INSIGHT

QUARTERLY MARKET REVIEW

Q4 2022

new capital
An EFG brand

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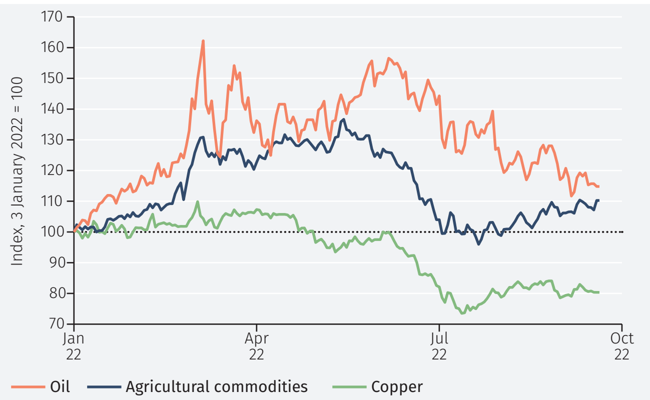
SPECIAL FOCUS

The 'G' in ESG

The focus of financial markets remains firmly on inflation. Expectations for a decline have been misguided in the past, but we are optimistic that it will now recede. We expect the headwinds that have faced markets to ease.

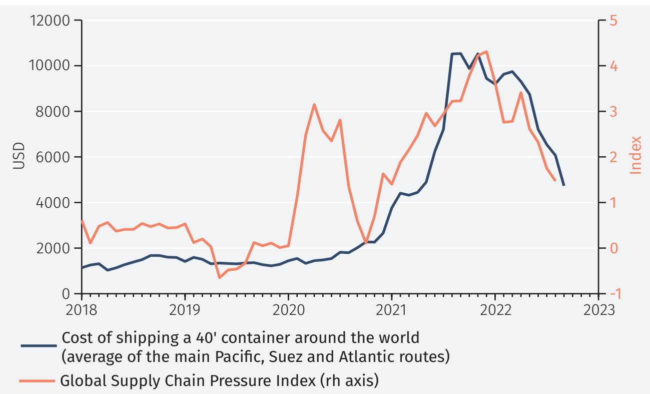
The attention of financial markets in the final months of 2022 will be primarily on one key issue: the path of inflation. In the US, UK and eurozone, markets would like to see a quick return towards 2% central bank targets. That would simultaneously restore policy credibility, ease pressure on interest rates, soothe concerns about an impending recession and underpin equity valuations. A trio of ingredients are in place for those favourable winds to blow. Key commodity prices have fallen back (see Figure 1). Supply chain pressures have eased (see Figure 2). And, from San Francisco to central London, there is a softening of conditions in the housing market. However, optimism about the trend in inflation has been misplaced throughout 2022. There is, therefore, a good deal of nervousness about whether the decline will materialise.

1. Weakening of commodity prices



Sources: Refinitiv. Data as at 1 October 2022.

2. Freight rates and supply chain pressures

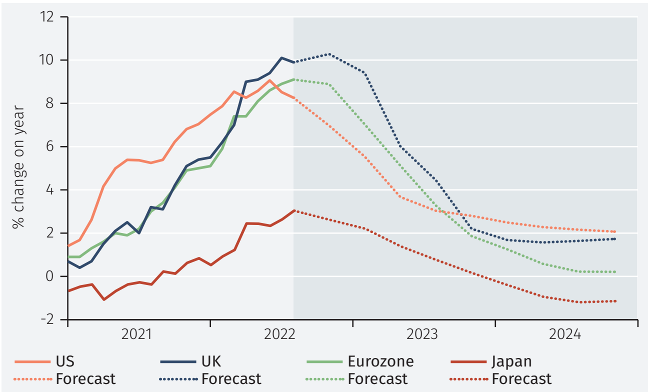


Sources: Freightos and New York Fed via Refinitiv. Data as at 1 October 2022.

Rear view mirror

We are cautiously optimistic that as we travel through late 2022 and into 2023, the inflation spike will retreat into the distance. Projections from one mainstream forecaster are shown in Figure 3. But the journey is unlikely to be smooth.

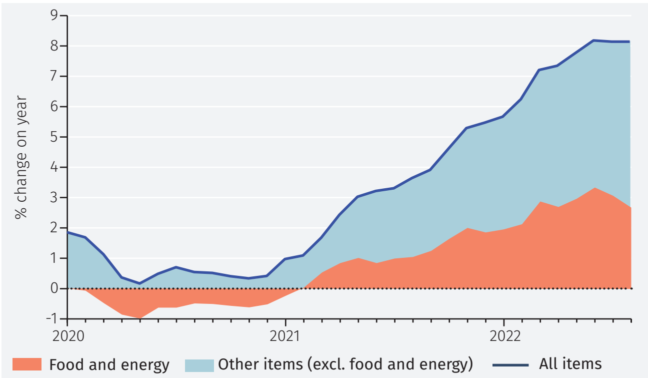
3. Advanced economies' CPI inflation rates



Sources: Refinitiv (actual data) and Oxford Economics (forecasts). Data as at 1 October 2022.

Food and energy prices (often excluded from inflation measures to give a guide to 'underlying' conditions) currently contribute more than two percentage points to the average inflation rate in advanced economies. They 'eat up' central banks' inflation allowance. Adding in the contribution from all other items, the average inflation rate in advanced economies is around 8% (see Figure 4). That is not a picture which suggests that central bank interest rate increases can be reversed quickly. Equally, however, we think there will soon come a time when it is appropriate for them to pause and to assess the tightening which has already taken place. That is especially the case in those economies (notably the US and UK) where important market interest rates (particularly for mortgages and corporate debt) have already risen sharply. In that sense, financial markets have already effected a tightening.

4. Inflation in advanced economies*



*US, UK, eurozone and Japan CPI, weighted by GDP at Purchasing Power Parity (PPP).
Source: Refinitiv and EFGAM calulations. Data as at 1 October 2022.

Obstacles in the road

Although we are optimistic about a retreat in inflation rates, there are two main obstacles in the road ahead. First, in the US economy, 'shelter' costs – actual and implied rents –

account for around one-third of the consumer price index. They tend to lag the trend in house prices. So, the most recent softening of house prices may well not show up in lower consumer price inflation for some time. Second, and much more fundamentally, for two decades the world appears to have been in a state of continued crisis. The global financial crisis morphed into the eurozone crisis; the Russian invasion of Ukraine came before the Covid pandemic was fully in retreat; and the current cost of living crisis is part of a bigger energy security and climate change crisis. By their very nature such crises are hard to predict: we simply do not know what might lie ahead.

