Kenanga Futures Spotlight: Sustainable Finance & Futures Market

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Kenanga

Kenanga Futures Sdn Bhd

Contents

Executive summary

As the costs and challenges of climate change continue to mount, so too has the need to mobilize capital to drive climate innovation. The financial services sector is an essential partner in meeting this need, by providing funding and managing the risks associated with sustainable investments, including project risk and interest rate and currency risks.

ESG adoption is on the rise, fueled by client demand and a desire to make an impact. As ESG momentum continues to gain steam, investors are refining and evolving their strategies. This can be seen in the implementation arena, where investors are moving away from basic screening methods towards more targeted and sophisticated strategies, Meanwhile, ESG integration remains the top implementation strategy showing how investors are taking a holistic approach as they look to comprehensively embed ESG into the investment process

Customers are searching for climate mitigation strategies and new ESG-related products, whether for investment or financing purposes. To avoid greenwashing and ensure a high level of trust and expected outcomes, the financial service industry constantly develops globally consistent ESG standards, best practices and taxonomies to ensure investment products are consistent and verifiably accurate in terms of delivering sustainable and socially responsible outcomes. Derivatives markets plays a big role in facilitating the transition to a sustainable economy where the enable more capital to be channeled towards sustainable investments, help market participants hedge risk related to ESG factors, facilitate transparency, price discovery and market efficiency.

This report has been exclusively created **by Kenanga Futures' Business Development & Strategy team.**

OVERVIEW OF SUSTAINABLE FINANCE MARKET

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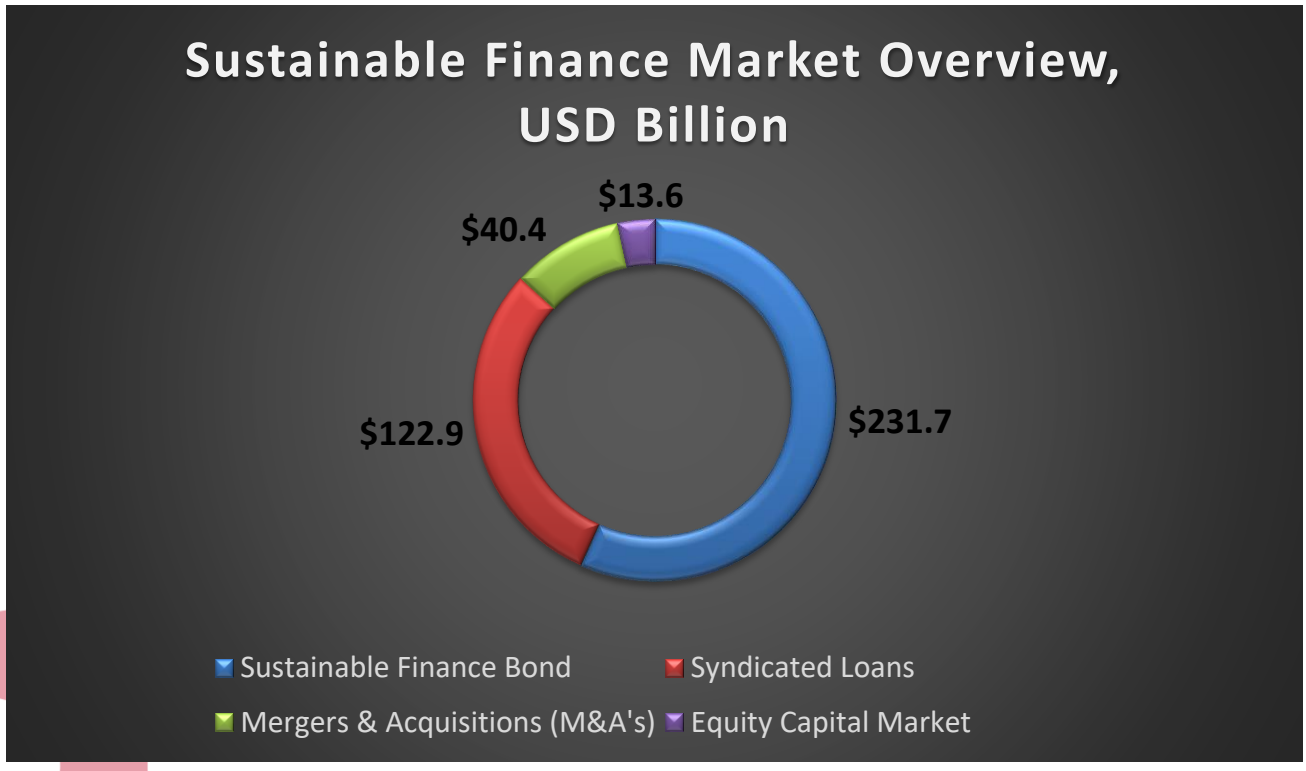
The financial sector is vital to fund the structural changes necessary for the transition towards a green and sustainable economy as set out in the Kyoto Protocol, Paris Agreement, or COP26 etc. Regulatory actions such as the IOSCO Principle 16, European Action Plan on Sustainable Finance, as well as shifts in consumer attitudes, have driven organisations around the globe to integrate sustainability concerns into their strategies and business models.

