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## Convertible Bond 2022 Review and 2023 Outlook

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### 2022 Review

The S&P 500 Index, along with most other market indices, rose during the first day of trading in 2022. From there, it was all downside. Outside of Commodities (where all the gains came in 1H), no asset class was spared last year<sup>1</sup>:

- S&P 500: Its fourth worst annual returns since WWII
- 10yr treasuries (including proxies): Its worst annual performance since 1788
- Investment Grade bonds: Its worst annual performance on record since 1977
- High Yield Bonds: Its second worst annual returns behind only 2008

Convertible bonds also struggled in 2022, returning -18.71%<sup>2</sup>. Performance suffered from the poor returns of the underlying equities as well as the widening of credit spreads.

The primary cause for market weakness was the sharp rise in interest rates. The market's interest rate expectations were continually behind the curve last year. At the start of 2022, the market was expecting a roughly 1% Fed Fund Rate in June '23. By the end of the year, expectations had risen to roughly 5%. In addition, fears of a global recession emerged soon after the Russian invasion of Ukraine. This led to a steady decline in GDP estimates and corporate earnings estimates, dragging the stock market down further.

The VIX (CBOE Volatility Index) increased in 2022 to finish at 21.67, though well off the high of 36.45 from early March. The more significant move was in the ICE BofA MOVE index, which measures interest rate volatility. It increased from 77.6 at the end of 2021 to 121.6. Credit spreads started the year near all-time lows. High yield spreads (Markit CDX North America High Yield Index) widened 189bps on the year but finished 143bps tighter than the September highs<sup>3</sup>.

There were seven countertrend rallies of 5%+ and three countertrend rallies of +10% in 2022. Most of these rallies were triggered by a combination of very weak market sentiment and false hopes of a Fed pivot<sup>4</sup>.

Market leadership in 2022 contrasted to that of most of the last decade<sup>5</sup>:

- Value outperformed Growth by a significant margin
- International stocks outperformed the S&P 500 (for only the 2nd time in 13 years)
- S&P equal weighted outperformed S&P market cap weighted and large-cap tech lagged

### 2023 Market Outlook

Market sentiment is currently very weak due to recession fears and a still hawkish Federal Reserve. Earnings expectations for 2023 have declined but still have further to drop. As of January 6, FactSet S&P 500 EPS growth expectations for 2023 are +4.8% y/y. This will most likely turn to negative growth as the year advances. Despite this, we still think the market will likely rally during the earnings' reporting season starting later this month because pessimism is so high for Q4 earnings and 2023 guidance<sup>6</sup>.

This would likely be yet another bear market rally rather than a green light for the market. A recession is likely in the second half of the year, and the earnings impact will not be fully reflected in estimates until later in the year. A sustained market recovery will likely not take place until earnings estimates bottom or the Fed pivots.

Despite a decline in both nominal and core CPI and PCE inflation indicators over the last few months and subdued inflation expectations (both market and survey based), we do not think the Fed is close to a pivot. Their primary focus is mainly on the labor markets and wage inflation and there are few signs of a slowdown in this area. The unemployment rate is at 3.5%, a half-century low, and the weekly jobless claims and monthly JOLTS (Job openings and labor turnover survey) data point to a still very tight labor market. In addition, the Atlanta sticky-price CPI is at a high despite the decline in overall CPI. The CPI and PCE should continue to decline throughout 2023, but it is unlikely that they will drop to near the Fed target of 2%<sup>7</sup>.

The Fed's most recent dot plots from their December meeting suggest two or three 25bps rate hikes remaining and then a long pause before any rate cuts. This differs from market-based expectations that are pricing in roughly 75bps of rate cuts by year-end after the Fed Fund Rate peaks in June. The market underestimating the Fed's resolve could be a negative for the markets, as it was for most of 2022.

Quantitative tightening (QT), which started in June '22, will likely continue for some time after the Fed rate increases stop. If QT continues as planned through the entire year, it will shrink the Fed balance sheet by close to \$1 trillion and will be a drag on liquidity.

