July 2022

# 2022 Mid-year Convertible Bond Commentary and Outlook


**Ravi Malik, CFA**, Principal & Portfolio Manager

**Steve Wachtel, CFA**, Portfolio Manager

**Mike Opre, CFA**, Portfolio Manager


## 1H'22 Recap

The first half of 2022 was a difficult period for most asset classes. The S&P 500 had its worst first half return since 1970[1]. Treasury, investment grade, and High Yield bond returns were near historic lows for any first half. It was also a very challenging period for Convertible bonds. After a stellar 2020 when Convertibles returned 46.2% (as measured by the ICE BofA All US Convertible Index–VXA0) and a solid 2021 return of 6.34% (lagging the S&P but ahead of all major fixed income indices), the asset class struggled in 1H'22[1]. This was due to the poor performance of the underlying equities as well as the widening of credit spreads.

| 1H'22 Performance[1] | Return |
|---|---|
| ICE BofA All US Convertible Index (VXA0) | -20.21% |
| S&P 500 | -19.97% |
| Russell 2000 | -23.45% |
| Bloomberg High Yield Bond Index | -14.19% |
| Bloomberg US Corporate Inv. Grade Bond Index | -14.39% |

Drivers of Convertible performance in the first half of 2022 include a -50% decline in underlying equities from their 52 week high, 150 bps rise in treasury yields and a 247 bps rise in High Yield spreads[2].

The S&P 500 peaked on the 2nd trading day of the year and it was all downhill from there. Concerns over rising inflation and a more hawkish Fed were the initial catalysts for the decline. Estimates for the number of Fed Fund rate hikes continued to grow throughout the first half as inflation proved to be far from transitory. The next major negative catalyst was the Russian invasion of Ukraine in late February, which further flamed inflation fears and introduced new geopolitical risks. Soon after, global growth estimates started to decline, starting in Europe but eventually hitting the U.S. China GDP growth was also challenged in 1H'22 due to the slowdown in the property sector and its zero-Covid policy, which put many cities in partial or full lockdown.

Global recession fears grew throughout Q2'22 and continue to rise so far in July. This can be seen in the weak relative performance of cyclical stocks of late, a group that was leading at the start of the year. Recession fears have even brought down commodities, one of the few asset classes with positive returns in the first half. Energy was consistently the leading sector YTD until early June when it also succumbed to recession fears. It has experienced a sharp drawdown over the last five weeks. Copper, iron ore, and other industrial metals started their decline earlier in the year.

1. Sources: Bloomberg, BofA Global Research, ICE Data Indices LLS, and Internal SSI research. 1H'22 returns as of 6/30/2022, unless otherwise noted.
2. Source: As of 6/17/2022. US Convertible Bond universe with issue size > $125M, based on SSI internal research.



2121 Avenue of the Stars | Suite 2050 | Los Angeles, CA 90067 | Tel: (310)595-2000 | Fax: (310)595-2089 | www.ssi-invest.com

Credit spreads began the year near historically tight levels. Spreads widened through most of the first half reaching a peak of 588bps on the High Yield CDX index. As of July 15th, the spread is 530bps compared to 293 bps at the start of the year. The VIX index increased in January and has been in a range for most of first half between 20 and 35. Considering the elevated fear and uncertainty and low investor sentiment that has been present for most of this year, it is somewhat surprising that the VIX never reached the 40 level and is currently under 30[3]. This could be because hedge funds' gross and net exposure have been very low for most of the year, thus decreasing their need for downside hedges.

**At the end of the first half, 57.13% of the VXA0 traded under par, which is an unusually high number.**

## Market Outlook

The path of inflation and the Fed's level of hawkishness will determine the market environment for the second half of the year. It is likely that inflation has peaked (the June CPI of 9.1%[4] marking the high point). The main reasons for this are:

- The sharp decline in energy and food commodities since early June
- The alleviation of some supply chain bottlenecks
- A spike in inventories at many retailers
- The drop in inflation expectations.

However, other areas of the economy are likely to show more inflationary persistence. Shelter, which makes up 32.4% of the CPI, is expected to stay at heightened levels through the rest of the year. This is because national rents are still increasing at fairly high levels and because of the lagging nature of the CPI shelter calculations[4].

We expect volatility to remain elevated at least through the fall. By that time, inflation indicators should be on a clear downward path and the Fed should be close to a dovish pivot, which will be bullish for the markets. The economy should continue to weaken through the rest of the year due to a slowdown in consumer spending from inflationary pressures and low consumer confidence. The 2yr-10yr Treasury curve has already inverted and the Fed fund rate – 10yr will likely invert after the expected September Fed rate hike[5]. Historically, these inverted yield curves are indicators of a looming recession.

