SSI Investment Management

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2023: Convertible Bonds Mid-Year Outlook

By Stephen Wachtel, CFA, Portfolio Manager

1H'23 Recap

After a difficult 2022, convertible bonds, as measured by the ICE BofA All US Convertible Index (VXA0), rebounded in the first half of this year to return +8.55%. Convertibles surpassed the 1H'23 returns of the Russell 2000, high yield bonds, and investment grade bonds, while lagging the returns of the S&P 500.

1H'23 Performance	Return
ICE BofA All US Convertible Index (VXA0)	+8.55%
S&P 500	+16.88%
Russell 2000	+8.06%
Bloomberg High Yield Bond Index	+5.38%
Bloomberg US Corporate Investment Grade Bond Index	+3.21%

The main driver of convertible returns was the strong performance of their underlying equities, which returned +16.2% in the first half[1]. The contractions in credit spreads also boosted convertible bond performance. The Markit CDX North America High Yield Index tightened by 54.27bps in 1H'23.

Entering 2023, most markets were very oversold after a rough December in which the S&P 500 declined by -5.77%. Sentiment and positioning were extremely negative, with fears of an imminent recession and tighter monetary policy running high. This sparked a classic January effect rally where the most beaten down stocks from 2022 rebounded sharply. The rally stalled in February as interest rates spiked following stronger economic data and the adoption of a more hawkish tone by the Federal Reserve. The market declined further in March as the collapse of Silicon Valley Bank caused a regional bank panic. Further panic was caused by the growing likelihood of a Credit Suisse bankruptcy. But the market bottomed shortly after as the Fed injected liquidity into the regional banks, which eventually halted the stampede of bank withdrawals. With assistance from the Swiss government, UBS agreed to acquire Credit Suisse on March 19th, removing fears of global contagion that would have likely followed Credit Suisse's collapse.

From the March bottom until the end of the first half, the S&P 500 went on a tear driven by large-cap technology stocks, which make up an outsized portion of the index. The S&P 500 entered a new bull market on June 8th when it crossed the 20% rally threshold from the Oct'22 low.

The regional bank crisis caused interest rates to dive in March (2-year Treasury yield plummeted -118bps in just five trading days) and caused a rotation away from cyclical stocks. Around the same time, the interest in generative artificial intelligence exploded just as Microsoft launched its improved version 4.0 of ChatGPT, and Google launched its competing Bard. All these factors led to huge gains from the largest tech stocks in 1H'23. The AI excitement grew further on May 24th after Nvidia reported its first quarter earnings and provided revenue guidance for Q2 that was more than 50% above consensus estimates due to surging demand for its data center products.

Meanwhile, the rest of the equity markets had much more modest returns for the first half. 1H'23 marked the narrowest 1H breadth in history, with just 25% of stocks outperforming the S&P 500. As stated above, small caps returned just over 8%, and the equal weighted S&P 500 (as measured by the Invesco S&P 500 Equal Weighted ETF) returned just 6.9%. Value stocks (as measured by the Russell 1000 Value Index) fared even worse with just a 5.1% gain.

2H'23 Market Outlook

The path of inflation and the likelihood of a recession will determine the market direction for the 2nd half of the year. Inflation, as measured by CPI, has declined significantly from the recent peak of 9.1% y/y in June'22 to 3.0% y/y in the latest report for this past June. This is primarily due to steep price drops in energy, food, and other goods. It is also likely that shelter prices, which make up close to 1/3 of the CPI, will decelerate meaningfully later this year. Forward looking rent measures, such as the RealPage survey of apartment rents, have shown a sharp decline in rent increases for some time now, and they will eventually be reflected in the lagging CPI shelter component. In addition, the Manheim US Used Vehicle Index showed a -4.2% decline in June, the largest decline since the start of the pandemic. The Manheim index closely tracks the CPI component for Used Cars and Trucks with a two-month lag.

However, The Fed is most concerned about non-housing service inflation, and this has not improved as much as headline CPI or PCE. This is mostly due to a still very tight labor market. From the most recent June payroll report, the unemployment rate stands at 3.6% and average hourly earnings grew +4.4% y/y. The latest JOLTS (Job Openings and Labor Turnover Survey) report for May showed a decrease in job openings but to a still very elevated 9.8m level. Additionally, the Quits ratio, one of the historically most accurate forward looking labor indicators, rose to 2.6% for May.

It will be difficult for inflation to decline to the Fed's target of +2% y/y without wage inflation slowing down more. Without this, the market expectations for the timing of the end of the Fed rate hike cycle and the beginning of rate cuts will have to be pushed out yet again.

