



Global Asset
Management

Convertible bonds: an asset class to own when volatility picks up



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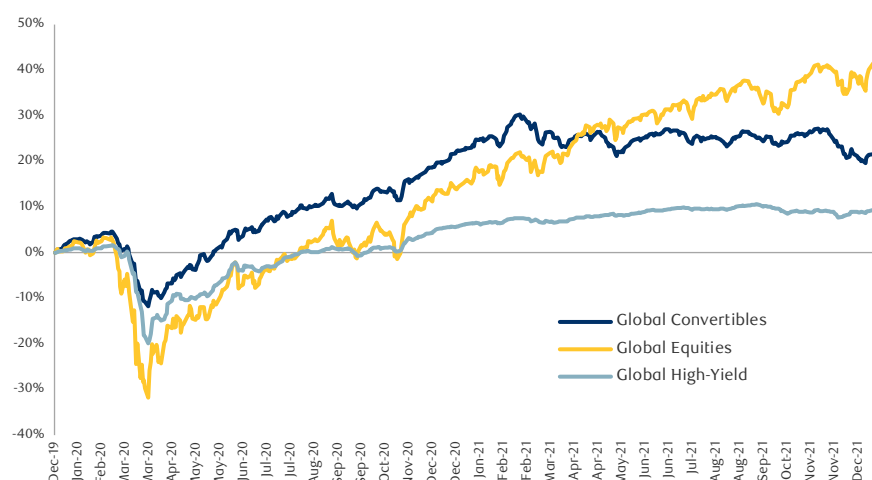


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- Slowing growth, sticky inflation and a hawkish Federal Reserve (Fed) make 2022 a potentially tricky year for investors.
- We believe hybrid asset classes like global convertible bonds should be favoured in such an environment to manage risk and increase diversification.
- As a result of this rather challenging macroeconomic backdrop, we expect volatility to pick up. A rise in volatility has historically been a driver of outperformance for convertible bonds.
- We expect some of the technical headwinds experienced by the asset class in 2021 to vanish. This should drive a catch-up in performance.
- Key areas of investment opportunities that we foresee for our strategy in 2022 are: Asian convertible bonds, overlooked or misunderstood ESG-specific opportunities and primary market issues.

Asset class comparison (total returns in USD)



Source: Bloomberg as at 31 December 2021.

Global convertibles: 2021 was a transition year

2020 was a great year for global convertibles; 2021, not so much. Looking at those two years together (see chart on page 1), global convertible bonds have offered better returns to investors than global high-yield and have managed to capture a large portion of the equity upside. The medium-term argument for allocating to the asset class is still in place.

The relative underperformance of global convertible bonds in 2021 is explained by the divergence in the regional and sectoral breakdown between the convertible bond universe and the main equity indexes (see chart 1). 2021 was a year when US large cap stocks outperformed with a narrow market breadth. Logically, global convertible bonds struggled, being highly diversified geographically (only around 50% in the US) and mainly exposed to mid and small caps. Our view is that as the Fed hiking-cycle gets closer, equity markets should move more in sync across regions and sectors and US exceptionalism should be challenged.

What to expect for 2022? Volatility!

Macro outlook is likely to be challenging for most financial assets

The market consensus for 2021 is for growth to remain solid but to decelerate, for inflation to be sticky and for a hawkish Fed. The combination of all three factors makes it challenging for most financial assets, especially traditional fixed income. From a fundamental perspective, it seems to us that equities remain attractive on a relative basis, since corporate earnings can continue rising. Corporate margins are high and have some buffer to weather the rise in inflation (see chart 2).

Valuations are stretched for most assets

Many market participants are pointing to expensive equity valuations across a set of traditional metrics. We agree, although we note that this view is in fact quite specific to US large cap equities. In other regions and sectors we see pockets of equity undervaluation.

Valuations for traditional fixed income assets are stretched, as long-term rates and credit spreads remain close to historical lows. The low level of all-in yield for many fixed income assets is putting a cap on expected returns for these asset classes (see chart 3). Diversification away from pure duration and carry plays is a major theme for fixed income investors. Hybrid asset classes with low effective duration that can offer price appreciation independent of yield compression – such as convertibles – should be favoured.

