Emerging Markets: a key piece in the climate puzzle

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The investment community is showing an increasing commitment to playing its part in reducing carbon emissions, particularly by decarbonising investment portfolios – aiming to limit the global temperature rise to 1.5°C above pre-industrial levels by 2050.

'Net zero' portfolios have become a popular way to think about achieving this, drawing on a number of different approaches, including:

- outright exclusions,
- divestment,
- buying up green investments via Environmental, Social & Governance (ESG) labelled bonds,
- focusing on investing in "best in class", with a developed markets bias.

Missing the bigger picture

All these strategies have their merits and limitations, and clearly are not mutually exclusive in their application. But, whether they are fit for purpose needs to be assessed against the goal investors are seeking – real economy outcomes – and not just portfolio level outcomes.

For instance, systematically excluding entire sectors or countries will result in capital being directed to a narrow set of geographies, industries, and companies, potentially creating price bubbles in areas such as renewable energy or issuers with the lowest current carbon footprint.

> "Climate change is the defining issue of our time and we are at a defining moment... Without drastic action today, adapting to impacts in the future will be more difficult and costly." United Nations

Exclusion of those companies in high carbon intensity industries, especially those with more complex transition trajectories, means they will be starved of ESG-conscious capital, increasingly narrowing their funding opportunities to investors that are not focused on their carbon footprint. Whilst the exclusion approach will result in low carbon portfolios, it will not deliver actual reductions in emissions in the real economy – perhaps to the contrary.

Companies with low emissions receiving excess financing will feel less urgency to keep improving and companies/ industries screened out of portfolios could also have little incentive to change if they, by default, cater increasingly to an investor base less/not concerned with ESG.

Outright exclusion also denies capital to those issuers with critical need who want to transition, and ignores the role active stewardship can play in engaging with laggards. Most importantly, this approach doesn't comprehensively tackle the problems the global economy is facing, particularly in Emerging Markets (EM), such as poverty, low income, and lack of access to financial and basic services. These conditions make the global economy more vulnerable to climate change and will need to be addressed for a successful transition.

Failure to directly tackle the underlying causes of climate change would most likely mean the 1.5°C goal will not be met, and lead to potentially dire economic and humanitarian consequences throughout the globe.

Why investors should focus on EMs

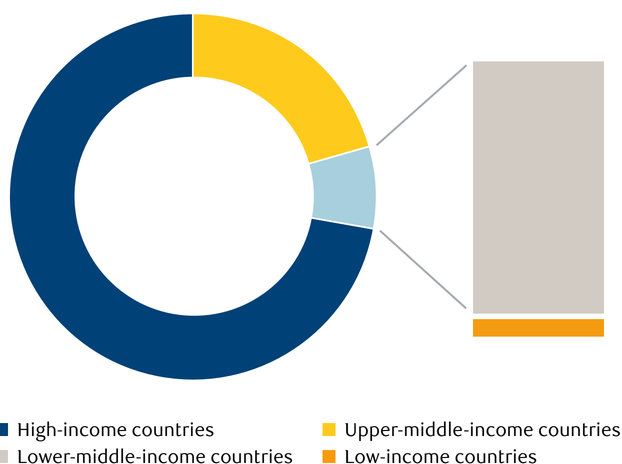
Whilst EM economies are presently responsible for the majority (63%) of current global greenhouse gas (GHG) emissions[1], this has not always been the case. Carbon dioxide – one of the major greenhouse gases – can stay in the atmosphere for up to 1000 years after it has been emitted[2]. This suggests that GHG emissions from the developed world's industrial revolution are still contributing to the excessive global warming we are seeing today.

To-date, the US has emitted more carbon dioxide than any other country[3], whilst large EM contributors today, such as China or India have not been the largest contributors historically. Yet EM countries, oftentimes those with some of the lowest level of emissions to date, are the most vulnerable to climate change effects, whilst also least able to respond effectively to many of the resulting transition and physical risks.

One analysis[4] estimated that EMs require around US$94 trillion of investments to meet net-zero targets by 2060 whilst continuing to grow and prosper. The United Nations Conference on Trade and Development (UNCTAD) estimates there is US$3.3-4.5 trillion funding gap in annual financing needs of developing countries to meeting the UN Sustainable Development Goals (SDGs) by 2030[5]. This is happening at a time when vulnerable countries are already facing excessive debt burdens and are effectively shut out of public markets, given high and rising interest rate costs.

What is more, EM countries will account for most of the increase in GHG emissions going forward, given population growth and urbanisation trends. EM countries accounted for 98% of global population growth and over 90% of new middle-class households in this decade[6]. As a result, EM countries will not only have to transition, but do so whilst meeting the rising energy needs of fast growing, rapidly urbanizing populations. This presents a huge challenge for swift mobilisation of external capital, but also shows the significant investment potential. The success or failure of EMs will have a significant impact on the ability of the world to reach net-zero emissions by 2050.

