A wild two weeks for the world, and for carbon credits

Investment Team

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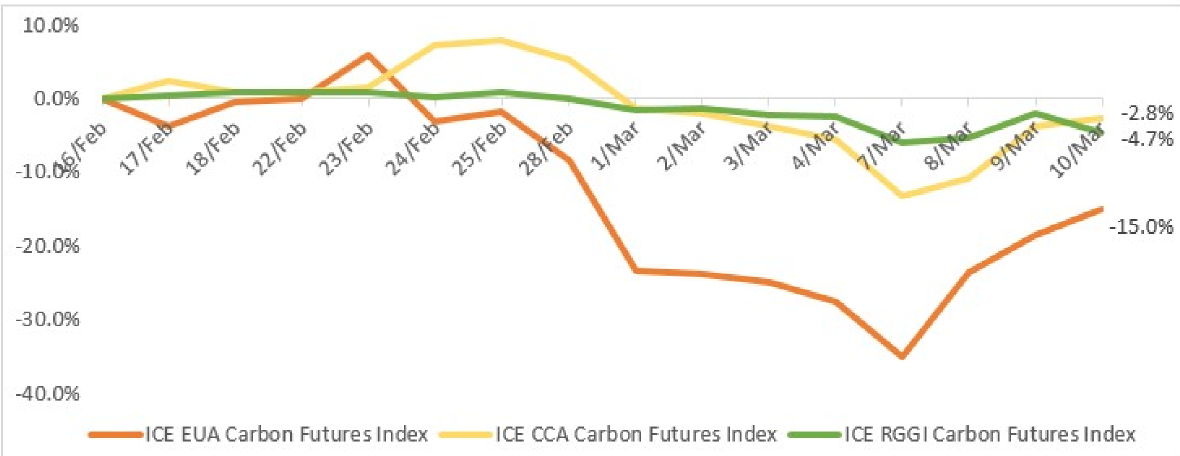
On February 24th 2022, the world watched in horror as Russia launched a full-scale military invasion of Ukraine. Over the next two weeks, the European Union Carbon Allowance (the "EUA"), the most liquid carbon credit market in the world, lost more than a third of its value. The California Carbon Allowance (the "CCA"), the second largest carbon credit market globally and the biggest in North America, posted a 14% loss during the same period.

It is worth noting that the EUA and CCA bounced back by 31% and 12% respectively over the three-day period between March 8th and March 10th. While short-term volatility remains extreme reflecting the threat that Russian's invasion of Ukraine represents to the global economy, we reiterate our view, however, that carbon pricing remains significantly below levels necessary to incentivize the meaningful changes required to achieve climate goals, and that the long-term fundamentals for the carbon credit market remain very bullish overall.

Figure 1: Cumulative Returns (Feb 16 - Mar 10)

Global Carbon Markets



Source: Bloomberg

The energy & carbon correlation

Traditionally, carbon credits are mildly positively correlated with fossil fuel prices and commodities. The logic is that increased gas prices encourage companies to switch to high carbon emitting fuels such as coal and, as a result, increase demand for carbon credits. Since Russia's invasion, the world stands on the cusp of an energy supply crisis. Despite the record high fossil fuel prices, the cost to emit carbon has seen a significant pullback. What happened?

Figure 2: Traditionally, carbon credits are weakly positively correlated with crude oil and commodities

	Carbon Credits	US Equities	International Equities	Bonds	Real Estate	Commodities	Crude Oil	Gold
Carbon Credits	1.00							
US Equities	0.27	1.00						
International Equities	0.25	0.56	1.00					
Bonds	-0.03	-0.19	-0.07	1.00				
Real Estate	0.25	0.76	0.47	-0.01	1.00			
Commodities	0.25	0.40	0.40	-0.14	0.30	1.00		
Crude Oil	0.19	0.32	0.27	-0.10	0.23	0.91	1.00	
Gold	0.10	0.16	0.23	0.23	0.20	0.11	0.05	1.00

