Looking into 2020 with Hermes

CORPORATE

2020 will be another uncertain year. Brexit will rumble on, bringing further volatility and polarising the UK political dialogue; China and US relations will remain tense and concern markets, despite a possible partial trade deal being secured before the end of 2019; and the US presidential race will be drawn out and likely unsettling for world markets.

However, when history reflects on 2020, it could well be marked by a more significant event. 2020 will see the UK play host to COP26 – the innocuous sounding, but critical United Nations climate change summit.

The conference intends to produce a coherent and coordinated international response to the climate emergency. It will be the biggest summit the UK has ever hosted with up to 200 world leaders expected to attend, along with 30,000 delegates.

A previous incarnation of this annual conference – COP21 – produced the Paris Agreement of 2015. Next year's iteration is set to raise the bar once again. Countries are due to submit updated climate plans to bridge the gap between varying national pledges and the overall goal of the Paris Agreement to hold global warming well below 2°C.

We all truly hope to see significant progress and outcomes from the summit. Nonetheless, I predict progress from COP26 will not just be driven by the leaders of nations, particularly in light of the US pulling out of the Paris Agreement, but will be partially driven by civil society and business.

Against a backdrop of rising societal scrutiny, we will see business, finance and other stakeholders having to, for pure business reasons let alone any other considerations, take their seat at the table. COP26 will inject new momentum behind initiatives, commitments and promises on climate change and a broader range of stakeholders will have a key role to play.

As an investor with a long history of meaningful engagement with companies in which we invest on these issues, this could prove a watershed moment.

In 2019 we have witnessed a profound shift in awareness of, and engagement in, the climate crisis. This has been reflected in public policy such as the revision of the UK Stewardship Code for professional investors and the amendment to the European Union's (EU's) Shareholder Rights Directive, compelling a longer-term view and consideration of a broader set of risks, such as climate change, in the context of investments and asset allocations.

Consequently, global investors will continue to come under enhanced scrutiny. We must act together as the potent force for change that the industry has the potential to be.

We have long advocated that sustainable practices result in sustainable and successful performance, in turn facilitating the creation of sustainable wealth. For anyone with a pension that must be the goal.

2020 will be the year that holds a mirror up to us all. We will be asked ever more challenging and fundamental questions about our purpose and what we want for our world. But as Abraham Lincoln declared in the midst of the Civil War: "The occasion is piled high with difficulty and we must rise with the occasion. As our case is new, we must think anew and act anew."

If, as I predict, the 'COP26 effect' succeeds in changing behaviour and practices across institutions, we will be infinitely better for it.

Saker Nusseibeh
Chief Executive

Two risks will dominate the investment landscape in 2020, one political and one environmental.

The political risk has two forms, both connected to trade. Every 80-100 years the British political system tears itself apart over the issue of tariffs – the Corn Laws imposed restrictions on imported food and grain between 1815 and 1846, Winston Churchill switched from the Conservative Party to join the Liberals in protest at the policy of protectionist tariffs preferentially favouring trade with the Empire in 1904, and in the coming year once again there will be fallout from the Brexit situation finally being resolved that has affects that reach far beyond the boundaries of Westminster.

The second aspect that will occupy our attention is the US presidential election towards the end of the year. In the lead up, the current trade tensions between China and the US will finally reveal themselves as a full-blown tech war, with the world lurching towards a splintered digital future. The heightened uncertainty that these risks bring will result in both investment opportunities and perils.

Finally, climate change, both in absolute terms and with respect to transition risk, will still be a great concern for investors. Greta Thunberg laid down the challenge at the UN in September, and now asset owners and investment managers have an imperative to reject our old neoclassical ways of thinking and to wholeheartedly embrace regenerative economics, recognising that we face a stark choice between acting now or accepting the unfathomable consequences of delay.

Eoin Murray
Head of Investment

Climate change will be the resounding theme for 2020 as regulators around the globe take an ever-closer interest in how asset managers, banks and insurers are assessing and responding to climate change risks and opportunities. The UK will lead the way on this, with the Prudential Regulation Authority and Financial Conduct Authority raising expectations on how firms implement and disclose the Task Force on Climate-related Financial Disclosures framework. None of this will be new for banks and regulators, for whom supervisory expectations in relation to climate change have already been strengthened in 2019, but for many asset managers there will be significant work ahead.

