2021 Outlook

Looking into 2021 with Federated Hermes

Federated Hermes International

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Corporate

Saker Nusseibeh, CBE
CEO

In my outlook for 2020, I argued that COP26, the UN climate change summit, would inject new momentum behind "initiatives, commitments and promises on climate change" from across business, finance and other stakeholders.

In the end, COP 26 didn't happen. But a brutal global pandemic did, jolting millions into sharp recognition of our fallibility. It exposed humanity's vulnerability and crystallised, for many, the catastrophic risks our planet faces.

However, in lockdown, cities started to see clear skies and their inhabitants experienced clean air for the first time. Governments started to talk about building back better and making new green commitments, while a glut of major brands and significant polluters set out their commitment to becoming net zero.

The events I expected came about, but not for the reasons I, or anyone else, could have anticipated.

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In a paradoxical way, after the year we have had, I feel more optimistic than I have for a long time. I say this from the standpoint of a long-term investor who has long advocated responsible investing being the only way to sustainable wealth creation.

In 2021, we will not only have the postponed COP26 but also COP15 of the Convention of Biological Diversity, a vital convening of nations on this most critical of global issues. We will also have in the White House a President who has already re-committed to the Paris Agreement on Climate Change.

These events will stimulate more ambitious plans for decarbonising economies alongside heightened societal scrutiny following a pandemic that opened many more eyes.

I am confident that as Covid restrictions lift, we will see a galvanisation of economic activity that will make good on the build back better promises. With continuing low interest rates, the opportunity is there for transformational business opportunities. As my colleague, Geir Lode, highlights, innovative and disruptive businesses bring rapid growth regardless of the economic environment.

2021 will also be a year where we see further convergence between regulators and other bodies determined to improve data quality and coverage across a wider range of ESG metrics. This is so important, as we seek better reporting standards and face up to the prevalence of greenwashing.

2020 was a year of extraordinary societal upheaval and its repercussions will be felt long into the future. However, if there are positives to be taken from it then it must be the awakening we have witnessed and the possibilities that raises.

The world responded to the events of this year, in large part, by saying lives matter. We should celebrate that.

2021 will require us to do the same but with a much broader array of challenges.

Macro view

Eoin Murray
Head of Investment

This may be the most optimistic outlook that I have yet written, and coming off the back of a global pandemic it will require some careful explaining.

With US President-elect Biden having promised to re-join the Paris climate agreement on his first day in office, shift in US policy will be a significant boost to global climate policy efforts and will set up 2021 for further progress. Biden is also proposing a US net-zero carbon emissions target for 2050, leaving India and Brazil among the 10 largest global economies still to set such a target. This turnaround sets the stage for an accelerated global effort to combat climate change at a time when record-breaking heat, wildfires and hurricanes are battering our planet. As a result, the chances of meaningful outcomes from the rearranged COP26 in Glasgow next year have significantly improved (secretly I am more optimistic that COP15 on Biodiversity in China next March may witness a real change of pace).

Given the continuing pandemic, it is likely that we will see further fiscal stimulus packages at various points throughout 2021, and I am hopeful that these will help us to focus and energise around a 'new normal', in which companies genuinely value all stakeholders, leading to investment in workers, technology and sustainability. We have had a lot of economic damage thus far and could have yet more with a second dip to the recession, yet the positive takeaway is that we may never have another opportunity quite like it to rethink our whole economic approach. Infrastructure, health care and urban regeneration will likely take the lion's share as we move towards a post-Covid world.

The really interesting development will be how governments (and corporates) finance their transition plans. I believe that issuance in 2021 of green bonds will increase exponentially as a proportion of total issuance from where it is today. Sovereigns are already placing greater importance on green financing with the UK announcing plans for its first green gilt and talks of the US following suit under a Biden administration. In addition to this, we anticipate that all issuers, sovereign, municipal and corporate, will come to rely on performance bonds. The rate of interest on these instruments is linked to the achievement of specific decarbonisation targets. Failure to achieve the appropriate trajectory results in the interest rate rising and the income payable to holders increasing, and vice-versa for surpassing interim target. They will have a cheaper source of financing to those bold enough to grasp the opportunity.

Silvia Dall'Angelo
Senior Economist

2021 is set to be the year of the recovery. The big question concerns the shape of such recovery, whether it will be vigorous (W-shaped, given multiple Covid waves), paltry (L-shaped) or uneven (K-shaped).