We expect volatility to pick up: a favourable environment for convertibles

A challenging macro background and stretched valuations are a natural backdrop for volatility to pick up. In addition, history suggests that as the Fed hikes rates and liquidity is removed, volatility gets pressured to the upside (see chart 4). Higher volatility and risk aversion have historically created a favourable environment for convertible bonds. This is the key reason for our positive outlook for the asset class. Maintaining some equity exposure with a lower volatility seems an attractive proposal for investors in 2022 – this can be achieved by investing in convertibles (see chart 5).

Where we see opportunities

Asian convertibles: a promising potential combination of yield and cheap optionality

Asian convertible bonds saw some significant moves on the back of the tech regulatory squeeze in China. This has created some dislocations and attractive opportunities for convertible bond investors. We hold the view that those regulatory developments are likely to cap equity returns but are not aimed at bankrupting the tech sector in China. Therefore, the level of yield on offer in some convertibles can be highly attractive – especially as the conversion options are mostly priced out and offered at cheap levels to investors (see chart 6). In our view, some of our best prospects come from that segment of the market.

More ESG differentiation in 2022 should favour our process

ESG-orientated strategies have attracted extraordinarily large flows in the past few years. This has created some distortion in pricing for financial assets most exposed to ESG thematics. At times in 2021, it felt that some of the ESG or “green” buying had been indiscriminate. This led to pockets of overvaluations in some low-quality businesses, while other companies with improving ESG fundamentals were valued cheaply. Because our ESG process reaches beyond current risks to also analyse changes in ESG profiles, it will help us identify these opportunities.

We expect the primary market to be active and drive a sector rebalancing

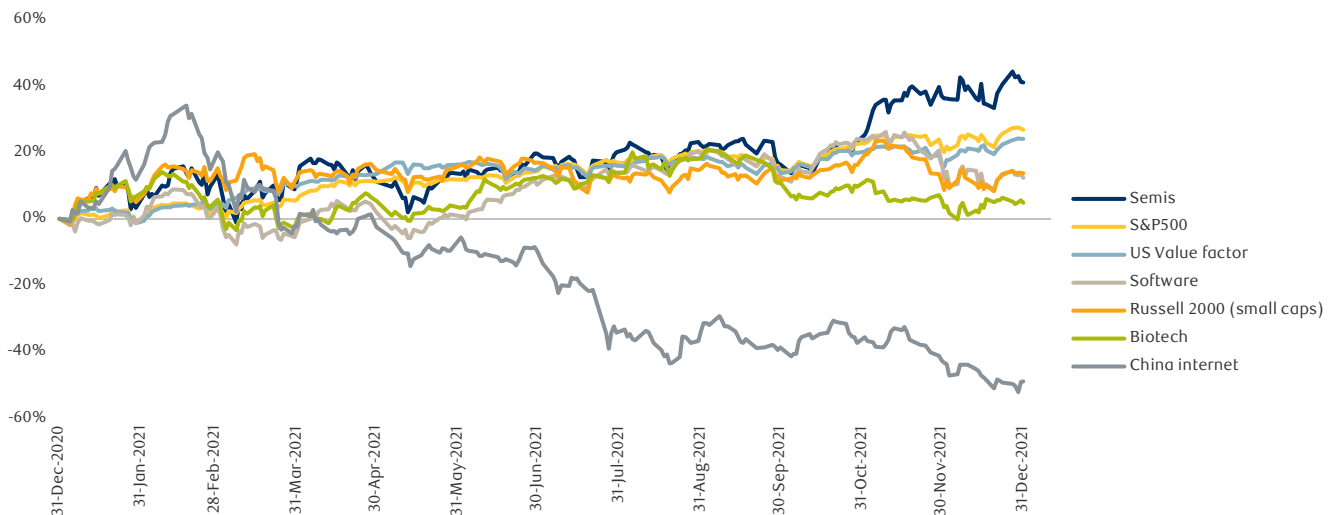
The primary market in convertibles was active in 2021, with the US and Asia leading the way in volume of issuance (see chart 7). The market cap of the asset class continues to expand, helping to attract investors and create opportunities for security selection. We expect to find many opportunities in the primary market. In the past, the dynamics of the primary market helped rebalance the sector profile of the universe. We expect a similar pattern in 2022, with a larger portion of issuance from the value space beyond the tech sector.

