

Convertible bonds: an asset class set to shine in the post Covid-19 world



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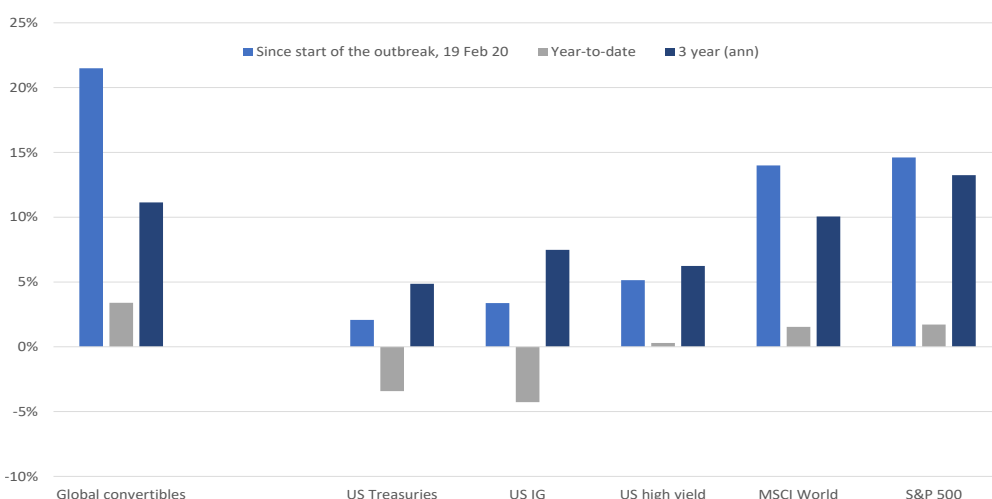
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- Convertible bonds have outperformed most equity and credit markets so far in 2021 and notably since the start of the Covid-19 crisis (see chart below). They seem the perfect asset class, in our view, to help investors navigate the post-pandemic world over the next few years.
- We believe the on-going reflation theme + historically low rates + elevated volatility makes the asset class more attractive than ever versus traditional credit or equities.
- The Covid-19 crisis has triggered a structural change; the recent wave of new issuance has set the convertible bond universe on a positive trajectory.
- We expect the market environment to remain highly favourable for convertible bonds in 2021 with an increasing number of businesses using them as a financing tool. This in turn should attract more investors to the asset class. We believe convertible bonds are changing status from a 'nice to have' allocation to 'can't be ignored'.

ASSET CLASS COMPARISON (TOTAL RETURNS IN USD)



Source: Bloomberg as at 28 February 2021

When volatility is elevated, convertible bonds tend to outperform

'Uncertainty' seems to be the word most commonly used these days to describe financial markets. Much of this is fuelled by speculation around monetary policies, which have become key drivers of financial asset performance. Fiscal policies have also become essential in supporting developed-market consumers. A key question for the coming years is how much additional stimulus can be pumped into the system, considering the unprecedented rise in government and corporate debt. Also, too much stimulus could push inflation and inflation expectations higher, leaving policymakers with the unusual task of supporting the recovery while re-assuring markets on their ability and determination to contain inflation. Overall, it seems likely that political uncertainty will remain close to the highs reached in 2020 (see chart 1 in the appendix).

Uncertainty is a source of volatility for financial markets and therefore we expect realised volatility for equity markets to remain elevated. We would argue that the Covid crisis has acted as a trigger to a higher-volatility regime. We note that the VIX index – one of the most commonly used measures of volatility – remains well above the 20% level, despite the recovery in risk assets.

We are firm believers that volatility can be a powerful driver of outperformance of convertible bonds. As short-term instruments, convertibles tend to be less sensitive to a widening in credit spreads traditionally associated with a rise in volatility. We saw this mechanism fully play out in 2020, which explains the outperformance versus other credit asset classes.

The downside protection offered by convertibles through their bond component also makes them potentially attractive to equity investors who want to avoid large drawdowns typical of volatile markets (see chart 2 in the appendix).

