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RBC BlueBay Asset Management

Convertible bonds outlook 2023

Positioning for a recovery without timing it (revisited)

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- Back in August 2022, we argued that global convertible bonds were a good way for investors to position for a recovery without timing it[1]. We have not changed our view. In fact, recent market developments suggest that this view is starting to play out and that the appetite for the asset class is slowly coming back.
- Convertible bonds are still looking attractive across all the valuation measures we follow. The recent improvement in market sentiment could be the beginning of a larger medium-term re-rating.
- We expect equity volatility to remain elevated in 2023 as macro uncertainty persists. A higher volatility regime should be favourable to hybrid asset classes, especially convertible bonds.
- We identified opportunities for our strategy that we will focus on in 2023.
  - **Asia:** We think Asian convertible bonds offer a great value opportunity and should see a solid recovery after two years of lacklustre performance.
  - **ESG:** We expect the ESG themes to start adding value again in 2023 while 2022 was mostly dominated by macroeconomic factors.
  - **Primary markets:** We foresee that the most profitable opportunities for our strategy will come from the primary market.

[1] https://www.bluebay.com/en-gb/institutional/what-we-think/insights/convertible-bonds-positioning-for-a-recovery-without-timing-it/

What happened: the asset class has started outperforming, and the valuation opportunity is still wide open.

Since the beginning of 2020: better than bonds, behind equities

When assessing the recent performance of various asset classes, we think the period starting in 2020 is most relevant as it captures the full monetary cycle from extreme central bank stimulus during the Covid crisis to the most recent aggressive hiking cycle to fight inflation. Over this period, global convertibles have underperformed equities and have outperformed high-yield credit (see chart 1). Despite a large de-rating, convertible bonds have offered fixed income investors some protection against higher rates and wider spreads. The asset class has shown its diversification benefits.

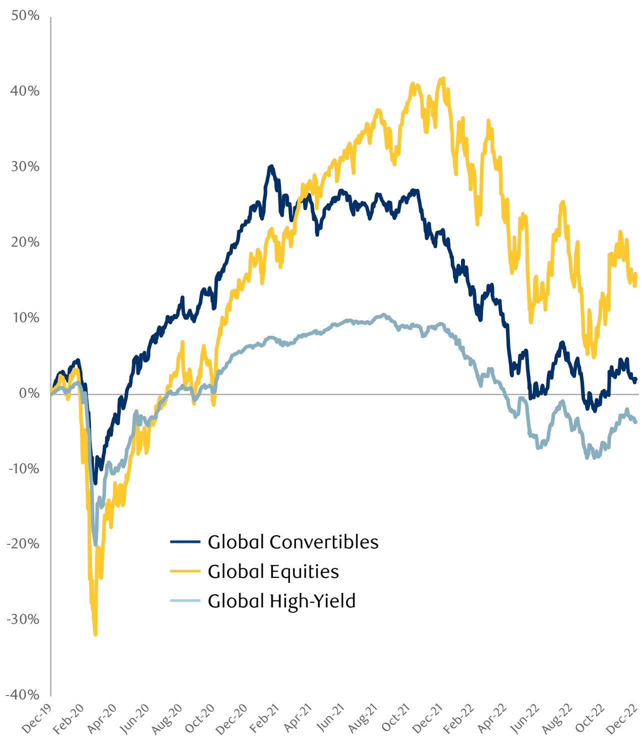
Valuation levels have stabilised, plenty of room for a catch-up

In previous comments, we introduced our favoured valuation measure for the convertible asset class that we developed internally and that we refer to as the 'basis' performance. This measure suggests that the de-rating phase for the asset class is over, but we have not seen any re-rating yet (see chart 2). A simple reading of this chart is that global convertibles remain historically cheap. Talking to investors looking at equities or credit, we often find that they do not see a clear value opportunity in their asset classes. Put simply, PE ratios are not historically cheap and credit spreads are far from historical highs. In contrast, convertibles seem to offer a deep value opportunity with levels of valuations in line with the 2008 crisis.

