



Mid-year Outlook 2023:

Making sense of the slowdown

June 2023

 **BARCLAYS** | Private Bank



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Contributors:

Henk Potts, London UK, Market Strategist EMEA
Lukas Gehrig, Zurich Switzerland, Quantitative Strategist
Nikola Vasiljevic, PhD, Zurich, Switzerland, Head of Quantitative Strategy
Julien Lafargue, CFA, London UK, Chief Market Strategist
Dorothee Deck, London UK, Cross Asset Strategist
Michel Vernier, CFA, London UK, Head of Fixed Income Strategy
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 "Mid-Year Outlook", the investment strategy update from Barclays Private Bank.

In our chapters, we look at the likelihood of already-stuttering leading economies entering a recession this year and assess the short- and medium-term implications for bonds and equities.

Taking a step back, we examine the longer-term, yet burning, topic of "de-dollarisation" and what it might mean for investors.

Beyond our asset class and financial market analysis, we examine how investors might reduce the biodiversity risk that lurks in their portfolio.

As always, we hope you enjoy the articles, and we thank you for entrusting us with your investments.

Jean-Damien Marie
and Andre Portelli,
Co-Heads of Investment, Private Bank

Managing the slowdown

At a time of slowing growth, persistently high inflation, even if easing, and interest rates that are nearing a peak, investors and the authorities will need to tread carefully. Diversification remains key. As new investment opportunities emerge, we remain constructive over the medium term.



Trying to anticipate how financial markets will perform in the next few months is always a challenge. Even more so, it seems, in the wake of the COVID-19 pandemic and the various ways in which it has reshaped businesses, work and society.

While educated guesses can provide pointers to what the macroeconomic picture might look like, be ready for surprises. Extrapolating top-down views into a market outlook adds another layer of uncertainty.

If someone had said six months ago that the first half of 2023 would see the following, few would have believed them:

- several major US regional bank failures
- a last-minute rescue of a 167 year old Swiss bank by its historical rival
- a German recession
- US credit default swaps (CDS) exploding to 175 basis points (bp) from 15bp, on fears over the debt ceiling

That said, while such bad news might be expected to rock markets, for all the turmoil, going into the second half of the year global equities (MSCI ACWI) are up some 6.8% in 2023.

Getting the view right is only half of the equation. Anticipating how investors will react to any event is where money is made or lost. To add to the challenge, markets are not always rational and its reaction function varies over time. This is why good (economic) news can occasionally be bad news for markets.

FRAMING THE CONVERSATION

With that in mind, investment analysts could tell you, with the utmost conviction, that the S&P 500 is expected to be at X level at the end of the year. Of course, the forecasts would likely be revised at least a couple of times between now and then.

Alternatively, investors can admit that the future is uncertain. That doesn't stop us in laying out our base case and the risks associated with it, both on the upside and the downside. From there, a strategy can be established that should help to maximise returns and minimise volatility.

In other words, trying to find the most efficient asset allocation for a specific level of risk. This won't prevent losses nor guarantee healthy returns every time, all the time. But, with the help of time, it should help grow capital.

IT'S A TOUGH WORLD

The world is in a tricky place, again. Uncertainty is high on all fronts: macroeconomic, geopolitics, climate and interest rates. Although visibility has rarely been so poor, the following is clear:

- Most people, including ourselves, expect the macroeconomic data to deteriorate over the rest of the year
- There is no exuberance (at least outside the topic of Artificial Intelligence) and investors' sentiment is at best neutral, if not outright cautious
- Debt, whether from governments or companies, is yielding something again.

Aside from that, it's all about assumptions, probabilities and interpretation.

OUR VIEWS

Starting with the economy, our base case is that global growth will slow but won't contract. Developed countries will likely flirt with recession, posting anaemic growth, even in an optimistic scenario. Lower growth is, in a way, good news as it should help to ease inflationary pressures. In turn, this means that central banks won't feel the need to lift rates much more. In fact, they may need to cut rates later this year, if the slowdown is worse than anticipated.

Consumers are, slowly but surely, depleting their COVID-related excess savings built up during the pandemic, but jobs remain plentiful. Even if unemployment rates were to rise, they would probably remain low by historical standards. As a result, consumption may slow, but should not collapse.

On the corporate side, the pandemic has been a great opportunity to strengthen balance sheets and streamline operations. In other words, management teams had planned for the worst, and so if this occurs, companies appear to be in much better shape than if they had gone into this economic slowdown after years of uninterrupted growth.

"Getting the view right is only half of the equation.
Anticipating how investors will react to any event is where
money is made or lost"

IT'S NOT GOING TO BE EASY

That being said, the rest of the year is unlikely to be a smooth ride. Equity valuations leave limited room for error, at least when compared to historical levels. Bottom-up analysts continue to expect solid earnings growth despite a worsening macroeconomic picture. Meanwhile, bonds remain highly volatile and cracks are appearing in the real estate market.

Beware the urge to hide in cash, especially now that investors don't have to pay (in nominal terms) for this privilege. Many are sitting on the sidelines and waiting for a better entry point to emerge, whether it's in the form of higher yield, lower stock prices or improved visibility. Unfortunately, better entry points only come with more uncertainty, making the investment decision even more difficult. Improved clarity, on the other hand, often means investing at less favourable levels.

EMBRACING UNCERTAINTY

Our message remains surprisingly consistent. The question is not whether one should be invested. Being "in the market" is still the key to long-term success. Instead, the discussion should be around how to be invested.

Diversification remains paramount. In that respect, high-quality fixed income securities have more appeal than was the case 12 months ago. Equity exposure continues to provide a source of long-term upside, and in doing so, a more active, stock-driven allocation may be called for. Here again, quality should be the main characteristic to look for.

When appropriate, opportunities outside of liquid markets might also be used to help boost returns and lower volatility. The world may be a tricky place, but this is probably when markets have most to offer long-term investors.

Author: Julien Lafargue, London UK, Chief Market Strategist

Global economy: the good, the bad and the ugly

In the face of a troubled banking sector, stubbornly high, if falling, inflation and squeezed living standards, the economy has performed relatively well this year. Furthermore, a recession has been avoided. However, simmering tensions between the US and China, and the conflict in Ukraine mean that uncertainty stalks financial markets.



Please note: All data referenced in this article is sourced from Bloomberg unless otherwise stated, and is accurate at the time of publishing.

ECONOMIC FORECASTS, YEAR-ON-YEAR (% F=FORECAST)						
	GDP			CPI		
	2022	2023F	2024F	2022	2023F	2024F
Global	3.3	2.7	2.4	7.1	4.4	3.1
Advanced	2.7	0.9	0.2	7.6	4.4	2.4
Emerging	3.8	3.9	4.0	6.4	4.3	3.9
US	2.1	1.2	-0.3	8.0	3.8	2.3
Eurozone	3.5	0.5	0.4	8.4	5.3	2.4
UK	4.1	0.1	0.4	9.1	7.0	2.7
China	3.0	5.3	4.5	1.9	0.8	2.0
Japan	1.1	0.8	0.7	2.4	2.8	2.0
Brazil	2.9	2.1	1.9	9.3	5.0	4.4
India	6.8	6.2	6.4	6.7	5.0	5.0
Russia	-2.1	-0.1	1.3	13.7	5.3	5.2

Source: Barclays Investment Bank, Barclays Private Bank, June 2023

Coming into 2023, it looked like being another very challenging year for the global economy, against the backdrop of heightened geopolitical tensions, the impact of elevated inflation levels on consumption and the tightening of financial conditions. The potential for an escalation of the war in Ukraine, concerns over China's intentions towards Taiwan and the intensification of the trade wars were further risks faced by the economy.

Whilst many of these issues remain relevant, the political backdrop has been more stable than predicted and economic activity has been far more resilient than anticipated. Consumer spending has been supported by dynamic labour markets, healthy balance sheets and excess savings. The service sector has continued to recover from the depths of the COVID-19 pandemic and the reopening of China's economy has boosted domestic demand and eased global supply constraints.

A DOSE OF REALISM

Despite the recent resilience, there remains much uncertainty around economic prospects. With a shallow recession anticipated in the UK and US, it will be difficult for advanced economies to generate meaningful growth over the next couple of years. As such, advanced economies are forecast to grow at 0.9% this year, and only 0.2% in 2024 (see table).

At a global level, the real gross domestic product (GDP) growth forecast for this year has been lifted to 2.7%, from January's 2.4% projection, supported by the recovery in China and India's strong growth profile. Consequently, China is forecast to grow by 5.3% this year, with India expected to be the fastest growing major economy, hitting 6.2% for 2023.

PRICE PRESSURES EASING

At the start of the year, the inflation trajectory looked like being a key driver for economic activity, sentiment and interest rates. Whilst price pressures have moderated, they have eased at a disappointingly slow rate. The impact of higher food prices, elevated energy prices and stronger wage growth has kept inflation above what had been anticipated at the start of the year.

Nevertheless, peak price pressures seem to be past in major economies and are expected to ease towards the central bank target levels over the next 12-18 months. Base effects are starting to impact year-on-year inflation calculations and government fiscal support is helping to partly offset the impact of higher energy bills. Higher levels of inventory, a relaxation of economic restrictions and an increase in capacity have already led to a material weakening of goods inflation.

Higher interest rates will slow demand, and labour market supply and demand dynamics are also beginning to improve. Participation rates are slowly normalising, which is helping to take some of the heat out of wage rises, although European negotiated salaries still pose some upside risk. Weaker commodity prices are also adding to downward price pressures. As such, global consumer prices are forecast to average 3.7% in the third quarter (Q3) of this year, 3.4% in Q4 and 3.0% in 2024, much better than the 7.1% surge seen in 2022.

INTEREST RATES

The slower-than-expected easing in inflation, surprising strength of the labour market and resilient economic activity, have kept the pressure up on central bankers. As a result, the peaks in interest rates have been much higher than had been anticipated in January.

The hiking cycle is expected to last into the second half of this year, with further increases likely from the US Federal Reserve, Bank of England and the European Central Bank. That said, a pivot to an easing stance appears to be on the cards in 2024, with interest rate cuts skewed towards the latter half of the year.

"Easing inflationary pressures and interest rate cuts should help to stabilise sentiment and allow activity to gradually improve in 2024"

BANKING SECTOR TURMOIL

One recent economic threat, that had appeared remote at the start of 2023, was a banking crisis. The wave of uncertainty sparked by concerns over the mid-tier US banks, and demise of Credit Suisse in March, brought back distressing memories of the global financial crisis (GFC) fifteen years ago. The latest turbulence, however, was more a crisis of confidence and lack of liquidity than more serious, broad-based concerns over asset quality.

History is littered with runs on banks, although the digital age means that the speed and intensity of withdrawals can be far more aggressive than seen in the past.

Despite the dangers of bank runs, policymakers and regulators possess extensive toolkits to help contain and isolate risks. On this occasion, officials used their widespread powers to guarantee deposits, provide liquidity and orchestrate takeovers. Although these solutions are far from perfect, they are considerably better than the disorderly failures and nationalisations that were seen during the GFC.

EARLY DAYS FOR ECONOMIC RAMIFICATIONS

The economic ramifications of the financial sector turmoil are still coming to light. That said, bank lending standards have already been tightened and regulators are likely to up capital and liquidity provisions, which could hit loan growth. Confidence levels are also vulnerable to a banking shock, however, surveys so far suggest that the influence on both business and consumer sentiment appears to be manageable.

Fears emanating from the banking crisis, coupled with higher interest rates, could develop into a more serious credit crunch. This has added to the risk of a harder economic landing than is currently being projected. If financial conditions tightened dramatically, this could also affect the path of monetary policy.

Most importantly, a re-run of the GFC seems unlikely at this stage. Capital levels are much higher than in 2008. Liquidity is much healthier and leverage levels have been radically reduced. Systemically important banks are subject to far more stringent stress tests when compared to the past.

That's not to say that further pressures on the system will not occur, but the risk of a failure of the financial system undermining the health of the global economy has been structurally reduced.

US DEBT CEILING FEARS

The bipartisan suspension of the debt ceiling until 1 January 2025 significantly reduces concerns the country would default on its debt for the first time, an outcome that could have been both calamitous for the domestic economy and the global financial system.

Under the deal, which lasts beyond the next presidential election, federal spending on defence and domestic programmes will be capped for two years. The Congressional Budget Office said the legislation would result in \$1.5 trillion of savings over the next decade¹. This minor fiscal contraction is expected to have only a marginal impact on growth and anticipated US rate path. Accounting for a 0.1 percentage point trim to anticipated growth for 2023 and 2024.

AFTER THE STORM COMES THE CALM?

After the turmoil of multi-decade high inflation and the steepest hiking cycle since the 1980s, policymakers will assess the impact of easing price pressures, rate moves and the extent of the slowdown on the economy.

Consumer activity in most advanced economies is likely to be depressed over the rest of the year as disposable incomes are further squeezed, saving rates rise and the tailwind from additional pandemic savings fades.

Business investment, and confidence, are expected to remain constrained by heightened economic uncertainty, rising wages and higher borrowing costs. Meanwhile, government spending is anticipated to be inhibited by high debt levels and limited fiscal headroom.

The recovery in emerging markets should help to partially offset the weakness in advanced economies, as they continue to benefit from pent-up demand, improving industrial production levels and strong secular growth. That said, weaker external demand and trade conflicts could slow growth prospects.

"Peak price pressures seem to be past in major economies and are expected to ease towards the central bank target levels over the next 12-18 months"

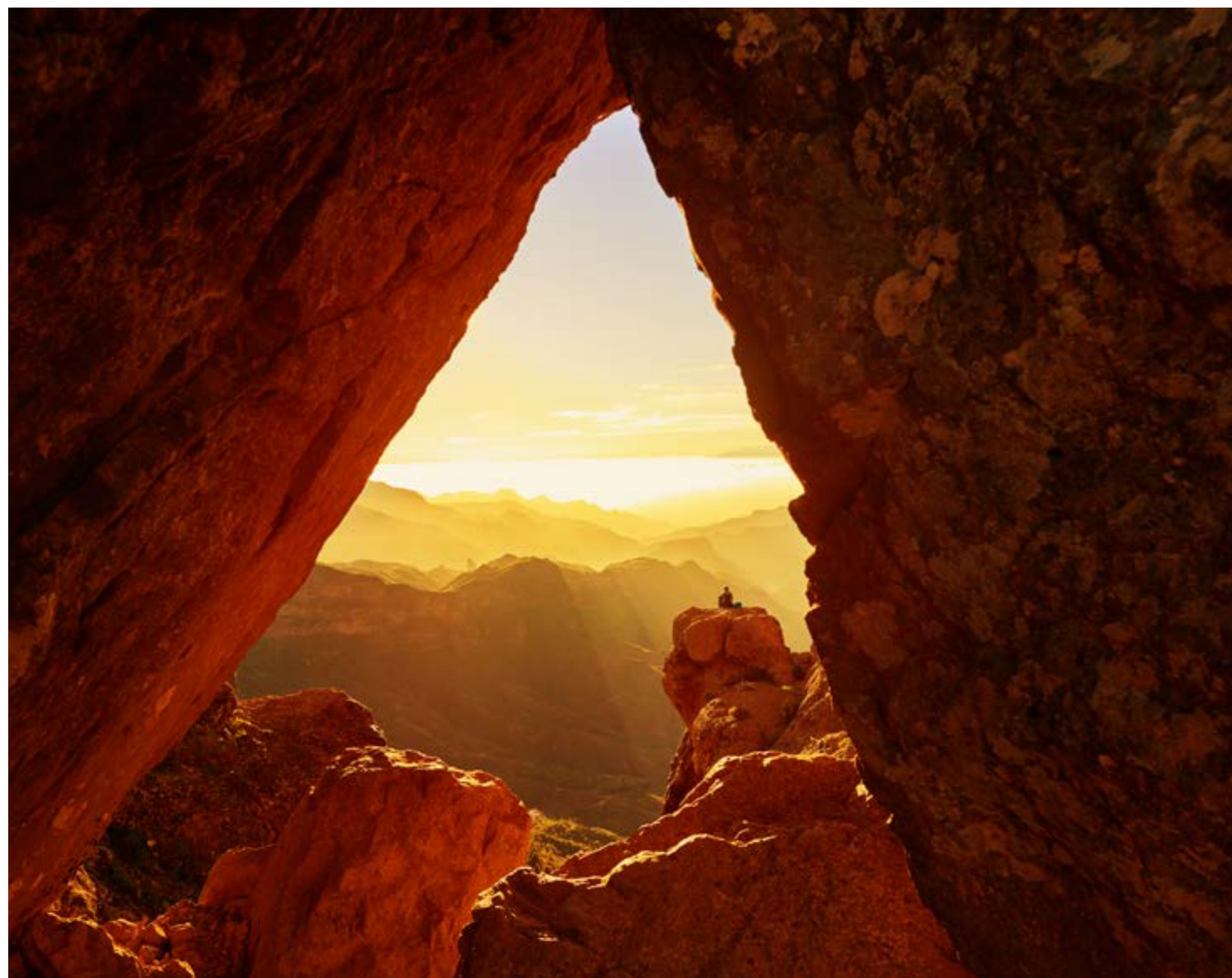
Turning to prospects for next year, GDP growth is anticipated to remain below trend, with the world economy predicted to expand by just 2.4%. The good news is that easing inflationary pressures and interest rate cuts should help to stabilise sentiment and allow activity to gradually improve in 2024.

Author: Henk Potts, London UK, Market Strategist EMEA

¹ WCBO says debt ceiling deal would cut deficits by \$1.5 trillion over the next decade, NPR, 31 May 2023 <https://www.npr.org/2023/05/31/1178995328/debt-ceiling-cbo-house-vote-mccarthy-biden-spending-deficit#:~:text=CBO%20says%20debt%20ceiling%20deal,trillion%20over%20the%20next%20decade&text=Dietsch%2FGetty%20Images-,House%20Speaker%20Kevin%20McCarthy%20speaks%20to%20members%20of%20the%20media,a%20debt%20deal%20on%20Wednesday>.

US teeters on the edge

As the surge in inflation and interest rates bite while the labour and housing markets slow, the US economy faces entering a recession later this year.



Please note: All data referenced in this article is sourced from Bloomberg unless otherwise stated, and is accurate at the time of publishing.

US ECONOMIC FORECASTS, YEAR ON YEAR (% , F=FORECAST)			
	2022	2023F	2024F
GDP growth	2.1	1.2	-0.3
CPI inflation	8.0	3.8	2.3
Unemployment rate	3.6	3.8	4.6
Gross public debt (% of GDP)	123.4	122.8	121.7

Source: Barclays Investment Bank, Barclays Private Bank, June 2023

While the US economy grew, if uninspiringly, in the first three months of the year (Q1), the outlook remains challenging. Q1 growth hit an annualised rate of 1.1%, which was slower than economists had expected and represents a sharp deceleration compared to 2.6% in the final quarter of last year.

The primary driver of the expansion was consumer spending, as household demand jumped 3.7% in Q1, compared to the 1% gain recorded in Q4 2022. However, the quarterly average was aided by a raft of purchases in January (following bad weather at the end of last year) with sales declining in February and March. Growth was also boosted by positive government spending on goods and services.

Elsewhere in the first quarter, lacklustre levels of business investment and a fall in the build-up of inventory hit activity levels. Business demand for equipment saw its biggest decline (7.3%)¹ since the start of the pandemic and inventory investment subtracted 2.3 percentage points from GDP growth¹.

SERVICES SECTOR OUTPERFORMS MANUFACTURING

The services sector has mushroomed in 34 out of the past 35 months. The Institute of Supply Management (ISM) stated that its services purchasing managers' index (PMI) reading rose to 51.9 in April², as consumers switched to buying services from goods, and new orders were lifted by rising exports.

¹ Gross domestic product, first quarter 2023, Bureau of Economic Analysis, 27 April 2023 [https://www.bea.gov/news/2023/gross-domestic-product-first-quarter-2023-advance-estimate#:~:text=Current%2Ddollar%20personal%20income%20increased,salaries\)%20and%20government%20social%20benefits.](https://www.bea.gov/news/2023/gross-domestic-product-first-quarter-2023-advance-estimate#:~:text=Current%2Ddollar%20personal%20income%20increased,salaries)%20and%20government%20social%20benefits.)

² Services PMI at 51.9%, April 2023 Services ISM, Institute for supply management, 3 May 2023 <https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/services/april/>

After the post-pandemic boom, the services sector expansion is likely to ease, while still supporting growth.

