BlueBay
Asset Management

BlueBay's conviction in CoCos in 2019

2018 was a year of significant turbulence to which few risk assets were immune. While we expect positive but slowing growth in 2019, macroeconomic developments would point towards investing with an increased degree of caution.

This said, we remain convinced that the fundamental improvements undertaken by banks are robust and that the contingent convertible bond ('CoCo') asset class remains mispriced in the bank capital structure and versus the rest of the credit universe.

In all but a severe recession, risks appear to be mispriced to us and we see significant opportunity potential to generate alpha as dispersion returns to the asset class. For the first time, we see supply dynamics being a tailwind to performance and can see significant upside potential should the current pause in monetary policy return us to the 'goldilocks' credit markets of 2017.

Our views on 2019

2019 started with a very different perspective to 2018. While the start of 2018 was met with animal spirits and optimism, 2019 saw assets move higher in what can best be described as a drift, with investors much more tentative and searching for direction.

Undeniably, the world is in a less certain place than a year ago. Trade disputes continue to rage between the world's two largest economies. The US Federal Reserve (Fed) meetings are now all 'live' and the path of rates uncertain. Quantitative tightening (QT) in Europe is occurring concurrently with growth slowing. Politics in Europe remain fraught in an election year that could see a very different European parliament; there is a changing of the guard at the Draghi-led dovish European Central Bank (ECB). The Brexit crescendo is nearing fever pitch and global politics continue with the trend of more populist inward-looking policies. With this agenda, it is no surprise that the International Monetary Fund (IMF) downgraded global growth forecasts and highlighted that risks to these estimates remain tilted to the downside.

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An extended cycle

While financial conditions undoubtedly tightened as we came into the end of last year and we saw some poor fourth-quarter data points, we maintain the view that the US economy remains fundamentally strong and, while slowing, there is still broad-based growth within Europe.

As such, we are not yet in the camp that a global recession is imminent and it remains our base case that this cycle has some more legs to run. Further, we think assets have already priced in significant downside risks and investor pessimism has grown quite consensus, leading investors to pre-emptively adjust their positioning for a negative outcome.

In our base case scenario of weak but still positive growth, we think returns for CoCos are likely to be in line with the carry of the asset class of approximately 7%. We expect volatility to remain high but as we will explore below, relative valuations continue to look very attractive to us and we are firm believers that the fundamentals of banks remain extremely strong and are mispriced.

Macro

We are mindful that having gone through 2018 – where we saw ECB quantitative easing (QE) coming to an end, multiple Fed rate hikes, tightening financial conditions in China and investors significantly de-risking portfolios – we are starting 2019 with market positioning much lighter and at the very least a pause, and potentially a reversal, in this tightening trajectory.

The Fed has clearly moved off autopilot into a pause, with the messaging that it will not move until the data justifies it; the ECB is considering a further round of TLTROs and discussing 'operation twist', where it would invest the proceeds of the purchase programme into longer-dated assets to compress yields; and China has already announced a range of easing measures to facilitate lending into the economy. Alongside murmurings of more fiscal measures across Europe, there is a very plausible case to be made that as long as the growth numbers hold up, we could be entering into a 'goldilocks' period for credit and bank capital that few market participants expect. This scenario could lead to significant capital appreciation.

It is also prudent to explore the possibility that the outlook turns out to be worse than we anticipate. Banks inherently trade with a large degree of cyclicality and new accounting standards will mean that the impact of entering a recessionary cycle will be front-loaded. This said, putting to the side an unexpected and deep recession, even in this scenario we believe that a marginal, but positive return, is achievable given both where valuations

have already reached and the resilience that we think will show through in bank fundamentals.

To give context to these predictions, we explore below the fundamental picture – where valuations are today and what is priced in by markets. We delve into the alpha opportunity potential that we see in the year ahead, together with the key risks to our outlook.

Fundamentals remain extremely robust

The price action of 2018 would suggest that there was a dramatic turnaround in the underlying credit fundamentals of banks. However, from a fundamental perspective, 2018 was another stellar year for European banks and the trajectory of underlying credit improvement remained unambiguously positive across almost every metric.

