## *NEW ISSUANCE IN THE CONVERTIBLE MARKET – WHAT'S AHEAD*

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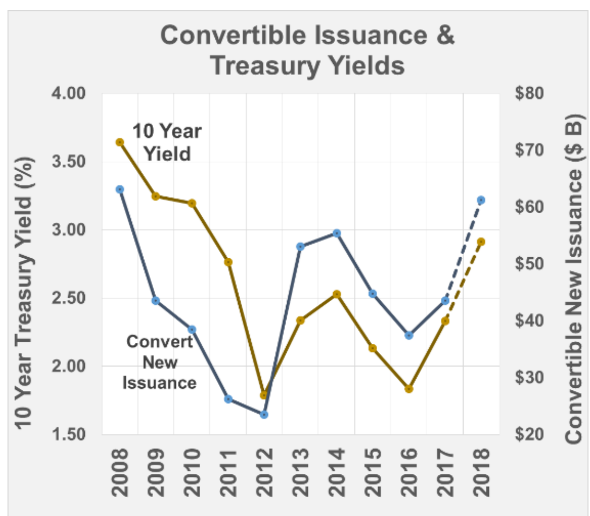
Three years ago, in late 2015, the Federal Reserve announced its intention to begin raising the target Fed Funds rate from its all-time low of 0-0.25%, which had been instituted in the wake of the Great Recession and coincided with massive rounds of quantitative easing. At the time, convertible new issuance had been on a downtrend, and the indication of higher future rates was a welcome news to the convertible investor, who typically expects performance and issuance to improve as rates rise. Three years later, with the target rate now in the range of 2-2.25% (possibly going higher on December 19), and the 10-Year Treasury yield around 3%, 2018 has turned out to be a robust year for new issuance in the U.S. convertible market, as predicted. Year-to-date figures in November imply an estimated annualized total of $50 to $55 billion by year-end for domestic benchmarks, and over $60 billion including convertibles that did not meet certain benchmark criteria[1]. Over the last twelve months, new convertible securities were brought by companies across a broad range of sectors and market caps: Twitter, Square, Zillow, Splunk, Illumina, Teledoc, Exact Sciences, Sarepta Therapeutics, Wayfair, Fortive, Atlassian, Herbalife, Blackstone Mortgage Trust, Sempra Energy, and Centerpoint Energy have contributed to the large uptick in issuance.

*Figure 1*




*Sources: Bloomberg, SSI internal research, ICE BofA ML*

Historically, **rising rate environments are correlated with increased convertible new issuance** (as depicted on Figure 1 on the right shows), as companies can typically raise convertible debt at lower interest rates relative to traditional fixed income. The 2017 U.S. tax reform, limiting deductible corporate interest expense, has further improved the attractiveness of issuing convertible bonds relative to high yield corporate debt. With rates finally breaking out on the upside this year, annualized issuance figures for the U.S. Convertible market in 2018 show record high levels not seen in a decade, during which time the Fed was in its final stages of contractionary monetary policy before the extreme easing that coincided with the Great Recession. We see the increased issuance trend likely continuing to follow the path of interest rates over the rest of the rate cycle, implying another uptick in issuance in 2019, and potentially out to 2020 or beyond, which should provide a favorable backdrop for convertible





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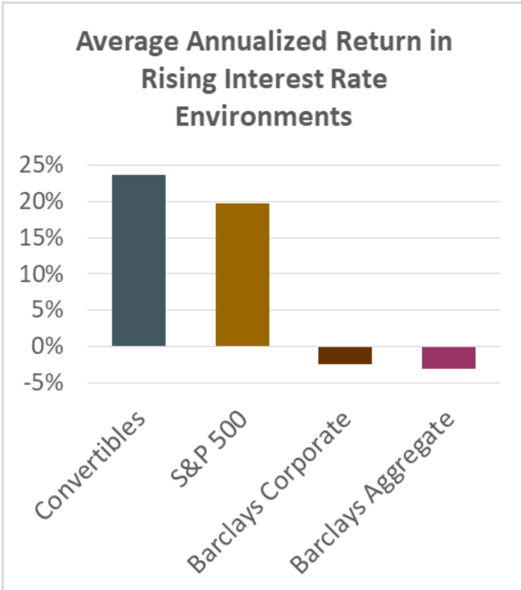
*Figure 2*

