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Investments

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# CIO Strategy Bulletin

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## Impacts of the US Treasury's New Borrowing

- The US bond market has reacted to increased Treasury borrowing with higher rates; however, the conditions have not yet disrupted credit markets or prompted a flight from bank deposits, as feared. The stability of markets and banks is partly attributed to the offset of the rise in US Treasury borrowing by reduced Federal Reserve borrowing.
- Equity markets have encountered some resistance following the strong rally in the first half of 2023, but potential opportunities remain. The Nasdaq is still 15% below its late-2021 peak, even after a substantial 30% rally this year. Global markets appear to have de-risked after significant declines in 2022, with potentially cheaper regional markets balancing out a pricier US market. Despite high valuations for large-cap US stocks and some investors remaining on the sidelines, global equity positions have so far seen a 12% return in the first half of the year.
- Over the second half of 2023 we expect a range of potential equity opportunities to unfold. We discuss the broad Energy industry below.

## OPEC's Gift to Energy Producers

- The global price of oil dropped 12% since OPEC+ announced its first round of production cuts in April, but if you're looking for signs of recession, you won't find them in Western energy firms. To help replace Russian gas supplies to Europe, US liquefied gas exports surged 45% above their pre-Covid level.
- Over the past 70 years, real oil prices have increased, in contrast to the march of technology which typically drives down prices. OPEC+ typically cuts production when demand falls and are a sign of weakness. However, OPEC+ seems unusually early and proactive in reducing output. Petroleum and gas supplies typically rise on a lagged basis when sustained energy demand surges.
- The global need for redundant energy supplies of every sort – from traditional oil and gas to renewables – distinguishes the energy sector from other cyclical industries. We see elements of the green energy space now reaching sufficient maturity to see increased profitability by leaders. Renewable energy has been filled with government-backed startups and speculative moon shots – a rolling recession should bring consolidation.

# Impacts of the US Treasury's New Borrowing

While the risk of higher rates for longer are growing, the immediate impact of higher Treasury borrowings has proven less troubling than we anticipated. The US bond market has seen yields back up as Fed Chairman Powell tries to "talk" his way to tighter financial conditions. Meanwhile, credit markets have taken increased Treasury issuance in stride. This is at least partly because banks have not seen a resumption of deposit flight.

The post-debt ceiling rise in US Treasury borrowing has been partially offset by reduced Federal Reserve borrowing (see **Figure 1**). The Fed's Reverse Repurchase Agreement Facility (RRP) has seen outflows of $335 billion while the US Treasury's cash balance has rebounded by $289 billion. Over roughly this time, US banks have managed to hold deposits and seen a little upside (up about $55 billion). This is despite the allure of US Treasury bill rates at around 5.25%. Overall, we see this as a good initial sign for banks, though risks remain prevalent.

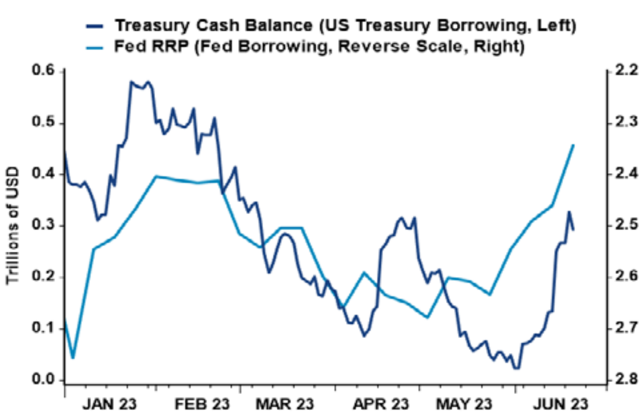
As we discussed in our Mid-Year Outlook 2023, the opportunity to earn a yield of 5.25% (more or less, depending on the instrument selected) for years to come should be appealing to bond investors who can take advantage of longer duration, high grade credit and other potential opportunities. The Fed's own longer-term forecast for cash returns of 2.5% is less than half this level. This means that investors may be able to lock in positive real yields should inflation abate, as we expect.

