

HEALTH WEALTH CAREER

# THEMES AND OPPORTUNITIES 2019

THE FOUR ELEMENTS

MAKE TOMORROW, TODAY



Our investment themes are intended to highlight the forces that we believe will shape economic and market dynamics over the years ahead – some themes are focused on the next one to three years, whereas others would be expected to play out over the course of a decade or longer. We therefore would not expect our themes to change dramatically from one year to the next, but rather to evolve and reflect important shifts in the investment landscape. Although we present them as discrete themes, in reality they are highly interdependent.

A summary of our themes follows. We then look at each in more detail to identify the opportunities arising for our clients.

## WHITE WATERS OF THE LATE CYCLE

We see mounting evidence of overextension of credit. Outstanding debt is increasing, while quality is decreasing. Covenants are deteriorating and speculative use of debt is becoming more evident. Meanwhile, we expect the continuing positive macroeconomic backdrop, pro-business policies and levels of business optimism to continue to assist the equity market in the near term. When these contrasting equity and bond market currents meet, there is scope for white-water turbulence. Navigating such an environment will require investors to be alert, prepared and tenacious. Investors should examine and waterproof their fixed income portfolios. The return of inflation, thought to be long banished, is an additional threat that investors cannot afford to ignore.

## WINDS OF CHANGE IN MARKET PARTICIPATION

After the global financial crisis, central banks stepped in for traditional banks as the primary providers of liquidity. As they now try to rein in their market involvement, it is far from clear what the implications for liquidity will be — investors should be on alert for signs of stress. The increased involvement of institutional investors in private markets affects both public and private investors, and a rise in the number of investment strategies that sit somewhere between traditional active management and traditional passive management is likely to benefit many investors not suited to either extreme.

## TECTONIC FRICTIONS IN THE GLOBAL WORLD ORDER

Our 2018 theme of political fragmentation continues to be relevant in 2019 (and beyond). It is now considered a credible possibility that the pace of globalization could slow, pause or even go into reverse. Perhaps the most obvious example of the influence of politics on international trade is the state of trade relations between the United States and China. China's growth and, perhaps more important, its efforts at opening up capital markets raise some practical questions for investors about how to manage their exposure to the world's second largest economy. Although more turbulence in global politics is likely to continue to weigh on markets, it may present a more favorable investment environment for certain types of opportunistic strategies.

## SUSTAINABILITY GATHERING MOMENTUM

Governments, regulators and beneficiaries are increasingly expecting those with responsibility for allocating capital to take a broader perspective of risk and return — although expectations strongly vary among different regions. Can the investment industry continue to invest without serious consideration of the way the world is changing demographically, socially, environmentally, technologically and politically? We recognize that the incorporation of sustainability considerations into portfolios involves the need for a longer timeframe than what is typically used for investment decision-making, but investors who do take a longer-term view may uncover opportunities that are not currently priced in.

We foresee a world where asset owners and investment managers incorporate sustainability as a standard action, moving on from optical responses to a place where sustainability is integral to idea generation and risk management.

# WHITE WATERS OF THE LATE CYCLE

We detect disparate currents in the bond and equity markets. Against a backdrop of continuing low yields, lending standards appear to be deteriorating, along with the ability to service debt. In contrast, a robust stream of economic good news continues to assist equities, with corporate success stories not hard to find (albeit often with rich valuations). Although companies benefit from an optimistic economic environment, they must also be able to hold down their financing, and their ability to do so could come under pressure from rising interest rates. When conflicting currents such as these meet, white waters can develop.

The approach of these white waters may be welcomed by those with the skill and experience to navigate their way to clear

water by taking advantage of tactical opportunities. For others, the priority is just to make it through the rapids in one piece. Both types of investors will benefit from revisiting and stress-testing their strategic asset allocation, to ensure it is fit for purpose and robust enough to take the knocks that the rapids ahead may present.

