

2021 Market Outlook

A Sustainable Future? 5 Sustainable Investing Themes That Will Define 2021

2020 has irrevocably changed our assumptions and perspectives on sustainable investing, with increased focus on social issues alongside environmental ones. In the wake of COVID-19, diversity, equality and inclusion have had renewed and elevated attention globally. We view 2021 as a potential watershed year for investors as we consider both the challenges and opportunities in sustainable investing, and outline MSIM Fixed Income's approach to navigating this landscape.



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2020 was characterised by a renewed focus on sustainability both among investors and issuers, and a significant rise in labelled sustainable bond issuance.¹ Several of the themes we highlighted in our previous paper “The Butterfly Effect & COVID-19”² are being realised. In this paper, we highlight five areas of focus for sustainable investing for Fixed Income in the year ahead.

Theme 1: Central Banks And Greening the Financial System

There has been a debate about whether central banks, particularly the European Central Bank (ECB), will incorporate environmental considerations into their Quantitative Easing (QE) programmes. Commenting on this matter, ECB President Christine Lagarde said that the bank was conducting an internal strategic review, “and it will very likely prompt us to use the fight against climate change as a parameter when calibrating our programmes for purchasing assets in the market—but it cannot be the sole parameter.”³ This led many market participants to speculate that the ECB could embark on a programme preferentially to buy labelled green bonds as part of its QE programme. Our view is that such a move would be counterproductive, distorting and impeding liquidity in what is still a small (albeit growing) proportion of the market. However, we also think that such a move is unlikely. Alternatively, the ECB has already announced plans to stress test banks on climate risks⁴ and therefore it is entirely plausible that they will turn this lens on to their own balance sheet and consider the sustainability risks that they run. The ECB’s Isabel Schnabel, reflecting on the asset purchase programme, observed that “we could consider ... for example, excluding certain bonds—based on clear and transparent rules—that are used to

finance projects that conflict with the decarbonisation objectives of the EU.”⁵ We have recently seen a precedent in the market, with Sweden’s Riksbank announcing that, from January 2021, it would “only offer to purchase bonds issued by companies deemed to comply with international standards and norms for sustainability.”⁶ We think a similar course of action is far more likely for the ECB, with potential implications for credit risk premia that need to be evaluated by investors.

Theme 2: The Rise of Sustainability-Linked Bonds

Sustainability-linked bonds have brought sustainable investing in debt capital markets full circle. At MSIM Fixed Income, we have a history of integrating an assessment of issuers’ ESG characteristics as part of our bottom-up fundamental research, which we apply across all our portfolios. When the labelled sustainable bond market began, the issuance instrument of choice was a labelled green or social bond, where the proceeds of the bond issuance were directed towards projects designed to achieve specific positive environmental or social outcomes. For debt investors, this brought notable benefits in the form of added transparency of an issuer’s investment plans and assets, as well as the opportunity to engage more deeply with issuers on sustainability themes as part of the marketing around such transactions. However, this also led to questions about how the projects supported by a green or social bond were aligned with an issuer’s overall sustainability strategy. In some cases, investors perceived significant anomalies; for example, the projects may be green but the company’s fundamental business model was not, or the bond may involve refinancing of old green projects without evidence of future commitments to sustainability.

Attention has therefore shifted back to issuers’ overall sustainability strategies. A criticism levelled at green and social bonds is that issuers have no “skin in the game”—if they are unable to find appropriate projects, there are no adverse consequences beyond a slightly bruised reputation. With sustainability-linked bonds, the most common structure involves setting an issuer-level sustainability key performance indicator (“KPI”) and quantitative target, and if this is not met, the issuer is obliged to pay a penalty coupon step-up. We view this as a positive development—provided the KPIs are meaningful and relevant to a company’s business model, and investors retain transparency around how issuers are achieving their specified targets. Sustainability-linked bonds may also represent a potentially interesting alternative to labelled Transition Bonds, which support projects for more carbon-intensive issuers to transition to low-carbon business models, especially in sectors with lower levels of capital expenditures to utilize in a use-of-proceeds transaction.

From September 2019 to date, only a few corporates have issued sustainability-linked bonds, aggregating to a total of US\$11.3 billion equivalent (see *Display 1*), compared to over \$1.5 trillion in labelled green and social bonds, but we predict that 2021 will see a significant increase in issuance volumes in the wake of the recent publication of the Sustainability-Linked Bond Principles by the International Capital Market Association (ICMA). Additionally, from the beginning of 2021, sustainability-linked bonds will become eligible collateral for the ECB and also eligible for its asset purchase programmes,⁷ which should further galvanise this market. Such growth should also help establish best practices for this new type of instrument,

¹ References to “sustainable bonds” in this paper are intended to encompass Green, Social, Sustainability and Sustainability-linked bonds, as defined by the International Capital Market Association (ICMA), as well as other labelled bonds financing specific environmental and/or social objectives.

