Market Update

Going Green?

Climate Policy under the Biden Administration

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Climate change is poised to take on far greater importance in US public life and markets with the election of President Joseph Biden and Democratic control of the Senate.

Former President Donald Trump's administration rolled back many climate change initiatives and broader policies on environmental, social, and governance (ESG) issues, including withdrawing from the Paris Climate Agreement, rescinding parts of the Clean Water Act, restricting the use of ESG funds in 401(k) plans, and limiting the authority of the Environmental Protection Agency (EPA),[1,2] among other changes. In contrast, Biden has made addressing climate change a top priority and broadly supports progress on ESG-related issues.

However, the very slim Democratic majority in Congress may limit Biden's ability to pass climate legislation, including the $2 trillion climate-related investment plan he campaigned on. So, what changes do we expect during Biden's first two years—before the mid-term elections for Congress in 2022?

In addition to signing legislation into law, the US president sets the tone for domestic policy, has broad powers over international relations and trade, oversees regulatory policy, and can make specific changes through executive orders. These are all tools that we expect Biden to use generously to take action on climate change, which, in turn, will likely bolster ongoing efforts by state and local governments, as well as the private sector.

In aggregate, we believe these developments will reinvigorate US efforts to fight an existential threat that already is having a major impact on all aspects of life. They will also lead to new risks and opportunities for investors.

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A Change in Tone

First and foremost, we expect the new administration to continue to make clear how seriously it takes climate change—that it is the greatest challenge facing the country and the world, in line with scientific consensus.[3] A change in tone at the top is likely to cement the importance of climate change among US policymakers—a marked difference from the prior administration—and create space for the country to become more ambitious on the issue in the future.

It will also send a message to the international community that the United States is ready to re-engage in an arena that demands cooperation. The United States is the world's largest economy and second-largest emitter of greenhouse gases, and as a result, major progress requires its participation. And an active United States could in turn lead to more ambitious goals among its peers.

Finally, we believe the change in tone will confirm for domestic business leaders that future policy will seek to mitigate the worst effects of climate change, which will make it easier for them to incorporate into long-term strategic planning, even if the details of changes in the short term remain uncertain.

The Day 1 Agenda

Making good on this change in tone, Biden has created a new cabinet-level national security position on climate—special presidential envoy for climate—and filled it with John Kerry, a highly respected former secretary of state. He also is poised to issue a raft of executive orders and to oversee many regulatory changes in the early days of his administration as part of his "Day 1 Agenda."

In fact, on his first day in office Biden issued two notable executive orders directly pertaining to climate change: The first order requires that science be the guide in tackling climate change and instructs all departments and agencies under the president to review the regulations and procedures of the past four years and move to reverse any that conflict with protecting the environment or the health of citizens.

The second order announced the president's intent to rejoin the Paris Climate Agreement. Making it official will require a detailed plan for fighting climate change, potentially with more ambitious targets than those of the Obama administration. The US plan, along with those from 189 countries, is due in November 2021 at the United Nations Climate Summit in Glasgow, Scotland.

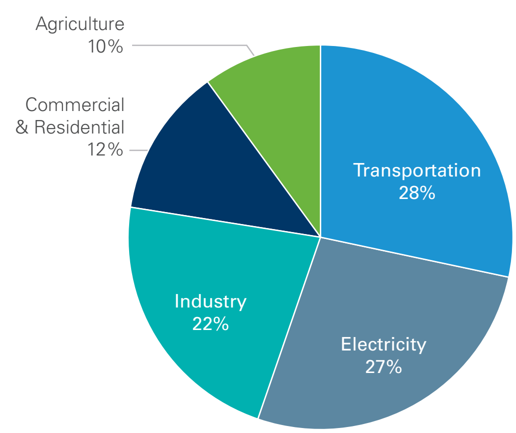
In keeping with these executive orders, Biden has more broadly committed to working with his counterparts around the world to fight climate change. These commitments include hosting a climate "summit," now set for 22 April, and setting a more ambitious domestic climate target that would put the country on a sustainable path to achieve net-zero emissions no later than 2050.[4]

While the Paris Agreement and these commitments are not legally binding, they will guide US energy and environmental policies, an area in which we believe the Biden-Harris administration will rapidly use its executive powers. A focus is likely to be greenhouse gas emissions from power generation and transportation, which account for the majority of total US emissions (Exhibit 1).