We should all bear in mind that the successful investments of the past are not guaranteed to be the successful investments of the future. Although fixed income assets offered a degree of protection during the last crisis, it is unclear whether that will be the case next time around.<sup>1</sup>

<sup>1</sup> Mercer. *Will Bonds Bail You Out Next Time?* September 2017, available at <https://www.mercer.com/content/dam/merc/attachments/private/nurture-cycle/gi-2017-wealth-will-bonds-bail-you-out-next-time-merc.pdf>.

We see in the leveraged loans market that more than three out of four loans are what is termed “cov-lite” – that is, they don’t have covenants that require the borrower to maintain prudent financial behavior. The proportion of loans without these protections has more than tripled from the levels immediately prior to the Global Financial Crisis. Essentially, this may have swept a lot of bad news under the carpet, as some borrowers would have undergone technical defaults by now if these covenants had been in place.

In the more creditworthy “investment grade” sector, the levels of leverage exhibited by borrowers have increased such that a large proportion of the outstanding stock is now positioned at BBB. If credit quality slides any further, investment grade bonds will take an automatic price hit when credit reclassifies to “high yield” – that is, it moves below BBB.<sup>2</sup> Of course, if it is believed these bonds are “money good” (that is, they will successfully pay out all scheduled coupons and principal payments) and investors can hold them to maturity, this may present a great opportunity in the form of a Buy and Maintain strategy.<sup>3</sup>

This outlook is quite distinct from that for the high yield market, which – relative to history – looks expensive, with low spreads suggesting lower potential prospective returns.

We still see opportunities in the area of growth fixed income, however, in both hard and local currency emerging market debt. Mandates in

which the investment manager has the ability to rotate between credit sectors are also well placed to take advantage of the changing prospects of different sectors of the credit universe (multi-asset credit managers are an example of this). If the credit cycle<sup>4</sup> does turn in the next couple of years, distressed debt may prove an interesting asset class to consider.

Equity markets have seen an artificially low failure rate over a long period of monetary largesse. The most levered companies may be at risk of failure, however, if they have thus far avoided the fate of bankruptcy due to refinancing costs remaining low. Along with these “zombies” (now a larger proportion of the market than ever,<sup>5</sup> and overdue a reckoning), income-rich stocks – such as utilities – are likely to be sensitive to faster-than-anticipated interest rate rises. We believe shares that are growing their dividends sustainably year-on-year may be the best port in a storm for equity investors.

It is also worth considering holding cash now, particularly in places where interest rates are normalizing, such as the US. It would also be easy to be complacent about the need for inflation protection in portfolios, as none has been needed for a long time, but we encourage investors to be inflation-aware.<sup>6</sup>

<sup>2</sup> BBBs make up 49.6% of global investment grade credit (as represented by ICE BofAML Global Corporate Index as at November 7, 2018) and 52.8% of US investment grade credit (as represented by the ICE BofAML US Corporate Index as at November 7, 2018).

<sup>3</sup> Buy and Maintain is a strategy in which a portfolio of bonds is bought that the manager believes will honor all payments in the long run and in which the bonds are held onto, provided that the original investment thesis on purchase remains sound. This approach, if successful, can be low cost due to the low turnover and can allow for some capturing of the illiquidity premium.

<sup>4</sup> Mercer. *Preparing for Late Credit Cycle Dynamics*, September 2018, available at <https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-wealth-preparing-for-late-cycle-dynamics-mercer.pdf>.

<sup>5</sup> McGowan MA, Andrews D, Millot V. *The Walking Dead: Zombie Firms and Productivity Performance in OECD Countries*, OECD Economics Department Working Papers, No. 1372, 2017.

<sup>6</sup> Mercer. *Inflation Awareness: Understanding Inflation and Its Impact on Your Portfolio*, April 2018, available at <https://www.mercer.com/content/dam/mercer/attachments/private/gl-2018-wealth-inflation-awareness-understanding-inflation-and-its-impact-on-your-portfolio-mercer.pdf>.

# WINDS OF CHANGE IN MARKET PARTICIPATION

Most marketplaces are dominated by one or more groups or agents, but from time to time this dominance evolves and changes hands, as a result of either policy action or market forces.

