

Convertible bonds: Outlook for 2022

Convertible Bond Portfolio Management Team
10 December 2021

2022 outlook for convertible bonds: clouds gather but positives remain

Executive summary

- **Global economy:** The ongoing recovery of the world economy remains intact but the outlook is clouded by, what we believe to be, temporary issues, such as supply chain disruptions, a yet undefeated Covid-19 crisis, pockets of labour shortages, and a material increase in input costs in general. Nevertheless, we expect the effects of those challenges to diminish over the course of 2022.
- **Normalisation risks:** Both monetary and fiscal policies have to adjust their very expansionary stance to a more normalised level as the recovery gathers strength. Tightening too much too soon could cause some serious negative effects here, including a premature stifling of the economy.
- **Political risks:** The conflict between the US and China is still lingering and it is hard to predict whether this will escalate next year. We expect that any domestic pressures could significantly worsen the relationship between the two countries.
- **Specific convertible bond themes:** After another year of extraordinary new issue activity, we expect the primary market to remain strong. This should give us the opportunity to diversify the portfolios into sectors that come into favour next year.

Review: We expected a mixed 2021 for convertible bonds with significant growth impulses in the second half of the year:

1. Global economy:

Statement at the end of 2020:

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.

Outcome in 2021:

The roll-out of Covid-19 vaccinations certainly accelerated the global economy to open up and thrive once again, even though starting in July the reopening theme got interrupted by the rise of the Delta-variant. In the US, economic growth measured by GDP was strongest in Q1 and Q2. The eurozone and China were also able to grow, albeit at a more subdued level. 2021 further stands for severe supply chain shortages, bottlenecks in logistics and soaring energy as well as labour costs. These fairly extreme developments have capped more vigorous economic growth.

Against this backdrop, central banks and governments continued to provide support. However, on 3 November, the Fed announced its first step towards tapering by reducing its Treasury purchases by USD 10 billion and mortgage-backed securities by USD 5 billion. The ECB and BOE have yet to introduce their tapering schedule. On the back of rising inflation rates in the major economies the pressure on central banks remains elevated.

In line with the gradual withdrawal of the lockdowns we have been able to slightly increase the risk in our portfolios, and to shift them more towards companies that would benefit from this reopening, until the occurrence of the Delta-variant gave us reason to once again turn more cautious. The ongoing support by monetary and fiscal policy, however, gave no cause for a further reduction of risk in our portfolios.

2. Political risks:

Statement at the end of 2020:

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.

Outcome in 2021:

Contrary to our expectations and unlike in 2020, this year US politics did not have a meaningful impact on markets. Neither had Brexit, at least not for broader markets. However, the effect of having exited the EU badly impacted the supply of certain goods, such as crude oil and petrol, in the UK, due to shortages in truck drivers and with that logistics bottlenecks. These effects were limited to the UK economy, and did not spread further volatility across global markets. Hence, there was no need to adjust the portfolios.

3. Sector rotation:

Statement at the end of 2020:

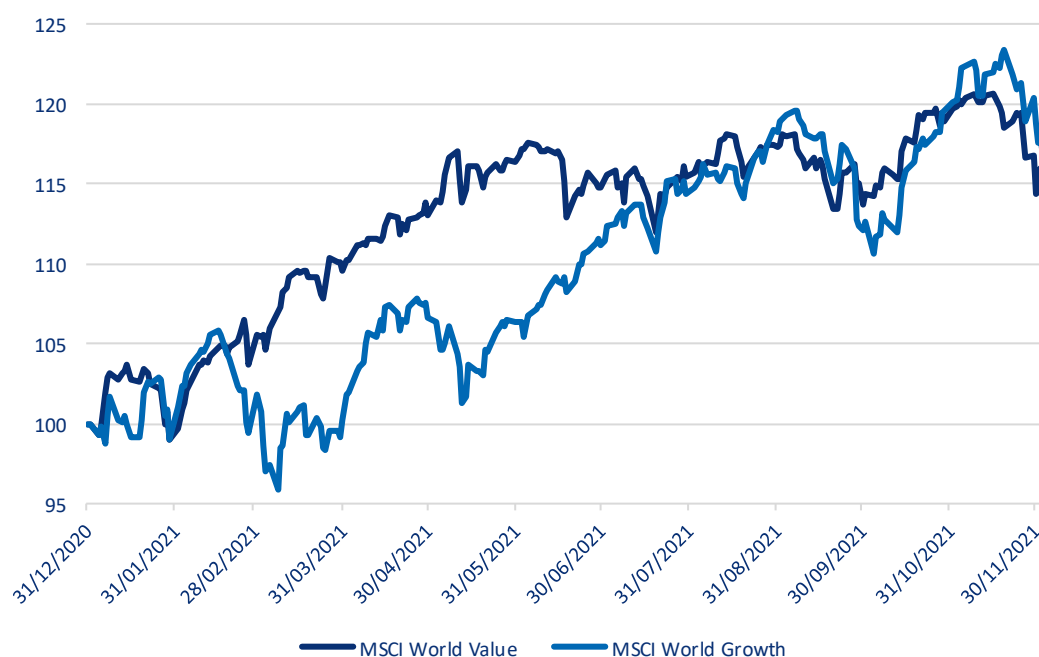
The rotation that has already started into what have been the losers in the crisis up to now, in particular cyclicals, should continue. One important factor determining the success of investing in this environment will likely be stock selection with a focus on the bond floor.

