SARASIN
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HOUSE REPORT

AS LUCK WOULD HAVE IT

COMPELLING OPPORTUNITIES REMAIN FOR THE PATIENT INVESTOR

- **Everything, everywhere, all at once: investing starts to resemble multiverse-jumping**
- **AI: Why investors, companies and governments may be under-estimating its impact**

STEPHEN ROTHWELL
EDITOR

Welcome to the Q2 edition of the House Report

Investors have had nothing short of a whirlwind start to the year.

As we emerge tentatively into spring, we've already seen global banking turmoil, further interest rate hikes (two each in the US and the UK) and inflation that is proving stubbornly sticky.

Even so, equity and bond markets ended the quarter in positive territory. With so many competing forces at play pulling policymakers in opposing directions, it is little wonder that the world feels a confusing place at the moment.

Subitha Subramaniam, our chief economist, captures this sentiment in her article 'Everything, everywhere, all at once'. She observes that investing is beginning to resemble multiverse-jumping where alternative realities are all possible at once, as central bankers navigate a highly complex environment with a multitude of possible outcomes.

Looking through this complex financial and geopolitical backdrop in his lead article, Guy Monson argues that, while we still need a fair wind and good timing, there are powerful opportunities for patient investors. He analyses how central banks are seeking to forge a path between the Scylla of recession and bank failures, and the Charybdis of high core inflation. Against this backdrop, he outlines what investors can do to insulate themselves against these risks, and where the opportunities may present themselves.

Turning to the powerful long-term trends shaping the global economy, there is no doubt that developments in artificial intelligence (AI) will have a profound impact on many aspects of our lives. The media frenzy surrounding ChatGPT has grabbed the world's attention. Portfolio manager and analyst Colm Harney believes investors, companies and governments may yet be under-estimating the impact of artificial intelligence, despite the hype it has attracted already. Looking through Sarasin's thematic investment lens, he highlights some potential beneficiaries of the dramatic progress in this field, as we keep a keen eye on how this might play out for the economy and for investment portfolios.

As the world attempts to address the urgent imperative of transitioning to net zero, Ben McEwen, our climate analyst, assesses what the high-carbon transition means for investors. While businesses certainly have more incentives to decarbonise, it is still up to investment managers to evaluate the credibility of companies' transition plans and targets, especially in hard-to-abate sectors. Ben discusses how we go about identifying companies with the potential to perform well in this environment.

Navigating the complexities of the investment world remains more challenging than ever, but we hope this report gives insight into the trends we see shaping the world and how these impact your investments and create opportunity. Please send us your article suggestions or feedback at housereport@sarasin.co.uk.

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GUY MONSON
CHIEF MARKET STRATEGIST
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Market View

AS LUCK WOULD HAVE IT

Compelling opportunities remain for the patient investor

> Central bankers will have to navigate deftly between the Scylla of recession and bank failures, and the Charybdis of stubbornly high core inflation.

A uniquely complex financial and geopolitical backdrop still saw markets deliver positive returns for the first quarter of 2023. Luck and good timing will still be needed for the rest of the year but there remain compelling opportunities in bonds, equities and currency, for today's patient investor.

A confluence of events and, yes, some good luck, left investment returns for the first quarter of 2023 better than most investors dared hope. In the face of two further US rate rises and bank failures on both sides of the Atlantic markets were, in the event, impressively calm. Government bonds, credit, equities and gold all delivered positive returns – and this was true even when measured in sterling (the best performing currency in the G10 this year).

The most unexpected move though, was a late surge in the Nasdaq as investors focused on two new themes: aggressive cost cutting (from the likes of Meta and Amazon) and a perceived 'safe-haven' status for the cash-rich technology giants seen as most likely to benefit from the nascent boom in 'generative artificial intelligence (AI)' (including Alphabet and Microsoft).

As luck would have it

Investors were lucky too. First, just as lockdown rules were scrapped in China (in January this year), US growth was itself starting to slow. Importantly, this meant that the return of Asian buyers only had a muted impact on energy and commodity prices, and thus headline inflation rates. Second, there looks to be some silver lining in last month's bank failures: the credit shock they created has ironically done much of the US Federal Reserve's (Fed's) policy tightening for them.

In comments after the March meeting, Chairman Jerome Powell stated that the tighter credit conditions are already a substitute for one or more interest rate rises. In other words, no matter how uncomfortable the banking shock felt, the tighter lending standards it has triggered will probably slow the US economy and ease labour market pressures, at just the point needed. Evidence of this is already starting to build, with US job openings falling well below expectations last month. Put these events together and you can see why markets rallied and equity volatility fell. In short: over the last quarter, we were lucky.

