Will the ESG backlash last? The December 2023 NFP Investor Quarterly Market Update

By Perpetual Wealth Management
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The December 2023 Perpetual Private Quarterly Market Update explores the recent countertrend that's seen some commentators question ESG strategies. You can watch the video above, download our full report, or read our concise review below.

Please note: except where otherwise noted or quoted, the views in this article are those of Perpetual Private's Investment Research Team.

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December Quarter 2023: What happened?

- Markets were surprisingly robust throughout 2023 and global economies managed to avoid the recession that many commentators expected. Despite this strength, we still believe a short, shallow recession in the months ahead is possible.
- Local share markets finished the year up 8% with global markets delivering similarly impressive returns of 5%. Higher interest rate expectations also helped push U.S. 10-year bond yields to their highest levels since 2007, before inflation optimism drove them back down as we came through November and December.

- Fixed income assets broadly, are delivering better yields with higher cash rates providing a floor for income producing assets.
- Geopolitical conditions deteriorated throughout the year, however neither Russia's invasion of Ukraine nor the ongoing Israel-Gaza conflict have had a significant medium-term impact on markets. The likelihood of additional regional conflicts flaring up in 2024 may briefly drive a spike in volatility but this is unlikely to have lasting impact.

Despite much consternation, 2023 proved to be a surprisingly good year for markets. Early predictions of recession failed to crystalise, tighter monetary policy improved income yields for many assets, and a rally in AI-linked tech stocks drove markets and bolstered sentiment.

The December quarter marked a strong finish to an unusual year, with Australian stocks generating more than 12% over 12 months. Global stock markets also generated an impressive 21%.

While that's certainly a nice note to end the year on, it's by no means the whole story. Although the quarter was generally positive, there were significant gaps between the market winners and losers. In Australia, listed property gained 16.5% while energy stocks lost 8%. A similar story played out in global markets, where listed property gained 9% while energy lost 8%.

ESG backlash unlikely to last

Recently, we've seen the emergence of an ESG countertrend. While some groups may be trying to do too much too quickly on ESG, much of the reversal is simply a natural reaction to the big swing towards ESG investing.

However, some of this backlash is politically driven, with perhaps the most widely publicised example being the actions of Florida governor and U.S. presidential hopeful Ron DeSantis. DeSantis has been a very vocal opponent of ESG, even going so far as to ban the use of government money to promote ESG goals and prohibiting the sale of ESG bonds across the state.[1]

We believe this countertrend will be short-lived.

The three pillars of ESG investing – environmental, social, and governance factors – should be key considerations for prudent investors.

Governance is perhaps the most easily understood. Investors have always sought to ensure that the vision of business leaders for the company aligns with their own goals and ambitions, and that those leaders are capable of doing their jobs.

But environmental and social factors have also long been important considerations.

Think back to 2007–08, following the Global Financial Crisis. In the UK, trust in the major British banks plummeted as customers saw a disconnect between the recessionary conditions that plagued their daily life and the sizable bonuses being paid to the executives seemingly responsible for the crash.

British banks lost their social license to operate and underperformed the market over the next decade as a result.

A few years after the Global Financial Crisis, BP found itself in a similar position. A leak at the company's Deepwater Horizon oil rig in the Gulf of Mexico triggered one of the largest oil spills in the history of the petroleum industry.

BP survived that disaster but exists now as a shadow of its former self.

These are precisely the sorts of risks that modern ESG practices are alert to – and investors try to avoid. We see investor pragmatism dissipating the backlash over time.

Turning of tides raises hopes for income

The past decade has been an arduous one for income investors. Following the Global Financial Crisis in 2007–08, efforts to repair global economies largely rested on rate cuts – a decision driven in part by the fact inflation wasn't particularly high at the time, nor did it increase much afterwards.

But even as rates scraped lower and lower and circled uncomfortably close to negative levels in several countries, this strategy was still being recycled in a bid to stimulate economies.

To put into context why this had such a harmful effect on income investors, we need to consider the way fixed income assets are valued.

When official interest rates are lowered, they have the effect of increasing the capital value of fixed income assets without a corresponding change in income generated. This means the percentage of income to capital drops, and income investors effectively receive a drop in the level of income they earn.

As rates got closer and closer to zero, the defensive assets we've previously relied on to produce income have been providing only around 2% in yield, forcing income investors to move higher up the risk curve.

That's now starting to change.

In 2022 we started to see official interest rates rise and the income to capital ratio shift back towards where it used to be. Importantly, beneficiaries are yet to realise the full benefit of these changes as tax rules and some structural features of the market create a lag between higher rates and improved incomes.

Over time, rising income levels will flow through portfolios and into beneficiaries' accounts. The worst is now behind us.

Perpetual Private's Quarterly Investment Update for December 2023 covers the changing nature of investment dynamics and looks at the outlook for shares, fixed income, real estate, currency and alternatives.

[Download the report]

[1] I Binnie and R Kerber, '*DeSantis signs sweeping anti-ESG legislation in Florida*', Reuters, 3 May 2023, accessed 17 January 2024

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