Although the US services sector has prospered, manufacturers (accounting for 11.1% of the economy³) have struggled this year. PMI for the sector was 47.1 in April⁴, and a reading below 50 suggests a sector is contracting rather than growing (in this case, for the past six months). The weakness remains broad-based with only two sub-sectors (petroleum and coal products, and transportation equipment) seemingly growing output.

Manufacturers appear to be delaying placing orders amid rising economic uncertainty and higher prices. Despite the weak demand and improving supply chains, factory-gate prices rose at their fastest pace of the year in April. New orders contracted for the ninth consecutive month in April, as customers cut back on investing in inventory for fear of weakening demand. This does not bode well for future production levels.

Industrial production will likely remain under pressure over the next 18 months, including a 3% year-on-year (y/y) contraction in Q4, and a 2.5% reduction in 2024.

LABOUR MARKET DEFIES FORECASTS

The worsening of the buoyant labour market expected at the start of the year has proved to be misplaced.

The US economy still created more than a third-of-a-million jobs in May and the unemployment rate of 3.7% remains close to a five-decade low. Whilst technology companies have been cutting staff numbers, after a hiring spree early in the pandemic, jobs have been added at pace in the healthcare, professional and business services, and hospitality and leisure sectors.

BUT IS MOMENTUM SLOWING?

While the labour market may appear to be booming on the surface, there are early signs that momentum may be slowing. The latest Job Openings and Labour Turnover Survey (JOLTS) showed the number of job openings increased by around 358,000 at the end of April to 10.1 million, but this is still down from a peak of 12 million in March 2022⁵.

Women have been returning to the workforce which has led to an improvement in the participation rate, which held steady at a post-pandemic high of 62.6% in May, albeit still below the 63.3% pre-COVID level⁶. Average hourly earnings growth cooled in May to 0.3% month-on-month (m/m) and 4.3% y/y compared to 0.5% m/m and 4.4% y/y increase registered in April.

Given the scale of economic slowdown, payroll growth will probably weaken and turn negative in the second half of the year. Indeed, the US unemployment rate is predicted to creep above 4% in the coming months and finish the year at 4.2% (see table).

³ Value added by industry: Manufacturing as a percentage of GDP, St Louis Fed, 30 March 2023 <https://fred.stlouisfed.org/series/VAPGDPMA>

⁴ Manufacturing PMI at 47.1%, April 2023 Manufacturing ISM, 3 May 2023 <https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/april/>
<https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/april/>

⁵ Job openings and labor turnover – April 2023, Bureau of Labor Statistics, 8 May 2023 <https://www.bls.gov/news.release/jolts.nr0.htm>

⁶ Employment Situation Summary, Bureau of Labor Statistics, 5 May 2023 <https://www.bls.gov/news.release/empstat.nr0.htm>

⁷ Personal income and outlays March 2023, Bureau of Labor Statistics, 28 April 2023 <https://www.bea.gov/sites/default/files/2023-04/pi0323.pdf>

⁸ National data, Bureau of Economic Analysis, 27 April 2023 <https://www.bea.gov/table/direct-investment-multinational-enterprises>

⁹ US mortgage rates hit 21-year high as Fed action weighs on housing sector, Guardian, 26 October 2022 <https://www.theguardian.com/business/2022/oct/26/us-mortgage-interest-rates-highest-2001>

¹⁰ S&P CoreLogic Case-Shiller US National Home Price NSA Index, S&P Dow Jones Indices, June 2023 <https://www.spglobal.com/spdji/en/indices/indicators/sp-corelogic-case-shiller-us-national-home-price-nsa-index/#overview>

“The economy is forecast to shrink for three consecutive quarters from Q4 this year, expanding by 1.2% this year and dipping 0.3% in 2024”

CONSUMER DIPS INTO THEIR PANDEMIC SAVINGS

The US consumer has been impressively resilient over the past year, with households now spending more of the excess savings built up during the pandemic to counter squeezed living standards. Demand was also supported by the historically low levels of unemployment and hardy wage growth. US consumer spending increased more than expected in April, with personal-consumption-expenditures (PCE) jumping 0.8% in April from March, double the consensus forecast.

This year, consumers have either been forced to, or prefer to, spend their wages rather than save them. The US personal savings rate fell to 5.1% in March, against the long-term average of 8.9%⁷.

There are, however, signs that the post-pandemic excess savings tailwind is starting to fade, and pressure from higher interest rates is starting to take its toll on demand. May's University of Michigan consumer confidence survey backed up this prognosis as the sentiment index slid to 57.7, its lowest level since November.

Given the expectations of a slowing economy, the moderate rise in unemployment and recent hit to disposable incomes, private consumption growth is likely to slow over the next 18 months. Demand is forecast to ease from 3.8% in Q1 to be flat in the final quarter of this year and first half of next year. Private consumption growth is projected to average just 0.3% in 2024. As household demand accounts for around 70% of activity⁸, this will obviously damage American growth prospects.

HOUSING MARKET STEADYING

US house prices have come under pressure as mortgage rates surged to 21-year highs⁹. The Case-Shiller Home Price Index declined for seven consecutive months before returning to growth in February¹⁰. The rebound accelerated in March with a 1.3% m/m increase, although the national composite for home prices is still 3.6% below the peak of June 2022.

Mortgage rates have stabilised over the past few weeks, though a lack of inventory continues to support prices. However, economic uncertainty, mortgage rates above 6% and tighter mortgage financing are all likely to be a headwind for the sector.

"As inflation continues to moderate, labour markets cool and activity slows, the Fed should flip to an easing stance next year and deliver 150bp of cuts"

INFLATION

Weakening US price pressures will be a relief for the US Federal Reserve (Fed). The headline consumer price index (CPI) rose 0.37% m/m, and 4.9% y/y in April, compared to 5% in March¹¹. Core consumer prices rose 0.4% and the annual rate ticked down to 5.5%¹¹.

The breakdown of the latest inflation report showed that core goods prices rose more than expected, helped by a robust increase in used cars. This was partially offset by declining prices for airfares, hotels and new cars.

Shelter costs, which make up around a third of the CPI, rose 0.4% last month¹¹ its smallest increase this year. This slowing trend is a positive sign, given that housing costs are a lagging indicator and so will take longer to moderate.

Most importantly, annual inflationary pressures have now eased for 10 consecutive months. For the first time in two years, the CPI is back below 5%, and a substantial improvement on the 9.1% peak in June 2022¹¹. In terms of the outlook, inflation is forecast to ease through the year and return to 2.5% by December.

CENTRAL BANK PREPARES TO TAKE ITS FOOT OFF THE ACCELERATOR

The Fed hiked rates by another 25 basis points (bp) in May. The latest increase pushed the benchmark rate up to between 5% and 5.25%, its highest level in 16 years¹². The central bank also signalled that the tightening bias would remain in place. The Federal Open Markets Committee (FOMC) statement stated that "additional policy firming may be appropriate to return inflation to 2% [the target level] over time". The FOMC will now determine the trajectory of price pressures on an ongoing basis, based on the incoming data.

The clearest message from Fed chair Jerome Powell was that officials' outlook for inflation does not support imminent rate cuts. Resilient consumption, inflation and labour market data indicates a higher terminal fed funds rate than we were projecting at the start of the year. The FOMC is now expected to deliver two additional 25bp rate hikes by the end of the year pushing the target range to 5.5%-5.75%. The timing of these increases remains more debatable.

The recent strong nonfarm payrolls report suggests that the June meeting is live, although markets are only pricing a 30% probability of a hike. June's policy decision is likely to be a close call and the committee might decide to postpone hikes until the July and September meetings.

As inflation moderates, labour markets cool and activity slows, the Fed is expected to flip to an easing stance in 2024, delivering 150bp of cuts, with the fed funds target range forecast to finish 2024 at 4-4.25%.

TIGHTER FINANCIAL CONDITIONS

The combination of higher interest rates, coupled with the turmoil that hit the regional banking sector in March, is expected to prompt tighter US credit conditions, which will weigh on growth prospects.

The Fed's senior loan officer opinion survey (SLOOS) on bank lending practices in April showed that the net share of banks that tightened lending standards to large firms rose to 46%, from 44.8% in January¹³. Data also showed that demand for loans has been much weaker.

MILD RECESSION ON CARDS FOR 2024

America's growth is expected to come under pressure in the second half of this year and through 2024, in the face of tighter financial conditions, easing domestic demand and a prolonged slowdown in manufacturing activity. The economy is forecast to grow by 1.2% in 2023, then shrink for three consecutive quarters from Q4 this year, resulting in a 0.3% contraction in 2024 (see table).

Author: Henk Potts, London UK, Market Strategist EMEA

¹¹ Consumer Price Index Summary, Bureau of Labor Statistics, 10 May 2023 <https://www.bls.gov/news.release/cpi.nr0.htm>

¹² Federal Reserve issues FOMC statement, Board of Governors of the Federal Reserve System, 3 May 2023 <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230503a.htm>

¹³ Senior loan officer opinion survey on bank lending practices, US Federal Reserve, 8 May 2023 <https://www.federalreserve.gov/data/sloos/sloos-202304-chart-data.htm>

Chinese wall of gloom becomes more of a boom

The Chinese economy is on the mend after a dire 2022, aided by the relaxation of pandemic rules late last year. Consumers have returned to the shops in their droves as the housing market also recovers. With growth expected to return to form this year, the country may become the main engine of global expansion again.



Please note: All data referenced in this article is sourced from Bloomberg unless otherwise stated, and is accurate at the time of publishing.

CHINA ECONOMIC FORECASTS, YEAR ON YEAR (% , F=FORECAST)			
	2022	2023F	2024F
GDP growth	3.0	5.3	4.5
CPI inflation	1.9	0.8	2.0
Unemployment rate	5.4	5.1	5.1

Source: Barclays Investment Bank, Barclays Private Bank, June 2023

The Chinese economy has prospered this year, even in the absence of the broad-based boom that some forecasters had predicted. The country substantially eased its rigorous enforcement of COVID-19 restrictions towards the end of last year, which had smashed demand, caused supply shocks and weakened growth expectations.

Activity has surged as the authorities tried to stoke demand by implementing a comprehensive plan to shore up the housing market and boosted stimulus measures.

In the first three months of 2023 (Q1) the economy grew at its fastest pace for a year. Gross domestic product (GDP) expanded at a better-than-expected rate of 4.5% y/y in the quarter, up from the 2.3% seen in the last three months of 2022¹. Growth was driven primarily by a surge in consumer spending and a recovery in industrial production. More recent data, however, suggests that the bounce in activity remains unbalanced and that several challenges persist.

CONSUMERS ENJOY THE FEEL-GOOD FACTOR

Freed from aggressive lockdowns, consumers have started to travel once again and returned to shops and restaurants in their droves.

Data shows that services consumption is rebounding at pace with the services purchasing managers' index (PMI) retreating to 55.1% in April after hitting 56.9 in March² — the highest level seen in the last year (a figure above 50 indicates growth). Hotel bookings at domestic hotels surged by almost 200% from 2019 for the Labour

¹ National economy made a good start in the first quarter, National Bureau of Statistics of China, 18 April 2023 http://www.stats.gov.cn/english/PressRelease/202304/t20230418_1938715.html

² Purchasing managers' index for April 2023, National Bureau of Statistics of China, 1 May 2023 http://www.stats.gov.cn/english/PressRelease/202305/t20230518_1939734.html

Day holiday³, illustrating that people are feeling more comfortable about going out. The China Air Transport Association (CATA) said aviation has recovered rapidly in the first three months of the year.

Demand for goods has shot up, aided by a 17.8 trillion yuan increase in household savings that were built up last year⁴. The improving labour market may have also boosted consumer sentiment. The urban jobless rate fell to 5.3% in March compared to 5.6% in February⁵, although wage growth and youth unemployment have yet to recover to pre-pandemic levels.

Retail sales gathered pace in April and surged to 18.4% y/y from 10.6% y/y⁶ in March in stark contrast to the 2.7% y/y decline in Q4 2022. Demand for cars continued to recover, with auto sales up by 3.4% y/y in April. Activity growth is expected to remain robust during this year, with retail sales ringing up a 9-10% advance in 2023.

AUTHORITIES FIRE THEIR DEMAND BAZOOKAS

Long term, officials have vowed to boost domestic demand as part of a “dual-circulation” development policy. They plan to do this by increasing local production, developing internal distribution and lifting national consumption levels. Domestic activity should also be stirred by incentives to increase household incomes and reduce the wealth gap between urban and rural residents.

Spending is expected to increase as the population becomes wealthier. China’s State Council estimates that the number of people in its middle-income group will rise to 700 million in 2035, from the current 400 million figure⁷. In order to encourage spending, particularly among youngsters, the country will need to reduce its relatively high savings rate by improving the social security safety net.

Two of China’s other pillars of growth have lagged the recovery in domestic consumption. Both fixed asset investment (FAI) and industrial production (IP) growth were lower than expected in Q1. The former increased 5.1%⁸, lower than Bloomberg’s 5.7% consensus, as property investment contracted by 5.8%⁸. Meanwhile, industrial output activity continues to fall behind its pre-pandemic levels, as commodities and vehicle production levels offset a fall in the production of computer equipment.

The difficult start to the year for Chinese exports continues, with purchases from the US slowing significantly. On the positive side, demand growth has been driven by soaring exports to south-east Asia, the resumption of shipments to the European Union and a doubling of purchases from Russia.

However, exports slumped 7.5% y/y in May, given the weak growth being seen in developed economies. Furthermore, external demand could remain under pressure, with net exports forecast to shrink in 2023 and 2024.

“China’s faster recovery in services consumption, stimulus measures and healthy infrastructure investment should drive upgrowth to 5.3% this year”

HOUSING MARKET IN RECOVERY MODE

After the near collapse of the Chinese property market last year, officials have introduced a range of measures to stir demand. The initiatives include credit support for housing developers, financial assistance to ensure the successful completion of projects, and the loosening of restrictions on property purchases by home buyers.

These actions appeared to stabilise the ailing sector at the start of the year, but recent data has cast doubt of the sustainability of the improvement. Real estate investment declined 13.2% y/y in March, and property sales slumped 27% y/y in April.

Regulators are now reportedly considering a broader range of measures, including reducing down-payments and lowering agent commissions to provide a further boost. The policies that have been implemented have helped to address the liquidity crisis for property developers, but buyer sentiment still remains weak and the sector is expected to remain a drag on growth prospects this year.

BANK LENDING SURGES

Credit growth is an essential component of China’s recovery and has rebounded this year. Banks have been encouraged to lend more, and demand from both corporates and households has improved. Bank loans surged by a better-than-expected 23% y/y in January¹⁰. Total social financing (TSF), a broad measure of credit and liquidity in the economy, accelerated to 10% y/y in April and March¹¹.

³ Broke Chinese Gen Zs turn factory town into top tourist spot, Bloomberg, 28 April 2023 <https://www.bloomberg.com/news/articles/2023-04-28/chinese-gen-z-tourists-flock-to-shandong-s-zibo-in-post-covid-travel-boom>

⁴ China’s elevated bank savings are valuable assets to back consumption, Global Times, 19 February 2023 <https://www.globaltimes.cn/page/202302/1285765.shtml>

⁵ China’s job market tough, especially for college graduates, vice minister says, Reuters, 27 April 2023 <https://www.reuters.com/world/china/chinas-job-market-tough-especially-college-graduates-says-vice-minister-2023-04-27/>

⁶ National economy sustained the good momentum of recovery in April, Bureau of Statistics of China, 16 May 2023 http://www.stats.gov.cn/english/PressRelease/202305/t20230516_1939490.html

⁷ Policy support set to boost consumption, China Daily, 8 May 2023 <https://www.chinadaily.com.cn/a/202305/08/WS6458622fa310b6054fad1a34.html>

⁸ Investment in fixed assets from January to March 2023, National Bureau of Statistics of China, 19 April 2023 http://www.stats.gov.cn/english/PressRelease/202304/t20230420_1938881.html

⁹ China trade: slowing exports to bottom out in late 2023 amid ‘increasingly clear’ weak demand, South China Morning Post, 9 May 2023 <https://www.scmp.com/economy/economic-indicators/article/3219876/china-trade-export-growth-accelerates-april-fall-imports-deepens-further>

¹⁰ China’s banks extend record loans as companies borrow more, Bloomberg, 11 February 2023 <https://www.bloomberg.com/news/articles/2023-02-10/chinese-banks-extend-record-loans-as-economy-starts-to-recover#xj4y7vzkg>

¹¹ China April bank loans tumble more than expected, raise pressure on c bank, Reuters, 11 May 2023 <https://www.reuters.com/article/china-economy-loans-idUKL4N3770NA>

Robust infrastructure investment has driven corporate credit demand, while the housing-market recovery has spurred mortgage demand. By contrast, bond issuance by the government and companies has slowed. The recovery in credit growth is likely to last and continue to support the economy this year.

INFLATION SLOWS ALMOST TO A STANDSTILL

While the rest of the world has been buffeted by multi-decade inflation highs, price rises in China are marginal. The country's consumer price index (CPI) edged up 0.2% in May to 0.3% y/y¹², after easing for three straight months to April, compared to 1% in February.

The April reading was the lowest seen since September 2021, driven by declining transportation and food costs, although improving demand pushed up services inflation. On the production side, deflation widened for a fifth consecutive month, with the producer price index (PPI) contracting by 4.6% in May¹², due to a higher base and lower energy prices.

Given the lack of price pressures, inflation is forecast to be 0.8% this year (see table), below the country's official target level of 3%.

POLICY RESPONSE

Following the 25-basis point cut in the reserve requirement ratio (RRR) in March¹³, the People's Bank of China (PBoC) is likely to remain accommodative, with a further 25bp cut in the RRR potentially on the cards in the second half of the year, with a trim to mortgage rates also a possibility. Such policy adjustments would supplement the PBoC's Pledged Supplemental Lending programme and aid infrastructure investment if momentum weakens.

At the recent National People's Congress, policymakers emphasised a range of policies that are required to drive the economy forward. These include building a modern industrial system covering electric vehicles and artificial intelligence. The authorities are also determined to expand domestic demand and enforce the support for state-owned enterprises and private companies.

The government believes that prosperity will be achieved by opening up the economy and attracting higher levels of foreign direct investment. In addition, it remains focused on defusing economic and financial risks, with the objective to resolve risks at small banks, insurers and trust companies.

SUSTAINED ECONOMIC BOOM IN THE OFFING

China's faster recovery in services consumption, stimulus measures and healthy infrastructure investment should drive up growth to 5.3% this year.

Longer term, Bloomberg data suggests that China will be the top contributor to global growth over the next five years, contributing double that of the US over that period.

Author: Henk Potts, London UK, Market Strategist EMEA

¹² China's PPI down 4.6% in May, Xinhua, 9 June 2023 <https://english.news.cn/20230609/c5fb19de8d194c00b9e9ded45435671a/c.html>

¹³ PBoC to cut reserve requirement ratio, Central Banking, 17 March 2023 <https://www.centralbanking.com/central-banks/financial-stability/7954985/pboc-to-cut-reserve-requirement-ratio>

European economy struggles to get out of first gear

European policymakers have scored a pass mark by avoiding a recession this year. However, inflation remains annoyingly high and the risk of energy supply shortfalls persists. With more interest rate hikes on the cards, as the central bank tries to get on top of price rises, eking out more growth will be tough.



Please note: All data referenced in this article is sourced from Bloomberg unless otherwise stated, and is accurate at the time of publishing.

EUROPE ECONOMIC FORECASTS, YEAR ON YEAR (% , F=FORECAST)

	2022	2023F	2024F
GDP growth	3.5	0.5	0.4
CPI inflation	8.4	5.3	2.4
Unemployment rate	6.7	6.9	7.0
Gross public debt (% of GDP)	93.7	93.0	93.2
Private consumption	4.3	0.4	0.4

Source: Barclays Investment Bank, Barclays Private Bank, June 2023

Fears that the eurozone economy would enter recession early in the year, dragged lower by energy-security risks, weakening domestic demand and slowing industrial output, appear to have been overblown.

Despite the deteriorating backdrop, the European Central Bank (ECB) has been forced to lift interest rates in an effort to combat record levels of inflation.

ENERGY RISKS COOL

With 40% of the European Union's gas coming from Russia in 2021¹, the area was always going to be vulnerable to the ramifications of Russia's invasion of Ukraine. Fortunately, Europe went into winter with increased levels of reserves and weather temperatures were significantly milder than expected, lowering peak demand.

European officials have managed supply-side shortages well. They have substituted some of the lost Russian gas through the aggressive importation of liquefied natural gas (LNG) and boosted power generation from renewable energy sources.

