

Emerging Market Debt: The opportunity for impact

WHAT IS IMPACT INVESTING?

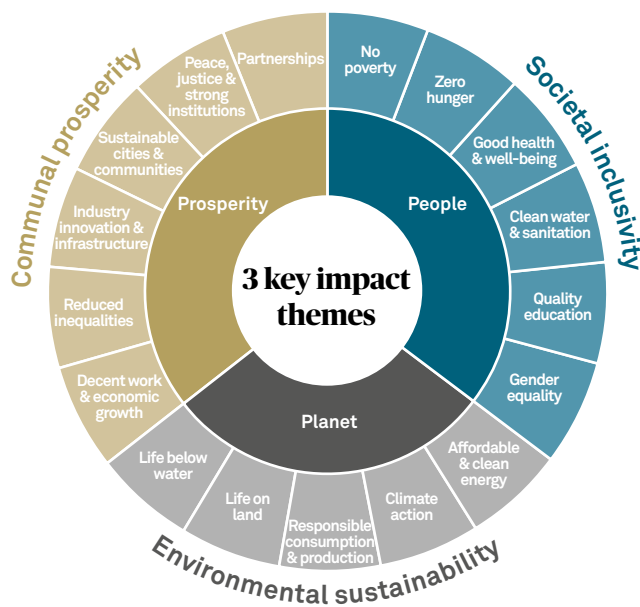
Impact investing is a broad term used to refer to investment approaches that emphasise aiming for a positive environmental and/or social impact.

Not being purely philanthropic, such an intention will typically sit alongside one of attempting to achieve financial returns, creating a dual objective in a single strategy.

DEFINING “IMPACT”

A helpful first step is to define what is meant by ‘impact’, or ‘positive environmental and/or social outcomes’. The 17 United Nations Sustainable Development Goals (SDGs) are widely regarded as reflecting the industry standard framework for defining impact. Insight believes they can best be grouped into three subsets covering People-oriented goals, Planet-oriented goals and Prosperity-oriented goals. These three groups may be thought of as reflecting key impact themes.

FIGURE 1: SDGS AND IMPACT THEMES



Source: United Nations Sustainable Development Goals, Insight. As at February 2023.

PEOPLE

The People theme includes six of the SDGs that can be thought of as seeking to improve the outlook for people and overall societal inclusivity, such as **gender equality**.

PLANET

In our view, goals that look to improve environmental sustainability could be considered to have a Planet theme, which would include **affordable and clean energy**.

PROSPERITY

Prosperity at a communal level is another impact theme Insight believes encapsulates a number of SDGs well. A good example is **industry, innovation and infrastructure**. Under the Prosperity theme Insight also include the final two SDGs of **peace, justice and strong institutions**, and **partnerships for the goals**.

UNPARALLELLED OPPORTUNITIES IN EMERGING MARKETS FOR MAKING A POSITIVE IMPACT

WHAT EMERGING MARKETS OFFER FOR IMPACT INVESTING

There is little doubt that the world currently faces a variety of crises at both the social and environmental levels. Climate change perhaps represents the most global threat, while solvable social emergencies remain commonplace.

Whether considering the potential scale of impact investing, or the broad scope for positive change, emerging markets (EM) are arguably unparalleled.

MOST OF THE WORLD'S POPULATION, AND NEARLY ALL OF THE POOREST PEOPLE, LIVE IN EM COUNTRIES

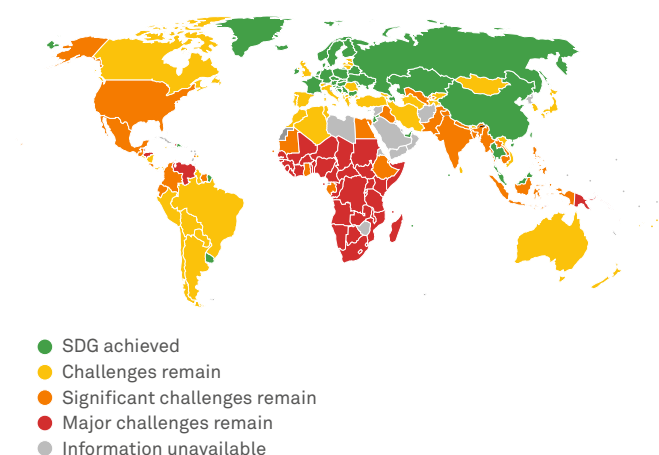
The countries of the EM are home to 85% of the world's population,¹ so when considering how it could be best to address the furtherment of social and gender equality and other SDGs, contained within the People impact theme, it is worth understanding the sheer scale of the potential to make an impact in EM.

