MARKETING COMMUNICATION

Allspring

Eye on SI: 2024 Outlook

Caution: Objects May Be Closer Than They Appear

While the rearview mirror holds important information about how far we've come on the road to sustainability, Allspring looks to the future.

The risks and opportunities related to sustainable investing (SI) are clearly accelerating, and we are committed to helping our clients manage both.

For 2024, we continue to research a wide range of areas related to sustainable investing. Three in particular are of increasing importance for portfolio management and of interest for our clients—biodiversity, water, and energy transition.

Biodiversity manages risk, naturally

Biodiversity increases the world's resilience to natural shocks, reducing risks to people and the environment. It also provides enormous and essential benefits to the global economy. Energy, for example, is key to a functioning economy, as are nutritious food, clean water, and the regulation of disease and climate. Even so, these natural assets are often undercounted or omitted from economic and political policy. This has led to a lack of investment in programs that manage and protect these important assets.

The bounty of nature

$125 trillion global natural assets[1]

$85 trillion global economy[2]

Risk increases as biodiversity decreases

Global biodiversity is in sharp decline. From 1979 to 2018, there was a 69% average drop in relative abundance of wildlife.[3] This is sounding alarms for the health of people and the planet:

- Over half of global gross domestic product (GDP) is estimated at risk from biodiversity loss.[4]
- This affects more than 75% of global food crop types, including fruits, vegetables, and important cash crops (coffee, cocoa, almonds, etc.) that rely on animal pollination.[5]
- It also puts at risk billions of people who rely on natural drug treatments or synthetics that were researched in nature, including 70% of cancer drugs.[6]

JAMIE NEWTON, CFA

+ Head of Global Fixed Income Research and Deputy Head of Sustainability

CHRIS MCKNETT

+ Head of Sustainable Strategy, Stewardship, and Implementation, Sustainability

EVAN MCEVOY

+ Sustainable Investment Strategist

What's being done about it? On the regulatory side, the European Union's Deforestation Regulation requires firms to prove their products do not contribute to deforestation. We expect this will lead to higher reporting and monitoring costs for companies. Commodity prices could increase, and companies will try to pass through higher costs to consumers to protect margins.

Companies lagging in biodiversity risk management could see their valuation discounted as investors become more attuned to biodiversity. The recently launched Taskforce on Nature-related Financial Disclosures is driving companies to improve information disclosed, which can help investors better understand biodiversity dependencies and impacts.

Opportunities Allspring is watching for in 2024

Firms innovating solutions that don't rely on natural assets to manufacture could capture growing consumer demand. That includes companies focused on reducing biodiversity impacts, such as sustainable agriculture and pollution prevention. Opportunities we're watching include:

- Water-reduction technology
- Regenerative agriculture
- Sustainable materials
- Plant-based and alternative proteins
- Habitat conservation and restoration

Biodiversity innovators could benefit from valuation premiums, and they may also be better prepared for future regulations. Allspring engages with firms on issues directly related to natural capital and biodiversity that are material to their business performance. We believe managing natural capital can contribute to resilient investments as well as a prosperous shared future.

What investors should keep an eye on

- **Sectors:** The most sensitive industry sectors include **forestry, agriculture, pharmaceuticals, food and beverage, electricity, and construction.**
- **Countries:** Biodiversity hot spots develop from a unique combination of local natural phenomena, some of which are globally important. **Latin America shows the greatest regional decline in biodiversity.**
- **Intersection with climate change:** Climate change also adds to biodiversity loss. **Changes in land use are the leading cause of biodiversity loss** and account for 12% to 20% of greenhouse gas emissions.
- **Regulation and disclosure:** Increasing regulations may raise costs and enhance disclosure. The launch and growing momentum of **the Taskforce on Nature-related Financial Disclosures is expected to improve transparency** for investors.

New high-water marks spell disaster

Water-related financial risk has steadily increased for decades, with little progress on slowing down the underlying causes of too little or too much water. Recent weather events are a reminder of water's unique impact on communities and economies.

Protecting our liquid assets[7]

75% of the planet is covered in water; only 1% is usable

40% increase in water demand over the past 40 years

25% increase in water demand expected by 2050

Too little water

Declining fresh water impacted an increasing portion of the world's geography and population in 2023.

