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TRANSCRIPT

Abortion Pills and the Climate of Bonds

Featuring:

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Mike Disabato:

What's up everyone and welcome to the weekly addition of ESG Now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host, Mike Disabato, and this week we have two stories for you. First, we are going to discuss abortion pills and the companies that make them, then we discuss what sovereign bonds can tell us about climate risks. Thanks as always for joining us stay tuned.

Mike Disabato:

There was a leaked draft of a Supreme court opinion this week that showed the possible reversal of the landmark abortion law in the US called Roe versus Wade. Roe V. Wade was a decision by the US Supreme court in which the court ruled that the constitution of the United States protects a pregnant woman's liberty to choose to have an abortion without excessive government restrictions. It's removal would mean states would be able to decide on the legality of abortion, which would likely translate into a map of legality that would file political divides. What has also meant is there is now a spotlight on other forms of nonsurgical abortion options, such as prescription pills that can be used to terminate a pregnancy. And the companies that make them these drugs are called abort efficient and they're made by about 44 companies in our coverage universe. And they go by the names like methotrexate, Misoprosotol and [inaudible 00:01:31] and fun fact about these pills is they aren't just used for abortions.

Mike Disabato:

Some are also cancer treatments, or they treat rheumatoid arthritis, which is fascinating. And I found out while talking to my guest and colleague for this episode, Namita Nair, now the reason we have detailed data on which companies make abort efficient is because some investors want to screen these companies out of their portfolios. Traditionally religious endowments, for example, wanted to screen these companies out of their portfolios. And I thought we should start this episode off by giving a quick background on these drugs and what it means for these companies that make these drugs to be in the middle of this political mail storm. So here's my conversation with Namita.

Namita Nair:

Most companies that market these abortion pills or abortion drugs, they give a combination of two medicines Mifepristone, Misoprostol, and these are used for terminating a pregnancy. It's usually happens in the earlier weeks of the pregnancy and these are the drugs that are usually marketed as abort [inaudible 00:02:38]. And there are a number of side effects for these drugs. And as a result, these are always prescribed biomedical professional, and they're usually administered in the presence of, or under the care of a healthcare professional.

Mike Disabato:

Well, these drugs aren't being made just by niche drug companies, right? There's Pfizer, everyone Pfizer by now there's Sanofi, which is this massive French pharmaceutical company that I probably just pronounced wrong. Sanofi. There's also Novartis, which is another massive pharmaceutical company with a market cap about the size of Coca-Cola. So are these giant companies now in the politically difficult situation, if Roe Versus Wade is actually overturned and more attention is now put toward those drugs, there's already been reports to people, hoarding them. Are, these companies now having to deal with that?

Namita Nair:

Okay, so the nuanced version of this answer would be that these drugs are not just abortion drugs. Drugs like methotrexate are actually anti-cancer drugs. They use for chemotherapy, even mifepristone Misoprostol they might be used, after childbirth to prevent excessive bleeding from the uterus. So while these drugs are available in the market, the dosage determines whether they're being used as abort efficients or they're being used for other indications. So it would not be that the company can actually stop, making these drugs if there is a ban, because there are other potentially lifesaving indications for all of these drugs.

Mike Disabato:

So does that mean that they're not under political pressure to comment on Roe versus Wade or comment on the drugs that they make? Do you think they're under any pressure at all due to the possible overturn of this landmark law in the US about abortions?

Namita Nair:

Again, that would be a very tricky stance for a company to take, given that these drugs do not account for more than one person of the total revenues that a company makes in a year on average, in most cases being less than half a percent and to take a political stance in this matter, might not be in the company's interest because it's not just for one indication and it's not just an abortion drug. There are many other indications for which these drugs have been approved. So it wouldn't be that a company's significant revenues are being shut down by because of the political climate around these drugs and usually companies, they tend to lobby around things like the market for a drug prices and the sort of reimbursements that they have to get from Medicare and mediclaim.

Mike Disabato:

Keeping with State disclosures, let's move to sovereign bonds and how they are unique in showing how the risks of climate change may manifest for our governments and our economies. Sovereign bonds are issued by a government treasury to finance government programs to pay down old debt, to pay interest on current debt and any other government spending needs. And like a company, the interest rate that an investor gets when they purchase a sovereign bond is dependent on the health of that country's economy showing how a country's debt it's GDP and it's possible inflation may impact its ability to pay back it's bond holders in the future. This is what sovereign bonds and bonds in general can tell you. For example, the 10 year German sovereign bonds are some of the most secure and have the lowest interest rate payments that are under 1%.

