

# » *Outlook 2023* *Convertible Bonds*



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Marketing material



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## Executive Summary

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- The rapid rise in interest rates has had a particularly severe impact on the growth segment, which is disproportionately over-represented in the convertible bond universe.
- With equity valuations already declining and interest rates expected to stagnate at a higher level, growth stocks should perform better again.
- The renewed positive yield to maturity should compensate investors for waiting until the equity markets rise again on a sustained basis.
- New issuance activity is also likely to rise amid higher interest rates, bringing first-time issuers to the market, seeking to benefit from the lower coupon levels typically associated with convertible bonds. This will help to diversify the universe and create new opportunities.

## Review of 2022

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At the start of the year, the focus was on the reopening of the economy after the Covid-19-related lockdowns. Companies in cyclical sectors, such as industrials and consumer discretionary, that were especially impacted by the pandemic were particularly hopeful of a noticeable recovery, with international supply chain issues expected to ease as a result. Although rising inflation was initially considered transitory, fears began to grow that this would result in increasingly restrictive monetary policy with its associated negative impact on the economy. However, Russia's invasion of Ukraine put an abrupt end to hopes of a pronounced economic recovery.

The resulting sharp increase in energy prices, disruption of global supply chains, and the Chinese government's extremely restrictive Covid adherence policy, with their negative impact on global trade, triggered another surge in inflation rates. Above all, the war between Russia and Ukraine fuelled fears of an energy crisis in Europe due to the cessation of gas deliveries from Russia, which would have a disproportionately severe impact on energy-intensive companies.

Against this backdrop, equity and convertible bond markets performed extremely poorly in the first half of the year, with convertible bonds suffering not only due to the negative equity markets but also from widening credit spreads and rising interest rates. This put the bond floor under increasing pressure, and it did not hold in many cases. This was largely due to the interplay between these three main performance contributors, all of which had a negative impact in this environment. While the summer saw a brief recovery rally, it stalled as a result of persistently high inflation and increasingly restrictive monetary policy.

The further consolidation of Xi Jinping's power at the Chinese Communist Party's congress in October dealt a major blow to hopes of further reforms in China, including a move away from the country's Zero-Covid policy. A slight decline in inflation figures in November raised hopes that the Fed might slow the pace of its rate hikes and gave equity and convertible bond markets some much-needed breathing space. However, even a potential end-of-year rally is unlikely to change the fact that 2022 is set to go down in history as the second-worst year for convertible bonds since the financial crisis in 2008.

The higher weighting of cyclical stocks at the start of the year had a pronounced adverse effect on the performance of our defensive strategies (IG and Defensive), while the rise in interest rates, which weighed heavily on particularly defensive positions with low equity exposures, contributed to a weaker performance until the midpoint of the year. Our repositioning towards companies with more stable business models and those that have benefited from the drastic change in conditions (energy, cyber security) brought considerably more stability to the portfolio.

In the case of our Opportunistic strategy, the underweighting of interest-sensitive sectors, such as real estate and growth companies (so-called long-duration assets), proved especially helpful. The latter are being hit particularly hard by rising interest rates due to the fact that their profits will be generated at a much later point in the future. The strategy also profited from its positioning in the energy sector, which proved a stabilising factor in light of the European energy crisis. Likewise, the constant focus on higher-quality names also paid off, with lower qualities recording particularly heavy losses as credit spreads widened.

In the Sustainable strategy, the sharp rise in energy prices created a challenging environment in the first half of the year. Sustainability considerations, such as high carbon emissions, meant that the strategy avoided not only energy companies but also cruise lines and airlines, which profited from a normalisation in passenger traffic. At the end of the year, the drastic interest rate hikes by central banks appeared to put the brakes on both the economy and inflation. A calming of the interest rate situation and flattening of inflation expectations provided a boost to sustainable investments.

The Dynamic strategy was able to profit considerably from its underweight in real estate and consumer-driven sectors, while its consistent overweighting of the energy sector also contributed to relative performance. Conversely, our positioning in commodities and industrials had a negative impact, with both sectors particularly suffering as a result of the energy crisis. Over the last few months, the strategy's focus has shifted away from cyclical stocks towards (renewable) energy as well as selected stable business models in the healthcare and cyber security sectors. The portfolio adopted a fundamentally defensive credit risk positioning over the course of the year.

## Outlook 2023

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The recession expected in the coming year (a detailed assessment of which can be found in our CIO's macro outlook) will have a noticeable impact on corporate profits in some areas. The least affected companies are likely to be those with only marginally cyclical business models and considerable pricing power. Only when there is more clarity about the depth and duration of the recession, opportunities will also arise for cyclical companies.

Inflation is also likely to continue having a significant impact on opportunities. Should we see a rapid trend reversal, this would likely generate numerous opportunities in the growth sector. Due to considerable uncertainty, however, we will not increase risk in this area too soon, especially as central banks are rather overshooting the mark with their restrictive monetary policy.

