the day after

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Covid-19: the invisible hand pointing investors down the road to the '70s

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ASSET MANAGEMENT

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Introducing "The Day After" series

Without a doubt, the Covid-19 pandemic is shaking the financial industry like never before. But this is not the first time the world has faced a pandemic of this scale, nor is it the first time that public policymakers, business leaders and pundits have asked: "Is it different this time around? Are we at a turning point?".

In this new series of papers entitled "The Day After", we share with our clients our thinking on what the long-term implications of the current, unprecedented crisis on the investment landscape could be.

To start "The Day After" series, in this first paper – Covid-19: the invisible hand pointing investors down the road to the '70s – we distill the key conclusions of a new work. We highlights the key reasons the current crisis could be the trigger for a regime shift that could, in the long run, lead to a new equilibrium with features similar to those seen in the '70s. The road back to the '70s will take time to travel and will not be straight. In the journey along this road, investors will need to stay active and rethink their investment approaches around some key principles, which combined represent the new toolbox for the 2020s.

Discover more in the full paper on

- The Covid-19 pandemic is the trigger for a new financial regime
- The inheritance from the 2010s: a regime of abnormally strong risk-adjusted returns
- Resetting performance targets: adding risk is not a panacea
- Investment implications of a road back to the '70s
- The investor road to the new decade: new wine and new bottles

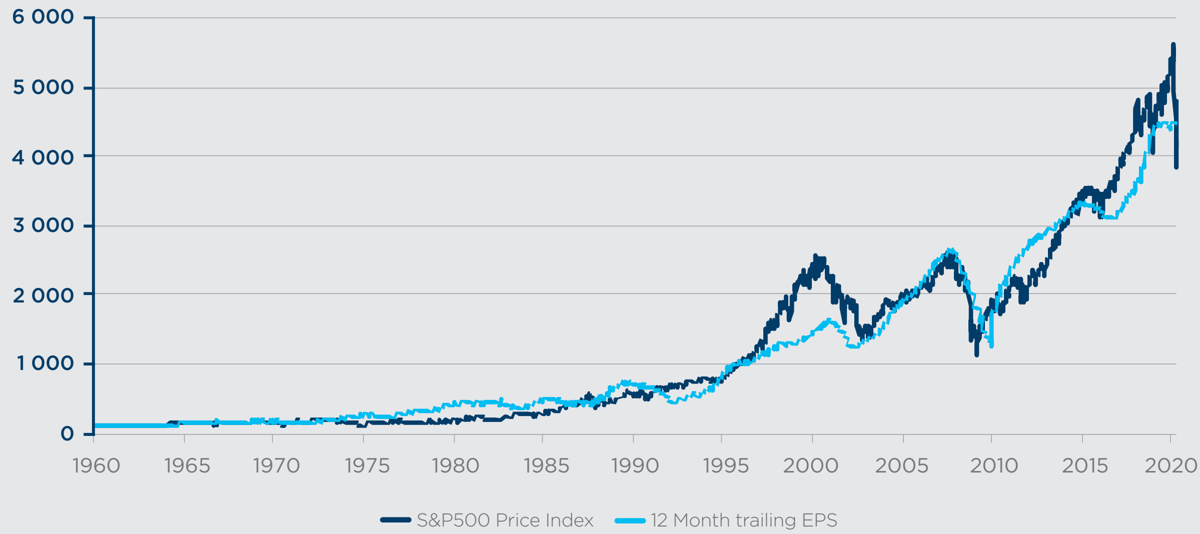
History shows that the economy and financial markets are dominated by long-term regimes that at some point come to a break point, where one regime gives way to a new one. In 2019, in the "Road back to the '70s" paper, we argued that the next recession could be the crossover point for a regime shift back towards the 1970s, which would trigger the end of a period of subdued volatility and excessive market exuberance.