Biden has already followed his day 1 executive orders with several others on 27 January. Broadly, Biden advocated a "whole of government" approach to climate change, making it an essential element of all foreign policy and national security for the first time. The orders created an official White House Office of Domestic Climate Policy—led by the first national climate advisor and deputy national climate advisor—and established a National Climate Task Force, assembling leaders from across 21 federal agencies and departments. More specific orders include:

- Using the federal government procurement system—which spends $500 billion every year—to push toward 100% clean energy and encourage the production of zero-emissions vehicles that are made in America
- Temporarily halting new oil and gas leases on public lands and waters
- Developing renewable energy sources on federal lands and waters with the goal of doubling offshore wind by 2030
- Calling for a Civilian Climate Corps Initiative for Americans to work on conserving and restoring public lands and waters, including addressing climate change.

Exhibit 1
Electricity and Transportation Account for More than Half of 2018 US Greenhouse Gas Emissions



As of 20 January 2021

Total emissions in 2018 = 6,677 million metric tons of CO_2 equivalent. Percentages may not add up to 100% due to rounding.

Source: Environmental Protection Agency

Other policies that President Biden has planned for the first months of his presidency demonstrate similar priorities and longer-term goals, including:

- Modifying elements of the Clean Air Act and Clean Water Act
- Setting aggressive methane pollution limits for new and existing oil and gas operations
- Modifying the Corporate Average Fuel Economy (CAFE) standards and developing rigorous new fuel economy standards aimed at ensuring that 100% of new sales of light- and medium-duty vehicles will be electric
- Strengthening policies that emphasize innovation in clean energy and industrial products and processes
- Reducing emissions through new, aggressive standards for appliances and buildings
- Rescinding the Trump administration's ruling on ESG funds in 401(k) plans
- Requiring public companies to disclose climate risks and greenhouse gas emissions in their operations and supply chains

Limitations on Legislation

Biden's broader climate agenda includes objectives that would require major new legislation, including $2 trillion in new spending over four years and an enforcement mechanism to achieve US emissions targets in the short and long term, such as an emissions tax or trading scheme. However, passing legislation requires the support of Congress, and with just 50 Democrats in the Senate, the president is limited in his ability to accomplish these goals.

In order to overcome the filibuster—a procedural blocking tactic[5]—any climate legislation would need 60 votes in the Senate, implying the support of at least 10 Republican senators, a challenging task in the current political environment. Absent a successful effort to remove the filibuster, which seems unlikely at the moment, the only alternate route to passing legislation is the budget reconciliation process.[6] Reconciliation requires just a simple majority but, critically, can only be used infrequently and for spending or revenue-related measures. Furthermore, a dissent from just one Democratic senator could derail any effort to pass legislation in this way, increasing the importance of centrist views.

Given these limitations, the most ambitious Biden climate proposals seem unlikely to be legislated in the next two years. However, Democrats are likely to try to pass at least two major spending packages in 2021, which could provide a vehicle for aspects of Biden's $2 trillion climate package—and possibly a carbon tax, though support on this specific issue is far weaker.

On 14 January, Biden announced that passing a $1.9 trillion package focused on responding to the health crisis and stimulating the economy would be his immediate priority, especially ahead of the mid-March phase-out of emergency unemployment benefits. Climate-related measures are more likely to find a place in a second package on job creation and infrastructure, which we expect to be announced in February.

Any spending package that is passed will ultimately be smaller than what is announced: its size, composition, and timing will depend both on negotiations and its path through the Senate. For example, traditional infrastructure and rural broadband likely enjoy more bipartisan support than some types of climate-related spending; also, budget reconciliation for spending purposes can only be done once before the end of September and once after. Congressional debates over the first package for $1.9 trillion in health and stimulus spending will be an important litmus test for how contentious subsequent infrastructure and related climate spending legislation may be.

