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After The Inflection Point: How The Climate Challenge Will Transform The Global Economy

The response to climate change, on both the spending and regulatory fronts, will dramatically reshape economic and market outcomes in a way investors can't afford to ignore.

Wellington's Central Macro Team believes climate change is an emerging megatrend that will reshape the global economy, and one that we'll be studying from a variety of perspectives in 2022 and for many years to come. Recent headlines—from deadly flooding in China and Germany to historic wildfires and hurricanes in the US—are adding momentum to the trend.

From a policy perspective, political leaders and societies around the world have made up their minds: The time has come to begin the long, complex process of decarbonizing the economy. While that much is clear, we believe the significance of this macro inflection point, which may lead to massive changes in infrastructure spending, regulation, and geopolitical dynamics, is underappreciated. It'll be decades before we know whether the ultimate objectives of decarbonization are realized, but in the meantime, investors should expect climate change to have ever larger and more material effects on economic growth, the cost of capital, and the performance of a vast range of companies and industries.

In this note, we outline the conclusions from a joint research project that our team, working closely with Wellington's Climate Research Team, conducted on the global, regional, and geopolitical implications of reshaping the world's economic framework for a lower-carbon future.

The Road To Economic Disruption

Looking across our areas of coverage, we see three broad drivers of economic disruption emerging as the efforts to address climate change intensify:

1. Spending

The economic response to climate change will require spending across the public and private sectors in all countries. Public infrastructure spending will most likely change and accelerate, potentially boosting overall investment spending by 1%–2% of GDP. Increased government spending and incentives, along with changing consumer preferences, should, in turn, spur more private-sector spending on innovation and new technology. **FIGURE 1** highlights specific areas of spending focused on mitigating the effects of climate change and adapting to those that can't be avoided.

Insight from sub-adviser, Wellington Management

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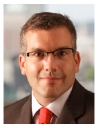
Geopolitical Strategist



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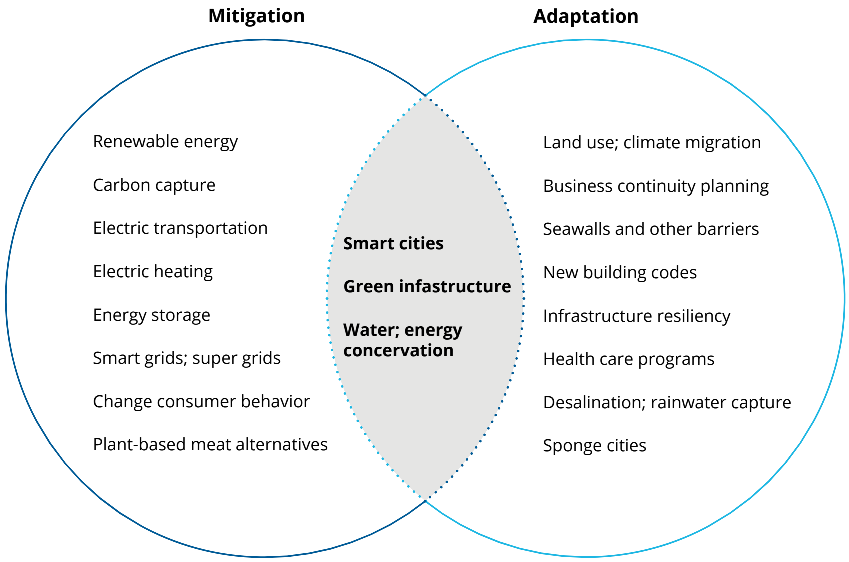
Key Points

- Investors should expect climate change to have ever larger and more material effects on economic growth, the cost of capital, and the performance of a vast range of companies and industries.
- Europe and China are already spending more on green infrastructure, but it may be an important factor in the US as well. Emerging markets may be more challenged to reduce their carbon use.
- Globally speaking, we would expect the impact on GDP and employment over the next decade to be positive, dominated by the rise in capital expenditures.

FIGURE 1
A Spending Inflection Point to Last for Decades
Where will the spending be?

Climate mitigation, adaption, and innovation



For illustrative purposes only. Source: Wellington Management.

Growing resource scarcity may inevitably drive conflict and raise defense spending.

2. Green Finance and Regulation

Finance is changing, and over time all finance may be green. The cost of capital will increase or decrease depending on a company's position on the carbon spectrum. Carbon markets might be directly investable and a significant new financial market whose price may be material to future outcomes for many companies.

