Junior-Subordinated Capital Securities Markets

July 2020 Updates

The Coronavirus pandemic is still compounding around the globe weighing far more on real economies and politics than on financial assets. July was the most positively correlated month among financial assets since before March – or, since the COVID-19 pivot. New issuance pace sweltered like the summer heat. Yields declined and spreads tightened. The Fed reaffirmed its commitments to Main Street funding and anchored US Treasury yields. The UST 5yr note has become the new 1yr T-bill and even 30yr T-bonds have become seemingly immune to net selling. Consequently, the volatility of the entire US Treasury market reached an all-time low this month -- thanks be to the Fed. Real rates are now negative beyond 10yrs to maturity, which implies that markets have indeed bowed to the monetarist mob. Gold melting up to a record high implies inflation and a renewed currency war (steeped in cheaper US dollars) are brewing. The 30yr US Treasury bond closed the month yielding 1.20% (21bps lower). The US Treasury 10yr note closed the month yielding 0.54% (11bps lower). The yield differential between these two longer US Treasury terms closed at 66bps (11bps less than last month; 18bps steeper on the year). The S&P500 had a steady progression up over 5.5% in July and the VIX (i.e., Chicago Board Options Exchange Volatility Index) crossed under its 200day moving average after bouncing off it during last month's brief correction. Equity has bought into policy goals for a US recovery and the volatility compression implies little risk of a paradigm shift in US politics for now.

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 4.78% to close yielding 5.37% (147bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 1.78% to close yielding 1.48% (47bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 2.51% to close yielding 2.11% (37bps 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 (sometimes called "hybrids") 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 hybrids 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 $319 billion (face amount) of investment grade and below investment grade instruments in both the retail $25par market (40%) and the institutional $1,000par market (60%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $136 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.

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*) @ 45% *of i0cs***
    - Comprised of IG $25par and IG $1,000par US AT1
        - The *p0p1* rose 4.24% this month to close yielding 2.07% (-180bps)
        - Headcount was unchanged; face value declined by $0.345 billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 23% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (no US AT1)
        - The *c0cs* rose 2.69% this month to close yielding 3.19% (-34bps)
        - Headcount was unchanged; face value declined by $0.800 billion
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 7% of *i0cs***
    - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
        - The *h0cs* rose 2.28% this month to close yielding 4.53% (-34bps)
        - Headcount declined by 1; face declined by $0.300 billion
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 25% of *i0cs***
    - Comprised of BIG $1,000par US AT1 and BIG $25par
        - The *p0hy* rose 5.95% this month to close yielding 4.57% (-157bps)
        - Headcount grew by 1; face value grew by $0.453billion

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 4.08% in July to close yielding 3.10%, which was 126bps lower than last month's closing yield and a spread of +259bps over comparable US Treasury securities (99bps tighter).

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 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 1.94% this month to close yielding 4.67%, which was 29bps lower than last month and a spread of +387bps over comparable US Treasury securities (-10bps tighter).

Implications of Market Activity:

