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2024, a year of normalisation and a nice tailwind for credit

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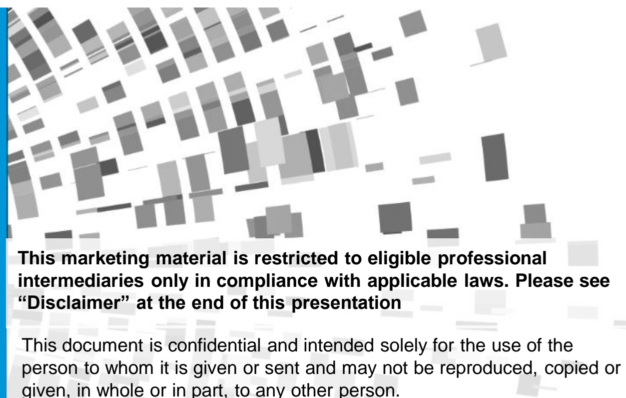

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Macro backdrop

When normalisation becomes the norms… a nice tailwind for credit

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GDP to grow below potential and inflation to further cool down…

- Financials > corporates
- IG > HY

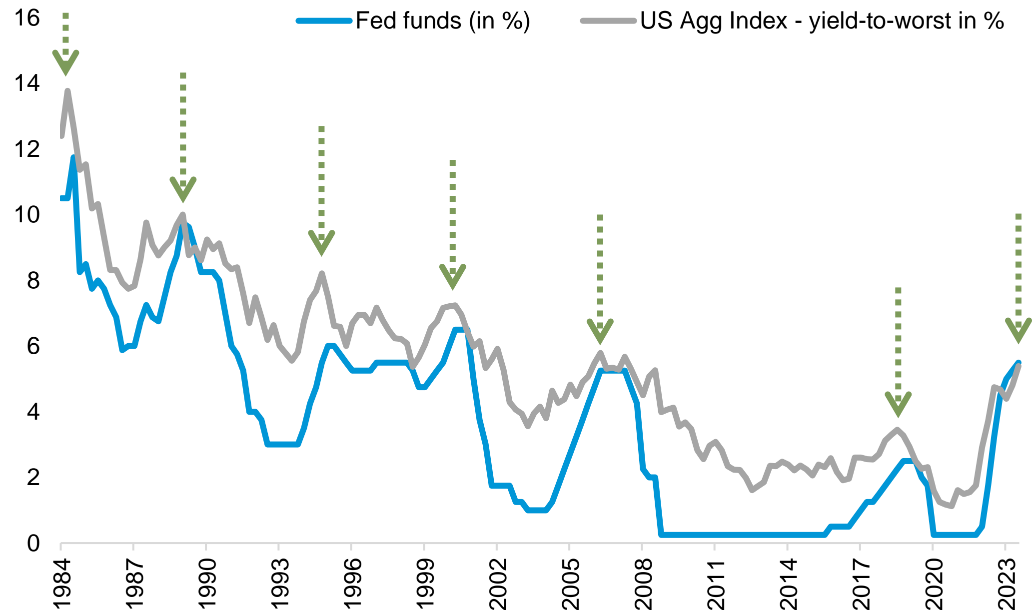
Enabling central banks to cut rates

- Tailwind for credit
- Treasury curve to steepen
- Cash to find its way into fixed income

What could challenge this narrative?

- Inflation, central banks, geopolitics, etc

When to add to credit? When the FED stops hiking…



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Source: Atlanticomnium and Bloomberg, 31 Jan 2024. The views are those of the manager and are subject to change.

Current environment is supportive for financials

Huge earnings buffer to protect bondholders

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A backdrop of higher for longer interest rates

