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MARKET UPDATE |**CONVERTIBLE BONDS**

THE TIME IS RIGHT FOR CONVERTIBLE BONDS

Manager's Insight | April 2017

UNION BANCAIRE PRIVÉE

Key points

- With already two interest rate hikes in only 3 months in the US and more to be expected this year, investors are looking for alternatives to their bond investments.
- When faced with a rise in interest rates, convertible bonds' embedded option acts as a safety cushion, partially offsetting the negative impact on the bond component.
- History has shown that when rising interest rates was paired with additional equity performance, convertible bonds could not only deliver positive performance but, in some cases, even outperform equities.
- The ECB's extensive asset purchase program has pushed prices upwards in credit markets across Europe. In contrast, convertible bonds have remained preserved from this massive distortion effect.
- Although a tightening trend has also started in the convertible space, at current spread levels, they still have much higher value potential to offer than comparable straight bonds.
- Over the past months, the combination of convertible bonds' key differentiating features has enabled them to significantly outperform straight bonds.
- We believe this is only the beginning.

The beginning of a trend

As widely expected, the Fed hiked its key rates by 25bps during its March FOMC meeting, on the back of recent solid equity markets' performance, firming growth indicators and rising inflation data. On this occasion, the US Fed chairman, Janet Yellen, reiterated that further increases should be expected this year.

While this is more imminent issues for US investors, European fixed income markets are not immune to the risk of rising interest rates. As indicators and growth outlook continue to improve in the Eurozone, an appeasement of political risks could lead the ECB to adopt a more neutral monetary policy stance over the course of the year, with a possible shift in communications over the summer months. On April 27th, while keeping rates unchanged, ECB President Mario Draghi yet acknowledged the vigor of the Eurozone economy.

For investors looking for alternatives to their bond investments, current environment points towards convertible bonds.

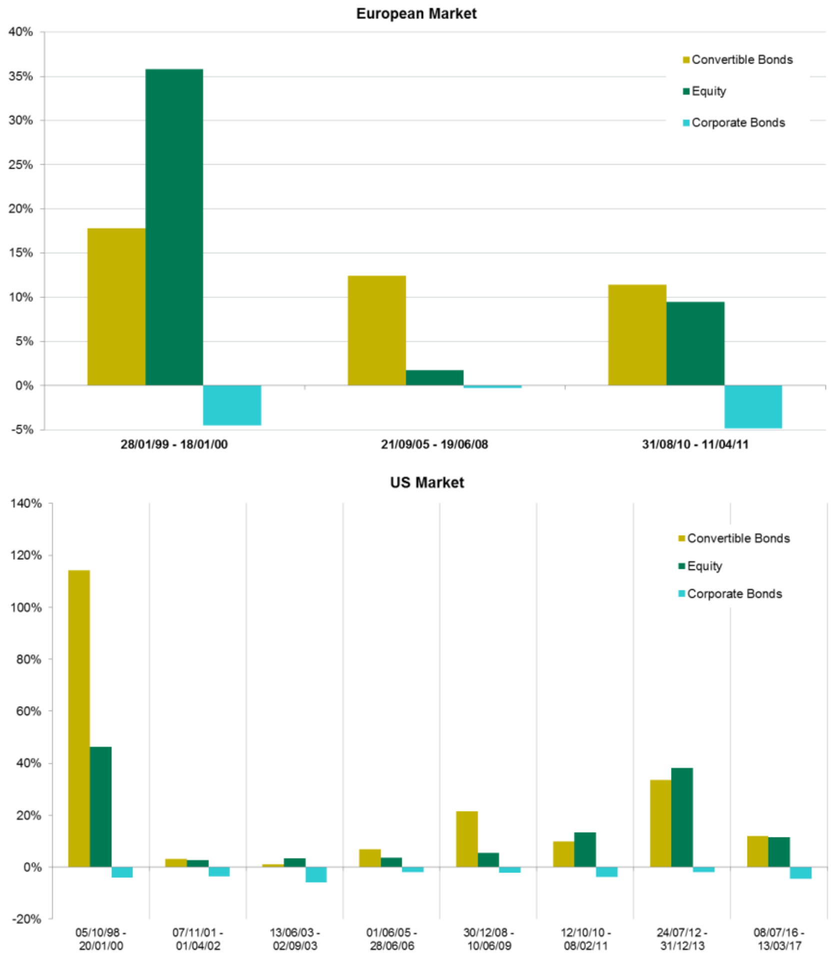
An efficient hedge against rising interest rates? History points the way.

