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GAM CREDIT OPPORTUNITIES STRATEGY

GAM OUTLOOK 2024

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Subordinated debt – A clear dislocation between fundamentals and valuations

After a choppy 2023, marked by chaos in the US banking sector and the acquisition of Credit Suisse by UBS, global bond markets have suffered a big drop, as investors adjust to the reality of prolonged high interest rates. Bondholders can benefit from high levels of carry - 10.9% yield to call on European banks' Additional Tier 1 (AT1) Contingent Convertibles (CoCos) and convexity given potential for spread tightening and as bonds get called at par. Despite short-term turmoil, we believe the current market dislocation is indeed presenting an attractive entry point in subordinated debt markets, especially for high yielding assets with solid fundamentals.

Strong fundamentals

Fundamentals have never been as supportive for bondholders – big banks had strong Q3 earnings, signified by 'ugly', 'bad' and 'good' features. The 'ugly' feature is that earnings may have already peaked at decade high double-digit return on equity (ROE). The 'bad' is capital stagnation around all-time highs – more than EUR 500 billion excess capital. The 'good' is the stubbornly benign loan loss provisions and non-performing loans (NPLs) – the credit quality of the sector is undoubtedly strong.

Attractive valuations

The strength of the European banking sector is not adequately reflected in the current valuations, in our view. With around 530 bps of spread between option-adjusted spread (OAS) and treasury (circa 11% yield to call), it is hard to find a lens through which AT1s do not screen well. AT1s currently offer circa 100 bps (1%) spread pick-up to high yield and to US bank preferred stock – around the highest differential seen over the past decade. On top of high income, this is a first leg of potential price upside, as there is high potential for spread tightening.

Convexity and call advantages

Investors can potentially benefit from significant convexity, which is how bond prices and yields change in a non-linear way when interest rates fluctuate, as market fears of extension risk lower prices further. Around two-thirds of AT1s are still priced to perpetuity, reflecting fears around issuers' ability to refinance bonds. Non-calls remained the exception in 2023, with over 90% of AT1s redeemed at their first call date (circa USD 111 billion out of USD 118 billion). We believe bond redemption will remain a supportive feature of the market in 2024, with at least 80% of AT1s expected to be called even at our most conservative expectation. In our view, many upcoming calls in 2024 are already safe because some AT1s had been pre-financed and could be replaced at a similar or lower cost. On top of this, adding the willingness from most European banks to pay some incremental cost, and banks' ability to call without refinancing by using excess capital, leaves limited call uncertainty.

The case for financial subordinated debt remains intact in our view, with a clear dislocation between fundamentals and valuations. The 'status quo' catalyst – ongoing strong earnings from the sector in upcoming quarters and bonds called at par – supports a normalisation of spreads. While investors in AT1s tend to benefit from high carry, potential for spread tightening and bonds re-pricing to call leaves the door open for price appreciation and solid overall total returns looking at the next 12 to 24 months.

Source: Bloomberg, Atlanti. All data as of 31/10/2023.

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Read the full Outlook:

GAM Investments

GAM CREDIT OPPORTUNITIES STRATEGY

A reliable income from investment grade companies

Marketing Material: Not for US investors

The strategy seeks to capture a high and steady income by investing in bonds from high quality European Financials, with a focus on subordinated debt to capture higher yields. Despite a challenging market environment, the credit quality of the strategy's issuers continues to be robust and financials remains one of the strongest sectors within credit markets.

Having successfully managed the strategy since 1985, Atlanticomnium S.A., which has the longest track record within the asset class, is well-placed to benefit from investing across the capital structures of banks, insurers and corporates.

Why Invest?

- Low sensitivity to rates - The portfolio is constructed to have low sensitivity to rates, by allocating mainly to fixed-to-floating bonds – where coupons are adjusted to interest rates when bonds are not called. Historically the strategy's sensitivity to rates has been very low.
- Regulation is a strong credit positive – Regulators have drastically re-shaped the European financial sector, now one of the most resilient after capital has tripled and the sector has been extensively de-risked. European regulators are extremely conservative, committed to ensure financials are the safest sector – de facto acting in subordinated debt holders' interests.
- High yield returns for investment grade risk – By investing in subordinated bonds, investors capture high income from investment grade companies. Subordinated debt provides a significant pick-up in yield compared to senior debt of the same issuer – with no increase in default risk.

Investment Team

The strategy is managed by Atlanticomnium S.A., an independent Geneva-based fund management company, which has specialised in credit investing since it was founded in 1976. The primary source of added value for the portfolios is the bottom-up credit selection ability of the managers and their familiarity with junior debt.

Strategy managers, Anthony Smouha, Gregoire Mivelaz, Patrick Smouha and Romain Miginiac have many decades of combined investment experience. The primary source of added value for the portfolios is the bottom-up credit selection ability of the managers and their familiarity with junior debt.

Strategy AUM of EUR 1.8 billion

Alpha Manager Rating – Anthony Smouha, FE FundInfo 2023

The strategy enables access to some of the best opportunities in bonds from banks and insurance companies, as well as corporates

Strategy classified as SFDR article 8 encompassing ESG integration and sustainability exclusions

EUR, CHF, GBP, USD, AUD, ILS and SGD classes are available

Online Strategy Page

For more information, please visit GAM.com

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