

Flash Info



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Thoughts from the Environmental Strategies Group

We in the Environmental Strategies Group have invested through more 'capitulation' events that we care to mention and we are re-living yet another one. Today's capitulation reaches far beyond the environmental solutions theme that is characterised by long duration, secular growth. It is driven by a significant de-risking across asset classes, growth worries and concerns over the near-term trajectory of lower economic growth and higher inflation.

Capitulation (noun): "When investors give up any previous gains in any security or market by selling their positions during periods of declines."

'Capitulation' is mostly being used in periods of market declines, but could as easily be used in periods of market exuberance where investors crowd into investments amid rhetoric of "this time it's different" or "higher for longer", throwing in the towel by chasing performance and markets into thin air. In 2020/2021, it was 'different' as the market was repricing growth and technology businesses were touted as being no longer cyclical. At the time, we heard that energy was 'higher for longer' given structural underinvestment and the usual supply side arguments.

One lesson we have learned is that it never is. It is never 'higher for longer' or indeed 'different this time'. The global economy is inherently cyclical and fossil fuel markets have consistently driven economic 'boom and bust cycles' – the question now is, will it be an equity supportive glide path or recession?

In the past 22 years of investing thematically, we have seen the inefficient market hypothesis play out consistently amid animal spirits and behavioural finance. These oscillations tend to play out over longer periods aligned with a traditional business cycle that is driven by supply and demand – the movement of the gross domestic product, the availability of capital, and expectations about the future.

This cycle is generally separated into four distinct segments:

- Expansion (early cycle)
 - Peak (mid-cycle)
 - Contraction (late cycle)
 - And if things get worse, a trough (recession).
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The first thing to establish is that we are indeed in a late cycle. The second is the realisation that there is a probability tree of outcomes between (1) a glide path to baseline growth and (2) a recession that we will discuss below. In both cases, we expect volatility to stay high as the market pivots to one or the other as data comes through. Future inflation prints will be a crucial signpost.

Underlying growth continues to be robust, but there are certainly downside risks as the US Federal Reserve *needs* to slow growth somewhat to stem inflation. In other words, you can't have your cake and eat it. The market has been spooked by this attempt to slow growth. So, will slower growth throw us into recession? Firstly, recessions on average last 8-12 months before we enter a more equity friendly expansionary part of the business cycle. However, as things stand, barring additional exogenous shocks, it is our view that a recession is unlikely. Household and corporate balance sheets are healthy with corporate buyback allocations at all-time highs. Pent-up demand is still waiting to be filled with car makers reporting they have sold out of electric vehicles (EVs) (granted, helped by lack of battery materials). There is a continued need for infrastructure spending globally, not least in China as well as the much anticipated energy bill – a re-birth of Build Back Better – in the US.

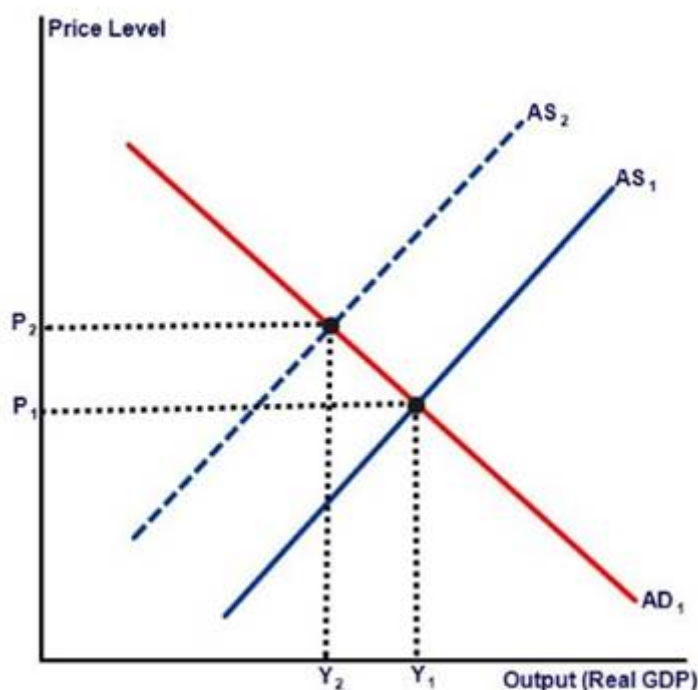
Inflation is the ONLY focus central banks have today and this means a tightening of financial conditions. This is rather unfamiliar territory for most investors. They have grown up with accommodative monetary policy and interest rates at historically low levels.

