



INVESTMENT INSIGHTS

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ESG: FROM “NICE TO HAVE” TO “MUST HAVE”

EDITORIAL VIEW

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- 2019 may well be remembered as the turning point for ESG investing
- The range of ESG vehicles is fast expanding, with large asset managers joining the fray
- As money continues to pour into this space, ESG rating systems will need to improve

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- Less clouds on the near-term horizon thanks to the “phase one” trade deal
- The economic backdrop remains supportive as we enter 2020
- Moderate/high-single digit upside on equities but expect a bumpy year

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- Forex - Reducing direct USD exposure on fading growth and rate differentials, adding some EM carry

Editorial View

ESG: From “Nice To Have” to “Must Have”

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For the swelling cohort of climate activists, the COP25 conference in Madrid provided an opportunity for 2019 to go out with a bang. Alas, far from providing a grand finale to the year (and despite running well overtime), this summit resulted in no real action on climate change, just some watered-down promises. Saving the day – and confirming that the green tide is alive and well – was the EU’s *Green Deal* unveiled by new Commission President Ursula von der Leyen. Ambitioning to “reconcile the economy with the planet”, it pledges to cut emissions by 50-55% (vs. the 1990 baseline) by 2030 and reach carbon-neutrality by 2050.

A much less publicised feature of the year just passed, and one that reaches beyond purely environmental concerns, is the rising prominence of ESG investing. 41 ESG ETFs were launched in 2019, while the Bloomberg database now counts over 2000 ESG-labelled funds, with a number of major asset management firms having made the plunge in the last year.

Money flows into the space have certainly been impressive, as environmental, social and governance considerations matter increasingly in portfolio allocation. According to BNP Paribas, ESG equity funds attracted 28% of asset inflows in 2019, second only to US government bond funds and well outpacing US and European equity funds. And the shift goes beyond equities: Danish renewable energy producer Orsted – a top ESG scorer – recently issued a 100-year hybrid “green” bond that was almost 7 times oversubscribed. All told, Goldman Sachs now puts the amount of assets under management that integrate ESG criteria at USD 17.5 trillion.

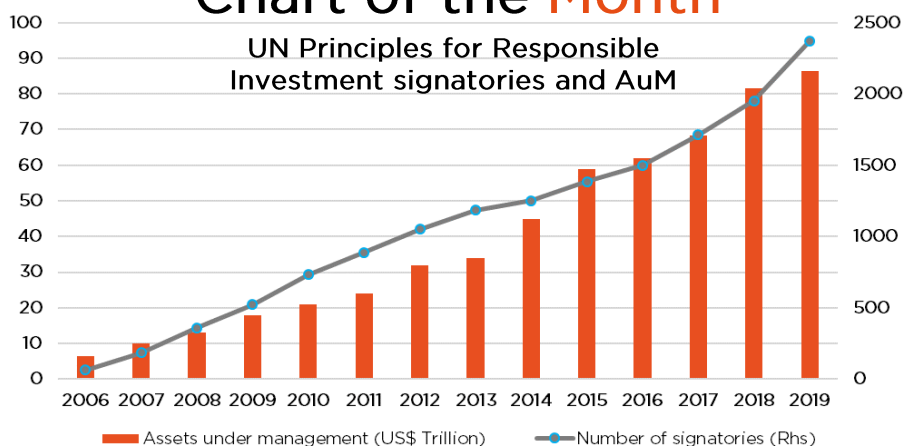
With this trend set to continue – indeed accelerate – in 2020, ESG rating systems will become ever more important. The question, though, is whether they are ready to bear such weight in investment decisions. A few months ago, an official at the US Securities and Exchange Commission described them as “labelling based on incomplete information, public shaming, and shunning wrapped in moral rhetoric”.

When comparing scores attributed by two large ESG-rating systems, the Economist found only a poor correlation – meaning that rating firms do not agree about which companies are “good” and which are “bad”. Their scoring systems also typically rely on sparse and out-of-date figures. Larger companies tend to get better ESG ratings, just because they can afford to make the necessary disclosures. Worse, some systems punish companies that do not make specific disclosures, quite regardless of the characteristics of the business they operate in.

