Edmond de Rothschild

OUTLOOK & CONVICTIONS

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THE FED COOLS THE US AND CHILLS THE REST OF THE WORLD

MATHILDE LEMOINE

Group Chief Economist Edmond de Rothschild

Global growth has been slowing since the end of 2021 due to softer trading conditions in the US and Asia. The US has enjoyed strong growth after recovering from the damage done by the pandemic but it is now close to its potential. In Asia, high vaccination rates limited the introduction of sanitary measures but growth was stymied by Beijing's determination to roll out a zero-Covid strategy to deal with low vaccination rates among older people. Paradoxically growth in the eurozone stayed strong at the beginning of 2022 despite the war in Ukraine and a four-fold increase in gas prices.

- **Europe is being punished twice, first by inflation imported from the US and second by the Russo-Ukrainian war**
- **Raising the Fed Funds rate to 4% will, according to our models, push the US into recession**
- **Asia is suffering from China's slowdown and tighter financial conditions**

Over the coming quarters, soaring food prices should accentuate slowdowns in emerging countries which import agricultural commodities, and especially those which depend on Russian and Ukrainian grain. The return of export restrictions and stockpiling have amplified the effects of the war on rising agricultural commodity prices. Food inflation is weighing on consumption and reinforcing a wait-and-see investment attitude in companies. We reckon that food inflation should add 4% to cumulative inflation in emerging countries by the end of 2022!

Moreover, the Fed has pulled out a bazooka to rein in inflation. US inflation has been running at a lofty 8.1% on average since the

beginning of this year and continues to be fuelled by overconsumption of goods despite the end of sanitary measures which triggered the price-wage loop. This inflation stems from persistently strong household demand in the US while supply continues to trail behind. **Persistent overconsumption of goods in the US is surprising. The lifting of sanitary measures should have caused spending to return to normal as in the eurozone.** As a result, manufacturing remained under pressure and so did goods transport. The combined effect of strong demand and reduced immigration, along with the "Grand Resignation" trend, put severe pressure on labour markets and set off the price-wage loop. The Fed is therefore trying to cool demand and anchor inflation expectations. The bank surprised markets by raising rates by 75bp in June and plans to continue increasing them to 4%. **According to our models, the US will pay the price with a recession in the last quarter of this year and in the first quarter in 2023. This would drag growth down to 0.7% in 2023 after 2.1% this year.**

Some central banks in developed countries like the Swiss National Bank took advantage of the Fed's move to return to more conventional monetary policy. The ECB, however, is in an impossible position.

Europe's economies are nowhere near the US in the economic cycle. **The eurozone's output gap is still at a negative 1% according to our calculations while it is over +1% in the US. The eurozone is the most exposed to the Russo-Ukrainian war and is also accelerating its energy transition. This could result in a recession with growth slowing sharply to 1.7% this year and 1.4% in 2023.** The ECB would be forced to embark on its rising deposit-rate cycle just when Europe's economic prospects were rapidly deteriorating. At the same time, the US recession and fears of a domino effect in the rest of the world would set off a flight to quality which would send the dollar higher. And the eurozone's imported inflation would only be increased even if oil prices were to stabilise at $80.

True, the eurozone's recession should only be temporary thanks to budgetary stimulus from the Next Generation EU plan and inflation shields in countries like Germany, France, Italy and Spain but the crisis would accentuate the lag in European growth compared to the US and Asia. In addition, it would aggravate the ECB's loss of independence compared to the Fed, a step backwards after the Draghi years; he actually managed the feat of getting European rates to dictate the trend in the US! Elsewhere, German policy is becoming harder and harder to read. And the Czech Republic is taking over as President of the European Council on July 1st so we might see more financial instability in the eurozone. As a result, the ECB's base rate hikes could trigger dramatically tighter financial conditions, especially in peripheral countries, forcing the bank to put further rises on hold. If not, the eurozone could suffer a severe recession. The eurozone's stability is at risk due to (i) the ECB's difficulty in convincing markets that it will avoid widening country spreads over the long term, (ii) the halt in the move towards a banking union and (iii) reduced European supervision in favour of reinforced national supervision. **That is why we think there will only be a limited rise in the eurozone's base rates.**

In Asia, as in every period after a strict lockdown, China could provide economic stimulus. In addition, its central bank is still easing monetary policy and rolling out budgetary stimulus measures. GDP could recover to 4.5% this year before rising to 5.1% in 2023 even if global demand softens because of the US recession. **However, we have reduced our estimates of ASEAN country growth to 2.1% this year and 2.5% in 2023 due to the combined effect of Fed pressure on emerging country central banks to raise rates and higher food prices.**

Providing oil is at $80 at end 2022 and European gas prices remain high, **we expect global growth to be an anaemic 2.5% this year and 2.3% in 2023.** Inflation will remain high until the end of this year before decelerating modestly in 2023. Our calculations suggest Europe's forced march towards energy transition could mean a 30% rise in energy prices for consumers. **But any slowdown in European inflation will still depend on how overheating in the US plays out.** The Fed's determination to rein in inflation has reinforced its credibility, possibly allowing it to halt its rate-hiking cycle before lending conditions become so tight that a global recession occurs. **The Fed is treading a very narrow path and the mid-term elections are approaching.** One thing is certain: the Fed's decision to exit its unconventional monetary policy and raise rates was the only way of guaranteeing medium-term financial stability. As the US is once again in a position of economic domination, it can expect to have lesser effect on the domestic economy compared to the rest of the world.