Outcome in 2021:

Sector rotation was one of the most important and biggest topics this year. On the back of rapidly rising interest rates in February and March, there was a massive rotation across sectors and a strong shift from growth to value. This effect retreated to a certain degree in the following months before re-appearing in September. Apart from sector rotation triggered by changes in interest rates, the spread of the Delta-variant was another driver, which affected themes that focused on the reopening of the economy, i.e. travel and leisure. In this environment, security selection was key.

We reacted to this with a timely adjustment of the portfolios, but the very erratic nature of this rotation proved a major challenge. During the year, security selection became more and more important.

Figure 1: Performance comparison of growth vs. value stocks in 2021



Source: Bloomberg, MSCI, November 2021

4. Green Bonds / Sustainable-linked convertible bonds:

Statement at the end of 2020:

We have already seen the first issues in this area in 2020, 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.

Outcome in 2021:

There were in total more than 10 new issues labeled as green or sustainable-linked convertible bonds, with names such as Enphase Energy, Edenred, Fisker or Posco. Even though the dynamic of new issues in this space did not accelerate to the extent we had expected, we remain convinced that there is more to come in terms of an increasing share of issuers deciding to have their convertible bonds labeled as green or sustainable-linked in the near future.

5. Idiosyncratic risks remain high:

Statement at the end of 2020:

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.

Outcome in 2021:

With hindsight we can absolutely confirm this prediction. Apart from sector rotations and Covid-19-related dynamics we saw countless idiosyncratic events affecting our universe. While earnings news led to distinct spikes, M&A activity did its part, and political rulings as well as surprising decisions by the FDA sent corresponding stocks soaring or plunging. To manage these idiosyncratic risks we decreased our exposure to companies with small market size and insufficient liquidity.

6. Potential for consolidation is still high:

Statement at the end of 2020:

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.

Outcome in 2021:

As assumed, we saw M&A activity in the US shale gas sector, with Pioneer Natural Resources Co closing even two deals over the course of the year. Furthermore, a deal that was accompanied by a lot of prior volatility was the takeover of Deutsche Wohnen by Vonovia. Another M&A worth mentioning was Square buying Afterpay. On top of that, there were numerous other deals that took place during 2021.

7. Continuing strong primary market:

Statement at the end of 2020:

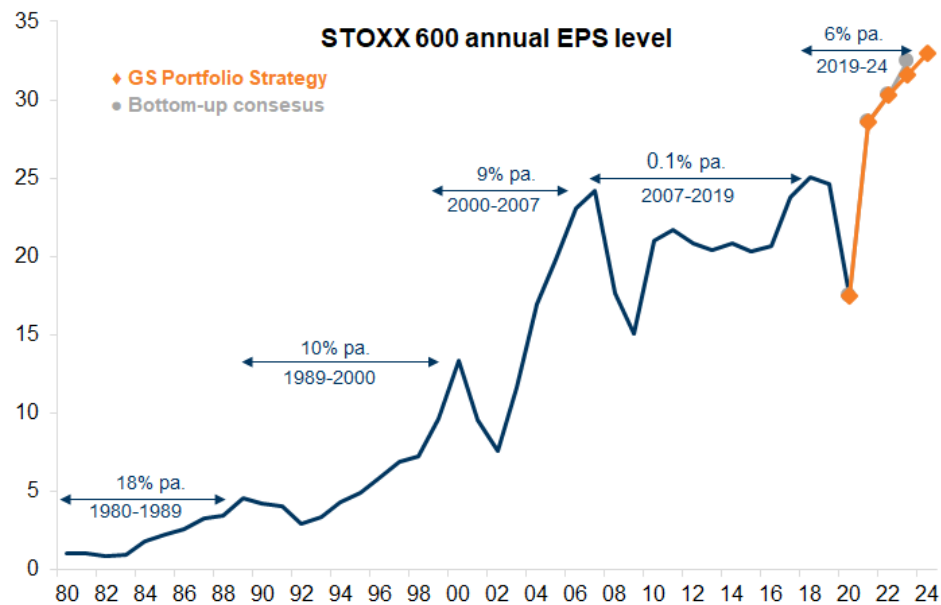
We expect the primary market to remain active in 2021. First, we believe that companies that were hard hit by the coronavirus crisis may need further financing and cover these requirements by issuing convertibles. Second, there are likely to be some companies using the convertible bond market for the 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.

Outcome in 2021:

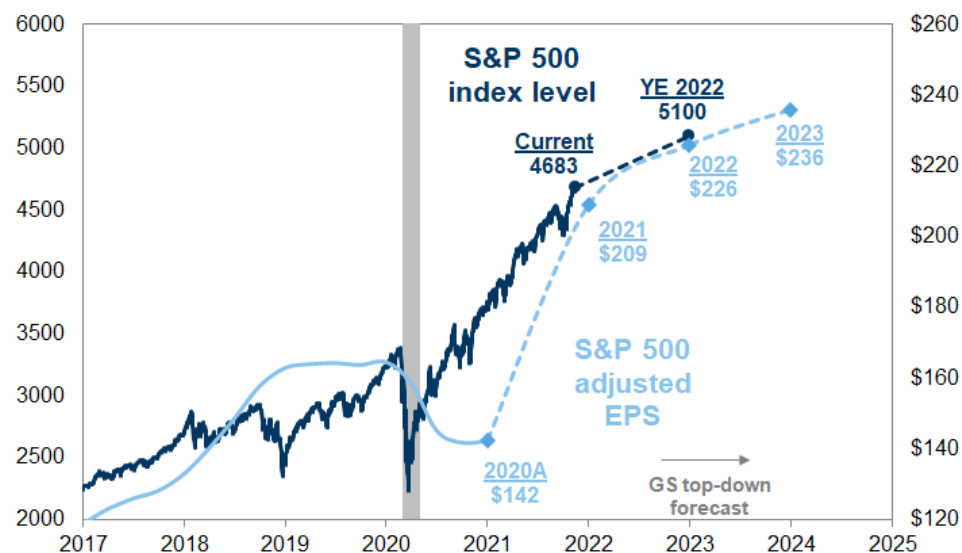
The primary market remained busy and we have seen many new issuers that added to our universe. This contributed to further diversification and allowed us to invest in new opportunities. On an annualised basis, 2021 has overtaken the record-setting year of 2020 in terms of new issuance. However, given the strong primary activity, we experienced pressure on valuations in the secondary market. We used the new issue opportunities to diversify the portfolios further and increase convexity.

Outlook 2022:

- Whereas the 2021 outlook was mainly about the reopening path following often extensive restrictions, the 2022 outlook is focusing on a diverse set of risk factors: These include the Covid-19 Delta and Omicron variants right now, the occurrence of possible further new variants, supply chain issues, China's more restrictive policy towards domestic businesses, inflation as well as monetary and fiscal policy responses. Most of these risk factors have started to ease already, and we expect them to dissipate further in 2022.
- **Covid-19:** The pandemic might persist for longer due to the risk of new variants but we feel that economies are better prepared to deal with the virus, as there are other developments helping to keep economies open, including new drug treatments, booster vaccines and covid-certificates. Hence, we expect the global economy to reopen further, albeit at a slower pace.
- We expect a combination of solid economic growth globally, the persistence of non-restrictive monetary policy and controlled inflation trends to continue in 2022 (a "**Goldilocks light**" scenario). Even though we anticipate inflation experiencing some structural upward pressure in the longer term, central banks have the situation well under control, but a degree of monetary tightening from very supporting levels is imminent.
- With "Goldilocks light" as our base case scenario, we see a further **normalisation** of the economy. This will likely be accompanied by the initial rate hikes being implemented, which will go hand in hand with a normalisation of monetary policy (longer-term upward trend in interest rates).
- The **tapering** by the Fed is now under way, with little to no repercussions so far, as the market appeared well prepared for it. Most central banks have done their job in guiding market participants as to the likely policy trajectory. We do not expect any major market turmoil on this topic in the future. One issue to watch will be the ECB policy, as it runs the risk of staying expansionary for too long, i.e. falling behind the curve, despite higher inflation prints.
- The reduction of **fiscal spending programmes** could provide a headwind for the global economy, as they were one of the main pillars of support during the crisis, not only helping to keep default rates low but also boosting private consumption.
- We expect the US, with its heavy reliance on global sourcing, to be more fiercely impacted than Europe by the continuing supply chain bottlenecks. However, we believe these will improve over time, but only in the second half of 2022.
- Another major topic is the development of labour markets, more specifically how pronounced **labour shortages** will be in putting upside pressure on salaries, causing **wage inflation**. Labour shortages are more palpable in the US, as businesses there have laid off many employees during the pandemic, whereas European companies have kept a larger percentage of their workforce employed. Labour shortages are extremely noticeable in lower-skilled jobs. We expect these labour shortages to persist into 2022, with the outlined divergence between the US and Europe, and high-skilled versus low-skilled workers. This will likely have a strong impact on the bottom-line of affected businesses (such as the services and retail sectors). There might be additional upside pressure on wages to reflect growth in corporate earnings.
- On the **China/US trade conflict**, which hasn't been at the forefront recently, we expect US politicians (including President Biden) to become more vocal before the midterm elections in November 2022. We expect fiercer rhetoric around China's stance towards Taiwan, Chinese ADRs listed in the US, and China's emission policy. Europe could play an important role here should Biden consider closer cooperation with Europe on topics such as climate policy.
- We expect equity markets to continue to be the key driver of the convertible asset class return. The positive performance of equity markets in 2021 has been cemented by solid and expanding corporate earnings, and we expect this trend to continue into 2022.

Figure 2: Earnings expectations for European companies as measured by the STOXX 600 EPS

Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research

Figure 3: Earnings expectations for US companies as measured by the S&P 500 EPS

Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research

Implications for convertible bonds:

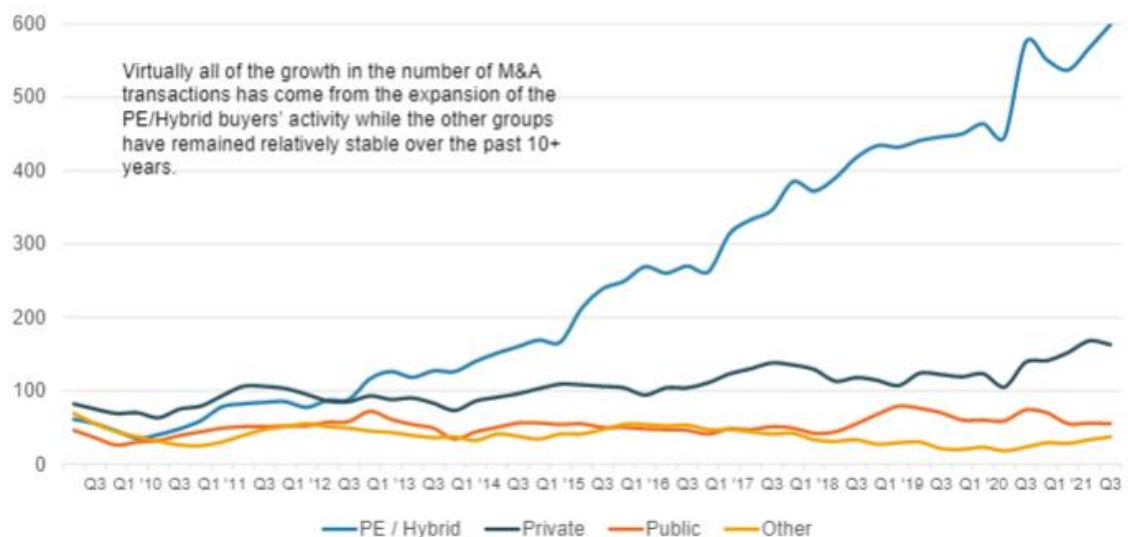
- As we expect some upward pressure on rates in the medium to long term, coupled with the growth bias inherent in the convertible bond universe, we take a cautious view on this segment of the convertible market. Higher interest rates provide a potential risk to long-duration assets, which is a common characteristic of securities issued by growth companies. Higher rates could potentially lead to earnings multiple compression, with richly valued companies being most prone to a revaluation of their growth prospects, when discounting at a higher rate. Hence, we are cautious on expensive growth stories and focus on names with strong fundamentals, where there is still room for upside potential, despite higher rates.

