

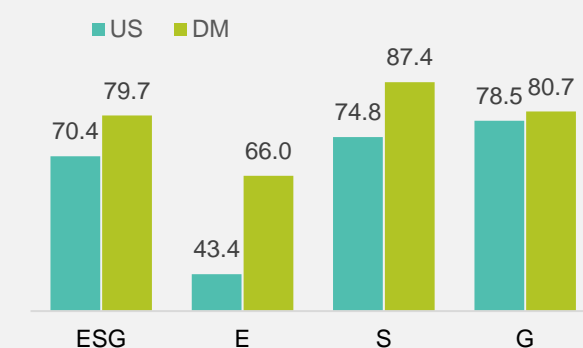
SOVEREIGN ESG INSIGHTS

NOVEMBER 2020

FEATURE ARTICLES

- + **The US After the Election**—The US continues to lag most other developed economies from an ESG perspective: it's close to the bottom of the fourth quartile according to our proprietary ESG indicator (see Page 8). Could a change of political leadership mark a different path?
- + **ESG in Action**—Nowhere is the power of ESG as an investment tool better illustrated than in Turkey, where a forward-looking focus on governance has been the key to anticipating this year's asset-price gyrations.
- + **Brazil: Time for A Rethink?**—Deforestation in the Amazon has tainted Brazil's reputation on the world stage. But the Brazilian central bank is ahead of the curve in its environmental policy agenda.
- + **ESG and COVID-19**—Can ESG help explain the different degrees of success governments around the world have had in handling COVID-19? At first glance, the answer seems to be no, but a closer analysis of COVID-19 in Europe reveals a close link between higher ESG scores and better public-health outcomes.
- + **ESG Ratings Dynamics: CEEMEA Focus**—ESG scores in the Middle East and Eastern Europe have outperformed over the past year, though recent social and governance instability poses a question mark over further near-term improvement.

ESG Scores: US vs. Developed-Market Average¹

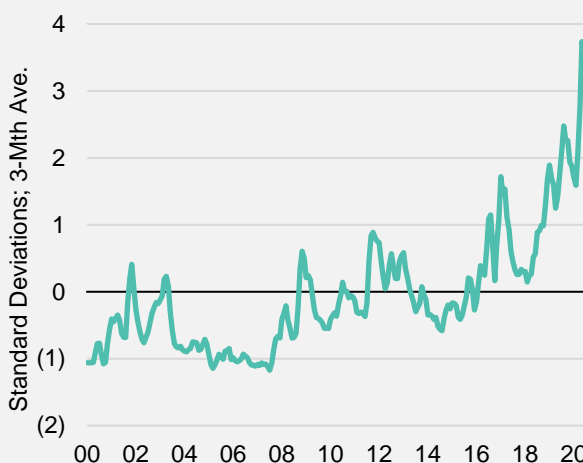


¹Simple average.
Source: AB

ESG & THE MACRO OUTLOOK

- + The focus of the post-election policy debate in the US has been on fiscal stimulus rather than trade policy. But an improvement in the latter could have important positive ramifications for the global economy.
- + President Trump's hostile approach to the rules governing international trade has caused enormous uncertainty in recent years, weighing on global growth. While the roots of this approach run deep—including populism and geopolitical conflict with China—there are early signs that a Biden administration would adopt a more conciliatory trade approach, at least with traditional US allies.
- + While an improved backdrop for global trade would be less beneficial for the US economy than fiscal stimulus, it might be just the kicker the rest of the world needs as it recovers from COVID-19.

Global Economic Policy Uncertainty



Source: Haver Analytics

DOES THE PRESIDENTIAL ELECTION REPRESENT A NEW ESG DAWN FOR THE US?

As the issuer of the global reserve currency, the US is rarely subjected to the type of sovereign analysis and scrutiny that is the norm for many other countries, particularly those in the emerging-market universe. That could change, of course, but we view any loss of reserve currency status as being a fairly distant prospect. As such, we think that US Treasury debt will be regarded as the global “risk-free” asset for some time to come and that US yields are likely to be less affected by ESG considerations than other assets.

That said, it is clear that the power of ESG to shape economic outcomes stretches beyond a narrow focus on sovereign creditworthiness ([Missing Pieces: A Better Approach to Sovereign ESG Analysis](#)). Moreover, ESG considerations have increasingly come to the fore during the 2020 election campaign and are likely to become even more meaningful in coming years.

The obvious starting point is to assess whether the controversial election reflects a durable deterioration in governance metrics. Will the fractious political climate allow for a timely and peaceful transition of power, should the election result mandate one? At the time of writing, this remains very uncertain.

There are also potential questions about the politicization of the judicial system to be addressed. Many judicial nominees have to be approved by the Senate. If the President and the Senate are from different parties, will that process function or grind to a halt? If one party controls both the presidency and the senate, will judicial appointments become more partisan? Will the judiciary lose the faith of the population if it appears increasingly to favour one party or the other? None of these questions can be answered *ex ante*, but all of them could surface in the future.

