buoyant mood early in 2023, sustaining a rally in equities and other risk assets towards the end of 2022. While there are more positive signs on the economic front to justify their optimism, the rally appears to be overdone. What can investors do to hedge their portfolios against downside risk in financial markets?

RISK ASSETS START THE YEAR ON THE FRONT FOOT

Equities, commodities and other risk assets, have started the year on a strong footing, extending their gains made since mid-October last year. Global equities had already gained 19% from their October lows, outperforming bonds by 13%, by 27 January. Non-US stocks have trounced their American peers by 7% during this period, while industrial metals have soared by 20% following the removal of China's COVID-19 restrictions. Meanwhile, the US dollar has depreciated by 10% against the currencies of its major trading partners.

The rally in risk assets since October has been fueled by expectations that the US Federal Reserve (Fed) and other leading central banks would soon halt their interest-rate hiking cycles, following a general easing of inflationary pressures, thereby increasing the chances of a soft landing for the economy.

> "European stocks have had a particularly strong run in recent months"

HOWEVER, EQUITY MARKETS SEEM TO HAVE OVERSHOT MACRO FUNDAMENTALS

Following the latest economic data releases, inflation has slowed faster than expected, while economic growth has surprised positively, which is generally a favourable environment for equity valuations (see chart, p7).

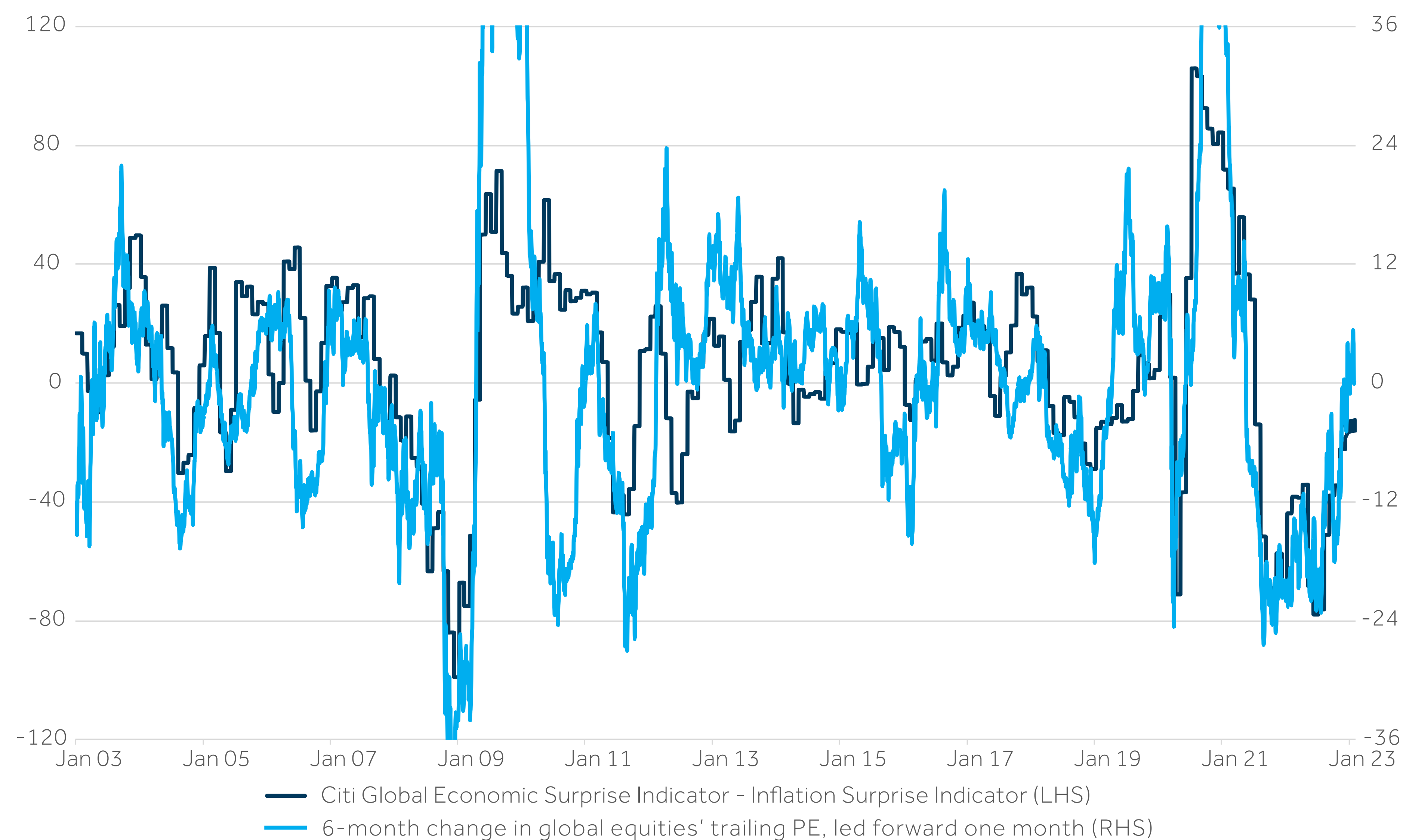
That said, investors have taken note and are now pricing in an improvement in the growth/inflation dynamics. However, the rally appears to have run ahead of macro fundamentals, which leaves room for disappointment in the near term.

The chart shows that the rise in global equity valuations observed in the past six months appears to have overshot the improvement in activity surprise relative to the inflation surprise. This is happening in the context of a highly uncertain environment:

- The lagged impact of previous rate hikes on the economy remains unclear.
- Central bank officials have maintained a hawkish stance in relation to interest-rate policy, despite a slowing economy. Policymakers have recently reinforced their message that rates are likely to stay elevated for some time, and probably for longer than the market currently expects.

GLOBAL EQUITIES SEEM TO HAVE RUN AHEAD OF THE IMPROVEMENT IN THE GROWTH/INFLATION MIX

Comparison of the six-month change in global equities' trailing price-to-earnings ratio, led forward 1 month, and the spread between the Citi global economic surprise indicator and the inflation surprise indicator since 2003



Sources: Refinitiv Datastream, Barclays Private Bank, January 2023

Note: The six-month change in global equities' trailing PE line has been clipped.

- The reopening of the Chinese economy is likely to be a long and chaotic process. The country will probably see a surge in COVID-19 infection rates in the coming weeks, following the Chinese Lunar New Year holiday (7 January to 25 February) - a time when many people travel across the country to visit their relatives. While Beijing seems unwilling to lockdown again, the spread of infections could lead to an increase in self-imposed restrictions that could slow the economic recovery.
- In addition, the expected boost to global growth from an acceleration in Chinese economic expansion is likely to be lower than in previous years, as it will be led by the services sector as opposed to manufacturing.
- The fourth-quarter earnings season has produced mixed results so far, and could add to volatility in financial markets. With investors' focus shifting from inflation to recession risk, corporate earnings releases and managements' perceptions of the outlook will be heavily scrutinised.
- And finally, with the war in Ukraine still raging, the geopolitical uncertainty is unlikely to subside soon.

With that in mind, we would not chase this rally until we see clear evidence that the economic data is improving and that the peak in interest rates is near.

WHAT COULD EQUITY INVESTORS DO TO LIMIT DOWNSIDE RISK?

Investors willing to reduce downside risk in equity portfolios should consider rebalancing their positions towards the more defensive parts of the market, but in a very selective way, and preferably via individual stocks rather than sector indices.

At the stock level, we would focus on companies with a history of stable earnings and solid balance sheets, which have been resilient through previous economic cycles, and trade at a historical discount.

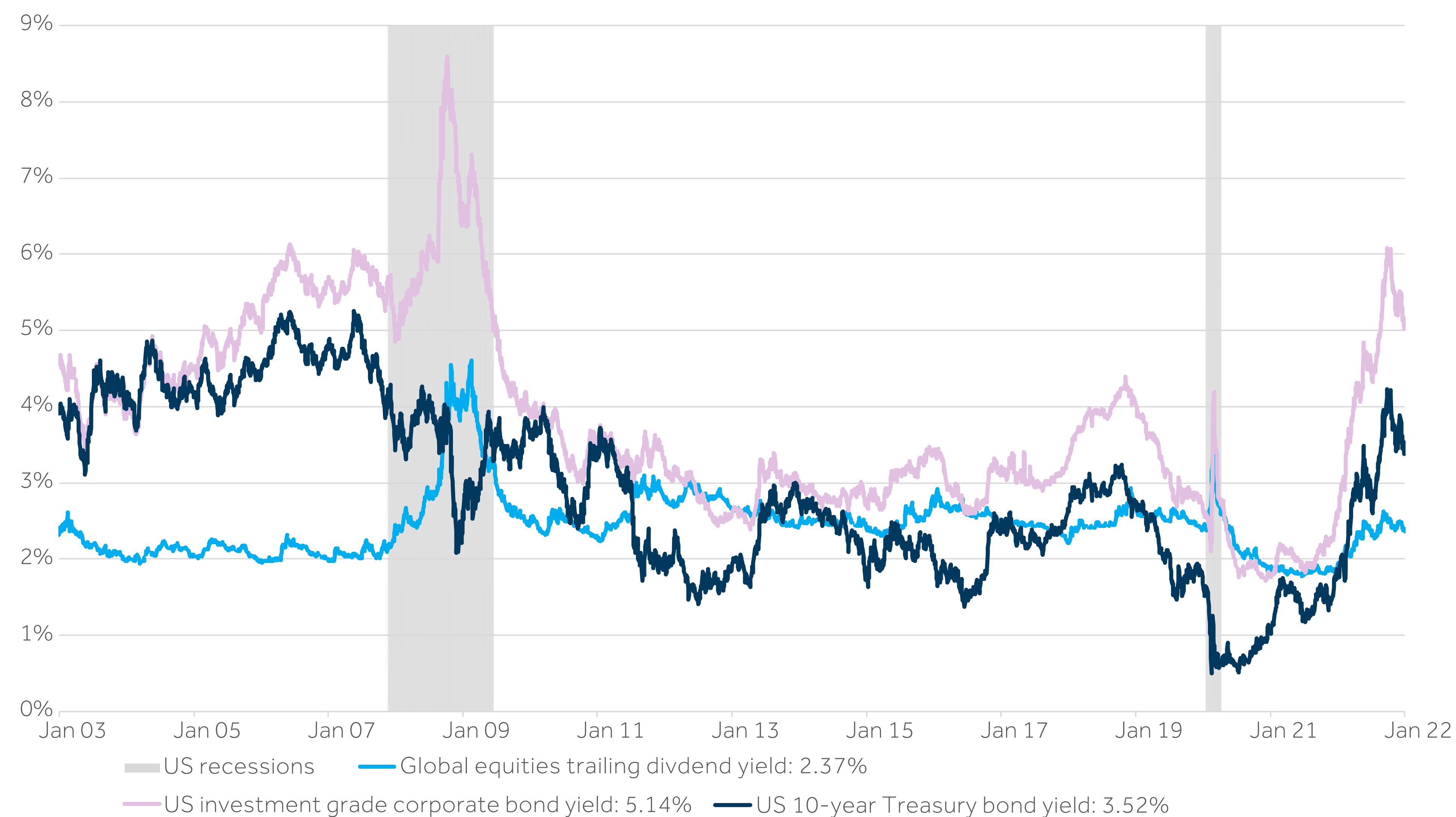
However, we would shy away from global sector indices in the defensive sphere, which seem very expensive at present. Following a substantial re-rating in recent months, such sectors now trade at an extreme valuation premium compared to valuations for cyclicals, based on forward price/earnings multiples. This premium is equivalent to 2.4 standard deviations above its 20-year average.

