THE MACRO DRIVERS OF CLIMATE INVESTING

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Overview

2022 proved a volatile time for global markets and geopolitics. Climate transition themes were sensitive to this uncertainty – both on the up- and downside. As we look forward into 2023, the picture is mixed. Renewables in the US remain boosted by the sugar rush of fiscal support, while European industrials need to adapt to a shifting energy supply picture. The wildcard once again will be China as it emerges from its zero-covid policy into a world increasingly favouring local production and shorter supply chains.

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2022: year in review

We began 2022 on the tails on of a widely-hailed COP 26 and an ebullient stock market. Many investors were initially convinced that the heightened inflation they were seeing was transitory and of limited concern. The Russia-Ukraine conflict put this view to bed and central banks around the world were forced to pursue a new tighter monetary policy narrative to dampen soaring inflation.

Growth-orientated investments - focused squarely on the tech sector – took the initial fall, as the premium investors had previously been happy to pay collapsed. While investors became more focused on the short term, this was offset by a broadening realisation - brought on by a combination of rising fuel prices, geopolitics and policy tailwinds - that energy independence and climate-change themes were here to stay.

The long reach of the war in Ukraine

The fallout of the Russian invasion of Ukraine quickly spread from the most immediate impact on the people of Ukraine to the wider European and global economy.

Escalating fuel prices – notably in the natural gas complex – undermined European industrials and prompted the spectre of a wider recession. With central banks already looking to stave-off inflationary pressures from the reopening of the global economy, the rush of energy inflation left policy makers with a dilemma – whether to fight inflation at the cost of accelerating recessionary pressures.

The backdrop was now set for increased volatility in financial markets. The initial reaction for Climate Transition themes, and the renewables space in particular, was supportive as the world looked to the value of energy independence. Renewable utilities in particular rallied, benefiting from a lost-cost generation base and the stability of regulatory contracts.

Meanwhile many European cyclicals – ironically dominant in the energy efficiency theme – were undermined by slowing growth and rising fuel costs. By consequence, European industrials faced a loss of competitiveness as the region looked beyond its dependence on cheap Russian gas towards more costly (and dirty) sources such as US shale gas.

Key Points

1. The market backdrop for 2022 was dominated by central bank inflation fighting and the energy crisis in Europe
2. Climate Transition themes found mixed support, with headwinds for European cyclicals while US renewables were boosted by the Inflation Reduction Act
3. As we look into 2023, we anticipate continued strong momentum for renewables, but with complexity introduced by a desire for many countries and industries to shorten supply chains and encourage domestic production.

Everything's bigger in Texas

The mid-year was marked by a landmark US bill: the Inflation Reduction Act (IRA) signed into law by President Joe Biden in August. Despite its name, the IRA can be viewed as a climate bill, with the goal of putting the country on a path to reduce greenhouse gasses by 40% below 2005 levels by 2030. While this GHG reduction is insufficient to meet the Paris Agreement goal of a 50%-52% reduction in emissions in the USA, it is a big step towards achieving this climate pledge.

Among its many provisions was stronger support for the installation of renewable generation capacity in the US, as well as broader climate-supportive pillars, such as the use of alternative fuel sources. The greater certainty provided by the Act – and the emphasis on domestic production – lit a fire under US-exposed solar stocks in particular. As the technology with the shortest horizon, the outsized performance of this theme has some fundamental justification, while we expect long lead time themes such as Wind to continue to strengthen over the coming years.

European regulation: a game of push and pull

Fiscal policy in Europe was more confused – leading to push and pull for exposed stocks. A number of programmes showed support for early-stage renewables – with Hydrogen producers offered a €5.2bn package negotiated by a group of EU countries. At the same time, the squeeze on government finances posed by the energy crisis has led many countries to impose windfall taxes - not only on fuel producers, but also renewable generators. The argument here is that the benefits of the lower cost of renewable generation should be shared with customers. While somewhat counterintuitive, it shows the strong case for energy independence offered by renewables and the growing cost-competitiveness of non-fossil fuel sources.

