IMCO WORLD VIEW

Investing to capitalize on the long- term trends shaping our future

JANUARY 2023

IMCO
Investment Management Corporation of Ontario

World View At-A-Glance: Themes

Addressing inequality

The past several decades have been characterized by a free-market approach to economic management. While this “hands off” attitude has helped generate unprecedented levels of wealth, it has also contributed to rising inequality. The resulting social discontent has spurred politicians around the world to increasingly shape policy in ways that address the uneven distribution of income and wealth.

Deglobalization

After decades of globalization, international economic integration is facing headwinds from increasingly protectionist policies, which are being enacted alongside a renewed focus on domestic employment and rising global tensions between the West and Russia/China. Additionally, geopolitical instability and the desire to secure supply chains is spurring countries to re-shore and/or “friend shore” production of critical goods and resources.

Policy inflection

Years of relatively low growth, coupled with a desire to pursue goals such as reducing income inequality, addressing climate change and re-shoring production processes, are likely to lead governments to make greater use of fiscal policy. Central banks, meanwhile, could become less willing to provide support to markets in times of slowing growth and heightened market volatility, focusing instead on taming burgeoning inflationary forces with restrictive monetary policy.

ESG & climate change

Both the public and private sectors are increasingly adopting cleaner energy sources and technologies, creating climate “winners and losers” at both the asset class and geographical levels. Mitigating climate change will require significant capital investments, new technologies and governmental policies, ushering in a new era of investing.

Disruptive technologies

Technological advancement has accelerated in recent decades, boosting productivity but also exacerbating inequality as gains have accrued to a narrow group of firms and skilled workers. Technological disruption and innovation will continue shaping how value creation, investment opportunities, and risks are generated and distributed across markets.

Evolving market structure

Private assets provide several advantages over their public counterparts, including greater flexibility to introduce strategic, operational and capital structure improvements. Their focus on long-term returns, rather than short-term (quarterly or annual) results, allows for the time and patience required for these improvement efforts to bear fruit. Attracted by the resulting potential for superior risk-adjusted returns, a growing number of institutions are dedicating resources to private markets at the same time that companies are increasingly turning to private market-based financing over traditional bank-based sources. This expanding pool of investment capital is likely to find a similarly expanded opportunity set within the growing private asset universe. At the other end of the spectrum, index-based investing also continues to grow in popularity as investors seek to reduce fees while gaining broad, liquid exposure to targeted markets. These characteristics provided many benefits to investor portfolios, but also heighten the potential for unintended exposures that need to be monitored and possibly managed.

World View At-A-Glance: Implications

End of low for long

Deglobalization, decarbonization, and fiscal policy aimed at addressing inequality are among the factors likely to generate higher and more volatile inflation – and therefore higher interest rates – over the next decade. As a result, investors should consider greater exposure to inflation-sensitive assets such as inflation-linked bonds, commodities and real assets in their asset mixes.

Heightened volatility & greater dispersion

Rising inflation and less accommodative monetary policy could lead to sharper and more frequent bouts of market volatility. High underlying inflation could also create a dynamic where central banks frequently need to slow growth to combat high inflation, leading to shorter economic cycles and higher market volatility. This environment should also be more conducive to greater dispersion, creating opportunities for outperformance through active management (e.g., sector, style, security selection) and portfolio construction. Higher market volatility could also generate more opportunities to take advantage of market dislocations and rebalancing benefits, while elevating the importance of currency hedging, all of which could lead to improved portfolio risk/return trade-offs.

Capital investment boom

Governments' growing focus on decarbonization and on-shoring will require significant capital investment, with additional impetus from investors' prioritization of climate change/ESG considerations. This will create opportunities around capital expenditure- and infrastructure-related investments, particularly in assets facilitating the energy transition.

Growing role for/complexity of private investments

As the private market universe opportunity set continues to grow, investors with scale, capabilities in value enhancement, and long investment horizons are best positioned to capitalize on their potential to provide superior risk-adjusted returns. Investments that rely on fundamental value creation levers rather than financial leverage as a driver of returns will likely have a greater chance of success in a more volatile economic environment.

Growing scope for unintended exposures

Index investing can mask exposures to specific countries and ESG-related issues that are inconsistent with investors' goals and values. Market-weighted indices can also present potential concentration risks, wherein a small number of individual companies disproportionately influence overall performance. Investors can mitigate unintended exposure risks by ensuring external managers' compliance with their own ESG policies and limit undue concentration risks through tools such as custom indices.

The need for innovation and flexibility

The scale of social and economic change currently underway is dramatic. In this environment, investors who can innovate and adapt are at an advantage, including those who invest in asset classes with a broad remit. For example, an ability to invest in public versions of private asset classes (and vice versa) can help investors manage risks and/or take advantage of opportunities in this fast-changing world. The current tumult also reduces the past's ability to inform the future and magnifies the importance of a research-driven investment process in which key insights are identified and integrated into portfolio-related decision making.

Contents

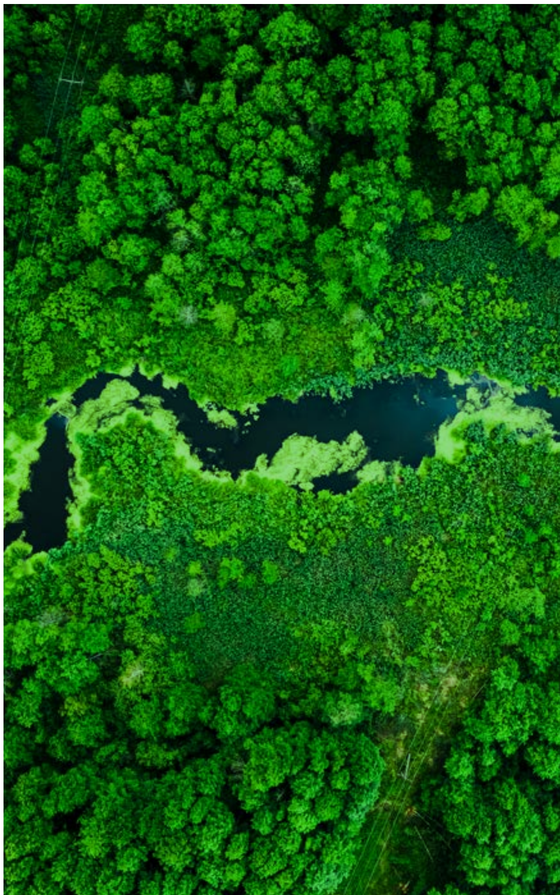
INTRODUCTION

After decades of relative global stability and ‘predictable’ economic policy, the world appears to be shifting towards a more volatile regime. Sources of economic and geopolitical disruption are surfacing everywhere: the global pandemic, the war in Ukraine, climate change, the rise of populism, tensions between the West and China – the list seems to grow with each passing year. Macroeconomic policy is also undergoing a profound revolution as frameworks that were once viewed as unflappable are starting to come under growing scrutiny.

At IMCO, we believe that these global trends are leading us towards a new era of investing – one where it becomes increasingly difficult to rely on the past as a predictor of the future. In recognition of these changes, we have developed our “world view” to define the trends that will most impact our clients’ assets and their accompanying implications.

SECTION ONE establishes the primary themes that we expect to play a significant role in driving returns over the coming decade. Many of these represent an “inflection point” or reversal of previously entrenched trends. Examples include the end of “low for long”, a shift away from globalization towards on-/friend-shoring and increased reliance on the fiscal policy lever relative to monetary policy tools.

