Convertible Bonds

Are the Stars Aligned for 2024?

Global convertible bonds may benefit from several positive performance drivers in 2024. Equity exposure to attractively valued mid-cap growth companies, potential interest rate cuts, and historically high yields are among the reasons why we believe the asset class is positioned to perform well this year.

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Comprising a conventional bond and an option to convert it into shares of the same issuer, the return profile of convertible bonds depends on the performance of their underlying shares and interest rates. Therefore, a market environment in 2024 potentially defined by falling rates and rising equity markets could be a promising one for this distinctive asset class.

This potentially positive scenario follows a difficult 2022 for convertibles and an uncertain 2023. In 2022, climbing interest rates coupled with lacklustre stock markets generated significant performance headwinds: the FTSE Global Focus Convertible Bond Index fell 13.8% in euro terms. In 2023, the index recovered by 5.6% after a strong final quarter more than compensated for three volatile earlier quarters.

We believe this upbeat conclusion to 2023 is a precursor to a more substantial rebound in the asset class in 2024. Below we examine our reasons for optimism, starting with the equity component of convertibles before reviewing the fixed income element.

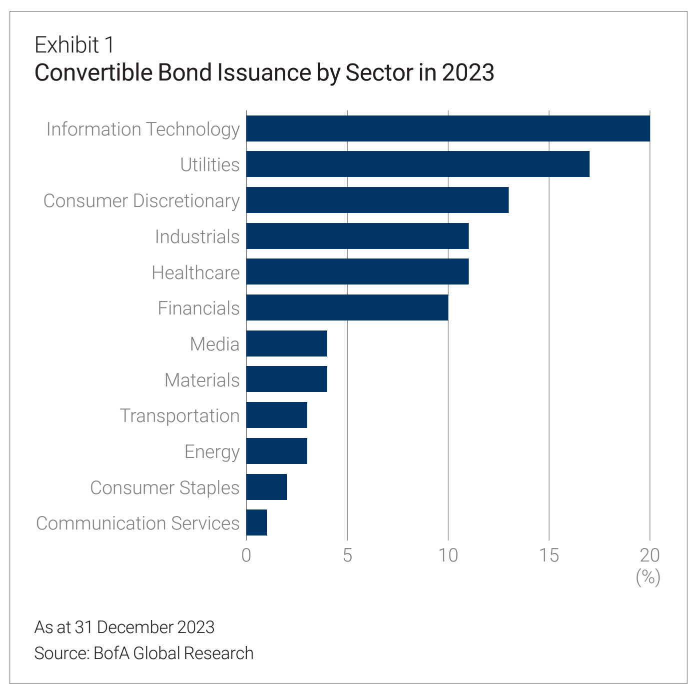
The Equity Component

Sensitivity to Out-of-Favour Mid-Cap Growth Stocks

Lower interest rates could particularly benefit growth stocks, especially the technology sector, which is the biggest issuer of convertible bonds, accounting for 20% of global convertible bond issuance in 2023 (Exhibit 1).

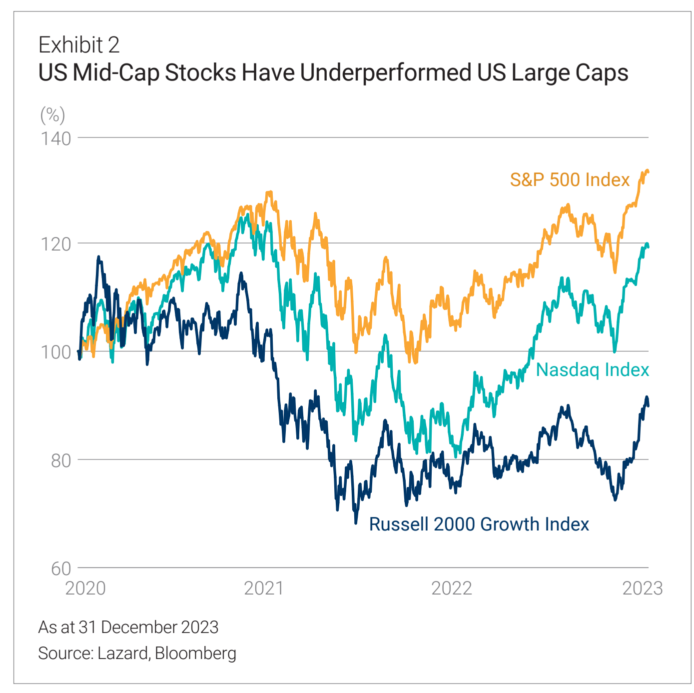
Furthermore, valuations in the mid-cap growth area of the market appear reasonable, in our view, compared with the "Magnificent Seven" (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), which do not typically feature in the convertible bond universe. We believe mid-cap growth stocks possess significant recovery potential, having fallen sharply since 2021, as reflected in the underperformance of the Russell 2000 Growth Index versus the Nasdaq and S&P 500 indices since early 2021 (Exhibit 2). This underperformance occurred despite mid-cap companies experiencing improved earnings over the period (Exhibit 3).

