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»Convertible bonds: Outlook for 2021

Convertible Bond Portfolio Management Team

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2021 outlook for convertible bonds: Mixed year with significant positive growth impulse in the second half of the year

Summary

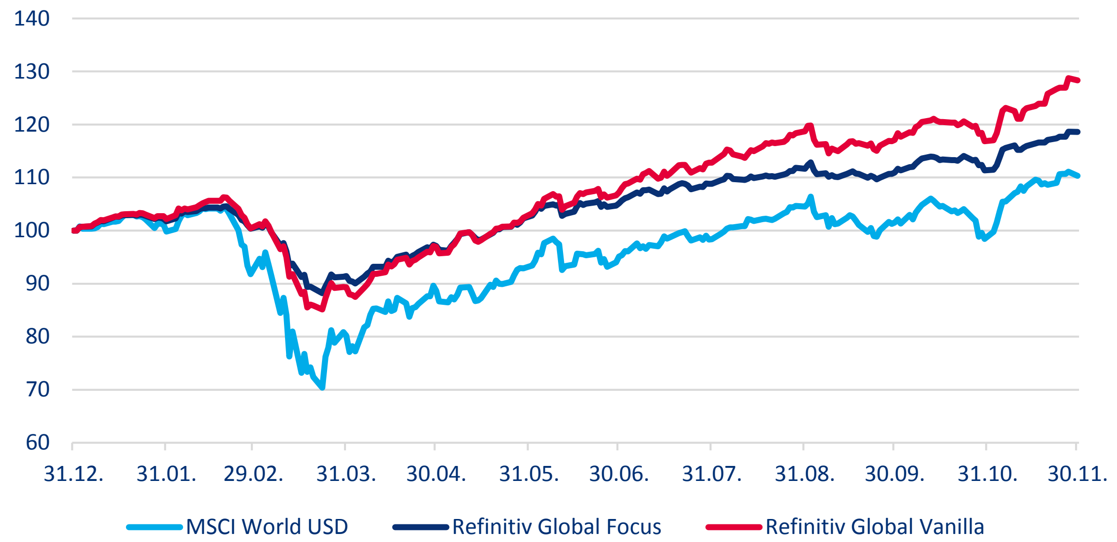
- **Global economy:** The successful outcome of the vaccination campaign will have a significant impact on the global economy. We expect it to be a success, which should be clearly reflected in economic growth in the third quarter at the latest. Central banks and governments will continue to provide support.
- **Political risks:** In the first half of the year in particular, the US Senate elections and the transfer of power to Biden, as well as Brexit in Europe, are likely to create uncertainty and volatility.
- **Sector rotation:** The rotation that has already started into what have been the losers in the crisis up to now, in particular cyclicals, should continue. One important factor determining the success of investing in this environment will likely be stock selection with a focus on the bond floor.
- **Specific convertible bond themes:** We are very optimistic about additional diversification opportunities as the investment universe increasingly broadens. This is taking place on the back of the continuing active primary market, which includes an increase in green bond issues.

Review: We expected 2020 to be a moderately positive year for convertible bonds, with the US/China trade conflict and the US elections taking centre stage:

- **Equity markets and interest rates:**
  View: We expected monetary policy to be moderately expansionary (although progressively less dynamic) to support equity markets, as well as slightly positive economic growth, and therefore no recession. We also identified the US/China trade conflict and the US elections as the most important themes for investors in 2020. In both cases, we expected greater stock market volatility to result. We deemed the pharmaceuticals sector to be significantly affected by the US election campaign. In addition, we expected investors to be cautious, initially awaiting news about the trade conflict or better fundamental data. We also predicted that changing expectations, as a result of some positive items of news, could lead to a strong rally in risk assets. Furthermore, we anticipated continuing sector rotation from the previous winners to the losers, which included traditional sectors like car manufacturing, mechanical engineering and chemicals. We also believed further improvement in economic fundamentals, with yields returning to normal in Europe, would lead to higher interest rates and a steeper yield curve.
  Result: During the first few weeks of 2020, our forecasts of rising equity markets seemed to be confirmed. However, the coronavirus pandemic soon brought stock indices to their knees. Although our estimates were superseded by the severe effects of the pandemic, they were correct as regards the trade conflict, which preoccupied investors well into the autumn. Particularly noticeable was the battle for technological leadership, which the US tried vehemently to defend with sanctions against individual companies, such as Huawei. This also included the recently issued blacklist forbidding US citizens from investing in selected Chinese companies.
  We were also right about the market shift towards increased risk appetite triggered by “sentiment”. However, the trigger for investors changing their thinking proved to be the potential quick reopening of public life following the strict coronavirus restrictions (lockdowns). This expectation triggered

sharp rises in share prices from the end of March. Sector rotation stalled as a result of the coronavirus pandemic, before making an even stronger comeback after the first positive vaccine results were announced. However, our interest rate estimates did not come to pass due to the economic impact of the coronavirus pandemic.

Chart 1: Year-to-date performance of global equities vs. convertible bonds

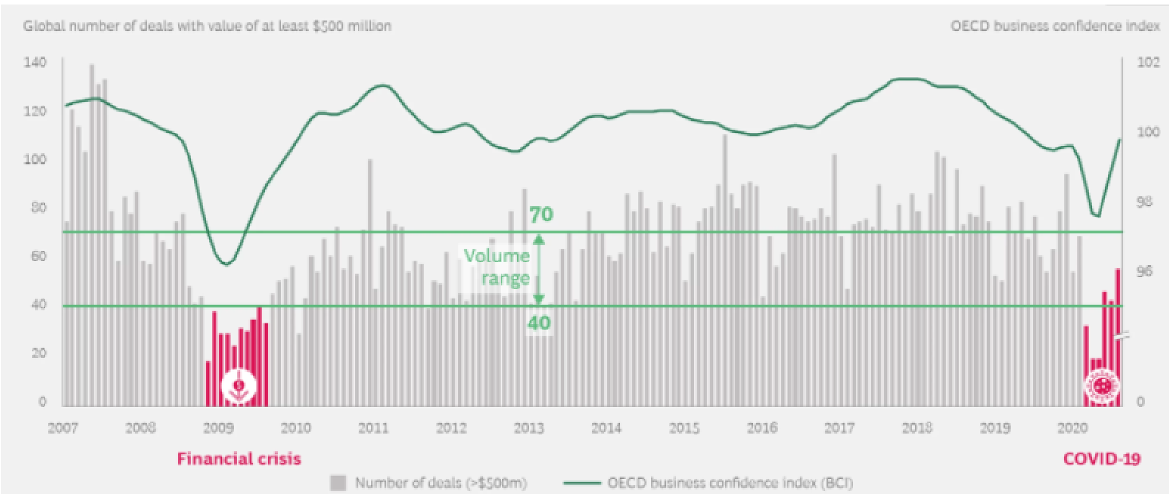


Source Bloomberg, Refinitiv Global Vanilla Hedged CB Index (USD), Refinitiv Global Focus Hedged CB Index (USD), MSCI World Total Return (USD), November 2020

We anticipated certain "specific" themes within the convertible bond market:

— **Sector consolidation/company results:**
View: We expected further mergers, acquisitions and joint ventures, particularly in sectors such as healthcare and car manufacturing, due to dwindling profits.
Result: M&A activity came to an almost complete standstill due to the coronavirus pandemic, before making a quick recovery (Chart 2).

