Private Bank

Europe Strategy

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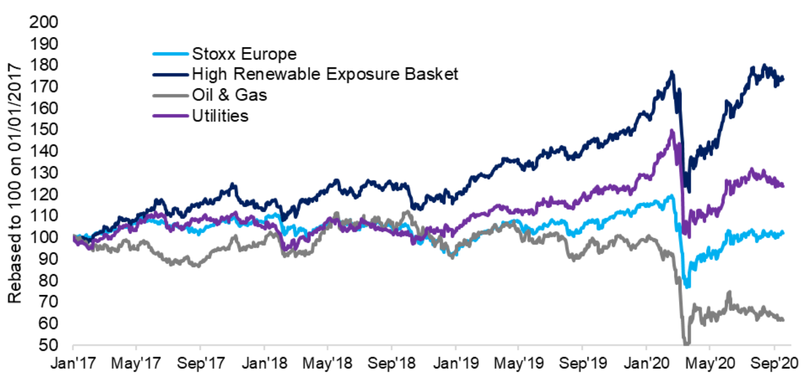
A greener Europe offers compelling investment opportunities

- **Europe continues to drive the global push towards climate change reform.** In February we highlighted the compelling investment opportunity surrounding the EU's push to achieve zero net carbon emissions by 2050, through their Green Deal initiative. The European Commission have recently given further impetus to the initiative, increasing the carbon emission reduction target to 55% by 2030 (from 40%).
- **The €750bn EU Recovery Fund will have a green emphasis, in terms of both the focus of expenditure as well as on fundraising.** Regarding the latter, the EU leaders are promising 30% of all debt raised will be through green bonds. Of the $255bn of global green issuance last year, the EU led the way with issuance of $107bn.
- **The green theme will grow in prominence.** Even while companies within the renewable energy space may face some idiosyncratic headwinds, this should be more than offset by greater governmental focus and funding availability, declining fixed costs, increased investor awareness and rising passive fund inflows.
- **This shift towards a greener Europe continues to offer a compelling equity investment opportunity.** Our European focused clean energy basket has delivered an annualized return of 16% since the beginning of 2017, outperforming broader Europe (0.5% annualized). Despite Covid volatility, the basket has also outperformed broader European equities by 29% year-to-date and by 17% since our initial note on February 6th **– figure 1.**

Figure 1: High renewable exposure basket outperformance (1st Jan 2017 to 18th Sept 2020)



Source: Bloomberg as of September 18th 2020. The basket reflects an equally weighted basket (excluding dividend reinvestment) of Enel, Ibedrola, Orsted, E.on, Fortum oyj, Vestas Wind, RWE, EDP, Atlas Copco, Cez, Siemens Gamesa Renewable Energy and Alfa Laval. **Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results, and future results may not meet our expectations due to a variety of economic, market and other factors. Real results may vary. This is neither a solicition to buy nor a recommendation to sell any of the aforementioned securities.** Utilities = Stoxx Europe 600 Utilities Index, Oil & Gas = Stoxx Europe 600 Oil & Gas Index**.**

EU green deal and EU recovery fund accelerate the trend towards a cleaner Europe

EU Green Policy

As we highlighted earlier this year ([A Cleaner Way to Play European Equities](#)), Europe has been the driver behind the global push towards a greener future. This is significant for two reasons. Firstly it establishes Europe's prominence at the forefront of the global energy revolution, and secondly it supports the long-term green capital allocation towards Europe. Within this note we look further at the EU green deal, the EU recovery fund, the growth of the green bond universe, and green equity investment opportunities.

The EU's climate and energy governance is focused around three key pillars. These are (1) a reduction in greenhouse gas emission from 1990 levels, (2) increasing the share of renewable energy in final energy consumption, and (3) improving overall energy efficiency, such as in cars, public transport and in homes. The EU green deal will see an acceleration in attempting to achieve these targets and a move by Europe towards a cleaner footprint.

