GENERALI INSURANCE ASSET MANAGEMENT



FOCAL POINT

Attractive entry point for ESG government bonds given advanced issuance activity

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Our Focal Point series explores topical issues on macro, markets and investment

- **Amid strong and well-diversified investor demand the EA euro-denominated ESG government bond issuance volume year to date is close to the level of the record year 2021. Particularly, the issuance of green bonds has recently gained significant momentum.**
- **Despite the broader market uncertainty caused by the turbulence in the banking sector, the primary market is easily absorbing new ESG bonds. However, given the high funding progress already achieved, we do not expect any new record volumes for 2023.**
- **The premium of ESG government bonds has generally narrowed in recent months. SSA bonds (sub-sovereigns, supranationals, agencies) are now trading almost in line with conventional bonds.**
- **With swap spreads still relatively wide, we regard SSA bonds in general as attractive versus sovereign bonds. This applies even more to ESG SSA bonds given the low and, in some cases, even positive premium compared to conventional bonds (e.g., EIB 05/2028 vs. Germany 02/2028).**

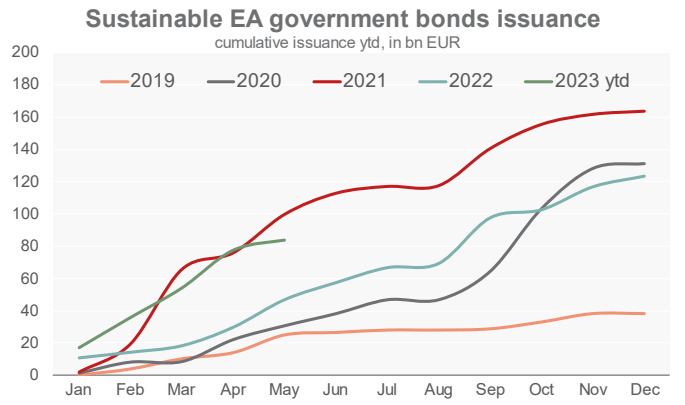
The importance of the ESG market has increased significantly in recent years. Even though ESG bonds still only represent a relatively small part of the overall market, they are increasingly the focus of interest due to their rapid growth. In this study, we will focus on the government bond sector, which is often overshadowed by ESG corporate bonds. In particular, we analyse the development of euro-denominated government bonds issued from euro area-based debtors, especially green, social, and sustainability bonds (no euro-denominated sustainability-linked bonds are issued by the governmental sector).

Issuance comparable with the record year 2021

Within the government bond sector, we distinguish between sovereigns and SSAs. After a somewhat hesitant start to the year, sovereigns have recently placed several new bonds and tapped old ones. Meanwhile, 5 new ESG bonds (4 green bonds, 1 sutainable bond) with a total volume of € 23bn have been placed. Including the tapping of existing bonds more than € 34bn has been absorbed by the market. Among others, Italy issued a bond with a volume of € 10bn and Germany recently issued its sixth green bond (the German Finance Agency will issue a seventh one in H2). Germany is thus underpinning its efforts to cover the entire curve and to establish a green benchmark curve in the long term. Overall,

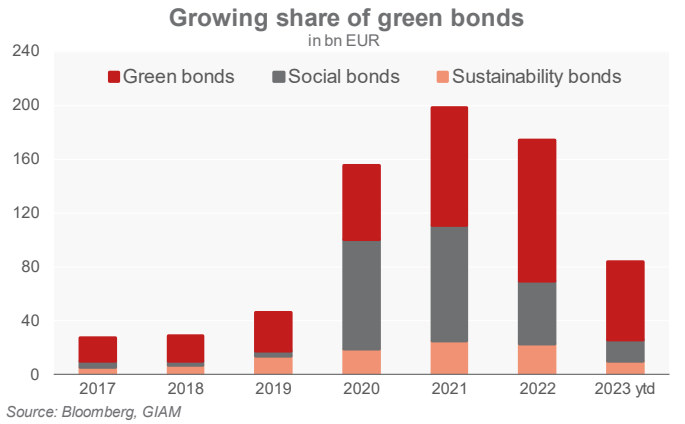
the issuing volume of sovereign issuers is well above the level of the previous years at this time of the year.

