Time for different choices

Post-pandemic recovery

Investment Outlook 2021

Triodos Investment Management

**The difficulty lies, not in the new ideas,
but in escaping from the old ones.**

John Maynard Keynes

Introduction

There are only a few examples in history when pandemics changed the course of the global economy and society: The Black Death in the Middle Ages, the Spanish flu in 1918-1920, and COVID-19, which we are right in the middle of now.
There are also examples in history when ecological disruption wiped out entire ecosystems. Think of the poor dinosaurs. And yes, again, we are right in the middle of such a disruption.

This is the background for our investment outlook 2021. There is a lot going on with the environment, our societies, our economies, all with grave consequences. But the strange thing is that financial markets by and large continue as if nothing is happening. Economic activity is slowly recovering, but a sustainable recovery is not yet to be seen.
We think it is time to face the challenges and to start making different investment choices. Both for the long and short term.

2021: What kind of recovery?

2020 will go into the record books as the year that saw the deepest global recession in peacetime. For 2021, we expect global growth to rebound, both in emerging and developed economies.
In **developed markets** the recovery will likely be slow amid recurring restrictive measures. Pre-pandemic economic activity levels can only be reached once a vaccine has become widely available. Despite positive vaccine developments, we don't expect this to happen before the second half of 2021. In the meantime, further stimulus is expected. Bold policy choices need to be made for the recovery to become sustainable and inclusive. For 2021, we expect global economic activity to rebound by 4.9% and developed economies to grow by an aggregated 3.7%. There is a great deal of uncertainty surrounding this forecast, however, relating to vaccine timelines and the continued need for restrictive measures.

Our **emerging and developing market outlook** for 2021 is one of a cautious and uneven recovery, with risks tilted to the downside. After almost a year of global crises – both health and economic – and unprecedented stimulus, support will be nearing an end for most countries. There is one swing factor that could help some countries to offset the impact of the pandemic to some extent in the coming year: China's recovery. As the second largest economy in the world, China is positioned as a fundamental player in terms of commodity demand, a foreign credit provider and a high value-added producer in the technology race.

Financial markets largely ignored the economic crisis, rescued as they were by central banks and fiscal measures. With debt levels at record highs, and an uncertain economic outlook that is only fully available during the year, we remain cautious in our asset allocation: neutral on average on bonds and negative about US equities and slightly positive about Japanese and European equity.

Different choices

In the **thematic part** of this Outlook, looking beyond next year, we forecast generally lower financial returns and a highly uncertain environment. The investment winds have turned: the tailwinds of the last four decades, favouring higher returns, have changed into headwinds leading to lower expected long-term returns across the board.

Our most urgent recommendation, is that the financial industry should look at returns in a different way. Otherwise, clients will be misguided for the right and the wrong reasons in what returns to expect from their investments. In addition, we issue this warning: expecting the same financial returns as before boils down to financing the collapse of ecosystems and leads to short-term gains for a permanent loss.

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Developed Markets Outlook 2021

An uncertain recovery: divided US suits the global status quo

Joeri de Wilde

Due to the COVID-19-related lockdown measures, 2020 will go into the record books as the year that saw the deepest global recession in peacetime. For 2021, we expect global economic activity to rebound, although the recovery will likely be slow amidst recurring restrictive measures. Pre-pandemic activity levels can only be reached once a vaccine has become widely available. Despite positive vaccine trial results, we don't expect this to happen before the final quarter of 2021. In the meantime, further stimulus will be needed. Bold policy choices need to be made so that the recovery can become sustainable and inclusive. This could be a vital first step towards a new economic system, one that is equipped to address the challenges of our time: climate change, biodiversity loss and inequality.

The US is still the largest economy in the world, with over 24% of global GDP. The change of leadership in Washington could, in theory, be the spark that ignites the much-needed global reset of our economic system. President-elect Joe Biden wants the US to 'lead the world' to address climate change and protectionism. This could speed up the global recovery and make it more sustainable. In practice this will be a very difficult task, however. A most likely Republican-controlled Senate will have a final say in almost any of Biden's decisions, and reluctance towards free trade is also present within the Democratic Party. The waning international dominance of the US also asks for close cooperation with friendly nations in a search for global compromises, but the US will find it hard to step away from the idea of American hegemony. The result will likely be watered down policy from the US and a struggle to reach ground-breaking agreements with other global powers. This suits the global status quo and makes a sustainable and inclusive global recovery less likely.

Global economy: growth rebound with much uncertainty

In 2020, we project global economic activity to contract by an astonishing 4.1%. Developed economies are expected to experience an aggregated growth contraction of 5.5%, as several regions have been hit by multiple COVID-19 infection waves. Countries have started to recover since the first series of lockdowns, supported by unprecedented monetary and fiscal stimulus. Nevertheless, we assume they will be unable to reach pre-pandemic activity levels before the final quarter of 2021, when a substantial part of their citizens have been vaccinated. In our outlook for 2020, we warned about the ultra-loose global monetary stance that merely sustained the ongoing inflation of asset prices and further financialisation of the economy. Of course, we did not envision that this would only be the tip of the iceberg. In 2020, financial markets have become even more detached from the real economy, floating in the air while the real, 'earthly' economic activities are in the midst of a hurricane. This trend may very well to continue in 2021, a worrying realisation.

Environmental

1. Extreme weather
2. Pandemics
3. Biodiversity loss

Social

1. Unemployment
2. Populism
3. Wage and wealth inequality

(Geo) Political

1. Protectionism
2. Brexit
3. Ongoing political tensions in US and eurozone

For 2021, we expect global economic activity to rebound by 4.9% and developed economies to grow by an aggregated 3.7%. There is a great deal of uncertainty surrounding this forecast, which relates to vaccine timelines and the continued need for restrictive measures. In our baseline scenario, we assume that several vaccines will be approved by early 2021, with developed economies able to vaccinate their most vulnerable citizens in the first half of the year. This implies that restrictive measures will be necessary until at least mid-2021. After that, reduced pressure on hospitals will allow developed economies to gradually return to pre-pandemic activity levels, with most countries reaching normal activity levels in the final quarter of 2021. Economic growth rates for the United States and Japan are expected to rebound by 3.2% and 2.9% in 2021, whereas the eurozone and the UK are expected to report growth rates of 4.7% and 4.9%. Growth rates for the US and Japan will be somewhat lower because these countries are set to experience a less severe contraction in 2020, as a result of less stringent and/or shorter lockdowns.

Risks are determined by vaccination timelines

The biggest risks to our outlook concern vaccination timelines Shortened vaccination timelines are a clear upside risk. This would entail rapid approval, production, distribution and implementation of several highly effective vaccines, meaning all developed economies would be able to vaccinate most of their citizens before mid-2021. In this positive scenario, restrictive measures wouldn't be necessary anymore in the second half of the year, resulting in a swift return to pre-pandemic activity levels. This would obviously boost our expectations for global economic activity in 2021. In the second half of the year, a possible relief rally could even make up for some of the incurred losses in economic activity, with households spending excessively once restrictions are permanently lifted. Unrelated to vaccine timelines, the US Democrats gaining control of the Senate would also positively affect global economic activity in 2021.

The main downside risk is slow vaccine deployment. Vaccine approvement could be delayed and large-scale production, distribution and vaccination might not go as smoothly as hoped for. A decreased willingness of part of the global population to get vaccinated could be an important reason for delay. In this downside scenario, we assume that developed economies will be unable to vaccinate their most vulnerable citizens before late 2021. This will mean a full year of recurring restrictive measures that prevent a return to pre-pandemic activity levels. Improved knowledge on treatment and spreading and scaled up track-and-trace capacity may gradually require less severe restrictions, however. Other downside risks, associated with environmental, social and (geo-)political factors are depicted on the previous page.

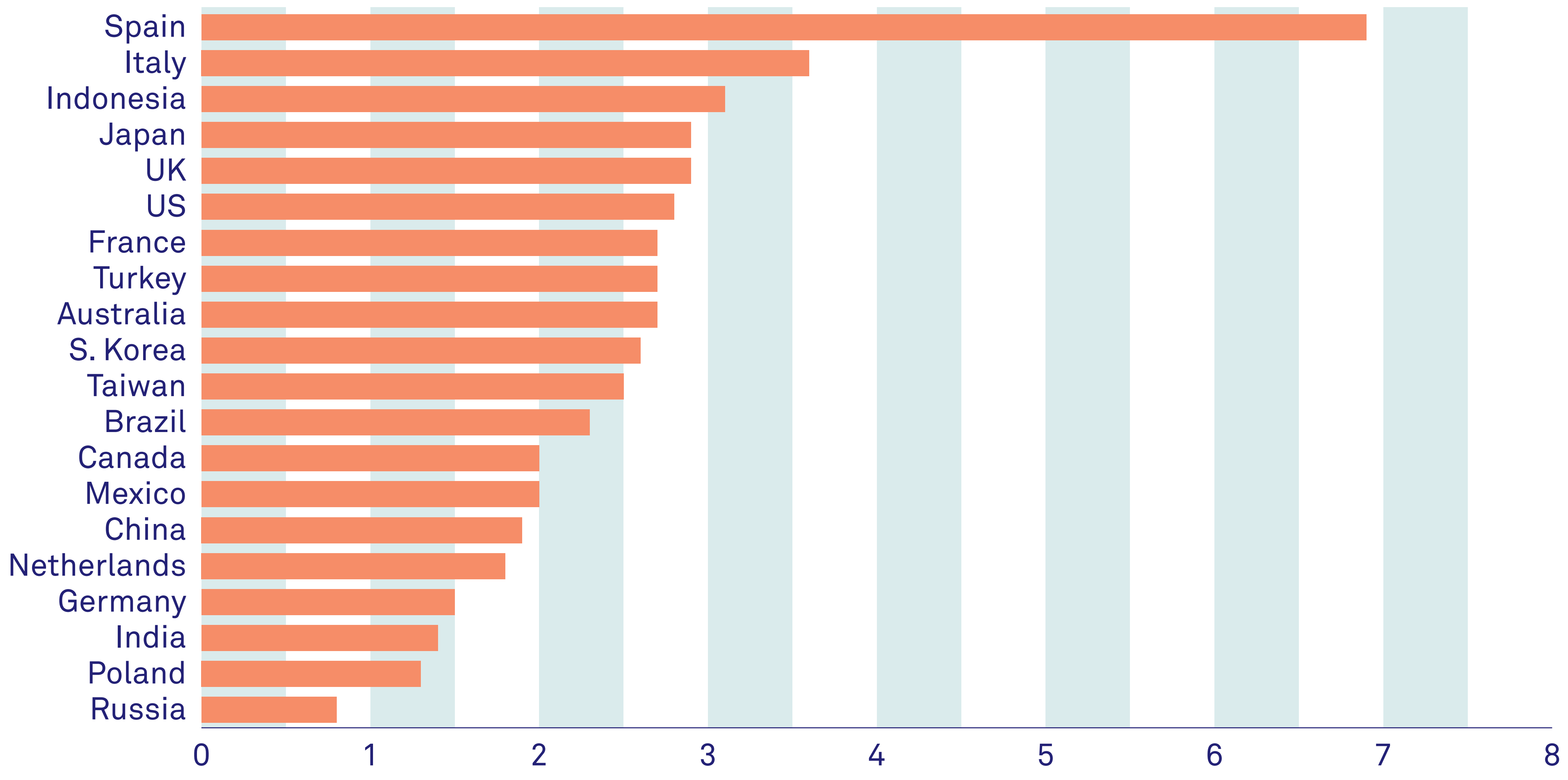
Bankruptcies, permanent job losses and sectoral divergence

