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ECONOTE No. 109 : Covid, Ukraine, ESG, Green Financing and Carbon Trading: Where to invest — Aug/Sept 2022

Summary

The content of this report may appear superciliously “clever” , but all the issues mentioned are interconnected. Hence the nightmare scenario of juggling with all of them in order to guide hapless investors where to lose their money. (No typo here!). We draw the interconnecting lines and note that Covid has still a major impact on macro developments and investment but totally unpredictable in its course as the Chinese state is expensively finding out. There are investment areas which are “Covid immune” such as the defence sector, which leads us to Ukraine. The impact of the war on the prices of gas and oil contributed greatly to inflation in the EU but less so in the US, but rates in both economies were hiked sharply. As energy -price-led -inflation spread, and economies slowed down, climate policies came under pressure at the same time of widespread discontent with the role of ESG, Green Finance and Carbon Trading.

Investment Conclusions

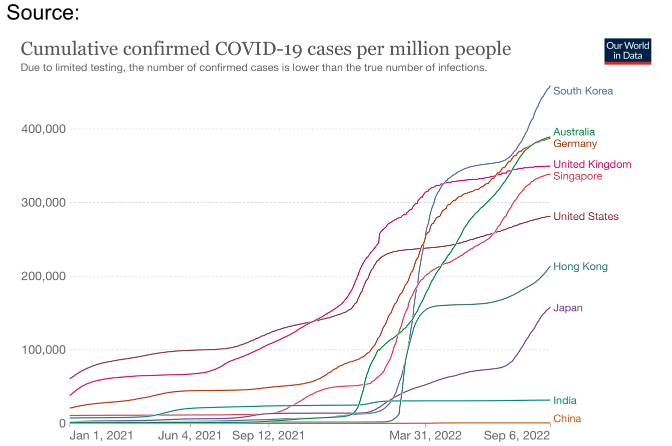
Bar China and Hong Kong, most countries are “living with Covid” thus minimizing the man - made impact of the pandemic via its lock-down and isolation policies. The infections continue to rise and their course is unpredictable as is the “Long Covid’ side effects now being felt. Hence Covid-related macro themes must be handled differently, and here is where the Defence sector steps in as it is Covid proof. The inflation related rate hikes in the US and EU (but be noted, not in Japan and China) will slow the economies down. An investible side-effect of this will be the pressure to ease on climate related policies (both macro and micro) thus making ESG and Green funding proposals, less relevant in addition to the doubts as to their veracity. Expect a short-term boom in fossil fuels with the easing of emissions controls and a bear period for carbon credits and offsets.

Covid and its impact on climate policies. Some macro thoughts

Covid and climate. The data in Fig. 1 are frightening but have generated little or no front-page coverage. With apologies for the poor choice of words “Covid 19 is alive and kicking”. In most developed Western and Asian countries, the totals of infections are rising although the rate of increase may, in some cases, may have fallen. The flat China numbers, very small additions per million, may indeed reflect the results of the extremely expensive Zero Covid policy. In India the low figures may reflect data collection limitations. The western countries with sharply rising totals have ceased to impose policies, such as lockdowns to limit these rises and, hence, the man- made Covid impact on GDP growth has ceased. No so, however, of the impact of these infections on health services (in UK at crisis level now) as well as rising concerns that the winter weather plus the common flu will bring home again the truth that it “ain’t over till the fat lady sings”, and she hasn’t! China will be left with the awesome problem that, even if zero infections are achieved and maintained, once the frontiers are open China will be a zero Covid island in the middle of ocean of Covid infections. While during 2020-21 most economies sacrificed growth via lockdowns to lower infections, the level of emissions fell, especially in China, where now are at the lowest levels for over a decade. Except for China, this is unlikely to last as lock down policies were abandoned in the course of 2022.**Macro thoughts**. Couple now all these issues with the impact of the Ukraine war on energy which led to gas and oil as well as staple food commodity price increases, and we have the making of yet another recession, at least in the US and the EU as interest rates rose. This impending recession plus shortages of gas and oil led to an upsurge in the global use of coal and a loosening of the emission controls and limits in order to avoid electricity shortages. Hence the likely negative impact of these developments on climate policies during 2022-23.

Fig 1. Covid infection totals are rising 2022 yd.

Source:



ESG, Green funding………

Concurrently with the energy crisis, there was a mounting wave of criticism on the use **ESG** as a part of investment and portfolio structure techniques. This was because of the wide discrepancies in the definition and veracity of the declared contents of ESG. The financial press is awash with studies showing wide differences in ESG ranking of the same companies by different providers of ESG ranks. There is, however, evidence that ESG ranking may affect market price performance and indeed may match the actual behavior of companies, but also of evidence to the contrary. To add to the confusion the war in the Ukraine has now brought the issue of the exclusion from ESG metrics of Russian assets but the re-introduction of Defence stocks! These “definitional” uncertainties may be partially assuaged as the International Sustainability Standards Board is planning to issue a set of standards on sustainability and climate-related disclosures at the end of this year. Parallel to these developments there was also the questions over **Green Funding and Financing** and of the veracity of the declared aims and uses of the funds so raised. As Fig. 2 shows investors had moved by the middle of 2022 about USD 2.7 trillion into about 5,900 sustainable funds. The contentious issue is how much of this money does go to “green” projects and if so “how green is green”. Morningstar has recently removed 1,200 funds from their portfolio as they did not pass muster as to their ESG standing and “greenness”. There is also a related move by major institutional investors such as BlackRock, Vanguard and State Street Global Advisors to look twice at climate related pressures on corporate policies which may harm the long-term interests of shareholders. No such thing as a free lunch.

