SNAPSHOT by SWEN CP

WHAT WILL 2021 AND BEYOND LOOK LIKE?

Market analysis #2 – March 2021

Contents

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The Covid-19 pandemic made 2020 an unprecedented year economically, with a contraction of more than 4% in global growth, a surge in G20 public debt to 11% of GDP, and, in France, a 12% plus expansion in private-sector debt! In spite of all this, the main financial asset classes – global equities and bonds – managed to achieve double-digit gains.
All of this, of course, has been driven by governments and central banks, which have acted massively and in relatively coordinated fashion.

The social, human and health situation remains challenging and fraught with considerable uncertainties. As of early January, there were 90 million Covid-19 cases and 2 million deaths (source: Johns Hopkins University), while social distancing measures have been ratcheted up drastically as various variants have emerged.

2021 nonetheless provides reasons for optimism, with the launch of large-scale vaccination campaigns and hopes for a return to normal as this planetary effort moves forward. What impact will this have on our companies? What is the outlook for investors? And how long will it take to get to the "new normal". And, finally, what lessons can be learnt from the pandemic's economic shock?

With our development model having been put to a severe test, an era is coming to a close. We must now set about immediately to build a world that is more resilient and more sober, one that focuses more on solidarity, but that is also more ambitious. This has indeed been a crisis of historic proportions, but also a unique opportunity to restart positive growth for our younger generations!

Our core mission at SWEN will help us get there by being more inclusive in connecting territories and the men and women living there. It also will be instrumental in boosting our investments in support of the energy transition!

We have no choice!

1. Macroeconomic outlook

The United States looks well placed, once again, to serve as an engine of global economic growth. The Democrats' victory in Congress points to further stimulus to come, including the 1,900 billion dollar fiscal stimulus plan, equivalent to almost 9% of GDP, that is in the works. With a reputation for expansionist policy from her days as Fed chair, Janet Yellen is now serving as Treasury Secretary. And the government is targeting full employment, while playing a central role in developing therapeutic solutions.

In Europe, the ECB's pandemic-motivated asset-purchase programme now amounts to almost €1,900bn, on top of its conventional quantitative easing and TLTRO negative-rate bank refinancing operations. With the carryover of the united front on Brexit, this collective effort is likely to provide greater momentum and carry the seeds of renewal.

On the pandemic front, reopenings appear to hinge closely on vaccinations campaigns, as most countries are keeping economic activity at the limits of their healthcare systems' capacities, while remaining on a cautious footing, chastened by past failures.

The previous economic cycle, which lasted more than 10 years, was followed by history's most brutal global recession. The cyclical recovery to come will be driven by monetary policies that, in light of current debt levels, is accommodative to a fault, along with wildly expansionary fiscal policies, the easing of international tensions with the arrival of a Democrat in the White House, and extremely high savings rates. Amidst a rally in commodity prices, a phase of inflationary pressures will be hard to avoid.

In addition to the rebound in activity, serious doubts subsist on how companies will deal with accumulated debt, as well as with adjustments – either temporary ones, once assistance has been withdrawn, or structural ones in adapting their operations to the new health risks laid bare by the pandemic. The structural changes engendered by this crisis are likely to be a reshoring of certain vital supply chains, digitalisation, an expansion in remote-working (with the resulting and paradoxical cost savings for companies from offshoring), the development of individual and environmentally friendly transport infrastructures, greater resources for the pharmaceutical industry, reorganised workplaces, more challenging financing conditions for capital-intensive industries, widespread adoption of contactless transactions (in particular in payments), an expansion of e-commerce, repricing of risks by insurance companies, and so on.

In short, we are on the verge of a new economic cycle in which the behaviour of companies and consumers will be radically different in many areas.
The biggest change brought by the Covid-19 crisis is probably in public expenditure. The experience of 2020 has ended the taboo on deficits and will make it harder to get people to accept fiscal austerity. Europe, in particular, will have to rewrite its budget guidelines after blowing up its Maastricht rules. Most of all, governments will play a stronger post-crisis role as a long-term investor, in guaranteeing infrastructures and in providing healthcare, but also in industries with extremely stretched balance sheets. Governments will also have to make climate issues more prominent in financing strategies.

What about with SWEN CP?

Our convictions & expertises – Our strategies (multi-strategy and direct)

Climate change is now a decisive factor in companies' long-term outlooks. Awareness is spreading rapidly, resulting in a fundamental transformation of the financial sector.