Central banks are still sailing between Scylla and Charybdis

Looking forward to the rest of 2023, policymakers will, once again, need skill and not a little luck. Central bankers will have to navigate deftly between the Scylla of recession and bank failures, and the Charybdis of stubbornly high core inflation. The risk of policy error is high. So how should investors react?

The first step is to toughen portfolios and improve resilience. For us this means reviewing all our key equity holdings, watching for companies with higher borrowings or re-financings, while minimising our exposure to sectors that are historically vulnerable to rate rises. Commercial real estate and utilities are two examples; these also face significant and expensive environmental challenges. In addition, it means looking for hidden leverage or financing risk across more illiquid alternative assets, especially in more complex infrastructure funds and green energy generators.

Second, US growth is clearly slowing. The well-regarded ISM services survey for March was notably weaker and we now expect a recession – albeit a shallow one – in the second half of 2023. For us this means moving to a less cyclical portfolio with additions to healthcare (across our ageing theme) and defensive consumer staples (in our evolving consumption theme). A particular challenge remains our holdings of European industrial companies. We remain positive about the opportunity for long-term climate expenditure, but we are concerned that slower growth in the short term will constrain earnings. Therefore, we are reducing position sizes.

Third, it means focusing on assets in areas where monetary support can materially lower risk. Today this is true of selected bank bonds, issued by the stronger global franchises. In this regard, the support offered by the Fed this month is particularly generous. It means banks are now able to pledge treasuries, agency debt and mortgage-backed securities as collateral to the central bank. Importantly, these assets will be valued at par, effectively eliminating any institution's need to sell any securities quickly in times of stress. My colleague Subitha Subramaniam focuses on the detailed implications of this overleaf. In a nutshell, it is supportive of bank debt and adds to liquidity globally.

Fourth, managers still face a world of heightened geopolitical flashpoints. These include escalating nuclear threats from Russia and increasingly bellicose behaviour from North Korea, alongside the now dire state of Sino-US relations. To give some protection against these 'known-unknowns,' we will continue to use portfolio insurance to hedge equity exposure for portfolios where we have permission. With equity volatility falling this month, costs are not unreasonable. Alternatively, for those accounts that cannot use derivatives, we will lower equity content below neutral, and compensate with higher corporate bond exposure.

Opportunities closer to home

Where else, then, can investors look for returns, in areas not overly impacted by tighter money? Our view is that there are opportunities in currency markets, and in particular sterling. As we have illustrated in our Six Minute Strategy reports, the UK currency has a long history of falling sharply in the aftermath of political crises, only to rally back slowly over the years that follow (see below). This occurred post the exchange rate mechanism (ERM) debacle in September 1992, after the Global Financial Crisis of 2008 and most recently in the aftermath of the Brexit referendum of June 2016. This time, while recovery is underway, we anticipate there is more of a rebound yet to come – and the reasons are not hard to find. The lack of credibility of the Boris Johnson government (including his stand-off with Europe), followed by the absurd Truss/Kwarteng budget of September last year meant, in effect, that many UK assets were simply off-limits to global investors.

CHART 1 POLITICAL SHOCKS TYPICALLY TRIGGER STERLING WEAKNESS, BUT AFTER THE EVENT THE CURRENCY TENDS TO RECOVER

SOURCE: MACROBOND, APRIL 2023
PAST PERFORMANCE IS NOT A GUIDE TO FUTURE RETURNS AND MAY NOT BE REPEATED

However, the picture has been transformed by the Sunak government in a remarkably short period of time. The Windsor Accord with Europe was signed with a crushing parliamentary majority, fiscal policy credibility has been transformed with a prudent budget, while the Prime Minister has laid out sensible, and largely deliverable, mid-term policy targets. The political alternatives also seem less alarming: Sir Keir Starmer's fiscal policy is little different to Sunak's, while even the threat of Scottish independence will surely be limited by the quiet implosion of the Scottish National Party (SNP). While there are still risks – particularly in settling very genuine public sector pay disputes – there is already evidence that UK markets are starting to regain investor flows.

On our model, the pound should trade at around U$1.32-35 to reach fair value, hence our steady increase in sterling exposure (via forward contracts) over the last few months.

Conclusion

The market challenges for the remainder of 2023 are clear: if central banks ease too soon, they will fail to contain core inflation, but tighten too much and they risk a deeper recession and potentially more financial failures. For this reason, we remain a little cautious. We are targeting less cyclical equity exposure and lower leverage across all our assets, as well as deploying portfolio insurance to hedge against elevated geopolitical risks.

But despite these challenges, the world is not short of investment opportunities. Very generous central bank support argues for bank bonds issued by the strongest franchises, while defensive equities that are still geared to the powerful long-term themes of climate change and emerging consumer demand, are attractive too. Within all of this there are also currency opportunities, particularly in a renaissance of sterling. So yes, we do need a little luck, but defensive portfolios with the right currency overlay could still deliver robust returns for the remainder of 2023.

