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Previously Investec Asset Management

We need to talk about carbon

What the pandemic means (and doesn't) for investing in a decarbonising world

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The fast view

- In unveiling its €1.85 trillion 'European Recovery Plan', the European Union has put accelerating the shift towards a lower-carbon, more sustainable economy at the heart of its post-pandemic stimulus strategy.
- Europe's announcement recognises that the world still has a massive task ahead to transition from today's unsustainable economy to one based on cleaner energy and transport, more efficient industrial production and more energy-efficient buildings.
- The products and services of select companies will be crucial in enabling that transition – providing those businesses, we believe, with a structural growth tailwind for years. That may prove a lifeline for investors in a growth-challenged world.
- While the coronavirus has not changed the direction of the 'decarbonisation' structural growth trend, current market conditions are anything but business as usual. Here are nine issues for climate-aware investors to watch in a post-pandemic world.

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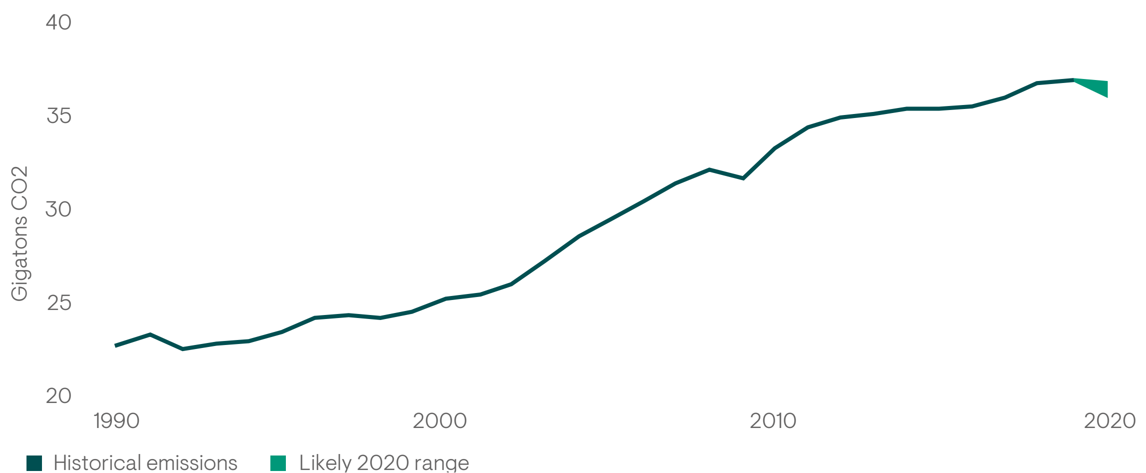
1 Decarbonisation remains urgent, and a driver of structural growth

The perception that the coronavirus, for all its devastating effects, is helping to tackle the climate crisis is not only bogus but dangerous. Global carbon emissions might fall by 5% this year, a blip in the trend of recent decades, and they'll resume their former trajectory when the economy starts to recover.

The latest research warns that climate change will hit humanity "harder, wider and sooner than previously believed"[1,2]. Transforming the way we produce and consume remains the only way to avert another global tragedy, with likely enormous loss of lives and livelihoods.

Decarbonisation may be delayed in the near term, but we see no change in the mid- to long-term growth drivers of select businesses across all three pathways to a more sustainable, lower-carbon economy: renewable energy, electrification and resource efficiency. There aren't many equity growth stories that include 'human survival' among their drivers.

