welcome to brighter

2020 vision

# themes and opportunities

... it's a matter of time

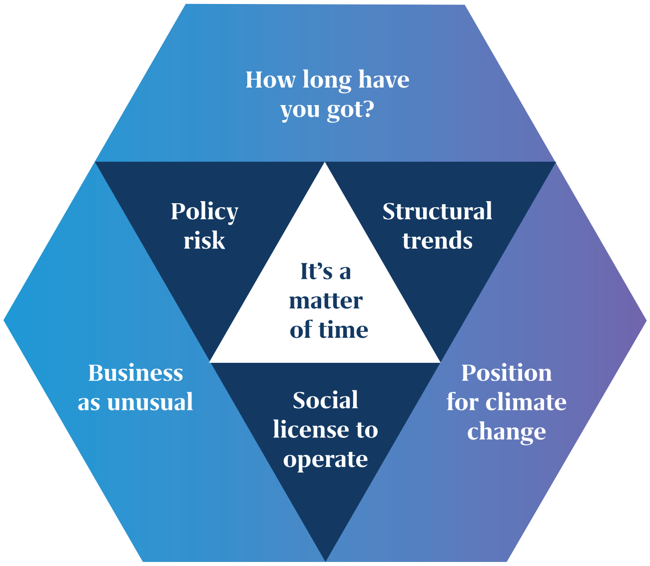
**A number of forces have the potential to radically reshape the investment landscape over the next decade. After the first decade of this century brought 9/11, the "tech wreck" and the global financial crisis, the taper tantrums, polarized politics and trade wars of the 2010s seem quite benign.**

**However, the puzzles facing investors in the coming decade are far from harmless: negative yields on more than a fifth of global bonds, stubbornly low inflation in the developed world, central banks running out of ammunition to stimulate growth, growing wealth inequality, and high public debt levels.**

**The effects of climate change are also becoming clear: $CO_2$ emissions are higher than ever and climate-related activism is accelerating. Change is on the horizon and you need to be ready.**

# It’s a matter of time ...

Be clear on your timeframe, be prepared for business as unusual and position your portfolio for climate change — all of this requires a clear understanding of how related risks and opportunities could develop over time. For most investors, this means extending focus beyond current events, such as geopolitical risk and slowing economic growth, to bigger-picture issues, such as potential shifts in economic regime, the impact of evolving structural trends and increasing market recognition of environmental, social and governance (ESG) issues, particularly climate change. To succeed in the coming years, you must reconcile all these issues and their different timeframes.



# How long have you got?

First off, you need to be clear on your timeframe. If your time horizons are shorter, perhaps exhibit more caution and focus on market and liquidity risks. If your time horizons are longer, you need vision to understand the evolution of structural trends and their impact on markets.

The primary risk to any investor is not meeting their objectives. Assess your risk in specific environments through scenario testing linked to your time horizon. This helps identify ways to potentially mitigate your risk and is a cornerstone of the strategic investment process.

In hindsight, the 2010s were an "easy" investment environment, with rallying equity and bond markets driving strong returns. And with QE suppressing volatility, market risk over this period was much lower than the previous decade. However, stability can breed instability, and with a long market rally behind us, riding the late cycle feels increasingly risky. This isn't the time to give up on diversification. Few investors expect a repeat of the past decade's equity and bond returns.

Bond yields in developed markets are extremely low or negative, appear to offer little downside protection and could perform poorly if inflation ticks up. Equity market valuations are not cheap and could be vulnerable to late-cycle dynamics.

We continue to advise allocations to less-constrained strategies, well-placed to capitalize on market dislocations. You may also find opportunities in strategies that have struggled to keep pace with broad market indices, such as value stocks, hedge funds, real assets and emerging markets.

Policy risk increases as we extend time horizons, and we discuss many of these risks below:

- **The reduced power of central banks to stimulate growth**
- **The likelihood that fiscal stimulus will make up some of the next wave**
- **The need for climate policy development in response to increasing scientific evidence and mounting activism**
- **The rising need for companies to earn a "social license" to operate**

Other areas, such as inequality and continuing global tensions, also raise policy questions, and the long list of issues suggests significant policy and regulatory change in the coming years.

