How the world would look post-pandemic

UOBAM shares a few thoughts about future investment trends

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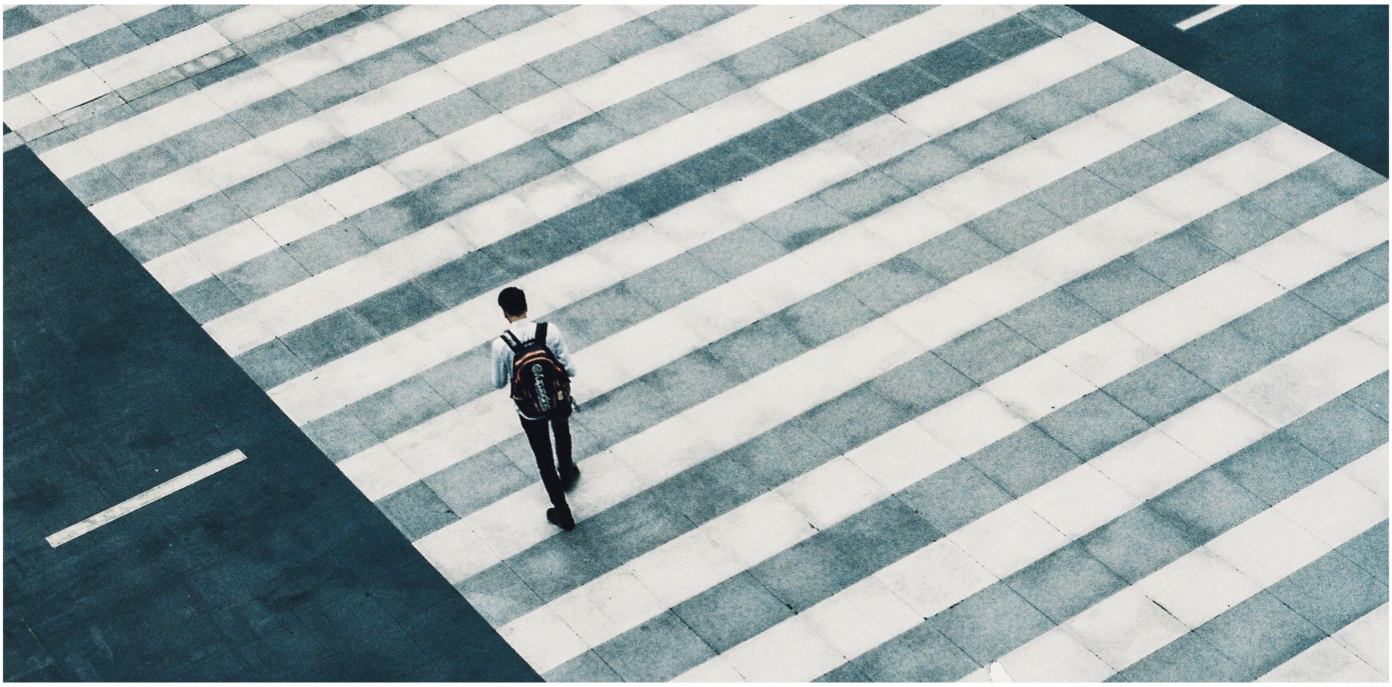
While nations are still in the throes of battling the coronavirus (COVID-19) pandemic with no certainty as to when, how and whether things will return to normal, we take a look at what the investment landscape might look like post COVID-19.

In short

In a world wrought by COVID-19, we expect to see the wheels of globalisation spin in reverse with more siloed economic blocs. In such a deglobalised world, we expect a manufacturing renaissance in the developed markets (DM) and more localised supply chains. With the preponderance of monetary and fiscal stimulus by DM, we expect financial markets to remain vulnerable to frequent bouts of volatility swings as asset bubbles build up. The divide between DM and emerging market economies will also widen. Corporate balance sheets will turn more conservative with returns metrics likely declining and the days of ratcheting up debt to pay dividends or buy back shares behind us. While concerted action on climate change will likely be put on the back burner, we think that sustainable investing with ESG (Environmental, Social and Governance) factors as a focus will continue to take centrestage and remain an enduring long-term investment trend. Pockets of opportunity exist with companies in technology, media and telecommunication, as well as e-commerce being key beneficiaries, while travel-related businesses and oil and gas industries will take a longer time to recover.



