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This year hasn't been kind to the global fixed-income market and the sustainable bond market in Asia hasn't been spared. However, our conviction toward this asset class remains strong and we expect current headwinds to weaken in the months ahead.

Sustainable Asia bonds: cutting through the noise

Market assessment: a very unusual nine months

It's been a challenging year for financial markets. While news headlines may suggest that the balkanization of the global economy is well under way, we remain very much in an interconnected world.

Markets in Asia aren't insulated from key events taking place elsewhere—these include the economic fallout emanating from Russia's invasion of Ukraine, the withdrawal of monetary stimulus, and crucially, the decision among most central banks (with the notable exception of the People's Bank of China and the Bank of Japan) to use interest-rate hikes as the primary tool to contain inflation.

Needless to say, these developments continue to have a profound impact on the region's markets, but there are other Asia-specific issues that have also weighed on investor confidence, notably, mainland China's property sector.

Leverage levels, COVID-19, and mainland China's real estate sector

What began as an idiosyncratic event involving a few highly leveraged property companies in China has since taken on more significance. The Chinese government's decision against providing these firms with a lifeline highlighted its commitment to crackdown on excessive leverage which is in itself a laudable decision; however, the arrival of the Omicron variant and subsequent lockdowns made what was already a difficult situation much worse.

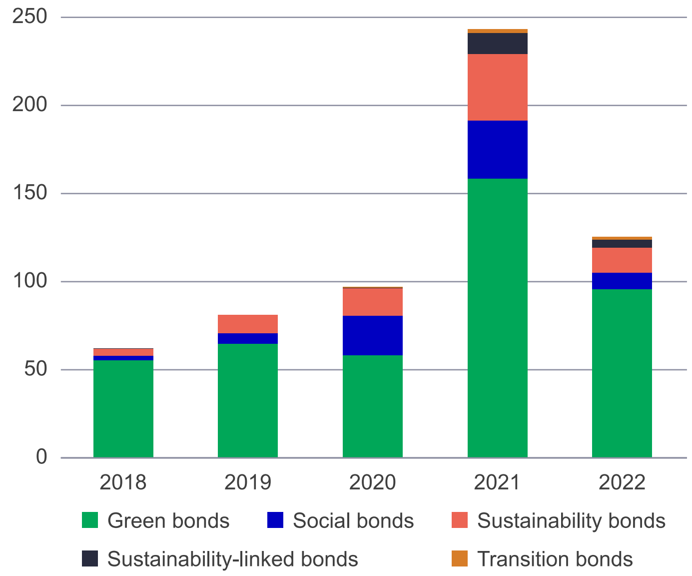
Economic activity in mainland China has been severely disrupted as a result of the lockdowns (a part of the government's dynamic zero-COVID policy). Its impact, however, continues to be keenly felt by the property sector, particularly among the highly leveraged construction firms that are reliant on presales and ample cashflow to complete their projects. As showrooms and sales offices shut, these companies lost an important source of funding. The way we see it, these developments have amplified the amount of stress within China's property sector.

Given its size (roughly 20% of GDP), the challenges confronting mainland China's property sector have dominated discussions about China and shaped investor attitude toward the country and, by extension, the region. In a similar way, given the prominent role that China plays in Asia's fixed-income market—particularly within the sustainable space—these developments have also weighed on sentiment.

Sustainable Asia bond issuance: a temporary blip

Despite the challenging macroeconomic environment, the sustainable fixed-income market in Asia has held up relatively well in the first six months of 2022 from an issuance perspective. Sustainable bond issuance in the ASEAN+3 market (ASEAN economies plus China/Hong Kong, South Korea, and Japan) during the period totaled US$125.3 billion, up from US$117.7 billion a year ago.

Chart 1: H1 2022 sustainable bond issuance in ASEAN + China, Hong Kong, South Korea, and Japan (US$ billion)



Source: Asian Development Bank, Bloomberg, September 2022.

What's perhaps less obvious from the aggregate issuance figures is that the rate of growth has actually slowed. On a quarter-over-quarter basis, sustainable bond issuance in these markets actually fell in Q2 due to reduced issuance in mainland China and Japan. The expected expansion in issuer depth and breadth hasn't materialised. Similarly, innovation in the region's sustainable bond market during the period paled in comparison to what we've witnessed in the previous two years. In our view, these developments are more a response to rising interest rates and the overarching sense of uncertainty than a reflection of dwindling demand or reduced financing needs.

In fact, our engagement with the investment community suggests that investor interest in the asset class remains healthy. A recent poll of investors and borrowers in Asia-Pacific found that nearly all respondents consider environmental, social, and governance (ESG) issues and are actively integrating these factors into their strategy.

Similarly, the need for funding to get sustainable projects off the ground hasn't diminished; rather, it's become more acute. The inaugural "Breakthrough Agenda Report 2022," a progress report that will be discussed at the upcoming 2022 United Nations Climate Change Conference (COP27) meeting in Egypt, noted that annual investment in renewable energy needs to more than double to US$1 trillion to meet global climate goals.