Where the UK goes, under the leadership of Bank of England Governor Mark Carney, others will follow – and so we can expect other jurisdictions to pick up the baton through similar moves. Germany and Australia are top contenders for fast follower status.

We also expect there to be a continued hotting up of the environmental, social and governance (ESG) debate in the US. Despite the June 2019 'Scarlett letters' speech by SEC Commissioner Hester Peirce, which decried ESG scores as an oversimplification of a set of complex facts (which, we would agree with), US regulator sentiment may well be at odds with changing US asset owner sentiment. This should drive debate – if not immediate policy action – in the US around whether in fact the riskier option is to ignore climate and wider ESG risks in strategic asset allocation and investment decisions.

Ingrid Holmes
Head of Policy and Advocacy

The 2019 PRI in Person conference was the biggest ever with 1,800 attendees from 54 countries. Once the domain of the select few, almost the entire investment industry is now paying stewardship and responsible investment significant attention and commanding substantial resources despite pressure on margins. There are some who are doing it due to deeply-held beliefs, others who are simply paying lip service to gain a share in a growing segment of the market and those who want to ensure compliance with the demands of policymakers. In 2020, we undoubtedly expect to see continued momentum. We believe that the quality and effectiveness of stewardship and ESG integration will improve and that asset owners will increasingly discern between best practice approaches and so-called greenwashing. We expect improvement however to only be gradual as it takes time and effort to make meaningful change to an investment firm's processes and its people's mindsets and behaviours – both necessary if responsible investment practice is to be credible. Increasingly, stewardship will become a core investment activity, reflected in the purpose and values of firms.

Climate change and technology disruption to business models in different sectors will continue in 2020. To be sustainable, businesses will have to consider how such disruption might impact the way they serve customers, employ staff and the impact they have on society. Neglecting their wider stakeholders will be detrimental to long term sustainable value. In 2020, we expect there to be continued pressure on the tech industry's approaches and underlying values relating to data privacy and artificial intelligence (AI). The extractives, utilities and automotive sectors will remain under climate change pressure and we are likely to see airlines and airports come under more scrutiny in 2020. We should also see more banks and investment houses reducing primary capital flows to carbon-intensive projects and a proliferation of thematic funds. Food and other consumer goods manufacturers will need to pay more attention to the usefulness (e.g. nutrition), utilisation and recyclability of their products and packaging as well as how they can optimise the level and effectiveness of their distribution networks. Across all sectors and globally, we should expect to see radical changes in HR processes as companies seek to address diversity gaps.

Leon Kamhi
Head of Responsibility

The global economy has slowed down sharply over the last few years, from a growth rate of almost 4% in 2017 to about 3% in 2019. Looking ahead, the outlook is uncertain, with the trajectory set to be shaped by the evolution of monetary, trade and fiscal policies.

The geographical divergence (that is, the outperformance of the US compared to the rest of the world) that prevailed in 2018 has morphed into a sectorial divergence over the course of 2019. The dichotomy between businesses – held back by policy uncertainty, notably concerning trade – and consumers – buoyed by a solid labour market – is unlikely to be sustainable. The labour market will be key, as it could act as a transmission channel for stress from businesses to consumers.

The policy mix will be crucial. Central banks have eased monetary policy in a coordinated fashion in 2019 (according to the Bank for International Settlements, there have been 38 cumulative rate cuts globally during the first nine months of the year), but doubts about the effectiveness of monetary policy have built up. For a start, it takes about 18 months for monetary easing to be fully transmitted to the real economy. More fundamentally, monetary policy tools are constrained and possibly ineffective in the current circumstances of high policy uncertainty and structural issues. It is unlikely that monetary policy has enough room to offset the impact of an outright trade war, should it happen, without significant fiscal easing.

A more active role for fiscal policy looks appropriate. However, anticipation in financial markets might be overblown. Fiscal stimulus is on its way (and populism is pushing in that direction), but a fiscal bazooka is unlikely to be imminent given the political configuration. The US presidential election later in the year might provide more clarity.