SUBITHA SUBRAMANIAM
CHIEF ECONOMIST

Investment Landscape

EVERYTHING, EVERYWHERE, ALL AT ONCE

" With every step up in interest rates, the risk that something within the financial system breaks has only grown more plausible.

2023 is proving to be a dizzying year. A multitude of events has buffeted markets: a sharp collapse in European gas prices followed by the rapid reopening of China's economy; resilient US growth and stubborn inflation requiring sustained increases in interest rates and central bank asset sales, or quantitative tightening; shocking bank failures necessitating the very opposite – aggressive central bank liquidity injections; and most recently, unforeseen cuts to oil supply from a Saudi-led OPEC coalition. Investing is beginning to resemble multiverse-jumping – alternative realities all possible all at once!

Making sense of the multiverse

Today, uncertainty about the trajectory of the economy has risen materially because short-term cyclical pressures are colliding with long-term structural shifts. This is possibly creating one of the most challenging economic backdrops since the Global Financial Crisis.

In particular, the post-Covid economy is proving to be the inverse of the post-GFC economy which was ruled by insufficient demand and low and inertial inflation. Long-term shifts like geopolitics, demographics and the energy transition, have intensified. Economic outcomes are being driven by the the security, scarcity and agility of supply. Great Power Politics is cleaving the world apart, demographic shifts are increasing labour scarcity and the energy transition is creating winners, losers and a more expensive market for carbon.

At the same time, the post-Covid economy is having to reckon with meaningfully strong cyclical pressures. Aggressive fiscal and monetary stimulus collided with discombobulated supply chains, scrambling supply and demand like never before. Inflation responded by racing higher and signalling to markets that supply needed to keep pace. Over the past year, these signals have worked and supply shortages have started to ease, most notably in the market for goods. Labour markets, however, have remained tight as the US economy continues to create jobs far in excess of the growth of new workers. As a result, service sector inflation remains resilient.

It is this intermingling of cyclical pressures with longer-term shifts that is creating a highly complex environment where a multitude of outcomes is still possible. To navigate this landscape, it is best to disentangle and understand the cyclical pressure points.

A slow dance to recession

For over a year, the US Federal Reserve (Fed) has been raising rates in an aggressive bid to bring demand in sync with supply. As the Fed tightened, other global central banks had little choice but to follow suit. The result has been a synchronised tightening in financial conditions.

Notwithstanding a concerted tightening in monetary policy, global growth has remined surprisingly resilient. In particular, the US economy has shown relatively low sensitivity to increases in short-term interest rates. Strong household balance sheets, long maturity of mortgage debt (typically 15 to 30 years) and the 'terming out' of corporate debt as businesses took advantage of the era of ultra-low rates have kept demand resilient even as rates marched higher.

Low sensitivity to interest rates was always going to be the Fed's Achilles heel because its key policy tool is less effective at restraining demand in a timely manner. It also increases the possibility that monetary policy lags have lengthened, increasing the uncertainty over the level at which interest rates become restrictive.

With every step up in interest rates, the risk that something within the financial system breaks has only grown more plausible. A decade of ultra-low interest rates was also likely to have led to investor complacency and mispricing of long-term risk.

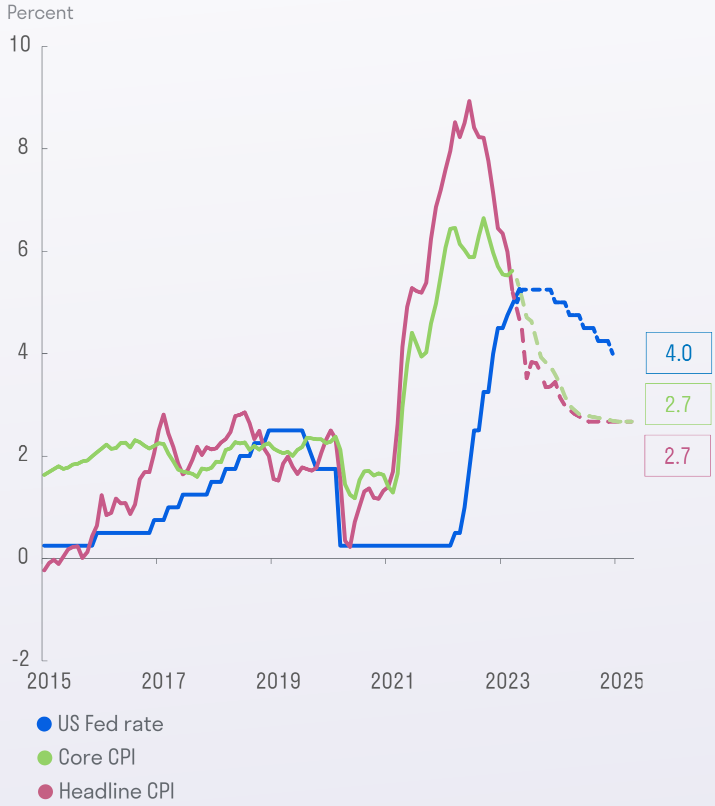
During the course of last year, as rates continued to march higher, there has been gathering evidence that risks were building up within the financial system. The implosion of the crypto industry following the collapse of a leading exchange, FTX, was the first casualty. Liz Truss's ill-fated budget was another. Last month's collapse of Silicon Valley Bank, Signature Bank and Credit Suisse are the most dramatic casualties of the central bankers' quest for price stability. Given their pole position in the heart of the financial system, central bankers had little choice but to move decisively and aggressively.