In Asia Pacific, vast economic, political and social differences among countries has translated into diverse sustainable finance regulations. The absence of common goals in carbon footprint reduction for example, have resulted in various countries such as China, South Korea, Japan, New Zealand, and Indonesia to have differing approaches and progress in regulating sustainable finance activities.

As Environmental, Sustainability and Governance (ESG) encompasses a wide variety of issues, ranging from the carbon emission through diversity in the board of director to social equitability, the spectrum of financial products targeting these is diverse and complex. This report provides an overview of the global market for sustainable financial products and highlights the availability of ESG product suite in current financial markets setting particularly in the listed derivative space.

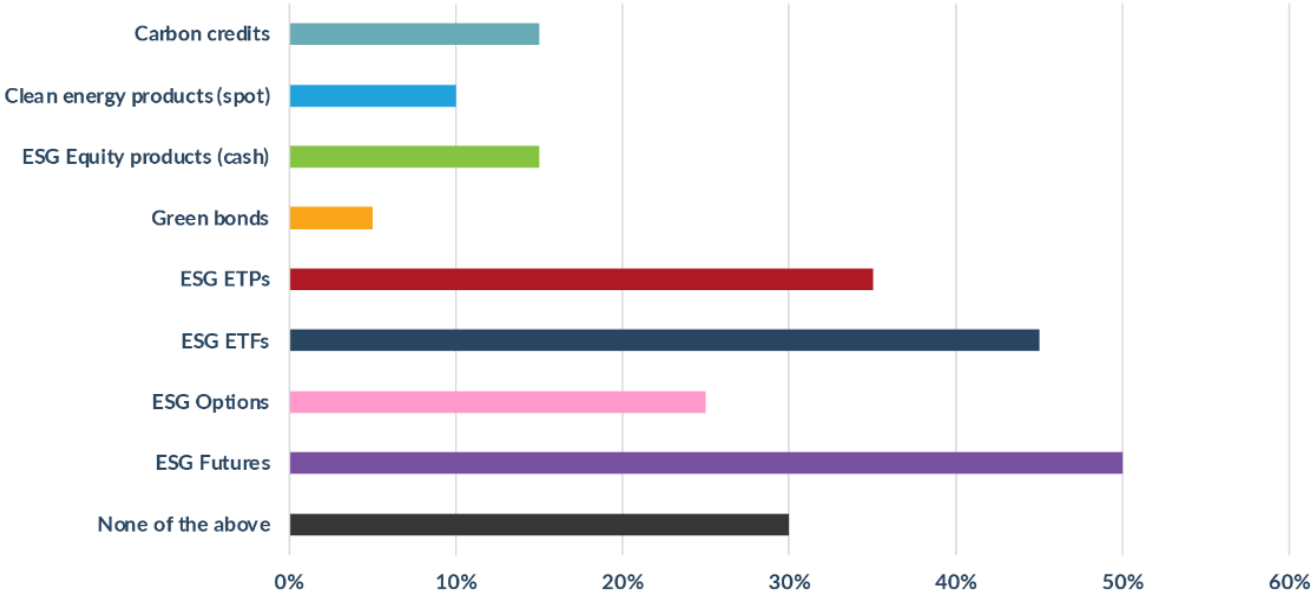
The market for sustainable financial products has witnessed significant growth in recent years, developing from a niche phenomenon to become a major force across the entire financial market. The chart below provides an insight into the importance of the market for sustainable financial products:



Source: *Refinitiv Sustainable Finance Review (Q1 2022)*

With global ESG assets under management expected to surpass US$50 trillion by 2025, sustainable finance presents a major opportunity, which is also demonstrated by the growth of market volumes across asset classes. The volume of sustainable finance bonds issued in Q1 2022 was US$231.7 billion, representing a 19.1 percent decrease compared to Q1 2021. Conversely, the sustainable syndicated loans volume has witnessed 8.2 percent increment to reach a total of US$122.9 billion between these periods. Similarly, equity issued by sustainable companies has increased in Q1 2021, with issues amounting to US$13.6 billion.

A greener path for futures and options market ?



Sustainable investing has been gaining prominence and popularity among investors of all sizes, and even with interest from retail investors growing in recent years. The market for ESG-related securities and derivatives continue to surge as investors globally rush to find value in these products. To date, more than a dozen of ESG products, particularly ESG futures, have been listed in across major exchanges around the world. According to CME Group, trading of E-mini S&P 500 ESG futures hit a new high in Q1 2022 with over 2,435 average contracts traded; a 140% increase compared to Q1 2021. And this attainment is based only on single product and have yet to include other variants such as carbon emissions offset futures— a product that is significantly in-demand in today's world.

According to Futures Industry Association (FIA), the total volume of futures and options traded on exchanges worldwide in 2021 reached 62.58 billion contracts in 2021, up 33.7% from the previous year. This marks the fourth year in a row that global exchange-traded derivatives markets set a record above the prior year in terms of total trading activity. Futures trading rose 14.6% to 29.28 billion contracts. Options trading jumped 56.6% to 33.31 billion contracts.

Source: *FIA (www.fia.org.com)*

In essence, ESG compound on few major derivatives exchanges with National Stock Exchange of India coming out on top in with 17.26 billion contracts traded in 2021. This amount almost doubles the amount traded in the previous year. Based on FIA's released statistics in January 2022, Brazil's B3 total ESG futures trading volume rose 38% to 8.76 billion, followed by CME Group with total volume of 4.94 billion (up 2.5% from 2020). Intercontinental Exchange (ICE) came in fourth, with volume rising 19% to 3.32 billion contracts. Close behind was Nasdaq, with volume rising 23.8% to 3.29 billion contracts.

Growing liquidity in these markets show the importance of derivatives exchanges as vital tools to help discover prices and manage risks related to climate change. According to a survey conducted by FIA European Principal Traders Association (EPTA) in December 2021, Europe's largest non-bank market makers and liquidity providers are looking to expand their activities in the ESG space, with the ESG Futures and ETFs being the two most sought-after asset classes. While participants surveyed are most active in supplying liquidity in ESG futures (50%), they are starting to grasp an increasing demand from both institutional and retail investors in ESG exchange-traded funds (45%), followed by Exchange-traded products (35%).

Policy makers too are becoming more cognizant of climate, social and governance risks. From Washington to London to Beijing, achieving a net zero emission is a top priority for policymakers. However, there is clear divergence around the specific actions and timelines between continents in their approach to sustainability issues. Whether it is in the form of direct public financing, creation of climate-aligned securities indices or setting up regulated Carbon Trading Exchanges such as those in Australia, Abu Dhabi, China or Singapore etc., it is designed to respond to one simple challenge — to diverge from an unabated coal-fired power generation and meet the needs of investors seeking to reduce their exposure to energy transition and physical climate risks in a wholistic manner.