Mike Disabato:

Argentina, which is unfortunately dealing with a host of economic issues, has the highest at almost 50% sovereign bonds can be a bellwether of a government's health and anyone that owns fixed income, let's say in your 401k, for example, owns a ton of sovereign bonds because of their safety. Most governments, aside from the very troubled, don't just fail to pay back their debt holders, but can climate change disrupt that norm specifically can physical climate risks and transition risks. The latter of which is the movement toward a low carbon economy affect a government as seen through the lens of their bonds? To answer that I call my colleague Bhaveer Shah who helps run our sovereign bond risk models. And I asked him first, what did sovereign bondholders see as the bigger current risk physical risks or transition risks?

Bhaveer Shah:

Yeah, so for sovereign debt holders, physical risk is actually the more intuitive concept to think about. It's a pretty one directional risk for a country in the sense that let's say having natural disasters or regions are just no longer economical or becomes a greater risk in a country servicing back its debt. So it's usually a fairly straightforward issue where it's bad for most sovereign bonds and most sovereign debt holders don't of course like the idea of physical risk on their portfolios, but the trouble is that unlike in equities bonds have varying majorities. So let's say a 10 year sovereign bond is being held and the physical risk might not actually directly apply to that bond over its lifetime. So some investors do question the case of how relevant physical risk is going to be on, let's say a bond maturity for a sudden bond expires before that risk takes place. It still matters, but it's more a risk that let's say materializes when that bond rolls over rather than perhaps have the lifetime of that duration.

Mike Disabato:

So basically it's when a possible natural disaster could come and completely impede government's ability to run itself. By the way, Bhaveer mentioned duration there. it's duration is a measure of interest rate risk. It's the years it will take the lender of cash to receive that same amount of cash back and interest rates. And if a country's interest rate changes due to say a natural disaster, then a bond with a long duration is going to go down in value, especially if that natural disaster happens during that bond tenure, those risks are a bit easier for us to model though, is what Bhaveer is saying. The scenarios are disturbing of course, but more understandable for bondholders. What is more esoteric is transition

risks, their transition risks for individual companies that we've talked about often, for example, if an oil and gas company doesn't transition away from fossil fuels, they may be left with massive regulatory burdens when governments enact regulation to curb carbon emissions, but then there are transition risks for countries.

Bhaveer Shah:

So when you have transition risks for a company, there is in theory, a government that applies a tax or title regulation onto companies, and that then translates into higher costs. But when you think about it for a country, there isn't really another policy maker that's going to apply that same level of regulation upon a country. So transition risk for countries is a little bit different and it's all about the cost or the benefit of that low carbon economy, the pain, the investment, the debt industries, and new industries that come with that transformation. So for sovereign, debt holders the way they think about the transition risk is about two things really. First is the amount of debt that is added onto a country's pile in order to transition. And essentially there's very few answers on that or any quantification on how sovereign debt order should be thinking about that.

Bhaveer Shah:

The only silver lining seems to be that some of what governments say invest domestically could be reconnected back as let's say, tax revenues. But the second questions are some debtholders focus on when thinking about transition risk is what happens to GDP. So is there a negative effect, a positive effect, when does that happen? And now we do have some tools to actually look at this. So the central banks use specialist, climate macroeconomic models that use scenarios to think about how countries behave in different scenarios. And the conclusion seems to be that GDP actually appears relatively modest in its sort of downside risk when countries start to decarbonize early, but those costs tend to show up quite quickly. The longer that decarbonization is delayed because renewables don't just come online overnight and playing catch drop is quite costly, but essentially the quantum modeling is telling us, at least so far that sovereign debt holders should not just worry about the costs of let's say adding onto a government's debt pile, but also worry about countries which are delaying carbonization, because that will raise the cost even further.

Mike Disabato:

So GDP isn't really a cause for concern for investors, when a government begins to transition to a low carbon economy, but the debts that countries incur due to borrowing for building new energy systems based on renewable energy, for example, will have to be paid attention to that is especially true. If a government waits to transition it's economy, if it engages in what is technically called a delayed transition scenario, which says that global annual emissions won't decrease until 2030. And then when that happens, we really need to put the herd on ourselves to limit warming to below two degree Celsius, to avoid catastrophic climate change.