Exhibit 1
Convertible Bond Issuance by Sector in 2023



As at 31 December 2023
Source: BofA Global Research

Exhibit 2
US Mid-Cap Stocks Have Underperformed US Large Caps



As at 31 December 2023
Source: Lazard, Bloomberg

Exhibit 3
Mid-Cap Growth Stocks Have Experienced Rising Earnings per Share

As at 31 December 2023
Past performance is not a reliable indicator of future returns.
Source: Lazard, Bloomberg

New Issuers Benefiting from the Post-Pandemic Recovery

In addition, since the end of the COVID-19 crisis, new convertible issuers from the tourism, events, and airline sectors have been benefiting from the global economy's return to its pre-pandemic state. The airline sector, for example, has rebounded strongly: the International Air Transportation Association (IATA) expects 4.7 billion people to travel by plane in 2024, exceeding the pre-pandemic level of 4.5 billion in 2019.[1]

The Bond Component

Rate Cuts Mean Higher Bond Floors

The markets are convinced: it will be a year of monetary easing by central banks. This prospect was seemingly confirmed in December when the Federal Reserve (Fed) projected three cuts to the fed funds rate in 2024. Consensus expectations for monetary easing have been more aggressive, with the market anticipating up to six 25-basis points (bps) cuts in US interest rates earlier in 2024, although Chair Powell did strike a more cautious tone on rates at the Fed's late January meeting.

For bondholders the prospect of rate cuts is clearly positive: when interest rates fall, bond prices rise. The same applies to convertible bonds: lower rates mean a higher bond floor (the minimum value for a bond).

Attractive Yields: A New Performance Driver

Rising interest rates globally have bolstered convertible bond yields: the average coupon on convertibles issued in 2023 was 3.13%, compared with 0.97% in 2021. Yield has now become an important performance driver. This is a novel aspect for the asset class, given the equity component has largely underpinned the performance of convertibles in recent years.

In addition to higher coupons, yields-to-maturity have also increased significantly. In the technology sector, for example, 40% of international convertible bond issues offer yields-to-maturity more than 5%, while some provide as much as 10% per annum (Exhibit 4).

Exhibit 4
Elevated Convertible Yields-to-Maturity

Yield to Maturity	Global Convertible Bonds *IT Sector (%)*	Global Convertible Bonds *All Sectors (%)*
Negative	40.0	37.4
0%–5%	19.5	33.3
5%–10%	36.2	23.8
>10%	4.3	5.4

As at 31 December 2023
Source: Lazard, Refinitiv

An Unjustified Discount versus Conventional Bonds

The risk premiums offered by non-investment-grade convertible bonds exceed those of traditional US high-yield bonds: the spread over conventional BB-rated corporate bonds stood at +313 bps at the end of 2023 (Exhibit 5).