Silvia Dall'Angelo
Senior Economist

STEWARDSHIP

The climate crisis is likely to remain top of the investor agenda in 2020. As a participant in Climate Action 100+, we will continue to encourage some of the world's biggest polluters to reduce emissions to help meet the goals of the Paris Agreement. We will also ask companies outside the scope of this initiative to consider climate-related risks and disclose these to investors.

Another key environmental theme for 2020 is the battle to reduce plastic packaging waste: we will be challenging companies to think about how they can adopt circular economy solutions, as well as shifting away from single-use plastic altogether over the longer term. Our engagements will also expand to cover issues such as biodiversity impacts and food waste, as sustainable proteins move up the agenda.

On governance, we have once again toughened our voting guidelines on diversity in several key markets. In the UK, gender pay gap reporting revealed little progress year-on-year, suggesting a step-change is needed at every level.

Another area of concern is around the use of AI and the potentially negative impacts on society and the individual. We will be intensifying our engagement on these issues in 2020 by focusing on AI applications in sectors outside of technology, such as financial services and healthcare.

Engaging on the UN's Sustainable Development Goals (SDGs) to encourage companies to contribute to solving problems such as inequality, poor health, climate change and poverty will continue into next year. The SDGs provide us with an opportunity to engage robustly along the value chain from supply to distribution.

It is our strong belief that companies can only create and preserve long term value if they profitably provide goods and services that meet societal needs. As the magnitude and materiality of sustainability issues threatening long-term value creation continues to rise, so will our expectations of companies. Therefore, we will increasingly benchmark performance and expect companies to set ambitious targets to achieve positive outcomes in line with long term societal expectations.

Dr Hans-Christoph Hirt
Head of Hermes EOS

EQUITIES

Slowing global economies coupled with heightened geopolitical risks have led to a deteriorating economic outlook. Globally, central banks are in an easing cycle and bond yields are likely to remain lower for longer. Global Purchasing Managers' Index (PMI) data is already pointing to a manufacturing recession in many countries. We expect the services sector to follow suit, US employment levels to start to fall, and that monetary responses will be insufficient to spark a global rebound.

Recognition of a global synchronised downturn could weigh heavily on cyclical stocks, pushing them towards historically low valuations. Quality names should perform relatively better. This downbeat economic scenario could create opportunity in the cyclical part of the market, as we anticipate a consensus would form around the need for a fiscal spending boost, starting in Europe, spreading to the US and from there to emerging markets over the next 18 months. Until this scenario becomes evident, however, the portfolio will remain tilted towards quality. In any case the fund already maintains some exposure to quality cyclicals that will benefit when the global economy turns up.

Today, few emerging-market countries exhibit the kind of macro vulnerabilities evident in 2013, and most offer positive interest rates after adjusting for inflation. The combination of a valuation discount, slowing global growth and the resulting lower yields should be particularly beneficial for asset prices in economies that can grow despite global headwinds such as trade wars.

Our bottom-up growth estimates for the portfolio indicate good medium to long term prospects, as it is well represented in secular areas of growth, such as the rollout of 5G, digitisation, logistics, premiumisation, and demand for healthcare and financial services.

Gary Greenberg
Head of Global Emerging Markets

Since the financial crisis in 2008, growth has consistently outperformed value. This outperformance has accelerated since 2017, to the extent that growth is now more expensive than at any time since the tech bubble at the turn of the century, even allowing for September's value rally. Global economic indicators have started to worsen, exacerbated by US-China trade tensions, Brexit uncertainty, Middle East tensions, protests in Hong Kong and numerous other geopolitical risks and flashpoints. This backdrop has polarised investor sentiment and prompted sharp swings in risk appetite, which may be a signal that the drivers of the current bull market are becoming less sustainable. A market inflection is likely to normalise the relative valuation between growth and value.

However, as growth rates decline, the likelihood of lower interest rates increases, with some equity investors welcoming weak economic news in the hope that this will prompt central banks to cut rates further, propelling markets – and growth – even higher. As such, predicting when the growth rally is likely to end is extremely difficult. For the moment, the worsening economic backdrop and the lower-for-longer rate environment is holding sway. However, we remain cognisant of the valuation of the companies in which we invest, believing that while markets are currently ambivalent towards the price of growth, this phenomenon cannot continue indefinitely.