Higher energy bills have also encouraged businesses and households to consume less. Indeed, European gas storage facilities are still more than 60% full, 20 percentage points higher than the 5-year average at this time of year².

¹ How Europe can cut natural gas imports from Russia significantly within a year, International Energy Agency, 3 March 2022 <https://www.iea.org/news/how-europe-can-cut-natural-gas-imports-from-russia-significantly-within-a-year>

² Europe's UGS reserves exceed 60%, application to Gazprom for gas transit via Ukraine rises to 40.9 bcm, Interfax, 3 May 2023 <https://interfax.com/newsroom/top-stories/90216/>

The easing supply and demand dynamic has been reflected in energy prices. European natural gas futures have recently been trading below €36 a megawatt hour³, having halved since that start of the year.

Whilst positive, the continent cannot afford to be complacent. Ongoing supply constraints, unusually cold seasons and recovering demand, could see prices soar again. For now, however, the risk of insufficient energy reserves undermining the economy has dramatically reduced.

DOMESTIC DEMAND

Unsurprisingly, household consumption has been extremely weak this year in the face of rising borrowing costs and stubbornly high inflation. The initial boost from reopening demand last year has faded and consumer spending has shrivelled to below pre-pandemic levels. Indeed, eurozone retail sales slumped 3.8% in March, compared to a year earlier⁴.

Although real incomes remain under pressure, the economic outlook is bolstered by a resilient labour market, moderating inflation and rising wages. The eurozone unemployment rate fell to a record low of 6.5% in April, compared to a peak of more than 12% in 2013⁵.

The tight labour market has driven up annual wage growth, which surged by a record 5.7% in the final quarter of last year⁶. This, however, has still not been enough to offset the increase in the cost of living over the same period.

Consumer confidence has slowly recovered, albeit from a very low base. The eurozone consumer confidence index rose to -17.5 in April from -19.1 in March, hitting its highest level in more than a year⁷. Despite some hopeful signs, household consumption will likely remain constrained over the next couple of years and weigh on growth prospects.

INDUSTRIAL PRODUCTION REMAINS WEAK

Despite stronger demand, improving supply chains and lower energy prices, industrial production continues to lag the recovery in the service sector. In March, euro area industrial production contracted by 4.1%⁸ and the S&P Global Eurozone Manufacturing PMI fell to 45.8 in April⁹.

While current output levels are robust, as manufacturers rush to fulfil a backlog of orders, the volume of new orders is disappointing and has declined for eleven consecutive months. In anticipation of more economic weakness, producers have cut inventory levels and employment in the sector grew at its slowest pace in more than two years.

Geographically speaking, southern European manufacturers have been outperforming their northern counterparts, with Greece and Spain topping the league table. Meanwhile, German activity has softened and industrial action has hit French output.

On a positive note, input costs fell for the first time since the pandemic. This should eventually filter through to lower prices and ultimately help stimulate demand, albeit taking some time to come to fruition.

“Despite some dire predictions around the length and depth of the contraction in Europe, the region is likely to avoid a recession this year”

GREEN DEAL PROMOTES SWITCH TO RENEWABLE ENERGY

The European Commission (EC) published its legislative proposals for the Green Deal Industrial Plan (GDIP) in February¹⁰. This new framework aims to speed up the EU's green transition and create a more competitive environment for the region's net-zero industry. Financing will come from a third of the €1.8 trillion set aside for the Next Generation EU Recovery Plan and the EU's seven-year budget¹¹.

Under these proposals, the EC wants to change the EU's climate, energy, transport and taxation policies to help reduce net greenhouse gas emissions by at least 55% by 2030, compared to the levels in the 1990s¹¹.

The green strategy is based around four major pillars. First, create a more predictable and simplified regulatory environment. Second, accelerate the funding of investments in clean-tech industries, while preserving the integrity of the single market. Third, establish a skilled workforce to support the green transition. Fourth, expand free-trade agreements to promote green transition at a global level and export good environmental practises, while defending the single market from unfair trade practices.

Assuming that these proposals are formally adopted by the European Parliament and the Council, the GDIP could radically alter Europe's development of clean technology and renewable energies. If implemented effectively, and efficiently, the plans would add high skilled jobs and promote innovation in the sector.

³ European gas halts decline amid uncertain outlook for demand, Bloomberg, 8 May 2023 <https://www.bloomberg.com/news/articles/2023-05-08/europe-gas-extends-drop-as-weak-demand-bolsters-inventories#xj4y7vzkg>

⁴ Volume of retail trade down by 1.2% in the euro area and by 1.1% in the EU, Europa, 5 May 2023 <https://ec.europa.eu/eurostat/documents/2995521/16668115/4-05052023-AP-EN.pdf/c47d6a66-31e4-4144-e0b7-14b4b5a6bd10>

⁵ Euro area unemployment at 6.5%, Eurostat, 1 June 2023 <https://ec.europa.eu/eurostat/web/products-euro-indicators/w/3-01062023-bp>

⁶ Annual increase in labour costs at 5.7% in euro area, Europa, 17 March 2023 <https://ec.europa.eu/eurostat/documents/2995521/16310164/3-17032023-BP-EN.pdf/d436fcd0-e23c-d714-db88-1defd3715c66>

⁷ Flash Consumer confidence indicator for the EU and euro area, Europa, 20 April 2023 https://economy-finance.ec.europa.eu/system/files/2023-04/Flash_consumer_2023_04_en.pdf

⁸ Industrial production down by 4.1% in the euro area and by 3.6% in the EU, Europa, 15 May 2023 <https://ec.europa.eu/eurostat/en/web/products-euro-indicators/w/4-15052023-ap#:text=15%20May%202023-Industrial%20production%20down%20by%204.1%25%20in%20the%20euro%20area%20and%20office%20of%20the%20European%20Union>

⁹ Euro zone factory downturn deepened in April, Reuters, 2 May 2023 <https://www.reuters.com/markets/europe/euro-zone-factory-downturn-deepened-april-pmi-2023-05-02/>

¹⁰ The Green Deal Industrial Plan: putting Europe's net-zero industry in the lead, European Commission, 1 February 2023 https://ec.europa.eu/commission/presscorner/detail/en/ip_23_510

¹¹ A European Green Deal: striving to be the first climate-neutral continent, European Commission, June 2023 https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal_en

EUROZONE INFLATION STICKS TO THE HIGH SIDE

Eurozone inflation has been stubbornly sticky this year. The harmonised index of consumer prices (HICP) ticked up to 7% y/y in April¹². At the same time, core inflation eased to 5.6%¹² from a record-high of 5.7% in March, helped by slowing goods price momentum.

Headline price pressures are still likely to moderate through the year, driven by slowing food inflation, falling energy prices and helpful base effects. As such, the HICP is forecast to average 2.8% by the final quarter of the year, decelerating to 2% at the end of 2024.

Policymakers will be keeping an eye on wage negotiations as an indication of coming inflationary pressures. A winter of strikes around Europe and aggressive pay demands from public sector workers are likely to keep wage inflation hot for an extended period.

In Germany, for example, 2.5 million public sector workers will get an average annual 5% wage rise for two years, plus a one-off payment amounting to €3,000¹³. In France, private pay is also accelerating, with hourly wages from private payrolls rising to 5.2% in Q1.

ECB BATTLES THE INFLATION DRAGON

As expected, the European Central Bank (ECB) hiked rates by 25 basis points (bp) at its May meeting, taking the deposit rate to 3.25%. It was the smallest increase of this cycle, but unlike the US Federal Reserve, the ECB cannot declare a ceasefire in its battle with inflation.

Whilst the monetary policy statement didn't provide any specific forward guidance on the path of policy, it indicated that the Governing Council (GC) will remain data-dependent and take decisions on a meeting-by-meeting basis.

Interest rates will probably need to be lifted again later in the year. Policymakers appear determined to take action that is sufficiently restrictive to win the battle against inflation.

“Despite some hopeful signs, household consumption will likely remain constrained over the next couple of years”

LIFE IN THE SLOW LANE

Further quarter-point hikes in policy rates appear likely at the June and July meetings. This would take the deposit rate to 3.75% and probably represent the top of this hiking cycle. That said, the central bank may keep rates on hold until the second half of next year, probably followed by a percentage-point of cuts in in the next six months.

Despite some dire predictions around the length and depth of the contraction in Europe, the region is likely to avoid a prolonged recession this year. This, however, should not mask the significant challenges the continent faces. It still has to deal with energy concerns, lacklustre household consumption and a stalling manufacturing recovery. Elevated interest rates, and inflation, will hit economic prospects for some time, which might act as a drag until well into next year.

Consequently, at best, European growth will be anaemic, being forecast to chalk up a 0.5% expansion this year, and 0.4% in 2024.

Author: Henk Potts, London UK, Market Strategist EMEA

¹² Euro area annual inflation up to 7.0%, Eurostat, 2 May 2023 <https://ec.europa.eu/eurostat/documents/2995521/16662671/2-02052023-AP-EN.pdf/449813c2-40a5-58e3-8019-27a58c973445?version=1.0&t=1682959566381>

¹³ German government, trade unions agree on wage deal for public workers, Politico, 23 April <https://www.politico.eu/article/germany-olaf-scholz-government-trade-unions-agree-wage-deal-for-public-workers>

¹⁴ Monetary policy decisions, European Central Bank, 4 May 2023 <https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.mp230504-cdfd11a697.en.html#:~:text=Key%20ECB%20interest%20rates,-The%20Governing%20Council&text=Accordingly%2C%20the%20interest%20rate%20on.effect%20from%2010%20May%202023.12> Euro area annual inflation up to 7.0%, Europa, 2 May 2023

Can the UK economy sparkle again soon?

Stubbornly high inflation, interest rates at a 15-year high and anaemic growth mean that the road ahead for the UK economy is bumpy. While the growth in prices is expected to ease over the next eighteen months and activity levels should tick up, policymakers face a tough task to lift the gloom.



Please note: All data referenced in this article is sourced from Bloomberg unless otherwise stated, and is accurate at the time of publishing.

UK ECONOMIC FORECASTS, YEAR ON YEAR (% , F=FORECAST)

	2022	2023F	2024F
GDP growth	4.1	0.1	0.4
CPI inflation	9.1	7.0	2.7
Unemployment rate	3.7	3.9	4.3
Gross public debt (% of GDP)	100.6	103.9	103.7

Source: Barclays Investment Bank, Barclays Private Bank, June 2023

The prospects for the UK economy looked despairingly gloomy at the end of last year. A cocktail of political turmoil, monetary and fiscal tightening and a cost-of-living squeeze had economists predicting that a prolonged recession was imminent.

Confidence was restored, however, as Rishi Sunak's new administration set about stabilising the nation's finances and stimulating growth. The Bank of England now forecasts that the domestic economy will avoid a slowdown this year, and that gross domestic product (GDP) will be 2.25% larger than it had predicted back in February, by mid-2026.

While the worst of the downturn may be averted, growth prospects remain very weak. Indeed, the range of troubles facing the economy means that a shallow "technical" recession, or two consecutive quarters when growth slows, looks likely.

ECONOMY DEFIES PROPHETS OF DOOM, FOR NOW

The UK economy beat the odds by expanding by 0.1% in the first three months of the year (Q1)¹. That said, momentum shows signs of easing as GDP shrank by 0.3% in March². Services had a poor month (-0.5%) but industrial production (0.7%) and construction (0.2%) both registered gains.

Demand for services may have been hit by periods of poor weather and industrial action. However, a broader-based weakening could be detected.

¹ GDP first quarter estimate, Office for National Statistics, 12 May 2023 <https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpfirstquarterlyestimateuk/januarytomarch2023>

² GDP monthly estimate, UK: March 2023, Office for National Statistics, 12 May 2023 <https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/march2023>

Elevated levels of inflation and higher mortgage rates are eroding household's real disposable incomes, and constraining spending power. Private consumption nudged up 0.1% in Q1¹, while retail sales volumes slipped by 0.9% in March³. Consumption growth looks set to remain weak, averaging just 0.2% this year and 0.3% in 2024, compared to the 5.6% increase recorded in 2022.

IS THE LABOUR MARKET COOLING, AT LAST?

The UK's labour market still looks tight by historical standards, giving employees the whip hand in wage negotiations, but there are indications that conditions may have started to cool. Unemployment has been rising for several months, the number of paid employees is shrinking, job vacancies are gradually declining and pay growth is forecast to moderate.

UK unemployment ticked up to 3.9% in Q1⁴ and the number of salaried staff fell by 136,000 in April, the first decline since February 2021. The number of job vacancies is still close to the 1.1 million mark⁵, or 31% above pre-pandemic levels, but has fallen for 10 consecutive quarters⁵.

The government has been trying to incentivise people, particularly the over 55s, who have 'retired' only recently to return to the workforce. In other words, the supply of labour is slowly starting to improve. Economic inactivity decreased by 0.4 percentage points in Q1, to 21%⁵, which will come as a welcome relief to human resources departments.

Average total pay surged by 5.8% in Q1⁵ year-on-year (y/y), driven largely by wage hikes in finance and business services sectors, followed by construction. However, real pay, which is adjusted for inflation, slumped by 3%⁵, the second-worst fall since 2001, when records began. Average annual private sector pay accelerated to 7% in the three months to March⁵.

Given the economic weakness that potentially lies ahead, unemployment rates will probably steadily rise over the next 18 months and finish 2024 at 4.5% (see table). In addition, the Bank of England (BoE) believes that private sector wage growth should slip to 5.5% at the end of this year, and be at 3% over its forecast horizon, as lower inflation eases pay demands⁶.

HOUSING MARKET ON THE MEND

The dramatic increase in interest rates since the start of last year, of 4.25 percentage points⁷, has hit the UK property market. House prices came under pressure as mortgage rates surged, affordability measures were stretched and banks became more reticent to lend. The combination of tighter lending standards and more nervous buyers led to a 30.5% drop in mortgage approval rates in February, compared to the average level seen in 2022⁸.

¹ Retail sales; Great Britain: March 2023, Office for National Statistics <https://www.ons.gov.uk/releases/retailsalesgreatbritainmarch2023>

⁴ Unemployment rate (aged 16 and over, seasonally adjusted): %, Office for National Statistics, 16 May 2023 <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/unemployment/timeseries/mgsx/lms>

⁵ Labour market overview, UK: May 2023, Office for National Statistics, 16 May 2023 <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/may2023>

⁶ Monetary policy report, Bank of England, May 2023 <https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2023/may/monetary-policy-report-may-2023.pdf>

⁷ Official bank rate history, Bank of England, June 2023 <https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp>

⁸ UK mortgage approvals rise for first time in six months, The Guardian, 29 March <https://www.theguardian.com/business/2023/mar/29/uk-mortgage-approvals-rise-for-first-time-in-six-months>

⁹ Data and resources, Nationwide Building Society, June 2023 <https://www.nationwidehousepriceindex.co.uk/resources/f/uk-data-series>

¹⁰ Public sector finances, UK: March 2023, Office for National Statistics, 25 April 2023 <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/march2023#:~:text=Borrowing%20in%20March%202023,-Initial%20estimates%20for&text=Public%20sector%20receipts%20were%20%C2%A3,110.3%20billion%20in%20March%202023.>

"The base rate seems likely to be nudged up by another quarter of a point at both the June and July meetings, the later probably the last in the current rate-hiking cycle, taking the terminal bank rate to 5.0%"

More recently, there have been signs that home prices are stabilising. After seven consecutive months when the value of residential property eased, monthly prices rose in April, although the annual figure dipped by 2.7%⁹.

Looking ahead, we do not expect the UK housing market to register dramatic falls over the next year, with a peak-to-trough decline unlikely to be more than 10%, as mortgage rates seem likely to plateau and resilient labour markets aid the ability of homeowners to meet mortgage payments. More structurally, supply-and-demand imbalances should provide further downside protection, particularly for the most desirable properties.

BETTER NEWS FOR GOVERNMENT FINANCES

The lack of a recession and a higher tax take have improved the fiscal outlook. However, the modest uptick should not be interpreted as an optimistic sign. The borrowing requirement is likely to ascend over the next few years, although more slowly than previously projected.

Public sector receipts were £88.8 billion in March, 2.3% more than in the same period last year. However, spending rose by 20% y/y to £110.3 billion¹⁰, reflecting the cost of the energy-support schemes. The shortfall between higher tax receipts and the extra government spending resulted in the UK having to borrow an additional £21.5 billion¹⁰.

The dramatic rise in inflation has increased the interest payable of index-linked gilts which increased by 46.9% in the fiscal year ending in April 2023, compared to the same period last year. The UK's debt-to-GDP ratio currently stands at 99.6%¹⁰, the highest since the 1960s.

The sunnier economic picture allowed the chancellor to spend more, at least in the short term, and to cut taxes. The main change was to allow businesses to fully expense investments over the next three years.

In the medium term, the fiscal outlook continues to be constrained. The freezing of income tax thresholds and the hiking of corporation tax rates are expected to up the tax burden to 37.7% of GDP in 2027-28, which would be the highest since the second world war¹¹.

INFLATION TO EASE, BUT REMAIN RELATIVELY HIGH

Unfortunately, UK inflation continues to power ahead of many of its advanced-economy counterparts. That said, the headline consumer price index (CPI) finally fell into single digits in April, at 8.7%¹², thanks to last April's surge in energy costs falling out of the calculations.

One of the reasons for the UK's racy inflation profile is the country's dependence on natural gas for power generation. The government policies introduced to help shield the economy from higher energy bills, and the disruption caused to the supply of goods and labour following Brexit, have not helped either.

The 8.7% y/y increase in the CPI, and 6.8% y/y lift in core price pressures¹², in April were above expectations. The monthly inflation report revealed that food inflation was running at 19.1%¹², services inflation was still elevated and disinflationary pressures in non-energy industrial goods had stalled. The BoE now believes that inflation will stay higher for longer and projects that CPI won't be back at the 2% target level until the start of 2025⁶.

While inflationary pressures might be more persistent than previously projected, the trajectory of price increases finally looks to be more benign. Base effects, from the different measurement period, lower energy prices and a slowdown in services inflation should all start to erode the year-on-year comparison.

Overall, annual average headline inflation is forecast to hit 7.0% y/y in 2023, and 2.7% y/y in 2024 (see table). For core inflation, the average is expected to reach 5.9% y/y this year, and 3.3% y/y next year.

"The UK economy is predicted to flatline this year, skirting a recession, and deliver only a tepid recovery in 2024, with inflation-adjusted GDP nudging up by 0.4%"

HAVE INTEREST RATES PEAKED?

The Monetary Policy Committee (MPC) has hiked rates for 12 consecutive meetings¹³, pushing its benchmark lending rate up from 0.1% in December 2021 to 4.5% in May, its highest since 2008.

At May's MPC meeting, policymakers left guidance on the future path of interest rates unchanged, so keeping their options open. Policymakers identified more evidence of persistent inflationary pressures (as determined by the evolution of the labour market, wage growth and services inflation) that could lead to further rate hikes.

The base rate seems likely to be nudged up by another quarter of a point at both the June and July meetings, the latter probably being the last in the current rate-hiking cycle, taking the terminal bank rate to 5.0%. Rates are likely to be held until well into 2024. While rate cuts are possible next year, any such move is unlikely to occur until late summer. A barrage of quarter-point rate reductions is then predicted to take the base rate to 4% at the end of 2024.

JUST HOW LONG WILL THE UK REMAIN DOWN IN THE DUMPS?

UK activity has been supported by resilient global growth, lower energy prices and the fiscal support which was offered in the Spring Budget. Low levels of unemployment have left households feeling relatively secure and the expected increase in precautionary saving has not materialised.

However, there is no escaping the impact of the aggressive rate hikes, the squeeze on consumer spending power and the medium-term fiscal tightening. As such, the UK economy is predicted to nudge up 0.1% this year, skirting a recession, and deliver only a tepid recovery in 2024, with inflation-adjusted GDP up by 0.4%.

Author: Henk Potts, London UK, Market Strategist EMEA

¹¹ UK still faces record hit to living standards, OBR predicts, Reuters, 15 March 2023 <https://www.reuters.com/world/uk/uk-still-faces-record-hit-living-standards-obr-predicts-2023-03-15/>

¹² Consumer price inflation, UK: April 2023, Office for National Statistics, 24 May 2023 <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/april2023>

¹³ Official bank rate history, Bank of England, June 2023 <https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp>

Brace for near-term squalls, position for long-term opportunities

After a surprisingly positive start to the year for equity markets, there is now a significant disconnect between what the equity and bond markets are pricing in. In this context, how might investors position portfolios to protect against the risk of a sell-off in the near term, while capitalising on long-term opportunities?.