The other main factor for the markets is whether the economy will enter a recession later this year. Historically effective recession indicators such as the yield curve, LEI (Conference Board US leading Index ten economic indicators), the Fed senior bank loan survey, negative M2 money supply growth, and the ISM manufacturing business new orders component have all been pointing to a recession for quite some time. However, the still hot job market, the recent rebound in housing, and strong auto demand (US auto sales +11.75% y/y YTD through June) suggest that a recession is not in the cards for this year.

Eventually, the 500bps (and counting) of rate hikes and the quantitative tightening (Fed balance is declining at roughly $1 trillion per year pace) will fully work through the economic system and likely cause a mild to moderate recession in 1H'24.

There is also the risk that something else breaks in the financial system as is typical in Fed tightening cycles. That risk is higher now that interest rates moved back to or above pre–Silicon Valley Bank crisis levels in early July. According to Bank of America, over the last 40 years, every single episode of a peak in UST 2-year yield was followed by some risk-negative event (Exhibit 1):

Exhibit 1 – Details of Specific Risk-off Events[2]

ΔOAS = change in HY OAS since peak UST 2-year yield

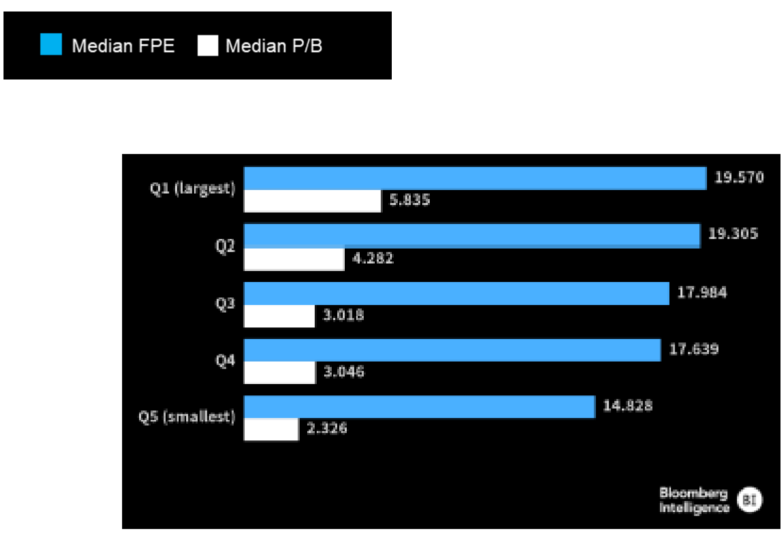
Peak 2yr	Event	Description	Time lag	ΔOAS
Jul-81	Aug-82	LatAm	13	377
Jun-84	Dec-84	S&L	6	368
Mar-89	Feb-90	Drexel	11	624
Dec-94	Dec-94	Mexico	0.5	95
Apr-97	Oct-97	Asia	6	342
May-00	Nov-00	Tech	6	290
Jun-06	Aug-07	GFC	14	486
Dec-18	Dec-18	Pivot	0.5	152
Average			**7**	**342**

We have already experienced the UK Pension liability-driven investment (LDI) crisis, the regional banks, and Credit Suisse so maybe the worst is in the rear-view mirror. But with the recent spike in interest rates, one should stay alert for any signs of a potential next financial shock.

Equity valuations appear elevated by most measures. However, earnings are expected to grow sharply next year so valuations look more reasonable based on 2024 estimates. It is also likely that valuations have been boosted somewhat by the expectations of future productivity gains due to AI. According to Goldman Sachs, Generative AI could potentially lift US productivity growth by roughly 1.5% per year over 10 years following widespread adoption. This would lead to a significant boost in net profit margins and thus earnings.

Outside of the large cap arena, there are many companies trading at cheap valuations. Even within the S&P 500, there is a large dispersion in multiples between market cap quintiles, as shown in Exhibit 2:

Exhibit 2 – Median Valuations by Market Cap Quintile[3]



After such dominance by large cap tech in 1H'23, it is likely that we will see an improvement in market breadth in the near future. According to Evercore ISI, the return spread between QQQ and IWM reached the 99th percentile on a 1 and 3 year basis on July 10th[4]. Therefore, some mean reversion in the 2nd half of the year is likely.

Convertible Bond Outlook

Entering the 2nd half of 2023, convertible bonds are attractively positioned with a significant yield advantage over equities and higher defensive qualities than historical averages. Convertibles are also able to meaningfully participate in any equity upside.

