On the Minds of Investors

May 2020

COVID-19 shows ESG matters more than ever

At the start of the year, sustainability was at the top of the political agenda, with new climate initiatives ranging from the organisation of the COP 26 to the launch of the Green Deal in Europe. Sustainability was on the trajectory to the mainstream, with asset managers prioritising the integration of material environmental, social and governance (ESG) factors into existing investment solutions, while the development of new sustainable investment solutions continued to accelerate in response to ever-growing investor interest.

However, the COVID-19 crisis has unfortunately changed the priorities, with policymakers having no choice but to focus on crisis management and to redirect already scarce financial resources to support their economies. And, unlike many policy interventions in recent years, this public support has often been extended without any ESG requirements.

Has the pandemic slowed down the momentum for sustainable investing in the financial industry? Market flows suggest otherwise. In the U.S., for example, Morningstar reported almost USD 10 billion of inflows to sustainable open-end mutual funds and exchange-traded funds in Q1 2020, already over half the total for the whole of 2019.

For investors, we believe the crisis will ultimately accelerate the ESG agenda, with wide-ranging repercussions. Environment is, of course, only one aspect of the equation. The crisis also highlights the importance of social and governance factors, as companies with more of a long-term focus have proven to be more resilient so far.

In this piece, we analyse the implications of the COVID-19 crisis through the lens of sustainability, identifying both short-term repercussions and some fundamental long-term shifts in how ESG factors will be considered in the context of investment.

ENVIRONMENT: Loss of momentum outweighs short-term benefits, but long-term commitment remains intact

When thinking about the environmental impact of the COVID-19 crisis, the first conclusion is often that it is positive. Satellite images from the European Space Agency (ESA) and NASA show a substantial drop in nitrogen dioxide concentrations in many countries. In Europe, for example, ESA data shows levels were down 50% from mid-March to mid-April, vs. the same period a year ago, in cities such as Paris, Rome, Milan and Madrid.

Lockdown measures have forced many people to work from home, abandoning their daily car commute to the office. Industrial activity and coal consumption for energy generation have fallen substantially – down 13.5%[1] and 8.9%[2] in China, for example.

However, these short-term environmental benefits come with an important loss of momentum in the fight against climate change.

[1] Year over year change in industrial production, January – February 2020: https://www.weforum.org/agenda/2020/03/covid19-economy-china-health-coronavirus-economics-global/

[2] Thermal power electricity generation: https://www.forbes.com/sites/jeffmcmahon/2020/03/24/chinas-covid-19-lockdown-crushed-every-other-form-of-energy-generation-but-solar-grew/#2edbe4ea2370

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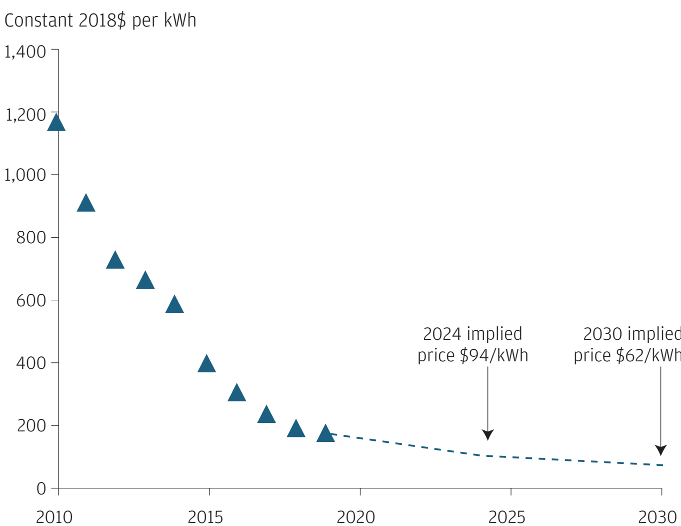
The COVID-19 crisis has led to the cancellation of many climate demonstrations and, more importantly, to the postponement of the COP 26 Climate Conference to 2021. This is a significant setback as the clock is ticking for the climate. The US National Oceanic and Atmosphere Administration recently announced that, according to its most recent measurements, 2020 could well be become the warmest year on record. We cannot afford to lose an additional year.

