HSBC Global Asset Management

ESG resilience in an uncertain world

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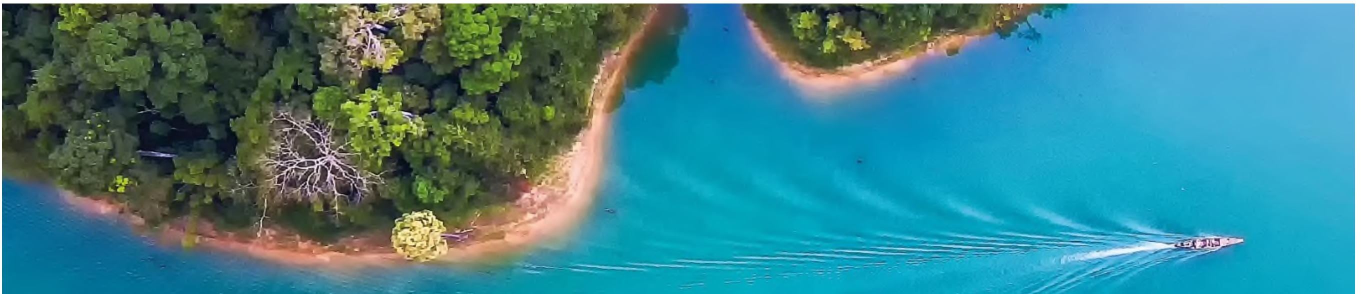


Summary

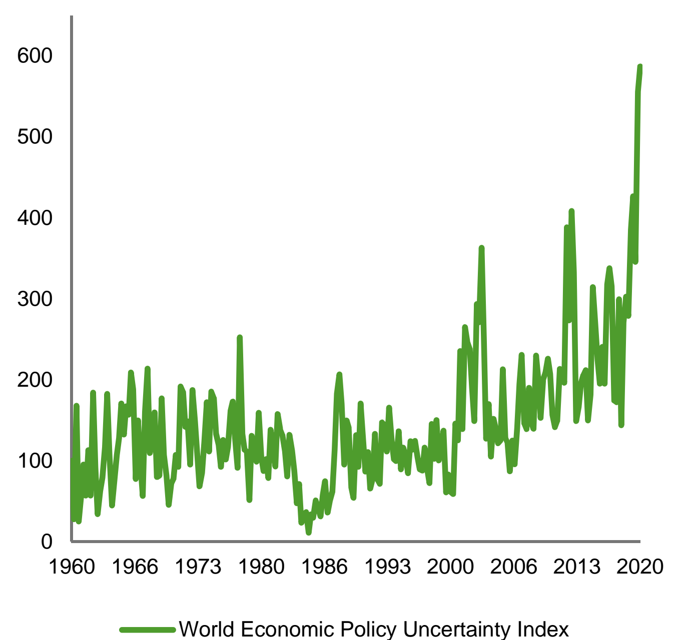
The crisis has revealed significant fragilities at the heart of our socio-economic system. But we can improve the economy's robustness by de-emphasising efficiency, in favour of system resiliency. In investment markets, today's steep capital market line encourages risk-taking. We find that medium-term market-implied returns for ESG equity indexes are at least as good as market-cap indexes. Investors can access ESG-friendly themes, which we anticipate will be structural beneficiaries of the move to "the resilient economy", without giving-up expected returns.

Uncertainty

The investment landscape post-covid is highly uncertain. As we continue in the recovery phase, investors are confronted with significant questions around the spread of the virus, the re-starting of economies, the policy outlook, and upcoming political events. It is hardly surprising that statistical measures of uncertainty are at unprecedented highs and heading higher (see figure 1). It implies that "multiple equilibria" are possible for the global economy at this point.

But beneath this layer of cyclical uncertainty, there are also important changes taking place to the structure of the macro-economy. Many secular trends have accelerated in the aftermath of covid. Perhaps the most obvious is the quantum leap in the adoption of technology to support remote working. But there are numerous others. Among them is a new primacy for environmental and social objectives.

Figure 1: Policy uncertainty index



Past performance is not a reliable indicator of future performance.
Source: Economic Policy Uncertainty, HSBC Global Asset Management, as at 31 March 2020.