According to Reuters, the value of traded global markets for carbon dioxide (CO2) permits grew by 164% to a record US$851 billion in December 2021. And with the global carbon credit market predicted to grow further to US2.4 trillion by 2027, Asia Pacific is expected to become one of the emerging players for this market and set to benefit from this growth trajectory. The question is how do we build a strong foundation for a market to transmit clear signals of demand and scalable moving forward?

Source: *FIA (www.fia.org.com)*

ESG IN FUTURES MARKET

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Illustrative product suite of ESG-related derivatives in the global market

Trading venue	On-exchange	Off-exchange
ESG index derivatives	ESG equity index futures and options	ESG-related credit default swap (CDS) indices
Carbon emission trading and derivatives	1. Emission caps and allowances • Spot bilateral transactions 2. Futures and options	Emission caps and allowances • Spot bilateral transactions • Forwards
Sustainability -linked derivatives	Not identified	• Interest rate derivatives • Foreign exchange derivatives (with an ESG pricing component)
Others	• Commodity futures and options (product design and encompassing sustainability factors in physical delivery) • Renewable energy and renewable fuels derivatives - Futures and options on credits of renewable energy and fuels and wind index • Weather derivatives • Temperature-based index futures and options	• Catastrophe and weather derivatives • Catastrophe swap

Source: *The Hong Kong Exchange (HKEX)*

Investors are increasingly seeking to capture climate opportunities from the nascent green economy and ensure their portfolios are align with Net Zero emissions pathways by 2050. FTSE Russell's 2021 Sustainable Investment survey of global asset owners found that over two thirds (68%) of APAC asset owners are prioritising climate issues and over half are 'very concerned' about climate risk. Many Exchanges are responding to this growing demand by either designing indices that aims to provide exposure to "green revenues" of the companies that are set to benefit from the transition to the green economy, or create sustainability-linked derivatives that track offset projects across energy, renewables, and weather etc.

In an effort to capitalize on this growing investment opportunities, many Exchanges including CME and ICE, entered the ESG derivatives fray recently. CME kicked off with a single contract, E-mini S&P 500 ESG futures, while ICE launched a collection of contracts based on MSCI indices. To go one step further, some are scaling up its efforts to develop an international carbon trading marketplace and a services ecosystem to support decarbonisation. The likes of ICE and AirCarbon Exchange etc. are already building end-to-end, state-of-the-art digital infrastructure to support their participation in carbon markets. New contracts that benchmark against global carbon prices from existing Emission Trading Schemes and Regional Greenhouse Gas Initiatives are being created to support hedging of future carbon costs.

US and Europe are not the only growth area to watch when it comes to ESG derivatives. Increasingly, Asia is moving towards ESG investment foray. With China's push towards greater

Source: *Reuters*

FACTORS AFFECTING THE FUTURE OF SUSTAINABLE MARKET

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Climate Change

Major countries around the world are contending with new weather patterns; with many experiencing climatic extremes such as raging storms and floods, to scorching temperatures and extended heat waves. Continental Europe saw record-setting temperatures of more than 48°C (119°F) in 2021. Scorching temperatures in Tokyo resulted in health concerns for some outdoor Olympic events. And for the first time, the US declared a water emergency due to persistent drought conditions. These extreme climate patterns manifest itself in myriad ways.

Mitigating climate catastrophe through decarbonization is, therefore, a huge and necessary response. The emission goals of the Paris Agreement and the 2030 Agenda for Sustainable Development is among the initiatives launched by the United Nations attempted to reduce global carbon footprint and to limit the temperature increase to 1.5 °C by 2050

Many regions and sectors are exposed to multiple overlaying impacts of climate change. As weather conditions become more variable with increase in the frequency and severity of extreme events, agriculture and food security will be affected in complex ways. On one hand, it affects food production directly through changes in agro-ecological conditions. On the other hand, it indirectly affects growth and distribution of incomes. A more pronounced climate fluctuation associated with continued emissions of greenhouse gases will adversely affect the stability of food supplies and reduce livestock productivity, particularly for the poorer regions.

