LA FRANÇAISE
INVESTING TOGETHER

LA LETTRE

SPECIAL EDITION - 25 MARCH 2020

There is no Planet B

By Xavier Lépine – Chairman of the Board of La Française

Photo: F. FERVILLE

A global health crisis is spreading exponentially – how far, and for how long, no one knows – in a world where both economic activity and financial markets are globalised. Only one thing is certain: the situation we find ourselves in is unprecedented, and everything we say or do could turn out to be right or wrong, depending on the health parameters, then the policy parameters, currently unknowns.

In concrete terms, the flight-to-quality concept has not quite panned out this time. The German Bund has also plummeted amid fears of budget deficits and the 'bazooka' support policy implemented by the ECB. This suggests that the zero long-term rate policy could end if not enough investors bite. Maybe now is the time to accept refuge as the place where people find their tribe, where they feel accepted. As such, refuge becomes temporary and relative. As it goes for the health, so it goes for financial markets.

This major crisis is a speeded-up version of the scenario we thought would unfold over the next 15 years. Lest we forget, when climate scientists warned us in the 2000s about the consequences of climate change in 2100, political and economic decision-makers were close to zero on the sensitivity scale. The preference for the present was "humanly, economically, and politically" dominant; a present value, mathematically speaking, of close to 0: $(1+3\%)^{\wedge-100}$ = 5% [where 3% is the very-long-term nominal rate of return]. Since COP21, climate scientists have managed to convince politicians of the climate emergency by referring to 2030, inferring a present value that then jumps from 5% to 65% or $(1+3\%)^{\wedge-15}$. From this abrupt acceleration in present value, either by becoming "ethically" aware or by simply anticipating that the game now in development will have new rules, economic players (in a growing majority) are incorporating these parameters into their strategy. The energy transition and the environmental transition (relocation, short supply circuits, local preferences, etc.) are becoming essential questions. If you recall, the cost of this transition, at least the carbon side, is estimated by the IPCC at €50 per tonne of CO_2, or €2 trillion in investments each year, equivalent to 2% of world GDP! Based on this, we have said that such financing would require managing long-term interest rates so they stay low for a minimum of five years, and more likely close to 10 years – long enough for the first investments to turn a profit and for inflation to rear its head (as globalisation has had the beneficial effect of driving the price maker concept right down). By the same token, in the developed countries, the social unrest spurred by globalisation is questioning democracies more and more, and the "S" measures that are part of SRI and ESG seem much too anaemic to resolve inequalities which have sometimes become intolerable (in 40 years, consumer prices have risen 3.5 times and the French minimum wage 4 times, but residential real estate prices have risen 10-fold in in-demand areas and the MSCI total index has increased by a factor of 33).

In mediating between short-term economic yield in a given competitive environment and sustainability, the two major challenges for businesses are organising a new, partially "deglobalised" supply chain and, more broadly, complexity in reframing the concept of productivity and capital efficiency, now that the ultimate Corporate purpose is no longer solely profit.

Except in its sudden and universal onset, the health crisis fits into the same rationale of externalities that, in this case, had never been factored into economic arguments, financial equilibrium, or political agendas... And its present value is 100!

The worst-case scenario must be considered, if only because it will be included as an assumption in government decisions so that it can be avoided. In concrete terms, over the first two quarters of 2020, global production will crumble by 30-40%, and if things do pick up in the third and fourth quarters, global production will be down 20% for the year as a whole.

However long this health crisis lasts and however far it reaches, it is not much of a risk to assert that "whatever the cost", the States and the Central Banks will do their part to support their people and their economies, but also that economic and social models will be thoroughly overhauled. As to the climate emergency, which would involve complex trade-offs between the "relative" urgency, its cost, and the loss of competitiveness among domestic and international competitors depending on how sensitive they are (by dint of their national regulations; see climate sceptics and other Trumpian mindsets), it now seems certain that health-related externalities will be recognised on an entirely different scale, challenging the "old-world" models.

"I'm afraid of the clean slate, but also of its opposite: that fear passes in vain, without leaving a trace behind it. " *Paolo Giordano (Contagions)*

While it is highly likely that the measures to ensure liquidity will be effective, the next question will be solvency; then orders and business capital, though, paradoxically, the widespread efforts at support may give a leg up to free riders, i.e. businesses or sectors that would no longer have a place in this new world, resulting in high inflation and ultimately a major social and political crisis.