Common equity tier 1 (CET1) capital continued to trend upwards, increasing by 20bps over the year to 14.5%. This was against the headwinds of rising risk-weighted assets due to asset growth, the impact of the transition to IFRS 9 – which on average cost banks 40bps of capital and increasing model harmonisation.

Improvements in asset quality showed no signs of slowing. The average non-performing loan (NPL) ratio fell from 4.4% to 3.6% over the year – the lowest level since the harmonisation of the NPL definition in 2014.

For context, in 2017 NPL sales were EUR144bn. In 2018, there were EUR125bn NPL sales completed by the end of the third quarter (of which c.50% were in Italy) with a further EUR60bn of deals in the pipeline. We anticipate at least half of these were completed by the year-end, which would take total European NPLs down towards EUR700bn – a EUR400bn reduction in the last three years. With asset quality remaining a strategic priority for the regulator, we can only see this trend continuing, albeit more slowly than the impressive pace we have seen to date.

Funding remained robust with liquidity coverage ratios increasing to 148% – well above the 100% requirements, loan-to-deposit ratios decreasing to 116% and asset encumbrance remaining stable.

Even profitability trends showed a glimmer of hope, despite margin pressure from low rates, with aggregated return on equity rising by 1%, driven by higher lending volumes and growing fee and commission income, as business models adapted, and falling provision charges as a result of improved asset quality.

While the metrics quoted above are static, the strength that we see in fundamentals were also put to the test with the sixth iteration of the EBA stress test. These were undoubtedly the most robust tests that we have seen to-date, with the macroeconomic scenarios and results summarised in Table 1.

TABLE 1: EBA stress test results

	2018	2016	2014	2011
Starting CET1	**14.40%**	**13.20%**	**11.20%**	**8.90%**
Hit to CET1	**4.10%**	**3.80%**	**2.78%**	**1.2%**
Adverse scenario capital position	**10.30%**	**9.40%**	**8.42%**	**7.70%**
Baseline scenario capital position	15.40%	13.90%	11.72%	9.80%
GDP growth	**-2.70%**	-1.80%	-2.10%	-0.40%
Unemployment	**9.70%**	11.60%	13%	10.50%
House prices	**-19%**	-21.30%	-14%	-11.60%
Commercial real estate	**-18%**			
Equity markets	-30%	-25.40%	-19.20%	-14.30%
Increased in bond yields	85bps	80bps	150bps	65bps

Source: EBA, BlueBay Asset Management, 30 November 2018

The results of these tests and ongoing regulatory oversight give us a lot of confidence that even if we are wrong and enter an economic downturn, banks are very well placed to weather the storm fundamentally.