- **Panama Canal:** Water levels dropped, limiting ships that can use the canal by nearly half this winter. This extends shipping times, increases costs, and damages Panama's economy.
- **Mississippi River:** Record-low water levels (for the second year in a row) reduced river traffic and the flow of goods. At the same time, saltwater continues to intrude on freshwater facilities.
- **Uruguay:** The worst water shortage on record resulted from a three-year drought, nearly cutting off supply to the capital, Montevideo, and forcing the country to use brackish water.

Too much water

Increasing global temperatures have led to more frequent and more extreme weather events.

- **Greece:** Cyclone Daniel was the deadliest and costliest Mediterranean storm on record, dumping more rain on Greece in five days than it typically sees in a year.

- **Libya:** Cyclone Daniel was also Libya's worst natural disaster in decades, crumbling dams, wiping out neighborhoods, and killing more than 11,000 people.

- **Hong Kong:** A record storm lasting 15 hours and including the highest hourly rainfall on record did widespread damage, flooding subway stations and submerging streets.

These disasters highlight the global implications of water risks, which resurged in 2023 and are expected to continue as climate change adds weather volatility.

Water-related risks cost billions of dollars each year, curb economic growth, accelerate transmission of diseases, add social unrest, and intensify geopolitical pressure. Physical risks stress existing resources, typically requiring added insurance and often new infrastructure. Continued water risks from extreme weather, population growth, and urbanization are likely to strain budgets of governments, municipalities, and companies. We expect operational losses to increase along with regulations.

Opportunities Allspring is watching for in 2024

Understanding the broader water-related risks and opportunities influences how we value firms and how we forecast risk and return. Allspring seeks out organizations managing water risk most diligently.

- Levels of water-related risk vary for local governments and agencies, as do their capacities to manage this risk.
- For 2024, significant sources of risk include the El Nĩno weather pattern and potential effects on Southeast Asia and Latin America.
- At the equity sector level, textiles are an example of where we are watching for regulatory risks related to water consumption.
- For fixed income sectors, security selection within the municipal water space and supply chains will be key as regulatory requirements and restrictions ramp up.

What investors should keep an eye on

- **Sectors:** Industry sectors most sensitive to water quality and quantity include **food and beverage, textiles, pharmaceuticals, mining, and energy as well as municipalities.**

- **Cities and countries:** Water-scarce communities and countries must manage access and quantity risk for their constituents and economy. As history shows, **water can lead to conflicts.**

- **Intersection with climate change:** Extreme weather—flood and drought—has **increased water risk over time.**

- **Regulation:** Increasing water regulation (including quality and access) influences firms' operations and expenditures—**regulation at all levels of government requires attention.**

Energy fuels the climate transition

Transitioning toward clean energy and a greener overall economy will impact—and be impacted by—a multitude of factors. Allspring has been tracking and analyzing the potential impacts of climate transition for many years. This year in particular we are focused on the regulatory landscape, the cost of clean energy financing, and geopolitical risk.

Regulatory landscape

Regulatory changes continue to shape the energy sector, introducing new reporting standards for publicly traded firms and adding transparency for investors. For example, the U.S. Securities and Exchange Commission proposed climate disclosure rules that are expected to standardize and enhance data reporting, ultimately benefiting investors and asset managers. In Europe, the Corporate Sustainability Reporting Directive will ultimately require an estimated 50,000 companies to disclose greenhouse gas emissions, among other data. In Japan, the Green Transformation proposes approximately $1 trillion of public-private investment to shift the country from fossil fuels to clean energy and reach net zero in 2050.

Cost of clean energy financing

Interest rates, inflation, and global unrest have added to the cost of energy transition and, in some cases, have slowed the transition. Higher interest rates are straining government budgets in developing nations—especially in Africa and Asia—while pushing down currency values. When borrowing costs soar, renewable energy projects are often hit harder than traditional fossil fuel projects, in part because of the high upfront costs for wind and solar initiatives. Many renewable developers sign long-term contracts to sell electricity at a set price before beginning construction, making them particularly vulnerable to rising interest rates and inflation. We see this as a challenge for clean energy projects in the short term but not an insurmountable one.