We're already seeing the effects on access to capital at the company and project level, and these trends may only intensify. Europe and China are moving in this direction most rapidly, but it may be an important factor in the US as well—particularly at the state and local level where many initiatives are already being launched to foster the roles of a green financial system (i.e., enhancing the return on green investments, reducing the returns on polluting investments, and increasing investor/consumer preference for green choices).

3. Geopolitical Factors

Climate change may trigger resource conflicts and migration globally, while destabilizing countries and regions, particularly in equatorial and nearby areas that are home to many emerging markets and geopolitical hotspots. Over time, the national security narrative and the climate policy narrative may become more intertwined, with a variety of macro and market implications. Growing resource scarcity, for example, may inevitably drive conflict and raise defense spending. On the other hand, adaptive solutions to climate change, such as those highlighted in **FIGURE 1,** may help to prevent mass climate migration and the accompanying political stress.

A Brief Survey Of Our Regional Views

There is strong policy momentum in the US, Europe, and China. But, of course, the specific commitments, policy initiatives, and potential outcomes vary.

US — Climate change is a top priority for the Biden administration, whose goals include net-zero carbon emissions by 2050 and a carbon-free power sector by 2035. The levers to achieve these goals may include increased investment in sustainable and eco-friendly infrastructure, as well as tougher environmental regulations. The infrastructure proposals, including climate-related initiatives, could provide a lift in economic growth of 0.50%–0.75% over the next few years, putting some upward pressure on interest rates. There are risks, as well. For example, the plans mark another step up in federal spending that could contribute to somewhat higher inflation.

Europe — The European Union (EU) joined others in committing to net-zero carbon emissions by 2050. But it didn't stop there, announcing that it would also reduce emissions more aggressively up front—by 55% from 1990 levels by 2030. In agreeing to a new budget framework for 2021–2027 and to the Next Generation EU package, EU leaders committed to focusing 30% of spending on climate-related projects. These commitments are, at least currently, strongly backed by the electorates. Europe may also substantially increase prices/taxes on carbon, reshaping economic incentives, and triggering large declines in carbon-intensive capex and spending, while driving up clean spending.

China — China announced a target of zero net emissions by 2060 and brought forward its peak emissions date to before 2030. The peak emissions pledge wasn't a surprise, as the rate of decarbonization is already at or above the rate of economic growth. The net-zero carbon commitment, however, will require an overhaul of the entire economic structure. The Chinese government plans to tackle this challenge by reworking the national energy structure and increasing energy efficiency; establishing a carbon price and developing a Green Financial System; adopting a framework for environmentally sustainable economic activities; and investing in mitigation, adaptation, and innovation solutions.

A Few Thoughts On Other Emerging Markets

There is great diversity in the energy mix of different emerging markets, with some having broad access to renewables while others have no choice but to burn oil and coal. These and other circumstances will determine the choices and constraints these countries face in addressing climate change. Multilateral institutions such as the World Bank are already considering climate issues in dealing with sovereign debt restructurings, grants, and other types of subsidized lending. And international cooperation will be essential to help incentivize countries to take actions that sometimes can be very expensive in terms of money and opportunity cost.

It seems clear that emerging markets are generally more vulnerable than developed markets given their geographical position, capital stock, the internal distribution of their populations, and the types of economic activity that are dominant. This is unlikely to incentivize mitigation spending, but could significantly raise the need for (and return to) adaptation spending.

International cooperation will be essential to help incentivize countries to decarbonize.

The Economic Big Picture

In coming years, the response to climate change, on both the spending and regulatory fronts, may dramatically reshape economic and market outcomes in a way that investors can't afford to ignore. Globally speaking, we'd expect the impact on GDP and employment over the next decade to be positive, dominated by the rise in capital expenditures. In the longer term, we would prepare for higher energy prices to depress energy-intensive capital expenditures and consumption.

The sustained rise in spending we've described may have strong multiplier effects, lifting investment and income in the global economy. Climate-related geopolitical disruptions may further pressure great-power competition in a variety of regions. Finally, even as the world moves forward with decarbonization, the required infrastructure rebuild may initially (perhaps over the first decade) drive demand for oil higher—and inflation with it. Longer term, rising energy/carbon prices may also have a sustained, direct impact on inflation. That could lead to higher real and nominal interest rates.

For more information about the impact of climate change on the economy, talk to your financial professional.

Important Risks: Investing involves risk, including the possible loss of principal. • Focusing on investments that involve climate change opportunities or sustainable and environmental initiatives may result in foregoing certain investments and underperformance comparative to funds that do not have a similar focus. Foreign investments may be more volatile and less liquid than U.S. investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. • These risks may be greater, and include additional risks, for investments in emerging markets.

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