Please note: This article is more technical in nature than our typical articles, and may require some background knowledge and experience in investing to understand the themes that we explore below.

Equity markets have been very resilient in recent months, and certainly more resilient than many market participants had anticipated given the uncertain macro backdrop. There is now a significant disconnect between what equity and bond markets are pricing in (a soft landing versus a recession, respectively).

With global growth slowing and central banks guarding against cutting rates too soon, the disconnect between the equity and bond markets seems more likely to resolve itself at the expense of the former. Crucially for investors, while the near-term outlook looks challenging, long-term prospects remain encouraging.

The article looks at how investors might position portfolios to protect against downside risk in the near term, while capitalising on attractive long-term opportunities.

EQUITY MARKETS REBOUND STRONGLY

Global equities had rallied 21% from their October lows by 2 June and are back to their February highs. Interestingly, most of this performance was achieved before the start of the quarterly earnings season in mid-April.

While corporate profits were generally better than feared in the US and Europe, they came on the back of lowered expectations, and corporate guidance was not strong enough to provide an additional impetus to markets.

... PRIMARILY DRIVEN BY POSITIVE ECONOMIC SURPRISES AND HOPES OF A PEAK IN INTEREST RATES

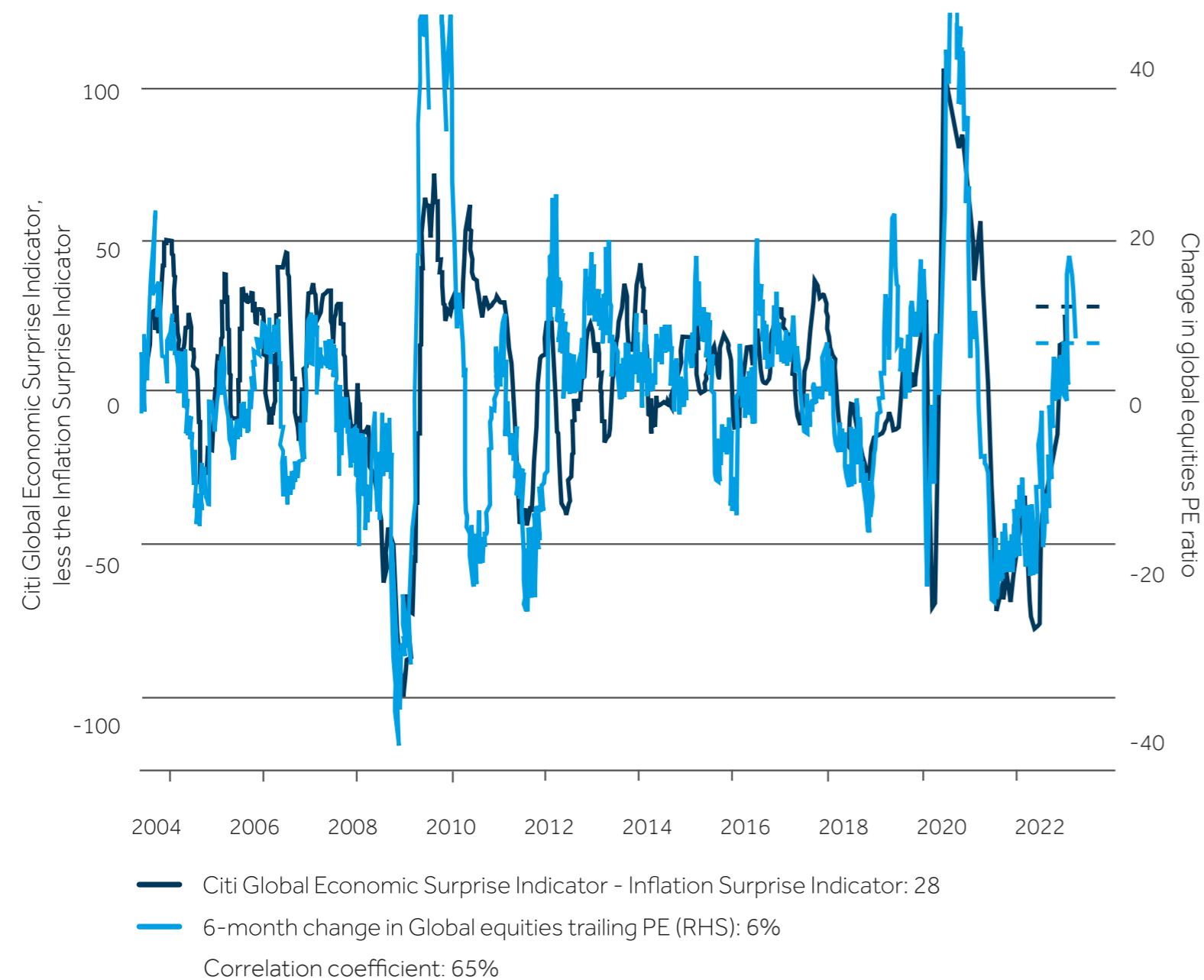
The increase in equity valuations in the past few months has been consistent with an improvement in the growth/inflation mix, relative to economists' expectations (see chart, p21).

Markets have also been supported by hopes that the US Federal Reserve (Fed) will soon cut rates, with futures markets pricing in interest rate cuts later in the year.

Those expectations have been pared back somewhat recently, following hawkish comments from Fed members, but they have sparked hopes of a return to a 'goldilocks' environment, where inflation moderates, while growth slows down but remains positive.

THE GLOBAL EQUITY RALLY HAS BEEN CONSISTENT WITH A BETTER-THAN-EXPECTED GLOBAL/INFLATION MIX

Six-month change in global equities' trailing price-to-earnings ratio, against global economic surprise minus inflation surprise indicators



Source: Refinitiv Datastream, Barclays Private Bank, May 2023

And more recently, since the collapse of Silicon Valley Bank and other US regional banks in March, equity markets have also been propped up by the outperformance of some of the mega-cap stocks in the technology and communication services sectors. The general hype around the potential long-term impact of artificial intelligence on the economy and financial markets helped to boost sentiment in this area.

HOWEVER, MACRO UNCERTAINTY, NARROW LEADERSHIP AND MARKET DYNAMICS RAISE QUESTIONS ABOUT THE SUSTAINABILITY OF THIS RALLY

The positive macroeconomic surprises mentioned earlier, which have supported the market in recent months, are unlikely to remain a tailwind over the long term. Economic surprises are mean-reverting by nature: economists (and investors alike) tend to raise their expectations in the face of positive data surprises, making it more difficult for subsequent data releases to beat their forecasts. Activity surprise has already rolled over in most regions since the end of March, and even turned negative in the eurozone.

In addition, rates are likely to remain elevated for an extended period of time, unless we see a significant rise in unemployment or a meaningful increase in financial stability risk.

Finally, the narrow leadership and internal dynamics of this rally potentially hinder its endurance. Since the October lows, cyclical sectors have performed in line with the more defensive ones globally. Meanwhile, financials have underperformed the rest of the market by 7%, small caps have underperformed large caps by 5% and, within metals, copper has lagged gold by 10%.

Such a pattern is unusual in a historical context, as strong and sustainable equity rallies tend to be led by the more cyclical parts of the market and coincide with the outperformance of risky assets against safe-haven ones.

A RECESSION SOMETIME IN THE NEXT 12 MONTHS IS WIDELY ANTICIPATED ...

The global economy is expected to slow in the second half of the year, potentially entering a recession, as the aggressive tightening in monetary policy and credit conditions seen in the past year filters through the economy. It is worth noting that in the past 30 years, hiking cycles that were accompanied by tighter lending standards have always led to US recessions (albeit history is never a guarantee of the future).

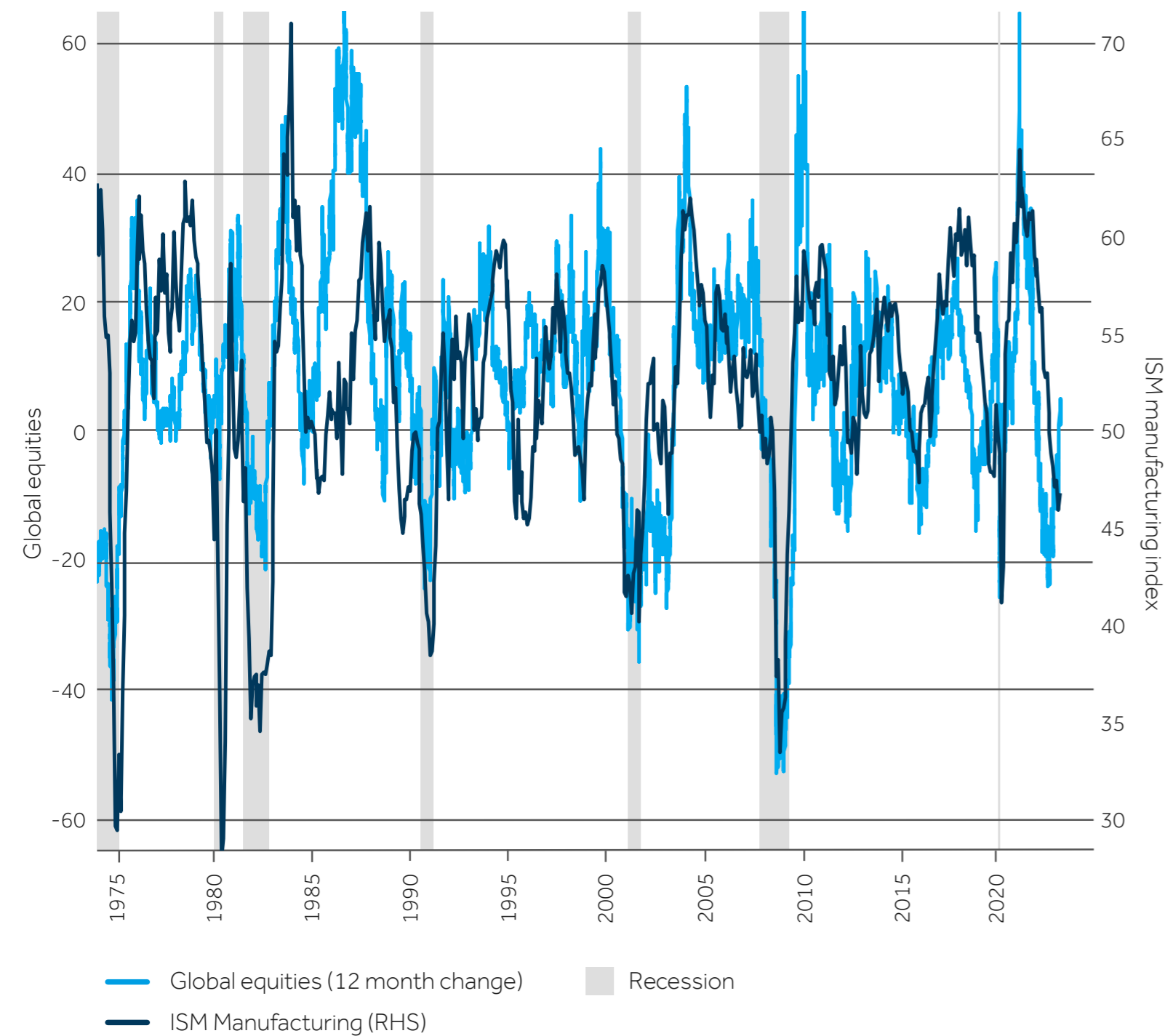
Arguably, a global recession sometime in the next 12 months is a widely-held call. A consensus of economists now expects global gross domestic product growth to drop below 3% in both 2023 and 2024, according to Bloomberg.

BUT ITS TIMING AND SEVERITY ARE MORE DIFFICULT TO CALL

What is more difficult to predict though, is the timing and severity of the next recession, which will be key determinants of financial asset performance. Monetary policy impacts the economy with long and variable lags, which will be exacerbated in this cycle by the recent strains in the banking sector.

GLOBAL EQUITIES APPEAR TO BE DISCOUNTING A SOFT ECONOMIC LANDING

12-month change in global equity prices, against the ISM Manufacturing Index



Source: Refinitiv Datastream, Barclays Private Bank, May 2023

Our central case remains that if a global recession materialises, it is more likely to be mild and short-lived, due to the absence of major imbalances in the economy or financial markets at present. Additionally, the banking crisis should remain contained.

THE EQUITY MARKET APPEARS TO BE PRICING A SOFT LANDING OF THE ECONOMY ...

Based on historical relationships, global equities appear to be discounting an improvement in the macro environment, with a rebound in economic activity and corporate earnings growth.

Historically, there has been a strong correlation between equity prices and economic activity (see chart). At current levels, global equity prices are discounting an improvement in the Institute of Supply Management (ISM) manufacturing index from 47 for the month of May to approximately 52 as of 2 June. A rebound above the 50 level would suggest that the manufacturing sector moves back into expansion territory.

Similarly, global equity prices suggest that corporate earnings could grow by approximately 7% in 2023, in line with their average growth over the past 25 years. This is significantly above analysts' bottom-up forecasts of flat earnings for the MSCI All Country World index this year. In contrast, US bank lending standards, which tend to lead global earnings growth by around six months, suggest that global earnings could decline by over 10% this year.

... SUGGESTING DOWNSIDE RISK TO EQUITY PRICES IN THE NEAR TERM, IF THE ECONOMY CONTRACTS AS EXPECTED

This implies downside risk to equity prices in the near-term, if the economy contracts and corporate earnings decline, as expected, as our base case assumes.

BONDS LOOK MORE ATTRACTIVE THAN EQUITIES IN THE NEAR TERM

Following the surge in bond yields in the past year, and as highlighted in previous articles, fixed income markets look more attractive than equities in the near term (see chart, p23). They provide a higher yield for a lower risk.

Looking at relative valuations between equities and government bonds, the global equity risk premium has fallen to 3.3%, compared with 6.2% in March 2020 and 20-year average of 4.2%.

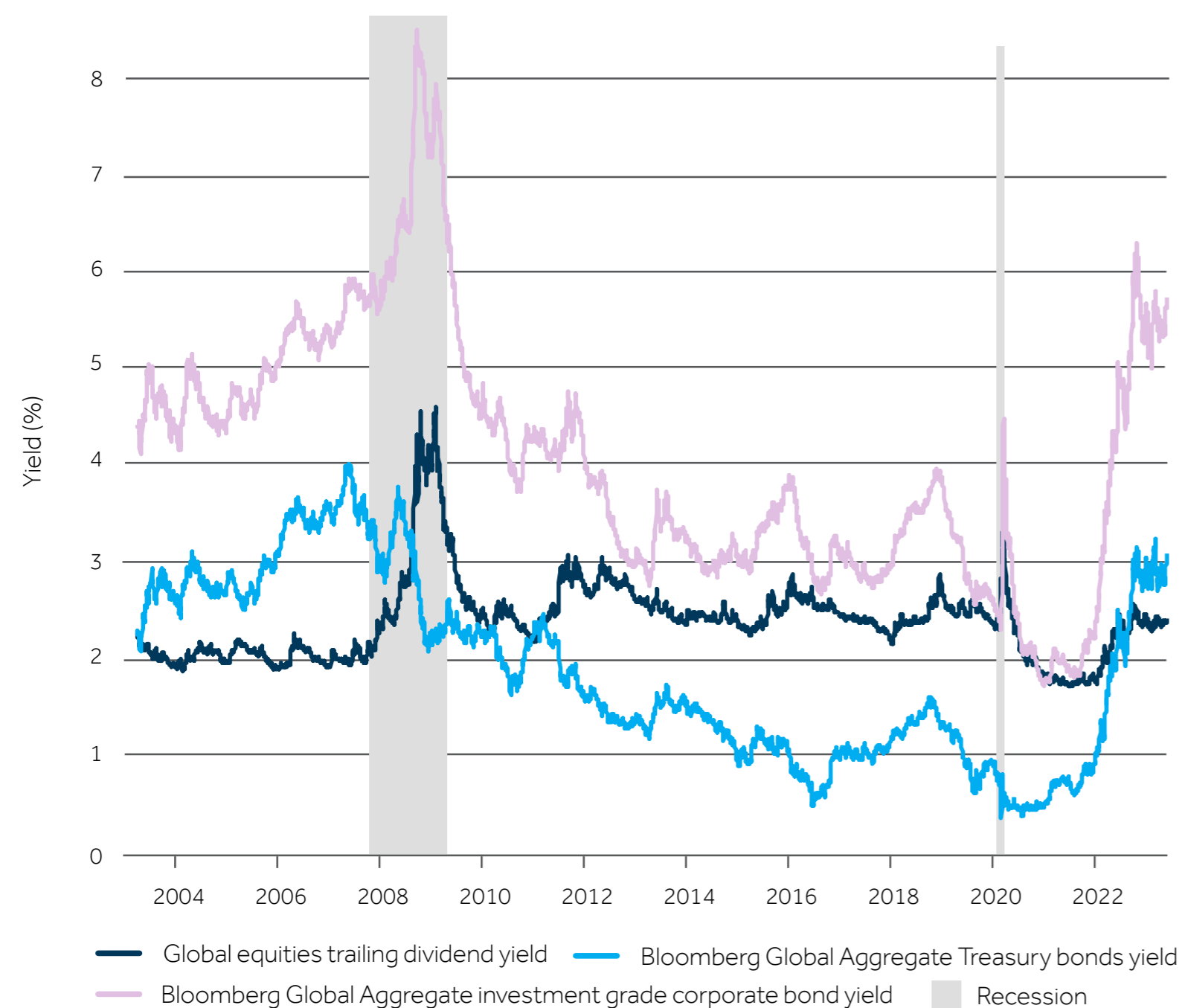
HOWEVER, THE LONG-TERM OUTLOOK FOR EQUITIES REMAINS CONSTRUCTIVE

While the risk-reward for equity markets looks mixed in the near term, the longer term picture is more positive, with stocks likely to outperform bonds meaningfully over a 10-year investment horizon.

Historically, cyclically-adjusted price-to-earnings (CAPE) ratios have been reliable indicators of long-term expected returns. At current levels, CAPE ratios suggest that global equities could generate annualised returns of 8% in the next 10 years, including dividends. While slightly below the 9% total returns posted in the past two decades, those returns are well above global bond yields of 3% at present over a similar period (see chart, p24).

THE GAP BETWEEN GLOBAL EQUITIES' DIVIDEND YIELD AND BOND YIELDS IS THE MOST NEGATIVE SINCE THE GLOBAL FINANCIAL CRISIS

The global equities dividend yield compared with the Bloomberg global aggregate Treasury bond yield and investment grade corporate bond yield



Source: Refinitiv Datastream, Barclays Private Bank, May 2023

HOW SHOULD INVESTORS BE POSITIONED IN THIS ENVIRONMENT?

At the asset-class level

With that in mind, and given the difficulty in timing a recession, long-term investors should stay invested, but with downside protection in place (see [The brightest binary star in the investment universe, and Waiting for a tipping point](#), and [Waiting for a tipping point](#), 40).

Options and capital protected strategies can be used to mitigate downside risk in portfolios and enhance risk-adjusted returns. Interestingly, and despite the current market uncertainty, implied equity volatility remains suppressed, which means that option strategies can still be implemented at a relatively cheap cost. Of note, put/call ratios in Europe and the US have been rising since the start of the year, suggesting renewed interest in downside hedges.

At the sector level

Investment opportunities at the sector level seem limited, in our view. All sectors appear to have overshot their historical relationship with economic activity and credit conditions.

While cyclical sectors trade at an 8% discount to historical levels globally, their earnings are closely tied to the business cycle and would suffer the most in a recession. On the other hand, defensive sectors' earnings tend to be more stable throughout the cycle, but they have significantly re-rated in recent months and now trade at a 25% premium versus history. In relative terms, the valuation premium of defensives versus cyclicals is now extreme, at over three standard deviations above its 20-year average, based on trailing price-to-earnings multiples (PEs).

Two sectors stand out as looking particularly cheap at present: energy and banks. They are currently trading at 1.5x and 2.4x standard deviations below their 10-year average, respectively, based on forward PEs globally. They also offer superior dividend yield prospects over the next 12 months, of 4.4% for energy and 5.3% for banks, versus only 2.3% for the broader market.