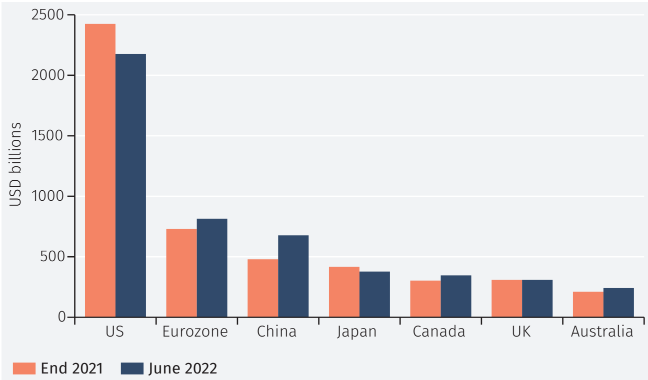
Of course, the policy response to such crises in the past has been to ease monetary policy - to cut interest rates and expand quantitative easing[1] and, more recently, use various fiscal support measures (such as the furlough schemes in response to the Covid pandemic and energy price caps in response to higher oil and gas prices). The big question raised by this is whether such activism can be expected in the future.

Large reversals in policy interest rates have followed previous tightening periods, notably in the US. That may happen again but fiscal policy flexibility is limited. The reaction to recent UK fiscal largesse (a weaker value of sterling, a rise in UK gilt yields, a rebuke from the IMF and unprecedented Bank of England intervention to support the government bond market) is a warning signal for other policymakers considering easing.

The rise in government bond yields we have seen in 2022 can also be seen as an overdue adjustment to low rates. For some time we have highlighted the unusually low, indeed often negative, levels of real bond yields, such as those on Treasury Inflation-Protected Securities (see Figure 5). These have now reverted to positive, albeit still low, rates. Although that reversal in real interest rates has been rapid and has caused some market dislocation, we see positive rates as generally a good sign of appropriate market pricing.

Higher interest rates and bond yields have heightened concerns about recession. Certainly, in continental Europe, the area most directly affected by the war in Ukraine, a near-term recession seems likely; but for the US we still judge any recession as unlikely before 2023 and, even then, mild. Excess savings built in the pandemic still remain high and will help cushion any downturn in consumer spending (see Figure 6).

6. Global excess savings: still around US$5 trillion



Source: Refinitiv and EFGAM calulations. Data as at 1 October 2022.

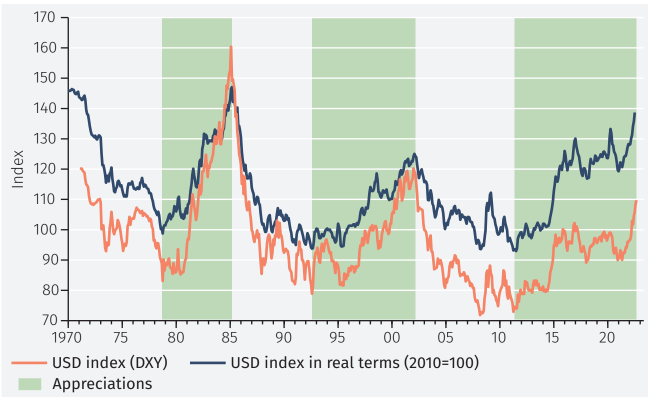
US dollar strength

The other key issue, looking ahead, is whether the US dollar can continue strengthening (see Figure 7). The relative stance of monetary policy (a pause in US tightening as other economies catch up) and the fact that the dollar is nearing historic peaks in real terms suggest to us that the favourable winds helping the dollar will recede.

5. Real yields: back to 'normal'

*Treasury Inflation-Protected Securities. Source: Refinitiv. Data as at 1 October 2022.

7. US dollar index



Sources: Refinitiv and BIS. Data as at 1 October 2022.

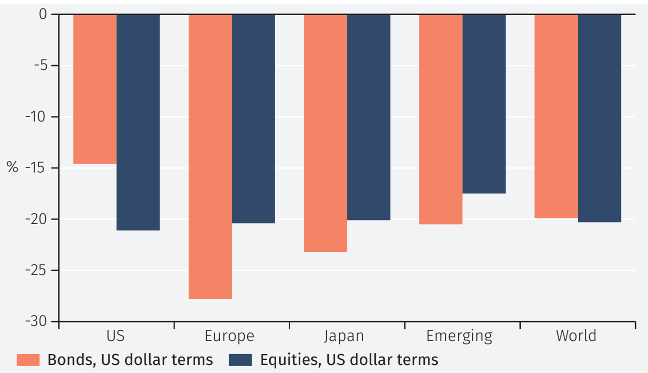
[1] Memorably, Erik Brynjolfsson, Stanford economics professor, commented that "The one thing we've learned ... is that if the Martians invaded Earth, our first response would be to lower interest rates."

Bond and equity market returns were negative across almost all markets in the first three quarters of 2022. The underlying cause was higher inflation, leading to higher interest rates and bond yields. The US dollar strengthened against most currencies.

Asset market performance

Global bond and equity market returns were both negative in the first three quarters of 2022. Returns from both asset classes in US dollar terms were around -20% (see Figure 8).[2] Rising inflation and actual and expected increases in policy interest rates pushed up bond yields around the world, with a consequent fall in bond prices. Such rising interest rates and yields put pressure on equity markets, which were also concerned about slowing economic growth and corporate earnings. In most markets, local currency returns were undermined in US dollar terms by currency weakness.

8. Asset market performance

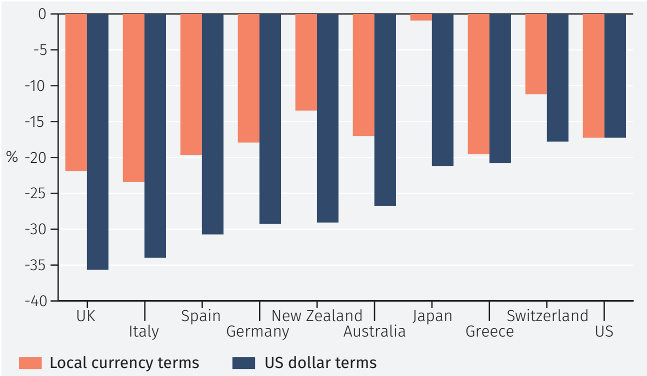


Sources: Barclays Bloomberg (bonds); MSCI (equities). Data for year to date as at 30 September 2022.
Past performance is not necessarily a guide to the future.

