EMERGING INSIGHTS – SUSTAINABILITY IN EMERGING MARKET BONDS

By Ulla Fetzer and René Lichtschlag

As the importance of emerging markets grows, there is an increasing degree of differentiation as professional investor groups are highly discerning. One example is the integration of sustainability criteria into the investment process. The inclusion of this additional risk perspective offers opportunities for fixed income investors – but it is by no means a straightforward proposition.

A lot has been happening in emerging markets. At the outset, this market segment was primarily of interest to equity investors, but these days it has become an important area of activity for many bond investors. In addition to government bonds, both investment-grade and high-yield corporate bonds – denominated in euros and US dollars as well as in local currencies – have become common instruments. Today, emerging markets are a firm fixture of globally focused portfolios, especially for European bond investors, as this is where the 'hunt for yield' was particularly pronounced due to the low-yield environment at home.

Photo: Archive Union Investment

Ulla Fetzer

EMERGING ADVANTAGES

Then there are the developments within the emerging markets themselves. Only a few years ago, many emerging markets struggled due to low commodity prices, weak growth in their main export markets and home-made political problems. Added to that were worries about an implosion of the Chinese economic model, along with concerns about what would happen if the US dollar appreciated as a result of the tightening of US monetary policy ('taper tantrum'). Today, almost all of those fears have evaporated.

Instead, things are moving forward. In 2017, emerging markets grew by 4.3%, but for 2018 our economists are predicting growth in economic output of 5%. Although there is still a great deal of variation, making it important to differentiate between them, many emerging markets are living up to their names and are on the rise once again.

TRANSFORMING CHINA'S SUCCESS

The markets are watching China with particular interest. The country is undergoing a process of transformation towards more sustainable growth driven by consumer spending. Although that will have an impact on momentum – we are expecting the rate of growth to fall by 0.5 percentage points to 6.4% in 2018 – it also offers opportunities. While producers of steel and coal will suffer as a result of the upheaval, companies in high-growth sectors are set to benefit.

THE CASE FOR SUSTAINABILITY

For a long time, sustainability was not a factor when differentiating between emerging markets. Consequently, they were not accessible to players investing in accordance with environmental, social and corporate governance (ESG) considerations. Even conventional portfolios were lacking a risk category. A properly understood ESG analysis protects investors against reputational and litigation risks, thereby providing a holistic view of the portfolio.

Previously, this shortcoming was primarily addressed at company level. That is certainly a logical approach. For one thing, it allows the use of the same analytical tools as in the developed markets – for example to look at company quality or share valuations.

At Union Investment, our proprietary Sustainable Investment Research Information System (SIRIS) tool provides company-wide access to the results of our own research, including on more than 400 individual companies in the emerging markets.

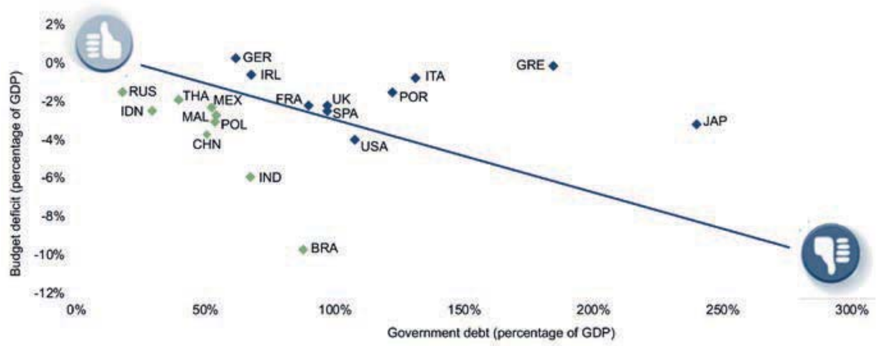
SUSTAINABILITY AND DEVELOPMENT

Extending the sustainability concept to government bonds is more difficult, as it involves more fundamental considerations. Once you start to apply western standards to political governance, the investment universe begins to shrink quite rapidly. What's more, the countries that remain tend to show many similarities with the developed markets, so they can no longer be regarded purely as emerging markets. This is hardly surprising, as countries in the early stages of development tend not to place much emphasis on ESG criteria when it comes to their economic policy. Instead they mainly focus on achieving growth targets.

Take India as an example. In 2017 2.5 million people died from diseases related to environmental issues, above all the air pollution in the large cities. The country therefore continues to face massive challenges. But there are some rays of hope. Although Indian companies are currently nowhere near European levels when it comes to corporate governance standards, most of them are able to voice an opinion on the topic of sustainability. Their reporting is much more advanced than that of Chinese firms. One reason for this is that the Indian market has for a long time been open to global investors, who are notoriously insistent on transparency.

China has made significantly more overall progress. Only a few years ago, ecological considerations played no part at all in the country's thinking. The consequences are well known. At times, up to 60% of the groundwater was too polluted to drink. Around 16% of the soil was highly contaminated with toxic substances, while at the same time particulate pollution exceeded safety limits in 90% of the cities. Since then, the government has declared these huge environmental problems to be challenges and is determined to combat them, for example by significantly lowering pollutant emissions.

Figure 1: Comparison of estimated debt for 2018



Source: Union Investment

SOVEREIGNTY IN SUSTAINABILITY

As we can see, sustainability is dependent on the path of development. The willingness and ability of countries to base their policies on ESG criteria varies depending on which stage they have reached in their economic catch-up process. This fact can and should be utilised in the design of suitable sustainability filters for emerging market government bonds. As a first step, all members of the investment universe should be subjected to an ESG assessment, based on a carefully constructed and methodically precise template. In the next step, these results must be compared against the level of prosperity within the country. This comparison allows conclusions to be drawn as to which countries should be classed as sustainable and which ones should not.

This procedure offers a number of advantages. The investment universe is extended to cover almost all emerging markets. The process provides adequate analysis results and therefore better investment decisions. And finally, the developing economies retain their often sorely needed access to foreign capital. If one was to look at the emerging markets through an (excessively) harsh filter based on western industrialised countries, the growth process might not be able to continue, or only at a reduced pace.

SUMMARY: THE PLACE TO BE

There continues to be much to recommend investing in emerging markets, particularly from the perspective of eurozone investors. In economic terms, these countries are gaining momentum. The worries of previous years, from low commodity prices and a strong US dollar to weak Chinese growth, have all evaporated. The prospects for returns have increased.

With regard to portfolio construction, the differentiation of recent years offers investors a broad range of options, covering almost every requirement of individual asset allocation. For a long time, the one exception was sustainable investment. Challenges here remain high, especially for government bonds, primarily due to fundamental questions about the relationship between sustainability and prosperity.

Investment in emerging markets is by no means guaranteed to be a success, it requires a range of skills in many different areas of expertise. Particularly when it comes to emerging markets, fundamental and sustainability analysis increasingly go hand in hand «

This article was written by Ulla Fetzer, Senior Account Manager and René Lichtschlag, Portfolio Manager at Union Investment.