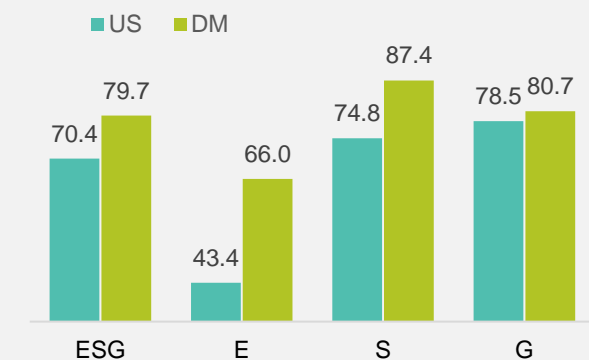
While governance may garner the headlines today, environmental and sustainability policies are also in play, as was made obvious when the US officially left the Paris Accords the day after the last presidential election. Given the polarized political environment, the outcome of the election could see either additional withdrawals from multilateral institutions and agreements or a renewed commitment to those same institutions and agreements.

ESG IN ACTION: GOVERNANCE CONCERNS THE KEY TO TURKISH ASSET-PRICE GYRATIONS

In contrast to the US and other developed markets, forward-looking ESG analysis is an integral part of thinking about emerging-market asset prices. Nowhere is the power of ESG as an investment tool better illustrated than in Turkey, where governance considerations have been the key to anticipating recent asset-price gyrations.

Combining ESG analysis with macroeconomic research and investment strategy can create a potent mix with numerous applications. For example, a relative assessment of ESG scores over time can provide the basis for exclusion

Latest ESG Scores: US vs Developed Market Average¹



¹Simple average.
Source: AB

To the extent that US action on the environment has been guided by international consensus, stepping away from the bodies that are most influential in laying out the forward path could lead to the pursuit of policies different from those recommended internationally. That may not matter directly to our assessment of sovereign creditworthiness, but the potential for greater tension with global partners could have an impact on growth in coming years.

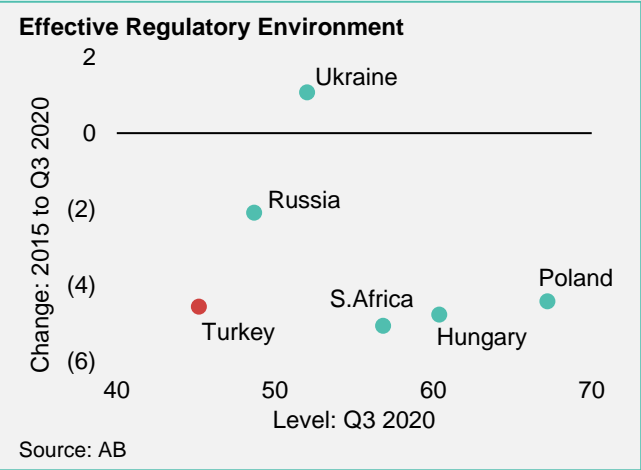
Irrespective of the near-term political environment, we believe that, over the longer term, the US is likely to pursue policies that reflect the need to transition to more environmentally conscious, sustainable sources of energy. That means ESG considerations will be a significant factor for assessing domestic companies, even if these considerations are less relevant for the sovereign.

The pace of that transition is an open question, however, and so is the extent to which ESG criteria are likely to impact company performance in the near term. A continuation of the Trump administration would have signaled slower progress toward environmentally friendly technologies and a longer period before the US accelerates the move from extractive to more sustainable industries. A Biden administration, as looks increasingly likely once the post-election dust has settled, would likely do the opposite, accelerating the move toward greener technologies.

strategies and help with the management of tail risks. And the subcomponents of ESG pillars can provide insight into countries' key vulnerabilities, especially when combined with economic and sovereign balance-sheet analysis. The reality is that ESG dynamics can pose unique challenges to individual countries, and that risk profiles and investment implications (especially beyond simple exclusion strategies) can differ significantly from country to country.

There is a symbiotic relationship between ESG and sovereign analysis: while the ESG factors provide many of the building

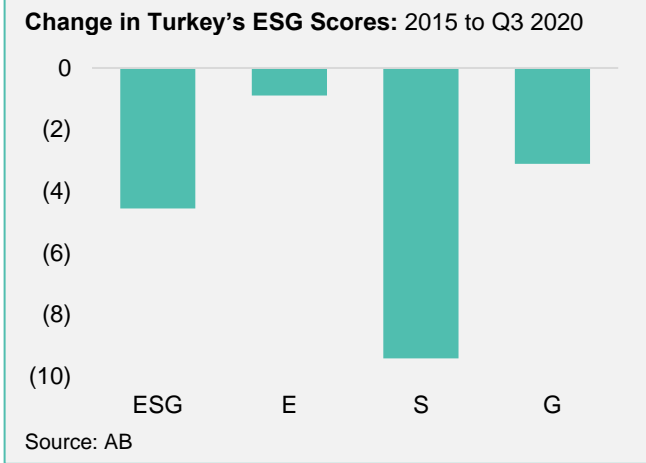
blocks of economic growth, real-time macroeconomic and institutional analysis can provide insights into future ESG trajectories. Turkey lends itself as a timely case study for the intersection of forward-looking ESG analysis with sovereign-credit research and investment strategy. Crucially, it is the detail embedded in the subcomponents of its governance score (G), combined with external debt, monetary policy and reserve-management issues that pinpoint the key risks Turkey has faced in recent years—and that it will continue to face in coming quarters.