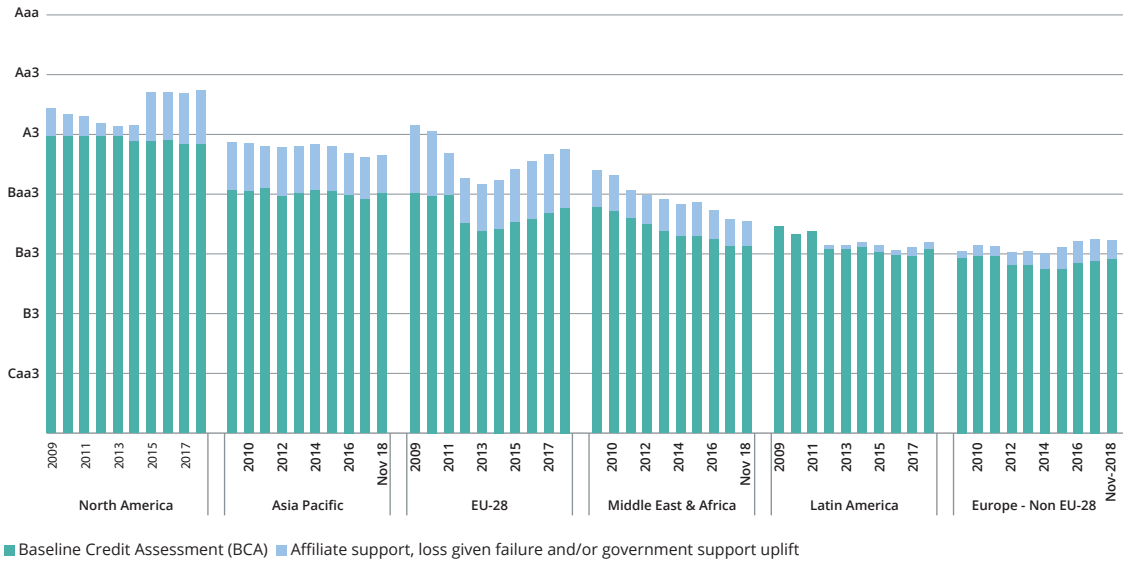
To add some context to this, in the 2001/2003 recession – which we would view as a more likely outcome to manage against than the recession borne out of the global financial crisis – loan loss provisions increased by 100%. The EBA stress testing exercise tested for an increase of provisions of 150% over the three year test period, which was front-loaded due to the new IFRS 9 accounting, along with a raft of other negative asset price movements.

On aggregate, results showed banks capital ratios still comfortably above regulatory requirements (which themselves are more than double the level of capital ahead of the financial crisis) and despite the hit to capital being the largest drawdown, a higher aggregate CET1 end point than in any previous tests. Notwithstanding, the stress testing was done on static balance sheets assuming no management actions are undertaken, which is an unrealistically harsh assumption.

We would also add that the significant regulatory oversight since the financial crisis has meant there has been very little in the way of animal spirits in European bank lending practices, highlighted in falling emerging market exposures, decreased US dollar lending and lacklustre loan growth, which would suggest provisioning levels may well end up much more subdued than in previous recessions.

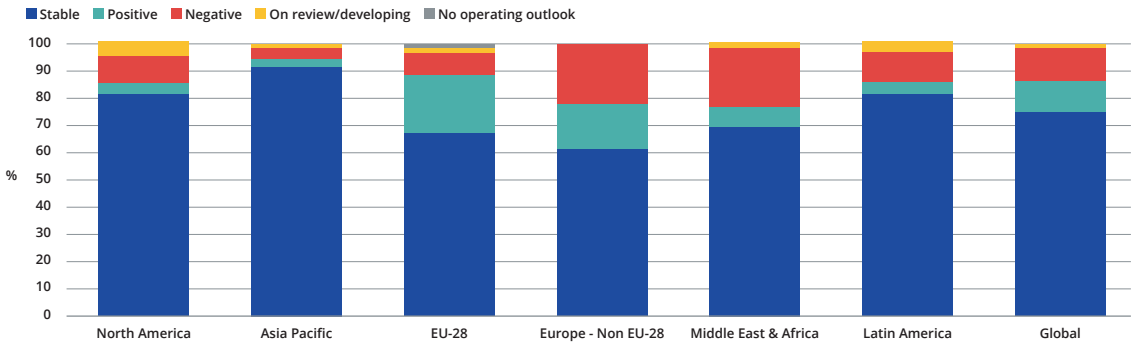
These fundamental trends are confirmed in rating agency views, with Moody's latest data on banking systems showing European banks continuing on an upward rating trajectory in ratings with the largest percentage of banks on positive outlook.

CHART 1: Moody's simple average long-term bank deposit ratings by region



Source: Moody's Investors Service, 28 November 2018

CHART 2: Moody's simple average issuer outlooks per region



Source: Moody's Investors Service, 28 December 2018

With this data in mind, the 33% decline in European bank share prices experienced in 2018 was somewhat surprising. Research examining previous share price declines of 30% or more generally relates to a recession or major risk-off event, which has a significant impact on profits, and this was not something observed in 2018.