After the Great Financial Crisis, banks saw their collective ability to act as the providers of credit and liquidity to businesses and individuals curtailed, thanks to stricter capital controls enforced by regulators around the world. This regulatory action affected investment markets in a manner very similar to a tightening of monetary policy — it reduced the amount of money being made available for lending, making it harder for companies and individuals to borrow. To prevent an even deeper recession, this liquidity had to come from somewhere new, and central banks became the providers of liquidity. In an already challenging economic environment, what began as an emergency injection of liquidity led to

an extraordinary loosening of monetary policy through both lower interest rates and huge asset purchases.

That's all set to change now — according to the central bankers, at least. If the world's major central banks proceed with their stated intentions to deleverage their balance sheets, the coming years are going to see a significant withdrawal of liquidity.<sup>7</sup> A likely indirect effect of this will be a reduction in the ability of individuals and corporations to borrow money for investment or consumption. Without another provider of liquidity stepping into the limelight — and it's hard to see how that can happen without a relaxation of banking regulation — this could be highly restrictive to economic growth. How firmly central bankers are willing to press the brake on economic growth, in order to reduce the size of their balance sheets, is a key question for 2019 and beyond.

<sup>7</sup> Mercer. *From QE to QT – Building Robust Portfolios*, October 2018, available at <https://www.mercer.com/content/dam/mercero/attachments/private/nurture-cycle/gl-2018-wealth-from-qe-to-qt-building-robust-portfolios-mercero.pdf>.

The prevailing wind looks increasingly challenging for public market investors, with extraordinarily low yields and generally elevated valuations.

Private equity and private debt, on the other hand, have continued to offer attractive growth opportunities, and constraints on bank lending have also increased the opportunities for sophisticated investors to lend directly to businesses. However, the level of asset flows into private markets — and the elevated valuations prevailing in certain segments — may be cause for concern. The importance of investors understanding their tolerance for illiquidity, in a range of scenarios, is heightened. So, too, is the value of ensuring balance in a program of private market investments that is diversified across vintages, managers, market segments and the capital structure.

The expansion of private markets may also limit the economic exposure of public markets if an increasing proportion of companies remain privately owned. This may be particularly relevant in emerging markets, where many investors allocate to gain exposure to economic growth in these higher-growth economies — this exposure may be skewed or diluted by more businesses staying away from public markets.

The final dynamic that we believe is worthy of discussion is one that we might historically have referred to as “active versus passive,” with growth of “passive” investing at the expense of “active” management. This characterization has always been too simple, but perhaps never more so than today. The growth of systematic or factor strategies, such as alternative risk premia<sup>8</sup> or multi-factor equity funds (sometimes referred to as “smart beta”), shows how demand for simpler,

often cheaper, products has been on the rise across a whole spectrum of product types, from hedge funds to indexed equity. Some of this change is being driven by investor concerns about alignment of fees<sup>9</sup> — a topic Mercer has been vocal about.

Active management can add real value, particularly in an environment of change, but it is not appropriate for all investors or for all markets. To implement active management successfully, asset owners need strong governance, an ability to withstand periods of underperformance and to be mindful of behavioral biases in an environment of variable, and often cyclical, relative performance. Where active management may not be suitable for reasons of market efficiency, a broader spectrum of available systematic and alternative index strategies is likely to benefit investors not content with a portfolio construction process set out purely by an index provider.

We are sometimes asked whether outflows from active strategies are a concern for the functioning of capital markets (given the important role played by active management in price discovery), or whether the rise of factor investing and the use of exchange-traded funds (ETFs<sup>10</sup>) could present systemic risks. Although there may be pockets of concern, we have, so far, seen little evidence to suggest any investor action is needed.

A higher prevalence of rules-based investing may make the landscape for traditional active management even more competitive, but the potential returns available to skilled investors through exercising judgement may also improve if such rules-based strategies create systematic biases that can be taken advantage of.