When faced with a rise in interest rates, convertible bonds' embedded option acts as a safety cushion, partially offsetting the negative impact on the bond component. This comes from the fact that equity options are positively correlated to interest rate moves. As such, they usually provide positive returns when interest rates rise.

Looking back at periods when the yield of the 10Y-Bund (in Europe) or of the 10Y-US Treasury soared by more than 120bps over the past 20 years, figures speak for themselves. During each of these 11 periods (3 in Europe and 8 in the US), **not only convertible bonds outperformed systematically straight bonds but they were also systematically positive whereas straight bonds were systematically negative in absolute terms.**

History has shown that when rising interest rates was paired with additional equity performance, convertible bonds could not only deliver positive performance **but, in some cases, even outperform equities.**

Chart 1 | Convertible bonds' behavior in periods of rising interest rates



Source: UBP, Bloomberg Finance LP.

1) For the US Analysis - Corporate bond index: Barclays US Gov/Credit TR USD; Convertible bond index: Thomson Reuters US Vanilla CB Index; Equity index: S&P 500.

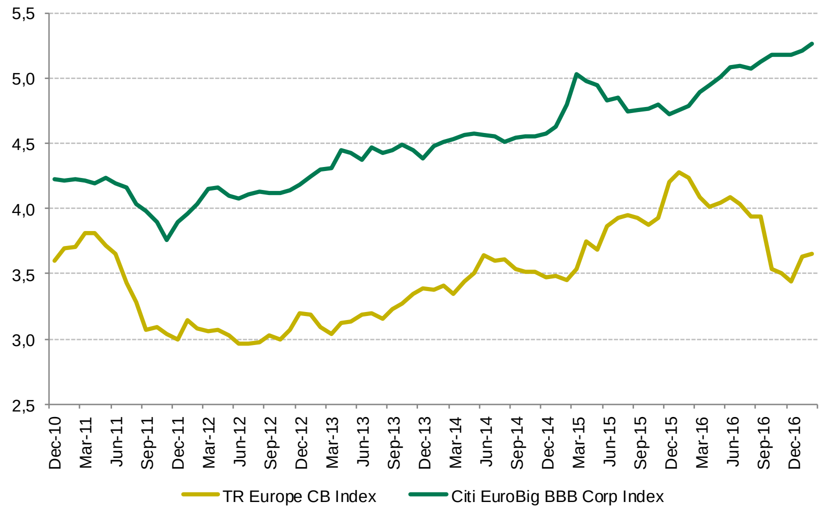
2) For the European analysis - Corporate bond index: Citi EuroBig Index; Convertible bond index: Thomson Reuters Europe CB Index; Equity index: Stoxx Europe 50 NR.

Past performance is not indicative or a guarantee of future results.

Not only convertible bonds offer lower sensitivity to interest rates than straight bonds for similar duration, but the overall duration of straight and convertible bonds markets have also been evolving in different ways.

Over the past years, expansionary monetary policies, and the induced ultra-low rate environment, has led longer maturities to become commonplace in the traditional debt market (chart 2). **In the convertible bond space however, the duration has shrunk over the last quarters**.

Chart 2 | Evolution of duration (Macaulay) in the European corporate vs convertible bond spaces



Source: UBP, Bloomberg Finance LP. Corporate index: Citi EuroBig Corporate BBB Macaulay Duration; Convertible index: Thomson Reuters Europe Convertible Bond (duration, in years).

The metrics of the Thomson Reuters index provided here are recalculated internally, based on the composition and the prices as provided by Thomson Reuters, to which we apply our internal calibration of market spreads.