The response has been massive, both from the Central Banks and from the States, but the fundamental question that remains is, how differently will our economies be organised, on the other side of this crisis?

Can we accept the idea that, once the health crisis is over, we will be in a new era, and that we will be moving into a wartime economy, where, just as at the start of the '40s in the United States, the industrial base must be structurally realigned: as such, the increase in healthcare spending that was taken as bad news, and the increase in auto sales as good news, would no longer be the right formula? While the soldiers on the front lines are those with the highest added value?

The "S" in ESG must from now on include healthcare: though we often ran into trouble mathematically quantifying the social in ESG, what is now clear is that healthcare will dominate the approach, just as much as the environment.

Still, while this health crisis creates an immediate and worldwide drop in demand and supply alike, and if it seems plausible that the global organisation of overconsumption will not carry on as it was, the essential question is, what will replace it?

While today, all governments (and Central Banks) are adopting a policy of support for their economies through extraordinary fiscal and/or monetary policies, not all countries are in a position to do so in any lasting way – specifically within Europe, where many States, and not just the smaller ones, were already deep in debt.

This new economy will prioritise healthcare: health, the services that revolve around it, food, sanitation, education, artificial intelligence and, more generally, virtual (rather than physical) travelling, which presumes converting a portion of industry whenever possible, just as in a wartime economy, and revaluing the social model to benefit these populations.

The issue of the S standing for Solidarity is becoming the essential question!

In an optimistic view, even though it is desired by the Secretary-General of the OECD and many economists, we can hope that States will implement a Green New Deal and a worldwide Marshall Plan in the interest of solidarity in establishing the new world "of relocation and decarbonisation" and even if we are incapable right now of quantifying the cost of such adaptation (including the socialisation of the financial consequences of the crisis), there are two fundamental departures from previous crises: there has been no physical destruction and, since the crisis is not financial or economic in origin, if the health crisis does not last too long, the majority of States will have succeeded in limiting the damage in terms of business failures. The recovery would be costly but time-limited, the colossal cost being the cost to transform our economic and social models.

In an approach that is, at this stage, sadly more realistic, we can reasonably expect that after the health crisis, stimulus plans will be highly nationalistic, with a very marked priority for the short-term, considering, quite mistakenly, that the climate change problem has been partially solved because of the drop in consumption, changed behaviours and relocations that will occur. Deglobalisation, which is already a matter for debate, will accelerate by necessity, but the answers will often be nationalistic, keeping local economies afloat (including nationalising airlines and other key employment segments, depending on the country). Many already debt-ridden States will use up their last resources supporting their population in the short term, and overall the "system" will end up even more depleted. In Europe, the "nationalist" stance of Germany, which has announced its stimulus plan and, so far, refused to set up a Europe-wide Marshall Plan / New Deal, is the perfect example.

It is true that the differences in social systems by country can only result in different treatments, at least initially. France has a strong protection system (unemployment and partial employment), while at the other extreme of the developed countries, in the US, the jobless rate will soar from 3 to 20% of the active population, with weak protections in place – and a jump in weapon sales, because, well, you've got to make a living.

Clearly it is too soon to tell which way the scales will tip – utopia or dystopia? In the best possible scenario, the shock of the health crisis creates a virtuous circle in the long term, with a sharp redirection of our economies towards an approach where negative externalities (health, environment, society) are factored in when organising the way the global economy works (relocation, decarbonisation). In the worst possible scenario, national pride carries the day, Europe and its single currency shatter, long-term interest rates spike for lack of long-term investors, short-termism has drained financial resources, and the planet surely but (somewhat more) slowly keeps heating up, due to a lasting and virtually global recession as a result of the combination of these factors.

Somewhere between these two extremes, which is most likely, we must hope that the economic transition that will ensue has enough impact so that the delay we will be facing in the environmental transition is manageable. For if there is an environmental crisis, we have no States, no Central Bank and no Planet B.

So the answer lies mostly in the hands of the States, the Central Banks (as well as the people), and solely in their ability to adopt a form of solidarity that, from the outset, looks less optimal for the State that supports the other States; in other words, in their ability to invest together in the medium term. Historically, there are examples of long-term challenges, but rarely short-term (including, recently, that mask-buying business).

What should investors do in this context?