Chart Appendix

Chart 1

US large caps' 2021 performance

This chart shows the 2021 performance (price appreciation without dividends) of some of the most important US equity sectors for the convertible bond universe. US large caps – represented by the S&P500 – were among the best performing sectors. The bias of the convertible bond universe towards software and bio-tech was a clear source of underperformance. Chinese companies listed in the US have large convertible bond issuance outstanding. The fact that their stocks saw a fully-fledged bear market in 2021 was a key source of underperformance. The dispersion in terms of performance across those sectors is striking.

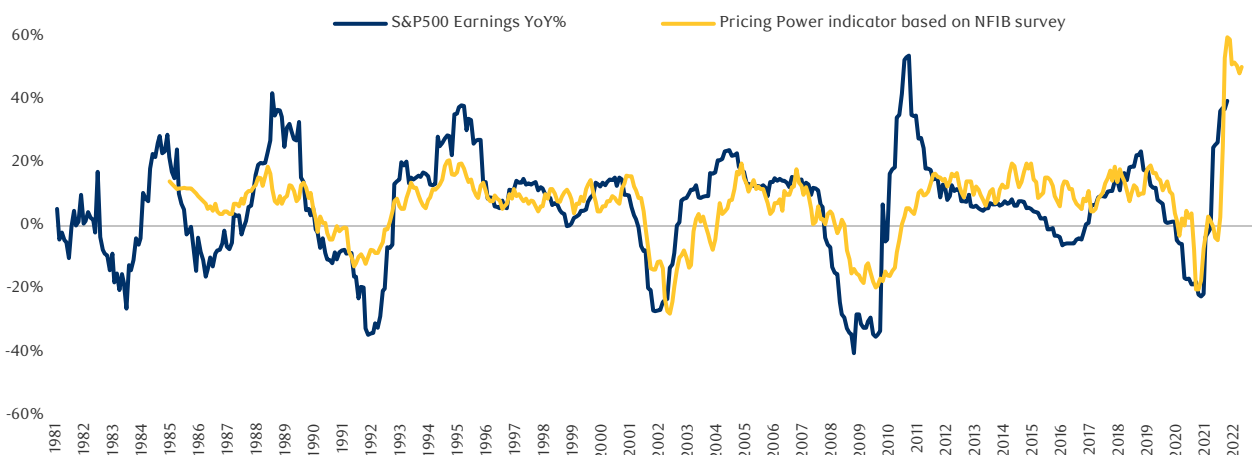


Source: Bloomberg. Daily data from 31 December 2020 to 31 December 2021. Indexes used: S&P 500 (SPX Index); Philadelphia Stock Exchange Semiconductor Index (SOX Index); MSCI US Value (MVUDUS Index); S&P North American Expanded Technology Software Index (SPNASEUT Index); Russell 2000 (RTY Index); ICE Biotechnology Index (ICEBIO Index); CSI Overseas China Internet (H11137 Index).

Chart 2

US companies' pricing power vs. S&P earnings

We developed our own indicator for pricing power for US companies based on the NFIB Small Businesses survey. At present our index suggests that despite the sharp rise in inflation, the pricing power is very strong as corporates can pass through price increases faster than they raise wages. As can be seen in the chart, the relationship between S&P earnings and this indicator has historically been strong and seems to indicate that earnings will remain strong in the coming months. This argues for investors to continue to favour equities vs. rate-exposed fixed-income assets.

