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Update on the subordinated debt market

Overview of events since Santander episode

October 2019

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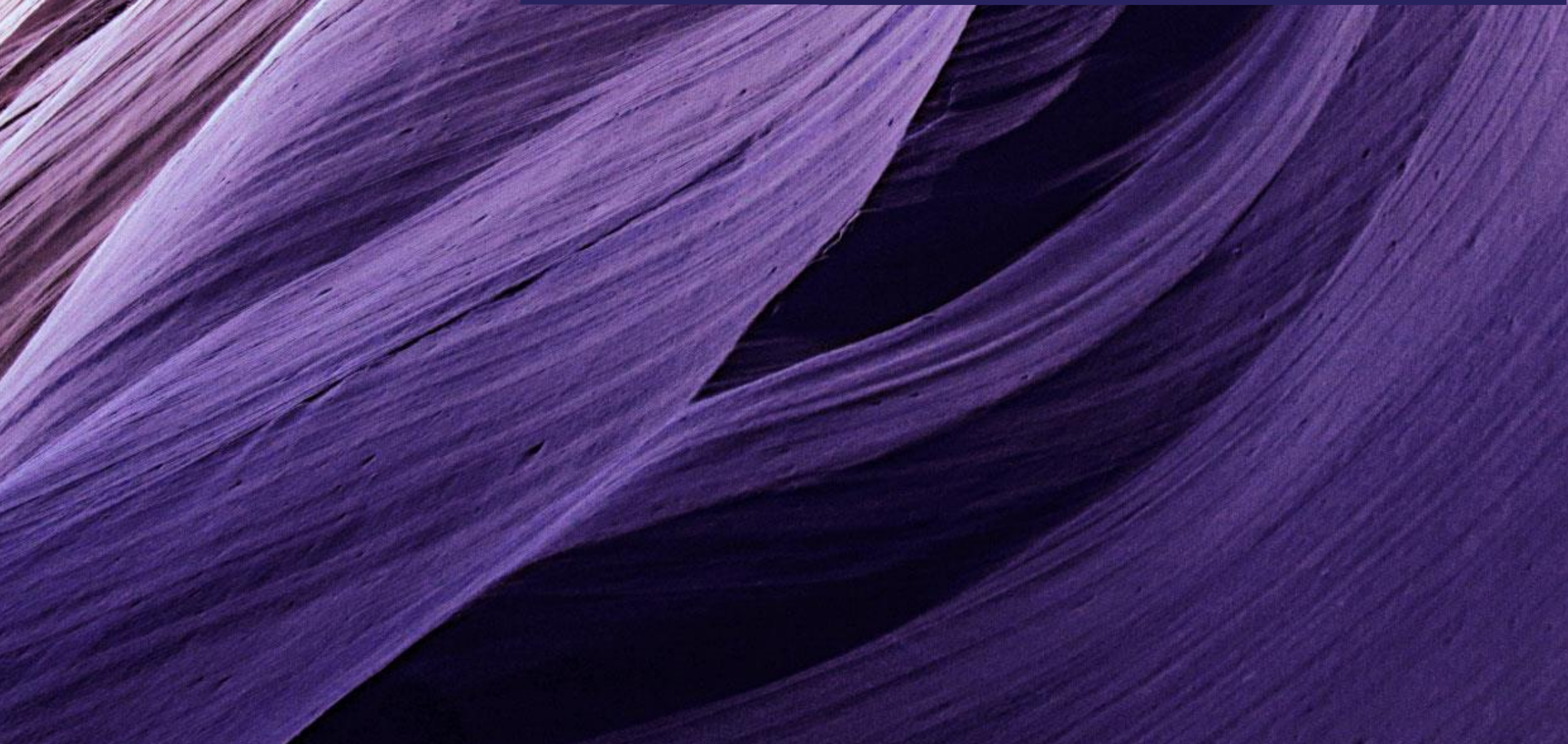


