The Changing Environmental, Political, and Investment Climate

Climate change is an important issue not only for our planet, but also when it comes to politics and investing. More importantly, these three are becoming increasingly linked. A tangible example of this happened in early June when U.S. President Donald Trump decided to pull the U.S. out of the Paris Climate Agreement, causing global consternation and much condemnation from other heads of state and business leaders (with the predictable exception of some traditional energy and coal industry executives).

In the wake of this decision, two members of the White House's business councils, Tesla's Elon Musk and Walt Disney's Bob Iger, decided to leave the President's advisory groups; which have all since been completely disbanded. Similarly, other business leaders were vocal in their criticism of Trump's decision. These included:

Tim Cook, Chief Executive of Apple (from an internal email obtained by the *Financial Times*): "I spoke with President Trump on Tuesday and tried to persuade him to keep the U.S. in the agreement. But it wasn't enough…I want to reassure you that today's developments will have no impact on Apple's efforts to protect the environment."

Indra Nooyi, Chief Executive of PepsiCo: "PepsiCo's longstanding commitment to addressing climate change will not change. We have a science-based goal to reduce absolute greenhouse gas emissions across our value chain by at least 20 per cent by 2030, and we will continue taking action to deliver on this goal."

David MacLennan, Chief Executive of Cargill: "It is extremely disappointing. Exiting international accords like the Paris Agreement will negatively impact trade, economic vitality, the state of our environment and relationships amongst the world community."

Many critics argued that the structural shift in world energy markets towards renewables and away from fossil fuels would continue, regardless of Mr. Trump's decision. The BMO Nesbitt Burns Portfolio Advisory Team is in full agreement with this view. Several representatives from U.S. cities and states – led by both Democrats and Republicans – reaffirmed their own commitments to reducing their greenhouse gas emissions, including:

Charlie Baker, Republican Governor of Massachusetts: "Massachusetts is aggressively working to exceed the goals of the Paris Agreement on the state level, while growing our economy through clean energy innovation and environmental stewardship."

Kevin Faulconer, Republican Mayor of San Diego: "San Diego remains as committed as ever to implementing our landmark Climate Action Plan and being a national leader in solar, renewable energy use, water purification and green job creation."

William Peduto, Democratic Mayor of Pittsburgh: "As the Mayor of Pittsburgh, I can assure you that we will follow the guidelines of the Paris Agreement for our people, our economy & future."

Tim Ryan, Democratic Representative from Ohio: "Clean energy jobs are booming. #ParisAgreement would have allowed leverage to drive these jobs to places that need them – like Youngstown."

But what does all this mean from an investment perspective? At first blush it may seem like a boon for the traditional Oil and Gas sector, which is extremely important to Canada and highly correlated to the Canadian dollar, as the Portfolio Advisory

Team has discussed many times. However, supply and demand fundamentals, not political posturing, continue to be the real drivers of oil prices. While the U.S. oil rig count appears to have plateaued in the short-term, inventories remain stubbornly high, which is why we do not believe the conditions are yet in place for West Texas Intermediate (WTI) crude oil to break out of its US$45-US$55 range. Conversely, the move toward cleaner energy will likely not be materially impacted by Trump's decision, given the views expressed by the business community and government representatives. While wind turbine and solar panel manufacturers can be extremely volatile investments, there are some more investable and conservative companies in the utility space which produce most of their power from renewable sources. Algonquin Power (AQN) and Boralex (BLX), both listed on the S&P/TSX Composite Index in Canada, are two favoured companies in this area.

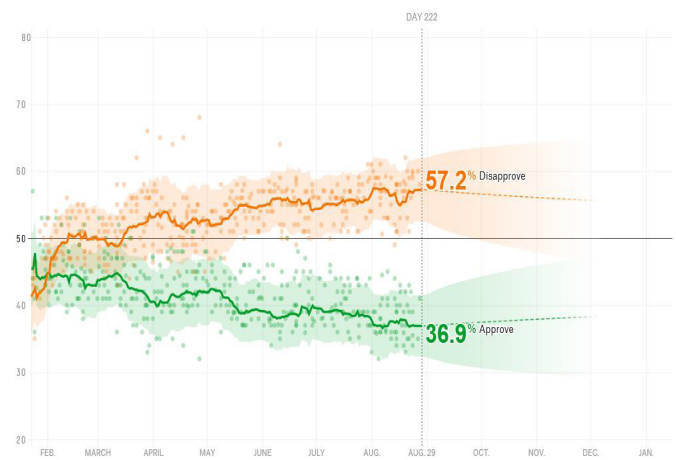
More broadly, the Portfolio Advisory Team thinks it is still appropriate to be overweight equities relative to bonds – given continued robust economic momentum and palatable valuations – with a preference for more defensive and high-quality stocks with good dividend growth potential.