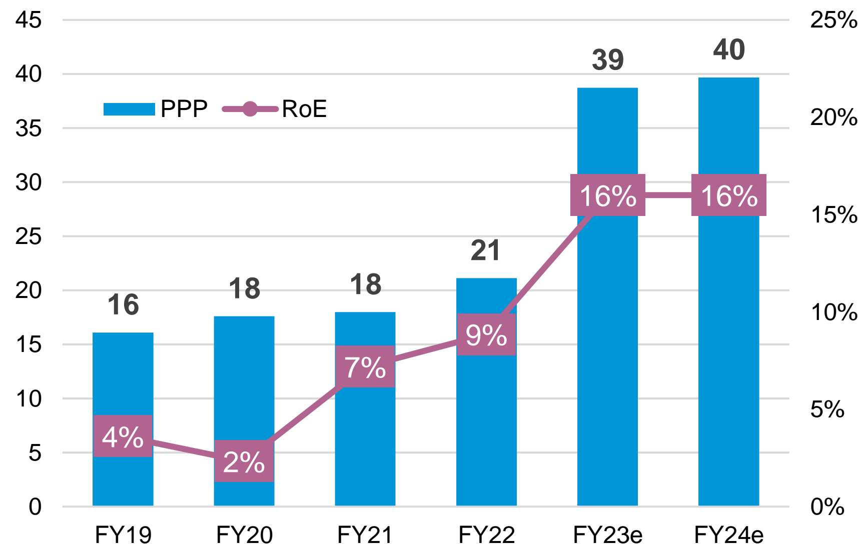
- Good for net interest margins and profitability
- Expected RoE of ~11% for the sector, has doubled since 2021

Is the equity story over? Still a positive catalyst

- For bondholders this is irrelevant, what matters is the extra earnings buffer available
- Higher earnings = higher capacity to absorb losses

What would it take to wipe out HSBC's earnings?

- Pre-provision profits ("PPP") expected to rise to ~$40bn in 2023/2024, compared to ~$19bn over the past 3 yrs
- HSBC's earnings could absorb:
    - ~4x rise in loan loss provisions vs '20 (Covid-19)
    - ~1.5x rise in loan loss provisions vs '09 (GFC)



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Financials as one of the most resilient sectors

Fundamentals are at their strongest in recent history… good for bondholders

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Solvency ratios – all time highs

CET1 increased by 30bps in 2023 to 15.7%, as rising rates boosted banks' profitability (RoE of 10.4%)

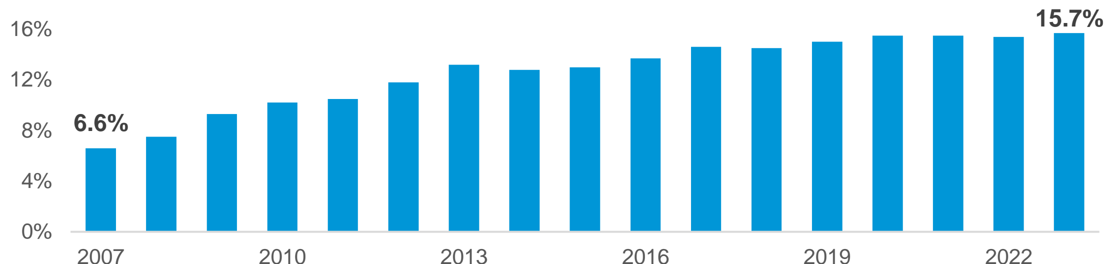
Asset quality – all time lows

NPLs remained stable in 2023 at ca. EUR 357bn or 1.8% of total loans. Cost of risk remains below historical levels at only 46bps

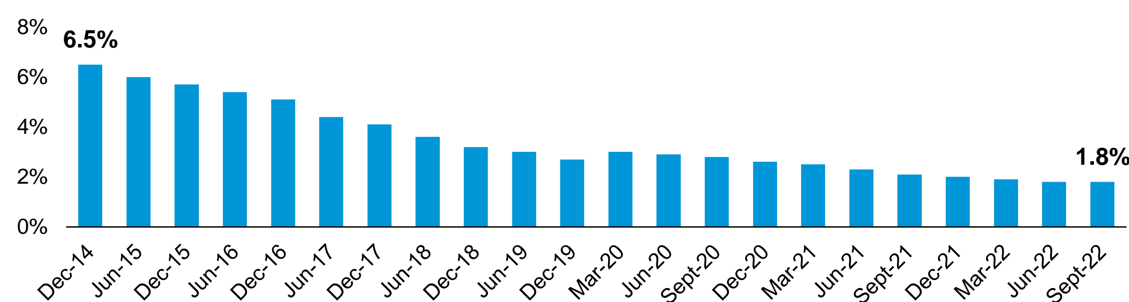
Liquidity – strong

European Banks' average regulatory **liquidity ratios of >160%** vs 100% requirement

Equity buffer i.e. CET1 (%)



Non-performing loans (%)



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Source: Atlanticomnium and Bloomberg, December 2023. CET1 = common equity Tier 1. The views are those of the manager and are subject to change.
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Bank exposures to commercial real estate?

