SEPTEMBER FURY
ENERGY TRANSITION

Is it possible to finance the energy and digital transition with inflation still far from the generally assumed target of 2% and with economies' growth capacities struggling below the interest rate level? This is perhaps a question that needs to be asked to try to interpret the uncertainty that characterises this phase of financial history. The central banks, and in particular the Federal Reserve, seem to have a clear answer: absolutely not. But they also have equally inescapable positions: transition is necessary to avert the evils of climate change, which are there for all to see.

The optimism surrounding the transformation faded after the outbreak of war in Ukraine. Joe Biden, in the US, based much of his economic policy framework on the need to rebuild the crumbling infrastructure, forgotten by the financial flows that had found comfort abroad. Over the past thirty years, when politics has left the reins of strategic decision-making in the hands of business, China has lowered the cost of production, but it has also killed the negotiating capacity of workers and the middle class in the West. The supply of products was good and profitable, the capacity to spend was, on the other hand, more and more naturally restrained and artificially supported by debt, at least in the US. Having come to power, Biden has also added pomp and circumstance to the Paris climate agreement to limit global warming to 1.5 degrees. This implies copious investments in wind and solar energy while exploring the promises of hydrogen and also evaluating, with varying degrees of acceptance, the new atomic energy. Stocks promising the miracle of transformation exploded during 2021.

Contributing to this development is also Europe, which has put energy transition at the centre of its internal and international debate. Even on this side of the Atlantic, the promise of a new green economy married with infrastructure restructuring seemed to be perfect to overcome the years of austerity in which everything was

blocked by Germany and the 'virtuous' countries.

The United States and Europe seemed to have found the magic way to impose a new green and efficient economy because it was due in view of the dangers shared by all of global warming. The old oil and gas economy had to be utilised, but without any investment in it because it would become useless in a few years.

At the heart of this operation was also a financial miracle: it would be free. With negative interest rates in the EU and around zero in the US, it was easy to imagine that going into debt to finance the change would not cost a penny, neither in euros nor dollars nor yen. The United States, Europe and Japan (the latter seemed to have forgotten that rates can go above zero) were aiming for a new world domination, a kind of eco-technological soft power, because they were ready financially and digitally to be leaders of the new economy. This design did not have the wisdom to calibrate the peculiarities of the losers or presumed losers.

China was attacked by Donald Trump, who introduced tariffs to punish its exports to the US. Joe Biden has maintained his predecessor's choices by going even further. Targeted are the Chinese productions of the new economy, from electric cars to digitalisation companies. Xi Jinping's reaction is one of clear defiance, but the ties and interdependencies between the two countries are still too intense to be quickly frozen. Although China clearly aspires to incorporate Taiwan, the current interconnections do not allow it to take this step. The position of Russia, which has an economy based on the raw materials needed by the old economy, especially gas and oil, and an ambition to revive itself among the great powers, is different.

The war in Ukraine is an attempt to curb a development that would, in the near future, kill the sources of income of Putin's country. The open clash has an overwhelming effect not only on the drama of the lives cut short, but also on a major enemy of the financial world capable of impoverishing growth and, once again, the middle class: inflation.

Inflation makes energy transition plans expensive and undermines the social solidity needed to sustain war sacrifices. The stakes are therefore very high. The United States, surprising those who thought that after its humiliating withdrawal

from Afghanistan the country was close to decay, has reacted with unexpected force. Militarily, through NATO, it has provided powerful military and economic aid to Ukraine. On the financial side, the fight was entrusted to the Federal Reserve, which dragged all the western central banks into an unrestrained inflation fight of turbo-charged interest hikes: if inflation is not reduced quickly, the costs of the green and digital transition are unsustainable. For its part, Joe Biden's government, while contradicting the Federal Reserve's restrictive policy, has not relaxed its plans to invest in the American economy. The result is receding inflation, a growing economy and a strong dollar. With these moves, America has confirmed its decision maker role in the world economy and finance.

