BlueBay
Asset Management

Cocos in 2020

Superior yield in a dislocated world

Against a robust macroeconomic backdrop, we remain in a world where USD12 trillion of fixed income assets are negative yielding. In this environment, bank capital in the form of coco bonds stand-out as a unique risk asset that we believe offers an attractive yield and alpha generation potential, in a sector with improving credit fundamentals. In this paper we explore the risk, regulation and macro factors that we see shaping returns through 2020 and outline our investment strategy for the year ahead.

We enter the new decade on a much stronger footing than we came into 2019. In our view, growth appears to have reached an inflection point and is showing signs of a stabilisation, central bank policy remains extremely accommodative and recessionary risks are abating. However, we also see a world where corporate leverage is increasing and the policy tools available to maintain the 'goldilocks' environment are increasingly limited.

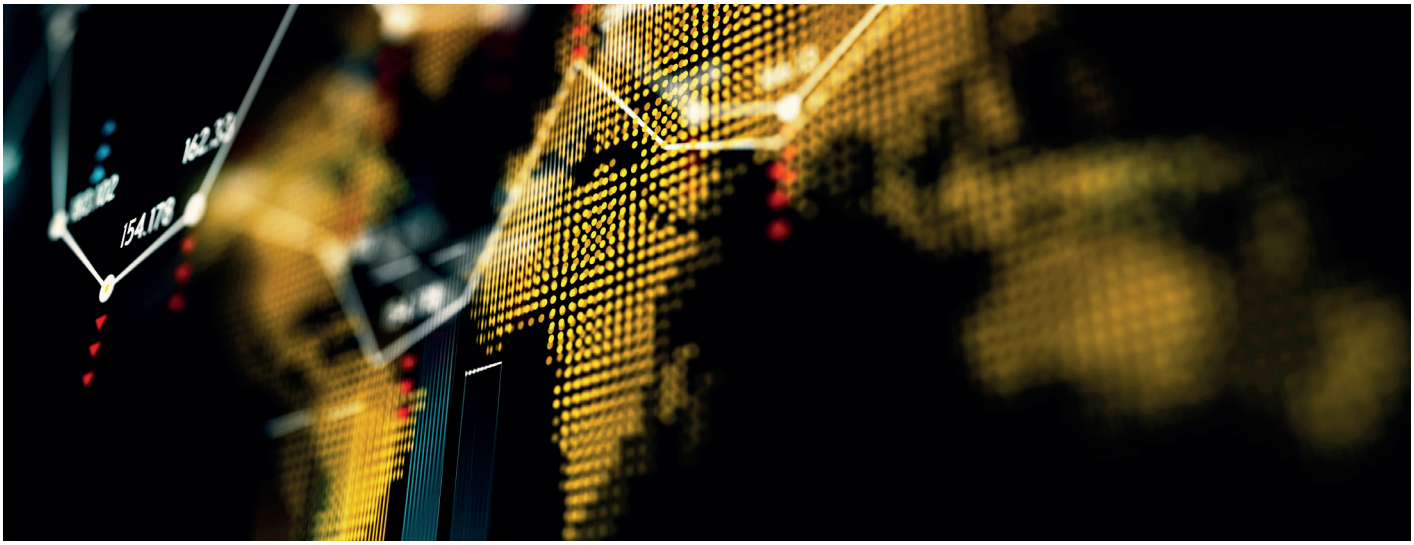
Quantitative easing has driven yields lower and forced investors to move down the risk spectrum or along the duration curve, thereby increasing the vulnerability of the market if downside catalysts emerge.

Against this backdrop, we believe bank capital remains a uniquely attractive risk asset:

- **The yield proposition looks increasingly attractive and disconnected from the inherent risks in the AT1 instrument, in our view.**
- **The banking sector continues to strengthen fundamentally and should benefit in the event of a rise in interest rates.**
- **The asset class has favourable demand/ supply dynamics and holds an alpha-rich opportunity set.**
- **Growth-sensitive credit has historically outperformed as recession risks recede.**

Looking at the landscape, we are excited about the opportunities ahead. The macroeconomic environment looks to be stable, the need for yield persists and we are confident that our investment process will allow us to generate notable alpha.

In our view, growth appears to have reached an inflection point and is showing signs of stabilisation, central bank policy remains extremely accommodative and recessionary risks are abating



The macro environment

In January 2019, deteriorating business sentiment, weakening economic activity and central bank tightening combined to amplify downside risks and create a market with a very bearish bias. This bias was short lived as central banks swiftly moved to reverse policy decisions of 2018; led by the US Federal Reserve (Fed), central banks representing 70% of world's economies by GDP moved to an easing monetary policy stance. This remarkable turnaround in policy drove positive returns across almost every asset class over the year and precipitated sharp declines in long-term yields, thereby easing financial conditions.

While growth forecasts were consistently downgraded for much of 2019, the easing bias appears to have had a positive economic impact. As we stand today, data points to an inflection point being reached in H2 – several major emerging market economies are recovering from recession and the slowdown in Europe appears to have troughed, if not stabilised – with a rebound in growth now being forecast in 2020. This said, the forecast recovery is subdued, and with ongoing geopolitical tensions and a global economy characterised by low growth and high debt, the environment remains vulnerable to adverse shocks.

We talked several times over the course of 2019 about a 'goldilocks' environment for credit. Low-but-positive growth combined with subdued inflation, ensuring central banks remained accommodative. This helped to extend the credit cycle, creating an environment where credit delivered attractive risk-adjusted returns.

With the US Presidential election in Autumn 2020, weak inflation in Europe and the never-ending Brexit saga moving onto trade negotiations, it seems likely to us that central bankers will exercise a strong degree of caution in moving from the currently expansive monetary stance. As such, we anticipate continuing on this 'glide path' for the time being.

Nevertheless, this is an equilibrium that central bankers may find increasingly difficult to navigate. There have been growing calls for a more expansive fiscal policy to supplement the easy monetary policy supplied by central banks. While we think this process will occur slowly, we believe any movement on the fiscal front has the potential to provide a large boost to growth, particularly as it should drive a big uptick in investment spend in the private sector, which has been lacklustre.

There have been growing calls for a more expansive fiscal policy to supplement the easy monetary policy supplied by central banks

The market does not expect such an environment, and indeed it isn't our base case; but with increasingly populist politics, driven by still-growing wealth inequality, weak growth and low yields, it seems an increasingly easy path to take, and we have already seen the US, UK, Japan and France make steps in this direction. Should such policies gain widespread momentum, central banks could quickly find themselves behind the curve if they are reluctant to move with the data, which will only serve to increase the risks of a policy mistake.

Our base case

Considering the above, we anticipate that rates at the front end will remain anchored for the best part of the year and that growth will continue to modestly rebound from the lows of 2019 – 'goldilocks' for credit remains our central scenario. However, with yields already at historic lows and geopolitical tensions ongoing, we are mindful of the risks and the tightrope the global economy continues to walk, which will be reflected in our risk management over the course of the coming year.

Valuations

2019's central bank pivot, and subsequent market reaction, crushed yields to historic lows, creating a staggering situation in which almost 25% of global fixed income assets now offer negative yields. As chart 1 shows, the proportion of assets that yield 3-10% has dropped from approximately 80% in 2007 to less than 9% today, leaving investors with limited options with which to generate returns in excess of the rate of inflation.