Geopolitical risk

Russia's invasion of Ukraine demonstrated how even traditional fossil fuel and natural gas supplies are vulnerable to shocks and that these shocks are often unpredictable. Geopolitical risk has increased throughout the world in recent years. The Middle East and Africa, in particular, are at risk of further migration and displacement crises, which can be triggered or worsened by energy shocks. Geopolitical risk can also dampen the outlook for clean energy by diverting attention and resources to seemingly more urgent problems.

Opportunities Allspring is watching for in 2024

- The Inflation Reduction Act in the U.S. unlocks significant fiscal support and opportunities for private capital for green hydrogen, carbon capture, and other technologies that decarbonize hard-to-abate industries such as cement.
- Some of today's heaviest-emitting firms could be tomorrow's decarbonization outperformers. We look for climate-aware competitive strategies, aligned asset positions, and ample financial flexibility.
- Regulations targeting building decarbonization are starting to bloom across Europe and the U.S. The trend to electrify has set the table for significant investments into efficiency technologies with particular upside potential for HVAC firms, utilities, and real estate.
- The 2023 UN climate summit (COP28) officially called for a transition away from fossil fuel energy—for the first time ever. Will nations now raise their decarbonization ambitions? Will fossil fuel producers adjust their strategies and capital expenditures?

What investors should keep an eye on

- **Policy impacts:** Concerns have increased that energy transition policy could lead to **oversupply of some technologies (such as solar cells) or escalating trade tensions** where protectionism is alleged.
- **Passenger EVs:** Electric vehicles (EVs) have reached **a tipping point in many countries, and renewable power is not far behind.** Which low-emission technologies might be next?
- **Demand:** The rapid growth of clean energy and electric vehicles pressures **critical minerals such as copper and lithium,** which are forecasted to be undersupplied in low-emission scenarios.
- **Delays:** New wind and solar projects often face long delays; Spain and Italy each have more than 150 gigawatts of **wind and solar capacity waiting in the grid queue.**[9] The U.S. has nearly 10 times that capacity waiting to connect.[10]
- **Elections:** The 2024 U.S. election cycle **could delay certain regulatory changes from going into effect or risk rollback,** depending on the outcomes.

Stocks running hot or cold

While many global clean energy stocks came under pressure in 2023, certain firms in the HVAC business outperformed a global clean energy index.[8]

Putting our outlook to work

Allspring believes sustainable investing represents risks and opportunities that should not be ignored. It's estimated that $2.4 trillion will be needed every year through 2050 in the energy sector alone to avoid a 2°C increase in global temperatures. Our key principle for successful sustainable investing is to build diverse portfolios with clear sustainability goals, aiming to beat the broad market. That means applying structured processes and methodologies to understand positive catalysts and avoid uncompensated risk in our portfolios. Allspring's climate transition framework includes evaluating a company's competitiveness by analyzing its business model plus its technological, physical, and regulatory risks as well as opportunities.

Our strategies help address clients' financial goals and sustainability intentions across equity, corporate debt, government debt, municipal bonds, liquidity instruments, and multi-asset solutions. Opportunities in the credit market in particular continue to expand. The municipal bond market is also a significant source of opportunities for climate-transition investments.

As 2024 unfolds, Allspring recognizes the importance of staying grounded in the present but making investment decisions for the future. While slowing down and checking the rearview mirror can be a safe response when uncertainty rises, that's not always the case for sustainable investing. Losing momentum and staying focused on the past could even be the most dangerous approach.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. Visit our website at www.allspringglobal.com.

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- To reach our retirement professionals, contact your dedicated defined contribution investment only specialist, or call us at **+1-800-368-1370.**

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- To reach our EMEA- and APAC-based investment professionals, contact us at **AllspringInternational@allspringglobal.com**.

FOR SUSTAINABLE INVESTING

- To discuss sustainable investing solutions, contact **Henrietta Pacquement**, head of Sustainability, and **Jamie Newton**, deputy head of Sustainability, at **henrietta.pacquement@allspringglobal.com** and **jamie.newton@allspringglobal.com.**

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