Changing tracks on monetary policy

OVERVIEW
Monetary easing expected as growth slows

US
Economic and profits recessions

UK
Recoupling with the US?

SPECIAL FOCUS
ESG investing
Evidence of softening global economic growth has led to a marked change in market expectations for the trend in interest rates. Bond yields have fallen and equity markets have strengthened. Trade tensions remain a key uncertainty.

Softer forecasts for global growth
From late 2018 onwards, general forecasts for global economic growth have been marked down. The change in the IMF’s forecasts, for example, are shown in Figure 1. The downward revisions have been seen across all the major regions – both developed and emerging economies – and have been most marked in the eurozone. This has been led by a downgrading of expectations for the German economy and a heightened concern about Italy.

In Germany, the adverse impact of trade tensions, a slowing of world trade growth and a weaker trend in China (particularly in car sales) have had a direct effect on exports. There are, furthermore, longer-term structural issues for the German economy and industry: in the energy sector as it transitions from a reliance on fossil fuels to renewables; and in the auto sector which has, so far, been slow to embrace the transition to electric and autonomous vehicles.

In Italy, there is now expected to be no growth in 2019 (in late 2018 it was thought a 1% expansion of GDP would be possible). Italian bond yields have remained at elevated levels, increasing financing costs; and any fiscal expansion remains constrained in the uneasy equilibrium between the Italian government and the European Commission. The sustainability of Italy’s eurozone membership is often raised and has not been calmed by Italian proposals for launching ‘mini BOTS’. BOTS (Italian government bonds) launched in small denominations could be a way for the government to finance its deficit: they could be used to pay government suppliers or employees, for example; but if they were used, as seems to be intended, as an alternative means of payment this would almost certainly set Italy on a collision course with the ECB as the euro is the only legal currency of the eurozone.

Change in interest rate expectations
Softer growth expectations have led to a sharp change in expectations for US policy interest rates. The financial futures markets are now pricing in the expectation that there will be three or four 25 basis point cuts in the Fed Funds rate by the end of 2020 (see Figure 2). Until early in 2019, expectations were for further increases. The basis for this change in expectations is that the Fed will make insurance cuts in interest rates to preserve the momentum of economic growth, as it did in the late 1990s. Between July 1995 and February 1996 (in response to a slowing of domestic US growth); and again between September and December 1998 (following the Asian financial crisis, Russia’s default and the collapse of LTCM, a hedge fund) the Fed cut the Fed Funds rate by 75 basis points.

Although, as yet, there has not been a sharp weakening of coincident indicators of economic activity (of which the manufacturing sector ISM index is one of the most closely watched, see Figure 3) any deterioration would cement expectations for such a Fed policy response.
Changing expectations of the path of short-term interest rates are reflected in the yield on two-year US Treasury bonds. Between October 2018 and 1 July 2019 this fell by 100 basis points, from 2.8% to 1.8%. The gap with German two-year yields (broadly unchanged over the same period at -0.6%) fell by a similar amount. In the past, that yield differential has been closely correlated with the exchange rate of the US dollar against the euro (see Figure 4). That suggests that the euro may now strengthen against the US dollar. That would be welcomed by President Trump, who has criticised the weakness of the euro: it makes Europe an attractive destination for US tourists; and gives European manufacturers an ‘unfair’ advantage over the US, in President Trump’s view.

Recently, however, the president of the ECB, Mario Draghi, has suggested that eurozone monetary policy may be also be eased again. Indeed, relative expectations for US and eurozone monetary policy have become an important determinant of short-term fluctuations in the US$/euro exchange rate.

Trade tensions and currencies
Longer-term considerations of the determinants of the euro/US dollar exchange rate do suggest that there is some basis for President Trump’s claim that the euro is too weak. Since its launch in 1999, one measure of the Purchasing Power Parity (PPP) rate for the euro against the US dollar has steadily appreciated, reflecting lower consumer price increases in the eurozone than the US (see Figure 5). That measure suggests the PPP rate is around US$1.38 to €1. Broader considerations of the fair value of the exchange rate, which consider current and capital account balances and relative trends in domestic economic activity suggest that euro should be weaker than that – around US$1.20 to €1. But on both measures the euro is below what may be considered fair value. However, the fundamental reason for the eurozone’s large current account surplus (see Figure 6) lies not in the level of the exchange rate but in the fact that the region is still one where domestic savings exceed investment, the opposite of the US’s position.
Asset market performance