The relentless equity rally of the first half of 2023 is now hitting some resistance (see **Figure 2**). But rather than fret over finding the perfect entry point for greater positions in equities (see last week's Bulletin *There Is No Perfect Time To Invest)*, investors should note that Nasdaq shares remain 15% lower than their late 2021 peak even after rallying more than 30% this year. In short, the double-digit declines in global equities and bonds in 2022 significantly de-risked markets and improved forward-looking returns.

Will double-digit gains for the S&P 500 be repeated in the second half 2023? We doubt it. Heavy-duty short covering is well underway and valuations for large-cap US stocks have risen meaningfully. Yet, many investors remain sidelined. US cash positions have earned 2.1% in the year to date, and may yield 4.5% over a full year. But investors who have maintained equity positions in 2023 saw a 12% return in global equities, so far.

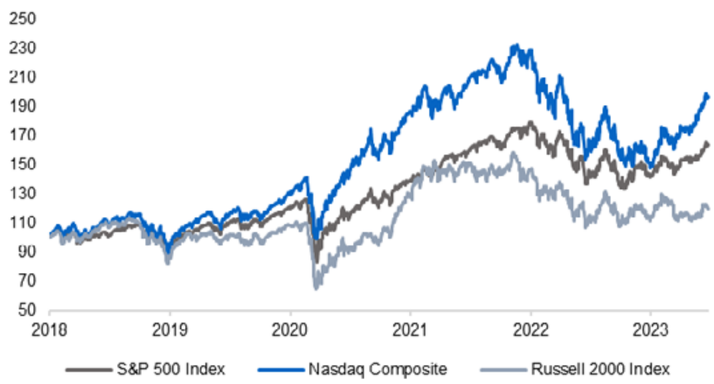
Over the second half of 2023 we expect a range of equity opportunities to unfold. Many cheap regional markets offset a rich US market. And across sectors, traditional and alternative energy may present opportunities as outlined in the second section of the Bulletin below.

**Figure 1:** US Treasury Borrowing Rises, Fed Borrowing (RRP) Falls




Source: Haver Analytics as of June 23, 2023.

**Figure 2:** S&P 500, Nasdaq Composite and Russell 2000 (Small Caps)




Source: Bloomberg as of June 23, 2023. Note: Indices rebased to 100 as of 1/1/2018. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

# OPEC's Gift to Energy Producers

Normally, signs of a recession would show up in the energy patch, but you won't find them looking at many Western energy firms today. In the US, crude oil output is gradually moving toward record highs. To help replace Russian gas supplies to Europe, US liquified natural gas (LNG) exports surged 45% above their pre-Covid level (see **Figure 3**). The world still relies on 6 million barrels per day of Russian crude oil exports, even if many western economies refuse to buy their exports. The US Strategic Petroleum Reserve has fallen 38% from end-2021 levels, prior to the war in Ukraine, and the US is buying oil again.

Amidst all this turmoil, the global price of oil has dropped by 12% since OPEC+[1] announced its first round of production cuts in April (-1.66 million b/d). OPEC+ has effectively reduced output by about 3% through cuts announced in October of 2022, April 2023 and again in June.

During prior recessions, OPEC+ typically cut production when demand was falling (see **Figure 4**). Production cuts were usually a sign of weakness. However, today OPEC+ is being proactive, reducing output early in an effort to keep the terminal price of oil higher as this rolling recession unfolds.

This is not welcome news for those looking to hammer Russian petrol income, or to those looking for oil to contribute to a major reduction in global inflation. This means that energy credit and equity investors can view the sector somewhat differently from its usual recessionary bust (see **Figure 5**).

The global oil price would be much higher without Russian crude exports. As the world is recovering from a period of oil shortages and supply chain disruption, crude oil trade has been effectively redirected. However, with the shutdown of the Nord Stream natural gas pipelines, the possibility that internal and external conflicts may disrupt a delicate balance for energy markets remains ever present.