Figure 1: Projected global CO2 emissions from fossil fuels in 2020



Source: Breakthrough Institute and GS

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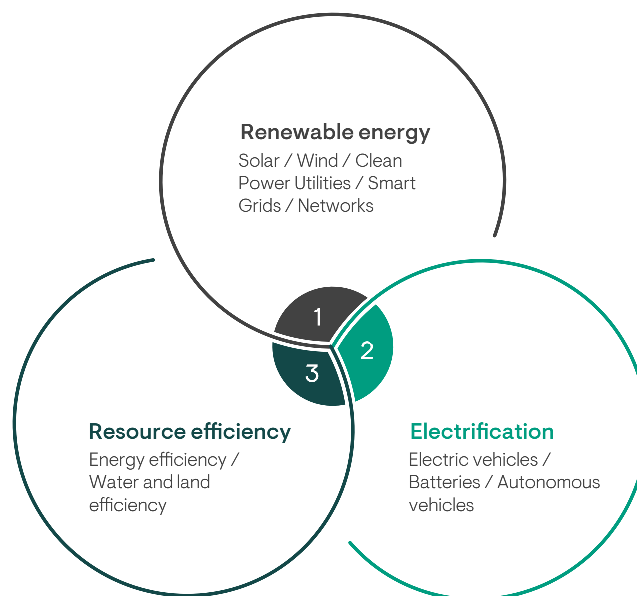
1. https://www.theguardian.com/environment/2020/may/05/one-billion-people-will-live-in-insufferable-heat-within-50-years-study
2. https://www.pnas.org/content/early/2020/04/28/1910114117

2 The stars may be aligned for a(nother) 'growth' moment

We don't usually wade into the 'growth vs. value' debate. But for equity investors wondering where within the asset class to position now, it may be interesting to note that it's often thought growth stocks tend to outperform when interest rates are low and when there is major technological change. A post-pandemic world looks likely to be a very low rate one for some time; while decarbonisation is nothing if not technologically disruptive. That may put the odds in favour of a growth-oriented equity portfolio.

Figure 2: The three pathways to a low-carbon future



Source: Ninety One

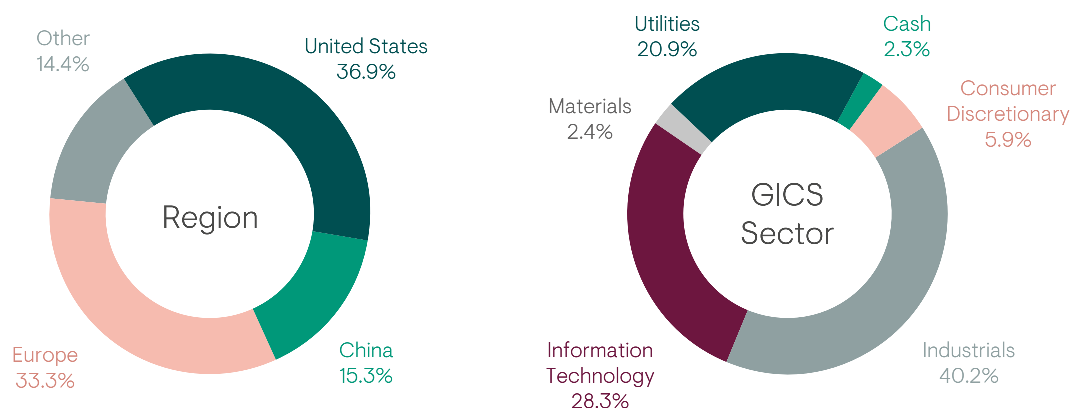
3 Be sure to tap decarbonisation's diversification potential

With the first corporate earnings having come through since the pandemic began, we're learning more about the companies in our decarbonisation universe – or at least having our assumptions tested *in extremis*. We have long argued that one of the useful characteristics of decarbonisation as an investment theme is that it comprises a hugely diverse group of businesses across regions and sectors: from wind-power developers, to logistics firms, to software companies, to biotech businesses, and more.

We saw the benefits of that during the global equity sell-off in Q1 2020. The defensive utilities in our portfolio – we are overweight utilities relative to broad equity indices because we hold a number of leading providers of renewable energy – did their risk-mitigating job, offsetting in benchmark-relative terms the heavy falls in cyclically exposed companies, such as auto-sector businesses (we hold various technology companies that are enabling the shift to electrified and ultimately autonomous transport).

