Sustainability Insights

COP27: Long-term transition still underway despite near-term focus on tackling the energy crisis

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- The annual UN climate conference, COP27, is unfolding in Egypt, which will bring attention back to long-term ambitions to tackle the climate crisis and reduce greenhouse gas (GHG) emissions in line with the Paris Agreement as the world faces an energy crisis.
- The focus at COP27 will be to deliver implementation solutions and actionable frameworks to the substantial, high-level net-zero commitments made in previous years. While the COP27 has gathered less (media) attention, we do not think that this is a reflection of the current energy crisis derailing the long-term net-zero transition and, if anything, this year's extreme weather events have reiterated the need and urgency to take actions now.
- Tensions might heat up at this year's COP when emerging markets will seek reassurance and transparency on the financing pledges made by developed markets, as many of the financial commitments have largely remained unfulfilled promises so far. Scaling up climate finance is key in order to deliver mitigation and adaptation solutions as well as to prepare and adhere to rising reporting standards.
- Energy security has been the near-term policy priority for most governments this year, as they are focused on ensuring to access all available sources of energy amid the current energy crisis. Climate financing plans have thus competed with emerging fiscal priorities to raise defence spending or implement support measures to shield households and businesses from soaring energy costs.
- The corporate world has already announced a vast range of measures to reduce demand and use energy more efficiently. Windfall taxes on gas and oil companies could help governments not only to support the most vulnerable groups but also make smart investments in the transformation of the global energy system aligned with decarbonisation ambitions.
- We continue to believe that the global economy is entering a multi-year rollout of emerging technologies that can contribute to the net-zero transition, such as renewables, carbon capture systems and smart-grid technology. We explore these investment opportunities in our high conviction theme Energy Transition and Independence. Tactically we favour leaders in the energy sector that have a clear net-zero path outlined in their corporate strategy.

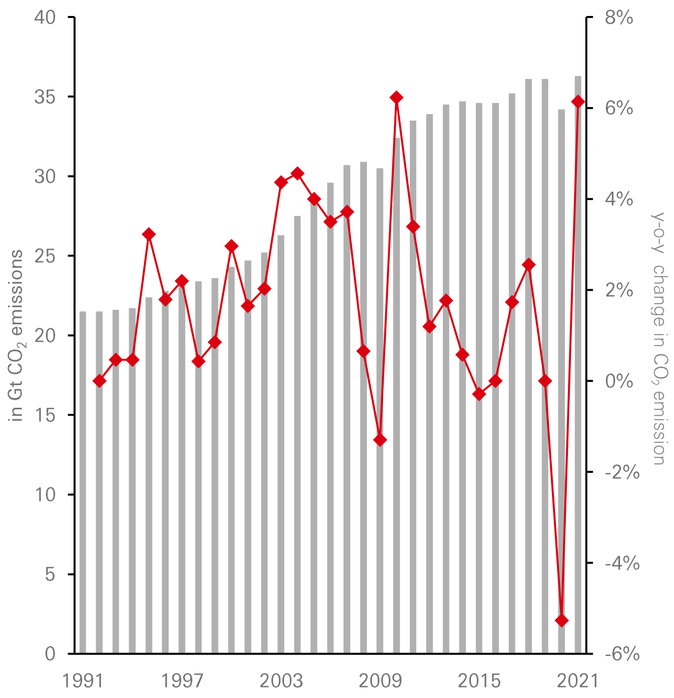
Climate clock is still ticking as COP27 unfolds

The annual UN climate conference, COP27, is unfolding in Egypt, which will bring attention back to long-term ambitions to tackle the climate crisis and reduce greenhouse gas (GHG) emissions in line with the Paris Agreement to keep global warming well below 2°C above pre-industrial levels, ideally to 1.5°C. But achievements since the last climate conference in November last year (COP26) appear limited, and climate efforts seem to lag as the global energy crisis triggered by Russia's invasion of Ukraine has taken centre stage this year. Supply disruptions and soaring energy prices have been two of the major challenges for governments, policymakers, businesses and the general public across the world.

