BlueBay
Asset Management

Coco bonds

How we're investing for 2021

Marc Stacey, Senior Portfolio Manager
James Macdonald, Senior Portfolio Manager
Peter Goldsworthy, Institutional Portfolio Manager

Q1 2021

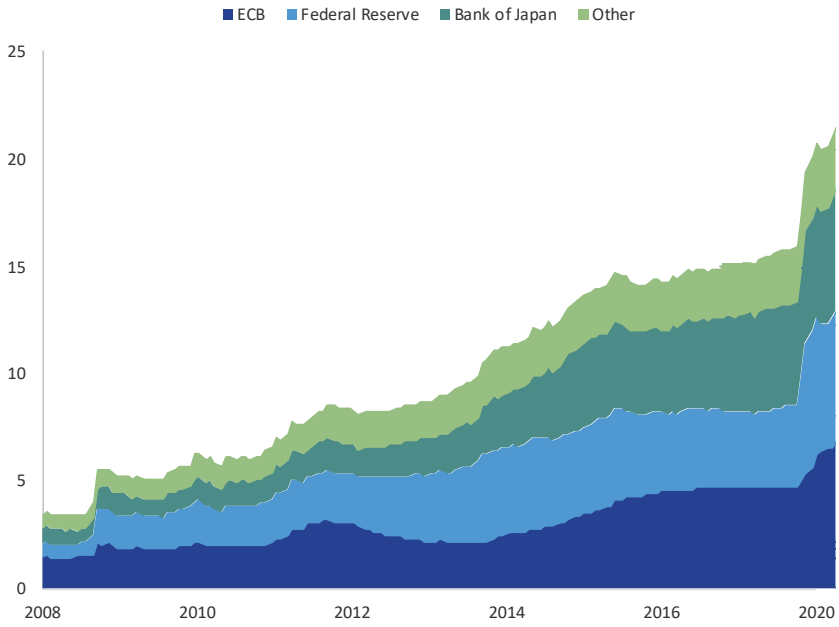
Macroeconomic environment

It's quite remarkable that during 2020, we saw the largest quarterly GDP fall in modern history as well as the S&P 500 index rebound to hit a new record high. This is arguably the inevitable consequence of the enormous policy response that was delivered in answer to the pandemic. Globally, we have seen monetary policy easing of USD7.5 trillion and fiscal support of USD12 trillion. To put this into context, aggregate assets at G10 central banks increased by double the amount seen during the two years of the global financial crisis in just six months during 2020.

We view the response as both necessary and effective, but where does it leave us when considering its implications for 2021?

Economic confidence remains low but policymakers have thrown everything and the kitchen sink at the issue. We are now in the third wave of the pandemic and it remains to be seen if there will be any more. We remain hopeful that, with vaccine roll-outs, further viral waves will increasingly be depleted in strength and the necessary responses be less prohibitive to normal life. As such, we remain constructive for the year ahead but acknowledge it will not be plain sailing.

G10 CENTRAL BANK ASSETS (TRILLIONS, USD)



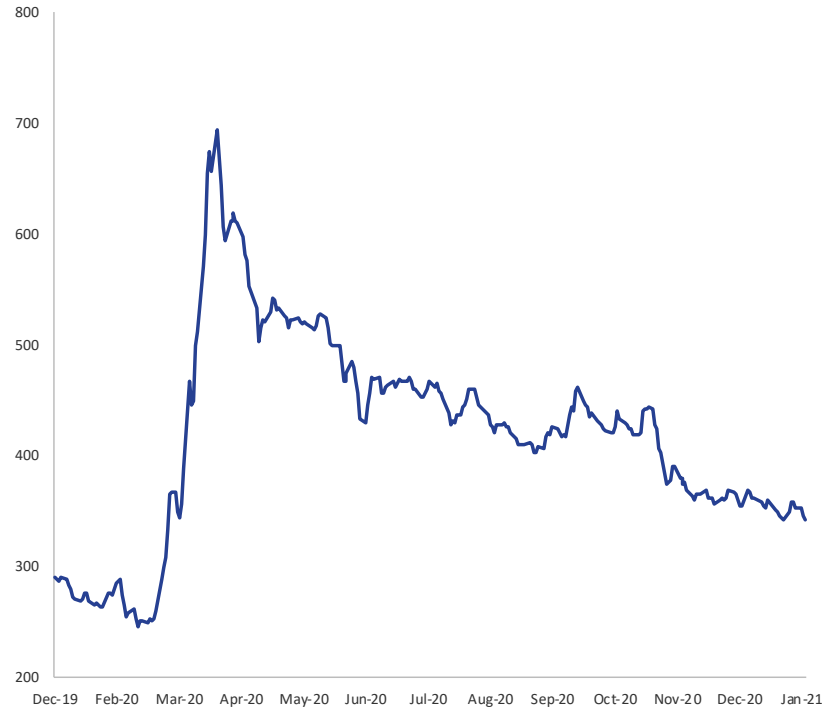
Sources: Bloomberg Finance L.P., respective central bank and ECB calculations.

