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Inequality in the context of the Covid-19 crisis

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Authors

Jean-Jacques BARBÉRIS
Head of Institutional and Corporate Clients Coverage

Bastien DRUT
Senior Strategist at CPR AM

Théophile POUGET-ABADIE
Business Solutions and Innovation

For several years now we have argued that the social theme, and in particular the issue of social inequality, was becoming a major issue for various global economies and for investors, both institutional and retail.

In this paper, we explain why and how we expect the COVID-19 crisis to accelerate this phenomenon in the months and years to come, and also present action levers for investors. Indeed, COVID-19, like all major pandemics in this century at least, is likely to push inequalities higher, in a context where inequalities were already becoming a major issue for societies, economies and consequently investors. This is crucial because the short-term responses from public policy makers, if they take place, will undoubtedly reshape the economic landscape, in terms of fiscal policies and redistribution, wage policies, regulation, consumer habits and so on. In this environment, investors will need to include the "inequality" dimension in their analysis of companies, and their engagement policies.

In a forthcoming publication, we will explore the reasons why the COVID-19 crisis could result in the merger of social and environmental issues, and how investors can **integrate this new trend**.

Social inequalities, a rising theme even before COVID-19

Social inequality has become a major issue for investors. In a previous publication (Drut, 2020)[1], we demonstrated the following:

- The growth of social inequality is a stylised economic fact that has accompanied the third wave of globalisation since the early 1980s;
- The growth of social inequality, and especially income inequality, has mainly involved developed liberal democracies, as evidenced by the famous elephant graph (Milanovic, Lakner 2013)[2]. Notwithstanding the current pandemic, this phenomenon was expected to press on in the coming years (Branko Milanovic describes a phenomenon of 'Kuznets waves'[3]).
- Countries' positions do differ, depending on the progressivity of their tax systems and the weight of taxes and social transfers in GDP (as the OECD showed in a 2015 paper[4]); and
- The economic literature has extensively covered the negative impacts of inequality on growth, which are: (I) lower potential growth[5]; and (II) induced political and macroeconomic risks, with rising social inequality leading to tensions that can undermine the functioning of liberal democracies.

Given the above, the social theme was already becoming extremely relevant for investors. Recently, several initiatives demonstrated this fact.

For instance, over the 2016-2019 period, we showed that the 'S' criteria in company selection (via a 'best in class' ESG approach) has a real impact on the prices of listed companies, particularly in Europe (Roncalli et al, 2019).[6] Indeed, a portfolio combining long positions in the highest rated companies (top 20%) and short positions in lowest rated companies (bottom 20%) would have generated annualised returns of +2.9% in the Eurozone and +1.6% in North America over 2018-2019.

Furthermore, we are the first to have developed a methodology for selecting companies based on an assessment of the relative participation of companies in reducing social inequalities in their country of origin (see below). Notably, we are demonstrating that such an investment universe, at the very least,

1. "Rising Inequalities: A Real Threat for the Economy", Bastien Drut, January 2020, CPR AM Focus Sustainable Development.
2. "Global Income Distribution: From the Fall of the Berlin Wall to the Great Recession", Christoph Lakner, Branko Milanovic, December 2013, World Bank Policy Research Paper.
3. "Global Inequality: A New Approach for the Age of Globalization", Branko Milanovic, April 2016, Harvard University Press.
4. "In It Together: Why Less Inequality Benefits All", May 2015, OECD.
5. "Trends in income inequality and its impact on economic growth", 2014, OECD Social, Employment and Migration working papers.
6. "ESG investing in recent years: new insights from old challenges", Roncalli et al, 2019, Amundi Working Papers.

offers a performance in line with the broader universe (in this case, the MSCI World).

Other studies have demonstrated a negative link between the pay dispersion between CEOs and median salaries and stock market performance.[7]

To summarise, the growth in social inequality since the 1980s is a major economic fact, the economic consequences of which are now well known. Investors had already started to integrate such themes into their investment decisions before the coronavirus crisis.

Up until the COVID-19 crisis, however, investor mobilization on social inequality had been (very) limited by certain factors:

- First, a lack of global (and sometimes regional or local) consensus on the levels of inequality deemed acceptable from a social and economic point of view. Between Europe and the Anglo-Saxon world, for example, the differences are stark. Interestingly, in response to the pandemic, Anglo-Saxon countries prioritized the preservation of economic capacity over the health response; and
- Second, and in part as a result of these divergences, there is a lack of methodological and technical tools for investors to integrate this dimension into their investment policies.

The pandemic, a tipping point for inequality?