² See “The Butterfly Effect & COVID-19: Six Implications for Sustainable Investing in an Interconnected World,” Morgan Stanley Investment Management ([link](#)).

³ Christine Lagarde, Interview with France 2, 4 June 2020

⁴ ECB Guide on Climate-Related and Environmental Risks, 27 November 2020

⁵ Isabel Schnabel, European Sustainable Finance Summit, 28 September

⁶ Minutes of the Executive Board, Riksbank, 25 November 2020

⁷ ECB Press Release, 22 September 2020

particularly what is considered an acceptable timeframe for the selected sustainability target and the size of the coupon step-up. We also expect further discussion on the opportunities for sustainability-linked bond issuance by non-corporate issuers.

Theme 3: Coming to America: 2021 Will See U.S. Sustainable Bond Issuance Accelerate

Despite the significant growth in sustainable bond issuance, which exceeded \$500 billion in 2020 (see *Display 1*), and the developments in new structures mentioned above, there has been proportionately less issuance from U.S. Corporates compared to their international peers.⁸ We believe that 2021 will be the turning point for the U.S. Corporate market. From a demand standpoint, appetite for issuance from U.S. investors is growing faster than anywhere else in the world. U.S. sustainable assets under management increased by 42% in 2018-2020 (see *Display 2*), further accelerating the 32% growth rate from the previous two-year period.⁹ Furthermore, the new Biden administration has set out an ambitious environmental strategy, encompassing climate mitigation, adaptation, pollution prevention and new low-carbon job-creation measures.¹⁰ We are cautious about how much of this will ultimately end up as part of the legislative agenda; however, we do believe that the change in tone and federal priorities, as well as symbolic gestures such as rejoining the Paris Agreement, will provide a supportive backdrop for Corporate America to consider its contribution to global sustainability goals.

Theme 4: An End to Social Distancing, an Increase in Social Investing

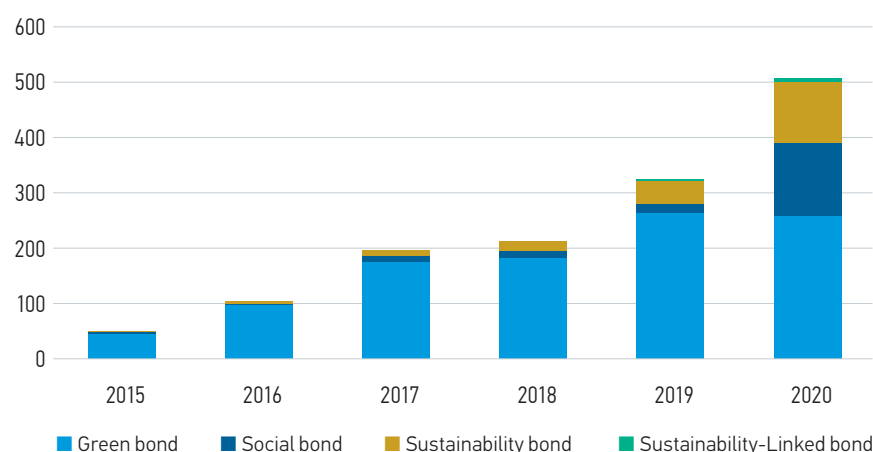
As we look ahead to an end to social distancing measures, we believe that the acute awareness of social issues—and their impact on the economy and value generation—will persist among investors and asset owners. Indeed, labelled social bond issuance has grown exponentially in 2020 (see *Display 1*),

representing over a quarter of total labelled sustainable issuance globally. Although this has partly been driven by the rise in COVID-19 response bonds, we saw a notable breadth of projects supported by the social bond market last year. In particular, several transactions came to market promoting diversity, inclusion, education, social mobility and provision of basic necessities to vulnerable or marginalised groups. We

