

CoCos – Reflecting on the year so far

Positioning refinement around conviction views is our theme for H2 2019.

- Yields in the asset class remain attractive, in our view.
- We believe the US economy is fundamentally strong and European growth broadly intact.
- We have a strengthening conviction that we remain in the midst of a ‘Goldilocks’ period for credit.
- We remain convinced in our investment process, which has a bias towards AT1 instruments with concentrated investments in our strongest-conviction ideas.
- We will maintain our core views through bouts of volatility and use all of the tools at our disposal to protect capital.

As we head rapidly towards the close of H1, it seems a timely moment to take stock of the contingent convertible bond (CoCo) market, review valuations and sharpen our outlook for the second half of the year.

We highlighted in our [2019 outlook](#) that the pivot we saw by central banks had the potential to create a ‘Goldilocks’ environment for credit, as long as global growth numbers held up in the face of recessionary fears. This has been the environment we have experienced year to date.

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Moving into H2 2019

The question we have to ask ourselves now is whether the valuations are still attractive and if anything has changed that could impact our fundamental view, given developments over the year so far.

Macro view

We maintain the view that the US economy is fundamentally strong and broad-based growth in Europe is intact.

While we are constantly testing this mindset, recent data points suggest that the weak numbers we saw at the end of last year and the start of this year represent troughs, rather than the start of a directional trend lower. We continue to anticipate 2.0–2.5% growth in the US and 1.0–1.5% growth in Europe for the year.

Despite these robust growth numbers, inflation remains weak, emboldening central banks to maintain a dovish stance and offering them the flexibility to exercise patience.

We anticipate this equilibrium being challenged by the market on an ongoing basis, which could lead to periods of volatility.

However, this has also strengthened our conviction that we are in the midst of a Goldilocks period for credit that will remain until we see either significant deterioration in data or signs of another pivot by central banks, which we anticipate being the key signals that would lead us to question our stance.

Bottom-up perspective

We believe fundamentals remain extremely robust. We are most of the way through first-quarter results and trends of cautious lending practices, non-performing loan reductions and conservative distribution policies remain key points of focus.

In our view, ongoing regulatory scrutiny, particularly over internal model harmonisation, continues to drive a conservative approach to capital.

We find it extremely unlikely that this cautious approach will change while the regulatory environment remains in flux; ensuring balance sheet strength continues to be the key management priority.

Despite this, margins continue to come under significant pressure and costs are sticky. Over 2018, margin pressure was clearly present, but for many banks, volume growth minimised the impact.

The combination of dovish central banks pushing rates lower and a weaker growth environment in Q4 2018/Q1 2019 left banks with nowhere to hide from these pressures.

While we continue to think valuations are overstating recessionary risks for the sector, without some form of earnings momentum to grasp onto, the bank equity story remains challenging.

With our fundamental rationale intact, where does this leave us on valuations?

Despite the impressive performance we have seen in the asset class this year, the yields on offer remain attractive, in our view.

Looking at the ICE BoAML Contingent Capital Index on a spread basis, we have seen spread tightening of 93bps – but this remains 110bps higher than the tightness seen in January 2018.

In short, we believe that this shows that despite the rally, the valuations in the asset class remain attractive and we are convinced that, over time, the spreads in this asset class will trade through the tightness that we saw in 2018 as the universe fully matures.

How will we position in light of this current view of the environment and the long-term story?

We retain conviction in our investment process, which has a bias towards AT1 instruments with concentrated investments in our highest-conviction ideas.

We continuously strive to protect capital and, as we mentioned at the start of the year, the asset class will not move in a straight line to the point that we believe will represent a fair valuation.

As such, while we will look to maintain our core views through bouts of volatility, we will continue to use all of the tools at our disposal to protect capital and optimise risk-adjusted returns.

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