2020 Investment Symposium highlights

Disruptors Today and Tomorrow: COVID-19, climate change, debt and geopolitics

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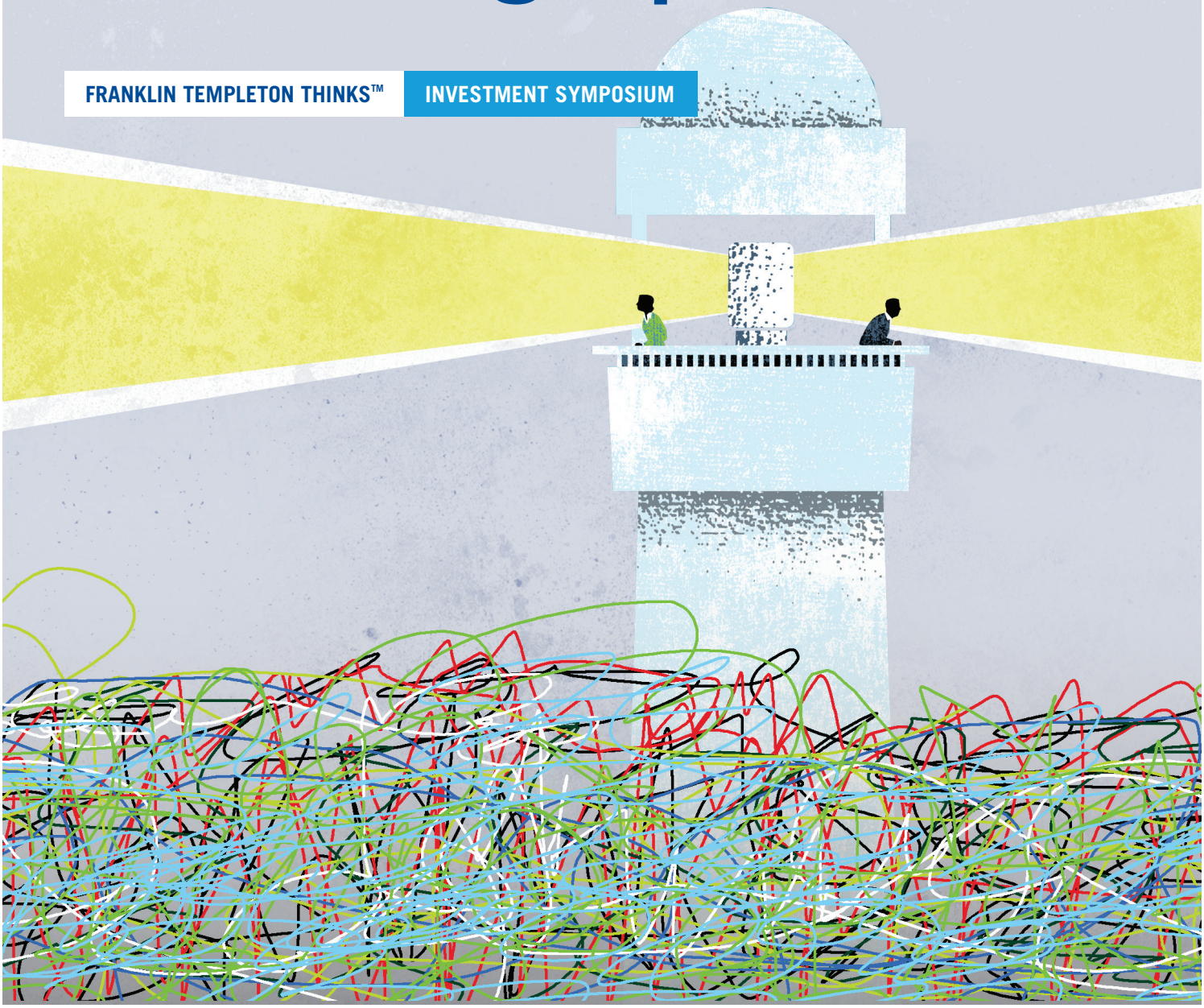

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Introduction

This live virtual research event hosted by Franklin Templeton Investment Solutions (FTIS), held on October 13–14, 2020, brought together experts from across Franklin Templeton's various investment groups in four moderated panels, concluding with a chief investment officer (CIO) roundtable featuring several of the firm's investment leaders. The panels are meant to focus on the medium- to long-term impact of a broad set of topics, ranging from what markets learned from COVID-19 to the global impact of the 2020 US presidential election to climate change implications.

