



Investment Views



May 2021

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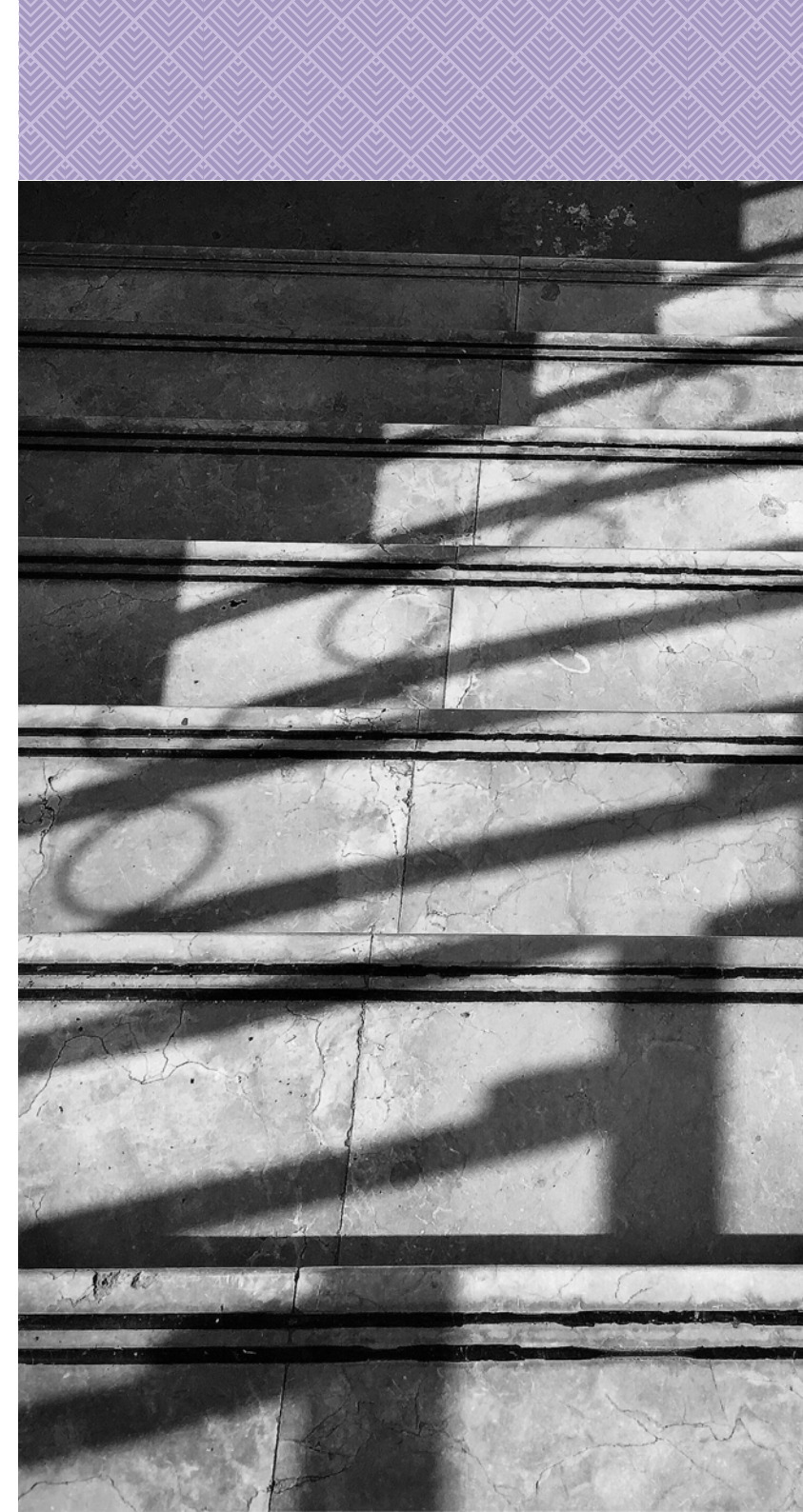
The Great Energy Transition