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The old economy was built around "efficiency"

Environmental and social considerations were already well-understood by economists and investors before the crisis. Policy economists discussed a possible Green New Deal[1], or reflected on the importance of Branko Milanovic's "elephant curve", depicting trends in global inequality. Among investors, our quantitative analysis of financial media news articles consistently showed climate change and ESG considerations at the forefront of investors' thinking. But to see why this theme has recently jumped in importance, we need to reflect on what we have learned through the covid crisis.

At the outbreak of the global pandemic, health policy focused on lengthy lockdowns and quarantine periods in order to flatten the epidemiological curve. This reduced virus transmission and case growth, relieving the burden on national health systems. But it also imposed a brutal sudden stop on economies; we flattened the epi curve, but created a recession curve. Despite bold and innovative policy support, we face the biggest economic crisis since the Great Depression. The pandemic has, in other words, exposed serious weaknesses and deficiencies in how the socio-economic system reacts to crises.

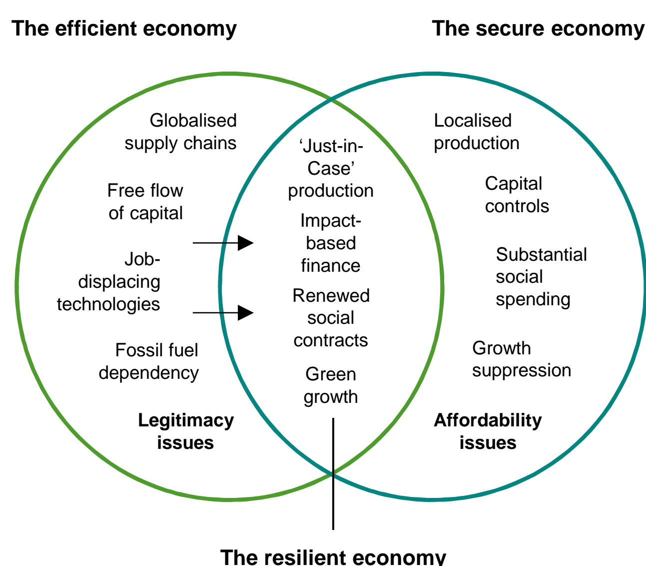
In the language of economists, we had prioritised efficiency over safety. Consider the example of the hyper-globalised supply chain in drugs; a recent French medical institute report suggests that the EU imports some 80% of its pharmaceutical ingredients. That intense global inter-dependency is replicated in food and energy supply chains. It is an elegant and well-oiled machine, an application of David Ricardo's idea of comparative advantage. But it meant that the macro system was too fragile and, going into covid, there were not enough buffers or shock-absorbers. Of course, more slack in the system would not have prevented the pandemic, but it might have helped us manage the challenge.

This matters because pandemic risk remains after covid. In the near-term, the threat of a second wave of infections persists; or consider the near-misses of MERS (2012) or Ebola (2014), or even the possibility that zoonotic diseases could appear more frequently in the future[2]. Perhaps we could face different "exogenous shocks" in the form of climate change; a recent review by Carbon Brief[3] suggested that of the 355 extreme weather events since 2000, over two-thirds were made more severe by humans. Suddenly, in the aftermath of covid, failing to prepare seems rather expensive.

The new economy can be built around "resiliency"

- All this could mean that covid accelerates a change in our socio-economic model. The question then becomes: a change to what?
- One target model, inspired by numerous academic writings, might be termed "the resilient economy". Figure 2 illustrates what we mean. The resilient economy has features of the current system, so it seems achievable and pragmatic. But it trades-off some economic efficiency in favour of more security. Ultimately it is a compromise between the two extremes, neither the low-growth autarky of the secure economy, nor the short-term profit maximisation and fragility of the efficient economy
- In practice, the resilient economy exhibits characteristics like just-in-case production, renewed social contracts with greater social spending, impact investing, and green growth. Moreover, in the long run, emphasising resiliency does not mean giving-up on efficiency; the goals are not mutually exclusive

Figure 2: The resilient economy Venn diagram



Notes:
1. https://ocasio-cortez.house.gov/sites/ocasio-cortez.house.gov/files/Resolution%20on%20a%20Green%20New%20Deal.pdf
2. https://wedocs.unep.org/bitstream/handle/20.500.11822/7664/Frontiers_2016.pdf?sequence=1&isAllowed=y
3. https://www.carbonbrief.org/mapped-how-climate-change-affects-extreme-weather-around-the-world

Source: HSBC Global Asset Management, as at June 2020. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Global Asset Management (UK) Limited accepts no liability for any failure to meet such forecast, projection or target.

