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Inflation may prove sticky due to the combination of decarbonisation expenditure and the efficiency losses from deglobalisation.

The Great Reversals

Introduction

We are witnessing the beginnings of a long-term economic transition where the nations of the world seek to reverse the centuries-long growth in burning carbon to fuel the global economy. At the same time, we are seeing the early stages of a reversal of the four-decades-long trend of globalisation. This inception of deglobalisation began with the Donald Trump-led trade war with China and a desire to protect technological advantage, subsequently reinforced by supply chain risks triggered by COVID and energy dependence risks that emerged from the Russia / Ukraine war.

Key findings:

- 1. Decarbonisation:** we expect an extended period of 'double spending' on the existing carbon energy system, and on building out the new energy systems, a feature exacerbated by the current 'under-spend' relative to what is needed to meet net zero timeframes.
- 2. Deglobalisation:** re-orientation of the developed world's manufacturing base away from geopolitically risky locations towards higher cost but 'friendly' nations, resulting in the erosion of efficiency gains of globalisation in exchange for perceived national security.
- 3. Inflation:** We believe the combination of the above two trend reversals is likely to be inflationary, rather than deflationary, which increases the risk that the great moderation of interest rates seen since the 1980s also begins to reverse, with implications for the cost of capital and investing.

1. Decarbonisation

Historically, the world has spent roughly 5-7% of GDP on upstream energy supply. This system spending is expected to rise over the coming decades, for a number of reasons.

A. Renewables and firming system build

The investment required to achieve net zero is estimated to be between USD4 trillion (IEA) to USD9trillion (McKinsey). By itself this represents roughly 6.5% of global GDP as a central case. This is roughly equal to the historical level of spending on the existing carbon-intensive raw materials supply chain (capital, operating costs, and margin).

B. Maintenance of existing system supply

Spending on the existing carbon intensive energy system can't immediately be shut off to make way for the renewables build out. In fact, there is a pressing need to ensure the existing energy system remains reliable over the transition period. Electricity generator and coal supply

interruptions in Australia in recent years have proven this. Additional investment has also been necessitated by the need for some of these assets to remain in the system for longer than planned.

C. Labour and materials inflation

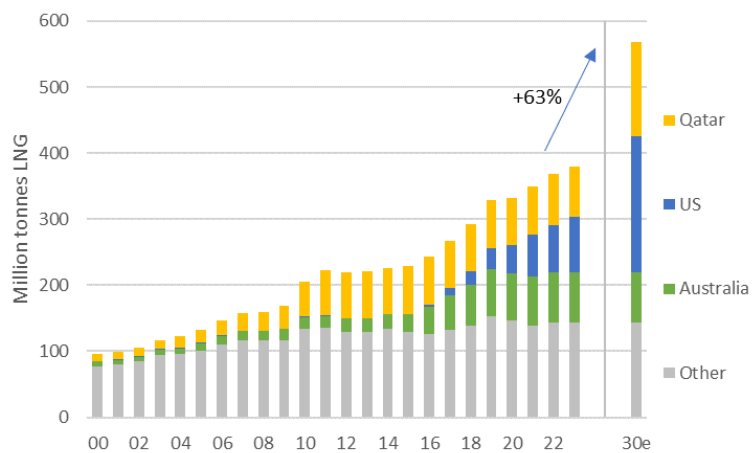
The combination of the above two factors means that demand for the labour required to build the new will be competing with the labour required for the legacy system. This may be exacerbated by the impact of the rapid, globally synchronised demand growth for resources such as lithium (storage), aluminium (structural), and copper (transmission).

D. Price incentives

The COVID and Russian sanctions catalysed energy price spike appears to have eased following the re-routing of trade flows out of Russia and the rise in interest rates globally. However, it is possible that the effect of this energy price spike may result in significant growth in LNG supply, most notably out of the United States.

Global decarbonisation will require a period of 'double spending' on energy systems.

Chart 1: LNG capacity growth potential



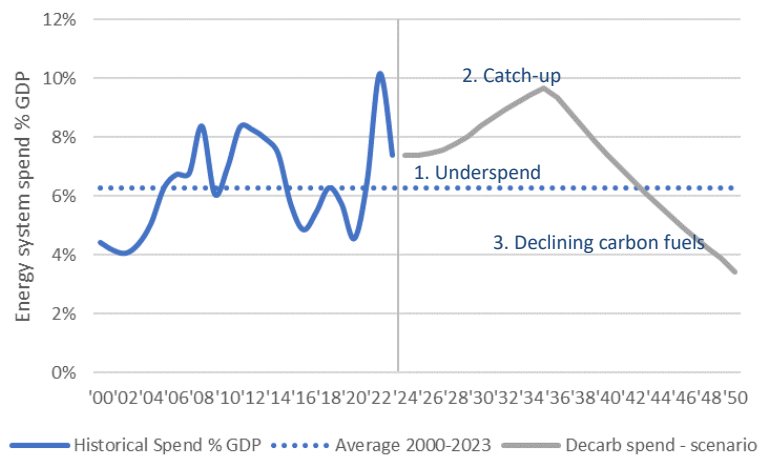
Data sources: Centre for Strategic & International Studies | QatarEnergy. Calculations / charting / estimates: Merlon Capital.

