

## Convertible Outlook 2020

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### Recap of 2019

Convertibles, as an asset class, delivered strong returns in 2019. As represented by the ICE BofA All US Convertible Index (VXA0), the asset class produced a return of 23.15%, representing a robust 74% capture of the return of the S&P 500 of 31.48%. The underlying equities of the convertible asset class outperformed major equity and credit benchmarks, as demonstrated below:

#### YTD Performance (December 31, 2019)

Underlying Equities of the Convertible Asset Class	33.09%
S&P 500	31.48%
Russell 2000	25.49%
Bloomberg Barclays High Yield Bond Index	14.32%
Bloomberg Barclays US Corporate Inv. Grade Bond Index	14.54%
Bloomberg Barclays Intermediate Treasury Bond Index	5.22%

Source: Bloomberg, Barclays

The sharp rebound in 2019 can be attributed to a radical Fed pivot towards dovishness. The Fed cut rates three times and restarted balance sheet expansion in 2019, after the rate hikes and phase of quantitative tightening that ran on autopilot in 2018. This progression to an easing stance took place against the backdrop of very light investor positioning. In particular, the 2018Q4 correction had led to significant change in positioning, with hedge fund beta declining sharply to the 15th percentile around Christmas 2018. Another significant contributor to strong 2019 returns was the cooling of trade tensions towards the end of 2019. Technology was the largest contributor to the convertible index in 2019, with a sector return of 29.13% and the largest sector weight in the index at 38.42% of the index (source: ICE, SSI internal research).

During Q4 2018, equity markets and all risk assets suffered a significant sell-off and heightened volatility. The sell-off was driven by tightening monetary policy in the face of a ratcheting up of trade tensions and slowing global growth induced by the combination of monetary policy and trade frictions. Valuations contracted severely, driven by a liquidity collapse and technical selling. Convertibles, as an asset class, did an exceptional job protecting capital in this environment, and similarly during the month of May 2019.

Convertibles Can Help Protect Capital During Equity Market Drawdowns	Year 2018	May 2019
ICE BofA ML All US Convertible Index (VXA0)	+0.15%	-3.28%
S&P 500	-4.39%	-6.35%
Russell 2000	-11.03%	-7.78%

Source: Bloomberg

## ***Outlook for 2020***

While maintaining the pace of 2019 returns will be a challenge in the convertible space, our outlook for 2020 remains constructive. The global economy is in the throes of a modest growth rebound, propelled by worldwide monetary stimulus and fiscal stimulus outside the US. Monetary stimulus acts with a large 12 to 18 month lag. Global short rates have declined -50 bps over the past year, just as Fed funds declined -75 bps. The yield curve is positively sloped again, and has steepened. The Fed, ECB, and BOJ are simultaneously expanding balance sheets, while the Fed is likely to hold rates steady for the rest of the year. China's policy mix of tax cut oriented fiscal stimulus, multiple cuts in bank reserve ratios (RRR) to bolster liquidity, and reforms of SOE's are working. This is starting to get reflected in leading economic indicators, such as PMIs. The efficacy of these measures is strengthened by the recent reduction in trade uncertainty and the signing of the US China Phase I trade deal. European economies, more levered as to China exports, are also starting to show signs of life.

We expect US GDP growth to rebound to 2.5% in 2020, from 2.2% in 2019, due to a recovery in corporate capex and housing, supported by lower bond yields, narrower credit spreads, a reduction in trade uncertainty, continued strength in the US consumer confidence and business confidence, and a rebound in global growth. This rebound in growth should provide an upward bias to corporate earnings. We see further tailwinds coming from the partial cutback in China tariffs, as well as a rebound in Renminbi due to resolution of trade uncertainty, leading to a weakening of trade weighted dollar. We expect high single digit earnings growth, driven by 4-5% top line growth, some margin expansion, and buybacks, contributing 2% to earnings growth. Meanwhile, inflation is predicted to stay contained at under 2%, driven by productivity growth, progress in trade (China, USMCA), and an increase in labor participation rate. The combination of improving earnings, ample liquidity, and contained inflation is a favorable backdrop for equities. Upside in equities is also likely to be supported by low net equity exposure among discretionary equity and macro hedge funds, as well as systematic strategies. There are some headwinds though, chiefly political uncertainty stemming from elections, and geopolitics.