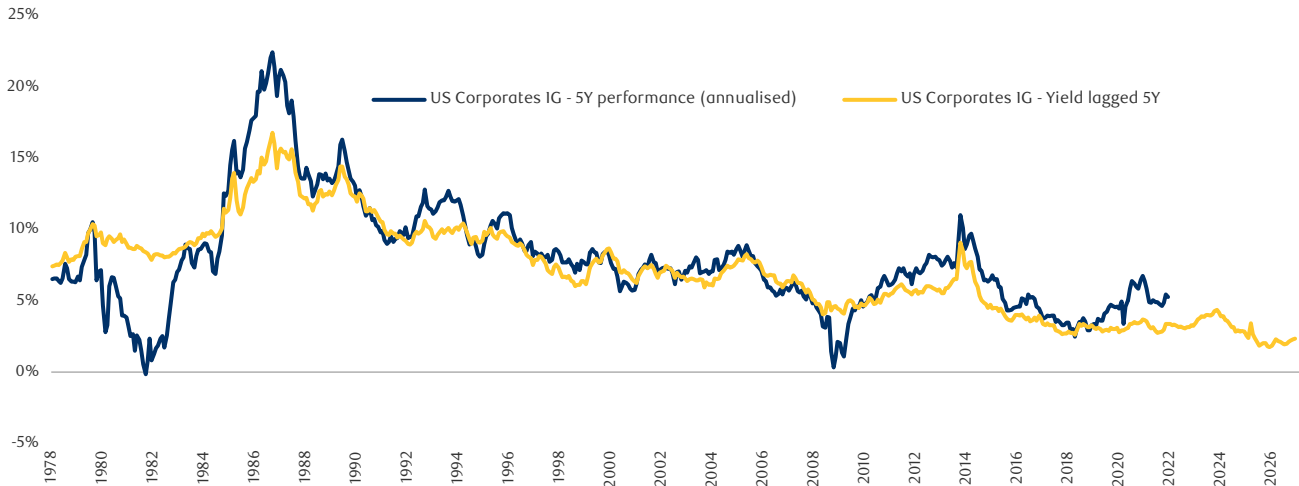


Source: Bloomberg. NFIB survey, BlueBay. Monthly data from 31 March 1980 to 31 December 2021. Pricing power indicator is calculated as $\text{NFIB Jobs hard to get} \times [1 + (\text{NFIB plans to increase prices} - \text{NFIB compensation})]$.

Chart 3

US investment grade (IG) corporate bonds – yields and average returns

In line with basic bond maths, the yield of investment grade corporate bonds can 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 IG is at historical lows, suggesting that investors' return expectations should also be at historical lows. This leads us to believe that diversification away from pure duration and carry plays will be a key theme for fixed income investors in 2022.