Within the decarbonisation universe, there are good opportunities to spread risk. But diversification doesn't happen by chance. Given the uncertainty over the near-term economic outlook, it is strongly advisable for any decarbonisation portfolio to actively seek and manage it.

Figure 3: Ninety One Global Environment strategy breakdown



The portfolio may change significantly over a short period of time.
Source: Ninety One 31 March 2020. Based on a pooled vehicle within the strategy and is not available at the composite level.

4 Companies are stronger this time around, but stay focused

The Ninety One Global Environment strategy launched in 2018, but as portfolio managers we have been holding many of the businesses we are currently invested in for a long time. We were with them through the 2008 Global Financial Crisis, and their latest results show they are generally stronger this time around. (As an aside, one of the handy things about having held these stocks in the last big crunch is that we can model very realistic downside scenarios for them).

This is comforting. But as McKinsey neatly summarised, something the coronavirus and climate change have in common is that they are "both risk multipliers, in that they highlight and exacerbate hitherto untested vulnerabilities inherent in the financial and healthcare systems and the real economy"[3]. So while we expect a recovery later this year, it would be risky to rule out further as-yet-unforeseen impacts from the pandemic. To us, that argues more than ever for an active and selective approach to investing in the decarbonisation growth opportunity – one that focuses on quality businesses with competitive advantages and strong, defensible market positions.

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3. https://www.mckinsey.com/business-functions/sustainability/our-insights/addressing-climate-change-in-a-post-pandemic-world?cid=other-eml-alt-mip-mck&hlkid=b165b5c6094c49018c7db340901e1cd9&hctky=9951632&hdpid=50056e1f-1960-4ae3-b9a3-ff33b5ea692e

5 Keep an eye on the regulatory drivers of decarbonisation

Government policy is a key influence on where, how and how fast decarbonisation drives economic growth – so investors seeking the businesses most likely to benefit from this tailwind need to watch it closely. Overall, we have no doubt that policy will continue to support the energy transition, near-term delays notwithstanding. But the pandemic clearly alters national policy priorities, budgets and political climates. Some of these changes could massively spur businesses positively exposed to decarbonisation, others may create headwinds – which may be dangerous for companies with weaker balance sheets and fewer competitive advantages. Again, to us that argues for a selective investment approach to decarbonisation focused on quality businesses.

6 Europe's post-pandemic recovery plan will spur decarbonisation sectors

In Europe, the Green Deal is the key policy underpinning the acceleration of the energy transition. The policy has now been repurposed (or, more precisely, 'dual-purposed') as a cornerstone of the post-pandemic recovery plan, aiming to mobilise public and private capital towards all three of the low-carbon pathways. It will drive significant investment in clean energy, energy efficiency of buildings, cleaner transportation and waste management, among other areas.

The President of the European Council sees the Green Deal as "essential as an inclusive and sustainable growth strategy". In a Europe struggling for growth, fiscal policy focused on decarbonisation is viewed as a key lever for achieving post-pandemic recovery. That creates a big opportunity for businesses exposed to the energy transition, and we think for investors, too.

EU Green Deal/Recovery Plan overview

1. A massive renovation wave of buildings and infrastructure and a more circular economy, bringing local jobs.
2. Rolling out renewable energy projects, especially wind, solar and kick-starting a clean hydrogen economy in Europe.
3. Cleaner transport and logistics, including the installation of 1 million charging points for electric vehicles and a boost for rail travel and clean mobility in cities and regions.
4. Strengthening the Just Transition Fund to support re-skilling, helping businesses create new economic opportunities.

7 Wildcard US is even less predictable

Under the Trump administration, the effect of US climate policy has always been difficult to gauge, given the variation in federal and state-level environmental stances, and the gulf between rhetoric and real-world impacts – illustrated by the continued decline of US coal, despite all the talk in the early days of the current presidency of saving the industry (a reminder that decarbonisation is happening regardless of policy, although its course is shaped by political developments). While the first US stimulus packages offered nothing for environmental sectors, future ones may.

