

**The Absolute
Return Letter**



December 2021

COP25½

“Climate change is not just about CO₂ levels and melting polar ice caps. It is about our public health and protecting our Earth for future generations.”

Mike Quigley, US Congressman

Why COP26 was only a limited success

Hotels, on average, require 80-85% of rooms to be occupied at any point in time to break even. For the airline industry, a similar calculation is more complex, as the amount of cargo onboard has a major impact on the bottom line, but my usually well-informed airline source tells me that the average commercial plane needs to be about 70% full for a flight to break even.

Now, think of the global fleet of 1.5 billion passenger cars. Habits obviously vary, but a fairly reliable worldwide estimate is that the average car stands still about 22 hours every day, meaning that the utilisation rate is only 5-10%. If one were to apply the same logic to passenger cars as one does to hotels or commercial aircraft, you don’t need to be as smart as Einstein to realise that owning a car is bad business.

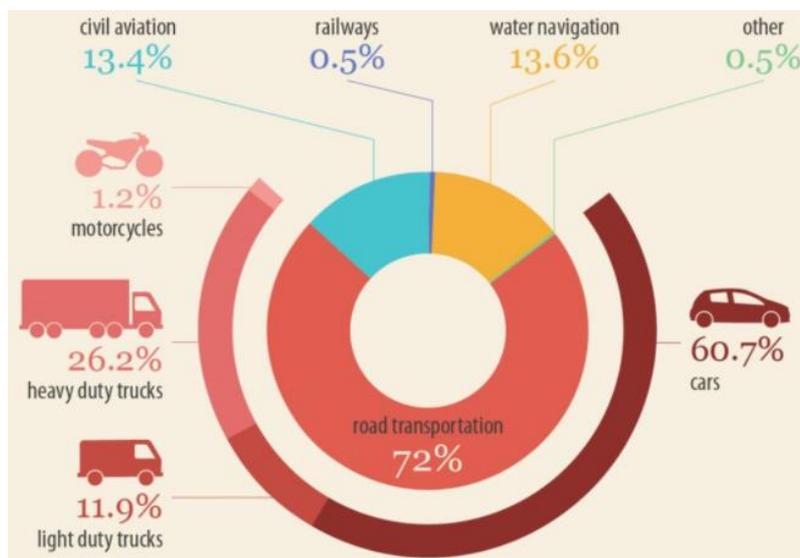


Exhibit 1: CO₂ emissions breakdown by transport mode, EU 2016

Source: [European Environment Agency](#)

Let's add Glasgow and COP26 to the equation. Despite standing still all those hours every day, passenger cars still account for over 60% of all CO₂ emissions coming from road transport in the EU (see Exhibit 1). Road transport accounts for 72% of all transport emissions which again account for nearly 30% of all CO₂ emissions in the EU, i.e. passenger cars make a meaningful contribution to the CO₂ problem in Europe despite being on the road less than 10% of the time. I don't have similar numbers from other parts of the world but cannot imagine they are dramatically different.

You may argue that the problem will gradually go away as more electric vehicles (EVs) are introduced. However, an uncomfortably high percentage of all EVs run on electricity from coal-fired power plants, and those EVs actually pollute more than modern petrol and diesel cars do. The other day, I came across a term I have never heard before. EVs that run on coal-generated electricity are now called EEVs – Emission Elsewhere Vehicles. I think that sums up the problem quite nicely!

In the context of COP26, this is relevant, as China and India refused to enter into any agreement that would force them to shut down their coal-fired power stations anytime soon. China only agreed to a complete phaseout by 2060 and India by 2070. Imagine what will happen to emission levels if car ownership becomes as popular in China as it is across the OECD (see Exhibit 2).