Geir Lode
Head of Global Equities

Engaging with companies at the smaller end of the market cap range on SDG-related initiatives is exceeding expectations; boards are having to consider to a much greater extent than they have done in the past (if they were at all) what they are doing about sustainability and we have the opportunity to be closely involved in that process and to contribute to it. We are speaking to more people at companies than we ever have before.

It also turns out that we are gaining additional investment insight from our engagement activity, in effect getting a better understanding of the quality of a business by looking at it from either a different perspective or looking into some aspects of the business in greater detail.

In the small-cap market, smaller companies have given up some relative performance this year as the world economy has slowed and the market has become more risk averse. However, looking at long-term trends (25 years) in the market, small caps are below their trend whereas developed large caps, as represented by either the S&P500 or the MSCI World, are respectively at or just below one standard deviation above theirs. Combined with their greater propensity for growth, which will likely be valued more highly in an overall low growth environment, this puts small caps in a favourable position.

Whilst small caps are inevitably more risky than large caps (although this might be less the case in this cycle given the bond-proxy nature of many large caps), what is less well appreciated is that this is less of a concern for truly long term investors; the incidence of loss in ten-year rolling returns in small caps is less than 1%, but this cannot be said of large caps. In other words, investors get compensated for taking additional risk. Given the diversification benefit that small caps also bring to a portfolio, it's not hard to see how they have punched above their weight in terms of contribution to investor returns over time.

Hamish Galpin
Head of Smaller Companies

Yields have tumbled this year against a weak fundamental backdrop which has polarised the value/growth factors in the market. This was apparent in early September, although only partially. Growth-stock valuations are at premiums not seen in the past decade, but in the late 1990s and early 1970s (the Nifty Fifty era) valuations were even more extreme. That said, the potential for a value rally is still there. For many value stocks, year-on-year earnings growth should start to improve as we move into 2020. But in light of some mixed manufacturing (and even services) data, it may well take more than just easier year-on-year comparisons for there to be a meaningful and sustained shift from growth to value. This would require a clear catalyst in the form of a settled US-China trade dispute, a coordinated increase in fiscal spending, a shift in the yield curve or agreement on the interminable Brexit question. None of these seem likely at present, but that could change quickly and given how bearish sentiment is any rotation could be significant. As we move into 2020, the market may find itself more led by the fundamental growth of companies and their valuations rather than yield led. There will certainly be risk in the markets and we may find a number of more cyclical companies masquerading as growth stocks as the earnings season progresses. Investment decisions have largely been about making a binary call on movements in bond yields, which may continue should economies continue to weaken. However, fiscal action from policy makers seems plausible which would put a floor under yields for now and lead to a more discriminating fundamentally led market. Our decisions are not driven by style characteristics, but we are aware of the valuation dichotomy. Whether we see a sustained style rotation or not, the portfolio is well balanced. Over the long term, bottom-up fundamentals should win.

James Rutherford
Head of European Equities

Within Asia ex Japan, after years of relative underperformance, compelling opportunities have emerged in two key parts of the market – 'value' and lower market cap stocks.

A low interest rate environment (that encourages investors to pay up for the distant positive cash flows projected for quality growth stocks, now hardly discounted at all) has also resulted in an extended down cycle in many cyclical value stocks (as the low interest rate environment slows the exit of excess capacity, even poorly run companies linger for longer, exacerbated by continued Chinese state-sponsored investment in unneeded capacity), with investors refusing to see through the down cycle. This has resulted in a recently-exacerbated extreme disparity between the valuations of 'value' and 'growth' companies, that we don't believe is justified despite the current environment.

Lower market cap stocks have been hard hit by a switch from 'active' to 'passive' by many investors. A renewed focus on liquidity by fund manager risk departments – specifically on the mismatch between daily liquidity offered and the time it takes to sell stocks - has resulted in many active managers (suffering redemptions) selling even favoured lower liquidity stocks first to prevent such stocks from comprising a larger part of a shrinking portfolio.