2023: some inertia – but scope for change

As we turn to 2023 we expect to see many of the themes that dominated 2022 to continue. There are some elements of change however, as European countries grapple with their shifting energy supply picture and China emerges from its Zero-Covid isolation.

The IRA steamroller rolls on

While the US lags Europe in terms of disclosures (although there has been a marked improvement for the former), it leads the way in terms of innovation. 2023 is likely to be a very strong year for the build out of solar installations (both on the utility side and the residential side) as penetration rates grow fast from a low base. Green hydrogen is increasingly becoming more price-competitive and carbon capture technology and regulation is evolving.

The bulk of the investments in the Inflation Reduction Act, costing an estimated $370bn over 10 years, are directed toward promoting clean energy and climate resilience. Two-thirds of this amount comes in the form of federal tax credits and one-third is accounted for by appropriations by the federal government to mitigate emissions from agriculture and forestry. The tax credits address four key areas: clean energy, manufacturing, transportation and clean technology. These tax incentives would help lower the price of clean technologies versus conventional peers, making these technologies more competitive. For instance, the WEF estimated that green and blue hydrogen will become cheaper than traditional hydrogen by 2030, while electric vehicles (EVs) and combustion vehicles could reach purchasing power parity in five years.

Shortening supply chains

With the IRA favouring domestic renewable technologies, there is rising concern that imports of greentech from Europe and Asia will lose their competitiveness in the US. The IRA bill in the US has been criticised by Europe and China as it often requires high local content for products to qualify for subsidies. In response, a trend that will dominate 2023 is non-US renewables opening manufacturing facilities on US soil. For example, South Korean battery supplier LG Chem is considering building a cathode production facility in Tennessee and announced the opening of an EV battery recycling venture in North America by end of 2023. However, the scale of the funding provided by the Act and the insistence on protectionism raises the spectre of retaliatory action from other governments.

This accelerates a broader trend, with the Covid crisis having uncovered the weaknesses of global, complex and highly efficient supply chains that are a key pillar of globalization. The consequences were numerous but the long delays or the lack of supply were the most impactful consequences. As a result, corporates and governments are now taking measures to ensure robust supply. In order to do so, supply chains are getting shorter by being localised and inventories kept higher along the value chain. The main outcome of such reorganisation is higher costs and a negative impact on global trade if pushed too far. In our portfolio, having companies with a domestic footprint is part of our approach to diversification as these companies are more likely to benefit from the different government bills/stimuli.

An uncertain environment for European cyclicals

Just as we were starting to understand the lasting consequences of the covid crisis, the war in Ukraine provoked an energy crisis that hit hard in Europe. While natural gas prices have cooled down lately thanks to a warm winter so far, the medium-term risks of higher energy prices, as well as supply issues, remain in Europe. The consequences are several here as well but this makes Europe less competitive and large corporates with a global footprint are already reallocating capital away from Europe to the US, Asia or the Middle East. This situation also incentivises households in Europe to be more efficient and independent when it comes to energy consumption. On top of the regulation, this is another booster in demand for products/solutions that can help achieve either or both goals. Heat pumps or solar panel on roofs are typical examples.

With the looming spectre of recession in Europe – already arrived in many countries – combined with inflationary pressures, the backdrop for European cyclicals remains challenging. While investors have digested the scope for earnings reduction at an index level, bottom up consensus remains elevated. Caution is advised and we are focused on seeking stocks where a deep recession and opportunities for balanced risks remain.

Accessing the opportunity of Climate Transition investing

2022 showed us the benefits of diversified exposure to Climate Transition, as complex drivers and uncertainty led to volatility within the underlying themes. With new multifaceted storylines already emerging for 2023, we expect a similar approach to profit this year. While Climate Transition has strong, acyclical drivers that give us confidence on the long-term return potential, combining these themes in a way that allows the investor to survive the journey is as important as identifying them in the first place. Continued strong momentum for Enabling themes, while Mitigators recover from a difficult 2022, sets a supportive backdrop for Climate Transition investing.

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