Deglobalisation trend picks up speed

In a post-COVID-19 world, we see the wheels of globalisation spinning in reverse, with more "go-it-alone" politics. The pandemic has exposed the dangers and fissures with tightly-linked global supply chains breaking down when countries block off exports of much-needed medical equipment and supplies as they prioritise self-sufficiency. With this pushback against globalisation, we expect the global economy to become increasingly divided into siloed economic blocs, as economic agents and policymakers become cautious and inward-looking. As populist and protectionist pressures brew alongside rising liabilities, such as when public pension systems become increasingly strained in a very low interest rate environment, governments would be focused on domestic priorities.

In such a deglobalised world, there could potentially be a rearranging of the political world order, with a jostling for global leadership as the traditional world powers struggle to display authority in how they are handling the pandemic. There could be an exacerbation in the political tensions within and between economic blocs, especially between the large superpowers. In particular, the European Union could potentially see further fractures and China could continue its ascent as another dominant superpower having fended off COVID-19 ahead of most other countries.

Manufacturing renaissance in developed markets

In the aftermath of COVID-19, cracks in long and complex global supply chains have been exposed, showing their susceptibility to altered geopolitical calculus. Hence we expect to see a manufacturing renaissance in the developed markets (DM) of the US and Europe, together with more localised, fragmented and less complex supply chains.

Reshoring activity back to DM economies would accelerate, as firms no longer consider the cost savings of offshoring to be worth the risk. In particular, for goods in critical sectors of national security such as drugs, medical supplies and food, local self-sufficiency and resilience would be valued over global efficiency. Regional supply chains would form, with a dismantling of the giant global supply chain. While China would remain the manufacturing hub for demand in Asia (and perhaps Central Asia and Africa), manufacturing hubs may develop in America and Europe to serve the respective regional markets.

The supply chain makeover would take on a high-tech hue with automation gaining prominence. The new manufacturing set-ups returning to developed economies would likely be highly automated by robots rather than being reliant on human manpower. This would mean more investments in robotics, automated factories, industrial software and high-tech warehouses. These support the secular investment opportunities in automation and digitisation of the economy.

Implications of helicopter money

To combat the economic fallout from COVID-19 and measures implemented to curb the spread of the virus, DM policy makers have turned to monetary and fiscal stimulus to avert a complete collapse of corporate and household balance sheets. Against this backdrop of helicopter money, the world is mired in greater amounts of debt while continued low interest rates raise the threat of higher inflation and call into question the merits of holding government bonds.

As the “lower-for-longer” interest rate environment gets extended, investors would also re-evaluate the risk-reward of holding corporate bonds. On the one hand, massive liquidity injections by Group of Seven (G7) central banks and the drastic repricing of assets exacerbates the ongoing struggle to find yield and investors continue to be pushed into income-generating assets such as corporate credits. On the other hand, financial markets remain vulnerable to bouts of volatility swings as we saw in 2015-2016 and in 2018, when the unwinding of leveraged strategies caused sharp market corrections. Hence the addition of corporate credits does not necessarily lower overall portfolio risks. Moreover, asset bubbles could form over time. As such, active management of risky positions would be a key source of value-add for investors.

Deepening divide between the haves and the have-nots

With the preponderance of monetary and fiscal stimulus by G7 nations with the means to nudge their economies on the path of recovery post COVID-19, we foresee a rising divide between DM and emerging market (EM) economies, with the latter increasingly at risk of being left behind. The weaker EM economies will likely need more debt relief or restructuring in years to come.

