Sustainability Insights

CIO Office

COP28 needs to act to keep the 1.5°C target alive

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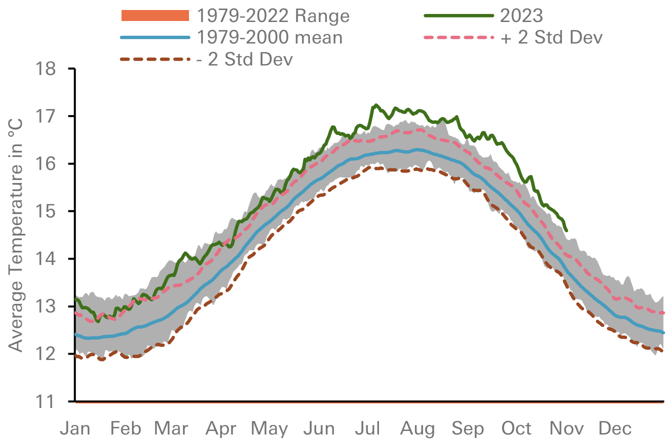
- The 28th annual Conference of the Parties (COP28) will kick-off in the UAE at the end of November, bringing the fight against climate warming back into focus, as this year's record-breaking temperatures and extreme weather events across the world evidenced the urgency to act.
- COP28 will mark an important milestone as the first-ever Global Stocktake concludes with an assessment of the world's progress in achieving the goals outlined in the 2015 Paris Agreement. Yet, we already know the dire and unfortunate truth—the world is not on track to limit global warming ideally to 1.5°C. Instead, existing climate policies are estimated to result in a temperature increase of over 3°C by the end of this century. This requires drastic actions to revive and keep the Paris Agreement alive.
- The contentious topic of climate finance is expected to heat up discussions and will likely exhibit a widening divide between developing and developed nations. After years of failing to meet the existing financing pledge, reassurances might not suffice, and actions need to materialise by formalising the framework of the Loss and Damage Fund and accelerating funding for adaptation needs. Yet, with a global decoupling underway and the recently revived geopolitical tensions, finding consensus will remain a key hurdle.
- This year will mark the second consecutive climate summit in the Middle East region. Leading the regional energy transition efforts, the UAE COP 28 Presidency aims to achieve a paradigm shift by prioritising tangible, implementable solutions and financial arrangements to ensure a just and equitable path towards a cleaner world of tomorrow. This will, in particular, put the focus on the private sector and the fossil fuel industry.
- Even if the structural story remains favourable, thanks to ongoing policy support and rising climate awareness, investments in the energy transition have taken a hit this year due to swiftly changing macro and market conditions, leading to a higher rate environment. Our view of the rate plateau until the second half of 2024 in the US should help to ease some headwinds.
- We consider the renewable energy space a thematic idea, as outlined in our high conviction theme "Opportunities in Sustainable Energy," that fits a small satellite investment alongside the principal core allocation, consisting of a well-diversified portfolio. While near-term risks persist, valuations look appealing, and investors should adopt a longer investment horizon to look through near-term volatility.
- An active investment approach and focus on quality companies with sustainable business models and strong balance sheets can help to build further resilience. Tactically, we are overweight on the energy sector as a hedge against geopolitical uncertainty and focus on companies with climate transition strategies.

Amid global boiling, the focus is on keeping the Paris Agreement ambition of 1.5°C alive

In a couple of weeks, the 28th annual Conference of the Parties (COP28) will kick-off in the UAE, uniting leaders and representatives from governments, international organisations, the private sector and society to discuss climate action. The urgency for actions to materialise from ongoing climate discussions was evidenced again this year by extreme weather events: Record-breaking heat waves passed through the US and Europe this summer; devastating wildfires in Canada spread across a record-breaking 18mn hectares (2.5x the previous record set in 1995); severe floods in Pakistan and China led to tragic losses; and polar ice in both Antarctica and the Arctic circle have melted at a record pace. While some of this year's events can be linked to the cyclical warming of the Pacific Ocean, also known as El Nino, the underlying truth is that record-breaking extreme events and temperatures are becoming more common.

Global air temperatures have hit fresh records this year, staying well above average



Source: Climate Change Institute, HSBC Global Private Banking and Wealth, 2 November 2023.