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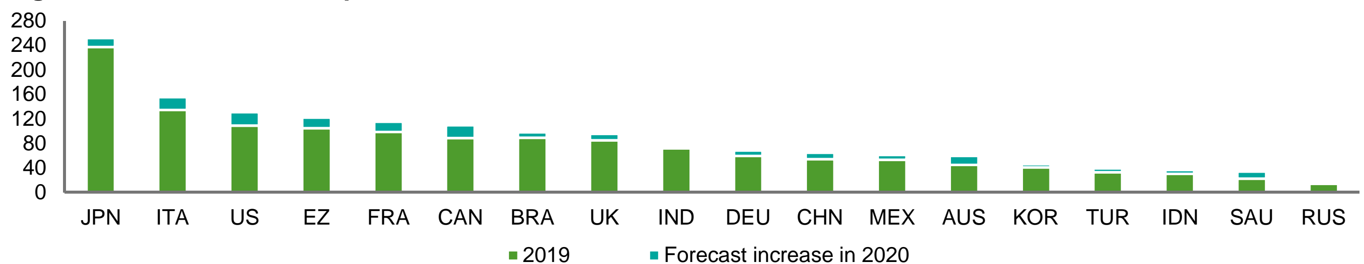
Constraints to change

This kind of new operating model for the economy would place ESG considerations at the heart of how we assess success. But, importantly, there are no guarantees, and two significant sources of risk remain.

The first risk is financial. We have seen bold policy support during the crisis. But the consequence of this is debt ratios rising by 20-30 percentage points for the main economies (see figure 3). This represents a significant move-up. Yet, with inflation dormant and bond yields anchored at all-time lows, whole-economy interest expense remains low even while gross debt levels balloon. Moreover, economists have suggested a range of measures, known as "financial repression", where the central bank and treasury work together to avoid a future interest rate shock.

That means that the biggest financial obstacle to financing a Green New Deal or enhancing other social contracts might not so much be in terms of the fiscal arithmetic, but rather connected to the conventional thinking about fiscal relationships in the minds of economists. In the real world, there is still policy space.

Figure 3: Fiscal arithmetic post crisis



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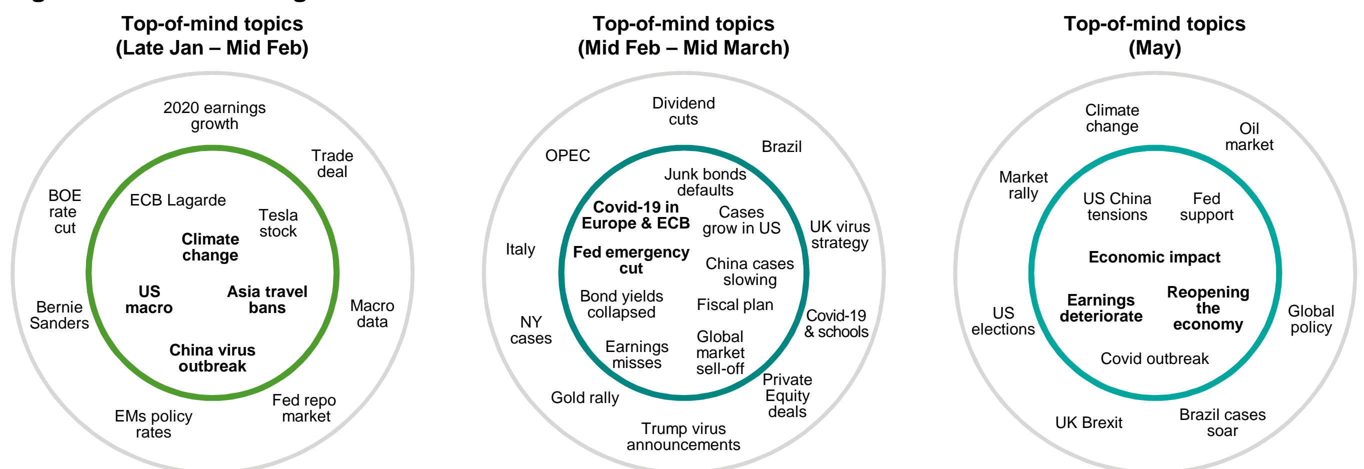
The second risk is perhaps more challenging and more uncertain. Post-crisis, international tensions and populist forces continue to rise. This reduces multi-national co-ordination and co-operation, and jeopardises progress on social and environmental goals. Instead, it injects significant uncertainty into what comes next.