Less risk, more value?

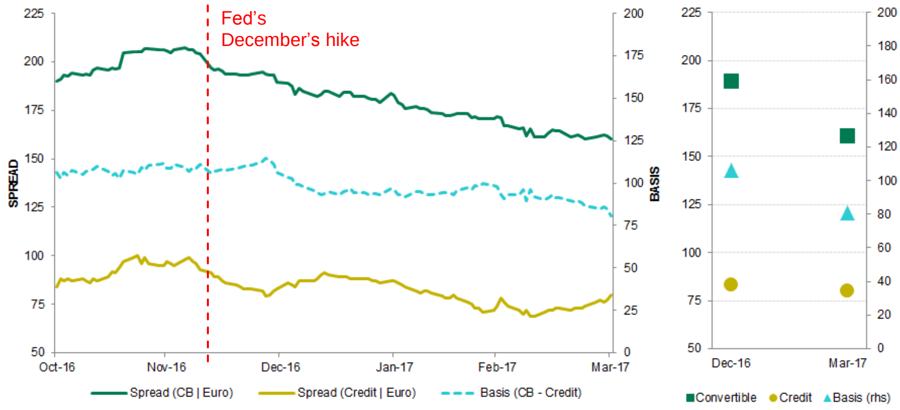
Since its inception, the ECB's extensive asset purchase program has biased prices in credit markets across Europe: from sovereign to corporate bonds and from investment grade to high yield bonds -as investors have eventually turned to this segment in their quest for yield. By doing so, the ECB's Quantitative Easing ("QE") has induced a strong distortion in the traditional bond market, draining the opportunities in terms of spreads and maintaining downward pressure on yields, as money has kept pouring into the European bond market.

While we acknowledge that the end of the QE may not constitute an imminent concern in Europe, we nonetheless believe that the question remains legitimate: **how will credit markets react when the ECB dominance will begin to recede?**

In the short-term, the trimming of the QE from this month onwards (from a monthly purchase volume of EUR 80 billion to EUR 60 billion) should already bring its share of uncertainty. Looking forward, the rhetoric used by the ECB will be a key driver.

Comparatively, not being part of the ECB's CSPP's ("Corporate Sector Purchase Program") eligible assets, **convertible bonds have remained preserved from this massive distortion effect.** At current spread levels, convertible bonds exhibit higher value than comparable (in terms of currency, credit quality, duration) straight bonds (chart 3).

Chart 3 | Spread comparison between Euro corporate and convertible bonds



Source: UBP, Bloomberg Finance LP, Thomson Reuters Convertible Research. As at 31.03.2017.
Corporate index: BofAML 3-5Y BBB Euro corporate bond index.
Convertible index: Thomson Reuters Eurozone Convertible Bond index (hedged EUR).
The metrics of the Thomson Reuters index provided here are recalculated internally, based on the composition and the prices as provided by Thomson Reuters, to which we apply our internal calibration of market spreads.

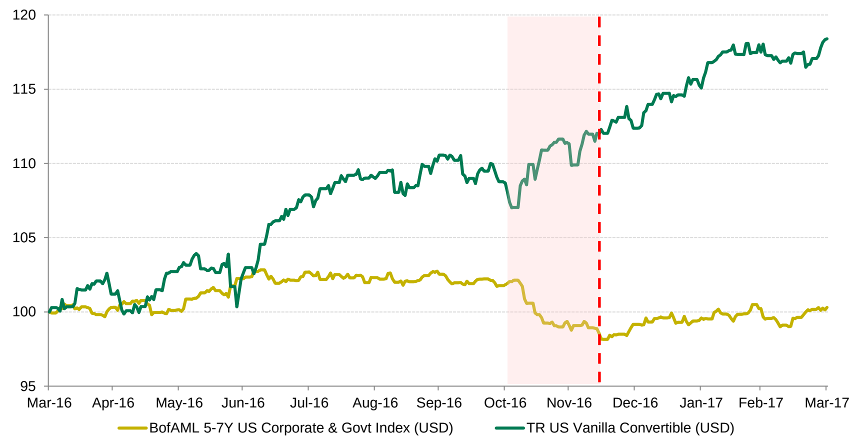
An environment beneficial to convertible bonds

In this context and at a time where equity markets benefit from a supportive momentum overall, **convertible bond's optional feature is a key asset as an alternative to ultra-low yields**.

