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POLAR CAPITAL

Convertibles outlook: 2H24

We see three key reasons to be optimistic on convertibles in 2H24.

First, the potential inflecting interest rate cycle across developed markets is likely to benefit both convert valuations and their underlying equities. Second, political crosscurrents in both Europe and the US are likely to present ongoing dispersion and outperformance opportunities. Third, convert primary market issuance year-to-date has been strong and diverse and we foresee this continuing for the rest of 2024 and into next year.

> "The convertible universe is well represented by small and mid-cap companies and is interest-rate sensitive by virtue of the bond component.
>
> Consequently, we believe convertibles are particularly well positioned to perform in the forthcoming interest rate cutting cycle.
>
> **David Keetley, Portfolio Manager**

Central bank tailwinds, finally?

The Federal Reserve began hiking interest rates in early 2022 to counter rising inflation, leading to the Federal Funds target rate moving from 0.125% in 2022 to 5.375%, as at the time of writing. This rapid tightening has been a material headwind to more interest-rate sensitive assets such as bonds and small/mid-cap equities.

Despite this, broad equity indices have generally performed well over this period, driven by mega-cap stocks which have been less impacted from rising rates given their large interest-bearing net cash balances, as well as accruing the most benefit from AI-related investments. This has resulted in a significant performance divergence over this period with the Russell 2000 (RTY) Index generating a return of -5.4% between January 2022 and June 2024 compared to a 55% return for the 'Magnificent Seven' (BM7T). Even year-to-date, these dynamics have resulted in one of the narrowest bull runs in market history, with the Magnificent Seven having outperformed the small-cap Russell 2000 by 35%.

With a lack of exposure to these mega-cap technology stocks and an interest rate sensitivity within the underlying stocks, the convertible asset class has similarly been challenged over this period.

However, looking ahead we believe a policy inflection across developed market central banks from one of hiking rates to cutting will boost bonds and the relative performance of smaller and mid-cap stocks. Consequently, convertibles will be a key beneficiary.

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David Keetley
Portfolio Manager

David joined Polar Capital in October 2010 to establish the global convertibles team and is co-manager of the Global Convertible Strategy and the Global Absolute Return Strategy.

Stephen McCormick
Portfolio Manager

Stephen joined Polar Capital in October 2010 and is co-manager of the Global Convertible Strategy and the Global Absolute Return Strategy.

Jake Collins
Senior Analyst

Jake joined Polar Capital in October 2013. He was promoted to Senior Analyst in 2022.

Michael Provvisionato
Investment Analyst

Michael joined Polar Capital as an Investment Analyst in the Convertible Bond Team in July 2022.

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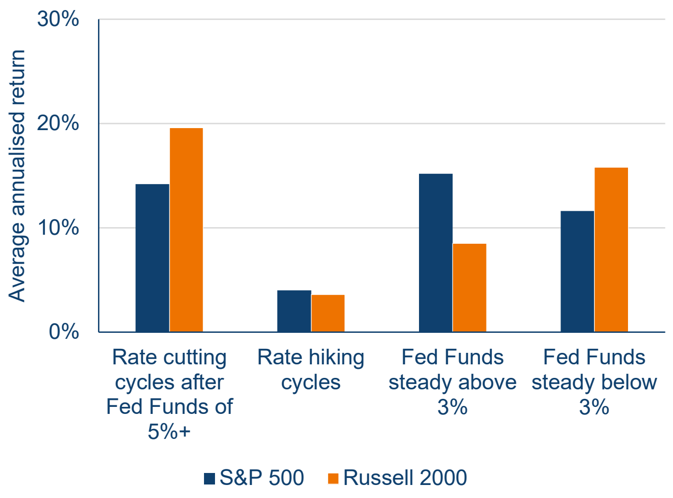
Indeed, history suggests the outperformance of small and mid-caps could be meaningful over the duration of the rate cutting cycle, as shown below:

S&P 500 and Russell 2000 performance versus rate cycles



Source: BofA Global Research, Bloomberg. Data as of 24 June 2024.

Given the convertible universe is well represented by small and mid-cap companies and is interest-rate sensitive by virtue of the bond component, we believe convertibles are particularly well positioned to perform in the forthcoming interest rate cutting cycle. We also note in this cycle the Fed Funds starting rate is 5.375%, thereby increasing the likelihood of strong performance, as shown in the chart above.

Political uncertainty and increased dispersion

The US election has taken centre stage, with significant implications for investors. While Biden was largely expected to step down, the landscape has shifted unpredictably with Kamala Harris as the presumptive Democratic nominee. Despite a general belief that she may struggle against Trump, the $50m raised the weekend Biden opted out is notable. Harris's appeal to key demographics as a black woman and her "youthful" contrast to Trump add unique dynamics to the election. Her positions on key issues remain unclear, and it is uncertain whether she will continue Biden's policies. While a Trump victory is widely expected, there could be unforeseen developments. This uncertainty might accelerate the de-risking process typically seen in the run-up to elections, impacting market volatility and investor strategies.

