Morgan Stanley
INVESTMENT MANAGEMENT

Fixed Income ESG Outlook 2024

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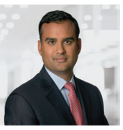
Despite a persistent challenging environment for fixed income investors, the Sustainable Bond market remained strong in 2023, with total Green- and Sustainable-labelled Bond issuance having reached again almost a trillion dollars as of year-end.[1] While new standards and increased investor scrutiny on companies' decarbonisation targets may, to some extent, decelerate sustainable corporate issuance in 2024, Morgan Stanley Investment Management's Fixed Income organization, including Calvert Research and Management's Fixed Income ESG Strategy and Research Team, ("Fixed Income organization", or we) expect a strong fixed income market backdrop as well as sovereign and supranational sustainable financing activity to ensure substantial Green & Sustainable supply and opportunities in the new year.[2]

On the regulatory front, we think 2024 will start seeing a move towards greater harmonisation across product labelling and sustainability reporting frameworks across jurisdictions, which can help create efficiencies and fast track investment flows into sustainable activities.

AUTHORS

BARBARA CALVI
Executive Director
EMEA Head of Calvert Fixed Income ESG Strategy & Research



ANUJ GULATI
Global Head of Calvert Fixed Income ESG Strategy & Research

RACHEL SMITH
Analyst, Calvert Fixed Income ESG Strategy & Research

[1] Global Green, Social, Sustainability and Sustainability-Linked Bond issuance stood at US$946 billion equivalent as of year-end 2023, slightly up compared to US$926bn in 2022. Source: Environmental Finance Data.

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We outline below some of the key ESG trends for fixed income investment in 2024:

A more thoughtful, standards-aware Green Bond market; nuclear energy could be the newcomer.

We continue to see opportunities for investors in the Sustainable Bond market as we move into 2024. Green-labelled Bonds, specifically, have continued to showcase their resilience compared to other sustainable bond labels (such as Social or Sustainability Bonds), with 2023 Green issuance closing at over US$560bn at year-end, an increase of c.7% yoy.[3] We expect increased standardisation and formalisation of best practices to act as a catalyst for more thoughtful and robust issuance. In Europe, the EU Green Bond Standard ("GBS")[4] will enter into force, on a voluntary basis, in late 2024,[5] and is intended to become the gold standard for issuers that are seeking to signal alignment with the most stringent definition of "environmentally sustainable economic activities", as per the EU Taxonomy. We expect the GBS to further raise the bar in an already mature European green bond market, while leaving flexibility for other issuers globally to demonstrate robust structures and governance beyond adherence to ICMA's Green Bond Principles, building on other credible international frameworks such as the Climate Bond Standard. The new GBS is also set to facilitate investors' disclosure of portfolio-level Taxonomy alignment, helping grow transparency across investment products domiciled or distributed in Europe, where such disclosure is required.

The adoption of the GBS may open the way for growth in Green Bond transactions partly financing nuclear energy, which is recognised in the EU Taxonomy as a transitional activity. Nuclear energy has gained strong momentum at the recent 2023 United Nations Climate Change Conference of the Parties (COP28) in Dubai, where leaders from 22 countries across four continents, including major economies like the US, the UK, and France, endorsed a declaration to triple global nuclear energy capacity by 2050[6] to meet climate goals and energy needs. While we recognise the role that existing nuclear capacity can play in plugging some of the energy supply gaps in the low carbon transition, we maintain a cautious view on investments in new nuclear capacity that could not only have significant adverse environmental and social impacts, but also prove uneconomical and (if implemented imprudently) divert resources from alternative energy solutions.

Focus on the improvement rate in climate transition.

