AT1 COCOS RIDE THE BOND WAVE

Wisdomtree EU
24 May 2021

If you want to take a pulse of the state of the bond market, look at the moves noted in US Treasury bond yields this year. US 10-year Treasury bond yields have risen from 0.91% to 1.63% since the end of 2020[1], accounting for nearly an 80% rise. Bond markets tend to quickly absorb the results of economic data and provide a forward-looking guide on long-term growth and inflation expectations. The fear factor that drove bond market behaviour during the 'taper tantrum' in 2013 appears to draw some parallels to the inflation fear factor weighing on bonds in 2021. As we begin to emerge from the Covid-19 induced crisis, investors are struggling to draw perfect parallels with past crises. Due to the unprecedented nature of the crisis, data is providing the most reliable insight to the market. As recent US data prints related to personal income, personal saving rates and wage growth provide an immediate pulse on the state of inflation in the US, investors continue to ponder whether inflation will be 'transitory' or longer lasting. The current moves on government bond yield curves could be coined the 'inflation tantrum'. In this blog, we will explore segments of the bond market that have traditionally gained more appeal in a rising yield environment and consider how Additional Tier 1 Contingent Convertible (AT1 CoCos) have historically performed against other bond asset classes amid large moves in bond yields.

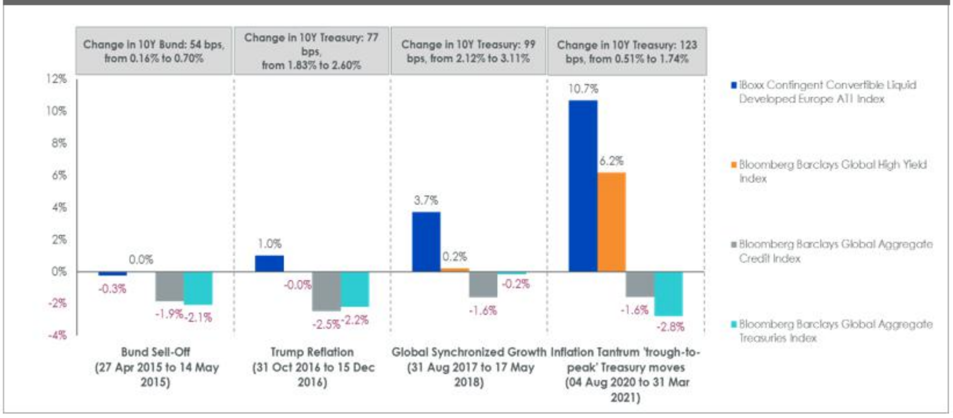
Do all fixed income asset classes behave equally during a rising rate period?

Not all asset classes behave the same in a rising yield environment. Shorter maturity bonds exhibit a lower duration profile making them less sensitive to interest rate risk. A positive factor when constructing portfolios in 2021 but one drawback to this approach is that typically an investor risks foregoing higher yields by staying invested in the shorter end of the yield curve. By the same token, an investor can consider investing in lower-rated bonds within the credit spectrum where issuers will aim to provide higher coupon and offer a higher investment yield for taking on the additional risks. The higher coupon rooted in the lower-rated bonds could potentially cushion against the principal loss that bonds face in a rising yield scenario.

With credit spreads in both high yield and investment grade bonds falling this year, investors increasingly seek relative value trades where exposure to certain asset classes can offer a yield pick-up compared to other segments of the bond market[2]. As of 27 April 2021, the yield to worst (YTW) for the Additional Tier 1 Contingent Convertible (AT1 CoCos) market[3], was at 3.75% with a duration profile of 3.49 years[4] providing a yield enhancement relative to the European high yield market[5] which was 2.54% YTW with a duration of 3.2 years for the same period. For an investor that is comfortable with the risk-reward profile of the asset class, AT1 CoCos which are generally issued by European banks is an area of the bond market that can provide a higher income yield versus other risk assets and has shown resilience when interest rates increase.

If we consider how AT1 CoCos have behaved during periods of large moves in bond yields, it becomes clear that not all fixed income assets behave in the same way when Treasury yields move. The great bond sell-off in 2015, the Trump reflation sell-off in 2016, and the recent Inflation Tantrum are worth considering, among others. During these periods, when Treasury yields rose, AT1 CoCos were able to offer diversification by providing better returns than many other areas of the bond market. As noted in figure 1.

Figure 1: Cumulative performance



Source: WisdomTree, Bloomberg. All indices are total return and USD-hedged indices. Calculations include backtested data. The iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (USD Hedged) started its live calculation on 09 March 2018. AT1 CoCos are represented using the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. Global High yield represented using the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. Global Investment Grade Bonds represented using the Bloomberg Barclays Global Aggregate Credit Index. Global Aggregate Treasuries represented using the Bloomberg Barclays Global Aggregate Treasuries Index.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Conclusion

The hunt for yield in bond markets continues to drive investor behaviour. Credit spreads can say a lot about the market's perception of credit risk and the average credit spread of major banks today is significantly lower than a year ago[6]. Investors previously concerned that the health pandemic could ignite a crisis within the banking system are now more positive about the sectors' outlook for 2021. As sentiment around banks improves, it is becoming increasingly difficult to disregard the potential benefits of AT1 CoCos within a diversified portfolio. AT1 CoCos history of providing portfolios with some cushion in a rising rate environment continues to pique investor interest.

Sources

[1] Bloomberg, 10-year US Treasury yield index considering the USGG10YR index as at 31 April 2021

[2] Credit spreads are defined as the spread above the treasury curve that aims to compensates investors for liquidity risk and credit risk. Data from Bloomberg Intelligence credit dashboard, as of 1 May 2021

[3] As reported by Markit considering the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index

[4] As reported by Markit considering the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index

[5] As reported by Markit considering the iBoxx EUR Liquid High Yield Index

[6] Bloomberg, considering the World CDS monitor of major banks, as of 4 May 2021

Related blogs

+ An Inflationary Mulligan Stew
+ Time to capitalise on value in Europe

Related products

+ CCBO - WisdomTree AT1 CoCo Bond UCITS ETF - USD

View the online version of this article here.

Important Information