Chart 2: M&A activity recovered quickly together with business sentiment



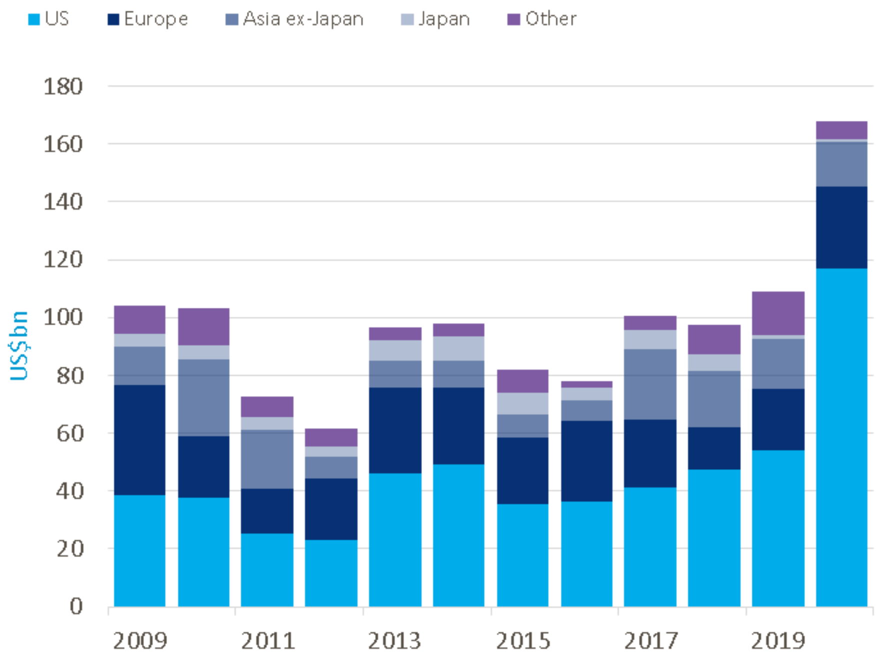
Sources: Refinitiv; OECD; BCG analysis.
Note: The total of 3,033 M&A transactions comprises pending, partly completed, completed, unconditional, and withdrawn majority deals announced between January 1, 2007, and August 31, 2020, with deal values greater than or equal to $500 million. Values include assumed liabilities.

Source Refinitiv, OECD, BCG Analysis

- **Portfolio stabilisers:**
  View: We were of the view that classic portfolio stabilisers would not be easy to find, with supposedly "defensive" sectors being particularly heavily influenced by regulatory and/or government measures.
  Result: We were right again here, as shown by the development of the housing market, which came under increasing regulatory pressure because of the sharp rise in property and rental prices.

- **Increase in new issues:**
  View: We expected a strong primary market due to higher interest rates in the US and Europe, US tax reforms (repatriation of capital and profits) and the need for financing (scarcer liquidity).
  Result: We were right in principle, although we did not expect such a record year (USD 168 billion on an annualised basis up to the end of November). The reasons for this were less to do with interest rates or US tax reforms, but more to do with the need for financing. This was also evident in particular during the first phase of recovery from the coronavirus-related slump in share prices, as more and more companies in struggling sectors, such as tourism and leisure, managed to secure liquidity via convertible bonds.

Chart 3: Convertible bonds global issue volume in USD billion (annualised)



Source Refinitiv, Fisch Asset Management, November 2020

- **ESG:**
  View: We anticipated not only growing interest in ESG products and aspects, but also higher investor expectations with regard to factoring ESG considerations into the investment process.
  Result: We were right in our estimation, which is also demonstrated by current regulatory developments demanding more and more disclosures and reports on ESG practices.

- **Timing:**
  View: In view of high volatility, political tensions and an economic situation on the verge of recession, we expected the timing of equity investments to be very challenging in 2020.
  Result: We were absolutely right. Although we did not predict the coronavirus crisis, this showed only too well how challenging market timing can be. In this situation, convertible bonds showed the strengths for which they are known and benefited from automatic timing. In exemplary textbook

manner, the delta decreased drastically during the correction, but also rose very quickly again in the recovery that followed.

