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Marketing Material

From "fad" to fact

Joe Biden's inauguration looks increasingly likely to mark a sea change for sustainable investing. This could have lasting implications well beyond U.S. shores.

- The new U.S. President Joe Biden appears eager to work together with likeminded partners both at home and abroad in combating climate change.
- The immediate scope for any new legislation is likely to be limited by the narrow majority Democrats have in both Houses of Congress.
- However, do not underestimate how much the change in tone is likely to matter in the longer term.

Last September, we argued that the 2020 U.S. elections were shaping up to be the potentially most momentous ones since 1980.[1] To see how and why the change in Washington is already impacting markets during Joe Biden's first 100 days in office, you might look at 10-year Treasury yields, which spiked above prepandemic levels in February. In part, that volatility in yields reflects unusually large bands of uncertainty around fiscal policy making. All else equal, the more a new administration spends by borrowing more, and the closer that might move the U.S. economy towards overheating, the higher the yield required to find willing buyers. How big is the overall spending going to be under Biden, due both to the recovery package currently working its way through Congress and infrastructure spending looming later on this year? Investors are understandably uncertain leaving plenty of scope for the occasional yield spike. In this piece, we cannot promise you answers on all the big questions, or even the small ones, either. Instead, by starting at the very granular level, we want to highlight that overall spending is far from being the only uncertainty – before providing some tentative answers on what the new administration is likely to mean for sustainable investing.

Consider the segment of municipal debt securities issued by U.S. state and local governments. According to Ashton Goodfield, Head of Municipal Bonds at DWS, municipalities have been responsible for constructing and maintaining roughly 75% of the country's infrastructure. Much of this has been financed with traditional tax-exempt municipal bonds, known as munis. This proven financing mechanism could be tapped via expanded and enhanced support for municipal projects with federal matching grants, interest-rate subsidies, and alternative mechanisms specifically designed to help smaller issuers of munis. There is certainly no shortage of potentially eligible projects including: Energy-efficiency retrofits of existing government buildings, electric grids, schools and municipal arenas; Strengthening of existing infrastructure to deal with the effects of rising sea levels, severe storms, drought, and wildfires, all of which have hit several states in recent years; Public-private partnerships that move toward the use of renewable energy such as building rooftop solar farms, wind turbines, electric-vehicle charging stations, and the like; And mass-transit systems and inter-urban transit authorities promoting high-speed rail.

[1] https://www.dws.com/insights/us-election-2020/cio-special-us-elections/

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Big ESG ambitions, but plenty of uncertainty on what the White House will be able to actually do

Step back from this ambitious laundry list just for munis. In our view, it offers a microcosm of the policy ambitions in other areas. The underlying message from the White House received by the muni market is clear: The federal government is back and eager to do business in ways that would have been hard to imagine in recent decades. And, perhaps for the first time in quite a while, a whole range of specific U.S. policy discussions will at least be informed by the latest scientific thinking on the world's changing climate. That is highly welcome. While there has been some progress, a lot more could be done, especially in the United States. As a good, recent summary article in Nature about the uses and misuses of climate-impact models summed up the thinking among leading climatologists: "Assessment of current policies suggests that the world is on course for around 3°C of warming above pre-industrial levels by the end of the century – still a catastrophic outcome, but a long way from 5°C. We cannot settle for 3°C; nor should we dismiss progress."[2]

Biden's green policy goals also chime well with renewed interest on Wall Street in investment strategies driven by environmental, social, and governance (ESG) criteria in general and climate change in particular. How big and how lasting, though, are any such changes likely to be, within munis or anywhere else in capital markets?

At least in the short to medium term, there are good reasons to be cautious, if the fight about raising the federal minimum wage is any guide. This fight shows that the scope for new legislation is limited by the narrow majority Democrats have in both Houses of Congress. That need not necessarily limit the size of potential spending commitments by the federal government. Biden's Covid-19 recovery proposals show there is plenty that can be done via the somewhat arcane budget-reconciliation process. On the plus side from the majority party's perspective, that means being able to pass measures without the need for Republican support. On the minus side, it means that measures such as the minimum wage not directly related to the budget are tricky to pull off.