Alternatively, investors can also increase defensiveness in multi-asset portfolios via investing in the fixed income market.

> "Global equities' dividend yields are at the biggest discount they've been to US 10-year bond yields in the past 12 years, despite higher risks"

THE GAP BETWEEN GLOBAL EQUITIES' DIVIDEND YIELD AND US 10-YEAR TREASURY YIELD IS THE MOST NEGATIVE IN 12 YEARS

Global equities' dividend yield compared with the 10-year Treasury bond yield and US investment grade corporate bond yield since 2003



Sources: Refinitiv Datastream, Barclays Private Bank, January 2023

Following the substantial increase in rates in the past few months, bonds, and credit in particular, now offer an attractive alternative to equities.

For most of the past ten years, the historically low yields on bonds pushed investors up the risk curve into equities. However, the gap between global equities' dividend yield and US 10-year bond yields is now the most negative it's been in the past 12 years, despite higher risks. And similarly, the gap between dividend yields and investment grade corporate bond yields is the most negative since 2008 (see chart).

Finally, option strategies can be a useful tool when it comes to protecting downside risk. We highlight below areas of the market which have performed strongly in recent weeks, and which investors may consider hedging.

WHICH AREAS COULD INVESTORS CONSIDER HEDGING?

1) EUROPEAN STOCKS

European stocks have had a particularly strong run in recent months (see chart, p9). From their October lows to 27th January, and based on MSCI indices, European stocks have returned 19% in local currency terms and +32% in USD, versus 14% for US equities.

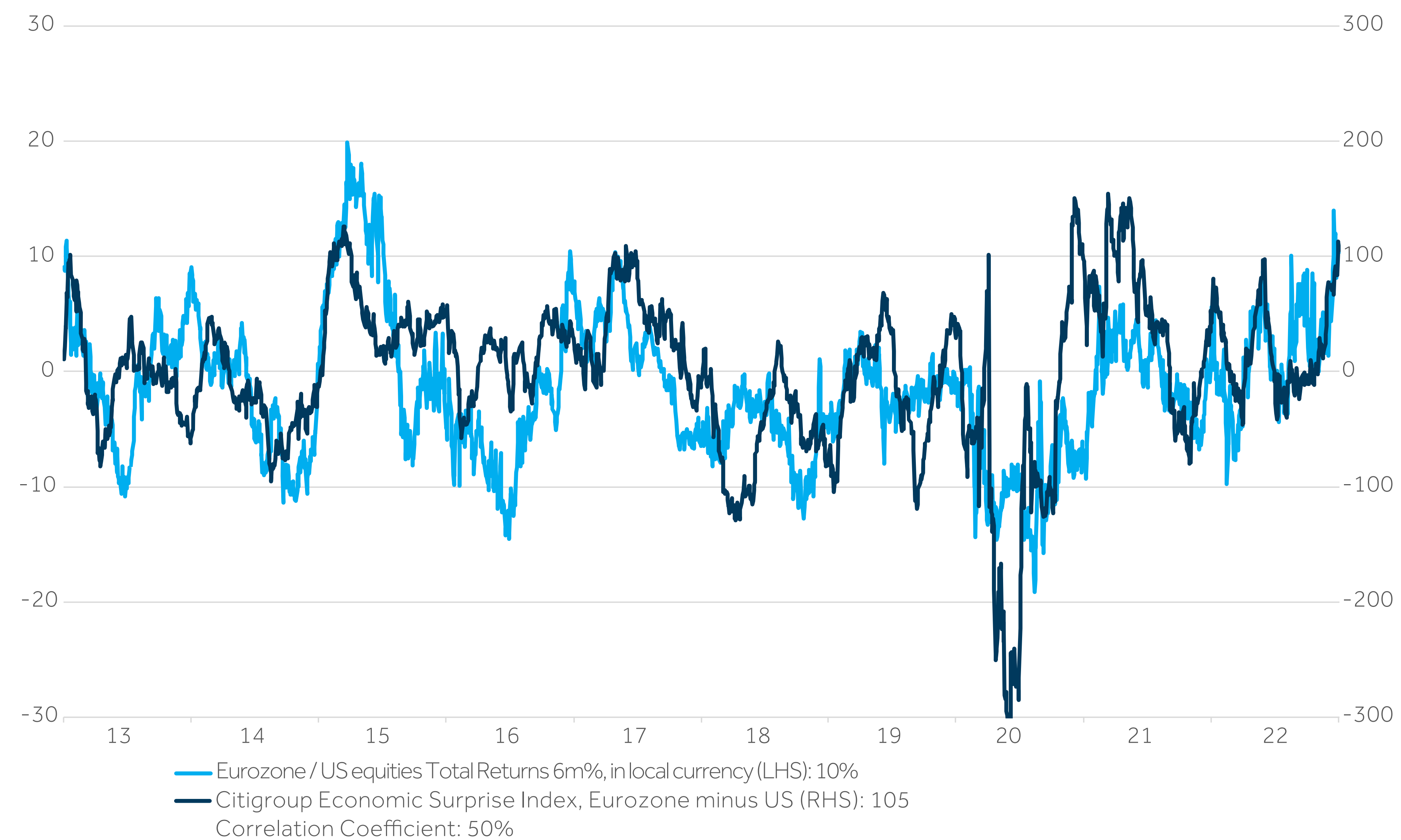
A combination of factors has led to this outperformance:

- More optimism on the energy front (lower energy prices, combined with a warmer than anticipated winter);
- The re-opening of the Chinese economy, to which European companies are significantly exposed;
- Better-than-expected growth and inflation data, especially compared with other regions;
- Europe's Value tilt and relatively cheap valuations in a rising rates environment, when Value has outperformed Growth stocks.

However, risks remain in the near term. With growth expectations being revised up, it will be more difficult for economic data to surprise positively. As noted above, the re-opening of the Chinese economy could be slower than anticipated. And finally, the geopolitical situation remains unpredictable and tensions could escalate.

EUROZONE EQUITIES OUTPERFORM THEIR US PEERS, AS ECONOMIC ACTIVITY SURPRISES MORE POSITIVELY IN THE BLOC

Comparison of the 6-month relative performance of eurozone equities vs the US, in local-currency terms, and Citigroup economic surprise index for the Eurozone minus the US since 2013



Sources: Refinitiv Datastream, Barclays Private Bank, January 2023

2) INDUSTRIAL METALS

Industrial metals have strongly benefited from the expected boost from Chinese growth this year and a weaker dollar in recent weeks. As of 27th January, they have returned 26% since the end of September. While we remain structurally positive on industrial metals, the re-opening of the world's second-largest economy may be bumpy, and hit industrial metal prices. Therefore, investors with short investment horizons may consider hedging some of those gains.

MAINTAINING A PRUDENT STANCE

In conclusion, the recent rally in risk assets may have run ahead of macro fundamentals. Much uncertainty remains in the near-term and prudence appears warranted.

Investors willing to reduce risk in equity portfolios should consider rebalancing their positions towards more defensive parts of the market (preferably via individual stocks). Meanwhile, multi-asset investors might consider increasing their allocations to bonds versus stocks. Finally, option strategies could help to improve the risk-return profile of those investments.

Author: Dorothée Deck, London UK, Cross Asset Strategist

Bridging the yield gap

With financial market expectations of the peak for interest rates falling of late, what does the outlook for rates, inflation and central bank policy mean for bond investors?

After the great repricing of the bond market last year, led by the short end and which saw the yield curve rapidly adjust to the need and determination of central banks to bring a turnaround in inflation, 2023 may finally bring the long-awaited and anticipated peak in policy rates.

That said, there remains plenty of uncertainty around the ultimate peak, and its timing and most importantly longevity. But the good news is that some easing of inflation in recent data for each jurisdiction suggests that a period of excessively high inflation may be a phenomenon of 2022, but not for 2023 and 2024. With lower trending inflation, the certainty around the peak level of the respective central bank rates should increase accordingly.

This greater certainty around the expected level of peak rates in the US and Europe is already visible in the overnight index swap (OIS) rate forward rate markets. The OIS yield curve shows the market has stopped adding further hikes, a common pattern seen in 2022, since late December, and instead show a fairly stable estimated level of the respective terminal rates (US Federal Reserve (Fed): 5.0%, Bank of England (BoE): 4.5%, European Central Bank (ECB): 3.5%).

As central banks continue to hike, the gap between prevailing rates and what is implied by the market is slowly closing (see chart, p11).

Since October, and as re-iterated in The road to normalisation for bond investors? we highlighted the opportunities to "lock-in yields"; in fact, one of our biggest convictions given historically high yields and our outlook for slowing economic growth for the subsequent years.

The bond market since late 2022 has started to celebrate the initial signs of what could be the great moderation of inflation (what might be called the "disinflation party"). The rapid decline of yields demonstrates that, as with life, the environment for financial markets changes; often more rapidly and by more than anticipated. Lower trending bond yields suggest that the opportunity window to pursue the "locking in yield strategy" is unlikely to last forever.

Locking in yields should not be confused with the widely popular "short-term cash plus" strategy, which involves investing in short-duration instruments with additional yield pick-up (although valuable in its own right). Instead, we believe that a locking-in yields strategy should be pursued with medium-term bonds.

