SSI Investment Management

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2024: Convertible Bonds Outlook

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2023 Recap

Convertible bonds, represented by the ICE BofA All US Convertibles Index (VXA0), rebounded in 2023 to return +12.99%. This lagged the S&P 500 Index but surpassed the return of the Bloomberg US Aggregate Bond index.

2023 Performance	Return
ICE BofA All US Convertible Index (VXA0)	+12.99%
S&P 500 Index	+26.26%
Russell 2000 Index	+16.88%
Bloomberg US Corporate High Yield Bond Index	+13.45%
Bloomberg US Aggregate Bond index	+5.53%

The main driver of convertible returns was the solid performance of their underlying equities. They returned +24.0% in 2023, below the returns of the S&P 500 Index but ahead of the Russell 2000 Index[1]. The contractions in credit spreads also boosted convertible bond performance as the Markit CDX North America High Yield Index tightened by 127.6 bps in 2023.

After an extremely rough year for both stocks and bonds in 2022, markets were very oversold entering 2023. Sentiment and positioning were extremely negative, and this set up for a nice rally to start the year. The rally soon came to a stop as the collapse of Silicon Valley Bank caused a regional bank panic that continued with the demise of First Republic Bank and Credit Suisse. But the market bottomed shortly after as the Fed injected liquidity into the regional banks and UBS agreed to acquire Credit Suisse, removing fears of global contagion.

For most of the year, the stock market was led by large cap technology companies, more specifically the Magnificent Seven, which had an average return of 107% for the year[2]. The heightened interest in generative AI was a primary driver of these gains. Also, earnings estimates for most large tech companies increased throughout most of the year due to cost cuts that improved margins and a better IT spending environment that stabilized and, in some cases, reaccelerated revenue growth.

By just observing the 10-year Treasury rate on the first and last day of the year (3.8748% vs 3.8791%), one could assume it was an uneventful year for interest rates. This of course was not the case as interest rate volatility remained elevated throughout the year with the MOVE Index averaging 121.66, well above historical averages. The 10-year Treasury rates reached a peak of just under 5% in October. This occurred

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as the prevailing consensus shifted towards the higher for longer perspective, driven by persistent inflationary pressures and consistently positive economic data.

However, both rates and the stock market reversed course starting in late October due to downside surprises in the CPI and PCE inflation measures as well as more dovish speak from the Federal Reserve. This led to a dramatic drop in rates with the 10-year declining over 100 bps from the end of October until year end. It also sparked a tremendous stock market rally, this time led by small and mid-cap stocks rather than the tech giants.

2024 Market Outlook

Market sentiment and positioning entering 2024 are at polar opposite levels from one year ago. Many indicators, such as call option volumes, SPY short interest, AAII bull-bears, and the VIX point to an overbought market with elevated levels of optimism. Therefore, it would not be a surprise to see the market struggle early in the year. However, we expect the stock market to have another positive year in 2024 due to declining interest rates and above average corporate earnings growth.

S&P 500 estimated EPS growth for 2024 is currently at +12%. This helps justify current stock market valuations, which are higher than historical averages. We see potential upside to earnings estimates in 2024, mostly from better operating margins. Productivity improved significantly in the 2nd half of 2023, and we expect productivity gains to continue in 2024 with generative AI starting to contribute to these gains in the 2nd half of 2024. This should lead to an upside in corporate margins. In the long run, there is even more upside to margins from 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.

Despite 11 Federal Reserve rate hikes over the last two years and quantitative tightening, the U.S. economy has been surprisingly resilient. A big question for 2024 is if the economy finally succumbs to all this monetary tightening and falls into recession or if it can engineer a soft landing. Many leading economic indicators such as the inverted yield curve, the Conference Board Leading Economic Index (LEI), the Fed senior bank loan survey, and negative M2 money supply growth have pointed to a likely recession for quite some time. However economic data continues to come in solid, and the job market remains robust. The GDP projection for Q4'23 stands at +2.2%, as per the Atlanta Fed GDPNow forecast, far from recessionary levels.

Another important factor for the markets is how many times will the Fed cut rates in 2024, and when will they start. The market is currently pricing in 5 or 6 rate cuts for the year, with the first cut likely happening in March. While inflationary trends merit a Fed pivot, it could be that the market is over-optimistic on the pace and start of Fed rate cuts.

Some other market risks for 2024 include the ongoing Russia-Ukraine and Israel-Hamas wars. China's slowing economy and property woes are a risk to global growth. In Japan, if the BoJ exits its yield curve control policy, it could lead to a decline in the global carry trade which would be a weight on risk assets. Domestically, uncertainty over the upcoming U.S. presidential election will likely increase volatility as we get closer to election day. And of course, there is the issue of $34 trillion in U.S. government debt and sky-high budget deficits.