Turkey has faced a number of ESG challenges over the past four to five years, especially with regard to judicial and civil-rights limitations in the aftermath of the 2016 coup attempt. A (temporary) deterioration in the domestic security situation amidst a worsening Syrian conflict and suicide bomb attacks has also taken a toll.

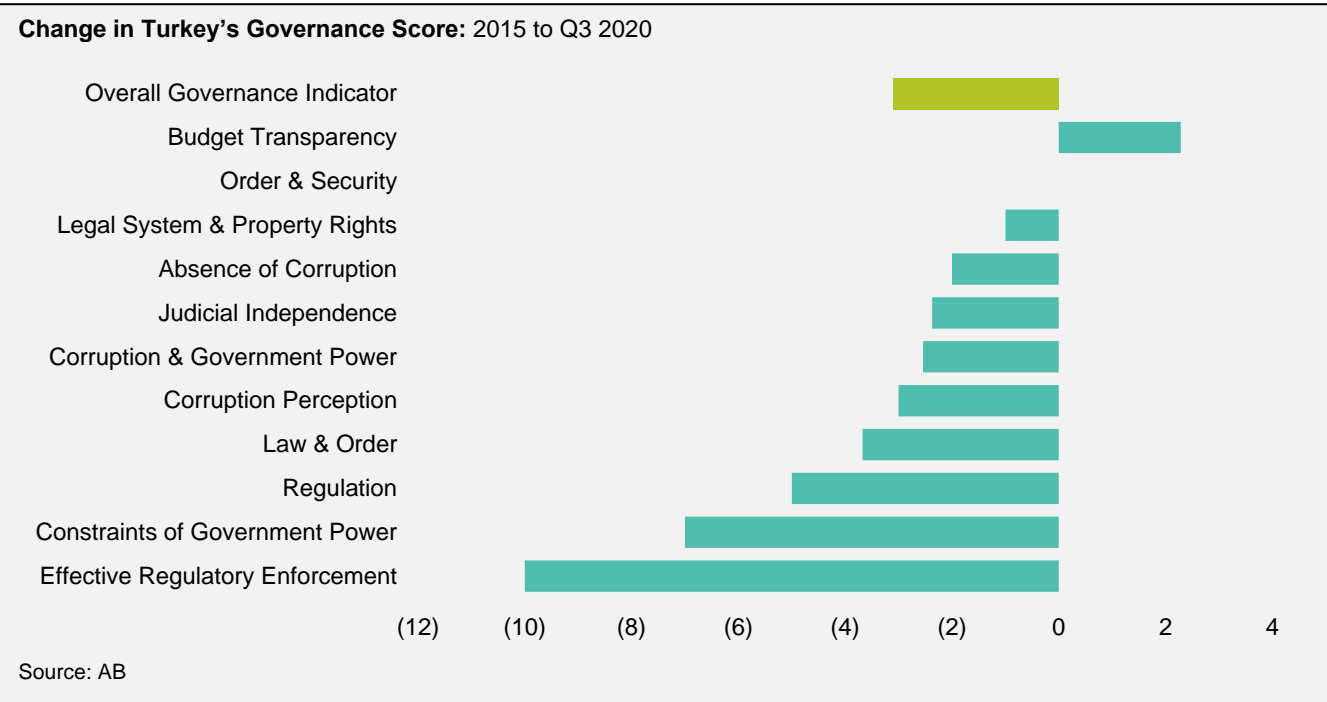
Yet, Turkey does not stand out in terms of well-publicised ESG challenges across the EMEA region during this period. While it registers a lower ESG score than other countries, the rate of deterioration is on par with that of South Africa, Poland

and Hungary: South Africa has been adversely affected by President Zuma's state capture, while Hungary and Poland have suffered from populist surges and associated infringements on judicial independence and civil rights.



Looking specifically at the compositional changes of Turkey's aggregate ESG score, it is noteworthy that social factors have seen the largest declines and also made the biggest contribution to the deterioration in the overall score. The aforementioned challenges to civil/political liberties and the domestic security situation are the predominant driving forces behind these changes. If unaddressed, infringement of civil and political rights will continue to harbour risks to political stability, especially in the context of Turkey's high social development and an emerging urban class.