While the trigger for such a move was uncertain at that time, we now believe that **Covid-19 is the perfect storm leading us towards a new era over the long run, but with some short-term implications in the meantime.**

Covid-19 the trigger of a mean reversion

The Covid-19 pandemic is the invisible hand triggering the mean reversion process and pushing volatility back to less subdued levels. This is bringing equity returns back in line with their long-term sustainable path, following a sequence of upward deviations essentially driven by monetary factors (inflation and rates trending lower).

S&P 500 index vs trailing EPS



Source: Amundi on Bloomberg data. Data as of 17 April 2020. S&P 500 price index vs trailing 12-month reported EPS, rebased at 100 at 31 Dec 1959.

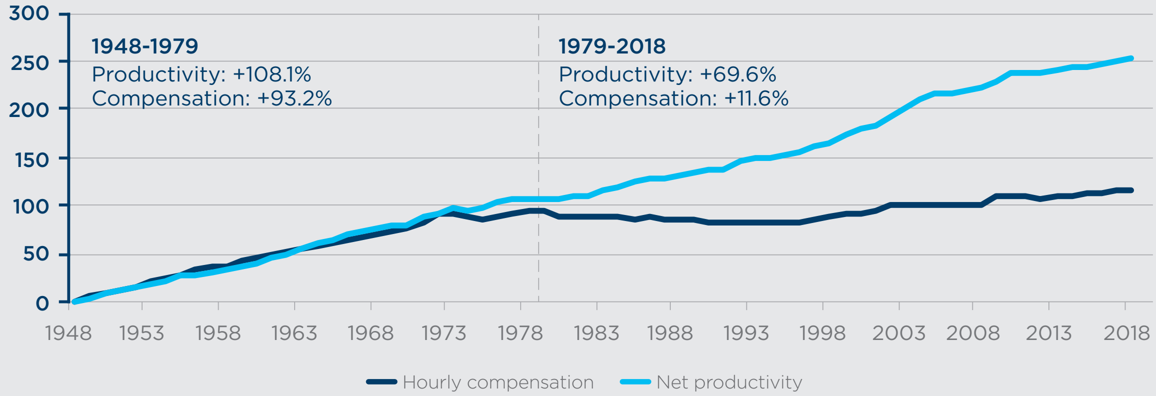
Covid-19 also the trigger for a regime shift

The Covid-19 regime change is bringing to an end the current Volcker sequence and the bias towards austerity on the budgetary side. Initiated by the arrival of Paul Volcker at the helm of the Federal Reserve after a long period of inflationary pressure, this symbolically brought to a close the macro-financial regime of the 1970s.

Looking back, the economy and markets have gone through a **sequence of regimes.** The **'70s were years of public debt monetisation**, with a dominance of wages over profits and with high levels of inflation in goods and services. **The '90s (sometimes called the regime of the shareholder, or patrimonial capitalism) were characterised by a regime of private debt**, with the dominance of profits over wages (with productivity gains not benefiting workers) and asset price inflation.

"The sequence of regimes from the '70s (the great inflation regime) to the '90s is now reaching a new turning point."

The widening gap between productivity and workers' compensation



Source: Economic Policy Institute. Analysis of unpublished Total Economy Productivity data from Bureau of Labor Statistics (BLS), the Labor Productivity and Costs programme, wage data from BLS Current Employment Statistics, BLS Employment Cost Trends, BLS Consumer Price Index and Bureau of Economic Analysis National Income and Product Accounts. Notes: Data are for compensation (wages and benefits) of production/non-supervisory workers in the private sector and net productivity of the total economy. 'Net productivity' is the growth in output of goods and services, less depreciation per hour worked.

