2021 MARKET OUTLOOK

Opportunities in a post-pandemic world
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INTRODUCTION

They say that change is accelerating. Exhibit A? The year 2020. Change can induce anxiety; we need to acknowledge that. But change can also bring opportunity, particularly for investors who are focused on the future.

The COVID-19 pandemic sweeping the globe is doing both those things. It’s causing no shortage of anxiety, and it’s opening the door to opportunity.

For our 2021 Market Outlook, we have highlighted five major transitions that offer investors opportunity through change. The first, the transition to a fiscal-led recovery, is a direct result of the pandemic. It is the start of the next cyclical recovery that will be measured in years, not months. Importantly, fiscal policies can be targeted to stimulate specific parts of the economy for investment, job creation, and growth. This can give a powerful boost to four other critical transitions the economy must navigate in the decade ahead.

Those transitions are: to a digital economy, to a sustainable economy, to a durable economy, and to a more equitable/inclusive economy. They were underway before the pandemic, but they were mere “green shoots,” to borrow a familiar phrase from a well-known crisis of the past. Now, in part because of the pandemic, these transitions are growing in strength and stature, with multiple stakeholders working hard to provide ideal conditions for the best possible outcomes.

Caution, however, is warranted. Not all transition effects will be positive for all companies. Some firms will succeed, others will fail. In a world where exogenous shocks are increasing, companies must pay less attention to maximizing short-term profit and more to building sustainable business models. By focusing on the long term, the winning companies will produce better outcomes for all their stakeholders. Finding those winners is what active management is all about—and that’s where we come in.

In the pages that follow, we share our views on the five transitions. We also bring you the perspectives of our world-class sub-advisors as they cover topics related to the transitions, ranging from Canadian small cap investment opportunities to growth in social impact investing to penetration of e-commerce in emerging markets.

The fragility of our economic system has once again been exposed (but differently this time). If we want to continue to grow, we must nurture these critical transitions toward a full and colourful bloom, under a new kind of financial system. A sustainable financial system, where investors and lenders are putting their money to use in a way that is positive not just for profit, but for the planet and its people as well.

I wish you all a safe and healthy New Year.

John Bai, CFA
Senior Vice President and Chief Investment Officer

“

The pace of change has never been this fast, yet it will never be this slow again.”

—Prime Minister Justin Trudeau, World Economic Forum, 2018
In response to the economic downturn of 2008, policymakers pursued aggressive monetary policy measures to save the global economy from collapse. What were once thought to be unconventional tools became the norm as central banks bought up government debt, sought to control the yield curve, and in some cases adopted negative interest rate policy.

Twelve years later, just as the global economy was seeing its longest-ever expansion cycle and monetary policy had normalized (for the most part), the COVID-19 pandemic sent the world economy into a downturn that was more severe, albeit shorter, than in 2008. In contrast to previous economic downturns, this one was driven by a health crisis, not a financial crisis. Monetary policymakers have responded by throwing the proverbial kitchen sink at the problem. There is a growing concern however that central banks are running out of tools to stimulate the economy. What do you do when central bank balance sheets are at record highs and interest rates are at record lows? Enter fiscal policy.

Monetary policy is often referred to as a blunt instrument, as it mostly benefits financial markets, financial institutions, and large corporations, whereas fiscal policy can be used with more precision. Governments can focus spending programs on individuals and businesses that need it most. While monetary policy typically has a direct and immediate impact on asset prices, the effects of fiscal policy can take longer to materialize but can have longer and more sustainable outcomes.

As monetary policy tools become increasingly stretched, we can expect fiscal policy to play an ever more prominent role in driving the recovery, with a range of implications for fixed income and equity asset classes.
Without doubt, fiscal policy has taken centre stage in the efforts to stabilize the economy during the pandemic. While emergency measures are warranted to help keep economies afloat, the substantial deterioration of fiscal balances and resultant surge in public debt will surely prove to be a burden to address down the road. That means either reduced public spending, increased taxes, or both—policies that will provide an unambiguous drag on future economic growth. For now (and for the foreseeable future), however, the cost of carrying that growing debt burden is far from onerous, thanks to central banks worldwide slashing interest rates to never-before-seen levels.

In the short to intermediate timeframe, however, the Bank of Canada estimates a continued rebound in real growth over the next two years. Nevertheless, excess capacity in labour markets will likely persist as the pace of job gains is expected to slow considerably relative to its recovery in the second half of 2020. As a result, inflation is expected to remain below the central bank’s 2% target over the forecast horizon.

Our forecast is for the Bank of Canada’s accommodative policy—both conventional and unconventional measures—to remain unchanged, and we expect fiscal policy to be employed as a shock absorber to any further sharp contraction in growth.

Looking ahead, a vaccine for COVID-19 is necessary to give confidence for a full reopening of the economy. A tightening of monetary policy remains a remote proposition, and will be signaled when central banks see that the handoff from fiscal stimulus to the real economy is fully entrenched.
Overall, we see interest rates remaining low for longer, but subject to volatility as markets attempt to price in the expected pace of recovery as the vaccine is deployed.

Beyond the implications of the more dominant role of fiscal policy, other trends discussed in this report will have implications for interest rates and the bond market. The transition to a digital economy, for example, will help free labour capacity, should lower service costs, and will likely result in a more sophisticated labour market. Assuming these factors contribute to growth without inflation and low volatility, they would serve to support lower policy rates relative to history and to suppress expected returns from traditional assets. Investors will likely need to cast a wider net to attain an attractive return.

**On global fixed income**

*By Amundi Asset Management*

Policymakers reacted decisively to the COVID-19 crisis not only by providing significant monetary accommodation, but also by deploying large (and timely) fiscal stimulus. The coordinated policy response has helped mitigate the impact of the crisis on output, employment, defaults, and inflation. However, as another COVID-19 wave hits major economies, the outlook will be determined by the approval of some promising vaccines and additional fiscal/monetary support to bridge the gap until the vaccines are rolled out.

