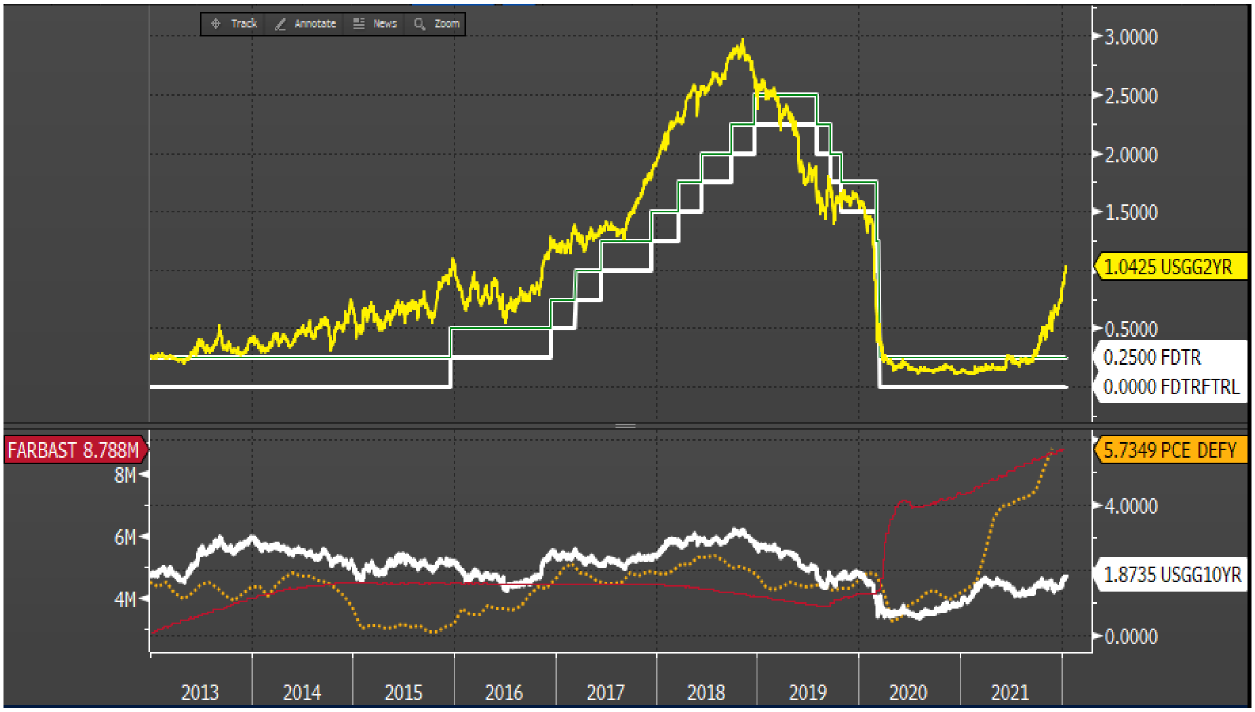
Hybrids: A Triple Play for the Defense

Bond markets are not accustomed to the US Federal Reserve Bank raising rates for the wrong reasons (i.e., to fight zooming inflation). For almost 2yrs now, equity markets have enjoyed a perverse sense of liquidity heaven primarily due to pandemic response programs and massive money creation which have created a habitual fear of missing out on rising prices. But the Fed's hawkish pivot last quarter and its more recent messaging in favor of balance sheet reductions has switched the market's fear of missing out into a motive for getting out. In our 2022 outlook we said, *"the Fed Put has probably expired for some time – the implication of this paradigm shift is that equity and bonds will have to reprice and clear valuations without liquidity being guaranteed by the Fed, but instead discovered by traders that are unaccustomed to the Fed as an inflation fighter.*"

Central bank anti-inflation war games are underway. It's primarily a war of words for the time being (i.e., until the Fed taper is done), with much heavier cumulative actions to follow. The objective is for monetary authorities to play or impel the market into their desired behavior, which is to deflate the price exuberance. The Fed, for one, is in a horse race with inflation and is playing this necessary but "tricky trifecta" bet:

1. Quantitative Easing (QE) is in run-off
2. Federal Funds are to lift-off
3. Quantitative tightening is to kick-off

The trick is to achieve success in cutting inflation fast enough, so it doesn't become entrenched and to do it without creating a recession through a policy mistake. The headline play is all about interest rates – that is, hiking interest rates. As we've said, the runway for a federal funds lift-off is always built in advance by the gap of the 2yr note:



The lift-off gap of the 2yr note hasn't been this steep since the Trump tax cut proposals were introduced in 2017. You can see that 3 rate hikes of 25bps are clearly set on the runway, but at least another move 25-50bps higher on the 2yr note yield is needed for fed funds to go wheels up to 1.00%-1.25% bound sometime this year. The challenge for the Fed is the roughly 4% gap between the PCE deflator and the UST10yr note – this is a very deep negative rate. We believe that it's symptomatic of the Fed's COVID response among other things. Ordinarily, the UST10yr note yield is higher than the PCE deflator, but since the pandemic response in early 2020, this gap has been negative, and its arc is still soaring. It looks like the Fed is way behind the curve in fighting inflation and that the gap (i.e., zooming inflation) is significantly associated with the surge in the Fed's balance sheet (shown as "FARBAST" in panel 2) – both lines have the same arc. This deeply negative differential between the UST10yr note and the PCE deflator is still extraordinarily stimulative; and it's becoming a political problem for the Biden Administration. So, the Fed's tricky trifecta may morph into the market's terrible trifecta (i.e., losses) in that, asset prices appear far too high yet because aggregate liquidity (i.e., the Fed's balance sheet) is still far too high as well (in fact, it's still growing) – this explains why the Fed had its first discussion in December about potentially shrinking its balance sheet. When this liquidity is in decline, we expect the equity market to have deeper and longer corrections, which should afford more extended buying opportunities for hybrids than the few short windows we've witnessed over the past 22 months.

Markets are beginning to realize that the Fed may move not only soon, but aggressively in playing all three tools in rapid succession. Therefore, playing defense will be key for investors as the Fed goes on its offensive against inflation. Hybrids (i.e., preferred securities and Cocos) offer a good fundamental defensive plan and investors an opportunity for a *triple play* against the Fed:

	Hybrids		Corporates	
1/19/2022	Preferreds	CoCos	IG Corps	BIG Corps
Bloomberg Index	*cips+hips*	*cdlr*	*c6c0*	*h0a0*
Mod. Duration	4.13	3.33	6.30	4.15
Yld-to-Worst	3.62%	4.26%	2.79%	4.73%
Inflation[1] Adjust	-2.78%	-2.78%	-2.78%	-2.78%
Real Yield	0.84%	1.48%	0.01%	1.95%
Default[2] Adjust	-0.11%	-0.11%	-0.04%	-2.57%
YTW, net, net	**0.73%**	**1.37%**	**-0.03%**	**-0.62%**
Composite Rating	BBB2	BB1	BBB1	B1

[1]Inflation assumption based on the UST5yr breakeven inflation rate
[2]Default assumption based on Spectrum's 10yr annual default study through 2020

The illustration above shows this defensive playbook for hybrids relative to investment grade corporates and (not so) high yield bonds. Defense and capital preservation through income and structure are our primary investment objectives for 2022. The triple play for hybrid capital securities can:

1. Defend against income erosion with high quality nominal yields
2. Defend against inflation with positive real yields, net of the UST5yr break evens
3. Defend against credit risks with low historical default measured by Spectrum

For investors that can take advantage of the dividend received deduction or qualified dividend income, the hybrid triple play can be even a bit more attractive than shown when some tax benefits to income are considered. The structure of hybrids with intermediate coupon re-fixings can also roll up portfolio income at the margin as rates rise over time, which should also help to preserve some capital as these central bank war games advance -- tightening cycles are usually not short-lived and there is nothing "usual" about this paradigm shift for markets. As the equity market corrects from the Fed's expected liquidity withdrawals soon, we expect intermittent better buying opportunities to prevail. If the Fed were to impel the bond market to flatten too much (i.e., 3mo. Bill yields to equal 10yrUST note yields) later this year, we would expect the Fed to twist its balance sheet by selling long bonds and buying 3mo. Bills – this would be a spread tightening action for credit because it would be forestalling the risk of a recession, which would be the primary reason for the market to flatten to that degree.

The closing takeaway:

A good defense is not only a relative game but can also be a tactical advantage for bond investors – hybrids offer an opportunity to play defense with prospects for a triple play.

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