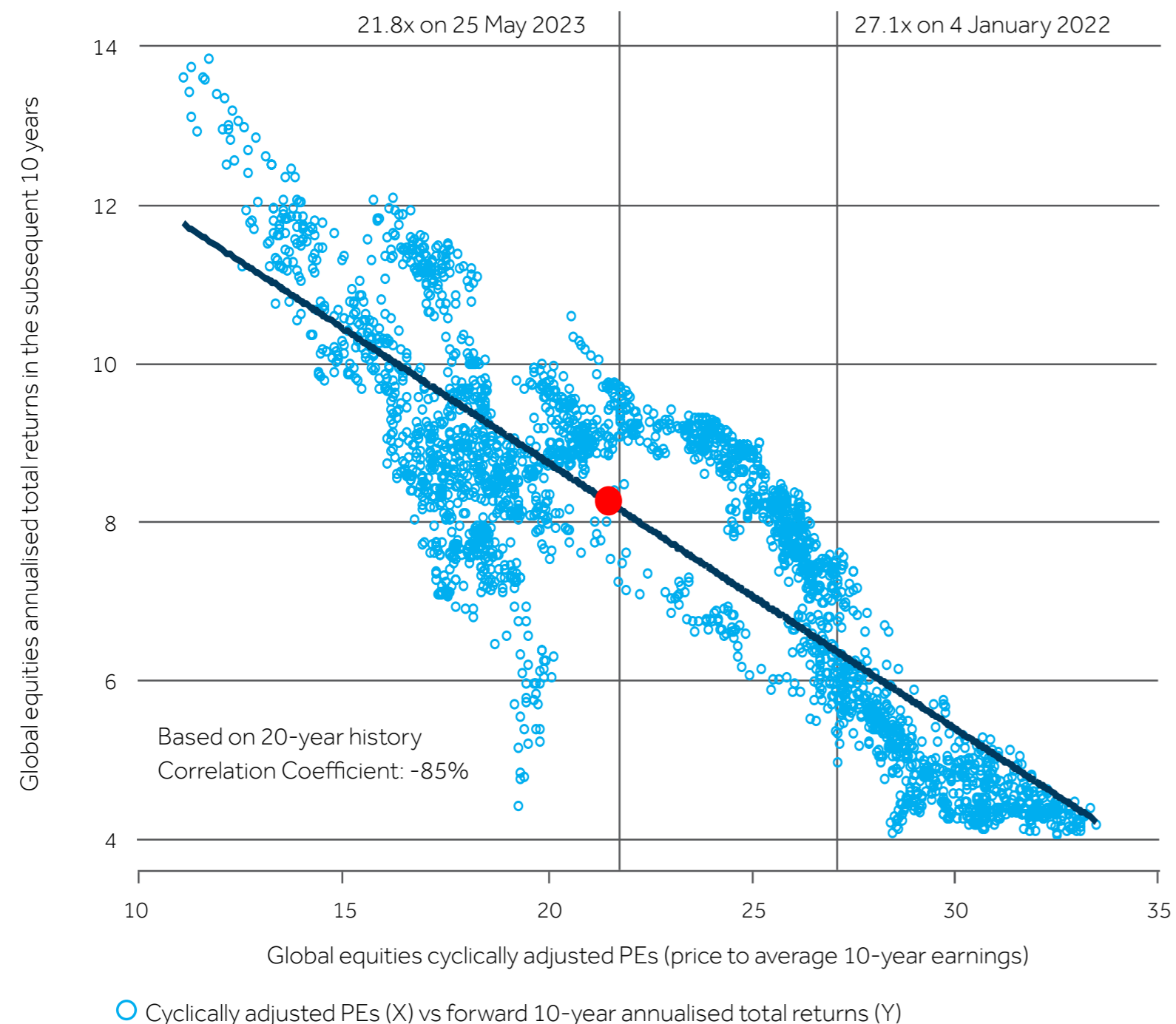
With regards to the banking sector, the valuation discount seems justified given the high level of uncertainty that is likely to prevail in the foreseeable future. The collapse of three US regional banks in March will lead to increased regulatory and liquidity pressures, and their impact on the sector's long-term profitability is difficult to assess at this point. Volatility is likely to remain elevated in the sector, and in the absence of a catalyst, the sector is unlikely to re-rate.

However, in the case of the energy sector, depressed valuations represent an attractive opportunity for long-term investors. Energy stocks have underperformed in recent months, due to recession fears and the decline in the oil price.

That said, stock prices have lagged their relationship with earnings, and the oil price should be supported by tight supply dynamics. The sector also represents an attractive hedge against inflation and geopolitical risk. Therefore, despite its sensitivity to a slowing economy, adding exposure to the energy sector on weakness may have merits. With the sector likely to remain volatile in the near term, shorter-term investors should favour capital protected structures.

CYCLICALLY-ADJUSTED PRICE-TO-EARNINGS RATIOS SUGGEST THAT GLOBAL EQUITIES COULD GENERATE ANNUALISED RETURNS OF 8% IN THE NEXT 10 YEARS, INCLUDING DIVIDENDS

Comparing global equities' cyclically-adjusted price-to-earnings ratios and annualised returns in the subsequent 10 years, including dividends



“Historically, cyclically-adjusted price-to-earnings (CAPE) ratios have been reliable indicators of long-term expected returns. At current levels, CAPE ratios suggest that global equities could generate annualised returns of 8% in the next 10 years, including dividends”

At the regional level

We see a similar picture at the regional level, with most markets offering a mixed risk-return profile in the near term.

However, if we take a step back and focus on long-term return prospects, attractive opportunities can be found selectively at the regional level.

Global equities trade at 15.6x forward earnings, in line with their 10-year average, but with significant divergences by region.

The US market trades at a slight premium to its historical average. Large-cap growth and technology stocks, which have driven the rally, look vulnerable if rates remain higher for longer than expected.

However, some markets such as eurozone and UK equities look particularly cheap relative to history. Despite near term challenges, they represent attractive value for long term investors, who can tolerate the volatility.

The market perception is that European equities are likely to underperform their US peers in a recession, as their sector composition is more cyclical. However, there is no evidence to support this contention. The last 50 years shows that the performance of US and European equities during recessions, from their peak to trough, has been around the same.

At the stock level

While most indices are now looking extended versus macro fundamentals, we believe that attractive investment opportunities can still be found in the near term at the stock level.

As discussed in [Tighter credit conditions call for increased selectivity](#), the dispersion of returns within the equity market is unusually low considering that a recession is looming. Stocks have been highly correlated with each other in the past year, driven by common macro factors more than idiosyncratic risk. However, the dispersion of returns should expand in the coming months, as investors become more discriminating and reallocate capital into higher-quality businesses. This should open up more stock-picking opportunities.

At this stage of the cycle, a more defensive, but balanced, positioning makes sense. Investors should focus on reasonably priced companies with established businesses, superior pricing power, stable margins and strong balance sheets. Opportunities can also be found among the more cyclical businesses and those exposed to the credit cycle, as long as they are trading on depressed valuations and discount a deeper recession than expected.

Finally, long-term structural plays are worth considering, as they tend to be less correlated with short-term market moves. Certain investment themes look particularly attractive at present, such as generative artificial intelligence and security (energy, food and cyber security, as well as defence).

In conclusion

Equity markets appear to have run ahead of the macroeconomic fundamentals, driven by a narrow group of stocks and defensive positioning. This implies downside risk to equity prices in the near term, if the economy contracts and corporate earnings decline, as our base case assumes.

In that context, a more defensive but balanced positioning makes sense. With most indices now looking stretched, the bulk of the opportunities lies at the stock level. The good news is that the dispersion of returns looks set to rise in the coming months, as the economy slows down and the weaker players are exposed, opening up more stock picking opportunities for investors.

Author: Dorothee Deck, London UK, Cross Asset Strategist

When the race is on during cycles

As policy rates seemingly near their peak, with inflation showing signs of easing, what are the implications for bond investors?



Please note: This article is more technical in nature than our typical articles, and may require some background knowledge and experience in investing to understand the themes that we explore below.

The first half of the year had plenty in store for bond markets. Rates climbed substantially after having retreated in the months before from the peaks seen back in October last year. In February, the rise in yields was spurred, once again, by inflationary pressures and concerns that the US Federal Reserve (Fed) might need to hike rates towards 6%.

But, as always, different factors were at play, and it was ultimately the peak in rates which exposed the unsustainable business models of some regional banks. In March, Silicon Valley Bank (SVB) collapsed due to the wave of deposit withdrawals from clients who saw better, and safer, yielding opportunities elsewhere.

The sale proceeds of SVB's Treasury holdings were insufficient to meet the bank's liquidity need, given the loss of value caused by the rise in yields.

BETWEEN INFLATION AND GROWTH CONCERNS

The market was quick to pare back estimates of terminal rates in this cycle, with increased concerns that the Fed has finally roke something within the financial system with higher policy rates. Indeed, a handful of medium-sized regional banks failed, but these concerns did not materialise, with the turmoil not turning into a larger banking crisis, as discussed in [Deciphering banking codes](#).

Consequently, the market once again shifted its focus to the inflation outlook again. The good news is that US headline inflation, but also in Europe and to a lesser extent in the UK, has retreated. The bad news is that core inflation has not followed this trend, and so central banks are unlikely to call victory yet.

INFLATION RISK REMAINS

In this environment, the bond market seems to be torn between sticky inflation and further rate hikes on one hand, and negative repercussions to the economy due to tighter financial conditions on the other hand.

This, in turn, has kept rates across the pond within a broad range: the last US rate peaks in October ranged between 3.35% and just over 4% for the 10-year government bond, and in Germany between 2% and 2.7% for the same maturity of debt.

What are the chances that these October highs could be breached again? History suggests that this will ultimately depend on the policy path of central banks and what the market prices for the future policy path. For medium- to longer-term rates to breach the highs, two factors are important: the remaining number of hikes and the timing of cuts further out.

1. Amount of hikes

The Fed and the ECB have stressed during their latest meetings that policy decisions will be dependent on the economic data (a so-called "conditional pause"). Should the economy and the labour market prove to be more resilient than initially expected, then further hikes can certainly not be ruled.

But as US Federal Reserve (Fed) member Austan Goolsbee commented: "There's still a lot of the impact of the 500 basis points we did in the last year that's still to come."¹ Meanwhile, Powell noted that the terminal rate did not seem too far away.

With inflation in the UK only returning to single digits in April², The Bank of England (BoE) must act quickly if it is to get on top of inflation. For a long time, the pressure for lower UK rates seemed to be greater, given the country's economic vulnerabilities.

The latest growth and prices data, however, shows that a recession might be averted in the short term, while core inflation is still on an upward trend, which changed the narrative leading to increased pressure for higher policy rate.

Indeed, the rate market has started to price in more hikes with an implied terminal rate of 5.5%. Four hikes seem ambitious while two hikes appear very likely. While a banking crisis did not materialise the challenge of tighter financial conditions have not entirely disappeared which may limit the amount of hikes to a certain extent.

2. Timing of cuts

The biggest source of upward pressure for rates might be down to the market pricing in cuts too early in America, in particular: the market expects five US rate cuts, compared with two in the UK and eurozone within the next 12 months, from the respective implied terminal rate.

This is clearly at odds with the Fed's intentions. Jerome Powell said, during the central bank's May press conference³: "So, we on the committee have a view that inflation is going to come down not so quickly. It will take some time. And in that world, if that forecast is broadly right, it would not be appropriate to cut rates. We won't cut rates."

Ultimately, the potential upward pressure for rates seems more contained in the US and Europe, than it is in the UK. In the first two-named economies, even a slightly higher terminal rate in combination with a somewhat longer period of peak rates may not necessarily translate into significantly higher rates levels as seen last October. However, in the UK, at least in the short term, this pressure seems to be greater.

The timing of cuts may be open to debate, and this may lead to temporary volatility, but policy-rate cuts will be on the agenda sooner or later and the broader disinflationary trend suggests putting a brake on much higher rates.

This begs the question, when is the best time to buy bonds, or should additional investment in bonds be avoided, given the risk of even higher yields?

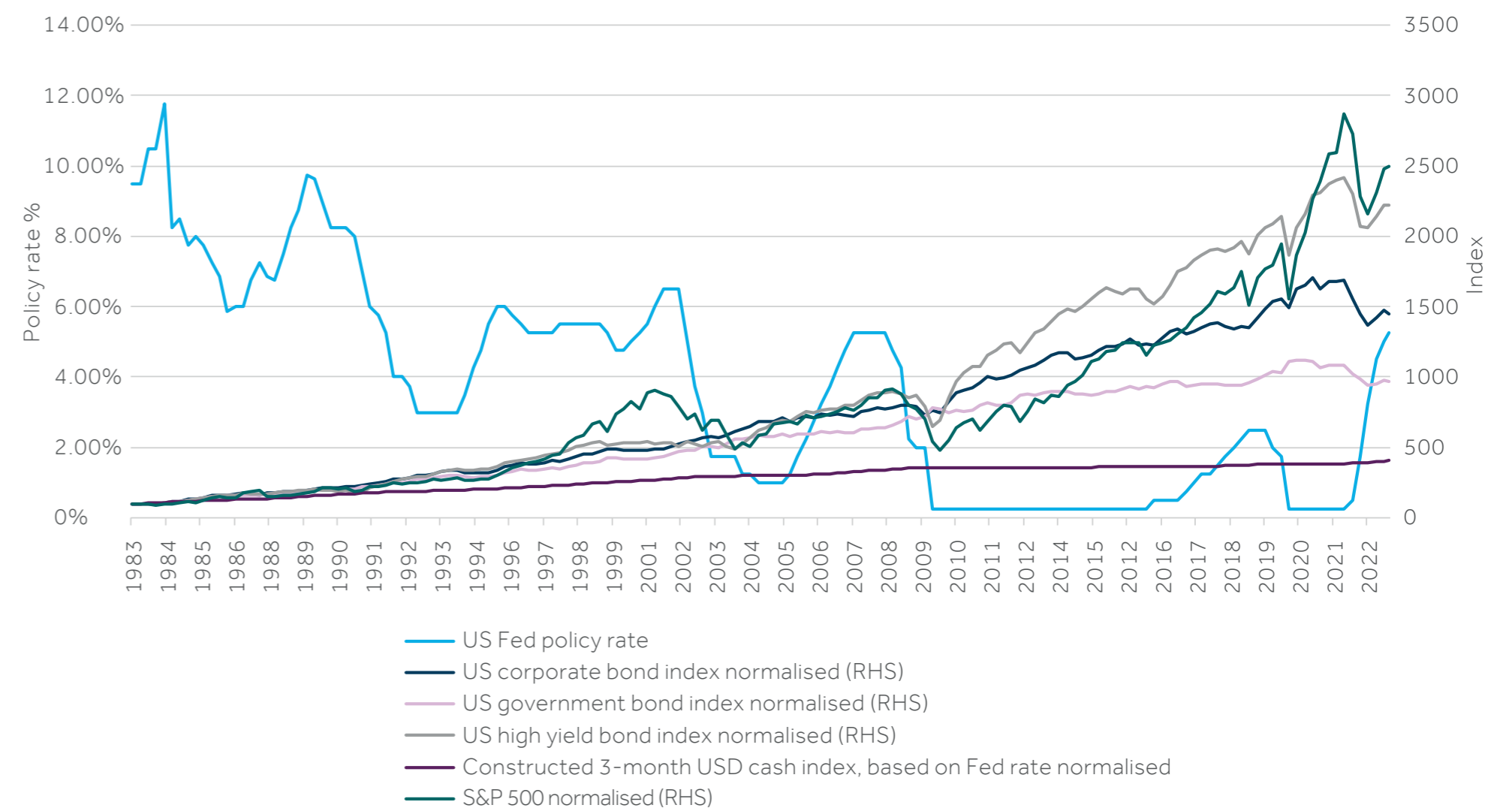
HISTORICALLY, BONDS HAVE OUTPERFORMED CASH

Major bond segments have outperformed cash since 1983 (see chart). Cash has quadrupled in value in the last 40 years. However, bonds shot up in value by a factor of 15 over the same period, for example.

Cash has underperformed substantially over the last 40 years, based on the US policy rate, constructed 3-months USD cash index based on Fed rates against major bond indices and S&P 500.

BONDS OUTPERFORM CASH

The performance of US corporate debt, high-yield debt and government bonds against the fed funds rate and cash



Source: Bloomberg, Barclays Private Bank, May 2023

¹ Ced's Goolsbee: 'way too premature' to expect June rate hike; Reuters, 5 May 2023 <https://www.reuters.com/markets/us/feds-goolsbee-way-too-premature-expect-june-rate-hike-2023-05-05/>

² Consumer price inflation, UK: April 2023, Office for National Statistics, 24 May 2023 [https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/april2023#:~:text=Image%20.csv%20.xls-The%20Consumer%20Prices%20Index%20including%20owner%20occupiers%20housing%20costs%20\(CPIH,of%209.6%25%20in%20October%202022,](https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/april2023#:~:text=Image%20.csv%20.xls-The%20Consumer%20Prices%20Index%20including%20owner%20occupiers%20housing%20costs%20(CPIH,of%209.6%25%20in%20October%202022,)

³ Transcript of chair Powell's press conference May 3, 2023, US Federal Reserve, 3 May 2023 <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230503.pdf>

And still, even someone who invested in a US investment grade bond index in 1978 via Fund or ETF investments for example, prior to the so-called “great rate rise” during the 80s (when US 10-year rates rose from 9% to 16%) would have returned 9.7% per year over the subsequent five-year period, despite suffering temporary mark-to-market losses.

TIMING IS KEY IN THE BOND MARKET

Admittedly, “time in the market” is not the only determining factor when it comes to bonds. Locking in yields at a yield of below 1%, as seen for almost all of the last decade, will return far less than doing so when rates are much higher naturally.

In this case, the level of central bank policy rates are by far the biggest driver for general bond yields and so considering hiking cycles seems crucial.

CATCHING PEAK BOND YIELDS AGAIN

The timing of peak bond yields was examined in our Outlook 2023: [The road to normalisation for bond investors](#) concluded that: “During past hiking cycles, including in the 1970s, the US 10-year rate usually peaked either at the moment short rates hit their top or slightly before, with the respective peak usually close to, or even below that seen in the policy rate.”

While predicting the ultimate peak correctly is a difficult task, as [The dangers of complacency](#) found, peak US policy rates lasted roughly six months, on average, while two years later, the respective policy rate was only roughly 60% of the levels seen at the highest rate: this would suggest locking in yields rather waiting too long, only to find that rates are much lower than was expected.

“Ultimately, the potential upward pressure for rates seems more contained in the US and Europe, than it is in the UK”

SLICING THE CYCLES

What does investing at, or near, peak rates mean for bond performance? And perhaps more importantly, wouldn't it be better to stick to higher cash rates rather being exposed to market losses, if rates rise further or don't fall swiftly?

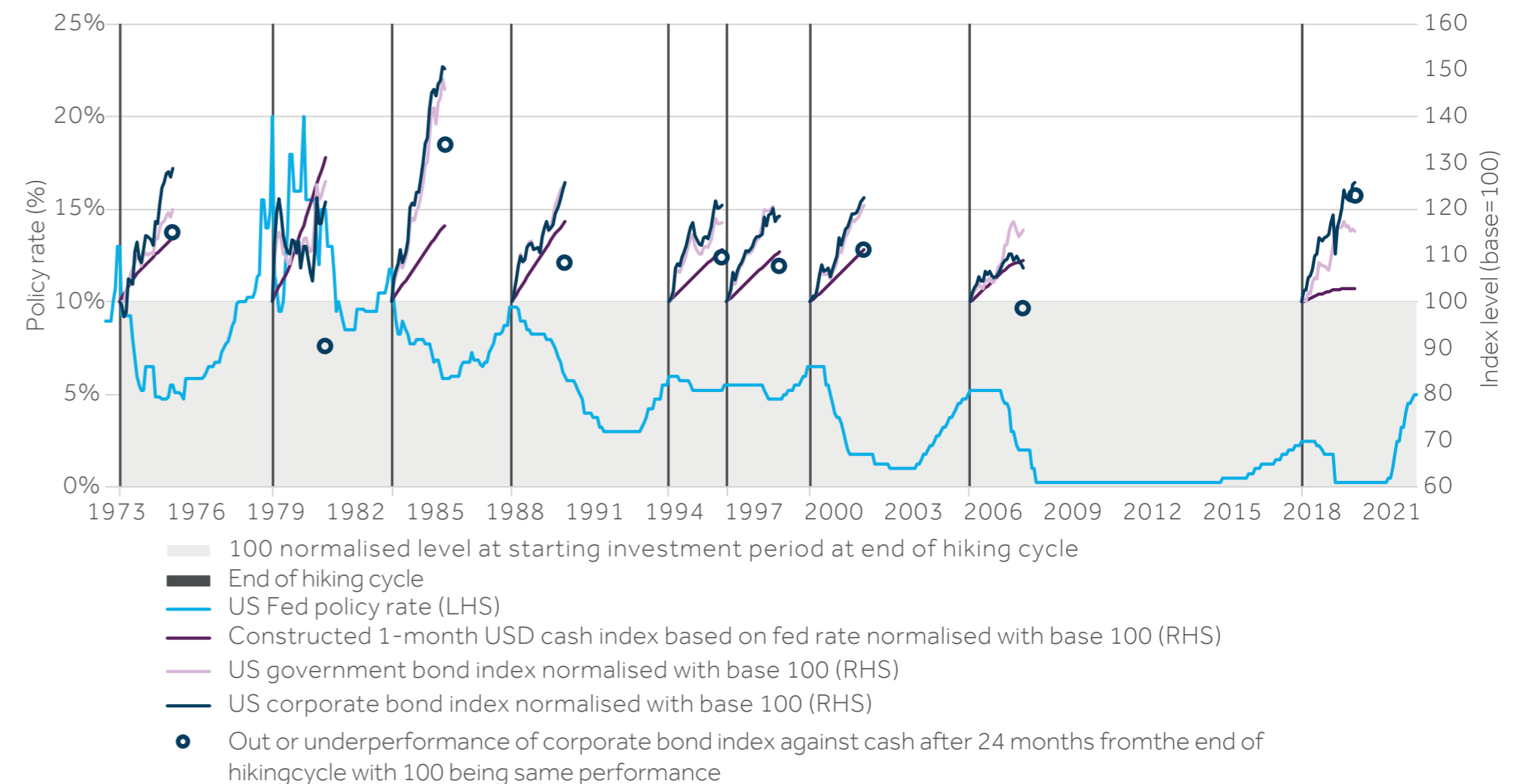
As the chart shows, during the last nine hiking cycles investment grade corporate bonds (based on the Bloomberg USD corporate bond index, with duration of around 6-8 years on average in dark blue) performed very well in the two years after the peak was reached.