In a low-rate environment, convertible bonds give fixed income investors the chance for capital appreciation

Another theme that we believe will drive markets in the coming years is persistently low interest rates. As an illustration, the US Federal Reserve's latest policy statement was interpreted by the market as ruling out any rate hike before 2023 at the earliest. As chart 3 illustrates, the level of yield has historically been a good

expected measure of forward performance for bond indexes. In the current environment, traditional fixed income investors are contemplating historically low levels of absolute returns in the coming years. They are also facing the risk of negative performance in the case of rising inflation expectations.

Convertible bond performance is not driven by the yield component but by the capital appreciation from the underlying equities. Therefore, expected returns are not constrained by the low-rate environment. In addition, the current developing inflation theme should benefit equity markets and therefore convertibles bonds.

Simply put, convertibles are a fixed income asset class that offers investors significant appreciation potential even in the current low-rate environment.

The Covid crisis has exposed the weakness of the old economy: convertible bonds enjoy a new economy bias

The mass adoption of home working has accelerated the move to a digital economy. As such, we have seen a disconnect between 'new economy' businesses outperforming and 'old economy' companies lagging. Following the shock of March 2020, market participants have integrated structural changes in their expectations and forecasts. The data (see chart 4) suggests to us that the divergence between the old and new economies will remain a key driver of markets after the pandemic. Convertible bonds are biased towards new-economy, high-growth sectors; we think this bias will continue to drive outperformance for investors over the medium term.

The asset class remains attractively priced

A common approach to judge the appetite for the asset class and recent flows is to measure the fair value of the embedded equity option. In chart 5, we can see that the options embedded in convertible bonds seem historically cheap, suggesting that the asset class is underowned by market participants. This indicator is consistent with our view that despite the recent positive performance, the asset class has not re-rated yet. We think that most investors were caught off-guard by the March 2020 sell-off, did not rebalance their portfolios in the subsequent bounce and are only now starting to reconsider their asset allocation mix. We think convertibles should benefit from these reallocation flows in the coming months.

Opportunities for investors

Convertible bonds have seen a large wave of new issuance since March 2020. They are favoured instruments for tech and new-economy companies to finance their expansion plans. They also help businesses directly affected by the pandemic to refinance while limiting the debt impact on their balance sheets. These new issues have presented significant opportunities to investors, fuelling the positive performance of the asset class in 2020.

We expect issuance volumes to remain healthy in 2021 with many new companies coming to the market to raise financing. As shown in chart 6, the rise in primary

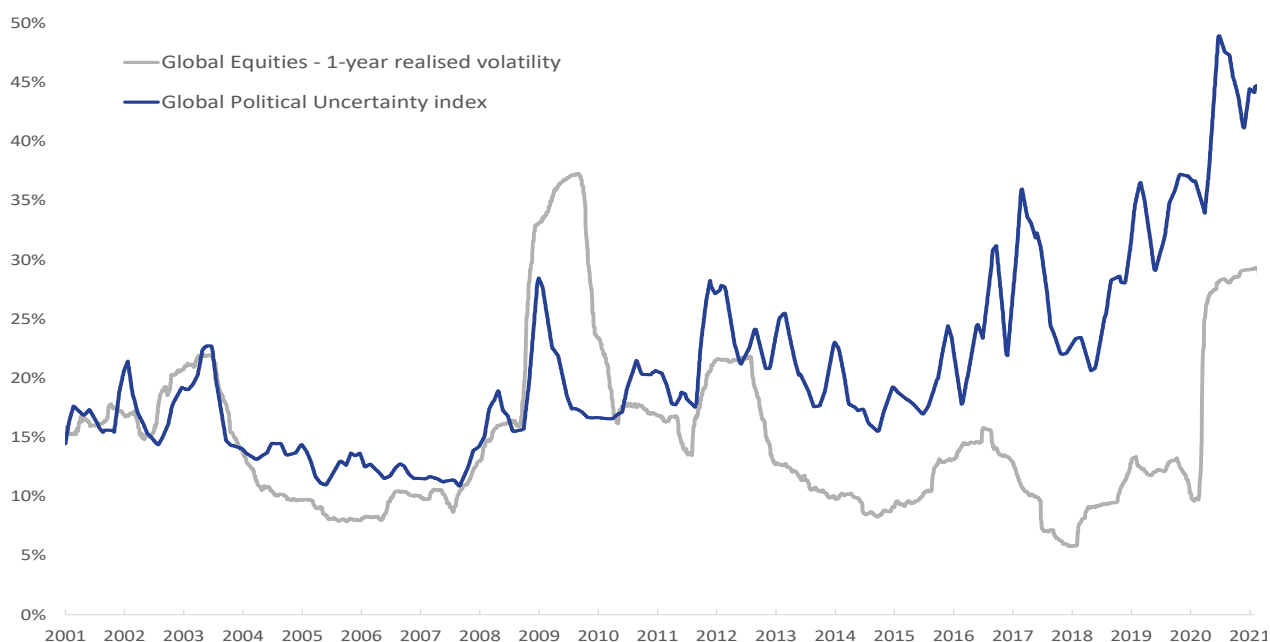
issuance has been driven by the US; we expect a pick-up in Europe and Asia in the coming months. We anticipate these new issues will offer opportunities to investors and aid asset-class outperformance.