Not a material issue for EU banks

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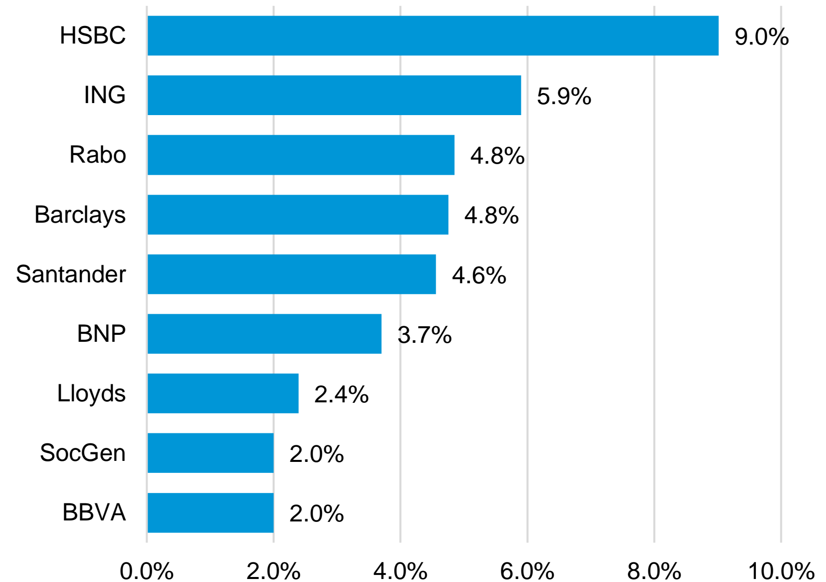
The typical EU bank has low exposure to CRE

- EU banks typically have 5-10% exposure to CRE in their loan books
- Exposures with low LTVs of ~50%
- Well diversified by type of asset and geography (mainly European exposures, limited exposure to the US)
- Strict underwriting criteria, banks typically hold the most secured debt

% of CRE exposure within lending book – Banks in the USD funds' top 10



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Why own subordinated debt

…One of the highest yielding asset class within liquid credit

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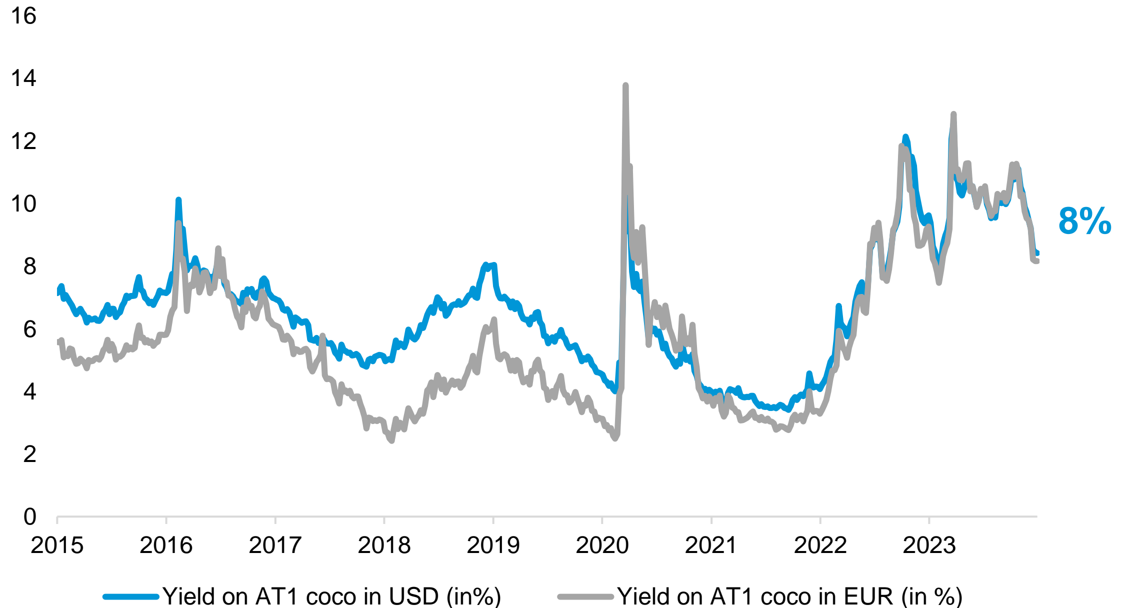
Is 8% the new normal?:

- **Spreads are very wide** and have scope to tighten
- **Rates are very high** and have scope to normalise
- New deals have been coming at very attractive levels i.e. coupons of between 9% up to 10% from strong issuers such as Santander, UBS or Societe Generale

Spreads on subordinated debt are wide



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Opportunity

BNP AT1 CoCo in USD

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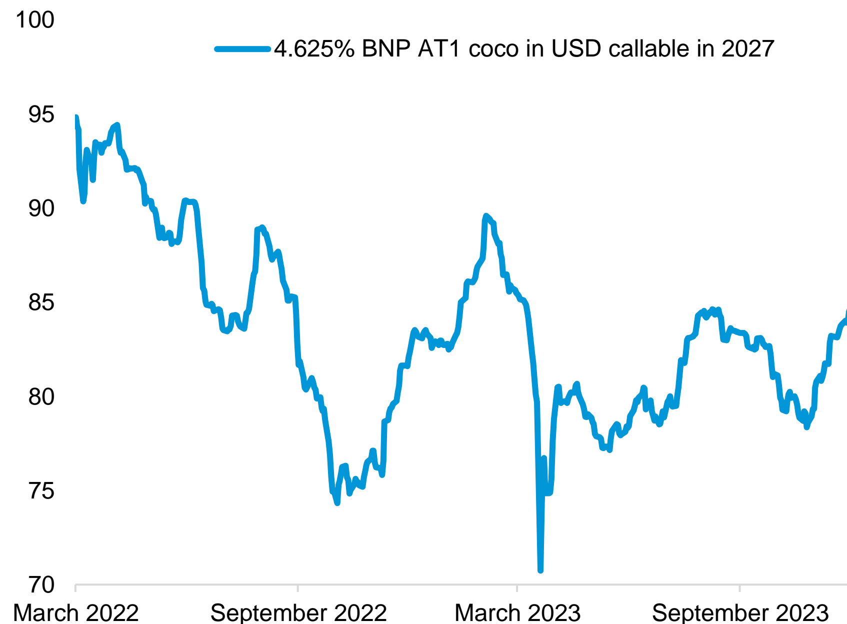
- Bond issued in March 2022. Coupon of 4.625%, spread of 320bps and callable in January 2027
- **Total return since inception of -7.7%** (cumulative coupon 7.3%, price move -15%)
- YTC of 10.1%, spread to call of 600bps
- Bond callable in **three years** and **expected total return of 29%** (income of 14% as well as 15% of price appreciation if called at par)
- Should BNP decide not to call the bond, coupon would currently increase from 4.625% to 7.3%



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Extension risk is currently mispriced