World equity markets produced positive returns of 17.6% in US dollar terms in the first half of 2019 (see Figure 8) on the basis of the MSCI World Index. This came after a weak final quarter of 2018. Global bond market returns were also positive, by 5.6% on the basis of the Bloomberg Barclays Global Aggregate Index. This reflected lower government bond yields, pushing up government bond prices, and improved conditions in corporate, high yield and emerging markets. The US dollar was broadly unchanged on the basis of its broad trade-weighted index. This was due to an appreciation against the euro and the Australian dollar offset by a weakening against the yen, Swiss franc and Canadian dollar. Emerging market bonds produced better returns than developed market bonds; although the opposite was the case in equity markets.

Equity markets

The US equity market (on the basis of the total returns from the MSCI US index, shown in Figure 10) produced total returns of 18.8% in the first half of the year. That was the highest first-half return since 1995 (a time when weakening US activity led to expectations of a cut in US interest rates, which materialised later in the year, driving the equity market even higher). Almost all developed and emerging equity markets produced positive returns in both local currency and US dollar terms. The UK equity market produced total returns of 13% in both sterling and US dollar terms. Sterling’s broadly unchanged exchange rate against the US dollar, despite continued concerns about Brexit, reflected some interest in UK assets from overseas at what is generally seen as a weak level for sterling.

Bond markets

Ten-year maturity US government bonds produced total returns of 7.6% in the first half of the year, as capital gains (resulting from a decline in yields) added to coupon income. Local currency returns from the eurozone market were a little lower, but at 6.2% were still strong. This reflected the renewed move back into negative territory for German 10-year bond yields, accompanied by the first-ever move to negative yields in France. Returns from the Italian bond market were also strong, reflecting the relatively stable (but still high) yield advantage of Italian over German and French bonds, as tensions between the Italian government and the European Commission eased (albeit maybe temporarily) a little.

A fall in Australian 10-year bond yields reflected a changed view on prospects for policy interest rates and translated into total returns in excess of 10%, which were only modestly offset in US dollar terms by currency depreciation. Japanese 10-year bond yields moved into negative territory, producing returns of 1.8% in yen terms, boosted in US dollar terms by yen strengthening.

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1 The Bloomberg Barclays Global Aggregate Bond Index is a benchmark of government and investment grade corporate debt from developed and emerging markets issuers in 24 countries.
UNITED STATES

The US economic expansion continues but concerns about a downturn are widely expressed. Corporate profits growth has weakened after a strong 2018, but productivity improvements are starting to come through.

A ten-year long expansion
By July the current US economic expansion looks set to match the record ten-year long one seen from 1991 to 2001. If it continues after that, President Trump will be able to claim that he has presided over the longest US expansion in history. Even so, there are concerns that it may be coming to an end.

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Close to a ‘profits recession’. Defined as a period of declining profits (see Figure 12) such recessions have occurred more frequently than economic recessions since the 1990s. Partly because profits growth was so strong in 2018 (over 20%) growth this year is set to be more modest, albeit still positive.

Productivity growth and inflation
Looking further ahead, one encouraging recent development has been a revival of productivity growth (see Figure 13).

First, consumer spending, the mainstay of US growth, has slowed recently (see Figure 11). With a strong labour market and lower interest rates, however, this may well prove temporary. Second, the yield curve slope has, on the basis of the most widely used measure (the US Treasury 10-year yield minus the three-month rate), become modestly inverted. Such an inversion has preceded all of the post-war US recessions. However, an inversion sometimes gives a false signal; and other measures of yield curve slope (such as the gap between 30-year and 10-year yields) have actually become steeper, not inverted, recently. Third, corporate profits growth has slowed and, according to some, we may be close to a ‘profits recession’. Defined as a period of declining profits (see Figure 12) such recessions have occurred more frequently than economic recessions since the 1990s. Partly because profits growth was so strong in 2018 (over 20%) growth this year is set to be more modest, albeit still positive.

This could well be a cyclical phenomenon: the combination of a strong economy and a tight labour market. A more benign interpretation, however, is that the benefits of new technology are finally being seen. Ever since Robert Solow, the founder of modern economic growth theory, quipped that “You can see the computer age everywhere but in the productivity statistics” weak productivity growth has been a puzzle. As productivity growth now picks up, it acts to reduce labour costs per unit of output, further restraining inflation which, in any case, is below the Fed’s target (see Figure 14).
The Bank of England has recently laid out the case for higher UK interest rates. Based on perceived excess demand and future inflationary pressures, it potentially conflicts with the need to support growth after Brexit.