Using the budget-reconciliation process also presupposes that Democrats can agree among themselves – effectively giving each Democratic Senator veto powers. And in the longer term, it is far too early to say whether Democrats will be able to defend, let alone expand, their Congressional majorities in the 2022 midterm elections. Electoral considerations are also likely to shape the infrastructure package to be unveiled later this year. "Despite having limited details behind the proposed infrastructure spending bill in the U.S., we know enough about the broader policy goals of the Biden administration to build a framework of what to expect," argues John Vojticek, Head of Liquid Real Assets at DWS. "It is clear that new government policy and infrastructure spending will be used to invest in the clean energy transition."

Already, executive actions are having plenty of impact on certain industries. In our view, a rough rule of thumb from a sector perspective, is likely to be that policy winners of the Trump years will continue to see those gains reversed. This has already begun to happen to the U.S. oil industry. Conversely, renewable-energy companies, such as windfarm operators or firms specializing in retrofitting buildings to enhance energy efficiency look poised to benefit from long-term structural growth drivers that are tied to meeting global environmental and socially conscious standards.

"For now, we do not expect Biden's green policy agenda to have much of an impact on the general equity market," argues Thomas Bucher, Equity Strategist at DWS. "We do not expect radical policy changes given the narrow Democratic Senate majority. Instead, we expect Covid recovery and fiscal stimulus in general to have the most impact on equities." Policy shifts could, however, impact health care and specific heavy emitters of greenhouse gases, from fossil-based power generation, cement, pulp and paper, to steel and metals and to some extent fertilizer companies.

[2] https://www.nature.com/articles/d41586-020-00177-3

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A lesson from Europe: Don't underestimate changes just because they take a while

Extrapolating from the latest trends can be a tricky business. In our experience, that's true for finance, economics, politics and even culture. Sometimes, a newer idea rapidly winning new converts is a powerful omen of things to come. More often than not, what its detractors call a fashion or a fad indeed proves little more than a blip. Erstwhile devotees eventually move on to the next big thing and the whole episode is quickly forgotten.

At DWS, we have probably been working on ESG-related issues for longer than most of our peers. For example, our work on what opportunities as well as risks climate change would create for long-term investors now goes back almost 15 years. Back in 2018, here is how we described some of the lessons we had already learned "The transition to an economy with much lower carbon emissions will be shaped not just by the increasingly visible real world effects of climate change but also by changes in policies, technologies, consumer preferences and market norms. (...) Essentially, climate-change risks and opportunities may be mispriced or incorrectly assessed by many investors. This suggests that the topic should best be approached with a combination of humility and an open mind."[3]

As a consequence, our natural inclination is not to read too much into any short-term trend or get carried away by media chatter. Next year, it will be 30 years since the United Nations Framework Convention on Climate Change (UNFCCC)[4] was negotiated and signed in Rio de Janeiro. Since then, there have been plenty of policy changes in different parts of the world, but overall progress on tackling climate change has been disappointingly slow.

At it's core, mitigating climate change is a collective action problem for the world as whole. The leaders of any one country might well want the rest of the world to take the policy actions required to limit the likely warming above pre-industrial levels to around 1.5°C of by the end of the century. But instead of taking politically costly actions themselves, they might hope for enough other countries to do so. Especially for smaller countries, that would secure the bulk of the benefits without having to incur the cost. Worries about such free-riding are a key reason to welcome Joe Biden's decision to reenter the 2015 Paris Agreement and commit the United States to pursue global efforts to limit the increase to 1.5°C. But if the volatility in U.S. politics in recent years is any guide, there remains a considerable risk this decision might be reversed – and once again encourage other countries too to free-ride the rest of the world's efforts.