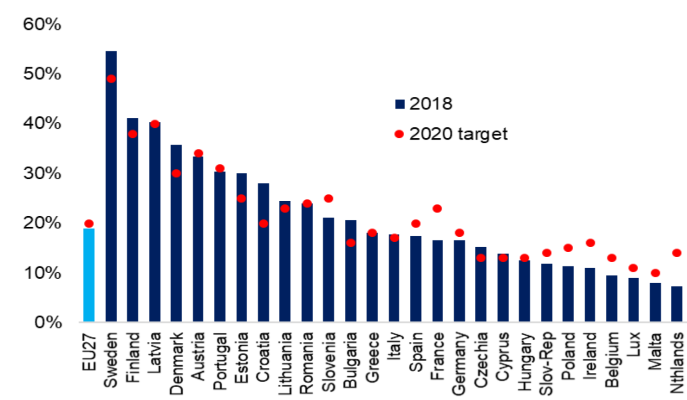
The EU is targeting to reach 20% of its energy from renewable sources by end of 2020 and at least 32% by 2030. In 2018, 18% of overall energy across the EU came from renewable sources – **figure 3.** This is double the 8.5% achieved in 2004. Sweden currently has the highest renewable energy share at 55%, followed by Finland (41%) and Latvia (40%), while Netherlands, Malta, Luxembourg and Belgium were all sub-10%. Netherlands and France also showed the largest distance from their goals.

EU Green Deal

To supplement this further, the EU Green Deal is a broad set of policy initiatives announced in late 2019, intended to further support achieving carbon neutrality by EU member states by 2050. The plan also included potential carbon tariffs for countries that don't reduce their greenhouse gas pollution at the sufficient rate. Last week, European Commission President Ursula von der Leyen further accelerated the EU's carbon emission reduction targets for 2030 from the existing 40% to at least 55% of 1990 levels **- figure 2**. Carbon prices have already reached 14-year highs at the prospect of tougher carbon emission restrictions.

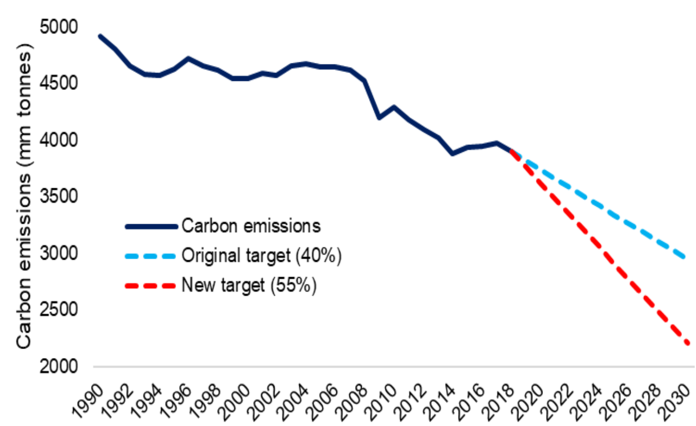
The EU Green Deal will still face obstacles. In addition to legal, political and economic challenges, the plan needs to be approved by all EU27 member nations, with countries such as Poland already voicing concerns over how the additional investment will be funded. Ambitious carbon reduction targets will also need to be accompanied by equally ambitious funding commitments. While the European Commission have committed €1 trillion worth of investment until 2030, the Commission's own estimates suggest around €3 billion will be necessary to meet targets. Additionally of the €1 trillion, €503 billion will come from the EU budget, €114 billion from national governments and the following €279 billion mostly from the private sector.

Figure 2: Share of energy from renewable sources (%)



Source: European Environment Agency ,Eurostat as of 2019

Figure 3: Ambitious EU carbon emission targets



EU Recovery Fund

The recently announced [€750bn EU Recovery Fund] has a heavy emphasis on fighting climate change. Adding green restrictions and targets to the fund's mandate also takes added significance as the European Commission try to level the playing field between richer and poorer EU nations where all nations set the same targets.

Key green points from the recovery fund are:

1. **Green bonds:** The European Commission are exploring the issuance of green bonds as part of the EU Recovery Fund, with EU leaders promising 30% of all debt raised will be through green bonds (approximately €225bn).

2. **All spending must also contribute to EU emission-cutting goals**: spending will be guided by a sustainable finance taxonomy which aims to direct private funding into technologies that contribute to at least one of six environmental objectives.

3. **Just Transition Fund:** The €17.5 billion fund is designed to support EU member nations with the highest dependency on fossil fuels, supporting their green transition. While all member nations are eligible for funding, resources will be focused on nations facing the largest challenges.

4. **Green Taxes:** A number of EU-wide green taxes are being considered in order to support repayment of the recovery fund borrowing. These include a non-recyclable plastics tax which will apply from January 2021. There are possible further taxes such as an increase in carbon emission taxes and a carbon border adjustment tax, which would get charged on imports from a nation that does not meet the EU's stringent targets.

