focus

Spotlight on Climate Change: Closing the gap between rhetoric and action

The slow burning threat of climate change is moving fast.

"Time is running out. Irreversible climate tipping points lie alarmingly close."
UN Secretary-General Antonio Guterres

"2021 is a make-or-break year for climate action, with the window to prevent the worst impacts of climate change—which include ever more frequent more intense droughts, floods and storms—closing rapidly." World Meteorological Organization

"An unprecedented surge in climate-related disasters since 2019" and "mounting evidence that we are nearing or have already crossed tipping points associated with critical parts of the Earth system." World Scientists' Warning of a Climate Emergency

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...emissions must halve over the next decade...

2021 was a year of headline news

In November, governments met (and underwhelmed many) at COP26. Throughout the year, frustrations at the slow pace of action spilled over into the streets and the topic of climate change made its way into boardrooms, courtrooms and parliamentary sittings.

On the positive side, investors and corporates making public commitments to achieve net zero emissions grew from a committed few to the expectation of many. At the same time investment dollars have continued to flow into Sustainable Investment funds at record speed. The investing community has recognised it has a key role in driving effective action.

What is net zero?

Net zero refers to a state in which the greenhouse gases (GHGs) going into the atmosphere are balanced by gases being removed. The term net zero is important because — for CO2 at least — this is the state at which global warming stops. The Intergovernmental Panel on Climate Change (IPCC) has concluded the need for net zero CO2 by 2050 to achieve the 2015 Paris Agreement goal of limiting the rise in the mean global temperature to preferably no more than 1.5°C.

To meet this goal, GHG emissions must halve over the next decade, falling 7% every year through 2030. Last year, 2020, this was achieved, but it took the first global pandemic in over 100 years to achieve it. This demonstrates just how considerable the required action is for every year out to 2030 and beyond.

COP26

The major international climate event of the year was COP26, the 26th meeting of the Conference of the Parties, where nearly 200 countries who are signatories to the United Nations Framework Convention on Climate Change (UNFCCC) came together. It was the first formal review of countries' climate policies since the Paris Agreement in 2015.

A few months ahead of the conference the IPCC released its 6th assessment report calling our current situation "a code red for humanity" and emphasising the need for rapid, immediate, and large scale reductions in GHG emissions. Furthermore, the International Energy Agency outlined a transformational pathway for us to get there.

With the facts and figures in hand, and a vision and pathway provided, hopes were high that world leaders would agree an ambitious plan of action. For many, the final muted tone of the main communique was disappointing.

Before Paris, country commitments put the world on track for a 3–4°C rise in temperature, an amount that would be near-catastrophic and was almost universally considered an unacceptable outcome. Paris brought that down to 2.7°C, a significant improvement but still short of the 'well below' 2°C target. Post COP26 we now sit somewhere between 2.1–2.7 degrees, depending on the extent those pledges and commitments are followed through.

...2020 was the seventh warmest year on record for New Zealand...

Whilst many countries have pledged commitments covering around 70% of global GDP and CO2 emissions, less than a quarter of these pledges are fixed in domestic legislation. Fewer still are underpinned by specific measures or policies.

New Zealand — not a shining light

2020 was the seventh warmest year on record for New Zealand. Six of the warmest years on record have occurred in the past eight years.

As has been the case internationally, in New Zealand there's been a lot of talk and advice. Our government signalled its intention to transition to a net zero economy and announced a more ambitious target to reduce net emissions by ~ 50% below 2005 levels by 2030, compared to ~ 30% previously. Notably though, two-thirds of this reduction is expected to come from international carbon offsets rather than domestic reductions.

In June, the Climate Change Commission released its first advice to government on how we achieve a low emissions future which includes recommendations to changes in the way energy is produced, the way people travel, the communities they live in and the way land is used. The price of New Zealand Units (NZUs) for the Emissions Trading Scheme has soared 80% year-to-date. And the External Reporting Board (XRB) has started to develop standards for mandatory climate related financial disclosures for large listed companies as well as large licensed insurers, registered banks, credit unions, building societies and investment managers.

Unfortunately, however, on the ground little has tangibly changed. Aside from some obvious COVID-19 related reduced travel — Forsyth Barr's third annual summary of carbon emissions suggests no meaningful change in emissions for the vast majority of companies.

What about looking forward?

Climate change and our response will impact every sector in New Zealand. Be it through direct consequences of warmer and wetter weather, new regulation, technology disruption, or changing consumer and investor preferences. ESG factors have already had real implications on investing flows, regulation, and financial returns over the past 15–20 years. Investors in the oil and gas, coal, tobacco, and the defence industries firmly recognise that a thorough understanding of ESG issues surrounding these industries is paramount. Those who correctly identified where risks were under-priced avoided some pitfalls. Looking forward, in our recent in-depth report on Climate Change we outlined four sectors in New Zealand — agriculture, construction, transport and tourism, and energy — that will be impacted by environmental factors and climate change in particular, some significantly in the near-term, others longer term.

The focus on these four sectors is partly, but not only, because they are the biggest emitters today. Taking energy as an example — we believe it to be equally important to understand the implications for 100% renewables companies as it is for companies that use fossil fuels. Investing

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flows into clean energy funds caused the shares of renewable energy companies Meridian and Mercury to whipsaw around earlier in the year. And the fact that Rio Tinto's Tiwai aluminium smelter is fuelled by renewable energy, and not coal like most international plants, means there's a growing chance this plant has a long-term future and will not be closed as planned.

Within Agriculture the most obvious consideration is the emissions from dairy farming, but potentially changes of land use, warmer weather and consumer preferences will also impact. Within construction and real estate, to date, the focus has largely been on the emissions from the likes of cement and steel production. What is now growing is attention on emissions from the built environment. Net zero buildings are already being built selectively across the globe. Property owners grabbing this opportunity are likely to see strong demand and premium pricing.

"Flight shaming" and growing consumer concerns around emissions could impact demand from transport and travel more than imposing costs on emissions. There are also potential opportunities. Air New Zealand is at the forefront of research around renewable jet fuel, and electric vehicles could transform the emissions profile of logistics companies.

These are just a few examples of sectors we are watching. Climate change and climate change policies, however, are moving rapidly. The impacts will probably be much broader than we imagine today. The potential impact of climate change on companies, industries, and markets is now a key factor in any investment portfolio.

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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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