While the economy will likely be weaker near the end of the year and possibly in a recession; the market is forward-looking and will look ahead to looser monetary policy and an economic recovery. Volatility historically rises leading up to mid-term elections so post-elections in early November could serve as another positive catalyst.

There has been a meaningful de-rating of stocks YTD, especially within growth equities. We believe we are near the end of multiple compression but we do expect earnings estimates for most companies to decline over the next few months due to a slowdown in demand, margin pressure, and USD appreciation. It will be difficult for a new bull market to emerge before earnings expectations reset. Surprisingly, earnings estimates for 2022 actually have risen +2.6% YTD through 7/14/22, although they fell -2.5% ex-Energy[6]. The current Q2 earnings season will likely be a catalyst for downward earnings revisions.

3. Bloomberg, SSI internal research.
4. Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: Shelter in U.S. City Average, retrieved from FRED, Federal Reserve Bank of St. Louis on 7/18/2022.
5. Source: Federal Reserve Bank of St. Louis, 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity [T10Y2Y], retrieved from FRED, Federal Reserve Bank of St. Louis on 7/18/2022.
6. Source: BofA Global Research, data as of 7/14/2022.



2121 Avenue of the Stars | Suite 2050 | Los Angeles, CA 90067 | Tel: (310)595-2000 | Fax: (310)595-2089 | www.ssi-invest.com

## Convertible Bond Outlook

The poor performance of Convertibles' underlying equities in 1H'22 was primarily due to their high exposure to growth stocks. The Convertible universe has historically been heavily represented by structural growth companies in the Technology and Healthcare sectors. Most of these stocks sold off sharply from significant valuation de-ratings caused by the shift in monetary policy. It is likely that the path of inflation will determine when the valuation compression stops. But we believe that these structural growth companies will outperform the market in the long run. Because of low productivity, demographics, high debt levels, and other factors, U.S. GDP will probably return to pre-pandemic growth levels of roughly 2%, which will once again put a premium on companies that can grow rapidly[7]. Many Convertible bond issuers are disruptors with large addressable markets in areas such as:

- Cloud computing/SAAS (software as a service), Digitization of the economy
- Genomics, personalized medicine, gene therapy, telehealth, and biotech M&A
- Data center growth, artificial intelligence, 5G build out, and automated mobility
- Green Energy: Solar, hydrogen fuel cells, EVs

With the high degree of market uncertainty, we believe convertible bonds are a better way to obtain exposure to growth companies when compared to equities. The principal protection of a Convertible bond that limits the downside is more valuable than ever during these volatile times. The Convertible universe currently has very defensive characteristics and an attractive yield profile. The universe of U.S. Convertible bonds w/over $125MM outstanding (484 issues) has a median bond price of 93.78, a delta of 40%, and an average yield to best of 6.02%[8]. Other characteristics of the asset class are listed below:

### Convertible Bond Universe Key Attributes and Characteristics[8]

**Key Attributes**
*As of 6/17/2022*

| | |
|---|---|
| Market Cap > $1B | **78%** |
| Positive EBITDA est. for 2022 | **75%** |
| Underlying Stock off from 52 week high | **-50%** |
| Yield >5% | **44%** |

***Characteristics***
*As of 7/13/2022*

| | Median | Average |
|---|---|---|
| Current Yield | 1.21% | 1.92% |
| Yield To Best | 4.42% | 6.02% |
| Delta | 40% | 40% |
| Effective Duration | 2.20 | 2.20 |
| Gamma | 0.40 | 0.42 |

**Given the extreme drawdown in the underlying equities, due to multiple compression as inflation fears rose, we expect a sharp rebound when the Fed pivots and there is an inflection in inflation expectations.**