Specifically, COVID-19 has exposed EM high-yield (HY) sovereigns’ vulnerabilities in stretching themselves too thin against a backdrop of easy liquidity. While they had aspirations to boost growth through infrastructure spending, these single ‘B’ rated sovereigns such as Ghana, Nigeria, Mongolia and Pakistan would have to cut back to meet interest payments and survive increases in healthcare costs and stimulus spending. At the same time, low oil prices is a bane to oil-reliant EM sovereigns such as Mexico, Angola and Ecuador, which have been negatively impacted. Overall, EM HY sovereigns could experience very low growth for the next few years, which might lead to political instability and inability to enact much needed reforms.

The shape of things to come: conservative balance sheets, dearth of share buybacks

As companies hunker down to weather the storm and rebuild, the scars etched by COVID-19 will compel them to build bigger buffers against unexpected shocks. We expect most companies to turn more conservative, likely moderating their operating and financial leverage. Coupled with a veering away from reliance on just-in-time manufacturing, we expect returns on equity (ROE) to decline as a consequence.

As revenues for businesses decline with safe distancing becoming the “new normal”, operating leverage would drop as well alongside lower asset turnover. In such an environment, large corporates – having access to greater resources and funding – would likely fare better than their fledgling counterparts. As smaller corporates get weeded out in the competition, the established players could turn out winners as they boost their market share.

Concurrently, the trend of increasing financial leverage to pay dividends and buy back shares will be scrutinised, as companies remain vulnerable to exogenous shocks. Regulators will demand that companies build greater resilience, which means hoarding more reserves for contingency purposes. In turn, the more conservative balance sheets would lower ROE as businesses build a larger equity base. In fact, US regulators are already demanding companies that receive aid to not pay dividends. Similarly, European banks such as HSBC have already cut dividends in order to shore up their balance sheets.

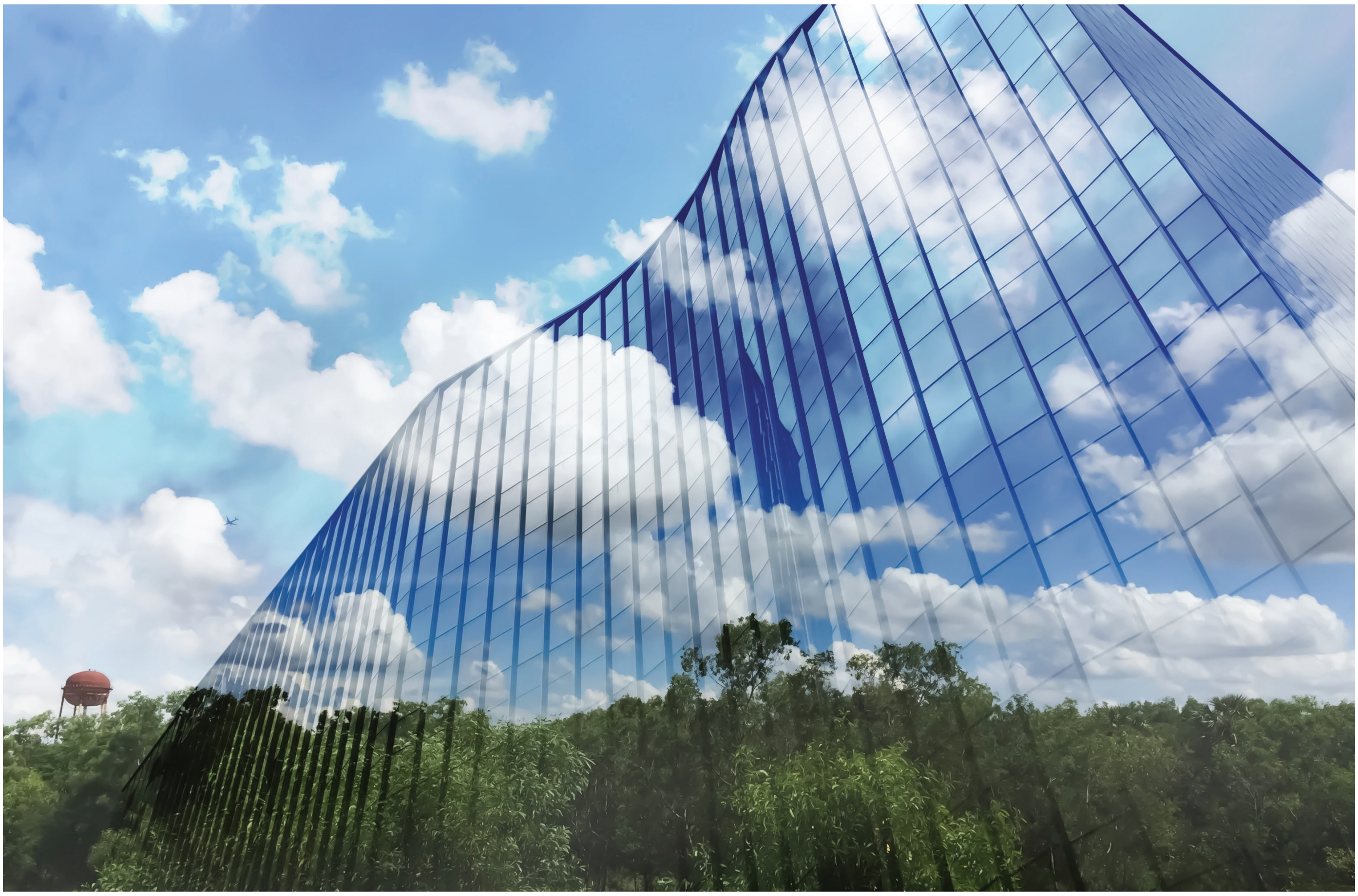
Wither ESG and the push for sustainable investing?