DISPLAY 1

Global Sustainable Bond Issuance 2015-2020

US\$ billion equivalent

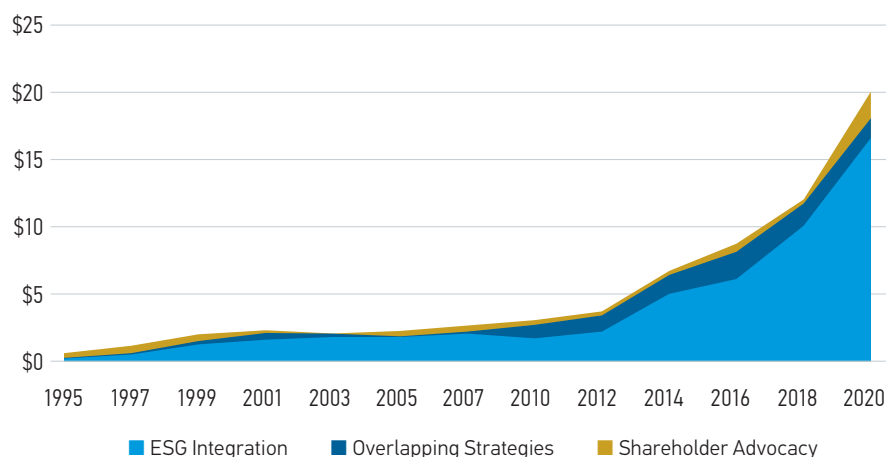


Source: Environmental Finance Bond Database

DISPLAY 2

Sustainable and Responsible Investing Assets Under Management in the U.S.

US\$ trillion



Source: US SIF Foundation, 2020

⁸ Sustainable bond issuance by U.S. Corporates represented c.20% of total corporate sustainable bond issuance in 2020 (source: Environmental Finance Bond Database).

⁹ Source: US SIF Foundation 2020

¹⁰ <https://joebiden.com/climate-plan/#>

think this will become an established feature of the market. In this post-pandemic environment, customers, employees and investors are increasingly scrutinising companies' behaviour with respect to the communities in which they operate, their supply chains and their workforces, as well as the accessibility and affordability of their services. Deficiencies in such behaviour may present risks to us as investors, whereas exemplary conduct may present an opportunity to capture investment alpha. This type of analysis does not spare sovereign issuers and municipalities, as investors will increasingly demand more transparent disclosure of their social expenditures and their associated outcomes, including through intensified engagement efforts (see *Display 3*).

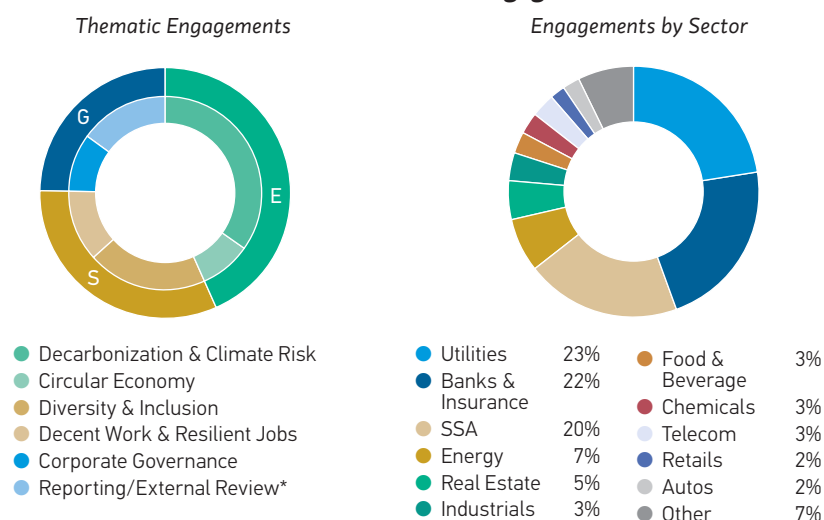
Theme 5: "Build Back Bolder"

In our previous insight piece, we commented on the prospect of "Building Back Better," and our assessment that the post-pandemic recovery would be characterised by greenness and social justice. Roadmaps like the EU Green Deal and UK Green Recovery Plan are encouraging, but we now consider how a green, inclusive recovery may be accelerated—how can we "Build Back Bolder"?