Taking a step back, we have for some time argued that inflation was *transitory* in the sense that inflation has occurred due to a *temporary, exogenous supply shock* that will ultimately revert to its equilibrium. This shock happened from the abrupt closing-down of the global economy due to Covid-19 and the significant disturbance to supply chains that has been extended and exacerbated by Russia's invasion of Ukraine. We would continue to argue that;

- The war in Ukraine will end (and hopefully soon, although that is hard to predict)
- The geopolitical premium will gradually come out of the oil market
- The structural environmental initiatives to wean ourselves off of fossil fuels will inevitably have a lasting impact on supply/demand for oil (even if the world at present needs more gas)
- That supply chains will recover as economies continue to reopen (with Asia admittedly lagging) and potentially overshoot as they are re-established more locally amid healthy corporate balance sheets and rising capital expenditure.

Indeed, we have long argued for the long-term deflationary forces at play through demographics, tech-led efficiency gains (and disruptions such as renewables and electric vehicles), the declining velocity of money, and global over-indebtedness – all work as structural, deflationary pulls.

The rise in prices we have seen is a natural consequence of textbook macroeconomic demand/supply curves.



Source: Businessstopia, 2021

When the productive capacity of the global economy is affected negatively, the aggregate supply curve shifts to clear at a higher price level with lower output and higher inflation. The last time we saw this energy-led 'stagflation' scenario was in the 1970s oil crises after a large spike in oil prices after Arab exporters stopped exporting to many Western countries as punishment for providing aid to Israel during the Yom Kippur war. The set-up today vs. the 1970s is different. For starters, the world was significantly more dependent on fossil fuels then and global savings rates today can cushion the rise in energy costs alongside recent subsidies for fuel and energy costs offered by governments around the world.

We expect to see inflation subside in the months and quarters to come partly because of the base effect of higher consumer prices. We are already starting to see short-term inflation expectations subside post the New York Fed's survey of consumer expectations, with the biggest fall in expectations in gas and food. If inflation (services and wages, in particular) moderates – as is our base case – this will anchor inflation expectations lower by potentially removing the need for the Fed to ramp up its fight against inflation. A transition from 'high inflation, rising rates' to 'high inflation but falling' marks a big change and – according to BCA Research – has led to a median three-month equity return of 3% and positive returns 69% of the time.

Indeed, once tighter monetary policy is priced in with inflation showing signs of moderating, we should see equities do well. Should this be the case, the energy and materials sectors – the biggest overweights in institutional portfolios today – should reverse recent gains, paving way for growth equities to perform once again from a significantly lower base.

So that's your macro view - What about environmental markets?

Environmental markets are not immune to de-risking events and these can be exacerbated by the long-duration growth characteristic of these technologies and end markets. They have been 'taken hostage' and are today significantly divorced from the fundamentals.

Environmental solutions companies have delivered spectacular returns since 2019 relative to the market and today trade at levels not seen since 2019 with P/E-to-growth ratios <1 where longer-term reliable growth will still matter in a low growth world. Since 2019, we have seen massive advances in:

- (1) Policy support
- (2) Growing commercial technologies and the market
- (3) The energy transition narrative; energy and food security concerns have brought decarbonisation and natural capital considerations forward by decades
- (4) Earnings momentum with continued significant earnings beats
- (5) Catalysts for environmental markets through a significant US energy bill, NEM 3.0, US non-circumvention issues being resolved
- (6) Large-scale M&A as evidenced by recent transactions.

Of course, multiples can always compress further, but we are encouraged by our deep fundamental work and multi-stage DCF framework, even incorporating conservative and elevated discount rates, that point to significant upside if companies deliver into their growing markets. As an example, we see opportunities in renewables with some companies holding up to a third of their market capitalisation in cash or trading below our break-up value. In such cases, we see scope for convincing triple-digit upside.

The fundamental signal for environmental solutions companies is flashing green, supported by generally strong reporting, while market sentiment, lack of liquidity and fear are flashing red. If history is a guide, the noise will subside and the fundamentals will ultimately matter.

In that sense, "it is not different this time around".

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