Changing investment climate over the last year

Figure 1 illustrates the shift that has taken place since Trump's November 2016 election. Early enthusiasm about his pro-growth promises (i.e., corporate tax cuts, infrastructure spending, financial deregulation, etc.) has been replaced by deep skepticism about his ability to get things done. Congress' recent failure to replace Obamacare has only exacerbated this trend. The conclusion for stocks is not necessarily sinister but, for the sake of conservatism, investors are cautioned not to bank on any equity friendly measures passing in Washington. In fact, this is exactly what the market has been doing; essentially discounting progressively lower probabilities of major positive reform being enacted. This has manifested itself across a number of key areas.

First, the President's disapproval rating is the highest of any President since WW2. And, if the bookmakers are any indication, betting sites are showing an almost 50% chance of Trump getting either impeached or resigning before 2020 (as reported by UK paper *The Telegraph*). This matters because the lower the President's approval rating, the less leverage he will have over members of Congress (particularly Republicans who disagree with him) to push through his agenda.

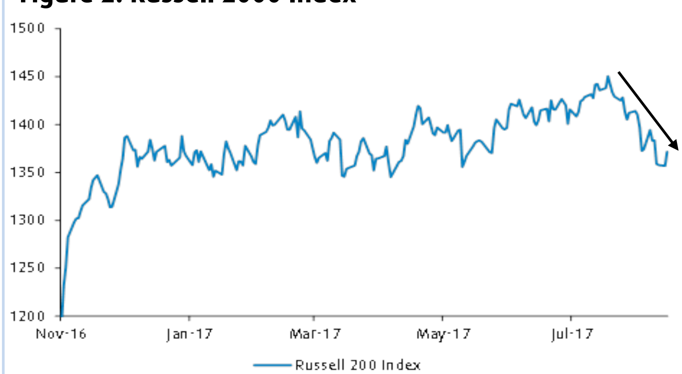
Figure 1: Trump's Approval Rating (as of August 29, 2017)



Source: FiveThirtyEight

Small-cap stocks, as represented by the Russell 2000 Index (**Figure 2**), have pulled back significantly of late. Since many of the companies in this Index are domestically focused, they will disproportionately benefit from a large tax cut and provide a good barometer of investors' expectations regarding the successful passage of fiscal reform.

Figure 2: Russell 2000 Index



Source: Bloomberg, July 2017

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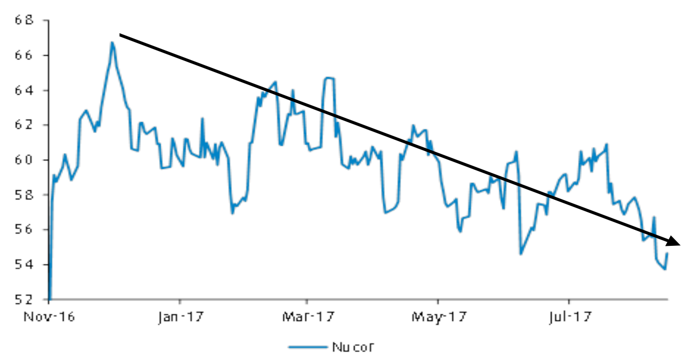
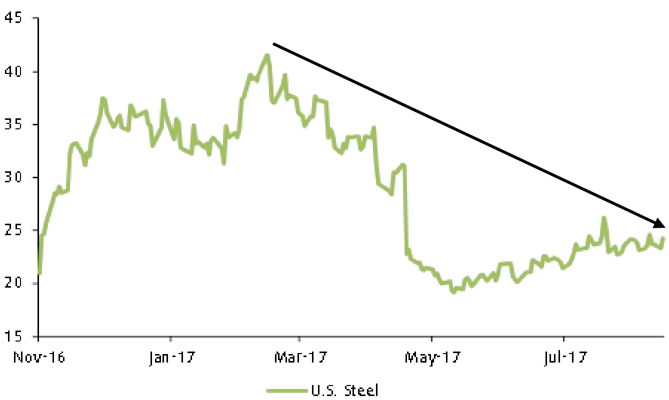
Steel stocks, which are prime beneficiaries of increased infrastructure construction, jumped after the November election but have given back all of their gains. In **Figures 3 and 4** – stock charts for two of the largest steel producers in the U.S., Nucor and U.S. Steel – we see how their stock price has declined since November 2016.

Figure 3: Nucor Stock Chart



Source: Bloomberg, July 2017

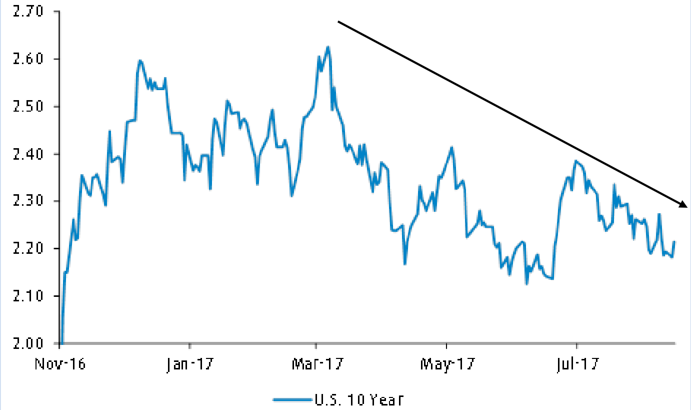
Figure 4: U.S. Steel Stock Chart



Source: Bloomberg, July 2017

The U.S. 10-year interest rate (**Figure 5**), the most important benchmark in the world of finance, jumped after the election on fears that Trump's agenda would be inherently inflationary. However, since peaking at over 2.6%, it has been drifting down as of late.