Notes: Left panel: the "Other" category refers to the balance sheets of the Bank of England, Swiss National Bank, Bank of Canada, Reserve Banks of Australia, Reserve Bank of New Zealand, Sveriges Riksbank and Norges Bank. Righ panel: euro-denominated sovereign debt and supranational debt in the euro area. Credit ratings are Moody's long-term local currency credit rating categories. Outstanding EU debt refers to the end of September 2020. EIB: European Investment Bank, ESM: European Stability Mechanism; SURE: European instrument for temporary Support to mitigate Unemployment Risks in an Emergency.

Valuations

While additional tier-1 bank capital (AT1) enjoyed a robust rebound from the Q1 2020 lows, the Bank of America Merrill Lynch Coco Index still finished 2020 +57bps wider than where it started the year and almost +100bps from the February 2020 levels before the pandemic-induced widening began.

BANK OF AMERICA MERRILL LYNCH COCO INDEX



Source, BAML, Bloomberg as at 20 January 2021

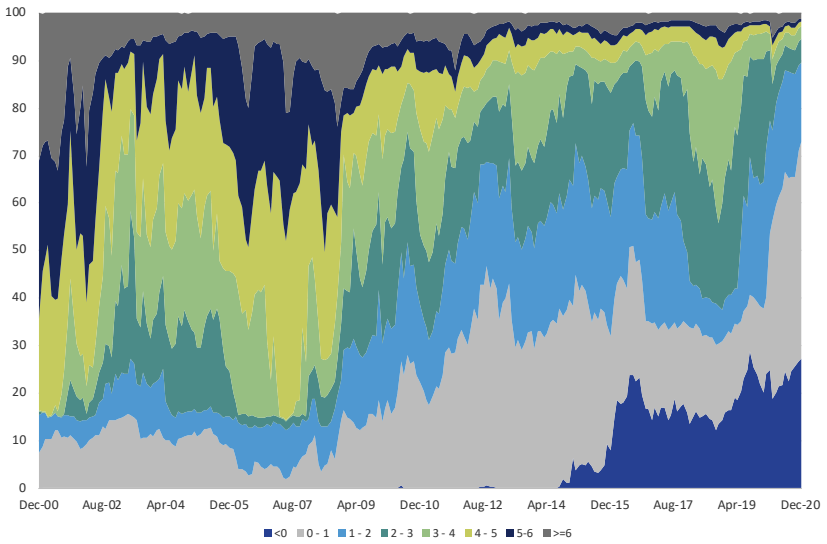
As such, not only does AT1 still retain a pre-pandemic premium, it remains the only financial institutions group (FIG) asset class which offers a positive real rate of return (net of inflation).

Financial institutions have spent the best part of the last decade shoring up balance sheets and deleveraging, whereas many corporates have used the macro environment of low interest rates and abundant liquidity to make acquisitions and increase leverage. Despite this upward trend in corporate leverage, euro-denominated AT1 bonds trade 126bps back of BB-rated non-financials. In USD-denominated bonds, the AT1 pick-up is 57bps.

We believe AT1 remains the sweet spot within the bank capital structure, as the coupon risk remains fundamentally mispriced. Considering the scale of this global pandemic, the 258bps differential versus lower tier II bonds (LT2) looks glaringly mispriced and we believe this should compress significantly, rewarding AT1 bondholders.