Creating an opportunity for bondholders

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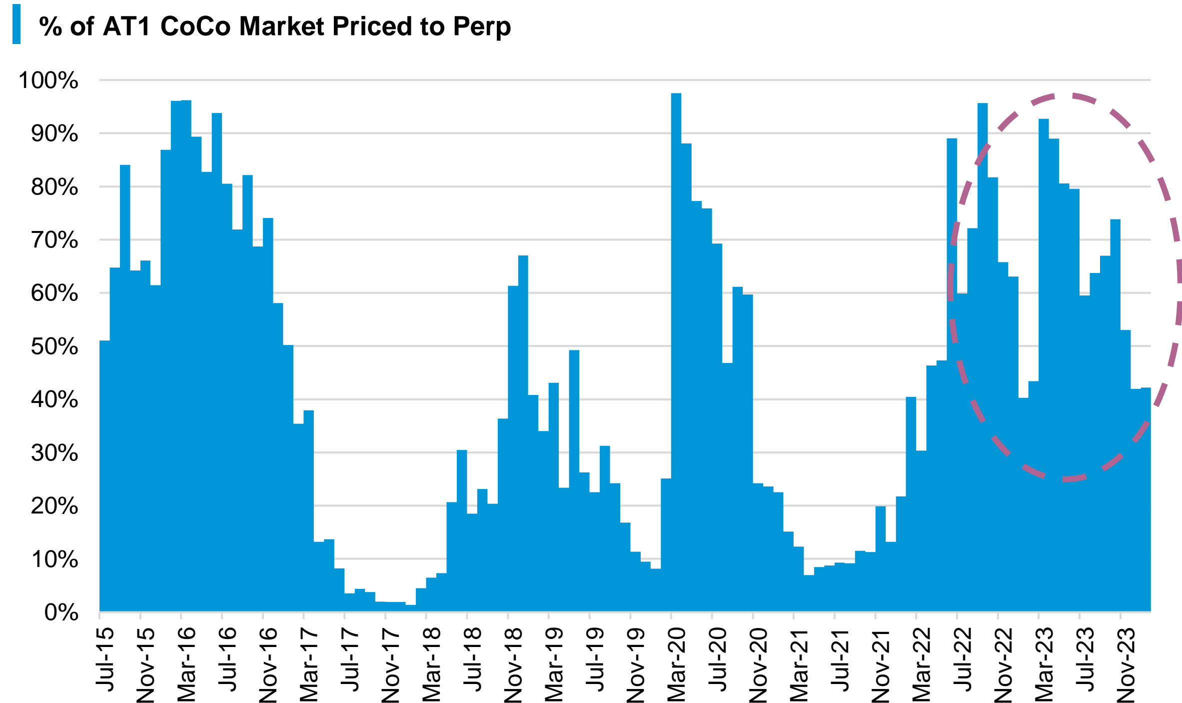
During risk-offs, investors tend to re-price callable perpetuals ***to maturity*** (the so-call extension risk)

- Right now, ***42%*** of AT1 CoCos are priced to maturity vs. a historical call rate of 90%
- Huge ***gap between perception vs. reality***

Implication for investors?
Large upside on a re-pricing to call



Past and current trends should not be relied upon as an indicator of future trends.

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Extension risk

What happens when bond doesn't get called? Taking Santander as an example

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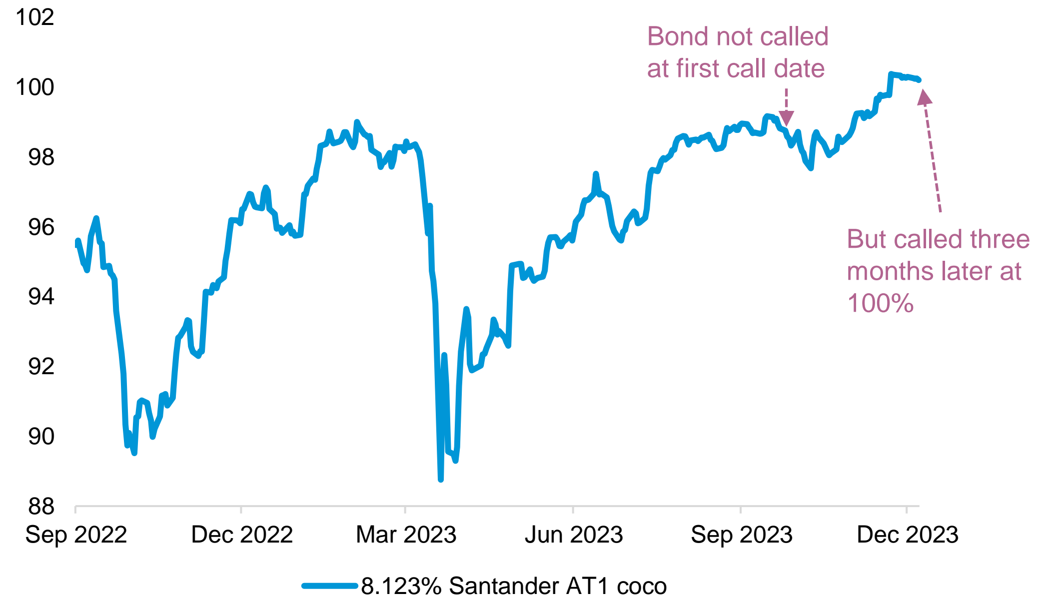
- Investors that bought the bond on the day of the non-call made 10% on an annual basis.
- **Total return in 2023 of 10%** (4% from price appreciation and 6% from income)
- **What happened**: Santander didn't call at first call date its AT1 CoCo in EUR with a coupon of 5.25% (coupon increased from 5.25% to 8.123%)
- Bond was callable on a quarterly basis and Santander called the bond three months later at second call date… so lots of noise for nothing.