¹ Source: Insight analysis as at December 2021, using International Monetary Fund (IMF) data and categorisation of Advanced, Developing and Emerging countries (Emerging markets = Developing and Emerging countries).

Similarly, Insight believe an investment oriented toward UN SDG objectives such as **no poverty**, providing **clean water and sanitation** or **quality education** in the emerging markets is likely to help achieving a demonstrable impact aligned to the People theme.

As the UN Sustainable Development Report 2022 shows, the goal of reaching **no poverty** remains difficult, particularly as 99% of the world's poorest live in EM countries.² Figure 2 shows that much of Africa still faces major challenges, while other EM countries such as India, Pakistan and Indonesia, to name just three, continue to face significant challenges.

FIGURE 2: ERADICATING POVERTY REMAINS A MAJOR CHALLENGE FOR LARGE SWATHES OF THE EM WORLD (SDG 1)



Source: United Nations Sustainable Development Report 2022 dashboard, (<https://dashboards.sdgindex.org/map>). As at September 2022.

MOST OF THE WORLD'S LAND MASS IS WITHIN THE EM

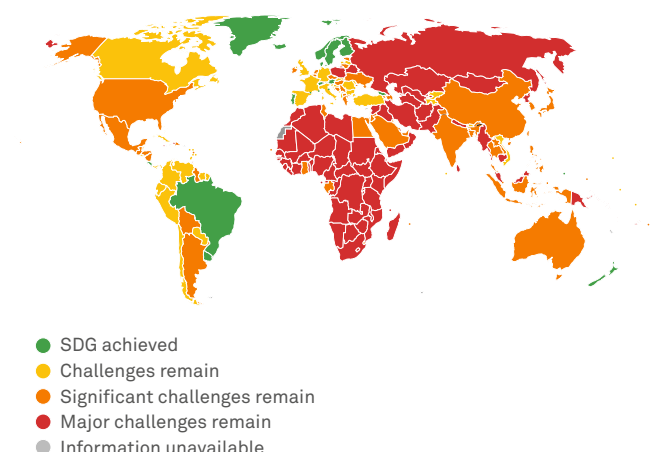
With 77% of the earth represented by EM², there is significant scope for impact capital aligned to the Planet theme within EM. The need to focus on SDG 13, **climate action**, is clear, particularly for EM where Insight can regularly witness the devastating effects of environmental disasters and climate change.

MOST OF THE ENERGY SUPPLY IN EM IS RELIANT ON FOSSIL FUELS

If you are serious about making an impact on fossil fuels at a global level, you cannot ignore EM, where over 70% of the energy supply is reliant on fossil fuels.³

Given the existing dependency on fossil fuels as the source of so much energy supply in EM, they arguably should be a focal point for capital. It may help enhance Prosperity, aligning with SDG 9 focused on **industry, innovation and infrastructure**, as well as address the Planet theme through improving the provision of **affordable and clean energy** (SDG 7) – where the UN Sustainable Development Report 2022 shows there are significant and major challenges remaining across much of the world (see Figure 3).

FIGURE 3: PROVIDING AFFORDABLE AND CLEAN ENERGY IS DIFFICULT IN MANY EM COUNTRIES (SDG 7)



Source: United Nations Sustainable Development Report 2022 dashboard, (<https://dashboards.sdgindex.org/map>). As at September 2022.

THE SCALE OF OPPORTUNITY

The monetary scale of impact opportunities in EM is also eye-catching. According to the International Monetary Fund (IMF), meeting the SDGs in 2030 would require spending of US\$2.6trn in 121 EM countries and low-income developing countries.⁴ This represents approximately 2.5% of 2030 world GDP.

The International Finance Corporation (IFC), as long ago as 2018, suggested that cities in EM countries could attract more than US\$3.1trn in investments across renewable energy, public transportation and waste and climate-smart water by 2030.⁵ Even that sum is dwarfed in the same report, by the estimated US\$24.7trn investment potential in green buildings in cities from the EM world.

They perhaps present unparalleled potential to benefit all People, the Planet as a whole and Prosperity in general.

POTENTIAL FINANCIAL BENEFITS OF EM INVESTMENTS

High inflation, tightening financial conditions and the growing risk of recession have led investors to reconsider their allocations to and within fixed income, looking for ways to cushion against those risks.