We believe the Covid crisis has triggered a structural change for the asset class which is now on an expansionary trend. As more businesses understand how to use convertibles for financing and more investors see the benefits of the asset class, the market capitalisation should continue to grow (see chart 7). In turn, this could change the perception of the asset class with large allocators and institutional investors from 'nice to have' to 'can't be ignored'...we would even argue it could become a 'must-hold'.

CHART APPENDIX

CHART 1

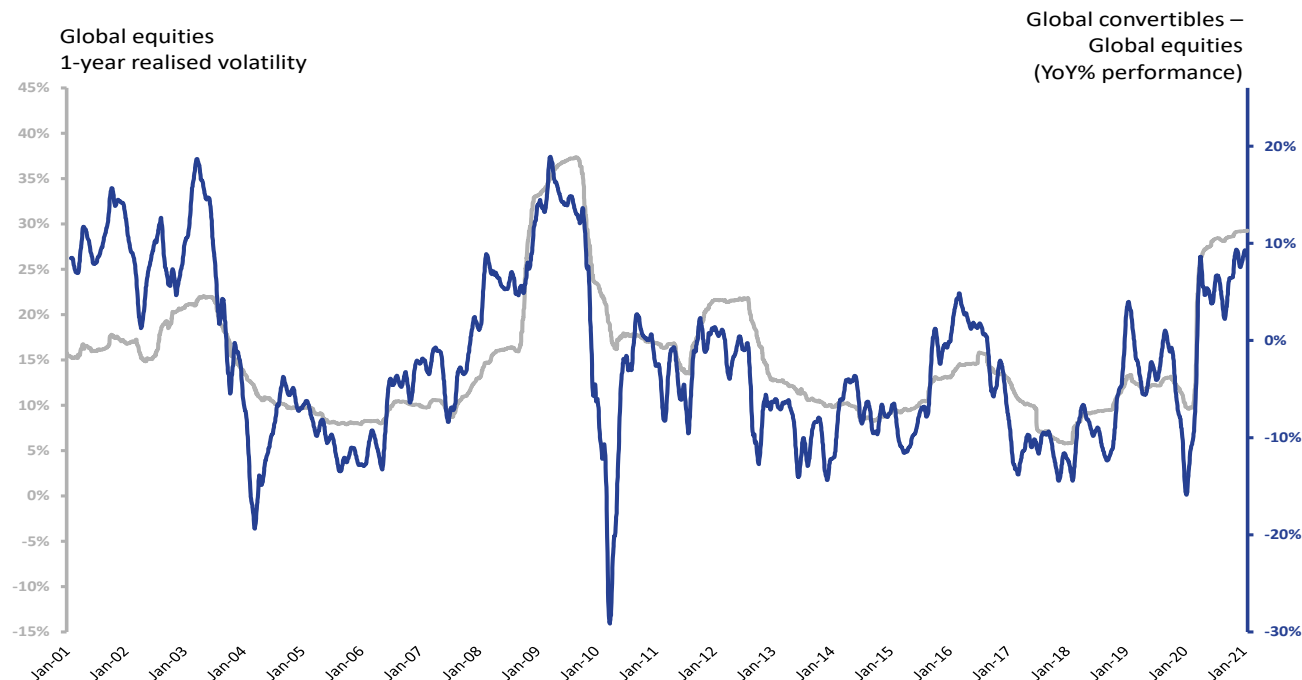
This chart highlights the historical relationship between the Global Political Uncertainty Index – a widely followed gauge of uncertainty – and the realised volatility of global equities. Up to 2011, the two time series were very closely linked. In the years after, the gap widened with volatility reaching very low levels (well below 10%). We see the Covid-19 crisis as a trigger to a higher-volatility regime more consistent with the record-high levels of political uncertainty.