One of the most important long-term themes in global markets and economics is the transition away from fossil fuels to cleaner, lower-carbon forms of energy. To tackle climate change and its negative impacts, 197 countries adopted the Paris Agreement in 2015 and the deal aims to substantially reduce global greenhouse gas emissions and to limit the global temperature increase in this century to 2 degrees Celsius. The US withdrew from the agreement as President Trump fulfilled a campaign promise to do so, but within hours of being sworn into office, President Biden moved swiftly to rejoin. Today, the climate crisis is a priority for the three most important economic regions in the world: the US, Europe and China. In an age of fractured geopolitics this is a rare area of consensus which puts it front of mind for financial market participants.

The International Energy Agency (IEA) recently released their latest publication “Net Zero by 2050, A Roadmap for the Global Energy Sector”. The special report describes cutting carbon dioxide emissions to nearly zero, and limiting global warming to 1.5 Celsius, as a “narrow but still achievable” goal, one that requires significant investment and the transformation of economies over

multiple decades. To achieve net zero the use of fossil fuels would need to fall from around 80% of the energy supply today to just 20% by 2050. The IEA estimates that coal demand would need to decline by 90%, gas demand by 55% and oil by 75%. Other than projects already committed to now, the roadmap sees no need for new oil and gas fields or coal mines. In reality this is an incredibly ambitious goal and it has already received pushback from countries such as Australia and Japan. While much debate remains, the direction of travel is certainly undeniable when it comes to both public and private efforts to tackle climate change.

Electrification and renewables are critical to the energy transition. Electricity accounts for around 20% of total energy consumption today but would need reach nearly 50% by 2050 to achieve net zero. This represents an increase of 2.5X, with demand driven by industry, transport, buildings and hydrogen. The use of wind and solar will also need to increase significantly and these both require significant investment. As clean energy technology uses much larger amounts of metal than traditional fossil fuel-based energy, we are seeing demand





for metals rise accordingly. Copper is a particularly important metal that is used to some degree in almost all clean energy technologies with some analysts going so far as to describing copper as the “new oil”.

Electric vehicles are also an important part of the energy transition and dominate many of the headlines due to the charisma and eccentricity of Tesla CEO, Elon Musk. Tesla entered the S&P 500 last year and is now one of the top ten largest companies in the index although never far from controversy. We have followed the company for some time but never invested in the stock as it does not

fit with our investment philosophy. From an investment perspective, the energy transition theme is challenging as there are so many uncertainties involved when it comes to new technology. We have already seen significant weakness in some areas of the clean energy complex, so one must be careful about the risk-reward trade-off in the more speculative technologies. However, we have been spending an increasing amount of time thinking about how the future of energy may evolve and have added exposure in less speculative areas such as the more traditional auto manufacturers, materials companies and commodities in appropriate portfolios.

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Fixed Income

The Inflation Conundrum

After the significant disruption witnessed in the first quarter when bond yields rose sharply, April gifted us positive returns in Fixed Income markets and broad risk assets. As referenced in previous commentaries, the catalyst behind the rapid move in US bond yields over the past few months has been the likely prospect of additional fiscal stimulus and also the success of the US vaccination rollout. Both feed into much higher growth and inflation expectations and this dynamic is likely to remain in place for most of 2021; supporting risk assets and keeping bond bears in business. So, whilst we have captured some capital gains in April, as the 10-year US Treasury rallied from 1.74% to 1.63%, we suspect this is simply a pause before yields continue grinding higher. That said, short-term US government bond yields in the 5-7 year space are enticing overseas investors with currency hedging costs now minimal and European bond yields vulnerable to a change in the German government, which will likely to lead to less fiscal constraint and higher Bond yields.