**UK and US interest rates**
Historically, there has been a close relationship between UK and US policy interest rates. Immediately before the Brexit referendum on 23 June 2016, policy interest rates in both economies were the same: 0.5% (see Figure 15). From the Bank of England being granted operational independence to set interest rates in May 1997 until the referendum, interest rates in the UK had, on average, actually been 1% higher than those in the US. This was even though the average consumer price inflation rate in the two economies was similar (2.2% in the US, 2.0% in the UK).

**Preventative easing**
After the Brexit vote to leave the EU, the Bank of England engineered a cut in interest rates and a renewed programme of quantitative easing to support the economy, fearing a substantial loss of output and a large increase in unemployment. The reality is that the economy has, in many key respects, performed well. Most notably, the UK unemployment rate has closely followed the post-financial crisis downward trajectory seen in the US (see Figure 17). Recently, the Bank of England has stated that “As excess demand emerges, domestic inflationary pressures are expected to firm, such that CPI inflation picks up to above the 2% target in two years’ time and is still rising at the end of the three-year forecast period.” That sets the stage for an increase in policy rates, a message delivered by several members of the Bank’s Monetary Policy Committee during June.

In this sense, one simple explanation of sterling’s weakness against the US dollar since the referendum (see Figure 16) may just be the gap between US and UK nominal and real short-term interest rates.

**Swimming against the tide**
If that were to happen the UK would clearly be swimming against the global tide: the US may well cut interest rates later in 2019 and the ECB seems likely to embark on another round of policy easing. In that sense, engineering such a rate increase may well drive sterling’s value higher. But it could also be very inappropriate given that there are now indications – especially declining business investment – that the economy is slowing. Furthermore, the chances of a disorderly Brexit and an adverse impact on UK trade and growth have increased. Uncertainty about the shape of Brexit and prospects for the economy will continue well beyond the latest (31 October) deadline for leaving the EU. In that context, foreign investors can be expected to maintain a wary attitude to UK exposure.

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With eurozone economic growth forecasts and long-run inflation expectations tumbling, what can the ECB do? It has plenty of tools available, but how easy they are to use remains a key issue.

Inflation expectations and growth forecasts tumble
One of the measures of future inflation known to be closely watched by the ECB is the five-year inflation rate five years in the future (see Figure 18). This measure has fallen to a new low point. It suggests that financial markets are putting little credibility in the ECB’s ability to achieve its inflation objective of “less than, but close to, 2%”. There are important caveats about the measure: it has been very volatile; and because it is derived from the term structure of interest rates and inflation, it is sensitive to changes which may be due to purely technical developments (such as changing demand and supply of particular debt maturities). However, with economic growth forecasts also being cut (see Figure 19), Mario Draghi, whose term as President of the ECB will come to an end later this year, has suggested more monetary easing may be required.

18. Expected inflation rates

<table>
<thead>
<tr>
<th>Year</th>
<th>US</th>
<th>Eurozone</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>1.3</td>
<td>1.8</td>
</tr>
<tr>
<td>2015</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>2016</td>
<td>1.8</td>
<td>2.3</td>
</tr>
<tr>
<td>2017</td>
<td>2.0</td>
<td>2.5</td>
</tr>
<tr>
<td>2018</td>
<td>2.3</td>
<td>2.8</td>
</tr>
<tr>
<td>2019</td>
<td>2.5</td>
<td>3.0</td>
</tr>
</tbody>
</table>

Source: Refinitiv. Data as at 1 July 2019.

ECB toolbox
What shape might such easing take? The ECB has a number of tools it can use (see Figure 20): cutting interest rates; renewed asset purchases; modification of the type of such asset purchases; and a change in the terms of its Targeted Longer-Term Refinancing Operations (TLTROs). Whilst not strictly a ‘tool’, a reassessment of the ECB’s inflation target may also be appropriate. That is especially the case in light of the review currently being carried out by the US Fed. It may also be possible to use Outright Monetary Transactions (OMTs) for countries, such as Italy, where bond yields remain stubbornly high. Nevertheless, such action currently requires the country to be in an adjustment programme (similar to those used in the ‘bailed out’ countries in the eurozone crisis). That may be unpalatable to Italy.

19. Forecasts for eurozone growth

![Graph showing forecasts for eurozone growth]

Source: IMF World Economic Outlook database. Data as at 1 July 2019.

