CARBON PRICES HEATING UP AS MERCURY RISES

Nitesh Shah – Head of Commodities and Macroeconomic Research, WisdomTree Europe
19 Aug 2019

The bear market in carbon futures[1] ended in 2017, with carbon futures posting a 375% cumulative gain between July 2017 and July 2019. Carbon thus ranks the best performing commodity over the past two years, surpassing rallies in palladium, oil and gold which have grabbed the headlines of late. As a lesser known commodity future, carbon has been flying under the radar for most investors. As global temperatures rise, the European Union - a signatory of the Paris Accord ¬– is likely to double-down efforts to thwart rising green-house gas emissions.

Carbon has recovered from a low base. Since the European Union's Emissions Trading System (EU ETS) was launched in 2005, calibrating the number of permits for polluting activity (allowances) has been a difficult task. A crash in carbon prices from over EUR30/tonne in 2008 to under EUR5/tonne in 2013 set in motion a bear market that lasted close to eight years. The Great Financial Crisis may have started the crash, but the European economy had long since recovered, while the price of carbon had languished due to an oversupply of allowances. That explains why the EU has been doubling down on its efforts to tighten allowance availability. The EU has been cutting the supply of allowances by 1.74% per annum since Phase 3 of the programme began in 2013. As the EU ETS enters Phase 4 of the programme in 2021, allowances will be reduced by 2.2% until 2030.

Figure 1: Historical Performance of Carbon Futures

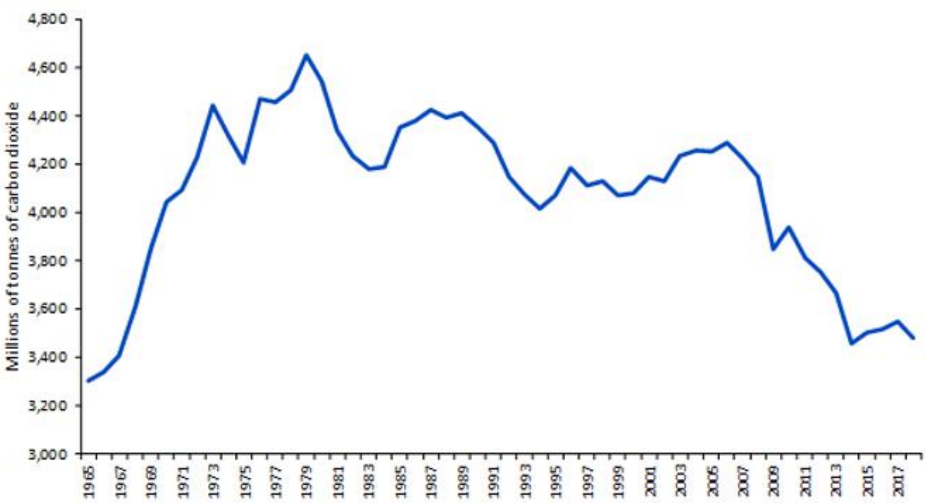
Source: Bloomberg, WisdomTree, data available as of close 09 August 2019.

Historical performance is not an indication of future performance and any

investments may go down in value.

As an economic recovery has taken place, polluting activity has been rising. As data from BP highlights, carbon emissions had been rising in the region between 2013 and 2017. Progress in curtailing harmful gasses in the atmosphere had thus been disappointing. To ensure continued decline in emissions the more aggressive cuts in allowances under Phase 4 is vital.

Figure 2: European Union carbon dioxide emissions



Source: BP, WisdomTree, data available as of close 03 August 2019.

With the EU having signed up to the Paris Accord – an agreement that promises to limit global temperature gains to 2 degrees Celsius[2] – the EU is under pressure to do more. The European Commission (EC) is akin to the European Central Bank - but instead of managing the money supply to target a level of inflation - it is responsible for adjusting the carbon allowances under the EU ETS to target the appropriate level of carbon and other emissions to limit temperature gains. However, there is one clear difference we see – the EC will not be loosening policy in the near future - because the target itself is likely to get more aggressive unlike the inflation target which has not changed since it became a concept. We see policy tightening in the EU ETS for the foreseeable future.

With the EC under new leadership, the market is convinced the administrative institution will maintain policy stability to continue with its emissions tightening programme.

There are risks which can't be ignored:

1. Brexit – the EU ETS currently relies on the UK's participation. What happens if the UK leaves the system in a disorderly fashion? Would allowances held by UK institutions flood into the market?
2. Will rising populism - à la Gilets jaunes[3] - reject the basis of climate management for the pursuit of cheaper energy? Will governments continue to neglect those who feel left out from the past 10 years of asset reflation? If so, will climate goals continue to be the scapegoat for declining living standards for the less skilled and economically marginalised?

There are clear mitigants:

1. Brexit contingency planning has already begun. The UK government claims it is firmly committed to its international climate change agreements and thus is unlikely to exit in a manner that will undermine the EU ETS system.
2. Equally likely is a 'green uprising'. The recent EU elections saw Greens take the highest votes in Berlin, Dublin and Brussels. Some political commentators predict that Greens will become "kingmakers" in the decision process. That is likely to keep environmental policies high on the agenda.

Carbon future prices have always been subject to policy decisions and we don't expect a break from the past, but we believe the policy inertia at this point is highly supportive for further gains as the European Union has set its sights on higher environmental outcomes.

Source

1 Intercontinental Exchange EU Allowance Futures that allow for entitlement to emit one tonne of carbon dioxide equivalent gas

2 The Paris Agreement's central aim is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius.

3 A protest movement that began in 2018 in France that was motivated by rising fuel prices, a high cost of living and claim that a disproportionate amount of government tax reform falls on the working middle class.

Related blogs

+ 40 Years of fraught US-Iran tension in the Persian Gulf plays on
+ Platinum's turn to shine in 2019

View the online version of this article here.

Important Information

Marketing communications issued in the European Economic Area ("EEA"): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as "WisdomTree" (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.