Although economic growth in developed economies is set to rebound in 2021, the expected recovery will likely be slow and unequal. Many of the negative effects of 2020's recession have been postponed by the unprecedented fiscal and monetary measures. Job retention schemes have prevented significant rises in unemployment in most developed countries, and support to businesses has kept bankruptcies at artificially low levels. However, in the likely case that social restrictions continue to be required until at least mid-2021, even substantial additional policy measures might prove to be insufficient. The result would be solvency issues for businesses leading to bankruptcies and job losses, leaving permanent economic scars as viable businesses disappear and discouraged workers drop out of the labour force.

Recurring restrictions will likely enlarge the divergence between sectors and regions. The service sector has been the main victim of social restrictions and will continue to bear the brunt in the first half of 2021. However, since we don't expect the reimplementation of complete lockdowns, the manufacturing sector can probably continue its operations and global trade can further pick up. Goods consumption has already recovered, partly substituting demand for services. Overall, this means that countries that are disproportionately dependent on the most impacted service sectors such as the hospitality sector (e.g. Italy, Spain, United Kingdom) will fall further behind in the first half of 2021, while goods-producing economies (e.g. Germany, several Asian countries) are better positioned for an early recovery. Leisure-dependent countries could potentially catch up in the second half of 2021 if restrictive measures are permanently lifted and relief spending materialises.

Within countries, sectoral divergence will further increase inequality. Low-income households will continue to be disproportionately impacted, as they are overrepresented in the shutdown sectors and are often

Figure 1 Size of the hospitality sector (% of GDP)



Source: Capital Economics

hired on a temporary basis. Small to medium-sized enterprises will also bear the brunt through tightening credit conditions, as they have to rely on bank loans. Large, listed companies, on the other hand, can raise capital through bond and share issuances, which due to implemented policies have become cheap (i.e. low interest rate environment and bullish equity market sentiment).

Biden's presidency reduces geopolitical tensions

Biden's victory in the US presidential elections will change the geopolitical landscape in 2021. We expect the US to return to diplomacy and break away from Trump's America First agenda. Relations with Western allies such as the EU will be strengthened again, and trade barriers potentially reduced. However, opposition from a Republican-controlled Senate and a substantial part of the population might make it difficult to completely step away from the current protectionism. Disputes on key issues such as regulation and taxation of US tech companies in the EU will also remain a divisive force between the traditional allies.

With respect to the EU-UK relationship, Biden's election victory will put pressure on the UK to forge a trade deal with the EU. Biden has stated several times that Brexit was a geopolitical mistake and that a UK-US trade deal would become more unlikely if Johnson undermined the Northern Ireland peace process. The EU and UK are still miles apart on several key issues. We expect that a deal will eventually be reached, as this is in the best interest of both parties, but ratification of the deal might be pushed further into the future, extending the period of uncertainty.

We expect the US to continue to oppose China's increasing global dominance, but the tone of voice will be more diplomatic and modest progress on the precarious phase one trade deal could potentially be made. Tensions will likely continue to dominate the relationship. The US is also likely to become more vocal regarding international conflicts, which might result in increased tensions with Russia, Iran, Turkey and North Korea, although Biden did pledge to return to the nuclear power agreement with Iran. A polarised US population will make it more difficult to find broad support for international engagement, however, reducing the chances for decisive US foreign policy actions.

Divided US unfavourable for global growth prospects

Reduced chances of a Democratic majority in the Senate will likely force US president-elect Biden to search for compromises. This does not favour his plans for a huge fiscal stimulus package financed by increased corporate and personal taxation. The result would likely be a less significant US-originated fiscal impulse for global growth early 2021. Later in the year, a more forward-looking stimulus package that focuses on investments in physical and digital infrastructure may be agreed on, as there is also support for such investments within the Republican Party.

For the eurozone and Japan, a more limited US fiscal package likely means less demand originating from their largest export partner. On top of that, widespread sympathy for protectionism in the US makes it difficult for Biden to completely step away from the built-up trade frictions, no matter the result in the Senate. For the eurozone, this adds to the trouble within the region caused by the resurgence of the coronavirus in the final quarter of 2020, where restrictive measures have again lowered economic activity. Japan has been less severely impacted by domestic COVID-19 infections than most other developed economies, but the recovery has so far been rather sluggish. On top of that, Japan is still struggling with the low-growth-low-productivity paradigm from before the COVID-19 crisis. This will likely force the governments of the eurozone countries and Japan to continue their sizable fiscal support programmes well into 2021.

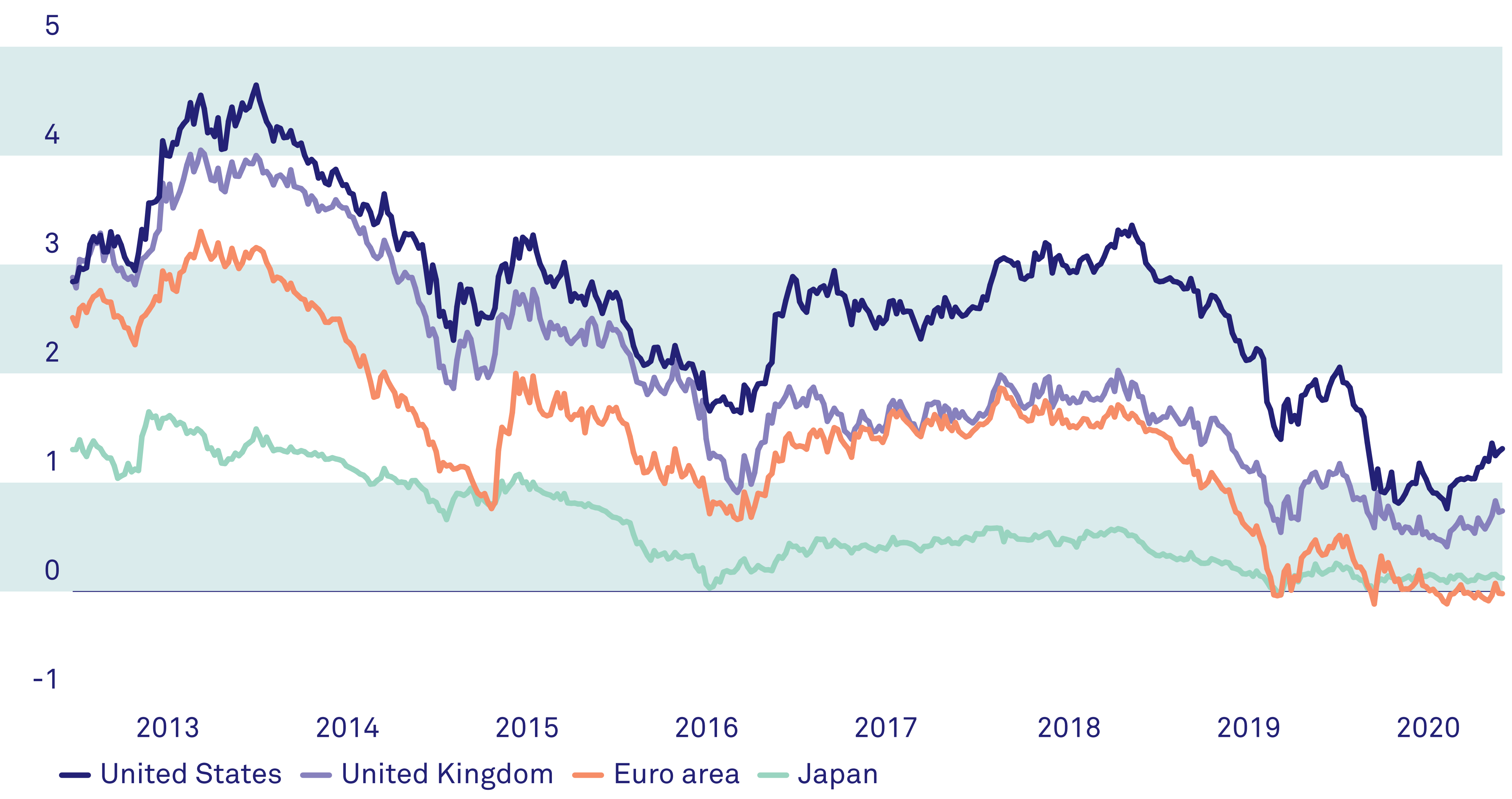
For the UK, much of its prosperity in 2021 depends on the result of the UK-EU trade negotiations. However, even when a trade deal arrives, the terms will be less favourable than they are now. In combination with the recent reimplementation of severe restrictive measures, this likely means that the UK will be one of the laggards of the developed market recovery. The UK will therefore be eager to increase its trade with the US, preferably through a trade deal. In any case, trade between the two countries will almost certainly benefit from a sizable US fiscal stimulus package.