Separately, the Asia Investor Group on Climate Change, an influential Asia-based investor group (of which Manulife Investment Management is a member), recently estimated that the continent will need to invest up to US$37 trillion by 2050 in energy infrastructure alone to meet its decarbonisation goals. Recent extreme weather events—for instance, the devastating flood in Pakistan and droughts in parts of China—also point to the growing urgency to hasten Asia's transition to a more sustainable future.

These findings have reinforced our belief that the slowdown in issuance we've seen so far this year is likely to be temporary, and we expect momentum to pick up again over the next 6 to 12 months.

Encouragingly, the recently revised China Green Bond Principles represent a determined effort to bring the country's definitions of green bonds into closer alignment with international standards and adopt a harsher opinion of greenwashing. In our view, this is an important step in the right direction that will set the tone for future sustainable bond issues originating from China.

We remain constructive on sustainable Asia bonds

While the current macro backdrop may not seem as supportive of sustainable Asian bonds as it was two years ago, our views toward the asset class haven't changed: We're convinced that it has the potential to do well in the medium and long term. Critically, we believe existing headwinds will slowly decline over the coming months and the outlook for the asset class will begin to look a lot more sanguine.

For a start, we believe the slowdown in growth in the United States will begin to be more observable by the beginning of next year, a development that should create a more supportive environment for Asian investment-grade (IG) bonds from an interest-rate and yield perspective. At this point, it's important to note that credit spreads on Asian IG debt have held up relatively well year to date despite choppy markets, which is heartening.

That said, indiscriminate selling, particularly within the Asian high-yield segment, has created a disconnect between company fundamentals and the market's price-discovery function, creating opportunities for the astute investor—even within the much-maligned Chinese property sector. In our experience, there have certainly been instances in which sustainable debt issues of firms we consider to be industry leaders are trading at the same level as their worst competitors.

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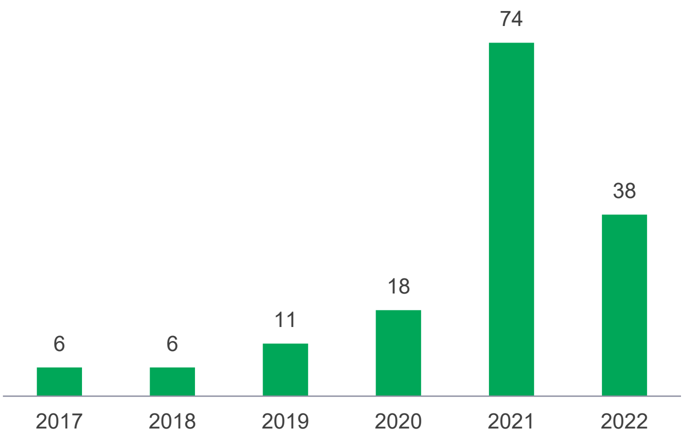
We also expect the narrative around China's economy to improve. To be clear, investors are correct to have concerns about mainland China's economic outlook—it's been an unusually challenging year for the country; however, we expect the government to continue to gradually announce additional stimulus measures to support growth, particularly after the ruling party's 20th congress in October. The event should see the appointment of a new economic management team with a renewed focus on enhancing stability and growth.

An important development we expect to see in mainland China over the coming months is the evolution of its dynamic zero-COVID policy. In September, Chinese President Xi Jinping embarked on an official tour to central Asia—his first trip abroad since 2020. The visit is seen by some as a sign that face-to-face diplomacy could soon be back on the agenda and that the government might recalibrate its zero-COVID policy and migrate to a new-normal (COVID-19) policy model in the first half of 2023. Such a development will no doubt jumpstart economic activity in the country and set the stage for a much-needed period of growth.

Overcoming obstacles to ESG investing: greenwashing, taxonomy, and transparency

The continued rise in investor appetite for ESG investing can be seen in the number of Asia-focused sustainability-themed investment products that have come to the markets in the past year. Nearly 40 ESG funds were launched in mainland China alone within the first eight months of the year. It's a very heartening outcome, particularly in light of the social restriction measures that had been in place. That said, in order for ESG investing to continue to expand in a meaningful manner, we're of the view that long-standing challenges regarding greenwashing, taxonomy, and transparency will need to be addressed.

Chart 2: Number of Chinese ESG funds launched by year



Source: Bloomberg, August 2022.

Greenwashing and taxonomy

The word greenwashing entered the vernacular in the last few years and has since cast a shadow over ESG investing. In the absence of a definitive, globally recognised set of taxonomy, investment managers and investors are likely to continue to find themselves caught between the gaps created by differing definitions in different jurisdictions and evolving expectations; the ongoing uproar in Europe relating to ESG fund ratings, for instance, is a case in point.

