MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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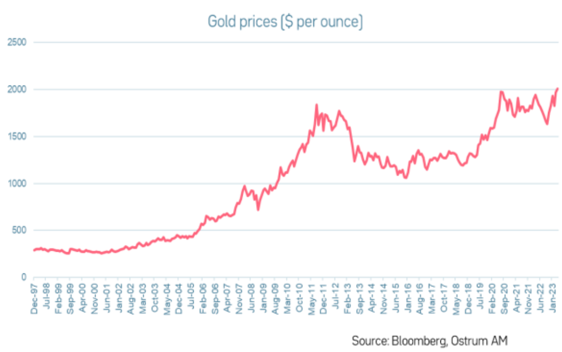
Topic of the week: Greening of the ECB's balance sheet

- **As part of its mandate, the ECB integrates climatic conditions into the conduct of its monetary policy;**
- **Since October, it has redirected its purchases of corporate bonds towards issuers with better climate performance;**
- **To be in line with the objectives of the Paris agreement, the ECB must accelerate the pace of greening its portfolio while its room for maneuver is reduced with the QT;**
- **It will have to expand and strengthen its action to other assets such as ABS, covered bonds, the collateral system and sovereign bonds;**
- **This will benefit less polluting issuers and green bonds, particularly those of supranationals and agencies.**

Market review: Desire vs. reality

- **The equilibrium of the financial markets requires rate cuts;**
- **Bunds ignore pickup in service activity, high inflation;**
- **US job market cools at the margin;**
- **Swap spreads still elevated despite lower volatility.**

Chart of the week



Gold prices have passed the $2,000 threshold which reflects a variety of risks.

Bond market volatility has fostered flows into alternative safe havens. Risk aversion is always a support for gold. Inflation is still elevated given sticky core measures, which historically fans demand for gold.

A weaker dollar also played a role in the run-up in gold prices.

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Figure of the week

-20.5

Source : Ostrum AM

In march, the world food price index have fallen by 20.5% year on year according to FAO but this was not seen in the food price index of the Euro area.

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Topic of the week

Greening of the ECB's balance sheet

Under the leadership of Christine Lagarde, the ECB is now integrating climate considerations into its monetary policy. Its mandate remains price stability and, to achieve this, the Central Bank is adopting measures to reduce the carbon footprint of its balance sheet. Since October, the ECB has been directing its purchases of corporate bonds towards issuers with better climate performance. While significant progress is already visible, there is still a long way to go to align the ECB's balance sheet with the objectives of the Paris Agreement. The ECB will have to strengthen and expand its action to other assets, in particular sovereign bonds.

Climate taken into account by the ECB

Governments are the key players in adopting policies aimed at combating global warming and Central Banks are responsible for price stability. As part of its mandate, the ECB now integrates the issue of climate change into the conduct of its monetary policy, given that it has an impact on growth, employment, inflation and financial stability.

The ECB drew up a first action plan in July 2021 as part of the review of the monetary policy strategy. It aims to reduce the Eurosystem's exposure to financial climate risk, to encourage companies and States to be more transparent in this area and to become less polluting.

Greening of the corporate bond portfolio held by the ECB

Since October 2022, the ECB has got to the heart of the matter by adopting measures aimed at gradually reducing the carbon emissions of securities held by the Eurosystem on a trajectory aligned with the objectives of the Paris Agreement. To achieve this, it directs its purchases of corporate bonds towards issuers with better climate performance.

For this purpose, a climate score is calculated for each emitter. It takes into account 3 components:

- the issuer's past greenhouse gas (GHG) emissions;
- the objectives set by the latter to reduce them in the future;
- the quality of the information published on GHG emissions and, in particular, its completeness and its verification by third parties.

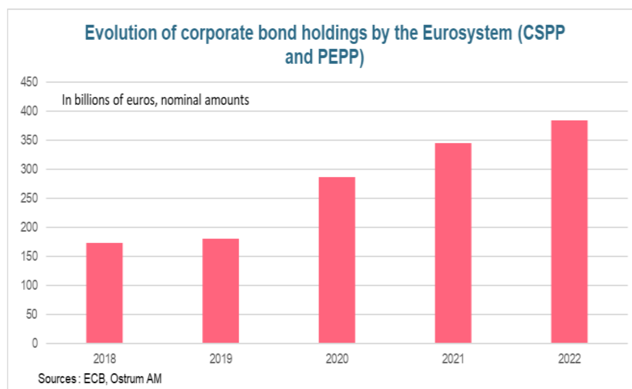
These measures aim to increase the relative weight of corporate bonds with a better climate score in the ECB's balance sheet and to reduce the relative weight of those with the worst. The ECB will thus buy more bonds issued by companies with the lowest GHG emissions, the most ambitious objectives in the fight against global warming and publishing better quality climate-related information. The climate score ranges from 0 to 5, with 5 being the best performance. Almost a third of issuers have a score of 4, almost 25% a score of 3 and less than 20% a score of 5, according to a recent report published by the ECB.