- In contrast to 2021, we do not expect to see major sector shifts. As our base case points towards a “Goldilocks light” scenario, the recovery should be rather broad based. However, we remain cautious on highly interest rate-sensitive sectors, such as telecommunication and REITs.
- Given a potential escalation in China/US tensions, the unpredictability of Xi Jinping’s political actions (e.g. his potential willingness to take on short-term pain for long-term gain), stronger Chinese policy responses to Covid-19 cases with negative economic impacts, and the potential of Chinese property funding issues spreading out to other sectors (e.g. commodities), we would rather stay underweight in this region.
- Higher inflation has also led to elevated input costs for many companies. We favour price setters over price takers, which are unable to pass on higher input costs to end clients. This involves an analysis of the company’s competitive landscape and availability of product substitutes.
- Credit risk has been suppressed by the unprecedented liquidity injection by central banks. Based on our normalisation scenario for 2022, we expect credit to slightly reprice on wider terms. But the current amount of cash on companies’ balance sheets keeps us reasonably confident that no major credit stress should occur next year. We will nevertheless keep our conservative positioning on credit risk and stay away from the weaker spectrum of our universe.

Additional topics:

- ESG will become an even more prominent topic in 2022, with many regulations underway on reporting and disclosing ESG-related activities, helping investors to understand investee companies to an even greater extent, while also gaining clarity on asset managers’ policies and processes towards ESG practices. Hence, we anticipate further issuance in green and/or sustainable-linked convertible bonds.
- We expect further consolidation in 2022. Whereas 2020/2021 had been a slower period (not so for private equity, though, see Figure 4) due to the pandemic and the corporate focus on going concern rather than expansion, this might change in 2022. We expect corporates to refocus on future growth opportunities given the record cash levels on balance sheets.

Figure 4: Rolling 12-month number of transactions by buyer type



Source: Optis Partners, October 2021

- In 2022, we will likely see more share buybacks, which many companies announced already during recent earning releases. Many companies are cash-rich and are seeing buybacks as a way to optimise