Perhaps anticipating lengthy and difficult negotiations in Congress, the Biden administration is also said to be looking into other budget maneuvers that could allow re-purposing of existing funds without new legislation, such as using Federal Emergency Management Agency (FEMA) grants to build climate-resilient infrastructure.[7]

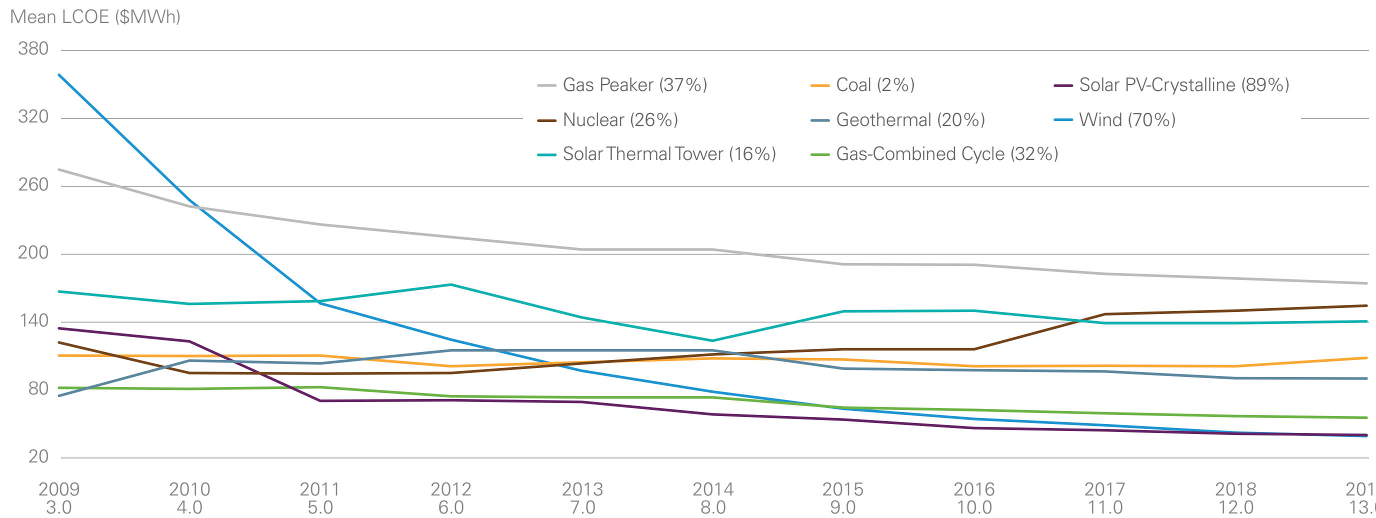
Local and Private Sector Efforts

Despite a lack of direct federal action over the past four years, state and local governments, as well as the private sector, have taken steps to adapt to and mitigate climate change. The change at the top of the federal government should add momentum to these efforts in the coming years.

At a state level, 23 governors representing 50% of the US population and more than 50% of US GDP have formed the US Climate Alliance and committed to reducing greenhouse gas emissions by at least 26%–28% below 2005 levels by 2025, consistent with the goals of the Paris Agreement. Fifteen states have also committed to a 100% renewable energy target, and many have started to implement carbon pricing schemes. At a local level, 468 US mayors, including those from the 10 biggest cities, have committed to upholding the principles of the Paris Agreement. In the private sector, more than 1,500 companies around the world, including almost 25% of Fortune 500 companies, have made net-zero greenhouse gas emissions commitments.

Technological progress also has been encouraging, due in part to more rapid change in European regulation and consumer behavior and to the wide deployment of many "clean" technologies, including renewable energy, LED lighting, and electric vehicles. Lazard's annual Levelized Cost of Energy (LCOE) study shows that even without the benefit of existing incentives like the US's Investment Tax and Production Tax Credits, there have been significant cost declines for utility-scale renewable energy, driven by decreasing capital costs, improving technologies, and increased competition (Exhibit 2).

Exhibit 2
Selected Unsubsidized Levelized Cost of Energy (LCOE) Values



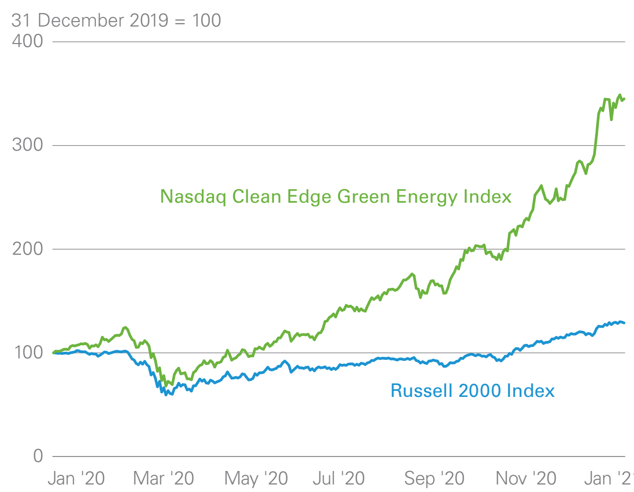
As of November 2020

Reflects the average of the high and low LCOE for each respective technology in each respective year. Percentages represent the total decrease in the average LCOE since Lazard's LCOE—Version 3.0 in 2009.