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Panel 1: **COVID-19 accelerates new economy**

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Even before the pandemic, a digital transformation was underway, reflecting a paradigm shift in the global economy. New business models were created by new technology, while traditional business models were forced to adapt to a new digital world order. COVID-19 meaningfully accelerated these trends. While some changes prompted by the virus may be transient, the consensus view is that many are likely here to stay.

Panelists agreed that nearly every industry, sector and segment of the economy is being impacted by a technological renaissance. Software and data applications are being applied more deeply in operations, transforming business models. In some instances, entirely new business models have been created.

Uber, Airbnb, Alibaba and Facebook, among others, are examples of companies where data and software technology have upended traditional industries like transportation and retailing. They offer carriage, accommodations, retail and media, respectively, without owning vehicles, hotels or inventory, or creating content.

In terms of traditional industries, digital impact has been significant as well—and accelerated by COVID-19. Companies have been able to radically transform cost structures using technology. For example, video calls for client meetings have been a great way to increase sales teams' productivity and reduce costs associated with travel and entertainment.[1]

Health care industry transformed through COVID-19

One industry especially impacted by COVID-19 has been health care. Panelists noted the pandemic has accelerated the trend away from high-cost hospital environments toward lower-cost retail clinics, ambulatory (and even home) surgery centers and telehealth (virtual interaction between physicians and patients).

Long term, the expectation is that the shift toward telehealth will be a permanent transition, as the technology and infrastructure for virtual interaction between doctors and patients is now in place. However, its sustainability hinges on keeping the changes COVID-19 prompted, such as parity reimbursement and flexibility in certain rules (information security and allowing for out-of-state practice, among others).

On the therapeutics side, the biggest change is the validation of new technology platforms and new vaccine approaches such as mRNA. In addition, changes to clinical trial structures allowing for more collaboration will speed up the path to market for new treatments.

For hospitals, the COVID-19 pandemic has presented a perfect storm of sorts. On the front end, the increase in critical patients has put excessive demand and stress on intensive care unit infrastructure and staff. On the back end, a dramatic decrease in non-COVID-19 related patients seeking treatment as well as hospitals forcing the cancellation of elective procedures has put tremendous fiscal and resource stress on hospitals.

The good news is that elective surgeries seem to be coming back to pre-COVID-19 levels, which is important as this is a big revenue source. Going forward, hospitals will need to think more about connecting with patients (end consumers) and providing better access to services. Technologies such as artificial intelligence could be utilized to offer remote patient monitoring (e.g., cardiac monitors). Big data can be applied to better observe how patients evolve over time, perhaps offering the ability to intervene earlier in mitigating disease. By using these technologies, panelists expect patients may be able to live at home for longer and avoid assisted living.

Tech valuations during the pandemic

Panelists noted that the technology sector has been seemingly immune to the pandemic, in terms of company valuations, and in many cases the crisis appears to have provided a bit of a tailwind. The sector is trading at a meaningful premium compared to the long-term average, but still below dot-com bubble valuations on a price-to-earnings basis.[2]

The consensus is that valuation levels are warranted given the sector fundamentals: cost of capital is down, growth is excellent and quality is good—it is one of the most profitable sectors by earnings before interest, taxes, depreciation, and amortization (EBITDA).[3] The view is that technology is no longer a cyclical sector. The belief is that higher multiples are deserved for greater predictability, as revenue is now driven by software and services as opposed to more cyclical hardware (semiconductors, personal computers or mobile phones). Panelists did not voice concern over tech concentration in Facebook, Apple, Amazon, Netflix, Google (Alphabet) and Microsoft ("FAANGM"), citing the companies' stellar performance.

When the world returns to normal

As vaccines come to market and are distributed over the next several quarters globally, the expectation is for cyclical assets (such as automobiles, travel and hospitality) to outperform. More cyclical areas of technology such as semiconductors and other IT hardware should also do well.

In terms of broader corporate credit, investment-grade and high-yield spreads are around historical averages, so the panelist's view was neutral, with idiosyncratic selection being key.

Biggest risks in the coming year

- Vaccine distribution and willingness of population to get inoculated.
- Potential strike down of the Affordable Care Act (ACA) or parts of it, while unlikely, would be very disruptive.
- Overly optimistic expectations for technology sector performance. Investors should look outside FAANGM for growth and alpha. At some point, additional regulations and or anti-trust action may impact the sector.
- A continued toxic environment and lack of bipartisan cooperation in Washington, DC. Populist trends and rhetoric.

