

» *Convertible Bonds: Outlook for 2020*

Convertible Bond Portfolio Management Team
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Convertible bond outlook 2020: Benign market environment should support the asset class

Executive summary

- **Interest rates and global economy:** Monetary policy is likely to remain moderately expansionary. We expect economic growth to be low but positive.
- **US/China trade conflict and US elections:** These are the dominant topics for investors in 2020 in our view. Depending on developments, volatility is likely to spike intermittently.
- **Sector rotation:** We may see a continuation of the recent shift into previously underperforming stocks.
- **CB-specific topics:** Increasing new issuance activity appears likely on the back of higher interest rates and corporate financing needs. Furthermore, security selection, with a focus on bond floors, is likely to prove crucial as we question the defensive characteristics of commonly acknowledged “defensive” sectors.

Review: We expected 2019 to be a positive year for convertibles, but felt that timing would prove challenging

— Equity markets and interest rates:

View: We expected upside potential to outweigh downside risks, identifying several positive catalysts: continued global economic growth, albeit with weaker momentum, a stabilisation of the Chinese economy and a possible resolution of the US-China trade dispute (although settlement appeared unlikely in the short term). As major risks, we factored in tensions caused by the trade dispute, fears of slacking global growth, a sharp slowdown in China, a steep decline in corporate profit growth, a reduction of fiscal stimulus in the US, corporate share buybacks and a hard Brexit. Furthermore, we anticipated interest rates to move higher on the back of more restrictive monetary policy by the Fed and the ECB, but did not expect this to have a significant impact on equity markets.

Result: Our outlook proved largely correct, in the sense that positive sentiment largely held sway and political responses were adequate in order to foster growth. However, we underestimated the extent of central banks' determination to step in once again with the full range of tools available to them to aggressively combat the economic slowdown. Together with the significant decline in interest rates, this provided a substantial boost to global equity markets, which so far this year have rallied more than 20% (see chart 1).

Chart 1: MSCI World Index: performance year to date



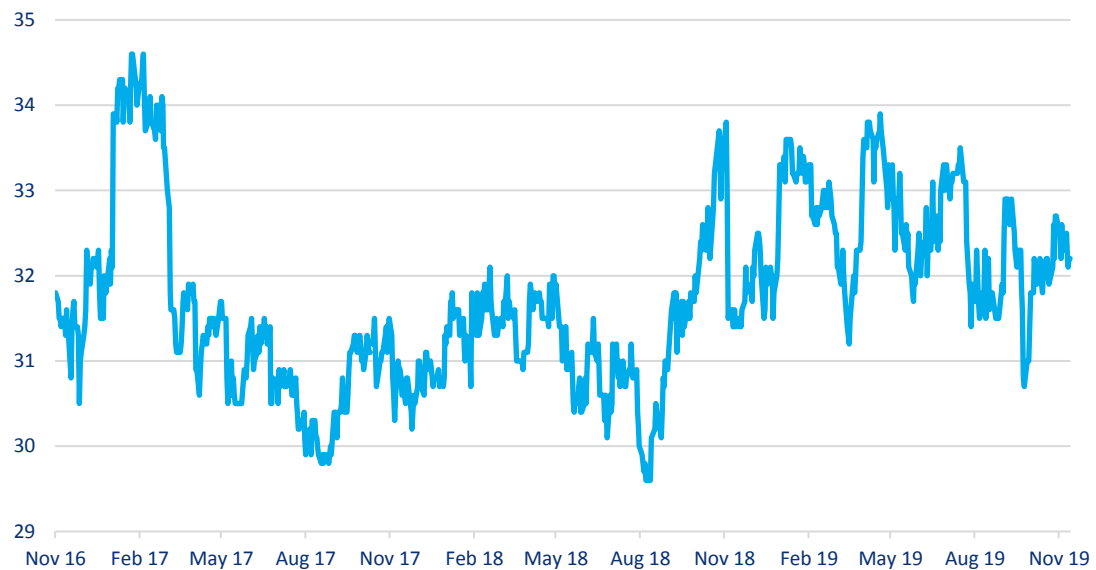
Source Bloomberg, November 2019

— Implied volatility:

View: We expected volatility to remain unchanged, with a fair amount of new issuance but not sufficient to create oversupply problems.

