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The Energy's War of Survival

Recently, one article is making its rounds in China's investor community: Zoltan Pozsar's "War and Industrial Policy." The article highlighted 3 key factors for the low-inflation world: cheap immigrant labor; cheap Chinese goods; and cheap Russian gas. All of them are being challenged right now, thus he believes in the emergence of Bretton Woods III. Zoltan Pozsar is a well-regarded market veteran who is currently Credit Suisse global head of Short-Term Interest Rate Strategy. He used to work in FED, IMF, and US Treasury, was famous for his insights on shadow-banking and more recently, for his non-consensus view on Russian-Ukraine conflict's impacts on inflation and financial systems.

In the mainstream school of thought, the high inflation came from excess monetary liquidity. Friedman once declared that all inflations are a monetary phenomenon. The USD can maintain its dominance because of its technological superiority. Zoltan took a different view and marked cheap Chinese goods and cheap Russian natural gas as the lynchpin of global low inflation. China and Russia bought G7 debts using their export incomes, thus recycling the surpluses and reinforced the stability of the global USD-based financial system. But now, that cycle is broken, which means all links of the chain are at risk. **In order to address this "Great Crisis of Globalization," Zoltan expected the Western nations to "re-arm (to defend the world order); re-shore (to get around blockades); re-stock and invest (commodities); and re-wire the grid (energy transition)," which will require literally trillions of dollars.** The global situation has deteriorated from last year-end's "Winter is Coming," to the current season of "Game of Thrones."

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1. Energy's War of Survival

Globalization works when there's trust, which worked well when Europe and Russia had their "Eurussia," and China and America had their "Chimerica." Unfortunately, such close trusting cooperations no longer exist. When the trust is gone, the previously closest collaborators can quickly become the fiercest competitors. Indeed we are seeing current offspring of that in the form of US manufacturing returning onshore, and the global energy race.

In the last few years, the hottest theme in the Chinese investment space was carbon-neutrality. From a collaborative perspective, Carbon-neutral is the biggest globally accepted common theme; yet from a competitive perspective, Carbon-neutral is a race towards developmental rights and energy independence. The current economic developments still require coal, oil, and gas. Nations must stockpile such strategic resources to offset potential crisis. **In the long-term, dependency on fossil fuel can only come from new energy transformation.** Right now, we have both traditional energy and new energy rallying side by side, because we do not have scalable substitutions yet.

This co-existence relationship is clearest in Europe: even though media have talked about how Europe must abandon Carbon-neutral commitments given the Russia-Ukraine conflict, we see the European focus not on giving up such commitments, but on dealing with the current energy crisis. In the European power generation structure, fire generation has the highest contribution at 26%. After Russia-Ukraine conflict, Russia had temporarily cut the Nord Stream 1 temporarily, and later reduced the supply to only 20% of max capacity. This drove up European gas prices to the stratosphere with European natural gas future price at more than 10 times the average price in the 2010-20 period. In 2022, European gas future has more than doubled, with no end in sight. Germany, France, and other European nations have made announcements to resume coal fire power plants. German plants are now testing coals from Australia, South Africa, Indonesia, and Columbia. Some German factions are even suggesting activating Nord Stream 2 to increase Russian supply. Netherland announced in June that it too will remove restrictions on coal-fire plants in the coming months. Coal fire will definitely increase the carbon-emissions, which will impact the progress on the Carbon-neutral milestones, but it doesn't mean abandoning European development of new energy. Since the Russia-Ukraine conflict, Europe has accelerated new energy transformation with substantial increase of photovoltaic equipment imports. In July YTD period, German has imported 3.8GW of Photovoltaic equipment, or almost triple the same period last year. Spain increased by a similar 160%. Netherland imported about 4.5GW in July alone, an increase of over 100% YoY.

While European nations must rely on coal and natural gas today, the transformation of the energy involves the long-term future. If addressing climate change is a topline global consensus, then transforming energy from resource industry into a manufacturing industry is bottom-line necessity – and the only way to survive the strangle-hold by commodity-producing nations. **The global climate change crisis management may be interrupted by war, or disrupted by mistrust, but because it deals with national security and survival, it can't and won't be avoided.**

Energy storage has been a big topic, because it's an effective tool to address the inherent instability of wind or solar power generation. There was once a wry remark amongst the energy-storage analysts that coal and oil is also a form of energy storage. From a scientific perspective, that statement is factually correct. Conversely, we can also think of energy storage as the coal and oil of the next energy age. And the ultimate solution may come in the form of hydrogen energy, which is a clean and high-intensity fuel.

For a casual observer, the war on energy may look like a political showcasing by Western environmentalists who try to limit the developing worlds. But in fact, the underlying theme behind the war on energy is a much more basic fight for survival. **Shifting geopolitical landscapes may be hard to understand, but the fight for national survival will remain the eternal theme.**

2. The Volatile New Energy

Recently there were high volatility in the new energy and even the EV sectors that shook the faith of some Carbon-neutral investors. Behind the changing faith is a fundamental lack of understanding on the industry. Blind faith on the hot theme will push up asset prices in short period of time – often pricing-in excessive growth for the next 3-5 years within just a few months. This will force some long-term investor to adjust their positions. But trees don't grow in the sky, and so the irrational faith must collapse someday. It's moments where market had abnormally large moves, and when the irrational faith collapses that the real investment experts can shine through.