Looking into 2021 the global economy may surprise to the upside if vaccines were to be rolled out in Q1. With central banks likely to remain accommodative and fiscal support continuing—with historically large fiscal deficits reduced over the medium term—there is room for inflation to exceed expectations, particularly in the U.S.

Against this backdrop, government bond yields will have room to gradually increase, but are likely to remain at historically low levels. U.S. inflation-linked bonds are likely to outperform, while the debt of both developed and emerging markets is set to benefit from the economic recovery and accommodative macroeconomic policy. A healthy surge in inflation also suggests that high-yield bond spreads will continue to compress as the yield-seeking behaviour among investors becomes more apparent.
Healthy improvement on growth/inflation outlook to support high yield spreads

Most importantly, the U.S. Federal Reserve announced a broad set of emergency lending facilities, including the Secondary Market Corporate Credit Facility. This was the most important monetary tool the high-yield market has ever witnessed. Despite the declining footprint of the facility, the signaling effects have been potent (see chart below). By supporting companies’ access to funding, the predictions of massive defaults did not materialize.

Secondary Market Corporate Credit Facility
Weekly purchase amount (US$B)

Source: Amundi Asset Management.

On high-yield fixed income
By Principal Global Investors

As COVID-19 spread in February and March, equities plunged and Treasury yields dropped substantially. Market liquidity deteriorated to levels experienced during the 2008/09 financial crisis. Overall corporate bond issuance dropped 60% year-over-year during this timeframe. Firms that could not access capital markets were at risk of defaulting. Spreads on corporate bonds widened significantly as the credit quality of firms declined; additionally, loans were unavailable for most firms, particularly high-yield firms. At the most acute phase of the period, trading conditions became extremely illiquid and some critical markets stopped functioning properly.

In response, central banks around the world took unprecedented monetary policy measures to restore smooth market functioning and to support the flow of credit in the economy.

As the market and economies move away from these monetary policies, fiscal policies take their place. Fiscal policy will need to remain supportive and flexible until a safe and durable exit from the crisis is secured. Many of the jobs destroyed by the crisis will likely not return. It will be necessary to distinguish sectors that may permanently shrink to sectors that will expand.

Every country will have different priorities, but the starting principle for all governments should be to seek to build more productive and resilient economies while tackling climate change and social inequalities. High-yield companies must realize this and make necessary adjustments, or they will not have access to the market in the ensuing years.
On Canadian equities
By QV Investors

Monetary policy has been a key support for financial markets since the financial crisis of 2008/09. It has been especially crucial for market liquidity and asset prices throughout the pandemic. With central bank balance sheets heavily extended, it is time to turn to other policy approaches.

A transition to a fiscal-led recovery is expected to have a positive impact on Canadian equities. Fiscal programs announced to date have had a near-term stabilizing effect on the economy, supporting individuals and enterprises most impacted by the pandemic. Longer-term, we believe the benefits of fiscal policy will evolve from a supportive function to one that drives job creation and growth through large investments in infrastructure, such as ports, rapid transit, highways, and bridges. Overall, rising productivity and a stronger operating environment for Canadian businesses should benefit Canadian equities.

On Canadian small cap equities
By Laurus Investment Counsel

Canadian equity valuations have expanded significantly as exceptionally accommodative monetary policies have pushed the risk-free rate to near zero, leaving equity risk premiums as the sole driver of the discount rates. While monetary policies have blunted the COVID-19 economic shock, policymakers have almost exhausted their monetary policy levers and will need to turn to fiscal policies to achieve targeted long-term growth rates.

However, the impact of fiscal policy on the economy and the Canadian equity market will not be the same as that of monetary policy. The yield curve response to a change in the overnight rate shows monetary policy can have an immediate effect. Expansionary fiscal policy is designed to spur inflation, economic growth, and real and nominal interest rates, and if successful, should steepen the yield curve over time.

Small cap stocks have historically performed well coming out of recessions and through inflationary environments.

Equity markets are forward-looking and are reflective of the expectations resulting from fiscal policy. In the short-term, expect a flurry of M&A activity as companies take advantage of the low cost of funding to acquire assets ahead of inflationary pressures. The Canadian equity market has a heavy weighting of precious metals companies, a sector that has recently seen valuation expansion because it is widely viewed as a hedge against inflation. Real Estate Investment Trusts can also benefit from inflation in real assets. Both these sectors have greater representation within the Canadian small cap equity market than the Canadian large cap market.

Small cap stocks have historically performed well coming out of recessions and through inflationary environments. Small cap companies tend to benefit most from accommodative tax policies and government spending, as they can quickly add to their workforce and increase output when economic activity begins to improve.

The following chart shows Canadian small cap companies delivered superior growth from the March 2009 low over the subsequent years.
On U.S. and international equities

By AllianceBernstein

With interest rates extremely low and central bankers balking at negative rate policies, fiscal policy broadly will have to pick up more of the slack. However, in the U.S., there may be a divided government with a Democratic president and a potentially Republican Senate. This may limit the scale of any fiscal stimulus in the U.S. over the short and medium term. Therefore, it is plausible the U.S. will be stuck in a low growth, low inflation world for longer.

The initial stages of any rotation that reflects increased confidence in the economy will likely be felt in the most beaten-down segments of the market, notably value stocks like financials and energy.

This could potentially be the catalyst that finally makes non-U.S., developed market stocks assert leadership, especially if fiscal policy is more aggressive in Europe, which has a more cyclical footprint than the U.S. In any event, with interest rates low, fixed income is relatively unattractive from a return perspective, and there may be no alternative to equities to meet investors’ objectives.

On sector rotation

By AllianceBernstein

With the tremendous amount of stimulus unleashed in the economy, coupled with a time when the virus moderates [and is hopefully soon eradicated], we expect a shift in market sentiment.

The initial stages of any rotation that reflects increased confidence in the economy will likely be felt in the most beaten-down segments of the market, notably value stocks like financials and energy. This is natural given their sustained underperformance.
Experience tells us that as recovery begins to take hold, many higher quality cyclical stocks that have faced heavy selling pressure may respond favorably should these forces become aligned. However, considering the range of possible outcomes is wide, having a balance of high quality, stable companies increases the odds of attaining a desired mix that both participates in the upside and defends against downside risks. Fortunately, these defensive names have also underperformed, as growth stocks have dominated markets for the past few years.