Contingent capital securities (cocos) remain one of the few fixed income assets that sit firmly within this 3-10% bucket and we remain convinced that on a relative basis there continues to be significant upside potential.

While yields on the asset class may be at the lows, this needs to be viewed in the context of falling core rates and when we look at spread levels, they remain at levels wider than those experienced in early 2018. Moreover, across bank capital structures, spreads are still 4x wider than the levels we saw in 2007 before the global financial crisis, despite banks being significantly more resilient on almost every metric. For numerous reasons, both fundamentally and technically, we see no reason why the tights of 2018 should not be surpassed, and this is why cocos remain, in our opinion, the most exciting asset class in the fixed income space.

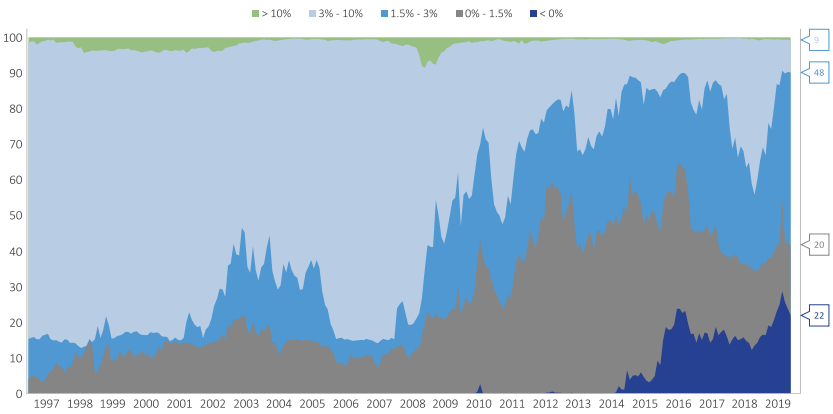
We see the key risks priced into cocos (loss absorption and coupon skip) as being grossly overstated. When considering the risk of loss absorption, we reason that the trigger levels on cocos are too low, and long before the point that a trigger is breached, we would see a regulatory intervention.

We are of the view, and what we have historically observed, is that there is very little differentiation between the recovery value on cocos and other subordinated instruments in a regulatory intervention given the depth of these debt layers within the capital structure and the leverage inherent within banks. While it is a simplification of the structures and market, you can extend this argument to say that if recovery values are the same in default, the additional spread pick-up (see chart 2) between a LT2 security and cocos must be representative of the risk of a coupon skip. On this basis, as long as a bank pays the coupon on its coco once every three years, returns will be greater by being in the coco from the same institution. We believe this is a significant mispricing of the risk of a non-payment of a coupon, which in part is driven by the lack of inclusion of cocos in fixed income indicies. Therefore, it is not surprising to us that rating agencies are also coming to this conclusion, which we expand on further in the ratings section.

We also find valuation arguments to own banks versus corporates compelling. Distortions from seemingly never-ending central bank liquidity and ultra-low interest rates continue to increase. The International Monetary Fund (IMF) highlighted in its most recent Global Financial Stability Report that non-financial corporates are taking on more debt, and their ability to service that debt is weakening (see chart 3). In the event of a material economic slowdown, they describe the prospects as "sobering." We have already started to see the effects of this in 2019 with global corporate defaults rising 43%, albeit from a low base and the S&P "weakest link" ratio (issuers rated B- or lower and which have a negative outlook) rising to a level equivalent to the financial crisis, which was itself a record high (see charts 4 & 5).

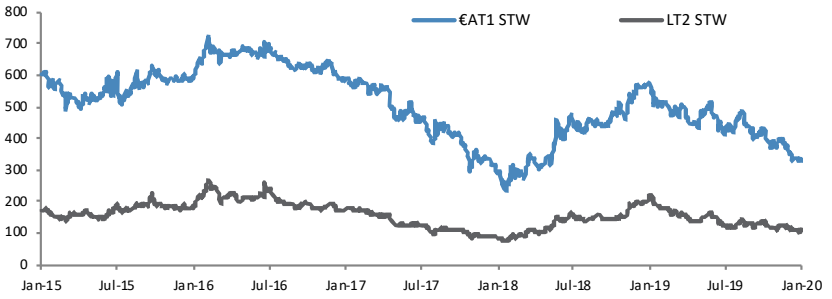
We see the key risks priced into cocos (loss absorption and coupon skip) as being grossly overstated

CHART 1: GLOBAL FIXED INCOME MARKET BY YIELD BUCKET



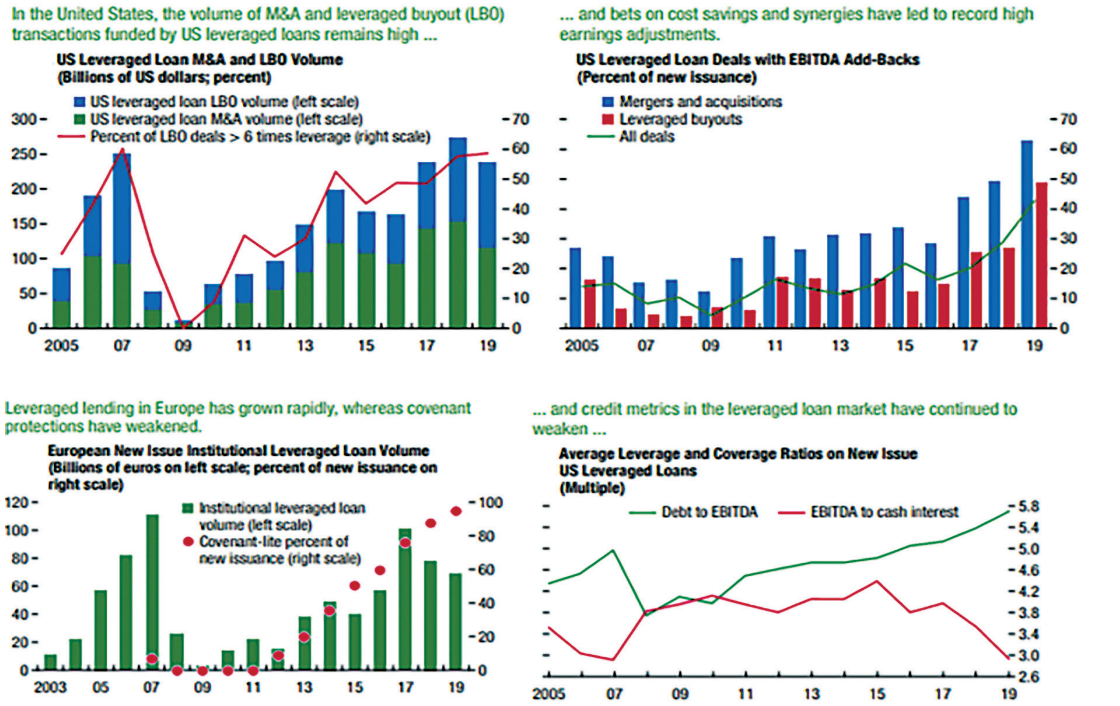
Source: BofAML Global Fixed Income Index; latest monthly data for November 2019

CHART 2: EUR AT1 SPREAD VS LT2 SPREAD



Source: JPMorgan, data to 8 January 2020

CHART 3



Source: IMF Global Financial Stability Report October 2019

In Europe, while deleveraging has occurred since the eurozone debt crisis, the window for cyclical improvements in credit metrics has likely passed.