We believe that the pandemic will allow us to turn a corner. Should inequality levels rise significantly around the world, the consensus issue will become obsolete. Moreover, new methodologies are being developed to address the lack of tools available to investors. **The combination of these two factors should accelerate the integration of inequalities into investors' investment policies and practices.**

First, the health crisis in most developed countries has put the issue of social inequality at the center of political and media attention through two main channels:

- The blatancy of social inequality embedded in the epidemic itself due to:[8] (a) the inequality in the face of the disease, with the most disadvantaged social groups and regions paying the heaviest price;[9] (b) inequality in terms of access to care in some countries; and (c) inequality in the response measures to the disease, with the most disadvantaged social groups hardest hit by containment measures, further increasing inequalities (notably through the partial de-schooling of children from families with the lowest incomes); and
- A particularly sharp symbolic turnaround[10] from a social hierarchy based on higher education and jobs with strong intellectual value to a social organisation that values manual workers (in industry, services and agriculture), which formed the lifeline of social and economic life under containment.

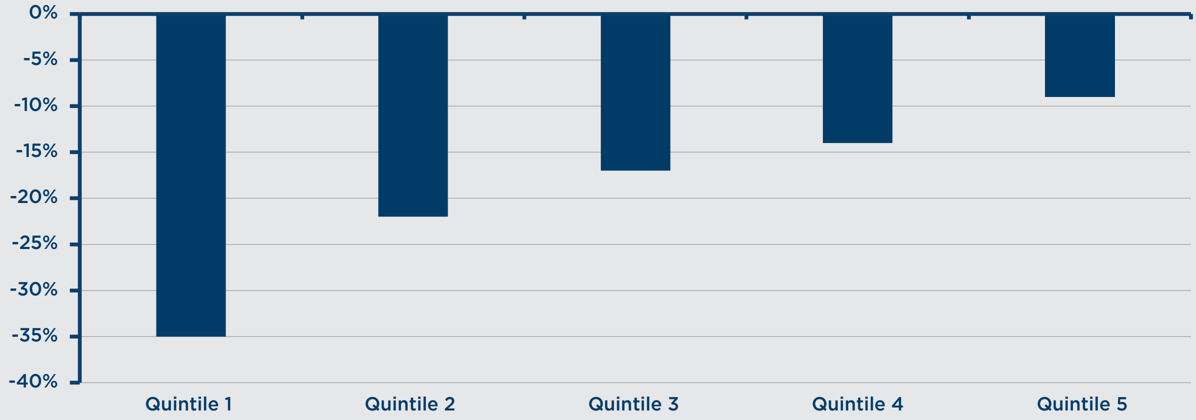
There will be consequences to this double turnaround, in particular in terms of the redistribution of added value.

Second, the health and economic crisis will have major social consequences, contributing in the short term to increasing relative inequalities in the following ways:

- A massive increase in unemployment in most developed countries (almost 37 million people filed for unemployment benefits in the US between early March and May 9), with the overwhelming brunt of the employment decline concentrated among lower-wage workers[11];
- An associated increase in extreme poverty and social exclusion (overstretched food banks in many countries). In the US, the rates of food insecurity observed in April 2020 are meaningfully higher than at any

7. "Equity Market Reaction to Pay Dispersion: Evidence from CEO-Worker Pay Ratio Disclosure", Pan et al, February 2020.
8. "COVID-19, inequality, and gig economy workers", Stabile et al, 2020, VoxEU. "The large and unequal impact of COVID-19 on workers", Adams-Prassl et al, 2020, VoxEU.
9. "Data Suggests Many New York City Neighborhoods Hardest Hit by COVID-19 Are Also Low-Income Areas", April 5 2020, Time Magazine.
10. "The Road to Somewhere", David Goodhart, 2017, C Hurst & Co. "L'archipel français", Jérôme Fourquet, 2019, Seuil.
11. "The U.S. Labor Market during the Beginning of the Pandemic Recession", May 2020, NBER working paper 27159.