Last year's UN climate summit in Egypt (COP27) concluded with slivers of progress, leaving many contentious issues—including the Loss and Damage Fund, the Global Goal on Adaptation and climate finance—unresolved. Ambitious net-zero strategies have failed to lead to tangible mitigation actions. And there was little evidence that climate pledges strengthened, suggesting that the Paris-aligned ambition to limit climate warming to well below 2°C, ideally 1.5°C, remained alive only on paper.

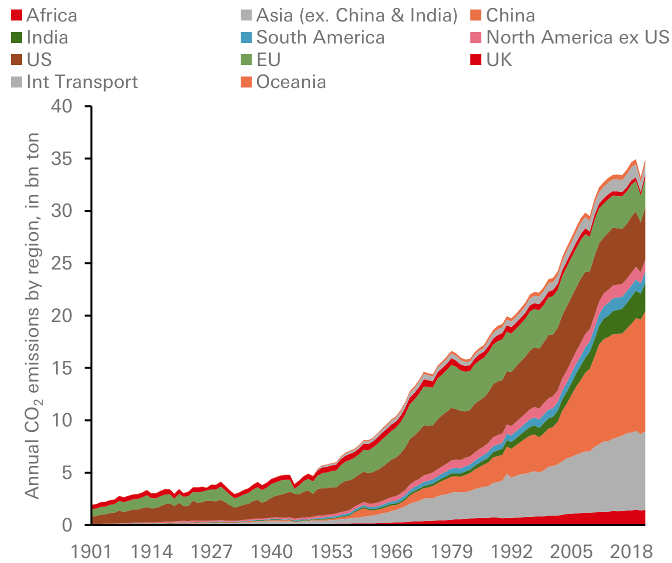
Ahead of this year's climate gathering, around a dozen of Parties revisited their Nationally Determined Contributions (NDCs), including most notably the host country. While recent geopolitical tensions resurfacing in the Middle East might have taken the focus away from the climate agenda, it has revived attention on the topic of energy dependency. Yet, with a global decoupling underway and increasingly diverging views among Parties, especially the widening stance between developed and developing economies, alignment has remained limited in the run-up to COP28. Thus, it sets the scene for another round of contentious discussions this year.

High expectations for COP28 to deliver actions

COP28 will mark an important milestone in the global climate fight as the first-ever Global Stocktake will conclude at this year's conference. The Global Stocktake is the assessment of the world's progress in achieving the goals outlined in the 2015 Paris Agreement. While technical in nature, it is a crucial health check of climate actions taken so far in terms of mitigation, adaptation and means of implementation. Going into COP28, recent progress reports already point to a dire, but unfortunately, unsurprising truth that the world is not on track to limit climate warming to 2°C. Instead, the latest indications signal that existing climate pledges could result in a temperature increase of over 3°C by the end of this century, and global emissions would need to be cut by at least 30% by 2030 to get back on track.

In this context, this year's host of the COP, the UAE, has set the intent to respond to the Global Stocktake outcome with a clear action plan that will need to outline implementable and practical solutions to close the gap with the Paris objectives. We think that this guidance to further strengthen climate action and support, especially in terms of financial support, will be crucial to assess whether the 1.5°C target will survive, and even see a revival. This should also strongly drive the update of national pledges (NDCs) that are due over the course of 2024.

After the drop in the pandemic year 2020, global CO_2 emissions are back on the rise, and the US & Europe together contribute roughly 1/3 of global emissions



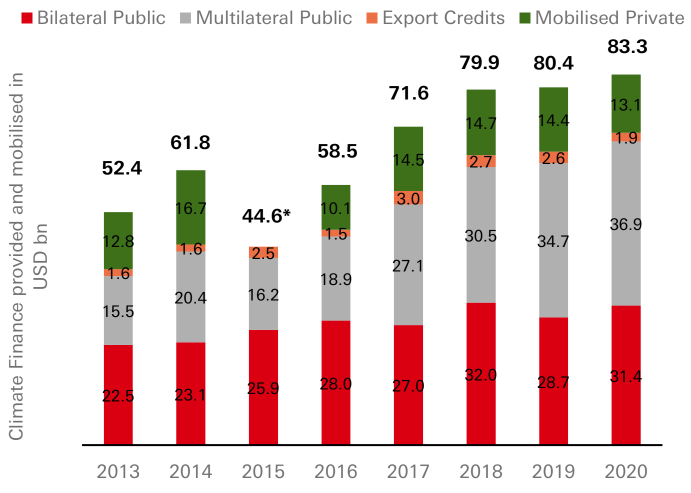
Source: Climate Change Institute, HSBC Global Private Banking and Wealth, 2 November 2023.