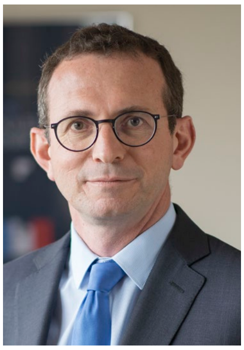
OUTLOOK ECONOMIC RESEARCH - EDMOND DE ROTHSCHILD

Central scenario - The Fed raises base rates to 4% and the ECB comes under investor pressure

In %	2021	2022f	2023f
GDP growth			
World	**5,2**	**2,5**	**2,3**
US	5,7	2,2	0,7
Eurozone	5,2	1,7	1,5
ASEAN	2,9	2,1	2,5
China	8,1	4,5	5,1
Inflation			
World	**3,8**	**6,3**	**3,7**
US	4,7	8,5	2,1
Eurozone	2,6	7,1	2,3
ASEAN	2,5	3	2,8
China	0,9	2,2	2,5
Base rates (at end of period)			
US	0,25	4	3,5
Eurozone (deposit rate)	-0,5	0,5	0,5
China (RRR in large banks)	11,5	10,5	12,5
10-y bond yields (at end of period)			
US	1,5	4,2	3,7
Germany	-0,2	1,6	1,4
Switzerland	-0,17	1,7	1,5
Change (end of period)			
EUR/USD	1,14	0,97	1,1
USD/CNY	6,39	6,55	6,6
EUR/CHF	1,05	0,99	1,01

Our oil price estimate: $80
Source: EdR Economic Research.

OPPORTUNITIES ARE COMING, THE TIME TO SEIZE THEM WILL COME



BENJAMIN MELMAN
Global Chief Investment Officer
Edmond de Rothschild Asset Management

The Ukraine war is dragging on with no end in sight. Russia has reduced its energy supplies to Europe, either on Europe's initiative or because Moscow decided.
The Covid pandemic has taken root across the globe as new variants emerge. Production chains are still being disrupted due to China's zero-Covid approach, a policy that is likely to persist at least until the 20th Chinese Communist Party Congress when Xi Jinping stands for another mandate.

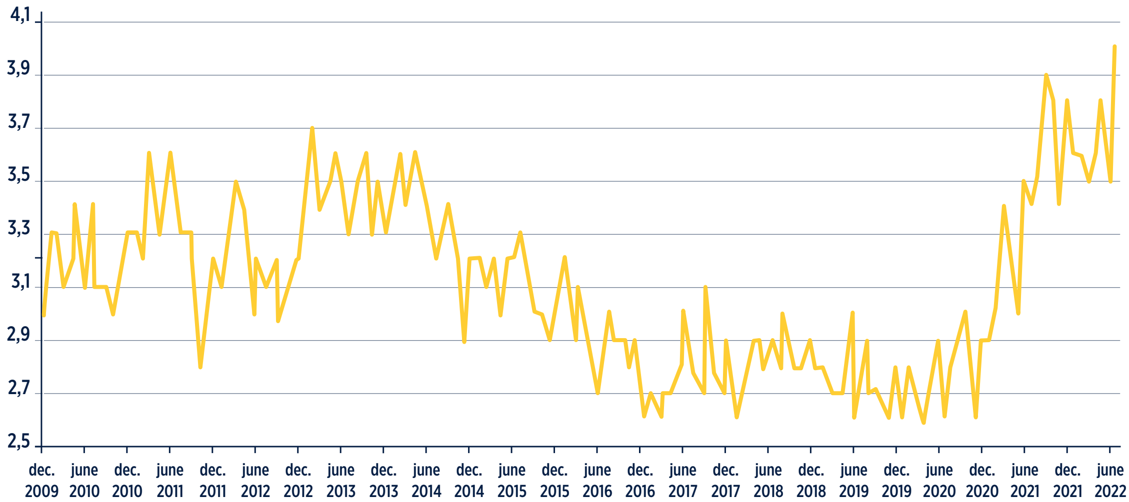
A MEDIOCRE ENVIRONMENT

- **The coming months will determine what interest rate levels markets should anticipate from monetary tightening**
- **Economies in the West are slowing but China should pick up**
- **Both equity and bond markets still offer numerous opportunities**

Agricultural prices seem to have stabilised overall since March but energy prices have continued to surge. Additional inflationary pressure amid strong demand has only accentuated the fact that some central banks are seriously behind the curve: they desperately wanted to wait for full employment to return before considering any monetary tightening. In the US, there are already signs of a de-anchoring in inflation expectations.