Source: Bloomberg (global equities represented by the MSCI World Index in USD); Baker, Bloom & Davis; BlueBay. Data as of 28 February 2021.

CHART 2

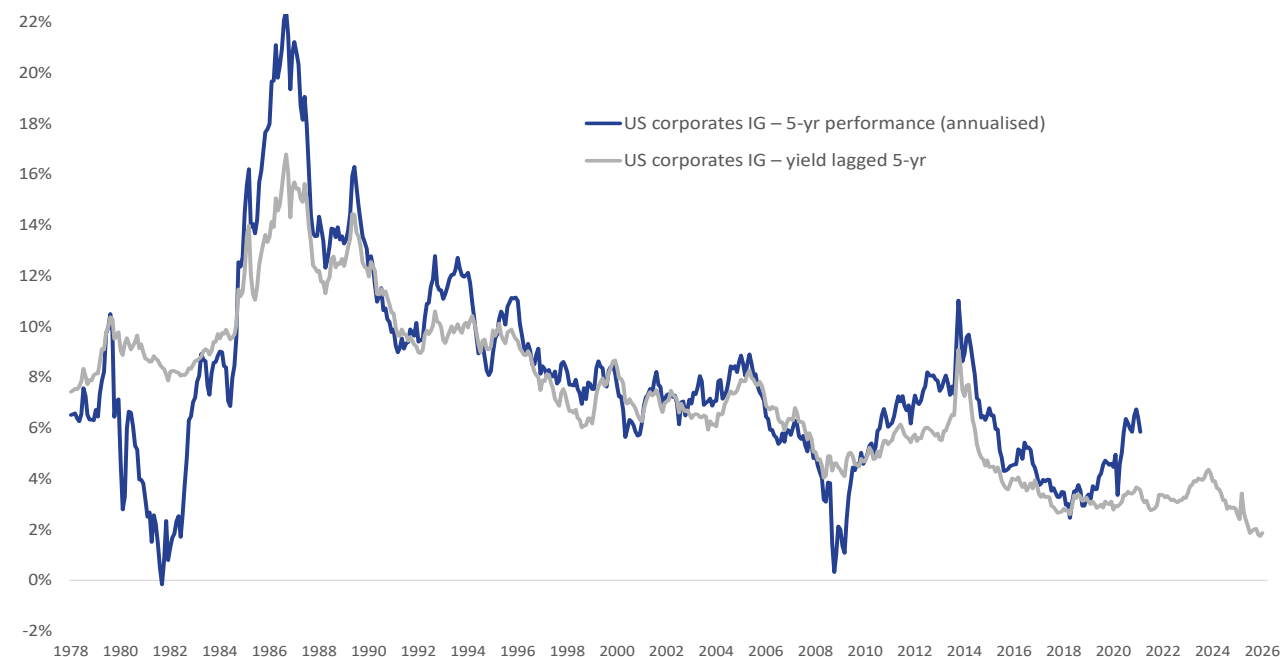
Here we highlight the historical relationship between the realised volatility of global equities and the outperformance of convertibles over equities. In periods of elevated volatility, convertibles tend to outperform equities. This relationship was accurate in predicting the outperformance of convertibles versus equities in 2021.



Source: Bloomberg (global equities represented by the MSCI World Index in USD); Refinitiv Global Convertible Focus Index in USD; BlueBay. Data as of 28 February 2021.

