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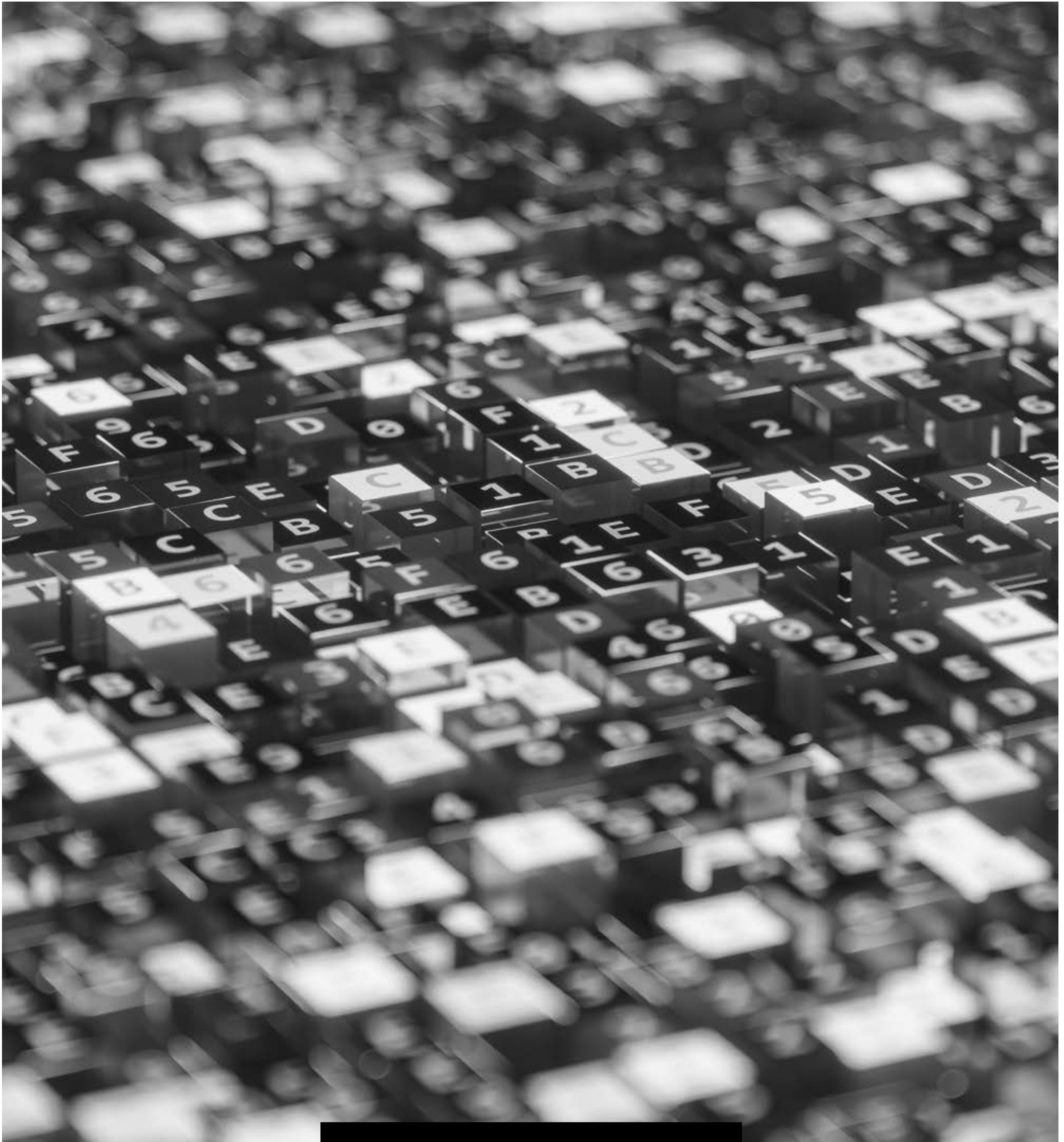
ANNUAL OUTLOOK 2021: SILVER LININGS

— *Alexis Crow*



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Introduction

One year after the first deaths due to COVID-19 were announced, the world is still grappling with the twinned health and economic crises resulting from the pandemic. At the start of 2021, it is evident that an uneven economic recovery has taken shape across the globe, with some countries -- such as Taiwan and Vietnam -- having experienced remarkably few cases, whilst others -- namely, the US, India, Brazil, and parts of Europe -- are still contending with successive waves of the virus and associated lockdowns.

