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POST-PANDEMIC RISKS TO EQUITY RETURNS

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The secular argument for equities has remained strong over the course of many decades, and we expect that to remain the case as we look ahead. That is not to say there aren't underlying risks. In this article, Roy Leckie, Executive Director Investment and Client Service, assesses how the Covid-19 pandemic might heighten these risks, and impinge on the long-term outlook for equity returns.

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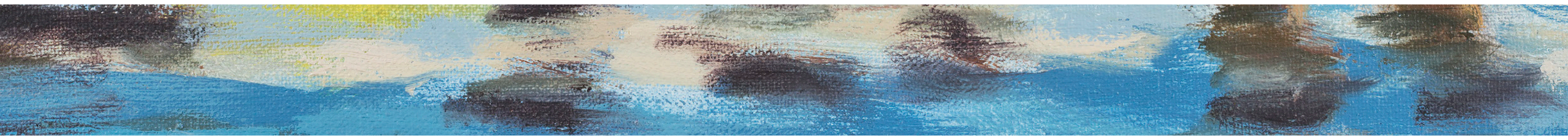


Of all assets, equities have always been best placed to reflect the general propensity of economies to grow, living standards to rise, and human ingenuity, enterprise, and technology to flourish. No other investment instrument enjoys such power of compounding; the ability to accrue returns to shareholders over the long term as companies grow profits, produce sufficient cash to fund future growth and pay dividends. Yet it needs no reminding that returns are not necessarily linear. History is littered with periods of turbulence that have disrupted the ability of companies to generate earnings growth, and clearly the current Covid-19 pandemic represents such an event.

Given our long-term perspective, we've been debating how the world might look in the wake of the pandemic. The issues we've been considering range from the acceleration of online commercial and consumer activity, to the endurance and impact of the working from home phenomenon beyond the current lockdowns. Such trends may re-shape economic behaviour, creating both opportunities and threats for various sectors of the equity market.

"The secular argument for equities has been strong"

Despite such periods of disruption, over the past decades, equities have charted the progression of endeavour and economic expansion as manifested in earnings growth. The secular argument for equities has been strong, and is likely to remain so in the long term. But to what extent is the pandemic exacerbating some of the risks that have the potential to chip away at returns from this asset class?

We have previously written at length about excess corporate debt, with reference to 'zombie' companies replete with high levels of leverage, which even prior to recent events were barely able to service it. With the onset of recession, the diminution of cash flows has seen many companies take on more debt to shore up creaking balance sheets, though it's also the case that some fundamentally good businesses have taken advantage of a super-low interest rate environment to raise capital.

For indebted weak companies with impaired business models, the adrenalin provided by cheap money will run out when interest rates eventually rise. Certainly the pandemic has highlighted the folly of using inappropriate leverage to conduct share buy backs. That instrument for enhancing EPS will be exercised with much more caution in the future.

But in the current pandemic, there has been another dynamic at play. Namely, the effective extension of state credit and bail outs aimed at keeping afloat enterprises where the economic, social, and political consequences of their demise would deem their failure unacceptable. Some countries that otherwise embrace Adam Smith, at least notionally, have been understandably quick to countenance the idea of quasi-nationalisation of enterprises. It has also been the case that given the extraordinary impact on labour markets, the state has stepped in as a partial underwriter of incomes.

Debt-to-GDP ratios are spiralling higher as governments seek to limit the damage. The OECD is predicting its members will see an accretion of extra debt of around US$17 trillion as they seek to prop up economies, with the result that liabilities across the group of nations will rise from 109% of GDP to 137% this year.

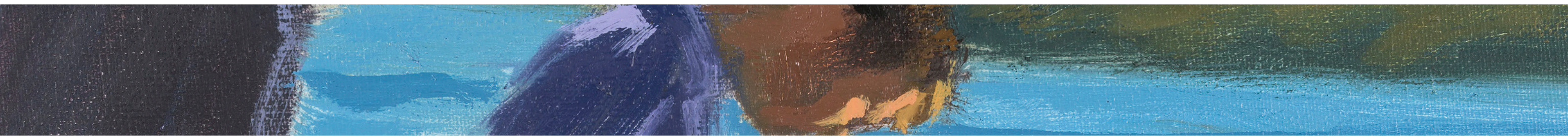
"It is likely that at some point this debt will have to be repaid"

Taken from the pages of the GFC playbook, the expedient of quantitative easing (QE) has seen central banks become to an even greater extent, the sovereign debt backstop. The suppression of interest rates is extraordinary. 'Even' the Bank of England issued debt this month at negative rates, for which there was appetite. The classical economic theory of 'crowding out', which suggests that interest rates should rise in such circumstances, has seemingly been rendered redundant by the printing of money which so far, has not caused inflation.

But we cannot assume that QE will exist in perpetuity. It is likely that at some point this debt will have to be repaid. With the GFC and the European Debt Crisis in mind, asking electorates which have laboured under fiscal austerity to fork up again, is a tall order. It is possible that the burden will fall on the corporate sector in years ahead, with obvious consequences on returns to shareholders.