In the US, regulators not only guaranteed all deposits (including uninsured) of the banks in receivership, but they also launched a new temporary lending programme that allows banks to borrow from the Federal Reserve using the par value of treasury bonds as collateral. Given the large unrealised losses across the banking system associated with treasury bond holdings, such a programme will likely be helpful in arresting the near-term financial panic. However, such a move is also highly controversial as it implicitly removes the downside risks from holding bonds.

Central banking, till now, has always followed Bagehot's dictum: Lend freely, at a penalty rate against good collateral. The latest Fed programme goes above and beyond this. By lending at par value, the Fed has removed not only the interest rate risk, but also market discipline associated with holding treasury bonds.

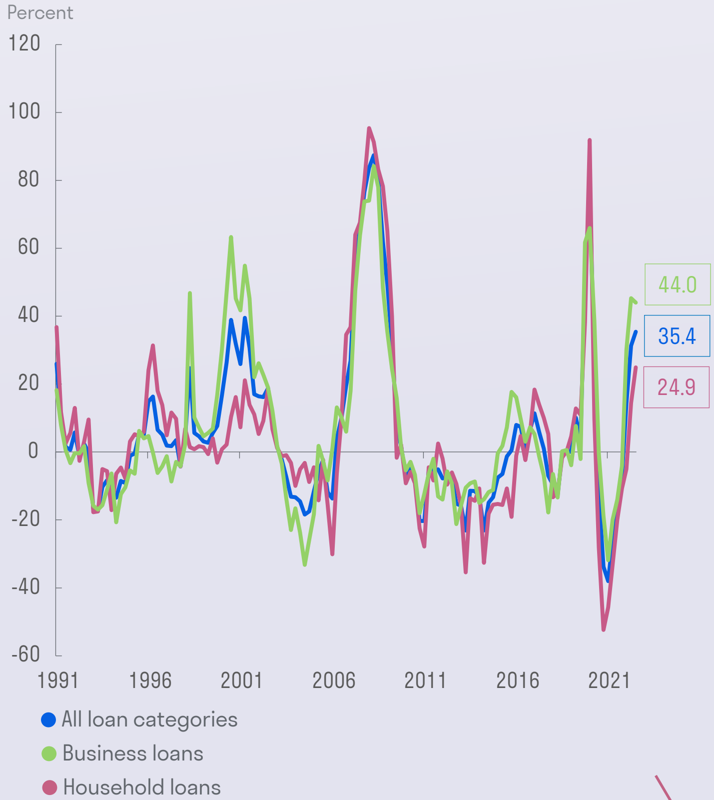
Even so, financial conditions are likely to continue tightening and tip the economy into a recession for two main reasons. First, as inflation continues to head lower, real interest rates will mechanically move higher. By the second half of the year, real interest rates are likely to be between 1-2% – a level that typically leads to a significant slowdown in demand.

CHART 1 REAL INTEREST RATES ARE SET TO TURN POSITIVE AS INFLATION FALLS



SOURCE: MACROBOND, APRIL 2023

CHART 2 SENIOR LOAN OFFICERS ARE TIGHTENING LOANS



SOURCE: MACROBOND, APRIL 2023

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EVERYTHING, EVERYWHERE ALL AT ONCE

Subitha Subramanian, Chief Economist

Second, banks are likely to pull back from lending in response to higher funding costs (as deposits continue migrating to money market mutual funds in search of higher returns) and more prudent balance sheet management (in response to rising delinquencies and defaults).

This is likely to be particularly true for regional banks, which play an outsized role in providing roughly 40% of all loans to the US economy and approximately 70% of loans to the commercial real estate market.