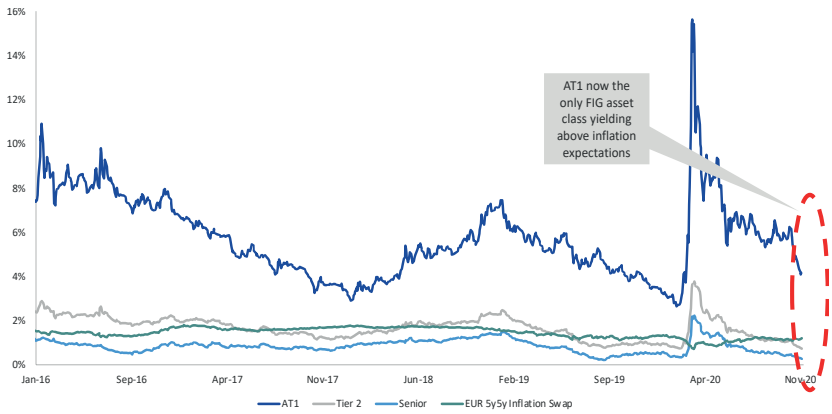
We expect technicals to remain supportive as AT1 supply expectations are modest and the bulk of the 2021 issuance is likely to be related to refinancing.

% OF THE GLOBAL FIXED INCOME MARKET THAT TRADES IN DIFFERENT YIELD BUCKETS



Source: ICE Data Indices, LLC, 31 December 2020

YIELD DYNAMICS SINCE 2016: AT1 THE ONLY ASSET CLASS OFFERING A POSITIVE REAL RETURN



Source: Goldman Sachs, 27 November 2020

Fundamentals

Unlike 2008, banks are a key part of the solution to this crisis rather than the cause of the problem.

Banks entered this recession with a robust capital base, which improved over the course of 2020. There is clear policy support for bank balance sheets, with the crystallisation of loan losses related to the pandemic likely to be prolonged given the various government-guarantee schemes and capital relief provided by regulators. As and when these programmes roll-off, we believe the credit cycle will play out, but in a context of improving economic growth and over a longer time horizon than previous cycles.

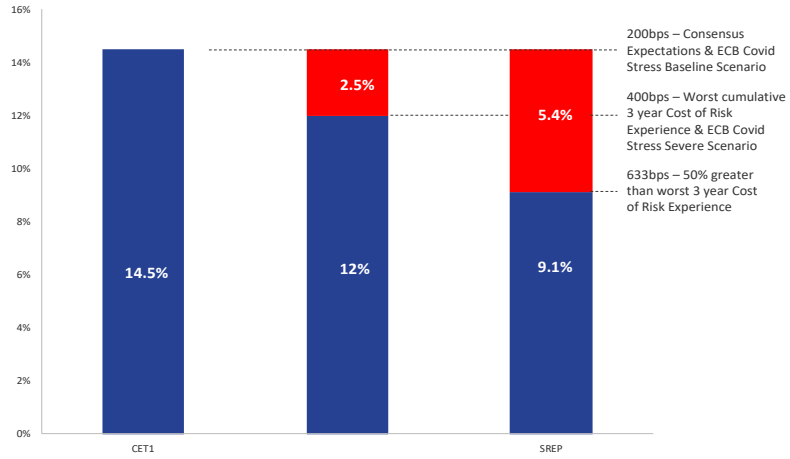
Stress testing

Applying the results of the ECB Covid stress test to this robust capital position further improves our confidence levels.

Under the ECB baseline scenario – 200bps of credit losses – there would be no capital deterioration given the pre-provision earnings power of banks. If we apply the severe scenario – 400bps of credit losses – which is equivalent to the worst cost of risk on record, we would see a 2.5% deterioration in bank capital ratios. This leaves capital levels at a still very healthy 12% of common equity tier 1 (CET1).