Low inflation and high unemployment guarantee loose monetary stance

Although business confidence in developed economies has returned to pre-pandemic levels, consumer confidence has remained subdued. We expect this discrepancy to continue in 2021, as the recent positive vaccine developments might trigger firms to anticipate a future without restrictions and consequently increase investments. Consumers, on the other hand, could remain cautious until they have been vaccinated, leading to weak consumer demand and elevated levels of saving until at least mid-2021. Continued restrictive measures also limit the options to spend money. Moreover, an inability to return to pre-pandemic activity levels before the final quarter of 2021 will keep developed market unemployment at elevated levels, with the risk of future solvency issues leading to further job losses. This means a lack of wage pressure on labour costs. As a result, for 2021 we expect inflation to stay below the respective developed market central bank targets (around 2%).

The combination of high unemployment and low inflation expectations guarantees that all major central banks will maintain their ultra-accommodative stance throughout 2021. We expect that policy interest rates will be kept on hold, but central banks will not hesitate to take additional easing measures in case downside risks materialise. The US Federal Reserve (Fed) will likely lead the way in case sizable additional fiscal stimulus remains absent and economic data deteriorates. In combination with a gradual global recovery, the continued easing of the Fed will likely weaken the US dollar. In general, if fiscal policy measures disappoint or the coronavirus causes new disruptions, central banks will likely step in with additional measures. The European Central Bank is already expected to expand its emergency bond

Figure 2 Inflation expectations (five year forward rates, %)



Source: Refinitiv Datastream / Triodos Investment Management buying programme (PEPP) and favourable long-term bank funding operations (TLTRO) in its last meeting of 2020.

Green and inclusive policy choices will remain scarce

In most developed economies, policy measures have understandably focused on emergency support, thereby putting existential threats such as climate change and biodiversity loss on hold. We acknowledge the necessity to support the economy by all possible means until the recovery has gained substantial strength. This avoids unnecessary permanent economic scars by losing viable businesses and jobs. However, current global efforts are insufficient to reach the Paris Agreement climate goals. On top of that, the economic recession induced by COVID-19 delays progress towards the world's 2030 Sustainable Development Goals (SDGs) by a further decade. Even before the coronavirus outbreak, it became clear that achieving the SDGs would not happen before 2080. This asks for targeted monetary and fiscal policies that facilitate a green and inclusive recovery, thereby catalysing the necessary transition towards a new economic system focused on long-term wellbeing. Immediate action is required.

Implementation of the International Monetary Fund's recommendations for public investment in green infrastructure, adequate carbon pricing and compensation for lower income households would mean significant progress. However, even the European Green Deal is way too limited to genuinely act upon these recommendations and deliver upon the Paris Climate Agreement and SDGs. Moreover, with a divided US incapable of leading the way, we are expecting even less government-induced progress outside Europe. This urgently asks for private investments that steer towards the required transition, aiming for impact rather than merely focussing on returns. This is precisely what we will continue to do in 2021, and we hope others will also find a new sense of urgency to jointly address short-term and longer-term challenges.

Growth projections 2020-2021

	GDP growth			Headline inflation		
	2019	2020	2021	2019	2020	2021
Global	**2.8**	**-4.1**	**4.9**	**3.6**	**3.2**	**2.8**
US	**2.2**	**-3.7**	**3.2**	**1.8**	**1.2**	**1.8**
Euro area	**1.3**	**-7.5**	**4.7**	**1.2**	**0.3**	**0.9**
Belgium	1.4	-8.1	5.1	1.2	0.6	1.2
Germany	0.6	-5.7	4.0	1.3	0.4	1.2
Netherlands	1.7	-5.2	3.6	2.7	1.2	1.4
Spain	2.0	-11.8	5.2	0.8	-0.4	0.7
UK	**1.5**	**-11.5**	**4.9**	**1.8**	**0.9**	**1.3**
China	**6.1**	**2.1**	**7.9**	**2.9**	**2.7**	**2.0**
Japan	**0.7**	**-5.6**	**2.9**	**0.5**	**-0.1**	**0.3**

Investment outlook

Financial markets have shown a spectacular recovery after the COVID-19-induced freefall. Bond and equity markets rallied as if a swift full-blown economic recovery was imminent, once again emphasising that financial markets have become completely detached from the real economy. The driving force behind the bullish investor sentiment continues to be a reliance on perpetual monetary stimulus. We acknowledge that this situation can continue for quite some time but remain cautious, as we believe a reality check is bound to happen and can have huge consequences.

Monetary dominance will continue

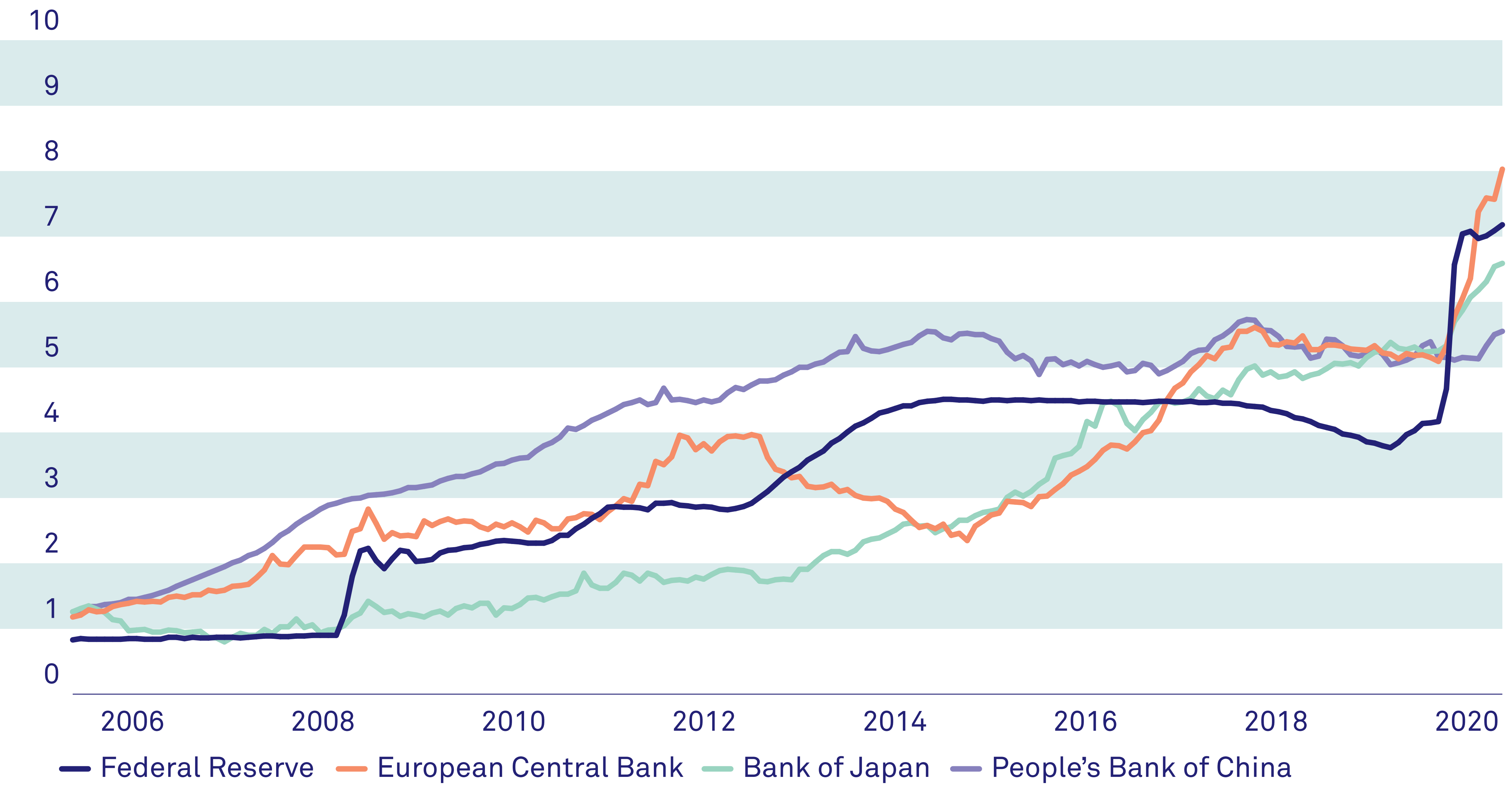
In 2020, investor sentiment was again soothed by policy makers implementing huge monetary and fiscal stimulus packages. This time, there was an actual crisis to justify action. As a result, the financial asset bubble became rapidly inflated, with some markets even surpassing their pre-COVID-19 highs. An uncanny development, considering the dire state of the global economy and huge uncertainty going forward. We are still convinced that valuations matter, and therefore believe that this situation cannot hold in the long term. We do however acknowledge that there is plenty of stimulus in the pipeline to satisfy short-term investor appetite. Low inflation expectations and the COVID-19-induced recession guarantee an ultra-loose monetary environment in 2021. Fiscal stimulus could also support investor sentiment, although the scattered political landscape in the US might result in smaller packages then hoped.

