RBC Global Asset Management

# AT1 recovery and why fundamentals win over time

June 2023


**James MacDonald**
Senior Portfolio Manager
BlueBay Fixed Income Team



Published June 2023


> "Most bank management teams realise that investors want predictable behaviour."

**Investment grade specialist James MacDonald, BlueBay Senior Portfolio Manager, discusses how the AT1 market has progressed since the turmoil in March and what is next.**

## The 'call economics' of the AT1 market

With close to EUR10 billion worth of Additional Tier 1 (AT1) bonds with call dates over the remainder of 2023 (since the Credit Suisse debacle), many investors are questioning whether issuing banks will choose not to exercise their calls. We believe most issuers will. This is the behaviour we have seen this year, with calls being exercised even at times of elevated spreads.

Most bank management teams realise that investors want predictable behaviour, and they will be rewarded for this through tighter credit spreads across the cycle and through time. When management teams think about 'call economics', the vast majority realise that it is short-sighted to think about this on a bond-by-bond basis at a particular point in time. Further to this, we see the sector as carrying significant levels of excess capital, and this gives issuers the flexibility to call bonds and wait for more opportune market conditions to reissue, rather than to be hostage to particular periods of market volatility.

## AT1 remains an important part of a bank's capital structure

It remains attractive for banks to issue AT1 bonds as an alternative to equity despite the elevated spread levels. And while most banks have the capital flexibility to afford to be patient to an extent, we do not think this will keep them away from markets for a sustained period. On the other side, there remains significant investor demand for the asset class. European bank fundamentals are in robust shape, and this has been underpinned by record results in Q1. We would expect at current levels that new issuance would be very well received by the market, and this demand could be a catalyst for the market repricing to tighter levels and continue to recover some of the ground lost in the first quarter of the year.

> **"Our strategy is broadly unchanged. European bank fundamentals remain extremely robust. We always believe that over time fundamentals will always reassert themselves and be efficiently priced by the market."**

## The AT1 market recovery

In the short term, the secondary market seems to have absorbed the shock, even bidding up prices of AT1 subordinated debt. We have continued to see the market recovering since the shock of March and this has been against the headwinds of further issues with US regional banks, debate over the US debt ceiling and ongoing macroeconomic volatility. As these issues are worked through, we expect this will give the asset class the breathing space to recover further. While AT1 saw a setback in Q1, we believe that the risk-reward potential of the asset class remains incredibly attractive and an opportunity that investors will continue to take advantage of, over this year.

## Fundamentals win over time

The start of the year was extremely optimistic for AT1 debt. However, pressures in the US regional banks and the shock of the Credit Suisse wipeout have had a very indiscriminate impact on the markets, but we do not believe this is a dynamic that will persist. As such, our strategy is broadly unchanged. European bank fundamentals remain extremely robust. We always believe that over time fundamentals will always reassert themselves and be efficiently priced by the market.

We continue to look towards high-quality banks with clear strategies and strong fundamentals and expect with spread levels where they are that over the year the AT1 market presents an extremely attractive risk-return opportunity.

## Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

LEARN MORE

This document was prepared by RBC Global Asset Management (UK) Limited (RBC GAM UK), authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC).

In the United States, this document may also be provided by RBC Global Asset Management (U.S.) Inc. ("RBC GAM-US"), a SEC registered investment adviser. The entities noted above are collectively referred to as "RBC BlueBay" within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of RBC BlueBay by the respective licensing or registering authorities.

With respect to the investment performance presented, past performance is not indicative of future performance. Actual account performance may or will vary from the performance shown because of differences in market conditions; client-imposed investment restrictions; the time of client investments and withdrawals; tax considerations; economies of scale; portfolio turnover; the number, type, availability, and diversity of securities that can be purchased at a given time; differences in the underlying currency of the assets in the account, and other factors. Client assets managed using these strategies in separate accounts or different vehicles may be subject to restrictions, fees or expenses that are materially different than those found in the non-US funds.

This document is confidential and, without RBC BlueBay's consent, may not be (i) copied, photocopied or duplicated in any form by any means or (ii) distributed to any person that is not an employee, officer, director or authorized agent of the recipient.

Information herein is believed to be reliable but RBC BlueBay does not warrant its completeness or accuracy. This document contains information collected from independent third-party sources. For purposes of providing these materials to you, neither RBC BlueBay nor any of its affiliates, subsidiaries, directors, officers, or employees, has independently verified the accuracy or completeness of the third-party information contained herein.

The information contained herein does not constitute investment, tax, accounting or legal advice. Recipients are strongly advised to make an independent review with their own advisors and reach their own conclusions regarding the investment merits and risks, legal, credit, tax and accounting aspects of all transactions. Any risk management processes discussed refer to efforts to monitor and manage risk but should not be confused with and do not imply no or low risk. No chart, graph, or other figure provided should be used to determine which strategies to implement or which securities to buy or sell.

Copyright 2023 © RBC BlueBay. RBC Global Asset Management (RBC GAM) is the asset management division of Royal Bank of Canada which includes RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management Inc., RBC Global Asset Management (UK) Limited and RBC Global Asset Management (Asia) Limited, which are separate, but affiliated corporate entities. ® / Registered trademark(s) of Royal Bank of Canada and BlueBay Asset Management (Services) Ltd. Used under licence. RBC Global Asset Management (UK) Limited, registered office 77 Grosvenor Street, London W1K 3JR, registered in England and Wales number 03647343. All rights reserved.

**RBC Global Asset Management (U.S.) Inc.**
Minneapolis | Boston | Chicago
800.553.2143 | **rbcgam.com**