Short-term performance suggests the asset class has regained its risk mitigation benefits

Market participants pointed out the underperformance of global convertibles at the beginning of 2022 and the lack of downside protection vs large cap equity indices. One element which was often put forward was the exposure to the tech sector.

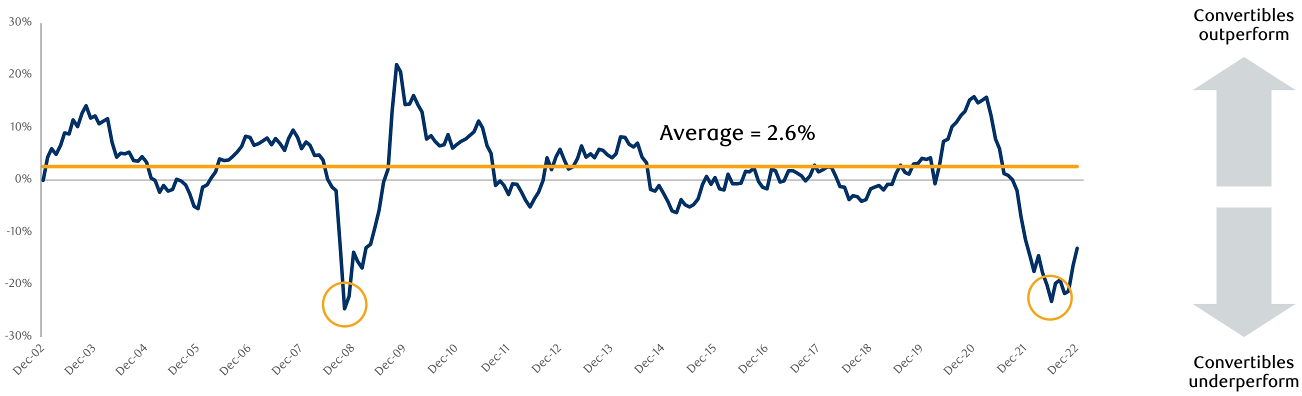
Chart 1: Asset class comparison (total returns in USD)



Source: Bloomberg as at 30 December-2022

Our view is that this period of underperformance is behind us as 1) valuations have de-rated massively 2) many instruments in the universe have lost a lot of equity sensitivity and now have more defensive profiles 3) the exposure to the tech sectors has diminished greatly. This view seems to be vindicated by the recent short-term performance (see chart 3). Despite a large correction in the tech sector, measured in our chart by the Nasdaq 100 index, Global convertibles have shown resilience and have even managed to outperform many large cap indexes such as the S&P 500. They have matched the performance of US high yield bonds.

Chart 2: Global convertibles - Basis performance vs. world equities YoY %



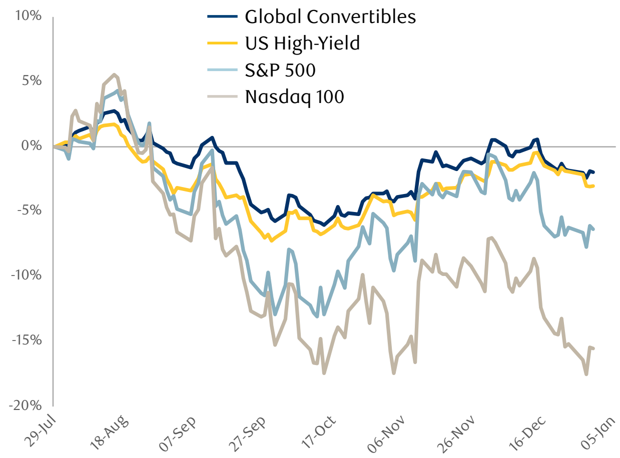
Source: MSCI, Refinitiv, Bloomberg, BlueBay Asset Management. Monthly data as of end of December 2022. Indexes: MSCI World Net Total Return USD Index and Refinitiv Global Focus Convertible Index (USD). Methodology: we use the monthly share sensitivity estimated for the benchmark index. We calculate the equity component of the convertible performance by multiplying the share sensitivity by the performance of the MSCI world. The 'basis' component is the residual.

