

Recent trends in the CoCo bond market

Published August 15, 2024

Ayush Babel

Director, Quantitative Research

Prof. Wim Schoutens

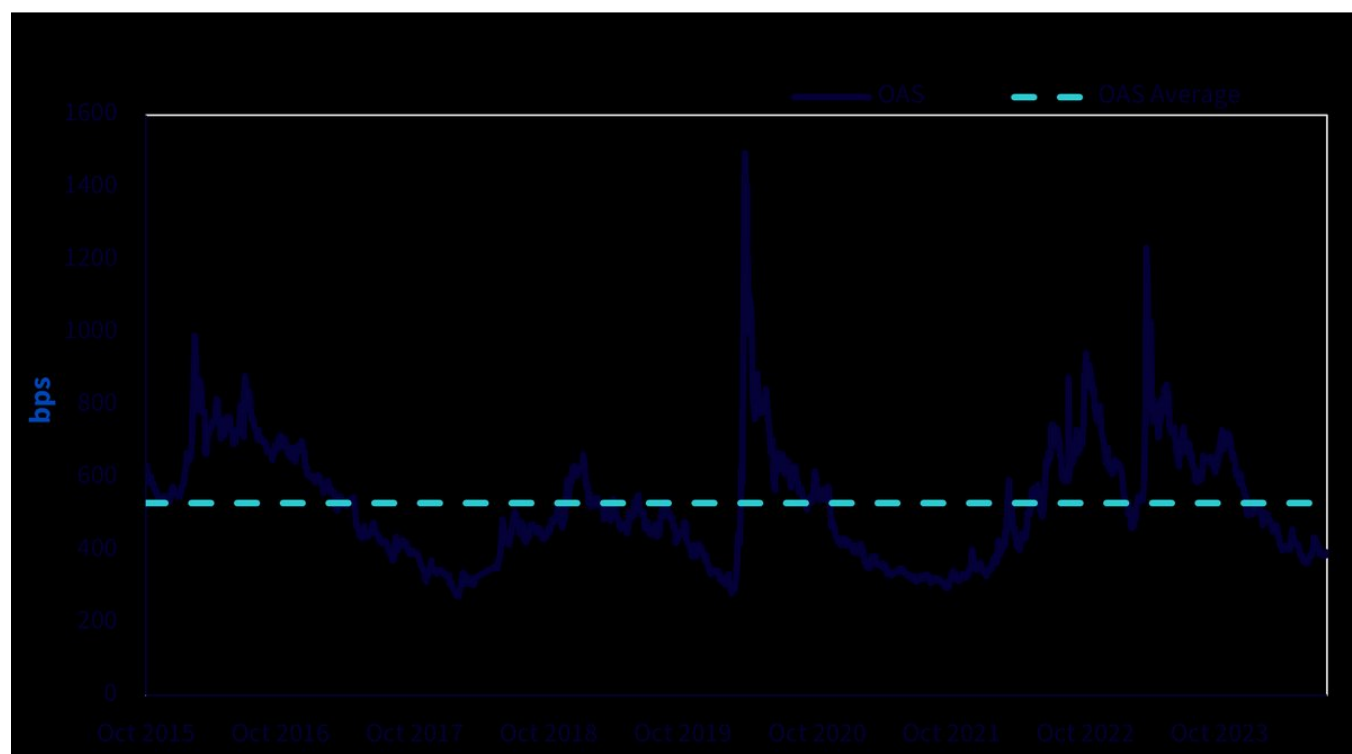
Professeur à l'Université de Louvain, en Belgique

Key Takeaways

- In recent weeks and months, the Contingent Convertible (CoCo) bond market has experienced notable tightening in spreads, approaching historical lows.
- One of the primary drivers behind the tightening spreads of CoCo bonds is the consistent action of issuers calling these bonds at par (price 100). This practice has created a strong "pull to par" effect, encouraging prices to converge towards their face value.
- The absence of significant adverse macroeconomic effects and a favourable monetary policy for banks have further supported the tightening of spreads.
- Related Products [WisdomTree AT1 CoCo Bond UCITS ETF - USD Acc](#) Find out more

In recent weeks and months, the Contingent Convertible (CoCo) bonds market has experienced notable tightening in spreads, approaching historical lows. This trend reflects several market dynamics and external factors influencing investor behaviour and market sentiment.

Figure 1: Historical OAS



Source: WisdomTree, Markit. Period from 01 October 2015 to 23 Jul 2024. **Calculations include backtested data.** OAS is the option-adjusted spread reported by Markit and is based on the effective duration-adjusted market value weighting. Workout dates used in the OAS calculation of individual bonds are reset at the end of the month in case the bonds are not called. This calculation approach impacts the OAS figures for the index intramonth until the workout dates are reset. The strategy is represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 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.**

Tighter spreads and pull to par effect

One of the primary drivers behind the tightening spreads of CoCo bonds is the consistent action of issuers calling these bonds at par (price 100). This practice has created a strong "pull to par" effect, encouraging prices to converge towards their face value. Issuers' reliability in calling these bonds has reassured investors, contributing to the recovery in prices observed since the Credit Suisse event last year.

Impact of the Credit Suisse event

The Credit Suisse event had initially caused significant market disruption, leading to a widening of spreads and a drop in bond prices. However, the subsequent recovery in CoCo bond prices indicates a resilient market response. The steady call actions by banks, both large and small, have restored confidence among investors. This regularity in calling bonds, post-Credit Suisse, underscores the stability and attractiveness of CoCo bonds as a financial instrument.

Macro effects and market sentiment

The absence of significant adverse macroeconomic effects has further supported the tightening of spreads. While there was some spread widening due to uncertainty surrounding the French elections, this was quickly reversed, illustrating the market's capacity to absorb political uncertainties without long-term adverse impacts. The swift recovery following the French election uncertainty highlights the robustness of the CoCo bond market in the face of potential macroeconomic disruptions.

