Tap the growing opportunities in Asia's sustainable bond market

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Asia's sustainable bond market bucked the global trend and issuance grew strongly in the first half of 2022 despite volatility in the bond markets. We expect the market to continue growing despite heightened inflation risks and rising geopolitical concerns. The expanding universe should present increased opportunities and greater diversification for investors.

The COVID-19 pandemic helped draw attention to environmental and social issues in the last two years, in turn fuelling inflows into responsible investments and boosting issuance of sustainable debt (bonds and loans). ESG debt funds attracted inflows of over USD135 billion in 2021, up from USD55 billion in 2020. Meanwhile, global sustainable debt issuance reached a new record of over USD1.4 trillion in 2021, almost double the previous year[1].

This momentum appeared to falter in 2022, as rising inflation and interest rates caused significant turmoil in global bond markets. Global sustainable debt issuance fell to USD645 billion in 1H22, nearly 15% lower than in 1H21, although debt issuance picked up in the second quarter[2]. The picture was somewhat more encouraging in the Emerging Markets (EM) and Asia. See Fig 1. Emerging and frontier markets issued over USD120 billion of sustainable debt in 1H22, up from USD100 billion in 1H21. Within EM, China was the largest issuer, raising USD73 billion in 1H22, followed by Turkey and the Philippines. On the other hand, issuance from Russia and India fell sharply[3].

We expect Asia's sustainable bond market to continue to grow despite rising rates, heightened geopolitical risks and the potential divergence in decarbonisation trajectories regionally.

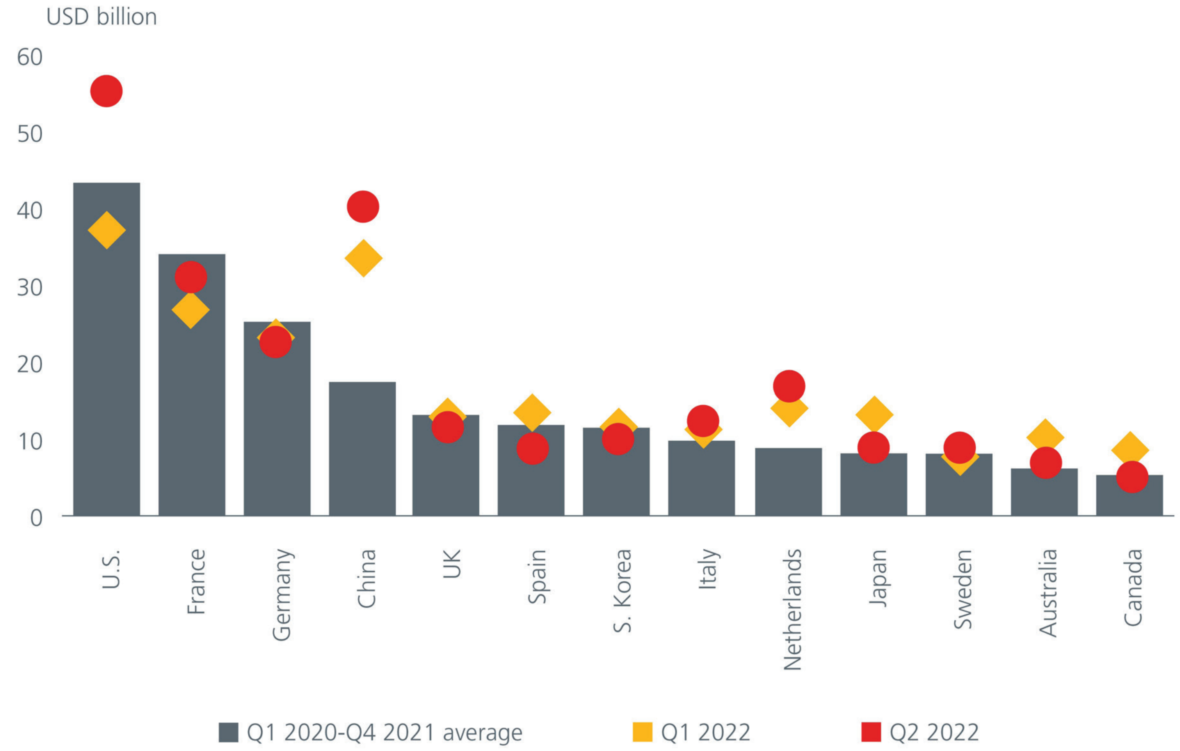
GEOPOLITICAL TENSIONS WILL NOT DERAIL ASIA'S GROWTH

Geopolitical concerns are not new - at the peak of the US-China trade tensions in 2019, there were fears that US- based investors could be discouraged from owning Chinese assets. The Russia-Ukraine war has once again thrust geopolitical concerns into the limelight, as the relationship between US and China further deteriorated following Russia's invasion of Ukraine.

