Green bond markets will emerge stronger from governments' fiscal splurge

Authors

Hugh Gimber
Global Market Strategist
J.P. Morgan Asset Management

A heavy issuance calendar may keep volatility in bond markets elevated, but an expanded opportunity set should ultimately cement the role of green bonds in a multi-asset portfolio

To say that bond markets have had a volatile year would be somewhat of an understatement. Against a backdrop of inflation at multi-decade highs, the extremely aggressive central bank hiking cycle has left few places to hide across the fixed income spectrum. With cracks in the growth outlook across Europe now starting to emerge, we may well be closer to the end of this hiking cycle than the beginning. Yet while a pause to rate hikes in 2023 would certainly be cheered by many parts of the market, government bond investors will still need to adjust to supply and demand dynamics that look very different versus history.

Ballooning borrowing

Increased debt issuance lies ahead, with governments across Europe announcing significant spending plans to help soften the impact of the energy crisis. Germany committed to big spending in late September with a EUR 200bn energy package. France's suite of energy measures is expected to contribute to a record EUR 270bn increase in public debt next year, while in Italy, new PM Giorgia Meloni is also eyeing up an increase in borrowing. The UK's Energy Price Guarantee scheme may now be scaled back from April 2023, but the support plans will nonetheless necessitate tens of millions of pounds of borrowing.

Equally important for fixed income markets is the demand side of the equation. Support within the Governing Council at the European Central Bank to begin shrinking the balance sheet appears to be growing. In the UK, when issuance last surged during the early stages of the pandemic, the Bank of England was on hand to hoover up GBP 290bn of UK Gilts. Now, the Bank's current plans see it shrinking its government bond holdings by a total of GBP 80bn over the next year.

The big issue

Against this backdrop of surging bond supply and diminishing demand, governments will be forced to think hard about their issuance strategy. Green bond markets are likely to be an area of particular focus. Of course, not all government spending can be financed by green bonds – they can only be issued in order to raise finance to tackle environmental challenges. Yet, with Russia's invasion of Ukraine providing a fresh incentive for European governments to accelerate the energy transition and improve energy security, there is no shortage of projects that could be financed via this new avenue.

For governments, there are obvious advantages to this approach. The first is strong demand: green government bond issuance has been very well absorbed by the market over the past two years, with demand for allocations typically several times higher than the available issuance and often stronger than the demand for conventional bonds. The second benefit is the investor base: green bond syndications have typically seen larger demand from investors such as pension funds and insurance companies – and therefore more stable lenders of capital – than conventional syndications, where investors with shorter time horizons tend to play more of a role. Third is pricing: green bonds tend to trade with a green premium – or "greenium" – to traditional counterparts, both in sovereign and corporate markets, allowing issuers to fund green projects at a marginally lower cost of capital.

For investors, the prospect of large amounts of incoming supply is rarely something to cheer, yet this overlooks the fact that this issuance should go a long way to addressing one of the green bond market's key deficiencies. While the UK and several nations across the continent, including Germany, have declared their intentions to build a green yield curve, the current offering of green sovereign bonds falls well short of this goal. Most European issuers have only a handful of outstanding bonds today, with the UK government's most recent green issuance only its third foray into the space. In the supranational sector, the European Union is poised to become one of the world's largest green issuers in the coming years, to finance the Recovery Fund, but also still only has three green bonds currently on offer, ranging in maturity from 2037 to 2048. As the green bond market matures, an expanded opportunity set that offers greater flexibility for investors is going to be a key requirement.

While there may be benefits for both issuers and investors from increased supply, an element of caution remains warranted. As ever when it comes to investing in green, social, or sustainable bonds, scrutiny at a security level will be key to success. Can the issuer demonstrate a clear link between bond proceeds and the intended project? Do the bond covenants contain measurable and specific targets for success? And will the bond materially change the position of an issuer relative to where they already stand? Only those bonds that meet these criteria will warrant a place in a green bond investor's portfolio.

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