The momentum and breadth of the recovery will eventually come down to the policy mix authorities deploy and whether hysteresis effects in the labour market settle in. Assuming a vaccine becomes widely available early in the year, the focus will be on both size and composition of fiscal packages. If public spending includes high-multiplier and structural items (infrastructure and labour force retraining, for instance), it will boost productivity, resulting in a significant and sustained impact on growth.

Meanwhile, monetary policy will remain extremely loose, and increasingly coordinated with fiscal policy. Central banks will extend or even expand their existing purchasing plans, with the G3 central banks already set to buy additional $4.5tn of assets over the next year. Additionally, they will strengthen their commitment to keep rates low (forward guidance and, possibly, adopting yield curve control policies), in turn providing an anchor for long-term rates. They will likely tweak their mandates, with broader adoption of Fed-style average inflation targeting frameworks and/or more explicit targeting of growth and employment.

Geographically, the recovery will be largely synchronised, the same way the sharp recession in 2020 concerned all regions. China – which was the first to be hit – will lead the way. However, synchronisation does not mean coordination, and the trend towards more insularity and regionalisation will likely continue, if anything intensified by the pandemic.

That said, there might be silver linings. The Covid crisis could trigger a process of creative destruction, which would also help productivity down the road. Indeed, businesses have come up with innovative ways to provide their goods and services. Also, crucially, the Covid crisis has acted as a catalyst to unleash public spending, with closer coordination across monetary and fiscal authorities. This framework – if successful in responding to the Covid crisis – could be applied to tackle some of the more urgent challenges of our times, notably climate change.

Client view

Harriet Steel
Head of Business Development

When we look back on this extraordinary year, one aspect of note has been the marked acceleration towards responsible and sustainable investing from clients across a more diverse range of jurisdictions and channels.

Early in the pandemic our own survey of UK IFAs picked up this with 85% of clients saying they have seen a rise in client requests to allocate capital to ESG-integrated funds since the start of the outbreak. It is widely accepted that the Covid crisis has brought the need for more rapid change into sharp focus and we are seeing clients of all types reassess their long-term objectives and the outcomes required of their investments.

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Firstly, demand for ESG and sustainable solutions has surged during 2020 and all signs are that this looks set to continue. Although focus on ESG had gathered momentum in recent years, in 2020 we have seen the conversation move from interest to allocations, with huge flows into a range of sustainable products. This has been particularly true in EMEA in the wealth channel; recent data from Morningstar showed the European sustainable fund market hitting highs of £800 billion assets under management in the third quarter of this year, representing a total of 9.3% of total European assets.

This trend has stimulated a swathe of fund launches from ESG, to Sustainability to Impact, and a broader and accelerated adoption of shareholder engagement and stewardship, now seen as a critical component of enhanced outcomes.

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The second significant trend we expect to continue is investors quest for diversified sources of income, as interest rates continue to stay low. Investors recognise the constraints of traditional fixed income markets and are turning towards unconstrained credit solutions and access to private markets. This is a trend we see gathering significant pace as we head into 2021, with commitments spilling over from traditional institutional channels into wealth. The huge cost of the pandemic and resultant pressure on rates will keep all types of investors seeking new and diversified sources of yield and less constrained income-based solutions.

Lastly, we must not forget regulation and the very important role it looks set to play in underpinning client trends. Europe has so far been at the epicentre – the revised Stewardship Code in the UK came into effect in January and asset managers and owners in EU member states are now meeting stringent requirements of the Shareholder Rights Directive. The asset management industry will undergo a further overhaul in March to meet the lofty impact reporting requirements of the EU Sustainable Finance Disclosure Regulation, creating transparency for clients into whether products are truly sustainable.

2020 has been a very tough year for many reasons but if there is a silver lining it is that responsible investing, which we have advocated for so long, is placed firmly at the centre of our clients' strategies today which is undoubtedly good for the investor and for society at large.

Stewardship and Responsibility

Dr Hans-Christoph Hirt
Head of EOS

The pandemic has had a devastating impact on society, and it will continue to take a toll on individuals and businesses in 2021.