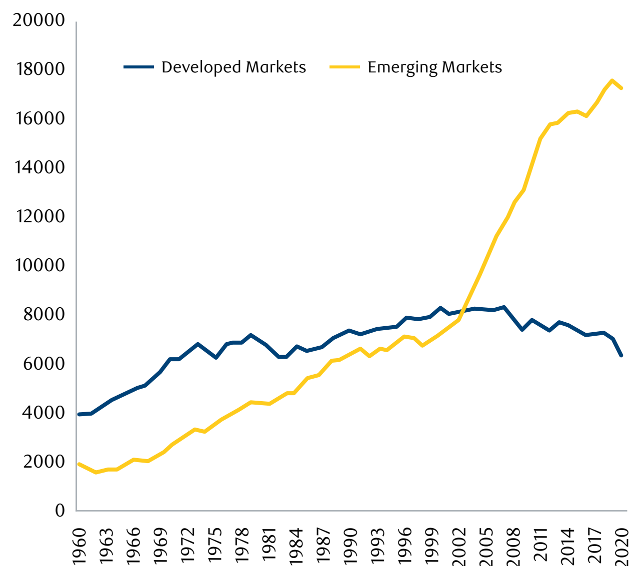
Cumulative CO_2 emissions since 1949



Source: Our Word in Data

Top 10 countries with largest CO_2 footprint

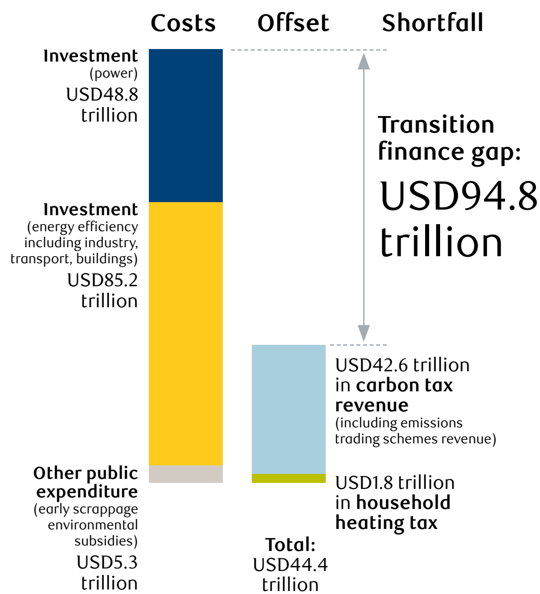
in 2020, territorial emissions in Mt CO_2



Source: Global Carbon Atlas. Developed Markets: Germany, Japan, US; Emerging Markets: China, India, Indonesia, Iran, Russia, Saudi Arabia, South Korea

[1] Center for Global Development
[2] UNEP, How do greenhouse gases actually warm the planet? (unep.org)
[3] OurWorldinData
[4] Standard Chartered
[5] World Investment Report 2014, unctad.org
[6] WEF: 3 actions to accelerate emerging market climate transition World Economic Forum (weforum.org)

EM Transition finance gap



Source: Standard Chartered (Emerging economies need help to reach net-zero and prosper | World Economic Forum (weforum.org)

Looking ahead – we're are all in it together

If EMs don't effectively transition to net-zero and meet their SDGs, the world cannot reduce emissions sufficiently to limit the temperature increase to 1.5°C.

Luckily, significant challenges come with significant opportunities for those who find solutions. There is a great need for investments in infrastructure, technological innovation, and social improvements in areas such as education, healthcare, clean water, clean energy, and affordable housing amongst others. EMs are already a global clean energy growth engine. However, these investments are concentrated mainly in China and India – there is scope to broaden these out.

The world needs creative solutions to tackle these problems before it is too late.

Attracting private capital: what investors need to consider

A fundamental rethink of asset allocation in the context of climate change mitigation and adaption is required. Investors need to adopt a more forward-looking, inclusive mind-set rather than investing only into clean, already high ESG performing countries and companies.

Asset owners need to work in partnership with their managers to actively drive change through thoughtful analysis, stewardship practices and engagement. ESG-labelled bond frameworks need to be revamped and ideally have more of a standardised approach, so that they are easy to implement for resource strapped issuers and standards tightened so that investors are comfortable investing into projects within "riskier" (high yield) countries which face unique challenges such as still high levels of corruption, weak institutional frameworks, and volatile growth pathways.

For fund managers, it is about offering clients solutions that meet their climate needs, and working with clients to provide increased transparency and reporting on key climate metrics and related data.

> **"A fundamental rethink of asset allocation in the context of climate change mitigation and adaption is required."**

We have identified several ways private capital can be channelled into EM corporate and sovereign fixed income to help address climate mitigation, support climate solutions and promote just transition. These channels should not be limited to investing only into issuers well advanced on their climate journey, benefiting from progressive climate profile and approach.

Increasing focus should be also on:

- Issuers transitioning towards lower carbon models with the help of active engagement from investors;
- Issuers whose core economic activities are providing solutions for a more sustainable future – including issuers contributing to inclusive society, circular economy, clean energy, health and wellbeing and others;
- Impactful projects mainly via, but not limited to, ESG labelled bonds, however with a discerning eye on poor quality projects and opportunistic issuance, with focus on the alignment with issuer's ESG strategy and performance.

This approach presents many challenges, not least because full climate related data sets are not available for EM issuers, but that shouldn't discourage issuers or investors. Diligent and proactive engagement can bridge this information gap and help close it in the future.

With the window of opportunity closing to prevent a disorderly low carbon transition, it is time to expand mindsets and access the broad range of tools at our disposal.

Emerging Markets are the missing piece in the climate puzzle and the world cannot afford to leave them behind.

Portfolio Manager Perspectives
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