[1] OPEC+ is a group of 23 oil-exporting countries, which includes the 13-core members of OPEC (Organization of the Petroleum Exporting Countries) and non-OPEC exporting nations including Russia. OPEC+ represents around 40% of world oil production and its main objective is to regulate the supply of oil to the world market.

**Figure 3:** US crude oil production and LNG exports

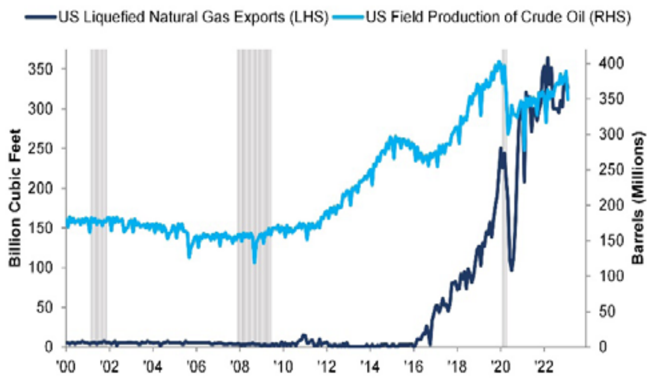
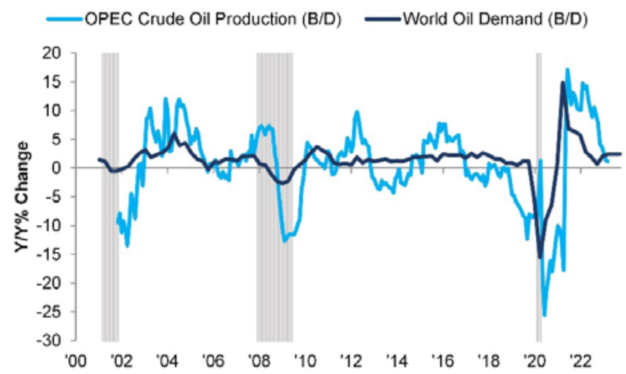



**Figure 4**: OPEC crude oil production and world demand Y/Y%




Source: Haver Analytics as of May 3, 2023. Grey areas note recessions. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

**Figure 5:** Peak-to-trough % change in S&P 500 sector EPS on average in last four US recessions

| | |
|---|---|
| Healthcare | 7.7 |
| Consumer Staples | 4.9 |
| Utilities | -13.2 |
| Telecom Services | -27.4 |
| IT | -32.3 |
| Industrials | -42.8 |
| Consumer Discretionary | -50.7 |
| Materials | -58.3 |
| Financials | -71.4 |
| Energy | -113.9 |

Source: Haver Analytics as of May 3, 2023. Note: Last four periods of US Recession dates based on official National Bureau of Economic Research (NBER) calculations: Jul 1990.(Q3) - Mar 1991.(Q1), Mar 2001.(Q1) - Nov 2001.(Q4), Dec 2007.(Q4) - Jun.2009 (Q2) and Feb 2020.(Q4) - Apr 2020 (Q2) along with near-term peaks and troughs in EPS associated with each of these four recessionary periods for each sector listed. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

## Thinking Ahead?

The OPEC+ group of oil producers met in Vienna on June 4-5th where Saudi Arabia announced it would cut production by a further 1 million barrels a day starting in July. This which would take OPEC output to the lowest level since June 2021. The move by the Kingdom to support global crude prices cedes ground to two key allies; Russia, which made no commitment to cut output further, and the United Arab Emirates, which secured a higher production quota for 2024. The UAE had been pushing for a higher production baseline reflecting significant additional investments in its industry.

Saudi Arabia's Energy Minister Price Abdulaziz bin Salman has said that he would "*do whatever is necessary to bring stability to the oil market,*"[2] suggesting the 1 million barrel per day reduction could be extended beyond the announced timeframe as Prince Abdulaziz tries to dissuade bearish oil speculators.

