OCT
05
2020

Sovereign ESG Analysis: Are Current Laggards Future Rising Stars?

Reina Berlien |

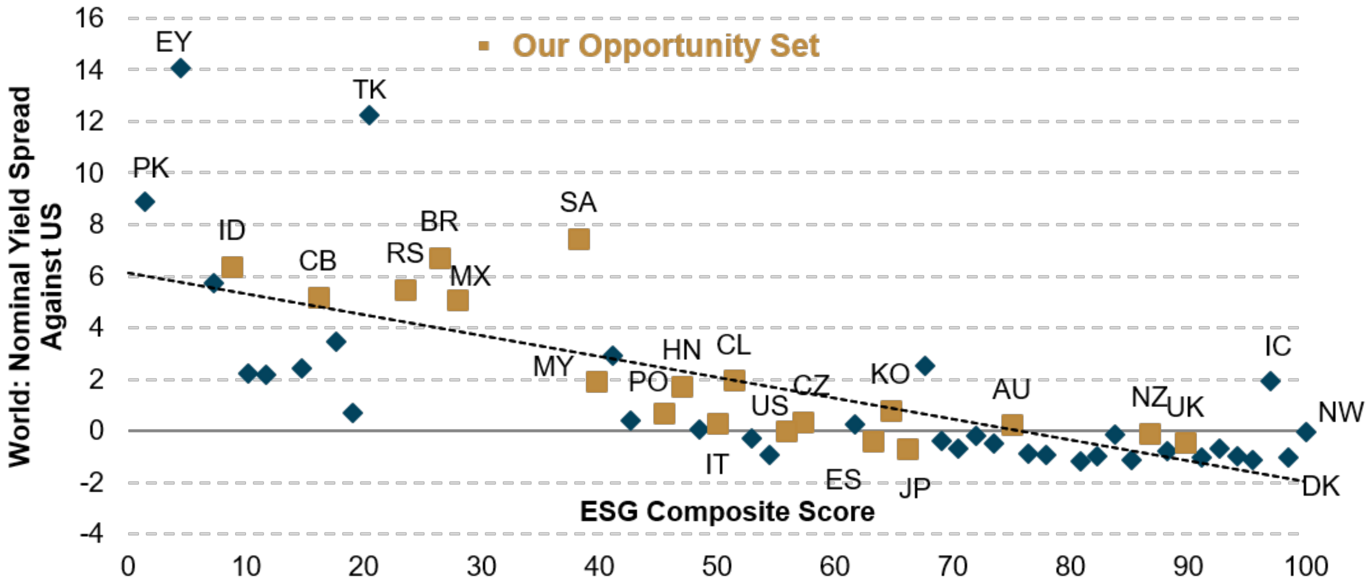
We are often asked, “is there a country we *wouldn’t* invest in based purely on ESG factors alone?” It’s a fair question, particularly as we advance our ESG analysis and integration. However, the short answer is “no.” There are a few reasons we don’t exclude countries based on ESG considerations alone, but for the sake of pithiness, it’s simply because we aren’t willing to ignore substantiated valuation opportunities—which is particularly germane in a low-yielding world. Oftentimes, the highest-yielding bonds are issued by countries with weaker ESG scores; the same tenet applies to sovereign credit ratings. The corollary holds true for the highest-rated countries according to our ESG scoring methodology.

Just as we think a country’s asset prices will revert to the mean over a business cycle, we also believe its domestic ESG issues should change—by either improving or deteriorating—over a given period. The projected improvement over time explains why we invest in these countries, and a reason why our ESG analysis and integration are inherent to our investment process. There are two particular charts that illustrate how we think about our investment universe and ESG analysis.

Compelling ESG and Valuation Opportunities

Chart 1 below ranks countries on their ESG scores on the x-axis and measures their 10-year government bond spreads relative to U.S. Treasuries on the y-axis. In our ESG scoring model, we emphasize the role of governance, as it ultimately affects social and environmental issues at the sovereign level. Together, the ESG score and any deviation from the fitted line flag potential opportunities to buy, sell, or completely avoid a government bond. The top and bottom deciles in Chart 1 exemplify the two cohorts’ dichotomous valuations and ESG rankings. Unsurprisingly, the Nordics and many other European countries have the highest ESG scores but offer paltry yields. The highest-yielding opportunities basically span the emerging market universe.

1 **10-Year Nominal Yield Spreads vs. Country ESG Scores**
As of 06/30/2020



Sources: Verisk Maplecroft and Brandywine Global
*ESG composite scoring created by Brandywine Global exclusively using Verisk Maplecroft data