E. Monetisation of carbon-rich resources

In addition to Point D. (above) we are seeing a growing desire from the state of Qatar to radically increase their own LNG supplies, and we can see an additional layer of energy investment on top of those described above. As an economy that is almost entirely reliant on the export of gas, this effort from Qatar may be designed to monetise as much of their natural resource as possible ahead of decarbonisation.

Conclusions: It appears plausible that ‘total energy system’ spending could approach 10% of the global economy by the mid-2030s. This is driven by the double-spend associated with 1. investment to build out the new energy system (including a catch up to account for the current period of underspend), and 2. investment to maintain the old energy system. The energy spending intensity should ultimately decline as the carbon fuels usage diminishes in line with the path to achieve the 80% reduction in CO2 emissions by 2050, thereby meeting ‘net’ zero.

Chart 2: a potential energy system spend-path (% GDP)



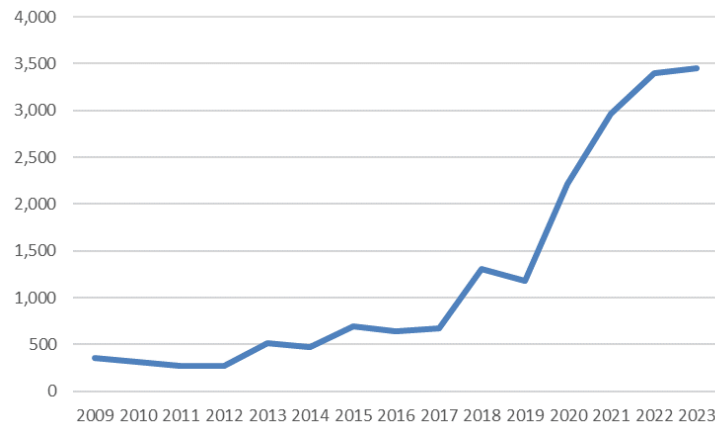
Data sources: Bloomberg. Federal Reserve of St. Louis. World Bank. Calculations, estimates & charting: Merlon Capital.

In the context of this significant global investment, we should examine the potential geopolitical environment in which this is taking place.

2. Deglobalisation

Donald Trump fired the starting gun in the modern trade war, with the imposition of tariffs on US imports of Chinese products in 2018. Chart 1 shows the growth in this trade war, as measured by the number of trade interventions (tariffs, embargoes, subsidies etc) applied each year.

Chart 3: number of implemented harmful trade interventions



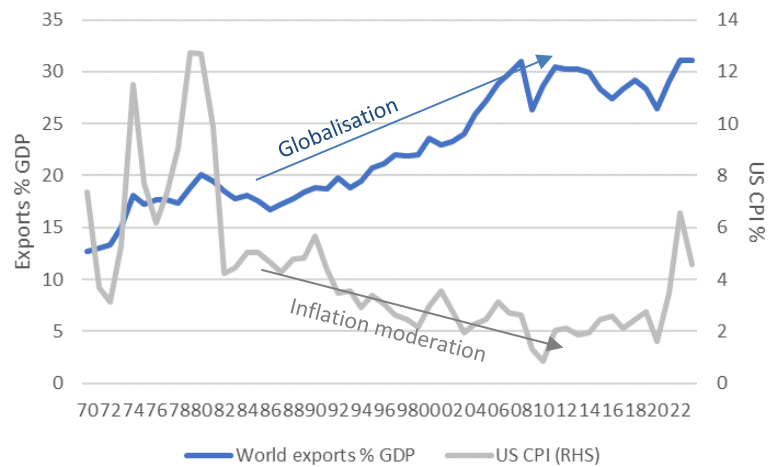
Data sources: Global Trade Alert. Calculations / charting: Merlon Capital.

Since then, we have seen the growth of fear-driven geopolitics over control of leading-edge technology ratcheting up the pressure further in the ‘chip wars.’ And today, we are seeing similar forces at play, with China leading the race to become a manufacturing power in the future decarbonised world, and the developed world looking increasingly at ways to reverse this trend in the name of jobs and national security.