The same applies to convertible bonds with high interest rate sensitivity, such as banks and real estate. Again, we are not expecting a swift reversal of trends in this area that would allow us to build up risk. As a result, we are initially continuing to focus on less interest-sensitive sectors and short-dated securities.

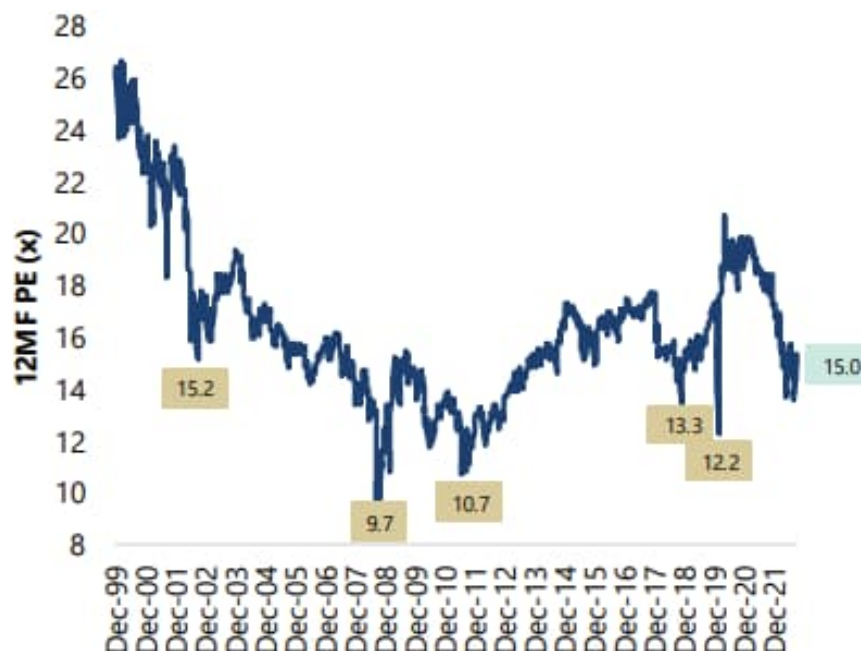
» Political risks are likely to play an increasing role.

We expect political risks, including the war in Ukraine and growing tensions between China and the US, to increasingly play a role. As a result, we continue to underweight companies whose business development is particularly affected by these factors. Increasingly ideologically-driven policy in China also calls for a degree of caution, particularly with regard to Chinese companies. The ongoing impact of this situation on global supply chains should not be underestimated. We will now see whether Xi Jinping gets serious and follows up his initial market-friendly measures with others. Having said that, the anticipated move away from China as a manufacturing centre is also creating opportunities, particularly among companies that will benefit from building capacity outside China.

In our view, issuance activity will pick up considerably once again as soon as companies perceive an economic recovery. We particularly expect this to be the case for those anticipating high levels of growth. This will create additional performance opportunities.

However, the interest rate sensitivity of equity markets has already diminished considerably due to the decline in valuations. With richly valued stocks being particularly punished by rising interest rates, a fall in valuations dampens this effect somewhat. As chart 1 shows, the price-earnings ratio of equities (as measured by the S&P 500 excluding the top 10 internet/tech firms) has dropped significantly. This ratio has now corrected down to 15x, having traded at a lofty 20x at the end of 2020.

Chart 1: Equity market valuations

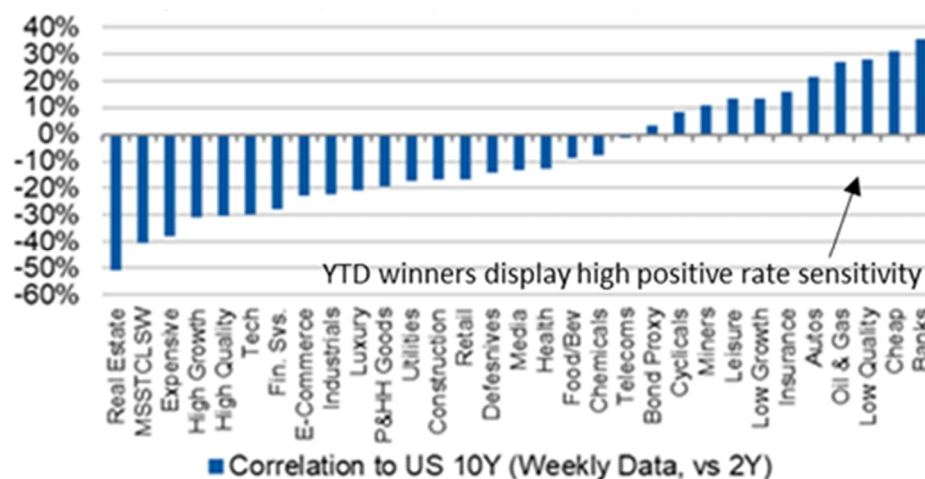


Note: Bottom-up aggregate weekly PE based on historical constituents and weights. Excl. top 10 US internet/tech by market cap.

