Junior-Subordinated Capital Securities Markets

January 2021 Updates

Credit prices deteriorated this month because the US treasury yields rose from the January refunding weight. Yields in junior subordination rose too, but more from the technicals of treasury yields than from any fundamental change in credit. Voter frustrations over the contested US presidential election culminated in deadly Capitol riots and troop presence for (beyond) President Biden's inauguration. The Fed met for its first meeting this year and held firm to its commitment to buy bonds at the current pace despite press reports of mounting tapering concerns. Real rates on the front end (e.g., UST 5yr TIPS; @ -1.84%) went down 40bps even though 5yr nominal rates went up; and gold prices slipped 2.67% after rising 6.83% in December. The 30yr US Treasury bond closed the month yielding 1.83% (19bps higher) and the US Treasury 10yr note closed yielding 1.06% (15bps higher) -- the differential between the two widened by 4bps to +77bps by month end. The S&P500 rose to new highs during the month only to fall by 3.7% in the last 4 days to finish January down 1.11% -- a negative start for the year. The VIX (i.e., Chicago Board Options Exchange Volatility Index) spiked 75% at one point to a high of 37.21, which was almost as high as last October (from pre-election concerns) and last June (from recovery concerns). The 2020 election of Joe Biden is historic by many measures including the plethora of executive orders this month that affirm more progressive policy actions than we initially thought were probable.

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:

- The junk market (measured by the ICE BofA High Yield ***h0a0*** index) rose 0.38% to close yielding 4.24% (1bp lower).
- Global bank credit (measured by ICE BofA ***e0ba*** index) declined 0.70% to close yielding 1.36% (7bps higher).
- The BBB rated 5-10yr corporate sector (measured by ICE BofA ***c6a4*** index) declined 0.55% to close yielding 1.94% (9bp higher).

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 has evolved 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 $338 billion (face amount) of investment grade and below investment grade instruments in both the retail

$25par market (38%) and the institutional $1,000par market (62%). The USD Contingent Capital Index of US dollar denominated junior-subordinated capital securities ***(cdlr)*** represents $145 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 $483 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* declined 1.36% this month to close yielding 2.04% (+71bps)
        - Headcount declined by 2, face value rose by $0.175 billion

2. **ICE BofA US Capital Securities Index (*c0cs*) @ 25% of *i0cs***
    - Comprised of dated IG $1,000par hybrids (no US AT1)
        - The *c0cs* declined 0.23% this month to close yielding 3.00% (+6bps)
        - Headcount rose by 1; face value rose by $1.439billion
3. **ICE BofA High-Yield Capital Securities Index (*h0cs*) @ 5% of *i0cs***
    - Comprised of BIG $1,000par legacy Tier1 and BIG $1,000par hybrids
        - The *h0cs* rose 0.58% this month to close yielding 3.42% (+4bps)
        - Headcount and face value both were unchanged
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* declined 0.43% this month to close yielding 4.04% (41bps)
        - Headcount rose by 2; face value rose by $0.357billion

Overall, the BofA All US Capital Securities Index (***i0cs***) declined 0.74% in January to close yielding 2.84%, which was 43bps higher than last month's closing yield and a spread of +240bps over comparable US Treasury securities (26bps 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 comprised of US dollar denominated constituents (exclusively), which represent 58% of the

mature master multi-currency benchmark (*coco*). We will utilize the USD benchmark (*cdlr*) as it more meaningfully reflects the contingent capital currency types held in our portfolios. The ICE BofA USD Contingent Capital Index (***cdlr***) rose 0.20% this month to close yielding 3.79%, which was 2bps lower than last month and a spread of +315bps over comparable US Treasury securities (8bps tighter).