SSA issuers have so far also issued a higher volume than last year, but they have not reached the record level of 2021. Overall, ESG bonds with a volume of around € 50bn have been issued by SSA issuers year-to-date. Here, too, green bonds make up the largest part with around € 25bn. Additionally, about € 15bn in social bonds and about € 10bn in sustainability bonds have been placed.



Source: Bloomberg, GIAM

Hence, in total year-to-date ESG bond issuance by the government sector (sovereign and SSA) is stronger than last year and comparable to the record year 2021 (see chart above). Due to the strong issuing activity of the sovereigns, the green bond volume in particular is heading for a new record year. With almost € 60bn, year-to-date more than 50% of last year's total issuing volume (€ 105bn) has already been placed.



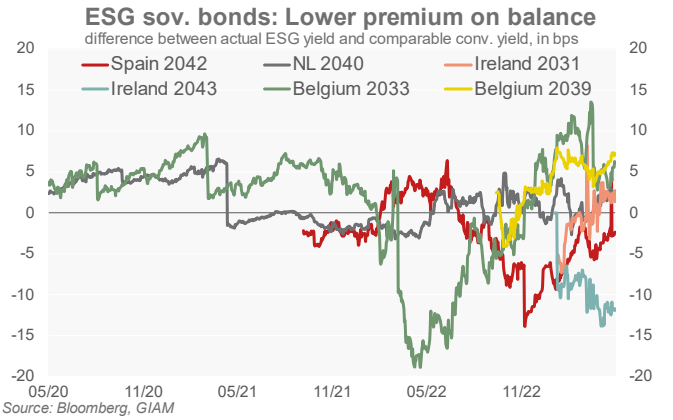
Source: Bloomberg, GIAM

The new ESG bond issuances were generally well received with orderbooks partially double-digit times subscribed and issuance spreads below guidance (e.g., tapping of EU 2.625% 02/2048 with twelve times subscribed orderbook at ms+68 bps, after guidance of ms+70 bps). The (strong) demand was well diversified in terms of investor type and regions. In particular, in the last few weeks, which were characterised by ongoing broader market uncertainty amid the smouldering banking crisis, SSA bonds have underpinned their status as a safe haven.

Despite the high issuance volume, we do not expect new highs to be reached in 2023. Several issuers are reporting strong funding progress and have already placed more than 50% of the targeted volume on the market (with the important exception of the EU, which has so far placed only slightly more than one-third of the expected annual volume). Accordingly, we expect this year's ESG bond issuance volume to remain below that of 2021, but to exceed the volume of 2022. Generally, it is to be expected that bonds from debtors who must place only a limited residual volume on the market will perform somewhat better going forward (see also below).

A trend toward shrinking ESG premiums

Due to the large number of ESG bonds, it is hardly possible to establish a general trend regarding premiums. We define the premium of ESG bonds as the difference in yield between an ESG and a conventional bond of the same issuer. A high premium, therefore, corresponds to a more negative value. Accordingly, a negative (positive) premium means that the ESG bond is trading richer (cheaper) than a conventional bond. While the premium can be determined immediately for German green bonds due to the twin concept[1] the analysis for other issuers is somewhat more complex since the maturity profile usually does not match. We circumvent the problem by estimating a conventional yield curve and using the set of coefficients to derive yields of synthetic conventional bonds matching exactly the maturity of corresponding ESG bonds.

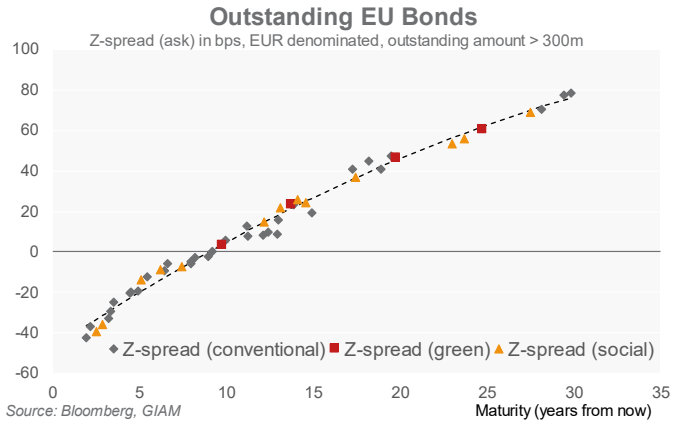


Source: Bloomberg, GIAM

In recent months, the premiums for ESG bonds have tended to narrow moderately. While most ESG sovereign bonds still have a (negative) premium, in some cases it has converged to 0 bps and even moved into positive territory. This reflects the recent comparatively high issuance volume of sovereigns