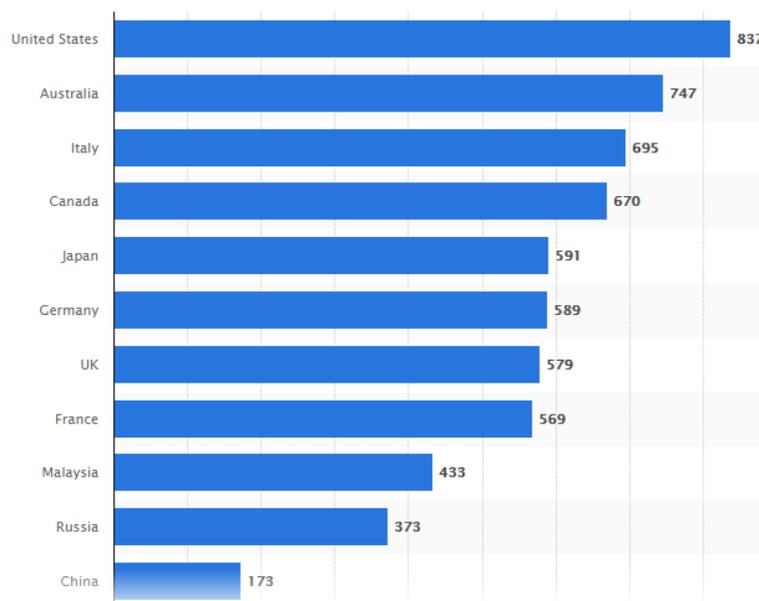


Exhibit 2: Number of passenger cars per 1,000 inhabitants

Source: Statista

Quite fortunately, there is rising evidence that young people, at least in the OECD, take a different approach to car ownership. Fewer young people own a car and, even more importantly, fewer even bother to have a driving license these days. Instead, young people increasingly look at cars as a mobility tool which can be shared and/or rented when needed. This attitude will benefit not only their wallets but also Mother Nature.

Unfortunately, to many in EM countries, owning your own car is still an aspiration, just like it was in our part of the world not that many years ago. As you can see in Exhibit 2, the most motorized major country in the world – the United States of America – has more than 800 passenger cars per 1,000 inhabitants. I should add that car ownership in New Zealand and in one or two other countries not included in Exhibit 2 is even more widespread than it is in the US.

Now, compare that number to car ownership in China. As you can see, with only 173 cars per 1,000 inhabitants, China has a long way to go before Western standards are reached – a worrying fact considering how big a problem the Chinese already have with greenhouse gas (GHG) emissions.

The combination of rising living standards throughout the EM world (rising living standards result in more cars on the road) and the failure in Glasgow to reach a worldwide agreement on the use of coal in power plants can only result in higher GHG emissions. Those ARP+ subscribers who have read our recent climate paper called [The Many Challenges of Going Green](#) will know why we think CO₂ levels will continue to rise for at least another 200 years.

Given that outlook, I can only reach one conclusion. Anyone who continues to argue that we still have a reasonable shot at limiting the temperature rise to 1.5°C when compared to pre-industrial times will go over in history as laughingstock. In this month's Absolute Return Letter, I will take a closer look at COP26. In that context, I should point out that subscribers to ARP+ should take a look (if they haven't already done so) at part III of our strategy paper on climate change, which we have just published. In there, we provide much more detail as to how to structure a climate change portfolio.

The coal dilemma

Despite all the challenges in Glasgow, to characterise the summit as a fiasco is not fair. Several results were achieved, which I will come back to in a moment, but allow me to start with the failure to reach a worldwide agreement on coal, as that was one of the most important objectives of the summit.

Coal is by far the most polluting of the three fossil fuels used when generating electricity in power stations around the world (the others being gas and oil). Worldwide, there are about 8,500 coal-fired power stations, generating about one-third of the world's electricity. Coal-fired power stations typically emit over 10 giga tonnes of CO₂ every year, which is about 20% of total GHG emissions worldwide. Eliminating the use of coal would therefore have had a meaningful impact on GHG emissions.

When countries like India and China refused to enter into an agreement that would force them to shut down their coal-fired power stations in the foreseeable future, it is easy for the wealthier nations to play the blame game. Having said that, despite the obvious damage to the environment from fossil fuels, I find it hard not to have some sympathy for the argument that the rich countries only got to where they are today by scrupulously exploiting fossil fuels. By denying countries like India and China access to those same fuels, the rich world is effectively establishing a barrier which will make it harder for many EM countries to join the DM 'club'.