It has highlighted the critical interdependence of different elements of society, including governments, and the need for businesses to think about their core values and purpose in order to be well positioned to create sustainable wealth. This has ramifications for our stewardship activities, and we will put a renewed emphasis on stakeholder relations, risk management and business purpose in 2021.

As companies have been the direct beneficiary of much government spending and support, corporate conduct will be subject to intense scrutiny, particularly against a backdrop of high unemployment and public debt. In our engagements, we will look closely at companies' treatment of employees, customers and suppliers, particularly in situations when difficult trade-offs are required.

The pandemic has also demonstrated why companies need to be better prepared for crises and for swift and sweeping changes to the way they can operate. Therefore, we will pay particular attention to risk management to ensure companies are resilient and robust.

Society will face even bigger challenges in the 2020s, such as responding to the climate crisis, dealing with job losses due to technological disruption and striving for racial equity as demographics shift. Companies must not lose their focus on these issues, even as they are dealing with the fallout from the pandemic.

In our engagements with companies as part of Climate Action 100+ and through our public policy advocacy work, we will continue to push for a swifter transition to a low carbon economy. Finally, given the underlying causes of the pandemic, we will further increase our focus on biodiversity and sustainable land use, recognising that ecosystem degradation poses serious risks to the financial system and the global economy.

Leon Kamhi
Head of Responsibility

Whilst there remains significant uncertainty on how quickly and effectively the world will emerge from the human and economic suffering caused by the pandemic, we should expect 2021 to be the year in which we begin to rebuild the economy and seek to mend the fissures which have developed in society.

There are many positives to draw from the actions taken by governments and corporations in response to the crisis and the varying degrees of lockdown which continue to be encountered in different countries and at different times. Lessons learned from the pandemic will prove indispensable in the future; the ability to take radical action fast, the genuine care and respect for the welfare of people and colleagues and the recognition that commitment to long-term business relationships trump short-term transactional benefits.

> This year, we should also expect to see stakeholders becoming more front and centre in company governance which historically has been shareholder driven.

If we are collectively successful in holding industry together, minimising insolvencies and pandemic-induced redundancies, then 2021 can be the year when progressive businesses implement plans to meet the urgent social, technological and climate challenges which are rapidly developing. This would include how to reduce emissions in a just transition to Net Zero and putting human dignity and wellbeing at the heart of all business practice. These plans should also consider how to protect and upskill employment in the face of rapid technology change and ensure that technology is deployed in a way which ensures data privacy, the mental health and non-exploitation of users. The view of customers will shift more emphatically to building relationships than executing transactions. This year, we should also expect to see stakeholders becoming more front and centre in company governance which historically has been shareholder driven. In 2021, I also hope to see companies and investment houses moving away from ESG platitudes and so-called greenwashing to affirmative action which solve societal issues in a practical and meaningful way. I fully expect the businesses which do so to be the future leaders of industry.

Ingrid Holmes
Head of Policy and Advocacy

Going into 2021, we will continue to see a growth in the numbers of financial firms committing to 2050 net zero carbon targets. This will help build a sense of positive momentum toward the delayed COP26 climate change conference in Glasgow.

However, nearer term targets setting out how firms will put in place more immediate climate commitments will be fewer and far between as firms increasingly experiment with approaches and work out what the next practical steps are.

> One enduring barrier to better reporting on impact remains lack of access to consistent and comparable decision-useful data.

The pushback against greenwashing will continue with regulators paying closer and closer attention, not only to how investors are integrating sustainability into investment decisions, but in progressive jurisdictions, how sustainable investors are delivering positive impact as a result of their actions. In short there will be a 'prove it' mentality.

One enduring barrier to better reporting on impact remains lack of access to consistent and comparable decision-useful data. 2021 will be the year global financial regulators and voluntary standard setters converge around concrete measures to improve data quality and coverage – not just on climate but on wider environmental and social factors. Expect to see a battle between the EU and international accountancy standard setters as to who will dominate the formalised sustainability accounting framework agenda.

Equities

Gary Greenberg
Head of Global Emerging Markets

After a surprisingly robust recovery in 2020, emerging market equities look set for a positive year in 2021 as North Asia, which constitutes the majority of the benchmark, exhibited notable competence in dealing with the virus and thus looks set to build on good numbers in 2020.