The old way: globalised supply chains

Before the trade war, the solution to building a new energy system would have been to seek the cheapest source of renewable energy componentry. This globalisation trend began in earnest in the 1980s, via the combination of Deng Xiaoping’s opening of China in 1978, the embrace of neoliberal market-reforming policies of the 1980s, and the collapse of the Soviet Union in 1991 and in turn, the end of the Cold War. And the benefits to the world economy were significant, with the continued growth in cheap exports from (primarily) China serving as a deflationary counterweight to global growth.

Chart 4: globalisation & inflation trends



Data sources: World Bank. Calculations / charting: Merlon Capital.

The new way: deglobalisation?

China’s central role in globalisation, coupled with Xi Jinping’s ‘Made in China 2025’ subsidy-led policy, saw it respond rapidly to expected demand for renewable energy equipment and entrench its, already dominant market position:

- 80% market share in the export of solar photo-voltaic equipment
- 65% market share in wind generation equipment, and
- the leading exporter of electric vehicles and electric vehicle batteries.

The West’s concern over this market dominance, and the growing unease at a strengthening alliance with Russia, has seen an acceleration in efforts to reduce reliance on China as a supplier of renewable energy products from a national security perspective.

In addition, there is a fear of another era of manufacturing job losses, this time in new energy equipment manufacturing. As US Treasury Secretary, Janet Yellen said recently, “China’s desire is to really have global domination of these industries.”

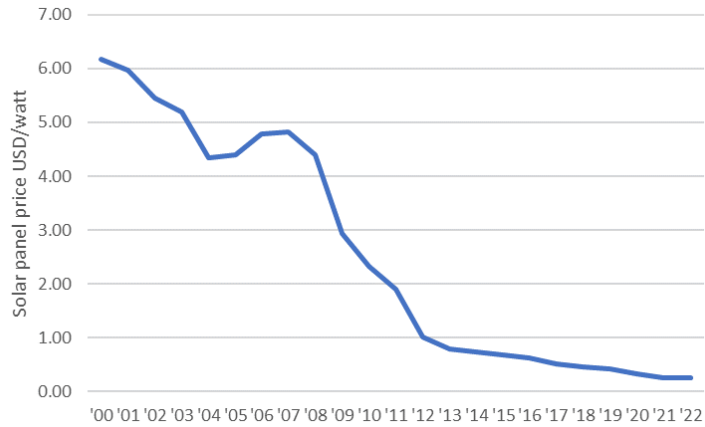
In its attempt to re-centre this manufacturing advantage, the US launched its USD370b ‘Inflation Reduction Act’ to attract capital into the US in order to build out manufacturing capability. And Europe is equally concerned. The European Commission has established an investigation as to whether subsidies provided by the Chinese state were providing an unfair advantage to its production of renewable-energy related generation, storage and transport products.

And domestically, we have seen Prime Minister, Anthony Albanese, recently announce a billion-dollar solar manufacturing project. For a nation to seek to compete with China, which holds 90%

Deglobalisation is being driven by geopolitics and jobs, even at the cost of higher prices.

market share of panel manufacturing, and which has driven prices down by 90% over the last decade, this decision and allocation of significant capital, can only be rationalised (if at all) through national security concerns, rather than through an economic rationalism lens.

Chart 5: Solar panel prices USD/watt (real)



Data sources: International Renewable Energy Agency. Calculations / charting: Merlon Capital.

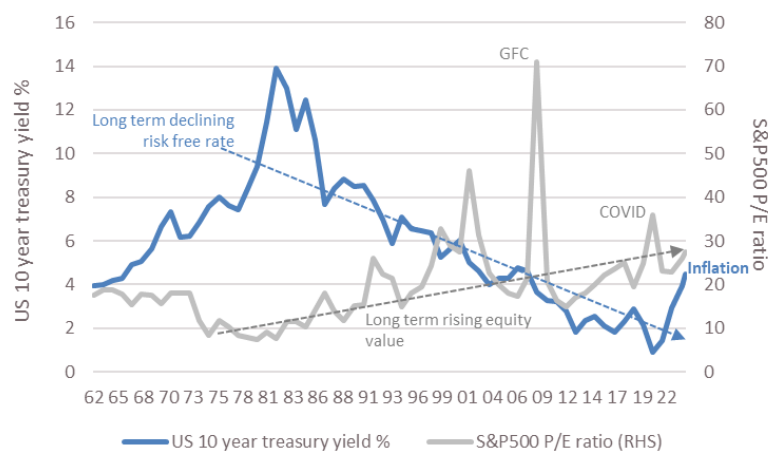
Conclusions: Thus, while globalisation was centred on supply chains developed around low cost and efficiency, its reversal is prioritising political alignment of values, jobs and security, over cost alone. In fact, the resulting higher cost of doing business is being accepted as a necessary trade-off.