Central bank messages have changed considerably. At the time of writing, investors were expecting the ECB to raise rates by 280bp over 18 months and the Fed by around 230bp. This would be an impressively fast pace and investors reacted so brutally in the second quarter that for the first time in decades, no asset class -including money

EXPECTED CHANGE IN PRICES DURING THE NEXT 5-10 YEARS ACCORDING TO THE UNIVERSITY OF MICHIGAN SURVEYS OF CONSUMERS



Source : Edmond de Rothschild Asset Management. Data as of 28/06/2022.

market funds- has managed to chalk up positive returns so far this year.

WILL THE MONETARY TIGHTENING EXPECTED BY MARKETS BE ENOUGH?

Optimists, led by central banks, think -or at least declare- that we only have to get back to neutral rates, and perhaps a little bit more from time to time, to get inflation back relatively quickly to its target level without too much collateral damage to the economy. Sceptics, on the other hand, think that taking the Fed Funds rate to around 4%, the level markets are currently expecting, will not be enough to douse inflation which is already trending higher than that. Quite simply, can we beat inflation when real base rates are negative? Olivier Blanchard, the IMF's former chief economist, thinks that the Fed has to go as high as 5%.

The coming months will determine what interest rate levels markets should expect to see from monetary tightening. In the meantime, markets will remain under pressure. Were inflation to start falling rapidly, it would be easier for investors to chart the rate hike cycle and wait to see how inflation behaves. That would be a more favourable scenario for investors as they might hope central banks could limit the risk of tipping economies into recession. If not, current inflation levels and signs that household inflation expectations are de-anchoring, could very well make markets expect more rate hikes.

There are others who think central banks will stop tightening at the halfway stage to avoid a more moderate version of the 1970s' recession and/or financial conditions. In other words, central banks would end up accepting inflation that is trending above their target levels. Central banks today find it easier to deliver more hawkish messages because of persistent labour market tensions. But will they be able to avoid prematurely easing when their economies turn down?

What unemployment rate would allow US inflation to return to its target? Judging from their dot plot sheets, some FOMC members think the jobless rate would have to rise to 4.1% to stabilise inflation, or 0.5% higher than the current rate. Such an increase has historically only been seen in a recession. These estimates are fragile but they are reinforcing investor convictions that beating inflation perhaps means

a US recession. Valuations are currently discounting a sharp downturn but not a recession.

COULD WE JUMP STRAIGHT FROM INFLATION TO DEFLATION?

Focusing on interest rates alone risks overlooking the fact that overall financial conditions dictate monetary policy. And central banks have considerable influence on these conditions. The Fed started shrinking its balance sheet in June and at a much faster pace than in its first quantitative tightening in 2018 which led to tougher financial conditions. As in the fourth quarter of 2018, we cannot rule out central banks being faced with another dilemma if markets skid. Should central backs then execute an about-turn and ease monetary policy to rescue markets? They would risk losing their credibility and it has already been hammered in recent months in the fight against inflation.

Given the amount of debt that has built up in the private sector, a market accident from central banks hoovering up liquidity would trigger a vast deleveraging movement that could make inflation jump directly into deflation. The ECB is trying to create an anti-fragmentation strategy to help it tighten financial conditions while keeping peripheral country spreads[1] under control. It is too early to say if it will be successful but central banks have the knack of innovating to reach inflation targets without jeopardising financial stability.

THE GLOBAL ECONOMY IS DOWN BUT NOT OUT

The fact that central banks are late in the tightening cycle has never been more obvious. However, the risks are high as we can easily imagine dire scenarios where central banks are either too lax, or so restrictive that they trigger a financial market crash. They will have to be very nimble to reach their targets without causing too much damage. The good news is that they are catching up and despite today's turbulent geopolitical and market environment, the global economy is down but not out.

Economies in the West are slowing but China should pick up. Disinflation might possibly be just ahead. In recent weeks, commodity prices have all been falling back significantly now that markets are worried about growth. And, despite shortages, some sectors have perhaps overstocked so deliveries could be facilitated and downward pressure on prices might begin.

For the moment, we remain cautiously positioned but we are on the watch to reinforce exposure. There are numerous opportunities in emerging country and high-yield debt as well as in equities.

