Sustainable Sovereign Debt: A Credible Source of Value in a Changing Macro Regime

> "We believe sustainable sovereign debt is a core source of resilient returns, particularly for investors seeking income, diversification and exposure to the long-term transition of the global economy."

David Katimbo-Mugwanya, CFA – Head of Fixed Income

Sovereign bond markets are undergoing one of the most meaningful shifts in over a decade. The era defined by low inflation, ample liquidity and minimal fiscal constraints has given way to an environment shaped by higher inflation, rising refinancing costs and increased demands on government balance sheets. While near-term policy rate expectations remain an important market driver, longer-dated sovereign pricing is increasingly rooted in fiscal credibility rather than central bank support alone.

At the same time, sustainability is becoming a financially material consideration in sovereign bond markets. The climate transition, biodiversity loss and adaptation spending are no longer abstract policy goals but determinants of medium-term growth and debt sustainability. Yet traditional ESG approaches, which are often reliant on labels or static scoring, have struggled to capture this shift. As a result, markets can misprice both the risks and opportunities embedded in sustainable government debt.

This changing landscape creates a compelling opportunity for investors. In a world of higher inflation, the most meaningful sustainability signal is not whether a bond carries a green label, but whether a government can credibly finance the transition without undermining its fiscal resilience. Sovereigns that integrate transition investment into coherent fiscal frameworks are better positioned to support long-term growth. Conversely, poorly sequenced or politically constrained transition plans can add to fiscal deficits without delivering economic returns – an imbalance that markets do not always reflect.

The macro backdrop reinforces this opportunity set. Public debt levels are significantly higher than in previous easing cycles, and refinancing costs have risen sharply. Policy divergence across the US, UK, Europe and Japan creates further differentiation in sovereign outcomes. In this environment, term premia linked to fiscal risk are unlikely to disappear, particularly at longer-dated maturity tenors. Investors who can distinguish between credible and less credible fiscal trajectories can unlock attractive relative-value opportunities across curves and geographical regions.

From a valuation perspective, sovereign bonds increasingly offer compelling compensation relative to other fixed income assets. Credit spreads remain historically tight, offering investors limited premium for taking on corporate credit risk, with government bonds offering stronger relative value. Markets are yet to fully distinguish between sovereigns that embed credible climate-transition strategies and those where sustainability commitments remain largely aspirational however – a gap that creates opportunities for selective, research-driven investors.

When it comes to portfolio construction, a disciplined, flexible approach to sustainable government bonds is key. Focusing on short-to-intermediate maturities whilst enhancing carry can help manage volatility. We also believe longer-dated exposure should be concentrated in issuers with demonstrable fiscal discipline and credible transition execution. Above all, sustainability should function as an input to sovereign risk pricing, not a parallel constraint.

In the next phase of the cycle, we believe sustainable sovereign debt is not a niche allocation but a core source of resilient returns, particularly for investors seeking income, diversification and exposure to the long-term transition of the global economy.

edentree | Sustainable investing. Elevated.