For securities, as we know, the speed at which securities have toppled – both equities and bonds – is virtually without precedent, except, in the "modern" investor's memory, for October 1987... in a much less financialised world. The 2008 crash was even bigger, but a bit more spread out over time, which allowed many investors to liquidate their positions. What this meant in real terms was that liquidity dried up almost instantly, which is why the vast majority of investors are still very heavily invested while on average the indices have dropped by 30% (as of noon on Wednesday, 25 March).

The extent of the plunge first depended on assets' liquidity, and second on the perceived impact of this crisis by sector. Obviously healthcare, telecoms and the digital economy have been less affected than major physical distribution, tourism or transport (all the way up to nationalising the airlines or other hard-hit industries), not to mention banks or commercial real estate. Take, for instance, Unibail Rodamco Westfield, whose 2020 dividend yield, after a temporary 50% reduction was announced, is 8%, and a market capitalisation that plunged to €8.7bn, for a property asset, including debt, of €60bn. The values of dividends/prices, even with a few lean quarters that would result in a lasting decline in the dividend of 30%, do not justify that kind of discount. Also on this list are the dividend yields of Total (9%), ING (15%), Bouygues (6%), Metro (8%), Allianz (6%), Enel (5%), Santander (8%), Evonik AG (6%), and ProSiebenSat.1 Media (11%)! Corporate bonds, meanwhile, have been especially hard hit by the crisis, with listings that were expressed as a spread above the risk-free rate (e.g. 250 bp) now increasingly reflected in prices (e.g. 60% of par).

Unless we consider that this health crisis is going to be replaying itself for a good long while, a great majority of these declines are excessive, specifically in light of the measures States have taken to shore up the economy and Central Banks to underpin liquidity.

In terms of commercial real estate, as far as France is concerned, the cycle of raising rents that had begun is probably broken. Still, the impact of deferring rent for struggling VSEs and SMEs should be put into perspective. The vast majority of collective vehicles are highly diversified, and if one year generates 4-4.5% in rental income (a little over 1% per quarter), we see that the impact of a quarter with less rent collected is much softer than the impact observed on other asset classes. It is true that there will be a medium-term impact that may be multi-directional depending on the sector. There will probably be fewer worldwide port and airport logistics platforms, and more decentralised logistics, working arrangements that will probably call more on remote work or community office buildings (for the Paris metro area), a quick recovery in trade and mid-range hospitality, and a debate over luxury residential property.

So we must hurry up and wait.

Obviously it's unsatisfactory for an asset manager to say that the best approach right now is to do nothing or, in any event, not to automatically sell. Of course, asset prices may fall further if the bad news just keeps coming in spite of support from the States and the Central Banks, but in the majority of cases, the losses have been excessive on listed and OTC assets alike, and there may be an abrupt upward correction. Whatever happens, we will exit from the crisis, and prices will recover somewhat from where they are today.

It is much too early yet to define a long-term asset allocation, particularly because no matter what form the recovery takes, depending on the country and sector it could be V-, U-, or L-shaped. The only thing that is even remotely certain is that this is the end of ultra-globalisation, and that relocation will have a structural financial cost that, from here, is impossible to measure.

So the sectors and countries to be prioritised will depend on if and when a Green New Deal is set up along with a Marshall Plan or, in contrast, on the selfishness and the short sight of nations.

In concrete terms, we have three possible scenarios for exiting the crisis:

- To cry victory too soon, i.e. without having the healthcare toolbox to keep the pandemic from taking hold again and driving us back into a second wave that is longer than the first. The advanced indicator of this will be what happens in China;
- To fall under the yoke of heavily authoritative regimes, using all technology to track and control populations, choosing health over freedom;
- A positive, empathic, restructured society, no matter what the cost, for the sake of future generations!

Beyond the impact, which has yet to be quantified, regardless of the trend or magnitude of these three trajectories, I am a born optimist. I remain convinced that this crisis, like an industrial revolution, will force every side to move our economies toward a more sustainable world, not just in terms of the economy, but also the environment, healthcare and society.

XX3489 - March 2020

LA FRANÇAISE
INVESTING TOGETHER

La Française Group
128, bd Raspail 75006 Paris - France
Tel. +33 (0)1 73 00 73 00 - Fax +33 (0)1 73 00 73 01
480 871 490 RCS PARIS - www.la-francaise.com