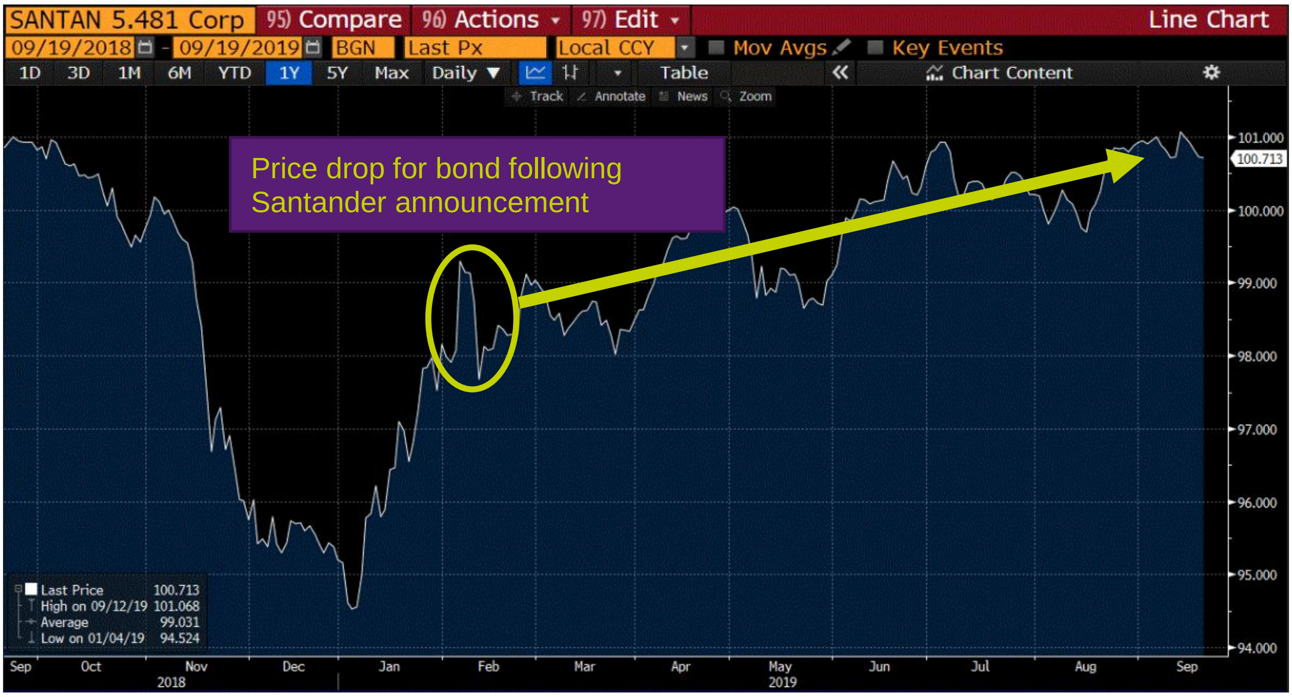
UPDATE ON THE SUBORDINATED DEBT MARKET

We outlined some quick thoughts on subordinated debt in early March following Santander's announcement that it would extend and not call its contingent convertible additional tier one bond (CoCo AT1 bond), which was due to be called in March.

The CoCo/AT1 secondary market remained resilient, with no downward pricing pressure, and similarly, there was no impact on the primary market either.

This specific event is a good reminder that calls for coco AT1 bonds must be assessed on an issuer-by-issuer basis, and it is worth remembering that all issuers have since met their call obligations.