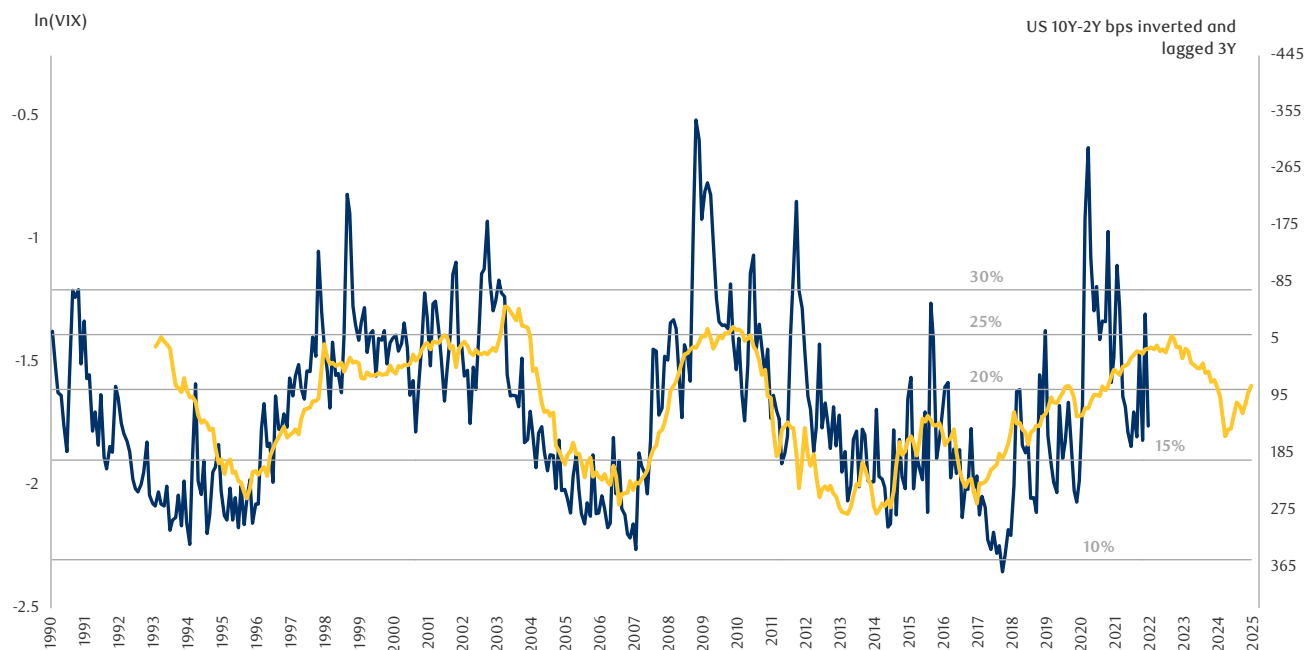


Source: Bloomberg (Bloomberg Barclays US Corporate Bond Index). Monthly data as of 31 December 2021.

Chart 4

US rate cycle and market volatility

We highlight the long-term relationship between the rate cycle, captured in this chart by the shape of the US yield curve, and the VIX, the most common measure of market volatility and risk aversion. Put simply, a flatter curve historically indicated a period of higher volatility, whereas a flattening curve was a sign of higher volatility. Although the VIX makes for a noisy time series, the yield curve seems to capture well its long-term cyclical component. Following the change of tone of the Fed to a more hawkish stance in the last quarter of 2021, the US curve has flattened, suggesting that the VIX should stay elevated in the coming periods.



Source: Bloomberg, as at 31 December 2021.

Chart 5

Global equities' volatility vs. relative performance of global convertibles and equities

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 2020. However, in 2021, although the drop in volatility explained part of the underperformance of convertibles, we saw a further divergence. This creates an opportunity for investors from two angles. First, as highlighted before, we expected volatility to rise, suggesting an environment where convertible bonds tend to outperform equities. Second, we expect the historical relationship to reassert itself and therefore see a catch-up of convertible bonds performance.