We expect the climate transition topic[7] to gain even more prominence over the course of 2024, with increasing investor sophistication in evaluation methodologies driven by more comprehensive climate-related disclosures and more detailed definitions resulting from regulatory developments. A more mature market creates room for the potential inclusion of energy transition enablers from higher carbon intensity sectors in portfolios, so long as sufficient capital expenditure is available to support the company's decarbonisation process and the emissions reduction trend substantiates the narrative. In our view, the focus of the coming year will shift more towards the momentum and speed of improvement, as opposed to a sole focus on best climate performers. Recent developments in product labelling regimes seem to accommodate this approach. For example, the final UK Sustainability Disclosure Requirements (SDR),[8] published in late November 2023, include a "Sustainability Improvers" investment product classification. We think other regulators may introduce similar categories. Additionally, we expect this focus on transition to expand beyond a narrow take on climate, with biodiversity use-of-proceeds bonds likely to gain prominence due to growing investor demand for nature capital investment solutions and improved guidance on science-based standards for targets and disclosures.[9] Clear communication will be needed from investors to establish what comprise credible investments to drive progress on these difficult-to-quantify efforts.

We believe Green Bonds will continue to be a credible tool to invest in the transition towards a well-below 2-degree economy, provided that a thorough assessment is conducted at both project and issuer level—we discuss this in our recent paper on the Merits of a Research-Driven Framework for Green and other Sustainable-labelled bonds. We anticipate greater scrutiny on issuers' net-zero commitments and the credibility of carbon offsets as part of these corporate strategies. We believe companies are likely to be criticised for the widespread

[3] Source: Environmental Finance Data, as of year-end 2023.
[4] European Commission, *EU Green Bond Standard*
[5] European Council, *European Green Bonds*
[6] Nuclear Energy Agency, *Declaration to Triple Nuclear Energy*.
[7] Calvert Research and Management, *Investing in the Energy Transition*
[8] Financial Conduct Authority, *Sustainability Disclosure Requirements and investment labels*
[9] Science Based Targets, *Forest, Land and Agriculture Guidance (FLAG)*

use of carbon offsets in achieving decarbonisation goals, especially at a time when the credibility of voluntary carbon credit markets is at stake, due to the uncertain additionality of most offsets being sold. Coupled with evolving best-practice standards,[10] we expect there will be appetite for issuers that come to the market with robust, additive Green Bonds backed by more tangible investment plans intended to support their decarbonisation plans.

A growing portion of the Global Aggregate sovereign constituents goes Green, while emerging markets focus on nature.

Sovereign Green and Sustainable-labelled Bond issuance has experienced its strongest year ever, with a total of US$156bn as of year-end. With Japan planning to issue climate transition bonds in February,[11] and other countries including Australia and Romania announcing a green or sustainability bond offering in 2024,[12] we expect there to be a growing overlap between the Green Sovereign Bond universe and sovereign constituents of the Global Aggregate Index. This makes Global Green Bond strategies a potentially attractive opportunity for investors in the global multi-sector and government bond space, as a means to further integrate sustainability into portfolios without having to give up a significant portion of the investment universe.

In the meantime, at COP28, a number of development organisations have formed a taskforce to support the deployment of nature-linked sovereign financing instruments across developing and emerging countries,[13] in an effort to mobilise capital towards not only climate change mitigation but also adaptation and natural capital. This can lead to greater diversification in the range of sovereign sustainable debt issuers and investable projects, broadening opportunities for emerging markets investors to get exposure to instruments with clearly defined impact objectives.

Moving towards top-down, product strategy-focussed sustainability labelling and disclosure regimes.

We think the global regulatory landscape for sustainable investing will start evolving from the current scattered, rather experimental environment towards a more harmonised, market consensus-driven set of sustainability disclosure and product labelling regimes. For example, the recent publication of the SDR in the UK, as mentioned above, may prompt a reconsideration of the structure of the EU Sustainable Finance Disclosure Regulation (SFDR), which has been under consultation in Q4 2023.[14] While the ultimate number and names of product categories may differ across jurisdictions, we believe most labelling and disclosure frameworks will ultimately converge towards an approach that focuses on how sustainability objectives are actually pursued through an investment product’s strategy, and on evidencing the core tools and analysis deployed to that end. This should help increase consistency in minimum thresholds and comparability of sustainability performance within the same product group. In this context, Green Bond strategies with clearly defined objectives, processes and intended impacts, are likely to remain amongst those investment strategies that provide the greatest clarity and transparency to investors.

