Junior-Subordinated Capital Securities Markets

November 2020 Updates

Credit prices improved remarkably this month as the mood for the US economy received a booster shot from news of promising COVID-19 vaccines becoming available this year. Yields in junior subordination declined as new issuance helped to tighten spreads despite higher Treasury yields to start the month but lower yields to end the month. Even uncertainty over a contested US presidential election could not stop the euphoria of getting back to some interactive normalcy sooner than later. The Fed met but did not change rates policy or hint of changing its bond buying pace. Real rates on the front end of the curve (e.g. UST 5yr TIPS; @ -1.35%) went down even though 5yr nominal rates were unchanged; and gold prices slipped 6.25%. The 30yr US Treasury bond closed the month yielding 1.57% (5bps lower). The US Treasury 10yr note closed the month unchanged yielding 0.84%. The yield differential between these two longer US Treasury terms closed 4bps lower (+73bps) on the month (26bps steeper on the year). The S&P500 surged 10.94% after falling the past two months and the VIX (i.e., Chicago Board Options Exchange Volatility Index) declined 46% to close at 20.46 – the lowest level since February before the pandemic hit markets. The 2020 election was a red (republican) wave in the House of Representatives, a potential hold for republicans in the Senate (Georgia's run-off races will decide the majority in January) and a contested loss for Donald Trump to Joe Biden – we talk more on the implications of the 2020 election in our Outlook for 2021.

Before we summarize the outlook below, 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 4.49% to close yielding 4.72% (104bps lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) rose 1.79% to close yielding 1.37% (20bps lower).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) rose 2.42% to close yielding 1.95% (31bps lower).

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***
   - Comprised of IG $25par and IG $1,000par US AT1
     - ❖ The *p0p1* rose 2.76% this month to close yielding 1.87% (-57bps)
     - ❖ Headcount was +6, face value increased by $3.0 billion
2. **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
   - Comprised of dated IG $1,000par hybrids (no US AT1)
     - ❖ The *c0cs* rose 2.99% this month to close yielding 3.02% (-32bps)
     - ❖ Headcount was up 1; face value was unchanged
3. **ICE BofA High-Yield Capital Securities Index (*h0c*s) @ 5% of *i0cs***
   - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
     - ❖ The *h0cs* rose 4.75% this month to close yielding 3.53% (-55bps)
     - ❖ Headcount was unchanged; face value was unchanged
4. **ICE BofA High Yield Fixed Rate Preferred Index (*p0hy*) @ 26% of *i0cs***
   - Comprised of BIG $1,000par US AT1 and BIG $25par
     - ❖ The *p0hy* rose 5.64% this month to close yielding 3.77% (-107bps)
     - ❖ Headcount was +2; face value declined by $0.6 billion

Overall, the BofA All US Capital Securities Index (***i0cs***) rose 3.61% in November to close yielding 2.74%, which was 59bps lower than last month's closing yield and a spread of +193bps over comparable US Treasury securities (49bps tighter). The ICE BofA USD Contingent Capital Index (***cdlr***) rose 4.27% this month to close yielding 3.90%, which was 66bps lower than last month and a spread of +335bps over comparable US Treasury securities (57bps tighter).

In this year's outlook, we'll take a brief look back at what we were expecting and discuss what transpired and then transition to what implication this should have for our 2021 Outlook – we'll discuss these topics:

1. US Interest Rates – modestly higher; steeper on the front end; eventually flatter on the backend
2. European Interest Rates – well anchored to stay negative across the curve
3. Global capital securities – constructive against backdrop of a relentless Fed
    a. $25par preferred securities – fully valued, but should outperform senior financials primarily from income
    b. $1,000 par preferred securities – best relative value to seniors
    c. Contingent capital securities – best absolute value to seniors
4. Outlook Summary – We expect divided government to push back on strong socialist tendencies in America. Continued bond buying, yield curve control and Fed balance sheet duration extensions are highly probable to mitigate the relentless US treasury supply pressures from expanding government – this should elevate treasury yields next year albeit, only modestly as the Fed governs down the classic "crowding out" effect of repricing supply.

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