SECTION TWO examines the economic and market implications of these themes, along with a brief description of what institutional investors such as IMCO might consider doing in response to these macroeconomic outcomes. For example, de-globalization, the green energy transition, and the greater use of fiscal policy will likely result in higher inflation than in the era between the Great Financial Crisis (GFC) and the COVID-19 pandemic (2008-2020). In that new world, some of IMCO’s clients could stand to benefit from a greater exposure to inflation-sensitive assets such as regulated infrastructure, inflation-linked bonds, and commodities. Other economic and market implications include greater volatility, an expected capital-intensive investment “boom” and a growing scope for unintended or undesired passive exposures – all of which can shape investors’ decision-making at the strategic and/or active levels.



SECTION ONE:

Key themes that will impact returns in the coming decade

THEME 1: Addressing inequality

A defining characteristic of developed market economies over the past several decades is their shared reliance on neoliberalism – the social philosophy that looks to competition, market forces and free-flowing capital to allocate society's resources and the fruits of economic activity. This approach gained traction in the wake of the inflationary 1970s, which many observers pinned – at least in part – on cost-of-living provisions within union contracts and wage-price spirals more generally.

The response to these inflationary dynamics included the rise of free trade agreements, increased cross-border flows of capital and labour, declining union membership, lighter regulation, fiscal restraint on the part of governments and inflation-targeting central banks. In sum, it tilted the playing field back in capital's favor at labour's expense.

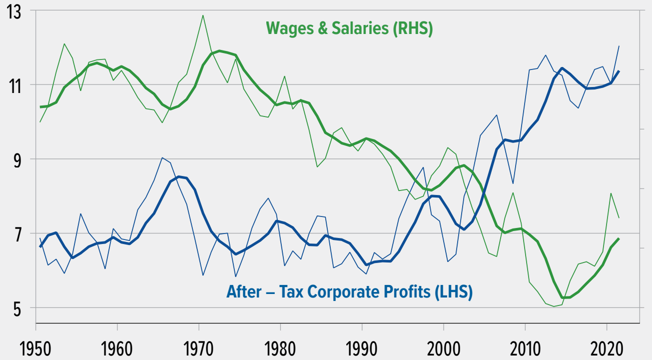
Although the neoliberal era has coincided with significant efficiency gains and unprecedented wealth creation, the distribution of these spoils has been uneven. Domestic labour, for example, has not participated as fully as capital or foreign labour in the neoliberal economy, resulting in an all-time low share for wages and salaries in US GDP **(Chart 1)**. At the same time, the benefits have been accruing to an increasingly concentrated group, to the point where the top 1% of American earners until very recently had surpassed the entire middle class in terms of wealth **(Chart 2)**.

Against this backdrop, it is no surprise that we are now seeing growing discontent and pushback socially as well as politically: the Occupy Wall Street movement; the rise of populist politicians outside emerging markets (e.g., Trump in the US, Le Pen in France, Meloni in Italy); calls from both sides of the aisle in the US to support domestic labour; the growing willingness to bolster incomes via fiscal policy; even China has shifted away from its pursuit of growth-for-growth's sake in favor of a "common prosperity" strategy that emphasizes the quality and distribution of the resulting gains. In our view, these are all signs that the pendulum may have swung as far as it can in neoliberalism's direction, potentially marking a secular inflection point and the advent of a new social and economic paradigm.

CHART 1

U.S. corporate profits' share of income is at record highs

Share of National Income (%, smoothed line is 5yr average)

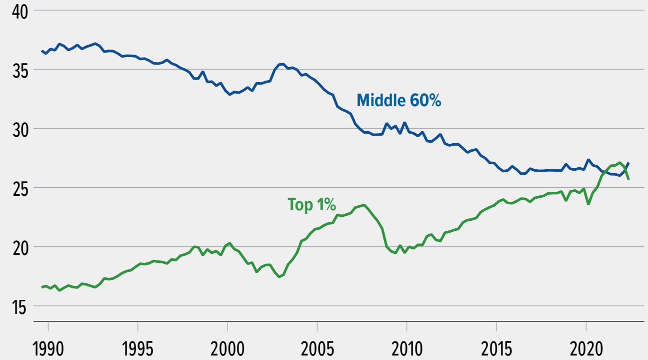


Source: BEA via Macrobond

CHART 2

The top 1% holds nearly as much wealth as the entire middle class in U.S.

Proportion of National Wealth Held by Each Income Cohort (%)



Source: Federal Reserve

THEME 2: Deglobalization

Since the 1980s, production processes and supply chains have become more efficient, due to reduced trade barriers and new technologies that allowed goods, services, and information to flow around the world more easily.

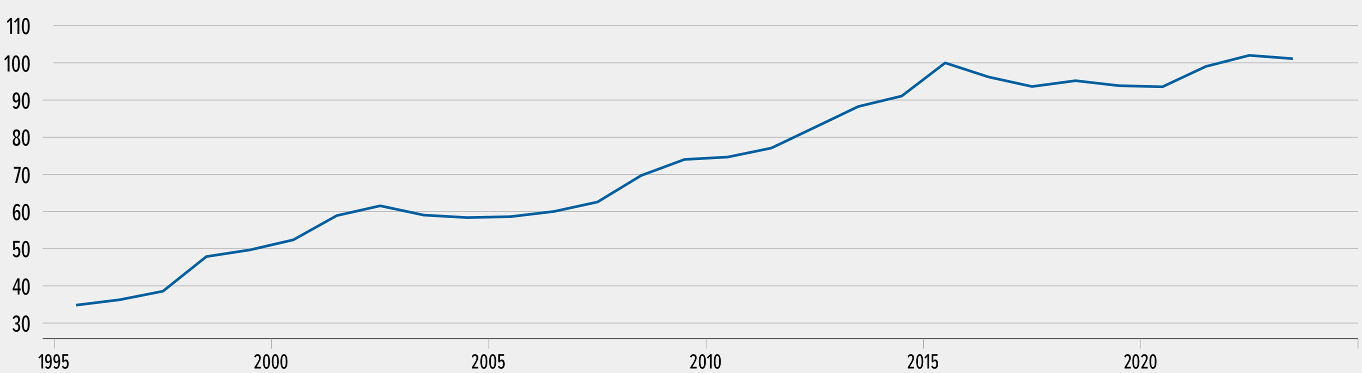
These developments enabled businesses to access vast new pools of labour in China, India and Eastern Europe as these countries became more integrated into the global economy. Efficiency became the chief arbiter and organizer of economic activity, pushing other considerations – such as under-participation of domestic workers and security of strategic supplies – further down the list.

The tides are now shifting, as politicians prioritize domestic employment as a means of addressing inequality. After decades of relative wage gains, emerging markets' labour cost advantage has waned **(Chart 3)**, making the decision to move production to domestic shores easier for global businesses. China's economic and military rise and its challenge for the US' status as the sole global superpower

CHART 3

China's competitive advantage has been steadily deteriorating

China Trade-Weighted Relative Unit Labour Cost Index (2015=100)



Source: OECD via Macrobond

has raised security concerns, further slowing the free flow of commerce. While these geopolitical tensions have thus far been limited to trade in the form of protectionism, there is a growing possibility that they evolve into direct physical conflict, with Taiwan as a potential flashpoint. Against this backdrop, the economic ties between the US and China and their related spheres of influence are fading, thus reversing the decades' long trend of increased globalization.