Counter-intuitively, one of the few bright spots for bank profitability was the continued decline in required provisions, which is the opposite trend that one would expect to see in a recessionary environment. Table 2, based on profitability falls in previous recessions, would suggest that European banks are pricing the probability of a recession at over 70%, which seems high despite the slowing growth numbers.

TABLE 2

	Peak-trough share price decline	Timeline (in months) 15 -38%	Decline in bank profits
Recessions			
1991/ 92	-23%	15	-38%
2002/03	-45%	22	-54%
2007-09	-83%	23	-79%
2012/13	-51%	19	-46%
Other macro			
2015/16 (EM & NIRP)	-42%	7	-10%
Average recession (ex 2007-09)	**-40%**	**19**	**-46%**
Specific events			
Black Monday 1987	-33%		
1st Gulf War 1990	-29%		
1994 bond crash	-22%		
LTCM/ Russia 1998	-45%		
9/11/2001	-21%		
Greek crisis 2010	-24%		
Brexit	-22%		
Average of specific events	-28%		
Current sell-off	**-33%**	**11**	**-5%**

Source: Autonomous, Bloomberg, 3 January 2019

This does not necessarily mean we are calling for a sharp resurgence in bank stock prices. We certainly see them as cheap relative to the probability of a recession, but despite balance sheet strength continuing to improve markedly, earnings momentum remains very subdued. Risk appetite from banks is lacking, margins continue to be under pressure due to competition, funding costs are set to increase with ongoing regulatory burdens and costs remaining stubbornly high, particularly given the ongoing technology spend that is required to upgrade ageing systems.

What we have seen from the banks in terms of business model transformation and risk appetite, combined with regulatory oversight gives us a lot of confidence, certainly from a fundamental perspective, that the credit bull story in European banks continues. However, the combination of significant balance sheet strengthening but very limited earnings momentum remains a cornerstone of our view that if you want to invest in European banks, CoCos – not equity – remains the sweet spot.

Where do valuations stack up?

Counter-intuitive to the fundamental improvements we have highlighted, AT1 spreads widened by 179bps over the course of 2018. To take stock of where valuations are now we think it is worth comparing where we are versus historical levels, the rest of the bank capital stack, high yield and emerging markets.

The average spread level at the start of 2019 was significantly wider than a year ago, and wider than the tights of 2007. As we have said before, we do not expect to return to the levels of 2007 but in our base case scenario we also find it difficult to see spreads move meaningfully wider given the repricing we experienced last year.

Chart 3 shows the BAML ICE CoCo Index since its inception in 2014. As evidenced, the index finished 2018 at the wides of the year with a spread of z+470, which is still some way from the levels reached in February 2016, and has already recovered sharply over the course of January 2019 to z+400.

However, just looking at the index composite level is misleading as a large number of the constituent bonds in the index have very high resets and are coming up for call. This leads the index to trade at tighter spreads than can easily be achieved from a portfolio of 'national champion' banks. As a representation of this, the horizontal lines on the chart are the trading levels of the most recently issued bonds from a range of 'national champion' banks. As can be observed when thinking about value, on this basis we are able to achieve wider spreads than the index at almost every time other than a very brief period in February 2016.

CHART 3: Attractive valuations

Source: Bloomberg, BlueBay Asset Management as at 31 January 2019

In our 2018 outlook we talked about banks being an improving sector generally and specifically about AT1s being the most mispriced part of bank capital structures – this remains the case. The differential between AT1 and LT2 securities has increased since the end of 2017 and depending on currency ranges between 340bps and 285bps. As we discussed before, in the case of a bank's failure we expect the recovery of AT1 and LT2 securities to be very similar.

As such, we can simplify the additional spread pick up between AT1 and LT2 securities to be representative of the risk of an AT1 security skipping a coupon (which is not possible for a LT2). The spread differential between AT1 and LT2 spread suggests that if we assume recovery values are the same, as long as a bank pays the coupon on its AT1 securities once every three years you are better off being in an AT1 security from the same institution.

In our opinion, this is drastically overpricing the risk of a non-coupon payment and we would note that there has not yet been an example of a bank skipping a payment on its AT1 securities, even in the case of Banco Popular.