Bond markets

There were substantial increases in government bond yields, driving down bond prices, across the major markets in the first three quarters. These ranged from increases of around 230 basis points (in 10-year yields in the US, Germany and Australia) to over 300 basis points in Italy and the UK. The latter two bond markets were undermined by political uncertainties and fears of higher government borrowing. The Japanese bond market remained comparatively stable, with the Bank of Japan continuing its purchases of government bonds, keeping 10-year yields below 0.25%. However, the yen weakened sharply (by around 20%) against the US dollar during the first three quarters of the year, undermining returns in US dollar terms. With sterling and the euro also weakening against the US dollar, UK and eurozone bond markets produced negative returns in US dollar terms of 20-35% (see Figure 9).

9. Bond market returns



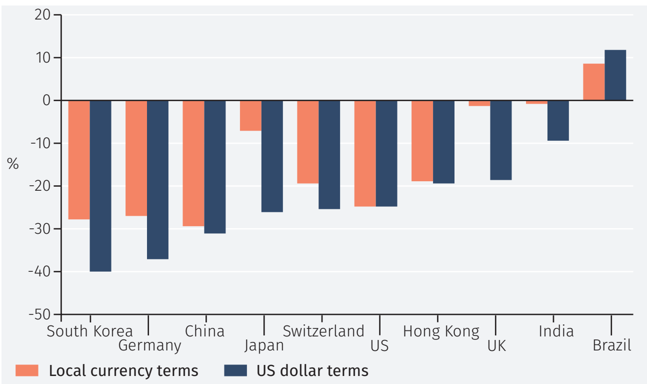
Source: Refinitiv. 10-year benchmark bond total returns. Data for year to date as at 30 September 2022.
Past performance is not necessarily a guide to the future.

Equity markets

Brazil was the one major equity market where positive local currency returns were augmented in US dollar terms by a strengthening of the currency (see Figure 10). Brazil acted early and aggressively to raise interest rates which, by later in 2022, was proving successful in moderating actual and expected inflation and improving the outlook for economic growth. Political developments were also particularly important (see the Latin America section on page 10).

Returns in the other main equity markets were clustered around the -25% return seen in the US market. The Chinese equity market remained weak. There were continued concerns about the property market and the zero Covid policy's impact on growth. The steps towards opening up the Hong Kong economy helped produce better returns there than in mainland China.

10. Equity market returns



Source: MSCI. Data for year to date as at 30 September 2022.
Past performance is not necessarily a guide to the future.

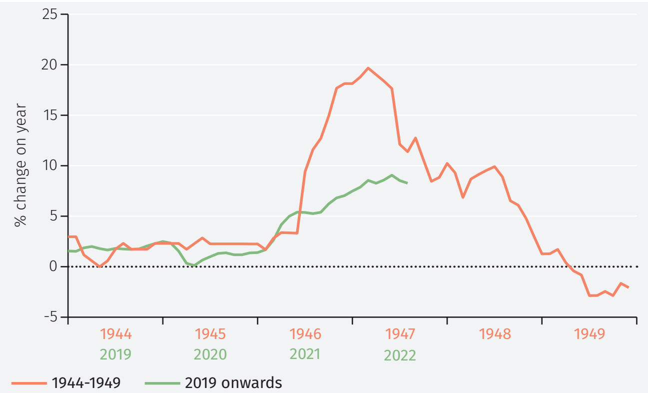
[2] Global bond returns are measured by the Bloomberg Barclays Global Aggregate Bond Index, which comprises government and investment grade corporate debt from developed and emerging markets issuers in 24 countries. Global equity returns are measured by the MSCI World Index which represents large and mid-cap equities across 23 developed markets.

Historic parallels provide some reassurance that inflation can fall. Additionally, financial conditions have tightened. But wage growth remains stubbornly high.

Historic parallels

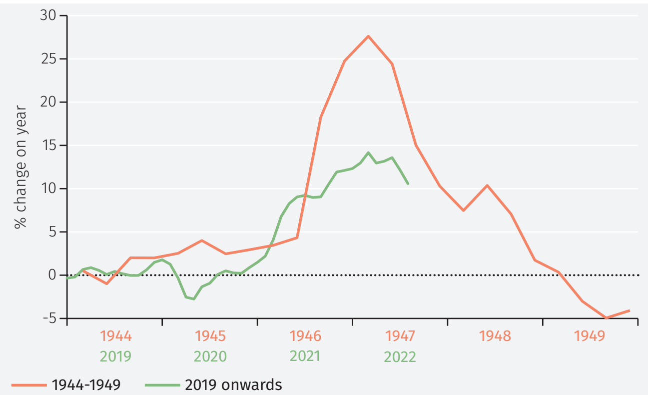
The post-Covid surge in US consumer price (CPI) inflation has some aspects in common with the post-World War 2 surge (see Figure 11).[3] In particular, much of the increase then, as now, came from commodities and reflected supply chain problems rather than excess demand (see Figure 12). As those supply chain pressures eased, so did inflation. This is one reason for us to expect that US inflation will, indeed, subside. The November CPI reading, released on 13 December, will be important, especially as it coincides with a Fed policy meeting.

11. US CPI inflation: post-Covid, post-World War 2



Sources: FRED and Refinitiv. Data as at 1 October 2022.

12. US CPI inflation: commodities



Sources: FRED and Refinitiv. Data as at 1 October 2022.

The other important reason for expecting a slowdown in underlying inflation is that financial conditions have already tightened appreciably. Mortgage rates have risen sharply (see Figure 13) and that is now clearly exerting some downward pressure on house prices which will eventually reduce the 'shelter' component of US inflation. Higher corporate bond yields also represent a tightening of financial conditions and the US dollar strength reduces imported inflationary pressures. Financial markets, in a sense, have done the Fed's work.

13. US Fed Funds, mortgage and corporate bond rates

Sources: FRED and Refinitiv. Data as at 1 October 2022.