Growing Green Bond Universe

Green bonds are an alternative method of raising capital for environmentally friendly purposes, and have also boomed as potential investments in recent years. According to Moody's rating agency, green issuance globally totalled $255bn in 2019, up over 50% from 2018 and up from less than $1bn a decade ago **– figure 4**. This number is set to exceed $350bn in 2020 and is expected to reach the $1trillion mark in early 2020's.

The EU was the largest issuer in 2019 with $107bn of green issuance, followed by the US at $51bn and China at $30bn. Countries such as Germany, France, Poland, Ireland, Netherlands and Sweden have all issued recently issued green bonds, with Germany's first green issuance in early September being in excess of 5 times oversubscribed. In terms of the projects financed by green bonds issuance in 2019, renewable energy and green buildings hold the largest share at 31% and 29% respectively **– figure 5.**

Figure 4: Global green bond issuance by year ($bn)

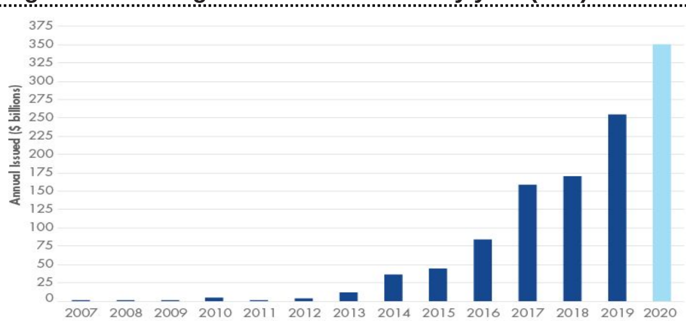
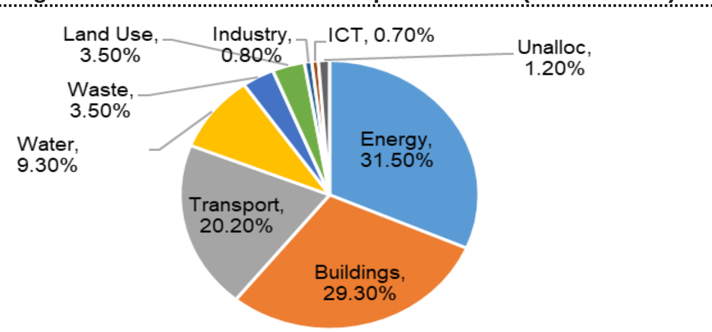


Figure 5: Green bond and loan proceed use (% total 2019)



Source: Climate Bonds Initiative as of Q1 2020. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For illustrative purposes only.'

Getting equity exposure to the green trend

In addition to solely renewable focused companies, the **European Commission have suggested nearly half of green deal capital expenditures could take place in the utilities space**. This heightened investment could go into upgrading solar and wind capacity, improving power grids and expanding charging stations. With investment set to rise from the existing €1 trillion over the next decade, utility companies could benefit from greater investment, better capital expenditure visibility and improved earnings profiles. The utilities market could also see consolidation as scalability rises in importance.

The EU Green deal and the EU Recovery Fund should drive increased investment within the clean energy sector. In February we highlighted our preferred basket of clean energy shares, which demonstrated exposure to some of the most exposed names within the European renewable space. Our favoured sub-themes included: (1) solar energy (2) wind energy, (3) hydro energy, (4) energy efficiency, (5) energy storage and (6) smart grids.

Since February 6th, our equally-weighted basket of our European clean energy companies has outperformed broader Europe by 19%. Taking a longer term view, since early 2017 our basket has returned 74% (16.1% annualised), outperforming broader European equities which are only up 2% (0.6% annualised). Since the beginning of 2020, the basket has outperformed Europe by 29% (shown in the earlier **figure 1**).

Despite the strong returns thus far, we believe outperformance and investment within this space is only beginning. The next decade is projected to see approximately $1 trillion worth of investment, with this number set to increase. Investors should allocate to this "Unstoppable Trend" in Europe for the long-term.

