SPECTRUM
Asset Management

Junior-Subordinated Capital Securities Markets

April 2020 Updates

The Coronavirus (COVID-19) has crushed the global economy despite asset prices making an astounding recovery this month. Initial jobless claims since mid-March have zoomed to over 33.4 million (compared to just 1.6mm during the 7wk. period since January) which is a clear signal that the costs of this pandemic are enormous and mounting. By the end of April, the slowing rate of infections can be viewed as a positive sign that coordinated global efforts to social distance are slowing COVID-19's surge and that treatment capacities won't be breached when the curve turns higher again this fall. For markets, April was an "appreciation month" for state-based capitalism as gargantuan liquidity backstops and spending measures have virtually become ingrained palliative aid that collapses volatility on contact. The 30yr US Treasury bond closed the month yielding 1.27% (8bps lower). The US Treasury 10yr note closed the month yielding 0.62% (7bps lower). The yield differential between these two longer US Treasury terms closed at 65bps (18bps steeper on the year). The S&P 500 gained 12.7% during April on the heels of March's historic policy response. So, despite the recession's arrival, market pricings have recovered far quicker than Main Street and appear free of lockdown discounts.

Before we discuss the performance in Spectrum's junior subordinated sectors this month, let's look at performance in some of the more senior corporate credit sectors for comparative references on returns and yield changes (note that any rebalancings this month for the ICE Data Indices were postponed due to the market disruption):

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) rose 3.80% to close yielding 8.19% (105bps lower).

- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 3.77% to close yielding 2.38% (83bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 6.97% to close yielding 3.47% (95bps lower).

Review of Market Structure:

The market for **global junior-subordinated capital securities** (*i.e.,* "**Jsubs**") is comprised of:

1. Preferred Securities, and
2. Contingent Capital Securities

Each sector is evolving with unique technical, structural and fundamental features that are discussed and updated below:

Global junior subordinated capital securities are comprised of two sub-sets that represent a broad group of global junior-subordinated capital securities, which can be referenced by two ICE BofA indexes: 1) The ICE BofA US All Capital Securities Index (***i0cs***) and 2) The ICE BofA US Dollar Contingent Capital Index (***cdlr***).

Our litmus test for junior-subordinated capital securities satisfies two core characteristics:

1) any non-payment of distributions would not accelerate an event of default (i.e., distributions are "junior-subordinated" to ordinary interest obligations) and,
2) balance sheet classification is something other than common stock under GAAP disclosure.

The US All Capital Securities (***i0cs***) benchmark of preferred securities represents $303 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (45%) and the institutional $1,000par market (55%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents

$138 billion (face amount) of investment grade and below investment grade fixed-rate instruments with contractual triggers that could subordinate them to common stock in a reorganization that would not fall into a receivership after the bail-in. These two benchmarks combine for a $441 billion universe of fixed-rate junior-subordinated capital securities with preferred securities (measured by ***iocs***) being a 69% subset and contingent capital securities (measured by ***cdlr)*** being a 31% subset of the total global USD junior subordinated group.

Preferred Securities

In the preferred securities sleeve, there are four sub-component indexes in the US All Capital Securities Index (***i0cs)*** – this entire index is comprised of global "preferred securities". A **"preferred security"** can represent a capital security issued either through charter amendment (i.e., as a stock) or through indenture (i.e., as a bond) typically within the context of a "gone-concern" statutory authority (*e.g.,* US banks). As a gone concern, a company reorganization would be processed through a bankruptcy court. Preferred security payments are in priority to common stock dividends, yet can be deferred (i.e., payments are cumulative) or eliminated (i.e., payments are non-cumulative) without causing an immediate event of default; any principal loss absorption on a preferred security would be forced only *ex-post* through a statutory resolution in a bankruptcy proceeding.