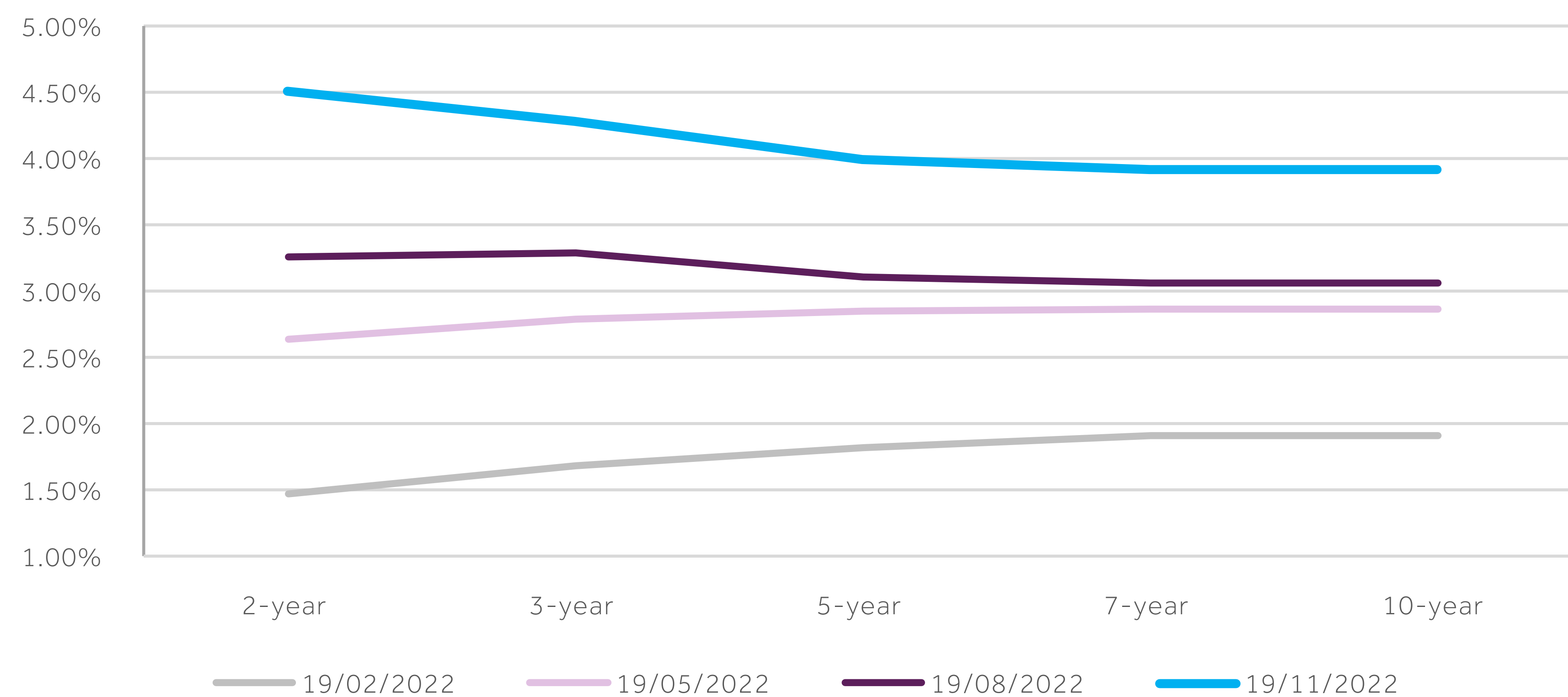
To many investors, the advantage of holding short-term bonds seems more obvious, while the risk of holding cash or short-term bonds in the near term is usually ignored. Short-term bonds usually work well at a time of higher trending or sideways trending yields. However, by focusing only on short-term bonds or cash, rolling respective investments at periods of very low yields can cause underperformance. It could even erode value, after adjusting for inflation, in a time of deep negative yields.

INTEREST RATE RISK STILL IMPORTANT

On the other hand, interest rate risk, particularly for long-dated bonds, should not be neglected entirely. But as outlined we see only limited risk of substantially higher inflation, and rates, from here.

ANATOMY OF ANTICIPATED US RATE RISES

US Treasury yield curve, at various stages since February 2022, shows that the rise in yields has been led by the front end



Sources: Federal Reserve Bank of St Louis, Barclays Private Bank, January 2023

The biggest risk to our base case view is that inflation moderates more slowly than anticipated by the rates market. The widely expected rapid easing is also a reason why longer yields are already falling compared to shorter-dated ones (leading to an inverted yield curve). Should inflation confound expectations and take longer to moderate, this would likely mostly cause a repricing at the longer end of the rate curve, as opposed to the medium or shorter end.

FOCUS ON MEDIUM-TERM BONDS

We are reluctant to extend duration to ten years or more, but rather feel more comfortable with medium-term bonds (generally with maturities of between four and eight years). By locking in yields over such a period, the biggest risk of re-investing (rolling) current term deposits or short-dated bonds at substantially lower yields can be almost eliminated: what might be thought of as bridging the yield gap.

Even through the real-adjusted or inflation-adjusted lens, medium-term bonds seem reasonably priced. At current levels, and assuming that the inflation-linked debt market adequately prices future inflation (through breakeven yields), real yields in the US are well over 1%.

BEWARE OF MORE CENTRAL BANK POLICY ERRORS

After their record over the last couple of years, central banks may be prone to commit more policy errors this year. Last year one of the policy mistakes, in hindsight, was by not upping policy rate levels quickly enough, but instead clinging too long to the view that the initial surge in prices was transitory in nature.

If there is a policy error to be committed going into the next cycle, we see the biggest risk being that central banks hike by too much, and potentially hold rates at a very restrictive level for too long, and thus risk a deeper recession occurring this year or next.

The Fed, for example, has a poor record of adapting quickly to changing circumstances, as seen in 2019 and last year. In any case, in both prescribed scenarios, successfully taming inflation with a soft landing or risking a hard landing, bonds should perform comparatively well.

Inflation rates and economic growth are likely to retreat substantially this year. The main risk to that view, as outlined earlier, is probably a longer than expected period of high inflation, rather than a higher peak. Such a scenario points to larger long-term yields as opposed to higher short-term or medium-term yields.

"One of our strongest convictions for this year is for investors to lock-in bond yields, given the high level of yields by historical standards and the prospect of slow global economic growth in the next few years"

SLOWER PACE OF RATE HIKES

The BoE and the ECB are likely to follow the Fed with a slower pace of hiking (from 50 basis points (bp) to 25bp incremental steps) and all are likely to stop the hiking cycle this year. The major difference between their policy rate paths lies in the timing. In the US, a peak is likely to come earlier, as December's inflation data hint that core inflation (excluding volatile food and energy components of inflation) seems to be slowing. While some components of inflation, like shelter costs, may still climb, and the job market is still very tight, early signs of an easing are evident.

US FEDERAL RESERVE

Should the Fed's own inflation projection of core personal consumption expenditures (core PCE) at 2.5% in 2024 materialise, its own projection of rates at 4.125% in 2024 may already be too high. In addition, this scenario ignores the risk of a "hard landing" for the economy, which could force the Fed to cut rates to an even lower, more accommodative, level.

While we do not want to bank too much on a continuation of declining yields, the level of current yields certainly does not appear to be too low in our view.

BANK OF ENGLAND

In the UK, inflation, and in particular core inflation, has not moved in the direction that the Bank of England wants yet. This, in turn, adds pressure to the notion of front-loading rate hikes swiftly to counter any wage spiral. Rate hikes would act mostly as a signal to the labour market.

The rate market prices in a terminal peak at around 4.5%, which seems realistic. But compared to the US, the UK economy is very vulnerable due to the housing market, effect of elevated mortgage rates and the cost-of-living crisis. While a recession may be averted, growth is likely drop well below potential growth, making swift and potentially drastic rate cuts much more likely at some point; a reason to lock-in rates now.

EUROPEAN CENTRAL BANK

In Europe, the ECB has turned more hawkish, and also when compared to their UK and US counterparts, while the economy is prone to dip into a recession, suggesting that rate cuts are in order at some stage. As in the US, inflation has already started to moderate and while the ECB may front-load hikes, the time available for raising rates may quickly come to an end.

DO CURRENT YIELDS OFFER VALUE?

With potentially lower yields, the question is what kind of yields can be expected and do these seem reasonable. Our table shows average yields in various bond segments. It also highlights that yields are well above their respective 10-year average. Indeed, in most cases, yields are close to the highest level seen in the last 10 years (over or close to the 90th percentile).

Segment	Yield/spread	Current	Average since 2012 (%)	Percentile since 2012	Modified duration
US investment grade	Yield	4.89	3.19	96%	7.60
	Spread	1.22	1.29	46%	
European investment grade	Yield	3.72	1.35	96%	4.76
	Spread	1.55	1.28	81%	
Sterling investment grade	Yield	5.19	3.06	96%	6.97
	Spread	1.70	1.57	72%	
US high yield	Yield	8.03	6.24	90%	4.38
	Spread	4.16	4.42	48%	
Pan-European high yield	Yield	7.27	4.53	88%	3.39
	Spread	4.68	4.16	75%	
Sterling high yield	Yield	9.97	6.69	91%	3.44
	Spread	6.23	4.91	83%	
Emerging market (USD)	Yield	6.98	3.29	99%	6.50
	Spread	3.37	3.28	64%	

Source: Bloomberg bond indices, where yield equals the index yield to worst, and spread equals the index option-adjusted spread

DO BOND SPREADS OFFER VALUE?

Many bond markets offer above-average spread valuations another important factor when assessing overall bond yields. That said, differentiation between the segments is key. While US spreads of 122bp within investment grade bonds seem unappealing, the peak in corporate investment grade bond yields rarely coincides with the peak in spreads but rather with peak in rates (see Catching peak bond yields).

Waiting for higher spreads to emerge in the investment grade bond segment may come at the cost of lower overall yields. In that respect, EU and sterling investment grade bonds appear attractively valued on both measures.

Turning to high yield debt, we are less convinced, given that spreads usually make up a greater proportion of the yields within the segment. We expect more spread volatility going into the economic slowdown, and given this backdrop, US high yield bonds in particular seem to offer the worst value against their peers. That said, pan-European high yield bonds, including sterling high yield, seem to offer better opportunities than US ones and a more appealing outlook for returns. Given the risk in the respective economies, a selective approach however seems justified.

