# Clean Economy strategy

## Extreme temperatures highlight the ongoing need to invest in electricity grids and renewable generation

- Lower inflation and resilient economic activity led to strong global equity markets
- 'Natural Resource Preservation' theme was a positive contributor to returns
- We exited a Chinese solar position to start a new one in a US-focused name

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### What's happening?

Global equity markets remained strong in July in US dollar terms as lower inflation and resilient economic activity raised hopes of a soft landing in the US and Europe. US equities led the way with Japan going sideways after an impressive first half of the year. On a sector basis, more cyclical areas of the market were strong, including energy and financials; more defensive areas including healthcare and service-based companies were weaker.

The macroeconomic environment continues to be mixed with softening inflation balanced against resilient economic activity and tight labour markets. Headline inflation decreased in the US, from 4% to 3% year-on-year in July, and Europe, from 7.1% to 5.5%. Inflation also fell more than expected in the UK from 8.7% to 7.9%, making up somewhat for last month's disappointing print. Meanwhile, Composite Purchasing Manager's Indices remain in expansionary territory across most major economies, with strength in services more than offsetting weakness in manufacturing, and wage growth continues to surprise on the upside.

Beyond economies and financials, unfortunately July 2023 will be remembered for some time for the exceptionally high temperatures, seen worldwide, as well as the devastating wildfires across southern Europe. The US National Centers for Environmental Prediction in fact measured Monday 3rd July 2023 as the hottest day ever recorded globally, surpassing the previous recording holding-day from August 2016. This "record" was then broken again the following day. Extreme temperatures are a public health risk, causing spikes in excess mortality, as well as highlighting the ongoing need to invest in electricity grids and renewable generation as building cooling demand rises. Similar to extreme temperatures, wildfires also destroy wildlife and ecosystems, impact public health (mainly respiratory issues caused by poor air quality) and are likely to increasingly damage service-oriented economies that rely on tourism. Wildfires also highlight the fragility of some of our responses to climate change to date. Tree planting has been a popular means of offsetting emissions, but this action is rendered useless if the trees do not remain in ground, living and absorbing carbon dioxide. Overall, these events highlight the urgency required, across public and private sectors, in responding to climate change.

*Source: All data are sourced from Bloomberg, AXA IM, as at 31/07/2023.*

## Portfolio positioning and performance

The portfolio underperformed the broader equity market represented by the MSCI All Country World Index in July driven by weakness in 'Smart Energy' holdings. On the positive side, 'Natural Resource Preservation' contributed to portfolio returns.

Returns in 'Natural Resource Preservation' were driven by paper and packaging company Smurfit Kappa and recycling company Darling Ingredients. Smurfit performed strongly as brokers upgraded the stock (as well as peers) on the belief that pricing was bottoming, and valuation looked compelling. Longer term, we believe Smurfit should grow strongly given structural demand for recycled packaging products. Darling's strength was driven by a recovery in fat prices and expectations of solid Q2 results for its core business, which will be reported in August. Ecolab and Waste Connections were the weakest stocks in this sub theme in July. These are both defensive stocks and their weaker contribution to returns is aligned with the sector performance trends observed above.

'Low Carbon Transport' was supported by returns from Infineon. Semiconductor companies had a good month generally; Infineon participated in this, perhaps with some investors buying in expectation of strong Q2 results. Wolfspeed was the second strongest stock in the sub theme, driven by the company's announcement of a $2 billion, 10-year agreement with Japanese chipmaker Renesas. This was taken well by the market as it indicated customers' worries around procuring sufficient silicon carbide substrate, of which Wolfspeed has around 60% global market share. This deposit also strengthens Wolfspeed's balance sheet, which had been a concern for some investors. Albemarle was a weaker name within the sub theme. The lithium sector was unsettled by the launch of EV battery-grade lithium futures on China's Guangzhou Futures Exchange, the price of which proceeded to fall. However, the futures prices have since stabilised and we think that the long-term supply and demand dynamics for the sector remain attractive.