It is also possible that the pandemic will further highlight the everlasting issue of inequality. During the GFC, extreme monetary largesse fuelled asset inflation, which arguably did little to benefit the wider populace. The gap between the asset-owning rich, the burgeoning incomes of the C-suite and the average worker has widened. Corporates, including disruptive 'big tech', have been on the back foot with regards to their economic power and influence on society.

The volume has been turned up on the stakeholder debate. The Business Roundtable, a group of leading US corporations with



members ranging from Amazon to JP Morgan, issued a 'statement of purpose' last year which pointed to a partial shift away from shareholder primacy, to a more inclusive relationship which embraces the concept of stakeholder capitalism.

In a number of countries the adherence to capitalism has always been tinged with the belief that companies served workers as much as the owners of their capital; Japan being a case in point. While arguably this facet of its corporate culture has inhibited the clearing process as the country *still* battles with the consequences of the bubble period of the 1980's, it was a social contract that helped foster the emergence of some of the world's leading companies. It is also the case that in the current pandemic, Japan has not fired legions of workers.

"Longevity of compound wealth creation requires enduring and sustainable businesses"

In many parts of the world however, the Covid-19 containment measures have induced a precipitous increase in unemployment. With millions of jobs now being lost, the pandemic has served to highlight socio-economic iniquities. Such inequality is not just a question of income disparity, but also of inequality of opportunity, access to health services, and education. This does not suggest that the scene is being set for a wholescale lurch towards the disenfranchisement of shareholders, but it is likely that the pandemic will propel the ongoing debate regarding the role of business in a more stakeholder-friendly world. It remains to be seen whether this leads to fiscal measures, or some corporate adherence to a social contract to achieve a measure of rebalancing between labour and capital.

Longevity of compound wealth creation requires enduring and sustainable businesses. Not only will a company fail to maintain its franchise if it can't retain this social licence to operate or maintain appropriate standards of corporate governance, but it will also do so if it disregards its environmental responsibilities.

Climate change represents a creeping glacier of economic dislocation, given its long-term effect on corporate productivity and agricultural production in addition to the increasing prevalence of weather-related disruption. A report published by the National Bureau of Economic Research in August last year suggests that in the absence of mitigating policies, a steady increase in global temperature of just 0.04% per annum will reduce world real GDP by 7.2% per capita by 2100[1]. Outcomes are not uniform; the 'warm' world will suffer disproportionately, exacerbating economic and social chasms.

The subject continues to gather momentum across society, garnering increasing attention amongst consumers, and companies will be obliged to adopt the best environmental practices. We have always held the view that those businesses that have the best ESG records make the best investments over time. There is a cost involved in complying with best practice but it is an investment, not a tax. The cost of not addressing climate threats is high at the corporate and global level.

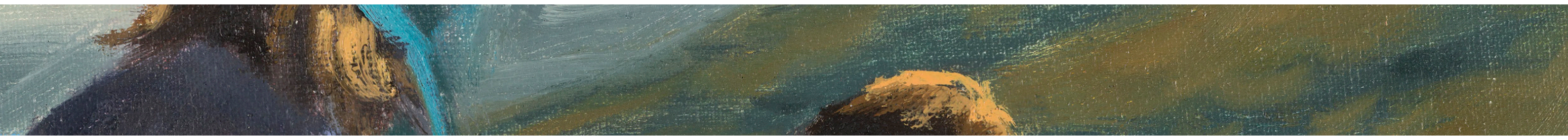
By-products of the pandemic containment measures have been the significant reduction in carbon emissions and the collapse in oil demand. It remains to be seen how long some of the current economic behavioural trends will last. Perhaps the scene is set for a decline in air travel, more 'WFH' (i.e. less commuting), and less freight shipping as supply chains are shortened and localised. This would exacerbate the long-term downward trajectory of oil demand, and indeed, the new CEO of BP, Bernard Looney, recently opined that the world has already passed 'peak oil' demand.

"Hurdles can be turned into opportunity as new growth paradigms evolve"

Consequently, a lot of fossil fuel supply may come out of the market, particularly in the most inefficient and 'dirty' areas. But while the long-term tide might be ebbing, given that the world is likely to need oil for some time, this might suggest a supply squeeze, prompting higher prices over the medium term, therefore presenting an opportunity for the efficient operators in the industry.

We present these challenges as events that may alter the equity landscape, or at least segments of it. But history has shown that hurdles can be turned into opportunity as new growth paradigms evolve. For us such changes are out of our control, but emphasise our need as investors to focus on financially robust enterprises with an ability to adapt, innovate, and tap into secular long-term growth trends. Share prices will always reward enterprising businesses that can grow earnings over time.

[1]The National Bureau of Economic Research (2019), 'Long-Term Macroeconimic Effects of Climate Change: A Cross-Country Analysis', https://www.nber.org/papers/w26167



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