Based on our fundamental approach, we remain cautious and do not chase the rally. Central bank policies not living up to investor expectations are a key risk that could lead to a turnaround in market sentiment, next to substantially delayed vaccine timelines or an increase in profit warnings and bankruptcies. This is enough reason for us to remain slightly underweight in equities and neutral in bonds.

Bond yields will likely remain near historic lows

In 2020, the COVID-19-induced recession increased safe-haven appetite and led to unprecedented central bank measures, resulting in historically low government bond yields. For the EU, going into 2021, low inflation expectations and subdued economic growth prospects might force the ECB to further increase its quantitative easing schemes. This will keep European capital market rates low for longer. The same goes for credits, where the sole focus on central bank measures implies continued low corporate bond yields. In this dreadful growth environment, we prefer high-quality credits with strong balance sheets, as the collapse in economic activity is likely to trigger a rise in downgrades. Overall, these considerations make us want to maintain a neutral position in bonds.

Figure 5 Major central banks balance sheets - total assets (x 1.000 USD billions)



Source: Refinitiv Datastream / Triodos Investment Management

Equity markets remain reliant on central banks

Despite the temporary corrections in 2020, global equity valuations have remained elevated. Earnings estimates have declined, but we think that the anticipated broad and firm earnings recovery in 2021 is unrealistic. A weak global economy combined with a great deal of uncertainty means negative earnings surprises are lurking, in which case lower equity prices and valuations would be entirely warranted. The continuation of the upward trend in equity markets mostly depends on additional fiscal and especially monetary easing measures, next to continued good news on vaccine approval, distribution and implementation.

The US equity market continues to look expensive, both relative to other regions and from a historical perspective. A divided US government reduces the likelihood of a huge fiscal stimulus package, but also restrains the Biden administration with respect to corporate tax rises and increases in regulation. European and Japanese markets look cheap relative to the US but are still (equally) expensive in absolute terms. It seems eurozone political risks have somewhat diminished after EU leaders agreed on a joint recovery fund, but trade uncertainty with the UK remains a severe risk. Going forward, the main difficulty for Japan will be subdued confidence and weak external demand from regions where the virus still roams around. Taking all of this into account, we remain negative about US equity, neutral to slightly positive about European equity and positive about Japanese equity.

Impact opportunities

We continue to see opportunities in the sustainable investment landscape. The European Green Deal, the EU's roadmap for making its economy sustainable, will likely gain momentum. The related development of a green taxonomy will enable investors to steer their investments towards more sustainable technologies and businesses, and the creation of an EU Green Bond Standard will deliver a uniform tool to assess green bonds. The Green Deal will also force companies to become more transparent and can serve as an example for the rest of the world. Besides Europe, we expect to continue to find sustainable investment opportunities in Japan. Overall, we hope that an increased sense of urgency facilitates a renewed focus on investments in climate mitigation and adaption and the fulfilment of the Sustainable Development Goals in the next 10 years.

Tactical asset allocation

Asset class	Valuation	Cycle	Sentiment	Total
Government bonds	**–**	**0**	**+**	**0**
EMU government bonds	–	0	+	0
UK Gilts	–	0	+	0
US Treasuries	–	0	+	0
JP government bonds	–	0	+	0
Credits	**–**	**–/0**	**+**	**0**
Euro IG corporate credits	–	–/0	+	0
Equities	**–**	**–**	**+**	**–/0**
Europe ex UK equities	0	–	0/+	0
UK equities	+	–	–/0	0
US equities	–	–	+	–
Japanese equities	+	–/0	0/+	+
Emerging equities	+	–	+	+

\+ = positive 0 = neutral – = negative

Emerging Markets Outlook 2021

Beyond the pandemic: Riding China's recovery wave

Maritza Cabezas Ludena

Our emerging and developing markets outlook for 2021 is one of a cautious and uneven recovery, with risks tilted to the downside. After almost a year of global crises – both health and economic – and unprecedented stimulus, support will be nearing an end for most countries. Yet uncertainty about the further course of the pandemic will continue, especially regarding the widespread availability of a COVID-19 vaccine. Meanwhile, governments will be picking up the bill of the pandemic and re-prioritising expenditure, with the accompanying social tensions. Countries that can attract capital to meet their financing needs will have more spending power. As for low-income countries that were the hardest hit by the pandemic, they will be trying to avoid more people falling into extreme poverty.

There is one swing factor that could help some countries to offset the impact of the pandemic to some extent in the coming year: China's recovery. As the second largest economy in the world, making up slightly more than 16% of global GDP, China is positioned as a fundamental player in terms of commodity demand, a foreign credit provider and a high value-added producer in the technology race. Although this has brought about challenges to the established geopolitical order, it has also resulted in stronger trade and financial ties with many emerging and developing economies.

Near-term outlook

Our **baseline projections** for emerging and developing markets assume that the worst of the crisis is over in terms of economic contraction, with the largest impact having taken place in the first half of 2020. However, the coronavirus pandemic will not end abruptly. It is likely to fade away slowly, and this process may go on beyond 2021. Our assumption is that an effective COVID-19 vaccine will be available to the public in the first half of 2021, but it will take longer for some emerging markets to get hold of it. Once available, the vaccine will require storage and distribution facilities that will have to be built in some places. There will also need to be a clear policy on who will be vaccinated first.

The distribution of the vaccine worldwide will take time, and this uncertainty will likely delay consumption and investment growth for a large part of the coming year. On top of this, disposable income is expected to drop on the back of declining government support. There is room for optimism though. Foreign trade has been picking up at a fast pace since the third quarter 2020, a trend that is likely to continue in 2021. This can be partly explained by the relatively rapid recovery of the goods producing sector, where social distancing was easier to follow and as a result of the increase in health-related imports. Whether the recovery of trade will be sustainable in the medium term depends on the demand of the largest economies, including China, and on geopolitical developments. Additionally, risk sentiment could improve with the vaccine, favouring emerging markets and the search for yield. But the cost is often onerous debt burdens, so governments and companies will have to be mindful and focus on borrowing that leads to sustainable growth.

Continuing into 2021, most emerging and developing economies will still be operating below their full potential or long-term trend growth. There was already a considerable amount of slack in most emerging countries prior to the pandemic. And unemployment is now on the rise. Workers who have lost their jobs because of the pandemic will find it more difficult to return to the labour market in the hardest hit sectors. These are the sectors with contact-intensive jobs such as hospitality and food, which employ mainly young women. In Latin America and sub-Saharan Africa, the largest number of lay-offs, according to the IMF, were among young women working in contact-intensive sectors.

Below-potential growth means less inflationary pressures in the near term for most emerging and developing countries. But where the pandemic has had a larger impact on supply chains, inflation pressures have been increasing. Some countries are reporting double digit inflation, including Nigeria, India and Turkey, which leads to further deterioration of the purchasing power for households. Russia and Kazakhstan have below double-digit inflation, but it has been increasing in the past months. Currencies in emerging markets are expected to have a mixed performance, related to the strength of their macroeconomic fundamentals and geopolitical tensions. Turkey's and Russia's currencies are feeling the pressure of the prospect of a tougher US stance, while China and South Korea will continue to see a favourable performance of their currencies on account of their solid recovery.

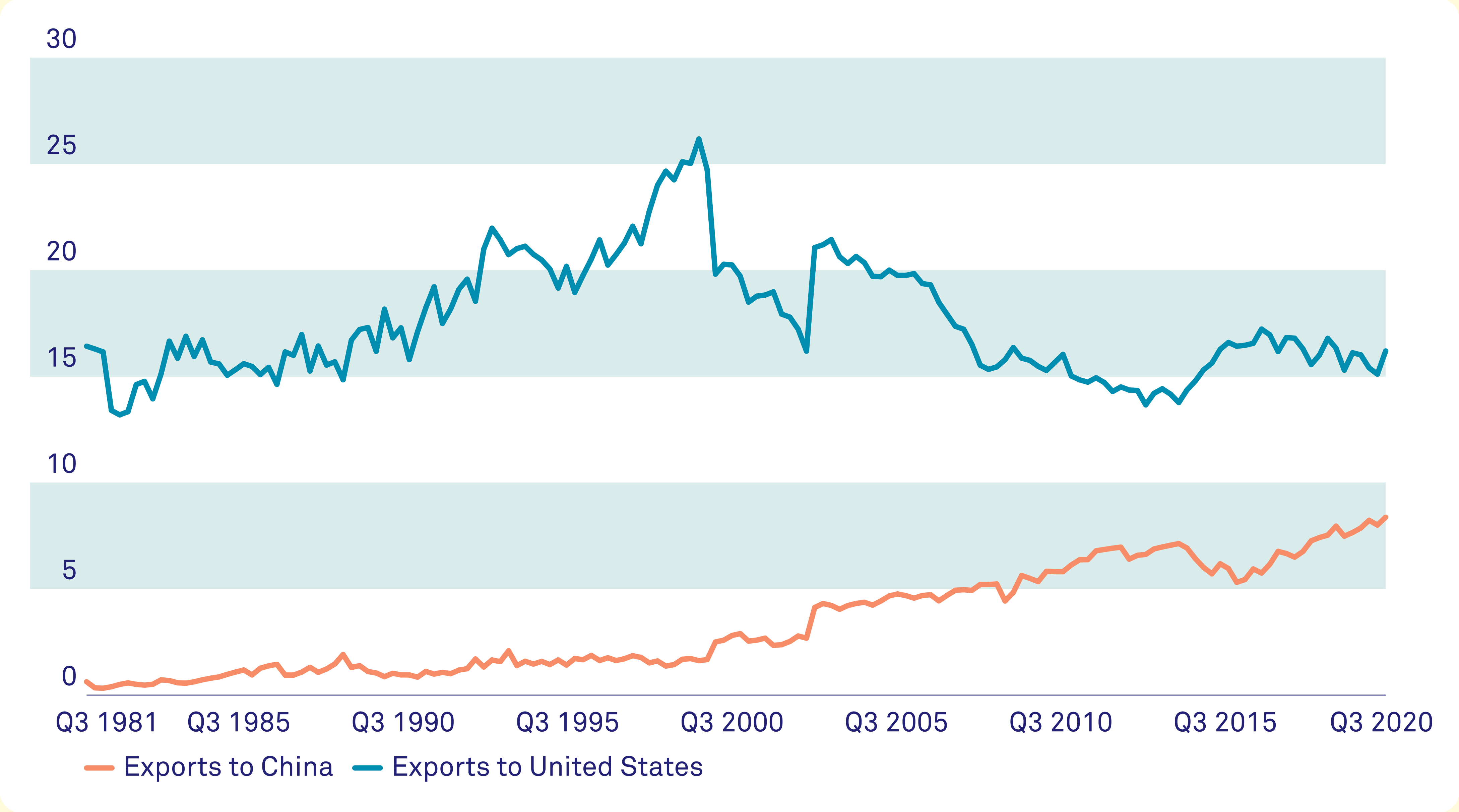
Poverty implications

The scarring from the pandemic has been large, depending on the state of health systems, fiscal space, the structure of economies and the degree of digitalisation of a country. Estimates from the World Bank suggest that poverty and income inequality will unavoidably increase. The deceleration of economic