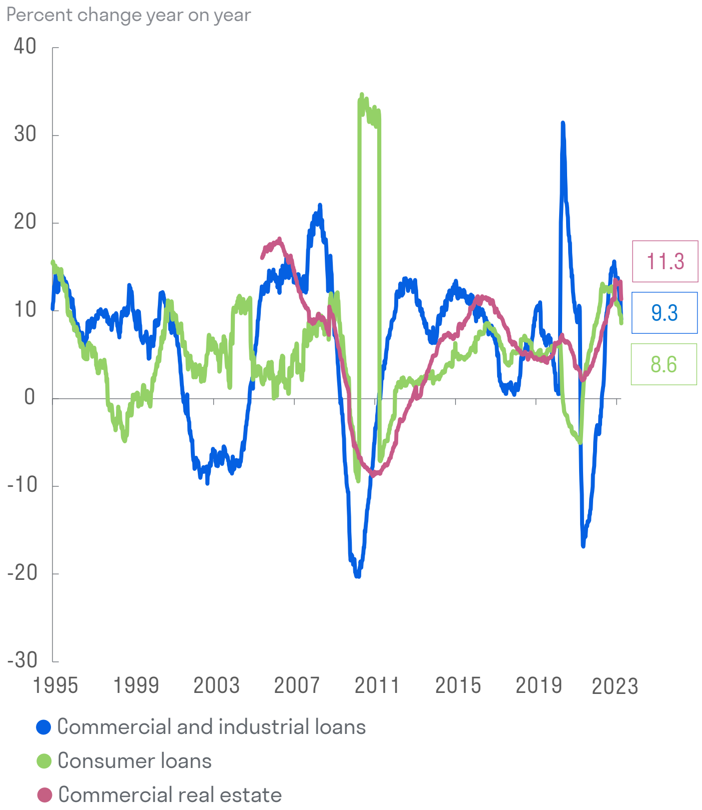
Foggy bottom

Central banks may have arrested a fast-moving financial panic, but are unlikely to do much to avert the slow-moving credit crunch that is now well underway. To a large extent, this is a credit crunch of their own making. With an eye to longer-term structural shifts, they are unlikely to turn back on their goal of right-sizing demand to match the supply potential of the economy.

As we look to the end of 2023, there continues to be a wide range of positive and negative potential outcomes. On the downside, negative momentum in the economy could lead to a more intense credit crunch. Inflation could also remain resilient – mark-ups continue to surprise on the upside as global businesses seem to be successfully pursuing price over volume strategies. On the upside, the downward momentum in prices could intensify, providing a much-needed reprieve for central banks. A cut in US interest rates could lead to a huge sigh of relief across the world and breathe fresh life into financial markets.

With such a wide array of outcomes still plausible, investors should be prepared for continued turbulence in the coming months. Multiverse-jumping and shape-shifting are likely to be with us for just a while longer as we ride out the current cycle. Against this backdrop, we believe in assuming a lower risk appetite until we have clarity on how deep any credit crunch turns out to be. We prefer credit exposure over equities, and favour more liquid alternatives that hedge against extreme outcomes, in particular gold, and commodities that are critical to the decarbonisation agenda.

CHART 3 US COMMERCIAL BANKS' LOAN GROWTH IS STARTING TO FALL



SOURCE: MACROBOND, APRIL 2023

AI: DEEP IMPACT

Investors, companies and governments may yet be under-estimating the impact of AI

COLM HARNEY
PORTFOLIO MANAGER AND ANALYST

Excitement around progress in artificial intelligence (AI) has been building rapidly in tech circles in recent years, but the wider world remained nonplussed – until recently. Following its release in late 2022, ChatGPT[2] attracted 100 million users in just three months, provoked a media frenzy and became one of the most talked-about tech developments of recent times, leaving competitors like Alphabet, Meta and Baidu scrambling to release similar products.

Amid the deluge of announcements from tech companies, it is easy to see AI as a 'tech story'. AI offers outstanding opportunities for some tech companies and will be hugely disruptive or even fatal for the business models of others. Yet the most significant impacts – and investment opportunities – are likely to be found elsewhere, as this powerful technology with the potential to accelerate productivity, spur creativity and reduce costs, is applied across the wider economy.

There is, however, one key difference between AI and previous transformative new technologies, such as railways, electrical power and the internet. These took decades to penetrate the global economy fully as the associated infrastructure of railway lines, electricity grids and telecommunications networks was painstakingly put in place. In contrast, the infrastructure needed for AI already exists. With widespread internet access, billions of personal computing devices, and a global network of cloud computing datacentres already in place, AI's transformative potential can be unleashed almost overnight.

Whatever one's views of AI, it is being adopted rapidly and disruption is guaranteed. We believe its overall impact is likely to be positive, but it is up to all of us to develop the norms and demand the regulations and governance that ensure we maximise its benefits, while mitigating the potential harms.