Panel 2: **Filling the hole with more debt**

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Generally, the panel did not express much near-term concern with current debt levels globally. Most of the debt is on government balance sheets versus corporations or households. This is different from what we saw in 2008. With public debt, metrics and ratios generally do not matter as much in the near term; what matters is a government's ability to service debt.

With nominal rates near zero across much of the developed world, insolvency is not likely. Accumulation of public debt is less significant than private debt, as public debt can be managed over an extended period and incrementally paid.

Potential paths for managing this debt longer term are unknown. Inflation is not a viable option currently—it will take some time to get back to full employment and higher wages, given the economic contraction. Inflation may be possible in the medium term, but nothing that occurred this year has materially changed the prospects for inflation. The global pandemic has blown a crater between savings and spending; thus, the only realistic demand management tool is deficit spending funded by central banks.

The main risks of low interest rates are too fast of a recovery (are we in this century's version of the Roaring Twenties?; we know how that party ended), hyper-inflation, and the potential that China (running a deficit now) starts attracting too much foreign capital to support its economy. Sustainability depends on who holds your debt, as investors will reassess whether they think they will get repaid. This will exacerbate differences between COVID-19 winners and losers; it may result in a country being held hostage by foreigners in currency terms.

Despite a record US$1.7 trillion in investment-grade debt issuance (on a gross basis), balance sheets in the corporate sector have been resilient. In the panel's view, debt issued by companies has been a precautionary action to build up cash to weather the extremely negative outlook forecast for COVID-19.

Corporate balance sheets are stronger than they appear

Despite a record US$1.7 trillion in investment-grade debt issuance (on a gross basis), balance sheets in the corporate sector have been resilient.[4] In the panel's view, debt issued by companies has been a precautionary action to build up cash to weather the extremely negative outlook forecast for COVID-19.

However, since the economy has performed much better than the dismal expectations formed in March–April 2020, proceeds of that debt went into cash. This is now an asset that corporations can use going forward to pay off debt and/or reinvest in their business.

Emerging market debt

Panelists observed that emerging market (EM) debt levels have been rising over the past 10 years, and COVID hasn't changed the trend significantly. Debt levels today are approximately 60% of what the International Monetary Fund (IMF) reported was sustainable for EMs in 2017 under some of their frameworks.[5;6] Continued low interest rates and IMF support should continue to make this debt sustainable today.

Nonetheless, we anticipate huge divergence within EM members: some countries might face more difficulty than others, and therefore selectivity matters. Panelists believe areas within EMs that are best for long-term sustainability include Southeast Asia or China; the most vulnerable region is South America, but there likely are significant differences even within regions.

European Union

Panelists were more circumspect with regard to the European Union (EU). There was disagreement on the importance of the creation of the Next Generation EU fund. While some viewed it is a small step forward, others believe it to be a significant step that will keep the EU together in the short term.

Some described the current state as a "crossing the Rubicon moment"—what solved the EU sovereign debt crisis is when the European Central Bank (ECB) agreed to purchase government debt in 2008. Will the money in 2023 and 2024 be well spent to improve economies and fuel growth? In the previous crisis, the EU had a quick response that was good, but momentum faded quickly.

A more optimistic view argues that the amount of aggregate stimulus to the EU economy is impressive—Germany has done as much as the United States in stimulus (despite its tradition of fiscal conservatism), as has the ECB. Time will tell.

Is this Modern Monetary Theory (MMT)?

Panelists discussed whether we are currently living in a world where MMT is being practiced. For some this is not the case, but eventually this could be viewed as MMT should this level of central bank intervention persist. For others, the US Federal Reserve (Fed) is monetizing savings already, hence this is MMT.

Implications for inflation varied—the panel offered different views regarding the US achieving 2% PCE inflation over the next 10 years.[7] Some predicted under 2%, but others said it is likely it will eventually go higher given the long time frame, central bank policies toward easing and the trend toward deglobalization.

Panel 3: **Politics and turbulent years ahead**

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The consensus is that as globalism recedes and populism emerges, the world is becoming more unstable. Many populist leaders were able to gain or cement their power due to COVID-19, and this is a negative for all regions globally.

