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How Covid-19 could shape the ESG landscape for years to come

From more rigorous integration of social issues into the investment process to the strategic case for sustainable investments

Overview

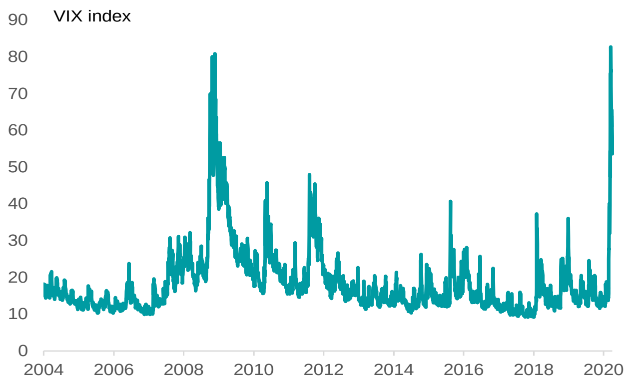
The coronavirus pandemic has hit the world economy at a critical time from an ESG perspective. Climate talks in Madrid at the end of last year ended in disappointment and all eyes were on the COP26 climate summit in the UK this November to put the Paris climate ambitions back on track. Now COP26 has been delayed until 2021.

The Covid-19 outbreak also hit at a time when global energy markets were already in turmoil. The collapse in the oil price triggered by a fight over market share between Saudi Arabia and Russia in February has now been aggravated by a more pronounced collapse in crude oil demand.[1] This has implications for the clean energy, biofuels and recycling plastic technologies.

This year should also witness the EU Action Plan and the European Green Deal beginning to take effect. With governments naturally focused on supporting healthcare systems and preserving human life, policy makers must keep their resolve to maintain and accelerate efforts to address the climate crisis and broader ESG issues.

We have witnessed an extreme spike in asset market volatility with equity market volatility back to levels last seen in the Global Financial Crisis (GFC).[2] Forecasts for global growth suggest we are likely to see the largest quarterly contraction in economic activity since the 1940s and predictions for global CO_2 emissions this year could be that they fall by as much as 5%.[3]

FIGURE 1. EQUITY MARKET VOLATILITY



Source: CBOE (Data as of April 1, 2020)

While central banks and governments have responded quickly to this crisis in terms of interest rate cuts, new quantitative easing programmes, and fiscal stimulus packages we, like many, worry that when the economic recovery comes, CO2 emissions growth will simply leap higher as it did in 2010.

If this was not enough, we also have another societal issue to be even more concerned about. The major financial winners since the GFC 10 years ago have been the super-rich helped by rapid asset price inflation such as in real estate and equities.[4] We believe we cannot afford this to be the outcome of this crisis. We expect addressing inequality will need to become an even greater priority for governments. Companies must play their role and not leave it for taxpayers to foot this bill yet again, in our view.

[1] Bloomberg Finance LP (April 1, 2020)
[2] CBOE (April 1, 2020)
[3] Bloomberg (March 27, 2020). Economists see US facing worst ever quarterly contraction

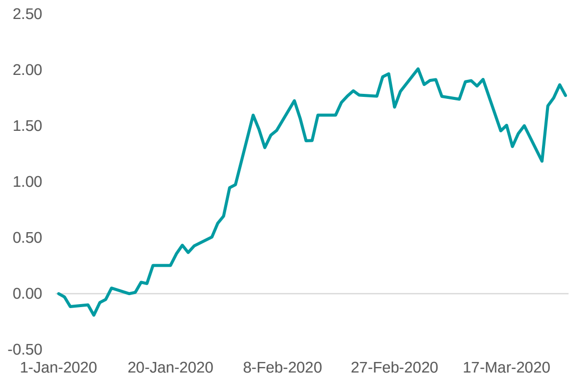
[4] UN Department of Economic and Social Affairs (DESA) (January 2018). World Inequality Report 2018

The macro implications

We believe the Covid-19 pandemic will have profound and long-lasting effects on the rapidly developing ESG market. In our view, the pandemic is illustrating the financial materiality of ESG. We also find that in the onset and in the early days of this crisis, MSCI ESG indices, for example, outperformed their parent benchmarks.[5]

In the current period of extreme market volatility, MSCI analysis shows that the majority of this outperformance has been reflected in ESG indices holding underweight exposures to the energy sector and oversized allocations towards healthcare and technology both of which are in the frontline of combatting the pandemic.[5]

FIGURE 2. MSCI USA ESG LOW CARBON INDEX PERFORMANCE VSPARENT BENCHMARK



Source: Bloomberg Finance LP (Data as of March 27, 2020)
Past performance is not a reliable indicator of future returns.

We also see some interesting trends when we look at fund flows. As the virus spread from Asia to Europe and then the U.S., fund flows have moved out of Europe and the U.S. and now, as confidence is slowing returning to Asian markets, inflows are moving back into China and Japan.[6] This tallies with relative equity market performance where we have seen the Chinese equity market outperforming other markets in March.[7]

However, even with these new inflows, current holdings in China are more than one standard deviation lower than the five-year average, implying there is significant scope for further inflows.[8] We are also encouraged by the recovery in Chinese manufacturing business confidence in March.[9] This represents the best level for business confidence since September 2017 and does hold some glimmer of hope that this business sector recovery might be replicated in Europe by the middle of the year.