China's rise – an impulse for emerging markets

Although the outlook for emerging markets' recovery highly depends on the course of the pandemic, it is also conditioned by a rapid economic recovery from China. China has been increasing its trade integration and financial links with emerging markets for a while. China's economic performance in the near and medium term will be relevant for growth in emerging markets and the patterns of supply chains and capital flows.

Figure 3 Share developing countries exports to US and China (%)



Source: Refinitiv

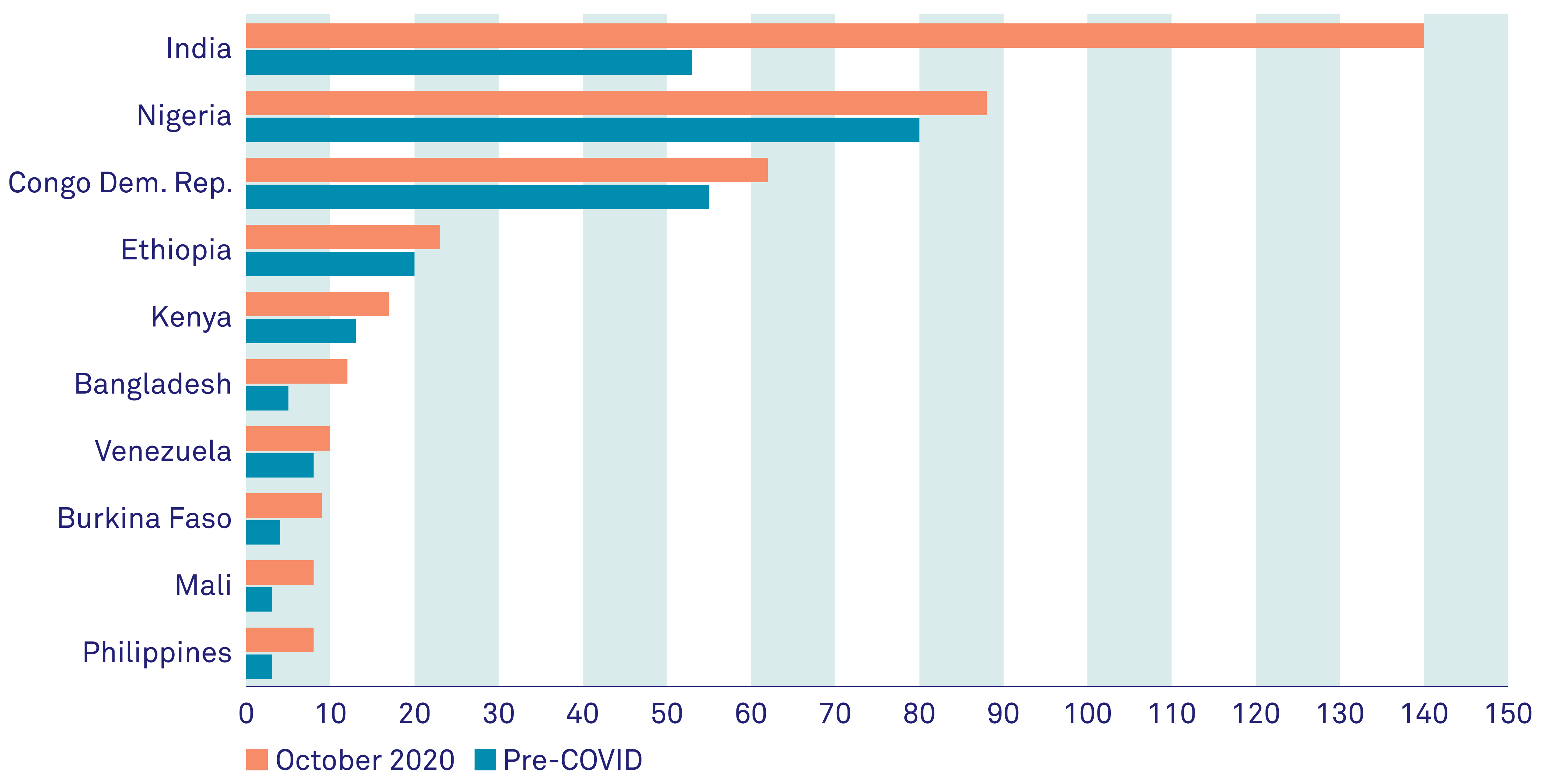
China's economy has been following a steady growth path after a strong contraction in the first quarter of 2020. This recovery is being led by strong import growth, with an increasing demand for hard commodities to support industrial production and construction, as well as greater demand for agricultural imports. The appreciation of China's currency has partly boosted this trend; a stronger currency makes imported goods cheaper. A more rapid shift to consumption would support the global recovery further, but China's household consumption is still modest, at around 39% of GDP compared to a global average of 63%. Improving safety nets in China would help to reduce precautionary savings and boost consumption, but this cannot be done overnight.

Trade with China is already making a difference, with some emerging and developing countries benefitting more than others. Over the past few years, China has accounted for a growing share in trade with developing countries (see graph), and it is becoming a major force in infrastructure and technology. Resource-rich countries are highly exposed to China's demand for commodities. Some African countries, like Angola, Eritrea and Gambia, export more than 50% of their total exports to China. The rebound in exports to China is even leading to upward revisions in the GDP growth of countries like Chile, Brazil and Russia.

But it's not only trade; China is also by far the most important investor in several developing countries, financing roads, ports, telecom networks and energy projects. China is the largest bilateral creditor for Africa and has surpassed the World Bank and the Paris Club in financing emerging markets and developing countries. The role of China as a major lender has gained force with the Belt and Road Initiative, a project between Asia, Europe and the Middle East introduced in 2013.

This role as a leading creditor for some low-income countries has been criticised by US politicians who see it as a strategy to increase China's global influence, while forcing excessive indebtedness of recipient countries. The Center for Global Development ranks donor countries across various dimensions in terms of policies contributing to development. China ranks last of 40 countries because of its opaque financing, small volumes of loans compared to its size and its non-concessional structure. On the positive side, since the pandemic China has participated in debt relief initiatives with other G20 creditors for payments due this year, showing that it can put aside its preference for bilateral agreements.

Figure 4 **Countries with largest increase in extreme poverty headcounts in millions, 2020**



Source: IMF/World Bank, Brookings

activity will hit the poorest hardest. The stronger effects will be felt in the more unequal societies. In 2021, an additional 110 to 150 million people will fall into extreme poverty and live below USD 1.90 a day. Almost two-thirds of the extremely poor live in South Asia and sub-Saharan Africa. Meanwhile, inequality will also increase because of job losses affecting those with lower levels of education, or those working in informal activities or in service-related activities, where social distancing is more difficult.

The number of people in extreme poverty could have been much higher though, had it not been for emergency aid programmes. According to the IMF, in Brazil these programmes managed to avoid the poverty increase doubling. In Pakistan, 12 million families benefitted from a cash transfer of USD 75. The World Bank estimates that around 55 countries implemented electronic cash transfers, many of which managed to provide some relief to household consumption (Bangladesh, Ethiopia, Kenya and Nigeria).

Budget constraints to limit government support

The rebound in economic activity for some countries will depend on the availability of foreign financing. Sub-Saharan Africa and South Asia have large funding gaps and limited access to foreign lending and therefore will likely have the smallest expansions, followed by Latin America. Emerging markets with available fiscal space and affordable financing conditions will be able to consider additional fiscal stimulus in the coming year. Emerging Asia has been successfully tapping into capital markets in the past few months and more borrowing is expected next year. Other medium-income countries with high fiscal deficits are seeing borrowing costs rise and despite the higher borrowing costs are seeking market access. This is the case for commodity-exporting countries with high public expenditures.

Additionally, more than half of the low-income countries are at high risk of debt distress, according to the IMF. Spending on healthcare will remain a priority for these countries, and we expect cash transfers to continue where possible. The IMF is supporting efforts to step up debt relief for low-income countries as rapidly as possible. The faster governments agree on future debt restructuring for low income countries, the faster they can reallocate resources.

Risks to the near-term outlook tilted to the downside

Many of the risks to consider are global in nature. Upside risks to our baseline scenario refer to those positive risks that could speed up the global recovery. If a vaccine becomes available for broad distribution earlier than initially expected, this will likely boost confidence and have a positive effect on business activity and consumption. Positive data from vaccine trials have already raised hopes that a vaccine could be approved by regulators in December.