Impacts of climate change has resulted in serious consequences for many countries, and over time, will likely wrestle in to every sector and economies. This coupled with the transition to net-zero emissions could give rise to financial risks, potentially causing unprecedented disruption in price discovery and supply-chain moving forward. The process of strengthening climate risk management will be inherently experimental and demanding. Persistent evaluation, consultation, and course-correction will therefore be par for the course.

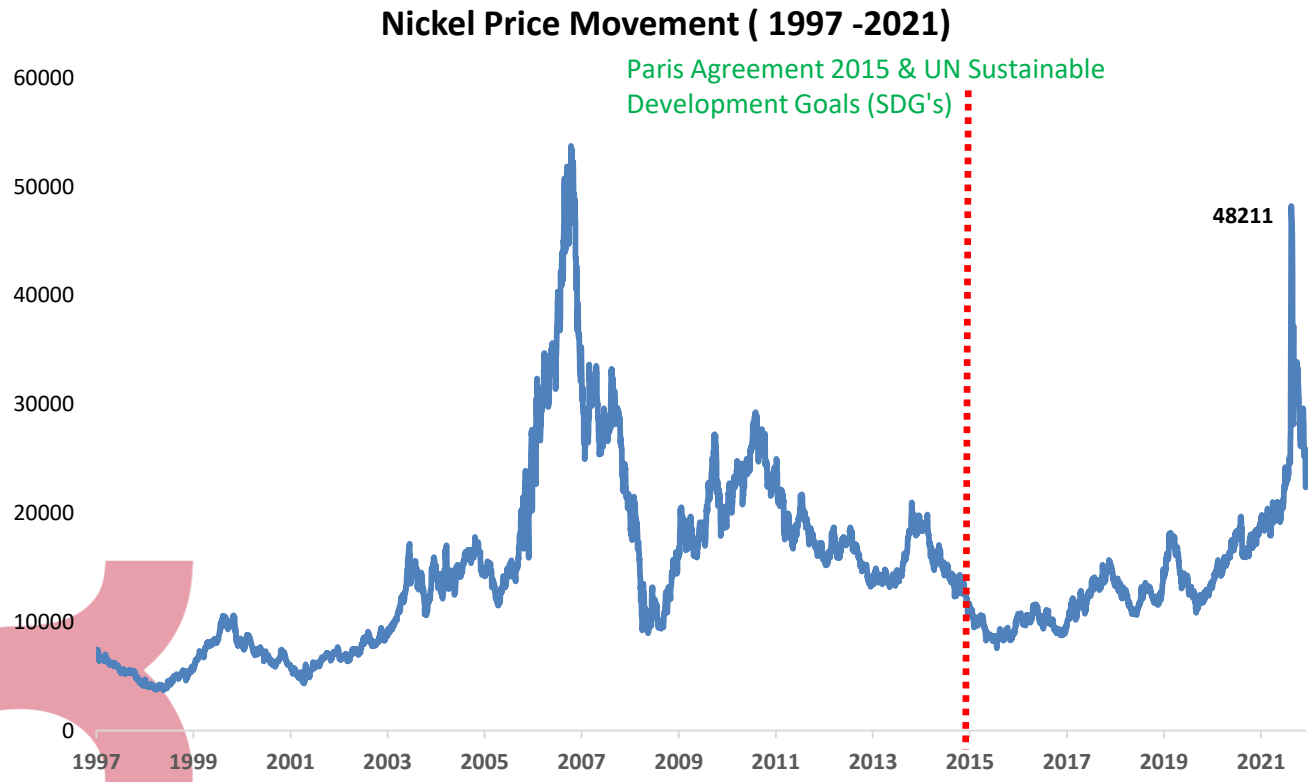
Source: *Bloomberg*

Transition to Green Economy

The transition from fossil fuels to clean energy will result in an unprecedented demand for new commodities as the range of relatively obscure materials become “essential” to delivering emissions-free transport, manufacturing and power generation etc. BloombergNEF estimates that this transition could require as much as US$173 trillion in energy supply and infrastructure investments over the next few decades.