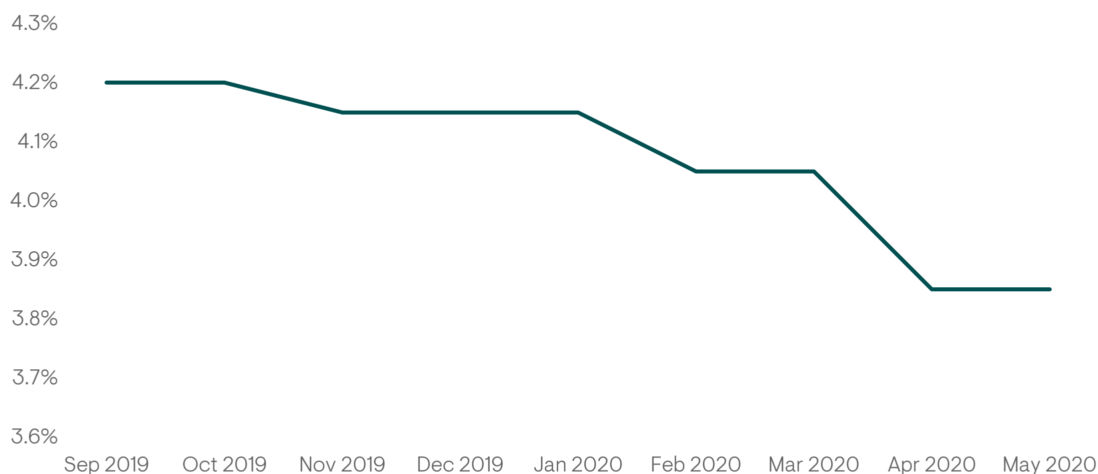
The really big political wildcard thrown up by the coronavirus is how this administration's handling of the pandemic could influence the outcome of the November presidential election. So far, the crisis seems to have increased the odds of a Democratic victory, with some potential even for a Democratic sweep. That would be extremely positive for decarbonisation-exposed businesses.

8 China is another policy question; the answer could be 'interest rates'

The need for fiscal stimulus provides an obvious opportunity to accelerate the growth of China's nine strategic industries, which include several decarbonisation sectors: new-energy vehicles, renewable energy, and energy-efficient and environmental technologies. However, to date Beijing has introduced only small measures to support cleaner tech. For example, an electric vehicle subsidy due to expire this summer has been extended for two years.

Further out, the direction of policy in China is hard to predict. But we have always believed that once the cost of renewable power-generation becomes cheaper than coal, Chinese clean-energy policy would accelerate significantly. The trend in interest rates is the biggest driver of that crossover (cheaper borrowing helps clean-energy sectors more than carbon-intensive ones). After monetary easing in China (see chart) and with the outlook for rates now (even) lower for (even) longer, the crossover has moved closer.