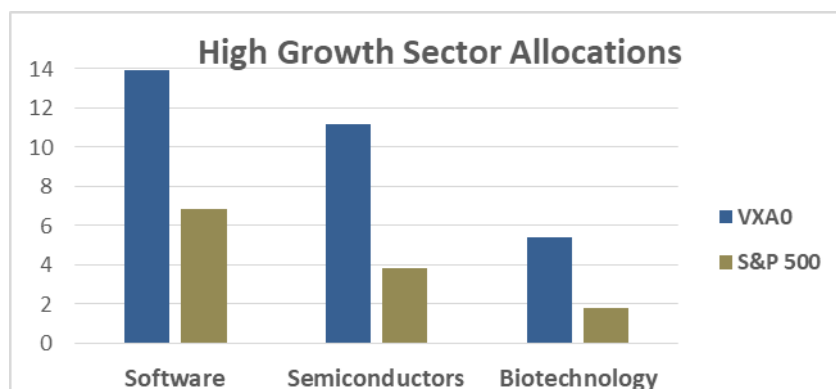
In our base case we expect convert returns of 8.8%. Analyst estimates for S&P call for an EPS growth of 9.6%. Companies underlying the convert universe have displayed a higher earnings growth and price appreciation in the last couple of years, because of the heavier weighting of rapidly growing companies in the Technology and Healthcare space in this universe. A continuation of this phenomenon is expected in 2020. We are assuming a growth rate and price appreciation of 11% for the companies underlying convertibles. The convert universe delta of 0.58 and a current yield of 2.4% translate to a total return of 8.8% (see Notes on Expected Returns at end of document).

The outperformance of equities underlying convertibles in the recent past has been a consequence of the composition of this universe of issuers. The universe has been dominated by structural growth companies in the Technology and Healthcare space that are disruptors with large addressable markets

and potential for high growth rates that are likely to be long lasting. Going forward, some of the major structural growth themes for 2020 incorporate the following:

- Digitization of the economy and cloud computing/SAAS (software as a service)
- Genomics, personalized medicine, gene therapy, gene editing, and biotech M&A
- 5G build out, data center reacceleration, artificial intelligence, and automated mobility

These themes are much more heavily represented in the convert universe:



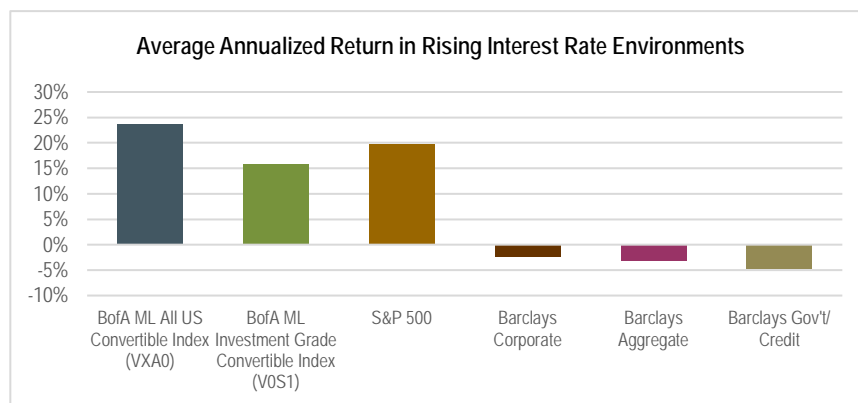
*Above chart as of 1/20/2020. Source / Notes: Bloomberg, ICE, using GICS Industry Group classification*

Companies in the software space, in areas relating to cloud computing/SAAS in particular, have become a more prominent part of new convertible issuance in the last 18 months, and the trend is likely to continue. Semiconductor companies powering this digitization are also very well represented in the convertible space. These companies also benefit from the increased adoption of AI, as well as a reacceleration of data center growth.