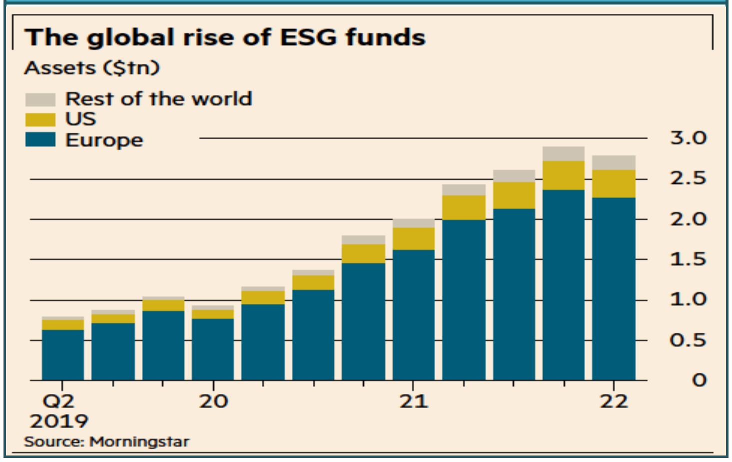
Fact Box: European Energy Allowances, EUR per ton of CO^2

This is the biggest carbon credits market, trading officially issued credits by the EU. The reasons for the fall in prices in Feb-March and in Aug-Sept 2022 reflect the instability of the energy markets. Expectations of falls in the output of energy reduced the demand for EEA. Perversely, also the expansion of the use of coal in various economies as a substitute for gas, might have led to expectations of looser application of emissions targets, as it has been happening in China, and thus to a lower demand for EEA. Another reason might have been the use of EEA as a liquid financial asset thus matching the crash in equities and bonds.

Source: Bloomberg

Last but not least, the even more contentious issue of **carbon trading and offsets.** Without repeating some well-known problems of these assets, we will just summarizer the key issues**. First,** for an offset to be truly offsetting CO^2 emissions the offsetting activity generating the offset, such as a wind power installation or forestry plantation must be additional to existing ones. Selling offsets from existing facilities does not lead to a net absolute reduction of CO^2 . **Second,** corporates claiming “net zero targets” on the basis of purchasing offsets have to be extremely careful on the net offsetting preconditions. **Third,** net zero targets can mean what their issuers want them to mean, including paying someone else to do the cleaning while they do the polluting. What is frequently missed out is that the whole idea is not only **not adding** CO^2 emissions **but reducing the existing ones.** Carbon capturing is the nearest true net. Even better, not emitting at all as opposed to emitting and “cancelling out” by buying offsets of doubtful veracity. **Fourth,** all this should not belittle the use of carbon trading to lower emissions

Fig.2: Investment in ESG funds, 2019-2022



Source: FT 7/6/2022

….and carbon trading plus investing in a messy universe

where there is a market determined cost to pollute and a price- reward not to do so. There are at present about 64 carbon markets with another 30 under development. Hong Kong has just acquired one, while China’s Emission Trading Scheme started operations in July 2021. But US carbon markets, especially the ones based on forestry offsets, were devastated by the California fires which dealt them a triple blow. The loss of the trees meant the cancelling of the credits based on them, but the fires also added millions of CO^2 tons in the atmosphere and also, effectively, wiped out the offsets set aside under an official insurance plan designed to protect the market from accidental losses. The investment consequences of all these developments are interrelated and complex. **First,** the pandemic it is not over just because most developed countries have adopted “living with Covid” policies**.** Infections continue to grow but mutations with low lethality prevent high death rates, although hospitals are still full with Covid patients. A new mutation could unpredictably change all this. There is no Covid-neutral investment policy to follow as Covid’s impact on GDP is not generated by market forces but by man- made policies. See China and Hong Kong. **Second** investment policies which are now focused on the cyclical and sectoral expectations of recovery, by necessity, rely on the expectations of the peaking of interest rates in the US and EU which, in its turn, in dependent on the ending of the energy crisis, which itself is now, at least, partially depend on the end of the war in the Ukraine .All these interdependencies leave Covid out ,not because it is not reported, but whose resurgence could sweep aside the current obsession with higher interest rates which are not, in any case, designed to stop supply shock inflation. Hence pure “macro” based investment proposals contain a well-known risk, Covid, whose resurgence cannot be predicted, and an end to a tight monetary policy which is dependent on Russia via its link with the energy crisis. **Third** it follows that investment proposals must by-pass these “predictably unpredictable” obstacles and focus on sectors which are unaffected by inflation, high interest rates and Covid related impacts. One sector stands out and that is Defence, unconnected to all these three issues. There is global resurgence on defence spending following the invasion of Ukraine and China’s hardening position on Taiwan. The end of the Ukraine war will have no impact whatsoever on the current spending spree because Defence plans and implementation are long term and complex. Another area, equally unloved, is a short-term return to fossil fuel sectors, while the energy crisis persists and oil and gas prices remain high. It follows that all these developments are bearish for carbon credits.