Two key themes for the asset class in the coming months:

1. **Volatility should stay elevated: a favourable environment for convertibles**
   With the Fed hiking cycle nearing the end and the drop in bond volatility, one could argue that the phase of high volatility for equities is behind us. Our view is that equity volatility will stay elevated in 2023. Macro uncertainty remains high as the shape of the yield curve suggests. Chart 4 clearly shows the impact of this indicator on future volatility. We also observe that even if the end of the Fed hiking cycle seems now consensual in the market, the start of the easing cycle is still highly uncertain. Finally, 2023 is a year that could see both an economic and a corporate earnings recession in the US and in our view this scenario is not fully priced in by equity markets. In that context, we think that managing portfolio risk will remain an important theme for investors. Convertible bonds are an attractive way for investors to retain equity exposure while limiting risk. Recent performance data suggests that the pattern observed historically of higher volatility leading to convertible bond relative outperformance vs equities has re-instated itself (see chart 5).

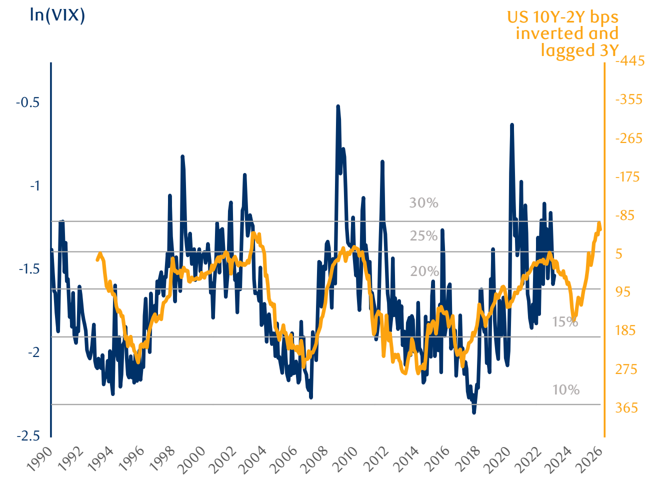
2. **Lowering credit quality may not be the way to boost performance**
   Credit spreads have widened meaningfully in 2022 and actual default rates have remained low. This combined with hopes of a 'Fed pivot' seem to make a good case for investing in lower credit quality credits. Put another way, investors could be tempted to go back to the pre-Covid typical strategy of increasing carry to boost performance. It feels to us too early to implement such a strategy. As just explained, we expect macro uncertainty to remain high and pressure volatility to the upside. And in case of a US recession credit fundamentals could deteriorate fast. Chart 6 highlights two key facts. First credit spreads widening has been moderate in comparison to previous cycles i.e. the value argument is not obvious. Second, spreads seem too tight in comparison to their historical relationship with equity volatility.

Chart 3: Short term performance since end of July 2022 (total returns in USD)