Labour market

Set against this is the fact that wage inflation, reflecting a tight labour market, has risen sharply. The year-on-year change in the employment cost index (which takes into account other employment costs, as well as wages) is running at its fastest rate since the early 2000s (see Figure 14). The tricky balancing act remains, therefore, reducing wage inflationary pressures without bringing about a recession.

14. US wage growth

Sources: Atlanta Fed and Refinitiv. Data as at 1 October 2022.

Close attention will be on the trend in the unemployment rate to assess whether this is happening. The Sahm indicator, named after its inventor, has been a reliable indicator of the onset of recession in the past. It is based on the unemployment rate compared to its recent lowest rate. Just a small rise in the rate (0.3 percentage points) coincided perfectly with the onset of recessions in 2001 and 2007. In current circumstances, if the unemployment rate were to rise to 3.9% that would be the signal that a recession has started.

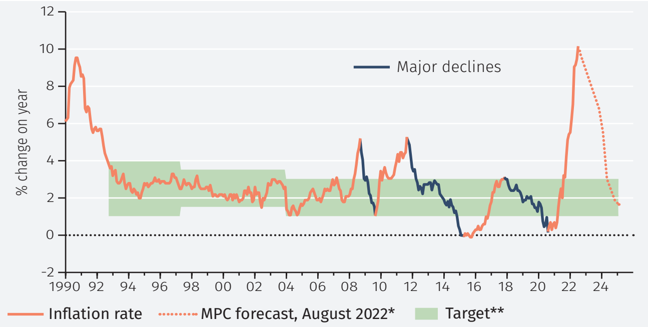
[3] Credit for this observation goes, particularly, to Dick Hokenson, *Inflation Hysteria Redux*, 21 September 2022.

The ingredients for a reduction in UK inflation seem to be already in place. However, uncertainty about policy direction remains a key issue.

Bringing inflation down

The UK first set an inflation target in 1992, shortly after the UK left the European Exchange Rate Mechanism, when sterling was linked to the Deutschemark. Five years later, the new Labour government granted the Bank of England independence in setting policy, reaffirming and slightly revising the inflation target. Although the inflation target has been met most of the time, we are now seeing the fourth major overshoot during the inflation targeting period. Encouragingly, all three previous overshoots were followed by major declines (see Figure 15). It is instructive to assess the reasons why. Much lower oil and commodity prices were a feature of all three periods; two of the three saw a UK recession. *None* of the periods saw higher interest rates; and *all* of the periods saw sterling weaken against the US dollar. On that basis, the current combination of lower oil and commodity prices; a likely recession; and higher interest rates seems a sure recipe for inflation coming back down. It may well constitute overkill.

15. UK inflation target



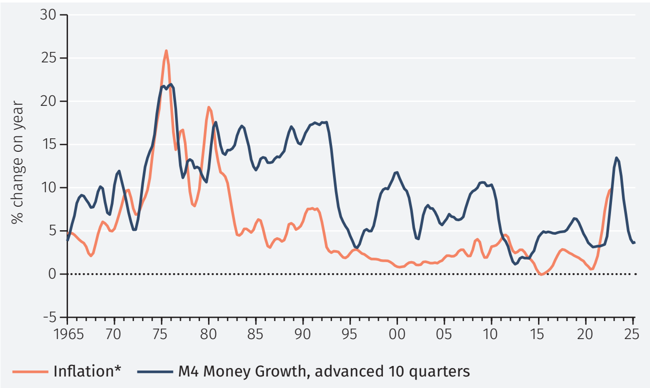
*MPC= Bank of England Monetary Policy Committee. Forecast adjusted to account for fuel price cap announced in September 2022.
**Target was first set in October 1992 for RPI (Retail Price Index) inflation of 0-4%. In May 1997, it was revised to 2.5% +/-1% and further revised in December 2003 to CPI inflation of 2% +/-1%.
Sources: Bank of England and Refinitiv. Data as at 1 October 2022.

Banks, money and inflation

At the same time that the Bank of England was given independence in 1997, banking supervision was taken away from it (and transferred to the Financial Conduct Authority). One criticism of that move was that the Bank became too technocratic, concentrating on inflation targeting itself and less on assessing monetary growth and credit conditions – driven, primarily, by the banking system.

Banking supervision was handed back to the Bank after the global financial crisis, but even since then there has been a notable absence of attention paid to money and credit growth. This was of pivotal importance in the assessment of inflation and broader economic prospects in the 1970s and 1980s. A downplaying, indeed disregard, of it has been a fundamental weakness in the assessment of UK Inflation prospects. Faster broad money growth preceded the recent upsurge in inflation; the more recent slowdown supports the case for lower inflation in the future (see Figure 16).

16. UK broad money and inflation



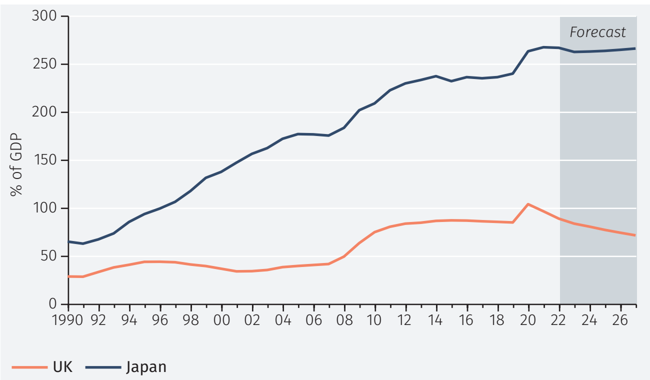
*CPI from 1989; RPI beforehand. Sources: Bank of England and Refinitiv. Data as at 1 October 2022.

Fiscal-monetary interaction

The government's September 'mini-budget' plans, involving a substantial easing of fiscal policy, have now largely been overturned following the adverse financial market reaction: notably, a substantial fall in long-dated government bond prices and in sterling's exchange rate against the US dollar. The emphasis is now on ensuring fiscal sustainability. The IMF's latest forecasts show this is set to be achieved, with government debt steadily falling relative to GDP (see Figure 17). It is most unlikely to rise on a multi-year basis, as has been seen in Japan, for example.

Indeed, there is a risk that fiscal policy verges on being too tight, easing the need for monetary policy tightening. Given the swings in policy direction seen in September-October, however, the outlook is uncertain.