Whilst central banks and governments continue to direct unprecedented amounts of relief and stimulus packages toward shoring up their economies -- and as the world awaits rapid and successful dissemination of multiple vaccines -- we weigh up the prospects for economic growth and recovery, and financial distress, as well as long-term investment opportunities in 2021. At the macroeconomic level, we consider the divergence between financial markets and economic reality within the US, and the impact on asset prices, as well as the outlook for corporate insolvencies in 2021. And at the socio-economic level, we explore deepening and widening income inequality, as well as the downside impacts of high food prices for both advanced and developing economies. Finally, in looking around the world and identifying opportunities, we shine a light on the prospects for investing in South Korea's Green New Deal; and also in AgTech and FoodTech in key geographies including India and Singapore.

US equity markets, asset prices, and economic activity

Despite America's posting of record COVID-19 cases and fatalities , and political instability in Washington, US equity markets continue to smash records. This is in part a phenomenon which predated COVID-19. Investors and traders have banked upon the Federal Reserve maintaining an accommodative stance, with officials having halted the path to policy normalisation and cutting rates in 2019 (throughout the volatility of the US-China trade tensions) -- and also by keeping rates close to the zero bound amidst the depths of -- and eventual recovery from -- the coronacrisis. The rally has also been largely sectorially concentrated in BigTech and in US financials -- two sectors which are seen to be immune from the economic stops wrought by the pandemic — as well as (and perhaps naively) thought to be shielded from US-China trade tensions. And with interest rates at historic lows in many advanced economies around the world, investors continue to pile in to equity markets, further propping up valuations.

Sky-high financial markets -- and a plethora of fixed income trading at negative yields -- have also contributed to lofty prices within the real asset space. In sectors such as real estate and infrastructure, there has been a lot of room for price discovery between buyers and sellers, with prices remaining elevated, even despite severe economic distress.

And yet, despite record highs and lofty valuations, the US remains in a very deep economic hole. Jobless claims remain elevated, with 965,000 Americans filing for new claims in early January 2021, and with 18.4 million people currently collecting unemployment aid of some kind (out of a labor force of 161 million). And, consistent with labor market dynamics throughout 2020, the bulk of these jobless claims are in the leisure and hospitality sectors, specifically in food services and accommodation. Sectors including mining, oil and gas, retail, and some transport and health care also remain hard-hit.

COVID-induced bankruptcies, delinquencies, insolvencies: the coming storm in 2021?

Set against this backdrop, observers ponder whether 2021 might become the year of reckoning for a wave of potential defaults, bankruptcies, and delinquencies, which have been put on ice in 2020. Largely as a result of unprecedented amounts of fiscal and monetary stimuli enacted by governments across the globe, the world has thus far managed to avert a financial crisis, even despite the twinned health and economic crises which continue to unfold in many regions. Such policies have channeled liquidity support to households and to companies in the face of sudden economic stops, and the ongoing pandemic. Where might we see some adjustment?

On the corporate side in the US, many of the defaults, restructurings, and Chapter 11 filings which took place in 2020 shook out for companies suffering from 'pre-existing conditions' before the virus. Some companies within the retail landscape and the US shale oil and gas space contended with long-term secular decline to their industries (with the rise of 'athleisure' and the decline of brick and mortar in retail; and climate-related headwinds and the high cost of drilling associated with US shale oil and gas).

Additionally, in recent years, many non-financial corporates have taken on significant leverage. From 2016 to Q1 2020, total non-financial corporate debt swelled from $12 trillion to $75.5 trillion, reaching an historic high of 95 percent of GDP. In addition to debt accumulation, the deterioration of credit quality has been touted as a key risk in the dashboard of the global economy. Indeed, even prior to COVID-19, some Fed officials have voiced their concerns surrounding financial vulnerabilities rippling within the corporate sector. On a global basis, firms piled up $1.5 trillion worth of leveraged loans during 2019. Also in recent years, there has been a deepening relationship between ETFs and passive investing within the corporate bond market. At the end of 2019, mutual funds and ETFs held some 16 percent of the corporate bond market, potentially rendering it prey to a redemption risk, such as during an earnings recession.