[1] For more details see here.

and several new green benchmark bonds. However, most ESG sovereign bonds are still trading richer. E.g., the new Ireland 2043 has steadily increased its premium since inception and has a premium of -12 bps according to our calculations now. German green bonds also continue to have a premium. Particularly, Germany 2025 and Germany 2027 benefit from strong demand as they have a unique selling point in that there are no other comparable green sovereign bonds with short maturities.



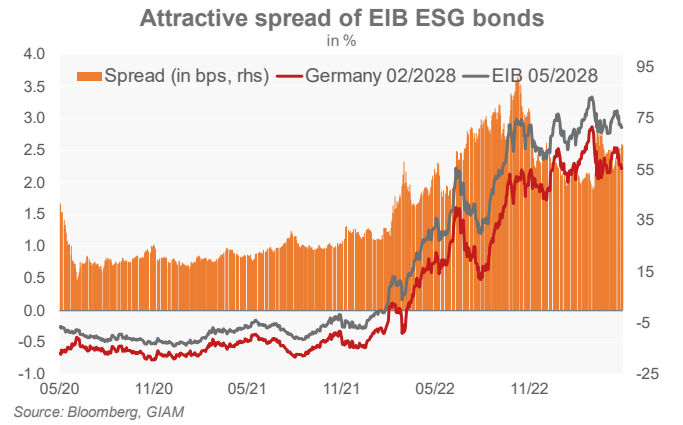
The SSA space is even more diversified, but it can be said that the ESG premiums for the major issuers declined as well. Meanwhile, the average premium for EU, KfW, and EIB bonds is now less than 2 bps. According to our calculations, some ESG bonds are even cheaper than conventional bonds, especially medium-dated bonds.

An attractive entry point for SSA bond investments

Due to the recent market challenges triggered by the turmoil in the banking sector swap spreads have widened noticeably and are currently well above the long-term average. As swap spreads are a major driver for SSA z-spreads (depending on the specific bond, a beta of 0.25 on average appears to be a reasonable starting point) they have underperformed versus sovereign bonds across the board in recent weeks.

Many SSA bonds (not just the ESG ones) are trading close to the widest level versus Bunds although the spread versus swaps has even tightened recently. This is due to SSA bonds being priced versus swaps while euro area sovereign bonds trade against Bunds (although large euro area supranationals have a quasi-German government guarantee they are still priced versus swaps). Hence, large high-rated SSA bonds are trading with a meaningful pickup to euro area sovereigns due to the wide swap/Bund spread. We regard this as an attractive entry point to set up or add long positions in SSA bond investments.[2]

E.g., the EIB 0% 05/2028 (a sustainability bond) versus Germany 0.5% 02/2028 spread has widened by almost 20 bps since March and is currently at more than 60 bps – well above what we consider to be fair.



The risk of this investment idea is an escalation of the banking concerns which trigger higher volatility and, hence, even higher swap spreads. This would induce a further cheapening of SSA bonds versus sovereign bonds. This applies even more as the lower liquidity of SSA bonds amplifies the underperformance of SSA bonds in times of financial market stress.

However, the movements of the last few weeks have also led to distortions within the SSA space. E.g., the spread KfW 1.125% 09/2032 versus EIB 1.125% 11/2032 is almost at a record level at -13 bps. An investment seems attractive, especially if financial stability concerns will fade in the medium term. Especially against the background that the EIB has already placed almost two-thirds of the targeted annual issuance volume on the market, while the KfW has less than 50% issued, a switch seems promising. The green EIB 1.125% 11/2032 also trades in line with conventional EIB bonds. Hence, investors not only achieve a higher return through the switch but can also expand their ESG portfolio without a yield penalty compared to conventional EIB bonds.

[2] Some caution is currently indicated regarding French agencies. Since the ratings are tied to the French sovereign rating, subsequent downgrades for French agencies are to be expected. As highlighted in its last comment Fitch already downgraded the EFSF to AA- following the downgrade of France.

Imprint

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