

Convertible bonds and how they perform in the aftermath of a rate hike cycle

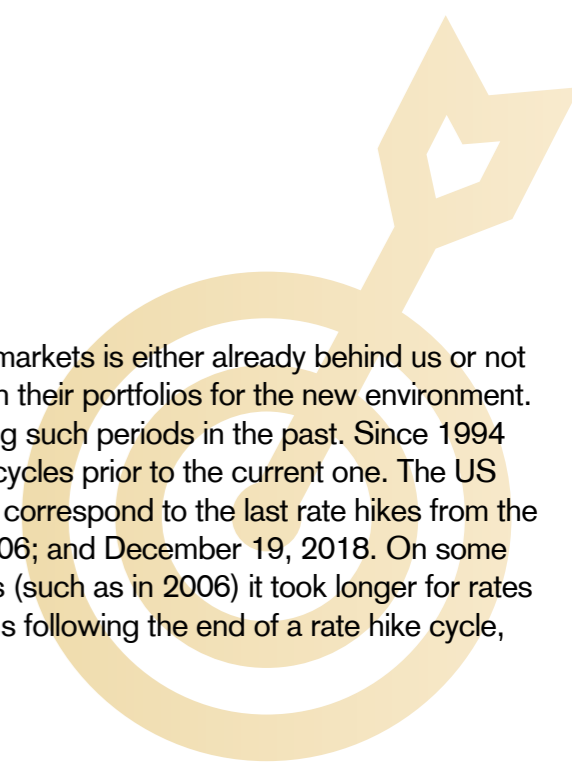
Many institutional investors choose convertible bonds on account of the compelling risk-adjusted performance the asset class has delivered over the long term. With the general expectation that the ongoing rate hike cycle will be coming to an end soon, investors are recalibrating their portfolios in preparation. In this article we look at previous inflection points – rather, the period that immediately follows the end of a rate hike cycle – and find that convertible bonds tend to do well in such times.

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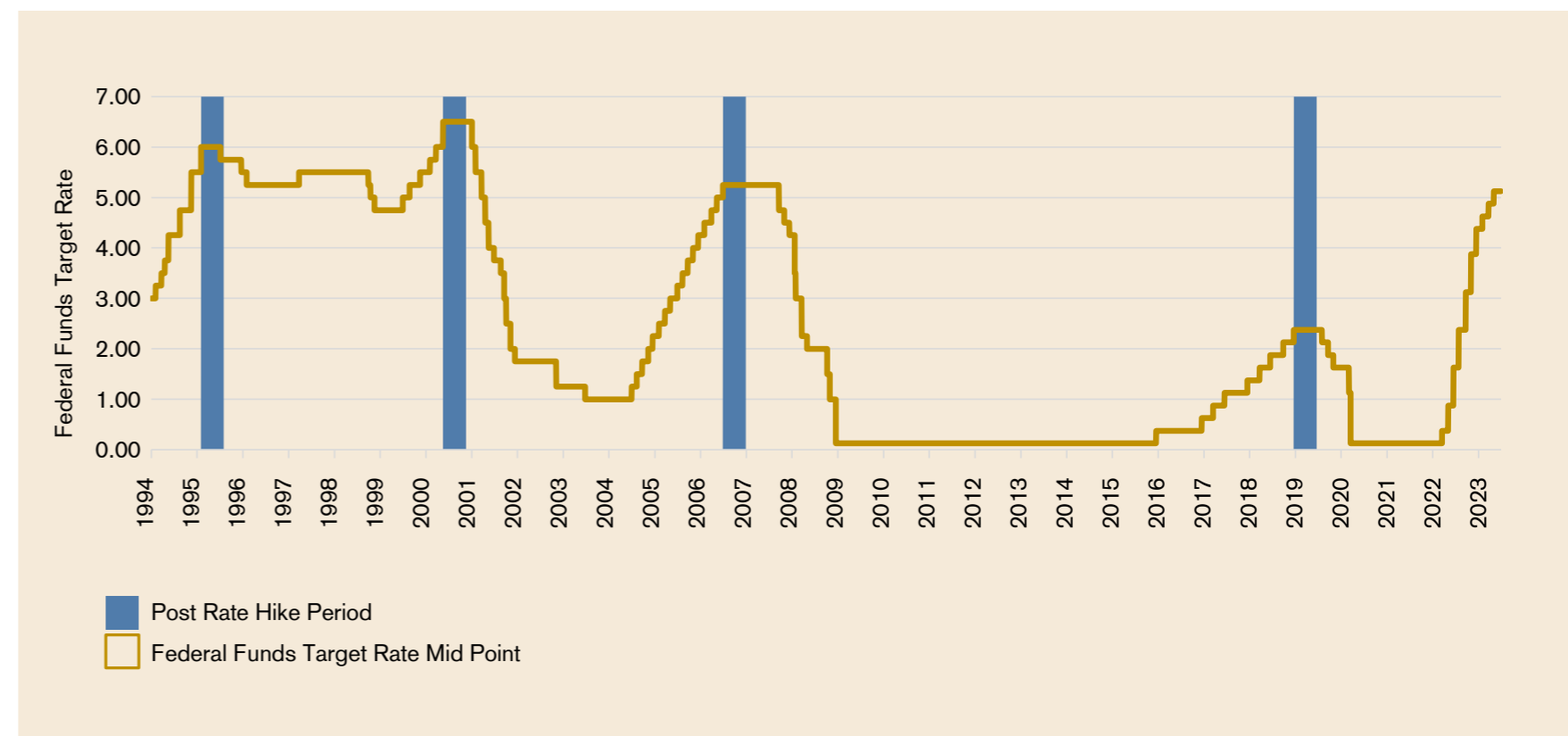
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It is generally assumed that the end of the ongoing rate hike cycle in key developed markets is either already behind us or not too far off. With this in mind, many investors ask themselves how to optimally position their portfolios for the new environment. We looked in the rearview mirror to examine how convertible bonds performed during such periods in the past. Since 1994 (when the Refinitiv convertible bond indices were launched) we identified four such cycles prior to the current one. The US Federal Funds target rate was used as our reference point. The following four dates correspond to the last rate hikes from the Federal Reserve during those cycles: February 1, 1995; May 16, 2000; June 29, 2006; and December 19, 2018. On some occasions, rates started retracing their earlier moves relatively quickly, while in others (such as in 2006) it took longer for rates to start declining again. In the interest of consistency, we looked at fixed time horizons following the end of a rate hike cycle, starting with six months as shown in the graph below:

Chart 1: Development of the Federal Funds target rate (mid point) and the period following the day of the last hike.



Source Bloomberg

Historical performance indications and financial market scenarios are not reliable indicators of current or future performance.

Table 1: The table shows the performance of convertible bonds in the context of equities and bonds in a six-month total return comparison

	Period 1	Period 2	Period 3	Period 4	Average
End of Fed Hike Cycle	01.02.1995	16.05.2000	29.06.2006	19.12.2018	
+6 Months Performance	01.08.1995	16.11.2000	29.12.2006	19.06.2019	
Global CBs	12.44%	-4.11%	10.90%	10.48%	7.43%
Global Focus CBs	12.12%	-0.78%	11.44%	7.14%	7.48%
Global IG CBs	13.05%	-3.91%	9.74%	6.11%	6.25%
Global Equities	16.36%	-8.40%	15.02%	15.54%	9.63%
Global Bonds	8.92%	5.36%	4.51%	5.90%	6.17%

Six-month total return comparison for five indices post Fed hike cycle. Ticker symbols: Global CBs: UCBIFFX01; Global Focus CBs: UCBIFFX02; Global Inv Grade CBs: UCBIFFX04; Global Equities: NDDUWI Index; Global Bonds: LEGATRUH;
Source Bloomberg

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Analyzing convertible bond performance using the Refinitiv Global Bond Index and subindices

As proxies for convertible bond performance, we used the Refinitiv Global Convertible Bond Index (Global CBs) together with its subindices Global Focus, which represent the balanced/convex subsegment as well as the investment-grade (IG) subsegment, all in USD hedged.

Strong short-term performance aligned with expectations

With the caveat that we only have four observation periods to work with, convertible bonds tend to perform well in absolute terms. In a relative context, the performance of

CBs was somewhere between that of equities and bonds. Thus, we can draw the conclusion that in the short run, convertible bonds behave broadly as expected in a bond/equity paradigm.

Long-term perspective reveals favorable characteristics of convertible bonds

What is even more interesting, however, is how the results change if we expand the observation period beyond the rather short six-month time horizon. What we find is that longer observation periods tend to favor convertible bonds. If, for example, a 24-month period is used, the results look as follows:

Table 2: The table shows the performance of convertible bonds in the context of equities and bonds in a 24-month total return comparison

	Period 1	Period 2	Period 3	Period 4	Average
End of Fed Hike Cycle	01.02.1995	16.05.2000	29.06.2006	19.12.2018	
+24 Months Performance	01.02.1997	16.05.2002	29.06.2008	19.12.2020	
Global CBs	37.57%	-10.96%	11.58%	55.57%	23.44%
Global Focus CBs	37.52%	-9.45%	10.54%	37.48%	19.02%
Global IG CBs	36.73%	-7.50%	9.66%	22.07%	15.24%
Global Equities	40.76%	-26.24%	11.79%	46.01%	18.08%
Global Bonds	25.17%	17.11%	10.34%	14.26%	16.72%

24-month total return comparison for five indices post Fed hike cycle. Ticker symbols: Global CBs: UCBIFFX01; Global Focus CBs: UCBIFFX02; Global Inv Grade CBs: UCBIFFX04; Global Equities: NDDUWI Index; Global Bonds: LEGATRUH;
Source Bloomberg

Historical performance indications and financial market scenarios are not reliable indicators of current or future performance.

Global convertible bonds in particular but also to a large degree the global focus subsegment outshine both equities and bonds, on average. Of course, a substantial portion of that relative outperformance is attributable to 2020 which was an exceptionally strong year by all standards. One could also argue that four observation periods represent mere anecdotal evidence and not empirical evidence, but we nevertheless find the results encouraging and believe they are worth highlighting and also deserving of additional monitoring and analysis.

Conclusion

It is still too early to say whether the end of the current rate hike cycle has already been completed or whether we still have one or two hikes ahead of us. In either scenario, however, the inflection point in the direction of interest rates and – with it – the period when convertible bonds start asserting themselves should not be too far ahead in the future.

If you'd like to discuss the matter in depth, please feel free to reach out to our CB specialists.

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