But North Asia won't be the only place for performance. The global economy should see a recovery in the second half of the year, as vaccines are distributed and global confidence returns, helping commodity producers like Indonesia, Peru, Russia and Mexico. Of course, the Democrats' partial victory will see less infrastructure spending that previously hoped, as the prospect of vaccination lends credence to a policy of fiscal prudence, one which will be wholeheartedly endorsed by the Republican US Senate. Emerging market valuations appear supportive as they are at the low end of their long-term range relative to developed ones.

> Overall, 2021 is likely to be a good year for financials and materials, but longer term, high economic growth rates are not on the cards so cyclicals remain more of a trade for 2021 than a secular investment.

In Latin America, although Biden should be more engaged, local politics will remain volatile. However, economic growth should be positive, even if not all countries have secured vaccines. The EMEA region will see a more difficult US/Russia relationship, but better demand for energy, base metals, and platinum/palladium, aiding not only Russia but South Africa as well. Politics however will remain difficult in the latter, and prospects for the current rally to last through 2021 are modest. Overall, 2021 is likely to be a good year for financials and materials, but longer term, high economic growth rates are not on the cards so cyclicals remain more of a trade for 2021 than a secular investment. Secular trends like digitalization, increasing spend on health care, logistics and premium products should continue.

Geir Lode
Head of Global Equities

We are starting the year with a moderately cautious outlook. Though equities and risk assets remain in demand, sentiment will continue to see short-term challenges with ongoing covid resurgences.

For the third wave (which will come, the only question is how big) we will be much better prepared. Unemployment numbers remain a cause for concern and while many economies escaped a technical recession during 2020, fiscal support will be required alongside continued monetary supply to stave off a US 2021 recession which could have a profound impact globally. At present, liquidity concerns are lower on investors' long list of hurdles.

The US election should bring more stability to global trade, improving sentiment towards those companies caught in the dispute, however short to medium term fears over the pandemic and the longer term tension between the US and China combine to cast a shadow over corporate outlooks. Earnings and growth expectations for 2021 and beyond remain optimistic at levels predicted at the start of 2020.

The pandemic has led to positive behavioural changes, which will persist long-term, as corporate resilience and the wellbeing of employees have become crucial issues. While interest rates are low, access to debt is cheap, allowing investment in transformational business opportunities. Innovative and disruptive businesses bring rapid growth regardless of the economic environment.

The ongoing case for sustainability continues to strengthen. Strong brands and premiumisation continue to deliver market leading profitability and more businesses are looking to benefit from this dynamic. The rescheduled COP will uncover more ambitious plans from countries on how they plan to decarbonise their economies.

We continue to focus on quality characteristics alongside valuation, growth, momentum and good or improving ESG characteristics, identifying solid companies, well positioned for the future. With the ongoing volatility in equity markets, remaining balanced in our exposure to themes and styles remains our favoured approach to delivering the consistency of outperformance.

Hamish Galpin
Head of Small and Midcap

Small cap stocks have been in a sideways trend since they peaked in the third quarter of 2018. Large caps, however, have this year managed to recover and remain at levels above the highs of 2018.

Looking at the longer term evolution of the indices – since 1995 as that was start of the MSCI World Small Cap index– small caps have fallen back from being two standard deviations above their trend in 2018 to just half one now. Large caps, on the other hand, rose to above two standard deviations at the end of August – exceeding even the level during the Tech boom at the turn of the millennium – and are still 1.5sd above trend.

The relative underperformance of small caps in the last two years is in part explained by the all-too-familiar outperformance of the large cap FAANG stocks, but is also reflective of the economic uncertainty the world economy has experienced during this time. But it also suggests that the asset class should be well positioned if the economy recovers next year and the ongoing economic impacts from Covid come to an end.

What is interesting currently is that the top-down perspective outlined immediately above is being reflected in our bottom-up investment experience. For several years in the run-up to the pandemic, market volatility was low and finding good upside (20%+) in attractive stocks was a challenge. Today, this is much more frequent and in fact more likely than not. In other words, in between the extremes of share price performance of a momentum-driven tech stock and a Covid-impacted travel stock, there are attractive entry points into the sort of businesses that we like to buy and retain to see them fulfil their potential.

Timing is, as ever, a risk, but with a three to five year investment horizon, one hopes that this risk is much reduced. I'm looking forward to 2021.