But as the COP27 takes place between 6-18 November, it would be too simple to point the finger at these factors only. Truly, the disruptions experienced this year have exacerbated the precarious situation the world has been in, as the near-term policy focus has primarily been centred on energy security. But Europe's energy markets already showed signs of stress in late 2021 due to a particularly cold winter driving up demand and lower-than-usual production levels of wind energy (please refer to our EMEA Perspectives October 2021). Prior to 2022, the pace of investments into renewable energy technologies was also not in line with projections to achieve the Paris Agreement by 2050 and global CO_2 emissions actually rebounded sharply in 2021, returning towards pre-pandemic levels. From that perspective, the 2022 energy disruptions can be seen as an opportunity in disguise, re-emphasising the challenge to deliver a just net-zero transition of the global energy system. The International Energy Agency (IEA) suggests that this year's disruptions might have actually prompted a re-thinking that might lead to actual structural change in the long-term as it estimates global emissions might grow by less than 1% this year (much smaller than the 6% rise last year) thanks to the rapid expansion of renewable energy sources in 2022 so far.

While the COP27 seems to gather less (media) attention this year, we do not think that this is a reflection of the current energy crisis derailing the long-term net-zero transition and, if anything, this year's extreme weather events have reiterated the need and urgency to take actions now. It is worth pointing out, however, that this year's climate summit stands in the shadow of the highly anticipated COP26 in Glasgow last year, which concluded with many announcements of new initiatives on climate financing and substantial, high-level commitments to reduce emissions. This puts this year's COP more into focus to deliver implementation solutions and actionable frameworks to the existing pledges instead of making new commitments. This year's event will also set the stage for 2023 when the first global stocktake at the COP28 takes place, assessing the actual progress made towards the Paris Agreement's objectives. As such, while expectations might be low, they should not diminish the importance of COP27. The climate change clock is still ticking, and COP27 will thus need to make progress in key areas such as mitigation and adaptation, as well as to strengthen international collaboration after this year's energy market turmoil has fuelled more domestic-oriented policymaking to address energy security and energy poverty risks. And given the recurrent theme of climate finance, tensions are inevitable to rise at the gathering.

Global CO_2 emissions have returned to a fresh record high in 2021, rising by roughly 2% p.a.



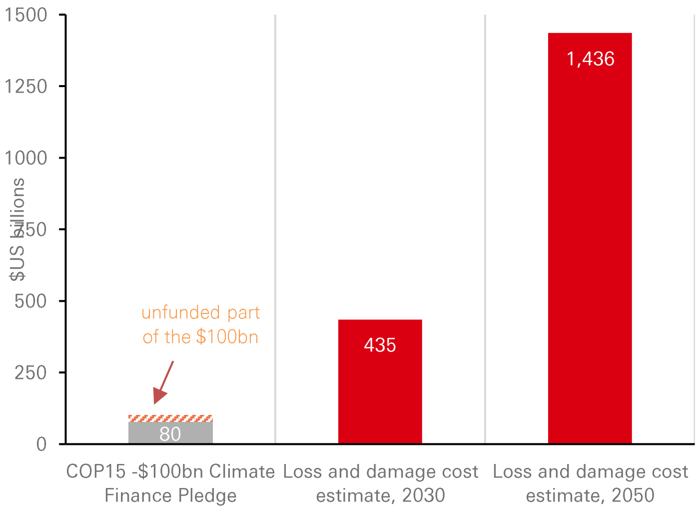
Source: OurWorldInData, IEA, HSBC Private Banking and Wealth, 31 October 2022

Climate financing is the recurrent theme across COP27

When speaking about climate finance, it is worth pointing out that the UN has not yet outlined the exact constituents defining climate finance. Since 2019 (COP25), discussions have been underway to define this term, but it is unlikely that a formal definition will be announced this year at COP27. Instead, it might provide "inputs for consideration," which will, however, not suffice to align parties on this contentious topic where bold commitments have remained unfulfilled promises to developing countries. This is exemplified by the 2009 pledge to provide USD100bn annually to developing economies to support climate action, of which, however, only roughly $80bn was provided in 2019 (latest data available). Last year's pledge to accelerate adaption financing to at least $40bn per year thus seems unlikely to be met as well.

Tensions might therefore heat up at this year's COP when emerging markets will seek reassurance and transparency on the funding plans by developed markets, especially as discussions will also centre around establishing the framework for new future goals beyond 2025 (also known as the new collective quantified goal on climate finance (NCQG)). In this context, ongoing discussions around the loss & damage tools and provisions will be equally difficult as expectations are that parties should agree at the current COP on the operational framework for loss and damage (known as the Santiago Network), even though the potential funding facility in the Glasgow Dialogue on Loss & Damage still remains elusive.

