Junior-Subordinated Capital Securities Markets

June 2020 Updates

The Coronavirus (COVID-19) is compounding around the globe and weighs more on the real economies than it does financial assets, though June did usher in a modest correction for some hybrids. New issuance pace was still sweltering like in May despite the gloomy economic outlook dropped by the Fed, which caused an equity correction. As rates dropped again, corporate debt has held to be so nominally cheap that issuers cannot pass up the extended opportunity to lock-in low financing costs which implies an issuer buy-in that the US economy will grow again and the Fed will not impel negative rates. The 30yr US Treasury bond closed the month yielding 1.41% (unchanged). The US Treasury 10yr note closed the month yielding 0.65% (unchanged). The yield differential between these two longer US Treasury terms closed at 76bps (29bps steeper on the year). The S&P 500 corrected -7.12% off its high after the Fed's messaging on June10th but recovered to still close up 1.84% on the month. So, despite the continuing challenges of controlling "the spread" while reopening local economies, equity prices are responding to the Fed's treatments and are indicating that main street will recover too.

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 0.98% to close yielding 6.07% (97bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 1.99% to close yielding 1.74% (34bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 2.87% to close yielding 2.47% (42bps lower).

<u>Review of Market Structure:</u>

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 into a mature product cycle with unique technical, structural and fundamental features that are discussed and updated below:

Global junior subordinated capital securities are comprised of two <u>sub-sets</u> 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 <u>two core characteristics</u>:

1) any non-payment of distributions would <u>not</u> 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 $320 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 $455 billion universe of fixed-rate junior-subordinated USD capital securities with preferred securities (measured by ***iocs***) being a 70% subset and contingent capital securities (measured by ***cdlr)*** being a 30% subset of the total global USD junior subordinated group.

<u>Preferred Securities</u>

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 "<u>gone-concern</u>" 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*) @ 44% *of i0cs***
    - <u>Comprised of IG $25par and IG $1,000par US AT1</u>
        - The *p0p1* declined 0.39% this month to close yielding 3.82% (+76bps)
        - Headcount grew by 6; face value grew by $4.25 billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 24% of *i0cs***
    - <u>Comprised of dated IG $1,000par hybrids (no US AT1)</u>
        - The *c0cs* rose 1.71% this month to close yielding 3.53% (-23bps)
        - Headcount declined by 1; face value declined by $1.10 billion
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 8% of *i0cs***
    - <u>Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids</u>
        - The *h0cs* rose 3.25% this month to close yielding 4.99% (-39bps)
        - Headcount grew by 2; face value grew by $3.60 billion
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 24% of *i0cs***
    - <u>Comprised of BIG $1,000par US AT1 and BIG $25par</u>
        - The *p0hy* declined 1.37% this month to close yielding 6.07% (+97bps)
        - Headcount grew by 7; face value grew by $1.74billion

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 0.16% in June to close yielding 4.32%, which was 46bps higher than last month's closing yield and a spread of +355bps over comparable US Treasury securities (38bps wider).

Contingent Capital Securities

A **"contingent capital security"** (i.e., a "CoCo") represents a capital security issued through indenture typically within the context of a "going-concern" 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 61% 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 1.73% this month to close yielding 4.92%, which was 18bps lower than last month and a spread of +394bps over comparable US Treasury securities (-57bps tighter).

Implications of Market Activity:

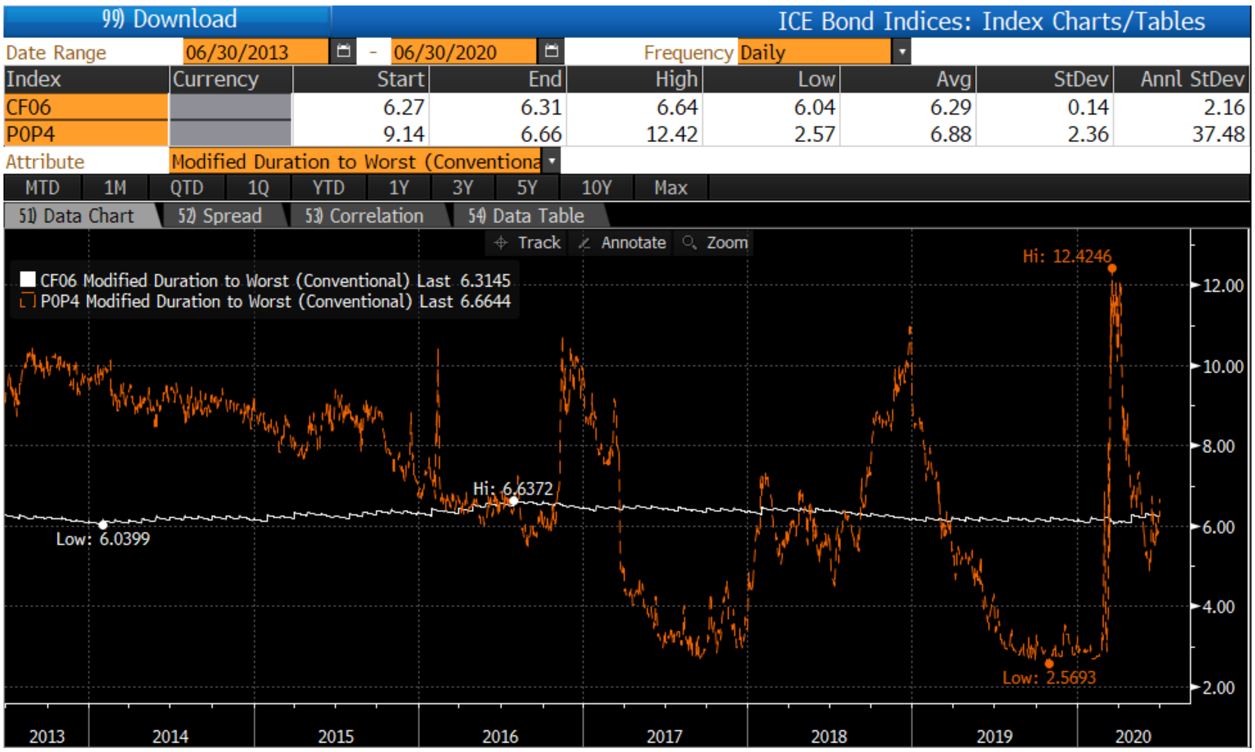
$25par Retail Preferred Securities Sector

The retail preferred securities sector declined $2.10 this month after the equity markets corrected into a more cautious mood sharply following Fed Chairman Powell's press conference in early June. 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 (CoCo) risks:

Source: Bloomberg

After the retail market's collapse in March (shown by the +588bps spread at the high), it rallied over a 55day span to peak (450bps tighter) the day before the Fed meeting in early June. After the press conference on the 10th the market whipsawed lower as the Fed's summary of economic conditions did not align with the market's exuberance about the re-openings. The retail sector widened by 159bps from its tights (+138 on June 8th) to close June spread at +297bps to treasuries, which was 99bps wider on the month. This move (+0.79 standard deviations measured over the last 84 months) pushed the relative spread in the retail sector closer to parity with NoCos, which is unusual. The retail sector continues to have a high (80%) correlation to equity performance, which is about 1.33x higher than its 7yr norm. As a result of June's correction in $25par prices, coupled with an inner month rally in treasury prices, the absolute spreads available in the retail sector are as high as they were across the three prior spread peaks since the Taper Tantrum in 2013. Indeed, there is plenty of room for the retail sector to tighten given its current spread positioning of 1.60 standard deviations wide of its 7yr average.

