IIF Green Weekly Insight
ESG in the Time of COVID-19

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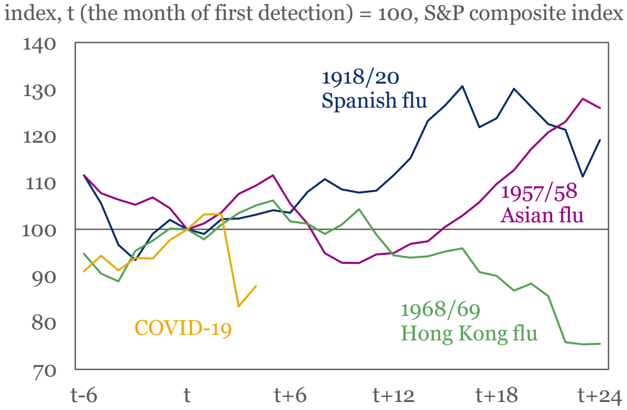
- As public health restrictions wear on, market assess how stimulus and support measures might shape the recovery
- ESG-friendly equities and corporate bonds continue to outperform their peers in major global markets, including the U.S.
- ESG-dedicated ETFs saw net inflows of over $3.7 billion in March, with a strong upswing in early April.
- A sustainable way to finance COVID-19 costs: social bond issuance has surged to near $7 billion in early April

One hundred years of solitude? As traders, analysts and investors around the world complete a first month of teleworking, the impact of COVID-19 on global financial markets has been unprecedented. While April's risk rally has staunched the bleeding, volatility remains elevated as massive job losses and sharply declining corporate earnings cloud the outlook, while adding to the debt burden for sovereigns, corporates and households. Moreover, the improvement in sentiment is based largely on aggressive policy measures (e.g. the Fed's decision this week to buy U.S. high-yield bonds) and attractive valuations. But the ultimate shape of recovery will depend on the extent to which COVID-19 can be treated. Without a vaccine or built-up herd immunity against the virus, it could well take far longer than anticipated to start widespread easing of social distancing. Past outbreaks may be instructive, despite differing circumstances for each. Each lasting more than 15 months, three major pandemics (1918/20, 1957/58, and 1968/69) that threatened U.S. public health were all accompanied or followed by a contraction in economic activity and a sharp rise in government budget deficits. Across these cases, output loss appears to have been associated with people falling ill, fear of going to work in order to avoid infection, and public health restrictions, rather than actual morbidity or mortality rates. However, the current pandemic has had a much sharper initial impact as widespread public health restrictions disrupt the highly interconnected global economy, resulting in a steeper U.S. stock market decline than in past episodes of disease outbreak (Chart 1).

Always something left to love: While ESG-labeled stocks and bonds have by no means escaped the impact of COVID-19, ESG indices to date have been hit much less hard than "traditional" benchmarks. Offering an opportunity to mitigate downside risks, ESG-friendly stocks

Chart 1: U.S. share prices during past pandemics

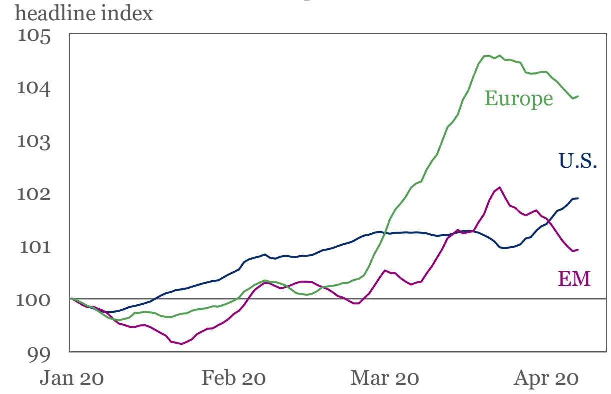
index, t (the month of first detection) = 100, S&P composite index



Source: Robert J. Shiller, IIF

Chart 2: ESG stocks—outperforming in troubled times

index, end-2019=100; relative performance of ESG to headline index



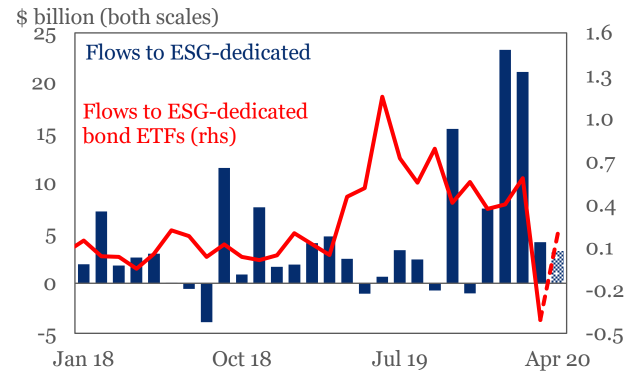
Source: Bloomberg, IIF

have outperformed peers across all major markets, particularly in Europe (Chart 2). Stocks with high ESG scores tend to be less volatile than those with low scores, helping pull more than $50 billion into ESG-dedicated equity ETFs year to date, with a significant upswing in flows in early April (Chart 3). In contrast, *outflows* from traditional equity mutual funds was over $110 billion. Within the smaller fixed-income universe, ESG investment grade corporate bonds are outperforming peers in the U.S., while continuing to track European IG benchmarks closely (Chart 4). We estimate that ESG-dedicated bond ETFs took in around $600 million year to date, with a renewed influx in early April—vs $80 billion outflows from traditional bond funds.

