Reflation

Anything to fear for ESG?

There have already been enough comments and analysis as to why ESG and Impact investments had a good 2020. It was a good year not to be invested in fossil fuels, airlines and tourism, bricks and mortar retail, hospitality and many other commodities. Whilst at the same time we have seen renewable energy march on as it matures, the electric car establish a firm foothold and IT take on a new importance in many of our lives.

It's obvious the world has changed in many ways, not just around work from home, but also there is a new lease of life in science, innovation and technology that had been lacking for some time.

In addition, 2020 was also the year of Brexit and an end to what has been a divisive, emotive and a huge drag on the country's economic development. The US has new leadership at the end of a divisive election, and it is now the turn of Europe, with close run elections in France and Germany taking place in 2021.

The UK and the US are leading the G7 in vaccinations and they have a clearer site out of the pandemic; along with the recovery in China, it seems three of the leading global economies are moving into the recovery stage, and markets, which by nature are forward looking, are now taking note.

Up until now, we have seen fiscal and monetary stimulus around the world to an extent never seen before, and at the moment no one is wanting to tone it down and risk the recovery. As the recovery starts, and views are being expressed that a certain level of inflation is in fact desirable, concerns about the risk of less controlled inflation are rising. So far, the UK is the only G7 economy talking about reducing stimulus ahead of the March 2021 budget.

At the same time the recovery has led to a number of bottlenecks, notably with microchips but also in a number of commodities, where producers have been caught out by the sudden rise in demand which in turn has added to the inflation concerns.

These issues have become more pronounced in the last 6 weeks, and recently the bond markets have begun to respond. We have seen bond yields re-price across the yield curve (which in turn has led to price falls) and expectations of higher interest rates and inflation in the more distant future have taken hold. For example, the 10-year UK Gilt yield has risen from a low of 0.21% to 0.8%. Whilst we have been under exposed to debt and the majority of our debt exposure has been shorter dated or floating rate notes, we have seen some falls in debt investments as a result.

At the same time equity markets have seen a swing back in favour of some commodity-based investments, undoing some of the relative gains for ESG and Impact investments. Whilst we see a recovery in many commodities and although the oil price has recovered, we do not see the share prices of this sector returning to the former levels. Not only is oil passé as a fuel, but the companies are running hard behind the curve to move into green sectors (as seen with the very high prices paid at the last UK offshore wind auction), with debt and investor demands.

Hospitality and travel may recover and we see both unemployment and underemployment falling. In the UK this has been more pronounced due to the makeup of the jobs market, but we liken the UK economy to a coiled spring, ready to bounce back. With Brexit over, Sterling continues to recover against the Euro and US$ which will keep import prices down.

This means in the short term, we feel reflation may favour some sectors that were hard hit in 2020, and this has taken some of the heat out of many of the global impact and ESG investments we favour. This is why we took some profits late last year, and although hesitant at the time, it was clearly a prudent move.

In the medium term, the new lease of life in energy storage, clean mobility, renewable energy, good & affordable housing, healthy and sustainable food, and a resurgence in medical technology as well as more sustainable working and living have all gained a new momentum that we see as only just starting. We see this as a bump and not a change in momentum.