Demand for issuer-reported data prompts the drive for robust international minimum sustainability reporting standard; in fixed income, focus on impact data likely to grow as a result of new product labels.

As regulation demands greater use of reported sustainability data, alignment in measurement and reporting is likely to remain central to issuer-investor and multi-stakeholder dialogue over the course of next year. Progress has been made, on the regulatory front, to align the UK and the EU’s corporate sustainability reporting standards to the International Sustainability Standards Board (“ISSB”), although inherent differences of approach remain, as the ISSB’s focus on financial materiality only partially overlaps with the EU’s double materiality-driven structure of disclosures. Other regions, such as Australia and APAC more broadly, are prioritising regulatory guidance on climate-related disclosures and corporate transition plans, before tackling an expanded set of sustainability indicators.[15] As more global frameworks emerge across developed and emerging markets, we see the need for a common backbone of principles and definitions, which we expect will be represented by the ISSB.

[10] For example, the Science Based Targets initiative (SBTi) recommends that carbon credits must not be counted as emission reductions toward the progress of companies’ near- or long-term science-based targets

[11] IPE News, *PRI in Person*

[12] Australian Government, *Green Bond program*; *Romania’s Green Bond Framework*

[13] Inter-American Development Bank, *Eight International Organizations and Development Finance Institutions Join Forces to Boost Innovative Financing for Nature and Climate*

[14] European Commission, *Targeted consultation on the implementation of the SFDR*. One of the points under consultation is whether SFDR shall remain a sustainability disclosure framework, or be converted into an investment product labelling framework.

[15] IGCC, *Joint Investor Statement*

In the fixed income market, investors' appetite for impact data is growing, spurred by "impact-focused" and analogous product classifications. Particularly for Green Bond strategies, we expect portfolio impact performance to become a more important differentiator going forward. Issuers that are able to report impact-related metrics beyond their Green and labelled Sustainable Bond securities, for their broader business activities, may also become more attractive investment targets for sustainable portfolios that seek to evidence positive environmental and social contributions. Voluntary market guidance, including the International Capital Market Association (ICMA)'s Impact reporting Handbook[16] and the Partnership for Carbon Accounting Financials (PCAF)'s methodologies for avoided and removed emissions, are key references for issuers to help standardise impact data and facilitate its usage, for the benefit of both issuers and investors.

We expect global taxonomies will continue to develop into 2024, with the EU Taxonomy leading the way in an effort to become the first comprehensive regulatory framework to define environmentally sustainable economic activities. However, we envisage some implementation challenges: for example, coming out of COP28 at the end of 2023, we expect elevated discussion on whether it is appropriate for investors to apply EU Taxonomy standards to projects in emerging market (EM) economies. Regional or local taxonomies may therefore become more defined in 2024, such as Mexico's Sustainable Finance Taxonomy published in March,[17] and Brazil's draft Sustainable Taxonomy Action Plan, which closed its public consultation in October. Whilst these EM taxonomies are more regionally tailored, for example by prioritising biodiversity protection and including a focus on social vulnerabilities and gender equality, there will continue to be alignment to international taxonomies for interoperability purposes.[18] As such, we expect continued benefit from these voluntary yet regulated frameworks, creating standardised and audited reporting requirements for issuers.

Whilst the regulatory landscape continues to evolve as we enter 2024, many investors have already built up resources, frameworks, and systems to navigate the differing global disclosure requirements. We expect that the marginal cost to adapt to new regulation will gradually decrease as guidance and harmonisation improve, and the market will benefit from greater standardisation and assurance on the quality of reporting. These efficiencies and enhanced transparency can help accelerate investment flows into green and other sustainable investments.

[16] ICMA, *Impact reporting Handbook*

[17] Gobierno de México, *Taxonomía Sostenible De México*

[18] Governo Federal Brasil, *Taxonomia Sustentável*

Risk Considerations

Diversification does not eliminate the risk of loss.

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in a portfolio. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (**liquidity risk**). They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, and correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss. **ESG Strategies** that incorporate impact investing and/or **Environmental, Social and Governance (ESG)** factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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MIDDLE EAST

Dubai: MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

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