Our faith in investment must be based on logic and foresights and not on submission to the authoritative opinions. **In order to survive in the investment industry for the long-term, there must be the generational Beta from the market and the individual Alpha from the investment manager.** Investment is about monetizing your insights, so only those with top insights can capture the top Alpha. People who do not understand the generational Beta may blow up when the Beta shifts. We are seeing recent examples of many investors losing their portfolio due to exposure to Real Estate trusts or debts. People who do not have Alpha nor foresights find it hard to capture excess gains, and may even suffer losses in the volatile markets.

Let's take an example: if a high-growth company's stock price went from $10 to $20 within a month, and then fall back to $15 after another month, what will you do? If you believe the stock is worth $20 now, will be worth $50 in three years' time, and that the market should correct in the next 6 months, then you should jump in a buy the stock no matter your investment style. On the other hand, if you believe the stock is only worth $10, and will be worth $15 in three years' time, then you should NOT buy the stock, no matter you're a value investor or a growth investor. And if you do not know how much the company is worth, then you can only chase the market on the way up and on the way down, becoming a real retail investor in buying high and selling low. This example illustrated that the most important thing is not whether you are a value investor or a growth investor, it's having the asset pricing capability and a deep knowledge about the market. **Knowing how much an asset is worth, and how long it'll be before the**

market corrects its mispricing, these are the true tests of whether an investment manager is a professional or just another retail investor with a big checkbook.

It's only when there's disagreements in the market that you can observe the investment manager's true insights. Like Taleb wrote in his book The Black Swan: "if you want to get an idea of a friend's temperament, ethics, and personal elegance, you need to look at him under the tests of severe circumstances, not under the regular rosy glow of daily life." Whether the investment manager has a sufficiently high success ratio will need time to tell: how did the manager do in the previous bull and bear cycles? New manager and experienced manager may see things very differently: when an industry collapsed prominently, the experienced manager who's been through multiple major cycles see this as a small episode within a larger economic cycle, while the new manager may see it as the end of the world. In fact, different participants will see the market differently: institutional investors, foreign capital, retail investor, liquid asset investors.

3. Allocate across Bull & Bear cycle

In the last three years, there's an interesting phenomenon that many experienced fund managers closed shop while other new and aggressive managers leveraged up on the New Energy theme and shot to the moon. So being experienced is not a guarantee of being successful. With the volatile market, transforming industries, fast thematic rotations, and frequent Black Swan events, can the experienced manager still deliver and adjust to the changing times? And the new managers, do they really understand the market, or are they just lucky in capturing the Beta? Will the new champions of today be in the bottom quartile next year?

The best approach for the investor may lie with asset allocation. All the managers have their own capabilities and constraints. Investor can view manager as an asset allocation tool, and not a horse to bet the house on. Or to put it in another way, stand on the shoulder of giants, not in their shoes. When we talk about asset allocation, people often think about stock vs debt allocation ratio. While this is indeed true, there needs to further allocation within the stock portfolio. In the age of high inflation, only high-growth stocks can outpace inflation. Even though photovoltaic stocks may be temporarily over-valued, but looking at a 5-year horizon, they're still worth holding to capture the structural opportunities. Investors may therefore choose carbon-neutral or industry-expert managers as a long-term core holding, and wait for the opportunities to arrive. At the same time, investor may diversify by choosing experts in other industries. Here are a few factors you may consider in choosing managers:

a) Has the research team done in-depth Carbon-related research for at least 7 years, and been through the bull-bear cycles of 2015 and 2018.
b) Fund Manager has at least 3 years of track record.
c) Fund Manager has case studies of long-term positioning in the sector.

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And investor does not have the time or the information to choose the best manager of each sector, one may consider a balanced fund. Here one need to consider the composition of new vs experienced managers. Compared to experienced managers, new managers tend to take on more risk, so they will perform better during period of large sector-specific moves. Therefore, for the investors with larger tolerance for risk, if they want more returns, they can allocate to more new managers to up to 50% of the total allocation. For the older investors, the steady experienced manager who demonstrated long-term win ratio can become the majority holdings or say 80%, so that even if the new manager that account for 20% of the portfolio got hit with a -30% drawdown, it'll only be a 6% loss on the portfolio.

Fund managers often promote the idea of long-term holding to prospective investors. But in the market, there are rarely any investors who can tolerate two or three years of negligible or negative returns. Even for professional institutional investors, this is a tough profile to keep. Investor will chase after returns, and in the process, experience fear and greed during volatile markets. This is human nature at work. Investor can use asset allocation to smoothen returns. The fund manager can also smoothen volatility by control drawdowns. As Arthur Ashe famously said: "Start where you are. Use what you have. Do what you can." **The manager should think deeper, work harder, and communicate better, so that investor will have a more enjoyable ownership experience.**

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