In fact, corporate bonds have outperformed cash, in all but two cases substantially, by over 12%, on average, since 1977. This is shown by the blue circle, with the outperformance shown as the respective value greater than 100 (grey area) against the performance of a strategy re-investing in cash or deposit rates.

This outperformance was realised even when engaging three months prior a respective peak in policy rates has been reached: on average by 10% for investment grade corporate bonds in the subsequent 2-year period.

CORPORATE BONDS TYPICALLY OUTPERFORM CASH AHEAD OF A RATE PEAK

The performance of US government debt, the fed funds rate and corporate bonds during the nine US hiking cycles since 1973



Source: Bloomberg, Barclays Private Bank, May 2023

TAKING A CLOSER LOOK AT OUTPERFORMANCE

A closer look at the performance ranges of corporate bonds in comparison with cash, but also other segments like government bonds, high yield bonds or emerging market bonds, seems justified.

Not only have corporate bonds usually performed best, on average, in a two-year period beginning three months before the US policy rate peaked, but performance has been positive in any of the last nine cycles since 1973.

The chart shows that cash returns appear to be more stable, and also value (at least on a nominal basis) was not lost, but this came at a cost, in the form of significantly lower average returns, as explained previously.

HIGH YIELD BONDS

While high yield bonds have racked up a positive performance, they underperformed other bond segments during the period. During the last five cycles (the period that historical data is available for) high yield bonds returned 18%, compared to the 25% achieved by investment grade corporate bonds over the same period.

An 18% return may appear high, but then rates have been much higher than seen more recently. Taking on additional credit risk and underperforming by 7% on average against respective government bonds, reflects the underwhelming return.

The main reason seems to be the fact that the primary driver for performance is lower trending rates during the observation period, while high yield bond spreads likely trended wider going into a slower-growth environment, typically evident when central banks start trimming rates again, as mentioned in [Credit cycle in the wake of the incoming rate tide](#).

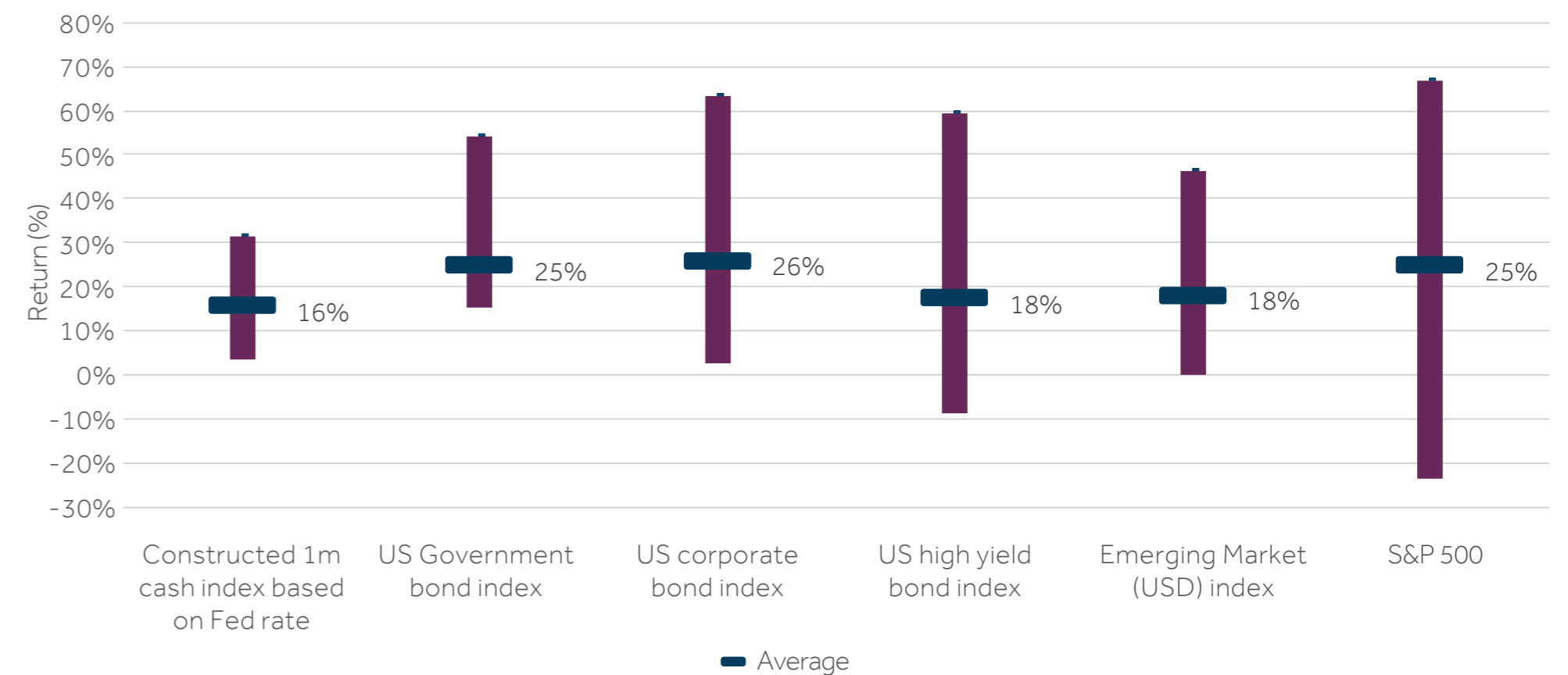
THE COST OF WAITING TOO LONG

While calling the peak in policy rates may be fruitless, history suggests that investing in investment corporate bonds should produce a positive performance, from an absolute and relative perspective, in times when policy rates are close to their peak. Waiting too long on the other hand may result realising only lower yields during the next cutting cycle.

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

HIGH YIELD BONDS UNDERPERFORM INVESTMENT GRADE BONDS AFTER HIKING CYCLES

Comparison of how cash and major bond markets performed in the two-year period starting three months before the peak in the fed policy rate



Source: Bloomberg, Barclays Private Bank, May 2023

No challenger in sight for King Dollar?

Just how likely is the US dollar to lose its crown as the world's reserve currency in the near term? This article digs into the last eighty years of data to find out whether, despite the dollar's weakening grip on its crown, any challenger is in sight. As the greenback fights for its dominance, opportunities are likely to emerge for investors.



In 1965, French minister of finance Valery Giscard d'Estaing called the US dollar's reserve status as the world's currency an "exorbitant privilege"¹. While less explicit than at the end of the Bretton Woods era, the hegemony of the greenback has not lost any of its effectiveness to this day.

The dollar's "privilege" can be seen in the US' ability to pass the inflationary effects of domestic policies and military expenditures onto others², and its de facto immunity to balance-of-payments crises, like the one that hit the eurozone periphery in 2012.

It is also the spice that draws investors to a market, despite dysfunction seemingly rife in America's political system, with the latest chapter being around the debt ceiling.

KING DOLLAR'S STATUS

While the US draws many advantages from its hegemonic position, suggestions that its sources of power may be about to end have repeatedly been dismissed.

Leaning on academic research into the monetary systems and power theory³, three key pillars of power that constitute a global currency can be identified: economic monetary capability, political monetary capability and currency influence. Currency influence summarises the functions of money (such as a medium of exchange, unit of account or store of value) at a global level.

"Problems of fiscal management and fears of a US default could not only deter investors, but might threaten the dollar system"

¹ The dollar's international role: An "exorbitant privilege"? , Ben Bernanke, Brookings Institution, 7 January 2016 <https://www.brookings.edu/blog/ben-bernanke/2016/01/07/the-dollars-international-role-an-exorbitant-privilege-2/>

² When did the dollar overtake sterling as the leading international currency? Evidence from the bond markets. Livia Chitu, Barry, Eichengreen, Arnaud Mehl, May 2012 https://www.nber.org/system/files/working_papers/w18097/w18097.pdf

³ For the three pillar typology, see Dollar hegemony: A power analysis, C Norrlof; 2014; also The US dollar's continuing hegemony as an international currency: a double-matrix analysis, A Kaltenbrunner, 2017 https://eprints.whiterose.ac.uk/104402/3/2ndDC%28final%2520corrected%29resubmit_13_7_16_authors%5B1%5D.pdf.

THE FIRST PILLAR: A FINANCIAL BEHEMOTH

The first pillar, economic monetary capability, is derived from a country's heft in the world's gross domestic product (GDP), trade and capital markets. It is the gravitational force that draws the global demand for a country's currency.

A reserve currency's pulling power can be explicitly institutionalised — as was the case during the Bretton Woods era, which essentially covered the three decades from the second world war, where a set of rules generated demand for a currency — but it need not be explicit.

While there are challengers to the US's leading position in global GDP and trade, its lead in (investable) capital markets is gigantic. The second largest "producer" of central government debt, Japan, issues only 17% of central government debt, while America accounts for 41%, according to the International Monetary Fund (IMF, see chart).

High levels of debt are often interpreted as a source of risk and instability. In the case of the established global currency, however, they also represent a globally sought-after good.

THE SECOND PILLAR: LEADING MILITARY POWER

A country's military power and ability to impose its rules on others reflects the political dimension of monetary capability.

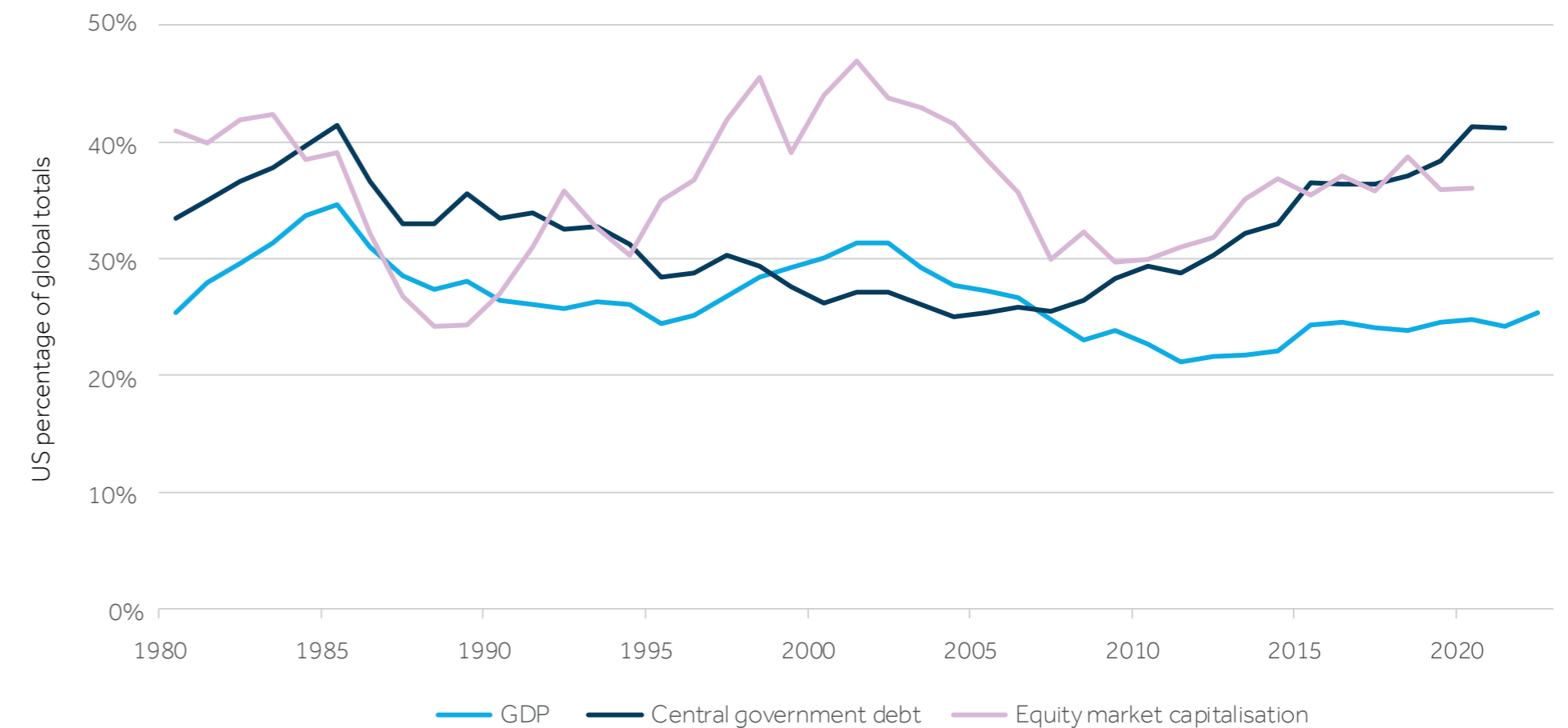
After World War Two, the US imposed the Bretton Woods system on the world. After the fall of Bretton Woods in the 1970s it ensured that oil, the traditional lifeblood of global production, was traded in dollars. More recently, it has sanctioned certain countries, not least Russia, for actions America disapproved of via the dollar system.

Like the first pillar, the second one can occur in a blunt or subtle fashion. Regional challengers have arisen, but for the foreseeable future, the threat of exclusion from the dollar-backed system, or disadvantageous treatment regarding market access, is very real.

Defence spending is a common gauge of military power, though it can be distorted, temporarily, by military operations. The US forces' might can be seen in annual military spending that trumps the EU, China and the UK combined (see chart p32).

US CAPITAL MARKETS ARE A GLOBAL COMMODITY

US share of global GDP, central government debt and equity market capitalisation



Sources: IMF, Barclays Private Bank, May 2023

THE THIRD PILLAR: A CURRENCY TURNED COMMODITY

The next pillar highlights a currency's ability to fulfil the three roles of money globally. Within a currency area, these three roles are to act as a medium of exchange within its borders, serve as a unit of account and a store of value.

Historically, when one of these roles was not fulfilled properly, others were quick to act and install a commonly-trusted means of payment or storage, such as the greenback itself. The same functions need to apply for a global currency to be successful.

For instance, if institutional investors need to increase their holdings of highly-rated government debt, to cushion for turbulent markets, they will probably need to buy US dollars, as the American government issues over 80% of top-rated sovereign debt globally⁴.

While not tracking all dimensions of currency influence perfectly, currency reserves are a good indicator for the third pillar. In this respect, the greenback is peerless (see chart, p33).

NO CHALLENGER CAN COMPETE ON ALL LEVELS

In the aftermath of using the dollar-backed financial system to limit Russia's ability to trade following the latter's invasion of Ukraine, many administrations have been investigating ways to establish an alternative to the greenback.

Recent settlements of energy commodity trades in the Chinese yuan, Indian rupee or Brazilian real have stirred much excitement in some quarters. However, looking at the three pillars, no serious challenge to the dollar is on the horizon.

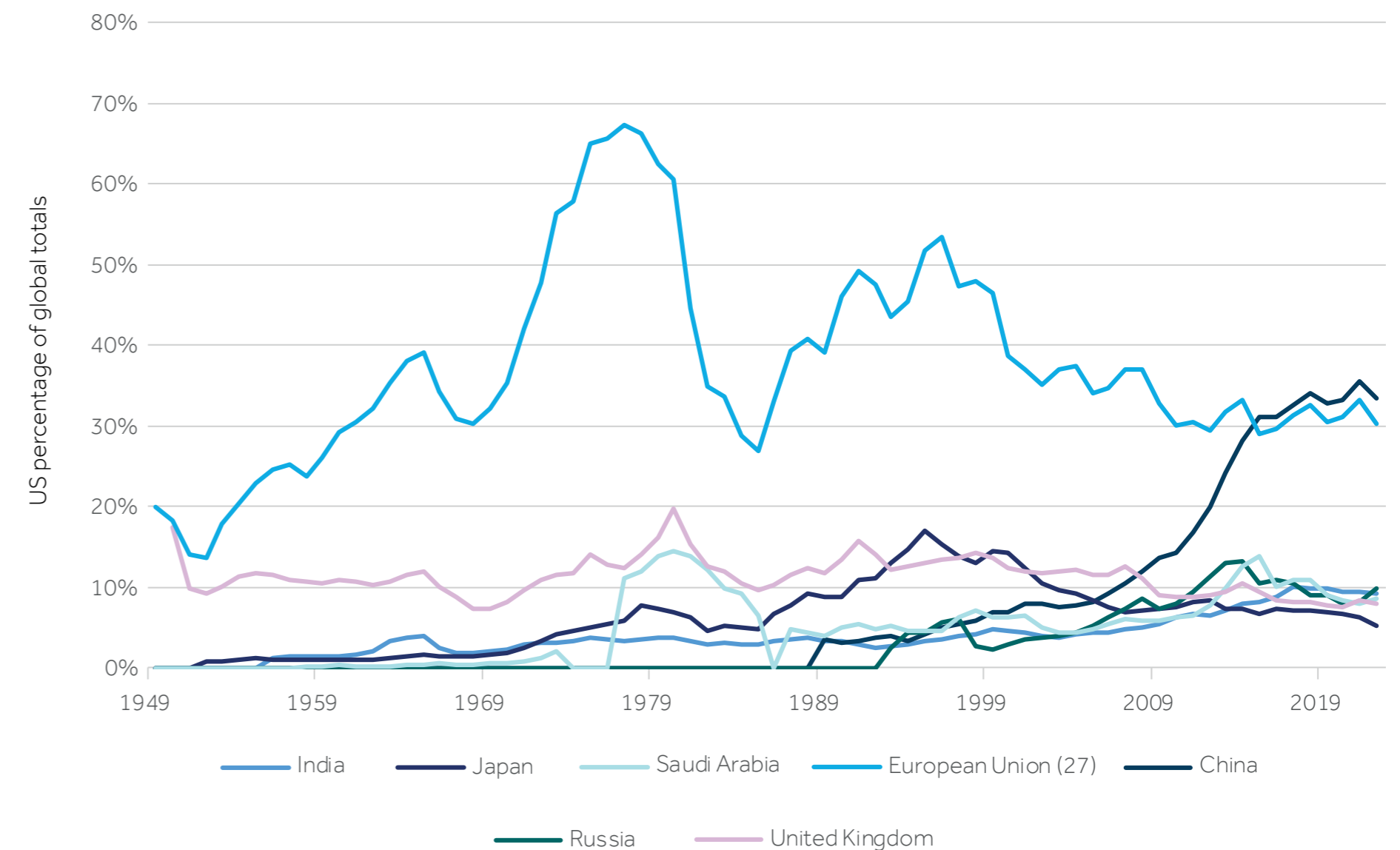
"Still, without currency influence, the yuan does not pose a substantial threat to the dollar"

The most established challenger is the euro. Its introduction around the turn of the millennium has seen the currency supersede the greenback as a European invoicing currency.

But to this day, euro capital markets remain fractured without the backing of a fiscal union and the issuance of common debt. It is unlikely that the single currency will surpass its current level of use as an international reserve currency, of around 20%, soon.