[2] https://www.cnbc.com/2023/06/04/saudi-energy-minister-defends-voluntary-oil-cuts-as-precautionary.html, 4 June 2023.

## Impacts of OPEC+'s Proactive Approach

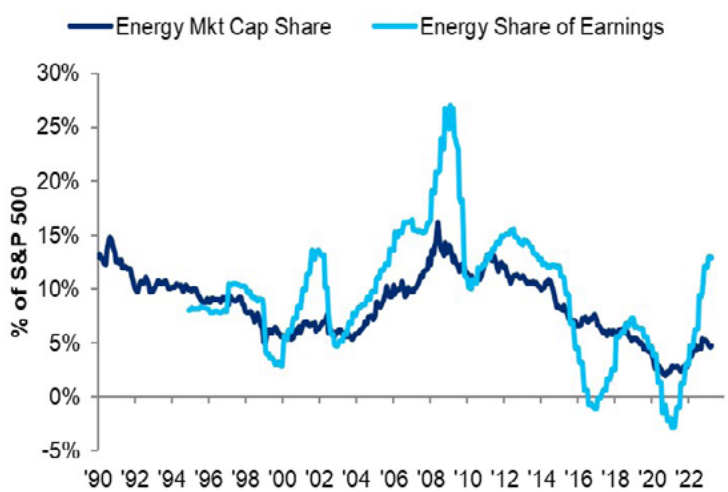
We are not expecting a new energy cycle and renewed equity appreciation for many energy companies . Citi Research's commodities team see sustained two-sided risks for commodities prices[3]. This includes the important fact that petroleum and gas supplies typically rise in a lagged response to sustained demand surges. As the historical record demonstrates, the cure for high prices is high prices.

The global need for redundant energy supplies of every sort – from traditional oil and gas to renewables – distinguishes the energy sector other cyclical areas (see **Figure 6**). As oil prices remain elevated, alternative energy sources have become more valuable. It will also help the renewable energy sector reach sustained profitability in coming years. This is the paradox of the 2023-24 oil market.

Higher recessionary pricing and the geopolitical necessity of maintaining adequate energy supplies are accelerating the value and profitability of alternative energy. Improvements in the economics of renewables in accelerating. Even in the relatively energy-rich US, electric heat pump installations are growing rapidly. US electric passenger vehicle sales grew by 65%, compared with a 14% decline for those with internal combustion engines. The American electric vehicle stock – at 2.4% of registered vehicles -- is no longer trivial when considering future US energy demand.

There's no denying security risks to traditional energy. However, during the transition, the world needs redundant energy supplies from every source possible and this raises intermediate return prospects for non-OPEC producers such as Brazil (see **Figure 7** and **8**).

**Figure 6**: S&P 500 energy sector market cap and EPS as % of S&P 500




Source: Bloomberg as of May 2, 2023. The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

3 Global Commodities - Commodities: Energy Outlook, 8 June 2023.

**Figure 7:** MSCI Brazil and CRB Commodity Index

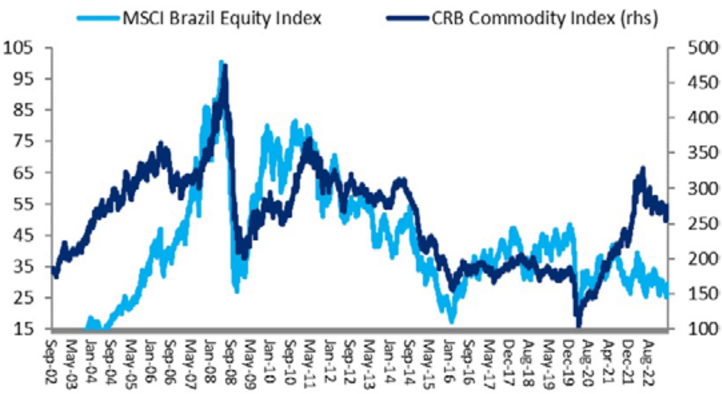
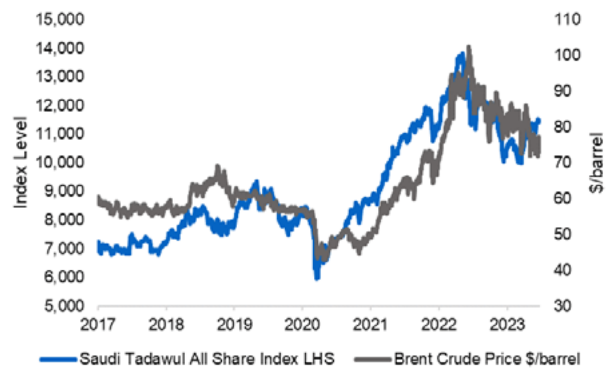



