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WHAT DOES CLIMATE CHANGE MEAN FOR RETAIL INVESTORS?

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Martina Hoffard, Head of Marketing at Spectrum Markets, on how retail investors should approach market volatility driven by the increased frequency and severity of extreme weather events, and the long-term economic implications of the changing climate.

Whether it's flooding in New York[1], wildfires in Southern Europe[2] or drought in East Africa[3], global warming is accelerating the frequency and severity of extreme weather events around the world. July 2023 was the hottest month in recorded history[4], with temperatures in August and September also breaking records by unprecedented margins.

While the extent to which markets may have positive impacts on the environment – e.g., through ESG investments – is being actively discussed, the opposite direction is undisputed: climate change will have direct and indirect implications for global markets.

On the one hand, government responses to climate change have immediate and delayed effects on markets. On the other hand, incidents such as extreme weather events also have direct, acute and indirect, chronic impacts. In this article, we'll go on to examine each of these phenomena.

The direct, acute impacts of climate change

A 2009 study demonstrated that natural disasters, across a panel of countries and whatever their cause, reduce GDP per capita by at least 0.6%[5]. And it is obvious that more frequent, more severe natural disasters will only cause greater hurt. Furthermore, the effects of more frequent extreme weather events will be compounded by the lengthy recovery time required for a country's economy after each event: a 2014 study based on data from 6,700 cyclones between 1950 and 2008 concluded that it takes twenty years for a country's economy to recover from the damage done to a by a single cyclone.

However, the picture is complex. Impacts vary between economic sectors and types of extreme weather event. Moderate disasters can have a positive growth effect on sectors engaged in rebuilding[6], but it would be heartless to argue that this effect is worth the cost of human suffering that such disasters bring about. Furthermore, less developed economies tend to see far less of a benefit; if they see any at all.

Aside from its impacts on economic growth, climate-change-driven extreme weather events are inflationary, too. In part, this is because extreme weather events can have a devastating impact on supply chains[7]. A 2014 study suggested that, to date, the inflationary impact of climate-change-driven extreme weather events had been mitigated by retailers preferring to run out of stock than to be seen as price gouging[8]. However, there is growing concern that, in the face of multiple crises, the taboo against price gouging has been terminally broken, giving climate-change-driven disasters the potential to trigger more extreme inflationary shocks[9]. Overall, almost 30% of medium term eurozone consumer inflation volatility, and lack of post-Great Recession disinflation, can be attributed to shocks to global harvests and supply chains[10].

According to the Bank of England's Q4 2022 bulletin "While physical impacts of climate change have been shown to temporarily raise inflation, in particular food prices, such effects have tended to dissipate in the medium term. However, the impacts of such events may be greater in the future if extreme weather events are more frequent and more severe[11]."

The indirect and chronic impacts of climate change

A number of factors, driven by ongoing impacts of climate change, are likely to cause longer-term negative economic outcomes. These include reduced labour productivity, slower human capital accumulation, diminished human health and increased political instability[12].

The University of Notre Dame's Global Adaptation Index[13] ranks a country's vulnerability to climate change alongside its readiness to improve resilience. This index reinforces a fact that has been demonstrated in many other studies, too. Poorer countries are more vulnerable to the impacts of climate change.

Less developed economies are more vulnerable to unpredictable harvests, countries that have suffered from exploitation during the colonial past continue to see poorer governance, health outcomes and political instability. All of these factors and more contribute to worse outcomes when climate-change-driven extreme weather events hit poorer countries[14] and lead to a lower capacity for those countries to prepare for the long-term effects of climate change.

But just because wealthier countries are to some extent insulated from the effects of climate change by their wealth, that doesn't mean they're immune to the long-term effects. Climate change is already driving increased immigration from poorer countries to wealthier ones as people strive to escape its impacts. To a large extent, this works to the advantage of those wealthier nations. Ageing populations are a challenge to economic growth and public finances of developed nations[15], and elevated levels of immigration help to address this problem across the EU[16]. However, over the long-term, this might be seen as a continuation of the pattern wherein richer nations extract human and material resources from poorer ones, exacerbating the inequalities that cause those poorer nations to suffer worse consequences from climate change.

The impacts of government intervention

Around the world, governments are enacting policies to reduce the factors driving climate change, and to mitigate its effects. These policies will have an impact on the markets. Retail investors should be aware of and prepared for these impacts.

Carbon taxes, emission trading schemes and subsidies for green industries will all affect the competitiveness of different industries in different ways. Initiatives to reduce energy usage will have huge long-term implications.

Other influences

The interactions between markets and the environment don't take place in a vacuum. The interplay of geopolitical and social forces, including those not related to climate change, also boost the need for investment in the infrastructure needed to deliver green energy.

The EU currently imports around 60% of its energy, and disruption of this supply is a cause of inflation and debt. Therefore, European countries are increasingly concerned about energy autonomy. This means that missing cross-border network interconnectivity, a volatile energy market and a lack of supply security are some of the EU's main energy policy challenges[17].

Investment in solving these challenges will help to pave the way to a more sustainable energy grid. For instance, better cross-border network interconnectivity will boost energy security while enabling the network to cope with variations in energy supply from wind and solar power[18].

How investors should react

To conclude, we will look at three factors that retail investors might want to bear in mind when considering how to proceed in the face of climate change induced shifts in the economy: short term volatility, long term mitigation, and the opportunities that come from the shift to net zero.

First, short-term volatility. A report from the IMF, published in June 2023, demonstrated that "Stock prices react positively to market-wide climate-favourable news but they do not react negatively to climate-unfavourable news[19]." Retail investors need to be able to react in real-time to events likely to cause short-term upward or downward movement in the markets – which is why it is important for them to be able to execute trades outside of normal trading hours.

In terms of measures to address the long-term unpredictability, the usual sensible investment advice holds: diversification tends to help minimise risk while maximising the chances of long-term positive returns[20]. It is also worth considering whether the shift to green technologies could lead to investments in high-carbon industries losing value[21]. The importance of such diversification is one of the reasons that Spectrum Markets puts such emphasis on giving retail investors access to a greater range of products and opportunities to trade.

Speaking of opportunities, these exist for retail investors, too. In previous articles we have discussed the **rise of ESG investing**: the transition to net zero will lead to growth in innovative industries[22], creating new investment opportunities. The Bank of England's 2022 Q4 bulletin points out that the shift to net zero "can be orderly, leading to a 'smooth transition', whereas a 'disruptive transition' may induce amplified effects on the economy." So, investors need to stay aware and informed, because by doing so, they are better placed to make investment decisions that will contribute to their financial wellbeing in a future made unpredictable and volatile throVugh the effects of climate change.

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