Apart from steering global climate action back on track towards the Paris Agreement objectives, the contentious topic of climate finance will likely heat up discussions at COP28. Last year, establishing the Loss and Damage Fund was a "make or break" issue for the Parties, given that the rising impact of climate change has been felt across the world, especially in the more vulnerable regions of the developing world. The Loss and Damage Fund has a clear objective to provide financial assistance to developing countries that are most vulnerable to the effects of climate change. Yet the main task for COP28 will be to define the operational framework to launch this fund going into 2024. Finding alignment on its governance, scope and funding, amongst other formalities, remains a key challenge, which could also derail the adoption timeline, in our view.

Promises are words as developed world remains off track to deliver on climate finance goals

Beyond the Loss and Damage Fund, there are four other key areas pertaining to climate finance. The first area actually refers to the lack of financing, i.e., the long-promised $100bn annual climate finance objective pledged by the developed nations in 2009. Again and again, this objective has been missed, as the graph below shows. And while the 2021 climate finance data is expected to be released prior to COP28, the latest update suggests that developed nations might have only delivered on this promise this year. Yet 2023 data will only be available by 2025, providing no reassurance to developing countries whether this is indeed the case. As such, the repeated failure to meet this $100bn goal shows that promises remain just words. But to put the world on track to achieve climate finance and 1.5°C ambitions, this will need action, as spelled out by the UAE and its Action Agenda.

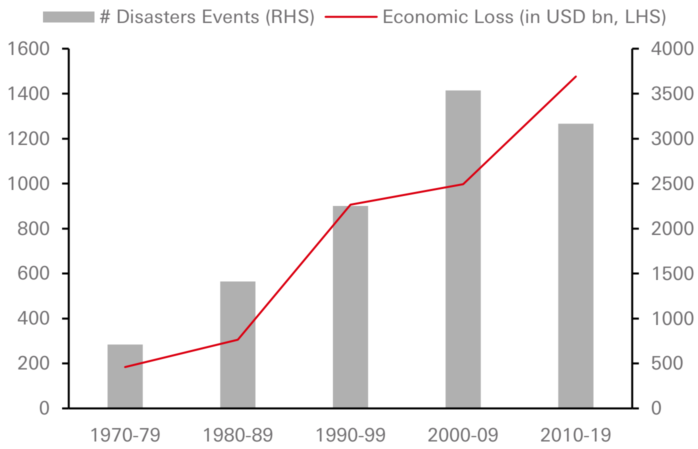
After years of missing the $100bn target, developed nations sounded confident to have met it this year, but the data confirmation will only come by 2025



Source: OECD, HSBC Global Private Banking and Wealth, 2 November 2023. * Data Gap in the Mobilised Private finance series in 2015 due to implementation of enhanced measurement method.

Similarly, there remains a lack of funding for adaptation, which is expected to at least double from the 2019 levels by 2025. This approximates $40bn of climate finance to be provided by developed nations. Yet the latest evolution in extreme weather events raises doubts that this target suffices, and COP28 will likely reiterate the need to raise not only the amount but also the commitment well ahead of 2025. Meanwhile, we do not expect any significant progress to be made on the topic of defining a New Collective Quantified Goal on Climate Finance (NCQC), given that the deadline is set for COP29. Moreover, the NCQC discussions are overshadowed by the ongoing deliberations to settle on a climate finance definition. A final agreement on what constitutes climate finance is unlikely to be found within the next month, yet a clustering approach to categorise different forms of climate finance should help to steer the discussion into next year.

The rising frequency and severity of extreme weather events create mounting costs for the global economy and society



Source: World Meteorological Organisation, HSBC Global Private Banking and Wealth, 2 November 2023

Looking beyond mitigation, the world still needs to react and adjust to impacts of climate change

While global CO_2 emissions could peak as early as this year and the latest by 2025, according to the IEA, adaptation remains a key focus for nations that have low emissions but face the most severe consequences of extreme weather events, as well as those events that are unfolding slowly. Over the last two years, work has unfolded to define a Global Goal on Adaptation (GGA). In 2023, discussions narrowed down the GGA framework to currently three options, which offer differing degrees of detail. Developing and vulnerable nations will favour more detailed solutions in order to avoid disappointment and unfulfilled promises. Yet we think finding an agreement will be another challenge at COP28, given the divergent views. This will likely lead to a wider set of adaptation targets, instead of a single objective, in order to outline specifics around exposure, adaptive capacity metrics and financial means to support implementation.