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Active management key in sub debt market

Market volatility creates opportunities

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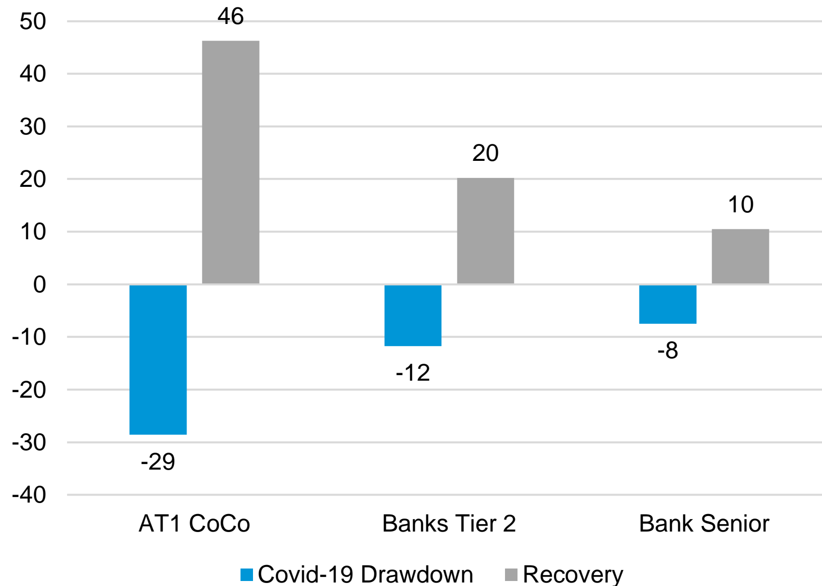
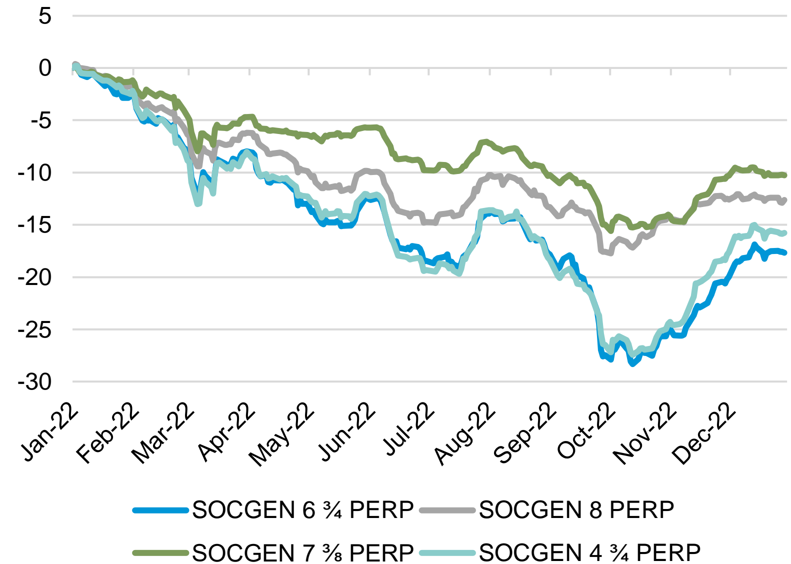
Tactical allocation across the capital structure is key to navigating volatility… (Covid-19)



… so is bond selection! (SocGen AT1 performance in 2022)



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Looking ahead

Fairly obvious mispricing to exploit

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Expect strong performance of sub debt based on current mispricing – capturing high income + spread tightening potential

1

Too much credit risk priced in

Perception: Sub debt must be riskier than High yield, given higher yield

Reality: Credit quality much stronger given IG nature of issuers

2

Strength of the financial sector discounted

Perception: Financials must be vulnerable to a recession

Reality: sector rock solid and with earnings boosted but higher rates

3

Risk of non-call overpriced

Perception: High spreads = higher refinancing costs = majority of AT1s not called

Reality: Bondholder friendly approach and pro-active management of refinancing = >90% called at first call date

Catalyst #1: Strong quarterly earnings from the financial sector

Catalyst #2: Bonds called at first call date

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Source: Atlanticomnium, January 2024.