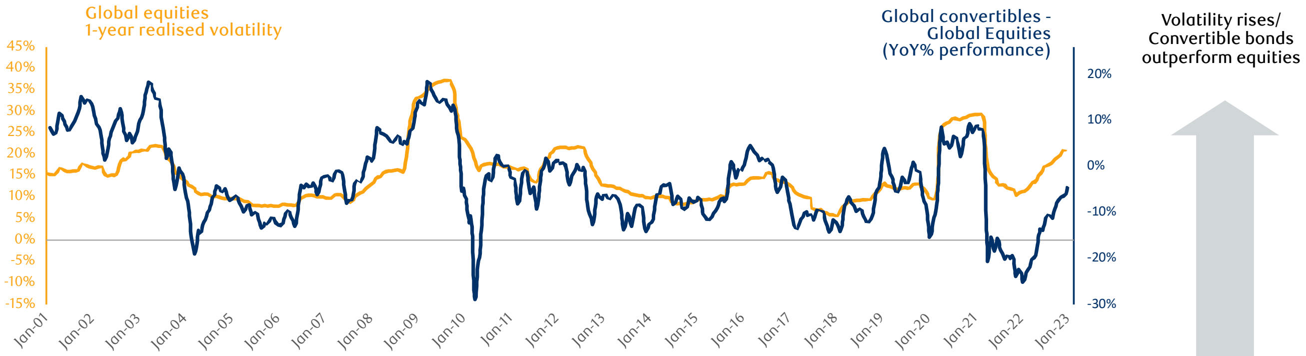
Source: Bloomberg as at 30 December-2022.

Chart 4: Long-term history of the VIX and the market cycles



Source: Bloomberg. Monthly data from 31 January 1990 to 30 December 2022. Indices: USYC2Y10 Index and VIX Index.For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

Chart 5: Relationship between realised equity volatility and the outperformance of convertibles vs. equities



Source: Bloomberg, Refinitiv, MSCI. Daily data from 1 January 2001 to 30 December 2022. MSCI World Net Total Return USD Index. Refinitiv Global Focus Convertible Bond Index (USD). For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

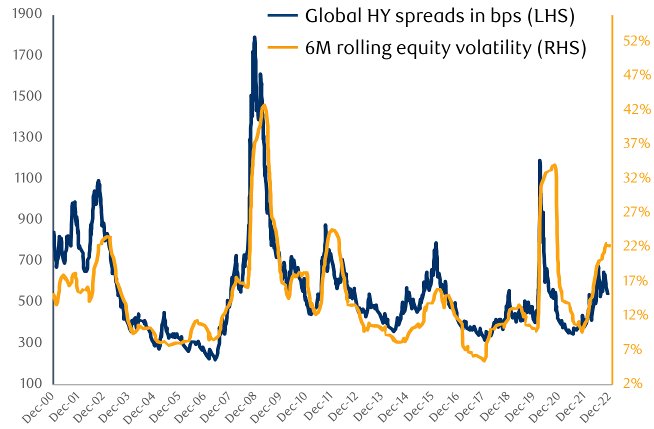
Why are global convertibles attractive in this context? 1) convertible bonds tend to have shorter maturities making the asset class less exposed to spread widening 2) global convertible bonds with 38% of investment grade issues and 37% of BB issues offer a strong credit quality (see chart 7) 3) as explained previously, convertibles, thanks to their embedded options, can be positively impacted by higher volatility.

What we are doing and where we see opportunities

1. **Asian convertibles: an attractive asset class to position for Chinese reopening**
   We have highlighted in previous comments the historically cheap valuation levels of Asian convertible bonds. The extreme pessimism among Asian investors in the past two years has led to a market dislocation. As a result, the embedded options for many convertible bonds are priced out completely. It creates an opportunity for credit investors who can benefit from 'free' optionality for the same level of yield when buying convertibles (see chart 8). The positive momentum around Chinese re-opening offers an obvious trigger for this market segment to re-rate. In fact, since the National Party Congress held in October 2022, we have seen many positive developments: some zero-Covid policy relaxations, easing of the regulatory framework for tech firms, more growth stimulative fiscal and monetary policies and even a potential end to the threat of de-listing of Chinese ADRs in the US. We expect a large part of the performance of global convertibles in the coming months to come from this region.