In the wake of COVID-19, sudden economic stops did not inflict acute distress for the top tier borrowers. Actions taken and sustained by central banks throughout 2020 enabled many corporates to go out to the credit markets to top up with cheap leverage, borrowing at record low interest rates. And by acting as buyer of the last resort -- and buying up some of the high yield debt through ETFs -- the Fed stabilised the corporate bond market within the first few weeks and months of the pandemic in the US. With the Fed as a backstop, some investors were willing to pile into high yield and junk debt funds, even throughout the depths of the crisis. In Europe, the ECB and governments continue to provide liquidity support, in the form of direct loans to banks to keep lending to companies, as well as administering state guarantees for banks whose loan payments might be deferred or suspended.

As jobless claims remain elevated, we forecast that financial distress is likely to unfold in 2021. Recent research points to a 'strong and intuitive historical relationship' between the level of unemployment -- as a barometer of the economy -- and 'the frequency of business bankruptcy. Data posits that at a 9.2 unemployment rate, the rate of business bankruptcies can increase by 140 percent, when compared with 2019 levels. This would amount to 91,256 bankruptcies within a year, which would cost an aggregate of $282 billion, or 1.4 percent of US GDP.

It is important to point out that many of the Chapter 11 filings in 2020 have been for large businesses. And in the face of negative sales wrought by COVID-19, many small to medium enterprises (SMEs) have experienced acute financial distress. For businesses with less than $1 million in annual revenue, a 30 percent plunge in annual revenue -- without offsetting fixed costs -- can destroy the equity of the company. Without the ability to go out to the capital markets to raise debt, and burdened with high fixed costs (think of a restaurant owner paying rent in New York City), many small businesses have had to make the difficult choice to close. Restructuring and bankruptcy filing can also be cost prohibitive for SMEs, with the cost of distress estimated to tally at around 10-20 percent of firm value.

What would the impacts be of a coming deluge, as well as potential solutions? Certainly, a surge in bankruptcies has the potential to overwhelm judges and caseloads,

with a potential increase of 158 percent, from the level in 2019. In considering the interconnection between firm and bank balance sheets and the risk of contagion for financial markets, in the case of the US, it seems unlikely that the banks will incur significant losses, given the fact that liquidations are more likely to occur within the small to medium enterprise space: since the Global Financial Crisis (GFC), the big banks have curtailed their lending to SMEs. Concerns remain surrounding the predominant share of the employment base which is made up of small and medium enterprises (SMEs): S&P 500 companies employ roughly 17 percent of the US workforce, vs 83 percent for SMEs. The US restaurant industry alone employed 12.3 million people before COVID-19.

While successive waves of stimulus have been directed at shoring up small businesses, many business owners have been confused about whether the relief provided is a grant or a loan. If the latter, it might result in a debt overhang which many found unpalatable in the face of plunging sales and economic uncertainty. Consequently, some of the stimulus funds remain untapped.

Certainly, we always learn from the last crisis: US banks are arguably in much better health after the GFC. If we consider COVID-19 as the severe shock to small businesses in the real economy -- constituting the backbone of the US employment base -- we need to consider ways in which to reform lending to small and medium enterprises (SMEs) during the good times -- and to reform liquidity support when the business cycle stops. Given the focus on climate change, tax credits can be stepped up for companies investing in the energy transition. And as we consider the need to invest in skills and upskilling our workforce for the future, SMEs which invest in skills and vocational could also be provided with tax credits. Currently, the ability to invest in upskilling remains the preserve of the biggest companies who can afford such investments. Given the scope and the need for change, we would do well to implement structural changes to be able to make such investments attractive, affordable, and digestible for SMEs.

Social pressures: deepening and widening income inequality

Beyond the spectre of looming corporate distress, many balance sheets at the household and individual level are under deepening duress. With jobs and incomes slashed, many American households remain in a state of acute economic insecurity: nearly 12 million renters will owe an average of $5,850 in back payments of utility and rent in January 2021. According to the Census Bureau, many African American and Latino families are struggling not only with housing insecurity, but also with food insufficiency.