**Figure 8:** Saudi Tadawul All Share Index vs Brent Crude Oil $/barrel



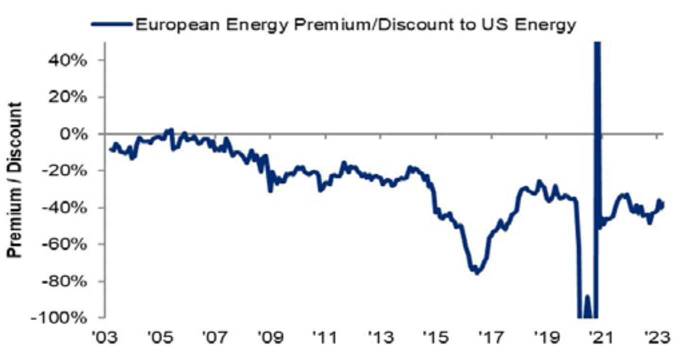

Source: Bloomberg as of June 23, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

## Better Traditional Valuations in Europe

Over the past two decades, European energy companies have been trading at a discount versus their US energy counterparts (see **Figure 9**). After reaching lows in 2021, European energy valuations have partially rallied but still offer a 40% discount to US energy firms. This valuation difference is relatively unjustified as European and US energy companies are structurally similar. Part of the valuation discount could be due to general European companies falling out of favor with investors versus their American peers.

However, European energy companies have made structural balance sheet and operational improvements over time. Many companies have stronger balance sheets and are wisely deploying capital on long-term projects relative to their US peers. The European firms are further along in driving a green energy transition. With this forward-looking transformation, EU energy companies are positioning themselves for potentially stronger returns. This is the basis for our view that the current 40% valuation discounts of European versus US energy firms will likely diminish.

**Figure 9**: European energy shares trade at a discount to US peers




Source: FactSet as of May 8, 2023.

# A Green Shift Even Among Oil Producing Nations

The global transition to greener energy sources presents a significant challenge for Middle Eastern hydrocarbon exporters and their dependence on revenues from fossil fuel extraction. As the world continues to grapple with the challenges posed by climate change and the need for a more sustainable energy future, the actions of OPEC+ and major oil-producing nations will play a crucial role in shaping the trajectory of the global energy market.

Investments in renewable energy infrastructure by Saudi Arabia, the United Arab Emirates and other countries across the Middle East-North Africa (MENA) region highlight the growing value of controlling interests in a diversified energy supply. Growing geopolitical tensions and changing market dynamics are driving them to prepare now for an unstoppable shift in the global energy landscape (see our Middle East Strategy).

The United Arab Emirates (UAE) and Saudi Arabia's ambitious renewable energy targets, such as the former's aim to achieve 30% renewable energy by 2030 and the latter's goal of 50% by the same year, signal a growing awareness of the need for change. By investing in renewable energy projects and infrastructure, these countries are not only securing their own energy futures but also contributing to the global push toward a cleaner, more sustainable energy mix. The need for large-scale investment in renewable energy infrastructure, coupled with the growing vulnerability of their existing business models, has led some observers to speculate that the energy transition could provide the impetus for improved trade and other reforms within the region.