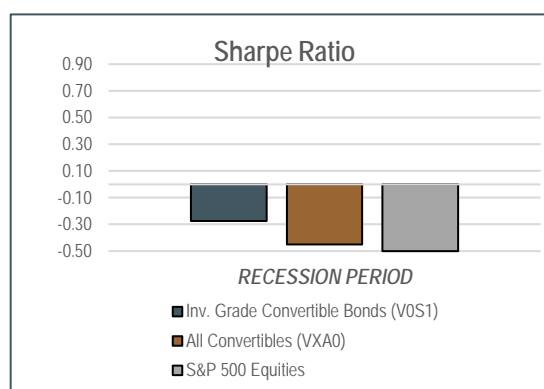
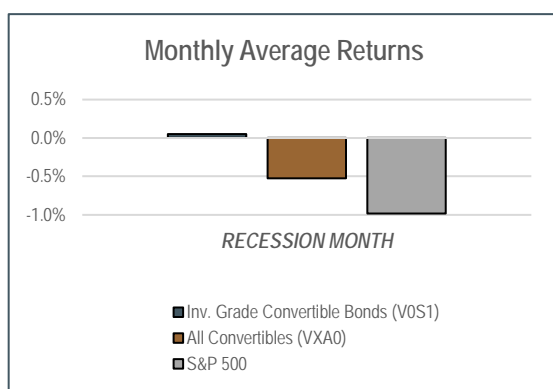
A new aspect of the current crop of issuers in the convertible universe is the strong financial profile of the companies, particularly in the software sector and internet space. These companies tend not to be capital intensive, are rapidly growing revenues, and have stronger balance sheets. They are at the forefront of the digitization of the economy, have led a rebound in capex as evidenced in the recent GDP data, and have spurred productivity growth. Software and R&D as a percentage of GDP now exceed durable goods, and the trend of increasing relative share continues. Convertibles represent the best risk-mitigated way to participate in this structural shift towards software and IP. With an average implied volatility close to 40% in the SAAS space, large moves in the stock price (as much as 40% move or more in a year with 32% probability) are likely. Convertibles, through their inherent asymmetric risk reward, can potentially improve risk adjusted returns in a meaningful way.

## The Case for Convertibles in 2020 and Beyond:

- Convertibles can provide **duration protection** in rising rate environments<sup>1</sup>.



- The current economic expansion is the longest in history. Concerns about a recession, although not conclusively borne by the data as yet, are rising. Historically, **convertibles outperform equities during economic recessions**, on both an absolute and risk adjusted basis<sup>2</sup>.



- Convertibles are 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, REITS, and Consumer Discretionary, with underweights in Technology and Healthcare. By contrast, convertibles have a high representation in Technology and Healthcare, along with underweights in Consumer Staples, Utilities, and Consumer Discretionary. 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.
- Convertibles are one of the few asset classes that contractually **provide downside protection**, as the principal and coupon are protected, and represent senior balance sheet claims to equity.

- Convertibles provide **exposure to fast growing, higher beta equities** in the Technology and Healthcare space **with meaningfully truncated downside** and reduced risk. *Investors who are bullish on growth equities* should utilize converts as a component of their growth allocation to maximize participation while controlling risk. *Investors who are cautious on growth equities* should shift some of their growth equity allocation to convertibles to reduce risk.

#### Notes:

<sup>1</sup>SSI internal research; BofA ML Convertible Research; Bloomberg; Barclays. Rising interest rate environment periods based on SSI internal research/evaluation where the 10-Year Treasury rises at least 100 bps in a twelve-month rolling period (periods shown in table below).

Analysis Periods				
12/21/89 - 4/30/90	12/31/95 - 6/13/96	10/31/01 - 4/1/02	12/30/08 - 6/10/09	7/24/12 - 4/29/14
10/8/93 - 11/18/94	10/8/98 - 1/21/00	6/3/03 - 6/28/06	10/6/10 - 2/16/11	7/8/16 - 2/14/17

<sup>2</sup>Bloomberg & BofA Merrill Lynch & NBER. Notes: Monthly Average Returns utilizes the average monthly return from three prior recessions: Early 1990's Savings & Loan recession (6/1990-3/1991); Early 2000's Dot-Com recession (2/2001-11/2001) and Mid-2000's Great Recession (11/2007-6/2009). Sharpe Ratios are calculated using full recession period returns.

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#### Notes on Forward Return Calculations:

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#### Notes on Expected Returns\*

S&P est. EPS Growth	9.6%	Assuming no change in market multiple, expected price appreciation and EPS growth would essentially be the same.
Convertible Issuers' est. EPS Growth	11%	Convertibles' underlying companies have displayed higher than average EPS growth and price appreciation vs. S&P companies. The 11% estimate utilized in the expected return calculation is reached by factoring in a multiplier of 1.15x to the 9.6% S&P EPS Growth figure.
Convertible Universe Delta	0.58	
Convertible Universe Current Yield	2.4%	
2020 est. Convert Return	8.8%	$(11\% * 0.58) + 2.4\% = 8.8\%$

\*Source: SSI internal research

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