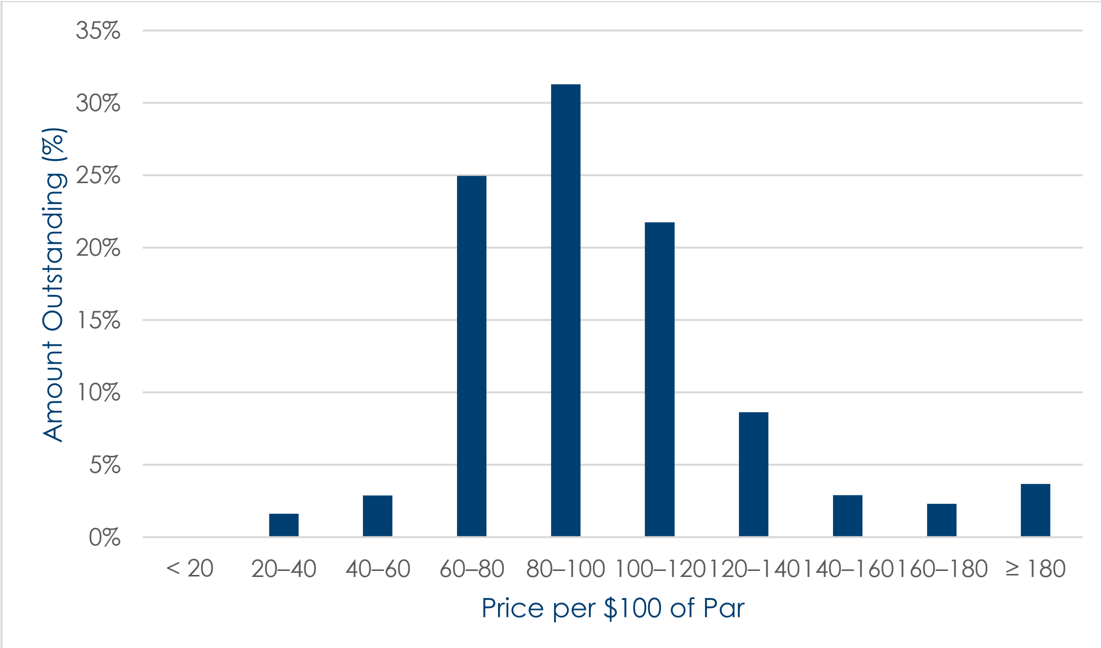
**There are a significant number of Convertible bonds that are trading close to their bond floor, have an attractive yield, and still have optionality that will allow for upside participation when stocks rebound. At the end of the first half, 57.13% of the VXA0 traded under par, which is an unusually high number[9].**

7. Source: U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis, data as of March 2020.
8. Sources: Bloomberg, BofA Global Research, ICE BofA All US Convertible Index (VXA0), Barclays Research, Key Attributes as of 6/17/2022, Characteristics as of 7/13/2022.
9. Source: Bloomberg, BofA Global Research, ICE BofA All US Convertible Index (VXA0), as of 6/30/2022.


2121 Avenue of the Stars | Suite 2050 | Los Angeles, CA 90067 | Tel: (310)595-2000 | Fax: (310)595-2089 | www.ssi-invest.com

The price distribution of Convertibles is illustrated in the chart below:

**Price Distribution**[9]




| Price per $100 of Par | < 20 | 20–40 | 40–60 | 60–80 | 80–100 | 100–120 | 120–140 | 140–160 | 160–180 | ≥ 180 |
|---|---|---|---|---|---|---|---|---|---|---|
| Amount Outstanding (%) | 0.00% | 1.63% | 2.87% | 24.96% | 31.29% | 21.74% | 8.63% | 2.89% | 2.30% | 3.68% |

The credit profile of the Convertible universe is very solid. Leverage amongst issuers remains fairly low. And according to BofA, 53% of US issuers only have Convertible debt on their balance sheet[9]. The last 12-month default rate for US Convertibles is 0.51%. While this rate will increase due to lower liquidity and a slowing economy, we don't expect default rates to spike to prior recession level peaks.

Convertible issuance has been very light YTD (as it has been for equity and straight debt issuance) due to the challenging market environment. But due to the record issuance in 2020 and strong issuance in 2021, the Convertible universe has expanded significantly over the last few years. Through 1H'22, the market size of the Convertible market has increased 23% from the end of 2019 and the number of securities increased 25.4% over that same period[10]. We expect issuance to pick up later in the year when volatility subsides and capital markets fully re-open. Also, it is likely that today's higher financing costs will cause some traditional High Yield borrowers to tap the Convertible market to lower their coupon rates. When issuance does return, it will come with more generous terms for Convertible investors than we saw in 2021.

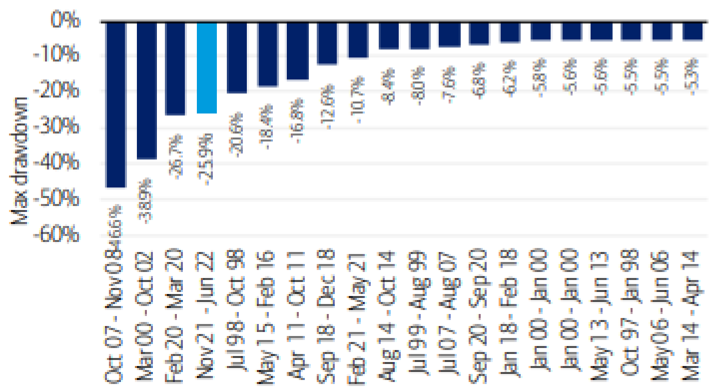
9. Source: Blomberg, BofA Global Research, ICE BofA All US Convertible Index (VXA0), as of 6/30/2022.
10. Sources: BofA Global Research, Barclays Research, data from 12/31/2019 to 6/30/2022.