Figure 5: U.S. 10-year Interest Rate



Source: Bloomberg, July 2017

And, finally, the U.S. Trade Weighed dollar continues to weaken (**Figure 6**).

Figure 6: U.S. Trade Weighted Dollar

Source: Bloomberg, July 2017

The Paris Agreement in a nutshell

In a BMO Economics report from last year, they stated: "On 22 April 2016, Earth Day, 174 countries (including Canada) and the EU, officially signed the Paris Agreement that was adopted in December (since then, five more parties have signed on). Essentially, for the first time ever, all industrial and developing nations have agreed to take action on climate change. In previous agreements, such as the Kyoto Protocol, developing countries weren't obliged to reduce their emissions of greenhouse gases (GHGs). Now, it's incumbent on all nations to cut emissions, in order to keep global warming to "well below" 2ºC above pre-industrial levels by the end of the century,

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making particular effort to limit it to 1.5ºC.[1] This will require humankind to reach a point of no net increase in GHGs – carbon neutrality – sometime during the second half of the century (as early as 2050)."

The Agreement contains commitments by rich countries to provide financial and technological assistance to poor countries. Note that Canada announced a C$2.65 billion climate finance commitment in November 2015, its largest to date, to support developing nations in their transition to low-carbon economies. Also, all countries committed to publishing progress on their Intended Nationally Determined Contributions (INDCs), or emission reduction targets. Like many other countries, Canada is already doing this. Although INDCs are not legally binding, "name and shame" can be a powerful prod. They will be updated every five years beginning with a 2023 review of 2018 vintage targets. **Figure 7** ranks the top 20 countries by their share of GHG emissions – from highest to lowest.

Under existing international agreements, not including the Kyoto Protocol which Canada pulled out of in 2011, Canada has committed to reducing its GHG emissions to 17% – below 2005 levels – the equivalent of 747 million tonnes of carbon dioxide (CO_2) – by 2020, and to 30% below by 2030.

Figure 7: Select GHG Emissions

Select GHG Emissions[1] (% of global total, 2014)

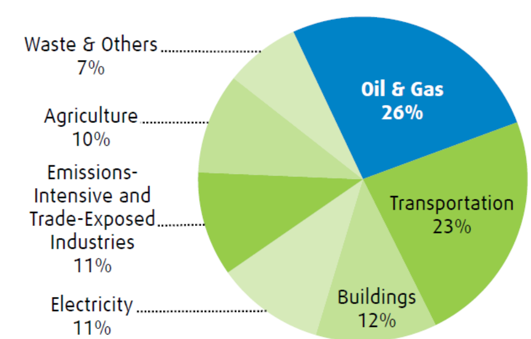
Rank		Share	Rank		Share
1	China	27.0	11	Canada	1.6
2	United States	15.5	12	Brazil	1.4
3	India	7.2	13	South Africa	1.3
4	Russia	4.4	14	Mexico	1.3
5	Japan	3.4	15	United Kingdom	1.2
6	Germany	2.2	16	Australia	1.1
7	Indonesia	1.8	17	Turkey	1.0
8	Iran	1.7	18	Thailand	0.9
9	Saudi Arabia	1.7	19	France	0.9
10	South Korea	1.7	20	Italy	0.9

[1] from the combustion of fossil fuels, cement production and land use only
Sources: BMO Economics, Global Carbon Atlas

According to the reporting standards of the United Nations' Intergovernmental Panel on Climate Change (IPCC), 81% of Canada's GHG emissions are related to energy production and consumption. For domestic policy purposes, ECCC also reports emissions by economic sectors and activities. Oil and gas production alone accounts for 26% of Canada's GHG emissions, followed by the combustion of fossil fuels for transportation at 23%. The heating and cooling of buildings comes in third at 12%, followed by the combustion of fossil fuels for electricity at 11% (**Figure 8**). Although energy usage is part of the remaining sectors' GHG emissions, production processes are the major sources (think methane emitted from farms and landfills, or carbon dioxide emitted from cement making).

Figure 8: Canada's GHG Emissions by Sector

Canada (% of total, 2014)



Sources: BMO Economics, Environment and Climate Change Canada

Climate change remains a real concern and will undoubtedly continue to impact both politics and investing. However, despite the decision of U.S. President Trump to pull out of the Paris Agreement, there is a strong commitment from countries around the globe, as well as U.S. government officials and business leaders to respond to these real changes and adopt practices that will have a positive impact. Combined, this will present investors with long-term tangible investment opportunities, as well as peace of mind.

For further information, or to discuss your investment portfolio, please contact your BMO Nesbitt Burns Investment Advisor.

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Footnote:

[1]Two degrees Celsius is the consensus view when climate change will have catastrophic consequences such as devastatingly-high sea levels.

ID1297 (08/17)