There has already been a shortfall in climate financing, and this is expected to rise as loss and damage costs are projected to mount sizeably



Source: Carbon Brief, HSBC Global Private Banking and Wealth, 31 October 2022

Scaling up climate finance is obviously key in order to deliver mitigation & adaptation solutions as well as to prepare and adhere to rising reporting standards. From that perspective, COP27 should build the foundation for the two-year work program around the global adaptation framework in terms of policy, planning and implementation as well as financing, which will also provide crucial inputs into the global stock take next year (see page 4 for further discussion).

While parties will come under pressure to deliver on bold financial commitments, the focus will also fall back on mitigation actions and here again, parties appear to be falling short of ambitious climate mitigation goals. A key takeaway of COP26 was to strengthen the 2030 climate pledges, however, only one tenth of the parties have actually done so, and only ¼ of the group has submitted strategic long-term mitigation plans that will be key in assessing the emission trajectory over the coming decades.

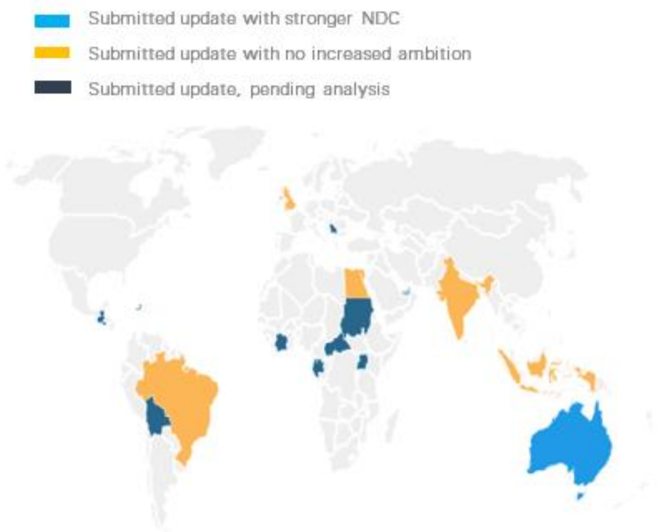
The current global energy crisis in the context of the long-term net-zero transition

Energy security has been the near-term policy priority for most governments this year, as they are focused on ensuring to access all available sources of energy amid the current energy crisis. This can imply fostering new trading relationships and revisiting existing energy infrastructure, such as returning to coal plants that can deliver readily available energy sources. From that perspective, COP27 will unlikely make significant steps towards eliminating fossil fuels in the coming years, as many have hoped for.

Meanwhile, renewable energy might not be supported by a well-established infrastructure to meet a sudden demand spike, and it has also faced current shortages of key net-zero materials to quickly build up new or expand existing installations. This should, however, not undermine the long-term economics of the transition in our view. And indeed, previous periods of conflict have often triggered an acceleration in energy transitions, as witnessed in the shift from coal to oil after World War I and the introduction of nuclear energy after World War II (Vaclav Smil, Energy and Civilisation: A History, MIT Press, 2016). Thus, the current energy crisis might face an equally transformational outcome after all.

The current policy prioritisation is also a reflection of the sentiment across society. According to the IPSOS Global Survey for Earth Day 2022, the majority of respondents remained concerned about the impact of climate change in their country and the lack of policy actions undertaken today. However, health, war and financial concerns in light of high inflation in the post-pandemic environment were seen as more pressing issues. While individuals feel the responsibility to change their behaviour to contribute to the fight against climate change, there is an even greater emphasis put on the role of governments and businesses to take actions and support consumers in the change. In this regard, governments' current action plans to reduce energy consumption and advocate more sustainable use of energy can help to align interests and support consumers towards more conscious and sustainable energy consumption patterns.

There has been only limited progress to strengthen climate pledges ahead of COP27



Source: Climate Action Tracker, HSBC Global Private Banking and Wealth, 31 October 2022

And even though climate financing plans are currently competing with other emerging priorities for governments, such as plans to raise defence spending and provide fiscal support to ease the burden on consumers and businesses from high energy costs, there have been some encouraging advances on climate action plans since the last COP. In the US, the Biden administration introduced the Inflation Reduction Act (IRA) this summer which is probably the most significant climate policy in the US as it includes $369bn in energy and climate provisions that might reduce its emissions by 40% by 2030, according to the IRA. In Europe, the RePowerEU Plan, published in May this year, reacted to the global energy market disruption, re-emphasizing the need to reduce energy dependence on Russia while tackling the climate crisis. This includes plans to double solar energy capacity, accelerate the build-out of the hydrogen market and simplify the approval and permit process for renewable energy generation and infrastructure developments in the coming eight years. This underpins our view that policy actions are aimed at navigating current challenges while building resilient energy systems in the long-term.