Thematic resilience of ESG in investment markets

Before covid, climate change and related issues like ESG were key market themes. Based on our big data modelling of market narratives using more than 3,000 news articles per month, it appears that investor focus on climate change and ESG waned at the peak of the crisis in late February and early March. For the following months, the singular focus of investors was the virus itself and its consequences. However, more recently, as countries re-open, markets recover and volatility falls, investors' thinking is returning once again to climate issues (see figure 4). Today, our mapping of the current market narrative shows strong thematic momentum around climate change; after a lull in the crisis, ESG is a key part of what investors are thinking about once again.

Figure 4: Climate change in the market narrative



Source: Quid, HSBC Global Asset Management, as at June 2020. We applied Natural Language Processing techniques to more than 5,000 Bloomberg news stories, to identify key topics and measured their network centrality, to then identify which were they most relevant and influential.

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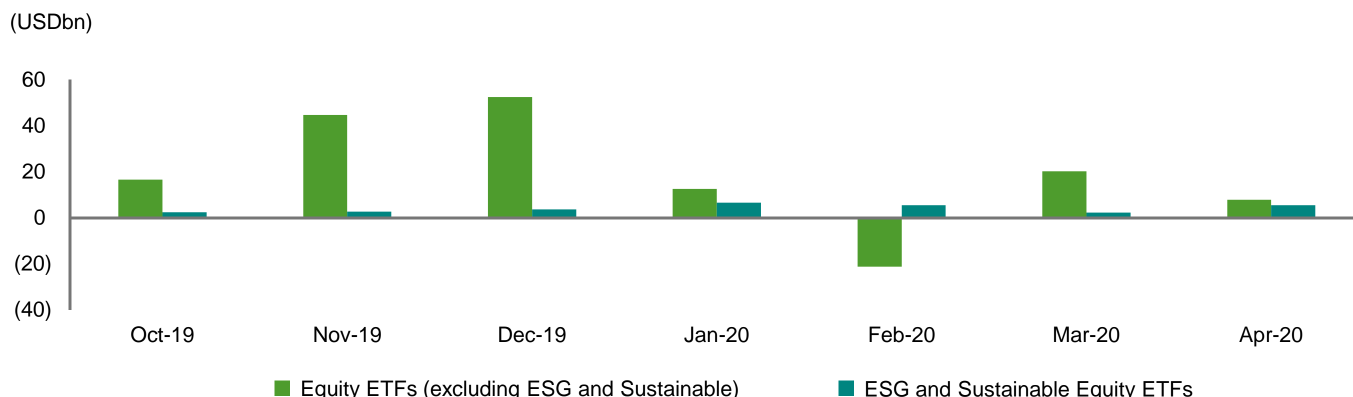
That thematic resilience is also evident in the fund flows and in price action. Figure 5 shows flows into ESG and Sustainable Equity funds which have continued through the crisis and recovery phases. Figures 6 and 7 show the long/short return to the ESG factor (excess returns versus the index) relative to other well-known equity factors in Q1 and in Q2. The ESG factor appears to be robust compared to the value factor over this period, even if it doesn't display the same defensive properties of minimum volatility or quality.