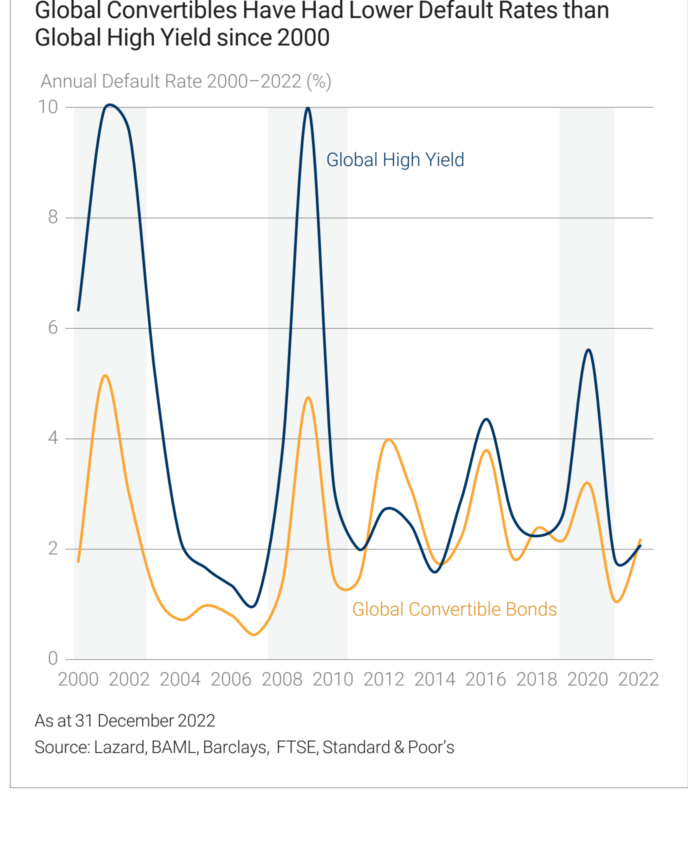
This discount is not due to a higher default history; indeed, quite the opposite. Since 2000, convertible bonds have experienced 44% fewer defaults on average than high-yield bonds. In particular, convertible issuers have historically tended to default less during recessions, as evidenced by lower default levels during the 2001, 2008, and 2020 economic downturns (Exhibit 6).

Pull-to-Par and Market Renewal

The redemption wall that faces the asset class in the years ahead is one of the themes currently on the minds of convertible bond investors. While the amount of convertible debt to be redeemed in 2024 is expected to be moderate, it will be much higher over the following two years with half of the convertible bond market reaching maturity in 2025 and 2026 (Exhibit 7).

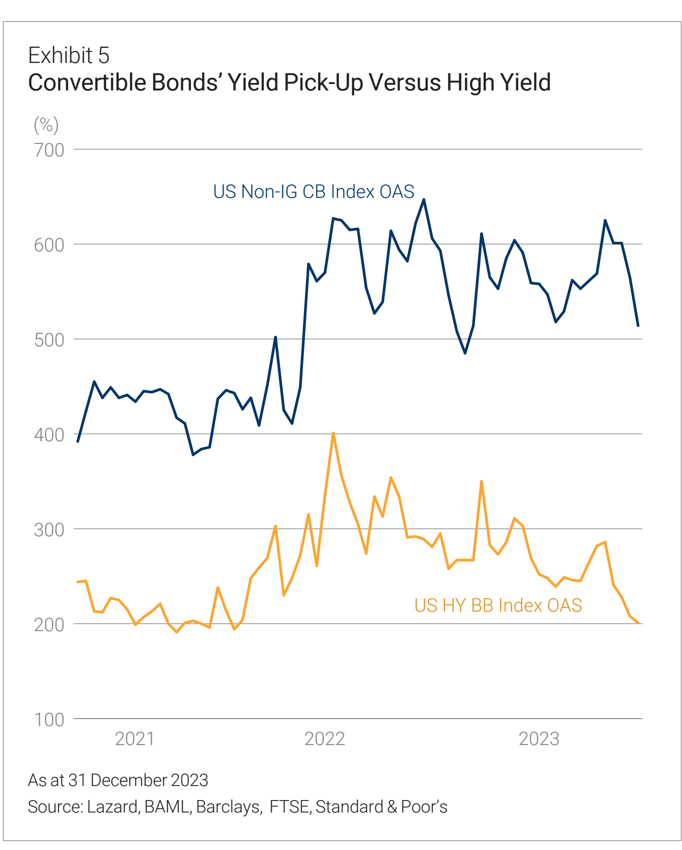
Far from being a problem, this bodes well for the convertibles market. As these bonds approach maturity, the return of their prices to par value could be a powerful performance driver this year. The new convertible bond issues replacing them are largely oversubscribed, allaying fears of insufficient investor demand. Above all, the convertibles market will be stimulated by new issues, with a growing proportion of bonds linked to sustainable development, as has been the case in recent years, especially in Europe and the US.

