focus

Good COP or **bad COP?**

Over the past 20 months or so the global community's focus has been on combating the COVID crisis. **For two weeks (at least) it will shift back to the slower-moving challenge of climate change.**

FORSYTH BARR

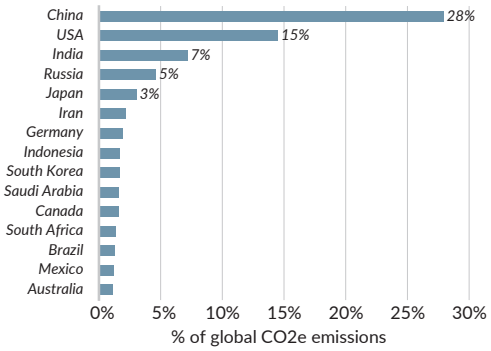
COP26 is the 26th meeting of the Conference of the Parties, the nearly 200 countries who are signatories to the United Nations Framework Convention on Climate Change (UNFCCC). The conference in Glasgow, Scotland kicked off on 31 October and runs to 12 November.

COPs have taken place each year since 1995 (except COVID-postponed 2020). They provide an opportunity for countries to review progress on climate change objectives and map the path forward. The most notable in recent years was the 2015 meeting, COP21, when the Paris Agreement was reached. The goal of the Paris Agreement is to limit the rise in the mean global temperature to "well below" 2°C versus pre-industrial levels, and preferably by no more than 1.5°C.

At this stage, however, experts tell us we remain well short of achieving this goal. The Intergovernmental Panel on Climate Change (IPCC) estimates a 45% cut in greenhouse gas (GHG) emissions by 2030 (vs. 2010) is required to meet the 1.5°C objective, or a 25% decline to keep it to 2°C. A recent UN report estimates, however, that emissions are on track to be up 16% in 2030 putting the world on track for a nearly 3°C lift in the mean temperature by the end of this century.

COP26 has been described as "the most important" conference since Paris. It is a "big COP", held every five meetings, where countries are asked to lift their emissions reduction ambitions and outline concrete plans to work toward those ambitions. We have to, however, remain realistic about what can be achieved at a two-week conference. Any agreement requires a consensus of 197 countries, extremely difficult given the divergent and partisan interests of different nations. COPs are notoriously messy and political, and, in the past, have seen some countries storm out in protest. The early signs for this time round weren't hugely promising. A pre-COP meeting of the G20 (the world's 20 largest economies) failed to agree on any binding measures to reduce emissions. According to US President Joe Biden "Russia and China basically didn't show up in terms of any commitments to deal with climate change".

LARGEST GREENHOUSE GAS EMITTERS (SHARE OF 2019 EMISSIONS)



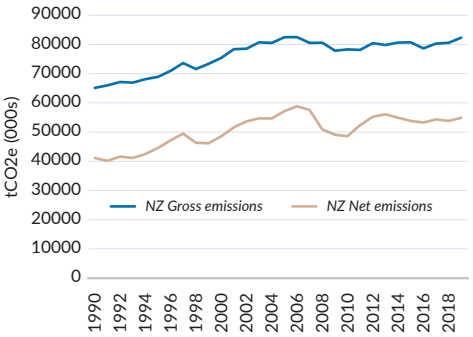
Source: Forsyth Barr analysis, Statista

It is, however, also important to appreciate COP26 isn't expected to be a silver bullet. We have seen some ratcheting of ambitions and plans (albeit they remain non-binding). But it is only one small step in what we expect is a long-term megatrend of growing policies and initiatives to combat climate change.

Where is New Zealand at?

New Zealand has a mixed track record on reducing emissions. Gross emissions (which do not include carbon offsets) have been largely flat over the past 10 years, but 2019 levels were 26% above 1990 mostly due to increases in methane from dairy cattle and carbon dioxide from road transport. Emissions did fall almost -5% in 2020, but this was a COVID-19 impact from the sharp drop in transport usage.

NEW ZEALAND GROSS AND NET EMISSIONS



Source: Forsyth Barr analysis, Stats NZ

New Zealand's delegation at COP is being led by Climate Change Minister James Shaw. Last weekend, on the eve of the start of the conference, our government announced a new, more ambitious emissions reduction target. This new target is to reduce net emissions by 50% below 2005 levels by 2030, compared to a 30% reduction previously (albeit two-thirds of this reduction can come from local or international carbon offsets). The plan for achieving New Zealand's targets is due to be released in May 2022.