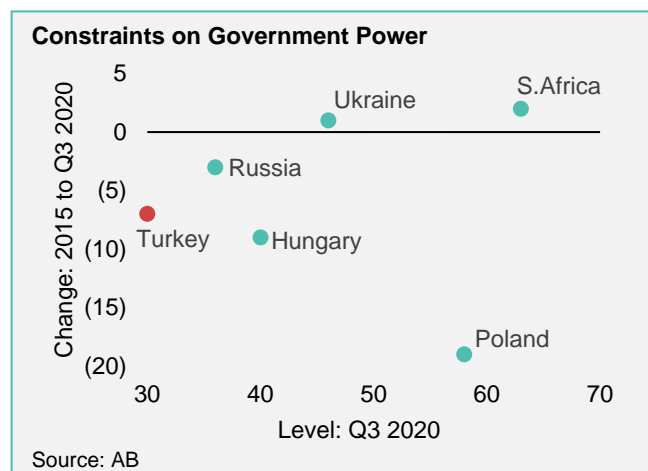
Despite important social dynamics, we believe that Turkey's underlying macroeconomic and current investment risks are largely encapsulated by changes in subcomponents of its governance score. The largest deteriorations have been seen in constraints on government power and effective regulatory



enforcement. Within the region, Turkey scores amongst the lowest in absolute terms in both of these categories.

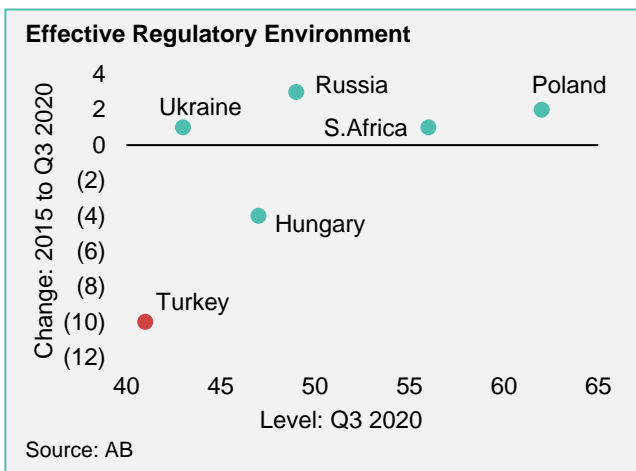
In Turkey's case, the overreach of government power and weakening of institutions have translated into a continuous erosion of central bank independence. This culminated in the full de facto capture of the Central Bank of the Republic of Turkey (CBRT) by the AKP government following the 2018 parliamentary and presidential elections, as well as the implementation of the executive presidency.

Weak and eroding institutional strength have had a profound impact on the economy. The government's focus on growth, low interest rates and the desire for a stable currency, against large short-term external debt refinancing requirements, led to several boom-and-bust cycles, most notably the balance of payment crisis in 2018. The accumulation of short-term debt within the private sector and limited efforts to correct it constitute an important regulatory shortcoming that has exacerbated Turkey's macroeconomic vulnerabilities.



With an ongoing pro-growth bias and loose monetary policy, the Turkish government has faced more severe challenges in 2020. Certain external imbalances, especially the current-account deficit, have improved over the past two years. But others, particularly the CBRT's increasingly negative net foreign asset (NFA) position, which has deteriorated by more than US\$70 billion this year to negative US\$50 billion, have

worsened markedly. This growing vulnerability was driven by monetary-policy-induced twin deficits of the current and financial account of the balance of payments, as well as FX interventions to defend the currency. Policymakers have been trying to address increasing exchange-rate pressure with a gradual tightening in domestic liquidity conditions, efforts that in the past have failed to alleviate market pressures sustainably.



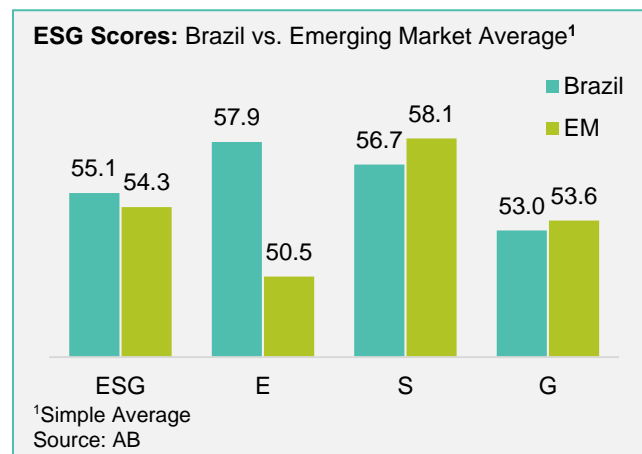
Against this backdrop, there is little evidence that governance indicators related to improving institutional strength, effective regulation and overreach of government power (political pressure on the CBRT) have improved, despite opportunities to learn from the 2018 crisis. A failure to run orthodox monetary policy for a sustainable period of time poses a serious threat to banking-sector confidence and countrywide financial stability.

Most recently, new appointments at the helm of the CBRT and the Ministry of Economy may represent a first important step toward a change in the broader policy setting. That said, personnel changes need to translate into concrete policy action—particularly a central bank that is less exposed to political interference—if they are to stabilise the economic situation and contribute to an improvement in Turkey's ESG governance indicators over the medium term.

BRAZIL: IS THE BCB AHEAD OF THE CURVE?

Brazil has been criticized in recent years by both the international community and investors for its environmental policies. Loose environmental enforcement under President Jair Bolsonaro has led to massive increases in illegal deforestation of the Amazon and other protected land, which has contributed to higher CO2 emissions and climate change. Despite calls for action, nothing has changed. In the eyes of the world, Brazil doesn't seem to care.