These measures also concern the primary market and the lowest-rated corporate bonds may be subject to a limitation in their maturity, in order to reduce the financial risk linked to the climate of the Eurosystem's portfolio. Green bonds have preferential treatment in the primary market, under certain conditions.

Significant progress made

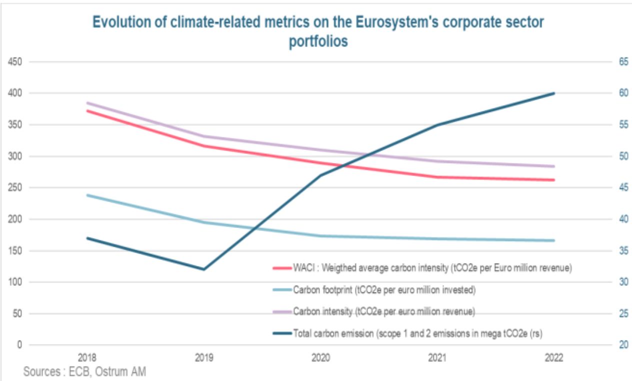
In order to assess the results of the measures taken to decarbonise its balance sheet, the ECB has just published its first report on the issue. An update will be published every year.

The results are encouraging. The ECB has sharply increased its purchases of private and public assets between 2018 and 2022, in order to make its monetary policy very accommodating.



This translated into a 123% increase in corporate bond purchases between 2018 and 2022 under the Corporate Sector Securities Purchase Program (CSPP) and, from March 2020, under the Pandemic Emergency Purchase Program (PEPP). The ECB thus held, at the end of 2022, 385 billion euros in corporate bonds.

The increase in GHG emissions linked to this portfolio was much less significant: +63% over the period, a twice less fast rate (dark blue curve on the graph below). This signals a lower carbon intensity of the portfolio relative to its size.



Evolution of climate-related metrics on the Eurosystem's corporate sector portfolios

Sources : ECB, Ostrum AM

To better understand the progress achieved independently of the size of the balance sheet, the indicators should be standardized.

The carbon intensity of the portfolio is thus measured in tonnes of CO_2 equivalent per million euros of turnover. This fell by 26% over the period, due to the progress made by each issuer to reduce its carbon footprint.

The report further shows that recent ECB measures are working. From October, it redirected reinvestments from maturities to issuers with a higher climate score. Purchases made in the 4th quarter of 2022 are more than 65% less carbon intensive than those made in the first three quarters of the year.

The ECB is also reducing the carbon intensity of the bonds and shares held as part of the pension fund for its employees and its equity portfolio, which are not falling under monetary policy.

The ECB will broaden and strengthen its measures

These encouraging results are only the beginning and much remains to be done to get in line with the objectives of the Paris agreement. This started in March when the ECB began to reduce the size of its balance, in order to make its monetary policy more restrictive to combat high inflation. Between March and June, reinvestments under the APP will be reduced by an average of €15 billion per month; this rhythm can be reviewed later.

This has already led the ECB to announce, on February 2, a strengthening of the reorientation of its purchases of corporate bonds towards issuers with the best climate performance, including on the primary market.

ABS and covered bonds

The reorientation of Eurosystem purchases of corporate bonds will also extend to asset-backed bonds and covered bonds, depending on progress made in terms of the quality and availability of climate data.

Guarantee system by the end of 2024

In July 2022, the ECB announced that the Eurosystem will limit, during its refinancing operations, the assets provided as collateral from companies with a high carbon footprint. A discount will be applied. Initially, negotiable debt instruments of non-financial corporations will be covered, then this may be extended to other assets depending on the improvement in the quality and availability of climate data.

For corporate bonds provided as collateral, the ECB takes climate risks into account when revising the haircuts to be applied.