The effects of soaring energy prices are also felt across the corporate world, either immediately through higher input costs or through second-round effects as energy prices are expected to stay higher for another year or so. This will be particularly painful for energy-intensive industries that have already seen a nearly 50% rise in their production costs, according to McKinsey. Consequently, businesses will need to review how to stay competitive, protect margins and future-proof their business models. Corporate strategies need to consider new ways of reliable sourcing and efficient use of energy in line with wider decarbonisation efforts. Quick and bold actions focused on those two areas could provide a substantial margin improvement of up to 10% while reducing the corporate carbon footprint by at least 40%, according to McKinsey estimates.

The corporate world across Europe is already announcing a vast range of measures to turn off non-essential lights and lighting during closing hours, lower the thermostat, install door-closing mechanism in air-conditioned or heated rooms and even reshuffle office space to shut down parts of the buildings. These energy savings measures are a clear consequence of the current energy crisis but also align with the rising net-zero commitments by companies globally. Over 1/3 of the largest publicly traded companies in the Forbes Global 2000 list have now net-zero targets, up from roughly 17% at the end of 2020, with sectors facing greater reputational risks around the energy transition, such as fossil fuel companies, having the highest percentage of net-zero targets. Despite prevailing concerns about the transparency and details of some of those targets, there has been a push towards renewables this year. Global renewable energy investments attained a total of $226bn in the first half of 2022, marking a fresh record for the same period in any of the previous years, according to BloombergNEF. This shows that despite the geopolitical tensions, the energy crisis and lingering supply-side disruptions, the renewable energy space is helping to address both energy security and transition. Enhancing energy efficiency and minimising energy use coupled with leveraging greener energy sources can help corporations to protect their margins against future price shocks.

Consequently, as clients and shareholders remain attuned to the energy transition, companies need to take the current crisis as an opportunity to transform their business model and the energy systems globally. And this transformation can also be facilitated through windfall taxes. Several countries, including the UK, Italy and Spain, for instance, have adopted windfall taxes on oil and gas companies that have benefitted from the soaring energy prices. While governments can use the proceeds to support the more vulnerable groups of society, these additional gains should also be used wisely by companies to make net-zero investments. Indeed, the IEA estimates that the current energy price environment could double the net income of the world's oil and gas sector to an unprecedented $4trillion in 2022, which marks a significant opportunity to invest smartly into the transformation of energy systems towards net-zero.

COP27 sets the stage for biodiversity discussion and sustainability agenda in 2023

While COP27 might be overshadowed by the country-level energy crises, its focus on delivering the implementation roadmap for previously announced commitments and pledges will set the scene for future climate and more broadly sustainability discussions in the coming months and quarters.

First, the first Global Stocktake is currently underway, which assesses the overall progress towards meeting the Paris Agreement objectives around adaptation, mitigation and support. The COP27 will undertake vital assessments to prepare the conclusions that will be presented in November next year. This will be an important inspection of climate actions and ambitions in order to enhance the response to the climate crisis.

Given that climate change is a key driver of biodiversity loss, the COP27 will also touch upon the wider topic of preserving nature and the interconnection between climate change and biodiversity. At last year's COP, the Pledge for Nature was endorsed by 94 countries aiming to reverse biodiversity loss by 2030, and the focus now turns to any conclusions on financial risk disclosures for nature and biodiversity. In addition, a new Forest & Climate Leaders' Partnership aimed at halting and reversing forest loss and land degradation is expected to provide clear action plans to protect, conserve and restore forests, which are an important natural carbon sink. Thus, reviewed climate ambitions and actions will be an important preparation for the biodiversity COP15 that will take place in Montreal in December 2022.