17. UK government debt



Source: IMF Fiscal Monitor database via Refinitiv. Data as at 17 October 2022.

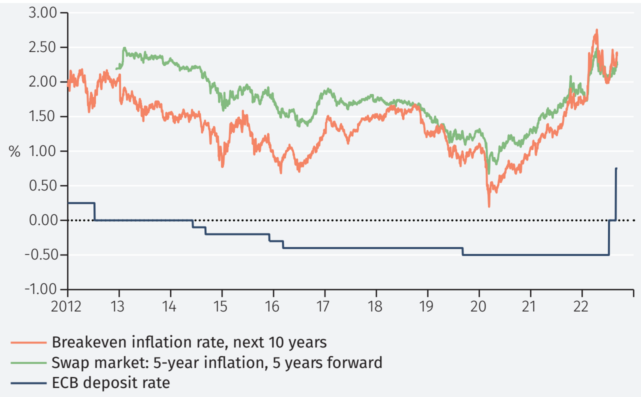
EUROZONE

Setting eurozone interest rates in the face of deteriorating inflation expectations, weak and divergent growth and a strong US dollar will continue to pose a challenge.

Cardinal principles

Isabel Schnabel, ECB Governing Council member, recently claimed that “a cardinal principle of optimal monetary policy in a situation of above-target inflation is to raise nominal rates by more than the change in expected inflation”.[4] While that sounds straightforward, the practical implementation is not. Inflation expectations are hard to measure: on two financial market-based measures (see Figure 18) German inflation expectations stand at around 2.0-2.5%. German households expect inflation over the next 12 months to be 5%; but Italian households forsee 8%.[5] ‘Nominal rates’ could refer to ECB policy rates (0.75%) but equally they could refer to longer-term bond yields which vary from 2% in Germany to 4% in Italy.

18. ECB policy rate and euro inflation expectations



Source: Refinitiv. Data as at 1 October 2022.

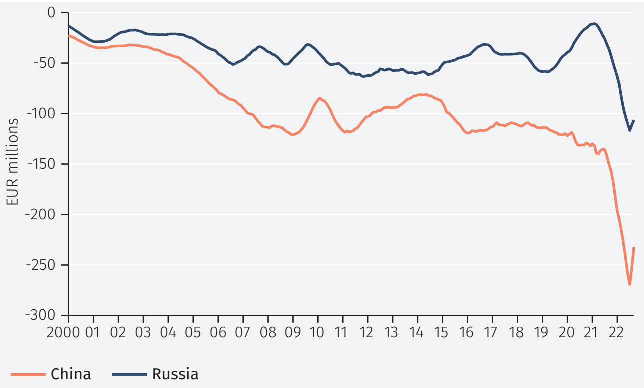
So, although the cardinal principle sounds clear, its interpretation is not so straightforward.

Three complications

Setting ECB policy faces three further complications. First, the eurozone most likely faces a recession in the short-term and overall weak growth in 2023 (see Figure 19). But the core economies (Austria, Germany, France and Italy) face much weaker growth than the periphery (Greece and Ireland, for example).

To a large extent this divergence reflects the second complication: the differential impact of trade with Russia; and the effects of the slowdown of the Chinese economy. The overall eurozone trade balance with those two economies has worsened (see Figure 20), but the impact has been larger on the core economies.

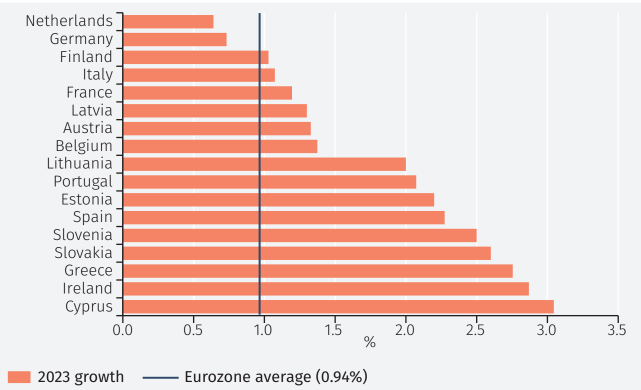
20. Eurozone trade balance with China and Russia



Source: Refinitiv. Data as at 1 October 2022.

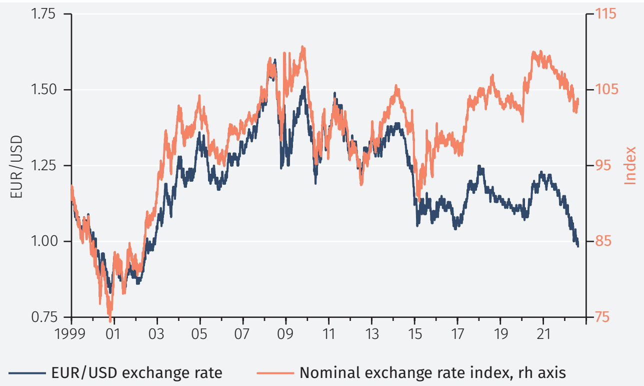
Third, the weakness of the euro against the US dollar may itself become a more important issue (see Figure 21). The concern is that it leads to an increase in imported inflation. However, the euro’s overall nominal exchange rate index has actually been stable to stronger recently, mitigating concerns about inflation and competitiveness. Building a consensus around ECB policy will be a difficult task for Madame Lagarde.

19. Eurozone: Divergent GDP growth in 2023



Source: Consensus Economics via Refinitiv. Data as at 1 October 2022.

21. Euro against US dollar and exchange rate index



Source: Refinitiv. Data as at 1 October 2022.

[4] *Monetary policy and the Great Volatility*, https://tinyurl.com/36e72zh6
[5] https://tinyurl.com/mryc449a

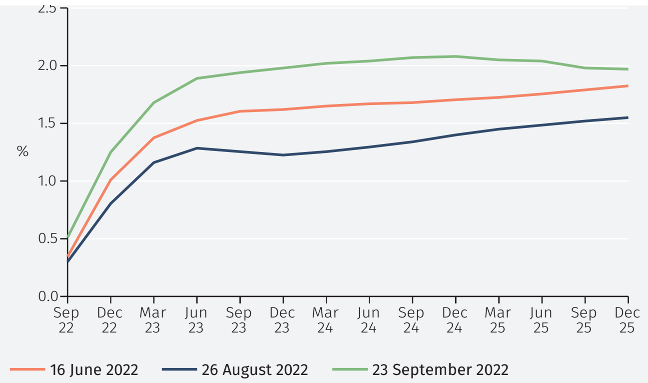
SWITZERLAND

The Swiss National Bank raised rates by 0.75% in September, ending the era of negative policy rates. However, we see the SNB as more dovish than the move would suggest.