While that may be true for the president, other segments of the Brazilian government are enacting policies to encourage a sustainable future. The Brazilian Central Bank (BCB) launched a sustainability pillar of its agenda in September, recognizing that climate change is a structural shift in the



economy which, without mitigation, might make it more difficult for the central bank to achieve its mandate of price and financial stability. Natural disasters like droughts, floods and wildfires can cause significant volatility in the price level and vulnerabilities in the financial system—and these events are becoming more and more prevalent as climate change progresses. If the BCB can reduce the frequency of these events, it will make its own job easier.

The BCB's sustainability programme helps direct capital to the right people—the individuals and businesses that are engaged in clean energy, clean agriculture and sustainable finance. By encouraging resource allocation to these types of operations, the central bank believes that it can help boost productivity as new, efficient processes are adopted. It also seeks to create new jobs within the “clean” economy. Over time, cleaner, more sustainable businesses should help reduce the frequency and severity of natural disasters.

Beyond encouraging the development of clean industries, the BCB stands out as a global leader in transparency and in truly incorporating sustainability across all of its functions. This includes incorporating climate risks in stress tests of the banking system, creating incentives in its rural credit program for green projects and strengthening reporting criteria for climate-related disclosures within the financial system.

While the central bank's focus on sustainability and climate-risk awareness can't offset the devastation caused by the government's reluctance to crack down on illegal deforestation, it does represent an important seed of change. The BCB is well ahead of other central banks globally in this area—even those in developed economies—and its agenda may help establish a culture that demands accountability across the Brazilian government and society.

CAN ESG RATINGS HELP EXPLAIN COVID-19 OUTCOMES?

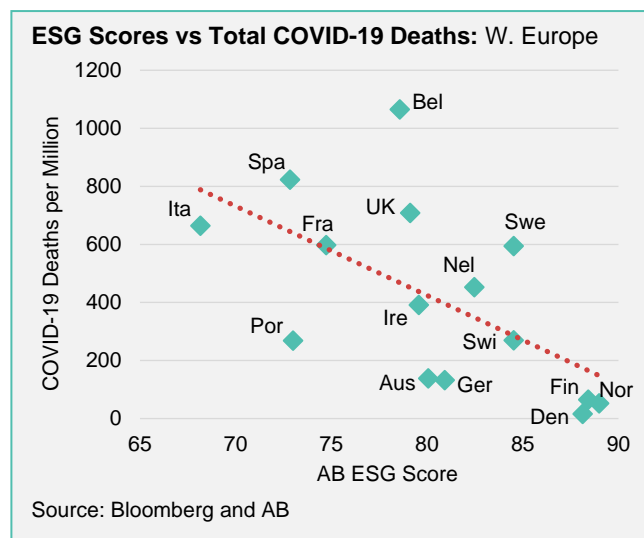
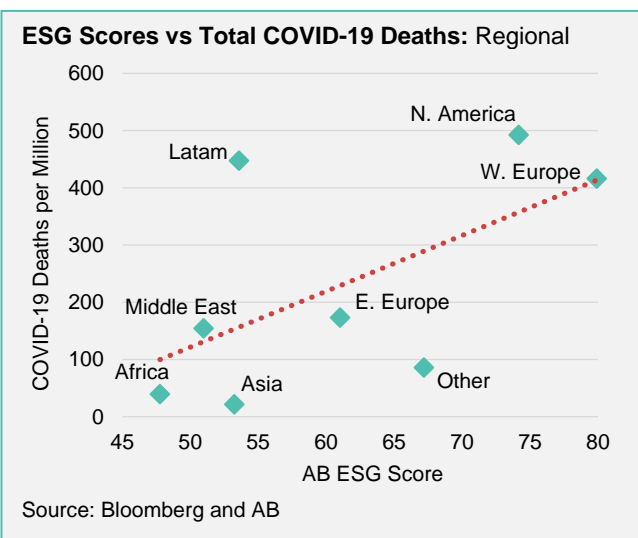
COVID-19 has delivered a huge shock to the global economy and a stern test for governments. But economic and public-health outcomes differ hugely within and across regions. Can our ESG scores shine a light on why these differences exist?

To analyze this question, we plotted average ESG scores against total COVID-19 deaths for the major regions of the world. Perhaps surprisingly, there's a positive correlation between the two, suggesting that countries with higher ESG scores have had worse public-health outcomes. The worst performers have been North America and Western Europe, the regions with the highest average ESG ratings. The best performers have been Africa and Asia where ESG scores are, in general, lower.

But this shouldn't really come as a surprise. Many different factors have influenced the public-health impact of COVID-19. Demographics and climate are two of those, but some countries—especially those in Asia—have also benefitted from recent virus experience.

To neutralize at least some of these factors, we plotted ESG scores against total COVID-19 deaths for western European countries. This presents a very different picture, with a clear negative correlation between the two. Italy and Spain, whose ESG scores are relatively low, have seen some of the worst COVID-19 outcomes. This stands in contrast to the very low incidence of COVID-19 in Norway, Finland and Denmark, the top three countries in our overall ESG ratings.