1. The spread represents the gap between a bond's actuarial yield and that of a risk-free bond with the same maturity.

RATE RISES ARE ON AN EXPRESS TRAIN

ALAIN KRIEF
Head of Fixed Income Edmond de Rothschild Asset Management

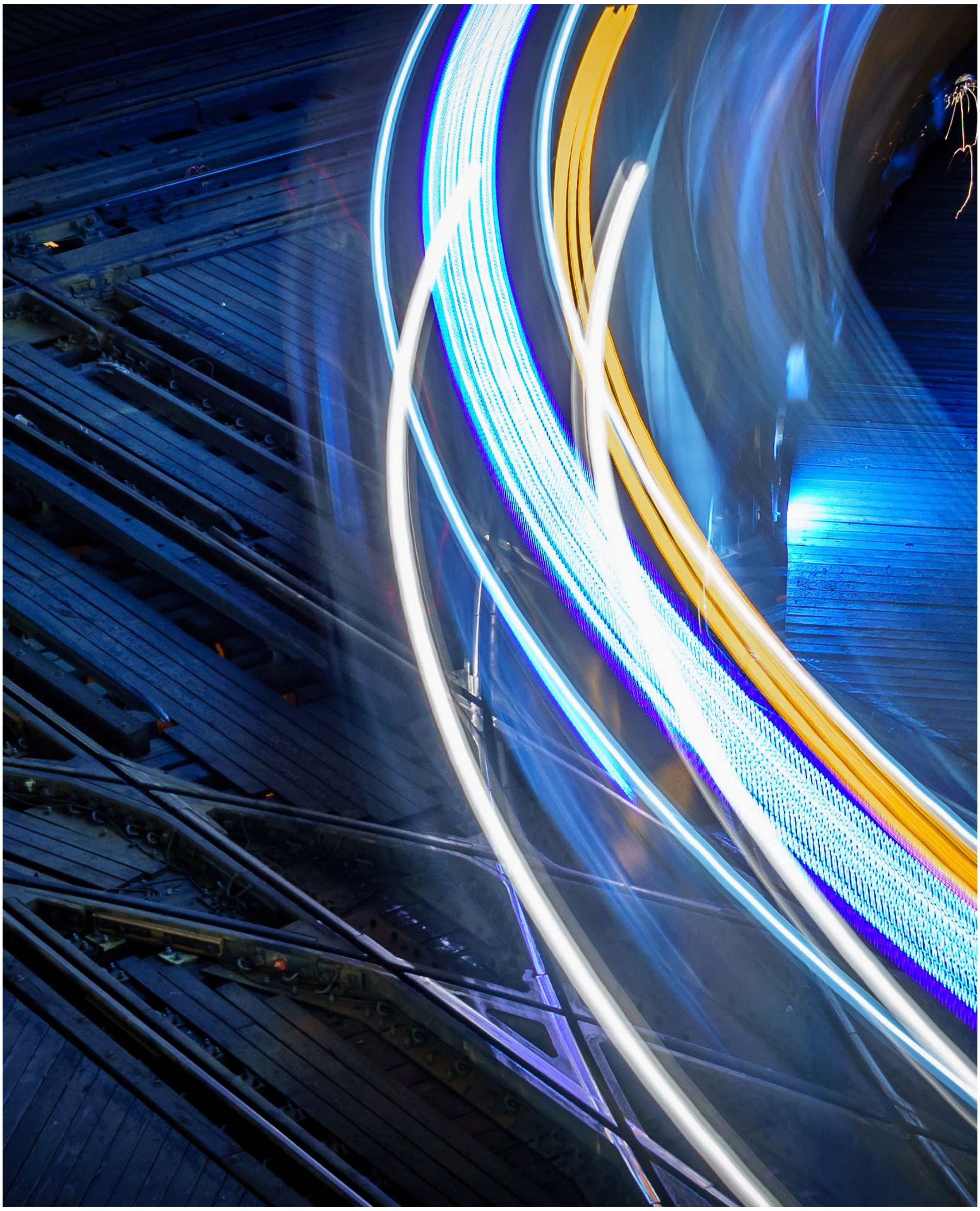
The bond market has reversed course. Negative rates in Europe, refinancing at low interest rates and easy money for companies are all a thing of the past. Inflation has reappeared since the pandemic ended, surging so fast that central banks had to rub their eyes. Price stability, a key central bank tenet, is over and energy prices are not alone in rising. And the Ukraine conflict has fuelled inflation practically across the board as commodity and food prices hit purchasing power and send wages higher.

Central banks had no choice but to act quickly and forcefully. The Fed got the message and even forward guidance was no longer enough. The ECB should soon follow suit following its decision to wind up Quantitative Easing[1]. Equities and all bond maturities anticipated these measure by reacting very quickly. For example, it took 10-year German Bund years 7 years to move from 2% to minus 0.8% and only a few months to do the reverse!

- **The fight against inflation has started and is now a central bank priority**
- **Refinancing costs are rising and default rates could increase**
- **Our approach is to select investment grade or high yield companies with robust fundamentals and significant free cash flow**

A LOT OF THE DISTANCE HAS ALREADY BEEN COVERED

The fight against inflation has begun and it is now a main central bank target. To get inflation to fall, central banks have chosen to ramp up bond yields. The aim is to limit demand and therefore limit growth. The policy raises several questions, namely (i) to what extent growth will slow; (ii) whether it might trigger a recession; (iii) what type of recession we should expect to see and (iv) if we are in fact already in a recession - future data are expected to show a contraction in both the US and Europe.



The answers to these questions are essential if we want to have some idea of credit market prospects. Rising rates have a direct impact on government bond markets whereas growth expectations will dictate the effect on spreads[2], whether in investment grade[3], high yield[4] or even emerging market bonds.

All bond market returns over the first half were mechanically very poor.

First, rising government bond yields led to a serious losses on all bond assets and especially long duration[5] assets in the so-called "risk-free class" (currently a misnomer!). Second, there were losses from widening spreads, as investors anticipated a strong slowdown in growth, and from volatile government bond market shifts.