The unintended consequence of COVID-19 on the physical environment has been positive in the short-term as social distancing and stay-home measures reduce carbon emissions brought about by travel, while work stoppages reduce the pollution caused by industries and factories. However, beyond the inadvertent impact, the intentional coordinated actions on Environmental, Social and Corporate Governance (ESG) look to have taken a back seat.

The more immediate concerns of governments to save lives and jobs, with the massive costs involved, have likely pushed climate change initiatives to the back-burner. The stresses brought on by social distancing, huge job losses, and premature loss of lives, with trillions of dollars spent on fiscal stimulus, would leave little political energy and money to address global warming concerns. As such, we expect there to be a delay in countries' moves to attain the 2030 United Nation's (UN's) Sustainable Development Goals (SDG). In 2015, the UN developed 17 SDGs, which range from poverty reduction, gender equality to climate action, as a universal call to action. We expect SDGs that are impacted in the near-term would be Economic, Education, Health and Environment.

In the near-term, it is worth noting that sustainable strategies – often comprising high quality stocks with high scores in ESG factors – have outperformed the broader market during this recent market drawdown. A Morningstar analysis found that 62 per cent of ESG-focused large-cap equity funds outperformed the MSCI World stock index in March 2020.

Over the longer term, we expect the push for sustainable investing and the focus on ESG to remain at the forefront of investment management. In fact, COVID-19 could see a reshuffling of the decks as individual companies' behaviour towards society in this crisis will be remembered, with businesses deemed to have done the right thing by their employees, customers and communities favoured.



Pockets of opportunity

As people globally adapt to changes brought about by COVID-19, staying home, telecommuting and effectively home-schooling their children, there are beneficiaries in certain sectors that offer investment opportunities. With the ubiquity of doing things online, key beneficiaries would be the technology, media and telecommunication (TMT) as well as the e-commerce sectors. Sectors struggling to recover would be travel-related businesses, as well as the oil and gas industries, post COVID-19.