Emerging markets (EM) countries face different challenges, but overall, EM starts to look more appealing from a pure valuation perspective. With a possible peak in the US dollar and US rates, and a potential top in local central bank rates, the segment starts to offer more opportunities again.

As always, the peak in yields is hard to predict. While many are keen to brag about having locked in very low funding or mortgage rates, the same is less prevalent when locking in higher yields on the investment side. A shame, given that long-term portfolio return would benefit on a risk-adjusted basis.

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

Private credit: when money isn't free anymore

In the face of an economic slowdown and rising rates, companies are finding it tougher to access traditional sources of funding. Private credit can fill the gap and help provide borrowers access to a more transparent source of debt, while offering investors the chance to diversify portfolios and potentially boost returns for little extra risk.

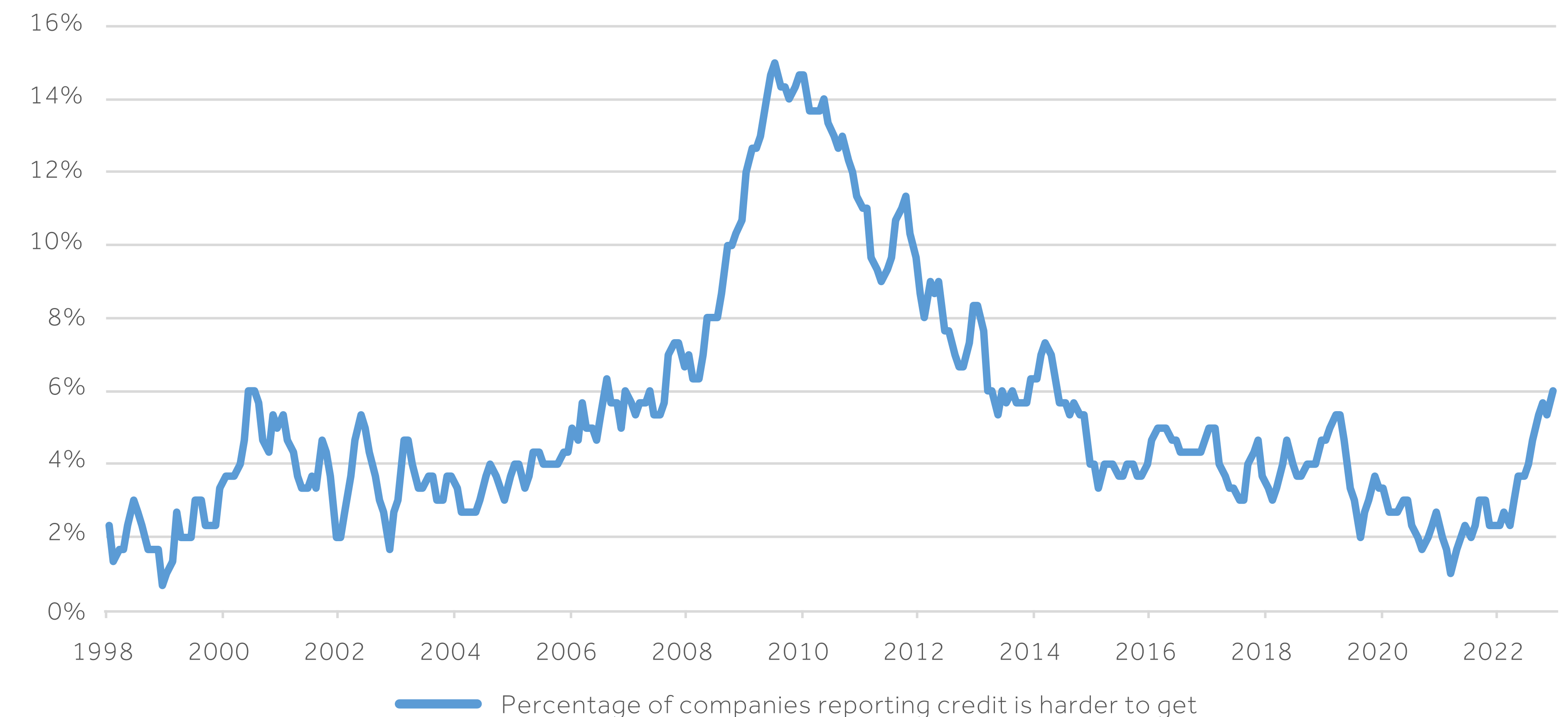
With central banks racing to hike interest rates, the era of "free money" we've grown used to in the last 10 years has come to an end. To illustrate this point, the global aggregate market value of negative yielding debt is now close to zero, after peaking at $18 trillion a couple of years ago, according to Bloomberg data.

At the same time, the macro and regulatory environment offers limited incentive for banks — a traditional source of corporate financing, particularly in Europe — to extend their lending book.

In this context, it's unsurprising to see small-business researcher NFIB's December business optimism survey[1], which tracks sentiment of small companies in the US, showing a growing proportion of respondents highlighting that credit is harder to get (see chart).

CREDIT CONDITIONS GETTING TOUGHER FOR US SMALL BUSINESSES

The percentage of US small businesses reporting that credit is getting harder to get is at its highest level since 2014



Sources: Refinitiv Datastream, Barclays PB, NFIB, Updated in December 2022

[1] Inflation pressures ease slightly on Main Street but remains the top business problem, NFIB, December 2022 https://www.nfib.com/surveys/small-business-economic-trends/

FINDING ALTERNATIVE SOURCES OF CASH

With capital becoming scarce, companies, especially those with complex capital structures and limited access to lending markets, will likely need to find alternative creditors. One option is private credit. Indeed, when done properly, this route can be attractive for both the lender and the borrower.

On the lending side, private deals tend to offer better risk-adjusted returns, as borrowing terms can be tailored to maximise potential returns while minimising risks. For instance, lenders would include specific terms (such as tighter debt covenants and rate floors) that provide more downside protection for investors.

On the other hand, for the borrower, private credit deals offer more visibility and customisation, with terms likely to better match the specific needs and characteristics of the borrowing company. The speed of execution may also favour private rather than public debt agreements, especially in volatile periods like the one seen last year.

WHEN BAD TIMES ARE GOOD

Of course, providing debt when economic momentum is slowing, whether via a public or private channel, isn't without risk. Yet, private credit can shine during slowdowns.

A quick look at past performance of private credit funds shows that some of the best returns were achieved by vintages that saw investments take place in a time of economic and financial stress. In fact, data from financial researcher Prequin shows that 2008 was an outstanding year for the median private credit fund manager.

This may be counter-intuitive, but easily explained by the creditor's ability to be selective and specific when structuring a financing deal. This often entails stronger guarantees and higher returns for investors, as a willing lender can more or less dictate their terms when access to capital dries up elsewhere.

HIGHER INTEREST RATES A TAILWIND

Investors may question the appropriateness of investing in credit instruments at a time when US and European interest rates are expected to rise this year. Here again, private credit can be useful. To protect against the risk of interest rates inflating, creditors tend to favour floating rates, embedding a de facto hedge against further rate increases.

Similarly, higher rates (and scarcer capital) make private credit a more valid option for borrowers. Not so long ago, a high yield issuer may have been able to finance itself in the open market at a cost of around 5%. Today, high yield debt is yielding anywhere between 8% to 10%. At this level, the 15% internal rate of return private debt funds typically seek does not seem prohibitive anymore.

IMPROVED DIVERSIFICATION

The attractions of private credit aren't limited to higher expected returns. Indeed, by incorporating such debt among their investments, investors can further diversify portfolios thanks to the relatively low correlation of the asset class to equities and bonds. This is, in part, due to the illiquidity premium embedded in private credit investments, which investors accept to take a longer-term approach to investing.

Further, diversification can be achieved at the fund level. To do so, managers often look to lend money across various parts of the capital structure, sectors and geographies. In other words, private credit can help boost returns while reducing risk.

A GROWING MARKET SEGMENT

Preqin estimates that private debt funds raised $226 billion in 2022, a similar amount to that achieved in 2021. However, ten years ago that number was just $66 billion, showing the increased popularity of the asset class. In fact, credit now represents 17% of total private capital, far behind private equity (57%), but a larger percentage than seen at any time in the last two decades.

The growth in private credit reflects its perceived attractiveness in an environment where yield is (still) hard to come by. Investors may challenge the premise that with increasing capital chasing limited opportunities, returns may suffer. However, the level of "dry powder", or investible funds, has been relatively stable at around 2.5 years thanks to private equity funds increasingly tapping the private debt market to finance their deals.

RISKS AND REWARD

Private debt investing isn't without risks. Typically, deals are struck with companies that have limited access to financing and with stretched balance sheets. As a result, the probability of default tends to be higher. Fortunately, thanks to the specific terms inherent to private deals and their more direct structure, recovery rates tend to be higher when defaults occur.

There is also the illiquidity of private debt instruments to consider. This is why we believe that relying on an experienced manager is essential when investing in private credit. With the right partner, extensive due diligence and the appropriate amount of diversification, we believe that the asset can generate attractive returns with the potential to compensate those who are willing to tolerate the risks.

Author: Julien Lafargue, CFA, London UK, Chief Market Strategist

US inflation is no 1970s retro act (for now)

While Europeans' living standards are being squeezed by the most in decades, which exerts considerable risk to inflation in its own right, US price hikes are slowing. With a fuel price shock and surge in inflation reminiscent of 1970s in many ways, we look at what parts of policymakers' 1970s playbook are useful for investors.

The path for US inflation this year is pretty clear, according to Bloomberg consensus surveys: a combination of base-effects (as the relevant earlier data falls off comparisons) and a slump-induced cooling of inflationary pressure is expected to see inflation rates drop to 3.0% at the end of 2023 from 7.1% at the end of last year. As such, peak inflation should be behind us, with the surge in energy costs and core inflation having reached their highest reading in June and September, respectively.

As inflation worries become yesterday's news and investors contemplate what the effects of last year's interest rate hikes will be for the US economy, we examine the latest inflation dynamic, 2020s style, and glance back to the 1970s for any hints as to what might be in store this time.