CHART 3

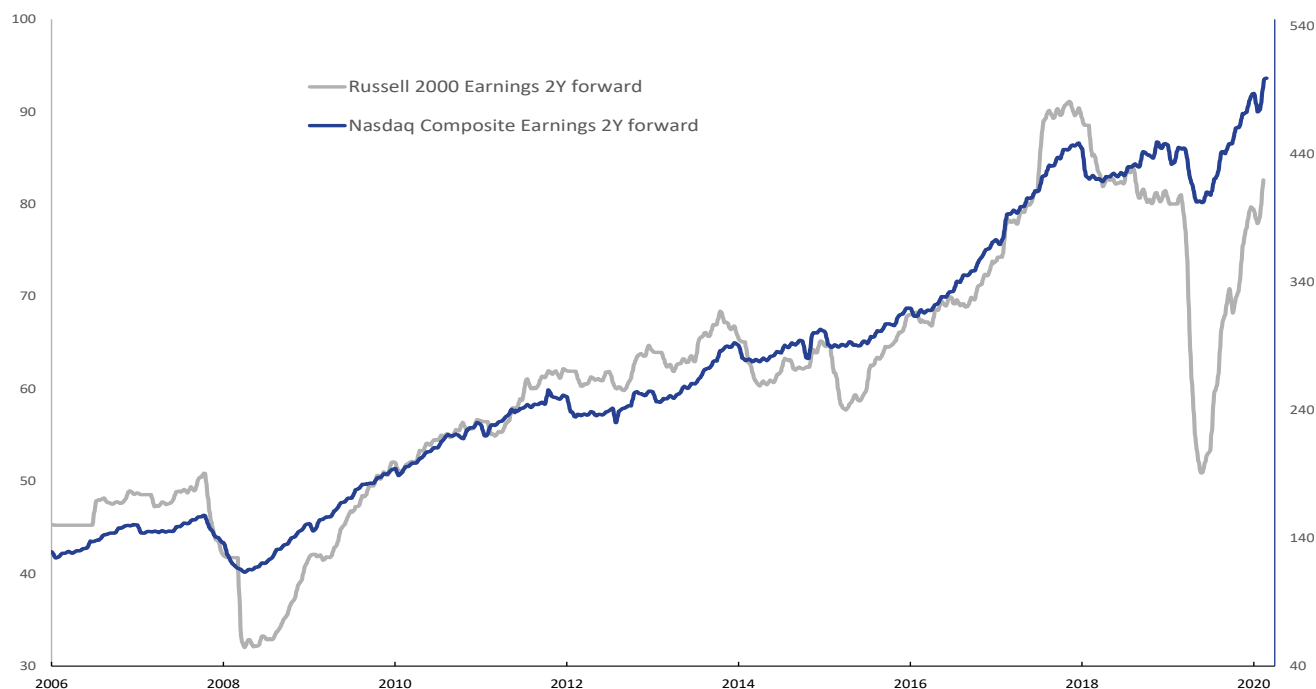
In line with basic bond maths, the yield of investment grade corporate bonds may be a good predictor of the average annual return of the asset class. In this example, we used a fixed five-year time horizon. The yield of US investment grade is at historical lows, suggesting that investors’ return expectations should also be at historical lows.



Source: Bloomberg (Bloomberg Barclays US Corporate Bond Index). Monthly data as of 28 February 2021.