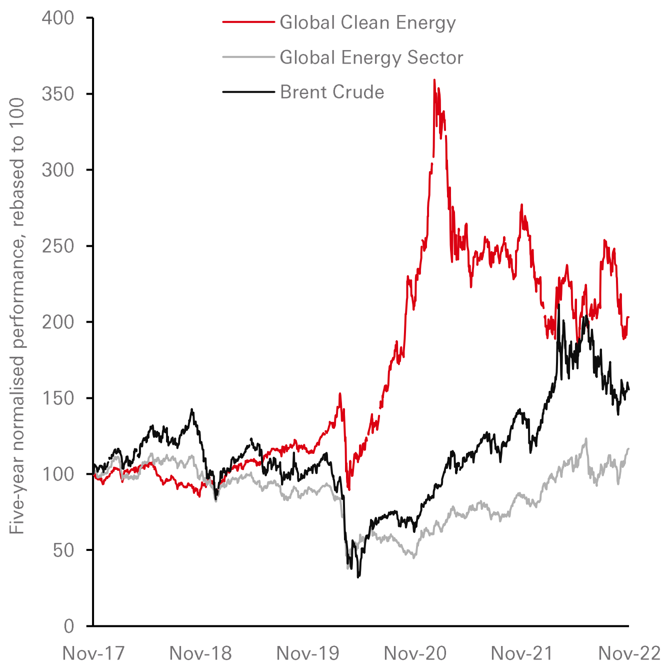
Investment implications

As the climate discussions resume at the COP27, we expect reiterated commitments to net-zero by governments, businesses, and the general public despite the current energy crisis. The global economy is in a more fragile position given elevated inflation levels, rising rates and tightening financial conditions. Coupled with a strong USD, emerging markets, in particular, are facing increased macro-economic and fiscal challenges while also being struck by climate disruptions. As COP27 will heavily focus on establishing the implementation plans for last year's bold commitments, tensions might be high between parties at the gathering, which adds to a backdrop of geopolitical tensions, deglobalisation and more domestic-oriented policies. In such an environment, diversification should be the underlying principle of investors' portfolios, and in our multi-asset allocation framework, we include hedge funds alongside other alternative investments to build resilient portfolios and enhance the risk-return profile.

Returning to the climate discussion, we continue to believe that the global economy is entering a multi-year rollout of emerging technologies that can contribute to the net-zero transition, such as renewables, carbon capture systems and smart-grid technology. Given that the near-term policy focus lays on energy security, there has been a return to coal power, which will likely keep emissions high despite encouraging signs of slower growth in emissions so far this year. Rising CO_2 emissions will reinforce the need to take actions in order to achieve net-zero pledges, and investments in the energy transition and independence are being pulled forward. Coupled with the severe extreme weather events this year, the global energy crisis reaffirms the urgency to accelerate the net-zero transition, opening up structural investment opportunities in our **high conviction investment theme of the Energy Transition and Independence** focused on areas in clean energy, energy efficiency and carbon reduction methods. Given the interconnectedness between climate and biodiversity, investors should also consider the **opportunities in Financing Biodiversity Action**, an investment theme aligned to our Top Trend Investing for a sustainable future. Here, we take a particular focus on forestry management and sustainable forest resource use, given that forests play a crucial role in absorbing an estimated 1/3 of global CO_2 emissions released from burning fossil fuels every year, according to the UN Forum on Forests. This theme also aligns investors with the UN Sustainable Development Goal 15, and we expect more details to be released at the COP27 about last year's deforestation initiative.

While energy provides a structural investment opportunity, the energy sector is among the strongest relative preferences in our tactical equity sector strategy (alongside consumer staples). The energy sector still stands out thanks to its triple-digit earnings growth in the current earnings season. And while this growth rate should normalise and windfall taxes might cap some earnings upside as well, valuations still remain attractive despite the strong rally until mid-year. Lingering concerns about the oil supply-demand balances, geopolitics and chronic under-investment should keep energy prices around current levels, and we favour **ESG leaders in the energy sector** that have a clear net-zero path outlined in their corporate strategy, as well as those energy companies that have a business model tilted towards the renewable energy space.

Clean energy has re-rated in line with the repricing in growth stocks, but the structural support remains in place and is less dependent on the oil price outlook



Source: Bloomberg data, HSBC Private Banking and Wealth, 31 October 2022

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Sustainable investing is an evolving area and new regulations may come into effect which may affect how an investment is categorised or labelled. An investment which is considered to fulfil sustainable criteria today may not meet those criteria at some point in the future.

Greenwashing risk is defined as giving a false impression or misleading information of a product's climate and environmental friendly credentials and, whilst not considered a standalone risk, can manifest through sales outcomes, marketing materials, product design and external disclosures at product and firm level.

Risk Disclosures

Risks of investment in fixed income
There are several key issues that one should consider before making an investment into fixed income. The risk specific to this type of investment may include, but are not limited to:

Credit risk
Investor is subject to the credit risk of the issuer. Investor is also subject to the credit risk of the government and/or the appointed trustee for debts that are guaranteed by the government.