THE 1970S PLAYBOOK

Last year we analysed the inflationary surges of the 1970s for comparisons with the latest inflationary shock and lessons for that may now play out (see Inflation: Learning from the 1970s). At first, we studied readily available consumer prices index (CPI) components to understand the dynamics of typical oil-price induced inflationary shocks. We found that:

- First, booms in the energy price preceded those for goods and services inflation.
- Second, interest rate hikes could accompany accelerating energy price inflation, as long as the economy did not crash into a recession.
- Third, significant negative output gaps and strong rises in unemployment were needed to curb non-energy inflation.

REDUCING INFLATION COMPLEXITY

We then carried out a principal components analysis, to dig deeper. Instead of using readily-available aggregates, like "energy" or "core inflation", standardised quarterly changes were run for all available subcomponents of the consumer price index (CPI) baskets in the US – items such as "housekeeping supplies" or "motor fuels" – through our model to extract the underlying factors behind the inflation dynamics[1].

The above analysis allowed us to capture over 70% of the variation in all subcomponents of the CPI in the first three principal components PC1, PC2 and PC3. According to the dominating loadings for each of these components, we named them "broad cycle" (PC1), "fuel" (PC2) and "necessities" (PC3).

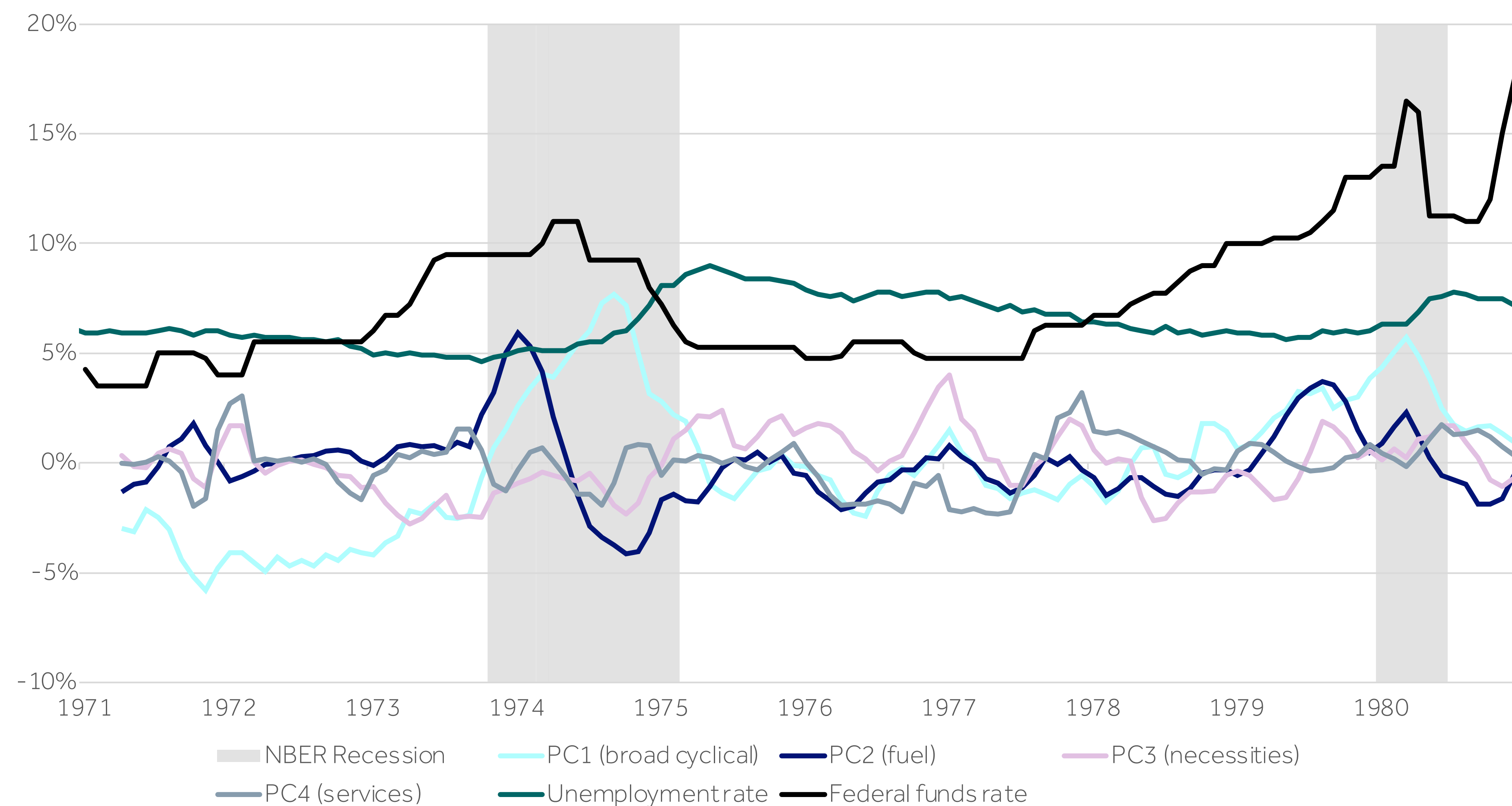
[1] Refer to Inflation: Learning from the 1970s for more details on the methodology

For this article, we add the fourth "services" principal component (PC4) to the group. While the latter did not add much explanatory power when looking at inflation in the 1970s, it is important to understand the differences between the 1970s and today.

Our analysis of 1970s inflation suggests that the fuel component leads the cyclical one by several months in a typical oil-price induced price shock. It also confirms that the broad cyclical inflation component (think of items such as apparel, furniture or new vehicles) only eased when unemployment rates start to rise (see chart).

INFLATION IN THE 1970S: FUEL IN THE DRIVER'S SEAT

Principal components of the US consumer price index, estimated for the decade between January 1971 and December 1980, and macro variables



Sources: US Bureau of Labor Statistics, Refinitiv, Barclays Private Bank, January 2023

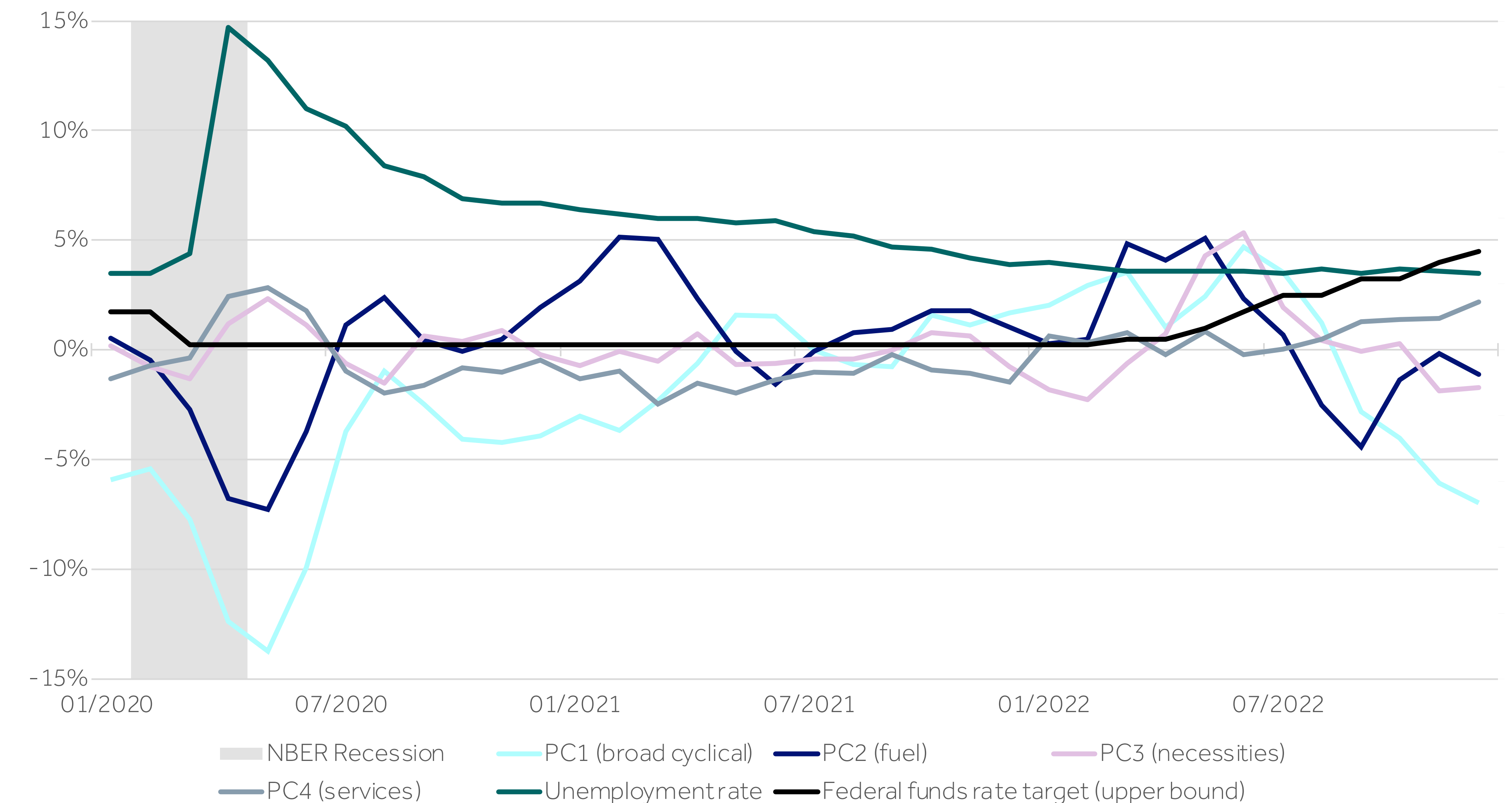
SPOTTING PARALLELS AND DIFFERENCES WITH THE 1970S

When the model that we trained on the 1970s is applied to the same CPI subcomponents from 2020 (see chart), we find parallels but also differences. Until September 2022, the parallels prevailed. The most notable was the sequence of peaks which remained the same: the cycle peak followed several months after the peak in energy inflation.

The differences started to emerge in last year's fourth quarter: first, neither broad unemployment rates or those of the most vulnerable parts of the labour market showed significant increases as the cyclical component peaked. Second, while price pressures in the broad cyclical factor seem to have relaxed, inflation is still simmering on price increases from the services factor (PC4).