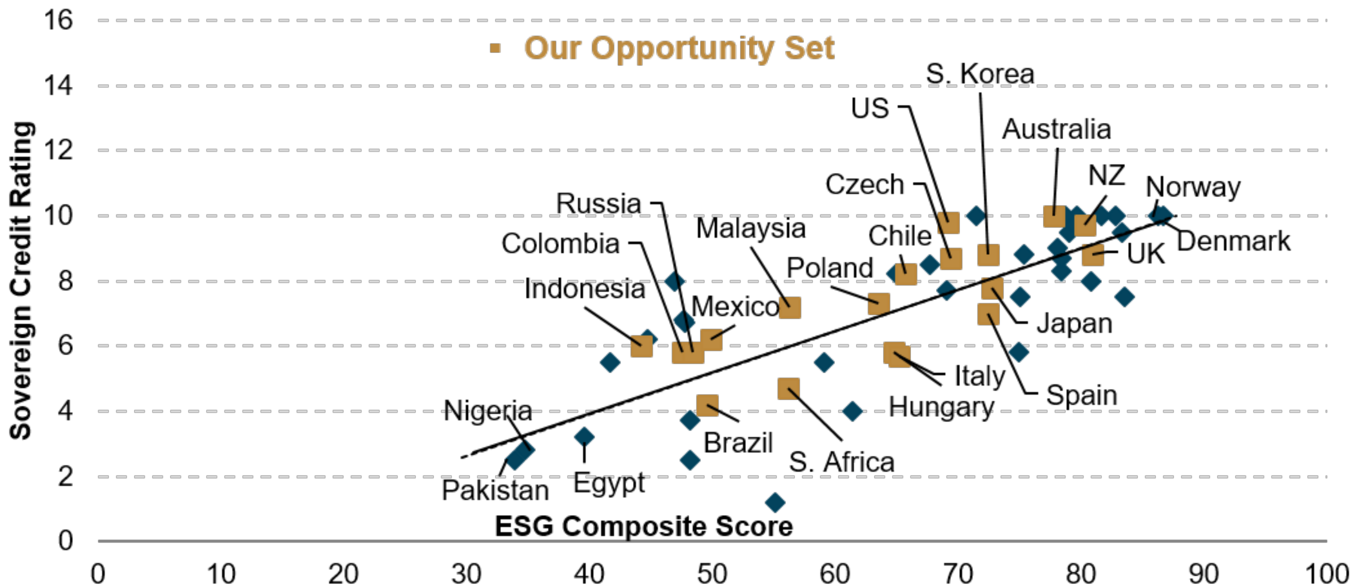
One could infer the top decile of countries has little incentive to improve in terms of ESG metrics—not to mention, they pose a significant amount of duration risk. Although countries in the bottom decile have ample reasons to improve on these factors, it doesn't mean they are automatic candidates for investment either. In fact, the bottom decile warrants extreme caution and continuous monitoring for any potential deterioration. Even if a position is initiated, any real-time precipitous decline in governance and/or social conditions could be a reason to close the position entirely, as was the case in Egypt earlier in the year. Conversely, a country with a notably improving ESG risk profile *and* attractive valuations may signal an opportunistic time to invest.

Indonesia is also in the bottom decile, even as governance and social considerations surprised to the upside during the pandemic. For an emerging market with a dispersed geography and smaller-scale healthcare system, Indonesia managed the first wave of the coronavirus relatively well. Bank Indonesia has been a perennial favorite monetary authority of ours and indeed exhibited stewardship during periods of extreme market volatility. The pandemic will certainly test the mettle of government officials around the world, and we expect a country's ESG score could change as a result of this watershed year. For example, Indonesia could see its overall score improve in 2020 due to a combination of targeted and prudent fiscal and monetary stimulus and/or improved access to healthcare. There are a myriad of ways for lower-ranked countries to improve, which then begs the question, *how should countries be incentivized to improve on ESG factors?*

Using Borrowing Costs as ESG Motivation

Sovereign credit ratings could be a useful tool in compelling a country to improve upon a variety of ESG metrics. Chart 2 once again plots country ESG scores on the x-axis, but this time against a sovereign's average credit rating on the y-axis.

2 Sovereign Credit Ratings and ESG Scores*
As of 06/30/2020



Sources: Verisk Maplecroft and Brandywine Global
*ESG composite scoring created by Brandywine Global exclusively using Verisk Maplecroft data

Weaker-scoring countries generally have lower credit ratings, likely because of the agencies' negative outlook on their economies and skepticism surrounding the sovereign's ability to manage outstanding debt. Lowering the cost of capital should be a welcome reprieve for any sovereign issuer, particularly those that already pay a premium on their debt. In theory, a country's credit rating should be upgraded as its economic fundamentals improve, especially those facets that help manage outstanding debt and budgetary demands. A country's borrowing costs should decline as it receives a ratings upgrade. The amount that a country was paying in interest could then be reallocated to a variety of ESG-centric causes, whether it's building sustainable infrastructure, improving healthcare, or providing access to better education.

South Africa is an example of a country that received a credit rating downgrade at the onset of the pandemic, continually tries to reconcile a significant budget shortfall with huge funding demands, and has abundant opportunity to improve across several ESG considerations. However, South Africa certainly isn't alone—most countries irrespective of credit quality and ESG scores are facing widening deficits and increased funding demands as a result of the pandemic. South Africa's overall ESG score has gradually declined over time due to weakness across all three factors. Despite some of the highest real yields in our universe, we have approached South Africa with caution given the country's elevated risk profile, particularly regarding matters of governance.

ESG Momentum Keeps Building

We will continue to improve our statistical research on the relationships between ESG scores, bond yields, and credit ratings. Our goal is to build predictive ESG models that identify potential changes in price and information risk. The next steps in our research initiatives include determining the degree to which governance and social factors are priced into bond yields. Although environmental risks have been largely underpriced until this point, market sentiment is poised to change as countries set their own aggressive climate agendas. Egypt issued its first five-year green bond very recently, while China announced its 40-year carbon neutral plan. The latter country was also the world's second-largest source of green bond issuance in 2019. Although both countries have weaker ESG rankings, perhaps they might focus on reducing climate risks as a strategy to improve their

overall scoring. Demonstrating the ability to manage shorter-term debt and verify use of proceeds will be paramount in gaining credibility with investors and ratings agencies alike.

In the meantime, we'll leave you with these parting thoughts: analyzing economic fundamentals and ESG factors are not mutually exclusive. There is a relationship between the two that explains possible valuation anomalies in global bond and currency markets; any changes to both components should be reflected in asset prices. It will be interesting to see how countries' ESG scores change as a result of how they handled the pandemic, and the economic impact of those policies. Hopefully, improving ESG scores, higher credit ratings, and lower borrowing costs will be a few things to look forward to in 2021.

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.