A good example of the difficulties and the dangers of reading too much, too quickly into false, political dawns is the European Union (EU) emissions-trading system (ETS). Launched in 2005 to fight climate change, this pan-European market for carbon allowances gives permit holders the right to emit a given amount of greenhouses gases. Theoretically, the ETS (which covers several smaller countries as well as EU members) was supposed to create market incentives to focus abatement efforts on industries and technologies where reductions were feasible in the most cost-effective ways. In practice, carbon prices lingered far lower than would have been necessary to create meaningful price signals – mainly because the European Commission allowed an excess of allowances to develop. Not coincidentally, green parties saw sizeable gains in the 2019 elections to the European Parliament across a wide range of member states.[5] Only in recent years has the EU's ETS started to function as intended.[6] Carbon-allowance prices rose sharply in recent months, anticipating further EU steps towards cutting emissions (see chart below).[7] As such, it also serves as a reminder not to underestimate change just because it takes a while.

[3] https://www.dws.com/insights/cio-view/emea-en/casualties-of-trade-conflicts/
[4] https://unfccc.int/files/essential_background/background_publications_htmlpdf/application/pdf/conveng.pdf
[5] https://www.dws.com/insights/cio-view/cio-view-quarterly/q2-2019/europes-green-wave/
[6] https://www.economist.com/finance-and-economics/2021/02/24/prices-in-the-worlds-biggest-carbon-market-are-soaring
[7] https://www.ft.com/content/915f168a-0d7d-4cb6-abe1-6dbf8f40188f

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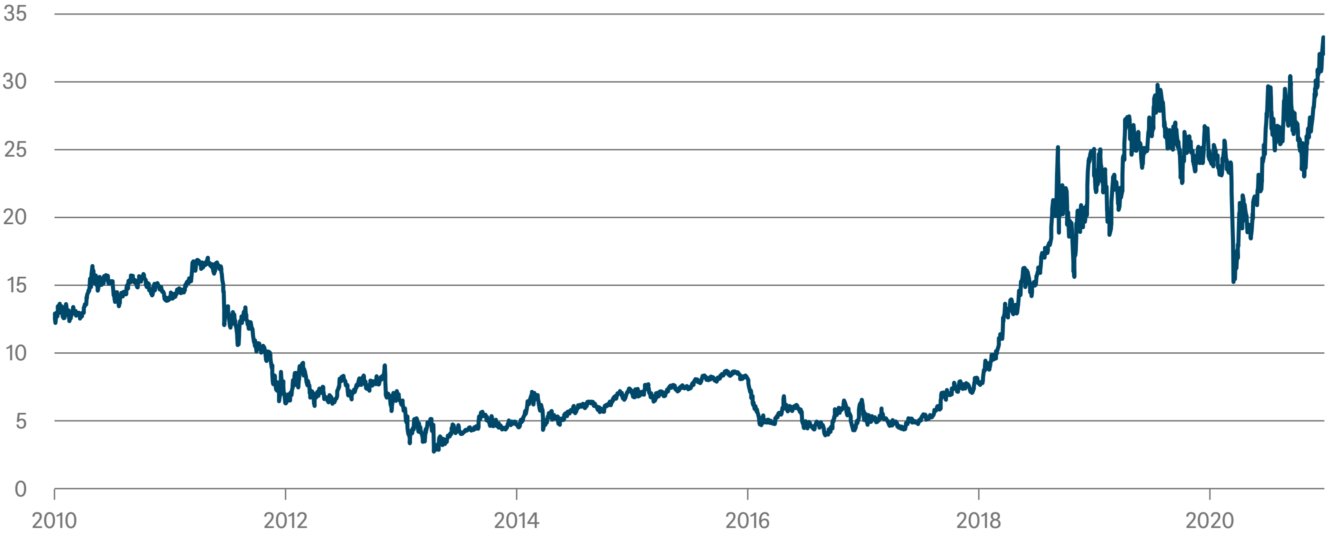
Carbon price (euro per tonne) in EU ETS



Sources: Bloomberg Finance L.P. and DWS Investment GmbH as of 3/4/21

"The ETS is now by far the world's most active market in terms of current carbon allowances and carbon futures- and interest from investors keeps growing. For now, there has not been a similar level of market participation in other carbon markets, such as the one in California. Even European carbon prices have not yet been included in any major commodity indices," points out Darwei Kung, Head of Commodities at DWS.

The history of the European market for carbon allowance well illustrates the complex interplay between institutional changes, politics and attitudes among both investors and society at large.

