SSI Convertibles: 2017 Market Outlook

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2016 was a solid year for convertibles, despite a somewhat volatile start to the year. The BAML All US Convertibles Index (VXA0) returned +10.43% for the full year, an 87% capture of equity market total return, as measured by the S&P 500 Index. On a long term basis, convertibles have maintained superior risk adjusted metrics relative to the equity market, with strong return capture:

Convertibles[1]	10 Years	20 Years
Total Return Capture vs Equity Market[2]	93%	98%
Volatility Capture vs Equity Market	88%	84%

[1]*BofA ML All US Convertible Index (VXA0)*
[2]*S&P 500 Index*

For 2016, strong underlying equity performance was a major driver of convertible total returns, as was massive spread tightening particularly in the lower grade credits. As such, the equity-sensitive and credit sensitive portions of the convertible universe outperformed traditional balanced, convex convertibles, a rare occurrence in an asset class where the balanced convex zone typically represents the best risk-reward tradeoff.

The coming year represents a seminal change in the macroeconomic fundamentals relative to the experience of the last few years. The 2016 economic backdrop was characterized by tepid 1% to 2% GDP growth, depressed productivity growth, and exceptionally easy monetary policy by all major central banks. By contrast, the November election outcome of a unified Republican administration in the White House and Congress has brought into focus the highly likely prospects of dramatic corporate tax relief, deregulation and expansionary fiscal policy. Indeed, economic indicators and earnings surprises already turned positive last year, and rates had begun to creep up ahead of the macro shifts we expect in 2017. Given our view for the year ahead, these factors should continue to improve and accelerate, barring any drastic unforeseen shifts in policy. Besides the expansionary fiscal policy initiatives, there has been a meaningful inflection in monetary policy by the Fed, to a tightening stance. Prospects seem likely for at least two additional Fed Funds rate hikes in 2017, given comments by chair Yellen as well as action in fed funds futures. Elsewhere in Europe, the economy has been strong and the pace of monetary expansion could be slowed down and even halted, as evidenced with Draghi's recent tapering stance, set to commence in spring 2017. The large moves in treasury yields and bund yields since the November election reflect both the changing course of monetary policy, and the policy changes expected of the new Trump administration.

Given the backdrop of fiscal stimulus along with improving GDP growth and economic data, we expect the high yield market to be generally stable and healthy, with the potential for further spread tightening across the lower end of the credit spectrum. High yield default rates are likely to be cut in half in 2017 based on the economic acceleration, the maturity profile and the improvement in the fundamentals of the most stressed sectors – energy and materials. The convertible market, with its low representation in the stressed sectors, is likely to witness an even lower default rate.

With the potential for stronger GDP growth and fiscal stimulus in the form of lower corporate tax rates, a rotation to value, cyclicals, and small-caps has already begun. We expect it will continue, however there are risks to our outlook. The prospect of deleveraging and a slowdown in China could be a meaningful shock to the global economy, as could political events in Europe surrounding French, Italian and German elections. In addition, the Fed is closely monitoring fiscal developments, and the path of future rate hikes may be calibrated to the pace of policy changes – if these go out of sync, one could expect potential volatility shocks to the markets. Additionally, the prospects of protectionism or trade wars could unsettle the markets. Meanwhile, to achieve revenue neutrality to offset potential tax cuts, the new administration will likely attempt to impose a border tax, which could cause a spike in the US Dollar. This could introduce volatility into corporate earnings and to the equity market.

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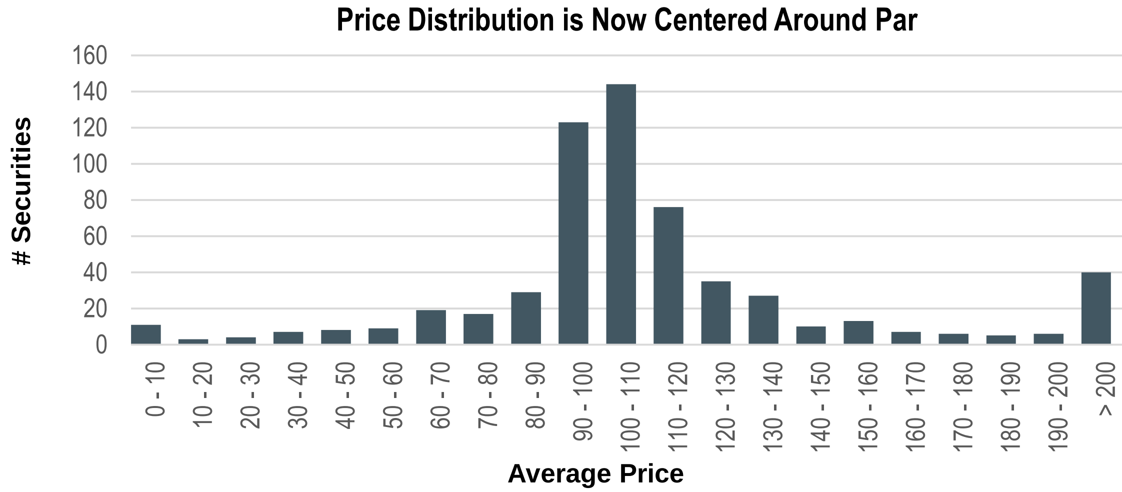
With their unique combination of fixed income and equity attributes, convertibles appear well poised to navigate the market environment ahead. This is because the asset class offers defensive downside protection through a par redemption value, while participating in equity market appreciation and minimizing duration risk. The asset class is highly convex at this point in time, and average dollar prices have moderated towards par, compared with the recent past:

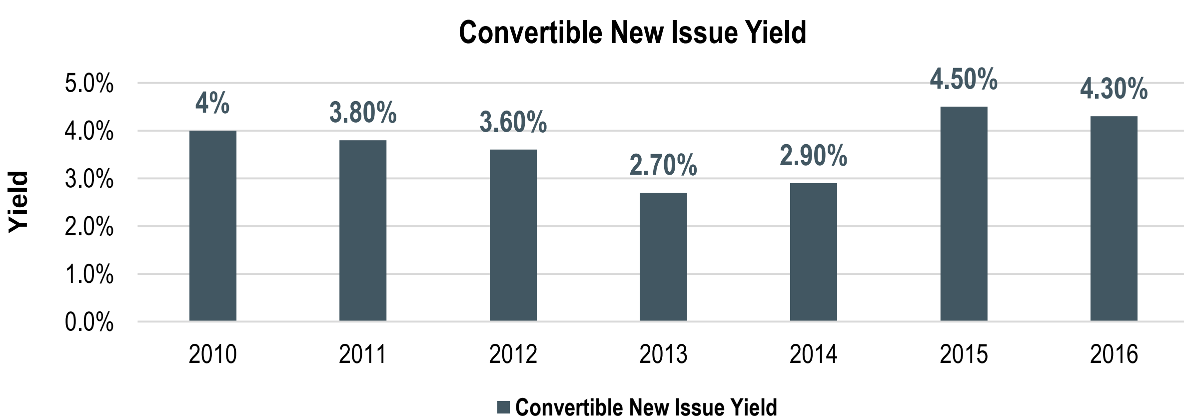


Source: SSI internal research

We expect convertible returns to be impacted by the following factors:

- The asset class is expected to participate in the appreciation of the equity market in line with its equity sensitivity, or delta.
- We expect some further tightening of credit spreads after last year's large move thereby lifting the fixed income value and causing price appreciation.
- In contrast to equity and fixed income assets that are likely to suffer under conditions of rising volatility and rising interest rates respectively, convertibles have a built in offset in the former and much more muted reaction in the latter environment. The equity option in a convertible rises in value when volatility rises, providing a meaningful offset in contrast with equities that generally suffer a drawdown when volatility rises. The muted reaction to rising rates relative to fixed income is a result of a duration that is less than half that of the Barclay's Aggregate Index.

The economic backdrop is supportive of increased convertible new issuance, as trends such as M&A, GDP growth, and higher bond yields tend to lead to companies tapping the convertible market to raise capital. These factors should bring about a rise in the volume of convertible new issuance, as well as a healthy increase in average new issue yields.



Source: Barclays

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In summary, we believe convertibles are competitively positioned for attractive returns on a relative and absolute basis in 2017.

Convertibles[1]: 2017 Outlook	
Convertibles Outlook	**9.7%**
Return Capture vs Equity Market[2]	85%

[1]BofA ML All US Convertible Index (VXA0)
[2]S&P 500 Index

Our return outlook for the general convert market is derived from expected price moves in the underlying equities, the current income of the asset class and expectations regarding the impact of moves in credit spreads and rates. As to equity market returns, we expect them to be in line with the growth in underlying earnings. While rising rates are likely to be a headwind for equity multiples, improving economic growth prospects and the decisive extinction of deflation risk are likely to act as tailwinds to multiples, by reducing the higher than normal level of current equity risk premium. The net result could be unchanged equity market multiples. Our equity market outlook is 11.4% as a base case, based on analyst expectations of S&P EPS growth of the same amount. Between the convertible market delta of approximately 55% and an average gamma of 0.5%, we calculate a price return for convertibles to be 6.6%. In addition, we expect 3.1% from current income, combined with spread tightening by 40 bps and rise in rates of 50 bps. Given the low duration of the asset class, the net effect of spread tightening and rate increases is likely to be immaterial in 2017. **This brings the base case outlook to 9.7% for convertibles in 2017**, and ignores potential improvement in volatility and vega effects, which we believe could be an incremental positive for asset class returns.

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Notes on Forward Return Calculations:
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