But this is still only part of the story. It is difficult, for example, to explain the different COVID-19 outcomes of Belgium and the UK, on the one hand, with those of Germany and Austria, on the other, based purely on their ESG scores—which are very similar. Still, it's a useful starting point and highlights the way in which ESG considerations and analysis can be used to enrich our understanding of events—even one as unusual as COVID-19.



A closer look at the evolution of our proprietary ESG scores highlights that EM sovereigns in parts of the **Middle East (UAE and Iraq)** and **Eastern Europe (Armenia, Azerbaijan, and Ukraine)** have seen some of the largest improvements in their respective ESG rankings over the past year. As we explore in more detail, recent on-the-ground developments cast doubt on the sustainability of these countries' positive ESG trajectories—with the exception of the UAE.

More broadly speaking, the 2020 coronavirus pandemic has strained social stability and governance around the world, while shifting government attention away from environmental issues and toward urgently needed support for healthcare systems and public finances. This may put negative pressure on aggregate global ESG score dynamics going into 2021, notwithstanding ongoing country-specific success stories.

Middle East

In the **Middle East**, the increase in the **UAE's** ESG score has been driven mainly by environmental factors, particularly improvements in the country's susceptibility to natural hazards. While that metric is coming from a low rating, the UAE government's more recent efforts in natural disaster prevention—such as planning for flash flooding—is being reflected in its environmental score. Moreover, a further commitment to gender equality has raised the country's social score. The UAE ranks first in gender equality among the Arab world and, according to United Nations Development Programme data, has also moved into the top quartile globally within our ESG universe. While other countries in the region appear to be lagging the UAE on gender equality, a number of them—Qatar, Kuwait and Saudi Arabia—have also improved their scores over the past five years, thanks to legislative changes to increase female participation in the labour force. As elsewhere, practical application of the law will be key to fostering future enhancements in gender equality.

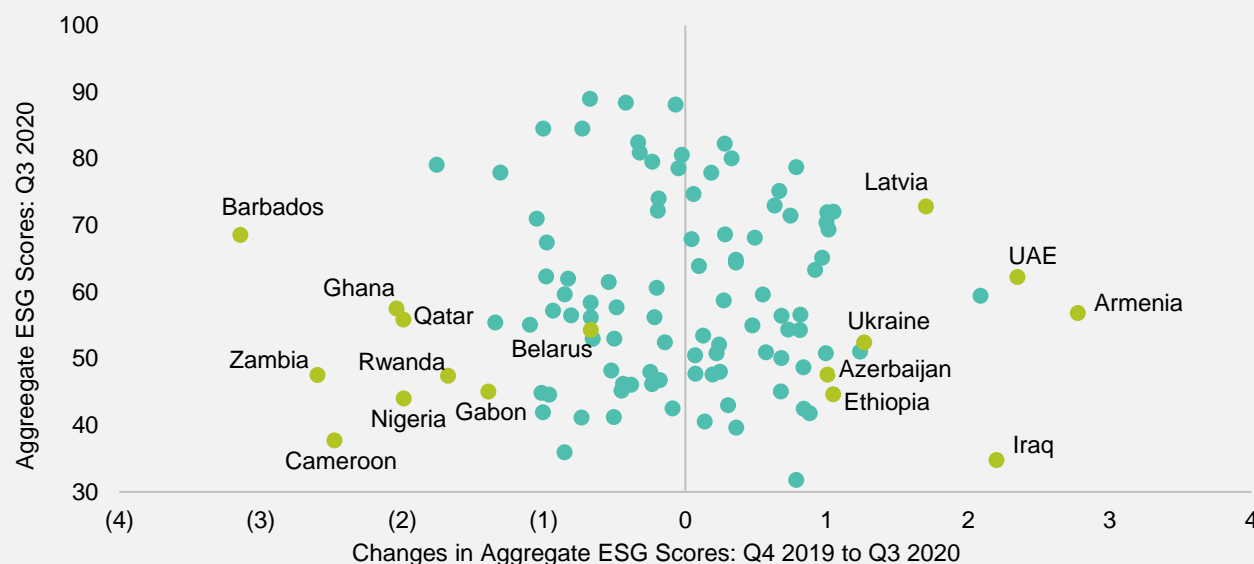
Iraq's ESG score remains one of the lowest ranked in our universe. Years of war, civil strife and the fight against the Islamic State group (ISIL) continue to take their toll on all environmental, social and governance aspects. The military defeat of ISIL in late 2017 led to a sharp decline in attacks on Iraqi territory in 2018 and improved domestic security, lifting scores for conflict and domestic law and order from very low bases. The reality remains, though, that Iraq's social-stability and domestic-security situations are very fragile indeed. ISIL attacks have been on the rise again since the second half of 2019, and violent anti-government protests have increased sharply since the "October Revolution" last year. The Covid-19 pandemic has added a burden to an already difficult domestic social and political environment.

Eastern Europe

Elsewhere, **Eastern Europe** has been back in the spotlight on negative ESG developments more recently, especially in the context of the Nagorno/Karabakh conflict, concerns around institutional erosion in Ukraine and political upheaval in Belarus.