Some measures of economic integration suggest that globalization has indeed stagnated since the GFC **(Chart 4)**. This trend gained further traction with the COVID-19 pandemic and Russia's invasion of Ukraine – both of which provided stark reminders of the need to ensure greater domestic or at least "friendly" access to essential goods and resources. In the case of the pandemic, some countries were unable to adequately source masks, ventilators, and vaccinations due to hoarding and prioritization of domestic supplies by producers/exporters. Related shutdowns also limited access to other key productive inputs such as semiconductors. More recently, Russia's invasion of Ukraine triggered price surges and shortages among key commodities, further highlighting the risks associated with relying on specific countries for critical imports such as food and energy.

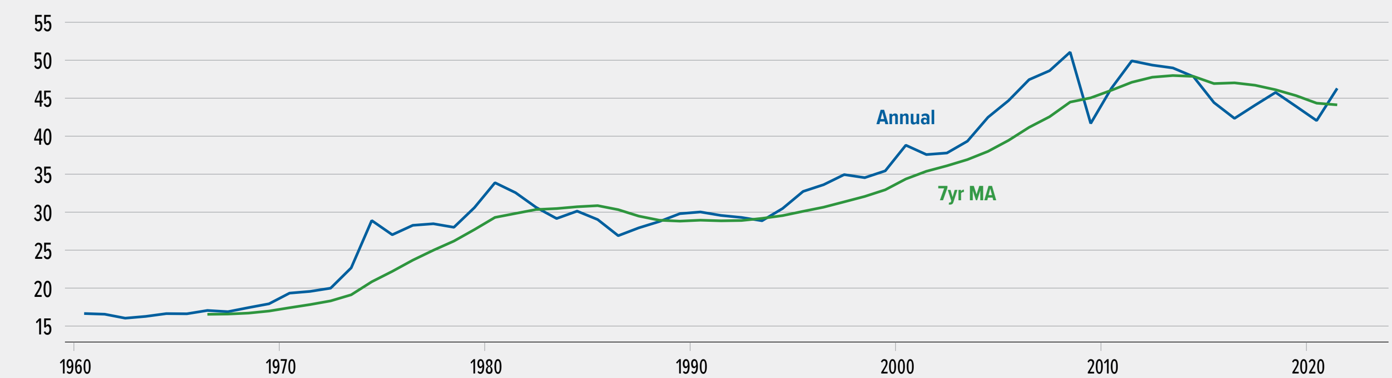
The "trust" nations have in the global economic system's ability to provide their citizens with what is needed, when it is needed, has been shaken. Countries will likely accelerate their move away from global economic integration in the years to come, choosing instead to on-shore production processes and/or "friend-shore" them amongst strategic allies. Growing populist support of nationalism and anti-globalization sentiment add further fuel to this process. The resulting disruption will likely be more severe for China than for the US, as China relies more heavily on the rival bloc for imports and external demand than does the US. Globalization drove the steady decline in costs and prices worldwide over the past several decades, and its reversal (or even slowing) could impart inflationary tailwinds as we head further into a new macroeconomic regime.

"Over the past several decades, globalization drove the steady decline in global costs and prices and its reversal (or even slowing) could impart inflationary tailwinds as we head further into a new macroeconomic regime."

CHART 4

Global trade peaked more than a decade ago

Total Global Merchandise Trade as a % of Global GDP



Source: World Bank via Macrobond

THEME 3: Policy inflection

Since the 1980s, central bankers have dominated the economic policy landscape, with politicians' spending and taxation decisions relegated to a secondary role. The "hands off" philosophy underlying this approach – in which a single monetary policy interest rate is relied upon to influence growth and inflation – is consistent with the broader neo-liberal, market-oriented model that characterized this era of globalization and free-flowing capital.

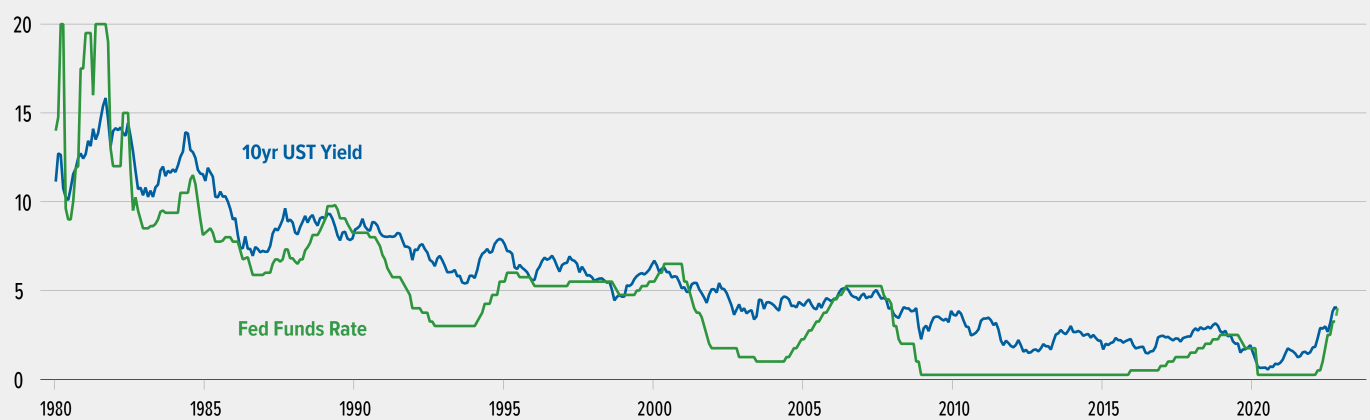
As the only game in town, central bankers felt compelled to offer support whenever the economy and/or markets faltered. And with inflation low and stable, there was little need for commensurate tightening during the booms – the net result being a one-way ride downwards on the rates front since the 1980s **(Chart 5)**. This multi-decade policy rate tailwind could be in jeopardy as central banks wrestle with burgeoning inflationary forces. While lower-than-desired inflation was the main challenge for central bankers in the post-GFC world, it appears that this could be supplanted by concerns at the other end of the target range in the years ahead.

Fiscal policy will likely add further impetus to this trend. In the low growth/low inflation years preceding COVID-19, central bankers recognized the limits of their toolkits and became increasingly vocal in their calls for greater support

> In the low growth/low inflation years preceding COVID-19, central bankers recognized the limits of their toolkits and became increasingly vocal in their calls for greater support from fiscal authorities.

CHART 5

Interest rates have been on a steady decline since the 1980s



Source: Federal Reserve via Macrobond

from fiscal authorities. No such encouragement was needed once the pandemic hit, as the unprecedented shuttering of the global economy was met with an equally unprecedented fiscal policy response **(Chart 6)**. Governments around the world introduced trillions of dollars' worth of spending programs, thus limiting the economic damage and staving off a potential Depression-like scenario.

This experience provided a stark reminder of "the power of fiscal" and could set the stage for greater use of this policy lever. Although still early days, the spate of inflation following in the wake of the COVID-19 pandemic and Russia's invasion of Ukraine does not appear to have limited the appetite for further stimulus. Indeed, many governments have responded with more fiscal support, including several European ones that provided domestic households and businesses with financial relief from the resulting rise in energy prices.

In the future, fiscal policy will likely be increasingly leaned upon to help navigate additional secular trends, including the energy transition and other climate-related initiatives, the growing desire to ensure domestic supplies of strategic goods and materials, and the growing need to address inequality. As recent experience has shown us, fiscal policy has a greater direct impact on growth and inflation – particularly to the upside – than monetary policy's arm's length channels. If inflation replaces deflation as the central banks' primary concern, their willingness to stimulate the economy will be dampened, thus putting even more onus on fiscal policy.