Thus, a barbell of sorts, one that mixes higher quality cycicals like specialty retailers, professional services companies, and insurance companies, with more traditional defensive names, can offer a balanced exposure to recovery.

**Diverse sector valuations: defensive and quality sectors look cheap**

Valuation Percentile for Developed Markets

Historical Percentiles (Jan 1990–September 2020)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Valuation Percentile</th>
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<tbody>
<tr>
<td>Financials</td>
<td>12</td>
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<tr>
<td>Health Care</td>
<td>9</td>
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<tr>
<td>Cons. Stap.</td>
<td>13</td>
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<td>Utilities</td>
<td>22</td>
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<td>Comm. Services</td>
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<td>Materials</td>
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<td>Real Estate</td>
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Longer-term, we believe the benefits of [Canadian] fiscal policy will evolve from a supportive function to one that drives job creation and growth through large investments in infrastructure, such as ports, rapid transit, highways, and bridges.

**On growth versus value**

*By QV Investors*

The monetary-to-fiscal policy transition will likely have mixed implications on growth and value investing. Against a backdrop of sluggish growth and ultra-low interest rates, growth-oriented investments are likely to continue enjoying premium valuations. However, we believe there could be significant downside risk to many of these investments on account of the market’s outsized growth expectations.

Value-oriented investments, such as companies in the financial sector, should benefit from marginal support for economic growth and more stable conditions, which could spark a re-rating relative to their growth investment counterparts. A recovery led by fiscal policy should also help energy demand, which plunged significantly in the early stages of the pandemic.

Ultimately, it remains unclear when the growth-versus-value performance shift may occur. We continue to focus on company-specific opportunities that we expect will demonstrate above-average earnings growth regardless of the interest rate environment. A focus on resilient, cashflow-generating franchises should also enable our holdings to weather challenging economic and health environments relatively well.
The “Fourth Industrial Revolution,” a concept introduced at the 2016 World Economic Forum, is underway, characterized by the emergence of technologies such as artificial intelligence, quantum computing, 3D printing and the internet of things.

According to the WEF, the fourth revolution is different from the third (which started in the 1960s with the invention of the internet) for two reasons: one, the gap between the digital, physical and biological worlds is shrinking, and two, technology is changing faster than ever.

The digital economy has grown 2.5 times faster than global GDP over the last 15 years, according to the United Nations’ 2019 Digital Economy Report, and currently accounts for about 15.5% of global GDP. For the last decade, online retailers such as Amazon have become an integral part of our daily lives, while the brick-and-mortar retail sector has withered.

Then came the pandemic. Businesses that relied on physical interaction to generate revenue were the hardest hit as governments mandated social distancing measures. Meanwhile, corporations ordered employees to stay home and quickly adapted to remote working measures, providing a massive tailwind for technology companies.

While the rise of the “FAANGs” has certainly benefitted Wall Street and investors, there is also a growing dark side to our increasing reliance on technology. Human rights, data privacy, and misinformation are just some of the growing concerns voiced by both investors and regulators.

Digital technology will continue to play an increased role in our daily lives, as well as in our investment portfolios. We believe companies that are able to navigate the transition to the digital economy will be rewarded, while companies that cannot, will languish.
On growth equity opportunities

By AllianceBernstein

The digital revolution over the past 15 years has created and disrupted myriad businesses in ways that we couldn’t have imagined. We have also seen the rapid growth of digitization across existing parts of the economy, including in payments, business interactions, and retail, in many cases materially changing the business models as well. Data takes on increased value, and can create huge first mover/market share advantages that create more stable and sustainable profit engines. Technology, once seen as a boom and bust business, now has many pockets that are consistently profitable.

To date, the big winners of this revolution have been in the U.S. (FAANG+) and China (Alibaba and Tencent), and this has left non-U.S. developed market stocks, and even emerging markets, lagging the returns of the S&P 500. It remains to be seen whether this will continue, or if the next mega-winner will come from Europe or Brazil, as examples.

In any case, it has left non-U.S. markets cheaper than U.S. markets, and growth, especially hyper-growth, more expensive. From an asset allocation point of view, it means investors could be overweight U.S. growth stocks. In consideration of the post-pandemic economic recovery, it may make sense for investors to assess current allocations and make sure they are in line with long-term objectives.

We also believe the accelerated transition to the knowledge-based economy will create opportunities in companies that provide information and proprietary data that are essential in a contactless world.

Today’s mega cap companies have truly distinctive capabilities that are in high demand during the pandemic, along with strategic business models that support long-term growth. Whether they continue to perform well will partially be a function of the nature of the economic recovery post pandemic, and any lasting cultural/behavioral changes that persist, like work from home.

There’s no doubt that most of the business models of the mega cap winners will remain winners in an economic sense: their profit engines will likely remain intact. Whether their valuations persist as elevated as they are in some cases—especially if interest rates rise, making far off cashflows less valuable—remains to be seen.

Giant growth stocks have driven U.S. market moves

FAANG vs rest of S&P 500 (%)
person be conducted via Zoom instead, since it’s better for costs and the environment?

Divining the impact of COVID-19 will be one of the primary research tasks of our fundamental analysts, and should provide ample opportunity for active security selection.

We also believe the accelerated transition to the knowledge-based economy will create opportunities in companies that provide information and proprietary data that are essential in a contactless world.

On innovation in emerging markets
By Columbia Threadneedle

The digitalization of economies is a structural trend that we have witnessed for a number of years, accelerating on multiple fronts since the pandemic. Significant demand has been brought forward from future years as firms and households equip themselves for the stay-at-home economy.

The momentum is expanding beyond technology and communication services. Penetration is accelerating in sectors such as consumer discretionary and financials, given the adoption of e-commerce by consumers and as financial firms build digital offerings.