CYCLICAL AND FUEL FACTORS PEAKED AS THE SERVICES FACTOR GRINDS UP

Principal components estimated between 1971 and 1980 applied to data and macro variables starting from 2020



Sources: US Bureau of Labor Statistics, Refinitiv, Barclays Private Bank, January 2023

UNDERSTANDING WHAT THE DIFFERENCES WITH THE 1970S MEAN

Understanding the reasons for the differences in factor behaviour can help to get to the bottom of the inflation dynamics. First, the change in the consumer baskets comes to mind. While all CPI subcomponents are as consistent across time as the data provider, the Bureau of Labor Statistics (BLS), can provide, their relative economic importance can change considerably.

Goods constituted over 60% of the CPI basket in 1972. By 2021 their share was below 40%, according to BLS data[2]. The budget freed up from goods went largely into shelter, which used to be one component of services, among others, and now makes up a third of the whole basket.

Second, not only has the consumer basket changed, but so has the reliance of the US on fuel. This reduced pressure could lag the effect of monetary policy intervention on the economy compared to the 1970s setting. This could lead to a softening of the finding from the 1970s that links peaks in the cyclical factor to a start in the rise of the unemployment rate.

Third, in addition to this lowered reliance, the American economy has one additional tool at its disposal that was borne out of the 1973 oil price shock: the Strategic Petroleum Reserve (SPR). The release of over 20% of the SPR between November 2021 and July 2022 is assumed to have contributed significantly to reducing the strain of rising fuel prices on producers[3]. At the end of January 2023, inventory levels of the SPR were over 60% off their peak and back to levels that were last observed in 1983.

> "Managed futures thrive on strong trends, no matter where macro data or markets are headed. This could provide a useful hedge against a repeated shock to energy prices"

KEEP THE SCRIPT IN REACH

We believe that the remaining inflationary pressure that is seen in the services component will fade as the US labour market tightens this year (see chart). However, while it may have exhausted its usefulness for now, investors might not want to put the 1970s script too far out of reach.

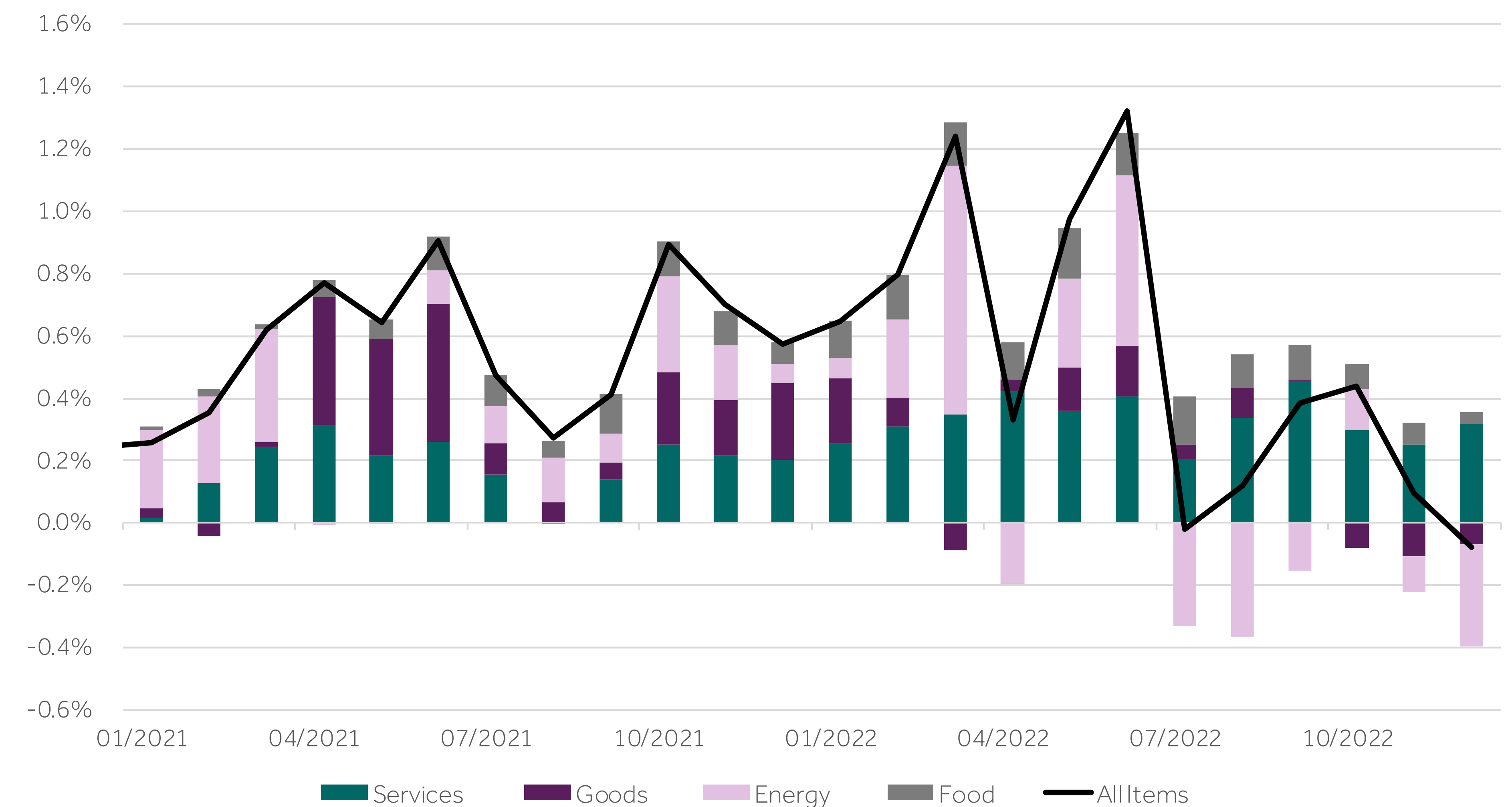
The 1973 oil shock, and its economic effects, etched itself into the memories of consumers, producers and market participants. By contrast, in 1979 it did not take a large price increase for oil to send another shockwave around the globe. While we expect US inflation rates to fall below 3.0% by the end of 2023, another surge in energy prices, whether caused by geopolitical actions or otherwise, remains a side-scenario to consider.

[2] Relative importance and weight information for the consumer price index, Bureau of Labor Statistics, 22 April 2022 https://www.bls.gov/cpi/tables/relative-importance/home.htm

[3] Did releasing oil from the Strategic Petroleum Reserve impact gas prices?, USAFacts, 18 October 2022 https://usafacts.org/articles/did-releasing-oil-from-the-strategic-petroleum-reserve-impact-gas-prices/

US SERVICES INFLATION STILL SIMMERING

Seasonally adjusted headline consumer price index, month-on-month, split by services, goods, energy and food subcomponents and by all items since January 2021



Sources: Bureau of Labor Statistics, Barclays Private Bank, January 2023

WHEN INFLATION ABOUNDS, THERE ARE FEW PLACES TO HIDE

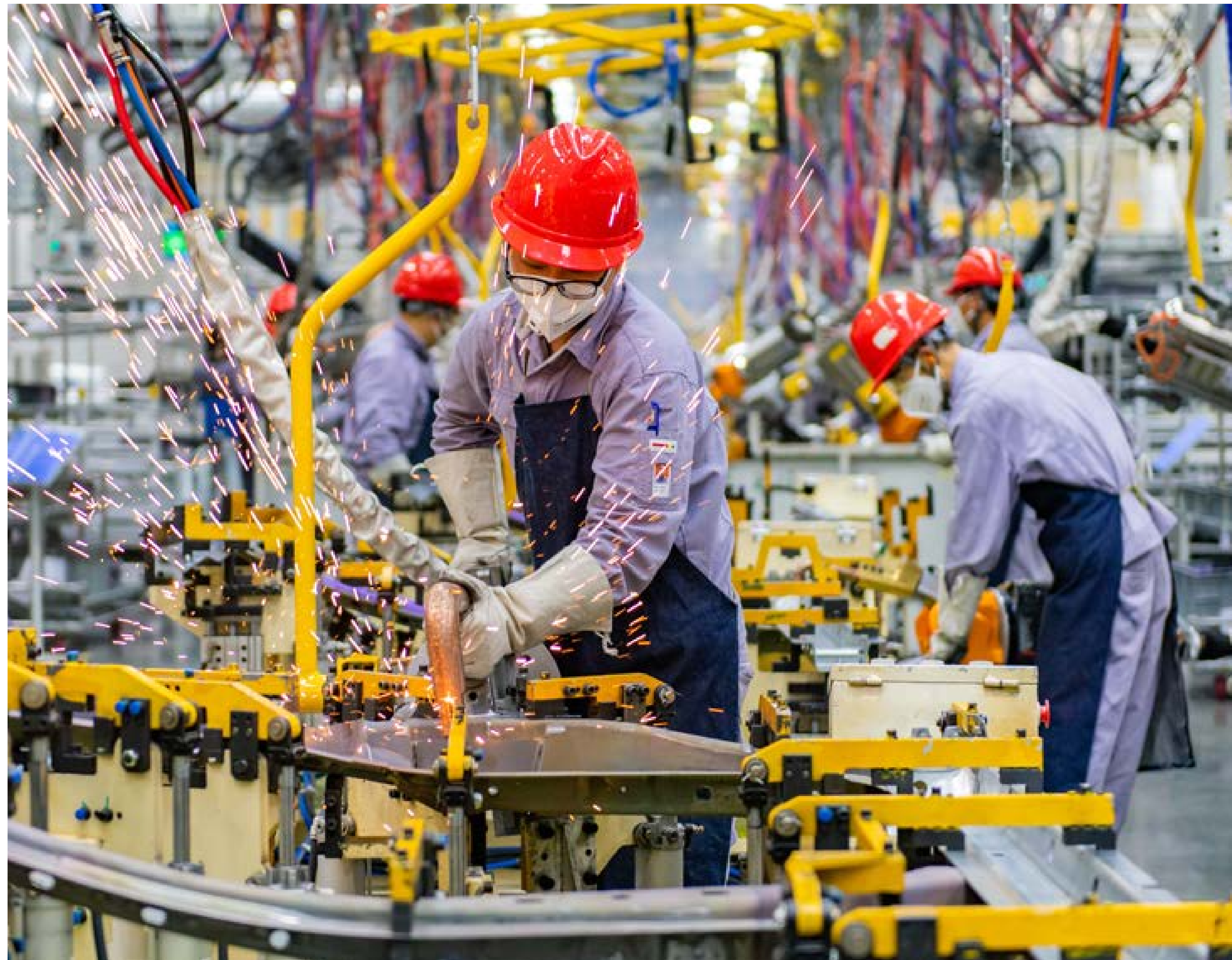
Investors may get a chance to fortify their portfolio against further inflation surprises this year. Outside of commodities, there are usually very few placed to hide from inflationary shocks in the absence of strong accompanying growth.

