Sustainable economic cycles

The shift to sustainability and impact

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July 2021

Summary

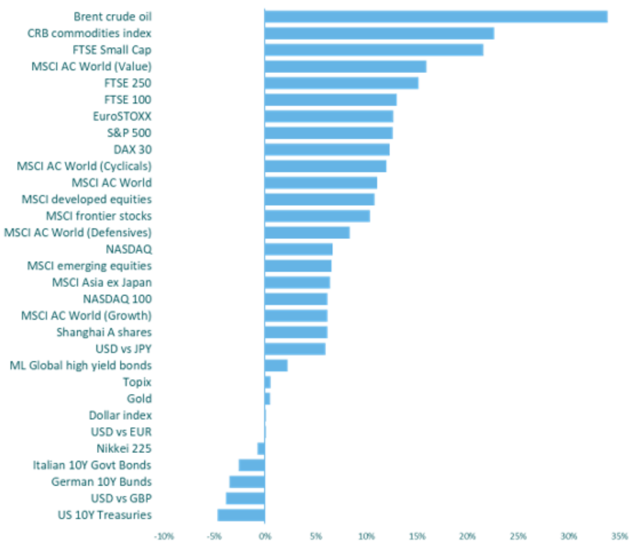
- We believe that the world is starting to embrace the notion of 'sustainable economic cycles', led by unprecedented sustainability-focused financial commitments from global governments.
- The year has thus far proved difficult for some sustainable and impact stocks, particularly renewables – but the investment universe is much wider than this.
- Investment flows, however, have continued into sustainable and impact strategies, supported by the sustainability agenda being placed at the centre of many post-COVID-19 recovery programmes around the world.

Are we shifting towards sustainable and impactful cycles?

As vaccination programmes accelerate and world economies emerge from lockdown, investor focus seems to have moved away from sustainability towards cyclical considerations.

The V-shaped economic recovery is undeniably behind this. Crude oil and commodities have been the best performing asset classes since the start of the year (see Figure 1) while supply chain disruptions remain unabated, causing inflationary pressures in multiple industries, including semiconductors and car manufacturers.

Fig 1: Asset class performance (USD) – YTD 2021



Past performance is not a guide to future performance.

Source: M&G, Refinitiv DataStream, 31 May 2021.

Could this sharp economic upturn derail investors' recent enthusiasm for sustainable and impact investing? Could a prolonged cyclical upturn prove incompatible with strong performance from companies delivering solutions to the most pressing environmental and social problems? We argue that the two are not mutually exclusive. On the contrary, we believe that the world is starting to embrace the notion of 'sustainable economic cycles'.

This is evidenced by unprecedented financial commitments from governments around the world for greener and more inclusive recovery programmes. The weaker performance of sustainable and impact investing observed year-to-date is, we believe, mainly the result of profit taking, ETF technical factors and investors' myopic focus on the renewables space. These short-term dislocations represent, in our view, the perfect opportunity to revisit solid, long-term fundamentals.

A difficult start to 2021 for sustainable and impact stocks

After a very strong 2020, sustainable and impact assets are trailing traditional benchmarks by a considerable margin this year. As a proxy, the MSCI Sustainable Impact index is up 5.4% (in USD, at 23 June 2021) compared with a 10.6% rise for the MSCI ACWI Index. Please remember that past performance is not a guide to future performance.

Within the sustainable and impact arena, renewable energy stocks are so far the weakest performers, globally down 20% from their 2020 peak. This is partly linked to profit taking after a very strong fourth quarter in 2020, while pressure from the rebalancing of ETFs has also played a role. With hindsight, the sharp rally in renewables at the end of last year was noticeably inflated by an influx of money chasing too few, narrowly focused, environmental ETFs. This technical factor snapped back the other way in February 2021, when a number of environmental ETFs added to their constituents, with many renewable stocks caught up in the rebalancing that followed.

Renewable stocks also got caught in the sharp momentum rotation away from growth and into value, when inflationary pressures started to surface. We think this reflected: 1) their inherent defensive characteristics, underpinned by stable and predictable cash flows; and 2) the fact that the bulk of their valuation is represented in the terminal value, or late-year cashflows. Renewable stocks have, in this regard, become the new 'long-duration growth' assets.

The fact that many environmentally-focused funds exclude fossil fuels and mining stocks, both of which have performed well this year, has also contributed to their relative underperformance so far in 2021.