NO-ONE COMES CLOSE TO SPENDING AS MUCH AS THE US

Annual defence spending for different countries and regions as a percentage of that spent by the US



Sources: SIPRI Military Expenditure Database, Barclays Private Bank, May 2023

CHINA'S DRAWBACKS

Among recent incumbents, China does rival the US in economic dimensions at least when it comes to size of market and trade, and it may even pose a military threat to the throne. Furthermore, while the country has a gargantuan debt market, it is not investable. Instead, the debt is mostly domestic and state-owned.

Investing directly in China over the long term remains a challenge for international investors, as there is no free movement of capital.

Ironically, it is precisely the size of the domestic debt market, that makes it very unlikely that China will open all doors to international investors in the near term. Regarding political power, the country has gained influence in many parts of the world and has institutionalised it as Asia's largest economy challenges the authority of the US.

Still, without currency influence, the yuan does not pose a substantial threat to the dollar. Currently, China's efforts to install itself as a lender of last resort are largely concentrated in the countries in its so-called China Belt and Road initiative, with the country responsible for lending equivalent to 20% of the level of IMF lending⁵.

NO MULTIPOLAR WORLD IN SIGHT

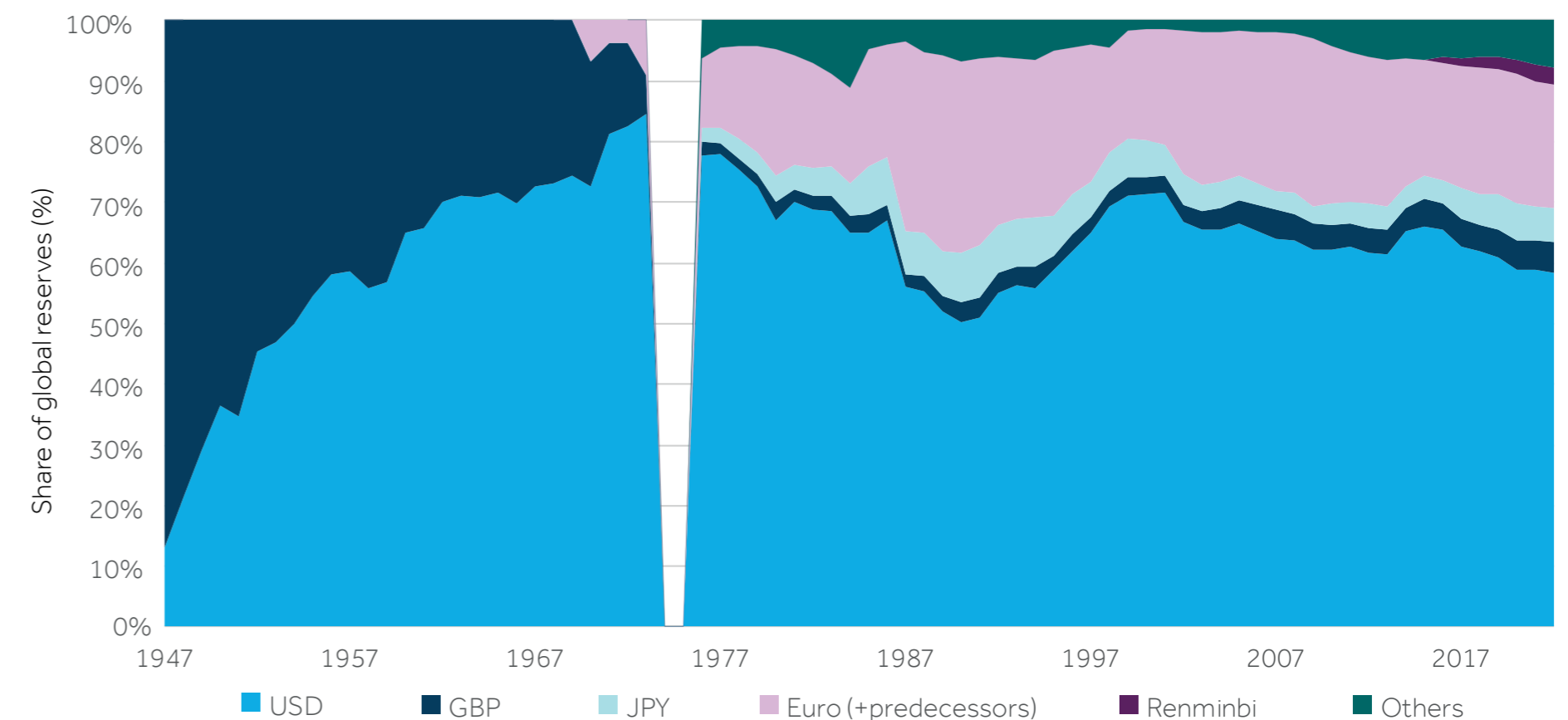
While undoubtedly still king, the dollar's grip on currency influence has weakened of late (see chart). Regional challengers are building a foothold. That said, they face major obstacles to be able to spar with the greenback for primacy. As such, a multipolar future, and the potential shifting sands of geopolitics, seem unlikely in the next decade.

Moreover, a currency transition is unlikely to happen overnight. This was seen when sterling lost its status to the US around a century ago⁶, while staying competitive as a public-debt issuer until 1935 and by currency-reserve usage until the 1950s.

Likewise, turning from a fiat currency, whether dollar-backed, gold-backed or even the distant prospect of using bitcoins as a global reference, is not an option: the history of failing gold-pegs suggests that both economic and financial systems need flexibility and room to inflate (see chart, p34).

KING DOLLAR: PEERLESS AS A RESERVE CURRENCY

The shifts in countries' or regions' share of global currency reserves since 1947, shows that the US dollar's ascendancy to be top-dog in the 1950s looks secure for now*



Sources: IMF, Barclays Private Bank, May 2023

* Own calculations based on numerous IMF publications, since 1951. For methodology and sources, see Stability or upheaval? The currency composition of international reserves in the long run, Barry Eichengreen, Livia Chitu, Arnaud Mehl, August 2014 <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1715.pdf>

Note: There is no data available for 1974 and 1975, after the breakdown of the Bretton Woods system in the 1970s.

⁴ Based on S&P, Moody & Fitch ratings and own calculations with IMF global debt statistics

⁵ China as an International Lender of Last Resort, Sebastian Horn, Bradley Parks, Carmen Reinhart, Christoph Trebesch, March 2023 https://www.ifw-kiel.de/fileadmin/Dateiverwaltung/Ifw-Publications/-ifw/Kiel_Working_Paper/2023/KWP_2244_China_as_an_International_Lender_of_Last_Resort/KWP_2244.pdf

THE DOLLAR'S REIGN HINGES ON ITS INFLUENCE

By excluding the Russian central bank and others from the dollar system in February 2022, the US “weaponised” its currency, but also endangered the one pillar of power where it faces least competition.

The US must tread carefully to ensure it doesn't deter investors from continuing to buy its biggest commodity. Problems of fiscal management and fears of a US default could not only deter investors, but might also threaten the dollar system, should demand for the greenback plunge.

“The second largest “producer” of central government debt, Japan, issues only 17% of central government debt, while America accounts for 41%”

PROFITING FROM CHINKS IN THE ARMOUR

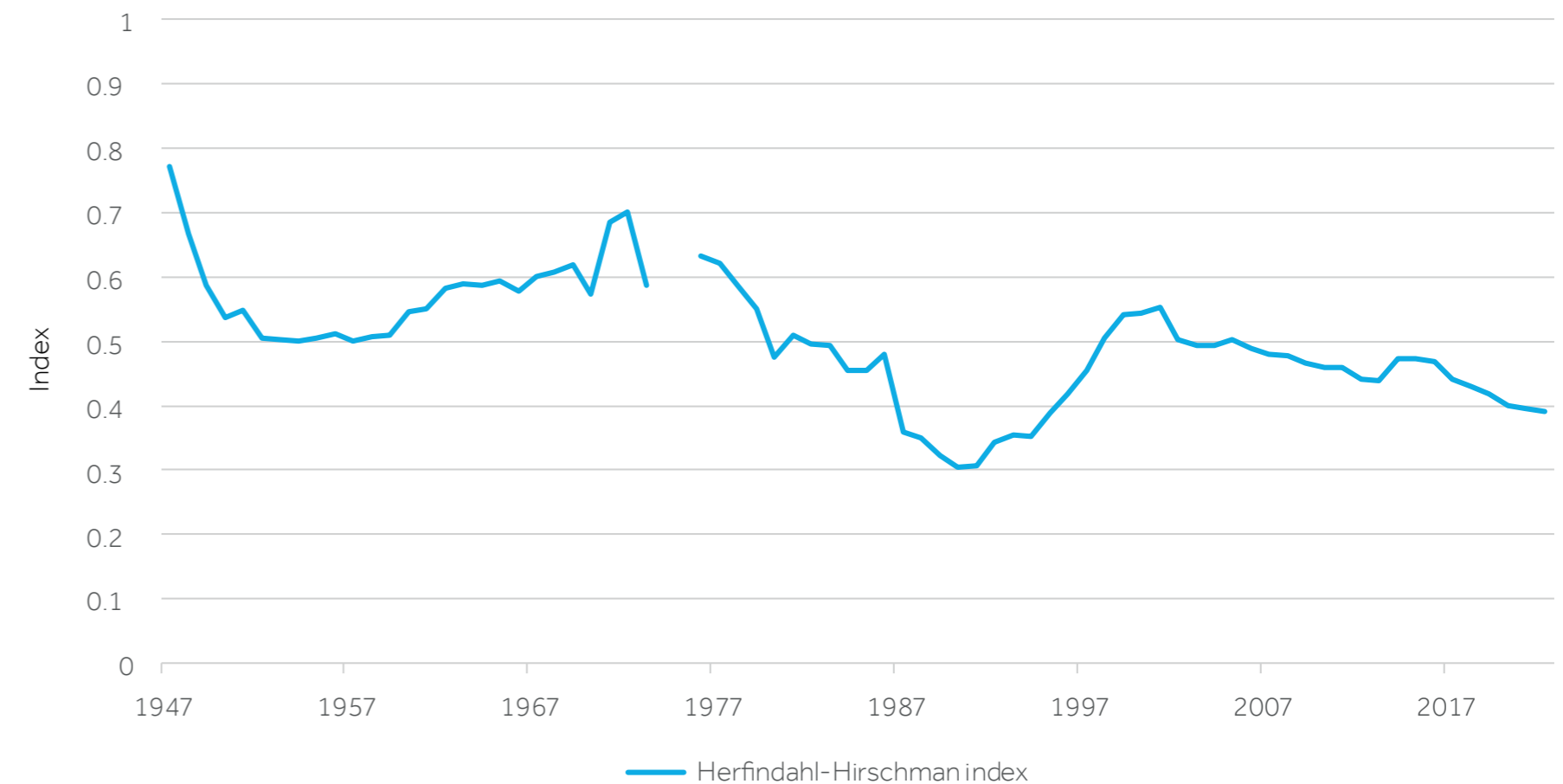
The gravitational forces which draw investors to the dollar are reinforced during economic slowdowns due to the safe-haven status of the currency, and linked to this, the heightened demand for assets that are perceived (and rated) as being safe. This implies that, at the onset of such a slowdown, taking positions against the dollar would seem unwise, no matter the view on challenger currencies.

For the next twelve months, and beyond, the dollar is expected to weaken from its current, expensive levels. As such, diversifying currency exposure into say Asian hubs might help to reduce portfolio risk (for more information, see Targeting alpha in Asian equities).

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

THE US DOLLAR'S GRIP ON POWER IS SLIPPING

Analysis, using IMF data, of the US dollar's global usage as based on the Herfindahl-Hirschman index. The index ranges from $1/N$ to one, where “N” is the varying number of currencies in the sample and one is the highest concentration possible



Sources: IMF, Barclays Private Bank, May 2023

Is your portfolio ready for biodiversity loss?

Getting to grips with the biodiversity-related risks in a portfolio, could be an important lesson for investors keen to protect both their wealth and the planet's health.



While nature surrounds us, investors might have little idea of the critical role it plays for businesses and economies. More than half of the world's gross domestic product (GDP), or approximately \$58 trillion of economic output, is highly or moderately dependent on nature¹.

Loss or damage to the value of environmental and ecosystem assets have implications for portfolios. Unfortunately, human activity is increasing the threats to nature², and therefore to investors.

While some investments offer possibilities to protect and restore nature, this article aims to improve your awareness of the potential biodiversity risks that might lurk in your portfolios.

HOW NATURE CAN AID ECONOMIC OUTPUT

Through a financial lens, nature might be seen as a stock of environmental assets. According to the United Nations, these can be defined as "The naturally occurring living and non-living components of the Earth, together constituting the biophysical environment, which may provide benefits to humanity."³

More simply, this includes renewable and non-renewable natural resources, ranging from plants and animals to air, water, soil and minerals. These stocks have value, both intrinsically and to the organisations and people who benefit from them.

Natural capital can be found in four "realms" – land, ocean, freshwater and atmosphere – which fundamentally differ in how they operate and function, according to the Taskforce on Nature-related Financial Disclosures⁴. Beneath these realms, thirty-four "biomes", such as savannas and grasslands, lakes, or coastal inlets and lagoons, classify areas that share similar features, based on similar levels of precipitation and temperature.

Within realms and biomes, environmental assets and associated ecosystems provide services that benefit people, companies, and the global economy (see diagram on p36). This might include natural resources like timber for housing, or freshwater for industrial processes. Other assets and ecosystems could help to regulate and maintain natural cycles around climate, water or nitrogen. For example, according to a 2018 Oceanography article, oceans have absorbed more than 90% of excess heat caused by human activity since 1971⁵. Finally, nature provides personal experiences or intangible services for cultural, recreational or tourism purposes, such as hiking through national forests, or hotels sited along coastlines.

Companies benefit from these ecosystem services, individually or combined, to generate financial value. Moreover, they can profit from many of these services without having to "purchase" them from nature.

¹ Managing nature risks: From understanding to action, PwC, 19 April 2023 <https://www.pwc.com/gx/en/issues/esg/nature-and-biodiversity/managing-nature-risks-from-understanding-to-action.html>

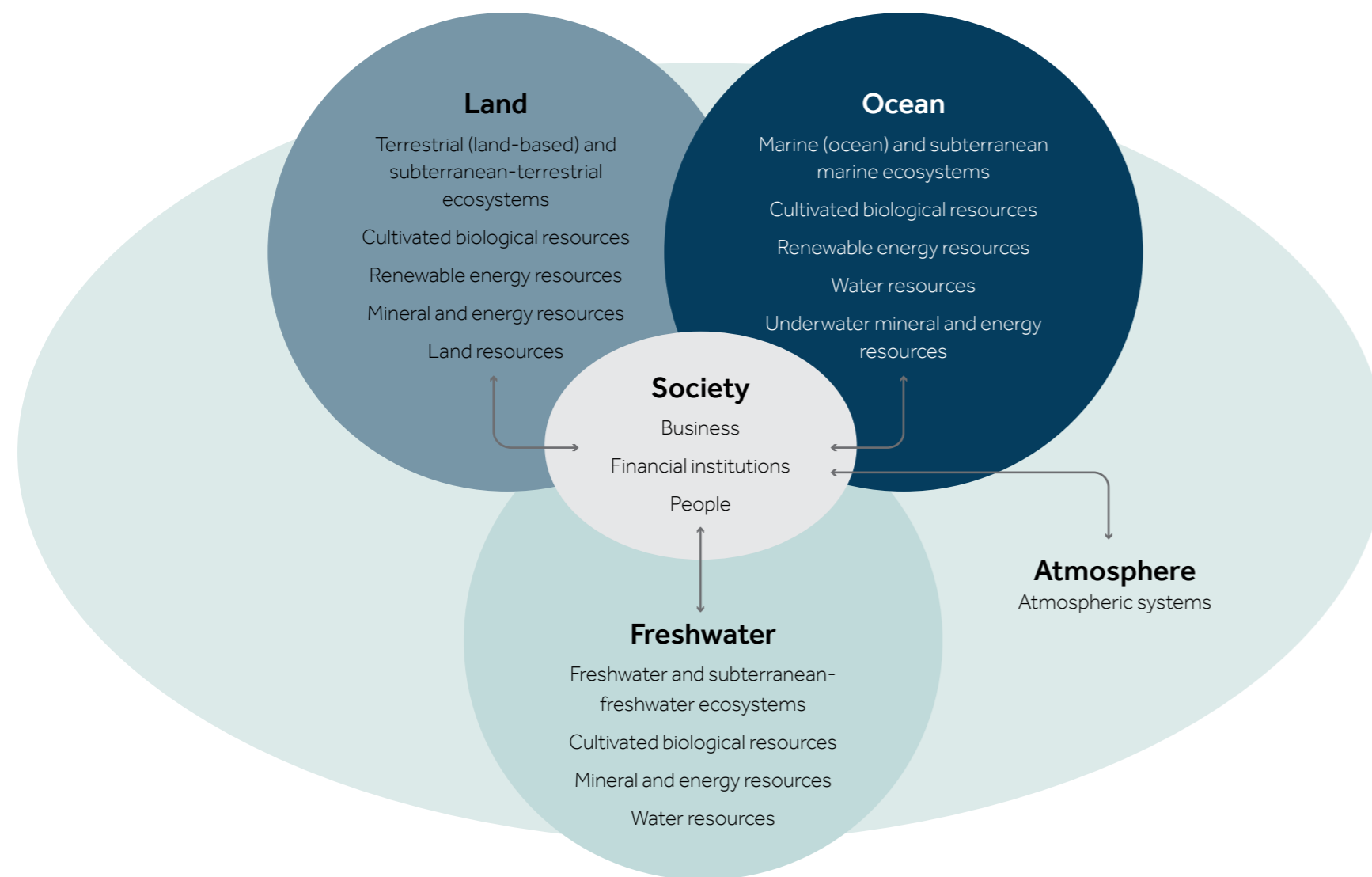
² Anthropogenic activities and biodiversity threats, Saduru Prakash and Ashok Verma, International Journal of Biological Innovations, 3 March 2022 <https://ssrn.com/abstract=4048276>

³ System of Environmental-Economic Accounting, Ecosystem Accounting, United Nations System of Environmental Economic Accounting, 2 September 2021 <https://seea.un.org/ar/node/2979>

⁴ Introducing the TNFD framework, TNFD, May 2023 <https://framework.tnfd.global/introduction-to-the-framework/executive-summary/v04-beta-release/>

⁵ Ocean Warming: From the surface to the deep in observations and models, Oceanography, 9 December 2018 <https://doi.org/10.5670/oceanog.2018.227>

ENVIRONMENTAL ASSETS BY REALM



Source: Taskforce on Nature-related Financial Disclosures, United Nations, May 2023

WHY SHOULD INVESTORS PAY ATTENTION?

Seeing nature as a type of capital recognises that even apparently 'free' resources have financial value. These resources reduce in value when lost or damaged. Moreover, adverse changes to this capital's worth can hit the value of the economic activities and businesses that rely on it.

Simply, if overfishing causes a fish stock to collapse, then so too does the associated fishing industry. Or, if over-extraction of freshwater, combined with climate-induced water scarcity, causes extra water stress, industries such as textiles and mining might no longer be able to operate.

Governments, regulators and industry are increasingly recognising the importance of nature to their economies and our ability to sustain life. For instance, more than 190 governments made commitments in December 2022 at the fifteenth United Nations Conference of the Parties (COP15) to the Convention on Biological Diversity that solidified global goals and ambitions around biodiversity⁶.

Protecting the environment is moving up the political agenda, reflected in various countries combining legislation, regulation and fiscal spending to preserve and restore biodiversity. For example, biodiversity is embedded in the European Union's Taxonomy Regulation⁷ and the Sustainable Finance Disclosure Regulation.

In the UK, most future planning permissions granted in England will be required to demonstrate at least a 10% biodiversity net gain⁸. Last year, the US government launched a \$1 billion America the Beautiful Challenge to support ecosystem restoration projects and accelerate land, water and wildlife conservation⁹.

In May, the Taskforce on Nature-related Financial Disclosures (TNFD) published its fourth iteration of its draft disclosure framework for final consultation, ahead of its planned publication later this year¹⁰. As a parallel framework to Task Force on Climate-related Financial Disclosures (TCFD), which has become a leading framework adopted by governments and central banks for mandatory climate disclosures for companies and stress testing for banks, it's possible to envisage TNFD will be similarly mandated.