The short-term reduction in greenhouse gas emissions could also be overshadowed by a rapid rise in fossil fuel consumption as economies start to reopen and recover over the medium to long term – with low energy prices potentially exacerbating the increase. This was true for the 2008 financial crisis, when emissions initially fell to from 32 gigatonnes (2008) to 31.5 (2009) before rising again to 33.2 in 2010.

However, technological advances offer some hope. First, the cost of producing electricity from renewable power such as wind and solar is becoming increasingly competitive, as is the cost of battery storage (see **Exhibit 1**), which should help to contain the rise in greenhouse gases as economies recover. In addition, the significant volatility in oil prices just in the last few weeks adds to the pressure on oil-dependent nations to diversify their revenue sources, boding well for a greener future. The International Energy Agency predicts that revenues will drop by as much as 80% in 2020 vs. 2019 for the largest producers.

EXHIBIT 1: LITHIUM-ION BATTERY PRICE SURVEY RESULTS: VOLUME-WEIGHTED AVERAGE



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On the policy front, we believe climate risk mitigation policies have only been postponed, and that governments and companies will recognise the need to step up their climate adaptation measures to be better prepared for the next crisis. The European Commission has released a statement stating that it is continuing preparatory work on long-term policy and priorities, including the European Green Deal. EU heads of states have backed this by tasking the European Commission to prepare a recovery plan with the green and digital transitions at its heart.

SOCIAL: COVID-19 magnifies and increases inequality

The COVID-19 crisis, probably more than any other crisis before, has magnified and increased inequality: between those who have access to efficient healthcare systems and those who have not, between those who have the ability to work from home and those who have not, between the children who can access online education and those who cannot… While many workers are simply doing their jobs from home, this does not apply across the workforce.

According to the U.S. Bureau of Labor Statistics, 61.5% of workers with earnings greater than the 75th percentile have the ability to work from home, but only 9.2% of those earning below the 25th percentile have the ability to do so. As a consequence, COVID-19 related job losses are much more extensive for those in lower income brackets, as evidenced by recent surveys performed by Oxford University.[3]

The COVID-19 crisis not only increases inequality within societies but also among countries, as it is clear that poorer emerging countries are being hurt the most.

Healthcare systems in poor countries are less equipped to deal with this health crisis. Mortality rates are, in part, a function of hospital capacity, Senegal has just 0.3 hospital beds per 1000 inhabitants, while Japan has 13.4.

However, it's probably on the economic front that poorer countries will be hit the hardest, given their reliance on financial flows/ remittances from their diaspora in rich countries. For Senegal, for example, such remittances account for 10% of GDP, and 62% of these flows come from countries that have implemented lockdowns.

Finally, most countries have implemented measures to cushion the impact of the crisis on their populations. However, more generous unemployment benefits, temporary unemployment benefits and other similar mechanisms only apply to those with an official work contract. In many emerging economies, most people don't have work contracts, instead living from small jobs in in the informal economy. On average 64% of the population in emerging markets works in the informal economy, but this is as high as 80% in India. For all those people, working from home means no income.

[3] University of Oxford, *"Inequality in the impact of the Coronavirus Shock: Evidence for the US from Survey Wave 2"*, by Abi Adams-Prassi et al., J.P. Morgan Asset Management.

As well as the short-term consequences, we also expect the crisis to have some significant longer-term implications. The first is greater job displacement due to increased automation. Many estimates suggest that around one third of the global workforce will have their jobs disrupted by artificial intelligence and automation over the next decade, peaking in periods of economic downturn. With automation replacing many workers stuck at home as a result of COVID restrictions, their jobs could be lost to tech forever. According to the World Economic Forum's Future of Jobs report, at least 54% of all employees will need reskilling and upskilling by 2022. Yet only 30% of employees at risk of job displacement because of technological change received any training over the past year. As a consequence, governments will face the risk that huge disparities among workers will lead to heightened populism. We believe that companies will need to step up their investment in their human capital through continuous training and by improving the health and safety condition of workers. While these measures will inevitably increase unit labour costs, in the long run a more skilled workforce should help to ensure the long-term sustainability of a company's growth.