Many forecasters are expecting a recession at some point in 2023, and there are several indicators that point to this being a very likely outcome<sup>8</sup>:

- Yield curve inversion. The 3-month treasury – 10yr treasury and the 2yr treasury – 10yr treasury are both highly inverted. As of 1/9/23, the 3m-10yr is more inverted than it has been in decades. Historically, the inversion of these yield curves has almost always led to a recession within 15 months.
- ISM manufacturing and Services indices are both below 50 and declining. According to Bespoke Investment Group, in 25 of the 26 prior months that both indices were below 50, the US economy was either in or within three months removed from a recession.
- The 425bps in Fed Fund rate hikes has yet to fully impact the economy since monetary policy operates with a lag. The rate hikes have already affected more interest-rate sensitive areas of the economy such as housing and autos.
- The LEI (Conference Board US Leading Index ten economic indicators) has declined 9 months in a row and stands at -4.5.
- It is likely that consumers will have burned through their excess savings by mid-2023.

While we agree that a recession is likely, we think it will surface later than many expect due to the continued strength of the labor market and the generally healthy consumer and corporate balance sheets. The downside to this is that it will take longer for earnings' estimates to bottom and a sustained market recovery to commence.

On the macro-economic front, the Russia-Ukraine war will loom largely again in 2023 though no changes are expected in the near future. China's exit from its zero-Covid policy should benefit global growth as it opens its borders and Chinese economic activity resumes. Domestically, the upcoming debt ceiling fight looms and if it is anything like the 2011 version, market volatility will rise as we approach the deadline.

## 2023 Convertible Bond Outlook

Entering 2023, convertible bonds have more downside protection than they have had in a long time. The delta and average bond price are well below historical norms, while the yield-to-best is at multi-year highs. This contrasts sharply from recent years<sup>9</sup>.

End of Year	Yield-to-Best	Delta	Average Price	% Equity Sensitive
2022	5.94%	45.2%	\$95.10	27.4%
2020	2.00%	72.0%	\$149.70	62.8%

We expect convertibles to outperform the S&P 500 in 2023 due to superior yields, high convexity, and downside protection. Due to its exposure to growth companies, convertible underlying equities will likely remain volatile until the Fed pivots. However, valuations have already corrected considerably, and by the end of 2023, we think the underlying convertible equities will have outgained the S&P 500.

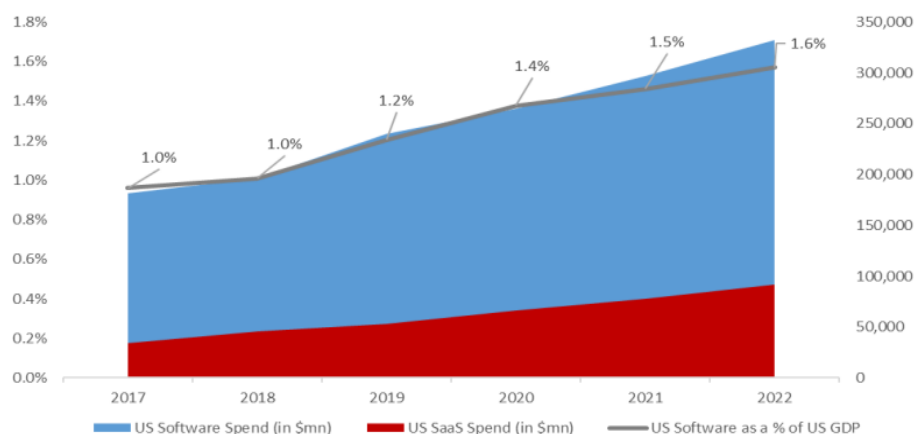
While not calling a bottom, the longer-term prospects for many growth stocks represented in the convertible market are very bright. For example, in the software space, valuations have corrected dramatically and are trading 49% below their trailing 5yr average, according to Morgan Stanley<sup>10</sup>.

EV / NTM Sales (Total Software Group ex. New Additions)<sup>10</sup>



In the meantime, software continues to grow as a percentage of the overall economy as corporations digitize, move to the cloud, and strive to be more efficient.

US Software & SaaS Spend Relative to US GDP<sup>11</sup>



Similar dynamics are taking place in other growth industries that are well represented in the convertible universe, such as biotechnology, clean energy, and semiconductors. With the high degree of market uncertainty, convertible bonds are the optimal way to obtain exposure to growth companies. The principal

protection of a convertible bond that limits the downside provides a superior risk/reward profile relative to growth equities.

