INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

GAD

3 December 2013

MONTHLY UPDATE

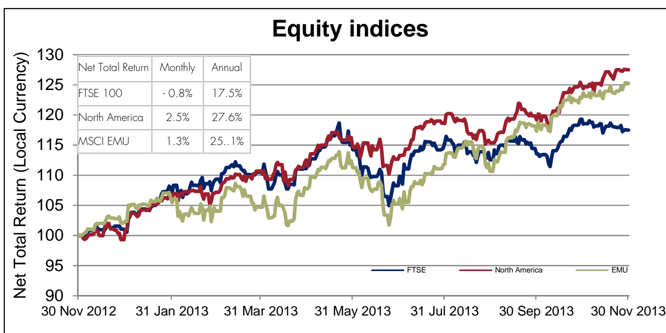
Overview

The Bank of England (BoE) has reiterated that it is unlikely to raise interest rates in the near future despite unemployment rates falling to 7.6% in Q3. However, the monetary policy committee now attributes over a 40% probability to unemployment falling below the 7% threshold before 2015. The BoE also revised up its estimate for GDP growth in 2013 by 0.2% to 1.6%. The BoE's Systematic Risk Survey shows Britain's financial institutions are more worried than ever about a potential interest rate shock, with 43% of respondents citing it as a 'key risk' to the economy.

In the eurozone, the European Central Bank announced a surprise 0.25% cut in their key interest rate to 0.25% as eurozone inflation fell to 0.7% in October and there were increasing worries about deflation in some countries. Ratings agency Standard and Poor's (S&P) lowered France's credit rating one notch from AA+ to AA, criticising high taxes and lengthy structural reforms. The S&P also downgraded the Netherlands from AAA to AA+, leaving only Germany, Luxembourg and Finland in the eurozone with S&P's top rating. However, S&P did note the economic outlook for Spain had improved.

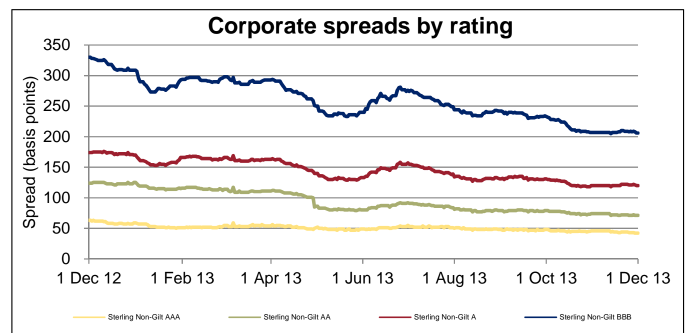
In the US, CPI declined by 0.1% in October and rose by only 1.0% in the 12 months to October. US GDP expanded at a faster than forecast annualised rate of 2.8% in the third quarter; however, some analysts speculate that the growth was driven by an increase in inventories that could impact on fourth quarter growth.

Overseas equity markets rose over the month



Net Total Return	Monthly	Annual
FTSE 100	- 0.8%	17.5%
North America	2.5%	27.6%
MSCI EMU	1.3%	25..1%

Credit spreads were largely unchanged over the month

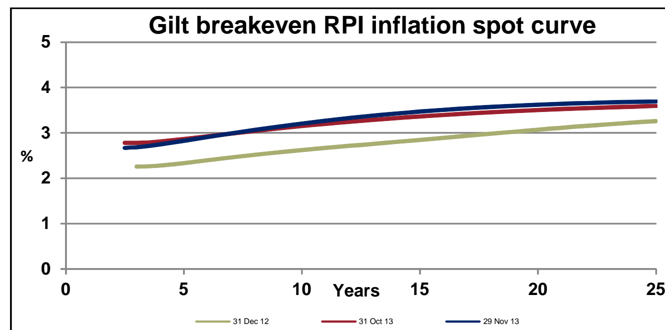


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase October (%y/y)	2.2%
Halifax house prices Oct (%m/m)	0.7%
IPD TR property index Oct (%m/m)	1.1%
PPF 7800 funding ratio end Oct	93.8%
VIX (volatility) index	13.7
$/£ exchange rate	1.64

Numbers as at the end of month unless stated

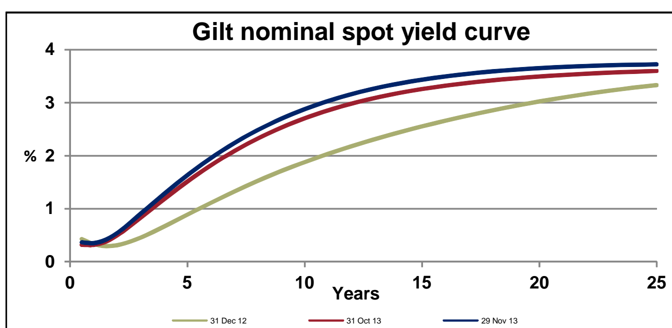
Breakeven inflation increased marginally this month



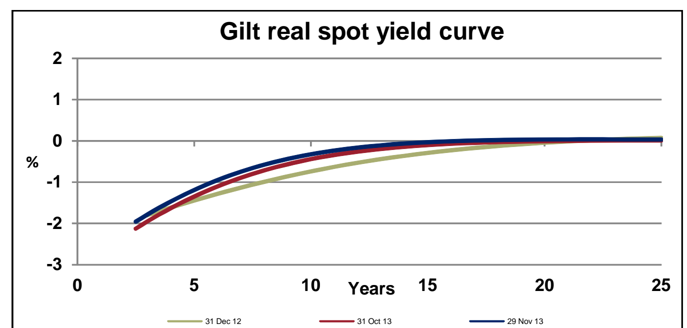
CALENDAR OF EVENTS AND DATA RELEASES

Autumn Statement 2013	5th Dec
MPC interest rate announcement	5th Dec
RPI / CPI	17th Dec
Labour Market Statistics	18th Dec
Minutes of MPC meeting	18th Dec
UK Current Account, GDP and Public Sector Finances	20th Dec
UK GDP (Q3 3rd est.)	21st Dec

