



# Robust banks' undervalued bond opportunity



## Authors

**Marc Stacey**  
Senior Portfolio Manager



**James Macdonald**  
Senior Portfolio Manager

## Published

November 2021

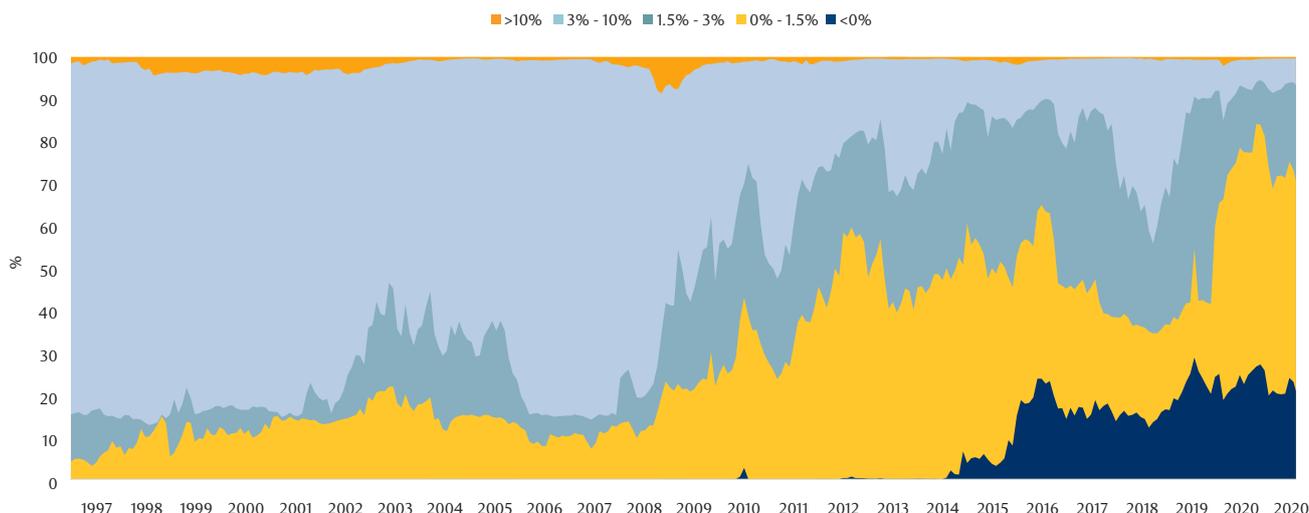
**Coco bonds are one of the few credit products that still offer spreads in excess of pre-pandemic levels and are set to benefit from any inflationary pressures that may emerge as the global economy recovers. Can they maintain these rare performance credentials as we move into 2022?**

Covid-19 has left economies and industries around the world bruised. While central banks have provided unprecedented levels of support for fixed income investors, seeking out returns has become increasingly problematic with negative yielding debt accounting for some USD17 trillion of the global universe. But positive performance is by no means a mythical investment unicorn – there are still pockets of potential opportunity on offer in fixed income.

One sub-sector enjoying a positive outlook despite the economic turmoil created by the pandemic is contingent convertible bonds, aka 'coco bonds'. These bank-specific securities offer a rare yield opportunity, with the cocos of top-quality national champion banks boasting yields in excess of 4%.

Banks have played a key role across the pandemic, acting as conduits for government policy to reach the real economy – notably through lending to corporates when other funding sources dried up and offering loan repayment holidays to retail customers. Unlike during the financial crisis in 2008 when banks were the villains, this time around they're acting as a force for good and have been key to the recovery story.

## Chart 1: Global bond market by yield bucket



Source: ICE BofAML Global Fixed Income Markets Index (GFIM); latest monthly data for September 2021

### Sitting in the sweet spot

Bolstered by the positive role of banks, cocos have outperformed most other fixed income sub-asset classes to-date in 2021, a year characterised by relatively low volatility and only a small generic tightening in credit spreads since January. The trend of economic recovery has most keenly benefited high-beta securities, including cocos.

We think cocos currently sit in a unique sweet spot in terms of investment risk versus potential reward. Asset prices in general have benefitted from the central bank support mechanisms implemented as a result of the pandemic and the banking sector in particular has enjoyed that fundamental support afforded to it by policymakers and central banks.

### 2022 potential

With thoughts of a new year rapidly approaching, the natural question is whether cocos will continue to enjoy this unique position and maintain positive performance.