This led to a bubble-burst phase, followed by a deflationary environment, and eventually to the rise in debt in the 2010s. **The legacy of that high debt level is now leading to pressure on central banks to monetise debt, sowing the seeds for a new regime shift**. This was a feature that we also highlighted in 2019, when we noted that in a new recession, **central banks would be increasingly pressured by governments to enrich their toolboxes and change their objectives, at the expense of some of their independence, as was the case in the '70s.**

The road back to the '70s

We went to bed in 2020 – we will wake up at the end of this phase of regime shift in 1973. Many think we will go back to the '30s, as the current economic recession conjures up reminders of the Great Depression. However, we think that **extreme policy accommodation will be the key feature of this new regime and the boundaries between fiscal and monetary policies will be more and more blurred.** The crisis will be fought with unprecedented and previously unthinkable measures. Words that were once taboo, such as "helicopter money", are becoming an acceptable if not a desired tool — a panacea of sorts — and are finding fertile ground in a debate that had already been evolving over the last few years, even before the crisis hit. We expect central banks and governments to continue to push, to the maximum possible levels, their tools to fight the economic recession driven by the pandemic. In our view, the recovery path will be slow and there is still a high level of uncertainty about which are going to be temporary losses vs more permanent losses in terms of potential output and employment. **Regardless of the shape that the recovery takes, from an investor perspective, it is important that the fear of a depression or a permanent loss of output will be enough to secure the extreme measures that we believe will drive the regime shift.**

> *"The road back to the '70s will not be straight and we will likely go through a deflationary phase first, followed by higher inflation amid de-globalisation forces, the monetisation of debt, and the redirection of value chains."*

We are not saying that investors will wake up **tomorrow** in a high inflationary regime; in fact, **the consequences of Covid-19 initially will likely be deflationary** (due to the demand shock, rising debt and secular stagnation features already present of low growth due to demographic trends) and core government bond yields may move even lower in the short term.

But even if inflation seems off the radar for now, **the seeds of higher inflation and higher inflation expectations are already all around us.** The direct monetisation of budget deficits (now more or less publicly admitted), a retreat from global trade/protectionism (with the breaking up of disinflationary value chains further accelerated by the disruption due to lockdowns), and a rebalancing of social and political policies in favour of labour are inflationary forces already visible. The social demand for protection will rise, alongside the requirement for better control and transparency of "critical" sectors. Company stakeholders will question business resilience (supply chain) and this should increase the cost of output in developed markets and undermine emerging market exports.

Investors should become prepared for this battle between deflationary and inflationary forces and be ready for the sequence that will follow (from deflationary to inflationary).

The elements accompanying a regime shift

A regime shift usually comes with three key trends:

1. **Intellectual victory and academic consensus around specific topics always precedes regime shifts.** Today, with inflation progressively forgotten as a threat, the idea emerging is that the current high debt levels are not an obstacle to budgetary stimulation, especially as the current crisis risks being deep and the memory of the 2008 recession is still sharp. Over the short term, debt/GDP ratios will have to increase to offset the effects of the crisis. However, taking a longer-term view, with interest rates on safe bonds expected to stay below growth rates, a low risk-adjusted rate of return to capital would justify the use of fiscal expansion and debt to finance public investment.

2. **A change in regime occurs when previous imbalances are no longer tolerated by society.** Well before Covid-19 materialised, we were living in an era of extreme inequalities, rising protectionist forces and nationalism, as well as increasing urgency around the climate change challenge. Skyrocketing unemployment, the struggles at the EU level to find a common solution, and the 'blame others' attitude which arises related to the Covid-19 outbreak will bring these imbalances to unprecedented levels.

3. **A regime shift involves a change in institutions (central banks, political parties, etc) that structure the regime itself.** We see central banks now permanently taking the "whatever it takes" position and political parties ready to expand debt as much as needed to ensure that the 2008 experience is not repeated. All of this is happening during a time of de-globalisation trends and a recession that faces a demand shock, and more importantly, a supply shock that could eventually be the trigger for an inflation pickup.