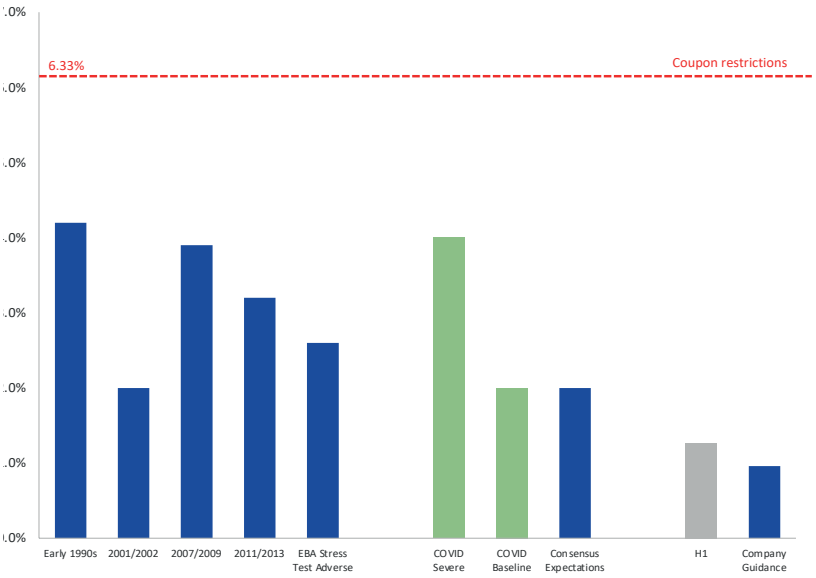
In fact, to reach the point where banks could breach the maximum distributable amount where coupons could come into question, we would need to see 633bps of credit losses – equivalent to a cost of risk 50% higher than the worst-ever recorded cost of risk experience over three years.

STRESSING THE CAPITAL BUFFERS



Source: ECB, BlueBay Asset Management, as at 20 September 2020

PUTTING THE STRESS IN CONTEXT



Source: Autonomous, ECB, BlueBay Asset Management, as at 20 September 2020

Regulation and policy

Over the period since the financial crisis, we have observed a transformation of the European banking sector. Capital levels have tripled, risk-taking has been supressed and balance-sheet strength at the expense of profitability has been the priority, encouraged through regulation.

As we came into the coronavirus crisis, this created a dichotomy that we believe will need to be addressed. Bank management and regulators have become so risk averse and focussed on balance-sheet strength that the importance of this over and above the functionality of providing credit to the economy has perhaps become unbalanced.

It's important to remember that this crisis has been the first test that the banking sector and the new regulatory regime has endured since the financial crisis. Broadly, we believe regulators should be pleased with the results. Banks came into the crisis with balance sheets in the best state they have been in for decades and have proven to be much more resilient than many believed they would be.

From an asset deterioration and non-performing loan formation stance, we remain at the start rather than the end of the crisis but we are firm believers that bank fundamentals are robust and that it would always take a test such as this to prove this was the case.

It's important to remember that this crisis has been the first test that the banking sector and the new regulatory regime has endured since the financial crisis.

ESG

As ESG considerations from asset owners and policymakers grow, their importance on bank regulation should increase in tandem.

While the growing importance of sustainability in public policy creates financial risks for many enterprises, we believe this is dwarfed by the opportunity set. We see banks as the primary policymaker instrument for influencing the transition to a more sustainable world.

Historically, banks have been viewed as having questionable ESG credentials, but we see this as a backward-looking stance. A number of factors suggest to us that the sector will not only lead in terms of disclosures and ESG credentials, but banks will increasingly be viewed as transition

champions that can have influence over financial flows. As such, we see the sector as well placed for active ESG investors and to be beneficiaries of the flows into sustainability strategies and financing.

Risks

Given the market's current dependence on central-bank intervention and fiscal support, this creates a degree of risk around policy mistakes. The steps that policymakers took at the start of 2020 give us a relatively good degree of confidence that they 'get' the situation, but we firmly believe there is a need to allow economies to fully enter a recovery phase before support measures are removed – there is always a danger that this happens too soon.

Ironically, we see this as more likely to happen if the vaccine roll-out and pandemic situation improves quicker than expected, as fiscal hawks are likely to quickly move on from the crisis to thinking about balanced budgets and debt levels again.