Snapshot of Junior Subordinated Spread Sector Moves:

	p0p4	p0p4-e0ba	stb8	stb8-e0ba	cdlr	cdlr-e0ba
	(a)	**(b)**	**(a)**	**(b)**	**(a)**	**(b)**
Last 7yrs	**Retail**	**Retail**	**NoCo**	**NoCo**	**CoCo**	**CoCo**
Sample Periods	03/31/2017 to Date		03/31/2017 to Date		03/31/2017 to Date	
Jr-Subs	***Absolute**	****Relative**	***Absolute**	****Relative**	***Absolute**	****Relative**
High	588	251	479	200	660	313
Low	-178	-267	174	53	223	143
Range	766	518	305	147	437	170
Average	28	-85	261	139	340	227
Stdev	129	106	44	24	62	36
Monthend	144	62	254	172	321	239
Sector Spread Score[1]	**1.14**		**0.61**		**0.01**	
Last Month's Score[1]	**0.30**		**0.71**		**0.16**	

1: Sector Spread Score = {[Monthend(a)-Ave(a)]/Stdev(a)+[Monthend(b)-Ave(b)]/Stdev(b)}/2

Monthend statistical position to average per unit of standard deviation

***Absolute**	0.90		-0.16		-0.31	
****Relative**		1.39		1.38		0.33

** Absolute = Option Adjusted US Government Spread*
*** Relative = spread to global financials measured by e0ba ICE Bond Index*

Source: Bloomberg, ICE Bond Indices

Implications of Market Activity:

$25par Retail Preferred Securities Sector

The retail preferred securities sector declined $2.02 this month which boosted the sector's benchmark yield by 101bps from last month to 2.30% -- overall, spreads widened by 92bps. This kind of spread volatility is not unusual for the retail sector because the short-term optionality creates a lot of swing rate for spread – for example, the monthly standard deviation of the sector's option-adjust spread is 129bps. The $500mm US Bancorp 3.75% fixed-for-life perpetual preferred stock that came in October traded down $4.40 before recovering $1.92 by month end. New issuance started the year slowly due to the sudden price decline in treasury long bonds. Equitable Holdings (Ba1/BBB-) kicked off the year with a $300million 4.30% fixed-for-life perpetual preferred stock that went down $1.72 under the weight of treasuries before recovering $1.60 by month end. Bank of America priced a $915mm (Baa3/BBB-/BBB) 4.125% fixed-for-life perpetual preferred stock that traded mostly sideways as heavy treasury issuance weighed on the market tone.

Last month, we discussed the implication of a continuing $25par market refunding trend with ever low coupons would increase the duration risk of the retail sector despite the measured duration going lower. The negative performance for the $25par market this month is a good example of how sensitive the sector can be as long bond rates trend higher. The retail sector's spread score of 1.14 this month is significantly improved from last month's score due to the price correction. In particular, we're cautious of low retail coupons as they would be the likely first sale candidates in any stock market correction (US Bancorp's dive this month is a good example). 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

This month, the sector spread rose off the lows set last month since the COVID collapse in March (shown by the 698bp vertical overall). The low spread marked a year ago January came when UST rates were much higher (e.g., the UST 5yr was 1.60%) and yields were as low as they are now. Relatively high yields are still scarce and not expected to get much relief from the Fed as they commit to keep rates low for a substantial period, but the weight of fiscal spending no doubt will require the Fed to shift its duration purchases into longer paper and long bond yields rise more as the year progresses. We know the year is young, though it does appear that conditions of rising bond yields and equity gains could set the conditions for an active tax loss harvesting season in the retail market during the 4th quarter – so, please make a “note to self” to reassess later this year.

$1,000par Institutional Preferred Securities Sector

This month, the $1,000 par institutional sector of the preferred securities market declined $0.62 after making an all-time high last month. Despite yield compression, relative values still look attractive in NoCos because more senior financials have rallied even lower and tighter. The chart below shows the yield-to-worst 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: 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, the ongoing COVID-19 recession. By the end of January, NoCo spreads to comparable treasuries closed 2bps wider (+256). Relative to more senior financials, NoCos have room to further tighten because

at +174 to senior financials, spreads in NoCos have a relative spread score of 1.38 standard deviations better than average.

There were two notable new deals this month in the NoCo sector: 1) $1.75bil. Zurich Finance Ireland (A2/A) 3% fixed-to-refixed 30yr notes @+278 vs. the 10yr constant maturity US treasury, and 2) $3.5bil. Wells Fargo 3.90% fixed to re-fixed perpetual preferred stock @+345 vs. the 5yr constant maturity US treasury. Overall, NoCos are scoring as the 2nd best value in junior subordination with a sector spread score of 0.61 this month, though the spread of 172bps over more senior financials is the best relative value statistically.

