Early in 2017, we see near ideal conditions for convertible bonds relative to other asset classes. We believe the best time to overweight this asset class is when stocks are expected to outperform but when the risks in the equity market are at the same time elevated. Currently, populist changes have brought both significant opportunities and challenges going into what should be a very interesting new year. We can summarize the outlook for convertibles in this context along three lines:

1. **THE ABSOLUTE RETURN FORECAST LOOKS PROMISING**

   Equity markets have been positive since the U.S. elections in November on the hopes for new policy initiatives in three key areas: deregulation, tax reform and infrastructure spending. Markets are clearly hoping that these forms of stimulus will both drive consumer spending, and save corporate costs, thereby combining to boost company earnings and economic growth. This would of course justify higher multiples on the equity market, causing it to rise. On deregulation, Trump already announced plans to cut up to 75% of government regulation early in his term. While it seems unlikely, even a fraction of this would be good news particularly for financials, where banks have been swamped by rules and regulations since the credit crisis. Tax reform looks to be high on the agenda

2. **KEY HIGHLIGHTS**

   Convertible bonds, which tend to generate most of their total return from sensitivity to equities, seem poised for a positive year based on the positive stock environment that is being driven by the potential for tax reform, deregulation and infrastructure spending from the new U.S. presidential regime.

   There still remains a lot of political policy uncertainty across the globe. Convertibles shine in this type of environment as they offer the potential upside of equities, but with a measure of downside mitigation.

3. **THE TECHNICAL STRUCTURE OF THE MARKET LOOKS STRONG**

   The convertible bond market’s technical structure is very healthy with issuance on the rise, and demand and market volatility starting to pick up. When combined with the current market environment factors, convertible bonds look to be a very compelling investment in 2017.
as well, with a material cut to the 35% corporate rate expected to encourage businesses to reinvest retained profits back into the domestic U.S. market. Finally, infrastructure spending is much needed in many U.S. cities and, while inflationary, would boost economic activity and efficiency. So, if all of this is good for stocks (we will explore the important “if” question in the next section below) then by extension it is good for convertible bonds, which generate most of their total return from sensitivity to equity. This sensitivity is from the “embedded call option” associated with convertible bonds that allows for the bond to be converted into shares of common stock at an agreed upon price on or before a particular date. Assuming that equities do rise in 2017, the next question could be “which stocks?” In 2016, defensive equity sectors performed best as investors fretted about a number of top-down headwinds such as oil prices, Brexit, U.S. elections, interest rates and the end of central bank easing. Using MSCI global equity sector indexes, we observe that defensive equity sectors increased an average of 13.4% in 2016, while cyclical, growth sectors moved higher by just 5.6%. But that trend has now turned on its head, with cyclical sectors beginning to outperform since the U.S. elections on the hopes of a return to economic growth. These trends are of particular relevance to the convertibles market because it is approximately 70% comprised of companies in cyclical sectors. This makes sense because the attraction to corporates to issue a convertible bond in the first place is in the value of the option—the more valuable the option they are selling, the more they save on coupon yield they need to pay. And cyclical companies have more volatile equity performance which means more valuable equity options. So, not only do we see a possibility for strong equity performance in 2017, we believe that this performance will be concentrated in cyclical sectors, reversing last year’s underperformance, and providing a magnified return in the cyclical-dominated convertibles market.

2. THE RELATIVE RETURN FORECAST LOOKS STRONG TOO

For the first time in several years, convertibles look like an appealing asset class against both underlying equity and credit markets.

On the equity side, it is never easy to forecast market direction but we believe the call for stocks in 2017 is one of the most challenging in recent memory. For now, market sentiment has been strong in recent months on the hope of a new growth platform in the U.S., but achieving the lofty goals of the Trump administration is certainly not without significant challenges:

- The “America First” mandate of the new administration could lead to very damaging relations with key U.S. trade partners, particularly China and Mexico, where the early dialogue has been very difficult. As these negotiations play out, there is certain to be a heated debate even within the Trump administration, which will undoubtedly cause market volatility.

- Tax and regulatory reform may sound appealing to markets, but both the unwinding and then new execution of such complex legislation promises to be fraught with difficulty, which could easily disappoint markets.

- Health care represents nearly 20% of spending in the U.S. and the proposed unwinding of the Affordable Care Act will certainly prove to be a monumental task. Of course, there will be winners and losers, but the turmoil to overall markets will reach far beyond the sector as the situation plays out.