Figure 4: China loan prime rate



Source: People's Bank of China; Investing.com

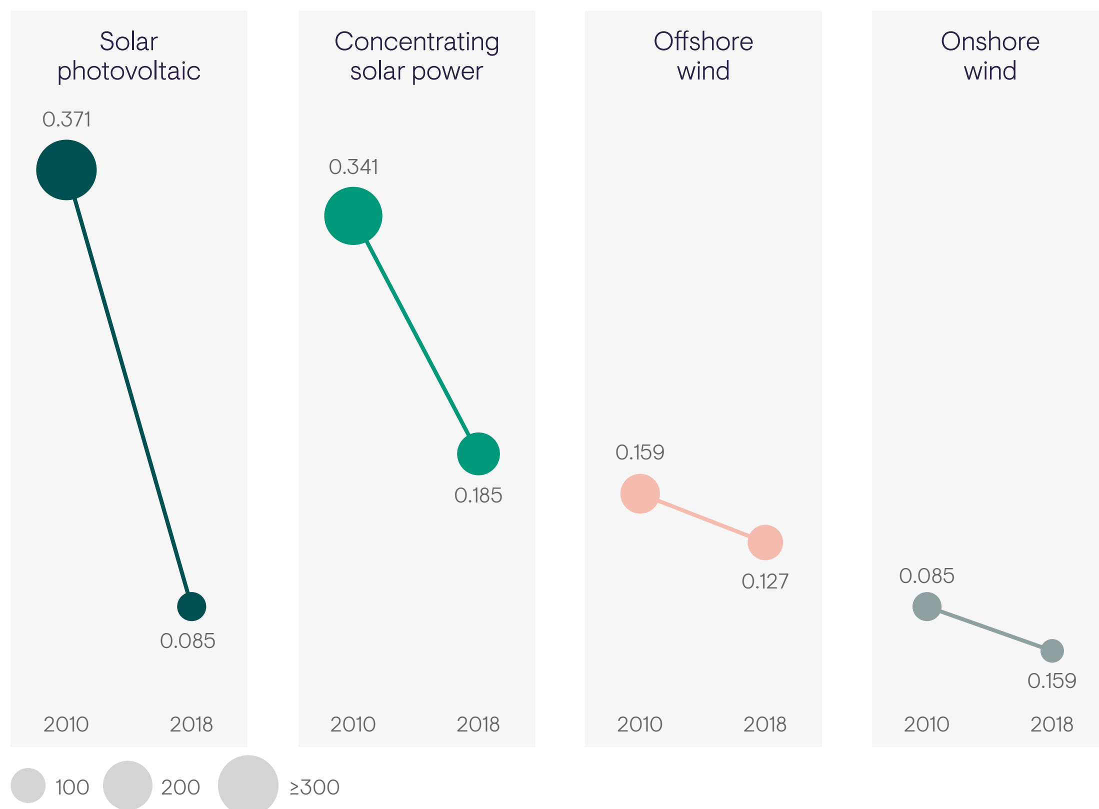
9 Trends in clean-energy economics continue, but competitive dynamics may change

From dolphins swimming in clear Venetian waterways to lockdown-inspired elephants getting drunk on corn wine in a Chinese village, the pandemic has engendered plenty of fake news. Among it has been commentary that cheap oil will derail the transition to clean energy. It won't – first and foremost because oil is not typically used to generate electricity. As for other fossil fuels, renewables are already so much cheaper than coal and gas in many parts of the world that changes in the prices of the latter hardly matter any more.

The pandemic and the oil slump have not altered the downward direction of clean technologies' cost curves, nor the pace of technological change that is driving it. From renewable electricity to electric vehicles and much else besides, decarbonising technology continues to become ever more cost competitive.

But one effect of the pandemic may be to increase the time environmental-sector leaders can sustain a competitive advantage. That is because, in more cash-strapped times, laggard companies will struggle to invest sufficiently in research & development to catch up. This is particularly true in the electric-vehicle supply chain. Once again, that argues for a concentrated, best-in-class investment approach.

Figure 5: Levelised cost of energy (USD/KWh)



Source: IRENA; data is for global utility-scale renewable power generation technologies

Investing in decarbonisation in a pandemic/post-pandemic world

In a growth-challenged world, decarbonisation remains a powerful and potentially valuable structural growth trend for investors. The coronavirus has not changed that, but it has created both opportunities and challenges for investors seeking to tap into it. Here are our key takeaways:

- In Europe especially, post-pandemic stimulus programmes are likely to increase the tailwind for decarbonisation-exposed businesses; but policy needs to be monitored carefully.
- Environmental businesses are generally stronger than in the 2008 crash; however, economic and policy uncertainty argues for a selective, best-in-class investment approach.
- Q1 2020 corporate results highlight that, as an investment theme, decarbonisation offers useful diversification opportunities – including in very volatile markets.
- The trend for clean technology to become ever more cost-competitive remains, but competitive dynamics within environmental sectors may change, to the advantage of leading businesses.

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