TABLE 3: Valuations: Then and now

	EUR			USD			GBP		
OAS spreads (bps)	2007	Dec-17	Now	2007	Dec-17	Now	2007	Dec-17	Now
Tier 1/ATI	69	343	529	90	284	491	100	408	590
Lower Tier2	22	91	203	42	142	206	51	189	251
Senior	6	30	102	19	86	141	24	111	160
Corporates	32	50	118	60	127	171	63	160	192

Source: Morgan Stanley as at 31 January 2019

There are a number of reasons that we can point to regarding this mispricing. One has been the lack of index eligibility, with AT1s not forming part of the investment grade or high yield indices. We interpret this as the buyer base being a very diverse mix of investors, including asset managers taking off index bets, specialist CoCo funds, hedge funds, equity income funds and sovereign wealth funds. On the one hand, this has meant liquidity has tended to be enhanced due to the diverse buyer base with different return expectations, but on the other, it has meant that the mispricing differential has yet to close.

New issuance plans

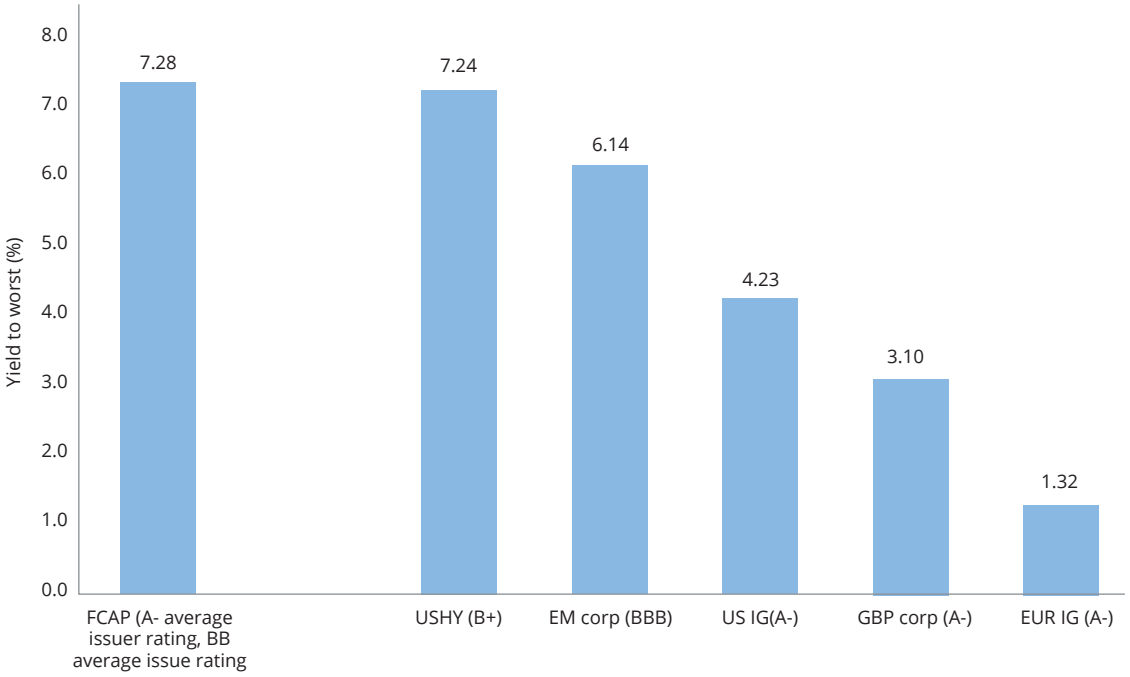
A dynamic that now looks quite favourable to us in this regard is that at the same time that specialist funds and other participants in AT1 have grown in size, the supply dynamic looks much more favourable as the large national champions are now a significant way through their AT1 issuance plans. As such, the significant portion of the supply we now expect to see is in refinancing existing securities, rather than further building of the AT1 tranche in bank capital structures.