Another positive impulse would be that the US President-elect Biden takes a strong stance on mending international trade and reducing unilateral tariffs. Reverting the withdrawal of trade agreements like the Trans-Pacific Partnership would benefit several emerging countries.

In this positive scenario, advanced economies continue their fiscal stimulus and keep interest rates near zero until they are well-placed for a steady recovery. The US dollar could weaken a bit on the back of lower safe-haven demand. The gains for emerging markets would come from more trade resulting from stronger growth in advanced economies, and stronger capital inflows searching for higher yields.

Risks that would lead to a more negative scenario include a longer-than-expected pandemic, as well as **fiscal imbalances and financing gaps** that constrain public expenditure and lead to more inequality. This is fertile ground for social unrest and a further deterioration of corporate balance sheets. Geopolitical tensions could resurface with more force – not only around trade, but also around migration, high debts and inequality – while governments debate policies and citizens seek better opportunities. **Studies of past pandemics** highlight that pre-existing divisions accentuate in the aftermath of a pandemic.

This more negative scenario plays out in higher market volatility and a stronger US dollar, benefitting from the flight to quality and the appeal as safe haven. In this scenario, low interest rates and stimulus in the US and eurozone are there for much longer. A further softening of inflation is expected. Divergence between China, the US and Europe increases geopolitical tensions between countries. Commodity prices fall. Currency wars dominate this scenario, delaying the global recovery.

Long-term outlook

Severe economic contractions like this one will undoubtedly cast long-term effects on potential growth and income inequality. The loss of human capital, reduced investment and slower adoption of new technologies means that countries will not be able to grow at their full potential. At the same time, given that poorer countries and the most vulnerable workers within a country were the hardest hit, this will exacerbate inequality now and in the future, if the right actions are not taken.

Governments have acted as quickly as possible to provide stimulus, but deliberate and structural attempts to address lower growth potential and higher inequality will likely be topics of debate in the coming year. The pandemic has given us a forced time-out to think and assess those policies that are most effective in bringing about positive change. Countries that decided to support their population, with strong health systems, safety nets and digitalisation, fared better during the pandemic. But also, countries that provided cash transfers to the poor avoided more people falling into extreme poverty. How large-scale meaningful players and projects like China's Belt and Road Initiatives become examples of international collaboration is still to be seen. And as impact investors, we will have to do more, by allocating capital for change (see vison paper Investing in Radical Change). We are in this together and we will have to intensify our efforts to rebuild a global economy that is more resilient and fit for the future.

Growth projections 2020-2021

	GDP growth (% yoy)			Inflation (CPI, % yoy avg)			Government debt/GDP (%)			Government balance/GDP (%)		
	2019	Forecast 2020	2021	2019	Forecast 2020	2021	2019	Forecast 2020	2021	2019	Forecast 2020	2021
Argentina	-2.1	-12.2	4.2	54.0	42.9	48.6	90.0	98.2	95.5	-3.6	-10.9	-6.7
Brazil	1.0	-4.5	3.0	3.5	3.1	4.3	76.0	94.2	97.4	-6.0	-18.4	-8.8
Chile	1.0	-6.6	5.1	2.5	2.9	2.4	27.8	35.0	39.7	-2.9	-9.9	-6.9
China	6.1	2.1	7.9	2.9	2.7	2.0	16.9	20.4	19.8	-4.9	-6.6	-5.8
Colombia	3.3	-7.7	4.5	4.0	2.6	2.8	54.0	66.3	64.9	-3.3	-7.1	-6.9
Czech Rep	2.5	-6.4	4.6	2.8	3.2	2.3	30.5	39.0	42.0	0.3	-7.6	-6.6
Hungary	5.0	-6.9	4.3	3.5	3.5	3.4	68.0	75.0	73.0	-2.0	-7.5	-3.5
India	4.2	-10.8	9.2	3.7	6.4	5.2	47.0	56.0	58.0	-7.7	-10.1	-8.3
Indonesia	5.0	-3.4	3.4	2.8	1.9	2.9	29.9	38.8	42.9	-2.5	-1.0	-5.9
Malaysia	4.3	-6.0	5.8	0.7	-1.0	2.1	52.5	59.3	59.7	-3.4	-6.0	-5.4
Mexico	-0.5	-10.0	4.3	3.5	3.4	3.4	44.8	56.2	53.0	-2.0	-6.0	-4.1
Peru	2.2	-12.5	8.7	2.0	1.7	2.3	26.8	35.4	33.3	-1.3	-10.2	-10.2
Philippines	6.0	-8.4	7.8	2.5	2.5	2.9	39.6	52.8	56.1	-3.3	-10.0	-8.6
Poland	4.0	-4.5	3.8	2.5	3.6	2.6	46.0	55.3	55.5	-0.7	-8.1	-8.1
Russia	1.5	-3.5	2.7	4.5	3.3	3.9	12.3	19.0	20.2	1.8	-4.4	-2.2
South Africa	0.2	-9.5	2.7	4.0	3.3	4.4	62.2	82.0	85.5	-4.0	-14.9	-14.9
South Korea	2.0	-2.0	4.8	0.5	0.7	1.4	36.7	41.8	44.0	-0.6	-4.1	-2.1
Taiwan	2.7	-1.4	3.6	0.6	0.2	2.0	33.4	33.3	32.3	-0.1	-1.1	0.0
Thailand	2.5	-7.6	4.0	0.7	-0.8	1.1	41.2	53.5	59.6	-2.7	-6.4	-6.4
Turkey	0.7	-6.1	4.5	15.2	12.0	12.4	32.5	41.0	40.4	-2.9	-6.5	-5.5

Source: IMF and IHS

Long-term returns, ecosystems and the avoidance of collapse

Long-term returns: wrong for the right and wrong reasons

Hans Stegeman

In the financial sector, most metrics are backward looking. The metrics that we promise our clients to deliver upon – notably expected returns – are chiefly based on historical performance. Yet we know that looking backwards does not suffice, hence our traditional disclaimer: 'past performance is no guarantee for future returns'. Furthermore, the COVID-19 crisis has brought us to a turning point; the world economy needs to and will radically change, which will certainly have repercussions on economic growth and financial returns. This is, of course, what we aim to achieve with our investment approach.

Our longer-term investment return expectations are therefore based on a different perspective. In our long-term outlook, we forecast generally lower financial returns in the coming years, in a highly uncertain environment. Almost all the headwinds we foresaw two years ago are currently playing out.

Our most urgent recommendation, however, is that the financial industry should look at returns in a different way. Otherwise, clients will be misguided for the right and the wrong reasons in what returns to expect from their investments. In addition, we issue this warning: expecting the same financial returns as before boils down to financing the collapse of ecosystems and leads to short-term gains for a permanent loss.

The origins of high historical returns

Long-term returns of risky assets such as equities have long averaged around 7% per year (Jorda, Knoll, Kusvhinov, Schularik, & Taylor, 2019). Safer investments, such as government bonds, yielded 1-3% on average but were rather volatile (Jorda, Knoll, Kusvhinov, Schularik, & Taylor, 2019). Recent research shows that the notion of asset returns (r) exceeding the rate of economic growth (g) seems to hold in the long run with a yearly gap of around 5% on average. This is especially true since 1990 when the size of the stock market became really detached from the size of the economy (Kuvshinov & Zimmerman, 2020). This idea was put forward by Thomas Piketty (r>g), and implies that inequality increases because the wealth of asset owners grows faster than the average income in an economy (Piketty, 2014).

Why were returns on assets so much higher than economic growth? Of course, part of it is risk premium. Another part can be a composition effect, since listed companies, which generally make up the largest part of asset portfolios, represent only a part of the total economy and thus do not need to equal average growth. Nevertheless, can we explain this high return phenomenon in hindsight? A comprehensive quantitative approach is almost impossible. Several qualitative factors, however, can explain both the high returns and in some cases the higher economic growth.

First, (financial) globalisation likely helped to increase global economic growth over the last decades (Grossman & Helpman, 2015). In addition to the evidence that globalisation enhanced factor productivity, there is some evidence that financial returns were positively influenced, although it is questionable if this is more than the overall performance of the economy (Bekaert, Harvey, Kguel, & Wang, 2016).

Second, financial deregulation and lower taxation supported asset returns, especially equity returns. For instance, average corporate tax rates decreased globally from 46.7% in 1980 to 26.3% in 2019, declining in every major region.[1]