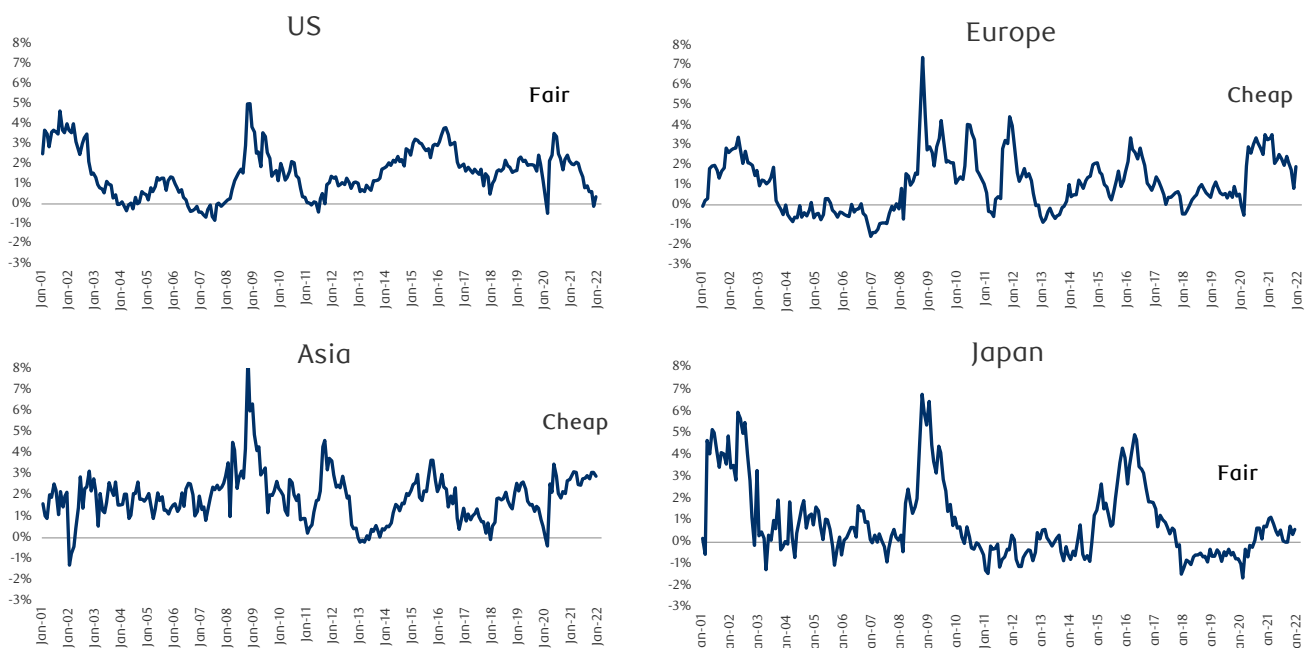


Source: Bloomberg (global equities represented by the MSCI World Index in USD); Refinitiv Global Convertible Focus Index in USD; BlueBay. Data as of 31 December 2021.

Chart 6

Global convertible bonds: fair value and quoted prices across the world

This chart shows the historical average deviation of fair value prices from quoted prices for each region of 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 particularly cheap in Asia ex-Japan.

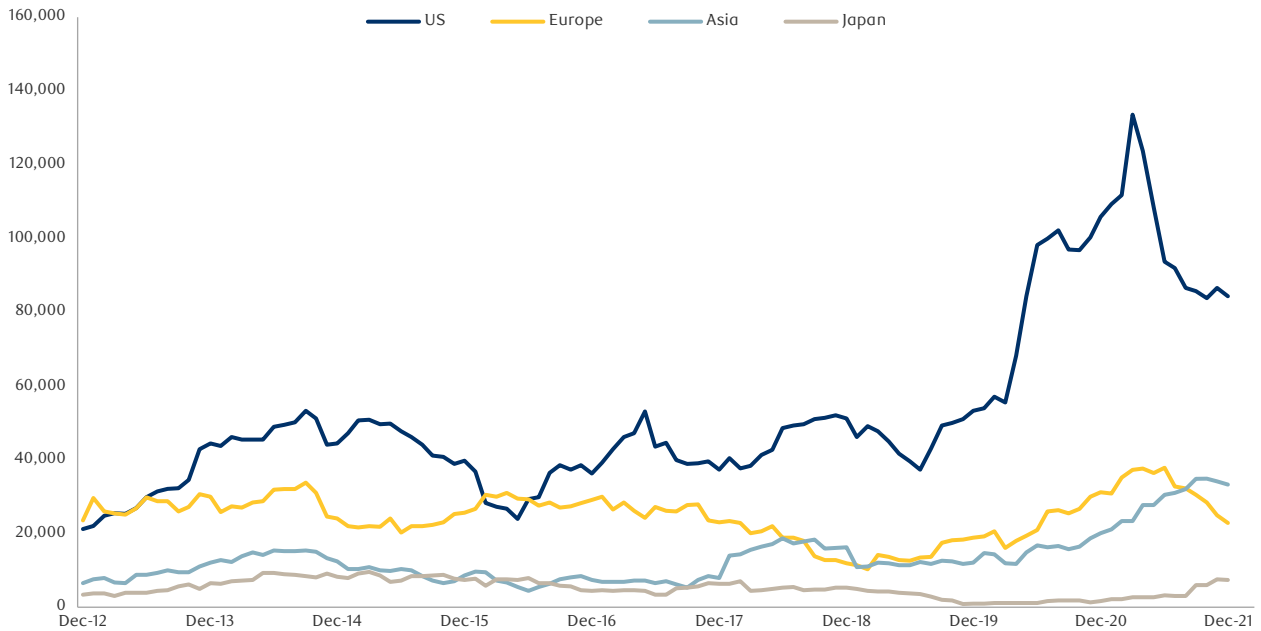


Source: BoA Convertible Research, BlueBay. Monthly data as of 31-December 2021.

Chart 7

Convertible bonds - primary market issuance over the past 12 months (USD million)

The wave of new issuance that followed the Covid-19 crisis has acted as a trigger for the US convertible market: the volume of issuance in 2021 remained elevated and almost matched 2020. We note that Asia ex-Japan has also seen a record high level of issuance in 2021. Historically, this is a strong primary market and has helped attract new investors to the asset class. We expect this to continue in 2022.



Source: BofAML convertible research team; BlueBay Asset Management. Monthly data as of 31 December 2021.

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