Capital market weakness impacted convertible bond issuance in 2022, just as it did for high yield and investment grade issuance. Convertible bond issuance totaled just \$28.4 Billion last year but we expect issuance to roughly double in 2023<sup>12</sup>. Capital markets should improve somewhat and there is a large demand for refinancing by many corporations that are trying to stay ahead of their debt maturities. Despite the low issuance last year, the convertible universe has expanded significantly over the last few years due to the record issuance of 2020 followed by another robust year of issuance in 2021.

## Positioning

SSI's positioning remains defensive going into 2023 from a credit perspective. We believe credit spreads will widen from current levels as we get closer to a recession. Thus, we continue to avoid most companies that have negative cash flows and/or high leverage. The average credit rating for SSI's portfolio is BB+ compared to BB- for the VXA0<sup>13</sup>.

From a sector perspective, we continue to favor the Healthcare sector. Within Healthcare, the focus is on profitable biotech companies with a robust pipeline that offer high upside optionality. The convertible bond structure is an optimal way to invest in these companies due to a solid bond floor and the ability to participate in the majority of the upside.

Energy is another favored sector due to positive supply/demand dynamics, attractive equity valuations, and an improving credit profile.

We have a slight underweight in the technology sector as earnings estimates overall need to come down and further equity multiple contraction is still a risk. Still, we see pockets of opportunities in higher credit names, with a balanced bond, and relatively stable growth prospects.

Consumer Discretionary continues to be an underweight in the portfolios due to margin pressures, overall high leverage, and the expected weakness of consumer spending.

## 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. The convex nature and low duration characteristics of Convertibles provide an improved risk/reward profile to equities and corporate bonds.

### 20 Years: US Risk Adjusted Metrics<sup>14</sup>

Data as of 12/31/2022	Annualized Return	Standard Deviation	Sharpe Ratio
ICE BofA All US Convertible Index (VXA0)	8.58%	12.36%	0.60
S&P 500	9.79%	14.73%	0.58
Russell 2000 Index	9.35%	19.60%	0.42
Bloomberg US Treasuries 1-3 Year	1.73%	1.39%	0.37
Bloomberg US Corporate High Yield	7.32%	9.15%	0.67
Bloomberg US Corporate Investment Grade	4.26%	6.27%	0.49

Convertibles are a great fit within a fixed income portfolio. They have a significantly lower duration than both corporate bonds and the Bloomberg Aggregate. 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<sup>15</sup>.

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.

There is a strong case for an allocation to convertible bonds over the long-term. In addition, 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.

Footnotes:

1. Source: S&P 500 & 10 Yr Treasuries: Bloomberg Research/ Investment Grade & High Yield Bonds: BofA Global Research, ICE Data Indices, LLC. Annual data as of 12/31/2022.
2. Source: BofA Global Research, ICE Data Indices, LLC. ICE BofA All US Convertible Index (VXA0). Annual return as of 12/31/2022.
3. Source: Bloomberg Research, BofA Global Research, ICE Data Indices. Data as of 12/31/2022.
4. Source: Bloomberg Research, accessed 1/6/2023. Counterally based on the S&P 500 index.
5. Source: Bloomberg Research, accessed 1/6/2023.
6. Source: Factset. Data as of 1/6/2023.
7. Source: Federal Reserve Bank of Atlanta, Sticky Price Consumer Price Index [STICKCPIM157SFRBATL], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/STICKCPIM157SFRBATL>, 1/6/2023.
8. Source: Bloomberg Research, Bespoke Investment Group Research, data accessed 1/6/2023.
9. Source: Barclays Research, U.S. convertibles, data accessed 1/6/2023.
10. Source: Morgan Stanley Research, Refinitiv, Company Data as of 1/6/2023.
11. Source: Factset, Evercore ISI Research. Data as of 12/31/2022, accessed 1/6/2023.
12. Source: Barclays, U.S. Convertible Bond Issuance, SSI Internal Research. Data as of 12/31/2022.
13. Source: ICE BofA All US Convertible Index, SSI Internal Research. Data as of 12/31/2022.
14. Source: Bloomberg
15. Source: Bloomberg Research, Bloomberg US Corporate High Yield, Bloomberg US Aggregate, BofA Global Research, Ice Data Indices, LLC, ICE BofA All US Convertible Index (VXA0).

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