Longer-term investors should give much thought to the impact of structural trends — powerful, transformative forces changing the global economy and the way we invest. Demographics have influenced the multi-decade fall in rates and will continue to impact economic growth for decades. Technology and artificial intelligence are already revolutionizing investment processes, alpha generation, and product design and distribution. Climate change is literally a force of nature, and its effects extend far beyond policy risk to serious physical impact risks and resource shortages.

Apart from perhaps demographics, structural trends don't develop in predictable straight lines. Sentiment spikes and crashes over time, creating opportunities for dynamic investors. In this way, the "long term" is a series of short terms, and investing in structural trends means balancing commitment to a long-term orientation with the need to be opportunistic.

Longer time horizons allow deeper liquidity budgets, and the impact and thematic opportunities expected to capitalize on long-term structural trends are found in both public and private markets.

# Business as unusual

Investors must constantly adapt to the changing environment. We've seen the emergence of new non-bank lenders, passive and factor investing (as well as exchange-traded funds), the personalization of savings, and major fractures in global trading relations.

We see two trends as particularly vulnerable to change, and these are areas where you should prepare for a period of business as unusual:

1. **Central bank asset purchases to increase liquidity, stimulate the economy and counteract disinflationary forces will likely be backed up by fiscal stimulus.**
2. **Regulation to counter climate-related environmental damage concerns will ramp up.**

The challenge is that the monetary policy measures used over the past decade are reaching their effective limits in many developed market countries. Central banks have relied on lower rates and balance-sheet expansion to steer the economy. Since 2008, however, those balance sheets have grown to unprecedented levels due to quantitative easing. With low or even negative interest rates across the developed world, monetary policy options are limited and there are concerns over what comes next.

In recent years, fiscal deficits appear to have become more acceptable across the political spectrum — the US is currently running a trillion-dollar deficit during an economic expansion under a Republican administration. Monetary and fiscal policy could morph into "modern monetary policy," essentially removing the separation between fiscal and monetary policy because central banks would increase the money supply to directly fund government deficits, allowing fiscal stimulus without raising taxes. Critics suggest this could lead to high inflation, weakening of the benefits of central bank independence (which has done much to prevent partisan economic policy, or "knee jerk" politics) and capital misallocation; supporters suggest offsets could be employed to minimize such risks.

In an environment of fiscal stimulus, it's increasingly important to evaluate how much portfolios protect against surprise scenarios, such as unexpectedly high inflation, which could make commodities, real assets and inflation break-evens more attractive. Depending on fiscal stimulus in other countries, such an environment could weaken the US dollar, and, in this case, the value of monetary hedges, such as gold, could increase.

Beyond inflation protection, you should diversify your defensive portfolio positioning to protect against multiple shocks. With traditional defensive assets like government bonds being richly valued in developed markets, investors with fewer constraints may consider more attractively priced defensive asset classes, such as creditworthy floating rate assets and structured credit, or simply keep some powder dry by holding cash.

Regulation has proved insufficient for dealing with climate and societal change. Consumers are increasingly aware of companies' environmental and social impact and are challenging Milton Friedman's maxim that "corporations have no higher purpose than maximizing profits for their shareholders." With the help of social media, consumers are also increasingly aware of the negative impacts of "business as usual" and are reflecting their values in their consumption. To earn their social license to operate from consumers, investors and wider stakeholders, companies will need to demonstrate that their contribution is leaving the world in a better place.

**In August 2019, US-based organization Business Roundtable issued a dramatically revised set of corporate governance principles that recognized a much wider set of company stakeholders, and it was signed by 181 CEOs. The principles stated, "If companies fail to recognize that the success of our system is dependent on inclusive long-term growth, many will raise legitimate questions about the role of large employers in our society." Companies that don't evolve may lose out, which is a risk that should be assessed in portfolio construction and further supports a case for investing in strategies with higher ESG ratings.**

# Position for climate change

## Climate change can feel like a long-term issue, with long-term consequences, for long-term investors. We believe, however, that the risks for investors are clear and present. Even if the physical effects of the climate crisis fall outside of your time horizons, climate policy has the potential to impact portfolios much sooner, independently of any realized physical impacts.

Currently, there is a gap between the stated ambitions of the world's governing bodies to limit global warming to well below 2°C and the pathway for global temperatures that will actually occur if governments adhere to current environmental policy. Most world leaders agree on the need for action, and visible evidence of the effects of climate change are only increasing, so we expect this gap to be closed by a more targeted policy.