> "The development of AI is as fundamental as the creation of the microprocessor, the personal computer, the internet, and the mobile phone. Entire industries will reorient around it. Businesses will distinguish themselves by how well they use it."
> *Bill Gates[1]*

Usability is the killer app

ChatGPT's success is not simply due to first-mover status and great public relations. New architectures, algorithms and astonishing amounts of data and computing power have turbocharged the latest AIs, known as 'foundation models'. These show increasingly impressive abilities to comprehend relationships between data, and form a rudimentary understanding of concepts expressed in language, images or other forms.

The latest foundation models, such as GPT-4, outperform many humans in maths, logic and image recognition tests, and demonstrate particularly impressive language skills, with an incredible ability to parse the meaning of text inputs and generate outputs, even across multiple languages.

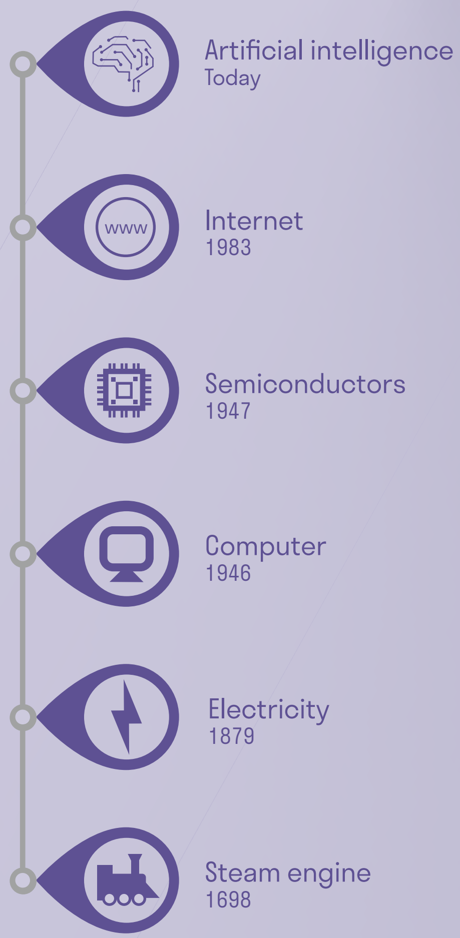
Continued

AI: DEEP IMPACT

Colm Harney. Portfolio Manager and Analyst

CONCEPTUALISING AI AS A GENERAL PURPOSE TECHNOLOGY (GPT)

Unlike most previous technologies, AI doesn't require a massive infrastructure build-out before it can be widely and experimented with.



These impressive abilities to understand, manipulate and generate language will directly impact industries like journalism, marketing and translation, but the bigger impact will come from the profound change in the human relationship with technology that this empowers. Ordinary users can now interact with software or even create personalised software in a natural, conversational way. When a user interacts with an AI model like ChatGPT, they are essentially reprogramming its software to produce a response, an activity that would have previously required a team of software engineers.

AI won't take your job – but an AI-assisted human might

AI will undoubtedly disrupt the technology sector, but the precise impacts are difficult to predict. The clearest beneficiaries are the broad enablers of digitalisation, such as TSMC, ASML and Nvidia. These companies dominate the design and production of the sophisticated semiconductors that underpin AI models. Similarly, IT consulting firms like Accenture that advise on how to use new technologies, could also benefit.

Other potential beneficiaries are software providers, as their products become more useful and valuable in daily life.[3] However, this may also reduce the barriers to entry in software development, thus increasing competition across the software sector. It can further highlight the importance of competitive advantages such as proprietary data, network effects and customer relationships. Customers could get the better end of the deal initially, but over the longer term, companies are likely to discover ways to monetise at least a portion of the consumer surplus.

There are several potential pathways for the development of AI-enabled products. We could see a proliferation of application-specific AIs, with each one trained to deliver the best performance for the lowest cost in its particular niche. Longer-term, these could be superseded by next-generation digital personal assistants, like a mobile, multi-media 'Siri' or 'Alexa' that interacts with all forms of software on our behalf.

Outside of the tech sector, the prizes for seizing the lead in applying AI could be even greater. Early adopters that deploy AI efficiently in their businesses to automate, speed up processes and leverage data could gain market share across

TABLE 1 AI WILL CHANGE THE RELATIONSHIP BETWEEN SOFTWARE AND USERS

	Define problem	Decide method	Execute task
No software	Human	Human	Human
Traditional software	Human	Software engineer	Computer
Neural networks 1.0	Software engineer	Computer	Computer
Generative AI	**Human user**	Computer	Computer

SOURCE: SARASIN & PARTNERS LLP, 2023

a swathe of industries. More broadly, AI could finally solve the 'productivity puzzle', in which technological advances since the 1980s have failed to produce stronger economy-wide productivity and growth. If, as some suggest, this has been driven by a lack of sufficiently cheap and flexible software, then the removal of this bottleneck could see a sharp, sustained improvement in productivity and living standards.