Economic data continues to surprise to the upside across most countries that have either made good progress with vaccinations or have generous fiscal support programs in place. Population mobility, which is generally an excellent real-time proxy for economic activity, is also rising across

Europe and the US. In addition, US airport passenger numbers reached an average of 1.39m per day in April as people resume their normal lives although this is still -41% below the long-term average. In the US the broad re-opening of the economy is spurring gains in employment, manufacturing and consumer confidence as evidenced by the strong numbers released during April but there could be a sting in the tail as supply chain pressures and overly generous unemployment support is clearly leading to an uptick in wage pressures and inflation. However, the market is expecting elevated headline US inflation over the next few months, mostly due to base effects but also massive pent-up demand. This has been reflected in US inflation breakevens with 5-year expectations reaching 2.59%, so the Federal Reserve is unlikely to react now especially as their new framework allows them scope to make up for previous deflationary episodes.

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Other market indicators such as raw commodities and crude oil are all rising with copper (a growth proxy) and surged by +19% in April alone and +35% year-to-date. Bond market volatility has also fallen, which is helping to contain the brief rise in US mortgage rates which reached 3.34% in March, but are now back to 3.05%. Within corporate credit, spreads continue to tighten as ample liquidity and the growth outlook support risk taking for now. Although, due to rich valuations, for accounts restricted to the investment grade universe we prefer to generate alpha via curve positioning and/or currency exposure.

In April the US dollar weakened broadly versus the G7 led by a resurgence in the Euro (rising from 1.17 to 1.20). The region is likely to benefit from a reduction in uncertainty due to the vaccination rollout, Canada's tapering of asset purchases and buoyant energy prices which turbo charged the Loonie, posting its best performance in four years versus the USD. Lastly, political uncertainty in the UK has returned with local elections in early May that could decide the timeline for a new Scottish independence vote.

Given that Sterling has been one of the best performing currencies in 2021 and positioning is very long, we could see elevated volatility in the coming weeks.

For the first time in over a year, COVID-19 isn't taking centre stage in this investment view and this is likely to continue as the year progresses. Nevertheless, we are still seeing outbreaks in Emerging Markets and, more concerning from an economic prospect, in India and Japan which still need monitoring. Vaccines are in short supply outside of wealthy countries and life is unlikely to resemble normality until at least early 2022 for most. In the West however, barring a new vaccine evading strain, this crisis is over.

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Equities

Journey Back to Normality Continues

April was another good month for equity markets as Europe's vaccine rollout picked up pace, the US economy continued to re-open and first quarter earnings came in ahead of estimates. A theme we have covered extensively over the past year is that markets have "front run" a lot of good news, with equities bottoming in March 2020, long before we had visibility of the end of the pandemic. With markets getting ahead of the recovery, it has been important that the vaccine rollout progressed well and company earnings have beaten expectations. Essentially, what we are seeing is equity markets becoming more synchronised with the economy. This is happening via an economic recovery catching up with markets, rather than a market catching down to economic disappointment, so it is a healthy development.

Of course, "normality" is not a static state - trends, habits and work practices evolve as society progresses. It has become a cliché to say the pandemic accelerated many underlying trends that were already in progress, but this is

a fair characterisation of what has happened. High-growth technology companies performed particularly well last year but suffered a sharp correction in recent months. We have written over the past year about the increasing participation of retail investors in financial markets and, with the most recent stimulus cheques in the US, there was an expectation that this money would find its way into financial markets. However this does not appear to have happened in individual name stocks, rather inflows into ETFs have been strong. This has removed some support for the retail favourite stocks, which include a lot of high growth technology companies.

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It does appear that some of this stimulus money did find its way into the crypto currency market. This has grown to be a large market with a total value of \$2 trillion at its recent peak. It is not something that we have written much about as we do not deem it to be an appropriate investment for our client base. There does seem to have been a closer link between what is happening in crypto currencies and traditional markets, as some companies have added holdings to their balance sheets (e.g. Tesla) and added crypto to their platform (e.g. PayPal) together with the IPO of the Coinbase exchange.

Part of the story with the weakness in the high-growth Technology stocks is the rotation we have seen into the cyclical stocks, which are better placed to benefit from the economy reopening and returning to normality, as markets look beyond the COVID-19 crisis. We have recently reduced our US Software exposure in appropriate portfolios to help tilt away from these more volatile areas of the markets.

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