Mike Disabato:

So here's where it gets a bit wonky because on the one hand, it seems pretty obvious. We should just transition right away. No questions asked, but on the other hand, what our sovereign bond climate risk models seem to show us is that if we transition our economy haphazardly, we could get higher inflation, which I know, I know we have all heard enough about inflation, but just remember that everyone hates inflation because a) it can raise the prices of the most visible parts of our economy, food, gas, and electricity, for example, and b) it can be hard to pinpoint where it's coming from. So it can be used as either political football or just a general stressor. But Bhaveer's going to explain a bit more here, but in this sense, bond holders are like everyone else. When inflation occurs, they see red.

Bhaveer Shah:

So where it gets more complicated is that decarbonization is not cost free for an economy in that it actually generates inflation. So it's almost paradoxical. What also hurts sovereign bond holders is that pathway of let's say, higher investment, a higher change in economy leading to let's say, higher inflation and then higher interest rates a bit like what we are seeing right now, where it just makes sovereign bonds less attractive to investors. So for sovereign bond holders, there really is a trade off between wanting to let's say, hold countries that are decarbonizing early, because the cost to let's say GDP of that transition are lower compared to holding those same countries when they start that transition later, versus also experiencing inflation almost that immediately once that economy starts to decarbonize, which tends to be quite negative for sovereign bonds. So the speed spot is really finding economies that are decarbonizing early, without generating too much inflation in the process.

Mike Disabato:

A correct thought in hearing this would be well, the meltdown of our ecosystem is more important than worrying about inflation, but another correct thought is thinking about what higher inflation can mean for lower income individuals or for the general ability of a government to stay in power and continue on a path of decarbonization. It reinforces the importance of clear communication and orderly transition by a government for trying to move away from high emitting systems. And there are some governments that are failing to do that. Take Australia, for example, according to our data, Australia has some of the highest sovereign warming potentials of anyone out there, meaning they aren't really doing much to lower their carbon footprint. They are right up there with Kuwait and Qatar. And in 2021, there was an assessment of 60 countries released at the global climate summon in Glasgow and Australia's government was ranked last in it's policy response.

Mike Disabato:

Remember Australia is a major coal exporter, so that shouldn't surprise you. They're not really doing much, and they don't have policies to do anything in the future. So far, most exposed country, worse management of that exposure means that there might be trouble brewing for their sovereign bonds and their state in general. It also means that they might be heading for a political unrest when they realize that not doing anything is not a viable option and they try to react and they have to react too quickly and they get a situation like what we saw in France with the yellow vest protests.

Bhaveer Shah:

So, I guess some of the messages which are coming out from all of this macroeconomic modeling of climate change are the decarbonization is not free. And that there is no free lunch and that's a really simple concept and we all know it at the back of our heads, but it really hits home when you have that message, let's say, inflation could be, or greenflation could be this kind of theme that does start to intensify more and more as we go deeper into this disorganization journey. And as we've sort of seen recently, some of those themes in some countries let's say in France have mixed reactions in the public.

Bhaveer Shah:

What we've seen is that inflation trends, which are linked to let's say energy prices are having mixed reactions in the public and in turn having even political consequences. And that is a cycle. And the extent to which let's say public support is going to remain for decarbonization, depends on how well policymakers, not just monetary policymakers, but government as a whole manage that inflation, there have been some speeches, but let's say ECB policy makers recently even trying to differentiate up these types of inflation, whether it's an inflation caused by higher energy prices or just an inflation resulting, let's say from decarbonization.

Mike Disabato:

Right. Having to explain inflation in a way can impede a government's ability to get stuff done. It can make people rightly question whether this or that action is actually working in their benefit, which is what is so interesting about looking at how economic models intertwine with various climate risks. They could point to asset movements yes. And are thus an important tool for investment, but they can also be a signal for how a citizenry might react to capital allocation decisions made by their governments.

Mike Disabato:

And that's it for the week I wanted to thank Namita and Bhaveer for talking to me about the news with an ESG twist. I wanted to thank you so much for listening. I really appreciate it. If you like what you heard, don't forget to rate and review us. It pushes up higher up on those podcast lists and more people can listen to us. And if you want to get me every week, get Bentley every week in your podcast medium, don't forget to subscribe and that can be your future and present and past. Thanks again and talk to you next week.

Speaker 4:

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