2121 Avenue of the Stars | Suite 2050 | Los Angeles, CA 90067 | Tel: (310)595-2000 | Fax: (310)595-2089 | www.ssi-invest.com

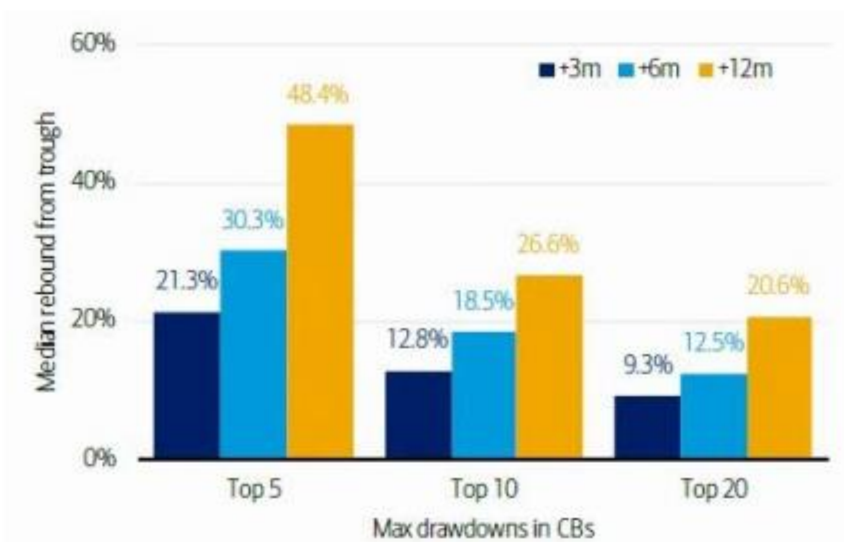
It is unclear when the markets will bottom but it does seem that the risk-reward for Convertibles is attractive judging by historical performance. As shown in the chart below, this is the fourth largest drawdown for Convertibles according to BofA Global Research.

**Top 20 Peak-to-Trough Drawdowns in US Convertibles**[11]




After large drawdowns, Convertible bonds returns have been very impressive. In 2009 and more recently in 2020, converts significantly outperformed the S&P 500 after the market bottomed as shown in the chart below.

**Convertible Bonds Median Rebounds from Historical Troughs**[12]




11. Source: BofA Global Research, ICE Data Indices, LLC. Data as of 30-Jun-2022.
12. Source: BofA Global Research, ICE Data Indices, LLC. Data as of 31-May-2022.

## The Long-term case for Convertibles:

The long-term risk-adjusted performance of converts against other asset classes is impressive, as shown in the chart below. The convex nature and low duration characteristics of Convertibles provide an improved risk/reward profile to equities and corporate bonds.

| **10 Years: US Risk Adjusted Returns**[13]<br>As of June 30, 2022 | Annualized Return (%) | Sortino Ratio | Sharpe Ratio |
|---|---|---|---|
| **ICE BofA All US Convertible Index (VXA0)** | **10.64** | **1.35** | **0.83** |
| Bloomberg US Aggregate | 1.54 | 0.38 | 0.27 |
| Bloomberg US Corporate High Yield | 4.41 | 0.72 | 0.54 |
| S&P 500 Index | 12.96 | 1.40 | 0.90 |
| Russell 2000 Index | 9.35 | 0.69 | 0.48 |

Convertibles are a great fit within a fixed income portfolio. They have a significantly lower duration than both Corporate High Yield bonds and Barclays Aggregate and have historically outperformed in rising interest rate environments. The issuer composition for Convertibles is very different then High Yield bonds and thus provides effective diversification. In addition, the historical default rate for Convertibles is significantly lower than High Yield bonds.

Convertibles are also a great fit for low volatility equity allocations. A low volatility quant equity strategy is likely to be skewed in favor of Utilities, Consumer Staples, and REITS, with underweights in Technology and Healthcare. By contrast, Convertibles have a high representation in Technology and Healthcare. Therefore, Convertibles can provide meaningful diversification benefits to a portfolio, along with the ability to significantly truncate the potential volatility from exposure to these high growth sectors.

***We believe that there is a strong case for an allocation to Convertible bonds over the long-term, however, the current environment provides a unique tactical opportunity set due to the market sell-off.*** Convertibles offer solid participation in equity markets with convexity provided by the downside protection of bonds. It is an ideal asset class for investors seeking growth with capital preservation as well as income.

13. Sources: Bloomberg, SSI Internal Research, data as of 6/30/2022.





2121 Avenue of the Stars | Suite 2050 | Los Angeles, CA 90067 | Tel: (310)595-2000 | Fax: (310)595-2089 | www.ssi-invest.com