<sup>8</sup> Mercer. *Alternative Risk Premia*, June 2018, available at <https://www.mercer.com/content/dam/mercer/attachments/private/gl-2018-alternative-risk-premia-investing-mercer.pdf>.

<sup>9</sup> Mercer. *Investment Manager Fees Expanding the Framework*, June 2018, available at <https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-wealth-investment-manager-fees-expanding-the-framework-mercer.pdf>.

<sup>10</sup> Mercer. *Exchange-Traded Funds — An Effective Tool for Implementation*, July 2018, available at <https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-wealth-exchange-traded-funds-an-effective-tool-for-implementation-mercer.pdf>.



# TECTONIC FRICTIONS IN THE GLOBAL WORLD ORDER

The total value of goods and services traded across international borders has grown exponentially over the last half century. With trade barriers being systematically dismantled, the world's major economies have become more and more intertwined. This “globalization” of the production and consumption of goods and some services has had a wide range of impacts – significantly increasing global wealth (albeit unevenly) and dampening inflation, as outsourcing has enabled lower production costs for many goods and services.

It is far from clear whether we can expect this trend to continue. Although the hard-to-measure trade-in-services data appear to show continued growth, in the last few years growth in the trade of goods has plateaued – the value of global goods exports in 2017 was lower than in 2011.<sup>11</sup>

<sup>11</sup> Trade in services is notoriously difficult to measure due to both the intangible nature and the inability of countries to apply at-the-border tariffs, which have led to more accurate compilation of data on cross-border trade in goods. Source: The World Bank.



In our 2018 themes, we talked about the risks posed by political fragmentation and the potential for increased protectionist or isolationist policy. Going into 2019, we are asking ourselves whether we may have reached peak globalization. We doubt that we will see the gains from globalization over the last 50 years reversed materially, but we recognize that the forces behind globalization may be fading.

Nowhere is a stalling of economic integration more visible than in the trading relationship between the United States and China.

In 1990, China was the twelfth largest economy in the world, less than a sixteenth of the size of the US (the world's largest economy) and with an average annual income per capita of around US\$315. In the 28 years that followed, the size of the Chinese economy increased by more than a factor of 30, lifting more than 700 million people out of poverty. It is a phenomenal growth story. Such significant growth, for such a large economy, is bound to cause friction.

In Washington, the mood toward China turned decisively during 2017 and 2018, with increases in trade tariffs between the US and China dominating headlines. The investment implications of the tariff increases have dominated many investor discussions since then and are likely to continue into 2019 (and maybe beyond). An important question is how investors can balance the risks associated with investing in China with the growth opportunity that the country still clearly presents.

If global trade reverses direction, a potential impact could be greater divergence in investment returns across regions and countries. This may present a challenge to our view that global investment mandates<sup>12</sup> are generally better placed than portfolios of regional mandates to deliver active returns (with some notable exceptions<sup>13</sup>), so this is a dynamic that we will be watching closely.

The (very gradual) introduction of onshore Chinese equities<sup>14</sup> (A-shares) into the MSCI Emerging Markets and All Countries World Indexes, and the announcement that Chinese bonds<sup>15</sup> will be incorporated into the Bloomberg Barclays Global Aggregate Index in 2019, will provide impetus for investors to consider how best to get exposure to the second largest economy in the world, and whether they are comfortable being led by index providers. There are undoubtedly risks to consider, too, many of which will be challenging to assess. However, we are definitely seeing a shift toward the East.

An environment of global economic divergence has the potential to present a favorable investment environment for unconstrained investors with global macroeconomic insight, but it could lead to more volatility in currency markets, prompting a review of how currency risk is managed within investor portfolios.

<sup>12</sup> Mercer. *The Challenge – Global or Regional Equity Mandates?* June 2016, available at <https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2016-equity-portfolios-wealth-and-investments-the-challenge-global-or-regional-equity-mandates-mercer.pdf>.

<sup>13</sup> Mercer. *Active Small Cap Equities and the Value of Local Knowledge*, September 2018, available at <https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-wealth-active-small-cap-equities-and-the-value-of-local-knowledge-mercer.pdf>.