Source: Lazard estimates

Finally, investors and capital markets are waking up both to the inevitability of change and to the potential for it to accelerate. Global green bond and loan issuance climbed by 49% to a record high of $249.5 billion in 2020. Sustainable funds had inflows of $46 billion in the first quarter of 2020 even as equity markets plummeted due to the COVID-19 pandemic, while the overall fund universe experienced $356 billion in outflows. Over the course of the year as a whole, industry segments like clean energy outperformed the broader market significantly (Exhibit 3).

Exhibit 3
The Nasdaq Clean Edge Green Energy Index Significantly Outperformed the Russell 2000 Index in 2020



As of 26 January 2021

Source: Bloomberg

Investment Implications

Under the Biden-Harris administration, efforts to fight and adapt to climate change should increase substantially. While the most ambitious policies from the campaign trail are likely to be limited by the narrow Democratic majority in Congress, many other policy changes are possible via executive order and re-regulation. Furthermore, a change in tone and re-commitment to long-term goals and international cooperation should contribute to future forward momentum in US policy, in the private sector, and potentially in other efforts globally. Regardless of policy change, climate change itself is increasingly touching every aspect of life.

Both climate change policy and the effects of climate change present many risks and opportunities, which are increasingly reflected in capital markets: more climate-related disclosures by companies; the increasing popularity of ESG and sustainable investment strategies; the rising use of climate-related financial instruments like green bonds; and recent strong performance in "pure play" companies and investment themes, like clean energy. We expect both that the investment landscape will continue to evolve in this direction and that it will become increasingly important for investors to incorporate climate risks and opportunities into their analysis. Ultimately, we believe an active, bottom-up approach supported by top-down expertise in climate-related issues will be crucial in the years ahead. Finding companies at the forefront of change and avoiding those most exposed to it requires understanding not only complex new policies, but also the far-reaching implications of climate change itself.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 "Criminal Enforcement Collapse at EPA," Public Employees for Environmental Responsibility, accessed on 1 February 2021, https://www.peer.org/criminal-enforcement-collapse-at-epa/

2 "In Pittsburgh, Administrator Wheeler Announces Final Air Regulations for Oil and Gas, Removing Redundant Requirements, Streamlining Implementation, and Reducing Burdens," US Environmental Protection Agency, accessed on 1 February 2021, https://www.epa.gov/newsreleases/pittsburgh-administrator-wheeler-announces-final-air-regulations-oil-and-gas-removing

3 "AR5 Synthesis Report: Climate Change 2014," UN Intergovernmental Panel on Climate Change, accessed on 1 February 2021, https://www.ipcc.ch/report/ar5/syr/

4 "The Biden Plan for a Clean Energy Revolution and Environmental Justice," Biden-Harris campaign, accessed on 1 February 2021, https://joebiden.com/climate-plan/

5 "What is the Senate Filibuster, and What Would It Take to Eliminate It?" Brookings Institute, accessed on 1 February 2021, https://www.brookings.edu/policy2020/votervital/what-is-the-senate-filibuster-and-what-would-it-take-to-eliminate-it/

6 "Budget Reconciliation: The Basics," House Committee on the Budget, accessed on 1 February 2021, https://budget.house.gov/publications/fact-sheet/budget-reconciliation-basics

7 "New U.S. Strategy Would Quickly Free Billions in Climate Funds," New York Times, accessed on 1 February 2021, https://www.nytimes.com/2021/01/25/climate/fema-climate-spending.html?referringSource=articleShare

Important Information

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The Russell 2000 Index is designed to represent the "small cap" market of US equity securities, composed of approximately 2,000 of the smallest securities in the Russell 3000 Index. (The Russell 3000 Index measures the performance of the 3,000 largest US companies, representing most of the investible US equity market.)

The NASDAQ Clean Edge Green Energy Index is a modified market capitalization weighted index designed to track the performance of companies that are primarily manufacturers, developers, distributors and/or installers of clean energy technologies, as defined by Clean Edge.

The indices are unmanaged and have no fees. One cannot invest directly in an index.