Probability of Trump winning US election on November 5th

US election probability (%)	24 June (pre-debate)	12 July (post-debate)	18 July (post-drop out calls)	22 July (post-drop out calls)
Trump win	**56%**	**67%**	**75%**	**64%**
Biden win	36%	16%	13%	-
Harris win	-	21%	18%	32%
Republican Senate	77%	80%	80%	82%
Democratic Senate	29%	20%	20%	25%
Republican House	48%	55%	54%	48%
Democratic House	60%	46%	46%	53%

Source: Bank of America, 2024.

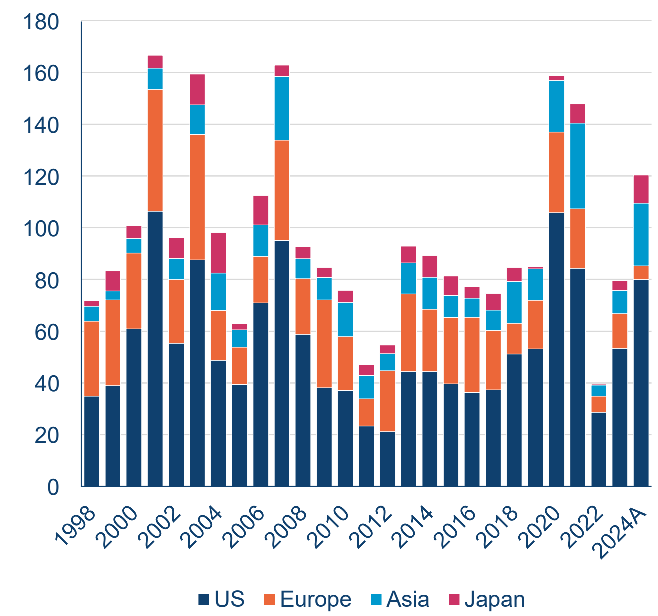
Political uncertainty earlier this year, most notably in France, also drove notable single-stock volatility in a number of companies which the team has been able to take advantage of through converts. As we approach the US presidential election we believe additional investment opportunities will emerge across a range of contentious policy areas including clean energy, electric vehicles, 'junk fee' related consumer services, cryptocurrency, biopharmaceuticals and onshoring of manufacturing. The convertible universe has numerous constituents within these areas which we can similarly use to gain asymmetric exposure to.

An active primary market

As highlighted in our *Four reasons to be cheerful* article earlier this year, we believed the convertible bond primary market was set for an acceleration in issuance, driven by higher rates and companies looking to get ahead of a substantial upcoming debt maturity schedule both in the high yield and convertible markets.

Through the first half of the year this prediction has proved to be accurate as convertible primary market activity is up 51% y/y to $120bn annualised, on pace for the sixth highest issuance level since 1998. As noted in our previous article, we believe this trend is set to continue for several years yet as companies seek to refinance Covid-era debt.

Annual convertible issuance ($bn)



Source: Polar Capital, Bloomberg, 2024.

In addition to increased issuance, we note the types of company using convertible debt are arguably becoming more interesting. Indeed, if history serves as a guide, convertible debt issuance will likely be at the centre of financing AI companies, which has been the case in previous technological cycles. In fact, dating back to the mid-19th century, convertible bonds were used to finance one of the first major technological advancements in post-industrial America – building the railroads. In the years since, convertible debt issuance has been involved in every major technological cycle, from the telecoms boom of the 1980s to the internet companies of the late 1990s/early 2000s, and more recently the transition to mobile, SaaS, IoT and the cloud.

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Experts believe AI is poised to produce a myriad of winners and losers, just as there was in the technological changes of the past 170 years. It is through these advances that the convertible market has a long history of offering attractive risk/reward propositions. In particular, by offering a strong credit backstop to ensure the principal is repaid, one mitigates the downside risk that often comes with these types of new-era investment in their early stages. On the upside, the asymmetric nature of convertible bonds allows the investor to participate in what could be meaningful price appreciation for those companies able to benefit from this paradigm shift.

Conclusion

In summary, we believe there are three key reasons to be optimistic for convertibles in 2H24: (1) an inflecting interest rate cycle should be positive for both convert valuations and the stocks underlying; (2) political crosscurrents in both Europe and the US have should continue to present opportunities, in our view; and (3) convertible new issuance is highly likely to remain strong and bring further attractive investment opportunities in the short term and as the AI theme develops further in the period ahead.

Polar Capital Global Convertible Team

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Contact Us

New York
1325 Avenue of the Americas
Suite 2818
New York NY 10019
United States

E investor-relations@polarcapitalfunds.com
W polarcapitalstrategy.com
T +44 (0) 20 7227 2700
F +44 (0) 20 7227 2799

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