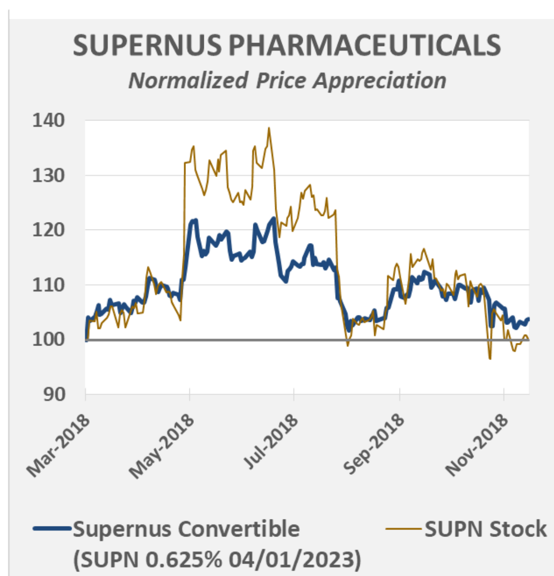



*Source: SSI internal research; ICE BofA ML Convertible Research; Bloomberg; Bloomberg Barclays. Rising interest rate environment periods based on SSI internal research/evaluation where the 10-Year Treasury rises at least 100 bps in a twelve-month rolling period.*

investors in the intermediate term. Empirically, **rising rate periods have also been good for convertible returns** (as depicted in Figure 2, left). In addition to outperformance during these rising rate environments, in oft subsequent recessionary periods after hiking cycles, convertibles have tended to outperform, capturing only about 50% of the downward move in the equity market during an average recessionary month[2].

While new issuance is somewhat esoterically seen as 'good' for the convertible market, higher than average levels of issuance have actually historically led to subsequent periods of above average intermediate term returns[3]. In addition to higher average returns, **record levels of new issuance in 2018**, especially from technology and healthcare companies, has helped to keep the convertible market *convex* in terms of risk-reward payoff, while stocking the convertible pond with companies that have high expected earnings growth rates. This has effectively given convertible investors a way to participate in growth equity investing, with significantly mitigated risk. As an example, healthcare company Supernus Pharmaceuticals (SUPN) specializes in central nervous system diseases and disorders, treating problems such as epilepsy, Parkinson's, ADHD, depression, and anxiety. The company has both existing and pipeline drugs, with superior EPS and revenue growth rates relative to its peers. The convertible bond, issued in March 2018, participated in a strong initial rally in the underlying SUPN stock, capturing about 60% of the equity's nearly 40% price rally in Q2 2018. However, after a significant stock selloff in Q3 2018 and spiking Q4 2018 volatility, the non-dividend paying stock is now flat from the date of issuance of the convertible bonds. Over the same time period, the convertible bonds have actually appreciated by nearly +4% in price[4] (refer to Figure 3), in addition to having paid coupon interest.

