Covid bonds – an emergency aid funding method worth addressing selectively

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The health and economic crisis that has swept the world is of unknown magnitude, and it soon became clear that Covid bonds offer a sustainable solution to finance the post-coronavirus world and address the funding needs required to stem the effects of the pandemic. Almost $100bn in Covid bonds have already been issued on the market since the start of the health crisis, and Ostrum AM expects robust issue volumes over the months ahead. On the back of its overlapping expertise in bond fund management and socially responsible investment (SRI), Ostrum AM has taken a closer look at this market to assess its features, opportunities and limitations of this new product.

With the Covid-19 crisis affecting most of the planet, the UN called on all investors worldwide to join forces to organize the funding needed to curb the severe economic and health problems triggered by the pandemic. A new funding instrument has thus emerged: Covid bonds, built on the same principles as green bonds. These impact investments are aimed at supporting two areas i.e. on the one hand direct investment in solutions to fight against the virus, such as research into treatments, vaccinations, and production of ventilators or masks, and on the other hand emergency support to reduce social impacts, including financing solidarity mechanisms and job protection measures.

For the moment, Covid bonds are primarily issued by sovereigns, supranationals and agencies (SSA), such as the World Bank, which has embarked on a $160bn program to combat the effects of Covid-19, with a significant portion of this naturally allocated to Covid bonds. The European Investment Bank (EIB), the African Development Bank and the Nordic Investment Bank are also involved, while governments are among the issuers too. As at May 4, 2020, 38 Covid bond issues had already been conducted, with only four of these not launched by SSA i.e. two by pharma companies (Pfizer and Getinge) and the other two by financials.

Is a new standard emerging?

These bonds have enjoyed stellar growth, and at the start of May, amounts issued came to $50bn – 40% of which was euro-denominated – while the figure has since doubled to $100bn. This trend is far from over as the environment is particularly buoyant. Several investors are keen to invest in this type of financial product given the urgent need to kick-start the world economy, particularly as these bonds fit neatly with their impact investment strategies. This explains why the first issues enjoyed strong success, with order books oversubscribed between four and seven times.

These bonds have got off to an impressive start, but it now remains to be seen whether we are truly in the throes of the creation of a new market. Initial issues admittedly went very well as Covid bonds are broadly speaking very similar to social bonds, which enjoy a well-established market. However, a number of pitfalls must be avoided if Covid bonds are to become a new standard. Several issuers could in theory request support to mitigate the social impact, or even countries for long-term stimulus plans: it may be difficult to demonstrate their social impact. A report from Natixis' Green Hub recently revealed that most investors primarily want to finance emergency aid to combat the effects of the Covid-19 epidemic, rather than long-term stimulus plans. A second obstacle is issuer quality, as they are not all SRI-driven. ICMA (International Capital Market Association) does not wish to hinder emergency financing and has been fairly flexible on the use of these new bonds, as long as they use the pre-existing social bonds framework, and are clear on the use of proceeds, that should be specifically devoted to alleviating the effects of Covid-19, at least for a great part. However, there are no checks on this, although for the moment, the risk of "Covid bond washing" has not really materialized, as issuers are primarily supranational agencies that are driven by social impact goals and generally have solid social bond issue processes. However, in the future, this could change, and corporate issuers that do not have a pre-existing social bond framework or, worse, that are subject to severe controversy, may issue on the markets, thereby compromising the SRI quality of investments on this theme.

Conviction-driven market seeks maturity

Beyond impact and solidarity aspects, it is worth remembering that Covid bonds are ultimately a type of bond and their assessment will depend on the yield they carry and the related credit risk, which is obviously connected to the bond issuer's quality. Issuers' credit quality – or at least for those that have issued Covid bonds (mostly AA/AAA rated) – broadly offers an additional reason for investing in these bonds, but the performance and particularly the absolute return on offer may be problematic in the current environment with very low bond yields.

One investor category that could be particularly interested in this type of bond involves those focusing on their portfolios' social purpose – first and foremost insurers. However, these investors also have certain requirements on absolute returns, and looking at the currently available products with this yield-based goal in mind, pickings are slim.

Just like for other bond assets, we think that financial interest in Covid bonds will primarily hinge on the investment format: investment that is seen to be optimal for a mutual fund may not be ideal in an insurance bond mandate that is built position by position and focuses on total return as opposed to relative performance, while the opposite is also true. The limitations involved in purchasing at very low or even negative yields may not be a hindrance to investment for a mutual fund format, but investment mandates with a position-by-position approach would logically be less inclined to invest in these bonds in the current context. Absolute return is still very low, with for example Covid bond issues from the IBRD – both rated AAA – and the EIB 8-year, respectively offering yields of -0.11% and -0.35%. However, issues such as the 6-year from Unedic, and the bond from *Agence Française de Développement*, both rated AA, with yields of 0.11% and 0.30% respectively (additionally with pickup to the OAT), are examples of issues that can meet success with insurers.