However, the markets had to re-evaluate the scenario that unfolded during the quarter and especially in the difficult month of September. Certainly, the Fed's policy seemed to be a success. Consumer prices rose 3.7% over the past year in August, more than the 3.2% in July, but far from the 9.1% peaks reached in June 2022. At the same time, growth unexpectedly turned out to be solid: the Atlanta Fed barometer even forecasts Gross Domestic Product (GDP) growth of around 4.9% in the third quarter. In spite of this success, Jerome Power, president of the central bank, decided for a pause at the September meeting, but wanted to signal that rates will remain high for a long time. The risk of inflation picking up again, perhaps helped by oil prices that reached dollar 95 a barrel in the month, is still considered too high. Reinforcing this prospect was also a solid member of the establishment: Jamie Dimon, the powerful chairman of JP Morgan, ventilated the possibility that rates could even rise to 7%. The already expected pause in restrictive monetary policy was in fact underpinned by words intended to dampen any exuberance. This prompted the markets to reprice financial assets, starting with ten-year US treasury bonds, which touched 4.6% in September (4.1% at the end of August). The S&P, the world's flagship stock market index, lost 5.4% and the Nasdaq 5.8%. In such an environment the dollar appreciated strongly, against the euro it even went below 1.05 (at the beginning of the month one euro was worth 1.09 usd).

The strength of the dollar becomes an expression of power. The emerging

countries and in particular China, forced to burn reserves to support its currency, are suffering the consequences. This American strategy undermines Xi Jinping's desire to establish Beijing's currency as a central bank reserve currency and a tool that can eventually undermine the centrality of the greenback. Grappling with the domestic real estate crisis, the world's second largest economy is trying not to follow the American path of Quantitative Easing (monetary easing), because it does not want to devalue. But the tensions on this front are increasingly difficult to sustain.

By punishing China with its policy, the US is putting its European allies in a difficult position. They have to deal with the strengthening of the dollar and the rising price of oil as Saudi Arabia and Russia reduce production: oil is still mainly bought in dollars and with the weak euro, inflation is imported. On this side of the Atlantic, the European Central Bank (ECB) managed to curb inflation by raising rates (the leading indicator is at 4%). In September, year-on-year inflation in the eurozone fell to 4.3%, from 5.2% in August (10.6% in October 2022). But ECB President Christine Lagarde, in the last meeting at which a 0.25% hike was announced, also emphasised that the cut in GDP growth in the eurozone for 2024, from 1.5% expected in June, drops to 1% in September precisely because of the ongoing slowdown this year (growth estimated at 0.9% in June, but reduced to 0.7% in September). Suffering most of all is Germany, the largest economy on the Old Continent governed by a coalition with a strong green bias: according to estimates by leading research institutes, German GDP will contract by 0.9% this year, reversing the weak growth of 0.3% that they had forecast in the spring for 2023.

What will happen now, after the difficult month of September? The US is forced to loosen its grip a little. The debt explodes and the attempts to put a ceiling on it, which partially failed on October 1st, will remain a heavy sword of Damocles. Rates are close to a peak and, although they will fall more slowly than expected, they will still stick to the growth path. The markets know that strategically the fight against inflation is a necessary step to make the costs of the energy transition sustainable. But they have also guessed that the transformation will now be more

pragmatic: oil and gas tensions will be calibrated to cushion the needs of the current economy, indirectly making producers more involved. In this design, the war in Ukraine becomes increasingly difficult to sustain.

In financial terms, central banks have become asset managers. They have nationalised the bond market and there is no shortage of incursions into the stock market. But while stock exchanges due to buy backs over the past two decades have seen the nominal amount of shares available remain static, the bond market, private and government, has exploded. For this reason, the portfolio strategy must diversify between stocks in the new economy (FANG) and those in the old economy that are less indebted and more forgotten. On the bond side, companies with long-term outstanding issues (those issued when rates were low) should be favoured tactically. The financial market is an integral part of economic stability, and the new large asset managers know this. Tactically, it is time to review portfolios and increase equity exposure alongside good bonds, given current yields. Fighting inflation and energy transition are still the key to strategically interpreting the path forward.

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