The four sub-components of the *i0cs* benchmark that consolidate into the retail and institutional sectors of rated preferred securities are:

1. **ICE BofA Fixed Rate Preferred Index (*p0p1*) @ 43% *of i0cs***
   - Comprised of IG $25par and IG $1,000par US AT1
     - ❖ The *p0p1* rose 6.30% this month to close yielding 3.52%
     - ❖ Headcount fell by 1; face value declined by $1.9bil.
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 26% of *i0cs***
   - Comprised of dated IG $1,000par hybrids (no US AT1)

- ❖ The *c0cs* rose 7.29% this month to close yielding 4.10%
- ❖ Headcount fell by 1; and face value grew $1.8bil.

3. **ICE BofA High-Yield Capital Securities Index (*h0c*s) @ 6% of *i0cs***

- o <u>Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids</u>
    - ❖ The *h0cs* rose 11.13% this month to close yielding 5.92%
    - ❖ Headcount and face value unchanged.

4. ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 24% of *i0cs*

- o <u>Comprised of BIG $1,000par US AT1 and BIG $25par</u>
    - ❖ The *p0hy* rose 10.19% this month to close yielding 6.00%
    - ❖ Headcount was unchanged; face value grew by $0.9bil.

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 7.72% in April to close yielding 4.39%, which was 163bps lower than last month's closing yield and a spread of +371bps over comparable US Treasury securities (142bps tighter).