EM corporate bond yields are currently at their highest level for about a decade (Figure 4) and are becoming more attractive. EM green bonds have offered a structural yield premium over developed market equivalents (Figure 5) since 2019, when the EM green bond market really began to achieve scale.

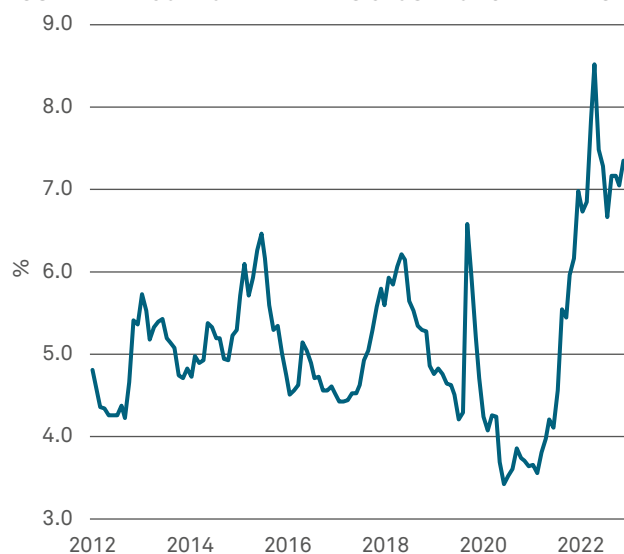
² Insight analysis using World Bank data available on poverty, land mass and poverty as at September 2021, setting the poverty gap at USD5.50 a day (2011 purchasing power parity, PPP).

³ Source: BloombergNEF, New Energy Outlook 2020 dataset.

⁴ Source: International Monetary Fund: Fiscal Policy and Development: Human, Social and Physical Investment for the SDGs January 2019.

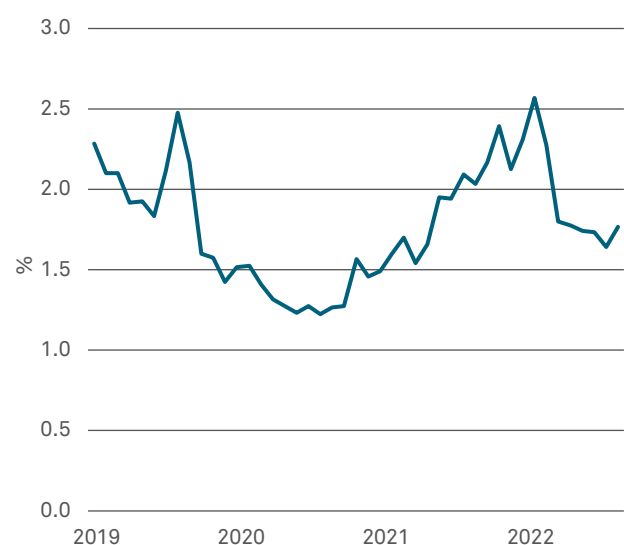
⁵ Source: International Finance Corporation – Climate Investment Opportunities in Cities (2018).

FIGURE 4: EM CORPORATE YIELDS CLOSE TO 10-YEAR HIGHS



Source: Bloomberg. As at 31 March 2023. JP Morgan CEMBI Broad Diversified Index Yield to Worst.

FIGURE 5: PERSISTENT GREEN BOND YIELD PREMIUM OVER DEVELOPED MARKETS



Source: Bloomberg. As at 31 March 2023. JP Morgan GENIE EM Index versus JP Morgan GENIE DM Index Yield to Worst.

This yield surge and spread widening is occurring while leverage among EM corporates is generally less than half that of US corporates, and with interest cover at decade highs.

Last, despite the challenging macro backdrop globally, Insight believe the fundamental outlook for EM corporates also remains positive.

ATTRACTIVE FEATURES FOR PERFORMANCE POTENTIAL

Structural yield premium on EM impact debt: EM currently offer the highest duration-adjusted yield anywhere in the mainstream fixed income markets. The same yield premium seen in the broader EM debt markets is also available within the impact universe. For instance, as at 31 May 2023, EM green bonds offered a yield of 5.6%, compared to 3.8% for developed market green bonds, for the same average rating, and despite duration of EM green bonds being three years shorter, on average.⁶

Diversification across a large, heterogeneous asset class: The war in Ukraine and ongoing tensions between the US and China have led to a cloud of uncertainty over markets, particularly in emerging markets. Yet with issues available across five continents as varied as the people that inhabit them, EM countries are offering vastly differing fundamentals and impact opportunities across that universe, and thus significant opportunities for active managers to seek to exploit.