As for government bond yields, it is hard to see them falling back sharply in the near future. Central banks, notably the Fed and the ECB, are waiting for the famous "neutral rate" to be reached, i.e. the level which would help inflation fall while allowing growth to recover. Market consensus pitches the neutral rate at 2.50% in the US and 1.5% in Europe (with Germany as a benchmark). In the middle of June, 10-year Treasury yields were as high as 3.25% and the equivalent German Bund at 1.75% so it would seem that most of the ground has been covered. Nevertheless, we still do not know if we might have to overshoot these levels to get to the 2% inflation target. Only when this target is met can we turn to the economy and reliably assess the extent of the recession and to what extent credit markets have priced it in.

A TRANSITION PERIOD

Has the supposedly defensive risk-free asset class lost its prime function? We think not. We are currently in a transition period. Just as rates had to be slashed when there was no inflation and the economy needed to be kick-started, so we need to raise them now to beat inflation. Once this ground has been covered and, more importantly, when inflation and volatility have fallen back, the risk-free asset class will once again behave as a safe haven.

So, pending improved visibility on the actual impact of central bank tightening, is credit an interesting asset in today's environment of sharply lower growth and ahead of a possible recession?

Credit markets are always well ahead of future cycles and they have already discounted some stress levels. Investment grade spreads are currently trading at levels seen during the 2008 financial crisis, high yield is anticipating a small recession and emerging market spreads are at historically low levels.

The expected recession may be mild or strong but with inflation running at such high levels, it will clearly be different from previous downturns. As a result, **average spreads have less value because of significant disparities in sector prospects.**

From the medium to long-term view, we should already be taking advantage of attractive valuations but **we need to adopt a clear-cut sector approach and target the highest quality companies.** The cost of refinancing has risen due to monetary tightening, higher rates and wider spreads. And we cannot rule out default rates rising by 2% from their current 5-6%. What is clear is that the current market configuration bolsters our policy of selecting investment grade or high yield companies with robust fundamentals and buoyant free cash flow.

Inflation is weighing on household purchasing power so we are cautious on distribution, especially as the sector has to contend with rising input costs. **We prefer to focus on more defensive sectors** like telecoms and those auto manufacturers which are well placed to deal successfully with challenges like increased use of electric vehicles. We are also looking at issuers likely to benefit from the post-pandemic recovery. Tourism (airlines and airports) is a good example. And we believe energy is currently a must-have: the sector represents a sort of passive inflation hedge, a situation we feel is likely to last in coming months. Emerging markets offer attractive opportunities and notably Brazil because of its excellent commodity companies.

Timing is, of course, important for investors with a short-term investment horizon. But with credit markets trading at such a significant discount and strong volatility stemming from the steep rise in central bank risk-free rates, we need to extend our horizon to tap into excellent investment opportunities.

1. Quantitative easing describes unorthodox monetary policy from a central bank in exceptional economic conditions

2. The spread represents the gap between a bond's actuarial yield and that of a risk-free bond with the same maturity..

3. Investment grade credit refers to bonds which are almost certain to be redeemed as they are issued by companies with very low-to-moderate default risk. Investment grade bonds are rated from AAA to BBB at Standard & Poor's.

4. High yield credit refers to corporate bonds with a higher default risk than investment grade bonds but offering a higher yield.

5. Corresponds to the average life of a bond discounted for all interest and capital flows.

EUROPEAN EQUITIES: NAVIGATING UNCERTAINTY

CAROLINE GAUTHIER

Co-Head of Equities Edmond de Rothschild Asset Management

Investors are gradually shifting from watching inflation to worrying about growth. They have realised that central banks could take the risk of triggering a recession to rein in inflation, especially as the surge in prices has perhaps not peaked. The question now is how long the slowdown will last. Will we have a soft or hard landing?

Given the uncertainty, markets have fallen back sharply. Investor caution is reflected in selling pressure on European equity markets and highly defensive positioning.

And yet if we poll companies, they sound far from catastrophic. On the contrary. **Rarely has company optimism differed so much with market pessimism.**