At the intersection of value and small cap we are seeing some companies that trade at substantial discounts to not only intrinsic value, but in some cases to the net cash held on balance sheets for even strongly and consistently profitable companies paying high dividends.

Perhaps 2020 will be the year that, irrespective of the prevailing interest rate environment, value and lower market cap stocks outperform as managers recognise the compelling opportunity available and bid them up.

Jonathan Pines
Head of Asia Ex-Japan

The continued resilience of the US economy surprised many in 2019 and translated into solid market returns. Consumer spending continues to be underpinned by a healthy balance sheet, an unemployment rate at 50-year lows and a consequent increase in wages and spending. The US consumer accounts for 60%-70% of the US economy.

Looking into 2020, we expect the US economic expansion to continue, although growth is likely to be tempered somewhat by global economic headwinds. The manufacturing sector is particularly exposed to uncertainty surrounding trade negotiations with China (and Europe). However, acknowledging this uncertainty, the Federal Reserve appears benign and has embarked on a policy of rate cutting. The consumer remains robust, in our opinion.

The political backdrop in the US remains unpredictable, but it is worth remembering that 2020 is an election year and President Trump will be hopeful of re-election. It seems clear that he has set the economy as the central tenet of his re-election case. To the extent he is able, one must assume he will do all in his power to ensure the economy is firing on all cylinders as we head into the autumn election process. An imminent, deep recession appears to us to be a low probability event.

With regards to the market, current positioning reflects this confusing backdrop, with investors herding into parts of the market which appear 'safe' (quality growth) and eschewing more cyclical stocks. In some cases, it appears that such stocks are pricing in the end of the cycle and/or a permanent impairment to their intrinsic value. While we continue to balance exposures within the portfolio, such cases offer a potentially attractive opportunity to acquire attractive franchises at rare discounts. Interestingly, longer-term private capital is acquiring public assets and the portfolio has seen an uptick in M&A activity. More broadly, top line revenues, operating profits and earnings per share (EPS) are all forecast to grow over the coming 12 months and any postponement to tariffs or a trade resolution could act as a further positive catalyst. And so we head into 2020 sticking to our guiding mantra: 'proceed, but with caution'.

Mark Sherlock
Head of US Equities

FIXED INCOME

And so the train rolls on. 2019 was an outstanding year for Fixed Income as an asset class with significant potential for alpha and a number of important themes that weigh heavily on the outlook for 2020. The first is, of course, the huge growth in negative-yielding assets across the globe and the planet eater effect that this has on spreads in other parts of fixed income markets. With over $17tn of negative-yielding assets and the lowest BBB to BB spread differential in history one might be forgiven for thinking there is nothing left to invest in. The second major theme was the huge change in appetite for rate risk and the knock-on effect this had on low duration products such as leveraged loans. Third of the major themes we should highlight is the healthy differentiation across quality with CCC-rated credit in particular having by far the worst year within fixed income. The final theme is the continued growth of private markets.

So where does this leave us as we look into 2020? Far from thinking there is nothing left to gain from Fixed Income we actually see 2020 as rich in opportunities; years in which there are super normal (more than one standard deviation above mean) returns in our asset class are almost always followed by meaningfully positive years and we expect 2020 to be similar. Flexibility and caution are the two watchwords we believe are most relevant as we perceive risk within both the super tight end of the credit spectrum and within private markets (see our commentary "Illiquidity: understanding the premium in fixed-income markets"). Having disliked most aspects of syndicated leveraged loans through 2019 we are starting to see some value there, increased investor discipline and discrimination are helpful. There are few reasons to believe 2020 will either be low volatility (in light of macro risks) or free from defaults, but if we are mindful of these, we feel confident that a good year lies ahead. In traditional Fixed Income style, we also hold out a little hope that the correction that is probably long overdue will begin to arrive in 2020.

Andrew Jackson
Head of Fixed Income

The global macroeconomic picture continues to suggest that we will go into 2020 in slowdown mode that only falls short of a broad recession, thanks to supportive monetary policy which is both necessitated and facilitated by inflation expectations that remain firmly anchored, particularly in Europe.