Climate Reporting Requirement for Warranties

The Eurosystem will only accept as collateral securities that comply with the Corporate Sustainability Reporting Directive (CSRD). As the directive has been delayed, this requirement will only come into effect from 2026. As asset-backed securities and covered bonds fall outside the scope of this directive, the ECB encourages them to improve the quality of publication of climate-related information.

For Isabel Schnabel, additional efforts are needed in 3 areas

During an intervention in January 2023, Isabel Schnabel was very clear. For the ECB’s action to be in line with the Paris agreement, additional measures must be taken. And this all the more so as the ECB is reducing the size of its balance sheet, thus limiting its room for maneuver.

Greening the stock of corporate bond holdings

The end of purchases of new corporate bonds, the reduction in reinvestments of maturities and then, eventually, the cessation of these reinvestments will significantly slow the pace of decarbonisation of the ECB’s balance sheet. This will only depend on the efforts made by the most polluting companies to become greener. Isabelle Schnabel thus proposes moving from a logic of flows (reinvestments) to a logic of stocks (actively redirecting the assets held towards the greenest companies).

This is not clearly spelled out, but such a reversal would involve active sales of corporate bonds with the worst climate scores to replace them with more virtuous companies. It nevertheless warns against completely disengaging from companies with the lowest ratings, at least initially, since they are the most likely to contribute to the energy transition, but rather encouraging them to take the necessary measures. This stock approach would also apply to ABS and covered bonds.

Greening the sovereign bond portfolio

It accounts for almost half of the balance sheet. The reorientation of purchases towards countries with a lower carbon footprint faces three constraints:

- Purchases must comply with the ECB's capital key (each country's share in the ECB's capital);
- There is not yet a reliable framework for judging whether a sovereign bond portfolio is in line with the objectives of the Paris agreement;
- The amount of government green bonds is still limited.

In this context, Isabel Schnabel considers two options. The first is to increase bond purchases of agencies and supranationals, with a larger share of green bonds. The second is to increase the share of government green bonds on the balance sheet, as they issue them.

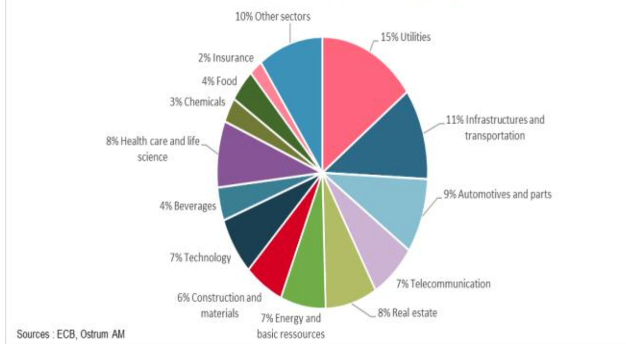
Greening lending operations

For Isabel Schnabel, we must go further than what has already been announced in terms of the framework of guarantees since this will initially only concern a part of the securities provided as collateral., She is talking about initiating targeted green lending operations when monetary policy becomes accommodative again.

Consequences

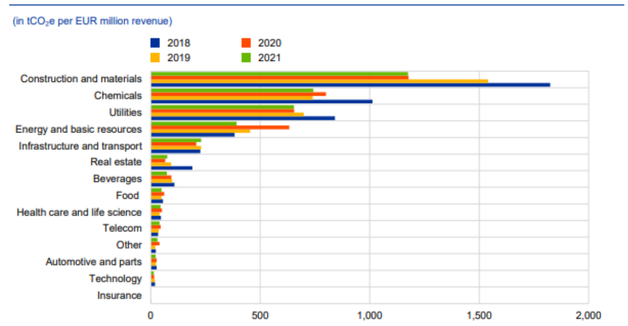
The portfolio of corporate bonds held within the framework of the APP (the CSPP) is mainly composed of companies belonging to the sectors of "utilities" (15%), infrastructures and transport (11%), automotive (9%) and energy (7%). These are among the most carbon-emitting sectors.

Economic sector repartition of CSPP holdings - Q3 2022



In its assessment report, the ECB shows that the sectors with the highest average carbon intensity are those of construction and materials, chemicals, utilities, followed by infrastructure and transport.

Evolution of average sectoral carbon intensities from 2018 to 2021



Sources: ISS and ECB calculations.