Issuer behaviour and market recovery

Post-Credit Suisse, most banks have resumed their regular calling schedules, reinforcing the market's stability. Notable exceptions include Raiffeisen International, which faces challenges due to its exposure to Russia, and PBB and Aareal Bank, which are affected by concerns related to commercial real estate (CRE) exposures. Despite these exceptions, the overall trend of regular calls has significantly contributed to the market's recovery and the tightening of spreads.

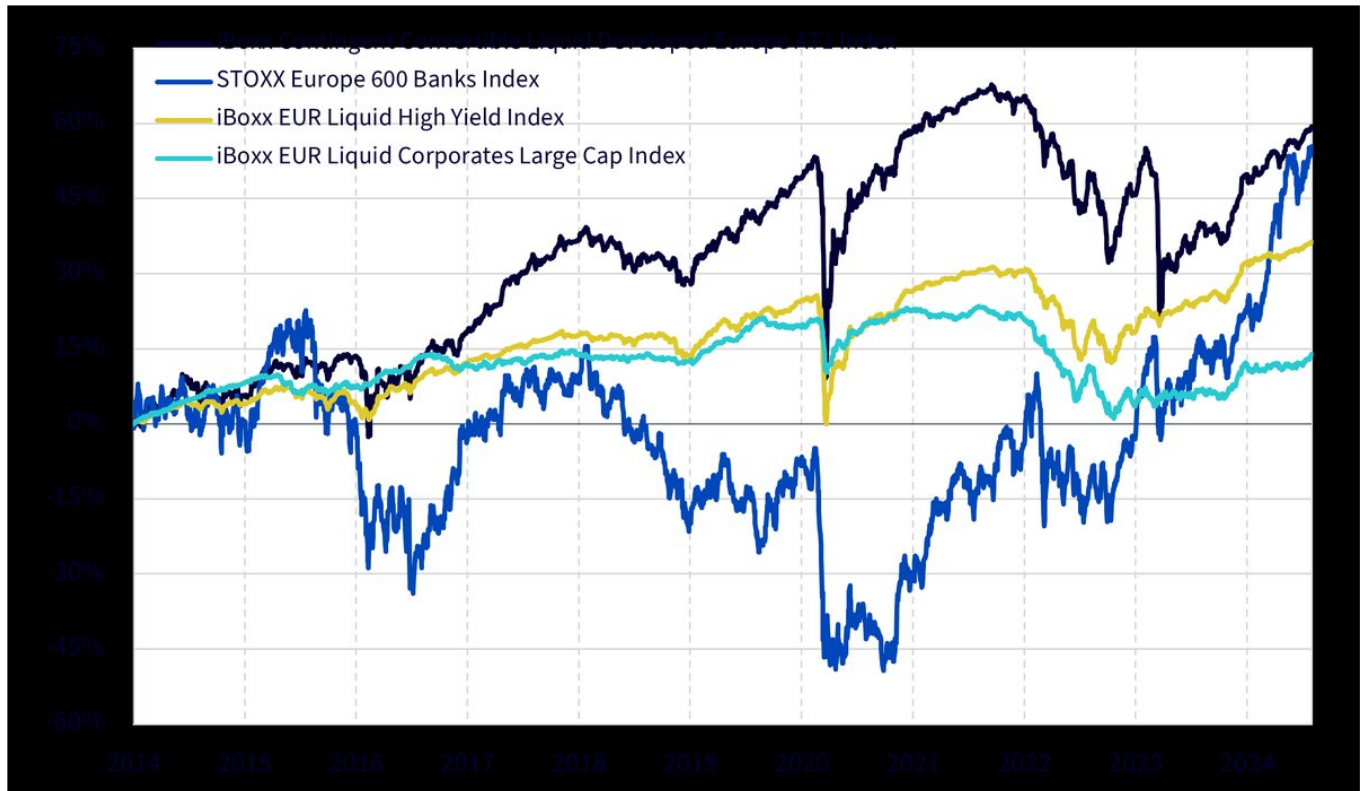
Higher interest rates

The primary mechanism through which banks profit is the spread between the interest they pay on deposits and the interest they earn on loans and investments. As interest rates rise, banks are generally able to charge disproportionately more for loans compared to the interest they pay to account holders, which can significantly enhance their interest income. This environment has been particularly beneficial in recent years, as central banks across major economies have hiked rates to combat inflation and stabilise financial markets. For banks, higher interest rates have directly supported return on equity (ROE) by widening the interest margin. This favourable interest rate regime has also contributed to the tightening of spreads.

Conclusion

The recent trends in the CoCo bond market are characterised by a notable tightening of spreads, driven by the consistent behaviour of issuers calling bonds at par, the recovery of prices following the Credit Suisse event, a favourable monetary environment and the absence of significant adverse macroeconomic effects. As issuers continue to call bonds and market confidence remains strong, the CoCo bond market is poised to maintain its stability and attractiveness to investors, even in the face of occasional uncertainties. It is notable that AT1 CoCos have maintained their outperformance over other comparable asset classes since their inception and have also witnessed much lower volatility than the STOXX Europe 600 Bank Index.

Figure 2: Cumulative returns



Source: WisdomTree, Bloomberg. Period from 31 December 2013 to 30 Jun 2024. Based on returns in EUR. All fixed income indices are total return indices; all equity indices are net total return indices. **Performance includes backtested data.** Performance of the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index is based on the EUR-hedged version of the strategy. The iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (EUR Hedged) started its live calculation on 09 March 2018. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

Important Risks Related to this Article

Important Information

Marketing communications issued in the European Economic Area (“EEA”): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as “WisdomTree” (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.