

FOCAL POINT

ESG bond market still offering investment opportunities

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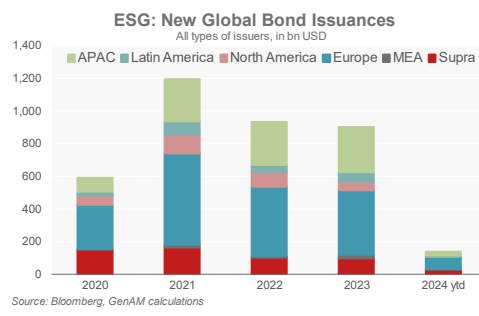
- Global ESG bond issuance decreased slightly in 2023, with the euro remaining the primary ESG funding currency, although its relative importance declined moderately.
- Issuing activity has been lively and higher than in previous years year-to-date, but we expect ESG government bond issuance by governments to be at around the previous year's level for the full year 2024.
- France is expected to remain the top ESG issuer in the euro area in 2024. We anticipate that green bonds will become more important in the euro area government sector, at the expense of social bonds.
- The premium for ESG bonds ('greenium') generally remained low throughout 2023, with no clear trend, and varied over time and among bonds. Despite the greenium, there are still opportunities to invest in ESG bonds without a yield disadvantage in sovereign and SSA (supranationals, sub-sovereigns and agency) segments.

After years of strong growth, the consolidation in the ESG bond market continued last year. The premium investors are willing to pay for ESG bonds has changed little in 2023. In this paper, we take this as an opportunity not only to trace and assess the latest developments but also to consider how the ESG bond market will develop in 2024, focusing on the euro area (EA) government sector. We also show to what extent investors who would like to increase their exposure can invest in a maturing market without yield disadvantage.

Further decline in global issuance volume in 2023

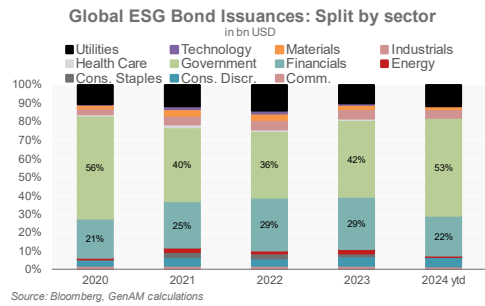
The overall volume of new ESG bonds (including all bond types, regions, and issuers) continued to decline slightly in 2023, falling to around USD 950bn globally according to our calculations. Europe remained the most important issuance market, although its relative importance (as well as that of

North America) continued to fall slightly. In contrast, the volume of issuances from countries in the Asia-Pacific region stagnated. It should be noted that the issuance volume of



conventional bonds did not decline. Hence, for the first time after years of rapid growth, the share of ESG bonds in the total volume fell slightly to 1.8%. The reasons for this decline are manifold. For example, the boom in ESG bonds to cope with the consequences of Covid-19 has come to an end. Moreover, high yield levels, increasing costs of components, and supply chain disruptions have penalised green projects, renewable energy in particular.

Given Europe's dominance of the ESG bond market, it is hardly surprising that the euro has remained the most important issuing currency. However, it is also apparent here that other currencies have caught up. The Chinese yuan has now reached a fairly high position with a 10% share.



In terms of issuers, governments remained the most important sector. In fact, not only has the relative share of the governmental sector increased, but also the absolute volume of issuances. The decline in the issuance volume is therefore attributable to the private sector, and here in particular to the US (reputational concerns, regulatory uncertainty, and a greenium close to zero played a key role in the slowdown). Irrespective of this, the financial sector has become increasingly important in recent years.

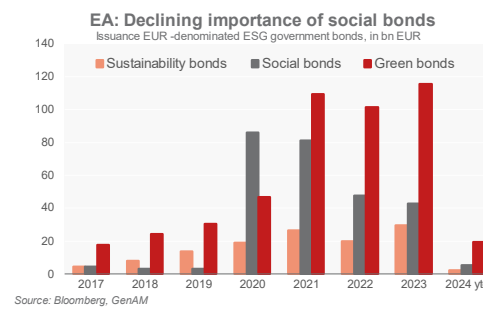
For 2024, we forecast the global issuance volume to be roughly on par with the previous year. Although the year has got off to a very lively start with an issuance volume of more than USD 140bn ytd (and an ESG share of 2%), we do not expect the volume from 2023 to be significantly exceeded. A growing number of entities are committing to a NetZero pathway, but the difficult macroeconomic environment has created a more complex backdrop for sustainable investments. Europe is seen to defend its dominant position, while North America will likely fall further behind. The upcoming presidential election and the ongoing anti-ESG movement will keep some issuers on the sidelines waiting for more policy clarity further down the road (although the Inflation Reduction Act can support as it is incentivising more energy producers to finance energy transition activities).

Greenwashing allegations and increased investor scrutiny on companies' decarbonisation targets, which have already caused some unrest in the recent past, may also increasingly come under the spotlight. In this context, the EU's Green Bond Standard (GBS), which was adopted in autumn 2023 and will come into force in December 2024, is of particular importance. It imposes consistent requirements on green bonds and ensures that they meet specific environmental objectives. This will incentivise and facilitate green bond issuance, ensure better transparency and greater harmonisation, and ultimately enhance credibility in the market. The GBS could therefore become the gold standard for issuers that want to signal a high alignment with environmentally sustainable economic activities.

