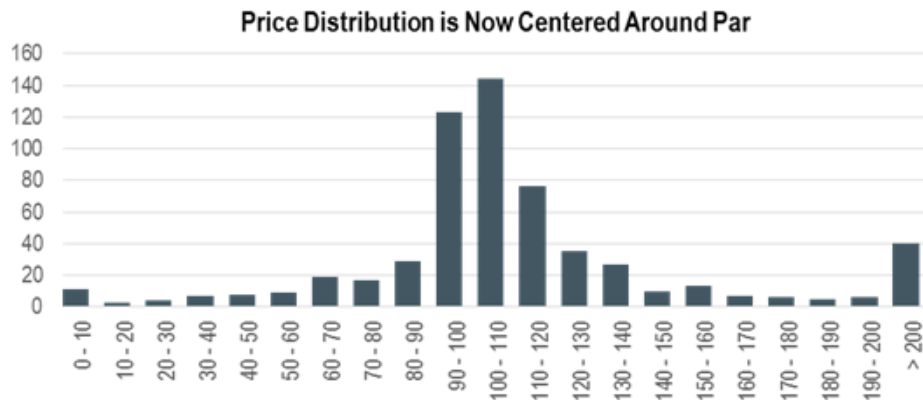


Convertibles: 2017 Mid-Year Review and Market Outlook

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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. 2017 is turning out to be a strong year for convertibles after a solid 2016. The BofA ML All US Convertibles Index (VXA0) returned +7.9% through June 2017, an 85% capture of S&P 500 total return. The underlying universe is comprised of large and mid-cap companies. In that context, the index captured more than 100% of the Wilshire 5000's +7.7% return. The asset class is highly convex at this point in time, and average dollar prices have moderated towards par (as you can see in below Chart 1), compared with the recent past:

Chart 1:



Source: SSI Internal research

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 vs. Equity Market ²	93%	98%
Volatility Capture vs. Equity Market	88%	84%

¹BofA ML All US Convertible Index (VXA0)

²S&P 500 Index

For 2017, strong underlying equity performance has been a major driver of convertible total returns, along with spread tightening, particularly in the lower grade credits, and an improvement in valuations. Spreads for non-Investment Grade convertibles tightened by 57 bps to 427 bps compared with a tightening of 21 bps in High Yield B index to 361 bps. The strong equity market performance led to the equity-sensitive portion of the convertible universe, outperforming traditional balanced, convex convertibles, which typically represent the best risk-reward tradeoff.

The year started with lofty hopes for dramatic corporate tax relief, deregulation, and expansionary fiscal policy. Against a backdrop of improved economic surprises in the second half of 2016, the market had started to price in a pickup in economic growth and tighter monetary policy. The yield curve had steepened, the dollar strengthened, and value stocks had outperformed growth stocks coming into 2017. As the year progressed, these hopes were increasingly priced out of the market as the politics of the Russia investigation bogged down the Trump Administration's agenda. By mid-year, the curve had flattened, the dollar weakened, and growth strongly outperformed. Although GDP growth this year is likely to be higher than last year's 1.6%, prior expectations have been brought down to a tepid 2.1%, in line with its recent slow rate. Monetary Policy normalization is likely to be very gradual, with the Fed Fund futures pricing having less than a 50% chance of additional moves by the Fed this year. However, a commencement of balance sheet reduction by the Fed, and tapering of quantitative easing by the ECB is likely to occur later this year. In addition, growth as well as economic surprises have been robust in both Europe and China.

Given the backdrop of steady yet uninspiring GDP growth, and continued easy monetary policy, we expect the high yield market to be generally stable and healthy, with the potential for some further spread tightening across the lower end of the credit spectrum. High yield default rates are likely to stay low based on the slight economic acceleration and the maturity profile. The convertible market, with its low representation in the stressed sectors, is likely to witness an even lower default rate.

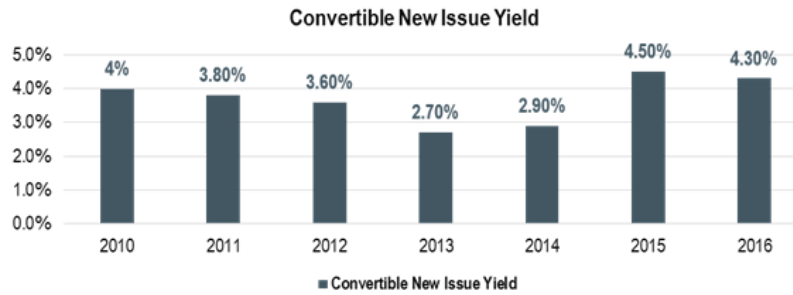
With the market almost completely pricing out any chance of policy action, there is the potential for positive surprises and stronger GDP growth, both from any movement on policy, as well as from easy financial conditions, including a much weaker dollar and a more dovish Fed. There are some risks to our outlook. The prospects of a major political shock, whether from the ongoing Russia investigations or a deleveraging and slowdown in China, could deal a blow to the global economy. Potential global political events in Europe surrounding the Italian and German elections also loom in the horizon. Additionally, the prospects of protectionism or trade wars could unsettle the markets.

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 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 Bloomberg Barclay's Aggregate Index.

The current economic backdrop remains 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 have already contributed to a recent rise in the volume of convertible new issuance, as well as a healthy increase in average new issue yields (as depicted in Chart 2 below). For 1H 2017, there was \$25.8 billion of new issuance vs. only \$14.7 billion in the first half of 2016. With YTD redemptions of only \$14.6 billion, 2017 net supply is strong at \$11.2 billion.

Chart 2:



Source: SSI internal research

In summary, we believe convertibles are competitively positioned for healthy market growth, as well as attractive returns on a relative and absolute basis in 2017. Our 2017 convertibles outlook is summarized as:

Convertibles¹ 2017 Outlook*

Convertibles Full Year Return Expectation	12.3%
Return Capture vs. Equity Market ²	85%

¹BofA ML All US Convertible Index (VXA0)

²S&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 14.5% as a base case, based on analyst expectations of S&P EPS growth of the same amount. Between the convertible market delta of approximately 60% and an average gamma of 0.5%, we calculate a price return for convertibles to be 9.2%. In addition, we expect 3.1% from current income, combined with spread tightening by -25 bps and rise in rates of +30 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 +12.3% 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.

***Notes on Forward Return Calculations:**

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