Assessing the wider impact of climate change on society and ecosystems

Finally, COP 28 is expected to adopt a broader lens when talking about climate change. The contribution of sectors such as agriculture on global emissions and also biodiversity loss has been widely featured in the remarks of the COP Presidency. As such, the role of preserving the health of oceans and forests will likely be featured again this year, exploring the linkages by tackling both crises (climate change and biodiversity loss) simultaneously. This will also underpin another ambition of the UAE Presidency: to deliver a just and inclusive transition that incorporates society in its assessment of climate change. For the first time, there will be links made between the health of society and climate change. The UAE and its neighbours are increasingly required to manage the consequences of heat stress on its labour force due to record-breaking temperatures in the summer months. Yet climate change also affects the availability and quality of food and water, risking an increase in waterborne and foodborne diseases, while extreme weather events tragically take the lives of many people. The WHO estimates that the current *"climate crisis threatens to undo the last 50 years of progress in development, global health and poverty reduction.*" With greater vulnerability in developing nations, which often contribute less to the global emission picture but bear the greater costs for mitigation and adaptation, there remains the need to deliver actions urgently for all members of society.

Oil-rich UAE puts spotlight on the fossil fuel industry as well as the private sector

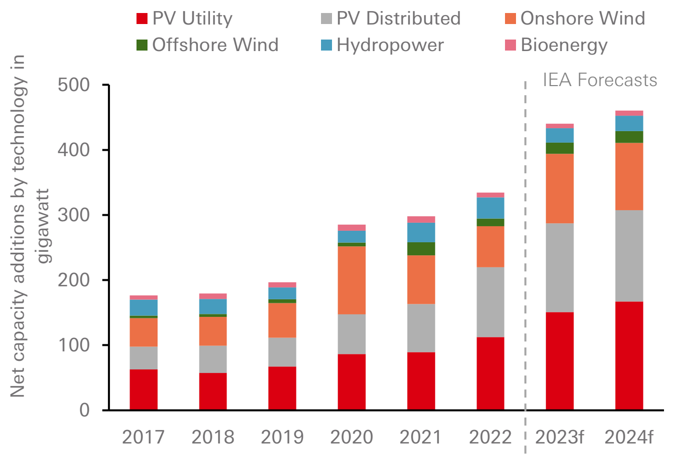
Acknowledging the need for meaningful and impactful climate actions, the UAE COP28 Presidency has set out an ambitious Action Agenda to deliver implementable solutions to meet regional and global climate targets. The UAE's intentions for the COP28 summit are summarised across the four Fs, which are aimed to mark a paradigm shift in the fight against climate change:

1. **Fast-track** the energy transition by building an energy system for the future and cutting emissions before 2030,
2. **Formalise** a framework for a new finance deal to deliver on old promises and make climate finance affordable, available and accessible to developing countries,
3. **Focus** on a fair transition by incorporating nature, people, lives and livelihoods into the heart of climate discussions and actions,
4. **Foundation** of this year's COP is "inclusion," which cherishes collaboration and diversity across all its work streams and events to ensure a collective effort globally.

To achieve this, the COP Presidency recognises the important role played by the private sector. This echoes the views of the IMF that are outlined in its Global Financial Stability Report in October that the private sector will have to provide roughly 80% of the investment needs required to meet climate goals by 2030, which is estimated to total around $2 trillion annually.

Being among the world's largest oil producers, the UAE Presidency thus puts a strong emphasis on the fossil fuel industry. Ahead of the climate summit, the UAE has already launched the "Global Decarbonisation Alliance," which will likely become a flagship COP28 initiative across the oil and gas sector to reach net zero emissions by 2050 (with a focus on scope 1 and 2 emissions only). This will likely reiterate the UAE´s leading position in the climate transition. In the GCC, the UAE was the first region to ratify the Paris Agreement and set a net zero strategy by 2050. It has also been one of the few countries, ahead of this year's COP, that have revised and strengthened their Nationally Determined Contribution (NDC) by moving to a fixed, base year (2019) based goal to reduce emissions. This could also trigger other GCC nations to follow suit, enhancing their existing business-as-usual projections. Yet on a global comparison, it is worth pointing out that major developed countries have more ambitious near-term targets, for instance, the US aims for 50% reduction based on 2005 levels while the EU envisions a 55% cut vs. 1990.