Societal responsibility calls for strong responses from investors. The transparency required for doing so will be provided by ESG markers (environmental protection, diversity, value sharing and connecting territories) and the NEC* methodology throughout our management processes.

** NEC initiative: www.nec-initiative.org*

2. Main risks

Managing the exit from the crisis will nonetheless be no walk in the park. Two major risks remain, a crisis of confidence and political risk.

Public debt levels won't have harmful consequences in the short term. That said, two scenarios are possible. The debt will either: 1/ be repaid over a very long period, thus burdening future generations to pay off the "war effort" against the 2020 pandemic and undermining, once again, potential growth in the most mature economies; or 2/ it will be implicitly cancelled, and then carried and isolated for the long term by the central banks. The risk that central banks will have to assume in forestalling a crisis of confidence is investors' perception of government solvency.

The second major risk is political. This has been clearly identified and has even materialised since the 2008 crisis. Although populist governments' performance in managing the crisis has not been brilliant, the inability of governments everywhere to improve citizens' daily lives and future prospects could lead to extreme political choices, as was the case in Greece, Austria, the UK, the United States and Brazil. Western economies had entered an era of weak structural growth; these challenges have now been ratcheted up by the debt piled up in 2020. The challenge will be to grow less and to grow better.

3. Private equity looks even better

Risk appetite, valuations and volatility on public markets suggest that investors are already pricing in the end of the storm. Meanwhile, after the momentary panic of March 2020, investors' relative peace of mind has shown up in the ongoing financing of private companies. European private equity funds resumed their pace of investments in the second half of 2020, taking advantage of US funds' slower path to normalisation.

Equity markets are trading at historically high valuations, pricing in a rebound in earnings this year, driven by a blend of optimism in risky assets and the fear of fighting powerful central banks. But this repricing of risky assets could become more sustainable. Modern monetary policy, which has been extremely effective in recent years on interest rates, moved to a new level in 2020 in supporting fiscal policies and the expansion in public deficits. Equity markets have priced this new paradigm into their valuations in accepting lower returns.

The 10-year US yield fell another 100 basis points in 2020, after a 100 bp decline in 2019. In Europe, government bonds yields have sunk a little more deeply into negative territory, thus forcing investors to seek out yields in risky assets or assets offering an illiquidity premium. Bond markets are once again unattractive this year, given their low yields and the upside risk, albeit moderate, in interest rates. Beyond central bank announcements, the roll-out of fiscal stimulus plans as public health conditions move back to normal is likely to send interest rates up – a movement that has already begun early this year, particularly in the United States, with European yields following in their wake. This is likely to help stabilise the dollar after its spell of weakness in the second half of 2020. Investors' quest for yields has lowered rates significantly in the riskiest corners of the bond market.

For the moment, the only inflation engendered by central banks seems to be inflation of financial assets, resulting in a dual wealth effect and enhancing saver and investor confidence. Risks of sustained inflation remain moderate as structural sources of deflation are still with us, including productivity gains, globalisation and massive unemployment. In the event of higher commodity prices or economic overheating, both private and listed equities offer some of the best protections, as long as their issuers can pass on higher costs. On the other hand, valuations of growth stocks as a "long-duration" asset could be undermined by higher discounting rates.

As noted above, we are on the verge of a new cycle. Amidst significant accumulated imbalances and low yields on liquid assets, coming years will involve controlling the pandemic's impact on companies, while keeping in mind the essential paradigms of climate and social impacts.

On the eve of this new cycle, private equity is likely to continue to draw in investors motivated by performance and impact. Performance, as this asset class compares favourably with the liquid assets equities and corporate bonds so far. Impact, as investment in non-listed companies is now structured and equipped with guidance tools recognised by all counterparties as a primary vector of action.

What about with SWEN CP?

Our convictions & expertises – Direct strategies to address challenges in the public interest

Our fiduciary obligations must fully reflect the impacts of our decisions over the entire financing chain, from financed assets to the end-client subscribers.

Our first impact fund will finance the infrastructures of tomorrow in financing biogas units, hydrogen solutions and natural gas supplies, thus strengthening the base of our agricultural industry and taking part in a low-carbon economy. Identifying positive impacts, measuring them and enhancing them are an integral part of projects developed by SWEN and of our conviction that our investments must take part in the sustainable development challenge of transforming the world.

4. Financing tomorrow's economy

The financial markets early this year seem to be focusing on cyclicals and commodities. However, we feel that the abundance of liquidity being injected into the financial markets is a wake-up call to investors to meet certain obligations and to promote more responsible economic growth.