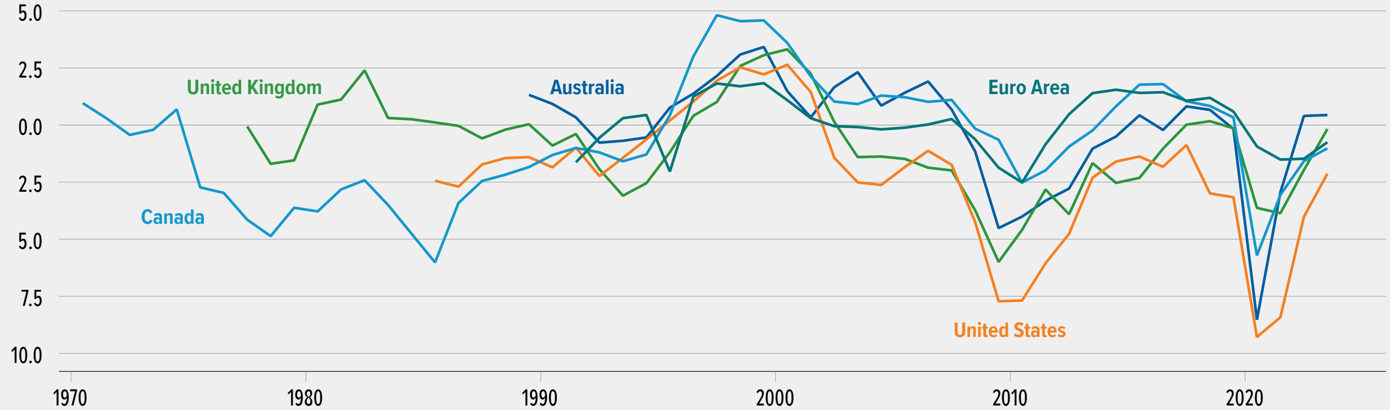
These developments suggest that the policy stage looks set to inflect – possibly dramatically – over the coming years, with fiscal levers and real economic priorities (e.g., employment, inequality, securing of strategic supplies, infrastructure etc.) taking growing precedence over monetary policy and its financial variables of focus (e.g., nominal prices, financing costs, asset values, etc.).

Europe has the potential for the greatest change, as it wrestles with the challenges of a shared currency absent a monetary backstop and corresponding fiscal and banking unions. The former shortcoming has been largely addressed by former European Central Bank president Mario Draghi's "whatever it takes" pronouncement and subsequent quantitative easing (QE) programs. Progress continues to be made on the fiscal front as evidenced by recent joint bond issuance and the growing flexibility around deficit limits. Further advances here will improve European policymakers' ability to pursue specific goals such as addressing inequality, enhancing energy security, reducing carbon, etc. as well as their ability to provide counter-cyclical support to their economies.

CHART 6

Governments spent significantly during the COVID crisis

Cyclically-Adjusted Government Primary Balance (% of Potential GDP)



Source: OECD via Macrobond

THEME 4: ESG and climate change

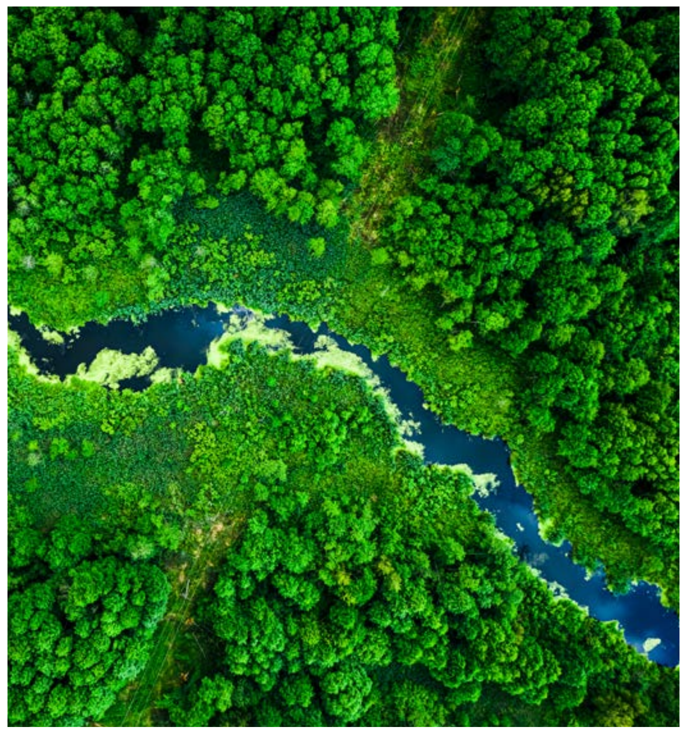
Environmental, social and governance (ESG) considerations are becoming increasingly prominent and consequential for investors, driven by rising global tensions, better access to information and forms of measurement, and evolving societal values and priorities. Climate change is arguably the single most important driver of this trend.

Shifting weather patterns will continue to alter human activity and systems at the local, regional, and global levels. The economic impact of climate change will arise both directly from changes in the climate itself (e.g., migration due to rising sea levels); and indirectly from policies enacted to help mitigate climate risk (e.g., investments in energy efficiency following the introduction of carbon pricing).

The potential for "stranded assets" will rise as governments, companies and consumers increasingly adopt cleaner technologies and energy sources at the expense of legacy ones. For example, new environmental rules and/or changing societal preferences could put conventional oil production at greater risk. The notion of climate-related winners and losers is also likely to arise in terms of geographies, with some locations better able to withstand and/or adapt to changing temperatures and weather patterns. As an example, some agricultural activities might shift to relatively cooler areas, or real estate along coastal areas could face elevated risks from rising sea levels relative to those located further inland.

Governments' push to decarbonize economies as part of climate change mitigation efforts will be expensive, requiring significant capital investments as well as new technologies. Government interventions such as carbon pricing and other policy measures are also likely to drive up energy prices, adding further tailwinds to the global inflationary trend. There may also be knock on-effects relating to energy security and geopolitical power.

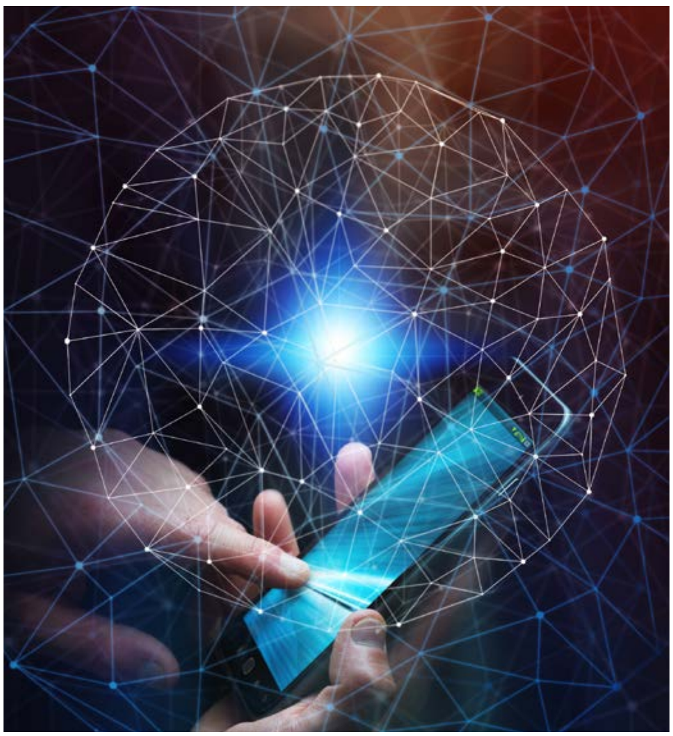
ESG-focused investors will face further risks from exposures to some non-democratic countries. Recent experience supports this likelihood, as illustrated by the sanctions placed by the US, UK, European Union and Canada on Chinese officials and firms in response to human rights violations against the mostly Muslim Uighur minority group in the Xinjiang region. Investors are finding it increasingly challenging to decipher the relationship between the authoritarian regime and the Chinese private sector due to the structure of the Chinese Communist Party.