1-year price trends for Santander's Coco AT1 5.481% bond



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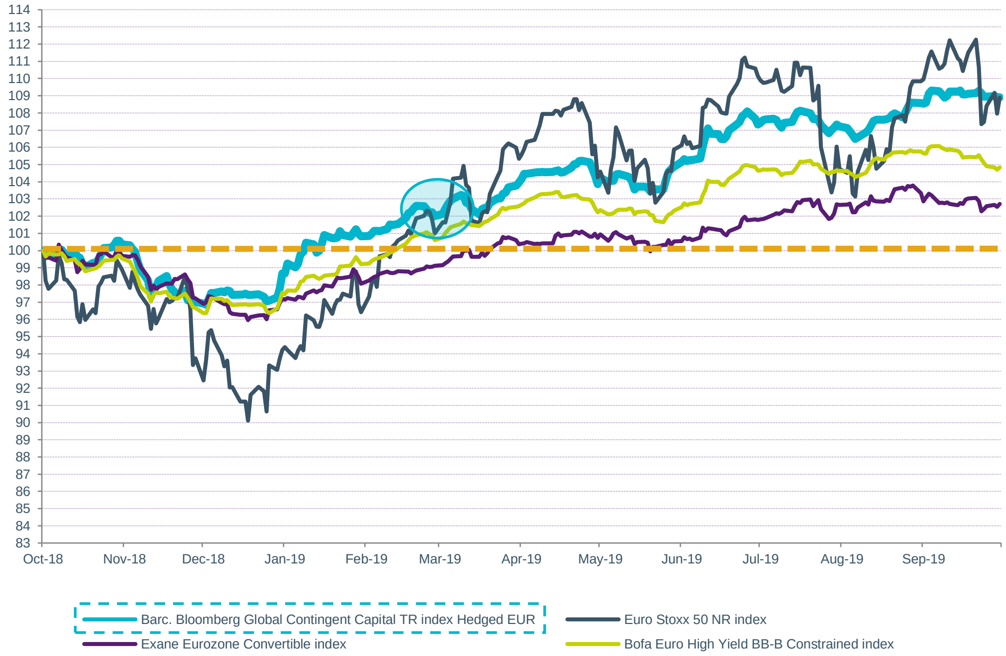
Since this event, the CoCo AT1 bond market has taken advantage of the decrease in credit spreads over recent months, as well as strong carry:

Comparison between Coco AT1 bonds and other asset classes

Cumulative performances over a year



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The asset class' various segments have continued to perform well since the start of the year:

Name	YTD	1M	3M	6M	1Y	3Y
Euro IG Credit - Barclays	6,65%	-0,11%	0,91%	3,11%	6,27%	7,08%
Euro HY Credit - BofaML	8,49%	-0,76%	0,25%	2,2%	4,86%	13,29%
Euro Non-Financial Sub Debt - BofaML	10,95%	0,08%	1,36%	5,06%	8,08%	16,71%
Euro Financial Sub Debt & LT2 - BofaML	9,2%	-0,15%	1,22%	4,2%	8,13%	14,79%
Euro Subordinate Insurance - BofaML	12,44%	-0,07%	1,78%	5,42%	10,97%	21,56%
Global CoCo AT1 - Euro Hedged - Barclays	11,76%	0,34%	1,39%	4,57%	8,92%	22,33%
Eurozone Convertible Bonds	6,73%	-0,63%	0,91%	2,34%	1,87%	10%
Euro Stoxx 50 NR	17,94%	-1,24%	-1,18%	2,86%	8,59%	23,1%

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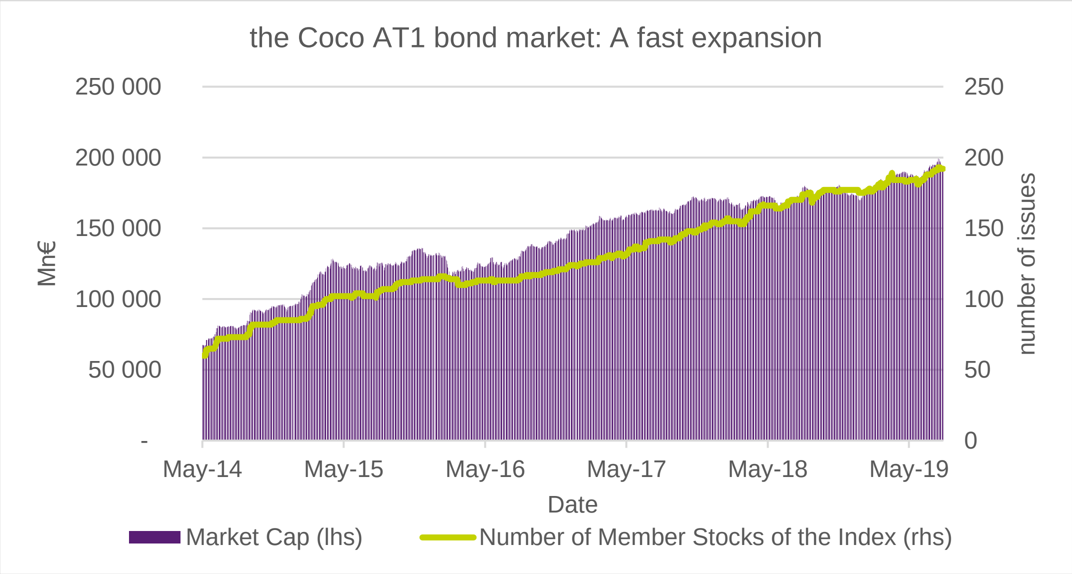
THREE MAJOR SUBORDINATED DEBT THEMES

I. Contingent Convertible Additional Tier 1 (Coco AT1) bonds boast positive technical factors

The situation has changed on the financial subordinated debt market: after seeking to meet their financial ratio targets required by regulation (Basel III) for several years, most of the main European banks have now achieved this goal.