Our expectations for ongoing supply are now in the EUR20–25bn per annum range, with this outlook likely to be tempered by market performance, which suggests that unlike in previous years supply will be a positive technical dynamic.

Relative value

As well as within bank capital structures, valuations of AT1s look attractive to us when compared with high yield and emerging markets. Chart 4 compares the yields on offer versus a range of sub-asset classes.

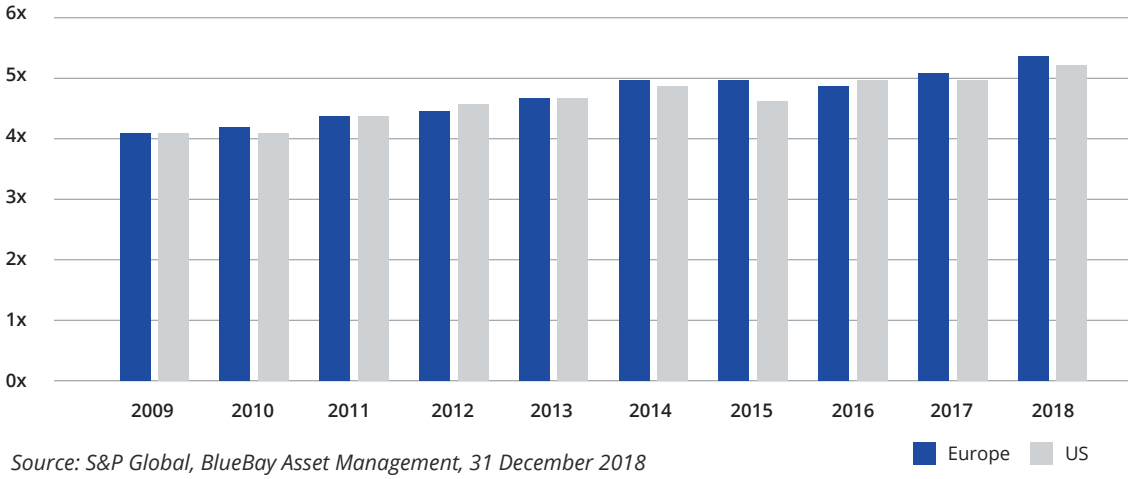
CHART 4: Yields of various sub-asset classes



Source: BlueBay Asset Management at 31 December 2018

The more attractive yield available in AT1 securities versus high yield corporates continues to puzzle us. Chart 5 illustrates total debt/EBITDA in loan markets and shows us a very clear trend in rising corporate leverage within Europe and the US which is in contrast to banks that are showing the opposite trend with capital levels continuing to increase. At the same time, while rising rates will pressure those companies with high leverage through higher refinancing costs, banks are the one sector that benefits in such an environment.

CHART 5: Total debt/EBITDA in loan markets



Source: S&P Global, BlueBay Asset Management, 31 December 2018

Similarly, emerging markets are another area that concerns us when considering a stronger US dollar and tightening financial conditions. It remains to be seen whether emerging economies are more robust than in previous US rate hiking cycles, but it is still a case of damage limitation, unlike for banks which are poised to benefit from a rising rate environment as interest margins increase.

Alpha opportunities

Given the dispersion exhibited in the asset class, we have always championed active management. Regulation has by design amplified the importance of active management by lowering the probability of bank failure but increasing the loss given failure should you invest in the wrong institution.

TABLE 4: Performance of index constituents (%)

PERFORMANCE OF INDEX CONSTITUENTS (%)

	Median performance	Average performance of top 10%	Average performance of bottom 10%
2000	4.08	11.03	-17.28
2001	18.29	29.11	9.18
2002	15.55	24 .09	3.42
2003	11.02	26 .01	5.75
2004	6.61	14.23	2.79
2005	4.18	8.21	0 .36
2006	1.64	4.27	-2.36
2007	-3.11	5.69	-21 .24
2008	-34.46	5.44	-78 .33
2009	42.95	158.62	-6.62
2010	15.41	67.18	-8.68
2011	-2.54	13.62	-34.74
2012	27.90	81.27	4.60
2013	10.44	41.30	-3.80
2014	1.55	9.82	-20.63
201S	5.33	38.58	-9.66
2016	5.00	30.57	-1.38
2017	12.43	25.71	-11.05
2018	**-2.84**	**4.66**	**-9.05**