Asset Allocation Definitions

Asset classes	Benchmarked against
Global equities	MSCI All Country World Index, which represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.
Global bonds	Bloomberg Barclays Capital Multiverse (Hedged) Index, which contains the government -related portion of the Multiverse Index, and accounts for approximately 14% of the larger index.
Hedge funds	HFRX Global Hedge Fund Index, which is designed to be representative of the overall composition of the hedge fund universe. It comprises all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.
Commodities	Dow Jones-UBS Commodity Index, which is composed of futures contracts on physical commodities traded on US exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The major commodity sectors are represented including energy, petroleum, precious metals, industrial metals, grains, livestock, softs, agriculture and ex-energy. The Thomson Reuters / Core Commodity Index is designed to provide timely and accurate representation of a long-only, broadly diversified investment in commodities through a transparent and disciplined calculation methodology.
Cash	Three-month LIBOR, which is the interest rates that banks charge each other in the international inter-bank market for three-month loans (usually denominated in Eurodollars).

Equities	
Developed market large cap	MSCI World Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in 23 developed markets. Large cap is defined as stocks representing roughly 70% of each market's capitalization.
All Country Ex US	MSCI All Country ex US, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in all countries excluding the US.
US	Standard & Poor's 500 Index, which is a capitalization-weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.
Europe ex UK	MSCI Europe ex UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in each of Europe's developed markets, except for the UK
Eurozone	Euro Stoxx 50 is a stock index of large cap Eurozone stocks. It's aim is to measure the performance of 50 of the largest Eurozone domiciled stocks.
Emerging Markets	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure stock performance 24 Emerging Market countries.
UK	MSCI UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in the UK
Japan	MSCI Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in Japan.
Asia Pacific ex Japan	MSCI Asia Pacific ex Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the performance of large cap stocks in Australia, Hong Kong, New Zealand and Singapore.
Developed market small and mid-cap (SMID)	MSCI World Small Cap Index, which is a capitalization-weighted index that measures small cap stock performance in 23 developed equity markets.
Emerging market	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure equity market performance of 22 emerging markets.

Bonds	
Developed sovereign	Citi World Government Bond Index (WGBI), which consists of the major global investment grade government bond markets and is composed of sovereign debt, denominated in the domestic currency. To join the WGBI, the market must satisfy size, credit and barriers-to-entry requirements. In order to ensure that the WGBI remains an investment grade benchmark, a minimum credit quality of BBB–/Baa3 by either S&P or Moody's is imposed. The index is rebalanced monthly.
Emerging sovereign	Citi Emerging Market Sovereign Bond Index (ESBI), which includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.
Supranationals	Citi World Broad Investment Grade Index (WBIG)—Government Related, which is a subsector of the WBIG. The index includes fixed rate investment grade agency, supranational and regional government debt, denominated in the domestic currency. The index is rebalanced monthly.
Corporate investment grade	Citi World Broad Investment Grade Index (WBIG)—Corporate, which is a subsector of the WBIG. The index includes fixed rate global investment grade corporate debt within the finance, industrial and utility sectors, denominated in the domestic currency. The index is rebalanced monthly.
Corporate high yield	Bloomberg Barclays Global High Yield Corporate Index. Provides a broad-based measure of the global high yield fixed income markets. It is also a component of the Multiverse Index and the Global Aggregate Index.

Securitized	Citi World Broad Investment Grade Index (WBIG)—Securitized, which is a subsector of the WBIG. The index includes global investment grade collateralized debt denominated in the domestic currency, including mortgage -backed securities, covered bonds (Pfandbriefe) and asset-backed securities. The index is rebalanced monthly.

Other miscellaneous definitions	
Asset Backed Securities (ABS)	A security whose income payments and hence value are derived from and collateralized (or "backed") by a specified pool of underlying assets such as consumer credit card debt or auto loans.
Commercial Mortgage Backed Securities (CMBS)	Commercial mortgage-backed securities (CMBS) are a type of mortgage-backed security that is secured by mortgages on commercial properties, instead of residential real estate.
High Yield Corporate Bonds (HY)	High yield corporate bonds are bonds with a credit rating less than BBB- (S&P) or Baa3 (Moody's), and are debt securities issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations.
Investment Grade Corporate Bonds (IG)	Investment grade corporate bonds are bonds with a credit rating equal to or above BBB- (S&P) or Baa3 (Moody's), and are debt securities issued by a corporation and sold to investors. The backing for the bond is usually the payment ability of the company, which is typically money to be earned from future operations.

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Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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