The world cannot afford to ignore China in the transition to a zero-carbon world. With China accounting for more than a quarter of the world's overall greenhouse gas emissions, China's decarbonisation journey matters. The more viable approach is therefore greater engagement, rather than avoidance. Hence, we believe that there will continue to be investor demand for China's sustainable bonds. China's

[1]Sustainable Debt Monitor. Institute of International Finance. January 2022. [2]Sustainable Debt Monitor. Institute of International Finance. July 2022. [3]Sustainable Debt Monitor. Institute of International Finance. July 2022.

Fig 1: ESG debt issuance – China maintained strong momentum in 1H22



Source: Bloomberg. IIF. July 2022.

issuance is also likely to remain robust as the sustainable bond market remains an important financing avenue for China in its net neutrality journey. In 2021, China accounted for 65.2% of the new issuance of sustainable bonds in Asia[4].

That said, the Russia-Ukraine war has highlighted ESG risks for sovereigns. At Eastspring, we incorporate both international and national data in our sovereign ESG evaluation and assign additional weight to the governance factor as it disproportionately influences policy and the country's overall ESG efforts. While we score and rank sovereigns by their ESG risks, we also consider how prepared the countries are to address material ESG challenges.

ASIA'S DECARBONISATION TRAJECTORY REMAINS INTACT

The growing focus on energy security following the Russian-Ukraine war should accelerate transition efforts to alternative and cleaner forms of energy. However, it could derail Europe's net zero course in the near term although Asia's decarbonisation trajectory is likely to remain intact.

European net-zero plans had included swapping coal for natural gas-fired power. However, supply shortages had lifted natural gas prices by almost 600% in Europe in late 2021 and the situation has been further compounded by supply disruptions arising from the Russia-Ukraine war in 2022.

As such, the pace of planned shutdowns for coal-fired power plants has slowed in Europe. Ireland and Poland have reportedly increased their use of coal plants as natural gas prices soared. The UK restarted an old coal plant, and the government may delay the closure of its remaining coal power plants. Meanwhile, the German government has passed emergency laws to reopen mothballed coal plants for electricity generation.

Asia is less reliant on Russia for its energy sources and hence the disruption in supplies is expected to have limited implications for Asia's net zero journey. Importantly, many Asian economies have re-affirmed their net zero commitments at COP26, and their National Determined Contributions (NDCs) are likely to be strengthened prior to COP27 in November 2022.

[4]ASEAN + China, Hong Kong, Japan and South Korea. Asia Bond Monitor. March 2022. [5]Climate risk and response in Asia. McKinsey Global Institute. November 2020.

With climate change forecasted to hit Asia the hardest, there is increasing recognition in the value generated from having sustainable growth strategies and the costs of not taking environmental risks seriously. It is also widely acknowledged that massive funding is required to combat climate change, and a large part of the financing will come from the bond market, in the form of sustainable and green bonds.

Across Asia, we have seen governments and policymakers make a concerted push to catalyse the growth of sustainable/green funding markets across their jurisdictions. These efforts are clearly bearing fruit, as seen from the strong growth of Green, Social and Sustainability (GSS) bond issuances in Asia over the past two years amid broader challenges (higher yields, poor investor sentiment and tightening financial conditions).