We feel this trend is more pronounced in emerging markets relative to developed markets, as countries skip a generation of development through the adoption of digital technology. Not only are countries following in the adoption, we are also witnessing innovation, sometimes at a much faster pace than in developed markets. This has been underappreciated by investors, originally perceiving companies in emerging markets to be “copycats.” But we can easily find examples of great innovation, with companies creating ecosystems and harvesting user data to improve experiences and conversion rates well beyond the figures of their developed market peers.

For many, the influence of Amazon in consumers’ retail habits has become evident, yet e-commerce penetration in the U.S. is only approximately 16%. The world average is roughly 13%, and the emerging markets average is less than 9%. Forecasted growth rates in emerging markets surpass all other regions. Compounded annual growth rates over the next five years is estimated to be about 20%, therefore, we are confident this will continue as we are still in the early stages of penetration.

EM e-commerce to grow faster than rest of world

Source: Euromonitor as of 8 June 2020.
On digital rights
By NEI Investments

The COVID-19 pandemic has thrust the digital economy to the forefront of how we live, communicate, and do business. As disruptive as the pandemic has been, consider how much more difficult life would be without the access to information, people, and commerce afforded us by digital technology.

That access, however, comes with risks, and NEI has devoted considerable effort both before and since COVID-19 to ensuring our inseparable connection to digital technology does not come at the expense of our rights as citizens.

From privacy risks around the sharing of sensitive user information to the algorithms that can potentially exacerbate bias, reinforce discrimination, or facilitate disinformation, technology companies continue to wade ever deeper into areas fraught with risk.

We asked the company to add a human rights oversight committee to its board. With management controlling over 50% of the votes, we knew this proposal would not receive majority support. But our message got through: the opening words at the AGM from board chair John Hennessy were exclusively dedicated to Alphabet’s approach to human rights. And in October, Alphabet added sustainability and civil and human rights to the responsibilities of its board level audit committee.

Risks to fundamental human rights are embedded in the business models of Alphabet and numerous other technology services and platforms. From privacy risks around the sharing of sensitive user information to the algorithms that can potentially exacerbate bias, reinforce discrimination, or facilitate disinformation, technology companies continue to wade ever deeper into areas fraught with risk.

The positive movement from Alphabet (albeit after significant investor and societal pressure) makes us optimistic that the initially defensive stance technology companies often take on human rights will shift, as they better recognize the inherent business risks associated with human rights and see the value of engaging with informed investors on this topic.

Our engagement with Alphabet is representative of this focus. After forming a coalition of over 80 investors (including NEI sub-advisor partner Federated Hermes) representing close to US$80T in assets, we approached Alphabet, the parent company of Google, in December 2019 to discuss human rights risks associated with its business. Our request for a meeting was declined, so we pressed forward with a shareholder resolution, which was tabled at Alphabet’s annual general meeting in June.
But we can easily find examples of great innovation [in emerging markets], with companies creating ecosystems and harvesting user data to improve experiences and conversion rates well beyond the figures of their developed market peers.
Climate change has been cited as arguably the single largest risk factor for economies and financial markets over the next decade. Efforts by world nations to address the growing risks of climate change started as the United Nations Framework Convention on Climate Change, then extended to the Kyoto Protocol, which was then superseded by the Paris Agreement.

Still, despite the commitments, most nations have yet to reach their emission reduction targets. Part of the challenge lies with lack of enforcement mechanisms. There is also the challenge of garnering the necessary funding committed to climate finance, as addressing both the physical and transition risks of climate change is very costly. However, if we do nothing, the economic cost could be as high as US$792 trillion by 2100, according to an analysis published in *Nature Communications*.

Amid talks of a “Green New Deal” and efforts to “build back better,” the unprecedented fiscal response to economic fallout from COVID-19 has given us a once-in-a-generation opportunity to accelerate the transition to a sustainable low-carbon economy. The global effort to reduce carbon emissions would mean substantial investments in renewable and clean energy, as well as investments in infrastructure for greater efficiency.

**Recognizing that some more vulnerable industries may be impacted in the short term, the transition to a low-carbon future will create a more sustainable economy with new jobs in new sectors, which means new opportunities for investors.**
On fixed income impact investing
By Wellington Management

The opportunity set of impact investments within public fixed income has grown rapidly over the course of the last several years and continues to accelerate. While our opportunity set for impact extends beyond the labelled bond market (green, social and sustainability bonds), the increased issuance and demand for these instruments is a good indicator of overall market growth.

This year alone, global, social and sustainability bond issuance reached a record high of US$392 billion, an increase of 42% over 2019, according to JPMorgan. Corporate issuance in particular rose to a high of US$192 billion, says JPMorgan, with over 200 issuers entering the market for the first time. This issuance has been driven by several factors, including the mounting global health crisis caused by COVID-19, increased racial inequality, and continued concerns over the social and environmental consequences of climate change. Asset owners are seeking to put their money to work in ways that directly address these issues, while companies and other organizations need capital to come up with effective solutions.

The issuance of green bonds and sustainability bonds focused on environmental-related outcomes remained a consistent theme in 2020. Issuers from across a more diverse set of industries are increasingly finding ways to tap the green bond market, for example retailers and telecom companies. Issuing in the green bond market serves as a way for these companies to signal to their investors that they are committed to ESG and improving their sustainability practices.

The market also continues to see innovation, with select issuance of sustainability-linked bonds where the coupon rate on the bond is directly tied to the company’s ability to achieve a particular environmental outcome, such as reduced CO2 emissions. With this type of structure, we believe it is important to evaluate whether the company’s environmental goals are ambitious enough.