Rising ESG concerns are ushering in a new era of investing, where the real and reputational risks associated with holding certain assets extend beyond traditional financial variables and objectives. They are also feeding into macroeconomic and geopolitical dynamics more than in the past, implying a growing need for investors to monitor and respond to ESG-related developments.

THEME 5: Disruptive technologies

Advances in computing, automation, and other technologies have continued to accelerate. The increase in innovation has become global in nature, with advanced and emerging countries pushing technological frontiers.



Tightly integrated and digitized global supply chains have allowed these innovations to propagate quickly. Technologies today are also merging, affecting both the physical and digital worlds.

This technological disruption is no longer confined to a limited number of market segments such as the software, hardware, and pharmaceutical industries. Industries that were not prone to disruption have also been affected. For example, the increase in on-line shopping and home delivery over the last decade has pushed established retail companies into bankruptcy and weighed heavily on retail real estate valuations. These assets served as the anchor for many portfolios, generating reliable returns over decades.

Other industries undergoing rapid change include entertainment and technology, with companies such as Netflix rising to lofty valuations only to be disrupted a few years later by increased competition and new business models such as TikTok's. Due to the dominant position of some of these tech stocks and their relatively high weights in the broader market indices, these types of disruptions can have dramatic impacts on markets.

Electric vehicles are another prominent example. Propelled by tightening global fuel emissions standards and the push to decarbonize, electric vehicle technologies are disrupting the ways that automobile companies do business and will have knock-on effects to other industries. The value of the vehicles themselves is being increasingly driven by their embedded software, information and technology rather than their physical components. We are only just starting to witness some of the disruption that these developments will bring to large segments of the global economy.

More generally, these technological advancements have coincided with the concentration of gains amongst a narrowing group of firms, consistent with the rise in importance of network effects within many emerging – often digital – sectors and the increased prevalence of winner-take-all competitive dynamics. When such economics are at play, the related value creation tends to flow to first movers and/or those who manage to become the "standard" setters. While technological advances and digitalization generate productivity gains, a recent report released by the UN Conference on Trade and Development (UNCTAD) suggests their benefits also risk worsening inequality by disproportionately accruing to the already wealthy and those who are relatively highly skilled.

We expect this heightened rate of technological disruption and innovation to continue for the foreseeable future, supported by ongoing capital investments. These developments will, in turn, continue to shape the ways that value creation, investment opportunities and risks are generated and distributed across markets.

THEME 6: Evolving market structure

Private markets have grown dramatically (**Chart 7**), with assets under management more than doubling to around $9 trillion over the last six years (by way of comparison, the market capitalization of the S&P 500 is around $32 trillion). This increase is consistent with the several advantages that private assets provide over their public counterparts, including greater flexibility to introduce strategic, operational, and capital structure improvements that ultimately drive long-term returns. This contrasts with public companies that may find themselves relatively more attuned to shorter-term (e.g., quarterly or annual) results and reporting concerns. Investors with the patience and resources to withstand the lower levels of liquidity that many private investments exhibit are best-suited to capitalize on these advantages.

Attracted by the resulting potential for superior risk-adjusted returns, a growing number of institutional investors are dedicating resources to private markets. At the same time, demand for/supply of such financing is growing as post-GFC regulations have encouraged a move towards private market-based financing over traditional bank-based sources. The net result has been an expanding pool of investment capital seeking a similarly expanding set of private market opportunities. This trend is expected to continue as suggested by estimates from Preqin – a firm specializing in alternative assets data and insights – which foresee private capital assets under management (AUM) increasing at a rate of nearly 15% per year to approximately $18 trillion by 2026.

This trend will be facilitated by continually improving access to these investments. As private markets have grown, so too have the institutions dedicated to these markets. The largest global private market investors such as Blackstone, KKR, Brookfield and The Carlyle Group have experienced considerable growth in recent years to the point that they now have approximately $2.5 trillion AUM collectively. Additionally, many traditional asset managers such as pension funds have substantially increased their private market allocations.

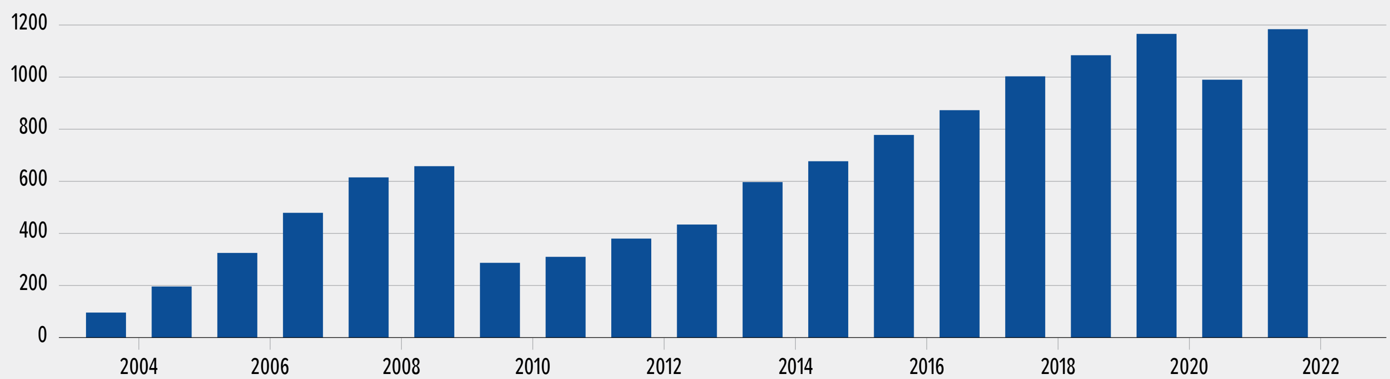
Another key structural development within markets is the continued rise of index-based investing. Due in part to a growing focus on investment fees – and the realization that, net of fees, many investment managers have been unable to beat their benchmarks – index investing has become increasingly popular over the last 20 years for both retail and institutional investors.

In fact, this approach has become so prevalent that, as of the end of 2021, passively managed index funds owned more of the US stock market than did actively managed funds. More broadly, a recent study conducted by Alex Chinco, City University of NY; and Marco Sammon, Harvard Business School estimated that passive investors held around 38% of the US stock market in 2020. The proliferation of products allowing for passive exposure globally beyond the US will add further fuel to this trend.