Banks therefore no longer need fresh subordinated debt issues, unless they are simply renewing the stock already issued, and this is particularly true for AT1. The AT1 market developed in 2014, and grew to reach a hefty €200bn by end-August 2019.



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Coco AT1 bonds were extremely successful with banks as they provide a substantial capital influx while not diluting, unlike stocks.

We think that growth in this figure should slow and stabilize over the months ahead, unless new smaller banking players appear on the market. This should act as a positive technical factor for subordinated debt, and particularly for AT1 as issues are set to remain limited on the one hand, while investors continue to hunt down yield in today's negative interest rate environment on the other hand.

II. Corporate hybrid bonds – a high-quality market

Here at Ostrum AM, we feel that the hybrid bond market is still particularly attractive for three reasons:

- The market is still dominated by investment grade companies with solid fundamentals such as Engie, Volkswagen, Telefonica and even CK Hutchison. So investors can lock in additional yield resulting from the bonds' subordinated status while maintaining the same issuer risk.

- Hybrid debt remains a vital source of long-term refinancing, as it provides increased leverage capacity and distinctive tax advantages to companies. Ratings agencies see the asset as half debt/half capital and it has no dilutive impact, unlike stocks. **The advantage for investors is that issuers have an incentive to call their hybrid bonds right from the first call date**. When the bond is not called after five years, these tax advantages may disappear, and the hybrid bond is booked as 100% debt on the company's balance sheet.

- The ECB's renewed investment grade corporate sector purchase program (CSPP) along with the negative interest rate environment – even on the credit market – should attract investors on the hunt for yield.

We are also keeping a close eye on a new trend on this market – the issue of hybrid corporate green bonds. Ostrum AM remains a leading investor in this segment with almost €20 million invested in issuers such as Engie (electricity supply, France), Iberdrola (electricity supply, Spain), Tennet (electricity transmission, Netherlands), or even Orsted (energy generation and supply, Denmark). In our view, this is an attractive opportunity to support the development of responsible investment, while continuing to safeguard yield.

III. Taking positions on market declines

Market sentiment has a considerable effect on the subordinated debt market, and particularly AT1 bonds, which are the most volatile subordinated debt segment. We believe that **corrections can be real opportunities to take positions** on this type of bond, as the issuers have a solid profile in terms of both fundamentals and technical factors.

OSTRUM AM'S OUTLOOK FOR THE ASSET CLASS

- We maintain our positive view of the asset class, despite tighter valuations, and we pay particular attention to the surge in geopolitical risks – i.e. US-China, US/UK-Iran, Brexit – which have been the main volatility drivers over the past several months.

- The main central banks' stance has eased over recent months, with the Fed cutting its key rate – or Fed Funds – in early August 2019, while the European Central Bank seems to be ready to do anything it takes to shore up economic activity in the event of a slowdown, particularly with the latest round of measures announced.