Social bond issuance set to surge: In the world's largest dollar-denominated social bond transaction to date, the African Development Bank (AfDB) launched a $3bn "Fight COVID-19" Social Bond, which pushed issuance for April to date to near $7bn—vs. a monthly average of just $1.2bn in 2018/19 (Chart 5). The offer was met with widespread investor support, as bids exceeded $4.6bn, a remarkable achievement given market volatility and given that this is the largest dollar benchmark the AfDB has ever issued. More broadly, the international financial institutions are rapidly marshalling resources to help vulnerable countries respond to COVID-19, including a $14 bn package from the World Bank and $50 bn in IMF emergency financing facilities; the need for support remains acute, with growing calls for debt relief (see our IIF letter on approaches to forbearance for vulnerable low-income countries). With leaders around the world under pressure to respond (prompting a record $2.1tn in government bond issuance last month) the AfDB's landmark bond could open the door for sovereigns across both mature and emerging markets to issue COVID-19 focused social bonds. With government deficits set to rise sharply, social bond markets could provide debt managers with welcome diversification of their investor base.

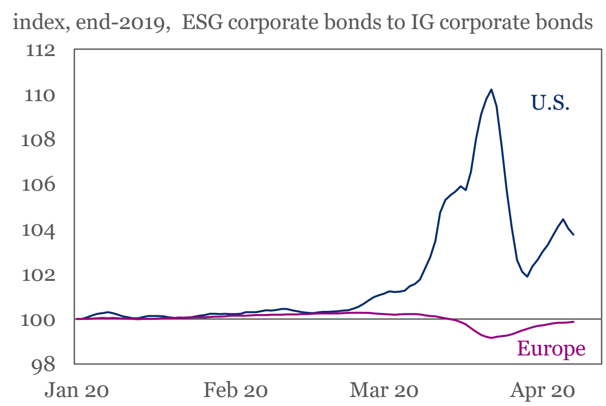
Social bonds are well suited for capital raising to fund government efforts to mitigate the socio-economic impacts of COVID-19 pandemic. For instance, issuers can direct proceeds to relevant efforts such as developing testing capacity, vaccines, and therapies; manufacturing health and safety equipment and hygiene supplies; or providing loans to negatively affected small and medium-sized enterprises SMEs. The Social Bond Principles (SBPs) define eligible use of proceeds categories, which include access to essential services such as health care, SME financing and other areas where COVID-19 may have negative impacts. The SBPs also specify that target populations can include "vulnerable groups" and the "unemployed," providing ample scope for channeling capital through social bonds towards the fight against COVID-19.

Chart 3: ESG equity funds pull in $50bn+ year to date



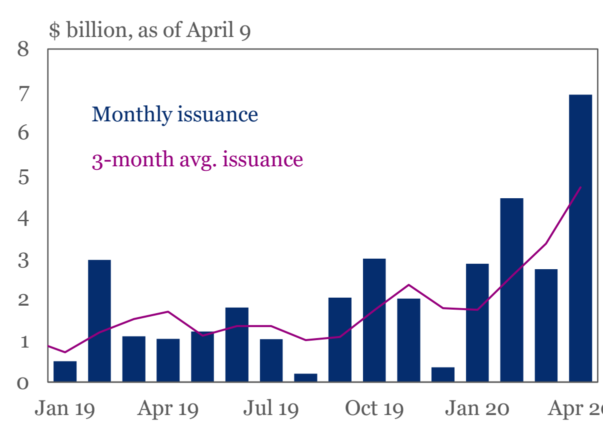
Source: Bloomberg, IIF

Chart 4: ESG corporate bonds outperform in the U.S. and continue to track IG benchmarks in Europe



Source: Bloomberg, IIF

Chart 5: COVID-19 could herald a social bond boom



Source: Bloomberg, IIF

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- Weekly Insight: COVID-19 hammers equity valuations (04/02/2020)
- Weekly Insight: COVID-19 Exacerbates Household Debt Burdens (03/26/2020)
- Weekly Insight: COVID-19 Drives Dash for Cash (03/19/2020)
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- IIF Sustainable Finance Working Group Report: The Case for Simplifying Sustainable Investment Terminology (11/06/19)