<sup>14</sup> Mercer. *The Inclusion of China A-shares in MSCI Indices – Implications for Asset Managers and Investors*, August 2018, available at <https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-wealth-the-inclusion-of-china-a-shares-in-msci-indices-mercer.pdf>.

<sup>15</sup> Mercer. *China Onshore Bonds – The New Territory*, November 2018, <https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-wealth-china-onshore-bonds-the-new-territory-mercer.pdf>.

# SUSTAINABILITY GATHERING MOMENTUM

Sustainability involves being aware of what is expected to happen in the broader world in the years to come and what that might mean for you as an investor; it is about understanding the impacts of actions taken today and the potential risks and opportunities they might create.

Investors are increasingly being encouraged, and in some cases forced, by a wide variety of governments and supranational organizations to adopt a sustainable perspective. The key lodestars are the United Nations' Sustainable Development Goals and the World Economic Forum's risk stewardship, as embodied by the Annual Global Risk Report. More widely, The UN Principles for Responsible Investment's (UN PRI) Global Guide to Responsible Investment Regulation has identified 300 policy instruments in the world's 50 largest economies that are supportive of investors considering long-term value drivers, including environmental, social and governance (ESG) factors.<sup>16</sup>

Alongside the support for sustainable return perspectives, these organizations are increasingly requiring investors to identify non-traditional risks in their portfolios. The world's climate is changing – and at an accelerating pace. Mercer has engaged with its clients for many years on the potential impact of climate change, and we will shortly be publishing *Investing in a Time of Climate Change – The Sequel*, along with extended and enhanced climate-impact modeling. We believe this work will be helpful to investors looking to take a broader perspective on risk. In particular, major disruption to energy producers is overdue, where a shift away from the energy sources that fueled the Industrial Revolution is

<sup>16</sup> Mercer. *The ABC of ESG*, November 2018, available at <http://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-wealth-the-abc-of-esg-mercer.pdf>.

already underway and gathering steam — a risk we believe investors should bear in mind is that they could end up with “stranded assets.”

Focusing on appointing managers that have strong ESG credentials (alongside a high investment due diligence rating) could be the most effective and appropriate first step for many investors looking to incorporate sustainability into their portfolios. This can then be extended to incorporating more sustainability-focused satellites into their equity portfolio — for example, by investing in an active environmental equity strategy. This involves investing in a portfolio of companies that would be expected to fare well in the transition to a low carbon economy. Clearly, this comes with a concentration risk that investors shouldn't be complacent about; however, this could be a good

complement to existing allocations. Academia provide a good level of evidence that incorporating sustainability into corporate strategy has yielded a neutral to positive impact on financial performance in recent times.<sup>17, 18, 19</sup>

For fee- and governance-sensitive investors, the next step could be to look at allocating to an ESG-focused index, as an evolution from a standard (market-capitalization-weighted) passive approach. We believe this approach has merit in terms of potential risk reduction and that the return prospects over the long term would be in line with traditional approaches. For unconstrained investors with a higher commitment to sustainability, impact investing through private market strategies is worth considering.

## TAKING ACTION

The ideas outlined in this paper represent our observations on the challenges, opportunities and drivers of change present in the current investment environment. We provide these ideas with the aim of provoking discussion, but the appropriate response at an investor level will be heavily influenced by the specific beliefs, objectives and constraints of each investor. We look forward to helping investors adapt their strategies as new risks and opportunities arise over the course of 2019.

<sup>17</sup> Deutsche Asset & Wealth Management Investment GmbH. *ESG & Corporate Financial Performance: Mapping the Global Landscape*, 2015.

<sup>18</sup> University of Oxford and Arabesque Partners. *From the Stockholder to the Shareholder*, 2015.

<sup>19</sup> Khan M, Serafeim G, Yoon A. “Corporate Sustainability: First Evidence on Materiality,” *The Accounting Review*, Volume 91, Issue 6 (February 2017), pp. 1697–1724.

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