Market Characteristics[5]

As of 6/30/2023

	Median
Yield to Best	5.01%
Current Yield	1.98%
Delta	48%
Price	100.4

Convertible bond issuance in 1H'23 was $23.1b, approximately 157% increase over 1H'22 issuance but still lower than the last 5yr average from 2018 to 2022[6]. A large portion of issuance this year has been for refis and this should continue as companies try and get ahead of debt maturing over the next two years. We expect higher issuance in the 2nd half of the year. Higher overall financing costs should result in some traditional high yield borrowers tapping the convertible market to lower their coupon rates. We can see this happening already. According to Bank of America Global Research, the ratio of convertible bond to high yield issuance increased to over 36% during the past year. This is the highest level since the Great Financial Crisis.

The first half of 2023 saw the return of investment grade convertible issuance with eight new issues coming to the market, all within the Utility and REIT sectors. We expect investment grade new issuance to continue due to high interest rates and a recent accounting standard issued from FASB, ASU 2020-06. This accounting change is advantageous to profitable convert issuers as they no longer need to bifurcate debt and equity to calculate interest expense. Therefore, there is no longer a non-cash interest expense, complexity is reduced, and it often results in a higher GAAP EPS than would be the case pre ASU 2020-06.

The credit profile of the convertible bond universe remains solid. In 2022, the default rate was only 0.1%, compared to a 1.1% default rate for the high yield market. In 1H'23, the convert default rate ticked up slightly but remained very low at 0.4%. As in most years, this rate was lower than the high yield default rate of 1.3%[7].

We do expect default rates for both converts and high yield to continue to climb in 2H'23 and 2024. Credit spreads have remained benign through 1H'23 but on an individual issuer level, there are a fair amount of issues trading at distressed levels. Also, in the first six months of 2023, there were 340 corporate bankruptcies, up 93% from a year ago and higher than every other comparable span in 13 years[8].

Positioning:

SSI continues to be selective on credit with a portfolio credit rating higher than the ICE BofA All US Convertible Index (VXA0). However, we are finding many attractive high yielding opportunities where we believe the credit is mispriced.

On a sector basis, we see many opportunities within Technology, both in software and semiconductors. We are focusing on quality growth names as well as companies levered to Artificial Intelligence. Despite high returns in the first half, many tech stocks still trade at reasonable valuations relative to historical averages. Within software, we target companies where demand has stabilized or re-accelerated and the cost structure has been optimized. These companies should show a significant upside in operating margins and earnings over the next year.

Within Healthcare, we favor equipment and tool names rather than biotech and pharma names that are sensitive to drug pricing or government spending.

While underweight Consumer Discretionary in general, we are focusing on companies leveraged to consumer spending on services including travel and leisure. All three major cruise lines have multiple convertible bond issues. There are convertible bond issues from airlines and lodging companies as well. There are multiple ways to play both the credit and the equity upside in companies in the travel and leisure space.

We are slightly overweight the more cyclical areas of the market (Energy, Materials, Industrials). Many of these cyclical companies should benefit from the trend towards onshoring of US manufacturing, the $1.2 trillion Infrastructure Investment and Jobs ACT, the CHIPS Act, and the Inflation Reduction Act (with targeted incentives for energy transition). In addition, they should benefit from the China economic reopening and recovery post the Covid lockdowns. However, the China recovery has been lackadaisical at best so far. We do expect that there will be more stimulus in China, and this will help the performance of stocks levered to China growth in 2H'23.

Financials and Utilities are both underweights in the portfolios due to earnings pressure and valuations that are not very appealing.

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 (Exhibit 3). The convex nature and low duration characteristics of convertibles provide an improved risk/reward profile to equities and corporate bonds.

Exhibit 3 – 10 Years: US Risk Adjusted Returns[9]

As of 6/30/2023

	Annualized Return (%)	Sortino Ratio	Sharpe Ratio
ICE BofA All US Convertible Index (VXA0)	**9.87**	**1.14**	**0.71**
Bloomberg US Aggregate	1.52	0.17	0.13
Bloomberg US Corporate High Yield	4.43	0.65	0.46
S&P 500 Index	12.86	1.24	0.80
Russell 2000 Index	8.26	0.55	0.37

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

Convertibles also serve as a solution for low volatility equity allocations. A low volatility quant equity strategy will likely 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. 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.

Notes/Sources:

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[1] *Source: Barclays*
[2] *Source: BofA Global Researcch*
[3] *Source: Bloomberg Intelligence*
[4] *Source: Evercore ISI weekly derivatives desk strategy 7/10*
[5] *Source: Barclays*
[6] *Source: Barclays*
[7] *Source: Barclays*
[8] *Source: S&P Global Market Intelligence*
[9] *Source: eVestment*

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