We see sustainability and climate change policies and regulations as being the most influential near-term drivers of large-scale industry change. For example, we expect that the European Green Deal, focused on making Europe climate neutral by 2050 through the rollout of various policy initiatives, will drive more capital toward companies focused on addressing climate change. This includes but is not limited to companies within industries such as energy, buildings, and transportation. The recovery plan for Europe in the wake of COVID-19 carved out specific funds to be dedicated to fighting climate change—a “green recovery.” As noted above, policies such as these have already driven increased issuance within the green bond markets, as companies seek to transition their businesses to be lower carbon and more sustainable.
Cumulative global GSS bond issuance (US$B)


Issuance distribution by investment type


On environmental markets and climate change

By Impax Asset Management

The investment case for environmental markets remains strong: a growing focus on energy efficiency and electrification across nations striving toward net zero carbon emissions; the urgent adaptation necessary for regions with too little or too much water; a noticeable increase in severe weather events which are extremely costly to governments, humanity, and the planet’s ecosystems; and the need to use natural resources more sustainably with less waste.

Climate change meanwhile presents both significant risks and opportunities. These risks and opportunities differ among sectors and industries, which means careful evaluation is needed to understand the dynamics.

The pandemic and associated response have reinforced the imperative to transition to a more sustainable economy. It has reminded us of the fragility of human society in the face of a natural phenomenon and has triggered the kind of collective response that will be needed to address climate change and other sustainability challenges. Looking ahead, the reaction of policymakers as they move from lockdown to rebuilding economies will likely incorporate societal feedback that simply rebuilding an unequal, fossil fuel powered economy is not enough.

Impax has been focused on the transition to a more sustainable economy for over twenty years. Not by coincidence, emerging lessons, consequences, and thus investment opportunities as a result of COVID-19 have many overlaps with thematic and sectoral areas of focus in our portfolios.

Some examples of tangible opportunities are in the areas of industrial automation, digitization, and health, safety and well-being. Importantly, unexpected disruptive events with dramatic consequences for
companies also reinforce the importance, and value-add, of our ESG integration and company-level ESG research, including many individual engagements with companies in our portfolio.

Climate change meanwhile presents both significant risks and opportunities. These risks and opportunities differ among sectors and industries, which means careful evaluation is needed to understand the dynamics.

The impacts of climate change, and the opportunities and risks associated with mitigation and adaptation, will persist for the foreseeable future, due to the persistence in the atmosphere of greenhouse gases ranging from a few years to decades and beyond. Thus, we see climate risk as something that confronts society in the short, medium, and long term. The only question is how significant these risks will be, which depends on how successful society is at limiting global emissions of greenhouse gases.

As part of our detailed company-level analysis, for a company to be included on the Impax “A-list,” the materiality of each company’s sustainability risks is assessed. Importantly, climate and carbon are viewed as a systemic risk for all companies, so climate and carbon risks—including physical climate risk and climate governance, data and targets—are assessed for each company as part of our proprietary ESG analysis.

On transition support through engagement
By Federated Hermes

The transition to a more sustainable economy represents an exceptional market opportunity. Fiscal spending is going to play an important role in nations’ efforts to stimulate an economic recovery. As such, companies which play an active role in adapting to and mitigating some of the greatest challenges that we see today in society are likely to be rewarded through future policy and legislation, promoting greater sustainable development. For example, green infrastructure is changing much quicker than many expected as governments around the world become more ambitious with their climate targets. This could accelerate further as Joe Biden, the U.S. president-elect, has placed climate change at the centre of his strategy.

Consumer spending habits are also changing and there is much more focus on a range of environmental and social issues. How a company manages the risks it faces will be increasingly important as the potential damage to reputation can have a long-lasting impact.

At Federated Hermes, we are also helping to drive some of this change by engaging with companies on a wide range of environmental, social and governance topics and, more importantly, holding them to account. For example, we have had several successful

Amid talks of a “Green New Deal” and efforts to “build back better,” the unprecedented fiscal response to economic fallout from COVID-19 has given us a once-in-a-generation opportunity to accelerate the transition to a sustainable low-carbon economy.

Regulatory risk is being driven by government action and mainly impacts the largest emitters, while physical climate risk impacts all industries, and is dependent on location and the ability (or inability) to adapt.
engagements with Ping An Insurance recently. These conversations have led to the company joining the UN Principles for Responsible Investment and the China-UK Task Force on Climate-related Financial Disclosures (TCFD) pilot group. Moreover, the company published its first TCFD report earlier this year, which sets out the company’s climate targets, enables investors to monitor its Scope 1, 2 and 3 emissions, and provides data on the waste it produces.

We have reached critical mass among the big players in Canada on alignment with a net zero future.

On progress in Canada
By NEI Investments

2020 was undeniably a watershed moment for the transition to a sustainable economy. Post COVID-19, there has been tremendous momentum behind the concept of “build back better”—momentum that has loosened real money ready to support distinct and necessary transition activities, including methane reduction in the oil and gas sector, addressing the issue of orphan wells and other liabilities, the shift to a hydrogen economy, and plastics circularity (the birth of the Canada Plastics Pact comes at exactly the right time to address the infrastructure implications of setting targets to reduce plastics use).

In 2021 we will seek to leverage this momentum and its associated financial support at the policy level, where we can most effectively drive the systems-level change that transition represents. That includes working with the Alberta-based Energy Futures Lab (EFL) as part of a multistakeholder effort seeking to develop key policy advice for the Alberta government on ways to use sustainable finance to support the transition by employing existing strengths, skills and assets within the province.

We are also part of the EFL’s LEAD (Leveraging Existing Assets for Diversification) project, focusing on how to use old well sites to create new economic opportunities around solar, lithium, and geothermal technologies. That the Alberta government is inviting proposals in these areas speaks to how significantly the collective transition mindset has shifted.

We have reached critical mass among the big players on alignment with a net zero future. Given the energy transition has been core to our engagement work for years, this is a gratifying development. But it is far from the end of the conversation. None of the oil and gas companies looking hard at diversification has given up the ghost on pumping oil in the near term. But even that activity has taken on a new tenor, as companies look, for example, at alternative uses for bitumen beyond burning it. This suggests the possibility of, if not diversifying the product itself, then potentially the end markets for it.