Ingrid Kukuljan
Head of Impact Investing

The Covid pandemic has created a large amount of uncertainty in near term supply and demand trends within many industries which is likely to continue into 2021.

Nevertheless, the macro uncertainty is likely to mean that low interest rates endure, and ongoing stimulus is provided which will in-turn offer further liquidity to global markets. These factors lead us to believe that equities have the opportunity to continue to outperform.

The impacts of Covid have highlighted the importance of increasing resilience in food and water security, health care systems and supply chains, as well as heightened awareness of topics such as climate change and workers rights. Whilst we already invest and engage on these topics, we hope that this increased consciousness endures into 2021 and leads to further investment and innovation. With the EU Green Deal in Europe and the election of a more environmentally focused president in the US, we hope that governments worldwide will utilise economic stimulus in particular to help support businesses which are providing solutions to such needs of society and the environment as outlined by the UN SDGs. With increased awareness about these issues we hope that the trend towards "investing for good" continues, with impact investing providing the purest opportunity to do so.

We remain confident of the long-term outlook for our strategy; impactful companies are essential to help service the unmet needs of the environment and society and are therefore exposed to enduring sources of demand – providing secular growth opportunities as well as providing positive impact towards people and the planet.

James Rutherford
Head of European Equities

Like many markets across the globe, the Covid pandemic and subsequent lockdowns have polarised the European market in 2020, both in share price performance and fundamental performance.

As we look ahead in to 2021 there is some hope of a return to normality, to mobility and economic activity, which should see the emergence of a strong earnings recovery in the more economically sensitive areas.

This is a significant portion of the European market and an area that has been effectively held hostage by the pandemic, causing companies to set a low base from which to grow. As such, we expect to see some mean reversion of the fundamental performance of companies deemed to be the 'Covid losers', resulting in a broadening of market breadth, which has been very poor throughout 2020.

> As the earnings scarcity diminishes, it could make some of these high multiple names vulnerable and provide opportunities in those names that suffered the most.

Meanwhile, valuations on some growth names have reached lofty valuations. In a market where earnings have been scarce this is understandable, but in some cases valuation metrics have been constantly adjusted to justify ownership. As the earnings scarcity diminishes, it could make some of these high multiple names vulnerable and provide opportunities in those names that suffered the most.

Market performance will, as always, be subject to other factors, and moves in bond yields and currencies will play their usual part. But with the US election and Brexit hopefully behind us and with expectations of improved testing, treatments or even an effective vaccine reducing the impact of the virus going forward, the market will hopefully be able to focus on earnings. Moreover, stimulus and monetary policy is likely to remain accommodative for a very long time and, given the heavy weight of more economically sensitive stocks in Europe, the fundamental backdrop and relatively low valuations will remain supportive for a much improved market than 2020.

Jonathan Pines
Head of Asia Ex-Japan

A low interest rate environment in Asia (like the rest of the world) has resulted in investors paying up for stocks that they consider to be able to grow quickly and sustainably.

But low interest rates should support all asset classes. Many stocks in Asia are now offering dividend yields that are many multiples of the relevant risk-free rate.

In most market conditions, the 'price' an investor must pay for investing in a high dividend yielding stock is the likelihood of future earnings (and thus dividends) declining from an initially high starting point for either structural or cyclical reasons.

> Promising developments in relation to a Covid vaccine might be the catalyst that encourages a switch in investor perceptions of relative attractiveness.

However, there are now many stocks in Asia offering high dividend yields while being on cyclically *depressed* earnings that are expected to grow.

This dynamic makes these stocks more compellingly better than cash (and less ambiguously or conditionally so relative to many recent highflyers), and holds the promise of a potential re-rating, withinvestors – in the meantime – being 'paid to wait'.

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Mark Sherlock
Head of US Equities

After the shocks and surprises of 2020, many investors will wish for a smoother ride in 2021 – unfortunately they may be disappointed.

While the governmental framework is now broadly set, deep divisions remain, both economically and politically, and willingness to compromise is scant. The continued course of the virus also remains unknown – albeit subsequent waves appear less deadly and a vaccine is in sight – government borrowing is high and tax revenues reduced.

Notwithstanding this challenging backdrop, the market is likely to continue to do well. A highly supportive Federal Reserve, record low interest rates, potential fiscal stimulus and a gradual return to economic normality should all prove positive factors. A vaccine (or vaccines) will be rolled out and, while there will be some unfortunate economic scarring, many companies will see much improved earnings and a brighter future ahead.