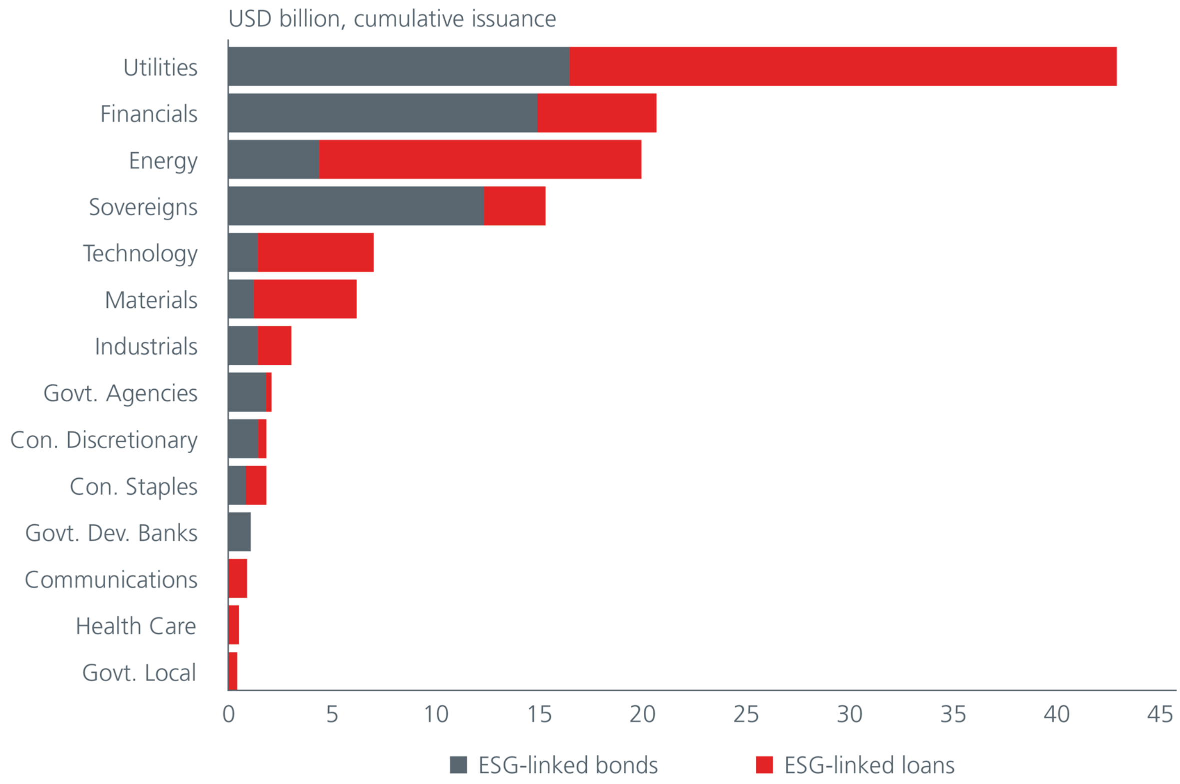
TAPPING ON THE OPPORTUNITIES

We look to increase the weights of GSS bonds in our portfolios as the investible universe continues its healthy expansion. Compared to two years ago, we have seen GSS issuances from more diverse sectors and countries, as issuers find specific use cases for bond proceeds amid expanded taxonomies.

In Asia, there is a good base of high quality (A-rated and above) GSS bond issuers out of Japan, Korea and to some extent, China. Even as the risk environment deteriorated over the last few months amid tightening financial conditions, the credit spreads of these issues have not widened significantly, further augmenting their status as defensive assets.

The financial sector will continue to play an important role in channelling funds towards sustainable activities. Fig. 2. Many banks that are active in Asia have drawn up a Sustainable Finance framework and strategy, which involves making specific commitments and targets to finance sustainable activities. Issuance of GSS labelled bonds will contribute to these efforts, and we expect to see more financial issuers going forward. With the real estate sector accounting for 40% of global carbon emissions, there is also a big role for the real estate sector and property owners. We have seen

Fig 2: Since 2013, utilities and financials have accounted for most of total issuance



Source: Bloomberg. IIF. As of 1Q 2022.

REITs and property developers in Singapore issue bonds where the proceeds are used to invest in green technology infrastructure to make buildings more energy efficient.

Asian policy makers continue to develop the sustainable bond market ecosystem within the region. Research suggests that higher disclosure requirements, introducing external certifications and expanding taxonomies can help reduce information asymmetry and reduce funding costs for reliable green issuers[6]. At the same time, studies show that frequent bond issuers pay lower yields as greater information transparency gets priced in by potential investors. This should help to encourage repeated issuance and deepen the market further[7], presenting investors with more opportunities and greater diversification.

[6]Asia Bond Monitor. March 2022. [7]Asia Bond Monitor. March 2022.

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