'Agriculture & Food Industry' returns were led by Deere and Genus. Genus represents a reversal of last month's weakness; the stock was stronger as it appears investors re-engaged after the stock price fell to a 52-week low in late June. Deere was strong as demand for large agricultural and construction equipment remains resilient. The stock's weakness earlier in the year appeared to be driven by worries regarding an agricultural and construction slowdown, which was round-tripped by the end of July (with the stock up 24% from its end of May low). We still think the current agricultural cycle remains extended, but the magnitude of it might be lower if the increasingly benign macroeconomic backdrop continues to play out. Trimble was a weaker stock in this sub-theme; destocking trends have weighed on the name lately and investors have engaged less with the name as some perceive downside risk to 2023 financial guidance. We remain positive on Trimble given its growing recurring revenue mix and portfolio of differentiated products and services, helping drive profitability.

Returns in 'Smart Energy' were relatively divergent; the strongest contributors to returns were Ameresco and First Solar, and biggest detractors were Enphase and SMA Solar. Enphase represents ongoing weakness in the residential solar sector (dominated by the US). This has been driven by higher interest rates and utility rates coming down (off high levels). We think the long-term outlook for residential solar remains strong given the low penetration, savings versus conventional utility bills, and the ongoing need to electrify homes. SMA Solar was weak, giving back the stock's gains from the previous month when 2023 guidance was raised. SMA remains well-placed as a leading solar inverter manufacturer, with greater exposure to the (currently) healthier utility-scale solar market. First Solar, another utility-scale solar stock, reported strong results with the market encouraged by the announcement of new manufacturing capacity as well as strong new orders and profitability for the quarter. Ameresco performed strongly, mainly due to the announcement of new battery storage business opportunities. These should contribute towards the company meeting 2024 guidance, which continues to be widely debated amongst investors.

Through July we closed our position in Chinese solar wafer and module manufacturer Longi Green Energy Technology. Our investment thesis failed to play out as we hoped it would; we thought that falling polysilicon prices would support margin expansion for downstream companies, as well as stimulating demand, but this failed to happen, partly due to China's stunted post-Covid recovery. Demand should return at some point, but our research suggests polysilicon prices may stay depressed as more capacity is due to come online. We used the proceeds of this sale to open a new position in Shoals Technologies. Shoals is a utility-scale, US-focused solar EBOS (Electrical Balance Of Systems) company, facilitating the wired connection of

*Source: All data are sourced from Bloomberg, AXA IM, as at 31/07/2023.*

solar panels to each other and the grid. Their technology enables a material reduction in the labour intensity of solar installation. We also think US utility-scale solar growth should remain strong, supported by the Inflation Reduction Act.

## Outlook

The outlook for companies that provide solutions to the world's greatest environmental challenges remains extremely positive despite the volatile macroeconomic backdrop. Support for the energy transition continues to increase with most major nations now having meaningful decarbonization plans in place. The European Union led the way with its 'Fit for 55' package, which aims to reduce net emissions by 55 percent by 2030, while China's goal of peak carbon emissions in 2030 and net zero by 2060 is a significant step in the right direction for the world's largest polluter. In the US, the Inflation Reduction Act is the largest climate investment in US history and will help to lower the nations carbon emissions substantially by the end of the decade. Meanwhile, the newly adopted Global Biodiversity Framework sets out an ambitious plan to halt and reverse biodiversity loss by 2030.

Achieving these goals requires significant investment in the areas of 'Smart Energy' and 'Low Carbon Transport'. Energy infrastructure requires smart grids and interconnection capacity between regions, renewable power and energy storage solutions while transportation systems will move away from fossil fuels towards a combination of electric vehicles, biofuels and green hydrogen. Within 'Agriculture & Sustainable Food', high crop prices and rising input costs are supporting demand for agritech solutions which improve yield and farming efficiency. Elsewhere, companies in 'Natural Resource Preservation', which facilitate recycling and reusing, along with better management of resources, are helping to mitigate environmental damage while meeting the needs of a growing population.

The Russia-Ukraine crisis has served to underscore the need for Energy Independence and has therefore strengthened the resolve of both policy makers and those for whom energy security and uptime is critical. This strong and resilient demand for clean technology solutions, now further underpinned by energy security considerations, encourages further innovation which continues to enhance the investment potential within the clean economy.

Following the sharp derating in valuations of long duration assets in 2022, many innovative companies in the Clean Economy universe look attractively valued in the context of robust long term growth outlooks. We do not expect the narrow market leadership experienced year-to-date to persist and retain the view that high quality management teams, operating businesses with a sustainable competitive advantage in markets that benefit from secular tailwinds are best placed to deliver capital growth in the long term. The portfolio is therefore well positioned to benefit from the secular growth opportunities we see within the Clean Economy.



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