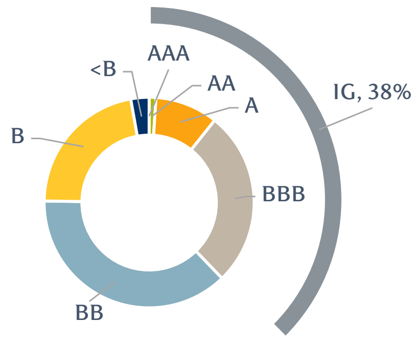
> **"The positive momentum around Chinese re-opening offers an obvious trigger for this market segment to re-rate."**

Chart 6: Relationship between realised equity volatility and credit spreads



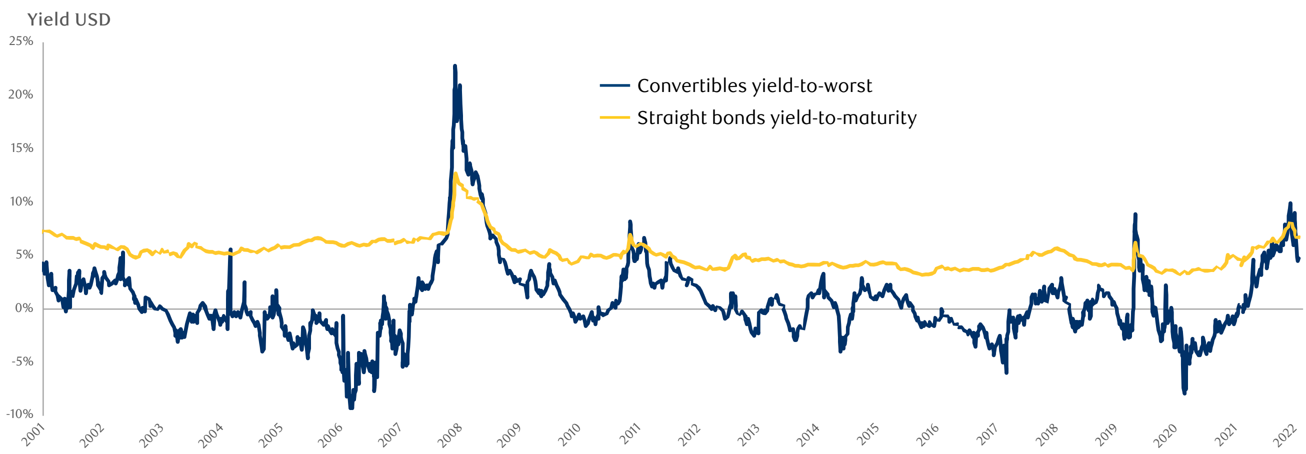
Source: Bloomberg, MSCI. Daily data from 1 January 2001 to 30 December 2022. MSCI World Net Total Return USD Index. Refinitiv Global Focus Convertible Bond Index (USD). For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

Chart 7: Rating breakdown of the Global Convertible universe



Source: Refinitiv, Bloomberg and BlueBay. When instruments are not explicitly rated, we are showing BlueBay's internal ratings. Breakdown is for the Global Focus Convertible Bond index from Refinitiv as at 30 December 2022.

Chart 8: Asia (ex-Japan) convertible bonds. Yield comparison (USD) vs. traditional credit



Source: Refinitiv Asia ex-Japan Convertibles index, ICE indexes ACOR <Index> , BlueBay. Daily data to 30-December-2022. The differential in yield can be seen as the cost of the embedded conversion option. When convertibles yield as much or more than straight bonds, one can say that the conversion option "is for free".

2. **ESG analysis will bring more value to the strategy in 2023**

   Our strategy is aiming at screening out companies with weak ESG profiles and promoting better ESG standards. It feels that this bias has had a lower contribution to performance in 2022 as compared to previous years. In 2022, markets were dominated by macro factors such as the level of interest rates, Fed policy and the rise in energy prices. In 2023, we think long-term fundamentals differentiation between companies and the sustainability of their business models will play a much more important role in a portfolio's performance. We expect our ESG analysis to bring some outperformance.