CHART 4

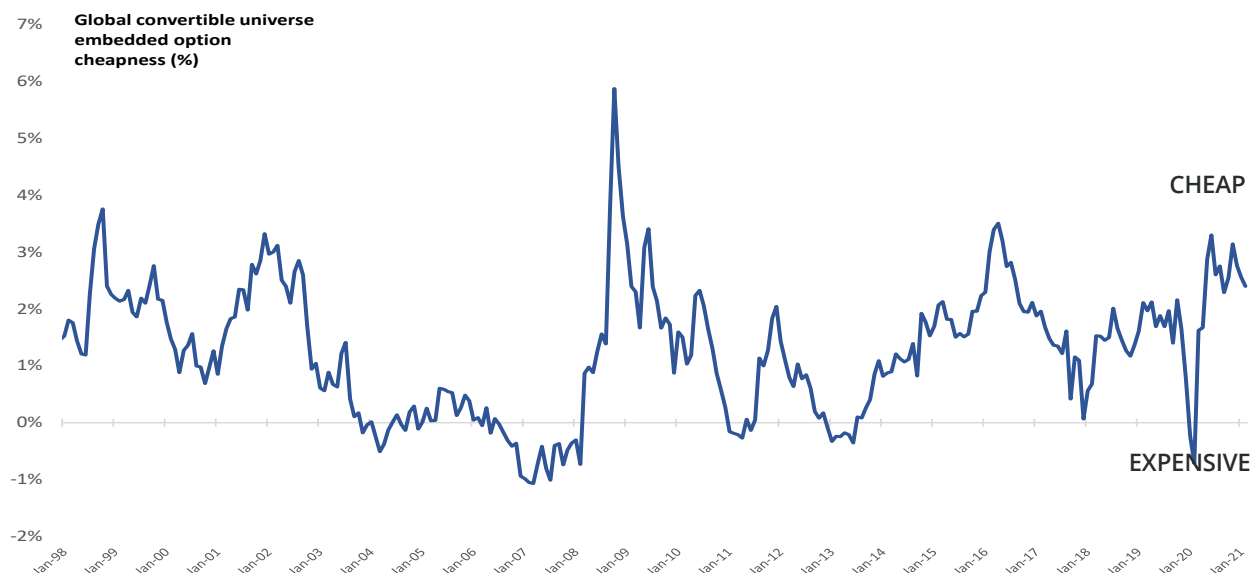
The Russell 2000 is one of the most widely followed small-cap indices in the US. It is often considered an ‘old-economy’ index. The NASDAQ index is the most widely followed ‘new-economy’ index. Historically, there was a robust relationship between the evolution of the two-year forward-expected earnings for the Russell 2000 and the NASDAQ. This relationship seems to have broken down somewhat following the Covid-19 crisis. Forward earnings for the NASDAQ made new highs early on in 2020, suggesting a moderate impact from the current recession. However, the Russell 2000 forecasted earnings suffered a historically sharp correction and, despite the recent remarkable recovery, are still some way off their highs. We expect that old-economy companies will struggle to fill the gap with new economies in the post-Covid world.



Source: Bloomberg (Bloomberg bottom-up analysts survey estimates); BlueBay. Daily data (smoothed over 10 days) as of 28 February 2021.

CHART 5

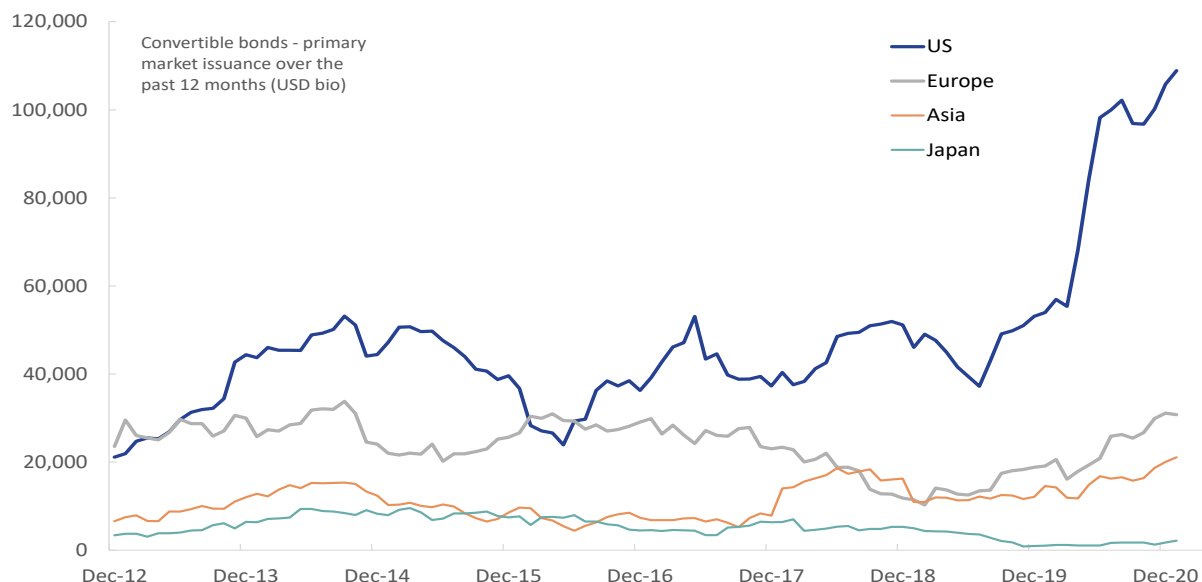
This chart shows the historical average deviation of fair value prices from quoted prices for the global convertible bond universe. Fair value prices are calculated by assessing the embedded option part of each convertible bond instrument after stripping out the fixed income and equity components. This chart highlights the fact that convertible bonds’ embedded options seem cheap in our view, suggesting that the asset class is under-owned by market participants.



