Low carbon credit performance: rates and equity sell-off update

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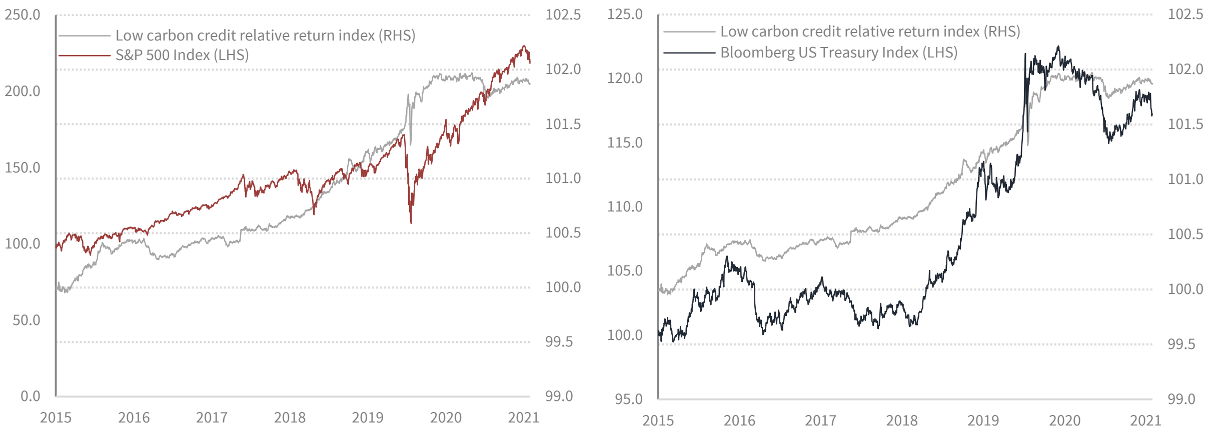
Equity and bond markets have experienced meaningful sell-offs in recent weeks, with the S&P 500 ending September down 5% versus its peak on 2 September (Figure 1, left panel, total return index) and the 10Y US treasury yield breaching 1.5% on 28 September in a 37-bp rise since 3 August (Figure 1, right panel, total return).

At the same time, the AFII gauge of low-carbon relative performance[1] has fallen "only" 5bp. Given the volatility in rates and equity markets in response, inter alia, to a more hawkish Fed,[2] one should consider a near-flat performance quite resilient.

The low-carbon relative performance index currently stands at an outperformance of 1.9% in return terms over 6 years (no down years), or 31 bps per year, with an annualized Sharpe ratio of 1.38%.

Figure 1. Low-carbon credit relative performance vs S&P 500 return index (left panel) and Bloomberg US Treasury Index[3] returns (right panel). Source: AFII, S&P, Bloomberg.



We observe that S&P 500 total returns and the ECOBAR-based index are in fact nearly uncorrelated over the full 6-year timeline of available data (Figure 2, left panel) suggesting that a low-carbon tilt

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[1] The low-carbon index is a low-carbon version of the S&P 500 IG corporate bond index constructed using the ECOBAR methodology, see "[Credit alpha and CO2 reduction: A portfolio manager perspective](#)." Detailed methodology for the index context originally in AFII piece "[Low carbon credit performance 2015-20](#)", 27 Jan 2021, and revisited in subsequent pieces, e.g. "[The oil rally and low carbon credit performance](#)", 21 Apr 2021.
[2] "[Stocks fall, bond yields jump as rate hikes loom](#)", Reuters, 28 Sep 2021; "[Stocks Suffer Worst Monthly Rout Since March 2020: Markets Wrap](#)", Bloomberg, 30 Sep 2021.
[3] Ticker LUATTRUU, which has a duration of approximately 7 years.

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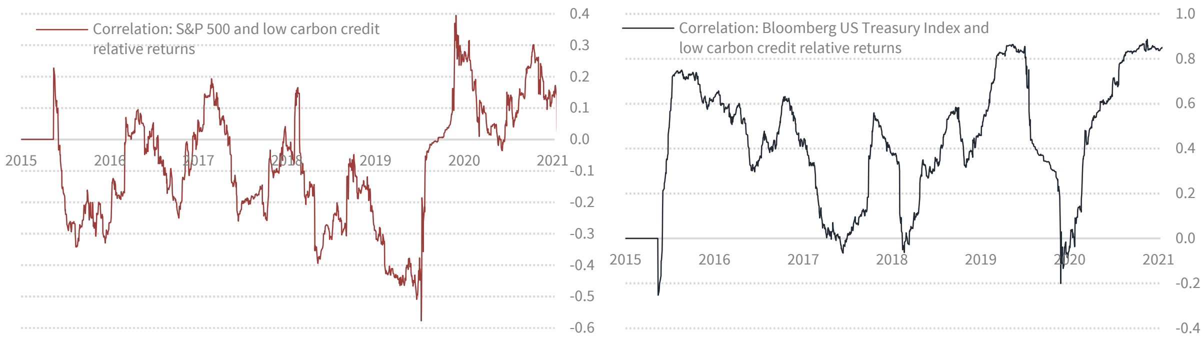
of a corporate bond portfolio can add interesting diversification benefits in an asset allocation context. The average correlation between S&P 500 and low-carbon credit performance is -0.03.