Not surprisingly, greater demand for ESG scores is attracting the bigger players into this space. 2019 for instance saw S&P Global purchase the ESG rating division of RobecoSAM and Moody’s do the same with Vigeo Iris. Odds are thus that ESG scoring systems will become more robust as the industry matures.

Ultimately, what this ESG tsunami really means is that companies will have to learn to live in a world of increased scrutiny – by customers, investors and activists alike, not to mention regulators and (quite possibly) central banks.

Chart of the Month



Global Strategy

Equities, what else?

- Less clouds on the near-term horizon thanks to the “phase one” trade deal
- The economic backdrop remains supportive as we enter 2020
- Moderate/high-single digit upside on equities but expect a bumpy year

Christmas came early for investors, with all their wishes duly fulfilled: a “phase one” US-China trade deal, some clarity on Brexit following the landslide victory of Boris Johnson’s Conservative party in the UK general elections, central banks’ commitment to remain on the dovish side, and additional signs – albeit fragile – that global manufacturing is bottoming.

We thus keep an overall constructive economic scenario. As far as asset valuations are concerned, we still acknowledge that current equity valuations leave little room – in the short-term – for growth disappointments, an unexpected spike in rates, a large credit accident or any major geopolitical disturbances. That said, they are certainly compatible with a context of slow (but stable and positive) growth, a historically low unemployment rate, muted inflation and anaemic interest rates. In any event, equities have greater appeal than bonds, given the depressed level of core rates, the tightness in credit spreads, and thus the meagre expected fixed income returns across different time horizons.

As we enter the new year, and the global business cycle recovers, there is a growing likelihood that the US dollar has peaked. Indeed, the narrowing of the interest rate and growth differential between the US and other developed economies is making the greenback less attractive. In the same vein, we may even experience some outperformance of non-US equities during the first half of 2020.

What these market trends should effectively reflect is a form of convergence of both economic growth and valuations. To the extent that it cannot rely on the strength, weight and resilience of US consumers to sustain growth, the rest of the world should be the main beneficiary of the economic stabilisation/improvement and is thus liable to “rebound more” than the US.

At the portfolio level, this constructive scenario still translates into a neutral allocation to equities and a bond underweight, supported by a modest pick-up in global growth, central banks’ accommodative monetary policies and elevated risk premia.

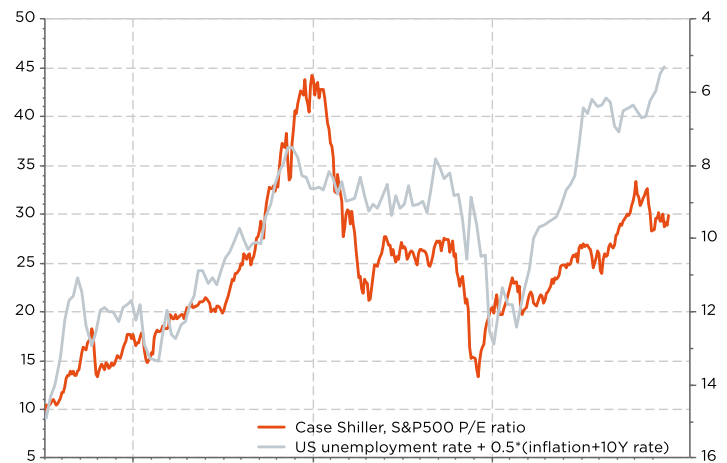
We have upgraded Eurozone equities to neutral, as a value play, given the more favourable macro backdrop. They also offer an attractive dividend, a rare (and thus precious) feature in this low yield environment.

As regards foreign exchange exposure, we have downgraded the dollar to neutral and the sterling to a slight underweight, on the back of a quick resurgence of the spectre of a no-deal Brexit by the end of 2020, given the challenging timeline. Finally, in a context of some recovery in global growth and a peaking USD, we have upgraded EM currencies to a slight overweight. Their attractive carry and rather cheap valuations should finally lure investors this year.