Assessing ESG risks

There are clear risks for the ESG investment universe. One of the most obvious is how recent macro trends will impact clean energy investments. The collapse in energy prices as well as carbon prices have placed renewed pressure on climate technologies. While we have seen a dramatic improvement in the cost advantages of clean technologies such as wind and solar over the past decade, lower oil prices and the Covid-19 crisis are leading to downward revisions in terms of the number of solar and wind projects.[10]

We are also likely to see lower sales of electric vehicles. There is also the potential impact on energy efficiency measures such as retrofitting homes and offices as well as regarding the development of biofuels, plastic recycling deployment and threats to the circular economy.[11]

In the U.S., the Environmental Protection Agency has stated that power plants, factories and other facilities will not need to meet environmental standards during the coronavirus outbreak.[12] The temporary policy, for which the Environmental Protection Agency (EPA) has set no end date, would allow any number of industries to bypass environmental laws. In addition, the federal government has announced that vehicle emissions standards will be less onerous, keeping less fuel efficient, more polluting cars on the roads.[13]

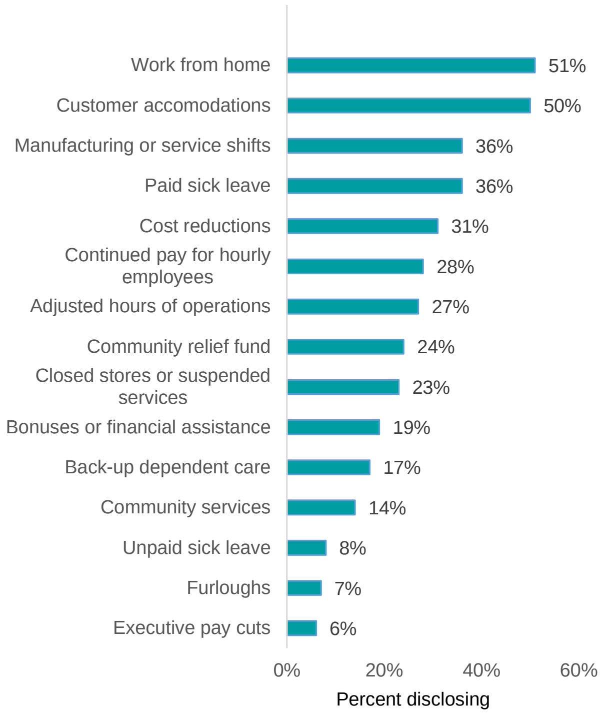
The current crisis may also put companies under the microscope as we may see increased efforts by asset owners and managers to integrate social aspects into ESG investing, an area that has often been overshadowed by climate risk integration. This should eventually mean better data capture in terms of scope and depth as it relates to social issues. This goes to the heart of the enhancements we have put in pace to our own norms-based ESG screening process. These capture labour rights, human rights and other social and environmental issues into the ESG integration process. Our work was well underway

[5] MSCI Inc (March 2020).
[6] EPFR Global, HSBC calculations (March 2020)
[7] Bloomberg Finance LP (Data as of March 27, 2020)
[8] EPFR Global, HSBC calculations (March 2020)
[9] National Bureau of Statistics China (March 2020)
[10] Irena (January 2019). Renewable power generating costs in 2018
[11] Bloomberg New Energy Finance (March 2020)
[12] US Environmental Protection Agency (March 27, 2020)
[13] CNBC (March 30, 2020). New Trump automobile mileage standards to guy Obama climate efforts

before the Covid-19 outbreak. We were discovering the most norms-based violations were occurring in the healthcare sector along with materials, energy, financials and consumer staples. We expect Covid-19 will reveal these issues in even sharper detail.

Work by JUST Capital has been informative in understanding where support mechanisms have been delivered, such as working from home, paid sick leave, community relief funds, and where it has not.[14]

FIGURE 1. HOW AMERICA'S LARGEST EMPLOYERS ARE RESPONDING TO COVID-19



Source: JUST Capital (March 2020) The COVID-19 Corporate Response Tracker. Data of America's 100 largest public employers as of March 24, 2020.

Now questions are being asked as to long-term company share buyback programmes and dividends, particularly in sectors which are now potentially seeking bailout provision. Share buybacks in the U.S. over the past 5-10 years have been most prolific in the airline and hotel industries and now these sectors are looking for bailouts.[15] The think tank 2° Investing has raised the question whether "rainy day funds" need to be created to avoid tax payers footing the bill in times of crisis.[16] This would seem most relevant for the oil majors when the climate crisis hits.

In a 2018 white paper we published with the University of Hamburg, we examined the link between ESG and corporate financial performance.[17] One of the most compelling results we uncovered was that corporate reputation had the strongest positive correlation to financial performance. Consequently, how companies respond and support their employees and customers during this crisis could have important implications for company performance. This can also extend to how companies are altering their production lines.