In the US, where cyclical credit improvements have been more marked, there has been a notable increase in financial risk taking by non-financial corporates – with pay-outs and M&A increasingly funded by debt. While the share of highly levered deals has grown, and now exceeds pre-financial crisis highs, unlike in the past, this debt provision has come primarily from the private market rather than banks, which are exercising considerable caution in their provision of credit to this market.

While growth taking an unexpected downturn is not our base case, these growing distortions do create the potential for significant vulnerabilities and volatility, particularly given the increasingly limited tool box for central banks to provide further stimulation.

The dynamics we observe in corporate sectors are quite different to the ones we see for banks, where improvements in credit fundamentals appear to be continuing unabated. Truth be told, we find it quite astonishing, that given the fragilities building up in the leveraged loan markets and worrisome changes in fundamental metrics, we are still able to achieve higher yields by focussing on cocos that have an improving fundamental and rating trajectory versus high-yield corporates (see chart 6).

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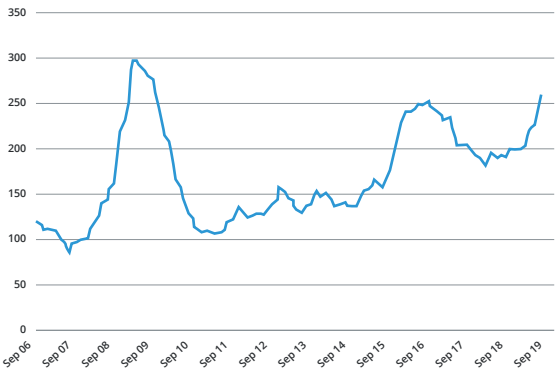
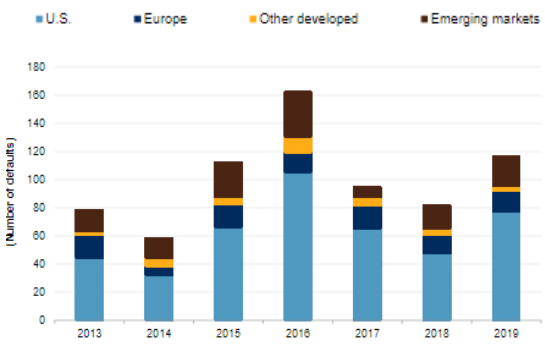
CHART 4: NO OF WEAKEST LINKS, HIGHEST SINCE NOVEMBER 2009



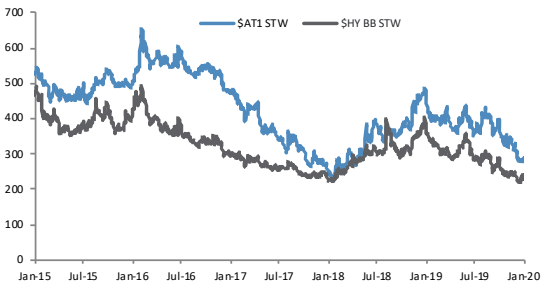
Source: S&P Global Ratings Research, 23 September 2019

CHART 5: DEFAULT FROM US & EM IN 2019 WERE HIGHEST SINCE 2016



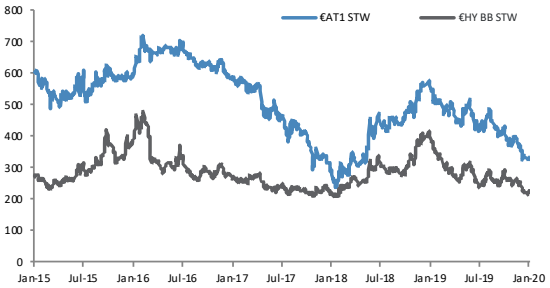
Source: S&P Global Ratings Research & S&P Global Market Intelligence, 1 January 2020

CHART 7: USD AT1 VS USD HY BB (SPREADS)



Source: JPMorgan, 8 January 2020

CHART 8: EUR AT1 VS EUR HY BB (SPREADS)



Source: JPMorgan, 8 January 2020

It remains true that in our base case of 'goldilocks' for credit, lower-rated and cyclical credit should perform well in 2020, but on a risk-adjusted basis, bank capital seems a much surer bet.

Also of note, we have seen growing levels of dispersion in the high-yield indices, implying that yields in the stronger names have been compressed to levels meaningfully tighter to that of the index. In order to achieve the stated average yield of the index, an investor would have to invest in the lower-rated issuers, thereby being exposed to companies with more fragile financial profiles.

The HY/IG rating anomaly

One of the interesting abnormalities we have always pointed to when thinking about cocos is that while they are typically high-yield rated, they are, in the vast majority of cases, issued by investment grade-rated companies. Given the high-yield rating, many investors compare cocos on a valuation basis and think about the probability of default versus other high yield-rated companies.

We disagree with this approach and think the rating methodology vastly overstates the probability of default, leading to a pricing anomaly.

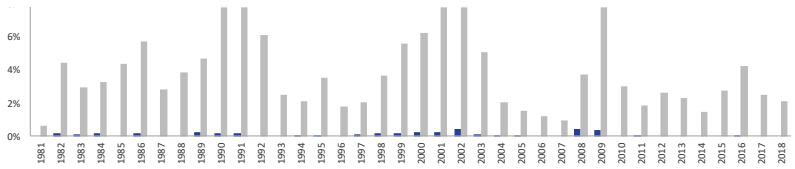
As shown in chart 9 below, long-term default rates for high yield bonds are significantly greater than those for investment grade. However, we struggle to envisage a scenario where a coco defaults without the whole bank, which is typically investment grade-rated, also defaulting.

While we do not debate that recoveries may well be zero or very low in a default scenario, our point is that the probability of this happening is extremely remote when compared to high yield (see chart 9).

It therefore remains counterintuitive to us that at this point in the cycle, given long-term default rates, that the yields are higher than those on offer in US or European BB credits (see charts 7 & 8).