Source: BlueBay Asset Management at 31 December 2018

Our investment process is suited to take advantage of this dispersion. We take conviction views underpinned by extensive bottom-up research, regulatory, political and macro analysis. As Table 4 shows, 2018 was one of the lowest dispersion years we have seen in bank capital, and certainly the lowest for the BAML ICE CoCo Index since its inception in 2014. This environment was particularly challenging for our investment process, which we view as much more suited to alpha generation rather than simply capturing beta, but it is not an environment we think is likely to prevail. We see ample opportunities for alpha generation and rising volatility in the year ahead.

We believe cross-currency differentiation continues to drive a strong medium-term opportunity. As can be seen in Table 3, USD securities continue to trade at tighter spreads than equivalent bonds issued in EUR. This remains an anomaly driven by market structures that offers what in our view is an attractive arbitrage opportunity for investors willing to look across currencies.

Investor demand

Demand for AT1s comes from a diverse investor base, both geographically and by investor type. A large proportion of investors continue to be yield-based, who appear attracted by the large coupons that banks are willing to pay on their USD securities. However, we think this ignores an obvious potential arbitrage opportunity available to investors, which involves buying EUR securities where not only can you lock in higher spreads but also benefit from the cross-currency basis when swapping these securities back into USD.

Extension risk / Call optionality

Idiosyncratic issuer actions may lead to increased issuer and security differentiation over the year. Unlike previous years, 2019 will likely be the first year where the economics of whether or not to call bonds for issuers will come into question.

We have long stated when looking at AT1 securities that investors are overly compensated for the risk of coupon deferral or conversion and under compensated for the optionality sold to issuers in terms of extension risk and subsequent calls thereafter. Should any bank choose not to call their securities, we expect a significant increase in scrutiny over the reset levels of bonds and subsequent call optionality, which should play well for those investors that have done their homework on the underlying bond structures.

Regulatory considerations

Regulation continues to be very fluid with lots of things happening in 2019. At some point in H1 we are likely to see the implementation of an updated 'banking package' in the EU. This will see a new iteration of the Capital Requirements Regulations (CRR2), Capital Requirements Directives (CRD V) and Bank Recovery and Resolution Directive (BRRD 2). Each of these has the potential to have an idiosyncratic impact across different banks and securities, which will undoubtedly present opportunities. For example, it will become a requirement that capital securities do not include a waiver of set off rights in the documentation. This has the potential to make some bonds ineligible for regulatory capital, thereby increasing the likelihood of them being called at the first call date or at the end of any grandfathering period if there is one.

Additional restrictions in how the maximum distributable amount (MDA) is calculated will add a further complication to understanding a bank's ability to pay AT1 coupons, and some banks may appear more restricted in this regard than investors first thought. In other jurisdictions, the ability to include additional reserves in this calculation will be a significant positive.

Pressure on balance sheet strengthening looks set to be maintained. NPLs on newly written loans will have specific provisioning requirements going forward and banks with NPL ratios above certain thresholds will be required to establish specific strategies and operational arrangements to manage their exposures, with the assessment of how they are doing this feeding into their supervisory review and evaluation process.

Resolution planning, minimum required eligible liabilities and subordination requirements will also impact issuance across the capital structure and how banks will manage their business, which will also have far-reaching implications.

Keeping ahead of the curve on understanding these regulations will be a key input in our investment process and will impact our ability to generate alpha.

Market activity

M&A noise has continued to pick up over the last year. Undoubtedly, the sector would benefit greatly from further consolidation as a whole, but it remains difficult to see combinations that would make sense other than at distressed levels. We expect the ECB and the market to continue to make noises on consolidation that will create trading opportunities, but unless we see regulatory changes to increase the attractiveness of doing deals or distressed situations, we continue to see this as a 'buy the rumour, sell the fact' trade.