While regulators might consider applying different risk weights for banks to favour green assets and penalise brown assets, therefore influencing the flow of capital in the economy, we believe more work needs to be

DISPLAY 3

Global Fixed Income Thematic and Sector Engagement in 2020



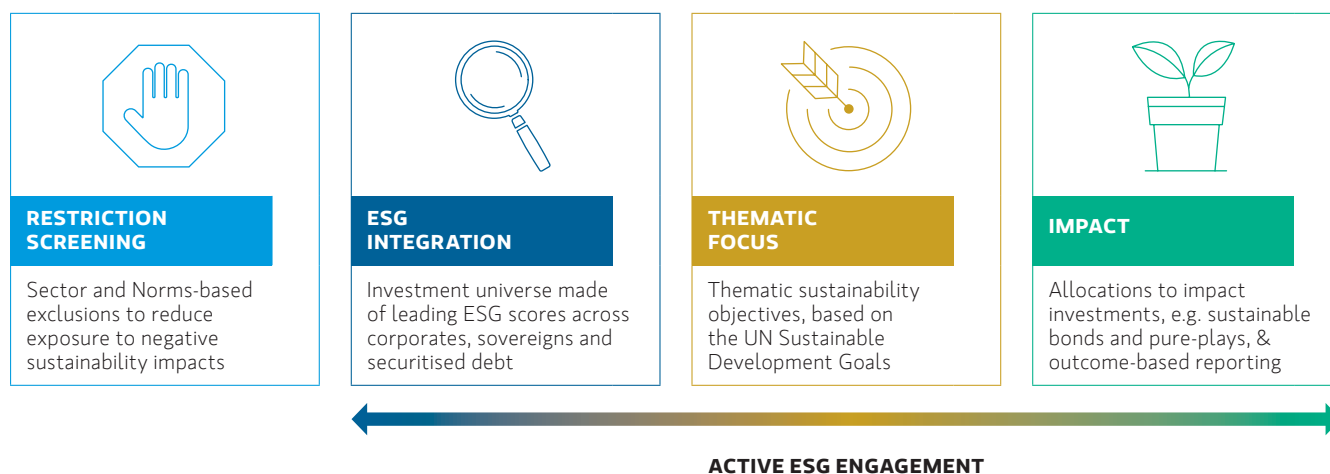
* Note: "Reporting and External Review" under the Governance (G) theme refers to engagements in the context of Sustainable Bond issuances.

Source: Morgan Stanley Investment Management

done to link sustainability and risk before implementing such a regime. An alternative idea that is gaining traction is to consider fiscal measures that could promote sustainability, and here we like the example of the U.S. tax-exempt municipal bond market. U.S. municipality issuers have a long history of investing in projects that have positive environmental or social benefits, and they may attract tax-exempt status, which means that end investors do not have to pay income tax on the interest earned. The net result is a lower cost of borrowing for the issuer and a beneficial return for the customer because of the tax saving. In Biscay in

northern Spain, the local government has signed a partnership with the UCL's Institute for Innovation & Public Purpose (IIPP) to explore a sustainable way out from the COVID-19 crisis,¹¹ with work so far focused on identifying which companies can be considered aligned with the UN Sustainable Development Goals ("UN SDGs"), and thus be entitled to tax credits after being certified as such. These innovative ideas, placing sustainability as a central pillar in establishing risk frameworks and fiscal policy, will be critical to both "Build Back Better" and "Build Back Bolder."

¹¹ IIPP enters agreement with Biscay Government for Sustainable Development Goals-led economic growth, University College London, 9 June 2020

DISPLAY 4**A Focus on Outcomes Through Holistic Use of Key Sustainable Investing Tools****How to Invest Sustainably With MSIM Fixed Income**

Our five themes have potential impacts on risk, return and liquidity which are relevant to all Fixed Income portfolios, with additional implications for strategies with specific sustainability objectives. MSIM Fixed Income's Sustainable Investing team has deep expertise to navigate a fast-moving space that, as we highlight above, is being influenced by politics,

regulation, culture and academia. We have developed a range of proprietary methodologies across all Fixed Income asset classes to cut through the rhetoric and objectively evaluate sustainability risks and opportunities, and also assess the integrity and impact of labelled sustainable bonds.¹² We also work closely to guide our clients to preferred solutions tied to their own sustainability goals, whether through our range of Sustainable Funds or through

customized Separate Managed Account strategies, which utilize a combination of approaches from our sustainable investing toolkit, as presented in *Display 4*, to help meet their objectives.¹³ 2020 taught us the importance of preparedness and resilience, and through our robust, dynamic and flexible approach, we will continue to focus on these for our clients as we navigate the sustainable investing landscape in 2021 and beyond.

¹² See "All Green Bonds Are Not Created Equal," Morgan Stanley Investment Management ([link](#)).

¹³ See "Crafting a Dynamic Sustainable Investing Strategy – Four Building Blocks for Asset Owners," Morgan Stanley Investment

Management and Morgan Stanley Institute for Sustainable Investing ([link](#)).

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