Swiss interest rate expectations

Despite raising rates by an unprecedented 75 basis points to 0.50% in late September, the Swiss National Bank (SNB) sent a surprisingly dovish signal to markets. While other central banks, including the US Federal Reserve and the European Central Bank, are keen to indicate that they will continue to increase rates forcefully to counter high inflation, the SNB only reiterated that further rate increases “cannot be ruled out”. Hence, although another rate increase before the end of 2022 remains possible, it is not certain that it will actually happen, let alone be as large as another 75 basis points, as markets expect (see Figure 22).

22. Implied Swiss 3-month interbank rates



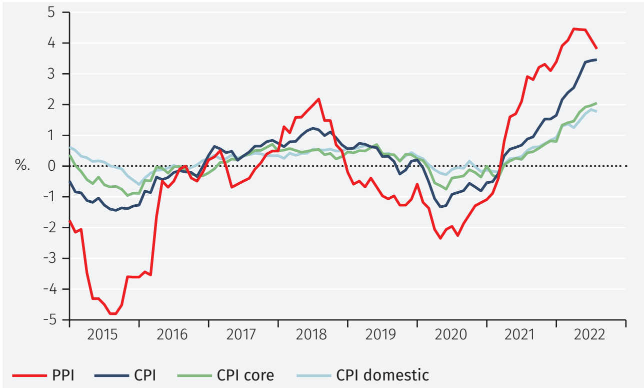
Source: Refinitiv. Data as at 1 October 2022.

In fact, the SNB set a high bar for new, aggressive rate increases. The new SNB conditional forecast sees quarterly inflation at 3.4% year-on-year until the first quarter of 2023. It is then expected to decline to 1.6% in early 2024 before rising again towards 2% in mid-2025. So, unless inflation exceeds the short-term forecasts, the SNB could conclude at its December meeting that the policy rate needs only a small increase to ensure that inflation falls back and stays within the 0-2% target range in the medium term.

Profile of the inflation outlook

That potentially cautious stance rests on good foundations. Current high inflation mainly reflects exogenous shocks to energy and food prices that are beyond the influence of monetary policy. With the increase in interest rates, the SNB aims to prevent the spread of inflationary pressures to other goods and services. It is encouraging that Swiss producer price inflation has recently declined because of weaker commodity prices (see Figure 23). If these trends persist, the high correlation between Swiss producer and consumer prices suggests that CPI inflation will indeed fall in the first quarter of 2023.

23. Swiss inflation

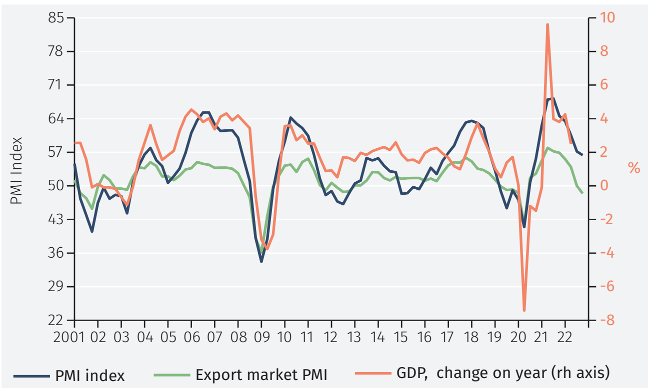


Source: Refinitiv. Data as at 1 October 2022.

Swiss franc valuation

Furthermore, the SNB recognition that the global economy has slowed “considerably”, represents a downside risk to growth in a small open economy like Switzerland (see Figure 24). The downside risks to growth are exacerbated by the preannounced policy tightening by central banks around the globe. In addition, weaker global demand will help to ease supply chain bottlenecks that have pushed prices higher following the reopening of the global economy after the pandemic. Finally, the strength of the Swiss franc supports the SNB’s cautious approach. Since mid-June, the trade weighted exchange rate of the franc has risen by more than 5%. Furthermore, the fundamentals continue to support a rise of the Swiss franc *vis-à-vis* the other major currencies in the longer run, and that would help to contain inflation in Switzerland.

24. Swiss business confidence and GDP growth



Source: Refinitiv. Data as at 1 October 2022.

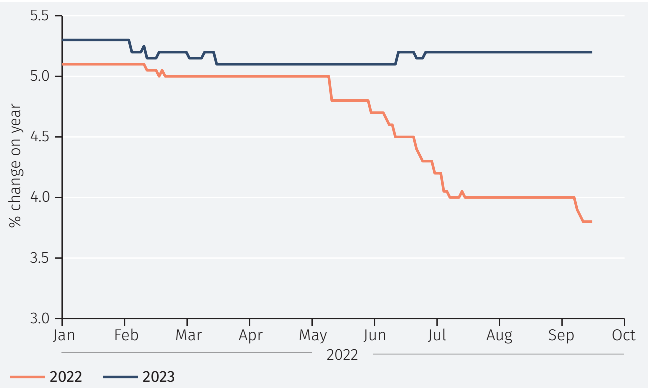
As SNB President Jordan has noted, central banks should consider the risk of overtightening, potentially leading to the return of too low inflation, if not deflation.

China's economy has weakened but policy easing means we expect improved conditions in 2023. Other Asian economies are well positioned to benefit from easier credit conditions.

China: missing the growth target

Expectations for Chinese GDP growth this year have been progressively revised down, especially since the summer (see Figure 25). The depressing effect of continued problems in the housing sector – weak new construction activity and new home sales – and the impact of the zero Covid policy have been the main explanations. Looking to 2023, consensus expectations are for growth to return to the government's 5.5% target. This seems a reasonable expectation to us for three main reasons.