Earnings growth remains predictably lacklustre, while corporate credit metrics are slowly deteriorating. Financials' profitability is under pressure in a low interest rate environment while capital buffers built since the crisis are strong. For some, even this is too much to bear and we will see default rates rise in 2020, combined with worryingly low recovery rates – a hangover from years of covenant light issuance coming back to bite.

This uncertain backdrop will have implications on capital allocation toward more defensive, creditor-friendly activity, with only the very top tier names deemed able to return cash to shareholders.

Sentiment is mixed, with evidence of discipline when it comes to primary market access being contradicted by extremely low levels of volatility both within equity and fixed income. Whilst this may suggest some unwelcome complacency, the technical backdrop remains strong across credit markets. A large amount of negative-yielding assets is encouraging strong inflows into spread products, with leveraged loans the only notable laggard.

While spreads look only moderately tight, the convexity profile of the return-seeking segments of credit remain challenging, particularly in the European high-yield market where many bonds are now trading above their next call price leaving them particularly susceptible to interest rate and/or spread widening. In such an environment, boosting yields needs to be done in a considered way. We see merit in taking subordination risk further down the capital structure amongst industry leaders.

In a world of uncertainty, we see significant value in being nimble. Overall our view remains negative, and we would look to benefit from dynamism to capitalise on the inevitable pullback that we are set to have to add opportunistically in a dislocated environment.

Fraser Lundie
CFA, Head of Credit

Some antiquated thinking shows "green" is the new black. However, indications from all corners of the debt capital markets and an evolution in corporate culture show that sustainable fixed income is no fad, but rather it is here to stay. The AUM of global bond funds with an ESG tilt has grown by 19% per annum since 2015 (FN: Broadridge). Meanwhile, the growth of the ICE BofAML Green Bond Index over the last five years has been torrid: from $55bn in 2015 to $345bn at 31 October 2019. During 2019 we have also seen issuance of 'blue' bonds; 'social' bonds; 'transition' bonds, and finally, the world's first SDG-linked bonds with coupon step-ups. Also in 2019, the principal rating agencies each launched renewed efforts to augment both the implementation and reporting of the integration of ESG factors in credit ratings.

And what of corporate culture? In August, the US Business Roundtable released a new statement on the purpose of a corporation, which declared that the 181 CEO-members "commit to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities and shareholders." In September, 130 signatory banks launched the Principles of Responsible Banking in order to "help the industry to demonstrate how it makes a positive contribution to society." All whilst company after company is pledging to reduce their carbon footprint and/or use of plastics.

And while all of this points to even more to come in 2020, the critical factor that ensures there is no going back on progress made in sustainable fixed income, is that regulators and leaders around the world support this evolution. Progress we've seen to date includes the revision of the UK Stewardship Code comprising specific language around fixed income and China's latest Five-Year Plan outlining incentives for green bond issuance and ESG disclosures by companies.

Mitch Reznick
CFA, Head of Credit Research and Sustainable Fixed Income

In 2019 we saw a drop off in transaction volumes in real estate, which also impacted the market for real estate loans. Continued Brexit uncertainty certainly played a role here. We have more recently seen somewhat of a reversal in this trend, though not much of a correction in asset prices. Many lenders are focussing their efforts in the core and prime parts of the market, thereby lowering lending margins in that space. As the cycle is getting rather long in the tooth, leverage (on a per square foot basis) is high and we would normally expect to generate increased margins to reflect that risk. As some tenants are struggling to maintain growth (not just in the retail sector), we will see downward pressures on both rents and values. Depending on political events, this has the potential to come to fruition soon in 2020, though the elections may deliver a government intent on fiscal stimulus which may see off a correction for a little while longer. Decades of upward only rent reviews, high business rates, a lower pound and changing consumer behaviours have dealt the retail sector a blow that we do not expect it to recover from by the end of 2020.

Mitigating climate change finally has the momentum behind it that it needs, and we expect this to feed through in valuations from next year. Efficient buildings will be in a much better position to maintain valuations and rental levels than less efficient and older properties. Increased focus on efficient operations of commercial real estate and engagement with landlords and tenants alike to reduce overall energy demand will deliver progress on the climate change transition. This is the start of a process that is likely to take the better part of two decades to complete; the goal being for the industry to achieve net zero carbon status.