The main results achieved in Glasgow

(In the following section on the results achieved in Glasgow, I have used [Chatham House](#) and [American Action Forum](#) as my two main sources.)

Despite not being able to persuade India and China to discontinue the use of coal anytime soon, some significant results – on coal as well – were still achieved in Glasgow. Most importantly, over 40 countries committed to phasing out coal-fired power plants, and over 30 countries agreed to stop all international financing of fossil fuel projects. China, for example, agreed to stop financing the construction of coal power stations abroad.

In addition to that, about 20 countries – including the US, which may spell problems for the shale industry – pledged to stop all domestic, public financing of unabated oil and gas projects as early as next year. The pledge still allows countries to grant certain exemptions and to fund projects that employ carbon capture technologies (more on that later). Those exemptions reflect the world's continued reliance on the internal combustion engine.

This is a significant turning point as far as the global attitude towards fossil fuels is concerned. It is actually the first time *ever* that fossil fuels are specifically referred to in the final COP communique – the so-called GCP (the Glasgow Climate Pact). With the launch of *Beyond Oil and Gas Alliance*, it is obvious that the penny has finally dropped; that there is a desperate need for decisive action on oil, gas and coal.

Furthermore, each and every country attending in Glasgow agreed to revisit their emissions targets for 2030, which are published in the so-called NDCs (Nationally Determined Contributions). At present, about 80% of global emissions are covered by NDCs. You can read more about the global ‘portfolio’ of NDCs [here](#).

More specifically, the US committed to lifting tariffs on aluminium and steel produced in the EU, which is less carbon intensive than similar products produced in China. Tariffs remain in place for other producers, including China, reflecting the Biden Administration’s desire to incorporate climate policy in international trade. The US and EU also launched the Global Methane Pledge – a pledge to reduce global methane emissions by at least 30% by 2030 from 2020 levels. Over 100 countries joined that pledge.

Finally, more than 100 countries committed to reforestation. Twelve wealthy nations committed to providing \$12Bn through 2025 to address deforestation in the developing world. That sounds great, but I should point out that, despite a similar agreement having been reached in 2014, deforestation has continued as if no such agreement was ever made.

The overall verdict on COP26

Many commentators have argued that, despite the results in Glasgow, not enough was achieved to reduce emissions levels enough to avoid dangerous climate change in the years to come. Previous COP summits have been long on pledges but short on action, the critics say. COP26 was perhaps a bit better, but was it enough? Governments all over the world need to demonstrate much more commitment and determination if we are going to stand a chance of keeping the temperature rise at tolerable levels, the critics argue.

I should also point out that, although all participating countries agreed to the GCP, there is no enforcement mechanisms built in. Therefore, the GCP serves only as a diplomatic tool to benchmark each country’s efforts. Those efforts have largely failed so far, highlighting the need for much more decisive action. Allow me to make one observation to highlight that issue. I would argue that the reductions in emissions from power stations over the past decade should not be attributed to policy implementation but rather to market forces. Due to improved techniques and relatively low prices, natural gas has replaced coal in many power stations, thereby reducing the quantity of GHGs. Government involvement? None!

What does it all mean?

As we have seen over the past 12 months on both sides of the Atlantic, climate change is already causing much devastation, and it is becoming increasingly clear that dramatic and unprecedented action shall be required to avoid the most disastrous implications. If we assume all current government targets (NDCs) are followed – and they rarely are – an increase in average temperatures of 2.2-2.7°C by the end of the century is already ‘baked in’ (see Exhibit 3). In other words, *much more* is needed.

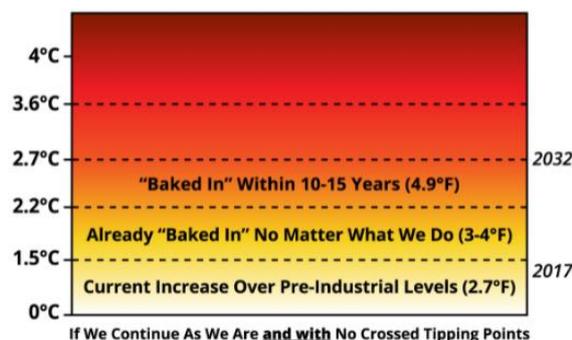


Exhibit 3: ‘Baked-in’ rise in global average temperature

Source: [Job One for Humanity](#)

According to the GCP, governments *must* raise the ambition level of their NDCs substantially before the end of 2022. They committed to that in Glasgow but, as we have seen so often before, pledges are ignored more often than not. With that in mind, a tool set to hold governments to account is required for COP26 to stand any chance to go down in history as a true turning point.