Contingent Capital Securities Sector

The CoCo sector closed $0.34 lower this month as the European bank equity sector drifted a bit lower too (after a strong move up last month). Resumed lockdowns are weighing on some Eurozone economies. 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 the benchmark's inception (Dec-13) – note that CoCos were improved in 2016 after the Pillar-2 capital stack was redefined, thus reducing payment trigger risks for CoCos:

Source: Bloomberg

The relative OAS differential between CoCos and more senior financials tightened by 7bps to close the month with a difference 239bps in favor of CoCos. Despite historic low yields, the relative value opportunity in CoCos compared to more senior financials is still statistically better than average at +0.33 standard deviations over the sample period. Despite CoCo's overall sector spread score (only 0.01) being the lowest of the three junior subordinated sectors, CoCos still provide 67bps of additional spread to NoCos and 177bps of additional spread to retail preferred securities. For example, Standard Chartered (Ba1/BB-) priced a 4.75% 10yr CoCo this month and it did well in trading up over a point.

Outlook:

Chairman Powell says that even if unemployment were to decline to low levels again, *"that wouldn't be a reason to raise interest rates unless we see troubling inflation or other imbalances that could threaten achievement of our mandate."* So, short-term interest rates will be anchored at zero bound for some time yet, perhaps years – remembering that the last time Joe Biden was in the White House, he arrived as vice president on the heels of a crisis and the federal funds rate remained at zero for nearly 8yrs. Now, Joe Biden is back in the White House but as president and again on the heels of a crisis with the federal funds rate anchored at zero – probably for years unless, in the Fed's view, inflation becomes "troubling" (which is plausible).

Indeed, inflation and Fed balance sheet expansion will need to co-exist in a symbiotic culture of Biden and Yellen (i.e., a "SCOBY"). But this fiscal-monetary kombucha will be spiked with a progressive punch named Sanders – Bernie Sanders. An empowered Sanders, as chairman of the Senate Budget Committee, significantly increases the odds that Modern Monetary Theory (MMT) will be tested soon. This ferments the policy and politics of Fed Chairman, Powell and Treasury Secretary, Yellen into a progressive paradigm shift that will need flawless execution – or risk another "taper tantrum" among other things. Interesting (and co-incidentally), as Chairman Powell urges Congress to spend more, Secretary Yellen urges Congress spend "big". The "taper" is already underway, but in a reverse form of super supply from the Treasury rather

than declining demand from the Fed – and the US treasury bond market has been unable to handle the tsunami without a repricing and the Fed's mop, which isn't big enough.

In financial markets, the equity market is the "low land" that the flood waters fill after soaking everything (i.e., other asset classes) along the way. Eventually, in the process of the lowlands filling, rivers are formed guiding floodwaters out to sea. At some point, (e.g., when the Fed attempts to pullback or "taper" against the relentless fiscal tide) the equity market will reprice and MMT will be necessary – especially if real yields return to more recent historic norms of 1% (as they were after the taper tantrum); and why wouldn't they if the structure of US government grows to impose more credit reliance (demands) on taxpayers and controls (censorship) on speech. Indeed, the "full faith and credit" guarantee of the US government cannot avoid being gradually eroded by the ensuing currency (debt) floods. So, what does this mean for hybrid securities like preferreds and CoCos? Hybrids are generally a safe raft to float on when the rivers flow – for three reasons: 1) financials are liquidity processors that can grow earnings with inflation, 2) hybrids can reset income higher when the term structure rises, and 3) historic default rates on hybrids are about 6.4x lower than below investment grade corporates. Irrespective of how low yields are today, it is still a relative game of finding a seaworthy lifeboat. For example, even though high yield still offers about 100bps of additional income compared to hybrids, if one adjusts for the risk of encountering unexpected whitewater rapids in high yield (i.e., default risk) hybrids in junior subordination offer higher default risk adjusted yields than junk bonds.

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