Another short-term trend that could prove to be a longer-term shift is that healthcare providers worldwide are racing to adopt treatment approaches that eliminate the need for physical meetings. We have seen interest in virtual care and telehealth rise dramatically. Already, Microsoft has launched a Health Bot service to deliver medical care, which is being offered to organisation on the frontlines of the COVID-19 response to help with screening. Innovations such as AI-enabled consultation, advanced robot-assisted surgery and virtual reality technologies could all present new investment opportunities.

We are also seeing changes in the supply chain. Goods and services are having to be sourced more locally in many economies in light of COVID-related restrictions. This could be bad news for emerging markets, where many economies may face prolonged unemployment as demand for their previously exported goods dries up and the workforce cannot upskill quickly as economies transition to a more equal service and manufacturing mix.

Finally, in our engagement with companies we are hearing increasing concern about cybersecurity as more and more business is conducted virtually, while the use of personal data by corporations to help governments with crisis management will come under significant scrutiny post-crisis. Inadequate management of customer welfare and data protection could result in loss of business, litigations and regulatory fines.

In summary, a wide range of "S" factors are likely to exacerbate inequalities in societies and increase unit labour costs, with the potential to impact the speed of economic recovery and corporate profitability.

GOVERNANCE: COVID-19 shows the value of good governance

This crisis is serving as a large-scale stress test of the resilience of corporations across the globe. The sudden loss of income in many sectors, together with the need to completely and rapidly reorganise value chains and methods of interacting with employees and customers, has proven disruptive for many businesses around the world.

As one would expect, companies with the best governance have fared better so far. Defensive capital allocation strategies have been rewarded as the level of cash on the balance sheet has suddenly become a more interesting metric for investors than the dividend yield – which in many cases will be reduced anyway due to decreasing earnings and/or regulatory pressures. Indeed, markets are pricing dividend cuts of 22% in the US, 30% in Japan, 45% in Europe and 51% in the UK.

As a result, companies with a higher governance score have outperformed their peers globally this year by a wide margin. The MSCI World Governance Quality index is down 5% year to date, while MSCI World is down 10% (see **Exhibit 2**).

EXHIBIT 2: STRONG GOVERNANCE ADDED VALUE FOR INVESTORS YTD

Index rebased on 01/01/2020

Source: Refinitiv Datastream, J.P.Morgan Asset Management. Data as of 29 April 2020.

As well as navigating the crisis, boards will need to ensure they maintain a focus on the company's long-term sustainability. The anticipated financial pinch, impending recession and current uncertainty will require companies to confront challenging capital allocation questions, where compromise will be required. Companies have good economic reason to retain a higher cash reserve by withholding dividend payouts and share buybacks in these unusual times, but ultimately this will hurt income-dependent shareholders. Boards and management will need to find the right balance between shareholder rights and the rights of other stakeholders, and between short- and long-term priorities.

Conclusion

The COVID-19 crisis once again highlights that environmental, social and governance factors can have significant implications for the economy and for society. We therefore need to speed up the ESG agenda globally. The crisis also demonstrates that embracing ESG is not a vague distant goal, but something that immediately strengthens the resilience of our societies and companies.

However, we need to recognise that this crisis will likely delay many policy initiatives in this field, as the priority for governments is now clearly to address the health and economic consequences of the pandemic.

Nevertheless, for investors, there is no time to waste. At a time when governments need to reorient their focus and financial efforts towards crisis management, it's up to private investors to step in and fill the gap to ensure that their long-term savings help to support our long-terms goals.

Stricter regulations will further encourage them to do so. Indeed, as government face more financial constraints in achieving their sustainability goals after the COVID-19 crisis, they may well focus on the regulatory framework to encourage private investors to finance ESG initiatives.

In every crisis lies the seed of opportunity, and for investors, the COVID-19 crisis is a unique opportunity to step up their ESG commitment.

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