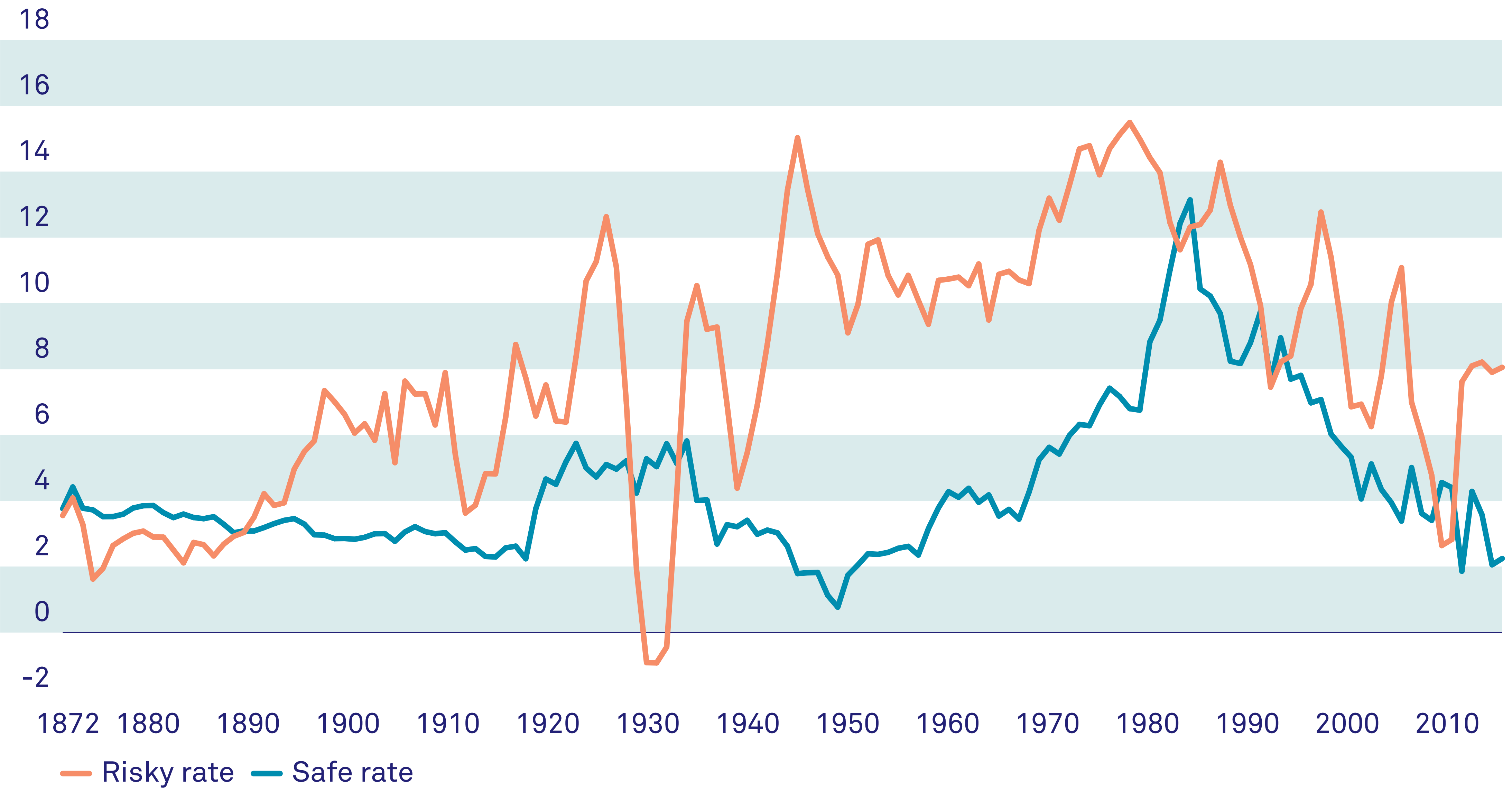
Third, further commodification of the economy increased GDP with the same level of economic activity. Commodification is the transformation of all kinds of products, services, nature, information, etc. into tradeable commodities, bought and sold on markets. This ranges from household or care activities that were formerly done within a family (childcare, cleaning, restaurant or takeaway meals), to marketisation of all forms of leisure activities that became commodities (fitness schools, holidays).

Fourth, debt-to-GDP (both private and public) has surged during the last half a century fuelling returns and laying a claim on future production (future GDP growth). Currently, global debt is higher than ever which implies that our claim on future production is also higher than ever. An important factor in the emergence of this enormous debt pile is that interest rates have been declining since the early 1980s, for a large part the consequence of monetary policies (Borio, Disyat, Juselius, & Rungcharoenkitkul, 2017). Claims on future productivity have thus become cheaper while current returns have increased.

In addition to these monetary arguments, returns exceeded economic growth for another important reason. The cost of externalities was lower than is optimal from a societal perspective; all external effects, from water and ground pollution to carbon emissions that were emitted during production, were never priced. Energy is a case in point. Ever since the Industrial Revolution, the whole economy has been fuelled and transformed using cheap fossil energy. Mainstream economic theory attributes all economic

[1] https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/

Figure 6 Historical returns on safe and risky assets (annual returns, %, 5-y moving average)



Source: (Jorda, Knoll, Kusvhinov, Schularik, & Taylor, 2019), database accessed 21 October 2020.

productivity to labour and capital. Yet the Industrial Revolution primarily meant the substitution of human labour by machines, fuelled by fossil energy. We only attribute the investments in machinery (which enable the use of fossil fuels) to a production factor (capital) and leave the rest (energy use) up to 'technological progress', while in fact it is substitution from human labour to energy. One barrel of crude oil performs about 1700 kWh of work, a human labourer about 0.6 kWh in one workday. Simple arithmetic shows that one barrel of oil equals over 11 years of human labour. Not explicitly taking energy (and the laws of thermodynamics) into account is a flaw that many ecological economists have already warned about (Kummel & Lindenberger, 2020). Correcting growth accounting for this omission shows that the production factor energy accounts for a substantial part of economic growth that mainstream economics has attributed to unexplained 'technological progress'. This development has led to higher private returns at the expense of the environment. In addition, the fact that cheap energy is almost exhausted must be considered when looking at future developments.

And what is true for energy, is also true for other, mostly negative, externalities from production, such as deforestation, biodiversity loss, cheap labour and poor working conditions. These factors have all contributed to higher returns than socially desirable.

Many factors that facilitate high returns can be recognised. Demography has also contributed considerably to real, overall growth, especially in the second half of the 20th century.

Forward-looking flaws

Traditionally, long-term growth expectations – the basis for longer-term return expectations – are calculated based on the classical Solow model (Solow, 1957). This shows growth in labour supply, changes in capital supply and productivity growth, in most cases based on historical averages. Based on these rather simple economic assumptions, structural growth paths for different economies are derived using a growth accounting framework. Growth expectations differ because of differences in labour supply. Aging countries grow less while differences in capital and productivity increase, and less advanced countries typically catch up on growth, also based on their institutions and integration in the world economy. Together with current market valuations, expected risk premiums and inflation, these growth figures are used to calculate long term return for different asset classes.

Our calculations arrive broadly at the consensus of relatively low long-term return expectations compared to historical averages (see box). The main reasons for this are a lower or even negative contribution from labour supply in most advanced economies (aging), low expected productivity gains, and the current high valuations in most markets. Generally, real global

Standard long-term asset returns

The expected long-term financial asset returns are part of our strategic asset allocation considerations. We use the ‘business as usual’ scenario to calculate these returns. We calculate these long-term returns for a period of 15 years, thus eliminating a permanent influence of short-term deviations, such as a strong COVID-19 recovery or a delayed recovery. However, this scenario completely neglects the negative effects of our current economic growth model for people and the environment, or the unsustainability of certain developments. This is synonymous with an unsustainable world. Standard calculations of expected returns on government bonds, corporate bonds and equities are low from a historical perspective. The calculated expected returns of US treasuries are the highest and also closest to their historical returns, compared to UK gilts, government bonds from eurozone countries and Japanese government bonds. The calculated expected returns for eurozone investment-grade credits deviate even further from their historical returns. The calculated expected returns of UK and Japanese equities match their historical returns. Expected returns of European and especially US equities remain far removed from their historical returns. Overall, risk taking is only mildly rewarded from a historical perspective.

annual growth expectations average between 1 and 1.5% annually while the historical average is around 3%.

This straightforward method has big advantages. It leaves a lot out of the equation, from economic inputs such as natural resources to consequences and causes of growth such as debt inequality and carbon emissions. And it makes very simple assumptions about the big unknown – productivity growth. It also assumes that capital can be substituted by labour or natural resources (and vice versa) and that ultimately technology will help us save the economy from ecological disasters.

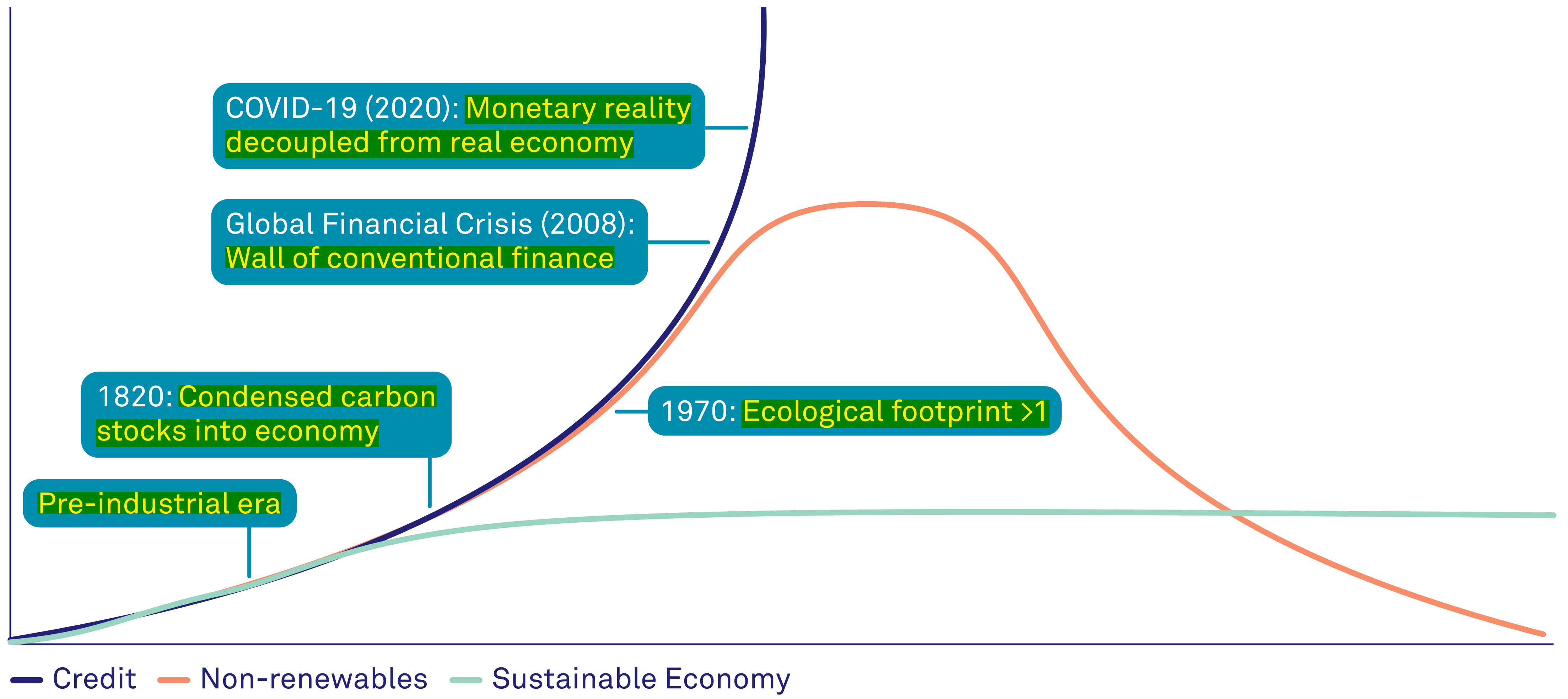
This is approach is wholly unsuitable, however. Firstly, it assumes that natural inputs play no role and that they are merely extrapolated from the past as a ‘total factor productivity’ black box. Yet we know that cheap fossil fuels are rapidly becoming depleted. Changing the energy mix going forward will have drastic consequences for economic growth. Other material inputs, from wood to metals, are also becoming scarcer and therefore more expensive.