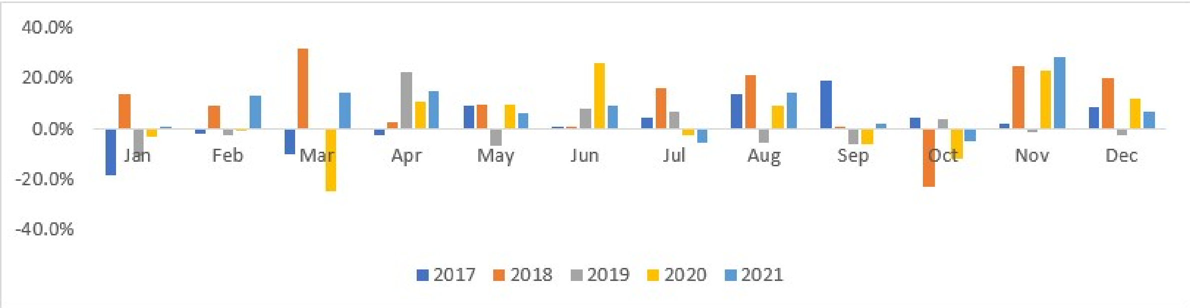
Source: Bloomberg

Russia upsets the applecart

There are several possible reasons for the recent price decline: investors seeking liquidity in volatile market environments like the one what we are currently in, international investors could be offloading European assets, there are reports that some market participants may have been forced to sell EUA to avoid margin calls caused by losses from soaring energy prices, certain countries (such as Poland) are calling for a reform of the EUA system and stop losses could be triggered as a result of all the above. Although selling pressure has been significant, the recent price movement further reinforced the fact that carbon credit futures can increasingly be considered a liquid asset class.

On the fundamental side, early spring has traditionally been a weak season for carbon credits as winter-driven heating and power generation fade. In addition, there are fears that the invasion could cause certain industries to reduce economic activity, leading to lower demand for carbon credits.

Figure 3: Monthly EUA Return Performance 2017 - 2021



Source: Bloomberg

Are financial market participants truly to blame?

Financial market participants are increasingly blamed for the volatility in the carbon credit price. However, according to Carbon Pulse, which quoted a report by European Securities and Markets Authority (ESMA), the EU's securities market regulator - “speculative” activity only accounts for around 4% of activity in the EU ETS market. According to the Carbon Pulse analysis, *"A high carbon price, combined with reduced volatility and more predictability and transparency, is fundamental to drive industrial decarbonisation. Ideally, carbon prices should rise steadily, without sudden spikes. But blaming financial speculation, the ETS, and climate policy for spiralling energy bills is disingenuous and unhelpful. If anything, high energy prices reflect a historic failure to decarbonise rapidly enough, leaving us dependent on volatile fossil fuel supplies…It is of utmost importance that* *the EU sets a high standard with its revision of the ETS, for a stable carbon market that encourages and enables industry to rapidly decarbonise, and that prepares the continent for the climate challenges ahead.*[1]*"*

We believe that financial market participation is essential to drive the true price discovery of the carbon market. Ultimately, a stronger, more liquid carbon price incentivizes businesses to discover more sustainable business models and encourages everyone to be part of the energy transition solution.

No change to the fundamentals

Within the EU, the possibility of the EU pausing the emissions trading system in order to address near term growth risks caused by the war has become a discussion point. Amid EU's dependence of Russian fossil fuels, Ursula von der Leyen, the President of the European Commission, reinforced the importance of EU Green Deal in her Twitter post on March 8th - an important component of the EU Green Deal is the strengthening of the existing emissions trading system. As the region focuses on energy security, a delay in the talks to strengthen the emission trading system is possible, but a cancellation is unlikely.

Figure 4: Twitter quote from Ursula von der Leyen on March 8

Source: Twitter

Furthermore, April 30, 2022 is the EU compliance deadline for surrendering sufficient carbon allowances against 2021 verified emissions. At the current lower carbon price, we see compliance buyers taking advantage to manage their compliance needs.

In North America, the long-term fundamentals remain strong. We continue to believe that an orderly energy transition, one supported by incentives like cap-and-trade programs, will sustain Canada's position as an energy superpower and leader in the clean energy transition. The investment community has an increasingly fundamental role in helping to achieve net-zero goals.

Why Ninepoint Carbon Credit ETF?

For an emerging asset class like carbon credit, volatility management is at the heart of our fund strategy. At the moment, the Ninepoint Carbon Credit ETF invests equally in the three major ETS markets globally with quarterly rebalancing. This strategy has demonstrated remarkable resilience in the unprecedented carbon market volatility.

Figure 5: Performance of Major Carbon Markets (Feb 16 - Mar 10)

	Cumulative Return (Feb 16 - Mar 10)	Daily Volatility (Feb 16 – Mar 10)
ICE EUA Carbon Futures Index (ER)	-15.0%	7.9%
ICE CCA Carbon Futures Index (ER)	-2.8%	3.9%
ICE RGGI Carbon Futures Index (ER)	-4.7%	1.6%

Source: Bloomberg

Reasons for investors to consider Ninepoint Carbon Credit ETF:

- **Diversification** - Balanced exposure to all carbon credit markets can help minimize single jurisdiction risk by eliminating over-concentration to any single market, as recent market action has demonstrated. Having a diversified underlying market portfolio is important for an emerging asset class with volatile price patterns, like carbon credits.
- **Upside Potential** - Compared to volume-weighted fund or funds that invest in one single market, we believe that our equal-weighted fund will have better upside, over the long-term, since it has allocations to under-represented carbon credit trading markets.
- **Core Value** - As a Canadian fund, by overweighting the two North American markets relative to their index weights, we are aligning our strategy with our values and our local community.

[1]Carbon Pulse, COMMENT: Higher carbon prices – is speculation truly to blame?

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