It remains true that in our base case of 'goldilocks' for credit, lower-rated and cyclical credit should perform well in 2020, but on a risk-adjusted basis, bank capital seems a much surer bet

CHART 9: HIGH YIELD DEFAULT RATE FAR EXCEEDS THAT OF INVESTMENT GRADE



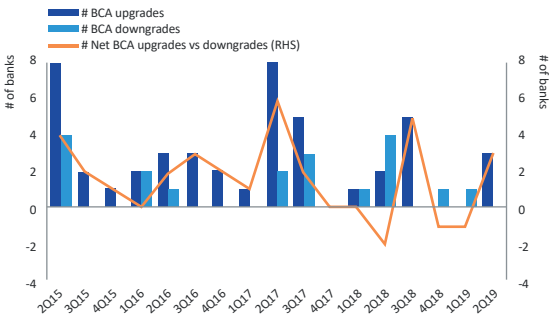
	Time Horizon			
%	1	3	5	10
Investment Grade	0.10	0.45	0.92	2.03
High Yield	3.75	10.39	14.95	21.21

Portfolio average issuer rating
A-

Source: S&P Global, BlueBay Asset Management, as at 7 June 2019

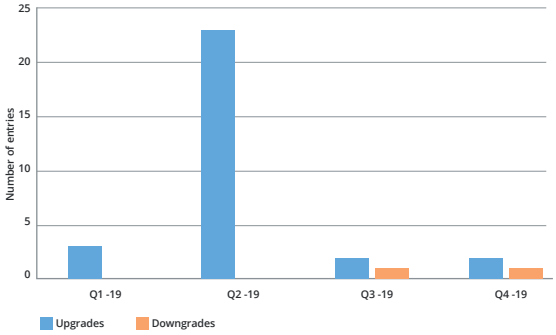
Ratings developments

CHART 10: MOODYS – EUROPEAN BANK UPGRADES OUTNUMBER DOWNGRADES



Source: Moodys, December 2019

CHART 11: S&P – EUROPEAN BANK UPGRADES OUTNUMBER DOWNGRADES



Source: Standard & Poors, December 2019

The rating developments we have observed have generally followed the fundamental developments that we have long highlighted for banks, with all three of the major rating agencies showing the number of bank upgrades exceeding the number of downgrades over the course of 2019 (see charts 10, 11, 12).

We have held the view for several years that rating agencies have been behind the curve on re-rating banks in line with the fundamental improvements we have seen since the financial crisis. The upgrade/downgrade ratios of the past five years now suggest this to be the case. This said, while we remain confident on the credit fundamentals for European banks, the significant momentum of improvements has now slowed. As such, the majority of rating transitions have likely now occurred, with upgrades and downgrades to standalone credit ratings likely to be more balanced going forward.

In our view, a more impactful development is the recent request for comment by Fitch, where it is proposing to adjust the notching it applies to subordinated debt securities, including cocos. The proposals, which we believe are likely to be applied in Q1 2020 will see LT2 debt notched down a step from the issuer's viability rating and cocos notched up a step, leaving a rating differential in the majority of cases of just one notch. These changes closely align with our view that the difference in yields between LT2 securities and cocos are more pronounced than they should be.

Fitch cited the reason for this change as being driven by a reduction in its assessment of incremental non-performance risk between the two classes of securities. Should they occur, Fitch have estimated this will lead to upgrades for approximately 40 issuers' cocos and downgrades for over 100 issuers' LT2s. **By our estimates, this proposed change could dramatically transform the structure of the coco universe by improving the composite rating of approximately 20% of the outstanding coco universe to investment grade, which would mean the overall volume of investment grade-rated cocos in the universe will rise from 30% to just over 50%.**

With ever more focus on the asset class, we believe this will have a positive effect on price performance.

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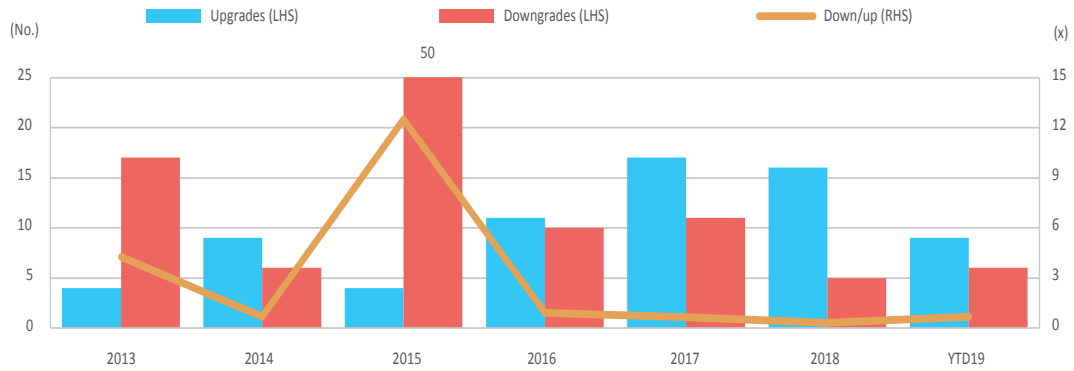
CHART 12: FITCH – EUROPEAN BANK UPGRADES OUTNUMBER DOWNGRADES



Source: Fitch Ratings, 5 December 2019

Fundamentals

TABLE 1: STRESS TESTING REVEALS STRONGER, AND STRONGER BANKS IN EUROPE

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%	1.20%
Adverse Scenario Capital Position	10.30%	9.40%	8.42%	7.70%
Baseline 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 bond yields	85 bps	80 bps	150 bps	65 bps

Source: EBA, BlueBay Asset Management, 30 November 2018

As noted above, while the pace of improvement in bank fundamentals has started to slow, they remain extremely robust. Stress testing exercises (summarised in table 1) that are now frequently carried out by regulators continue to give us confidence in the resilience of banks should we enter an unexpected downturn.

Capital

The average common equity tier 1 ratio (CET1) remained flat year over year at 14.4%, while at the same time the denominator of the ratio – namely risk-weighted assets – saw modest increases in line with asset growth. In our view, it is likely that CET1 ratios have peaked at current levels and regulation will instead be directed towards improving the quality of this ratio. What we mean by this is that we expect that risk weights will continue to rise through various regulatory exercises. So, while the ratio may drift down from the current high levels, the absolute levels of capital will stay the same, or even increase further, ensuring bank credit fundamentals are not compromised.

Non-performing loans

While capital levels have remained robust, asset quality has continued to improve. The average non-performing loan (NPL) ratio decreased further over the course of the year to just 3% – the lowest level since the definition of NPLs was standardised in 2014. While the pace of improvements has slowed, the scale of improvements should not be underestimated.

NPLs have now more than halved since 2014 from over EUR1.2 trillion to nearly EUR600 billion – while at the same time outstanding loans have increased by over 15%. In the last year alone, the decrease in NPLs has been over EUR110 billion. With a number of dedicated NPL reduction programmes coming online in the few remaining countries with high NPLs (Greece, Cyprus & Italy), we have no doubt that 2020 will see another year of significant improvement in these ratios.

Funding conditions

Bank funding conditions also improved markedly over the course of 2019. A fall in volatility precipitated by the central bank actions in Q1, the announcement of TLTRO III and the introduction of deposit tiering, were all extremely helpful for banks in managing the liability side of their balance sheets.

As with capital ratios, the key funding metrics we look at, such as the liquidity coverage ratio and loan to deposit ratio, stayed stable on a year-on-year basis but access to, and use of, market-based funding improved markedly, which we observed through the tightening of spreads and stable issuance volumes. We also saw the deposit base of banks continuing to increase with the share of customer deposits as a proportion of total liabilities now at their highest levels since 2014, highlighting banks preference to prioritise the stability of funding over profitability, given the negative carry associated with such deposits.

Profitability

Bank profitability has remained at low levels and continued to miss expectations. Nevertheless, there is some scope for optimism. Interest income in the year trended upwards on the back of increasing volumes and with the turnaround in economic data, we see no reason for this trend not to continue in 2020.