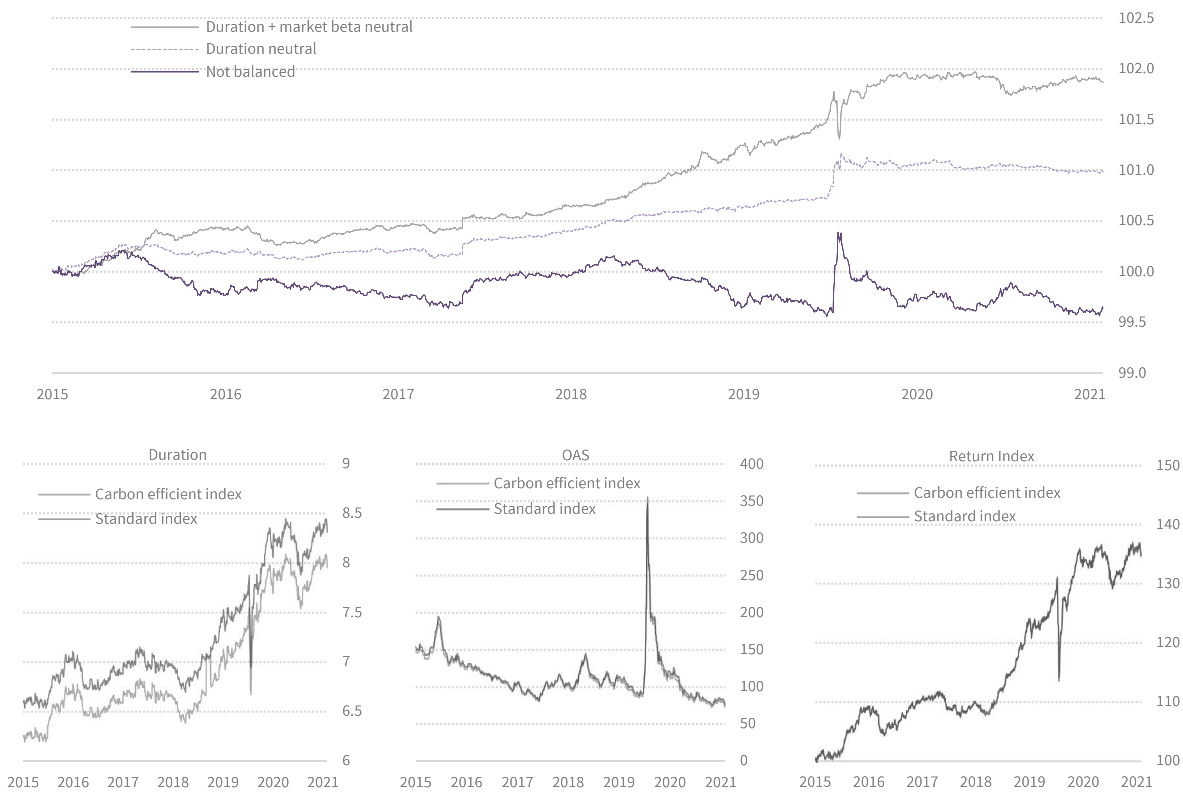
In terms of rates, we find that with a 90-day correlation of 0.40 (Figure 2, right panel), low-carbon performance moved less independently of nominal rates this summer, revealing a potential sectoral bias within the index (which is duration-neutral by design).

Figure 2. Rolling 90-day correlation between low-carbon credit relative returns and S&P 500 (left) and Bloomberg US Treasury Index returns (right). Source: AFII, S&P, Bloomberg.



The low-carbon relative performance index is constructed using an identical set of issuers (as the S&P IG corporate bond index) but altered portfolio weights according to the ECOBAR methodology and a duration and spread beta neutral weighting scheme. The S&P bond indices are available: carbon-efficient and traditional index. We provide a detailed description of the model and methodology in earlier AFII pieces referenced in footnote 1.

Figure 3. Low-carbon credit relative returns: duration- and OAS-adjusted and unadjusted versions. Source: AFII, S&P.



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