The good news is that a Biden administration in the United States is thought to be a positive for the world in terms of political stability, especially in terms of "green" and environmentally friendly sectors. The United States is still expected to be the predominant superpower in 10 years. The expectation is that the Biden administration will move toward seeking multilateral approaches to solving global problems. The administration is also expected to immediately re-sign the 2016 Paris Agreement and invest in green infrastructure. A green agenda will likely bring Europe and the United States closer than they have been in quite some time, as the United States has not been as on board with the green agenda. A more globalist approach will likely help EMs, potentially through a transpacific partnership or something similar. This globalist approach will also likely benefit multinationals and governmental organizations.

China relations

From a US perspective, conflict is expected because of techno-security competition. The nature of war has also evolved and become digitized, leading to more continuous sub-kinetic conflicts (digital rather than physical and mechanical). A 20th century type of war is unlikely; however, we have already been at war according to a 21st century definition of using non-military means for achieving political and strategic goals—"breaking the enemy's resistance without fighting them." Under a Biden administration, expect China to replace Russia as US public enemy number one. This hurts China as it has limited allies after antagonizing many countries.

Of note, some panelists suggested we may have already seen peak Chinese per capita GDP (gross domestic product) growth. As the country moves more toward a control society, the rewards that come from successful entrepreneurial activity and capitalism are diminished. In other words, increased autocracy naturally limits growth.

Thoughts on Taiwan

Taiwan has the potential to be a catalyst for conflict, as it has for decades. China has spent years studying the capabilities of the US military. If China did make a move on Taiwan, it would be difficult for the United States to respond. So instead of trying to match the US carrier aircraft group, for instance, China has developed very capable anti-ship missiles so it can keep US aircraft carriers five to 700 miles off the shore. Typically, the potential for conflict has been mitigated through fluid lines of communication in economic, political and military matters. A lack of dialogue between the United States and China, such as that experienced during the Trump administration, could result in policy mistakes. The expectation is that communication channels will improve with the Biden administration.

Thoughts on the Azerbaijan-Armenia conflict

The Azerbaijan-Armenia conflict is certainly a messy situation worth watching. Turkey is backing Azerbaijan, and Russia is backing Armenia. Russia has a military base, a large number of citizens in Armenia and tremendous economic interests at stake (Azerbaijan has its own gas pipeline to Europe). In addition, Russian President Vladimir Putin would benefit from a division in NATO (Turkey has the second largest military in NATO) by forcing NATO to discuss support to Turkey.

Panel 4:
Beyond the profit motive: Infrastructure, climate change, and diverse organizations

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Panelists agreed that among the biggest issues associated with environmental, social and corporate governance (ESG) initiatives is climate change and regulations around carbon impact. The EU is committed to cutting carbon emissions by 55%, and China has said it intends to be carbon neutral by 2030. There are questions as to the ability and commitment of China to meet this ambitious goal.

Regulations vary across regions with different incentive schemes—Europe is incentivizing citizens to purchase electric vehicles, while the United States is going in the opposite direction. This divergence in regulations presents the biggest challenge for multinational corporations. Risk management differs across regions, especially for automobiles. Panelists agreed public subsidization is key in incentivizing environmental change due to the prohibitive costs of electric vehicles, at least in the early stages. The EU has been excellent in public subsidization.

Larger companies are better prepared to manage to cross-border standards, due to the necessary scale and ability to absorb fixed costs associated with developing green technologies. Many corporations have formed alliances to adjust to changes in regulations.

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Companies were reluctant to accept the carbon movement initially, but now many European companies seem to be fully committed, which has led European companies like Airbus to talking about the hybridization of jet engines.

In the United States, commitment regarding global climate solutions is taking place on the municipal (rather than federal) level, with many cities reducing carbon output. This trend should change with the incoming Biden administration.

As markets become more developed, the price on carbon will only increase, thus helping to further reduce emissions. We saw this in Europe—pricing does matter! There is always the risk of emissions getting exported to countries with lower restrictions, which demonstrates the importance of a global agreement.

Peak oil?

The consensus view was that peak oil will likely occur in the next 10 years. As electrified propulsion systems are developed, demand for oil will naturally decline. That said, it could extend beyond 10 years as EM countries are early enough in their economic development that demand will continue. In either case, it will come later than ESG investors would prefer, though COVID-19 may have accelerated this trend. Things like reduction in business travel, less commuting, etc., may persist well after COVID-19 is extinguished.