Climate and social challenges mean that we must place sustainable finance at the heart of our concerns. Far from being incompatible with investors' required returns, responsible investment considers corporate social responsibility to be an important factor in adaptation and performance. In the age of telework, companies' efficiency depends more than ever on employee commitment and autonomy. Valuation of human capital will be a stronger criterion in evaluating the prospects of companies seeking financing.

On the eve of this new cycle, the challenge of human capital, along with public health issues, joins the ranks of the secular trends of digitalisation, governance and combating climate change.

The same goes for reshoring. Taking part in financing the connecting of territories and shortening supply chains, a theme that had been focused on the goal of reducing environmental footprints, has taken on additional impetus for reasons of supply chain security.

Lastly, greater public intervention could be the main legacy of this crisis, in more forthrightly addressing long-term environmental and energy transition issues. This new trend coincides with the expected return of the United States to the Paris Agreement, which will help strengthen coordination and consistency in combatting climate change – the main challenge of the new economic cycle that is now beginning.

What about with SWEN CP?

Our convictions & expertises – Venture Capital

Innovation must serve people!

Through its investments in start-ups, SWEN Capital Partners supports the economic fabric and the emergence of the actors of tomorrow. It strives to make these future solutions benefit people by offering essential goods and services that respect individuals and their environment, and by acting as a responsible player for the challenges and needs expressed.

5. An ESG regulatory arsenal for a clearer view (at last)

Not only has the Covid-19 crisis called on us more to accelerate the integration of social and environmental considerations in models for calculating economic valuations, it also requires that we admit, once and for all, their usefulness and relevance. The need to take social and environmental concerns, particularly climate concerns, more into account in investment decisions has never been as pressing as it is now, from the origins of the pandemic to its impacts on our economies and societies, whether already observables or foreseeable.

With this in mind, there is still lots to organise. It would be wrongheaded to fail to recognise the remarkable progress in recent years in responsible investment practices and ESG integration. Nevertheless, in dealing with the many and complex issues to be addressed, responses remain very insufficient and disparate and, very often still, suffer from a lack of visibility regarding their true impact. The alert has been sounded on climate change and its impact on biodiversity, but it is still hard to judge to what degree words have been transformed into deeds. Governments in particular are expected to set a course for meeting the objectives enshrined in their public commitments, the Paris Agreement and the European Union’s 2050 Carbon Neutrality target.

This is the unique context that will make 2021 a transition year in getting the financial industry behind environmental and social transformation objectives. An initial and crucial milestone will be met with the formalisation and standardisation of practices. This will help eliminate “greenwashing” practices. This is the goal of the new wave of current and future regulation, to which financial actors will simply have to adjust over the next two years.

For example, at the European level, the Sustainable Finance Disclosure Regulation (called “Disclosure” for short), aims, among other things, to define the concept of sustainability based on a principle of double materiality. There are, on the one hand, sustainability risks (i.e., the ESG impact that external events can have on the value of an investment) and, on the other hand, impacts on sustainability (i.e., the impacts that investments can have on external sustainability factors). As the concretisation of the European Commission’s 2018 action plan in favour of sustainable finance, this regulation has been supplemented by the “European Taxonomy”, which establishes a strict framework aiming to describe environmentally sustainable activities. Texts are due out in the first half of 2021, specifying the operational distinction in these concepts under these two regulations.

Regarding the need to adjust to these new legal constraints, keep in mind the opportunity that the defining of a clear, structured and homogeneous framework represents for financial actors. This allows them to communicate transparently on the integration of sustainability in investment practices. While it is true that the agenda looks crowded with many regulatory texts whose contours are still fuzzy, they will ultimately have the merit of clarifying and stipulating key concepts and integrating them into operating practices, in disclosures, and, above all, in measuring them transparently through the use of relevant metrics.

What about with SWEN CP?

Our convictions & expertises – ESG

We have no choice!

Economic and societal challenges require harmonisation and the establishment of a regulatory framework setting the rules for achieving the objectives that have been set. Far from being irrelevant for economic agents, European regulations offer an opportunity and a fabulous challenge to meet, and effective coordination in achieving a sustainable economy will constitute true progress.

And this is the direction that SWEN Capital Partners has taken in its actions, in working actively and collectively to set up common extra-financial reporting benchmarks within its profession, in promoting the integration of climate change in investment decisions, and in supporting the development of impact investment management.

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This note is the fruit of a joint and cross-disciplinary effort between SWEN CP teams, who have been called on to provide their expertise for the relevant portions of this market analysis.

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