Source: Jefferies, FactSet

It is also worth noting the extent to which this year's sector performance depended upon interest rate sensitivity. The strongest sectors were those with the highest positive interest rate sensitivity, such as banks, as well as those with low quality or cheap valuations. On the other hand, sectors with high negative interest rate sensitivity, such as real estate and expensive growth companies (long-duration assets), faced the strongest headwinds (see chart 2). Combined with an outlook that includes a consolidation in interest rates, sectors with high negative interest rate sensitivity in particular are unlikely to encounter any additional headwinds.

Chart 2: YTD interest rate sensitivity of EuroStoxx50 equity sectors



Source: MS EU Equity Derivatives, weekly data vs. YTD

Furthermore, the US consumer price index published in November showed some first softening, coming in at a lower rate than expected. If this trend is confirmed in December, it will enable the Fed to deviate at least to some extent from their “data dependency” and adopt a slightly more flexible approach. This could allow the pace of interest rate hikes to slow considerably and support stock market valuations, with heavily punished growth stocks in particular set to profit in the medium term.

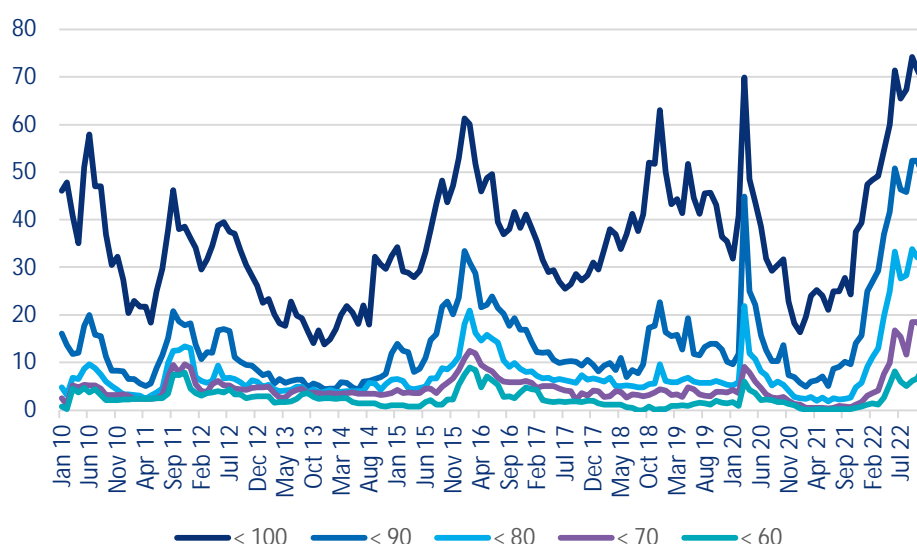
» Stock selection will be a crucial factor for performance generation.

Nevertheless, we expect equity market volatility to remain high. In addition, an environment of higher interest rates will result in greater differentiation in the market. In contrast to the last few years of low or falling interest rates, stock selection will be decisive in generating performance in the current high interest rate environment, providing a strong case for a rigorous bottom-up approach. As a result, meticulous stock selection will be a crucial factor in generating alpha in 2023.

Convertibles are likely to attract more interest from issuers once again on the back of higher interest rates, as they represent an attractive financing solution in this environment. In addition to traditional issuers of convertible bonds (growth companies), this should also entice issuers from other sectors, which in turn would further diversify the convertible bond universe.

In the fourth quarter of 2022, a record percentage of convertible bonds are trading below their issue price (> 70% of US convertibles as of mid-October 2022, see chart 3). This results in a positive yield to maturity for these CBs. We are not anticipating a pull-to-par effect any time soon, as we do not expect equity markets to rally or credit spreads to narrow significantly. As a result, we expect a steady move closer to their par value as the redemption date approaches.

Chart 3: The majority of convertibles are trading below issue price



Source: Nomura Securities International, Inc.

» Within cyclicals, we prefer companies with pricing power.

Future monetary policy will be decisive for our broad strategies (Opportunistic, Sustainable and Dynamic) due to the higher weighting of growth stocks in these segments. As outlined above, we certainly see supporting factors in the medium term here, which could lead to a build-up of risk in long-duration assets over the course of the year. Across all strategies, we particularly prefer companies with pricing power in cyclical sectors, as well as those that will be less affected by a recession. In addition, we will continue to maintain our defensive stance towards credit risk, as the global macro picture still suggests increased risks for vulnerable companies.

## Conclusion

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With 2022 set to go down in history as the second-worst year ever for convertible bonds, we expect them to be in a much stronger position to start off 2023. First, the sharp correction in equity valuations that has already taken place, as well as the likelihood that interest rates will stagnate at an elevated level, should create a significantly more favourable environment. Growth companies (long-duration assets), which are disproportionately over-represented in the convertible bond universe, are likely to be the biggest beneficiaries of this trend. Furthermore, positive yields to maturity will create an additional source of returns. Likewise, new issuance activity is expected to improve, as companies increasingly look for alternatives to keep their refinancing costs low in an environment dominated by elevated interest rates.

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