> Small and mid-cap stocks currently trade on a discount to their larger-cap peers – an anomalous situation relative to longer-term history.

Within the market we expect some rotation. Small and mid-cap stocks currently trade on a discount to their larger-cap peers – an anomalous situation relative to longer-term history. This is likely to revert as economic fundamentals become clearer and, within the asset class, a broader group of stocks will benefit. Overall, we expect a volatile but improving picture as America, and the world, gets back to work.

Fixed Income

Andrew Jackson
Head of Fixed Income

It would be hard to overstate the degree of turbulence that we have seen within Fixed Income markets in 2020.

The primary driver for the moves has been the pandemic and its associated effects on society. The velocity and amplitude of the moves would, however, have been less if we had not entered 2020 in such a precarious condition. After years of central bank intervention and worsening underlying credit conditions we have seen something of a reckoning in some sectors as stress has led to distress and loss. It is for this reason then that I remain convinced that we will see volatility continue in fixed income markets.

On almost any measure fixed income looks well placed from a technical perspective for 2021. Developed market government bonds offer close to no (and often negative) returns and clearly offer less defence against future shocks, while equities look to deliver a much lower forward-looking return than they have been able to drive for the last decade. Against that backdrop and despite yields being paltry by historical standards, the value of credit risk premium and illiquidity premium is meaningful and offers excellent risk adjusted value. Moreover, fixed income remains one of the asset classes where it is still very possible to deliver significant alpha. Within our underlying asset classes there exist currents and trends that make a more flexible holistic view hugely valuable, our clients are seeing that more and more. Our view of fundamentals is less positive than of the technical and it is primarily for that reason that we also see risks to the downside in our asset class.

In most instances we think that a cautious risk minded approach will be a good first line of defence against the moves we expect to see, but we are also finding ourselves challenging long-held assumptions in this changing world. The best evidence of this is that we expect 2021 to be a year in which default rates are somewhat above historical averages, but with recovery rates significantly below norms.

Last, but certainly not least, 2021 like 2020 and every year before it in my decades of lending will be a year which places a high value on quality underwriting, caution and diligence.

Fraser Lundie, CFA
Head of Credit

The relationship between the real economy and the financial markets is undoubtedly stretched as central banks' injections of liquidity battle to offset the pandemic shock.

This continues to make determining the immediate direction of travel very difficult but the importance of careful analysis paramount. While the scale of the stimuli is almost without limit – its lifespan is not.

Q3 earnings have generally exceeded expectations but in absolute terms they remain very weak with many sectors still reliant on government support. Having raised a large amount of cash, businesses look secure in the short term but longer term the outlook could be challenging. Ratings downgrades and distress ratios have both come down, highlighting a stabilising credit outlook. Investor confidence has been high, and spreads have tightened significantly from the March lows, limiting upside in certain areas.

There is no doubt that the technical environment is an excellent one for credit. There is little-to-no yield to be found in developed-market sovereign debt, equity income is challenged, and credit spreads are close to historical averages. We have a less positive view on fundamentals, which in some respects are weaker than they have been for a decade.

For some, even this is too much to bear and we will see defaults in 2021, combined with worryingly low recovery rates – a hangover from years of covenant light issuance coming back to bite. 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.

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Credit spreads have normalised since March but there is considerable dispersion beneath the surface offering pockets of value. Going forward, we will take an active, conservative approach to credit investing that uses detailed, bottom-up analysis – something we believe will help us seek out the opportunities that are so often overlooked.

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

Into 2020 the growing prominence of green finance was often pointed to as a typical sign that capital markets were reaching their cyclical peak. The kind of luxury you can afford to look at when all is well.

Yet if this were true, sustainable capital markets activity would have come to an abrupt halt in the first half of this year. Looking back, this was clearly not the case. Instead, the green evolution in finance has been resilient throughout the coronavirus crisis and represents a long-term, secular change.

Setting aside the wave of regulation that comes into force next year in Europe, some obvious catalysts for growth in sustainability-themed debt capital markets will be switched on. The EU is poised to begin funding a E225bn green bond program to finance a "green recovery". And, while project-based green financings are necessary to address the climate crisis, they are not sufficient. Companies must decarbonise at the firm level, across all operations. In support of this notion, the ECB will include sustainability-linked bonds (SLBs) in its monetary programs from 1st January, removing a high barrier for growth. SLBs attach the cost of debt to a firm's ability to hit sustainability targets, therefore encouraging broader firm-level change and action.