While we would put a low probability on it, there is a danger that inflationary pressures rise faster than is currently expected, forcing central bankers to adjust their view and raise interest rates sooner than the market expects. This would create significant rate volatility, which is always damaging for credit spreads. It could lead to a tightening of financial conditions, which central banks are trying to avoid, and one hopes that the taper tantrums of the past will serve as a valuable lesson not to be repeated.

How we will invest in 2021

2020 underlined that the market has priced in too much risk of coupon deferral for AT1 securities versus the rest of the bank capital stack. Over 2021, we expect compression in the asset class to reflect this view. Regulatory changes should also provide a windfall for the asset class over and above the robust carry prospects.

The macroeconomic and policy environment remains extremely conducive to tighter credit spreads and we continue to benefit from investor flows into the asset class. We expect quantitative easing to anchor spreads, pushing investors further down the credit spectrum. In this environment, we believe AT1 debt looks attractive both from a yield perspective and with regards to its fundamental outlook.

As long as this environment continues, expect us to take advantage of the AT1 compression and be fully invested from a cash perspective to capture the attractive beta of the asset class.

Dispersion in the asset class remains a consistent theme. While there has been significant compression over the last year, this trend looks set to resume in 2021. With this in mind, we will look to maintain an overweight to the European periphery and the UK to capture this compression.

Germany looks to us to be a relative economic outperformer coming out of the crisis, and coupled with increased potential for consolidation, leads us to also look favourably on the ability of the German national champion banks to surprise to the upside.

Dollar securities notably outperformed both euro and sterling bonds in 2020. We anticipate that inflationary pressure is most likely to come from the US, pushing dollar yields higher and pressuring the dollar AT1 market. As such, expect our bias to favour the higher spreads available in euros and sterling.

M&A activity is likely to be a recurring theme in 2021, which we expect to create opportunities. We intend to position to take advantage of this dynamic where it can be invested with asymmetric outcomes.

Following years of underperformance, the environment for bank equities to rebase against the market looks attractive, in our view.

Nevertheless, there remain a number a number of risks on the horizon and being attune to the policy environment and the long-term economic impact of the pandemic will be vital. Where we see risks growing and asymmetric ways to protect capital, such as CDS protection and interest rate futures, we will continue to make full use of our investment toolbox.

We expect quantitative easing to anchor spreads, pushing investors further down the credit spectrum.

Marc Stacey
Partner,
Senior Portfolio Manager

Marc is a Senior Portfolio Manager within the Investment Grade team focusing on non-sovereign debt and specialising in financials. Marc started at BlueBay in June 2004 as an operations analyst before joining the Investment Grade Debt Team in March 2006 as a trader. He moved to his current role in January 2011. As a lead portfolio manager, Marc has been instrumental in driving the success of the European IG credit strategies as well as the peer group-leading performance of the Financial Capital Bond Fund. He holds a Bachelor of Business Science (Hons) in Economics and Finance from the University of Cape Town, South Africa.

Peter Goldsworthy
Institutional Portfolio Manager

Peter is an Institutional Portfolio Manager within the Investment Grade team at BlueBay. Peter joined the firm in November 2011 as a fund accountant within the Finance department transferring to his current role in October 2013. Prior to this role, Peter worked for two years at Royal Bank of Scotland in London as a cash equities financial controller. Peter qualified as a chartered accountant with Deloitte in South Africa where he worked for four years during which time he was seconded to the Deloitte office in Chicago, Illinois. Peter holds a Bachelor of Commerce degree and honours in Accountancy from the University of Cape Town and is a member of the South African Institute of Chartered Accountants (SAICA). Peter is a member of the National Futures Association (NFA) in the US.

James Macdonald
Partner,
Senior Portfolio Manager

James joined BlueBay in September 2007 as a financials analyst within the Investment Grade team. His experience and knowledge of the European banking sector has been widely utilised within the firm by both the Investment Grade and High Yield teams at BlueBay. His views on European financials have been instrumental in generating the peer group-leading performance of the BlueBay Financial Capital Bond fund since its inception in January 2015. He holds an MA (Hons) in Business & Finance from the University of Edinburgh. He is a Chartered Accountant and a CFA charter holder.

RBC Global Asset Management

BlueBay Asset Management