$25par Retail Preferred Securities Sector

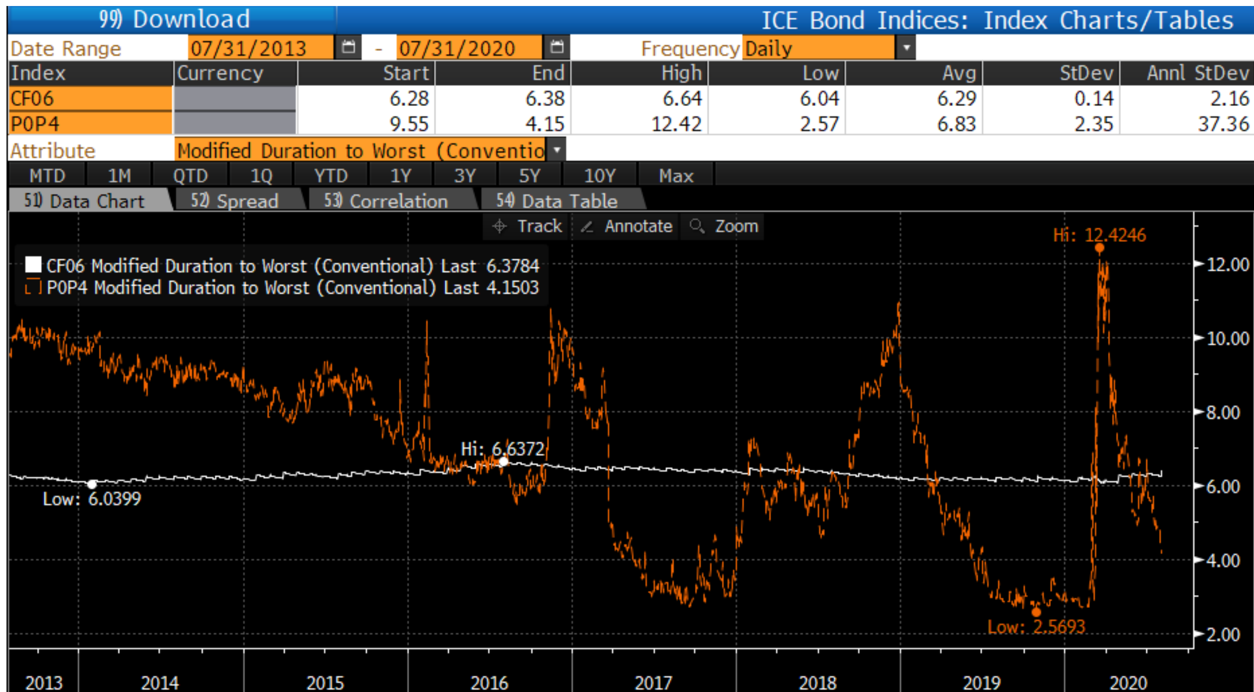
The retail preferred securities sector rose $4.46 this month aided by buoyant equity prices, better treasury prices and an attractive spread positioning to start the month (see last month's report). The graph below shows the spread in the $25par market (i.e., p0p4) over the past year compared to the 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:

Index	Currency	Start	End	High	Low	Avg	StDev	Annl StDev
P0P4		-65	134	588	-101	99	170	2,694
STB8		238	302	482	195	280	69	1,103

Source: Bloomberg

After the retail market's collapse in March (shown by the +588bp spread at the high), it rallied 450bps tighter up to the day before the Fed's meeting early last June only to be disappointed by a dismal economic outlook during the press conference that followed. The correction last month set a stage of exuberance leading to the Fed's meeting this month. The retail sector tightened by 163bps to an OAS of 134, which was 4bps tighter than the prior tights set on June 8th. This move (+1.33 standard deviations measured over the last 84 months) pushed the relative spread in the retail sector well below the spreads available in the institutional sector of preferred securities. The retail sector appears to be a fair value with considerably less spread available than in June, but still 0.31 standard deviations in excess of the 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:



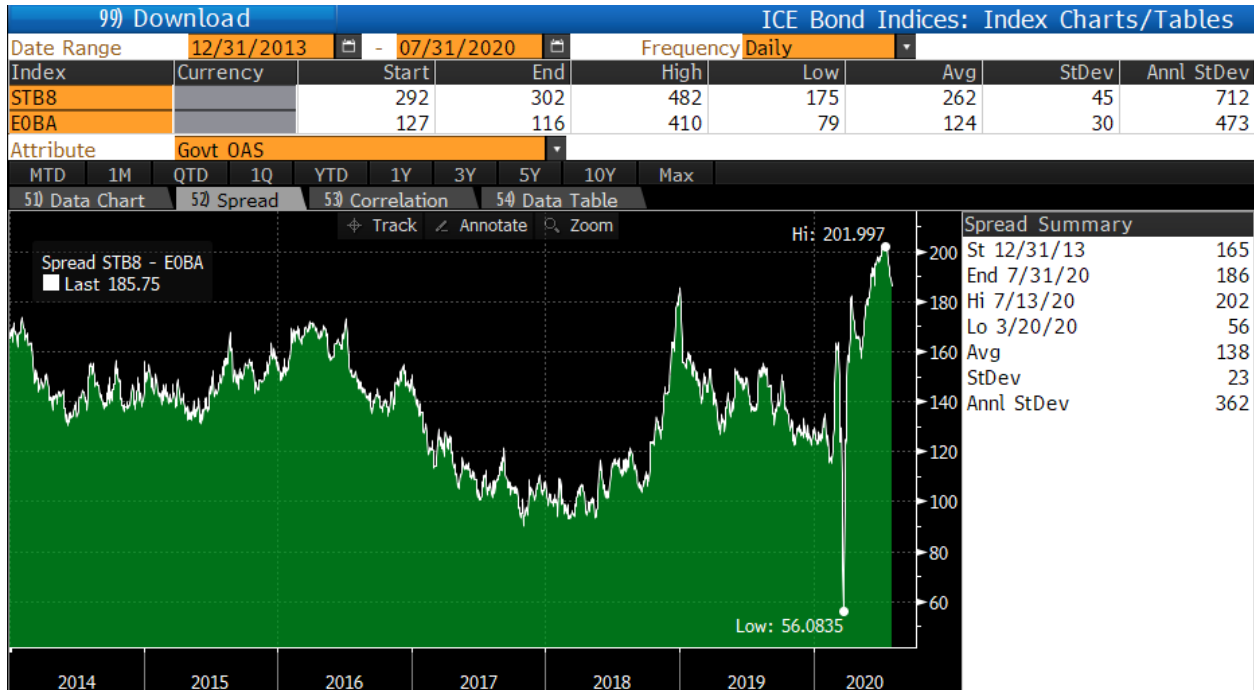
Source: Bloomberg

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 more often than overweight in our diversified 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 dropped 2.51yrs to less than parity

compared to bullet financials, which flags more risk than is implied by the 4.15yr duration of the retail sector.

$1,000par Institutional Preferred Securities Sector

The $1,000 par institutional sector of the preferred securities market rose $3.21 in July. The NoCo sector has recovered all its yield break this year and yields are now just 15bps higher than the record 7yr lows set in February – but relative spreads in NoCos are above average, especially when compared to senior paper. 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 looking beyond. At the end of the month,

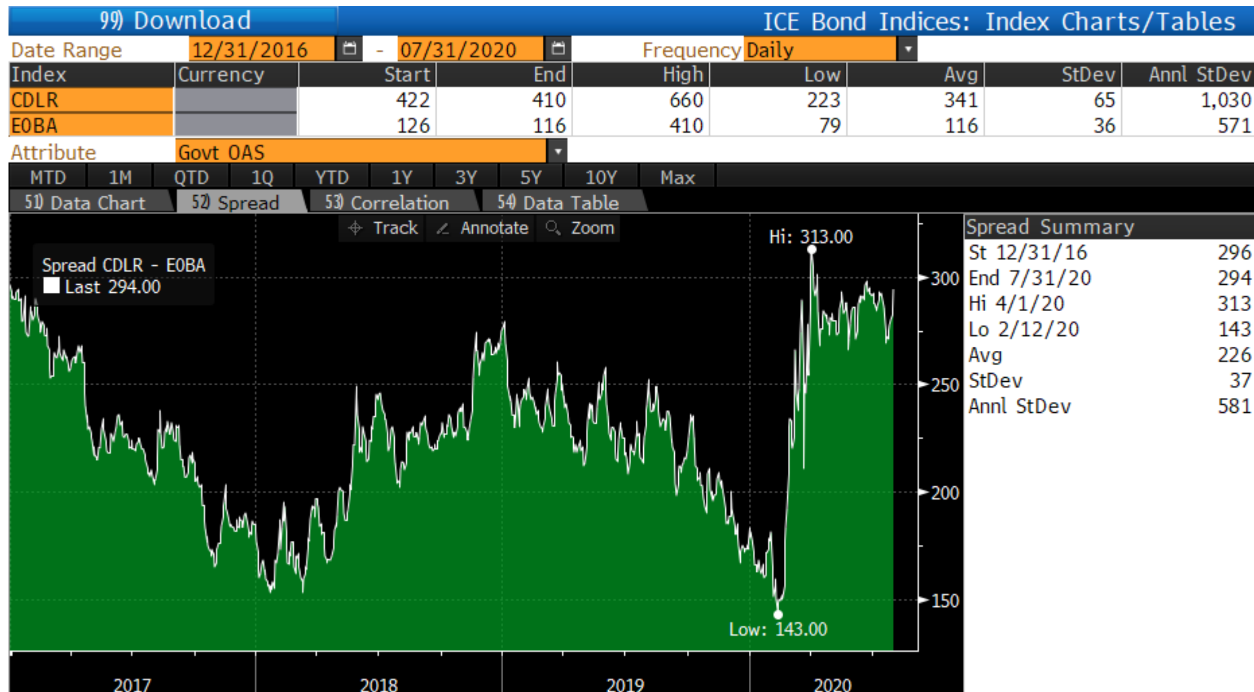
NoCo spreads to comparable treasuries closed 29bps tighter (+302), which was a 0.64 standard deviation advance tighter on the month. This move was 15bps more than the tighter move in more senior financials this month – NoCos have room to further tighten because at +186 to senior financials, spreads in NoCos are 1.22 standard deviations better than average; and 0.89 standard deviation better than average to comparable treasuries. Lower yields lead to further issuance this month, though slower than last month's pace. Here's a list of the notables:

