How ESG Considerations are Reshaping Central Bank Mandates

Moving toward integrating social and environmental issues.

July 2021

KEY INSIGHTS

- The objectives of developed market central banks are expanding beyond their traditional goals of growth and inflation.
- In the future, central banks may shift lending and bond-buying programs toward greener companies.
- We believe that incorporating ESG factors into central bank activities, while welcome, may lead to greater uncertainty around inflation targeting and bond valuations.

Building back greener, fairer, and more sustainable is not just the goal of governments and companies—central banks have also begun to incorporate issues such as employment equality and climate change into their policies. What we should expect from these developments, and their implications for bond markets and monetary policy, were the key discussion points during our latest investment policy meetings.

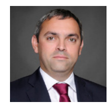
Central Banks Moving Toward More Flexible Policy

Central banks are expanding beyond their traditional objectives of inflation and growth. The European Central Bank (ECB) and Bank of England have vowed to take greater account of climate change risks in their decision-making, and some other developed market central banks have incorporated social considerations into their monetary policy frameworks. The Federal Reserve, for example, is focused on a "broad-based and inclusive goal" of full employment, which means that the unemployment rate across the different sections of the population will be assessed when deciding on policy, not just the overall aggregate rate.

"We expect monetary policy to become more flexible as the objectives of developed market central banks evolve to include targeting issues such as employment equality and climate change," said Quentin Fitzsimmons, a portfolio manager and member of the fixed income investment team. It is likely to become harder to predict the actions of central banks going forward as more factors and data will now need to be taken into consideration, Mr. Fitzsimmons added.

There is also likely to be greater uncertainty around the path of inflation. "We recognize there is a potential risk

Global Fixed Income Team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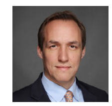
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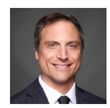
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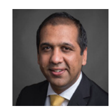
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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

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There's a risk of a two-tier corporate bond market developing if central banks start applying greater differentiation.

that central banks do not react quickly enough to signs of price pressures rising under this new framework," warned Mr. Fitzsimmons. For example, a central bank might ignore inflation overshooting if unemployment remained high in a particular group of society, Mr. Fitzsimmons noted.

Greater Interest Rate Volatility on the Horizon

These risks add to an already complicated picture around inflation. "The debate about whether the current spike in prices is transitory or structural in nature remains fierce," said Mr. Fitzsimmons. He added that while inflation may have reached a peak, it may be more persistent and not fall as fast from these elevated levels as markets anticipate. This could drive developed government bond curves steeper[1] again, but that is unlikely to happen until concerns around the coronavirus delta variant recede, Mr. Fitzsimmons said.

In general, then, the environment remains highly uncertain. "The delta variant may be front and center in bond markets right now, but there are inflation risks in the background—and these risks are magnified by uncertainty over future central bank actions due to the lack of clarity on how they are going to incorporate issues such as employment equality and climate change into policy," said Mr. Fitzsimmons.

All of this suggests that there is likely to be greater volatility in fixed income markets on the horizon, a trend that we are already seeing signs of in 30-year government bonds in select countries, including Germany, the UK, and the U.S. Against this backdrop, we believe actively managing duration[2] will be imperative going forward as greater flexibility will likely be needed in an environment of greater monetary policy uncertainty.

Potential Bond-Buying Programs Are Altered

To help meet goals such as tackling climate change, central banks could make changes to their bond-buying programs. At present, bonds from all sectors that contribute to the economy are typically purchased. In the future, however, central banks may decide to give preference to bonds from companies that meet certain environmental, social, and governance (ESG) criteria. This would mean that some companies, such as those operating in heavy polluting sectors, could be left out of the purchases.

"There's a risk of a two-tier corporate bond market developing if central banks start applying greater differentiation," said Mr. Fitzsimmons. "Indeed, for those companies that don't make the preferred buying list, liquidity could deteriorate, which might increase the credit premium[3] required to borrow and perpetuate the problem further."

On the positive side, central banks are likely to play an active role in the green evolution. The prospect of bond and lending programs being altered to align with climate change goals is likely to influence companies to make changes as it should help facilitate their access to finance. These developments underscore the importance of having an ESG integration approach because it may help identify early the companies and the sectors that are making positive changes. It will also likely have a strong influence on how we assess valuations when looking at new bond issues that are brought to the primary market.

[1] A steep yield curve describes a situation in which long-term yields are significantly higher than short-term yields.
[2] Duration measures a bond's sensitivity to changes in interest rates.
[3] Credit premium is the premium required by the market to try to compensate for the trend in credit quality and the probability of future default.

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