Fixed income's role in achieving net zero

Scott Freedman outlines Newton's thoughts on the prospects for global fixed-income markets and the crucial part that bond markets are likely to play in the transition to a low-carbon economy

The role that fixed-income markets have in funding the journey towards a better environmental and social future is a crucial one, as most of the future funding towards that aim is expected to come from debt rather than via equity. We view this process very much as a 'journey', because a large range of stakeholders will take time not only to agree on the roadmap and how best to achieve it in our lifetime, but also on how to collectively put their plans into action.

Challenges ahead for fixed income

At the same time, while fixed-income markets continue to provide some positive investment opportunities, they are facing a range of potential threats in 2022, particularly from inflation and the removal of monetary stimulus by central banks. We expect that these concerns will be particularly influential in government-bond markets until the second quarter of this year, but from that point on we would anticipate a more stable safe-haven environment for yields.

Yet, as mentioned above, this is undoubtedly a challenging backdrop for fixed-income markets, and, to add to the pressing issues facing bond investors, the *Intergovernmental Panel on Climate Change's (IPCC) Gap Report* for 2021 warns that the world is on track for 2.8 degrees Celsius of warming by the end of the century based on current policies. As bond markets strive to play their part in countering the threat posed by climate change, we have seen a significant recent acceleration in 'green' spending, as the number of companies making firm net-zero commitments continues to grow.

Huge capex, growing debt…

Additional spending requirements to achieve net-zero carbon emissions range from the low to high single-digit trillion dollars per year; to provide some context on the scale of the challenge ahead, the world's 2,000 largest non-financial companies are expected to have paid out $3.7 trillion in 2021 on business-as-usual capital expenditure alone.

Whichever way you cut it, this is a huge amount of additional capital that needs to be funded, and global debt to GDP is only going to increase further as a result. For us, this increases the need for global monetary policy to remain accommodative to maintain access to low-cost funding. However, it is cheaper to act now than to have to deal with the consequences of inaction later.

We believe the next step will be the further internalising of 'externalities': companies will have to pay a price for carbon emissions – a cost which society bears today. This has material implications, in that the acceleration of cost pressures for higher emitters will increase credit risk, thereby limiting access to capital that can be acquired at attractive interest rates. As climate regulations increase, we may see more stranded assets, while business models and carbon-intensive companies are likely to see steeper credit curves (higher spread compensation for debt with longer maturity). This will not just be the case for companies, but for countries too, with sovereign credit risk being an important consideration when seeking access to markets for funding.

Fixed income's growing role in the transition

In terms of key opportunities, we believe the role fixed-income markets have in funding the transition away from carbon-intensive economies will become increasingly critical. Most of this funding is expected to be financed by debt from governments, international development agencies and companies, rather than via equity. We expect it increasingly to come through 'labelled' bonds (bonds with specific environmental, social and

governance (ESG) or sustainability objectives), such as green, social, sustainable and sustainability-linked bonds, as well as through 'vanilla' bonds. Private capital will be key as government balance sheets will struggle to sustain the necessary level of investment required, which will be needed for all sectors and countries – not just the most carbon-intensive ones.

There are already some big central-bank stimulus programmes in place, but we believe these are just a start. Sustainable finance has been growing quickly, but it is still small, and much more will be required for the world to achieve net zero. Take the labelled-bond market, for example; although it has reached $1.5 trillion in outstanding issuance, this only represents 1.2 per cent of the global bond market.

Increasing accountability of stakeholders

There is the risk that a slight premium that can exist for green bonds today could potentially limit the growth of the market, but the demand for green products continues to grow. Over the next few years, we think there will be less need for bond issuance to be in labelled-bond form. The increasing accountability of all stakeholders, including governments, companies, investors and asset owners, should mean less need for labels but more emphasis on differences in the cost of capital between issuers.

While investors must be on their guard against the threat of 'greenwashing' or overstating the environmental impact of products, we believe this growth in demand for labelled-bond issuance and other sustainable fixed-income assets will continue to gather pace. Our view is that thorough due diligence and careful continuing analysis of ESG factors for issuers from a holistic perspective, rather than a single project and asset focus, can help investors avoid greenwashing pitfalls. And it is not just investors putting pressure on companies; net-zero policy is driving banks to expect clients to demonstrate a credible carbon-reduction plan as part of the 'greening' of their loan books.

Pivotal role

While the wider backdrop of monetary and fiscal policy will be important given the likely increasing quantum of debt, we believe both central banks and fixed-income investors can and will play an increasingly pivotal role in directing capital to projects that can help move the planet to a potentially more equitable, lower-carbon way of life.

To avoid a proliferation of different standards, it will be important to encourage cohesive regulation to enhance the role of the financial system. The private sector needs to have rigid frameworks in place to give some confidence around potential returns on capital. There is a potential risk that diversion of financial and labour resources to potentially less productive efforts could contribute to creating inflation.

Finally, we must remember that there are social consequences to funding the climate transition, so green targets should not be considered in isolation. Public finance needs to align with climate goals and economic development objectives, while mainstream capital also needs to be mobilised alongside green capital.

Need for a just transition

The investment community is beginning to recognise the significance of social challenges, especially since the onset of the global pandemic. Our view is that environmental and social factors should not always be separated, given the importance of the idea of a 'just' transition. We must remember that there are also social consequences to funding the climate transition, such as the change in profile of workforce skills required and robustness of the ethics within new supply chains, i.e. ensuring that the environmental focus does not cause any significant harm in terms of social considerations. We believe that this concept therefore lends itself to sustainability-linked bonds, which can incorporate a broader range of key performance indicators (KPIs), such as social targets that the issuer should be also held accountable for.

None of this will be achieved overnight, but what we can say for certain is that the shape of the fixed-income market is changing at a considerable rate; we expect to see a future in which fixed-income markets play an increasingly important role in providing positive environmental and social outcomes for society.

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