While markets remain buoyant that a Democrat-controlled Senate might usher in successive waves of stimulus and relief measures -- and while these packages do indeed provide rental assistance and income support -- it is important to note that the cost of basic human needs such as rent, food, and medical and hospital services continues to rise in the US.

Indeed, even amidst an otherwise stable price environment prior to the onset of COVID-19, the rising costs of shelter and healthcare eroded real incomes for the bottom quintiles of the income distribution in America. Yes, the US boasted multi-decade lows in unemployment at the start of 2020: however, for the bottom three quintiles of the income distribution, real incomes have stagnated, and have been further etiolated by these rising costs of health and shelter.

As we emerge from the pandemic, and as this crisis gives way to eventual recovery, policymakers should focus on implementing longer lasting structural changes in order to address social problems when economic stops

suddenly occur. Indeed, COVID-19 has revealed how variegated fiscal programmes are, even within advanced economies. Countries such as Germany and France with strong social safety nets relied upon 'automatic stabilisers' -- that is, welfare schemes which were already in place -- to be able to provide lifeline support to households in need. These are akin to having a large hose in place to address a sudden drought, when it occurs. By contrast, the US enacted discretionary transfers, the dissemination of which was often held up by political gridlock. These payments were somewhat like passing buckets of water down a long and winding path, rather than having a hose already in place to reach the drought expediently and efficiently.

Important policy prescriptions are currently underway for the ways in which the US might be able to implement lasting structural changes, including implementing automatic stabilisers, in order to enable more stability in the system once the shocks inevitably occur. In so doing, the US would learn not only from the experience of the COVID-19 crisis, but also indeed from the policies of other countries. Investing in infrastructure is also a critical relief measure which would bolster current and future economic growth, both directly and indirectly. With the new Biden administration, many will be looking to the US to pass a long-awaited infrastructure bill, which -- with the President's focus on climate change -- is likely to contain a significant focus on the environment and sustainability.

Social pressures at the global level: an eye on high food prices

At the start of 2021, global food prices have hit a six year high. In the wake of the supply chain and production shocks wrought by COVID-19, adverse weather conditions, and the lockdown effect of people dining at home, the price of some food commodities skyrocketed in 2020. In June 2020, the price of rice reached the highest level since 2011 , and the price of coffee spiked throughout 2020 a result of both extreme weather as well as household hoarding under lockdown. For many food crops, La Niña has impacted production, generating excess rainfall in some regions, and a drought in others. And, according to the FAO, export controls by some of the world's largest agricultural producers are also contributing to an uptick in prices in key food crops such as corn and wheat.

In addition, the bear market for the US dollar (USD) has also amplified food prices, given the inverse relationship between the value of the USD and most commodities. As currencies generally track economic performance, we are likely to see continued softening of the USD until American economic recovery is on track -- likely for Q2 2021, in an optimistic scenario. Thus, with strong demand, the increase in adverse weather-related events, and a depreciated US dollar, food prices are likely to remain elevated throughout much of 2021.

The implications of this are that many poorer nations face critical shortages of food, and food insecurity for their populations. Even in nations of seeming abundance such as the US, many households contend with hunger and the ability to meet the nutrition needs of their children. The higher cost of basic human needs -- such as food, healthcare, and rent -- further compound etiolated incomes within advanced economies. And, in countries where consumption fuels a significant portion of annual economic activity -- diminished purchasing power weighs on the economic outlook.

Additionally, for some emerging markets (EMs), rising food prices present a conundrum for inflation-targeting central banks. Many EMs have been successful at keeping inflation under control whilst embarking upon unprecedented stimulus programmes in response to COVID-19. However, for a country like Brazil, the central bank and the government may need to make difficult decisions to withdraw expansionary policy in order to curtail inflation, and before their economies are in full swing recovery. And in India, stagflation -- that is, a time of slow economic growth, but with high interest rates in order to curb inflation -- might ensue. Beyond the macroeconomic level, and thinking to the geopolitical nexus, high food prices might also spur popular discontent and instability. According to the FAO, the current elevated prices might provide a 'recipe for social unrest.'

At the global level: opportunities for long-term investing

In considering geographies and sectors ripe for investing, certain Asian countries -- and certain sectors of basic human need -- infused with venture and technology - stand out. Amidst a polarised geopolitical landscape, with ongoing tensions between the US and China, some rich income Asian countries can at times be overlooked in the horizon for capital allocation. One country which appears to be on a blossoming green path to recovery is South Korea. Indeed, while the world focuses on the great green 'reset', and the climate change agenda is front and center for policymakers across the globe, South Korea offers an attractive opportunity for investing in green infrastructure, real estate, and innovation.