Why the new U.S. administration could mark a sea change

It is against this international and capital-market backdrop that President Biden's new administration looks increasingly likely to mark a sea change for sustainable investing world-wide. It is less a matter of immediate, radical policy changes, not least as the climate plans Joe Biden campaigned on were comparatively modest. It's rather more a matter of tone, of allowing more learning by doing, and of working together with likeminded partners both at home and abroad.

For example, for schemes such as the EU ETS to live up to their full potential, some form of border-tax adjustment may eventually be required to keep domestic carbon-intensive industries competitive. Implementing a carbon border tax raises a host of complicated issues, though. Think of, for example, tackling data verification (how to accurately capture emission intensity) or cross-border value chains (how to fairly tax finished vs. semi-finished goods). Satisfactorily resolving such technical issues would probably require several years, as well as a global effort and political will on all sides. At least as far as the U.S. is concerned, that still looks unlikely. But just having Washington in on the conversation will probably change the dynamic, not least between the EU and China, the world's biggest emitter.

"The U.S. will be back at the table for multilateral cooperation," argues Nicolas Schlotthauer, Head of Emerging Markets Fixed Income at DWS. "This is crucial in many regards, for instance environmental topics, but also trade agreements. Overall, a "green agenda" could also help many emerging-market countries (notably in Africa) via the potential availability of additional financial support through multilateral financial institutions such as the World Bank and regional development banks." The positive growth impact arising from U.S. domestic fiscal stimulus is

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also likely to be supportive for many emerging-market countries, as this will help support export growth and commodity prices (such as base metals). in our view, this would particularly help various sovereign issuers from Africa and Latin America. In several countries, such as Mexico and parts of Central America, we could also see more direct U.S.support for specific social and environmental projects.

Closer to home, one of the more surprising legacies of the Trump years has been the amount of thinking among businesses as well as state and local governments within the U.S. on what could and should be done to fight climate change. Most now acknowledge that continued renewable energy investment will require new build-outs that focus on improving existing electric-transmission grid systems to connect new energy sources and strengthen the broader grid. For example, electric vehicles will need incremental spending that strengthens the transmission and distribution infrastructure grid. Areas such as "smart-grid" power and water infrastructure[8] projects are also likely to trigger plenty of innovation, specifically regarding power transmission and distribution and water-supply-infrastructure assets. Similarly, the transition in transportation looks set to create new project opportunities for more efficient HOV* lanes and electric vehicles. "Smart Mobility," perhaps powered by self-driving technology and electric vehicles, promises to use roads more efficiently and reduce congestion, potentially leading to big savings in both ecological and economic terms. If Joe Biden can secure the necessary funding from Congress, there are likely to be plenty of projects soon ready to get started.

All of which illustrates that – provided there is sufficient support in Congress – the United States could see plenty of progress very quickly. One handy tool we use to monitor and to some extent forecast climate-transition risk at the country level is our sovereign Climate-Transition-Risk Rating (CTRR). In particular, we use various data providers, most notably Sustainalytics and MSCI to measure risks arising from climate change and carbon emissions. Then, we assess a country's current climate-related status as a baseline and correct it by a resilience wealth component. "This way, we aim to not only take into account the current risks and policies in place but also a country's wealth, including human capital, and the quality of its institutions that can contribute to the implementation of necessary policies," notes Petra Pflaum, CIO for Responsible Investments at DWS.

Various climate-impact modellers use slightly different methodologies. There is little dispute that the United States is far behind in terms of its current climate-protection status. The chart below shows one such modeller's ratings for a selected number of countries across different performance measures (with a high rating indicating performance better geared towards limiting global warming to 1.5°C).[9] Given its wealth and institutions, however, the United States has plenty of potential to rapidly catch up in mitigating climate risks by adopting policies geared towards that end.