20. What’s in the ECB’s toolbox?

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
<th>Current Position</th>
<th>Potential Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate levels</td>
<td>Main refinancing operations (MRO) rate</td>
<td>Interest rate which banks pay to borrow money from ECB for one week. Collateral has to be provided. Current rate is 0%.</td>
<td>Could be cut further. It is mainly used by southern eurozone banks.</td>
</tr>
<tr>
<td></td>
<td>Marginal Lending rate</td>
<td>Interest rate at which banks can borrow from the ECB overnight (currently 0.25%).</td>
<td>Could be cut further.</td>
</tr>
<tr>
<td></td>
<td>Deposit rate</td>
<td>Interest rate paid to banks for depositing money at ECB overnight (currently -0.40%).</td>
<td>Could be cut further. Move to a tiered deposit rate also possible.</td>
</tr>
<tr>
<td>Asset purchases</td>
<td>Asset Purchase Programme</td>
<td>Ended in December 2018. Mainly involved purchases of government bonds but also included covered, asset-backed and corporate bonds.</td>
<td>Outright purchases could be restarted; could favour different areas of the market, e.g. corporate bonds.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Principal payments from maturing securities are reinvested.</td>
<td>Composition of reinvestment could change, say to favour corporate bonds.</td>
</tr>
<tr>
<td>TLTROs</td>
<td>Targeted longer-term refinancing operations</td>
<td>Provide financing to banks at favourable rates for up to four years depending on their lending patterns.</td>
<td>Terms could be eased.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Current scheme (TLTRO II) began in June 2016. Finance provided at Deposit Rate (-0.4%)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>A new scheme (TLTRO III) starts in September 2019. Finance provided for 2 years at MRO rate plus 10 basis points.</td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td>Inflation target</td>
<td>Current target of “less than, but close to, 2% inflation”</td>
<td>Target could be reviewed and revised: e.g. a more precise target; a range; an average inflation target; or a price level target.</td>
</tr>
<tr>
<td>OMT</td>
<td>Outright Monetary Transactions</td>
<td>Scheme launched in 2012, has never been used. Potentially unlimited purchases of a sovereign's 0-3 year maturity bonds if they are in an ESM economic and fiscal adjustment programme (like, for example, those of Greece and Ireland in the past).</td>
<td>Terms could be eased, say with less conditionality or to allow longer-maturity bonds to be purchased.</td>
</tr>
</tbody>
</table>

Source: ECB & EFGAM. For information only.

Despite mixed signals from economic indicators, the SNB still expects the Swiss economy to grow by 1.5% in 2019. It has revised up (slightly) its short term inflation forecasts.

**Monetary policy on hold**
As widely expected, the SNB maintained its expansionary monetary policy in June, confirming the rate on sight deposit at the SNB at -0.75%. In contrast to other countries, Swiss economic growth accelerated earlier this year. GDP grew by 0.6% between the final quarter of 2018 and the first quarter of 2019. Economic growth in the second half of 2018 was also revised upwards. All of the demand components of GDP contributed positively, in particular private consumption (supported by the solid labour market – see Figure 21).}

**21. Swiss job market is strong**

The SNB expects economic growth at 1.5% in 2019, but risks are on the downside. In particular, a slowdown in global economic growth would have negative consequences for Swiss exports. Furthermore, ongoing geo-political uncertainty due to the Brexit negotiations and trade tensions between the US and China could negatively affect economic sentiment.

Unsurprisingly, in this environment, Swiss forward-looking economic indicators have worsened. The Swiss manufacturing PMI in April and May stood around 48.5, the first time since the end of 2015 that it fell below the 50 threshold which separates expansion from contraction (see Figure 22). The Swiss manufacturing sector has clearly suffered from the weakness in the rest of Europe (particularly Germany), the main destination for Swiss exports.

The services sector is also affected by the weakening of foreign demand. The KOF leading indicator of economic growth that looks at the whole economy fell in May to 94.4, from 96.2 in April and has remained below the threshold of 100 since November 2018.

In April, the IMF emphasized that fiscal policy remains underutilised in Switzerland. Therefore there would be scope for using fiscal policy to support growth against the global trade slowdown.

Inflation has stabilized at around 0.6% year-on-year over the last six months (see Figure 23). The SNB’s inflation forecasts for the coming quarters have been revised upward compared to March (0.6% on average in 2019, against the previous 0.3%), mainly as a consequence of higher import prices. In contrast, the longer-term forecasts were more or less unchanged and remain consistent with the objective of price stability.