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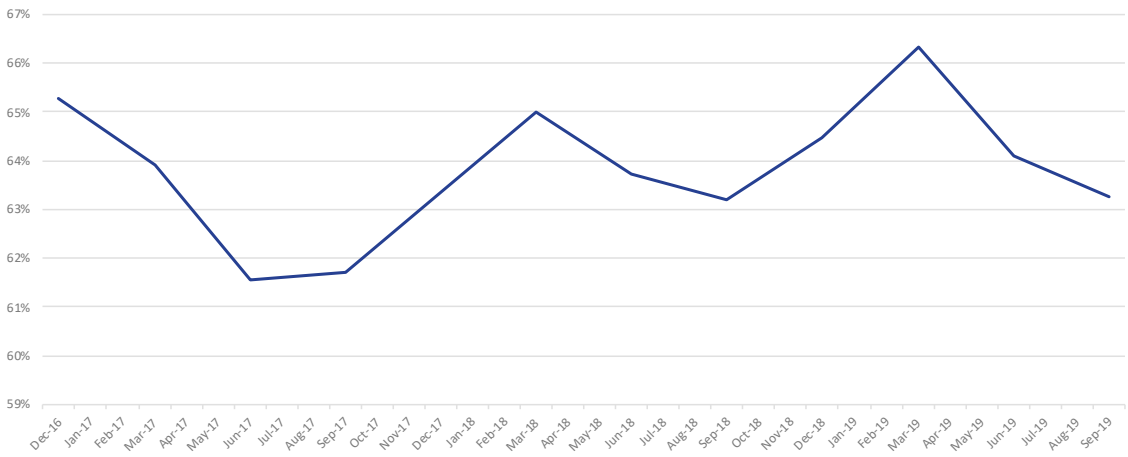
CHART 13: COST/INCOME RATIO OF EUROPEAN BANKS



Source: Bloomberg, September 2019

Conversely, fee & commission income revenues suffered from intense competition and the market volatility observed in late 2018. We expect to see a solid recovery in these revenues, driven by the improved market stability and the increasing propensity for banks to charge for deposits or convert these deposits into asset management products.

As we touched on above, we also see optimisation on the liability side of the balance sheet as a key lever to pull in 2020. Banks have been very conservative in the liquidity buffers that they have been running. As management, and the market, becomes more confident over balance-sheet strength, we would expect to see further optimisation to improve the cost of these liquidity buffers (e.g. buying short-dated government bonds rather than leaving cash at the central bank and charging negative deposit rates to a growing number of clients).

We also expect to see some margin improvements as the cost of wholesale funding has receded through central bank measures, including deposit tiering and the lower cost TLTROs introduced in 2019.

Despite these areas of optimism, we remain sanguine when we think about the ability of management teams to manage costs. Staff and administrative expenses have proved remarkably sticky (see chart 13) and we see no reason for this to change in the coming year without more comprehensive structural business model changes. The cost of credit has probably also reached the lows and will likely drift higher without the benefit of large-scale writebacks, which have benefited many banks over the recovery phase since the financial crisis.

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M&A

We have long been sceptics of M&A within the European banking sector, citing the costs along with the potential regulatory burdens associated with such transactions.

The European Deposit Insurance Scheme (EDIS) is viewed by many to be the key to opening wide-spread M&A across the European banking system but we remain sceptical of the progress being made. In our view, the market was prematurely upbeat about recent comments from Olaf Scholz, the German Federal Minister for Finance, without reading the unworkable details of his proposals, which at first glance appeared to show a renewed flexibility. Once again, despite the flurry of excitement, the importance of progressing this scheme appears to have fallen by the wayside for the time being.

While we remain sceptical of large cross-border transactions, we are warming to the idea that 2020 may see some domestic M&A occur. Structurally, this makes a lot of sense as many markets remain overbanked and, given the wholesale balance sheet improvements we have observed across Europe, it is a natural progression for management to strategically focus on profitability and really think about their ability to survive as a viable business within their domestic markets. It was interesting to hear from Yves Mersch that the ECB may revisit their assessment criteria of M&A and highlighting that "while an enlarged group will naturally bring supervisory scrutiny due the operational risk challenges posed by merging complex structures this shouldn't lead to double counting of requirements and that market forces should not be undermined by unnecessary obstacles."

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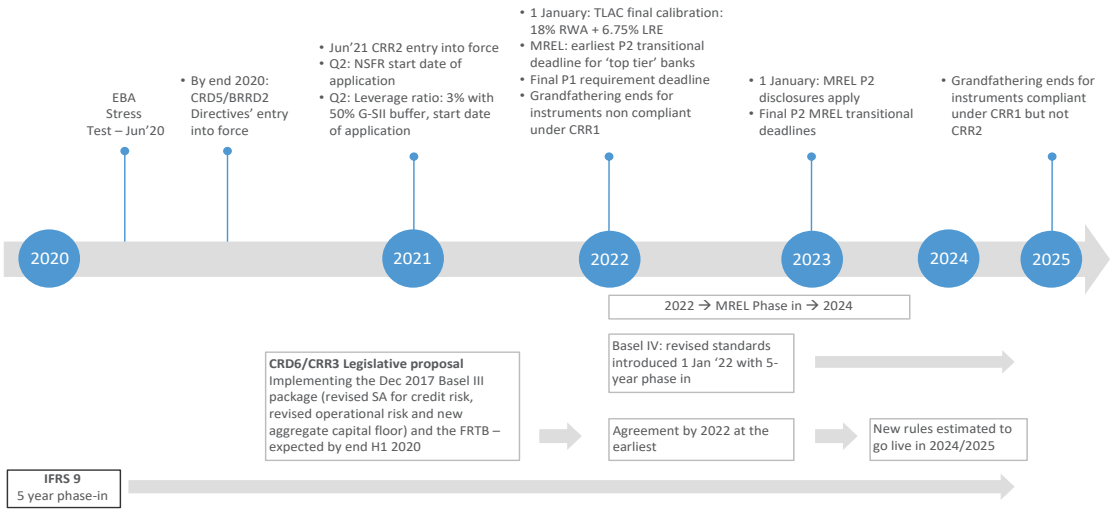
Bank equity

Where do these dynamics leave us on bank equity? While 2020 saw a rise in equity valuations, it was another year of underperformance versus the market more generally.

Although we are not equity specialists, we see reasons to be optimistic for some catch-up in 2020, but caution against the view that we will see a meaningful cyclical turnaround in bank share price performance. As we discussed above, there are reasons to be positive with bank profitability improving from the anaemically low levels driven by modest loan growth, lower funding costs and stable markets. In addition, as balance sheet strength has improved, we have seen growing confidence from bank management teams who, in several instances, have started share buy-backs, which will be supportive for what historically already look like attractive valuations This said, despite small incremental improvements we struggle to see a structural change in underlying profitability and note that while management teams have been willing to start buyback programmes, signalling some confidence in their capital position, there has been little sign of banks willing to increase dividend pay-out ratios, which we would see as a bolder step that management are confident about underlying earnings momentum.