3. **Corporate activity is picking up: primary issuance, M&A and bond buybacks should give a kicker to the asset class performance**

   After the shock that financial markets experienced in 2022, companies will have to re-evaluate the shape of their capital structures and the opportunity for external growth. We expect convertible bonds to be a key beneficiary of this pick-up in corporate activity. The primary market has seen low volumes of issuance in 2022 (see chart 9). We expect a meaningful bounce in 2023. As rates, credit spreads and equity volatility have all moved higher in 2022, the cost of capital has gone up for issuers and the incentive to look for alternative financing tools is strong. In that context, convertible bonds are attractive as they allow issuers to monetize the higher volatility of their stock price. Put another way, issuing a convertible bond allows issuers to meaningfully reduce interest payments as compared to a straight bond issuance. Historically, a revival in primary issuance has added performance to the asset class as issuers are happy to offer cheap optionality to investors in return for lower coupons.

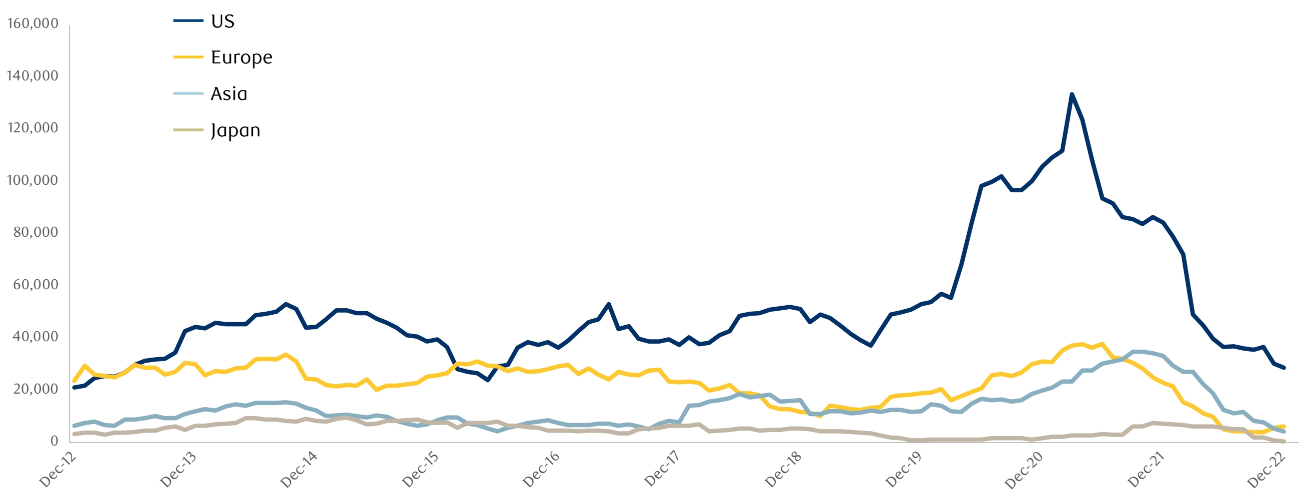
A recovery in M&A activity is also likely to enhance the performance of the asset class in 2023. The dramatic correction seen in equities has left some businesses valued at historically cheap multiples. It is only natural that those businesses should become takeover targets. This is especially true in high-growth, tech-type sectors such as software, internet, or biotech. Convertible bonds are instruments which tend to offer large upside to investors in case of a takeover and therefore they should benefit from a bounce in M&A.

> **"Convertible bonds are instruments which tend to offer large upside to investors in case of a takeover and therefore they should benefit from a bounce in M&A."**

Another positive development for the asset class is the recent pick-up in buyback activity. Following the sharp correction in equity markets, many convertible bonds are trading at dislocated levels with conversion options completely priced out. This creates a strong incentive for issuers to buy back those instruments even at a premium to quoted prices. Investors benefit from this incremental performance.

As we progress through 2023, managing portfolio risk, as ever, will remain an important theme for investors. We maintain our view that global convertible bonds are an attractive way for investors to position for a recovery without timing it.

Chart 9: Convertible bonds – primary market issuance over the past 12 months (USD million)



Source: BofA Convertible Research, as at 31 December 2022.

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