Panel 5:
CIO roundtable

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The hottest topic during the roundtable was modern monetary theory (MMT). Several panelists suggested that pursuing MMT is a huge risk going forward. MMT has taken the global economies down a dangerous path; the theory was considered ludicrous several years ago, but now some economists are advocating for it. For some, the issue is that MMT, or sustained quantitative easing, generates diminishing marginal returns, exacerbates income inequality and inflates asset prices. Zero interest rates are the root cause of the divergence between markets and main street economies. The path toward economic growth will take a long time, and we expect Fed policy to remain loose for some of this time but not all of it. Estimates for when US inflation will be over the 2% range are sometime in 2022 or 2023, occurring approximately six months or a year after the Fed raises rates.[8]

Zero interest rates have distorted government behavior and portfolio construction, and they explain why there is such a divergence between the markets and the economy. Innovation is stalled when there is no cost to financing. We cannot afford to waste the capital in the way we have been—looking at history, there was much faster industrialization and production opportunities to scale up (like railroads during industrial revolution) than what we have today.

Another key topic likely to gain prominence over the next few years is the impact of the current economic shock on governments as well as in social contracts with governments.

Thoughts and views on the future

The post-COVID-19 world will likely be a hybrid, combining the old and the new (e.g., mix of work from home and return to office). Sectors with potential for innovation and disruption include health care and technology; however, factory automation will have a key role, and we expect a renaissance in manufacturing in the United States due to deglobalization. Changes following the pandemic will likely improve the quality of our lives and increase productivity.

Views on performance of asset classes over the longer term diverged, ranging from equities outperforming credit to investment-grade credit outperforming equities, to indications that both asset classes will suffer and that selectivity within asset classes will be key. Asset classes and currencies nominated by the CIO panelists to offer the strongest performance potential over a medium-term horizon (one to three years) were:

- Dividend equities
- US credit
- Real estate
- Yen-denominated gold
- Yen-denominated Japanese equities
- US dollar

The post-COVID-19 world will likely be a hybrid, combining the old and the new (e.g., mix of work from home and return to office). Sectors with potential for innovation and disruption include health care and technology.

Panelists' preferences on alternative asset classes included:

- Real estate
- Gold and commodities
- Relative value currencies
- Non-directional strategies, such as spread-based trades
- Long-short strategies due to divergence

Panelists discussed a wide range of topics, including views on cryptocurrencies, as well as the deregulation of energy markets, FAANGMs and US-China relations. While some of the CIOs believe cryptocurrencies will likely gain greater acceptance in the medium to long term, others indicated that greater acceptance is subject to the presence of sovereign backing.

There was consensus around three key issues. First, deregulation of energy markets is viewed as highly unlikely, and regulation benefits bondholders. Second, it is unlikely that the FAANGM companies will break up, but the ability to make further acquisitions will likely be challenged going forward. Possibly the most vulnerable to regulation is Facebook. Third, the US-China conflict is serious and here to stay. Other critical areas, in which we could see crises unfolding in the near future, are credit markets and pension fund entitlements.

Endnotes

1. Source: Weinstein, I. *The New Business Case for Video Conferencing*, Wainhouse Research, October 2013.
2. Source: Bloomberg. S&P 500 Index, as of October 2020.
3. Source: Bloomberg. S&P 500 Index, as of October 2020.
4. Source: Securities Industry and Financial Markets Association. As of October 2020.
5. Source: International Monetary Fund. "World Economic Outlooks (October 2020)," *IMF Datamapper*, October 2020.
6. Source: Pienkowski, A. 2017. *Debt Limits and the Structure of Public Debt,* IMF Working Paper, WP/17/117.
7. The personal consumption expenditure price index (PCEPI) is one measure of US inflation, tracking the change in prices of goods and services purchased by consumers throughout the economy.
8. Source: Federal Open Market Committee. Economic Projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, September 2020.

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The hallmark of our approach is a central forum—the Investment Strategy and Research Committee—which generates a top-down view across asset classes and regions, and connects and synthesizes the bottom-up sector and regional insights of the global investment teams at Franklin Templeton.

The FTIS research team features a group of highly specialized quantitative analysts dedicated to the pursuit of new sources of return, strategic diversification and calibrated volatility management, allowing us to apply the highest level of innovation in our client portfolio solutions. In addition to the quantitative research behind this paper, the team is focused on volatility strategies, smart beta strategies and risk premia strategies.

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