In such an environment, strategies with returns that are uncorrelated to macro variables can provide a buffer. Managed futures, for example, thrive on strong trends, no matter where macro data or markets are headed. This could provide a useful hedge against a repeated shock to energy prices.

Authors: Lukas Gehrig, Zurich Switzerland, Quantitative Strategist;
Nikola Vasiljevic, PhD, Zurich Switzerland, Head of Quantitative Strategy

How ESG can help investors navigate the year ahead?

Many key global issues for 2023 may be already known, but as investors' experience of 2022 demonstrated, new challenges can rapidly emerge. Underlying many of the current issues and potential risks is a common theme: sustainability. Here we review how investors can use sustainability to better identify risks and opportunities in their portfolios.



After 2022 saw an energy crisis, sky-high inflation and soaring interest rates, investors are probably relieved to start this year with minimal volatility and positive market momentum. However, you may be wondering how persistent these challenges will be and scanning the horizon for new issues.

So, what are the main risks that might push your portfolio off-course? Alternatively, where can investors look to spot opportunities that others may have missed?

"WHOLLY NEW AND EERILY FAMILIAR" RISKS

The World Economic Forum's (WEF) Global Risk report, published in January, highlights the global risks that business leaders foresee currently, as well as over short and longer time-periods[1].

While predicting the future is notoriously difficult, understanding widely held views can still be valuable when considering market sentiment and how companies are adapting to shifts in the world.

In collating the views of over 1,000 experts, the WEF report suggests that widely held views on the chief risks facing businesses are "wholly new and eerily familiar". While current risks, around issues such as food, energy and security, may be historically familiar, they have manifested in new ways. Indeed, if there is an overarching factor connecting the current iteration of these risks, then it might be "sustainability" (see table on p19).

During 2023, the top-ranked issues appear to repeat last year's flashpoints — energy supply crisis, cost-of-living squeeze, high inflation, food supply crisis and cybersecurity attacks. Across each of the five issues, underlying sustainability factors affect them all.

Extending the assessment horizon by just one year results in half of the ten severest risks being environmental in nature. Looking at a ten-year horizon, and five becomes six, with "Biodiversity loss and ecosystem collapse" entering the top ten. Moreover, the top four overall risks are environmental.

To account for these risks, investors can look to understand and incorporate the relevant sustainability factors into their investment processes, specifically the environmental, social, and governance (ESG) dimensions that affect company performance.

To illustrate further, we consider one key ESG risk that companies will likely face this year. While these risks are not exhaustive, and their financial materiality varies by industry, they demonstrate how including ESG factors into your investment process can inform security selection decisions in 2023.

[1] The Global Risks Report 2023, World Economic Forum, 11 January 2023 https://www3.weforum.org/docs/WEF_Global_Risks_Report_2023.pdf

TOP 10 PERCEIVED RISKS FACING INVESTORS

In the following table, survey respondents were asked: Please estimate the likely impact (severity) of the following risks in 2023 and over a two-year and ten-year period.

	In 2023		Over two years		Over ten years
1	Energy supply crisis	1	Cost-of living crisis	1	Failure to mitigate climate change
2	Cost-of living squeeze	2	Natural disasters and extreme weather events	2	Failure of mitigate-change adaption
3	Rising inflation	3	Geoeconomic confrontation	3	Natural disasters and extreme weather events
4	Food supply crisis	4	Failure to mitigate climate change	4	Biodiversity loss and ecosystem collapse
5	Cyberattacks on critical infrastructure	5	Erosion of social cohesion and societal polarization	5	Large scale involuntary migration
6	Disruptions in global supply chain for non-food goods	6	Large-scale enviromental damage incidents	6	Natural resources crises
7	Failure to set, and meet, national net-zero targets	7	Failure of climate-change adaption	7	Erosion of social cohesion and societal polarisation
8	Debt crisis	8	Widespread cybercrime and cyber insecurity	8	Widespread cybercrime and cyber insecurity
9	'Weaponisation' of economic policy	9	Natural resources crises	9	Geoeconomic confrontation
10	Weakening of human rights	10	Large-scale involuntary migration	10	Large-scale enviromental damage incidents

Risk categories

Economic | Environmental | Geopolitical | Societal | Technological

Source: World Economic Forum, Global Risks Perception Survey 2023, January 2023

ASSESS COMPANY READINESS FOR THE IMPACT OF CLIMATE CHANGE

The physical impact of climate change is already becoming more visible and pronounced, not least via extreme weather events. In 2023, investors should arguably be looking more deeply at the climate risks facing countries and companies, as well as how prepared their portfolio holdings are to meet them.

With climate change, the frequency and intensity of extreme weather, such as heatwaves, droughts and floods, have intensified. Last year, the top ten extreme weather events each caused at least $3 billion worth of damage[2]. Beyond the immediate economic and humanitarian devastation, such weather incidents can damage infrastructure and disrupt supply chains, upping potential financial losses for companies and investors.

Companies that do not adapt to this new reality will be at a significant disadvantage in the long run. Risk-aware investors should examine if investee companies have climate transition plans and take a view on if they are sufficient to guard against both the immediate physical risks and the longer-term transition risks.

"More than seven in ten (72%) "traditional" investors now assess ESG factors for their portfolios, up from 60% last year"

OBSERVE HOW COMPANIES TREAT THEIR WORKFORCE

Companies face a divergent set of challenges when managing their staff this year — employee expectations in a post-pandemic, high-inflation world versus slowing growth or potential for recession.

The economic slowdown has already seen some companies, especially in the technology sector, reduce staff numbers. Leaving aside the immediate financial need for this, the way such cuts are implemented can affect a company's reputation and share price performance. Firms that manage such employment issues poorly may be marked down by consumers and avoided by jobseekers.

At the same time, several groups of "key workers" are seeking higher wages at a time of the worst cost-of-living squeeze in decades, as rising inflation eats into the value of wages.

Last year's "great resignation" seen in many developed countries is arguably shifting to a "great reshuffle". Companies known for having a poor culture or dubious labour practices around wage disparities, and employee benefits in general, will likely struggle more to attract and retain staff. Furthermore, those organisations seen as contributing to social inequality may face increased labour action, public scrutiny and pressure from activists. All of this could hurt companies' financials.

Investors should be assessing company culture and leadership style, as well as more detailed aspects of social and labour practices, as part of judging their attractiveness as investments.

[2] Counting the Cost 2022: A year of climate breakdown, 20 December 2022 https://www.christianaid.org.uk/resources/our-work/counting-cost-2022-year-climate-breakdown

LOOK FOR A STEADY HAND ON THE GOVERNANCE TILLER

The strength of an organisation's corporate governance can underpin how smoothly management pilots their company in the current tough macro waters.

Companies with poorer corporate governance practices may be more likely to suffer financial losses through ineffective or slow management oversight. As managers come under greater pressure to "make their numbers", a lack of accountability and transparency can lead to more financial fraud, insider trading, and other unethical practices.

In selecting investments, investors should look for companies with strong corporate governance practices, such as diverse and active boards, effective oversight, and clear communication with stakeholders.

USING SUSTAINABILITY FOR BETTER INVESTMENT DECISION-MAKING

While ESG factors primarily provide data on how a company operates, and not on its goods and services, by evaluating the ESG practices of current or potential holdings, investors may be able to rest easier knowing they did all they could to make fully-informed investment decisions.

In fact, the most recent Investing for Global Impact report shows that more than seven in ten (72%) "traditional" investors responded to say they now assess ESG factors for their portfolios, up from 60% last year[3].

At the same time, investors should look at investment opportunities as well as risks. Ventures with products or services that address sustainability issues have potential for strong growth. For example, clean energy companies enabling the world to transition away from fossil fuels to reach global climate goals, as we reviewed in The case for investing in clean energy, in our Outlook 2023.

Sustainability is becoming more important for governments, consumers, and companies alike. As such, investors should view sustainability as a critical issue for every current or potential holding, especially when seeking to navigate the rebalancing act that is 2023.

Author: Damian Payiatakis, London UK, Head of Sustainable & Impact Investing

"[The chief risks facing businesses] demonstrate how including ESG factors into your investment process can inform security selection decisions in 2023"

[3] Investing for Global Impact: A Power for Good 2022, Barclays Private Bank, GIST, Campden Wealth https://privatebank.barclays.com/insights/2023/january/investing-for-global-impact/

Do you need to change your investment behaviours in 2023?

While predicting how markets will perform in 2023 requires a crystal ball, forecasting how investors will behave is arguably more straightforward, as humans tend to act in fairly systematic ways that often are not in our best interests. What common behavioural traits should investors look out for this year?

PREDICTING THE FUTURE

Forecasting how markets will perform in 2023 requires an ability to foresee a wide variety of events, as well as how governments, companies and markets will react to them. This is incredibly difficult.

The outlook remains positive for long-term investors, despite the recent surge in inflation, hikes in interest rates and risks of a recession in leading economies.

Many of the potential risks we identified for markets last year did materialise over the course of the year. Whilst this was of course bad for portfolios, it does mean that much of the bad news is already priced in, which could limit further possible downside risk whilst improving the outlook from here.

In looking to best position themselves for the year ahead, investors may find value in considering how other investors typically behave, and reflecting on how this compares with their own investing habits. We usually behave and react to market events in fairly systematic ways. Having an appreciation for some of these traits can help us to be better prepared for them.

2022 was a challenging and unsettling year for several investors, and the reaction many will have had to the impact of events on their portfolios is understandable. However, it is important to appreciate that when examined objectively in a cold, rational state, many of the actions taken in the moment may not be optimal when viewed through the lens of achieving long-term goals.

HOW WILL INVESTORS BEHAVE IN 2023?

Investors will likely spend much time this year doing the following, some of which may be best avoided:

MARKET EVENTS

- React to unexpected short-term market developments, most of which will make little difference to long-term returns.
- Seek expert commentary on these events and their potential impact on investment portfolios, but also follow market noise that means little to long-term performance.
- Declare, after the event, that unexpected events that occurred were entirely predictable.