Risks associated with high yield fixed income instruments
High yield fixed income instruments are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default. The net asset value of a high-yield bond fund may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced; and
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment.
- Vulnerability to economic cycles - during economic downturns such instruments may typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Risks associated with subordinated debentures, perpetual debentures, and contingent convertible or bail-in debentures
- Subordinated debentures - subordinated debentures will bear higher risks than holders of senior debentures of the issuer due to a lower priority of claim in the event of the issuer's liquidation.
- Perpetual debentures - perpetual debentures often are callable, do not have maturity dates and are subordinated. Investors may incur reinvestment and subordination risks. Investors may lose all their invested principal in certain circumstances. Interest payments may be variable, deferred or canceled. Investors may face uncertainties over when and how much they can receive such payments.
- Contingent convertible or bail-in debentures - Contingent convertible and bail-in debentures are hybrid debt-equity instruments that may be written off or converted to common stock on the occurrence of a trigger event. Contingent convertible debentures refer to debentures that contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event. These debentures generally absorb losses while the issuer remains a going concern (i.e. in advance of the point of non-viability). "Bail-in" generally refers to (a) contractual mechanisms (i.e. contractual bail-in) under which debentures contain a clause requiring them to be written off or converted to common stock on the occurrence of a trigger event, or (b) statutory mechanisms (i.e. statutory bail-in) whereby a national resolution authority writes down or converts debentures under specified conditions to common stock. Bail-in debentures generally absorb losses at the point of non-viability. These features can introduce notable risks to investors who may lose all their invested principal.

Changes in legislation and/or regulation
Changes in legislation and/or regulation could affect the performance, prices and mark-to-market valuation on the investment.

Nationalisation risk
The uncertainty as to the coupons and principal will be paid on schedule and/or that the risk on the ranking of the bond seniority would be compromised following nationalization.

Reinvestment risk
A decline in interest rate would affect investors as coupons received and any return of principal may be reinvested at a lower rate. Changes in interest rate, volatility, credit spread, rating agencies actions, liquidity and market conditions may significantly affect the prices and mark-to-market valuation.

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Although sovereign bonds may be guaranteed by the China Central Government, investors should note that unless otherwise specified, other renminbi bonds will not be guaranteed by the China Central Government.
Renminbi bonds are settled in renminbi, changes in exchange rates may have an adverse effect on the value of that investment. You may not get back the same amount of Hong Kong Dollars upon maturity of the bond.
There may not be active secondary market available even if a renminbi bond is listed. Therefore, you need to face a certain degree of liquidity risk.
Renminbi is subject to foreign exchange control. Renminbi is not freely convertible in Hong Kong. Should the China Central Government tighten the control, the liquidity of renminbi or even renminbi bonds in Hong Kong will be affected and you may be exposed to higher liquidity risks.

Investors should be prepared that you may need to hold a renminbi bond until maturity.

Risk disclosure on Emerging Markets

Investment in emerging markets may involve certain, additional risks which may not be typically associated with investing in more established economies and/or securities markets. Such risks include (a) the risk of nationalization or expropriation of assets;
(b) economic and political uncertainty; (c) less liquidity in so far of securities markets; (d) fluctuations in currency exchange rate;
(c) higher rates of inflation; (f) less oversight by a regulator of local securities market; (g) longer settlement periods in so far as securities transactions and (h) less stringent laws in so far the duties of company officers and protection of Investors.

Risk disclosure on FX Margin

The price fluctuation of FX could be substantial under certain market conditions and/or occurrence of certain events, news or developments and this could pose significant risk to the Customer. Leveraged FX trading carry a high degree of risk and the Customer may suffer losses exceeding their initial margin funds. Market conditions may make it impossible to square/close-out FX contracts/options. Customers could face substantial margin calls and therefore liquidity problems if the relevant price of the currency goes against them.

Currency risk – where product relates to other currencies

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There is a liquidity risk associated with CNY products, especially if such investments do not have an active secondary market and their prices have large bid/offer spreads.

CNY is currently not freely convertible and conversion of CNY through banks in Hong Kong and Singapore is subject to certain restrictions. CNY products are denominated and settled in CNY deliverable in Hong Kong and Singapore, which represents a market which is different from that of CNY deliverable in Mainland China.

There is a possibility of not receiving the full amount in CNY upon settlement, if the Bank is not able to obtain sufficient amount of CNY in a timely manner due to the exchange controls and restrictions applicable to the currency.

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