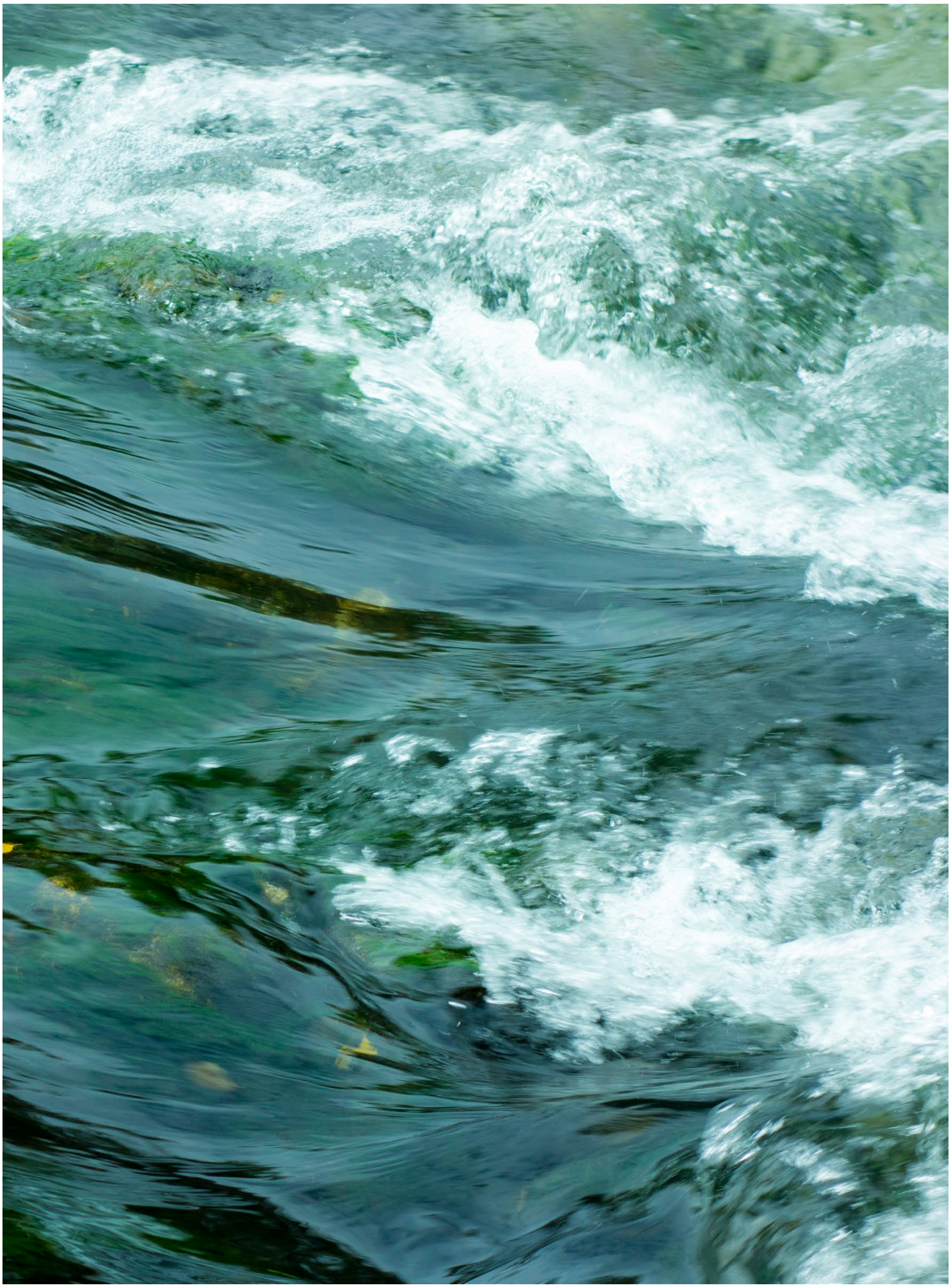
COMPANIES ARE STILL UPBEAT SO IS THIS RESILIENCE OR DENIAL?

Although companies and analysts often fail to anticipate, **most CEOs are currently making positive noises.**

Despite more expensive commodities, energy, transport, logistics and labour, earnings so far keep on being revised higher due to persistently robust demand, the ability to raise prices and margins which are still relatively under control.

CEOs are not in denial over the economic slowdown which is taking shape, rather they insist on greater resilience and their capacity to ride out crises.

European companies have generally learnt from the 2008 financial crisis and the Covid pandemic starting in 2019 to become nimbler in navigating uncertain conditions.



They have reduced fixed costs and adapted variable costs. Travel expenses have been cut since the Covid crisis and so have office rents as people worked from home. But they have also introduced transformational measures to boost productivity with automation and increased digitalisation to deal with labour shortages. Some industries have also made investments to be able to change their energy source should gas supplies be cut off. Others have rapidly revamped product design to cope with unobtainable electronic chips.

Cash flows are at 20-year highs, ensuring companies have the leeway to deal with even a severe downturn. Financial leverage is still reasonable and tighter financial conditions will only affect the most indebted companies or the least mature businesses which require regular external funding.

We find the same upbeat attitude in investment and acquisition projects. Companies are determined to find extra growth drivers before the economic situation returns to normal.

We believe that the key factor in finding a good balance for companies is solid final demand. If wages do not rise, demand could be hit by persistent inflation.

So far, strong demand has allowed most companies to pass on production costs.

The few profit warnings to have appeared have, for the moment, been due to supply side problems or not having enough staff to deliver from record order books. Another reason is the lag between rising costs and upward adjustments in prices.

But the next warnings in the second half could come from demand. The first signs are starting to appear in the consumer and construction sectors.

- **Inflation, rapidly rising interest rates and the threat of eurozone fragmentation are all weighing on markets**
- **CEOs are not in denial over the economic slowdown which is taking shape, rather they insist on greater resilience and their capacity to ride out crises**
- **The second half should offer interesting entry points in some cyclicals and growth stocks**

We expect current double-digit expectations for earnings growth in Europe to be revised lower. Even so, results should end the year higher thanks to operating leverage, higher prices (and thus higher sales figures), the euro's depreciation for exporters, support from personal savings accounts and the gradual impact of economies reopening.

AN EXTREME DISCONNECT HAS LED TO STRONG MULTIPLE CONTRACTION

Results have been trending higher so the market decline since the year began is chiefly due to multiple contraction. The 12-month forward market PE has fallen from 17 times a year ago to 11.2 times. Although downward earnings revisions could take it a bit higher, we believe many share prices are already discounting a strong slowdown.