Examples of intellectual victory

- According to Blanchard, "public debt may have no fiscal cost" as the ratio of debt to GDP could decrease over time.
- We have seen consensus rising around the Modern Monetary Theory (MMT), which suggests that fiscal and monetary policy roles may merge as MMT assumes that expansionary fiscal policy could be financed by money creation (Mitchell et al).
- L Summers noted that a lower natural interest rate of equilibrium, though not observable, paves the way for "greater tolerance of budget deficits (and) unconventional monetary policies ... all of which are now becoming a reality".

Implications for investors

1. **Covid-19 signals the outbreak of a liquidity crisis in the corporate sector (not in banks, at least for now), making liquidity the critical dimension that investors should incorporate into the investment process.** It also brings a definitive shift in market structure, with a critical role for the buy-side in the functioning and financing of the economic financial system. However, this also comes with risks that are different from the traditional bank-centred approach. This all points to a necessity for the various authorities (central banks, regulators) to include the consequences of this reality in their policies and direct transmission channels of action. This is what the Fed is doing: not fighting the past war, but plugging facilities into the buy-side in pursuing its policies. This is finally providing compelling evidence **that liquidity in our industry must be fully integrated as a key dimension in the portfolio construction process, that liquidity mismatches do happen, and that there is a trade-off between returns and liquidity.** Investors no longer should consider liquidity as exogenous and ex-post, an irregularly measured element, but as a constant ex-ante dimension of portfolio construction. Liquidity should also be **viewed not only as a defensive tool to mitigate volatility, but also as a key element to exploit investment opportunities when they arise.**

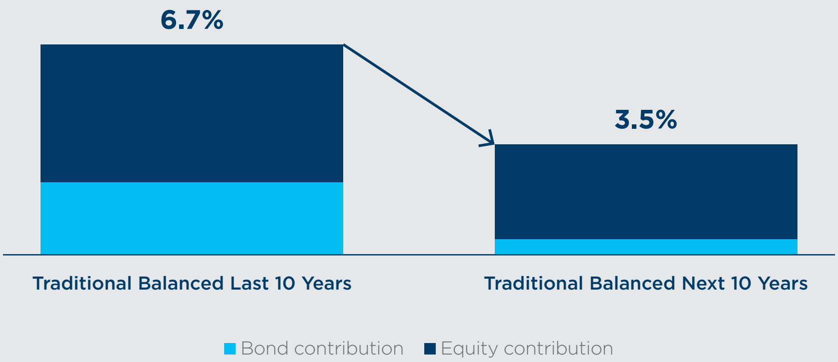
"The most relevant implication will be the need to make liquidity one of the critical dimensions that investors have to consider in portfolio construction."

2. **As a corollary of the previous point, the crisis is not only making liquidity a key aspect to watch, but it is also bringing back questions about what are safe risk-free assets.** In theory, this should be a relative concept, dependent on liabilities, but in reality, Treasuries and Bunds are the only consensual risk-free assets. This concept should be distinguished from the concept of liquid assets, but in reality, safe and liquid assets are intertwined, as the current crisis is effectively showing. Hence, the pool of effective, global safe (ie, recognised as such by the investment community) and liquid instruments is limited: **this is why it is normal that these assets come with a premium** or, to put it another way, that **investors should hold them irrespective of other classic metrics** (valuation, expected path of central banks, etc).

3. **Investors will have to optimise the cost-adjusted returns of their portfolios, considering all costs, amid the lower expected returns.** In the new regime, investors should expect lower returns for the next decade. According to our forecasts, a Euro balanced portfolio (50% Bloomberg Barclays Global Aggregate Bond Index and 50% MSCI World in EUR unhedged) will return a meagre 3.5%, compared with 6.7% over the last decade (from March 2010 to March 2020)[1].

1. For a similar US portfolio with 50% S&P500 and 50% US Aggregate, we forecast an annualised return of 4.4% for the next decade vs 7.2% of the last decade (from March 2010 to March 2020).