Added to this, the social side of sustainable and impact investing is under direct pressure from the second wave of COVID-19. This, to a large extent, reflects the fact that under-addressed social needs tend to be more prominent in developing countries, where the second wave is particularly acute.

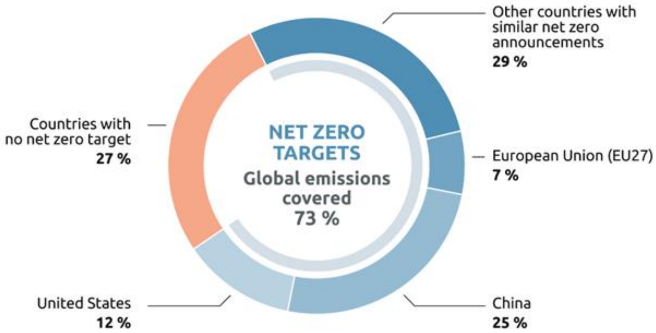
Is the post COVID-19 recovery compromising the shift towards sustainability and impact?

It shouldn't. Sustainability fundamentals are undeniably stronger today than they were 12 months ago. This is because the sustainability agenda has been placed at the centre of many post-COVID-19 programmes around the world, suggesting that sustainable development and cyclical upturn are very much intertwined and part of the same debate.

Plans to rebuild cleaner and greener point to a recovery that should have a much broader sectoral reach compared with previous cycles, including sectors such as building renovation, EV infrastructure, hydrogen and carbon capture, utilisation & storage. In total, countries that have either announced or considered net zero targets now account for 73% of total greenhouse gas emissions (see Figure 2). While Europe was already ahead of the pack, 2020 commitments from the US and China should help shift the dial meaningfully in the right direction.

The dramatic shift observed in the US in particular, with Joe Biden pledging to cut emissions by 50-52% below 2005 levels by 2030, is indicative of a government willing to fundamentally change its course of action. We expect this to go far beyond a traditional business cycle, with governments willing to make concrete plans for the next 30 years.The trillions pledged to tackle climate change should not be underestimated. Europe's climate commitments, including the green deal and the green sleeve of the Recovery fund, should amount to €1.3 trillion, or around 9% of EU GDP.

Fig 2: Net zero emissions target announcements



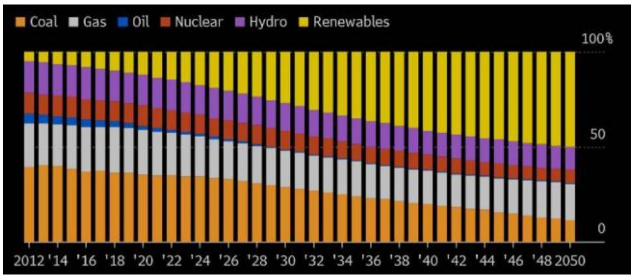
Source: Climate Action Tracker (CAT): share of GHG emissions covered by countries that have adopted or announced net zero emission targets (agreed in law, as part of an initiative, or under discussion). Compilation based on Energy and Climate Intelligence Unit (ECIU) 2021 as of 29 April 2021, complemented by CAT analysis. Emissions data for 2017 taken from EDGAR emissions database (EDGAR, 2019). Copyright © 2009-2021 by Climate Analytics and NewClimate Institute.

In the US, Joe Biden seems on track to get his US$1.0 trillion infrastructure package through the senate[i]. In the UK, the Climate Change Committee, which advises the UK government on getting to net zero, has projected that around £1.5 trillion over 30 years is the amount required to fully electrify transport and green the insulation and heating of 30 million UK homes[ii].

While these numbers create solid foundations, industry experts estimate that a lot more investment will be needed to convincingly reach net zero by 2050. To get a sense of proportion, the International Energy Agency (IEA) announced in May 2021 that a realistic roadmap would require US$5.0 trillion of investments annually, versus only US$2.0 trillion today[iii]. This, we believe, represents an unprecedented runway of growth for companies capable of providing innovative solutions to the climate challenge.

With solar and wind power technology now de-risked and operationally cheaper to run than coal, the shift to renewables seems incredibly hard to derail[iv]. BloombergNEF predicts that the share of renewables should rise from 7% of the electricity generation mix globally to 50% by 2050 (see Figure 3).