The CSPP, therefore, has a bias towards the most polluting sectors and towards companies with a larger carbon footprint. This is explained by the fact that the ECB has set itself the principle of neutrality, during these market interventions, in order to limit distortions. In this context, it made its purchases of corporate bonds according to the availability of securities on the market. Since the companies with the highest GHG emissions are those with the highest investment needs, the ECB bought more bonds from issuers with the worst climate performance.

The greening of the ECB's balance sheet will have the effect of favoring issuers with the best climate performance relative to those with less good ones. In this context, the share of carbon-intensive sectors, such as utilities, transport and energy, should decrease in favor of an increase in the share of companies belonging to sectors with lower emissions, such as services excluding transport and storage.

These measures will also have the effect of encouraging companies to adopt ambitious and realistic GHG reduction targets and to publish quality information. Without this, the ECB will assign them a poor climate score, which will reduce the relative holding of these securities and result in relatively higher funding costs.

It is important for the ECB to take these three sub-scores into account when assessing the climate risk of companies, so as not to penalize the companies that emit the most carbon and which therefore have greater investment needs to reduce their GES.

Finally, when the data is of good quality and consistent between countries, the ECB will include sovereign bonds in the greening of its balance sheet. As we have seen, this should benefit green sovereign bonds and, in particular, those of supranationals and agencies.

Conclusion

The ECB has taken ambitious steps within its mandate to decarbonize its portfolio of corporate bonds, incentivize them to achieve ambitious and achievable climate goals and improve the quality of disclosure. This is an important first step. To be in line with the objectives of the Paris Agreement, the ECB will have to extend these measures to the guarantee scheme, to ABS and covered bonds as well as to sovereign bonds. This will favor less carbon-intensive issuers, as well as green bonds, including those from supranationals and agencies.

Aline Goupil-Raguénès

Market review

Desire vs. reality

The burden of proof of an impending recession is on the bond market.

The tug of war between the Fed and the markets has been going on since banking turmoil erupted in March. The Central Bank is advocating for monetary status quo which the markets do not buy into due to the risk of credit rationing and recession. Market action infers that rate cuts would work as an antidote to the equities slump. Indeed, major US and European indexes remain near their 2023 highs. The current financial market equilibrium therefore hinges on action that central bankers refute. The use of emergency liquidity tools is easing somewhat, which may be a sign of an improvement in the US banking sphere. US rates (3.40% at 10-year maturities) remain close to the 2023 lows due to the first consistent signals of a slowdown in the labor market. This leads Bund yields (below 2.20%) despite stronger fundamentals of growth and inflation in the euro area. Interest rate volatility has little effect on credit spreads. The first month of quantitative tightening by the ECB even went unnoticed. However, the pick-up in primary market issuance to high yield coincides with a further widening of around 20 bps before the Easter weekend, which limits trading volumes. The foreign exchange market is kind of quiet compared to the volatility seen in rate markets. We note, however, the surge of the New Zealand dollar driven by the surprise rate hike of 50 bps by the RBNZ. Sterling is a free rider posting the best performance of the G10 in 2023.

Available data point to annualized growth close to 2% in the first quarter. The strength of private consumption, sustained by employment and the rise in social transfers in January, is leading to a deterioration in the trade balance. Housing investment is improving. On the other hand, business capital expenditure is falling in parallel with a reduction in the demand for labor (lower jobs openings in February). A clear imbalance persists in the labor market in the United States, but excess demand is less acute. However, job creations amount to 236k, which is still more than enough to absorb the increase in the labor population (unemployment at its lowest at 3.5%). Non-farm payrolls are up by fully 1 million in the first quarter. The average hourly wage is slowing (4.3% YoY) in line with the Fed's objective to reduce inflationary pressures. In the euro area, economic surveys point to a strong recovery in the spring, driven by services. The decline in inflation to 6.9% in March was however tainted by the acceleration in the prices of services (5%) and evidence of a price-wage loop. In China, surveys in services also describe an economic upturn.

The equilibrium of the financial markets is inherently unstable as it assumes that the Fed will cut rates by some 100 bps this year. The 7% rise in the S&P 500 in 2023 seems inconsistent with recession fears, unless we consider that a rate cut would erase the effect of negative earnings revisions on valuations. The other hypothesis is that atypical margin behavior in this cycle will protect valuations from a relapse in activity. It is also extremely rare to observe a recession when margins are at their highest. More than complacency, low equity volatility may reflect this unusual profit cycle. The earnings season that will soon begin in the United States will serve as an acid test for equity valuations.