As electric vehicles replace gas guzzlers, and renewables substitute coal as an important energy sources, commodities like lithium, cobalt and rare earths are on the edge of rapidly accelerating demand. Upside for metal miners, technology manufacturers and energy traders are enormous. Proliferation of renewable-energy stocks since the start of this decade, as well as the emergence of new types of green futures contracts have further extended opportunities for investors or traders to gain exposure under the current trend.

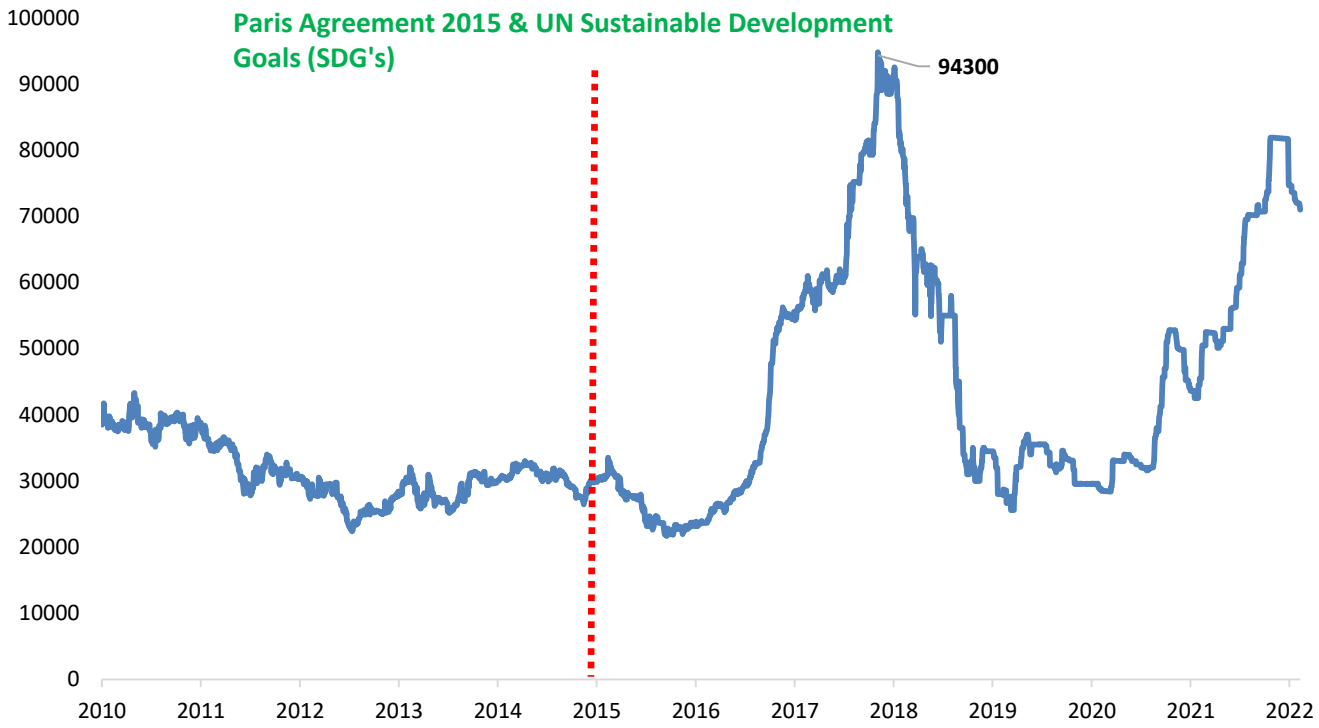
Efforts to lift supplies of key raw materials to keep pace with future requirements could face steeper growth curves and particularly challenged by pricier commodities. For instance, demand for cobalt, along with consumption of lithium and nickel by the battery sector, may set to surge significantly. These new key components of the energy transition show the complexity of supply chains required to help the world quit fossil fuels, and how the need for vast investments and risk management tools to meet a net zero economy by 2050.