Capturing ESG opportunities

The crisis may also shine a light on what and how an acute shock may result in a rapid shift in economic value, similar to what we could see happen with climate change. This provides real-life experience of stress-testing techniques that have been developing for climate risk for some time, but, will have new dimensions to consider such as the restrictions placed on the free movement of people, goods and services.

Country lockdowns have also shown the ways in which the world can adapt without many of the carbon intensive activities enjoyed before the crisis. We expect this will encourage new company and employee behaviours with virtual meetings and conferences potentially helping to alter the growth in air travel as well as greater scope for more flexible hours and working from home provision particularly if the duration of lockdown periods is extensive.

The crisis may also have a meaningful effect on how we view asset classes from an ESG perspective. For example, in real estate we expect to see further developments in what can be defined as ESG best practise when it comes to disaster preparedness and resilience planning, responsible labour practices, designing and operating healthy buildings and community stewardship.

We may see greater focus on the composition of fiscal stimulus programmes. In China, we are already witnessing the government strengthening regulations regarding the proper treatment of sewage and industrial waste.[18] We expect this will provide even greater impetus in the area of Chinese clean tech and energy investments.[19]

Attention is now turning to fiscal stimulus programmes in Europe and the U.S.. At the end of March, EU heads of state concluded an EU summit which will prepare a recovery

[14] JUST Capital (March 2020) The COVID-19 Corporate Response Tracker Data of America's 100 largest public employers as of March 24, 2020
15 Washington Post (March 18, 2020). Trump's coronavirus plans includes industry bailouts
[16] Jakob Thoma, 2º Investing Initiative (March 25, 2020)

[17] DWS Research Institute white paper (September 2018). ESG and corporate financial performance: Digging deeper
[18] Deutsche Bank Research (January 2020). Coronavirus update. Messages from the top
[19] DWS Research Institute white paper (March 2020). The response to the coronavirus epidemic

plan that includes the green and digital sectors, which will mean long term stimulus will incorporate clean energy, transportation and smart infrastructure.[20]

In the U.S., while the initial signs have not been good in terms of EPA and emissions rulings, there is bipartisan support for part of the next fiscal stimulus plan to include green infrastructure. With the U.S. embarking on trillions of dollars in terms of fiscal stimulus this could be a material investment programme.

This latest crisis should also see a refocusing of attention for corporates and investors. It could mean that heavy industries such as energy, utilities, miners and autos, which have been at the centre of the climate crisis, may be joined by greater scrutiny for those companies operating in the gig and service part of the economy, as these have been hit particularly hard from the Covid-19 pandemic.

Strengthening investor expectations about how companies should respond are likely to gather momentum. For example, a call on companies to maintain health benefits—and to the best extent possible to maintain some level of salaries for workers, consultants and contractors.

The PRI has also recently published guidance for its signatories in this area.[21] Their recommendations include encouraging investors to engage with investee companies that are failing in their crisis management or where other harm is being hidden by the crisis. An investor statement on coronavirus has also been issued by Domini Impact Investments, the Interfaith Centre for Corporate Responsibility (ICCR), and the Office of the New York City Comptroller calling on investee companies to protect employees, customers and suppliers through the current Covid-19 crisis.[22]

The strategic case of sustainable investments

While healthcare systems are under severe strains in developed markets, the available resources in emerging markets when it comes to healthcare is, in many instances, significantly worse. Indeed we are acutely aware that the ability to cope and respond is severely curtailed in emerging market countries.

Weak healthcare systems, poor sanitation facilities, low internet connectivity, the inability of these countries to access international capital markets to fund stimulus programmes present considerable challenges to respond to this crisis effectively. We therefore expect the crisis will mean emerging markets will become even greater recipients of impact investment flows in the years ahead.

We should also not forget that this crisis has its origins in biodiversity loss, rapid urbanisation, rising population levels and humans coming into closer contact with animals through deforestation and bushmeat markets.[23] We therefore see Covid-19 entrenching the strategic importance of sustainable investments particularly focused on healthcare, education and financial inclusion.

Even before the Covid-19 outbreak, asset owners in Denmark have been the pioneers in ESG investing committing USD50bn of investments to support the Paris Agreement and the UN Sustainable Development Goa.l[24] To encourage similar commitments from other institutions, Danish pension funds formed the Climate Investment Coalition.

Later this month we will be publishing a new research paper examining the strategic case for sustainable investments. We believe Europe and China have a critical role to play in driving this agenda.

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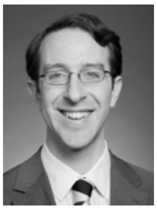

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[20] Euractiv (March 27, 2020). EU leaders back green transition in pandemic recovery plan
[21] PRI (March 27, 2020) How responsible investors should respond to the Covid-19 coronavirus crisis
[22] Interfaith Centre for Corporate Responsibility (March 2020). Investor statement on coronavirus response
[23] Ensia-John Vidal (March 17, 2020). Destruction of habitat and loss of biodiversity are creating the perfect conditions for diseases like covid-19 to emerge
24 IPE (December 2019). PKA chief at heart of newly-launched Climate Investment Coalition

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