**22. Swiss PMI below 50 for the first time since 2015**

The Swiss franc, which continues to experience pressures to appreciate due to its safe haven status, has strengthened on a trade-weighted basis recently and, according to the SNB, remains “highly valued”. The central bank reiterated its willingness to intervene in the foreign exchange market should be necessary.
In China, reflationary policies have offset a trade-war induced slowdown but longer-term uncertainties remain. In Japan, economic growth remains reasonably firm but a sales tax increase is due soon.

**China: strong, but slowing, growth**

Amid the uncertainty related to US-China trade, China’s economy continues to expand at a pace only marginally lower than in recent years. In May, the US increased tariffs on US$200bn of Chinese products to 25% from 10%. At the new rate, that represents around 0.4% of China’s GDP. However, two offsetting changes have taken place. First, China has reduced banks’ reserve requirements, cut corporate and personal taxes and loosened local government debt issuance restrictions, helping to stimulate infrastructure spending.

Second, the renminbi has weakened against the US dollar by around 10% since the US first imposed tariffs in early 2018.

Figure 25) and its largely closed capital account facilitate exchange rate control. Although China has imposed retaliatory tariffs on the US, it has cut import tariffs for other countries. This has proved to be a notable benefit for Japanese car exporters to China, especially with car sales to China having recovered after weakness in 2018 (see Figure 26).

**Japan**

In Japan itself, real GDP growth remained reasonably firm in the first quarter of the year (at a 2.2% annualised rate). The economy continues to benefit from spending related to the 2020 Olympics; a much higher level of tourism from the rest of Asia and, on the supply side, greater immigration. These factors should mitigate the effect of the scheduled further increase in the sales tax (to 10%) in October. In 2014, when the sales tax was increased from 5% to 8% there was a sharp contraction in the economy (see Figure 27). It is still possible that there will be another delay in raising the tax if the economy weakens over the coming months.

One closely watched issue is whether the renminbi/US$ exchange rate will “break 7” (weaken below that rate against the US$). To some extent this is, however, a misplaced focus as China now pays more attention to managing its trade-weighted exchange rate (see Figure 24), which has been less volatile. China’s US$3tr of foreign exchange reserves (see Figure 25) and its largely closed capital account facilitate exchange rate control. Although China has imposed retaliatory tariffs on the US, it has cut import tariffs for other countries. This has proved to be a notable benefit for Japanese car exporters to China, especially with car sales to China having recovered after weakness in 2018 (see Figure 26).

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**24. China: renminbi against the US dollar and index value**

Source: Refinitiv. Data as at 1 July 2019.

**25. China: foreign exchange reserves**

Source: Refinitiv. Data as at 1 July 2019.

**26. China: retail and car sales**

Source: Refinitiv. Data as at 1 July 2019.

**27. Japan GDP growth**

Source: Refinitiv. Data as at 1 July 2019.
While there have been encouraging signs of a pick-up in Latin American growth, the region faces both old and new challenges.

**Pick-up in growth**
2018 saw a pick-up in real GDP growth in several key Latin American economies with growth of 2% in Mexico, 2.7% in Colombia and 4% in both Chile and Peru. For the region as a whole, in contrast to the global trend, the IMF expects growth this year to be higher than in 2018. Nevertheless, recent developments have demonstrated how the region faces both old and new challenges.

**Three old challenges…**
The first of the long-standing concerns is high inflation. Consumer price inflation has recently picked up in Brazil and Chile; and remains above 4% in Mexico (see Figure 28).

Second, the region is still largely reliant on commodities as a source of export earnings, economic growth and government revenues. Government finances improved across the region in the commodity boom up until 2011, but since then have suffered as commodity prices have generally weakened.

Third, generous welfare systems in many economies are a structural weakness which constrains the ability of fiscal policy to operate in a counter-cyclical manner when needed.

**…and three new ones.**
Against this background, there are three new challenges. The first relates to the mercurial nature of relations with the US. The Mexican peso fell sharply, then rebounded just as sharply, on two of President Trump’s tweets about tariffs on Mexico (see Figure 30). Although Mexico recently became the first country to ratify the ‘new NAFTA’ agreement, there is now an understandable concern that the trade arrangement may, unpredictably, be amended. The risk for Mexican businesses is that well-developed supply chains with the US may be compromised.

