

Convertibles: Sharp Handling of the Trump, Dow 20,000 Turns

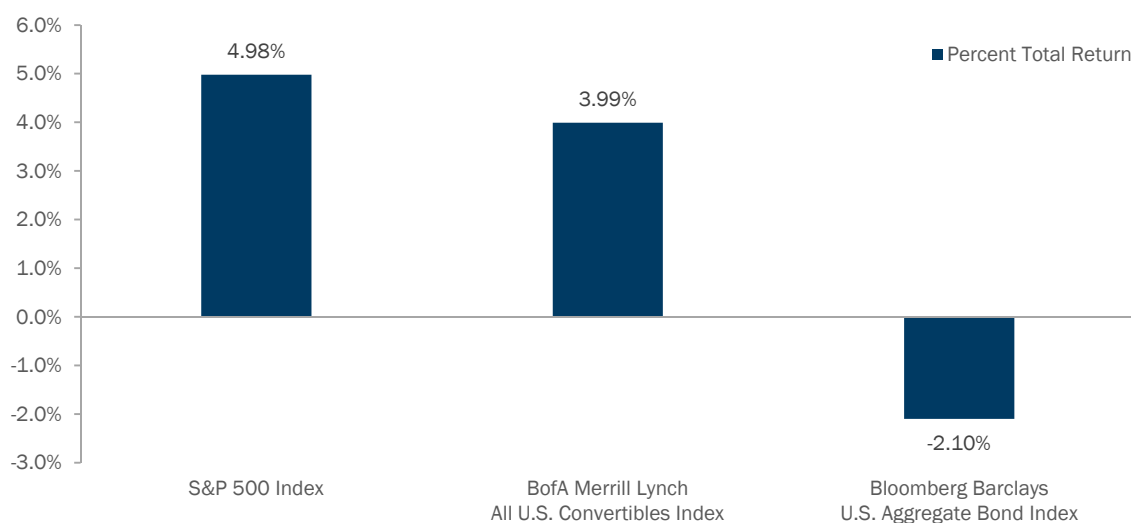
We recently caught up with Portfolio Manager, Edward Silverstein, of the MacKay Shields' Convertible Bond Team.

Election to December 31

Following the November 8 election and a few hours of market upheaval, the stock market soared higher, with the Dow Jones Industrial Average finishing the year just shy of 20,000 – a level it would later reach on January 25, 2017.

If we look at asset class level performance between the election and year-end 2016, the BofA Merrill Lynch All U.S. Convertibles Bond Index returned 3.99%, or about four-fifths of the 4.98% return of the S&P 500 Index. By contrast, a popular bond benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index, returned -2.10%, as investors focused on the possibility of tax cuts, fiscal stimulus, and reduced regulations.

Convertibles Captured 80% of the S&P 500's Rally after the Election



Source: Asset class level performance between 11/8/16 and 12/31/16. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index.

The latest run-up serves as a reminder that convertibles can behave quite differently at times from other bonds. Over the past 15 years ended December 31, convertibles had a negative .29 correlation to long-term Treasuries and a negative .26 correlation to intermediate-term Treasuries.¹

Pledges, Promises, and 60/40

Looking ahead, Silverstein believes the new administration has to transform pledges, promises, and executive orders into some more tangible accomplishments in the next 9-12 months to keep the market's animal spirits, well, up. Meanwhile, corporate profits are growing, and the typical convertible bond today (the average bond that makes up the index) has a price of about 116 and a "delta" near .60, meaning convertibles might realistically be expected to capture about 60% of any orderly upward stock market move or, alternatively, 40% of any orderly downward stock market move.²

Relative Value and Economic Outlook

Silverstein and the team believe equities and equity-linked securities are attractively valued, compared to the low yields on offer on U.S. Treasury bonds and investment-grade debt. They feel the U.S. stock market is fully valued, but should benefit, as profits grow.

Modest economic growth is expected to continue in the U.S. and globally, alongside low, but rising, inflation and interest rates. The Fed is expected to gradually raise rates, but monetary policies around the world should remain accommodative. Given these conditions, we believe equities and equity-linked securities have the potential to perform reasonably well in the 12-18 months ahead. However, it is not an environment that encourages taking unnecessary risks. In this sense, convertible securities can help investors participate in equity market advances, while providing the potential for some downside protection, should volatility occur.

Silverstein is generally encouraged by the fourth-quarter 2016 earnings calls he has listened to so far this reporting season. The team is overweight energy and industrials versus its benchmark and peers. By contrast, the team is underweight financials, utilities, and real estate investment trusts (REITs).

Odds 'n' Ends

Convertible issuance has been robust in 2017, so far. Issuance in January totaled \$3.3 billion.³ Companies want to obtain low-cost financing, given that interest rates may be higher down the road than they are today.

Conclusion

Continued economic growth, low but rising inflation, and attractive valuations provide an encouraging backdrop to an asset class that has little correlation to changing interest rates and less historical volatility than the equity market.

¹ Bloomberg 2/8/17 last data point 12/30/2016. Based on rolling monthly returns of the BofA Merrill Lynch All U.S. Convertibles Index with the Bloomberg Barclays U.S. Intermediate Term Treasury and Long-term Treasury indices.

² Bank of America Merrill Lynch and Bloomberg, as-of 2/7/2016.

³ Bank of America/Merrill Lynch, as-of January 2017.

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