What should investors do?

An obvious implication of all of this is that the next few years (possibly more than a few) will be very bumpy. On the negative side, the occasional natural disaster – whether linked to climate change or not – will serve as a painful reminder that we are on track for something truly gruesome unless drastic action is taken. On the positive side, the invention of new technologies and new techniques will, from time to time, drive up enthusiasm. Therefore, my first conclusion is that climate change will result in rising volatility.

My second conclusion is that, despite fossil fuels being phased out over the next 30-40 years, fossil fuel prices will probably appreciate as a result of all of this. This may not make much sense to you, so allow me to explain. Total fossil fuel output has always been closely tied to capex levels in the energy industry. With capex being dramatically reduced in almost all countries outside of OPEC at present, I expect energy, and oil in particular, to be in short supply over the next few years. Therefore, although I expect oil to go to \$0 eventually, I wouldn't be at all surprised if we hit \$150 before we hit \$0.

My third and final conclusion is about technology. Reforestation and other well-meaning projects do little to fix this problem. The only viable solution is carbon capture at scale, which shall require a technology that does not yet exist. Net zero CO₂ emissions sounds like a solid solution but will do little to fix the problem. Only capturing and destroying a meaningful amount of already existing CO₂ will have a noticeable impact on the average temperature. Why is that?

CO₂ emitted into the atmosphere takes hundreds of years to disappear again. Therefore, it is really cumulative CO₂ emissions one should worry about – not current emission levels. To reduce cumulative emissions, unless you have hundreds of years to fix the problem, only carbon capture will work. As you can see in Exhibit 4 below, there is a very powerful relationship between the overall CO₂ level (i.e. cumulative emissions) and the global, average temperature, hence why we *must* bring the overall CO₂ level down – not just stop new emissions from happening.

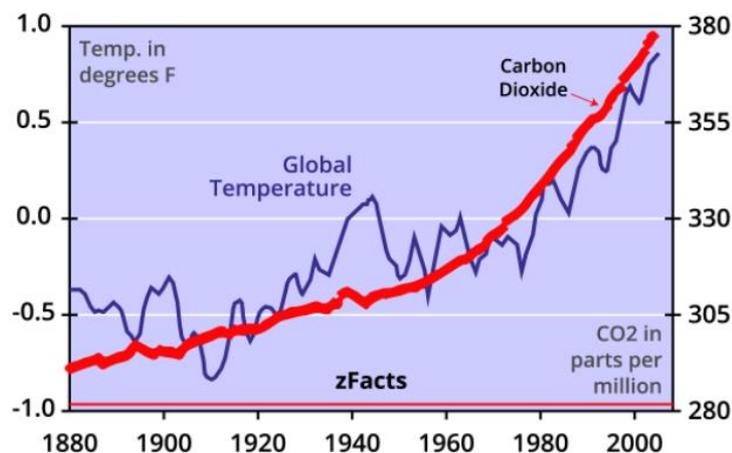


Exhibit 4: CO₂ vs. global temperature

Source: [Job One for Humanity](#)

I cannot tell you which technology you should invest in, as I don't know (yet). In fact, nobody does. That said, I *can* promise you that if you are an early-stage investor in the first company to roll out a viable carbon capture technology, you will probably earn a higher return than you have ever earned before.

With those optimistic words, I wish you and your family a Happy Christmas whether you celebrate it or not. I will spend both Christmas and New Year in Denmark as I do most years and then come back early in the New Year with the first Absolute Return Letter of 2022, containing my expectations for next year. Until then, stay safe!

Niels C. Jensen

1 December 2021

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