AI can help solve problems – or make them worse

New general-purpose technologies, particularly new media technologies, tend to cause societal disruption before new norms emerge. The humble printing press shoulders some responsibility for the religious Reformation and Europe's witch-hunting mania of the early modern period.[4]

What will AI bring? A fight over copyright seems certain. Pre-dating ChatGPT by a year, OpenAI's Dall-E image-generating model saw great popularity. However, AI-generated art has been accompanied by a string of court cases brought by artists whose work has been used to train AI models. Is this plagiarism and copyright infringement, as critics claim, or more akin to the inspiration inherent in any form of artistic creation?

A wider concern is how AI-powered news, work, entertainment and education will shape our societies and cultures. As AI-powered software plays a greater role in our lives, the values implicit in it become more important. The development of regulation and usage norms will be essential, but establishing these could be a painful process. Some parties will favour maximum regulation – to protect their businesses, intellectual property or cultural values – and some states will regulate to preserve tight social control, or reduce the risks of a runaway 'artificial general intelligence'. Battles over copyright, centralisation versus decentralisation, on-device use or cloud-based approaches will all be important and could ultimately be influenced by regulation.

A thematic lens adds clarity

The present hype around AI is redolent of crypto mania and Ready Player One expectations for the metaverse. In reality, most significant technological breakthroughs take decades to overcome teething problems and for economies to take full advantage of them. In the case of AI there is the potential for a lot to happen very quickly, but legal and ethical issues, as well as regulatory intervention could delay widespread deployment.

In the near term, AI will continue to be primarily a productivity-enhancing tool, particularly for creators and software programmers. In time, it is likely to be used to reduce boring or time-consuming tasks and improve life in myriad ways, for example through personalisation of services such as entertainment and education.

Longer term, AI has the potential to boost productivity and living standards dramatically. By removing the bottleneck of costly software, we could see the digitalisation of economies accelerate further, boosting productivity. For example, a lack of suitable software has prevented technology from having a big impact in the education or health sectors; with AI, the promise of truly personalised and dramatically more effective learning and healthcare could be achieved. If the leading AI models continue to progress at the current rate, it's feasible to hope these could help unlock solutions to some of greatest challenges facing our society, such as developing new materials and technologies needed to address climate change.

While it is too early to assess the implications for individual companies, these will undoubtedly emerge after a period of disruption and adjustment. In our view, a thematic, fundamental investment approach is key to spotting and understanding the complex ramifications of tech breakthroughs such as these. We believe the effect of AI will be transformative for the economy, and wider society, and we keenly follow the progress of this exciting space.

1 Wall Street Journal, Bill Gates Says AI Is the Most Revolutionary Technology in Decades, 22 March 2023

2 GPT stands for 'generative pre-trained transformer'.

3 For example, Microsoft recently announced a suite of AI 'co-pilots' for supply chain managers, marketers and salespeople. The Economist, 6 March 2023.

4 The widespread dissemination of non-Latin bibles, Protestant pamphlets and Heinrich Kramer's Maleus Maleficarum (1487) would not have been possible without the technology of the moveable type printing press.

BEN McEWEN
CLIMATE ANALYST

In conversation with Ben McEwen

HOW DO WE FIND OPPORTUNITIES IN THE HIGH-CARBON TRANSITION?

> Companies that aren't addressing significant transition risks, principally adaptation to climate change or mitigation of emissions, will be less likely to sustain their returns over the medium to long term.

As companies attempt their transition to a net-zero world, we sat down with Ben McEwen, Climate Analyst at Sarasin & Partners, to understand more about what the high-carbon transition means for investors and how we assess the credibility of companies' climate claims.

We often hear it's essential for all sectors of the economy to decarbonise rapidly, but why is high-carbon transition so important?

We're all increasingly cognisant of the rates of warming that we're seeing globally. As of last year, the world has experienced 1.1°C of global warming relative to the pre-Industrial Age. On land masses, that's actually about 1.6°C of warming, already above the Paris Agreement, which called for well below two degrees of warming, with a target of 1.5°C.[1]

Current policies take us towards 3°C of warming by the end of the century. That will have profound socio-economic consequences, due to rises in sea levels, loss of biodiversity and more frequent extreme weather events. In the US, for example, climate and weather-induced damages were in the order of $165 billion in 2022. For context: the annual average was approximately $30 billion in the 1990s, increasing to about $58 billion in the 2000s. In short, we already see a significant increase in climate-induced damage.

Analysis from bodies such as the Network for Greening the Financial System[2] shows that scenarios with the worst macroeconomic damage are those in which we have unabated climate change. It's clearly in all stakeholders' interests to abate emissions as quickly as possible.

Some indispensable industries – such as steel, chemicals and cement – will struggle to transition. What is the incentive for companies to change?