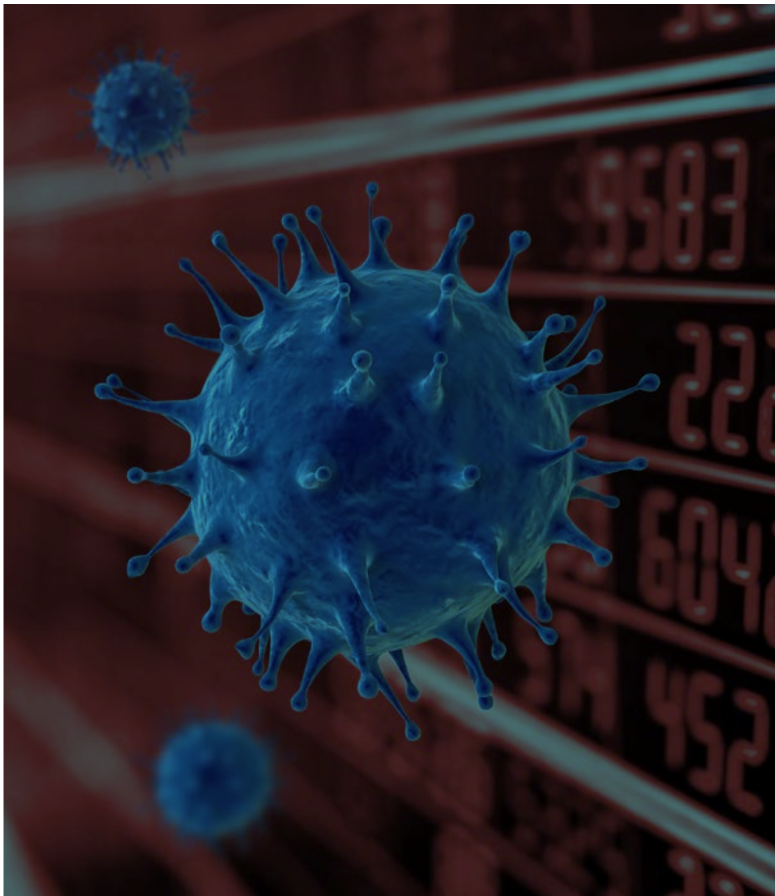
CHART 7

Private market fundraising continues to sit near all-time highs

Annual Private Market Fundraising ($bln)



Source: McKinsey



SECTION TWO:
Economic and Investment Implications

IMPLICATION 1: End of low for long

A confluence of factors will likely mean the end of the "low for long" environment that defined the post-GFC, pre-COVID-19 era – a time characterized by relatively low growth, inflation, and interest rates.

Inflation looks set to be higher and more volatile than what we have been accustomed to, with growth similarly experiencing higher steady state levels. Taken together, these developments raise the likelihood of higher interest rates and yields, reversing one of the prevailing market tailwinds of the past few decades.

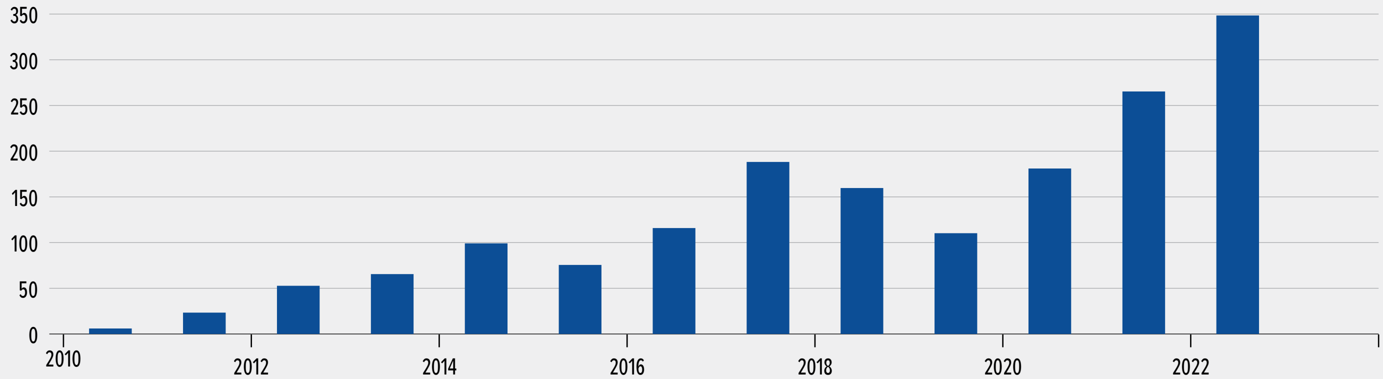
Deglobalization will likely play a role in driving inflation as re-shoring shifts production to higher-costing regions **(Chart 8)**, potentially increasing consumer prices. Duplicating supply chains will also likely increase demand for both labour and raw materials globally, driving up input prices. And if politically popular "buy domestic" policies gain further traction, local businesses could see increased pricing power as global competitive pressures wane.

Decarbonization efforts could provide additional inflationary tailwinds through multiple avenues. One of these is via the substantial infrastructure-related investments required to facilitate the net-zero transition. These projects would boost the demand for various commodities amidst tight supply – an ideal recipe for commodity price increases. They could also stoke demand more generally by providing a new and steady source of employment and income. Additionally, green energy currently tends to be more expensive than traditional sources. A transition at prevailing relative cost structures could add inflationary pressures via higher spending on energy inputs. Strategies to discourage energy generation from fossil fuels (e.g., carbon taxes) would exacerbate this dynamic.

CHART 8

Companies are increasingly moving production to the US

Annual Re-shoring + FDI Job Announcements (000's)



Source: Reshoring Initiative

Fiscal policy is another potential contributor to elevated inflation as its role continues to grow relative to the past several decades. It was proven to be an effective lever during the COVID-19 crisis and will likely be increasingly relied upon to tackle policy objectives relating to climate change, on-shoring and inequality. As governments direct spending towards expanding domestic production capacity, developing new sources of clean energy and alleviating income inequality, the additional income created could be a boon for demand and act as an inflationary tailwind. It might also drive up the cost of the materials needed for such projects, exacerbating the inflationary impulse.

> “For investors, the expected inflationary tailwinds imparted by deglobalization, decarbonization and shifting policy priorities favour greater exposure to inflation-sensitive assets.”

For investors, the expected inflationary tailwinds imparted by deglobalization, decarbonization and shifting policy priorities favour greater exposure to inflation-sensitive assets. For example, a mix of fixed income assets tilted more toward inflation-linked versus nominal bonds will likely perform well, especially given the relatively low levels of long-term breakeven inflation rates. Additionally, commodities should enjoy a relative boost in an inflationary environment. Thus, adding commodity-linked assets (such as natural resources, mining royalties, etc.) and/or increasing exposure to real assets such as real estate and (regulated) infrastructure investments in an asset mix should be considered when appropriate by investors who have access to such opportunities and the skills and expertise required to manage them.

‘Growth’ equities, including some major tech-related names, were beneficiaries of low rates in the post-GFC era, thanks to their anticipated cash flow stream being further off into the future (thus amplifying the effect of low discount rates). This was reflected in growth equities’ high valuations, which are now at increasing risk as rates continue their rise. In addition, the correlation between stocks and bonds may not be as reliably negative as it has been over the past 20 years as inflation supplants the growth cycle as the dominant risk to markets, potentially reducing fixed income’s ability to be a risk diversifier vis-à-vis equities.

IMPLICATION 2: Heightened volatility and greater dispersion

In the pre-COVID-19 era, markets were largely driven by developments related to growth, with inflation playing a lesser role thanks to its relatively muted volatility and its tendency to remain in line with central banks' targets (or below).