Result: Convertible bond volatility was very much unchanged over the course of the year with some correction at the beginning of October, when a flood of new issues came to the market. However, valuations recovered thereafter (see chart 2).

Chart 2: Implied volatility of Thomson Reuters Global Focus Index



Source Bloomberg, November 2019

— Credit spreads:

View: We expected credit spreads to trend slightly wider.

Result: Our spread outlook turned out to be erroneous as spreads have generally tightened in all regions and segments (see chart 3).

Chart 3: Bloomberg Barclays EuroAgg Corporate Average OAS



Source Bloomberg, November 2019

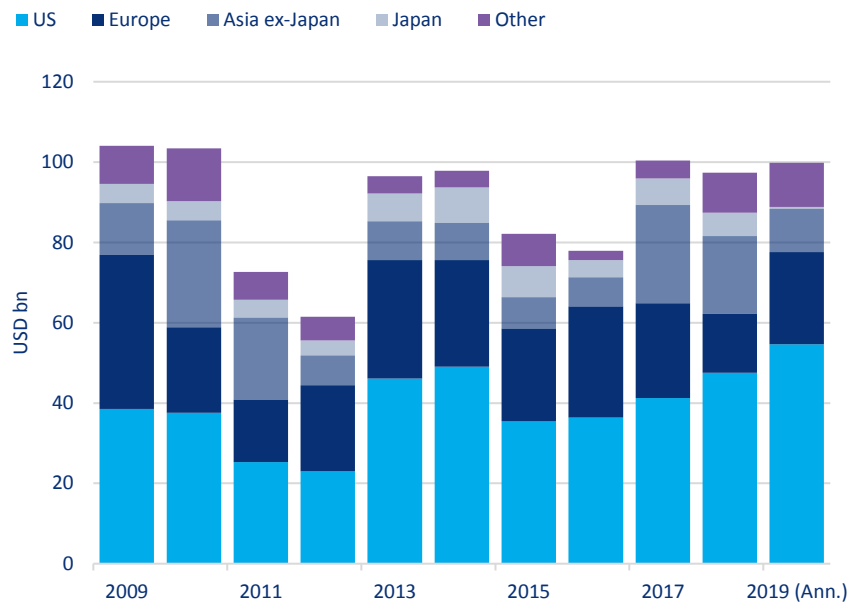
We expected to see some CB-specific topics:

— Greater European issuance:

View: We expected European Central Bank policy to push up interest rates and therefore incentivise companies to issue CBs.

Result: European issuance lagged our expectations, with issuance increasing from the previous year but still lagging the US activity by a large margin (see chart 4).

Chart 4: Global convertible bond issuance in billion USD



Source Thomson Reuters, Fisch Asset Management, November 2019

— Defensive sectors:

View: We raised the concern that “defensive” sectors may not be truly defensive, as they are often highly influenced by politics and/or regulation.

Result: The rental floor debate in Berlin, which hit Deutsche Wohnen and other CB names in the real estate sector, proved our concerns were well-founded.

— Challenging conditions for momentum:

View: With increased market volatility we expected the environment to be challenging for our momentum approach.

Result: The momentum approach did indeed face a somewhat difficult environment. We responded by putting more focus on fundamental drivers and the long-term trend in the underlying stock; the net result being lower trading activity.

Basic outlook unchanged from previous year, but decisive differences:

- **US/China trade conflict and US elections:** We see the ongoing US/China trade conflict and the upcoming US election as the dominant topics. In our view, these will be the key drivers for equity markets in 2020. The US election could provide an incentive for President Trump to be more open towards negotiations. If the conflict were to ease, cyclical names would profit most. However, we believe volatility will remain elevated until a potential resolution is reached. In the run-up period to the US election, the healthcare sector, and pharma & biotechnology in particular, can be prone to increased volatility as related campaign promises will probably play a prominent role.

- **No recession, low but positive growth:** In our view, the global economy is healthy and we expect low but positive growth (low single digit).
- **Monetary policy:** We expect further monetary expansion but with weaker momentum to be supportive for global equities. Together with improving economic fundamentals, we expect a normalisation of yields in Europe, resulting in rising interest rates and steepening yield curves.
- **Sentiment:** Many investors remain on the sidelines and are shying away from re-entering risky assets. A resolution of the trade conflict and/or improving economic data, such as PMI, could diminish recessionary fears, reverse sentiment and trigger a sudden rally in risky assets.
- **Sector rotation:** We expect the current rotation from recent winners into former losers to continue. As a result, the previously underperforming “traditional” industries, such as machinery, automobile and chemicals may gain relative strength. Additionally, this would mean that the underperformance of value versus growth, which has persisted for more than a decade, might revert.