Vincent Nobel
Head of Asset Based Lending

MULTI ASSET

In 2020, we will see how effective central banks are at reinvigorating a fast aging cycle amidst an increasingly volatile and fractured geopolitical environment. The US presidential election is also likely to be packed with market-moving twists and drama. While current valuations and market indicators may signal an irrational dichotomy across asset classes, investors appear to have been extremely rational when swiftly integrating the "Fed put" the moment its existence was confirmed. Next year is likely to see a resolution of the contradiction between stocks and bonds. Should the global economy fail to react to the additional round of central banks policies, it is possible that the uber rationality of investors seen in 2019 will be tested.

In our view, 2017 marked the end of the broad-based and liquidity-induced asset reflation environment. Since 2018, we have entered a phase characterised by choppier and diverging market trends both across and within asset classes. This in turn has benefited active tactical allocation over passive alternatives. Mean-reversion strategies have also benefitted from a largely range bound market. We expect this setup to persist.

As bond yields have plummeted, we are less confident that government bonds can deliver as a hedge in a recessionary environment. Cross-asset momentum and long volatility strategies are tools that can supplement our bond exposure in delivering such profile.

Meanwhile, in an environment where inflation is low and expected to remain low indefinitely, we find comfort in accumulating inflation hedges. While we cannot confidently point to an imminent catalyst that would cause inflation to overshoot, we can be confident that the market at large would be caught unprepared if it did. Highly asymmetric pay-offs like this are worth the trouble.

Tommaso Mancuso
Head of Multi-Asset

PRIVATE MARKETS

We continue to remain cautious about the level of real estate pricing in absolute terms given the continued profound structural changes affecting the fundamentals of occupational demand. For many investors, of course, the positive yield gap between real estate and bonds continues to support the investment case for relative value which has arguably created a real assets bubble.

However, we are already witnessing outward yield movement across the retail sector as the underlying occupiers continue to face fixed overheads with no real wage inflation to support sales growth and further leakage of sales on-line; technology, urbanisation, demographic lifestyle trends and an increasing awareness of climate and environmental risks are all affecting how occupiers behave across all sectors of the real estate market. A conviction to understand the dynamics of occupational demand remains pivotal to the Hermes approach to deliver sustainable value with the principles of ESG firmly embedded within our investment processes. In this way, we believe we are able to measure and manage risk appropriately.

As highly active, responsible real estate managers with a long term approach to investing we see further opportunities to deliver holistic returns by creating great places, accessible and community engaged estates which are relevant to a diversified range of occupiers and which can attract and retain talent, thereby creating optionality to deploy capital over time commensurate with occupational demand.

Increasingly next year we expect to see further capital declines across the retail sector in particular as much of the existing space is no longer relevant, those managers which address the fundamental drivers of income and have integrated ESG within their analysis should outperform.

Chris Taylor
Head of Private Markets

With fundraising for direct lending strategies at an all-time high, and increased pressures for fund managers to deploy, competition for the best loans will remain acute in 2020.

Competition will not be centred on pricing but primarily on loan structures and lender protection rights. Unitranche lenders with return targets above current market yields will continue to seek to make themselves attractive to borrowers by increasing leverage on offer or relaxing covenant protection for example.

The smaller SME lending segment will continue to provide pockets of value as the banks are the lenders who control this segment. With the banks unwilling to compromise on loan protection rights and with yields remaining generous, this segment will continue to offer investors value.

In Europe, Scandinavia remains, in my opinion, the market that offers investors the best value. Lenders in this market benefit from a creditor-friendly legal environment coupled with attractive deal flow and a benign economic environment. Germany will continue to be competitive but there will be value in loans to smaller Mittelstand companies. With ongoing uncertainty over Brexit, the UK market will continue to be less competitive. UK businesses in industries with significant exposure to consumer spending will be shunned and lenders will concentrate on stable businesses. This should see the sterling premium continue to rise. France will continue to offer little value due to weak legal environment and government initiatives which distort yields.

Patrick Marshall
Head of Private Debt

HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | New York | Singapore | Denmark

For more information, visit **www.hermes-investment.com** or connect with us on social media:

PR000794 Global 0007661 11/19