Both the level and volatility of inflation (and possibly growth) are expected to remain higher than was experienced in the pre-COVID-19 era. This, in turn, could usher in an era of greater market volatility than investors have grown accustomed to.

One way this could manifest is via a decreased willingness and/or ability on central banks' part to step in and provide the type of policy support that was commonplace when markets experienced significant volatility over the past couple of decades. Whether it was then-European Central Bank President Mario Draghi's vow to do "whatever it takes" to preserve the European currency union, or the "Powell pivot" away from rate hikes in early 2016 as markets got spooked by a China growth scare, or the Bank of Canada's supporting provincial and corporate bonds in the face of the COVID-19 pandemic, central banks have been a steady and calming presence over that time. Absent similar initiatives, markets could experience more frequent and significant bouts of volatility, both from the initial reaction to more varied economic data as well as the consequential policy responses (or lack thereof).

To the extent that the latter are motivated by concerns around inflation, the ensuing tightening will have the knock-on effect of slowing growth and injecting additional volatility into markets. Once a given bout of inflation is brought under control, the underlying inflationary drivers could remain, thus prompting central banks to consider tightening policy once again. Under these dynamics, higher inflation can lead to shorter cycles (and higher market volatility) as central banks switch back and forth more frequently between acting to slow growth and combatting high inflation. This would also likely translate into higher interest rate volatility, which typically leads equity market volatility.

In addition to these impacts at the asset class level, heightened market and economic volatility would also likely coincide with greater dispersion across sectors, segments, and individual securities within asset classes themselves. Shorter/more extreme economic cycles are intuitively more conducive to a broader spectrum of return outcomes, as opposed to the "rising-tide-lifts-all-boats" dynamic that characterized the post-GFC era **(Chart 9)**. Companies that previously relied upon persistently low interest rates and inflation would also face a particularly heightened set of new challenges.

From an investment perspective, these challenges also present opportunities. For example, higher market volatility can increase the window of opportunity for investors to take advantage of market dislocations when they arise. At IMCO, rebalancing already allows for this, and a more robust and nimble rebalancing program could further enable us to be opportunistic. The ability to purchase public versions of private assets – such as real estate – also enables investors to take advantage of temporary discounts in public markets that may not yet be visible in private market valuations. Despite the potential for positive correlation between stocks and bonds going forward, bonds will retain a valuable role (and thus asset allocation) within investor portfolios as a source of liquidity; higher volatility means more transactions/rebalancing, and the liquidity of bonds allows their holders to undertake these activities without being forced to sell other assets (potentially at a discount).

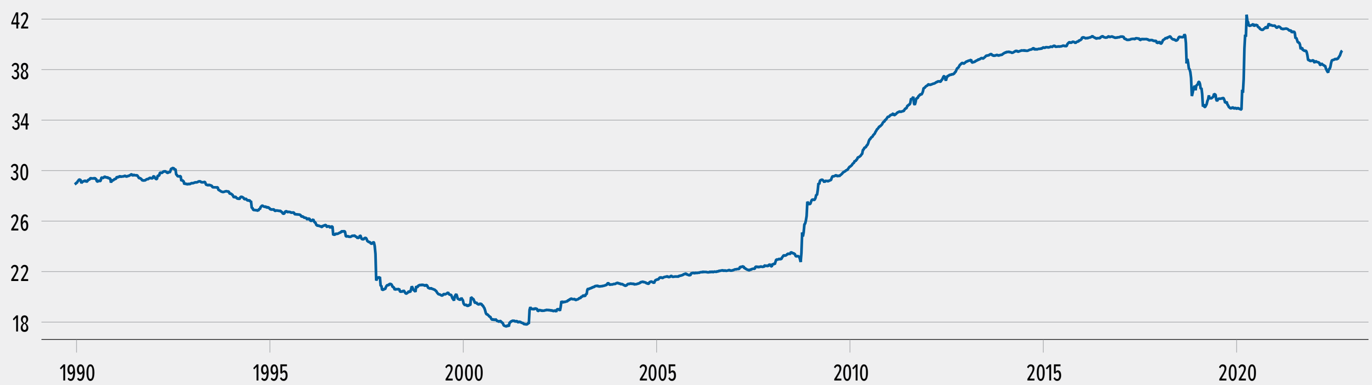
> "The ability to purchase public versions of private assets – such as real estate – also enables investors to take advantage of temporary discounts in public markets that may not yet be visible in private market valuations."

At an asset class level, increased dispersion within asset classes will generate opportunities for outperformance through security selection (i.e., active investment management outperforming passive). This provides added incentive to build best-in-class investment teams to take advantage of alpha generation opportunities via security selection and portfolio construction. Lastly, heightened volatility will elevate the importance of currency hedging approaches to improve portfolio risk/return trade-offs.

CHART 9

Equities have experienced low dispersion since the GFC

Proportion of S&P 500 Members' Variance in Returns Explained by 1st Principal Component (%, Rolling 10yr Window)



Source: Bloomberg, IMCO Calculations

IMPLICATION 3: Capital investment boom

After more than 20 years of under-investment across industries, the coming decade appears poised for an investment boom.

A key potential driver is the pursuit of government priorities (e.g., decarbonization, green infrastructure, securing of strategic supplies, etc.), with further impetus provided by the private sector's efforts to shorten supply chains, on-shore production facilities and revamp their aging capital stock.

The push across developed countries to on-shore manufacturing processes will likely be a key driver of this anticipated investment wave. Shifting production activities in this way requires significant capital expenditure as it involves the creation of an entire manufacturing base that is more self-sufficient across the value chain. Already, the US government has pledged $280 billion to boost the domestic chip-making industry and scientific research. The bipartisan nature of the related bill highlights the fact that the desire to bolster domestic manufacturing capabilities is strong across the political spectrum.

Climate change is also likely to spur further capital investment in support of the transition to lower emissions **(Chart 10)**. The International Energy Agency projects that global clean energy investment will reach $1.4 trillion in 2022, accounting for almost three quarters of the growth in overall energy investment. Still, these numbers are below what is necessary for countries to hit their climate targets and are expected to grow significantly in the coming decade. Energy security concerns, stoked recently by the Russian invasion of Ukraine, will accelerate the urgency with which domestic energy sources are developed.

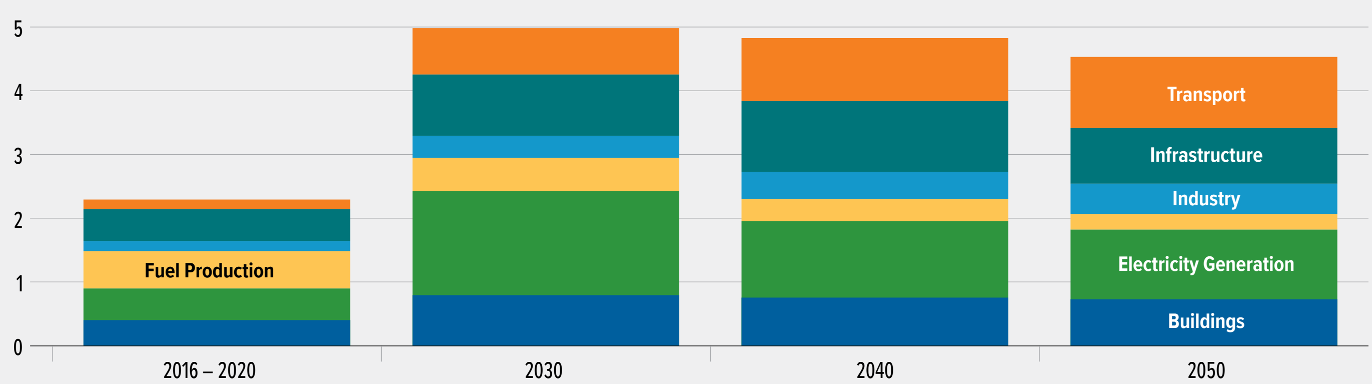
Governments are not the only ones likely to drive capital expenditures. Due in part to both the strong nominal growth environment and ongoing labour shortages, companies are expected to continue expanding productive capacity. Even with its cyclical ups and downs, housing also looks primed for sustained investment activity, given the significant underinvestment seen in the sector following the GFC (especially in the US and Canada). Millennials entering prime home-buying age will require large amounts of additional housing to be built and will act as another driver of capital expenditure.