Armenia & Azerbaijan: The Nagorno-Karabakh conflict experienced an unexpected and sudden escalation at the end of September, the worst since the signing of the 1994 ceasefire. Military confrontations have remained limited to the Nagorno-Karabakh region, and international mediation efforts are aimed at preventing a widening of the conflict. Despite expectations of containment and an eventual ceasefire, both countries' aggregate ESG scores will likely decline, given the sudden and unexpected resurgence of hostilities. Armenia's ESG score, which arguably received a premature benefit from a downgrade in conflict risk earlier this year, is likely to experience renewed pressure from security concerns that could outweigh the positive impact from improvements in the regulatory environment. On the latter, Armenia has certainly benefited from the signing of the

Global ESG Dynamics: Latest ESG Score vs Change Since Q4 2019



Source: AB

Comprehensive and Enhanced Partnership Agreement (CEPA) with the European Union in late 2017; that pact is unlikely to be affected by the conflict and will remain an important anchor for institutional strength.

Ukraine: Significant efforts over the past few years to establish an independent central bank (NBU), as well as an effective anti-corruption bureau (NABU) and courts, have benefited Ukraine's ESG score. Improvements in judicial independence have continued to push Ukraine's ESG score higher this year. That said, recent institutional changes at the NBU and Constitutional Court rulings against Ukraine's anti-corruption framework pose a question mark over the country's institutional strength. This issue has caught the attention of the International Monetary Fund, which has so far delayed financial disbursement under its current stand-by agreement. The Ukrainian government, under the leadership of President Volodymyr Zelensky, has pledged its support for the country's key institutions, but urgent action is required to preserve recent reform efforts. While politically challenging, the latest crisis offers the government an opportunity for comprehensive Constitutional Court reform, which would be an important positive for Ukraine's future ESG score and rating.

Belarus: The contested re-election of President Alexander Lukashenko in August triggered mass demonstrations and violent confrontations between protestors and security forces, with battles continuing into the autumn. Historically, Belarus' aggregate ESG score has remained stable, underpinned by strong governance and social factors such as low risks of social strife and relatively high levels of social equality, respectively. Looking ahead, we are likely to see more significant declines in these factors as they negatively impact social stability, with little sign of an end to the political

standoff. Moreover, reports of arbitrary arrests and torture may weigh on scores such as civil and criminal justice.

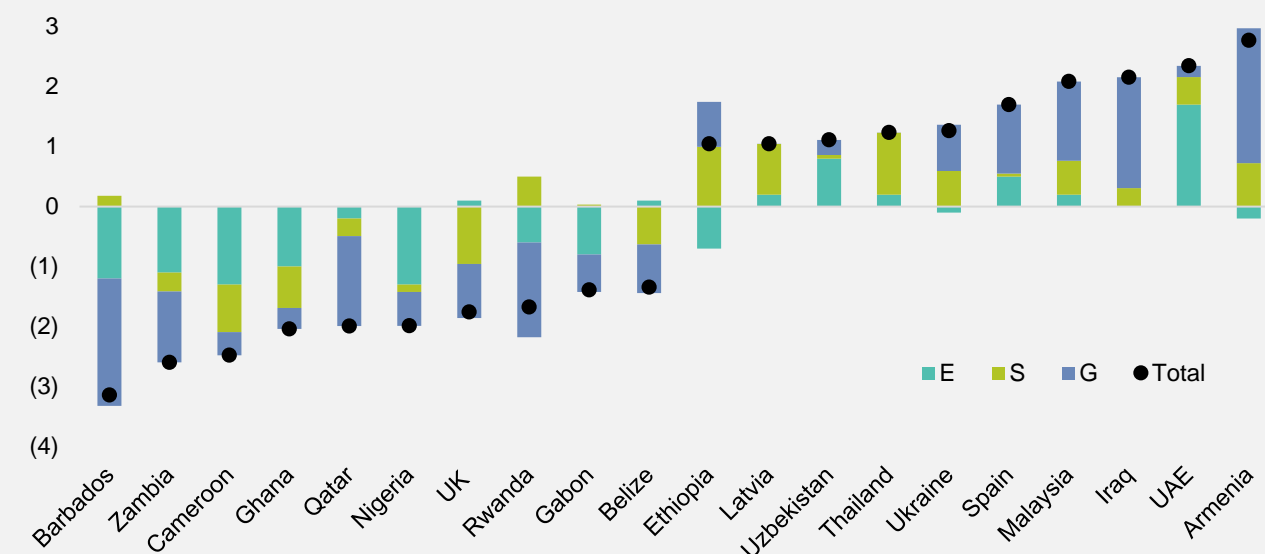
Sub-Saharan Africa

When looking at deteriorating ESG scores over the past year, several sub-Saharan African countries stand out, notably **Zambia**. President Edgar Lungu's term in office has been marred by the country's drift onto an unsustainable debt trajectory, and by challenges to the independence of the judiciary and the legal system. The pressure on the judiciary is related to uncertainty regarding Lungu's eligibility to stand for reelection in 2021.