[8] To find out more about the systematic risks behind water scarcity, check out: https://www.dws.com/insights/dws-research-institute/a-transformational-framework-for-water-risk/* High-occupancy vehicle

[9] Take, for example, the most recent ratings compiled by : Germanwatch, NewClimate Institute and Climate Action Network International: CCPI Results 2021 as of 12/2020; available at: https://ccpi.org/download/the-climate-change-performance-index-2021/

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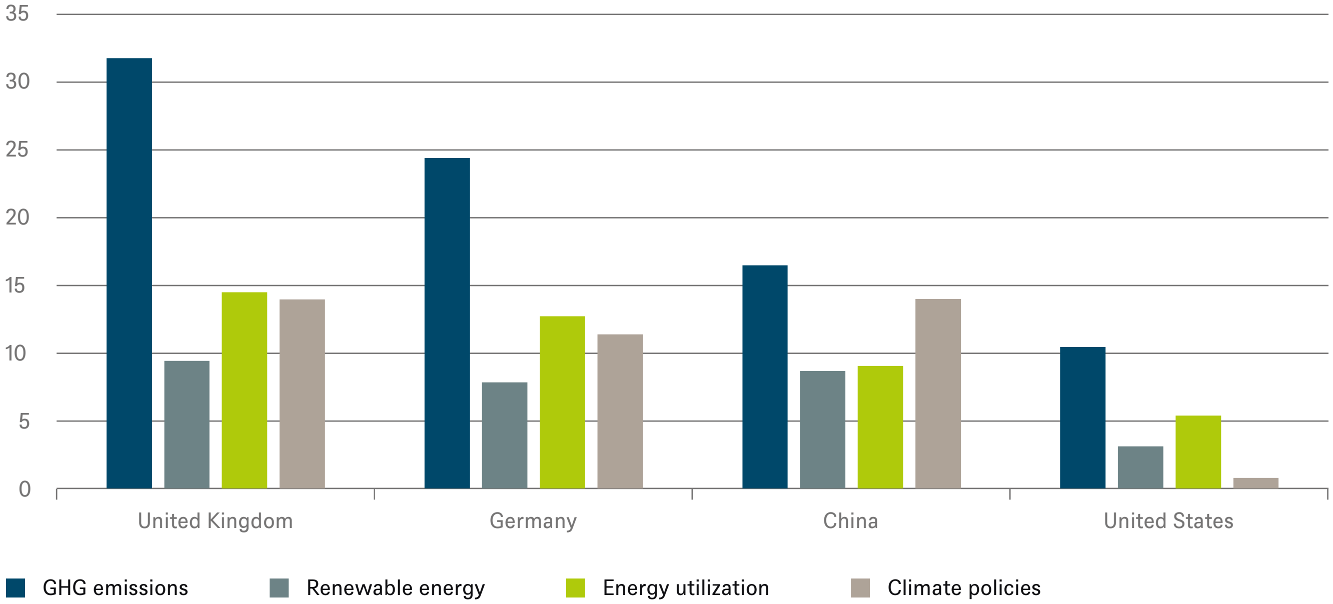
Rating according to CCPI results



Sources: Germanwatch, NewClimate Institute and Climate Action Network International: Climate-Change Performance Index (CCPI) Results 2021 as of 12/2020

So what, you might well ask? Well, in the face of a global collective action problem, a show of leadership has the potential to make a great deal of difference, even if short-term political considerations were to limit the scope for immediate changes.

What and how much Biden can get done will be important, before specific implications for munis and other asset classes can be assessed. "For municipal bonds, a critical question in our view will be which of the financing mechanisms noted above are going to be utilized and to what extent," explains Ashton Goodfield, Head of Municipal Bonds at DWS. "For example, if the initiatives were largely funded via tax-exempt issuance that leverages federal matching dollars, we would expect less of a transformational change to the muni market than if federal programs were to encourage municipalities to issue more taxable debt."

For now, investors should probably resist the temptation of getting lost in the nitty-gritty details of potential policy changes. We believe the bigger story is that tackling climate change is even getting seriously discussed again in Washington's corridors of power. That alone marks quite a sea change with potentially far reaching implications well beyond U.S. shores.

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GLOSSARY

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

Investors increasingly take environmental, social and governance (ESG) criteria into account when analyzing companies in order to identify non-financial risks and opportunities.

The European Commission (EU Commission) is the executive body of the European Union (EU) which represents the interests of the EU.

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The Republican Party (Republicans), also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

The United States Senate is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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