At the epicentre of the green revolution, Europe will continue to inspire green finance activities globally as sovereigns and corporates seek to benefit from the so-called "greenium". Look no further than number of countries outside of Europe declaring themselves to be "net-zero" by 2050, with the prospects increasing that the US will be back on the list.

Importantly, investors have become increasingly sophisticated on all matters of sustainability. They are hip to the ways of those merely dipping a brush into green paint. In 2020, some 440 companies have pledged to decarbonise their production processes through commitments approved by the Science Based Targets Initiative, a spike in comparison to last year when total signatories stood at 590. Next year, these companies must prove that they've made much more than paper promises to garner the affections of investors in the near term.

Vincent Nobel
Head of Asset Based Lending

During 2020 we have seen markets react with relative sanguinity to the biggest disruption in our lifetime. Yet, house prices went up, rather than down, despite the UK having the highest number of Covid deaths in Europe.

This mix of thoroughly bad news with a relatively muted market response has been a theme running through the real estate markets for all of 2020. This cannot last. We expect that the extensive levels of financial government support will have to be reduced during the course of 2021. This will lay bare the true state of the economy. It will be faced with cyclical and structural headwinds. Unemployment will stand at record numbers. Structurally it will need to adjust to consumer purchasing patterns having been pushed further online (and unlikely to revert) as well as the mess that is Brexit. These headwinds combine to force the market into major adjustments in how and where it seeks value. The real estate market is not exempt and the relatively minor shifts in value that we have seen during 2020 are likely to continue apace. Structural shifts in occupier demand as a result of the pandemic will impact real estate values.

So far, senior lenders have emerged as the relative winners. Additional risk posed by both the pandemic and Brexit is being priced into loans, while real estate total returns are likely to be muted. This squeezes borrower returns in favour of the lender. Maintaining high rental levels is the only way for landlords to maintain performance in the short term, which brings us to one of the key tenets of the Federated Hermes real estate philosophy; long term value is driven by active asset management. Continuing to make assets better suited to life in a post-pandemic world will be a key differentiator. Carbon transition and occupier health and wellbeing will be important themes for landlords across the country.

Private markets

Chris Taylor
CEO, Real Estate

As Covid-19 continues to wreak havoc with global economies, beneath the surface we will maintain our conviction to understand the underlying structural trends affecting occupational demand which will continue unabated; technology will continue to drive further change across the retail sector, as retailers adjust their bricks and mortar strategies to retain market share, a long-term trend which has been accelerated and accentuated by the pandemic.

> We can expect to see a greater bifurcation between poorly specified offices and those with carbon efficient credentials in accessible locations.

Demographic lifestyle trends will continue to support the nascent Build to Rent Sector. Climate risk and social equality will remain important drivers ahead for investors and occupiers alike; office demand in aggregate will be adversely affected by the move towards greater flexible working, but well specified, accessible offices in an attractive environment will prove to be sustainable.

We can expect to see a greater bifurcation between poorly specified offices and those with carbon efficient credentials in accessible locations. The halo effect of well-managed estates such as King's Cross, benefitting from great placemaking, will prove to be the long-term winners in real estate. Such estates offer an environmentally compelling destination to an engaged community, with mixed use buildings and facilities, maintaining a region's heritage links to the past creating a sense of purpose and belonging for all citizens, not just its occupiers. This manifestation of delivering holistic returns will prove to be relevant and sustainable at a time when occupational demand has been profoundly affected by structural change.

Hamish de Run
Head of Infrastructure

The ongoing social and economic fallout from the coronavirus pandemic has accelerated sustainability discussions in several areas that already had momentum before the crisis.

In many respects we are experiencing the evolution of a new normal, including a modernised social contract and increased cognisance of environmental and social impacts. The ability of infrastructure investors to recognise and embrace change may determine not only what's next, but who thrives.

