Overweight California Carbon Allowances/Underweight Global Equities

Recommended since October 31, 2021

Investment thesis: We believe California Carbon Allowances (CCAs) will outperform global equities, given our expectation that supply/demand fundamentals will drive CCA prices up toward their first price containment tier. With CCAs priced near the program's floor, they offer highly asymmetric return potential. Regulated entities are allotted free allowances for a portion of their emissions and must purchase additional credits to satisfy remaining obligations.

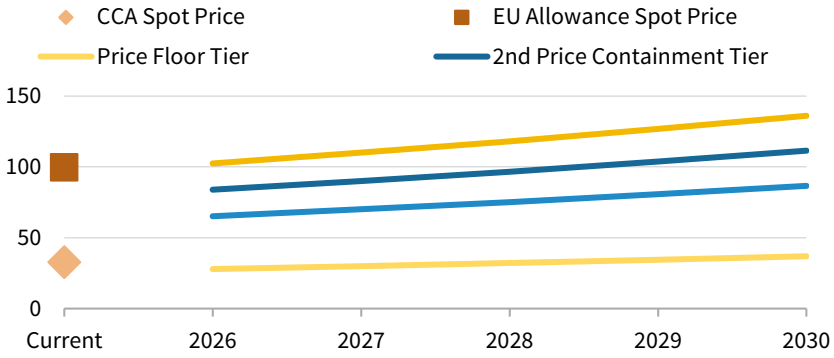
Key support 1: On August 31, California's Office of Administrative Law approved the long-awaited overhaul of the state's Cap-and-Invest regulation, resulting in a reduction of 118M CCAs between 2027 and 2030. The package includes a Manufacturing Decarbonization Incentive that has potential to reduce some of the supply tightening to the degree emitters commit to investments in eligible decarbonization projects. These changes will increase expected CCA deficits, which in more mature carbon markets have typically led to price increases. Prices will receive an additional boost once it is joined with Washington state's program, which is expected by 2027.

Key support 2: We anticipate that relative to equities, CCAs offer less downside risk with significantly more upside potential. The program includes a floor indexed by inflation plus 5% that limits downside risk, while reductions in supply relative to demand increase upside in contrast to global equities.

Key risks: Regulatory changes present the biggest risk to CCAs, although the program is well established and provides significant revenue to the state of California. Implementation delays and poor communication by CARB related to adoption of increased program stringency measures has put downward pressure on CCA prices. Therefore, we have extended the timeline by which prices are expected to increase in response to tightening supply as reflected in our return protections. CCAs can also experience short-term volatility related to technical issues in the options and futures markets. Finally, global equity performance may exceed our expectations. From an implementation perspective, rolling futures cost an estimated 1.5% annually, while options for owning physical allowances are limited.

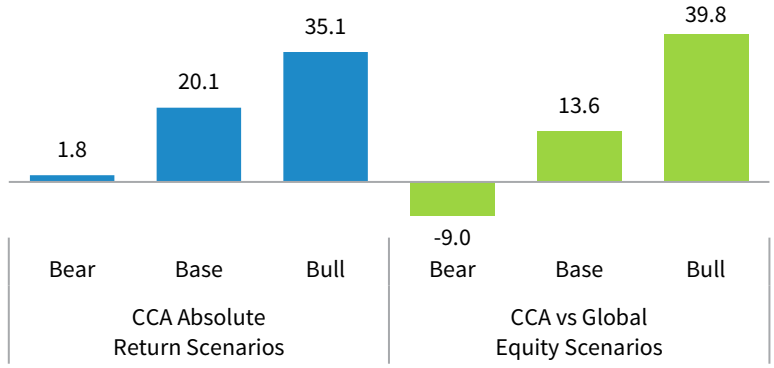
CCA price compared to EU and price containment tiers

As of October 31, 2026 • US dollars



Return projection scenarios

As of October 31, 2026 • 3-yr annualized average compound return (%)



Sources: Bloomberg L.P., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: LHS - Spot prices use near-month futures. Price tiers rise 5% plus US TIPS 10-yr breakeven inflation annually. Price containment tiers trigger extra allowances to hedge higher costs. RHS - CCAs: Bear Scenario = 2029 price floor; Base Scenario = halfway to 2029 1st containment tier; Bull Scenario = 2029 1st containment tier. For CCAs vs Global Equity: Bear Scenario = Bear Scenario for CCAs minus Global Equity Bull Scenario where cyclically normalized P/E rises by a decile (or to all-time max if >90th %ile), 6% annual nominal earnings growth. Base Scenario = CCA Base Scenario minus Global Equity Base Scenario where P/E is unchanged, growth reflects recent averages. Bull Scenario: CCA Base Scenario minus Global Equity Bear in a Deflationary Bust where P/E drops 50%, earnings growth averages -2%.

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