Renewable energy continues to grow rapidly, driven by policy support, energy security concerns and improving cost competitiveness



Source: IEA, HSBC Global Private Banking and Wealth, 2 November 2023. Forecasts are subject to change.

Middle East to host second consecutive COP, connecting climate action to broader economic priorities

This year marks the second consecutive COP summit being held in the Middle East, and we are witnessing an accelerating awareness for environmental considerations in the regional policymaking. While the higher oil price environment has strengthened public finances in the region, there still remains a drive for structural reforms and diversification of the economic model within and beyond the energy sector. In particular, the UAE and Saudi Arabia continue to lead the exploitation of renewable energy solutions with both countries accounting for around 90% of the GCC's overall renewable energy capacity, according to S&P Global Ratings. This drive should help reduce the transition risks emerging from the climate crisis, as the region remains highly vulnerable to the impacts of climate change. For example, water is increasingly becoming a highly scarce resource, due to low and infrequent rainfall, and air temperatures are rising the most in the GCC nations, increasing the risk of heat stress on their population as well.

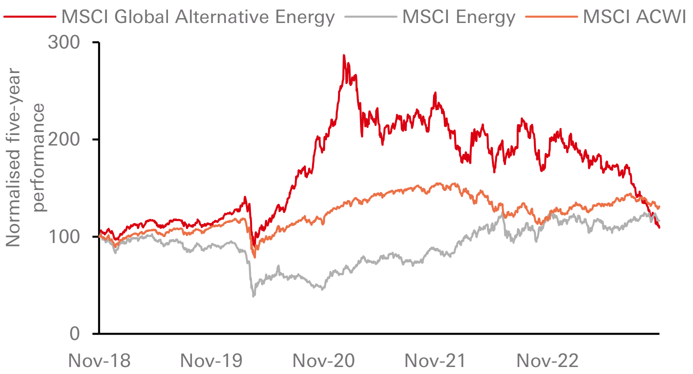
It is thus paramount that the UAE accelerates the transition when hosting COP28 by focusing on tangible implementable solutions and climate finance arrangements to ensure a just and equitable path towards a cleaner, greener world of tomorrow.

Investment Implications

2022 was a strong year for renewable energy, with record capacity additions and strong policy support being announced across the world with Europe's REPowerEU, the US Inflation Reduction Act and China's 14th Five-Year Plan for Renewable Energy. The drive for energy security amid geopolitical tensions after the outbreak of the Russia-Ukraine war and more recently in the Middle East, should be a positive for renewables both in the short and long term. This structural momentum continues to unfold and should provide further tailwind for the deployment of renewables in the coming years. Indeed, the International Energy Agency forecasts 2023 to be another stellar year for global renewable capacity, forecasted to grow by the largest absolute level ever—107 GW.

Yet for investors, the renewable energy space has been quite a challenge, especially since the start of 2023. Even if the structural story remains favourable, investments in the energy transition have taken a hit and underperformed the traditional global energy sector which features fossil fuel companies.

Energy transition stocks have suffered this year amid macro challenges and market risks



Source: Bloomberg, HSBC Global Private Banking and Wealth, 2 November 2023

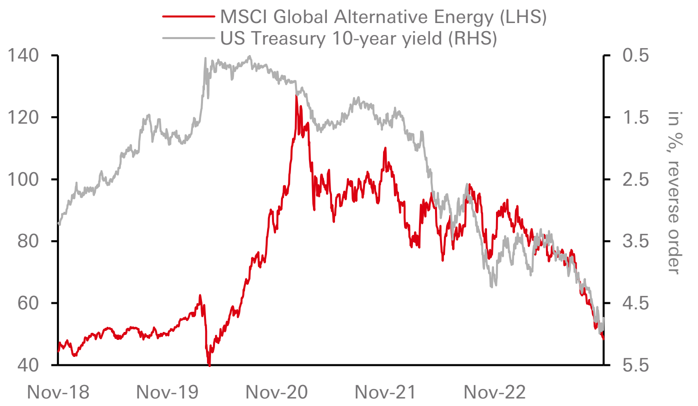
We consider the renewable energy space as a thematic investment idea, as outlined in our high conviction theme "Opportunities in Sustainable Energy," which we consider should be a small satellite investment alongside the principal core allocation consisting of a well-diversified portfolio. These thematic ideas are underpinned by structural forces over the coming decades, but they are not immune to prevailing market conditions. As such, the headwinds from a higher interest rate environment have exposed vulnerabilities of this sector. Worth pointing out is that many companies in this space lock in prices in long-term contracts before embarking on their projects, which means with the drastically-changed macro conditions over the last twelve months or so, the heat has started to rise this year.