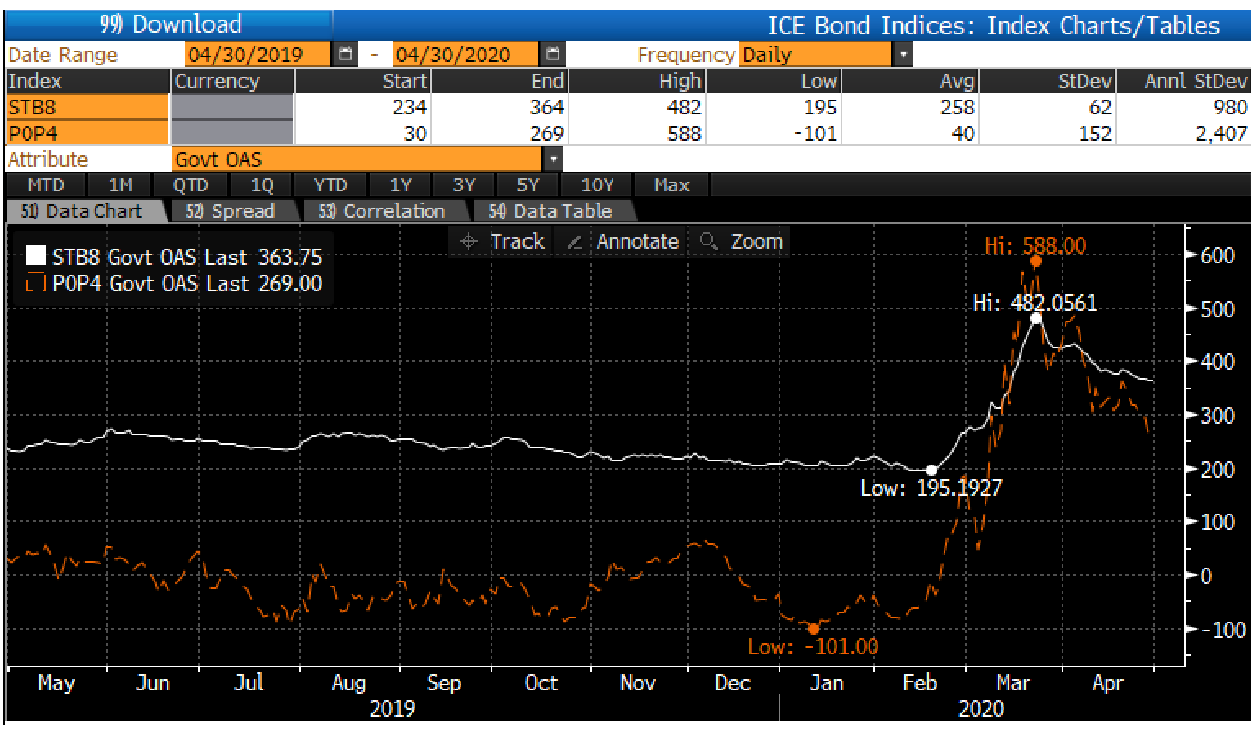
<u>Contingent Capital Securities</u>

A **"contingent capital security"** (i.e., a "CoCo") represents a capital security issued through indenture typically within the context of a "<u>going-concern</u>" type regulatory regime for banking, which would reorganize a potentially insolvent bank through the contracts of its capital before falling into a conservatorship proceeding. CoCos payments are non-cumulative and *pari passu* to common stock dividends and can be reduced or eliminated without causing an event of default. Principal loss absorption on a CoCo could be forced ex-ante through a regulatory action in advance of any bankruptcy proceeding (note that an actual bankruptcy may not happen because enough loss absorbing bail-in capital, including tier-2 capital, could be available through the "living will" of core capital). The ICE BofA USD Contingent Capital Index (***cdlr***) is a new benchmark launched in January and is comprised of US dollar denominated constituents (exclusively), which represent 62% of the mature master multi-currency benchmark (*coco*). We will utilize the new USD benchmark (*cdlr*) this month as it more meaningfully reflects the contingent capital currency types held in our portfolios. The ICE BofA USD Contingent Capital Index (***cdlr***) rose 7.72% this month to close yielding 5.37%, which was 90bps lower than last month and a spread of +476bps over comparable US Treasury securities (83bps tighter).

Implications of Market Activity:

$25par Retail Preferred Securities Sector

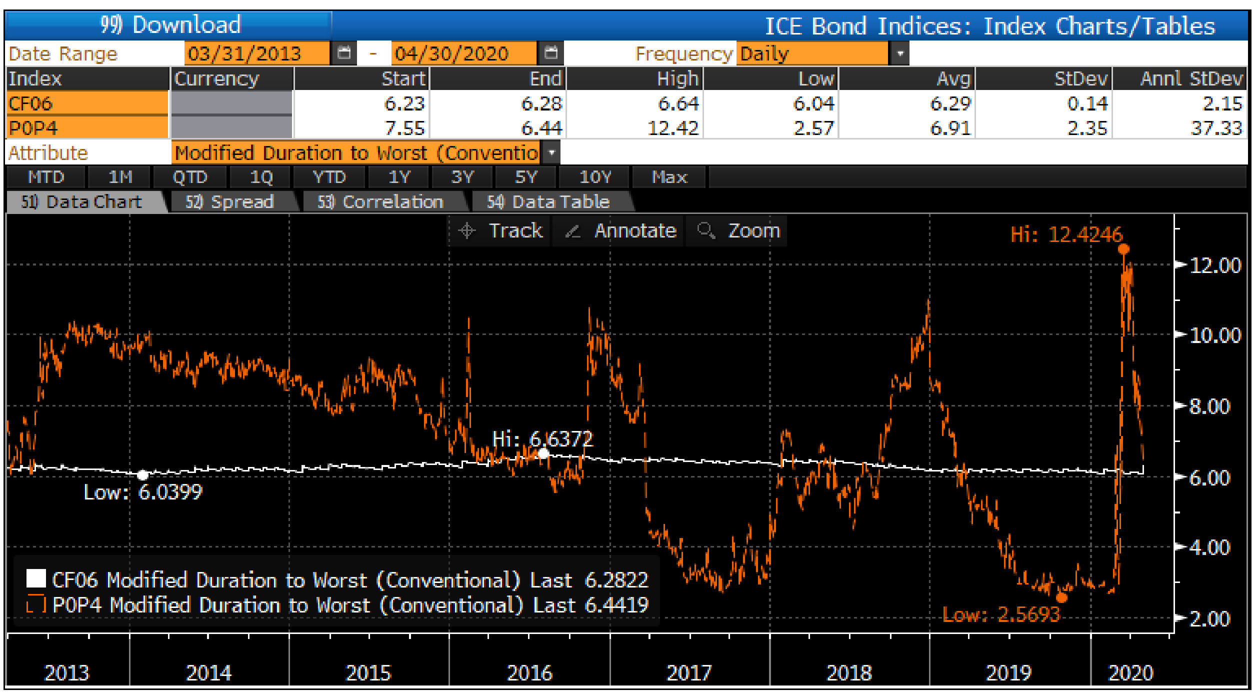
The retail preferred securities sector rose $7.71 this month and was significantly aided by the strongest April for equities in over 80 years. The graph below shows the spread in the $25par market (i.e., p0p4) over the past year compared to the spread in the $1,000 par institutional preferred securities market (stb8), which we call "NoCos" to distinguish $1,000 preferred securities from $1,000par contingent capital securities risks.