The outlook for 2021 shows a mixed picture but with very positive momentum for the second half of the year:

— In the first and probably the second quarter, coronavirus will continue to have a significant impact on markets. The central question will be not only when the vaccine is available, but also the take-up (people's willingness to be vaccinated) and its effectiveness. In our base scenario, however, we expect the vaccine to be available in early 2021, and restrictions can then be relaxed gradually in order to get public life and the economy back to normal. We believe there is a good chance of higher growth rates as of the second quarter. However, it is likely to take until the third quarter for enough of the population to be vaccinated.
— We consider both monetary policy and fiscal policy as supportive so that a wave of bankruptcies can be avoided. There is still a lack of fiscal stimulus packages from the US, although these may be announced once Biden becomes President.
— We do not consider inflation to be a major risk for 2021, as levels remain very low and capacity utilisation is low.
— In terms of sector performance, we expect to see a continuation of the current sector rotation already in place away from the previous winners – mainly growth stocks – towards the coronavirus losers. In our opinion, cyclicals will become more sought after, as these companies should visibly benefit from further relaxation of coronavirus restrictions. This is the case for the tourism sector and industrials, as well as the leisure industry and shops. Stock selection focusing on a solid bond floor should play a decisive role in determining investment success.

However, our outlook is still subject to two significant risks that we will keep a close eye on:

— The first risk concerns the availability of the vaccine, the take-up and its effectiveness: Our positive base scenario is based on the assumption that the vaccine is available in sufficiently large quantities from the first quarter, that it is also effective and that the population is willing to be vaccinated. If there are any delays or a low take-up of the vaccine, this would result in a substantially more negative scenario for 2021.
— There is also a focus on political risks: We regard the election in Georgia to finally determine the Senate in January 2021 as a potential risk of the opposition (Republicans) becoming too dominant. This could lead to a blockade in Congress, which could paralyse political progress. The transfer of power from Trump to Biden also represents an uncertainty should it not proceed amicably. We also believe there are political risks in Europe, including Brexit, which could considerably dampen our base scenario if the consequences are more significant than anticipated.

An array of convertible bond-specific themes will keep us occupied in 2021:

— **Green Bonds/Sustainable-linked Convertible Bonds:** We have already seen the first issues in this area this year, including those of Umicore, Neoen and Schneider Electric. We expect this trend to be amplified in 2021, as convertible bond investors are also paying more and more attention to ESG aspects. We therefore believe a larger proportion of the green bond/sustainable-linked convertible bond universe will also provide better diversification opportunities in the future.

— **Idiosyncratic risks remain high**: We expect performance to be strongly influenced by idiosyncratic aspects in 2021 and volatility to remain high. Fluctuations in both directions will be inevitable even within the same sectors. Stock selection remains central, including the preceding research process.
— **Potential for consolidation is still high**: We expect further takeovers and/or mergers in IT and pharmaceuticals, as well as in the shale gas sector and among traditional industrials (e.g. aircraft manufacturing) in particular. Continuing low interest rates, the desire to expand product ranges and low profits could be the main drivers.
— **Continuing strong primary market:** We expect the primary market to remain active in 2021. Firstly, we believe that companies that were hard hit by the coronavirus crisis could show further financing requirements and cover these by issuing convertibles. Secondly, there are likely to be some companies using the convertible bond market for the first time to finance themselves. We believe that the record year of 2020, coupled with considerable interest on the demand side, is a motivation for these companies that have not yet ventured into convertible bonds. This would lead to a substantial broadening of the convertible bond universe and better opportunities for diversification.

Conclusion

In a fundamentally positive environment, characterised by economic recovery flanked by monetary and fiscal policy, equity markets should be able to achieve positive returns. The political and coronavirus-related risks, which should not be underestimated, could contribute to high volatility. A scenario of this kind would make convertible bonds the instrument of choice. The manifold idiosyncratic risks in combination with a promising primary market argue in favour of rigorous bottom-up analysis.

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