From a fundamentals perspective, we see the outlook as positive, with continued central bank support and a banking sector characterised by robust regulations, record levels of capital and well-governed management teams, on top of the macroeconomic tailwinds that are very supportive for the sector.

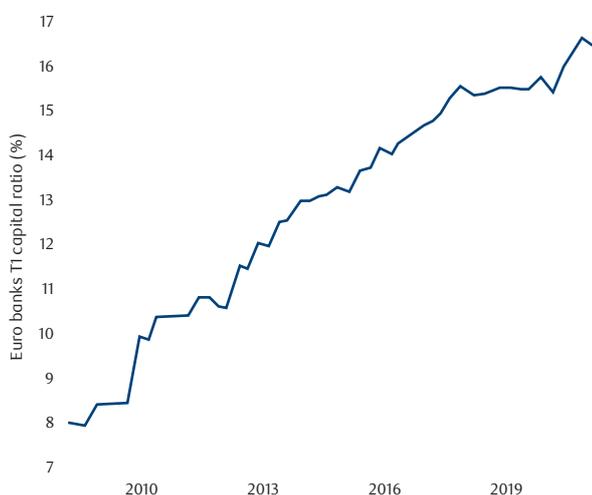
From a technical perspective, the diverse and growing buyer base continues to enhance the liquidity profile of the asset class, even during periods of stress. We noted that additional tier 1 (AT1) securities remained highly liquid even through the most volatile periods at the height of the pandemic, benefiting from a wide range of investor types in multiple locations and jurisdictions.

Lastly, valuations remain attractive and we expect a continued compression of coco/AT1 spreads towards those of European high yield and tier 2 securities.

### Interest rate implications

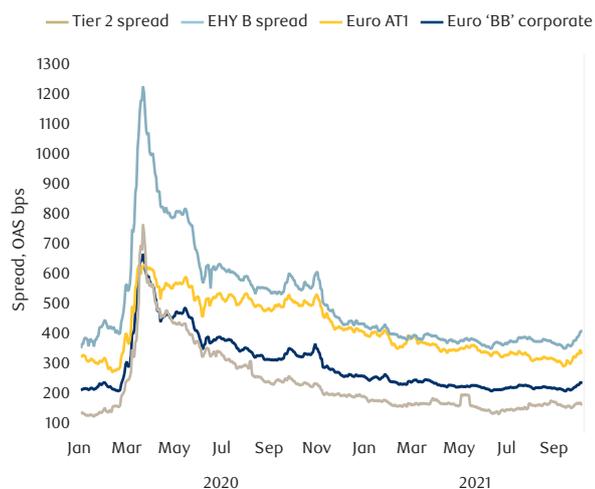
The threat of interest rate hikes is a hot topic for investors across the board. A rate-hiking environment is expected to generate a degree of volatility for fixed income markets, leading to the potential for capital loss in traditional benchmarked portfolios as assets reprice. In cocos, however, this is less of a concern due to the lower interest rate sensitivity of AT1 instruments and the higher carry (yield/coupon) component of the underlying bank bonds. Provided rate hikes are well communicated to the market, we don't envisage higher interest rates as detracting from AT1 performance in the medium term.

## Chart 2: Euro area banks Tier 1 capital ratio



Source: ECB; latest data for Q4 2020

### Chart 3: Euro bank debt & Euro 'BB' & 'B' corporate spreads



Source: Bloomberg indices European Banks CoCo Tier 1 & Tier 2 spread; Bloomberg indices Pan Euro High Yield spread (OAS); latest data at 26 October, 2021

Further, in contrast to other corporates, banks are uniquely placed to benefit from interest rate increases and we are confident that the financial sector will outperform as banks become more profitable through any rate hiking cycle.

#### Performance drivers

Aside from rates, there are four main factors that could influence coco performance as we move into 2022.

**Fundamentals:** Banks have built up resilient capital bases, which remained stable through the pandemic. There remains ongoing balance-sheet support, with loan losses likely to be more muted than a normal cycle given the various furlough, moratorium and government guarantee schemes, coupled with capital relief from regulators. When these programmes eventually roll off, we expect the credit cycle to play out, but this will be in a context of improving

economic growth and over a longer time horizon than previous cycles, which means banks capital levels should prove very resilient.