Secondly, this method assumes that historical averages of productivity growth and growth in inputs to the economy are in some way indicative of what might happen in the future. This is highly doubtful. The factors that contributed to higher returns have a huge ‘one-off’ factor and cannot easily be repeated in the years to come. What is more likely is that some of these factors will be reversed, leading to even lower average returns. Only a forward-looking approach, which considers all the different factors that contributed to a favourable financial environment in the past, can give some direction for future return expectations.

Third, and most importantly, it assumes that historical factors that contributed to growth (except demographics) will continue forever.

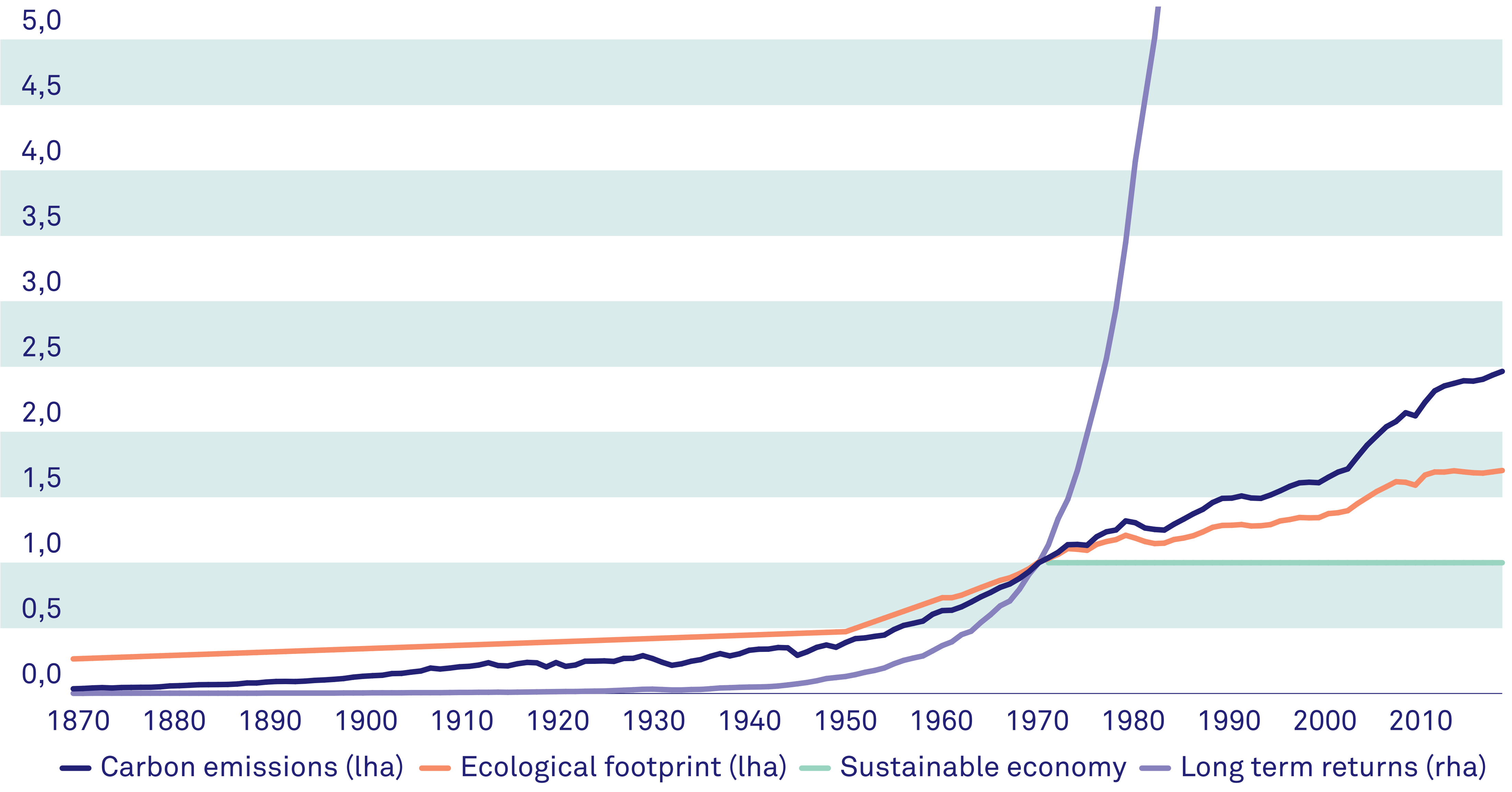
Figure 7 is a highly stylised version of the relation between material inputs, economic growth and credit in the economy, based on Hagens (Hagens, 2020). Figure 8 shows the ‘real-life’ situation of developments based on actual world data. Credit can, in the long

Figure 7 Resources, credit growth and a sustainable economy



Source: Triodos IM, adapted from Hagens (2020)

Figure 8 Resource use, carbon emissions and long-term returns (Index, 1970=1)



Sources: Long term returns: Macrohistory; Carbon emissions: Our world in data; Ecological footprint: Global footprint network, Toth & Szigeti, 2016

term, be loosely interpreted as financial asset returns. In pre-industrial times, it was quite clear that economic activity, credit and material inputs were on average directly linked to each other. The share of the financial system in relation to the rest of the economy was incomparably smaller, and economic activity stayed clearly within ecological boundaries. Around 1820, economic activity started crossing these boundaries when we started using coal as easy-to-grab inputs for our economic system. The resulting economic growth led to materially improving living conditions. The success of this model led to an economic system that had exceeded its ecological boundaries by 1970 From the 1980s onward, the great disconnect between the real economy and finance accelerated with an increasing amount of the economy becoming financialised until the financial crisis in 2008. Since then, we are stuck in an era of unconventional finance characterised by strong interventions by central banks with extremely low interest rates and accommodative monetary policies, as well as huge public and government debt to support economic activities. The success of these policies and measures has been limited, and the last 10 years were marked by a lack in effective demand (Summers, 2018), resulting in lower growth rates (yet higher financial returns).

COVID-19 might be a watershed moment. Since the outbreak of the pandemic, our exponentially increasing financial growth model needed the support of unprecedented ‘rescue’ packages: a fiscal impulse of around 12% of global GDP and a monetary impulse of around 4% of global GDP (IMF, 2020). This resulted in a further disconnect between real economic activities and financial returns.

Looking forward: lower is inevitable, unless...

If we take time to reflect, it is very clear that we need a different, more forward-looking approach to see what the long-term returns of investments might be. Expecting the same returns as before would be equal to financing a collapse: possible in the short term, but inevitably disastrous in the long run.

The 21st century is diverging from the trajectory we have experienced in previous decades:

1. Energy and resources are again becoming constraining factors on economic and societal development.
2. Physical expansion predicated on credit is becoming riskier and will eventually reach a limit.
3. Societies are becoming polarised and are losing trust in governments, media, and science.
4. Ecosystems are degrading, having to absorb large quantities of energy and material waste from human systems.
5. Favourable financial circumstances for corporate profitability such as tax reductions will probably reverse.

We don't know how these effects will play out in the years to come. However, we can break them down into several factors that are relevant for the investment environment.

First, the energy transition requires a long-term orientation. Not only in terms of expected labour productivity, which, as we have explained, is part of the productivity increase attributed to energy, but also in terms of asset allocation. Whereas investing in fossil fuels is not the best option from a sustainability perspective or a risk-return perspective. Therefore, investing in transitions, either in energy or in general non-renewable to renewable resources, is a better option in asset allocation.

Second, making finance with finance is becoming a more dangerous game (although it can go on for some time), with high debt levels globally. The best way to achieve an adequate financial risk-adjusted return in the longer term is to invest in the real economy. Companies with strong balance sheets that do not depend on high growth expectations are the safer options.

Third, geopolitical tensions are here to stay and can make global supply chains highly vulnerable. There is no easy way to mitigate this risk in the strategic asset allocation; we leave that problem to our tactical asset allocation framework in this investment outlook. In the long run, we expect that adverse effects of geopolitics will in general be covered by changes in supply chains and strategic adaptations in business models and sourcing.

Fourth, harnessing against degrading ecosystems in an investment approach can be done in two ways. The positive approach is to invest in sustainability solutions, such as overweight companies that contribute to a circular and/or regenerative economy. Or avoid companies that have high risk (in business and externally) to sustainability threats and use vulnerable ecosystem services in an irresponsible way in their business model.

The challenges we face should be taken into account in every strategic asset allocation framework. Our approach is to assess them from a positive angle and to invest in impact and transitions. This approach will help to avoid risks and guarantees a positive long-term return.

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