These investments have taken various forms, such as the development of large-scale solar and green hydrogen projects, as well as the construction of refineries focused on producing petrochemicals instead of traditional transportation fuels. Middle Eastern countries' shift to renewable energy sources has been driven by concerns over stranded assets and the growing global focus on energy transition, as well as the favorable economics of solar power in the sun-drenched region.

At the same time, Saudi Arabia and the UAE continue to expand their oil production capacity, reflecting their belief that oil demand will continue to grow for the foreseeable future. This has led to a delicate balancing act, as these countries seek to capitalize on their vast, low-cost oil reserves while also preparing for a future in which fossil fuels play a diminishing role in the global energy mix.

## A round of consolidation that will accelerate the energy transition

There is an increasing likelihood that emerging clean tech companies will face their first non-Covid recession at a profitable stage. Technological improvements, rising demand and a relatively high oil price suggest greater profit performance from the strongest alternative energy firms and their suppliers over the coming years.

Meanwhile, across many sectors in the alternative energy space, the recent dramatic rise in capital costs for unprofitable firms will likely bring consolidation. We think this could trigger mergers, much like we saw with railroads and oil at the beginning of the 20th century – and again in the tech sector in the beginning of the 2000s. We view this sort of creative destruction as a feature – not a bug – and is likely to help accelerate the green energy transition.

OPEC+'s production cut means that energy prices will likely fall less in the recession to come than they have in previous downturns. In turn, energy firms that have substantial cash flows from oil will be less impacted. This will give them the opportunity to gain market share and acquire valuable human and patent resources from firms less well-positioned to weather the rolling recession.

In this emerging environment, selectivity becomes key. Businesses with a valuable product or intellectual property asset -- but no good way of executing on it – may be absorbed by entities with access to capital and strong execution capabilities. Such consolidation may create opportunities, so we see selective asset choice as essential to pick firms with a better chance of emerging from any shakeout as winners. If this sort of rationalization does occur in the industry, it's likely the clean tech segment will end up bigger, but with fewer firms.

Investors should consider focusing on firms that are cash-flow positive, with strong balance sheets and limited have the resources to weather the recession and have cash to spend on smaller entities with potential. For example, battery, metals and other established companies may be an alternative to startups and cash flow negative enterprises with high rates in a slowing economy. In the electric vehicle space, larger players are focusing on vertical integration.

Startups typically benefit more from government policy that focuses on grants as opposed to consumption stimulus. And as green energy matures, government funds are shifting from research to consumption stimulus. Likewise, carbon taxes have more meaningful impacts on larger players, so firms that can either generate offsets or reduce carbon emissions more create more value. For example, a tax refund on an electric vehicle will benefit larger companies selling more vehicles, while smaller companies simply can't capture as large a share of the government spending.

In this cycle, the leaders become bigger winners. Like 1998, this is a moment of concentration when renewable companies that consolidate will do best, resulting in a stronger industry with greater power and capital. We believe this is a historically important moment for Clean Tech – many of the winners of the next decades will be decided. It's therefore important for investors to focus on the leaders that are consolidating and evolving.

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**Bond rating equivalence**
Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

| Bond credit quality ratings | Rating agencies | | |
|---|---|---|---|
| **Credit risk** | **Moody's[1]** | **Standard and Poor's[2]** | **Fitch Ratings[2]** |
| **Investment Grade** | | | |
| Highest quality | Aaa | AAA | AAA |
| High quality (very strong) | Aa | AA | AA |
| Upper medium grade (Strong) | A | A | A |
| Medium grade | Baa | BBB | BBB |
| **Not Investment Grade** | | | |
| Lower medium grade (somewhat speculative) | Ba | BB | BB |
| Low grade (speculative) | B | B | B |
| Poor quality (may default) | Caa | CCC | CCC |
| Most speculative | Ca | CC | CC |
| No interest being paid or bankruptcy petition filed | C | D | C |
| In default | C | D | D |

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
2 The ratings from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standing within the category.

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Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

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