25. China: expected GDP growth in 2022 and 2023

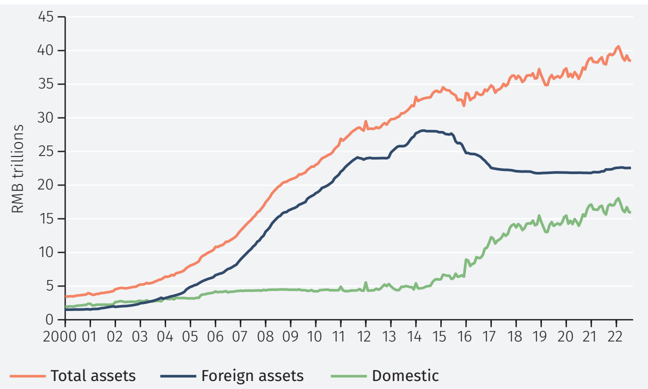


Source: Factset. Data as at 1 October 2022.

Reasons for a rebound

First, the central bank, the People's Bank of China (PBoC), continues to expand its balance sheet. Now, that is mainly because of the acquisition of domestic assets rather than (as was the case in the past) foreign assets (notably foreign exchange reserves), as shown in Figure 26. Effectively, this is China's version of the quantitative easing pursued by western central banks.

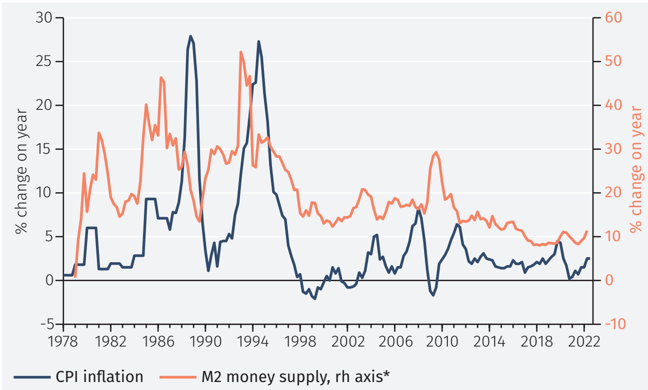
26. China: central bank balance sheet



Source: Refinitiv. Data as at 1 October 2022.

Second, money and credit growth have remained relatively subdued as a deliberate act of policy. Concern that faster money and credit growth could stoke higher inflation is, of course, well-founded in China's monetary history – not just the experience of the expansion after the global financial crisis but during the 1980s and 1990s (see Figure 27). Modest money growth recently has meant that domestic Chinese inflation has remained under control. Third, consumer price inflation was only 2.5% year-on-year in August 2022, having risen from a rate recently close to zero. In that context, inflation does not act as an obstacle to further easing.

27. China: money and inflation

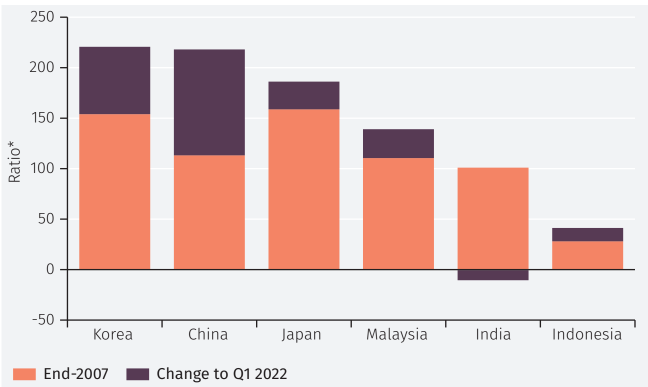


*M1 from 1978-1981. Sources: John Greenwood, IMF and Refinitiv. Data as at 1 October 2022.

Credit in other emerging economies

Credit growth in China since 2007 has been strong (see Figure 28) – hence the recent emphasis on restraining further growth. In other Asian economies, however, credit growth has been much more restrained. That is a key reason why we think there are relatively more interesting opportunities in those markets: credit growth can facilitate economic growth in the coming years with, hopefully, the lessons learned from China's experience cautioning against any over-exuberant expansion.

28. Asian credit*/GDP ratios



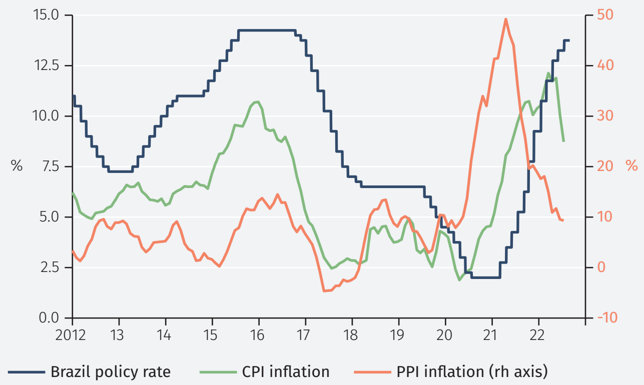
*Credit to private non-financial sectors. Source: BIS via Refinitiv. Data as at 1 October 2022.

Brazil reacted quickly and aggressively to rising inflation. The result, now, is a decline in inflation and improved growth.

Brazil's reaction to higher inflation

Producer price inflation in Brazil – an indicator which leads more general consumer price inflation by around six months – started rising in early 2020. The policy response was initially relatively slow – it was only when consumer price inflation had started to rise that interest rates were increased. But once that ratcheting up of interest rates started, it was determined and aggressive. In total, there have now been twelve increases in Brazil's policy interest rate, taking it to 13.65% (see Figure 29). First, producer price and now consumer price inflation have turned decisively lower. Interestingly, Brazil's central bank was not given full autonomy until 2021: perhaps, therefore, its actions can be interpreted as an exercise of its new-found freedom.

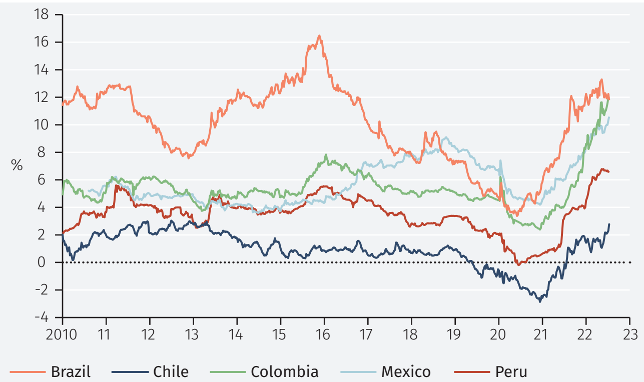
29. Brazil: inflation and policy rate



Source: Refinitiv. Data as at 1 October 2022.