The convergence of environmental policy and stated ambitions is unlikely to be smooth, but some sort of policy response is inevitable. This represents a significant risk to carbon-intensive companies and industries over even relatively short time horizons, and we don't believe that this is fully priced into current valuations.

The most likely policies to address these issues include:

- **Increased renewable infrastructure spending**
- **Carbon pricing that could increase the risk of stranding a portion of energy producers' fossil-fuel assets**
- **Increased air flight taxes**
- **Restrictions on internal combustion engine vehicles**

More broadly, as consumers and other stakeholders demonstrate behavioral change to moderate their environmental impact and become more politically active, we expect that firms in any industry that fail to follow suit will find their social license to operate (and ultimately their revenues) increasingly under threat.

Investors will find themselves under increasing pressure to understand and address the environmental impact of their investments. While more investors are acknowledging climate change and seeking to address it in their policy documents, efforts to address climate change within portfolios have progressed more slowly. We recommend all investors undertake some form of carbon-footprint analysis of their investment portfolios as part of a broader assessment of their exposure to climate policy risk, and then chart a course for alignment with global climate targets.

Looking beyond the policy horizon of the next few years, the physical and human risks to investors' portfolios resulting from climate change are broader, more complex and potentially much more severe — especially if the policy response is muted. Mercer's latest climate change study emphasized how much greater the physical damages and investment risks are if global warming reaches 3°C or 4°C.

Expected annual return impacts are most visible at an industry or sector level, rather than at an asset-class level and are most evident in the 2°C scenario over the next decade, in which climate-change mitigation efforts are significant. This means that the most appropriate way to defend returns in the most damaging climate scenarios, and to improve returns in a transition scenario, is to invest in sustainable or low-carbon strategies that are positioned to capture a low-carbon transition premium.

Any type of climate transition will require significant investment in infrastructure, which brings opportunities for real asset investors, among others.

Transforming the world's energy supply from primarily fossil fuel to renewables demands new structures, such as wind turbines, hydro-stations and solar farms. Technological investment is also needed to improve storage and combat weather dependency. All of this requires equity and debt financing, potentially supporting an expansion of the emerging green bond universe.

There are opportunities for real asset investors, but also vulnerabilities. The stubborn locations of existing assets may become less attractive with a more substantially changed environment, and aging infrastructure built for a milder climate may require retrofits or see its yield curtailed.

The Intergovernmental Panel on Climate Change estimates that for each degree of global warming, approximately 7% of the global population will experience a decrease in renewable water resources of at least 20%. That resource strain will, in some cases, require new infrastructure assets, such as desalination plants, but more broadly will increase demand for water-efficient technologies and could lead to the relocation of certain water-intensive activities.

Such assets could offer investors opportunities to achieve strong, inflation-sensitive and climate-resilient returns. Investors can influence the likelihood of a transition to a lower-carbon economy by investing positively — and those that do have the opportunity to be "future makers."

# Taking action: Key recommendations for 2020

Change is on the horizon, and you need to be ready. Be clear on your timeframe, be prepared for business as unusual and position for climate change.

We've highlighted many actions for investors to consider, and here are our key recommendations.

- **We continue to advise allocations to less-constrained strategies well placed to capitalize on either market dislocations or long-term structural trends. These can be found in both public and private markets.**
- **You may find opportunities in strategies that have struggled to keep pace with broad market indices, such as value stocks, hedge funds, real assets and emerging markets. Now isn't the time to give up on diversification.**
- **You should reassess your portfolio's resilience to "inflation surprise" scenarios, which could make commodities, real assets and inflation break-evens more attractive.**
- **Companies and asset owners face increasing social pressure to consider a broader range of stakeholders, further supporting a case for investing in strategies with higher ESG ratings.**
- **With traditional bonds richly valued in many markets, investors with fewer constraints should consider creditworthy floating rate assets and structured credit, or cash.**
- **We recommend undertaking a carbon-footprint analysis and charting a course for alignment with global climate targets.**

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# At Mercer, we believe in building brighter futures.

## About Mercer

Together, we're redefining the world of work, reshaping retirement and investment outcomes, and unlocking real health and well-being. We do this by meeting the needs of today and tomorrow. By understanding the data and applying it with a human touch. And by turning ideas into action to spark positive change.

For more than 70 years, we've been providing trusted advice and solutions to build healthier and more sustainable futures for our clients, colleagues and communities.

Welcome to a world where economics and empathy make a difference in people's lives.

Welcome to brighter.

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