THE MESSAGE

Sustainable finance according to AiSM LUXEMBOURG

IR ACT

The ESG roller-coaster

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It's only two months ago that we were considering the hesitations of ESG investors and how the Taxonomy legislation was viewed as an obstacle to profitable investments. Today the fortunes of ESG stocks look bright again thanks to the Inflation Reduction Act, the Biden plan to push decarbonization and green energy sources.

After 18 months of exhausting give and take, the package – that in January 2021 included a Climate Plan of USD 2 tn – has been approved a few weeks ago at the US Senate after 3 senators agreed to support it. Just about to pass the law (51 in favor vs 50 against) and with a substantial reduction to 740 bn, of which 370 for renewable energies to fight climate change.

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Even so, **the IR Act provides a budget as much as four times higher than the previous climate plan of 2009**. According to independent estimates, matching the Democrats' data, the investments to fight climate change would cut carbon emissions by 40% by 2030 compared to 2005. It's not quite the 50% initially announced by Biden, but the target may be increase in the next eight years if everything goes according to plan and the energy cost will decrease thanks to wind, solar and hydrogen.

The IR Act approval on July 27th spurred a rally on stocks linked to renewable energy, especially in the US. Solar and hydrogen companies have recorded average performances around 25% in the three following days, reaching peaks of 35% for the former and 60% for the latter on Aug 15th. Stocks like Array Technologies, that were hard hit over the past few months and that have reported better than expectations in the earnings season, have almost doubled in two weeks showing year-to-date performances ranging from -60% in May to +50% in mid-August. In Europe things have been somewhat quieter, with single-digit performances for solar and wind companies and +15% for hydrogen ones. Since the law approval, the S&P Global Clean Energy Index increased by almost 15% in three days reaching +21% on Aug 15th.

This happened in a year that renewable energy stocks exhibited extreme volatility following global geopolitical events: after the negative start, the S&P Global Clean Energy went back to positive territory due to the invasion of Ukraine by Russia, when the S&P 500 was still around -10% at the beginning of March. After the Q1 reporting season, the rates hikes, energy and labor cost increases and supply chain issues have pushed the index back in the red to -20% around mid-May, a loss greater than the general S&P 500. Now with the Biden plan the index is again positive, performing around +12% as of Aug 15th while the S&P 500 is almost at a double-digit loss.

The prices of these companies are evidently influenced more by expectations on a far future than by objective valuations. Depending on the investment case, analysts justify the prices assigning a greater or lower probability to revenues from future contracts. We are seeing again the same environment that led to the excesses of January 2021 (coinciding with the USD 2 tn infrastructure plan by Biden) and its following unravelling until May 2022.

It's not easy to navigate these wild fluctuations, but two considerations can be done: on one side, **the IR Act shows once again the willingness by world governments to reduce the GHG emissions over the next three decades**; on the other side, any company with excessive valuations exhibits a high intrinsic risk even if it operates in a sector with strong growth.

If we add that many of the companies in the decarbonization business are continuously expanding with negative cashflows and substantial investments, it's easy to see that even a minor setback could derail the growth story and put the company in danger. So if investors cannot stay out of a secular growth trend, they still should avoid stocks with outlandish multiples and avoid specific themes that appear to be overheating.