Encouragingly, 2-year local currency bond yields now seem to have stabilised (see Figure 30) and the Brazilian real has been one of the few currencies in the world to gain against the US dollar in 2022.

30. Latin America: 2-year government bond yields (local currency)



Source: Refinitiv. Data as at 1 October 2022.

Rising to the challenge

Encouragingly, the pessimism about Brazil's growth prospects which was widely evident at the start of the year (a pessimism which we did not share) proved unfounded: economic growth projections for the full year have been revised steadily higher since April/May. This is even more impressive given the downward trend in advanced economies' growth over the same period (see Figure 31).

31. Brazil: expected GDP growth in 2022

Source: Factset. Data as at 1 October 2022.

Political uncertainty

The major challenge facing Brazil in the rest of the year relates to political uncertainty. With neither incumbent President Bolsonaro nor former President Lula obtaining an absolute majority in the first round of elections in October 2022, the second round run-off also looks likely to be tight.

A return to office for Lula, who led Brazil from 2003 to 2010, would mark an extraordinary political comeback. He was jailed in 2017 following a corruption investigation. He was released in November 2019 and his criminal convictions were later annulled, paving the way for him to seek a return to the presidency.

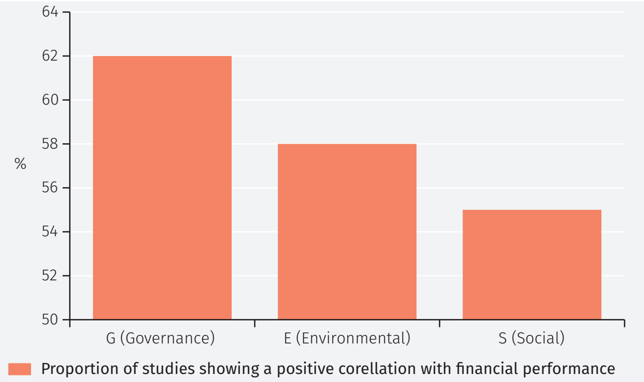
Bolsonaro has been criticised for an initially slow response to Covid and has faced possible impeachment.

In terms of economic policies, Lula's pledge to reform policy resonates with calls around the world. It remains to be seen how much either candidate can achieve once elected, given the notoriously fragmented nature of the Brazilian legislature.

As ESG (Environmental, Social and Governance) investing has become much more popular in recent years, the ‘G’ – governance element – has tended to be overshadowed by the ‘E’ and ‘S’ factors. A reappraisal is needed.

The ‘G’ in ESG investing refers to the governance factors which are considered alongside ‘E’ (environmental) and ‘S’ (social factors). Although G factors tend to have been overshadowed by the other two, one influential study shows a closer link between governance factors and corporate financial performance than the other two (see Figure 32).

32. ESG and corporate financial performance



Source: Friede, Busch and Bassen, ‘ESG and financial performance: aggregated evidence from more than 2000 empirical studies’. *Journal of Sustainable Finance & Investment*, 15 December 2015.

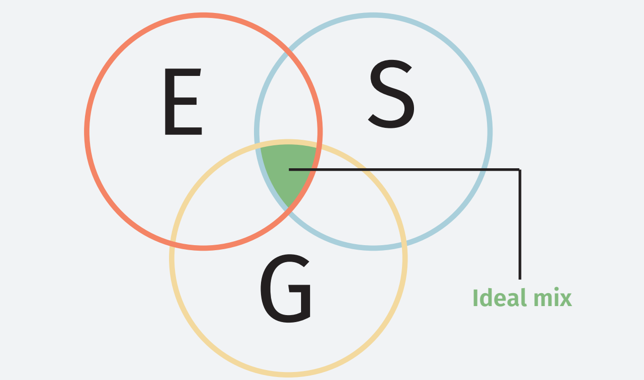
Effective governance is, however, far from a new concept. The first formal corporate governance code emerged in the UK in 1992 following the work of the Cadbury Committee. Much of what it recommended (an audit committee meeting at least twice a year and the separation of the roles of CEO and chair) is still included in corporate governance codes. Importantly, however, there is now a much greater emphasis on board leadership and company purpose.

Old ‘G’

Opinions on what interests should be prioritized in corporate decision-making are split. The ‘traditional’ view was that good governance involved maximising financial returns for shareholders. In August 2019, however, an important step was taken when major corporations worldwide declared as part of the Business Roundtable[6] that companies should commit to lead their companies for the benefit of all stakeholders – customers, employees, suppliers and communities – along with shareholders. Companies should support the communities in which they work and protect the environment by embracing sustainable practices.

In terms of asset management, the choice of assets to satisfy these requirements would therefore be at the intersection of those that have good governance as well as social and environmental practices (see Figure 33).

33. G: overlap with E and S



Source: EFGAM for illustrative purposes only.

ESG ratings

It is hard to object to such a principle but in practice ESG assessments are not black or white but rather are on a scale. ESG ratings are sometimes compared to credit ratings but the ratings of different ESG rating agencies often diverge.[7] Investing according to ESG considerations, even with such imperfect ratings, involves reallocating capital according to ESG metrics. But there is scepticism about whether this can really ‘change the world’.[8] Rather, the evidence is that more active pressure on improving governance is a more effective route.

Activist investors

The actions of Engine Number 1 in utilising its 0.02% stake in Exxon to effect governance changes are particularly notable in this respect.[9] It argued that the company’s climate approach and its financial underperformance were deeply intertwined and that only changes to the board and strategy would fix it. Exxon responded to the pressure with its own climate initiatives, including new emissions reductions targets and the creation of a low-carbon business. It appointed three new board members.

We think we will see many more examples of such governance changes. It is set to become one of the most important themes of coming years.

6 https://tinyurl.com/2d86y8uz
7 See, in particular: Berg, Florian and Kölbel, Julian and Rigobon, Roberto, ‘Aggregate Confusion: The Divergence of ESG Ratings’ (15 August 2019). *Forthcoming Review of Finance*, Available at SSRN: https://ssrn.com/abstract=3438533 or http://dx.doi.org/10.2139/ssrn.3438533
8 Comments made by Jason Jay, MIT Sloan Sustainability Initiative and EFGAM Future leaders panelist: *ESG — Climate Saviour or Greenwashing?* https://www.youtube.com/watch?v=C96iovYccSU
9 https://www.ft.com/content/ebfdf67d-cbce-40a5-bb29-d361377dea7a

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