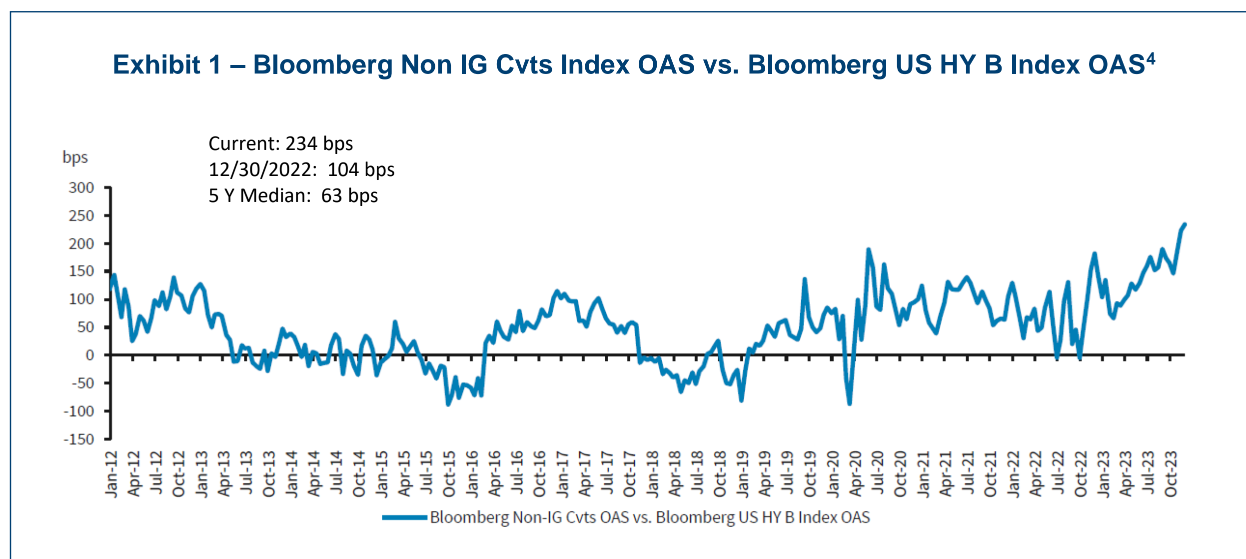
Convertible Bond Outlook

Entering 2024, convertible bonds are attractively positioned with a significant yield advantage over equities and higher than usual defensive qualities.

Characteristics[3] 12/28/2023	
Greater of CY/YTM/YTP	4.8%
Current Yield	2.0%
Delta	49%
Price	102.6

Convertible bond valuations look very attractive relative to high yield bonds. This can be seen by comparing Non-Investment Grade convert spreads vs. High Yield 'B' rated bonds. The spread has widened out to record levels, as shown in Exhibit 1. We expect the spread to narrow in 2024, which will help the relative performance of converts.

Exhibit 1 – Bloomberg Non IG Cvts Index OAS vs. Bloomberg US HY B Index OAS[4]



Convertible bond issuance in 2023 was $51.6bn compared to $28.4bn in 2022. We expect issuance to grow again this year. There is a large maturity wall in 2025 and 2026 and a lot of that debt is likely to be refinanced in 2024 with convertible bonds. Higher overall financing costs are causing many traditional high yield borrowers to issue convertible bonds to lower their coupon rates. M&A should pick this year after a lackluster 2023 and this should also lead to more issuance.

Last year saw the return of investment grade convertible issuance with 13 new issues coming to the market. We expect investment grade new issuance to continue to be active 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 expenses, complexity is reduced, and it often results in a higher GAAP EPS than would be the case pre ASU 2020-06.

Positioning:

2023 was an unusual year in which balanced convertible bonds underperformed against both high yield converts and in the money converts. This can be seen in Exhibit 2.

