The day after the crisis: implications for long-term investors

In a recent piece of paper[1] long-term investors found a broad analysis of the most relevant post-crisis elements they need to consider in order to make a more informed decision about their investments: central banks support, inflation situation, deglobalisation trend, low-carbon transition and inequality assessment were the main features to consider. In light of this perspective, what key challenges investors may anticipate?

The hunt for yield will continue

Central Banks are expected to continue their support to economies with all means at disposal. Nominal interest rates will be low or even very low for the foreseeable future, and the "hunt for yield" will continue, with a progressive allocation to riskier assets. The latter's fair value could also be revised upwards.

Skyrocketing central banks' balance sheets will also have an impact on the overall capital markets structure, especially for bonds. For the latter, at least in the short term, eligibility for Central Banks' purchase programmes will have a strong influence on their attractiveness; companies whose debt cannot be purchased in the context of QE programmes will be at higher risk of default.

Anticipate changes in firms' attractiveness

Furthermore, the deglobalisation trend will cause a shift in the attractiveness of companies in the long term. Rising competitors focusing on a local or regional scope could challenge big global players, whose supply chains were heavily impacted by the crisis and that could be pressed by regulators to partially relocate back to the home country. Strategic sectors such as the pharmaceutical or health equipment industry will be particularly affected: they extensively took advantage of low production costs in developing countries and will need to reconsider entirely their value chains.

Reconsider inflation risk

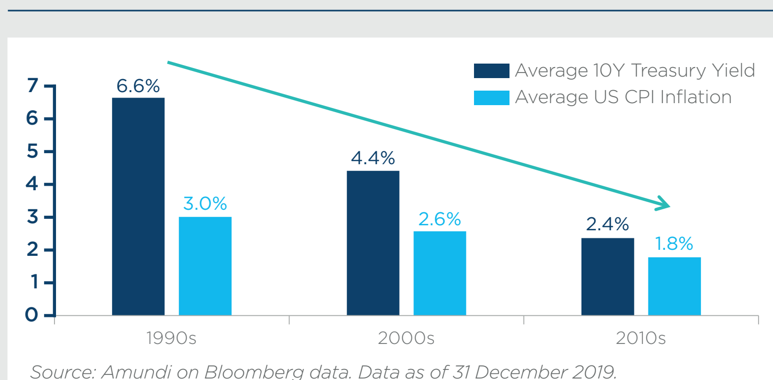
A supportive investment environment benefitted investors for the past three decades, with trends of low inflation and interest rates that contributed especially to the exceptional fixed income market performance. The last decade after the GFC had been especially impressive with strong real returns and low volatility. The latter has suddenly reappeared back in financial markets due to the effects of the global pandemic.

In the next years, inflation risk could also make a comeback. Long-term investors seeking income, like pension funds, should consider dedicating an investment bucket to hedge inflation risk with high allocation to short-term bonds (inflation-linked), real assets, commodities and gold. "Traditional" assets such as government bonds, credit and equities will tend to be more challenged in periods of unexpected inflation.

Fear a financial deglobalisation

The deglobalisation tendency is an element of support towards inflationary trends as well as towards a financial crisis. In fact, a moderate degree of financial globalisation, characteristic of the period spanning from 1890 to the beginning of WWI, could make a comeback. Worryingly, a mild level of financial globalisation was found to be correlated with a higher risk of financial contagion, i.e. "a significant increase in cross-market linkages after a shock" (Accominotti et al., 2020). Thus, in crisis time, we hope for extreme financial globalisation, which is not really the outlook that we can envision.

Inflation and Treasury yield dynamics over the last three decades



Source: Amundi on Bloomberg data. Data as of 31 December 2019.

ESG funds have proved their resiliency

As documented by several recent studies[2], even before the COVID-19 pandemic, share prices of companies with better environmental, social and governance (ESG) performance increased more than their competitors.

As discussed, the pandemic will bring about changes on ESG-related risks and opportunities. What we know with certainty for now is that ESG funds have been very resilient in the midst of the pandemic: while the MSCI World index dropped by 14.5% in May, 62% of large-cap ESG funds outperformed this index[3]. This outperformance partly stems from exposure of these funds to sectors less affected by containment and social distancing measures (e.g. technology and telecom).

On the Exchange-Traded Funds (ETFs) side, a similar phenomenon appeared in the US market: the growth of ESG ETF shares outstanding relative to conventional ETF in the first months of 2020 more than tripled compared to the past decade.

React with a deeper integration of climate change-related risks

Focusing on individual ESG pillars, we can expect that climate change impact on portfolios will heavily depend on which of the scenarios will unfold:

- the optimistic scenario, where climate change is integrated into decision-making process of both public and private sector stakeholders.
- the pessimistic scenario, where short-term objectives such as growth in Gross Domestic Product (GDP), employment, and balance sheet protection overshadow the fight against climate change.
- the status quo scenario, where risks induced by climate change are not fully integrated into recovery plans and internalised by the private sector.

In the pessimistic scenario, on one hand, the materialisation of physical and transition risks could accelerate, with a strong "inevitable policy response" from governments to follow later. A deeper integration of climate change-related risks and opportunities with an increase in low-carbon investments and engagement activities are potential actions for investors to react to both this and the "status quo" scenario.

On the other hand, in the optimistic scenario, clear roadmaps from regulators, enhanced international collaboration and better ESG data disclosure will make investing in line with the Paris Agreement easier and more standardised. Investors should expect ESG factors to materialise more and more in assets' performances and capitalise on these.

Acknowledge the need to incorporate social risk

As far as inequality is concerned, a stronger integration of the social ("S") pillar had already been observed. In fact, after lagging behind the other two factors in the past years, the social factor has been the stronger "ESG contributor" in North American portfolios in the first months of 2020.

Looking ahead, investors ought to integrate in their decision-making process that pro-equality measures could be introduced and that companies could be increasingly scrutinised on their contribution, whether positive or negative, to all societal stakeholders.

FOOTNOTE

1 QR code: AMUNDI PENSION FUNDS LETTER N°9 - The Covid-19 crisis: two sides of the same coin for pension funds

2 See, for example, Amundi Discussion paper: ESG Investing in Recent years: New insights from old challenges.

3 Financial Times: ESG funds continue to outperform wider market, Madison Darbyshire, April 3, 2020

Find out more here.

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