

Bonds that build back better

Some might argue that building a sustainable economy is a technological problem. It isn't. The world is sufficiently stocked with greenhouse gas-reducing technologies such as renewable fuels, carbon capture and energy storage. What it lacks is capital.

USD 60 trillion. This is how large the sustainable fixed income market could be by the end of this decade if world leaders are serious about net zero. That is equivalent to approximately one third of all global government bonds outstanding.

It's a surge in growth that would transform fixed income investing. In as little as five years, climate-aligned, green, sustainability-linked and social bonds could be investment staples for investors worldwide. It is a future in which the mitigation of climate change, the protection of biodiversity and the promotion of social cohesion will be possible through fixed income investments.

These are the findings of new research undertaken on behalf of **Pictet Asset Management** by the **Institute of International Finance** (IIF).

Our research looked at several climate capital scenarios that could plausibly unfold over the next five to 10 years. Under the most bullish of our three main scenarios, annual issuance of bonds that are labelled as having environmental, governance and social (ESG) objectives could climb from the current USD1 trillion to as high as USD4.5 trillion by 2025. Green bonds – securities the fund specific environmental projects – are expected to represent the biggest single market, followed by sustainability-linked bonds, instruments whose coupons are tied to corporate environmental targets.

The research also lays bare the critical importance of climate capital in the developing world. Emerging market sovereign and corporate bond markets could see annual issuance of ESG-labelled bonds reaching some USD2 trillion.

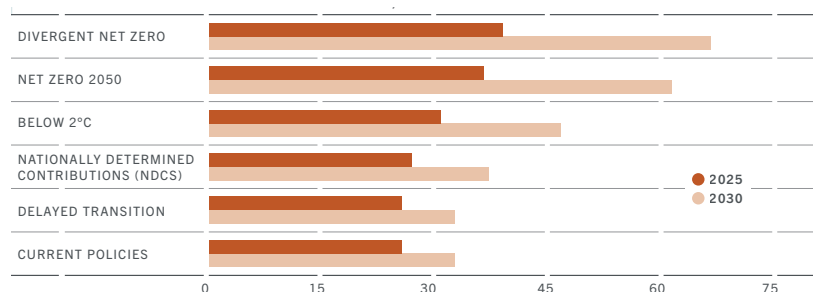
Yet these forecasts cover just one part of the sustainable bond universe. It does not take into account climate-aligned bonds - securities that don't carry an ESG label but are issued by companies that contribute directly to the clean energy transition. Sold by firms that operate in green industries such as clean energy, water recycling and carbon capture, these bonds have also attracted the attention of investors.

Recent estimates from the Climate Bonds Initiative, an environmental consultancy, suggest some USD900 billion in new climate-aligned bonds were sold in 2021 alone. To account for this growth, the IIF also devised projections for climate-aligned fixed income, basing estimates on the various energy transition scenarios set out by the Network of Central Banks and Supervisors for Greening the Financial System.

Using this methodology, IIF's research forecasts that, combined, the ESG-labelled and climate-aligned bonds markets could grow to USD32 trillion in 2030 under current climate policies and to as much as USD60 trillion under a more ambitious net zero path.

Nevertheless, for all its dynamism,

Estimated size of climate-aligned bond market under different climate scenarios, USD trillion



Source: IIF, forecast covering period 31.12.2025 and 31.12.2030

ESG and climate-aligned fixed income is not yet guaranteed to evolve into the mainstream. There are some difficult obstacles to navigate. Progress towards greater harmonisation across sustainable finance taxonomies and ESG disclosures is essential. Without this, the ESG-labelled market in particular will struggle to achieve critical mass. Currently, the labelling and certification of sustainable bonds differs considerably from one country to another, while efforts to harmonise disclosure requirements haven't met with much success.

Another pre-requisite is greater transparency on how ESG rating agencies - which pronounce judgement on bond issuers' sustainability credentials as well as use of proceeds - collect, analyse and calculate sovereign and corporate ESG metrics.

Investors also need to be convinced that such bonds are as liquid and stable as their conventional counterparts. Here, the bar is high. Due to their complexity, ESG securities tend to be costly to analyse, requiring far greater scrutiny than their conventional counterparts. Nor do they fit neatly into the portfolio construction frameworks investors favour.

Still, if the world is serious about financing the transition, none of this appears insurmountable. The bond market could be the difference between decarbonisation success and failure.



Raymond Sagayam
Chief Investment Officer
- Fixed Income, Pictet Asset
Management

For more information on our research paper, scan QR code or visit am.pictet.



ESG bonds characteristics

KEY	KEY CHARACTERISTICS OF ESG-LABELLED BONDS				
	ACTIVITY-LEVEL	ENTITY-LEVEL	HYBRID		
	GREEN BONDS	SOCIAL BONDS	SUSTAINABILITY BONDS	SUSTAINABILITY-LINKED BONDS	TRANSITION BONDS
500+ USD, BILLION	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
100-499 USD, BILLION	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
50-99 USD, BILLION	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
0-49 USD, BILLION	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
USE-OF-PROCEEDS	✓	✓	✓	✓	✓
KPI-LINKED (GENERAL-PURPOSE)	X	X	X	X	X
INTERNATIONAL PRINCIPLES/GUIDELINES	ICMA GBP	ICMA SBP	ICMA SBG	ICMA SLBP	N.A
SIZE OF THE MARKET	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
SECTORAL TAKEUP/POTENTIAL	SOVEREIGNS	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
	SUPRANATIONALS	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
	GOVERNMENT-RELATED (EX. SOVEREIGNS)	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
	FINANCIALS	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
	NON-FINANCIAL CORPORATES	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓
	HEAVY EMITTERS	✓✓✓✓	✓✓✓✓	✓✓✓✓	✓✓✓✓

Source: IIF, as of December 2021

Important notes: This marketing material is for distribution to professional investors only. However, it is not intended for distribution to any person or entity who is a citizen or resident of any locality, state, country or other jurisdiction where such distribution, publication, or use would be contrary to law or regulation. The information and data presented in this document are not to be considered as an offer or solicitation to buy, sell or subscribe to any securities or financial instruments or services. Information used in the preparation of this document is based upon sources believed to be reliable, but no representation or warranty is given as to the accuracy or completeness of those sources. Any opinion, estimate or forecast may be changed at any time without prior warning. Investors should read the prospectus or offering memorandum before investing in any Pictet managed funds. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Past performance is not a guide to future performance. The value of investments and the income from them can fall as well as rise and is not guaranteed. You may not get back the amount originally invested. This document has been issued in Switzerland by Pictet Asset Management SA and in the rest of the world by Pictet Asset Management (Europe) SA, and may not be reproduced or distributed, either in part or in full, without their prior authorisation. For UK investors, the Pictet and Pictet Total Return umbrellas are domiciled in Luxembourg and are recognised collective investment schemes under section 264 of the Financial Services and Markets Act 2000. Swiss Pictet funds are only registered for distribution in Switzerland under the Swiss Fund Act, they are categorised in the United Kingdom as unregulated collective investment schemes. The Pictet group manages hedge funds, funds of hedge funds and funds of private equity funds which are not registered for public distribution within the European Union and are categorised in the United Kingdom as unregulated collective investment schemes.