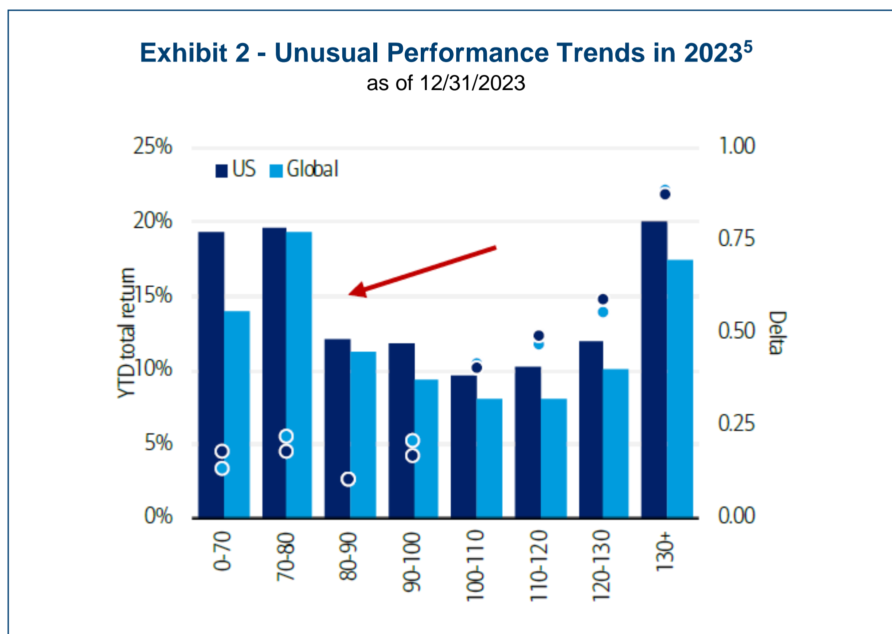


Exhibit 2 - Unusual Performance Trends in 2023[5]
as of 12/31/2023

We expect the balanced segment of the convert market to rebound this year and outperform, but there are many opportunities in the busted/high yield segment where credit is still mispriced.

On a sector basis, we continue to favor Technology. Software had a big run in 2023, but we still see upside this year. Margins continue to expand for most software companies, and IT budgets overall are stabilizing or improving. AI adoption should start to provide revenue uplift for select software companies in 2H'24. We favor security software names, companies levered to AI, and more generally, companies with re-accelerating revenue growth and expanding margins.

In Healthcare, we have become more constructive on biotech names after significant underperformance in 2023. M&A has heated up in the biotech arena and should remain busy in 2024 as many large pharma companies need new drugs to offset large patent cliffs. Declining interest rates should boost biotech valuations and ease funding constraints.

Within the cyclical arena, we prefer the Industrial sector. We are focused on companies that will benefit from the trend towards onshoring of U.S. manufacturing and that have exposure to the $1.2 trillion Infrastructure Investment and Jobs ACT, the CHIPS Act, and the Inflation Reduction Act. We expect the commercial aerospace industry to continue to outperform, as demand trends look strong with record backlogs.

The Long-term Case for Convertibles:

The long-term risk-adjusted performance of Convertibles against other asset classes is impressive, as shown in the table 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 – 20 Years: US Risk Adjusted Metrics[6]
as of 12/31/2023

	Annualized Return (%)	Standard Deviation (%)	Sharpe Ratio
ICE BofA All US Convertible Index (VXA0)	8.01	12.60	0.52
S&P 500 Index	9.69	14.89	0.56
Russell 2000 Index	8.11	19.93	0.34
Russell 1000 Index	9.78	15.18	0.55
Bloomberg US Aggregate	3.17	4.14	0.42
ICE BofA US High Yield	6.47	9.12	0.55
S&P 500 Low Volatility	9.20	11.41	0.68

Convertibles are a great fit within a fixed income portfolio. They have a significantly lower duration than both corporate bonds and the Bloomberg Aggregate Index. 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. The relative performance of convertible bonds relative to other bond categories also makes convertibles an enticing addition to a fixed income portfolio.

Exhibit 4 – Convertibles Outperform Bloomberg Fixed Income Indices[7]
as of 12/31/2023

	3 YRS (%)	5 YRS (%)	10 YRS (%)	15 YRS (%)
ICE BofA All Convertible Index (VXA0)	**-0.78**	**11.96**	**8.91**	**12.13**
ICE BofA US Invt Grade Convertible (V0S1)	**3.28**	**7.52**	**9.66**	**10.67**
Bloomberg US Aggregate	-3.31	1.10	1.81	2.68
Bloomberg US Aggregate 1-3 Year	0.09	1.46	1.26	1.59
Bloomberg US Corporate High Yield	1.98	5.37	4.60	9.17
Bloomberg US Credit	-3.21	2.45	2.83	4.49
Bloomberg US Government	-3.74	0.56	1.27	1.60
Bloomberg US Govt/Credit	-3.53	1.41	1.97	2.77
Bloomberg US Interm. Aggregate	-2.06	1.14	1.62	2.46
Bloomberg US Intermediate Credit	-1.28	2.44	2.46	4.04
Bloomberg US Intermediate Treasury	-1.86	1.02	1.25	1.53
Bloomberg US Long Govt/Credit	-8.68	1.12	3.22	4.27
Bloomberg US Long Treasury	-11.41	-1.24	2.28	2.28
Bloomberg US Municipal	-0.40	2.25	3.03	3.98
Bloomberg US Municipal: High Yield	0.75	3.49	5.00	7.21

For low volatility equity allocations, convertible bonds also make a lot of sense. A low volatility 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.

In summary, we believe that there is a strong case for an allocation to convertible bonds over the long-term. 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: Tovima.com. Magnificent 7: Apple, Microsoft, Google Parent Alphabet, Amazon.com, Nvidia, Meta Platforms, Tesla*
[3]*Source: Barclays Research, as of 12/29/2023*
[4]*Source: Barclays Research, as of 11/30/2023*
[5]*Source: BofA Global Research, ICE Data Indices, LLC*
[6]*Source: eVestment*
[7]*Source: eVestment*

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