Source: BoA Convertible Research, BlueBay. Monthly data as of 28 February 2021.

CHART 6

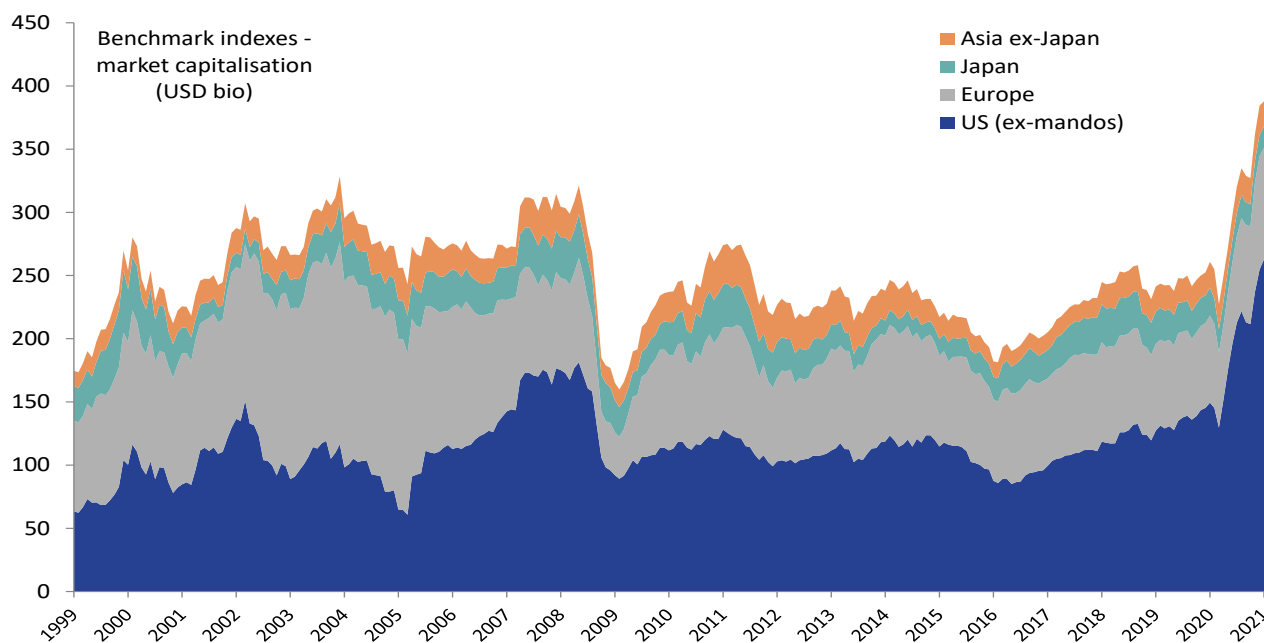
The wave of new issuance that followed the Covid-19 outbreak has been noteworthy by historical standards. Although the bulk of the issuance so far this year has been in the US, the primary markets in Europe and Asia have started to pick-up in recent months.



Source: BofAML convertible research team; BlueBay. Monthly data as of 28 February 2021.

CHART 7

The Global Financial Crisis of 2008 acted as a significant negative catalyst for the market capitalisation of global convertible bonds. At the time, companies stopped issuing and the primary market dried up, restricting the opportunity set for investors. In a completely different fashion, we believe the Covid-19 crisis of 2020 has acted as a positive catalyst. The primary market is active and the market capitalisation of the asset class is expanding, driving renewed interest from issuing corporates and investors.



Source: Refinitiv indexes; BlueBay. Data as of 28 February 2021.

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