Exhibit 6
Global Convertibles Have Had Lower Default Rates than Global High Yield since 2000



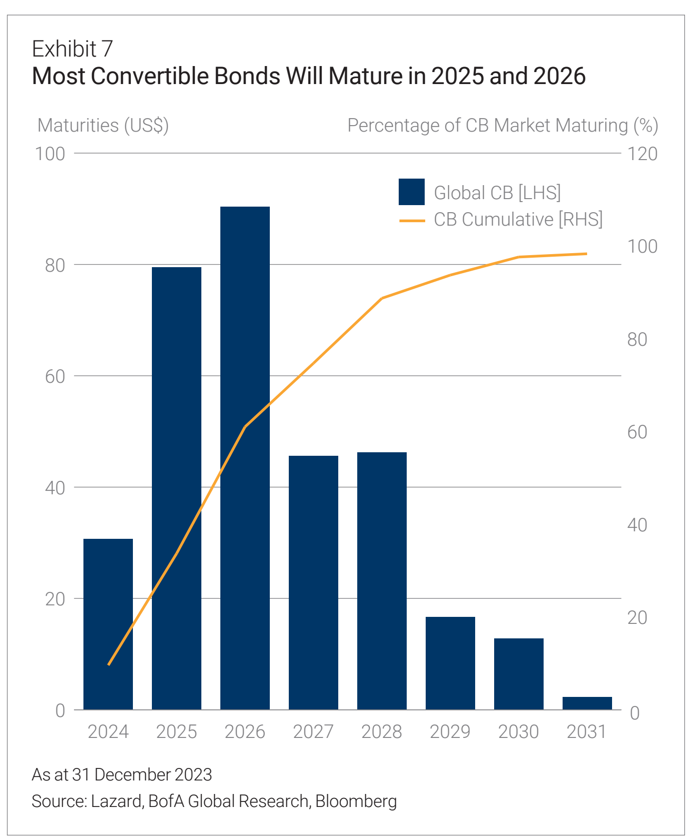
As at 31 December 2022
Source: Lazard, BAML, Barclays, FTSE, Standard & Poor's

Exhibit 5
Convertible Bonds' Yield Pick-Up Versus High Yield



As at 31 December 2023
Source: Lazard, BAML, Barclays, FTSE, Standard & Poor's

Exhibit 7
Most Convertible Bonds Will Mature in 2025 and 2026



As at 31 December 2023
Source: Lazard, BofA Global Research, Bloomberg

Higher Convexity Means Less Reliance on "In-the-Money" Exposure

Finally, refinancing convertible bonds improves convexity (how the duration of a bond changes as interest rates change) by avoiding excessive "In-the-money" exposure. Put differently, it limits investors' dependence on changes in the underlying share price to drive returns when share prices have already risen sharply. It is a way of resetting issuers' convertible bonds, giving them more leeway to take advantage of the opportunities inherent in the asset class.

In our view convertible bonds offer an attractive way to position for the potential recovery of small- and mid-cap growth stocks with less volatility while at the same time benefiting from a larger-than-usual yield component. The potential emergence of these positive performance drivers leads us to believe the stars may be aligned for convertible bonds in 2024. We encourage investors to take another look at this distinctive asset class.

Exhibit 8

Summary of the Current Opportunities in the Convertible Bond Market

	2022	2023	2024 Expected
Equity Sensitivity	✗	=	✓
Credit Sensitivity	✗	✗	=
Interest Rate Sensitivity	✗	=	✓
Option Valuation	✗	✗	✓
Yield	Absent	New	✓

The opinions expressed above are as of the date of publication and subject to change.
Source: Lazard

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Notes

1 Source: www.iata.org/en/pressroom/2023-releases/2023-12-06-01/

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