Regulatory developments

CHART 14: REGULATORY FACTORS TIMELINE



Source: Credit Suisse, BlueBay Asset Management as at 31 December 2019

Regulation has been the single most important element driving bank fundamentals over the last decade, to the benefit of credit investors

Regulation has been the single most important element driving bank fundamentals over the last decade, to the benefit of credit investors. As shown in chart 14, we see no slow-down in the number of regulatory factors that will continue to drive idiosyncratic opportunities across banks and securities in 2020.

The finalisation of the 'risk reduction package' in 2019, which included Capital Requirement Regulation 2 (CRR 2), Capital Requirements Directive 5 (CRD5) and Bank Recovery & Resolution Directive 2 (BRRD 2), has had numerous effects. One of these has been the creation of a new slew of 'legacy' instruments that do not have all of the required features within their documentation to meet the enhanced legislation. Another has been the ability of these legacy regulatory capital instruments to count towards MREL (regulatory approved debt for bail-in purposes) or whether certain features, such as issuance from a special-purpose vehicle, make them an impediment to resolution. Clarity over how the authorities will treat 'legacy' instruments is due to be provided over the course of the year and this may create some interesting trading opportunities, given the potential for liability management exercises or the use of regulatory and make-whole calls. At the front of our minds as we look for opportunities are the first generation 'legacy' instruments created by the original capital requirement regulation, which are due to lose their regulatory grandfathering treatment in 2022, leaving the window for banks to actively manage these securities ever smaller.

2020 will see the next iteration of the EBA bi-annual stress test. We see little cause for concern given the capital levels and risk aversion we have seen in banks, but nonetheless it remains an important exercise that provides investors with significant data that is helpful in decision making. History tells us that it also remains an important deterrent for bank management teams' risk appetite.

We believe the most significant piece of regulation for the coco market and banks this year is Capital Requirement Regulation 3 (CRR3). While we just talked above about the impact of CRR2, which had been five years in the making and which was only brought into law in June 2019 as part of the risk-reduction package, legislators are already back at the drawing board. The reason for the quick legislative upgrade is because CRR3 is the legislation that will be used to implement Basel IV, due to be phased into European law from 2022.

A major part of the legislation will focus on the well documented standardisation of risk weights through the introduction of floors in internal models, fundamental review of trading books and operational risk charges. It is this part of the legislation that gives us a lot of confidence that, on the one hand while capital ratios have likely peaked, capital returns to shareholders will be limited as management teams remain unsure of the final impact of the legislation, and are unlikely to have the confidence to over optimise capital ratios that they run in the interim.

The latest EBA study has conservatively suggested that capital requirements for European banks will rise as a result of this legislation by 23.6% on aggregate. To add context to this number, while it is large enough to ensure banks tread with caution, this equates to EUR83 billion for the sector, to be phased in over a five-year period from 2022 to 2027. Last year European banks earned approximately EUR125 billion, so over five years, before considering mitigation, this is an impact that we see falling in the sweet spot for credit, in that it maintains pressure on banks to preserve capital levels, without being overbearing.

In this context, despite protests from bank management, it is not surprising to us that the regulator sees the benefits of Basel IV reform, designed to preserve risk sensitive regulation and reduce variability of risk weighted assets, as significantly exceeding the costs.

Although the main thrust of the next phase of European banking legislation will be directed towards Basel IV, it also brings with it the opportunity to introduce new developments and tweak existing standards, and it is through this that we see the potential for a more direct impact on the coco market.

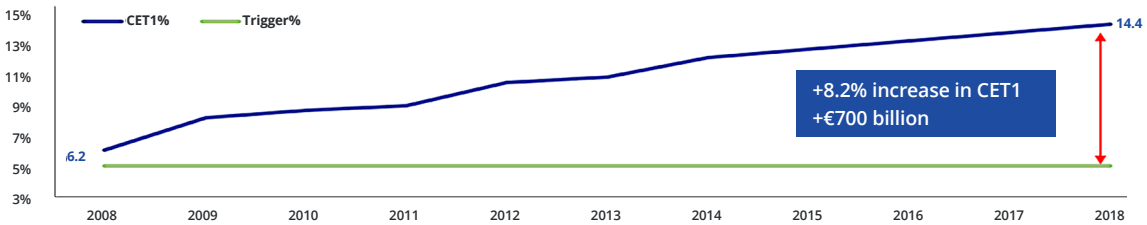
Historically, while a number of authorities have allowed banks to meet their Pillar 2 requirements using a small proportion of cocos, the ECB as regulator of European banks has been opposed to this approach and instead asked banks to meet this requirement fully with CET1.

However, within CRD5, an article has been included that essentially says banks will be allowed to meet a portion of Pillar 2 with cocos unless the regulator cites an exceptional circumstance. This has created an interesting dynamic as it puts the ECB as regulator in a position where they must accept the use of cocos to meet Pillar 2 requirements, which is something they have always disagreed with.

On the one hand the ECB may just increase Pillar 2 requirements so that the overall CET1 requirement remains the same. Alternatively, they could address the concerns that they have in allowing cocos to meet Pillar 2 requirements.

Legislation brings with it the opportunity to introduce new developments and tweak existing standards – through this we see the potential for a more direct impact on the coco market

CHART 15: CAPITAL HAS INCREASED MAKING BANKS SAFER, YET YIELDS REMAIN ELEVATED



Source: EBA, BlueBay Asset Management, December 2019

Cocos & the ECB: The potential for pivotal change

Like us, the ECB have long viewed cocos as an instrument that do not carry out the job they were designed for; the triggers are too low to ever be activated and switching off a coupon would have no benefit and create financial stability risks.

However, given the ECB has been forced to accept that cocos must play a role in meeting Pillar 2 requirements going forward, the trump card that remains in its hands would be to increase the trigger levels of the instruments to make them more effective, and CRR3 would be the vehicle with which they could make this change occur.

We believe this would have an enormously positive impact on the outstanding stock of cocos as not only would the vast majority of securities be phased out (most likely through grandfathering as we have seen in the past), but it would be a clear acknowledgement from the regulator that the instruments in their current form are ineffective from a regulatory perspective, leading to a market repricing.

By no means is this change a certainty, but it is certainly conceivable. It makes sense when considering where we were when the instruments were designed (an average 6% CET1 with the triggers set at 5.125% rather than the 14.4% of CET1 today (see chart 15)) and those jurisdictions that already allow AT1 to meet Pillar 2, such as the UK, already require higher triggers. Further, we have been involved in a number of working groups with regulators, eager to explore the topic, giving a clear indication that it is a consideration that is on the table.

This is a development that will be of the utmost importance to follow closely and highlights the benefits of us integrating regulatory and political analysis within our investment process.

Market technicals

Every year since the inception of the coco asset class, we have seen positive net supply, as issuers have built-up the coco layer within their capital stack to the optimal regulatory level. In just five years, we have seen the asset class grow from zero to over USD200 billion, which is significant given the European high yield market is approximately USD300 billion in size.

While in the past supply has been a headwind to price performance, in 2020 this should become a tailwind. Despite USD35 billion of gross supply in 2019 (the biggest year since 2015), it was the first year with sizeable redemptions (USD15.5 billion), which was a notable driver of returns for the asset class.