1. Enbridge 5.75% Jr. Sub debt (Ba1/BBB-) +506
2. Farm Credit Bank of Texas 5.70% perpetual preferred stock (Baa1/nr) +542
3. UBS 5.125% CoCo AT1 (Ba1/BB) +486
4. Fifth Third Bank perpetual pfd. stk. 4.50% (Baa3/BB+)

Issuance was all well received and closed the month trading above par. NoCo paper is pricing off 5yr and 10yr constant maturity 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 5% area current yields and wide reset spreads continues to make IPOs for NoCos quite compelling.

Contingent Capital Securities Sector

The CoCo sector closed $1.44 higher this month in the wake of joint fiscal stimulus in Europe along with unlimited support from the European Central Bank that would end only if there were significant upside surprises in growth. 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 moved 3bps wider this month and continues to be even wider than levels in 2016 when Pillar-2 capital was redefined in support of CoCos. The relative value opportunity in contingent capital is aided by further easing of concerns that regulators would recommend European banks pass AT1 dividends – in fact recently, regulators with the Bank of England are considering temporary changes to the buffer framework to foster more COVID-19 era lending and ease concerns around distribution risks in AT1. The European Central Bank's pandemic emergency purchase program (PEPP) is in full sail and heavy fiscal spending should give the Eurozone added wind power over the next year or so. By the end of July, CoCos were 14bps tighter yet still 1.06 standard deviations wide of their average spread to comparable treasuries and 1.83 standard deviations wider than more senior financials since the end of 2016.

Outlook:

The growing spread of COVID-19 and related social distancing continues to stifle the US economy. The pandemic is compelling many governors to run their states at idle speeds to the ire of many – in short, people's constitutional rights are (arguably) at odds with the sanctions and demands of elected officials. Exacerbating the anxieties germinated by the coronavirus are violent protests that have frightfully advanced well beyond the origins of peaceful protests against racial injustices – among the results are police forces being neutered driving more folks to buy guns to protect themselves (a 2nd Amendment right in America) they fear that the police cannot. Politics have gone wild in America and as I write this note, there is an impasse on negotiations for additional fiscal relief from the virus. Indeed, this is developing into an election year like no other year in my lifetime and its outcome (which may not be easy to figure on election night) should have material longer term macro investment consequences either way as economic incentives change and behaviors change with them.

For now and in broader terms, there are two evolving political battles underway potentially affecting the macroeconomic backdrop in America – each has been simmering for years and are at rolling boils: 1) an internal ideological war against cultural imperfections that has popularized socialist movements, and 2) an external cold war against the Chinese Communist Party – the coronavirus is a global flashpoint and its response has become highly politicized. Both battles will persist beyond the November elections and will embed lasting paradigms in the base battlegrounds of state and local policies. Indeed, the Democrat and Republican parties have never been further apart in ideologies than they are now – the electorate is at a fork in the road.

Yogi Berra (a Hall of Fame New York Yankee) once said, "When you get to the fork in the road – take it." You see, his house was on a circle so, regardless of choosing to go left or right at the

fork, you would get to the same place -- Yogi's house. Today, Mr. Berra's house is the American republic. But, American politics is different this time because the fork in Election Road no longer enters a circle but rather, it divides leading to vastly different locations – either socialism or capitalism. The implications of turning left or right on the investment climate could be vast and disruptive. Either way though, Yogi's house will be in a different kind of America – I am just not sure on how different quite yet.

For now, markets aren't allowed to care because the Fed is in the driver's seat of a planned monetary system -- and nobody on its governance board is arguing about directions either as the view to keep the federal funds rate at zero is still unanimous. Chairman Powell will do whatever he can to allow the economy to run hot which means doing something new but being in no hurry to do it. Yield curve control for now is not on the table because the market is controlling the curve just fine as real rates plummet. Above average spreads in hybrid capital securities should trend tighter as the yield curve steepens from the product of money creation, fiscal excess, and wage growth. The hybrid sectors have lagged more than senior corporate credit sectors and still represent compelling relative value. Junior subordinated capital securities have structures that can reset yields higher if US Treasury rates ever do move higher – time and elections should tell.

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