Source: Bloomberg

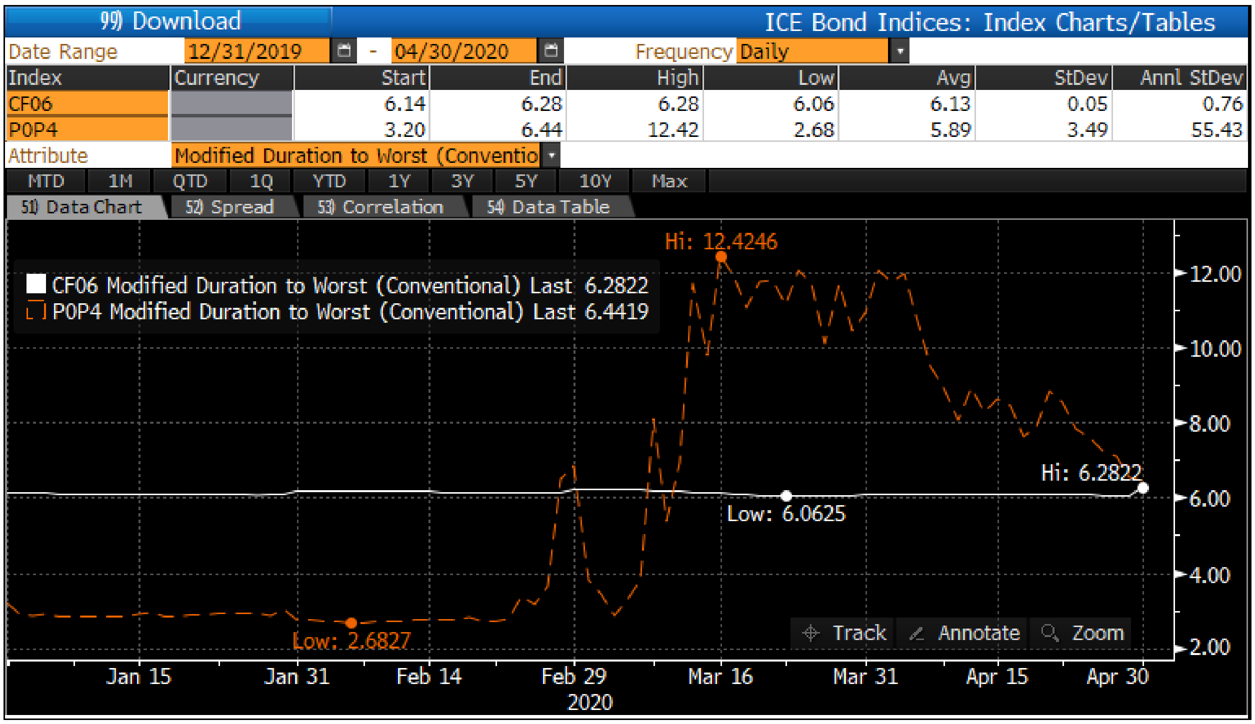
The graph shows the market's collapse in March as the +588bp spread at the high and the 156bp rally the second half of March. This month, the rally continued with a further bull tightener of 162bps for the retail sector. This move (-1.3 standard deviations) tightened up the retail sector to again spread less than the institutional sector, which is normal given the retail sector's high running yield, but drift to negative convexity when prices rise and call options price deeper in-the-money. Despite the big move, there is still plenty of room to tighten as the retail market is still priced 1.8 standard deviations wide of its average spread over the last 7yrs.