PERCEPTION OF THE MARKET

- Think about 'the market' instead of their portfolio.
- View the market as one entity, instead of as being shares in individual companies operating in different sectors and countries across the world.
- Focus on companies' share prices instead of their long-term prospects, as indicated by high rates of return on capital compared to the average company; the ability to reinvest capital; limited use of leverage; and the power to price products and services above the costs of production without affecting demand.

PORTFOLIO RETURNS

- Check market and portfolio performance too frequently, especially given their investment horizon.
- Fear periods of underperformance.
- Feel the need to act and adjust their portfolio in response to a short-term period of underperformance.

PORTFOLIO CHANGES

- Attempt to time the market, despite the difficulty of the exercise and lack of informational edge, as timing can only be seen to have worked, or not, in hindsight.
- Want their investment managers to make portfolio changes in response to periods of poor performance.
- Question the usefulness of diversified portfolios when a particular asset class is performing very well or poorly.

TIME TO THINK

- Let their own behavioural biases impair investment decision-making, perhaps becoming more myopic in their thinking in periods of extreme market volatility and price falls.
- Recognise the importance of taking a step back to regain perspective during bouts of market stress, but struggle to do so when most required.
- Think and talk in terms of certainties instead of in probabilities.

LOOKING TO THE FUTURE

- Extrapolate events in 2023 out into the future.
- Lose sight of the fact that gradual improvements in wealth, health, productivity and technology are typically the biggest determinants of long-term returns, not short-term news flow.
- Focus on short-term performance over beating inflation to protect, and grow, wealth over the long term.

FOCUS ON DOING LESS, NOT MORE

While it can be difficult to change your behaviour, it is important to recognise that many investment behaviours can, and do, detract from portfolio performance.

For investors who have the correct building blocks in place for strong long-term investment returns, beware of the actions listed above, some of which could impair the ability to reach those returns.

We've covered actions that may be unhelpful. But how should investors prepare for 2023? From a behavioural perspective the answer is simple, doing less is more for the long-term investor. The correct building blocks need to be in place to create a portfolio that can generate the returns necessary to protect wealth from the value destruction caused by inflation, and to grow it to meet their financial goals.

KEEP IT SIMPLE

This means having an asset allocation process that is based on valid assumptions about the long-term returns expected across asset classes, while being appropriate for the level of risk that an investor has the tolerance and capacity to bear. An important dimension of this portfolio allocation is having the appropriate level of diversification, both for the financial as well as behavioural benefits it confers.

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

Multi-asset portfolio allocation

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

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

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

CASH AND SHORT DURATION BONDS

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

FIXED INCOME

- We see increasing opportunities in fixed income
- We maintain a preference for developed market government bonds as a hedge against any macro volatility
- In credit, we prefer the higher-quality segment and remain selective elsewhere
- In high yield, where selection is key, our exposure is relatively low, as spreads have room to widen further in an adverse scenario
- We prefer high yield and emerging market (EM) hard currency debt over EM local currency debt, considering the risk that faces their economies and currencies.

EQUITIES

- We believe that equities remain relatively more appealing than bonds for long-term investors
- Yet, we are highly selective in our allocation
- In line with our long-term investment philosophy, portfolios remain geared towards high-quality, cash-generative and conservatively-capitalised businesses
- As a function of our bottom-up selection, we currently see more opportunities in developed market equities compared to their emerging peers.

ALTERNATIVE TRADING STRATEGIES (ATS)

- There are a limited number of opportunities in the ATS space, as the cost/benefit trade-off can be challenging
- Our focus is on strategies offering diversification benefits due to their low correlation to equity markets.

COMMODITIES

- As a risk-mitigating asset, gold remains the only direct commodity exposure held in portfolios
- From a portfolio management perspective, we believe that our risk budget is better spent outside of the asset class.

Author: Julien Lafargue, CFA, London UK, Chief Market Strategist

privatebank.barclays.com

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

This document is for information purposes only. It is general in nature and does not take into account specific investment objectives, financial situation, knowledge, experience or particular needs of any particular person. It should not be relied upon in considering the merits of any particular transaction. It does not constitute a prospectus, offer to buy or sell, invitation or solicitation to buy or sell or invest in or refrain from investing in securities or other investment products. It may provide an introductory summary of products or services that we may potentially provide, and you should consider whether any of those may apply to your own circumstances and needs.

It is not intended to provide the sole basis for any evaluation of securities or any other instrument, which may be discussed in it. The information in this document is not investment, tax, legal, accounting, regulatory or other advice, and you should consider seeking advice tailored for your own circumstances, including any impact an investment may have on your personal tax position from your own tax adviser. You have sole responsibility for the management of your tax, accounting, legal and regulatory affairs including making any applicable filings and payments and complying with any applicable laws and regulations. We have not and will not provide you with, and you should obtain your own, independent, tax, accounting, legal and regulatory advice.

Any offer or entry into any transaction with Barclays as a party, requires Barclays' subsequent formal agreement which will be subject inter alia to internal approvals and execution of binding transaction documents. Terms and conditions if any herein are indicative and subject to change and/or negotiation between us. Full details of final terms and conditions will be contained in a prospectus or offering or other document.

Investment products may be subject to investment risks, including, but not limited to, market and currency exchange risks, fluctuations in value and possible loss of principal invested. Where investments are concerned, past performance does not predict or guarantee future performance. Investments can fall as well as rise in value. Your capital or the income generated from your investment may be at risk. The value of any investment may also fluctuate as a result of market changes.

Although any content in this document from other sources is believed to have been obtained from sources which are reliable, we neither represent nor warrant its accuracy or completeness, nor the timeliness or reliability of such information set out herein. Where information in this document has been obtained from third party sources, we believe those sources to be reliable but we do not guarantee the information's accuracy. Information set out herein may be incomplete or condensed. Barclays is not responsible for information stated to be obtained or derived from third party sources or statistical services. Any past or simulated past performance including back-testing, modelling or scenario analysis contained herein is no indication as to future performance. No representation is made as to the accuracy of the assumptions made within, or completeness of, any modelling, scenario analysis or back-testing. You should carry out your own due diligence and verification of such information accordingly. This document may become outdated and/or its contents subject to changes at any time and without prior notice to you, and in that regard, we are under no obligation to update or correct this document or inform you in relation to any such changes to the contents herein. Any estimates and opinions from Barclays as may be included in this document constitute our judgement as of the date of the document and may be subject to change without notice, and we have no obligation to provide revised estimates or opinions.

Unless expressly stated, products are not guaranteed by Barclays Bank PLC or its affiliates or any government entity.

This document is not a product of the Barclays Research department. Any views expressed may differ from those of Barclays Research.

This document is strictly confidential and may be being made available to selected recipients only. It may not be reproduced or disclosed (in whole or in part) to any person without our prior written permission. Barclays or its affiliates may act upon or use material in this publication prior to publication. The manner of distribution of this document and the availability of the products and services may be restricted by law or regulation in certain countries and persons who come into possession of this publication are required to inform themselves of and observe such restrictions.

Barclays Bank PLC ("Barclays"), its affiliates, and their respective directors, employees, and agents ("Barclays Group") make no representation or warranty as to the accuracy, completeness, timeliness or reliability of the contents of this document. To the maximum extent permitted by law, no member of the Barclays Group accepts any liability whatsoever for any direct, indirect or consequential losses (in contract, tort or otherwise) (including, without limitation, any liability arising from fault or negligence on the part of any of them) for any loss whatsoever arising from the use of or reliance on this document or its contents or otherwise arising in connection with it.

The contents of this document have not been reviewed or approved by any regulatory authority.

Barclays offers wealth and investment products and services to its clients through Barclays Bank PLC registered in England and operates in India through its subsidiaries, including Barclays Securities (India) Private Limited (BSIPL), Barclays Wealth Trustees (India) Private Limited (BWTIPL) and Barclays Investments & Loans (India) Private Limited (BILIPL). BSIPL is a company incorporated under the Companies Act, 1956 having CIN U67120MH2006PTC161063. BSIPL is registered and regulated by the Securities and Exchange Board of India (SEBI) as a Portfolio Manager INP000002585, Stock Broker INZ000269539 (member of NSE and BSE), Research Analyst:INH000001519; Depository Participant with the National Securities & Depositories Limited (NSDL): DP ID: IN-DPNSDL- 299-2008, Investment Adviser: INA000000391. BSIPL is also registered as a Mutual Fund Advisor having AMFI ARN No. 53308. The registered office of BSIPL is at 208, Ceejay House, Shivsagar Estate, Dr. A. Besant Road, Worli, Mumbai – 400 018, India. Telephone No: +91 22 67196363. Fax number: +91 22 67196399 Compliance Officer contact details: Name: Mr. Anupam Mohaney, Contact number: +91 22 61754000, E-mail:bsiplcompliance@barcap.com. Investor Grievance E-mail: bsipl.concerns@barcap.com. Website: www.barclays.in/bsipl. BWTIPL is a company incorporated under the Companies Act, 1956 having CIN U93000MH2008PTC188438. BWTIPL is a Corporate Agent (Composite) of (i) HDFC Standard Life Insurance Company Limited and (ii) ICICI Lombard General Insurance Company Limited, under IRDA Registration Code CA0078. The registered office of BWTIPL is at 208, Ceejay House, Shivsagar Estate, Dr. A. Beasant Road, Worli, Mumbai – 400 018, India. Telephone No: +91 22 67196363. Fax number: +91 22 67196399. Email Address for corporate agency (insurance) matters: xrawealthindiainsura@barclayscapital.com, Email Address for other matters: wealthindiatrust@barclays.com. Grievance Officer contact details: Name: Ms. Poonam Mirchandani, Contact number: +91 022 6719 6359, E-mail: bwtipl.concerns@barclays.com Website: www.barclays.in/bwtipl. BILIPL is a company incorporated under the Companies Act, 1913 having CIN U93090MH1937FTC291521. BILIPL is registered and regulated by the Reserve Bank of India (RBI) as a Non Banking Finance Company (NBFC): Registration no.B-13.02176. The registered office of BILIPL is at. Nirlon Knowledge Park, Level 10, Block B-6, Off Western Express Highway, Goregaon (East), Mumbai - 400063, India. Telephone No: +91 22 61754000. Fax number: +91 22 61754099. Grievance Redressal Officer contact details: Name: Mr. Ruzbeh Sutaria, Contact number: +91 22 61754244, Grievance E-mail: bililcompliance@barclayscapital. com. Website: www.barclays.in/bilil.

BARCLAYS | Private Bank