The Rise of Green Bonds

Why investors should take a closer look at the green bond market.

KEY INSIGHTS

- Growth of the green bond market expected to continue in 2020, led by sovereigns.
- Germany’s willingness to issue green bonds is likely to act as a reference point for other issuers.
- There is an opportunity to start integrating green bonds into fixed income portfolios.

In our latest policy week meetings, we discussed the dynamics and trends of green bonds—one of the hottest trends in fixed income. One topic covered was how our portfolio managers are incorporating green bonds into their fixed income portfolios independently from the environmental, social, and governance (ESG) standards that are already in place across strategies. Since the issuance of the first green bond just over a decade ago, the market has gone from strength to strength. Last year, a record USD 255 billion of bonds were sold for the purpose of financing environmentally friendly projects and activities. That’s an increase of more than 45% from the previous year and more than three times the amount issued in 2016. “The environment has become a critical issue driving rapid growth in

Green Bond Market Has Grown Steadily Since 2014

(Fig. 1) Total market value of green bonds

As of December 31, 2019.
Source: Bloomberg Index Services Limited (see Additional Disclosure).
“The market’s strong momentum looks set to continue as more and more companies and countries step up their efforts to turn greener.”

— Quentin Fitzsimmons
Portfolio Manager

green bond issuance,” said Quentin Fitzsimmons, a portfolio manager and member of the global fixed income investment team. “The market’s strong momentum looks set to continue as more and more companies and countries step up their efforts to turn greener.”

Several countries are planning to sell green bonds for the first time this year, including Italy and Sweden. More may follow in the future if governments are allowed increased flexibility in their fiscal and budget rules when borrowing to finance for green and environmentally friendly activities. “As many major central banks seem to have exhausted their ability to stimulate growth through monetary easing, developed market countries will likely embark on new fiscal easing—and it’s possible that green bond issuance is part of this,” said Mr. Fitzsimmons.

Credibility Improving, But More Progress Needed

Any increase in green bond issuance would need to be met by investor demand. However, despite great strides made in the market, certain issues are still holding back the mainstream investors from participating. These include a lack of globally accepted standards and the lack of transparency around how the proceeds raised from a green bond sale will be used, particularly how it will be refinanced or paid back in the future. “A clearer explanation of the way the financing is used over time is needed to improve credibility around green bonds,” said Mr. Fitzsimmons.

Another development that could strengthen the market is the German government’s plans to issue green bonds across a range of maturity profiles. Mr. Fitzsimmons said, “A comprehensive German green bond yield curve could potentially be a game changer for Europe as it could serve as a reference point for other sovereigns and corporate issues denominated in euros.”

Not all governments are on the same page when it comes to selling green bonds, however. The UK debt management office, for example, has expressed concerns about the costs of building a liquid government yield curve of green bonds.

Better Liquidity Provide Opportunities for Investing in Green Bonds

Despite spectacular growth, the green bond market remains small in comparison with the overall size of the bond market, although its share is growing. One of the factors holding it back has been a lack of liquidity, but the investment team believes there are signs of improvement on this front. “The boom in green bond issuance is helping to increase their liquidity profile, which,

Who Issued Green Bonds in 2019?
(Fig. 2) Breakdown by issuer type and the five largest issuers

<table>
<thead>
<tr>
<th>By Type of Issuers</th>
<th>Total Issuance in 2019 (USD Bn)</th>
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<tr>
<td>5 Largest Issuers</td>
<td></td>
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<tr>
<td>Fannie Mae</td>
<td>22.8</td>
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<tr>
<td>KFW</td>
<td>9.0</td>
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<tr>
<td>Netherlands</td>
<td>6.7</td>
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<tr>
<td>France</td>
<td>6.6</td>
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<tr>
<td>Industrial &amp; Commercial Bank of China</td>
<td>5.9</td>
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</tbody>
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As of December 31, 2019.
Sources: Climate Bond Initiative and T. Rowe Price estimates.
The boom in green bond issuance is helping to increase their liquidity profile, which, in turn, should provide opportunities for portfolio investing,” said Mr. Fitzsimmons.

In a further positive sign, liquidity in the secondary market has picked up in the past year thanks to jumbo deals from France and the establishment of liquid “green” benchmarks in countries like Ireland. Against this backdrop, we believe it may be the right time to possibly start integrating a layer of green bonds into fixed income portfolios. “In the event we can identify a green bond with the same valuation characteristics as a similar equivalent conventional bond, it is likely to be considered as a preferred selection in some of our portfolios,” Mr. Fitzsimmons said.

Turning attention to the corporate sector, the team noted that green bonds issued in this market could become more attractive than conventional corporate bonds. “Some corporations have a vested interest in enhancing their green credentials as it will help diversify their revenue stream and ultimately improve their ESG scoring with investors,” said Mr. Fitzsimmons.

— Quentin Fitzsimmons
Portfolio Manager

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