Excluding external shocks, the second half should offer interesting entry points **in some cyclicals and growth stocks. Cyclical stock valuations now mostly factor in a recession. And growth stocks have already been savaged by rises in interest rates and they could peak in the next half.**

Stock picking is still essential. We are convinced that high-quality stocks with strong pricing power, competitive edge, a healthy balance sheet and buoyant cash flow will emerge as winners. Companies in strategic sectors like healthcare, energy, agriculture, defence and technology should also be favoured as long as they are trading at reasonable levels. All these sectors have acquired a **national and/or regional interest** following the outbreak of the Ukraine war.

IS MAJOR CONSOLIDATION ON THE CARDS?

JACQUES-AURÉLIEN MARCIREAU

Co-Head of Equities Edmond de Rothschild Asset Management

The thought of "Leaving the party while you're still having fun" is going through the heads of several generations of entrepreneurs and business leaders, across all sectors and industries. And while their reasons may vary, the outcome does not. Our intuition is the following: the clouds on the horizon will trigger a fast and structural change to the world's economic fabric and a shift in leadership at the helm of many companies, as was the case in the years that followed the great recession of 2008-2009.

A SENSE OF DEJA VU

- **The clouds on the horizon will trigger a fast and structural change to the world's economic fabric and a shift in leadership at the helm of many companies**
- **Mergers and alliances are therefore likely to occur under the scrutiny of regulatory authorities which have a new-found appetite for intervention**
- **The plurality of economic players and healthy competition are essential if we are to avoid the many dangers that are invariably created by domineering positions**

In the midst of the Covid-19 pandemic, as companies were weakened by the crisis, many of us were expecting a huge wave of consolidation that would have driven a Darwinian-style competition between firms.

This didn't happen, but something changed.

Today, when a company like Twitter makes a U-turn and accepts an offer previously viewed as unacceptable because it was 30% below the highs reached six months ago; when Reed Hastings (Netflix) and Jeff Bezos (Amazon) – both young and at their zenith after the pandemic-driven boost - choose to

hand over; when so many successful Tech businesses are being sold, a common trait is emerging: **the decision to quit the party while you're still having fun and hand over the reins to the next generation as a new era is being ushered in.**

Now that they are over, let's look back at these happy times: the Tech entrepreneur, who for the past decade has lived with the paradigm of "growth at all costs", blitzscaling[1], and a globalized and serene market... is now having to face inflation and rising capital costs, and navigate increasingly complex logistics and much greater governmental/political interference.

The qualities that are needed have evolved - and so has the horizon: the key word is no longer to conquer the world and then assume good housekeeping will follow... From now on, ambitions will be determined by the quality of housekeeping, in other words, cash flow generation.

A PERIOD OF REVIVAL

This observation extends well beyond the Tech sector. In more traditional industries, entire generations of entrepreneurs are preparing to step down. This is particularly the case in Europe, but also in Asia, in Taiwan and South Korea, where the leaders who built the recovery are now tying up their succession plans. And let us not forget the many companies that survived Covid-19 but are facing a bleaker future due to the rising cost of debt, which will reduce their latitude at a time when investments in new technology are so necessary to upgrade their production systems.

Mergers and alliances are therefore likely to occur under the scrutiny of regulatory authorities which have a new-found appetite for intervention, as the 'live and let live' doxa popular since the Reagan years is gradually waning.

This all points to thrilling moments ahead, particularly as cross-border mergers are concerned.

No judgement is being made here on the trend that is emerging. However, as is the case with biodiversity, the plurality of economic players and healthy competition are essential if we are to avoid the many dangers that are invariably created by domineering positions.

Conviction-driven asset managers will have a role to play in these changing times: by supporting the new generation of leaders, by patiently focusing on solutions that create long-term value for all stakeholders, and not giving in to the temptation of cashing in short-term gains after a successful deal. These periods of revival offer bountiful opportunities for conviction driven-stock pickers, who can deliver alpha by leveraging on their in-depth understanding of corporate strategies and value chains.

1. Very fast growth.

ENERGY INDEPENDENCE AND TRANSITION GO TOGETHER

JEAN-PHILIPPE DESMARTIN
Head of Responsible Investment Edmond de Rothschild Asset Management

With the Ukraine war raging and fossil energy prices scaling the heights, energy independence is a major concern, and especially in Europe. Energy transition means focusing on reducing our dependency on fossil fuels -currently around 80% for the global economy -to accelerate the decarbonisation process. Linking energy transition and independence therefore strikes us as more than ever essential.