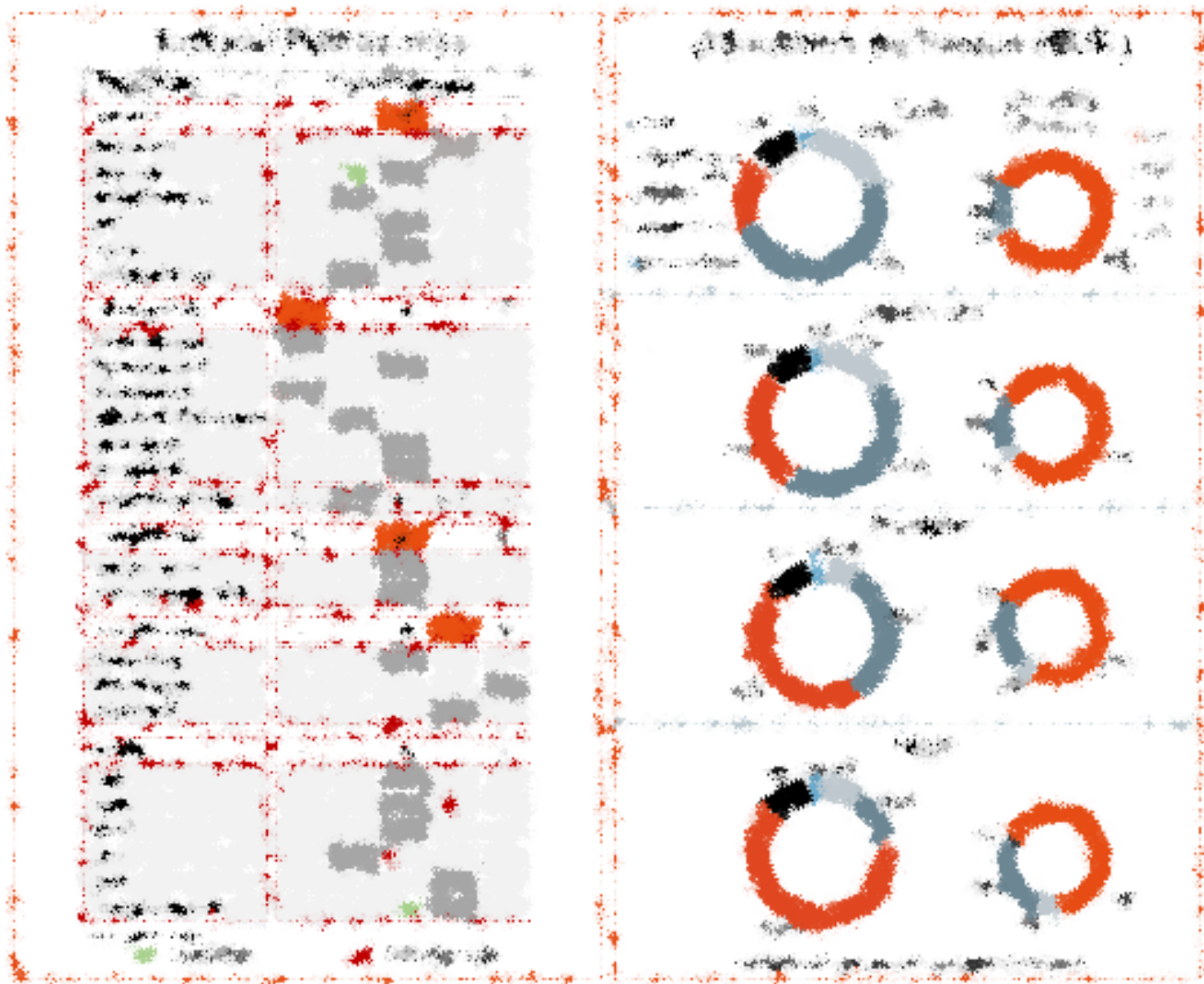
2Y interest rate spread and EUR/USD



S&P500 Case-Shiller PE and modified misery index



Asset Allocation



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Contacts

DECALIA Asset Management SA

31, rue du Rhône
Case postale 3182
CH - 1204 Genève

Tél. +41 22 989 89 89
Fax +41 22 310 44 27
info@decaliagroup.com

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External sources include: Refinitiv Datastream, Bloomberg, FactSet, UN PRI

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