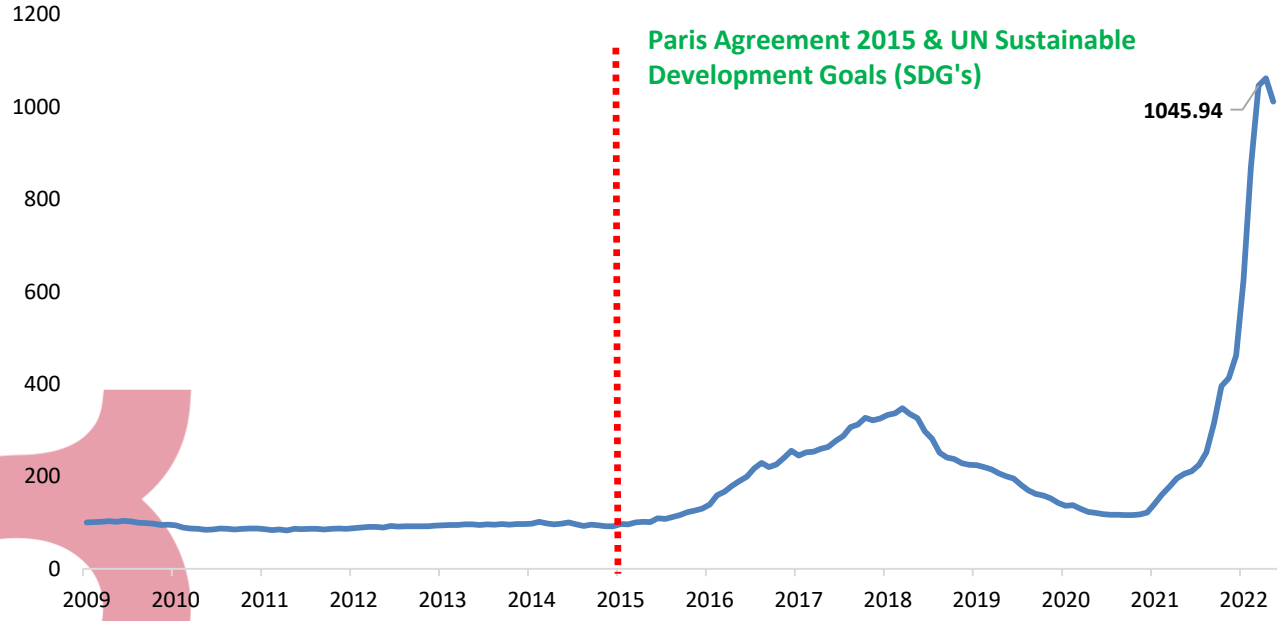
Source: *Bloomberg*

Transition to Green Economy

Cobalt Price Movement (2010 - 2022 YTD)



Lithium Price Movement (2009 - 2022 YTD)



