Sustainable Investing Perspectives

Sustainable investing

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- Social bonds appear to be gaining traction globally, and we expect the market to continue to expand.
- Investors are turning to the US election for the next catalyst in the ESG space, but we continue to believe sustainability linked themes can outperform regardless of the election outcome.
- The EU taxonomy is setting the stage for other governments to adopt similar frameworks.
- China’s announcement to reach net zero emissions by 2060 adds to the growing number of regulatory catalysts for climate related solutions.

ESG themes remain supported regardless of the election outcome

A record USD 147 billion of ESG-labeled bonds were issued globally in Q3 2020 due to rising societal demands, and the ESG bond market has surpassed USD 1 trillion in debt outstanding. More specifically, government support for social-linked bonds appears to be picking up. In September, Mexico became the first country to issue a sovereign Sustainable Development Goal (SDG) bond. Demand for the 1.35% coupon bond was 6.4 times the allocated amount, and over 250 global investment firms participated.

Following Mexico’s SDG bond, the European Union issued 10- and 20-year social bonds as part of its EUR 100bn SURE (Support to mitigate Unemployment Risks in an Emergency) program. The EU’s first social bonds attracted record demand with bids of more than EUR 233bn for the first EUR 17bn sale, according to Reuters. In our view, the success of both Mexico’s SDG bond and the EU social bonds are indicative of growing appetite for sustainability linked bonds. We see this as a sign of robust demand, and we expect the market to double within the next nine months.

Moreover, a blue wave outcome from the US election could provide an additional catalyst for "green themes", as proposed by the USD 2 trillion spending plan by Joe Biden. That said, these themes are exposed to strong secular growth trends, and further support from the private sector alongside a growing number of state level initiatives should help to put a floor under demand regardless of the election outcome. For example, twenty-four US states including California and New York have joined the U.S. Climate Alliance, pledging to uphold the Paris Agreement commitments, and hundreds of metropolitan centers have announced plans to advance climate initiatives (Fig. 1). The proposal also presents a risk for companies most exposed to stricter environmental regulations, though the market seems to be pricing some of this risk in already, given the underperformance of the US energy sector so far this year.

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Sustainable investing

Figure 1 - There are a number of state level initiatives aiming to advance environmental objectives

Takeaways for investors:
• In our view, government and global investor focus on social bonds should continue to grow, and it could benefit certain SDG themes specific to each issuer’s use of proceeds.

• The election has several implications for climate linked longer-term investment themes, such as Renewables, Energy Efficiency, and Smart Mobility, but in our view these themes are exposed to strong secular growth drivers and should see high growth in the years ahead regardless of the election outcome.

• In the event of a Biden victory, stricter environmental regulations could create a competitive advantage for ESG leaders relative to peers.

EU taxonomy driving innovation in impactful investment products
Two months from now, the first taxonomy for climate change mitigation and adaptation should be established in the EU, defining the criteria that fund managers and institutional investors need to use to disclose how, and to what extent, they determine the environmental sustainability of their investments. Many investors are asking what does this mean for sustainable investments in the EU and globally?

The EU taxonomy regulation, “a framework to facilitate sustainable investment”, was signed into law in July 2020 and focuses on six environmental objectives: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems.

While the taxonomy for the first two climate-related objectives will be in place by end 2020, the remaining four are not expected until the end of 2022. Right now, companies and investors are scrutinizing the recommendations for design and implementation of the taxonomy to figure out how to get the data it demands and what this means for their business model. For some, the information demanded may be commercially sensitive.

For the wider sustainable investing (SI) industry, the taxonomy may be the next step in the evolution of SI toward prioritizing how to have real impact through our sustainable investments. The European Sustainable Investment Forum has expressed the view that the taxonomy will emphasize the progression from ESG integration to a greater emphasis on risk and return, and evidencing the impact that our investments are having. The EU work is already creating global ripples. In Japan this month, academics published “transition taxonomies” – a guide for financing corporates and individual businesses to support a transition to a low-carbon economy. Canada plans to launch a ‘transition taxonomy’ to define sustainability in the context of its resource-heavy economy, and others such as Russia, UAE, Mexico and South Africa have announced plans for their own taxonomies.

Takeaways for investors:
• The taxonomy will be more relevant for some asset classes or categories, such as environmentally focused approaches e.g. green bonds, or environmental thematic investing.

• Investors who want more exposure to the growth opportunities in sustainable industries identified in the taxonomy could increase their allocation to thematic and green bonds approaches.

• All investors should benefit from the greater portfolio transparency that the taxonomy aims to provide in the coming years.

President Xi’s carbon neutrality pledge adds further support for clean energy opportunities
At the United Nations General Assembly this September, President Xi pledged that China would achieve carbon neutrality by 2060, with domestic carbon emissions peaking in 2030. Being the biggest carbon emitting
country (~30% of global share), China will likely need to set much higher green energy targets in the coming five years in order to reach their goal.

China’s previous target for 15% renewable contribution was achieved in 2019, and China has continued moving toward a cleaner energy structure, with coal’s share in energy consumption declining to about 58% in 2019 from over 70% a decade ago. After aggressive investments and policy support in past years, Chinese companies today dominate the manufacturing and deployment of key technologies in solar, wind and renewables, but more will be needed to reach net zero (Fig 2).

Carbon emissions per unit of GDP are on a clear downward trend over the past decades, and looks set to trend further downwards in the future given China’s strong commitment. The national carbon emissions trading system, which has been piloted in 7 provinces and municipalities since 2011 and is expected to be the world’s leading carbon trading system. Carbon emissions trading should incentive businesses to lessen emissions and further green their businesses, and should in turn be supportive of the clean energy technologies that will be needed in the transition.

Another promising green trend is the growth of the electric vehicle (EVs) market due to the tightening emission standards. EVs now account for around 5% of total car sales in China, and the government targets 25% EV penetration in new cars sold by 2025. China has also launched a wide range of “green” finance instruments since 2016, including green bonds, loans, shares, development funds and insurance products. The Chinese green bond market, with total outstanding bonds of USD 140 billion at end-2019, is now the world’s 2nd largest, and 6th most active by issuance. Meanwhile, mandatory Green Credit Guidelines have mobilized banks’ support of green loans, which is now a vast RMB 11 trillion outstanding at the end of Q2 2020.

Takeaways for investors:

- China’s acceleration to a green economy should continue to benefit companies providing solutions across the renewables value chain, supporting key listed players in the solar and wind power sectors.
- China’s net zero pledge should have significant impact on the demand outlook for smart mobility, and we expect the electrification trend to continue to support the EV value chain.
- Reaching net zero will also require improvements in energy efficiency, and incentives like carbon trading programs add to our positive view of companies with revenue exposure to the Energy Efficiency theme.

1. South China Morning Post, China’s carbon neutral energy pledge adds more weight to 14th five-year plan for 2021-25, 2020.
Appendix

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