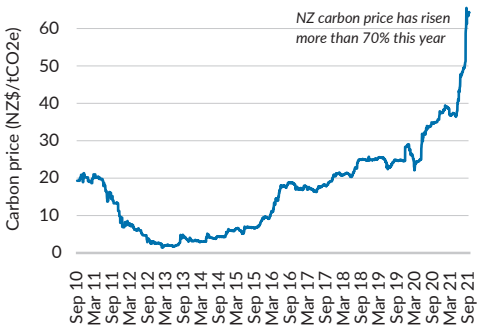
Two subjects of focus at COP will be carbon markets and the transparency of climate reporting – areas which New Zealand has recently made progress on.

The New Zealand emissions trading scheme (ETS), underwent a revamp this year, including the removal of the NZ$25 cap on the price of each tonne of carbon. As a result we have seen a significant jump in the price to around NZ$65 CO2e/t. Price signals matter. Already this lift is changing behaviours. Estimates suggest carbon farming is now more profitable than traditional land uses such as sheep and beef. There are reports that farms being sold are increasingly being purchased by foresters. This is the intent– using price signals to change economic

...sales of electric vehicles (EVs) have started to take off...

behaviour. But it will also have costs – (effectively subsidised) land use change lowers the country's overall productive output.

NEW ZEALAND CARBON PRICE



Source: Forsyth Barr analysis, Bloomberg

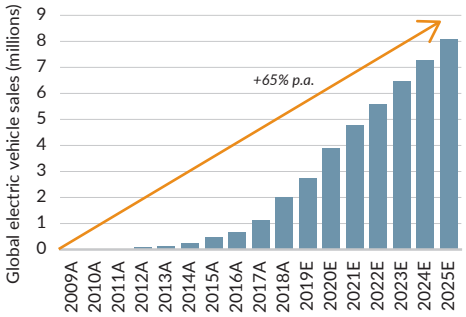
On the transparency of climate reporting, New Zealand is a world leader. Legislation currently before parliament would require large companies, banks, insurers, investment managers, and public sector entities to provide detailed climate change-related disclosures. New Zealand was the first country in the world to announce compulsory reporting by companies; others are following suit.

Investing in the climate change megatrend

We expect the battle against climate change will have a dramatic influence over the global economy and financial markets for decades to come. New industries and companies are being created. Older, carbon intensive industries will shrink and may disappear. COP26 has specifically identified the need to (1) accelerate the phase-out of coal, (2) curtail deforestation, (3) speed up the switch to electric vehicles, and (4) encourage investment in renewables.

Sales of electric vehicles (EVs) have started to take off and are expected to accelerate rapidly. The United States has, to date, been a laggard in promoting EVs, but plans to rapidly catch up – President Biden's American Job Plan proposes a US$174 billion investment to promote EVs including the rollout of 500,000 charging stations by 2030.

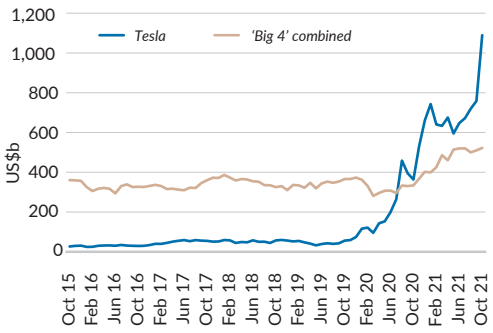
GROWTH IN EV SALES



Source: Forsyth Barr analysis IEA, HSBC, EVVolumes.com

Unsurprisingly investment in EV companies has boomed. While many debate whether it is rational, the market value of Telsa is now more than double the four largest auto companies – Toyoto, GM, Ford, and Volkswagen – combined.

MARKET CAP OF TESLA VS 'BIG 4' (VW, TOYOTA, FORD, GM)



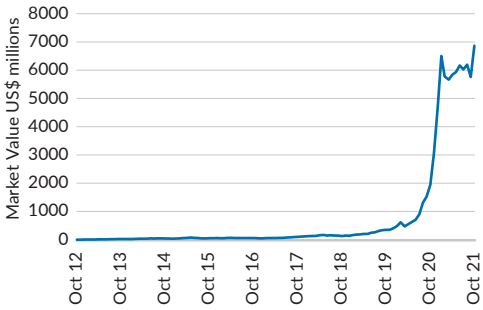
Source: Forsyth Barr Analysis, Refinitiv

Electrification only reduces emissions if it comes primarily from lower carbon, ideally renewable, sources. Also unsurprisingly, forecasts for

...cross-laminated timber has started to become more common...