As for the fixed income market, the publications suggesting a drop in labor demand (employment components of the manufacturing ISM, JOLTS, Challenger survey) caused three successive downward shifts in US 10-year yields. The announcement of a output cut of 1 mbpd in OPEC quotas only generated temporary tension that was quickly erased by weaker employment data. The T-note yield thus returns to its lowest level of 2023 near 3.30% on the eve of Good Friday (and the monthly employment statistics). Friday's negligible volumes make it difficult to interpret the knee-jerk rebound in long rates following the NFP release. In the euro area, Bund yields are further dragged down by T-notes whose spread (112 bps) has tightened significantly since last May's peaks about 200 bps. The Bund yield about 2.30% ignores the reality of inflation as well as signals of an economic upturn. Sovereign spreads are remarkably stable. The banking turmoil in March and the decrease in ECB APP reinvestments have had no impact on spreads. Fiscal deficits are deteriorating markedly in France and, even more so, in Italy, where the government balance is in deficit by €53 billion in 1Q 2023. At this stage, details are lacking to identify the reasons for the slippage, but Italian government measures to support for households and businesses and the revaluation of social transfers in line with inflation probably weigh more than expected on spending. The Italian BTP spreads keep trading around 185 bps against the German Bund. The swap spread has stabilized above 70 bps. The absence of banking stress in Europe, apart from the reflex targeting of a few names like Deutsche Bank in the panic, should contribute to a tightening of swap spreads. The primary credit market has regained some activity since the lull caused by recent high interest rate volatility. End-of-quarter credit fund outflows seem to be fading as reallocations towards fixed income products resume. IG spreads in the euro area have stabilized around 170 bps. High yield offers a significant risk premium at around 500 bps.

In the foreign exchange market, the recent decline in the dollar is echoed in the rise of gold above $2000 an ounce and the euro which is approaching $1.09. Sterling is appreciating despite inconsistent signals from MPC members.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	11-Apr-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.65%	+5	-45	-12
EUR Bunds 10y	2.24%	-1	-27	-33
EUR Bunds 2s10s	-41.4bp	-6	+18	-21
USD Treasuries 2y	3.97%	+15	-61	-45
USD Treasuries 10y	3.39%	+5	-31	-49
USD Treasuries 2s10s	-59.4bp	-10	+30	-4
GBP Gilt 10y	3.5%	+6	-14	-17
JPY JGB 10y	0.46%	+4	-6	-2
€ Sovereign Spreads (10y)	**11-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	51.65bp	+1	+2	-3
Italy	185.62bp	-1	+5	-28
Spain	105.29bp	+2	+4	-3
Inflation Break-evens (10y)	**11-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.45%	-1	-5	-10
USD 10y Inflation Swap	2.53%	+3	+6	+1
GBP 10y Inflation Swap	3.82%	-9	+0	-9
EUR Credit Indices	**11-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	169bp	-3	+24	+2
EUR Agencies OAS	76bp	+1	+11	-3
EUR Securitized - Covered OAS	89bp	+1	+17	+5
EUR Pan-European High Yield OAS	516bp	+20	+101	+4
EUR/USD CDS Indices 5y	**11-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	86bp	-1	-6	-5
iTraxx Crossover	449bp	-3	-17	-25
CDX IG	78bp	-1	-11	-4
CDX High Yield	481bp	-4	-43	-3
Emerging Markets	**11-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	487bp	+7	+13	+35
Currencies	**11-Apr-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.091	-0.393	1.668	1.9
GBP/USD	$1.244	-0.496	2.101	2.9
USD/JPY	JPY 133	-1.037	0.090	-1.5
Commodity Futures	**11-Apr-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$84.7	-$0.3	$2.5	-0.11
Gold	$2 004.9	-$15.5	$91.2	9.92
Equity Market Indices	**11-Apr-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 109	0.00	6.41	7.0
EuroStoxx 50	4 333	0.42	1.27	14.2
CAC 40	7 397	1.03	0.79	14.3
Nikkei 225	27 923	-1.29	-0.78	7.0
Shanghai Composite	3 314	0.52	2.58	7.3
VIX - Implied Volatility Index	19.08	2.86	-23.06	-12.0

Source: Bloomberg, Ostrum AM

Additional notes

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