

Subordinated bonds still offer a compelling investment case

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European subordinated bonds have been one of the best-performing fixed income assets of 2017. In our view, the strong run experienced so far is far from over and further gains will be available to investors. Not only do relative spreads, performance trends and valuations all point to better relative returns going forward, but our positive view for the sub-asset class is also strengthened by three key tailwinds: positive economic momentum, decreasing political risk and improving issuer fundamentals. Finally, dispersion among bonds and issuers remains significant, offering active managers with a flexible and selective approach opportunities to exploit mispricing and generate alpha for investors.



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“Dispersion among issuer quality presents active and fundamentally-disciplined managers with many opportunities to find mispriced instruments and build a portfolio of positions that maximizes returns and optimizes actual -not perceived or market price implied- risk.”

European subordinated bonds have proved to be one of the best-performing fixed income assets of 2017. In our view the strong run experienced so far – supported by strong data – is far from over and further gains will be available to investors. On both an absolute valuation and relative to other fixed income assets basis, there are compelling reasons to expect that subordinated debt will extend its attractive 1H 2017 performance going forward.

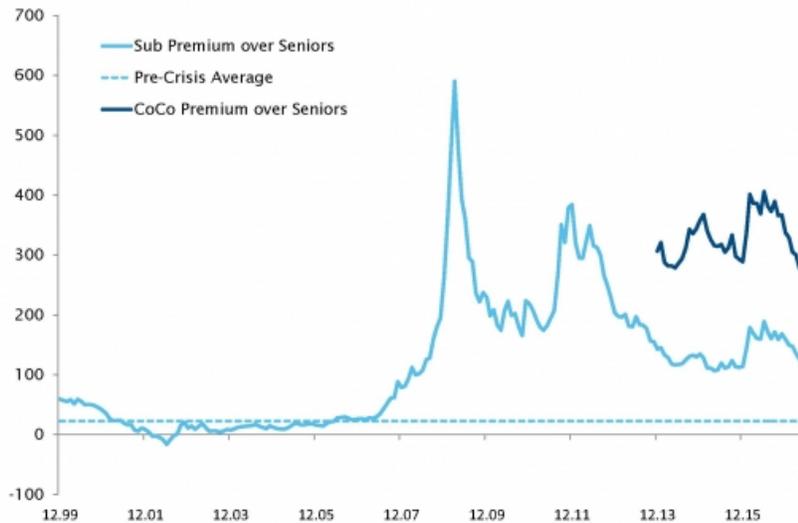
Take first the relative performance argument. By analyzing total returns for a set of fixed income indices and their moves from December 2015 (hence including market drawdown of January-February 2016), we can see that, notwithstanding the recent outperformance, subordinated bonds indices have barely caught-up with European high yield but lag way behind US high yield.

Supportive valuations offer relative edge

Valuations equally, remain supportive, even considering they are tighter than 12 months ago, as historical premiums and relative spreads remain above long term averages. Investment grade subordinated bonds (excluding CoCo's) still offer 120 bps above senior Investment grade financials, i.e. more than twice seniors' spreads (230 vs 110 bps) vs 1.5 times pre-crisis (Chart 1). Furthermore, they pay as much as high yield paper, but carry far better issuer credit profiles and ratings. This is where the main opportunity lies - subordinated bonds are perceived riskier than they really are and investors who understand them can be handsomely rewarded.

It is not only spreads, relative performance and valuations that point to better relative returns going forward, but, crucially, our positive stance on the sub-asset class is strengthened by three key tailwinds: positive economic momentum, decreasing political risk and improving fundamentals.

Subordinated financials yield much more than before 2008



Source

SYZ Asset Management, BofA Merrill Lynch, Bloomberg. Data as at 31.05.2017

European economic revival drives sentiment

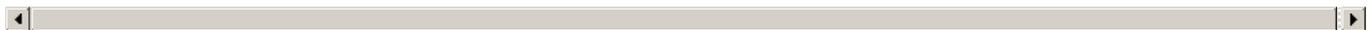
From a top-down perspective, Europe is currently enjoying a positive and accelerating economic cycle with inflation momentum remaining subdued. Supporting this trend is a monetary policy that will likely remain extremely accommodative until more stable and consistent pressures mount on consumer prices. This moderate, but positive, growth scenario is reflected also in credit fundamentals, where issuer margins have been rising at a business level and leverage has been decreasing since the second half of last year.

Last, but not least, with Dutch, French and recently UK elections stemming the tides of populist and anti-European movements, political risk is also decreasing, as well as their associated risk premiums. All of these macro factors are contributing to an improvement in sentiment towards riskier assets: subordinated bonds have and will continue to be no exception in our view.