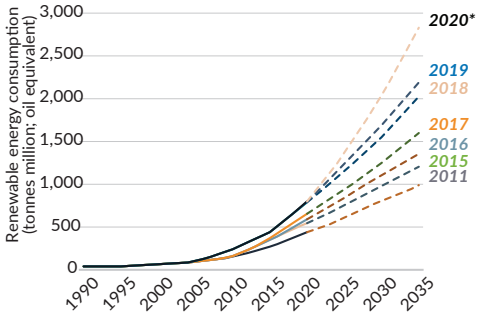
renewable energy output continues to grow, as do the number of investors crowding into renewables companies. The iShares Global Clean Energy ETF (ICLN), a passive renewables fund, has seen a surge in new investors lifting total money invested in the fund by over ten times since the start of 2020 (to be clear, this is not the investment return, but the amount of money invested in the fund).

GROWTH IN FUND VALUE OF ISHARES GLOBAL CLEAN ENERGY ETF



Source: Forsyth Barr Analysis, Refinitiv

RENEWABLE ENERGY CONSUMPTION FORECASTS



Source: Forsyth Barr analysis, BP

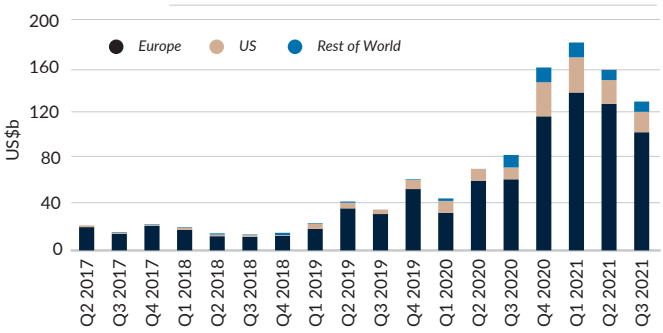
Companies that rely on traditional, carbon-intensive products and processes will struggle if they don't innovate. Here in New Zealand, gas connections to residential homes could be a thing of the past if the Government follows the Climate Change Commission's advice to ban new gas connections by 2025. Industrial processes, another major source of emissions, are increasingly moving away from coal. The a2 Milk Company is decommissioning the coal-fire boiler at Mataura Valley Milk and replacing it with a high-pressure electrode boiler, with electricity provided by Meridian Energy.

Cement production is a highly carbon-intensive industry, responsible for around 8% of global carbon emissions. Canadian company CarbonCure has developed a technology that increases the strength of the concrete by injecting CO2 into the mixture before it has cured. The end result is a 7% reduction in cement use for similar strength concrete and CO2 that is permanently embedded.

There is also potential to reduce cement demand by changing the way we build. While concrete and steel are currently the most common structural materials used in high-rise construction, cross-laminated timber has started to become more common. Wooden alternatives emit less in production and store C02.

In addition to considering the impact of climate change on specific sectors and companies, investors are also faced with a proliferation of "sustainable" investment funds. A growing number of these are high quality. But, in our experience, for many, what's implied by the fund name or marketing description isn't matched in the fine print and execution – it's another challenge for investors to navigate.

INFLOWS INTO SUSTAINABLE INVESTMENT FUNDS



Source: Morningstar, Forsyth Barr Analysis

Navigating the opportunities and pitfalls ahead

Irrespective of your personal views on climate change, and regardless of whether significant steps are made at COP26, we expect policies and initiatives to combat climate change will only grow in the years and decades ahead. Emissions reduction targets will become increasingly ambitious. And pressure will grow on all countries to "pull their weight". The megatrend of climate change will present both opportunities and risks for investors. New assets, such as carbon units, and industries, such as electric vehicles and renewable energy, will grow substantially. New technologies will emerge. Older industries will decline.

Through this, however, it's very important to maintain investment disciplines. Just because a new technology might be new, exciting, and even revolutionary, doesn't mean it'll be a good investment. In fact, because a technology is new and exciting, there is a heightened risk of over exuberance leading to an investment being overpriced. For lessons we can look back to the 2000 dot-com crash – yes, the internet changed the world, new leading global companies emerged, but obviously not all internet investments proved successful.

Forsyth Barr makes a substantial investment in its research team – we have 20 people and are growing. We have recently appointed a Head of ESG ("environmental, social, governance") to further upskill the firm. We are supported by high quality research and investing partners from around the world. We are consistently working to find opportunities that emerge from the climate change megatrend and avoid the pitfalls in the years ahead.

Matt Henry
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Understanding that sudden changes in financial markets can cause concern or indicate opportunity, your Forsyth Barr Investment Adviser is available to provide you with advice and assistance at any time.

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