K-Pop: spotlight on investing in South Korea's Green New Deal

Even despite a recent uptick in cases, South Korea has been touted as a model to follow for containing the coronavirus pandemic. In December 2020, exports grew at the fastest pace in 26 months, in part driven by South Korean's market dominance in producing semiconductors, mobile devices, and IT products, in high demand as a result of the 'working from home' phenomenon (ref: Figure 1). As we can see in Figure 2, manufacturing activity shot to a 10-year high and held steady through the end of 2020.

In addition to South Korea's recent export and manufacturing dynamism, at the geopolitical level, the government is working to cement significant trade deals. In addition to joining RCEP, South Korea is finalising free trade agreements with Indonesia and Israel, and accelerating negotiations with India and the Philippines. Seoul has motioned that it would like to deepen trade ties with Latin America, and that it may join the TPP. All of these movements suggest that while part of the world may shudder and recoil from trade, some OECD countries have found it to be a pathway for substantial economic growth.

At the sector level, Prime Minister Moon's 'Green New Deal' (GND) promises significant opportunities for investing across the spectrum of the energy transition. Amidst a multitude of commitments to 'build back better' and to reset societies in the wake of COVID-19, South Korea has been lauded as one of the only countries in the world to advance upon a decidedly green recovery programme. With a focus on three strategic pillars of 'green urban development', 'low carbon decentralised energy,' and 'innovative green industry, the plan effectively brings forward South Korea's 'Green Growth' strategy and provides specific targets for investment and development. South Korea has vowed to become net zero by 2050, and in moving toward this target, to increase renewables to 20 percent of the total energy mix by 2030 (up from 3 percent in 2017). Crucially, Korea's GND focuses on job creation, with a goal of creating 659,000 jobs in renewable energy, energy transition, and green innovation by 2025.

With a focus on green remodelling, South Korea might become a magnet for global real estate investors, especially for those who consider their investments in 'prop tech' and real estate as a service. Technology companies within the green space might also think of South Korea as a blossoming market, in terms of both expansion, as well as a source of potential JV partners. Indeed, two of Korea's largest corporations have recently made significant investments in companies in the US and Canada in hydrogen, as well in electric vehicles. With the long-term track record and prowess of Korean companies' expansion into emerging Asia (such as in Vietnam), such a venture might be an ideal way for as yet underexposed western companies to gain a foothold in the fastest growing markets in the world.

Figure 1: South Korean exports (USD billions)