In Argentina, following its sharp currency depreciation, inflation is above 30% and Venezuela continues to experience hyperinflation. Nervousness about future inflation trends and the central bank’s response has kept policy interest rates at high levels, notably in Brazil and Mexico (see Figure 29).

The second concern relates to the direction of policy in some countries. Some are concerned about the leftward-leaning policies of Mexican President Andrés Manuel López Obrador (AMLO). He has increased spending on social welfare programmes, leading some to question his fiscal probity.

Finally, the patience required to introduce effective reform policies and strengthen the infrastructure (still a weakness across the region) clearly conflicts with the time scales demanded by financial markets. That, in essence, is the problem Argentina has faced in the last four years: initial enthusiasm about President Macri’s reforms turning to disappointment, crisis and the country’s 19th IMF bailout.
Investing according to ESG (environmental, social and governance) principles has rapidly become a much more important consideration for investors. But what is meant by such an approach and how can it be implemented?

**ESG investing**
Investing according to ESG factors is becoming increasingly important to the financial markets. One demonstration of that is the increase in the number of signatories to the United Nations-sponsored Principles for Responsible Investment (PRI). US$90trillion of assets, over three quarters of the global total, are now managed by signatories to those principles. The principles are based on the requirement to take ESG issues into consideration when making investment decisions. In turn this means seeking greater disclosure of ESG issues by companies and actively engaging with them on such issues. The range of ESG issues is, however, very broad: from air pollution to audit committee structures; from biodiversity to bribery; from child labour to climate change. The main ESG rating agencies, for example, take into account several hundred ESG criteria when assessing individual companies. The choice of, and importance given to, different ESG indicators can vary markedly and, partly because of this, there is a low correlation between different ESG ratings, adding to the complexity of taking such factors into account.

**Seven strategies**
There is also a wide range of ESG strategies which can be implemented: seven are widely used.

**Exclusion** is the oldest and still the largest style of ESG investing: it excludes investment in certain companies, such as those in the alcohol, tobacco, gambling or armaments sectors. Such an approach is not as straightforward as it may seem. Selecting which companies to exclude may be controversial; and it can be argued that owning a company with poor ESG standards can be an effective way of bringing about change. **ESG integration** refers to the systematic and explicit inclusion of ESG considerations in investment analysis. ESG factors and traditional financial factors are considered and assessed together to form an investment view. This approach has grown rapidly in recent years. **Engagement** refers to the practice of engaging with companies on ESG issues. Ownership rights can be used to encourage change. Often such engagement is done in collaboration with other investors, through bodies such as PRI. **Norms-based screening** selects investments by reference to standards based on international norms such as the seventeen Sustainable Development Goals (see Figure 31). In practice, it is unlikely that a specific investment can contribute to all of those goals, but some recent bond issues have been compliant with a number of the SDG goals.

**Positive/best in class screening** selects companies with better and/or improving ESG performance relative to their sector peers. This is the approach used in the Dow Jones Sustainability Indices. **Sustainability-themed investing** is based on selected ESG issues. It is the strongest-growing ESG theme over the last two years. These can include, for example, green energy and sustainable forestry and agriculture. With this approach, a portfolio of companies reflecting their involvement in progressing the selected investment theme is constructed. Or the strategy can be implemented using exchange traded funds investing in a certain theme. **Impact investing** refers to investing with the intention of generating social and environmental benefits alongside a financial return. In some cases, this approach overtly places financial return as a secondary consideration. Examples include schemes to help prisoners find work.

**ESG performance**
There have been a large number of studies on the relationship between ESG criteria and corporate financial performance (CFP). Perhaps the most comprehensive assessment found that “the business case for ESG investing is empirically very well founded. Roughly 90% of studies find a nonnegative ESG–CFP relation.” However, corporate financial performance can be assessed in many different ways. For equity market investors, investing according to ESG criteria has had varied results. In some cases ESG-based investment strategies and indices have underperformed their benchmarks. However, there is a good deal of evidence that ESG investing helps to mitigate downside risk. That is demonstrated by the fact that disasters such as Deepwater Horizon (BP’s rig explosion) and Fukushima (Tokyo Electric Power’s nuclear power station meltdown) involved poor governance and environmental standards.

ESG investing is certainly far from straightforward. It raises a number of challenges and, of course, presents great opportunities to invest in a manner to benefit society and the environment, whilst improving standards of governance.

**31. SDG goals**

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Image credit: The PRI Association
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