Cash-flow will be 'king' if interest rates remain higher for longer.

3. Inflation...and investing

The combination of spending to decarbonise and the declining global efficiency from deglobalisation is likely to introduce an inflationary risk to the global economy. Should this flow through to represent the end to the third long duration trend noted in the paper, namely the multi-decade trend of declining nominal risk free rates, the structurally higher discount rates used in valuing companies are likely to favour those with more valuable shorter-dated cash-flows.

Chart 6: S&P500 price/earnings ratio vs US 10-year treasury yield



Data sources: Federal Reserve of St. Louis. Calculations / charting: Merlon Capital.

Yet through all cycles, Merlon's approach has been consistent, assessing each company's sustainable free cash flow and valuing these cashflows using long term real interest rates (long term nominal treasury yields adjusted for long term inflation rates).

This focus on the long term means we focus on what matters (cashflows) and rather than adjusting our valuations to short term changes to interest rates has enabled us to invest on the basis of more stable valuations and invest in opportunities provided by shorter term market volatility, notably buying when the market has become overly pessimistic, and selling when the market has become overly optimistic.

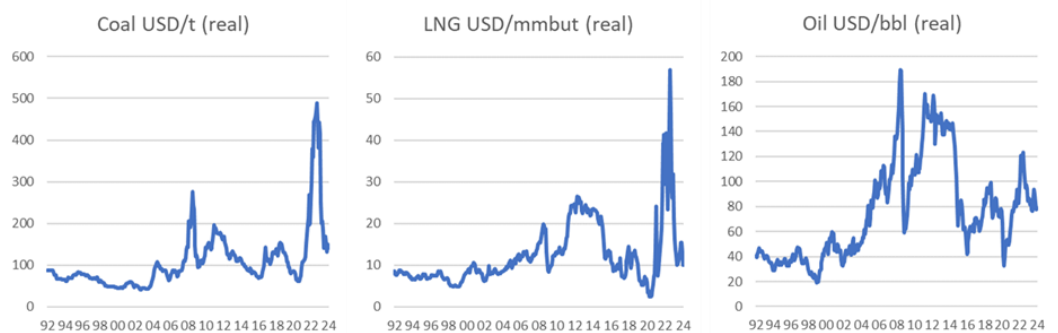
Old energy investment

We still retain some investment in energy related companies, although materially less than we did when they were trading at our low case valuations several years ago. While the inflation spike of recent years has moderated, these companies still offer an attractive risk-return proposition given their appealing cashflows, coupled with the longer than expected need for their energy in the form of oil, gas and coal.

Active ownership

Merlon has been arguing - for many years - that 'active ownership' is a better approach towards 'old energy' companies – oil, gas and coal. It is through this approach that we have been able to achieve positive board engagement, which would have been unlikely with a 'divest and forget' approach. It is only through being an active shareholder that the argument for a rundown of carbon-rich energy reserves in line with the path to net zero can be made *and* be heard. **Merlon currently holds positions in Santos (STO), Woodside (WDS) and Whitehaven (WHC).**

Chart 7: 'old' energy prices



Data sources: Bloomberg. Federal Reserve of St. Louis. Calculations / charting: Merlon Capital.

New energy investment

Copper and aluminium are old commodities and now new again in the world of renewable energy. Large scale lithium is new and subject to overexcitement (tick) and then disappointment (also tick). Given the short but extremely volatility price history, a wide valuation range for companies such as Pilbara Minerals and Mineral Resources is used to gauge an appropriate margin of safety when investing. Also, the risk of displacement by new battery technologies and cheaper extraction methods is higher than 'traditional' commodities. **Merlon currently holds a position in Alumina Limited (AWC).**

Chart 8: 'new' energy prices



Data sources: Bloomberg. Federal Reserve of St. Louis. Calculations / charting: Merlon Capital.

Conclusions:

We have identified the prospect of three large scale reversals to drive global financial markets over the coming decades. These are 1. environment-driven decarbonisation, 2. geopolitics-driven deglobalisation, and 3. an inflationary impulse, seeing interest rates settling at a potentially higher level than enjoyed over recent decades.

The implications for equity investing of these three factors is a potentially higher discount rate for valuing companies. While lowering valuations across the market, we would expect this effect to favour companies with nearer term cashflows more highly relative to longer dated cashflows, a characteristic systematically favoured by Merlon since our inception in 2010.

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