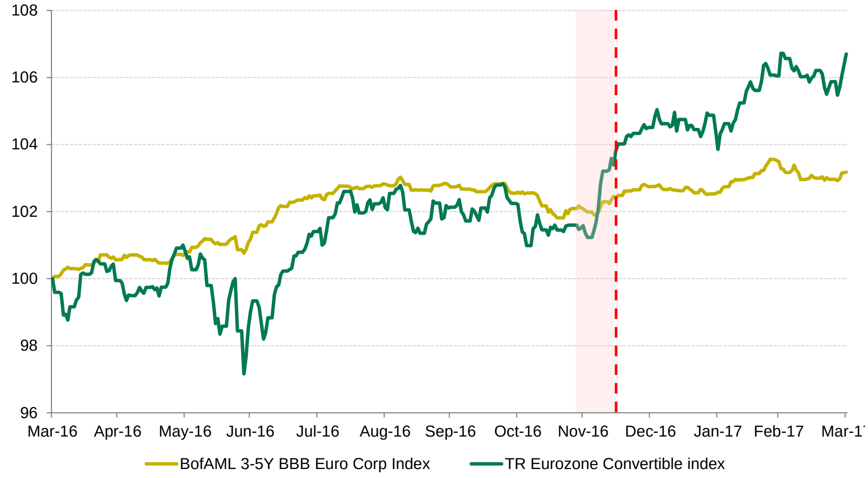
Over the past months, the combination of convertible bonds' key differentiating features previously mentioned (lower sensitivity to interest rates; higher tightening potential left in terms of spread and risk-controlled exposure to equity markets) has enabled them to significantly outperform straight bonds.

We believe that we are only at the beginning of this phenomenon and that these same benefits should allow supportive dynamics for convertible bonds in the near future.

Chart 4 | 1Y-rolling performance comparison between corporate and convertible bonds (US and Europe)



Source: UBP, Bloomberg Finance LP. As at 31.03.2017. Corporate index: BofAML 5-7Y US Corporate & Government Index (USD). Convertible index: Thomson Reuters US Vanilla Convertible Bond (USD). Past performance is not indicative or a guarantee of future results.



Source: UBP, Bloomberg Finance LP. As at 31.03.2017.Corporate index: BofAML 3-5Y BBB Euro Corporate Index. Convertible index: Thomson Reuters Eurozone Convertible Bond index (EUR). Past performance is not indicative or a guarantee of future results.

The Fed made it clear: the hikes of December 2016 and March 2017 are the first steps of what should be a gradual rise spreading out over 2017 and 2018.

In Europe, although the end of the QE does not seem to be on the ECB's agenda for 2017, we however expect it to adopt a more neutral monetary stance over the course of this year, as indicators continue to point towards an improvement of the Eurozone economy. By doing so, it could cast a cloud over euro fixed income markets. For investors looking for an alternative to their bond investments, the time seems right to consider convertible bonds.

By reallocating their bond portfolio in favor of convertibles, investors could benefit from both a partial hedge against rising interest rates, as well as from an exposure to equity markets' upside potential.

By favoring defensive convertible bonds, these benefits could be achieved while keeping a limited exposure to equities' volatility and downside risk. **For those willing to take some additional exposure to equity markets, a dynamic global convertible strategy would seem an appropriate choice**, in order to benefit from the current supportive economic background, while leveraging on the benefits of convertible bonds' bond-floor protection as well as of a global diversification. The combination of lower sensitivity to interest rate moves and of a risk-controlled equity exposure appears all the more valuable at a time where bonds' yields remain too low to deliver sufficient return on a standalone basis, and where periods of accrued volatility should be expected in global equity markets, on the back of still high political uncertainty.

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