THE TIME FOR ACTION IS NOW

"Three years to act to keep our world liveable." This was the alarm call in the latest GIEC[1] report released in 2022. Bear in mind that our daily carbon footprint will last on average for the next hundred years. Temperatures have already risen by 1.1°C on average since the pre-industrial era. We are now rapidly moving towards +1.5°C. This means icecaps melting, advancing deserts, islands disappearing under water and heat domes making some regions uninhabitable. There are also tensions and even wars over

- **We need to take urgent action on climate issues. The IPCC says we only have three years to preserve the world as a place worth living in for the greatest number**
- **Energy efficiency is a key solution as the best energy is the energy we do not use and renewable energy sources mean independence**
- **The good news is that investors now have increasingly reliable climate methodologies and monitoring tools**

water supplies and some species are facing extinction. Increasingly frequent extreme events show that global warming is already with us. A Stanford University study in 2017 calculated that there was a 93% chance temperatures would rise by 4°C by the end of this century if carbon emissions remained stuck in a "business as usual" scenario. **If we fail to stop this trend, the world will even become impossible to insure**. This catastrophic scenario would hit every part of our economy and society, especially in emerging countries where the global population is concentrated. By 2050, it is estimated that 1 billion people living in coastal areas would be affected by rising water levels or sea flooding, and that $10 trillion-worth of infrastructure could be at risk from exceptional flooding. To act, the simplest solution is to embrace energy sobriety and efficiency, just like generations of wise men before us.

ENERGY EFFICIENCY IS THE KEYWORD

Today's geopolitical tensions have contributed to soaring fossil energy prices, exposing the extent of Europe's energy dependency. Given this highly unsettled background and the fact that nobody knows how long the situation will last, **the best energy is obviously the energy we do not use**. Acting on energy demand and consumption can actually be a rapid process. As we saw in Japan after the 2011 Fukushima crisis, reductions in energy consumption can run to double digits. Japan cut energy consumption by 16% in absolute value between 2010 and 2019[2]. **Solutions and results depend both on technological advances but also on how much people, companies and governments embrace energy sobriety**. Fortunately, there are a number of useful actions like insulation, sustainable mobility, electricity distribution optimisation and heat pumps. Installing a heat pump can slash a household's energy bill by 60%. And ADEME, France's ecology transition agency, says cutting heating by 1°C helps save 7% on bills. Energy efficiency and sobriety are thus the same levers across all sectors and they also concern construction, industry and transport. In transport, for example, the European Environment Agency estimated in 2020 that a plane's carbon footprint amounted to 285g/km per passenger, or 20 times more than a train. In construction, aid packages are being introduced to fund removal of energy escape routes. To sum up, energy efficiency is the best short and long-term solution as it will help to save the planet by 2100 while enabling consumers to spend less on bills.

INCREASING THE USE OF RENEWABLE ENERGY

The energy transition also means moving from fossil to renewable energy sources. There are almost **innumerable amounts of renewable power sources like wind farms on land and at sea, solar, hydraulic, geothermal, biomass, biomethane and green hydrogen**. Barely 20% of final energy consumption in the world comes from renewable energy sources (IAE, 2022)[3], although renewable energy has been gaining ground depending on its end use. For example, electricity production has seen the biggest rise with 83% of net renewable capacity additions in 2020 coming from renewable sources (REN21, 2022)[4]. Heating and transport, in contrast, have been much slower in making the change. Moving towards a low-carbon economy and energy independence will require the installation of more renewable energy parks. They also have **the social advantage of reshoring more sustainable, qualified and less qualified, jobs, helping to revive economically abandoned regions**. Note, however that "Not In My Backyard" (NIMBY) campaigns have slowed the arrival of renewable energy sources in Europe, especially wind farms and biomethane units.

COMPANIES AND INVESTORS NOW HAVE MORE RELIABLE TOOLS.

Another positive factor is that we now have more efficient tools to measure carbon footprints. The period when vague carbon assessments under scope 1 and 2[5] were the norm is increasingly a distant memory. Similarly, **we are seeing genuine progress on scope 3 emissions**[6], the elephant in the room as they represent around 80% of total emissions, and scope 4[7] criteria which are essential in assessing the carbon footprint of an entire value chain. Independent entities with rigorous methodologies help companies assess their carbon footprint and provide investors with the means to align portfolios with the Paris Accord. **Investors are increasingly better equipped to shape their portfolios** and take real action against climate change.

ACTING FOR A JUST TRANSITION

Faced with energy dependency and the climate emergency, we should activate levers to drive energy efficiency and the development of renewable energy sources. Quite simply we need to consumer less and better. Energy transition is tricky to roll out as our societies have depended on fossil energy since the 19th century. Another challenge in ensuring success is to accompany transition with social measures. Hence the notion of a just transition. France's gilet jaune disruptions in 2018-19 were a stark reminder of reality. Efforts will therefore be required to revive and maintain employment through job conversions in regions, for example, which depend heavily on traditional, internal combustion, vehicle manufacturing.

By recognising the complexity of managing short and long-term views while integrating environmental, social and economic pillars, investors are an important part of the movement towards a sustainable economy.

1. IPCC The Intergovernmental Panel on Climate Change, Sixth Assessment Report, February 2022.
2. International Energy Agency, "Japan 2021 – Energy Policy Review", March 2021.
3. International Energy Agency, "Tracking SDG7 - The Energy Progress Report 2022", June 2022.
4. REN21 Renewables Now, "Renewables 2021 Global Status Report", June 2021.
5. Scope 1 concerns direct emission and scope 2 indirect emissions from energy.
6. Scope 3 covers other indirect emissions.
7. Scope 4 covers avoided emissions.

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