EA sovereigns continue to expand portfolio in 2024

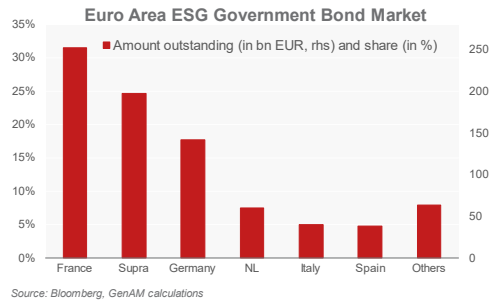
In the remainder of the paper, we analyse the development of the EA ESG government bond sector in more detail. Overall, the sector placed a volume of around € 185bn last year (just under € 130bn SSA, around € 55bn sovereigns), with green bonds remaining by far the most important type (as the EU no longer issued SURE bonds). The sovereign sector continued to issue predominantly green bonds (8 green bonds, 1 sustainable bond). Italy in particular deserves special mention with the highest volume issued for a green bond by an EGB issuer in a single transaction (€ 10bn). This brings the outstanding EA ESG sovereign bond volume to over € 225bn.

In terms of domicile, France and Germany were the most important issuers in 2023. Overall, France remains the country with the highest outstanding amount of ESG government bonds in Europe.



Looking into 2024, we forecast this year's issuance volume by the EA governmental sector to remain around 2023's level (although the start of the year has been outstanding with an issuance volume of almost € 30bn so far). While EA sovereigns could still increase the issuance volume up to € 70bn, we expect issuances in the SSA sector to fall slightly. This applies even though we assume that the EU, the largest issuer in the SSA segment, will increase its ESG issuance

activity compared to 2023. The EU had announced that it would issue 30% of NGEU bonds as ESG bonds and is currently still slightly below this mark. Germany will continue to build a green curve and France has already issued a new 25-year green bond with a volume of € 8bn.

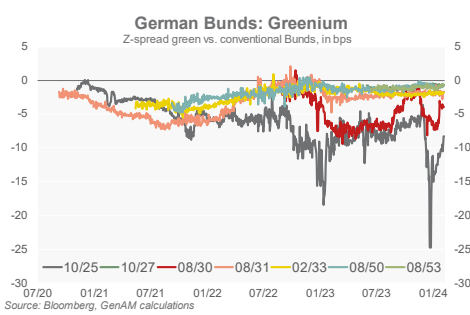


Hence, sovereigns are likely to further expand their green portfolio, the SSA sector is reducing supply a bit. There are various reasons for this. Existing projects from 2022 and 2023 will have to be processed. Furthermore, lower capital expenditure (e.g., in the real estate sector) and high inflation have contributed to delays and, in some cases, project cancellations. Finally, the necessary fiscal consolidation of the EA countries also harms the issuance activity. In contrast, ESG funds are reporting unchanged high inflows and central banks continue to endeavour the Paris Agreement which could increase the incentive to issue ESG government bonds.

Heterogeneity of EA greenium likely to linger

The development of the premium of ESG bonds showed no clear trend in 2023. We define the so-called greenium of ESG bonds as the difference in the Z-spread between an ESG bond and a conventional bond. Hence, a higher greenium means that the ESG bond trades richer than the equivalent conventional bond (= a more negative value). Due to different maturities, we first estimate a conventional yield curve for this purpose and derive synthetic conventional bonds with the same maturity as the corresponding ESG bond. Due to the **twin concept**, the comparison is easier in the case of German government bonds (see chart below).

Generally, most EA ESG government bonds trade with a small single-digit greenium (= lower yield for ESG bonds than conventional ones). However, the greenium is not stable over time and also varies from bond to bond. Moreover, even bonds of one issuer do not show a common trend and the greenium of each bond moves largely independently of others. Taken with a pinch of salt, it can be stated that the greeniums of most EA ESG government bonds fell slightly from spring to autumn in 2023, but they have recently risen again moderately. Going forward, we do not expect any

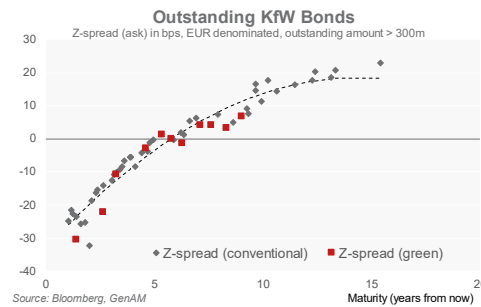


noticeable upward or downward trend in greenium for 2024 either.

Cherry-picking in EA ESG bonds is still possible

Notwithstanding that, there are still attractive investment opportunities considering the lower risk associated with an ESG bond due to the transparency obligations. Moreover, the premium of some ESG bonds is very low and a few even offer a negative greenium (meaning a higher yield of an ESG bond compared to a conventional one).

In the sovereign sector, we regard Slovenian ESG bonds as the most attractive. The two Slovenian ESG bonds trade on par with conventional bonds and thus enable the ESG portfolio to be expanded without any yield disadvantage. Additionally, these are sustainable bonds, which are very rare in the sovereign sector. They therefore represent an opportunity to diversify the portfolio even more.



The options in the EA SSA segment are significantly higher in terms of both issuers and bond types. Additionally, some ESG bonds in this segment have a negative premium. We currently consider medium-dated green bonds issued by the Kreditanstalt für Wiederaufbau to be particularly attractive. For example, KfW 0% 06/2029 trades cheaper than other (conventional) KfW bonds.

Imprint

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