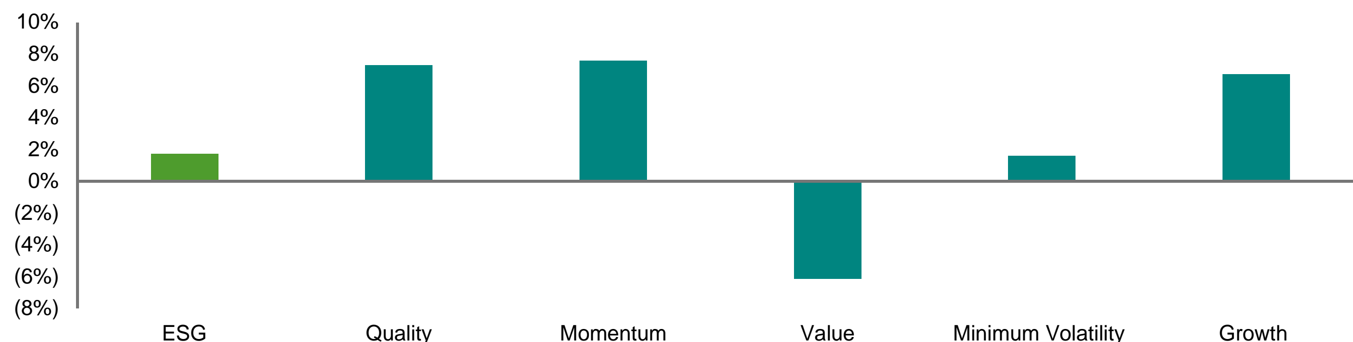
Figure 5: Monthly net inflows into ESG and Sustainable Funds

(USDbn)



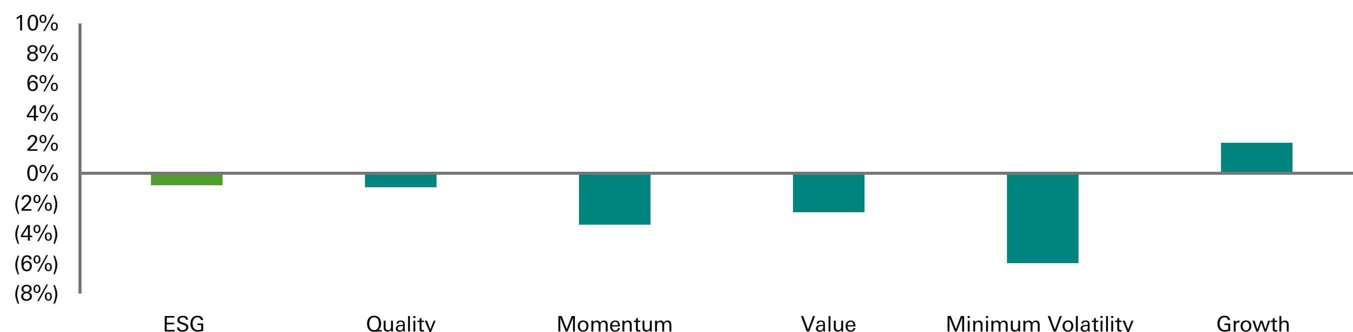
Source: Morningstar, HSBC Global Asset Management, as at April 2020.

Figure 6: ESG factor excess returns relative to the market (Q1 2020)



Past performance is not a reliable indicator of future performance.
Source: Bloomberg, HSBC Global Asset Management, as at Q1 2020.

Figure 7: ESG factor excess returns relative to the market (Q2 2020)



Past performance is not a reliable indicator of future performance.
Source: Bloomberg, HSBC Global Asset Management, as at Q2 2020.

