

Green appetite: ESG and EMD, taking the long view

✓ **Investors with allocations to emerging market debt now need to understand the true impact on developing economies of long run factors like climate change and human capital development**

Governments everywhere are racing to lock in historically low borrowing costs by issuing ever longer dated debt. That presents several new challenges for fixed income investors. Particularly those who own emerging market (EM) bonds.

Not only do bondholders have to weigh up the usual near term factors like political, economic and commodity cycles but, in lending money to sovereigns over extended periods, they now also have to consider the impact of longer term trends, such as climate change and social development. Both can affect creditworthiness in profound ways.

This has called for a new approach; economic and financial forecasts are having to be recast with climate dynamics in mind. Meanwhile, modelled pathways of climatic change are themselves subject to expectations about future technological change as well as the evolution of political thinking in these countries. The number of moving parts only grows as investors realise they also have a role to play in shaping how governments approach making their economies sustainable and low-carbon.

Bondholders have also recognised the importance of taking a long-term view on environmental issues. This is apparent in both the appetite for green bonds – capital earmarked for environmental- or climate-related projects – and, more generally, bonds that fall under the environmental, social and governance

(ESG) umbrella.

Governments are happy to meet that demand. Increasingly, they recognise the need to make efforts to mitigate climate change, and given that emerging market economies make up half the world's output, they have a significant role to play in meeting global greenhouse gas emissions goals.

Overall, green bonds generate positive feedback. The rising volumes of green bond issuance highlights investors' willingness to take more of a long-term approach to EM investing. But at the same time, governments are being made more accountable – in order to issue these bonds, governments are having to publish their sustainability frameworks in greater detail. This additional accountability helps to mitigate the political risks that are a key consideration in EM investing. Investors, however, will need to analyse and monitor developments closely to ensure proceeds are used as intended.

For all the sovereign issuance of green bonds so far, a great deal more funding will need to be raised to limit climate change. A significant part of the costs will need to be borne by emerging economies, not least because they are likely to suffer most.

How governments react to long-term issues like climate change or to the challenge of developing their human capital will influence their economies' trajectories and, ultimately, play a role in

their credit ratings.

Countries with good, well-structured policies are likely to see their credit ratings improve, which attracts investors, drawing funding into their green investment programmes and ultimately driving a virtuous investment cycle.

All this implies that investors have an active role to play – they can't just passively allocate funding based on index weightings or be purely reactive to policymakers' decisions. The most successful investors will help steer governments towards the path that boosts their credit ratings, gives them most access to the market and improves the fortunes and potential of citizens.

This sort of intensive analysis – using everything from long run macro models to meetings with leaders of youth clubs in impoverished districts – can also help to paint a rounded picture of what's happening in a country.

For EM investors, ensuring all of these cogs mesh correctly is a difficult proposition, especially given that the parts are moving all the time. But by using the full breadth of analytical tools, independent research and shoe leather fact-finding, it's possible to gain a deeper and more profitable insight into these markets than a simple reading of credit ratings or index weightings offers. And, at the same time, influence policy makers to champion their country's sustainable initiatives. Taking a sustainable approach to growth and issuing related bonds, emerging economies can fundamentally change their prospects for the better. It has the potential to be revolutionary for emerging markets and exhilarating for those of us who invest in them.



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