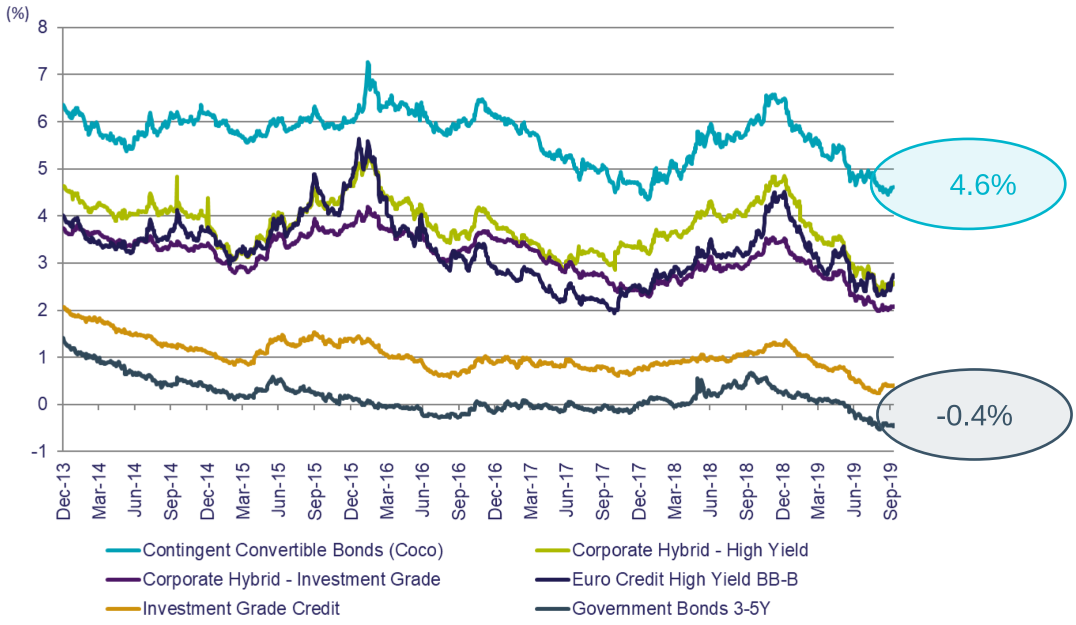
- However, the current low interest rate environment carries its fair share of risks for the banking sector, and the main question in the sector for the years ahead is set to be banks' profitability. Against this backdrop, the portfolio management team will focus on issuers that can find ways to tackle this situation by developing diversifying businesses for example, or taking consolidation measures or even adopting digital transformation and/or cost-cutting policies.

- In our view, the asset class still offers an attractive risk premium i.e. subordination, liquidity, extension – and this is particularly true of Coco AT1 bonds – if we take positions on financial and non-financial issuers with solid fundamentals and an investment grade credit rating.

- In light of yields on the euro fixed-income market, subordinated debt can help investors in their search for yield, while enabling them to continue targeting investment grade issuers.

Yield to worst trends

(at 10/09/2019)

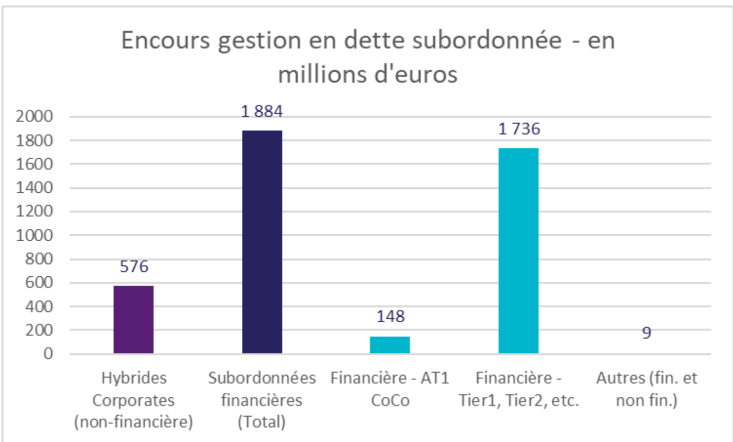


Source: Ostrum AM, Bloomberg, BOA Merrill. Data at October 9, 2019. Figures mentioned refer to previous years. Past performance does not guarantee future results. Source: Bloomberg. Indices: Bofa Coco index / Bofa Hybrid High Yield index / Bofa Hybrid Investment Grade index / Bofa Euro government index / Bofa Euro Corporate index / Bofa Euro High Yield index. The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change. No information contained in this document may be interpreted as being contractual in any way.

OSTRUM AM'S KEY ADVANTAGES IN SUBORDINATED DEBT

Ostrum AM manages close to €2.5 billion in subordinated debt, excluding insurance, via a full range of strategies i.e. subordinated debt, investment grade credit, high yield and crossover, and aggregate/flexible.

The company has a team of credit portfolio managers specialized on the asset class, and also boasts a credit research team with 26 credit analysts who cover the full subordinated debt market spectrum for both financial and non-financial issuers.



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