Despite all regulatory efforts, sovereigns and banks remain fundamentally interlinked and 2019 is set up to be another year of political volatility that will influence spreads. The Italian coalition remains inherently unstable, with the far right and left continuing to jostle for position in what remains a marriage of convenience. With pressure rising following Italy entering into technical recession in early 2019, we think the stopwatch to another round of elections has already started ticking.

Political impacts will continue in 2019

Brexit implications will be profound. On the base case scenario that a deal is reached by 29 March, the under-appreciated fact is that this will just be the end of the beginning, with any future trade deal and relationship, not just with the EU but also with the rest of the world, needing to be thrashed out. As such, even in the more benign of outcomes quantifying the economic impact on the UK will continue to be extremely challenging.

While unlikely, should a 'no deal' Brexit occur, the ramifications will be profound not just for the UK but also for the EU, with both parties likely to see a sharp negative shock to growth.

2019 is also a European election year with EU parliamentary elections in May. There is a strong likelihood that the composition of the European parliament will change, with gains expected for anti-European parties. While it seems unlikely the gains will be large enough to change the voting majorities, it would seem likely that such parties capturing a significant share of votes will bear influence on policy thinking at the European level.

Bringing politics back to macro, we are also seeing growing pressure towards more fiscal measures in Europe on a country by country level. The Italian budget was leaning in the fiscally expansive direction and in the face of the 'Mouvement des Gilets jaunes' (yellow vests movement), France is likely to follow suit. While this is clearly not a Europe wide policy, with Germany already starting on a fiscal spending program agreed in 2018, this is an area that we think requires paying attention.

The macro effect

Focusing purely on macro, we expect monetary policy to be very influential in 2019 – not just for broader risk assets but particularly because of the

implications that it can have for banks. The Fed has clearly paused for the time being but data can change and we expect the Fed to change with it. For now, we see the Fed pause as a tailwind to risk assets, but significant scrutiny will remain as to how they manage the normalisation process and if they are moving at the correct speed over the course of the year.

Closer to home the composition of the ECB governing council will change fundamentally in October, forcing the market into a guessing game as to how it will communicate and act going forward. Prior to that there will be even bigger questions to answer. With the data weakening, just at the moment of the ECB exiting the bond purchase programme, we see an increasing impetus to give the addicted market another injection of easing.

The most obvious route to this, in our view, is another Targeted Long Term Refinancing Operation (TLTRO), but there is also the potential for tiering of interest rates, which would be very helpful to the banks who have now lived with negative rates for close to five years and operation twist – which would look to reinvest the proceeds of the purchase programme in the longer end putting downward pressure on spreads.

In the UK, the Bank of England has clearly been impeded from acting in the face of Brexit uncertainty and the data we are seeing would normally equate to much higher rates. As such, whatever the outcome of Brexit we would expect pressure on the Bank of England to act one way or another.

The only real point of clarity we can draw from all of these discussion points above is that we are undoubtedly in a phase of elevated uncertainty from a policy and political perspective. In most instances the outcomes are uncertain and what will remain important is that we formulate our views quickly in line with changing circumstances.

How we will invest in 2019

We expect dispersion to revert to what we normally see in the asset class. As such, do not expect any changes in our investment process. We will continue to take concentrated, conviction views and strongly believe that this is the most effective way to generate alpha in the asset class over the medium term.

Undoubtedly, we expect 2019 to be characterised by increased volatility. We can plausibly paint both a bull and bear picture for risk assets, but our greatest confidence is that there is less directional certainty. This warrants taking an increased degree of caution in how we invest, but still focussing on the most mispriced parts of the capital structure and where we see arbitrage opportunities.

While the outlook for risk assets is more uncertain, our conviction view on the asset class remains strong. Price action at times may be volatile but we believe fundamentals will prevail and we remain convinced that when the credit cycle does turn banks will outperform.

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