It is worth noting that despite interest already witnessed, and expected, from investors, Covid bonds issued so far have not required an additional premium compared with similar issues without the Covid bond label, as is currently the case for green bonds. We have actually seen the opposite situation, with subscribers on the primary market for some Covid bond issues even benefiting from the customary issue premium. The BBVA 5-year senior preferred issue is a good example, as it was valued at 112bps over mid-swap, or a premium of around 10bps to its curve on the secondary market, despite strong demand, with the order book coming out at €4.8bn for a €1bn issue volume. In our view, this is understandable as it is a new market that is seeking to attract interest.
While the trend is promising, the road is still long for this asset category and we think it is still too early to describe the Covid bond market as fully-fledged. In our view, there are at least four challenges to tackle:

Challenge of market depth: as we outline above, the market seems to be growing fast in terms of volumes, with outstanding amounts now exceeding €100bn in the space of just three months. However, this market remains primarily focused on a single issuer category – supranationals and agencies – which is understandable given these issuers' objectives. Meanwhile, the private sector's interest in this market is restrained for now, although we have recently seen the beginnings of a trend that seems to be developing. In addition to the two corporates that were the first to issue these bonds (Pfizer and Getinge), two banks also played an active role in this trend i.e. Bank of America, which issued a 4-year $1bn bond on May 14 (which came out at T-note +130 bps), followed by Spanish bank BBVA, which issued a 5-year bond with 0.85% yield on May 27 (112bps over mid-swap) for a total of €1bn. We can also expect other banks to follow their lead, which is particularly crucial for the development of this market given the hefty weighting of banks' issues on the credit market. Of course the arrival of corporates – excluding banks – on this market will provide additional motivation to extend the investor base, particularly those that are forced or prefer to buy at strictly positive yields, such as insurers as part of their so-called line-by-line portfolios. The private sector's involvement in Covid bond issues would no doubt provide assurance of development for this market.

Challenge of timing: corporates' reticent presence on Covid bonds is a hindrance to the market's appeal for the moment. In the current environment and in light of the high price of sovereign, supranational and agency debt issues (very low sovereign rates and swaps), the credit asset class still remains competitive, despite the rally on the market since its peak in late March/early April. Since the period of widening spreads from mid-March, the bond market has essentially been a credit market, with credit spreads at continued attractive levels. In this respect, potential corporate Covid bond issues should enjoy considerable success.
Challenge of liquidity: a market's maturity is also assessed via the liquidity it provides for participants – both buyers and sellers. In light of the profile of investors that should be interested in this market – for example insurers – we would not be surprised if these securities then did not trade on the secondary market. These investments are intended to be held in their portfolios, with the aim of holding to maturity, and it is also worth remembering that Covid purchases are primarily motivated by investors' engagement goals. All else being equal, like green bonds for example, we expect Covid bonds to be less liquid that bonds without these labels, pending development of this market. However, compared to a standard illiquid bond such as private placements, which often offer a yield premium, weaker liquidity on Covid bonds as a result of their rareness would ironically promote increased prices over time.

Challenge of maturity: a bond market needs to provide liquidity across all segments of the curve if it is to be attractive. Buy and hold, and buy and maintain type investors, who seek steady income over time, would be more interested in issues on longer maturities, from 10 years and over, yet most of the currently available market is focused on short and medium-term maturities. The average maturity of Covid bond issues denominated in both euros and dollars currently stands at around 5-6 years at this stage: 53% have 5-year maturity. This reduces interest from investors who are seeking carry, particularly as the short-medium part of the reference curve (swap) is fairly pricey, especially in Europe with the ECB's ultra-accommodative approach, with historically low and mostly negative absolute rates.

The depth of the available market is admittedly limited for the moment for the reasons outlined above, but the market's development can also be faced with a more broad-based SRI issue, as at this stage there are not enough high-quality impact assets or projects to finance.

In conclusion, Covid bonds are an emergency mechanism to be used on a selective basis. This is a conviction-driven market that certainly provides an attractive vehicle for SRI investment, but in terms of performance, it is still a developing market, and we will probably see a change over the months ahead on projects that carry attractive yield.

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