The European Union's (EU's) approach to regulating ESG investing is widely seen as the most advanced (if not stringent) globally. Among the many rules embedded within the EU's Sustainable Finance Disclosure Regulation (SFDR) framework is a requirement for investment firms to classify their products into one of three categories:

- **Article 6**—investment products with no ESG focus
- **Article 8**—sustainable investment isn't an objective of these products, but sustainability factors can inform an aspect of the overall investment process
- **Article 9**—investment products that identify sustainable investment as their primary objective, and are required to comply with the EU's "do no significant harm" principle

It isn't difficult to understand why investment managers are incentivized to have their products categorized in such a manner: It provides an easy way for investors to understand how green each product is and could be a useful marketing tool. What's only becoming clear in recent months, however, is the extent of detailed disclosure that investment managers need to provide to maintain their desired designation. Given the nascent stage of the industry, access to data required by EU regulators isn't always easily available. Research suggests that many investment managers in Europe will likely need to reclassify their product designations (i.e., downgrade) because they're unable to meet SFDR requirements.

It's a development that's likely to spark fresh allegations of greenwashing; however, it's equally important to acknowledge that ESG rules are constantly being tightened as regulators work to address gaps in the existing governing framework.

That said, it's equally difficult to discount the possibility that a small section of the investment industry might have been overly ambitious about their ability to commit to sustainability goals, having been enticed by growing investor enthusiasm. In our view, continued open dialogue with regulators and a firm commitment to transparency can help investors navigate the perplexing world of ESG investing.

Transparency and access to resources at the local level

We've always taken the time to emphasise the diverse makeup of Asia's economies. We believe it's important for investors to understand the heterogeneity and complexity that define the region's fixed-income markets and how they inform the unique sustainability challenges that each economy in Asia faces. This couldn't be more relevant to the investment process.

We believe investment managers offering sustainability-themed products need to be clear about their approach to sustainable investing. In practice, this means being transparent about their investment processes, the framework underpinning their investment analysis, how they procure their sustainability data set, and how they've chosen the benchmarks that will be used to measure their impact and/or performance.

The degree to which investment managers rely on third-party ESG ratings and data sets to form an investment view is crucial, particularly in Asia. In our opinion, this can have a material impact on the quality of investment decisions and, by extension, investment outcomes. The absence of a global set of definitions, standards, and processes means that local ESG expertise is needed to harmonize data sets and ratings procured from external vendors to derive meaning from a collection of disparate information. This is also an area in which the ability to conduct proprietary ESG research at the regional and local levels can have a potentially outsized impact on the investment process. It must also be noted that achieving consistency in this area within a single market is difficult enough—the challenge is amplified many times over when applied to an economically diverse region.

This is why we believe that having access to ESG resources—in addition to investment personnel—on the ground is critical to ESG investing in Asia. A dedicated team with the ability to conduct proprietary sustainability-themed research can, in our experience, have a material impact on the quality of investment decisions. This is an important factor that investors should consider when navigating the rapidly expanding world of sustainable investing in Asia.

Events and developments that could shape the outlook for sustainable Asia bonds

Looking ahead, there are a number of events and developments that we're monitoring. While we don't expect them to affect our constructive view of the asset class, how each event and trend unfolds could influence the pace at which Asia's sustainable debt market develops.

- **COP 27**—Hosts of the upcoming summit have pushed for a focus on climate financing to help emerging economies (particularly those that didn't directly contribute to global warming) mitigate the impact of climate change.

- **U.S.-China collaboration on addressing climate change**—The United States and mainland China are the world's largest emitters of greenhouse gases. While both countries are deeply committed to address climate change, Beijing's decision to suspend climate talks with Washington in August has sparked fears that any positive traction that had been gained through collaboration and open dialogue could be lost. We hope both parties will resume their collaboration soon.

- **Transitioning stranded assets**—As Asia begins to pivot away from fossil fuel and embrace cleaner sources of energy, the task of transitioning and retiring its existing fleet of coal-fired power plants becomes more urgent. Although developments remain at a nascent stage, it's clear to us that the debt market has an important role to play to facilitate this transition.

In a sense, developments in the first nine months of the year have taken the sheen off the sustainable bond market in Asia as macro factors such as geopolitics, rising interest rates, and recession fears dominated sentiment. However, as those headwinds weaken and economies on the continent continue to return to business as usual (as it has in Singapore), the seemingly stalled momentum behind the sustainability movement should resume its march forward.

Important Note

A widespread health crisis such as a global pandemic could cause substantial market volatility, exchange-trading suspensions and closures, and affect portfolio performance. For example, the novel coronavirus disease (COVID-19) has resulted in significant disruptions to global business activity. The impact of a health crisis and other epidemics and pandemics that may arise in the future, could affect the global economy in ways that cannot necessarily be foreseen at the present time. A health crisis may exacerbate other pre-existing political, social and economic risks. Any such impact could adversely affect the portfolio's performance, resulting in losses to your investment

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