We view modified duration of the *p0p4* benchmark to be a contra-indicator of value due to the benchmark's usual negative convexity. In other words, the higher the modified duration the more absolute value there is to the sector – conversely, when duration is the lowest, price risk is the highest if yields revert higher. The chart below illustrates the effective duration of the retail sector measured by *p0p4* vs. the 5-10yr US financial sector measured by *cf06* as a baseline:



Source: Bloomberg

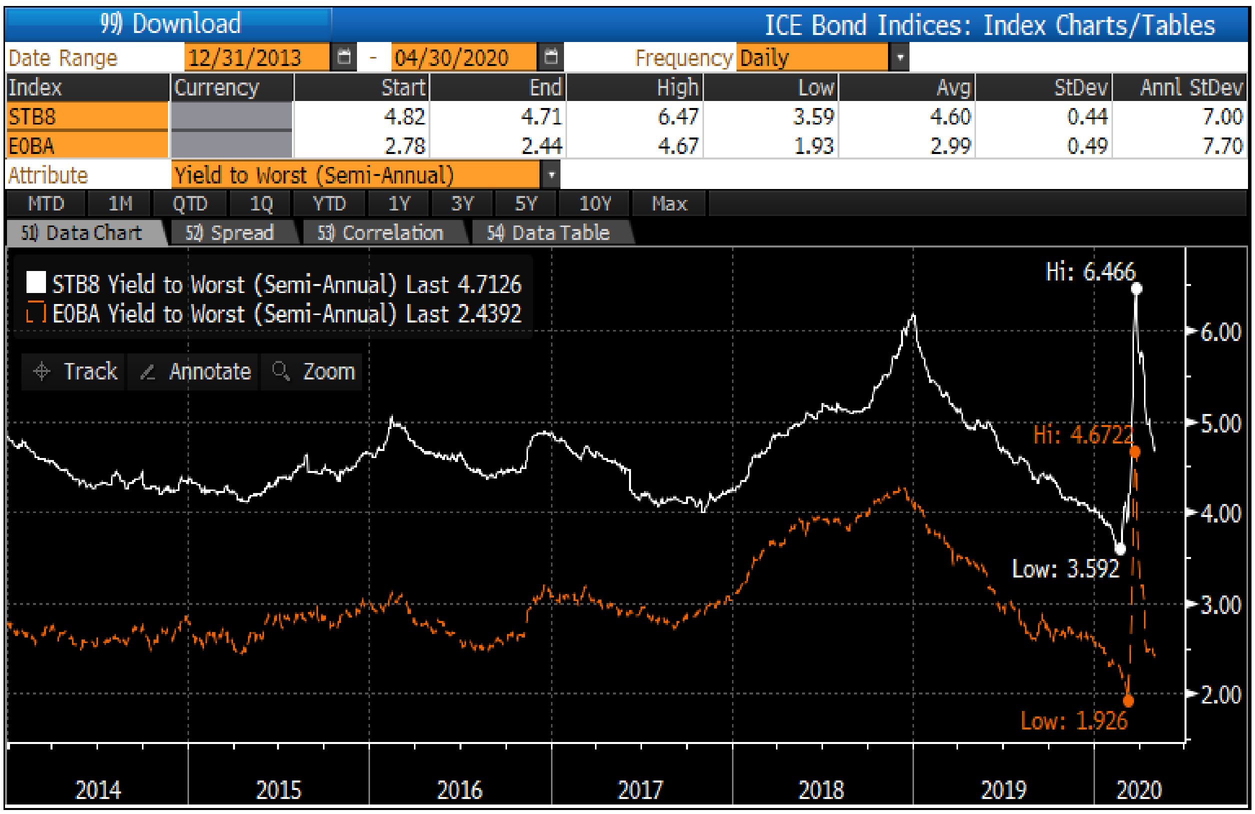
When duration of the $25par market is below the duration of the ICE BofA 5-10yr US Financial Index (cf06) negative convexity slows potential price progression and OAS spreads can become overvalued – which is primarily why we have been underweight the retail sector for some time in our funds. Below we look at another zoom shot of duration behavior for both benchmarks over the course of the year:



The modified duration of the retail $25par market was zooming higher as fast as the price of the benchmark was falling in March. In fact, last month we said that *"the significant repricing flagged by double digit modified duration leaves the retail sector with an unusual value trifecta of 1) discount price ($92.17), 2) high yield (6.80%) and 3) generous spread (431bps)."* Clearly, the $25par market's modified duration collapsed in April as prices zoomed up almost 8pts to finish just below par ($99.88). So as spreads tighten further in retail paper, we expect the $25par market's relative value to slip compared to its institutional counterpart (i.e., NoCos).

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $6.12 in April. The NoCo sector has recovered over 60% of its yield break this year, but still looks cheaper than average. The chart below shows the yield-to-worst of NoCos (i.e., *stb8*) vs. Eurodollar Banking Index (i.e., *e0ba*) since 2013:



Source: Bloomberg

We look back to 2013 to include three intra-cycle shocks to yield and spread: 1) the end of the Taper Tantrum (2013), 2) the end of the commodity implosion and high yield (oil) market bust (2016) and 3) the end of the market's revolt to the Fed's overshoot on rates (2018) -- and now we have the COVID-19 recession. At the end of the month, NoCo spreads to comparable treasuries closed 60bps tighter (+364) which was a -1.4 standard deviation bull move tighter.

Though NoCos had a big move up this month, they are still 2.3 standard deviations wide of their average spread to treasuries over the past 7yrs. There was one new issue of note this month in the additional tier1 market – a $2.5 billion preferred stock for Charles Schwab Corp @ 5.375% with a fixed-to-variable reset 5yrs forward. The deal was significantly oversubscribed and quickly traded up to $102 3/8 bid.

Contingent Capital Securities Sector

The CoCo sector closed $6.68 higher this month against the backdrop of a continued weak bank equity sector in Europe. The graph below shows the spreads in CoCos (i.e., *cdlr*) relative to the spreads measured in Eurodollar bank credit that is not CoCo (i.e., *e0ba*) since 2016 – note that we do not include prior history because CoCos were improved in 2016 after the Pillar-2 capital stack was redefined, thus reducing payment trigger risks for CoCos:

Source: Bloomberg

The relative spread differential between CoCos and more senior financials trended tighter this month trading within a 45bps range, which was one-half the range of last month. Fears have faded that European AT1 may pass on dividends due to the European Central Bank's specific recommendation that EU banks refrain from making dividend distributions on common shares. The rally in CoCos and decline in equity is anecdotal of the CoCo market's more supportive outlook. ECB Supervisory Board chairman, Andrea Enira, has reiterated that the ECB has no plans to order banks to suspend interest payments on their AT1 instruments. Also, it is quite interesting that after Rabobank eliminated it payments on its common equity tier1 certificate causing it to bottom this month at €89.18 (down from €136.86 in February), the issue has rallied back to €98.58 even though it pays no income. Indeed, the market appears confident that Rabobank will resume payments in October based on the guidance from the ECB that payments not be made until at least October to ensure that banks retain capital to support their local economies – we think that the risk of banks being told in September to extend this no-pay period beyond October is above average because recovery is likely to be slow and regulators may require more time to get brighter signals that a recovery can be sustained in Europe. This month, RaboBank announced that it will call its 5.50% €AT1 CoCo issue in June. Either there are crossed signals on capital preservation or Rabobank is highly confident that it will be able to refinance its 5.50% €AT1 at a more economic spread than +525bps this summer. Over the course of March, CoCo securities tightened by 94bps relative to comparable treasuries, which was a move -1.3 standard deviations tighter. At the end of April, CoCos were 1.8 standard deviation wide of their average spread to comparable treasuries since the end of 2013.