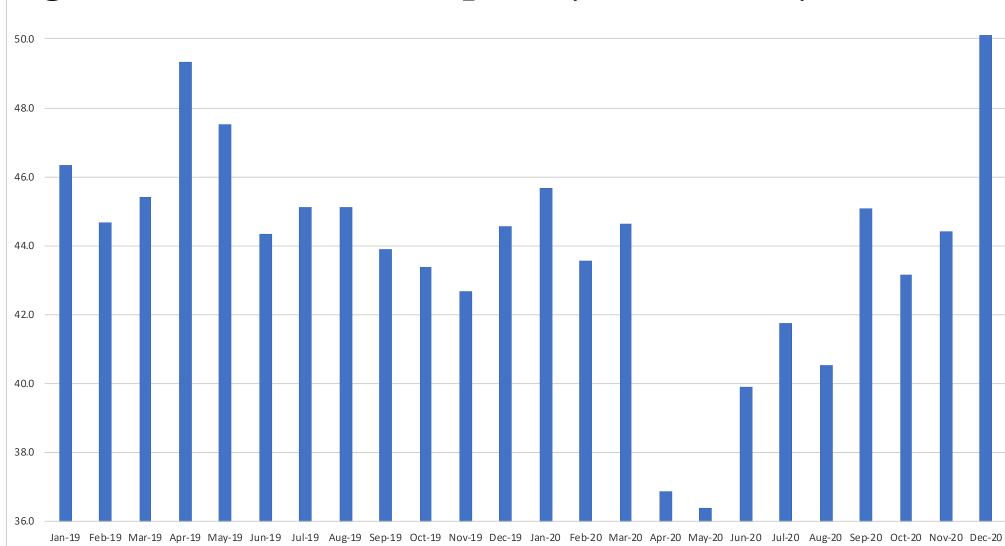
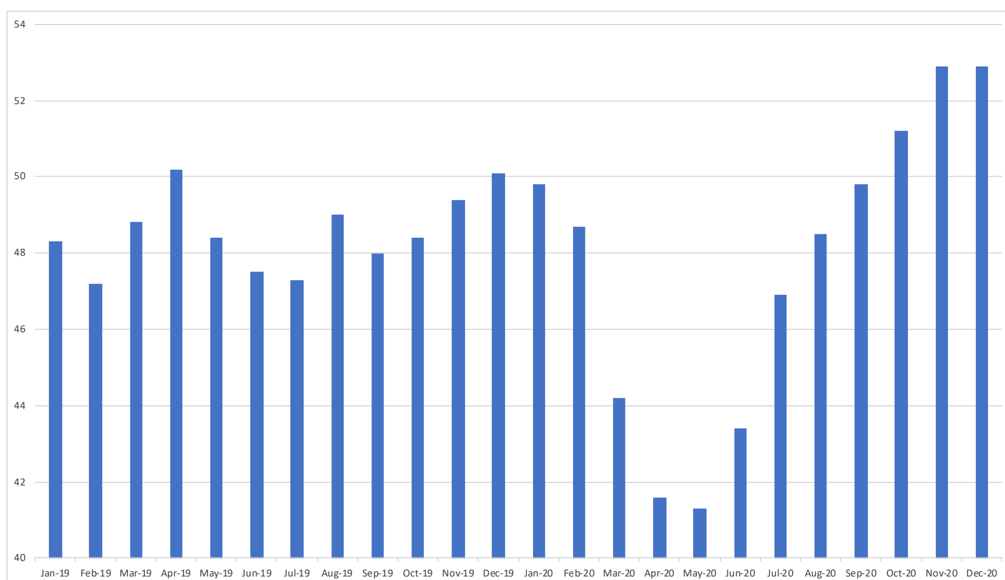


Figure 2: South Korean Manufacturing PMI (points)



Source: Trading Economics

Food for thought: investing in AgTech and FoodTech in India and Singapore

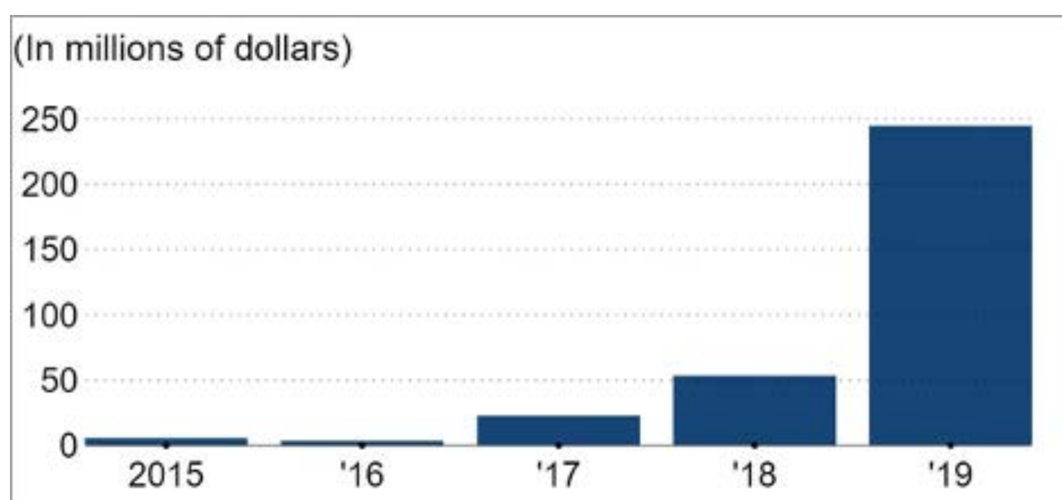
As we consider the entire spectrum of sustainability and ESG investing, capital, portfolio flows, and executive attention is often directed toward the energy space. However, as activists increasingly have their eye upon the relationship between carbon emissions and the global food system (responsible for some 21-37 percent of global greenhouse gas emissions), innovations in agricultural production and the food industry will be critical in the years to come. Additionally, in light of the high price environment discussed above, such advancements have the potential to moderate volatility in prices, whether by addressing weather shocks and supply shortages at the crop level, or by supporting changing patterns of demand for end products, such as through meat alternatives. For example, a recent collaboration between a major European bank and the FAO has focused on deploying sustainable investments in the food ecosystem, with pilot projects on reducing food spoilage in India, as well as Kenya. Indeed, the fact that one of the world's largest institutional investors is banking on significant returns from the agricultural sector is a telling tale.