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Expected returns

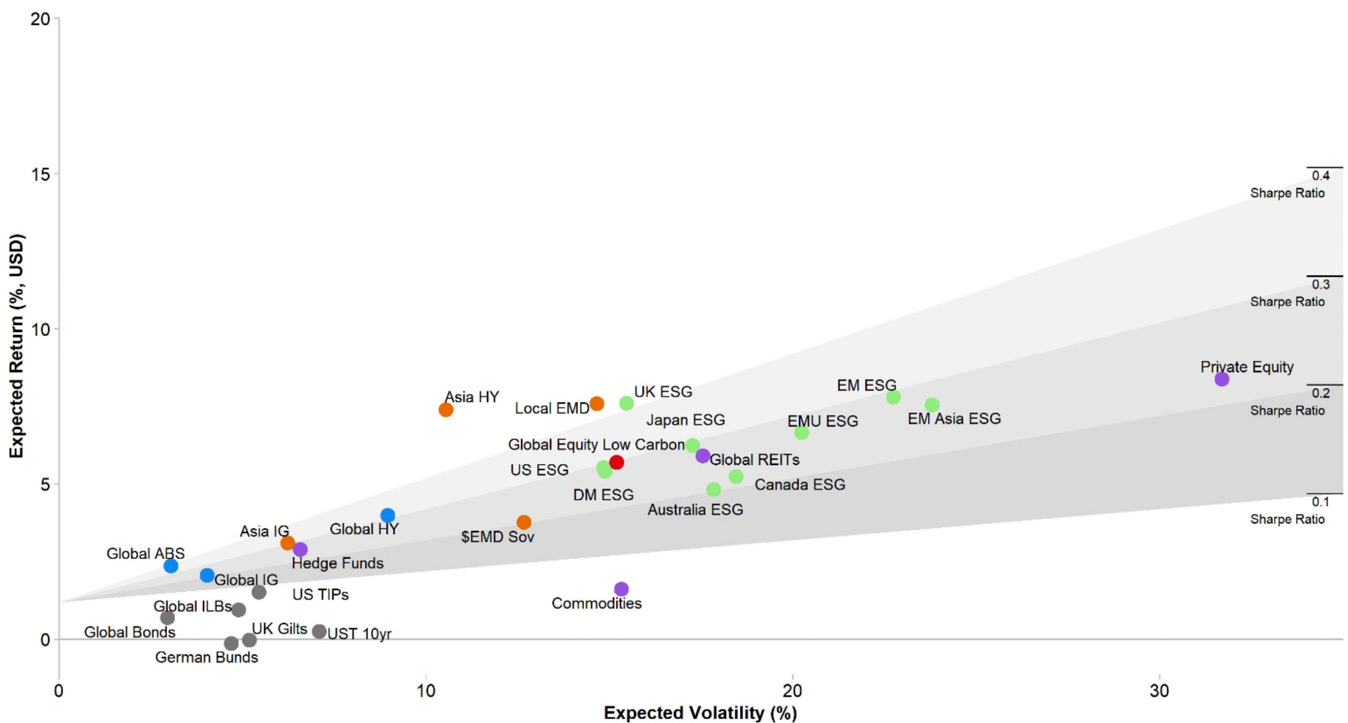
Valuations are the key determinant of medium-term returns. In the aftermath of the crisis, ever-lower market interest rates mean that the available return on global government bonds has declined further.

Today's capital market line - which links prospective returns and risks across our investment universe - is steep (see figure 8). While we need to be realistic around what kind of medium-term returns are available, the reward for taking risk (relative to sitting-it-out in traditional defensive assets) is high.

We estimate that the prospective, medium-term return for global equities is 5.9% today. But our analysis, based on market prices and the present value relationship, shows that prospective returns for indices with an ESG or low carbon tilt are as high, or higher, than market-cap indexes. There is no give-up in expected returns, despite the thematic resilience and growing popularity of the area.

If that is right, then it would appear that there is still a "free option" for investors. It also seems likely that the future distribution of returns for ESG equities is more favourable; ESG-friendly asset classes should be relative winners from the structural shift toward the resilient economy.

Figure 8: A steep capital market line



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Conclusion

Rather than turning the world completely on its head, the crisis has accelerated a number of structural trends that were already underway. There is significant uncertainty about how the near and medium term will play-out. But for investors, market pricing seems to indicate there is no give-up in expected returns to back ESG-friendly themes today. If economies transition as we hope they will toward a more resilient macro system, investors can benefit from an additional tailwind which should support ESG asset class returns even further.

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