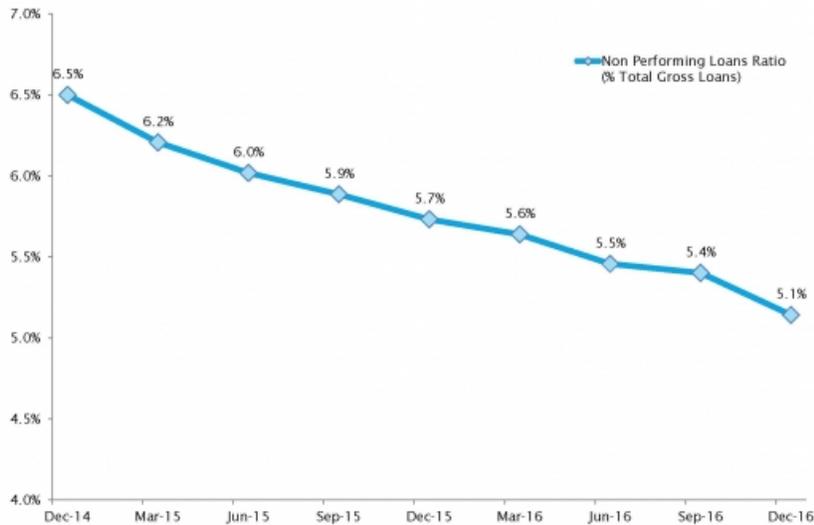
Raft of bank capital increase a positive

From a bottom-up point of view, bank fundamentals continue their positive trends: capitalization is increasing while risk solvency decreases. Year-to-date, three major European players launched capital increases: Unicredit raised EUR 13 bn, while Deutsche Bank and Credit Suisse, followed with eight and four billion respective offerings; more recently Santander also joined the field with a EUR 7 bn offering in order to deal with their latest Banco Popular acquisition. A total of EUR 32 bn has easily been absorbed by equity markets and positively impacted issuers' subordinated instruments as banks shore up their capital positions.

On the risk side, overall RWA (risk-weighted assets) and NPLs (non-performing loans) ratios are decreasing at a steady pace, with the latter having fallen over 20% in a two-year period. Thus, we can argue that, at a systemic level, the embedded riskiness of subordinated instruments is decreasing. Moreover, this theme has legs as the structural recapitalization of the European financial system is still on-going with several institutions needing and in many cases obliged by regulators to further fulfill capital requirements.



Non-performing loans ratios are decreasing steadily



Source

SYZ Asset Management, European Banking Authority. Data as at 31.12.2016

Selective opportunities amid varying asset quality

While the rising tide of improved economic outlook and improvements in sovereign and corporate balance sheets has fueled asset price advances, material quality dispersion among issuers remain.

At a sovereign level, countries such as Italy and Portugal remain under pressure from legacy problems related to non-performing debt or simply very large debt stocks, while Spain and Ireland have worked hard to reduce Debt/GDP ratios and stimulate domestic growth to improve current account issues.

At a corporate level, a dichotomy of issuer quality also exists. Within Europe, initiatives to improve transparency and carry out published stress test results have helped investors better discriminate between issuers and instruments. The challenge today is not necessarily access to data, but rather making use of the data and understanding the risks investors assume in exchange for the yields that are available.

In both cases, this dispersion among issuer quality presents active and fundamentally-disciplined managers with many opportunities to find mispriced instruments and build a portfolio of positions that maximizes returns and optimizes actual - not perceived or market price implied - risk.

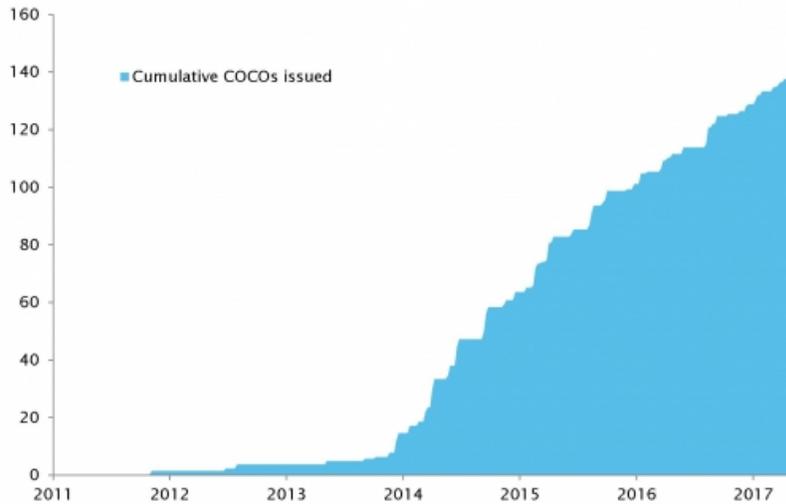
Cocos: benign environment to accelerate issuances

This is true for CoCos, this year's best performer, which after the enthusiastic "start" in 2013-2014, suffered from low transparency, especially on regulators' attitude towards coupons payment for lower capitalized banks. Finally after last summer, the ECB and other Central Banks changed the way they define capital needs, distinguishing between requirements and guidelines, lowering the former, that was prescriptive to the level of non-viability for banks below which a coupon cancellation may be imposed.

The combination of regulation changes and a risk-on environment has triggered a powerful start of 2017 for CoCos, further pushed out by the pro-EU political outcomes. This, in turn, will probably also revitalize the primary market. In fact, as of December 2016 only 18% of banks had already reached the minimum 1.5% of AT1 capital required, whereas 75% of them were still below 1%.

The total CoCos market from western European banks has reached around EUR 140 bn, but the 1.5% requirement, at least for major institutions, leaves another EUR 30 bn of space for new issues. We expect the current benign environment will accelerate issuances through year-end, offering more attractive opportunities for newcomers into the asset class.

The CoCos primary market keeps on growing



Source

SYZ Asset Management, Bloomberg. Data as at 31.03.2017

Conclusion “more gains to come...”

Despite recent strong performance, the European subordinated bond space still offers a compelling investment case underpinned by improving fundamentals and strengthening macro tailwinds. However, to unlock the potential of this complex asset class, investors must adopt a flexible and selective approach.

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