Market size exceeds other mainstream fixed income areas: The hard currency EM bond market is roughly US\$4 trillion in size according to JP Morgan, as at May 2023. This is made up of 1,500 issuers from over 100 countries, across all sectors. Sovereign and corporate issuers represent approximately \$1.5 trillion each, with the remaining \$1 trillion being quasi-sovereign issues. This compares to the US high yield market of about \$1.4 trillion, or the euro investment grade market of approximately \$2.8 trillion (€2.7 trillion).

Additional demand from conventional bond strategies: Impact debt may be equivalent to conventional debt issued by the same entity, with similar risk/return characteristics, albeit with an additional impact commitment. So, conventional bond strategies may decide to invest in an impact bond based on its financial characteristics alone.

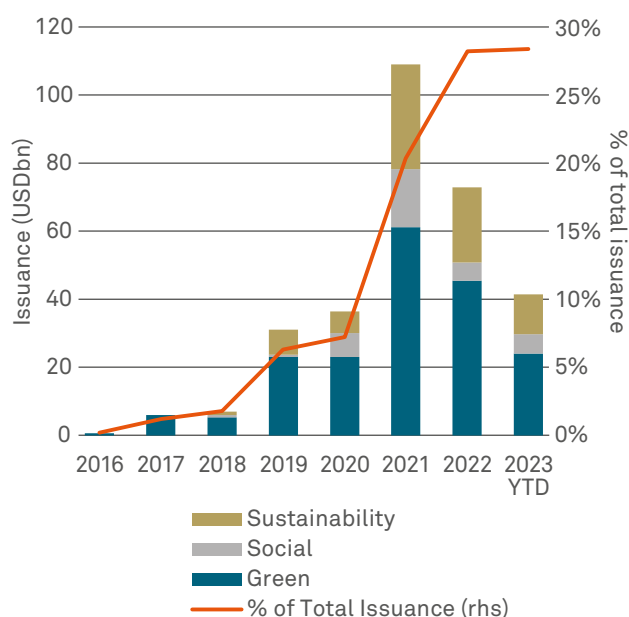
THE RAPIDLY EXPANDING IMPACT OPPORTUNITY SET IN EMERGING MARKETS

The opportunity set for achieving impact began a decade or more ago with the introduction of green bonds, but it has grown substantially since then, and now accounts for a significant proportion of EM issuance. At the end of May 2023, impact bond issuance in the EM had represented 28% of all EM issuance for the year to date⁷ (Figure 6), with the hard currency impact bond universe now totalling over USD 300bn outstanding, from over 300 issuers from over 40 countries.

6 Source: JP Morgan GENIE Index, EM and DM respectively. As at 31 May 2023.

7 Source: Insight analysis of Bloomberg data, as at 31 May 2023.

FIGURE 6: EM IMPACT BOND ISSUANCE HAS SURGED



Source: Insight, Bloomberg, as at 31 May 2023. For illustrative purposes only.

The first generation of EM impact funds mostly focussed purely on green bonds, those with specific projects targeting environmental outcomes. As the broader market has evolved

and matured, Insight can now see a wider opportunity set in public fixed income. Insight expect this will improve both potential financial returns and the potential breadth and extent of impact through three types of impact security: 'impact bonds', and bonds from what Insight refers to as 'impact issuers' and 'improving issuers'.

An impact bond is one that specifies its proceeds will be used to have a positive environmental or social impact. Common types include green bonds, social bonds and sustainability bonds. As data availability and issuer frameworks have developed, it has now become possible to also target impact via issuers whose revenue (impact issuers) or capex (improving issuers) is directly aligned to the UN SDGs or EU taxonomy. For all three types of impact security, Insight believe it is critical to assess the risk of 'impact-washing', to ensure capital is genuinely being used for the positive advancement investors target.

THE OPPORTUNITY FOR IMPACT INVESTING

Insight believe EM offers potentially unparalleled opportunities for making a positive impact, in a rapidly expanding investment universe that also has the potential to deliver very attractive long-term financial returns.

Insight Investment uses impact bonds as an umbrella term for fixed income issuances the proceeds of which are dedicated solely to projects intended to meet environmental or social criteria. This encompasses the universe of bonds referred to as green or sustainable as well as more specific outcome-oriented issuances such as blue, gender and transition bonds.

IMPORTANT INFORMATION

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