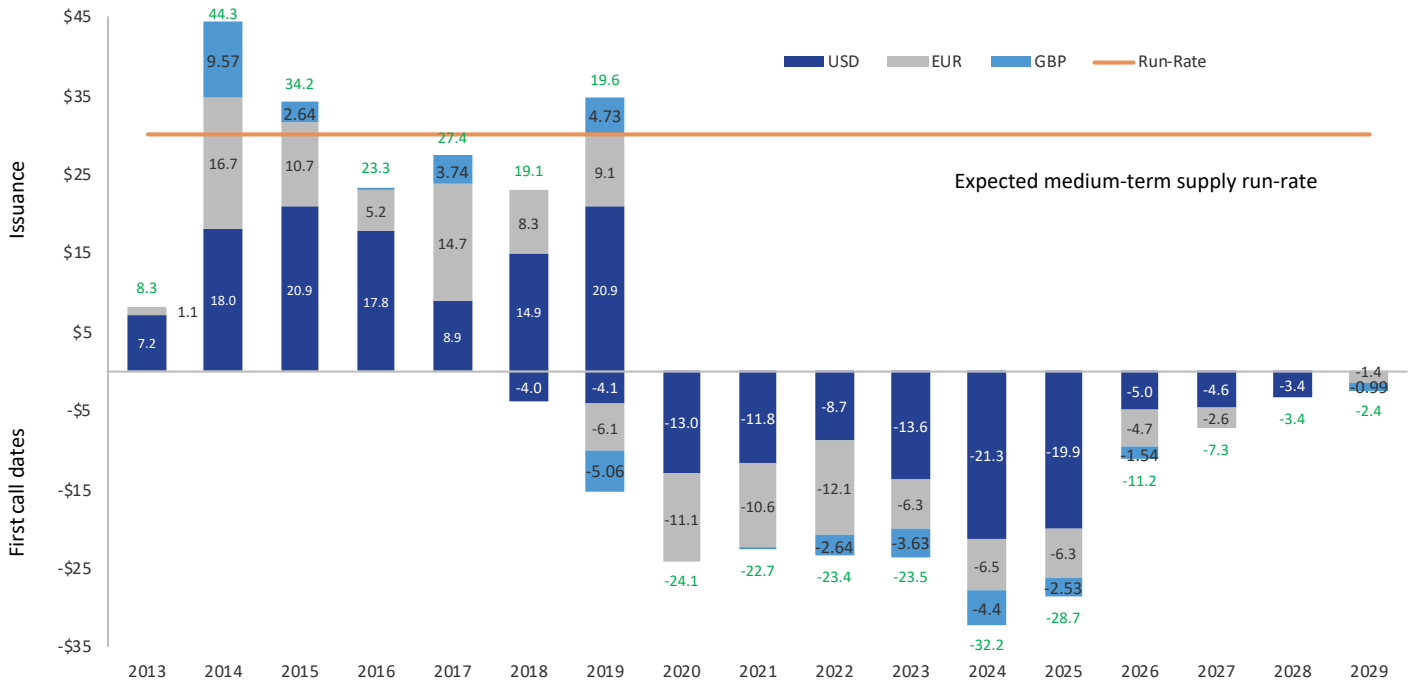
In 2020, this dynamic is likely to be even stronger as there are USD24 billion of bonds coming up for redemption and by our estimates 25% were already refinanced over the course of 2019. Further, the implied shortfall of issuance required to optimise the capital structure is growing ever smaller and more limited to second-tier banks. As such, while we expect gross supply of between USD30-35 billion in 2020, net supply in AT1 is likely to be at its lowest level since the inception of the asset class (see chart 16).

When CRD5 is fully integrated into national laws we expect that the regulator will allow banks to fill part of their requirements with AT1 – which would equate to an additional EUR30 billion of supply over time. However, given the questions that remain on timing, volumes and structure, we see very little appetite to attempt to front-run any changes, so we do not see this having an influence in 2020.

At the same time as we are seeing this dynamic on the supply side, demand for cocos continues to grow. Unsurprisingly, the asset class has become more mainstream and surveys indicate that traditional asset managers are continuing to become ever-larger holders of the securities – a trend we do not envisage slowing down anytime soon. As we outlined when considering valuations, there are very few asset classes that offer the yield, rating and risk profile as that provided by cocos. Until this mispricing is arbitraged out of the market, we see demand only continuing to grow, which in our view puts the asset class in a good position to outperform its beta in both up and down markets.

While in the past supply has been a headwind to price performance, in 2020 this should become a tailwind

CHART 16: SUPPLY HEADWIND EXPECTED TO DISSIPATE WHILE DEMAND REMAINS ELEVATED



Source: Goldman Sachs, 31 December 2019

Risk

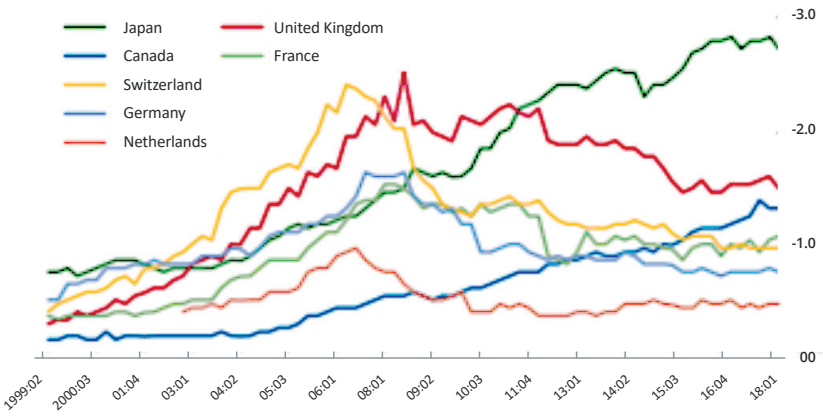
The macro environment appears to us to be the perfect temperature for credit – not too hot and not too cold – but it will be an increasingly difficult equilibrium to maintain. As we saw in 2018, while rising rates are good for banks, they tend not to rise in a stable manner and this volatility tends to be painful for credit spreads. As already noted, we see it as difficult for central bankers to change their policy at the current point in time so if the economy runs hotter than everyone expects, we see a real danger that they could fall behind the curve. This in turn could set us up for a more volatile time in H2 should government bond yields move sympathetically higher to the extent that it has an impact on risk assets, including fixed income and equities.

At the other end of the spectrum, while we have been in praise of regulators for strengthening bank balance sheets, there are a number of changes that have been made that remain untested in a downturn and will have a procyclical impact from an accounting perspective.

In particular, IFRS 9, which forces banks to provision for life-time losses based on forward-looking economic forecasts, could have a surprising impact. If we were to enter an unexpected downturn, there is every possibility that we see provisioning levels significantly higher than both the market and regulators expect, even though these changes have been stress-tested, they have been untested in application through the cycle. While economically these changes should not make a difference over time, this doesn't necessarily equate to less volatility in the short term and is something over which we remain cautious.

We are often asked about the growing reliance of non-US banks on USD funding. In the ever-increasing hunt for yield, not necessarily just from banks but also from their clients, US dollar assets among non-US banks have grown steadily with the gap between assets and liabilities at 13%, which is the widest level that we have seen. While there have been many theories put forward for the sudden spike in USD repo markets last September, we suspect that the growing need for dollars from non-domestic banks was at least one factor that played a role. On a positive note, the need for USD from European banks has been falling since the financial crisis and this funding gap has mainly been driven by Japanese and Canadian banks (see chart 17). This said, while EBA studies have shown that while the gap has fallen, there is still a robust need to access USD liquidity and all banks outside of the US remain vulnerable to this market staying open to them.