As much as the U.S. will face uncertainties in 2017, there are many challenges elsewhere in the world too. Europe is central to market concerns as the pending Brexit, French elections, and the state of Italian banks all have the potential to upend the European Union (EU). At the beginning of 2016, markets took a cautious view as opportunity seemed modest and challenges were high. But as we start 2017, both opportunity and risk are high. Many investors will want to have exposure to stocks so as not to “miss the party” but it will come at the cost of greater uncertainty of returns. This is the exact market moment where convertibles shine as they offer equity upside but with greater protection on the downside. This gives a strong signal to investors to add to their convertibles weighting as an equity proxy in 2017.

Because convertibles are a hybrid investment, some investors consider investing out of fixed income rather than from the equity side. In this respect, convertibles also look appealing because the U.S. is poised to raise rates, which creates headwind for traditional bond strategies. However, convertibles, offer a hedge against rising rates for two reasons: (i) they are short duration because issuers do not like giving long-term options on their stock, and (ii) the asset class has typically provided positive returns when rates go up, simply because the return profile is driven more from the embedded equity option. Usually, when rates are going up it is because the economy is performing well and central banks raise rates to manage inflation. In this context,

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1 Source: MSIM. As of December 31, 2016.
equity markets often rise and convertibles benefit too. To test this, we looked at all of the months over the past 20 years when U.S. 10 year Treasury rates rose 25 basis points (bps) or more and observed that U.S. convertibles rose an average of 3.08%. Conversely, in months when the U.S. 10 year rate fell 25 bps or more, average U.S. convertibles returns were -1.89% (Display 1). Intuitively, this makes sense as convertibles’ losses from rising rates on the bond side were more than offset by rising optionality on the equity side.

3. THE TECHNICAL STRUCTURE OF THE CONVERTIBLE MARKET IS HEALTHY

Even if underlying equities look promising, convertible bonds are not necessarily a good investment unless the market is healthy in terms of liquidity, balanced supply and demand, and valuation of bond plus option pricing. In terms of demand, investors have been net sellers of convertibles since early 2015 as equity market sentiment had softened in the latter stages of the central bank easing trend of the previous five years. In this context, we have witnessed around a 40% decline in assets under management across the 15 funds in our direct peer group.2

The lower demand has followed lower supply as the convertibles market has been shrinking over the past two years from its average market size of approximately $500 billion to a current size around $400 billion.3 Companies tend to issue convertibles when their stock is going up and when interest rates rise. In 2017, we expect a healthy issuance calendar as the markets appear positioned for both equity performance and rate increases. New supply will be much welcomed for the convertible market to restore it towards long-term average market size and provide investors with a wider choice of investment ideas to trade.

Another important consideration in the technical appeal of convertible bonds is the level of volatility, as higher volatility adds to the value of “embedded options.” In the past two years, volatility has been down at very low levels, reflecting the malaise in investor sentiment towards equity upside at the end of the central bank easing cycle. But we believe that global uncertainty over the new U.S. government and the state of the EU will rise in 2017 and cause greater deviation in equity and bond prices.

Investors agreeing with the notion that 2017 will be an uncertain year should closely consider adding to convertible bond allocations—there is rarely a year when convertibles look as sensible compared to stocks and credit as they do in 2017.

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2 Source: MSIM. As of December 31, 2016.

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Display 1
Convertible performance when rates rise or fall by more than 25 bps in a quarter

<table>
<thead>
<tr>
<th>UST 10yr Rate Change (%)</th>
<th>Performance of U.S. convertibles (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-2.0</td>
<td>-20</td>
</tr>
<tr>
<td>-1.5</td>
<td>-20</td>
</tr>
<tr>
<td>-1.0</td>
<td>-20</td>
</tr>
<tr>
<td>0.0</td>
<td>0</td>
</tr>
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<td>0.5</td>
<td>5</td>
</tr>
<tr>
<td>1.0</td>
<td>15</td>
</tr>
<tr>
<td>1.5</td>
<td>20</td>
</tr>
</tbody>
</table>

Source: UST 10yr rate represented by the Bloomberg Barclays U.S. Government 10 year Index. U.S. convertible performance represented by the Thomson Reuters U.S. Convertible Index. Data as of December 31, 2016. This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.
INVESTMENT INSIGHT

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