A fundamental pre-requisite for sustainable investment in infrastructure is that private finance is perceived to be legitimate. The right to steward critical infrastructure assets for both current users and the next generation, requires public trust, in not only the competence of infrastructure businesses, but in their ethics. Post-covid, calls have been made for a new social contract, focussing on topics which directly address public perceptions of unfairness – stakeholder accountability, diversity, transparency, tax and fair remuneration. While governance discussions in essential infrastructure have often focused on boards of infrastructure companies, they will need to evolve, both to include such previously taboo topics and to acknowledge that the market spotlight has been turned firmly upwards, to the owners of assets and their conduct.

Despite the pandemic we continue to witness an accelerated focus on climate change and demand for impact reporting. A plethora of tools and regulations are being developed to support and guide investors in their ever-increasing ambitions. If managers are to support the new normal, impact reporting will need to become more credible and climate risk frameworks, scenario planning and data more robust and consistent.

As mainstream expectations evolve, best-in-class infrastructure fund management will require more than financial and operational skills. It will require resourcing, commitment and a diversity of experience and perspective to genuinely serve our beneficiaries and wider society. To see what's next in sustainable investment, we must move with the times.

Patrick Marshall
Head of Private Debt

2021 will be a year of continued uncertainty for both lenders and prospective borrowers. This will be a year when discipline in lending criteria and strong origination platforms will be key to success.

The M&A market will remain subdued in the first quarter and only pick up when potential acquirers are able to get clarity on the financial performance of proposed acquisitions post Covid. Until there is a significant pickup in the M&A pipeline, transactions will remain centred on small financings for add-on acquisitions and refinancings. The limited transaction flow will lead to unitranche lenders, already under pressure from banks who are gaining market share, to go back to competing on loan terms for borrowers of better credit quality. Companies, in more cyclical business sectors such as the retail sector, will continue to struggle raise financing. Loan yields are unlikely to move much for senior secured lenders, and may contract a little for unitranche lenders, but lender protection rights will weaken potentially negatively impacting default recoveries in the longer term.

Defaults will continue to rise, with many companies continuing to survive on government support schemes. Defaults will remain centred on business sectors reliant on consumer spending which have already been affected strongly by the Covid pandemic. Many lenders will try to find short term solution to potential defaults by increasing covenant headrooms or providing borrowers with other form of short-term relief. In the longer term this strategy of not being willing to restructure failing businesses early on will negatively impact recoveries.

We continue to believe that a low-risk strategy centred on senior secured lending, in non-cyclical industries provides investors with the best value. Ongoing economic uncertainty due to Covid and Brexit, will mean that the year ahead is one of uncertainty.

Peter Gale
CIO and Head of Private Equity, Hermes GPE

2020 has been a watershed moment for many of the structural megatrends that had already been underway in the global economy. In order to make sense of where opportunities lie in the 'new normal' and act accordingly, investors will need to update their mental maps and assumptions in order to successfully to navigate the post-COVID environment.

The pandemic represents one of those existential crises that result in lasting changes in attitudes and behaviours. Technological disruption is leading to the decay of old business models and the emergence of new ones, and the range of investor return outcomes is being amplified. Fat tails will be part and parcel of the new normal.

During 2021, businesses, consumers and societies at large will continue to build on new habits formed during 2020, with an emphasis on adjusting to the requirements of an increasingly virtual economy. For companies, this means accelerating plans to digitalise all aspects of their operations, while consumers will continue their own digital shift in the way they shop, play and live.

With technology adoption in many parts of society accelerated by years in a matter of months over the course of 2020 – think cloud adoption, virtual healthcare and e-commerce – we expect the marked bifurcation of the economy to continue and indeed accelerate further over the coming years. The developments of 2020 and 2021 are likely to only mark the beginning of more profound change.

Our observations are set against the context of an accelerating pace of change in innovation that had been steadily increasing even before the onset of the COVID-19 pandemic. Our private equity investment programs with their forward-looking thematic investment strategies have been actively seeking out innovative high growth companies across the globe. We look for market segments that are experiencing structural growth tailwinds and we remain confident that we can continue to deliver exceptional long-term risk-adjusted returns for our investors in the post-COVID era.

Applying a sustainable investment lens throughout this dynamic and changeable environment will ensure that the right investment decisions are made that will enhance outcomes for all of us. The pull from populations and consumers and the necessity of addressing climate change creates multiple business opportunities for companies that provide innovative solutions around the future of nutrition, net zero economies and responsible consumerism.

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Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

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