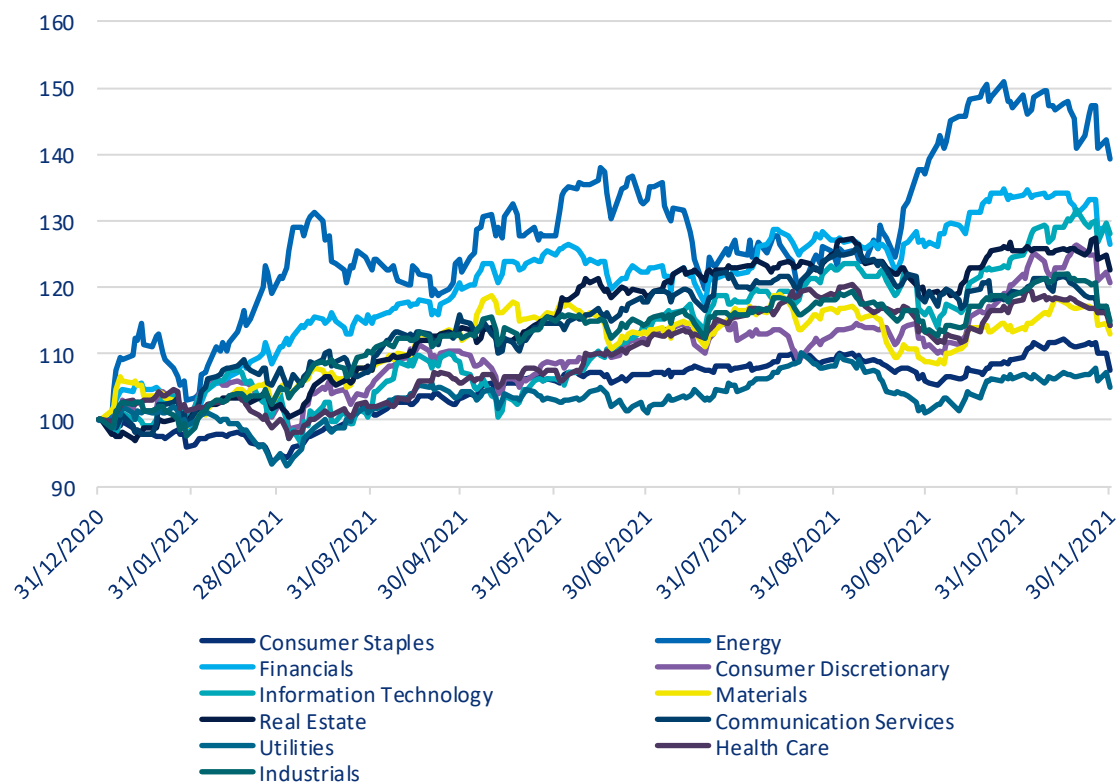
their capital structure (reducing equity share capital). However, plans by the US government to raise taxes on share buybacks might cause some headwinds here.

- The trends we described in our “Megatrends” paper in early 2021 should persist in 2022. For us, some of the most interesting topics within the convertible bond universe are renewables (solar), electric vehicles and digitalisation (information technology).
- We also see a strong new issue pipeline for 2022, as interest rates are grinding higher. This provides issuers with an attractive financing solution by saving on interest rate costs relative to straight bond issues. However, we are unlikely to see a repetition of the exceptionally strong primary market years of 2020 and 2021. But we nevertheless expect to see a growing universe (with the US most likely proving the driving force once more), with a good mix of companies refinancing and new first-time issuers tapping the market. Hence, we do not expect to see another substantial drag on convertible performance due to implied volatility (valuation) corrections as we witnessed in 2021.

2021 was an exceptionally strong year for equities, what more to expect for 2022?

- Barring any last-minute surprises, 2021 was an exceptionally strong equity year (MSCI World Net Total Return up by 17% as at 30/11). There was a wide divergence in performance across sectors, with energy (+39%), IT (+28%) and financials (+26%) leading the pack, while consumer staples (+8%) and utilities (+5%) substantially lagged behind.

Figure 5: Performance of MSCI World index by sectors



Source: Bloomberg

- We don't expect 2022 to deliver a repetition of 2021. However, given our constructive outlook, we still believe equities can deliver high single-digit returns.

Risks to our outlook:

- One main risk to our scenario lies in a possible deterioration of the supply chain issues, which could lead to lower growth and higher inflation.
- Another important topic to watch will be second-round effects caused by wage increases. These would make inflation much more persistent and would possibly lead to some immediate reactions by central banks.
- The route to a normalisation of central bank policy always bares the risk of false guidance and untimeliness (either acting too soon or too late), which could cause some severe market reactions.
- High debt levels of governments and/or companies make them more vulnerable in the event of stronger-than-expected rate increases, while also impinging on the manoeuvrability of central banks to respond to higher inflation.
- And finally, there is still the possibility of another, more contagious Coronavirus variant, with the (by now) well-known consequences, such as lockdowns.

Conclusion

We expect 2022 to be another year offering plenty of opportunities to generate an attractive performance with convertible bonds. Monitoring the above-mentioned challenges will be key to performance, requiring ongoing analysis and, if needed, an immediate adjustment of portfolio positioning. The expected high level of new issue activity will give us sufficient support here.

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