CHART 17: NON-US BANKS' USD-DENOMINATED CLAIMS (TRILLIONS OF USD, EXCLUDING INTRAGROUP CLAIMS)



Source: IMF Global Financial Stability Report, October 2019

While the magnitude of the spike in repo that we saw in September was worrying, we were reassured at the willingness of the Fed to quickly step into the vacuum and return repo to more normalised levels. It is our belief that the situation was created by several idiosyncratic factors coming together, rather than any more worrisome single driver.

Therefore, while this does not cause any immediate cause of concern – and we would suggest that it does not represent an acute vulnerability, despite the greater reliance on USD funding – this growing mismatch remains something over which we retain a watchful eye.

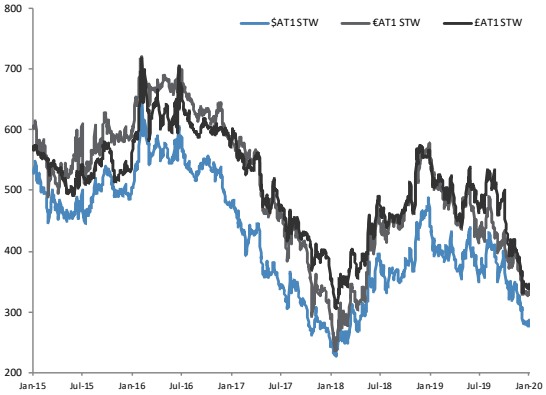
The macro environment: It will be an increasingly difficult equilibrium to maintain

Arbitrage

As well as arbitrage opportunities across the bank capital structure, we see ongoing mispricing of risks and opportunities across currencies. We continue to see significant spread pick-up by investing in EUR or GBP assets which we fully hedge back into the base currency of our strategy (USD) to capture the additional spread, often in the same issuer (see chart 18).

In the past we also benefitted from the attractive cross-currency basis carrying out this arbitrage and while this has reduced in recent months, we anticipate that this will remain an ongoing benefit given the structural dollar shortfall that we note above (see charts 19 & 20).

CHART 18: USD AT1 VS EUR AT1 & GBP AT1 (SPREADS)



Source: JPMorgan, 8 January 2020

As well as arbitrage opportunities across the bank capital structure, we also see ongoing mispricing of risks and opportunities across currencies

CHART 19: GBP/USD BASIS (3M)

Source: Bloomberg, 13 January 2020

CHART 20: EUR/USD BASIS (3M)

Source: Bloomberg, 13 January 2020

ESG

Political uncertainty, social unrest and environmental risks are key themes that are increasingly shaping how companies, regulators and investors behave. We believe the demands from asset owners and regulators to address these issues will undoubtedly lead to greater dispersion and idiosyncratic risks, and will be a major theme for 2020 and in the years to come.

The incorporation of ESG – environmental, social and governance factors – explicitly into the investment process is the rational response to these rising risks, and something that, if investors undertake through a structured and well-developed process, should create opportunities for superior alpha generation.

On the ESG regulatory front we have already observed some key steps being taken. The European Banking Authority has been tasked with a number of measures including:

- An assessment as to whether to include ESG risks as part of its supervisory review and evaluation process, which has the potential to create a direct link between a bank's capital requirements and its inherent ESG risks.
- An assessment as to whether or not a dedicated prudential treatment of exposures related to assets associated with environmental or social objectives would be justified.
- Disclosures of sustainability-related risks, including physical and transition risks.
- The development of a climate change stress test.

The Bank of England is following a similar path, with the publication of a recent paper stating its intensions to analyse the financial risks from climate change for UK banks.

On the funding side, assets continue to flow into dedicated funds creating diversified funding markets for green bonds, sustainability bonds and dedicated asset backed finance facilities. On the asset side, banks are increasingly being forced to consider their lending practices and the risks of these practices in the face of

changing investor demands and corporate responsibilities.

This is not only a theme that will continue to grow but one that will influence how banks and their investments perform, in our view.

We have long believed that ESG factors have the potential to have a material impact on asset performance. Poorly-managed ESG risks can lead to inefficiencies, operational disruption, litigation and reputational damage, all of which we have seen in abundance, and which may ultimately impact an issuer's ability to meet their financial responsibilities. Supplementing traditional financial analysis by reviewing ESG-related management practices and performance is therefore not only prudent but also in line with our aim to optimise returns.

Our approach applies an ESG integration strategy that involves the identification and assessment of investment material ESG factors. As such, ESG factors are an input into our investment process, but they are not necessarily the key determinant in the final investment decision-making process, which ultimately reflects the view of an investment's risk-return profile.

A full breakdown of our integrated ESG process can be found on our website.

The Bank of England is following a similar path, with the publication of a recent paper stating its intensions to analyse the financial risks from climate change for UK banks

How will we invest in 2020?

We remain convinced that our investment process of taking concentrated conviction views driven by in-depth bottom-up research with an overlay of macro, political and regulatory analysis, is the right one and will continue, in our view, to put us in a position to generate alpha and to optimise risk-adjusted returns.

Our base case that we see low-but-positive growth, supported by accommodative monetary policy, warrants us to maintain our bias towards European bank cocos.

In our view, cocos remain a structurally mispriced asset. Expect us to show a preference for EUR and GBP securities over USD to take advantage of this arbitrage opportunity while it exists.

We continue to believe the market has mispriced call optionality, extension risk and bond-specific structural features such as resets. As such, our bias to securities with longer duration, fewer call options and structurally superior features will remain.

In a year where the demand/supply dynamics look to be especially supportive, expect us to be fully invested the vast majority of the time and to manage through any periods of market dislocation by using the full tool box available at our disposal to protect returns, rather than retaining high cash balances. While this may at times feel uncomfortable, we are convinced that this approach will prove beneficial over the medium term.

In our view, legacy securities have never proven a fertile hunting ground but the closing window for these to provide banks with regulatory benefit is increasing the likelihood of management action that may prove rewarding for investors. It is highly unlikely that this will ever form a core part of our investment portfolio, but we will continue to scour the universe and be opportunistic should attractive investments present themselves.

Conversely, national champion banks with robust credit profiles will continue to form a core part of our investment strategy.

This said, the more stable economic environment merits giving some consideration to banks that are exhibiting notable improvements in their fundamental credit profile that are still to be recognised by the market. The growing potential for domestic M&A and a consideration of the banks involved and potential re-rating on a transaction is also likely to deserve some attention.

Valuations warrant an ongoing bias to the periphery but as beta is extracted from the market expect to see our strategy increasingly rotating into lower-beta jurisdictions.

Similarly, expect positioning in the UK to be adjusted tactically over the course of the year as Brexit newsflow progresses. Positioning will always be undertaken with a focus on alpha generation and optimisation of risk-adjusted returns.

Our base case that we see low-but-positive growth, supported by accommodative monetary policy, warrants us to maintain our bias towards European bank cocos