The significant capital investments – public as well as private – required in support of these new objectives should lead to an expanded opportunity set within capital expenditure- and infrastructure-related investments. Assets that facilitate the energy transition, rather than assets that are already low carbon (a potentially "crowded trade") is an area of opportunity. As a result, investors with the required skills and resources could benefit from continuing to build their ability to deploy capital directly and through external funds that have demonstrated expertise in funding transition investments.

CHART 10

Net zero transition will require significant capital expenditure

Average Annual Capital Expenditure by Sector Under Net Zero Scenario ($Tln)



Source: International Energy Agency

IMPLICATION 4: Growing role for/complexity of private investments

As noted previously, there are numerous benefits to owning private assets for long-term investors, including the potential to better finance promising business strategies – such as those that involve significant changes to capital structures, operations, or strategic approaches – in private markets than in public ones. This is due in part to public markets' relatively higher awareness of short-term results and reporting requirements, in contrast to private markets' relative flexibility and focus on longer-term value creation. Additional benefits can accrue to private market investors that have the ability to wait for such value-creation strategies to be implemented and bear fruit – potentially generating superior risk-adjusted returns in the process.

These dynamics suggest that investors who have the required resources and patience could be well advised to continue increasing their exposure to private investments, in line with the growing private markets investable universe. This is especially the case for larger institutions, given that size matters when it comes to investing generally, and even more so when it comes to private markets specifically. Large organizations committed to private investments enjoy economies of scale and related cost advantages, better access to potential deals and origination opportunities, and the ability to build dedicated operational expertise in a wider array of value-enhancement strategies, all of which improve the potential for superior returns. Mere access is not enough, as the standard fees charged by large private asset managers can more than offset many of the advantages of investing in private assets.

Given these dynamics, large institutional investors can benefit from partnering with best-in-class large private asset managers and using their size to negotiate preferable fees. Those with appropriate resources would also potentially benefit from leveraging and expanding their internal operational expertise to better invest alongside these partners across various industries/sectors. Done properly, this approach could generate favourable risk-adjusted returns for patient investors with long time horizons.

Finally, in a higher and more volatile interest rate environment, there appear to be greater chances of success for private investing opportunities that rely more heavily on fundamental value-creation levers than those that emphasize financial leverage as a driver of investment returns.

> “Size matters when it comes to investing generally, and even more so when it comes to private markets specifically.”

IMPLICATION 5: Growing scope for unintended exposures

Index investing's growing popularity among retail and institutional investors masks the growing risks associated with these passive exposures.

Most indices are constructed mechanically using metrics such as market capitalization, with little-to-no weight given to other criteria that might – and increasingly do – matter to individual investors' goals and values. These could relate to ESG considerations and undesirable country-specific exposures. Recent examples include high greenhouse gas emitting industries, Russian exposures following its invasion of Ukraine, and China-related risks stemming from its regulatory crackdowns on specific sectors and its rising tensions with the US and Canada.

Market capitalization-weighted indices also present potential concentration risks, wherein a small number of individual names can influence overall performance in an outsized manner. For example, the relatively large gains by US tech stocks in the past decade have led to a very heavy representation in market cap-weighted indices, to the point where the five largest members of the S&P 500 represent almost 25% of the index, around double their weight from just five years ago.

> It is prudent to continue to build the ability to provide index-based exposures in ways that align with investors' ESG beliefs and limit the potential for undue concentration risk.

Despite the above shortcomings and risks, there is still a role for the benefits provided by broad-based liquid exposure in investor portfolios. With that in mind, it is prudent to continue to build the ability to provide index-based exposures in ways that align with investors' ESG beliefs and limit the potential for undue concentration risk, via custom indices for example. Here at IMCO, we also work to ensure that all our external managers comply with our ESG policy for such managers.

IMPLICATION 6: The need for innovation and flexibility

We believe that technological, political, and societal changes are as dramatic now as they have been at anytime in recent memory.

We also believe that innovation and flexibility are key ingredients to effective investing. This includes investing in asset classes with a broad remit to manage risks and take advantage of opportunities in this fast-changing world, including having the flexibility to invest in public versions of private assets.

Given the scale of social and economic change underway, the ability to identify and integrate key insights into the investment process has never been more important. At such times of tumult, the past's ability to inform views about the future is diminished. This, in turn, enhances the potential returns from observation and analysis of the current environment relative to the simple extrapolation of history.

Diverging prospects in China and Europe provide a timely example, with China's extremely high economic growth of the past couple of decades masking the many forthcoming hurdles investors are likely to face in that market, including greater exposure to deglobalization, rising trade tensions with the US, domestic regulatory risks, and ESG issues. Meanwhile, Europe's relatively low growth belies the region's improving investment environment, particularly its scope for a more stable and supportive institutional structure (e.g., greater fiscal union, presence of a monetary backstop) and its pursuit of potentially investment-friendly economic goals (e.g., energy transition, infrastructure improvements, etc.).

These idiosyncratic country drivers highlight the need to look beyond broad, relative economic growth rates – both past and prospective – when evaluating potential investments. History suggests countries' GDP growth rates and domestic equity market performance exhibit only a very loose relationship over the past couple of decades **(Chart 11)**. Clearly, other factors also matter and point to the need for a thorough assessment of potential returns, risks, diversification benefits and investors' own abilities to outperform. For these reasons, a research-driven investment process that allows investors to monitor and respond to the changing world around them is imperative.

And finally, because such change is not only likely but inevitable, it is necessary to review economic, market, and asset return assumptions and adjust related asset mix advice regularly, while remaining humble and flexible.

CHART 11

There is no clear relationship between GDP growth and equity market returns

20yr Annualized Growth (2001-2021) in USD

Source: Bloomberg, IMCO Calculations

CONCLUSION

Many of the “certainties” investors have taken for granted over the past several decades appear to be fading. On the economic front, globalization, low and stable inflation, and the related one-way ride down in interest rates have been turned on their heads. Societal priorities also appear to be shifting, with domestic concerns around inequality, security of strategic supplies, and climate change rising on the political agenda, thus supporting the use of a more “visible hand” on the policy front. Taken together, these potential structural shifts reduce the benefit of hindsight to shape forward-looking views.

For investors, effectively navigating these changes requires an elevated level of thought leadership and a willingness to adopt dynamic and innovative approaches to asset management. IMCO will regularly review and if necessary – revise – its views on these shifting trends and their related investment implications over time. We believe that this flexible research-driven investment process, coupled with IMCO’s ability to recognize and respond to the needs of its clients, strengthens our ability to build resilient portfolios in a changing world.