While full of possibilities, the direction of the transition is more unified than ever before. 2020 will no doubt be remembered as the year of the virus, but it should also be known as the year the transition to a sustainable economy became an objective all stakeholders finally stood behind in a meaningful way.
The acceleration of globalization since the 1990s has created an interdependence of economies through cross-border trade in goods, services, technologies, and capital flows. Corporations have increasingly outsourced entire aspects of their manufacturing process, creating a vast global supply chain network where often the lowest cost producers prevail. Adoption of techniques such as just-in-time manufacturing have helped reduce production lead times and helped reduce the burden of inventory levels and overhead. For consumers, this trend has generally been a net benefit by helping lower the cost of goods.

But in order to slow down/prevent the spread of the pandemic, countries have had to close their borders, and of course this has led to a disruption in the flow of goods. Recall during the onset of global lockdowns there was a severe shortage of medical personal protective equipment, hand sanitizer, as well as everyday staple items. In light of the exogenous shock created by COVID-19, 87% of global corporations are expected to change their supply chain management priorities over the next three years, according to a McKinsey Global Survey from March 2020.

To make this transition, companies committed to building sustainable value must drill down on ESG issues across the entire organization, including the supply chain, to increase resilience in a world prone to exogenous shocks and satisfy a customer base more focused on environmental and social issues.
On supply chain opportunities
By Addenda Capital

As companies shift from an offshoring focus to one with more flexibility and proximity to the customer, low-cost countries are poised to be more negatively impacted. Countries that have developed higher-level competencies in these areas are likely better positioned, but the offshore model of producing for the world looks less sustainable from both a financial and environmental perspective.

However, the benefits of global trade and economies of scale are still clear. As a result, companies are more likely to try to strike a balance and find closer (near-shore) solutions to manage costs. Automation can help in this regard, but it also increases fixed costs which strengthens the argument for greater economies of scale.

We see several themes emerging from changing supply chain priorities:

1. Consolidating supplier relationships: Historically, working with fewer suppliers that can service global companies wherever they operate favors those suppliers with a broader global footprint.

2. Delivering quality at scale: Tight inventory control needs timely deliveries to be successful.

3. Creating trusted partnerships: Whether through higher service levels or differentiated capabilities, creating more durable relationships is a key benefit in tougher operating environments.

We look for companies that are global leaders [less likely to be impacted by local and geopolitical factors], and companies with a focus on non-commoditized business models. This steers us toward firms with stronger value-chain positions, focusing on those making the sourcing decisions.

In a recent conversation with U.K. consumer goods company Reckitt Benckiser, they discussed how they increased the supply of Lysol and Dettol (disinfectants) to meet surging demand using contract manufacturers, rather than additional capacity internally. Contract manufacturers had excess capacity given weaker demand for their products due to COVID-19. We view this as a strong strategy, as the increased demand for these products may prove temporary.

Change can induce anxiety; we need to acknowledge that. But change can also bring opportunity, particularly for investors who are focused on the future.

As companies strive to find a balance, they are investing in automation and technology to facilitate smarter, more flexible production and maintenance solutions. In addition to cloud and internet companies, these investments also include industrial companies that are increasingly focused on software and data analytics in production but also in ongoing monitoring and predictive maintenance for their products in the field.

This transition is complementary to the transition of the economy toward more sustainable energy sources and more sustainable operations overall. Modern lifestyles are consumption oriented, and while more durable habits are definitely a substantial part of the solution, improving the recapture of waste and better management of a product’s end-of-life impact stand to make a meaningful contribution as well. The value chains around these are underdeveloped but are quickly developing into larger scale businesses as increasing demand pulls them forward.
Many supply chains are complex enough that re-engineering them in normal course is difficult and expensive. Proactive companies have been taking advantage of the pandemic as an opportunity to test re-engineered processes and work out the kinks in a live work situation, something normally not afforded to rapidly growing companies. While this has helped moderate the decline for many production automation and technology suppliers, we see this as a much longer process that stands to drive significant growth for these areas over many years.

**On the growth shift in emerging markets**

*By Columbia Threadneedle*

Over the last decade there has been a fundamental shift in the emerging market universe—in 2008 over 60% of the universe was exposed to cyclical growth, today over 60% of the universe is exposed to structural growth. Both the depth and the quality of the universe has changed profoundly, ideal for active management. The dominance of export-driven economies in emerging markets is fast being replaced by domestically exposed growth stories.

**Cyclical and structural growth exposures**

![Cyclical and structural growth exposures](image)

Source: Columbia Threadneedle.

It’s important for investors to consider more direct exposure to emerging markets companies and consumers, rather than through developed market companies. An active approach identifying the widening gap between the winners and losers is essential, especially given the change in supply chains and the rise in integration between emerging market economies. Finally, a focus on quality will be best placed for long-term sustainable returns.

**On corporate engagement priorities**

*By NEI Investments*

Core to our beliefs and value proposition is that companies that consciously incorporate ESG factors into their operations and add value for all stakeholders—not just shareholders—will make better, more sustainable long-term investments. In the immediate wake of COVID-19, we witnessed companies quickly shift their operations to adopt a multistakeholder approach that saw short-term profits take a backseat to value creation for stakeholders like employees, customers, and communities. This was multistakeholder capitalism on a scale never-before witnessed.

Just as suddenly, however, many companies stopped and returned to their old habits. This reversal caused us to alter our engagement approach with many companies. While we were quick to commend the good work when the crisis was in its initial stages, we also recognized that for many companies this behaviour was not their comfort zone. Changing focus in a crisis is one thing. Recognizing the lessons of the pandemic around the importance of long-term resilience and sustainability and undertaking a fundamental shift in how you do business? That’s another matter altogether.
In our decades-long engagement experience, we know the most important quality of a successful engagement is the will of a company to listen, and to work closely with investors in addressing their ESG-related risks. We remain positive that companies are reading the tea leaves and understand the importance, now more than ever, of adopting a multistakeholder business model. And where we have seen that will and the opportunity to engage, not on specific ESG issues, but instead on helping engineer the strategic transition to a multistakeholder approach, we have shifted our engagement focus. In 2020, this was the case for approximately 20 of our ongoing engagements.