Figure 1: US: employment changes by initial wage quintile (between mid-February and mid-March)

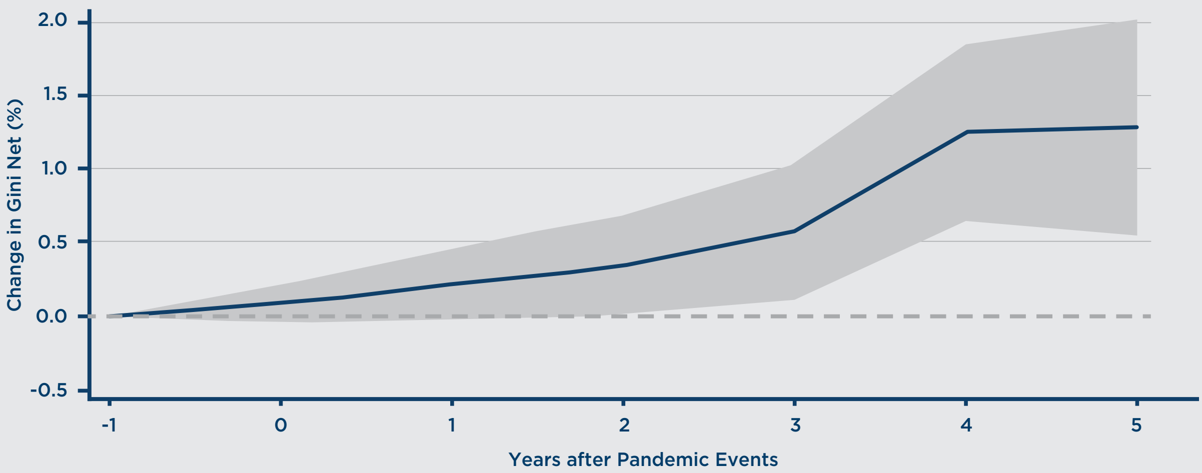


Source: CPR AM, Cajner et al. (2020)

point for which there is comparable data (i.e., 2001 to 2018)[12];

- A decrease in relative income for a large share of the population, combined with rising unemployment, and also possible price inflation in the coming years (monetary policy and more localised economic reorganisation, pushing up prices); and
- While in one respect relative wealth inequality could decrease as a result of the drop in the value of financial assets, this is unlikely to compensate for the inequalities built up over recent decades, notably as a result of a gradual convergence between high labour incomes and capital accumulation (see, for instance, Global Inequality, 2016);

Figure 2: Impact of pandemics on inequality[13]



Source: VoxEU. Notes: The figure shows the impulse response (and 90% confidence bands) of the net Gini to a pandemic for five years after the event for 175 countries over the period 1961-2017. The baseline specification includes two lags of the dependent variable and current and two lags of the pandemic dummy variable. Gini coefficients are from the Standardized World Income Inequality Database. See Furceri et al. (2020) for details.

12. "The COVID-19 crisis had already left too many children hungry in America", May 2020, Brookings Institution.
13. COVID-19 will raise inequality if past pandemics are a guide, Davide Furceri, Prakash Loungani, Jonathan D. Ostry, Pietro Pizzuto 08 May 2020.

This would be consistent with the historical evidence, which shows that inequalities have increased after pandemics.

Policy response to address the rise in inequalities

It is possible that a political and economic response will arise to address rising inequality via:

- The implementation of social policies, associated in particular with massive budgetary transfers to the most disadvantaged groups;
- Incentives for or the organisation of wage revaluation policies for the lowest incomes, in particular for businesses involved in the symbolic reversal described above[14]; and
- The implementation of policies that aim to increase the contribution of the most favoured economic and social groups to the reconstruction effort, both for budgetary reasons (financing of the above mentioned measures) and for symbolic reasons, which are necessary for social cohesion (i.e., the contribution of the most well off to the 'war effort'). This is evidenced by the first debates on the distribution of dividends or control over compensations;

From a macroeconomic perspective, this should result in:

- An increase in tax and social transfers in most developed countries;
- The remolding of tax rates in the sense of greater progressivity (in most developed countries, income and capital taxes have been declining for the top deciles);[15]
- A relative increase in income, wealth and corporate taxes (in the United States the marginal tax rate on the highest earners[16] went from 94% at the end of the Second World War and stabilised at about 70% during the postwar period before gradually falling from the 1980s to 36% today, with the corporate tax rate having fallen from 50% in the 1950s to 16% today)[17]; and
- In relative terms, a redistribution of the value added between capital and labour in favour of the latter factor, the impact of which may be amplified by an increase in inflation that further reduces the value of assets, particularly financial assets.

These developments should be supported by the synchrony of the crisis in all countries, possibly limiting the risk of fiscal 'loss of competitiveness.' In a sense, since all countries are facing the same challenge, it is quite possible that the argument of capital flight risk for not implementing these types of policy is now less admissible.