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:

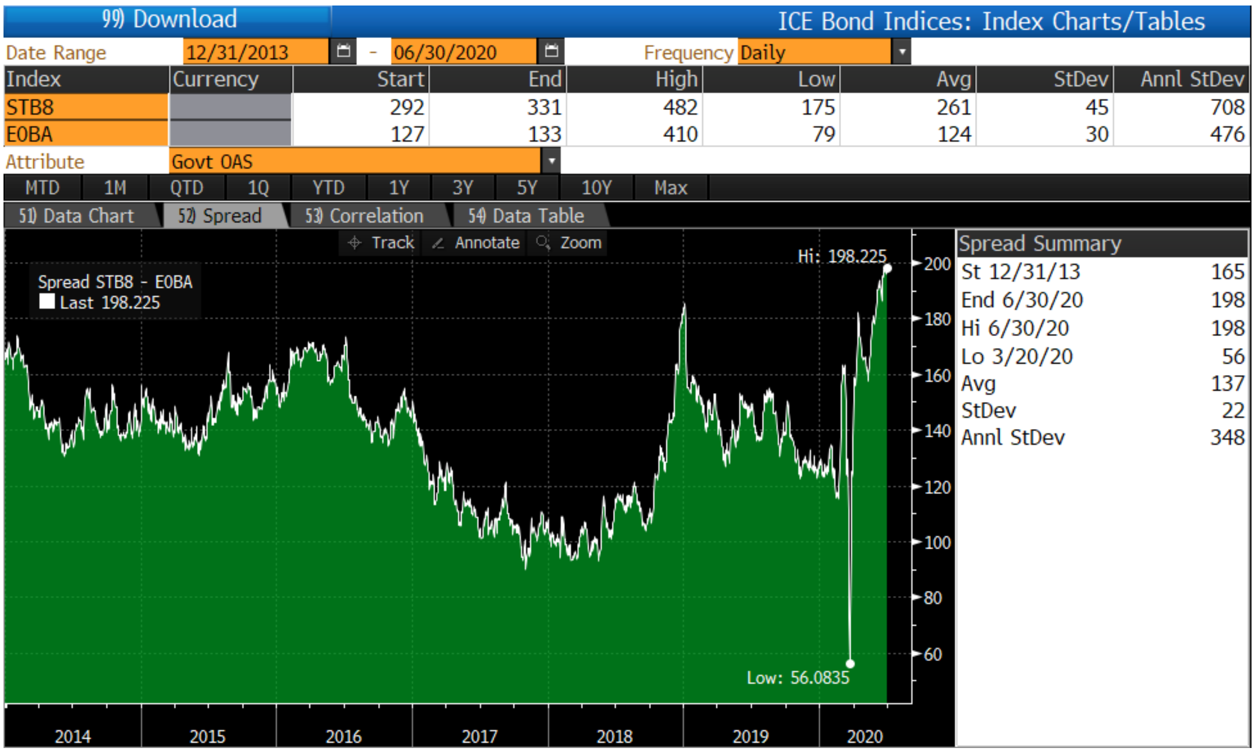


Source: Bloomberg

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 more often than overweight in some of our funds. As spreads tighten in retail paper, the $25par market's relative value tends to slip more compared to its institutional counterpart (i.e., NoCos). This month, the retail sector's modified duration rose 1.33yrs to more than parity compared to NoCos, which flags a buying opportunity in the retail sector.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $1.00 in June. The NoCo sector has recovered 93% of its yield break this year, and yields are now marginally lower than average – but relative spreads in NoCos are well above average. The chart below shows the yield-to-worst of spread of NoCos (i.e., *stb8*) vs. Eurodollar Banking Index spread (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 which markets are quickly looking beyond. At the end of the month, NoCo spreads to comparable treasuries closed 15bps tighter (+331) which was a 0.33 standard deviation move tighter on the month. Despite this move, NoCos did not move as fast as more senior financials did in June, which has NoCos posting a new 7yr+ wide in spread compared to the more senior global bank benchmark. By the end of June, NoCos were spread +1.55 standard deviations wide in the absolute and 2.77 standard deviations wide in the relative. But to an issuer, absolute cost generally matters most so new issuance continued in high fashion during June. Here's a list of the notable NoCo IPOs this month:

1. Regions Financial 5.75% AT1 (Ba1/BB+) +543
2. Sempra Energy 4.875% perpetual preferred stock (Ba1/BBB-) +455
3. Discover Financial 6.125% AT1 (Ba2/BB-) +578
4. British Petroleum Capital Markets perpetual pfd. stk. (5yr) 4.375% (A3/BBB)
5. British Petroleum Capital Markets perpetual pfd. stk. (10yr) 4.875% (A3/BBB)
6. Truist Financial 5.10% AT1 (Baa2/BBB-) +435

New issuance was all well received and closed the month trading above par. Most NoCo paper is pricing off 5yr constant UST yields rather than off LIBOR swaps, which gives the belly of the UST curve for the reset rather than the functional uncertainty of 3mo.LIBOR (or some similar rate). Importantly, the combination of generally 5% area current yields and wide reset spreads continues to make IPOs for NoCos in this market quite compelling – especially when spread off the treasury five year looking 5yrs forward.

Contingent Capital Securities Sector

The CoCo sector closed $1.20 higher this month against the backdrop of hopes for joint fiscal stimulus in Europe along with unlimited support from the European Central Bank. 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:

99) Download — ICE Bond Indices: Index Charts/Tables

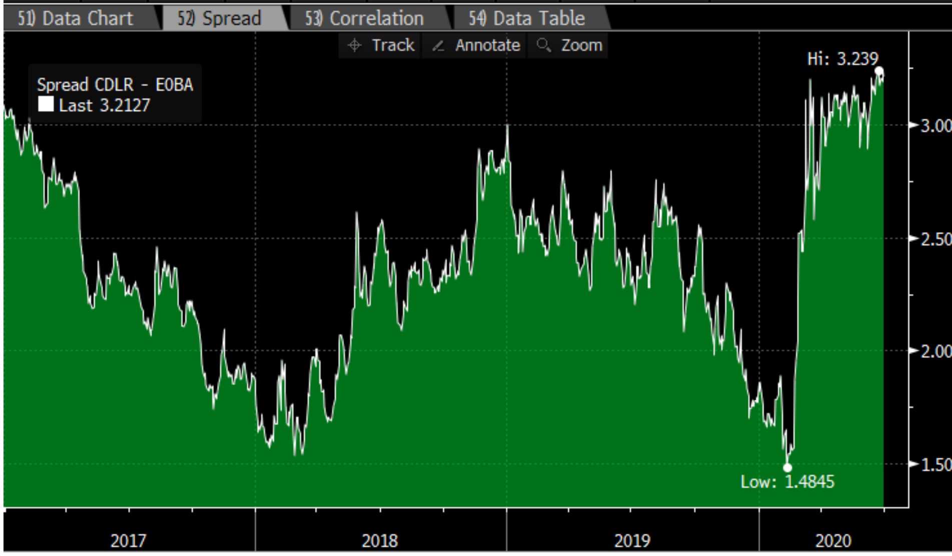
Date Range 12/31/2016 - 06/30/2020 Frequency Daily

Index	Currency	Start	End	High	Low	Avg	StDev	Annl StDev
CDLR		6.15	4.96	7.56	3.82	5.53	0.71	11.28
E0BA		3.07	1.74	4.67	1.74	3.17	0.59	9.39

Attribute Yield to Worst (Conventional)

MTD 1M QTD 1Q YTD 1Y 3Y 5Y 10Y Max

51) Data Chart 52) Spread 53) Correlation 54) Data Table



Spread Summary	
St 12/31/16	3.08
End 6/30/20	3.21
Hi 6/22/20	3.24
Lo 2/12/20	1.48
Avg	2.35
StDev	0.41
Annl StDev	6.51