One of the most overt challenges to the independence of Zambia's judiciary was included in the Constitution of Zambia (Amendment) Act, 2019. The proposed bill included amendments to the electoral system, the rules regarding presidential election petitions and the functions of the Bank of Zambia. The proposed amendments on disciplinary measures against judges and oversight of state loans were particularly controversial; those affecting the Bank of Zambia did not raise significant concerns. However, Lungu's unexpected dismissal of the governor of the Bank of Zambia in August brings into question the effective independence of the central bank.

Concerns about the proposed bill justifiably contributed to a deterioration in Zambia's ESG score over the past year, especially on perceived risks around judicial independence. However, the bill failed to garner the support of the required two-thirds of parliament members in October, a development that might partially reverse the ESG score's deterioration. The political cycle and the government's request for debt-service suspension on all commercial debt could, however, have a continued negative impact.

AB ESG Score Changes Q4 2019 - Q3 2020: Top 10 vs Bottom 10



Source: AB

AB ESG SCORES: OCTOBER 2020

Country	Latest Score				Country	Latest Score			
	ESG	E	S	G		ESG	E	S	G
Norway	89.0	84.8	92.0	88.9	Tunisia	56.2	50.9	63.6	53.9
Finland	88.6	83.4	90.3	89.6	Belarus	56.6	61.5	58.4	53.6
Denmark	88.0	78.0	92.0	89.5	Qatar	56.5	65.8	61.4	49.7
Sweden	84.7	80.5	89.2	83.6	Brazil	55.0	57.9	57.3	52.4
Switzerland	84.6	72.7	92.2	84.7	Kazakhstan	54.2	49.1	58.2	53.9
Netherlands	82.5	67.1	90.0	84.2	Paraguay	53.6	65.5	59.0	45.7
New Zealand	82.3	59.4	88.0	88.0	Sri Lanka	54.2	53.4	55.7	53.7
Germany	80.8	67.1	86.6	82.8	Bahrain	54.1	64.4	48.6	53.2
Austria	79.9	71.0	86.3	79.6	Peru	52.8	39.2	60.9	53.3
Ireland	79.4	67.4	90.6	77.4	Oman	53.5	42.5	53.0	58.2
United Kingdom	79.5	67.3	83.2	82.2	Senegal	52.2	49.7	52.7	52.9
Australia	78.6	53.1	86.4	84.1	Ukraine	52.0	52.8	56.0	49.2
Belgium	78.4	69.3	86.1	77.4	Thailand	51.0	39.2	50.7	55.8
Singapore	78.2	67.5	78.3	82.4	Colombia	50.4	42.5	51.7	52.8
Canada	77.8	56.0	87.0	81.1	Indonesia	50.6	33.2	52.9	56.2
Czechia	74.9	66.4	85.2	72.0	El Salvador	50.1	40.2	57.8	49.4
France	74.7	63.2	82.5	74.6	Ecuador	49.7	38.3	59.6	48.4
Uruguay	73.6	73.2	80.2	69.8	Russia	48.7	44.8	47.3	51.0
Portugal	72.9	63.0	84.8	69.7	Philippines	48.1	31.7	50.4	53.2
Spain	72.4	59.1	83.0	71.3	Mexico	47.9	37.8	51.5	49.7
Japan	72.2	36.5	86.6	77.9	Kenya	47.8	52.3	41.8	49.6
United States	70.3	43.3	74.4	78.7	India	47.8	26.7	50.2	54.9
South Korea	68.3	42.3	83.2	69.8	Zambia	47.7	63.7	46.6	42.0
Italy	67.7	52.9	80.4	66.0	Tanzania	46.7	55.9	42.8	45.3
Costa Rica	67.6	49.4	77.7	68.8	Saudi Arabia	46.8	55.5	42.4	45.9
Poland	67.3	62.2	77.7	63.2	Turkey	45.2	39.9	43.2	48.4
Chile	64.6	43.2	74.9	67.0	Vietnam	45.0	35.0	51.0	45.4
Croatia	64.1	53.4	77.3	60.5	Gabon	45.6	65.7	36.4	43.0
Greece	62.2	48.4	75.4	59.8	Lebanon	44.7	45.7	51.2	40.3
United Arab Emirates	62.2	49.7	62.7	66.9	Côte d'Ivoire	44.3	56.8	41.0	41.3
Israel	62.3	53.7	75.0	58.1	Nigeria	43.8	62.3	36.3	40.9
Hungary	60.5	55.9	71.0	56.0	China	43.4	30.3	44.9	47.7
Jamaica	59.1	46.0	69.4	58.2	Bolivia	42.0	50.6	52.7	32.1
Argentina	59.2	52.9	71.0	54.6	Angola	42.2	54.8	37.8	39.9
Malaysia	59.2	46.7	63.0	62.0	Egypt	41.9	46.6	36.9	43.0
Ghana	57.8	55.3	59.5	57.7	Pakistan	40.4	32.1	35.9	46.4
South Africa	56.8	42.5	58.2	61.7	Cameroon	38.0	58.4	30.5	34.4
Panama	56.3	43.7	69.0	53.7	Iraq	33.0	39.0	31.7	31.3

Source: AB

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