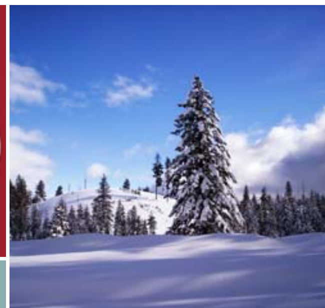
Nominal yields have increased slightly this month



Real yields increased marginally this month



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.



Contingent Convertible Bonds—A new type of asset

What are contingent convertible bonds?

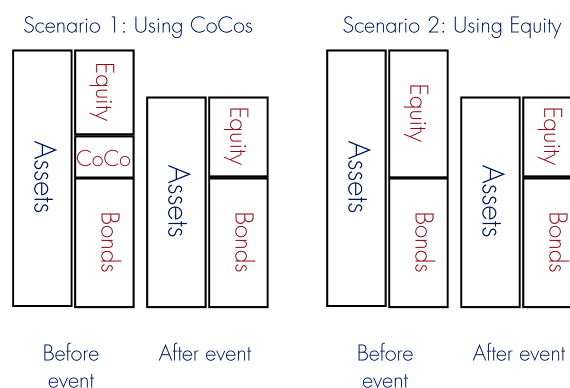
Contingent convertible bonds (or 'CoCos') are a type of convertible bond whose conversion is triggered by a specific criterion such as a change in the issuing company's share price or capital ratio. Once triggered the bond may convert into equity, change its principal value or be written off entirely. As CoCos can be structured so that they convert in the event of a deterioration in financial health, they are increasingly issued by banks as a loss absorbing form of capital to protect more senior bondholders and depositors.

Why are banks issuing contingent convertible bonds?

Banks are subject to regulatory capital requirements which aim to ensure that they have sufficient assets in times of distress to ensure depositors are protected. Following the financial crisis, these requirements have been reviewed in an attempt to avoid situations where the taxpayer has to step in and support large financial institutions. Since 2009, there has been a significant increase in the issuance of CoCos by banks in Europe. This has been driven by the banks' need to increase the capital they hold and the regulatory treatment of CoCos. Issuing CoCos allows banks to increase their capital ratios and more easily meet regulators' stress tests without the need to dilute their shareholders' holdings. There has been a record issuance of CoCos by European banks this year and this is expected to increase even further next year due to regulatory changes (ie Basel III).

However, there are some complications for financial institutions issuing CoCos. Investors are likely to demand a higher return to compensate for the additional risk and these instruments are likely to be complicated and time consuming to design and implement, especially as the regulatory and tax treatment of CoCos varies between different jurisdictions.

Box 1— CoCos vs. Equity



The diagram above shows how the debt structure of a financial institution would be affected after an event which triggers the conversion of CoCos to equity. We can see that the level of debt is unchanged before and after the event. In Scenario 1 the CoCos are converted to equity and the value of equity, including converted equity, falls in line with the assets. In Scenario 2 there is no conversion and the equity value also decreases. The net result from both scenarios is the same levels of equity and debt. Hence, with appropriate trigger levels, regulators consider CoCos as equity-like capital.

From an investor's perspective

In this low interest rate environment, the key attraction to investors is the high yield provided, with some issues yielding 8%. CoCos offer fixed returns and would normally be expected to provide lower variance of returns than equities. However, CoCos do come with high tail risks and some commentators suggest that CoCos offer the downside risk of equity investments without the potential upside. Some issues result in a complete capital loss in the event of a conversion being triggered, reversing the typical capital structure whereby bondholders would expect to lose less than equity investors. Alternatively, if CoCos are converted to equity, it is likely the underlying reason for conversion (e.g. low capital levels) will also have caused the equity price to fall.

There are many different CoCo structures and also differences in regulatory regimes. This heterogeneity and difficulty in assessing the likelihood of conversion has resulted in an absence of credit ratings, with more than half remaining unrated. The lack of credit ratings can make their inclusion in traditional mandates difficult. Although CoCos may provide some diversification benefits, the returns are likely to be correlated to other bank-issued instruments and wider equity markets. Their return profile may be particularly ill-suited to institutions such as insurance companies who need to mitigate tail risks and have their own capital requirements.

Sovereign contingent debt

It is not only for banks that CoCos are being considered. Recently, the Bank of England published a joint paper[1] with the Bank of Canada intended to spark a debate about the best approach to sovereign debt; this discussed the possible introduction of sovereign contingent bonds. This paper argued that the current issuance of bonds is suboptimal for a number of reasons. These include the risk of moral hazard and that the current system puts 'inequitable amount of tax-payer resources at risk'. To mitigate these risks they suggest two complementary types of state-contingent bonds: sovereign CoCos that will automatically extend repayment maturity if a trigger is reached; and GDP-linked bonds where coupon payments are linked to a country's level of nominal GDP. However, some commentators have argued that issuing sovereign contingent debt will increase the cost of borrowing, particularly for nations which are seen as 'riskier'. Further, linking coupon payments to GDP may encourage 'short-termism' in the government bond market, where unsustainably high GDP growth may be sought in the short term.

[1]http://www.bankofengland.co.uk/publications/Documents/fsr/fs_paper27.pdf

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