*Figure 3*

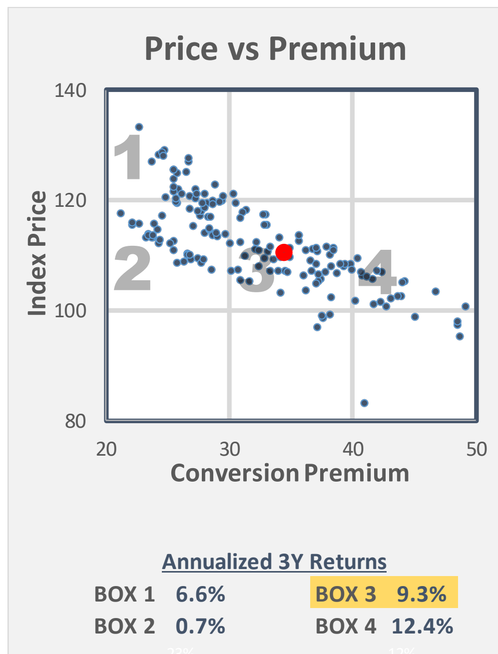



*Source: Bloomberg*

The marked **increase in equity market volatility** in Q4 2018 has actually increased the value of equity options embedded in convertible securities. Coincident spread widening has had only a slightly negative effect on valuations of most convertibles, which on average exhibit significantly higher average credit quality than hard hit high yield fixed income. The rising volatility environment partially reflects the growing divide in the investing community on whether peak earnings have been reached, as the benefits of tax cuts dissipate and a slowdown in global growth has arguably begun.

With **rising uncertainty about the medium-term path of the markets**, convertibles offer investors an attractive opportunity to invest in future growth and appreciation, with mitigated downside risk. At a technical level, the convertible market currently appears quite attractive. Although convertibles have generated positive returns[5] year-to-date through late November 2018, the average price of a convertible has fallen to $111 from $120 during the same period, due primarily to the influx of par-priced new issues this year. Above average issuance has also increased the conversion premium of the market, dampening immediate equity capture but increasing gamma, and significantly reducing distance to bond floor. The combined effects have enhanced the convex risk-reward profile inherent in the convertible market, providing increased downside protection, while maintaining attractive theoretical equity market capture, especially given the profile of the companies issuing convertibles over the last twelve months.

*Figure 4*




*Source: SSI internal research based on data provided by Barclays, Bloomberg Barclays Convertible Index, average annualized return of 9.3% vs standard deviation of 2.4% for Zone 3.*

Statistically speaking, **the convertible market is now in its sweet spot** – the current combination of conversion premium vs. price is right in the middle of the zone most frequently seen in the market; i.e., a premium between 30 - 40%, with a price around $110 (represented by the red dot in zone 3 in Figure 4 above[6]), a relationship present in about one-third of the total monthly observations since inception of the Bloomberg Barclays Convertible Index. Medium-term (3-year) forward returns in this zone annualize to +9.3%, with minimal standard deviation. Average returns are second only to those in zone 4, which only account for about one-tenth of total observations, and mostly represent the post-recession rebound period, expressing higher standard deviation of returns.

Where does this leave us? As we still seem to be in a gradual rising rate environment, suggested by Federal Reserve Chair Powell's recent statement that the benchmark interest rate was still "below the broad range of estimates of the level that would be neutral for the economy," the convertible market should remain an attractive place to seek **equity-like returns with mitigated risk**:

- If interest rates continue to rise, and the economy remains expansive, the likely influx of future convertible issuance would help moderate the average index price downward if the existing universe continues to appreciate, preserving the convex risk-reward tradeoff inherent in convertibles, and highlighting the asset class as an attractive and competitive supplier of risk adjusted returns.
- Conversely, if rates continue to rise gradually, and the economy moves toward or into a recession, issuance levels may fall, but should still continue to aid in the reduction of average dollar price of convertibles (as well as distance to bond floor), lessening potential future downside risk. Moreover, on a relative basis, convertibles have on average outperformed equities by a wide margin during periods of recession, and are more insulated from credit shocks that high yield fixed income is subject to during these periods.

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[1]Source: ICE BAML, Barclays, SSI

[2]See October 2017 SSI article *'Resilience of Convertibles in Economic Recessions'*

[3]Based on SSI's study of 3-year returns in various issuance environments (higher than average, average, and lower than average); source: SSI internal research, ICE BofA ML, Barclays

[4]as of 7:30am 11/28/2018

[5]Bloomberg Barclays Convertible Index +1.66% YTD as of 11/27/2018, source: Barclays

[6]Data points provided by Bloomberg Barclays, red dot represents a conversion premium of 34.9% and a price of $111.30 as of 11/27/2018