There are really two forces that drive change: regulation and increasingly attractive economic incentives for change. On the one hand, regulatory and legislative incentives drive companies to decarbonise. This already has an effect in Europe, where the price of carbon recently reached €100 per tonne for the first time in history.

Coupled with this, are the economics of transition. The cost of offshore wind energy fell by approximately 60% between 2010 and 2021. Over the same period, the cost of solar energy has fallen by 83% and the cost

What we are looking for in our high-carbon transition sub-theme is to protect our clients' capital and generate durable returns over the medium to long term.

of producing electric batteries is down 89%.[3] This means companies have an increasingly compelling economic rationale to expedite the change to net zero. However, we do have to bear in mind the significant differences between industries in terms of their ability to change – and nuances within specific industries.

Given these differences, how do you go about finding companies that are likely to perform well over the coming years as we transition to net zero?

We can't expect industries to decarbonise at a linear pace that will take us all to net zero. The steel industry will decarbonise at a different pace to the cement industry, and the chemical industry will have its own path to follow. We also have to consider the individual firms within those sectors, as well as the core competencies and attributes that could enable them to make the transition.

Essentially, what we're looking for in our high-carbon transition sub-theme – as we do in all of our themes – is to protect our clients' capital and generate durable returns over the medium to long term. Companies that aren't addressing significant transition risks, principally adaptation to climate change or mitigation of emissions, will be less likely to sustain their returns over the medium to long term. We have to consider whether our clients' capital would be put at risk by investing in those companies.

How does Sarasin assess the credibility of a company's transition targets?

We draw on a variety of sources, including our own Sustainability Impact Matrix (the SIM), in an attempt to standardise the type of information we seek from every company. The SIM presents over 160 questions on a range of environmental, social and governance (ESG) metrics to help us pin down where a company might be vulnerable to ESG-related risks. We also use some external data providers to help us think about companies' physical risks and the viability of their transition pathways.

Importantly, we bring internal and external ESG and transition metrics together with our fundamental analysis. A company might score highly in terms of its alignment with climate targets but still, in our fundamental analysis, be unattractive in terms of its ability to generate cashflows.

Do you hold any companies in hard-to-abate industries in the portfolios?

Two interesting examples are Rio Tinto and Air Liquide. Rio is one of the largest mining companies in the world and it faces interesting challenges and opportunities in its decarbonisation journey. It has significant exposure to copper and lithium – both of which will be in high demand during and after the energy transition. By some estimates, production of global lithium will need to increase about 42-fold over the next 30 years to keep pace with battery demand[4], while copper is crucial in electrification and building smarter power grids.

HOW DO WE MANAGE THE HIGH-CARBON TRANSITION?

Ben McEwen, Climate Analyst

It faces a great set of opportunities, but it also has significant exposure to iron ore, which has high scope 3 emissions. These are outside of Rio's control, as they are caused by activities elsewhere in the value chain. The question is: How does Rio go about capitalising on higher demand for copper and lithium, whilst also decarbonising its business and reducing reliance on cash flows from iron ore, for which there is likely to be lower demand over time?

Another interesting company in terms of the high-carbon transition is Air Liquide, a global leader in industrial gases. Today it has a high emissions footprint due to the energy intensity of its products, but it also has two interesting energy transition opportunities. The first is carbon capture storage, which has some controversial aspects, but will be needed in some form. The second is hydrogen production. Hydrogen's multipurpose potential has been much-hyped, but the industrial sector will increasingly need hydrogen. Air Liquide is a global leader in producing hydrogen and has good potential to generate enduring cash flows from that value chain.

Does this process lead to avoiding companies in hard-to-abate sectors?

We don't rule out any specific industries. We aim to protect capital by looking at the world in terms of the themes that are shaping society. Given these forces, we seek to identify companies that are most likely to benefit as a result.

There are companies in hard-to-abate sectors that won't protect our clients' capital. But these may also be companies that we can engage with and apply very specific targets for change. Shifting those companies towards a more responsible path can lead to capital protection and more durable cash flows.

So yes, we can and will invest in high-carbon companies – if they meet our ESG requirements or can be shifted towards a responsible path. It remains an investment decision. If our research shows that a company's returns will be challenged, then we'll look for better opportunities elsewhere.

1 Synthesis Report of the IPCC Sixth Assessment Report (AR6), 2021, p.6.

2 The Network for Greening the Financial System is a network of 114 central banks and financial supervisors that aims to accelerate the scaling up of green finance and develop recommendations for central banks' role for climate change. The NGFS was created in 2017 and its secretariat is hosted by the Banque de France.

3 IRENA, Renewable Power Generation Costs in 2021, July 2022.

4 US State Department, quoted in New York Times, Falling Lithium Prices Are Making Electric Cars More Affordable, 20 March 2023.

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