As we look toward 2021, we see a range of burgeoning ESG risks facing companies across all industries. Our hope is that by establishing a new baseline for company behaviour focused on the interests of all stakeholders, we will address those risks from a new position of awareness and strength.
Changing focus in a crisis is one thing. Recognizing the lessons of the pandemic around the importance of long-term resilience and sustainability and undertaking a fundamental shift in how you do business? That’s another matter altogether.
2020 was a watershed year for the “S” in ESG. Not only did we witness a pandemic that furthered the wealth gap (the so-called K-shaped recovery), we also saw a global wave of social unrest and action toward combatting systemic racism and inequality.

The conventional wisdom has been that industrial/manufacturing sectors are often vulnerable to economic cycles and that the service sector, largely driven by consumer spending, is more resilient and less sensitive to economic downturns. The pandemic turned all that around.

Service sector workers, often lower wage, have been struggling in a world of physical distancing with restaurants and bars closed and the tourism industry essentially shut down. Meanwhile, as a result of remote work measures, higher-wage/white collar workers have actually increased their savings rate with no commute plus saving on meals, entertainment and childcare.

Then in June, the murder of George Floyd sparked a wave of protests across the U.S. that eventually made their way around the world. This is not the first time we’ve witnessed the consequences of systemic racism, and sadly it won’t be the last. That said, we could be at a turning point on this issue as for the first time we are seeing significant responses from both the corporate and investment world.

Companies that expand their purpose can achieve this transition and generate value for all stakeholders. For example, they can prioritize the health and safety of their employees and provide opportunities for underrepresented groups, helping to attract and retain top talent and maintain a strong corporate reputation.
On building corporate resiliency
By Impax Asset Management

The pandemic has brought many sustainability issues into sharper focus, especially around the social aspect of ESG. We believe the pandemic and reaction to the inequality it exposed has created a tipping point in social consciousness around both environmental and social challenges.

We are directing an even greater focus in this area, taking a close look at how companies are handling worker health and safety, human resources management, customer safety, and community impact. These areas have been of concern to sustainable investors for a long time; the pandemic has brought them into the spotlight. As part of our analysis and conversations with companies during the earlier stages of the COVID-19 crisis, we asked questions such as: How have they implemented furloughs? What are they doing about executive pay? What are they doing to protect employees and customers? How are they retooling products and services to meet the needs of this moment?

We have also written to companies in some high-risk industries—retailers, grocery chains, healthcare businesses—to find out what they are doing now, or plan to do, to build more resiliency into their businesses. We appreciate that many of these companies were focused on the immediate emergency, but we aim to continue the dialogue on these topics.

In the longer term, we believe that companies that maintain strong relations with their key stakeholders [e.g., staff, suppliers] during the crisis will emerge strengthened. Can they modify their sick time policies in a way that could help protect their entire workforce? Can they extend remote work arrangements to gain efficiencies and lower their carbon footprints? For all it has wrought, the pandemic has also shown what is possible, and there’s much to be gained from that insight.

On social impact investment opportunities
By Wellington Management

In 2020, social and sustainability bonds gained significant market share relative to green bonds, with many issuers raising capital to put toward COVID-19 relief projects. For example, a number of government agencies and supranational issuers like development banks issued social bonds where proceeds would be used to provide loans to low-income households facing unemployment, as well as to small businesses struggling to stay open amid the economic shutdown. The market saw further innovation with the issuance of bonds focused on tackling racial inequality, by aiming to provide financing to Black and Hispanic communities in the U.S. for activities such as mortgage loans, construction loans, and small business investments.

At Wellington we are able to take advantage of that shift. We invest in a wide variety of issuers that are tackling major social challenges, including but not limited to education, affordable housing, and healthcare. Below are three investment stories worth highlighting.

Every country will have different priorities, but the starting principle for all governments should be to seek to build more productive and resilient economies while tackling climate change and social inequalities.

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1. This year, we invested in a taxable municipal bond issued by Howard University, advancing our education theme. Howard University is a historically Black university located in Washington D.C., offering undergraduate, graduate, professional, and doctoral degree programs. When evaluating colleges and universities like Howard for our impact portfolios, academic literature shows that social mobility outcomes offer the most robust way to assess the quality of a college’s education. Therefore, we look for universities that produce above-average social mobility outcomes. Some universities do better than others in educating greater shares of low-income students and propelling them into higher income brackets. We believe Howard University stands out as a leader in social mobility.

2. In support of our Affordable Housing theme, we invested in an organization called Sanctuary Housing Association, one of the largest not-for-profit housing associations in the U.K. Their mission is to provide housing and services for people on low incomes, those in need of additional care and support, and the elderly. Sanctuary Housing owns and manages more than 100,000 homes and is committed to building more housing to create a more inclusive housing market. We believe that investments in affordable housing can improve overall health and wellness and support social upward mobility, and therefore we will continue to identify opportunities globally to advance this theme.

3. Within our health theme, we invested in a company called Emergent BioSolutions, a global life sciences company whose mission is to protect and enhance life by developing and manufacturing medical solutions specifically to address public health threats. Most recently, this company has been focused on developing COVID-19 treatments while also collaborating with others in the industry on the development and manufacturing of potential vaccines. We expect to continue to look for opportunities to lend to biopharmaceuticals and diagnostics companies that are focused on developing vaccines and treatments as well as testing tools for novel diseases, as the COVID-19 pandemic has highlighted the increased need for these products and services.

Proactive companies have been taking advantage of the pandemic as an opportunity to test re-engineered processes and work out the kinks in a live work situation, something normally not afforded to rapidly growing companies.