Source: Bloomberg

The relative spread differential between CoCos and more senior financials trended 18bps wider this month and set a new wide for relative value due to the bigger rally in senior paper this year. This relative value opportunity in CoCos is aided by further easing of concerns that regulators would recommend that European banks pass AT1 dividends -- like they have on common dividends. During an investor conference this month the Chair of the ECB's Supervisory Board, Andrea Enria, again made it clear that there will not be a blanket ban on AT1 coupons. He explained the rationale for recommending temporary common dividend omissions as an earned income savings scheme to soften risks from what is expected to be a sharp but brief recession; and that common shareholders would have potential recovery available with increased future payments and share buybacks. The European Central Bank's pandemic emergency purchase program (PEPP) and heavy fiscal spending should give the Eurozone a sustained boost over the next year. New issuance re-opened for CoCos in June with Standard Chartered and Royal Bank of Scotland each issuing 6% coupons on the AT1. Overall, CoCos closed the month 1.86 standard deviations wide of their average spread to comparable treasuries since the end of 2016.

Outlook:

The growing spread of COVID-19 and the expanding policy of needed social distancing in the US has caused the most severe impact to the US economy since the Great Depression – frankly, it is causing genuine depression for many. The pandemic and strengthening socialist movements in the US add dynamic uncertainties to our evolving outlook. The 2020 general elections should clearly frame core grievances and other platforms (to the extent that COVID-politics will allow pre-election debates) with solutions and visions, which will surely further mold the developing market outlook for next year.

COVID-19 is an acute problem that should largely resolve itself (even without a vaccine) while the social unrest is a chronic symptom of deeper issues that need thoughtful long-term core redress. The growing spread of COVID-19 is a resurging alarm for a media that constantly angles for storylines; and some states are dialing back on their phase-in plans for schools and businesses to slow the spread again. Nationally, Congress will likely spend trillions more in additional stimulus which means that the US Treasury bond market will have to absorb trillions more for years. Indeed, at some point this coronavirus should be absorbed and over-written by human immunities (even without a vaccine) much the way we download new software updates to our cell phones; so, the global economy will indeed grow again. When the government bond market feels a weakness (like a capitalist economy progressing or socialist economy digressing) it will provoke the Fed to do something – like control the yield curve as real yields turn positive. For now, the US government bond market is going mostly sideways with some forceful persuasion from the Fed and threats of even more actions.

Clearly, the Fed will keep the federal funds rate at "zero" for an extended period – this view is unusually unanimous according to the Dots Report of the June FOMC meeting. Indeed, the Fed always gets what the Fed wants, afterall, it makes the rules that make the tools – it's just a matter of time and perseverance before some or all of those tools work. During the press conference, Chairman Powell propounded that the Fed will *"look to get inflation back up…so, you know, we're not thinking about raising rates or thinking about thinking about raising rates."* The Fed will do whatever it takes to foster an economy that runs hot – which means doing something old (i.e., zero rates) before doing something new (i.e., yield curve control). Yield curve control can help a potentially overloaded US Treasury market manage funding (and refunding) demands as inflation rises but the market does not need it yet. Nonetheless, the Fed will certainly talk about it in advance – perhaps at the Jackson Hole Symposium later this year (if there is a symposium this year).

As growth & inflation become more probable, conversations of yield curve controls will happen in advance of actual policy implementation which can decelerate the near-term rise in longer term rates, but not prevent the longer-term rise – remember, the Fed's goals are recovery, expansion and inflation. Above average spreads in hybrid capital securities have ample room to trend tighter as the yield curve steepens from the home-grown expansion being a product of money creation, fiscal excess, and wage growth. Equity markets should rise to new highs as new money floods the market plains with currency supply. Since March, spread performance in the hybrid sectors have lagged more senior corporate credit sectors and represent compelling relative value. Junior subordinated capital securities have structures that can reset yields higher as US treasury rates gradually ebb higher into the expansion. For now, the total rate of return implication for hybrids is constructive given the breadth of the prospective money creation; and its likely delivery to an increasingly broader base of people taking pride in a domestic manufacturing surge – that is, provided the Republic is capitalist, not socialist.

Stay tuned…

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