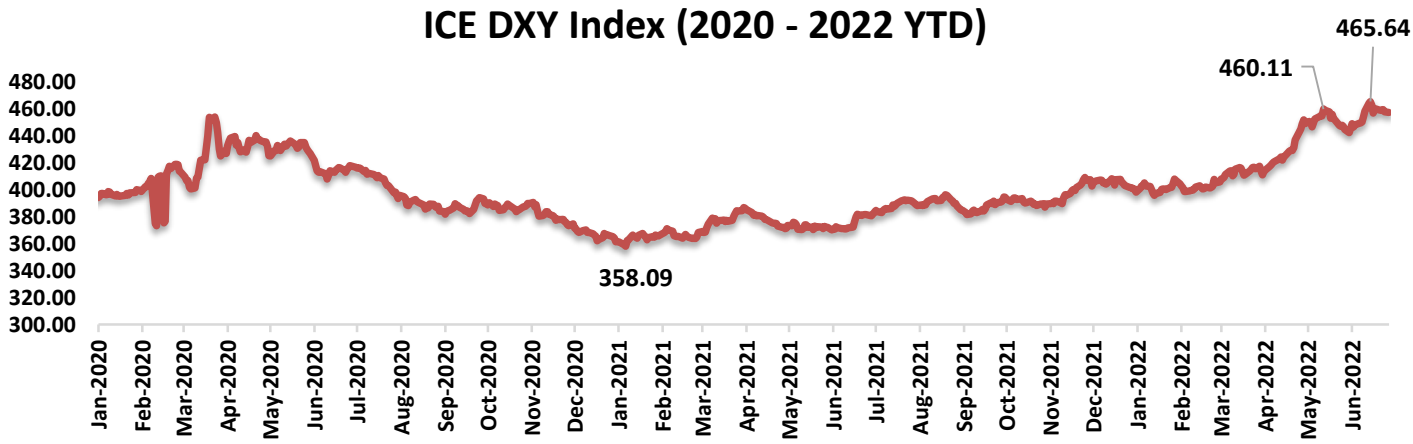
Source: *Bloomberg*

Geo-political conflict

Open markets and free trade have been a basic tenet of the international order. The Russia-Ukraine conflict and the various sanctions imposed thus far have intensified the discussion on the economic repercussions of a shift in global trade policy; from an open trade policy to geopolitical considerations that limit interdependence.

Markets have seen large intraday swings as soon as Russia announced a special military operation against Ukraine. On the first day of the invasion, the European Stoxx 600 index fell 3.2% and sank to its lowest level since May 2021 on further expectations of severe sanctions on oil and gas exports between Russia and other trade nations. Oil has surged over the US$130 per barrel mark for the first time since 2008 and gas prices have spiked to all-time highs. Sunflower oil shipments were severely interrupted and has sent cooking oil prices spiraling.

The risks to global growth posed by the confrontation are pronounced and material. It has decelerated global growth and heightened inflationary expectations. Recent OECD estimates that global GDP will hit 3% in 2022 — a 1.5% point downgrade from a projection done in December 2021. While the dollar has strengthened since the onset of the conflict, some countries in Asia have witnessed downward pressure on their currencies. The DXY index, a weighted average of the dollar's value against six major currencies, reached a 20 year high in mid-May, having appreciated by 9% since 24th February 2022. This coupled with capital flight have pushed the central banks in the APAC region to tightened monetary policies and impose capital controls.



While sanctions and export controls have been broad-based to date, targeting Russian exports, the conflict has nevertheless revealed extreme tension on energy security and international trade relationships going forward. Commodity producers in Asia, South Africa and Oceania may stand to benefit from higher commodity prices and Russian's weakening market share in the global commodities supply markets. Asia should be supported by the higher quality composition and greater proportion of a domestic investor base, which could potentially result in less susceptible to a reversal in global Emerging Market flows. Nevertheless, the on-going Russia-Ukraine confrontation does raise a serious question of how much growth might be shred if the global economy were to decouple, as well as a disintegration of the global trading system into blocs.

Source: *Bloomberg & Intercontinental Exchange (ICE)*

CONCLUSION

Derivatives are a core component of financial markets and have become more transparent and standardized since the 2007-08 financial crisis. Derivatives markets can play a significant role in the context of the European Green Deal and the transition towards a low-carbon economy. They facilitate capital raising via the hedging of risks related to sustainable investments. Moreover, they enhance the transparency and the price formation process of the underlying securities, and thus foster long-termism.

The use of derivatives by market participants is being examined in the context of the EU sustainable regulatory framework that is currently being developed. The EU Taxonomy sets the framework for what is regarded as sustainable, while the disclosures framework will enhance the transparency surrounding sustainable investments. Derivatives will be developed to reference these new measurements and metrics with a view to contributing to the financing of projects and funding of companies in the transition to a sustainable future.

The European Green Deal is the cornerstone of the EU's response to the Covid-19 pandemic, given the massive amounts required for a sustainable and green recovery. ESG products have demonstrated their resilience during the market decline caused by the pandemic and will play a pivotal role in accelerating the transition to a sustainable economy

Source: *ISDA – Derivatives in Sustainable Finance*

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