Fig 3: Power shift: wind, solar and other renewables should account for half of all power by 2050



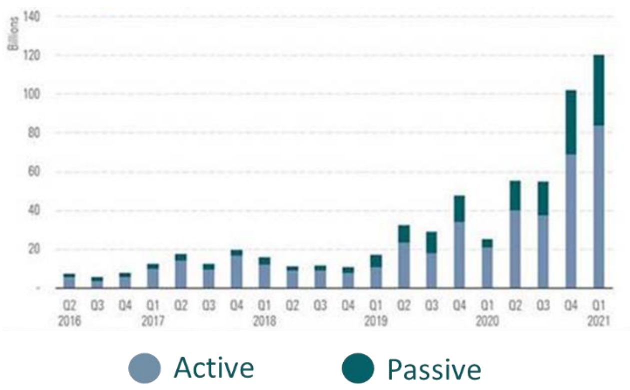
Source: BloombergNEF

As evidenced by the breadth of the proposed US package, it isn't just climate issues that are getting attention, with the plan including US$1.8 trillion in new spending and tax cuts for workers, families and children[v]

The pandemic has helped shine a harsh light on a wide range of latent social issues, from uneven access to healthcare and inequalities in health systems, to the fairness of employment and quality of education. Back in 2017, the World Bank estimated an annual health funding gap of US$176 billion by 2030[vi]. This will most likely have worsened as a result of the pandemic.

Finally, the weaker performance in the first quarter of 2021 did not dissuade investors from investing in sustainable and impact funds. On the contrary, Morningstar reported that €120 billion flowed into European sustainable strategies in the first quarter, or a 20% increase on the final quarter of 2020 (see Figure 4).

Fig 4: Sustainable funds' assets touched a record high in Q1. Quarterly European sustainable fund flows (€ billion)



Source: Morningstar Direct, Manager Research. March 2021

Is the market's perception of sustainability and impact negatively influenced by renewables myopia?

Investors' concerns seem to centre mainly on the valuation of renewable stocks. While these stocks undeniably entered 2021 on lofty valuations, the sharp price correction experienced since mid-February leaves their two-year forward P/E premium less than 10% higher than the market (see Figure 5). This is lower than the top of the historical range, which seems out of kilter with their improved fundamental outlook.

Fig 5: Renewables valuation: Global Renewables vs MSCI AC World

Source: Goldman Sachs Global Investment Research: 'Renewables and other companies investing for the future', June 2021

Besides, we believe that investors' single focus on renewable stocks is creating a false sense of overvaluation in the wider sustainable and impact universe.

This focus seems to overlook the full environmental spectrum, which stretches far beyond renewables and includes areas such as energy efficiency, smart construction, building renovation and circular economy, to name the more obvious. Circular economy stocks, for example, have not attracted nearly as much attention as their renewable counterparts. Their valuation, we believe, does not yet fully reflect their emission saving and waste reduction potential.

Meanwhile, the social side of sustainable and impact investing seems to have been generally ignored. This, we believe, largely reflects the sheer reality that areas such as education, childcare and healthcare have been the most disrupted by the pandemic, but also a function of emerging and developing markets and their poor access to vaccinations.

These activities should, however, ultimately join the rest of the recovery. We are, in fact, already seeing green shoots of improvement in sectors such as childcare and health treatment in developed countries, while the social agenda is gathering momentum across the globe, with governments getting to grips with the long-term economic costs of deepening social inequalities caused by COVID-19.

The latest report from the UN Department of Economic and Social Affairs estimates that 114.4 million people have been pushed into poverty because of the pandemic, with a disproportionate impact on women and girls[vii]. And COVID-19 has also highlighted the importance of both preparation and investment in resilient healthcare systems to cope with any future outbreaks.

All of this, we think, represents a strong tailwind for sustainable and impact investment, and we expect companies providing solutions to the massive environmental and social challenges we are facing to be long-term beneficiaries.

M&G Investments

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[i] https://www.freepressjournal.in/business/united-states-bipartisan-infrastructure-deal-worth-usd-1-trillion-back-on-track
[ii] https://www.theccc.org.uk/wp-content/uploads/2020/12/The-Sixth-Carbon-Budget-The-UKs-path-to-Net-Zero.pdf
[iii] https://www.iea.org/reports/net-zero-by-2050
[iv] https://www.lazard.com/media/451086/lazards-levelized-cost-of-energy-version-130-vf.pdf
[v] https://www.nytimes.com/2021/04/28/upshot/biden-families-plan-american-rescue-infrastructure.html
[vi] https://documents1.worldbank.org/curated/en/641451561043585615/pdf/Driving-Sustainable-Inclusive-Growth-in-the-21st-Century.pdf
[vii] https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/publication/WESP2021_UPDATE.pdf

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