Outlook:

The arrival of COVID-19 in the US has caused the most severe impact to the US economy since the Great Depression. The Fed and Congress are doing just about everything they can to prevent another depression -- we believe that the confluence of policy efforts will succeed. But change is certain. Global economies are going to be reassessing supply chains and take more nationalistic views toward protecting their own – the US is very likely to be moving this way. People are going to have lingering concerns over protecting themselves. Attitudes towards business travel and public transit are likely to compel socially distanced mindsets to stay away from crowded venues and either drive to work or stay home if work modalities can operate remotely. So, the complex system of integrated demand functions that foster money velocity are mutating like the virus because there is an innate code in both to survive. There is no question, that economic growth will happen again sometime because humans are wired to innovate. In fact, innovation is the thematic curiosity of the Fed.

Indeed, Chairman Powell has made some profound statements over the years and we have commented on some such as, "*The lack of inflation is the greatest challenge of our time.*" After April's policy meeting, Chairman Powell made another profound statement:

"The Fed is prepared to engage in an open-ended period of policy innovation to support the years it's going to take the economy to dig out."

The two aspects to this statement that strike us relative to their implications are: 1) "innovation" and 2) "years". The concept of innovation means doing something new -- especially something that changes what is powerful policy today into something exceptionally powerful tomorrow. Change happens through new ideas or morphs from old ideas that have not yet been implemented. The relevance to "innovation" is that doing something new does not mean doing something old especially if old has repeatedly failed -- that would define insanity. Therefore, if the Fed were to adopt a negative-interest rate policy (NIRP), which has failed in Europe & Japan, then it would be insane do that. The Fed is not insane, so having dismissed NIRP is rational. Fixed income investments would become fixed cost divestments pushing money flows deeper into equities, thus giving the illusion that credits are improving while levering up with more debt that still must be returned to senders someday. So, the Fed's commitment to "policy innovation" is not suggesting something old be done like NIRP, but rather something new be done – like "helicopter money". Certainly, the idea of printing currency with no commensurate asset to debit the Fed's balance sheet is that old idea that has never been tried, but it's the theory of what could have been done to avoid the Great Depression. We are not looking at unsecured currency yet, nor do we expect another depression from the COVID-19 pandemic. But the "years" the Fed expects to pass before the economy is back to ground level is concerning given the fiscal path to ever more debt. So, in order to manage the debt tsunami, yield curve control is the next Fed "policy innovation" coming which is nothing more than sophisticated central bank bullying of what would otherwise be free market pricing supply cheaper. This creeping state based capitalism is the precursor to helicopter money as the state will need years of political cover and an outsized Fed balance sheet to rationalize forgiving trillions of UST notes under the guise of Modern Monetary Theory. The Treasury's back loading new borrowings with $54 billion of new UST 20yr bonds in June & July (for starters) is a good move for Treasury and indicates that the Fed policy will contra-NIRP using yield curve control over endless debt supply.

Our outlook this year is to embrace the Fed's coronavirus put – indeed, the Fed put has never been so powerful. The Fed gets what the Fed wants, and the greatest challenge of its time is the lack of inflation. So, under the spirit of never allowing a good crisis to go wasted, Chairman Powell will ultimately get the inflation he desires through a long period of ZIRP and yield curve controls to guide Modern Monetary Theory in practice. Over the near term, the Fed is determined to operate in good conscience within its mandate to effectively promote the goals of maximum employment, stable prices and moderate long-term interest rates, which are low now. But low for longer does not mean low forever. Uniquely, the junior subordinated capital securities market has a core structural attribute enabling fixed rates to reset higher if inflation happens. Ironically, higher rates and a steeper yield curve should bode well for bank earnings (and provisioning growth) which can help to recover loan losses that are a natural cost to every recession. So, the outlook is certainly complicated with change, yet we are constructive about this change as some needed inflation can be healthy – especially within the context of quality financials and the value trifecta currently available in junior subordination that averages 1.8 standard deviations of above average spread to treasuries.

Health be with you and yours.

Phil Jacoby
CIO, Spectrum Asset Management
May 8, 2020