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Biographies

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Romain Miginiac

Romain Miginiac is portfolio manager of GAM Sustainable Climate Bond fund and Head of Research at Atlanticomnium S.A. Prior to joining Atlanticomnium SA in September 2018, Mr Miginiac was with Aberdeen Standard Investments as a credit analyst covering European financial institutions. Prior to that, he held positions with KPMG and UBS in financial services audit and wealth management respectively. Romain holds a bachelor's degree in economics from the University of Geneva and a master's degree in finance from ESADE Business School. Romain is a CFA® Charterholder and has passed the GARP's Sustainability and Climate Risk Certificate as well as CFA's Certificate in ESG investing. He is based in Geneva.

Gregoire Mivelaz

Gregoire Mivelaz is a Fund Manager and a member of Atlanticomnium's Management Committee. He joined Atlanticomnium in 2009 and co-manages the GAM Credit Opportunities and GAM Climate Bond strategies. Gregoire has over 20 years' experience in bond markets, both on the buy as well as sell-side, having held various positions such as Head of Credit Research as well as Credit Analyst. Gregoire graduated from the University of St Gallen and holds a BA in Finance and Capital Markets, an MA in Economics and is a CAIA Charter Holder as well as holds the CFA UK Certificate in ESG investing. He is based in Geneva.

Patrick Smouha

Patrick Smouha, who joined Atlanticomnium in 2012, is co-managing both GAM credit opportunities strategies and GAM Sustainable Climate bond fund alongside existing managers Anthony Smouha and Gregoire Mivelaz. Prior to this Patrick was assistant fund manager, where he covered portfolio analysis and also developed a deep understanding of companies and individual bond features. He has been a member of Atlanticomnium's Investment Committee since 2016. Patrick holds a BSc in management from the University of Lausanne (HEC) and an MSc in finance from the University of Geneva (HEC). Patrick holds the CFA UK Certificate in ESG investing.

Source: Atlanticomnium.

Biographies

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Yi Qian

Yi Qian is a Credit Analyst at Atlanticomnium S.A., covering financial institutions and real estate companies. Prior to joining Atlanticomnium in December 2019, Yi had worked as credit analyst at Investment & ALM department at AXA Group for over four years. She had provided credit opinions on global financial institutions with deep knowledge of different banking systems. She holds a MSc specialising in Quantitative Economics and Finance from HEC Paris and is a CFA Charterholder with a Certificate in ESG Investing issued by CFA UK. She is based in Geneva.

Anthony Giret

Anthony Giret is a Credit Analyst at Atlanticomnium S.A. Prior to joining Atlanticomnium in June 2020, Anthony worked for seven years as a credit analyst at Spread Research, an independent credit research firm and credit rating agency. He was mostly covering corporate bonds in the European high yield market. He holds a master's degree in finance from IAE Lyon, and also attended the Copenhagen Business School and Ottawa's Carleton University as an exchange student. He is based in Geneva and holds a CFA Charterholder.

Source: Atlanticomnium.

Client coverage

GAM Investments

Philip Rosenberg

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Philip Rosenberg is Managing Director and Head of Distribution - Middle East. He looks after institutional, private wealth, and wholesale relationships across the region. Phil has been involved with asset management distribution for over 33 years, including fixed income, equities, and alternatives. He joined GAM Investments in 2010 and has been closely connected to the firm since 1998. Before joining GAM, Phil was an Executive Director at Julius Baer, in the Middle East team. He also worked at EFG Bank advising clients in the US, Middle East, and the UK. Prior to this, he held senior distribution and marketing roles at Liberty Ermitage, and Credit Lyonnais. Phil started his career at Lehman Brothers in 1989 where he was a pioneering member of the alternatives investment team. He studied sound engineering and music technology and holds CFA UK Certificate in Investment Management (IMC) and CISI Level 6 qualifications. He is based in London.

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