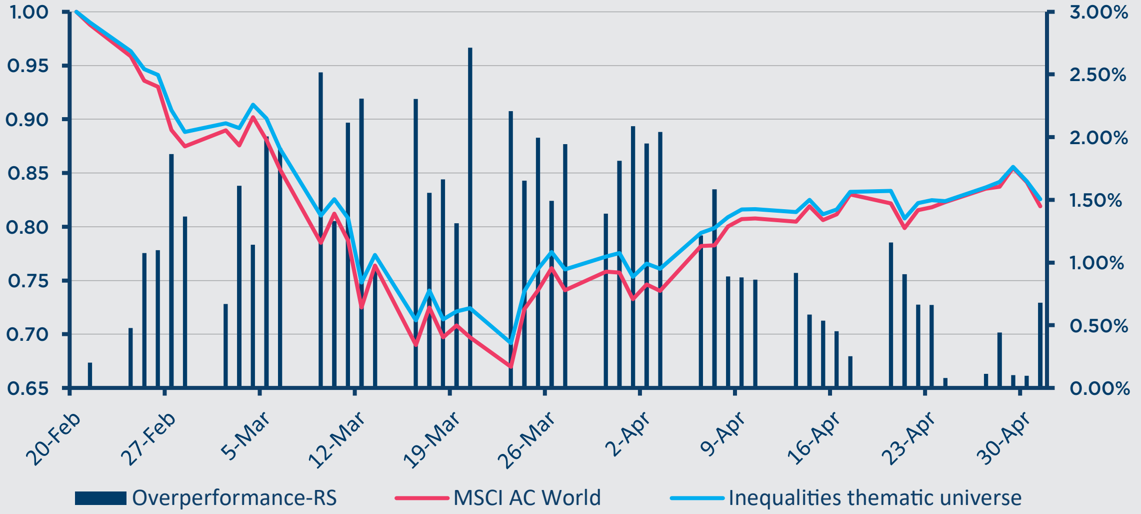
The pace of these developments is obviously difficult to assess and will depend heavily on political developments in individual countries. In this respect, two main types of scenarios are possible: (I) the rapid adoption by existing governments of ambitious social agendas (the 'New Deal' model); and (II) the initial pursuit of 'business as usual' policies by the governments in place, which is quickly challenged by large-scale social movements leading to new political forces ('populist' or not) coming to power on social and/or anti-elite agendas.

What implications for investors?

The implications of these developments for investors will obviously be key. It is interesting to note that in an ESG approach for selecting companies, the 'S' factor has contributed relatively more to financial performance since the start of the coronavirus crisis, particularly in the United States. Indeed, our ESG research shows that the big 'ESG' performer since the beginning of the crisis has been the 'S' pillar in North America. It should also be noted that the investment universe we have built, based on the relative contribution of companies to social inequalities, outperformed its index by

14. In the US, the *HEROES Act* passed by the House of Representatives proposes to establish a $200 bn "Heroes' Fund" to boost pay and aid the recruitment of 'essential' workers.
15. "The Triumph of Injustice: How the Rich Dodge Taxes and How to Make Them Pay", Gabriel Zucman, Emmanuel Saez, 2019, W.W. Norton.
16. Top 0.1%.
17. Ibid.

Figure 3: Inequalities universe overperformance over the crisis



Amundi internal calculation on PMS (Portfolio Management System). Inequality thematic universe is based on an assessment of the relative participation of companies in reducing social inequalities in their country of origin.

119 basis points over the period February-April 2020;

From a macroeconomic point of view, there are two major issues for investors:

- *A priori*, the more a country was mired in inequality before the crisis, the more the response could be massive at the end: investors should therefore fully consider this factor in their assessment of the relative economic situation of different countries;
- In general, as capital returns are expected to decline as a result of these changes, a new asset class hierarchy should emerge, which will be discussed in a forthcoming publication;

From a microeconomic point of view, and in terms of company assessment, we believe investors should:

- Incorporate the issue of inequality into their assessment of companies, notably according to: (i) their contribution to public finances; (ii) their salary policies for the highest earners; and (iii) their wage policies and profit-sharing policies.

  From a stylised risk perspective alone, it could be that a large company whose model is based on a low-wage policy for average employees, massive pay gaps, a lack of employee profit-sharing schemes and the massive optimisation of its revenues could see this model challenged by societies and political systems in the coming years.

  This phenomenon has already emerged in Europe, with Laurent Berger, Secretary General of the CFDT (France's largest trade union) and the Social Market Foundation in the United Kingdom calling for an overhaul of the 'social contract' in the early weeks of the crisis, and Denmark suspending all coronavirus-related aid to companies registered in tax havens[18]; and
- Participate through their engagement and voting policy in an active integration of these issues by companies.

Ultimately, we believe that the social issue, which was already becoming increasingly important in the eyes of investors, will become a central focus in the years to come.

18. "Denmark Extends Business Aid to Increase Spending By $15 Billion", April 18 2020, Bloomberg.

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