**Valuations:** European bank AT1 trades meaningfully back of European high yield BB-rated bonds (some +70 basis points), which seems counter intuitive given the fundamental pressure likely to impact parts the levered corporate sector. AT1s also enjoy around 185 basis points of pick-up versus bank LT2 spreads, which represents a significant premium given the respective risks. There remains scope for notable spread compression, especially since AT1 represents one of the few asset classes yielding more than inflation expectations.

**AT1 coupon risk:** We see this as low, given the very robust capital levels banks have built up and the strength of their balance sheets.

**Supply:** AT1 supply expectations are modest and the bulk of the issuance in 2022 will be refinancing related, while at the same time the buyer base continues to grow.

#### A rare return pocket

As economic activity begins to normalise, we anticipate that the investment landscape will expose clear success and failure stories, especially as central bank accommodation starts to unwind. We expect to see this trend manifest on a corporate, sector and country basis. Geography could become particularly relevant as we see differing country approaches to handling the prolific Delta variant of Covid-19, which is preventing societal restrictions being lifted.

We continue to believe that banks in the US and Europe are likely to be the clear success stories in terms of a sector that will likely benefit from both the economic recovery and subsequently higher yields which follow improving data. Cocos represent a rare pocket of credit that still offers pre-pandemic levels of return and is set to benefit from any inflationary pressures that may emerge as the global economy recovers.



This document may be produced and issued by the following entities: in the European Economic Area (EEA), by BlueBay Funds Management Company S.A. (the ManCo), which is regulated by the Commission de Surveillance du Secteur Financier (CSSF). In Germany and Italy, the ManCo is operating under a branch passport pursuant to the Undertakings for Collective Investment in Transferable Securities Directive (2009/65/EC) and the Alternative Investment Fund Managers Directive (2011/61/EU). In the United Kingdom (UK) by BlueBay Asset Management LLP (BBAM LLP), which is authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and is a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC). In Switzerland, by BlueBay Asset Management AG where the Representative and Paying Agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. The place of performance is at the registered office of the Representative. The courts of the registered office of the Swiss representative shall have jurisdiction pertaining to claims in connection with the distribution of shares in Switzerland. The Prospectus, the Key Investor Information Documents (KIIDs), where applicable, the Articles of Incorporation and any other documents required, such as the Annual or Semi-Annual Reports, may be obtained free of charge from the Representative in Switzerland. In Japan, by BlueBay Asset Management International Limited which is registered with the Kanto Local Finance Bureau of Ministry of Finance, Japan. In Australia, BlueBay is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of financial services as it is regulated by the FCA under the laws of the UK which differ from Australian laws. In Canada, BBAM LLP is not registered under securities laws and is relying on the international dealer exemption under applicable provincial securities legislation, which permits BBAM LLP to carry out certain specified dealer activities for those Canadian residents that qualify as “a Canadian permitted client”, as such term is defined under applicable securities legislation. The BlueBay group entities noted above are collectively referred to as “BlueBay” within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of BlueBay by the respective licensing or registering authorities. To the best of BlueBay’s knowledge and belief this document is true and accurate at the date hereof. BlueBay makes no express or implied warranties or representations with respect to the information contained in this document and hereby expressly disclaim all warranties of accuracy, completeness or fitness for a particular purpose. Opinions and estimates constitute our judgment and are subject to change without notice. The document is intended only for “professional clients” and “eligible counterparties” (as defined by the Markets in Financial Instruments Directive (“MiFID”) ) or in the US by “accredited investors” (as defined in the Securities Act of 1933) or “qualified purchasers” (as defined in the Investment Company Act of 1940) as applicable and should not be relied upon by any other category of customer. No part of this document may be reproduced, redistributed or passed on, directly or indirectly, to any other person or published, in whole or in part, for any purpose in any manner without the prior written permission of BlueBay. Copyright 2021 © BlueBay, is a wholly-owned subsidiary of RBC and BBAM LLP may be considered to be related and/or connected to RBC and its other affiliates. © Registered trademark of RBC. RBC GAM is a trademark of RBC. BlueBay Funds Management Company S.A., registered office 4, Boulevard Royal L-2449 Luxembourg, company registered in Luxembourg number B88445. BlueBay Asset Management LLP, registered office 77 Grosvenor Street, London W1K 3JR, partnership registered in England and Wales number OC370085. The term partner refers to a member of the LLP or a BlueBay employee with equivalent standing. Details of members of the BlueBay Group and further important terms which this message is subject to can be obtained at [www.bluebay.com](http://www.bluebay.com). All rights reserved.

Published date: November 2021



Global Asset Management  
BlueBay Asset Management