BlueBay
Asset Management

The asset class that takes inflation in its stride

PUBLISHED
April 2021

READ TIME
5 minutes

AUTHORS

Pierre-Henri de Monts de Savasse
Senior Portfolio Manager

Zain Jaffer
Portfolio Manager

As markets begin to price in higher inflation as economies return to pre-Covid norms, our experts consider how an allocation to convertible bonds can help strengthen your portfolio.

With Covid-19 vaccination programmes continuing apace in developed markets, a return to pre-pandemic conditions is coming ever closer. However, that doesn't mean the global economy can pick up where it left off in March 2020.

The substantial sums spent by governments to shore-up economies in the face of one of the biggest health challenges in a century could yet prove an issue, as inflation – which has remained stubbornly low in recent years – looks set to return.

The pandemic-induced recession was short and sharp, but as we emerge out the other side, growth is likely to rebound equally as briskly as it contracted, thanks to the unprecedented policy response. In regions that are leading the fight against the virus, such as Asia, industrial activity and exports have already bounced back. We're also beginning to see early signs of recovery in developed markets where vaccination programmes are paving the way for a return to pre-Covid conditions.

As consumers have had their usual spending habits curtailed by months of lockdowns, savings ratios have moved higher, indicating significant disposable income at hand as restrictions ease off.

Why inflation matters now

Strengthening growth and elevated levels of disposable income could see inflation move higher. And it could stay high for some time, as policymakers err on the side of caution before raising interest rates from the ultra-low levels we've seen throughout the pandemic. However, markets have begun to anticipate a faster change in policy by the Federal Reserve more recently, suggesting that the investment environment may turn inflationary sooner than expected.

IN PERIODS OF ELEVATED VOLATILITY, CONVERTIBLES TEND TO OUTPERFORM EQUITIES

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.

> In a market where government bonds yields have reached multi-year lows, hybrid asset classes with promising return potential – like convertible bonds – can play an important role in portfolios.

With rates likely to rise, institutional investors may start to rotate out of long-duration assets and into those that can thrive in an inflationary environment.

In a market where government bonds yields have reached multi-year lows and there are few attractive opportunities in investment-grade credit, hybrid asset classes with promising return potential – like convertible bonds – may play an important role in portfolios.

Hybrid benefits

While sitting in the fixed income universe, convertible bonds don't typically behave like their peers, except in one respect: their volatility is broadly in line with other parts of the fixed income market. When markets become more volatile or correct abruptly, the fixed income component of the convertible bond has the potential to provide protection for investors.

Having an equity component within the bond structure means that as stock markets continue to rise – albeit with a change in leadership due to reflation – convertible bonds should also appreciate over the medium-to-long term. Our research has found that convertible bonds may even outperform equities during volatile periods.

Attractive valuations

Aside from the volatility profile, convertible bonds also present an attractive valuation argument in the current climate, as the asset class hasn't yet seen the levels of inflows that push prices higher. Indeed, the suddenness of the 2020 market crash caught everybody by surprise; by the time investors were able to make changes to their portfolios, the recovery had already begun. Now we are beginning to see conditions manifesting that increase the appeal of convertible bonds and we anticipate investor interest building in this part of the market, pushing prices higher.

We believe it makes sense to partner with an asset manager with an expertise in the market. With a well-established track record in convertible bonds, our actively managed approach, rigorous investment process and considerable experience can help you avoid the value traps and overpaying for optionality.

We believe that with inflation looking likely to pick-up in the coming months, equity markets remaining volatile and traditional fixed income assets looking unattractive from a yield perspective, now is the time to allocate to convertible bonds.

Global Asset Management

BlueBay Asset Management