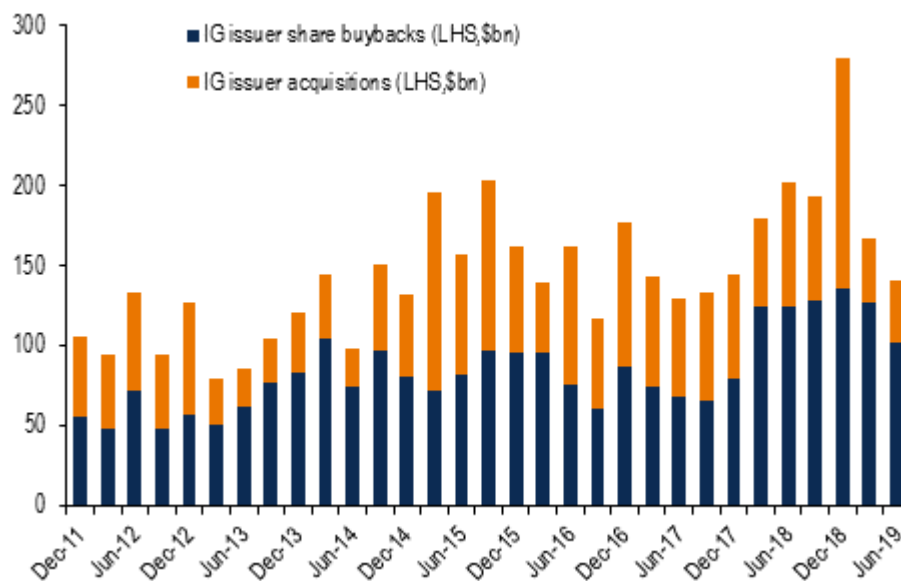
Nonetheless, there is a key risk to our outlook that we will be monitoring closely:

- **Economic expectations may be too positive:** The global economy could enter a recession, with yield curves inverting, global demand slowing down and commodity prices tumbling. This could be triggered by an extended trade conflict and monetary policy choices.

There are a number of CB-specific topics that will occupy us:

- **Industry consolidation / corporate events:** We expect industry consolidation to continue in sectors such as automobile and healthcare, owing to profit deterioration. However, in our view, these events are likely to be structured as joint ventures rather than acquisitions, given high stock valuations.
- **Portfolio stabilisers:** There are no clear stabilisers, such as “defensive” sectors. Here, we stress again the topic raised in last year’s outlook that so-called defensive sectors are highly influenced by politics and/or regulation. Security selection, focusing on solid bond floor positions (decent credit analysis), will be central.
- **Increased new issue activity:** Primary market activity should gain traction. We see several reasons for this: 1) higher interest rates in Europe and the US; 2) repatriation triggered by US tax reform is mostly completed; 3) financing needs as companies have returned capital via dividends and share buybacks. Share buybacks have already started to decline, pointing towards tighter corporate cash situations (see chart 5).

Chart 5: Share buybacks (in billion USD)



Source BofA, July 2019

- **ESG:** The increasing appetite for the integration of ESG considerations into investment decisions is also unlikely to let up in 2020. With regulatory proposals underway, we expect convertible bond management to come under increased scrutiny. Not only do we anticipate increased flows into “sustainable” or “responsible” products, sectors and companies, but we also expect to see greater professionalism in terms of how ESG is integrated into the various investment approaches.
- **Timing will again prove difficult:** The timing of equity investments is likely to be very challenging in an environment of increased volatility, political tensions and an economy potentially close to the edge of a recession. Here, convertibles can offer investors a smart way of benefiting from their built-in automatic timing.

Conclusion

We envisage a challenging environment, in which the upside potential outweighs the downside risks. In such an environment convertibles have the advantage of built-in market timing and low sensitivity to interest rate movements. To avoid pitfalls an active management approach, focusing on solid bond floors, idiosyncratic opportunities and deliberate trading activity, will be crucial in 2020.

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