Historical vs expected future returns for a Euro traditional balanced portfolio
(50% Bloomberg Barclays Global Aggregate Bond Index and 50% MSCI World in EUR unhedged)



Source: Amundi CASM Model, Amundi Institutional Advisory and Research Teams, Bloomberg. Data as of 20 April 2020. Past performance is no guarantee of future results.

The efficient frontier will be much lower and flatter, but a **5% target will still be achievable**. However, with lower expected returns, investors should rethink their portfolio around three components: idiosyncratic alpha, beta and income. In making active allocation choices in terms of beta exposure or any replicable factor exposure (replicable alpha) they should seek to cut their costs on this type of allocation.

On the other hand, investors should also pursue the idiosyncratic alpha (not replicable) opportunities that will be available, especially in markets where inefficiencies continue to exist (fixed income, emerging markets, small-mid cap, ESG). Finally, they would need to add new income engines (real assets, dividends) beyond the traditional fixed income component.

“In an era of de-globalisation, diversification across different axes (geographic, factor and style) will have a greater role to play in enhancing risk-adjusted returns.”

4. **Investors should also widen their investment spectrum to explore the benefits of diversification on different axes as we move away from a single factor (monetary) driving returns to multiple factors (growth, inflation, etc).** In an era of de-globalisation (global growth does not mean global trade anymore), with possible higher inflation in the future (with the trend moving from trending down to rising up) and higher volatility, diversification across different axes (geographic, factor and style) will have a greater role to play in enhancing risk-adjusted returns. Growth, for example, will be a key driver of returns in exiting from a real economy crisis such as the one we are entering now. In this respect, **investors should consider slightly increasing their risk asset allocation and having**, if they do not already, **a dedicated material allocation to EM assets in their strategic portfolio**. In addition, **strategies based on geographical/regional diversification will come back into focus** while those exposed to globalisation, which benefited the most in the last three decades, will become less effective.

5. **The setting of clear investment objectives (income, downside risk tolerance, inflation protection, etc) will be key in order to build a tailored portfolio by considering the asset classes that offer the highest probability of achieving the desired goal.** For example, for investors targeting high returns, equity could continue to be a good choice, but corporate debt, especially if trading at highly discounted levels, could also be very appealing.

   For those searching instead for income, government bonds will be less remunerative going forward and equity dividends could be more suitable, on a highly selective basis, after the situation settles down. To seek higher income streams, investors could also consider illiquid real assets such as private debt, real estate or infrastructure.

   For capital preservation purposes, **to protect against inflation, investors should bear in mind** that both bonds and equities have not delivered well in real terms during periods of high and growing inflation, such as the '70s, while **real assets**, such as commodities, real estate and infrastructure, **have delivered better risk-adjusted returns**. Therefore, **we believe it is crucial for investors to rethink their strategic asset allocation and reconsider the new hierarchy in risk premia**, including their exposure to real assets, to adjust to the different inflation scenarios that could materialise in the future.

6. **Finally, in the new regime ESG themes will have greater importance in investors' portfolios.** The already growing trend of climate change-related investments is set to continue, as the issue is high on the agenda of all policymakers and the general public.

   Another main trend will be the societal focus towards higher social equality, **with the growing dominance of the S component**. There will be greater scrutiny over the way companies act in the interests of all stakeholders and the community. This will translate into a greater impact on stock prices of some ESG risk factors, which will provide opportunities for active managers, both in the equity and bond spaces.

In conclusion, as is the case in any dynamic system, the path to reach the new equilibrium will not be a straight one; it will oscillate and develop in waves. Investors will have to be active and flexible to exploit the opportunities that each of these waves will offer.

The new equilibrium, with new rules replacing the old ones, that is reached at the end of this sequence will be very different from the one we have been used to in the last decade, the era of low inflation and low rates. But it will take time to reach and for now the focus should be to concentrate on liquidity, exploit a wide range of risk premia, and stay active.

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