On influencing policy change
By Impax Asset Management

As policymakers move from lockdown to rebuilding economies, we expect them to incorporate societal feedback telling them that simply returning to the old normal is not enough. The people most vulnerable to the economic losses we will face if we do not successfully mitigate climate change and reverse biodiversity losses live in low-income communities and are disproportionately minority groups. We’ve already seen how vulnerability to COVID-19 has more profoundly affected minorities due to a long legacy of inequality and its tentacles—poor housing, exposure to pollutants and contaminated air and water, and racial profiling that affects everything from law enforcement encounters to credit ratings to employment.
We can act on these threats through advocacy, such as urging regulators to make markets more aware of these systemic factors. This year, Impax petitioned the U.S. Securities and Exchange Commission to oblige companies to make the precise locations of their key facilities publicly available so investors could better assess the companies’ physical risks in the face of climate change. We also revised an earlier petition to the agency about gender pay reporting, asking them to require companies to disclose pay gaps for all demographic groups—gender, ethnic and racial.

In addition, ahead of the UN Climate Change Conference in November 2021, attention is being focused on how governments can shape policy to attract investments to clean energy economies, the bulk of which will come from the private sector. We have produced a five-step framework for developing what we’re calling “clean investment roadmaps”:

1. Agree and publish clear sectoral objectives and investment requirements
2. Build understanding within government of sector and project economics
3. Implement investment-grade policy at all levels: sectoral, indirect and investment climate
4. Provide implementation resources that address local circumstances and barriers
5. Initiate a clean investment dialogue with private investors and other key stakeholders at the start of the process

If we cannot solve the inequality among races and genders, we face a future of rising strife and conflict—the same future that comes with climate change. Impax will support calls for both private and public sectors to invest in the green economy as part of post COVID-19 economic stimulus packages, as well as tackling persistent areas of inequality.

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We believe the pandemic and reaction to the inequality it exposed has created a tipping point in social consciousness around both environmental and social challenges.

### On diversity and inclusion

By NEI Investments

The “S” was the relatively quiet component of ESG until the cracks opened by COVID-19 more explicitly revealed the inequities and injustices embedded in our economic and social fabric. The killing of George Floyd further served to emphasize this fact, placing one issue in particular—systemic racism—at the centre of our ESG conversations around social risks, which translated into a renewed focus on diversity and inclusion, or “D&I.”

D&I is an “all sector” issue, though strategies for promoting more equitable and inclusive workplaces will vary based on corporate and industry circumstances. Regardless of sector, in our proxy voting and engagement work we encourage all companies to set diversity targets and build and implement D&I strategies that are aligned with their corporate mandates—just the way they would in developing an effective, company-specific strategy for any other aspect of their business.

Shining a brighter spotlight on D&I has revealed one significant challenge we face when seeking to make progress on this issue: data, and in particular data related to diversity beyond gender. We saw enhancements in 2020 around D&I disclosures now required under the Canadian Business Corporations Act, but have yet to see how these requirements
may influence (or not) more voluntary disclosures by non-CBCA issuers. For our part, we recently changed our guidelines this year to require at least two independent women on corporate boards and have also started voting based on the appearance of a lack of racial/ethnic board diversity. And we were a founding signatory of the Responsible Investment Association’s Canadian Investor Statement on D&I.

Aside from D&I, other “S”-related issues that have been thrust into the spotlight post COVID-19 include employee safety and fair wages for food retailers and other exposed sectors. We engaged with several companies on how they are managing workers’ health, safety and rights, not only in the context of the pandemic, but also with a view to a post-pandemic world where health and safety and fair wages must remain crucial considerations. In this effort, we continue to work in concert with other investors through organizations like the Interfaith Center on Corporate Responsibility and the International Association for Human Rights.

**Engagement case study: Salesforce**

*By Federated Hermes*

One engagement example is Salesforce, where we have encouraged the company to continue the development of its Futureforce university recruitment program to target women in science, technology, engineering, and mathematics subjects.

Furthermore, the company has implemented responsible technology and ethics principles in its business, hiring a chief ethical and human use officer to the board. This is a critical issue for the company’s employees, who feel strongly about being on the “right side of issues” for their customers and the wider community.

We have also challenged the company to think about how it can quantify its contribution to the UN Sustainable Development Goals in relation to how it enables small and medium-sized enterprises, and women- and minority-owned businesses, to succeed and grow. This would enable it to articulate how its business is helping to deliver equality, decent work, and positive economic development outcomes.
POST-PANDEMIC INVESTMENT OPPORTUNITIES AT A GLANCE

To close out our 2021 Market Outlook, we have identified ten investment opportunities from the pages of this report and consolidated them below. These are opportunities that NEI and its roster of sub-advisors have identified as having the potential to drive increased returns or help reduce risk over the next year and beyond.

In the words of one of our sub-advisors, investors will likely need to “cast a wider net” to achieve their desired returns. At the same time, they will need to recognize the growing importance of investing in companies focused on addressing ESG themes, and which incorporate all stakeholders in their strategies for long-term value creation.

1. U.S. inflation-linked bonds are likely to outperform traditional government bonds; developed and emerging market debt is likely to benefit from economic recovery and accommodative fiscal and monetary policy.

2. Canadian precious metals companies and Real Estate Investment Trusts may benefit from an inflation in real assets.

3. Small cap companies tend to benefit most from accommodative tax policies and government spending that occurs during the early stages of an economic recovery.

4. A “barbell” investment strategy can offer a balanced exposure to recovery—one that mixes higher quality cyclical companies such as specialty retailers, professional services companies, and insurance companies with more traditional defensive businesses in sectors such as consumer staples and utilities.

5. Foreign developed market stocks may outperform their U.S. counterparts, which could suffer from weaker fiscal support and lower interest rates as compared to Europe.

6. Companies in the financial sector should benefit from economic support and more stable conditions.

7. The surge in technology sector stock prices may have left investors overweight U.S. growth stocks; time to revisit asset allocations against long-term growth objectives.

8. Tangible opportunities in the transition to a more sustainable economy include industrial automation, digitization, and health, safety and well-being.

9. Companies with strong value-chain propositions, that have control over the sourcing decisions in their supply chains, are likely to do well.

10. The opportunity set for impact investments within public fixed income is growing, with social and sustainability bonds gaining market share relative to green bonds, offering more opportunities in areas such as education, affordable housing and healthcare.
As policymakers move from lockdown to rebuilding economies, we expect them to incorporate societal feedback telling them that simply returning to the old normal is not enough.
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