Despite beneficial tax credits and subsidies, soaring interest rates have taken a toll on companies in the renewable energy space that have been leveraging up to manage upfront capex requirements. And while consumer price indices are showing signs of a gradual normalisation towards central banks' targets, the sector is still feeling the bite from the sharp rise in costs that has been exacerbated by the rapidly-growing demand for renewable energy projects. Over the past couple of weeks, the earnings season has also highlighted the cyclical challenges for this sector, with questions rising about project profitability in a higher rate world.

Headwinds to renewable energy thematic could start to reverse in 2024

Looking beyond the near-term challenges, we believe that earnings should improve amid medium to long-term growth outlook. Our view of a rate plateau at major central banks that should lead to rate cuts in the second half of 2024, should also remove a key headwind for the sector more generally. In light of the appealing valuations, we remain convinced of the structural investment opportunity in the renewable energy space, as outlined in our high conviction theme. Yet we caution that near-term risks persist, and investors should thus adopt a medium-to-long-term investment horizon in order to be able to look through the near-term volatility. An active investment approach and focus on quality companies with sustainable business models and strong balance sheets can help to build further resilience.

Higher rates have weighed on growth stocks and consequently on pure plays in the renewable energy sector



Source: Bloomberg, HSBC Global Private Banking and Wealth, 2 November 2023

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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 cancelled. 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. cotractual 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.

Contingent convertible securities (CoCos) or bail-in debentures are highly complex, high risk hybrid capital instruments with unusual loss-absorbency features written into their contractual terms. Investors should note that their capital is at risk and they may lose some or all of their capital.

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 nationalisation.

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 have a negative effect on the prices, mark-to-market valuations and your overall investment.

Risk disclosure on Dim Sum Bonds

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.

Alternative Investments

Hedge Fund - Please note Hedge Funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. They can also be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and may involve complex tax structures and delays in distributing important information. Alternative investments are often not subject to the same regulatory requirements as, say, mutual funds, and often charge high fees that may potentially offset trading profits when they occur.

Private Equity - Please note Private Equity is generally illiquid, involving long term investments that do not display the liquid or transparency characteristics often found in other investments (e.g. Listed securities). It can take time for money to be invested (cash drag) and for investments to produce returns after initial losses.

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 nationalisation 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.
The leverage of a product can work against you and losses can exceed those of a direct investment. If the market value of a portfolio falls by a certain amount, this could result in a situation where the value of collateral no longer covers all outstanding loan amounts. This means that investors might have to respond promptly to margin calls. If a portfolio's return is lower than its financing cost then leverage would reduce a portfolio's overall performance and even generate a negative return.

Currency risk – where product relates to other currencies
When an investment is denominated in a currency other than your local or reporting currency, changes in exchange rates may have a negative effect on your investment.

Chinese Yuan ("CNY") risks
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.

Illiquid markets/products
In the case of investments for which there is no recognised market, it may be difficult for investors to sell their investments or to obtain reliable information about their value or the extent of the risk to which they are exposed.

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In broad terms "ESG and sustainable investing" products include investment approaches or instruments which consider environmental, social, governance and/or other sustainability factors to varying degrees. Certain instruments we classify as ESG or sustainable investing products may be in the process of changing to deliver sustainability outcomes. There is no guarantee that ESG and Sustainable investing products will produce returns similar to those which don't have any ESG or sustainable characteristics. ESG and Sustainable investing products may diverge from traditional market benchmarks. In addition, there is no standard definition of, or measurement criteria for, ESG and Sustainable investing or the effect of ESG and Sustainable investing products. ESG and Sustainable investing and related measurement criteria are (a) highly subjective and (b) may vary significantly across and within sectors.

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