"Longer-term shifts in ecosystems, while not as obvious today, have deeper implications for companies and communities"

⁶ COP15 ends with landmark biodiversity agreement, United Nations Environmental Programme, December 2022 <https://www.unep.org/news-and-stories/story/cop15-ends-landmark-biodiversity-agreement>

⁷ Regulation (EU) 2020/852 of the European Parliament and of the Council, EU, 22 June 2020 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852#d1e23389-13-1>

⁸ Schedule 15, Environment Act 2021, May 2023 <https://www.legislation.gov.uk/ukpga/2021/30/schedule/15/enacted>

⁹ Biden Harris administration launches \$1 billion America the beautiful challenge to support a and accelerate locally led conservation and restoration projects, The White House, 11 April 2022 <https://www.whitehouse.gov/ceq/news-updates/2022/04/11/biden-harris-administration-launches-1-billion-america-the-beautiful-challenge-to-support-and-accelerate-locally-led-conservation-and-restoration-projects/>

¹⁰ Introducing the TNFD framework, TNFD, May 2023 <https://framework.tnfd.global/introduction-to-the-framework/executive-summary/v04-beta-release/>

FIVE DRIVERS OF BIODIVERSITY LOSS

A starting point for investors to understand potential portfolio risks from biodiversity requires an understanding of the drivers of biodiversity loss. The Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (IPBES) identified five direct drivers of biodiversity loss¹¹.

The first, and biggest¹², driver of biodiversity loss is a change in land and sea use. For example, removing forests for agriculture or cattle usage, mining for minerals or metals, repeated river or marine dredging, all change the biodiversity of the associated biome.

Second is climate change. Changes to weather patterns or increases in water temperatures and acidity can affect near-shore marine ecosystems, for example. The next driver is pollution, primarily from chemicals and waste. Excess nitrogen and phosphorus from fertilisers damages freshwater or marine biomes¹³. Microplastics in oceans are finding their way into fish¹⁴.

Over-exploitation of natural resources is the fourth driver. From marine fish and trees to precious metals and water, humans have, at times, consumed more of these resources than are available or renewable.

Finally, invasive alien species can negatively affect ecosystems by causing the decline or even extinction of native species. As non-native animals, plants, fungi and microorganisms out-compete local biodiversity, the original ecosystems services can be damaged.

HOW BIODIVERSITY IMPACTS COMPANIES

Biodiversity loss has significant implications for companies. Broadly this is either due to their dependency on biodiversity or their impact on it.

Companies depend on biodiversity, as direct or indirect inputs, to generate value. Sectors such as forestry, agriculture and fisheries directly rely on natural capital and ecosystem services for their business well-being. But other sectors may have indirect, but critical, reliance on environmental assets. For example, the use of freshwater in textiles, utilities, food and beverage, data centres, or mining operations.

Here, the physical risks of such natural pollinators vanishing, might lead to higher costs for food producers, or the loss of stocks, as invasive species push out the more valuable native species. In addition, companies will face the transition risks, around reputation or market dynamics, from any potential backlash from consumers and investors for over exploitation.

Businesses also impact biodiversity through their operations or their goods and services. For example, pesticide runoff into water systems can cause fishery stocks to collapse, while construction might fragment or damage local ecosystems.

For industries impacting nature, they face a broad range of transition risks, from regulatory changes that will drive higher costs and, again, consumer or investor pressure. Companies that damage natural environments could face litigation risk with any related additional legal costs.

These financial material risks mean investors will need to assess underlying threats to environmental assets and ecosystems that affect your sector or company allocations.

“More than half of the world’s gross domestic product (GDP), or approximately \$58 trillion of economic output, is highly or moderately dependent on nature”

ASSESSING PORTFOLIO RISKS

In looking to assess the biodiversity risks in portfolios, notably, investment practices are still nascent. While frameworks, approaches and biodiversity data providers are being developed, investors can start by looking from a broader macro or micro level.

For instance, from a macro perspective, developing a deeper understanding of global dynamics and sector-specific risks could provide a useful baseline. And while the investment capabilities might be nascent, scientific research and civil society organisations are long-standing across nearly every theme or sector. Prioritising sectors can be driven by interest, or more pragmatically, a review of current industries in your portfolios.

Recent analysis from PwC has highlighted sixteen industries with high or moderate nature dependency¹. For these industries, the economic value coming from business activities could either fail financially (high dependency) or is likely to experience a material reduction in financial returns (medium dependency) due to particular ecosystem disruptions. This contrasting with activities with low dependency, where there may be limited material financial effects from ecosystem disruptions (see chart, p40).

At the micro-level, investors can evaluate biodiversity risks for assets or companies in their portfolio. Investors will need an appreciation for risks at the industry or biome level, along with an understanding of the local contexts or locations, to fully assess the risks. Here, one component of the TNFD framework, can provide structure to investors’ thinking. While designed primarily as a company disclosure framework, the TNFD guides companies to locate, evaluate, assess, prepare (LEAP) for biodiversity risks¹⁵.

¹¹ Global assessment report on biodiversity and ecosystem services, IPBES, May 2023 <https://ipbes.net/global-assessment>

¹² The direct drivers of recent global anthropogenic biodiversity loss, Science Advances, 9 November 2022 <https://www.science.org/doi/10.1126/sciadv.abm9982>

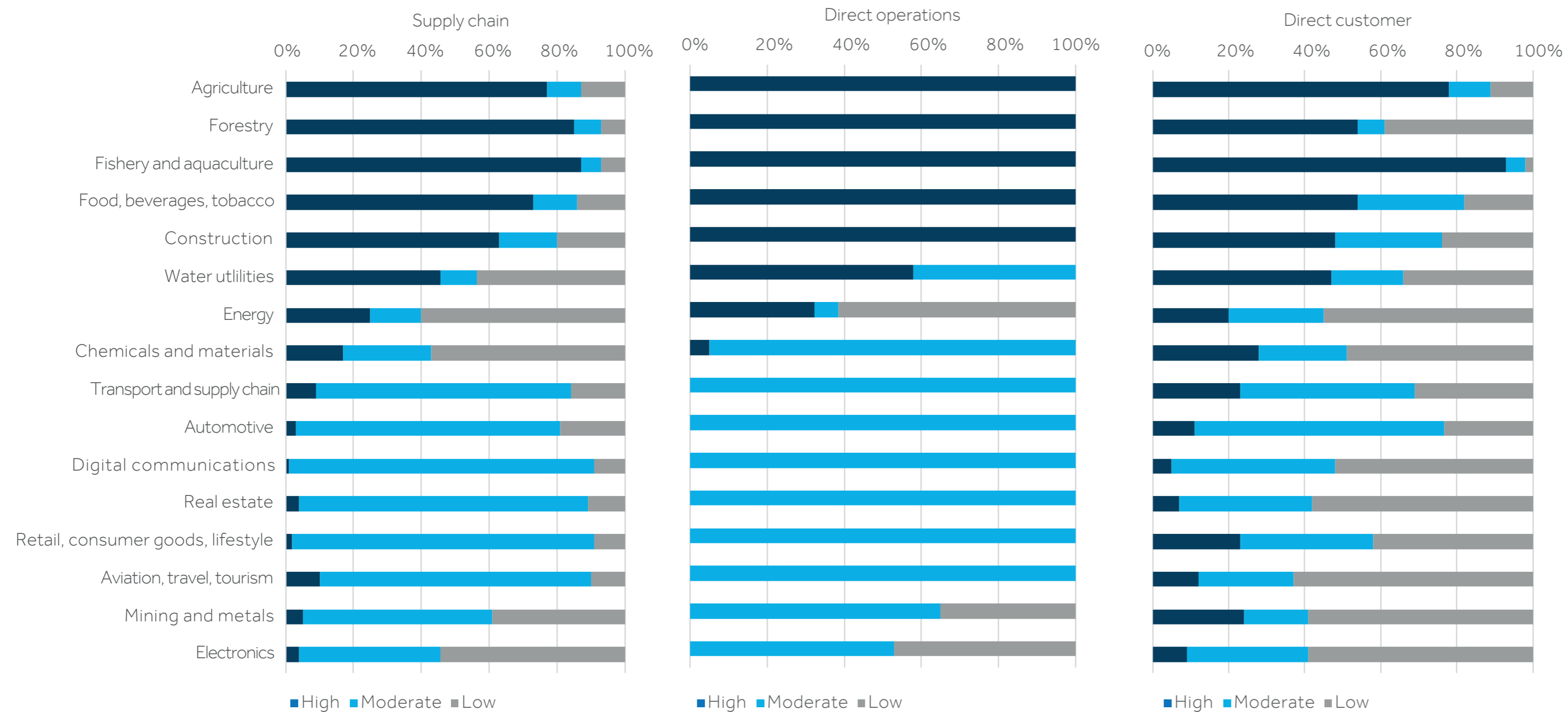
¹³ Nutrient Pollution, US Environmental Protection Agency, 23 March 2023 <https://www.epa.gov/nutrientpollution>

¹⁴ Marine Pollution Bulletin, Science Direct, May 2023 <https://doi.org/10.1016/j.marpolbul.2020.111681>

¹⁵ LEAP – the risk and opportunity assessment approach, TNFD, May 2023, <https://framework.tnfd.global/leap-the-risk-and-opportunity-assessment-approach/>

INDUSTRY DEPENDENCY AND IMPACT ON BIODIVERSITY

The impact of the environment on a range of industry sectors, with reference to their supply chain, direct operations, or immediate customers



Source: Data from PwC, Barclays Private Bank, May 2023

¹⁶ The economics of biodiversity: The Dasgupta Review; February 2021 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/962785/The_Economics_of_Biodiversity_The_Dasgupta_Review_Full_Report.pdf

¹⁷ Media release: Nature's dangerous decline 'unprecedented'; species extinction rates 'accelerating'; ipbes, 5 May 2019 <https://www.ipbes.net/news/Media-Release-Global-Assessment>

While LEAP guidance is intended to support voluntary internal, nature-related risk and opportunity assessments, using the same structure can make investors' efforts more comparable. Thereafter, as metrics, targets, data and reporting continue to standardise, and improve, investors can include such items to their due diligence processes.

ACTING BEFORE IT'S TOO LATE

Incorporating nature into investing is difficult to achieve, not least as it is a relatively new concept. But even if current methods are far from perfect, they are better than nothing, given the level of biodiversity risk commonly faced by investors' portfolios. As well, the risks to "our economies [which] are embedded within Nature, not external to it"¹⁶.

The loss of biodiversity seen in recent decades is accelerating and becoming more visible¹⁷. Given many companies' dependence on nature and its associated scale, environmental loss and damage can be expected to hit investor returns, ultimately.

Longer-term shifts in ecosystems, while not as obvious today, have deeper implications for companies and communities. If the natural world cannot be preserved and regenerated, then society faces even greater risks. Investors should prepare accordingly.

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

Waiting for a tipping point

Scary as it may be, being afraid of investing just ahead of a vicious sell-off can be costlier than staying in cash for too long. While nothing is guaranteed, the rest of the year looks likely to be just as eventful as the first half has been. So, what can investors do to conquer their fears and remain true to their investment strategy through thick and thin?



It has been a tough year for investors, in-part given the economic after-effects of Russia's invasion in Ukraine and the tail-end of the COVID-19 pandemic.

As geopolitical risk, not least Sino-American relations, stalks financial markets, the combination of stubborn inflation, future interest hikes and recession risks, potentially add to further uncertainty and strain in the second half of the year. While it might be time to buckle up, it's imperative that investors don't allow themselves to feel overly anxious.

WAITING FOR THE MIST TO CLEAR

As investors try to judge the path for interest rates, inflation and economic growth, they, along with central bankers, are paying attention to each and every data release for hints on what it might mean for policy and financial markets. Some investors may be holding out for a brighter investing environment, indicated by signs of rate cuts or more vigorous growth in advanced economies, before investing. However, as we've seen in the last year, just as one cloud disappears, another one can take its place. In other words, as investors weigh up all the information, some may be waiting for a tipping point to emerge before seeing an environment more conducive to investment returns.

IS THERE A PERFECT TIME TO INVEST?

But, is there a perfect time to invest? Of course, but only in hindsight. For example, after COVID-19 struck in early 2020, equity markets sold-off and bottomed on 23 March that year. They then quickly recovered. Trying to time the market and invest when valuations are close to their bottom is extremely difficult and can induce investors to take biased decisions that hurt long-term returns (see [Being comfortable with the uncomfortable](#)).

UNDERSTANDING MARKET EXPECTATIONS

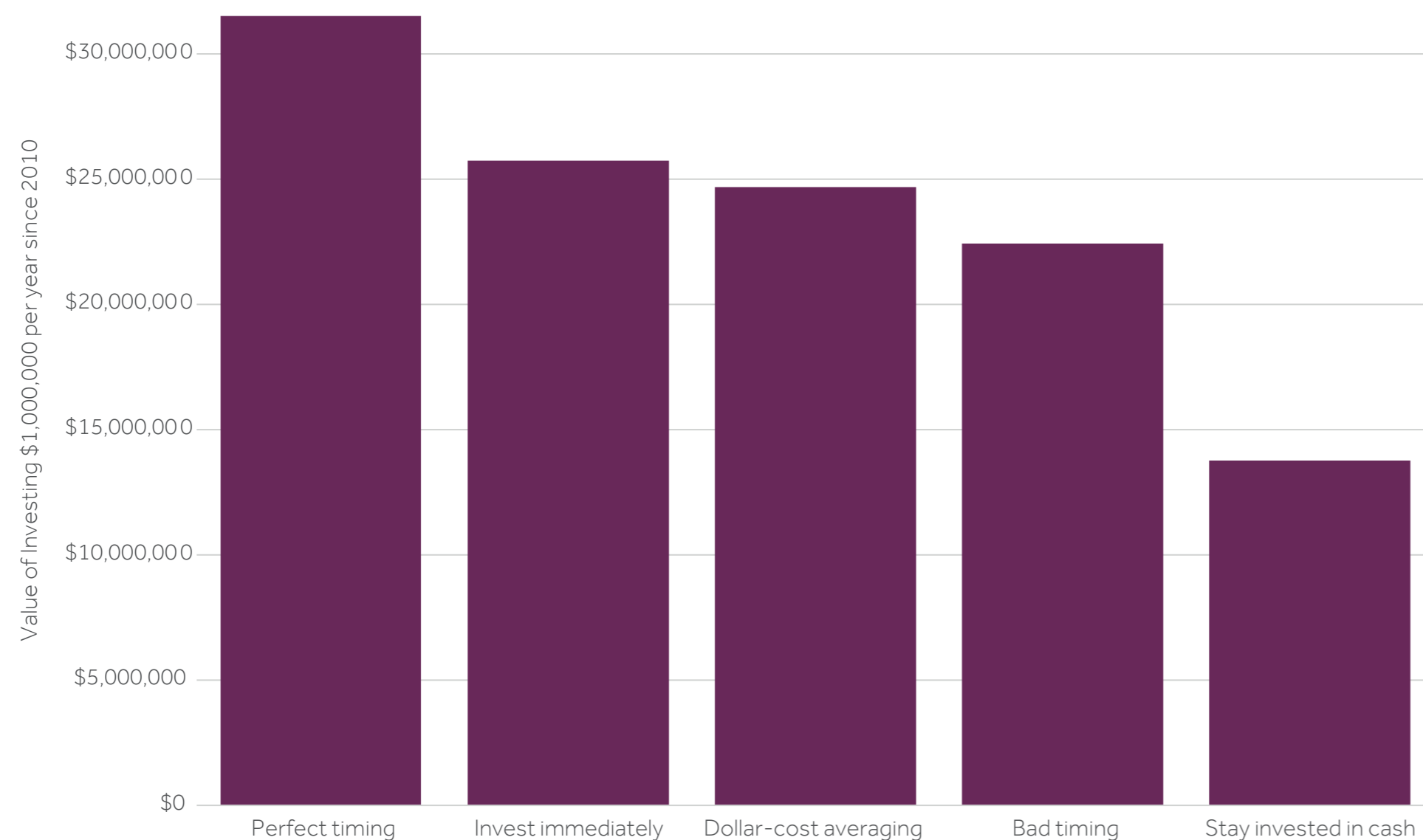
When thinking about market timing, it's important to understand how market expectations are formed. Markets are forward-looking and future events are priced in, which gives investors implied probabilities. For example, OIS forwards currently imply the first 25-basis point rate cut by the US Federal Reserve will be in December 2023.

Because of the forward-looking nature of markets, in many cases the events that investors are waiting for, before taking action, have already been priced in. Therefore, the realisation of the event may cause a security's value to change by much less than an investor expects. Indeed, it is surprises that may have a larger impact on the market; for example, a data point which is worse than expected.

Waiting for an event to happen might mean acting too late and inaction might be counterproductive. This is because while investors are waiting for something to happen, inflation eats into your capital. In such circumstances, even investing in the market at what seems to be the wrong time, can trump doing nothing (see chart, p40).

EVEN BAD TIMING TRUMPS DELAYING INVESTING OVER THE LONG TERM

The wealth of five investors in the S&P 500, following different investment strategies, since 2010 shows that poor timing (or investing at each year's market high) would be worth 63% more than having left the funds in cash



Source: Bloomberg, Barclays Private Bank, May 2023

Note: Perfect timing – Investing in the market every year at the lowest closing point; Invest immediately – Investing in the market on the first day of trading; Dollar-cost average – Investing in 12, monthly, equal instalments; Bad timing – investing at the market's peak for the year; Stay in cash – Treasury bills were used as a proxy for investing in cash.

¹ The average yearly return of the S&P 500 since 1957, when it first became an index of 500 stocks, is 10.13%, as of the end of December 2022.

Source: Official Data, April 2023 <https://www.officialdata.org/us/stocks/s-p-500/1957?amount=100&endYear=2022>

² Barclays Equity Gilt study, 2022, Barclays Investment Bank, July 2022 <https://www.cib.barclays/news-and-events/2022-equity-gilt-study.html>

HOLD YOUR NERVE

Many investors might feel that this year has gone well, simply because advanced economies have avoided a recession, contrary to some economist predictions six months ago. While that may be so, growth has been sluggish. With inflation heading lower at last, albeit more slowly than expected, and central banks turning the interest rate screws tighter, the rest of the year could be stormy (see Global economy: the good, the bad and the ugly, p5).

That being said, the outlook need not be entirely gloomy. The end of the hiking cycle could be in sight. In fixed income, calling the peak in policy rates may be fruitless, and history suggests that investing in investment grade corporate bonds should produce a positive return, from an absolute and relative perspective. In equities, while the near-term outlook appears challenging, long-term prospects remain encouraging, and a more defensive, but balanced, positioning makes sense. That there is no exuberance and investors' sentiment is at best neutral, if not outright cautious, could, counterintuitively, also be seen as supportive.

Also, in the face of bank runs in March, persistent rate rises and fears that the US may breach its debt ceiling, equity markets have been surprisingly resilient. The S&P had roared ahead by 9.5% in 2023, by the end of May.

SUNNIER LONG-TERM PROSPECTS

While the short-term outlook may be challenging, longer term the outlook is better. Focusing on equities, cyclically-adjusted price-to-earnings ratios imply an 8% return over the next ten years (5% if dividends are excluded from performance). By contrast, US 10-year Treasury bonds currently yield 3.7% over the same period. (see Brace for near-term squalls, position for the long, see p20).

So, while it might be worth reducing portfolio risk, by perhaps hedging portfolios against market falls, in the short term, the importance for long-term investors of remaining invested is clear from the point of view of preserving and growing wealth (see [The importance of an optimistic outlook](#)).

THINK ABOUT TODAY

When mulling over whether to invest or not, or whether it is better to do so in bond or equity markets, a sensible approach would be to take a step back and think about one's individual long-term goals, as well as the investment decisions that would likely maximise the chances of reaching them. When investing, people should view the market and their decisions through the lens of their own circumstances.

If the primary aim is to protect and grow wealth for the long term, remember that humanity's ability to innovate lies behind most long-term success stories. And through wars, famines or pandemics, business innovation has invariably persisted.

Worrying about trying to find the perfect moment to act is often a fruitless task. Holding fire and waiting for the ideal moment to strike can introduce complexity and risk into the decision-making process. In doing so, getting hung up on timing the market correctly might ultimately leave you poorer.

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 heightened level of uncertainty in financial markets, and to manage portfolio risks, we prefer higher-quality and liquid opportunities.

FIXED INCOME

- More opportunities are popping up in fixed income
- We still favour developed market government bonds as a hedge against any macro volatility
- In credit, the higher-quality segment is preferred, while remaining 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 are cautious on the emerging markets segment.

EQUITIES

- Equities still seem to be 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 bottom-up selection, more opportunities are seen in developed market equities compared to their emerging market 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 that offer 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

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