At the crop level, AgTech investments in India have expanded at a rapid clip in recent years. As we can see in Figure 3, investments in the space expanded by 350 percent in 2019, up from the previous year.

Venture capital companies from across the region are attracted by the deployment of some of India's top tech talent to the country's rich agricultural sector, with digital pioneers utilizing data and AI to help farmers boost productivity at a micro and organic level. Innovations in ways to cut water consumption by using smartphones and sensors, and to improve distribution and food spoilage, constitute budding opportunities.

Additionally, in considering end products, Singapore is well poised to become a major food tech hub for the region and for the world. In part due to government support and also perhaps in part by its unique geostrategic position, and rich culture of R&D. German and US companies have set up shop in the city state, with the hope of expanding their businesses in vertical farming—or 'skyscraper farms'—innovation in improving crop yields, and in developing plant-based proteins.

Figure 3: Investments in India's AgTech sector



Source: Nikkei Asia

Conclusion

In sum, in considering the economic and geopolitical investing outlook for 2021, several key themes predominate. Even despite unprecedented amounts of fiscal and monetary stimulus, unemployment levels remain elevated. In addition to the loss of jobs and hours, incomes have slashed, contributing to a deepening and a widening of income inequality, often contributing to social unrest in 'rich income' countries such as the US, as well as within developing economies. While sky high equity markets continue their bull run -- contributing to a lofty asset price environment -- the spectre of business distress looms, particularly for small to medium enterprises (which represent a lion's share of the workforce in the US and in Europe).

While many of the relief measures enacted by officials are designed to stem the bleeding of economic distress, we would do well to implement long-lasting structural changes to help improve the support of small businesses, and catalyse infrastructure investing which is resistant to the business cycle. At the global level, high food prices also weigh on the economic and geopolitical outlook. The rise in cost of basic human needs such as food eats into already eroded incomes, compounding a state of economic insecurity for families from Africa to Asia to North America.

Nevertheless, despite a sobering outlook, several opportunities at the geographical and the sector level shine as silver linings for global investors and executives. The prospect of investing in South Korea's Green New Deal remains significantly attractive in the infrastructure, renewable energy, energy transition, and real estate landscape. And as countries contend with supply shortages, and increasingly confront the interrelationship between climate change and the global food system, the opportunities for investing in AgTech and FoodTech in dynamic markets such as India and Singapore present alluring opportunities. As we emerge from the teeth of the pandemic, and as investors and executives ponder the ramifications of government actions across the globe, we would do well to take note of truly sustainable investments, which have the potential to stimulate jobs, reduce social costs, and to generate long-term returns -- returns which inevitably might emanate from beyond one's own borders.

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Endnotes

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52. https://reliefweb.int/report/world/fao-and-rabobanks-new-partnership-focuses-helping-make-food-systems-more-sustainable

53. https://www.temasek.com.sg/en/news-and-views/stories/future/the-next-food-revolution/agriculture-big-opportunity ; See also https://news.crunchbase.com/news/agtech-sector-blooms-as-more-dollars-and-startups-rush-in/

54. https://asia.nikkei.com/Business/Startups/India-s-agritech-startups-help-modernize-underused-farmland

55. https://asia.nikkei.com/Business/Startups/Singapore-emerges-as-food-tech-hub-thanks-to-state-support

56. Other notable FoodTech investments beyond the scope of this article address the concept of 'food as medicine' and integrative health as a way of combating chronic disease. One innovator is working with Medicare to deliver healthy meals to people diagnosed with chronic disease. See https://news.crunchbase.com/news/agtech-sector-blooms-as-more-dollars-and-startups-rush-in/

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