We expect the TMT sector would continue to grow strongly. As telecommuting becomes the new normal of corporate life for certain market segments, this would boost demand for services from technological companies and support semiconductor-related stocks. Levels of network usages, video conferencing, digital payments, and home entertainment/gaming could remain high. For example, increased telecommuting could encourage companies to invest in communication equipment such as handset upgrades, and networking infrastructure such as 5G, data servers and data centres.

The e-commerce sector would benefit too. As human behaviour adjusts towards more modes of online business transactions, business-to-business (B2B) or business-to-consumer (B2C) sectors will continue to flourish even after this pandemic ends. Other online businesses include: online education, gaming, video streaming and teleconferencing. We think the structural trend that will stick the most is the shift towards online and flexibility – more online entertainment, more online shopping, more flexible working arrangements.

Other sectors that could see a boom include fintech-based digital solutions with the proliferation of services paid for via mobile or online platforms. Industrial sectors, particularly in automation and robotics, will see growth from a shift in manufacturing. With COVID-19 revealing gaps in the global healthcare systems, medical and health-tech sectors will also evolve to address the lacunas it exposes. We expect that the pandemic will spur further development of companies involved in hospital services, telehealth and lab diagnostics. In the related sectors of Health & Protection and Business Interruption insurance, we expect growth to be driven by higher demand and upward revisions in premiums following COVID-19.

On the flip side, we think the travel-related businesses and the oil and gas sectors would take a longer time to recover. With limited tourist arrivals, countries and businesses which are dependent on tourism will be hard hit. Airports, hotels, hospitality real estate investment trusts (REITs) are examples of businesses which might be affected for a longer time. In addition, oil and gas industries would be adversely affected by the current low oil price which is expected to persist due to much lower global economic activity. Capital expenditures are already being cut to preserve cash by almost all the oil majors.

As for the consumer sector, we are of the view that the defensive staples segment such as grocery retail and supermarkets would continue to perform well as these are essential services. As for the broader consumer sector, it is unclear how they will respond post COVID-19. Will there be "revenge spending" when the pandemic eases, as was documented earlier when China lifted its lockdown? Or will the new normal be belt-tightening as the young emerging consumer class sober up to the notion that they need more financial buffer to weather future unexpected economic storms? We think the answer will depend on whether the economy takes on a V-shaped, U-shaped or L-shaped recovery. In a V-shaped recovery, we will more likely see "revenge spending", while a U- and L-shaped trajectory will likely see belt-tightening.

Implications for longer-term asset allocation

At the macro level, we expect to see reshoring activity and the emergence of manufacturing hubs in America and Europe, which would be supportive of secular investment themes such as automation and digitisation. A rising divide between DM and EM economies suggests that EM HY sovereigns would likely underperform. Active management of risky positions would be critical, as the financial landscape remains vulnerable to unwinding of excessive risk-taking behaviour. We expect volatility in credit markets to be higher than what it has historically been.

At the corporate level and in the ESG space, we expect reduced operating and financial leverage and declining ROE, with large high-quality corporates outperforming smaller businesses. Key beneficiaries would be the TMT and e-commerce sectors, while key underperformers would be travel-related businesses and the oil and gas industries. The push for sustainable investing will become more prominent with ESG remaining an enduring investment theme.

Within currencies and alternative investment, we expect that in a more deglobalised world, the US dollar would remain the world reserve currency but some other currencies such as the Japanese Yen and even cryptocurrencies could likely continue to gain interest. Against the global uncertainty and volatility, we see attractiveness of gold as an alternative investment for long-term asset allocation.

As nations continue to battle COVID-19 and contain the collateral damage inflicted on their economies, we expect that some aspects of investment management will be altered after the crisis. While it may not seem appropriate to think about investing when we are still in the throes of taming the virus, we would suggest that failure to do so may cause more pain in the long run as people's savings are indisputably tied to financial markets. As they say, in every crisis, there is opportunity. Investors would do well to seize the opportunities presented and not let this crisis go to waste.

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